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Minutes of Executive Board Meeting 86/59

10:00 a.m., March 31, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
	M. K. Bush
	G. Ercel, Temporary
M. Finaish	T. Alhaimus
H. Fujino	
G. Grosche	
Huang F.	
J. E. Ismael	
	J. R. N. Almeida, Temporary
T. P. Lankester	
	I. Puro, Temporary
	L. Leonard
	J. A. K. Munthali, Temporary
	J. Abramovich
	J. E. Suraisry
	J. de la Herrán, Temporary
	G. Nguyen, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
	L. Tornetta, Temporary

J. W. Lang, Jr., Acting Secretary
L. Collier, Assistant

Also Present

IBRD: W. A. McCleary, South Asia Regional Office. Administration Department: R. H. Floyd. Exchange and Trade Relations Department: J. T. Boorman, E. J. Zervoudakis. Legal Department: J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; S. H. Hitti, H. E. Jakubiak, E. B. Maciejewski, M. Yaqub. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Ouanes, M. Z. M. Qureshi. Assistants to Executive Directors: M. Arif, A. Bertuch-Samuels, V. Govindarajan, S. King, B. Tamami, H. van der Burg.

1. PAKISTAN - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Pakistan together with a proposed decision concluding the 1985 Article XIV consultation (SM/86/51, 2/28/86; and Sup. 1, 3/28/86). They also had before them a report on recent economic developments in Pakistan (SM/86/58, 3/13/86).

Mr. Finaish made the following statement:

During the period under review, economic policies in Pakistan have continued to be formulated within the broad framework of a strategy of adjustment with growth that was initiated around the beginning of this decade. The strategy aimed at combining improved demand management with growth-oriented structural reform. The record of the economy's performance since 1980 shows that, overall, notable success has been achieved in the implementation of this strategy. A wide range of financial and structural adjustments have been made, while growth has been maintained at an impressive average rate of over 6 percent. Given the vulnerability of domestic agriculture to the vicissitudes of weather and of the economy at large to external developments, such as fluctuations in the demand for the country's exports and their prices and in workers' remittances, it was inevitable that economic and financial performance would vary over short periods. These variations in performance--and the weakening of the external position during the past two years is a case in point--do not imply that the authorities' resolve to persevere with needed adjustments has wavered. On the contrary, they have further strengthened the authorities' commitment to implement adjustments that remain to be made, so as to build up the economy's resilience to exogenous shocks and thereby make possible more stable economic performance in the future.

The performance of the economy was particularly favorable during 1980-83. Improved demand management policies helped reduce domestic and external financial imbalances. Inflation was substantially contained. Favorable weather conditions, aided by supportive policy measures, permitted vigorous agricultural growth, leading to the attainment of self-sufficiency in major foodgrains. Manufacturing output also rose at a brisk rate. These developments were underpinned by important structural adjustments in several areas of the economy: these included cost-price rationalization, especially in the agricultural and energy sectors; introduction of a flexible exchange rate system; import liberalization actions; a relaxation of controls on private investment; reform measures relating to public enterprises; and a reorientation of public investment strategy. Most of these adjustments formed part of programs supported by an extended arrangement with the Fund and a structural adjustment loan from the World Bank. The record of implementation under these arrangements was good.

Beginning in 1983/84, this generally favorable trend in economic performance was interrupted. Two factors played an important role in this development. First, adverse weather conditions in 1983/84 caused the output of most major crops to fall substantially. The drop in output was particularly large in the case of cotton, a major export item. Second, workers' remittances, a key source of foreign exchange earnings, which had increased buoyantly in preceding years, recorded a significant decline. Both these factors worked to weaken appreciably the economy's growth and external sector performance in that year. Notwithstanding these unfavorable developments, the authorities were able to reduce the overall fiscal deficit relative to GDP by 1 percent by a combination of domestic revenue mobilization and expenditure restraint.

With an improvement in weather conditions in 1984/85, agricultural output rebounded strongly, lifting the overall growth rate to nearly 8.5 percent. For 1985/86, GDP growth is projected to remain high at about 7 percent. While growth thus recovered strongly in 1984/85, the external position weakened further. Among the factors contributing to this outcome were another significant decline in workers' remittances; lower prices for commodity exports; weaker demand in some oil exporting countries in the region, which constitute an important export market; and the effect of quantitative restrictions in some industrial countries on textile exports, a major item among the country's manufactured exports. The stance of domestic financial policies also weakened during the year. As a result of both shortfalls in revenue and overage in expenditures, the overall fiscal deficit as a proportion of GDP rose significantly, whereas a reduction had been envisaged in the budget. Among other factors, the depreciation of the Pakistan rupee during the year contributed to the excess in expenditures by causing expenditures on imports and debt servicing to exceed budgeted levels. The increase in bank financing necessitated by the rise in the fiscal deficit caused domestic credit expansion to exceed substantially the target for the year. However, because of the much greater than projected contractionary effect of the balance of payments outcome, total domestic liquidity growth was about the same as targeted, at a level below the growth in nominal GDP. Inflation during the year fell back to about 6 percent, having risen moderately in the preceding year.

The authorities are aware of the aforementioned weakening of the fiscal and external positions. While some special factors have played a role, they recognize that some structural weaknesses also existed in public finances and the external accounts. With respect to public finances, a combination of measures to raise revenues and contain expenditures is expected to reduce the overall deficit by about 1 percentage point relative to GDP in 1985/86. This expectation is supported by the latest estimates available for the year. For the future, the authorities are planning more fundamental structural measures so as to bring about a durable improvement in public finances. Currently, a National Taxation Reforms Commission is engaged in preparing substantive recommendations for broadening the base of the tax system and improving its elasticity, some of which could be implemented in the next fiscal year. The tax reform is expected to include a more broadly based sales tax. At the same time, a National Deregulation Commission has been engaged in drawing up comprehensive proposals for deregulatory measures aimed at reducing and eliminating subsidies. The Commission has already submitted its recommendations regarding the deregulation of trade in wheat and edible oils, both major subsidy items, and a decision on these recommendations is expected soon. The marketing and pricing of sugar and cement have already been deregulated.

With respect to the financing of the budget deficit, domestic bank borrowing was to be completely avoided under the original budget for 1985/86. Shortfalls in external financing, however, have necessitated some use of bank financing. The amount of such financing projected for the year is still less than one third of the level of last year. This is expected to contribute to a substantial reduction in domestic credit growth during the year. The authorities would also seek to reduce the budget's dependence on domestic nonbank borrowing as the contemplated tax reform permits more revenue to be raised in the future through taxes. In the interim, however, domestic nonbank borrowing provides a preferable alternative to bank borrowing for raising needed financing for public expenditures. The authorities are aware of the debt service implications of financing the budget through borrowing, but they do not think that the Government's tapping of private savings could be claimed to be depressing private investment by siphoning funds, as adequate funds have been available to the private sector. Indeed, certain government small savings schemes could be said to have helped in mobilizing additional savings and directing them toward productive public investments.

The authorities recognize that the cessation of the previously rapid growth in workers' remittances, due to the diminished employment opportunities for expatriate workers in the oil exporting countries in the region, marks the beginning of a significant structural change in the country's balance of payments. Realizing that a greater proportion of foreign exchange earnings in the future would need to be generated from merchandise exports, they have been taking measures aimed at a vigorous promotion of such exports. A revival of the previously healthy growth trend in manufactured exports would be of particular importance in this regard, a task that would be facilitated if restrictions in industrial countries on some exports of key interest to the country, such as cotton products, were eased. In order to maintain export competitiveness, the authorities intend to continue to employ a flexible exchange rate policy. Since February 1985, the rupee has been allowed to depreciate in real effective terms by about 20 percent, which has more than eliminated the appreciation that took place in some months of 1983/84 when the U.S. dollar was rising strongly against other major currencies. Since the adoption of a managed float in 1982, cumulative real effective depreciation of the rupee now amounts to close to 30 percent. The authorities have also improved, in line with staff recommendations, the method used for estimating changes in competitiveness as a guide to exchange rate policy. Moreover, export action groups have been established for promoting specific exports by reducing regulatory constraints and developing new markets. Export subsidies were expanded in 1985 in view of the continuing weakness in exports. With the substantial real depreciation of the rupee subsequently, the removal of these subsidies is being considered.

It is encouraging to note that exports are rebounding strongly in 1985/86. Thanks mainly to a projected 25 percent surge in exports, which includes a recovery in manufactured exports, the current account deficit is to be substantially reduced, and the overall balance is to show a surplus compared with a large deficit last year. Contrary to the apprehensions expressed in the staff report about the attainability of the authorities' projections for the current year, estimates for the first eight months of the year show that the current account deficit is likely to turn out to be even lower than previously projected by the authorities.

The authorities have the firm intention of continuing their traditionally cautious external borrowing policy. External public debt consists predominantly of medium-term and long-term public debt contracted at concessional rates, with short-term debt and debt on commercial terms forming a small part. The increase in short-term commercial borrowing in the current year is being used to build up reserves rather than finance imports. This borrowing was undertaken as a temporary measure pending the implementation of appropriate corrective policies to strengthen the balance of payments and the reserve position. The authorities intend to continue to limit the incurrence of such debt and to contain the burden of debt service within manageable proportions.

The policy of introducing needed structural reforms in various sectors of the economy initiated in the earlier part of the decade has been carried forward during the period under review. Appropriate adjustments in pricing policies in the agricultural and energy sectors have continued to be made. Increased producer incentives in the energy sector have contributed to the more than tripling of petroleum production since 1982/83 to the equivalent of about one third of domestic consumption. Regulations and procedures pertaining to private investment have continued to be eased, a process that is to be given fresh impetus by proposals being drawn up by the National Deregulation Commission. Private sector investment has been encouraged in industries previously set aside for the public sector, while public investment has been increasingly oriented toward the priority sectors of agriculture, energy, and social services. A major initiative has been taken in the current year involving divestiture of public enterprises to the private sector. A performance evaluation and incentive system for public enterprises established recently in collaboration with the World Bank has become fully operational. In the financial sector, the conversion to Islamic banking has introduced much greater flexibility in banks' rates of deposit and return which should serve to improve credit allocation and stimulate savings. Some of the tax measures announced in the 1985/86 budget also aim at strengthening incentives for private savings and investment. Raising domestic savings and investment levels is a major objective of the Sixth Plan (1983/84-1987/88). In the external sector, the ongoing work of the National Taxation Reforms Commission includes the formulation of recommendations for a comprehensive tariff reform aimed at rationalizing effective protection and increasing the exposure of domestic industries to foreign competition. As part of the extended arrangement with the Fund, and during a period when protectionism elsewhere was on the increase, Pakistan implemented a major import liberalization program. Since then, additional liberalization and simplification measures have been taken. Significant further moves toward the liberalization of the import system would depend importantly on the strength of the external position.

