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Trade and Industrialization Policies for an Accelerated Development in Pakistan

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Pakistan achieved high rates of economic growth from the mid-1970s. Growth was facilitated by the external circumstances that relaxed the balance-of-payments constraints. However, growth was not accompanied by an improved social development. Moreover, as the external circumstances worsened, the underlying macroeconomic imbalances emerged and the growth slowed down. The paper assesses how the domestic and international economic policies might be adjusted to attain a more sustainable pattern of development.

I. INTRODUCTION

Pakistan sustained an exceptionally high real rate of economic growth for more than a decade. Between 1977 and 1987, real gross domestic product (GDP) nearly doubled. Pakistan's real GDP growth among low-income countries in the 1980s was second only to that of China.[1] Substantial structural change accompanied the high economic growth (Tabel 1). The share of the industrial sector in GDP grew sharply while that of agriculture declined (Table 2).

The recent period of high growth was preceded by a time of economic difficulty and relative stagnation.[2] Pakistan had to adjust to a number of severe shocks during the early to mid-1970s. Among these were the 1971 conflict that ended with the secession of East Pakistan (now Bangladesh). Erratic government policies and a wave of nationalizations led to a period of sporadic and, on average, low economic

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[1]Data from *World Development Report 1989* (World Bank, New York: Oxford University Press), Table 2 statistical appendix, p. 166. Average real growth of GDP in 1980–87 for 37 low income economies (those with per capita incomes under $ 460 in 1987) was 1.7 percent (excluding China and India). China, with 10.4 percent, has the highest growth rate among all low income countries and Pakistan ranked second with 6.6 percent growth over the period.

[2]Long-term trend growth in Pakistan (1965–80) has been just over 5 percent per annum (World Bank, *World Development Report 1989,* p. 166). However, between 1970 and 1977, real GDP growth averaged only 4.6 percent compared to 6.7 percent between 1977 and 1987 (see Table 1).

Table 1

Annual Growth of Real GDP and its Sectors
(Compounded Rate)

	1971–77	1977–87	1987-88
Real GDP	4.6	6.7	5.4
Sectors			
Agriculture	2.3	3.7	4.5
Industry	4.9	9.0	6.3
Manufacturing	4.0	9.1	7.5
Services	6.3	7.4	5.3

Sources: Asian Development Bank, *Key Indicators of Developing Member Countries of ADB,* April 1985 and July 1989.

Table 2

Structure of GDP[a]
(Percentage of Total GDP at Current Market Prices)

Year	Agriculture	Industry	Other
1960	46	16	38
1970	37	22	41
1977	32	22	45
1986	23	29	48

Sources: Asian Development Bank, *Key Indicators of Developing Member Countries of ADB,* April 1984 and July 1989.
World Bank, computer data tapes 1988.

Note: [a]West Pakistan only in 1960 and 1970.

growth. The lower growth was most pronounced in the manufacturing sector as private industrialists reduced investment. High inflation and exchange rate uncertainty were exacerbated by external events including the 1973-74 oil shock and the subsequent severe world recession.

In part, the high growth that occurred in the late 1970s could be attributed to recovery from the recession and the economy's adjustment to the traumas of the early 1970s.[3] However, the fact that rapid real GDP gains were sustained year after year into the late 1980s indicates that a fundamental acceleration in trend growth occurred in the late 1970s.

The improvement in growth performance has been associated with higher manufacturing and agricultural growth (Table 1). Increasingly, the orientation of the trade, the exchange rate, and the industrial policies has been to exports and competitive markets. Regulatory restrictions on business have been relaxed and an expanded role given the private sector. These positive changes may help explain the high growth rate from 1977–87. The assessment of how much the partial liberation of policies influenced productivity and growth is tempered by the realization that a number of special circumstances also influenced the outcome. For example, a sharp increase of workers' remittances from the Middle East after 1979 and large inflows of foreign aid in response to the invasion of Afghanistan allowed the economy to grow at a faster rate than warranted by the domestic savings rate. After a decade of growth averaging almost 7 percent between 1987 and 1990, real growth of GDP fell to an average of about 5 percent, indicating that some of the favourable factors for growth have receded. At the same time, a number of rather serious macroeconomic imbalances have arisen, and these demand corrective measures that could further reduce growth. These include wide deficits in the budget and trade accounts, the low and declining saving rate, rising inflation, and an increasing debt service burden.

Between 1981 and 1988, Pakistan's population grew by 20 million. Rapid growth in the labour force will be a fact of life for the foreseeable future. Pressures and social tensions arising from this and wide inequalities in income and wealth, as well as regional and rural-urban inequalities, are alarming. These problems will have to be addressed if Pakistan is to complete its ascent from poverty to middle-income status by the turn of the century.

The purpose of this paper is to examine how Pakistan might establish a firm base on which to build a more equitable and sustainable process of growth. In doing so, our central argument is that further and more thorough liberalization of trade as well as regulatory and investment policies can spur employment-oriented growth, and simultaneously reduce macroeconomic structural imbalances. In doing so, we examine how partial liberalization has influenced growth and macroeconomic balance. An assessment of why policies of an illiberal nature have persisted is made in order to broaden understanding of the conditions necessary for a more thorough

[3] See, for example, Syed Nawab Haider Naqvi and Khwaja Sarmad, *Pakistan's Economy Through the Seventies.* (Islamabad: Pakistan Institute of Development Economics, 1984), p. 13n.

opening up of the economy.

