

WORLD TRADE ORGANIZATION

RESTRICTED

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Committee on Balance-of-Payments Restrictions

REPORT ON THE CONSULTATIONS WITH PAKISTAN

1. The WTO Committee on Balance-of-Payments Restrictions met on 21 and 22 April to consult with the Government of Pakistan. The consultation was held under the Chairmanship of Mr. P.R. Jenkins (United Kingdom), in accordance with the Committee's terms of reference, pursuant to Article XVIII:B, paragraph 12(b) of GATT 1994 and the Understanding on the Balance-of-Payments Provisions of GATT 1994. The International Monetary Fund was invited to participate in the consultation in accordance with Article XV:2 of GATT 1994.

2. The Committee had before it the following documents:

WT/BOP/15	Basic Document supplied by Pakistan, 28 October 1996
WT/BOP/15/Add.1	Basic Document supplied by Pakistan, Addendum
WT/BOP/W/17	Background Paper by the Secretariat, 30 October 1996
WT/BOP/N/14	Notification received from Pakistan, 25 October 1996
WT/BOP/N/14/Add.1	Addendum to notification received from Pakistan
WT/BOP/W/15/Rev.1	Revised schedule of meetings
WT/BOP/INF/4	Updated membership list
WT/BOP/N/18	Notification received from the Republic of Bulgaria

Opening Statement by the Representative of Pakistan

3. The opening statement by the representative of Pakistan is attached as Annex I.

Statement by the International Monetary Fund

4. The statement by the representative of the International Monetary Fund is attached as Annex II.

Discussion in the Committee

(i) Balance-of-payments position and prospects; alternative measures to restore equilibrium

5. Members recognized the adverse economic situation Pakistan faced and the fragility of its balance of payments. The current account deficit had widened to 6.6 per cent of GDP in the preceding fiscal year and reserves had declined from eight weeks to a current estimated four weeks of import coverage; significant foreign debt represented an additional burden on the external account.

6. Members expressed appreciation for the bold policy initiatives introduced by Pakistan in an effort to stabilize the economy, especially the reduction and simplification of tariffs and other trade

reforms. Members recognized, and expressed full support for, the Government's commitment to trade liberalization in spite of a difficult balance-of-payments situation. They encouraged Pakistan to continue in this direction. Some commented that revenue sources could be diversified further and policy fine-tuned to increase the domestic savings rate.

(ii) System, method and effect of restrictions

7. Members sought clarification on the import prohibitions listed in WT/BOP/N/14 and Add.1, expressing the view that justification for many of the prohibitions might more appropriately be sought on religious, safety or security grounds. One Member deduced that separating out such items would essentially leave only textiles and clothing products on the list.

8. Some Members pointed out that the restrictions did not address the general level of imports. They suggested that it would be more appropriate for Pakistan to have recourse to price-based measures, since quantitative restrictions constitute a blunt instrument for addressing the balance-of-payments problem. They noted that a switch to price-based measures would be consistent with the overall thrust of Pakistan's reforms and the approach to trade liberalization, through tariffication, outlined in paragraph 55 of the Basic Document (WT/BOP/15).

9. A third point raised, seen as relevant to the provisions of the Understanding, was the absence of a time schedule or plan for elimination of the restrictions. In this context, some Members, pointing out that Pakistan had not increased restrictions in spite of its economic difficulties, contended that Pakistan needed time to phase out restrictions, especially in the light of the slow pace of global liberalization in textiles and clothing. Others thought Pakistan should give priority to drawing up a time schedule, as stipulated in paragraph 1 of the Understanding, noting that it could be modified to take account of changes in Pakistan's balance-of-payments situation.

Replies by the Representative of Pakistan

10. The representative of Pakistan argued, that, while, in principle, his Government agreed that price-based measures were preferable to quantitative restrictions, in this case quantitative restrictions were the only way to prevent a surge in imports since the items on Pakistan's list - excluding those banned for moral, safety or similar reasons - were items for which the elasticity of demand was low. He undertook to produce a revised notification, making the distinctions Members had suggested which would be appropriate, but felt that in the light of Pakistan's balance-of-payments position and prospects, it would be premature to produce a time schedule for elimination. Time should be allowed to assess the impact of the very liberal policies the Government was adopting under its reform program.

Conclusions

11. Committee Members recognized that Pakistan was facing a serious balance-of-payments problem and agreed that it was justified in resorting to measures in accordance with Article XVIII:B of GATT 1994.

