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Pakistan's Economy: The Boom Is Likely To End

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An Intelligence Assessment

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This paper was written by [redacted] Office of Near Eastern and South Asian Analysis, [redacted] Comments and queries are welcome and should be directed to the Chief, South Asia Division, NESA [redacted]

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Pakistan's Economy: The Boom Is Likely To End

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Key Judgments

Information available as of 1 February 1988 was used in this report.

Pakistan's overall economic growth has been impressive in the decade since President Zia assumed power. Among low-income countries, only China has surpassed Pakistan's average real increase of 6.8 percent per year in GNP. In the midst of this rapid growth, Pakistan has avoided the severe international debt and payments problems plaguing many other developing countries. Factors beyond the control of Pakistani officials—including high worker remittances, large amounts of foreign assistance, favorable world commodity prices, and good weather—were the major contributors to the country's economic success.

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Pakistan's relative prosperity masks major gaps in its social and economic development:

- Large government budget deficits, sparked by growing defense spending and outlays for interest payments on domestic debt at the same time that the government is loath to impose taxes on agricultural income.
- Domestic savings and investment that are too low to sustain rapid economic growth over the long term.

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Pakistan's economic performance is likely to deteriorate before 1990. Worker remittances are likely to decline as employment opportunities and wage rates in the Gulf states shrink. Textile exports will level off as they bump against import quotas. Islamabad will have to make difficult choices between curbing government spending and raising taxes if it is to contain the government's deficit. Increasing political party activity leading to elections scheduled for 1990 and ethnic rivalries will make businessmen and policymakers less willing to take the risks required to sustain high economic growth.

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Islamabad most likely will be able to cope with the increasing strains without an abrupt balance-of-payments crisis or unacceptable political instability, but with increased unemployment, shortages, and inflation. Pakistan's foreign payments position is most vulnerable, forcing policy responses that will probably limit longer term development prospects. Faced with increased uncertainty about import and credit restrictions, private investors will proceed more cautiously in implementing their investment plans, slowing real GDP growth by 1990 to less than 3.5 percent a year. As the slowdown spreads to labor-intensive sectors, the unemployment rate would rise—perhaps exceeding 8 percent in urban areas.

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Although less likely, there is a 1-in-3 chance of a severe downturn that would probably begin with international financial problems. In this scenario, import shortages and loss of confidence by domestic investors would lead to a marked slowdown in manufacturing. Ethnic and regional grievances would intensify economic troubles and ultimately might lead to political protest and violence. We would not rule out a return to martial law.

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We see some, although much slimmer, likelihood that Pakistan could achieve sufficient export growth to permit an increase in foreign exchange reserves and relatively high economic growth. Islamabad would have to implement more economic reforms than it has so far and depend on good luck with world prices and weather. Under these circumstances, private investors would be more willing to expand capacity or undertake new ventures.

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A gradual economic deterioration would probably not entail fundamental changes in Pakistan's relations with the United States over the next couple of years or affect US interests in regional stability. Islamabad, however, will look to Washington for help in coping with the economic slowdown. As Pakistan's largest creditor, the United States would have a major role in shaping any financial relief. Should the United States cut or substantially reduce its aid to Pakistan, Islamabad would be in much greater danger of facing a foreign exchange shortage. The United States almost certainly would be made the scapegoat for severe economic troubles, whether or not they were triggered by a US aid cutoff.

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Pakistan's Economy: The Boom Is Likely To End

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Impressive Economic Gains

Rapid Growth. Pakistan's overall economic growth has been impressive in the decade since President Zia assumed power. Among low-income countries, only China has surpassed Pakistan's average real increase of 6.8 percent per year in GNP, according to World Bank data. Even with rapid population growth, real GNP per capita has increased 3.6 percent per year to $330 at present, enough to permit a noticeable increase in the availability of basic consumer goods and to provide more luxury items.

Agricultural successes have provided indispensable support for the expanding economy. Crop output, though occasionally depressed by bad weather and pests, has averaged a satisfactory 4.8-percent annual growth in real terms, according to official Pakistani statistics. Acreage and yields have increased for wheat—the main food crop—and new seed technologies and the larger area under cultivation produced bumper cotton harvests—the main export crop—during the past three years. These gains had a ripple effect in other sectors because agriculture employs more than half the work force, provides a substantial portion of raw materials for domestic industry, and, in normal years, accounts for about 60 percent of export earnings.

Small-scale industries also have been booming. According to a fiscal year 1983 Pakistani Government survey, these industries grew 9.4 percent in real terms.[1] Because Pakistani statisticians projected the growth rate to continue during the past four years, government statistics indicate that small-scale industries now account for 30 percent of manufacturing output and 80 percent of employment in manufacturing. The gains include a wide variety of production for the domestic market, as well as rapid expansion of garment production for export. Planning Minister Mehbub-ul Haq, who in 1968 dramatized the lack of small firms by noting the economic dominance of 22 families, observed in 1983 that Pakistan had developed more than 22,000 small, enterprising, labor-intensive businesses.

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Larger private firms, although less dynamic than the small-scale sector, helped maintain a satisfactory rate of industrial growth, compensating for a targeted decline of $1.1 billion in public-sector investment in manufacturing during the 1983-88 Five-Year Plan compared with the previous five-year plan. Most of the leading business houses were still implementing ambitious expansion plans in early 1987. In addition, crude oil production—two-thirds generated by private firms—has more than tripled to 42,000 barrels per day since 1984, supplying one-fourth of domestic petroleum consumption.

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Satisfactory Balance of Payments. In the midst of this rapid growth, Pakistan has avoided the severe international debt and payments problems plaguing many other developing countries. Infusions of US aid following the Soviet invasion of Afghanistan and remittances from Pakistanis working in the Gulf states helped cover chronic trade deficits. Recently, Pakistan has benefited from an increase in the volume of its textile exports and an inflow of private bank deposits. Imports, more than twice as large as exports as recently as fiscal year 1986, were only 1.6 times as large as exports in fiscal year 1987 because of falling world prices for major imports, such as petroleum and fertilizers. Even during temporary troubles—following the international oil price increases of 1979-80, and in 1984 when pests and bad weather reduced cotton exports—Islamabad has avoided imposing additional import controls that would have hampered the economy.

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[1] Pakistan's fiscal year ends on 30 June. Fiscal year 1983 refers to a one-year period beginning on 1 July 1982.

