Transitions in Development

The Role of Aid and Commercial Flows

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CHAPTER 3 IJAZ NABI AND NAVED HAMID

The Aid Partnership in Pakistan

At independence in 1947 Pakistan was one of the poorest countries in the world. Since then, with an impressive average growth rate of 5.3 percent per year over the past four decades, the country has started to climb out of the abject poverty it inherited from the British raj. Foreign aid played an important role in the pattern of growth, not only in the volume of resources it made available but also especially through its influence on the development strategy Pakistan pursued.

Pakistan's growth has fluctuated considerably. In the 1960s, a period of high growth, gross domestic product (GDP) grew an average of 6.7 percent per year. With population growth of about 3 percent per year, this translated into annual per capita growth of 3.7 percent. The 1970s were a difficult period, and GDP grew only 3.9 percent a year, which was less than 1 percent per capita. In the 1980s GDP again grew rapidly, at an average 6.6 percent per year (3.6 percent per capita). During this period, Pakistan's economy has undergone considerable structural change. In slightly less than four decades between the end of the 1940s and the mid-1980s, agriculture declined from more than one-half to about one-quarter of GDP, while manufacturing grew from 7.8 percent to almost 20 percent.

Because Pakistan is in a particularly sensitive geopolitical position, aid to the country, especially from the United States, has also fluctuated a great

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deal in response to changing political circumstances. In the early 1960s aid reached a peak of more than 11 percent of GDP per year. It declined slightly in the latter half of the decade, and then in 1971 fell markedly to under 7 percent. Although U.S. aid has increased from its lows in the 1970s, total aid in the late 1980s was no greater in constant dollars than it was in the 1970s; in fact it is lower as a fraction of GDP, less than 4 percent. In the 1980s, however, the country was helped by substantial remittances from workers employed overseas, especially in the Middle East.

The net effect of aid on Pakistan's development is a complicated issue. Certainly, despite their instability, aid flows have compensated for a low savings rate, which has averaged around 13 percent; and periods of high growth have been stimulated by policy reforms, especially trade liberalization, encouraged by donors. Moreover, technical advice from donors, an especially important component of aid to Pakistan, gave shape to the country's economic institutions and led to the growth-oriented development strategies of the 1960s and 1980s.

Despite these achievements, Pakistan has made few improvements in basic health care, population control, and education, which sorely need attention. The country's very low rate of primary school enrollment in relation to other developing countries is especially troubling. Nor has the aid partnership adequately addressed equity issues. The country's import-substitution policies during the 1960s, for which the donors shared responsibility, were not only inefficient but also inequitable; they concentrated benefits in the rapidly industrializing West Pakistan at the expense of the poorer East Pakistan. And, as in the case of so many developing countries, its policy of subsidizing large enterprises at the expense of smaller ones has not served either efficiency or equity very well. Moreover, to sustain its current growth rate, Pakistan will have to continue to rely on foreign aid, which, given aid's past instability, is a worrisome prospect.

This chapter examines the successes and failures of Pakistan's aid-induced development strategy. It begins with a brief discussion of macroeconomic trends since independence and shows the role that aid played in helping Pakistan achieve its growth. Then follows an examination of Pakistan's geopolitical location and its relationship to aid flows. The next section highlights the importance of aid in Pakistan's decision making by tracing the main phases of the aid partnership between Pakistan and its major donors, the United States and the World Bank, and evaluating policies and performance in each phase. Further evidence on the aid partnership appears in the section on donors' lending portfolios.

Next there is a discussion of aid effectiveness in Pakistan, focusing on the relationship between aid and growth, and between aid conditionality and policy, as well as on savings and trade gaps in Pakistan. The chapter then looks at Pakistan's debt burden, which will influence the country's creditworthiness and thus also its ability to attract foreign capital in the future. Finally, we consider the potential for alternatives to aid, such as

TABLE 3.1 Growth Rates of GDP in Pakistan, 1950–87 (percentage)

Period (ending fiscal year)	Average growth rate
Pre-plan period (1950–55)	3.1
First Five-Year Plan (1956–60)	3.1
Second Five-Year Plan (1961–65)	6.8
Third Five-Year Plan (1966–70)	6.7
Non-plan period (1971–77)	3.9
Fifth Five-Year Plan (1978–83)	6.6
Sixth Five-Year Plan (1984–88)	6.9[a]
1949–50 to 1986–87	5.3

a. 1983–87.
SOURCE: Pakistan, Ministry of Finance, *Pakistan Economic Survey*, various years.

domestic resource mobilization and exports, and conclude by considering a few lessons from the Pakistani experience, including an agenda for policy reform.

Macroeconomic Performance

At independence Pakistan had an annual per capita income of about $100. Since then the growth rate has been enviable, with GDP increasing at an annual average of 5.3 percent, putting Pakistan ahead of its South Asian neighbors (India, 3.5 percent; Sri Lanka, 4.6 percent; Bangladesh, 3.9 percent; and Nepal, 3.5 percent). As a result, despite rapid population growth of about 3 percent annually, per capita income has increased by over 140 percent in real terms; at today's prices, it is just under $400, which puts Pakistan at the upper end of the low-income countries. This growth performance is remarkable in view of the traumas Pakistan has experienced. At independence economic activity was disrupted by the partition of the Indian subcontinent, which uprooted nearly 14 million people. Pakistan has fought two full-scale wars with India, in 1965 and 1971, and has suffered a civil war that led to the creation of Bangladesh. The list of shocks to the economy would be considerably longer if it included the vagaries of the monsoon in the Indus River basin.

Although the rate of growth over the forty-year period has been high, it has also been uneven (see Table 3.1). In the 1950s, the average annual growth rate was only 3.1 percent, which (with 3 percent population growth) produced almost no growth per capita. This decade was a period of recovery after the partition. Before independence the areas comprising Pakistan were primarily agricultural; for manufactured goods they depended on industrial centers that are now in India. Consequently, the cessation of trade with India in 1949 was very disruptive, and economic performance reflected this. The economic policies of the 1950s were largely an attempt to adjust to the new economic realities.

The 1960s were a period of high growth in both industry and agriculture. During this decade, GDP grew at 6.6 percent annually, and by the end of the 1960s a substantial industrial base had been created. In the early 1960s, however, policies emphasized growth and ignored equity considerations. In the second half of the decade, the government planned to redress this, but external resources declined sharply, forcing the plans to be shelved. This may have contributed in an important way to increasing social and economic tensions, an important factor in the rise of the People's Party and its assumption of power in 1971.

During the 1970s Pakistan faced numerous internal and external shocks. In 1971 the country was dismembered, and the eastern half emerged as the independent country of Bangladesh. In 1972–73 the People's Party government undertook widespread nationalizations in the industrial and financial sectors. The first oil shock also occurred in 1973. Economic growth during the 1971–77 period averaged only 3.9 percent per year (less than 1 percent per capita), with large- and medium-scale industry growing at about 2 percent annually, compared to the 15 percent annual rate in the previous two decades.

In the 1980s rapid growth returned, with the government of General Zia-ul Haque reviving the economic policies of the 1960s. GDP grew at 6.6 percent annually, large- and medium-scale industry at about 10 percent, and agriculture at about 4 percent.

To sum up, Pakistan has witnessed alternative periods of slow and rapid GDP growth, and the average annual growth rate of 5.3 percent does not tell the whole story. This growth has resulted in significant structural transformation of the economy. Agriculture's share of GDP declined from 53.2 percent in 1949–50 to 25.5 percent in 1986–87. The share of manufacturing, particularly that of large- and medium-scale industry taken together, increased from 7.8 percent in 1949–50 to 19.9 percent in 1986–87. Sectoral employment shares have also undergone similar though less dramatic changes; agriculture employed over 75 percent of the labor force in 1949–50, but in the late 1980s employed just over 50 percent. Despite this apparent structural transformation, however, the economy is still heavily dependent on agriculture. Nearly one-half of manufacturing output and four-fifths of exports are based on agriculture.

Despite sustained aggregate growth, Pakistan's record on equity and its performance in the social sector leave much to be desired. Public pronouncements of planners in the 1960s suggest awareness of the mounting problems of social neglect. In practice, however, little was accomplished. A review of selected social indicators reveals that in 1983 the average Pakistani's quality of life was still quite low compared about that of people in other countries (see Table 3.2). Particularly striking is the alarmingly low rate of primary school enrollment relative to other developing countries. The meager share of expenditure on education and health reflects a lack of concern with the impact this might have on future growth rates. An unhealthy and

TABLE 3.2 Pakistan's International Ranking in Socioeconomic Indicators, 1983

Indicator	Value	Rank in all 120 market economies	Rank in 36 poorest economies
Population (millions)	92.4	9	4
Per capita GNP (US$)	380	80	2
Enrollment in primary school as % of age group	49	99	24
Life expectancy at birth (years)	51	23	8
Average index of per capita food production (1974–79 = 100)[a]	104	23	11
Daily per capita calorie supply as % of requirement	95	30	10
Central government defense expenditure as % of total expenditure	34.8	4	1
Central government expenditure on education as % of total	3.1	65	14
Central government expenditure on health as % of total	1.0	65	15

a. Data are for 1982–84.
SOURCE: World Bank (1986a).

