NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/185

10:00 a.m., December 28, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	Di W., Temporary
	A. Rieffel, Temporary
	J.-P. Schoder, Temporary
E. T. El Kogali	
	R. J. Lombardo
L. Filardo	M. A. Fernández Ordóñez
M. Finaish	
	P. Gorjestani, Temporary
	B. Goos
	E. Kiriwat
	S. P. Shrestha, Temporary
B. Jalan	
	J. E. Zeas, Temporary
M. Massé	
	A. R. Ismael, Temporary
	I. A. Al-Assaf
	M. Al-Jasser Temporary
	M. Fogelholm
H. Ploix	
G. A. Posthumus	
C. R. Rye	
	N. Adachi, Temporary
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

Also Present

IBRD: M. Cohen, Europe, Middle East and North Africa Regional Office. Asian Department: R. Hemming. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; M. Fisher, S. Kanesa-Thasan, N. Kirmani, B. C. Stuart. External Relations Department: A. F. Mohammed, Director; S. Nawaz. Fiscal Affairs Department: G. A. Mackenzie. Legal Department: T. M. C. Asser, A. O. Liuksila, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; Z. Iqbal, M. D. Knight, E. B. Maciejewski, P. van den Boogaerde. Research Department: N. Haque, M. S. Khan, I. Zaidi. Bureau of Statistics: K. W. Nahr, K. W. O'Connor. Advisors to Executive Directors: A. G. A. Faría, P. D. Péroz, G. Pineau, D. C. Templeman, A. Vasudevan, R. Wenzel. Assistants to Executive Directors: S. Chakrabarti, T. T. Do, S. K. Fayyad, J. Gold, P. Kapetanović, C. Y. Legg, W. K. Parmena.

1. PAKISTAN - 1988 ARTICLE IV CONSULTATION, STAND-BY ARRANGEMENT, AND STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1988 Article IV consultation with Pakistan and Pakistan's requests for a 15-month stand-by arrangement, in an amount equivalent to SDR 273.15 million, and for a three-year structural adjustment arrangement, in an amount equivalent to SDR 346.90 million, and the first annual arrangement thereunder (EBS/88/250, 12/7/88; and Sup. 1, 12/27/88), together with a memorandum on economic policy of the Pakistan Government (EBS/88/232, 11/15/88) and a policy framework paper (EBD/88/331, 11/15/88). They also had before them a background paper on recent economic developments in Pakistan (SM/88/273, 12/19/88; and Cor. 1, 12/21/88).

The Acting Managing Director made the following statement:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their December 19, 1988 discussion in Committee of the Whole of a paper entitled "Pakistan: Policy Framework Paper, 1988/89-1990/91."
>
> 1. The Executive Directors of the Bank and IDA discussed, in a meeting of the Committee of the Whole on December 19, 1988, the paper entitled "Pakistan: Policy Framework Paper, 1988/89-1990/91."
>
> 2. The staff confirmed that the economic program contained in the policy framework paper has the full support of the new Government of Prime Minister Benazir Bhutto. The Government is fully aware that a strengthened economy and the additional resources which would result from the implementation of the program are necessary to sustain the strong record of growth with equity. The program has been designed to correct the growing macro-imbalances and undertake comprehensive structural reforms in the areas of public finance, trade, and investment. The Executive Directors welcomed the commitment of the new Government to undertake the structural adjustment program and commented that it deserves support.
>
> 3. Directors noted that the adjustment program was a difficult and challenging one, with ambitious targets. Some Directors felt, on the other hand, that the pace of policy reform was too gradual. Directors agreed that the Government would have to be resolute in the program's implementation, if it is to be successful. Several Directors noted that reduction of the fiscal deficit and public finance are the priority areas of the program and agreed on the importance of tax reform to

broaden the tax base and generate additional revenues. Progressive liberalization of the trade regime was also considered to be a necessary part of the adjustment program.

4. It was noted that while the adjustment process will have social costs, the programs in health and education will have benefits for the poor and for improving the low levels of female health care and education. Although the program emphasizes resource mobilization, low-income groups will be protected.

5. Executive Directors commented on the importance of devoting greater attention to the social sectors and to human resource development. The rate of population growth in Pakistan is high, and the social indicators are generally low. They noted the Government's intention to give priority in its investment program to the social sectors and to the core investment program for essential infrastructure. Directors endorsed the priority of human resource development and emphasized the need for specific programs, including the creation of employment opportunities.

6. Noting the difficult balance of payments problem facing Pakistan, the Executive Directors underlined the importance of expanding exports. Progress in this field will depend on the energetic implementation of the financial policies and reforms included in the adjustment program, so that an appropriate framework and incentives may be established for expanding the export base.

7. The staff explained that the Bank's lending would support the structural changes being made through sector adjustment loans and that project financing would be directed at helping finance government programs in the social sectors, key infrastructure investment, and private sector investment in energy generation and industry.

8. It was noted that the Bank has taken and would continue to take a leadership role in helping mobilize and coordinate bilateral and multilateral assistance through its chairing of the international aid consortium for Pakistan, cofinancing efforts, and sector studies.

The Director of the Middle Eastern Department stated that since reaching agreement with the Pakistan authorities on a macroeconomic and structural reform program to be supported by the use of Fund resources, the staff and management had been in close and frequent contact with them. On December 8, 1988, the Government had presented a new budget, as called for by the Constitution, for fiscal year 1988/89, which had begun on July 1. On the basis of information provided by the authorities, the staff had confirmed that the recently approved budget was consistent with the agreed adjustment program. The budget contained only one revision to revenue measures, namely, a further increase of 1 percentage point in the import surcharge to 7 percent, which the authorities estimated would yield about PRs 600 million for the remainder of the fiscal year.

The authorities had also stated that there were no new expenditure measures in the budget, the Director noted. The authorities had revised fiscal projections for the current fiscal year to an overall deficit somewhat below the programmed target of 6.5 percent of GDP. A preliminary assessment by the staff indicated that the fiscal outturn for the year could be marginally higher than that target, but a full reassessment of the likely fiscal outturn would be made in the context of the first program review in late February/early March 1989.

Mr. Finaish made the following statement:

Pakistan's economy has performed remarkably well during most of the 1980s, with real GDP expanding at an average annual rate of more than 7 percent in the period 1980/81-1986/87, and inflation declining steadily to less than 4 percent by 1986/87. This performance, which occurred despite an unsettled regional situation and the presence of more than 3 million refugees in the country, as well as a generally unfavorable international economic environment, largely reflected the prudent economic management of the Pakistan authorities and the policy reforms that were put in place after 1980. These reforms, many of which were implemented in the context of the extended arrangement with the Fund, have moved the economy closer to a market-oriented system and thereby increased its resilience. The implementation of timely adjustment policies has also helped Pakistan to avoid debt-servicing difficulties such as those that many developing countries have had to face during this decade.

Notwithstanding this favorable performance, it has become increasingly clear in more recent years that Pakistan's economy has continued to suffer from underlying structural weaknesses which, if not corrected, had the potential to threaten growth and financial stability. The weakening of the fiscal position in particular, which resulted partly from a relatively inelastic and narrowly based revenue structure, was beginning to have serious negative implications not only for investment and therefore future growth potential, but also for the sustainability of the balance of payments and for external debt management. Although the current account deficit, which had reached 5 percent of GDP in 1984/85, was reduced substantially the following year, the underlying protracted structural weaknesses continued to threaten external stability. Indeed, in 1987/88, and despite the authorities' efforts to increase revenue, the fiscal position weakened further, thereby renewing the pressures on the balance of payments and contributing to a resurgence of inflation.

It was against this background that in early 1988 the Pakistan authorities began to formulate an adjustment program to reverse the unsustainable trends of recent years while safeguarding the momentum of growth. The program, in support of which the use of Fund resources is being requested today, represents a comprehensive plan to deal fundamentally with key financial and structural imbalances in the economy. The three-year program is designed and paced in a way that takes into account the compatibility and feedback effects of various policy measures. Although fiscal tightening constitutes a key element of the adjustment program, the fact that it will be brought about through fiscal reforms designed to enhance saving and investment should mitigate any negative effects on growth in the short term and should increase the rate of growth which is compatible with normal capital inflows over the longer term.

The three-year adjustment framework and the 1988/89 program are presented in detail in the staff documents. I will, therefore, comment only on a few objectives and policies that should be particularly highlighted.

- A key objective over the medium term is to increase the rate of capital formation. Given the rapid increase in population and the low per capita income, a sustained increase in investment and continued strong growth will be essential for the authorities' development goals. This increase in investment will be brought about by, first, shifting the distribution of government spending in favor of capital outlays, which would be a reversal of recent trends; second, increasing incentives and enhancing the institutional and legal environment for private sector investment; and third, reducing the public sector borrowing requirement and thus providing adequate credit for private investment. More generally, the strengthening of overall confidence in the economy as a result of the authorities' reform and adjustment program should also help to promote investment activity.

- For the increase in investment to be compatible with a viable external position, another key objective of the medium-term program is to raise domestic saving. The primary instruments for this purpose will be the targeted reduction in public sector current outlays and the increase in revenue associated with the fiscal reform. Indeed, by the end of the program, the government sector is projected to become a significant contributor to national saving. At the same time, over the medium term, major reform measures will help to improve the efficiency of the domestic financial system, thereby fostering private saving. By 1990/91, it is projected that national saving will finance about 87 percent of domestic investment, a significant increase from the 75 percent estimated for 1987/88.

- The achievement of the medium-term growth and balance of payments objectives will clearly depend on the success of fiscal reform and adjustment, which are at the center of the authorities' program. Over the three-year period, the overall fiscal deficit is projected to decline from 8.5 percent of GDP in 1987/88 to 4.8 percent in 1990/91, which will be compatible with the balance of payments target. As regards the pace of adjustment, it is relevant to note that half of this deficit reduction is to be achieved during the first year of the program. On the revenue side, the Government, starting with the current year's budget, has introduced several structural measures aimed at broadening the domestic tax base and making the tax system more equitable over the program period, thereby increasing significantly both its yield and its elasticity, and reducing the present overreliance of revenues on taxes on international trade. An important element of the tax reform is the planned introduction of a general sales tax at the manufacturing and import stages in mid-1990. A phased program for this purpose is being implemented. In the meantime, a significant broadening of the sales tax on domestic production is planned for July 1989. With respect to direct taxation, the measures introduced this year, which involve the removal of some of the exemptions, should help to improve the equity and elasticity of the tax system. On the expenditure side, to restrain current outlays the Government has recently taken measures to strengthen its control over both its own spending and that of the provinces. In particular, provincial governments will be asked to assume full responsibility for their expenditure overruns and will be encouraged to rely more on their own revenue sources. With regard to capital expenditure, the Government will prioritize its investment projects, thus enabling it to channel funds to projects that are more conducive to growth while protecting essential social programs.

- The Government recognizes that cautious domestic credit policies are essential for containing inflationary pressures and achieving balance of payments viability. With this in mind, the authorities are confident that the established credit ceilings will be met and that the Government's net recourse to bank borrowing will be kept to the levels consistent with sound demand management. Over the program period, appropriate annual targets for the growth of credit to the private sector will be set so that gains in real private investment and production can be realized. The Government will also take steps, within the context of the intended reform of the financial system, to promote the use of market mechanisms to allocate available credit and encourage private saving. In this regard, the authorities intend to enhance the present flexibility in the borrowing and lending rates.

- In the external sector, a key objective is to achieve a viable balance of payments position that can be financed by normal aid flows. Consistent with this objective, the program calls for a reduction of the external current account deficit in relation to GNP from 4 percent in 1987/88 to 2.5 percent by 1990/91, a reduction in the external debt service ratio from 30 percent to 25 percent, and an increase in gross official reserves from a level equivalent to three weeks of imports to a level of about seven weeks. With respect to trade liberalization, the Government has undertaken a comprehensive trade policy reform, which it considers to be a key element of Pakistan's structural adjustment effort. This reform program, which has already been initiated with the introduction of the 1988/89 Import Policy Order, involves a gradual but steady removal of nontariff barriers as well as reductions in the level and range of the tariff structure. The Government will also continue to pursue a flexible exchange rate policy with the specific purpose of fostering the international competitiveness of nontraditional exports--which is another key objective of the program--and strengthening the external reserve position. Flexible exchange rate management will also complement the policy of financial tightening in containing the potential effect of import liberalization on the current account position.

