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Macroeconomic Policies and the Balance  
of Payments in Pakistan: 1972-1986

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Abstract

This paper describes developments in the balance of payments of Pakistan during 1972-86, focusing particularly on the factors that gave rise to external payments problems and the macroeconomics policies that were adopted by the authorities. While performance on the growth and inflation fronts compares favorably with other developing countries, the balance of payments remained persistently weak. A combination of favorable external shocks, such as the large increase in workers' remittances and sizable foreign aid inflows, allowed the economy some breathing room, but ultimately did not reduce the need for comprehensive fiscal and trade reforms to ensure medium-term viability of the balance of payments.

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## I. Introduction

The broad objectives of macroeconomic policy are the achievement of a high and sustained rate of economic growth, reasonable 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 the availability of resources, so as to prevent the emergence of imbalances that can be reflected in growing external payments deficits, inflationary pressures, and reductions in the growth rate. For convenience, these macroeconomic policies can be grouped according to whether their impact falls primarily on the level of aggregate demand and production--namely monetary and fiscal policies--and on the composition of aggregate demand and production as between tradable and nontradable goods--specifically exchange rate and trade policies. 1/

The purpose of this paper is to analyze and evaluate macroeconomic policies in Pakistan during the past two decades. The specific question addressed here is whether the macroeconomic policies achieved the objectives for which they were designed. This question is of obvious importance as the answers have a significant bearing on the role and conduct of macroeconomic policies and policymaking in the future.

As a first step it is useful to see how the economy has performed over the period 1972-86. 2/ The basic macroeconomic indicators in Table 1 tell a very favorable story. The growth in real GNP averaged almost 6½ percent per annum, and inflation was kept at an annual average rate of about 11½ percent. This was considerably better than the experience of all non-oil developing countries as a group, where growth averaged less than 5 percent and inflation was over 27 percent per year during the same period. The current account deficit, however, was sizable--representing almost 5 percent of GNP, more than twice as large as that for all non-oil developing countries--and although a large part of it was financed by official aid flows, 3/ there was a significant build-up of foreign debt. The average level of international reserves during the period was a little over \$1.1 billion, equivalent to about 3 months of imports. By and large, relative to other developing economies where periods of hyperinflation, stagnation, and extreme financing difficulties have prevailed, Pakistan's macroeconomic performance in the last 15 years or so has been quite impressive.

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1/ This follows the categorization of policies suggested by Khan (1987). It should be noted that exchange rate policy also has demand-side effects, although typically the expenditure-switching effect is given greater emphasis.

2/ For more detailed discussions of economic performance during the 1970s and 1980s, see Ahmad and Amjad (1984) and Asian Development Bank (1985). The 1970s experience is also described in Baqai (1979) and Burki (1981).

3/ Between 1972 and 1986 Pakistan had received grants and concessional loans amounting to over \$17 billion.

Table 1. Basic Macroeconomic Indicators, 1972-86 1/

(In percent)

Period	Growth of Real GNP	Inflation <u>2/</u>	Current Account Deficit <u>3/</u>	Inter- national Reserves <u>4/</u>	External Debt <u>4/</u>
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
<u>Average:</u>					
1972/73 -	6.4	11.4	4.7	1,117	--
1985/86					

Source: Pakistan Economic Survey, 1986-87.

1/ Data are for fiscal years starting July 1.

2/ Consumer price index.

3/ As percent of GNP.

4/ In millions of U.S. dollars (December).

Even more impressive is the fact that this performance took place in the face of a worsening international economic environment. A series of external shocks during the 1970s and 1980s made the problem of economic management much more difficult than it had been in earlier decades for most developing countries, as well as for Pakistan. <sup>1/</sup> The substantial fluctuations in the world market prices of primary commodities, the sharp increases in the international price of oil, and the slowdown in economic activity in the industrial countries put the economy under considerable pressure. As a result of these developments Pakistan's terms of trade deteriorated steadily over the period at an annual average rate of nearly 2 percent. In addition to these external factors, Pakistan also experienced political shocks that put a major strain on 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 3 million) following the Russian 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 output originating in the agricultural sector, the economy was also prone to periodic weather-related shocks.

The positive growth and inflation picture should not, however, be taken to imply that the economy was crisis-free during 1972/73 to 1985/86. Pakistan, like most other low-income developing countries, has operated under a severe balance of payments constraint. On several occasions a crisis in the balance of payments erupted causing the government to alter the course of macroeconomic policies. But in contrast to the experience of many developing countries, these crises were not generally created by government policy mistakes, but rather were of external origin or due to other exogenous events. Of course, it can be argued that while governments did not precipitate these crises, on certain occasions they did aggravate the situation either by inaction or inappropriate policy responses. In many cases prudent policies could have prepared the country for the crises that occurred by ensuring a larger cushion of foreign reserves.

Basically in the eyes of Pakistani governments, the current account balance and the level of international reserves has been a crucial barometer of the performance of the economy. Even when growth was high by historical standards and inflation below the average rate, i.e., in 1976/77-1977/78 and 1979/80, the economy was considered to be in a crisis situation because the international reserves had dropped below some notional desired level. Evidence for this judgement is the fact that the government negotiated several programs with the Fund despite the positive growth and inflation

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<sup>1/</sup> Dell (1980) and Killick (1981), among others, argue that these external factors were primarily responsible for the balance of payments difficulties of all developing countries. See also Khan and Knight (1982), and (1983) for a somewhat different view.

performance at that time. Successive stand-by arrangements were in effect during 1972-75, and another one was agreed for 1977-78. A three-year Extended Fund Facility program was implemented in 1980. Since Fund-supported programs are based on a "balance of payments need", it is reasonable to conclude that the external payments position had become precarious in those periods. It would seem legitimate, therefore, in the case of Pakistan to concentrate on the relationship between macroeconomic policies and the balance of payments. 1/

The remainder of this paper proceeds as follows. Section II contains a discussion of certain institutional issues, such as who makes macroeconomic policy in Pakistan, and what instruments are utilized to conduct policy. Section III describes the balance of payments developments in Pakistan during the period 1972/73 to 1985/86, and the macroeconomic policies that were followed. The concluding section presents an overview of macroeconomic policies, focusing specifically on the success and failures of these policies. Some general lessons from the experience are also drawn for the future conduct of macroeconomic policies.

## II. Macroeconomic Policymaking in Pakistan

Political developments in Pakistan over its history have been reflected in economic policymaking, although not to the extent that would have been expected. The changes in ideological and institutional frameworks have created shifts in the balance between government intervention and the market mechanism, and in the relative emphasis placed on the public and private sectors. However, these political economy shifts 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 changes in money and prices. Overall Pakistan has remained a mixed economy, and successive governments of different political persuasion have eschewed radical reforms of any type.

This section first discusses briefly the process and structure of economic policymaking in the country, and then turns to a description of the policy instruments that have been employed to conduct macroeconomic policy.

### 1. Macroeconomic policymaking

The most notable aspect of economic policymaking in Pakistan has been its continuity and consistency over time. Despite the political changes and upheavals that occurred over the last 30 years or so, macroeconomic policies have remained remarkably stable. This continuity in policymaking can be attributed to three factors. First, Pakistan adopted a planning approach to

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1/ This does not mean that the other objectives are totally unimportant, rather that they have been apparently less significant from the standpoint of macroeconomic policy.

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. <sup>1/</sup> The formulation of long-term (five-year) plans, supplemented by annual plans, established the broad parameters within which macroeconomic policy had to operate. Second, the overall direction of economic policy has been in the hands of a few individuals, generally from the civil service and supported by it, for some twenty years now. This small close-knit 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. Third, during the period 1972-86 Fund-supported programs were in effect for 8 years. These programs established specific quantitative monetary and fiscal targets that the government had to adhere to as conditions for the loans it received.

The Planning Commission is charged with preparing the Five Year Plans and the Annual Development Plans, in collaboration with the relevant ministries. 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 the 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 political-economy tone that the government would follow by specifying the relative weights of the public and private sectors in the operation of the economy. To make the Five Year Plan operational, 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. <sup>2/</sup>

The Planning Commission of Pakistan became increasingly powerful during the regime of Ayub Khan (1958-1969). Even though it was responsible for the formulation of the First Five Year Plan (1955-60), its guidelines had been 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 to transform the economy toward a more

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<sup>1/</sup> See Haq (1963).