TABLE 3.3 A Summary of Pakistan's Macroeconomic Indicators, 1961–88 (plan period averages in percentages)

	Second Plan (1961–65)	Third Plan (1966–70)	Non-plan period (1971–77)	Fifth Plan (1978–83)	Sixth Plan (1984–88)
GDP growth rate	6.8	6.7	3.9	6.6	6.9[a]
Agriculture growth rate	3.8	6.3	1.7	4.4	3.9[b]
Industry growth rate	16.0	9.9	3.7	9.5	8.3[c]
Investment (% of GDP)	19.30	16.26	15.99	17.74	16.94
Domestic saving[d] (% of GDP)	11.48	12.20	12.65	15.69	15.76
	(11.65)	(12.29)	(10.44)	(7.26)	(7.99)
Aid inflow[e] (% of GDP)	11.11	10.58	6.81	5.25	3.82
Public capital formation (% of total capital formation)	49	47	63	64	60
Imports (% of GDP)	14.97	11.29	16.49	22.27	20.64
Exports (% of GDP)	7.31	7.31	10.95	11.80	11.70
Net factor income from abroad (% of GDP)	−0.17	0.08	2.21	8.43	7.77
Budget deficit (% of GDP)	n.a.	n.a.	9.85	5.68	7.00
Inflation index[f]	105.56	126.81	220.55	411.40	567.72
Debt (% of GDP)	10	20	43	36	31

NOTE: n.a. = not available.
a. 1983–87.
b. Actual and target.
c. 1983–86.
d. National savings rate in parentheses includes net factor income from abroad.
e. Net transfers.
f. GDP deflator 1959–60 = 100.
SOURCE: *Pakistan Economic Survey*, various years, Government of Pakistan, Ministry of Finance, Economic Advisor's Wing.

uneducated work force is not likely to be very efficient either at work or at war (note Pakistan's high ranking of the share of defense expenditure).

Pakistan's growth is all the more remarkable given its mediocre success in mobilizing domestic resources for development. The savings rate, averaging approximately 13 percent from 1961 to 1988, has been low historically (see Table 3.3) and is less than half that of neighboring India's. The investment rate, on the other hand, has been higher than the savings rate. This difference can be largely explained by the considerable amount of foreign aid Pakistan has received. In the following discussion the relationship between aid donors and Pakistan is explored in order to examine the role of aid and its effectiveness in Pakistan's economic development.

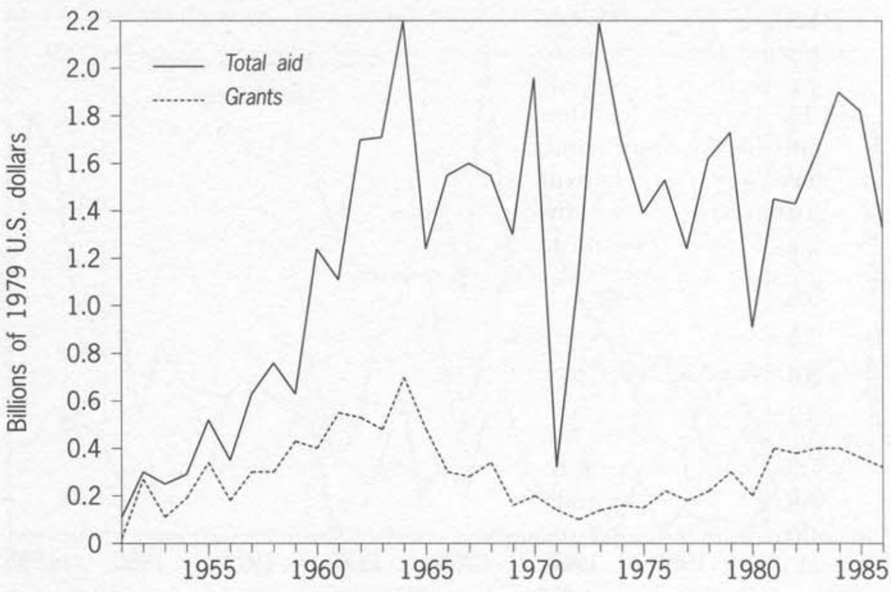
Geopolitics of Aid to Pakistan

Pakistan, bordering on the Middle East, Central Asia, and South Asia, has as its neighbors the world's three most populous countries: China, India, and the USSR. It lies close to, and shares a religion with, the strategically important, oil-rich Persian Gulf region. As a result of this geopolitical position, political considerations have remained paramount in determining aid to Pakistan. In particular, the terms of Pakistan's relationship with the United States have greatly influenced the quantity of aid it has received. This relationship has passed through three broad phases. During the Cold War, in the 1950s and the early 1960s, the United States established a chain of military alliances for the containment of Soviet communism. These stretched from Europe (NATO) through the Near East (CENTO) to the Far East (SEATO). Pakistan, as a member of both CENTO and SEATO, was an important link in this chain. In the late 1960s and early 1970s, the era of detente and growing U.S. involvement in Vietnam, these military alliances and Pakistan's standing with the United States declined in importance. Pakistan's close links with both China and the United States, however, allowed Pakistan to act as an intermediary between the two countries and to continue to enjoy favor with the Nixon administration.

In the 1970s, with the end of the Vietnam War and the aftermath of Watergate, the United States turned inward and relations with Pakistan reached a nadir. At the same time the Organization of Petroleum Exporting Countries (OPEC) emerged as a major economic power. Pakistan, because of its proximity and religious ties, became a supplier of defense personnel and civilian manpower to the oil-rich Islamic countries and in return received considerable official aid from them.

Finally, at the end of the 1970s with the fall of the Shah in Iran (a key country in U.S. strategic plans for the region), the invasion of Afghanistan by the USSR (which posed a threat to the oil-rich Gulf states), and the emergence of the United States from its post-Vietnam seclusion, Pakistan

FIGURE 3.1 Total Aid and Grants to Pakistan, 1951–86

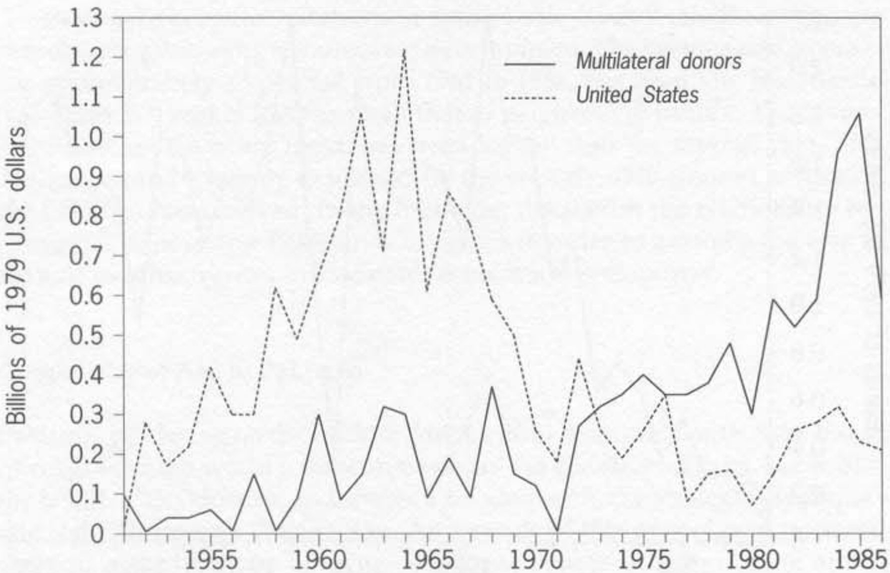


SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

once again became a close ally of the United States and a frontline state for containing the Soviet Union.

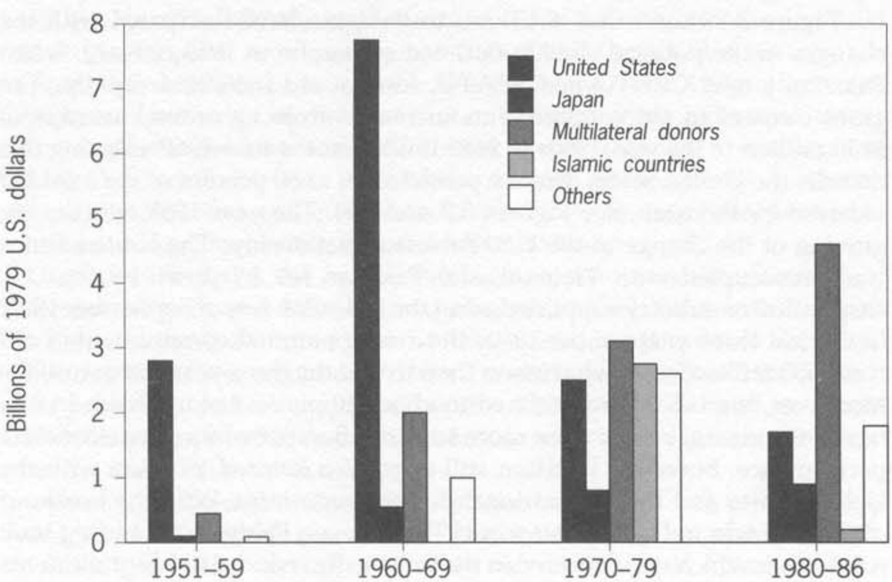
Figure 3.1 shows that aid flows to Pakistan have fluctuated with the changes in the political climate outlined above. From 1955 onward, when Pakistan joined CENTO and SEATO, foreign aid increased rapidly. The grant element in aid commitments increased from an annual average of $150 million in the mid-1950s to $635 million in the mid-1960s. During this decade, the United States directly provided 50 to 80 percent of the total aid received by Pakistan (see Figures 3.2 and 3.3). The year 1965 was the beginning of the change in the U.S.-Pakistan relationship. The United States was preoccupied with Vietnam, and Pakistan felt let down by the U.S. suspension of military supplies during the Indo-Pak war of September 1965. In the last three years of the 1960s the average annual commitment of aid was $600 million, somewhat lower than that of the three years prior to 1965. Moreover, the U.S. share declined to about 40 percent of total aid. In real terms, the changes were even more striking. Because of its good economic performance, however, Pakistan still enjoyed a favored position with the United States and the international donor community. With the breakout of the civil war in East Pakistan in 1971, however, Pakistan's standing took a nosedive, which was reflected in the drastically reduced aid commitments in 1971–72.

