

# Liberalization of the Foreign Exchange Market

by

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There is a pattern in the evolution of exchange control systems. A typical sequence of events is:

*Phase 1, implementation*—in response to a serious balance-of-payments deficit, a free foreign-exchange market is abandoned in favour of price control and rationing of foreign exchange. Initially exchange control applies only to major categories of receipts and payments but is rapidly extended to cover all external transactions.

*Phase 2, consolidation*—a black market appears; regulations are extended and revised to close loopholes, to cope with shortages, and to repair inequities and anomalies. The foreign-exchange market is fragmented and differential treatment is accorded to different types of trade or traders. Taxes, subsidies, or multiple-exchange rates are introduced to offset, in a discriminatory way, the effect of an overvalued currency on foreign-exchange receipts and the demand for imports. The system becomes increasingly complex and administratively burdensome.

*Phase 3, rationalization*—the complexity of the system is reduced by consolidation of market fragments. Regulations are simplified and applied to broader categories of transactions. *De facto* but selective devaluation, through tax, subsidy, and exchange-rate adjustments, becomes a policy instrument. Portions of the market are “liberalized” by returning to a limited free market in which price resumes its functions of evoking supply and limiting demand. Continued disequilibrium, however, sustains the black market which may be “tolerated” as a sort of unofficial free market.

*Phase 4, termination*—to the accompaniment of some further adjustments of the tax and subsidy structure, there is a return to a free market. However, complete termination may be postponed; phase 3 may continue more or less indefinitely.

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With due allowances for Pakistan's unique circumstances and after recognition of some interesting Pakistani innovations, it may still be said that, so far, the origin and development of Pakistan's exchange control system fit tolerably well into the above pattern. While it is clearly too soon to predict the advent of "phase 4" it does appear that Pakistan has entered "phase 3". Recent changes have, to a limited extent, simplified and rationalized a complex, discriminatory system. There is open and audible discussion among businessmen and government officials on the question of further liberalization. In [2] and [3] the present writer has argued that a freer foreign-exchange market in Pakistan is both feasible and desirable. The purpose of this paper is to examine in some detail the feasible and likely paths to further liberalization of the foreign-exchange market.

Some general background on the origin, characteristics, and evolution of Pakistani exchange control is presented in Part I. This is followed, in Part II, by a description of the main features of the present (1968) system. Part III suggests a convenient and expeditious mechanism for liberalization—in anticipation that the arguments for doing so eventually become persuasive to those in authority. The paper concludes with a brief statement of some of benefits to Pakistan which would follow from liberalization.

## I

Exchange control in Pakistan was adopted in 1954 in the face of a serious balance-of-payments deficit. The circumstances may be illustrated by Figure 1. DD and SS represent the demand for and supply of foreign exchange for Pakistan *circa* 1954. The end of the Korean War had brought a serious decline in export markets and a drastic reduction in foreign-exchange receipts. Maintenance of the official exchange rate,  $OR_o$ , together with free access to the market, required an outflow of gold or foreign-exchange reserves, VZ, per period of time. (Previously, during the Korean War boom, the D and S functions presumably intersected somewhere in the vicinity of A so that  $OR_o$  was approximately an equilibrium price for foreign exchange.) When the loss of reserves became intolerable, exchange control was adopted as an alternative to devaluation. (Barring destabilizing speculation and assuming normal elasticities,  $OR_o$  would be the equilibrium rate.) Henceforth, all foreign-exchange proceeds—and existing private foreign-exchange holdings—were required, by law, to be surrendered to the exchange control authority at the official rate of exchange. The foreign exchange forthcoming at this rate, OV, was then rationed, somehow, to importers and other users of foreign exchange. The degree of disequilibrium is represented by the "horizontal gap" between amount demanded and amount supplied, VZ, or by the "vertical gap" between the official, ration price of foreign exchange and its scarcity value,  $OR_p$ . The latter "gap",

$R_oR_p$  is a "scarcity premium" which becomes a windfall profit to importers favoured by the rationing system.

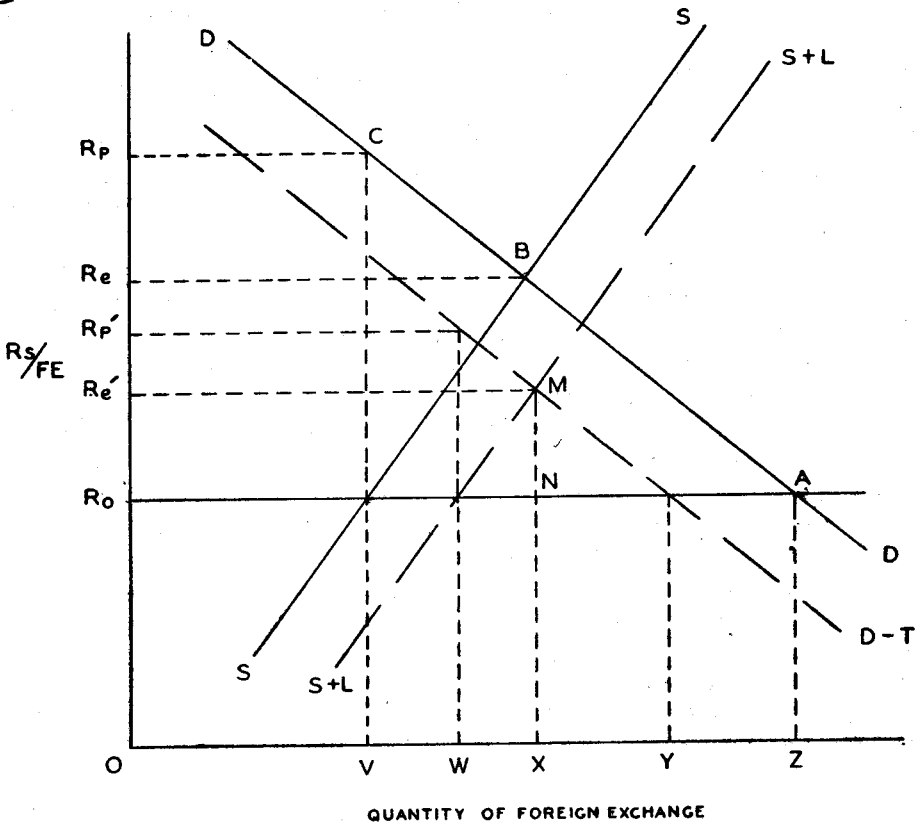


Figure 1. Foreign Exchange Market

It would have been possible to retain price as a rationing device, *i.e.*, to auction the available foreign exchange in an open market, limiting demand to those willing and able to pay the highest prices and thus clearing the market at the premium price  $OR_p$ . This procedure, widely used in Latin American countries and in pre-War Germany, would introduce a dual pricing system. Absorption of the scarcity premium by the monetary authority would be tantamount to a tax on external transactions<sup>1</sup>. Price control, in effect, continues the "tax" but diverts the entire amount as a subsidy to importers.

