FOR AGENDA

SM/86/51

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February 28, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Pakistan - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Pakistan, which has been tentatively scheduled for discussion on Monday, March 31, 1986. A draft decision appears on page 24.

Mr. Hitti (ext. 4520) or Mr. Jakubiak (ext. 7109) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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Department Heads

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INTERNATIONAL MONETARY FUND

PAKISTAN

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the 1985 Consultation with Pakistan

Approved by A.S. Shaalan and J.T. Boorman

February 26, 1986

I. Introduction

The 1985 Article IV consultation discussions were held in Islamabad during September 9-18 and December 8-15, 1985. The Pakistan representatives were led by Mr. H.U. Beg, Finance Secretary, and Mr. A.G.N. Kazi, Governor of the State Bank of Pakistan, and included the secretaries and other senior officials from concerned ministries and government agencies. During the September visit, the staff also had discussions with Dr. Mahbub ul Haq, then Minister for Finance, Planning, and Economic Affairs. Mr. Mohamed Finaish, Executive Director for Pakistan, attended the December discussions. The staff representatives were Messrs. S. Hitti (Head), H. Jakubiak, E. Maciejewski, and R. Floyd (all of MED), who participated in both the September and December discussions; Mr. E. Zervoudakis (ETR) and Ms. H. Sudo (Secretary - MED) who participated in the September mission; and Ms. C. Byrne (Secretary - MED) who took part in the December visit. Mr. I. Bannon (IBRD) attended some of the September meetings as an observer.

Pakistan continues to avail itself of the transitional arrangements of Article XIV.

II. Recent Developments

1. Background

During the 1980/81-1982/83 1/ period, Pakistan made substantial progress in implementing structural and financial adjustment policies that were supported by an extended arrangement with the Fund 2/ and a structural adjustment loan from the World Bank. The major structural changes put in place included enhanced price incentives in the energy

1/ Fiscal years beginning July 1.

2/ The program under the extended arrangement and Pakistan's performance relative to the program's targets and objectives were reviewed in EBS/83/249 (11/23/83). Pakistan's relations with the Fund and the World Bank Group are summarized in Appendices I and II, respectively.

and agricultural sectors, the adoption of a flexible exchange rate system, and the implementation of import liberalization actions. However, some important reforms that were included in the authorities' program, in particular the reform of the domestic tax system and external tariffs, were not implemented.

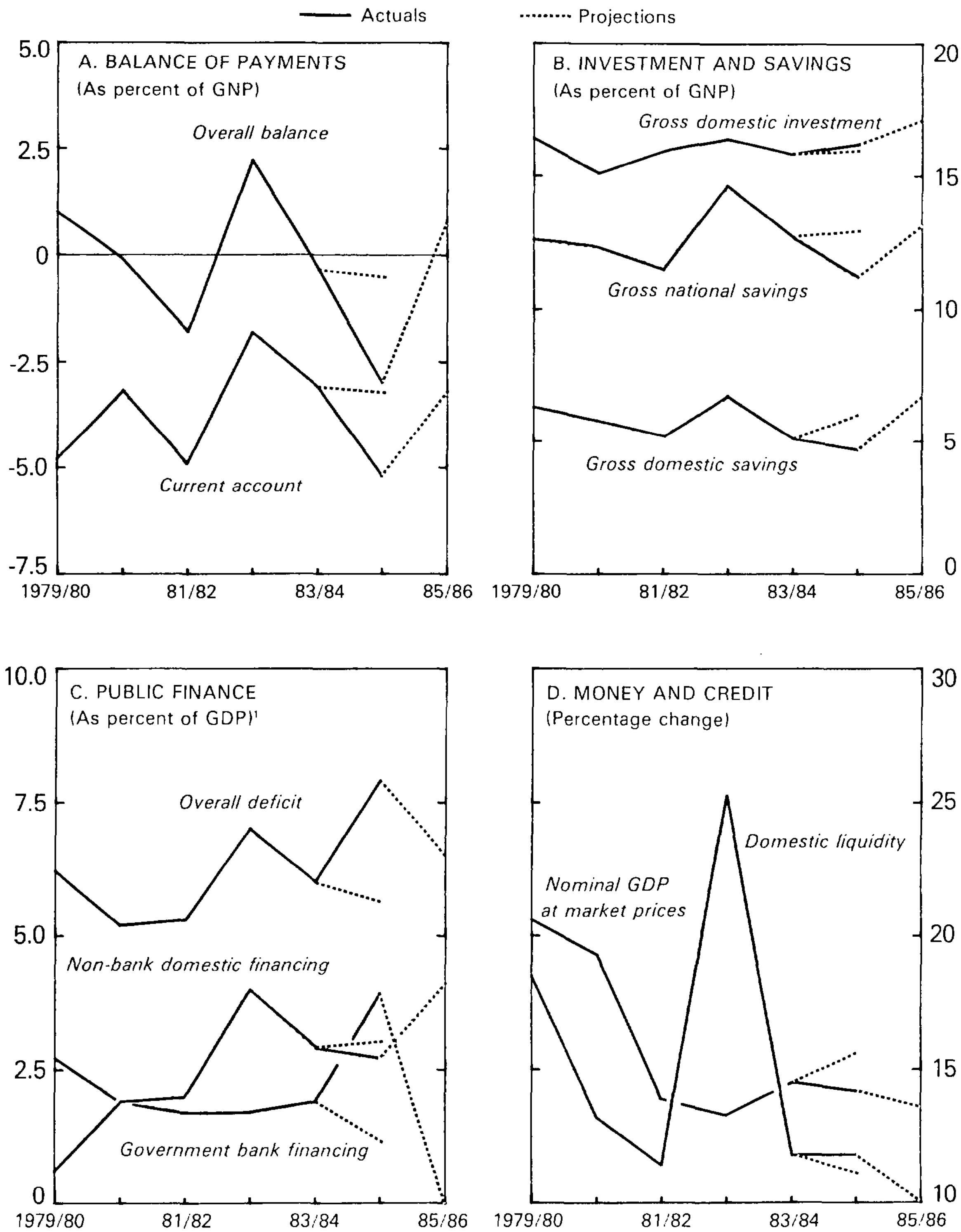
Over the three years, real GDP rose at an average annual rate of over 6 percent (Table 1 and Chart 1). Production records were established for the major crops, and self-sufficiency in major foods was attained. Manufacturing output also expanded rapidly, although investment and savings levels remained relatively low. Fiscal performance was satisfactory during 1980/81-1981/82 but evidenced a deterioration in 1982/83. Over the three-year period, Pakistan's demand management stance was on balance cautious, and contributed to a declining rate of inflation and an improved external sector performance. In 1982/83, however, the rate of monetary expansion accelerated to 25 percent (more than twice the average of the preceding two years), reflecting in large part the emergence of a substantial balance of payments surplus. In that year, export and remittance growth responded to the exchange system reform and the real effective depreciation of the rupee by some 20 percent in 1982 (Chart 2), and thereby contributed to an overall external surplus of nearly US$700 million. As a result, Pakistan recorded a cumulative balance of payments surplus of nearly US$100 million over the three-year period. At end-1982/83, gross official reserves were about US$2.0 billion, equivalent to 15 weeks' imports.

Pakistan's growth performance received a setback in 1983/84 when adverse weather conditions resulted in a 40 percent decline in cotton production as well as declines in wheat and rice output. In the aggregate, value added in agriculture fell by 6 percent and lowered the overall real growth to about 3.5 percent (Appendix III, Table 2). The pace of price adjustment in the energy sector was sustained as both producer and consumer energy prices were increased considerably. The policy of linking petroleum producer prices to international equivalents less a percentage discount was continued so that for all fields prices were broadly in line with international values. However, in agriculture, the pace slowed generally for both output and input prices. Expenditures under the Annual Development Program (ADP) fell in 1983/84 which, in combination with a good revenue performance, resulted in a decrease in the overall fiscal deficit by over one percentage point to 6 percent of GDP (Appendix III, Table 3). Budget receipts rose by about 20 percent, reflecting discretionary measures introduced with the budget. However, the growth of current spending at 25 percent remained high, reflecting about 20 percent and 25 percent increases in subsidy and interest payments. The latter resulted for the most part from the doubling of domestic nonbank borrowing over the 1982/83-1983/84 period. With a shortfall in external resources, the financing of the fiscal deficit remained heavily reliant on domestic private savings, while domestic bank borrowing was triple the budget forecast. In addition, lending to the private sector was also higher than planned by the authorities.

CHART 1

PAKISTAN

ECONOMIC INDICATORS, 1979/80-1985/86



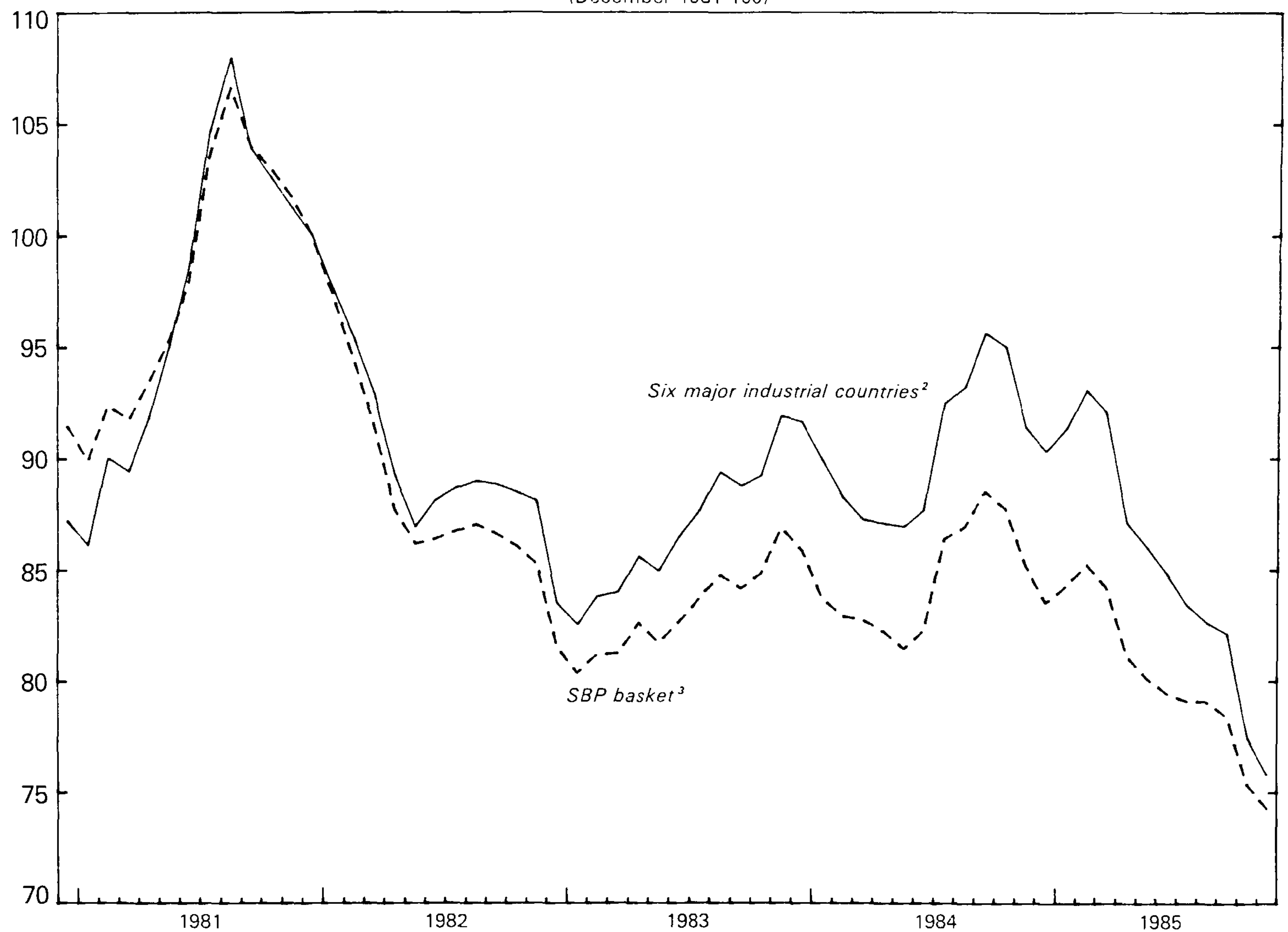
Source: Data provided by the Pakistan authorities.
[1]Absolute values.

CHART 2

PAKISTAN

REAL EFFECTIVE EXCHANGE RATE INDICES[1], 1981-85

(December 1981=100)



Source: Staff calculations based on *IFS* data.

[1] Increases mean appreciation.

