Structural Adjustment and Macroeconomic Policy Issues
Structural Adjustment and Macroeconomic Policy Issues

Moderator
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Papers presented at a seminar held in Lahore, Pakistan
October 26–28, 1991

International Monetary Fund
Pakistan Administrative Staff College
Washington 1992

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Foreword

An understanding of the macroeconomic issues surrounding structural adjustment is a vital part of the International Monetary Fund’s work and a crucial aspect of policy formulation in developing countries. Although at times differences have arisen between the Fund and developing countries in this area, a greater understanding of the need to sustain macroeconomic growth through reform has emerged. The Fund has increased its appreciation of the impact of adjustment programs on the wider economy and on the population at large, and has placed greater weight on the specific circumstances guiding each country’s reform efforts. For their part, developing countries have become more willing to endorse Fund approaches to macroeconomic reform. This is not to say that full consensus reigns, but the dialogue is more open, cooperative, and fruitful. In an effort to sustain the vitality of this collaboration, policy experts and academics from member countries and Fund staff members gather occasionally to discuss their experience with adjustment programs. The seminar held in Lahore, Pakistan, on October 26–28, 1991, was just such an exercise.

The Fund was pleased to join with the Pakistan Administrative Staff College in sponsoring this seminar. We highly value the input of government authorities on macroeconomic and structural issues and are grateful to the Staff College for providing such a productive forum for the discussions. During the seminar, which focused on the qualities needed to create sustainable and successful reform programs, the Pakistani experience was used to illustrate many of the points made concerning structural reform. The important lessons learned by Pakistan as it has strived to meet its domestic concerns and those of the international community are clearly relevant to the developing world at large.

It is hoped, therefore, that the frank exchange of theoretical argument, practical experience, and research at this seminar will prove useful to other countries. The diverse group of participants—from Bangladesh, India, the Islamic Republic of Iran, Pakistan, Sri Lanka, and Turkey, as well as from the IMF and World Bank—is encouraging in this regard. While the views expressed in this volume are not necessarily shared by the Fund, it is our wish that their dissemination can contribute to a more informed discussion of the issues.

MICHEL CAMDESSUS
Managing Director
International Monetary Fund
Acknowledgments

This seminar was jointly sponsored by the International Monetary Fund and the Pakistan Administrative Staff College. The diverse group of seminar participants and their high level of policy expertise attest to the importance of this subject for Pakistan and other developing countries.

I wish to express my gratitude to Azizali Mohammed, former Department Director, and Ahmed Abushadi of the External Relations Department of the International Monetary Fund for initiating, planning, and organizing this project as well as to Cyrus Sassanpour, the IMF's Resident Representative in Pakistan, for his work as a liaison. I would also like to thank Saida Riaz for helping with the logistical arrangements in Lahore. Other assistance with the seminar proceedings was offered by Seeman Waheed, Khalid Ikbal, and Mohammad Bashir. Finally, I would like to thank Rozlyn Coleman of the Editorial Division of the IMF, who edited and prepared the volume for publication.

V.A. Jafarey
Karachi, Pakistan
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Welcoming Remarks
Aslam Iqbal

It is my pleasant duty to welcome today our distinguished guests, both from within and without Pakistan, who have taken the trouble to come to Lahore to participate in this seminar entitled “Structural Adjustment and Macroeconomic Policy Issues” as jointly sponsored by the International Monetary Fund and Pakistan Administrative Staff College.

In 1981, the International Monetary Fund initiated a program of seminars for nonofficials, which was aimed at promoting a broader understanding of the role of the IMF. This end was to be achieved by addressing questions of significant importance and concern to the member countries and by an exchange of views among academic, professional, and other groups in such countries. The seminar program has also aimed to improve the IMF’s knowledge of what these groups think about the issues facing their countries. In organizing such seminars, the IMF has sought to maintain a regional balance. To date, 25 seminars on various critical topics have been held in Asia, Africa, Australia, Europe, and North and South America.

Such a seminar is being held for the first time in Pakistan and will provide an opportunity for examining and analyzing the macroeconomic disequilibria besetting developing countries—an instability characterized by inflation, balance of payment difficulties, and increasing debt liabilities. Valuable suggestions aimed at the adjustment and restructuring of these economies, with a view to reducing the rate of inflation, improving balance of payments and exports, and promoting economic growth, will warrant serious consideration.

A number of prominent journalists, businessmen, academicians, financial experts, and bureaucrats from Pakistan are attending this seminar. Top financial and monetary experts from the neighboring countries of India, Bangladesh, Sri Lanka, the Islamic Republic of Iran, and Turkey are also participating. In addition, a very strong group of the IMF’s own experts are here to take part in the proceedings, which augurs well for the seminar’s success.

I sincerely hope that this seminar achieves the purposes for which it was held here. I also hope that our guests enjoy their stay in Pakistan. Thank you and welcome.
Opening Statement
Sartaj Aziz

It gives me great pleasure to address this seminar, with its distinguished group of policymakers, academics, and international civil servants. I would like to welcome all the participants and especially Mr. Camdessus on his first visit to Pakistan. I am very pleased that he can be among us today after his grueling schedule at the recently concluded Annual Meetings of the International Monetary Fund and World Bank in Bangkok, Thailand. Much of Mr. Camdessus’ speech at the Annual Meetings was devoted to a set of issues and themes that form the subject of this seminar and that he has often addressed in the past, namely the most important ingredients of growth-oriented adjustment and the actions and policies required from both adjusting countries and the international community to ensure reasonable and sustained economic growth in countries making structural and macroeconomic adjustments.

Since the mid-1980s, when Mr. Camdessus became the Managing Director of the IMF, there has been a growing concern in the international community about growth-oriented adjustment. Mr. Camdessus has made a significant contribution by raising awareness about the problem and encouraging the debate on how it might be achieved. This renewed emphasis on growth with macroeconomic stability has not only been a welcome improvement in the IMF’s approach to these issues but a very befitting response to the actual experience of the first half of the 1980s. The debt crisis, sharply higher interest rates, a substantial slowdown in the growth of world trade, adverse terms of trade, and the drying up of capital flows to developing countries, which marked the beginning of an era of large negative transfers, all combined to highlight the enormous difficulty of adjustment. This substantial deterioration in the international environment—arising mainly from the excessive reliance of the United States on interest rate policy to reduce its budget deficit rather than on a reduction in defense expenditure or an increase in taxes—generated an unprecedented economic crisis with enormous social costs. This crisis gave us new insights into the problems of adjustment, the sequencing of reforms, and most significant of all, the importance of maintaining the pace of economic growth by maintaining a minimum level of investment and import capacity.
Growth-Oriented Adjustment

While the requirements of growth-oriented adjustment in different countries are still being debated, a consensus on the following broad requisites seems to have been reached:

- balance between supply-side stimulus and demand management;
- reform programs that are country-specific, that is, tuned to the particular circumstances of a country rather than based on general nostrums;
- sustained commitment by the government to the economic policies of adjustment to generate the necessary confidence in and credibility of the reform program; and
- a supportive international environment in which flows of official and private capital are adequate, debt-service burdens are manageable, trade is not restricted by protection, and countries with strong economies follow appropriate policies to ensure adequate growth of the world economy, world trade, and global savings.

Within these broad parameters, many features and policies may be particularly relevant for different countries or groups of countries. Before commenting on the process of reform and adjustment that Pakistan is currently undertaking, then, let me again emphasize that adjustment is not a unidirectional process with a set agenda for all countries at all times. It is a dynamic and flexible process that must be sustained. Its basic purpose is to remove any imbalances that may have arisen in the system, though, by definition, the removal of one imbalance creates or accentuates other imbalances which a dynamic adjustment process must deal with. For example, the most common imbalance is generally the fiscal one. If a government’s expenditures are persistently higher than its revenues, a fiscal imbalance is bound to develop. This can be corrected either by raising additional revenues or by cutting expenditures. However, if the adjustment process leads to such drastic cuts in new investment and such sharp curbs on credit that the rate of economic growth slows down, the adjustment would by itself lead to lower revenues in the following years, thus re-creating the fiscal gap. Sound demand management to correct fiscal and monetary imbalances must therefore be accompanied by adequate supply-side measures to achieve growth-oriented adjustment. This is the judicious balance Pakistan is seeking. I am confident that when we have achieved these goals in the coming years, with the help of the IMF and other agencies, it will go down as an outstanding example of dynamic, flexible, and successful adjustment, a process that was able to combine sustained stability with rapid growth. I hope the partici-
pants of this seminar will undertake a critical examination of the main ingredients of our program and offer suggestions for strengthening and improving it.

**Pakistan’s Economic Reform**

In November 1990, the new government launched an ambitious agenda of economic reforms to deepen, broaden, and accelerate the structural reform process initiated in 1988. The basic thrust of the accelerated reforms can be summarized as privatization and deregulation, in other words, unleashing the potential of the private sector to accelerate economic growth, while maintaining macroeconomic stability and self-reliance. At the same time, public sector programs were to be redirected toward human resource and physical infrastructure development and environmental protection, and they were to be made more efficient.

This approach has involved a fundamental change. While in the short run one can correct the fiscal imbalance by raising additional revenues and restraining inessential expenditures, the longer-term solution lies in a drastic reduction in the scope of public sector activity. If the government continues to preempt a large amount of the resources available in the economy and persistently uses them less efficiently, the fiscal imbalance will become chronic. But if the government gets out of activities that it does not perform very well (like producing and selling cement or vegetable ghee) by privatizing them, it will not only cure the fiscal imbalances but will also have more resources for the activities it should undertake, like physical and social infrastructure building.

The most important reforms, therefore, have been aimed at privatization and deregulation to revitalize a market-based economy. The privatization program has made good progress. The government has received acceptable offers for 24 industrial units and 2 commercial banks and hopes to sell most of them within 12 to 18 months. The government has also opened to the private sector many activities previously reserved for the public sector. These include power generation and distribution, shipping, airlines, and telecommunications. New commercial banks and several investment banks have also been allowed in the private sector.

Pakistan has also undertaken far-reaching reforms in the financial sector by establishing an auction market for short-term treasury bills and long-term federal investment bonds and a secondary market for government securities. It is also planning to strengthen the role of the central bank in regulating and supervising the financial institutions.
Exchange and trade reforms have removed most of the restrictions on foreign exchange transactions, travel, and foreign borrowing by the private sector. Import licensing has been eliminated and the maximum tariff has been reduced from 125 percent to 90 percent. Nontariff barriers are also being reduced.

Many measures have been adopted to encourage foreign investment. Apart from deregulation of the procedures for setting up industries, there are no longer any restrictions on the share of foreign equity, payment of royalty or technical fees, or employment of foreign experts. Foreign parties can also participate in existing industrial ventures through the stock exchange.

Thus, this wide-ranging reform program is aimed at creating a more open, liberalized, and privatized economy, which is more growth oriented and efficient. The reforms are expected to stimulate private savings, private investment, and private sector initiatives and divert them from "rent seeking" activities of dubious economic merit to more productive arenas. Moreover, by reducing the scope of public sector activities, the reforms are intended to make the government more effective when undertaking the activities that it can most usefully accomplish. These include the development of human resources, the alleviation of poverty through social sector programs, the provision of infrastructure, and the protection of the environment.

Macroeconomic Stability

The strong growth impulses imparted by the supply-side reforms have to be accommodated within a framework of macroeconomic stability. This requires bringing down the fiscal and balance of payments deficits to sustainable levels. At the same time, adequate resources must be mobilized for development expenditure, and its effectiveness must be increased in order to ensure accelerated economic and social progress.

In this way, Pakistan aims to achieve a truly growth-oriented adjustment: a considerable acceleration in investment and growth while maintaining stability by reducing the fiscal deficit and not allowing the rate of inflation to reach double digits. The basic goal is to make Pakistan a middle-income developing country before the end of this century. It has been at the threshold of middle-income status for the past two decades but has been unable to cross it. This time the country is determined. Mr. Camdessus in his opening remarks at a symposium held in February 1987 on growth-oriented adjustment said that "growth can best be combined with adjustment if adjustment takes the form of increases in export capacity, in savings, and in economic
efficiency, and if high-quality investment projects are allowed to survive.” Mr. Camdessus also stressed the importance of the country’s own commitment to the reform program rather than its viewing the program as imposed from outside. He remarked, “No program can succeed without the support of governments and of public opinion.” These ingredients of successful adjustment are present to an ample degree in Pakistan.

In this context, I would like to stress another notable feature of Pakistan’s reform program. First, unlike many countries in Africa, Latin America, and Eastern Europe, Pakistan’s adjustment program was not delayed until a full-blown economic crisis had emerged. In fact, Pakistan was one of a handful of countries whose economic growth actually accelerated in the 1980s to about 6.5 percent a year from an average 5.5 percent in the 1970s. This rate of growth, however, was not sustainable unless Pakistan corrected its large fiscal deficits, removed constraints on physical infrastructure (notably transport), and paid more attention to social sectors. These imbalances, then, formed the focus of our adjustment program.

A second notable feature of Pakistan’s adjustment program is that of strong government commitment to the reforms. This is evidenced by the fact that the government on its own initiative launched an ambitious agenda of reforms that went well beyond what was envisaged in the original adjustment program of 1988, which the IMF and World Bank supported.

Third, because of its strong commitment to reform and despite the acute difficulties caused by the Middle East crisis and the lack of any special external assistance to deal with it, the government not only continued its program of exchange and trade liberalization but actually accelerated it. And it did so while honoring its debt and debt-servicing commitments in the face of acute balance of payments difficulties caused by the crisis.

International Environment

Before concluding, let me emphasize the importance of a positive international environment for the success of adjustment programs being undertaken by developing countries like Pakistan. At present, the environment is not very positive. Net official development assistance is declining in real terms, private capital flows are scarce, and international trade in the face of the deadlock in the Uruguay Round

\footnote{Both remarks are taken from Corbo, Goldstein, and Khan (1987, pp. 7–8).}
is affected by growing protectionism. Textile trade, a particularly important export for Pakistan, remains outside rules governing the General Agreement on Tariffs and Trade.

After three decades of intense debate on alternative development strategies, there is now an emerging consensus about the vital importance of market-friendly policies for the process of development. Many developing countries have already demonstrated their resolve to implement such policies. It would be a tragedy of historic proportions if adverse international forces were to frustrate these “unprecedented opportunities,” as Mr. Camdessus has called them, by denying developing countries better access to trade opportunities or capital markets.

It would also be somewhat ironic that, after persuading developing countries to follow liberal economic policies, the developed countries did not follow these same policies and instead continued to impose restrictions on trade and other factors of production. I believe that Pakistan is doing its part. I hope that the international community will provide an adequately supportive environment for developing countries, like Pakistan, to undertake vigorous and far-reaching programs of economic reform.

In conclusion may I thank the IMF and the Pakistan Administrative Staff College for organizing this seminar. The timing could not have been better. I look forward to its recommendations.

Reference

Address
Michel Camdessus

It is a pleasure to be with you today for the opening of this seminar. And allow me to express my thanks to all who changed carefully prepared arrangements to offer me the opportunity to address this opening session. It is particularly appropriate that we are discussing the joint issues of structural adjustment and macroeconomic policy in Pakistan, and I am gratified that the Pakistan Administrative Staff College has joined with the IMF in sponsoring these proceedings.

The program that the Pakistan authorities have been implementing in recent years, with the support of the IMF, is based on a policy approach that seeks to establish a sound basis for long-term efficiency and growth by dealing with long-standing structural weaknesses. At the same time, the policies address the pressing problems of macroeconomic imbalances. The Pakistan authorities are courageously implementing a comprehensive program, and although they have encountered difficulties, owing to unforeseen developments, they have also shown a commendable willingness to adapt to changing circumstances and to persevere with the thrust of the reforms. They have risen to the challenge, and the IMF for its part has worked out appropriate modifications so that the program has stayed broadly on track.

As the seminar discussions will undoubtedly focus at length on macroeconomic adjustment and structural reforms both in Pakistan and in other countries, I will begin my remarks by referring to the salient features of the structural adjustment facility (SAF) program that Pakistan has been implementing for the past several years, before drawing more widely applicable conclusions. Through most of the 1980s, Pakistan experienced strong economic growth and a steady rise in per capita income, despite its high rate of population growth. During this period, Pakistan maintained an impeccable record of external debt service at a time when many other developing countries were experiencing debt-servicing problems. Nevertheless, by 1988 Pakistan faced severe macroeconomic difficulties, superimposed on historical structural weaknesses. The domestic saving rate remained low by international standards, and this was closely associated with rising fiscal deficits, which reached 8.6 percent of gross domestic product in 1987–88. Inflation approached double digits, and the external current account deficit widened to more than 4 percent of gross national product. The major structural weaknesses included a narrow and inelastic base for domestic taxation and a highly restrictive external
payments and trade regime. In addition, a weak financial system, a
distorted domestic price structure, and a range of restrictions and
regulatory bottlenecks inhibited domestic and foreign private sector
investment and activity, including foreign direct investment.

The authorities recognized these problems and in 1988 introduced
a macroeconomic adjustment and structural reform program sup­
ported by a 15-month stand-by arrangement and a 3-year SAF.
Together these resource commitments amounted to about $900 mil­
ion. The key policy objectives of this program have been:
— to strengthen the fiscal position through durable structural
reforms that improve tax revenue performance and expenditure
control;
— to achieve external viability while liberalizing the external trade
regime;
— to enhance the competitiveness of local industry; and
— to ensure a sound and healthy financial system.

Considerable progress has been made in achieving these objectives
under the first two annual SAF arrangements. This progress has been
achieved despite some policy slippage and an inhospitable inter­
national environment, which caused substantial declines in Pakistan’s
terms of trade in both 1988–89 and 1990–91.

In the light of these accomplishments, I am particularly pleased that
agreement has been reached on the final phase of the current program
in the context of a third annual SAF arrangement, which will be
presented to the IMF’s Executive Board in December 1991. This
arrangement encompasses ambitious policy action on several fronts.
It also balances an emphasis on macroeconomic adjustment with an
increased emphasis on social welfare. The implementation of such a
program should keep the economy on a path of sustained growth.
Pakistan very much needs that growth, and although there will be
many more challenges to overcome, I believe that Pakistan cannot
afford to eschew the measures needed to accomplish the transfor­
mation. The international environment is increasingly competitive: Paki­
stan is not alone in pursuing the path of structural reform. At present,
some 70 countries have programs with the IMF either in operation or
under negotiation, and several more—notably in Asia—are pursuing
similar programs of structural change, frequently with IMF technical
assistance in key areas but without IMF support for their balance of
payments. Be assured that the IMF will do its utmost to facilitate the
process of change in Pakistan. We are confident that the successful
implementation of the three-year SAF program will provide a sound
basis for even deeper and more comprehensive reforms, which can,
in due course, be supported by additional IMF resources. Of course, rapid economic changes may imply adverse transitional effects for some groups in society, even though, in the medium term, everyone gains from stronger growth performance. That is why the IMF, in cooperation with the World Bank and other international institutions, attaches great importance to the design of efficient and effective social safety nets for the poorest and most vulnerable groups. In many countries, the twin demands of economic stabilization and essential social expenditure require modernization of the tax system, with several important priorities: sufficient revenue, minimal distortions to the domestic economy and to trade, and a combination of efficiency and equity. I am delighted that this seminar will have an opportunity to consider this important issue in depth as it draws on international experience.

I must stress that the IMF does not have a standard blueprint for economic reform. None of us should pretend to have that. Nor do we have any simple formulas for good economic management. Anyone who pretends to have one, or an abstract model that can be applied to all countries alike, is ignoring the special circumstances, different culture, and unique political and social realities of each country. What the IMF can offer to a particular country is advice based on the experience of all its other members, experience stretching over more than forty years and now encompassing practically the entire community of nations.

This long experience of the IMF membership includes many successes and not a few failures. Indeed, the entire postwar era has seen an extraordinary range of experiments with economic systems, growth strategies, and economic ideologies. We have seen the development of more effective techniques for handling severe economic difficulties, and the IMF has been part and parcel of that long, complicated learning process, although there is still much to discover. All this varied experience has been accompanied by lively debate, sometimes leading to heated controversy. This is only appropriate, because the interests involved are very important—what is at stake is human well-being, not just economic abstractions. Our technical advice rests on this continually enriched experience, but in each new case it has to be complemented by a considered judgment as to whether the recommended policies, in their totality, will be regarded as credible by the rest of the world. In other words, is the program strong enough to boost domestic and foreign confidence? In the final analysis, a program will only succeed if it attracts strong support not only at home, by a country’s own citizens, but also abroad, by the creditor governments and the international capital markets. This support will come readily
enough if people believe that the economic program will contribute to
the country’s long-term stability and prosperity. It takes steady and
firm application of sound policies to foster the kind of confidence that
will make people willing to save and invest, to commit themselves to
productive activities, and to take a long-term perspective. It is also
important to foster the confidence of foreign investors, so that foreign
direct investment and portfolio capital is attracted from overseas,
including the repatriation of funds held abroad by the country’s own
citizens. This confidence in a country’s potential and in its policies is
essential, and the IMF’s candidly expressed opinion can make a useful
contribution in this regard.

In addition to its direct contribution, helping to design and finance
adjustment programs and to build confidence, the IMF has another
important contribution to make—improving the global economic envi­
nronment within which Pakistan and all member countries must oper­
ate. Indeed, that is the ultimate object of the IMF’s work in the field
of policy coordination among countries, including the major industrial
countries which bulk so large in the global economy. And that is the
aim of surveillance, a major component of the IMF’s responsibilities.
Let me expand on this. You will recall that the founders of the IMF,
at the Bretton Woods conference in 1944, started from the basic belief
that a cooperative solution to any global problem is always better than
a “go it alone” or confrontational approach. Their aim was to avoid a
repetition of the evils of the 1930s. So they established a set of rules
of the game, with the IMF as a kind of referee. The IMF is acutely
aware that the problems and policies of any one country are important
for the rest of the world. A key feature of the IMF setup, then, is
that countries share responsibility. This is the basis for the IMF’s
involvement in policy formulation in each of its member countries,
developing and industrial alike. For example, the IMF endeavors to
ensure that the major industrial countries take proper account of the
consequences of their policies for the rest of world. The IMF also
promotes trade liberalization and greater efficiency of capital markets
because it is important for Pakistan, or any country seeking to modern­
ze its economy and achieve higher growth, to have ready access
to export markets and foreign capital. Clearly a supportive global
economic environment is essential for the healthy growth of the Paki­
san economy and is needed to create employment opportunities,
support the rapidly growing population, and achieve a lasting
improvement in living standards.

Now, to come to the present day, how do we in the IMF see the
global environment? First, in the short run, we see a moderate recov­
ery in global economic activity, primarily because the short and shal-
low recession in the industrial countries will likely be followed by an upturn in 1992 of about 2.75 percent, the average rate of growth over the past decade. Second, we see a potential problem with global savings and investment because of two factors. On the one hand, the growth of savings has been sluggish in the main industrial countries for some years, and this trend is expected to continue. On the other hand, we face increased demands for investment in many countries. We expect to see strong new needs for capital worldwide—to reconstruct the economies most damaged by the Middle East war, to finance the Eastern European countries undertaking systemic reforms, and to help finance the fundamental transformation in the former U.S.S.R. These new demands will come on top of pressing and important existing needs—to assist developing countries, including the poorest and those emerging from debt difficulties, and to finance the expansion of the industrial countries. In the absence of strong measures, this impending imbalance between low savings and a high demand for investments will be corrected by the classic operation of markets, namely an increase in real interest rates.

There is no need to spell out how a shortage of global savings would work to the disadvantage of developing countries like Pakistan. This prospect is indeed a leading issue on the IMF’s agenda, not least because it has important ramifications for all the other problems facing the world economy. There is, fortunately, a cooperative solution to this challenge. I have been explaining it extensively to both the industrial and the developing countries in recent months. This solution—the only practical one—is for all countries to make stronger efforts to improve their own saving and investment performance. On the saving side, most countries have considerable scope for promoting higher saving by reducing their budget deficits. Clearly this is as urgent a task in those developing countries, such as Pakistan, where the deficit is large in relation to GDP, as it is in some industrial countries (the United States and several others) that loom large in the global financial picture and that face a similar problem. In every country there is scope to reexamine public spending, eliminate waste, reduce all kinds of unproductive spending, and align spending more closely with the main priorities of national policy. To contribute to this, I take every opportunity to emphasize the urgent need to reduce substantially the agricultural subsidies of the industrial countries and hopefully to eliminate them before too long. This must be a key element of a successful Uruguay Round in the GATT negotiations; it would both improve the prospects for many developing countries’ exports and stimulate greater efficiency in the industrial countries.
Our best estimates suggest that the problem of global savings is manageable provided that all countries make the necessary effort. There is no good reason why the pressing needs of the developing countries of Asia, Africa, the Middle East, and Latin America should suffer because of the new demands stemming from Eastern Europe and the states of the former U.S.S.R.

One particular element of the global economic picture deserves a special word. The recent political changes in the U.S.S.R. and Eastern Europe are creating a very different world—a world in which the reduction in East-West tensions is creating the prospect of substantial reductions in military spending and a reallocation of human and financial resources toward better uses. This view was widely endorsed by many delegates at the recent Annual Meetings of the IMF and World Bank in Bangkok. It is not my aim here to comment on what is or may be the optimal level of defense spending for any country; that depends on many factors, particularly the regional context, and involves a complex value judgment by those responsible for each country’s security. Rather, I wish only to stress that the large military cutbacks now envisaged by certain countries (notably the United States, the former U.S.S.R., and the countries of Eastern and Central Europe) will have important economic consequences for those countries and for the rest of the world. And surely every developing country should also reassess carefully its military spending to see whether it can transfer human and financial resources to more productive uses, such as investment that would underpin its growth strategy. I had interesting discussions on this subject a few days ago in India, where the authorities are already engaged in meaningful reductions in defense expenditures. And I hope that Pakistan also will show leadership in this direction. What a fine example it would be to the rest of the developing world, if these two great nations could each transfer substantial human and financial resources to activities that more directly contribute to growth and to the reduction of poverty! What a prospect for a better life that could create for everyone in the subcontinent! Cuts in military spending are obviously desirable for any country, where this is consistent with maintaining national security. And at the global level such cuts, by a sufficient number of countries, could help to solve the problem of inadequate savings.

In conclusion, I have described the efforts that the IMF is making to improve the global economic environment within which Pakistan must operate as well as those it is making to support the far-reaching program of structural reform that Pakistan has undertaken. The most important contribution, however, will be that made by the government and people of Pakistan. This seminar will provide an opportunity
to discuss the many challenges that arise in such comprehensive reform programs, and it can therefore make a timely contribution to the process of change in this country and indeed in the region. I welcome this discussion warmly and wish you every success in your deliberations.
The past few years have seen an increasing convergence between the thinking of the International Monetary Fund and the concerns of the Third World. The movement toward greater agreement appears to have occurred from both directions. The IMF has gained new perspectives on development issues, and developing countries have acknowledged the validity of certain IMF approaches to economic adjustment and reform. This mutual recognition promises to improve the quality and durability of future adjustment efforts, and it is hoped that this seminar will prove another step along the path to such cooperative efforts.

The change in the IMF’s outlook and policies began in the mid-1980s and has been characterized by an increased awareness of the need to sustain a basic standard of living during adjustment programs. In other words, growth cannot simply be sacrificed to adjustment. Moreover, a concern for income distribution, which was never absent, is now emphatically expressed. The duration and concessionality of IMF loans have also increased as have the linkages between World Bank and IMF lending. These cross conditionalities imposed by the two bodies have not proven as serious a problem as developing countries had anticipated. In addition, a number of IMF lending programs allow for modifications in the case of exogenous shocks or other exigencies; this flexibility had been among the developing countries’ most persistent demands. The IMF also now recognizes the importance of public support for adjustment programs, as evidenced, in part, by the presence of Michel Camdessus, the Managing Director of the IMF, at the inauguration of this seminar.