12. Members welcomed and expressed support for the bold actions taken by Pakistan within the context of the recently announced economic reform package. They commended the Government's policies aimed at improving the supply of productive factors by, *inter alia*, lowering tariffs and other indirect taxes, broadening the tax base and curtailing public expenditure.

13. While Members appreciated the reduction of items on the Negative List from 214 to 68 since 1989, some pointed out that many of the items listed should more appropriately be justified under other

WTO provisions, e.g. on grounds of health, safety, public morals or security. Members requested that Pakistan produce, in accordance with paragraph 11 of the Understanding, a clearer notification regarding which items were specifically being justified under Article XVIII:B. In addition, some questioned the recourse to quantitative restrictions, noting that price-based measures were normally to be preferred.

14. The Committee agreed to meet again in October 1997, with a view to concluding, on the basis of (i) a clarification of Pakistan's notification of items restricted on balance-of-payments grounds, as well as an explanation as to why quantitative restrictions were preferred to price-based measures, and (ii) a short paper which addresses the procedural requirements contained in Paragraph 1 of the Understanding.

ANNEX I

Statement by the Representative of Pakistan

1. It is indeed a matter of privilege for me to lead Pakistan delegation to the full consultations on balance of payments under Article XVIII:B(12)b of GATT 1994.

2. Pakistan attaches great importance to these consultations as they are being held after almost eight years. During this period, Pakistan's economy has not only witnessed significant structural changes but also come a long way in terms of its integration into the world trading system.

3. Mr. Chairman, Pakistan is a country of substantial economic potential endowed with rich natural resources. It is also a country which faces onerous developmental challenges. To meet these challenges and establish a basis for sustained growth, fundamental changes have been introduced in the country's economic policies. I would like to emphasise here that Pakistan was perhaps one of the first countries in our region to have completely transformed its basic economic framework from a regulated to a virtually free system in a short span of time even in the face of economic difficulties.

4. The Basic Document prepared by Pakistan on balance of payments and macroeconomic performance along with the background paper prepared by the WTO Secretariat have been circulated to all concerned. These background papers provide a brief account of Pakistan's economic performance and changes in its trade regime since the fiscal year 1991-92.

5. I would like to briefly re-capitulate major developments in the economy during the period 1991-92 to 1995-96. Whereas Pakistan's real GDP registered an average growth rate of 5 per cent for the period 1991-92 to 1996-97, there were wide fluctuations on a year-to-year basis. For example, the real GDP (FC) grew by 7.7 per cent in 1991-92 but the growth rate declined to a low level of 2.3 per cent in 1992-93, primarily due to damage caused by excessive rains to the primary sector and industrial infrastructure, adverse movement in commodity terms of trade and slippage in the Government's financial policies. The economy however, entered a phase of recovery in subsequent years. In 1993-94, GDP registered a growth rate of 4.5 per cent and in the years 1994-95 and 1995-96, GDP grew at an annual rate of 5.3 per cent. The estimated GDP growth for 1996-97 is 4.5 per cent. Pakistan economy had also to face the adverse impact of external shocks such as increase in prices of some of the major import items like palm oil, etc. These shocks were responsible for raising the unit value for major imports and increasing the import bill with consequent deterioration in the balance of trade.

6. Mr. Chairman, Government of Pakistan has undertaken extensive economic reforms aimed at the creation of a liberal investment and trading environment and promotion of a macro-based economy as pointed out in the Basic Document prepared by Pakistan. The entire system of licences, permits and controls on business activities and transactions has been abolished and foreign exchange restrictions have been removed. Investment decisions no longer require a No Objection Certificate from the Government.

7. Mr. Chairman, Pakistan is taking appropriate policy measures to implement its commitments under the Uruguay Round Agreements. We have fulfilled the myriad obligations in different areas, relating to tariffs (market access), Agriculture, Textiles and Clothing, Trade Related Intellectual Property Rights, Trade Related Investment Measures and Services, etc. Despite the costs involved and the constraints which the implementation process imposes on a developing country like Pakistan, our efforts to live up to our contractual obligations will be continued.

8. Against the background of global economic environment, and the policy framework of liberalization and privatization being pursued by the Government of Pakistan, I would like to highlight some of the major economic problems which we face. These include: the threat of an inflationary spiral, external sector disequilibrium and high budgetary deficits. During the current fiscal year, prices have been under pressure. From July 1996 to February 1997, the CPI increased by 11.34 per cent over the corresponding period last year. To this increase, food, beverages and tobacco contributed 5.02 per cent, fuel and lighting 0.54 per cent and transportation 1.12 per cent. The inflationary pressures have been caused by both internal and external factors. Excessive money supply in the economy and increase in the unit value of imports have been the major factors contributing to the inflationary pressure. It is hoped that increasing local supply in combination with demand management measures would make it possible to halt the upward trend in prices.