[2] Based on export weights for manufactured products.

[3] Based on major trade partner weights (excluding petroleum).

Table 1. Pakistan: Selected Economic and Financial Indicators, 1980/81-1985/86

	Actual				Prov. Actuals	Official Proj.
	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86
	(Annual change, unless otherwise specified)					
National income and prices						
GDP (at constant factor cost)	6.6	6.6	6.2	3.4	8.4	6.5
GDP deflator (market price)	10.8	9.0	6.0	9.7	5.6	6.6
Consumer prices (period average)	12.4	10.0	4.5	8.3	7.5	...
External sector (in U.S. dollars)						
Exports (f.o.b.)	19.5	-17.1	13.3	1.6	-12.0	25.3
Imports (f.o.b.)	14.5	3.7	-2.7	6.7	-0.9	1.0
Non-oil imports (c.i.f.)	9.8	3.2	-1.7	11.3	-0.5	4.2
Workers' remittances	20.3	6.1	29.8	-5.2	-10.6	3.0
Real effective exchange rate						
Trade basket 1/	2.4	5.4	-13.8	0.3	0.7	...
Industrial country basket 2/	4.5	10.1	-11.7	3.1	2.5	...
Money and credit						
Money and quasi-money	13.2	11.4	25.3	11.8	11.8	10.2
Domestic assets (net), of which:	15.1	16.8	16.3	14.4	23.9	7.4
Government	(11.2)	(12.2)	(14.8)	(10.5)	(23.3)	(-11.5)
Nongovernment	(18.9)	(20.0)	(20.7)	(21.7)	(16.8)	(22.9)
Velocity	4.5	1.6	-4.6	-2.8	2.1	2.4
Interest rates (annual rate, one-year savings deposits)	10.5	10.5	10.5	10.5	10.5	... 3/
Government						
Total revenue	22.1	10.5	14.0	22.2	7.7	15.4
Tax revenue	19.5	10.7	14.0	18.8	4.3	16.7
Total expenditures	16.5	11.6	22.7	14.8	17.6	12.3
	(In percent of GDP)					
Government						
Total revenue	16.6	16.1	16.2	17.3	16.3	16.5
Tax revenue	13.7	13.3	13.4	13.9	12.7	13.0
Total expenditure	22.5	22.0	23.8	23.9	24.6	24.3
Overall deficit	5.2	5.3	7.0	6.0	7.9	6.5
Budgetary financing:						
Domestic bank	0.8	1.7	1.7	1.9	3.9	-0.1
Domestic nonbank	1.9	2.0	3.9	2.9	2.7	4.1
Foreign (including grants)	2.5	1.6	1.4	1.2	1.3	2.5
Total bank financing (including commodity operations)	2.3	2.0	2.6	1.6	3.8	-2.1
	(In percent of GNP, unless otherwise specified)					
Gross domestic investment, of which:	15.6	16.3	16.4	15.8	16.2	17.1
Gross domestic fixed capital formation	(14.2)	(14.3)	(14.3)	(14.0)	(14.6)	(15.5)
Gross domestic savings	5.8	5.2	6.7	5.1	4.7	6.7
Gross national savings	12.3	11.5	14.6	12.7	11.2	13.1
External sector						
Current account deficit 4/	3.2	4.9	1.8	3.1	5.2	3.2
Overall balance	-0.1	-1.8	2.2	-0.3	-3.0	0.8
External debt 5/	34.0	34.7	39.1	37.0	37.5	37.2
Debt service ratios (in percent of current account receipts)						
Including use of Fund credit	16.2	12.9	13.3	15.6	19.7	20.8
Excluding use of Fund credit	11.5	9.7	10.7	13.7	16.3	15.9
Interest payments (in percent of current account receipts)	7.3	5.5	6.3	7.0	7.7	6.3
	(In millions of U.S. dollars, unless otherwise specified)					
Current account deficit	-991	-1,610	-557	-1,031	-1,775	-1,148
Overall balance	-24	-580	698	-86	-1,001	281
Gross official reserves (in weeks of c.i.f. imports)	8.8	6.9	15.2	13.9	5.2	8.0 6/

Sources: Ministry of Finance and Economic Affairs and State Bank of Pakistan.
1/ Depreciation (-). Based on major trade partner weights (excluding petroleum).
2/ Depreciation (-). Based on industrial country competitor weights for manufactured goods.
3/ The financial system was changed to an Islamic noninterest basis effective July 1, 1985.
4/ Excludes grants which are included in long-term capital.
5/ Total civilian debt consisting of medium- and long-term disbursed debt repayable in foreign currency, use of Fund credit, short-term debt (of one year or less) and disbursed foreign debt repayable in local currency.
6/ Includes foreign currency deposits by nonresident commercial banks.

This excess credit growth was largely vented through the external sector, but with the lagged impact of the substantial monetary growth in the previous year, the GDP deflator reached nearly 10 percent.

The balance of payments recorded an overall deficit of US$85 million in 1983/84 (Appendix III, Table 5) as the current account deficit almost doubled to about US$1 billion (3.1 percent of GNP). The major developments contributing to this outcome were a weakening of export growth (to under 2 percent) mainly due to the poor cotton crop, a decline in workers' remittances, and a surge in private sector imports resulting in part from the large monetary expansion in the previous year. In addition, capital inflows were substantially lower. With regard to the trade reform, the changeover of the import system from a positive list to a negative/restricted list system was introduced for 1983/84. However, the Import Policy Order (IPO) document continued to include the former positive list and other industry-specific positive lists. Certain limits on invisible payments for travel and education were raised.

2. Developments and policies in 1984/85

a. Real sector developments

In 1984/85 there was a sharp recovery in agricultural production which lifted the overall growth rate to nearly 8.5 percent. In particular, cotton output more than doubled (and surpassed its previous record level by nearly 25 percent); in addition there was a rebound in wheat. The strong cotton performance reflected, apart from good weather conditions, measures taken by the authorities to ensure the timely availability of inputs and extension guidance for farmers. However, only limited changes were made in agricultural output prices, and there were no major changes in prices of agricultural inputs. The increases in the procurement prices for cotton lint were marginal, and the increase in the wheat procurement price was 9 percent. Fertilizer prices were not raised in 1984/85, and consequently the objective of eliminating the fertilizer subsidy by mid-1985 was not achieved. Moreover, for the second consecutive year no water price adjustments were effected, and this outcome, in conjunction with a sizable expenditure growth, resulted in a decline in the cost recovery ratio to 45 percent in 1984/85 compared with 57 percent in 1982/83. In the area of deregulation, the stocking and marketing of sugar was turned over to the private sector.

In the energy sector, the authorities continued their program of price rationalization with World Bank assistance. Substantial progress continued to be made in adjusting consumer energy prices, while the policies of enhancing petroleum producer prices and encouraging exploration by international companies contributed to new oil discoveries. As a result, domestic oil output doubled to about 26,000 barrels/day, covering nearly 20 percent of domestic consumption. However, natural gas production showed more limited growth, and gas shortages continued to result in insufficient electric power supplies. These have adversely affected both the industrial and agricultural sectors. A major recent development in the manufacturing sector was the start up of production from the Pakistan Steel Mill in December 1984; the mill provides a variety of steel products which were previously imported. Apart from the completed steel mill, no other major industrial projects were being implemented under the ADP in recent years.

Major policy objectives of the authorities in the real sector have been to reorient government investment outlays away from industry toward the priority sectors of energy, agriculture, and rural development, as well as transport and telecommunications, and the substitution of private for public investment in the industrial sector. In this context, the 1984/85 sectoral spending pattern under the ADP reflected increasing disbursements for energy and agriculture and was in line with World Bank recommendations. Moreover, a number of measures were also implemented to assist private investors. These included issuance of the Industrial Policy Statement for the Sixth Five-Year Plan (1983/84-1987/88) which eased investment licensing procedures. With regard to investment and savings performance, the domestic fixed investment ratio showed some improvement rising to 14.6 percent of GNP, reflecting essentially a 25 percent increase in ADP expenditures. Although investment performance improved, there was a weakening of savings performance. Domestic savings fell below 5 percent of GNP, and with declining inflows of workers' remittances the national savings ratio slipped to 11 percent.

b. Fiscal and credit developments

For 1984/85 the authorities' objective was to lower further the fiscal deficit ratio to 5.6 percent of GDP primarily through restraining the growth of current expenditures to 5 percent. Development spending was targeted to rise by 24 percent. Although the budget did not incorporate any major revenue-generating tax measures, tax revenues were forecast to rise by 10 percent. The principal resource mobilization actions were price adjustments for energy products and the settlement of income tax claims. Borrowing from domestic nonbank sources was expected to cover more than half of the overall fiscal deficit with domestic bank borrowing to be held to 1.2 percent of GDP.

In the event, there were substantial departures from the budget forecasts. Tax revenue rose by only 4 percent, primarily because receipts from income and excise taxes as well as from the petroleum price increase fell short of target. The income tax shortfall reflected partly the reduction of effective tax rates in lower income brackets and larger than expected income tax refund payments, while lower production levels due to power shortages and shifts in demand patterns adversely affected excise collections. On the expenditure side, development outlays were implemented as planned, but the growth rate of current expenditure at 15 percent was triple the budget forecast. The bulk of the excess was attributable to higher than planned subsidies and defense expenditures. Subsidies increased as the domestic prices for certain subsidized commodities were not adjusted to reflect increases in international prices and the depreciation of the rupee. With these developments, the overall deficit was 50 percent above the 1983/84 level, and the deficit ratio at nearly 8 percent of GDP was well above the budget target. The increase in the deficit was financed almost entirely through domestic bank borrowing, which at 3.9 percent of GDP was about triple the average borrowing level of recent years; reliance on domestic private savings also remained substantial.

The credit plan for 1984/85 continued to aim at a cautious approach to the management of domestic credit. Domestic liquidity was forecast to grow by 11-12 percent and the actual growth rate was virtually on target (Appendix III, Table 4). However, underlying this result was a much weaker than anticipated balance of payments outcome and a more rapid than targeted expansion of domestic credit. While credit use within the nongovernment sectors moved in line with the authorities' plan, the sharp weakening of the Government's fiscal performance and the very large resort to domestic bank financing caused an expansion in net domestic credit about double the amount envisaged. As the excess in credit growth was essentially vented through the large balance of payments deficit, the inflation rate fell back to a 6-7 percent range.

c. External sector developments

Pakistan's current account and the overall balance of payments positions deteriorated sharply during 1984/85. The overall deficit, widened to US$1 billion from less than US$100 million in 1983/84. This outcome was much weaker than anticipated and entailed a 60 percent decline in gross official reserves to some five weeks' imports. Even though imports stagnated, the current account deficit, which had almost doubled to about US$1 billion in 1983/84, rose by a further 70 percent to more than 5 percent of GNP. The major factors contributing to this outcome were 10-12 percent declines in exports (in U.S. dollar terms) and workers' remittances.

The weakening of export performance was reflected in both commodity and manufactured exports. Although cotton supplies recovered strongly, this was accompanied by lower world prices. Domestic rice supplies were steady, but these exports were also confronted with falling international prices, and strong price competition from other exporters reduced Pakistan's market shares. The slide in the performance of manufactured exports to a decline of 10 percent (compared with increases of 16 percent in 1982/83 and 7 percent in 1983/84) affected cotton products and other items as well. While quantitative restrictions on textile imports in some developed countries and weaker demand in some oil exporting countries in the region were contributory factors, the real effective appreciation of the rupee was an important cause for the weakness. In recognition of the erosion in export competitiveness, the authorities expanded export subsidies in April 1985 to new items and increased subsidy rates. These rates presently are in the range of 7.5-12.5 percent and apply mostly to manufactured goods. The decline in remittance inflows was attributable for the most part to the diminished employment opportunities for Pakistan workers in the oil producing countries of the region.

On the capital account, there was some erosion in net long-term capital inflows on concessional terms, and reliance on external commercial borrowing was modest. Most outstanding disbursed debt is on concessional terms, as the authorities have traditionally taken a cautious approach to commercial borrowing. Consequently, official short- and medium-term commercial debt was only 4 percent of GNP at end-1984/85. Total civilian foreign debt increased little and at US$12.7 billion was equivalent to about 38 percent of GNP. Debt service payments (including repayments of Fund credit) rose to US$1.2 billion (Appendix III, Table 6), and with the weak performances of exports and remittances the debt service ratio increased by four percentage points to 19.7 percent of current receipts.

