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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/31

3:00 p.m., February 27, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
C. H. Dallara	M. K. Bush
	G. Ercel, Temporary
	G. E. L. Nguyen, Temporary
M. Finaish	
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
A. Kafka	C. Robalino
	A. Lindø
E. I. M. Mtei	A. Abdallah
	B. Jensen
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	
C. R. Rye	A. V. Romuáldez
G. Salehkhou	
	A. Vasudevan, Temporary
	T. A. Clark
	I. Angeloni, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

W. A. McCleary, South Asian Regional Office, IBRD. Asian Department: Tun Thin, Director; A. Ariyoshi, W. G. L. Evers, L. Mendras, D. A. Scott. Exchange and Trade Relations Department: C. D. Finch, Director; M. Guitián, Deputy Director; K. M. Huh, S. Kanesa-Thasan, A. B. Petersen. External Relations Department: S. Nawaz. Legal Department: W. E. Holder, J. K. Oh, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; S. H. Hitti, H. E. Jakubiak, B. A. Karamali, M. E. Massourakis, G. Tomasson, M. Yaqub. Research Department: H. C. Kim. Western Hemisphere Department: K. B. Bercuson, M. Caiola, P. B. Clark, C. V. A. Collyns, L. E. DeMilner, S. V. Dunaway, E. Hernández-Cata. Bureau of Statistics: K. W. O'Connor. Advisors to Executive Directors: A. A. Agah, H. A. Arias, D. Hammann, P. Péterfalvy, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, E. M. Taha. Assistants to Executive Directors: E. M. Ainley, J. R. N. Almeida, J. de la Herrán, R. Fox, N. Haque, G. D. Hodgson, Z. b. Ismail, A. K. Juusela, H. Kobayashi, M. Lundsager, K. Murakami, W. K. Parmena, M. Rasyid, J. Reddy, D. J. Robinson, J. E. Rodríguez, C. A. Salinas, A. A. Scholten, A. J. Tregilgas, A. H. van Ee, E. L. Walker.

1. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Robalino upon the termination of his service on the Executive Board.

2. CANADA - 1984 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/30, 2/27/85) their consideration of the staff report for the 1984 Article IV consultation with Canada (SM/85/28, 1/28/85). They also had before them a report on recent economic developments in Canada (SM/85/43, 2/11/85).

Mr. Joyce noted that Investment Canada, the successor to the Foreign Investment Review Agency, was designed primarily to stimulate investment in Canada, rather than to screen proposals to make investments in the country. While it did retain some residual screening functions, reviews of investments in Canada would no longer be required, except investments related to cultural activities, such as publishing and film production. Accordingly, the number of acquisitions subject to review by Investment Canada would be reduced by 90 percent, compared with reviews under the Foreign Investment Review Agency. Direct acquisitions involving amounts of less than $5 million would not be subject to review; that provision alone would substantially reduce the number of cases subject to review. In value terms, investments subject to review would be reduced to approximately 70 percent. Accordingly, the operations of Investment Canada would constitute a major change in the authorities' policy on foreign investment in Canada.

The Acting Chairman made the following summing up:

> Executive Directors expressed their satisfaction with the continued economic expansion during the past year, the further progress made in reducing the rate of increase of labor costs, and the reduction in the rate of inflation that had eliminated the inflation differential with the United States. At the same time, Directors observed that Canada's unemployment rate had remained high, and that investment had been slow to recover. Regarding Canada's external position, Directors noted the improvement in Canada's trade and current account performance, but also pointed out that the improvement stemmed from developments in trade vis-à-vis the United States while there had been some deterioration vis-à-vis non-U.S. markets. Directors also noted that after two years of economic recovery the Federal Government continued to run a very large fiscal deficit, and that interest rates in real terms remained high; they expressed their concern that the continuation of these fiscal and financial trends were creating uncertainty about the direction of economic policy and were adversely affecting the revival of productive investment and the sustainability of the present expansion. Directors also noted and generally supported the priority attached by the

present Canadian Government to creating a better framework for economic growth by reducing government regulation and by stimulating private initiative.

Directors generally took the position that the main task of economic policy in Canada was to foster the conditions for extending and broadening the economic expansion and for achieving a lasting reduction in unemployment while consolidating the progress toward price stability. In their view, the most important ingredient of a strategy to achieve these broad objectives was a comprehensive plan to deal with the federal deficit while continuing a monetary policy that would consolidate the gains made in reducing inflation. In addition, some Directors thought that the removal of structural rigidities in the markets--particularly the labor markets--might contribute to a reduction in unemployment.

While noting with approval the fiscal measures announced in the Government's November 1984 economic statement, Directors generally stressed that these measures needed to be followed promptly by a plan to achieve a major strengthening of the federal fiscal position over the medium term. Indeed, most Directors made it clear that they shared the staff's call for prompt and decisive action rather than a more gradual approach to reducing the fiscal deficit. While noting that decisive fiscal action could result in the near term in slower growth and less progress in reducing unemployment, most Directors observed that prompt action on the fiscal deficit would be needed to avoid the risk of an excessive rise in the federal debt and interest payments as well as to stimulate the necessary revival of productive investment. Such investment was seen as necessary to permit sustained growth and to achieve a lasting reduction in unemployment.

In discussing the need for Canada to cut its fiscal deficit, a number of Directors cited the link between the U.S. and Canadian economies and the desirability for a simultaneous reduction in deficits of both countries. However, those Directors went on to state that it was desirable for Canada to reduce its fiscal deficit even if there were not significant cuts in the U.S. fiscal deficit.

With respect to monetary policy, Directors agreed that monetary restraint had played a major role in bringing about the large reduction in inflation over the past two years. They noted that the continued instability in the relationship of the monetary aggregates to economic activity made it difficult to use these aggregates as guides for policies, and observed that the Bank of Canada was basing policy decisions on a variety of economic indicators, including the exchange rate between the Canadian and U.S. dollars. Some Directors encouraged the

Canadian authorities to continue their search for a practical targetable monetary aggregate. Directors noted the desire of Canadian officials to achieve lower interest rates, but pointed out that the Bank of Canada had found its room for maneuver limited by the behavior of U.S. interest rates.

While noting that Canada's overall competitive position appeared to be satisfactory, many Directors observed that in recent years the Canadian dollar had appreciated substantially against currencies other than the U.S. dollar. This movement, a number of Directors noted, had adversely affected Canada's share in overseas markets, and the high interest rates resulting from the emphasis on the exchange rate relationship with the U.S. dollar might have discouraged investment within Canada. A number of Directors stressed that an early, decisive strengthening of fiscal policy would facilitate the conduct of monetary policy. Some Directors also suggested that a reduction in the fiscal deficit could work to strengthen Canada's international competitive position through its impact on the real effective exchange rate.

Directors noted the efforts now under way in Canada to remove obstacles to the working of the price mechanism. In particular, they welcomed the intention expressed by the Canadian authorities to allow the price of oil to be determined by market conditions, and the measures already announced to reduce restrictions on foreign investment in Canada. Regarding the oil sector, Directors welcomed the intention to move to market-oriented policies and encouraged the authorities to review further the complex oil compensation and subsidy system. Regarding efforts to reduce restrictions on foreign investment, some Directors hoped that the investment liberalization would be extended to the financial sector. Directors also noted the Government's announced intention to re-examine the management and ownership of federal Crown Corporations with a view to improving their efficiency and reducing the need for financial assistance from the Federal Government.

In the area of foreign trade policy, Directors encouraged the Canadian authorities to dismantle existing quantitative restrictions on imports over the next several years, particularly those on footwear and textiles. Such actions would increase the efficiency of resource allocation in Canada as well as the rest of the world, and would aid the adjustment efforts of developing countries. At the same time, Directors urged the Canadian authorities to resist new requests for relief from import competition. They welcomed Canada's support for a new round of multilateral trade negotiations.

Directors also welcomed the intention of Canadian officials to meet the 1985 target of 0.5 percent of GNP for official development assistance and commended Canada's continuing commitment to a sizable real increase in aid spending in the years ahead. Canada's participation in the World Bank's Fund for sub-Saharan Africa was also welcomed.

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

3. LAO PEOPLE'S DEMOCRATIC REPUBLIC - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the Lao People's Democratic Republic (SM/85/42, 2/6/85). They also had before them a report on recent economic developments in the Lao People's Democratic Republic (SM/85/53, 2/13/85).

Mr. Ismael made the following statement:

The Lao economy made considerable progress in 1984, after two years of stagnation that had negated some of the gains made earlier. Owing largely to buoyant rice crops, real GDP grew by about 8 percent, bringing the annual average growth rate in GDP for the first four years of the Five-Year Plan (1981-85) to 3.3 percent. The plentiful rice crop also helped the rate of inflation--as measured by the year-on-year consumer price index--to decelerate to approximately 19 percent in September 1983, from 76 percent in the preceding 12 months.

Rice production continues to be the mainstay of agriculture, the most important sector of the economy. Production of rice surged by 15 percent in 1984. Per capita availability is, however, considered by the authorities to be somewhat below minimum requirements. More efforts will therefore be made to increase rice output. Such efforts will concentrate on extending the area under cultivation, improving agricultural inputs and support services, and double cropping irrigable land. In addition, more remunerative procurement prices will be maintained as incentives to farmers. Development of other crops has been relatively slow, owing to a shortage of agricultural inputs and processing facilities as well as inadequate transportation facilities. The authorities intend to facilitate farmers' purchases of inputs and agricultural tools by extending existing agricultural credit schemes. To improve extension services, more agricultural engineers and technicians will be trained, both abroad and domestically.

Timber is one of the country's most abundant natural resources, but development has continued to be hampered by shortages of equipment and fuel. A more realistic pricing policy is also needed. The authorities intend to make a greater effort to develop the timber industry, including the domestic processing of timber. Their recent decision to accept foreign technical assistance in the marketing and pricing of timber abroad should establish a firm basis for the development of this promising sector.

In manufacturing, which remained stagnant in 1984, owing mainly to a clampdown on imports, the authorities will continue their attempts to improve capacity utilization of existing factories, particularly those processing domestic raw materials.

Substantial progress has been made in the mining of tin and gypsum, which contributed significantly to the buoyant output enjoyed in 1984. With foreign assistance, the prospects are good for futher progress. The Lao People's Democratic Republic also possesses important deposits of unexploited mineral resources, such as iron ore, limestone, potash, gold, copper, lead, and coal. Foreign assistance would be necessary for them to be exploited.

According to estimates, the budgetary accounts deteriorated in 1984, because of a decline in receipts from taxes and customs duties attributable to the slowdown in manufacturing production and imports. This was exacerbated by decreases in transfers from public enterprises and foreign aid receipts, which normally make up the difference between budget revenues and expenditures. Consequently, the authorities were able to avoid recourse to bank financing of budget deficits. Subsidies have become a major burden on the budget. A significant upward adjustment of official retail prices was made in January 1982, but, since then, official prices have lagged far behind free-market prices. The authorities now have an adjustment in prices under consideration. For the 1985 budget, a number of measures are likely to be introduced to improve the financial performance of public enterprises through greater cost effectiveness. In order to lay the groundwork for future development, a large share of public capital expenditure has been devoted to communications and public works, including the upgrading of roads and the laying of a pipeline, which will link Lao towns to Vietnamese ports.

It is unclear whether positive real interest rates would have a significant impact on private savings, since incomes are basically at a subsistence level. The authorities recognize, however, that interest rates could play a useful role in ensuring a more efficient use of scarse financial resources. Proposals to increase interest rates are therefore under consideration. The authorities also recognize the need for more adequate balance of payments and monetary data. They have requested technical assistance from the Fund to improve balance of payments statistics.

The external position has remained weak in recent years. The current account deficit fell somewhat in 1984, due mainly to the sharp drop in imports necessitated by shortages of foreign exchange. Exports also stagnated. Implementation of the more flexible pricing policy that is being contemplated should have positive results on exports. The authorities recognize that a devaluation of the kip would help to stimulate more exports and attract more transactions into official channels. They are, however, concerned about the effect of a devaluation on domestic prices.

The external debt, though not large in absolute terms, amounts to almost 55 percent of GDP. The debt service ratio has increased to nearly 17 percent. Despite the low foreign exchange reserves and the weak external position, the country has remained current in all its foreign obligations, including those to the Fund. The authorities are following prudent external debt policies, considering foreign loans only where a significant net contribution to the balance of payments is assured.

In conclusion, the staff's preparation of the papers on the Lao People's Democratic Republic cannot have been an easy task, considering the dearth of data in the country. The focus of the staff's appraisal on the need to contain inflation, improve resource allocation, and strengthen the balance of payments appears to me to be well placed.

Ms. Bush remarked that in 1984 the economy had recovered somewhat from the stagnation in 1982 and 1983. Favorable weather had led to the recovery of rice production that had been a factor in the increase in real GDP during 1984 in excess of 8 percent. More abundant food harvests, particularly of rice, and lower food prices in the free market had contributed to the reduction in the rate of inflation from 76 percent in the third quarter of 1983 to 19 percent in the fourth quarter of 1984. While manufacturing output had fallen by 6 percent in 1984, the mining of tin ore and gypsum had increased.

