

## **Pakistan and the World Economy**

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This paper aims to explore Pakistan's geo-economic options in the difficult situation that confronts following the easing of sanctions, which added acute balance of payments pressures to its existing ailments of near-stagnant exports, a lower growth trend than in preceding decades, an unattractive climate for foreign investment, and weak social indicators. The first question explored is whether Pakistan has any opportunity of participating in a regional trade grouping. It is argued that the only conceivable way of achieving this would involve the development of SAARC, which would demand a profound transformation of Indo-Pakistani relations (though one no more profound than that realised in Franco-German relations since the founding of what is now known as the European Union). One benefit of achieving deep integration through SAARC is that this would create the possibility of Pakistan developing a serious engineering industry far more rapidly than will otherwise happen. In the absence of deep integration in SAARC, it is argued that Pakistan's best option would be a policy close to unilateral free trade, so as to place it in a position to take advantage of whatever the next generation of labour-intensive activities demanded by the world economy proves to be. Under either of those scenarios, the re-establishment of a dynamic industrial sector will require the maintenance of a competitive exchange rate, something that, it is argued, is not necessarily guaranteed by floating.

The paper also discusses the role of inward direct investment in contributing to the export success of East Asia, and considers whether the expatriate Pakistani community might be capable of playing a role comparable to that played by the overseas Chinese in nurturing the Chinese export expansion of the last two decades. It is suggested that such a hope was set back by the extra-legal attempt to renegotiate power tariffs with the independent power producers in the course of 1998, and that Pakistan needs to become a country of laws rather than discretion if foreign investors, including expatriate Pakistanis, are ever to find the country an attractive export platform. While more inward direct investment would almost certainly be beneficial, the same is not true for inward financial investment, where too large an inflow can easily expose a country to very significant risks, as the East Asian crisis showed. In the long run, Pakistan needs to be prepared to repel excessive capital inflows if they materialise; but its immediate problem is still balance of payments pressure, and this seems to demand targeting a major and sustained improvement in the current account over the next several years.

### **INTRODUCTION**

Pakistan survived the experience of the sanctions imposed on it in 1998 surprisingly well. Economic growth remained positive, in a year when many other

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Asian countries were recording negative growth. Inflation did not accelerate significantly, as was anticipated by most external forecasters. The current account deficit declined further, so that Pakistan's short-run balance of payments position remained viable once lending by the IMF and World Bank was resumed and debt had been rescheduled by the London and Paris Clubs (something that was about to happen at the time of the conference where this paper was presented).

Complacency would nonetheless be out of place. Exports have been declining throughout the fiscal year 1998-99, normal capital inflows have almost dried up, and the country's weak credibility and policy uncertainties have discouraged foreign direct investment in particular and productive investment in general. Pakistan is the only country in South Asia that has recorded a lower rate of growth in the 1990s than in the preceding decades. Suspension of the convertibility of the foreign currency deposits, and the London and Paris Club reschedulings, were essential in the short run, but they will tend nevertheless to compromise Pakistan's ability to borrow internationally for years to come. The social indicators—literacy, mortality, fertility, and poverty—remain poor, even for a country with Pakistan's per capita income, and the squeeze on the budgets of the provincial governments suggests that this is unlikely to improve much in the short run. The country clearly faces a difficult challenge in reviving its economy and in achieving a level of social standards in which it can begin to take pride.

The present paper aims to explore what options exist, and which of them look to have more potential, in this difficult situation. The focus is on Pakistan's relations with the rest of the world, in the tradition of a series of studies on *Country X in the World Economy* that have been produced during recent years by the Institute for International Economics, where I worked for many years before joining the World Bank. These studies have sought to identify the strategic options and principal issues confronting various countries, and where their national interests lie, in relating to the world economy.

This focus on external issues should not be construed as casting doubt on the proposition that profound domestic reforms are essential if Pakistan is to restore the economic progress that it recorded in the first decades after independence, and begin to realise the social gains that have so far eluded it, let alone if it is to realise its potential of becoming a miracle economy. That is conceivable only if universal education is at last achieved, if population growth is rapidly brought down, if the rural oligarchy can be persuaded to forego its privilege of not paying taxes, if the encouraging reports of less corruption are confirmed and prove to be the first step in a thoroughgoing transformation of the standards of public life...; in short, if the agenda of my late and much lamented friend Mahbub ul Haq at last becomes a reality instead of just a personal dream.