Under the managed floating exchange rate system, the authorities continued to rely on currency baskets to guide their exchange rate. While the overall objective was to sustain the real effective depreciation of the rupee near the level achieved in early 1983, there were nevertheless periods in 1983-84 and early 1985 when the rupee evidenced significant real effective appreciations, ranging up to 9 percent. In particular, with the strength of the U.S. dollar against most other major world currencies, the rupee appreciated substantially in real terms against the currencies of certain major European countries, some of which were competitors in certain manufactured exports. In peak periods, the appreciations were in the 15-25 percent range. In the import system, industry-specific positive lists continued to be included in the IPO.

III. Policy Discussions

The discussions took place against the background of the Executive Board review of the 1984 consultation. 1/ On that occasion, the Directors expressed concern about the slowdown in the pace of implementing structural reform and about the worrying prospects for public finances and the external sector. Board members urged that price rationalization measures be strengthened and be complemented by further deregulation and reform of the import and tariff systems. Additionally, measures were needed to correct the structural weakness in the budget through the implementation, without delay, of a substantive tax reform. In view of the deterioration in the balance of payments, timely measures aimed at enhancing export competitiveness and remittances were also needed, in particular a more flexible exchange rate policy to reverse the appreciation of the real effective exchange rate.

1/ The 1984 Article IV consultation discussions were held during August and December 1984, and the staff report (SM/85/29, Sup. 1 and Cors. 1 and 2) was discussed by the Executive Board on February 27, 1985 (SUR/85/23).

In view of the substantial weakening in Pakistan's internal and external finances in 1984/85, the policy discussions focused on an assessment of the outlook for 1985/86 and on the measures needed to strengthen economic and financial performance. 1/

1. Production, investment, and pricing policies

Following the strong recovery in the agricultural sector in 1984/85, the authorities have forecast for 1985/86 a return to a more normal growth rate for agriculture (5 percent) and real GDP (6.5 percent). Real growth in manufactured output is projected to remain in the range of 8-9 percent. Development outlays are expected to rise by nearly 20 percent, with the energy and agricultural sectors continuing to receive priority. With this increase and an expectation of buoyant private sector investment, the domestic fixed investment ratio is forecast to rise by about one percentage point to 15.5 percent of GNP. At the same time, the authorities expect the investment-savings gap to decline by one percentage point to 4 percent of GNP, due primarily to a two percentage point increase in the domestic savings ratio.

In the agricultural sector, irrigation water and rain were inadequate in the second half of 1984/85, and although the water situation subsequently improved, the authorities' latest estimates were that cotton output would reach 5.5 million bales, somewhat below the 1984/85 peak level. However, as priority in the allocation of available irrigation water was given to the cotton crop, this decision was expected to be reflected in about 10 percent lower levels of rice and sugarcane output. In view of plans to import 1.7 million tons of wheat and resume sugar imports, the staff observed that, after a period of sustained growth and the attainment of self-sufficiency in major food crops, the production levels of recent years appeared to suggest that output plateaus had been reached, and inquired whether this reflected physical constraints or insufficient price incentives. The Pakistan representatives stated that the recent setbacks in agricultural output were due mostly to adverse weather conditions, and there were no major domestic structural barriers to production. Pricing policies continued to be reviewed to ensure their appropriateness, and although yields had generally increased in recent years, there was scope for further improvement.

With regard to pricing policies, the authorities increased cotton and some rice procurement prices by about 2 percent for the 1985/86 crop. The staff commented that, at the current exchange rate and international prices, the procurement prices for ordinary rice varieties and cotton appeared to be generating losses for the government export agencies, entailing in effect subsidies to producers. Moreover, given the current exchange rate, it was not possible to adjust domestic

1/ The quality of economic and financial data is generally good, and data questions are not a factor impairing policy analyses. Statistical issues are discussed in Appendix V.

cotton and rice prices in order to absorb an upward shift in fertilizer prices directed at reducing the fertilizer subsidy. However, regarding wheat, the price and exchange rate relationships afforded some latitude. A wheat procurement price increase of 14 percent was announced in October, but a proposal to increase also the price for the major phosphatic fertilizer was not implemented. In other price areas, an increase in irrigation charges was put into effect for 1985/86 in Sind, and the Northwest Frontier Province also issued a notification of an increase for this year.

A broad review of the policy issues surrounding wheat and edible oils marketing, pricing, and subsidization is being undertaken by the National Deregulation Commission, whose establishment was announced with the budget. Initially, most of the Commission's deliberations have focused on new arrangements for the wheat trade, but the Commission is also considering alternative approaches to edible oils marketing. The Pakistan representatives noted that the recent declines in the world prices of edible oils had substantially reduced the budget subsidy and benefited the balance of payments, and they considered that in the present situation deregulation would not be accompanied by a considerable rise in domestic prices. The mandate of the Deregulation Commission also covers other sectors of the economy.

Regarding manufacturing, while this sector will continue to be subject to electric power load-shedding, the authorities expect that better cotton supplies and the resultant recovery in textile-based activities as well as implementation of external sector measures (see below) will help sustain a good performance. In the public industrial sector, a more flexible cement pricing system has been introduced, and a revised pricing structure was established for products from the Pakistan Steel Mill. As a continuation of the authorities' deregulation program, the public sector cement plants were permitted in late 1984/85 to vary within a range of 8 percent their basic ex-factory price to reflect local market conditions: cement pricing is fully flexible in the private sector. Under the new pricing framework for the steel mill, put in place in early 1985/86, the domestic prices for the mill's various products have been fixed at proportions of the landed cost of comparable imports (c.i.f. value plus duty). In order to sustain the external competitive position of domestic steel-using exporters, they will be allowed subsidies equivalent to the difference between the domestic steel price and the c.i.f. price; the subsidies will be funded from the federal budget.

In the energy sector, the continued implementation of enhanced price incentives for domestic petroleum producers is projected to result in a substantial further increase in crude oil production (by some 50 percent) to an average of 40,000 barrels/day; this would cover almost one third of domestic consumption. To encourage the exploration and development of nonassociated gas, the authorities have also implemented in collaboration with the World Bank a policy of linking the domestic producer gas price to international energy prices less a percentage discount for all new concessions agreed after September 1985. The program of adjusting consumer energy prices has also been continued, and with the budget the user prices of natural gas and of most petroleum products were raised, resulting in weighted average price increases of 51 percent and 5 percent, respectively. Most petroleum product prices are well above border prices, 1/ and with the budget price increase, consumer gas prices were moved to 60 percent of the international equivalent compared with the authorities' target of a two-thirds equivalence by 1988.

2. Fiscal policy

The original 1985/86 budget estimates aimed at a reduction in the overall fiscal deficit to 6.7 percent of GDP from 7.9 percent in 1984/85. A 19 percent rise in total revenue was forecast to result primarily from the doubling of the import surcharge to 10 percent and the increases in natural gas and petroleum products prices. However, income and some customs and excise taxes were reduced, and exemptions from the domestic sales tax were expanded. The resource mobilization effort was estimated at the equivalent of 1.4 percent of GDP, but as receipts from the import surcharge were earmarked for additional education expenditures, the net revenue gain to the budget of discretionary measures was an increase of only 4 percent (or 0.5 percent of GDP). The budget also proposed the divestiture of some of the Government's equity in certain public enterprises. The growth of current expenditure was budgeted at 14 percent with most of the increase accounted for by higher salaries and pensions for public sector employees, which were also partially indexed to the cost of living; increased subsidy outlays, which were budgeted to rise by over 25 percent mainly due to larger wheat and export subsidies, and the introduction of the exported steel subsidy; and higher defense and interest outlays. The financing of the deficit forecast a tripling of net external borrowing and a further large increase in domestic nonbank borrowing, bringing financing from each of these sources to about 3.5 percent of GDP. A major feature of the budget is the objective of avoiding completely recourse to domestic bank borrowing.

In commenting on the original budget, the staff observed that the net revenue effect of discretionary measures had been small, there had been a weakening of the structure of public finance, and the overall deficit remained high. Moreover, dependence on external and nonbank financing was projected to rise markedly, and there was a question whether the anticipated levels of such financing were achievable. To correct the situation, measures were needed to contain expenditure growth and enhance domestic resource mobilization by increasing the elasticity of the tax system. These measures should aim at a substantial reduction in the deficit ratio to a level consistent with a strengthening of the external position. The projected heavy and rising reliance on domestic private savings and external financing was cause for concern, as this pattern of financing would limit the availability of private

1/ For example, gasoline at US$1.70-2.00 per U.S. gallon.

savings to finance private investment and give rise to future repayment obligations for which resources would have to be generated. Moreover, this debt financing permitted a growth of expenditures, for which resources were not available and which would be difficult to reduce in the future.

The Pakistan representatives stated that the authorities were aware of the tight fiscal position and the structural weakness in public finance, and that borrowing for the budget on the scale of this year's would not be sustainable. They acknowledged the need for tax reform, but indicated that the report of the Tax Commission could not be expected before March 1986 and no measures could be taken until the next fiscal year. For this year, the Deregulation Commission had begun to review subsidized items, and it was hoped that subsidization could be reduced.

To reflect developments subsequent to the introduction of the budget, certain estimates were later revised. In September the total revenue growth projection was reduced from 19 percent to 16 percent, reflecting mainly lower forecast receipts from customs, income, and excise taxes. In December the salient revisions included a large reduction in defense spending due to the nonavailability of linked external financing, and an increase in supplementary expenditures by the provincial governments which is to be offset by a decline in edible oil subsidies arising from lower world prices. Essentially with these changes, the official estimate for the overall fiscal deficit was reduced to 6.5 percent of GDP. 1/ Budget financing was also revised to reflect a 28 percent reduction in anticipated net external financing from the original budget and a 25 percent increase in domestic nonbank borrowing.

The revised estimate for nonbank borrowing includes PRs 2.7 billion in net proceeds from Special National Fund (SNF) bonds 2/ and PRs 2.0 billion from the sale of Foreign Exchange Bearer Certificates (see below). These new debt instruments were announced with the budget. The SNF bonds were introduced to encourage the declaration of untaxed assets, and thereby expand the future tax base. Purchasers were assured that they would not be liable for past income and wealth taxes to the extent that these assets were declared through purchasing the bonds. In the event, prospective purchasers indicated that many of their untaxed assets were illiquid, and consequently the authorities decided that, to facilitate the sale of the bonds, domestic banks could lend outside their credit ceilings to finance SNF bond purchases. While purchases

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1/ The authorities are undertaking a research effort to improve the format of the budget by introducing a "Net lending and equity participation" entry. This undertaking could involve some major reclassifications and thus changes in budget aggregates. For example, the 1985/86 ratio target would be estimated at 5.9 percent under the new format rather than 6.5 percent.

2/ See Appendix III, Table 3, footnote 2.

of the bonds during the sales period (July-August 1985) totaled PRs 13.7 billion, bank lending to finance the bond purchases totaled PRs 11 billion. To offset the impact of this lending on total domestic credit and liquidity growth, the authorities decided to retire an equivalent amount of outstanding government credit for commodity operations. Since the SNF bond interest costs were lower than the cost of carrying bank credit for commodity operations, the substitution generated interest savings for the budget. As the authorities are committed to avoiding any bank financing for the budget in the current year, this commitment would mean that at end-year the combined position of the Government's budget and commodity financing from the domestic banking system would show a net reduction in outstanding credit of PRs 11 billion.

The mission expressed the view that the latest official budget estimates appeared optimistic in several respects. On the revenue side, it seems that the projected growth of customs revenue (30 percent) was unlikely to be realized in view of the customs results for the period July-November 1985, which showed an increase of 15 percent over the same period of last year, and the 1 percent growth forecast for imports in the balance of payments for 1985/86 as a whole. Moreover, income and excise taxes, certain profit transfers, and the surpluses of autonomous bodies seem to be overestimated. In addition, as procedural decisions on divestiture of public enterprises were delayed, a shortfall may well occur in this category. On the expenditure side, the historical buoyancy of current outlays would suggest the possibility of a substantial overrun. For example, defense expenditures, which have risen sharply in the past, are now forecast to decline in nominal terms despite the wage increases granted at the start of the year. In the aggregate, the staff estimates, given the target level for development spending, a gap equivalent to about 1.5 percent of GDP between the likely demands for and availability of resources, without considering shortfalls from projected financing for the overall deficit. This would imply an overall deficit ratio of 8 percent of GDP. With regard to financing, the mission noted that the estimate for net external borrowing remains more than double the level of the previous year and is not corroborated by the capital inflows data in the balance of payments for the first three months of the year.

The representatives stated that while there might be some revenue shortfall from the December estimates, it would be substantially less than estimated by the staff. The authorities also intended to hold current expenditures within the revised budget estimates, to achieve the development outlays included in the budget, and to avoid any recourse to domestic bank financing. The budgetary situation would be kept under review and adjustments, if they appeared necessary, would be made.