In summary, adjustment policies continue to be pursued in Pakistan hand in hand with the maintenance of strong growth. The authorities' generally satisfactory record in the implementation of this strategy, however, is not making them overlook the problems that remain, especially the structural weaknesses in public finances and the balance of payments. In the period ahead, adjustment efforts are to be focused in particular on addressing these problems more effectively.

Extending his remarks, Mr. Finaish reported that the authorities' latest estimates for the first eight months of 1985/86 indicated that economic and financial developments during the year had been favorable. The forecast for real GDP growth for the year had been raised from 6.5 percent to 7 percent. The overall fiscal deficit relative to GDP was expected to decline to a level close to the authorities' revised projections. The outcome for the current account of the balance of payments was in fact more favorable than the authorities' previous projections reported by the staff.

Mr. Suraisry said that he was in broad agreement with the staff analysis and conclusions and endorsed the proposed decision. Supported by a Fund extended arrangement and a World Bank structural adjustment loan, Pakistan had made commendable progress in the early 1980s. The adjustment approach followed by the authorities had been growth oriented and had met with noticeable success. Internal and external imbalances had been redressed, and the economy had been restructured in the right direction. Inflation had been brought under control, higher rates of economic growth had been achieved, and Pakistan had become self-sufficient in major foodgrains.

More recently, however, it had become apparent that high rates of growth could only be achieved at the cost of high external deficits, Mr. Suraisry continued. In 1984/85, the overall growth rate of 8.5 percent had been accompanied by a sharp deterioration in the balance of payments position, with the current account deficit reaching about 5 percent of GNP. That position was clearly not sustainable in the long run, particularly as it did not lead to increased productive capacity to meet the already large debt-servicing burden. While some special factors had played a role in weakening the Pakistani economy, structural problems, in particular the low levels of investment and savings, the high and increasing fiscal deficit, and the vulnerability of foreign exchange earnings, had also been important.

While high rates of growth had been possible in the past despite a low investment ratio, clearly that was not sustainable in the long run, Mr. Suraisry observed, and the authorities had been cognizant of the need to increase investment. In that respect, a number of measures had been taken to increase private sector investment, including the streamlining of government investment approval procedures, the substantial increase in ceilings related to imports of capital goods, the issuance of the Industrial Policy Statement for the Sixth Five-Year Plan, and the proposed introduction within the 1985/86 budget of tax incentives benefiting some private sector investors. In addition, central bank foreign exchange equivalent to $200 million had been made available for purchase by the private sector to facilitate capital goods imports. Only about 20 percent of that amount had been purchased in 1983/84, and no purchase had been made from that facility in 1984/85. He asked the staff to comment.

Those measures had undoubtedly moved private sector investment in the right direction, but the level remained low, and further measures were needed, Mr. Suraisry added. For example, the authorities should increase the pace of deregulation and forge ahead with the proposed divestiture of some public enterprises. Equally important was the need to ensure that in the conduct of fiscal and monetary policies, private sector investment was not crowded out.

An important factor in increasing private sector investment was enhanced private savings, Mr. Suraisry commented. Table 2 in Appendix III (SM/86/51) indicated that gross domestic savings ratios, which had already been relatively low, had declined markedly to 5.1 percent in 1983/84 and even further to 4.7 percent in 1984/85. That declining trend was a cause for concern, particularly because it was not expected to be supplemented, as in the past, by increases in workers' remittances, which were expected to decline over the medium term. Unless reversed, that unfavorable trend was likely to compromise the authorities' cautious debt management strategy and the long-term growth prospects of the Pakistani economy. Enhancing the private sector's savings ratio would require the strengthening of public finances and the maintenance of low inflation.

The low investment and savings levels observed in recent years had reflected, in large part, structural weaknesses in the public sector, Mr. Suraisry remarked. High and rising fiscal deficits had increasingly absorbed resources. That course was worrying, since it tended to crowd out private sector investment; furthermore, it reduced fiscal flexibility, as increased debt payments would limit the scope for future fiscal retrenchment. He therefore welcomed the authorities' recognition of the need to reduce the fiscal deficit and to increase public savings, thereby enhancing public investment. However, in addition to more realistic pricing policies and expenditure control measures, there was a need to implement tax reforms aimed at broadening the tax base, with a view to encouraging private sector participation in economic activity. To do so would be consistent with the Government's strategy of strengthening the private sector.

Consolidation of the fiscal position would facilitate the process toward tightening monetary policy, which was consistent with the authorities' aim of controlling inflation, Mr. Suraisry noted. The authorities' commendable efforts to proceed cautiously and gradually with the Islamization of the banking system were noteworthy. Such a change had effectively resulted in a financial deregulation and in the introduction of greater flexibility in the rates of return on deposits. That development was welcome, as it would not only improve the efficiency of the banking system but would also enhance private sector financial savings. The task of demand management in the period ahead would be facilitated by the substantial flexibility of the rates of return on deposits inherent in the Islamic financial system. The experience of Pakistan with that system would also prove valuable to other member countries.

An important factor in the structural weakness of the balance of payments had been the lack of export diversification and the heavy reliance on earnings from the export of two primary commodities--cotton and rice--Mr. Suraisry stated. While there had been some progress toward export diversification, manufactured exports had not contributed sufficiently to the widening of the export base, suggesting the need for wage and pricing policies, including exchange rate policy, aimed at enhancing the competitiveness of manufactured exports. Higher export earnings in Pakistan would not only improve its capacity to import and, therefore, to sustain a higher level of growth, but would also ease the burden of servicing its external debt. However, the country's efforts should be supported by its trading partners by opening their markets to Pakistan's exports.

He was concerned about the recent introduction of foreign exchange bearer certificates, Mr. Suraisry said; while they had resulted in an effective easing of exchange controls, they had also introduced more uncertainties. In particular, because the certificates were responsive to exchange rate and balance of payments developments, they might be destabilizing, especially if their size was large in relation to gross foreign assets. He asked the staff to comment on the potential problems associated with those certificates.

He commended the Pakistani authorities for their growth-oriented adjustment policy and their commitment to address the remaining structural weaknesses, Mr. Suraisry concluded.

Mr. Wijnholds observed that Pakistan's economic performance remained impressive in many ways. Its growth rate of real GNP over the past five years had only once dipped below 6 percent; in 1984/85 it had reached 8.5 percent, and the revised projection was for a rate of 7 percent for 1985/86--a satisfactory achievement by any standard. Its inflation performance, with single-digit rates, was favorable. On the external side, the current account, after a disappointing performance in 1984/85, was expected to show a considerable improvement in 1985/86, with the deficit projected at less than 3 percent of GNP. Moreover, Pakistan seemed to have embarked upon a course of continuing structural reforms, although progress had been uneven both over time and across sectors.

Those positive developments were welcome, Mr. Wijnholds continued, but less satisfactory developments had occurred in three areas of Pakistan's economy. First, the government budget deficit had increased over the past year and at present was clearly too high. Second, exchange rate policy might be insufficiently flexible as the rate of the rupee against the dollar--the currency in which most export crops were fixed--had remained fairly stable over the past year and had thus given rise to a number of problems. Third, the debt service ratio had risen considerably over the past years, due, inter alia, to repayments to the Fund, and at present amounted to some 20 percent of exports of goods and services--the maximum the country could prudently bear.

For those reasons, he shared the Government's objective of limiting the current account deficit to 2 percent of GNP, Mr. Wijnholds said. To do so would require a considerable strengthening of demand management policies, primarily in the sphere of fiscal and exchange rate policies. During 1985 the rupee had fallen considerably in real effective terms--by almost 20 percent. That development was welcome and had helped to strengthen Pakistan's overall competitiveness. However, the rupee had stayed stable against the dollar, the currency in which Pakistan's major export crops were priced. In terms of the dollar, the rupee might well remain overvalued, which meant that on the one hand those crops could not be exported except with the aid of government subsidies, and on the other hand that producer prices could not be raised, thus giving rise to subsidized agricultural inputs. For those reasons, and because of the authorities' desire to pursue an export-led growth strategy and the need to eliminate costly export subsidies, the authorities should consider a further adjustment of the rupee. It was encouraging to learn that the authorities were considering the removal of those subsidies.

There was a clear need to decrease the government budget deficit and to strengthen government finances, Mr. Wijnholds commented. The measures implemented over the past year seemed to indicate that a considerable weakening of goverment finances had occurred. The reliance on import taxes had increased, and the decrease in subsidies of edible oils had been used to increase transfers. He therefore hoped that the tax reform, which should aim at mobilizing domestic resources and lessening the dependence on taxing foreign trade, could be implemented soon.

The decision to avoid bank financing for the budget had been desirable, as such financing would either increase inflationary pressures or, if lending ceilings were imposed, imply a crowding out of the private sector, Mr. Wijnholds remarked. It was regrettable therefore that the authorities--first, indirectly through bank financing of the SNF bonds and, more recently, directly--had had recourse to bank financing on a considerable scale. He doubted whether the sale of foreign exchange bearer certificates was a good way to finance a budget deficit; the certificates could be encashed at any time, which meant that the Government's debt service contained a highly volatile element.

Another area of concern was the behavior of the gross domestic savings rate, which, on the whole, had been on a decreasing trend over the past five years, Mr. Wijnholds noted. With gross investment as a percentage of GNP on a slightly rising trend, the implication was that the domestic savings/investment ratio had deteriorated considerably over the past few years. No doubt the increasing government budget deficit had contributed, although the peak in the savings rate in 1982/83 had been accompanied by a peak in the budget deficit. Nevertheless, he wondered whether there were more structural causes of the deterioration in the propensity to save. He also wondered on what grounds the authorities had projected a rise of 2 percentage points in the savings rate in 1985/86. He would welcome any comments by the staff.