However, the improvements in some areas of the economy had been overshadowed by continued problems in other sectors, Ms. Bush remarked The Government had been able to make some progress in revenue collection and had held civil servants' salaries constant, but the overall budgetary performance had apparently deteriorated, owing to the reduction in transfers of profits from public sector enterprises to the Government, the insufficient movement in official prices toward free-market levels, the decline in customs duty revenues, and the fall in foreign aid receipts. At the same time, the lower profitability of public enterprises had spurred an increase in credit expansion.

The decline in the current account deficit in 1984 had not resulted in an overall improvement in the external sector, Ms. Bush noted. The fall in foreign aid receipts and the increase in debt service payments had caused the overall balance of payments surplus to decline from $10 million in 1983 to $1 million in 1984. The authorities had retained the complex exchange system, and the exchange rate for the kip was still at a level that adversely affected exports and diverted exchange rate receipts from official channels.

If the economy were to sustain the growth achieved during 1983 and reach the goal in the Five-Year Plan, the authorities must take concrete steps in several key areas, Ms. Bush considered. Their efforts must be comprehensive and carefully aimed at strengthening the balance of payments in order to achieve lasting improvements in the economy, which was structurally weak and faced many handicaps due to external factors.

The efforts to increase agricultural output could be supported by many of the policies announced by the authorities that were described in the staff report and Mr. Ismael's opening statement, Ms. Bush continued. However, those measures must be accompanied by a more flexible pricing policy, a reduction in subsidies on certain agricultural products, and an increase in production incentives. The authorities' intention to accept foreign technical assistance for the timber industry was welcome. The renewed World Bank and other foreign technical and financial assistance in agriculture and forestry were positive developments.

The introduction of cost-control measures and an increase in efficiency in the public sector, through appropriate pricing and budgetary policies, were essential if the authorities were to improve the public finances, Ms. Bush stated. An adjustment in the customs valuation rate, an extension of import duties, and continued expenditure reduction would also be helpful. A sound fiscal policy together with an appropriate monetary policy, including steps to achieve positive real interest rates and more efficient credit-granting mechanisms, were essential to ensuring a further reduction in the rate of inflation, establishing a foundation for real growth in all sectors, and improving the balance of payments.

The outlook for the external sector--particularly the large debt service payments--would remain bleak unless the authorities acted to spur exports through a flexible pricing policy and a devaluation of the kip, Ms. Bush said. Those measures, together with the various pricing, credit, and budgetary measures that she also favored, would help to restore a viable balance of payments position.

She agreed with the staff that more timely and complete statistics were required, and she hoped that the authorities would receive technical assistance from the Fund in that area, Ms. Bush commented. Finally, she agreed with the staff's recommendation concerning the country's continued reliance on a multiple exchange rate system and bilateral payments agreement.

Mr. Sugita said that he broadly agreed with the staff appraisal. The proposed decision was acceptable.

Despite its abundant natural resources and small population, the country's per capita GDP remained one of the lowest in Southeast Asia, Mr. Sugita remarked. The economy had rebounded in 1984, owing to an increase in rice production following a favorable rainfall pattern, although agricultural production was still vulnerable to weather conditions. Manufacturing output had declined because of shortages in imported raw materials, although the output of tin and gypsum mines had increased. The stagnation of nonelectricity exports was a cause for concern. While electricity exports had nearly tripled over the previous several years and were expected to increase further, exports of traditional commodities, such as coffee and forestry products, had stagnated or declined. The need to cut imports substantially in 1984, partly because of the weak export performance, was regrettable.

To broaden the production base and to attain self-sufficiency in food supply, the authorities must improve the basic infrastructure, including transportation, communications, and rural electrification, Mr. Sugita said. Transportation difficulties were a major constraint on the development of the forestry sector, one of the sectors with the greatest potential. In that connection, public investment, foreign aid, and World Bank assistance could be helpful. The amount of financial assistance provided thus far by the World Bank Group was rather moderate, particularly given the country's low income. In its report, the staff had noted that, if bottlenecks in project identification and preparation were reduced, disbursements from IDA would increase in the rest of the 1980s. A further comment on how the bottlenecks could be eliminated would be helpful.

He agreed with the staff that price incentives should be used more effectively to promote domestic production and exports, Mr. Sugita remarked. The procurement prices for many products with great export potential, such as timber, coffee, and tobacco, had changed only a little over the previous few years, despite rising costs. A more flexible adjustment of procurement and export prices would bolster export performance. There was also an urgent need to adjust the exchange rate, as the disparity between the commercial and parallel market rates was growing.

Reducing the public sector borrowing requirement, particularly the requirement of public enterprises, was needed to curb monetary expansion, Mr. Sugita commented. In that connection, it was particularly difficult to deal with the rapidly growing rice subsidy; it had increased from 4.3 percent of GDP in 1981 to 7.1 percent in 1984. The first step was to contain the expansionary trend; to that end, the staff had usefully suggested that the authorities should make the rice subsidy an explicit part of the budget, so that the subsidy could be carefully reviewed in the context of the overall public finances. The authorities should also use a more active interest rate policy to mobilize domestic resources. Finally, they should make a greater effort to improve the adequacy and timeliness of their statistics. He hoped that, with the Fund's assistance, the authorities would be able to provide additional data, so that a page on the country could be included in International Financial Statistics.

The staff representative from the Asian Department said that the main bottlenecks were the lack of trained manpower--which had impeded the identification and implementation of development projects--and the lack of adequate data, particularly for the regions outside the Vientiane Plain. Improvements in those areas would have to precede further development in most sectors of the economy.

Mr. Ismael thanked Executive Directors for their comments.

The Acting Chairman made the following summing up:

Executive Directors were in general agreement with the views expressed in the appraisal of the staff report. It was noted that both agricultural production and mineral output had increased in 1984. However, Directors noted that, due to shortages of raw materials and spare parts, manufacturing production had declined, and that the deterioration in the finances of the public sector had led to an acceleration in monetary expansion. Inflation had leveled off in 1984 as a result of the abundant harvest that had led to lower rice prices in the free market. Declining merchandise exports and rising foreign debt service payments had contributed to a sharp curtailment of imports.

Concern was expressed that, in addition to severe limitations imposed by geographic location, bottlenecks in transportation, and a lack of trained manpower, the Lao economy had become subject to severe foreign exchange constraints and continued inflationary pressures. Directors urged the authorities to strengthen their efforts to mobilize domestic resources and to stem the growth in current expenditures by the Government. Other measures to improve the financial position of the public sector that were mentioned included more flexible pricing policies and a reduction in subsidies for selected groups of consumers. In order to reduce the financial burden on public enterprises, the cost of consumer subsidies should be included in the Government's budget, which would allow an evaluation of these costs within the context of the budgetary process.

Directors also stressed that an appropriate adjustment of the exchange rate of the kip, domestic price adjustments, and other appropriate production incentives--including the adoption of more realistic official export prices--were essential for achieving a viable balance of payments, and that the World Bank could be helpful in providing technical assistance in various sectors of the economy. Directors urged the authorities to terminate the existing multiple currency practice.

It is expected that the next Article IV consultation with the Lao People's Democratic Republic will be held on the standard 12-month cycle.

The Executive Board approved the following decision:

1. The Fund takes this decision relating to exchange measures of the Lao People's Democratic Republic subject to Article VIII, Sections 2 and 3, in concluding the 1984 Article XIV consultation with the Lao People's Democratic Republic and in the light of the 1984 Article IV consultation with the Lao People's Democratic Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that the Lao exchange system remains restrictive and involves a multiple currency practice described in SM/85/42. The Fund encourages the authorities of the Lao People's Democratic Republic to terminate the multiple currency practice as well as the bilateral payments arrangements with Fund members.

Decision No. 7917-(85/31), adopted
February 27, 1985

4. PAKISTAN - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Pakistan (SM/85/29, 1/29/85; Cor. 1, 2/25/85; and Sup. 1, 2/26/85). They also had before them a report on recent economic developments in Pakistan (SM/85/31, 2/4/85; and Cor. 1, 2/25/85).

Mr. Finaish made the following statement:

The economic strategy followed in Pakistan since the end-1970s can be characterized as one aimed at "adjustment with growth." The performance of the economy during this period shows that notable success has been achieved in pursuit of that objective. The adjustments put into effect have been wide ranging, comprising improved demand management and substantial structural reform. During the three-year period ended 1983, these adjustment policies were supported by an extended arrangement with the Fund. The overall implementation record under the arrangement was good, and success was achieved in attaining many of its financial and structural reform objectives. The strong adjustment effort was instrumental in reducing domestic and external financial imbalances and slowing inflation. At the same time, a healthy rate of growth was maintained: real growth averaged over 6 percent during the three years of the arrangement, bringing to six years the period over which that rate had been sustained. Making this record the more creditable is the fact that it was realized in the face of several adverse factors, such as the prolonged international recession, a continued terms of trade deterioration, and the presence in the country of over 3 million Afghan refugees.

The forward movement in the economy during the six years up to 1983 was quite well spread. With agriculture maintaining an average growth rate of 4 percent, self-sufficiency was achieved in major foodgrains. The growth rate for manufacturing output averaged about 9 percent, and the volume of exports expanded at a similar rate. The improvement in the economy's financial performance, particularly during the period of the extended arrangement, was also broad based. The fiscal deficit and bank financing of the deficit were reduced relative to GDP. A gradual tightening of monetary policy helped to lower the rate of inflation to 5-6 percent. In the external sector, the current account deficit was reduced to under 2 percent of GNP, and the reserve position was strengthened substantially.

These developments were underpinned by wide-ranging adjustments of a structural nature. To rationalize the cost-price structure, substantial adjustments were made in the consumer and producer prices of energy products and in agricultural output and input prices. Expenditure on subsidies as a proportion of total public expenditure was about halved. The public sector investment strategy was reoriented away from capital-intensive, long-gestation projects and toward agricultural and rural development, energy, and social services. Measures taken to encourage private investment included a simplification of regulatory procedures, the channeling of a larger proportion of credit growth to the private sector, easier access to imported inputs and assistance in the financial restructuring of a large number of problem industrial units. Reform measures relating to public enterprises included divestiture, closure, or restructuring in a number of individual enterprises, and the introduction in stages of a general performance evaluation and incentive system designed in collaboration with the World Bank. A flexible exchange system was introduced under which the rupee was allowed to depreciate sufficiently to restore competitiveness. In a period when protectionism elsewhere was on the increase, a substantial import liberalization package was implemented.

Owing to adverse weather conditions, among other factors, developments during 1983/84 were less favorable than in the preceding few years. Output of most major crops fell, and the drop was particularly pronounced for cotton. Cotton being a key export item, the poor crop also contributed to a large shortfall in exports. Despite the sharp reversal in the agricultural sector, however, an overall growth of 4.5 percent was recorded. Agricultural output is showing a strong rebound in the current year, and GDP growth of 8.5 percent is projected.

Despite a larger than expected increase in current expenditures, owing to certain special factors, and a shortfall in external financing, the overall budget deficit and government bank financing were reduced by 1 percentage point relative to GDP in 1983/84. Contributing to this outcome was a 19 percent increase in tax revenues, reflecting both new tax measures and improved collection. The budget for 1984/85 projected a further reduction in the overall deficit and government bank financing of about 0.5 percentage point relative to GDP. To that end, strict restraint was to be exercised on current expenditures. Revised projections for the year, however, indicate that the overall deficit would be larger than originally estimated. This development reflects higher expenditure on imports and external debt servicing as a result of the further depreciation of the rupee as well as some shortfall in revenues. Moreover, since a sizable shortfall is now expected in receipts from nonbank borrowing, the excess of government bank financing over the original estimate is projected to be greater.

While public sector development expenditure has declined in real terms in the last few years, reflecting both shortfalls in project aid as well as domestic resource constraints, the decline has in part been offset by increasing private sector investment, so that the overall investment to GNP ratio has been fairly stable. Besides, the composition of development expenditures has been improved in line with the reorientation of public investment strategy noted above, and current expenditures have also been channeled increasingly to maintenance of infrastructure and improvement of educational and health services. In 1984/85, public development expenditure is projected to increase in real terms. With respect to tax reform, the authorities are of the view that tax evasion remains the major problem and that further reform in this area could generate greater resources than new tax measures. However, some tax measures have been taken in recent years, and the authorities continue to seek additional feasible ways of broadening the tax system and improving its elasticity. They also seek to reduce the use of nonbank borrowing from the private sector for financing the budget, but consider that this would be attainable only gradually over the medium term as larger revenues can be raised through taxes. They are mindful of the increasing budgetary cost of this mode of financing, but they do not think that the Government's use of private savings is at present having the effect of weakening private investment, as adequate financing is available to the private sector. In their view, government small savings schemes have helped in mobilizing additional savings and directing them toward productive investments. In general, the authorities recognize the need for greater efforts to raise domestic savings over the medium term, in both the public and the private sectors.