The discussions on budgetary prospects for 1985/86 took place before the recent declines in international petroleum prices. If the staff estimate regarding the possible full benefit of lower oil prices to the balance of payments (see below) were to apply fully to the budget, the revenue gain could be equivalent to 0.4 percent of GDP if domestic consumer prices remain at present levels. Under these circumstances, the budget could also benefit from parallel downward adjustments in domestic producer prices for crude petroleum.

3. Monetary and credit policies

The authorities' credit plan for 1985/86 aims at a substantial reduction in the growth of total domestic credit to 7 percent with the objective of containing pressures on the balance of payments. The major factor accounting for this reduction is the policy objective of not permitting domestic bank borrowing for the budget. At the same time, the target growth rates for lending to the private sector (excluding credits extended to finance SNF bond purchases) and particularly the public enterprises have been lowered. 1/ The effect of including in private credit growth commercial bank lending for SNF bonds is to raise the private credit expansion forecast to 28 percent, but as noted above the authorities will neutralize the liquidity impact of this operation through retirement of an equivalent amount of debt on account of commodity financing. The mission commented that historically commodity credit had proven difficult to monitor and control, and therefore strict monitoring would be needed over credit movements in this category in order to ensure a complete neutralization.

On the outlook for the credit aggregates, the staff commented that there were indications that it would be difficult to avoid recourse to the domestic banking system for the budget in view of the likelihood of a larger than projected overall fiscal deficit and the possibility of shortfalls from the expected levels of external and nonbank domestic financing. However, while the mission believed that credit expansion might well exceed the target set out in the authorities' plan, the balance of payments situation could well show an overall deficit while the authorities were predicting a surplus. These considerations rendered the monetary growth outcome for 1985/86 difficult to predict. 2/ If a balance of payments surplus materializes while considerable recourse to domestic bank financing of the budget becomes unavoidable, the rate of monetary expansion might exceed that of the forecast nominal GDP posing a threat to price stability; inflation is envisioned by the authorities

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1/ The much reduced credit allocation for the public enterprises reflects for the most part the winding down of the credit requirements of the completed steel mill.

2/ Provisional monetary data for the July-December 1985 period indicate a domestic liquidity expansion of 5 percent resulting essentially from 13 percent growth in private credit (adjusted for SNF bond borrowing). Credit for the budget rose by 2 percent to PRs 1.7 billion.

to be in the range of 6-7 percent. The mission's view was that considering the uncertainties with respect to external developments, the general strategy should be to implement a tight demand management stance in order to contain the demand for imports and to strengthen external sector performance.

With regard to changes in bank regulations, in August 1985 the commercial banks were permitted to accept foreign currency deposits from financial institutions abroad (see below). To encourage the soliciting of these resources, the participating domestic banks will be allowed increases in their credit ceilings equivalent to 65 percent of net increases in such deposits. This regulation represents an extension of a previously existing practice under which the commercial banks were allowed 50 percent ceiling increases for nonbank foreign currency deposits. The Pakistan representatives' view was that this new regulation would not reduce the effectiveness of credit controls or result in credit growth beyond planned levels, as the central bank allows scope for these possible increased credit allocations in its aggregate credit plan.

With effect from July 1, 1985, all deposit and all new financing operations of the scheduled banks were placed on an Islamic noninterest basis. The Pakistan representatives indicated that the changeover had proceeded smoothly. Some minor accounting changes had been made, but there were broadly no alterations to existing monetary or credit terminology or classifications, and the central bank's existing credit allocation and control system and its ability to administer the system through ceilings and targets were not affected. In the course of the conversion to Islamic banking, major steps have been taken toward a more flexible rate of return and deposit structure for the financial system. In May 1985, bank interest rate charges were abolished and replaced by a system of rates of profit, under which there is no maximum rate for most investment financing and a maximum rate for most trade financing of 20 percent. Previously, interest rate ceilings of 11-14 percent had applied. Moreover, since the introduction of profit and loss sharing deposit accounts, the banks have been free to set individually their deposit rates. Also as part of the deregulation effort, since April 1984 banks have been essentially no longer subject to regulations on service charges.

4. Balance of payments policies

The authorities envisage a substantial improvement in the balance of payments position in 1985/86. In September, a decline in the current account deficit of some US$370 million (to 3.9 percent of GNP) was projected, while the overall position was expected to show a surplus of about US$100 million. The improvement was predicated on a 25 percent growth in exports, based on increased rice and cotton exports as well as about a 20 percent growth in manufactured exports, and a doubling to US$1 billion of net official concessional foreign loans and grants (excluding refugee assistance). Moreover, net official short-term capital was expected to show a large turnaround primarily as a result of an anticipated inflow of US$125 million from sales of foreign exchange certificates. A moderate expansion in imports of 3.5 percent was projected along with a 2 percent decline in workers' remittances. Gross reserves were expected to benefit from foreign currency deposits of US$100 million from nonresident commercial banks.

During the December discussions, the Pakistan representatives indicated that external sector developments over the first four months of the year had been encouraging. Exports had recorded an increase of over 30 percent relative to the same period of 1984/85. Cotton lint exports had performed particularly well, but even excluding cotton and rice exports, other exports were 16 percent larger. Workers' remittances were 10 percent higher due mainly to greater inflows from the United States and the United Kingdom, and imports were 5 percent lower reflecting in part the benefit of the fall in world edible oil prices. On the basis of these developments, the authorities revised certain items of their forecast for the year as a whole. The import growth projection was lowered to 1 percent and that for remittances was altered to a 3 percent increase. As a result the current account deficit was anticipated to be US$625 million lower than in 1984/85 (3.2 percent of GDP). With a moderate downward adjustment in net capital inflows, the authorities expected the overall external surplus to be US$280 million. These improvements did not reflect possible additional benefits from lower world petroleum prices (see below). Despite the forecast for higher current account receipts, the debt service ratio would still rise to 20.8 percent (Appendix III, Table 6).

The staff expressed the view in December that the authorities' external sector projections were optimistic in certain respects. Most of the export growth over the July-October 1985 period was in cotton lint (US$135 million) and cotton product exports (US$68 million), reflecting in large part better cotton supplies due to the bumper 1984/85 crop. These exports had been exceptionally low in the same period of 1983/84 due to the poor crop. Rice exports were 7 percent lower. Excluding these three categories, all other exports recorded an expansion of only 6 percent or US$22 million. Thus, the forecast of a 20 percent increase for these latter items appeared doubtful. In the area of imports, the official forecast does not provide for any increase in private sector imports nor does it accommodate the expansion in capital goods imports implied by the large increase planned for ADP expenditures. As regards remittances, monthly inflows from Middle Eastern countries, which account for four fifths of total remittances, were only 1 percent higher over the first four months of the year: thus the higher revised growth rate may be difficult to sustain. Moreover, the authorities' forecast increase in workers' remittances is actually larger than implied in their estimate since workers abroad are also expected to make substantial purchases of foreign exchange certificates. Taking these reservations into consideration, the staff's evaluation was that the current account deficit could be US$250-300 million larger than projected by the authorities. Moreover, the official estimates for capital inflows also appear optimistic despite the downward revision in December and are not supported by the level of actual capital inflows over the first three months of the year. Considering the historical pattern of a shortfall of 15-20 percent from official forecasts for project aid and that negotiations pertaining to certain sectoral lending by the World Bank are proceeding more slowly than anticipated, the staff assessment in December was that the overall external position could show a deficit of US$200-250 million. The staff indicated that as constraining imports through quantitative restrictions would have implications for economic activity and efficient resource allocation, circumstances called for the adoption of strong adjustment measures. These would aim at boosting exports and at containing imports through appropriate exchange rate and demand management policies.

The authorities' and staff balance of payments assessments were made before the weakening of petroleum prices in February 1986. The staff estimates that if Pakistan were able to benefit fully over the balance of 1985/86 from lower petroleum prices (as reflected in the current WEO base line scenario), 1/ a savings in oil import payments of about US$140 million could result. These savings, however, might be offset to some extent by lower workers' remittances and export receipts from the oil exporting countries of the region.

In December the staff also expressed concern that an external deficit would need to be financed through expanded short-term commercial borrowing, as a further drawdown of reserves did not seem possible. Moreover, the increased inflows from foreign exchange certificates would involve an expansion in a highly liquid potential claim on reserves making such assets vulnerable to shifts in confidence. Pakistan's reserves continued to fall in the first few weeks of 1985/86, but began to rise in late August after the authorities introduced the policy of attracting short-term deposits from nonresident commercial banks. These deposits amounted to US$300 million at end-November and more than accounted for the increase in reserves over the first five months of the year. Excluding these inflows, reserves declined. If for the year as a whole the balance of payments were to show a deficit of US$200-250 million, and after meeting repurchases to the Fund, reserves would be less than two weeks of imports. With the full benefit from lower oil prices, the lower overall deficit would leave reserves at over three weeks' imports.

The Pakistan representatives explained that foreign currency deposits and bearer certificates were being used mainly to build up the gross foreign asset position. Such short-term financing was not viewed as a solution to the external asset situation, but rather as a transitional measure pending implementation of appropriate corrective policies. The authorities said that they intended to continue the cautious external debt policy, so as to limit short-term borrowing,

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1/ Marker crude oil at US$20 per barrel. Pakistan imports about 47 million barrels of crude petroleum and products per year.

particularly on commercial terms, and to contain debt service payments within manageable levels. As for the official balance of payments projections, while these might prove to be optimistic in certain instances, the authorities believed that they were generally appropriate. The targeted increase in manufactured exports was high, but efforts were underway to facilitate its achievement. Apart from countertrade proposals, these efforts included the activities of the export action groups responsible for reducing regulatory constraints on exports and developing new foreign markets, the April 1985 expansion of export subsidies, and the real depreciation of the rupee since February 1985. While it was still too early to judge the effectiveness of these measures, the authorities intended to pursue a flexible exchange rate policy. Additionally while the capital inflows forecast was high, some imports would not be undertaken if these inflows did not occur.

For the medium term, the authorities envisioned overall external surpluses averaging US$115 million during the 1986/87-1989/90 period. They were targeting at containing the current account deficit to 2 percent of the GNP, and approximately sustaining a level of gross official reserves equivalent to five weeks of imports (Appendix III, Table 7). The realization of these targets was predicated on an annual export growth of 10-13 percent and annual net capital inflows from foreign grants and concessional loans of about US$1.1 billion. The import growth rate was forecast to rise from 1 percent in 1986/87 to 6 percent in the later years, and a moderately declining level of remittances was also expected. As on previous occasions, the Pakistan representatives underlined the difficulties of undertaking quantified medium-term forecasts, as compared with qualitative assessments, and continued to view their medium-term forecasts as indicative targets for which policy measures would be needed. The staff commented that, even allowing for the fact that medium-term projections were necessarily subject to wide margins of error, external sector and demand management policies would require substantial strengthening in order to achieve the authorities' targets and contain an increase in the debt service ratio.

The authorities' forecasts did not incorporate assumptions regarding a lowering of world oil prices. If the authorities' forecast of oil imports were to be adjusted to reflect the petroleum price assumptions utilized for the current WEO base line scenario, import payments would be about US$950 million lower over the four-year period. However, as noted above such savings could be offset to some extent by lower workers' remittances from and exports to oil exporting countries.

