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CONFIDENTIAL

December 7, 1988

To: Members of the Executive Board

From: The Acting Secretary

Subject: Pakistan - Staff Report for the 1988 Article IV Consultation and Request for a Stand-By Arrangement and for Arrangements Under the Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report for the 1988 Article IV consultation with Pakistan and its requests for a stand-by arrangement and arrangements under the structural adjustment facility. Draft decisions appear on pages 36 and 37.

This subject, the Memorandum on Economic Policy of the Pakistan Government (EBS/88/232, 11/15/88) and the policy framework paper for Pakistan (EBD/88/331, 11/15/88), will be brought to the agenda for discussion on a date to be announced, once the Fund is satisfied that remaining prior actions are taken and has received confirmation from the new Government of Pakistan of its intention to implement in full the programs to be supported by the proposed stand-by arrangement and arrangements under the structural adjustment facility.

Mr. Knight (ext. 7474) or Mr. Maciejewski (ext. 7112) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

PAKISTAN

# Staff Report for the 1988 Article IV Consultation and Request for a Stand-By Arrangement and for Arrangements Under the Structural Adjustment Facility

Prepared by the Middle Eastern Department

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Legal, Research, and Treasurer's Departments)

Approved by A. Shakour Shaalan and S. Kanesa-Thasan

December 6, 1988

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## I. Introduction

The 1988 Article IV consultation discussions with Pakistan, together with discussions on economic and financial programs to be supported by a stand-by arrangement (SBA) and by arrangements under the structural adjustment facility (SAF), were held in Islamabad on a number of occasions during February-October 1988. 1/

The previous Article IV consultation discussions with Pakistan were held in February and April-May 1987. The staff report (SM/87/137, and Supplement 1) was considered by the Executive Board on August 3, 1987 (SUR/87/78). On that occasion, Directors expressed concern over the absence of significant resource mobilization efforts; the rapid growth of government current spending; the continuing deterioration in the overall fiscal position; the increase in domestic and external debt and debt servicing obligations; and the vulnerability of the balance of payments. They observed that a substantial correction of fiscal imbalances would be needed to enhance the unduly low level of domestic savings and to strengthen the external current account. At the same time, a higher investment ratio would also be needed to sustain economic growth and promote social development over the medium term. In this context, Directors stressed the need for early implementation of a more broad-based sales tax and other revenue measures, together with more forceful reform of the trade system and price deregulation. They also encouraged the authorities to continue their flexible exchange rate management, to adhere to a restrained credit policy stance, and to improve external debt management.

The Pakistan authorities have prepared, in close collaboration with the staffs of the Fund and the World Bank, a policy framework paper (PFP) summarizing the Government's economic and financial objectives for the three-year period 1988/89-1990/91 and the macroeconomic and structural adjustment policies designed to achieve these goals. The paper has been transmitted to the Managing Director of the Fund and the President of the World Bank, and is scheduled for early consideration by

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1/ Fund staff who participated in one or several missions were Messrs. M. Knight (Head), E. Maciejewski, E. Bell (all of MED); M. Shadman (FAD/ETR); G. Mackenzie (FAD); and J. Hicklin and M. Fisher (ETR). Mr. A. S. Shaalan was present for policy discussions on several occasions, and met with Mr. Ghulam Ishaq Khan, President of Pakistan, in September.

The staff missions held discussions with Dr. Mahbub ul Haq, Minister for Commerce, Finance and Planning and Development, and with the Finance Secretary, the Governor of the State Bank of Pakistan, the Deputy Chairman of the Planning Commission, and other senior officials. Mr. M. Finaish, Executive Director for Pakistan, was present for the policy discussions in October 1988. Members of the World Bank staff took part in the SAF discussions.

the Bank's Executive Directors at a meeting of the Committee of the Whole. The World Bank has a large lending program with Pakistan, which is described in Appendix III.

In the Letter of Intent ("Memorandum on Economic Policy of the Pakistan Government", EBS/88/232), dated November 15, 1988, the authorities request a 15-month stand-by arrangement in an amount equivalent to SDR 273.15 million (Attachment I), which represents 50 percent of Pakistan's quota or 40 percent at an annual rate (Table 1). They also request a three-year structural adjustment facility arrangement covering 1988/89-1990/91 (fiscal year starting July 1) and the first annual arrangement thereunder (Attachment II). The Letter of Intent (EBS/88/232) and the Policy Framework Paper (EBD/88/331) were circulated in advance to the Executive Board on November 15, 1988. The cumulative amount that will be available to Pakistan under the SAF is currently projected at about SDR 346.90 million.

There will be six purchases under the proposed stand-by arrangement. The first purchase to be effected upon Board approval will encompass the whole of the outstanding first credit tranche and will amount to SDR 142.03 million (26 percent of quota). Subsequently, four quarterly purchases of SDR 26.22 million each are anticipated in 1989, and one purchase of SDR 26.22 million in 1990. Under the first SAF annual program a loan of SDR 109.26 million is to be effected upon Board approval. The access proposed for the combined stand-by and SAF arrangements is deemed necessary to support the proposed adjustment and structural reform program, in particular the trade liberalization measures and the reduction in tariff rates, and to permit the Fund to play a catalytic role in encouraging donor assistance to Pakistan. When the stand-by arrangement expires in March 1990, net Fund credit outstanding will be SDR 741 million (135.6 percent of quota). Of this amount, 85.6 percent of quota will be under the tranche policies and 50.0 percent of quota on account of the SAF 1/ (Table 1).

With effect from November 24, 1980, Pakistan had a three-year extended arrangement with the Fund for SDR 1,268 million (252 percent of the then existing quota), of which SDR 1,079 million was drawn. An assessment of performance under the extended arrangement was made by the staff on the occasion of the 1983 Article IV consultation (EBS/83/249). Scheduled repurchases and repayments on account of the purchases made under the extended arrangement and the Trust Fund have been timely. Pakistan continues to avail itself of the transitional arrangements of Article XIV. A summary of the Fund's relations with Pakistan is included in Appendix II.

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1/ This assumes that the second SAF annual arrangement is in place.

Table 1. Pakistan: Fund Position During the Period of the Proposed Stand-By and SAF Arrangements, December 1988–June 1991

| | End-Dec. 1983 | Jan. 1 1984–Nov. 30, 1988 | 1988/89 Dec. 1988 | 1988/89 Jan.–March 1989 | 1988/89 April–June 1989 | 1989/90 July–Sept. 1989 | 1989/90 Oct.–Dec. 1989 | 1989/90 Jan.–March 1990 | 1989/90 April–June 1990 | 1990/91 July–Dec. 1990 | 1990/91 Jan.–June 1991 | Total Transactions During Period of Arrangements |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | (In millions of SDRs) | | | | | | |
| Reserve tranche purchases | | 88.6 | | | | | | | | | | |
| Transactions under tranche policies (net) | | -740.0 | 115.1 | -16.5 | -11.3 | -5.9 | -4.7 | -5.9 | -30.9 | -45.2 | -41.0 | -46.2 |
| Purchases | | (—) | (142.0) | (26.2) | (26.2) | (26.2) | (26.2) | (26.2) | (—) | (—) | (—) | (273.2) |
| Ordinary resources | | [—] | [142.0] | [26.2] | [26.2] | [26.2] | [26.2] | [26.2] | [—] | [—] | [—] | [273.2] |
| Repurchases | | (-740.0) | (-26.9) | (-42.7) | (-37.5) | (-32.1) | (-30.9) | (-32.1) | (-30.9) | (-45.2) | (-41.0) | (-319.3) |
| Ordinary resources | | [-283.9] | [-16.6] | [-20.2] | [-25.0] | [-20.2] | [-25.0] | [-20.2] | [-25.0] | [-45.2] | [-41.0] | [-238.4] |
| Enlarged access resources | | [-456.1] | [-10.3] | [-22.5] | [-12.5] | [-11.9] | [-5.9] | [-11.9] | [-5.9] | [—] | [—] | [-80.9] |
| Transactions under special facilities (net) 1/ | | -180.2 | — | — | — | — | — | — | — | — | — | — |
| Purchases | | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) |
| Repurchases | | (-180.2) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) |
| Structural Adjustment Facility (net) | | | 109.3 | — | — | — | 163.9 | — | — | 73.7 | — | 346.9 |
| Purchases | | | (109.3) | (—) | (—) | (—) | (163.9) 2/ | (—) | (—) | (73.7) 3/ | (—) | (346.9) |
| Repurchases | | | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) |
| Total transactions | | -920.2 | 224.4 | -16.5 | -11.3 | -5.9 | 159.2 | -5.9 | -30.9 | 28.5 | -41.0 | 300.7 |
| Total Fund credit outstanding (end of period) | 1,317.2 | 397.0 | 621.4 | 604.9 | 593.6 | 587.7 | 746.9 | 741.0 | 710.1 | 738.6 | 697.6 | |
| Under tranche policies | (1,137.0) | (397.0) | (512.1) | (495.6) | (484.3) | (478.4) | (473.7) | (467.8) | (436.9) | (391.7) | (350.7) | |
| Under special facilities | (180.2) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | |
| Under Structural Adjustment Facility | (—) | (—) | (109.3) | (109.3) | (109.3) | (109.3) | (273.2) | (273.2) | (273.2) | (346.9) | (346.9) | |
| | | | | | | (As percent of quota) | | | | | | |
| Total Fund credit outstanding (end of period) | 241.1 | 72.7 | 113.8 | 110.7 | 108.7 | 107.6 | 136.7 | 135.6 | 130.0 | 135.2 | 127.7 | |
| Under tranche policies | (208.1) | (72.7) | (93.8) | (90.7) | (88.7) | (87.6) | (86.7) | (85.6) | (80.0) | (71.7) | (64.2) | |
| Under special facilities | (33.0) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | (—) | |
| Under Structural Adjustment Facility | (—) | (—) | (20.0) | (20.0) | (20.0) | (20.0) | (50.0) | (50.0) | (50.0) | (63.5) | (63.5) | |

Sources: International Monetary Fund, Treasurer's Department; and staff estimates.

1/ Compensatory financing facility.
2/ Assuming the second SAF annual program is in place by November 1989.
3/ Assuming the third SAF annual program is in place by November 1990.

The quality of Pakistan's economic and financial data is generally good and the authorities have recently taken steps to enhance it further, particularly in the fiscal and monetary areas. Statistical issues are reviewed in Appendix IV.

## II. Background and Recent Economic Developments

### 1. Overview of developments during 1980/81-1986/87

Over the 1980/81-1986/87 period, economic developments were characterized by expansion of real GDP at an average rate of more than 7 percent a year on the strength of the agricultural and manufacturing sectors; and by generally good price performance, with the annual increase in the consumer price index (CPI) declining from an average rate of 9 percent over 1980/81-1984/85 to less than 5 percent over 1985/86-1986/87 (Table 2).

The robust growth performance was facilitated by the implementation of a number of structural policies, many of them during the period of the extended Fund facility arrangement. In particular, active producer pricing policies and deregulation of the pricing and trading of important commodities contributed to major output gains in the agriculture and energy sectors. While progress was made in moving away from an extensively regulated economy toward a more market-oriented system, the pace was faster in the areas of industrial investment, pricing, exchange rate policy, and monopoly deregulation, and slower in trade liberalization and disinvestment in the public sector. These developments notwithstanding, Pakistan's real per capita income remains low (around US$385) partly reflecting the high rate of population increase, at 3 percent per annum. While progress has been made in education, health, and infant mortality, the adult literacy rate is currently 24 percent, and only 5 percent of the relevant age group is enrolled in tertiary education. Corresponding rates for the female population are lower than those for males. 1/ It should also be noted that the presence of an estimated 3-3.5 million refugees has complicated the tasks of economic and social policy.

On the economic policy front, the fiscal position weakened considerably over the period, despite strong economic growth (Chart 1). The increase in the overall fiscal deficit from an average of 5.3 percent of GDP during 1980/81-1981/82 to 7.6 percent during 1984/85-1986/87 reflected a combination of inelastic government revenues and strong expenditure growth. In order to contain the deterioration in the fiscal position, the authorities were obliged to reduce development outlays from initially budgeted levels in 1983/84-1986/87.

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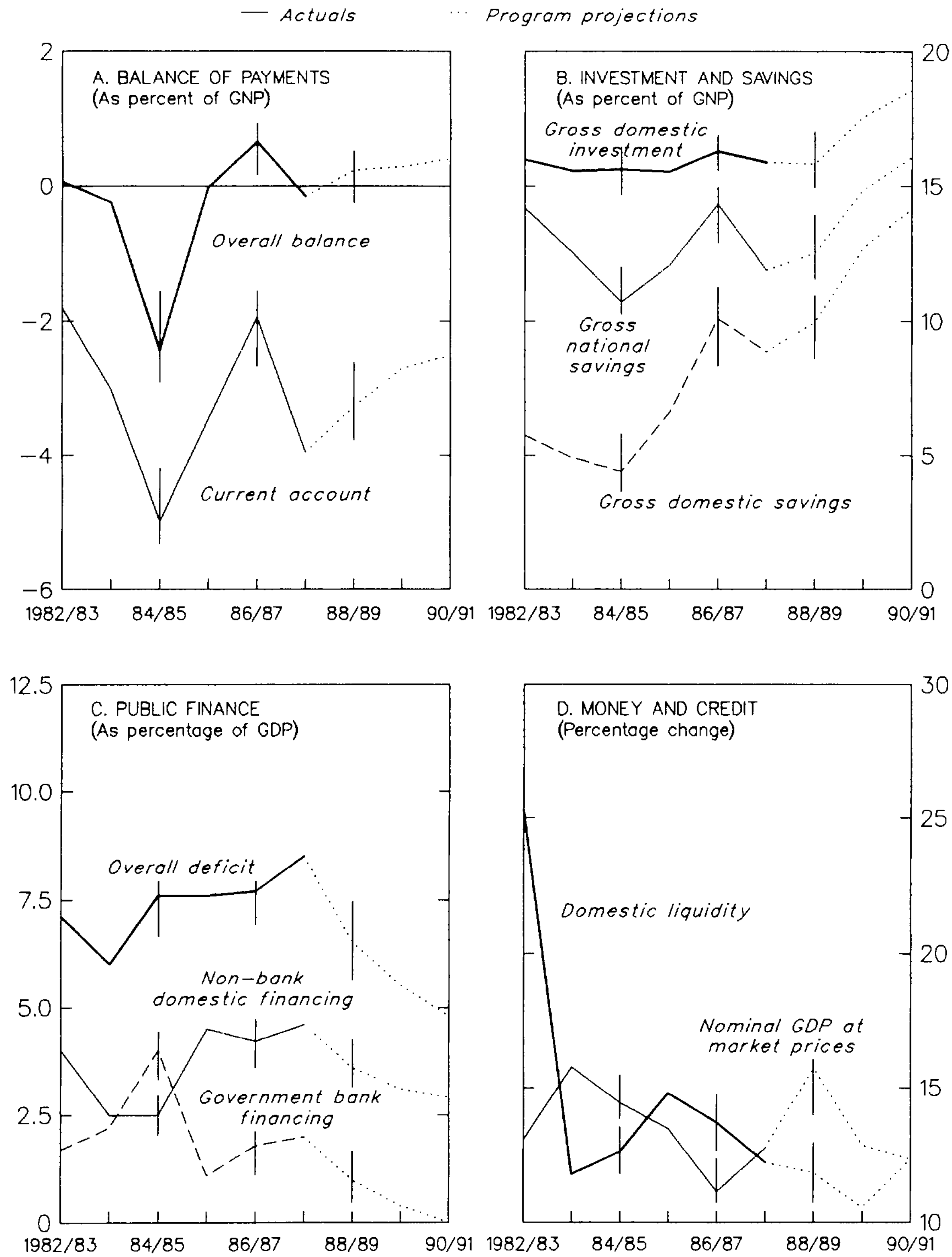
1/ See "Pakistan--Basic Data" in the forthcoming report on Recent Economic Developments.

CHART 1
PAKISTAN
ECONOMIC INDICATORS, 1982/83–1990/91




Source: Data provided by the Pakistan authorities.