9. Mr. Chairman, the 7 per cent devaluation of the Pakistani Rupee in October 1996 did moderate the trade deficit, as anticipated, at least in the short term. The monthly deficit came down to US\$310 million in November and US\$241 million in December 1996 as compared to the deficit of US\$452 million in October 1996. However, the devaluation is not expected to have any substantial impact on the cumulative 12 month trade imbalance which would be around US\$3 billion in 1996-97, almost the average trend for the last three years.

10. It is important to realise that Pakistan's main imports are raw materials, machinery and food items. The erratic, yet sharp upward trend in the import of food items is cause for concern, since domestic price increases in edible oil and flour has a disproportionate impact on low income households. To pre-empt or rectify a sharp increase in the price of these essential food items, Pakistan often has no choice but to import to make up for the supply shortfall.

11. As regards Pakistan's imports, looking at the quantitative increase in select items, we find the following ranking of the sharpest linear increase: (1) unmilled wheat posted the steepest trend despite a very erratic growth pattern; (2) machinery imports show a strong increase with two major spikes, one in 1991/92 because of the boost in the textile sector, and the other, after June 1994; (3) chemicals have shown consistent growth, which rose sharply in the last fiscal year; and (4) imports of petroleum have also risen rather sharply since 1990/91.

12. Pakistan's exports can be ranked as follows: (1) cotton yarn exports have shown the strongest trend, but have tapered off since 1993/94; (2) despite accounting for only 3.1 per cent of export revenues in 1995/96, sports goods have posted the sharpest upward trend in the past three years; (3) garments have largely carried Pakistan's exports accounting for only 2.5 per cent of earnings in 1980/81, and rising to 7.5 per cent in 1995/96; and (4) cotton cloth comes next showing a consistent increasing trend.

13. In the immediate future, it is likely that Pakistan will continue to face pressure on the external sector. In fact, the trade imbalance for the first nine months of 1995/96 was US\$2.67 billion, which increased to US\$3.66 billion for the full fiscal year. The first nine months of the fiscal year 1996-97 have already witnessed a deficit of US\$2.62 billion, which is most likely to result in a trade deficit of US\$3 billion for the year as stated earlier. More generally, fiscal 1995/96 witnessed a current account deficit of US\$4.6 billion which was 6.6 per cent of GDP, compared to a deficit of US\$2.5 billion, which was 4.1 per cent of GDP, in 1994/95. Given the recent trend in the trade sector, it seems highly unlikely that Pakistan will be able to meet the targeted current account deficit of 4.4 per cent of the GDP in 1996/97. If last year's trends in remittances and the deficit in trade services were to persist, this implies that the current account deficit for this fiscal year will be US\$4.3 billion. The present level of liquid foreign exchange reserves is US\$800 million which is expected to rise to around US\$1 billion at the close of the fiscal year 1996-97, equivalent to four weeks of imports cover.

14. Notwithstanding this pressure on balance of payments, the Government of Pakistan has refrained from any tightening of the import regime. On the contrary the Negative List has been pruned from 214 items in 1989-90 to 68 items in 1996-97.

15. Mr. Chairman, these were the economic conditions facing Pakistan when the new Government assumed office following the General Elections held on 3 February 1997. The new Government has an overwhelming mandate from the people of Pakistan to formulate and pursue appropriate policies to rectify the serious economic situation it inherited. The avowed aim of the Government is to undertake economic reforms and to provide momentum to the process of liberalization in order to meet its international commitments under the Uruguay Round Agreements. The Addendum to Pakistan's Basic Document outlines the measures undertaken by the Government on 28 March 1997 to revive the economy. It is a bold package designed to deal with the acute economic crisis and to raise the level of investment and exports by enhancing productivity and enlarging production. We expect that the economic revival package will generate sufficient resources not only to offset revenue losses but create additional revenue sources thus making it possible to reduce the budget deficit. We have tried to rationalize our tariff structure to provide incentives to investment and production through abolition of the regulatory duty of 10 per cent and reduction of the maximum tariff from 65 per cent to 45 per cent. The number of slabs has been reduced from 13 to 6 (0, 10, 15, 25, 35 and 45 per cent). It is hoped that these liberal tariff reforms will prove beneficial to the economy, increase production and provide momentum to the process of economic growth. The Government has also announced a package of incentives for the agriculture sector on 3 April 1997 with a view to achieving self-sufficiency in food.