II. MACROECONOMIC AND STRUCTURAL IMBALANCES

Over the entire time span that we are considering, problems characteristic of low-income developing countries have persisted in Pakistan. A low rate of domestic savings is particularly noticeable.

Between 1977 and 1987, the resource gap measuring the difference between capital formation and domestic savings, on average, has exceeded 11 percent of GDP (Table 3). This difference is not a typical for low-income South Asian countries;

Table 3

Domestic Savings and Investment of Pakistan, 1971–1988
(Percentage of GDP)

Year	Gross Domestic Saving	Gross Domestic Investment	Resource Gap
1971	13	16	–3
1972	13	14	–2
1973	14	13	1
1974	10	13	–4
1975	7	16	–9
1976	11	19	–8
1977	11	19	–9
1978	9	18	–9
1979	7	18	–11
1980	8	19	–11
1981	8	17	–10
1982	7	18	–11
1983	7	17	–10
1984	6	17	–11
1985	5	17	–12
1986	9	16	–7
1987	10	17	–7
1988	9	16	–8

Source: International Monetary Fund, *International Financial Statistics*, Yearbook 1989.

however, it is alarming that the domestic savings rate has stagnated or even fallen despite the accelerated growth in GDP. The gross national savings (GNS) rate, which includes the savings out of remitted incomes, is much higher than the gross domestic savings rate in the 1980s. Even if GNS is used, a substantial resource gap averaging 5 percent of GDP remains.

An important part of the government's growth strategy was an effort to increase investment efficiency. Raising the investment ratio through the encouragement of the private sector became a major component of the high growth strategy adopted by the government after 1977. A continued high level of public investment was to complement the private investment expansion. The government investment programme would concentrate on infrastructure, private investment on productive sectors – agriculture, industry, and services. The government was successful in raising the share of private investment in total between 1978 and 1988 from 30 percent to 50 percent (Table 4). Yet, the growth of total investment has been so slow that between 1978 and 1988 the investment rate fell slightly as a percentage of GDP. A remarkable feature of the high growth since the late 1970s is that it has been accomplished with relatively low investment levels.[4]

The government's fiscal deficit has been the principal macroeconomic problem area for Pakistan for many years. The government's current expenditures rose at an average rate of 20 percent between 1980 and 1988. Consequently, the current expenditures reached as high as 19 percent of GDP, while the revenues were static [ADB (1989), pp. 128–132]. The dissaving by government reached –1.6 percent of GDP in 1988. In contrast to current expenditures, government capital outlays have fallen as a proportion to GDP. Clearly, the government is losing the battle for resources. The percentage of the overall deficit to GDP was 9 percent during the period 1972–77 as compared to 7 percent during 1978–85. However, the deficit kept increasing after 1981, and 1985 was marked with a dramatic change in which the deficit was Rs 10 billion higher than that 1984. By 1988, the budget deficit had risen to 8.6 percent of GDP. The main weaknesses in the government budget were underscored by budgetary outcomes of recent years.

First, the tax structure has been inelastic with respect to the levels of economic activity. There is excessive reliance on indirect taxation. Taxes on imports accounted for 33 percent of total revenue in 1985, an increase from the early 1970s [Hamid *et al.* (1988), p. 45]. On the whole, foreign trade taxes (including export taxes) comprised 45 percent of revenue [ADB (1988), p. 130]. In recent years, the tax-GDP ratio has been kept at about 13 percent but only by recourse to *ad hoc*

[4] Jungsoo Lee, "The External Debt-servicing Capacity of Asian Developing Countries". *Asian Development Review,* Vol. 1, No. 2, 1983. Lee finds the incremental capital-output ratio in Pakistan fell from 2.6 in 1966–75 to 2.2 between 1976–82.

Table 4

Government and Private Gross Fixed Investment (Percentage of Total Investment)

Period	Government (%)	Private (%)
1972–73	51.3	48.7
1973–74	64.2	35.8
1974–75	67.9	32.1
1975–76	71.5	28.5
1976–77	70.5	29.5
1977–78	69.8	30.2
1978–79	69.5	30.5
1979–80	68.0	32.0
1980–81	63.7	36.3
1981–82	64.8	35.2
1982–83	63.6	36.4
1983–84[a]	62.2	37.8
1985–86	54.4	45.6
1986–87	55.7	44.3
1987–88	53.5	46.5
1988–89	49.7	50.3

Sources: Syed Nawab Haider Naqvi and Ashfaque H. Khan, *Pakistan's Economy: Past Performance and Future Outlook.*
Pakistan, *Ten Years of Pakistan in Statistics: 1972–1982.*

Note: [a]Provisional.

surcharges on imports and through capturing windfall gains from the decline in world petroleum prices after 1986. Indirect taxes, including excise, sales, and duties, made up 85 percent of tax revenue [ADB (1989), p. 131]. Non-tax revenue was only a one-fifth of current revenue and showed no tendency to increase. Direct tax revenues have increased at a slower rate than overall revenues and accounted for less than 15 percent of total revenues.

