7

Macroeconomic Balances

MOHSIN S. KHAN

In this chapter, the macroeconomic policies of Pakistan are evaluated with an emphasis on the period after 1971. Macroeconomic policy aims to achieve a high rate of economic growth, price stability and a viable external payments position. To this end, governments have to design and implement policies that control the growth of aggregate demand in the economy and expand availability of resources. These include monetary and fiscal policies which affect the level of aggregate demand and production, and exchange-rate policies which affect the composition of aggregate demand and production as between tradable and non-tradable goods.

Pakistan's macroeconomic performance has been quite impressive. In the period 1971 to 1989, as shown in Table 7.1, rates of real GNP growth and inflation compare favourably with those of other non-oil developing countries as a group. The current account deficit has been high, and although a large part of it was financed by official aid flows, there was a significant build-up of foreign debt. (Between 1971 and 1989 Pakistan had received grants and concessional loans of over $23 billion.) Average reserves were equivalent to about three months of imports. External shocks in

TABLE 7.1
***Basic Macroeconomic Indicators, 1972–89*[a]**
(percentage)

Period	*Growth of real GNP*	*Inflation*[b]	*Current account deficit*[c]	*International reserves*[d]	*External debt*[e]
1972–73	6.8	9.7	2.0	286	4,022
1973–74	5.3	30.0	6.1	489	4,427
1974–75	3.4	26.7	10.3	472	4,796
1975–76	5.6	11.6	7.0	418	5,755
1976–77	5.0	11.8	6.7	539	6,341
1977–78	10.7	7.8	3.2	534	7,189
1978–79	5.4	6.6	5.3	832	7,792
1979–80	8.4	10.7	4.5	1,210	8,658
1980–81	6.1	12.4	3.4	1,815	8,765
1981–82	6.0	10.0	4.7	1,589	8,799
1982–83	8.0	4.5	1.5	1,527	9,312
1983–84	4.8	8.3	2.9	2,770	9,469
1984–85	7.1	7.5	4.9	1,715	9,732
1985–86	7.6	4.8	3.4	1,452	11,108
1986–87	4.7	3.6	2.1	1,446	12,023
1987–88	4.9	6.3	4.3	1,405	12,443
1988–89	4.8	10.4	4.9	1,258	14,190
1989–90	4.6	6.0	4.5	1,233	15,198

Source: *Pakistan Economic Survey*, 1986–87, 1987–88, and 1989–90.
Notes:
a. Data are for fiscal years starting 1 July.
b. Consumer price index.
c. As per cent of GNP.
d. In millions of US dollars (December).
e. In millions of US dollars (December). Calculated based on disbursed outstanding long-term debt.

the 1970s and 1980s made the problem of economic management more difficult. Substantial fluctuations in the world market prices of primary commodities, sharp increases in the international price of oil, and the slowdown in the industrial countries put the economy under considerable pressure. Pakistan's terms of trade deteriorated steadily over the period at an annual average rate of nearly 2 per cent. Pakistan also experienced political shocks that put a major strain on its resources. These included a war with India that resulted in the loss of the entire eastern wing of the country in December 1971, and a large influx of refugees (estimated to be

about three million) following the Soviet intervention and the ensuing civil war in Afghanistan. Domestic political developments were also not conducive to economic stability, with the political system oscillating between martial law and civilian rule, and ethnic and provincial divisions intensifying and creating social disturbances. Last but not least, with a substantial portion of the output originating in the agricultural sector, the economy was also prone to periodic weather-related adverse shocks.

On several occasions a crisis in the balance of payments erupted causing the government to alter the course of macroeconomic policies. While governments did not precipitate these crises, on certain occasions they aggravated the situation either by inaction or inappropriate policy responses. In many cases prudent policies could have prepared for crisis avoidance by ensuring a larger cushion of foreign reserves. The current account balance and the level of international reserves have been considered crucial barometers of the performance of the economy. Even when growth was high by historical standards and inflation below the average rate, i.e., in 1976–77 to 1977–78 and 1979–80, the economy was considered to be in a crisis situation because the international reserves had dropped below some notional desired level. The government negotiated several programmes with the IMF despite the positive growth and inflation performance at that time. Successive standby arrangements were in effect during 1972 to 1975, and another one was agreed for 1977–78. A three-year Extended Fund Facility programme was implemented in 1980. Since IMF programmes are based on a 'balance of payments need', one can be reasonably certain that the external payments position had become precarious in those periods. It would seem legitimate, therefore, to concentrate on the relationship between macroeconomic policies and the balance of payments in Pakistan.

Political developments in Pakistan have been reflected in economic policy-making. However, these do not appear to have had a significant influence on the growth of the economy, savings and investment, fiscal developments, the balance of payments, and money and prices. Changes have occurred but overall, Pakistan has remained a mixed economy, and successive governments of different political persuasion have eschewed radical reforms of any type.

Economic policy-making in Pakistan has been consistent, in spite of political upheavals. Pakistan adopted a planning approach to development in the early 1950s, allowing the bureaucracy to play a central role in administering the economy, and the Planning Commission became the central institution in the economic decision-making process.[1] The formulation of five-year plans, supplemented by annual plans, helped to establish parameters within which macroeconomic policy was supposed to operate. The overall direction of economic policy has been in the hands of a few individuals, generally from the civil service which has supported it for some 20 years now. This small group of technocrats have rotated between the Planning Commission, the Ministry of Finance, and the State Bank of Pakistan (the central bank), creating a tradition of conservative macroeconomic policies. Also, during both the 1970s and 1980s, IMF programmes in effect established specific quantitative monetary and fiscal targets that the government had to adhere to as conditions for the loans it received. Recently (1988 to 1992), a four-year structural adjustment programme was put in force, backed by both the IMF and the World Bank.

The Planning Commission is charged with preparing the Five Year Plans and Annual Development Plans. The broad economic objectives of the Five Year Plans have been to achieve a target rate of growth of per capita GNP over the plan period; an increase in the level of employment; an improvement in the distribution of income; and provision of basic needs, such as health, education and housing. The Plan defines how these objectives would be achieved, the sectoral priorities to be adopted, and the foreign and domestic resources that the Plan would require. The Plans also set the tone that the government would follow by specifying the relative weights of the public and private sectors in the operation of the economy. The Planning Commission also prepares a series of Annual Plans, with the size and composition of each being determined by the progress of the Five Year Plan and by the availability of resources in the current year. The Annual Plans contain the targets for the year, and they specify the monetary, fiscal, trade and exchange rate policies that the government intends to follow.[2]

The Planning Commission of Pakistan became increasingly powerful during the regime of Ayub Khan (1958 to 1969). Even though it was responsible for the formulation of the First Five Year Plan (1955 to 1960), its guidelines were virtually ignored.

Economic decision-making until Ayub Khan's government was housed in the Ministry of Finance and the State Bank, both of whom regarded the Planning Commission as a rival and were determined to maintain their own control. The technocrats associated with Ayub Khan, however, saw the Planning Commission as a vehicle for transforming the economy into a more market-oriented one and for allowing the private sector to play a larger role.[3] The President assumed the chairmanship of the Planning Commission and a Deputy Chairman, with the rank of minister, was appointed to administer the agency. This elevation in status was essential if the Planning Commission was to be the pre-eminent player in the policy-making game. During the period 1958 to 1969 the Planning Commission had a say in virtually all economic decisions made in the country. Even government budgets, which were the responsibility of the Ministry of Finance, were prepared in the context of the Annual Plans produced by the Planning Commission.