Table 2. Pakistan: Selected Economic and Financial Indicators, 1984/85-1990/91 1/

| | Actuals | | | Prov. Actuals | Program Projections | | |
|---|---|---|---|---|---|---|---|
| | 1984/85 | 1985/86 | 1986/87 | 1987/88 | 1988/89 | 1989/90 | 1990/91 |
| | (Annual change, unless otherwise specified) | | | | | | |
| National income and prices | | | | | | | |
| GDP (at 1959/60 market prices) | 8.2 | 7.8 | 5.4 | 5.3 | 5.2 | 5.5 | 5.5 |
| GDP deflator (market price) | 5.8 | 5.1 | 5.4 | 7.1 | 10.0 | 7.0 | 6.5 |
| Consumer prices (period average) | 6.1 | 4.6 | 3.8 | 6.3 | ... | ... | ... |
| External sector (in U.S. dollars) | | | | | | | |
| Exports, f.o.b. | -7.9 | 19.7 | 18.9 | 24.1 | 13.4 | 11.7 | 12.1 |
| Imports, f.o.b. | 0.3 | -0.4 | -3.2 | 18.8 | 2.8 | 3.0 | 8.7 |
| Non-oil imports, c.i.f. | 2.3 | 6.7 | 0.2 | 18.3 | 6.5 | 2.4 | 8.8 |
| Workers' remittances | -10.6 | 6.1 | -12.2 | -11.6 | -5.6 | -- | -1.3 |
| Real effective exchange rate 2/ | — | -14.6 | -15.9 | -7.1 | ... | ... | ... |
| Money and credit | | | | | | | |
| Money and quasi-money | 12.6 | 14.8 | 13.7 | 12.3 | 11.9 | 10.6 | 12.4 |
| Domestic assets (net), of which: | 23.9 | 14.8 | 13.3 | 13.0 | 10.4 | 9.2 | 11.0 |
| Government sector (net) | (23.2) | (8.9) | (11.2) | (17.5) | (7.0) | (3.8) | (--) |
| Nongovernment sectors | (16.8) | (27.5) | (14.0) | (12.8) | (12.0) | (12.3) | (11.9) |
| Government | | | | | | | |
| Total revenue 3/ | 6.8 | 16.0 | 13.9 | 14.5 | 21.3 | 19.1 | 15.1 |
| Tax and nontax revenue | 7.1 | 16.1 | 15.6 | 13.9 | 18.2 | 19.3 | 15.2 |
| Tax revenue | 5.2 | 18.3 | 14.6 | 12.0 | 19.0 | 22.0 | 16.8 |
| Total expenditure | 16.8 | 15.2 | 13.3 | 17.8 | 10.5 | 12.9 | 11.4 |
| Current expenditure | 14.7 | 13.8 | 20.9 | 12.2 | 10.8 | 9.2 | 11.0 |
| | (In percent of GDP) | | | | | | |
| Government | | | | | | | |
| Total revenue 3/ | 16.6 | 16.9 | 17.4 | 17.6 | 18.5 | 19.5 | 20.0 |
| Tax and nontax revenue | 16.1 | 16.4 | 17.1 | 17.2 | 17.6 | 18.6 | 19.1 |
| Tax revenue | 12.7 | 13.2 | 13.6 | 13.6 | 14.0 | 15.1 | 15.7 |
| Total expenditure | 24.2 | 24.6 | 25.1 | 26.2 | 25.0 | 25.0 | 24.8 |
| Current expenditure | 17.7 | 17.8 | 19.3 | 19.2 | 18.6 | 18.0 | 17.8 |
| Overall fiscal deficit 4/ | 7.6 | 7.6 | 7.7 | 8.5 | 6.5 | 5.5 | 4.8 |
| Budgetary financing | | | | | | | |
| Domestic bank | 4.0 | 1.1 | 1.9 | 2.0 | 1.0 | 0.5 | -- |
| Domestic nonbank | 2.5 | 4.5 | 4.2 | 4.6 | 3.6 | 3.1 | 2.9 |
| Foreign (including grants) | 1.1 | 2.0 | 1.6 | 1.9 | 1.9 | 1.9 | 1.9 |
| Total bank financing (including commodity operations) | 3.8 | 1.7 | 1.8 | 2.8 | 1.3 | 0.7 | 0.3 |
| | (In percent of GNP, unless otherwise specified) | | | | | | |
| Gross domestic investment, of which: | 15.6 | 15.5 | 16.3 | 15.9 | 15.7 | 17.6 | 18.6 |
| Gross domestic fixed capital formation | (14.0) | (14.0) | (14.8) | (14.4) | (...) | (...) | (...) |
| Gross domestic savings | 4.4 | 6.6 | 10.1 | 8.9 | 9.9 | 12.7 | 14.2 |
| Gross national savings | 10.7 | 12.1 | 14.3 | 11.9 | 12.4 | 14.9 | 16.1 |
| External sector | | | | | | | |
| Current account deficit 5/ | -5.0 | -3.4 | -1.9 | -4.0 | -3.3 | -2.7 | -2.5 |
| Overall balance | -2.4 | -0.2 | 0.7 | -0.2 | 0.2 | 0.3 | 0.4 |
| External debt 6/ | ... | ... | 46.4 | 44.6 | 45.5 | 47.7 | 43.9 |
| Debt service ratio, including use of Fund credit (in percent of current account receipts) | 22.7 | 27.5 | 30.7 | 30.4 | 29.6 | 27.5 | 24.1 |
| Interest payments, including IMF charges (in percent of current account receipts) | 10.3 | 10.5 | 10.8 | 11.7 | 11.7 | 12.0 | 11.4 |
| | (In millions of U.S. dollars, unless otherwise specified) | | | | | | |
| Current account deficit 5/ | -1,680 | -1,236 | -719 | -1,594 | -1,371 | -1,142 | -1,198 |
| Overall balance | -819 | -7 | 242 | -65 | 99 | 179 | 190 |
| Gross official reserves (in weeks of following year's imports c.i.f.) 7/ | 5.3 | 7.6 | 6.2 | 3.1 | 4.7 | 6.6 | 7.4 |

Sources: Ministry of Finance and Economic Affairs; State Bank of Pakistan; and program projections.

1/ External sector projections for the period 1988/89-1990/91 are based on the assumption of a 15-month stand-by arrangement as well as a SAF arrangement, both starting in the last quarter of 1988.

2/ Based on the Fund's Information Notice System calculations; depreciation (-).

3/ Includes surplus of autonomous bodies (listed in footnote 4).

4/ The definition comprises the federal and provincial governments (including railways, post office, telephone and telegraph) and four autonomous bodies (the Water and Power Development Authority (WAPDA), the Oil and Gas Development Corporation (OGDC), the National Fertilizer Corporation of Pakistan (NFCP), and the Pakistan Television Corporation (PTVC)).

5/ Excludes official transfers, which are included in long-term capital.

6/ Total debt, consisting of medium- and long-term disbursed debt repayable in foreign currency, use of Fund credit, short-term debt (of one year or less), disbursed foreign debt repayable in local currency, and certain monetary liabilities.

7/ Includes foreign currency deposits by nonresident commercial banks and Foreign Exchange Bearer Certificates.

The weakening budgetary position, with associated strong growth in domestic absorption, was also reflected in the relatively low levels of total domestic savings (8.4 percent of GNP on average over 1985/86-1986/87) and tended to crowd out private investment. Gross domestic investment averaged 15.8 percent of GNP during 1980/81-1986/87. As regards public development strategy, the Government redirected outlays toward energy, transport and communication, education and health, water distribution, rehabilitation of existing irrigation schemes, and farm water management. However, the public infrastructure system generally remained weak, in particular in transport and highways, and progress in the social sectors was below expectations.

In recent years, the authorities have maintained a flexible exchange rate policy with the aim of enhancing the competitiveness of the tradables sector and attracting workers' remittances. From early 1985 onward the rupee moved broadly in line with the dollar as the latter depreciated against other major currencies. In real effective terms, the rupee was some 31 percent lower in June 1987 than it had been in February 1985 (Chart 2). As regards trade liberalization, in 1983 the import regime was changed to a negative list system, in which all items not specifically banned or restricted were freely importable. Overall, however, the import regime has remained restrictive and complex and has involved a significant anti-export bias.

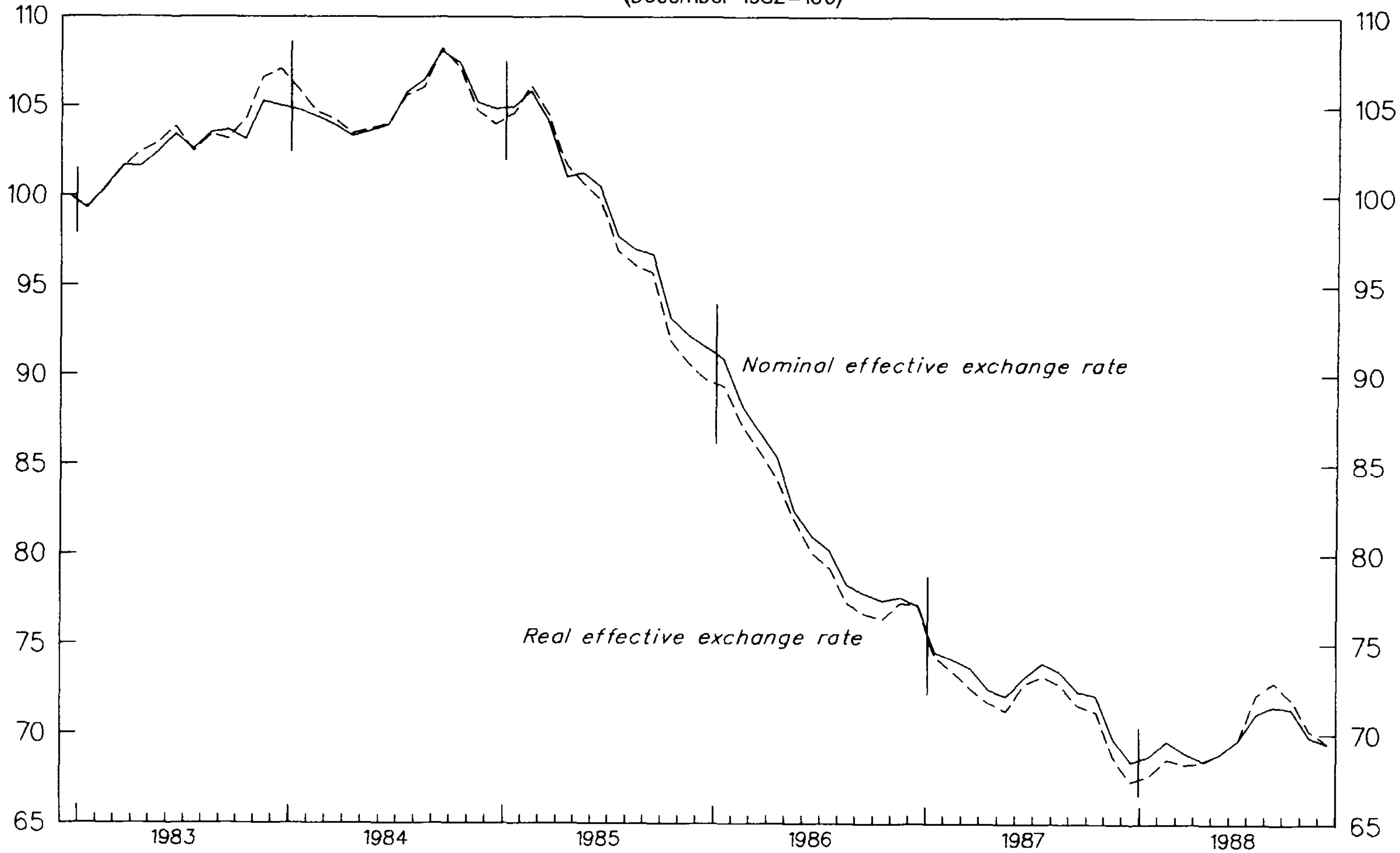
Following a substantial reduction to under 2 percent of GNP in 1982/83, the external current account deficit widened again to 5 percent of GNP in 1984/85 when a major drought affected cotton and rice exports; in addition, workers' remittances declined, in part reflecting weakening economic activity in certain oil exporting countries. The current account improved in the following two years when the deficit was reduced to 1.9 percent of GNP in 1986/87, mainly as a result of a strong recovery in cotton and rice exports, buoyant exports of cotton-based manufactures, and substantially lower world prices for major imports. Despite this improvement, the overall balance of payments has remained subject to wide fluctuations owing to protracted structural weaknesses. These include high dependence on cotton-based exports that are vulnerable to world commodity price movements and protectionism in foreign markets; limited expansion of nontraditional exports; large trade deficits; the trend decline in workers' remittances; and larger interest payments on the growing external debt. As a result, even with extensive trade controls the authorities have experienced increasing difficulties in external reserve and debt management. Gross official reserves have remained at very low levels for a number of years, and have had to be sustained by sales of Foreign Exchange Bearer Certificates (FEBCs) and borrowing via foreign currency deposits from nonresident commercial banks. Reflecting these developments and higher recourse to medium- and long-term borrowing on less concessional terms, the foreign debt rose steadily and the ratio of external debt service to total current account receipts increased from around 23 percent in 1984/85 to 31 percent in 1986/87.

CHART 2

PAKISTAN

EFFECTIVE EXCHANGE RATES, DECEMBER 1982–NOVEMBER 1988[1]

(December 1982=100)




Source: International Monetary Fund, Information Notice System.

[1]Increases mean appreciation.

## 2. Developments in 1987/88 and early 1988/89

With large cotton and sugarcane crops and a better than expected wheat harvest real GDP grew by 5.3 percent in 1987/88, about the same rate as in the previous year. Buoyed by strong foreign demand for cotton-based manufactures, domestic manufacturing activity was brisk. There was also a further increase in domestic crude oil production.

On the policy front, the overall fiscal deficit rose from 7.7 percent of GDP in 1986/87 to 8.5 percent of GDP in 1987/88. Despite the introduction of a tax on certain cotton exports in July 1987, growth of total tax receipts remained weak, reflecting the inelasticity of the tax system. Moreover, substantial overruns were incurred in current expenditures, while development spending increased by 38 percent, reflecting both an effort to meet the development targets under the Sixth Five-Year Plan (1983/84-1987/88) and increased foreign aid utilization. Largely because of the heavy bank financing of the budget deficit, but also owing to weaker control of private sector credit, the net domestic assets of the banking system increased by 13 percent in 1987/88--the same rate as in 1986/87--exceeding the credit plan target of 11 percent. Although part of the excess liquidity was vented through the balance of payments, the increase in the total money stock was larger than planned. Associated with these developments, as well as flood-related food cost increases and somewhat higher import prices, consumer price inflation accelerated to 6.3 percent in 1987/88, from 3.8 percent in 1986/87, and further to 10.4 percent in the 12 months to October 1988. 1/

The expansionary stance of fiscal and monetary policies resulted in a strong acceleration of total real consumption growth in 1987/88, but the growth of total real investment slowed because of weakening price performance and the crowding-out effects of the rising fiscal deficit and weakened business confidence. With total absorption increasing more rapidly than output and workers' remittances declining further, the ratio of the external current account deficit to GNP more than doubled to 4 percent, from its level in 1986/87 (Table 3). This deterioration occurred despite a broadly based increase of 24 percent in exports reflecting sustained foreign demand in 1987/88, a further depreciation of 7.1 percent in the real effective exchange rate, and the impact of other domestic policies aimed at encouraging exports. The current account deterioration was largely on account of a 19 percent increase in imports, higher interest payments on the foreign debt, and the further decline in workers' remittances. This last development was due in part to the much weaker oil prices and less favorable employment opportunities abroad, but also to weakening confidence in the economy.

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1/ Rapid domestic liquidity growth and associated expectational effects may also have contributed to the rise in the premium on FEBCs to a peak of 14 percent in May-June 1988.

Table 3. Pakistan: Balance of Payments, 1984/85-1996/97 1/

(In millions of U.S. dollars)