As for the developing countries, their approach to development issues has been significantly revised as well. First, the notion that nationalization is a panacea for economic ills has been abandoned. There is now a consensus that the role of the state in the economy should be reduced through privatization and other reforms. Second, countries have grown more willing to rely on prices and markets for the allocation of goods and services and have become less tolerant of
direct market intervention by the government. Third, the importance of export promotion has been recognized. Fourth, Third World countries are taking a more pragmatic and less ideological approach to global economic issues.

Yet, although the IMF and developing countries have approached consensus on several issues, their views on adjustment strategies and development philosophy are far from full agreement. The developing countries feel that some of the changes in the IMF’s thinking have yet to be reflected in lending programs. These countries also still lack some faith in IMF-supported adjustment strategies because success is not guaranteed and past experience does not provide conclusive evidence to support these strategies.

Still, there does seem to be some agreement, particularly on specific issues. For example, the belief that macroeconomic disequilibrium is a principal impediment to growth appears unanimous. It is also agreed that removing the disequilibrium requires global action. The developing countries have long complained that the IMF does not pressure industrial countries to rectify imbalances in their economies as vigorously as it pushes less developed countries to do so. The developing countries argue that the weight of the adjustment effort is thrown unfairly upon them. It appears that the IMF and other international organizations are beginning to recognize this problem. A final issue on which there is agreement is the need for low inflation: price stability is essential for both growth and equity.

**Elements of Adjustment Strategies**

As mentioned above, the IMF has recently adopted a comprehensive approach to the problem of economic imbalances, emphasizing the importance of structural change and the protection of development priorities. This agenda contrasts with its previous, narrower strategy, which focused on removing fiscal, external, and monetary imbalances. Thus, the most recent IMF-approved adjustment programs come close to the kind of comprehensive approach long favored by less developed countries. Some aspects of these new strategies are described below.

**Trade and Exchange Rate Policy**

One important area of structural reform is trade policy, in particular import liberalization and exchange rate management. A discussion of these issues must not only review current strategy but also analyze previous experiences with import-substitution policies. Although opinions differ on the merits of Pakistan’s earlier import-substitution
strategy, it is nevertheless agreed that this phase was unduly pro-
longed. A consensus has now evolved on the importance of export
growth as a dynamic element of economic strategy, although develop-
ing countries have expressed some reservations regarding exchange
rate depreciation as an instrument for promoting exports. It is felt that
exchange rate adjustment is a soft option and is used too frequently.
On the question of the feasibility of rapid export growth, more mixed
assessments have been offered. According to some arguments, struc-
tural changes in the economy, including diversification of the export
base, must precede any attempt to stimulate exports through exchange
rate measures. It has been noted, however, that structural adjustment
programs do not rely solely on exchange rate changes for achieving
export expansion. Exchange rate flexibility is helpful only in support
of stabilization policies. In addition, there could be distortions in
export policies. In Pakistan, quantitative restrictions exist on many
agricultural exports. These restrictions have been part of a short-
sighted strategy to protect consumers; they have resulted, in the long
run, in stagnating output and higher prices.

As for the process of liberalizing imports, it may be useful to summa-
rize the merits and demerits of import substitution, a development
with which Pakistan has had to contend.

—Import-substitution policies may have been helpful to Pakistan in
the early stages of industrialization. Some industries, set up under
the import-substitution regime, have now become major export-
ers. Nonetheless, heavy protection, even in the initial stages of
industrialization, can be considered inappropriate when protec-
tion encourages industries in an indiscriminate manner. Import
substitution carries the risk of inhibiting the development of genu-
ine export industries.

—The enthusiasm for import-substitution strategies appears to have
subsided considerably. Pleas for protection are now confined to
capital goods and high-technology industries.

—Developing countries face a conflict between the need for import
liberalization and the need for reducing the budget deficit. Because import duties offer a quick and politically convenient
way of raising revenue, there is a temptation to postpone tariff
reforms.

—External resources are needed to help developing countries in the
initial phase of their adjustment programs. Developing countries
should be able to liberalize imports without risking the depletion
of foreign exchange reserves.

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The liberalization of global trade is essential if developing countries are to be persuaded to reduce tariffs and remove restrictions on imports and open their markets fully.

**Fiscal Policy**

In the fiscal sphere, it is generally agreed that a reduction in the public sector deficit is a key step in the removal of macroeconomic imbalances. Yet, measures to reduce the deficit should not be judged solely on a quantitative basis. The quality and durability of a deficit reduction program must also be considered. Developing countries maintain that actual lending programs of the IMF tend to overemphasize quantitative change. On the flip side, though, these types of changes are easier to specify and monitor objectively.

Both the IMF and developing countries agree that social sector programs, with their long-term significance, should not suffer in the process of fiscal retrenchment. Developing countries point out that the fiscal adjustment required by an IMF program is usually so large that it cannot be achieved solely by raising revenue or by cutting nondevelopmental expenditure. They argue that deficit reduction should be spread out over a longer period in order to avoid the painful squeeze on social programs.

The scope for a reduction in nondevelopmental expenditure exists through the curtailment of subsidies. Only those subsidies that are accurately targeted at low-income groups and administered in a cost-effective manner would need to be retained. A saving in government payroll expenditures should be sought through a reduction in the public sector work force rather than through a cut in real wages. In addition, possible cuts in military spending are now being discussed. (In the past, the IMF had been reluctant to engage in this debate publicly.) Developing countries are being advised to emulate the superpowers and reduce their defense outlays. It does not appear, however, that any international institution is contemplating the extreme step advocated by Robert MacNamara—that external assistance be formally linked to a reduction in defense expenditures.

On the revenue side, IMF and Western aid donors have been advocating a shift from taxes on trade to taxes on consumption. They also emphasize the importance of charging adequate prices for public utilities in order to keep abreast of inflation and provide resources for the expansion of infrastructure. Developing countries have voiced concern that increases in consumption taxes and utility charges would put pressure on the cost of living, impose an unfair burden on the poor, and erode competitiveness in export markets. The differences in
the two viewpoints appear related to the speed and scale of adjustment rather than the program’s underlying principles. Indeed, there is general agreement on positions relating to direct taxes, such as increasing their share in total revenues, minimizing tax evasion, and improving tax administration.

**Monetary Policy**

In the sphere of monetary policy, it is generally agreed that controls over interest rates and credit allocation should be considerably reduced. On balance, a greater market orientation to monetary policy is welcome, and the development of capital markets should be given greater importance.

Developing country representatives argue that a total reliance on the market mechanism would neglect less developed areas, small borrowers, and weaker sectors of the economy, such as agriculture. In addition, they believe the pace of reform, under pressure from international lending agencies, is often too rapid. Reforms need to be adjusted to the realities of the situation in each country. The sequence of liberalization is also important. Premature liberalization is risky, as evident from the experiences of several developing countries. Further, it is essential to strengthen both the regulatory system and the general legal framework for market development. Indeed, one argument given for slowing down the pace of reform is that institutional change takes place slowly.

With regard to financial sector reform, observers maintain that if the central bank is to be effective it must be given complete autonomy, not only with respect to the conduct of monetary policy but also with respect to the exit and entry of enterprises into the financial system. It might be noted that the financial reforms being undertaken in Pakistan have been based on a gradual approach. Simultaneous with the liberalization of the financial system, efforts have been made to improve regulatory procedures, extend their coverage, and strengthen the position of the State Bank of Pakistan.

**Issues in Privatization**

The debate on privatization has been wide ranging and intense, covering both the general concepts guiding privatization schemes and Pakistan’s current program of accelerated privatization. Sharp differences are evident between the views of developing country representatives and those from international institutions—though not necessarily along the expected lines. Individual differences appear
more related to the scope, pace, and sequence of privatization than to the principle itself.

Pakistan's strategy of rapid privatization, the Great Leap Forward, has come in for considerable criticism. There are reservations regarding the program, and many observers agree that gradual change would have been more appropriate, as would an approach based on clear guidelines, adequate preparatory work on individual units, and a strengthening of the regulatory framework for public utilities. In defense of the government's program, it has been recognized that a bold and accelerated strategy may have been necessary because of the urgent need for structural reform and because difficult economic reforms are best accomplished when executed rapidly and decisively. The government, it has been argued, could learn while doing.

On the scope of privatization, it is generally agreed that the public sector should withdraw from the manufacturing of consumer goods and from the provision of services. Chronic loss-making enterprises should also be divested. More controversial has been the privatization of public utilities. Because the prices that utilities are generally allowed to charge are not sufficient to meet the marginal cost of production, private investment may not be forthcoming for these projects. The need for improved regulation of utilities is clear, but opinions differ about whether regulatory arrangements must be strengthened before privatization or whether this can wait. In the case of utilities financed from foreign loans, international lending agencies would have to be consulted before the assets could be disposed of. Several other concerns have also been raised: the insufficient methods for valuation of public assets, the dubious sources of funds being used by the private sector for the purchase of public assets, the danger of private wealth becoming concentrated among a few owners, and the failure to develop a capital market.

**IMF-Supported Adjustment**

Adjustment programs are essentially collaborative efforts between the developing country, which is guided by a variety of imperatives, and international lending agencies and creditors, which have their own sets of considerations. Although the IMF's original mandate emphasized short-term balance of payments assistance—eschewing structural reform issues as being too close to the development work of the World Bank—the Fund has more recently adopted a longer-term approach. The introduction of structural adjustment facilities in the 1980s was a recognition that many developing countries would be better served by more concessional lending and deeper macroeco-
nomic reform. This reformulation of IMF programming has increased the institution's flexibility and made it more responsive to developing country needs.

An IMF program is now likely to consider country-specific conditions, supply-side effects, and the program's impact on the population, especially on the poor. In implementing IMF-supported programs, various options regarding the pace and sequence of reform, the quality of the macroeconomic targets being employed, and the extent of restructuring are debated within the context of the individual country undertaking adjustment. It is recognized that, when correcting macroeconomic disequilibria, one size does not necessarily fit all.

Experience with IMF-supported programs has varied. Programs that draw on the structural adjustment facilities (SAF/ESA F) have tended to achieve their growth targets more often than they have achieved their inflation targets. Programs funded from the stand-by and extended arrangements performed rather better on the inflation front. Both sets of programs have a mixed record with regard to other variables. It should be noted, however, that it can be difficult to measure the impact of adjustment programs, since macroeconomic data may not be well constructed and the causal links between the program and other influences on the economy may be difficult to untangle.

Concluding Remarks

The need for adjustment programs brings into focus the long-standing dilemma of choosing between rapid growth and the need for stabilization. Stabilization programs sometimes result in stagnation; yet macroeconomic disequilibrium can also frustrate growth and lead to declines in output and per capita income.

Regarding the appropriate strategy for structural reform, the option is between a gradual step-by-step approach and a quick, sweeping change. The pace and sequencing of liberalization programs are also extremely important. As to the advantages and disadvantages of the two approaches, each country must decide for itself, depending on its circumstances. There is no standard adjustment program available to meet the requirements of all developing countries. It is essential to have country-specific solutions.

The concern for income distribution and protection of low-income groups needs to be translated into concrete provisions in adjustment programs and financing arrangements. There is also an increasing recognition of the importance of economic management skills and judgment to ensure quick adjustment to changing circumstances. In addition, a favorable external environment, with respect to resource
inflows and opportunities for export expansion, is essential to the success of adjustment strategies.

To be sure, there are serious problems in evaluating the effect of adjustment programs undertaken by developing countries. Macroeconomic results are influenced by so many factors that it is difficult to determine the exact role of the adjustment program in the failure or success in meeting targets. Nonetheless, continuity in government policy should be maintained to ensure the success of the adjustment strategy. The policies will be credible and effective with the public only if the government itself displays full confidence in the program and is capable of sustaining it.

In Pakistan, there has been public criticism that agreements between the IMF and the government are kept secret. No public debate has occurred either before or after agreements are concluded. It is felt that this secrecy adversely affects the acceptability of the program by the general public and by private enterprises. However, it should be recognized that it would be difficult for the government of a developing country to negotiate with the IMF when the press, opposition parties, and general public are looking on. The government might need to take up positions during the discussions that it would wish to modify later in order to reach a compromise. Yet it is possible, and probably desirable, for the government to publish a document outlining the broad features of the agreement and the strategy underlying it; of course, details involving possible taxation policy and other specific reforms would have to remain secret to avoid speculation.

On balance, then, structural reform in developing countries must take account of both local and universal concerns. Country-specific solutions are required in order to meet the needs and demands of a nation’s population. Yet larger principles and the general lessons learned from other adjustment efforts must also be acknowledged. Finding ways to satisfy both elements in an adjustment strategy means effective communication and implementation of policy. It is the aim of this seminar to provide the forum for such an exchange. Perhaps the discussion here will illuminate the “middle ground” that Pakistan and other developing countries are seeking.
Import Liberalization, Exchange Rate Management, and Capital Flows
Qazi M. Alimullah

Trade and exchange rate policies together determine the relative prices of imports vis-à-vis exports and of tradables vis-à-vis nontradables. The relationship between import liberalization and exchange rate management is thus analytically inextricable. The intimacy of trade and exchange rate policies is indicated by the way in which international trade economists use the term "real or effective exchange rate." In the literature on trade and development, which has been dominated by the distinction between outward-looking and inward-looking strategies, this orientation of development strategies has been defined in terms of the effective exchange rate of exports ($EER_x$) relative to that of imports ($EER_m$).

The effective exchange rate, in turn, pertains to the combined effect of exchange and trade policies on relative prices. $EER_x$, then, is the domestic currency acquired per unit of foreign exchange earned as a result both of the nominal exchange rate (say, rupees per U.S. dollar) and of all subsidies (whether direct or indirect) minus import duties and the like. Similarly, $EER_m$ is the combined effect of the nominal exchange rate and all duties on the domestic currency paid to acquire a unit of foreign currency.

If $EER_x > EER_m$, then selling goods in the export markets on average provides greater revenues than selling them in the home market, and the price incentives can be said to create a bias favoring exports. In the literature, however, this sort of bias is almost invariably referred to as an ultra outward-oriented strategy; simple outward orientation is identified as a neutrality of incentives between home and export.

1The author wishes to acknowledge the assistance of Akbar Noman in the preparation of this paper. As Secretary, Ministry of Finance, the author would also like to stress that the views expressed in this paper are personal and do not necessarily reflect those of the Government of Pakistan.
sales, or $EER_x = EER_m$. The apparatus above is not the only possible usage of the term real effective exchange rate. Macroeconomists also use it to mean the relative price of tradables and nontradables and derive it by simply deflating the nominal exchange rate by the domestic price level. According to Jagdish Bhagwati, "[this] usage is basically inadequate since, in many developing countries, duties, subsidies and other subventions and charges are important, and concentrating on the parity is not enough. For this purpose the Bhagwati-Kreuger National Bureau of Economic Research (NBER) Project defined the added concept $PLDEER$, that is, price-level-deflated $EER$, to get at the appropriate concept that macroeconomists should use."\(^2\)

While the exchange rate and trade policy are analytically bound together, capital flows enter the picture through the effect of import liberalization on the balance of payments and through the possible effect of capital flows on the nominal exchange rate. Moreover, notwithstanding their analytical inextricability, the nominal exchange rate and trade policy are two quite different sets of policy instruments, and the precise combination used to yield any given $EER$ is significant, particularly during a period of transition from an inward-oriented to an outward-oriented regime, or vice versa.

Thus, the sort of policy issue typically facing policymakers is how rapidly and in what sequence to liberalize trade and what sort of policies to adopt regarding the exchange rate and foreign borrowing. These certainly have been and remain the policy issues in Pakistan, and they form the main focus of this paper.

**Liberalization, Adjustment, and Outward Orientation**

**Import Liberalization**

Import liberalization involving the reduction of tariffs and quantitative restrictions leads to a rise in imports, other things being equal. Concern over the effect on the balance of payments has inhibited import liberalization just as defending the balance of payments has so often been the rationale for imposing and intensifying import restrictions. Import liberalization, though, also has a positive effect on the balance of payments since it shifts incentives away from production for the home market and toward production for the export market. How much and how quickly imports and exports respond is the crucial issue from the point of view of the effect of import liberalization on the balance of payments.

The question is one of the demand elasticity for imports vis-à-vis the supply elasticity of exports, and for any given set of such price elasticities, the net effect on the balance of payments depends on the exchange rate policies adopted, or the real exchange rate as macroeconomists use the term. A depreciation of the exchange rate would shift domestic demand from tradables to nontradables and foreign demand from other countries' products to those of the economy that has depreciated its currency. For such expenditure "switching" to bear the sole brunt of balance of payments equilibrium may require excessive depreciation, especially when there are no restraints on domestic demand. Whatever the relevant price elasticities, restoring or maintaining equilibrium in the current account of the balance of payments is best done when both the exchange rate and expenditure switching are combined with restraints on aggregate domestic demand or with the "absorption" of tradables. The lower is aggregate demand, the lower will be the increase in imports upon import liberalization and the greater will be the surplus available for exports.

In theory, import liberalization does not have to worsen the current account because any rise in imports will be offset by an increase in exports. A modest depreciation of the exchange rate may be enough to correct any balance of payments disequilibria, or mild restraint on aggregate demand may do the trick. In practice, though, a substantial liberalization of imports is likely to involve some combination of all three adjustment mechanisms, and the required correction in the exchange rate and aggregate demand may be quite considerable. This is partly because the short-run demand elasticity of imports tends to be fairly high while exports are likely to respond with a longer lag. Invariably, the supply elasticity of exports tends to be significantly higher in the long run than in the short run.

Foreign capital inflows can greatly reduce the potential short-term costs of import liberalization. To the extent that such capital is available, it facilitates the macroeconomic management that must accompany import liberalization. Foreign capital lessens the need for or risk of such an excessive depreciation of the exchange rate that it becomes substantially undervalued in the short run compared with its longer-run equilibrium, with the possible danger of setting off an inflationary spiral. Similarly, the stabilization measures do not need to restrain demand quite as much when additional foreign capital inflows are available during the adjustment period.

Moreover, the availability of additional foreign resources is likely to induce the government authorities to undertake more import liberalization than they otherwise would. The uncertainty about the short-run balance of payments effects and about the possible social and
economic costs often inhibits liberalization of imports. To the extent that foreign capital inflows lessen the need for growth-restricting policies, adjustment involving import liberalization will likely cause fewer short-term costs in terms of economic growth.

Two caveats to the positive role that foreign capital can play in supporting import liberalization should be mentioned. One is to guard against the danger that capital inflows will lead to an excessive appreciation of the exchange rate; a mistake that has not always been avoided. The other is the importance of avoiding external debt that is in excessive amounts or on inappropriate terms and of making sure to use the foreign capital to adjust adequately, not to squander it.

The lessons of experience suggest the following ingredients of successful and sustained import liberalization: an exchange rate policy that encourages exports and efficient import substitution; avoidance of macroeconomic imbalances, since both high inflation and expansionary demand-management policies hinder the needed structural shifts in production and the viability of the balance of payments; and additional inflows of foreign capital on appropriate terms, which can facilitate import liberalization by reducing its possible short-term costs and giving governments the confidence to undertake more rapid or more substantial liberalization than they might otherwise have considered. This is not to say that faster, greater import liberalization is always better. But timid reforms that fall short of a critical minimum are likely to lead nowhere and fail to provide clear, strong signals to economic agents.

Development Experiences

Since the publication of the seminal critique of import-substituting, or inward-oriented, industrialization in developing countries (Little, Scitovsky, and Scott, 1970), the subject and related issues have probably received more attention than any other set of issues involving the economies of developing countries. More recently, however, awareness of and a consensus on the benefits of export promotion, or outward orientation, has grown, as has acknowledgement of the costs of an excessive emphasis on import substitution. The limitations of government intervention are also much better appreciated, and it is recognized that market failure, in itself, is not a sufficient justification.

For a survey of the leading issues and approaches in this area, see Noman (1991a) and Corbo, Goldstein, and Khan (1987), particularly the contributions of Jagdish Bhagwati, Stanley Fischer, Gerald Helleiner, Constantine Michalopoulos, Y.C. Park, Jeffrey Sachs, and John Williamson.
for government action. As such, the probability and costs of inappropriate or ineffective intervention must be taken into account. Thus, a broad consensus has emerged that the following measures should be avoided: extreme levels of protection and an overvaluation of exchange rates, at least for prolonged periods; liberalization of the capital account of the balance of payments before liberalization of the current account; and macroeconomic instability.

However, many important areas of controversy remain. A vigorous debate continues on various matters: the pace and sequencing of trade and payments reforms, including the relative merits of across-the-board liberalization versus selective liberalization; the validity of the infant-industry argument; and more generally, the ingredients of growth-oriented adjustment. In the light of developing country experiences and the economic literature, the following "lessons" can be discerned (also see Noman, 1991a).

— While extremely high levels of protection should be avoided in the long run, they can help in the early stages of industrialization, at least in medium to large countries. The crucial features of good economic management are not to prolong this early phase but to initiate policies aimed at efficient resource allocation and resource use, thus leading to the fairly quick removal of the anti-export bias so that $EER_x \geq EER_m$.

— Adjustment need not be sudden and across the board. Although large variations in effective trade protection are not recommended, considerable variance within $EER_x$ and $EER_m$ (while on average $EER_x \geq EER_m$) has been a feature of such East Asian miracles as Taiwan, Korea, Japan, and more recently, Thailand. The contrast between import substitution and export promotion has often been overdrawn—not just in the sense that import-substituting industries can become export industries with rising levels of efficiency but also that it is possible to pursue both simultaneously.

— Rapid export growth can precede import liberalization. In most cases, export growth should ideally precede an across-the-board liberalization of imports, especially when foreign capital flows cannot ease the balance of payments constraint that the consequent surge in imports can quickly face.

— Undervalued exchange rates can be a powerful way of promoting exports and providing protection, as demonstrated by the experiences of Korea, Taiwan, Japan (in the 1950s and 1960s), and Chile (in the early 1980s). However, moving to an undervalued exchange rate can be a tricky business because of the inflationary
implications of exchange rate depreciation. But a realistic exchange rate, in the sense of a nominal exchange rate that does not require enormous subsidies to exporters, is necessary for sustained export expansion.

—Macroeconomic stability is essential to sustain liberalization and growth. But more controversial questions are what constitutes the right blend of demand- and supply-side measures for growth-oriented adjustment and whether stabilization should precede or accompany structural adjustment in cases of severe imbalances. Certainly, a poor supply response and an inadequate growth orientation have been major concerns.

—Credibility, consistency, and coherence are important for the success of liberalization policies. This requirement is closely related to the question of governmental commitment to its reform program. Without strong commitment, indeed without “ownership” by the government, reform efforts are most unlikely to succeed.

—The ability of governments to intervene successfully varies enormously. The differences are partly a matter of the quality and experience of the civil servants responsible for the design and implementation of policy and partly one of political economy. This factor along with the level of development and size of the country are among the most crucial contextual issues determining the appropriate set of reform policies.

Economic Development and Macroeconomic Policy: The Case of Pakistan

Pakistan’s experience during the 1950s and the 1960s has been widely hailed both as a model of successful development, especially of industrialization, and as one of the worst examples of import-substituting industrialization. An assessment of these contrasting views and the subsequent industrialization of Pakistan can be found in Noman (1991b). Interestingly, both views of Pakistan’s industrialization have considerable merit, though there is almost certainly more merit in the view that Pakistani industrialization was more a success than a disaster.

As for Pakistan’s industrialization after this initial stage, an economic setback in the 1970s, partly caused by the “shock” of nationalization and the break-up of the customs union of East and West Pakistan, was followed by a decade of fairly rapid growth. But it has

been argued that this reflected developments which permitted fairly rapid, easy industrial growth without the need to undertake the policy reform needed to create a more competitive, technologically advanced, and dynamic industrial sector. Thus, in the late 1980s, when the favorable external shocks ended, the need for a major reform of trade and industrialization policies, particularly to boost exports, became fully apparent. To examine Pakistan’s experience in greater detail, these various periods of industrialization will be discussed individually.

The 1950s

The decision not to devalue along with the pound sterling and the Indian rupee in 1949 was immediately followed by a run-up in the prices of Pakistan’s exports (at that time, mainly raw jute and cotton). An overvalued exchange rate, quantitative restrictions on imports, and acute scarcities created by the disruption of trade with India meant high return on imports. Importers made quick fortunes.

In the face of a balance of payments crisis at the end of the commodity boom in 1952, which had been related to the Korean War, the government intensified import restrictions. In addition to heavy protection, the manufacturing sector was provided with generous fiscal incentives and cheap credit. Profits were high and guaranteed, and inflation was modest. The traders who had earlier made overnight fortunes were now in a position to respond to these powerful incentives, and they did. As Little, Scitovsky, and Scott noted about their sample, only Pakistan, and to a lesser extent Taiwan and the Philippines, needed to create an entrepreneurial class. Within a decade, Pakistan had done so.

It should be noted that a large domestic market and the presence of raw materials that could be easily processed and marketed (jute and cotton) made the early stage of inward-oriented industrialization easier and longer. Nevertheless, the most extreme period of protection lasted only seven years, 1952–59.

The 1960s

In 1959, Pakistan began to reverse the anti-export bias of its trade regime. The second plan period, 1959/60–1964/65, witnessed a number of important departures, including:

—the introduction of an export bonus scheme—in effect, a multiple exchange rate system favoring manufactured exports—and a host
of other incentives for exports, including preferential access to foreign exchange;
— a substantial increase in foreign capital inflows (on concessional terms);
— a significant liberalization of imports that was accompanied by increases in import capacity, via rising exports and aid, and carefully managed to avoid a balance of payments crisis; and
— the beginning of the "green revolution" in agriculture.

Economic growth accelerated sharply. Ahmad (1980) has observed that the rise in agricultural productivity and incomes occurred at a time when the limits placed on the domestic market for manufacturing by import substitution were being increasingly felt.

1970–77

This was a period of severe exogenous and endogenous shocks: war and civil strife, the break-up of the country, the nationalization of large parts of industry and finance, and the first oil shock. At the same time, the familiar complexities and distortions created by the multiple exchange rate system ended with unification and the devaluation of the exchange rate.\(^5\)

Pakistan's manufacturing industries that had learned to export in the 1960s were quite successful in diverting sales from the protected market of the former East Pakistan to the world market in the early 1970s. But the effects of the devaluation are impossible to distinguish from those of the "shocks" noted above.

After 1977

Following the upheaval of the early to mid-1970s, industrial growth recovered with the support of earlier "heavy" investment by the public sector and a rapid expansion in domestic demand. The latter reflected a rapid growth in workers' remittances, a rise in foreign resource inflows and illicit exports related to the war in Afghanistan, and a growing fiscal deficit. This period can be characterized as one of relatively easy, soft-option growth fueled by booming domestic demand. Improvements in international competitiveness and exports were at best inadequate. By 1988, however, all these trends had been reversed.

\(^5\) The nominal devaluation was from 4.76 rupees to 9.9 rupees per U.S. dollar, but the effective devaluation was an average 25 percent for exports and 40 percent for imports. See Guisinger and Scully (1988).
Remittances had stabilized at a level well below their peak; foreign resource inflows related to the Afghan war began to decline; and fiscal deficits began to be reduced.

Between about 1980 and 1990, there was gradual liberalization, and the exchange rate system was moved to a managed float in 1982; since that time, the rupee has gradually depreciated. In 1990, a major package of economic reforms was introduced. It focused on exchange and payments reform (including liberalization of the capital account), privatization, deregulation, attraction of foreign direct investment, fiscal reforms, and export promotion. While some generalized import liberalization was also planned, its pace has been slower than that of the other reforms noted above.

The new reforms include the following measures:

—Restrictions have been removed on foreign currency bank accounts, on foreign exchange for travel, and on other payments for advertising abroad, education, publications, trade fairs, and so on. Certain other restrictions, such as the rules governing private sector foreign borrowing, have been greatly liberalized.

—A number of restrictions on foreign direct investment have been abolished or greatly liberalized. Among the former category are rules pertaining to the approval of investments, limits on equity shares, and remittances of dividends and profits.