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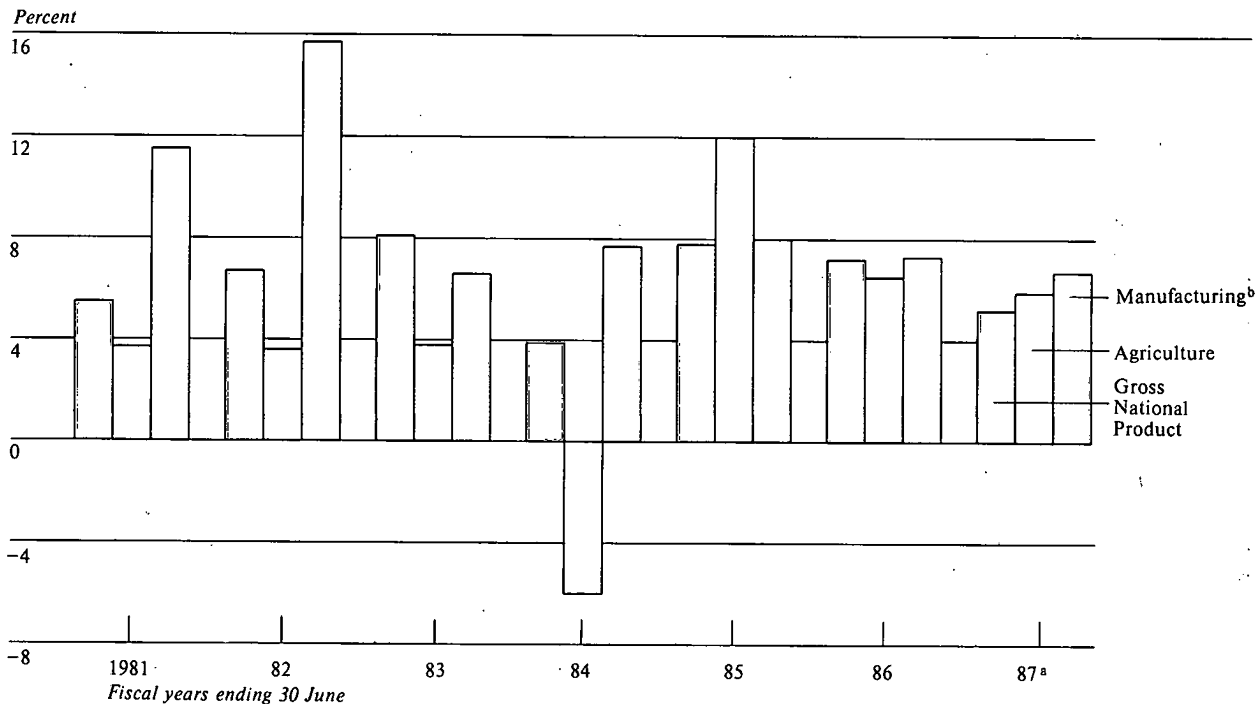
Figure 1
Pakistan: Annual Growth Rates, 1981-87



[a] Estimate.
[b] Large and medium-scale units.

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Afghan Refugees: Not a Burden. We believe the benefits to the Pakistani economy, particularly in the North-West Frontier Province and Baluchistan, in the past few years have matched, and perhaps exceeded, the cost of caring for the roughly 3 million Afghan refugees. An economic boom generated by the inflow of aid funds has created new jobs for Pakistanis. Some 6,000 Pakistanis work in the North-West Frontier Province to assist in the administration of refugee camps, according to the US Consulate in Peshawar. Several hundred more jobs have been created by private voluntary organizations, often at salaries higher than those paid by Pakistani employers.

The refugees' willingness to work for low wages at unskilled or seasonal jobs has benefited Pakistani employers. Refugees routinely accept 15 to 25 rupees—90 cents to $1.50—per day for unskilled work, while Pakistani laborers seek as much as 30 rupees—$1.80—per day, according to a UN High Commission for Refugees report. Afghan masons, carpenters, and day laborers substantially undercut established wage scales, sometimes by 20 to 40 percent, according to a Baluchistan official.

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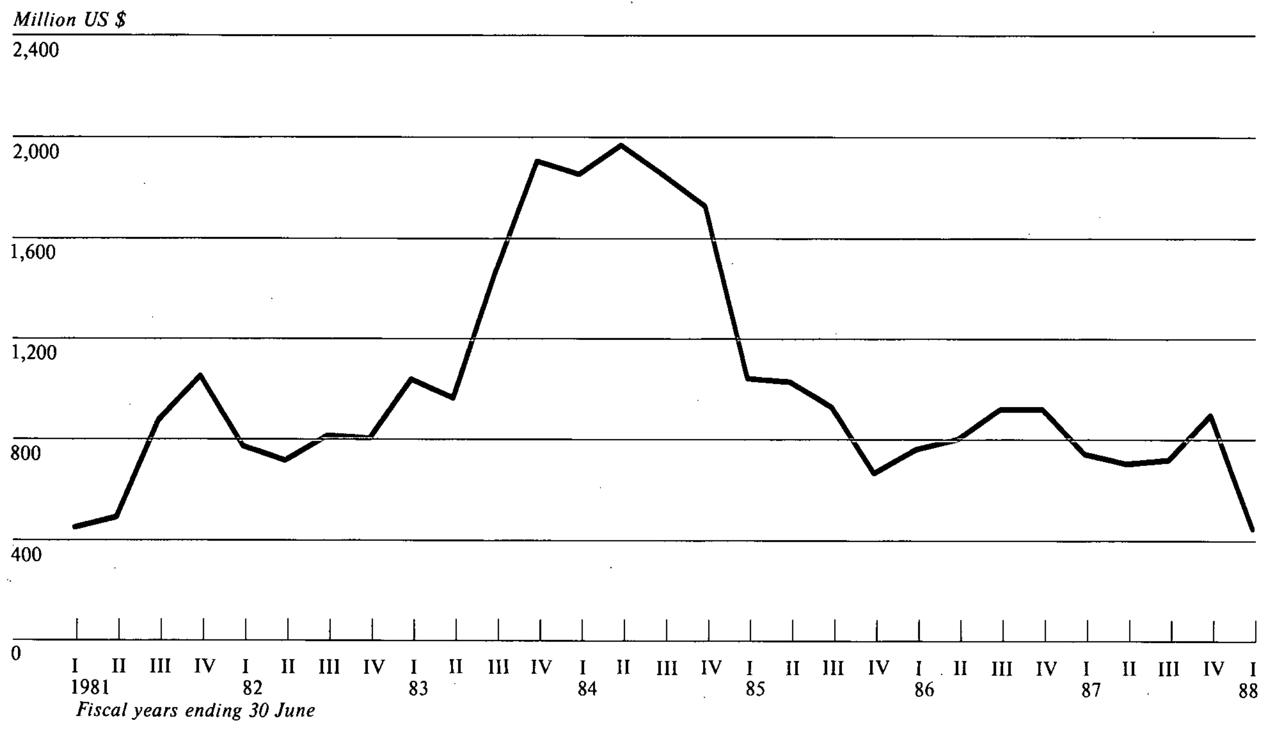
Figure 2
Pakistan: International Financial Reserves, 1981-88 [a]



[a] End of period.

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Pakistani landlords, particularly in Peshawar, have reaped windfall profits from soaring rents caused by the influx of refugees, wealthy Afghan businessmen, and officials of relief agencies. On the basis of conversations with tenants and landlords, officials of the US Consulate in Peshawar report that residential rents have risen by as much as 500 percent since 1979. New construction abounds, with lots once considered suitable for a single residence now subdivided to accommodate three or four houses.

the boomtown look of many frontier cities is caused mostly by profits obtained by corruption in the distribution of refugee relief. Legitimate commercial activity generated by the refugees represents only a small part of the frontier economy, according to the US Consulate in Peshawar. Press reports claim that Pakistani administrators in refugee camps regularly charge up to $100 for new ration cards, which are supposed to be given to the refugees at no cost. Other press accusations include charges that Pakistani middlemen control nearly all aid-related distribution and use their influence for personal gain.

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Table 1
Pakistan: Foreign Payments, FY 1982-87 [a]

Million US $

	1982	1983	1984	1985	1986	1987 [b]
Trade balance	−3,450	−2,989	−3,324	−3,552	−3,042	−2,292
Exports, f.o.b.	2,319	2,627	2,669	2,457	2,942	3,539
Imports	5,769	5,616	5,993	6,009	5,984	5,832
Services balance	1,678	2,279	1,986	1,626	1,582	1,294
Of which:						
Interest payments [c]	−416	−425	−585	−529	−593	−650
Worker remittances	2,225	2,886	2,737	2,446	2,595	2,300
Private transfers	163	153	307	241	226	250
Current account deficit	−1,609	−557	−1,031	−1,685	−1,234	−749
Principal repayments [d]	−649	−501	−599	−740	−1,138	−1,100
Aid disbursements [e]	1,855	1,843	1,207	1,256	1,528	1,466
Other, net	154	316	245	109	1,099	358
Change in reserves	−249	1,101	−178	−1,060	255	−25

[a] Data for fiscal periods ending 30 June of the stated years.
[b] Estimated.
[c] Excluding military payments and some interest paid on suppliers' credit.
[d] Includes IMF repurchases; excludes military debt service.
[e] Includes debt relief and IMF credits.