| | Actuals | | | Prov. Actuals | Program Projections | | | Staff Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1984/85 | 1985/86 | 1986/87 | 1987/88 | 1988/89 | 1989/90 | 1990/91 | 1991/92 | 1992/93 | 1993/94 | 1994/95 | 1995/96 | 1996/97 |
| Current account balance | -1,680 | -1,236 | -719 | -1,594 | -1,371 | -1,142 | -1,198 | -1,244 | -1,345 | -1,449 | -1,529 | -1,657 | -1,794 |
| Trade balance | -3,552 | -3,042 | -2,294 | -2,542 | -2,158 | -1,796 | -1,767 | -1,672 | -1,582 | -1,559 | -1,472 | -1,471 | -1,437 |
| Exports, f.o.b. | 2,457 | 2,942 | 3,498 | 4,341 | 4,921 | 5,495 | 6,161 | 6,751 | 7,324 | 7,910 | 8,543 | 9,227 | 9,965 |
| Imports, f.o.b. | -6,009 | -5,984 | -5,792 | -6,883 | -7,079 | -7,291 | -7,928 | -8,423 | -8,906 | -9,469 | -10,015 | -10,698 | -11,402 |
| Services (net) 2/ | -815 | -1,016 | -982 | -1,349 | -1,368 | -1,515 | -1,586 | -1,705 | -1,849 | -1,979 | -2,149 | -2,281 | -2,455 |
| Receipts | 941 | 963 | 1,013 | 939 | 991 | 1,065 | 1,138 | 1,202 | 1,259 | 1,315 | 1,383 | 1,460 | 1,538 |
| Payments | -1,756 | -1,979 | -1,995 | -2,288 | -2,359 | -2,579 | -2,724 | -2,907 | -3,108 | -3,294 | -3,532 | -3,741 | -3,993 |
| Private transfers (net) | 2,687 | 2,822 | 2,557 | 2,297 | 2,155 | 2,169 | 2,155 | 2,133 | 2,086 | 2,089 | 2,092 | 2,095 | 2,098 |
| of which: workers' remittances | (2,446) | (2,596) | (2,278) | (2,013) | (1,900) | (1,900) | (1,875) | (1,850) | (1,800) | (1,800) | (1,800) | (1,800) | (1,800) |
| Capital account balance 3/ | 892 | 1,255 | 953 | 1,578 | 1,470 | 1,321 | 1,388 | 1,425 | 1,490 | 1,582 | 1,685 | 1,805 | 1,906 |
| Official transfers (net) | 390 | 468 | 383 | 486 | 598 | 531 | 493 | 507 | 523 | 539 | 554 | 572 | 588 |
| Medium- and long-term capital (net) | 508 | 607 | 451 | 761 | 729 | 731 | 836 | 909 | 958 | 1,034 | 1,122 | 1,224 | 1,309 |
| Project and non-project (net) 4/ | 339 | 394 | 269 | 566 | 660 | 577 | 662 | 736 | 776 | 882 | 975 | 1,070 | 1,153 |
| Other official (net) 5/ | 60 | 13 | 53 | 38 | -70 | 15 | 35 | 30 | 35 | -- | -10 | -7 | -10 |
| Private (net) | 109 | 200 | 129 | 157 | 139 | 139 | 139 | 143 | 147 | 152 | 156 | 161 | 166 |
| Short-term capital (net) | -31 | 155 | 109 | 322 | 134 | 50 | 50 | -- | -- | -- | -- | -- | -- |
| Commercial bank (net) 6/ | -16 | -21 | 38 | 217 | 64 | -- | -- | -- | -- | -- | -- | -- | -- |
| Foreign Exchange Bearer Certificates (net) | -- | 148 | 64 | 113 | 70 | 50 | 50 | -- | -- | -- | -- | -- | -- |
| Other official (net) | -15 | 37 | 8 | -7 | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| Private (net) | -- | -9 | -1 | 1 | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| Debt relief 7/ | 25 | 25 | 10 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 |
| Errors and omissions | -31 | -26 | 8 | -49 | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| Overall balance | -819 | -7 | 242 | -65 | 99 | 179 | 190 | 181 | 145 | 133 | 156 | 148 | 112 |
| Net foreign assets | 819 | 7 | -242 | 65 | -99 | -179 | -190 | -181 | -145 | -133 | -156 | -148 | -112 |
| State Bank of Pakistan | 954 | -379 | -391 | 39 | -129 | -219 | -230 | -181 | -145 | -133 | -156 | -148 | -112 |
| Gross reserves (increase -) | (1,036) | (-146) | (46) | (451) | (-263) | (-372) | (-214) | (-60) | (39) | (9) | (-80) | (-67) | (-21) |
| IMF (net) | (-82) | (-250) | (-358) | (-322) | (174) | (153) | (-16) | (-121) | (-184) | (-142) | (-76) | (-81) | (-91) |
| Purchases | [--] | [--] | [--] | [--] | [398] | [318] | [97] | [--] | [--] | [--] | [--] | [--] | [--] |
| Repurchases | [-82] | [-250] | [-358] | [-322] | [-224] | [-165] | [-113] | [-121] | [-184] | [-142] | [-76] | [-81] | [-91] |
| Other | (--) | (17) | (-79) | (-90) | (-40) | (--) | (--) | (--) | (--) | (--) | (--) | (--) | (--) |
| Deposit money banks | -135 | 386 | 149 | 26 | 30 | 40 | 40 | -- | -- | -- | -- | -- | -- |
| FCDs: nonresident banks 8/ | (--) | (480) | (359) | (54) | (30) | (40) | (40) | (--) | (--) | (--) | (--) | (--) | (--) |
| FCDs: nonresident nonbanks 8/ | (-49) | (16) | (44) | (101) | (--) | (--) | (--) | (--) | (--) | (--) | (--) | (--) | (--) |
| Other | (-86) | (-110) | (-254) | (-129) | (--) | (--) | (--) | (--) | (--) | (--) | (--) | (--) | (--) |
| Memorandum items: | | | | | | | | | | | | | |
| Gross official reserves 9/ | 668 | 915 | 864 | 457 | 720 | 1,092 | 1,306 | 1,366 | 1,327 | 1,318 | 1,398 | 1,465 | 1,486 |
| (In weeks of following year's imports, c.i.f.) | (5.3) | (7.6) | (6.2) | (3.1) | (4.7) | (6.6) | (7.4) | (7.3) | (6.7) | (6.3) | (6.2) | (6.1) | (6.2) |
| Current account deficit (as percent of GNP) | -5.0 | -3.4 | -1.9 | -4.0 | -3.3 | -2.7 | -2.5 | -2.4 | -2.4 | -2.4 | -2.4 | -2.4 | -2.4 |
| Growth rates: | | | | | | | | | | | | | |
| Exports, f.o.b. | -7.9 | 19.7 | 18.9 | 24.1 | 13.4 | 11.7 | 12.1 | 9.6 | 8.5 | 8.0 | 8.0 | 8.0 | 8.0 |
| Imports, f.o.b. | 0.3 | -0.4 | -3.2 | 18.8 | 2.8 | 3.0 | 8.7 | 6.2 | 5.7 | 6.3 | 5.8 | 6.8 | 6.6 |
| Workers' remittances | -10.6 | 6.1 | -12.2 | -11.6 | -5.6 | -- | -1.3 | -1.3 | -2.7 | -- | -- | -- | -- |

Sources: State Bank of Pakistan; Ministry of Finance and Economic Affairs; program projections; and staff projections.

1/ The financing projections are based on the assumption of a 15-month stand-by arrangement, as well as a SAF arrangement, both starting in the last quarter of 1988.

2/ For 1988/89 through 1996/97, includes interest payments projected to arise from new disbursements in each fiscal year.

3/ Excludes net foreign assets of the banking system.

4/ Includes amortization of Trust Fund loans.

5/ Mainly commercial bank borrowing of over one-year maturity.

6/ Commercial bank and Islamic Development Bank borrowing of one-year maturity or less.

7/ 1981 debt rescheduling.

8/ Foreign currency deposits.

9/ Includes foreign currency deposits by nonresident commercial banks and Foreign Exchange Bearer Certificates which together totaled US$1.2 billion at end-June 1988.

Despite increased net inflows of foreign aid and further large recourse to short-term commercial borrowing, gross official reserves were again drawn down to finance the widened external current account deficit and to make scheduled Fund repurchases. By end-October 1988, foreign exchange reserves had fallen to US$468 million (three weeks of imports) and the net foreign liabilities of the banking system stood at about US$1.2 billion.

To summarize, by June 1988 the domestic economy was characterized by rising inflation, a large and growing external current account deficit, and slackening growth momentum. In particular, the deteriorating fiscal picture increased the difficulties of maintaining development as well as social spending; the difficult external position was an obstacle to trade liberalization; and lack of confidence in the stance of policies was weakening private savings and investment, as well as workers' remittance inflows. These developments and conditions exacerbated Pakistan's protracted balance of payments difficulties.

## III. Summary of Discussions on the Policy Framework for 1988/89-1990/91

### 1. Objectives and policies

As it became evident by early 1988 that the domestic and external financial trends of recent years would not be sustainable in the medium term, the authorities began devising a program of vigorous fiscal and monetary policy adjustment, supplemented by appropriate structural and external sector policies, that promised to restore medium-term balance of payments viability and to contain the resurgence of inflationary pressures. At the same time, in order to underpin the relatively strong economic growth performance of recent years, thereby improving employment prospects for the rapidly growing population, a key element of the program would be a gradual increase of domestic investment levels over the medium term.

Accordingly, the discussions with the Fund and Bank staffs focused on a medium-term framework of policy action for 1988/89-1990/91 to achieve the following objectives: an annual real GDP growth rate in the 5.2-5.5 percent range; a reduction in the annual inflation rate to around 6 percent in 1990/91, from a projected 10 percent in 1988/89; a gradual lowering of the external current account deficit from 4 percent of GNP in 1987/88 to 2.5 percent by 1990/91; an associated reduction of the external debt service ratio from over 30 percent to less than 25 percent during the program period, with further modest declines in later years; 1/ an increase in gross external reserves to US$1.3 billion (about seven weeks of imports); and a significant reduction in the banking system's net external liabilities by the end of the program period. After a slight decline to 15.7 percent of GNP in 1988/89 owing to firm fiscal restraint, gross investment is projected to rise during the rest of the program period to 18.6 percent of GNP in 1990/91. Consistent with the targeted fiscal adjustment, domestic savings are expected to increase from less than 9 percent of GNP in 1987/88 to over 14 percent in 1990/91. These medium-term objectives are broadly in line with the overall strategy of the Seventh Five-Year Development Plan (1988/89-1992/93) introduced on July 1, 1988 (see below). Table 4 gives a summary of the macroeconomic objectives and policies for the three-year program.

Redirection of policies along these lines was initiated in June-July 1988 in the context of the fiscal budget and the Import and Export Policy Orders for 1988/89. In view of subsequent economic developments and because some structural fiscal elements were not yet in place, discussions between the authorities and the staff on a strengthening of policies continued until October, when the present package was agreed. In order to achieve the above objectives, the authorities' medium-term program emphasizes: (1) major initiatives for reducing the overall fiscal deficit and for structural fiscal reform; (2) further trade liberalization; and (3) continued progress in structural reform, including further adjustments to administered prices, liberalization of investment sanctioning, and improved incentives for fixed capital formation. These measures are to be supported by a more restrained domestic financial stance, as well as a continuation of flexible exchange rate management.

## 2. Fiscal policy

### a. Policy targets

The medium-term fiscal reform program initiated with the 1988/89 budget aims at reducing the overall fiscal deficit from 8.5 percent of GDP in 1987/88 to 4.8 percent in 1990/91. This reduction is to be achieved through structural reform of the direct and indirect tax system, as well as forceful restraint of current spending.

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1/ These estimates refer to debt service obligations on Pakistan's total external debt, including military debt. The authorities have furnished the staff with projections of external debt service on this comprehensive definition. The data on the disbursed stock of external public and publicly guaranteed debt provided to the staff by the authorities excludes military debt. Most of Pakistan's military debts are owed to the United States. Information on the amounts and terms of the outstanding stock of U.S. claims, as well as on future commitments, is available from creditor sources, and has been taken into account.

Table 4. Pakistan: Summary of 1988/89-1990/91 Macroeconomic Objectives and Policies

## Objectives

1. Sustain real growth at about 5.2 percent in 1988/89 and at about 5.5 percent in both 1989/90 and 1990/91.

2. Increase gross domestic savings from about 10 percent of GNP in 1988/89 to over 14 percent in 1990/91, mainly by raising government savings; raise gross investment ratio from about 16 percent in 1988/89 to over 18 percent in 1990/91.

3. Confine the rate of inflation to 10 percent in 1988/89 and reduce it gradually to 7 percent in 1989/90 and further to around 6 percent by 1990/91.

4. Reduce the external current account deficit (including official transfers) to 3.3 percent of GNP in 1988/89 and further to 2.7 percent of GNP in 1989/90 and to the sustainable level of 2.5 percent of GNP in 1990/91.

5. Reduce the external debt service ratio from 30.5 percent of current receipts during 1986/87-1987/88 to 29 percent in 1988/89 and further to the sustainable level of less than 25 percent by 1990/91.

6. Increase gross official reserves from the equivalent of some 3 weeks of imports (less than US$0.5 billion) at end-1987/88 to nearly 5 weeks of imports (US$0.7 billion) at end-1988/89 and further to over 7 weeks of imports (US$1 billion) at end-1990/91.

## Policy Measures

1. Fiscal policy

a. Reduce the overall fiscal deficit to 6.5 percent of GDP in 1988/89 and further to 5.5 percent in 1989/90 and 4.8 percent in 1990/91.

b. In the area of both direct and indirect taxation, introduce revenue measures aimed at increasing the elasticity of the tax system and expanding the tax base, and at reducing reliance of the tax system on international trade over the medium term.

c. Improve direct taxation through elimination of immunities and improved auditing procedures.

Table 4 (continued). Pakistan: Summary of 1988/89-1990/91 Macroeconomic Objectives and Policies

d. Expand base of sales tax on imports as well as domestically produced goods through removal of exemptions and extension of coverage on July 1, 1988 and more substantially on July 1, 1989.

e. Introduce a General Sales Tax by July 1, 1990.

f. Increase tax elasticity through annual revisions of those excises and customs duties that are levied at specific rates; maintain income and profit tax exemption limits at constant levels.

g. Strengthen administration of both direct and indirect taxation.

h. Contain expenditure growth below growth of nominal GDP through strengthened control and monitoring procedures.

i. Implement domestic cost and price adjustments with a view to reducing expenditure growth and enhancing nontax revenues.

2. External sector policy

a. Improve resource allocation and enhance noncotton-based manufactured exports through a phased program of import liberalization and external tariff reforms. The first phase, which was implemented on July 1, 1988, involved a shortening of both the negative and restrictive lists with the latter merged into a single list, a lowering of the maximum tariff rate from 150 to 125 percent, a further step in rationalizing the structure of tariff rates, and increases in the real value of ceilings on imports of machinery and millwork against cash licenses and on imports by actual users. The second phase, to be implemented on July 1, 1989, will involve a further shortening of the negative list and the single restricted list, a further rationalization of the structure of external tariffs, and significant increases in the real value of ceilings on imports of machinery and millwork against cash licenses and on imports by actual users. These actions will be pursued further in a third phase, to begin on July 1, 1990, which will also involve a further reduction in the maximum rate to 100 percent.

b. Pursue a flexible exchange rate policy consistent with the balance of payments objectives of the program.

c. Limit the growth of short-term external indebtedness through ceilings on debts with an initial maturity of up to and including one year; improve the structure of the banking system's net external liabilities by containing the growth of such liabilities; and gradually reduce recourse to sales of Foreign Exchange Bearer Certificates.

Table 4 (continued). Pakistan: Summary of 1988/89-1990/91 Macroeconomic Objectives and Policies

d. Improve external debt service profile through limits on the contracting of loans with initial maturities of more than one year and up to and including twelve years and, within these limits, on the contracting of loans with initial maturities of more than one year and up to and including five years.

e. Phase out existing bilateral payments agreements, barter trade protocols, and special trading arrangements which give rise to exchange restrictions, as well as other exchange restrictions. Refrain from entering into any new arrangement giving rise to exchange restrictions.

3. Monetary policy

a. Limit the growth of net domestic assets to 10.4 percent in 1988/89, 9.2 percent in 1989/90, and 11.0 percent in 1990/91; and limit total liquidity growth to 11.9 percent, 10.6 percent, and 12.4 percent, respectively, as compared with nominal GDP growth rates of 15.7 percent, 12.9 percent, and 12.4 percent, respectively.

b. Reduce net domestic bank borrowing for budgetary financing to 1 percent of GDP in 1988/89 and further to 0.5 percent of GDP in 1989/90, to bring it to a negligible level by 1990/91.

c. Continue to implement the system of global credit ceilings as the major instrument of monetary policy, but strengthen control over credit extended by commercial banks.

d. Improve domestic debt management and promote establishment of a capital market, by rationalizing the rate structure of the National Savings Schemes, issuing auctioned government debt instruments, and maintaining appropriate real interest rates.

e. Improve efficiency of credit allocation by moving toward market-oriented rate of return for concessional credit schemes.

f. Prepare and implement improved prudential regulation for supervision of banks and other financial institutions through better accounting and auditing procedures, establishment of a credit information bureau, and improved debt recovery.

4. Pricing and other sectoral policies

a. Annually adjust electricity tariffs as required to achieve 40 percent self-financing of WAPDA's core investment program.

b. Shift away from cost-plus pricing formula with a view to increasing incentives for efficiency and to encourage new private sector investments in the petroleum refinery subsector.

Table 4 (concluded). Pakistan: Summary of 1988/89-1990/91
Macroeconomic Objectives and Policies

c. Pass through to consumers increases in the cost of domestic and imported petroleum.

d. Annually adjust the price of natural gas supplied to domestic household consumers, with a view to reaching 100 percent of the border price of fuel oil by 1992/93.

e. Annually review and adjust prices for key crops to keep these prices in line with trends and levels of world market prices and exchange rates.

f. Gradually eliminate economic subsidies for fertilizers, with a view to eliminating the economic subsidy for all types of phosphatic fertilizers by October 1991 and that for potash fertilizers by October 1995.

g. Annually adjust the investment sanctioning limit to take account of inflation; no expansion of the list of specified industries.

h. Divest partially or fully certain identified public sector enterprises, while developing corporate rationalization/restructuring program for the remaining enterprises.

Sources: Pakistan - Structural Adjustment Facility - Policy Framework Paper, 1988/89-1990/91, EBD/88/331; and Pakistan - Memorandum on Economic Policy of the Pakistan Government, EBS/88/232.

Over the program period, structural fiscal reforms are intended to raise total revenue as a proportion of GDP by 2.4 percentage points, while reducing both total and current expenditures by 1.4 percentage points (Table 2 and Appendix I, Table 8). Following a decline in 1988/89 owing to the need to reduce the overall fiscal deficit sharply in the initial year of the program, development expenditures are projected to be maintained at their 1987/88 level of 7 percent of GDP.

b. Structural reforms

The deterioration of Pakistan's fiscal position in recent years has reflected, inter alia, serious structural weaknesses in the budgetary revenue system, including the narrow and inequitable tax base, the low elasticity of the tax system, and the heavy reliance of revenues on international trade taxes. To address these problems, beginning with the current year's budget the Pakistan authorities have started to implement tax reform measures in both the direct and indirect taxation areas aimed at improving the elasticity of the tax system by expanding the base of taxation. As regards direct taxation, the authorities explained that several of the new measures were also expected to enhance elasticity by reducing the scope for tax evasion. As regards indirect taxation, they explained that for the 1988/89 fiscal year the authorities' desire to broaden the base of the sales tax on domestic production had been tempered by the resurgence of inflation. Nevertheless, in order to increase both the yield and the elasticity of the sales tax and excise system, the authorities are committed to extending the base of the sales tax from the present level of about 22 percent of domestic industrial production to 30 percent as of July 1, 1989, via a broadening of the sales tax base to include a substantial number of domestically manufactured goods that are presently exempt. 1/ Another fundamental element of structural tax reform to which the authorities are committed is the introduction of a General Sales Tax (GST) on July 1, 1990. To this end, a phased action program has been drawn up and a formal request has been made to the Fund for technical assistance in designing the tax and making arrangements for its implementation. Nearly all goods are to be taxed at the standard rate unless exempted or zero-rated; in addition, a mechanism will be introduced for crediting taxes paid on inputs against tax liability on sales. The tax will initially cover the manufacturing-importer level and will be extended to other productive activities, such as wholesale and retail trade, at a later stage.