Although the Pakistani economy was relatively closed, with exports and imports constituting only a modest percentage of GNP, the country's external position had proved to be vulnerable in the past, Mr. Wijnholds said. While the weakening trend in remittances was contributing to that vulnerability, the increased domestic production of oil and the decline in the price of oil were clearly reducing it. For 1985/86 the overall external position might well be in balance after an initial projection by the staff in December 1985 of a deficit of $200-250 million. However, care should be taken that the decreased pressure on the external position did not lead to complacency. Pakistan's reserves, although rising again, were still modest at about seven weeks of imports, and some further strengthening would be desirable.

The authorities' policy of limited borrowing, especially on commercial terms, had been wise, Mr. Wijnholds commented, and that kept the debt service ratio within a manageable range. Nonetheless, it should not be overlooked that Pakistan's external debt was high as a percentage of current account receipts--over 200 percent; that indicator was perhaps of as much relevance as the ratio of external debt to GNP--which was not particularly high-pointing again to the desirability of a better export performance. The staff had observed that data on military debt and non-guaranteed private debt were not available and that the latter was believed to be small; he then wondered whether the former might be sizable. If so, the overall external debt position would be of more concern than seemed to be the case on the basis of published figures.

There was also a need for caution with respect to short-term borrowing abroad, Mr. Wijnholds remarked. Although short-term deposits from nonresident banks were not considered part of the external debt, they were not really different from taking up foreign loans, Mr. Wijnholds remarked. In addition, they were not a stable form of financing and were subject to withdrawal, although it was useful that their maturity was a minimum of one year. The authorities had stated that short-term external financing was a transitory measure until more fundamental corrective action could be taken. He welcomed that stance and hoped that the authorities would implement all the policies required to ensure medium-term viability of the balance of payments.

Pakistan's economic performance continued to be good in many respects, but weaknesses remained, particularly with regard to fiscal policy, Mr. Wijnholds stated. Further adjustment, including that of a structural nature, appeared desirable to ensure a stronger export base. The authorities deserved continued support from the international community for their efforts.

Mr. Grosche commented that Pakistan's economic performance had been mixed in 1984/85. On the one hand, the economy had witnessed vigorous overall growth and low inflation; but on the other, the strong recovery of output had not been used to make further progress in addressing major weaknesses. The worsening budget deficit, mounting balance of payments pressures, and persistent structural problems had already been the focus of the Board discussion one year previously. Since then, the causes for concern had become even greater. Although part of the slower than expected progress had been due to unfavorable external circumstances, there had also been a weakening of domestic policies.

With respect to fiscal policy, the staff had appropriately focused on the imbalances in the public finances, Mr. Grosche noted. The actual outturn for the overall deficit in 1984/85 was expected to exceed the original target by a sizable margin. Official estimates for 1985/86 projected a small reduction in the actual volume of the deficit, which, he agreed with the staff, could only be achieved given a number of optimistic assumptions regarding revenue and expenditure developments. The expected substantial increase in tax revenues was unlikely to materialize, given the high share of import duties in overall tax revenue--30 percent--and the weakness in the external accounts. Moreover, with the apparent lack of concrete measures on the expenditure side and the past experiences of substantial current expenditure overruns, it was doubtful whether even the revised deficit targets could be achieved.

It was necessary to broaden the tax base, Mr. Grosche continued. The Board had expressed its concern about the insufficient elasticity of the tax system on several occasions, and it was regrettable that reforms in that area had again been delayed. He was also concerned about the rising share of subsidies in total expenditure. Not only did they constitute a growing burden on the budget, they also hampered rationalization and adjustment in the productive sector. The authorities had begun to review the system of subsidies, and he encouraged them to seek speedy progress in that area.

He shared the staff's concerns about the rapid growth of credit, Mr. Grosche said. Excessive credit growth in 1984/85 had not resulted in an acceleration of monetary growth and in inflationary pressures, but only at the cost of a deterioration in the external accounts. The authorities could not expect to rely on that mechanism again in 1985/86, given the low level of international reserves. There was a clear need for further progress in curbing public deficits and in limiting the Government's borrowing requirement. Without determined action, the rate of inflation would rise and pressures on the balance of payments would increase further.

He also shared the staff's reservations regarding the authorities' optimistic medium-term projections for the balance of payments, Mr. Grosche continued. Pakistan's external financing requirement could be substantial, even under the assumption of more favorable external developments. The Pakistani authorities' cautious approach to external borrowing taken thus far was commendable. However, to maintain such a prudent stance, demand management policies must be strengthened, and measures aimed at enhancing export competitiveness must be implemented without delay. A realistic exchange rate level for the rupee, providing an adequate link between domestic and international prices, would play an essential role in that effort. The depreciation of the rupee in 1985 had been helpful, and he welcomed Mr. Finaish's statement that the authorities intended to continue to employ a flexible exchange rate policy. Of course, such a flexible policy would have to be supplemented by structural reforms and adjustments in domestic pricing policies.

In the energy sector, where substantial progress in adjusting prices had been made, the positive effects had already become noticeable, Mr. Grosche remarked. He therefore encouraged the authorities to step up their efforts in those sectors where progress in rationalizing prices had been slow.

His authorities found it disconcerting that for several years the Pakistani authorities had announced the imminent termination of the bilateral payments agreements, yet they still continued to be in operation, Mr. Grosche commented. In one case, a bilateral payments agreement had been renewed. He therefore supported the proposed decision urging the authorities to remove those arrangements as soon as possible.

Mr. Lankester said that by the standards of many other countries, Pakistan's economic performance in recent years had been enviable. The outturn for 1985/86 on a range of measures was likely to be better than estimates in the staff appraisal, which had been based on consultations that had taken place toward the end of 1985. The current account deficit--because of growing exports, improved remittances, and compressed imports--had been substantially reduced. The fiscal deficit seemed likely to reach the authorities' original projections; economic growth mainly owing to the probable excellent cotton and wheat crops, had been revised upward to an enviable 7 percent; and inflation seemed to have moderated.

However, Mr. Lankester continued, underlying that improved overall picture for 1985/86 were some less promising features. Lower receipts of some important federal taxes had been offset by the surcharge on petroleum; current expenditures were higher than originally projected; development spending seemed to have been lower than originally planned; and there had been some significant bank financing of the government deficit that had not been planned in the original budget. Nontraditional exports had performed disappointingly, and the balance of payments would likely be in overall balance compared with the surplus originally projected.

The strong growth of recent years had been, to a significant extent, the product of successful policies in the 1960s and 1970s, including a high and productive level of investment in that period, Mr. Lankester observed. In spite of the latest developments, which were better than the staff's assessment at the time of its visit, he shared the staff's concern regarding Pakistan's medium-term outlook. Apparently the balance of payments would remain under considerable strain over the next few years, as underlined by the staff's medium-term scenarios showing the existence of significant financing gaps over the coming few years on the basis of a range of plausible assumptions. Those scenarios suggested the need for a significant and perhaps unsustainable increase in external borrowing, although in recent years the authorities' cautious approach to borrowing had been commendable and had placed Pakistan in an advantageous position.

In addition to the pressures on the balance of payments, the external position appeared to be more vulnerable as a result of the foreign exchange bearer certificates scheme, which in essence created a liquid claim on reserves that could be made at any time, Mr. Lankester noted. Should participants in the scheme come to regard a given level of the exchange rate as unsustainable, they might seek to withdraw their funds, thus potentially magnifying any difficulties facing the authorities. That risk emphasized the need to maintain a realistic level for the exchange rate, and he endorsed the staff's suggestions in that area and welcomed the flexible management of the exchange rate in recent months as announced by Mr. Finaish.

The external difficulties he had described were partly a reflection of the underlying domestic imbalances stemming mainly from the public deficit, Mr. Lankester commented. As the authorities recognized, the fiscal position remained tight, and current borrowing levels were not sustainable. In that light, the reduction in borrowing envisaged in the current year's budget was at least a step in the right direction, but there were some doubts about the full achievement of those objectives, although the decline in oil prices would be helpful. He wondered whether the current oil price was likely to reduce significantly the expansion of Pakistan's oil production. Even if the budget estimates were fully achieved, as appeared likely from supplement 1 to SM/86/51, further reductions in the public deficit would be required if the public sector's excessive reliance upon private sector savings was to be reduced. In seeking to achieve that reduction, there appeared to be significant scope for broadening the revenue base and improving the elasticity of the revenue system. He endorsed the staff's suggestion for broadening the the sales tax base and eliminating many of the current exemptions. Those measures to improve revenue performance would also need to be supported by stricter expenditure controls; for example, the rising expenditure on subsidies, partly reflecting delays in increasing prices, appeared an obvious area for potential economies. The authorities were aware that action was necessary, and he hoped that they would be able to implement the proposals of the National Taxation Reforms Commission in full.

The need to finance the large fiscal deficit in a noninflationary manner had increased the pressures on monetary policy, Mr. Lankester continued. In response to those difficulties, the authorities had introduced various financing instruments, including the foreign exchange bearer certificates and the Special National Fund (SNF) bonds. While those devices had increased the range of savings accessible to the authorities, they also involved some risks. In addition to the potential for speculative shifts inherent in the foreign exchange bearer certificates scheme, there was also some risk that the greater bank lending associated with the sales of the SNF bonds might pass through into faster credit growth unless fully offset by the authorities through lower government credit for commodity operations. The authorities had explained the need to allow the banks to lend outside their credit ceilings to finance SNF bond purchases because of the illiquid nature of many of the untaxed assets toward which the scheme was directed. That lending would thus presumably be repaid in due course as the relevant assets were liquidated. He asked Mr. Finaish or the staff whether that had already begun to happen and how quickly that unwinding was likely to occur. Under that sort of scheme there appeared to be a danger that tax avoidance would increase as funds from the taxed as well as the untaxed sectors of the economy were attracted into the SNF bonds.

Although there had been some price reforms recently, many key prices remained distorted, Mr. Lankester noted. For example, the prices of cotton, rice, and steel remained subsidized. It was also disappointing that further progress had not been made in liberalizing the relatively complex and restrictive import system; he hoped that the authorities would be able to do so in the context of more appropriate external policies.