After the fall of Ayub Khan the Planning Commission went into decline. It had become too closely identified with the economic policies pursued by the Ayub Khan regime, and when these policies came into disfavour with the People's Party government of Zulfiqar Ali Bhutto that came to power in December 1971, the Planning Commission became the target of criticism. Serious planning came to a standstill during the second martial law period (1968 to 1971). In March 1969 the Third Five Year Plan was virtually abandoned and a Fourth Plan (1970 to 1975) was produced, but it too was ignored because of the political conditions in the country. The People's Party was extremely suspicious of the Planning Commission and was determined to reduce its power. In 1972 it was made part of the Finance Ministry, and the government decided to guide the economy through Annual Plans, rather than through a comprehensive Five Year Plan. From 1972 to 1977 the bulk of economic decisions were made in the Ministry of Finance, and to a lesser extent in the State Bank of Pakistan. The Planning Commission did participate in the formulation of the Annual Plans, but its overall influence was substantially diminished.

The Zia ul-Haq government that assumed power in 1977 decided to revive the Planning Commission as a major policy-making institution. A new Five Year Plan (1978 to 1983) was formulated, but political uncertainties prevented its publication. Nevertheless, the

Planning Commission became more active in the design of Annual Plans and associated policies. The Sixth Five Year Plan (1982–83 to 1987–88) saw the return of the Planning Commission to its previous high-level status. It became on par with the Ministry of Finance in the running of the economy, and for most of the Zia ul-Haq period, the Minister of Finance also held the Planning portfolio.

The State Bank of Pakistan has also played a significant role. The relationship between the Ministry of Finance and the State Bank has historically been close, to the extent that the Governor of the State Bank effectively reports to the Ministry of Finance, and typically had served previously as Secretary of Finance. While the Ministry of Finance has primary responsibility for the conduct of fiscal, trade and pricing policies, it also gets involved in monetary and credit policies—the purview of the State Bank. Indeed, in Pakistan it is sometimes argued that monetary policy has been subservient to the fiscal stance of the government, because of the need for the government to finance fiscal deficits via borrowings from the State Bank or the banking system. In the area of exchange rate policy the State Bank has had some freedom in managing the exchange rate on a short-term basis, but the size of any depreciation of the currency over the course of the year has to be approved by the Ministry of Finance.

Instruments

The government authorities have traditionally relied on a variety of policies, including fiscal, monetary, credit, and trade and exchange rate policies for meeting macroeconomic objectives. Structural policies, that is policies designed to increase productive capacity or improve the efficiency with which resources are utilized, have not been employed as an instrument for short-run macroeconomic adjustment. Such structural policies are part of the long-term development strategy adopted in the planning process.

Fiscal policy in Pakistan generally takes the form of changes in government expenditures, with variations in taxes playing a relatively minor role.[4] The important fiscal indicator has been the fiscal deficit, and how it is financed determines the growth of aggregate demand and the current account balance. Monetary policy is formulated in terms of domestic credit, as is the case in what has come to be known as the 'monetary approach' to the balance of payments.[5] In addition, the government frequently applies selective controls to determine the sectoral composition of credit.[6] Until very recently interest rates were regulated, but were not often used as an instrument of monetary control.[7]

Exchange rate and trade policies have been central in the government's pursuit of its balance of payments objectives. For the first 10 years or so of the period since 1971, the exchange rate was pegged to the US dollar (following a major devaluation in May 1972). In January 1982 the peg was removed and since then the Pakistani rupee has been on a managed float system. Active use of the exchange rate as a policy instrument, therefore, came into effect only in the 1980s.[8] Controls on foreign trade—including exchange controls, import quotas, licensing schemes and tariffs—as well as export subsidies, have been an important component of the portfolio of policies.[9] While there has been a move towards liberalization, coinciding to some extent with the adoption of managed floating of the currency, the trade system remains quite regulated. Indeed, one can argue that for a good part of the last 40 years, the use of quantitative controls on both the trade and capital accounts of the balance of payments has been the mainstay of the government's efforts to correct balance of payments disequilibria, although how effective these controls have been, particularly in the 1980s, remains an open question.[10]

Balance of Payments Trends

The merchandise trade balance and the current account balance have been consistently in deficit throughout the period under consideration (Table 7.2). While the average growth of Pakistani exports during 1972–73 to 1988–89 was over 15 per cent per annum, there was considerable instability in the year-by-year growth rates (Fig. 7.1). The most urgent task facing the government in 1972 was to find new markets for the roughly 50 per cent of exports that had previously been going to the eastern half of the country. Through a combination of policy action, principally the very large devaluation in 1972, and favourable external circumstances, such as the improvement in the terms of trade, exports grew very rapidly in 1972–73 to 1973–74, rising by an annual average rate of nearly 30 per cent in US dollar terms. For the following three years export performance was poor due to bad harvests, a decline in world demand as the international economy slowed down, the nationalization of industry which caused private investment to fall, and perhaps most importantly, the sharp deterioration in the terms of trade that occurred. The terms of trade declined by over 37 per cent in 1974–75, and although they did recover somewhat in the next two years, they were still well below the peak 1973–74 level (Fig. 7.2). Exports of traditional goods, such as raw cotton, cotton yarn and cloth, leather products, and hides and wool, all registered declines in real terms. Between 1974–75 and 1976–77 Pakistani exports grew at about 4 per cent, or roughly half the rate of increase of merchandise export earnings of all non-oil developing countries.

In the period 1977–78 to 1980–81, exports increased sharply in response to higher prices brought about by the upswing in world trade, as well as increased production. Even though the terms of trade had again started to weaken (Fig. 7.2), in 1979–80 there was no immediate impact on exports. In contrast to the poor performance of the earlier years, exports of rice and raw cotton grew faster during this period than did those of its principal competitors. Non-traditional exports, such as carpets, tanned leather, surgical equipment, and sports and engineering goods, also grew at a rapid pace. The picture changed quite dramatically in 1981–82 when export earnings declined by over 17 per cent. This was in part due to the previous fall in the terms of trade, and in part to the loss of international competitiveness. The real exchange rate appreciated by over 10 per cent in 1981–82 (see Fig. 7.8). The subsequent change in exchange rate policy helped to get the export growth rate back up to around two per cent per year in 1982–83 to 1984–85. In 1985–86 exports grew by nearly 20 per cent (Fig. 7.1), and exports continued to grow at an average of 20 per cent between 1985–86 and 1988–89.

While the average rate of growth of exports may have been reasonable, imports have grown at a much faster rate, averaging 19 per cent per year during 1972–73 to 1988–89 (Table 7.2). The

TABLE 7.2
***Balance of Payments, 1972/73 to 1988/89*[a]**
(US $ millions)