Monetary policy continues to aim at maintaining financial stability while making adequate credit available to meet the needs of a growing economy. Domestic liquidity grew by 11 percent in 1983/84, well below the increase in nominal GDP, and a similar outcome is projected for 1984/85. The implied monetary restraint is helping to reverse the resurgence of inflationary pressures observed last year. Latest available data show that the rate of inflation has dropped again to about 6 percent. As regards the problem of the large increase in net unclassified liabilites of the banking system during the past two years, the authorities have taken measures to correct the accounting practices of banks that lay behind this development, with the result that the increase has been substantially reversed in the first few months of 1984/85.

Developments in the balance of payments since 1983 have generated some concern. The weakening of the payments position in 1983/84 largely resulted from a combination of three factors, namely, a large shortfall in exports on account of the poor cotton crop, a decline in remittances, and lower capital inflows. As import growth was also lower than forecast, however, the current account deficit was contained at 3 percent of GNP, compared with the projected increase to 2.7 percent, with the overall balance of payments showing a small deficit. The original projections for 1984/85 pointed to a healthy recovery in exports and a relatively limited increase in the deficit. However, the weakness in exports persisted in the early months of the year, largely reflecting the reduced stocks of cotton and rice as a result of the last year's poor crops. The drop in cotton output also affected exports of cotton products, but exports of some other manufactured items were lower as well. In addition, the decline in remittances has continued. While exports should recover significantly in coming months in view of the good crops this year, the payments deficit for the year as a whole is now projected to be much higher than originally estimated. The authorities have the situation under close review, and are examining what policy options they might have for reversing the weakening of the external position.

If the recent declining trend in remittances persists, it could entail an important structural change in the country's balance of payments, as it would call for generating larger foreign exchange earnings from merchandise exports. Much, however, would depend on the pace of such a change. If remittance growth tapers off gradually, as against a sharp decline in the flow, the adjustments required could be manageable. The category of exports that can be expected to provide an increasing share of foreign exchange earnings over time is that of manufactured and semimanufactured goods. These exports, particularly nontraditional manufactured exports, have in recent years shown a healthy growth rate, and the authorities have actively sought to promote their expansion. Recently, working groups have been set up to study the prospects for specific exports. The authorities' efforts would be helped if barriers in industrial countries to some exports of key interest, for example, textiles, were eased. With respect to exchange rate policy, the authorities continue to operate a managed floating system aimed at preserving export competitiveness. Currently, they are re-examining the method used in calculating the real effective exchange rate.

With respect to external debt, a prudent policy has been maintained. As a reflection of this, the debt service ratio is projected to remain at about 15 percent before declining toward the end of the decade.

During 1983/84, and in the current year, the process of structural reform aimed at improving the efficiency of resource allocation has been carried forward. Further important price adjustments have been made in energy and agriculture. The comparatively smaller adjustments made in fertilizer prices and irrigation water charges do not imply any weakening of the policy of cost-price rationalization; rather, they reflect special circumstances, namely, a stagnation in offtake, the emergence of excess supply, and weak international prices in the case of fertilizer, and the introduction of ushr (an Islamic welfare tax on agricultural produce) in the case of irrigation water charges. Regulations and procedures pertaining to private investment have been further eased and simplified in line with the larger role allotted in the Sixth Plan (1983/84-1987/88) to such investment. Private sector participation has been encouraged in areas previously set aside for public investment. The performance evaluation and incentive system devised for public enterprises has begun to be implemented. In the external sector, the change from a positive to negative list import system was completed, and the authorities intend to keep the new system under review for further improvements. Significant initial moves have been made as part of a comprehensive reform of the tariff structure. Export subsidy rates were reduced in 1983/84 for a range of commodities, and the authorities have recently turned down requests from exporters to raise subsidies in response to the weakened export performance.

In conclusion, Pakistan's growth and adjustment record in recent years is fairly impressive. Largely as a result of adverse weather conditions and a decline in remittances, developments during the last year and a half have been less favorable. The progress made during the preceding few years, however, has increased the resilience of the economy. The authorities are carefully reviewing the present situation, and their adjustment record to date gives confidence in their ability to put in place further adjustments that might be called for in the period ahead. In the medium term, they intend to continue their reform efforts of recent years aimed at improving domestic economic performance and attaining sustained balance of payments viability.

Mr. Zhang noted that the authorities had believed that, with the inauguration of the Sixth Development Plan in 1983/84, the stage had been set for the economy to reach the takeoff point. He was therefore disappointed that the staff report had not assessed the authorities' policy measures in the light of the strategy behind the Development Plan, had not compared actual economic developments in 1983/84 to the Plan targets and objectives, and had not stated whether the Development Plan had remained on track in 1983/84.

The tone of the staff appraisal was rather pessimistic, as the staff's discussion had concentrated on the problems facing the economy in 1983/84, Mr. Zhang continued. Some of the developments in that year had indeed been unfavorable: production of the main crops had fallen by 9 percent; exports, 20 percent of which consisted of agricultural products, had fallen sharply; and real GDP had risen by only 4.5 percent, compared with 6.4 percent in 1982/83. However, the behavior of other macroeconomic variables had generally been in line with the trend since 1980/81. The rate of inflation had continued to fall, and the rate of monetary expansion had been greatly reduced. Moreover, the ratios of the current account deficit, the overall external balance, and the total foreign debt to GDP in 1983/84 had been in line with their respective averages in 1980/81 and 1982/83. Similarly, in the public sector, the overall budget deficit as a percentage of GDP had remained essentially unchanged, as the increase in government expenditure had been offset by the rise in revenues. Furthermore, the total financing of the public sector as a whole had been reduced, and gross domestic investment and fixed capital formation had remained stable in relation to GDP, although gross domestic savings had declined somewhat. Hence, the performance of the economy in 1983/84 had been fairly good. The pessimistic tone of the staff appraisal contrasted sharply with the positive assessment of Mr. Finaish in his opening statement, in which he had provided evidence of the "notable success" and "adjustment with growth" that had characterized Pakistan's recent economic performance.

According to the official projections for 1984/85, the rate of increase in GDP would be double that of 1983/84, and exports would recover, Mr. Zhang commented. He agreed with the staff that achievement of the authorities' various objectives for 1984/85 would require a favorable external environment and the successful implementation of the adjustment program. In that connection, Mr. Finaish had usefully noted that the economy had become more resilient, that the authorities' confidence in their ability to implement additional adjustment measures had increased, and that they intended to maintain their effort to reform economic policy over the medium run.

The staff had attributed the decline in workers' remittances and the weak export performance to the loss of competitiveness and had suggested that a devaluation would enhance competitiveness, Mr. Zhang observed. Noting the evidence of the overvaluation of the rupee, the staff had observed that the rupee had appreciated in real effective terms by 1 percent from January to June 1983 and by a further 4 percent between end-June 1983 and end-October 1984. Workers' remittances had increased from $1.74 billion in 1979/80 to $2.74 billion in 1982/83, a 57 percent increase, but there had been sharp annual fluctuations in those remittances since 1980/81, probably reflecting changes in economic conditions in the countries where Pakistanis worked. In 1983/84, workers' remittances had actually declined by 5 percent in absolute terms, and only part of that loss was expected to be recovered in 1984/85. The staff attributed the decline to structural factors but had not elaborated on that point or shown how a change in exchange rate policy would reverse the trend. The decline in workers' remittances in 1983/84 might have been due to the decision by Pakistani workers to remit to Pakistan only an amount of U.S. dollars that would provide fairly stable support for their families in Pakistan in terms of rupees and to keep the remainder in savings held outside Pakistan. In that context, a decline in workers' remittances in terms of U.S. dollars had been a natural response to the depreciation in real terms of the rupee against the U.S. dollar in 1982/83 and 1983/84. A similar pattern had been evident in other countries, such as China, where remittances were an important item in the external current account.

The weak export performance in 1983/84 had probably been due more to poor crops and weak world prices than to any overvaluation of the rupee, which had appreciated by only about 1 percent in that period, Mr. Zhang remarked. A longer-term perspective suggested that the weak export performance had been due to Pakistan's inability to build a solid export base on the international commodities that had enjoyed a continuously and rapidly expanding demand in world markets; none of Pakistan's nontraditional exports were in that group of major commodities. Moreover, some of Pakistan's nontraditional exports, particularly textiles, had been adversely affected by the rise in protectionism abroad. Accordingly, Pakistan's weak export performance was attributable to structural rather than price factors.

The 19 percent increase in tax revenues in 1983/84 had been attributable both to new tax measures adopted in recent years and to improved collection, Mr. Zhang observed. The favorable revenue performance had contributed significantly to the reduction in the budget deficit in 1983/84. However, he agreed with the staff that one of the remaining structural problems in public finances in Pakistan was the inelastic domestic tax system, which should be reformed. Most developing countries faced that problem, and they, like Pakistan, had to determine how broad-based and rapid tax reform could be accomplished effectively under the present economic and social constraints in those countries. The Pakistani authorities believed that tax evasion was still a major problem, and that further reform in tax administration could generate more fiscal resources than new tax measures. The staff should comment on that matter.

Mr. Rye remarked that, after performing well under the extended arrangement, the economy had deteriorated, although, as Mr. Zhang had stressed, the deterioration was by no means evident in all sectors of the economy. The external factors noted by Mr. Finaish in his opening statement had clearly adversely affected Pakistan's economy. But some of the problems facing the economy had been caused partly by domestic factors, following the slackening of the authorities' commitment to the policies that had contributed significantly to the favorable performance of the economy in the early 1980s. Those factors included the 19 percent real effective depreciation of the exchange rate in 1981-83; the reorientation of development expenditure away from large-scale, long-term capital projects and toward agriculture, rural development, and energy, the liberalization of trade policy; the rationalization of procurement prices in agriculture; the progress in realigning domestic energy prices with international prices; the efforts to improve the performance of the public enterprises; and the containment of the public sector deficit to about 5 percent of GDP in 1980/81 and 1981/82, together with substantial nonbank financing of those deficits. The weakening of the authorities' commitment to such policies was reflected in the slippage in the fiscal position in 1983/84 and the further deterioration in 1984/85, and also in the slippage in the implementation of trade liberalization, tax reform, and rationalization of relative prices. Moreover, there had been a sharp deterioration in the external position in 1983/84, and the staff's tentative medium-term projections, which were based on reasonable assumptions, were worrying. The authorities should be urged to formulate measures--especially in the fiscal and exchange rate policy areas--to arrest the deterioration, and Mr. Finaish's assurance in that respect was welcome.

At first glance, interest rates in Pakistan seemed low, especially in the light of recent inflationary pressures, Mr. Rye commented. He wondered whether the adoption of Islamic banking practices in Pakistan had been evident in monetary policy in general, and in interest rates developments in particular. He also wondered whether the staff saw any connection between the Islamization of Pakistan's financial system and the decline in workers' remittances. The staff had noted that the authorities were making the shift to Islamic banking practices in a cautious manner.

Mr. Nimatallah said that he agreed with the general thrust of the staff appraisal. The proposed decision was acceptable. Pakistan had made substantial progress in restructuring its economy by adopting far-reaching adjustment measures and with the support of an extended arrangement and a World Bank structural adjustment loan. As a result, Pakistan had achieved strong economic growth, moderate inflation, self-sufficiency in major food grains, and, until recently, growing reserves. The authorities were certainly to be commended for their achievements.

In the coming period, the authorities must consolidate the gains they had made, Mr. Nimatallah continued. To that end, they should pay particular attention to three policy areas. First, further fiscal reforms were needed to increase domestic savings. Second, incentives should be maintained to encourage domestic production and greater private sector participation in the economy. Third, export competitiveness should be maintained to achieve a viable medium-term balance of payments position.

The authorities' commitment to reducing the overall budget deficit was welcome, Mr. Nimatallah said. However, further action was needed to strengthen the public finances, mobilize new resources, and increase investment. In that connection, the staff had usefully suggested that effective tax reform measures should be implemented as soon as possible. He agreed with the authorities that fiscal reform would take time, but they should be encouraged to intensify their efforts, especially as tax receipts were well below potential. Fund technical assistance in that area had already been provided, and he was confident that additional technical assistance could be made available if necessary. On the expenditure side, the authorities' determination to reduce the overall deficit by keeping the growth in current outlays within appropriate limits was impressive. At the same time, however, the authorities should be encouraged to avoid cutting public investment.

Increasing domestic savings was crucial for Pakistan's development process, Mr. Nimatallah considered, as it would offset the declining flows of remittances and reduce the country's reliance on external borrowing. Indeed, the authorities should spare no effort to mobilize and generate savings. Such efforts would increase confidence in the Government's policies. The authorities had made impressive efforts to mobilize savings and encourage project financing on the basis of Islamic principles. The citizens of Pakistan, like citizens in many Muslim countries, could be expected to save if they could secure their savings in sound financial institutions, if appropriate incentives were provided for a rate of return that would not be impermissible by religious standards, and if they were able to use their savings whenever they chose to do so. The Pakistani authorities were gradually providing such a savings climate. The principles of Mudaraba and Musharaka had been successfully applied in Pakistan to attract savings for investment financing. In applying those principles, the authorities had created the appropriate institutions and framework within which to issue financial instruments and to attract funds.