## GEOPOLITICS

During the Cold War Pakistan occupied a key strategic position near the frontier with the Soviet Union, a geopolitical fact which gave the country an ability to rely on Western support, or at least acquiescence, in a crisis. That advantage has now ended, as was graphically illustrated by the hostile G-7 reaction following the nuclear tests of last May, which led to the imposition of sanctions that would have crippled the economy had they remained in place any longer. If it remains without strong regional partners, Pakistan will need to cultivate a self-reliance that has not so far been necessary.<sup>1</sup>

Recent years have seen a strengthening of regional groupings in many parts of the world, alongside the development globalisation. While some economists [e.g. Baghwati and Krueger (1995) and Srinivasan (1998)] see these two processes as competing with one another, I am among those who instead view the two processes as complementary. That is, rather than regarding regional groupings as a threat to the global system, I believe they provide natural opportunities for a deeper level of integration than is practical at the global level, and offer the chance of experimenting with new forms of integration that would be unlikely to emerge from global negotiations without the prior development of regional models among groups of states with particularly close relations.

It is therefore natural to ask whether Pakistan's geopolitical situation offers it the potential to participate in any such grouping. To its north, Pakistan has as neighbours a group of weak commodity producing states. The potential of links with these countries would appear to be limited. If and when the conflict in Afghanistan ends, the provision of transit routes for the export from the region of oil and gas, and the opportunities for exchanging a number of Pakistani industrial and agricultural products for energy supplies, would surely be worthwhile, but these hardly offer a basis for changing Pakistan's economic destiny.

Many of Pakistan's western neighbours are relatively rich, and there are important cultural and religious links with the region. On the other hand, with the possible exception of Iran. It is a region of very limited industrial potential, which therefore offers no possibilities for the development of the sort of trade in intermediate industrial products that has been the mainstay of other successful regional arrangements. And even Iran is much more distant from Pakistan's industrial heartland in Punjab than are some of India's industrial regions.

Pakistan's existing regional arrangement is indeed focused on South Asia, a region with which it has had acute political problems, but which certainly seems the most natural economic partner. I conclude that there are really only two strategic options for Pakistan. One is to seek to develop SAARC, and the other is to go it alone as a member of the multilateral system.

<sup>1</sup>Self-reliance is not the same as self-sufficiency, which would be impossibly costly in this age of globalisation. By self-reliance I understand rather the ability to cope purely on the basis of commercial relationships, without relying on the goodwill of any foreign power.

## SAARC

Table 1 shows the direction of Pakistani trade. It can be seen that the principal trade partners are the OECD countries, with the oil-importing countries also being an important source of imports. Trade with Pakistan's partners in SAARC is miniscule; the ASEAN countries are of a similar order of importance as an export market, and are a much more important source of imports. Table 2 shows that, among the SAARC countries, little Sri Lanka and distant Bangladesh are more important export markets than giant, nearby India. Of course, everyone believes that much trade with India takes place through Dubai, or is smuggled over the border, so that the statistics do not give a true reflection of India's importance as a trade partner; but even if one accepts the common estimate that half the trade is missed by the official statistics, bilateral trade with India still seems very modest, given the size and geographical proximity of the Indian market. Indo-Pakistani trade is only some 1 percent of Pakistan's total trade, which is a fraction of the level that would be predicted by a gravity model even in the absence of common membership of a trading arrangement. This is presumably one reason why in 1998 Pakistan's exports amounted to only 13.2 percent of GDP and its imports to 16.1 percent of GDP, which are fairly low figures by international standards, although one should allow for the fact that Pakistan is a relatively large country.

It is not just the level of trade that is repressed: there is a whole type of trade, namely intra-industrial trade in manufactures, that is largely missing from Pakistan's export bundle (see Table 3). Such semi-manufactures as Pakistan does export tend to be cotton goods rather than engineering products, which is the type of trade that has traditionally been nurtured by regional trade agreements. While it may well be possible to trans-ship consumer goods through Dubai without adding so much to costs as to eliminate the incentive to trade, it is quite implausible that carburetors could be made in Lahore and shipped to Haryana that way and still compete in the era of just-in-time inventory management. This is what I conjecture Pakistan is missing by virtue of its membership in a regional arrangement that is dysfunctional.

Up to now SAARC has established preferential trade arrangements among its members, on the basis of a positive list of products on which concessions have been negotiated one at a time. The impact of these preferences on actual trade appears to have been minimal, and is in any event still offset by a number of active impediments to intra-regional trade, including India's maintenance of quantitative restrictions on imports of consumer goods and Pakistan's failure to extend most-favoured nation treatment to India, as well as some notable absences of essential transport links. SAARC has tried to shift to a more effective way of liberalising trade, and at one stage did succeed in getting the SAARC leaders to commit themselves to free trade by 2001. But at the last SAARC summit it was acknowledged that this timetable was unrealistic, and the leaders committed themselves instead to the objective of achieving agreement by 2001 on how and when to achieve regional free trade.