16. The Government is also making concerted efforts to reduce its trade deficit by adopting substantive measures to boost its exports. The measures, in brief, are:

- (a) Duty on import of machinery for export-oriented industries has been reduced to 10 per cent.
- (b) Import of raw materials used mainly for exports are being zero-rated.
- (c) To facilitate exports from SMEs, it has been decided to channel export credit to small- and medium-exporting firms on a preferential basis.
- (d) To encourage exports of non-traditional items, the Government proposes to extend support through introduction of simplified customs procedures and lowering of transaction costs of exports by upgrading the transport and communications infrastructure.
- (e) Relevant agencies are accelerating their efforts to put in place systems of accreditation and certification about quality standards so that more companies could obtain ISO 9000 and ISO 14000 certification.

17. The Finance Minister of Pakistan, when presenting the package of economic reforms to our National Assembly on 28 March, stated:

"The historic mandate delivered by the voters in the recent election has guaranteed political stability and vastly improved the investment climate. In this positive environment, the package I have just announced has the potential of taking Pakistan out of the current economic crisis. It is our own package. We are pleased that our

new approach package has been endorsed by the IMF and will form the basis of negotiations on an E.S.A.F. facility in the next few weeks."

18. Mr. Chairman, we hope that the Committee on Balance-of-Payments Restrictions will appreciate the substantial trade liberalization measures which have been implemented by Pakistan since 1988 and the bold economic reforms package which the Pakistan Government has recently initiated. We also hope that the Committee will appreciate the economic difficulties which Pakistan confronts and the measures which our Government is taking to overcome these difficulties. We are confident that the Committee will extend its full support and understanding to Pakistan's trade and economic policies and reforms, which are designed to maintain sustained, low-inflation growth, through a liberalized, export-oriented and investment-friendly economic framework. We, in Pakistan are confident that with patience and honest endeavour, we will succeed in surmounting our current economic difficulties and restoring Pakistan's economy to the path of high and dynamic growth.

ANNEX II

Statement by the IMF Representative

This statement (i) updates the information on external sector developments in 1996/97 (July-June fiscal year) contained in the supplementary background material for the WTO (SM/96/263, dated 10/22/96); (ii) describes the most recent policy developments; (iii) reviews the outlook for the fiscal year as a whole; and (iv) provides a brief assessment of the new government's economic strategy.

1. Recent balance-of-payments developments

In view of the emerging trends described in SM/96/263, the Pakistani authorities adopted in October 1996, after consultation with the Fund staff and management, a corrective policy package supported by structural reforms. The package included fiscal measures, increases in key interest rates, and an 8.5 percent devaluation of the rupee with full pass-through to petroleum prices. The structural measures emphasized, inter alia, implementation of an agricultural income tax and restructuring of the banking sector.

The caretaker government, which assumed office on November 5, 1996, endorsed these policies and reinforced them with additional fiscal measures--including a 5 percent increase in petroleum prices, elimination of the 5 percent concessional rate of the General Sales Tax (GST) with transfer of items to the next higher rate (10 percent), increases in some federal fees and charges, and further non-priority expenditure cuts.

Partly because of the political uncertainties in the run-up to the national elections held on February 3, 1997 and also due to weaknesses in implementation on the fiscal front, the above described corrective measures did not produce the envisaged improvement in the macroeconomic situation. As a result, Pakistan's balance of payments performance in 1996/97 continues to be characterized by a large current account deficit, heavy reliance on short-term financing, and a relatively weak external reserve position.

In the first nine months of the fiscal year, the current account deficit (before official transfers) amounted to an estimated US\$3.7 billion reflecting a trade deficit of US\$2.6 billion and a deficit in the services account of US\$2.8 billion which were partly offset by private transfers amounting to US\$1.7 billion. Net medium- and long-term capital inflows amounted to about US\$1.5 billion while net short-term capital inflows amounted to about US\$900 million. Reflecting these developments, the net foreign asset position of the central bank deteriorated markedly, including a decline in gross official reserves to below US\$900 million (3.6 weeks of imports) at end-March, from US\$2.1 billion at the beginning of the fiscal year.

2. The Government's stabilization and reform measures

In response to the continued vulnerable external outlook, the government that assumed office after the February 3 elections has embarked on a consolidation and intensification of the structural reforms and adjustment efforts initiated in October 1996. This includes a re-enforcement of the macroeconomic stabilization effort and structural reforms in the tax system, in the financial sector, and in the non-financial public sector.