—All commercial banks nationalized in 1974 are to be privatized; two of them already have been transferred to the private sector. A number of areas previously subject to public sector monopoly have been opened to the private sector (power generation, telecommunications, airlines, and shipping), with 115 industrial units to be privatized.

—Measures to encourage exports have included improvements in the scheme for duty drawback, bonded duty-free imports, and export credit. Also, the scheme for export-processing units, the allocation of textile export quotas, and income tax rebates are among the export-promotion policies that have been revamped.

—Import licensing has been largely eliminated, and the small list of exceptions is being reduced further. The maximum tariff has been reduced from 125 percent to 90 percent (except for motor vehicles).

—Industrial investment has been largely deregulated and offered strong incentives.

Perhaps the most potent manifestation of these reforms has been the 23 percent increase in exports during 1990–91; GDP growth has also accelerated, to 6.5 percent a year. These improvements occurred
Despite the severe adverse impact of the Middle East crisis on Pakistan and the nonavailability of any official assistance to deal with it. There were also larger capital inflows in the form of a 25 percent increase in foreign currency deposits.

Concluding Remarks

Over the four decades 1950–90, Pakistan’s GDP increased at an average annual rate of 5.2 percent; excluding the first decade, the growth rate was 6 percent. During 1980–89, Pakistan was one of the few countries in which GDP growth accelerated compared with growth over the previous decade. At 6.4 percent a year, GDP growth in this period exceeded that of all countries except China, South Korea, Hong Kong, and Thailand (barring the curious cases of Botswana, Oman, and war-torn Chad). “Large-scale” manufacturing has been the fastest growing sector in Pakistan, achieving an annual rate of more than 10 percent over the past forty years.

It has been widely noted that during the 1950s and 1960s, the extensive system of controls was administered by a competent civil service with relatively modest corruption. Since then, there has probably been a deterioration on both these counts. Macroeconomic stability, in the sense of modest inflation and avoidance of severe contractions of demand, has existed throughout the period.

As to the inefficiencies of Pakistan’s early industrialization, recent research has shown them to be much exaggerated (Noman, 1991b). While there is considerable evidence of total factor productivity growth and technological innovations in the 1960s, what has happened since seems more disturbing. A recent study finds evidence of much technological backwardness and industrial inefficiency, though also some cases of success (IMG Consultants, 1989). Liberalization until 1990 was much too slow. Protection still remains high by international standards with a number of anomalies in protection.

With the end of the favorable shocks of the 1980s and the accumulated shortcomings of past policies, the need to reform trade and related policies has increased, particularly in order to boost exports. The government’s recently launched economic reform program is a major response to this need. Its success in raising exports has made the task of import liberalization smoother by easing the balance of payments constraint. However, both tariff and financial sector reform conflict with the need to reduce the fiscal deficit. How to phase in and sequence these reforms and reconcile them with macroeconomic stabilization are the major challenges for economic policy today. At the policy level, there is a strong commitment to complete the agenda
on tariff reforms by the middle of the 1990s and to create an environment that encourages secular capital flows and investment and that ensures allocative and productive efficiency.

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Comments

Malcolm D. Knight

The two distinct parts of Qazi Alimullah's paper are a fitting reflection of his wealth of experience as both a professional economist and a senior civil servant actively engaged in policymaking. The first part of the paper enunciates several general propositions, or "lessons from experience," drawn from the academic literature and Pakistan's recent economic history. The second provides a concise survey of some major economic trends in Pakistan since the early 1950s. In my comments, I would like to discuss these lessons from experience and relate them, from a slightly different perspective, to economic developments in Pakistan over the very recent past.

Three of the general themes that run through Alimullah's paper are unexceptionable: (i) that macroeconomic stability is essential to sustain liberalization and economic growth; (ii) that credibility, consistency, and coherence of policy are very important for the success of a government's efforts at trade liberalization; and (iii) that the ability of governments to intervene successfully in the economy varies according to the economic management skills of those who must implement the policies, namely senior civil servants.

These are sound and sensible propositions that need no further elaboration. Indeed, the macroeconomic adjustment and structural reform program that the Pakistani authorities initiated in mid-1988 was based on their conviction that these principles must be enacted to achieve a sustainable external position while maintaining satisfactory growth performance. Essentially, the broad intention has been to adhere credibly and consistently to a comprehensive medium-term program. Key elements of the program have been fiscal deficit reduction through structural revenue reforms and expenditure restraint; correction of domestic cost and price distortions through adjustments in administered prices and other steps to deregulate markets; trade liberalization and tariff reform; firm domestic credit restraint and financial sector reform; management of the exchange rate to maintain international competitiveness; and steps to strengthen the performance of public sector enterprises.

Despite a number of adverse external developments and, at least until recently, a weaker than expected pace of structural reforms, the implementation of this program has allowed Pakistan to avoid severe balance of payments problems while posting solid economic growth performance. These results are a tribute to the practical relevance of
Alimullah's three propositions. But Alimullah also enunciates three other "lessons" the applicability of which is, at least to my mind, less general and more controversial. Let me express some of those doubts both at the general level and in light of Pakistan's experience.

First, concerning restrictions on international trade, Alimullah acknowledges that extremely high levels of protection are to be avoided in the long run, but he nevertheless asserts that "they can help in the early stages of industrialization, at least in medium to large countries." Although the paper does not say so explicitly, this view is based on the infant-industry argument—the idea that if a fledgling industry is given sufficient trade protection to achieve economies of scale, then unit costs can gradually be reduced to a point where the industry can produce without the need for continued protection.

At first sight, Pakistan does seem to provide a reasonably good example of the extensive use of protection to achieve rapid industrial growth. As Alimullah notes, the period 1952–59 saw an intensified emphasis on nontariff barriers as well as heavy use of other fiscal incentives, and the period was also characterized by rapid growth of industrial production. But I cannot help wondering whether this policy of protection was really a paramount factor in contributing to the strong growth.

At least until 1988, Pakistan's trade regime remained both pervasive and highly restrictive. It comprised extensive negative lists of banned and restricted imports, very high nominal rates of tariff protection across a broad range of commodities, and a complex system of tariff concessions and exemptions. To the extent that this trade system operated to raise the prices and reduce the availability of imported inputs, it acted as a tax on export activity. Nor was its scope focused on protecting only those industries that were likely to enjoy a comparative advantage in the long run.

These features of Pakistan's system of trade protection have left its economy with two adverse legacies. First, despite important structural fiscal reforms implemented in the past few years—including the introduction of the general sales tax and a marked expansion of the sales tax base—Pakistan's fiscal system still relies heavily, perhaps excessively, on revenues from taxes and charges on international trade. Taxing any activity reduces the incentive to undertake it; international trading activities are no exception to this economic truism. The second problem is that partly because pervasive tariff and nontariff barriers raise the cost of imported inputs, they limit the incentive to diversify the export base. As a result, while Pakistan achieved solid growth performance during much of the 1980s, external sector performance has often been inhibited by the concentration of exports in a small
number of industries. This lack of diversification has made Pakistan's external sector performance vulnerable to the vagaries of foreign demand and supply and to protectionist trends in a small number of markets, including those for textiles and rice. These consequences of Pakistan's extensive trade protection have left structural weaknesses that the recent period of more vigorous trade liberalization has not yet overcome.

With regard to the second of Alimullah's lessons, I have similar reservations about his argument that rapid export growth can precede liberalization. Alimullah argues, "In most cases, export growth should ideally precede an across-the-board liberalization of imports, especially where foreign capital flows cannot ease the balance of payments constraint." This proposition implicitly assumes that most imports are final consumer goods rather than inputs since—as I have already noted—import protection acts as a tax on export activities. It is my impression that both the quality and diversity of Pakistan's export expansion may have suffered from the adverse effects of high tariff and nontariff barriers on imported inputs, and the various exemptions and concessions that have been granted to exporters (and potential exporters) over the years suggest that the authorities have shared these concerns.

In summarizing the relation between protectionism and economic growth in Pakistan, I would submit the following alternative view. On paper, the system of tariff and nontariff barriers that existed in Pakistan from the 1950s to at least the late 1980s was comprehensive. But in Pakistan it proved virtually impossible for the authorities to hermetically seal the domestic economy because the restrictive trade system could easily be circumvented. Many banned or prohibitively taxed goods entered the country through other channels and were widely available at prices only moderately above world market levels.

The implications of this practice have been several. First, owing to the limited effectiveness of the system of protection in achieving policymakers' aims, the system had a much less distortionary effect on resource allocation than the authorities themselves intended. Thus, in practice, it did not act strongly to inhibit growth and diversification of exports and output. Second, even a major liberalization of nontariff barriers such as the one that began in 1988 would be unlikely to cause an import surge and pressure on international reserves, since many banned and highly taxed goods were entering the country anyway. Given Pakistan's porous borders, the main role of import liberalization has probably been to produce an efficiency gain by allowing a broader range of foreign goods to enter the country at prices nearer world market levels.
Finally, I will say only a few words on Alimullah’s third general proposition that an undervalued exchange rate can be a powerful tool for promoting exports. Without addressing directly the merits of such a policy, let me say that it is very tricky to implement it effectively for any length of time. This is because undervaluing the real exchange rate requires not just a single policy but rather a combination of several analytically separate instruments. These include measures to influence the nominal exchange rate and sterilize the resulting effects on the money supply as well as policies for restraining domestic unit labor costs. Both of these policies are hard to operate effectively over the longer term.

But even if such a policy package could succeed, what would be the result? A deliberate policy of undervaluing the real exchange rate would tend to make production more labor intensive than it would have been in the absence of such a distortion. While Pakistan has a high rate of population growth, an undervalued exchange rate does not seem like a very effective means of increasing employment. And capital market distortions are hardly likely to make production excessively capital intensive in Pakistan. On balance, I would conclude that it is important to get the exchange rate “right” in real effective terms. But this does not justify the risky strategy of intentionally undervaluing the rate, since this can destabilize domestic prices.

In relating the exchange rate issue to the debate between free trade and protection, I would return to Alimullah’s three basic propositions. Macroeconomic stability is essential to allowing the authorities to sustain reforms and liberalization efforts. This is particularly so in the trade sector, where rent-seeking pressures are often intense. But it is also important for reform elsewhere, such as in the financial sector or the state-enterprise sector. Given firm demand management, good expenditure control, and monetary policies that can achieve moderate inflation, competitiveness can be maintained while the economy is liberalized to exploit the longer-run gains from international trade. That is why the Government of Pakistan has recently renewed its emphasis on supply-side reforms. That is also why, despite setbacks, a major liberalization of the trade and exchange system has occurred in Pakistan without adverse output and employment effects or an uncontrollable surge in imports.
Fiscal Restructuring and the Tax System

Vito Tanzi

In recent years many countries have adopted economic programs aimed at "adjusting" their economies. By and large, the adjustment efforts have focused on reducing the rate of inflation, improving the balance of payments, and promoting economic growth. All these adjustment programs have required that substantial attention be paid to the fiscal situation since a reduction of the fiscal deficit is now recognized to be a necessary condition for improving the macroeconomic situation. Yet the experience of many countries indicates that fiscal reform is very difficult.

Many of the issues that arise in pursuing fiscal reform concern (i) the determination of the correct size of the fiscal adjustment needed, (ii) the difficulties in measuring the existing fiscal disequilibrium, and (iii) the type and timing of the required fiscal reforms. These issues are discussed in the following sections.

Fiscal Adjustment Needed

In many developing countries a major cause of the external imbalance of a country is excessive monetary expansion. By increasing nominal incomes, the expansion leads to increases in nominal spending and in domestic prices. When exchange rates are pegged, it encourages imports, discourages exports, and, by creating expectations about devaluation, induces capital flight and the dollarization of the economy. In developing countries, excessive monetary expansion is often the result of fiscal deficits that cannot be financed through noninfla-

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1The author would like to thank Ehtisham Ahmad and George A. Mackenzie for their comments. The views expressed here are strictly personal. They do not necessarily reflect official positions of the International Monetary Fund.
tionary channels.\textsuperscript{2} Thus, a kind of "fiscal approach to the balance of payments" arises that establishes a close connection, through liquidity expansion, between the financing of the fiscal deficit and the outcome of the balance of payments.

Limiting the fiscal deficit to a level that can be financed internally in a noninflationary manner (say, by selling bonds to the public) or externally through available, ordinary credit, a country may be able to eliminate the short-run problems associated with the fiscal imbalance. Thus, an adjustment program that focuses on the short run requires that the fiscal deficit be reduced enough to eliminate the need for inflationary financing. The program, therefore, would not focus on the part of the deficit that can be financed, in the short run, in noninflationary ways. This does not mean, however, that the part of the deficit not financed by monetary expansion is of no concern. If this part leads to an increase in the share of public debt in GDP, crowds out the private sector, or skews portfolio distributions in the financial sector, good adjustment programs must also attempt to set limits on the total fiscal deficit. In some countries the continuous and prolonged reliance on bond financing has increased the share of domestic debt in GDP to worrisome levels. Eventually this domestic debt leads to serious difficulties and to the need to introduce major and painful fiscal restructuring.

It is perhaps necessary to emphasize that the part of the fiscal deficit that can be financed in noninflationary ways varies from country to country. In relatively closed economies, it depends on the saving rate of the private sector and on the after-tax real rate of return on government bonds. The higher the private sector saving rate, the higher the after-tax interest rate that the government pays on the public bonds, and the lower the private sector borrowing, then the higher is the fiscal deficit that a country can finance in a noninflationary way. Countries such as India and Italy were able to finance large fiscal deficits in relatively noninflationary ways for long periods of time. However, as domestic (or foreign) debt accumulates, this strategy becomes progressively more costly unless the public sector borrowing

\textsuperscript{2}The basic accounting identity in a financial programming exercise is $\Delta M = \Delta R + \Delta D$. That is, the change in the money stock ($\Delta M$) is the sum of the change in the domestic currency value of international reserves ($\Delta R$) and the change in domestic credit ($\Delta D$). The change in domestic credit, in turn, can be decomposed into credit to the government and credit to the private sector. Credit to the government is a reflection of the fiscal deficit. The higher the fiscal deficit, the larger is the credit to the government, and thus the higher is the increase in liquidity. By restricting credit to the private sector, overall liquidity creation can be reduced. However, the cost of this action is crowding out of the private sector.
is channelled to very productive investments that lead to a higher rate of economic growth.

**Measuring the Fiscal Disequilibrium**

Correctly measuring fiscal disequilibrium is formidably difficult.\(^3\) The commonly used measures of the fiscal deficit can be highly inadequate. They may not be comparable over time or for a given country (or across countries) in a given period of time. And they are often imprecise gauges for determining the size of the needed fiscal correction. Several other difficulties also complicate matters.

The first difficulty is connected with the quality of the data. With few exceptions, governments have not given a high priority to gathering and providing reliable and up-to-date statistics. The second issue concerns the comprehensiveness of the available fiscal data. The central government, which is often the main actor in adjustment programs, represents in many countries only a limited part of the public sector. The whole public sector comprises the central government, local governments (provinces and municipalities), public enterprises, the central bank, stabilization funds, and various forms of extrabudgetary accounts, including social security. These subsectors are often interconnected, and implicit transfer prices determine the scope of financial or resource flows among them. These transfer prices often do not reflect market prices. For example, the central bank may finance other parts of the government at subsidized rates or assume some of their budgetary functions, as has happened in several Latin American countries where governments have run very large deficits. The public enterprises may sell services to the central government at below market prices or may borrow to reduce transfers from the central government. Social security institutions as well as public enterprises may be forced to buy government bonds at interest rates below what the government would have paid in the free market.

To avoid this problem, the data on which the fiscal adjustment will be based must be comprehensive enough to encompass the whole or at least much of the public sector. But achieving this is extremely difficult, even impossible, because the information required is often not available and when it is available it is not up to date. For example, data from the provinces, the municipalities, and the public enterprises can be hard to obtain and are often unreliable. This limitation may create serious difficulties in the conduct of fiscal policy.

\(^3\)For discussions of fiscal deficit measurement issues, see Tanzi, Blejer, and Teijeiro (1987) and Blejer and Cheasty (1991).
In the presence of domestic debt, inflation can bring about dramatic changes in the size of the conventionally measured fiscal deficit by increasing nominal interest rates and thus nominal interest payments. Inflation disguises as interest payments what in reality are amortization payments, and while amortization payments are conventionally not counted as part of the deficit, interest payments are. As a result, the conventional deficit becomes a direct function of the rate of inflation. In such situations the deficit ceases to provide a useful measure of the size of the fiscal correction needed by the adjustment program.

A country with a large foreign debt can influence the measurement of the fiscal deficit (as a share of GDP) by changing its exchange rate. An overvalued exchange rate will convert the foreign exchange interest payment on the debt into fewer domestic monetary units, and thus give the impression of a lower fiscal deficit. This lower deficit may mislead policymakers into believing that the fiscal problem is less serious than it is or may raise their resistance to a necessary devaluation.

Timing issues also create difficulties. A deficit can be measured on the basis of cash flows (that is, actual cash receipts and payments) or on a commitment basis for expenditure and on an accrual basis for revenue. A government can increase its spending but delay the actual payment for the additional goods and services that it has bought from suppliers. When arrears are increasing, an adjustment program that employs the cash concept may misjudge the pressure on resources and on demand that is associated with expenditures made but not yet paid for. In other words, the cash concept will underestimate the real size of the deficit. The impact on the real economy is likely to be felt mostly when the resources are transferred to the government rather than when the government’s check is actually cashed.

**Essential Fiscal Reforms**

A given reduction in the fiscal deficit may be genuine and of good quality or largely cosmetic and of low quality. The economic effect of these two types of “adjustments” especially over the medium run are likely to diverge widely. Unfortunately, cosmetic changes are frequently easier and politically less costly to make.

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4. In other words, during inflation nominal interest payments come to contain an element of amortization so that the government is actually repaying its debt at a faster pace. See Tanzi, Blejer, and Teijeiro (1987).

5. This has led some economists to conclude that devaluation always increases the size of the fiscal deficit. See Tanzi (1989) for a different view.
It is often not appreciated that a specific reduction in the fiscal deficit is usually not the result of a single policy decision but the summation of many specific policy decisions, both on the revenue side and on the expenditure side. A high-quality fiscal adjustment must be associated with measures that are efficient, durable, and equitable. In other words, these measures must not introduce avoidable distortions; they must not self-destruct in the near future; and they must not eliminate expenditures that are important for economic or social reasons when alternatives are available. The public spending to be reduced must be that spending which contributes least to the efficiency and fairness of the economic system.

Revenue Measures

On the revenue side, and broadly in order of preference though not in order of facility of introduction, the following measures could be taken.

First, a general consumption tax, possibly one with the characteristics of a value-added tax (VAT), should be introduced or, when it exists, broadened. Second, the government should fully explore the revenue possibilities of excise taxes. These excises should be imposed on commodities with inelastic demand or on those whose consumption generates substantial negative externalities.

Third, important changes should be introduced to the personal income tax. Personal income taxes still contribute little to total revenue in developing countries. If basic changes are made, the threshold of the tax can remain generous and high marginal tax rates can be cut without much revenue loss and with potential gains in work effort and taxpayer compliance. Given the income distributions prevailing in developing countries, personal income taxes do not need to cover the entire population to generate substantial revenues. Focusing on the top 10 percent of the population would be sufficient.

Even changes in one tax, say the personal income tax, involve many decisions. For example, reform of the personal income tax requires decisions about the level of the personal exemption, the extent of deductions, the treatment of the family, the special treatment of particular incomes, the levels of the various rates, the incomes at which they become effective, the form of payments, the desirability of inflation adjustments, and so forth. The official description of the 1986 income tax reform in the United States ran into the thousands of pages.

The value-added tax is now in existence or in the process of being introduced in almost 60 countries. The latest country to introduce such a tax with a uniform rate of 10 percent is Thailand, where the tax was enacted in October 1991.
For taxes on enterprises, similar considerations apply. Enterprise income taxes are often eroded by excessive incentives and complex laws. These incentives rarely achieve the intended objectives but create major problems for tax administration. The elimination of these incentives often achieves a great simplification of these taxes and makes them more equitable.

The next measure, which in the short run can be especially important from a revenue standpoint, consists of raising public utility prices and introducing user charges for particular services provided by the public sector, such as higher education and health. The real prices at which electricity, water, telecommunications, transportation, and other public sector services are sold normally fall quite drastically during inflationary periods. This fall increases the demand for these services and, given common capacity constraints, leads to crowding and overuse. Because of the losses experienced, the public enterprises cannot muster the resources to expand capacity. Often these enterprises do not even have the funds necessary for operation and maintenance, especially in light of the more intensive utilization of their plants. Thus, capacity declines and the quality of the service deteriorates. The greater the fall in the real tariffs charged by the public enterprises and the greater the demand response to that fall, the greater will appear the need to expand investment in these activities. Thus, an artificial justification for capacity expansion will be created by the fall in real prices especially when the resources necessary to satisfy that expansion are sharply reduced.

A correction of these prices will thus (i) generate more revenue, (ii) reduce the need to expand capacity by lowering demand, and (iii) lower operational and maintenance costs by reducing overuse. Generally, this revenue increase can also be defended on the basis of equity considerations since the very poor often have no access to these services. In fact, by keeping prices too low, the resources needed to provide the poor with access to these services are reduced. Broadly similar considerations are relevant to the implementation of user charges, especially for higher education.

Finally, imports should be made to generate larger revenues either by dismantling quotas and other quantitative restrictions and replacing them with import duties or by removing the excessive erosion of the import tax base created by incentives and special exemptions and introducing a minimum tax on all imports.8 In both cases the additional revenue would be accompanied by improved efficiency.

8The replacement of quotas and other quantitative restrictions with tariffs shifts the power to tax from those who benefited from these restrictions to the government.
**Expenditure Measures**

On the expenditure side, a variety of steps should also be taken.

First, and most important, unproductive investment projects must be eliminated. The popular argument that investment must be protected during adjustment is simply misguided. While productive investment is an important source of growth and must be protected, unproductive investment, especially if associated with imported machinery and capital equipment, is a major burden on the economy. In many developing countries the investment budget is padded with politically motivated and unproductive investments which can and should be eliminated. Unlike consumption expenditure, which always benefits someone within the country, investment, especially if associated with imported capital equipment, may contribute little to the welfare of the country’s citizens. Furthermore, if it is obtained with foreign credit, it becomes a long-term drag on the economy. Hence, unproductive investment must be the first area where cuts are made.9

Some of the savings from this source should be allocated to operations and maintenance expenditure, which would increase the efficiency of the existing capital structure and would permit that structure to support a higher level of income.10

A second area where reductions should be made is in the wage bill of the public sector. During adjustment, many countries have attempted to reduce the wage bill of the public sector but have often preferred to reduce real wages than the actual level of public employment. Yet in many developing countries the public sector is overstaffed. Therefore, fiscal adjustment that aims to reduce the wage bill permanently must cut (in some cases quite considerably) the number of public sector employees. This may require privatizing some activities. Since a public employee receives not just a wage but also workspace, tools, family allowances, and other benefits, the reduction in public employment would also reduce the necessity for some public investment (buildings) and for some nonwage expenses (paper, electricity, and so forth). These potential savings disappear when real wages, not public employment, are reduced.11

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9 Of course, the determination of what is an unproductive investment may be difficult. Nonetheless, a close technical scrutiny of the investment budget is always useful. Decisions should relate to specific investments not to the total investment budget.
10 The trade-off between a better utilization of the existing capital structure and an addition to that structure has not received the attention that it deserves.
11 There are other costs associated with a reduction of real wages below some efficiency level. These costs are not discussed in this paper.
The third important area for reduction, although a politically difficult one, is military expenditure. An argument can be made that military expenditure remains excessive in all countries. In developing countries it absorbs as much as 5 percent of GDP and about 30 percent of total tax revenue, thus greatly reducing the government resources available for education, health, and other important sectors. It does not take much imagination to see how a country could benefit from the wise alternative use of these resources. For example, by cutting military spending a country could raise its growth rate by at least 1 percentage point a year; or it could double the real income of the lowest 20 percent of the income distribution; or it could raise the level of human capital or the quality of life. And tragically, military spending often increases "national security" only in the abstract, since it commonly leads to equivalent increases by potential enemies. International pressures to downsize military establishments, particularly in rival countries, could generate very high returns, although it may lead to complaints about interference in the domestic affairs of countries.

Fourth, many countries engage in various forms of "unproductive" expenditure, from the building of monuments to the subsidization of unnecessary activities. In many of these countries the enforcement of useless regulations also requires substantial public sector resources, and compliance with those regulations can require even higher private sector resources. Reducing regulation lowers public spending while often enhancing the productivity of private sector activities. In most countries the budgets of many of these activities could stand pruning.

Subsidies must be closely scrutinized. Those which are essential, because of well-defined social objectives or because of significant positive externalities, should be protected, provided that they reach their objective in the most efficient manner. But generalized subsidies, provided through artificial reduction in the prices of general consumer goods, should be eliminated. These subsidies often result in large transfers to families in the upper percentiles of the income distribution and little help, perhaps even hurt, those most in need. Worthwhile social objectives can often be achieved far more cheaply and efficiently than is generally the case.

**Cosmetic Versus Genuine Fiscal Reforms**

A conflict arises in adjustment programs between the need to achieve quick results and the time necessary to develop, legislate, and implement sound policies. The need for quick results is required by (i) the usual precariousness of the economic situation (rising inflation, exhausted foreign exchange reserves, building up of arrears), (ii) the
fear that if changes are not made immediately, they will not be made, and (iii) the arrangements with international institutions that are often time constrained.

While changes in interest rates, exchange rates, and many other elements of economic policy can be made relatively quickly and seldom require legislative approval, good fiscal reforms, including tax reform, public sector reorganizations, privatization, and reform of public expenditure programs, require time, much effort, and in many countries legislative approval. As a consequence countries often opt for "quick fixes"—fiscal reforms that reduce the fiscal deficit in the period immediately ahead but are neither durable nor efficient.

Common elements of these quick-fix solutions have been (i) sharp reductions in public sector real wages to levels below their likely long-run equilibrium, (ii) sharp and indiscriminate cuts in investment expenditure without much assurance that the projects eliminated are the least productive,¹² (iii) sharp cuts in expenditures on operation and maintenance, leading to a faster deterioration of the existing capital infrastructure and to a much reduced capacity utilization,¹³ (iv) emergency tax legislation, including the temporary introduction of distortionary taxes, such as those on exports and financial instruments, and of temporary surtaxes on import duties, income taxes, and others, (v) excessive increases in some excises (such as those on petroleum products, beer, and several others), (vi) anticipation of tax payments, sometimes by providing discounts for anticipated payments to taxpayers, thus reducing future tax collection, (vii) tax amnesties, (viii) quick sales of some assets, and (ix) delayed payments to suppliers and other creditors, thus building up arrears.

Most of these measures are self-destructing or of questionable quality, or both. They are not the kind of measures that characterize a good program or that result in durable adjustment. They increase uncertainty and send negative signals to investors, thus discouraging capital repatriation and encouraging capital flight. Therefore, a deficit reduction achieved through these means should not be expected to

¹²In some cases, projects may not be eliminated but their completion may be stretched out. This process can lead to sharp increases in the final discounted cost of projects. In some cases the politically protected investment may survive even though its productivity may be lower than that of a less protected project.

¹³Because of drastically reduced expenditure for maintenance, the capacity utilization of some plants and infrastructure is sometimes reduced to a small proportion of its potential.

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improve economic conditions. Such a reduction can only be justified if it is clearly announced and believed to be a transitory step toward a more durable and higher-quality package. Unfortunately, these measures often exhaust the political will of the government to make more basic reforms or they are seen as the only way to reduce the fiscal deficit. They also exhaust the time of economic and finance ministers and other relevant policymakers.

Sustainable fiscal policy requires, almost by definition, measures that will survive the test of time and that will not impede the efficient allocation of resources. It requires a coordinated and closely monitored effort carried out by competent and determined individuals. It must involve good macroeconomists working in close cooperation with public finance specialists experienced in both policy and administration. The group in charge of this effort must be given a clear mandate, the human and material resources needed to carry it out, and a realistic but short deadline to produce concrete proposals. The group must coordinate closely with key individuals in the legislature in order to explain to them the need for given actions and to coordinate various positions, and it must report routinely to the finance minister and other relevant authorities.