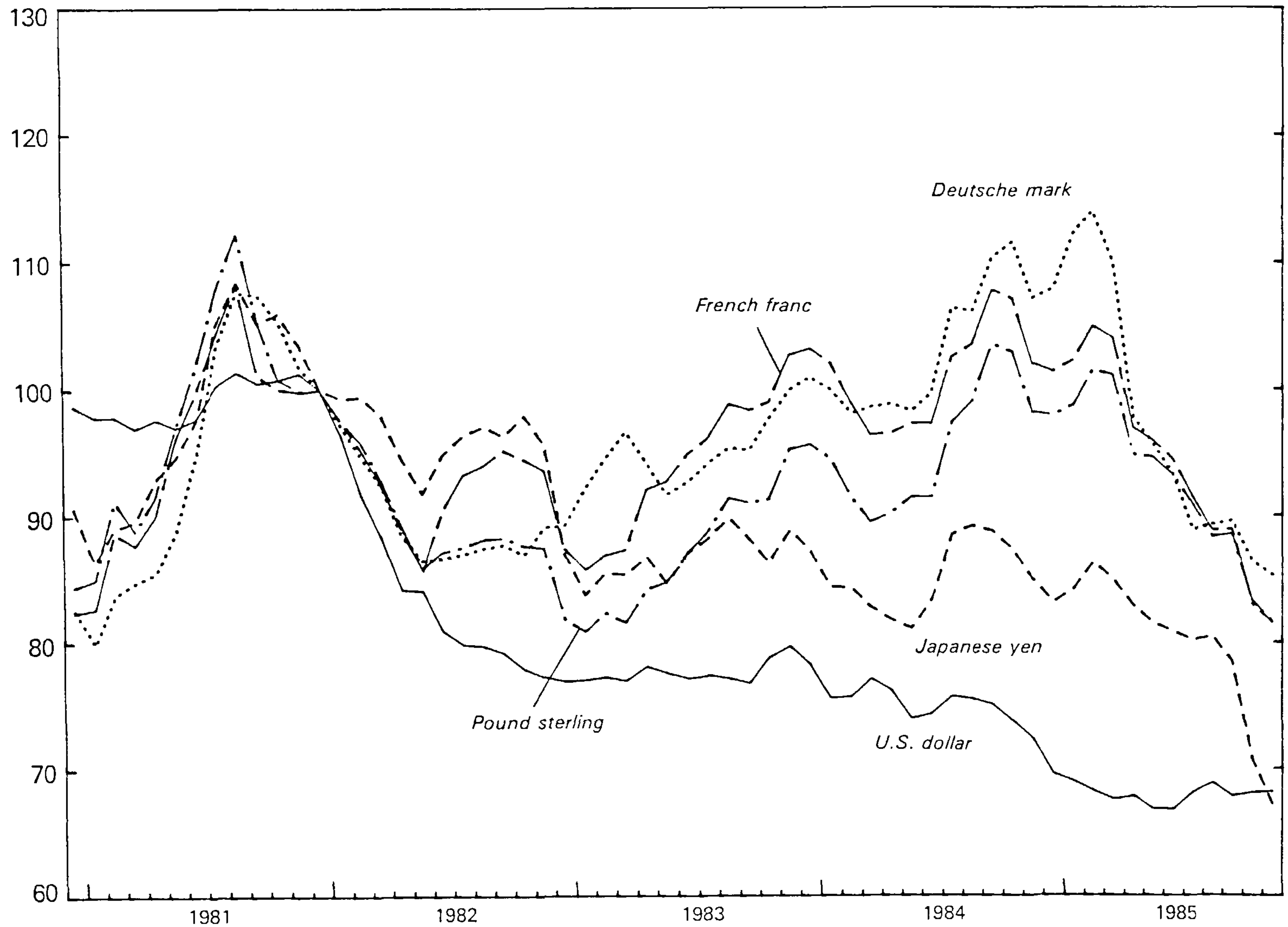
To examine the sensitivity of the medium-term forecasts to different assumptions, the staff has calculated a number of scenarios based on (1) the staff's assessment of the likely outcome for 1985/86; (2) a target of raising gross official reserves (excluding nonresident commercial bank deposits) to two months' imports by end-1987/88, and holding at that level for the balance of the period; (3) the assumption that gross long-term capital inflows rise moderately by 4 percent per annum, which is the average growth rate of recent years; and (4) the current

WEO base line assumptions regarding petroleum prices. These calculations show that if a financing gap is to be avoided, while annually non-oil imports are assumed to rise by 5 percent and remittances to fall by 2 percent, exports would need to rise on average by 16 percent. As such export performance would appear difficult to achieve over a medium-term period, an alternate scenario could be to assume export growth of 8 percent. On this basis, unfinanced gaps would emerge in the balance of payments for the next four years totaling nearly US$4 billion. A more optimistic scenario based on export and non-oil import growth of 10 percent and 3 percent, respectively, and only a 1 percent annual decline in remittances, suggests that the uncovered financing gap would fall to under US$2 billion. Under the latter two scenarios, a large part of the financing gap occurs in 1986/87. These scenarios suggest that with unchanged policies and moderately rising external assistance inflows, Pakistan's medium-term external financing requirement could be substantial despite lower world petroleum prices. To avoid such large recourse to external borrowing, early implementation of external and demand management adjustment measures are needed. Without such measures, it would be difficult for the authorities to maintain their traditionally cautious approach to external borrowing.

5. The exchange and trade system

The Pakistan representatives stated that exchange rate management was directed toward enhancing export competitiveness and has been guided by the use of a number of currency baskets, including a basket covering the currencies of six large industrial countries. Although in 1984 and early 1985 some real appreciation of the rupee against various European currencies had been difficult to avoid, since February 1985 the rupee had been allowed to depreciate by nearly 18 percent in real terms against the industrial countries' basket in order to benefit export performance (Chart 3). However, exchange rate action could not deal with the recent substantial weakening of international commodity prices and its concomitant effect on some of Pakistan's manufactured exports. Under these circumstances, incentives covering specific export items had to be combined with exchange rate adjustment. Nevertheless, the question of the desirability of export subsidies would remain under review. The staff commented that export subsidies benefited specific items and did not provide an across-the-board enhancement of export incentives. As the authorities recognized, with the stagnation and decline in remittances, Pakistan must pursue an export-led growth strategy, and to achieve this a substantially improved export competitiveness was needed. The adequacy of the exchange rate level should be assessed on the basis of the underlying balance of payments position. In addition to employing a basket more responsive to export competitiveness requirements, rate movements should also be guided by net foreign asset and export growth. While contributing to a restoration of competitiveness, more flexibility would also assist in restraining import demand.

CHART 3
PAKISTAN
MOVEMENT OF BILATERAL REAL EXCHANGE RATES[1], 1981-85
(December 1981=100)



Source: *International Financial Statistics.*
[1] Increases mean appreciation.

Substantive changes in the exchange system were introduced in August 1985. To encourage inflows of foreign currency deposits, Pakistan nationals were permitted to maintain foreign currency accounts for a period of three years, rather than six months, from the date of their return home. In addition, as noted, commercial banks were permitted to accept foreign currency deposits of not less than US$10 million and a maturity of at least one year from nonresident financial institutions. Finally, largely for the purpose of attracting savings from overseas Pakistanis, foreign exchange bearer certificates were introduced. The certificates, which are issued only against foreign exchange but denominated in rupees, may be freely taken in and out of the country and may be encashed at any time in Pakistan rupees or in foreign exchange at the current exchange rate. Since these certificates may be freely encashed in foreign exchange by residents, they have narrowed the effectiveness of exchange controls for private current payments and capital transactions. 1/ The staff indicated its concern about the scheme's provision for encashment at any time at the current exchange rate, as this could place a sudden pressure on reserves as a result of an anticipation of a depreciation of the currency. The staff also explained that these certificates could under certain circumstances give rise to a multiple currency practice. The Pakistan representatives stated that to the extent a secondary market in these certificates developed, this was entirely autonomous and without any official sanction or encouragement. They indicated that data on effective exchange rates for market transactions in these certificates were not presently available.

Bilateral payments agreements with three Fund members (China, Hungary, and the Islamic Republic of Iran) continue to be in effect. The agreement with China is being phased down with most trade now being conducted on a cash basis; the barter agreement with Hungary was extended by two years from the date of expiration in March 1985; and the agreement with the Islamic Republic of Iran is being renewed annually. These three arrangements had not been approved, and the mission urged that they be terminated as soon as possible.

Limited changes were introduced in the import system through the 1985/86 Import Policy Order (IPO). Three items were removed from the negative imports list, but of these, two were put on the restricted list, and a value ceiling for permitted machinery imports was raised. There was a presentational recasting of the restricted lists in the IPO with the merger into one restricted list of the three restricted lists worked out under the extended arrangement 2/ and the former industry-specific positive lists. Regarding countertrade arrangements, the representatives indicated that no agreements had as yet been signed, but any arrangements would be carried out in the framework of the import and export policy orders. While the authorities preferred to avoid such arrangements, under some circumstances they were considered helpful in promoting exports. It was not the intention to include in such arrangements features that involved restrictions on current payments.

1/ Imports continue to be subject to licensing.

2/ Governing consumer goods subject to quantitative restrictions, imports from tied sources, and items importable by the public sector.

The staff observed that the import regime continued to be restrictive and complex, and this year's changes represented only limited progress toward simplification. The new restricted list was extensive, and both the negative and restricted lists were too long and difficult to use. Although the weak external position made further liberalization difficult, it was important that early progress be made. The representatives explained that since the adoption of the negative list system, they had not received complaints from the private sector regarding the import system. As a general practice, suitable suggestions from private and public sector agencies were incorporated into each annual policy order.

IV. Staff Appraisal

Pakistan's economic performance in the early 1980s was characterized by a good growth performance, declining rates of inflation, and improving balance of payments. These favorable trends were facilitated by the implementation of important structural reforms, an appropriate demand management stance, and a prudent external borrowing policy. In 1984/85 the economy rebounded from the setback caused by the weather-induced decline in agricultural output, and a continuation of high growth is forecast for 1985/86. A notable development in the economy was the more than tripling of petroleum production since 1982/83 to the equivalent of about one third of domestic consumption. This gain reflects the improvements in petroleum producer pricing and institutional measures introduced in recent years. Consumer energy prices have also been adjusted substantially.

Apart from the energy sector, however, the pace of price rationalization has lagged. While depressed world commodity prices have contributed to the difficulties of increasing domestic output prices, and therefore input charges, exchange rate policy has also constrained the scope for agricultural price adjustments. In manufacturing, the price framework adopted for the products of Pakistan's new steel mill will entail new export subsidization. The staff believes that the authorities should intensify their efforts at price adjustment generally in the economy, keeping in view the key role played by the exchange rate in linking domestic and international prices. An active exchange rate policy with full pass through to domestic prices is a prerequisite for further progress in stimulating output and reducing subsidies. For some important consumer goods, such as wheat and edible oils, the issues of pricing and subsidization are being examined by a recently appointed government commission, and it is to be hoped that the authorities will find it possible to implement substantive actions in these areas.

Pakistan's high real growth of recent years has been possible despite relatively low levels of aggregate investment and savings, but clearly this is an unsustainable situation in the long run. These low investment and savings levels have reflected in large part structural weaknesses in public finances. Before 1984/85, rapid growth of current expenditure, an inelastic tax system, and the objective of containing the overall budget deficit combined to necessitate a compression of development spending. Despite this, there emerged a rapid expansion of the budget's reliance on private savings in order to limit government bank borrowing. In 1984/85, with the objective of increasing public investment, the compression of development spending was eased, but due to a weak resource mobilization effort, the overall deficit rose by about 50 percent and was accompanied by a tripling of domestic bank borrowing. For the current year, a further large increase in investment spending is envisioned, but the authorities are also seeking to avoid any recourse to the domestic banks. To permit this, with only limited net new revenue for the budget, the strategy is to contain current outlays and undertake very large expansions in external and domestic private borrowing.

In the absence of additional supporting policy measures, the staff believes that revenue shortfalls are likely to emerge, while current expenditures, as in the past, might well exceed the budgeted level. A substantial resource gap is estimated without taking into consideration possible shortfalls in external and nonbank domestic borrowing which have been targeted at levels that may be difficult to achieve. Under these circumstances, new policy measures should be implemented without delay in the current fiscal year to generate incremental resources for the budget and to contain the growth of spending. While it may be too late in the year to prepare and implement tax measures which could have much impact, pricing and subsidy reduction measures could offer some assistance and may need to be accompanied by reductions in development spending. Without such efforts, the targeted decrease in the overall deficit/GDP ratio is not likely to materialize, and large budgetary reliance on domestic bank borrowing will become unavoidable. For 1986/87 the authorities will need to implement measures aimed at a considerable strengthening of fiscal performance in order to lower substantially the overall deficit ratio. In addition to pricing and expenditure control measures, the authorities will need to implement major new tax measures directed at increasing the elasticity of the tax system and raising quickly the tax to GDP ratio. These should include, inter alia, broadening of the base of the existing sales tax by eliminating the bulk of exemptions. Such measures would also contribute to reducing the budget's dependence on private savings, which should assist in raising private investment, and to achieving the increases in public sector savings needed to permit the desired higher level of investment overall in the economy.

In 1984/85, with large borrowing for the budget, credit growth rose sharply, but as this pressure from domestic demand was essentially vented through the balance of payments, Pakistan's monetary growth rate remained low and price performance was not adversely affected. For 1985/86 such a release of domestic pressures is not feasible given the weak reserves position. Thus an appropriate approach to demand management will depend critically on the Government's avoiding substantial recourse to the domestic banks for the budget, containing the growth of credit to the nongovernment sector to the planned levels, and ensuring that the envisioned contraction in commodity financing materializes. This contraction is needed to neutralize the large expansion of credit to the private sector which was permitted to finance purchases of Special National Fund bonds. The task of demand management this year should be facilitated by the authorites' decision to permit substantial flexibility in rates of deposit and return under the Islamic financial system. This new flexibility for rates to reflect relative demands for available resources should assist the efficiency of the economy, the task of credit management, and the private domestic savings effort. The low overall savings and investment levels would also likely benefit from an acceleration in the pace of deregulation and price rationalization.