	1972/ 1973	*1973/ 1974*	*1974/ 1975*	*1975/ 1976*	*1976/ 1977*	*1977/ 1978*	*1978/ 1979*	*1979/ 1980*	*1980/ 1981*	*1981/ 1982*	*1982/ 1983*	*1983/ 1984*	*1984/ 1985*	*1985/ 1986*	*1986/ 1987*	*1987/ 1988*	*1988/ 1989*
Exports	767	1,020	978	1,162	1,132	1,283	1,644	2,341	2,799	2,319	2,627	2,669	2,457	2,942	3,498	4,362	4,364
Imports	891	1,493	2,114	2,139	2,418	2,751	3,816	4,857	5,563	5,769	5,616	5,993	6,009	5,984	5,792	6,919	7,207
Trade balance	−124	−473	−1,137	−977	−1,286	−1,469	−2,172	−2,516	−2,764	−3,450	−2,989	−3,324	−3,552	−3,042	−2,294	−2,557	−2,573
Non-factor services	−63	−152	−163	−179	−187	−181	−205	−238	−254	−176	−189	−275	−309	−376	−287	−553	−586
Investment income	−84	−73	−98	−145	−169	−181	−233	−281	−261	−320	−420	−442	−506	−640	−695	−828	−875
Private transfers	145	150	229	353	590	1,226	1,496	1,895	2,242	2,412	3,081	3,044	2,687	2,822	2,557	2,256	2,100
(Workers' remittances)	(136)	(138)	(212)	(334)	(578)	(1,156)	(1,397)	(1,748)	(2,095)	(2,225)	(2,886)	(2,737)	(2,446)	(2,595)	(2,278)	(2,013)	(1,897)
Current account balance	−126	−548	−1,168	−948	−1,051	−605	−1,114	−1,140	−1,037	−1,534	−517	−997	−1,680	−1,236	−719	−1,682	−1,934
Private capital	13	57	96	194	160	128	163	174	261	364	673	265	108	757	320	330	328
Public capital	235	324	917	741	582	811	743	1,365	811	605	522	652	586	939	656	1,242	1,659
Allocation of SDR	—	—	—	—	—	—	38	39	37	—	—	—	—	—	—	—	—
Errors and omissions	7	−5	15	−9	57	−20	−17	15	−25	−15	20	−6	−31	−26	7	−30	−42
Changes in reserves (− = increase)	158	−148	139	20	252	−315	185	−453	−45	580	−698	86	1,017	−434	−264	140	−11

Source: *Pakistan Economic Survey*, 1986–87, 1987–88, and 1989–90.
Note:
a. Data for 1972–73 and 1973–74 are obtained from *Pakistan Economic Survey, 1981–82*.

Figure 7.1
Pakistan: Imports, Exports and Remittances
(millions of US dollars)

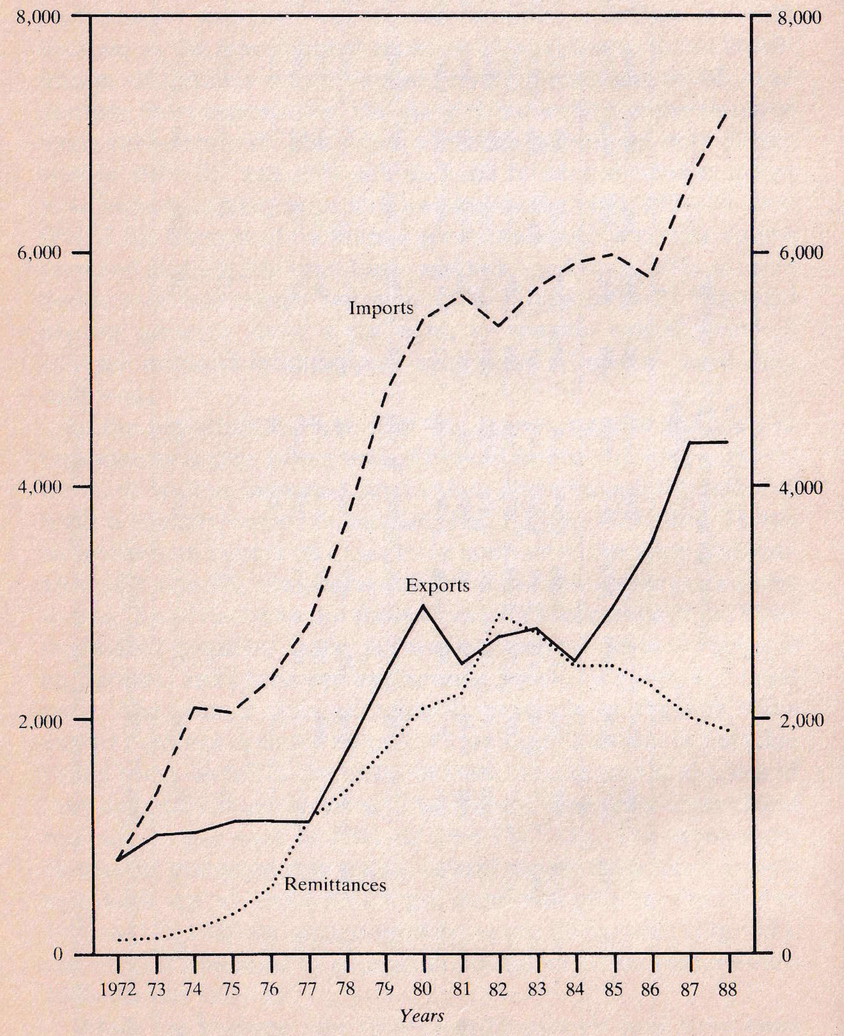
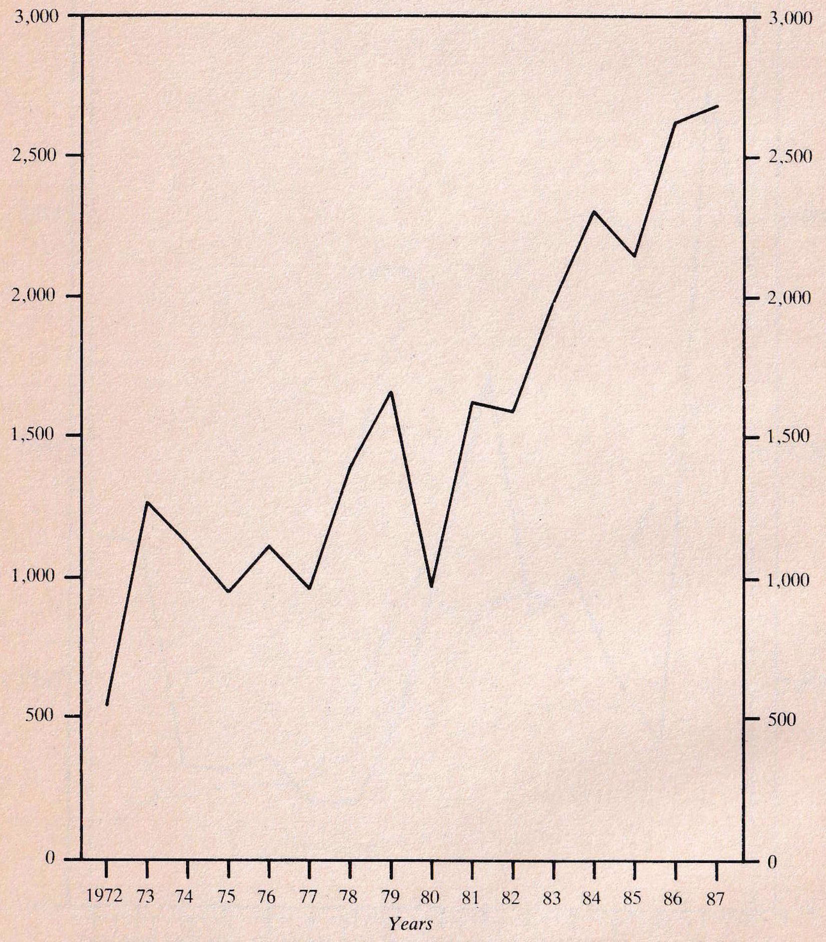


Figure 7.2
Pakistan: Terms of Trade
(1975 = 100)

Figure 7.3
Pakistan: Foreign Aid
(Millions of U S Dollars)



Note: Commitments basis

Figure 7.4
Pakistan: Debt-Service Ratio
(per cent)