This group, which could be referred to as the "fiscal reform commission," should make a careful assessment of the magnitude of the fiscal correction needed, an inventory of the possible actions required (quantifying to the extent possible their effects), and a strategy related to the optimal phasing in of the various changes. The commission would recognize that some measures take more time to introduce than others and could thus contemplate the use of temporary measures, provided that their cost in terms of inefficiency and depletion of political capital is not too high and that they are justifiable, transitory, and necessary steps in an overall strategy. The main consideration must be that the general strategy is credible and consistent and that it is clearly and forcefully articulated early in the process. A schedule for the introduction of the measures must be prepared and adhered to as closely as possible. International financial and technical support for a country that sets out to deal seriously with its fiscal problem should be particularly generous.

Although the details will differ from country to country, and only an in-depth analysis can provide precise guidance for a particular

\[14\] If the improvement in the fiscal situation is seen as temporary, investors will not want to sink their financial wealth into fixed assets that may lose value as soon as the situation worsens again. There should be no surprise, then, when growth does not quickly follow this kind of adjustment.
country, in broad terms the sequence of important fiscal reform measures might be as follows.

**Increasing Revenue**

A revenue measure that can be introduced relatively quickly and that can have several beneficial economic effects is an increase in public utility tariffs when these tariffs have been allowed to fall because of inflation or political considerations. It is important, however, to take steps to prevent the benefits from being dissipated in higher salaries, higher employment, or in unnecessary or postponable investments by the public enterprises. If the central government is unable to control the behavior of the public enterprises, their privatization might provide the only solution to their being a drain on the budget. Assuming that public enterprise spending can be controlled, the tariff increase may be larger in the short run than would be necessary if other measures were in place. For a while, the government can exploit the monopoly power of these enterprises to raise needed revenue. The increase in tariffs must not be neutralized by future inflation, and the government must resist the temptation to fight inflation by freezing tariffs since these attempts never work. After the initial adjustment, these tariffs should be adjusted as needed to maintain their real level.15

The revenue potential of particular excises should also be fully exploited. Increases in taxes on tobacco, alcoholic beverages, gasoline, and a few other commodities can be justified on various efficiency grounds (inelasticities, externalities, or benefit-received criteria); they also give quick revenue, and, in modern economies, their equity cost is usually small. But once again the initial increases must be protected against the eroding influence of future inflation. Indexation of specific excises or the use of ad valorem rates would be desirable to ensure that the price elasticity of these taxes is at least unity. Excises levied with specific rates almost always result in inelastic revenue. Thus, until the fundamental reforms are in place, these excises can be made to generate more revenue than might be desired over the long run. On the basis of what is known or presumed about the demand elasticity of these products, taxes that would maximize their revenue generation and minimize their efficiency cost could be imposed. These taxes could eventually be reduced to levels justified by the traditional reasons for

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15When normalcy returns and fundamental fiscal reforms have been put into place, the tariffs can return to levels justified by purely allocative (rather than revenue-generating) considerations.
imposing excises. Selected “luxury” products could also be taxed (cars, televisions, cameras, and so forth) to generate revenue and introduce equity into the tax system. The taxation of these products with ad valorem rates also raises the elasticity of the tax system.

Some administrative changes for raising tax revenue in the short run can also be considered. For example, in inflationary situations, collection lags can be shortened. When the inflation rate is high, this reduction in lags can raise revenue by significant amounts. Tax evasion can be reduced by the judicious use of penalties. For example, giving the tax administration the faculty to close, for specified periods (one week, one month), shops or enterprises whose owners have not filed returns or have evaded taxes in other ways can go a long way toward encouraging taxpayer compliance, especially if these closures are well advertised. Postponement of tax payments can be discouraged by steeply raising the interest charges on delayed payments to high positive levels. Tax administrations can also focus on the largest taxpayers since in most countries a small proportion of taxpayers generates the overwhelming share of tax revenue.\(^{16}\)

While the above changes are being made, the fiscal reform commission should be preparing the more fundamental reforms. With the properly trained people or with the assistance of foreign experts, the required studies can be done in a relatively short time, certainly in a period of months. The search for excessive precision, however, could significantly delay the conclusion of the studies. The longer the delay, the less likely it is that serious reform will be carried out. Long and detailed studies by tax commissions often become excuses for delaying action. Being approximately right is normally good enough, and being approximately right is much faster than attempting to be precisely right.\(^{17}\)

The introduction of a value-added tax with the widest possible tax base and a single rate should be a central element of the fundamental reform. If the country does not already have a general sales tax, it will need at least two years to implement a value-added tax. If it already has a general sales tax, the time for reforming it can be cut considerably, though such a change still requires at least a year. Estimations

\(^{16}\)A common conflict for tax administrators is whether to concentrate on the largest taxpayers or to administer as large a number of taxpayers as possible. When the revenue objective becomes important, it is more efficient to focus on the largest taxpayers (both enterprises and individuals). Of course, this may conflict with the equity objective of taxation. Thus, the group in the spotlight should progressively become larger as administrative capacity improves.

\(^{17}\)Very few tax commissions have produced studies that resulted in major tax reforms. The reason is the time that these commissions require to fulfill their mandate.
of the size of the potential VAT base will be necessary in order to
determine the rate required to raise the desired revenue. Of course,
the larger the share of the potential base that is exempt, the higher
the rate must be. The argument that many products will need to be
exempt for equity reasons should be resisted as it rarely has much
rationale. Equally, the arguments in favor of multiple rates regardless
of their theoretical validity cannot be allowed to prevail for purely
administrative reasons. Many important administrative actions (the
design of forms, the organization of the tax office, the use of comput­
ers, the determination of the list of taxpayers, the campaign to inform
taxpayers, and the development of auditing procedures) require time.
Administrative mistakes can be costly, and time can help reduce the
number of mistakes. The introduction, or broadening, of the VAT
often has beneficial effects on the revenue raided from other taxes,
especially from the income taxes.

The reform of income taxes (personal and corporate) also requires
time, though much less than the introduction of the VAT. Most devel­
oping countries already have income taxes so that it is mainly a matter
of modifying the existing structure and improving the administration.
Frequently these taxes are applied to tax bases that have become
too narrow because of legal decisions to exempt whole sectors (for
example, agriculture), regardless of the income of the taxpayers in
those sectors. The tax bases also become too narrow because of a
proliferation of tax incentives to industries and regions. These incen­
tives rarely achieve their intended objectives but instead create distor­
tions, inefficiencies, and inequities as well as reduce tax revenue.

For the personal income tax, the main policy changes concern (i) a
reduction in the often very high level of personal exemptions, (ii) the
elimination of many deductions and special treatments of particular
income, (iii) a change in the rate structure, probably by raising the
base rate to at least 10 percent and reducing the highest rates to the
30–40 percent range, after careful analysis of the income levels to
which these rates should apply, (iv) the introduction of withholding
in all cases where it is feasible (wages and salaries, interest payments,
dividends, and payments to suppliers or others by the government
and public enterprises), and (v) the forceful use of presumptive taxa­
tion in connection with hard-to-tax activities (farming, professional
services, and shopkeeping, for example). Some of these changes
require more time than others. A serious effort should also be made

18Ahmad and Stern (1991) have strongly recommended the use of presumptive taxes
on agricultural incomes in Pakistan. For a discussion of these taxes, also see Tanzi and
to improve the administration of these taxes by relying on all the information available to the government (imports, social security payments, and property ownership, to name a few) to reach potential taxpayers and determine their income.

Changes in corporate income taxes can also be introduced relatively quickly, although, as with personal income taxes, the revenue effects may not be felt for two years. The basic changes involve several measures: the elimination of deductions associated with various forms of tax incentives, which can nearly wipe out the tax base; the lowering of the tax rate after the elimination of the incentives; and better administration. The use of minimum taxes can also be contemplated, but they must be very simple to administer. In some recent reforms, these minimum taxes have been based on the imports of corporations, their turnover, and their gross assets. These minimum taxes now exist in many countries.

In developing countries, land and buildings are potentially important tax handles and can contribute needed revenue, especially to local governments. However, if property taxes exist, the assessed values are probably well out of date. One method of generating quick revenues is through proportionally adjusting those values. This adjustment could reflect the change that has occurred in some relevant price index since the last time property values were determined. Adjustments in relative values must wait for a more appropriate time because these reassessments take many years to carry out. The main obstacles to raising property taxes are political and legal rather than technical. When income taxes on properties (land and buildings) are very low or zero, it is important that this tax base contribute to tax revenue through property taxes.

Changes in import taxation can also be made relatively quickly once the legislation is approved. The most important and quickest change is the imposition of a minimum tax of perhaps 20 percent on all imports. For very open economies, such a change can generate substantial revenue in a very short time. This change also improves the efficiency of the economy by reducing the dispersion in effective protection. Changes involving the tariff structure of imports and changes aimed at dismantling quantitative restrictions are also very important but they require more time to implement.

**Decreasing Expenditure**

In recent adjustment programs, expenditure reductions have tended to be more significant than revenue increases. However, the approach taken in cutting expenditures has not always been efficient.
If public sector wages are high (when compared with those in the private sector), their reduction could be part of an adjustment package. However, wage reductions must not be so excessive as to lead to inefficiency or to expectations that real wages will be raised in the near future. The cuts must not exceed what is justified by wage levels in the private sector, and wage differentials, reflecting different skill requirements and responsibilities, must not be overly compressed. Real wages can obviously be reduced quickly and thus can result in rapid expenditure reductions. Over a longer period, however, it is the size of the public sector work force that is the major determinant of public expenditure on wages and salaries. The reduction of public employment is difficult and may be financially costly in the near term, but it must be pursued vigorously if a durable adjustment is to be achieved. Therefore, a concerted effort must be made to reduce the number of public employees, even if this action involves short-run increases in public spending (for severance pay and other compensation).

The second important category of public expenditure that should receive early attention is the investment budget. A close evaluation of all planned and ongoing investment projects must be carried out, with the help of the World Bank or other institutions where indicated. Projects planned for but not yet initiated should be carefully scrutinized regardless of whether they have foreign financing or not. Often the availability of foreign financing has been used as an excuse for carrying out projects of dubious merit. Only if their (realistically estimated) expected rate of return is very high should they be pursued. For the ongoing projects, considerations of sunk costs play a role as do the costs associated with stopping these projects and restarting them at a later date. In some cases this stop-go approach can be very costly. The criterion for maintaining these projects must be the same as that for going ahead with planned projects: those that cannot be justified on the basis of high productivity must be terminated.

The third obvious expenditure area for close scrutiny and quick expenditure reduction is subsidies. Some subsidies may be very important to the poorest groups and must be retained. Others may be important in subsidizing activities that generate significant positive externalities (for example, subsidies to urban mass transport). However, in many countries, much of the expenditure on subsidies meets neither of these criteria. When subsidies are not targeted for the poor but are general in nature, especially when they encourage the con-

19 In some countries, this compression has been so extreme that government ministers and their drivers have received comparable cash salaries.
sumption of a traded good or support inefficient enterprises, they must be cut. If adjustment means anything, it must mean that the state cannot continue to subsidize the consumption habits of the middle classes or the production activities of inefficient enterprises.

Obviously, as argued earlier, the military budget must not escape close scrutiny. Unfortunately, expenditure on these programs has proven very resilient during adjustment programs. Nonetheless, the fiscal reform commission should put downward pressure on this spending by requiring a full accounting of the military budget and by analyzing the opportunity cost of using these resources for defense purposes rather than for economic or social ones.

As a longer-run objective, the commission should reassess public sector involvement in the economy. In most countries many activities have been taken over by the government, perhaps for reasons that appeared legitimate at the time. A period of adjustment is a good time to make an inventory of these activities and question anew their justification. Vested interests and pressure groups will argue for the status quo, but a determined government with a clear sense of direction can show the absurdities of many regulations and governmental activities and can make a concerted effort to eliminate many of them.

Concluding Remarks

This paper has surveyed some major issues that arise when trying to control the public finances of a country during an adjustment program. It has emphasized the much greater complexities and difficulties that arise in the fiscal area as compared with other areas of economic policy. Most economists do not fully appreciate that good fiscal policies are difficult to develop, legislate, and implement. For this reason easy-to-introduce, quick-fix policies have been used not as necessary transitory steps toward a more durable and efficient policy package but as the ends in themselves. These policies, however, are at most a palliative. They are unlikely to provide a sustainable solution to the fiscal problem.

In recent years there has been a lively discussion among economists and policymakers on whether countries should opt for shock therapy or for gradualism in their adjustment programs. This is not a meaningful debate, however, if applied to fiscal policy because good fiscal measures always require time. Nonetheless, two observations are important. First, good macroeconomic policies in other areas often improve the fiscal accounts, especially if they reduce inflation and
bring about realistic exchange rates. Second, gradualism can be interpreted in two ways. One is that gradualism delays decisions about and the implementation of important policies. The other is that the basic policy decisions in a gradualist approach are made early, but the implementation follows a sequencing pattern that allows good policies to be developed, legislated, and implemented. If a clear strategy is developed early, the introduction of the fiscal measures can follow a pattern as close to optimal as possible. Given the importance of expectations for economic performance, even the elaboration and announcement of a sustained long-run policy path can be a first step toward stabilization.

A final comment concerns the legal and constitutional impediments that exist in many countries. These can create formidable difficulties during fiscal reform. For example, in some countries arrangements regarding revenue sharing with local governments, or even with public enterprises and other institutions through earmarking, can impede reform if no major legislative changes are made. Special treaty arrangements with some trading partners can impede reforms in import taxation (an example being the introduction of a minimum tax on imports). Tax incentives provided to some enterprises may impede the reform of corporate income taxes or even other taxes. Constitutional limitations on the use of some taxes can prevent their introduction. Various forms of legal entitlements reduce flexibility on the expenditure side as well. Without the removal of these impediments, sound fiscal reform is difficult. The removal of these impediments will ensure that the fiscal adjustment is spread throughout all sectors of the economy and all levels of government rather than concentrated in those areas over which the central government has some control.

References


For example, in India the central government cannot introduce a VAT that extends beyond the manufacturing sector. In Pakistan, the constitution excludes agricultural income from the federal income tax income.


Comments
Azizali F. Mohammed

This paper by Vito Tanzi is a valuable distillation of countries' experiences with the complexities of fiscal adjustment. He has correctly identified fiscal reforms as the most difficult of the various policy changes required in adjustment programs. Indeed, the difficulties that he enumerates are so many and the need for "quick fix" solutions to immediate problems so pressing that one is actually at something of a loss to explain successful instances of "high-quality" fiscal adjustment. Tanzi is evidently aware of this dilemma for he consoles us, "Being approximately right is normally good enough, and being approximately right is much faster than attempting to be precisely right."

While recognizing the limits of quantification, one must confess to disappointment that Tanzi does not venture beyond qualitative statements to define the size of the required fiscal adjustment and the proportion of it to be completed during the period typically covered under an IMF or World Bank program. Tanzi speaks of a fiscal approach to the balance of payments that suggests limiting the fiscal deficit to a level that can be financed internally in a noninflationary manner and externally through "available, ordinary credit." The internal aspect is linked to liquidity expansion through a change in the domestic credit extended to the government. Tanzi notes, however, that even that part of the deficit that is not being financed by monetary expansion is a cause for concern if it leads to an increase in the ratio of public debt to GDP, if it crowds out the private sector, or if it skews portfolio distributions in the financial sector. Tanzi would perform a valuable service by developing a modeling framework that delimited the boundaries of a sustainable fiscal deficit.

This exercise would entail, as a first step, an assessment of that portion of public expenditures which represents domestic, but not foreign exchange, outlays as well as that portion of public revenues which subtracts from the domestic income stream. A distinction between domestic and external financing is implicit in Tanzi's thinking since, as noted above, he does refer to that portion of the deficit that is financed externally. However, his reference to "available, ordinary credit" is not clear. How, for instance, would he treat a deficit that is financed by recurring foreign grants? Moreover, the portion that is financed by external credits raises different issues of debt-servicing liability and real resource transfers. True, there are connections between external and internal financing, such as the need to find
supporting domestic funds for foreign-aided projects, the treatment of counterpart funds arising from the sale proceeds of nonproject aid, and the preempting implications for domestic resources in "utilizing" foreign aid. However, these connections do not quite justify lumping domestically and externally financed deficits together into a single figure of the permissible deficit and fixing targets for fiscal reduction as if these two forms of financing were economically equivalent in their implications or consequences.

Tanzi has provided a useful catechism of "dos" and "don'ts" in dealing with both revenue and expenditure aspects of correcting fiscal imbalances. He has little to say, however, on issues of tax administration and expenditure control mechanisms, which often lie at the heart of implementation. To design a package of high-quality measures that meet efficiency, durability, and equity criteria would be of little help if they are not implementable in the political, constitutional, or administrative circumstances of a given country.

This last point is particularly relevant to conditions prevailing in Pakistan where tax administrators are compensated at levels far below the higher-priced employees available to the private sector (who are paid to resist the legitimate claims of the tax authorities). One can only agree with Tanzi when he argues that over a longer period it is the size of the public sector work force that is the major determinant of public expenditures on wages and salaries. There is a need to protect real wages in the public sector if corruption is to be constrained and an even greater need to raise real wages for those dealing with tax and expenditure matters in the public sector.

This does not mean, however, that public enterprise expenditures on wages and salaries must necessarily be validated by corresponding increases in the prices of the services these enterprises provide. Tanzi is well aware that increases in public utility tariffs can be dissipated in higher salaries, higher employment, or lower-priority investments; if such spending cannot be controlled, he would rather see these enterprises privatized. But since most public utilities are natural monopolies, this immediately raises the issue of effective regulation. It is a moot point whether a government that is unable to control the wage-setting behavior of its public enterprises will be any more effective in regulating the behavior of privatized monopolies.
Financial sector reforms are policy measures designed to deregulate the financial system and transform its structure with the view to achieving a liberalized market-oriented system within an appropriate regulatory framework. The pace of financial sector reform and innovation began to accelerate in the late 1970s in many industrial countries and in the early 1980s in a number of developing countries of the Pacific Basin and Latin America. Currently, major financial reforms are under way in many African countries and in Eastern Europe. The initial situation in many developing countries and in the formerly centrally planned economies of Europe was characterized by direct controls on interest rates and credit allocation, the absence of well-developed money and securities markets, and underdeveloped and highly regulated banking systems. With reform of the financial sector, this situation is giving way to a greater flexibility in interest rates, an enhanced role for market forces in credit allocation, a gradual deepening of money and securities markets, and increased autonomy for commercial banks. Alongside these developments, the framework of monetary policy is also undergoing major changes. Bank-specific credit ceilings and selective credit allocations are being replaced by market-based instruments for implementing monetary policy, and prudential supervision systems are being put into place to foster sound credit decisions.

In support of such a transition, financial sector reform has involved measures to achieve the following objectives: greater independence for central banks in macroeconomic stabilization and adjustment efforts;
enhanced competition in the banking system; stronger balance sheets and a higher quality of bank portfolios; an effective banking supervision system; and an efficient clearing and settlement system for payments. The relative importance of these objectives and the specific details of the supporting measures have varied from country to country, depending on the prevailing conditions, the commitment to reform on the part of the government authorities, and the speed of the reform process.

In all cases, however, such reforms have been motivated by the need to pursue stabilization and broader structural reform objectives in an efficient and effective manner. It is apparent that the linkages among financial sector reform, the monetary policy framework, and stabilization and other structural reform policies are close and complex. Successful pursuit of stabilization policies is necessary for the effectiveness of broader structural reforms—price reform, fiscal reform, exchange and trade system reform, and industrial restructuring policies—and for financial sector reform. At the same time, it is clear that stabilization policies may not be sustainable unless they are supported by rapid structural changes in key areas. In particular, wide-ranging structural changes in the financial sector are often needed for the effective and efficient conduct of monetary policy; without them, progress toward macroeconomic and financial stability would be difficult to achieve. Indeed, a growing literature suggests that the structure of the financial sector can have a significant influence on macroeconomic performance.2

Furthermore, the appropriate sequencing of different types of structural reform has been found important for overall stability.3 These complex interactions pose special challenges in the design of reform measures in the financial sector and in the sequencing of these measures in coordination with stabilization and other structural policies.

This paper provides an overview of the linkages between financial sector reform and the monetary policy framework—in particular the objectives, instruments, and operating procedures of monetary policy—based on the recent experiences of developing countries. The paper's primary focus is on how financial sector reform affects the design and conduct of monetary policy and not on the financial sector reforms themselves.4 The paper presents a conceptual framework that highlights the role of financial sector reform in facilitating the transformation of a monetary policy framework. It also deals with the

2 See, in particular, Gertler (1988) for a survey of this literature.
3 See, for example, Genberg (1991).
4 For case studies and analysis of financial sector reforms, see World Bank (1989).
implications of financial sector reform for the objectives and design of monetary policy by considering the effects of reforms on money demand, the money supply process, and the transmission mechanism between monetary policy and the principal macroeconomic aggregates. Finally, the paper addresses some issues surrounding the implementation of monetary policy in the context of financial sector reform, with a particular focus on the problems of transition.

Financial Sector Reform from a Monetary Policy Perspective

The transition from direct controls on interest rates and credit aggregates toward indirect management of these variables, increasingly through market-based instruments, can be seen as an interactive and evolutionary process, whereby certain financial sector reforms facilitate the transformation of the monetary policy framework and vice versa. As illustrated in Chart 1, this process can be divided conceptually—not necessarily chronologically—into several stages distinguished by their degrees of interest rate flexibility. The transition from one stage to the next typically involves parallel reform in many central banking functions and in the broader financial sector.

Country experiences clearly illustrate the need for preliminary or parallel reforms of the financial sector when moving toward greater flexibility in interest rates and their eventual liberalization. In general, successful interest rate liberalization—that is, the successful management of interest rates through indirect instruments—is associated with several conditions: a relatively stable macroeconomic environment; an interest rate structure that is not in serious disequilibrium before liberalization; adequate competition in the banking sector; reasonable financial strength in the banking sector; an active and well-functioning money market; monetary policy instruments that are able to influence the marginal cost of funds to banks; and sufficiently strong bank supervision policies and instruments.\(^5\)

Although theoretically an optimal sequence of reform is plausible, in a majority of developing countries reform of monetary management and the development of money markets must be pursued simultaneously. This is because, in practice, there are strong policy and operational linkages between the development of interbank money markets and markets in short-term instruments, on the one hand, and the reform of monetary management and the development of market-

\(^5\)See, for example, Leite and Sundararajan (1990).
### Chart 1. Model of Reforms of the Financial Sector and Monetary Control

**Stage 1**
Direct controls on interest rates and credit dominate; conventional indirect instruments that are not market based play a supporting role (reserve or liquid asset requirement). Selected central banking and financial sector reforms—particularly strengthening bank balance sheets, clearing and settlement operations, and the legal framework for money market and fixed-income securities—are introduced to facilitate transition to Stage 2.

**Stage 2**
Direct controls on credit begin to be phased out; greater discretion and flexibility are used with conventional indirect instruments; market-based indirect instruments begin to be used with consequent encouragement of primary markets in securities and interbank markets. Discount window remains the prime source of liquidity to securities. Interest rates still remain insufficiently flexible.

**Stage 3**
Interest rates are fully flexible. Central bank acts at its own initiative with sophisticated market-based instruments and information systems and manages money market liquidity at its own discretion. Secondary markets are fostered so that the market provides liquidity rather than the discount window.

Further reforms to deepen capital markets, promote institutional development of banks, foster bank and enterprise restructuring, and modernize payments system.

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Footnote:
1 Includes actions to deal with fixed-rate loans, nonperforming loans, capital adequacy, and subsidized selective credits.
based instruments of monetary policy, on the other. Owing to these linkages, money market development has been emphasized early in the reform sequences of many countries (for example, Malaysia, India, and Indonesia).

The absence of well-developed money and securities markets implies that market-based instruments rely on operations in primary securities markets—typically government securities—and in the unsecured interbank market. Recognition that such operations must be carried out at market-related yields is a key step in stimulating interbank and money markets. Such markets, in turn, facilitate the efficient redistribution of surpluses and deficits of short-term funds, which is necessary for the smooth operation of indirect instruments. These technical linkages have to be exploited early in the reform program to provide adequate structural and operational support for implementing efficient and effective monetary policy. An early start on an interactive reform process is also required, because such reform can take some time to implement owing to the need to simultaneously establish various complementary changes in forecasting and other information systems as well as in the underlying accounting and interbank settlement systems themselves. Moreover, the reliance on primary markets in government securities as a means of implementing monetary policy generally calls for supporting changes in domestic public debt management policies and procedures. Thus, many parallel reforms—in central banking functions, money market structures, and public debt management—are involved in the transition from direct to market-based monetary management (from Stage 1 to Stage 2 in Chart 1).

As money and securities markets continue to develop, the range of monetary policy instruments and operations could be widened further. This widening enables the central bank to act primarily at its own initiative, with more sophisticated instruments and information systems, and to manage financial market liquidity at its own discretion (Stage 3 in Chart 1). The range of indirect instruments would now extend to include—in addition to reserve requirements and conventional refinance facilities at preannounced interest rates—arrangements for greater discretion in the use of refinance, special refinance facilities at the initiative of the central bank (such as refinance auctions and refinance quotas), operations in the primary-issue market (such as central bank auctions of its own paper or treasury bill auctions), operations in the unsecured interbank market (such as operations in government deposits, intervention in the interbank market through a specific lead bank, and special deposits with central banks), repurchase operations in specified securities (and in the foreign exchange market), and direct interventions in secondary markets.
In general, the role of primary-market operations in managing bank reserves would decline in relative importance, while that of other market-based instruments would rise. The level of reserve and liquid asset ratios would be reduced owing to the availability of market-based instruments. The importance of "defensive" monetary policy operations—operations to smooth out short-term fluctuations in bank liquidity and short-term interest rates—would also rise in order to prevent excessive interest rate volatility and to ensure that changes in trend are not obscured by day-to-day volatility. Such defensive monetary policy operations help to speed up the transmission of the effects of monetary policy and enable the smooth functioning of financial markets.

In moving toward full interest rate flexibility, parallel reform of prudential regulations and supervisory systems in addition to financial restructuring policies to deal with problem loans and enterprises have been found particularly important. Sound prudential policies and their proper enforcement are critical for minimizing major disruptions to growth and stability. Inadequacies of prudential policies and enforcement procedures together with the failure to correct macroeconomic imbalances in a timely fashion in the course of financial reform have contributed to excessive increases in interest rates (for example, in Chile and Uruguay), partly as a result of excessive risk-taking by banks. To prevent such outcomes, in addition to setting up adequate banking supervision, appropriate measures to recapitalize banks and deal with problem loans may have to be taken in order to ensure the effectiveness of adjustment policies and the success of interest rate liberalization. In many countries, decisions on interest rates have been constrained by a large share of low-fixed-rate loans and nonperforming loans in bank portfolios. Some initial financial restructuring policies to deal with these problems would greatly facilitate more active interest rate policies and more efficient credit allocation.

**Implications of Financial Sector Reform**

The various financial sector reforms discussed in the previous section—in particular, removal of credit ceilings, liberalization of interest rates, strengthening of prudential regulations, and development of

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6 Although most central banks have historically sought to minimize interest rate volatility, analytical and empirical discussions of the impact of such volatility is scarce.

7 See Sundararajan and Balino (1991) for a discussion of the macroeconomic implications of weak bank portfolios and financial restructuring policies to address the weaknesses.
financial and securities markets—can have substantial and important effects on the demand for money, the money supply process, and the transmission mechanism between monetary policy and key macroeconomic aggregates, such as prices, output, and the balance of payments. This section examines the potential effects of financial sector reform on the demand and supply of money and then describes how the transmission mechanism is likely to change in the wake of financial liberalization.