While the program clearly aims at achieving a sustainable balance of payments position over the medium term, it is equally clear that the attainment of this objective will depend on a number of factors that are beyond the authorities' control. Among these is the continued availability of concessional aid flows both during and beyond the program period, as well as the extent to which Pakistan will be permitted access to export markets.

Finally, it is fair to say that the recent postbudget measures as well as the exchange rate management over the past few months are indicative of the authorities' readiness and ability to adapt economic policies when necessary. Moreover, the steadiness of economic management over the recent period, despite the uncertainties that were associated with the elections, and the full endorsement of the economic program by the new Government, should provide added reassurance about Pakistan's commitment to the charted adjustment course.

Mrs. Filardo made the following statement:

Today's discussion is of crucial importance because it reflects the new Government's commitment to implement a comprehensive economic program and structural reforms so as to enhance past accomplishments and to enforce the transformation and development of the country, now a new democracy. We welcome this opportunity and encourage the authorities to set in motion all the steps necessary to meet the objectives set out in the memorandum on economic policy and the policy framework paper as well as the different performance criteria and benchmarks of the Fund-supported programs.

Perhaps, as some Executive Directors of the World Bank commented, the program is too ambitious and too detailed. Nevertheless, through reviews and consultations with the authorities, it is feasible that the program can be kept on track and that the staff can indicate corrections or adjustments as new situations emerge.

Having said that, we only wish to re-emphasize the advice we gave to the authorities previously and as stressed in the staff papers. It is of utmost importance that economic growth and the control of inflation be considered among their objectives, taking into account the viability of the external sector. Pakistan is a very populous, poor country that requires careful management of its economy, as envisaged by the new Government.

The authorities should therefore be aware that prudent and sound fiscal, monetary, exchange rate, trade, and external debt management policies are a precondition for healthy growth and balance of payments viability. Thus, these areas have to be monitored carefully, as contemplated under the program. This will reinforce Pakistan's accomplishments under its extended arrangement in the past and will allow the authorities, in the medium term, to absorb the growing labor force and to improve the standard of living of the population, which will certainly suffer from the adjustment measures. Therefore the consideration given to the social programs in the policy framework paper is welcome. We endorse the proposed decisions.

Mr. Al-Jasser made the following statement:

I welcome the new Pakistan Government's decision to go ahead with the policies and measures detailed in the memorandum on economic policy and the policy framework paper. This is a positive sign that the new Government confers a high priority on meeting the formidable economic challenges facing Pakistan.

Since our discussion for the previous Article IV consultation with Pakistan on August 3, 1987 (EBM/87/116), the economy's performance has been mixed. The growth of real GDP was maintained at a healthy rate of 5.3 percent in 1987/88, owing to the good performance of agricultural and industrial production, which contributed to an impressive rise in exports. The partial streamlining of the import and pricing systems has also contributed positively to sustaining that economic growth.

Notwithstanding these positive signs, the Pakistan economy remains bridled by the structural rigidities and dislocations recognized by the Executive Board on August 3, 1987. Most important of these are the absence of significant resource mobilization efforts and the rapid growth of current government spending. These two problems manifested themselves in 1987/88 in a deterioration of both the fiscal deficit, which rose to 8.5 percent of GDP, and the external current account deficit, which rose from 1.9 percent to 4.0 percent of GNP. In addition, there was a resurgence of inflationary pressure, which had not been a problem in the previous two years.

These are only manifestations of more serious structural rigidities in the economy. The rise in the share of consumption in GNP from 85.1 percent in 1986/87 to 88.1 percent in 1987/88 is untenable. Likewise, the decline in the ratio of gross national saving to gross domestic investment from 88.1 percent to 75.1 percent, as a result of the decline in gross national saving from 14.3 percent to 11.9 percent of GNP, is also unsustainable.

The faltering of tax revenues combined with the substantial overruns in current expenditures led to the rise in the fiscal deficit. Moreover, the need to finance that deficit apparently led the authorities to relax their monetary policy and credit targets. The resulting crowding-out effect not only aggravated the resurgence of inflationary pressures but also precipitated a decline in business confidence, as the staff points out. Such a decline can only hurt the investment momentum that is so crucial to sustaining and expanding the present growth rate.

The mobilization of economic resources will have to be achieved through fiscal policy, financial intermediation, inflation, or a combination of these factors. Inflation, however, is the worst alternative since, in addition to its unsustainability, it retards all other alternatives. Through a sound broadening of the revenue base and a rational streamlining of tax rates and tax administration, fiscal policy should increase the rate of national saving. A sensibly reformed financial system would contribute measurably to the mobilization of private funds and the promotion of the saving habit rather than the consumption habit. I am pleased that this is the path the new Pakistan Government intends to follow. I am also hopeful that the conflict in Afghanistan will come to an end, allowing the refugees to return home and saving Pakistan the associated costs.

As to the balance of payments, I urge the Pakistan authorities to sustain the impressive trend in exports through diversification, especially in the area of nontraditional exports. The diversification of production should also be pursued. In agreeing with the thrust of the staff appraisal, I urge the Government to seize the opportunity afforded by the popular mandate it enjoys and to implement the necessary structural reforms to put Pakistan on the path to sustainable economic growth and development. I welcome the reassuring information in the recent letter from the new Pakistan authorities and in Mr. Finaish's statement. Therefore, I support the proposed decisions.

Mr. Goos said that he agreed with the staff appraisal. Undoubtedly, the policy framework paper and the program for the current fiscal year represented a substantial adjustment effort for which the authorities should be commended. It was, of course, difficult to assess the appropriateness of a given pace of adjustment, in particular where special factors were at work, such as natural calamities and the refugee problem in the present case. However, given the vulnerability of Pakistan's external position and its low standard of living, the authorities should make every effort feasible to improve the conditions for sustainable growth as fast as possible. Recent experience had revealed the important contribution of structural reforms to the observed buoyancy of the economy. While the obvious conclusion from that experience was reflected in the design of the program under consideration, in that it provided for further tangible progress in economic liberalization, it appeared that, at the end of the three-year program period, economic activity in the private sector would remain burdened by pervasive administrative controls. The extent of the authorities' adjustment effort should not be minimized, but perhaps bolder steps at liberalization--notably of industrial and trade policies, including the reduction of taxation on imports and exports--would be advisable.

The eventual success of the export-led growth strategy of the authorities will depend critically on the private sector's ability to develop its full potential, implying the provision of strong incentives and the ability to import advanced technologies for the modernization of production, Mr. Goos commented. He therefore supported the staff's advice to move rapidly in those areas.

The balance of payments pressure that could result from an enforced pace of liberalization should be countered, in the first instance, by appropriately restrictive financial policies, Mr. Goos remarked. His advice applied also to the desirable dismantling of the existing multiple currency practices and exchange restrictions, where the progress envisaged under the program was unsatisfactory. He encouraged the staff to pursue the matter further in its forthcoming discussions with the authorities, with a view to reaching an early agreement consistent with the Fund's mandate to work toward an international payments system free of restrictions. In that regard, the period for the proposed approval of the mandatory import deposit scheme--until July 1990--was rather long, and he encouraged the authorities to seek early elimination.

He commended the authorities for their efforts to strengthen domestic savings, Mr. Goos said. The envisaged correction of the fiscal deficit would no doubt make an important contribution to that end. In comparison, the contribution of private sector savings appeared limited and was actually projected to be negative in the first program period. That projection amplified the importance of the contemplated reform of the financial sector and the need, as recommended by the staff, to secure attractive rates of return on domestic financial assets. Nevertheless, in the light of the strong policy commitments of the authorities in those areas, it might be useful to have the staff comment on the reasons for the poor prospects for private sector savings. A stronger performance by private savings could make an important contribution toward reducing the high dependence of the country on foreign capital inflows and thereby improve the prospects for the restoration of a viable balance of payments position. In that regard, he was somewhat uneasy about the large external financing requirement that would remain at the end of the adjustment period. He had, of course, noted the staff's assessment that the requirement would be sustainable or could be covered by normal capital inflows, but he was concerned that the staff's assumption could be overly optimistic.

A stronger performance by private savings would greatly facilitate the task of containing domestic inflation, Mr. Goos added. He was, however, concerned about the strong price pressures expected in 1988/89 because of the destabilizing effects they might produce in private sector confidence. It therefore appeared that a clear demonstration of the authorities' resolve to fight inflation was of paramount importance, and that fight, to be successful, needed to be pursued through sufficiently restrictive financial policies rather than administrative instruments. He made that point also because, as noted in the staff paper, the authorities intended to use indexation mechanisms for specific excise taxes and import duties. It was well known that that was the wrong approach to inflation, as experience indicated that such mechanisms--at least in the longer run--tended to reinforce, rather than counter, inflationary pressures.

The high rate of population growth was one of the major constraints to improving the country's low living standards, Mr. Goos said. Accordingly, he considered the lack of agreement on birth control measures a major shortcoming of the program.

He agreed with previous speakers and the staff that the program constituted a substantial and commendable adjustment effort, Mr. Goos said. The program's implementation would place heavy demands on the authorities and would require, in particular, perseverance and considerable flexibility in adjusting to changing circumstances. In general, he agreed with Mr. Finaish that the budgetary adjustment measures introduced recently, as well as the endorsement of the program by the new Government, were encouraging developments in that regard.

Mr. Enoch made the following statement:

I welcome the opportunity to discuss Pakistan's request for a stand-by arrangement and a structural adjustment arrangement. The three-year program underpinned by the structural adjustment arrangement began in July 1988, so it is already almost five months old. This naturally causes some difficulties, and some might argue that the Board could have discussed the program some time ago. However, it is useful to recall the Chancellor of the Exchequer's statement at the Annual Meetings in Berlin: "I welcome the determination of the Fund not to be rushed into supporting macroeconomic programs before they are satisfied about the soundness of those programs and the commitment of the authorities to persevere in implementing them." It is therefore most appropriate that the Board has received assurances from the newly elected authorities in Pakistan that they are committed to this program, and I note that on December 23, the Prime Minister of Pakistan, in a major speech, emphasized her commitment to the Fund. I welcome the timely response to the authorities' assurances by Fund staff and management that has enabled Pakistan's request to be brought to the Board today. As the staff notes, Pakistan's performance over the 1980s has been impressive, with growth rates of about 7 percent, owing at least in part to the liberalization Pakistan undertook as part of its extended arrangement with the Fund at the beginning of the decade. Over the past few years, however, it has become increasingly apparent that the existing strategy is not sustainable, with high fiscal deficits crowding out private environment, wide fluctuations occurring in the external accounts, indebtedness rising significantly, and international reserves falling to dangerously low levels. The purpose of the program before us is to support macroeconomic adjustment and structural reforms that will permit a more sustainable economic strategy so as to enhance the long-run growth prospects for the economy.

The reduction of the budget deficit to 4.8 percent of GDP by 1990/91 from 8.5 percent in 1987/88 is one of the centerpieces of the program. This will involve firm measures to reduce expenditure and to raise fiscal revenue. I welcome the measures undertaken by the authorities to establish more control over provincial expenditure, by making the provinces entirely responsible for any expenditure overruns. Regarding revenue enhancement, the measures announced for the current financial year seem helpful, but the proposed general sales tax will be the most significant element of the authorities' strategy to broaden the tax base and enhance the elasticity of revenue. Although I recognize the time lags involved in introducing such a fundamental tax change, it is unfortunate that the general sales tax is not to be introduced until July 1990--more than two years after the authorities first committed themselves to its introduction. In any case, the authorities must ensure that there is no slippage from this proposed timetable. In addition, I urge the authorities to begin planning at an early date--certainly before the general sales tax is introduced--for its broadening into a full value-added tax. The staff states that it is the authorities' intention to move in this direction but regrettably is vague about the time scale envisaged, and I would welcome staff comments on this matter.