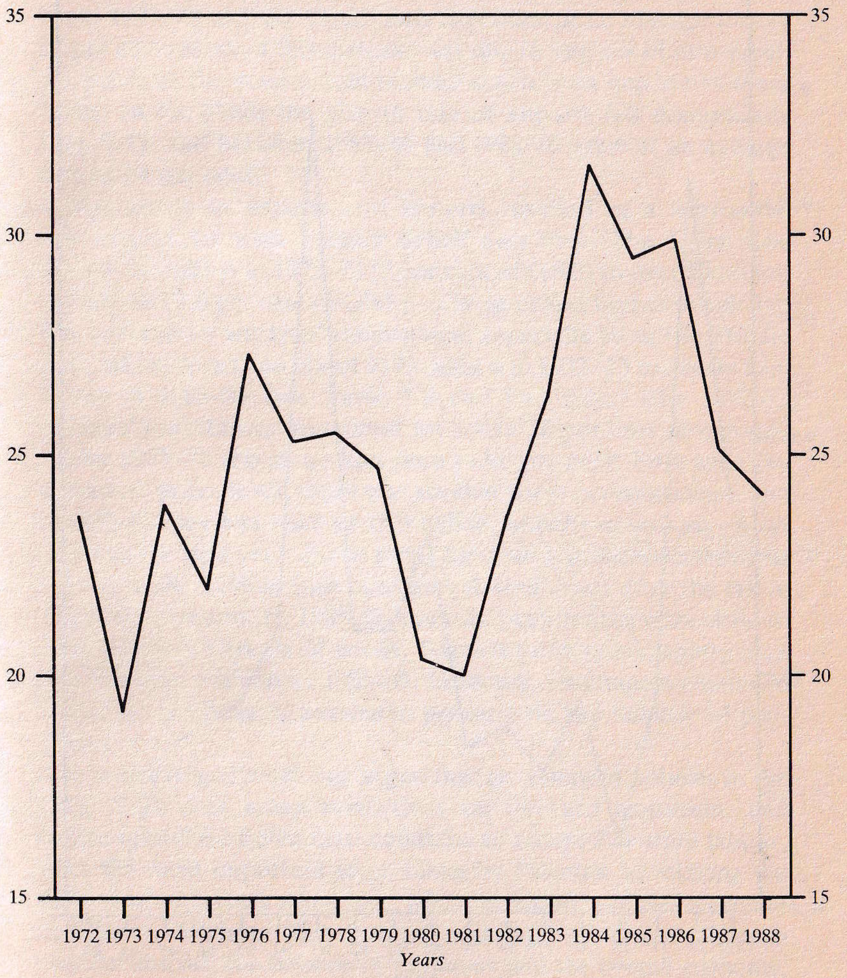
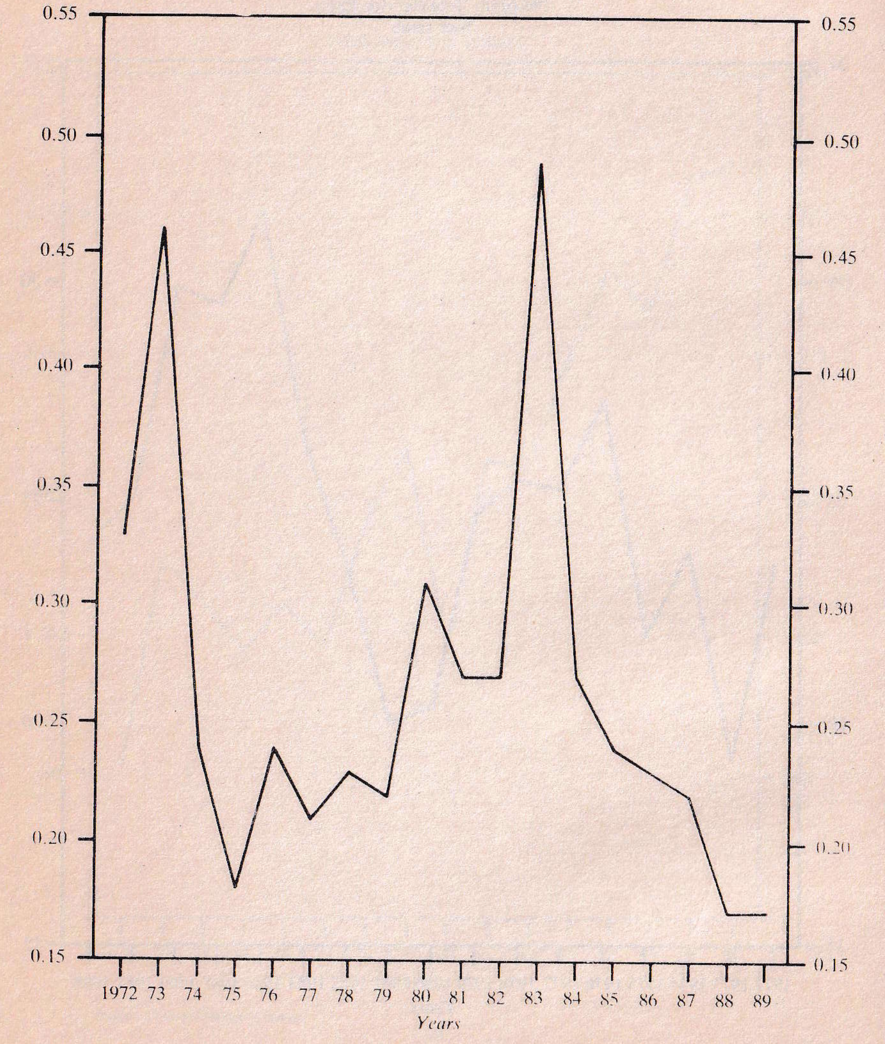


Figure 7.5
Pakistan: Reserves to Imports Ratio



large expansion in imports after 1972–73 was due to both domestic developments and external factors. The rapid increase in public sector investment required increased imports of intermediate and capital goods, and the floods and poor harvests of 1973 raised food imports. Furthermore, the oil import bill grew very sharply, with the share of petroleum products in the value of total imports increasing from 7 per cent in 1972–73 to 17 per cent in 1976–77. From 1977–78 to 1980–81, imports expanded at an average rate of 27 per cent. Most of this increase was due to imports of intermediate goods as the government relaxed controls on imports of these items. In the 1980s the growth rate of imports fell dramatically (Fig. 7.1), and between 1985–86 and 1988–89 grew at an average rate of 14 per cent.

The trends in exports and imports resulted in a substantial widening of the trade balance deficit over time. The deficit rose from $123 million in 1972–73 (2 per cent of GNP) to over $3 billion in 1985–86 (9.8 per cent of GNP). A large proportion of this deficit was covered by workers' remittances, especially from the Middle East, which rose from about $175 million in 1972–73 to nearly $2.6 billion in 1985–86 (see Table 7.2 and Fig. 7.1).[11] The 1972–73 workers' remittances accounted for about 20 per cent of exports, but by 1977–78 this share had risen to 90 per cent. Following the second oil price shock, there was another surge in remittances, and in 1982–83 they had reached $2.9 billion, actually surpassing export earnings for that year. Since then, the flow has been declining as activity in the Middle East countries slowed down after the fall in oil prices. Even so, by 1985–86 workers' remittances were close to 90 per cent of exports of goods. Exports grew more rapidly than imports from 1985–86 to 1988–89. However, remittances continued to decline resulting in continued pressure on the balance of payments.