<sup>2/</sup> For a useful description of the planning process, see Haq (1963) and Ahmad and Amjad (1984).



market-oriented one and giving the private sector a larger role. <sup>1/</sup> The President assumed the chairmanship of the Planning Commission and a Deputy Chairman, at 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 policymaking game. During the period 1958-69 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 somewhat of a decline. It had become very closely identified with the economic policies pursued by the Ayub Khan regime, and when the Peoples Party government of Zulfikar Ali Bhutto attained power in December 1971, the Planning Commission became the target of criticism. Serious planning had already come to a standstill during the second martial law period (1968-71). In March 1969 the Third Five Year Plan was virtually abandoned and a Fourth Plan (1970-75) was produced, but it was ignored because of the political conditions in the country. The Peoples Party was extremely suspicious of the Planning Commission and was determined to reduce its power. In 1972 the Planning Commission was made part of the Ministry of Finance, and the government decided to run 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 took over in 1977 decided to revive the Planning Commission as a major policymaking institution. A new Five Year Plan (1978-83) 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 period, the Minister of Finance also held the Planning portfolio.

Notwithstanding the influence of the Ministry of Finance and the Planning Commission, the State Bank of Pakistan also played a significant, albeit secondary, role in economic policy of the country. The relationship between the Ministry of Finance and the State Bank has historically been a very close one. While the Ministry of Finance has primary responsibility

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<sup>1/</sup> In some sense, this can be seen as a contradiction in terms--the Planning Commission reducing the role of the government and of itself. However, by expanding the areas of the economy in which the private sector could participate, the Plans and the Planning Commission was doing precisely this.

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 mostly passive to the fiscal stance of the government because of the need for the government to finance fiscal deficits via borrowing 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 have the approval of the Ministry of Finance.

## 2. Instruments of policy

In order to correct balance of payments problems and thus achieve a desired level of international reserves the government authorities have relied on a variety of policies. These include fiscal policies, monetary and credit policies, and exchange rate and trade policies. 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. 1/ 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. Most of the attention of policymakers in Pakistan has been on the size of the fiscal deficit, and the effects it is likely to have on the economy. Monetary policy is formulated primarily 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". 2/ In addition, the government has frequently applied selective controls to determine the sectoral composition

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1/ See Kemal (1987b).

2/ This approach considers the balance of payments to be a reflection of the desire of residents to accumulate or run down their stock of money balances. In this framework, with fixed exchange rates, an expansion of the domestic component of the money stock--domestic credit--induces the public to dispose of surplus money by buying foreign goods and securities, leaving output and prices unaffected. There is thus a one-for-one relationship between the balance of payments and domestic credit expansion. For a discussion of this approach, see Frenkel and Johnson (1976) and IMF (1977).

of credit. 1/ Until very recently interest rates were regulated, but were not often used as an instrument of monetary control. 2/

Exchange rate and trade policies have been central in the government's pursuit of its balance of payments objectives. For the first ten years or so of the period 1971/72-1985/86, the exchange rate was pegged to the U.S. 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. 3/ 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 authorities' portfolio of policies. 4/ 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 forty 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. 5/

### III. Macroeconomic Policies and Balance of Payments Developments

This section begins with an overview of balance of payments developments over the period 1972/73 to 1985/86, and then turns to a discussion of the macroeconomic policies--monetary and credit policies, fiscal policies, and exchange rate and trade policies--pursued during this period.

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1/ See Zubeiri (1983) and Morshed (1987).

2/ The transformation of the banking system into an Islamic system during the last few years has led to the replacement of interest-based transactions with profit and loss sharing arrangements. The government has less control over the rates of return implicit in the latter, although it can, and does, influence these rates. For a description of Islamic banking as practiced in Pakistan, see Iqbal and Mirakhor (1987) and Ahmad (1987).

3/ For an analysis of Pakistan's exchange rate policy, see Khan (1986). The main theoretical aspects of exchange rate policy in developing economies have been discussed in numerous papers, including Johnson (1976), Dornbusch (1981), and Khan (1987).

4/ Exchange and trade restrictions have been in force in Pakistan since independence in 1947; see Islam (1981). The evolution of the system of controls is described in Kemal (1987a). See Tirmazi (1987) for a comprehensive discussion of export subsidies and taxes.

5/ See Khan (1989) for a discussion of how foreign exchange controls have been circumvented in recent years, as well as the steps taken by the government to relax some of these restrictions.

## 1. Balance of payments trends

The merchandise trade balance and the current account balance have been consistently in deficit throughout the period under consideration (Table 2). This in itself is not unusual, as developing countries in general require inflows of foreign capital to supplement domestic resources. As a matter of fact there are few developing countries, other than oil producers, that have run surpluses on the current account in the 1970s and 1980s. The conventional wisdom is that these deficits should be sustainable, that is, they should be covered by normal or spontaneous capital inflows. If they cannot be covered by normal capital flows or drawdown of international reserves, then a balance of payments crisis can result, requiring changes in policies to correct the imbalance. There were several years where the Pakistani external position proved to be unsustainable as so defined.

While the average growth of Pakistani exports during 1972/73-1985/86 was over 12 percent per annum, there was considerable instability in the year-by-year growth rates (Chart 1). The most urgent task facing the government in 1972 was to find new markets for the roughly 50 percent 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 favorable external circumstances, such as the improvement in the terms of trade, exports grew very rapidly in 1972/73-1973/74, rising by an annual average rate of 33 percent in U.S. 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 nearly 60 percent in 1974/75, and although it did recover somewhat in the next two years, it was still well below the peak 1973/74 level (Chart 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 percent, or roughly half the rate of increase of merchandise export earnings of all non-oil developing countries.

In the following three years (1977/78-1980/81) 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 (Chart 2) in 1979/80 there was no immediate impact on exports. In contrast to the poor performance in 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 percent. 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 percent in that year. The change in exchange rate policy helped to get the export

Table 2. Balance of Payments, 1972/73 to 1985/86 1/  
(In millions of U.S. dollars)

	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
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
Imports	891	1,493	2,114	2,139	2,418	2,751	3,816	4,857	5,563	5,768	5,616	5,993	6,009	5,984
<u>Trade Balance</u>	-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
Non-factor Services	-63	-152	-163	-179	-187	-181	-205	-238	-254	-176	-189	-275	-309	-376
Investment income	-84	-73	-98	-145	-169	-181	-233	-281	-261	-320	-420	-442	-506	-640
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
(Workers remittances)	(136)	(138)	(112)	(334)	(578)	(1,156)	(1,397)	(1,748)	(2,095)	(2,225)	(2,886)	(2,737)	(2,448)	(2,595)
<u>Current Account Balance</u>	-126	-548	-1,168	-948	-1,051	-605	-1,114	-1,140	-1,037	-1,534	-517	-997	-1,680	-1,236
Private Capital	13	57	96	194	160	128	163	174	261	364	673	265	108	757
Public Capital	235	324	917	741	582	811	743	1,365	811	605	522	652	586	939
Allocation of SDR	--	--	--	--	--	--	38	39	37	--	--	--	--	--
Errors & Omissions	7	-5	15	-9	57	-20	-17	15	-25	-15	20	-6	-31	-26
<u>Changes in Reserves</u> (- increase)	158	-148	139	20	252	-315	185	-453	-45	580	-698	86	1,017	-434

Source: Pakistan Economic Survey, 1986-87.

1/ Data for 1972/73 and 1973/74 are obtained from Pakistan Economic Survey, 1981-82.