The rate of population growth in Pakistan remained extremely high, Mr. Lankester commented. Unless progress were made in reducing the population growth rate, the prospects for decreases in per capita consumption would be inhibited.

He recognized the substantial progress that the Pakistani economy had made in recent years, Mr. Lankester concluded, and the authorities' determination to make changes in some of the areas indicated by the staff so as to move the economy back onto a path of continued rapid growth.

Mr. Huang remarked that in the past several years, Pakistan's economic performance had been impressive, with a growth rate of over 6 percent, an improved balance of payments position, and a declining rate of inflation, even though that favorable economic performance had been interrupted by adverse weather conditions in 1983/84. Meanwhile, a wide range of financial and structural adjustments had been carried out. Those achievements reflected the appropriateness of the economic policies pursued by the authorities. Although some problems and weaknesses beyond the authorities' control existed in the economy, that did not infer that the authorities had relaxed their adjustment and development efforts.

The fiscal deficit had amounted to 7.9 percent of GDP in 1984/85 and had fallen to 6.7 percent in 1985/86 only through great efforts of the authorities to reduce the deficit, Mr. Huang commented. However, a fiscal deficit of 6.7 percent of GDP was still high and could have an adverse impact on the national economy in the long run.

High real growth in recent years had been carried out in spite of relatively low investment and savings levels, Mr. Huang continued. However, it was evident that under the circumstances of low investment and savings and a high deficit, such a high rate of growth would not be sustainable in the long run. A key point was how to shift economic growth to a solid fiscal base. In response to that problem, the staff had stressed that "new policy measures should be implemented to generate incremental resources for the budget and to contain the growth of spending," and had called for quickly raising the tax/GDP ratio in addition to implementing pricing and expenditure controls. While a certain degree of increase in the tax/GDP ratio might be desirable, a rapid increase in that ratio might have an adverse effect on private investment and savings. He therefore would attach greater importance to a reduction in the public expenditure/GDP ratio rather than a quick increase in the tax/GDP ratio.

Pakistan's external position had deteriorated in 1984/85, largely because of the decline in exports and remittances, but had improved in 1985/86 at the expense of the rupee depreciation and export subsidies, Mr. Huang observed. The improvement in the external position could not rely on subsidies and a depreciation for a long time. Pakistan needed the international community's support in rolling back protectionism, which prevailed in some industrial countries, in addition to its own efforts in strengthening export competitiveness.

The combination of adjustment and growth policies pursued by Pakistan was impressive, Mr. Huang noted. The policy measures being undertaken by Pakistan reflected the authorities' determination to implement the structural adjustment program designed for Pakistan's future growth, and he was confident that an appropriate policy stance would succeed in the years ahead.

Mr. Fujino commented that after a temporary decline in the growth rate in 1983/84 to nearly one half the level of previous years--due primarily to the impact of adverse weather conditions on agriculture--real growth had picked up in 1984/85 to over 8 percent. That record of favorable growth combined with moderate inflation under the difficult external conditions of the 1980s demonstrated the effectiveness of the determined pursuit of appropriate macroeconomic policy and of important structural measures. The authorities were to be commended for those achievements.

The authorities' prudent approach to external borrowing and timely implementation of adjustment measures explained to a great extent the substantial progress of the economy, Mr. Fujino continued. Nevertheless, the case of Pakistan endorsed the validity of the debt initiatives under consideration. The appropriate policy framework of macroeconomic and structural measures, if pursued with determination and perseverance, would be conducive to a satisfactory rate of growth with low inflation.

As in many other Asian countries, Pakistan had become self-sufficient in major foodgrains, Mr. Fujino remarked. Given the high population growth, that was by no means a small achievement. Technological improvements and flexible pricing policies seemed to be the major factors behind that success. If the increase in agricultural production was considered to be leveling off, owing to the limitations of the water supply among other factors, further efforts would be required to realize adequate prices for important inputs such as fertilizer and irrigation. The authorities' shift of policy focus from industry to the priority sectors of agriculture and energy was a welcome trend, and the World Bank assistance given in those areas would help to streamline the efforts of the authorities.

The start of production at the Pakistan Steel Mill would help to strengthen the production base of the domestic producers who utilized steel products for their manufactures, Mr. Fujino commented. It was not clear how the actual costs of production compared with those in international markets. The estimated burden of subsidies of PRs 1.1 billion for 1985/86 was almost comparable to the subsidy for fertilizer. In view of the global trend to oversupply, it was important to make the operation very efficient in order to reduce costs and to cut budget subsidies. Further comments by the staff would be appreciated.

Against that bright side of the economy, there were some weaknesses that, if not addressed adequately, would create a problem for sustained and satisfactory future growth, Mr. Fujino noted. As his chair had pointed out during the previous Article IV consultation with Pakistan, one factor was the weak trend of the domestic savings performance; the savings rate had further deteriorated to 4.7 percent in 1984/85. The large inflow of workers' remittances was, to a considerable extent, offsetting the low domestic savings ratio, but it could be subject to fluctuations, depending on external conditions. Measures to strengthen domestic savings were called for to strengthen the structural base of the economy. More flexibility in the rate of return on deposits was a positive step. However, he was concerned that if greater uncertainty accompanied that flexibility with respect to the prospective trend of future returns, the measures could involve disincentives to save. He also wondered whether improvement was needed in the institutional setup of financial organizations, such as the distribution of branches and types of deposit. Comment by the staff would be appreciated.

Development expenditure as a percentage of the total budget was projected at about 28 percent for 1985/86--almost 9 percent lower than six years previously--while that of subsidies was increasing, Mr. Fujino observed. The overall budget deficit in 1984/85 had amounted to 7.9 percent of GDP--1.9 percent larger than the previous year. Especially disappointing was the slow growth of tax revenues, which had risen by only 4 percent. The increase of the fiscal deficit was entirely financed by domestic bank borrowing, which would affect the narrow savings base. He welcomed Mr. Finaish's statement that the authorities were fully aware of the problem and were planning fundamental structural measures to bring about a durable improvement in public finance. The envisaged tax reform was an encouraging step in that direction. The projected deficit for 1985/86, although smaller than that for 1984/85, was still 6.9 percent of GDP, and strong efforts would be needed to secure the necessary revenues and to contain expenditures.

The balance of payments performance, which had generally been favorable, had deteriorated sharply in 1984/85, reflecting a weakening performance in major items, a stagnation in exports, a surge in imports, and a decline in workers' remittances, Mr. Fujino remarked. The export performance might have been influenced considerably by the real appreciation of the rupee. The depreciation of the U.S. dollar since September 1985, which had brought about a depreciation in real effective terms of 20 percent, would work strongly to restore export competitiveness. Imports were expected to be low, and a considerable narrowing of the current account deficit from 5.2 percent of GNP in 1984/85 to 2.9 percent in

1985/86 was forecast, although there seemed to be a difference of opinion between the staff and the authorities on the degree of improvement in the external account and on the medium-term projections.

The prospect of a growing finance gap would not be consistent with the authorities' prudent external borrowing policy, Mr. Fujino said. He expected the authorities' continued efforts would contain the external balance along the indicated medium-term targets. Finally, he supported the proposed decision.

Mr. Salehkhou commended the Pakistani authorities for their efforts in having introduced Islamic laws to the banking operations since July 1985. Substitution of banking interest rate charges by a system of rates of profit, and steps taken toward a more flexible rate of return and deposit structure for the financial system, seemed to be operating satisfactorily. However, a comprehensive appraisal of that important issue by the staff was lacking, despite a Fund mission to Pakistan to study the changes.

In 1984/85, the overall performance of Pakistan's economy had been largely satisfactory, resulting in a considerable growth of 8.5 percent in real GDP, Mr. Salehkhou continued. Effective measures by the authorities to facilitate the availability of input in agriculture and price rationalization in the energy sector had mainly contributed to the doubling of cotton production and domestic oil output. While the authorities' policy objectives of giving priority to government investments in the fields of energy, agriculture, and rural development and of encouraging the private sector to invest in manufacturing were impressive, the weak performance of the government budget and developments in the balance of payments continued to remain areas of concern.

Investment expenditures in 1984/85 had been in line with the budget forecast, Mr. Salehkhou noted. The budget deficit had risen more than 50 percent above that of the previous year as a result of lower tax revenues and higher current expenditures. Domestic credit, therefore, had expanded considerably as the increase in the deficit had been financed almost entirely by domestic bank borrowing. Taking into account the adverse effect of excessive credit expansion on inflation and the balance of payments, the authorities' objective of avoiding further borrowing from the domestic banking system to finance the budget in the years ahead was a step in the right direction. Heavy reliance on external and nonbank financing, however, seemed unsustainable in the medium term. Therefore, implementation of more corrective measures to enhance domestic resource mobilization and the containment of current expenditure growth in order to reduce the projected fiscal deficit appeared to be a more feasible solution.

The excessive credit expansion in 1985 had been mainly reflected in the balance of payments, while the rate of inflation had abated to 7.5 percent, Mr. Salehkhou observed. Pakistan's balance of payments had been adversely affected by external factors. Despite the stagnation of imports, the overall balance of payments deficit had increased more than tenfold to $1 billion, and gross official reserves had fallen by 60 percent to the equivalent of only five weeks' imports. The major factors that had contributed to that outcome were a decline in world prices of cotton and rice, quantitative restrictions on textile imports by some developed countries, weaker demand in some oil exporting countries, and diminished employment opportunities for Pakistani workers. Despite the considerable efforts by the authorities to cope with those exogenous factors by enhancing export competitiveness through, inter alia, an increase in the rate of export subsidies, that sector had shown a weak performance in 1984/85. The balance of payments improvement achieved during July-October 1985 had clearly reflected the corrective measures taken so far by the authorities in that regard. However, he shared the staff view that the higher revised growth rate for exports and workers' remittances might be difficult to sustain in 1985/86, taking into account the sluggish growth in most of Pakistan's trading partners and increasing protectionist pressures abroad.