FIGURE 3.2 U.S. and Multilateral Aid to Pakistan, 1951–86



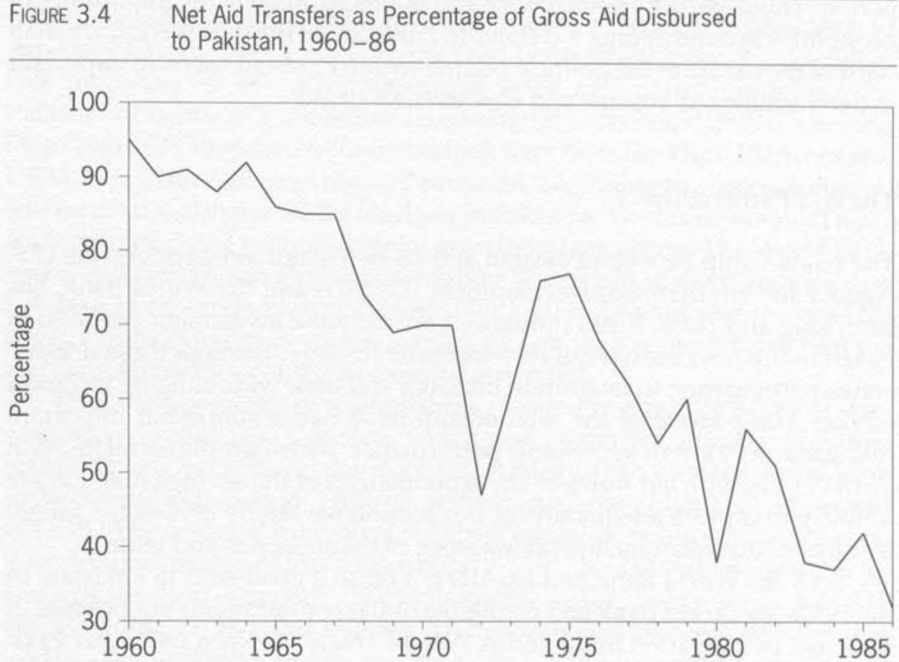
SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

FIGURE 3.3 Total Official Capital Flows to Pakistan, 1951–86



SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

FIGURE 3.4 Net Aid Transfers as Percentage of Gross Aid Disbursed to Pakistan, 1960–86



SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

After an increase in 1972–73, U.S. aid to Pakistan was on a downward trend, reaching an all-time low (about $50 million) in 1980–81. Flows from the Aid to Pakistan Consortium countries remained more or less constant in real terms at approximately $100 million in 1979–80 prices, much lower than the average commitment of $1,600 million (in 1979–80 prices) during the mid-1960s.

This decline in aid to Pakistan coincided with a rapid increase in energy prices. With stagnating gross real aid flows and declining net flows (see Figure 3.4), Pakistan was forced to look to other sources. The oil-rich Islamic countries provided some assistance (see Figure 3.3): following the first oil shock, Iran committed $580 million in 1973–74, and other Islamic countries provided $260 million in 1974–75. After the second oil shock, Saudi Arabia provided $260 million in 1979–80.

The invasion of Afghanistan by the Soviet Union reemphasized the strategic importance of Pakistan to the United States, leading to the third phase of U.S.-Pakistan aid relations. Though complicated by the nuclear proliferation issue, U.S. aid to Pakistan has increased steadily, with its level in the mid-1980s reaching 2.5 times that of the 1970s in real terms. This was accompanied by an increase in aid from the Consortium countries as a whole, which reached an annual average of about $1,600 million in the 1983–86 period. This is hardly a coincidence and points strongly to the importance of geopolitics in determining aid flows to Pakistan. In the next section we shall see that the nature of the political regime within Pakistan was also important in determining the volume and effectiveness of aid.

The Aid Partnership

The relationship between Pakistan and its two major aid partners, the U.S. Agency for International Development (USAID) and the World Bank, has been long and close. It has influenced not only the investment portfolio in Pakistan but also the overall development strategy, through these donors' active participation in institution building and their wide-ranging technical advice. These facets of the relationship have had a subtle but important influence on Pakistan's economic performance, which simple correlations of growth rates with aid flows or the econometrics of the savings function are unlikely to capture adequately. In this section we briefly review the salient features of this relationship, taking stock of the successes and failures.

Both the World Bank and USAID got off to a good start in Pakistan. In the 1950s the World Bank had negligible dollar commitments but because of its active participation in the Indus Waters Treaty between India and Pakistan, and its leadership of the Aid to Pakistan Consortium established to implement that treaty, it was perceived by the government of Pakistan as a friend and a guide. The successful completion of that treaty overcame a major conflict between India and Pakistan and was crucial to the later success of the Green Revolution.

USAID had an active food aid program under PL 480 that provided crucial balance of payments support when Pakistan began to run deficits after the Korean boom.[1] In Pakistan there was some ambivalence toward this nascent aid relationship. To fully understand this attitude we would have to delve into Pakistani politics in some detail, which would take us beyond the scope of this paper. Simply put, Pakistani politicians were fissiparous while the bureaucratic structure inherited from the British raj was relatively coherent. Within the bureaucracy, there was a left-leaning faction—in the tradition of British Fabianism—that was opposed to Pakistan's involvement in the aid relationship. However, Ayub Khan's military coup of 1958 and the new alliance between the army and the bureaucracy rendered that view unfashionable and thrust the bureaucrats into a position of decision making rarely paralleled elsewhere. Ayub Khan was favorably disposed to the West in general and to the United States in particular, and had ambitious plans for the economic development of Pakistan. Thus began the long partnership between Pakistan, the World Bank, and USAID.

Ayub Khan (1958–69): The blossoming of the aid partnership. Conditions were right for the aid partnership to blossom; Pakistan had a stable and well-disposed government with ambitious development goals. The Harvard Advisory Group, put in place by the Ford Foundation, played a dominant role in preparing the development strategy and policy guidelines for Pakistan's Planning Commission. Its domination continued until the Second Plan (1961–65); Pakistani technocrats took over from the Third Plan onward. USAID was, through its earlier aid program, beginning to acquire technical and institutional expertise for working in Pakistan. The Indus Waters Treaty was completed and promised major growth in agriculture. The World Bank was well liked, and as a young institution in the field of development, saw Pakistan as an excellent opportunity. Not least important was the fact that development economics was beginning to acquire a respectability that the Harvard Advisory Group was eager to put to test.

These complementary relationships resulted in a massive flow of concessionary capital into Pakistan, which was channeled into the economy according to a thought-out development strategy. (Net transfers to Pakistan in the Second Plan period, 1961–65, were at an all-time high of 11.11 percent of GDP.) The essential ingredients of the strategy were import-substituting industrialization, taxation of agricultural exports, and investments in energy and irrigation infrastructure. The tools to achieve the goals were commodity aid, including PL 480, and a strong dose of technical advice. The latter was invaluable in building up the pool of skilled manpower that now runs the important institutions established during this period, such as the Water and Power Development Authority and Pakistan Industrial Credit and Investment Corporation.

During the Second Plan period of the early 1960s, capital flows were being channeled primarily into the water and power sectors and resulted in the completion of the Mangla and later the Tarbela dams, which were to play an important role in Pakistan's Green Revolution in the latter half of the 1960s. Here the United States, Pakistan's largest donor, took the lead in developing a comprehensive strategy for agricultural development outlined in the Ravelle Report (United States 1964), whose objectives were to build on the extensive canal network that already existed in Pakistan and to tackle the associated problems of soil waterlogging and salinity. The positive side of the report was that its groundwater development scheme met with success unprecedented in Pakistan's history. The negative side was that it recommended administrative restructuring of the country that went far beyond what Pakistan's bureaucracy considered to be legitimate interference by a donor. The Bank supported the U.S. position, and seeds of discord were sown in what had been a smooth relationship.

Overall, however, this was a period of remarkable success in the partnership between Pakistan and its major donors, which was reflected in the macroeconomic performance already described in the first section. What is noteworthy is that the partnership showed little awareness of the equity problems likely to emerge from a development strategy that tended to concentrate benefits on fast-industrializing West Pakistan at the expense of jute-exporting East Pakistan. Nor, it seems, was there much concern for neglect of the social sectors, blame for which was later laid at Pakistan's door alone. Notice also the shared responsibility for the import-substituting development strategy, which today is so out of vogue.

Meanwhile, other aid-related problems had begun to surface. With the large inflow of foreign capital, Pakistan began to experience an early version of the Dutch disease: the appreciation of the real exchange rate discriminated against exports and encouraged the flow of resources to the nontradable sector. To counter this, the government put in place an export bonus voucher scheme with multiple exchange rates that favored exports and influenced the pattern of imports. For all its merits, the scheme was complicated, and after a while the supply and demand of vouchers could not be managed, leading to arbitrariness and corruption. To further liberalize trade, Pakistan adopted a "free list," but only after the United States agreed to provide commodity aid (albeit tied to U.S. sources) for balance of payments support. This arrangement worked well and Pakistan was on its way to trade liberalization until 1965, when Pakistan and India fought a war, and Pakistan's naivete in counting on politically motivated U.S. aid, even when a sound economic program was being implemented, was fully revealed. For the next fifteen years Pakistan remained in political disfavor; U.S. political concerns and alliances changed (see previous section) and no matter what the economic performance, the United States would have a low aid profile in Pakistan for some time to come.

Pakistan's sustained growth in the Third Plan period (1966–70), despite reduced aid flows, was made possible by the success of Green Revolution technology—agriculture grew at a remarkable 6.3 percent during this period—which, in turn, resulted from investments in irrigation and agriculture, such as research at Faisalabad Agricultural University, made during the Second Plan period. The aid partnership, however, was disrupted again and then virtually suspended after the civil war of 1971, which created Bangladesh.