Chart 1  
Pakistan: Imports, Exports and Remittances  
(Millions of U.S. dollars)

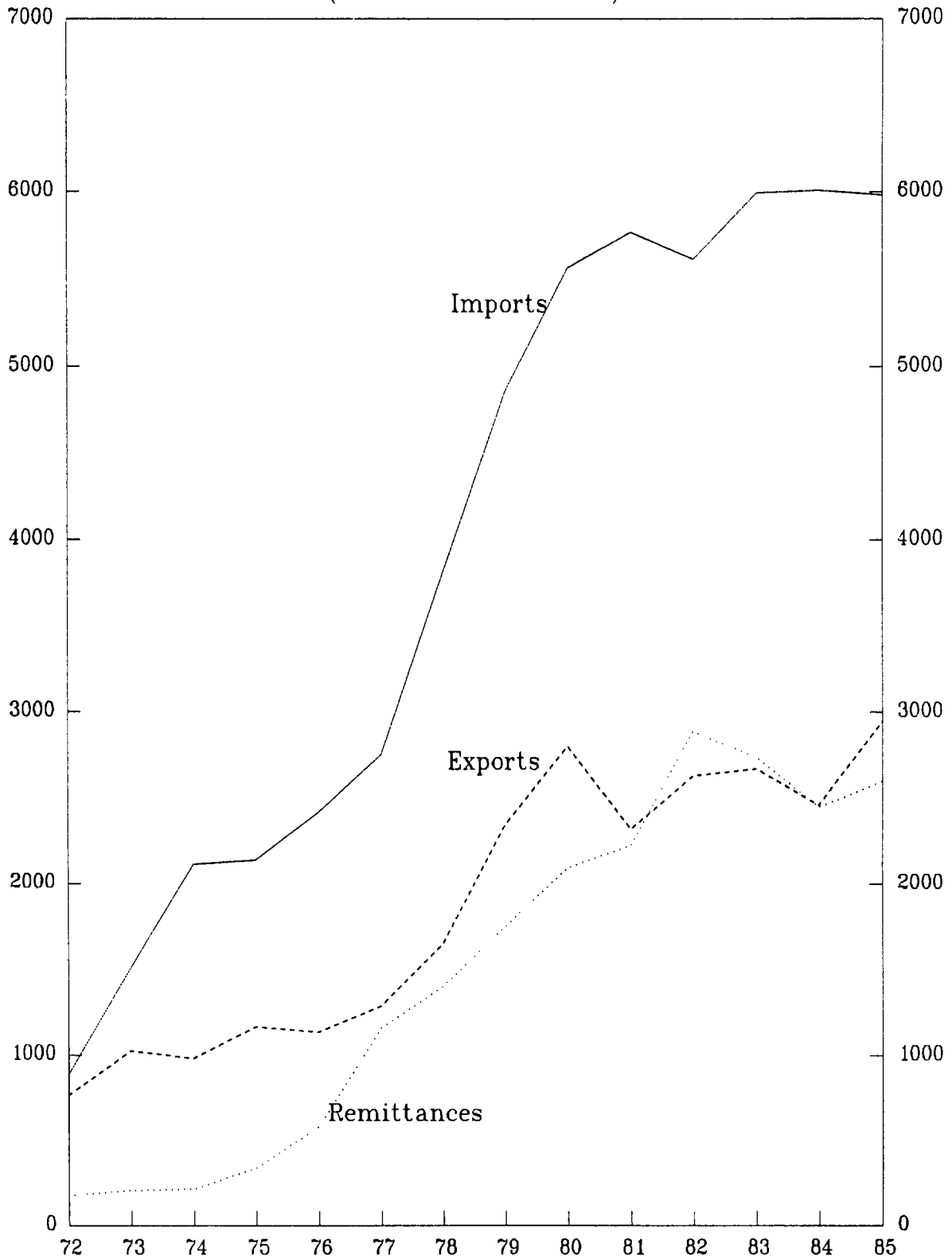
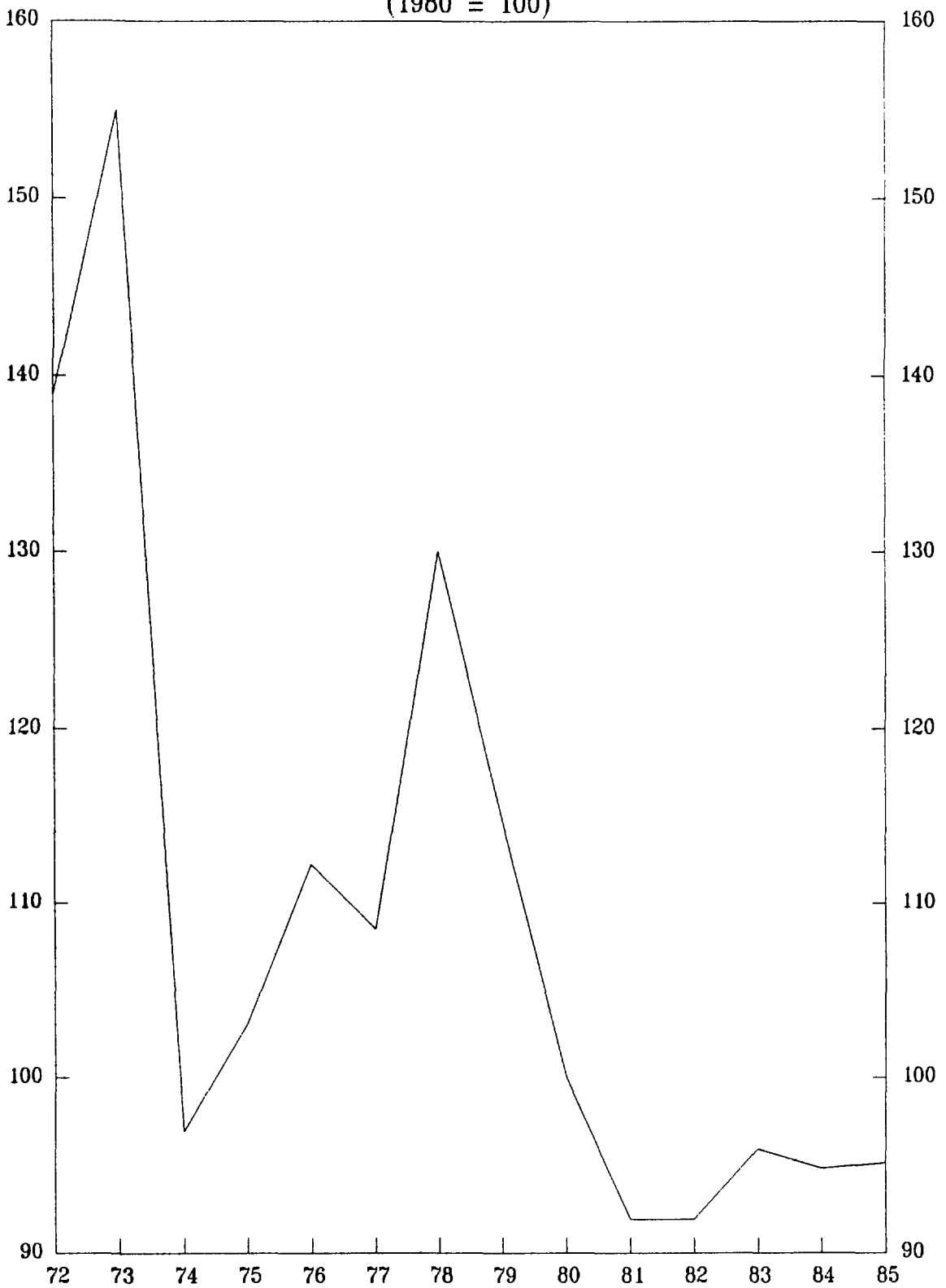


Chart 2  
Pakistan: Terms of Trade

(1980 = 100)



growth rate back up to around 2 percent per year in 1982/83-1984/85. In 1985/86 exports grew by nearly 20 percent (Chart 1).

While the average rate of growth of exports may have been reasonable, imports have grown at a much faster rate, averaging over 17 percent per year during 1972/73-1985/86 (Table 2). The 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 percent in 1972/73 to 17 percent in 1976/77. From 1977/78 onwards imports expanded at an average rate of 24 percent through 1980/81. Most of the increase came in imports of intermediate goods as the government relaxed controls on these items. In the 1980s the growth rate of imports fell dramatically to less than 2 percent per annum (Chart 1).

The trends in exports and imports resulted in a substantial widening of the trade balance deficit over time. The deficit rose from \$124 million in 1972/73 (2 percent of GNP) to over \$3 billion in 1985/86 (8.5 percent of GNP). A large proportion of this deficit was, however, covered by workers remittances, especially from the Middle East, which rose from about \$136 million in 1972/73 to nearly \$2.6 billion in 1985/86 (see Table 2 and Chart 1). <sup>1/</sup> In 1972/73 workers remittances accounted for about 18 percent of exports, but by 1977/78 this share had risen to 90 percent. 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 in that year. Since then the flow has been declining as activity in the Middle East countries slowed down in the wake of the fall in oil prices. Even so, by 1985/86 workers remittances were close to 88 percent of exports of goods. 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 labor, were the most important steps taken by Pakistan in relaxing the balance of payments constraint. Macroeconomic policies and other structural policies helped, but were nowhere nearly as 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 deficit was only \$126 million in 1972/73, but it deteriorated very rapidly in the next two years. In 1973/74 and 1974/75 it averaged 8.2 percent of GNP--which is large by any standards. Over the period as a whole the current account deficit has averaged about 5 percent of GNP, which is significantly higher than observed for all non-oil developing countries (where the average deficit was 2½ percent).