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Causes of Success

External Factors. In our judgment, factors beyond the control of Pakistani officials—including high worker remittances, large amounts of foreign assistance, favorable world commodity prices, and good weather—were the major contributors to the country's economic success. As a result, Pakistan has had the income and foreign exchange that allowed consumption to increase substantially. Remittances from Pakistanis working in Middle Eastern oil-exporting countries, which peaked at $2.9 billion in fiscal year 1983, have more than compensated for the increased cost of petroleum imports. We estimate 1.8 million Pakistanis had jobs in the Middle East in 1985, and in some years their remittances brought in more foreign exchange than was obtained through merchandise exports. Overseas employment eased the problem of finding productive jobs for a labor force growing at 3 percent a year. Aid disbursements averaging $1.5 billion in recent years provided valuable foreign exchange, and good weather—except for the drought in 1984—boosted agricultural output. 25X1

Falling world commodity prices have helped contain Pakistan's import bill in the latter half of the decade. In the early 1980s, petroleum and fertilizers accounted for more than one-third of total import value compared with 18 percent now. Increased domestic crude production also permitted a slight reduction in the volume of oil imports. The price of imported fertilizer has fallen by 22 percent since the early 1980s. Although world prices for edible oils and tea—Pakistan's other major imports—surged in fiscal years 1984 and 1985, they have declined during the past

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two years. Public-sector trading organizations contributed to government coffers by not passing along the lower prices of petroleum and edible oils to Pakistani consumers, according to US Embassy reporting.

Ironically, textile quotas imposed by industrial countries helped spur Pakistan's garment export industry during this decade. We believe low-quality Pakistani exports that might not have been competitive gained entry into industrial countries' markets because of quantitative restrictions imposed on major competitors like Hong Kong and South Korea. As a result, Pakistani clothing exports have quadrupled from $103 million in 1980 to $463 million in 1986, according to government statistics. Cotton yarn exports have also been booming recently, partly because competing producers such as China have been diverting yarn from export markets for use in their own textile industry. At present, Pakistan is also benefiting from rising world prices for cotton because droughts have limited output by some major producers.

Economic aid receipts—$1.5 billion in each of the last two years—have also been indispensable to Pakistan's economic success. During the past several years, aid receipts have been equivalent to roughly two-thirds of the government's development expenditures. The World Bank overtook the United States in 1987 as Pakistan's largest donor (US military support is excluded), providing $406 million—more than one-fourth of the country's aid receipts, according to Pakistani Government estimates.[2]

Foreign aid not only supports specific programs and projects but also eases general foreign exchange shortages and provides revenue to the government. General balance-of-payments support accounted for 6 percent of aid receipts in fiscal year 1985. Moreover, when aid funds are used to meet the domestic costs of projects, foreign exchange becomes available for other uses. Islamabad also obtains local currency for discretionary spending by selling commodities, such as fertilizer and edible oil, that have been imported with foreign aid funds.

[2] Although gross economic aid receipts are large, net receipts per capita, according to World Bank data, are among the lowest in the world, a reflection of Pakistan's large population and high principal repayments.

Policy Initiatives. Economic conditions imposed by aid donors have played a small role in Pakistan's economic successes by promoting policy reforms, in our judgment. For example, a World Bank requirement that the public-sector power authority finance internally at least 40 percent of its development costs led to an increase in user fees that will prompt energy conservation. Donor influence on policy, however, is limited. Islamabad has declined World Bank and International Monetary Fund (IMF) loans that would have required substantially higher taxes and fees or exposed domestic industries to more competition.

Pakistan's own policy moves to attract foreign funds, to allow the rupee to depreciate, to maintain agricultural incentives, to control unions, and to loosen restrictions on the private sector have helped ease foreign payments strains and promoted growth in recent years. In mid-1985, Islamabad issued several types of tax-free, zero-coupon bearer bonds yielding as much as 17 percent a year. Foreign exchange bearer certificates garnered $148 million during the first year they were available, according to the IMF. Since then, net receipts have slowed considerably. High interest rates during fiscal year 1986 also attracted $480 million in foreign currency deposits from commercial banks abroad.

Depreciation of the Pakistani rupee against the currencies of major European trading partners and Japan has helped promote Pakistani exports, particularly since early 1985, by making them more competitive. After a weak balance-of-payments performance in fiscal year 1985, Islamabad decided to let the rupee move down with the dollar against other currencies. The floating rate for the rupee is now managed with reference to several currency baskets and bilateral rates. Between January 1982 and March 1987, the real effective exchange rate had depreciated by 37 percent against the currencies of industrial countries, according to IMF data. Despite the higher local currency cost of imports, domestic inflation was only moderate during this period because the availability of basic food items increased and the government intervened to regulate many prices.

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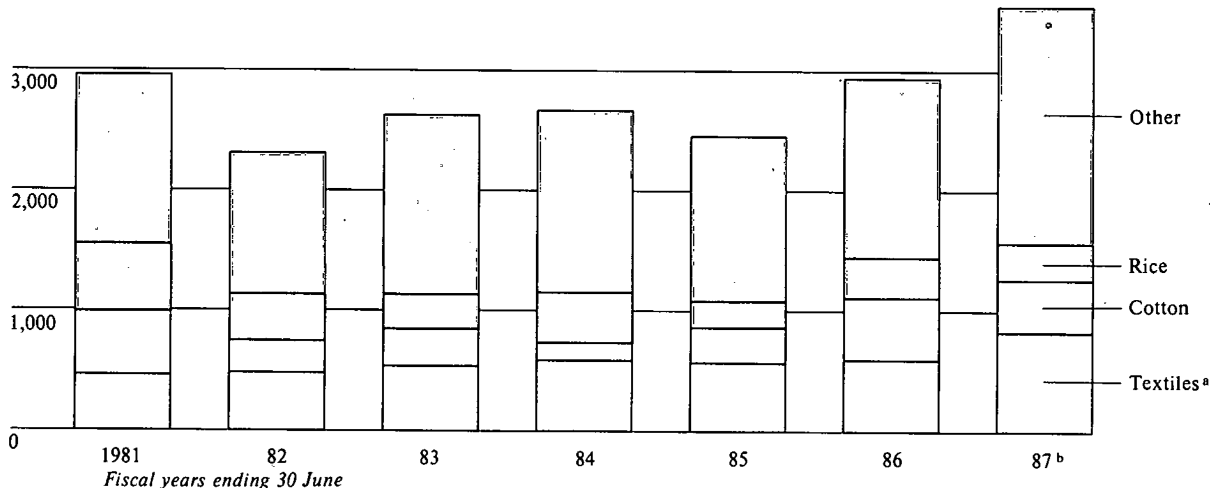
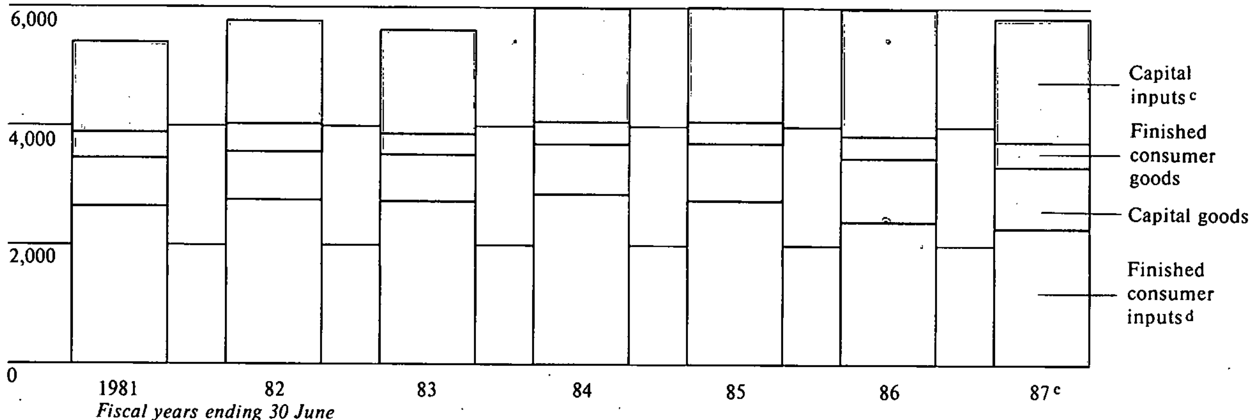
Figure 3
Pakistan: Foreign Trade, 1981-87