However, Pakistan eschewed price as a market-clearing device and chose, rather, to ration exchange by non-price means. It introduced a comprehensive

<sup>1</sup>Is the exchange profit of the monetary authority,  $R_oR_p$  per unit, a "tax" on exporters who receive less than the market value of their export earnings? Or is it a "tax" on importers who must pay more than the exporters receive for their foreign exchange?

system of licensing and administrative procedures through which to decide which of the competing demands would be satisfied. Presumably, demands of "high social priority" were met in full; those of lower priority were met in part; and low priority, non-essential uses of foreign exchange were denied — except insofar as there was leakage from the system into a black market. Indeed, the divergence between the assessment of private and social values would almost certainly lead to a black market and a black-market price of exchange, a price in excess of either a devalued free-market rate or the price that would exist in an auction market for scarce exchange. To the extent that administratively determined social priorities required satisfaction of demands of those purchasers with low demand prices — those included in the lower right portion of the demand function — there was a diversion of exchange away from those willing to pay very high prices but with low priority — those included in the demand function above B or even C (see, Figure 1). We might note in passing that the emphasis on social priorities and the simplicity of rationing by price could be reconciled. By segmenting the import market into, say, capital goods, raw materials, essential consumer goods, and luxuries, available foreign exchange could be allocated to each segment and then auctioned freely within that sub-market. This would, of course, be a system of multiple-exchange rates, a system widely used in exchange controlling countries because of its (relative) simplicity. Such a system can be made more sophisticated by introducing multiple export rates as well. As we shall see shortly, over time Pakistan's trade and payments control system has evolved toward one which approximates these characteristics. In any event, price rationing was avoided, at least at first, probably in an (ultimately ineffective) effort to avoid increasing the rupee cost of imports.

Pakistan's decision not to devalue was, under the circumstances of the time, a reasonable one. At that time virtually all foreign-exchange earnings were derived from traditional agricultural exports. Given normal, low supply elasticities and given world prices, a higher exchange rate would mean higher rewards to exporters without much increase in output, *i.e.*, higher economic rents. In the case of jute, low demand elasticity abroad, even with a positive supply response, might *reduce* foreign-exchange earnings. On the import side, prices would increase across the board — on consumer goods, capital goods, and imported raw materials. The total impact would be essentially a change in the *internal* terms of trade in Pakistan — in favour of sectors producing traditional agricultural exports and against consumers generally and industry in particular. Questions of "fair" distribution of income aside, such a change was inconsistent with plans for a high saving rapidly industrializing economy with urban/industry as the leading sector (see [2;3]).

Systems of exchange control substitute administrative rules, regulations, and procedures for the indirect controls of a self-regulating market place.

Since the foreign-exchange market is normally highly organized and centralized, it appears to be easily regulated; virtually all international transactions pass through the hands of a few foreign-exchange dealers, usually commercial banks, who conduct their affairs meticulously and with a high degree of technical efficiency. With exchange control, however, it soon becomes apparent that there are numerous other, though less convenient and efficient, ways to accomplish international money transfers. The pressure of excess demand makes these alternatives attractive and profitable; effective, exchange control requires that these "loopholes" be closed or brought into the controlled system. And as each loophole is closed, new ones appear — a tribute to man's ingenuity. Exchange control contains a sort of built-in, self-generating mechanism for its own extension; once established it must be constantly revised and extended.

Pakistan's exchange control is no exception to this rule; it has been consistently, regularly revised. Virtually every issue of the official *Gazette of Pakistan* contains some addition, deletion, or modification of the regulations and procedures. Just a few examples: prices of traded commodities are subjected to administrative review to reduce the incidence of over- and under-invoicing of imports and exports; travellers are subject to a variety of constraints and record-keeping requirements to reduce black-market currency transactions; international mail must be inspected to check illegal currency transfers and to minimize private barter/compensation arrangements between two pairs of trading partners; some sort of "certificate of origin" (and inspection) is required for commodities which might originate in a country with which trade is banned; and, of course, there is the chronic problem of smuggling.

The more serious the market disequilibrium the greater the pressure for circumventing the regulations and for extra-legal transactions. An alternative to more rigid controls is a reduction of the disequilibrium pressure and Pakistan has, from time to time, revised its control system in this direction. The scarcity premium on imported goods, the difference between internal scarcity value and landed cost, has been reduced by higher import duties; tariffs and excises have been increased and new surcharges imposed. (Additional taxes on imported goods shift the demand curve for foreign exchange downward from D to D-T in Figure 1.) The Bonus Voucher Scheme has decontrolled or "liberalized" a portion of Pakistan's foreign trade, *i.e.*, returned it to a more or less self-regulating free market. The price paid for bonus vouchers effectively absorbs the scarcity premium on goods so imported and transfers this premium to exporters to offset partially the inhibiting effects of an overvalued currency on the volume of exports (*see below*, 174). All these measures, and others, reduce the incentive for circumventing exchange control.

Autonomous or fortuitous circumstances also affect the system and lead to change. A substantial inflow of aid loans and private capital has, over the years, augmented foreign-exchange supplies, reducing the excess demand for

and the scarcity premium on foreign exchange and reducing the need for even tighter controls. (Capital imports shift the supply curve in Figure 1 from  $S$  to  $S+L$  and, in conjunction with the lower demand curve,  $D-T$ , reduce the scarcity premium to  $R_0R_p'$ ). The war with India, hesitant action by the Aid-consortium, and substandard harvests during 1966 and 1967, on the other hand, increased the disequilibrium. The devaluation of sterling in November of 1967 was the occasion for a significant liberalization; the bonus voucher issue rate for eligible exporters was increased by 10 per cent, stamped (restricted use) bonus vouchers were eliminated, the export taxes on raw jute and cotton were eliminated, and a 10-per-cent "regulatory duty" was imposed on a wide variety of imports<sup>2</sup>. We might add that these actions are tantamount to a 6-9 per cent devaluation despite the official announcement to the contrary that Pakistan would not devalue its currency in the wake of the British pound.

Finally, an exchange control system will be modified over time to adapt it to changing public policy goals. As indicated above, Pakistan adopted exchange control to meet a serious balance-of-payments deficit. Today the rupee remains overvalued and exchange control continues to defend the balance of payments. But exchange control now serves a larger purpose; it has become part of a comprehensive system of economic controls designed to promote saving, investment, and economic growth. By controlling the volume, composition, and terms of international transactions, it seeks to guide the quantity and quality of domestic economic activity — the price structure, resource allocation, output composition, and income distribution. Such goals require more and different devices than simple management of a foreign-exchange scarcity. The system has become comprehensive, complex, and discriminatory. In addition to a multiplicity of discriminatory taxes, it employs a variety of equally discriminatory and frequently discretionary quantitative and procedural controls over external transactions.

## II

The most striking and important feature of the present exchange control system is the fragmentation and compartmentalization of the foreign-exchange market. While the various sub-markets have certain common characteristics, each one has its own unique features with respect to commodities which may be traded, eligible participants, procedures to be followed, and degree of constraint.

Except for the ceiling imposed on the exchange rate, administrative constraints on exports from Pakistan are few. Exports are licensed but this is essentially a surveillance procedure designed to encourage compliance with

<sup>2</sup>Exceptions: the new regulatory duty was not applied to bonus-voucher imports nor to a few commodities used exclusively in agriculture. The duty was limited to 5 per cent on a few consumer goods and on capital goods and machinery imported into East Pakistan.

the requirement that export proceeds be surrendered to the monetary authority. About 55 per cent of Pakistan's export earnings from raw jute, cotton, skins and hides, and a few minor items, are converted to rupees at the official rate (Rs. 4.75 = \$1). The remaining exports—from the developing manufacturing industries, certain service industries, and some invisibles—receive supplementary price incentives of various sorts (to be described below) which increase their rupee return to Rs. 6-8 per dollar with a few rates going as high as Rs. 12 per dollar.

On the import side, capital goods for establishment, expansion or modernization of industry enter the country at the official rate of exchange (plus various taxes) and access to exchange for these purposes requires a licence based on a prior "investment sanction" that the project is in accordance with the Comprehensive Investment Schedule of the development plan. All other imports enter the country under one or more of seven import procedures<sup>3</sup>.