Table 1  
Pakistan's Direction of Trade

	Unit	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Total Imports of								
which Share of	(Rs Million)	229889	258643	258250	320892	397575	465001	436338
OECD	(%)	62.2	58.6	52.6	49.3	49.9	48.7	46.5
OIC	(%)	16.5	16.9	20.9	21.3	22.4	26.0	23.3
ASEAN	(%)	7.3	8.5	9.5	12.6	11.2	9.0	12.6
SAARC	(%)	1.5	1.5	1.6	1.4	1.5	2.4	2.3
Other	(%)	12.5	14.5	15.4	15.4	15.0	13.9	15.3
Total Exports of								
which Share of	(Rs (Million))	171728	177028	205499	251173	294741	325313	373160
OECD	(%)	54.9	56.7	60.0	58.6	55.3	59.7	59.5
OIC	(%)	14.6	16.0	13.7	12.9	12.9	11.8	12.5
ASEAN	(%)	5.6	5.2	3.7	4.0	5.3	2.5	3.2
SAARC	(%)	4.7	3.8	3.1	3.4	2.7	2.5	3.5
Other	(%)	20.2	18.3	19.5	21.1	23.8	23.5	21.3

Source: Economic Survey-Statistical Supplement, 1997-98.

Note: OIC is the Organisation of Islamic Countries.

Table 2  
*Pakistan's Trade with SAARC*

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Total Imports	3404	3871	4174	4485	5926	11163	10009
Bangladesh	1183	1129	864	964	1194	1499	1654
India	1213	1748	2126	1974	3172	7980	6675
Sri Lanka	849	959	1160	1529	1535	1632	1639
Total Exports	8109	6719	6475	8514	7786	8293	12877
Bangladesh	3218	2890	3092	5233	3956	3413	4257
India	2814	2175	1288	1284	1379	1412	3912
Sri Lanka	2017	1601	1989	1869	2223	3222	4385

Source: Economic Survey—Statistical Supplement, 1997-98.

Table 3  
Structure of Imports and Exports of Pakistan

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Total Imports of which							(Rs Million)
Share of							1997-98
Capital Goods (%)	229889	258643	258250	320890	397575	465001	436338
Raw Materials for	42	42	38	35	35	37	32
Capital Goods (%)	7	6	6	5	6	5	5
Consumer Goods (%)	38	38	43	46	45	43	45
Consumer Goods (%)	13	14	13	14	14	15	18
Total Exports of which							
Share of	171728	177028	205499	251173	294741	325313	373160
Primary Commodities (%)	19	15	10	11	16	11	13
Semi-Manufactured (%)	21	21	24	25	22	21	17
Manufactured (%)	60	64	66	64	62	68	70

Source: Economic Survey—Statistical Supplement, 1997-98.

It is obvious that SAARC will never achieve the sort of deep economic integration that has been achieved in Europe, or is in process of being achieved in Mercosur, without a transformation of Pakistan's political relations with India. I do not believe that this necessarily implies that a strategy of seeking to build up SAARC as a regional trade arrangement is doomed to failure. On the contrary, it is worth remembering that when the European Common Market<sup>2</sup> was first formed, in the 1950s, the inspiration was very much that of using commerce as a means to build functional cooperation that would ensure permanent peace between France and Germany, which had been at least as hostile to each other for the preceding century as India and Pakistan have been for the past half-century. Although relations with India have long been difficult, one should not rule out the possibility of a breakthrough because of the current political situation in India; just as it took a Nixon to declare peace with China, so a BJP government would be politically well-placed to initiate cooperation with Pakistan if it chose to take that path. The agreement-in-principle already reached between Pakistan and India for the former to sell electric power to the latter is an encouraging indication that functional cooperation is possible between the current regimes.<sup>3</sup> Of course, functional cooperation needs to be complemented by a mutual political desire to improve relations if it is to lead on to permanent reconciliation and deep economic integration of the sort that France and Germany have now achieved.

In economic terms, one benefit that I would anticipate Pakistan could hope for from effective regional integration would be the chance to develop a serious engineering industry. This is the part of the industrial sector that is critically dependent on the existence of a large network of suppliers, where economies of scale and scope really count. Pakistan's economy alone will be too small to support much of this until development has proceeded a lot further, whereas the chance to fill niches in the Indian market would offer it an opportunity of rapid growth relatively soon. There may also be prospects of Pakistan exporting cotton textiles, processed foods, and raw agricultural products, prospects enhanced by the country's ability to import world-class machinery and engineering goods to produce downstream products with a higher quality and technology content than India can aspire to so long as its downstream industries are constrained to buy Indian inputs.