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<sup>1/</sup> For a description of the trends in workers remittances, and their impact on the Pakistan economy, see Burney (1987).



Capital inflows to Pakistan take mainly the form of official aid. Between 1972/73 and 1985/86 Pakistan had received grants and concessional loans amounting to approximately \$17 billion. Chart 3 shows the annual foreign aid (on a commitment basis) received by the country over the period. Most of the aid flows have come 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 2), but there is evidence of unrecorded private outflows. Khan (1989), for example, argues 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 percent 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 \$1 billion over the six-year period. 1/

Along with the inflow of foreign capital, there has been a steady increase in the debt-service ratio--Chart 4. Over the period as a whole the debt-service ratio has averaged about 25 percent of exports of goods and services (excluding remittances), which is fairly high by international standards. Furthermore, debt-servicing has been growing fairly rapidly in the 1980s. However, as a proportion of foreign exchange earnings, that is merchandise exports plus remittances, debt-servicing has averaged only 13 percent. 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 percent of gross disbursements; by 1984/85 the percentage had fallen to 13 percent. There was a pick-up in disbursements in 1985/86 to \$1.4 billion and total outflows amounted to under \$1 billion. Consequently, the ratio of net transfers to disbursements rose to 24 percent in that year. Total external debt of Pakistan grew steadily from \$4 billion to \$11.1 billion between 1972/73 and 1985/86, or at a rate of about 11 percent a year--slightly less than the rate of growth of exports.

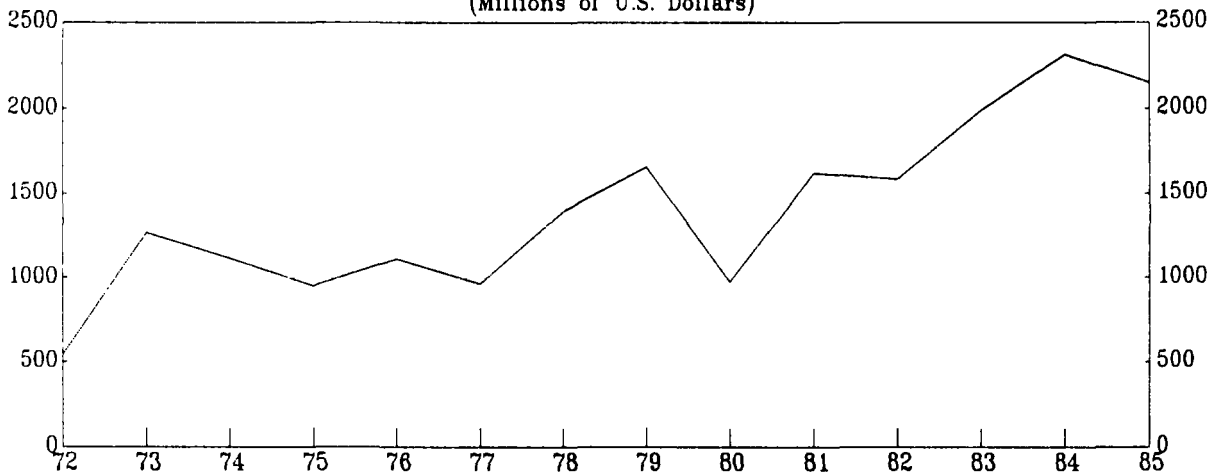
The movements in the ratio of international reserves to imports over the period 1972/73-1985/86 are displayed in Chart 5. It is evident from this chart that there have been considerable fluctuations from year-to-year. Between 1972/73 and 1979/80, total international reserves rose from less than \$300 million to \$1.2 billion. The 1980s saw a large build-up, with international reserves in 1983/84 reaching \$2.8 billion, or nearly 6 months of imports. The following two years there was a significant decline in reserves, although even in 1985/86 international reserves were about 4 months of imports.

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1/ Other estimates, for example by the Karachi Chamber of Commerce, put outflows at \$3-4 billion over a similar period.

**Chart 3**  
**Pakistan: Foreign Aid<sup>1/</sup>**

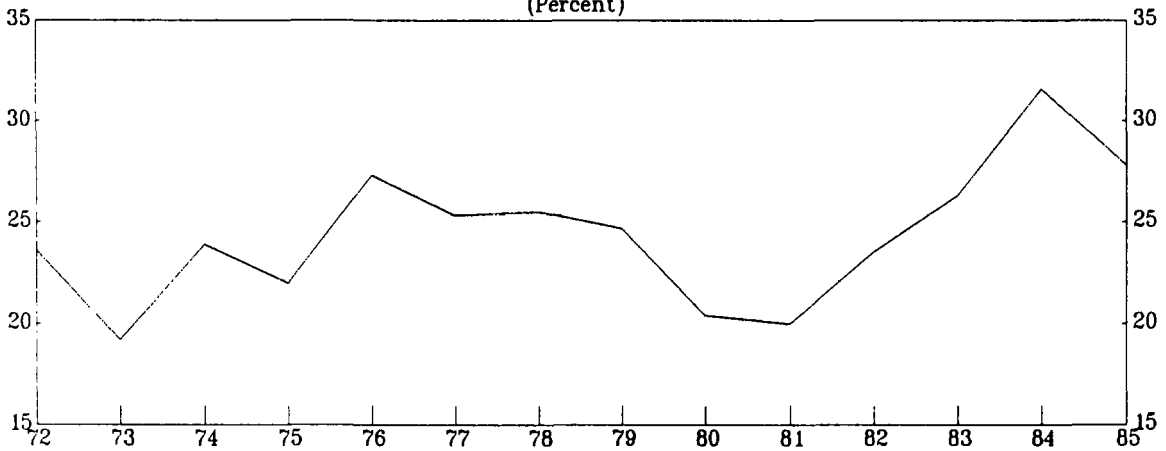
(Millions of U.S. Dollars)



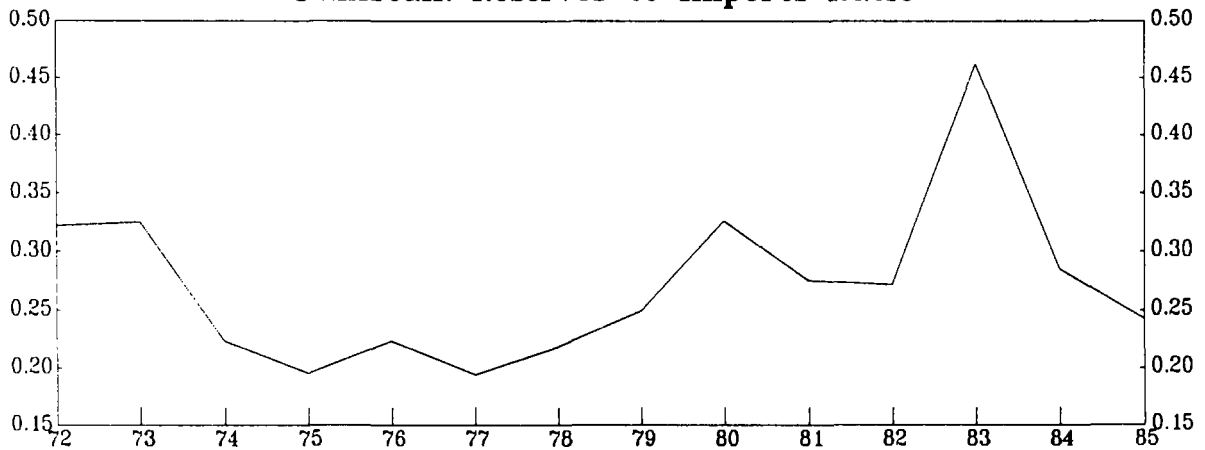
1/ Commitments basis

**Chart 4**  
**Pakistan: Debt Service Ratio**

(Percent)



**Chart 5**  
**Pakistan: Reserves to Imports Ratio**



## 2. Monetary and credit policies

As compared to many developing countries, monetary expansion in Pakistan has not been excessive. Over the period the money supply has grown by about 16 percent, a rate somewhat less than the growth in nominal GNP (Table 3). The income velocity of money rose considerably in the early 1970s, but since 1978/79 has fluctuated between 3-3.5 (Chart 6). Domestic credit, which is the relevant monetary policy instrument, grew at approximately the same rate as nominal GNP (i.e., 18 percent). By and large one could conclude that monetary policy has been fairly restrained during the 1972/73-1985/86 period.