Regarding the various other revenue measures listed by the staff, their individual effects are mixed, and the staff states only that the net effect will be positive in terms of revenue enhancement. I encourage the authorities to look closely at some of the measures that will reduce direct tax revenues, especially the tax holidays for selected enterprises. As with all such incentives, there is a danger that they will lead simply to windfall gains to these enterprises.

The proposed reforms of the financial sector are welcome, particularly debt management and the supervision and regulation of financial institutions. To this end, the rationalization of the structure of national savings schemes, moves toward establishing market-oriented rates of return on government debt instruments, and the improved regulation of domestic capital markets are all steps in the right direction. The maintenance of a positive real rate of return is particularly important in order to encourage higher savings and ensure an appropriate allocation of domestic resources.

The Pakistan authorities have begun a comprehensive program of trade liberalization, the first stages of which included the replacement of nontariff barriers by tariff protection, the removal of many items from the negative list, and some rationalization of the restricted list. Reductions in the tariff structure are in prospect. While the direction of these changes is welcome, there must be a serious question as to whether they go sufficiently far. Tariffs are currently at a ceiling of 125 percent plus a 7 percent import surcharge, the new 5 percent Iqra surcharge, and an indeterminate license fee. A reduction to 100 percent, plus extras, is expected by 1990, but the authorities state that it is difficult to go further. Without data on estimated average nominal and effective protection, it is hard to make a clear assessment of the overall impact of these tariff changes on the economy; nevertheless, on the basis of available information, the liberalization envisaged at present is too limited to provide much stimulus to enhancing the efficiency of the domestic economy. I therefore urge the authorities, at a minimum, to accept the staff's recommendation for a maximum tariff level of 80 percent by 1991, and to consider seriously whether they might go beyond that at an early stage. Concern about loss of tariff revenue seems misplaced, as the authorities might accompany accelerated trade liberalization with an accelerated and broadened general sales tax. Another viewpoint is that further tariff reductions, both directly and indirectly through stimulating competition and efficiency, could also put downward pressure on inflation, thus helping to meet the concern of the authorities about the inflationary impact of the general sales tax, which in turn should facilitate its timely and effective introduction.

The authorities' commitment to ensure that the real level of the exchange rate does not exceed its level of mid-1988 is welcome, but again there may be some question as to whether it goes far enough. Pakistan's external position at the end of the program period is likely to remain fragile. For instance, reserves are projected at a level equivalent to seven weeks of imports for 1990/91; in contrast, the staff recently suggested levels equivalent to three months as a prudent minimum for Bangladesh and five months in the case of Nepal. Moreover, as the staff's financing projections show clearly, Pakistan is likely to have to rely heavily on external assistance, much of which will have to be on concessional terms, for the foreseeable future. In these circumstances, there seems to be a case to depreciate the exchange rate further so as to rebuild reserves, discourage an import surge in the aftermath of trade liberalization, encourage private remittances above their projected continued depressed levels, and stimulate the diversification of exports away from their present narrow, and rather vulnerable, sectors.

Regarding the exchange system, Pakistan maintains a number of bilateral payments agreements, and progress toward their elimination is an objective of the program. I would be interested in the staff's assessment of prospects for phasing them out. Also, there is some disagreement over the elimination of mandatory non-interest-bearing deposits, but the authorities have undertaken to eliminate them by July 1, 1990. In that connection, the final sentence of the proposed decision concluding the 1988 consultation is somewhat obscure. The authorities' stated intention to eliminate the multiple currency practice by July 1, 1990 is taken as the justification to approve restrictions only until December 31, 1989. This is presumably intended to maintain the pressure on the authorities to accelerate their timetable. I would be interested in an explanation of this proposed wording.

I endorse the comments of other speakers commending the program, and I can fully support the proposed decisions.

Mr. Shrestha made the following statement:

I am broadly in agreement with the staff's assessment of developments in Pakistan, prospects for the economy, and the measures to be implemented during the period of the stand-by and structural adjustment arrangements. I therefore support the proposed decisions.

Pakistan has pursued a wide range of adjustment policies in recent years to bring about positive changes in its internal and external sectors. Most important among them are the enhancement of producer price incentives, deregulation of the pricing and trading of important commodities and manufactures, and maintenance of a flexible exchange rate. As a result of the implementation of these policy measures, Pakistan experienced satisfactory economic growth and impressive export gains. However, the weak demand-management stances adopted in recent years resulted in a less satisfactory price performance and a sharp deterioration of both the external current account and the overall balance of payments situation of the country.

The authorities have shown tremendous courage in implementing the adjustment measures in the past, and the impressive growth rate and export performance in recent years show the capability of the authorities to implement the desirable actions mentioned in the policy framework paper. My authorities express their sympathy for the damages caused by the flood and the resulting constraints on the full implementation of the adjustment measures.

While the economic performance of Pakistan in recent years is commendable, I nevertheless wish to draw attention to the following areas. The growing fiscal deficit has resulted in increasing recourse to external financing, domestic nonbank financing, and domestic bank credit. Such a development has created an adverse impact on Pakistan's external position as well as on domestic price performance. I therefore urge that the fiscal deficit be contained at a more manageable level.

In the external sector, despite the impressive growth of exports, balance of payments difficulties have been experienced because of a decline in workers' remittances from oil exporting countries and growing imports owing to expansionary fiscal policies. Therefore, the authorities are well advised to limit monetary expansion. Although export performance has remained impressive over the years, too much dependence on traditional agricultural and cotton-based manufactured exports is a matter of concern. Much needs to be done to diversify and widen the export base.

Government investment and saving in relation to GDP have declined considerably over the years. To achieve a sustainable level of development and essential current expenditures aimed at maintaining high economic growth, domestic resource mobilization efforts should be given high priority.

It is encouraging that public sector pricing policies are in line with the structural adjustment program and that the authorities are committed to introducing pricing policies that give incentives to producers. I urge the authorities to implement this policy in a timely manner.

I note with concern the multiple currency practices maintained in Pakistan at present. These practices arising from foreign exchange bearer certificates and the mandatory minimum margin requirements for opening letters of credit should be eliminated as soon as possible. I would appreciate additional comments from the staff on developments in this regard, especially on the premium on the market price of bearer certificates over the official exchange rate.

Mr. Rye made the following statement:

Overall, I agree with the conclusion of the World Bank Board that the proposed program is an ambitious one, centered around the objective of increasing domestic savings by more than 5 percentage points over the three years to 1990/91 while maintaining real growth at over 5 percent. Of course, the program must be ambitious, given the severe underlying structural weaknesses in Pakistan's economy and external accounts. Indeed, some of the objectives might be considered the minimum necessary, namely, the increase in gross external reserves from the current precariously low level to about seven weeks' import equivalent, the 5 percentage point reduction in the debt service ratio, and the relatively modest increase in gross investment. Therefore, the program represents a finely judged balance, economically and doubtless politically also.

Given the change of Government, it is perhaps inevitable--though regrettable--that the heavy front-loading of Fund disbursements under the proposed stand-by and structural adjustment arrangements is not matched by equivalent front-loading in the implementation of the necessary policy reforms. That makes it more essential for the authorities to press on with the implementation of the program, in both its macroeconomic and structural aspects, with all practicable speed, and I join earlier speakers in urging them to do so.

In the area of fiscal policy, I have no argument with the focus placed on the need for extensive reform of the tax system, given its poor elasticity and obvious inequities. However, more could have been done to reduce current expenditures, which grew by an average of 20 percent a year in 1980/81 through 1986/87 and a further 12 percent in 1987/88. While the heavy pressures on Pakistan's resources undoubtedly made rapid increases inescapable, they were clearly a prime factor in the deterioration of the overall fiscal position. Against this background, the planned decrease of 0.6 percent in current expenditures as a share of GDP in 1988/89--as a result of reducing subsidies, limiting indexation of civil service salaries, and modifying armed services pension arrangements--while welcome, appears only modest. Moreover, the revised budget estimates, which show an increase in expenditures over the earlier estimate of more than 3 percent, suggest that the planned reduction may not be achieved.

The need to develop fully the centerpiece of the proposed tax reform--the general sales tax--before its introduction in July 1990 is obvious. The long delay is disappointing, however, and the proposed policy measures to extend the base of the existing sales tax during the transition period are very much in the nature of a stopgap. More important, recent decisions to expand the list of key industries eligible for customs duty exemptions, and to offer new firms in these industries a four-year tax holiday, may only undermine the political consensus in favor of more thoroughgoing tax reform.

Failure to push on with sufficient vigor on the fiscal front would imply a greater burden on monetary policy and credit control to constrain consumption and import demand. It is well recognized that monetary policy is often a blunt instrument. Moreover, it is clear that the institutional arrangements in Pakistan's financial markets remain ill-suited to this task, notwithstanding the authorities' commitment to build slowly on the use of market-related credit controls. On an incidental point, I am puzzled by the projected pattern of growth in liquidity, in particular the acceleration from 10.6 percent in 1989/90 to 12.4 percent in 1990/91, while nominal GDP continues to decline; any explanation by the staff would be welcome.

The three-phase approach to the proposed trade liberalization seems excessively cautious, and while Pakistan's extreme shortage of external reserves makes caution understandable, the authorities' reluctance to consider reduction of the effective rate of protection as other than a "desirable longer-term goal" is disappointing. I endorse Mr. Enoch's comments on this subject.

On the inflation forecast, price rises are now running at about 15 percent, well above the figure of 10 percent for 1988/89 included in the staff paper. What implications does this have for the program?

I welcome the staff assurance that the $4.2 billion in new financing commitments necessary to close the financing gap over the life of the program will be forthcoming. However, the staff papers are short on details other than a passing reference to "other sources," including bilateral and multilateral concessional lenders, and it is unclear how firm these commitments are. In any case, even a casual examination of the balance of payments projections suggests that Pakistan will continue to rely heavily on external aid well beyond the conclusion of the program. Notwithstanding these reservations, I agree with Mr. Goos that it is appropriate to end on a positive note. The program represents a substantial adjustment effort, and I can support the proposed decisions.

Mrs. Ploix made the following statement:

The Fund is about to extend strong support for Pakistan's adjustment efforts. The combination of a stand-by arrangement with a structural adjustment arrangement will result in a significant financial commitment on the part of the Fund. It will also enable Pakistan to benefit from more concessional financial terms. Moreover, even if it is fully consistent with the Fund's current practices, the phasing of purchases is heavily front-loaded.

The spirit of cooperation that has prevailed between the Fund and Pakistan since the beginning of the 1980s, associated with the magnitude of the country's external financing requirements, warrants significant Fund assistance. However, the strong deterioration of Pakistan's economic situation over the recent period, especially in the fiscal and external areas, calls for strict implementation of the Fund-supported program. Given the program's rather ambitious growth objective, there is no room for slippages if the adjustment process is to take hold rapidly.

As the staff acknowledges, fiscal policy is undoubtedly the most critical area. It must be noted that the approach to be followed is gradualist, a stance that seems warranted in view of the constraints the authorities are facing on the expenditure side. However, by focusing on revenue the authorities must be fully committed to making substantial resource mobilization efforts. In particular, it is crucial that the tight schedule adopted for the introduction of the new general sales tax be complied with. Any delay would put the fiscal retrenchment process at risk, to the extent that the other revenue-enhancement measures would not be able to make up for the planned reduction in international trade-based taxes.

One way of mitigating the downside risks associated with this approach would be to seek a greater contribution from the expenditure side. The authorities should act more forcefully in the parastatal sector. A more active pricing policy combined with some privatization measures could usefully supplement other efforts made to correct the fiscal position. I would welcome the staff's comments on this point.

With regard to monetary policy, the authorities' main objective is clearly to foster national savings. Considering that the public sector borrowing requirement is to remain substantial throughout the program, noninflationary or non-external-debt-creating means of financing the fiscal deficit must be promoted. The banking sector loan, which the authorities are currently negotiating with the World Bank, should go a long way toward introducing more market-based public debt management techniques. A greater reliance on interest rate movements should also help to improve the mobilization and allocation of private savings resources. This World Bank loan is all the more interesting in that Pakistan is complying with Islamic banking principles.