Zulfiqar Ali Bhutto (1972–77): Souring of the partnership. The new Pakistan's internal politics further exacerbated the falling out that had started in 1965. The Bhutto period presents an interesting paradox concerning the aid relationship, arising partly from the mixed signals sent by the government. In 1972 the rupee was devalued from Rs 4.76 to Rs 10.59 to the dollar, leading to the discontinuation of the export voucher scheme and some import liberalization that should have pleased donors. The land reform, however, was less convincing, as was the rhetoric on improving income distribution. In fact, inflation soon eroded gains in money wages made by workers. Then followed a spate of nationalizations that scared away private investment. To generate revenues for the expanding government, Pakistan nationalized trade in cotton, wheat, and edible oil. The energy crisis and the world recession then put a double squeeze on the economy, increasing the import bill and exposing the inefficient import-substituting industrialization that had taken place. Further nationalizations followed. This frenzied scenario had grave economic consequences, and most macroeconomic indicators fell sharply (see Table 3.3).

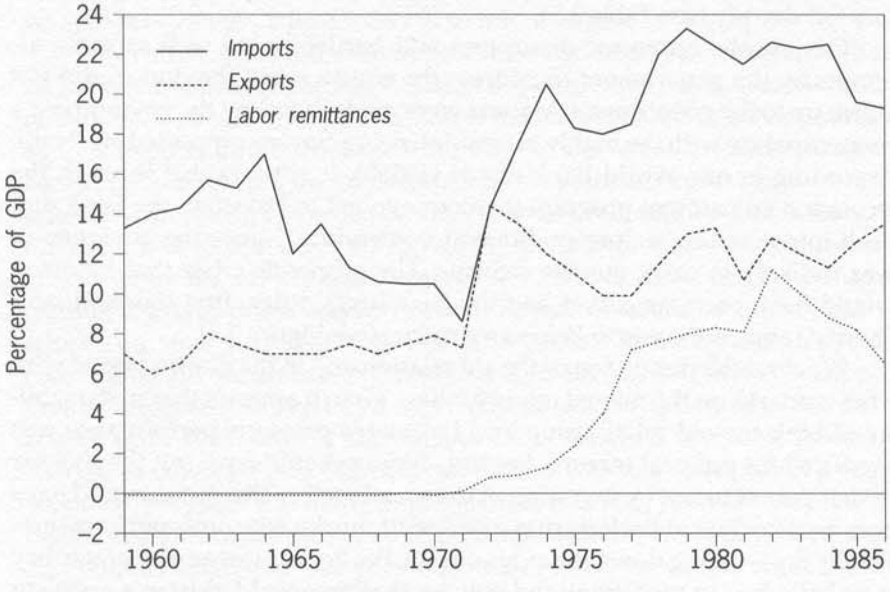
Despite the economic disruption and hardships, as well as some attempts by the government to address the equity issue, the donors did not warm up to the government. Matters were made worse by the government's preoccupation with the highly capital-intensive, Soviet-supported steel mill. According to one World Bank report (1986b), it appears that through the structural adjustment program it recommended to Pakistan, the Bank dug itself into position of "preconditioned nonlending," since the government was unlikely to carry out the reforms. The economic crisis that followed would have been far graver had the Islamic countries, first Iran and later Saudi Arabia, not come to Pakistan's rescue (see Figure 3.3).

We close the discussion of the aid relationship in the Bhutto period with a few remarks on the missed opportunities. First, it appears that sustainability of both the aid relationship and Pakistan's previous performance was sacrificed for political reasons. Second, donors should have put the rhetoric of that period to test by investing in the social sector. This focus would have been worthwhile in itself during a period of murky economic performance. Finally, by winding down the aid program, the donors lost any leverage they may have had in modifying the policies that reversed Pakistan's excellent economic progress.

Zia-ul-Haque: Lending for structural adjustment. In 1979, the Soviet Union invaded Afghanistan, and Ayatollah Khomeini ousted the Shah of Iran. Pakistan's geopolitical location again commanded a premium. The donors who had shunned General Zia-ul-Haque after the military coup and Bhutto's execution were keen to forge a new aid partnership. The government adopted a more liberal economic strategy, encouraging privatization and restoring private investors' confidence. Investment began to trickle into the social sectors as well. However, lending programs were unimpressive, reflecting the reduced resource availability in the 1980s compared to the 1960s and the growing awareness of inefficiencies in resource utilization. The structural adjustment concerns resulted in program lending by the World Bank through structural adjustment loan (SAL) I in 1980–83 and by the International Monetary Fund (IMF) through its Extended Fund Facility. The multilaterals advised Pakistan to delink the rupee from the dollar (which led to a gradual depreciation of the rupee), focus on efficient import substitution, reduce government expenditures, establish tax reforms to increase domestic resource mobilization, encourage savings, institute price reforms, and push for export-led growth and privatization.

This was a long and diverse menu, and Pakistan was selective. The rupee was delinked and devalued against the dollar, farmgate prices were raised, some concrete measures were taken to reassure the private sector,

FIGURE 3.5 Shares of Trade and Labor Remittances in GDP in Pakistan, 1959–86



SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

and further import liberalization measures were taken. The new policy initiatives bore fruit, and Pakistan achieved a remarkable 6.6 percent growth rate during the Fifth Plan period (1978–83). Both industry and agriculture contributed to this progress with growth rates of 9.6 percent and 4.4 percent, respectively. In the Aid to Pakistan Consortium meeting of 1982, the World Bank congratulated Pakistan on its economic successes, which paved the way for further aid. The Bank itself was generous to Pakistan: toward the mid-1980s, thirty-seven projects were sanctioned—equal to the number of projects approved throughout the 1960s and 1970s.

Despite the recovery, problems remained. Public sector expenditure was high, tax reforms were pending, and the savings rate was low. Moreover, Zia had his own agenda for Islamization of the economy, especially the banks,[2] which he was determined to push through despite the uncertainties created in the financial markets. Furthermore, at least in the Fifth Plan period, only lip service was paid to investment in the social sector. (In the Sixth Plan period of 1984–88, Pakistani planners at last began to address the dismal situation of the social sector. In 1987 nearly 45 percent of the budget was spent on that sector.) Thus, although the relationship between the World Bank and Pakistan improved in the 1980s, it is not as cozy as it was in the early 1960s. This change is evident in the government's refusal to sign the second industrial sector loan, because it felt unable to agree to some of the conditions

TABLE 3.4 World Bank Lending to Pakistan, FY 1960 to FY 1984

	IBRD		IDA		Total	
Sector	Millions of US$	Number of projects	Millions of US$	Number of projects	Millions of US$	Number of projects
Agriculture	145.2	5	862.4	34	1,007.6	39
(Cancellation)			(64.4)		(64.4)	
Public utilities	40.0	1	207.4	10	247.4	11
(Cancellation)			(50.0)		(50.0)	
Transportation	295.8	13	275.8	14	571.6	27
(Cancellation)	(35.0)		(39.8)		(74.8)	
Education	0.0	0	85.1	7	85.1	7
(Cancellation)			(17.5)		(17.5)	
Population	0.0	0	18.0	1	18.0	1
Development finance corporations	280.0	10	253.0	8	533.0	18
(Cancellation)			(3.0)		(3.0)	
Industry	105.5	3	62.8	2	168.3	5
Nonproject lending	60.0	1	341.1	10	401.0	11
(Cancellation)			(27.0)		(27.0)	
Energy	167.4	6	105.0	4	272.4	10
Grand total	1,093.9	39	2,210.5	90	3,304.4	129
(Cancellation)	(35.0)	(1)	(201.7)	(19)	(236.7)	(20)
Actual lending	1,058.9	38	2,008.8	71	3,067.7	109

NOTE: IBRD = International Bank for Reconstruction and Devlopment; IDA = International Development Association.
SOURCE: Statement of loans/credits presented in World Bank (1986b).

contained in it. Meanwhile, Pakistan's balance of payments position was better than it might have been because of the new, albeit temporary, inflow of remittances from Pakistanis working in the Persian Gulf, which peaked at nearly $3 billion in 1982 (see Figure 3.5). Another factor, of course, was that Pakistan had patrons other than the World Bank. The United States resumed its aid in 1982 with a large six-year commitment of $1.66 billion from fiscal 1982 to 1987, and the Asian Development Bank increased its lending. The thrust of their economic programs is taken up in the next section, where the project portfolios of donors are discussed in more detail.

Donors' Lending Portfolios

Priorities in donor lending and consistency in their pursuit of development objectives are best analyzed by examining their project portfolios.

The World Bank. Calculations based on the aggregate World Bank lending portfolio (the portfolio is presented in Table 3.4) suggest the following trends. First, there has been considerable fluctuation in lending from one plan to another. Second, loans to Pakistan have been made through both IDA (concessionary) and IBRD (nonconcessionary), the former becoming more important throughout the 1970s. In recent years, the IBRD window has again become more important. Third, most of the lending has been in agriculture and water (33 percent), followed by industry and finance (23 percent), transportation (19 percent), public utilities and energy (9 percent), and finally the social sectors—education and population (about 3 percent). Nonproject lending amounted to 13 percent; thus direct policy-based lending through SALs has been small. As shown above, however, there was plenty of policy content in the project loans, given the earlier warm relationship between the World Bank and Pakistan.

Priorities have been changing over time, and in most cases quite appropriately. Early in the Bank's relationship with Pakistan (in the Second Plan period) large water projects, crucial to Pakistan's successful Green Revolution, were important. Emphasis on industry and finance started in the Third Plan. Lending for energy was also important, reflecting the difficulties faced by Pakistan because of the oil crises. In the 1980s, irrigation again assumed importance for both area expansion and maintenance and improvement of existing facilities. Lending to the social sectors is also a recent phenomenon, but unfortunately still on a smaller scale than the situation has warranted. Here the Bank's vital input may be the analytical support it is providing to identify the parameters of a comprehensive education program.