A. *Licensing* has, since 1954, been the basic procedure through which to ration limited supplies of foreign exchange. Simple in form, licensing requires that established importers "register" with the Chief Controller of Imports and Exports and, as such, they become eligible to obtain licences for import of eligible commodities up to some specified limit. Each registered importer's quota is expressed as a percentage of his "entitlement" or "category" the amount imported during some base period or the amount adjudged necessary to operate his facilities at a "normal" rate. Licensed imports enter the country at the official exchange rate, plus applicable duties.

Over the years the list of items importable under ordinary licensing has been reduced as alternative import procedures have been instituted. At present there are 25 groups of commodities remaining on the licence list and they are subject to a variety of constraints and restrictions; three groups are importable by public sector agencies only, three by "industrial users" only, and five by "actual users" (ultimate consumers) only. The rest are available to any eligible "commercial importer". Certain goods are importable only from specified countries and two commodities may be imported "subject to availability of U.S. PL 480 funds". Pharmaceutical importers are required to obtain prior approval of the Director General of Health and their incoming shipments must contain not less than 30 per cent (in value) of a list of specified goods but not more than 30 per cent of another list. Payment to abroad must be accomplished through a banker's Letter of Credit (L/C) the face value of which must fall within minimum and maximum limits set by the monetary authority. The limits vary among commodities; pooling of quotas to accommodate these limits

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<sup>3</sup>The following summary of procedures with respect to each import sub-market is based primarily on the "Import Policy" announced in the *Gazette of Pakistan, Extraordinary*, January 15 and January 20, 1968.

is permissible. Import of "spares" for industry requires the approval of the Directorate of Industry. This list of constraints is not exhaustive but representative.

B. *The Free List* includes those items which may be "imported without cover of licence". A reading of the "fine print" explaining the procedure reveals, however, that the free list is free in name only. Of the fourteen groups of commodities on the list, two are importable by the public sector only, five by industrial users only (of which two are specified, particular industries), one is for East Pakistan only. Industrial users may open L/C's equal to 100 per cent of their entitlements (quotas) as shown in their importers' passbooks, while commercial importers may open L/C's within stated minima and maxima *provided* they were importers of that same commodity between July 1964 and July 1967 *and provided* that their L/C may not exceed the amount imported during July-December 1967. Moreover, commercial importers are limited to trade in one, in some cases two, commodities on the list. There are additional constraints similar to those applicable to ordinary licensing which leads to the conclusion that except in the most formal and limited sense, free-list importing is essentially a second licence procedure. Originally the free list was a special category of goods importable from countries which have (tied) commodity aid programmes for Pakistan. Since aid-financed goods may now also be imported under other procedures, this distinction has lost much of its meaning, although free-list items are still specified as to source, *i.e.*, they may be imported only from countries with aid or barter agreements with Pakistan.

Free-list goods enter the country at the official rate of exchange plus applicable duties. While the degree of excess demand is not serious, there is apparently some scarcity premium; otherwise there would be no need to ration imports.

C. *The Bonus Voucher Scheme* is the most novel and interesting element of Pakistan's foreign-exchange market (*see* [1; 4; 7]). Briefly, under this procedure selected exporters receive bonus vouchers — a right to purchase foreign exchange at the official rate of exchange—in an amount equal to some fraction (currently 20 per cent, 30 per cent, or 40 per cent) of the foreign-exchange proceeds surrendered at the official rate to the exchange control authority. Upon presentation of bonus vouchers, import licences are issued automatically to importers of a list of eligible goods. Given the scarcity value of imports, voucher holders have a valuable and marketable property. There is an organized market (including a futures market) for bonus vouchers. Given the exporters' supply function, the bonus voucher issue rate, and the demand function of eligible imports, there is a unique bonus voucher price and rate of sale which will clear the market<sup>4</sup>.

<sup>4</sup>The mechanics of the bonus-voucher market will be examined in detail below, *see* p. 180.



The bonus voucher segment of the foreign-exchange market has been gradually expanded since its inception in 1959. Currently almost all exporters of manufactured goods, certain service industries (*e.g.*, aircraft maintenance, hotels), tourist sales centres, and exporters of Basmati rice<sup>5</sup> may earn bonus vouchers—unless they are re-exporting or are exporting under barter agreements. The import list has grown to include 244 commodity groups from machinery and raw materials to consumer durables. In addition, with one or two exceptions, any item on the free list, the licence list, or on the cash-cum-bonus list (see below) may also be imported at the higher bonus rate of exchange. There are some administrative constraints. Certain items are importable into only one of the two wings of Pakistan and several are importable by industrial users only. A number of bonus imports are subject to quantitative restrictions (*e.g.*, automobiles).

The bonus-voucher market is the channel through which the stultifying effects of direct controls have been ameliorated without, apparently, sacrifice of public policy goals. It has been a major factor in promoting exports of Pakistan's nascent industry; manufactured exports have increased at a rate of almost 100 per cent per annum since 1959 and the share of such goods in Pakistan's total exports is approaching 50 per cent. On the import side, bonus vouchers face an exchange rate more than 150 per cent above the official rate and are subject to (frequently very high) taxes and surcharges. Nevertheless, bonus imports are currently nearing 10 per cent of the total. It is an outlet for excess demand in other segments of the market.

D. A *Cash-cum-Bonus* procedure was established in 1967; as the name implies it is a compromise between the bonus-voucher system and ordinary licensing. Under this arrangement importers may obtain import licences only when applications are accompanied by bonus vouchers covering 50 per cent of their exchange requirements. Quotas for industrial users are set at 100 per cent of their half-yearly entitlements; those of commercial importers are set by stated minimum or maximum value of the L/C's which may be opened. Commodities transferred to this new segment of the market from the free or bonus lists, for which there were no established quotas, are available only to importers with a previous record of imports. The cash-cum-bonus list contains 73 commodity groups of which 43 are importable by industrial users only and five are importable into East Pakistan only.

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<sup>5</sup>The inclusion of Basmati rice, which accounted for 6 per cent of Pakistan's exports in 1967, is incongruous. Trade control regulations specify that this high quality rice is for export only. Although there is substantial "disappearance", the entire crop is subject to government procurement at a low fixed price. The government's purchases are then sold, at auction, to exporting firms. The auction price is expressed in terms of foreign exchange payable after the rice is actually exported. They are, however, granted 20 per cent bonus vouchers on their export proceeds. Under these circumstances the bonus vouchers "earned" are at best superfluous, at worst a simple windfall to the exporters.

If it operates as described the system is essentially a variation of the ordinary licensing procedure with an import surcharge ; the bonus-voucher requirement transfers a portion of the scarcity premium on imports to the bonus-voucher market and should support the bonus-voucher price. There are reports that, in fact, cash-cum-bonus importers have been unable to obtain the "cash" portion of their licences while the "bonus" portion is readily available. If this is true, and this writer has not been able to verify the report, the cash-cum-bonus procedure is a *de facto* extension of the bonus-voucher system with a quota constraint.

E. *Export Performance Licensing* (EPL) of imported industrial inputs is permitted, subject to approval of the Chief Controller of Imports and Exports and the Export Promotion Bureau. Import licences, presumably above and beyond entitlements under normal licensing, are issued at rates of 2½-30 per cent of the *f.o.b.* value of exports of some 143 commodities. Advance licensing based on an agreed export target is also permitted but an exporter who does so is subject to a penalty in the form of bonus vouchers to cover licences issued but not ultimately "earned" by export performance. Although imports under export-performance licences are not supposed to be transferable, their value, like that of bonus vouchers, derives from the domestic scarcity value of imported goods. They are, in effect, restricted-use bonus vouchers similar to the stamped bonus vouchers issued to exporters of jute manufacturers until the end of 1967.