Pakistan's external position deteriorated in 1984/85, largely because of declines in exports and remittances. While cotton supply difficulties and world commodity prices were factors contributing to the export decline, the deterioration extended beyond commodities and cotton textiles and included also a weak performance generally by manufactured exports. To an important degree, these developments reflected the loss of export competitiveness due to the real appreciation of the rupee in some periods of 1983-84. In recognition of the need to enhance competitiveness, the rupee was allowed to depreciate in real effective terms after February 1985, and in April export subsidies were expanded considerably. The staff believes that the expanded reliance on subsidies to promote exports was not appropriate as this approach does not provide the broad incentives needed to expand the export base and represents an additional burden on the budget.

Over the early months of 1985/86 a further real depreciation of the rupee has occurred as the rupee was allowed to move down with the U.S. dollar against other major world currencies. Exchange rate policy has thus moved toward supporting the objective of enhancing export competitiveness, and this stance along with the two-year rebound in cotton production should generate a turnaround in export growth this year. The slide in remittances apparently halted early in the year, and the authorities are forecasting a sharp increase in capital inflows. It is doubtful, however, that these factors will combine to produce a sizable overall surplus in the balance of payments. Developments over the first several months of the year do not support such an expectation. Although the recent decline in world oil prices will be of assistance, in the absence of further policy measures, Pakistan's balance of payments performance may well remain weak necessitating short-term foreign borrowing in order to avert a further drawdown of reserves. These circumstances suggest the need for greater reliance on an exchange rate policy guided by the growth performance of exports, in particular manufactured exports, and the restoration of reserves. Such a policy approach would underpin the authorities' intention of pursuing an export-led growth strategy.

There is a need to exercise caution with respect to the expanding reliance on external short-term borrowing. The foreign exchange certificates scheme involves the use of liquid claims on reserves and could limit the scope for taking exchange rate action because of the possible effects on encashment decisions. Moreover, these certificates and nonresident commercial bank deposits constitute high-cost financing with possible troubling implications for debt service. Pakistan has traditionally pursued a cautious external borrowing policy and has so far succeeded in maintaining a relatively low external debt service ratio. In this context, it would be prudent to consider the recent expanded borrowings as merely a temporary expedient designed to give the authorities some time to implement effective policies for improving balance of payments performance. The outlook for the second half of the 1980s indicates that in order to ensure balance of payments viability over the medium term, a substantial and timely strengthening of adjustment efforts is necessary.

The recent substantive changes in the exchange and trade system have focused on inducing foreign exchange inflows, while the introduction of foreign exchange certificates has also resulted in an effective easing of exchange controls for private current payments and capital transactions. In the import system there was a presentational recasting of the restricted lists, but only limited liberalization. While further progress toward import system reform appears to be difficult in current circumstances, it is to be hoped that the adoption of appropriate external sector policies will allow an early resumption of progress in this area. Pakistan maintains bilateral payments arrangements with three Fund members that are subject to Fund approval under Article VIII. The staff is not recommending their approval. The staff will seek to obtain information on the effective spreads involved in the bearer certificate scheme when it becomes available. Other exchange restrictions are maintained by Pakistan under the transitional arrangements of Article XIV.

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

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Pakistan's exchange measures subject to Article VIII, Section 2 and in concluding the 1985 Article XIV consultation with Pakistan, in the light of the 1985 Article IV consultation with Pakistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Pakistan maintains restrictions on payments and transfers for current international transactions, including those maintained under the transitional arrangements of Article XIV, as described in SM/86/51, and bilateral payments arrangements with three Fund members. The introduction of the foreign exchange bearer certificates has the indirect effect of easing the restrictions on current payments. The Fund urges the authorities to eliminate the bilateral payments arrangements with Fund members as soon as possible, and take appropriate steps toward early removal of the remaining restrictions on the making of payments and transfers for current international transactions.

Pakistan - Fund Relations

(As of End-January 1986)

I. Membership Status

a. Date of membership — July 1950

b. Status — Article XIV

A. Financial Relations

II. General Department (General Resources Account)

		SDR Millions	Percent of Quota
a.	Quota	546.3	
b.	Total Fund holdings of rupees	1,640.2	300.2
c.	Fund credit	1,093.9	200.2
	Credit tranches	7.9	1.4
	Extended Fund facility	523.3	95.8
	Supplementary Fund facility	427.6	78.3
	Compensatory financing facility	135.2	24.7
d.	Reserve tranche position	--	--

III. Use of Fund Resources

a. Previous stand-by and extended arrangements

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

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

(2) 1977/78 stand-by arrangement

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

b. Special facilities

(1) Compensatory financing facility

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

c. Reserve tranche

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

IV. SDR Department

a. Net cumulative allocation: SDR 169.99 million

b. Holdings: SDR 17.8 million, or 10.47 percent of net cumulative allocations

V. Administered Accounts

a. Trust Fund

(i) Disbursed: SDR 229.65 million
(ii) Outstanding: SDR 115.12 million

b. SFF Subsidy Account

(i) Payments by the Fund: SDR 55.94 million

VI. Overdue obligations

None

B. Nonfinancial Relations

VIII. Exchange System

With effect from January 8, 1982, the rupee ceased to be pegged to the U.S. dollar, and Pakistan introduced a managed floating exchange rate system based on currency baskets, with the U.S. dollar continuing to be the intervention currency. As of February 15, 1986 the exchange rate was PRs 15.98 per U.S. dollar. Pakistan maintains restrictions on payments and transfers for current international transactions.

IX. Last Article IV Consultation

The last Article IV consultation discussions were held in Islamabad during August 26-30, 1984 and December 1-2, 1984. The staff report (SM/85/29, Sup. 1 and Cors. 1 and 2) was discussed by the Executive Board on February 27, 1985 (SUR/85/23). The Executive Board's decision [Decision No. 7918-(85/31)], adopted on February 27, 1985 was as follows:

1. The Fund takes this decision relating to Pakistan's exchange measures subject to Article VIII, Section 2(a), in concluding the 1984 Article XIV consultation with Pakistan, and in the light of the 1984

Article IV consultation with Pakistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. As described in SM/85/31, Pakistan has relaxed certain restrictions on payments for current invisible transactions. The Fund urges that the authorities remove the restrictive features of the three bilateral payments arrangements with Fund members and encourages the authorities to remove the remaining restrictions on the making of payments and transfers for current international transactions as soon as possible.

Pakistan is on the standard 12-month cycle.

X. Technical Assistance

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

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

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

Pakistan--Relations with the World Bank Group

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

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

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

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

Since SAL I, the Bank Group's financial assistance has been channeled through project loans and one sector lending operation. Post-SAL lending commitments totaled some US$1,358.3 million over the 1983-85 period of which over 80 percent was in the form of project-lending and the balance in the form of an energy sector loan. 1/ Among the project loans carrying policy objectives were an Industial Investment Loan Credit (1984), the Second Small Industries Project (1984), the Fourth and Fifth Water and Power Development Authority (WAPDA) Power (Transmission) Projects (1985), the second Toot Oil and Gas Project (1984), the Petroleum Exploration Project (1984), and the Petroleum Resources Joint Venture Loan (1985). The first two of these project loans were directed at supporting the policy of greater private sector involvement in industry through providing foreign exchange resources to individual firms via the domestic development financial institutions. The two WAPDA loans focused on a national power plan and electricity tariffs. The second Toot loan addressed producer pricing and self-financing of the public sector Oil and Gas Development Corporation. The Petroleum Exploration and the Petroleum Resources Joint-venture loans sought to promote greater investments through joint ventures with foreign private investors and addressed issues of oil and gas pricing.

The Energy Sector Loan (1985) had as its major policy objective the continuation of price and investment program rationalization in the energy sector. This included a continued emphasis on the target of raising domestic gas user prices to two thirds of the international equivalent by mid-1988 and a new policy objective for natural gas producer pricing. In this latter regard, a policy was introduced linking natural gas producer prices to two thirds of the international equivalents less a discount for all new concessions granted after September 1985. Moreover, a strengthening of electric power pricing policies was also included by directly linking electricity prices to self-financing of a quantified capital investment program. More specifically, in conjunction with the Fourth WAPDA loan, the Energy Sector Loan provided that electricity prices be adjusted so that self-financing by WAPDA cover 40 percent of the specified investment level.

In 1986 the focus of the Bank Group's project lending is on telecommunications, industrial and agricultural credit, education and urban development, while in the area of sectoral lending, emphasis is being placed on agriculture and export promotion.

1/ As of September 1985, the Group's ongoing financial operations in Pakistan of US$1.9 billion (on a commitment basis) evidenced a broad sectoral distribution (see attached table).

Pakistan - Financial Relations with the World Bank Group

(In millions of U.S. dollars)

	IBRD	Third Window	IDA	Total
IBRD/IDA lending operations 1/				
Fully disbursed operations 2/	781.4	32.0	1,001.6	1,815.0
Ongoing operations 3/	718.2	10.0	1,202.1	1,930.3
Agricultural and rural development	20.2	10.0	689.6	719.8
Education	--	--	87.5	87.5
Power and utilities	200.0	--	86.0	286.0
Transportation	--	--	100.0	100.0
Industry	140.5	--	207.0	347.5
Population	--	--	18.0	18.0
Energy	357.5	--	--	357.5
Other 4/	--	--	14.0	14.0
Total 1/	1,499.6	42.0	2,203.7	3,745.3
Repayments	501.1	4.6	44.3	550.0
Total now held by IBRD/IDA 5/	998.5	37.4	2,159.4	3,195.3
IFC investments 6/	--	--	--	60.06

Source: World Bank.

1/ Loans and credits as of September 30, 1985.
2/ Ninety-eight loans and credits fully disbursed. Excludes the disbursed portion of loans and credits wholly or partly for projects in former East Pakistan which have now been taken over by Bangladesh. Also excludes amounts which have been cancelled.
3/ Includes one IBRD loan of US$100.0 million and two IDA credits amounting to US$87.0 million that were approved by the Board but are not yet effective.
4/ Includes two technical assistance projects.
5/ Prior to exchange adjustments.
6/ As of September 30, 1985. Gross commitment less cancellation, terminations, repayments, and sales held by IFC.

Table 2. Pakistan: National Product and Expenditures, 1981/82-1985

(In percent)

	1981/82	1982/83	1983/84	Official Proj. 1984/85	Prov. Actua[illegible] 1984/85
Real growth rates					
GDP (at factor costs)	6.6	6.2	3.4	8.5	8.4
Agriculture	3.7	3.6	-6.3	10.2	9.9
Manufacturing	13.7	9.2	8.0	9.2	8.6
Consumption	3.3	3.6	6.1	7.8	8.3
Gross domestic fixed capital formation (GDFCF)	13.1	14.4	5.9	12.2	12.5
GNP at market prices	4.2	7.9	4.4	8.2	7.3
GDP growth at current market prices	13.9	13.3	14.5	15.6	14.[illegible]
GDP deflator change (at market prices)	9.0	6.0	9.7	6.6	5.[illegible]
Consumer prices change					
Annual average	10.0	4.5	8.3	6.6	7.
Year end	7.1	6.6	7.1	...	7.
Ratios 1/					
Consumption/GNP	88.5	85.4	87.2	86.7	88.
Gross domestic investment/GNP	16.3	16.4	15.8	16.0	16.
Of which: GDFCF/GNP	(14.3)	(14.3)	(14.0)	(14.3)	(14.
Net exports of goods and services/GNP	-4.8	-1.8	-3.1	-2.7	-5.
Gross national savings/GNP	11.5	14.6	12.7	13.3	11.
Gross domestic savings/GNP	5.2	6.7	5.1	6.0	4.

Source: Ministry of Planning and Development.

1/ Calculated from current price data.