Secondly subsidies have risen rapidly, going from 3.5 percent to 7.5 percent of central government current expenditures between 1982 and 1988 [IMF (1990), p. 4]. Although massive subsidies appeared in 1980, there had been considerable progress in reducing or holding down subsidies through 1982. Total subsidies increased in

1983 and began accelerating in 1984. The main government subsidies were given to consumers of wheat and edible oils, as well as to exporters and fertilizer users. Increased costs of wheat and edible oil imports were not passed on to consumers, resulting in a large increase in subsidies in recent years.

Thirdly, low public savings led to increasing reliance on domestic bank borrowing and bond issues. The government offered generous returns for those willing to finance its short-term borrowings. But this has made interest payments a large autonomous item in expenditure. In 1985, government borrowing from "captive" domestic banks financed almost 50 percent of the deficit, which compared to an average of 29 percent over the previous five years. For 1986, the government budgeted an increase of 52 percent in nonbank borrowing and 58 percent in external borrowing over 1985 levels in order to avoid more domestic bank borrowing. But such a shifting of the sources of borrowing is less an issue than the problem of rapidly rising government indebtedness. Illustrative of the problem is a rise in interest payments from 1 percent of GDP in 1981 to 3 percent in 1988 [ADB (1989), p. 130].

The above suggests that reforms are needed to increase the revenue and reduce the expenditures. However, the structure of government expenditure may show little room for the government to cut expenditure. A large portion of the expenditure is for defense and interest payments – which together accounted for over half of government current expenditure. Development expenditures, including investment and spending on social and economic services declined from 8 percent of GDP in the early 1980s to under 7 percent of GDP in 1988, and this share could hardly be any further reduced. Consequently, the improvement of budgetary deficits from the expenditure side will rely heavily on reducing subsidies and improving performance of public enterprises.

One of the unfortunate consequences of weakness in government ability to mobilize funds is deterioration of basic social services and a running down of infrastructure. Local and provincial governments, starved of resources and burdened by other priorities, were unable to provide adequate basic government services and infrastructure. The central government, by attempting to govern activities better left to private initiative, weakened its ability to deliver the basic elements of public security and public goods necessary to a functioning economy.

With deficits in the current budget and in the capital budget; and with private domestic savings inadequate to finance both private investment and the budget shortfall; deficits in the trade balance arose. The deficit in foreign trade in goods and services was extremely large in the 1980s. However, the trade deficit was offset by large and increasing remittances from Pakistani workers in the Middle East. Remittances reached a peak of almost $ 3 billion in 1983 (Table 5), helping to offset a trade imbalance and resulting in a small $ 25 million current account surplus (Table

Table 5

Workers' Remittances in Pakistan

Year	US $ Millions
1976	410
1977	866
1978	1,303
1979	1,495
1980	2,038
1981	2,056
1982	2,580
1983	2,925
1984	2,567
1985	2,526
1986	2,443
1987	2,172
1988	1,860

Sources: International Monetary Fund, *Balance of Payments Statistics*, Yearbook 1985 through 1988 and October 1989.

6). Remittances averaged about 9 percent of GDP in the 1980s. On average, however, deficits in the current account in the balance of payments were quite large, exceeding $ 1 billion in the period 1984–87; and after improving in 1987, again rising to over $ 1 billion in 1988 (Table 6).

These remaining deficits were filled by foreign capital inflows chiefly in the form of concessional bilateral and multilateral aid. The size of foreign assistance loans and grants, while substantial, did not rise much after the initial increase that occurred at the time of the Soviet occupation of Afghanistan in 1979 and 1980. Moreover, because of repayments on previous loans, net inflows from official sources are far less than the gross aid inflows.[5] Direct and portfolio investment in Pakistan remained quite small; though after 1984, these sources for foreign funds increased somewhat.

[5] International Monetary Fund (IMF), *International Financial Statistics* (IFS) (Washington, D. C.: IMF), various issues. Interest and loan payments are included in debit on other goods, services, and income in the balance of payments. The debit figure rises steadily from $ 1.4 billion in 1982 to $ 2.4 billion in 1988 (IFS December 1988a, p. 410).

Table 6

Current Account Balance and Merchandise Trade Balance

Year	Current Account Balance (US $ m)	Trade Balance (US $ m)
1970	–667	–538
1971	–482	–420
1972	–241	–233
1973	–68	–101
1974	–917	–888
1975	–1,049	–1,157
1976	–780	–1,025
1977	–734	–1,366
1978	–719	–1,824
1979	–1,114	–2,341
1980	–921	–2,876
1981	–914	–2,926
1982	–802	–3,403
1983	25	–2,715
1984	–1,195	–3,753
1985	–1,080	–3,230
1986	–645	–2,780
1987	–562	–2,316
1988	–1,403	–2,607

Sources: International Monetary Fund, *International Financial Statistics*, Yearbook 1989 and January 1990.

The external payments position of Pakistan is under pressure from a number of forces. These include rising debt servicing obligations. The total external debt of Pakistan rose from $ 5.6 billion in 1975, to $ 9.5 billion in 1980, to $ 13.6 billion in 1986, and reached $ 20 billion in 1989 [ADB (1989), p. 129]. Debt service payments as a percentage of exports reached over 30 percent in 1988.[6] Capital flight has also become more pronounced in recent years as government instability and uncertainties facing private business have worsened.