Although changes in the portfolio mix of World Bank lending have adequately reflected changing priorities, there are some questions as to the commitment to equity, particularly with regard to financial sector support. For example, since the 1970s World Bank lending both to the Agricultural Development Bank of Pakistan (ADBP) and to industrial development finance institutions has increased. ADBP lending for farm mechanization has been criticized on equity grounds, because it is seen to lower rural farm employment opportunities. Similarly, financial institutions' lending to industry has been accused of focusing too much on large firms.

The Asian Development Bank. The Asian Development Bank (ADB) began lending to Pakistan in 1968 (see Table 3.5), and its importance has increased over time. Until June 1986, total ADB lending to Pakistan (disbursed and undisbursed) was $2,456 million, approximately 15 percent of the total external indebtedness of Pakistan. Between 1982 and 1986, the loans committed by ADB to Pakistan averaged about $340 million per year, or about 25 percent of all foreign loans to Pakistan. Of the total funds committed to Pakistan by ADB, almost 60 percent are at highly concessionary terms from ADB's special funds (Asian Development Fund, or ADF) and the rest are from ordinary capital resources. Project lending in energy, agriculture, and industry comprises most of ADB development assistance to Pakistan. Except for a small program loan for crop intensification in 1979, program assistance

TABLE 3.5 Asian Development Bank Lending to Pakistan by Sector/Subsector, 1968–84 (millions of U.S. dollars)

Sector	OCR[a]	SF[b]	Total	%
Agriculture and agro-industry	67.10	503.85	570.95	27.00
Irrigation	0.00	265.50	265.50	
Fisheries	6.73	79.50	86.23	
Livestock	0.00	33.20	33.20	
Agricultural credit	0.00	64.00	64.00	
Agro-industry	60.37	61.65	122.02	
Energy	477.37	410.50	887.87	41.98
Hydro	230.00	69.70	267.90	
Thermal	103.60	224.40	328.00	
Transmission and distribution	0.00	116.40	116.40	
Gas	143.77			
Industry and nonfuel minerals	44.52	51.50	96.02	4.54
Development banks	233.00	136.00	359.00	16.97
Industrial Development Bank of Pakistan (IDBP)	70.00	20.00	90.00	
Pakistan Industrial Credit and Investment Corporation (PICIC)	89.00	24.00	113.00	
National Development Finance Corporation (NDFC)	48.00	80.00	128.00	
Bankers Equity Limited (BEL)	14.00	12.00	26.00	
Transport and communication	66.80	10.80	77.60	3.67
Ports	37.80	10.80	48.60	
Telecommunication	29.00	0.00	29.00	
Water supply	0.00	61.50	61.50	2.91
Social infrastructure	0.00	62.00	62.00	2.93
Education	0.00	31.00	31.00	
Health and population	0.00	31.00	31.00	
Grand total	878.79	1,236.15	2,114.94	100.00

NOTE: Data include line of credit to Bankers Equity Limited (approved in 1983) and direct equity investment to NDFC (approved in 1984).
a. OCR = ordinary capital resources.
b. SF = special funds that are highly concessionary.
SOURCE: Asian Development Bank, Manila.

was channeled through development finance institutions (DFIs) that on-lent to individual enterprises.

There have been a number of shifts in emphasis in ADB's sectoral lending priorities. Before the first oil shock, lending was to development banks and to agriculture. After the oil shock, there was a significant shift toward the energy sector. In the 1971–78 non-plan period, lending to energy went from zero to $272.4 million, or 41 percent of overall lending during the period. This emphasis was maintained during the Fifth Plan (1978–83) when 42.4 percent of total lending went to this sector. The increase in ADB assistance to energy was accompanied by a reduction in industry's share, which, although it increased from $37 million in 1966–70 to $175.6 million in

1970–78, decreased as a proportion of total ADB lending to Pakistan from 79 percent to 26.3 percent. This was still the second largest sectoral allocation during the period. Loans to the agricultural sector increased from $9.9 million in the Third Plan (1966–70) to $108.5 million in the non-plan period, but overall lending increased even faster so that the proportion of agricultural loans in total lending fell from 21 percent to 16.3 percent. In the Fifth Plan period, ADB loans to agriculture increased, both absolutely and relatively, to $290.6 million or 27.6 percent.

A comparison of the sectoral distribution of Pakistan's overall development expenditure with ADB lending shows that while in certain sectors they have tended to complement one another, in others they have reinforced existing biases. For example, in the decade after the first oil shock, Pakistan increased the share of energy in development outlays fairly slowly, from 18 percent in the non-plan period (1971–78), to 25 percent in the Fifth Plan period (1978–83), while ADB directed over 40 percent of its lending to the energy sector. This greater emphasis on energy was timely and appropriate; however, Pakistan's failure to reorient its own development expenditures to this sector resulted in increasing energy shortages in the 1980s. In the social sector Pakistan followed a policy of benign neglect throughout the period, allocating 13 to 16 percent of development outlays to these sectors; ADB also neglected the sector, allocating it less than 8 percent of total lending. Part of the explanation for poor external financing of the social sector lies in the complex center-province financial relations. Currently, social sector financing is a provincial matter, making it difficult to obtain external resources for social expenditure. Until recently, ADB channeled most of its funds for lending to industry through DFIs for on-lending to individual enterprises. More recently, it has also begun to undertake direct equity participation on an experimental basis.

To sum up, Asian Development Bank lending has accommodated Pakistan's development priorities well: ADB conditionality and policy dialogue have, in general, not led to friction with the Pakistani government. The continuous increase in ADB's annual lending to Pakistan, without any sharp fluctuations (unlike World Bank lending, for example) testifies to a harmonious relationship.

USAID. In August 1981, Pakistan and the United States signed an agreement whereby the United States would provide Pakistan with $3.2 billion in military and economic assistance between 1982 and 1987. Half of this was economic aid, nearly 40 percent of which was to be financed out of PL 480 funds (owned by the United States through food sales to Pakistan) to meet local costs of projects. Military aid was provided at commercial interest rates, and economic aid was a mixture of concessionary loans and outright grants.

To assess the USAID strategy, we briefly compare it with past objectives by reviewing non–PL 480 aid commitments (see Table 3.6). Between 1959 and

TABLE 3.6 U.S. Bilateral Aid Commitments to Pakistan, 1959–87 (non–PL 480 assistance in millions of U.S. dollars)

	1959–68			1973–77			1982–87	
	Millions of US$	%		Millions of US$	%		Millions of US$	%
Industry	1,014.3	66		40.0	13		0.0	0
Technical assistance	9.3		Fertilizer plant	40.0				
Loans to PICIC	22.0							
Commodity loans	983.0							
Agriculture	185.8	12		216.9	71		223.2	40
Technical assistance	24.8		Water management	10.3		Agricultural research	3.2	
SCARPS	36.0					Irrigation system management	65.0	
Fertilizer	125.0		Fertilizer imports	206.6		Farm water management	10.0	
						Agricultural commodities and equipment	120.0	
						Forestry planning and development	25.0	
Infrastructure	341.5	22		0.0	0		185.0	34
Railways	155.1					Rural electrification	155.0	
Other transport	12.4					Energy planning and development	30.0	
Telecommunication	4.6							
Power	169.4							
Social sector	0.0	0		51.1	16		86.6	16
			Malaria control	24.0		Malaria control II	41.0	
			Family planning	18.6		Population welfare planning	25.6	
			Rural health	8.5		Primary health care	20.0	
Special projects	0.0	0		0.0	0		55.0	10
						Gadoon-Amazai area development	20.0	
						Project design	10.0	
						Tribal area development	15.0	
						Development support training	10.0	
Total	1,541.6	100		308.0	100		549.8	100

SOURCE: Data for 1959–68 and 1973–77: Jeffalyn and Johnson (1982); 1982–87: provisional, supplied by USAID, Islamabad.

1968, 66 percent of the total $1.54 billion of aid committed was to industry, 12 percent to agriculture, and 22 percent to infrastructure. There was clearly a heavy commitment to industry; substantial commitment was also made in the form of PL 480 food exports to Pakistan, which, by keeping agricultural prices low and supporting the balance of payments, helped the industrialization strategy.

Aid commitments in the 1973–77 period reflected a shift of priorities in the then low-profile aid program. The focus was mainly on agriculture, with the fertilizer support program occupying center stage. What little aid industry received was for fertilizer manufacture, an agricultural input. Projects were also initiated in the social sector—malaria control, family planning, and rural health—to reflect new concerns with equity and poverty eradication.

A proper analysis of the recent, larger aid program of the 1982–87 period will be possible only as more data become available. By 1983, twenty projects had been identified, and data for these were released to the authors by USAID in Islamabad. Most of the commitments were in agriculture. Commitments to infrastructure development were renewed, and social sector projects—malaria control II, population, and primary health care—continued to be emphasized. Further technical assistance was provided through a number of initiatives such as project design and development support training. A tribal area development project was designed, reflecting concern with the sensitive Pakistani-Afghan border. USAID has also responded to the recent alarming increases in drug abuse and drug smuggling out of Pakistan. A project was designed in the Gadoon-Amazai area, a center of narcotics production, to provide alternative economic opportunities.

Although, as suggested above, data to make a full assessment of the impact of the new aid partnership on Pakistan's economy are not yet available, it is clear that the partnership is building on previous successes. The contribution of USAID-supported irrigation projects to Pakistan's agricultural development is well documented. The new aid program has given timely attention to improving the efficiency of the existing system through maintenance support and reduction of water losses on the farm. Similarly, the research (Pakistan Agricultural Research Council) and training programs initiated will help to increase the pool of technical expertise vital to Pakistan's growth. Although social sector projects have been designed, much more needs to be done, particularly in the areas of population control and education, to help overcome alarming deficiencies in this area.

The discussion of the U.S.-Pakistan bilateral aid relationship is incomplete without mention of aid tying, which reduces total resource availability to Pakistan. Mahboob-ul-Haque (1967) has identified two main costs of aid tying: source tying results in higher per unit costs of aid-funded imports of equipment and commodities, and freight on U.S. carriers is often substantially more expensive than on other (including Pakistani) carriers. To date, little has been achieved on this issue.