**Money Demand and Money Supply**

The quantitative formulation of monetary policy typically assumes the existence of a relatively stable money demand function. Financial reforms that affect the determinants of the demand for money—income, prices, interest rates, and exchange rates—may lead to significant changes and possible instability in the demand for money. Such changes in the demand for money, particularly if they are unpredictable, obviously make it more problematic to ascertain the liquidity needs of the economy, thereby creating greater uncertainty in the supply of credit and money needed to achieve the policymaker’s ultimate objectives. In many countries undertaking financial sector reform, it has been observed that the ratios of money and credit to gross domestic product have risen, while the ratio of currency to deposits has declined.

The effects of financial liberalization on money demand may be divided into one-time shifts of monetary stocks and changes in the elasticities of money demand with respect to its determinants. One-time shifts in the stock of monetary aggregates may result from portfolio reallocations that arise from (i) interest rates that better reflect the risk-return characteristics of financial assets, (ii) the removal of certain quantitative restraints in the types of assets that can be held, and (iii) the development of new assets that would compete with money. Structural changes in money demand—changes in the effects of the variables determining money holdings—may be caused by some of the same factors, by the move toward indirect monetary control instruments when administrative credit ceilings are replaced by the volun-

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6 This requirement is sometimes interpreted incorrectly as implying that income velocity must be constant. What is required, however, is that the demand for money, or velocity, be a predictable function of a few variables.


10 For details on the effect of financial liberalization on the demand for money, see Tseng and Corker (1991).
tary portfolio behavior of agents responding to changes in income, wealth, and interest rates, and by policies to improve and deepen financial markets. The consequent competitive pressure and lower transaction costs in financial markets, and a reassessment of the risks of holding financial assets, are likely to lead to portfolio shifts and a heightened sensitivity of money demand to changes in income, wealth, and interest rates.

Consider, for example, the case of interest rate effects on the demand for money. In many developing countries interest rates are seldom considered an important determinant of money demand for two main reasons. First, the lack of alternative financial instruments tends to restrict agents to holding only monetary claims—principally currency and bank deposits. Second, interest rates are typically under official control and are often set below their equilibrium level. Since there are few interest-bearing financial assets and interest rates are infrequently changed, it is not surprising that the effect of interest rates can be ignored or discounted. Financial reforms that expand the menu of financial assets that bear market interest rates are likely to lead to an increased sensitivity of money demand to interest rates. Furthermore, as reform of the financial sector is a dynamic process, changes in the demand for money may occur continuously over time. Thus, shifts in the demand for money are not only likely in the short run but are also a possibility in the long run.

Turning now to the money supply process, in the pre-liberalization period characterized by direct controls on credit, interest rates, exchange rates, and capital flows, the traditionally measured money supply can often be specified simply as a function of reserve money.\(^\text{11}\) The money supply can be related to the money multiplier and reserve money as follows:

\[ M = mRM \tag{1} \]

where \(M\) is the stock of money, \(m\) is the money multiplier, and \(RM\) is the stock of reserve money. The money multiplier can be expressed as:

\[ m = \frac{1 + C/TD}{C/TD + RE/TD + RR/TD}, \tag{2} \]

where \(C\) is the stock of currency, \(TD\) is total deposits, \(RE\) is excess reserves of banks, and \(RR\) is required reserves. Insofar as the ratios in equation 2 are constant owing to the fixity of their determinants in the pre-liberalization period, equation 1 is a useful representation. In practice, the combination of credit ceilings and unfettered growth in bank reserves (for example, the liberal provision of refinance to support selected priority sectors) could lead to a large build-up or variations in excess reserves, causing the money multiplier (\(m\)) to vary, but possibly in a predictable way.
the money multiplier is thus constant. In the post-liberalization period, both the public and the banks are free to choose their asset-liability portfolios according to market-determined rates of return and relative risks. As such, the components of the money multiplier can no longer be considered constant, rather they are endogenous variables that respond to changes in income, wealth, and interest rates. Among these components—namely, the currency-deposit ratio, the excess reserve ratio, and the required reserve ratio—only the required reserve ratio is directly influenced by policy. The other two ratios are behavioral functions of income, wealth, and the various interest rates (reflecting opportunity costs) facing both the public and the banks. When interest rates are liberalized and portfolio restrictions lifted, these component ratios change and by changing the money multiplier have an impact on the money supply. For example, the elimination of credit and interest rate ceilings facilitates a decline in excess reserves, reinforced by higher lending rates, while an increase in deposit interest rates generally leads to higher demand for bank deposits. The reduction in reserve requirements raises the value of the money multiplier and, for a given level of reserve money, the money supply as well. The increase in the money multiplier is also supported by the fall in the currency-deposit ratio as the opportunity cost of currency holdings rises12 and by a lower excess reserve ratio prompted by higher bank lending rates and a deepening of money markets. Thus, the interdependence of reserve money operations and the money multiplier, absent during the pre-reform period, is a major result of financial liberalization.

The predictability of the money supply hinges not only on the actions of the monetary authorities, through changes in reserve requirements and reserve money operations, but also on the predictability of the demands for currency, bank deposits, and excess reserves. Any variations in these demands mean that forecasting the money supply following financial liberalization will be difficult. Thus, it is readily apparent from a theoretical standpoint that financial liberalization—by altering the behavior of the public and banks—will change both the demand for money and the money supply process. By how much is an empirical question.

Several empirical studies have examined the effects of financial liberalization on the demand for money. For example, a recent study

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12The currency-deposit ratio is also likely to fall for another reason: the process of the reintermediation of financial flows back to the previously controlled banking system and away from less regulated intermediaries and financing channels, which are unlikely to have been measured in monetary statistics previously.
of nine Asian countries in different stages of financial sector reform reveals instability in the short-run demand for money in five of the nine cases and stability in the long-run demand for money in all cases. In addition to one-time shifts and changing income and interest rate elasticities, instability is reflected in the statistical significance of interest rate variables that were unimportant in the pre-reform period. Evidence on the effects of financial innovations on the demand for money—which are possible once financial sector reforms are undertaken—also bears on this issue. For example, Arrau and others (1991) show in a sample of 10 developing countries that the role of financial innovation (modeled in alternative ways) was quantitatively important in determining money demand. Their paper goes on to argue that, while it may be difficult to measure and forecast financial innovations, it is necessary to take them into account. Failure to do so may lead to inaccuracies in the projection of the demand for money and in problems identifying the transmission mechanism for monetary policy.

In contrast to the availability of empirical work on financial liberalization and the demand for money, empirical studies on the effects of liberalization on the money supply process are lacking. While there is evidence that the money multiplier and its component ratios do tend to change over time, demand equations for currency, bank deposits, and excess and borrowed reserves (or free reserves) have yet to be estimated for periods that cover pre- and post-financial liberalization. In theory, in the absence of offsetting changes in reserve money, increases in real interest rates and reductions in reserve requirements following financial reform would tend to raise the money supply through an increase in the money multiplier, which, in turn, is brought about by shifts out of currency and into bank deposits, by declines in excess and free reserves, and by lower required reserve ratios. Empirical validation of the theory is needed, although this task will prove more difficult than in the case of the demand for money if only because a larger number of demand functions need to be estimated and tested for stability.
Monetary Policy Transmission Mechanism

In industrial countries with highly developed financial markets, a broad consensus on the nature of the transmission mechanism has existed for some time. In brief, an expansionary monetary policy—undertaken, for example, through an increase in bank reserves supplied by the central bank through an open market purchase—leaves the private sector with too much money in its portfolio relative to other assets. In reestablishing portfolio equilibrium, banks increase credit, and agents bid up the price of securities and durable assets, thereby lowering their respective rates of return. Since the market price of securities rises, and that of durable assets such as physical capital increases relative to their replacement costs, agents attempt to increase their stocks of such assets by increasing their demand for newly produced units of these assets. In this way, an open market purchase of securities results in an increase in aggregate demand. Essentially, interest rates represent the key link between monetary actions and macroeconomic variables. The central bank alters interest rates indirectly, which, in turn, affects the interest-sensitive components of aggregate demand—housing, consumer durables, and investment expenditures—and thus prices, output, and the balance of payments. With a floating exchange rate, the central bank's actions also affect the exchange rate, with further effects on the components of aggregate demand through changing wealth and relative prices.

In developing countries, however, the picture differs somewhat. In the first place, the menu of assets available to private agents is very limited. Organized securities markets in which the central bank can conduct open market operations scarcely exist in many developing countries. By and large, individuals can hold currency and deposits issued by the banking system, and they can borrow from commercial banks, although informal markets often emerge resulting in financial disintermediation through "curb" markets for deposits and loans. Durable goods, such as land and physical capital, can be held directly, but organized equity markets are small or nonexistent. Capital controls and prohibitions on the holding of foreign exchange limit the extent to which foreign assets may be acquired by domestic residents, although parallel markets for foreign currency surface in response to such regulations, thereby allowing agents to circumvent official controls to some degree. Finally, even in the case of those assets and liabilities available

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16See, for example, Laidler (1978).
17See Montiel (1991) for a detailed discussion of the transmission effects of monetary policy in developing countries.

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to individuals, such as demand, time, and savings deposits and bank credit, official restrictions often determine the interest rates paid or charged by financial institutions, although a variety of methods for avoiding interest rate controls typically emerge.

Monetary policy in such a controlled environment operates primarily through a credit-rationing channel, with the role of interest rates depending upon the extent to which agents circumvent or avoid direct controls through less formal and less regulated markets. Changes in the supply and control of credit—typically brought about through administrative means—have direct effects on aggregate demand. In simple terms, those agents who have credit made available to them are able to expand demand. Insofar as the effects of interest rates on the economy are concerned, two basic schools of thought exist. Adherents of the McKinnon (1973) view maintain that raising controlled bank interest rates need not be contractionary, because in a rationed regime the induced increase in saving will result in an increased supply of credit, which facilitates the financing of private investment and working capital. By contrast, the "neo-structuralist" view, as represented by van Wijnbergen (1983), emphasizes the importance of informal loan markets when bank interest rates are subject to legal ceilings. In this case, it is argued that increases in bank interest rates will draw funds away from such markets, thereby increasing the marginal cost of funds and exerting contractionary effects on the economy from both the demand and supply sides.\textsuperscript{18} For the McKinnon school, the primary channel of transmission is the direct effect of the controlled bank deposit interest rate on private saving, whereas the neo-structuralist school focuses on effects that are transmitted from the loan interest rates (both formal and informal) to interest-sensitive components of demand and supply—much as in the case of developed economies.

The removal of credit ceilings, the liberalization of interest rates, and the financial sector reform change the transmission channel from predominantly direct credit rationing, as discussed above, to predominantly price rationing through market-determined interest rates.\textsuperscript{19} The transmission channel thus begins to approximate the developed country paradigm. In this regard, the key market is the one for bank reserves, which the monetary authorities attempt to influence through control over the stock of reserve balances of banks. For example, a

\textsuperscript{18}In the latter case, this occurs because of the need to finance working capital.

\textsuperscript{19}It should be noted that even in liberalized markets an important element of quantity rationing by banks is likely to remain optimal—because of uncertainty and information costs involved in credit analysis, for example. See Stiglitz and Weiss (1981).
decrease in bank reserves brought about by open market sales of securities would raise short-term interest rates, which, if perceived as a lasting effect, would create a ripple along the yield curve, thus influencing the medium- and long-term rates as well. In addition, in an open economy, capital flows and exchange rates provide additional transmission channels for monetary policy. In countries with relatively open foreign exchange markets but fixed exchange rates, capital flows would prevent the domestic interest rate from deviating substantially, and for any length of time, from international rates. For instance, a decrease in bank reserves through open market sales would raise the domestic interest rate. The resulting capital inflows would offset both the initial reduction in reserves and the initial increase in the domestic interest rates. In these circumstances, the monetary authorities do not fully control the supply of money, which is partly determined by balance of payments deficits or surpluses. Full control in this case requires sterilization of balance of payments imbalances. Absent adequate amounts of securities and foreign exchange, such sterilization would be difficult to sustain while maintaining the fixed exchange rate. On the other hand, where capital flows are free and exchange rates flexible, the capital flows induced by the increase in domestic interest rates tend to cause the domestic currency to appreciate, which gives a measure of independence to short-run domestic interest rates and reinforces the restrictive monetary policy by lowering demand for domestically produced tradable goods and reducing inflation.

In a liberalized financial environment, the term structure of interest rates is also an important aspect of the monetary transmission process, since financial liberalization is likely to affect the yield curve. Whether the relationship between short-term rates and long-term rates is affected or not depends on two interdependent factors: the direct liquidity effect and the effect of the inflationary expectations–monetary policy credibility nexus. Under the first effect, short-term rates are negatively related to discretionary monetary operations. As for the second effect, a credible restrictive monetary policy, which is perceived to be anti-inflationary, will likely reduce the inflation premium built into long-term rates. On the other hand, a contractionary monetary policy that lacks credibility will do relatively little to affect long rates. Since in a liberalized financial regime the private sector has greater freedom to manage its portfolio, including its maturity structure, any policy-induced increase in short-term interest rates will be dampened by substitution away from long-term assets in the

\[20\text{See Organization for Economic Cooperation and Development (1990).}\]
expectation of higher yields on short-term holdings, given that policy is seen to be credible.21

In response to changes in reserve money, the short-term rates and the relationship between short and long rates may also be affected by the endogenous behavior of components of the money multiplier in response to initial changes in the short rates. Changes in the interest rates on treasury bills and securities associated with open market operations affect bank deposit and lending interest rates, and hence the currency and excess reserve ratios.22 Changes in bank deposit and lending rates and in other interest rates also influence private decisions to accumulate real and financial assets and to purchase goods and services via income and wealth effects.

The relative importance of the liquidity effect in financially liberalized industrial countries is evident in the results from empirical tests of the relationship between long-term rates and both short-term and foreign interest rates.23 For most of the major industrial countries, the sensitivity of long rates to short rates is reduced during financial liberalization, while the responsiveness to foreign rates increases. This suggests that financial reforms increase the relative importance of inflationary expectations and of foreign rates in domestic interest rate determination, while the impact of domestic liquidity on the slope of the yield curve becomes weaker.

Even in financially liberalized economies, variations in the availability of credit have been considered an important transmission channel for the effects of monetary policy by various economists. This "credit school" has gathered strength in recent years owing to recent analytical and empirical developments in explaining credit rationing and examining credit market disturbances. These studies have espoused

21For example, if an increase in short-term interest rates is seen as a clear shift toward tightness and reduces expected inflation, then long-term rates would decline, and the substitution effect would dampen short-term rates. Therefore, for a temporary period, a credibly restrictive monetary policy could produce a negative yield curve. Similarly, if the authorities add to bank reserves and attempt to reduce short-term rates, and if this is seen as a weakening of the anti-inflationary stance, then long-term rates would tend to increase (reflecting higher inflationary expectations), which would pull shorter rates back up through substitution effects.

22The impact of short-term rates (which can be controlled by the central bank) on bank deposit and lending interest rates (which are based on banks' pricing and portfolio decisions) could be complex and depends on the extent of competition in the banking industry, the regulatory constraints and quality of bank assets that affect portfolio choice and marginal costs (such as capital adequacy and provisioning rules, reserve and liquid asset requirements, and the proportion of nonperforming loans), and the degree of openness of the economy to capital flows.

that changes in credit availability can have large effects on the real economy, both on the level of aggregate output and on its sectoral distribution. Their observation has implications for the choice of financial aggregates to be used as targets of monetary policy and calls for more explicit attention to bank regulations, bank behavior, and credit market conditions in formulating and analyzing monetary policy.24 Thus, the relative importance of credit rationing and price rationing as channels of monetary policy are affected not only by the degree of progress toward interest rate liberalization but also by the prevailing macroeconomic environment and financial structure that govern bank behavior toward credit allocation.25

The discussion above shows that the relationship between financial aggregates and ultimate monetary objectives as well as the ability to control aggregates—that is, the relationship between instruments and operating targets of monetary policy, on the one hand, and financial aggregates, on the other—is likely to undergo changes in the process of financial liberalization. Therefore, the choice of financial aggregates that could serve as intermediate targets to guide monetary policy, as well as of operating procedures to ensure monetary control, has changed in most countries. First, the coverage of instruments that constitute different monetary aggregates and the information content of various aggregates have been reexamined in many industrial and developing countries. Second, central banks have increasingly relied on a basket of indicators rather than on a single intermediate target—such as a particular financial aggregate or interest rate—and pragmatically reset the chosen targets according to the latest information and developments. Third, the issue of making the appropriate choice between interest rate targets and financial aggregate targets has received more attention. Finally, the instruments and operating procedures of monetary policy have significantly changed in all countries that undertook financial liberalizations; new approaches were needed to improve monetary control in the changing environment.

Operational and Institutional Aspects of Monetary Policy During Financial Reform

In discussing monetary policy in a liberalized system, the previous section highlighted the roles of bank reserves and short-term interest

24See Jaffee and Stiglitz (1990) and Modigliani and Papademous (1980, 1987) for discussions of credit market behavior and its role in the transmission of the effects of monetary policy.
25See, for example, Villanueva and Mirakhor (1990).
rates in market-based monetary management. The procedures and instruments by which the central bank tries to influence the level of bank reserves and short-term interest rates (and exchange rates) depend on several institutional factors. Among these, the level of development of a country's money markets, the nature of its clearing and settlement system (including the reserve accounting framework), and the type of domestic public debt management system in place are the most important. These factors influence the design of the monetary policy instruments and the instrument mix. Hence, reforming these factors is the first order of importance for monetary policy implementation. As already noted, the monetary policy framework itself affects the structure and depth of the money market, and the nature of the clearing and settlement system is another dominant force influencing the structure of the money market.26

The need initially to use primary markets in government securities—in part reflecting the lack of depth of secondary markets—for both monetary and debt management raises a variety of operational and institutional questions relating to the coordination of treasury and central bank policies. If the supply of government securities to the market based on debt management considerations proves insufficient or excessive and cannot be effectively coordinated with monetary goals, should the central bank use its own securities to manage bank liquidity? What are the respective roles of the treasury and the central bank in the primary issue of government securities, in managing the secondary market in those securities, in the clearing and settlement of transactions in the securities, and in short-term cash forecasting to facilitate debt and monetary management? If liquid asset ratios are used for monetary and debt management, what is the appropriate transition strategy for moving toward voluntary debt issue and market-based instruments? Such questions have been addressed in many countries during the course of monetary reform (including Poland, Nepal, New Zealand, and Malaysia).

Several aspects of the payments system governing money market transactions play a crucial role in the implementation process. First, whether the clearing and settlement of such transactions take place on the same day or with a lag (or whether there is a mixed system) affects the demand for excess reserves. The level and volatility of excess reserves depend not only on the accounting rules governing clearing and settlement between the central bank and private banks

26For further elaboration of monetary policy implementation procedures, see Freedman (1990) and Kneeshaw and Van den Bergh (1989) for the case of industrial countries and Johnston and Brekk (1989) for the case of developing countries.
but also on those governing the private bank and its customers.\textsuperscript{27} These rules, together with the level of communications technology, could cause large variations in the size and variability of the interbank float, with major implications for the design and effectiveness of indirect instruments. The lags and other features of the settlement system for payments, the terms and conditions of access to central bank credit (to settle payments), and the rate of remuneration on excess reserves are some of the key elements that determine the demand for excess reserves and short-term money market conditions.

The structure of the reserve requirement system—particularly reserve averaging and the length of period over which the averaging is conducted—also interacts with the clearing and settlement system and affects the volatility of short-term interest rates and the operating costs to banks. For example, reserve averaging reduces interest rate volatility caused by uncertainties and lags in the settlement system. Lags in the reserve requirement as well as the coverage and uniformity of such requirements across institutions and instruments are important factors affecting monetary control. Reform of reserve requirement systems has figured prominently in many financial reforms (two examples are Malaysia in 1989 and the United States in 1984); some countries have even instituted zero reserve requirements (New Zealand, Canada, the United Kingdom, and Mexico), supported by adaptations in their interbank settlement and refinance systems.

Refinance systems—the rules and procedures by which a central bank provides credit to financial institutions—have also changed dramatically over the course of financial reforms. Refinancing and rediscounts provided at the initiative of the central bank have increased, while the amounts provided through conventional credit facilities at preannounced rates have declined. In particular, the use of sale and repurchase transactions in securities and bills and of auctions of refinance has increased as a means of supplying reserves at the initiative of the central bank. Such procedural changes have facilitated greater flexibility and control over short-term interest rates and fostered greater activity in money markets.

The choice of an operating system for monetary policy influences the pace of structural reform. First, active liquidity management by the central bank will induce banks to be active, thereby contributing to the development of markets. Active liquidity management, however, requires strong policy research and information systems to anticipate developments in bank reserves. It is only the central bank that can

\textsuperscript{27}See Summers (1991) for a discussion of the role of central banks in payments system reform.
operate to anticipate situations of protracted excess liquidity or conversely a shortage of reserves when most agents are on one side of the market—and thereby promote conditions conducive to market development. Second, the instrument mix of the central bank should be consistent with market development goals as well as the goals of monetary policy. For example, a central bank could readily inject liquidity into the system by not replacing the securities being redeemed. However, in some circumstances, the central bank may choose to maintain the outstanding volume of securities in the market and inject additional liquidity through other means, so as to better sustain market development. Finally, the specific design of individual instruments can contribute to the structural development of the financial sector. The choice of securities that are eligible as collateral for refinance or repurchase operations, the specification of eligible liquid assets, and the structure of the reserve requirement system are some of the factors affecting the demand and supply of securities, the interest rate structure, and the depth of various segments of the market.

In addition to such structural considerations, the appropriate mix of instruments to absorb and supply reserves depends on the choice of operating targets (borrowed reserves versus unborrowed reserves, net domestic assets, and so on) and the projected path of autonomous factors affecting bank reserves. This projected path, in relation to the desired path of an operating target, determines the mix between those instruments that absorb reserves and those that supply them and also determines the maturity of various monetary operations.

Moreover, the choice of operating targets (and intermediate targets) should depend on the nature of the shocks affecting the monetary system. Conventional wisdom, based on analysis contained in Poole (1970), states that in times of major financial sector reforms resulting in significant shifts in the behavior of various money and credit aggregates, it is preferable to target interest rates. In times of major shocks to the real economy, it is appropriate to target money or credit aggregates. Similar considerations affect the detailed design of operating procedures. The choice between targeting some short-term interest rates (overnight interbank rates or auction rates for treasury bills) or some quantity measure (excess reserves, free reserves, borrowed reserves, or various definitions of domestic credit) also depends on the relative size of disturbances affecting the financial system. In times of major macroeconomic adjustment and supporting financial sector reform, it is hard to assess the relative magnitude of various

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28See Bryant (1983) for an analysis of the choice of operating targets under alternative sources of disturbances.
shocks to the real sector and the financial system. Therefore, as noted earlier, central banks often tend to rely on a basket of indicators and pragmatically readjust the chosen target on the basis of the latest available information. Nevertheless, at any one point in time, the choice between prices and quantities becomes secondary to setting the right target for the prices or quantities, given the prevailing financial and nonfinancial indicators, and to achieving the target through an efficient set of monetary policy instruments that support both stabilization and structural objectives.

Concluding Remarks

Financial sector reform and monetary policy reform in both developed and developing countries during the past two decades have proven, on balance, to be highly beneficial. Reduced credit rationing and greater interest rate flexibility have led to an improved allocation of financial resources, while increased competition among banks and other financial institutions has lowered the cost of intermediation. At the macroeconomic level, growing evidence suggests that countries with more liberalized financial systems have benefited from increased savings, better and more efficient investment performance, and faster rates of economic growth.

Significant adaptation of the targets and operating procedures of monetary policy have been needed over the course of financial liberalization and innovation. The adaptations have included the pragmatic resetting of chosen targets—whether financial aggregates, interest rates, or exchange rates—based on up-to-date financial and nonfinancial indicators, and improved, flexible operating procedures both to influence the marginal cost of funds to banks and to foster active money markets.

Nevertheless, in a number of cases such reforms have created serious problems for the financial system. The failure to correct macroeconomic imbalances and implement an appropriate supervisory framework have been the primary reasons that such reforms have failed. The interaction between macroeconomic instability and inadequate bank supervision has encouraged banks to undertake risky lending in the presence of deposit insurance and loan guarantees, which has often resulted in an immediate and steep increase in real interest rates, with adverse consequences for investment and growth.

To prevent such outcomes, economic stabilization and improved bank supervision should generally accompany a full liberalization of interest rates. Indeed, a better flow of information, adequate disclosure, strong supervision of the banking system, and macroeconomic
stability are key features of successful experiments in financial liberalization. Based on country experiences, a reassessment of deposit insurance and loan guarantee schemes is also necessary to sharpen the risk analysis performed by banks. Excessive short-term interest rate volatility could be minimized by the appropriate design of specific monetary policy instruments and operating procedures. For example, reserve averaging, modifications to refinance policy, and improvements in clearing and settlement systems reduce the interest rate volatility caused by uncertainties and lags in the settlement system and thus improve control over short-term interest rates. Most important, the elimination of fiscal imbalances and timely actions to recapitalize banks and deal with problem loans and enterprises would help relieve pressures on interest rates. Together, these measures would ensure the success of both stabilization and financial liberalization and thus lead to a more efficient financial system.

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Villanueva, Delano, and Abbas Mirakhor, "Strategies for Financial Reform: Interest Rate Policies, Stabilization, and Bank Supervision

Comments
I.A. Hanfi

Let me start by congratulating Mohsin Khan and V. Sundararajan for their comprehensive and high-quality treatment of this subject. I share the main message of their paper that a stable financial and monetary framework is an important prerequisite for noninflationary and sustained economic growth.

In the past, public policy in much of the developing world was characterized by confidence in the capacity of the state to promote development by channeling resources to priority sectors. Monetary policy was seen as contributing to growth through a system of direct credit allocations and administered interest rates rather than through aggregate demand using traditional tools of monetary policy such as open market operations, changes in reserve requirements, and variations in the discount rate. Various factors, mostly of a structural and institutional character, strengthened the preference for direct control mechanisms. The narrow market for government securities did not allow the use of open market operations. Government securities were held by a limited number of financial institutions, basically as part of liquidity ratio requirements. The financial markets were narrow, unintegrated, and noncompetitive. The overall level of credit could theoretically have been controlled by changes in reserve requirements, but their effectiveness was often counteracted by the existence of windows for concessional finance. Whatever the virtues of selective credit control for monetary management in a particular developing country, its use tended to create vested interests and entailed large efficiency and social costs even when administered properly.

Of late, there is a growing appreciation in many developing countries of the merits of market forces for determining the allocation of resources, including credit. This thinking has been reinforced by the collapse of the centrally planned economies and their movement toward market-oriented, outward-looking systems. This historic conversion has been instrumental in encouraging similar changes in many parts of the world as long-hidden costs of centrally directed investment, production, and resource allocation have become better known. As a consequence, many governments are now undertaking deregulation, denationalization, and privatization in various sectors of the economy, including the financial sector.

One should remember that there are several preconditions to the success of any program of financial liberalization. Macroeconomic
stability is one of the most important. A complete liberalization of interest rates in countries with high and unstable rates of inflation can lead to high real interest rates, which may retard investment and growth. Furthermore, macroeconomic instability makes it difficult to maintain the stability of the real exchange rate or the interest rate. The removal of controls on cross-border flows of capital may lead to volatile capital flows and undermine monetary control in situations of large macroeconomic imbalance. Where prices are distorted, financial liberalization may not improve the allocation of resources. Indeed, deregulation may make matters worse. Thus, financial reforms should start by controlling the fiscal deficit and establishing macroeconomic stability.

Second only to the maintenance of macroeconomic stability is the issue of central bank independence as a precondition for the reform process. With very few exceptions, central banks are generally not independent of government influence and, in some cases, of government control. Yet, the priorities of central banks and finance ministries can often diverge with respect to the weights to be assigned to growth, inflation, and the stability of the currency. As such, it is generally recognized that unlike other financial institutions, the central bank must have special status in order to perform its task without being unduly influenced by noneconomic considerations of a transient nature. For the central bank to take an objective stand on economic issues and to maintain a steady course, it must have the right to act independently and speak freely. The pursuit of an independent monetary policy presupposes both the willingness of the political authorities to allow the central bank the freedom to perform its statutory tasks and their preparedness to accept the cost of monetary policy conducted in a market-related environment, especially in the area of debt management.