Export-performance licensing is an administrative nightmare of such horrendous complexity as to break the spirit of the ablest bureaucrat. Procedures for establishing eligibility and issue rates are complex and responsibility is split. Supervision of the procedure and enforcement of conditions by the responsible agencies are onerous; costs of compliance on the part of businessmen are unusually high. The system is a channel for political pressure from special economic interests. Any useful purpose served by export-performance licensing can be met by incorporating it into the general bonus-voucher system; EPL should be abandoned forthwith.

F. *The Trading Corporation of Pakistan* (TCP) was established in 1967 as a public agency through which importers are required to place their orders for six metal products from seven countries. Importers' quotas — at 29 to 262 per cent of the old half-yearly entitlements—are effectively pooled and bulk purchases made. Since the commodities concerned are covered by barter agreements with various countries it would appear that TCP is simply an indenting service established to control the volume and terms of barter trade. Importers are fearful that it is more of a device to erode their profit margins by absorbing the scarcity premia on goods so imported. The writer has not yet found incontrovertible evidence to support or refute these fears but the anguished cries of the business community lead one to suspect that it is so.

Bulk purchasing or sales in barter or other markets by TCP might permit better terms on external transactions. TCP offers its services as a broker or agent to any interested importer or exporter and while the agency hopes to provide a useful service, few firms have thus far availed themselves of the opportunity.

G. Under the *Baggage Allowance* exemption, Pakistani travellers returning to the country may import, duty free and without licence, Rs. 1,250 worth of goods per trip including one refrigerator, one air-conditioner, and one radio per year. The volume of consumer durables so imported has led to a structured market for these items and their market price has fallen below landed cost plus normal markup in commercial channels. Indeed businessmen offer and publicly advertise their willingness to order and receive merchandise from abroad so that no traveller's exemption need be lost. While it seems reasonable to permit travellers to bring home some personal items, gifts, and mementos, the present exemption clearly provides a loophole through which a significant volume of foreign exchange is drained.

Superimposed over this entire exchange structure is a large element of discretionary administrative control. The Chief Controller of Imports and Exports, in consultation with a number of other governmental units, has the major responsibility for formulating and implementing public policy in this area. The State Bank has the immediate administrative responsibility. The State Bank, in turn, relies upon foreign-exchange dealers, the "scheduled" commercial banks, to operate the system by requiring that all foreign-exchange transactions must pass through the banking system. Import transactions must be accomplished through letters of credit opened at one of the scheduled banks, each bank being responsible for supervision and enforcement of the applicable regulations. In the process the State Bank must, within the limits of the "foreign-exchange budget", establish sub-allocations or sub-authorizations of exchange which set a limit on the availability of exchange for various categories of importable goods. There is some evidence that the State Bank imposes informal foreign-exchange quotas against which L/Cs may be issued to various importers; when the allocation is exhausted no further L/Cs may be issued unless and until additional foreign-exchange allocations are forthcoming. Indeed, the January 1968 Import Policy explicitly states that import quotas will be met "subject to the availability of exchange". Commercial banks, in turn, may discriminate among their customers. Moreover, the State Bank and the various scheduled banks which act as its agents exercise considerable discretion in the speed with which administrative procedures are completed, effectively hastening or delaying the process for particular transactions. This is especially notable with respect to the occasional provision for so-called "automatic repeat licensing" available to importers of certain commodities during a six-month shipping period.

The complexity and variability of the system requires that the State Bank and CCI & E establish an appeal procedure to resolve questions about eligibility of importers, the size of quotas, and applicable procedures. It appears that the controlling agencies have established a sort of rule-by-precedent to reduce the load of discretionary decisions.

Further, the monetary controls are buttressed by (buttrass?) the basic commercial policy. Export duties have been abolished but imports are subject to tariffs, excises, a defence surcharge, a rehabilitation tax and regulatory duties, as well as licence and registration fees. In general, the tax rates are "cascaded" with highest rates applicable to "non-essential" consumer goods or products whose production is encouraged under the "import substitution" policy, lower rates on essentials and industrial raw materials, and the lowest rates on capital goods. On many items there is an outright ban. The latest import policy contains eight lists of banned items and anything not explicitly permitted is banned. There are exceptions — lathes are importable but certain sizes commonly used in Pakistan are banned. There are exceptions to exceptions—steel pipe is importable, except certain sizes which are banned, except certain specialty pipe which is permitted.

The complexity and intricacy of the system is, if anything, understated by this summary. Yet we hasten to add that Pakistan's exchange control authorities have shown remarkable ingenuity and responsiveness in the ways in which they have modified — and even simplified—the system so that it would serve as an effective instrument of public policy. Until 1965 substantial liberalization and simplification of the system was obtained through Open General Licensing, expansion of the free list, and the introduction of the Bonus Voucher Scheme. In 1965-67, with an increased degree of disequilibrium, administrative controls were tightened. Open general licensing was abandoned, the free list became just another licensing procedure, and the bonus-voucher system was hedged with quotas and administrative constraints. However, the new cash-cum-bonus procedure plus a variety of other minor changes in the latest import policy suggest that more liberal policies are possible.

We may note, parenthetically, that some discrimination and bilateralism is imposed externally. So long as the various aid-lending countries tie their development loans to their own particular exports, exports which are priced above the world market price, Pakistan has little choice but to impose bilateral clearing for aid-financed commodities. The alternative is chaotic, dual pricing for a single commodity or the imposition of constantly changing and probably ineffective discriminatory taxes and subsidies to eliminate the differential between prices in the world market and the aiding country (*see* [2]).

## III

The liberal case for a free market as the mechanism for allocation of scarce resources is based, primarily, on two arguments: (1) economic efficiency and (2) low social cost of administration. The former argument has become somewhat attenuated because of a growing awareness, among political practitioners if not among economists, that the achievement of "Pareto Optima" is an inadequate or even inappropriate public policy goal. It is clear that private and social values or costs can and do diverge. Problems of externalities, convexities, and interpersonal comparisons of welfare vitiate the usefulness of criteria of economic efficiency. The dynamics of growth frequently call for abrogation of the requirements of static efficiency. In less arcane terms, social goals with respect to economic growth, resource use, and income distribution may require decisions inconsistent with those which would obtain when private individuals make unfettered decisions in a "natural", unregulated, market-guided economy. It is on such grounds that Pakistan has opted for a controlled disequilibrium rather than a free market for foreign exchange. In doing so, however, Pakistan has run afoul of (2) above. Exchange control has clearly become costly to administer. It is complicated, slow, cumbersome, uncertain, inefficient, and conducive to corruption. One suspects that it has become so intricate that it no longer "controls" effectively, that it is unable to accomplish the ends for which it is intended.