But this does not mean that monetary policy was totally passive. Indeed, active use has been made of monetary policy in correcting external payments problems. In 1973/74-1974/75 the balance of payments came under severe pressure, with the current account deficit in both years over 10 percent 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 percent in 1973/74 the rate of growth of domestic credit was kept under 13 percent.

In order to tighten up credit conditions in the economy and thus limit the loss of international reserves during 1973-74, the government raised the 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 percent (Table 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 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 percent (Table 3). The balance of payments in that year was in deficit to the tune of around \$252 million (Table 2). Similar movements in domestic credit and international reserves flows are evident in other periods as well.

Having established some casual evidence on the link between domestic credit and international reserves in Pakistan, it would appear worthwhile to test this relationship within the context of the monetary approach to the balance of payments. For empirical testing one needs, however, to specify the model underlying this approach more precisely.

Table 3. Macroeconomic Policy Indicators, 1972-86 1/

(In percent)

Period	Growth of Domestic Credit	Growth of Money Supply	Fiscal Deficit <u>2/</u>	Nominal Exchange Rate <u>3/</u>	Real Exchange Rate <u>4/</u>
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
<u>Average:</u>					
1972/73 - 1985/86	17.9	16.3	6.9	--	--

Source: Pakistan Economic Survey, 1986-87.

1/ Data are for fiscal years starting July 1.

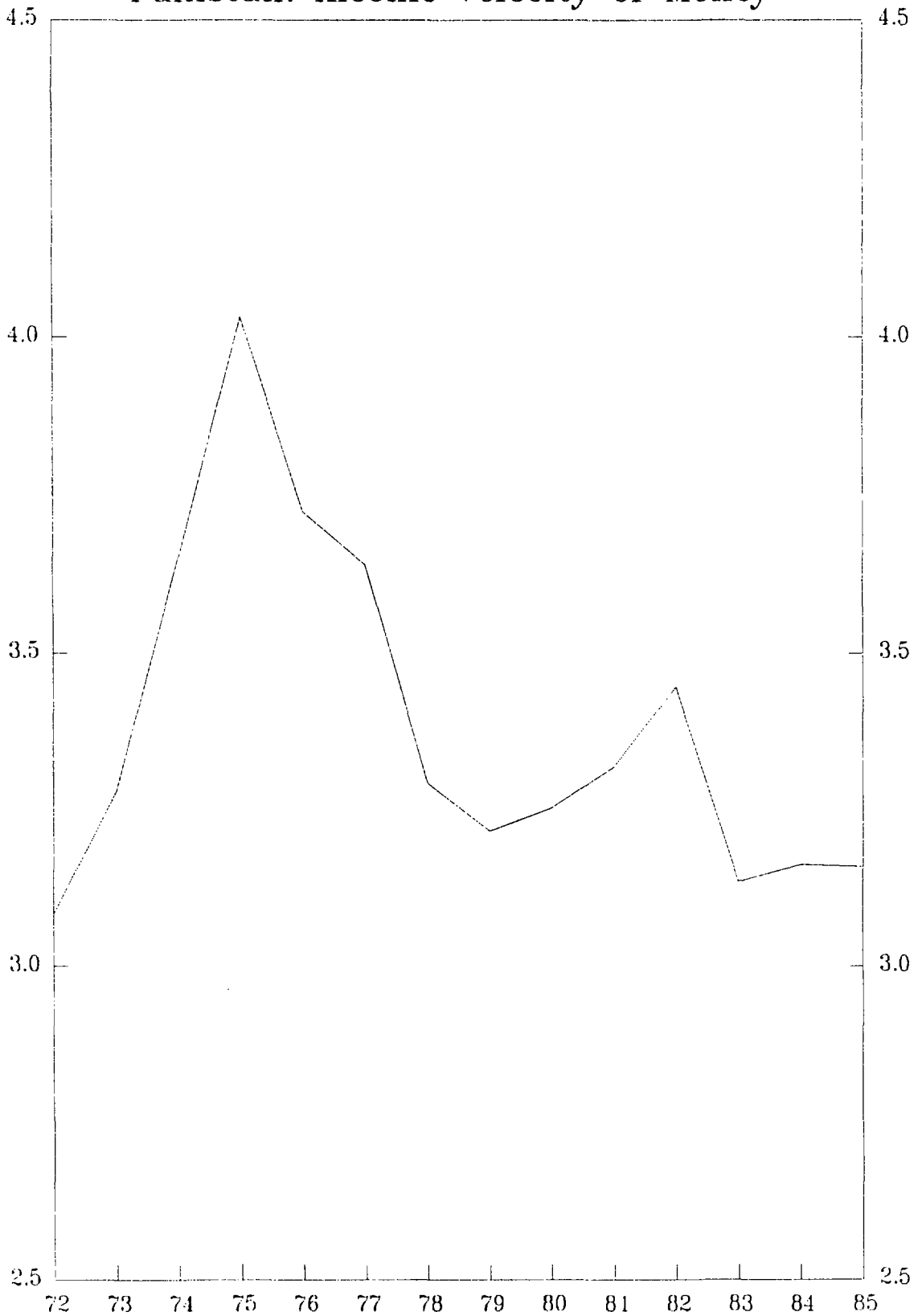
2/ As percent of GNP.

3/ Rupees per U.S. dollar; average for year.

4/ 1980 = 100.

Chart 6

Pakistan: Income Velocity of Money



The monetary approach, as applied to the case of a small open economy operating under a fixed exchange rate, starts with the accounting identity expressing the change in the money stock as the sum of the changes in its international and domestic components:

$$(1) \quad \Delta M = \Delta R + \Delta D$$

where M is the stock of money, R is the domestic-currency value of net foreign assets (international reserves), 1/ D is domestic credit of the banking system, and  $\Delta$  is a first-difference operator. Basically (1) is the balance sheet relationship for the banking system, where liabilities (money) are equal to the sum of foreign and domestic assets.

The second building block of this model is the demand for money. Typically the demand for nominal money balances is related to income, prices, and the opportunity costs of holding money:

$$(2) \quad M^d = f(y, P, \pi)$$

In equation (2) the demand for nominal money balances ( $M^d$ ) is positively related to real income (y) and the price level (P), and negatively to the expected rate of inflation ( $\pi$ ). 2/

The third and final building block is a condition defining flow equilibrium in the money market:

$$(3) \quad \Delta M^d = \Delta M$$

These three components (1), (2), and (3), can be combined to yield an expression relating the balance of payments (change in international reserves) to the difference between the change in the money stock (equal to

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1/ For simplicity it is assumed here that all foreign assets are held by the central bank, so that a change in net foreign assets (R) is equal to the balance of payments of the country. This is a reasonably valid assumption to make for Pakistan.

2/ In countries where alternative financial assets are readily available one would also include the rate of return on these as an additional opportunity cost variable. However, for most developing countries, including Pakistan, the more appropriate specification turns out to be (2), as interest rates seldom turn out to have a statistically significant effect. For evidence on Pakistan, see Hasan, Kadir, and Mahmud (1988).

the change in the nominal demand for money from the equilibrium condition) and the change in domestic credit:

$$(4) \quad \Delta R = \Delta M - \Delta D = \Delta f(y, P, \pi) - \Delta D$$

If the demand for money is independent of changes in domestic credit, that is  $y$ ,  $P$ , and  $\pi$  are exogenous, any increases in domestic credit above the desired increase in money will be offset by decreases in international reserves on a one-for-one basis.

To test the monetary approach one can either estimate reduced-form equation (4) or first estimate the demand for money equation (2), substitute these estimates into equation (1), and then estimate the resulting equation. For the purpose here we chose the latter two-step approach.

A very standard demand for money function was estimated for the period 1972/73-1985/86, and yielded the following results: 1/

$$(5) \quad \log (M/P)_t = - \begin{matrix} 6.971 \\ (6.41) \end{matrix} + \begin{matrix} 1.207 \log y_t \\ (12.39) \end{matrix} - \begin{matrix} 0.005 \\ (2.93) \end{matrix} \overset{\bullet}{P}_{t-1}$$

$$R^2 = 0.961 \quad ; \quad D.W. = 1.84 \quad ; \quad \rho = 0.509 \\ (4.48)$$

As can be seen, the results for the demand for money seem very reasonable--the coefficients have the right signs and are significant at the 1 percent level; the overall fit is good; and serial correlation in the errors has been removed. The sizes of the estimated coefficients also seem plausible, with the long-run income elasticity above unity, as found in other studies for Pakistan. 2/

1/ In the equation  $M$  is the stock of broad money balances ( $M2$ ),  $y$  is real GNP, and  $P$  is the consumer price index. We approximated the expected rate of inflation by the previous period's percentage change in the consumer

price index ( $\overset{\bullet}{P}_{t-1}$ ). T-values are reported in parentheses below the

coefficients;  $R^2$  is the coefficient of determination; D.W. is the Durbin-Watson statistic; and  $\rho$  is the estimated coefficient of first-order autocorrelation.