Sharing risks and rewards was the underlying principle of Islamic banking, Mr. Nimatallah noted. Under Islamic banking practices and principles, financial transactions were nonspeculative and were conducive to a more equitable distribution of income. Mudaraba instruments were roughly similar to bonds, and Musharaka instruments were essentially similar to shares. Under a capitalistic system, bondholders and lenders secured a fixed return, while shareholders took all the risks involved, thereby leading over time to a distribution of income in favor of lenders of capital. Under the Islamic approach, both lenders and shareholders shared the risk and the return--whether positive or negative--in proportion to their contribution. That approach was consistent with the fundamental teaching of Islam of avoiding speculation and unfair income distribution. He was pleased that the Pakistani authorities were approaching the Islamization of the banking system in a prudent manner. Interest rates would continue to play a role in Pakistan's international transactions. He looked forward to the completion of the staff study on Islamic banking in the Middle East.

On the supply side, the far-reaching measures to eliminate cost and price distortions, reduce regulation, and improve incentives, had enhanced the efficiency of resource allocation, accelerated the growth in agricultural output, encouraged exploration for oil and gas, and improved industrial performance, Mr. Nimatallah commented. Hence, he strongly supported the authorities' intention to maintain those policies and to encourage greater private sector participation in the development effort. The liberalization of licensing and approval procedures for private investment was welcome. Good progress had also been made in improving the efficiency and profitability of public enterprises; the World Bank's technical and financial support had been useful.

The authorities had taken commendable steps to improve export competitiveness while liberalizing imports, Mr. Nimatallah noted. Although the results of those policies had been positive, the balance of payments had weakened since 1982/83. Some of the underlying causes of the weakness in the balance of payments were within the authorities' control, but others were not, and he hoped that the authorities would make every effort to enhance export competitiveness; to that end, the flexible exchange rate strategy should be maintained. He also hoped that Pakistan's trading partners would open their markets to Pakistan's exports to a greater extent. Finally, Mr. Finaish's comments on the authorities' determination to deal effectively with any possible adverse economic developments in the coming period were encouraging.

Mr. Goos recalled that, during the previous discussion on Pakistan, the performance of the economy had been hailed as an example of what a well-designed extended arrangement could achieve. However, since then, most of the earlier progress had not been maintained, or had actually been reversed. Of course, the poor crops in 1983/84 had adversely affected exports and the domestic economy, and the inflow of workers' remittances had dwindled. However, the most worrying recent economic developments--namely, the substantial deterioration in the external accounts, and the erosion of the fiscal position--had been due largely to inadequate policy measures. Indeed, during the previous discussion on Pakistan, the Executive Board had clearly warned the authorities to avoid weakening domestic demand management and had noted the potential risk of undue slippages and delays in meeting the structural reform objectives. Although the authorities had adopted a cautious monetary policy, which had helped to contain inflationary pressures, much remained to be done in structural reform: the deregulation and reform of the tariff system had not yet been achieved; the import system was still complex; price liberalization had been much slower than might have been wished, as, for example, domestic energy prices were still substantially below world market prices; and, perhaps most important, there had been repeated delays in strengthening the structure of public finances. The authorities had made some progress in recent years, but the economy would probably have been more resilient to the external shocks experienced during the previous year if the structural problems had been tackled more forcefully. Further delay in making the needed structural reforms would run the risk of increasing the imbalances of the economy.

The staff's general assessment of the problems facing Pakistan's economy was fully appropriate, Mr. Goos said. Given the low savings ratio, it was not surprising that fiscal performance had closely paralleled developments in the external current account. The most recent revision of the balance of payments forecast for 1984/85 underscored the urgent need to improve the fiscal position. Maintaining the current wait-and-see attitude in the fiscal area would be counterproductive. The authorities should be strongly encouraged to implement the long-delayed tax reform measures to deal with the inelasticity of the tax system and improve public revenue performance. That the authorities seemed reluctant to introduce such reforms and preferred instead to continue their more gradual approach was disappointing. A gradual approach was not warranted at the present stage; it could offset the benefits of earlier adjustment efforts. Moreover, any tax reform measures would have to be supplemented by a greatly increased effort to contain current expenditure. In that connection, the impressive reductions in subsidies were welcome, but accelerating the pace of the reduction would certainly be helpful.

The authorities' monetary policy stance seemed appropriate, but the most recent upward revision in the rate of growth of net credit to the Government was a cause for some concern, Mr. Goos commented. The authorities would have to be careful to keep slippages in net credit to the Government from undermining their ability to implement an appropriate monetary policy. Their intention to continue the Islamization of the financial system in a cautious manner was welcome. Due attention should be paid to the need to avoid any further decline in the already low savings ratio. He wondered to what extent the significant reduction in workers' remittances was traceable to the elimination of interest-bearing deposits.

He was somewhat concerned about the authorities' intention to continue borrowing in the domestic nonbank market by using interest-bearing credit instruments that were no longer available to other borrowers, Mr. Goos continued. That policy could easily crowd out the private sector. Apparently the authorities believed that the supply of credit to the private sector was adequate, while the staff had some reservations about that conclusion. The Government had provided financial institutions with $200 million in foreign exchange for loans to the private sector, but only $40 million had actually been borrowed. He wondered why the private sector had hesitated to use the available funds.

The authorities' more realistic assessment of the balance of payments outlook and their consideration of policy options to enhance export performance were welcome, Mr. Goos said. A further comment on their intentions would be helpful. He agreed with the staff that an exchange rate adjustment would be appropriate if the rupee were found to be overvalued in real terms. Such a finding would not be surprising, given the recent strong downward revision of the export growth rate, which might be an indication of a general deterioration in the country's external competitiveness. Of course, any exchange rate action should be supplemented by the adoption of more rigorous structural adjustment measures.

The authorities' continued recourse to bilateral payments arrangements was a cause for concern, and the staff had correctly decided not to recommend approval of them, Mr. Goos remarked. He also agreed with the staff that the import regime should be simplified. Import liberalization had been a major objective under the extended arrangement, and it would be unfortunate if the significant benefits of meeting that objective were lost through the reintroduction of inappropriate import regulations.

Mr. Clark commented that, in some respects, Pakistan's economy had continued to perform well. Growth had been sustained, although it had slackened from the pace of the early 1980s; the rate of inflation, although it had accelerated somewhat, had been relatively well contained. However, some worrying trends had emerged, particularly in the fiscal and balance of payments areas, and, if not tackled promptly, they could seriously undermine economic performance in the future.

During the previous Article IV consultation with Pakistan, his chair had noted that the progress under the extended arrangement had not been consolidated and could easily be reversed, and there were already indications that that was happening, Mr. Clark said. The improvements under the extended arrangement had not been followed through into continuing economic reforms, and the authorities needed to take substantial steps to reform the tax system and liberalize the trade regime; they should also take further steps in domestic pricing. The authorities' modest plans for introducing such measures were disappointing.

The authorities had made no genuine progress either in expanding the coverage of the tax system, or in shifting from reliance on trade taxes toward taxes on domestic income and spending, Mr. Clark commented. Under the 1984/85 budget, tax revenues in relation to GNP were the lowest in many years. He would welcome the staff's comments on the likely effect, if any, of Islamization of the tax system on the overall fiscal position. As he understood it, the yield of the Zakat had no substantial net impact, because it was collected, and the proceeds were disbursed, locally. The authorities recognized the need for greater fiscal restraint, but, like the staff, he wondered whether their efforts in that area--particularly the setting of very restrictive expenditure targets--were fully credible. A number of major areas of expenditure, especially defense and interest payments, together representing approximately 60 percent of total expenditure, might be difficult to restrain. A medium-term approach to fiscal planning was necessary. The authorities had expressed their reservations about the value of medium-term projections, but if such projections were seen as a way of indicating the areas where pressures were likely to arise, rather than as forecasts, they could be useful.

Domestic savings amounted to only 5 percent of GNP, Mr. Clark noted. That fact reinforced his concern that the Government's heavy reliance on internal borrowing to cover the persistently large budget deficits might be crowding out private sector investment. In that connection, further discussion of how Islamization affected the mechanism of government funding, and of nonbank lending to the Government in particular, would have been helpful.

The excessive buildup of liquidity in 1982/83 had apparently affected the rate of inflation in 1983/84, and the velocity of money had been volatile, Mr. Clark commented. He agreed with the staff that the behavior of net unclassified liabilities in the banking system might reflect attempts to circumvent credit targets.

During the previous Article IV consultation, his chair had drawn attention to the country's heavy reliance on the continued buoyancy of workers' remittances and had underscored the uncertain nature of those inflows, Mr. Clark recalled. It was disturbing to find that there had indeed been a substantial decline in workers' remittances, which, together with the decline in exports, had placed the external accounts under considerable pressure. The Sixth Development Plan, which would be in effect through 1987/88, projected a substantial rise in export receipts, mainly from higher-value products. In fact, however, Pakistan's export receipts apparently were still vulnerable because of their geographical and product concentration.

He regretted that the authorities had taken only limited steps away from the present complex and inefficient import licensing system, which, under the extended arrangement, was to have been eliminated by July 1983, Mr. Clark continued. Apparently the system was to remain in place for at least another four or five years. Given the most recent economic developments, the authorities should be strongly encouraged to re-examine the case for an exchange rate adjustment, rather than continue to rely on controls and subsidies. Unless substantial action were taken, there was a risk that the external financing gap could be much larger than the $5 billion foreseen by the staff over the coming five years. The staff could have usefully constructed a set of medium-term projections, despite the authorities' reservations. It was true that the debt service ratio was relatively low, as the average interest rate on Pakistan's external debt was only around 3 percent and reflected Pakistan's heavy reliance in the past on concessional assistance. However, there was some question whether it was realistic to assume that the same structure of financing could be maintained in the future.

Commenting on industrial and development policy, Mr. Clark said that, despite the relatively depressed cotton sector, manufacturing output had expanded rapidly--by approximately 9 percent per annum--during the fifth plan period. However, the growth had been dominated by public sector and large-scale industrial units. The success in promoting private sector investment had been limited, reflecting perhaps some crowding out of that sector, excessive government regulation, and uncertainty about government policies. Under the Sixth Development Plan, the authorities intended to ease the burden posed by regulations, but during the previous fiscal year there had been a major shortfall in imports of capital goods by the private sector. A further comment on the future direction of government policy on deregulation and private sector activity would be helpful.

The Pakistani economy had a number of positive features and had made progress in recent years, Mr. Clark concluded. However, there was now some risk that progress could be reversed, and that financial imbalances would increase sharply unless firm policy action were taken. The authorities should be encouraged to follow the advice given during the present and previous consultation discussions.

Mr. Vasudevan remarked that, as Mr. Zhang had appropriately stressed, Pakistan's economic performance during the previous several years had been fairly impressive, despite the rather subdued tone of the staff appraisal. High real GDP growth rates had been registered, the rate of inflation had been fairly moderate, monetary expansion had been kept within reasonable bounds, and, although the external current account deficit had grown, the debt service ratio seemed manageable at present. Some Executive Directors had noted that the latest available information suggested that the fiscal position had deteriorated; in fact, the fiscal deficit had been stabilized at about the size recorded in 1982/83. In addition, agricultural production was expected to reach a record level in 1984/85.

The staff had concluded that the fiscal and balance of payments positions were a cause for concern, Mr. Vasudevan noted. According to the revised forecast, the fiscal deficit in 1984/85 would be larger than estimated, because of revenue shortfalls and unexpectedly large expenditures on imports and external debt servicing owing to the further depreciation of the rupee. Mr. Finaish had stated that the expenditure overruns would not adversely affect the quality of public outlays; he had noted that the composition of development expenditures had improved, and that current expenditures were being channeled increasingly to cover the maintenance of infrastructure and to improve educational and health services. The authorities should be encouraged to improve the nature and quality of expenditures with a view to restraining current expenditure, especially on security, which amounted to some 30 percent of total expenditure. The need to increase revenues through tax or price measures should be met over the medium term. At the same time, Pakistan should take steps to mobilize domestic savings in order to increase the domestic savings ratio.

In recent years, the authorities had deliberately reduced the size of the public sector and encouraged private sector activity, Mr. Vasudevan remarked. As a result, public sector investment in manufacturing had declined, and there had been an offsetting increase in private sector investment; overall investment in relation to GNP had remained remarkably stable, an important achievement. However, he suspected that the private sector had been unduly cautious in implementing its investment plans, and he hoped that the sector would soon display the requisite dynamism.

