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CONTAINS CONFIDENTIAL
INFORMATION

March 28, 1986

To: Members of the Executive Board

From: The Secretary

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

The attached supplement to the staff report for the 1985 Article IV consultation with Pakistan has been prepared on the basis of additional information.

Mr. Maciejewski (ext. 7112) is available to answer technical or factual questions relating to this paper prior to the Board discussion on Monday, March 31, 1986.

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INTERNATIONAL MONETARY FUND

PAKISTAN

Staff Report for the 1985 Article IV Consultation
Supplementary Information

Prepared by the Staff Representatives for the
1985 Consultation with Pakistan

Approved by S.H. Hitti and J.T. Boorman

March 28, 1986

Since the issuance of the Staff Report (SM/86/51), some additional data have been provided by the Pakistan authorities. 1/ The information points to a good overall performance in the agricultural sector in 1985/86. The latest output estimates are a 20 percent increase in cotton production to an historic record of 7.1 million bales, a 12 percent decline in rice production to 2.9 million tons, and a 16 percent decline in sugarcane production to 26.9 million tons. The excellent cotton crop (for the second successive year) resulted from favorable weather conditions, as well as the measures taken by the authorities to ensure the timely availability of inputs and extension services to farmers. The weak rice performance reflected the severe water shortage in May-June 1985 which had delayed sowing and transplanting and had thereby made the crop more susceptible to pest attack. Another factor was the relatively low support price for basmati rice. The decline in sugarcane production was due in part to the water shortage. The authorities, however, recognized that certain areas in Pakistan were not suitable for sugarcane cultivation. They added that, despite an increase of PRs 5.4 per 100 kgs in the support price for the 1986/87 crop, some operations remained unprofitable and that the authorities intended to look into the possibilities of streamlining the sugar industry. With regard to wheat, the expectations are for an excellent crop possibly approaching 14 million tons. Precipitation and temperatures during the sowing period were near perfect and the available information on sown areas and use of fertilizers suggests that the production of wheat in 1985/86 is likely to increase by over 15 percent compared with 1984/85. As a result of the record cotton and (expected) wheat crops, the projected real growth of the economy has been revised upward by about one-half percentage point to approximately 7 percent. Inflation continued to moderate and for the July 1985-January 1986 period, the consumer price index was 5.7 percent higher on a period average basis than in the same period in the previous year; in this latter period, the comparable inflation rate was 6.8 percent.

1/ A staff team consisting of Messrs. A.S. Shaalan (Head), S.H. Hitti, and E. Maciejewski (all of MED) visited Islamabad during March 18-20.

In the area of public finance, only partial information is available on the results for the first seven months of 1985/86. The indications are that in this period: (1) receipts for some important federal government taxes, especially federal excises and customs duties, were running substantially lower than expected; (2) current expenditures were somewhat higher than expected; (3) nonbank domestic financing was on target; (4) external nonfood commodity and project-related financing was equivalent to one third of the amount originally budgeted for 1985/86 as a whole; and (5) domestic bank financing (excluding commodity financing) was PRs 2.3 billion during July 1, 1985-February 27, 1986.

In view of these developments, the authorities have revised their forecast for the 1985/86 budget (Appendix Table 1). Total revenue is now projected to increase by 19 percent, or about the same in aggregate as in the original budget estimate. Although tax revenues are projected at about the same level as in the original budget, there have been changes in the composition. Receipts from excises, the sales tax, and import duties are projected at about PRs 3.2 billion below the budget estimate, but these shortfalls are almost exactly offset by higher than originally projected receipts from the surcharges on petroleum. The latter reflect the decline in international prices which have not been passed on in lower domestic prices. On the expenditure side, current outlays are projected to rise by 15 percent and to exceed the original budget estimate slightly, mainly due to higher projected provincial outlays. Defense outlays are expected to decline by 4 percent in nominal terms, in contrast to previously projected declines. Development expenditure is projected to rise by 16 percent, compared with 19 percent in the original budget, reflecting lower external financing than originally anticipated. With these changes, the overall fiscal deficit is projected at 6.9 percent of GDP, or somewhat more than the original budget estimate. However, if the projected receipts from the sale of government shares in public enterprises do not materialize, the deficit would reach 7.2 percent of GDP. Net external financing is expected to be only slightly more than half the level projected in the original budget. Domestic bank financing, which was to be avoided according to the original budget, is projected at about 1.1 percent of GDP. In addition, commodity operations in the year as a whole may show an increase of PRs 1 billion.