On the external side, the authorities have been following an appropriately flexible exchange rate policy, which is reflected in a satisfactory export performance. However, the exchange regime remains rather restrictive, and progress should be made during the program toward the eventual unification of exchange rates. The elimination of multiple rates coupled with the implementation of import liberalization measures are essential if new tradable goods sectors are to be developed. The simplification of the exchange system should also encompass the gradual elimination of ad hoc export promotion schemes. Given the fiscal impact of this measure, I would like to learn from the staff whether a more forceful approach could not have been envisaged.

I note the magnitude of Pakistan's external financing requirements for the medium term. The needed financing has already been identified, but short-term borrowing on commercial terms should be kept to a minimum. This is essential if a new balance of payments crisis is to be avoided; it also implies that given the heavy involvement of multilateral institutions, Pakistan will have to adhere to a strict adjustment path. Finally, we support the proposed decisions.

Mr. El Kogali made the following statement:

We have noted not only the growth registered by Pakistan from the beginning of this decade but also the setbacks suffered in 1987/88 owing to a weakening fiscal position, which resulted in inflationary and balance of payments pressures. Against this background, we appreciate the need for the new democratic Government to muster a new momentum for balanced and revitalized growth in the medium term. Indeed, it was also a good opportunity for the stand-by arrangement and the structural adjustment arrangement to begin at the same time as the Seventh Five-Year Development Plan (1988/89-1992/93) so that the demand-management and structural policies would be fully harmonized. In this connection, we have noted that the programs are geared to step up GDP growth from 5.2 percent in 1988/89 to 5.5 percent annually thereafter, while the rate of inflation, although initially rising in 1988/89 to 10 percent owing to deregulation, will be progressively reduced. In the external sector, a viable current account deficit should be attained with sound reserve and debt service positions by 1990/91. We were pleased to hear from the staff that more recent budgetary measures are fully consistent with program objectives.

We therefore fully endorse the authorities' medium-term objectives under the stand-by and structural adjustment arrangements and the Development Plan. As explained by Mr. Finaish, the key to the medium-term growth objective is to increase the rate of public and private capital formation through the shifting of government expenditure in favor of investment and the provision of incentives and institutional backing for private savings and investment. While commending the authorities for their strategy of increasing the role of the private sector in the new development effort relative to the public sector, I was particularly encouraged to note that at the same time they are ensuring that the public sector development program stresses essential social outlays in primary education, health, rural water, and urban development. This is desirable and urgent during the initial years of the adjustment process when the burden of adjustment on the poor is heaviest because of higher unemployment resulting from public retrenchment and higher prices owing to deregulation. In addition, such investment for social infrastructure, including public services and better targeting of subsidies, constitutes a basis for sustaining structural adjustment in the long run.

On fiscal policy, we have noted the ambitious objective of lowering the budgetary deficit from 8.5 percent of GDP in 1987/88 to 4.8 percent by 1990/91 through tight control and rationalization of public expenditures while considerably increasing revenues. On the expenditure side, the undertaking to protect the government investment level at 7 percent of GDP when the overall government expenditure level and the deficit are falling is particularly innovative. This is in sharp contrast with a number of adjustment programs under which capital budgets bear the brunt of the adjustment burden. On the revenue side, while welcoming the broadening of the tax base, including the introduction of a general sales tax by mid-1990, we would have liked to see a faster pace in the adoption of these measures. The staff recommended that the authorities should take any feasible steps to bring the agricultural sector under income taxation. Knowing that there are frequently prohibitive practical administrative problems regarding income taxation of this sector, I would appreciate any comments from Mr. Finaish or the staff on how they envisage tackling such problems.

With regard to credit and monetary policies, we are in full agreement with the thrust of the staff recommendations, as we find the pursuit of tight credit policies necessary to achieve the inflation and balance of payments targets. We also see a useful role to be played by private financial institutions and greater development of the capital markets in the promotion and mobilization of private savings and investment.

As to the external sector, I agree with the authorities that ambitious structural reforms are a key element of export-oriented growth in Pakistan. In particular, we encourage the authorities to pursue relentlessly, in the medium term, a flexible exchange rate policy, tariff reforms, and a program of trade liberalization to move from the present complex controls and restrictions. Even though Pakistan will attain external viability at the end of the program supported by the structural adjustment arrangement, the debt service burden will remain high, calling for a very cautious borrowing policy and continued concessional assistance. We support the proposed decisions, and we hope that the flow of funds will continue to adequately support the adjustment.

Mr. Rieffel made the following statement:

In August 1987, when we last discussed the Pakistan economy, we expressed concern about the rising fiscal deficit and the falling domestic saving rate. We also expressed doubts about the sustainability of growth in an economy hobbled by extensive government controls.

From this perspective, my authorities are extremely pleased that Pakistan has committed itself to undertake a comprehensive program of economic reforms aimed at trimming the fiscal deficit and boosting domestic savings. This commitment is especially noteworthy because it has been reaffirmed by the new Government. We commend the many Pakistan officials who have labored with skill and dedication over the past six months to formulate and launch the new program, and we fully support the proposed decisions.

The staff papers provided for today's discussion appear to reflect close collaboration with the staff of the World Bank. The summary and time frame included in the policy framework paper is one of the most complete we have seen. As we generally agree with the staff appraisal, I will touch only on a few areas of particular concern to my authorities.

The fiscal objectives of the program are critically important. To meet these objectives, it will be necessary for the authorities to avoid expenditure overruns, such as those that occurred in the past fiscal year. More fundamentally, it will be necessary to strengthen the structure of revenues by shifting away from taxes on trade toward taxes on domestic consumption and income. In this regard, the commitment to introduce a general sales tax by July 1, 1990 is welcome. We would prefer, however, to see this tax introduced even earlier; we are also disappointed that it will not be extended beyond manufacturers and importers until somewhat later. We urge the authorities to include this extension in their next policy framework paper as an objective for 1991, if it is not possible to move faster. With regard to income taxes, we share the staff's concerns about the exemptions recently introduced for new industries. We would also like to see in the next policy framework paper some substantial moves toward broadening the tax base, such as encouraging the provinces to tax agricultural income.

While we welcome the measures included in the program, the staff paper highlights the extreme restrictiveness and complexity of Pakistan's trade regime. Consequently, even at the end of a three-year program of trade liberalization, we have the impression that trade restrictions will continue to be a major constraint on economic growth. While the average rate of duty incidence fell from 52 percent in 1983/84 to 44 percent over the first eight months of the past fiscal year, 44 percent represents a high level of protection relative to other countries that have economic programs supported by the use of Fund resources. We are aware that lowering the maximum tariff rate from the 125 percent level that will be maintained through the 1989/90 fiscal year would make it more difficult for the authorities to meet the fiscal objectives of the program. Nevertheless, we would prefer to see a further substantial lowering of the maximum rate at the beginning of the next fiscal year, and another reduction at the beginning of the following fiscal year. More generally, we would like to know how much time the authorities think they will need to bring the average rate down to the approximate median for countries that currently have programs supported by the Fund. In this connection, I was told by the staff that for a sample of 14 major developing countries in Asia, the average incidence of import duties in the period 1980-84 was in the range of 14-18 percent.

We have expressed doubts in the past that Pakistan faces protracted balance of payments problems. The staff has evidently given this issue considerable thought, and we appreciate the arguments put forward in the staff report. Accordingly, we have been persuaded that Pakistan meets this criterion for access to the structural adjustment facility. Nevertheless, the case is not an overwhelming one, and the question may need to be revisited in the event that Pakistan seeks another Fund arrangement in the future for which this criterion is relevant.

More narrowly, I am somewhat concerned about the projected decline in workers' remittances in the years ahead. I would be interested in knowing the opinion of the staff on how sensitive these remittances are to the exchange rate. Furthermore, is it not possible that remittances would rise significantly if barriers to private investment were reduced?

My last comment in this area is to underscore the importance we place on phasing out the bilateral payments agreements and other arrangements that give rise to exchange restrictions. We would also like to see a phaseout of multiple currency practices included in Pakistan's next annual structural adjustment arrangement.

On the structural content of the program, I was surprised to see a target date of October 1995 for phasing out subsidies for potash fertilizers. An earlier phaseout would seem feasible. More important, we are not comfortable with the pace of reforms in the parastatal sector. Given the importance of this sector in the Pakistan economy, and the potential for benefits from reorganizing the sector and making individual enterprises more efficient, we would have expected a more comprehensive set of reforms in this sector. We hope that this will be an area of emphasis in the next policy framework paper and the second annual structural adjustment arrangement.

Finally, I have three comments of a procedural nature. First, I found very little in the papers on the subject of Pakistan's capacity to repay the resources that will be provided by the Fund under the structural adjustment and stand-by arrangements. We do not have significant concerns in this particular case, but we take very seriously the commitment of the Board, in its recent report to the Interim Committee on arrears, to provide explicit assessments of the capacity to repay in connection with all requests for the use of Fund resources. Second, we consider the performance criteria to be appropriate, and we welcome, in particular, the external borrowing limits that have been agreed upon. Third, we regard the array of structural benchmarks that have been incorporated in the arrangement as a good model for other countries. In conclusion, we are pleased that Pakistan has decided to seek the support of the Fund in its efforts to strengthen the foundations for economic growth.

Mr. Gorjestani made the following statement:

It is unfortunate to note that after impressive economic progress over 1984/85-1986/87, the economic performance of Pakistan tended downward, and since 1987/88 it has faced serious problems. The present state of the economy as described in the staff papers seems to some extent worrisome. It is characterized by a large and growing external current account deficit owing to the increase in demand for imports and payments on foreign debts, rising inflation, the huge and protracted fiscal deficit, lack of confidence in the performance of the economy--which has resulted in a low level of private savings and investment--and finally a very slow rate of economic growth. These problems have emerged as the result of some exogenous factors as well as the prevailing structural weaknesses in the economy. Unless the structural constraints to the growth of the economy are addressed through the implementation of a comprehensive adjustment program, supported by adequate foreign assistance, the country will not return on track to balanced growth.

Pakistan is heavily dependent on exports of a limited number of traditional commodities, such as sugarcane, rice, and cotton-based manufactures, as well as on workers' remittances. As shown in Table 57 of the background paper, the share of workers' remittances in the country's current account balance has been roughly the same as the share of its total export earnings. Its trade and current account balance deficit has been large for many years. The declining trend in workers' remittances and Pakistan's large interest payments on growing foreign debt have exacerbated the external position of the country and have contributed to economic instability.

We agree with the staff's appraisal, comments, and suggested corrective and structural measures in respect of weaknesses in other areas of the economy. The staff papers reveal that the weaknesses in the economy have resulted mainly from the large and persistent overall fiscal deficit and protracted adverse balance of payments situation.

It is encouraging to note that the authorities are aware of emerging problems and have already taken some corrective structural measures aimed mainly at curbing inflation, further liberalizing trade, and reducing the fiscal deficit and public finance through augmenting total revenue and restraining total expenditure. These measures are the key elements and indeed the initial steps for the restoration of economic growth and stability. To this end, the authorities' courageous efforts to implement structural reforms of the tax and tariff system, to revise the sources of budgetary finances, and to enhance domestic savings are commendable. As noted by Mr. Finaish, it is expected that by the end of the program, the government sector will contribute significantly to national savings.

We are confident that the Islamic banking procedures implemented successfully in Pakistan have produced substantial flexibility in the working of the banking system, and will give rise to substantial private savings, as experienced in other countries.

With regard to trade liberalization, there is no hope for further progress unless the balance of payments situation improves, which would entail sufficient external assistance on concessional terms. Continuation of the flexible exchange rate policy has proved to be helpful in promoting exports. We hope that all these corrective and structural measures will continue to be implemented rigorously.

It is heartening that the authorities have responded positively to the views expressed and the recommendations made by the Executive Board during last year's Article IV consultation discussion. It was partly on the basis of the Board's advice that the authorities committed themselves to adopt so many corrective measures. It was also on this basis that the authorities produced in collaboration with the staffs of the Fund and the World Bank the policy framework paper before us. This is a well-designed program containing a package of suitable macroeconomic and structural adjustment policy measures. We compliment the new authorities for their vigilance and awareness of the problems that the country is facing and for their swift and full support of this program.