The share of long-term capital inflows on concessional terms in 1984/85 had decreased, Mr. Salehkhou remarked. The authorities' cautious approach to commercial borrowing clearly justified the use of foreign currency deposits and foreign exchange bearer certificates to meet the short-term financing needs. However, given the potential pressures of the certificates on reserves, the authorities should be fully prepared to cope with sudden changes in anticipation of exchange rate developments. The medium-term balance of payments scenarios calculated by the staff suggested substantial external financing requirements which, in the absence of new corrective measures, made it difficult for the authorities to continue their cautious approach to external borrowing. Therefore, the authorities' export-led growth strategy would help the country overcome its balance of payments problems. Adjustments in the exchange rate might enhance Pakistan's competitiveness and contain import demand.

He would be interested in the staff's assessment of the effects of price rationalization on the growth of Pakistan's domestic energy output, as well as the workers' remittances, in view of recent developments in the international oil market, Mr. Salehkhou concluded.

Mr. Sengupta said that the most striking aspect of Pakistan's performance in the 1980s was the impressive growth rate of over 6 percent it had maintained--despite several adverse external factors--accompanied by declining rates of inflation and an improving balance of payments situation. Very few countries had been able to achieve such success on all three fronts simultaneously in recent times. That success had been facilitated by the prudent internal and external policies adopted by Pakistan. During that period, substantial structural reforms had been undertaken, including those in the energy sector, which had resulted in increased efficiency and production. The efforts of the Pakistani authorities were commendable.

However, that favorable trend had been interrupted in 1983/84, mainly because of adverse weather conditions that had affected agricultural output substantially, and also because of a significant decline in workers' remittances, which had been a substantial source of foreign exchange earnings for Pakistan for over a decade, Mr. Sengupta continued. Although growth had recovered substantially in 1984/85 and was expected to continue in 1985/86, weaknesses had developed in the external sector. The factors that had contributed to that development, however, were largely beyond the authorities' control. They included, besides the decline in workers' remittances--mainly from the Middle East, reflecting the economic slack in that area--a fall in commodity prices, weak demand for exports to some oil exporting countries, and the impact of quantitative restrictions on textiles in some industrial countries.

The authorities would be able to take a number of steps to rectify that situation during the current year, Mr. Sengupta noted. Although the latest estimates contained in the supplementary staff paper indicated that the overall fiscal deficit would be about 6.9 percent of GDP--slightly more than expected in the budget estimates--the authorities had taken significant steps whose impact would be felt later during the current year or in the following year. The National Taxation Reforms Commission had been set up to broaden the tax base and improve its elasticity. The National Deregulation Commission, set up to submit proposals for deregulatory measures to reduce and eliminate subsidies, had presented its recommendations. Implementation of the recommendations of those two national bodies should help introduce needed structural changes in the fiscal area in the next two years and reduce fiscal deficits to a more sustainable level. To cover the deficit in the current year, the authorities were having recourse to modest bank financing with much of the deficit being covered by external sources and domestic nonbank sources. The authorities approach had been cautious, but they had had no alternative until their reforms bore fruit. The Government's tapping of private savings would not depress private investment; schemes such as those to attract small savings mobilized additional savings and directed them to productive public investment and could not be viewed as crowding out private investment. Frequently public infrastructure investment was essential to support growth of private investment.

The balance of payments outcome, according to the latest estimates of the authorities for 1985/86, appeared to be brighter than envisaged, as the result of a substantial increase in the exports of raw cotton, rice, and cotton-related manufactured exports, Mr. Sengupta observed. Workers' remittances had risen by about 7 percent, compared with a 2 percent decline projected in the staff report. That improvement was a result of sharply increased remittances from the United States and the United Kingdom, while remittances from the Middle East had stagnated. In addition, the proceeds from the sale of foreign exchange bearer certificates had also been higher than expected. The major result of those developments was that the current account deficit as a percentage of GNP would be less than 3 percent, or nearly 1 percent less than earlier estimates. However, the authorities' approach of looking at the longer-term prospects of balance of payments developments was prudent, and in that context Mr. Finaish's observation was appropriate that the cessation of the previously rapid growth in workers' remittances marked the beginning of a significant structural change in the country's balance of payments.

To undertake such a structural change, Pakistan must shift to a greater reliance on merchandise exports for its foreign exchange requirements and, for that purpose, a number of steps needed to be taken, Mr. Sengupta continued. While a realistic exchange rate policy could help in improving the competitiveness of Pakistan's exports, there were products--such as textiles--in which Pakistan, India, and other Asian countries had a comparative advantage, and such exports could not be promoted unless restrictions in industrial countries were removed. In addition, steps--beyond the management of the exchange rate--needed to be taken by Pakistan to improve the production and efficiency of nontraditional exports.

Pakistan had benefited in the current year from favorable factors, such as increased agricultural production--especially cotton and wheat--and a decline in the price of edible oils and crude oil, Mr. Sengupta noted. But in the medium term, some of those factors might not continue to be beneficial. The external debt service ratio of Pakistan was already over 20 percent, excluding interest payments on workers' remittances, and to ensure that the debt service was kept within manageable limits, Pakistan should continue its prudent borrowing policy. For that purpose it was necessary to improve its capacity, in the medium term, to earn non-debt-creating foreign exchange.

Mr. Leonard commented that the indications of slippage in the management of the Pakistani economy in 1983/84 had been apparent again in 1984/85. Chart 1 of the staff report strikingly illustrated the failure of public finances and money and credit to perform as envisaged by the authorities. On the public side, the overall budgetary deficit had risen instead of falling, nonbank domestic financing had fallen below expectations, while bank financing had increased sharply instead of falling. Domestic liquidity had also been easier than expected.

The effects of the slippages had been apparent primarily in the external account, where both the current and overall deficits had been wider than expected at the beginning of the year, Mr. Leonard continued. Other forces, of course, had also been at work, and in several respects economic performance had been positive. Nevertheless, it was disquieting that while the authorities again saw improvements in fiscal and monetary performance in 1985/86, both the latest data available and staff reservations on the authorities' original forecasts for the year suggested that the budgetary outturn would show a sizable deficit and the overall financial position would be fragile. The external account, moreover, would also remain vulnerable and, as indicated by the staff's assessment of the official medium-term calculations, that vulnerability would continue for some time to come, with the emergence of uncovered financing gaps over the next four years. Even on the basis of fairly optimistic assumptions about export and non-oil import growth, those gaps would remain although they would be smaller.

In the light of the internal and external prospects, he urged the authorities to implement the staff's proposals for adjustment in the management of the economy, Mr. Leonard said. A strengthened fiscal performance, as well as vigorous implementation of price reform, was especially desirable.

He had slight reservations with regard to exchange rate policy and what could be accomplished by it, Mr. Leonard remarked. While there had been a real appreciation of the Pakistan rupee in 1984 and early 1985, mainly as a result of movements in the U.S. dollar, the general trend of the rupee had been downward since 1983. Therefore, while he did not disagree with the staff that further depreciation of the rate would be helpful to exports and would keep imports low, substantial ancillary action as regards nontraditional exports was necessary. In particular, Pakistan's export mix might not be adequately matched to demand in export markets and there might be deficiencies in marketing abroad. Alternatively, protectionist practices might be the main obstacle to expanding nontraditional exports. He asked the staff to shed any light on the weight of those factors on export promotion.

The staff report, Mr. Leonard noted, 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 National Deregulation Commission had begun to review subsidized items, and it was hoped that subsidization could be reduced." That quotation suggested a deliberation of pace--even a lack of urgency--on the part of the authorities that was not what one would expect in remedying a situation that was the source of many of the other weaknesses in the management of the economy. He asked the staff or Mr. Finaish to comment on that apparent dilatoriness and whether administrative capacity in any way needed to be improved to overcome it.

Mr. Ercel observed that the economic program carried out by Pakistan since the early 1980s had been satisfactory. Although a marked slowdown in the real growth rate had occurred in 1983/84, since then there had been a notable increase in the growth rate of output, reflecting increased production in the manufacturing and agricultural sectors, while the inflation rate had remained relatively low. However, despite the progress made with adjustment, the structural weakness of the economy remained a vital issue. Removal of the remaining constraints on development was a crucial precondition to the achievement of a viable balance of payments position and stable economic growth. The main objectives of the authorities' structural program seemed to be well chosen but needed to be reinforced by increased investment productivity, higher domestic savings to cover investment, and an expanded agricultural sector. The budget had also displayed structural weaknesses that should be corrected.

The external sector needed reinforcement through a reallocation of resources to the balance of payments sector, with emphasis on the replacement of public by private investment, the liberalization of imports, and the consistent application of a flexible exchange rate regime, Mr. Ercel continued. Successful implementation of those structural measures would depend on the pursuit of cautious, sound financial and external policies.

Discussions between the staff and the authorities had rightly focused on structural problems as well as on fiscal policy, especially weaknesses in the system of public finance, Mr. Ercel noted. As in similar economies, low per capita income had been a major obstacle to increasing tax revenues on income and profits. On the one hand, that situation called for increased emphasis on transactions involving goods and services and external activities; on the other, it narrowed the room for fiscal maneuver to encourage the supply-side adjustments required for development projects and private initiatives. Table 11 in the report on recent economic developments showed that the ratio of income tax revenue to total tax revenue was about 10 percent at present and had been declining since 1980. The authorities' intention to institute tax reforms was therefore welcome, although the envisaged measures could not be applied during the current fiscal year. New policy measures might be required to mobilize additional resources and reduce the budget's dependence on private savings.

Despite uncertainty over the impact of the recent oil price slide on the Pakistani economy, several recent developments in the external sector were encouraging, Mr. Ercel remarked. Exports had recovered over recent months, and the real depreciation of the rupee since February 1985, in parallel with the U.S. dollar, had enhanced the competitiveness of the economy in nontraditional exports.

He shared the staff's concerns about the recent increase in short-term financing, Mr. Ercel commented. Although short-term debt had decreased by about one fourth over the past five years, and its share in total debt was still low, policy in that area must be carefully designed. The central bank's reserve position should be strengthened against unexpected pressures. The authorities also intended to set a limit on short-term borrowing.

The staff had indicated that the foreign exchange bearer certificates might, under certain circumstances, give rise to multiple currency practices, Mr. Ercel noted. He asked the staff for further clarification, particularly as to which circumstances might give rise to such practices.