The government has re-enforced its macroeconomic policy stance through the following actions: (i) implementation of fiscal measures yielding PRs 10 billion during April-June 1997 (1.6 percent of GDP

on an annual basis); (ii) increases in key interest rates; and (iii) containment of non-government credit during 1996/97 to PRs 73 billion through use of open market operations. Moreover, a responsive exchange rate policy will be pursued.

As regards tax policy reform and reform of the non-financial public sector, the government has taken the following steps: (i) taking advantage of the recently adopted revenue sharing arrangement (which has removed the disincentives to tax reform that existed under the previous arrangement), the government is embarking on a thorough rationalization and simplification of the tax system; (ii) it is containing and rationalizing public sector expenditure through actions regarding the level and composition of the budgetary outlays and improvements in the operations of the public sector enterprises; and (iii) it will secure legislative approval, by May 15, 1997, of the four provincial ordinances adopting agricultural income taxation which were issued last December.

The thrust of the tax reform component is a rationalization of the rate structure and a reduction in tax rates concurrent with a broadening of the tax base. Consistent with these objectives, the following steps have been announced:

- **Tariff reform:** As part of a three-year program, the government has reduced the maximum tariff rate to 45 percent (from 65 percent), and the numerous duty rates to a six-band system (0, 10, 15, 25, 35 and 45 percent). The 10 percent regulatory duty has been eliminated. To broaden the tax base, all concessions will be abolished, except for those relating to international commitments, exports, or which are time bound. In addition, the list of zero-rated goods will be reduced to an absolute minimum.
- **GST reform:** The base of the GST will be extended horizontally by bringing into the GST net, by end-June 1997, several exempt manufacturing and imported goods. As a step towards extending it vertically to the retail sector, a turnover tax of 3 percent will be imposed by end-August 1997 in all areas with metropolitan/municipal status (while offering the choice to traders to register for the GST). The rate structure has been simplified by eliminating the highest of the three non-zero rates (the 23 percent rate); and the standard rate has been reduced to 12½ percent (from 18 percent).
- **Reform of direct taxation:** The government will implement, by end-June 1997, a reduction in the level and number of income tax rates, together with an expansion of the definition of income (to include allowances and perks in kind) and the obligatory filing of returns for persons owning cars and telephones, occupants of different categories of property through ownership or leasing, and persons engaged in foreign travel. In addition, by end-June 1997, the government will implement a scheme of obligatory filing of wealth tax returns based on ownership of assets (similar to that for income taxation) and the adoption of a minimum tax on large homes and automobiles.

As regards the financial sector, the authorities will: (i) secure parliamentary approval, by May 15, 1997, of the ordinances promulgated by the caretaker government aimed at improving governance in the public sector financial institutions and strengthening the role of the central bank in conducting monetary policy and in regulating and supervising the financial sector; and (ii) advance with the restructuring and privatization of the public sector banks and development finance institutions.

3. Near-term outlook

If implemented on a timely basis, the above policy package would have the impact of containing the budget deficit at 4.8 percent of GDP in 1996/97 (down from 6.3 percent in 1995/96) and the expansion

of the net domestic assets of the banking system at 17.7 percent of the initial liquidity stock (down from 18.5 percent in 1995/96). This is expected to contribute to contain the external current account deficit at about the same level as in 1995/96 (US\$4.3 billion, equivalent to 6.8 percent of GDP). On this basis, gross official reserves would recover to above US\$1 billion (about five weeks of imports) by the end of the 1996/97 fiscal year notwithstanding the scheduled debt service payments.

4. Conclusions

The implementation of the new government's reforms initiatives would constitute a substantial and much needed change in the structure of the economy. The reforms would provide a firm basis for further efforts to enhance the growth potential of the Pakistan economy, eliminate chronic structural weaknesses, and improve the inflation and balance of payments performance. There are, however, downside risks. First, the external outlook remains fragile and the economy is very vulnerable to unfavourable changes in market sentiments. Second, the wide range of the proposed reforms will put a strain on the country's implementation and administrative capacity. Third, it is critical that the package of reforms be implemented fully and on a timely basis. In particular, any slippage in the broadening of the bases of the affected taxes would lead to revenue losses that would need to be immediately compensated by further fiscal efforts. In view of these risks, Fund staff has stressed to the authorities the importance of determined policy implementation and high responsiveness of the policy stance to changes in market sentiment.