3. Financial reform and monetary policy

To support structural reforms in other areas, the authorities are contemplating an integrated set of financial reforms in the context of a sectoral loan from the World Bank which they are currently negotiating. Reforms will be initiated in the areas of debt management,

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1/ This would increase tax collections on goods by 0.3 percent of GDP. See the Memorandum on Economic Policy, paragraphs 12-14.

supervision and regulation of financial institutions, and improved efficiency and profitability of the banking system. They will include rationalization of the structure of National Savings schemes; establishment of market-oriented rates of return on government debt instruments; 1/ and improved prudential regulation of domestic capital markets and financial institutions, including the nationalized commercial banks. The authorities will also begin auctioning short-term treasury bills in the near future; it is intended that such instruments may serve eventually as a means for market-oriented techniques of monetary control. Rates of return on bank lending averaged 15 percent per annum over the past two years; 2/ in view of the resurgence of inflationary pressures, the authorities recently increased rates of return on certain government securities (see below) and will continue to monitor them with a view to ensuring that real rates of return remain attractive and that the public sector's financing needs can increasingly be met from nonbank sources. To the extent that higher real returns raise the cost of capital relative to labor, they will serve as a stimulus to employment.

The authorities emphasized their determination to maintain firm control of total domestic credit growth during the period when the adjustment and reform package is being implemented, with a view to reducing the annual inflation rate as well as supporting balance of payments adjustment. To this end, they stated that global credit ceilings would continue to be employed as the major instrument of monetary control over the next few years, until indirect credit control instruments could be put in place.

### 4. Development strategy, supply policies, and other structural measures in the real sector

The established goals of the Seventh Five-Year Development Plan (1988/89-1992/93) are to achieve high rates of economic growth and employment as well as greater involvement of the private sector in the economy, notably in the energy sector. As regards the public sector development program under the Plan, the World Bank staff has noted that the authorities have increased outlays on the priority sectors such as energy, transport and communication, and agriculture; simultaneously, they have made a determined effort to protect essential social programs, particularly in primary education, health, rural water, and urban redevelopment. The programmed rise in total gross domestic investment in the period to 1990/91 is intended to be associated with an increase in the private sector's share of total investment from the current level

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1/ Pakistan's financial system was changed to an Islamic noninterest basis in July 1985. While this move brought about greater flexibility as regards rates of return on bank lending, the rates on government debt instruments continue to be fixed administratively.

2/ This compares with the 20 percent ceiling permitted by the State Bank of Pakistan on rates of return on bank lending, and to average rates of return on deposits at commercial banks of about 7.5 percent.

of around 60 percent. The Bank staff are of the view that the public sector investment program, together with growing private investment, is consistent with the real GDP growth rate averaging 5.5 percent a year that is projected for the medium term.

In the agricultural sector, the authorities' strategy is to continue encouraging production of wheat, sugarcane, and certain minor crops, while strengthening the cotton and rice sectors. To this end, further enhancements in output price incentives will be implemented and agricultural input prices will be adjusted further. In particular, a price adjustment formula has been established with the objective of eliminating economic subsidies for all types of phosphatic fertilizers by October 1991, and for potash fertilizers by October 1995, as agreed with the World Bank. As regards energy, the Pakistan representatives expressed satisfaction with the performance of the oil and natural gas sectors; in view of the interest shown by foreign investors, they expect further progress in oil and gas exploration and production in the next few years. To increase output and investment in oil refineries and to enhance the efficiency of existing facilities, the Government has decided, in the context of the forthcoming energy sector loan from the World Bank, to introduce a new pricing formula for refined petroleum products linking domestic producer prices to border prices. Moreover, to contain demand the authorities intend to pursue their policy of staying in line with international prices by passing through to consumers all price increases for crude oil. Consistent with this policy, except for one item (aviation fuel 1/), the domestic prices of petroleum products have not been adjusted downward with the decline in world market price for crude oil. In line with their long-term objective of enhancing self-financing of investments, the authorities intend to make further adjustments in user prices for natural gas. They remain committed to making appropriate annual adjustments in electricity tariffs.

As regards industrial deregulation, the sanctioning procedures for investment projects have been simplified for all industries. The authorities would consider elimination of the restriction as regards industries where raw material imports represent more than 60 percent of investment expenditures after the tariff structure has been rationalized further. The industrial sanctioning limit was raised to PRs 700 million on July 1, 1988, and will be reviewed regularly. A Presidential Ordinance was issued on August 3, 1988 to facilitate divestiture of public enterprises, and measures (see paragraph 28.a. of the Memorandum on Economic Policy) will be taken to enhance efficiency in remaining public enterprises.

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1/ The price of aviation fuel was reduced to PRs 4.05 per liter to bring the Pakistan price for this product in line with those in competing countries.

## 5. External sector policies

### a. Trade liberalization

With the 1988/89 Import Policy Order (IPO), the authorities have initiated a comprehensive trade liberalization effort as an element of their medium-term structural reform program. 1/ The first stage of the liberalization emphasizes replacement of nontariff barriers by tariff protection, reduction of the maximum tariff rates, and rationalization of the tariff structure. As detailed in the Memorandum on Economic Policy, a large number of items were removed from the negative import list effective July 1, 1988, although major exportable categories such as textiles were retained for reasons of reciprocity. With the 1989/90 and 1990/91 IPOs, the authorities will remove a similar number of items from the negative list of banned imports in roughly equal steps, with a view to limiting the remaining list to items banned for religious, security, and reciprocity considerations, or under international agreements. All lists of items importable subject to restrictions were merged into a single list and several categories of formerly restricted import items were liberalized. The ceiling on imports by actual users was doubled to PRs 10,000 (US$555) and the cash value ceilings and subceilings on imports of machinery and millwork against cash licenses were increased by 20 percent. The remaining restricted list of items importable under various specified conditions will be reduced and rationalized further during the next two fiscal years. The agreed package of trade liberalization measures is consistent with the joint Fund and Bank proposals that had been discussed with the authorities prior to issuance of the 1988/89 IPO.

As of July 1, 1988, all ad valorem tariff rates were reduced to 125 percent or less, 2/ except for alcoholic beverages, spirits, and luxury vehicles which carry higher rates. Previously, maximum tariff rates for items other than those just listed had been 150 percent. The tariff structure was also rationalized, involving a substantial reduction in the range of tariff rates on imports of raw materials and intermediate goods, as well as of capital goods. In the process, most consumer goods were subjected to tariff rates in the higher end of the range, with the highest tariff rates generally assigned to finished goods. Tariff rates on 1,134 categories of imports were reduced, compared with increases in the rates for 462 categories. These changes are expected to reduce the weighted average of nominal tariff rates. The authorities are confident that firm management of domestic demand and flexible exchange rate policy should minimize the danger of an import surge.

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1/ Some items had been removed from the negative list with the Import Policy Order for 1987/88, and tariffs on imported raw materials, semi-finished and intermediate goods, and capital goods had also been lowered. However, new items--particularly engineering goods--were added to the negative list at that time.

2/ Excluding the 6 percent import surcharge, the 5 percent Iqra surcharge, and license fees.

Rationalization of the tariff structure will continue over 1989/90-1990/91 and beyond. The authorities are committed to removing most exemptions from the standard customs duties, except for duty drawbacks for exports, and to implementing a further reduction in the maximum import duty rate to 100 percent on July 1, 1990. The Pakistan representatives stated that a reduction in the effective rate of protection was a desirable long-term goal of the tariff reforms, but they felt that a further lowering of the maximum tariff rate to 80 percent by July 1, 1991 would be very difficult because tax revenue would be adversely affected and the General Sales Tax would have been phased in first. Although the authorities believed that balance of payments pressures would not make it possible to eliminate ceilings on the values of machinery and millwork imports against cash licenses or on imports by actual users in the near future, both sets of ceilings will be increased significantly in real terms on July 1, 1989 and on July 1, 1990.

b. Exchange rate policy and the exchange system

In order to promote exports, the authorities intend to continue the flexible exchange rate management that they have pursued in recent years. This policy, together with the tighter financial stance referred to above, will also help to contain the demand for imports, particularly in the context of import liberalization. Accordingly, the authorities are committed to adjusting the nominal exchange rate of the rupee in the light of developments in domestic inflation and inflation in Pakistan's major trading partners and competitors. In particular the authorities will ensure that, at a minimum, during the period of the SAF arrangement the real effective exchange rate does not rise above its average level for April-June 1988. In addition to this commitment, exchange rate management will be guided by developments in the external accounts (especially the behavior of nontraditional exports and workers' remittances) and in the net foreign asset position of the banking system. For this purpose, end-quarter indicative targets have been established for net international reserves which are consistent with the overall balance of payments objectives. Failure to meet these targets will trigger consultations with the management of the Fund to assess developments and to discuss remedial action, if necessary.

The authorities stressed that although there continue to be tight restrictions on the availability of foreign exchange through official channels for invisible transactions, in practice the private sector has unrestricted access to foreign currency for either current or capital transactions through the market in FEBCs, which are freely tradable on the Karachi stock exchange and may be encashed on demand into either foreign exchange or Pakistan rupees. The Pakistan representatives noted that although the decision to allow FEBCs to be traded freely had given rise to a multiple currency practice subject to the approval of the Fund under Article VIII, the FEBC system nevertheless represented a substantial liberalization of the exchange system. Moreover, they noted that the premium on FEBCs was typically fairly small (about

7-9 percent). The Pakistan representatives added that, as a step toward further reducing the premium, they had recently increased the allowances for tourism, business travel, and studies abroad. Further progress would depend upon a steady improvement in the balance of payments. The staff representatives welcomed these positive intentions and stressed that with sustained adjustment it should eventually be possible to phase out the FEBC system.

The staff commented that the mandatory noninterest-bearing deposits of 30 percent of the value of letters of credit opened to finance many categories of imports also gave rise to a multiple currency practice. The staff emphasized in this regard that demand restraint and flexible exchange rate management were superior means for bringing about needed balance of payments adjustment. The authorities replied that they regarded the deposit requirement as a useful instrument by which the State Bank of Pakistan could restrain the demand for imports, especially at a time when the trade system was being liberalized. They did not feel able to make rapid progress with the elimination of the margin requirements, but agreed to eliminate them by July 1, 1990.

Pakistan maintains bilateral payments agreements and other trading arrangements with eight member countries. Since these agreements do not provide for the timely settlement of the balances outstanding under the agreement, they give rise to an exchange restriction subject to the approval of the Fund. The authorities explained that the sums involved were very small in relation to total trade flows, and that these arrangements had been introduced in order to stimulate exports.

c. Medium-term balance of payments adjustment and financing

The official objectives are to reduce progressively the external current account deficit to 2.5 percent of GNP by 1990/91, and the external debt service ratio from over 30 percent in 1987/88 to 24 percent in 1990/91 (Appendix I, Table 10). Cotton-based and rice exports and workers' remittances are expected to remain a sizable proportion of current foreign exchange earnings in the next several years. In view of protectionism in major foreign markets, efforts at upgrading exports of cotton manufactures and at finding new outlets for them will be strengthened considerably. Moreover, the authorities are acting to consolidate recent gains in noncotton-based manufactures and other nontraditional exports. The Pakistan representatives are confident that the domestic and external policies described above will permit them to achieve the projected average rate of export value growth of 12 percent over 1988/89-1990/91; this compares with an average annual growth of 21 percent over 1985/86-1987/88, when exceptionally favorable conditions buoyed exports of raw cotton and cotton-based manufactures (Table 3).

The U.S. dollar value of total imports is projected to grow at 3 percent in 1988/89 on account of the restraint of domestic demand brought about by the financial and exchange rate policy stance. Over the rest of the program period, total import values are projected to increase by 6 percent annually, a rate broadly consistent with the GDP growth objectives of the program. This would result in a small improvement in the balance on merchandise trade. The balance on the service account is expected to deteriorate as receipts remain sluggish in the face of rising payments, especially interest payments. There will be little change in the balance on private transfers, as the improved business climate and incentives will be largely offset by projected less buoyant employment opportunities abroad. Inflows on the capital account are expected to be sufficient to finance the current account deficits and to provide for modest overall surpluses. These will enable Pakistan to service its obligations to the Fund and to achieve the targeted increase in gross official reserves.

As noted in earlier sections, Pakistan has experienced protracted balance of payments difficulties in recent years. While a steady improvement is expected under the program, the external payments situation will remain difficult. Even with the external current account declining significantly relative to GNP, Pakistan will need to continue to rely on substantial amounts of external assistance. Moreover, such assistance would have to be mostly on concessional terms to improve Pakistan's external debt profile. Given this external debt profile, substantial recourse to short-term financing on commercial terms would be inappropriate. In addition, Pakistan's gross official reserves are at a low level. With the drawings under the prospective Fund arrangements, the program envisages that gross official reserves will be increased to only about seven weeks of imports by the end of the three-year program. Even this level of reserves would provide only a modest cushion for continued liberalization of the trade regime and against the uncertainties of the balance of payments problems to which Pakistan is exposed.

Over the three-year program period as a whole, Pakistan's total need for external assistance to finance the current account deficit, make the scheduled amortization payments (including Fund repurchases), and rebuild the reserves by US$0.8 billion is projected to amount to US$8.1 billion (Table 5). Of this amount, disbursements on existing commitments of grants and loans are expected to total about US$3.1 billion. Disbursements under the prospective stand-by and SAF arrangements would amount to a further US$0.8 billion, leaving US$4.2 billion to be financed from new commitments from other sources. This additional assistance is expected to be provided by bilateral donors on concessional terms and by multilateral development banks (mainly the World Bank and the Asian Development Bank). These additional financing requirements, though large initially, would decline over the program period, and the staff expect that thereafter the financing requirements could be met from normal aid flows without recourse to additional balance of payments support. Financing on the assumed terms would permit the service ratio on total external debt to decline to less than 25 percent by the end of the program period. It is expected that there will be some further modest progress in reducing the debt service ratio in later years (Appendix I, Table 10).

Table 5. Pakistan: External Financing Requirements, 1988/89-1990/91

(In millions of U.S. dollars)

| | 1988/89 | 1989/90 | 1990/91 | Cumulative Total Over the Program Period |
|---|---|---|---|---|
| Current account | 1,371 | 1,142 | 1,198 | 3,711 |
| Amortization 1/ | 1,046 | 1,032 | 931 | 3,009 |
| Change in reserves | 263 | 372 | 214 | 849 |
| IMF repurchases | 224 | 165 | 113 | 502 |
| Total financing requirements | 2,904 | 2,711 | 2,456 | 8,072 |
| Grants | 598 | 531 | 493 | 1,622 |
| Private and short-term 2/ | 434 | 439 | 429 | 1,302 |
| Disbursements: Existing commitments | 1,099 | 1,006 | 987 | 3,093 |
| Disbursements: Expected new commitments | 773 | 735 | 547 | 2,055 |
| Identified financing | 2,904 | 2,711 | 2,456 | 8,072 |
| Financing gap | -- | -- | -- | -- |

Sources: Pakistan authorities; and program projections.

1/ Includes repayment of Trust Fund loans.
2/ Includes borrowing from commercial banks and import trade credit provided by the Islamic Development Bank.

## IV. Discussions on the Program for 1988/89

Within the macroeconomic objectives of the three-year program, the primary goals for 1988/89 are to maintain a rate of real economic growth of over 5 percent, 1/ to contain inflation to no more than 10 percent year on year, and to reduce the external current account deficit to 3.3 percent of GNP. The program also aims at improving Pakistan's gross official reserves by US$0.3 billion to nearly five weeks of imports by end-June 1989; containing the growth of short-term external indebtedness; and reducing the external debt service ratio to 29 percent of current receipts. Consistent with these objectives, fiscal adjustment is intended to reduce public sector dissaving; consequently, gross domestic savings are projected to rise by one percentage point, to 9.9 percent of GNP in 1988/89. These objectives are to be achieved through a mix of structural reforms, tight demand management, flexibility in exchange rate policy, and prudent external borrowing policy.

### 1. Fiscal policy

#### a. The 1988/89 budget

The 1988/89 budget targets a reduction in the overall fiscal deficit to 6.5 percent of GDP in 1988/89, from 8.5 percent in 1987/88. This reduction is to come from revenue measures introduced with the budget (described in the Memorandum on Economic Policy) that are aimed at raising total revenue 2/ to 18.5 percent of GDP, from 17.6 percent in 1987/88 (Table 2 and Appendix I, Table 8), as well as from expenditure restraint.

In the area of direct taxation, the measures introduced on July 1, 1988 include: elimination of important exemptions and rationalization of tax credits; simplification of assessment and auditing procedures for taxpayers earning less than PRs 100,000; introduction of a 10 percent surcharge on the regular tax liability of taxpayers whose income exceeded PRs 200,000 in 1987/88; the addition of agricultural income 3/ to nonagricultural business income for calculating the tax rate to apply to taxable income; and substantial improvements to tax audit procedures. With a view to providing enhanced incentives, new income tax exemptions have been introduced for exporters and for newly established firms until June 1991 in connection with an expanded list of

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1/ The projected real GDP growth of 5.2 percent in 1988/89 takes account of the likely effects of the decision to cut development expenditure relative to the budget allocation (see below) and of the effects of the floods that struck Punjab province in September 1988.

2/ Including the surplus of autonomous bodies.

3/ Under Pakistan's constitution, taxation of agricultural income is the prerogative of the provincial governments.

"key industries," replacing previous legislation granting holidays. The net additional revenue from the above measures is expected to be 0.2 percent of projected GDP in 1988/89.

In the area of indirect taxation, the 1988/89 budget has introduced a number of changes to excises, sales tax, and import duties which are projected to increase the yield of expenditure taxes by 0.8 percent of projected GDP. As regards the sales tax, a large number of previously exempted categories of imports have been subjected to the standard tax rate of 12.5 percent. For domestically produced goods, some previously exempted items and others previously taxed at reduced rates have been subjected to the sales tax at the standard rate of 12.5 percent; the authorities plan to index any remaining specific excise taxes and customs duties in order to maintain their ad valorem rates over time, thereby raising the elasticity of these taxes. Changes in the tariff system include a reduction in the maximum rate of customs duty to 125 percent (except for certain luxury products), the introduction of improved valuation procedures, and indexation of specific duties. For revenue purposes, the import surcharge has been raised by one percentage point, to 6 percent. At the same time, however, machinery imports by newly established enterprises belonging to the list of "key industries" referred to above have been exempted from customs duties.