The Effectiveness of Aid

Aid and growth. The relationship between aid and economic growth in Pakistan seems indirect and complex. In the 1960s Pakistan received large amounts of foreign assistance, and the economy expanded rapidly. The savings rate increased in the first half of the decade, and exports grew faster than imports. Between 1969–70 and 1975–76 the average level of real net transfers was less than two-thirds of the 1960s level. During this period economic growth was much slower, the real value of exports stagnated, and real savings actually declined. Although the aid climate has been favorable since 1976–77 and commitments have been higher, the level of real net transfers has only been about 75 percent of the 1970–76 level and less than half that of the 1960s. Export performance has been erratic, with periods of rapid growth in 1977–81 and 1985–87, and a decline during 1982–84. Nonetheless, over the entire period, exports doubled in real terms while imports increased by less than 60 percent. Also, as discussed earlier, the savings rate remained at the level reached in the 1960s and did not increase.

A simplistic reading of the evidence would suggest a positive correlation between aid and growth. In the 1960s and 1980s, Pakistan had the support of the donor community, it received substantial aid flows, and it achieved high growth rates. In the 1950s and 1970s this was not the case, and economic growth suffered. A closer look at the amount of flows in the 1980s, however, reveals that aid as a fraction of GDP in fact declined substantially (see Table 3.3). A better explanation is that domestic economic policies and the international economic environment were more conducive to economic growth in the 1960s and 1980s than in the 1970s. In the 1980s, remittances eased the resource flow situation considerably. The international economic environment may be independent of foreign aid but domestic policies are not. Thus it may be hypothesized that when large flows of aid are available, the donors are able to exercise greater influence on domestic policies that improve economic performance. Some examples of the influence of donors on domestic economic policies are discussed below.

Policy and aid conditionality. Some form of conditionality is attached to most large projects funded with aid. Here we discuss only those conditions that tend to be concerned with overall policies rather than those that are project-specific. We will discuss three episodes of aid conditionality and its influence on Pakistan's domestic policies.

At the time of the first martial law in 1958 Pakistan had an extremely restrictive trade regime, with almost all imports subject to licensing and strict controls. During that period, in addition to economic aid, the United States provided direct technical input into economic policy formulation. The Harvard Advisory Group made policy recommendations to the government of Pakistan and helped set up a planning board, which was later upgraded to the Planning Commission. It functioned as an independent body with great influence on economic policy-making. U.S. advisers felt that the restrictive trade regime was the primary obstacle to economic growth and were able to convince Pakistan to undertake a program of import liberalization. As a result, first the export bonus voucher scheme was introduced, and then the open general licensing (OGL) scheme was greatly expanded. By 1965 considerable import liberalization had taken place and a large number of industrial raw materials were placed on the OGL scheme (funds were directly made available by USAID for free import of iron and steel under this scheme). In 1965, however, the reduction in aid following the Indo-Pak war halted these import-liberalization programs, and controls were reestablished. Although some steps toward import liberalization were again introduced in the late 1960s, the momentum was lost.

In the 1960s, the United States was by far the largest donor and greatly influenced Pakistan's domestic economic policies through the sheer size of its aid programs. A USAID (1967) paper stated that "existing government policies, priorities, and administrative capacity should not be taken as immutable but rather regarded as policy variables." In this regard the case of import liberalization in Pakistan during the first half of the 1960s was cited as an example of effective influence over the recipient country's economic policies.

In 1981 the IMF and the World Bank argued that Pakistan's exchange rate was out of line and that devaluation was necessary. This condition was attached to the IMF structural adjustment loan of 1981. In January 1982 Pakistan delinked from the dollar and eliminated overvaluation of the rupee. It is interesting to note that even after the structural adjustment loan period was over, Pakistan continued to follow a flexible exchange rate policy and to devalue the rupee against the dollar. This is an example of a reform introduced under pressure from outside agencies that was continued after pressure was removed because Pakistan recognized its usefulness.

The World Bank and IMF have been advising Pakistan to institute a tariff reform and an import-liberalization program for many years now. The government, however, has resisted this advice, because of the likely loss of revenue from the reform and the failure to appreciate the benefits of the programs. A recent example is the government's refusal to sign an agricultural loan with the World Bank, because of conditions attached that involved eliminating the subsidy on fertilizer and increasing irrigation water rates. Though the government accepted the economic rationale of these measures, it felt that the steps would have unacceptable negative political impact in rural areas.

To conclude, where sufficient resources are involved and when the government can clearly see the value of particular economic policy changes, it is willing to implement reforms. There are always, however, internal political considerations and revenue implications that the government must take into account when implementing any policy change. Reforms that adversely affect established interest groups or have broad negative political consequences are generally not undertaken despite external pressure.

Chenery and Strout "gaps" and Pakistan. According to Chenery and Strout (1966), a country passes through three stages on its way to self-sustaining growth. In the first stage the dominant constraint is the country's absorptive capacity: the economy is so primitive it cannot beneficially invest the minimum amount—approximately 15 percent—necessary to achieve the required growth rate of 5 to 6 percent. At this stage the purpose of foreign aid is to increase absorptive capacity by providing technical assistance, training, education, managerial ability, entrepreneurial talent, and so forth.

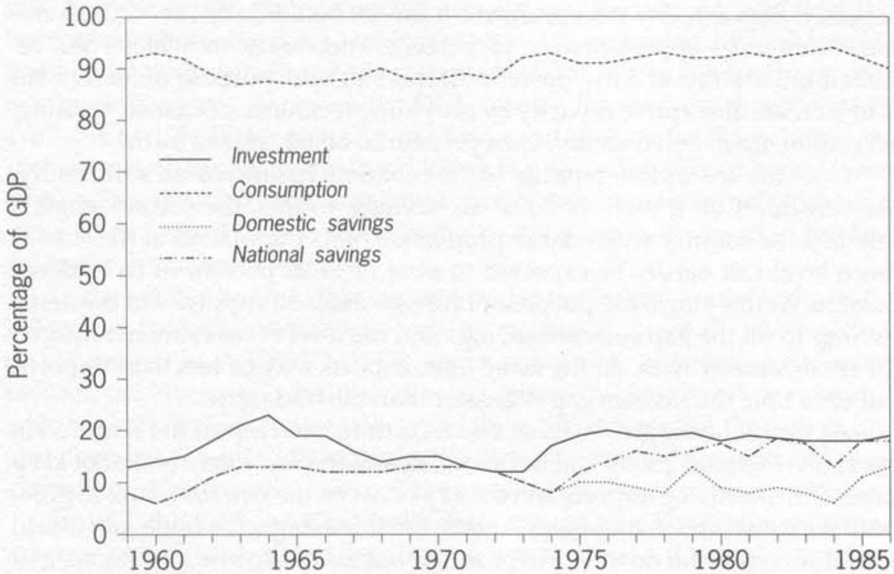
Once the absorptive capacity of the economy has increased sufficiently, the constraint on growth is domestic savings. In this, the second stage, a low-income country with a large proportion of its population at the subsistence level can hardly be expected to save 15 to 20 percent of its national income. At this stage, the purpose of foreign aid is to supplement domestic savings to fill the gap between savings and the level of investment required for reasonable growth. At the same time, exports may be less than imports, but for a time the savings gap is greater than the trade gap.

As the economy grows, more and more imported inputs are required in the form of capital goods and industrial raw materials. Exports cannot keep pace with increasing imports and the gap between the two continues to grow until it exceeds the savings gap. At this, the third stage, the trade gap is said to be dominant, and now the purpose of foreign aid is to bridge this gap, and in doing so, aid more than fills the savings gap. As the economy develops further, rising levels of income lead to an increase in savings as a proportion of national income until the required rate of savings is attained and the savings gap is closed. As development proceeds, import substitution of capital goods takes place first with the result that exports grow faster than imports and ultimately catch up with them, closing the trade gap. With the closing of the trade gap, the need for foreign aid ends.

Since the above outline of Chenery and Strout's framework was largely inspired by the Pakistani experience, it is appropriate to see how their basic ideas have stood the test of time in the context of subsequent developments in Pakistan. Before looking at actual data, however, it is necessary to point out some of the problems in applying the model. First, in most developing countries, including Pakistan, savings are calculated by the residual method using the familiar national income accounting identity, $S = I - (M - X)$, where S is savings, I is investment, M is imports, and X is exports. This defines the savings gap $(I - S)$ as always being equal to the trade gap $(M - X)$; therefore it is impossible to say which gap is dominant by merely examining the data. It is a matter of judgment whether, at any given time, it is lack of savings or scarcity of foreign exchange that is the binding constraint on investment and growth.

Second, there is some ambiguity as to whether the appropriate measure of foreign aid is gross disbursements, net disbursements, or net transfers (net disbursements are gross disbursements less principal repayments; net transfers are net disbursements less interest payments on past debt). When

FIGURE 3.6 Investment, Consumption, and Savings as Shares of GDP in Pakistan, 1959–86



SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

Chenery and Strout wrote their paper, it made very little difference which of the three measures was used. It now seems obvious, however, that in the context of the model net transfers is the appropriate measure, and it is used in this discussion.

It appears that in the 1950s absorptive capacity was a constraint on growth in Pakistan; technical assistance, particularly in the area of economic management, helped remove it. Toward the end of the 1950s, however, Pakistan had clearly entered the second phase, where the savings gap was dominant; the domestic savings rate was 6 to 8 percent, but foreign aid made possible an investment rate of 13 to 14 percent. As a result of the rapid increase in foreign aid in the first half of the 1960s, the investment rate rose quickly and reached 23 percent by 1964–65. The savings rate also rose significantly, to 13 percent in 1964–65, but the savings gap increased from 6 percent of GDP in 1959–60 to about 10 percent in 1964–65. In the latter part of the decade, the savings rate remained in the 12 to 13 percent range, and as foreign aid declined so did the investment rate, which came down to about 16 percent by the end of the 1960s. It seems clear that in the 1960s lack of savings was the primary constraint on investment. Foreign exchange shortages, which resulted in a reversal of the trade-liberalization process in the second half of the 1960s, also had an adverse impact on investment and growth.