2/ See, for example, Hasan, Kadir, and Mahmud (1988).

In the second stage we subtracted the fitted values of money balances ( $\hat{M}$ ) from the stock of international reserves (in domestic currency terms), and ran that as a function of domestic credit. The results in first-difference form (and correcting for first-order autocorrelation) were: 1/

$$(6) \quad \Delta(R-\hat{M})_t = 1295.6 \quad - \quad 1.133 \Delta D_t \\ (0.67) \quad (7.87)$$

$$R^2 = 0.872 \quad ; \quad D.W. = 2.10 \quad ; \quad \rho = -0.381 \\ (1.31)$$

The coefficient on domestic credit is not significantly different from unity, thereby verifying the basic hypothesis of the monetary approach to the balance of payments. The results here thus confirm that there is a close link between changes in domestic credit--the principal monetary policy instrument--and the balance of payments in Pakistan. One interesting 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 we would have observed a much weaker relationship between the balance of payments and domestic credit expansion.

### 3. Fiscal policies

The major macroeconomic problem in Pakistan has been the lack of control over fiscal deficits. Over the period 1972/73 - 1985/86 the fiscal deficit averaged nearly 7 percent of GNP (Table 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 of the lack of long-term viability of the balance of payments.

In 1972/73 the fiscal deficit was less than 6 percent 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 defense expenditures, 2/ and that the new government was committed to large-scale development and social programs to improve standard of living of the poorer classes. However, as tax revenues rose by over 20 percent in the year, mainly as a result of the increase in export tax receipts, the fiscal position was not out of hand.

1/ R is the domestic-currency value of net foreign reserves, and D is domestic credit of the banking system. T-values are presented in parentheses below the coefficients;  $R^2$  is the coefficient of determination; D.W. is the Durbin-Watson test statistic; and  $\rho$  is the estimated coefficient of first-order autocorrelation.

2/ In 1972/73 defense expenditure was about 43 percent of total current expenditure and 8 percent of GNP.



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 percent over the previous year) were required for flood relief, repair of flood damage, higher subsidies, wage increases, and for financing an expanded development program. On the other hand, new revenue measures were introduced so that revenues rose by over 40 percent. Nevertheless in 1973/74 the fiscal deficit rose to 6.4 percent 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 fulfill the governments 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 programs. As a result the fiscal deficit shot up to 10 percent of GNP--the highest level ever recorded in the history of the country.

The expansionary fiscal policy in 1974/75 showed up very clearly in the current account position. In the same year the current account deficit was over 10 percent of GNP, with most of the financing for it being 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. <sup>1/</sup> 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 slowly brought deficit down to 8.1 percent of GNP by 1976/77. The Zia government, which negotiated a stand-by arrangement with the IMF, continued with the relatively contractionary fiscal stance. The fiscal deficit was again reduced by close to 1 percentage point of GNP (to 7.4 percent) through a combination of revenue-increasing measures and controlling expenditures. The steady reduction in the fiscal deficit over the period 1975/76-1977/78 was reflected in the current account deficit, which fell from 7 percent of GNP in 1975/76 to 3.2 percent 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 percent 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

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<sup>1/</sup> For example, in 1973/74 the Government of Iran provided a medium-term loan of \$250 million on very easy terms.

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 percent 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 percent of GNP, and the government was unable to achieve a significant or lasting improvement. Expenditures, particularly on defense and on servicing the debt, continued to rise steadily, while revenues stagnated.

The message that comes through this brief discussion of fiscal policies in Pakistan is twofold: first, that fiscal deficits have been large throughout the period; and second, the demand pressures created by fiscal deficits have not shown up in inflation, but rather in current account deficits. The close correspondence between fiscal and current account deficits in Pakistan is evident in Chart 7. With the exception of possibly of one year (1982/83) changes in the fiscal deficit to GNP ratio were matched by changes in the same direction of the current account deficit to GNP ratio.

This relationship between fiscal deficits and current account deficits can be formally tested. We start from a basic national accounting identity defining the current account balance:

$$(7) \quad CA = (Sp - Ip) + FB$$

where CA is the current account balance, Sp and Ip are private savings and investment, respectively, and FB is the fiscal balance (equal to government savings minus government investment).

We can use a life-cycle concept for determining private savings: 1/

$$(8) \quad \frac{Sp}{Y} = \alpha \dot{y} \quad \alpha > 0$$

and a variant of the simple accelerator model for private investment:

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1/ See, for example, Lahiri (1988). Of course this specification is highly simplified, but it is not the purpose here to model savings behavior in any detail.

$$(9) \quad \frac{I_p}{Y} = \beta \dot{y} \quad \beta > 0$$

where Y is nominal GNP, and  $\dot{y}$  is the rate of growth of real GNP.

Expressing (7) in terms of ratios to nominal GNP, and substituting for private savings and investment, we obtain:

$$(10) \quad \frac{CA}{Y} = \alpha_0 + (\alpha - \beta) \dot{y} + \gamma \frac{FB}{Y}$$

where  $\alpha_0$  is a constant and  $\gamma$  is a positive parameter. Equation (10) yields a direct relationship between the current account and fiscal deficits, and also implicitly tests whether there is any indirect relationship via the excess of private savings over investment. 1/ If  $\gamma < 1$  then it can be argued that some part of the effect of a fiscal deficit is offset by a change in private saving or investment. On the other hand if  $\gamma = 1$  there is no such offset.

The results from estimating equation (10) for the period 1972/73-1985/86 were: 2/

$$(11) \quad \frac{CA_t}{Y} = -2.800 + 0.607 \dot{y}_t + 0.869 \frac{FB_t}{Y}$$

(0.83)      (1.95)      (2.85)

$$R^2 = 0.551 \quad ; \quad D.W. = 2.20$$

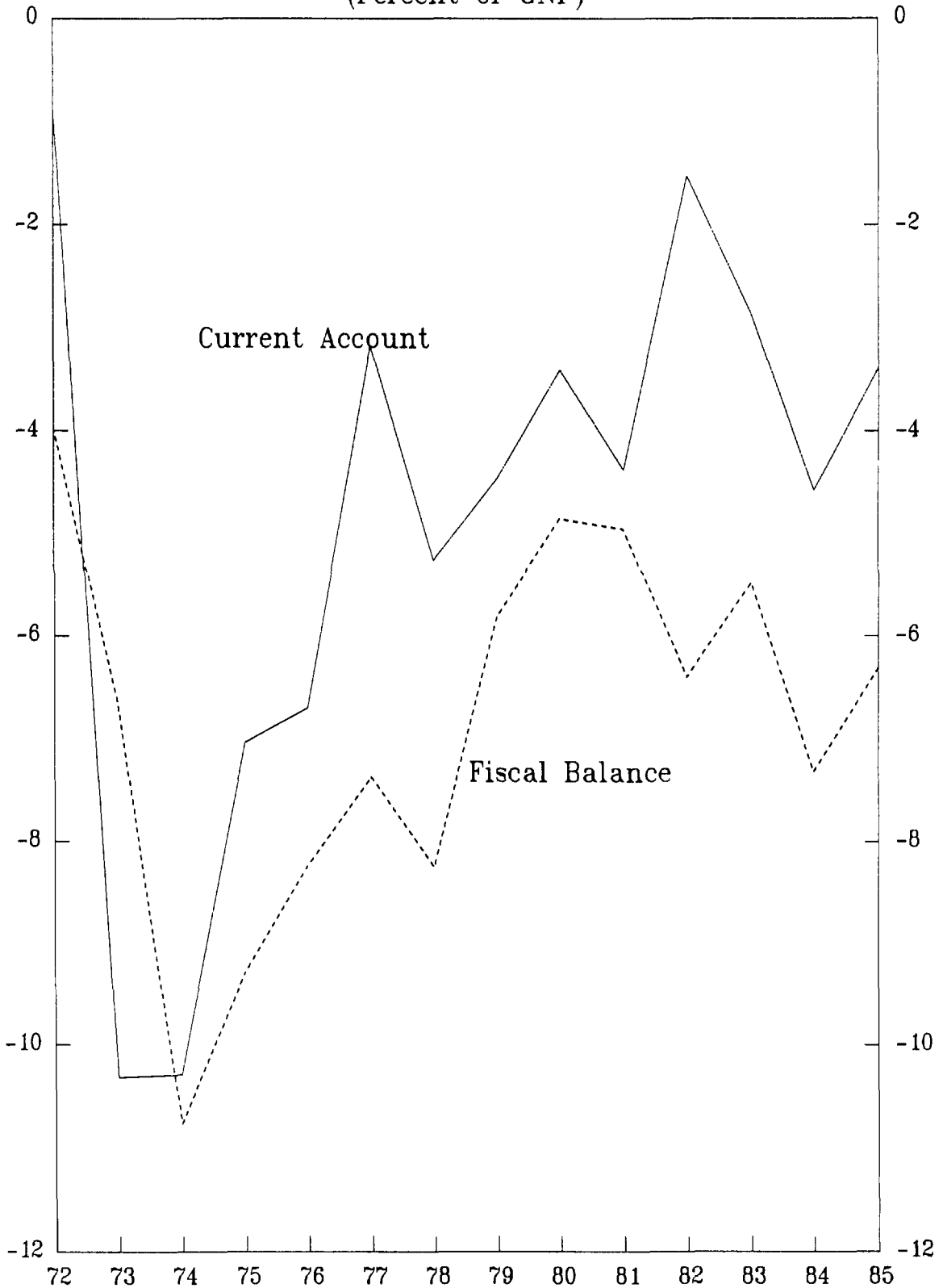
These results indicate that, while the fit is not very good, 3/ the coefficient relating the current account and fiscal balances is not