To enhance nontax revenue and correct distortions in costs and prices, a number of fees and user charges for government services have been increased. For instance, the annual increase in electricity rates for 1988/89 was made in August and averaged 16 percent. In October, the Government increased the prices of the major phosphatic and potash fertilizers by 10-15 percent. These adjustments are projected to contain fertilizer subsidies to PRs 1.4 billion in 1988/89. The prices of natural gas supplied to all categories of domestic household consumers were raised by PRs 8 per thousand cubic feet (30-40 percent) effective December 1, 1988, eliminating the subsidization of natural gas consumed by this group. As regards petroleum prices, if the rupee price of imported crude oil rises above the corresponding level at the time domestic retail prices were last fixed, the differential will be promptly passed through to consumers.

Turning to public expenditures, the Pakistan representatives indicated that the Federal Government's spending program had been reassessed and rationalized when the Seventh Five-Year Plan (1988/89-1992/93) was formulated. In 1988/89 current expenditure is to be lowered by 0.6 percentage points of GDP to 18.6 percent (Table 2 and Appendix I, Table 8) by reducing subsidies, revising armed forces pension arrangements, and limiting indexation of civil service remuneration. To achieve their spending target, the authorities have strengthened expenditure control procedures further (see paragraph 17 of the Memorandum on Economic Policy), via closer scrutiny of expenditure requests by federal ministries. Provincial governments will be obliged to use their own revenues to finance any spending not covered by the deficit spending grants provided by the Federal Government in the

1988/89 budget. The Government has also decided to review the effectiveness of expenditure control procedures, with technical assistance from the Fund.

b. Post-budget developments and additional fiscal measures for 1988/89

During August-September 1988, some slippages occurred from the targeted fiscal adjustment path for 1988/89, owing to post-budget measures that reduced projected revenues and introduced supplementary expenditure allocations, mainly for defense. Tax receipts, particularly from import duties, were also below expectations during the early months of the fiscal year. In addition, the floods that struck Punjab in late September were expected to exert some adverse effect on the overall fiscal position.

In the discussions with the staff, the Pakistan representatives acknowledged the paramount importance of reducing the overall fiscal deficit to the targeted level of 6.5 percent of GDP. Accordingly, they introduced additional fiscal actions to safeguard prospects for achieving this target. For instance, domestic telephone rates and installation charges were increased in October 1988, and the federal and provincial Public Sector Development Program was cut by PRs 4.9 billion (about 9 percent of the original amount). The selection of the projects on which the cuts are to fall has been undertaken by the authorities in consultation with the World Bank, with a view to limiting the adverse impact on development and maintaining the flow of external financing; the cuts are being implemented during the second and third quarters of 1988/89. Although the Pakistan representatives felt that it would be premature to conclude that the recent trend in import duty collections was irreversible, they stated that if they realized by early December that this shortfall was not being fully compensated by other receipts they would promptly take additional measures, including an increase in the import surcharge, that would be sufficient to avoid a shortfall in receipts from this source for the year as a whole. If budgetary performance during the first three quarters of 1988/89 proves to be better than currently projected, development expenditure may be restored by a corresponding amount during the fourth quarter.

Domestic bank borrowing for budgetary financing was unusually high in the early months of the year. The authorities explained that new issues of Bearer National Fund Bonds (BNFBs) had not taken place as was usual in August, and that the performance of other bearer instruments had been weak. To enhance the attractiveness of the new tap issue of BNFBs that took place during the first week of November, the authorities raised the offered rates of return significantly. 1/ The performance of

1/ In early November 1988 the rate of return on one-year BNFBs was raised by nearly 2 percentage points to 12.4 percent; that on the two-year maturity by 0.8 percentage points to 13.3 percent; and that on the three-year maturity by 0.4 percentage points to 15 percent.

the BNFB issue--as well as that of other public sector financial instruments--is being carefully monitored, and the authorities are committed to take further measures to ensure achievement of the projected level of nonbank borrowing set for 1988/89 as a whole under the program.

## 2. Money and credit policy

Monetary and credit policy for 1988/89 has been designed to achieve the inflation objective, restrain the growth of domestic absorption and import demand, and strengthen the international reserves position. These goals are to be achieved by constraining total domestic credit growth, mainly as a by-product of fiscal deficit reduction. Nevertheless, in view of recent increases in inflation and of the pressures on the balance of payments, the need for a substantial tightening of the domestic credit stance has also necessitated some restraint in the growth of credit to the private sector.

In line with the price and balance of payments objectives of the program the growth of net domestic assets of the banking system will be limited to 10.4 percent in 1988/89, as against 13 percent in 1987/88 (Table 2 and Appendix I, Table 9). On this basis, the growth of domestic liquidity is expected to slow to 11.9 percent, from 12.3 percent in 1987/88. Taking into account expected external financing and recourse to nonbank private savings of PRs 28.4 billion, the targeted improvement in the overall fiscal position is consistent with net bank borrowing for budgetary financing of no more than PRs 8 billion (1 percent of GDP) in 1988/89, and credit for commodity operations of PRs 2 billion. In order to meet the net domestic assets ceiling, credit to the private sector is programmed to grow by 15.6 percent (compared with 17.7 percent in 1987/88). This rate, which is roughly equal to the projected growth of nominal GDP, is considered adequate to finance the private sector's requirements for working capital and fixed investment.

## 3. External sector policies and prospects in 1988/89

At 13 percent, export value growth is expected to remain strong in 1988/89, albeit less than that of the last several years. Although the full effects of the September floods in Punjab have not yet been assessed by the World Bank, the program projection makes some allowance for their likely adverse balance of payments effects. Cotton export volume is expected to reach record levels, reflecting the carryover of stocks from 1987/88, while exports of cotton manufactures are projected to remain buoyant. Total imports are projected to increase slowly as a result of domestic demand restraint, a drawdown of stocks imported toward the end of the last fiscal year, and continued flexible exchange rate management. With little change in the balance on the service account and a modest further decline in receipts from workers' remittances, the external current account deficit is projected to decline to about 3.3 percent of GNP. Buoyant gross inflows on the capital account are projected, since the authorities are expected to continue rapid implementation of a number of externally financed projects and to receive an exceptional grant of US$200 million to finance wheat imports. With only small inflows into FEBCs, net short-term inflows are expected to be modest. Overall, the balance of payments is projected to show a surplus of about US$100 million which, taken with the purchases under the prospective Fund arrangements and other transactions, would allow the level of gross official reserves to rise by some US$370 million to just under five weeks of imports by the end of June 1989.

The real effective exchange rate of the rupee appreciated somewhat during the period July-August 1988 from its average value in April-June. In the following weeks the authorities depreciated the rupee against the U.S. dollar and at the same time the dollar depreciated against major currencies. As a result, the real effective exchange rate of the rupee depreciated (Chart 2), and by the middle of November it was estimated to be 2-3 percent below the average level of April-June 1988. In addition, the premium quoted on the stock exchange for Foreign Exchange Bearer Certificates, which had risen to a peak of 14 percent in May-June 1988, had declined to 8.5 percent by end-October.

The program provides for tight constraints on the accumulation of short-term public sector external debts in 1988/89. In addition, if there are large short-term capital inflows via either FEBCs or foreign currency deposit liabilities of the banks, the authorities will ensure that these flows will be reflected in matching increases in gross official reserves, or reductions in other short-term liabilities. By implementing firm adjustment measures and by continuing to mobilize support from the donor community, the Government intends to prevent the emergence of debt servicing problems over the medium term. To this end, the Government has placed firm limits on the commitments of medium- and long-term nonmilitary debts.

## 4. Performance criteria and benchmarks

Table 4 summarizes the financial program for which the authorities have requested a stand-by arrangement. To assess progress in program implementation, quantitative and nonquantitative performance criteria have been established, as summarized in Table 6. Quantitative performance criteria include end-of-period quarterly ceilings on the net domestic assets of the banking system. Within these ceilings there are subceilings on net bank credit for budgetary financing and on bank financing of the Government's commodity operations, respectively.

Table 6. Pakistan: Quantitative and Nonquantitative Performance Criteria Under the Stand-By Arrangement

| | 1988 | 1989 | |
|---|---|---|---|
| | Dec. 31 | March 31 | June 30 |
| **A. Quantitative Performance Criteria** | | | |
| | (In millions of Pakistan rupees) | | |
| Net domestic assets | | | |
| Stock | 315,661 | 319,204 | 325,794 |
| Cumulative change 1/ | 20,722 | 24,265 | 30,855 |
| Net bank credit for budgetary financing | | | |
| Stock | 134,466 | 133,966 | 135,466 |
| Cumulative change 1/ | 7,000 | 6,500 | 8,000 |
| Bank credit for commodity operations | | | |
| Stock | 12,736 | 12,144 | 13,455 |
| Cumulative change 1/ | 1,281 | 689 | 2,000 |
| | (In millions of U.S. dollars) | | |
| Limits to the outstanding stock of public and publicly guaranteed short-term external debt 2/ | 415 | 365 | 215 |
| Limits 3/ to the contracting of new public and publicly guaranteed debts: | | | |
| a. With initial maturities of over one year and up to and including five years | 300 | 300 | 300 |
| b. With initial maturities of over one year and up to and including twelve years | 870 | 870 | 870 |
| **B. Quantitative Indicative Targets** | | | |
| | (In millions of U.S. dollars) | | |
| Quarterly minimum limits (floors) on changes in net international reserves 4/ | | | |
| Stock | -2,105 | -2,157 | -2,116 |
| Short-term, nonimport-related external liabilities 5/ | 2,627 | 2,604 | 2,484 |

C. Nonquantitative Performance Criteria (Reviews)

A first review of the program, including the reaching of understandings on the performance criteria for the remaining period of the arrangement after June 30, 1989, to be completed no later than May 15, 1989.

A second review of the program to be completed no later than November 15, 1989.

Exchange Rate Management

Implementation of flexible exchange rate management in accordance with the undertaking included in paragraph 23 of the Memorandum on Economic Policy of the Pakistan Government (EBS/88/232).

Exchange and Trade Restrictions

The Government of Pakistan will not introduce any new or intensify existing restrictions on current international transactions, introduce new or modify existing multiple currency practices, or impose or intensify import restrictions for balance of payments reasons.

D. Consultation with the Management of the Fund

The Government of Pakistan will consult with the management of the Fund whenever: (a) the end-period quarterly net international reserves targets are not observed; (b) indications are that achievement of the overall fiscal deficit target of PRs 51.7 billion or 6.5 percent of GDP appears to be uncertain; and (c) Pakistan is about to enter a new bilateral payments, or barter trade protocol, or special trade arrangement with another Fund member, in order to ascertain whether the contemplated features give rise to an exchange restriction.

Source: Memorandum on Economic Policy of the Pakistan Government, EBS/88/232, hereafter referred to as the Memorandum on Economic Policy.

1/ On a cumulative basis from stock data as of the last working day of 1987/88 (June 30, 1988); as defined in Table 1 attached to the Memorandum on Economic Policy.

2/ With initial maturities of up to and including one year. These limits exclude import-related credits, the external liabilities of the banking system, and Foreign Exchange Bearer Certificates; as defined in Table 2 attached to the Memorandum on Economic Policy.

3/ The limits apply to cumulative new commitments from the end of September 1988 to the last date and exclude military debt; as defined in Table 2 attached to the Memorandum on Economic Policy.

4/ As explained in paragraph 23 of the Memorandum on Economic Policy, these limits will be treated as indicative targets a breach of which will initiate consultations with the management of the Fund, except for any period when the indicative target for public and publicly guaranteed short-term external liabilities is breached, in which case the limit on net international reserves will be a performance criterion for that period; as defined in Table 3 attached to the Memorandum on Economic Policy.

5/ As defined in Table 2 attached to the Memorandum on Economic Policy. Includes short-term debt as defined in footnote 2 above, the short-term external liabilities of the banking system and the outstanding stock of Foreign Exchange Bearer Certificates.

The program also includes end-of-period ceilings on the disbursed stock of all public and publicly guaranteed external debts of up to and including one-year initial maturity (excluding import-related credits), as defined in Table 6; in addition, the program includes indicative targets on short-term external liabilities, including the liabilities of the banking system and the outstanding stock of FEBCs, and on the level of net international reserves. For any test date on which the indicative target for the short-term external liabilities as defined above is breached, the level of net international reserves will be treated as a performance criterion. Finally, there are quarterly limits on the cumulative flow of newly contracted public and publicly guaranteed external debts with an initial maturity of over one year and up to and including twelve years, including separate subceilings on debts with an initial maturity of over one year and up to and including five years.

The nonquantitative performance criteria include implementation of flexible exchange rate management, the standard injunction regarding trade and payments restrictions, and two reviews to be undertaken during the stand-by arrangement to assess progress under the program. The first review is to be completed by May 15, 1989 and the second by November 15, 1989. Both reviews will assess fiscal and monetary policies, balance of payments financing, the exchange rate, and import liberalization. The May 1989 review will establish the performance criteria for the remaining period of the arrangement and will initiate discussions on the policy elements of the second-year program under the structural adjustment facility, which will be fully established only at the time of the second review.

In order to gauge progress under the structural adjustment facility the program contains, in addition to the quantitative performance criteria under the stand-by arrangement referred to above, a number of structural benchmarks listed in Table 7 and in Table 4 of the Memorandum on Economic Policy.

## V. Staff Appraisal

Pakistan experienced impressive output growth over 1980/81-1986/87. These achievements reflected in part steady enhancements of producer price incentives and, since 1985/86, deregulation of the pricing and trading of important commodities and manufactures, as well as flexible exchange rate management. Although 1987/88 was another year of satisfactory economic growth and impressive export gains, the weak demand management stance of recent years manifested itself in less satisfactory price performance and a sharp deterioration of both the external current account and the overall balance of payments.

Table 7. Pakistan: Quantitative, Nonquantitative, and Structural Benchmarks Under the First SAF Annual Program

A. Quantitative Benchmarks

Same as the quantitative performance criteria and the quantitative indicative targets for the stand-by arrangement (see Table 6).

B. Structural Benchmarks

1. Incorporation in the 1989/90 budget of the objectives and specific policy undertakings in the fiscal, tariff reform, and domestic pricing areas contained in the Policy Framework Paper and Policy Matrix, and in the Memorandum on Economic Policy in paragraphs 8, 24(b), and 27, as listed in Table 4 attached to this Memorandum.

2. Incorporation in the 1989/90 Import Policy Order of the objectives and policy undertakings in the trade liberalization area contained in the Policy Framework Paper and Policy Matrix, and in the Memorandum on Economic Policy in paragraph 24, as listed in Table 4 attached to this Memorandum.

3. Implementation of financial sector reform measures and other policy undertakings, as listed in Table 4 attached to the Memorandum on Economic Policy.

4. Implementation of the flexible exchange rate management policy described in paragraph 23 of the Memorandum on Economic Policy.

5. Completion of technical assistance work on the consolidation of the financial position of the major nonfinancial public enterprises and reclassification in general government budget by April 1989.

6. Completion of technical assistance work on reporting procedures for monetary accounts by April 1989.

7. Completion of technical assistance on the action program for the implementation of the General Sales Tax by March 1989.

Sources: Memorandum on Economic Policy of the Pakistan Government, EBS/88/232, and Table 6.

This weakening policy stance has been concentrated in public finance, where growing fiscal deficits have necessitated increasing recourse by the Government to external financing, domestic nonbank financing, and domestic bank credit; it has also been reflected in an accommodative stance of credit to the private sector. These expansionary financial policies have contributed to strong growth of domestic demand and relatively low gross domestic savings and investment rates.

Notwithstanding the solid growth performance of recent years, the underlying weaknesses in the structure of the balance of payments have persisted even though there were temporary declines in the external current account deficit at times of strong growth in cotton-based exports and lower world prices for major import commodities. Current earnings have remained heavily dependent on agricultural and cotton-based manufactured exports and on workers' remittance inflows which have been on a declining trend; the performance of nontraditional exports has generally remained weak, reflecting in part the maintenance of extensive trade controls. In order to stem the drain on gross official reserves, the authorities have increased external borrowing substantially, with the result that total external debt and debt service payments have risen rapidly to uncomfortable levels.

In 1987/88 these protracted balance of payments difficulties were exacerbated when workers' remittances fell further, largely owing to developments in oil exporting countries and confidence effects, while import growth accelerated sharply under the expansionary stance of financial policies. Despite buoyant exports, substantially increased aid inflows and additional short-term borrowing, gross official reserves fell sharply while the net short-term external liabilities of the domestic banking system continued to increase. Persistence of these balance of payments difficulties has complicated the task of economic management, and has left the country vulnerable to shifts in confidence and shortfalls in export receipts. In addition, the present level of reserves does not provide the safety margin required to support continued import liberalization.

The authorities have recognized for some time that the domestic and external financial trends of recent years were not sustainable, and that an early restoration of domestic financial stability, supported by structural reforms, was needed in order to assure balance of payments viability while sustaining economic development over the medium term. Maintenance of strong growth performance is an important objective in order to absorb the growing labor force. Introduction of a comprehensive program of adjustment measures with the 1988/89 budget represents an important initial phase of such an effort.

The program to which the authorities have committed themselves for the next several years is properly set in a medium-term framework. It includes measures of a structural nature--tax and tariff reform, pricing flexibility, trade liberalization--that adequately address the long-standing weaknesses of the economy, and will improve efficiency. It also emphasizes demand restraint that will help contain inflation and improve the balance of payments. In the view of the staff, this integrated program will serve to enhance incentives for increased savings, productive investment, and export diversification, especially by the private sector.