According to the revised forecast for 1984/85, the external current account deficit would increase because of the persistent weakness in exports and the continued decline in workers' remittances, Mr. Vasudevan commented. Mr. Finaish had noted that the authorities had the situation under close review and were examining the policy options available to reverse the weakening of the external position. He had also hinted that the prospects for specific exports--especially nontraditional, manufactured goods--were being studied. He agreed with Mr. Finaish that the authorities' efforts would be helped if the barriers in industrial countries to some key exports, such as textiles, were reduced. He was pleased that the authorities were reviewing the method of calculating the real effective exchange rate, and that they did not favor introducing export subsidies--despite the strong domestic pressures for them--mainly because of their adverse effect on the budget.

The authorities' external debt policy had been prudent, Mr. Vasudevan considered. Debt service payments were about 14 percent of current account receipts and might well decline if export performance improved and workers' remittances remained at least stable.

The stringency of monetary policy and its favorable effect on prices were striking, Mr. Vasudevan said. The authorities' cautious approach to the Islamization of the financial system was appropriate, as it would enable accounting practices to be adjusted without disrupting the existing system.

Mr. Leonard remarked that many aspects of the economy's performance in recent years had been satisfactory. There had been strong economic growth, the country had come closer to self-sufficiency in food production, and the rate of inflation had generally been slower than at the beginning of the 1980s. Moreover, the ratio of external debt to GNP had declined, while the debt service ratio had remained manageable. As 85 percent of Pakistan's external debt was concessional and at fixed rates, the economy appeared to be essentially insulated against the effects of future increases in international interest rates. Signs of potential imbalances in the economy had been evident in 1983/84, but in recent months it had seemed reasonable to expect the signs to disappear. However, the latest available information suggested that the adverse trends had gained momentum in 1984/85 and would require the authorities' close attention.

During the previous discussion on Pakistan, his chair had expressed its concern about the medium-term viability of the external position, Mr. Leonard recalled, and the information in the present staff papers showed that the concern had been warranted. The rate of inflation had risen significantly during the previous year, and the overall balance on the external accounts had moved from positive to negative. The upward movement of prices still seemed strong, and the authorities' revised forecast suggested that the external current account deficit would increase by approximately $450 million, to $1.6 billion, or 4.4 percent of GNP, and that the deterioration in the overall external balance would be even greater. Moreover, rough projections suggested that there was some risk of an unmanageable financing gap emerging. Action was obviously needed to correct those trends. As had been noted during the previous consultation discussion, strong adjustment measures were particularly needed to strengthen export competitiveness and to achieve a better sharing of the burden of the adjustment effort between the public and the private sectors. In the immediate future, additional demand management measures would also be required.

The restrictive monetary policy in 1983/84-1984/85 was welcome, particularly in the light of the surge in inflation and the current price trend, Mr. Leonard said. He was pleased that the monetary outcome for the present fiscal year was expected to be more or less as the authorities had expected. The means of obtaining that outcome would of course be different from the authorities' initial expectations, as the behavior of foreign assets and domestic assets had differed from the authorities' expectations. The authorities should have taken appropriate action to contain public sector demand for bank financing.

It was equally important to limit nonbank financing of the public sector, as there was reason to believe that the already heavy reliance by the public sector on private sector savings had been a factor in the poor performance of private sector investment, Mr. Leonard continued. Although the prospective public sector deficit in 1984/85 was larger than initially expected, the extent of the inroads on private sector savings had been reduced through higher borrowing from other sources. Looking to the future, he agreed with the staff that the authorities should examine potential expenditure cuts. In doing so, however, they should be careful to avoid excessive cuts in development expenditure, which had already borne the brunt of fiscal restraint, while current expenditure had repeatedly exceeded planned levels. He also agreed with the staff that the efforts to restore fiscal balance should increase the income elasticity of the tax system.

The sluggish performance of exports and the decline in workers' remittances had been a cause for growing concern, Mr. Leonard commented. In past years, disappointing export performance had been blamed on the global recession and poor harvests of export crops, but at present there were indications that a reduction in competitiveness had also played a role. The authorities had correctly decided to resist pressures to increase export subsidies as a means of encouraging exports; such subsidies caused fiscal strain as well as resource misallocation and invited reprisals by other countries. An appropriate exchange rate adjustment and policies designed to promote considerable flexibility in the economy were greatly preferable means of promoting exports. Hence, the authorities' determination to improve the operation of the managed exchange rate system was welcome. They should also be encouraged to promote greater market determination of domestic prices and to reduce import barriers further.

Since 1982/83, workers' remittances had been a larger source of foreign exchange than merchandise exports, Mr. Leonard noted. If, as the staff suspected, the decline in those remittances was structural, the consequences for the external balance would be significant. A further decline in workers' remittances would depress the national savings rate and investment, thereby undermining the prospects for favorable economic growth in the medium term. In one sense, those trends were already apparent, as there was some doubt whether the assumptions underlying the authorities' medium-term plans were realistic. He agreed with the staff that the authorities should be encouraged to examine the causes of the decline in remittances--including the possible influence of the exchange rate--and to initiate whatever adjustment measures might be called for. It would be useful to know the extent to which the revision of the forecasts for GDP growth in 1985/86-1987/88 was due to the changed prospects for export receipts.

Even if the decline in workers' remittances were found to be temporary in nature, rather than structural, the urgent need for appropriate policy action would remain, Mr. Leonard said. The flow of workers' remittances was the mirror image of the progress made in developing the domestic economy: unless the economy stagnated, workers' remittances would diminish over time, as fewer workers would migrate and those already abroad would return to Pakistan. The tapering off of workers' remittances was likely to be prolonged, but the sooner offsetting trade measures were introduced, the better. Such measures would be consistent with the authorities' design for Pakistan's long-term development; in that connection, a considerable increase in manufactured exports seemed required. To that end, the authorities should act as quickly as possible to increase productive private investment and expand the industrial base.

The relaxation of exchange controls on invisible payments was welcome, Mr. Leonard remarked. He agreed with the staff that the authorities should remove exchange restrictions in the form of bilateral payments arrangements.

In recent years, the World Bank had significantly helped Pakistan to implement structural adjustment measures, Mr. Leonard commented. Continued structural adjustment would be needed if Pakistan were to achieve both a viable balance of payments position and an acceptable rate of economic growth over the medium term. Both the Fund and the World Bank were likely to be involved in that process, and the high degree of cooperation between the two institutions in aiding Pakistan should continue and, if necessary, be increased.

Mr. Jaafar said that he agreed with Mr. Zhang that the behavior of the various macroeconomic variables in 1983/84 had been satisfactory, despite the adverse impact of special domestic and external factors. The authorities were to be commended for the impressive growth in real GDP over the previous several years.

Impressive progress had also been made in strengthening public finances in the period after the extended arrangement, Mr. Jaafar remarked.

The authorities' commitment to reducing the fiscal deficit to a more sustainable figure was clearly reflected in the budgets for 1983/84 and 1984/85. For example, revenue performance in 1983/84 had been impressive, and there was evidence of expenditure restraint. The authorities were to be commended for their efforts in the fiscal area, although the large size of the overall fiscal deficit was still worrying. Indeed, according to the latest estimates, the budget deficit in 1984/85 was 6.3 percent of GDP, rather than the 5.6 percent initially projected. The various fiscal problems had been addressed under the extended arrangement, but the need remained for fundamental action on the fiscal front.

During the previous discussion on Pakistan, the Executive Board had stressed the importance of tax reform, Mr. Jaafar recalled, and he agreed with the staff that the authorities had not made sufficient progress in that area. The present tax system was not buoyant; moreover, it was excessively dependent on imports as the primary source of revenue. Mr. Finaish had usefully noted that tax evasion was still a major problem, and that solving it could generate more revenues than new tax measures, but he agreed with the staff that the coverage of the tax system should be broadened, and that reliance on domestic revenue sources should increase. That approach would ensure a more stable tax base and enhance tax revenues. The lack of progress in the tax field was regrettable, and the authorities should make the needed changes without delay.

The crucial need for tax reform was underscored by the constraint on development spending owing to the poor revenue performance, Mr. Jaafar remarked. Development expenditure by the public sector had actually declined in real terms because of the domestic resource constraint. The ratio of private savings to GDP was already low by international standards; therefore, using those savings to finance public investment would not be an adequate solution, as it would deprive the private sector of the funds needed to sustain its investments.

The authorities' monetary and credit policies were consistent with their objective of containing inflation, Mr. Jaafar commented. The growth of the monetary aggregates had moderated in 1983/84, and a similar outcome was expected in 1984/85. The authorities were to be commended for that trend, but they should avoid any further extraordinary recourse to the domestic banking system to finance the budget deficit. After all, domestic financing in 1984/85 had been estimated at PRs 9 billion by November 1984, compared with the forecast of PRs 2.5 billion for the entire fiscal year. The authorities should ensure that sufficient credit from the banking system would be available to sectors outside the Government.

The steps that the authorities had taken to apply Islamic banking principles in Pakistan were welcome, and he looked forward to a report on the progress in that area during the next Article IV consultation, Mr. Jaafar said. He doubted whether there was any link between the application of those principles and the decline in workers' remittances. Changes in economic conditions abroad had probably been the main factor in the fall in those remittances.

The recent weakening in the balance of payments was worrying, Mr. Jaafar commented. The deterioration had exceeded the authorities' expectations, and new measures were clearly needed to adjust to changing external conditions. In his opening statement Mr. Finaish had shown that the authorities were aware of the problem and were examining possible policy options. The weakness in workers' remittances could be structural; therefore, the official projection of 2 1/2 percent growth in those remittances over the coming five years should be re-examined, and appropriate adjustments to the trend in remittances should be made. Moreover, the revised export projection for 1984/85 had significantly changed the balance of payments prospects for that year and subsequent years. The combined effect of the decline in workers' remittances and the weak export performance accounted for the projected sharp increase in the original estimate for the external current account deficit in 1984/85 from 3.2 percent of GDP to 4.5 percent; at the same time, a substantial overall balance of payments deficit was expected, and gross official reserves were expected to fall to the equivalent of less than 13 weeks' imports in 1984/85. The weak export performance suggested the need for the authorities to examine Pakistan's export competitiveness. In that connection, export subsidies would not be an appropriate solution, and the authorities were to be commended for resisting pressure to increase those subsidies.

The medium-term balance of payments projection was useful, as it highlighted the prospects and the available policy options, Mr. Jaafar said. Given the latest revisions in the outlook for the external position in 1984/85, the authorities would probably have to revise their projections for the coming four years; to that end, the staff's analysis on page 15 of SM/85/29 should be helpful. The projected 7 percent annual increase in imports over the coming four years no longer seemed attainable, as it would require a 20 percent increase in exports, something that was unlikely. The projected growth of workers' remittances of 3 percent per annum also might not be realized. According to the staff's simulations, which were based on what the staff felt were more realistic assumptions regarding exports and workers' remittances under present policies, Pakistan would face a financing gap of $2-5 billion in the coming four years. A financing gap of $5 billion could emerge if workers' remittances were to decline by 2-3 percentage points each year, if imports and exports were to grow by 10 percent and 7 percent, respectively, each year, and if gross reserves were to be maintained at the equivalent of two months' imports. Those calculations underscored the need for the authorities to implement appropriate adjustment policies. Mr. Finaish had said that exports could recover significantly in coming months because of the good harvests; a further comment on the possible effect of that outcome on the balance of payments in the coming year and on the medium-term scenarios would be helpful. Trade barriers in industrial countries had hurt Pakistan's exports, particularly textiles. The Pakistani authorities' adjustment efforts would be much easier if trade barriers abroad were reduced. Finally, the proposed decision was acceptable.

Mr. Polak remarked that Pakistan's continued impressive growth performance was due to a significant extent to the authorities' judicious handling of the economy. They had made good use of the opportunity to maintain a steady policy stance designed to achieve adjustment with growth. Their progress in implementing needed structural adjustments had been steady, although slow and, recently, perhaps excessively slow.

On the whole, the authorities' macroeconomic policies had been cautious, Mr. Polak commented. However, the authorities had apparently persisted in maintaining existing policies instead of responding promptly to changing conditions. At the present stage, the most important issue was the extent and nature of the stagnation in foreign exchange earnings. In that connection, the recent developments described by the staff were disquieting: the projection for foreign exchange earnings in 1984/85 had been revised from an increase of $360 million to a decline of $350 million; gross official reserves had been nearly halved over the previous seven months. The foreign exchange shortfall was traceable mainly to export performance. Cotton exports might well pick up following the recent bumper crop, but recent developments in exports of manufactures were worrying. Those exports accounted for more than half of total exports, and volume growth apparently was declining for the second consecutive year, despite the increase in world trade.

Pakistan's competitiveness, as indicated by the movement in the real effective exchange rate, had been eroding during the previous two years, Mr. Polak noted. Faced with the same problem several years previously, Pakistan had responded by permitting a sufficient depreciation of the exchange rate. The authorities' present determination to solve the problem by means other than an increase in export subsidies was welcome. The existence of export subsidies was an indication that the exchange rate had not been sufficiently adjusted.