The monetary data for the first eight months of the 1985/86 fiscal year indicate that domestic liquidity rose by 9 percent over this period compared with 7 percent during the comparable period of the previous year (Appendix Table 2). The factors contributing to these results were different in the two years. The change in net foreign assets had a large contractionary impact in 1984/85 but was roughly neutral in the 1985/86 period. However, the growth in net domestic assets was much greater last year than in the current period. A notable development this year was an acceleration in the growth of the scheduled banks' claims on the private sector; the latter (excluding PRs 11 billion of bank financing of Special National Fund bonds) expanded at an annualized rate of 26 percent during the first eight months of 1985/86 compared

with 21 percent during the same period in 1984/85. These estimates suggest that the increase (11 percent) in claims on the nongovernment sector targeted in the official credit plan for 1985/86 as a whole might be exceeded. However, assuming that the State Bank will be able to implement the credit plan for the nongovernment sector as originally envisaged, the additional financing requirement for the budget (PRs 6.1 billion) and for commodity operations (PRs 1 billion) would result in net domestic assets growing by PRs 21 billion compared with PRs 14 billion estimated at the beginning of the year. Given that the authorities now estimate a somewhat smaller overall balance of payments surplus, the growth in total domestic liquidity is estimated at about 13.5 percent compared with a little over 10 percent in the original monetary plan.

In the external sector, total export receipts over July 1985-February 1986 were 19 percent above such earnings during the same period of 1984/85. However, most of the increase was attributable to raw cotton, rice, and cotton-related manufactured exports. Raw cotton and rice exports accounted for more than four fifths of the total increase and raw cotton exports alone for about three fifths of the total increase. Nontraditional manufactured exports declined in value terms. Total imports declined by 1 percent over July 1985-February 1986, primarily as a result of declining prices for imported primary commodities. During the same period, workers' remittances rose by some 7 percent, mostly as a result of sharply increased remittances from the United States and the United Kingdom, while remittances from the oil producing countries in the region virtually stagnated. The authorities indicated that gross official disbursements on project and nonfood commodity aid had been lower than expected. However, net proceeds from the sale of foreign exchange bearer certificates were higher than anticipated and totaled US\$142 million over the August 1, 1985-March 16, 1986 period. At end-February 1986 gross official external reserves (excluding gold) were US\$915 million, equivalent to seven weeks of projected 1985/86 imports (c.i.f.). Excluding foreign currency deposits by nonresident commercial banks of US\$390 million, gross official reserves were US\$525 million, equivalent to four weeks of projected 1985/86 imports (c.i.f.).

In light of the developments during the first eight months of 1985/86, the authorities have revised their balance of payments forecast for 1985/86 as a whole (Appendix Table 3). The major revisions from the first official forecast, discussed with the staff last September, are a lowering of the current deficit by 1 percentage point to less than 3 percent of GNP and a smaller overall balance of payments surplus. The original forecast for the growth in total exports remains unchanged. There was, however, a major change in the composition of exports, including in particular a sharply higher export volume of raw cotton and a much lower growth in noncotton manufactured exports. The latter are now projected to rise by only 11 percent compared with 21 percent in the original forecast. Workers' remittances had been revised upward. The staff noted in this regard that the large inflows that occurred during the first eight months of the current year might represent a temporary bulge resulting from transfer of savings by returning overseas workers.

With regard to the revised balance of payments forecast, the authorities have explained that the smaller current account deficit resulted largely from lower imports which were projected to decline by about 1 percent in 1985/86 primarily as a result of decreases in world prices for crude oil and edible oils and of lower project-related imports. The recent depreciation of the rupee in real effective terms was expected to help achieve the revised growth target of 11 percent set for noncotton manufactured exports. The authorities also believed that workers' remittances from the oil producing countries in the region would not be affected substantially by the recent decline in crude oil prices during the remainder of the current fiscal year. About 70 percent of workers' remittances projected for 1985/86 as a whole had already been received during the first eight months of the year. The authorities explained that a smaller overall balance of payments surplus was now projected for 1985/86, mainly as a result of substantially lower than originally anticipated gross official disbursements of project-related and nonfood commodity aid as well as lower foreign borrowing from commercial banks.