Table 3. Pakistan: Summary of Public Finance, 1981/82-1985/86

	Actual 1981/82	Actual 1982/83	Actual 1983/84	Budget Estimate 1984/85	Prov. Actuals 1984/85	Budget Estimate June 1985 1985/86	Official Revised Estimate Sept. 1985 1985/86	Official Revised Estimate Dec. 1985 1985/86
	(In billions of Pakistan rupees)							
·enue	51.9	59.2	72.3	80.0	77.8	92.5	90.0	89.8
·ax	43.0	49.0	58.2	63.9	60.7	73.4	70.9	70.9
:ontax	8.9	10.2	14.1	16.1	17.1	19.1	19.1	18.9
plus of autonomous bodies	1.9	2.3	2.6	2.6	1.9	4.8	4.8	4.8
›enditure	71.0	87.1	100.0	109.9	117.6	135.9	135.9	131.9
:urrent	46.4	59.7	74.4	78.1	85.7	97.9	97.9	94.0
›evelopment	24.6	27.4	25.5	31.8	31.9	38.0	38.0	37.9
lending and equity participation	--	--	--	--	--	-2.0 1/	-2.0 1/	-2.0 1/
Overall deficit(-)	-17.2	-25.7	-25.1	-27.3	-37.8	-36.5	-39.0	-35.3
ancing	17.2	25.7	25.1	27.3	37.8	36.5	39.0	35.3
xternal (net)	5.3	5.2	5.0	6.8	6.0	18.8	16.9	13.5
omestic nonbank	6.3	14.4	12.2	14.7	13.0	17.7	22.1	22.3
anking system	5.5	6.1	7.9	5.8	18.7	--	--	-0.5
orandum items:								
omestic bank financing	6.6	9.7	6.6	5.6	18.0	-0.2	-11.2	-11.5
Budgetary support	5.5	6.1	7.9	5.8	18.7	--	--	-0.5
Commodity operations	1.0	3.6	-1.3	-0.2	-0.7	-0.2	-11.2 2/	-11.0
DP at current market prices	322.8	365.8	418.8	485.2	478.3	543.1	543.1	543.1
	(As percent of GDP at current market prices)							
otal revenue	16.1	16.2	17.3	16.5	16.3	17.0	16.6	16.5
Of which:								
Tax revenue	(13.3)	(13.4)	(13.9)	(13.2)	(12.7)	(13.5)	(13.1)	(13.0)
xpenditure	22.0	23.8	23.9	22.6	24.6	25.0	25.0	24.3
Current	(14.4)	(16.3)	(17.8)	(16.1)	(17.9)	(18.0)	(18.0)	(17.3)
Development	(7.6)	(7.5)	(6.1)	(6.6)	(6.7)	(7.0)	(7.0)	(7.0)
verall deficit	5.3	7.0	6.0	5.6	7.9	6.7	7.2	6.5
xternal financing (net)	1.6	1.4	1.2	1.4	1.3	3.5	3.1	2.5
omestic nonbank	2.0	3.9	2.9	3.0	2.7	3.3	4.1	4.1
omestic bank financing	2.0	2.6	1.6	1.2	3.8	--	-2.1	-2.1
Of which:								
Budgetary support	(1.7)	(1.7)	(1.9)	(1.2)	(3.9)	(--)	(--)	(-0.1)

ource: Ministry of Finance and Economic Affairs.

/ *Proceeds from sales of government shares in public enterprises.*

/ The proceeds from sales of Special National Fund bonds, which were financed by bank credit to private sector :hasers totaling PRs 11 billion, was used to repay outstanding bank credit for commodity operations. Such credit is included within the definition of credit to Government for budgetary purposes. While inclusion of these proceeds in the Government's budget operations would be conceptually correct, such treatment would have resulted in reases of the Government's expenditure, overall deficit and domestic nonbank borrowing by PRs 11 billion, and would distorted the comparability of the 1985/86 budget data with that of earlier years.

Table 4. Pakistan: Factors Affecting Changes in Money and Quasi-Money, 1981/82-1985/86 1/

	1981/82	1982/83	1983/84	Official Proj. 1984/85	Prov. Actual 1984/85	July-December 1984/85	July-December 1985/86	December Official Proj. 1985/86
	(In billions of Pakistan rupees)							
Money and quasi-money	11.9	29.5	17.2	18.1	19.3	11.8	9.6	18.6
Money	7.4	15.6	6.9	...	14.8	7.1	3.0	...
Quasi-money	4.5	13.9	10.3	...	4.5	4.7	6.6	...
Foreign assets (net)	-5.3	10.0	-2.9	-2.6	-18.9	-6.5	0.5	4.5
Domestic assets (net)	17.2	19.5	20.1	20.7	38.2	18.3	9.1	14.1
Claims on Government (net)	6.8	9.2	7.5	5.6	18.4	6.8	-10.7	-11.1
Budgetary support	(5.5)	(6.1)	(7.9)	(5.8)	(18.7)	(10.2)	(1.7)	(--)
Commodity operations	(1.1)	(3.6)	(-1.3)	(-0.2)	(-0.7)	(-3.2)	(-12.1)	(-11.1)
Government deposits with scheduled banks	(0.5)	(0.1)	(1.4)	(...)	(0.8)	(-0.2)	(-0.1)	(...)
Zakat Fund deposits at SBP	(-0.3)	(-0.6)	(-0.5)	(...)	(-0.4)	(--)	(-0.2)	(...)
Claims on nongovernment sectors	12.0	14.9	18.8	17.6	17.8	9.2	22.7	27.6
Claims on private sector	(9.0)	(10.9)	(15.5)	(13.6)	(13.9)	(7.6)	(22.8)	(25.1)
Scheduled banks	[7.4]	[9.9]	[13.7]	[10.6]	[11.8]	[6.9]	[21.9]	[22.0]
SBP credit to nonbank financial institutions (NBFI)	[1.6]	[1.0]	[1.8]	[3.0]	[2.1]	[0.8]	[0.9]	[3.1]
Claims on public sector enterprises	(3.0)	(4.0)	(3.3)	(4.0)	(3.9)	(1.6)	(-0.2)	(2.5)
Counterpart funds	--	-0.1	0.3	--	0.1	0.1)		--
Other items (net) (increase-)	-1.6	-4.5	-6.5	-2.5	2.0	) 2.2)	-2.9	-2.5
	(Changes in percent)							
Money and quasi-money	11.4	25.3	11.8	11.1	11.8	7.2	5.3	10.2
Money	10.0	19.3	7.2	...	14.3	6.8	2.6	...
Quasi-money	14.6	39.1	20.9	...	7.5	7.8	10.3	...
Domestic assets (net)	16.8	16.3	14.4	13.1	23.9	11.5	4.6	7.1
Claims on Government (net) 2/	12.2	14.8	10.5	7.2	23.3	8.6	-11.0 (0.4)	11.4 (0.1)
Claims on nongovernment sectors 2/	20.0	20.7	21.7	16.6	16.8	8.7	18.4 (9.4)	20.4 (11.4)
Claims on private sector	21.0	21.1	24.8	17.4	17.8	9.7	24.8 (12.8)	27.2 (15.3)
Scheduled banks 2/	19.6	22.2	25.1	16.0	16.7	10.0	27.2 (13.6)	27.4 (13.7)
SBP credit to NBFI	28.7	14.3	22.3	30.6	21.3	8.2	7.9	26.4
Claims on public sector enterprises	17.7	19.7	13.6	14.4	14.1	5.9	0.5	8.0
Memorandum items:								
GDP (at current market prices)	13.9	13.3	14.5	15.6	14.2	...	...	13.6
Velocity	2.3	-9.6	2.4	4.0	2.1	...	...	3.3

Source: State Bank of Pakistan.

1/ Data are on a fiscal year basis ending June 30.
2/ Percentage changes in parentheses for July-December 1985 and for the 1985/86 forecast exclude the effect of the PRs 11 billion of bank financing of Special National Fund Bonds.

Table 5. Pakistan: Balance of Payments, 1981/82-1985/86

(In millions of U.S. dollars)

	1981/82	1982/83	1983/84	Official Projections Original 1984/85	Official Projections Revised 1984/85	Prov. Actual 1984/85	Official Proj. Sept. 1985 1985/86	Official Proj. Dec. 1985 1985/86
Trade balance	-3,450	-2,989	-3,324	-3,564	-3,601	-3,587	-3,201	-3,050
Exports, f.o.b.	2,319	2,627	2,669	2,953	2,662	2,350 1/	2,945	2,945
Cotton lint 2/	(264)	(303)	(132)	(229)	(...)	(279)	(337)	(300)
Rice 2/	(391)	(287)	(422)	(380)	(...)	(222)	(365)	(343)
Other 2/	(1,810)	(2,105)	(2,214)	(2,439)	(...)	(1,987)	(2,371)	(2,376)
Imports, f.o.b.	-5,769	-5,616	-5,993	-6,517	-6,263	-5,937	-6,146	-5,995
Services (net)	-546	-607	-714	-710	-815	-820	-825	-841
Receipts	935	979	1,064	1,176	1,076	1,003	1,075	1,045
Payments	-1,481	-1,586	-1,778	-1,886	-1,896	-1,823	-1,900	-1,886
Of which: interest 3/	(-416)	(-425)	(-471)	(-447)	(-457)	(-462)	(-429)	(-429)
Private transfers (net)	2,387	3,039	3,007	3,092	2,785	2,632	2,618	2,743
Of which: workers' remittances	(2,224)	(2,886)	(2,737)	(2,805)	(2,450)	(2,446)	(2,400)	(2,520)
Current account balance	*-1,609*	*-557*	*-1,031*	*-1,182*	*-1,631*	*-1,775*	*-1,408*	*-1,148*
Official transfers (net)	421	327	296	330	330	360	537	537
Of which: refugee assistance	(293)	(178)	(155)	(200)	(200)	(150)	(200)	(200)
Long-term capital (net)	287	836	595	659	618	500	789	742
Project, food, and other commodity loans (net)	179	554	360	550	501	332	680	558
Disbursements	(671)	(974)	(880)	(1,088)	(1,039)	(869)	(1,262)	(1,140)
Amortization	(-492)	(-420)	(-520)	(-538)	(-538)	(-537)	(-582)	(-582)
Other official (net) 4/	25	194	170	8 5/	16 5/	79	31	106
Disbursements	(25)	(194)	(234)	(...)	(...)	(200)	(215)	(290)
Amortization	(--)	(--)	(-64)	(...)	(...)	(-121)	(-184)	(-184)
Private, net	83	88	65	101	101	89	78	78
Short-term capital (net)	54	40	-7	...	...	-77	150	125
Official (net) 6/	-9	-233	-109	...	...	-31	150	175
Foreign currency deposits 7/	63	273	102	--	--	-46	--	-50
Debt relief 8/	258	35	28	25	25	25	25	25
Principal	204	31	27	24	24	24	24	24
Interest	54	4	1	1	1	1	1	1
Errors and omissions (including private short-term capital)	9	18	33	...	...	-34	--	--
Overall balance	-580	699	-86	-168	-658	-1,001	93	281
Net foreign assets (increase-)	580	-699	86	168	658	1,001	-93	-281
Net use of Fund credit	374	426	-15	-90	-84	-84	-225	-225
Purchases	(505)	(507)	(--)	(--)	(--)	(--)	(--)	(--)
Repurchases	(-131)	(-81)	(-15)	(-90)	(-84)	(-84)	(-225)	(-225)
Other central and commercial banks (net)	206	-1,125	101	258	742	1,085	132	-56
Memorandum items:								
Gross official reserves 9/	809	1,910	1,732	1,006	957	672	640	1,028 10/
(*in weeks of following year's* imports, c.i.f.)	(6.9)	(15.2)	(13.9)	(10.9)	(7.0)	(5.2)	(4.9)	(8.0)
Current account deficit (as percent of GNP)	4.9	1.8	3.1	3.2	4.4	5.2	3.9	3.2
Growth rates:								
Exports f.o.b.	-17.1	13.3	1.6	10.7	-0.2	-12.0	25.3	25.3
Imports f.o.b.	3.7	-2.7	6.7	8.6	4.3	-0.9	3.5	1.0
Workers' remittances	6.1	29.8	-5.2	2.5	-10.5	-10.6	-1.9	3.0

Source: Ministry of Finance and Economic Affairs.

1/ Excludes outstanding export bills (US$125 million).
2/ On a c.i.f. basis.
3/ Actual interest payments on debt outstanding as of end-June of each year and interest rescheduled in 1981. For 1985/86, includes interest arising from new disbursements.
4/ Mainly commercial bank borrowing of over one-year maturity.
5/ Includes commercial borrowing of less than one-year maturity, which is otherwise included in the entry "Official (net)" under short-term capital.
6/ Commercial bank and Islamic Development Bank borrowing of one-year maturity or less, and proceeds from sales of Foreign Exchange Bearer Certificates (US$125 million in the September forecast and US$150 million in the December forecast).
7/ Nonbank foreign currency deposits.
8/ Debt rescheduled in 1981.
9/ Excludes gold.
10/ Includes US$300 million of foreign currency deposits by nonresident commercial banks.