As sources of foreign exchange, workers' remittances were as important as exports of manufactures, Mr. Polak commented. The volatility of workers' remittances in past years had posed a problem for policymaking in Pakistan. The authorities should not wait and see whether the recent decline in workers' remittances was temporary or structural. The staff had presented only a limited discussion of the causes of the decline in workers' remittances. More detailed information on the areas from which workers' remittances had declined, and on the number of Pakistanis working in various different foreign countries, would be helpful. The sharp increase in the value of the dollar against the currencies in which Pakistani workers abroad were paid, as well as against the rupee, might help to explain the decline in workers' remittances to Pakistan.

Given the rapid deterioration in the balance of payments together with the 8 percent growth in real GDP, the weaking in the fiscal position seemed particularly inappropriate, Mr. Polak said. The fiscal position must be brought under control. Pakistan had enjoyed a remarkable degree of fiscal stability over the previous six years, when revenues and expenditures as percentages of GNP had remained roughly stable. That outcome was commendable, but the authorities' inability to reduce the structural gap between revenues and expenditures was disappointing. There was a clear need for structural improvement in tax revenues; stricter administration of the present tax laws would in itself be insufficient. Continued financing of the budget deficit through domestic credit threatened both the balance of payments and price stability. However, the staff conclusion on page 18 of SM/85/29 that excessive use of private savings to finance the budget deficit weakened private investment was puzzling. After all, private investment as a share of GDP had increased during the previous several years. Apparently the generous provision of credit to the economy had compensated for the reliance on private savings to finance the budget deficit, a trend that had increased the burden on the balance of payments.

Irrespective of the medium-term prospects, the balance of payments required immediate policy action, Mr. Polak considered. Pakistan did not have sufficient reserves to sustain another annual balance of payments deficit as large as the one expected in 1984/85. The country's medium-term debt profile could worsen rapidly if the external financing gap were closed by additional commercial borrowing. He hoped that the authorities would resist the temptation to increase bank borrowing from abroad.

The staff's visit to Pakistan shortly after the Article IV consultation discussions in order to provide the Executive Board with an appraisal of the latest economic developments was an encouraging example of enhanced surveillance that should be emulated in similiar future cases, Mr. Polak said.

Mr. Dallara considered that the authorities were to be commended for the number of positive developments in the economy over the previous several years, and particularly the positive economic growth, the containment of inflation, and the near attainment of self-sufficiency in food grains. However, the latest available information suggested that some of the authorities' achievements were in danger of being reversed; prompt policy action was needed to avoid that outcome.

Economic developments during the previous fiscal year had been less favorable than originally forecast, Mr. Dallara noted: the external current account deficit had increased; the budget position had improved less than the authorities had expected; the pace of real economic growth had slowed; the rate of inflation had accelerated. Moreover, developments in the first six months of 1984/85 were not very encouraging, in contrast with the promising trends discernible during the previous Article IV consultation with Pakistan.

The reforms introduced thus far in the trade sector had been aimed at improving the efficiency of domestic industries, Mr. Dallara observed. The tariff reform originally to have been introduced in July 1983 had been postponed for four or five years. Moreover, the list of prohibited imports remained extensive, and export subsidies had not been further reduced. Such subsidies hampered the movement of resources to industries that enjoyed a genuine comparative advantage and burdened the budget, which continued to be in substantial deficit. The authorities had further adjusted procurement prices for rice, cotton, and wheat, and the effect on output had generally been positive. Energy prices also had been adjusted but still remained considerably below international prices. He was pleased that the authorities had reduced the regulation of investment, and that foreign exchange was being provided to the private sector to finance imports of capital goods. He wondered why only $40 million of the $200 million in foreign exchange allocated to the private sector had actually been used.

Although there had been several positive developments in pricing and related areas, the continued extensive government control over resource allocation was worrying, as it undermined efficiency and limited the benefits from regional development and specialization, Mr. Dallara remarked. The financial performance of the public enterprises had clearly improved, but divestiture of some of them still seemed the best solution.

There was an increasing need to reduce the fiscal deficit--which had reached the equivalent of 6 percent of GDP during the previous fiscal year--in order for more resources to be available to support the growth of the private sector, Mr. Dallara said. Foreign financing had fallen short of expectations, and the increase in net domestic credit to the public sector had been unexpectedly large. A smaller fiscal deficit would enable the authorities to reduce the Government's recourse to nonbank borrowing. The low elasticity of the tax system suggested that stronger tax reform measures were needed, but the thrust of fiscal adjustment should be on expenditure restraint. He was pleased that the authorities shared that view, although the latest information indicated that they were having difficulty in restraining expenditure. The fiscal deficit was expected to reach the equivalent of 6.3 percent of GDP in the present fiscal year, despite the authorities' efforts to reduce it. The authorities should be urged to adopt additional measures in the current fiscal year, rather than wait to do so until the start of the next fiscal year, particularly in view of the need for higher rates of savings, investment, and economic growth.

The decline in workers' remittances, a major source of national savings, underscored the need to increase the rate of domestic savings, Mr. Dallara continued. The authorities must ensure adequate real rates of return in the banking sector to generate domestic savings and to encourage the inflow of workers' remittances.

Pakistan's export base should be broadened to ensure positive economic growth in the medium term, Mr. Dallara remarked. In addition, an adjustment of the exchange rate could increase the inflow of workers' remittances; the adjustment in 1982 apparently had had a positive effect on those remittances. The discussion on page 76 of SM/85/31 suggested that slack economic activity in the oil exporting countries had not been the main cause of the decline in workers' remittances in Pakistan in 1983. A further comment on the current sources of workers' remittances and the likely response of those inflows to an adjustment of the exchange rate would be helpful. The trend in workers' remittances was important not only for the medium-term outlook, but also for the immediate future. The staff's helpful simulations, which were based on the assumption of a continued decline in workers' remittances, suggested that a financing gap in the range of $2-5 billion could emerge over the coming four years. The large size of the potential gap clearly indicated the need for prompt action on both the domestic and the external fronts. The authorities might not have time to wait and see whether the present trend in workers' remittances was temporary or structural. Nor did they have much time to react to the drop of $800 million in official reserves during the previous eight months.

The proposed decision was acceptable, Mr. Dallara concluded. A number of recent economic developments in Pakistan had been positive, but other developments and the uncertainty about the sustainability of the current positive trends in the economy were a cause for concern. The authorities should be urged to take appropriate steps to deal with those developments.

Mr. Sugita considered that the authorities had made substantial progress in restructuring the economy under the extended arrangement. Some slippages and delays had occurred, but the significant structural reform measures introduced had contributed to the stronger real output growth during the life of the arrangement. The increase in the output of major crops in response to the more realistic procurement prices had been particularly encouraging. In recent months, however, the efforts to rationalize costs and prices apparently had weakened, although some progress had been made in rationalizing energy prices and the procurement price for wheat. Although the authorities intended to eliminate fertilizer subsidies by mid-1985, the reduction in spending on those subsidies had been smaller than had been expected under the 1984/85 budget. In addition, despite the authorities' objective of adjusting irrigation water charges to cover full operating and maintenance costs, no increase in those charges had been made in FY 1983/84, and only a moderate increase was included in the FY 1984/85 budget. Pakistan's disappointing savings and investment performance during the period of the extended arrangement and the continued weakness in 1983/84 were also disappointing. The ratio of gross fixed investment to GNP had averaged less than 14 percent over the previous four years, and the ratio of public gross fixed investment to GNP had declined over the same period, partly owing to budgetary constraints. The substantial reliance on private sector savings to finance the large budget deficits had contributed to the weak private investment performance.

He agreed with the main thrust of the staff appraisal, Mr. Sugita said. One of the staff's main conclusions was that, despite the authorities' efforts, the fiscal deficit had been increasing. According to the latest estimates, the deficit for 1984/85 would not only exceed the original forecast, but would equal the deficit registered in the previous year. Strict expenditure restraint was being exercised in order to keep the growth in the deficit from exceeding 6 percent of GDP in 1985/86. However, given the large increase in current expenditure during the previous two years, he agreed with the staff that achieving the 6 percent target would require a strenuous effort by the authorities in coming months. Introducing additional fiscal measures might be necessary to achieve the target, and the authorities might have to be prepared to adopt the contingency plan recommended by the staff. The chronic budget deficits suggested the need for new revenue measures, as well as expenditure restraint. The tax system, which relied excessively on import taxes, clearly lacked sufficient elasticity. The authorities should be urged to introduce measures to broaden the tax base and to increase the elasticity of the tax system.

The excess liquidity created in 1982/83 had apparently intensified price pressures in 1983/84, although the increase in unclassified liabilities of the banking system had also been a factor in the increased price pressure, Mr. Sugita commented. The authorities were committed to maintaining a tight monetary policy stance in 1984/85. Their target of an 11 percent increase in domestic liquidity in that year was appropriate, but their ability to achieve it would depend on the extent to which they could contain the fiscal deficit and bank financing of the deficit.

The balance of payments had deteriorated because of the weak performance of workers' remittances and exports, Mr. Sugita noted. The authorities were concerned about recent developments in the balance of payments. If the weakness in the external position were to persist, serious consideration would have to be given to the implementation of a more active exchange rate policy. The medium-term forecasts, which were based on realistic assumptions, suggested that a substantial financing gap--$2-5 billion--might emerge over the coming four years. Additional domestic policy measures, together with an active exchange rate policy, were needed to strengthen external performance. Finally, he agreed with the staff that the authorities should be urged to eliminate the restrictive features of the bilateral payments arrangements. The proposed decision was acceptable.

Mr. Ercel said that he agreed that the authorities had made satisfactory progress in recent years, particularly during the period of the extended arrangement, when output had grown rapidly, the rate of inflation had been relatively low, and monetary growth had been balanced. Since then, however, a number of external and internal factors had negatively affected the country's foreign exchange earnings, causing a larger than expected external current account deficit. In addition, the large budget deficit and the remaining structural weaknesses in the economy, especially the low gross domestic savings and investment ratios, were still causes for concern.

Although the real GDP growth rate and the rate of inflation had been nearly constant over the previous four years, tax revenues had fluctuated considerably, Mr. Ercel noted. Over the medium term, the authorities should make the domestic tax system elastic by implementing a wide range of reforms. They should also pay closer attention to subsidy policy and establish better control over current expenditure. That policy mix would not only help to reduce the budget deficit but also increase the growth rate of the share of development expenditures in total outlays.

The external current account deficit had averaged about $1 billion over the previous five years, Mr. Ercel noted. The two most important elements of that account--exports and workers' remittances--had fluctuated during the previous four years: their annual growth rates had increased and then declined. The fluctuations had been caused by policy actions, external conditions, and changes in agricultural output.

Workers' remittances were important to the economy, Mr. Ercel commented. They exceeded export earnings, and their contribution to national savings exceeded that of domestic savings. Workers' remittances gave a developing country a good opportunity to obtain needed savings and foreign exchange, but they were very sensitive to both external and internal developments and to the impact of domestic policies; moreover, they tended to react so quickly to changing circumstances that policymakers could not keep abreast of developments in those remittances. Hence, the more a country depended on workers' remittances, the more flexible its policy actions must be to protect those inflows. Without that preparation, the authorities would run the risk that their projections of the balance of payments and national income account would not be realized. For those reasons, it seemed advisable to gradually reduce the relative importance of workers' remittances over the medium and longer run by increasing exports of goods and services and by strengthening the other elements of the balance of payments.

The medium-term projections for the balance of payments and external debt indicated that the debt service ratio was likely to remain manageable, Mr. Ercel remarked. The authorities should give priority to encouraging exports in order to ensure a healthy evolution of the external accounts.

Mr. Mtei recalled that, during the previous discussion on Pakistan, the Executive Board had urged the authorities to strengthen demand management and to continue the import liberalization and structural reforms. The authorities had in fact done so with considerable success in 1983/84. The contractionary fiscal policy, structural reforms, and supply-side measures had helped to keep the overall economic situation from seriously deteriorating in 1983/84, when adverse weather and other factors beyond the authorities' control had resulted in the lowest rate of GDP growth in recent years, namely, 4.5 percent, compared with more than 6 percent in earlier years.

If the economy were to regain its earlier vigor, the authorities should adopt additional measures affecting public finance and trade, Mr. Mtei commented. Their successful demand management had reduced the budget deficit from the equivalent of more than 7 percent of GDP in 1982/83 to 6 percent in 1983/84, despite the exceptional current expenditures, including increased subsidies and transfers. The authorities had also succeeded in shifting the burden of financing the budget deficit from banking to nonbanking sources. They had intended to reduce the budget deficit to 5.6 percent of GDP in the present fiscal year and to cut domestic bank financing of the deficit to only 1.2 percent of GDP, but preliminary estimates indicated that the deficit would be 6.3 percent of GDP and domestic bank financing 2.6 percent. The slippage underscored the basic weakness of public finances owing to the inelasticity of the tax system. The budgetary restraint in 1984 had been possible because of the suppressed expenditure, particularly capital expenditure, which had not been permitted to increase even in nominal terms. Capital expenditure obviously could not be held constant in the future, and the authorities should be urged to conduct a major review of the tax system with a view to finding means of increasing its elasticity.