For example: businessmen and government officials have informed this writer that, in some cases, the combined export incentives under the Bonus Voucher Scheme and Export Performance Licensing are sufficient to permit profitable sale of exports for less than the cost of their imported raw material content. Similarly, it is reported that the scarcity premium on imported raw materials is high enough that, in some cases, it pays to import capital equipment solely for the raw material import quotas that can be justified by higher output capacity. Since capital-goods imports are routinely over-invoiced, the fact that capital equipment may be under- or unutilized is not a deterrent. The scarcity value of imported raw materials plus the premium attached to foreign balances is great enough to offset the cost of capital equipment which may be imported at an artificially low exchange rate. It is anomalous that capital goods are imported, under a rationing system at artificially low prices, when existing productive facilities in industry operate at 40-60 per cent of capacity<sup>6</sup>. These and other examples suggest that the exchange system in Pakistan is out of control. A liberalization of the foreign-exchange market would actually promote better "control" in the sense that the pricing system would enforce more economical use of scarce resources and simultaneously reduce the admin-

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<sup>6</sup>These figures are "armchair" but widely accepted estimates in Pakistan. For an incomplete but informative report on rates of utilization of capacity in selected industries, see [6].

istrative burden of the system. A generalization of the bonus-voucher market offers the most expeditious route to this end.

The operation of the bonus-voucher market may be illustrated with the aid of Figure 27. Let  $OS_b$  represent the foreign-exchange supply function for certain export industries; it assumes given world prices, given domestic cost functions, and given domestic demand for exportable goods. At the official

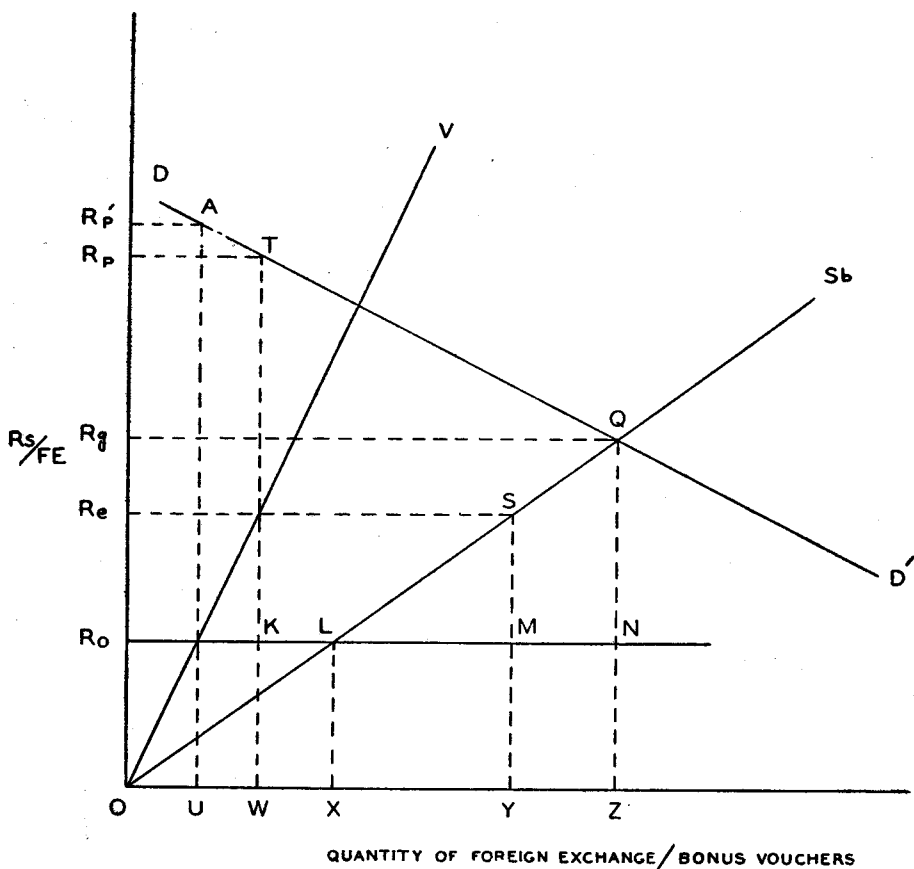


Figure 2. The Bonus Voucher Market

rate of exchange,  $OR_0$ , exporters of these products will export (say)  $OX$  dollars (pounds, francs, etc.) worth of goods, receiving  $OR_0LX$  rupees in exchange. Suppose that these particular industries are now provided export incentives in the form of (say) 30 per cent bonus vouchers, i.e., for each \$100 of foreign exchange earned and surrendered to the exchange control authority at the official

<sup>7</sup>The following presentation of the mechanics of the bonus-voucher market is taken from Glassburner [4].

rate of exchange, exporters receive transferable bonus vouchers entitling the holder to purchase \$30 of foreign exchange together with an import licence for \$30 worth of eligible goods. The line OV is a reference line indicating the volume of bonus vouchers issued with each alternative rate of export proceeds<sup>8</sup>. Alternatively, the line OV indicates that fraction of the foreign-exchange proceeds of bonus-voucher exports which must be earmarked to honour the exchange authority's commitment to sell foreign exchange against vouchers. For example, if OY of foreign exchange is surrendered to the exchange control authority by the exporters concerned, OW of this amount is committed to those importers exercising bonus-voucher rights and WY of exchange is available to the authority to meet other demands.

Indeed, in this example, OY is the equilibrium foreign-exchange value of bonused exports. DD' represents the demand for foreign exchange for those commodities eligible for import under bonus. Upon introduction of the Bonus Scheme, exporters who have been earning OX of foreign exchange will receive, in addition to  $OR_oLX$  rupees, OU of bonus vouchers. In an auction market, importers will pay  $OR_p'$  rupees for each of the OU units of exchange available to them. Since they pay  $OR_o$  for each unit of foreign exchange when they utilize the bonus vouchers,  $R_oR_p'$  is the price they will pay for the vouchers themselves—the bonus-voucher premium. The bonus-voucher premium provides a price incentive to exporters to generate more bonus vouchers. As export earnings and the volume of vouchers rise the price of vouchers will fall; equilibrium will be reached when OW of vouchers sell for  $R_oR_p$  rupees each. At that price the total bonus-voucher premia  $R_oR_pTK$  is just sufficient to generate OW supply of vouchers; this amount, when spread over total exports, yields an exporters' premium of  $R_oR_e$  per unit of foreign exchange for a total of  $R_oR_eSM$ . (The area  $R_oR_pTK$  equals the area  $R_oR_eSM$ .) Any bonus-voucher price other than  $R_oR_p$ , given the 30 per cent issue rate, will lead to an excess of demand for or supply of bonus vouchers.

There are at least five interesting features of the bonus-voucher system:

- (1) imports under bonus are "liberalized" in the sense that these goods are rationed by the pricing system rather than by an administrative procedure;
- (2) the scarcity premium on eligible imports is captured and transferred to exporters thus stimulating export earnings, *i.e.*, the procedure is a *de facto*, albeit partial, devaluation of the rupee;
- (3) unlike exporters who receive vouchers for a fraction of their foreign-exchange earnings, importers must buy all of their foreign-exchange with vouchers;
- (4) that fraction of export proceeds not committed to honour bonus-voucher holders' claims is available to the exchange

<sup>8</sup>In fact, bonus vouchers are issued at three different rates — 20 per cent, 30 per cent and 40 per cent — for different export commodities. For simplicity of presentation a single rate of issue is assumed.

control authority to meet other import demands; and (5) the fractional issue rate of bonus vouchers drives a wedge between the import and export rates of exchange, it creates a multiple-exchange rate system<sup>9</sup>. Generalization of the bonus-voucher system — and further liberalization — could be accomplished by increasing the bonus voucher issue rate to 100 per cent and extending the system to cover all transactions.