Fiscal adjustment and reform is a key element of the program. The reduction in the fiscal deficit over the medium term, half of which is to come in the first year, is appropriate not only in terms of magnitude but also because it is expected to come largely from revenue measures that will augment the yield and elasticity of both direct and indirect taxes, mainly by expanding the tax base. Firm expenditure restraint is also regarded as crucial for achieving the targeted fiscal deficit reduction, not only in 1988/89 but also over the medium term. The staff welcomes the authorities' commitment to ensuring firm restraint of expenditure at both the federal and provincial levels. In this context, the authorities are urged to continue reviewing their expenditure program in order to economize on less productive spending, to develop a comprehensive policy toward growth of the public sector wage and salary bill, and to continue to strengthen expenditure monitoring and control.

Structural reform of the tax system is important to maintain the momentum of deficit reduction after 1988/89, and to improve the elasticity of public sector revenues in the long run. The measures proposed under the program represent a meaningful move toward broadening the tax base and increasing the elasticity of the system, since they raise the contribution of income taxes to the revenue effort and rationalize the indirect tax system while expanding its coverage. To ensure achievement of these goals in the direct tax field, the structural measures taken in 1988/89 to improve audit procedures and to eliminate immunities and exemptions must be forcefully administered. The staff remains concerned that the four-year income tax holiday for newly established firms--as well as the customs duty exemptions--that were granted in connection with the expanded list of "key industries" may detract from the improved elasticity of tax revenue resulting from other measures. It therefore urges the authorities to take appropriate administrative steps to minimize the scope of this measure. While the staff is aware that agricultural income taxation is not in the federal domain, it urges the authorities to take whatever steps are feasible to extend income taxation to this sector.

As regards the indirect tax system, the staff welcomes the authorities' commitment to introduce a General Sales Tax by July 1, 1990. This tax promises to yield a durable improvement in the equity and elasticity of Pakistan's tax system and will eventually contribute to a reduction in the country's dependence on taxation of international trade. It will also facilitate the intended restructuring of import tariffs, a further lowering of the maximum tariff rate, and other efforts at import liberalization. The measures introduced this year to increase revenues from the sales tax on domestically produced goods, while substantial, were somewhat deficient in structural content. In this regard, the staff would have preferred that more forceful action to broaden the sales tax base on domestically produced goods had been implemented with the current year's budget, and urges the authorities to strengthen their efforts in this area considerably with the 1989/90 budget. Moreover, in order to maintain the pace of fiscal adjustment, the staff also urges the authorities to adhere strictly to the established timetable for implementation of the General Sales Tax.

Experience during the first quarter of 1988/89 suggests that fiscal management may prove to be difficult in the current year, particularly given the tightness of the limits on expenditure. In this regard, the readiness that the authorities have shown to adopt new fiscal actions promptly in light of developments during the first part of this fiscal year is commendable evidence of their commitment to the program. The staff would strongly encourage the authorities to continue to adopt new actions promptly when necessary, in order to ensure full achievement of the targeted adjustment effort and to ensure that a firm basis for fiscal reform is established. In this context, the staff would urge the authorities to adhere firmly to their stated intention to avoid any supplementary expenditure allocations in excess of the very small remaining margin for 1988/89.

The 1988/89 Import Policy Order has initiated a major liberalization of the import system that is programmed to continue over the medium term. The initial stage of trade liberalization emphasizes the shift from nontariff to tariff protection. Moreover, the reduction of the maximum tariff rate and rationalization of many individual rates have improved the tariff structure. The further shortening of the negative list, the establishment of a single and considerably simplified restricted list, and the increases in the value ceilings on imports of machinery and millwork against cash licenses and of imports by actual users are welcome steps toward a comprehensive simplification and liberalization of the import system. The authorities' commitment to reinforce their efforts in this direction over 1989/90-1990/91 is welcome. The staff would encourage the authorities to move rapidly in all these areas during the remaining period of the program.

A crucial supporting element of the adjustment and structural reform program is restraint of domestic credit while ensuring that adequate financial resources are available to the private sector. Firm adherence to the established credit ceilings will be needed, together with maintenance of adequate real rates of return on financial assets, in order to reduce price and balance of payments pressures and ensure that credit is being used efficiently. The intended reform of the financial system, including efforts to promote the capital market and to strengthen the financial position of domestic bank and other financial institutions, will also be an important element in increasing the rate of financial savings and the efficiency of financial intermediation over the medium term.

The staff welcomes the authorities' continuing commitment to implementing flexible exchange rate management, as evidenced by recent actions. Maintenance of a realistic exchange rate level, together with further reductions in the anti-export bias of the trade system and removal of domestic cost and price distortions, should facilitate implementation of the authorities' export-oriented growth strategy, and will help to strengthen the balance of payments. At the same time, it is important to maintain cautious foreign borrowing policies in order to avoid an increase in the external debt servicing ratio from the sustainable level that is projected to be achieved at the end of the program.

Pakistan maintains a number of exchange restrictions in accordance with Article XIV. In addition, Pakistan also maintains some restrictions which are subject to approval of the Fund under Article VIII, including a number of bilateral payments arrangements with member countries, which involve exchange restrictions, and two restrictions that give rise to multiple currency practices: the spread between the exchange rate in the official exchange market and that implicit in Foreign Exchange Bearer Certificates (FEBCs), and the mandatory import deposits against letters of credit. The staff recognizes that trading in FEBCs has resulted in a significant de facto liberalization of the exchange system, and welcomes the reduction in the implicit spread against the official exchange rate in recent months. However, it does not recommend Executive Board approval of the multiple currency practice associated with the spread between the official exchange rate and that on FEBCs or of the bilateral payments agreements, since the authorities have not agreed to a timetable for their elimination. As for the multiple currency practice that arises from the mandatory minimum margin requirements for opening letters of credit, the staff recommends that the Executive Board grant temporary approval in light of the authorities' intention to eliminate them by July 1, 1990.

Despite strong performance of total export value in most recent years, the balance of payments situation remains difficult. Pakistan is heavily dependent on external assistance, the debt service ratio is at a relatively high level, gross external reserves are very low, and net external reserve levels are negative. Consistent with its overall growth objectives, the program targets a reduction in the ratio of the external current account deficit to GNP from 4 percent in 1987/88 to 2.5 percent by 1990/91, a reduction in the external debt service ratio from over 30 percent to 25 percent, and an increase in gross official reserves from a level equal to three weeks' imports to a level of about seven weeks. After the program period, the external current account deficit ratio is projected to remain at around 2-2.5 percent of GNP, the debt service ratio to decline further by a modest margin, and reserves to rise by a similarly modest margin. Pakistan will continue to depend heavily on external support and on concessional terms. Moreover, the programmed increase in gross official reserves would still provide only a moderate cushion for further liberalization of the trade system, particularly in the light of the uncertainties that confront several components of Pakistan's balance of payments. Most of the programmed reserve increase will also reflect purchases from the Fund under the proposed stand-by and SAF arrangements.

The projected improvement in the balance of payments, debt and reserve position during the program period and beyond is expected to enable Pakistan to continue to service its obligations to the Fund on a timely basis. Assuming full use is made of the Fund's resources under the proposed arrangements, outstanding Fund credit to Pakistan will be 128 percent of quota (as compared to over 240 percent at the end of the extended arrangement in November 1983) and the share of debt service to the Fund will be 6.5 percent of total debt service over the next nine years. Pakistan has a satisfactory record of program implementation, and has settled its obligations to the Fund on time.

The staff is of the view that the strong and comprehensive measures already adopted and those that the authorities intend to implement over 1989/90-1990/91 deserve Fund assistance in the forms of a stand-by arrangement and the structural adjustment facility. At the same time, careful monitoring is needed on a continuous basis so that any slippages in the adjustment are promptly corrected. In pursuance of these objectives, the first review of the program is scheduled to take place at end-February 1989 and to be completed by May 15, 1989.

It is expected that the next consultation discussions will take place on the standard 12-month cycle.

## VI. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

### 1988 Consultation

1. The Fund takes this decision relating to Pakistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1988 Article XIV consultation with Pakistan, in the light of the 1988 Article IV consultation with Pakistan conducted under Decision No. 5392-(77-63), adopted April 29, 1977 as amended (Surveillance over Exchange Rate Policies).

2. Pakistan maintains a number of restrictions on payments and transfers for current international transactions. These are maintained under the transitional arrangements of Article XIV with the exception of bilateral payments agreements with Fund members, mandatory minimum margin requirements for opening import letters of credit which give rise to a multiple currency practice, and the system of Foreign Exchange Bearer Certificates which also gives rise to a multiple currency practice. In light of the authorities' intention to eliminate by July 1, 1990 the mandatory minimum margin requirements for opening import letters of credit, the Fund grants approval for the retention of this multiple currency practice until December 31, 1989 or the completion of the next Article IV consultation with Pakistan, whichever is the earlier.

Stand-By Arrangement

1. The Government of Pakistan has requested a stand-by arrangement for a period of 15 months from December , 1988 for an amount equivalent to SDR 273.15 million.

2. The Fund approves the arrangement set forth in EBS/88/250.

Structural Adjustment Facility
Three-Year and First Annual Arrangements

1. The Government of Pakistan has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the structural adjustment facility.

2. The Fund notes the Policy Framework Paper for Pakistan set forth in EBD/88/331.

3. The Fund approves the arrangement set forth in EBS/88/250.

Table 8. Pakistan: Summary of Public Finances, 1983/84-1990/91

| | Actuals | | | | Approved Budget Estimates | Prov. Actuals | Program Projections | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1983/84 | 1984/85 | 1985/86 | 1986/87 | 1987/88 | 1987/88 | 1988/89 | 1989/90 | 1990/91 |
| | (In billions of rupees) | | | | | | | | |
| Revenue | 72.3 | 77.4 | 89.9 | 103.9 | 114.6 | 118.3 | 139.8 | 166.8 | 192.2 |
| Tax | 58.2 | 61.2 | 72.4 | 83.0 | 89.1 | 93.0 | 110.7 | 135.0 | 157.7 |
| Nontax | 14.0 | 16.2 | 17.5 | 20.9 | 25.5 | 25.3 | 29.1 | 31.8 | 34.5 |
| Surplus of autonomous bodies | 2.6 | 2.6 | 2.9 | 1.8 | 5.2 | 2.7 | 7.0 | 8.1 | 9.1 |
| Total expenditure and net lending | 100.0 | 116.8 | 134.5 | 152.4 | 172.7 | 179.6 | 198.5 | 224.1 | 249.6 |
| Expenditure | 100.0 | 116.8 | 134.5 | 152.4 | 172.7 | 179.9 | 196.5 | 221.8 | 247.1 |
| Current | 74.4 | 85.3 | 97.1 | 117.4 | 126.2 | 131.7 | 145.9 | 159.3 | 176.8 |
| Of which: subsidies | (7.7) | (9.5) | (8.1) | (6.9) | (10.0) | (9.1) | (8.2) | (7.4) | (6.6) |
| Development | 25.6 | 31.5 | 37.4 | 35.0 | 46.5 | 48.2 | 50.6 | 62.5 | 70.3 |
| Net lending and equity participation | -- | -- | -- | -- | -- | -0.3 | -- | -- | -- |
| Supplementary allocation | -- | -- | -- | -- | -- | -- | 2.0 | 2.3 | 2.5 |
| Overall fiscal deficit 1/ | -25.1 | -36.8 | -41.7 | -46.7 | -52.9 | -58.6 | -51.7 | -49.2 | -48.3 |
| Financing | 25.1 | 36.8 | 41.7 | 46.7 | 52.9 | 58.6 | 51.7 | 49.2 | 48.3 |
| External (net) | 5.0 | 5.2 | 11.0 | 9.5 | 13.5 | 13.2 | 15.3 | 17.1 | 19.1 |
| Domestic (net) | 20.1 | 31.6 | 30.7 | 37.2 | 39.4 | 45.4 | 36.4 | 32.1 | 29.2 |
| Banking system | 9.3 | 19.4 | 5.8 | 11.4 | 7.7 | 13.9 | 8.0 | 4.0 | -- |
| Nonbank | 10.8 | 12.2 | 24.9 | 25.8 | 31.7 | 31.5 | 28.4 | 28.1 | 29.2 |
| Memorandum items: | | | | | | | | | |
| Commodity bank financing | -1.3 | -0.7 | 3.7 | -0.2 | -2.8 | 5.0 | 2.0 | 2.0 | 2.0 |
| GDP (at current market prices) | 421.2 | 482.1 | 547.1 | 608.1 | 685.9 | 685.9 | 793.7 | 896.0 | 1,006.7 |
| | (In percent of GDP) | | | | | | | | |
| Total tax and nontax revenue | 17.2 | 16.1 | 16.4 | 17.1 | 16.7 | 17.2 | 17.6 | 18.6 | 19.1 |
| Surplus of autonomous bodies | 0.6 | 0.5 | 0.5 | 0.3 | 0.8 | 0.4 | 0.9 | 0.9 | 0.9 |
| Total expenditure and net lending | 23.7 | 24.2 | 24.6 | 25.1 | 25.2 | 26.2 | 25.0 | 25.0 | 24.8 |
| Current expenditure | 17.7 | 17.7 | 17.8 | 19.3 | 18.4 | 19.2 | 18.6 | 18.0 | 17.8 |
| Development expenditure | 6.1 | 6.5 | 6.8 | 5.8 | 6.8 | 7.0 | 6.4 | 7.0 | 7.0 |
| Overall fiscal deficit | -6.0 | -7.6 | -7.6 | -7.7 | -7.7 | -8.5 | -6.5 | -5.5 | -4.8 |
| External financing | 1.2 | 1.1 | 2.0 | 1.6 | 2.0 | 1.9 | 1.9 | 1.9 | 1.9 |
| Domestic nonbank financing | 2.6 | 2.5 | 4.5 | 4.2 | 4.6 | 4.6 | 3.6 | 3.1 | 2.9 |
| Domestic bank financing | 1.9 | 3.9 | 1.7 | 1.8 | 0.7 | 2.8 | 1.3 | 0.7 | 0.3 |
| Of which: budgetary support | (2.2) | (4.0) | (1.1) | (1.9) | (1.1) | (2.0) | (1.0) | (0.5) | (--) |

Sources: Ministry of Finance and Economic Affairs; and program projections.

1/ That is of the federal and provincial governments (including railways, post office, telephone and telegraph) and four autonomous bodies (the Water and Power Development Authority (WAPDA), the Oil and Gas Development Corporation (OGDC), the National Fertilizer Corporation of Pakistan (NFCP), and the Pakistan Television Corporation (PTVC)).

Table 9. Pakistan: Factors Affecting Changes in Money and Quasi-Money, 1984/85-1989/90 1/

| | Actuals 1984/85 | Actuals 1985/86 | Adj. 2/ 1985/86 | Actuals 1986/87 | Prov. Actuals 1987/88 | Adj. 2/ 1987/88 | Program Projections 1988/89 | 1989/90 |
|---|---|---|---|---|---|---|---|---|
| | (In billions of Pakistan rupees) | | | | | | | |
| Money and quasi-money | 20.6 | 27.2 | 27.2 | 28.9 | 29.4 | 29.4 | 32.0 | 31.9 |
| Foreign assets (net) 3/ | -15.8 | -0.1 | -0.1 | 3.7 | -2.1 | -2.1 | 1.6 4/ | 2.2 4/ |
| Domestic assets (net) | 36.4 | 27.3 | 27.3 | 25.2 | 31.5 | 31.5 | 30.4 | 29.7 |
| Claims on Government (net) | 18.3 | -2.4 | 8.6 | 10.6 | 29.5 | 18.5 | 9.5 | 5.5 |
| Budgetary support 5/ | (18.7) | (6.1) | (6.1) | (11.5) | (24.4) | (13.4) | (8.0) | (4.0) |
| Commodity operations | (-0.7) | (-7.3) | (3.7) | (-0.2) | (5.0) | (5.0) | (2.0) | (2.0) |
| Government deposits with scheduled banks | (0.7) | (-0.3) | (-0.3) | (-0.1) | (0.5) | (0.5) | (--) | (--) |
| Zakat Fund deposits at SBP | (-0.4) | (-0.8) | (-0.8) | (-0.5) | (-0.5) | (-0.5) | (-0.5) | (-0.6) |
| Claims of nongovernment sectors | 17.8 | 33.9 | 22.9 | 22.0 | 12.0 | 23.0 | 22.9 | 26.4 |
| Claims on private sector | (13.9) | (30.4) | (19.4) | (21.3) | (10.8) | (21.8) | (20.9) | (24.4) |
| Scheduled banks | [11.8] | [27.9] | [16.9] | [18.2] | [8.7] | [19.7] | [...] | [...] |
| SBP credit to nonbank financial institutions (NBFIs) | [2.1] | [2.5] | [2.5] | [3.1] | [2.1] | [2.1] | [...] | [...] |
| Claims on public sector enterprises | (3.9) | (3.6) | (3.6) | (0.8) | (1.2) | (1.2) | (2.0) | (2.0) |
| Counterpart funds | 0.1 | 0.4 | 0.4 | 0.3 | 0.7 | 0.7 | -- | -- |
| Valuation adjustment | -1.7 2/ | -2.0 | -2.0 | -5.1 | -2.0 | -2.0 | -- | -- |
| Other items (net) (increase -) | 2.0 | -2.6 | -2.6 | -2.6 | -8.6 | -8.6 | -2.0 | -2.2 |
| | (Changes in percent) | | | | | | | |
| Money and quasi-money | 12.6 | 14.8 | 14.8 | 13.7 | 12.3 | 12.3 | 11.9 | 10.6 |
| Domestic assets (net) | 23.9 | 14.8 | 14.8 | 13.3 | 13.0 | 13.0 | 10.4 | 9.2 |
| Claims on Government (net) | 23.2 | -2.4 | 8.9 | 11.2 | 28.0 | 17.5 | 7.0 | 3.8 |
| Of which: budgetary support (net) 6/ | (29.5) | (6.8) | (6.8) | (12.5) | (24.3) | (13.6) | (6.3) | (3.0) |
| Claims on nongovernment sectors | 16.8 | 27.5 | 18.6 | 14.0 | 6.7 | 12.8 | 12.0 | 12.3 |
| Claims on private sector | 17.8 | 32.9 | 21.0 | 17.3 | 7.5 | 17.3 | 13.5 | 13.9 |
| Scheduled banks | 17.3 | 34.7 | 21.0 | 16.8 | 7.1 | 16.2 | ... | ... |
| SBP credit to NBFIs | 21.3 | 20.9 | 20.9 | 21.3 | 12.0 | 12.0 | ... | ... |
| Claims on public sector enterprises | 14.1 | 11.5 | 11.5 | 2.2 | 3.4 | 3.4 | 5.4 | 5.2 |
| Memorandum item: | | | | | | | | |
| GDP (at current market prices) | 14.4 | 13.5 | 13.5 | 11.2 | 12.8 | 12.8 | 15.7 | 13.4 |
| | (In billions of Pakistan rupees) | | | | | | | |
| Net domestic assets for program purposes 7/ | -- | -- | -- | -- | -- | -- | 30.9 | 30.2 |
| Net bank credit to the Government for budgetary support for program purposes 8/ | -- | -- | -- | -- | -- | -- | 8.0 | 4.0 |
| Bank credit for commodity operations for program purposes | -- | -- | -- | -- | -- | -- | 2.0 | 2.0 |

Sources: State Bank of Pakistan; and program projections.