Empirical studies suggest that market forces need to be supported by consistent public policies. While there are many instances of misguided intervention by authorities, the fact remains that practically no country that has modernized its financial sector in recent decades has pursued purely market-determined policies. No single model will suit all countries at all times. Policy must be pragmatic and based on a realistic understanding of how monetary and financial variables interact with the real sector. Latin American experience suggests that a sudden dash to financial liberalization without appropriate institutional and legal frameworks can end in a crash, thus requiring even greater government intervention than before the reform. It is fashionable to call for doing away with the regulation of interest rates and the limitations on competition among financial institutions. But this line
of thinking could in certain situations push up the cost of finance in unpredictable ways, with a devastating effect on the growth performance of the real sector. Hence the third precondition for the success of a financial reform program is managing the transition in a careful and prudent manner so as not to impose on the economy any avoidable burdens and risks in the wake of deregulation.

Besides the economic requisites, some institutional requirements also need to be met in order to support a program of financial sector liberalization. Rationalization of corporate and commercial laws and their efficient administration are necessary for a liberal financial system. Laws and procedures relating to disclosure of information, restructuring, bankruptcy, enforcement of contracts, foreclosures, and auditing of accounts are all relevant in this respect. No less important is the need to strengthen the machinery for effective supervision of the financial system. With the globalization of the financial markets, the need for much closer cooperation among national supervisory authorities is being increasingly felt. Some progress has been achieved toward such cooperation but much remains to be done.

Pakistan is in the process of financial sector reform. Together with a progressive deregulation of the economy, the Government of Pakistan has undertaken, on a priority basis, the speedy implementation of a comprehensive program of financial sector reform. The objectives of the program are to strengthen the role of the formal financial sector, contain the unofficial market, improve saving incentives, enhance the allocative efficiency of bank credit, and minimize intermediation costs through competition. The reforms initiated in the financial sector broadly cover the areas of public debt management, privatization of financial institutions, increased reliance on market-related monetary instruments, and a strengthening of the supervision of the banking system.

In the area of debt management, the main thrust of the reforms has been to improve and refine the pricing and marketing of government debt. Toward this end, auctioning of the public debt instruments of short-, medium- and long-term maturity is fully in place. Considerable progress has been made in reducing distortions in the interest rate structure. Policy changes in this area are designed to provide a secure return to small savers, achieve a balanced maturity structure of government debt, and develop a secondary market for financial instruments.

The scope of reforms relating to monetary policy extends to eliminating distortions in the interest rate structure and reducing the incidence of subsidized and directed credit. To achieve these objectives the market orientation of policy instruments has been encouraged and sharpened. Increasing reliance has been placed on the indirect control
of money and credit, with the eventual goal of eliminating credit ceilings which have served as an instrument of credit regulation for a number of years. Also, progress has been made in the rationalization of rates of return together with reducing the size of subsidized and directed credit.

In the area of bank organization and supervision, the thrust of the reform measures taken so far has been to improve the performance of banks, including the development of financial institutions. New prudential regulations for all banks on loan classification, income accrual and provisioning policy, exposure limits, and audit requirements have been introduced. A program is being implemented to strengthen the capital base of banks. The State Bank of Pakistan is being strengthened to adequately perform its supervisory functions as well as those functions related to monetary policy and public debt management. The supervision of nonbank financial institutions will also be taken over shortly by the State Bank. A credit bureau is being set up to pool information from all financial institutions on their exposures and on the payment records of borrowers.

In conclusion I would like to say that liberalization of the financial sector accompanied by appropriate fiscal and exchange policies and competitive market conditions should be beneficial for the economy. However, a program of financial sector reform should be carefully sequenced over a reasonable, rather than a compressed, time frame. Also important is the need for effective supervision of the financial sector to ensure its viability and maintain public confidence. In this respect one cannot overemphasize the imperative need for ensuring that financial institutions are managed by persons of high integrity and competence.
Privatization, Deregulation, and Macroeconomic Policies: The Case of Pakistan
*Ibrahim Elwan*¹

The emergence of independent developing countries following World War II shifted the responsibilities for economic management from the colonial powers to the new governments. Policymakers inherited economies largely dependent on the export of primary commodities, cash crops, and semimanufactured goods. A large proportion of these exports was produced by foreign private sector enterprises. The rest was produced by subsistence farmers and small cottage industries. Infrastructure was limited to the industrial enclaves, large agricultural estates, and urban areas. Independence emphasized self-reliance and the need to decrease dependence on exports of primary goods and agricultural products by promoting industrialization. Failure by private sector enterprises to respond to the aspirations of the new governments because of entrepreneurial risks or an inability to mobilize the needed resources frustrated development plans. In response, governments consolidated their control over existing industries through expropriations and nationalization to capture rents for financing new industrial investments. As a result, private sector investment declined and foreign venture capital became scarce. This coupled with relatively low levels of domestic savings, poorly equipped capital markets unable to mobilize savings, and competition from the industrialized countries for reconstruction capital left a gap in the resources available to developing countries.

Faced with limited access to private sector capital, governments had to rely increasingly on external official grants and credits and guaranteed loans to finance their development plans. The growing demands on governments to accelerate growth by developing infra-

¹The views expressed in this paper are those of the author and should not be taken to represent the views of the World Bank.
structure—transport, telecommunications, power, water, and ports—and the industrial and agricultural sectors forced the public sector to take greater responsibility for the development of new industries and infrastructure by concentrating new investments in the state-owned enterprises (SOEs). Gradually, the number of SOEs increased and the extent of their activities broadened.

SOEs were created to achieve national development priorities, which at times paid little attention to comparative advantage, economies of scale, capital constraints, and profit generation. As a result, a large proportion of these SOEs depended from the outset on subsidies and budgetary transfers. Loans with subsidized interest rates were made available by governments to cover firms' operating deficits and new investments. Nonperforming loans were converted to equity or changed to grants. SOEs also enjoyed protection from competition through licensing, concessions, preferential exchange rates, exemption from duties, and tax holidays. These practices undermined the incentives for efficiency and increased the SOEs' dependence on budgetary support. According to a study by Malcom Gillis, SOEs' deficits in developing countries increased from 5.5 percent of GDP in the 1970s to as much as 12 percent in the 1980s in some countries. Deficits and investment plans of SOEs were financed by governments through domestic and external borrowing. In the late 1980s, SOEs, particularly in the infrastructure sectors, accounted for more than 50 percent of domestic banking debt and as much as 40 percent of the external debt of developing countries.

The debt crisis of the mid-1980s brought with it severe limits on the access of developing countries to foreign exchange. This, in addition to the shortages of domestic resources attributable to poor pricing and taxation policies and the deteriorating efficiencies of SOEs, which imposed an increasing burden on national budgets, focused attention on the need to put the reform of SOEs at the top of the economic agenda. The pressure on governments to resume economic growth in the late 1980s and early 1990s, after more than a decade of slow growth and stagnation, called for policies to restore fiscal, monetary, and external balance. Critical to the success of these policies was the rationalization of the state-owned sector. The industrialized countries in which SOEs play a major role in the economy, such as the United Kingdom, New Zealand, and Japan, had launched earlier similar programs for the rationalization of SOEs. Their programs involved restructuring, corporatization, divestiture, and liquidation on the path

to privatization. The success of these privatization programs gave confidence to developing countries that hoped to make privatization one of the main elements of their economic adjustment programs.

The purpose of this paper is to review Pakistan's privatization strategy in the context of its current macroeconomic adjustment program. To provide a basis for this review, the paper starts with a definition of privatization and the means for its attainment. It then proceeds to discuss the general objectives for privatization and the framework linking macroeconomic policies, deregulation, and privatization. Pakistan's privatization program is also briefly presented. Key issues likely to affect the implementation of the program are discussed in the last section.

**Definition of Privatization**

Privatization refers to the involvement of private sector enterprises, foreign and domestic, in the design, finance, development, ownership, and operation of facilities engaged in the production, transport, and delivery of goods and services. Privatization can be achieved by (i) developing new private sector facilities; (ii) transferring, partially or totally, the ownership of SOEs to the private sector; or (iii) contracting out or leasing a publicly owned asset to a private firm for operation and management.

**Development of New Facilities**

This approach involves the design, finance, construction, ownership, management, and operation of new facilities for the production of goods or delivery of services. The facilities could operate as new industries introduced for the first time in a market or they could operate in parallel with already existing facilities owned by the public sector. Privatization could also be achieved by diluting public sector ownership of SOEs. This would involve expanding the capacity of existing SOEs by allowing private sector enterprises to finance and construct the expansion. These private firms would then own part of the equity in the new larger SOEs. Success in this approach usually requires expanding the size of existing facilities of SOEs to the point where private sector enterprises acquire the majority shares and assume control over management.

**Transfer of Ownership to Private Sector**

This approach to privatization involves the partial or total sale of SOEs to the private sector. The transfer could be achieved by selling
the controlling shares to private firms through private offers. The purpose of such a sale is usually to provide an opportunity for private enterprises to introduce their know-how in terms of management and operations with a view to improving the efficiency and financial performance of SOEs. Alternatively, the transfer of ownership could be achieved through public offerings, involving the sale of shares in national and international capital markets. The shares could be sold in one block or a series of blocks, depending on the industry, the absorptive capacity of domestic capital markets, and the assessment of risk and financial returns by international financial markets. The two approaches to the transfer of ownership, through private offers and public offers, can be combined. This would involve the sale of part of the equity of SOEs through a private offer to attract the technical, managerial, and financial know-how of private enterprises and the placement of the rest of the equity in the form of shares in trust until the SOEs are restructured and their performance improved. Thereafter, the shares held would be disposed of, usually at better prices, through a public offer.

**Contracting Out or Leasing**

This approach involves the leasing of SOEs to private sector companies for operation and management; the ownership and financing of the assets would remain in public sector hands. Similarly, private enterprises could be contracted to deliver services previously undertaken by the public sector. Under the contracting out and leasing arrangements, private firms agree on efficiency criteria and remuneration for services, which would cover costs and provide a fair return, dictated solely by the private firm’s ability to achieve the level of efficiency agreed.

The first two approaches to privatization—the development of new facilities and the transfer of ownership—involves the assumption of control over SOEs and hence the right to exploit, expand, contract, or dispose of assets. The third approach, contracting out and leasing, provides only for the right of exploitation. All three approaches share the expectation that the private sector would bear the financial consequences of all of its decisions.

**Objectives of Privatization**

Governments pursue privatization to achieve at least one of the following objectives: (i) improve the efficiency of SOEs; (ii) mobilize
resources from the sale of assets; and (iii) tap the private sector's technical know-how and markets.

**Improvement of Efficiency**

A number of comprehensive studies to assess the performance of SOEs have provided strong evidence that, on average, the productive efficiency of SOEs is lower than that of private sector enterprises engaged in the same activities. SOEs in developing countries operate in a highly controlled environment, in which the owner is the state and the management is essentially the agent. However, for all practical purposes, managers carry out their responsibilities as owners of the assets. The absence of a system for monitoring their performance, financial discipline, and achievement of social objectives provides few incentives to managers to improve efficiency.

The inefficiency of SOEs is attributable to their lack of autonomy in setting targets and prices for output, in recruitment and employment of workers, in compensation and rewards, in acquisitions and retirement of assets, and in access to needed foreign exchange. Privatization contributes to the improvement of efficiency in that it redefines the owner-agent relationship and allows the latter to exercise full control over SOEs in order to achieve well-defined objectives, usually the maximization of profits. This also prevails in cases of contracting out and leasing where the facilities are owned by the public sector but the private sector performs as an independent agent with an agreed objective. The emphasis on profits explains how the contracting out and leasing approach to privatization has succeeded in improving the productive efficiency of enterprises previously requiring budgetary support.

Managers' incentives under the system of SOEs are rarely linked to profitability but are tied to output quotas, sales turnover, maintenance of employment, and other performance measures. On the other hand, managers' incentives in the private sector are linked to profit, and there rests the basis for improved efficiency once SOEs are privatized. Privatization coupled with deregulation, promotion of competition, and reliance on market forces achieves allocative efficiency. Private sector managers compete by considering the prices of all inputs and outputs when determining the level of output that would maximize profits.

**Resource Mobilization**

The burden of SOEs on the national budget, in terms of investment needs and transfers to cover the shortfalls in operating revenues, was
financed during the 1970s and early 1980s by external and domestic borrowing. This contributed to the fiscal deficit and increased the external and internal public sector debt. Privatization was seen as a way to mobilize resources through the proceeds of the SOE sale, which would allow governments to capture domestic and foreign savings. The mobilization of the resources for privatization has had two aspects. The first covers the short term, where the transfer of ownership brings in sale proceeds to the government, which can be applied to priorities such as debt reduction, contribution to fiscal resources, and new investments. The second is long term, in that it frees resources that would have otherwise been allocated to support the SOEs.

**Private Sector Know-How and Access to Markets**

Implicit in privatization activities is a recognition of private sector expertise, both technological and managerial, in terms of project development, project finance, and enterprise operation and management. In addition, the private sector's ability to capture the economies associated with comparative advantage and to penetrate new and existing world markets is key to developing countries' attempts to improve economic performance. Access to markets covers several fronts. The private sector could provide privatized firms with access to domestic and international capital markets in the mobilization of equity and long-term debt financing. Confidence in reputable private sector firms with proven track records reduces the extent of commercial risk associated with the operations of privatized SOEs and hence improves their access to resources. The private sector could also provide the privatized SOEs with access to international markets by integrating them vertically into global multicountry production processes that would ensure demand for their output and secure returns earned internationally. Technological improvements of SOE operations and better training of personnel could also take place with privatization.

**Macroeconomic Framework**

Governments can be involved in economic activities in three ways: as suppliers of commodities and services; as setters of output and prices; and as regulators. As suppliers, governments can be directly involved through ownership of the means of production, either through ministries or through SOEs. In setting prices, governments can subsidize the prices of goods and services either explicitly or implicitly by (i) pricing factors of production below their opportunity
cost, or market-determined price, (ii) extending interest rate subsidies directly to specific sectors, and (iii) converting public sector loans into equity to reduce SOE debt-service burdens. As for regulation, governments’ involvement can, at one extreme, leave market forces to operate unhindered, limiting involvement to the setting of standards for output, in terms of quality and safety, and developing strong regulatory and legal systems to enforce these standards and provide recourse to public agencies, producers, and consumers. At the other extreme, governments can fully control the day-to-day operations of sectors and SOEs by setting input and output prices, employment levels, performance criteria, and production levels.

Governments are involved in their economies in all three ways. Movement toward economic liberalization and deregulation requires a withdrawal of the government from the supply of goods and services and the setting of prices and output quotas. It also necessitates a strengthening of their regulatory functions and the promotion of competition. Ideally, governments should concentrate on creating an enabling environment for private sector firms. In terms of economic policy, a greater role for the private sector requires, in the absence of unlimited resources, the rationalization of the public sector as a producer. Theoretically, rationalization of the public sector implies that it produce those goods and services that, if otherwise produced by the private sector, would involve higher economic and social costs. Public sector productive activities should be limited to the provision of goods and services whose consumption would yield net social benefits, provided both costs and benefits reflect the true cost of the resources to the economy.

The mix between the public and private sector is determined by comparing for each activity the cost and benefit that, if summed across all goods and services, would maximize the benefits to the economy. The optimal mix of public and private sector participation in an economy rests to a large extent on the willingness of policymakers to rely on market-determined prices for evaluating the options. Subjective assignment of costs and benefits on national grounds of independence, self-reliance, and security would introduce distortions into the evaluation and lead to a suboptimal mix in the productive activities of the two sectors.

The private and public sectors will achieve the optimal mix in their economic activities only if both face the same market signals for factor inputs and outputs. This requires the elimination of all subsidies and the pricing of tradable commodities at their market-determined level. Governments should refrain from setting interest rates and allocating credit through quotas. Market forces should be relied on for setting the
value of domestic currencies relative to foreign currencies. Moreover, import restrictions should be abandoned in favor of an environment conducive to competition, leading, in turn, to optimal resource allocation by both private and public sectors. The reliance on market prices would also require governments to address taxation policies and collection practices with a view to redesigning taxes, duties, and levies to improve resource mobilization, while imposing the least possible distortion on relative prices.

The process of liberalization and privatization requires the creation of regulatory institutions to establish the pricing, entry, and competition pertaining to each sector. Governments also need to put in place strong, sound legal frameworks to support producers, consumers, and government entities in resolving conflicts and seeking recourse in an orderly, expeditious, and efficient manner. Regulators for the various sectors should be independent of government agencies, with regulatory bodies staffed by experts.

Finally, one has to be concerned with the social impact of the structural changes in the economy. The restructuring of various sectors to realign the responsibilities of the public and private sectors involves decisions on the use of factors of production that will inevitably result in labor redundancies. Policies to mitigate these negative social effects should constitute any program for liberalization, deregulation, and privatization.

Pakistan’s Privatization Program

Pakistan is currently in the process of implementing a privatization program representing the logical continuation of the economic reforms initiated in 1985. These reforms covered several key sectors of the economy: energy, transportation, industry, agriculture, and finance. The structural reforms have been introduced while sustaining a relatively healthy level of growth. This growth, however, was accompanied by increased budgetary deficits and, at times, upward pressure on the general price level. The fiscal deficit, which increased from 2 percent of GDP in fiscal year 1979 (FY79) to 9 percent of GDP in FY88, was due to (i) increased public sector expenditures; (ii) the inadequacy of revenue generation attributable to the underpricing of most public sector services, such as natural gas, electricity, fertilizers, wheat, cooking oils and fats, and transport; (iii) inadequate tax levies and collection, particularly in the agricultural and household sectors; and (iv) sustained increases in economic and financial transfers to SOEs. The fiscal deficit was financed by public sector borrowing and by tapping household and institutional savings. Subsidies to SOEs between 1981
and 1992 amounted to PRs 32,048 million, or $1,302 million. The distribution of these subsidies among the major SOEs are presented in Table 1.

The increased fiscal deficit and the historical levels of public sector expenditure and borrowing were virtually impossible to sustain while attempting to restore balance and maintain growth. As a result, public expenditure and borrowing were rationalized, and the shortfall in the investment required to sustain economic growth was earmarked for the private sector. The increased reliance on the private sector has focused attention on the need to deregulate the economy in order to provide an attractive environment for venture capital.

Pakistan's privatization program was initiated under the Seventh Five-Year Plan (1989–93), concentrating primarily on the energy sector. The sector was in adjustment for the last three years of the Sixth Five-Year Plan (1984–88), following the realization at the end of the first two years of the plan that the investment targets for the sector were greater than the external and domestic resources available. A process of rationalizing expenditures was initiated to match the outlays and the available financing. This process brought to the fore two essential issues. The first was that after correcting for the distortions in energy prices, by setting them equal to economic costs, the available financial resources were substantially less than those required to ensure the optimal development of the sector. The second issue was that bottlenecks in the supply of energy were attributable in part to the inadequate implementation capabilities of SOEs in the sector. This

<table>
<thead>
<tr>
<th>State-owned enterprise</th>
<th>Millions of rupees</th>
<th>Millions of dollars</th>
<th>Percentage of subsidies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cotton Export Corporation</td>
<td>4,733</td>
<td>192</td>
<td>14.8</td>
</tr>
<tr>
<td>Karachi Electric Supply Corporation</td>
<td>6,295</td>
<td>256</td>
<td>19.6</td>
</tr>
<tr>
<td>Karachi Shipyard and Engineering Works</td>
<td>137</td>
<td>5.6</td>
<td>0.4</td>
</tr>
<tr>
<td>Pakistan Steel Mills</td>
<td>7,935</td>
<td>322</td>
<td>24.7</td>
</tr>
<tr>
<td>Mechanized Construction Ltd.</td>
<td>715</td>
<td>29</td>
<td>2.3</td>
</tr>
<tr>
<td>Pakistan Railways</td>
<td>12,041</td>
<td>489.7</td>
<td>37.6</td>
</tr>
<tr>
<td>Pakistan Industrial Development Corporation</td>
<td>192</td>
<td>7.8</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>32,048</strong></td>
<td><strong>1,302</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>
led the government to develop a Core Investment Program (CIP), which represented the minimum investment needed by SOEs. The CIP comprised ongoing and new investments needed to minimize the shortfall in achieving the output targets and ensure a smooth transition to the seventh plan. The implementation of CIP was successful and provided the basis for the formulation of the seventh plan by identifying at the outset the investments and financing needed to achieve the plan targets.

The identification of the output targets for energy supplies showed that the SOEs would not be able to achieve them. The difference between the required investments for the seventh plan and the investment sanctioned for the SOEs was earmarked for the private sector. As a result, CIP for the seventh plan was the first program to include investment plans by both SOEs and private sector firms. Policies for enhancing the role of private sector firms in the exploration and development of oil and gas were followed and new higher producer prices were declared with a view to providing better incentives for private sector activity. Some gas and oil fields were allocated for sole exploration by private firms; others were earmarked for joint venture with an SOE, namely the Oil and Gas Development Corporation (OGDC); and the rest were earmarked for OGDC alone. In the power subsector, amendments to the laws were introduced to allow private firms to design, finance, construct, own, and operate power generation units to supply the national SOEs, the Water and Power Development Authority (WAPDA), and the Karachi Electricity Supply Company (KESC).

Unprecedented activities by the private sector were seen in both the petroleum and power sectors. And so far, Pakistan has been able to exceed the plan targets for oil and gas. Further investments in the power sector have been identified; however, their implementation has been delayed. In addition, the privatization of the largest gas distribution company in Pakistan, Sui Northern Gas Pipeline Limited (SNGPL), was initiated through a process of private placement with an internationally reputable gas company. The competitive bidding process aimed at bringing the technical know-how of a large gas corporation to SNGPL and boosting public confidence in the future prospects of the company. The rest of the shares were to be sold through a public offer. The process of divestiture would reduce government ownership of the company from 98 percent to 26 percent as a first step. The next step would see government involvement phased out, limited in its ownership to a goldenshare. The government has also divested of 10 percent of its ownership in Pakistan International Airline.
The present government has continued the process of privatization. The objectives of the privatization program are as follows:

- provide opportunities for private sector firms in activities previously reserved for the public sector, such as power generation, airlines, ports, shipping, highways, and telecommunications;
- deregulate the financial sector to operate in accordance with market forces, privatize the banks nationalized in 1974, and encourage new private sector commercial banks; and
- privatize 115 SOEs.

The deregulation and privatization of the telecommunications sector and the power sector were later added to the list.

The government has created an independent privatization commission that reports to the cabinet. The commission has identified the industries to be privatized in consultation with the appropriate ministries and with the approval of the cabinet (Annex 1). The cabinet has sanctioned the divestiture of 102 SOEs, excluding those in the power and telecommunications sectors. Table 2 summarizes the SOEs offered for sale by type of industry.

Of the 102 SOEs offered for sale, 48 are in the food processing sector. So far, agreements on sales have been reached in connection with the divestiture of 36 SOEs, which are expected to provide proceeds of about PRs6,786 million ($277 million). However, when examining the transfer of ownership from the public to the private sector, only 25 SOEs have been effectively privatized, with expected proceeds of about PRs2,599 million ($105.6 million). As for the remaining 11 SOEs, agreements on their sale prices have been reached but the actual transfer of ownership has not taken place, as payments to the govern-

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of SOEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotive</td>
<td>8</td>
</tr>
<tr>
<td>Cement</td>
<td>14</td>
</tr>
<tr>
<td>Chemical and ceramics</td>
<td>12</td>
</tr>
<tr>
<td>Engineering</td>
<td>9</td>
</tr>
<tr>
<td>Fertilizer</td>
<td>5</td>
</tr>
<tr>
<td>Cooking fats and oils</td>
<td>23</td>
</tr>
<tr>
<td>Bakeries</td>
<td>17</td>
</tr>
<tr>
<td>Rice mills</td>
<td>8</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>102</strong></td>
</tr>
</tbody>
</table>

Source: Government of Pakistan
ment by the private sector have not been made. Moreover, of those firms where ownership has been transferred, the government has received PRs 1,106.4 million ($44.9 million) and the remaining balance, secured by bank guarantees amounting to PRs 1,493 million ($60.7 million), would be paid on an agreed timetable. Table 3 summarizes the breakdown of the proceeds from the expected divestiture of the 36 SOEs.

The privatization of the 36 SOEs was carried out through a bidding process in which each bid was made open to the public on the announced date for evaluation. Of the 36 SOEs privatized thus far, 16 are in the food processing industry, ranging in bid prices from PRs 152 million ($6.2 million) for Associated Industries, a producer of edible fats (vegetable ghee), to PRs 1.6 million ($65,000) for Bahawalpur bakery factory (roti plant). The remaining 20 SOEs privatized are in the automotive, cement, chemicals, and engineering industries, ranging in bid prices from PRs 1,799 million ($73.5 million) for D.G. Khan cement plant to PRs 16.9 million ($690,000) for Pioneer Steel Mills Ltd. (See Annex 1 for details.)

The present government has blamed labor union resistance for the difficulties experienced in 1989, when the previous government first introduced the privatization program. As a result, its privatization program provides a social safety net for cushioning the labor force of SOEs from the full adverse effect of divestiture. Under the present privatization program, the welfare of the labor force employed in the SOEs to be divested is protected through the following provisions:

—employees of privatized SOEs cannot be declared redundant during the first 12 months of private ownership;
—employees can acquire up to 10 percent of the shares of the privatized SOE;

<table>
<thead>
<tr>
<th>Action</th>
<th>Number of SOEs</th>
<th>Sales price</th>
<th>Payment received</th>
<th>Balance due</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Rupees</td>
<td>Dollars</td>
<td>Rupees</td>
</tr>
<tr>
<td>Ownership transferred</td>
<td>25</td>
<td>2,599</td>
<td>105.6</td>
<td>1,106</td>
</tr>
<tr>
<td>Ownership to be transferred</td>
<td>11</td>
<td>4,187</td>
<td>170.2</td>
<td>2,781</td>
</tr>
<tr>
<td>Total</td>
<td>36</td>
<td>6,786</td>
<td>275.8</td>
<td>3,887</td>
</tr>
</tbody>
</table>

1The exchange rate used is 24.6 rupees to the U.S. dollar.
employees declared redundant are given priority in receiving permits for employment overseas and credits on easy terms should they elect to become self-employed;

- employees declared redundant are given priority in employment elsewhere and until they are employed receive unemployment benefits of PRs 1,000 a month ($40), representing two-thirds of the official minimum wage, for a maximum of two years. In addition, grants for children’s education and marriage are made available.

- employees opting for early retirement are entitled to grants (a golden handshake) of one month’s salary and benefits for each year of service and four months’ basic salary for each year of service;

- employees declared redundant are entitled to a training program to enhance their chances of securing new employment; and

- employees are entitled to arrange independent financing to bid for “employee buyouts” of their SOEs.

The provisions of the safety net are fairly comprehensive and could provide opportunities to enhance the future earnings of the affected labor force through training and self-employment. It is, however, too early to determine whether this program is effective. Its success will undoubtedly depend on the extent and speed with which the provisions are made available.