Increasing the issue rate to 100 per cent would eliminate the difference between the import and export rates of exchange. Again referring to Figure 2, equilibrium in the limited bonus-voucher segment of the market would be reached at Q; the effective rate of exchange would be  $OR_g$ . OZ amount of foreign exchange would be traded for  $OR_oNZ$  rupees and an equal amount of bonus vouchers would trade for  $R_oR_gQN$ . Since the 100 per cent rate of issue of bonus vouchers “commits” the entire proceeds of bonus-voucher exports the voucher system no longer contributes any foreign exchange to other import procedures. However, total export proceeds would rise as would bonus-voucher imports. If the bonus-voucher system were completely generalized to apply to all transactions, it would mean *de facto* devaluation, a free market, and a unified rate of exchange. Referring back to Figure 1, OX of foreign exchange would be “officially” traded at the price  $OR_o$  and bonus vouchers of the same quantity would be exchanged in a free market for a premium of  $R_oR_e'$ . Total export earnings would rise permitting an increase in total imports.

The crucial difference between a generalized bonus-voucher market and an ordinary free market is that it retains the key role of the State Bank in the exchange market. All foreign-exchange receipts would continue to be surrendered to the State Bank (or its agents) at the official (arbitrary) rate of exchange; all foreign-exchange purchases would be made from the Bank (or its agents) at the same rate. The State Bank would remain the bottleneck through which foreign exchange is channelled and the free market for vouchers is superimposed on top. An equilibrium quantity of exchange would pass through the market at the official rate of exchange but the market would actually be “cleared” or “equilibrated” by an exchange of bonus vouchers at some equilibrium price. There are singular advantages to this dichotomy.

First, it is possible effectively to exclude certain foreign traders from the market in accordance with public policy, *e.g.*, those who demand foreign ex-

<sup>9</sup>The import rate of exchange is  $R_m = R_o(1+p)$  where  $R_o$  is the official rate and  $p$  is the bonus-voucher price expressed as a percentage of the official rate. The export rate is  $R_e = aR_m + (1-a)R_o = R_o(1+ap)$  where  $a$  is the bonus voucher issue rate. For some years bonus vouchers sold at 150-160 per cent of the official exchange rate; therefore  $R_m$  is approximately Rs. 12 = \$1 and  $R_e$  is approximately Rs. 7 = \$1 when the bonus voucher issue rate is 30 per cent. Since November 1967 the price of bonus vouchers has been generally higher and somewhat less stable.



change for non-permissible capital export or for purchase of banned commodities. Secondly, it continues the Bank's careful scrutiny, but not rationing, of foreign-exchange transactions. Thirdly, it maintains the organization and structure of the exchange control system intact. In the event of large shifts in external conditions which require adjustments beyond the ability of a free market or the internal economy to respond in an orderly way, controls and non-price rationing can be adopted forthwith. In short, it retains a second line of defence in the event of a disorderly foreign-exchange market.

We also note in passing that it would probably be appropriate for the State Bank to intervene, on occasion, as a participant in the voucher market. In the face of seasonal fluctuations in the demand for or supply of vouchers/exchange, it would be expedient to dampen price fluctuations and discourage disequilibrating speculation. It would also reduce the element of uncertainty in foreign trade associated with fluctuating exchange rates. This is nothing more than the usual suggestion that the monetary authority be willing to risk temporary losses or accumulations of foreign-exchange reserves by acting as an exchange stabilization fund<sup>10</sup>. If the present futures market for bonus vouchers can be developed to perform this stabilizing function, the need for official intervention is reduced.

Two earlier import procedures, Open General Licensing and the original Free List, were attempts to move toward a more "liberal" payments system; each proved nugatory in the end. Both arrangements are moribund and they were quietly dropped in 1967 without benefit of public announcement. The bonus-voucher system remains the single major success in the direction of liberalization. There are indications in 1968 import policy, however, that this market, too, is to be brought under more direct control; quotas were imposed on certain bonus imports and the cash-cum-bonus procedure, which carries quantitative restrictions, implies new controls in the bonus-voucher market. Closer examination, however, reveals that integration and coordination of the cash-cum-bonus and ordinary bonus-voucher procedures offer possibilities for liberalization of the foreign-exchange market. Generalization of the combined bonus-voucher and cash-cum-bonus systems presents an attractive and feasible method for rationalization and simplification which is potentially as effective as and perhaps more flexible than a simple 100 per cent bonus-voucher market as described above.

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<sup>10</sup>The rather remarkable stability of the present limited bonus-voucher market has led some observers to suspect such intervention on the part of the monetary authority. Officials at the State Bank have denied any such stabilizing actions. It is possible that the futures market contributes a stabilizing influence. The policy-making authorities seem to consider stability in the bonus-voucher price when they alter the rate of issue of bonus vouchers and change the composition of the bonus-voucher import list — as they do every six months. Also, see below p. 188.

It will be recalled (*see* Figure 2) that fractional bonus-voucher issue rate on the export side and a 100-per-cent bonus-voucher requirement on the import side separates the import and export rates of exchange. Dual pricing is consistent with market equilibrium because only 30 per cent (OW) of bonus-voucher export proceeds are committed to bonus-voucher imports; the remaining 70 per cent (WY) of export earnings is diverted to other segments of the foreign-exchange market. The export rate is the weighted average of the official and bonus-voucher import rates<sup>11</sup>.

The cash-cum-bonus import procedure is analogous to the fractional bonus-voucher issue rate on the export side. Importers of cash-cum-bonus items must purchase a portion of their foreign exchange with bonus vouchers but, when they do so, they are entitled to purchase their remaining foreign-exchange requirements at the official rate. This procedure increases the exchange control authority's commitment of foreign exchange to bonus-voucher holders. For example, if the present cash-cum-bonus ratio of 50/50 were applied to all bonus-voucher importers participating in the market, illustrated by Figure 2, the fraction of bonus-voucher export proceeds available to importers would be doubled. Since each unit of foreign exchange purchased with voucher permits an additional unit to be purchased without voucher, each bonus voucher becomes, in effect, a right to purchase two units of foreign exchange<sup>12</sup>. In terms of our diagram we need another "reference line". OV still shows the volume of bonus vouchers generated by the system but a second reference line, rotated clockwise from OV so that it stands at 60 per cent of the horizontal distance from the vertical axis to OS<sub>b</sub>, denotes the foreign exchange available to voucher importers. This change would, of course, require an adjustment to a new equilibrium relationship involving the price of bonus vouchers, the volume of exports, and the differential between importers' and exporters' rates of exchange.

More generally, the portion of foreign-exchange proceeds available to bonus-voucher importers is  $S = S_b (r/f)$  where  $r$  is the bonus-voucher issue rate and  $f$  is the bonus-voucher fraction of the exchange requirements of cash-cum-bonus importers. It is apparent that, if  $r$  and  $f$  are equal, the total foreign-exchange earnings,  $S_b$ , are committed to bonus-voucher importers and that dual pricing of exchange is eliminated<sup>13</sup>.

The system can, of course, be generalized. Suppose that a bonus voucher issue rate of 30 per cent is applied to *all* export transactions and that *all* imports require cash-cum-bonus in a 70 per cent/30 per cent ratio. Refer-

<sup>11</sup>See footnote 9 on page 182.

<sup>12</sup>As mentioned earlier, there are reports that the exchange authority does not always honour its commitment to provide the cash portion of cash-cum-bonus importers' requirements. Also there are quantitative restrictions on cash-cum-bonus imports. It is here assumed that cash exchange is provided and that quotas are eliminated or redundant.