We welcome the Acting Chairman's statement that the World Bank has also firmly supported the envisaged program. The emphasis that the Executive Directors of the Bank have attached to the social sector and human resources as well as to the enhancement of export performance in the development of the economy is of paramount importance.

In light of the capabilities and good record of the authorities in program implementation, we believe that if the envisaged program is rigorously and strictly implemented it will restore the economy on track to sustainable growth. Furthermore, we agree with the staff's assumption that the projected improvement in the country's balance of payments is expected to enable Pakistan to meet its obligations to the Fund. In view of this assumption, we support the requests for the stand-by arrangement and for the three-year structural adjustment arrangement and the first annual arrangement thereunder.

Finally, with regard to the operation of the foreign exchange bearer certificates, at this early stage of market development, trading in this instrument strictly at the official exchange rate does not seem to be practicable. As the staff has noted, trading in foreign exchange bearer certificates would be helpful in the liberalization of the exchange system in Pakistan. We therefore suggest that the Executive Board allow sufficient time for the elimination of the spread between the exchange rate in the official exchange market and the rate implicit in this instrument. Similarly, we recommend that the authorities agree to a timetable for elimination of the spread as soon as possible.

Mr. Jalan noted that the Government of Pakistan deserved congratulations for presenting a well-thought-out memorandum on economic policy. The policies contained in the memorandum fully justified the proposed decisions, which he was happy to support. He was particularly glad that it had been possible to work out an arrangement under the structural adjustment facility, which should provide resources to the Government on appropriate terms, allowing the authorities to undertake the proposed adjustment. The fact that the new Government had been able to confirm the arrangements worked out with the Fund on such short notice testified to the authorities' confidence and determination and boded well for the future. He had no doubt that the program would be successful.

The staff had presented a well-balanced background paper and appraisal of the Government's program, and he had no specific comments on the content of the program, Mr. Jalan remarked. However, one general issue arose in connection with the present discussion, and he would welcome staff comments in the context of the Pakistan program or at a later discussion. By all accounts, the Pakistan economy had performed very well between 1980/81 and 1986/87. The economy had yielded average real GDP growth of more than 7 percent a year, an increase in manufacturing output of nearly 9 percent, and a rate of inflation of less than 5 percent during 1984/85-1986/87. That performance was outstanding compared with that of a number of developing countries and, indeed, many industrial countries. The staff pointed out that those achievements had resulted from the implementation of a number of good structural policies, including creation of an environment that was conducive to greater private sector investment. Yet, the financial situation had deteriorated sharply in 1987/88 and to date in 1988/89.

He wondered what had gone wrong, Mr. Jalan continued. The staff had not provided the answer. Had the seeds of present problems been sown in the policies pursued earlier, or had certain independent events caused the problems? Import liberalization was emphasized in all Fund-supported programs, but in the context in which many member countries were placed, with strained balance of payments positions and export situations, the issue of liberalization needed to be examined carefully. He urged the staff to consider the impact of rapid liberalization measures, both on reserves and on domestic savings. He raised the question in the context of not only the present structural adjustment program but the design of future Fund programs, and he suggested that the Board discuss it on another occasion.

With respect to the quantitative criteria, he was somewhat uncomfortable about setting quarterly targets for movements in net international reserves, Mr. Jalan remarked. Those figures were volatile, depending, for example, on certain movements in aid flows and investment, and the period was too short to give an accurate indication of underlying trends; he asked the staff to comment. He hoped that if the quarterly targets were not met, some flexibility would be shown in discussions with the authorities and sufficient consideration would be given to statistical volatility and insufficient data.

He asked the staff to clarify the information presented in Table 3 in EBS/88/232, Mr. Jalan said. At present, the signs indicated two opposing movements in the same table.

Mr. Massé made the following statement:

> The program being considered today encompasses substantial macroeconomic adjustment in the next 15 months and significant structural reform over the three-year period of the structural adjustment arrangement. At the same time, the economy will continue to expand at a healthy rate. However, in light of the rapid population increase, real per capita income will grow only at a rather moderate rate. It took some time to conclude the discussions between the authorities and the Fund staff, and further time elapsed before the program could be brought to the Board for consideration, but in certain circumstances a delay of this sort is unavoidable--and perhaps even necessary--when it leads to a better program and/or a fuller commitment to the program by the authorities. In the present case, we are now confident that the program is worthy of support and can achieve the ambitious objectives of the Pakistan authorities. Moreover,

we would like to convey to the authorities our appreciation for their letter reaffirming the new Government's commitment to fully implement this program.

My authorities generally concur with the staff report. The program is difficult and challenging, with ambitious targets. We are also impressed by the number of measures already implemented, and we would suggest that such prior actions become standard practice, at least in cases where both stand-by and structural adjustment arrangements are being considered.

As the staff notes, fiscal retrenchment is central to this program. We commend the authorities on the steps already taken in that direction--both the planned reforms contained in the budget and the additional measures introduced subsequently to ensure that the objectives are met. The fiscal target is ambitious with regard not only to the magnitude of the cut in the deficit, but also to the array of measures that are being introduced, in particular the revenue-enhancing measures. However, it is clear that without full implementation of these policies, the program cannot succeed. We caution the authorities to stand firm and to monitor developments to avoid any slippages. We suggest preparing an alternative fiscal plan in case developments are not as originally envisaged. The outcome of the tax reform is especially difficult to forecast and, despite full implementation, the objectives may not be attainable during the original time frame. In these circumstances, further expenditure cuts may become necessary.

With regard to the monetary sector, the paper does not show clearly the impact of the introduction of Islamic principles on financial markets and the behavior of private investment. I wonder whether the staff or Mr. Finaish could elaborate on this, and on whether the application of Islamic principles presents a structural constraint on the implementation of an appropriate monetary policy.

We welcome the substantial efforts made toward trade liberalization to date, but we note that the economy remains highly regulated, with significant restrictions on imports. In this respect, the continuation of the mandatory non-interest-bearing deposits of 30 percent required for a large category of imports is a particularly inefficient instrument to bring about the required balance of payments adjustment. The authorities plan to eliminate this practice by July 1990, and we urge them to take early and tangible action toward this end, and in general to move more aggressively in pursuing trade liberalization. This would greatly assist the authorities' efforts in developing nontraditional exports.

My authorities welcome the authorities' intention to continue the flexible and responsive management of the exchange rate regime. Nevertheless, we wonder whether there is not some room for further adjustment. The staff indicates that tight restrictions remain on the availability of foreign exchange through official channels. However, according to the authorities, the use of foreign exchange bearer certificates provides unrestricted private access to foreign currency. We agree with the staff that the Board should not approve the multiple currency practice associated with these certificates. These instruments, while representing considerable liberalization of the exchange system, are also potentially highly destabilizing, particularly during periods of devaluation during which they can exacerbate the loss of confidence in the economy. Furthermore, in light of the high rate of return on these certificates, they can become a significant drain on the Treasury. We urge the authorities both to undertake a more aggressive exchange rate regime that would align the rupee closer to its true market value and to do away with this instrument.

The level of foreign reserves is critically low while short-term debt has been rising rapidly. This is likely the most important motivating factor behind the authorities' seeking the Fund's assistance. However, the level of reserves will continue to remain uncomfortably low even at the end of the structural adjustment arrangement period. Although the overall debt burden is not unmanageable, it appears that owing to short-term liquidity constraints, Pakistan could benefit in the coming two years from a Paris Club rescheduling. Could the staff or Mr. Finaish comment?

My authorities consider this a challenging and ambitious program that, if fully implemented, should stabilize the macroeconomic environment and permit the continuation of the high rate of growth that Pakistan enjoyed during the first half of this decade.

Mr. Posthumus made the following statement:

The papers before us today contain a wealth of information, which is commendable. However, a somewhat clearer picture of the policy dilemmas facing Pakistan would have been helpful, not only for the Board but, more important, for the authorities themselves.

Over the past few years the real economy has grown reasonably well. However, financial performance, in particular as reflected in the fiscal and external situation, lacked strength. Thus, further economic development may be affected unless an ambitious adjustment program is carried out. In particular, tax reform is of great importance in increasing revenue and sustaining an appropriate level of expenditure; a fiscal deficit of 7-8 percent of GDP is excessive. I therefore fully support the staff's advice on tax policy.

Current expenditure has grown substantially because of increases in defense spending, interest payments, and outlays for social services. Somewhat more explicit information could have been given about the exclusion of military debt from the performance criteria; only a footnote to a table is provided. The share of social services in total expenditure has been more or less constant and has increased as a percentage of GDP. The level may endanger the adjustment effort but, if so, the authorities should develop alternative sources of finance rather than slow down the adjustment process.

The Government has adopted a commendable medium-term program of trade liberalization, but the program also entails some risk. Export performance has been reasonably good--if unbalanced--but the geographic destination of exports shows that the combined share of the industrial countries has increased substantially. Many Directors commented about Pakistan's restrictions on imports. However, at the same time Pakistan faces substantial impediments to its exports to the group of industrial countries shown in the background paper. We are all aware of this phenomenon in a general sense; but we see it here in a particular case, and perhaps it could be indicated in the summing up of this discussion that the industrial countries should make a greater effort to support strong growth of Pakistan's exports.

The nominal exchange rate of the rupee will be manipulated in such a way that the real effective exchange rate will not rise over the period of the structural adjustment arrangement. While I do not disagree with this aim, under the particular form of the commitment--a quarterly adjustment--exchange rate policy will fully accommodate inflation. However, a commitment to stabilize the nominal exchange rate and adjust it if required might place more emphasis on internal financial policies. After all, exchange rate adjustments require other policy adjustments as well. In a not excessively high-inflation country like Pakistan, such a policy may be a worthwhile alternative.

The foreign exchange bearer certificates are freely negotiable and give rise therefore to a separate exchange rate. Apparently, these certificates were introduced to attract remittances from workers abroad. For this purpose in particular, exchange of the certificates in rupees should remain attractive, and this is guaranteed through two mechanisms: the free pricing on the market and the premium payable at the time of encashment in rupees. This premium represents a nominal interest rate that seems relatively high in real terms. It also is a burden on the budget that becomes heavier as inflation falls. The price being paid for this source of foreign exchange--partly substituting for foreign exchange earnings from remittances that would have flowed to Pakistan anyway--seems relatively high compared to a straight bank loan. Finally, I fully support the proposed decisions.

Mr. Schoder made the following statement:

The case before us today is that of a developing country that has succeeded in recent years in combining strong economic growth with relatively low inflation rates, thus laying the groundwork for a sustained rise in the living standards of its large and growing population. However, structural defects in the fiscal system combined with poor control of public expenditures have weakened the public finances to such a degree that the fiscal position has become a worrisome element in Pakistan's development picture. The prolonged and growing public deficit, by driving up interest payments on the public debt, is constraining autonomous decisions in the fiscal area and undermining, through its money-creating effects, Pakistan's ability to resist inflation. The public sector's increased absorption of resources is beginning to crowd out the private sector, weakening prospects for economic growth. Moreover, the public sector deficit has spilled over into external account imbalances that must be financed through external borrowing and that have caused official gross reserves to slip to a very low level.

Given this overall economic picture and the demographics of Pakistan, this chair welcomes the launching of a three-year adjustment program addressing both the macroeconomic imbalances and their underlying structural causes. We agree with the basic thrust of the program and its component measures. The program provides an appropriate mix of macroeconomic adjustment through fiscal tightening and structural reform measures in the taxation and pricing areas as well as in the financial, industrial, and external sectors aimed at moving Pakistan's economy closer to a market-oriented system and thereby fostering and maintaining Pakistan's growth momentum.

We are somewhat concerned that this major adjustment program, particularly the trade liberalization measures, will have to be implemented under conditions of depleted foreign exchange reserves. We wonder whether the elements of the program could not have been phased differently, without altering its basic thrust and content. We would have preferred to see the majority of the trade liberalization measures back-loaded in the second half of the program, when the foreign exchange reserve position would be reinforced and protected somewhat more by implementation of the fiscal reform and restraint measures during the first half of the program--these fiscal measures being more front-loaded. Some elaboration by the staff on the reasons for ordering the program as it stands might reassure us; I agree with Mr. Jalan and Mr. Posthumus that a fuller discussion of policy dilemmas would have been helpful in the staff papers.