In many respects one can argue that government policies in the early 1970s that eased restrictions on outward migration, and encouraged the Middle East countries to accept Pakistani labour, were the most important steps taken by Pakistan in relaxing the balance of payments constraint. Macroeconomic policies were not significant. Without the foreign exchange generated through workers abroad, the balance of payments and the overall economy, would undoubtedly have been in much worse shape.

The current account defict was only about $100 million in

1972–73, but it deteriorated very rapidly in the next two years. In 1973–74 and 1974–75 it amounted to over 10 per cent of GNP—which is large by any standard. Over the period as a whole, the current account deficit has averaged about 5 per cent of GNP, which is significantly higher than that observed for all non-oil developing countries (where the average deficit was 2.5 per cent).

Capital inflows to Pakistan take mainly the form of official aid. Between 1972–73 and 1988–89 Pakistan had received grants and concessional loans amounting to approximately $23 billion. Figure 7.3 shows the annual foreign aid (on a commitment basis) received by the country over this period. Most of the aid flows came from the Pakistan Aid Consortium, although the share of OPEC countries increased during the 1970s and early 1980s. Over time there has been a continuing shift in the composition of official capital inflows from grant-type assistance to loans and credits. Official statistics indicate a steady inflow of private capital (Table 7.2), but there is some evidence of unrecorded private outflows. In a previous study (Khan 1989), I have shown that capital flight from Pakistan during the 1980s was fairly significant. Deposits of Pakistani residents in foreign banks, which stood at $700 million in 1981, have risen at an annual average rate of nearly 20 per cent since then. In 1987 these deposits reached over $1.7 billion. Capital flight, narrowly defined as the increase in foreign deposits, thus amounted to over a billion dollars over the six-year period.[12] Along with the inflow of foreign capital, there has been a steady increase in the debt–service ratio (Fig. 7.4). Over the period as a whole the debt–service ratio averaged about 25 per cent of exports of goods and services (excluding remittances), which is fairly high by international standards. Furthermore, debt–servicing grew fairly rapidly in the 1980s. However, as a proportion of foreign exchange earnings, that is mechandise exports plus remittances, debt–servicing averaged only 13 per cent. The net transfer of resources to Pakistan has been falling over time as debt–service payments have increased. For example, net transfers in 1977–78 were 56 per cent of gross disbursements; by 1984–85 the percentage had fallen to 13. There was a pick-up in disbursements in 1985–86 to $1.5 billion and total outflows amounted to under a billion dollars. Consequently, the ratio of net transfers to disbursements rose to 27 per cent in that year. However, in 1986–87 disbursements fell to $1.3 billion while outflows exceeded one billion dollars. Disbursements grew rapidly

thereafter, exceeding $2 billion in both 1988–89 and 1989–90, with outflows rising more slowly. The change reflects the IMF/World Bank structural adjustment programmes. The total external debt of Pakistan grew steadily from $4.8 billion to $15.2 billion between 1974–75 and 1989–90, or at a rate of about 8 per cent a year.

The movements in the ratio of international reserves to imports over the period 1972–73 to 1988–89 are displayed in Fig. 7.5. Between 1972–73 and 1979–80, total international reserves (including gold) rose from less than $300 million to $1.2 billion. The 1980s saw a large build-up, with international reserves in 1983–84 reaching $2.8 billion, or nearly six months of imports.[13] In the following years there was a significant decline in reserves, and in 1989–90 international reserves fell to only two months of imports.

Monetary and Credit Policies

Monetary expansion in Pakistan has not been excessive. Over the period the money supply has grown annually by about 16 per cent, a rate somewhat less than the growth in nominal GNP (Table 7.3). The income velocity of money rose considerably in the early 1970s, but since 1978–79 it has fluctuated between 3 and 3.5 (Fig. 7.6). Domestic credit, which is the relevant monetary policy instrument, grew at approximately the same rate as nominal GNP (i.e., 18 per cent). Thus, by and large, one could conclude that the monetary policy has been fairly restrained.

But this does not mean that the monetary policy was totally passive. Indeed, it has been actively used for correcting external payments problems. In 1973–74 to 1974–75, the balance of payments came under severe pressure, with the current account deficit in both years rising to over 10 per cent of GNP. It is certainly likely that these deficits, and the consequent loss of international reserves, would have been larger had it not been for the restrained credit policy pursued by the State Bank. Even though nominal GNP rose by over 27 per cent in 1973–74, the rate of growth of domestic credit was kept under 13 per cent.

In order to tighten up credit conditions in the economy and thus limit the loss of international reserves, the government raised the

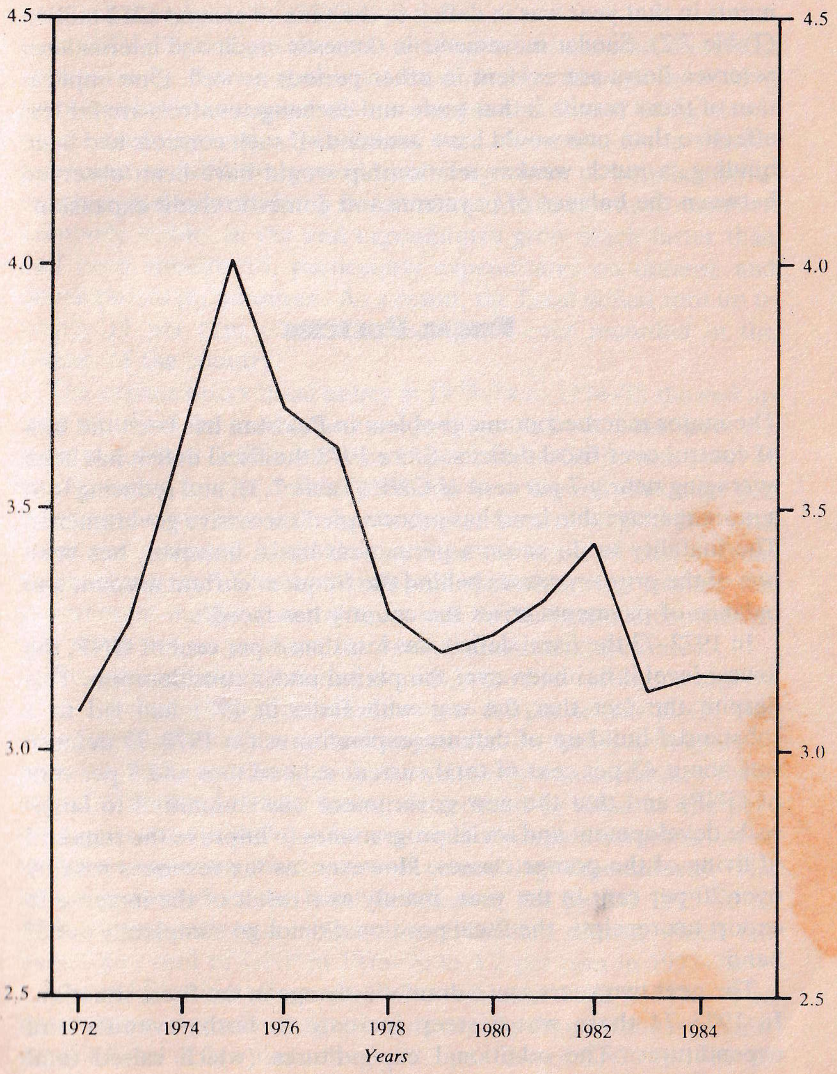
TABLE 7.3
Macroeconomic Policy Indicators, 1972–89[a]
(percentage)