Issues and Constraints

Sequencing of Privatization

As mentioned, Pakistan’s privatization program started in 1989 in the energy sector, which was undergoing a comprehensive program of structural adjustment launched in 1985. This adjustment program had a broad focus, covering the formulation of a national development strategy for the exploitation of energy resources, the identification of investment priorities, the rationalization of energy prices, and the strengthening of the sector’s regulation. In this respect, the deregulation of the sector and the creation of a regulatory framework preceded the process of privatization and divestiture. The concentration of the energy sector in relatively few SOEs contributed to the government’s ability to prepare for their corporatization as a first step toward privatization. In addition, the sector has always involved the coexistence of SOEs and private sector enterprises. In the petroleum subsector, OGDC, the predominant SOE responsible for the exploration of oil
and gas, has relied on foreign expertise to assist in exploration activities and the development of new fields through joint venture arrangements, farming out of gas and oil areas, and leasing. The petroleum refining sector has also been characterized by the coexistence of private and public enterprises. These attributes have facilitated the process of privatization and contributed significantly to the speed and success of the divestiture program. The privatization of SNGFL, the corporatization of OGDC and the divestiture of some of its holding to the private sector, and private sector expansion of refining capacity have all been accomplished. Significant achievements with respect to the refining sector have been the new Hydrocracker plant, to be implemented shortly by a private sector joint venture, the National Crescent Petroleum Corporation, with an investment of about $450 million, and the development of four million tons of petroleum refining capacity by PARCO.

It is noteworthy that within the energy sector privatization has been much slower in the power subsector, which is under the control of two SOEs: the Water and Power Development Authority and the Karachi Electric Supply Company. Resistance by these SOEs to the privatization of the sector has been strong. WAPDA has taken substantial time to change its attitude toward private sector generation. Only after its own investment program was curtailed did it accept the prospects of having private firms supply about 2,000 megawatts of power to the system.

The privatization of the energy sector and the accelerated pace at which economic liberalization has taken place over the past two years have provided the basis for the initiation of the second phase of the privatization program. The second phase involves the privatization of 101 SOEs, whose divestiture is currently under way. The blueprint for the privatization of WAPDA is currently under preparation. The government has also changed the Telegraph and Telephone Department of the Ministry of Communications into a corporation, Pakistan Telecommunications Corporation (PTC). The deregulation of this sector is motivated by a desire for more competition. Consultants are being recruited to formulate the strategy for the privatization of PTC. Several other major state-owned railways, ports, and other facilities are currently being prepared for privatization.

The success of the second phase of privatization in Pakistan has been commendable given the span of time during which it has been implemented. In the energy sector, privatization progressed in an orderly manner, moving from deregulation on the sectoral level to divestiture at the enterprise level. By contrast, the privatization of WAPDA, telecommunications, ports, highways, and railways is pro-
gressing in tandem with deregulation. This is likely to hinder the effectiveness by which their privatization is achieved. Potential buyers will be asked to bid for the SOEs while not being fully aware of the regulatory framework under which they will operate, the extent of competition they would face, and the basis they will use for pricing, compensation, and repatriation of profits. These uncertainties would lead the private sector to hedge its bids and offer lower prices for the assets than would be the case if the risks did not exist. Privatization of the major infrastructure is largely dependent on the enabling environment and the regulatory framework as well as on the availability of foreign and local resources needed to acquire the assets. Given these issues, the speed with which privatization of the 36 enterprises has taken place is encouraging. However, the same speed would not be possible in the case of the large SOEs, such as WAPDA, PTC, railways, and ports, which will require substantial effort and resources to transfer ownership.

If the experience in privatization, gained from transactions with foreign companies and in the domestic oil and gas sector, are to be taken into consideration, then the government's privatization program should proceed with the divestiture of the 102 SOEs already sanctioned, provided the sectors in which they operate are deregulated. As for the major regulated industries, the first step should be their corporatization: the delinking of SOEs from budgetary support and the severing of the control of civil servants over their daily operation and management. In addition, financial performance criteria, preferably expressed in terms of net operating revenue and return on assets, should be agreed. Totally independent management teams with proven track records in their field of expertise should be appointed to manage the SOEs with mandates to prepare them for divestiture. The second step, which can be implemented in parallel with the first, would involve the creation of a regulatory framework, deregulation of the sectors, and identification of the sequence in which SOEs would be privatized.

The final step would cover the privatization of the SOEs over a longer time horizon. It is extremely difficult, if not impossible, for the capital market and private sector investors to cope with the divestiture of major SOEs simultaneously. The declared objectives of the government to privatize all major SOEs within a period of 18 months is unattainable and if pursued would undermine the process of divestiture. There is a need to note not only the successes achieved elsewhere in terms of privatization but also the extensive preparatory work involved in identifying the priorities and in sequencing the SOEs to be privatized. It is not accidental that the first SOEs privatized in
several countries have been those with potential for foreign exchange earnings—telecoms in Mexico, Argentina, Malaysia, Chile, Venezuela, United Kingdom, and Japan; airlines in Venezuela and Brazil. If these experiences are to influence the privatization strategy of Pakistan, the telecommunications sector, PTC, and the petroleum subsector should be given the highest priority, followed by ports and airways and gradually power and railways.

**Adequacy of Financial Resources for Privatization**

The success and pace of privatization are closely linked to the availability of financial resources to provide the equity and possibly to refinance the debt for private firms to acquire SOEs. The success of the privatization program in the United Kingdom, New Zealand, France, and Japan was due to the government's ability to rank the SOEs in terms of sequencing and pacing of privatization and to ensure the availability of domestic and external financing. In developing countries, the potential for mobilizing domestic financing through the capital market is limited and hence the reliance on external sources for financing privatization is greater. In Pakistan, the need for domestic financing through the capital market, to the extent needed for the privatization of the major SOEs (WAPDA, KESC, and PTC), is far greater than the equity market could meet. In 1992, the largest transaction in terms of local equity to be underwritten by a financial institution in Pakistan is expected to be for the Hub Complex, a 1,292 megawatts power plant to be designed, financed, constructed, owned, and operated privately, in the amount of PRs 2,460 million ($100 million). This represents a sevenfold increase over the largest equity ever raised through a public offer. As the economy of Pakistan moves toward greater reliance on the private sector for developing capital-intensive projects—refineries, power plants, port terminals, airports, telecommunications facilities, cement, and fertilizer plants, all of which are under preparation at present—the equity demands on the domestic capital market would eventually be impossible to meet.

Pakistan's capital market is far weaker than should be the case. In 1991, the Karachi Stock Exchange had about 398 companies listed with a total equity capitalization of only PRs 59,688 million ($2,426 million). Of these, 352 companies are private and 46 are SOEs. Most of the SOEs listed on the stock market are those whose financial performances have been weak. Despite their performance, several continue to declare dividends, mainly because of the government's willingness to forgive debt service for sovereignly guaranteed loans. To illustrate, consider KESC, which is listed on the Karachi exchange. In 1990, it declared a
dividend despite a financial rate of return on revalued assets of less than 4 percent. This was possible by deferring interest payments on outstanding loans and postponing tax payments. KESC has been in default on its financial obligations for the past ten years, and a quick review of its projected financial performance shows that it is likely to default for the next five years. The value of KESC’s shares, including the bonuses, has increased by 300 percent since 1980 despite its poor performance. The appreciation in the value of KESC’s shares took place while the company was receiving a subsidy from the government amounting to PRs 6,295 million ($256 million), representing 19.5 percent of the total subsidies extended to SOEs between 1981 and 1991.

KESC illustrates the effects of government intervention in the operations of SOEs and the cost it bears as a result of subsidies, forgone tax revenues, and rescheduled debt. KESC also provides a glimpse at why the general public doubts the reliability of information provided by the Karachi stock market. As is the case with KESC, the share values of a number of SOEs do not accurately reflect their financial performance because of government intervention. Discrepancies between the financial performance of companies listed on the stock market and the value of their shares undermines the confidence of investors in the ability of the market to ration capital.

Government affects the operation of the capital market in Pakistan in two ways. The first involves the issuance of sovereignly guaranteed bonds for the major SOEs to mobilize local financing with relatively high assured yields. These instruments have in the past crowded out the private sector. The second involves the financing of SOEs’ investment through guaranteed five-year rolling bonds whose maturity is shorter than required for long-lead investments such as power generation, telecommunications, and ports. The success in the past of selling the bonds of SOEs has been largely due to the government’s directives to the banking and insurance enterprises in the public sector to pick up whatever financing was not acquired by the general public. Continued guarantees for the financing instruments issued by large SOEs undermine government plans to put them on a purely commercial footing. This interference in the financial market erodes its effectiveness and its ability to mobilize equity.

Privatization in all of its forms requires long-term financing. This is expected to be one of the major impediments to privatization in Pakistan. So far, the available financing has a maturity of about five to seven years, including a two-year grace period. The government should consider allocating substantial resources to the development of the long-term financial market, possibly by guaranteeing, initially and until the market is established, payments for the end years and
hence extend the available instruments of 5- or 7-year maturities to 10 and 12 years by guaranteeing the last five years.

The capital market in Pakistan would need to be deregulated and credit ceilings removed. The regulatory framework for the operations of the financial sector should be established and an independent regulatory body appointed to privatize gradually the sector and to foster competition. The regulation of the stock market should also be strengthened, and laws governing financial reporting and audits of companies should be enforced. Financial performance indicators for companies listed on the stock market should be set and applied to both public and private enterprises. SOEs' financial performance should be declared and adherence to internationally accepted standards for financial practices should be enforced. These measures would enhance the confidence of investors in the accuracy of the stock market's valuation of companies. In addition, loss-making SOEs would be easily identified and corrective measures taken to restore their financial position if possible. Failure to restore financial health would make the SOEs suitable for liquidation.

As for the mobilization of foreign equity to support the privatization program in Pakistan, concerns over the transfer risks are the principal constraints to the flow of direct investment. The level of foreign reserves continues to be the benchmark for the assessment of the risks of foreign exchange availability. Reserves in September 1991, about $415 million, do not provide the confidence required by the private sector to assume the transfer risks. It is expected that the liberalization of the economy, particularly the financial market, would improve Pakistan's foreign reserves. However, during the time horizon for the implementation of the privatization program, the government would need to allow slightly higher returns than normal to compensate private sector investors for transfer risks. Direct foreign investment in 1989 amounted to only $120 million, which is significantly lower than would be required to sustain the privatization of the large SOEs, such as WAPDA, with paid-up share capital and accumulated profits of about PRs 44 billion ($1,400 million) and the National Fertilizer Corporation, with paid-up capital and reserves of about PRs 4.2 billion ($170 million). The scarcity of direct foreign investment should be taken into consideration in sequencing the privatization of SOEs and timing the placement and flotation of shares to the private sector.

Higher returns are expected to be more effective in attracting equity financing than debt financing. Equity would follow the returns, provided they are competitive with alternative investments internationally. On the other hand, debt financing would be difficult to attract in the amounts and maturities needed for privatization in Pakistan.
because of considerations regarding foreign exchange availability, debt burden, and deficits. The use of foreign debt financing for privatization in Pakistan should be selective and limited, allocated primarily to the foreign exchange-earning SOEs and new private sector enterprises. Gradually, this can be relaxed as the international financial community gains confidence in the stability of the economy with the improvement of its foreign exchange potential. So far Pakistan has not been able to mobilize foreign commercial bank financing, except for a maximum of $100 million per year with one-year maturities. The use of enhancements—that is, guarantees from multilaterals and export credit agencies—would increase the size of the loans and lengthen the maturities and grace periods. Government should consider the use of these enhancements for select key projects and privatization transactions, with a plan to phase out these supports as confidence in the credit market builds through the acquisition and successful retirement of long-term commercial bank financing.

Reference
### Annex 1.
**List of 102 SOEs Offered for Sale: Status of Privatization and Proceeds**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Total proceeds (millions of dollars)</th>
<th>Total value (millions of rupees)</th>
<th>Advance received (millions of rupees)</th>
<th>Balance due—bank guarantee (millions of rupees)</th>
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### Annex 1 (continued)

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## Annex 1 (continued)

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### Annex 1 (concluded)

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<td>Shahdadkot Textile</td>
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<td>Quaidabad Woolen Mills</td>
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<td>Dir Forest</td>
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<tr>
<td>National Petrocarbon</td>
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</table>
Comments
Balwanth Reddy

In current debates on economic development, there is a great temptation to start an argument with the implicit, uncontrovertible axiom that the public sector is inherently inefficient and the private sector is the sole engine of efficiency. Yet a bit of historical analysis makes evident those circumstances that have previously led governments, even in countries that strongly believe in private initiative and enterprise, to intervene across a broad spectrum of economic activities—from setting up regulatory regimes (including price regulation) to participating in the direct production of goods and services. The interventions have generally been unavoidable when larger public interests conflicted with narrow private ones and when response-adjustment time in a totally private regime took too long. Indeed, even in large organizations, whether public or private, significant allocative decisions are often taken outside the market framework and its associated pecuniary incentives, which constitute the principal arguments supporting privatization.

As Ibrahim Elwan points out in his paper, the principal reason for the current well-orchestrated advocacy of privatization from the international lending agencies, the potential borrowing governments, and the associated elites is the large budget deficits in many developing countries, to which the losses of public enterprises make no mean contribution. Privatization would reduce the deficit partly because the losses would no longer be debited to the public sector account. But the main reason it would reduce the deficit is because the proceeds from the sale of public assets would make a handsome contribution to reducing the public debt and the interest liability on it. Incidentally, privatization can also make it easier to circulate the large amounts of income that escape the income tax net.

In this budgetary context, considerations of efficiency become secondary. Yet ailing industries are not unique to the public sector; their incidence is substantial in the private sector, too, though perhaps not as great. And without understanding the underlying causes for industrial malaise, whether in the public or private sector, privatization as an article of faith will not assure efficiency, though it may meet immediate budgetary needs. Some causes of industrial infirmity are common to both the public and private sectors, while others are specific to one or the other.
In addition to the question of efficiency, no developing economy can afford to ignore the major related issue of income distribution, which is intimately connected with the manner in which wealth in a country is distributed. Privatization, irrespective of the way it is carried out, will have a great effect on the distribution of private wealth.

A critical analysis of privatization is important and urgent because even the residual activities left with the public sector, whether they cover only administrative issues, public order, and defense, or extend to regulatory institutions and infrastructural components of the economy, must be operated efficiently in terms of costs. Such an analysis may also shed considerable light on those activities that would enjoy greater efficiency if left to the private sector. These may include, at one extreme, repair services, restaurants, and the like, and, at the other extreme, research and development activities, which have considerable externalities and pose all the problems associated with appropriability. In these latter areas, even with the protection conferred by patent legislation and allied measures, the private sector may not deliver the goods without substantial support from the public domain, as evident from the experience of privately owned large industries in the United States and Japan.

One can spell out the proximate criteria by which to judge the success of privatization programs, but in the ultimate analysis success must be reckoned in terms of its effect on the rate of economic growth and the income distribution within a country. Elwan would have done well to examine these issues in his paper.

There are many conditions common to both the public and private sectors in terms of efficiency and effect on the economy. For a privatization program to succeed, it must take these conditions into account. The first and most important condition is the design of a rational and effective price structure, covering not only principal inputs but also labor and the exchange rate. The structure must be rational in the sense that it recognizes market forces—the responses of households and enterprises—and the implications of increasing returns, externalities, asymmetric distribution of information among the participants in various markets, transaction costs, and the obstacles to creating markets where they do not exist. Clearly, this price structure differs from one determined exclusively by market forces, as envisaged by Elwan. It is not enough to call for the correction brought about by market-determined prices. What is more important and difficult to create is an institutional mechanism that can generate these prices for principal inputs and outputs and can shape the necessary fiscal instruments to make them operationally effective. To expect a rational price system to emerge as an automatic response to privatization is unrealistic.
The second condition common to both the public and private
domain relates to the pace at which technology in various sectors of
the economy is likely to improve. Profitability and efficiency in both
domains depend on easy access to efficient technologies and their
continuous improvement. Given the nature of research and develop­
ment activities and the diffusion and absorption of improved technol­
gies, the private sector, especially in developing countries, can play
only a limited role. How imaginatively and effectively the public
authorities marshall and direct the resources of a country to promote
 technological improvement will be crucial to the long-term success of
privatization.

The third common condition is connected with the control of enter­
prises and their accountability, especially the concurrent accountabil­
ity of management to the community at large and to the owners in
particular. One of the principal reasons why in most countries public
enterprises incur significant losses is the diffused nature of controls
and accountability. This is perhaps an inevitable consequence of the
manner in which boards of management are constituted, chief execu­
tives are selected, and bureaucrats and politicians intervene in man­
agement. In this respect, the private sector is not significantly different
from the public domain. In the past, shareholders have been marginal­
ized in private enterprises, and the effective power has been exercised
by the managerial elite and the plutocrats, with an uneven distribution
of “information” between them and the shareholders. This develop­
ment has not been easy to avoid. Openness, especially easy access to
information and the ability to use this information, is a sine qua non
for enhancing accountability.

The incentive structure within the enterprise, at all levels of its
hierarchy, is the fourth condition common to both sectors. The incen­
tives need not always be pecuniary, though these are the dominant
ones. It is widely believed that privately managed enterprises, gov­
erned by pecuniary incentives, operate more efficiently than public
enterprises, which are guided by inadequately designed incentives.
The question of incentives also raises larger issues with implications
extending beyond the working of the enterprises, though I do not
have the space to detail them here.

The short-term gain from privatization in terms of its effect on
budgets is not difficult to see. Gains from the additional “savings”
from accounted and unaccounted incomes are also easy to visualize.
But these are not the long-term goals of privatization. Success in this
respect, as I have argued, will depend on the foregoing conditions,
which must flow from public policy and the Government of Pakistan’s
commitment to privatization.
Structural Adjustment and the Role of the IMF

Brian C. Stuart

One of the responsibilities of the International Monetary Fund in promoting international monetary cooperation is the provision of financial support to the adjustment programs of countries suffering external payments difficulties. The IMF's loans are not for specific development projects but represent general balance of payments financing. Resources are provided in support of macroeconomic adjustment and structural reform programs under stand-by arrangements generally covering one or two years, and the IMF supports comprehensive macroeconomic and structural adjustment programs under three-year extended arrangements (which under certain circumstances can be lengthened to a fourth year). The rate of interest on these resources is market related; the repayment period is generally three to five years for resources borrowed under stand-by arrangements and up to ten years for extended arrangements.

In addition, under the structural adjustment facility and the enhanced structural adjustment facility (SAF/ESAF), the IMF administers concessional loans to low-income developing countries in support of three-year structural adjustment programs. (Under the ESAF, arrangements can be extended to a fourth year.) The rate of charge on these loans is 0.5 percent a year and the repayment period is up to ten years.

The IMF also makes resources available to members under the compensatory and contingency financing facility (CCFF) to compensate for temporary shortfalls in exports of goods and services, to help members face unexpected changes in the external economic environment, and, on a temporary basis in the wake of the recent Middle

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1This paper is based in part on the work of International Monetary Fund staff involved in the ongoing review of the experience of countries with IMF-supported programs. Views expressed in this paper are the sole responsibility of the author and do not necessarily reflect those of the IMF.
East crisis, to compensate for temporary increases in oil import costs. Finally, since 1989 the IMF has provided financial support to countries agreeing to debt-reduction operations with commercial bank creditors, in association with stand-by and extended arrangements.

As more countries are adopting macroeconomic adjustment and structural reform programs, the IMF is involved in lending to a record number of countries. At present, the IMF has arrangements with almost 50 member countries (about one-third of the total membership), representing commitments of about $22 billion. In addition, discussions on adjustment programs that could be supported by the IMF are being held with 15–20 other countries. Total outstanding IMF credit now amounts to about $34 billion.

In addition to supporting adjustment through the provision of financing, the IMF aims to improve the working of the international monetary system through its surveillance function. This involves regular visits by IMF staff to all member countries for discussions of economic policy with government officials—usually on an annual basis. This is followed by a staff report on economic conditions in the country and a full discussion of the member country’s economic policy in the IMF’s Executive Board.

The IMF also examines how economic policies in individual countries interact to affect the smooth functioning of the world economy. This analysis forms part of the World Economic Outlook exercise which is conducted twice a year. In addition, for meetings of the finance ministers and other officials of the seven largest industrial countries (the Group of Seven), the IMF analyzes the progress being made in reducing economic imbalances among the industrial countries and suggests policy adaptations that may be required.

Finally, the IMF helps member countries improve policy design through the provision of technical assistance. Earlier in the IMF’s history, such advice was limited to banking and monetary matters, but now the IMF provides assistance in many fields—fiscal, monetary, balance of payments, banking, exchange and trade systems, government finance, and statistics. Assistance is provided through staff missions, longer-term field assignments by staff members or outside experts, and studies prepared at the IMF’s headquarters.

Overview of the Adjustment Process

Imbalances and Structural Problems

Macroeconomic imbalances reflect an excess of domestic demand over supply and, often, serious distortions in the economy. Many
developing countries are still dealing with the legacy of unsustainable levels of external borrowing in the late 1970s and the world recession in the early 1980s. For most countries, the external environment in the past several years has been mixed. While the world economy and trade expanded at impressive rates throughout the latter part of the 1980s, many countries experienced a downward trend in the relative price of their exports, and world interest rates remained at high levels in real terms. In addition to the large number of countries that adopted adjustment measures in the 1980s, in the past two years the countries of Eastern Europe have undertaken fundamental transformations of their economic systems.

Each country in need of adjustment has its own set of difficulties, built up over time in response to changing economic circumstances and particular pressures from various groups in the society. High rates of credit and money expansion and shortages of national savings often reflect large public sector deficits. Various distortions can reduce output and limit economic growth: quantitative barriers to imports and high import duties; inefficient public enterprises and distortionary tax systems that feature a narrow tax base with high rates; financial regulations that result in negative real interest rates, reduce saving, misallocate resources, and lead to a substitution of local currency by foreign currencies; consumer subsidies, price controls, and other impediments to the functioning of goods markets; and wage policies (including indexation and minimum-wage laws) and labor market regulations and conditions (limits on hirings and firings as well as weaknesses in the educational system and housing infrastructure) that limit the mobility of labor.2

Adjustment

In considering the adjustment process, it is important to recognize that a country cannot live beyond its means indefinitely. When imbalances exist, adjustment of one kind or another will take place. This adjustment can be orderly or disorderly, and an important role of the IMF is to help members ensure that the adjustment is as orderly as possible.3

Disorderly adjustment can manifest itself in shortages of goods and the emergence of black markets, in high rates of inflation (an inefficient and regressive form of taxation), and in the buildup of external pay-

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2For a discussion of the relationship between demand-oriented fiscal and structural measures, see Hernández-Catá (1989).
ments arrears (a limited and very costly form of foreign finance). Orderly adjustment, on the other hand, is associated with declining inflation, the correction of economic distortions, and the prospect—at least in the medium term—of sustained economic growth. In general terms, the IMF assists in the design of orderly adjustment programs that help the borrowing country attain a viable balance of payments, sustainable economic growth, and reasonable price stability. At the same time, financing is provided to ease the adjustment.

In the past, IMF-supported programs tended to focus on the demand side of the economy attempting to bring aggregate demand in line with aggregate supply. The IMF worked on reducing the fiscal deficit, limiting overall credit expansion, and containing the balance of payments deficit and external borrowing. Moreover, the IMF’s formal conditionality on quantitative targets for key macroeconomic variables was also motivated by demand considerations. However, structural measures to increase supply were not ignored. All programs required the avoidance of trade and payments restrictions and other measures “destructive of national and international prosperity” (as required by Article I of the IMF’s charter). In this context, many programs featured adjustment of the exchange rate to ensure the proper alignment of domestic and foreign prices.

However, since the mid-1970s there has been an increasing recognition that the problems of some members are more intractable than originally thought, given a world economic environment that has often created difficulties for developing countries. This change in the IMF’s focus was also induced by the large number of developing countries joining the IMF with problems that required supply-side attention. The approach to economic adjustment has evolved accordingly and is reflected in a lengthening of the possible duration of adjustment programs supported by the IMF from one year to three years and most recently to a possible four years.

More important, from the point of view of this paper, the scope of issues stressed in adjustment programs has broadened considerably in recent years. Greater attention is being paid to the efficiency with which existing resources are used and to increasing the capability of economies to adapt to changing circumstances. These efforts involve the economic pricing of goods and of factors of production as well as improved management and possible privatization of public enterprises.

Attention is also being paid to the adverse effects of high tax rates on the public’s willingness to work, save, and invest and to the need to increase saving in the economy through strengthening public sector saving, establishing appropriate interest rate levels, and strengthening
financial institutions. The liberalization of restrictions on foreign direct investment and other measures to deregulate the economy, as well as the establishment of clear rules of the game for foreign and domestic investors, has led to the increased availability of foreign savings and technology. Finally, efforts are being made to ensure more productive investment through better pricing and interest rate policies and careful setting of public sector investment priorities.

This greater focus on supply-side policies in the work of the IMF occurred at the same time that the World Bank was moving into the area of policy-based lending. These developments have been a factor leading to the intensified collaboration between the IMF and the World Bank.

Of course, the greater emphasis on addressing supply-side problems does not imply that the adjustment process is painless. First, in a situation where a country has been living on excessive levels of foreign borrowing or inflationary financing, spending often needs to be reduced, even though the society will tend to resist such attempts to bring overall spending into line with available resources. Second, efforts to improve the efficiency of the economy—to benefit society as a whole by raising overall levels of economic welfare—will be resisted by those groups that have enjoyed the extra income or rents associated with existing economic distortions.

It must be acknowledged that an important and frequent effect of adjustment programs is a change in the distribution of income and a lower level of spending by certain groups in society. It is also recognized that the only way to alleviate poverty in a lasting way is through the sustained growth of output in a stable macroeconomic environment.

However, it is important also to protect the poorest groups in society from possible short-run effects of adjustment. In its policy dialogue with member countries, the IMF is paying increasing attention to improving its knowledge of poverty in individual countries, to identifying the possible effects of adjustment programs on the poor, and to helping with the design of targeted programs to help shield the poor from adverse transitional effects of adjustment measures. In addressing poverty concerns, the IMF cooperates closely with the World Bank, other specialized United Nations agencies, and social ministries and nongovernmental organizations in individual countries.

Analyzing the Effects of Programs

Before turning to the experience of countries with macroeconomic and structural reform programs, it would be useful first to address
important methodological points related to the assessment of adjustment programs. This is a difficult area and the issues remain controversial.

A number of studies have attempted to evaluate the effects of IMF-supported programs on major macroeconomic variables, such as growth, inflation, and the balance of payments. More recently, studies have examined the effects of reform programs on income distribution and poverty.

In the studies, various approaches have been followed, each with its own strengths and weaknesses. Two shortcomings of most approaches are the lack of a method for "predicting" the policies that would have been pursued in the absence of the IMF-supported program and the absence of a model of economic adjustment that would permit the analysis of the effects of alternative policies. This problem is referred to as the absence of a "counterfactual" that would permit a detailed assessment of the adopted policy package in light of the alternative measures that could have been implemented.

Three main approaches to the evaluation of programs can be identified—the "before-after" approach, the "with-program and without-program" approach, and the "target versus actual" approach. The before-after approach compares developments in the macroeconomic variables in the period prior to the program with developments during and after the program. This is a fairly easy test to design. Its major shortcoming is that it does not take account of changes in nonprogram factors—such as terms of trade, world demand, and weather conditions. The approach thus attributes any change in economic performance between the pre- and post-program periods to the program itself. Also, it may be the case that the pre-program situation would have been unsustainable under any policy approach—for example, when high levels of spending are supported by excessive levels of external borrowing. In this context, the before-after approach incorrectly blames a deterioration in the economic situation on the adoption of adjustment measures rather than on the initial conditions facing the economy.

A comparison of a group of countries undertaking IMF-supported programs with a group of countries without such programs—the with-without approach—may get around some of the problems arising...
from changes in nonprogram factors (provided that these nonprogram factors affect both groups of countries in similar ways). However, the simple with-without approach does not take into account the different starting positions of the two groups of countries. It generally could be expected that countries entering into IMF-supported programs start from a weaker position than other countries, and a comparison of the two groups may incorrectly attribute poorer relative performance to the IMF-supported program.

As with the before-after approach, the with-without studies generally divide countries into two groups based on whether they have a program in place or not. As such, the comparisons do not take account of the extent to which programs have been implemented as planned and thus may not represent an evaluation of the programs as originally designed.

The third approach to program assessment is to compare the outcomes for various economic variables with the objectives set out in the adjustment programs. This is an important comparison for an institution like the IMF to make when evaluating the effectiveness of the programs it has supported. However, this assessment of adjustment programs will be affected by the ambitiousness of the targets themselves. Also, as with the before-after approach, nonprogram factors can also affect outcomes independent of the quality of the program itself.