[6]*IMF Survey* (Washington, D. C.), January 8, 1990, p. 2. Debt service payments were 23 percent of current receipts in 1983-84.

Another cause of balance-of-payments pressure arises paradoxically from the oil price bust of the 1980s. Pakistan benefits from lower oil prices in its merchandise trade, but the gain in lower oil prices must be weighed against possible losses from declining workers' remittances as labour demand declines in the oil-exporting nations. In Pakistan's case, cheaper oil reduced the import bill by about $ 500 million between 1985 and 1988 [IMF (1989), p. 409]. However, remittances fell by over $ 660 million; hence the net effect appears to be negative by a wide margin! Remittances fell below $ 2 billion in 1988 for the first time since 1980 (Table 5).

The pressures on Pakistan's balance of payments have been manifesting themselves in the country's official reserves position for the past few years. Official international reserves have declined markedly in recent years, and have fallen even more relative to the imports. According to the [IMF (1990), p. 4], gross official reserves were about two months of the following year's imports in 1986, but averaged less than three weeks of the 1989 imports in 1988.

The prospects for increases in foreign assistance on concessional terms from official sources – particularly bilateral – are clouded by several factors including the Soviet withdrawal from Afghanistan and the end of the Gulf War between Iran and Iraq. While it is difficult to speculate on future aid programmes, clearly there is not much scope for U.S. assistance to increase the aid; and, given the changing external conditions, there is even less strategic reason for a large U.S. aid programme.[7] Pakistan is likely to receive funds under harder concessional terms than in the past, and this trend is already manifest. Given the climate of political instability inside the country, it also appears unlikely that private investment will rise to fill the gap. Hence, no alternative to Pakistan seems available but to attempt to improve on its domestic savings effort for internal balance, and to boost exports to improve the external balance. Otherwise, the imports and growth will have to be cut sharply.

III. ACCELERATED GROWTH: 1977–87

What factors underlie the more rapid growth that transpired after 1977 and lasted well into the 1980s? There was a marked increase in growth of agricultural and industrial sector real GDP, though services growth remained about the same (Table 1).

Inflation has been substantially lower in the high growth period than previously. The average annual rate of increase in consumer prices went down from over 14 percent in the period 1971–77 to under 8 percent in 1978–87.[8] The

[7] Sweeping changes in Eastern Europe are likely to place new demands on limited U.S. aid funds. In addition there is concern in the U.S. Congress over the nuclear proliferation issue in South Asia.

[8] See *Pakistan Economic Survey* 1986-87 and various issues. Consumer price inflation has accelerated from 3.6 percent in 1986 to 10.4 percent in 1988 (Naqvi and Khan 1989, p. 9).

improvement was partly a result of more stable prices of essential imports but also reflected the strong agricultural performance that helped keep domestic prices more stable.

Clearly, the acceleration of industrial growth was assisted by the stronger agricultural performance – though it is not at all clear that linkages worked well in the other direction. The rise in agricultural production seems to have been caused by favourable weather conditions in most years (1984 and 1987 being exceptions). There is little evidence of a sustained rise in productivity in agriculture, particularly in foodgrains [ADB (1989), p. 132]. Rather rainfall adequacy allowed a greater *barani* area to be cropped. In contrast, cotton production almost doubled between 1984 and 1988 in response to the strong external demand and improved yields. Sugar production also rose in response to deregulation. Sustaining further growth from a higher production level could prove to be difficult.

Agri-based industries, including rice, sugar, leather and hides, and cotton textiles, account for over 40 percent of manufacturing value-added and over 50 percent of merchandise exports [ADB (1989), p. 131]. The diversification of exports from agriculture to labour-intensive industries has been rather slow and is still limited in scope.

In the following section, our focus is on trade and industrial patterns and policies in the 1980s. We examine recent performance in light of the incentive structure and external conditions.

IV. TRADE AND INDUSTRIALIZATION IN PAKISTAN IN THE 1980s

According to the factor proportions theory of international trade, *a priori*, one would expect a labour-surplus, agrarian country like Pakistan to specialize in the production and export of labour-intensive and agri-based goods. Given the scarcity of domestic savings, it would tend to import goods intensive in various forms of capital – both physical and human. In fact, this pattern appears to more or less fit Pakistan's foreign trade.[9]

Pakistan's export performance during the period 1971–77 was relatively poor. The share of non-traditional (mainly labour-intensive) exports was stagnant. Manufactured exports between 1970 and 1985, in nominal terms, averaged only 10 percent per annum growth; or less than half the average for all developing coun-

[9]Agri-based goods and labour-intensive manufactured goods are prominent in exports. Besides petroleum, transport equipment, machinery, and chemicals are the principal imports. See Asian Development Bank (ADB), *Key Indicators of Developing Member Countries of ADB* (Manila: ADB), July 1989a, pp. 240–3.

tries.[10] During much of the 1970s – a period of relatively robust growth in world trade compared to the 1980s – trade and industrial policies in Pakistan were erratic. After 1977, efforts were made to rationalize policies to some degree in order to establish more effective incentives to exports, substitute domestic production for imports, and promote efficiency in stimulating industrial growth. Perhaps the most significant change was the adoption of more flexible and aggressive exchange rate management beginning in the early 1980s.