Period	*Growth of domestic credit*	*Growth of money supply*	*Fiscal deficit[b]*	*Nominal exchange rate[c]*	*Real exchange rate[d]*
1972–73	17.9	−4.0	5.7	10.6	115.7
1973–74	12.6	22.7	6.4	9.9	90.9
1974–75	6.7	13.7	10.3	9.9	101.4
1975–76	12.6	7.5	8.6	9.9	108.1
1976–77	25.1	25.9	8.1	9.9	109.7
1977–78	30.7	24.3	7.4	9.9	108.7
1978–79	18.8	23.0	8.3	9.9	100.7
1979–80	23.8	23.5	5.8	9.9	99.1
1980–81	16.5	17.6	4.9	9.9	100.0
1981–82	12.1	13.2	5.0	10.5	109.6
1982–83	18.8	11.4	6.4	12.7	97.7
1983–84	20.7	25.3	5.5	13.5	93.2
1984–85	16.3	11.8	7.1	15.2	93.7
1985–86	17.2	12.6	7.1	16.1	87.4
1986–87	13.3	13.7	8.3	17.2	—
1987–88	12.6	12.2	8.0	17.6	—
1988–89	7.1	4.7	7.3[e]	18.7	—

Source: *Pakistan Economic Survey*, 1986–87, 1987–88, and 1989–90.
Note:
a. Data are for fiscal years starting 1 July.
b. As per cent of GNP.
c. Rupees per US dollar; average for year.
d. 1980 = 100.
e. As a per cent of GDP.

discount rate, the liquidity ratio, and interest rates on loans and deposits in August 1973; increased selective credit controls in September 1973; and imposed ceilings on credit expansion by commercial banks in November 1973. The interest rate changes were small—leaving most rates still negative in real terms—and the bulk of the adjustment fell on domestic credit expansion. The credit policy was maintained in 1974–75, with domestic credit growing by less than 7 per cent (Table 7.3). Even though the current account deficit was unaffected in both years, in 1973–74, despite the jump in oil prices, the balance of payments was in

Figure 7.6
Pakistan: Income Velocity of Money



surplus. A deficit was recorded the following year, but taking the two years together, the balance of payments was roughly in equilibrium.

The opposite effect was observed in 1976–77 when domestic credit expanded by 25 per cent (Table 7.3). The balance of payments in that year was in deficit to the tune of around $252 million (Table 7.2). Similar movements in domestic credit and international reserves flows are evident in other periods as well. One implication of these results is that trade and exchange controls are far less effective than one would have assumed. If such controls had been binding, a much weaker relationship would have been observed between the balance of payments and domestic credit expansion.

Fiscal Policies

The major macroeconomic problem in Pakistan has been the lack of control over fiscal deficits. Since 1972 the fiscal deficit has been averaging nearly 7 per cent of GNP (Table 7.3), and reducing it to a more manageable level has preoccupied successive governments. The inability to do so on a permanent basis, however, has been one of the primary causes behind the frequent current account and balance of payments crises the country has faced.

In 1972–73 the fiscal deficit was less than 4 per cent of GNP, the lowest level it has been over the period under consideration. This despite the fact that the war with India in 1971 had led to a substantial build-up of defence expenditures (in 1972–73 defence was about 43 per cent of total current expenditure and 8 per cent of GNP) and that the new government was committed to large-scale development and social programmes to improve the standard of living of the poorer classes. However, as tax revenues rose by over 20 per cent in the year, mainly as a result of the increase in export tax receipts, the fiscal position did not go completely out of hand.

The next two years saw a dramatic change in the fiscal situation. In 1973–74 there was a steep increase in both revenues and expenditures. The additional expenditures (which raised total expenditures by 34 per cent over the previous year) were required

for flood relief, repair of flood damage, higher subsidies, wage increases, and for financing an expanded development programme. On the other hand, new revenue measures were introduced so that revenues rose by over 40 per cent. Nevertheless in 1973–74 the fiscal deficit rose to 6.7 per cent of GNP, with the bulk of it being financed through external grants and loans provided in the main by Arab members of OPEC.

In 1974–75 the government attempted to reverse the fiscal expansion by curtailing current expenditures through restricting increases in defense expenditures, wages and cost of living allowances. Development expenditures were, however, to be sharply increased to fulfil the government's objectives of building infrastructure and industrializing the economy. While revenues remained relatively stable, in the end expenditures grew much faster than had been anticipated, particularly expenditures on defense and development programmes. As a result, the fiscal deficit shot up to nearly 11 per cent of GNP—the highest ever recorded in the history of the country.

The expansionary fiscal policy in 1973–74 to 1974–75 showed up very clearly in the current account position. In both these years the current account deficit was over 10 per cent of GNP, with most of the financing for the deficits obtained from abroad. Pakistan had developed close ties with the Arab members of OPEC and with Iran, and managed to obtain significant amounts of capital from these countries.[14] The availability of such financing relaxed the government budget constraint, as well as the external constraint, and there was no pressure for drastic adjustment measures.

The government attempted to rectify the fiscal situation and by 1976–77, slowly brought deficit down to 8.3 per cent of GNP. The Zia ul-Haq government, which negotiated a standby arrangement with the IMF, continued with the relatively contractionary fiscal stance. The fiscal deficit was again reduced by close to one percentage point of GNP (to 7.4 per cent) through a combination of revenue-increasing measures and controlling expenditures. The steady reduction in the fiscal deficit over the period 1975–76 to 1977–78 was reflected in the current account deficit, which fell from 7 per cent of GNP in 1975–76 to 3.2 per cent in 1977–78.

The stabilization effort received a serious setback in 1978–79 as government expenditures grew more rapidly than revenues, resulting in a fiscal deficit amounting to 8.3 per cent of GNP. In 1979–80 there was a renewed effort to correct the fiscal situation through postponing certain expenditures and cutting back on others (excluding defense). While the unanticipated spending for Afghan refugees and increased subsidy payments did keep expenditures rising, the government was able to increase revenues significantly without imposing new taxes. Basically the improvements came about through a successful drive to collect existing taxes. As a consequence, there was a significant reduction in the fiscal deficit (to 5.8 per cent of GNP) despite the additional financial burden resulting from exogenous developments, such as the influx of Afghan refugees, military tensions in the region, and sharp price increases for imported oil and related products.

During the 1980s the fiscal deficit was about 6 per cent of GNP, and the government was unable to achieve a significant or lasting improvement. Expenditures, particularly on defense and debt–servicing, continued to rise steadily, while revenues stagnated.

Thus, fiscal deficits have been large throughout the period under discussion. But rather than showing up in inflation, the demand pressures created by fiscal deficits have shown up in current account deficits. The close correspondence between fiscal and current account deficits in Pakistan is evident in Fig. 7.7. With the exception of possibly one or two years (1982–83 and 1987–88), changes in the fiscal deficit to GNP ratio were matched by changes in the same direction of the current account deficit to GNP ratio.

The evidence of a strong relationship between monetary policy, as represented by changes in domestic credit, and the overall balance of payments, as well as a similar relationship between the fiscal deficit and the current account balance, suggests that fiscal and monetary policy are closely linked. There is, of course, good reason to believe in the existence of such a link, as Pakistani governments have frequently resorted to borrowing from the banking system to finance fiscal deficits.

Exchange Rate and Trade Policies

Pakistan's exchange rate policy had two distinct phases: (*a*) a large devaluation in 1972 followed by constant parity with the US dollar

through December 1981; and (*b*) adoption of managed floating from January 1982.