<sup>13</sup>In the previous example of a generalized bonus-voucher market,  $r = f = 100\%$ .

ring to Figure 3, OS represents the foreign-exchange supply function and OV the (30 per cent) bonus-voucher reference line. Given demand, DD', equilibrium will be established at B with OX volume of foreign exchange traded at an effective rate of exchange of  $R_e$ . OR remains the official (and arbitrary) rate of exchange; the average premium over the official rate is  $R_o R_e$ . Concomitantly, OZ of bonus vouchers (30 per cent of OX) are traded at a price of  $R_o R_p$ ; the area  $R_o R_p AK$  is equal to area  $R_o R_e BC$ . Moreover, any value for  $r$  and  $f$  would do as well. Given an equality of  $r$  and  $f$ , the total bonus-voucher premia must be  $R_o R_e BC$  if the market is to be cleared; the market price of bonus vouchers will vary inversely with the volume of bonus vouchers

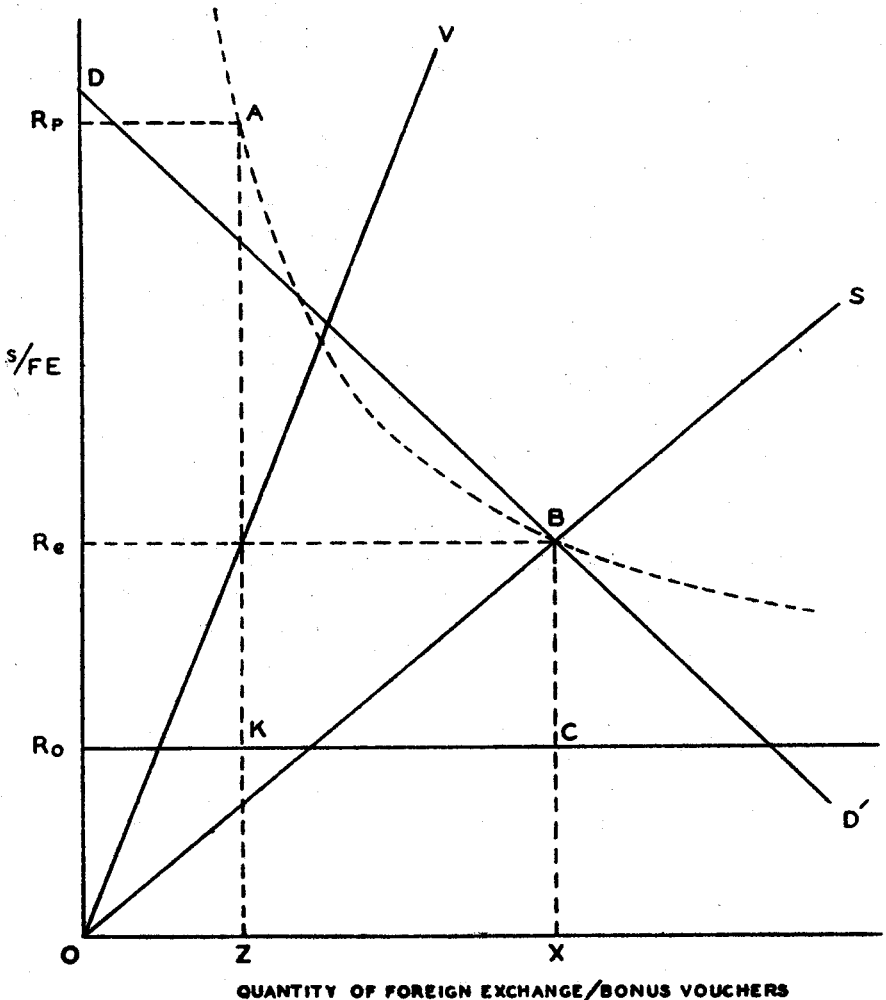


Figure 3. Bonus Vouchers/Cash-cum-Bonus: Foreign Exchange Market

generated by the system. Using the line  $R_0C$  as a horizontal axis, the dashed line  $AB$  in Figure 3 is a rectangular hyperbola, a locus of points representing the various bonus-voucher premia for different  $r = f$  values. In short, it is feasible to accomplish simplification and rationalization of the foreign-exchange market by generalizing the cash-cum-bonus procedure.

It is also possible to continue the discriminatory treatment of import and export transactions by application of differential or multiple rates of  $r$  and  $f$ . If the bonus-voucher portion of cash-cum-bonus ( $f$ ) equals the bonus-voucher issue rate ( $r$ ), 100 per cent of the economy's foreign-exchange earnings are available to importers and there will be a single, unified rate of exchange. On the other hand, if  $r/f \neq 1$ , there will be an inequality between current bonus receipts and current bonus payments and a disparity between the effective import and export rates of exchange. If  $r/f < 1$ , some portions of bonused export proceeds are diverted away from the market for, e.g., non-price rationing to preferred importers, official government imports, official debt service, or accumulation of foreign-exchange reserves<sup>14</sup>. If on the contrary,  $r/f > 1$ , the exchange control authority is committing foreign-exchange resources beyond current bonus receipts, i.e., drawing down foreign-exchange reserves<sup>15</sup>. In addition, if public policy goals call for discrimination among importers and exporters, multiple rates of  $r$  will provide differential incentives (penalties) to different categories of exports and multiple rates of  $f$  will establish preferred (or penalty) rates of exchange to different importers. So long as the weighted average of  $r$ 's and  $f$ 's are equal, the market will be cleared; if the weighted average of  $r/f \neq 1$  foreign-exchange reserves will rise or fall. A bonus-voucher system is a powerful instrument for use or misuse by public policy-makers.

It is clear that some form of generalized bonus-voucher procedure will simplify and liberalize Pakistan's foreign-exchange market. There are, however, institutional constraints which may preclude extension of the system to the entire market. The problem areas are imports of government and quasi-governmental units, aid-financed imports, and trade under barter agreements.

(1) Government imports and imports of government enterprise are currently purchased at the official, undervalued price of foreign exchange. This practice seriously understates the scarcity value of imported resources. If all privately used imported resources were priced at a free-market rate, as they would be if a bonus-voucher procedure were generalized, underpricing

<sup>14</sup>This is, of course, the state of affairs in the present, limited, bonus-voucher market. (see, p. 180).

<sup>15</sup>It would be possible to support an excess of  $r$  over  $f$  by offering aid-funded foreign exchange or other official capital inflows to supplement foreign-exchange receipts from trade and private capital inflow. For reasons to be noted below, there are compelling arguments against doing so. See p. 187.

of government imports would become an even more serious problem. Without entering into a debate over the relative efficiency of government and private enterprise, the price discrepancy would be so large as to lead to serious mis-allocation of resources. The price disparity would be eliminated if government agencies and enterprises, too, were required to import with bonus vouchers<sup>16</sup>. (There is still a question of the dutiability of government imports.) The budgetary impact of higher rupee cost of imports would be modest and would be more than offset by revenues from premia on aid-supplied foreign exchange.

(2) Aid loans are tied to exports of the aid-lending country, frequently to products whose prices exceed those of the world market. Tied loans require creation of a special sub-market for aid-exchange. As already noted, aid-eligible commodities are imported under free-list or cash (aid)-cum-bonus procedures and, while relatively free from unusual constraints, are importable only from the specified, aid-lending countries. It is difficult to integrate the aid-goods market with the general market. A merged market would require a single bonus-voucher price; barring the unlikely case in which the effective exchange rates are equal in the two separated markets, a unified price would create an inequality between aid flows and aid imports, *i.e.*, the accumulating of unutilized aid (or the misuse of aid) or the import of expensive aid-type goods against Pakistan's own foreign-exchange earnings, (*see* [2, appendix]). An alternative would be the use of a discriminatory regulatory duty on import of aid-competing goods from the world market. This latter possibility is apparently the purpose and the announced — but not yet implemented — price-equalization tax. A price-equalization tax is a cumbersome device which would need continual adjustment to reflect changing external price differentials. A second alternative is the introduction of a special variety of bonus vouchers sold against aid exchange and goods only for import of aid commodities from the respective aid lending countries. This would be the operating equivalent of the recently eliminated stamped bonus vouchers. It would mean constructing a separate sub-market for aid goods but, within that market, price would be the rationing device and the differential between the price of aid and regular vouchers would automatically reflect the high prices of the aid-financed goods. Aid vouchers would presumably sell at a discount compared to the more valuable, regular vouchers.