Million US $



[a] Cotton, cloth, thread, and yarn only.
[b] Commodity shares based on data for nine months only.



[c] Industrial raw materials for capital goods.
[d] Industrial raw materials for consumer goods.
[c] Commodity shares based on data for nine months only.

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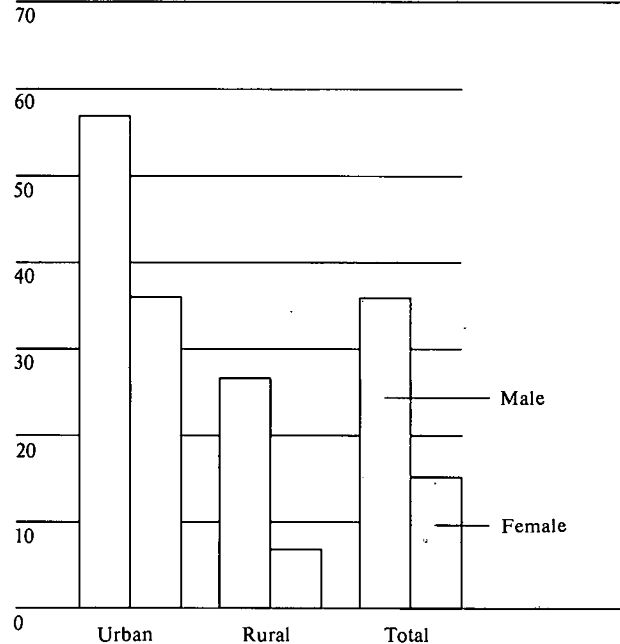
Pricing policies for agricultural inputs and main crops have helped sustain the incentive for increased production—but until recently have required substantial subsidies, more than $588 million in fiscal year 1986, according to US Embassy reports. Until domestic distribution was decontrolled in April 1987, the government lost money by buying wheat from farmers at high prices and selling flour to domestic consumers at low prices. Government agencies still sell imported phosphatic fertilizer below cost. Perhaps most important, charges for irrigation water are too low to provide for adequate maintenance and operation of the irrigation system, much less contribute toward capital costs. [ ] 25X1

Government restrictions on labor unions have minimized disruptions to production. Under martial law, which ended in December 1985, strikes and protest demonstrations were prohibited. Union activity is still banned in "essential services" and companies such as Pakistan International Airlines, hospitals, and police. Opposition political parties have tried to energize the labor movement, but, as US Embassy officials noted in mid-1986 and we believe still holds, the Pakistani worker is not dissatisfied enough to risk his job in a political confrontation. Real wages for skilled workers and for agricultural laborers probably rose during the decade before 1984 [ ] 25X1 [ ] and Pakistani economic officials note that wages per unit of output are probably higher than in other South Asian countries. [ ] 25X1

Figure 4
Pakistan: Literacy Rates, 1981



[ ] 25X1

Cautious easing of detailed government controls on investment, imports, and prices has stimulated private industrial output and expansion plans, in our judgment. Although President Zia and Prime Minister Junejo have consistently promised more liberalization than they have delivered, comment in the Pakistani press indicates that business leaders appreciate the gradual shift from the disruptive populist policies of the Bhutto regime toward policies that favor the private sector. Since 1977, Islamabad has:

- Exempted many small and medium investors from onerous government approval procedures.
- Reduced government investment in manufacturing, leaving more scope for the private sector.
- Adjusted import licensing rules to ease access to intermediate inputs and capital goods.
- Lowered tariffs, but not enough to expose domestic industries to competition.
- Linked producer prices for new oil and gas fields to international prices.

These economic reforms have eased the bureaucratic obstacles confronting smaller producers who rely on local resources. Recent changes, such as permitting private-sector investment in electricity generation, have opened new opportunities for larger investors with foreign connections. [ ] 25X1

Constraints to Sustained Growth

Pakistan's relative prosperity—visible to visitors from other South Asian countries and evident in overall growth data—masks major gaps in social and

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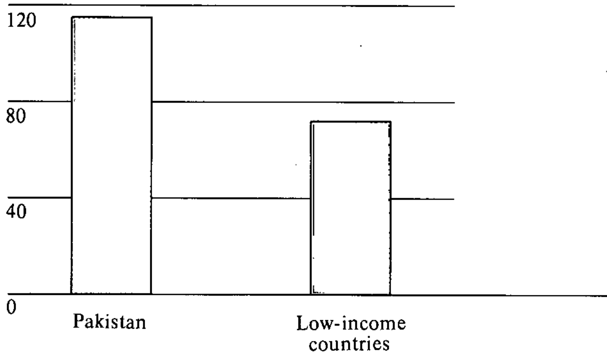
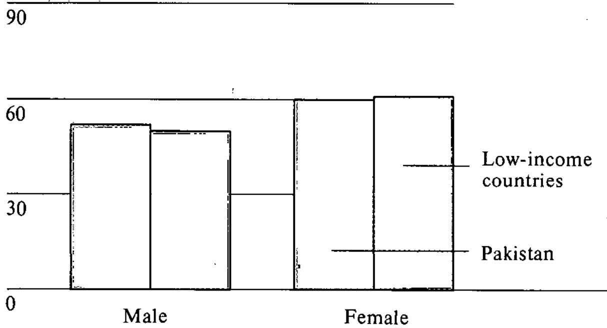
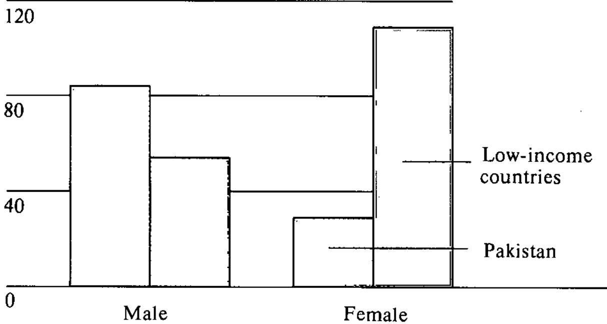
Figure 5
Pakistan: Health and Education







[a] Enrollment ratios exceed 100 percent because some pupils are younger or older than the country's standard primary school age.