On 12 May 1972, Pakistan implemented a major exchange reform which involved a unification of existing multiple exchange rates, and the establishment of a new par value of Rs. 10 per US dollar (a depreciation of about 130 per cent). This devaluation resulted in a depreciation of the real effective exchange rate of nearly 62 per cent. Given that the exchange rate was considered sacrosanct in Pakistan policy-making circles, the size of the devaluation was a surprise and there is reason to believe that the government overshot in order to avoid having to devalue again soon. In other words, the action was thought of and sold to the public as a one–time change.

After a small appreciation in 1974, the nominal exchange rate was maintained at Rs. 9.9 to the US dollar for nine years (Fig. 7.8). The real exchange rate, however, did fluctuate—appreciating by some 20 per cent between 1973–74 and 1975–76. The government was aware of the problem, but was unwilling to change the nominal rate. Basically devaluation was viewed as a measure of last resort. As it turned out, the real exchange rate started to depreciate in 1977–78, primarily due to the decline in the US dollar with respect to the currencies of Pakistan's major trading partners. In the following year the real exchange rate depreciated by about 7.5 per cent, and in 1979–80 by nearly 2 per cent (Fig. 7.8). However, the rise in domestic inflation relative to foreign inflation caused the real exchange rate to appreciate slightly in 1980–81 and then by nearly 10 per cent in 1981–82.

The devaluation in 1972 was accompanied by some liberalization and simplification of the existing import control regime. Restrictions on current payments, particularly for foreign travel, were also relaxed.[15] On the export side, however, in order to avoid windfall profits for exporters from the devaluation, export duties were introduced for a number of commodities. While the liberalization was a significant step, it must be realized that the changes in 1972 still left the trade and payments system quite restrictive. Quotas, tariffs, import licenses, exchange controls, and export subsidies and taxes were still maintained. In general, the government felt that it had proceeded on liberalization as far as it was possible, and that further progress in that direction would be at a measured pace.

Figure 7.7
Pakistan: Current Account and Fiscal Deficits
(per cent of GNP)

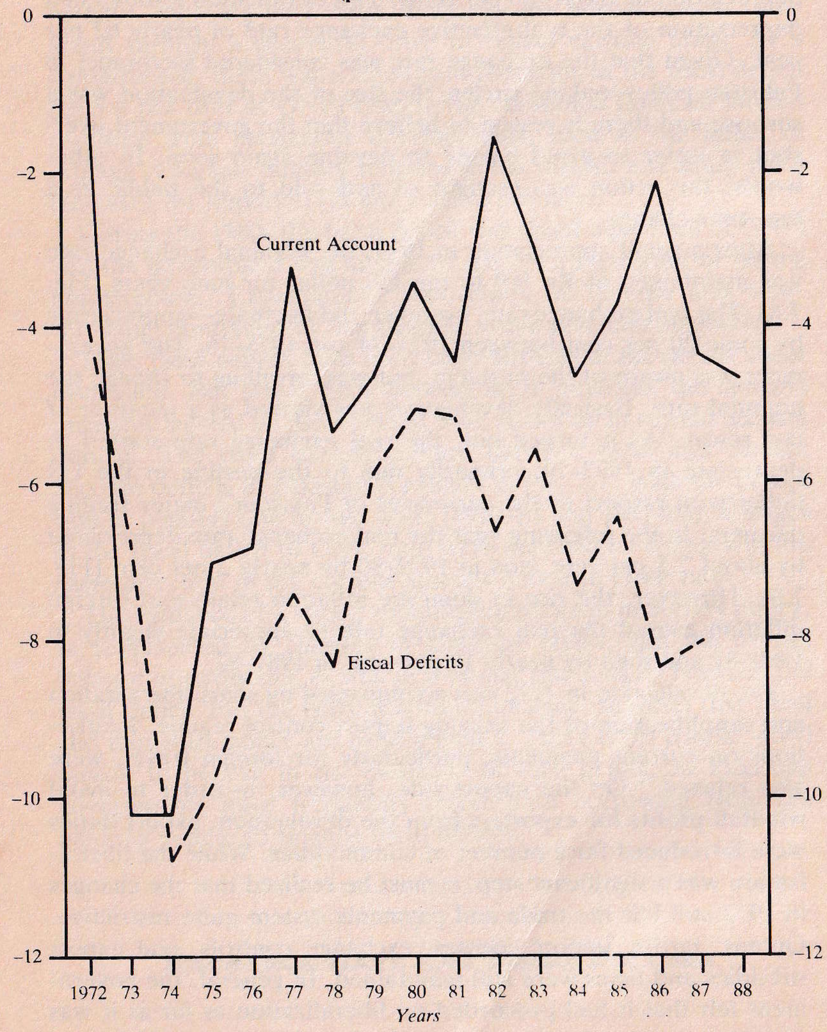
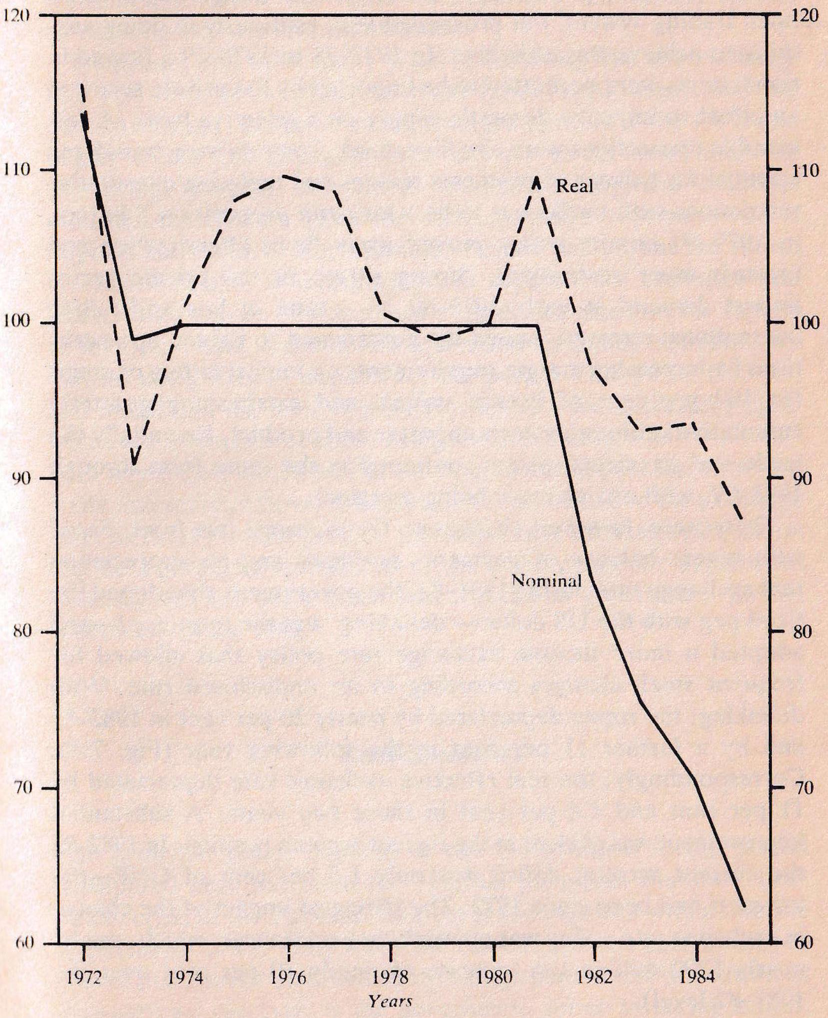


Figure 7.8
Pakistan: Nominal and Real Exchange Rates
(1980 = 100)



For the remainder of the Bhutto government, controls on imports were kept in place and were regarded as an important policy tool in balance of payments adjustment. Although some small steps to liberalize imports of capital and intermediate goods were taken, the system remained highly restrictive as regards consumer goods. The Zia ul-Haq government announced its commitment to an open trading system, but proceeded very cautiously in doing anything to achieve this objective. In 1977–78 to 1978–79 a few additional items were permitted to be imported by the private sector in an effort to improve domestic supply on a selective basis. A few invisible transactions were also liberalized. Controls were considered essential for balance of payments reasons and replacing quantitative restrictions with tariffs was to be a long-run proposition.[16] In fact, in 1979–80 import policy moved away from liberalization and towards more restrictions. Strong surges in the private sector import demand in early 1979–80, at a time of low and falling international reserves, caused the government to tighten up restrictions by increasing margin requirements on import letters of credit (to 100 per cent of license value), and establishing quarterly cumulative ceilings for each importer and product. Essentially the trade and payments system continued in the same form through 1988–89, with any changes being marginal.