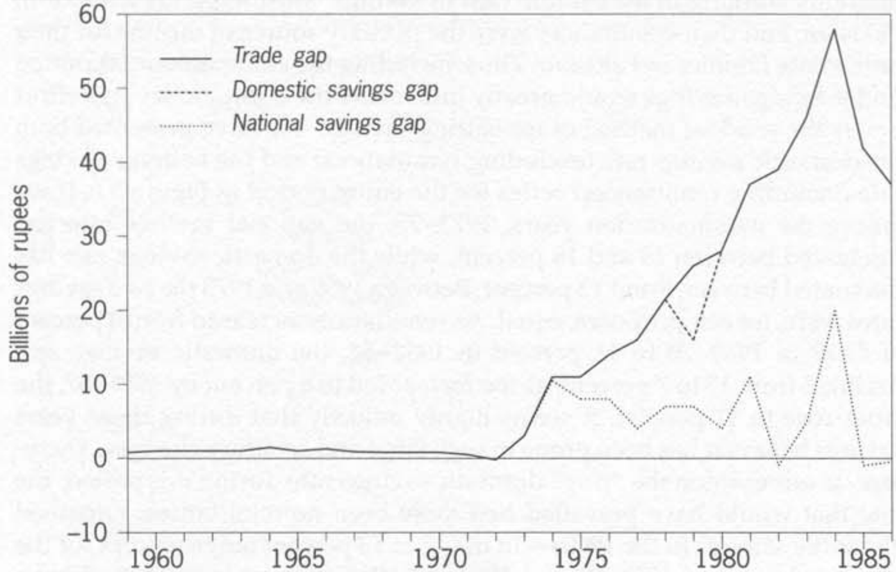
Third, there is also the question of how to include remittances from migrants working in the Middle East in savings. Most migrants left jobs in Pakistan, and their remittances were the primary source of income for their immediate families in Pakistan. Thus, including the entire amount remitted under foreign savings would greatly understate the domestic savings effort under the residual method of measuring savings. We have presented both the domestic savings rate (excluding remittances) and the national savings rate (including remittances) series for the entire period in Figure 3.6. If we ignore the nationalization years, 1973–75, the national savings rate has fluctuated between 13 and 18 percent, while the domestic savings rate has fluctuated between 5 and 13 percent. Between 1959 and 1973 the two savings rates were, for our purposes, equal. As remittances increased from 0 percent of GDP in 1969–70 to 11 percent in 1982–83, the domestic savings rate declined from 13 to 7 percent; as the former fell to 6 percent by 1986–87, the latter rose to 11 percent. It seems highly unlikely that during those years savings behavior has been prone to such large and arbitrary changes. Therefore, in our opinion the "true" domestic savings rate during this period, the rate that would have prevailed had there been no remittances, remained about the same as in the 1960s—in the 12 to 13 percent range (except for the abnormal years of 1973–75 and 1984–85). Remittances from abroad have added, on average, 2 to 3 percent of GDP to savings. The average investment rate since 1974–75 has been around 18 percent, and therefore foreign aid has raised the investment rate by about 3 percent.

During the entire period, Pakistan has followed an extremely restrictive trade regime, and although some liberalization has taken place in the last few years, the levels of effective protection still remain high. The government, while reducing nontariff barriers through exchange rate policy and imposition of across-the-board import surcharges, was able to prevent imports from increasing. Since 1979–80 Pakistan's total imports have remained constant in real terms at around $5.5 billion. This indicates that in the 1980s the binding constraint has been the availability of foreign exchange.

To sum up, in Pakistan during the 1950s, foreign aid laid the basis for subsequent growth by raising the technical skills and absorptive capacity of the economy. In the 1960s foreign aid supplemented domestic savings and made possible high rates of investment and growth. During the 1970s, because of the two oil shocks, foreign exchange was the primary constraint, and foreign aid (and remittances) bridged the trade gap and made possible what little growth did take place in that period. In the 1980s rapid growth resumed, but it is difficult to evaluate the contribution of foreign aid. The savings rate remained low, not rising above the level reached in the 1960s, and the trade gap also seemed to be binding (see Figure 3.7). Net transfers, however, contributed little to imports (8 to 11 percent) or to investment (9 to 14 percent).

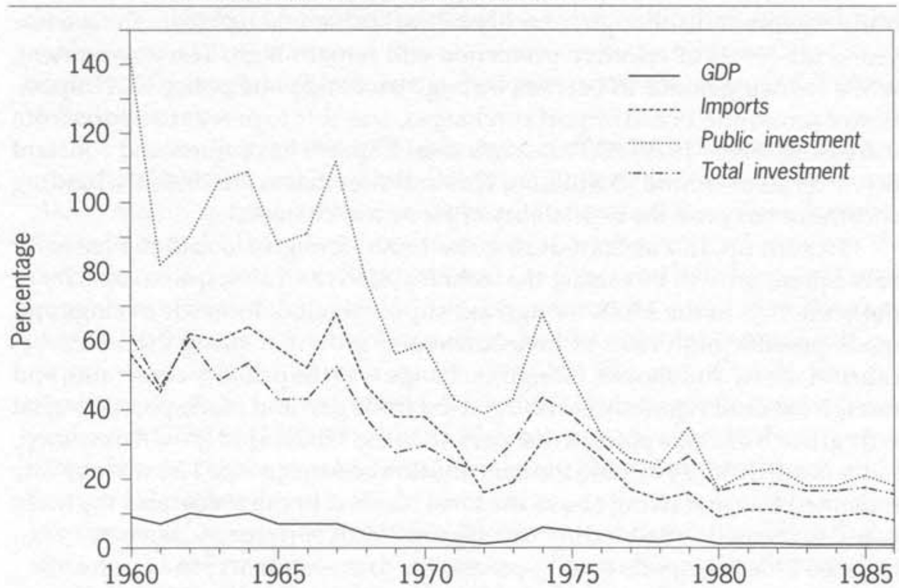
Before concluding the discussion on the role of foreign aid, it is necessary to highlight one important function it has had in Pakistan, namely, as a supplement to government resources for public investment. In the first half of the

FIGURE 3.7 Trade and Savings Gaps in Pakistan, 1959–86



SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

FIGURE 3.8 Net Aid Transfers as Percentage of GDP, Imports, Public Investment, and Total Investment in Pakistan, 1960–86



SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

1960s, net transfers provided 100 percent of government investment (see Figure 3.8). They declined to approximately 50 percent by 1970–71 and stayed at that level until 1975–76. This figure has since fallen to an average of around 18 percent in the mid-1980s. At the same time, however, undisbursed aid has increased from $2.8 billion in 1983–84 to $4.4 billion in 1985–86. An important factor in this buildup is that most of the aid commitments are for projects, and shortages of government complementary rupee resources prevents their full implementation. In this sense insufficient government savings have become the primary constraint on growth, and at this stage aid could be most effective if it alleviated this constraint.

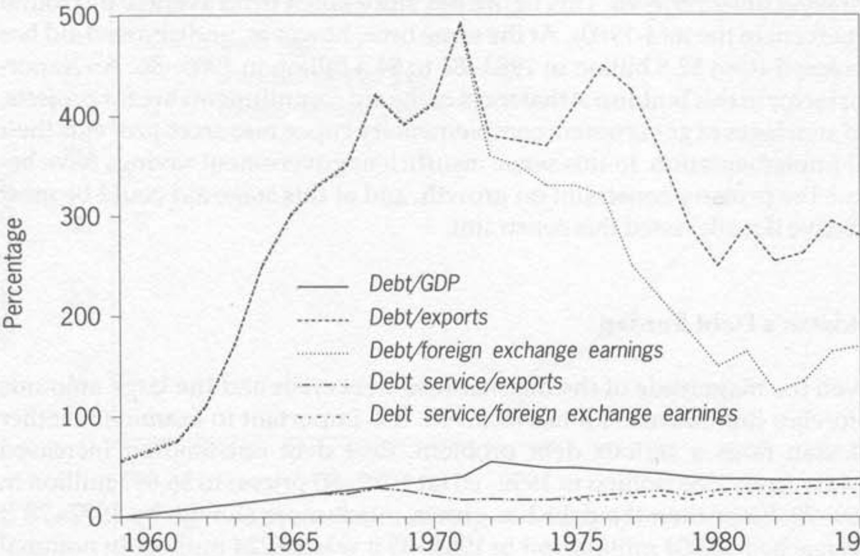
Pakistan's Debt Burden

Given the magnitude of the international debt crisis and the large amounts of foreign capital Pakistan has received, it is important to examine whether Pakistan faces a serious debt problem. Real debt outstanding increased rapidly from $386 million in 1959–60 (at 1979–80 prices) to $6,897 million in 1969–70. Since then the debt has grown much more slowly: by 1977–78 it had reached $9,004 million and in 1984–85 it was $9,224 million. In nominal terms, however, debt has increased from $150 million in 1959–60 to $3 billion in 1969–70, $7 billion in 1977–78, and $11 billion in 1985–86. The difference between these two series shows that inflation in the 1970s was reducing the burden of debt almost as fast as new debt was being incurred. Thus in real terms, Pakistan's outstanding debt has increased by only 50 percent in the last fifteen years.

Looking at debt outstanding as a percentage of GDP, exports, and foreign exchange earnings over the 1960–87 period sheds some more light on Pakistan's debt situation (see Figure 3.9). As a percentage of GDP, debt outstanding increased from 4 percent in 1959–60 to 35 percent in 1971–72. Because of the large devaluation of the Pakistani rupee in 1972, this figure jumped to 55 percent in 1972–73; since then it has declined steadily, reaching 30 percent in 1981–82. In 1982 Pakistan adopted a flexible exchange rate policy, and since January 1982 the rupee has been devalued against the dollar by over 70 percent, which has exerted an upward pressure on the debt to GDP ratio. This has countered the declining trend, and over the 1981–86 period this ratio has remained in the 30 to 33 percent range.