Ms. Bush recalled that during the previous Article IV consultation discussion on Pakistan, speakers had noted that various favorable economic developments had occurred in recent years. Final figures for 1984/85 indicated that growth had continued at a high rate and that consumer price increases had moderated somewhat. A worrying development was the large increase in the current account deficit from some 1.8 percent of GDP in 1982/83 to 3.1 percent in 1983/84 and 5.2 percent in 1984/85. Although official projections showed that the deficit would fall, it was not clear whether the current account deficit would be sustainable at lower levels in the medium term without some strengthening of macroeconomic and structural policies.

It was reassuring to learn that the authorities were expecting strong private sector investment during the current year, Ms. Bush said. The authorities' view was that pricing incentives in the agricultural sector were adequate and were kept under constant review; however, a more flexible pricing policy, including the pass-through of exchange rate changes, was required to stimulate further increases in productive capacity. She hoped that the authorities would continue their record of structural reform by further rationalization of pricing policies in more areas, which would be particularly important to boost productivity. The authorities were moving forward on some reforms in the energy, edible oil, and manufacturing sectors, including cement. While those reforms were welcome, subsidization policies should be kept under review and subsidies reduced to rationalize the pricing structure.

She fully endorsed the Government's plan to divest part of its equity in some public enterprises, and she recommended an accelerated pace of action, Ms. Bush continued. The performance evaluation and incentives system for public enterprises was being implemented with assistance from the World Bank, she would be interested in receiving information on the system from Mr. Finaish or the World Bank representative. She was also concerned about overall budgetary developments, as demonstrated by the outcome in 1984/85. While the authorities were projecting a reduction of the deficit as a proportion of GNP during the current year, the ratio was still high. If the authorities turned increasingly to domestic financing to meet the deficit, the strong performance of the private sector could be eroded. From the description in the staff paper, it did not appear that the issuance and sale of the Special National Fund bonds were drawing liquidity from the private sector thus far, since banks were being permitted to increase lending for that purpose, but she wondered whether that financing would not ultimately reduce private sector resource availability, as eventually credit expansion must be curtailed to restrain long-run inflationary trends. That the authorities had not moved forward on the recommended tax reforms was disappointing, although the report of the Tax Commission was expected that month. The National Taxation Reforms Commission had the objective of broadening the tax base and improving elasticity. She hoped that the Commission could also look at ways to encourage savings and investments, which were very low; improvement could be instrumental in allowing Pakistan to continue its strong record of growth and the strengthening of the private sector. Regulations and procedures pertaining to private investment were being eased, and investment normally set aside for the public sector was being encouraged in other sectors.

The switch to Islamic banking had taken place fairly smoothly and had, in fact, increased the flexibility of the rate of return structure, Ms. Bush commented. It would be interesting to see whether the national savings rate increased as hoped. Other developments were, however, raising some warning signals, particularly the incentives created to generate foreign deposits at local banks. While those inflows strengthened the payments position in the short run, they created a corresponding short-term liability that could easily be "called" by the foreign institutions if questions of confidence were to emerge.

If the overall balance of payments became too dependent on those short-term inflows, Ms. Bush remarked, the question would be whether a solid foundation was being laid for long-run payments' sustainability. Because of the sluggish growth of manufacturing exports, the large dependency on workers' remittances, and the present vulnerability of those remittances, it would be prudent to adopt an approach that could strengthen the trade accounts and reduce vulnerability to partially exogenously determined factors. The responsiveness of exports to exchange rate policy should be monitored, thereby following the authorities' cautious policy with regard to external debt. The slow progress in reforming the import regime was disappointing, as the present structure did not appear to encourage the most efficient domestic allocation of resources.

In sum, in many respects Pakistan was doing very well in maintaining a high rate of domestic growth and, for the time being, a viable overall payments position, Ms. Bush noted. However, those factors might not be sustainable in the medium term as high budget deficits absorbed domestic resources and as high current account deficits led to increased foreign debt. The authorities had the opportunity to avoid those potential problems by implementing the recommended broad structural and macroeconomic reforms.

Mr. Romuáldez observed that the staff report covered Pakistan's economy in terms of recent policies and practices--notably the effects of pricing and exchange rate policies on subsidies and the fiscal position, as well as the relative weaknesses of the country's credit policies. He agreed with the staff's more conservative estimates and appraisal concerning the country's prospects for 1985/86 and the medium term, compared with the authorities' more optimistic view. The pressures on public finances led to apprehension over Pakistan's external debt position, in particular given the fact that some major debt categories were not known. The expansion of short-term foreign borrowing could aggravate Pakistan's vulnerability to the vagaries of risk perception in the financial markets.

Although the authorities were supposed to be exercising more effective control over the budget, their commitment to subsidy reduction seemed to be flagging, Mr. Romuâldez commented. Data on recent developments in the authorities' export subsidy reduction program showed that reductions during the two previous years had been reversed more recently. To encourage exports, authorities should opt for the more general and market-related incentives that a flexible exchange system afforded rather than for limited, and often distorted, incentives associated with subsidies.

While the growth rate of the economy during the first half of the 1980s was impressive, he was not sure that that rate could be continued in the coming years, Mr. Romuâldez remarked. Expansion at the targeted rate seemed unsustainable; although price developments had been favorable to date, danger signals could be seen as much in the monetary as in the balance of payments figures for 1984/85.

The tripling of petroleum production since 1982/83, to a level at which one third of domestic consumption could be covered, was welcome, Mr. Romuâldez said. Equally important were the structural improvements that had made the production figures possible, for example, appropriate producer pricing policies and institutional rehabilitation. He commended the authorities for those measures and welcomed the information that the overall performance in agriculture would be better than expected despite some setbacks in rice and sugarcane production.

Pakistan's export performance might require more than exchange rate flexibility to improve meaningfully, Mr. Romuâldez commented. Greater access to markets, particularly in a number of industrial countries, must be made available and protection against some of Pakistan's exports must be diminished or dismantled.

The staff representative from the Middle Eastern Department commented that, with regard to the real sector, the impact of changes in international prices on the domestic production of petroleum could be affected, although the current domestic price paid to producers was not the full international price. There remained room for the Government to make an upward adjustment to offset the decline in international prices, although there would be some budgetary impact. In the energy sector, Pakistan planned to develop hydroelectric power and its gas resources. An appraisal of investments in utilities would be conducted with the assistance of the World Bank, which had been closely involved with the authorities in developing an overall energy policy. If, however, a decline in international prices were not offset by some decrease in the ratio paid to domestic producers, the pace of exploration and development would be affected although output would not.

The steel mill, as a major new venture in the real sector, was expected in the initial phase to receive some subsidization, the staff representative continued. The tariffs imposed by the authorities on steel products were in the range of 50-70 percent. Domestic steel prices were pegged to a high proportion--between 75 percent and 80 percent--

of the cost plus the import duty, and the export subsidy reflected the margin between international costs and the domestic price. Those figures did not fully reflect the extent of the implicit subsidy in the operation, because the steel mill was, to date, not yet producing at 80 percent capacity utilization, and the mill would not contribute toward debt service borne by the Treasury on the financing borrowed to put the facility in place. Although how the pricing structure and the element of subsidy implicit in the steel operation would evolve in future was uncertain, there was fairly broad subsidization at present. The steel mill was the last large productive industrial project implemented in the public sector; in line with the industrial policy statement issued by the authorities two years previously, the burden of industrial investment and growth would be carried by private enterprises and initiative.

Access to adequate resources was needed by the private sector to carry out the task assigned to it by the overall policy framework of the authorities, the staff representative remarked. A facility of $200 million had been set aside in 1983/84 to assist the private sector in securing the necessary foreign exchange financing for investment. Only $42 million had been used in 1983/84 and no figure had been specified for 1984/85. One explanation for the relatively low utilization of the facility was that in the industrial policy statement the level of investment sanctioned before the private sector could produce had been raised, while access to foreign exchange for financing had not been increased at a commensurate rate, implying an expectation of a change in the mix of foreign and domestic resources. Private sector access to foreign exchange for purchases of industrial and capital goods was regulated under the import policy order.

A number of Directors had commented about the need to make further progress in cost-price rationalization, the staff representative noted, and the staff had pointed out that a more flexible exchange rate policy was a key element. With the dollar/rupee rate essentially unchanged, it had been difficult for the authorities to increase certain domestic procurement prices in order to allow further progress in raising input prices. The Cotton Export Corporation was contributing little to the budget; therefore exchange rate flexibility would give greater flexibility to cost prices in the agricultural sector as well as having a direct impact on the budgetary situation. There was a need to strengthen public finances, as reflected to a large extent in weaknesses in the resource situation and the domestic savings ratio.

In the early 1980s, the authorities had resorted each year to wide-ranging discretionary tax and price measures to increase the financial resources available to the budget, the staff representative explained. Developments in 1984/85 and 1985/86 had reflected the inelasticity of the tax system: the tax measures taken in earlier years had lagged. As 1984/85 had been an election year, the authorities had not increased taxes or prices, and the result had been a sharp deterioration in the overall fiscal situation and a concomitant large increase in bank financing of the budget. In 1985/86, the authorities had, on a gross basis, implemented a large number of tax and price measures but had also granted a number of tax concessions. Some of those tax changes implemented in 1985/86 had run counter to the need for strengthening the elasticity of the system, as some exemptions from the sales tax had been increased and the threshold for direct import taxation had been raised. In addition, the authorities had linked certain expenditures direct to increases in revenue items. The net impact of the discretionary tax measures in 1985/86 had not been conducive to a strengthening of domestic savings.

The National Taxation Reforms Commission had been expected to report to the authorities at the end of March 1986, but their work had not been completed and they had received an extension until September 1986, the staff representative noted. It was not clear how that delay would affect the authorities' ability to start a broad tax reform at the beginning of the coming fiscal year, starting July 1. Although the authorities intended to take some steps in the next fiscal year, it would be unrealistic to expect substantive measures because of the delay in the completion of the report.

With regard to the Special National Fund bonds, that operation had been conducted in July-August 1985 and had involved a tax amnesty designed to bring into the tax base a broader range of assets than had so far been taxed, the staff representative said. However, those bonds were two-year maturities and would be unwinding in 1987/88. The authorities' management of the unwinding operation would determine whether the impact on domestic finances would be expansionary or whether it would continue to be neutral. Thus far, the authorities had acted prudently and had decreased the stock of borrowings on commodity operations, which was the highest cost component of public sector borrowing for the current year. Although originally estimated at $11 billion, the latest estimates suggested that there would be an offset of only $10 billion; the difference of $1 billion would be used to finance a bigger procurement program because of larger than anticipated wheat and other crops.