There were, however, changes on the exchange rate front. Faced with severe balance of payments problems and an appreciating real exchange rate during 1981–82, the government abandoned the fixed peg with the US dollar—'delinking' was the term used—and adopted a more flexible exchange rate policy that allowed for frequent small changes according to an undisclosed rule. With delinking, the rupee depreciated by nearly 20 per cent in 1982–83 and by a further 11 per cent in the following year (Fig. 7.8). Correspondingly, the real effective exchange rate depreciated by 11 per cent and 4.6 per cent in those two years. A substantial improvement was evident in the current account position. In 1982–83 the current account deficit was only 1.5 per cent of GNP—the lowest it had been since 1972. The strongest impact of the change in exchange rate policy was on workers' remittances, which rose by nearly $700 million (an increase of nearly 30 per cent over the 1981–82 level).

The nominal rate of depreciation slowed down in 1984–85, and the real exchange rate appreciated slightly. There was a deterioration of the current account position and remittances fell by almost $300 million. To counter this the government accelerated the nominal rate of depreciation in 1985–86, and the resulting real depreciation helped to reduce the current account deficit and raise remittances above what they otherwise would have been. The government continued to allow the rupee to depreciate thereafter, further stimulating exports and remittances.

It appears that after many years of believing that the exchange rate had little or no effect on trade flows, remittances, and the current account, the government changed its mind in the 1980s and began to use the exchange rate actively as an instrument for correcting external imbalances. Available empirical evidence indicates the relative–price (or exchange rate) responsiveness of imports and exports. For example, Tirmazi found that the return to exporters, that is including prices adjusted for exchange rate changes and export subsidies, had a significant effect on the exports of textiles.[17] Also, Sarmad and Mahmood estimated equations for various categories of imports for the period 1969–70 to 1983–84, and found that the relative-price elasticities were statistically significant for a number of these categories, including total imports.[18]

In any event, the empirical evidence does support the view that trade and services flows in Pakistan are responsive to the exchange rate, as theory would predict. Consequently, exchange rate action can be a powerful instrument in the macroeconomic adjustment process, and has been taken into account in government policy, specifically since 1982.

Conclusions

The principal policy concern of the Government in the period considered here has been the external payments situation. Economic crisis in the Pakistani context is synonymous with a balance of payments crisis. Only when the current account deteriorates to a level that cannot be financed by foreign capital and drawdown of international reserves, is the government prone to taking action. This is not to suggest that growth and inflation rates do not matter at all, but as both have been fairly respectable in the face of a number of serious external and domestic shocks, they have not been central to the government's macroeconomic policy-making. By most criteria it would be fair to conclude that the level of foreign exchange reserves has dominated other macroeconomic targets in the government's objective function.

In addressing the balance of payments problems, the Pakistani policy-makers have used orthodox policies—monetary and fiscal restraint, exchange rate depreciation—but have also relied heavily on direct intervention, particularly in the foreign trade area. On the basis of this study we can form some broad judgments on the effects these policies have had on balance of payments developments during the period 1972 to 1989.

Monetary policy throughout the period was geared to moderate growth rates of the money supply and domestic credit. Any sharp increases in monetary and credit variables were shortlived as the State Bank moved quickly to curb the expansion. The monetary authorities have used the rate of domestic credit expansion by the banking system as their principal instrument of control. Interest rates have not been allowed to play a significant role in the allocation of credit. Instead, selective controls have been employed to direct credit towards particular sectors or activities. There was a fairly close link between changes in domestic credit and the balance of payments, with an expansion in domestic credit being associated with international reserve losses. Consequently, one observes that the government did tighten monetary policy when faced with an actual, or potential, reserve loss.

On the exchange rate front, policy-makers in Pakistan were initially reluctant to use the exchange rate as a policy instrument. After the devaluation in 1972, the rupee was kept fixed to the US dollar for almost 10 years. There were two main reasons advanced for not using the exchange rate to achieve balance of payments objectives. First, it was believed that foreign trade flows and services, in particular workers' remittances, were not responsive to relative price changes, and thus exchange rate policy was impotent. Second, there were concerns that devaluation of the rupee would create inflationary pressures, and perhaps even recessionary tendencies, in the economy. These feelings changed somewhat in January 1982 when a managed floating rate system was adopted, and since then the exchange rate has been adjusted periodically.

My analysis has challenged the view that the exchange rate would not affect the components of the current account of Pakistan. Indeed exports, imports, and workers' remittances have been significantly affected by variations in relative prices and the exchange rate. This is very evident in the 1980s when the exchange rate was allowed to move.

Unlike the case of monetary policy, fiscal restraint has been very difficult to achieve in Pakistan. For the whole period 1972 to 1986 the fiscal account was in deficit, and while attempts were made on several occasions to reduce the deficit, the success was only temporary and limited. The generally expansionary fiscal policy certainly had a lot to do with the current account problems that the country has faced. This study has provided evidence of a close link between fiscal deficits and current account deficits, implying that had the government been able to bring the fiscal situation under control the balance of payments constraint would have eased.

It is then only natural to raise the question as to why successive governments were unable to bring these fiscal deficits down permanently, especially as everyone was apparently quite aware of the problems they were creating for the economy. In one sense the answer is very simple: revenues could not be increased and expenditures could not be cut. As regards revenues, the tax base of the economy is very small. The agricultural sector, accounting for 25 per cent of GDP, has been completely exempt from direct income taxes, and substantial tax exemptions have also been granted to the industrial sector through tax holidays, tax credits and accelerated depreciation allowances. The problem has been compounded by a low compliance rate—it is estimated that roughly three-quarters of the potential taxpayers do not pay any income tax. As such, governments have had to rely on indirect taxes, particularly trade taxes, for their revenue needs. In 1988–89 the share of direct taxes in total tax revenues was about 13 per cent, down from 16 per cent in 1972–73.

On the government expenditure side, the major share of current expenditures, approximately 35 to 40 per cent, has been going to defense. In recent years interest payments on external and domestic debt have loomed larger. Between 1975–76 and 1987–88 the share of interest payments in current expenditures rose from 12 per cent to about 25 per cent.[19] Since defense and debt-service payments

However, as things currently stand, unless such adjustments are made, and macroeconomic policies are geared to the goals of achieving a sustainable balance of payments, domestic financial stability, and a higher savings rate, it is uncertain whether the country can achieve a rate of economic growth that can support a rapidly rising population. Without such a growth rate the economic and social future for the country looks very uncertain.