### GO-IT-ALONE

One problem with the regional strategy is that it takes two to tango; either partner can certainly torpedo the chances of cooperation succeeding, but it cannot unilaterally will the strategy to succeed. Hence, even if one were convinced of the

<sup>2</sup>This is what the European Union was called when the initial steps were taken. It subsequently became the European Economic Community, then the European Community, and finally the European Union.

<sup>3</sup>The start of a bus service between Lahore and Delhi after the conference is another similar step.

superiority of the regional strategy, it would be necessary to consider also the alternative strategy of go-it-alone.

Many economists, including me, would argue that the best go-it-alone strategy would be something fairly close to a policy of unilateral free trade, involving a moderate uniform tariff of no more than 10 percent (motivated partly by revenue considerations and partly by a belief that there is a legitimate social interest in some pressure to expand the industrial base) and no other trade restrictions. Many economists would also rate this option preferable to the regional strategy, but here I part company with them. To explain that, I should clarify that I would regard the first-best as unilateral free trade by both India Pakistan, but I make the judgement that the chance of India adopting unilateral free trade is near-zero. Since I see a very strong Pakistani interest in duty-free and guaranteed access to the Indian market, my preferred policy is one of regional cooperation (provided this can take place within a context of relatively free trade with the rest of the world, so that the costs of trade diversion are modest).

What sort of industrial future would I see for Pakistan under such a policy? In the near term, I would expect it to remain predominantly an exporter of low-tech consumer goods like cotton clothing and sports goods; perhaps branching out into non-cotton textiles if and when the process of importing intermediate goods needed to produce exports is eased. In the longer term future, I would hope that Pakistan would be ready to take advantage of whatever the next generation of labour-intensive activities demanded by the world economy proves to be. (The last generation involved assembly of electronic products, but there is already excess capacity in that business, which is part of East Asia's current problem. The current generation happens not to involve manufacturing at all, but rather to consist of electronic services, including software, transcription, and data entry, activities where India is at last making a mark on the world economy. Given the weakness of Pakistan's education system, one fears that it is unlikely that it will be in a position to emulate India here.) This will be the case only if Pakistan undertakes important policy reforms to eliminate the systemic anti-export bias that grew up in the decades following independence [Khan (1999)]. The simplest way of doing this would be to adopt a policy close to free trade, so that there is no need for a system of import duty drawbacks such as in indispensable if export industries that use imported intermediates are to have a chance under a regime of protection.<sup>4</sup>

There is at least one way in which the world is now an easier place in which to pursue a policy of export-led growth than it used to be, and that is a result of the long

<sup>4</sup>Note that a system of duty drawbacks, even if operated without the hurdles that so diminish its usefulness in Pakistan, is not a full substitute for free trade in terms of providing a hospitable environment for exporters. One reason is that tariffs cause the real exchange rate to appreciate, which makes exporting less cost competitive. Another is that import tariffs raise the price of imported goods above world prices, and these price effects spill over into the overall cost structure. So even if exporters can buy inputs at world prices (after negotiating the administrative hurdles) they still face a higher local cost structure than do competitors in countries with lower effective protection, which constitutes a hidden tax on exporters.

series of international initiatives to liberalise trade, which have culminated in the creation of the World Trade Organisation. The agreement in the Uruguay Round to phase out the Multi-Fibre Arrangement (MFA) is of particular interest to Pakistan in view of the leading place of cotton textiles among its exports. Our assessment in the Bank [World Bank (1997)] is that this will offer a major opportunity to increase its exports to Pakistan, although one needs also to recognise that the elimination of restrictions will also expose countries like Pakistan to the risk of bigger and quicker losses of market share if they stumble in maintaining a supportive environment.

### **EXCHANGE RATE POLICY**

Under either of these scenarios, the re-establishment of a dynamic industrial sector will be dependent on macroeconomic policies, and specifically on exchange-rate policy. It is no good imagining that rapid export expansion can be achieved on the basis of a policy of a strong exchange rate, or an exchange rate policy that is dedicated to countering inflation that would otherwise result from loose fiscal or monetary policies, or a reluctance to allow the exchange rate to depreciate when this is necessary to maintain competitiveness. No sensible person would deny that many other factors besides the exchange rate influence export competitiveness, but unwillingness to use the exchange rate as the residual factor to maintain an adequate degree of export competitiveness means that policy-makers have one hand tied behind their back in seeking export-led growth. My own view, which I have propagated in a long series of writings going back to long before I joined the World Bank, and which was most recently expressed in Williamson (1998), is that the maintenance of a competitive exchange rate is not always well-served by a policy of floating. Periods of strong capital inflows occur, when a floating exchange rate can float up to a level that threatens the incentive to continue investing in export industries. In such circumstances I believe the maintenance of export competitiveness is better served by a policy of substantial but nonetheless circumscribed flexibility, involving a wide band with a crawling central parity. But of course an excessive capital inflow is not a threat that Pakistan faces in the foreseeable future: rather, the immediate need is to ensure that the exchange rate is indeed used as the residual factor in maintaining enough export competitiveness to ensure rapid export growth.