As a result of the considerable success in industrialization, more than half of Pakistan's exports consisted of manufactured goods, Mr. Mtei observed. Agricultural exports had fluctuated from year to year, but the growth in manufactured exports had become rather sluggish, despite considerable efforts at restructuring and deregulation. The broad range of structural reforms that had already been implemented was commendable. The authorities had continued their efforts to rehabilitate industries and had permitted a broader range of capital goods and raw material imports. They were also providing additional stimulus to public industries whose profitability had traditionally been low; a new bonus scheme for managers of profitable industries had been introduced. The authorities should be encouraged to pay even greater attention to the future competitiveness of exports. They were considering possible studies on the effective exchange rate to determine whether or not competitiveness had been eroded, and any additional information on developments in that area would be helpful.

Timely adjustment of the rupee, if it were found to have appreciated in effective terms, would not only increase competitiveness but also help the overall balance of payments, which had been deteriorating, Mr. Mtei commented. Despite the record output of cotton and rice, total exports were not expected to grow in the present fiscal year; according to earlier projections, exports had been expected to increase by 11 percent. The stagnation of exports and the sharp decline in workers' remittances were expected to increase the external current account deficit to $1.6 billion, or more than 4 percent of GNP. The authorities should act quickly to adopt appropriate exchange rate measures and maintain the supply-side restructuring effort to avoid the emergence of a financing gap which, according to the staff estimates, could reach $5 billion over the coming four years. Finally, the proposed decision was acceptable.

Mr. Salehkhou remarked that, after six consecutive years of progress, the economy had experienced an overall downturn in 1983/84. While the economy had grown in real terms at an average annual rate of more than 6 percent during the fifth Five-Year Plan, it had slowed to 4.5 percent in the first year of the Sixth Plan. The decline was attributable primarily to adverse weather conditions, pest infestation of the cotton crop, and constraints on irrigation of the wheat crop, which had contributed to the reduction of 5 percent in overall agricultural output; production of cotton and wheat in 1983/84 had been 40 percent and 12 percent, respectively, lower than in 1982/83. The unfavorable effects of poor weather had also been felt in the manufacturing sector, although its performance had remained strong, as output had grown by 7.7 percent in 1983/84; the projected increase of 9.3 percent had not occurred because of the adverse impact of the poor cotton crop on the ginning and textile industries. Nevertheless, agricultural and industrial output was expected to increase by some 10 percent in 1984/85, and GDP was expected to grow by approximately 8.5 percent. Indeed, the output of cotton had reached record levels. The recent positive production trends, the viability of the authorities' policies, and the appropriateness of their demand and credit management were results of the precautionary efforts to reduce impediments to efficient resource allocation and of measures designed to rationalize prices, conserve energy, develop energy substitutes, and upgrade the performance of industry in both the private and the public sectors.

The staff and the authorities held different views on the appropriate fiscal policy for Pakistan, particularly the means of reducing the overall budget deficit during 1984/85, and further comments on the issue would be helpful, Mr. Salehkhou said. Apparently the authorities were aware of the need to implement a prudent fiscal policy. They had significantly reduced the fiscal deficit in 1983/84 and intended to reduce it further in 1984/85, mainly through expenditure control and an increase in revenues. The staff had underscored the expected increase in current outlays, the likely revenue shortage, the inelasticity of the tax system, and the absence of a contingency plan in the event of a revenue shortfall. There were significant differences between the tone and substance of Mr. Finaish's positive opening statement and the staff appraisal and additional information in SM/85/29, Supplement 1.

A balance of payments surplus of $94 million had been expected during the previous two fiscal years, Mr. Salehkhou remarked. In fact, the external position had deteriorated, owing to a decline in workers' remittances, lower cotton exports, and the unexpectedly small volume of net capital inflows. In the light of the $170 million balance of payments deficit projected for 1984/85 and the detailed discussions between the authorities and the staff, particularly in December 1984, on exports, imports, and reserves, he was confident that the authorities would maintain their traditionally cautious external policies. There was no connection between the decline in workers' remittances and the implementation of Islamic banking principles in Pakistan; the main factor had been economic conditions in the neighboring countries where the remittances originated.

In monetary and credit policy, the most notable development in the current fiscal year was the broadening of the financial and banking systems and operations in accordance with Islamic principles, Mr. Salehkhou said. Any sincere and determined effort to adopt and implement complete and successful Islamic financing and banking principles and practices was welcome. During the previous discussion on Pakistan, the staff had promised to include in future Article IV consultation reports additional information on the introduction of Islamic banking principles and practices in Pakistan, especially as such a broad change was bound to have positive implications for the financial system of an economy as large as Pakistan's; any additional information on the subject would be welcome. He looked forward to the successful implementation of Islamic banking in Pakistan. The proposed decision was acceptable.

The staff representative from the Middle Eastern Department commented that the authorities had readily responded to the staff's suggestion to hold additional consultation discussions as soon as it had become apparent that the economic situation had changed significantly. The authorities had provided up-to-date information that had enabled the staff to report on developments through end-1984 and to clarify the main current issues and the latest prospects for the economy.

Some Executive Directors apparently felt that the tone of the staff appraisal was fairly pessimistic, the staff representative said. In that connection, it was important to bear in mind that there had been warning signals in 1983/84 of potential problems in the coming period. For example, real development expenditure had declined, savings had fallen, the investment ratio had remained relatively low, and the authorities could not have maintained the tight monetary policy stance without having incurred a balance of payments deficit. Moreover, the rupee had appreciated in real terms against a number of the major European currencies since mid-1983. The tone for the staff appraisal had been set by the staff's view on the prospects for 1984/85 and beyond and by the cautious approach that seemed called for in the light of the possible difficulties that the staff had described.

In its reports, the staff had not compared actual macroeconomic developments with the plan targets, the staff representative noted. However, the staff had assessed developments under the annual programs during the extended arrangement, and many of the program targets were similar to the plan targets. In any event, the plan had been sidetracked, as total expenditure under the annual development plans had been reduced from PRs 255 billion to PRs 180 billion. Subsequently, the authorities had begun to use a three-year period, rather than a five-year period, in making planning decisions. The staff would make every effort during the next consultation discussions to compare actual developments with the plan targets.

The question had been raised whether private sector investment had been constrained by the heavy demand made on private savings by financing for the budget, and some speakers had noted that only $40 million of the $200 million made available to specialized banks to finance imports of capital goods by the private sector had actually been used, the staff representative remarked. The issues involved were complex and interrelated. The return on private sector lending to the Government was attractive and tax free, and the investment risk was minimal. Moreover, the overall investment atmosphere resulting from the relaxation of restrictions, the general effort at deregulation, and import liberalization under the new industrial policy had not been as broad or as inviting as the private sector had expected. For example, the limit on access to foreign exchange, price regulation, and location policy had not been eased as much as had probably been necessary to encourage broader investment activity by the private sector. Still, the private sector's share in total investment had been increasing, and overall investment performance would have been much weaker in the absence of that trend.

The World Bank staff and the authorities were discussing a sectoral loan for the development of Pakistan's energy sector, including an increase in power generating capacity and further exploitation of natural gas, the staff representative went on. The discussions had reached an advanced stage, and the loan agreement would provide for increases in the domestic producer and consumer prices of gas and for an increase in electricity tariff rates. An objective was to bring producer gas prices to two thirds of the international level by mid-1988. The World Bank and the authorities were also discussing a loan for the industrial sector under which the authorities would introduce deregulation measures to encourage more vigorous private sector industrial investment.

Public finances were the key factor in the present economic situation, and there was an urgent need to improve them, the staff representative said. Tax reforms were required. The broader taxation recommended in the staff's technical report to the authorities on the tax system would take time to implement, and the positive effects would be felt only in the medium term. The staff had recommended the progressive elimination of exemptions from domestic sales taxes on production in order to make the tax system more elastic. Even if adopted in the near future, such reform efforts were unlikely to improve the fiscal situation in 1985/86 or 1986/87. Therefore, it was essential for the authorities to take what they believed were viable steps to enhance tax receipts by broadening the base of potential taxpayers. In the absence of substantive measures to increase the elasticity of the tax system, the authorities probably would continue to have to introduce extensive discretionary measures to finance rising expenditures. The deterioration in public finances was worrying: tax revenues were clearly inelastic, and expenditures were not being contained to the extent needed to achieve the projected improvement in public finances. The effort to strengthen public finances would have to include a reduction in the cost of subsidies to the budget, for example, by addressing the subsidies to fertilizer producers and increasing the prices for other items sold by the Government to the private sector.

The introduction of Islamic banking principles and practices was a major change, but the authorities had been proceeding cautiously, and their efforts were unlikely to be disruptive, the staff representative commented. The process had been started in 1979 and had been gradually expanded. Noninterest-bearing time and savings accounts represented nearly one fourth of all such deposits in the banking system. The regulations governing noninterest-bearing accounts were clear, and the timing of each step of the process was carefully based on the likely effects of the new action. Some major forms of lending were still interest bearing but presumably would eventually be brought under the new system. For example, interest could be earned on all lending to the Government by the private sector; Islamic principles and practices governing that form of lending might be introduced under the next budget. In addition, all foreign lending and deposits in foreign currency accounts continued to pay interest. It was most unlikely that the introduction of Islamic banking principles and practices had significantly affected the flow of workers' remittances.

Following the rapid monetary expansion in 1982/83, the authorities had tightened the monetary policy stance in 1983/84, the staff representative said. In so doing, they had assumed that the fiscal situation would be held very tight, and that the balance of payments would be in surplus. The authorities had initially intended to make substantial domestic savings and bank financing available to the private sector to encourage private investment. In fact, monetary expansion had moderated in 1983/84, but a contractionary effect from the balance of payments deficit had offset the unexpectedly sizable recourse by the Government to the banking system. The private sector had used only a small portion of the foreign exchange available to it to finance imports for its investment activities and had continued to invest heavily in financing the budget deficit.

The exchange rate movements had assisted the performance of nontraditional exports, largely of manufactures, the staff representative remarked. The link between the movement of the exchange rate and the flow of workers' remittances was less clear. For some time before the exchange reform of January 1982, the rupee had appreciated in real effective terms while the export performance had substantially weakened and remittances had declined. During the year following the introduction of the exchange reform and the floating rate, which had been managed in order to recapture lost competitiveness, the rupee had depreciated in real effective terms by nearly 20 percent. Export performance had subsequently improved greatly, and the flow of remittances had increased markedly. It was conceivable that remittances were withheld when workers expected the rupee to depreciate. Export performance probably had been substantially benefited by the enhanced competitiveness owing to the depreciation of the rupee. The movement of the rate had clearly had a direct bearing on the performance of the so-called nontraditional exports.

The staff did not believe that the exchange rate had been a major factor in the flow of workers' remittances, the staff representative from the Middle Eastern Department said. That flow had probably been affected by the level of activity in some countries--for example, Saudi Arabia, the United Arab Emirates, Kuwait, and Libya--where Pakistani citizens had been working. There were many theories about the factors that governed the flow of workers' remittances. Workers might well have in mind a fixed amount of their earnings that should be remitted to their home country. Some workers might remit a fixed proportion of their income in terms of the currency actually earned. The various indications suggested that the recent decline in workers' remittances might well be structural. That was not to say that the 10 percent drop forecast for 1984/85 would necessarily be repeated in coming years; the volume of remittances might well stagnate in coming years or decline less rapidly. The staff forecast for workers' remittances had been used merely as a part of the illustrative overall medium-term projections for the balance of payments, which were meant merely to indicate the areas where close attention would be required in the coming period.

The medium-term projections clearly suggested that there was an urgent need to strengthen the balance of payments, although the staff did not feel that the projected financing gap of $2-5 billion would be unmanageable. The staff was concerned that, in the absence of basic policy actions to strengthen the balance of payments in the medium term, the new borrowing would merely raise the debt service ratio without providing any lasting benefit for the balance of payments. The authorities had resisted new borrowing from commercial banks, and the staff was confident that they would maintain their cautious approach in order to retain the favorable debt service profile.

Mr. Finaish commented that, as a number of Executive Directors had emphasized, developments in the economy during the previous two years should be seen in the context of the longer-run record: Pakistan had been able to make substantial financial and structural adjustment while maintaining a high rate of economic growth. The overall performance under the extended arrangement had been a good one. The substantial progress in making needed adjustments since the end of the 1970s, together with the positive economic growth, had increased the resilience of the economy. However, those successes had not caused the authorities to become complacent. They recognized that further adjustments were required in areas such as those that the staff had identified in its appraisal, and they intended to maintain their reform efforts over the medium run. Moreover, adjustments had continued to be made along a broad front since the end of the extended arrangement.