The methodological issues concerning the macroeconomic analysis of programs apply equally to an assessment of the programs' effects on income distribution. The problems are compounded in a major way by a serious lack of information in most countries on income distribution and on the sources of income and the spending patterns of the poor.

**Country Experiences**

A number of studies on the effects of IMF-supported programs were surveyed in a recent paper by Mohsin Khan and can be summarized as follows.\(^5\) Almost all of the studies conclude that the programs were successful in containing inflation, while a somewhat smaller number of them conclude that the programs were helpful in reducing external current account or overall balance of payments deficits. Most of the studies conclude that, at least in the short run, the effects of the programs on economic growth were negative.

In his paper, Khan also examined the adjustment experiences of about 75 developing countries over the period 1973-88, correcting for some of the shortcomings in the standard approaches to program evaluation that were described above by taking account of certain nonprogram factors and differences in the starting positions of the adjusting countries. However, it was not possible to differentiate between countries based on whether programs were fully implemented or not. The results of Khan’s analysis were broadly consistent with earlier studies. In the first year of the programs, adjustment was seen as improving the external accounts and containing inflation, while the effects on growth were negative. When the analysis was extended to cover the first and second year of the program, the effect of adjustment on the external accounts and inflation was strengthened, while the negative effect on growth was lessened.

As part of an ongoing review, the IMF has recently examined the effects of programs in low-income countries supported by the structural adjustment and enhanced structural adjustment facilities (SAF/ESAF), the macroeconomic effects of programs in middle-income countries supported by IMF stand-by and extended arrangements, and the implications of IMF-supported adjustment programs for poverty.

Recent SAF/ESAF Programs

The review of SAF/ESAF programs covered those in place between January 1990 and April 1991. As regards growth performance under these programs, about half of the programs achieved or exceeded their growth objectives, and output rose by almost 4 percent a year (Table 1). By way of comparison, output growth in these countries averaged about 2.6 percent a year in the three years preceding the program, and output growth for all of the least developed countries averaged 2.5 to 3 percent a year in 1990 and 1991.

The programs were somewhat less successful in meeting inflation targets. Only about a third of the programs met their inflation objectives and the median rate of inflation increased slightly from pre-program levels. In particular, it proved difficult to reduce inflation rates to below 10 percent a year.

In contrast to inflation performance, well over half of the programs met the external current account and overall balance of payments objectives. On average, the programs targeted a small increase in the current account deficit to allow for increased imports in light of increased foreign financing. In general, the weakening in the current account balance was contained to the targeted amount.
## Table 1. Summary of Program Developments

<table>
<thead>
<tr>
<th></th>
<th>Economic growth</th>
<th>Inflation</th>
<th>External current account</th>
<th>Overall balance of payments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(In percent)</td>
<td>(In percent of GDP)</td>
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<td></td>
</tr>
</tbody>
</table>
| Programs supported by SAF/ESA
  F arrangements, 1990–91     |                 |           |                          |                             |
| Pre-program average, three  | 2.6             | 13        | -11.7                    | ...                         |
| year                          | 4.3             | 12        | -13.8                    | ...                         |
| Target                        | 3.9             | 15        | -13.7                    | ...                         |
| Outturn                       |                 |           |                          |                             |
| Number of programs that      |                 |           |                          |                             |
| Met objective or overperformed| 11              | 7         | 17                       | ...                         |
| Failed to meet quantitative  | 9               | 13        | 11                       | ...                         |
| objective                     |                 |           |                          |                             |
| Programs supported by stand-
  by and extended arrangements, |                 |           |                          |                             |
| 1985–88                       |                 |           |                          |                             |
| Pre-program year              | 1.2             | 43        | -5.8                     | -1.4                        |
| Target                        | 2.3             | 27        | -4.6                     | -0.7                        |
| Outturn                       | 2.5             | 39        | -4.4                     | -1.2                        |
| Number of programs that      |                 |           |                          |                             |
| Met objective or overperformed| 24              | 23        | 25                       | 24                          |
| Failed to meet quantitative  | 20              | 21        | 19                       | 20                          |
| objective                     |                 |           |                          |                             |

Source: IMF staff estimates.

### Stand-by and Extended Arrangements, 1985–88

The review of programs supported by stand-by and extended arrangements covered the period 1985–88. The objective for economic growth was met in about half of the programs, as were the objectives for inflation, the external current account, and the overall balance of payments. The growth rate under these programs averaged about 2.5 percent a year—roughly in line with targeted growth and well above the average growth rate in the pre-program year of just over 1 percent.

Inflation was brought down on average, but, as with SAF/ESA programs, the rate of price increase remained above targeted levels. Particular problems were encountered in meeting the inflation objectives in cases where the rate of price increase was targeted to remain relatively high in the program year. On average, the targeted improvement in the external current account was achieved, but the objective for the improvement in the overall balance of payments was not.
To review programs supported by stand-by and extended arrangements, an attempt was made in Table 2 to evaluate the effects of program implementation on economic performance. The results suggest a fairly strong association between the implementation of fiscal and credit policies and program results. Objectives with respect to growth, inflation, and the balance of payments were met in 60–75 percent of the cases when both credit and fiscal policies were implemented as planned. These objectives were met in fewer than half of the cases when neither credit nor fiscal targets were met. For programs meeting both fiscal and credit targets, the rate of economic growth averaged 4.4 percent a year, well above the targeted rate (Table 3).

The evidence from the programs suggests a strong association between developments in the terms of trade and a country's ability to implement adjustment policies as planned. In 11 of the 22 programs where terms of trade movements met or exceeded projections, both credit and fiscal targets were met. In contrast, only 3 of the 16 programs that experienced weaker than expected terms of trade met both credit and fiscal targets. There was also a close relationship between terms of trade developments and performance with respect to the external current account. In almost all of the cases where the terms of trade met or exceeded expectations, the current account target was met.

### Table 2. Program Implementation and Results

(Number of programs)

<table>
<thead>
<tr>
<th></th>
<th>Fiscal and credit targets met</th>
<th>Fiscal targets met/Credit not met</th>
<th>Credit targets met/Fiscal not met</th>
<th>Fiscal and credit targets not met</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth objective</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Met</td>
<td>13</td>
<td>3</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Not met</td>
<td>4</td>
<td>4</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Inflation objective</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Met</td>
<td>11</td>
<td>2</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Not met</td>
<td>6</td>
<td>5</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>External current account objective</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Met</td>
<td>13</td>
<td>3</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Not met</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Overall balance of payments objective</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Met</td>
<td>10</td>
<td>4</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Not met</td>
<td>7</td>
<td>3</td>
<td>4</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: IMF staff estimates.
Table 3. Program Implementation and Macroeconomic Performance

<table>
<thead>
<tr>
<th></th>
<th>Economic growth (In percent)</th>
<th>Inflation (In percent)</th>
<th>External current account (In percent of GDP)</th>
<th>Overall balance of payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal and credit targets met</td>
<td>Pre-program: 1.8</td>
<td>20(^1)</td>
<td>-5.3</td>
<td>0.5</td>
</tr>
<tr>
<td></td>
<td>Target: 3.0</td>
<td>17(^1)</td>
<td>-4.0</td>
<td>1.2</td>
</tr>
<tr>
<td></td>
<td>Actual: 4.4</td>
<td>19(^1)</td>
<td>-2.4</td>
<td>1.6</td>
</tr>
<tr>
<td>Fiscal targets met/Credit not met</td>
<td>Pre-program: -0.6</td>
<td>48</td>
<td>-1.8</td>
<td>-1.3</td>
</tr>
<tr>
<td></td>
<td>Target: 3.2</td>
<td>34</td>
<td>-2.5</td>
<td>0.6</td>
</tr>
<tr>
<td></td>
<td>Actual: 2.9</td>
<td>72</td>
<td>-2.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Credit targets met/Fiscal not met</td>
<td>Pre-program: 0.6</td>
<td>30</td>
<td>-7.5</td>
<td>-2.7</td>
</tr>
<tr>
<td></td>
<td>Target: 1.7</td>
<td>16</td>
<td>-6.8</td>
<td>-0.7</td>
</tr>
<tr>
<td></td>
<td>Actual: 0.5</td>
<td>13</td>
<td>-8.4</td>
<td>-3.5</td>
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<tr>
<td>Fiscal and credit targets not met</td>
<td>Pre-program: 2.9</td>
<td>93</td>
<td>-7.8</td>
<td>-2.7</td>
</tr>
<tr>
<td></td>
<td>Target: 1.1</td>
<td>52</td>
<td>-4.9</td>
<td>-0.7</td>
</tr>
<tr>
<td></td>
<td>Actual: 1.0</td>
<td>78</td>
<td>-5.1</td>
<td>-3.5</td>
</tr>
</tbody>
</table>

Source: IMF staff estimates.

\(^1\)If the two programs that targeted an inflation rate of 40 percent or more are excluded, the averages were 13 percent (pre-program) and 11 percent (target and actual).

The association between the implementation of fiscal and credit policies and the achievement of inflation and external objectives suggests that the approach to financial programming has been broadly appropriate. The possible linkages between fiscal and credit policies and growth performance are more complex. The correlation between program implementation and higher than projected growth could suggest that adjustment supports economic growth, even in the short run. The results also point to the importance of a balanced approach to adjustment. Credit policy was relatively effective in containing inflation even in those cases where fiscal policy was not implemented as planned, but this mixed approach was associated with weaker than projected economic growth.

Care is needed in drawing conclusions about cause and effect relationships based on the program-versus-actual approach. However, the growth performance of countries under recent IMF-supported programs is encouraging. It suggests that the approach to adjustment
adopted in recent years, involving a comprehensive set of macroeconomic and structural measures, is supportive of growth. At the same time, the recent drop in output in the Eastern European countries, as these economies adopt comprehensive reforms, suggests that the transitional costs of a fundamental transformation of economies—short-run declines in output and employment—may be substantial.

**Effects of Adjustment Programs on the Poor**

A recent study by the IMF of the effects of adjustment programs on the poor, based on case studies of selected countries, concluded that many adjustment measures directly benefit the poor—currency depreciation raised the incomes of the rural poor (Ghana, Kenya, and the Philippines); financial system reform increased the availability of credit to the poor (Ghana, Kenya, and Chile); and the removal of price controls reduced rents based on political privilege (Ghana and the Philippines). The paper also concluded that the poor are least able to protect themselves from the effects of inflation, shortages, and other consequences of disorderly adjustment and that the poor may consequently be better off in a period of orderly adjustment.

At the same time, the study acknowledged that some adjustment measures can hurt the poor. Examples were the adverse effects of currency devaluation on the urban poor or in a nontradable goods sector that was labor intensive (Chile, the Dominican Republic, and the Philippines), cuts in health and education expenditure accruing to the poor (Sri Lanka and the Philippines), and restrictive monetary policies affecting employment (the Philippines).

As noted above, the IMF is paying greater attention to the social aspects of adjustment and an increasing number of programs include specific social measures, particularly the programs of the poorest member countries supported by the IMF's structural adjustment and enhanced structural adjustment facilities. These measures fall into four main categories—consumer subsidies of certain goods; income transfers from the budget; wage policies, job programs, and other measures to directly raise the income of the poor; and protection of education and health expenditures.

Among the various adjustment programs, consumer subsidies have involved direct subsidies for certain goods consumed by the poor or indirect subsidies through an exemption of the sales tax on basic foodstuffs as well as the waiving of user charges in priority sectors,
such as basic health and education. These efforts have been better targeted in recent programs.

Income transfers from the budget have varied and included direct financial support to some affected groups and a general reallocation of central government expenditure. Direct financial support has been provided to civil servants laid off in the wake of administrative reforms or to low-paid civil service employees after the removal of subsidies on the sale of basic foodstuffs. The reduction in central government transfers and subsidies has been accompanied by a change in its composition—increased direct transfers and special programs (food stamps and midday meal programs) to the poorest households.

A third group of actions has consisted of efforts to raise directly the income earned by the poor. In a number of programs, this action was undertaken through an increase in the minimum wage or the creation of employment opportunities, for example, through road repairs and irrigation projects.

Finally, most programs have recognized the need for increases in social expenditure for basic education and health and the need for poverty alleviation. In general, increases in this area were aimed at meeting basic needs as well as redressing inequities caused by expenditure cuts in the adjustment program. In most cases, this additional expenditure has been funded by a cut in other categories of expenditure, including budgetary subsidies and restraint in the growth of wages and salaries. Basic education and health have been identified as priority sectors in a number of programs.

Programming Issues

In designing adjustment programs, a number of important programming issues arise, including the linkages between macroeconomic stabilization and structural reforms, the appropriate pace and comprehensiveness of reforms, and the sequencing of reforms. The adjustment strategy that is chosen will depend on the particular circumstances of each country, but some general lessons are emerging to guide the choices facing country authorities. In the end, the success of the effort will depend crucially on the commitment of the government to the program and the perseverance shown in its implementation.

Macroeconomic Stability and Structural Reforms

Macroeconomic stability can be seen as a prerequisite for sustained growth of output. In other words, there appears to be no trade-off,
especially in the medium term, between output growth and inflation. When developing countries are divided into two groups depending on whether they have an inflation rate above or below the median, the countries with low inflation had an average national saving rate almost 10 percentage points of GDP higher than the high-inflation countries over the 1982–88 period; their growth rate averaged about 3.5 percentage points higher.\(^7\)

It is also generally accepted that structural reform will be largely ineffective in a situation of financial instability. High rates of inflation mean that prices and other market signals will not be particularly useful to economic agents in deciding how to allocate resources. This suggests that macroeconomic adjustment should precede structural reforms or that steps to restore macroeconomic balance should be taken simultaneously with structural measures.

The lesson from partial market-oriented reforms in centrally planned economies in the 1980s—particularly China and Yugoslavia—is that once direct controls are relaxed a good deal of progress in the structural area may be needed to maintain macroeconomic stability. As more autonomy is given to enterprise managers and other economic agents, control over the demand and supply of credit and over wage policy may decrease unless deeper reforms of enterprises and the financial system are undertaken, leading to a hardening of the budget constraint facing producers. The recent experience of the countries in Eastern Europe confirms this linkage between the need for progress in the structural area and the establishment of macroeconomic stability.

**Comprehensiveness and Sequencing of Reforms**

A second issue to be addressed in the design of adjustment programs is the comprehensiveness and sequencing of reforms. The comprehensiveness of needed reforms depends on the extent of the distortions in the economy. Given the linkages between various reforms, a comprehensive approach is needed in an economy with pervasive distortions.

For example, reform of the exchange and trade system would have little effect if distortions in the domestic pricing system are not also removed. At the same time, price reform would have little effect on the allocation of resources unless enterprise reform is undertaken to give firms an interest in increasing profits (and make them responsible for their losses). Credit would not be allocated efficiently unless the

\(^7\)See Aghevli and others (1990).
financial system is reformed to strengthen the supervision of banks and give greater play to market forces. Tax reform would not necessarily improve efficiency if personal and business income is based on a distorted wage and price structure.

The reallocation of labor among different industries and geographical areas (and the related transitional costs of higher unemployment) can be smoothed by the establishment of social safety nets. In societies where family allowances, health benefits, and housing are provided by employers, it will be necessary to make the provision of these benefits and services independent of the place of employment in order to increase labor mobility.

Indeed, the theory of the second best suggests that the removal of a single distortion, while other distortions remain, may actually worsen economic welfare rather than improve it. For example, the decentralization of economic decision making in a situation of continued serious price distortions may result in a less efficient allocation of resources than the continued centralized control of resources. This argument strengthens the case for a comprehensive approach to reforms.

However, many countries lack the administrative capacity for a comprehensive approach, or governments may not have sufficient political support to undertake reforms simultaneously across a broad front. In these circumstances, some sequencing of reforms may be necessary. The ideal sequence depends on the particular circumstances of each case, but as a general rule it is considered appropriate to reform first those markets that are slowest to adjust or most costly to change. More specifically, labor and goods markets generally should be freed before financial markets. Thus, it is widely accepted that one of the problems encountered in the liberalization programs of the southern-cone countries (Argentina, Chile, and Uruguay) in the late 1970s and early 1980s was that financial markets and the capital account of the balance of payments were liberalized ahead of trade reform.

Following on this argument, financial system reform affecting the allocation of investment resources would not be efficient if it were attempted before a reform of domestic prices took place that ensured resources are moved into appropriate activities. Similarly, it would not be appropriate first to adjust the structure of domestic prices in order to clear domestic markets and then, only after the costly reallocation of resources had occurred, to open up the trade system for a further round of changes in production and consumption patterns based on world prices. Thus, in the recent reform programs in centrally planned economies, particular emphasis has been placed on the early reform of prices and the trade and exchange rate systems.
Speed of Adjustment and Reform

The debate over the speed of adjustment—a gradual approach versus shock therapy—is a long-standing one, to which there is no easy answer. However, the experience with shock approaches to the elimination of inflation in Argentina, Bolivia, Brazil, and Israel in the mid-1980s, after the repeated failure of gradualist approaches, showed that inflation could be brought down quickly even in countries with a history of high inflation.

In these cases, output also recovered fairly quickly, after an initial period of weakness. This response of output has been attributed to either the supply-side effects associated with more efficient resource use in a low-inflation environment or the redistribution of income (associated with the elimination of the inflation tax) toward lower-income families, who have higher propensities to spend. The short-lived success of the anti-inflation programs of Argentina and Brazil in the mid-1980s also points to the crucial importance of fiscal and monetary restraint if inflation is to be kept low.

Early experience with the bold adjustment programs that have been undertaken in Eastern Europe—where output has dropped more quickly than originally expected—suggests that the supply-side effects of more efficient resource use may not be sufficient, in the short run, to overcome the transitional drop in output associated with a major transformation of the economy. To some extent, the drop in output can be attributed to the collapse in trade with the former Soviet Union and other members of the recently dissolved Council of Mutual Economic Assistance and to delays in the implementation of reform measures. It may also be that the official data on output do not accurately reflect a pickup in private activity associated with the reforms. Nevertheless, it would seem that the degree of inefficiency in these economies and the transitional costs of economic adjustment were underestimated.

Quality Versus Quantity in Fiscal Adjustment

As adjustment programs give greater emphasis to structural aspects, particularly in the fiscal area, the possible trade-off between the quality and the quantity of fiscal adjustment becomes an issue. The approach followed by the IMF when discussing adjustment programs with member countries is to estimate the reduction in the fiscal deficit needed to achieve the macroeconomic objectives of the program.

Meeting these fiscal targets may preclude the reduction of inefficient taxes or require cuts in public investment or other productive expenditure.

Nevertheless, recent programs supported by the IMF have increasingly recognized that the specific measures through which fiscal adjustment is achieved have important effects on the medium-term success of the program. A question from the point of view of the IMF is the extent to which the emphasis on structural reform should be reflected in the conditionality attached to its lending operations—in other words, the extent to which continued access to IMF resources should be conditional on the quality of adjustment as well as on the meeting of macroeconomic targets.

Determinants of Program Implementation

The success of adjustment programs depends on careful program design, which, in turn, requires an accurate assessment of the problems facing the economy, a detailed specification of measures to be adopted, careful program monitoring, and protections for the program against the effects of adverse exogenous shocks. Such protections include the provision of additional financing and the adaptation of the program to the changed external economic environment. In the end, however, the degree of implementation will depend on the strength of the authorities’ commitment to the program.

This commitment can be strengthened by ensuring that the authorities are involved at the very early stages of problem diagnosis and program design and that all agencies of the government responsible for the implementation of the program are committed to the program. In the IMF and the World Bank it is said that the member country must “own” the program if it is to be successful. Very often, the success of a program is limited because support within the government is too narrowly based. Broad public support for a program can be fostered by clearly explaining the benefits to be gained from early and orderly adjustment and by being realistic about the timing of the expected benefits.

Concluding Remarks

The nature of programs supported by the IMF have changed through time. While the supply-side, or structural, aspects of adjustment were by no means ignored in the past, they have been given substantially more emphasis in recent programs.
Similarly, more focus has been given to the effects of adjustment on the distribution of income and on the poor. The IMF continues to deepen its understanding of these issues, while helping member countries design measures to protect the poor from the transitional costs of adjustment.

While care must be taken in drawing strong conclusions from the experiences of countries adopting adjustment measures, the recent assessment by the IMF of economic developments under programs it supports show that adjustment can be associated with growth even in the short run. However, the experience of the centrally planned economies in Eastern Europe suggests that a decline in output during major economic transformations may be inevitable. Performance under recent stand-by and extended arrangements also suggests that the financial programming approach to reducing inflation and containing external imbalances, which has been adopted in recent programs, is broadly appropriate.

The relationship between macroeconomic adjustment and structural reforms is being increasingly understood. Financial stability is seen as a prerequisite for the effectiveness of structural reforms; at the same time, in countries characterized by widespread market distortions, major progress in structural reform can be seen as essential to the establishment or maintenance of macroeconomic stability.

While the correct sequencing of reforms must be determined on the basis of a careful analysis of each case, general lessons about the appropriate sequencing of reforms are also becoming clear—the liberalization of goods and factor markets should precede the freeing of financial markets. In the final analysis, however, the success of adjustment programs will depend on the design of adjustment programs by the authorities, on a detailed understanding of the characteristics of their economies, and on their perseverance in implementing the programs.

References


Comments

Akbar Noman

Brian Stuart does a commendable job of succinctly covering a wide gamut of issues in his ambitious paper, although he does not simply summarize issues and evidence. Along the way, Stuart takes positions in complex, ongoing debates, making for a stimulating essay but also a somewhat tendentious one, if for no other reason than that he seems cramped for space. Because of this scope, his is not an easy paper on which to comment. Thus, the parts that are persuasive or unexceptionable, as well as some of the caveats in the paper, I shall ignore in order to sharpen my focus on some of its bolder and more contentious aspects.

The author's paper contains an excellent summary of the methodological problems involved in evaluating the effects of programs supported by the International Monetary Fund. These problems stem essentially from the absence of a counterfactual in making such assessments—that is, the inability to measure what would have happened in the absence of a given program. By now there is a fair body of studies that attempt to substitute for the counterfactual, and this evidence shows that programs have favorable effects, though the findings are neither overwhelming nor entirely conclusive. The question that arises, then, is when and to what extent do programs not meet their objectives and why do they fail? One of the following five reasons might provide an answer:

(i) problems in measuring the effects of programs (for example, poor national accounts), which create the illusion of failure;
(ii) exogenous shocks of external or domestic origin (terms of trade, political crises, or weather);
(iii) unrealistic expectations about the program's likely results (forecasting the effects of a certain set of policies on such variables as economic growth, inflation, and the balance of payments is an imperfect art, and the forecasts may reflect wishful thinking);2

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The tendency to exaggerate what programs can achieve may arise because of either a self-serving bias on the part of technocrats involved in the program or pressures to display “viable” programs to executive boards and management of international organizations or to the domestic political leadership.

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(iv) inadequate implementation; or
(v) faulty design.

The last two are closely related and may be difficult to distinguish: weak implementation may reflect design inadequacies. Thus, if programs do not adequately take into account the constraints on implementation, political feasibility, or "ownership" by governments, they are likely to suffer in implementation. Programs may not only neglect but even exacerbate these constraints by being overambitious, internally inconsistent, or overloaded with conditionality. There are difficult judgments to be made about what constitutes an appropriate, feasible, and adequate policy. Stuart's paper is not unmindful of these considerations but in my view pays too little attention to them.

There is some tension in the paper between emphasizing the specific circumstances of a country and seeking to draw general lessons, with Stuart leaning toward the latter. In drawing general lessons, it would have been helpful to develop a typology of country circumstances or initial country conditions. As Stuart recognizes, an important question is how general these lessons truly are. Indeed much of the current debate on macroeconomic and structural adjustment turns on this question.

On the sequencing of macroeconomic stabilization and structural reforms, Stuart argues that there is no conflict between stabilization and growth, at least in the medium term. He also suggests that stabilization should take precedence over structural reforms except when major systemic reforms are being undertaken, such as in Eastern Europe. Yet there is also an argument for reverse sequencing. Stabilization and growth are both complements and substitutes: macroeconomic stability can facilitate sustained growth, but too strong a dose of stabilization can hinder growth. The issue is one of striking the right balance between supply-side and demand-side measures, a balance that depends on the initial country conditions. The question of the sequencing between stabilization and structural reforms arises only in acute cases of macroeconomic imbalance or major systemic reforms. In the case of the former, there is a strong presumption that stabilization should precede structural reforms. In the latter situation, the reverse holds true.

On the scope of programs, Stuart argues for comprehensiveness, invoking the theory of the second best, which says that the removal of a single distortion while other distortions remain may actually worsen economic welfare not improve it. However, the theory of the second best also says that removing, say, 20 out of 30 distortions is not necessarily better than removing 10 of them, nor does it state that
a faster reduction in any given set of distortions is always better than a slower one.

Stuart acknowledges the constraints of administrative capacity and political support facing comprehensive reform. Stuart also points out that it is a good idea to liberalize slower-adjusting markets like the goods and labor markets before liberalizing the quick-adjusting ones like the financial market. But other good reasons also favor a less comprehensive approach in particular areas. For example, it has been argued that export promotion should precede across-the-board import liberalization, as distinct from selective liberalization, in order to ease the balance of payments constraint that such liberalization can quickly run into. Another important argument against more rather than less comprehensive reform is the capacity of economic agents to assess the effects of reform. Reforms may increase uncertainty and dampen the response of economic agents, particularly investors, to the reform program.

Closely related to the issue of comprehensiveness is that of the pace of reform. Again, Stuart, while noting there are no easy answers, believes that quicker is better than slower. This presumption is subject to qualifications like those guarding the argument for comprehensiveness. Indeed, as Stuart recognizes, there is a trade-off between the quantity and quality of fiscal adjustment, and quality often argues for gradualism. Similar quality and quantity trade-offs arise in other spheres of adjustment.

In the messy real world, programs are often designed with tight deadlines, invariably with imperfect information, and necessarily under the exercise of judgment. The questions are how to narrow the area of judgment and which policies should be given priority. To minimize the scope for judgment and translate general lessons into the context of a particular country—or discover the _mutatis mutandis_ that attaches to any general lesson—is more challenging in the absence of good policy-relevant research on the economy at hand. Usually such research is scarce in developing countries. In these circumstances, the temptation to rely excessively on general lessons must be stoutly resisted.

In Pakistan, economic policymaking more often than not must be undertaken with a paucity of information and policy-relevant research. And Pakistan, in my view, is better than other developing countries on this count. This lack of analysis and inadequacy of data frequently reflect the fact that policymakers have not demanded them consistently or for a long enough period of time. Statistical systems, a capacity for policy analysis and research, cannot be created overnight.
Thus, policymakers can sometimes find themselves the victims of the past policymaking mistakes.

Outside agencies, like the IMF or the World Bank, can only partly substitute for the weakness of a domestic statistical system. While the IMF is often criticized for its policy presumptions and conditionalities, countries should perhaps work to overcome their own vacuum of analysis before criticizing too loudly. Too often, critics deride a package of adjustment policies without offering any clear alternative or recognizing, as Stuart points out, that in the face of macroeconomic imbalance, countries have to adjust. The choice frequently is not between an adjustment package and its absence but between orderly and disorderly adjustment. Critics of IMF programs in Pakistan often tend to focus on the economic and social costs of an adjustment program but not on the costs of not adjusting at all.

The IMF has been criticized for not paying enough attention to minimizing the costs of adjustment and for doing too little too late on the supply side and the poverty alleviation issue. Whatever the merits of such a charge, it should also be recognized that the problem often lies with governments. Authorities frequently tend to be more concerned with the costs imposed on the politically powerful than on the really poor.

Stuart neglects or is perhaps too polite to mention the difficulties that such country “circumstances” present to the design of appropriately country-specific programs. As a result, the pressure to lean on general lessons becomes harder to resist. Some of these lessons are more contentious and less general than Stuart seems to suggest in his useful and stimulating paper.
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