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economic development. A World Bank study published in 1986 commented that Pakistan has been living on borrowed time. Islamabad has slighted development of human resources and has postponed self-reliance by failing to mobilize more internal resources. We believe these shortcomings not only limit the quality of life for Pakistanis but, increasingly, will also constrain economic growth, particularly if the economy experiences a string of bad luck. 25X1

Many government officials and international donors see large government budget deficits, which escalated to almost 10 percent of gross domestic product (GDP) last year, as the key economic issue facing the country. We do not believe that expenditures can continue to grow rapidly without tapping politically sensitive sources of revenue or risking severe inflation. Defense costs are 25 percent of current spending compared with 20 percent for India. Interest payments on domestic debt are rising about 20 percent a year, according to US Embassy reports. According to the World Bank, the tax base is not growing fast enough, in part because many earnings—particularly agricultural income—are exempt, evasion is extensive, and reliance on import duties is excessive. Proposals for a substantial hike in tax rates were hastily withdrawn in June 1987 following widespread business protests. During the past several years, Islamabad has avoided painful tax reform because it obtained additional revenue from high-interest domestic borrowing. Compounding the impact on the deficit, the interest earned from many of these loans is not taxed. 25X1

Low Savings and Investment Rates. Domestic savings and investment are too low, in our judgment, to sustain rapid economic growth over the long term. The domestic savings rate has fluctuated between 4 and 8 percent of GDP in recent years, far below the average of about 24 percent for low-income countries, according to World Bank data. Islamabad has so far been lucky to achieve a tepid investment rate of about 16 percent of GDP compared with an average of 29 percent for low-income countries because a large share of worker remittances and foreign loans and grants makes its way into investment spending. The

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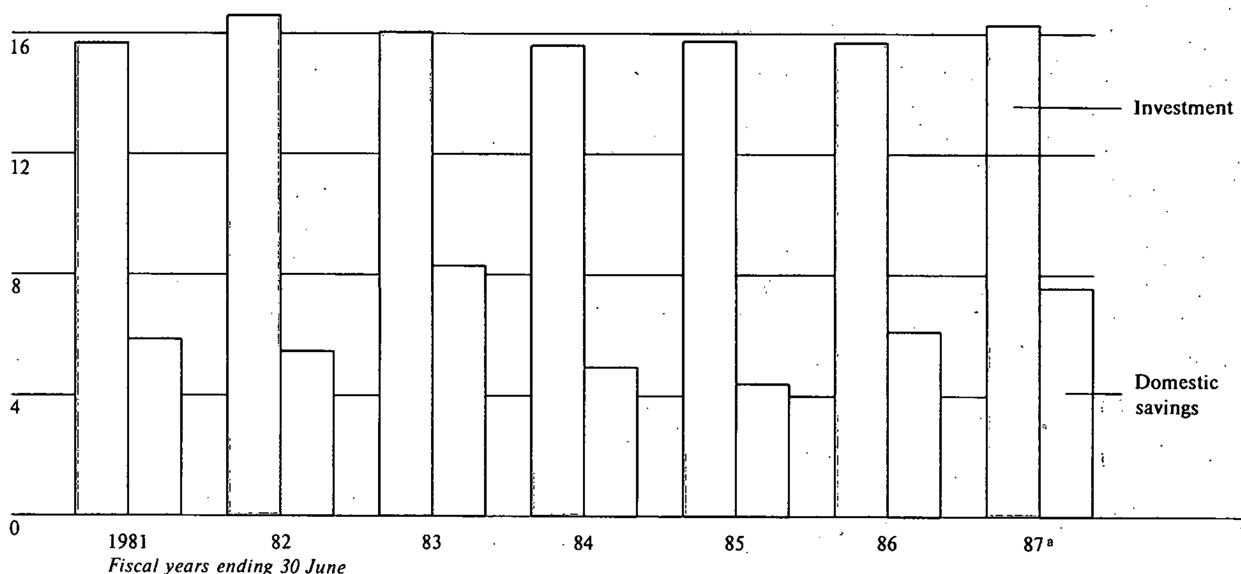
Figure 6
Pakistan: Savings and Investment as a Share of GNP, 1981-87[a]



[a] Estimate.

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downside of Pakistan's past success in attaining high growth with low investment rates can already be seen, according to World Bank analysis, in deteriorating roads and irrigation facilities, low levels of education, and the technical backwardness of the private sector—all signs that Pakistan is depleting its capital base.

Despite the moves toward liberalization in recent years, a plethora of detailed bureaucratic regulations still hinder private diversification and development initiatives. Government permission is still required for ventures that have foreign equity or a high import content. Central government allocations of bank credit, far more regulated than in most countries, limit access to working capital. Policymakers have tried to retain control of major business decisions and still consider the government responsible for preventing investment in sectors where overcapacity is likely, in our judgment.

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Narrow Industrial and Export Base. Islamabad's plans to diversify exports and industrial production have not yet succeeded, leaving Pakistan vulnerable to fluctuating world prices, poor weather, agricultural pests, and growing protectionism in industrial countries. Cotton and textiles still account for more than one-third of merchandise exports. Completion of a Soviet-aided steel mill has not led to industrial diversification into downstream engineering products even

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though Islamabad subsidizes the steel and has offered financial incentives and protection for new industries.

Political Constraints on Economic Policy. In addition to economic impediments, Pakistan's political development has provided neither a reliable mechanism for reconciling conflicting economic interests nor consistently offered the stability that encourages long-term investment. In each of Pakistan's smaller provinces (Baluchistan, North-West Frontier, and Sind), according to US Embassy officials, ethnic and regional political groupings—based primarily on resentment of perceived Punjabi domination—are the most serious threat to Pakistan's internal cohesion. Sporadic large-scale ethnic rioting between Pushtuns and Muhajirs closed most businesses in Karachi and led to hundreds of deaths during the past year.[3] Longstanding rivalries have become much more disruptive during the past several years because the availability of firearms has increased—a side effect of the war in Afghanistan.

Prime Minister Junejo and President Zia have shown little interest or skill in using political parties or interest groups to build support for needed economic reforms. At the same time, in our judgment, they are extremely sensitive to pressure from key groups—not only the major landowning and industrial families, but also small businessmen and traders in Punjab who have a vested interest in the status quo. As a result, the Junejo government has taken a cautious approach to economic reform and has quickly retreated at the first sign of trouble. Within days of protests, it scuttled the tax increases originally proposed in the government budget for fiscal year 1988. Public debate that might help shape a consensus about economic policies is only just beginning, according to US Embassy reports.

[3] Pushtuns are the dominant ethnic group in the North-West Frontier Province and part of Baluchistan. Many have migrated to Karachi in search of better economic opportunities. Muhajirs—refugees—came to Pakistan from India after partition of the two countries in 1947. They and their descendants are sometimes regarded by other Pakistanis as a separate ethnic group, especially in Karachi.

Declining Prospects Through 1990

Pakistan's economy is likely to deteriorate before 1990, but we believe Islamabad will be able to cope. Long-term financial problems are likely to become more acute as world markets and aid donors become less accommodating. Meanwhile, we believe that increasing political party activity leading up to the election scheduled for 1990 and ethnic rivalries will make businessmen and policymakers less willing to take the political and economic risks required to sustain high economic growth.

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Shaky Balance of Payments. Pakistan's balance-of-payments position is particularly vulnerable. We believe Pakistan's international financial reserves will remain uncomfortably low and remittances from workers will continue to decline as employment opportunities and wage rates in the Gulf states shrink. Short-term funds that were attracted by high interest rates could be the source of a large foreign exchange drain in coming years if holders become concerned about Pakistan's economic outlook. Moreover, export revenues are likely to slow because Pakistan probably cannot continue growth in export volume at the unusually high rates of the past two years. This is in large part because Islamabad is running into quota limits for textile sales to the United States and European countries and lacks the equipment, technology, and funds to upgrade extensively to higher value products. Weather will play a crucial role. For example, a lack of substantial rainfall this winter may force Pakistan to import 1.5 million metric tons of wheat, according to the US Embassy.