It would be necessary to establish a separate aid voucher and aid-voucher market for trade with each country providing tied aid loans. If the aid loans are commodity-tied as well as country-tied, or if the total volume of aid from a particular country was very small, special bonus vouchers would be impractical.

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<sup>16</sup>As this paper goes to press, the government has announced a withdrawal of the preferential treatment of public sector industry with respect to importation of raw materials and spares. Henceforth publicly operated enterprise must import these items under the same conditions as private firms.

In those cases, it would be expedient to acquire aid-financed imports through the Trading Corporation of Pakistan, both to insure the best possible terms of trade and to capture for public purposes any scarcity premium on goods so imported.

A major advantage of the special voucher is that its price would absorb the scarcity premia presently available on aid imports. Furthermore, it would generate at least 80-100 crore rupees of government revenue, more than enough to offset the budgetary impact of higher government import costs mentioned earlier.

(3) Barter trade creates similar problems. The only difference between the market for barter trade and aid-financed trade is that the supply of foreign exchange for the former derives from Pakistan's supply of barter-eligible export commodities and the demand for these goods by the trading partner rather than from a negotiated loan. The achievement of "equilibrium" in these markets depends upon the constraints imposed either unilaterally or by negotiation. Trade in such commodities could also be conducted with another variety of restricted voucher or, since barter agreements are generally negotiated with socialist countries, barter trade could be conducted through the Trading Corporation of Pakistan to insure volume and terms of trade which are consistent with the agreement and mutually acceptable to both trading partners.

A final point: We have noted the rather remarkable stability of the price of bonus vouchers at 155-160 per cent of the official rate of exchange. Such stability appears to be the consequence of official policy. Whenever the voucher price departs substantially from the "norm", subsequent revision of the "Import Policy" alters the composition of the bonus import list to increase or decrease the demand for bonus-vouchers and brings the price back to the "desired" level. The apparent motive is to provide a "proper" level of incentive to bonus-voucher exporters, *i.e.*, an effective export rate of exchange of around Rs. 7 = \$1. While such a procedure clearly reduces the element of uncertainty in the market for bonused exporters, it does so at the expense of a high degree of instability and uncertainty for importers. Continuation of this practice would be inconsistent with liberalization of the foreign-exchange market. As noted earlier, short-run exchange rate stability can be provided by operations of the futures market and/or by stabilizing intervention in the market by the State Bank (*see* page 183).

#### IV

In this paper we have emphasized the mechanics of Pakistan's exchange control system. We have suggested a means by which policy-makers could, if they so desired, liberalize the system. Given the present state of affairs, it would appear that some sort of generalized Bonus Voucher Scheme is the most

expeditious route to a liberal market. Furthermore, the writer has made no effort to conceal his own conviction that such a liberalization is desirable as well as feasible. Major benefits would accrue to Pakistan from a freer, simpler foreign-exchange market.

In the first instance, the present system is very costly to administer. Management of a disequilibrium market requires an extensive governmental apparatus, both to facilitate compliance and to minimize evasion. Administrative talent is a scarce resource in Pakistan; reducing the volume of regulations and narrowing the range of bureaucratic discretion would reduce the administrative burden. Similarly, fewer and simpler rules reduce the cost of compliance for foreign traders — the paper work, the multiple approvals, the delays and uncertainties, the petty tyrannies of minor officials — implicit in extensive and discretionary regulation. Substantial savings of administrative and managerial resources are possible by greater reliance on a free market.

We have also noted that the present system is almost beyond effective control; a freer market for foreign exchange would promote efficient operation of Pakistan's economic system. For example:

(1) Generalized bonus vouchers would extend to traditional, non-industrial exports, the incentives and favours currently granted only to manufactured products<sup>17</sup>. Now, when agricultural productivity and production are rising sharply as a consequence of rapid innovation, is an appropriate time for change in export policy. Normally low price and income elasticities of demand will certainly lead to falling agricultural prices; unless agricultural prices can be supported, price changes will wipe out much of the gains to farmers from the agricultural revolution. But a government price support programme would flood available storage facilities at high cost to the public treasury. Falling rupee prices may eventually open export markets but bonus-voucher export incentives will promote exports with a smaller decline in the internal price level. Liberalization along the lines described above will promote export earnings without such a serious wrenching of the internal economy and will do so at a propitious time when the flow of foreign aid/loans is diminishing.

(2) If foreign-exchange earnings expand there can be a larger and more stable flow of imported raw materials, promoting more intensive use of existing but underutilized industrial capacity and reducing the problem of unemployment of labour.

(3) Generalized bonus vouchers would increase the cost of imported capital; this, too, would have a salutary impact on the economy. Capital in

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<sup>17</sup>The bonus vouchers given to exporters of Basmati rice benefit only the commercial exporter, not the rice producer. Indeed, the artificially low rice procurement price is a disincentive to the grower.

Pakistan is presently underpriced and rationed. However, as noted above, the exchange control regulations have permitted and even encouraged the creation of idle industrial capacity. Moreover, when capital is underpriced, businessmen and farmers have incentives to substitute capital for labour even though it is obvious that, in Pakistan, capital is a scarce resource and labour is so abundant that much of it is idle. A price for capital more nearly equal to its scarcity value would discourage creation of further excess capacity and remove the capital-intensive bias in present investment programmes. It would induce the system to economize on the use of its scarce capital and promote employment of abundant labour.

(4) Expansion of employment and avoidance of the more extreme capital-intensive methods of production will be conducive to more rapid and widespread development of labour skills. The machinery used in capital-intensive methods of production is usually complex and requires a small number of highly skilled workers for its effective operation and maintenance. Highly skilled workers are scarce in Pakistan. Utilization of somewhat more modest and less complicated equipment will introduce mechanical skills to more people more quickly, at lower cost and with less effort. Later, as the labour force becomes more familiar with machinery and capital is more abundant, the transition to more complex technology can be accomplished with less trauma.

(5) A liberalized foreign-exchange market would alter the internal intersectoral terms of trade and relative factor prices; it should reduce, somewhat, the extremely unequal distribution of income. Increasing demand for labour, as per (2) and (3) above, will increase the total wage bill and perhaps the wage rate. Agricultural prices will be higher than would otherwise be the case. More importantly, liberalization would eliminate the windfall profit (scarcity premia) presently accruing to favoured, and usually well-to-do, importers. While the cost to importers of imported goods or goods with import content will rise, the price to the users of these goods will not rise; their scarcity value is already reflected in the market price charged by importers. Increased volume of imports may even lead to a decline in the prices paid by consumers.

In short, a liberal market would increase economic efficiency through more intensive use of available resources and through more efficient allocation of those resources among alternative employments. This is not, we assert, an ideological question nor a special brief for a free market *per se*. A price system as a guide to economic activity is, after all, only a means to an end and not an end in itself. Direct controls are both necessary and desirable under a variety of circumstances. At this stage in the development of Pakistan's economy, however, a free market is indicated on purely pragmatic grounds — it would better serve Pakistan's interests.



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