1/ For a discussion of the indirect effects of fiscal deficits on private savings, see Haque (1988) and Haque and Montiel (1989).

2/ The variables are defined in the text. T-values are reported in parentheses below the coefficients;  $R^2$  is the coefficient of determination; and D.W. is the Durbin-Watson test statistic.

3/ Obviously there are omitted variables, such as the exchange rate, terms of trade, etc., from the specification, so that one would not expect a particularly close fit. See Khan and Knight (1983) for a more general specification of the current account equation for developing countries.

Chart 7  
Pakistan: Current Account and Fiscal Balances  
(Percent of GNP)



significantly different from unity. Thus, it can be argued that a percentage point improvement (worsening) in the fiscal position will result in an equivalent improvement (deterioration) in the current account balance, and that there is no offsetting response from the private sector.

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 frequently Pakistani governments have resorted to borrowing from the banking system to finance fiscal deficits.

This hypothesis can be easily tested by running a simple regression relating changes in domestic credit to the fiscal deficit. The results were: 1/

$$(12) \quad \Delta D_t = -1317.3 + 0.886 FD_t \\ (0.54) \quad (7.35)$$

$$R^2 = 0.818; D.W. = 2.10$$

These results tend to confirm the view that the fiscal position has a lot to do with domestic credit expansion. The coefficient implies that a unit increase in the fiscal deficit will lead to about a 0.9 unit increase in domestic credit. At the same time, however, the relationship between the change in the money supply ( $\Delta M$ ) and the fiscal deficit is weaker because of offsetting movements in foreign reserves. The results for the relationship are:

$$(13) \quad \Delta M = -1304.1 + 0.573 FD_t \\ (0.43) \quad (13.85)$$

$$R^2 = 0.553; D.W. = 2.37$$

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1/  $\Delta D$  is the change in domestic credit and  $FD$  is the fiscal deficit. T-values are reported in parentheses below the coefficients;  $R^2$  is the coefficient of determination; our D.W. is the Durbin-Watson test statistic.

#### 4. 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 U.S. dollar through December 1981; and (b) adoption of managed floating from January 1982. <sup>1/</sup>

On May 12, 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 U.S. dollar (a depreciation of about 130 percent). This devaluation resulted in a depreciation of the real effective exchange rate of nearly 62 percent. Given that the exchange rate was considered sacrosanct in Pakistan policymaking 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 U.S. dollar for nine years (Chart 8). The real exchange rate, however, did fluctuate--appreciating by some 20 percent 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 U.S. dollar with respect to the currencies of Pakistan's major trading partners. The following year the real exchange rate depreciated by about 7.5 percent, and in 1979/80 further by nearly 2 percent (Chart 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 about 10 percent in 1981/82.

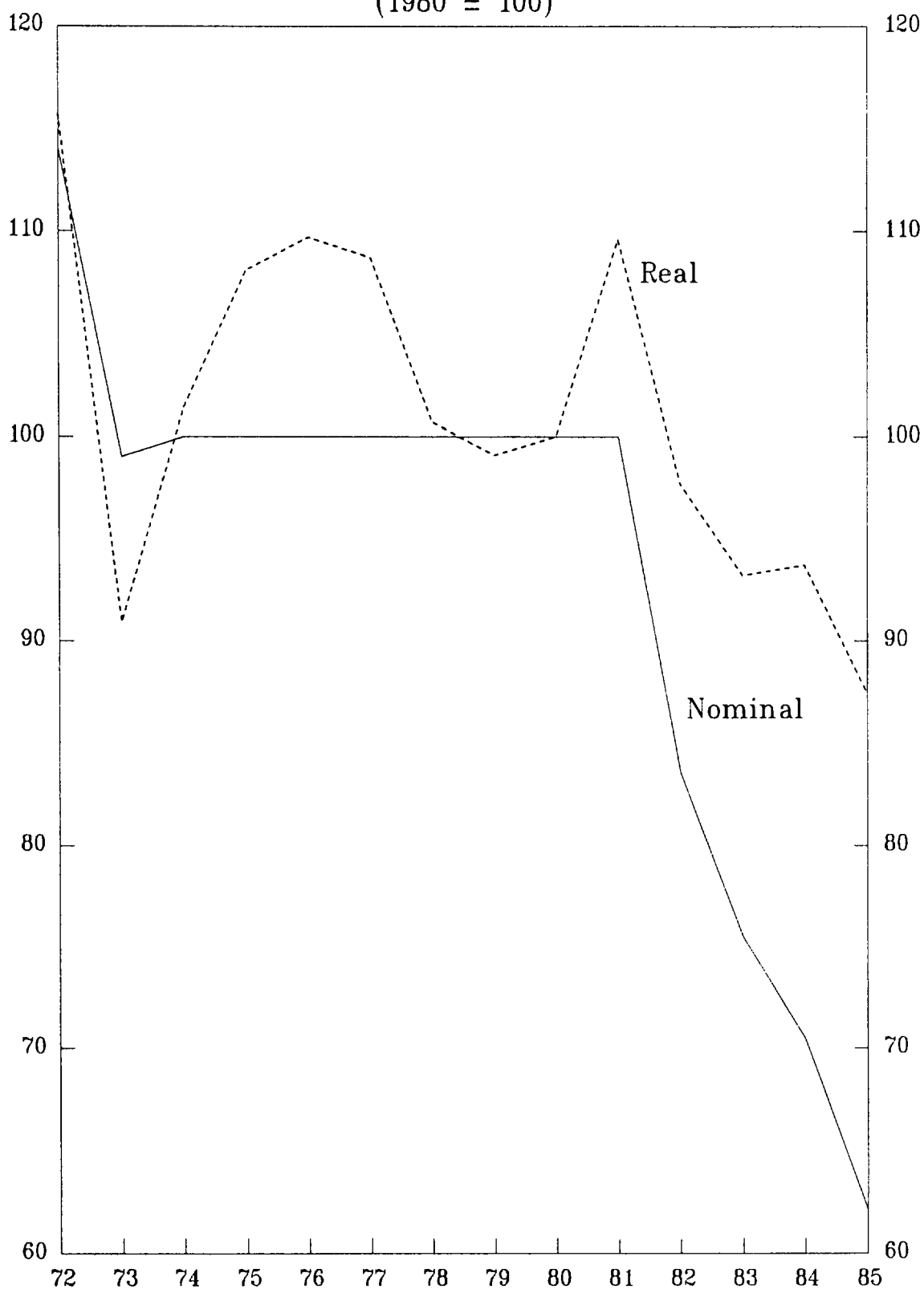
The devaluation in 1972 was accompanied by some liberalization and simplification of the existing import control regime. Restrictions on current payments, particularly for foreign travel, were also relaxed. <sup>2/</sup> On the export side, however, in order to avoid windfall profits for exporters from 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.