We are confident that should slippages in the fiscal domain occur, Pakistan's authorities will once again take the necessary corrective measures to ensure the success of this comprehensive and consistent program. The program is being launched at a most opportune moment, not only because of the economic factors mentioned earlier but also because of the political momentum created by recent events in Pakistan. We therefore support the proposed decisions.

Mr. Lombardo made the following statement:

I congratulate the Pakistan authorities for their commitment to correcting the imbalances that characterized their economy in the past few years. In particular, it is remarkable that the new Government has decided to go ahead with vigorous fiscal and monetary policy adjustment, supplemented by appropriate structural and external sector policies that promise to restore medium-term balance of payments viability and to contain the resurgence of inflationary pressures. This is remarkable because, despite relatively strong growth and a generally acceptable inflation performance in the past few years, per capita income of $360 and a literacy rate of 30 percent of the population have remained low and progress in a number of important social areas has been slow. The social costs involved present a severe constraint when a country decides to go ahead with adjustment; however, the Government has set aside this concern and is headed toward strong adjustment that will provide a genuine solution.

It is important that the Pakistan Government should recognize that a substantial correction of existing fiscal imbalances is vital to ensure sustained economic growth over the medium term, without excessive recourse to external borrowing on commercial terms. As the staff notes, fiscal adjustment is a key element of the program. We welcome the fact that the main part of the fiscal adjustment is concentrated on the revenue side, in particular the objective of bringing about fundamental changes in the tax system that will make it fair and equitable, while achieving a substantial improvement in government finances. Moreover, as the staff points out, the authorities' readiness to take new fiscal action during the first part of the fiscal year is commendable evidence of their commitment to the program. The experience during the first quarter of 1988/89 suggests that fiscal management might prove to be difficult in the program period, particularly given the tightness of the limits on expenditure.

Other measures taken by the Pakistan authorities regarding monetary policy, exchange rate management, the financial system, and import liberalization are strong steps toward adjustment. In this regard, I encourage the authorities to go ahead with their program of trade liberalization, despite the problem of external current account deficits. I also encourage the reform of the financial system so as to promote capital markets, which would be an important element in increasing the rate of financial savings and the efficiency of financial intermediation over the medium term. Despite the recent measures liberalizing the exchange system, it still has a number of restrictions that we hope can be eliminated, notably the multiple currency practice that arises from the mandatory minimum margin requirement for opening letters of credit.

While some speakers might consider the pace of certain policy reforms too gradual, the starting point in this case is complex. Difficult political and social restrictions exist, despite the Pakistan Government's commitment to adjustment and its readiness to take action as well as the strong and comprehensive measures already adopted.

Mr. Di made the following statement:

I am in broad agreement with the staff appraisal. I welcome the new Government's full endorsement of the implementation of a structural adjustment program aimed at addressing further the growing macroeconomic imbalances and the long-standing weaknesses in the economy. Economic developments in Pakistan in recent years have been characterized by an impressive rate of economic growth and a steadily declining rate of inflation. Underlying this impressive performance are prudent economic management by the Pakistan authorities and significant structural reforms introduced since 1980. However, notwithstanding these achievements, the economy has continued to suffer from basic structural weaknesses that have the potential to threaten growth and financial stability. The adverse impact of these weaknesses on domestic and external financial stability has become more striking in the recent past, resulting in an increase in the overall fiscal deficit, an acceleration in consumer price inflation, and a widening in the current account deficit during the past year. Taking all these considerations into account, I believe that the proposed comprehensive adjustment program is timely and that the policy framework is, in general, appropriately set, despite some of the program targets appearing to be rather ambitious and challenging.

Pakistan, as a low-income developing country with a limited export base, is heavily dependent on external financial assistance in its economic development. Even though its performance in total export value has been sound in recent years, Pakistan's balance of payments position remains difficult, which has complicated the task of economic management; also, the low level of foreign exchange reserves cannot provide the safety margin required to support continued reforms in the trade regime. Therefore, a continued inflow of external financial assistance will be an essential component in the proposed structural adjustment program. I fully support the proposed decisions.

Mr. Fogelholm made the following statement:

I join other speakers in welcoming Pakistan's ambitious economic adjustment program. This is an opportune time to embark on such a program for many reasons; for example, Pakistan has just witnessed a change in Government. Even if the adjustment program was initiated by the previous Administration, it is probably easier politically for a new Government to start fresh, and in this connection, I note with satisfaction the full commitment of the new Government to implementing the program. Moreover, the authorities were wise to approach the Fund with a request for financial assistance before the economic situation became unmanageable. While the situation is critical--both the internal and external balances of the economy have deteriorated rapidly in the past year or so--firm implementation of corrective policies could turn the tide.

I agree with the staff analysis regarding the causes of this situation. In particular, a weak fiscal policy stance has resulted in both an unsatisfactory price performance and a sharp deterioration in the external current account. Consequently, a substantial tightening of fiscal policy is the correct prescription, and the fiscal course adopted by the authorities deserves our support. Revenues should be strengthened and expenditures cut. The fact that half of the anticipated reduction in the fiscal deficit over the medium term is to take place during the first year, and that the authorities have expressed their commitment to introduce additional tightening, if necessary, is most welcome.

Structural reform of both the direct and indirect tax system is necessary for the achievement of the revenue goals set by the Administration. In this connection, I am, however, concerned about the distorted effects--not only on the widening of the tax base, but also on resource allocation--caused by the existing immunities and exemptions under the present system. I agree with other speakers that the authorities should aim at accelerating this reform process by introducing in next year's budget as many as possible of the still pending elements of the tax reform.

Expenditure reduction is always a difficult task and must be even more so for the new Administration. It seems, however, that the targets for expenditure cuts in the program are well founded. In particular, I subscribe to the new salary policy described in the background paper, as well as to the intended measures to reduce subsidies on fertilizers, although I agree with Mr. Rieffel that the pace could be faster. Furthermore, I hope that the decreased military and political tensions in the region will allow for even more far-reaching savings in military spending than currently planned.

In view of the low real income per capita, the high adult illiteracy rate, and very low participation rate of relevant age groups in tertiary education, I strongly endorse the investment priorities of the Government in the areas of health, education, and related sectors, as outlined in the policy framework paper.

With these observations, and because I can subscribe to the staff's recommendations as regards monetary policy, trade liberalization, and structural policy in general, I support the proposed decisions. I also agree with the staff that it would not be appropriate for the Board to approve the present multiple currency practices.

With regard to Table 5 of the staff report, which depicts the financing requirements for the next three budget years, the residual, on the penultimate line, is called "identified financing." I would appreciate clarification from the staff on why this financing does not appear in either "existing commitments" or "expected new commitments." Furthermore, I agree with Mr. Rye that there is little specific information on the identified financing needed to cover the financing gap.

Finally, I support Mr. Posthumus's proposal to note in the summing up the impediments to Pakistan's exports caused by the protectionist measures of the industrial countries.

Mr. Adachi made the following statement:

The structural reforms initiated under the extended arrangement with the Fund in the early 1980s brought substantial gains to the Pakistan economy. The measures taken by the authorities contributed to high growth and moderate inflation during the decade. The continued deregulation of pricing and the enhancement of producer incentives in particular merit commendation. However, recent economic indicators show somewhat worrisome symptoms. Previous speakers remarked that the fiscal deficit has increased, inflationary pressure is rekindling, and, despite robust exports, external imbalances are widening again.

To redress the imbalances rooted in the economy and to sustain growth, Pakistan must tackle a number of structural and financial problems, which are recognized by the authorities and dealt with in great detail in the program. This program is well designed and, given the strong commitment of the new Administration--as illustrated by the Prime Minister's speech--we have no difficulty in supporting the proposed stand-by and structural adjustment arrangements. We join other speakers in commending the authorities for their efforts to formulate a substantial and extensive program. Nevertheless, we wish to stress some points that are essential for the achievement of program objectives.

First, the enhancement of capital formation through increased domestic savings is critical, given the rapid demographic expansion. The reduction of the fiscal deficit, which is essential to contain inflationary pressures as well as to resume balance of payments viability, would be the key to the success of the program. However, we have serious concerns about the adverse developments in early 1988/89. While the additional measures taken by the authorities might compensate for the slippage, we urge the authorities to implement further supplementary measures as necessary. In this context, like Mr. Enoch, we encourage the authorities to introduce a general sales tax without delay, and we welcome the staff's comments on the possibility of expediting the proposed timetable.

The high level of domestic bank financing for the first quarter was also worrisome. We are encouraged by the authorities' efforts to increase the attractiveness of the Bearer National Fund Bonds. However, we are concerned about the increase in interest payments resulting from such action. We would welcome the staff's comments on the possible effect on government expenditure of debt service, which accounts for about one fourth of current expenditure. We would also emphasize the importance of restraining expenditure, although we understand the political sensibility accompanying restraint on defense-related expenditure.

Second, the continued flexible exchange rate policy will call for tightened credit policy in order to resume price stability. Monetary policy should also share with fiscal policy the responsibility for consolidating domestic absorption.

Third, given the proposed pace of reduction of the external deficit, we encourage the authorities to strengthen--and expedite, if possible--their efforts toward trade liberalization, although we recognize the small margin in the reserve position and the need to monitor carefully the effect on revenue.

To underpin the capital formation necessary for growth, and given the political environment in Pakistan, the country will have to continue to rely on concessional external support. Thus, it will be essential for Pakistan to provide confidence to potential donors and creditors by persevering with the adjustment program.

Mr. Zeas said that because the financial program presented by the Pakistan authorities was comprehensive and represented a realistic adjustment effort, he could support the proposed decisions. He wished to associate himself with those Directors who had cautioned about the pace of trade liberalization, and in particular, he agreed with the point made by Mr. Jalan, Mr. Zeas noted. The problem of excessively fast trade liberalization for a financially weak country had been one of his concerns for some time. For example, the same point had been raised during a recent Board discussion of another stand-by arrangement. Important negative short-run effects had to be taken into consideration, including the effects on government revenue, the increase in import demand, and the lack of net international reserves. Export promotion and diversification were the answer to those problems; however, recent increases of protectionist tendencies, particularly on the part of the more industrialized countries, made it more difficult, if not impossible, for countries such as Pakistan to achieve growth through a rapid increase in exports.

For those reasons, it was necessary to be cautious about a unilateral and excessively rapid reduction in import tariffs, and he warned against making that a performance criterion for either Fund or World Bank loans, Mr. Zeas stated. In any event, matters such as tariff reductions and trade liberalization were dealt with in a bilateral and symmetrical fashion by specialized institutions, such as the GATT.

Mr. Al-Jasser said that he joined those speakers who had suggested that if Pakistan was asked to liberalize its trade regime, its trading partners should be expected to remove their restrictions on imports.

The Director of the Middle Eastern Department noted that many Directors had recognized that the core of the program in Pakistan was the attempt to correct fiscal imbalances and to improve the structure of the budget. Speakers had commented on the high tariff protection accorded by Pakistan and the desirability of accelerating the timetable for the introduction of the general sales tax. Pakistan, of course, depended heavily on trade taxes. The proposed structural adjustment arrangement involved a significant reduction in import duties, but the authorities were reluctant to accelerate the pace, admittedly with some reason. They were taking important tax actions as regards both indirect taxation, through the introduction of a general sales tax, and direct taxation, through specific and potentially far-reaching structural measures affecting income tax. Thus, the authorities had removed immunities that adversely affected income tax collection and introduced a new panel audit system aimed at improving existing auditing procedures; both measures were also expected to help enhance revenue yields--particularly on the income tax side. As regards import duties, the average rate of duty incidence mentioned by Mr. Rieffel as having fallen from 52 percent in 1983/84 to 40 percent in the first eight months of 1988 was correct assuming that duties were levied on dutiable imports only; however, as at least one third of imports were not dutiable, the duty incidence rate for 1988 was closer to 30 percent of total imports. While that figure was much higher than the average rate in some Asian countries, such intracountry comparisons were perhaps not especially meaningful in that respect.