With regard to the exchange rate system, as of March 1986 the exchange rate for the rupee was PRs 15.98 per U.S. dollar. This rate had remained unchanged since October 31, 1985. The rupee has depreciated by about 20 percent in real effective terms since February-March 1985, reflecting mainly the sharp depreciation of the U.S. dollar vis-a-vis other major currencies during the latter half of 1985. Foreign exchange bearer certificates with a maturity of three years started to be quoted on the Karachi Stock Exchange on March 6, 1986, effectively giving rise to a secondary foreign exchange market. Their price averaged PRs 107.25 during March 8-11 and rose to PRs 107.50 on March 12 (latest available date), indicating a likelihood that the scheme gives rise to a multiple currency practice. 1/

The economy and finances of Pakistan have been benefitting in the current year from a number of favorable factors including good cotton and wheat crops, declines in the prices of edible oil and crude oil, and some increase in workers' remittances. The authorities have also taken steps to recapture the loss in international competitiveness experienced before early 1985. There were adverse factors at play, principally weak export prices for a number of commodities. The authorities have now revised their fiscal and external payments forecasts for the current year to reflect the developments during the first half of the year. The revised forecasts are more realistic than the original estimates, which, as explained in the staff report, were optimistic in a number of respects. The staff, however, continues to believe that

1/ The staff will seek from the authorities additional relevant information, in particular the date of issue of the certificates, in order to determine whether the scheme gives rise to a multiple currency practice. If the information indicates that the scheme effectively gives rise to a multiple currency practice, the staff will not recommend that the Executive Board approve the multiple currency practice.

the overall fiscal deficit, and the bank financed component, might well turn out to be higher than the authorities' latest estimates, while the balance of payments might show a deficit or be in approximate balance.

Both the authorities and the staff are aware that the favorable factors enumerated above might be reversed, but more importantly that even in their presence, Pakistan's financial situation remains fragile. In the circumstances, the staff would hope that the authorities are able to make use of the present opportunity to implement in a systematic and orderly fashion the needed reforms, as explained in the staff report, to overcome the structural weaknesses in public finances and the external accounts.

Table 1. Pakistan: Summary of Public Finance, 1981/82-1985/86

	Actual			Budget	Prov.	Budget	Official
	1981/82	1982/83	1983/84	Estimate	Actuals	Estimate	Revised
				1984/85	1984/85	June 1985	Estimate
						1985/86	Mar. 1986
							1985/86
(In billions of Pakistan rupees)							
Revenue	51.9	59.2	72.3	80.0	77.8	92.5	92.7
Tax	43.0	49.0	58.2	63.9	60.7	73.4	73.4
Nontax	8.9	10.2	14.1	16.1	17.1	19.1	19.3
Surplus of autonomous bodies	1.9	2.3	2.6	2.6	1.9	4.8	3.6
Expenditure	71.0	87.1	100.0	109.9	117.6	135.9	135.6
Current	46.4	59.7	74.4	78.1	85.7	97.9	98.7
Development	24.6	27.4	25.5	31.8	31.9	38.0	36.9
Net lending and equity participation	--	--	--	--	--	-2.0 ^{1/}	-2.0 ^{1/}
Overall deficit(-)	-17.2	-25.7	-25.1	-27.3	-37.8	-36.5	-37.3
Financing	17.2	25.7	25.1	27.3	37.8	36.5	37.3
External (net)	5.3	5.2	5.0	6.8	6.0	18.8	10.3
Domestic nonbank	6.3	14.4	12.2	14.7	13.0	17.7	20.9
Banking system	5.5	6.1	7.9	5.8	18.7	--	6.1
Memorandum items:							
Domestic bank financing	6.6	9.7	6.6	5.6	18.0	-0.2	-3.9
Budgetary support	5.5	6.1	7.9	5.8	18.7	--	6.1
Commodity operations	1.0	3.6	-1.3	-0.2	-0.7	-0.2	-10.0 ^{2/}
GDP at current market prices	322.8	365.8	418.8	485.2	478.3	543.1	543.1
(As percent of GDP at current market prices)							
Total revenue	16.1	16.2	17.3	16.5	16.3	17.0	17.1
Of which:							
Tax revenue	(13.3)	(13.4)	(13.9)	(13.2)	(12.7)	(13.5)	(13.5)
Expenditure	22.0	23.8	23.9	22.6	24.6	25.0	25.0
Current	(14.4)	(16.3)	(17.8)	(16.1)	(17.9)	(18.0)	(18.2)
Development	(7.6)	(7.5)	(6.1)	(6.6)	(6.7)	(7.0)	(6.8)
Overall deficit	5.3	7.0	6.0	5.6	7.9	6.7	6.9
External financing (net)	1.6	1.4	1.2	1.4	1.3	3.5	1.9
Domestic nonbank	2.0	3.9	2.9	3.0	2.7	3.3	3.9
Domestic bank financing	2.0	2.6	1.6	1.2	3.8	--	-0.7
Of which:							
Budgetary support	(1.7)	(1.7)	(1.9)	(1.2)	(3.9)	(--)	(1.1)

Source: Ministry of Finance and Economic Affairs.