If we look at debt outstanding as a percentage of exports, we see similar trends, except that the exchange rate effect acts, if anything, in the opposite direction. Between 1960 and 1972, the debt as a percentage of exports increased from 50 percent to 490 percent. The devaluation of 1972 increased exports, and the ratio declined to 370 percent, where it remained for the next three years. The ratio increased in the next three years because of stagnating exports, and reached 430 percent in 1977–78. With the renewal of export

FIGURE 3.9 Pakistan's Debt Burden, 1959–85



SOURCE: Economic Affairs Division, Government of Pakistan, Islamabad.

growth it declined once again, reaching 290 percent in 1979–80, where it has hovered since.

Since remittances were of increasing importance in the 1970s and the early 1980s and have declined in the last few years, the debt to foreign exchange earnings ratio declined steadily from 360 percent in 1972–73 to 130 percent in 1982–83, but slowly increased to reach 170 percent in 1985–86.

On the basis of all three of these measures one would conclude that Pakistan does not face a serious debt problem. Debt outstanding as a proportion of GDP, exports, and foreign exchange earnings has declined over most of the period from 1970 to 1985.

Another aspect of debt is the burden imposed by principal and interest payments, which have increased over time in real terms. Principal repayments have gone up from $16 million in 1959–60 to $575 million in 1986–87. Similarly, interest payments have gone up from $8 million in 1959–60 to $296 million in 1986–87. In current prices the estimated principal plus interest repayments for 1985–86 was $906 million. The ratios of debt service to export and to foreign exchange earnings show the impact of the debt service burden. Between 1959–60 and 1968–69, the debt service to export earnings ratio increased from 4 percent to 26 percent. Because of debt rescheduling and diversion of trade between East and West Pakistan to international markets (resulting in an increase in measured export earnings of West Pakistan), the ratio declined to 16 percent in 1971–72. For the next five years it remained in the range of 16 percent to 18 percent, and has since fluctuated around 20 percent without showing a significant trend. In 1980–82 it declined to 16 percent because of the second round of debt rescheduling. It then increased and was estimated at 22 percent in 1986–87.

As mentioned above, remittances have been an important source of foreign exchange for Pakistan since the early 1970s, making it appropriate to examine the debt service to total foreign exchange earnings ratio as well. This ratio shows a downward trend between 1972 and 1983 when it declined from 16 percent to 9 percent. Since 1983 it has been increasing as remittances have declined, and in 1986–87 it is estimated at 15 percent.

Thus we can conclude that on the basis of past debt service trends, the existing burden is not very high and in fact is about the same as it was in the early 1970s. The primary reason a debt problem does not exist is that very little of Pakistan's debt is from commercial sources. However, unless the government improves its resource mobilization (since the early 1980s almost the entire public development expenditure has been met from domestic and foreign borrowing) and undertakes a tariff reform to remove the existing bias against exports, aid requirements are likely to increase rapidly over the next decade. If Pakistan succeeds in borrowing abroad, from either commercial or official sources, there is a real danger of a rapid increase in the debt service burden.

Alternatives to Aid

According to World Bank estimates (1987), nearly 64 percent of Pakistan's external capital requirements between 1982 and 1986 were financed by aid. Thus aid played a crucial role in generating growth over this period. Furthermore, current projections indicate that aid's share in Pakistan's external capital requirements will increase to about 74 percent between 1986 and 1990, and to 87 percent between 1990 and 1994. On the other hand, ensuring flows of external, concessionary capital is likely to get more difficult. Moreover, as Pakistan has experienced in the recent past, there is considerable uncertainty attached to politically motivated aid. Pakistan, therefore, may have to seek alternatives to aid to sustain growth and to invest in the social sector. One alternative, remittances by Pakistani workers, has been important in the recent past, but they have tapered off and in the future are likely to be lower. Two other alternatives, improving domestic resource mobilization and increasing exports, are explored briefly below.

Improving domestic resource mobilization. Because of inadequate financial institutions and incentives, the domestic savings rate in Pakistan has been persistently low, and public investment has made up a large proportion of total investment (see Table 3.3). Budgetary expenditure as a proportion of GDP has been increasing, but mostly in the form of current expenditure. The government has been unsuccessful in meeting planned targets for reducing wheat and fertilizer subsidies and increasing the tax base (agricultural incomes are not taxed and excise duties favor domestic consumption goods which reduce revenues).

In the previous section we saw that Pakistan's debt service ratio was not severe. Most of it, however, is incurred by the public sector, and interest payments on the external and internal debt (interest payments on the internal debt, at 15 percent, are higher than the marginal cost of domestic borrowing) constitute a large proportion of government expenditure. In this sense, Pakistan does have a debt problem. Moreover, Pakistan's defense expenditure, at about a third of total expenditure, is one of the highest in the world. These factors have combined to raise the budget deficit to approximately 7 percent of GDP and the internal debt to approximately 34 percent of GDP in 1986.

The projected trends are quite alarming. If Pakistan continues on its growth path and fails to reduce current expenditure and raise revenues, it is estimated that between fiscal years 1986 and 1995 the budget deficit will rise from 7.5 percent to 10.2 percent of GDP and the internal debt from 34 percent to 56 percent of GDP (World Bank 1987). This situation is likely to have at least three disturbing consequences: a further increase in debt to make higher interest payments, an increase in expenditure on tradable goods that might worsen the balance of payments, and government displacement of investment (the "crowding out" effect) because of a squeeze on domestic private credit. These consequences are likely to occur even if external flows continue to be available to support projected growth rates. The situation will be considerably worse if there is little reliance on external flows. Thus it is even more compelling for the government to increase revenues, by broadening the tax base and rationalizing the tariff structure, and reduce nondevelopment expenditure.

Increasing exports. Pakistan's exports have grown at a rate of 7.5 percent between 1978 and 1986—a little faster than the overall growth rate—and they now constitute about 12 percent of GDP. The prospects for more rapid growth are not very good, because of the heavy reliance on commodity exports (cotton, rice, and textiles), which suffer from both price and volume uncertainties. The international outlook for commodities is not encouraging: according to projections made by the World Bank, the commodity price index fell from 100 in the period 1979–81 to 73 in 1986 and is likely to rise slowly to 77 by 1991. The manufacturing value index will grow only slightly faster, from 113 in 1986 to 121 by 1991. Moreover, most of Pakistan's exports are affected by nontariff barriers, such as quota restrictions. For example, 51 percent of Pakistan's exports to the United States are subject to such restrictions, as are 53 percent of those to the EEC and 11 percent of those to Japan. These restrictions are likely to worsen, given the lackluster growth in international trade and the increasingly protectionist trade environment.

Pakistan competes with many other countries in the range of goods that it exports. Thus, given reduced world demand, Pakistani exports will grow only if they are cheaper than those of its competitors. In order to make this possible, exporters must be given incentives that include lower export taxes, lower import duties on intermediate goods used as inputs in export manufacturing, and a careful monitoring of the real exchange rate to maintain incentives for resources to flow into the tradable goods sector. These measures will go some way in enabling Pakistan to fully meet its allotted export quotas. Technological innovation is essential to move toward higher-value textile exports. Currently, unit values of various Pakistani textile exports to the United States and the EEC are substantially below the average of all developing country textile exports.

To sum up, as a strategy for Pakistan's economic development, trade as an alternative to aid does not appear to have a very bright future. For it to succeed, a considerable policy shift will be needed to carve out a larger share in the slowly growing volume of international trade, and there is little evidence that such a large policy shift is in the offing.

Concluding Remarks

In the early 1960s, Pakistan received large aid flows, which slowed in the 1970s and increased again in the 1980s. These trends, which have closely followed the political relations between Pakistan and its largest donor, the United States, lend support to the belief that aid to Pakistan has been largely politically motivated. Periods of rapid economic growth in Pakistan have also coincided with periods of large aid inflows. Moreover, it appears that donors have contributed not only directly by providing substantial resources, but also indirectly by influencing policy changes that have encouraged growth. This was particularly evident in the 1980s, when policy reforms were enacted that achieved growth rates comparable to those of the 1960s, even though real aid flows were below the 1960s level.

The technical assistance component of aid has been important in Pakistan. For example, the Harvard Advisory Group helped the government in formulating the development strategy of the 1960s. Important institutions that have shaped Pakistan's economy, such as the Water and Power Development Authority, Pakistan Industrial Credit and Investment Corporation, Pakistan Agricultural Prices Commission, and even the Planning Commission itself, have benefited from donor technical advice as well as financial support. Given this close relationship, it would not be wrong to credit the successes and the failures of economic policy in Pakistan to the partnership between the government and its major aid donors, the United States and the World Bank.

A glaring failure of the partnership in the 1960s, however, was the inadequate attention given to equity at both the individual and regional levels. In the 1970s, donors wrung their hands but failed to come to Pakistan's rescue, missing a good opportunity to support Bhutto's promise of social reform and to use the leverage of aid to check the policy slide that disrupted Pakistan's growth. Only in recent years have donors focused on neglected social sectors by identifying the seriousness of the problem and by constantly reminding the government of the importance of a literate and healthy work force.

To maintain its growth through the 1990s, it appears that Pakistan will have to continue to rely on aid. This is a cause for concern because the international aid environment is getting tighter and because Pakistan may once again go out of political favor. Given current trends, alternatives to aid, such as an increase in exports and greater domestic resource mobilization, are not very promising. If Pakistan is to be less dependent on foreign aid, policy reforms must focus on increasing both public and private domestic savings and improving the quality of exports in order to make them competitive in international markets.