1/ Data are on a fiscal year basis ending June 30.

2/ Adjusted data and percentage changes for 1985/86 (actuals) and for 1987/88 (provisional actuals) exclude the effect of the PRs 11 billion of scheduled bank financing of Special National Fund Bonds (SNFBs) issued in August-September 1985 and redeemed in August-September 1987.

3/ Excludes valuation changes, which are shown separately under domestic assets (net).

4/ Net foreign assets have been computed using the exchange rates prevailing at the end of June 1988 as reported in IMF, International Financial Statistics, and the PR/SDR rate used by IMF Treasurer's Department as regards transactions with the Fund.

5/ Net of government deposits at State Bank of Pakistan (SBP) only.

6/ Net of government deposits at both the SBP and the scheduled (or commercial) banks.

7/ Excludes Zakat funds deposited at SBP but includes other items (net) of the banking system.

8/ Excludes Zakat funds deposited at SBP; and net of government deposits at both the SBP and the scheduled (or commercial) banks, both of which are assumed to be zero in 1988/89 as well as in 1989/90.

Table 10. Pakistan: External Debt Service Payments, 1984/85-1996/97 1/

| | Actuals | | | Prov. Actuals | Program Projections | | | Staff Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1984/85 | 1985/86 | 1986/87 | 1987/88 | 1988/89 | 1989/90 | 1990/91 | 1991/92 | 1992/93 | 1993/94 | 1994/95 | 1995/96 | 1996/97 |
| | (In millions of U.S. dollars) | | | | | | | | | | | | |
| Total external debt service | | | | | | | | | | | | | |
| Including use of Fund credit | 1,381 | 1,856 | 2,176 | 2,304 | 2,341 | 2,404 | 2,284 | 2,413 | 2,619 | 2,770 | 2,833 | 2,907 | 3,011 |
| Amortization | 754 | 1,151 | 1,414 | 1,417 | 1,400 | 1,354 | 1,211 | 1,283 | 1,440 | 1,523 | 1,495 | 1,518 | 1,532 |
| Interest | 627 | 705 | 762 | 887 | 941 | 1,050 | 1,073 | 1,130 | 1,179 | 1,247 | 1,338 | 1,389 | 1,479 |
| Medium- and long-term debt 2/ | 1,104 | 1,379 | 1,610 | 1,746 | 1,872 | 1,972 | 1,923 | 2,047 | 2,201 | 2,406 | 2,541 | 2,609 | 2,704 |
| Principal | (672) | (901) | (1,056) | (1,095) | (1,176) | (1,189) | (1,098) | (1,162) | (1,256) | (1,380) | (1,419) | (1,436) | (1,442) |
| Interest | (432) | (478) | (554) | (651) | (696) | (783) | (825) | (885) | (945) | (1,026) | (1,122) | (1,173) | (1,262) |
| Use of Fund credit 3/ | 216 | 372 | 451 | 401 | 290 | 240 | 167 | 165 | 216 | 162 | 90 | 94 | 104 |
| Repurchases | (82) | (250) | (358) | (322) | (224) | (164) | (113) | (121) | (184) | (142) | (76) | (81) | (91) |
| Charges | (134) | (122) | (93) | (79) | (66) | (76) | (54) | (44) | (32) | (20) | (14) | (13) | (13) |
| Short-term debt interest 4/ | 61 | 105 | 115 | 157 | 179 | 192 | 194 | 201 | 202 | 202 | 202 | 204 | 203 |
| Excluding use of Fund credit 2/ | 1,165 | 1,484 | 1,725 | 1,903 | 2,052 | 2,164 | 2,117 | 2,248 | 2,403 | 2,608 | 2,743 | 2,813 | 2,907 |
| | (In percent of current account receipts) | | | | | | | | | | | | |
| Total debt service ratios | | | | | | | | | | | | | |
| Including use of Fund credit | 22.7 | 27.5 | 30.7 | 30.4 | 29.0 | 27.5 | 24.1 | 23.9 | 24.5 | 24.5 | 23.6 | 22.7 | 22.1 |
| Excluding use of Fund credit | 19.1 | 22.0 | 24.3 | 25.1 | 25.4 | 24.8 | 22.4 | 22.3 | 22.5 | 23.0 | 22.8 | 22.0 | 21.4 |
| Memorandum items: | | | | | | | | | | | | | |
| Current account receipts | | | | | | | | | | | | | |
| In millions of U.S. dollars | 6,086 | 6,738 | 7,083 | 7,578 | 8,077 | 8,735 | 9,460 | 10,091 | 10,675 | 11,320 | 12,024 | 12,788 | 13,607 |
| Total external debt 5/ | | | | | | | | | | | | | |
| In millions of U.S. dollars | ... | ... | 17,468 | 18,363 | 19,450 | 20,393 | 21,066 | 21,616 | 21,915 | 22,855 | 23,748 | 24,711 | 25,837 |
| As a percent of GNP | ... | ... | 46.4 | 44.6 | 45.5 | 47.7 | 43.9 | 41.9 | 39.8 | 38.1 | 37.1 | 35.5 | 34.0 |

Sources: State Bank of Pakistan; Ministry of Finance and Economic Affairs; IMF Treasurer's Department; program projections; and staff estimates and projections.

1/ The external debt service projections are based on the assumption of a 15-month stand-by arrangement, as well as a SAF arrangement, both starting in the last quarter of 1988.
2/ Includes Trust Fund interest and principal payments.
3/ Includes interest and repayments on new Fund purchases, beginning in the last quarter of 1988.
4/ Includes estimates of interest on domestic bank monetary liabilities and foreign currency deposits, as well as Foreign Exchange Bearer Certificates.
5/ Civilian and estimated military debt.

## Pakistan - Fund Relations

(As of end-November 1988)

I. a. Date of membership — July 1950

b. Status — Article XIV

### A. Financial Relations

II. General Department (General Resources Account)

| | | SDR Millions | Percent of Quota |
|---|---|---|---|
| a. | Quota | 546.3 | |
| b. | Total Fund holdings of rupees | 943.2 | 172.7 |
| c. | Fund credit | 396.9 | 72.7 |
| | Credit tranches | -- | -- |
| | Extended Fund facility | 316.0 | 57.8 |
| | Supplementary Fund facility | 80.9 | 14.8 |
| | Compensatory financing facility | -- | -- |
| d. | Reserve tranche position | 0.1 | -- |

III. Use of Fund Resources

a. Previous stand-by and extended arrangements

(1) 1980/81-1982/83 extended arrangement

(i) Duration: three years beginning November 1980
(ii) Amount: SDR 1,268 million
(iii) Utilization: SDR 1,079 million (85 percent)

(2) 1977/78 stand-by arrangement

(i) Duration: one year beginning March 1977
(ii) Amount: SDR 80 million
(iii) Utilization: 100 percent

b. Special facilities

(1) Compensatory financing facility

(i) Approved: August 2, 1982
(ii) SDR 180 million

c. Reserve tranche

(i) Fully drawn on July 25-26, 1985
(ii) Amount: SDR 88.57 million
(iii) Utilization: 100 percent

IV. SDR Department

a. Net cumulative allocation: SDR 170 million

b. Holdings: SDR 9.2 million, or 5.4 percent of net cumulative allocations

V. Administered Accounts

a. Trust Fund

(i) Disbursed: SDR 229.65 million
(ii) Outstanding: SDR 41.43 million

b. SFF Subsidy Account

Payments by the Fund: SDR 74.03 million

VI. Financial Obligations Due to the Fund as of November 28, 1988

| | Total Principal Outstanding Nov. 28,1988 | Overdue Financial Obligations Nov. 28,1988 | Principal and Interest Due | | | |
|---|---|---|---|---|---|---|
| | | | Nov. 28, 1988- Dec. 31, 1988 | Jan. 1, 1989- Dec. 31, 1989 | Jan. 1, 1990- Dec. 31, 1990 | Jan. 1, 1991- Dec. 31, 1991 |
| | (In millions of SDRs) | | | | | |
| Principal | | | | | | |
| Repurchases | 417.79 | — | 47.77 | 143.14 | 108.14 | 71.66 |
| Trust Fund repayments | 41.42 | — | — | 26.27 | 14.26 | 0.89 |
| Charges and interest, including SDR and Trust Fund (provisional) | | — | 0.11 | 34.24 | 22.91 | 15.64 |
| Total | 459.21 | — | 47.88 | 203.66 | 145.31 | 88.19 |

## B. Nonfinancial Relations

### VIII. Exchange System

With effect from January 8, 1982, the rupee ceased to be pegged to the U.S. dollar, and Pakistan introduced a managed floating exchange rate system based on currency baskets, with the U.S. dollar continuing to be the intervention currency. As of December 1, 1988 the Central Bank's buying exchange rate was PRs 18.7 per U.S. dollar. Pakistan maintains restrictions on payments and transfers for current international transactions.

### IX. Last Article IV Consultation

The last Article IV consultation discussions were held in Islamabad during February 1-12 and April 27-May 3, 1987. The staff report (SM/87/137 and Sup. 1) was discussed by the Executive Board on August 3, 1987 (SUR/87/78). The Executive Board's decision [Decision No. 8669-(87/116)], adopted on August 3, 1987 was as follows:

1. The Fund takes this decision relating to Pakistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1987 Article XIV consultation with Pakistan, in the light of the 1987 Article IV consultation with Pakistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 as amended (Surveillance over Exchange Rate Policies).

2. Pakistan maintains restrictions on payments and transfers for current international transactions, including those maintained under the transitional arrangements of Article XIV, as described in SM/87/152, and bilateral payments arrangements with four Fund members. The introduction of the Foreign Exchange Bearer certificates, while having the indirect effect of easing the restrictions on current payments, has given rise to a multiple currency practice. The Fund urges the authorities to eliminate the bilateral payments arrangements with Fund members and the multiple currency practice as soon as possible, and to take appropriate steps toward early removal of the remaining restrictions on the making of payments and transfers for current international transactions.

Pakistan is on the standard 12-month cycle.

### X. Technical Assistance

a. The Fiscal Affairs Department has provided technical assistance to the Government of Pakistan on reform of the indirect taxation system (April 1981).

b. The Bureau of Statistics has provided technical assistance to the State Bank of Pakistan on price index methodologies (July 1983) and on balance of payments statistics (December 1983 and August 1984).

c. The Bureau of Computing Services has provided technical assistance to the Ministry of Finance on the development of a computer-based data management system (March 1984).

Pakistan--Relations with the World Bank Group

The World Bank Group has been involved in most sectors of the Pakistan economy in recent years. Before 1982, the Group's financial assistance was mostly in the form of project lending. However, under the Structural Adjustment Loan (SAL I) of May 1982, the Bank Group also provided balance of payments financing to support structural reform policies at the time of the extended arrangement with the Fund (1980/81-1982/83).

The policy focus of SAL I (1982) included a number of institutional reforms, mostly in investment planning, agriculture, and energy. In planning, the Bank staff assisted in the reorientation of the development program toward the priority sectors of agriculture, irrigation, and energy and the reconciliation of investment spending plans with available financial resources. In the agricultural sector, the Bank helped establish the Agricultural Prices Commission in order to improve the quality, timing, and flexibility of pricing decisions. With regard to specific pricing policies, targets were established to eliminate gradually the subsidization of agricultural inputs in order to release domestic resources for the priority investment programs. This effort incorporated the target of eliminating budgetary fertilizer subsidies by mid-1985, and gradually increasing irrigation water charges in order that receipts from this source cover fully the costs of the operation and maintenance of the irrigation system by about the early 1990s.

In the energy sector, the Bank Group supported institutional and producer pricing reforms in order to accelerate the pace of exploration and development of energy resources. For petroleum, this included the initiative of linking producer prices for older fields to international equivalents, less a discount; these efforts continued subsequently so that by 1983/84 producer prices for all fields were broadly in line with international levels. With regard to natural gas production, the SAL assisted in developing an investment program and identifying the finance for Pakistan's largest gas field (Sui) and in establishing natural gas producer prices that made the investment program financially attractive. In the area of consumer energy prices, the Bank Group's objectives supported the efforts under the extended arrangement to bring domestic user prices for petroleum products generally into line with international equivalents, while for natural gas a program was worked out to move consumer prices to two thirds of the international equivalent by mid-1988.

The SAL reform effort in the industrial public enterprise sector included a program entailing a performance evaluation system for individual firms and financial incentives to reward efficient management. The phased implementation of this program was completed in 1983/84. An additional policy area targeted under the SAL was the reform of the tariff system. Here, the Bank provided financial assistance for a study of the tariff protection system which was to be used as the basis for a comprehensive tariff reform.

Since SAL I, the Bank Group's financial assistance has been channeled through project loans and three sector lending operations. Post-SAL lending commitments totaled some US$3.4 billion over the 1983/84-1987/88 period, of which 87 percent was in the form of project lending and the balance in the form of energy, export development, and agricultural sector loans. 1/ Among the project loans carrying policy objectives were an Industrial Investment Loan and Credit (1984 and 1986), the Second and Third Small Industries Projects (1984 and 1987), the Fourth, Fifth and Seventh Water and Power Development Authority (WAPDA) Power (Transmission) Projects (1985 and 1987), the second Toot Oil and Gas Project (1984), the Petroleum Exploration Project (1984), the Petroleum Resources Joint Venture Loan (1985), the Telecommunications V Loan (1986), the Refinery Energy Conservation Loan (1987), the Punjab Primary Education Project (1987), and the Private Sector Energy Development Loan (1988).

The first two of these project loans were directed at supporting the policy of greater private sector involvement in industry through providing foreign exchange resources to individual firms via the domestic development finance institutions. The three WAPDA loans focused on a national power plan, expansion of generation capacity through new investments or improvements in the efficiency of existing plants, and improvements in self-financing of investments. The second Toot loan addressed producer pricing and self-financing of the public sector Oil and Gas Development Corporation. The Petroleum Exploration and the Petroleum Resources Joint Venture loans sought to promote greater investments through joint ventures with foreign private investors and addressed issues of oil and gas pricing. The Fifth Telecommunication loan would expand the domestic and international networks while providing additional resources through changes in rates. The Refinery Energy Conservation Project would support the formulation of an investment program for the petroleum products subsector and the rationalization of the structure of refinery prices. The Punjab Primary Education Project focuses on meeting primary education needs in rural areas and the needs of female students, in particular. The Private Sector Energy Development Project seeks to mobilize private sector resources in order to expand Pakistan's electric power-generating capacity.

The Energy Sector Loan (1985) had as its major policy objective the continuation of price and investment program rationalization in the energy sector. This included a continued emphasis on the target of raising domestic gas user prices to two thirds of the international equivalent by mid-1988 and a new policy objective for natural gas producer pricing. In this latter regard, a policy was introduced linking natural gas producer prices to two thirds of the international equivalents less a discount for all new concessions granted after

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1/ As of September 30, 1988, the Group's ongoing financial operations in Pakistan of US$4.8 billion (on a commitment basis) evidenced a broad sectoral distribution (see attached table).

September 1985. Moreover, a strengthening of electric power pricing policies was also included by directly linking electricity prices to self-financing of a quantified capital investment program. More specifically, in conjunction with the Fourth WAPDA loan, the Energy Sector Loan provided that electricity prices be adjusted so that self-financing by WAPDA would cover 40 percent of the specified investment level.

The Export Development Loan (1986) had as its major policy objective the continuation of the industrial and trade policy reforms of SAL I, including in particular an improvement in the export incentives framework and a resumption of efforts to liberalize the import regime. To this end, both direct and indirect exporters are to be put on a free-trade basis by having access to imported inputs at duty-free prices; the standard duty drawback rates are to be systematically updated and revised on a continuous basis in the future, and an "open-bonded manufacturing system" is to be introduced. Regarding import liberalization, the loan provided that no additions would be made to the list of banned imports for protective or balance of payments reasons and that a review of existing import bans would be undertaken with the objective of reducing the number of such bans in the 1987/88 Import Policy Order.