Before examining the effects of these reforms on trade and industrialization, we attempt to briefly summarize the structure of protection embodied in trade, industrial, and exchange rate policies at the beginning of the 1980s (presumably after the "recovery-led" type growth we alluded to on page 1 had taken its course). Several studies exist that evaluate the structure of protection and the effects of various promotion policies on Pakistan's industries.[11]

Comparatively, Pakistan's domestic market has been heavily protected. Among Asian developing countries in the early 1980s, Pakistan had one of the highest average tariff levels.[12] (See Table 7). Not only were tariffs high, but imports were all subject to quantitative restrictions. Nevertheless, over time, it appears the overall level of protection in Pakistan has been reduced.[13]

One of the most significant features of trade protection and industrial promotion policies in Pakistan is the unevenness of incentives across activities and even within industries according to size or location of firms. This unevenness is amply demonstrated by studies of "effective protection" and industrial policies. These irregularities arise for a variety of reasons – including variations in tariffs, differences in treatment of import licences, varying rates of indirect taxes (including excises and export duties), and subsidies and differences in access to the government bureaucracy itself. The variations in rates of protection often produce unintended, even bizarre,

[10]United Nations Conference on Trade and Development, *Handbook on International Trade and Development Statistics* (New York, NY: UN, 1986).

[11]See S. Guisinger and C. W. Scully, *The Timing and Sequencing of a Trade Liberalization Policy: The Case of Pakistan* (London: Basil Blackwood, 1989); Syed Nawab Haider Naqvi, *et al. The Structure of Protection in Pakistan 1980-81* (Islamabad: Pakistan Institute of Development Economics, 1983); and J. Adams and Sabiha Iqbal, *Exports, Politics and Economic Development: Pakistan 1970–82* (Boulder, CO: Westview Press, 1983).

[12]See William E. James, Seiji Naya, and Gerald M. Meier, *Asian Development: Economic Success and Policy Lessons* (Madison, WI: University of Wisconsin Press, 1989), p. 37.

[13]Naqvi, *et al. op. cit.* Vol. II, p. 6, points out that the effective protection rate averaged 271 percent in 1963-64, 125 percent in 1968-69, and 60 percent in 1980-81. Hamid, *et al.*, *Financing Public Sector Development Expenditure in Selected Countries: Pakistan* (Manila: Asian Development Bank, 1988), p. 37, state that overall, import duties averaged only about 30 percent by 1986.

Table 7

Summary of Tariff Structure, 1985-86

Duty Range	Major Items	Percentage of Imports
0% to less than 10%	Wheat	2.0
	Vegetable Oil	9.1
	Crude Petroleum	17.0
	Petroleum Product	1.3
	Fertilizer	3.6
	Jute Fiber	0.9
	Aircrafts/Parts	2.5
	Insecticides	1.4
	Medicaments	1.7
		39.5
10% to 50%	Tea	4.2
	Tallow	1.1
	Organic Chemical	2.7
	Machinery (Mechanical)	12.8
	Machinery (Electrical)	4.6
	Paper	2.0
	Miscellaneous Chemical Products	2.0
	Others	2.2
		31.6
50% to 100%	Artificial Resin	2.0
	Rubber	1.3
	Continuous Fiber	1.8
	Discontinuous Fiber	1.4
	Iron and Steel	4.6
	Vehicles	7.4
	Optical-medical Equipment	1.6
	Others	1.8
		21.9
Over 100%	Betel Nuts and Betel Leaves	0.5
	Others	0.1
		0.6

Source: Naved Hamid and Ehsan ul Haque, *Tariff Structure: A Need for Reform 1986.*

results.[14] Examples are: high protection of inefficient industries; negative protection of efficient and export-oriented industries; encouragement of capital-intensive, large-scale firms; and discouragement of efficient and small- and medium-scale enterprises.

The existing studies indicate that protection in Pakistan in the early 1980s was strongly biased against export activities in which the country had comparative advantage.[15] By 1981, some estimated the rupee was overvalued by as much as 20 percent *vis-a-vis* the dollar.[16] The exchange overvaluation, coupled with the high average tariffs, restrictive quota licences on imports, and deployment of indirect taxes on imports and exports (some partially offset by duty drawbacks and subsidies), created a strong overall bias in favour of import-substituting industries and gave encouragement to firms to produce for domestic (protected) markets over all foreign markets.

The system of protection also had negative effects on employment and distribution by unduly favouring investment in large inward-looking industries.

The adoption of discretionary controls over imports reflected the evolution of bureaucratic management of the economy. The controls over foreign trade were justified by periodic balance of payments crises that often originated from external sources. Examples include the cessation of the Korean War boom in exports, the separation of East Pakistan and creation of Bangladesh, the oil shocks of 1973 and 1979, and now, the collapse of the economic boom in the Middle East. In a sense, the import quotas and bans in addition to tariff restrictions were necessitated by efforts to overcome short-term disturbances and crises manifested in foreign exchange shortfalls. The pernicious longer term consequences of discretionary trade controls were rarely considered. The objectives of protecting domestic industries in sectors with comparative advantage, and thereby eventually attaining a stronger export- and import-competing industrial base, were undermined. The businesses that received the licences for imports and allocations of foreign exchange concentrated on collecting rents resulting from excess demand and cultivating bureaucrats rather than efforts to increase efficiency in their plants so that they could compete in external markets. The administrators, for their part, had little way of knowing which new businesses should receive protection on the basis that they had potential to become competitive. The resulting structure of protection tended to provide wide variances in the degree of protection. It also tended to favour established, large-

[14] See Naqvi *et al.*, Vol. I, p. 38. Hamid, *et al.*, p. 37, also point out the structure of protection is plagued by wide variations that foster industrial inefficiencies.