Many Directors had referred to the sharp increase in current expenditures in the past few years, which was largely attributable to interest payments, the Director stated. Those payments had been considerable in the short run. The authorities had attempted to limit borrowing from the banking system and had paid high rates of return to finance the budget deficit outside the system. Of course, with the reduction in the budget deficit over the medium term, that source of financing would be needed to a much lesser degree. Provincial expenditures had been held down in 1988/89 to about 4.1 percent of GDP, compared with an average of 4.6 percent in the two previous years. As a proportion of GDP, total expenditures, excluding interest payments, were projected to decline from approximately 15 percent in 1987/88 to about 13.5 percent 1988/89.

The authorities had taken a number of expenditure-restraining measures, the Director continued. Partial indexation of federal government wages and salaries had replaced full indexation; the fertilizer subsidy had been reduced; armed forces pension expenditures had been postponed; and a procedure to review carefully requests for supplementary appropriations had been instituted. The authorities were adhering strictly to their guidelines regarding federal transfers to the provinces and had limited the provinces' ability to borrow from the markets. Those measures would apply pressure on the provinces to reduce their expenditures or, equally important, encourage them to introduce agro-income taxation, although that tax was difficult to implement, because of the division of the instrument's constitutional authority between the provinces and the Federal Government. The budget as approved on December 8, 1988 showed an increase in expenditures, not because of a change in policy but because of revisions in some environmental assumptions. Nevertheless, the staff's preliminary assessment was that the overall deficit would remain within the target of 6.5 percent of GDP in 1988/89.

The increase in liquidity projected for the third year of the program--above 12 percent--appeared to be adequate following the mopping up of excess liquidity in the earlier two years, the Director remarked.

The faster than anticipated rise in the rate of inflation in the early part of the current fiscal year had resulted from special factors, the Director reported; for example, certain meat products had been hit by viruses, and meat prices had almost doubled within a short period of time; moreover, floods had hampered the transportation and distribution of essential goods. Year over year, however, the staff remained of the view that the increase would be in the order of 10 percent in 1988/89.

The authorities had attempted to introduce price reforms in the public enterprise sector, particularly with regard to the major parastatals, the Director remarked. Self-financing would assume a larger role in the financing of the Water and Power Development Authority of Pakistan.

The decline in workers' remittances could be attributed to various causes, the Director observed. In Pakistan, the exchange rate was just one of many factors that affected remittances, and over the past five or six years Pakistan's history of exchange rate management had been more than satisfactory. While remittances would be affected if barriers to private investment were reduced, it was important to recognize the effect of confidence. Accordingly, the authorities had taken measures to regain confidence, such as increases in investment sanctions and in the previously limited amount of imports permitted for final users.

Despite the disadvantages mentioned by many speakers regarding the foreign exchange bearer certificates, they offered a vehicle for the encouragement of private sector investment through the provision of foreign exchange, the Director noted. The premium on those certificates over the official exchange rate ranged between 7 percent and 9 percent. As to the indicative targets for net international reserves, footnote 1 to Table 3 in the memorandum on economic policy should have read: "Minus signs mean an increase in net foreign assets, as well as in net international reserves."

The staff did not consider that the Islamic banking system introduced in Pakistan had been an impediment to monetary policy, the Director said.

As to possible Paris Club rescheduling, the subject had not been broached with the authorities, perhaps in part owing to the fact that there was no balance of payments gap, assuming all debt service payments were made, including payments to the Fund, the Director noted. Additionally, the Pakistan authorities might be concerned that if they requested debt rescheduling, credit facilities could possibly be cut back. Moreover, in view of the large amount of concessional aid that had been received in the recent past and was expected to be provided, at about the same level, in the future, it was possible that the authorities did not consider rescheduling an appropriate financing option at that time.

A high level of bank financing of the budget had been evident at the beginning of the year, the Director said. Sales of bearer bonds, which had traditionally been an important instrument in financing the budget deficit, were stopped in August 1988 and had been resumed only on November 7, albeit with a remarkably favorable response. The sales would increase interest payments in the budget only by a small amount because most of the outstanding stock of debt had been incurred at lower rates.

The staff had attempted to report on Pakistan's ability to service its obligations to the Fund in Appendix Table 10 in the staff report, which showed how external debt service payments would be made under the adjustment program, the Director of the Middle Eastern Department pointed out. The staff had also indicated that if the program was fully implemented, the debt service ratio should be reduced from somewhat more than 30 percent to about 25 percent over the program period, thus improving Pakistan's foreign debt obligation situation. As Board members were aware, Pakistan's record of economic management had been good, and the discharge of its obligations--to the Fund or other creditors--timely.

The staff representative from the Middle Eastern Department recalled that several speakers had referred to the poor prospects for private saving in the program. The recent data on private sector saving that were available to the staff presented problematic information. The average private sector propensity to save in 1986/87 had been nearly 17 percent of GDP, but it had fallen to 13.8 percent in 1987/88. The staff believed that the financial reform program on which the authorities were about to embark would, over the medium term, act as a significant incentive in fostering financial saving by the private sector. Nevertheless, the question arose as to how much reliance should be placed on that prospect in the overall design of the program. In the first year, a fairly substantial reduction in the fiscal deficit was programmed, and the staff considered it prudent to assume that since that reduction would be achieved by measures to increase tax and nontax revenue for the Government and by restraint on some expenditures that would be relatively close substitutes for private sector consumption, total domestic saving would rise less than government saving in the initial year. Thus, the program projections assumed that the increase in government saving resulting from the fiscal adjustment would be associated with an initial decline in private sector saving from 13.8 percent in 1987/88 to about 12.9 percent in 1988/89. Thereafter, it was assumed that private sector saving would rise again to about 13.9 percent at the end of the program--a level broadly consistent with past saving behavior, excluding 1986/87, which was an atypical year. Of course, the possibility remained that financial reforms could result in higher private sector saving than had been assumed as a basis for the program.

Several Directors had expressed concern about the high inflation rate for 1988/89, the staff representative continued. The staff had projected a year-on-year inflation rate, as measured by the GDP deflator, of 10 percent in 1988/89. That projection mainly reflected the fact that prices had increased very rapidly toward the end of the previous fiscal year and in the first several months of the current fiscal year. During the first program year, price increases would have to be relatively slow to achieve the inflation target. For that reason, the targeted rate of growth of net domestic assets for 1988/89 was only 10.4 percent, against a projected rate of growth of nominal GDP of over 15 percent. The tight ceiling on the rate of growth of net domestic assets would help to bring down the rate of inflation relative to the situation that had prevailed prior to the initiation of the program.

The staff did not consider that the projections for capital receipts during the program period were too optimistic, the staff representative remarked. Apart from the drawings under the stand-by and structural adjustment arrangements, most of the funds needed to fill the financing requirements of the program during the adjustment period were expected to come from the World Bank and the Asian Development Bank. Work was advancing on a number of program loans in both institutions, and the staff's projections of World Bank disbursements were significantly lower than the World Bank's own current assumptions in conjunction with its projected lending program. Moreover, based on past experience, the forecasts for disbursements from bilateral creditors did not appear to be overly optimistic.

The indexation of specific import duties would have no adverse effect on inflation and, in fact, the measure was commendable, the staff representative commented. The authorities had noted that when excise and import duties were levied at specific rates, the ad valorem equivalents of those specific duties often tended to fall over time if the prices of importables rose. They therefore considered it important to revise the rates each year to maintain their ad valorem equivalence. Such measures should not contribute to more rapid inflation.

The authorities had considered introducing the general sales tax before July 1, 1990 and had sought advice from external consultants, the staff representative noted. While the general sales tax would initially be extended to the importer and manufacturer level only, it would be a value-added type tax in the sense that it would be accounts based, would consider all goods taxable in principle, and would have tax credit features. It was thus very important for the success of the tax that it be properly introduced and administered. The Fund staff had had considerable practical experience with the introduction of such taxes and its technical assistance had been requested by the authorities. The staff considered that implementing the tax earlier than July 1, 1990 would not be feasible.

During the past year the authorities had already substantially extended the base of the sales tax on imported commodities and on a small number of relatively important domestically produced goods, the staff representative added. The authorities had made a commitment that in the budget for 1989/90 they would, as an interim measure in moving to the general sales tax, widen the base of the sales tax on domestic production from 22 percent to 30 percent by a relatively broad extension of the tax base to at least 50 additional manufactured items. Such action was also a good structural measure that would help to achieve the targeted fiscal adjustment. A number of speakers, while welcoming the authorities' commitment to introduce the general sales tax in 1990, had expressed concern at the delay in extending it to the wholesale and retail level until a later date, but the staff considered that such an extension would involve practical difficulties. The present sales tax was paid by about 4,000 taxpaying entities, and 70 percent of it was levied at customs. Applying the general sales tax to importers and to large and medium-sized manufacturing establishments would greatly expand the base while increasing the number of taxpaying entities to about 12,000. However, according to the partial data available, a further extension of the sales tax through the wholesale and retail stage would increase the number of taxpaying entities by about 50,000 while increasing revenues from the sales tax by only about 7 percent--a fivefold increase in the number of taxpaying entities to achieve an increase of less than 10 percent in gross tax revenue. Thus, it was necessary to review the experience with implementing the general sales tax at the importer and manufacturer level to see what administrative difficulties had arisen before extending it to the wholesale and retail level.

A general question had been raised suggesting that the results of the import liberalization process and the deregulation that had taken place over the past few years had not been satisfactory, the staff representative recalled. The view had been held that while high rates of total GDP growth and especially of manufacturing growth had been achieved, the external current account deficit associated with the liberalization was a significant problem. The staff, looking at the experience of the economy, considered instead that the impetus to trade liberalization had taken place in the early 1980s, partly under the program supported by an extended arrangement with the Fund. The increase in the external current account deficit that had occurred in 1987/88 was not directly related to the earlier liberalization; rather, the staff would argue that the increase in the external deficit had reflected the relatively lax fiscal and monetary stance of recent years. Therefore, the staff considered it possible to proceed expeditiously with properly sequenced import liberalization without it having a significant negative impact in terms of a serious import surge, provided that the fiscal adjustment contemplated under the program was taking place at the same time.

Some concern had been expressed about the inclusion of targets for net international reserves in the program, because Pakistan's balance of payments--like that of many other developing countries--was subject to relatively large short-term swings, the staff representative from the Middle Eastern Department noted. The authorities had expressed the same concern and, as a result, the net international reserves test in the program was generally an indicative target that would result in discussions with management if breached. The only occasion on which the net international reserves floor became a performance criterion was when the indicative target for external non-import-related short-term external liabilities was breached. That approach was needed because the authorities had large outstanding liabilities in the form of foreign exchange bearer certificates and foreign currency deposits from nonresident commercial banks. The outstanding stock of those liabilities could be liquidated at the instance of the holder and was therefore not under direct control. If an accumulation of foreign exchange bearer certificates and foreign currency deposits breached the indicative ceiling for non-import-related short-term external liabilities, the broader external objectives of the program were not necessarily being missed, provided that the proceeds from that accumulation went into reserves. For that reason the program contemplated that, for any test date when the indicative target for those short-term liabilities was breached, the net international reserves floor would become a performance criterion to guarantee that the proceeds from any accumulation of foreign exchange bearer certificates and foreign currency deposits from nonresident commercial banks went into gross reserve accumulation.

The staff representative from the Exchange and Trade Relations Department noted that although the authorities intended to eliminate the multiple currency practice associated with the advance import deposits by May 1990, the staff was proposing approval for only 12 months from the date of the decision, and it would discuss earlier elimination with the authorities.

The staff had treated the country's capacity to repay the Fund in the staff report, but some Directors would have appreciated further information, the staff representative noted. The paper that was being prepared for the Board's consideration in connection with the next review of overdue financial obligations to the Fund would include a discussion of members' capacity to repurchase. Any specific guidance from Executive Directors could be provided to the staff in that context.

Mr. Finaish observed that it was significant that the Board discussion and the negotiations leading to it had taken place against the backdrop of accession to power by a new, democratically elected government. It was particularly noteworthy that the recent political transition in Pakistan had taken place in a smooth fashion, which attested to the high degree of political and institutional maturity the country had been able to achieve. With democracy in place, it was absolutely imperative that it be given a chance to work.