Table 6. Pakistan: Debt Service Payments, 1981/82-1989/90

	1981/82	1982/83	1983/84	1984/85	Official Projections 1985/86	1986/87	1987/88	1988/89	1989/90
	(In millions of U.S. dollars)								
A. Scheduled debt service	985	922	1,078	1,203	1,423 1/	1,494 1/	1,546 1/	1,361 1/	1,292 1/
Medium- and long-term debt 2/	723	711	932	991	1,069	1,087	1,195	1,077	1,036
Principal	(492)	(420)	(593)	(658)	(766)	(720)	(829)	(725)	(696)
Interest	(231)	(291)	(339)	(333)	(303)	(367)	(366)	(352)	(340)
New medium- and long-term debt	--	--	--	--	15	23	42	66	99
Principal	(--)	(--)	(--)	(--)	(4)	(5)	(6)	(9)	(12)
Interest	(--)	(--)	(--)	(--)	(11)	(18)	(36)	(57)	(87)
Use of Fund credit 3/	181	177	128	203	330	375	300	209	148
Repurchases	(131)	(81)	(15)	(84)	(225)	(292)	(242)	(171)	(127)
Charges	(50)	(96)	(113)	(119)	(105)	(83)	(58)	(38)	(21)
Short-term debt interest 4/	81	34	18	9	9	9	9	9	9
B. Debt relief	258	35	28	25	25	10	9	9	9
Principal	204	31	27	24	24	9	9	9	9
Interest	54	4	1	1	1	1	--	--	--
C. Debt service payments									
Including use of Fund credit (A-B)	727	887	1,050	1,178	1,398	1,484	1,537	1,352	1,283
Excluding use of Fund credit	546	710	922	975	1,068	1,109	1,237	1,143	1,135
	(In percent of current account receipts)								
Debt service ratios									
Including use of Fund credit	12.9	13.3	15.6	19.7	20.8	20.6	20.2	16.9	15.2
Excluding use of Fund credit	9.7	10.7	13.7	16.3	15.9	15.4	16.3	14.3	13.5
Memorandum item:									
Current account receipts	5,642	6,650	6,741	5,985	6,734	7,191	7,607	7,998	8,427

Sources: Ministry of Finance and Economic Affairs and IMF Treasurer's Department.

1/ Based on debt outstanding as of end-June 1985.
2/ Includes Trust Fund.
3/ Based on IMF Treasurer's Department actual transactions data.
4/ Interest on commercial bank and Islamic Development Bank debt of one year or less; excludes interest on domestic bank monetary liabilities, foreign currency deposits, and foreign exchange bearer certificates.

Table 7. Pakistan: Official Balance of Payments Projections, 1985/86-1989/90

	1985/86	1986/87	1987/88	1988/89	1989/90
	(In millions of U.S. dollars)				
Trade balance	-3,050	-2,745	-2,710	-2,721	-2,721
Exports, f.o.b.	2,945	3,335	3,735	4,109	4,519
Cotton lint 1/	(300)	(375)	(419)	(...)	(...)
Rice 1/	(343)	(370)	(372)	(...)	(...)
Others 1/	(2,376)	(2,727)	(3,025)	(...)	(...)
Imports, f.o.b.	-5,995	-6,080	-6,445	-6,830	-7,240
Services (net)	-841	-880	-912	-940	-986
Of which: interest payments 2/	(-429)	(-478)	(-469)	(-456)	(-457)
Private transfers (net)	2,743	2,730	2,690	2,650	2,610
Of which: workers' remittances	(2,520)	(2,500)	(2,450)	(2,400)	(2,350)
Current account balance	-1,148	-895	-932	-1,011	-1,097
Official transfers (net)	537	330	350	355	360
Of which: refugee assistance	(200)	(200)	(200)	(200)	(200)
Long-term capital (net) 3/	742	675	674	773	824
Short-term capital (net) 4/	125	15	--	--	--
Debt relief 5/	25	10	9	9	9
Overall balance	281	135	101	126	96
Net use of Fund credit	-225	-292	-242	-171	-127
Other central and commercial bank	-56	157	141	45	31
Memorandum items:					
Gross official reserves in weeks of following year's imports, (c.i.f.)	8	7	6	5	5
Current account deficit (as percent of GNP)	3	2	2	2	2
	(In percent)				
Assumptions					
Exports, of which:	25	13	12	10	10
Cotton	(8)	(25)	(12)	(...)	(...)
Rice	(55)	(8)	(12)	(...)	(...)
Other	(20)	(15)	(11)	(...)	(...)
Imports	1	1	6	6	6
Workers' remittances	3	-1	-2	-2	-2
Increase in oil price in U.S. dollars 6/	-7.9	-5.9	2.3	4.5	4.5
Increase in world market prices for manufactures 6/	4.5	6.7	4.3	4.5	4.5
International interest rates 6/	8.5	8.2	8.0	8.0	8.0

Source: Ministry of Finance and Economic Affairs.

1/ On a c.i.f. basis.

2/ Interest on debt outstanding as of end-June 1985 and interest arising from projected new disbursements.

3/ Includes commercial borrowing of over one-year maturity.

4/ Includes commercial borrowing of one-year maturity or less.

5/ Debt rescheduled in 1981.

6/ World Economic Outlook assumptions of December 1985.

Pakistan - Basic Data

Population	94.73 million (January 1, 1985 estimate) 1/
Population growth	3.1 percent per annum 1/
GNP per capita	US$357 (1984/85) 2/

Year ended June 30	1980/81	1981/82	1982/83	1983/84	Prov. Actual 1984/85
	(In percent)				
Annual changes in national product aggregates (1959/60 prices)					
GNP (at market prices)	6.8	4.2	7.9	4.4	7.3
GDP (at factor cost)	6.6	6.6	6.2	3.4	8.4
Agriculture	3.5	3.7	3.6	-6.3	9.9
Manufacturing	10.6	13.7	9.2	8.0	8.6
Services	7.0	6.6	7.2	6.2	8.0
Investment, consumption, and savings ratios					
Gross domestic fixed capital formation/GNP	14.2	14.3	14.3	14.0	14.6
Consumption/GNP	87.7	88.5	85.4	87.2	88.8
Gross domestic savings/GNP	5.8	5.2	6.7	5.1	4.7
Gross national savings/GNP	12.3	11.5	14.6	12.7	11.2
Oil production	-1.3	10.7	19.5	-1.6	102.6
	(In millions of Pakistan rupees)				
Government finances					
Tax revenue	38,846	43,003	49,029	58,246	60,758
Nontax revenue	8,156	8,927	10,152	14,044	17,080
Surplus of autonomous bodies	2,019	1,909	2,286	2,565	1,944
Current expenditure 3/	40,318	46,370	59,718	74,429	85,684
Development expenditure	23,321	24,643	27,403	25,573	31,876
Overall deficit (-)	-14,618	-17,174	-25,654	-25,147	-37,778
External financing (net)	(6,977)	(5,345)	(5,162)	(5,001)	(6,045)
Domestic nonbank financing (net)	(5,286)	(6,313)	(14,368)	(12,280)	(12,999)
Bank financing	(2,355)	(5,516)	(6,124)	(7,866)	(18,734)
	(In percent)				
Rate of change of:					
Total revenue	22.1	10.5	14.0	22.2	7.7
Tax revenue	(19.5)	(10.7)	(14.0)	(18.8)	(4.3)
Nontax revenue	(36.0)	(9.5)	(13.7)	(38.3)	(21.6)
Current expenditure	13.4	15.0	28.8	24.6	15.1
Development expenditure	22.2	5.7	11.2	-6.7	24.6
Overall deficit	-0.3	17.5	49.4	-2.0	50.2
As percent of GDP:					
Tax revenue	13.7	13.3	13.4	13.9	12.7
Nontax revenue	2.9	2.8	2.8	3.4	3.6
Current expenditure	14.2	14.4	16.3	17.8	17.9
Development expenditure	8.2	7.6	7.5	6.1	6.7
Overall deficit	5.2	5.3	7.0	6.0	7.9
External financing (net)	2.5	1.6	1.4	1.2	1.3
Budgetary support	0.8	1.7	1.7	1.9	3.9
Domestic nonbank financing (net)	1.9	1.9	3.9	2.9	2.7

1/ *Pakistan Economic Survey*, 1984-85, Appendix II, Table 1.1.

2/ The average exchange rate of PRs 15.16 per U.S. dollar for 1984/85 was used to convert rupee per capita income.

3/ Includes development subsidies which in the ADP are classified as development expenditures.

Pakistan - Basic Data (Concluded)

	1980/81	1981/82	1982/83	1983/84	Prov. Actual 1984/85
	(In millions of SDRs)				
Balance of payments					
Trade balance	-2,203	-3,034	-2,760	-3,165	3,619
Exports, f.o.b.	(2,229)	(2,040)	(2,425)	(2,541)	(2,371)
Imports, f.o.b.	(-4,432)	(-5,074)	(-5,185)	(-5,706)	-(5,990)
Services (net)	-365	-480	-560	-680	-827
Private transfers (net)	1,778	2,099	2,806	2,863	2,655
Current account balance	-790	-1,415	-514	-982	-1,791
Official transfers (net), of which:	201	370	302	282	363
Refugee assistance	(88)	(258)	(164)	(148)	(151)
Long-term capital (net)	228	252	772	566	504
Short-term capital (net)	202	47	37	-7	-77
Official (net)	(156)	(-8)	(-215)	(-104)	(-31)
Foreign currency deposits	(46)	(55)	(252)	(97)	(-46)
Debt relief	128	227	32	27	25
Errors and omissions (net)	12	9	16	32	-34
Net foreign assets (increase-)	19	510	-645	82	1,010
Memorandum items:					
Gross official reserves (end-period) 1/	920	741	1,788	1,680	673
Gross official reserves (in weeks of following year's imports, c.i.f.)	(8.8)	(6.9)	(15.2)	13.9)	(5.2)
	(In percent)				
Rates of change					
Merchandise exports (f.o.b.) 2/	20	-17	13	2	-12
Cotton and rice (c.i.f.) 2/	44	-40	-10	-6	-10
Manufactured products (c.i.f.) 2/	16	-3	16	5	-10
Merchandise imports (f.o.b.) 2/	15	4	-3	7	-1
Workers' remittances 2/	20	6	30	-5	-11
Money and quasi-money	13	11	25	12	12
Domestic assets (net)	15	17	16	14	24
Claims on Government (net)	11	12	15	11	23
Claims on nongovernment sectors	19	20	21	22	17
Consumer prices 3/	12	10	5	8	8
Wholesale prices 3/	13	8	4	11	4
GDP deflator	11	9	6	10	6

1/ Excludes gold.
2/ Calculated from U.S. dollar values.
3/ Change in the average level of the index compared with the previous year.

Pakistan - Statistical Issues

1. National income accounts

Pakistan compiles full nominal and constant price national income data. The overall quality of the data is good although some problems exist with the manufacturing investment deflator price series. At present the constant price national income accounts use 1959/60 price weights. The authorities are in the process of rebasing the income accounts to 1980/81 price weights.

2. Prices

While the price data are generally good, there is in both the consumer and wholesale price indices a large administered price component which may result in understatements of price movements.

3. Government finance

The budgetary data in the consultation reports are a consolidation of the accounts of the federal and provincial governments. The authorities are undertaking to develop the data base for the entry "Net lending and equity participation." This undertaking if successful could involve some major relcassifications and thus changes in the budget aggregates. The first efforts at these reclassifications, which have been undertaken for the period 1983/84-1985/86, suggest that the effect on the overall deficit would be to lower the ratio to GDP by roughly 0.5 percentage points each year.

4. Monetary accounts

Pakistan's monetary and credit data is broadly accurate. However in 1983/84, a problem emerged with the treatment of the transactions of certain banks, which had the effect of overstating considerably the contractionary impact from the net unclassified liabilities of the banking system. In 1984/85 the authorities sought to correct for this accounting misclassification to the extent feasible. Discrepancies exist between the changes in the net foreign assets position of the banking system and the overall balance of payments position.

5. Balance of payments

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

6. External debt

The coverage of civilian official foreign debt data is thorough. The official data, however, excludes military debt, on which information is not available. There is a need to improve the data on the maturity structure of official debt, and the compilation of medium- and long-term private debt data in terms of its amount and terms. The volume of this debt is believed to be relatively small.

Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Pakistan in the February 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the State Bank of Pakistan, which during the past year have been provided on a timely basis.

		Latest Data in February 1986 IFS
Real Sector	- National Accounts	1984
	- Prices	November 1985
	- Production	June 1985
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1983
	- Financing	1983
	- Debt	1984
Monetary Accounts	- Monetary Authorities	October 1985
	- Deposit Money Banks	October 1985
	- Other Financial Institutions	October 1985
External Sector	- Merchandise Trade: Values	October 1985
	- Balance of Payments	01 1985
	- International Reserves	December 1985
	- Exchange Rates	December 1985