In assessing Pakistan's past performance, it was also important to bear in mind the difficult external factors, such as the prolonged world economic recession and the decline in Pakistan's terms of trade, Mr. Finaish continued. Moreover, Pakistan had the largest concentration of refugees in the world. In addition, the less favorable developments since 1983 were to a substantial extent related to factors largely beyond the control of the authorities. For example, the adverse weather conditions had hurt agricultural output and exports, and the volume of workers' remittances had fallen. The drop in remittances was not attributable to domestic factors, such as the Islamization of the banking sector mentioned by some speakers.

Fiscal performance, largely on target during 1983/84, had weakened during the current year, owing to higher expenditures on imports and external debt servicing as a result of the further depreciation of the rupee, some shortfall in revenues, and lower capital receipts, Mr. Finaish remarked. To contain the impact of those factors on the fiscal position, possible remedial measures were being considered. Tax reform was one of the issues under consideration for bringing about a more durable improvement in public finances. The authorities viewed tax evasion as a major problem. Improvements in tax collection and administration in recent years had netted sizable additional revenue, and the authorities believed that further improvements in that area could generate much larger revenue than some new tax measures. Side by side with efforts to improve tax collection and administration, however, some new tax measures had been taken in recent years, and the authorities were continuing to give serious consideration to additional measures to broaden the tax system, improve its structure, and increase its elasticity.

The authorities recognized that nonbank borrowing involved a budgetary cost, but they believed that, in the context of appropriate demand management, it was preferable to bank borrowing, Mr. Finaish commented. The authorities intended to reduce their recourse to nonbank financing over the medium term, as tax revenues increased. They saw no evidence that private investment was being crowded out. Moreover, the small savings schemes had helped to mobilize additional savings and to direct them toward productive investments.

The authorities recognized that the savings and investment ratios were low by international standards, and they attached importance to the objective of raising the national propensity to save, Mr. Finaish continued. To that end, they were attempting to keep inflation under control, ensure an adequate return on financial assets, diversify the available savings instruments, promote private investment opportunities through deregulation and an increase in incentives, and improve the financial performance of public enterprises. The authorities were fully aware of the need to strengthen the efforts to mobilize domestic resources. The ratio of national savings to GNP was projected to increase from an average of 12 percent during the period of the Fifth Five-Year Plan, which had ended in 1983, to 15 percent during the Sixth Plan, which would end in 1988. The ratio of gross investment to GNP was projected to increase from about 16 percent to 18 percent in the same period. Besides raising the level of investment, the authorities had also been emphasizing upgrading the quality of investment. The public sector investment program had been reoriented away from capital-intensive, long-gestation activities to investment in agriculture, energy, and social services. Investment in manufacturing had been left largely to the private sector, which had also been encouraged to invest in areas previously set aside for the public sector, and special attention had been given to promoting small-scale investment. It was noteworthy that, although Pakistan's aggregate investment in recent years had been low by international standards, its GDP growth rate had been relatively high.

Questions had been raised whether the decline in remittances since 1983 had heralded a permanent structural change in Pakistan's balance of payments and about the implications of such a change, Mr. Finaish noted. It was too early to conclude whether the absolute drop in remittances since 1983 represented a trend that would continue. Indeed, remittances had increased by 30 percent in 1982/83. For the past four fiscal years, the annual changes in remittances had been 20 percent, 6 percent, 3 percent, and minus 5 percent. Those variations showed that it was difficult to project remittances. Available information on the behavior of remittances was fairly limited, and further work on the matter by the staff would be helpful. In broad terms, what one could say was that a sharp and continuous absolute drop in Pakistan's receipts from remittances appeared rather unlikely in the near future. A recent study by the International Labour Organisation had estimated that net migration of workers from Pakistan, though reduced, was still significant, and that it could remain so for some years. That prospect should serve to cushion the impact of any slower growth of workers' incomes on the total volume of remittance inflows. The more likely medium-term scenario appeared to be that growth in remittances would indeed slow down, perhaps entailing declines also in absolute terms, but that the slowdown--averaged over the medium term--would not be very sharp. If the pace of change in remittance inflows were relatively gradual, the adjustments required could be manageable; the impact on the balance of payments would be spread over time and could therefore be accommodated without causing serious external financial difficulties.

The authorities' medium-term balance of payments projections already assumed a growth rate for remittances that was a small fraction of the average growth rate of the past several years, Mr. Finaish went on. Those projections showed that the slowdown in remittance growth at the assumed rate could be consistent with a sustainable, even a gradually improving, external position, if the assumptions about other components of the balance of payments--particularly exports--proved accurate. The projections, therefore, pointed to the increased resilience of the external sector. Exports of manufactured and semimanufactured goods had shown a healthy average growth rate in recent years. The buoyancy shown by nontraditional manufactured exports had been particularly encouraging. Manufactured and semimanufactured exports could be expected to provide an increasing share of foreign exchange earnings in coming years and to offset to some extent the slowdown in remittance growth. The authorities recognized that export growth at the needed rate would require maintenance of an appropriate set of incentives and adequate investment in export production capacity, as well as adequate access to export markets. The last factor, of course, was beyond the control of the authorities and would depend on the pace and extent of any reduction in protectionism in industrial centers.

Important steps had been taken under the extended arrangement to liberalize imports, Mr. Finaish noted, and that policy had since been maintained. For example, most licensing restrictions had been removed, ceilings on imports that continued to require licenses had been raised, and over the three-year period through end-June 1983, the proportion of domestic industry protected by import bans or equivalent restrictions had been reduced from 65 percent to 30 percent. In July 1983, a negative list of prohibited and restricted imports had been adopted to replace the more restrictive positive list of permitted imports; since then, the new list had been simplified and reduced, and the old list had been phased out. The old list was being made available on a temporary basis in response to requests from importers as they continued to find it useful for reference purposes, but imports were officially regulated only on the basis of the new list. The authorities had indicated that they intended to continue to review the new list in the context of their regular reviews of import policy.

The authorities were considering a comprehensive tariff reform that they expected to implement over the coming four or five years, Mr. Finaish remarked. A background study on effective rates of protection in Pakistan had been reviewed by an intergovernmental working group that had already made its initial tariff recommendations. On the basis of those recommendations, adjustments had been made in duty rates for products with particularly pronounced tariff rate divergencies, covering mainly the products and imported inputs of the engineering and pharmaceutical industries. The adjustments made affected 40 percent of the value added in the large-scale manufacturing sector. Delays in the implementation of the tariff reforms had been caused by delays in the completion of background technical work that could serve as a basis for a comprehensive reform of the tariff system.

Since the adoption of the floating exchange rate regime in January 1982, the rupee had depreciated in relation to the dollar by approximately 60 percent in domestic currency terms and 37 percent in foreign currency terms, Mr. Finaish said. That movement in the exchange rate policy had resulted in substantial nominal and real effective depreciation. The exchange rate policy had obviously been flexible; the authorities had not hesitated to adjust the exchange rate whenever necessary. They intended to continue to make needed adjustments in the exchange rate under the existing managed floating system so as to preserve export competitiveness. At present, they were reviewing the method for calculating the real effective exchange rate.

The Islamization of the banking system had been preceding for some time, Mr. Finaish noted. The authorities' approach to it was cautious, systematic, and gradual. The intention of introducing Islamic banking principles and practices had first been announced in 1977, and the first step in that direction had not been taken until 1979, when three public financial institutions had been permitted to reorient their activities toward noninterest-bearing operations. The next step had been taken in 1981, when commercial banks had been permitted to accept noninterest-bearing accounts. The phased transformation of the entire banking system to an interest-free basis was to be completed by the end of 1984/85. Foreign loans and deposits denominated in foreign currencies would not be affected. The response to the introduction of noninterest-bearing accounts had been encouraging. Profit-and-loss demand accounts represented 8 percent of total demand deposits, and profit-and-loss savings and time deposits had been equivalent to 23 percent of quasi-money in June 1984. Careful thought had been given to the lending aspects of the new system; more than a dozen modes of financing had been identified.

The Acting Chairman made the following summing up:

Executive Directors noted that Pakistan had achieved considerable economic and financial success during the three-year period 1980/81-1982/83, when it had had an extended arrangement with the Fund. It was recalled that, in this period, inflation had been brought under control, vigorous economic expansion had been sustained, the external payments position had been strengthened, and Pakistan had become self-sufficient in food grains. In 1983/84 and 1984/85, however, developments had been less favorable, with agricultural output declining in the former year due to adverse weather conditions, and serious financial imbalances emerging in the current year. The recent developments, several Directors noted, appeared to indicate that the authorities were not making full use of the foundation laid earlier for advancing reform efforts and financial stabilization.

Directors noted that Pakistan was likely to experience a high growth rate in 1984/85, resulting in part from the new output peaks recorded for the cotton and rice crops, while new petroleum discoveries have given a boost to output. These developments were due partly to the substantial revisions to agricultural and petroleum output prices. However, Directors expressed concern that the pace of price rationalization in some important areas had slowed. It was noted, for example, that gas prices remained well below world market levels, and that adjustments in irrigation charges remained inadequate. Directors also regretted the slowdown in the progress in structural reform programs dealing with deregulation and the public enterprises. Directors urged the authorities to sustain their reform efforts in these areas, since the economy would clearly benefit from them. With respect to improving the efficiency of state enterprises, an important role was seen for the World Bank. The growth and efficiency of the industrial sector would also be bolstered by furthering the reforms initiated in the import and tariff systems. In this connection, several Directors expressed disappointment that Pakistan had not liberalized import restrictions more vigorously.

Directors stressed that the national income shares of savings and investments would need to be raised if the growth of the economy were to be sustained. Of course, an improvement in domestic savings would also work to strengthen Pakistan's external payments position. The weakness in savings and investment was linked largely to the structure of public finances. In this regard, Directors generally agreed with the staff that measures were needed to arrest the deterioration in the budgetary situation, and that substantive tax reform measures should be implemented without delay. They observed that, for some years, an inelastic domestic tax system, including elements of widespread tax evasion and quickly growing current spending, had led to curtailments in public sector investment outlays, which had recently been reflected in reductions in the Five-Year Development Plan. Directors noted that, despite the compression of development spending, the budget deficit had been expanding, and that its financing had required increasingly large recourse to private domestic savings and the domestic banking system.

While the rate of monetary growth currently forecast for 1984/85 was viewed as appropriate, a number of Directors pointed out that this likely outcome was due largely to the substantial external deficit, a situation which a number of Directors believed could not be continued. As the authorities must take steps to reduce the external deficit, Directors believed that they would soon be confronted with difficult decisions regarding the allocation of available credit in the context of an appropriate demand management stance. A substantially strengthened fiscal performance constituted the key in this area also. In addition, in the financial sphere, Directors expressed interest in the initiatives being introduced to Islamize the financial system, and they commended the authorities for their cautious approach to ensure an orderly transition. Taking into account the low level of domestic savings and the importance of inflows of remittances from abroad, Directors also emphasized the importance of appropriate returns on financial savings in order to strengthen resource mobilization. Several Directors expressed confidence that recent institutional changes to implement Islamic banking principles would encourage savings. Specific reference was made to Musharika (profit and loss sharing in a partnership) and Modaraba (a type of investment fund).

Directors generally expressed concern about recent developments and prospects in the external position. The deficit forecast for 1984/85--which was related largely to the outcome of the expected weakness in export growth and the decline in remittance inflows--was expected to absorb much of the reserve buildup achieved in 1982/83 and to reduce these assets to the equivalent of less than two months' imports. Directors observed that the present good agricultural crops would have a positive effect on the external position, but stated that the weakness of manufactured exports in the face of a strongly growing world economy and the recent appreciation of the real effective exchange rate of the Pakistan rupee suggested that exports faced competitive difficulties. Some Directors also wondered whether the recent declines in remittances might portend the onset of a structural shift in the balance of payments.

Given the deterioration that had taken place in the balance of payments, Directors urged the authorities to respond with timely measures aimed at enhancing export competitiveness and remittances. In particular, most Directors encouraged the authorities to follow a more flexible exchange rate policy, thus reversing the recent appreciation of the real effective exchange rate. Mention was also made of the desirability of the authorities' not resorting to export subsidies as a means of promoting exports; indeed, the authorities were encouraged to reduce the export subsidies that remained. Directors cautioned that without such measures it would be difficult to close the large gaps in the balance of payments that could appear in the medium term.

The alternative of large foreign commercial borrowing--which would be the outcome of not making the necessary adjustments--was noted by several Directors as being inconsistent with the authorities' past cautious approach to the accumulation of external debt.

In sum, while commending the Pakistani authorities on the significant successes achieved with the economic strategy of "adjustment with growth" followed since the late 1970s, Directors expressed concern regarding the perceived waning of the vigor with which the authorities were implementing the policies of structural reform and about the worrying prospects with respect to public finances and the external sector. It was clearly the general view of Directors that, unless adequate measures were taken promptly to reverse the deteriorating fiscal and external positions, overall economic performance could be adversely affected.

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(a), in concluding the 1984 Article XIV consultation with Pakistan, and in the light of the 1984 Article IV consultation with Pakistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Decision No. 7918-(85/31), adopted
February 27, 1985

APPROVED: December 2, 1985

LEO VAN HOUTVEN
Secretary