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Compounding the foreign payments crunch, foreign aid inflows in the late 1980s could be much lower than the levels recorded in recent years, in part because Pakistan may fail to meet associated economic policy conditions. In July 1987, following Islamabad's backpedaling on the budget, the World Bank warned that high levels of support could be sustained only if Pakistani officials develop and implement a medium-term strategy that includes tax and tariff reform. As of late October, according to US Embassy reports,

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Islamabad had mollified the World Bank by promising to plan such reforms, but we expect Pakistani officials to continue to drag their feet, perhaps leading to delays in World Bank aid. Islamabad is also likely to have continuing trouble—because of its deficit problems—finding the domestic funds that are required for some project-related foreign loans. Moreover, continuing concerns about Pakistan's nuclear policies and US budgetary constraints could prevent Islamabad from receiving all of the $4 billion US aid package for US fiscal years 1988-93.

Islamabad will face politically difficult choices between curbing expenditures and raising taxes if it is to contain deficit spending. We believe, however, the Pakistani Government will not tackle this problem unless forced to as a condition for IMF assistance in the event of a foreign exchange crunch. Debt servicing costs from several years of attracting private funds by offering high rates of return and tax concessions will soon begin to divert resources from private investment, according to World Bank analysis. Yet additional investment in physical infrastructure is essential, in our judgment, because shortages of electricity and inadequate transportation already impede economic growth. Rapid expansion of credit to both government and private sectors could lead to excessive inflation. Prime Minister Junejo, who rescinded 1987 tax increases following business protests, is probably leery of again attempting to increase the burden on taxpayers.

Election Politics. We believe that internal political competition in the runup to the national election promised for 1990 will make economic reforms more difficult. We see little popular support for or understanding of economic decontrol proposals and tax revisions. To avoid creating a campaign issue, government leaders will probably give more weight to protests by businessmen with political clout who would be hurt by exposure to foreign and domestic competition or by reduced subsidies. Members of the parliament who direct the allocation of some development funds in their constituencies will be tempted to ignore priority needs in order to buy votes. Potential private investors may prefer to delay their projects if they suspect the Pakistan People's Party might come to power. Although party leader Benazir Bhutto has denied plans to return to the disruptive populist policies her father instituted as prime minister in the 1970s, businessmen remain concerned, according to US Embassy reports.

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Unemployment will become an increasingly significant political factor. By 1993, according to World Bank projections, 3.8 million people—almost 11 percent of the labor force—could be without jobs compared with roughly 5 percent in 1985. Long-term trends toward greater capital intensity in industry and agriculture, as well as the return of expatriate workers from the Middle East, account for much of the expected increase. We anticipate increased social and political strains from competition for jobs and probably more violence even if the increase in unemployment is 2 or 3 percentage points less than projected by the World Bank. Under these circumstances, the government would come under pressure to adopt expansionary policies that would worsen the foreign payments situation and inflation.

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As the economy slows, ethnic conflict is likely to intensify over the next several years, increasing the reluctance of investors. Many of the Pushtun and Punjabi workers who return from the Middle East will probably settle in overcrowded Karachi, increasing the competition for jobs and housing. Banditry in rural Sind, no longer an isolated nuisance, is becoming part of an ethnic and political protest against Punjabis. Communal political parties, such as the Muhajir Quami Movement recently formed to advance Muhajir interests, are becoming more active. Even when businesses are not destroyed, increased ethnic rioting forces them to shut down because employees cannot get to work. Slowdowns at Karachi Port and occasional disruption of traffic on the main highway to Punjab would spread the effects of disturbances in Sind to other parts of the country.

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Muddling Through. Islamabad most likely will cope with these increasing strains without an abrupt balance-of-payments crisis or unacceptable political instability, albeit with increased unemployment, shortages, and inflation. We project a financial gap of

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roughly $2 billion a year through fiscal year 1990, assuming export volume growth of 5 percent and import growth of less than 2 percent in fiscal years 1989 and 1990.[4] Capital inflows—aid receipts, foreign direct investment, and net short-term capital flows, for example—have amounted to about $2 billion annually in recent years. Thus, as long as capital inflows do not decline, Pakistan could get by without having to draw down its foreign exchange reserves.

Pakistan's policy response will probably limit longer term development prospects. Meeting the projected import targets may require Islamabad to impose tighter import licensing restrictions, adding to the government's budget problems because customs receipts account for about 40 percent of tax revenues. We believe Islamabad would try to cope with revenue shortages by cutbacks in areas that are already shortchanged—primary education and health, for example—further impairing the quality of the labor force. Maintenance of roads and irrigation facilities is also likely to suffer.

Foreign suppliers' credits or additional commercial borrowing probably could be found to pay for projects that require considerable quantities of imported machinery—electricity plants, for example—but the debt servicing costs would mount after the usual grace period of two to five years. Islamabad also might be willing to make the minor improvements in economic policy or bureaucratic efficiency needed to accelerate disbursements from the substantial foreign aid funds—probably more than $5 billion—that have been committed but not yet used.

The import restraint and budgetary stringency implied in this scenario would slow real GDP growth by 1990 to less than 3.5 percent a year, permitting almost no increase in per capita GDP. Faced with increased uncertainty about import and credit restrictions, we believe private investors would proceed more cautiously in implementing their investment plans. Moreover, their costs would increase because of spot shortages and the deteriorating transportation network. As the slowdown spread to labor-intensive sectors, such as construction and services, the unemployment rate would rise—perhaps exceeding 8 percent in urban areas.

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Sources of Volatility

A variety of circumstances—fluctuations in foreign aid, weather, the economic health of the Gulf states and the OECD—could affect the Pakistani economy, entailing some risk for our forecast of "muddling through." Because a substantial portion of the country's economic success in recent years has been based on Pakistan's ability to take advantage of favorable external factors, such as good weather, we see a considerable downside risk if one or more of those factors changes. For example, Pakistan is experiencing a drought that will depress agricultural production and exports if the spring monsoon does not materialize. Conversely, there is a slimmer chance that favorable factors, combined with prudent economic policies, could result in an even healthier economy.

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Significant Risk Scenario. Although less likely than "muddling through," there is a 1-in-3 chance of a sharp deterioration that would probably begin with international financial problems but quickly spread throughout much of the economy. If, for example, drought or pests limit crop production so that export volume growth falls to 2 percent a year while imports grow 5 percent and worker remittances rapidly plunge, Pakistan's financial gap could reach $3.5 billion by fiscal year 1990. Even under the most optimistic circumstances, we do not believe that capital inflows would increase sufficiently to avoid a major foreign exchange crisis. Even under the previous scenario, Islamabad would face similar financial straits if capital inflows fell sharply—a possibility we would not rule out, especially if the United States should cut aid because of Pakistan's pursuit of its nuclear program or its reluctance to initiate economic policy reforms required by such donors as the World Bank.

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[4] The financial gap is the sum of projected current account balances and principal repayments and indicates the magnitude of capital inflows that would be required to avoid drawing down foreign exchange reserves.

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Such financial problems would be severe. We believe investors would panic and attempt to cash in their short- and medium-term securities for foreign exchange, worsening the crisis in the process. Foreign commercial bankers would be unwilling to lend to Pakistan except in limited amounts and at high interest rates. Under this scenario, Pakistan would be forced to try to reschedule some of its debt repayments and might even default on some of its loans. Any economic rescue package put together by international financial institutions would be conditional on implementation of tax measures and other economic reforms that Islamabad has so far deemed politically unacceptable.