For its part, Pakistan's new leadership recognized that success in carrying out its mission rested on its ability, both real and perceived, to improve the lot of the country's large and rapidly expanding population, Mr. Finaish commented. Despite a relatively strong growth performance in the 1980s, per capita income--at \$385--and the literacy rate--at 30 percent--had remained low, and progress in a number of other important social areas had been slow. Also, Pakistan's rates of capital formation and domestic savings had remained low in recent years while the infrastructure had become inadequate. In addition, financial imbalances had recently grown larger, thereby threatening the economy's growth and balance of payments prospects.

Against that background, the new Government had decided to fully endorse the policy framework underlying the program under consideration, Mr. Finaish continued. That endorsement reflected the Government's recognition that the substantial reforms, particularly those leading to an early strengthening of Government finances, envisaged under the program were important for ensuring sustained economic growth over the medium term without excessive recourse to external borrowing on commercial terms and while ensuring that the country's balance of payments was not subjected to pressures that the excessively low level of gross official reserves might be unable to withstand. As noted by several Directors, the authorities' letter to the Fund's management, which was circulated recently, highlighted the Government's firm commitment to the timely implementation of the adjustment and reform measures envisaged under the program.

The international community would, of course, have a key role to play in supporting Pakistan's adjustment and reform effort in the period ahead, Mr. Finaish noted. With the protracted nature of the country's balance of payments difficulties, it was clear that notwithstanding the significant reduction in the current account deficit relative to GNP envisaged under the program, Pakistan would have to continue to rely on rather substantial amounts of external assistance, mostly on concessional terms.

It should also be kept in mind that even with the programmed increase in official reserves, those would still 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 was exposed, Mr. Finaish observed. Regrettably, an important source of those uncertainties continued to be the protectionism in major foreign markets. The staff provided in Appendix III of the background paper a list of trade barriers faced by Pakistan. It was ironic that at a time when many developing countries were embarking on far-reaching trade liberalization measures and opening up their markets, the success of their export-driven adjustment strategies continued to be threatened by protectionist barriers in major foreign markets. Several Directors had commented on the role a flexible exchange rate policy was expected to play in promoting nontraditional exports, which was a key objective of the program. However, at least as important in that regard was translating competitiveness into enhanced export performance through assured access to foreign markets.

For the Fund's part, by supporting Pakistan's adjustment and reform effort and by doing what it could to ensure the success of that effort, it would have an opportunity to demonstrate the virtues of not waiting too long before embarking on needed reform and adjustment measures with Fund support, Mr. Finaish remarked. Compared with other cases that had come to the Board, the Pakistan economy had not been in a crisis, or on the verge of one, when the authorities decided to adopt the adjustment program under consideration. Nor were the authorities contemplating a rescheduling of foreign liabilities upon approval of the program, as was generally done in other cases. However, it had become apparent to the authorities that the fiscal policy stance and the structural weakness from which the economy continued to suffer had the potential to threaten growth and financial stability if not resolutely corrected.

Regarding the pace of adjustment and reform, it would seem that, given the available financing as well as the growth and balance of payments objectives, to argue cogently that the envisaged pace was too slow--an argument that overlooked the substantial front-loading of fiscal adjustment and the significant price increases that had ensued in a number of sensitive areas--one would have to either demonstrate that the pace was too slow to achieve the said objectives, or be prepared to accept a more modest growth target than envisaged under the program, Mr. Finaish remarked. With respect to the first possibility, he wondered whether there was a compelling--or perhaps not so compelling--reason to challenge the internal consistency of the programming exercise undertaken by the staff. As to the second possibility, he could only reiterate the importance that should be attached in the circumstances of Pakistan, and perhaps even more so in light of the political changes that had recently taken place, to effecting a discernable improvement in the standards of living of that country's some 110 million people. Besides, and more fundamentally, he wondered why a more modest growth target should be incorporated in the program. Were the current conditions of the Pakistan economy such that a shock treatment was callled for, or was the stance in the major policy areas so much at variance with the usual Fund prescription as to warrant that kind of treatment? A fair reading of the staff documents should, if anything, lead one to believe the contrary to be the case. That was, of course, not to suggest that adjustment and reform were not needed. The authorities, having recognized that need, had begun in early 1988 to devise a program of vigorous fiscal and monetary policy adjustment, supplemented by appropriate structural reform measures, that promised to restore medium-term balance of payments viability and to contain the resurgence of inflationary pressures, while improving the employment prospects for a rapidly growing labor force.

In several major respects, the program built upon previously intitiated and implemented reforms, Mr. Finaish observed. For example, in the area of exchange rate management--quite frequently, an area in which there was considerable divergence of views between the Fund staff and the authorities of member countries--the Pakistan authorities had for some time maintained a flexible exchange rate policy with the aim of enhancing the competitiveness of the tradable sector and attracting workers' remittances. Under the program, the authorities intended to continue to manage the exchange rate flexibly in light of developments in inflation both domestically and in Pakistan's major trading partners. In particular, the authorities would ensure that, at a minimum, the real effective exchange rate did not rise above its average level for April-June 1988. In accordance with that objective, the authorities had recently depreciated the rupee against the U.S. dollar, which, combined with the depreciation of the dollar against the major currencies, had led to a real effective depreciation in the rate for the rupee to 2-3 percent below the average level of April-June 1988.

Other examples of reform measures that had been implemented previously and that the program would build upon were those aimed at fostering trade and price deregulation, Mr. Finaish reported. With regard to the trade regime, following the switch from a positive to a negative import list in July 1983, the authorities had reduced duties on raw materials, semifinished intermediate products, and capital goods. Export subsidies had been abolished in 1986, a move facilitated by continued flexible management of the exchange rate. The authorities' medium-term policy framework incorporated a phased program of import liberalization and external tariff reform. The first phase, implemented in July 1988, involved, among others, a shortening of both the negative and restrictive lists with the lists of items importable subject to restrictions merged into a single list, and a lowering of the external tariff rate from 150 percent to 125 percent. The second phase, to be implemented in July 1989, would involve a further shortening of the negative list, as well as additional rationalization of the tariff structure. Those actions would be pursued further in the third phase, which would involve a reduction in the maximum import duty rate to 100 percent.

Moreover, the authorities had initiated other reforms already initiated upon which the proposed program would build, Mr. Finaish noted. It should be clear, therefore, that the Pakistan authorities' prudent management of the economy had been considerably aided by reforms that had been in place for some time and that, since their implementation, had continued to be strengthened. Earlier in the year, the authorities had decided to pursue their adjustment and reform effort in the context of a comprehensive program with the aim of dealing fundamentally with key financial and structural weaknesses that beset the performance and prospects of the economy. In support of that program the authorities were seeking, and rightly deserved, the understanding and the continued assistance and cooperation of the Fund and the international community.

The Acting Chairman made the following summing up:

Executive Directors concurred with the thrust of the appraisal in the staff report. They commended the Pakistan authorities for the rapid growth achieved in the 1980s and for the comprehensive adjustment and structural program that they initiated with the 1988/89 fiscal year.

Despite some misgivings regarding the adequacy of certain aspects of the program and the proposed pace of implementation of some key measures, Directors, nevertheless, believed that this program represented a substantial and ambitious effort to address unsustainable internal and external financial imbalances, in particular the excessive overall fiscal deficit and the critically low level of gross official foreign reserves. It also represented a commendable effort to implement a framework of structural change conducive to increased saving and investment, sustained export-led economic growth, and greater involvement of the private sector in economic activity.

Directors emphasized that fiscal adjustment and reform were central elements of the program and that there should be no slippage in the implementation of these measures. They welcomed the strong start in deficit reduction that is programmed for 1988/89, and they viewed the proposed structural reform measures to expand the tax base and to increase its elasticity as crucial. They stressed the need to push forward as scheduled--and, in the view of some, at a faster pace--with the substantial broadening of the base of the sales tax by July 1, 1989 and with the introduction of the general sales tax by July 1, 1990. In the area of direct taxation, the measures to improve audit procedures and to eliminate immunities and exemptions should be forcefully implemented. A few Directors also stressed the desirability of extending taxation to agricultural income.

Given the high levels of fiscal deficits in recent years, a number of Directors observed that to achieve the targeted fiscal adjustment, the authorities should act more forcefully than planned to reduce recurrent budget outlays and to improve expenditure monitoring and control procedures. Many Directors therefore urged the authorities to be prepared to take any additional measures, including timely adjustments in administered prices, and to adhere strictly to the implementation schedules of tax reform. Directors noted that the fiscal targets for 1988/89 were tight, and they urged the authorities to take prompt action as needed in support of the program.

Directors welcomed the medium-term liberalization of the import system recently implemented by the authorities; this liberalization emphasizes a shift from nontariff to tariff protection and entails a lowering of the maximum tariff rate together with rationalization of many individual rates. A number of Directors believed, however, that the proposed pace of import liberalization was too cautious and that the tariff level would remain unduly high. They urged the authorities to act more boldly in the area of trade liberalization, as well as in dismantling the pervasive pricing, trade, and industrial regulations, since such measures would strengthen efficiency, competition, and export-led growth and help to reduce inflationary pressures. Some Directors, however, cautioned that decisions affecting the pace of trade liberalization should take into account the country's weak reserve position and the pace of supporting domestic policy adjustments. Directors also expressed concern about the impact on Pakistan of import restrictions in industrial countries and emphasized that Pakistan needed more open markets in industrial countries to realize its export potential.

Directors stressed that firm domestic credit restraint would be a crucial supporting element of the authorities' adjustment program. Furthermore, they noted that to ensure that adequate financial resources are available to the private sector, the authorities should adhere strictly to their limits on domestic bank borrowing by the Government. Directors were generally supportive of the financial sector reform program contemplated by the authorities; implementation of this reform would help to mobilize private savings--in this connection, the current low level of savings was noted as a source of concern by a number of Directors--and would also reduce rigidities in the financial system and enhance the financial soundness of the domestic banking system.

Directors commended the authorities for their continuing commitment to implementing flexible exchange rate management, with some Directors encouraging a more active approach to exchange rate adjustment. Directors welcomed the decision of the authorities to limit Pakistan's recourse to foreign borrowing on commercial terms. The rapid growth of external debt in recent years was a source of concern to many Directors, who urged the authorities to adhere strictly to the limits they had set on foreign borrowing with a view to returning rapidly to a sustainable level of external debt service. Many Directors also stressed that, for many years to come, Pakistan would remain dependent on generous and large inflows of concessional assistance.

Directors welcomed recent moves to liberalize restrictions on international current and capital transactions. However, they encouraged the authorities to eliminate the remaining bilateral payments agreements, the multiple currency practice associated with the foreign exchange bearer certificates, and the mandatory minimum margin requirements for opening import letters of credit as early as possible.

Finally, Directors warmly welcomed the commitment of the new Government of Pakistan to implement fully the proposed program, and they exhorted the authorities to seize this opportunity to reform the structure of the economy so as to strengthen the basis for durable and balanced growth.

It is expected that the next Article IV consultation with Pakistan will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV 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 earlier.

Decision No. 9051-(88/185), adopted
December 28, 1988

Stand-by Arrangement

1. The Government of Pakistan has requested a stand-by arrangement for a period of 15 months from December 28, 1988 for an amount equivalent to SDR 273.15 million.

2. The Fund approves the stand-by arrangement set forth in EBS/88/250, Supplement 3.

Decision No. 9052-(88/185), adopted
December 28, 1988

Structural Adjustment Arrangement

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 (EBD/88/331).

3. The Fund approves the arrangements set forth in EBS/88/250, Supplement 4.

Decision No. 9053-(88/185), adopted
December 28, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/184 (12/21/88) and EBM/88/185 (12/28/88).

2. NEPAL - TECHNICAL ASSISTANCE

In response to a request from the Nepalese authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/88/366 (12/19/88).

Adopted December 23, 1988

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 88/79 through 88/82 are approved. (EBD/88/364, 12/19/88)

Adopted December 23, 1988

APPROVED: June 22, 1989

LEO VAN HOUTVEN
Secretary