[15] This is major conclusion of Guisinger and Scully, *op. cit.*

[16] See "Highly Ill-Advised" in the editorial column of *The Dawn*, Monday, February 23, 1981.

scale businesses over newcomers. These features have delayed the diversification of exports and have hamstrung the development of labour-intensive manufacturing activities with export potential. In turn, these problems themselves led to efforts to reform and liberalize trade policies, starting in the early 1980s. Those advocating liberalization have had to contend with arguments that Pakistan's exports were price inelastic, that foreign markets were closed or would not welcome goods from Pakistan, and that surging imports would harm domestic industries and draw down precious foreign exchange reserves. Resistance to liberalization predictably has been strong enough to somewhat delay and weaken reforms.

V. TRADE LIBERALIZATION IN PAKISTAN

The general problem of liberalization can be simply expressed as one of revising the incentives so that it is roughly equally profitable to produce goods for domestic and foreign markets. Conceptually, if we ignore for the time-being nontradables and international transactions other than trade, a uniform tariff on all imports and a matching subsidy on all exports would cancel each other out. The trade regime would be completely neutral and, all other things equal, there would be no change in the equilibrium exchange rate.

A basically neutral trade regime was put into place in Taiwan and Korea in the mid-to-late 1960s, with spectacular results.[17] The movement towards a neutral trade policy regime may involve varying degrees of intervention. It does not at all imply that "free trade" is practiced or even necessarily that all quantitative restrictions are removed.

One often encounters the view that policy interventions to restrict imports and expand exports are "doubly protectionist". In fact, interventions to subsidize exports are not additive to import controls or tariffs, rather they are offsetting.[18] However, the manner in which a country moves towards a more neutral posture certainty matters. For example, a country that maintains high import protection faces the problem of providing sufficiently large export subsidies to offset the negative effects on its competitive position. Leaving aside questions of administration, large subsidies can lead to budgetary deficits. Fiscal deficits may be met either through domestic financing that can have crowding-out or inflationary effects, or can

[17] See James, Naya, and Meier, *op. cit.* Also Ramon H. Myers, "The Economic Development of the Republic of China on Taiwan: 1965–1981," in L. Lau, ed., *Models of Development* (San Francisco, CA: International Center for Economic Growth, 1986), pp. 13–64.

[18] See G. M. Meier, *International Economics* (New York, NY: Oxford University Press, 1980), pp. 320–3. Also L. W. Westphal, "The Republic of Korea's Experience with Export-Led Industrial Development," *World Development,* March 1978, pp. 347–82.

lead to increased foreign borrowing and indebtedness.[19] In the case of inflation, aggressive exchange rate policy may be necessary to avoid real appreciation.

The alternative of reducing and rationalizing tariff and nontariff import protection seems preferable on economic grounds. Cutting export taxes and import duties can also have fiscal effects – but these could be offset by introducing broad-based consumption or income taxes. Reducing the number of items that are under restrictive licencing (shifting to tariff-based protection) could offset any revenue losses.

Opening up Pakistan's economy to foreign trade and investment has been, at best, a gradual process. Moreover, liberalization measures have not been introduced as part of a well thought out programme but rather piecemeal often under the prodding of external donors. Despite this haphazard approach, it appears the sum of the changes introduced has been substantial.

Since the early 1980s, Pakistan has broadly followed a combination of policies to move toward a more neutral trade regime. Despite the partial nature of trade liberalization in Pakistan, the trend has been comparatively clear in the 1980s *vis-a-vis* the previous decade. The average level of tariffs and the dispersion has been reduced. By the late 1980s, the tariff level averaged 30 percent compared to 70 percent in 1979.[20] The reduction in import controls has also been noticeable. Export incentives have also improved. Among these have been aggressive, flexible exchange rate management. From 1981 to 1989, the rupee has depreciated against the SDR by 135 percent [IMF; IFS (1989), pp. 408-9].[21] Imports have been liberalized by expanding the open general licence for imported equipment and industrial raw materials. Export subsidies have included not only duty drawbacks but also export credit facilities. The procedures for collecting rebates for exporters were

[19]The Republic of Korea adopted a policy regime of offsetting import protection by subsidizing exports. The subsidization mechanism was mainly the provision of cheap credit through the national banking system. The government borrowed funds extensively from abroad to finance the programme. Because inflation rates were quite high during the 1970s in Korea, devaluation was required from time to time to keep export prices competitive and profitable. Korea's approach led to massive external debt by the early 1980s. It then shifted to a policy of reducing import protection and this reduced pressures to directly subsidize exports. Inflation subsided and deficits declined, but a large external debt remained. Taiwan by contrast, relied on reducing import protection and keeping inflation low (hence preventing the real exchange rate from appreciating) to promote exports. It avoided the large indebtedness as a result. See Tibor Scitovsky, "Economic Development in Taiwan and South Korea," in L. Lau, ed., *op. cit.*, pp. 135–95.