The staff had reservations with regard to the foreign exchange bearer certificates as they were a liquid claim on reserves, the staff representative said. The authorities considered them attractive as a vehicle for inflows--remittances or capital--granting roughly 5-6 percent incentive on the exchange rate, which was implicit in the calculations converting foreign exchange to domestic currency. The preponderant encashment of that facility had been in terms of rupees, indicating that the certificates served the purpose of a small incentive to encourage inflows. The staff considered that that was an appropriate exchange rate policy, and, combined with the right level of internal rates of return, would be sufficient to continue those inflows. The certificates were a highly volatile instrument that could cause a sudden claim on reserves, which, considering the fragility and low level of reserves, could cause complications. In addition, the scheme's operation could hinder the authorities' flexibility with regard to exchange rate policy insofar as the perceived intention to change the rupee/dollar rate could precipitate large claims for withdrawals from that foreign exchange facility and claims for foreign exchange reserves by the private sector. The staff would study the implications of the scheme in greater detail, look at comparable schemes that had been implemented in the past in other countries, and communicate its findings to the authorities.

On exchange rate policy, Directors had commented that the authorities had acted correctly by attacking discretionary measures and by keeping the peg to the dollar, which had depreciated recently and thereby effected a real effective depreciation of the rupee of about 20 percent, the staff representative noted. It had been asked whether the decline in nontraditional exports had been a direct result of the exchange rate or whether other factors, such as protectionism in certain importing countries, were involved. Until recently, a loss in market shares had been directly attributable to the weakening position of Pakistan vis-à-vis its competitors. Restrictions in importing countries had also been an important factor. The rupee's movement with the dollar had left the position of Pakistan unchanged compared with other countries whose currencies had also moved in the same direction. Adjustment against the dollar was a question that the authorities would need to address seriously for balance of payments as well as for fiscal reasons. Subsidies, possible increases in domestic prices, the restoration of profitability to the Cotton Export Corporation, and a change in the rupee base of import revenues were important factors affecting the fragile budget situation.

The decline in savings had been the result of the weak performance of the public sector as a whole, the staff representative from the Middle Eastern Department explained. The authorities contemplated a 2 percent increase in savings in 1985/86; although projections tended to be somewhat optimistic, they reflected an expected improved budgetary situation, which would be the crucial factor. With regard to bank branch facilities, the authorities had recently focused on improvement of the services and flexibility of banks under the Islamic system in order to give better rates of return and to mobilize savings.

The staff representative from the Exchange and Trade Relations Department commented that the staff was concerned about the foreign exchange bearer certificates scheme because of that mechanism's volatility The staff's concern stemmed from the fact that the certificates were issued against foreign exchange but were denominated in local currency at the current exchange rate. As they were encashable at any time in rupees or in foreign exchange at the prevailing exchange rate, there was no protection in the case of a change in the exchange rate. Consequently, the potential volatility arising from an exchange rate change would be higher than for a bank deposit denominated in foreign exchange. The staff believed that the domestic interest payable at the time of the encashment of those certificates should be established at a rate that would encourage, to the fullest extent possible, an immediate and permanent conversion into the local currency, thereby minimizing the risk of an outflow.

The staff would judge that the certificate scheme could give rise to a multiple currency practice if the secondary market for the Certificates operated with official approval and if transactions therein resulted in effective exchange rates that differed by more than 2 percent from the official exchange rate, the staff representative explained. In the present case, the authorities had introduced the Foreign Exchange Bearer Certificates and also had allowed a secondary market to develop. There was no doubt that the scheme could potentially give rise to a multiple currency practice if the calculated exchange rates differed by more than 2 percent. However, the staff had not been able to make that calculation because the price quoted in the secondary market had not specified the maturity of the instruments. That information was necessary to calculate the effective exchange rate in a particular transaction.

The staff representative from the World Bank said that, to date, the Bank's efforts had been largely involved in a signaling system with satisfactory results. Coverage of public manufacturing and industries had been good and represented about 95 percent of sales of all manufacturing enterprises. Firms outside the system were quite small, were involved in activities that did not lend themselves to monitoring--such as consulting services--or had been established for reasons of social justice.

The system was set up to monitor the performance of public manufacturing enterprises more closely, the staff representative continued. The Government monitored performance in terms of a number of fiscal and financial indicators, with performance targets set up annually in consultation with the Expert Advisory Committee and the corporations themselves. Bonuses were awarded to the management of those corporations that reached established goals, taking into account exogenous factors beyond the firms' control.

The performance of public manufacturing enterprises had improved as a result of that system, the staff representative said. Essentially, the performance targets were in terms of profits, energy efficiency, and fiscal efficiency, with emphasis on private sector financial profits and productivity. The system could be improved further, and the Bank would assist the authorities in doing so. One drawback of the system was that it was limited to one-year targets, and the Bank was attempting to have the firms engage in medium-term planning, of both financing and investment, so as to broaden the horizons to four or five years and avoid the conflicts that arose between short-term and long-term objectives.

The World Bank was involved in an export development project that would include a medium-term planning component for the public manufacturing enterprises, the staff representative from the World Bank remarked. In addition, the Government was being encouraged to proceed as expeditiously as possible with the divestiture and disinvestment of its shares of public enterprises. The Bank was hopeful that the announced target of PRs 2 billion would be reached, with a disinvestment of 1 billion shares in six enterprises during the current year.

Mr. Finaish said that the economic strategy that had been followed in Pakistan since the beginning of the decade could be characterized as one aimed at adjustment with growth, combining improved demand management policies with growth-oriented structural reform. The economy's performance during that period had been generally quite good, as noted by almost all speakers. The average GDP growth rate had been about 6.5 percent for a period of nine years, which was an impressive achievement, especially compared with the average growth experience of developing countries during the same period. That growth record had been combined with the implementation of important financial and structural adjustments. During 1980-83, an extended arrangement with the Fund and a structural adjustment loan from the World Bank had been successfully implemented. Domestic and external financial imbalances had been reduced, and inflation had been lowered rapidly. The record was especially creditable because it had been realized in a difficult environment, marked by a prolonged international recession, terms of trade deterioration, and the presence in the country of over 3 million refugees from Afghanistan--a problem that had political, economic, and social implications.

The country's external position had weakened in 1983/84 and 1984/85, Mr. Finaish continued. Adverse exogenous factors had played an important role in that development, namely, unfavorable weather conditions in 1983/84 that had reduced cotton exports, a decline in workers' remittances, lower prices for commodity exports, and weaker demand in the oil exporting countries in the region that constituted an important export market for Pakistan. The fiscal position had also weakened in 1984/85. However, GDP growth had rebounded strongly in that year and was continuing at a high level in the current year.

The authorities fully recognized that the weakening of fiscal and external positions in 1984/85 had also reflected structural weaknesses in public finances and the external accounts, Mr. Finaish commented. They had taken some corrective measures and were determined to make the additional necessary adjustments.

Despite the apprehensions expressed in the staff report about the attainability of the authorities' fiscal target for 1985/86, estimates for the first eight months of the year showed that the overall fiscal deficit relative to GDP would be reduced by 1 percentage point, as reported in the staff supplement, Mr. Finaish noted. Both revenue mobilization and expenditure control had been strengthened during the year. The substantial expenditure overruns that had been forecast in the staff report had not occurred. Even defense expenditure was being cut by about 4 percent in nominal terms compared with the amounts previously budgeted.

The authorities were aiming at some fundamental structural adjustments for a more durable improvement in public finances in the period ahead, Mr. Finaish stated. With the 1985/86 budget, the establishment of a National Taxation Reforms Commission and a National Deregulation Commission had been announced. The first Commission was preparing recommendations for substantive tax reforms, including an appropriate extension of the sales tax. The second Commission was preparing recommendations for deregulating trading in certain essential commodities so as to bring down substantially subsidy expenditure. Recommendations of those Commissions could begin to be implemented in the near future.

The increase in domestic bank financing for budgetary support that had occurred during the previous year was unusual, Mr. Finaish remarked. In all other years since 1980, such financing had been kept below 2 percent of GDP and had averaged less than 1.5 percent. In the current year, such financing would have been avoided altogether except for the large shortfall in external assistance.

The authorities intended to reduce the use of domestic nonbank borrowing for budgetary financing in the future as they intensified their efforts to raise tax revenues, Mr. Finaish explained; meanwhile, they considered the use of nonbank borrowing to be better for demand management purposes than bank financing. There was, of course, a budgetary cost involved in borrowing, and the authorities were aware of that aspect. But there was no evidence that nonbank borrowing had crowded out private investment, and the authorities believed that the evidence pointed to continued adequate availability of financing and credit to private investors. Although some other factors could constrain private investment in Pakistan, the authorities were not convinced that the availability, or lack, of domestic credit and financing to the private sector was a major element. The authorities also viewed some of their small savings schemes as helpful to the effort to mobilize additional savings and direct them toward productive investments. A portion of the amounts shown as nonbank borrowing in the current year represented proceeds from special bonds that had been issued by the Government to encourage the declaration of assets on which tax payments had previously been evaded. The amounts so declared had served to expand the future tax base. In addition, a significant part of what was currently shown in public finance statistics as nonbank borrowing consisted of repayments of previously extended government loans. An adjustment for that factor would reduce nonbank borrowing and the overall fiscal deficit relative to GDP by over 1/2 percentage point. Appropriate reclassifications reflecting that adjustment would be made in tabulating budgetary statistics in the future.

Both the current account and the overall balance of payments positions were to improve substantially during the current year, Mr. Finaish remarked. The current account deficit relative to GNP would decline by over 2 percentage points to under 3 percent, and the overall balance was likely to be in surplus compared with a large deficit in the past year. That encouraging improvement reflected in large measure a strong recovery in exports. As in the case of the fiscal outcome for the current year, balance of payments estimates available for the first eight months of the year had not borne out the apprehensions expressed in the staff report that the authorities' projections for the year were optimistic. Indeed, the current account outcome was turning out to be even more favorable than projected by the authorities, as confirmed in the staff supplement.