^{1/} Proceeds from sales of government shares in public enterprises.

^{2/} The proceeds from sales of Special National Fund bonds, which were financed by bank credit to private sector purchasers totaling PRs 11 billion, was used to repay outstanding bank credit for commodity operations. Such credit is not included within the definition of credit to Government for budgetary purposes. While inclusion of these proceeds within the Government's budget operations would be conceptually correct such treatment would have resulted in increases of the Government's expenditure, overall deficit and domestic nonbank borrowing by PRs 11 billion, and would have distorted the comparability of the 1985/86 budget data with that of earlier years.

Table 2. Pakistan: Factors Affecting Changes in Money and Quasi-Money, 1982/83-1985/86 ^{1/}

	1982/83	1983/84	Prov. Actual 1984/85	July-February 1984/85 1985/86		Dec. 1985 Official Proj. 1985/86	March 1986 Official Proj. 1985/86	
(In billions of Pakistan rupees)								
Money and quasi-money	29.5	17.2	19.3	12.0	16.4	18.6	24.4	
Money	15.6	6.9	14.8	...	...	...	...
Quasi-money	13.9	10.3	4.5	...	...	...	...
Foreign assets (net)	10.0	-2.9	-18.9	-13.1	-0.3	4.5	3.2	
Domestic assets (net)	19.5	20.1	38.2	25.1	16.7	14.1	21.2	
Claims on Government (net)	9.2	7.5	18.4	9.8	-9.3	-11.1	-3.9	
Budgetary support	(6.1)	(7.9)	(18.7)	(12.4)	(2.3)	(--)	(6.1)	
Commodity operations	(3.6)	(-1.3)	(-0.7)	(-3.1)	(-11.2)	(-11.1)	(-10.0)	
Government deposits								
with scheduled banks	(0.1)	(1.4)	(0.8)	(0.4)	(-0.3)	(...)	(...)	
Zakat Fund deposits								
at SBP	(-0.6)	(-0.5)	(-0.4)	(--)	(-0.1)	(...)	(...)	
Claims on nongovernment								
sectors	14.9	18.8	17.8	11.8	26.5	27.6	27.6	
Claims on private								
sector	(10.9)	(15.5)	(13.9)	(10.6)	(26.0)	(25.1)	(25.1)	
Scheduled banks	[9.9]	[13.7]	[11.8]	[9.5]	[24.8]	[22.0]	[22.0]	
SBP credit to nonbank								
financial institutions								
(NBFI)	[1.0]	[1.8]	[2.1]	[1.1]	[1.2]	[3.1]	[3.1]	
Claims on public sector								
enterprises	(4.0)	(3.3)	(3.9)	(1.2)	(0.5)	(2.5)	(2.5)	
Counterpart funds	-0.1	0.3	0.1))	--	--	
Other items (net)				) 3.5	) -0.5		
(increase-)	-4.5	-6.5	2.0	)	)	-2.5	-2.5
(Changes in percent)								
Money and quasi-money	25.3	11.8	11.8	7.4	9.0	10.2	13.4	
Money	19.3	7.2	14.3	...	...	...	...
Quasi-money	39.1	20.9	7.5	...	...	...	...
Domestic assets (net)	16.3	14.4	23.9	15.7	8.4	7.1	10.7	
Claims on Government (net) ^{2/}	14.8	10.5	23.3	12.4	-9.6	(1.7)	-11.4 (0.1)	-4.0 (7.3)
Claims on nongovernment								
sectors ^{2/}	20.7	21.7	16.8	11.2	21.5	(12.6)	20.4 (11.4)	20.4 (11.4)
Claims on private sector ^{2/}	21.1	24.8	17.8	13.5	28.2	(16.3)	27.2 (15.3)	27.2 (15.3)
Scheduled banks ^{2/}	22.2	25.1	16.7	13.8	30.9	(17.2)	27.4 (13.7)	27.4 (13.7)
SBP credit to NBFI	14.3	22.3	21.3	11.3	10.1		26.4	26.4
Claims on public sector								
enterprises	19.7	13.6	14.1	4.5	1.7		8.0	8.0
Memorandum items:								
GDP (at current market								
prices)	13.3	14.5	14.2		13.6	13.6
Velocity	-9.6	2.4	2.1		3.3	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 1985-February 1986 and for the 1985/86 forecasts exclude the effect of the PRs 11 billion of bank financing of Special National Fund Bonds.