[20]Data from James, Naya, and Meier, *op. cit.*, p. 37 and Hamid, *et al.*, pp. 36–7. Guisinger and Scully, *op. cit.*, estimate that nominal protection, including nontariff barriers fell from 77 percent in 1980 to 66 percent in 1987.

[21]Asian Development Bank, *Asian Development Outlook 1989*, p. 131, reports that the real exchange rate depreciated 25 percent between 1985 and 1989.

streamlined and focused on nontraditional (new manufactured) exports.

Exporters of manufactured goods are allowed to import items that are otherwise banned or restricted on a cash basis under the Raw Material Replenishment (RMR) scheme. Under RMR, licences to import are automatically issued at predetermined values on submission of export documents. Exporters are also eligible for an income and profits tax reduction of 55 percent. The effective corporate tax rate paid by exporters is 25 percent compared to the 55 percent rate of those producing for the domestic market.

The use of the flexible exchange rate policy lessened the need to provide export subsidies to traditional exporters. Since adopting the more flexible exchange rate policy, the government has eliminated export rebates for cotton and woolen yarn, and reduced rebates on cloth from 10 to 5 percent, and from 12.5 to 7.5 percent on other textile items, carpets, and leather goods. A greater inflow of remittances than otherwise also resulted from the flexible exchange rate policy.

The internationalization of a significant part of Pakistan's labour force through participation in overseas (or over land!) contract labour has had a strong influence on the overall direction of the economy. The demonstration effect of labourers returning from working in countries where automobiles, VCRs, and other imported consumer durables are readily available has created strong demand for import liberalization in Pakistan. In order to afford a greater influx of imported consumer goods without extreme pressures on the balance of payments, Pakistan has faced the need to expand exports more rapidly. In doing so, further liberalization has been required to make imported inputs more readily available to exporters. Consequently, more and more items have been liberalized and are readily importable without special licences.

The World Bank has estimated that the share of industries where imports have been liberalized in the sense of being on the free list or under Open General Licence (OGL) has expanded from only one-third in 1980 to two-thirds or more. The level of tariffs on various major commodity imports is shown in Table 9. Tariffs above 50 percent are imposed on only about one-fifth of total imports.

In addition to trade policy changes, there has been an increasing emphasis on the role of private business and investment in Pakistan. The share of private investment in total capital formation has risen fairly steadily in the 1980s compared to the 1970s (Table 4). Within the industrial sector itself, private investment has become of overwhelming importance during the sixth plan period, reaching 83 percent of total industrial investment in 1988.[22] The government has also begun to introduce a programme to privatize a number of state-owned enterprises. The effects of these changes on Pakistan's trade and industrial composition and growth

[22] Asian Development Bank, *Asian Development Outlook 1989* (Manila: ADB), pp. 129–30.

appear to be significant.

VI. RECENT TRADE AND INDUSTRIAL PERFORMANCE

The direction and composition of Pakistan's trade is undergoing remarkable change. Total exports grew by 60 percent in nominal terms between 1980 and 1987, despite an absolute decline in the value of primary commodity exports (Table 8). The export of manufactured goods has grown in rapid fashion, reflecting improved incentives and increasing ability of Pakistani manufacturers to compete in foreign markets. The changing composition of exports also reflects increased processing of cotton into yarn, cloth and rising exports of basic manufactured goods like garments and miscellaneous manufactured goods. Export growth in real terms has been maintained at over 9 percent per annum, even after 1987 (Table 9). So despite the overall slowdown in real GDP growth, exports have performed creditably.

The changes in the direction of trade have been equally dramatic as in the composition. Between 1980 and 1988, exports from Pakistan to the industrial nations of Japan, the United States, and the EC have made a substantial jump (Table 10). At the same time, exports to developing regions, particularly the Middle East, have slumped. This reflects not only the reversal of the fortunes of oil-rich MENA (Middle East and North African) countries, but also the improved export performance of Pakistan's industry. Notably, exports to Korea and Taiwan have

Table 8

Composition of Pakistan's Exports
(Percentage of Total Exports)

	1971	1977	1980	1987
Total Exports (US $ m)	666.0	1,174.4	2,618.4	4,177.7
Primary Commodities[a]	44.4	40.2	50.9	27.9
Raw Materials[b]	31.2	10.8	27.7	14.3
Agriculture and Food[c]	13.2	29.3	23.3	13.5
Manufactured Goods[d]	55.5	58.2	48.8	71.9

Sources: United Nations, *Yearbook of International Trade Statistics*, various issues.
Notes: [a]SITC (0+1+2+3+4+67+68).
[b]SITC (2–22+3+67+68).
[c]SITC (0+1+22+4).
[d]SITC (5+6–67–68+7+8).

Table 9

Export Growth

Period	Annual Export Growth (Percent, Compounded Rate) Nominal	Real
1971–77	16.8	1.3
1977–87	13.4	9.2
1987–88	8.4	9.1

Sources: International Monetary Fund, *International Financial Statistics,* Yearbook 1989 and January 1990.