The authorities were alert to the implications for the structure of the country's balance of payments of the beginning of a decline in workers' remittances, as employment opportunities for expatriate workers diminished in the oil exporting countries in the region, Mr. Finaish continued. They recognized that it would be crucial for the future viability of the balance of payments that merchandise exports, especially manufactured exports, showed a healthy and consistent growth trend. To that end, they intended to pursue an active policy of export promotion. They were aware that a flexible exchange rate policy would play an important role in that respect. Moreover, they did not regard export subsidies as a sustainable alternative to an appropriate exchange rate policy. Since the adoption of a managed floating system in 1982, exchange rate policy in Pakistan had been quite flexible. Cumulative real effective depreciation of the rupee since then had amounted to about 30 percent. The appreciation against European currencies that had taken place in some months of 1983 and 1984 had been difficult to avoid in view of the large increase in the value of the U.S. dollar against those currencies. Since then that appreciation had been more than corrected. The authorities' efforts to promote exports would be helped if barriers in industrial countries to some exports of key interest to Pakistan--such as textiles--were relaxed.

While the rupee/dollar exchange rate in recent months had remained largely unchanged, as pointed out by some speakers, during the same period the rupee had depreciated substantially in real effective terms, Mr. Finaish noted. The authorities' foreign exchange policy was guided by competitiveness indicators that had been worked out in light of staff recommendations. When exchange rate policy was guided by a basket of currencies, it was to be expected that the exchange rate relationship could move differently in terms of individual currencies. The authorities were continuing to conduct their exchange rate policy with a view to maintaining competitiveness in terms of a representative basket of currencies.

The authorities had every intention of maintaining their traditionally cautious external debt policy, Mr. Finaish said. Some short-term commercial borrowing had been considered necessary in the current year to build up reserves. The authorities did not consider a resort to that kind of borrowing as a substitute for appropriate adjustment measures. They intended to continue to limit such borrowing and, as in the past, to keep debt service within manageable levels. Short-term debt and debt on commercial terms amounted to only about 5 percent of total external debt.

The authorities recognized that Pakistan's savings and investment levels had been relatively low for some time, Mr. Finaish remarked. Raising the national propensity to save was an objective to which they attached due importance. Policies that directly or indirectly sought that objective had included the provision of an adequate return on financial assets, the development and diversification of savings instruments offered by the financial system, tax incentives, the promotion and dissemination of private investment opportunities by deregulation and the enhancement of incentives, and--in the public sector--the generation of larger surpluses by the Government and public enterprises. The authorities agreed on the need to further strengthen efforts for greater domestic resource mobilization. A strengthening of the tax system in the future could be helpful in that respect.

Under the current Five-Year Plan, the objective was to raise the national savings and investment ratios by 1987/88--the last year of the Plan--to 15 percent and 18 percent of GNP, respectively, Mr. Finaish pointed out. The savings/GNP ratio was projected to rise by 2 percentage points during the current year and the investment/GNP ratio by 1 percentage point. Several factors were expected to contribute to the projected increase in the domestic savings rate, including an increase in private investment, reflecting improved confidence and incentives; encouragement of financial savings through higher deposit rates; improvement in the fiscal performance; and a high rate of overall income growth.

During the period of the extended arrangement with the Fund, Pakistan had implemented a substantial, broad-based liberalization of the import system, Mr. Finaish noted. Significant steps had been taken during that period, followed by additional measures since then, toward a more open trading system, notwithstanding the fact that during the same period the trend in many other countries--notably the industrial countries--had been in the opposite direction. Most licensing restrictions had been removed, and ceilings had been raised on import items that had continued to be subject to licensing. The proportion of domestic industry protected by import bans or equivalent restrictions had been lowered from about 65 percent to about 30 percent. A negative list system that specified prohibited or restricted imports had been adopted to replace the more restrictive positive list system that specified permitted imports. Since then, the negative list had been shortened and simplified. While the process of liberalization and simplification of the import system was continuing, further significant steps in that direction would need to be carefully assessed, keeping in mind the strength of the external position.

The National Taxation Reforms Commission was preparing recommendations for a comprehensive tariff reform to extend the measures that had been taken in recent years to rationalize the tariff structure, Mr. Finaish said.

With respect to the exchange system, Mr. Finaish continued, an implication of the recent introduction of foreign exchange bearer certificates had been an effective relaxation of exchange controls for private current and capital transactions. The authorities were mindful of the fact that those certificates represented highly liquid claims on reserves, and they intended to exercise due caution in their policy in that respect.

The country's overall growth and adjustment record in recent years had been fairly good, Mr. Finaish concluded. The authorities recognized the areas in which further adjustments were needed. In the period ahead, they intended to persevere with their adjustment efforts in the context of sustained growth, and they would aim in particular at bringing about durable improvements over the medium term in the fiscal and balance of payments positions.

The Chairman made the following summing up:

Executive Directors noted that in 1984/85 the economy of Pakistan registered a high growth rate as the agricultural sector recovered strongly while inflation was kept under control. Directors observed, however, that while the growth performance was impressive, both the budget and the balance of payments positions had deteriorated substantially. The fiscal position weakened considerably because, while spending rose sharply, budgetary receipts increased at a modest pace due to a weak resource mobilization effort. Consequently, both the overall fiscal deficit and the bank-financed component expanded and there was continued heavy reliance on domestic nonbank borrowing for the budget. The substantial deterioration in the balance of payments position reflected essentially declines in exports and remittances as well as the excess aggregate demand stimulated by the large fiscal deficit.

Regarding developments in 1985/86, Directors noted that a number of favorable factors were expected to contribute to an improved balance of payments and, to some extent, fiscal performance, while real growth would be sustained at a high level. Reflecting enhanced incentives, petroleum production was likely to be more than triple the 1982/83 level and equivalent to one third of domestic consumption. In the interest of efficiency and in order to sustain growth further, Directors recommended a substantive resumption of price rationalization efforts in the agricultural sector and urged the authorities to take early actions in the area of deregulation.

Directors noted with concern that the domestic savings and investment rates had been low over the past years and would need to be raised if the growth of the economy were to be sustained. Most Directors linked the low savings and investment levels to the structural weakness of the budget. They also expressed concern over the absence of a substantial resource mobilization effort in 1985/86, the planned large reliance on external financing and domestic private savings, and the likelihood of considerable recourse to domestic bank financing. Thus, for this year no durable improvement in the fiscal position was likely, although some special factors, including declining oil prices, would benefit the budget position. Directors generally agreed with the staff's assessment that policy measures should be implemented to strengthen the fiscal position. They urged the authorities to tighten control over public expenditures and in particular to curb budgetary subsidies. They also stressed the need for early implementation of a substantive tax reform aimed at broadening the tax base and enhancing the elasticity of the tax system. Moreover, there was a need to provide greater incentives to savings.

In the monetary policy area, Directors commended the authorities for the greater flexibility now permitted for rates of deposit and return under the Islamic financial system. In view of budget developments during the first eight months of the year, Directors urged the authorities to limit credit expansion if the balance of payments deficit is to be contained.

Directors commented that although the external current account position was likely to improve in 1985/86, Pakistan's balance of payments situation remained vulnerable and, in particular, own reserves were at a low level. The heavy reliance on primary commodity exports--in particular, cotton and rice--and workers' remittances and the continuing weak performance of noncotton manufactured exports were sources of concern. Directors commended the authorities for the exchange rate policy pursued over the past year, which had entailed a substantial real depreciation of the rupee. In view of the continuing weak performance of manufactured exports generally and the low level of reserves, Directors encouraged the authorities to move toward greater flexibility in exchange rate policy. Concomitantly, concerns were expressed with respect to quantitative limitations maintained by some importing countries--in particular, on textiles--that constrained the growth of certain of Pakistan's exports. Directors also expressed concern over the recent expanded reliance on external short-term foreign borrowing to enhance external reserves. In particular, caution was advised with regard to attracting short-term deposits from commercial banks and also in relation to the foreign exchange bearer certificates scheme, which do not constitute a stable form of financing. Directors praised the authorities for their traditionally cautious external borrowing policy and urged them to continue to adhere to this stance, especially in view of the rising external debt service ratio.

In sum, Directors commended the authorities for the high growth rates achieved in recent years, with relatively low inflation and under sometimes difficult external conditions. They also welcomed the progress in the energy and agricultural sectors--and it was noted in this respect that Pakistan had become close to self-sufficient in agriculture--and the correction in some prices and in exchange rate policies. However, Directors expressed concern about the somewhat slow progress in price rationalization, structural reform, the strengthening of public enterprises, and deregulation. They also held the view that the authorities should make use of the present opportunity of more favorable external factors to implement the comprehensive adjustment measures needed to correct the structural weaknesses in both the fiscal and external positions and to lay the foundations for continued sustainable growth. The importance of the role of the World Bank was stressed in this regard. It is expected that the next Article IV consultation with Pakistan will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

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 to take appropriate steps toward early removal of the remaining restrictions on the making of payments and transfers for current international transactions.

Decision No. 8244-(86/59), adopted
March 31, 1986

2. IBRD - RELEASE OF INFORMATION

The Managing Director proposed that Executive Directors accede to a request from the World Bank to receive the staff memorandum and Executive Board decisions relating to the establishment of the structural adjustment facility within the Special Disbursement Account, together with his summing up of the discussion at EBM/86/56 (3/26/86).

The Executive Board then took the following decision:

The Executive Board approves the transmittal to the World Bank of the staff memorandum relating to the establishment of a structural adjustment facility within the Special Disbursement Account (EBS/86/53, 3/4/86; Sup. 1, 3/13/86; and Sup. 2, 3/20/86);

the Chairman's summing up of the discussion at EBM/86/56 (3/26/86); and the relevant Executive Board decisions adopted on March 26, 1986 (EBS/86/53, Sup. 3, 3/31/86).

Adopted March 31, 1986

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/58 (3/28/86) and EBM/86/59 (3/31/86).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/93 and 85/94 are approved. (EBD/86/82, 3/24/86)

Adopted March 28, 1986

APPROVED: December 24, 1986

LEO VAN HOUTVEN
Secretary