The import cuts that would become necessary under this scenario would lead to a slowdown in manufacturing because of input shortages. We believe economic growth could decline by as much as 3 percent annually. Lower industrial output and trading activity would translate into higher unemployment—perhaps more than 10 percent. Shortages could boost inflation into double digits despite continuation of some administered prices. Pakistani businessmen—already familiar with informal channels for getting money out of the country—would abandon many of their investment and expansion plans.

In our judgment, already existing ethnic and regional grievances would be magnified by such economic strains. We believe ethnic parties and non-Punjabi business groups would claim to see a pro-Punjabi bias in almost any expenditure cuts or tax revisions mandated by foreign aid donors and creditors. Competition for jobs, which already contributes to ethnic violence in Karachi, would become even more intense. With foreign financial support contingent on reduction of budget deficits, Prime Minister Junejo and President Zia could not appease key interest groups with subsidies or handouts.

Under these circumstances, we would not rule out a return to martial law. Public opinion is not prepared for austerity, and, given the budget fiasco last summer, we are not confident that the Junejo government has the necessary political adroitness to successfully

Table 2
Pakistan: Financial Gap Scenarios, FY 1988-90 [a]

Million US $

	1988	1989	1990
Most likely scenario			
Trade balance	−2,380	−2,380	−2,370
Exports, f.o.b.	3,960	4,320	4,700
Imports, f.o.b.	6,340	6,700	7,070
Services and transfers balance	1,340	1,270	1,180
Remittances	2,100	2,050	2,000
Other	−760	−780	−820
Current account balance	−1,040	−1,110	−1,190
Principal repayments	−1,000	−900	−950
Financial gap	−2,040	−2,010	−2,140
Significant risk scenario			
Trade balance	−2,560	−2,880	−3,260
Exports, f.o.b.	3,780	4,020	4,250
Imports, f.o.b.	6,340	6,900	7,510
Services and transfers balance	1,340	1,080	730
Remittances	2,100	1,900	1,700
Other	−760	−820	−970
Current account balance	−1,220	−1,800	−2,530
Principal repayments	−1,000	−900	−950
Financial gap	−2,220	−2,700	−3,480
Optimistic scenario			
Trade balance	−2,070	−2,070	−2,070
Exports, f.o.b.	4,200	4,670	5,180
Imports, f.o.b.	6,270	6,740	7,250
Services and transfers balance	1,440	1,450	1,500
Remittances	2,200	2,200	2,200
Other	−760	−750	−700
Current account balance	−630	−620	−570
Principal repayments	−1,000	−900	−950
Financial gap	−1,630	−1,520	−1,520

[a] Data for fiscal periods ending 30 June of the stated years.

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handle the repercussions of economic stringency. We would anticipate that if riots, strikes, and other violence get out of hand—particularly if Punjab Province is greatly affected—the Army would reimpose martial law.

Optimistic Scenario. We see an even slimmer possibility—perhaps 10 to 15 percent—of a scenario in which Pakistan could achieve sufficient export growth to permit an increase in foreign exchange reserves and relatively high economic growth. If worker remittances level off at $2.2 billion a year and export volume grows more than 7 percent annually, import volume could increase almost 4 percent a year and Pakistan could narrow its financial gap in fiscal year 1990 to about $1.5 billion. Assuming capital inflows at the $2 billion level of recent years, Islamabad could add to its foreign exchange cushion. Under this scenario, we believe that the economy would grow by 5 percent a year in real terms.

Islamabad would have to implement more economic reforms than it has so far and depend on good luck with world prices and weather to achieve this kind of scenario. High growth and improved public welfare are possible, according to a World Bank analysis with which we agree, only if Islamabad adopts measures such as tax and fee increases, slows growth in government expenditures on subsidies and defense, relaxes industrial controls, eliminates most import restrictions, and provides a more effective system of tax-free inputs for exporters. Under these circumstances, we believe private investors would be more willing to expand capacity or undertake new ventures. Islamabad could use some of its revenues from import taxes to repair infrastructure and boost education, for example.

Implications for the United States

A gradual economic deterioration probably would not entail fundamental changes in Pakistan's relations with the United States before 1990 or affect US interests in regional stability. Islamabad, however, will probably look to Washington for help in coping with the coming economic slowdown. As Pakistan's largest creditor, the United States would have a major role in shaping any financial relief. We believe that Pakistani officials will seek rescheduling of some debt service obligations to the United States, US support in softening the economic policy conditions for loans from the IMF and the World Bank, and greater access to US textile markets.[5]

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Should the United States cut or substantially reduce its aid to Pakistan, Islamabad would be in much greater danger of facing a foreign exchange shortage. A cutoff of US aid would be especially likely to frighten potential investors and lead to additional capital flight. We believe, however, that an aid cutoff that is not accompanied by other economic problems would be manageable, at least during the next three years. The United States provides less than 18 percent of Pakistan's economic aid receipts, and loss of benefits from some projects like coal-based power generation that could be delayed or dropped would not be evident for several years. Islamabad would probably turn to China or Western Europe rather than forgo acquisition of new tanks, artillery, and fighter aircraft but might be able to postpone initial payments beyond 1990. Seeing the opportunity for a propaganda coup, the Soviet Union might offer additional low-interest loans, probably tied to purchases of Soviet goods. The most immediate financial effect of a US aid cutoff would be the loss of commodity loans and of foreign exchange from aid that finances the domestic costs of development projects. We estimate that such aid is less than $200 million a year.

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The United States almost certainly would be made the scapegoat for severe economic troubles, whether or not they were triggered by a US aid cutoff. Any Pakistani government would try to deflect criticism outward, and Washington is the most likely target because, according to many Pakistani press articles, it is already seen as interfering in Islamabad's economic policy choices. During rapid economic deterioration accompanied by intensified social unrest—our second scenario—we believe President Zia would be much less responsive to US preferences on political as well as economic topics.

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[5] Although this paper excludes consideration of Pakistan's repayment of its military debt to the United States, we believe the coming economic slowdown could make repayment for US military equipment an issue of growing importance in US-Pakistani relations.

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Appendix

Selected Economic Policy Changes

	Event	Comments
Martial law government		
March 1978	***Investment.*** Five-year tax holiday and exemption from import duty on machinery offered for industries in specified underdeveloped areas. Concessions later extended to additional areas and to a few industries regardless of location.	Effort to promote economic links between poor, remote areas and rest of country. Signaled support for private sector. Financial incentives insufficient to compensate for lack of infrastructure in remote areas.
September 1978	***Exports.*** "Compensatory rebates" of 7.5 percent to 12 percent of f.o.b. value offered for some textiles.	Provided an export subsidy; payments were in addition to rebate of indirect taxes.
February 1979	***Investment.*** Protection of Rights in Industrial Property Order prohibited arbitrary acquisition of industrial property and provided judicial review of compensation.	Contrasted with nationalizations of previous government. Intended to attract domestic and foreign investment.
October 1979	***Investment.*** Major policy statement promised that public sector would be limited to basic industries, those in which private sector was not interested, or those whose nationalization would be in national interest.	Continued effort to stimulate private industrial investment and growth.
June 1980	***Islamization.*** Proceeds from new taxes on financial assets and agricultural production would be disbursed by private committees, used for education and social welfare. Similar tax on imports imposed in 1984.	Receipts and expenditure would not appear in central government budget.
January 1981	***Islamization.*** Domestic banks began gradual shift from interest payments by accepting profit and loss accounts. By July 1985 all commercial banking in rupees was interest free.	Interest payments would be permitted on foreign currency deposits and foreign loans. Changeover introduced flexibility in rigid credit controls by providing equivalent of positive real interest rates.
March 1981	***Agriculture.*** Commission established to advise on prices for major crops and inputs. Asked to consider production incentives, rational use of land and water.	Effort to rationalize government policy, limit subsidy burden on government budget. Probably not an attempt to move toward free market prices.
January 1982	***Exchange rate.*** Rupee unlinked from dollar. Managed floating rate system guided by currency baskets introduced.	Permitted substantial depreciation to make exports more competitive.
July 1983	***Imports.*** Any item could be imported unless specifically prohibited. Previously only goods already on approved list could be imported.	Intended to provide better availability of imported items, not to permit competition for domestic producers. New negative list was extensive.
May 1984	***Imports.*** Tariffs restructured—generally lower except on raw materials for consumer goods and on machinery for which domestic substitutes had become available.	Attempt to remove anomalies in tariff structure rather than to liberalize trade. Prompted by study that found some industries underprotected. Changes reflected, in part, advice from multilateral aid donors.