Table 10

Direction of Trade
(Percentage of Total Exports and Imports)

Year	Total (US $ m)	United States	Japan	EC	Asia-Pacific[a]	Middle East	Rest of the World
Exports							
1970	723.7	11.7	5.9	25.6	12.2	8.0	36.6
1980	2,617.9	5.3	7.8	19.8	25.6	24.8	16.8
1988	4,509.3	11.2	11.4	30.2	23.1	11.1	13.0
Imports							
1970	1,102.0	28.4	10.9	29.9	4.6	5.8	20.4
1980	5,349.5	14.1	10.3	21.9	14.4	29.1	10.3
1988	6,588.6	13.0	14.7	25.9	19.4	15.3	11.6

Sources: International Monetary Fund, *Direction of Trade Statistics,* Yearbook 1989 and computer data tapes.
Republic of China, Ministry of Finance, Department of Statistics, *Monthly Statistics of Exports and Imports, Taiwan Area, The Republic of China.* No. 224 (April 1988) and No. 236 (April 1989).

Note: [a]Includes, NIEs, ASEAN-4, South Asia, and the Pacific Islands.

also shown a rising trend in terms of share of total exports. Import patterns are somewhat similar to changes in the direction of exports. One difference is that the U.S. share in Pakistan's imports declined slightly between 1980 and 1988, and the share of Asia-Pacific developing countries (including the newly-industrializing economies and China) rose to almost 20 percent.

Japan surpassed the United States as Pakistan's number one trade partner in 1986, whith two-way trade of $ 1.2 billion. A major past distinction between the United States and Japan is that U.S. imports were mainly manufactured cloth and textile products, while Japan's imports were mainly raw cotton. This pattern has been changed by the realignment of the yen. Pakistan is now taking advantage of its increased price competitiveness in labour-intensive manufactured goods to expand the share of processed products in its exports to Japan.

Pakistan's trade with the East Asian NICs, ASEAN, China, and other South Asian countries increased gradually, though around a fluctuating trend. Trade with neighbouring member states of the South Asian Association for Regional Cooperation (SAARC) has not risen much. Greater trade with India (now very small) could change this picture rapidly.

Export performance has been sustained despite withdrawal of export rebates after the 1986 budget [Hamid *et al.* (1988), p. 4]. The exchange rate policy has been sufficient to maintain export incentives along with the more liberal import policy.

Industrial sector growth has slowed since 1987 (Table 1). The growth of large-scale industry has become sluggish. In contrast small- and medium-scale industrial firms have been more buoyant. The latter tend to be more export-oriented than large-scale enterprises. Import liberalization and management of the exchange rate to maintain export competitiveness seems to have helped manufacturing growth up to 1988. Thereafter, manufacturing growth has plunged – particularly in the large-scale sector – but also in general [Government of Pakistan (Various Issues)]. Positive trends in terms of improved distribution of growth between large- and small- and medium-scale industry and greater export orientation have been threatened by adverse developments, including ethnic violence and instability in the industrial centre of Karachi [Naqvi and Khan (1989)].

The slowdown in manufacturing growth is likely to cut export growth as well. A number of serious obstacles and challenges are emerging that could short-circuit the growth process. Furthermore, continued failure to redress pressing social problems of education, health, and employment could lead to eruptions that would curtail investment. We briefly consider these issues in the concluding section.

VII. CONCLUSION

Pakistan's impressive growth over the past decade has failed to lead to mass prosperity, indeed the benefits it has produced are not likely to be sustained without major changes in economic fundamentals. Yet, policy changes of a sensitive political nature may not only be difficult to put in place, they might upset a delicate political equilibrium. An optimistic scenario would identify Pakistan as a fast-growing country that could emerge from low income status within the next decade. Such a scenario is hard to reconcile with basic facts of a literacy rate of but 25 percent, a domestic saving rate of 10 percent, a chronically low tax base on which to improve basic government services and infrastructure, and exports of about $ 40 per capita. Meanwhile, population growth exceeds 3 percent per annum and labour force additions are of staggering magnitude.

Declining opportunities for employment in the Middle East and reduced or at best stagnant flows of foreign aid, coupled with a rising debt burden, will make for difficult choices. The government will need to either improve on its tax and nontax revenue base or limit expenditures. Introducing taxes on agricultural incomes and generally improving enforcement of tax laws will be essential. Additional user charges and elimination of subsidies on inputs will help as well. Many of the 180-plus state-owned enterprises are a chronic problem. Getting them to become self-financing or selling them to private owners would alleviate pressures on the budget. Raising domestic savings will require improvements in the government-dominated financial sector. These basic domestic policy issues and the need to rapidly upgrade government services in order to improve human resource development will be the dominant policy concerns over the next few years.

Externally-oriented reforms can also proceed, but only to the extent domestic imbalances are corrected. It has been demonstrated that Pakistan's manufactured exports are very responsive to policy liberalization and this provides some basis for optimism. Still, the economy could be opened to a much greater degree to foreign investors. This would serve to hold down general obligation debt and would introduce a new element of dynamism and competition into leading sectors. Maintenance of export incentives and competitiveness through active exchange rate policies and non-inflationary monetary-fiscal policies will be essential to a sustainable balance of payments.

Speaking more generally, improvements in delivery of basic government services at the local and provincial levels and improvement of institutions for administration of contracts, security of property rights, and even-handed enforcement of laws and regulations are clearly the preconditions for Pakistan to achieve a more equitable pattern of development.

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