Table 3. Pakistan: Balance of Payments, 1981/82-1985/86

(In millions of U.S. dollars)

	1981/82	1982/83	1983/84	Official Projections		Prov. Actual 1984/85	Official Proj. March 1986 1985/86
				Original 1984/85	Revised		
Trade balance	-3,450	-2,989	-3,324	-3,564	-3,601	-3,587	-2,948
Exports, f.o.b.	2,319	2,627	2,669	2,953	2,662	2,350 ^{1/}	2,945
Cotton lint ^{2/}	(264)	(303)	(132)	(229)	(...)	(279)	(472)
Rice ^{2/}	(391)	(287)	(422)	(380)	(...)	(222)	(355)
Other ^{2/}	(1,810)	(2,105)	(2,214)	(2,439)	(...)	(1,987)	(2,192)
Imports, f.o.b.	-5,769	-5,616	-5,993	-6,517	-6,263	-5,937	-5,893
Services (net)	-546	-607	-714	-710	-815	-820	-831
Receipts	935	979	1,064	1,176	1,076	1,003	1,045
Payments	-1,481	-1,586	-1,778	-1,886	-1,896	-1,823	-1,876
Of which: Interest ^{3/}	(-416)	(-425)	(-471)	(-447)	(-457)	(-462)	(-429)
Private transfers (net)	2,387	3,039	3,007	3,092	2,785	2,632	2,743
Of which: workers' remittances	(2,224)	(2,886)	(2,737)	(2,805)	(2,450)	(2,446)	(2,520)
Current account balance	-1,609	-557	-1,031	-1,182	-1,631	-1,775	-1,036
Official transfers (net)	421	327	296	330	330	360	537
Of which: refugee assistance	(293)	(178)	(155)	(200)	(200)	(150)	(200)
Long-term capital (net)	287	836	595	659	618	500	500
Project, food, and other commodity loans (net)	179	554	360	550	501	332	436
Disbursements	(671)	(974)	(880)	(1,088)	(1,039)	(869)	(1,018)
Amortization	(-492)	(-420)	(-520)	(-538)	(-538)	(-537)	(-582)
Other official (net) ^{4/}	25	194	170	8 ^{5/}	16 ^{5/}	79	-14
Disbursements	(25)	(194)	(234)	(...)	(...)	(200)	(170)
Amortization	(--)	(--)	(-64)	(...)	(...)	(-121)	(-184)
Private, net	83	88	65	101	101	89	78
Short-term capital (net)	54	40	-7	---	---	-77	175
Official (net) ^{6/}	-9	-233	-109	---	---	-31	175
Foreign currency deposits ^{7/}	63	273	102	--	--	-46	--
Debt relief ^{8/}	258	35	28	25	25	25	25
Principal	204	31	27	24	24	24	24
Interest	54	4	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	201
Net foreign assets							
(Increase-)	580	-699	86	168	658	1,001	-201
Net use of Fund credit	374	426	-15	-90	-84	-84	-225
Purchases	(505)	(507)	(--)	(--)	(--)	(--)	(--)
Repurchases	(-131)	(-81)	(-15)	(-90)	(-84)	(-84)	(-225)
Other central and commercial banks (net)	206	-1,125	101	258	742	1,085	24
Memorandum items:							
Gross official reserves ^{9/} (in weeks of following year's imports, c.i.f.)	809	1,910	1,732	1,006	957	672	1,038 ^{10/}
Current account deficit (as percent of GNP)	4.9	1.8	3.1	3.2	4.4	5.2	2.9
Growth rates:							
Exports f.o.b.	-17.1	13.3	1.6	10.7	-0.2	-12.0	25.3
Imports f.o.b.	3.7	-2.7	6.7	8.6	4.3	-0.9	-0.7
Workers' remittances	6.1	29.8	-5.2	2.5	-10.5	-10.6	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 March forecast).^{7/} Nonbank foreign currency deposits.^{8/} Debt rescheduled in 1981.^{9/} Excludes gold.^{10/} Includes US\$390 million of foreign currency deposits by nonresident commercial banks.