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Selected Economic Policy Changes (continued)

	Event	Comments
June 1984	***Industrial policy.*** Raised value of projects and imports below which government approval of private investment not required. Future public-sector investment would be limited to modernization and to projects that businessmen are reluctant to undertake.	Significant easing of bureaucratic barriers to small- and medium-scale investment. Did not apply to large projects, those with foreign equity, many specified industries, or if payments for foreign loans and technology exceeded standard terms.
February 1985	***Textiles.*** Expansion of spinning industry allowed. Imports of textile machinery could be financed from any source.	Reversed earlier policies that opposed new spinning units because of excess capacity. By March 1987, 12 new units had begun production.
Martial law—elected parliament		
May 1985	***Government budget.*** Reduced taxes on corporate and personal income, dividends. Increased rail fares, some electricity rates, price of gas to business users. New import surcharge.	Business reaction mixed, mostly negative.
	Proposed sale of shares in some profitable public-sector enterprises. Established National Deregulation Commission to help dismantle unnecessary controls. National Taxation Reforms Commission would ensure that taxes were equitable and growing.	Raised aid donor expectations for comprehensive economic reform.
	New government securities. Tax-free foreign exchange bearer certificates and rupee bonds offered high yields. Provided channel to legitimize "black" funds.	Successful but expensive way of easing foreign payments and domestic budget strains. Money flows could be reversed on short notice.
May/June 1985	***Cement.*** Prices decontrolled for private producers. New factories could be established without government permission.	Attracted additional private investment. Continued tariff protection against imports and cross-subsidization of high-cost producers within public sector.
June 1985	***Natural gas.*** Producer price for new fields linked to international prices.	Prompted by interest in attracting private exploration and development and by World Bank loan condition.
September 1985	***Electricity.*** Private sector permitted to invest in power generation. Must sell to government transmission system. Investors must provide at least 25 percent of cost from resources other than loans.	Major shift from public-sector monopoly. Prompted by shortages of revenue and electricity.
Civilian government		
April 1986	***Edible oil.*** Removed price controls, import restrictions, and production ceilings for private-sector producers. Retained support prices for farmers.	Significant decontrol of basic consumer item advocated by aid donors. Investment in new plants would still require government approval.
May 1986	***Nitrogen fertilizer.*** Price and internal distribution controls removed. Efficient producers no longer required to subsidize less efficient.	Eased government subsidy burden. Led private-sector plants to increase production. Foreign aid donors had urged this move.
	Basmati (luxury) rice. Farmers allowed to sell to highest bidder. In past, had to sell 83 percent of harvest at government-fixed price.	Response to declining production. Rice exports remained government monopoly.
	Import tariff. Structure simplified—duty on plant and machinery no longer to vary among categories of end users. Rates lowered for industrial raw materials, machinery not manufactured locally, and goods frequently smuggled.	Major revision. Tariff reductions since early 1980s were substantial, especially for capital goods, but retained protection for local industry.

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Selected Economic Policy Changes (continued)

	Event	Comments
June 1986	***Export subsidies.*** "Compensatory" rebates on manufactured exports and textiles abolished from September 1986. Indirect tax rebates and tax credits for exporters continued.	Depreciation of rupee made payments unnecessary, according to official explanation. Fear of retaliation by importing countries and budget costs probably also prompted politically risky decision.
	Five-Point Program (1986-90). Quantified statement of national goals made as martial law lifted in December 1985. Emphasized rural development, social services, jobs. Modified Priority Plan, which modified Five-Year Plan for 1983-88.	Rural projects considered necessary trade-off for patronage lost when industrial controls liberalized. World Bank staff saw emphasis on jobs for educated youth as politically motivated waste of money.
September 1986	***Crude oil.*** Revised link between international and domestic producer prices.	Maintained incentive for petroleum production despite decline in world prices.
October 1986	Raised electricity prices for about 10 percent of domestic consumers.	Met policy condition for World Bank loan. Price hike partly reversed in February 1987.
January 1987	***National Taxation Reform Commission recommendations.*** Lower import duties but eliminate exemptions. Broaden sales tax to cover all products except fresh food. Remove ban on trade in foreign currency. No consensus about agricultural income tax.	Detailed, unpublished recommendations called for flat 15-percent import duty plus 5-percent Islamic surcharge, 5-percent sales tax. US Embassy officials doubted government would implement fully, despite potential for substantial revenue gain.
February 1987	***Flour rationing.*** Government supply of cheap grain to consumers abolished from 15 April. Subsidized distribution would continue in deficit areas. Farmers still protected by support price.	Intended to ease government subsidies. High stocks protected consumers against price increases in near future. Corrupt rationing system had not been effective.
	Fertilizer. Private-sector imports permitted.	Complemented May 1986 deregulation of fertilizer prices and production.
March 1987	***Privatization.*** Offered to sell 40 percent of shares of Bankers' Equity Limited, a development institution that invests in private sector.	Intended to provide additional funds for supervised investment without burden on government budget. Offer unsuccessful—private buyers did not see enough potential for capital gains.
April 1987	***Investment.*** Businessmen no longer needed government permission to invest in 12 previously regulated industries, including basic steel and cotton spinning, or in projects that cost less than $30 million.	Effective September 1987. Foreign investment required government approval.
June 1987	***Budget.*** Proposed "defense tax"—surcharge on import, excise, income, and wealth taxes—and increased energy prices.	Led to strong protests from businessmen and within ruling party. Officials recognized need for additional revenue but had not prepared the public and the parliament for harsh measures.
	Budget revision. Hastily withdrew major part of proposed tax and price hikes. Substituted increased import license fee, cutbacks in expenditure, and plans to curb tax evasion.	Revenues likely to fall short of revised projections.
	Trade policy. Reduced some import restrictions on raw materials and intermediate goods, but added protection for electrical equipment. Proposed restructure of income tax concessions for exporters to favor domestic content.	Restatement of existing activities designed to produce sense of forward motion without changing or costing much.

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Selected Economic Policy Changes (continued)

	Event	Comments
	Countertrade. Would seek links between export of machinery and import of tea, edible oil, petroleum. Government agency would replace private importers for most tea.	Previous countertrade efforts had not been successful.
	Privatization. Private sector permitted to export cotton and luxury rice.	Restrictive conditions, in practice, retained government monopoly of cotton exports.
August 1987	***Local content.*** Would revise "deletion" program that required certain manufacturers to reduce the import content of their production, to provide penal import duties for noncompliance, but eased restrictions on production.	Existing programs for vehicles and durable consumer goods unrealistic, not enforced. This policy statement not yet implemented.

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