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<sup>1/</sup> For a discussion of Pakistan's exchange rate policy see Khan (1986).

<sup>2/</sup> See Kemal (1987a) for a description of the changes that were implemented.

Chart 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, mainly as a result of Fund advice, the system remained highly restrictive as regards consumer goods. The Zia government announced its commitment to an open trading system, but proceeded very cautiously in doing anything to achieve this objective. In 1977/78-1978/79 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. <sup>1/</sup> 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 percent 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 1985/86, with any changes being marginal.

There were, however, significant 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 U.S. dollar--"de-linking" was the term used--and adopted a more flexible exchange rate policy that allowed for frequent small changes according to an undisclosed rule. <sup>2/</sup> With de-linking, the rupee depreciated by nearly 20 percent in 1982/83 and by a further 11 percent in the following year (Chart 8). Correspondingly, the real effective exchange rate depreciated by 11 percent and 4.6 percent in those two years. A substantial improvement was evident in the current account position. In 1982/83 the current account deficit was only 1½ percent 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 percent 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.

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<sup>1/</sup> The highly restrictive nature of the import regime became apparent when the government compiled a list of imports that were banned. This list covered more than 6000 items, even though it was evident that for a large number of them there was apparently no domestic demand.

<sup>2/</sup> See Khan (1986).



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 does indicate the relative-price (or exchange rate) responsive of imports and exports. For example, Tirmazi (1987), 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. Also, Sarmad and Mahmood (1987) estimated equations for various categories of imports for the period 1969/70-1983/84, and found that the relative-price elasticities were statistically significant for a number of these categories, including total imports.

The relationship between worker's remittances and the real exchange rate can be tested by running a simple regression relating the ratio of remittances to exports (REM/X) to the percentage change in the real effective exchange rate (RER) over the period 1974/75-1985/86. The results of this estimation are: 1/

$$(14) \quad \text{REM/X}_t = 76.535 - 2.767 \text{ RER}_t$$

(11.73)      (2.77)

$$R^2 = 0.435 \quad ; \quad \text{D.W.} = 1.34$$

These results basically confirm the hypothesis that an appreciation (depreciation) of the real exchange rate will reduce (increase) the inflow of worker's remittances. 2/ While there are undoubtedly a host of other factors--both economic and political--that affect how much foreign exchange workers abroad will send back to the country, the change in the real exchange rate, which implicitly reflects the government's current exchange rate policy as well as providing an indication of what future policy might be, also plays an important role. For example, an appreciation today in the real exchange rate may signal a nominal devaluation in the future, and this would provide workers abroad with an incentive to delay remitting funds home.

1/ T-values are reported in parentheses below the coefficients;  $R^2$  is the coefficient of determination; and D.W. is the Durbin-Watson test statistic.

2/ Note that we consider only remittances received through banking channels. Unrecorded remittances would also be expected to be equally sensitive to exchange rate changes.

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, particularly since 1982.

#### IV. Conclusions

The principal macroeconomic policy concern of the Pakistani governments in the fifteen-year 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 policymaking. 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 policymakers 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 1986.

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 short-lived as the State Bank moved quickly to curb the expansion. Basically, 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. We have found that over the period 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, we observe that the government did tighten monetary policy when faced with an actual, or potential, reserve loss.

On the exchange rate front policymakers in Pakistan were initially reluctant to use the exchange rate as a policy instrument. After the major devaluation in 1972 the rupee was kept fixed to the U.S. 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 obviously changed in January 1982 when a managed floating rate system was adopted, and since then the exchange rate has been adjusted periodically. Our analysis has challenged the view that the exchange rate would not affect the components of the current account of Pakistan. Indeed we found exports, imports, and workers' remittances to 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. Our 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 been eased, even in the face of the various adverse external shocks the country experienced.

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 percent 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 its revenue needs. In 1973/74 the share of direct taxes in total revenues was about 14 percent, almost exactly the same as in 1985/86.

On the government expenditure side, the major share of current expenditures, approximately 35-40 percent, has been going to defense. In recent years interest payments on external and domestic debt have loomed larger. Between 1975/76 and 1985/86 the share of interest payments in

current expenditures rose from 12 percent to about 20 percent. <sup>1/</sup> Since defense and debt-service payments were regarded as fixed obligations by the government, and with large-scale development expenditures necessary to build infrastructure, the government found itself having to continually increase spending while revenues stagnated. Fiscal deficits were thus a normal outcome, and these were reflected primarily in chronic current account deficits.

Since monetary and exchange rate policies were not used aggressively, and with rare exceptions, fiscal policy remained expansionary, quantitative controls on imports and capital became essential for balance of payments reasons. While there is evidence of a trend towards external liberalization over the 1971-1986 period, it is a very gradual one. Throughout this period Pakistan remained a fairly regulated economy, and most trade and capital transactions had to be conducted under government sanction. The main reason why governments continued to maintain controls was that many of the key policymakers were unconvinced of the merits of an open trading system, and even those that were persuaded, advocated a cautious approach to liberalization on grounds that sudden and large changes would prove extremely detrimental for the economy. The fact that these trade and payments controls apparently did not have any obvious adverse effects, at least from the point of view of macroeconomic performance, raises a question of how binding these controls have been, particularly in more recent years. This question certainly deserves study.

In general, many of the macroeconomic problems that Pakistani governments have faced since 1972 still remain. The balance of payments continues to be persistently weak, with trade and services subject to external shocks; the fiscal situation is not sustainable; and regulations and controls give the trade system an anti-export bias. As long as foreign financing is available these problems can be managed, but at the expense of a rising debt burden and larger debt-service payments. Many would argue that the country has reached, or even passed, sensible limits of debt and debt-servicing capacity.

If one believes that ready access to foreign financing is now coming to an end, then clearly changes have to be made. In our view putting the fiscal house in order and restoring financial stability is an absolute must. Fiscal reforms that generate revenues to meet the necessary increases in government expenditures in the future need to be undertaken. Increased collections of existing taxes will help, but new taxes--both direct and indirect--will need to be imposed. Undoubtedly there are political costs to be incurred in putting in place additional taxes, but there are political costs to cutting expenditures as well, which is something that would have

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<sup>1/</sup> In a sense the fiscal deficits became almost self-perpetuating in nature. Increased fiscal deficits were financed by external and domestic borrowing, and the interest payments on the increased stock of debt led to additional expenditures and further deficits.

to be done in the absence of additional revenues. But increasing public savings needs to be complemented with raising private savings in Pakistan as well. At present the rate of private savings is very low, and there is no definitive explanation of why Pakistanis save so little. It could be cultural factors--there is a view that Pakistani's tend to be too consumption-oriented--or demographic factors, or the lack of suitable savings instruments. Whatever the reasons, ways need to be found to generate additional domestic private savings to compensate for the expected declines in foreign financing.

Exchange rate policy should continue to be conducted in a way that maintains the country's competitiveness and offers exporters incentives to expand and diversify their production. Dependence on a few export products makes the economy very vulnerable to shifts in world demand, terms of trade changes, as well as to domestic shocks, such as floods. Furthermore, by making more active use of the exchange rate would allow a relaxation of the import controls and reduce the extent of unproductive rent-seeking activities that have accompanied the existing system. An initial step in the liberalization direction would be to replace quotas and import licensing schemes with tariffs. This shift would also benefit the fiscal position as the government would have an additional source of revenues.

In conclusion, the record of macroeconomic policies in achieving their primary objective of balance of payments improvement is a mixed one. While there were some successes, these were dissipated fairly soon. Although there were adverse external developments, the Pakistan economy has had a fair share of good fortune--the oil price shocks of 1973 and 1979 led to large inflows of remittances; the Afghan war that increased the level of foreign aid; and favorable weather conditions in the 1980s. In retrospect, it would also appear that the steps taken by the Pakistan government in the early 1970s to make it easier for workers to go abroad, particular to the Middle East, and the cultivation of the Arab countries that led to employment opportunities as well as financing, proved to be a very far-sighted policy decision. The gains to the economy from this one policy probably outweigh the effects of all other factors. For example, over the period 1973-86, workers' remittances amounted to over \$20 billion, even larger than total foreign aid (grants and concessional loans). This combination of luck and adept foreign policy certainly eased the pressure on policymakers to make major economic adjustments in the past. 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. Indeed, the fall of in growth more recently is a cause of serious concern to the authorities, and accordingly wide-ranging structural reforms to restore the growth rate are being put into place.

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