The Agricultural Sector Loan (1988) had as its major policy objective the continuation of the Government's previous efforts to establish a competitive framework for the agriculture sector, with a view to enhancing sustainable productivity and growth. To this end, specific measures will be implemented to enhance cost and subsidy reductions, to rationalize the investment programs in the agriculture and water sector, and to introduce institutional improvements. The major measures include in particular the phasing out of economic subsidies on phosphate and potash fertilizers within four and eight years, respectively. Other measures include the phasing out of all public tubewells in most fresh ground water areas, steps to improve the efficiency of existing assets in the agriculture and water sectors, and support services in agricultural research and extension.

For the remainder of the 1988/89 period, the focus of the Bank's project lending will be on the provision of credit for industrial development, private tubewell development, port modernization, gas transmission and distribution, and provision of adequate water and sewerage services in Karachi. The focus of sector lending will be on financial and energy sector adjustments within a satisfactory medium-term economic framework. Financial sector reforms will focus on the institution of market-oriented government debt management; deregulation of interest rates and subsidy reduction; improvements in bank supervision; bank restructuring; and increasing bank competition. Energy sector reforms will encompass adjustments to the level and structure of prices, institutional development, and definition of a core investment program.

Pakistan - Financial Relations with the World Bank Group--
Outstanding Stock of Loans and Credits as of September 30, 1988

(In millions of U.S. dollars)

| | IBRD | Third Window | IDA | Total |
|---|---|---|---|---|
| IBRD/IDA lending operations | | | | |
| 1. Fully disbursed operations 1/ | 911.5 | 39.0 | 1,408.4 | 2,358.9 |
| 2. Ongoing operations 2/ | 1,905.1 | -- | 1,221.6 | 3,126.7 |
| Agricultural | (406.6) | (--) | (641.9) | (1,048.5) |
| Education | (--) | (--) | (237.7) | (237.7) |
| Infrastructure | (152.0) | (--) | (201.0) | (353.0) |
| Industry | (488.0) | (--) | (102.0) | (590.0) |
| Population | (--) | (--) | (18.0) | (18.0) |
| Energy (including power and utilities) | (858.5) | (--) | (--) | (858.5) |
| Other 3/ | (--) | (--) | (21.0) | (21.0) |
| 3. Total (1 + 2) | 2,816.6 | 39.0 | 2,630.0 | 5,485.6 |
| 4. Repayments | 607.9 | -- | 81.1 | 689.0 |
| 5. Total now held by IBRD/IDA 4/ (3 - 4) | 2,208.7 | 39.0 | 2,548.9 | 4,796.6 |
| IFC investments 5/ | -- | -- | -- | 86.0 |
| Memorandum item: | | | | |
| Total IBRD/IDA undisbursed loans | 1,333.4 | 29.4 | 1,076.1 | 2,438.9 |

Source: World Bank.

1/ One hundred and ten loans and credits fully disbursed. Excludes the disbursed portion of loans and credits wholly or partly for projects in former East Pakistan which have now been taken over by Bangladesh. Also excludes amounts that have been cancelled.

2/ Includes three IBRD loans amounting to US$381.4 million and three IDA credits amounting to US$189.5 million equivalent that were approved by the Board but are not yet effective.

3/ Includes three technical assistance projects.

4/ Prior to exchange adjustments.

5/ As of September 30, 1988. Gross commitments (loan and equity) less cancellation, terminations, repayments, and sales held by IFC.

## Pakistan - Statistical Issues

### 1. National income accounts

Pakistan compiles full nominal and constant price national income data. The overall quality of the data is good. Nevertheless, a number of statistical deficiencies exist as regards available data on domestic savings, owing in part to methodological issues and to weaknesses in the price series that is used to deflate nominal investment in manufacturing. The authorities have initiated various projects in this area with a view to improving the statistical base for national accounts estimates. At present, the constant price national income accounts use 1959/60 prices. The authorities are in the process of rebasing the national income accounts to 1980/81.

### 2. Prices

While price data are generally good, there is a large administered price component in both the consumer and wholesale price indices, which may result in understatement of price movements. Revised series based on expenditure surveys for 1980/81 were introduced in 1986.

### 3. Government finance

The budgetary data that are presently used in consultation reports are a consolidation of the accounts of the federal and provincial governments and four autonomous bodies (the Water and Power Development Authority, the Oil and Gas Development Corporation, the National Fertilizer Corporation of Pakistan, and the Pakistan Television Corporation). Some of the data for budgetary receipts are provided only with expenditures netted against gross receipts. To the extent possible, the staff has adjusted such data to show gross receipts and expenditures separately. Owing to the lack of detailed data, however, such an adjustment has not been possible in a number of instances. Moreover, the available fiscal data have a number of classification problems, particularly as regards some of the expenditure items, net lending and equity participation, and nonbank borrowing items. The Pakistan authorities have also indicated their intention to remove from the present budget presentation some public sector entities and ministerial departments (e.g., Telephone and Telegraph Corporation). In line with this intention, they have decided to review the coverage and classification issues related to fiscal data, with a view to improving government finance data as well as the coverage and accuracy of data on the nonfinancial public sector. To this end, they have requested technical assistance from the Fund.

Annual data published in IFS cover consolidated central government operations through 1987, including provisional data for 1986 and projected data for 1987, as reported for publication in the 1987 Government Finance Statistics Yearbook (GFSY). Data published in the

1987 GFSY cover consolidated central government operations as described above, and state and local government operations through 1979. Data on general government operations have been derived through 1979. Central government detailed final data for 1986, revised provisional data for 1987, and preliminary data for 1988 have been received for publication in the 1988 GFSY, and are being processed.

Action is awaited on the Pakistan authorities' follow-up of the undertaking by Pakistan officials, following the 1987 Asian Seminar on Local Government Statistics, to obtain current statistics for four provinces and 12 municipal corporations, as well as projections of such data for one year ahead. It is believed that these steps would be highly beneficial.

4. Monetary accounts

Pakistan's monetary and credit data are broadly accurate. However, in 1983/84 a problem emerged with the treatment of the transactions of certain banks, which had the effect of overstating considerably the contractionary impact from the net unclassified liabilities of the banking system. The authorities have sought to correct for this accounting misclassification to the extent feasible. However, several aspects of the reporting procedures for the monetary accounts need to be improved. To this end, the Pakistan authorities have requested technical assistance from the Fund. Discrepancies that existed between the changes in the net foreign assets position of the banking system and the overall balance of payments position have been corrected, and these data are now comparable.

5. Balance of payments

The balance of payments data are good and the coverage is extensive. The authorities have recently made considerable progress in reconciling the capital account and external debt data. However, substantial improvements are needed in the quality of the export and import unit value and volume indices.

Pakistan does not presently report data on stocks of external assets and liabilities.

6. External debt

The coverage of civilian official foreign debt data is reasonably good. The present official data on debt stocks, however, evidence a number of shortcomings, particularly with regard to official short-term debt, guaranteed and nonguaranteed private debt, and military debt. There is also a need to improve the data on the maturity structure of official debt and debt service forecasts on a timely basis to reflect exchange rate and interest rate changes. These problems would suggest that the establishment of an External Debt Cell to centralize and compute the debt information could be of assistance in improving the quality of existing external debt and debt servicing data. Major progress has already been made in computerizing the public and publicly guranteed medium- and long-term external civilian debt within the Economic Affairs Division of the Ministry of Finance and Economic Affairs; steps are being actively considered to computerize the portion of Pakistan's civilian debt that is directly monitored by the State Bank of Pakistan. Consideration is also being given to the establishment of a unit that would coordinate the monitoring of short- and medium- and long-term civilian debts, including the debts directly monitored within the External Finance Division of the Ministry of Finance and Economic Affairs.

## Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Pakistan in the November 1988 issue of *IFS*. The data are based on reports sent to the Fund's Bureau of Statistics by the State Bank of Pakistan, which have been provided on a timely basis during the past year.

| | | Latest Data in November 1988 IFS |
|---|---|---|
| Real Sector | - National Accounts | 1987 |
| | - Prices: CPI and WPI | July 1988 |
| | - Production | Q4 1987 |
| | - Employment | n.a. |
| | - Earnings | n.a. |
| Government Finance | - Deficit/Surplus | 1987 |
| | - Financing | 1987 |
| | - Debt | 1986 |
| Monetary Accounts | - Monetary Authorities | June 1988 |
| | - Deposit Money Banks | June 1988 |
| | - Other Financial Institutions | June 1988 |
| Interest Rates | - Discount Rate | August 1988 |
| | - Bank Deposit/Lending Rates | n.a. 1/ |
| | - Bond Yield | August 1988 |
| External Sector | - Merchandise Trade: Values | July 1988 |
| | - Balance of Payments | Q4 1987 |
| | - International Reserves | September 1988 |
| | - Exchange Rates | September 1988 |

1/ The financial system was changed to an Islamic noninterest basis effective July 1, 1985.

Pakistan: Stand-By Arrangement

Attached hereto is a Letter of Intent ("Memorandum on Economic Policy of the Pakistan Government"), with attached Tables 1, 2, 3, and 4, dated November 15, 1988 from the Minister for Commerce, Finance and Planning and Development of Pakistan and the Governor of the State Bank of Pakistan, requesting a stand-by arrangement and setting forth the policies and objectives that the authorities of Pakistan intend to pursue for the period of this stand-by arrangement, and the understandings of Pakistan with the Fund regarding reviews that will be made of the progress in realizing the objectives of the program and of the policies and measures that the authorities of Pakistan will pursue for the period of this stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of 15 months from December __, 1988, Pakistan will have the right to make purchases from the Fund in an amount equivalent to SDR 273.15 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 142.04 million until February 28, 1989, the equivalent of SDR 168.26 million until May 15, 1989, the equivalent of SDR 194.48 million until August 31, 1989, the equivalent of SDR 220.70 million until November 15, 1989, the equivalent of SDR 246.92 million until February 28, 1990, and the equivalent of SDR 273.15 million until March __, 1990.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Pakistan's currency in the credit tranches beyond 25 percent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary resources.

4. Pakistan will not make purchases under this stand-by arrangement that would increase the Fund's holdings of its currency in the credit tranches beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the limit on net domestic assets of the banking system as described in paragraphs 19 and 29 of the attached Letter and specified in Table 1 annexed to that Letter, or

(ii) the limit on net credit to the Government for budgetary financing, as described in paragraphs 19 and 29 of the attached Letter and specified in Table 1 annexed to that Letter, or

(iii) the limit on bank credit for commodity operations, as described in paragraphs 19 and 29 of the attached Letter and specified in Table 1 annexed to that Letter, or

(iv) the limit on the outstanding stocks of public and publicly guaranteed short-term external debts (other than normal import-related credit, the external liabilities of the banking system and Foreign Exchange Bearer Certificates), with an initial maturity of up to and including one year specified in paragraphs 25 and 29 and in Table 2 annexed to the Letter, or

(v) the targets on outstanding stocks of all public and publicly guaranteed short-term external liabilities (other than import-related credit), including short-term external liabilities of the banking system and the outstanding stocks of FEBCs as described in paragraphs 25 and 29 of the attached Letter and specified in Table 2 attached to that Letter, or the minimum limits on net international reserves as described in paragraphs 23 and 29 of the attached Letter and specified in Table 3 annexed to that Letter, or

(vi) the limits on the contracting of new public and publicly guaranteed external debts, excluding military debts, with an initial maturity of more than one year and up to and including twelve years, and within these limits on the contracting of new public and publicly guaranteed external debts, excluding military debt, with an initial maturity of more than one year and up to and including five years, as described in paragraphs 25 and 29 of the attached Letter, and specified in Table 2 annexed to that Letter are not observed, or

(b) during any period after May 15, 1989 until the first review contemplated in paragraphs 29 and 33 of the attached Letter is completed and suitable performance criteria have been established for the remaining period of the arrangement after June 30, 1989, or after such performance criteria have been established, while they are not being observed; or

(c) during any period after November 15, 1989 until the second review contemplated in paragraphs 29 and 33 of the attached Letter is completed, or while any of the established performance criteria are not being observed; or

(d) if Pakistan:

(i) fails to implement the flexible exchange rate management in accordance with the provisions set out in paragraph 23 of the attached Letter, or

(ii) imposes new or intensifies existing restrictions on payments and transfers for current international transactions, or

(iii) introduces new or modifies existing multiple currency practices, or

(iv) concludes bilateral payments agreements, which are inconsistent with Article VIII, or

(v) imposes or intensifies import restrictions for balance of payments reasons.

When Pakistan is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Pakistan and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Pakistan will not make purchases under this stand-by arrangement during any period of the arrangement in which Pakistan has an overdue financial obligation to the Fund or is failing to meet a repurchase obligation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase.

6. Pakistan's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Pakistan. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Pakistan and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Pakistan, the Fund agrees to provide them at the time of the purchase.

8. Pakistan shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

9. (a) Pakistan shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Pakistan's balance of payments and reserve position improve.

(b) Any reductions in Pakistan's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

10. During the period of the stand-by arrangement, Pakistan shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Pakistan or of representatives of Pakistan to the Fund. Pakistan shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Pakistan in achieving the objectives and policies set forth in the attached Letter.

11. In accordance with paragraphs 32 and 33 of the attached Letter, Pakistan will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of this stand-by arrangement and while Pakistan has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Pakistan's balance of payments policies.

Pakistan--Structural Adjustment Facility:
Three-Year and First Annual Arrangements

Attached hereto is a letter, with an annexed Memorandum on Economic Policy of the Pakistan Government (see Attachment I), dated November 15, 1988, from the Minister for Commerce, Finance and Planning and Development, and the Governor of the State Bank of Pakistan, requesting from the International Monetary Fund a three-year structural adjustment arrangement and the first annual arrangement thereunder, and setting forth:

(i) the objectives and policies of the program to be supported by the three-year arrangement, and

(ii) the objectives and policies of the program to be supported by the first annual arrangement.

To support these objectives and policies, the Fund grants the requested arrangements in accordance with the following provisions and subject to the Regulations for the Administration of the Structural Adjustment Facility:

1. For a period of three years from December __, 1988, Pakistan will have the right to obtain three successive loans from the Fund under the Structural Adjustment Facility in a total amount equivalent to SDR 346.90 million.

2. The first loan, in an amount equivalent to SDR 109.26 million, is available for disbursement at the request of Pakistan.

3. The second and third loans will be available upon approval by the Fund of the corresponding annual arrangements and will be disbursed at the request of Pakistan. The amount of the second loan will be equivalent to SDR 163.89 million, and the amount of the third loan will be equivalent to SDR 73.75 million.

4. Before approving the second annual arrangement, the Fund will appraise the progress of Pakistan in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, taking into account primarily:

(a) the indicators in paragraphs 30 and 31 of the attached Letter ("Memorandum on Economic Policy of the Government of Pakistan"),

(b) imposition or intensification of restrictions on the making of payments and transfers for current international transactions,

(c) introduction or modification of multiple currency practices,

(d) conclusion of bilateral payments agreements, which are inconsistent with Article VIII,

(e) imposition or intensification of import restrictions for balance of payments reasons.

5. Pakistan will provide the Fund with such information as the Fund requests in connection with the progress of Pakistan in implementing the policies and reaching the objectives supported by the first annual arrangement.

6. In accordance with paragraphs 32 and 33 of the attached Letter, Pakistan will consult the Managing Director on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because he considers that consultation on the program is desirable. These consultations may include correspondence and visits of officials of the Fund to Pakistan or of representatives of Pakistan to the Fund.

Pakistan - Letter of Transmittal, Request for a Three-Year Arrangement, and the First Annual Arrangement Thereunder

November 15, 1988

Mr. Michel Camdessus
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus:

1. The annexed Policy Framework Paper* has been prepared in collaboration with the staffs of the Fund and the World Bank. It describes the major economic problems and challenges facing Pakistan; the objectives of a three-year medium-term program; the priorities and the broad thrust of macroeconomic and structural adjustment policies; and the likely external financing requirements, together with the available sources of such financing.

The Government of Pakistan will remain in close contact with the staffs of the Fund and the World Bank on developments and progress in implementing these policies, and the Policy Framework Paper will be updated annually as the program is implemented.

2. The annexed Policy Framework Paper sets out the objectives and policies that the Government of Pakistan intends to pursue for the three-year period 1988/89-1990/91 (beginning July 1, 1988) for which balance of payments assistance is needed. The specific objectives and policies for the first year (1988/89) of this period are set out in the Letter of Intent (or Memorandum on Economic Policy of the Government of Pakistan) dated November 15, 1988 for both a stand-by arrangement and first annual SAF program. In support of these objectives and policies, Pakistan hereby requests from the Fund a three-year structural adjustment arrangement in the amount that will be made available to Pakistan under the Fund's Structural Adjustment Facility, and the first annual arrangement thereunder.

3. Pakistan will provide the Fund with such information as the Fund may request in connection with the progress of Pakistan in implementing the policies and achieving the objectives of the program.

4. The Government believes that the policies set forth in the attached Policy Framework Paper and in the Letter of Intent (Memorandum on Economic Policy of the Government of Pakistan), sent separately, are

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* See EBD/88/331, November 15, 1988.

adequate to achieve the objectives of its program but will take any further measures that may become appropriate for this purpose. Pakistan will consult the Managing Director of the Fund on the adoption of any measures that may be appropriate, at the initiative of the Government of Pakistan or whenever the Managing Director requests such consultation.

5. To facilitate a wider distribution of the Policy Framework Paper within the donor community, the Government of Pakistan authorizes you, at your discretion, to transmit this paper to any international organization providing assistance to developing countries that requests it, for the exclusive use of that organization.

Sincerely yours,

(signed)
Dr. Mahbub ul Haq
Minister for Commerce, Finance
and Planning and Development

(signed)
Mr. I. A. Hanfi
Governor
State Bank of Pakistan

Annex: Policy Framework Paper