### **FOREIGN DIRECT INVESTMENT**

Much of East Asia's export success was based on inward direct investment, particularly in Singapore, Malaysia, China, and Thailand. The Chinese experience is particularly interesting, because much of the inward investment there came from the Chinese expatriate community. Pakistan is also a country with a relatively large and affluent expatriate community, and so it is worth asking why there has (so far as I am

aware) been virtually no inward investment by expatriate Pakistanis. I would hypothesise that the main explanation goes back to the issue that has just been discussed, namely Pakistan's failure to convert its economy into an attractive export platform, because the investment by the overseas Chinese was predominantly in relatively low-tech industries directed toward exporting. So a part of the answer as to what needs to be done to attract FDI is to improve the exporting climate. A possible additional explanation is that Pakistan has created such an array of attractive, convenient financial instruments for investments by expatriate Pakistanis as to have diverted some capital inflows that would otherwise have come in the form of FDI.

The other critical factor is to improve the rule of law. The extra-legal attempt to renegotiate IPP tariffs by threatening prosecution over corruption, and related events in mid-1998, created a great deal of resentment among the existing stock of foreign investors. They are unlikely to forget easily, and one cannot expect that potential new investors will be ignorant of their complaints. By far the most hopeful way of overcoming these complaints is to make Pakistan a country of laws and not of discretion. Of course, this would have additional benefits in improving the climate for Pakistani business too.

I have taken it for granted that more FDI is better than less, which is not a position that is universally accepted. One attraction of FDI is that it is unlikely to suffer massive withdrawal during an economic crisis: in fact, FDI was essentially unchanged in East Asia last year, in contrast to the massive reversal in other components of the capital account, just as it has continued to come into Pakistan on a modest scale since last May (although this probably reflects the completion of existing projects and cannot be taken as assurance that future FDI will be unaffected by the events of last summer). Another is that it brings with it ancillary benefits in the form of access to technology, know-how, management, and markets. The countervailing disadvantage in the eyes of some is that it involves a measure of foreign control over the economy. But, unless one takes a very nationalistic position on that issue, FDI is in most circumstances a good thing.

Two exceptions may be noted. One is the case of immiserising growth analysed by Carlos Diaz Alejandro and Richard Brecher in the 1970s, when the foreign investment is directed to an import-substituting industry (ISI) that is so heavily protected that the social value of the firm's net output is less than the profits it is able to earn and remit abroad. Given the ubiquity of ISI in Pakistan in the past, it is entirely possible that some of the FDI that did come fell in this category. The other would arise if a foreign investor were able to get such favourable contract terms (e.g. such a high power tariff) as to outweigh the efficiency gains that it brings. While I acknowledge that this is a possibility, and I understand that there are claims that this case also arose in Pakistan, it is a case that one would expect to arise only if the contracting process is corrupted. Even if either or both of those unfortunate cases did occur in the past, it would be foolish

to rule out future FDI because of past errors, instead of making sure that in future contract negotiation will be undertaken within a secure legal framework and a less distorted policy environment.

### FINANCIAL INVESTMENT

Openness to financial investment raises very different issues. We are all familiar with the benefits that flows of financial capital can in principle bring, notably the possibility of increasing investment above the level that could be financed from domestic savings (for a country where the rate of return on investment equal to domestic savings exceeds the world rate of interest plus the country risk premium), and the opportunity of diversifying the risk of savers by holding an international rather than a national portfolio.

Unfortunately there is now also pretty conclusive evidence that exposure to the international capital market can bring with it very significant risks. In particular, the evidence suggests that the crisis that originated in Thailand in July 1997 became a general East Asian crisis because the countries involved had built up a level and structure of liabilities that made them extremely vulnerable to adverse shocks.

Consider the various hypotheses that have been advanced to explain the contagion in East Asia. Many observers have focused on inadequacies of the system of financial supervision, which permitted banks to take on a dangerous level of short-term and/or foreign currency debt. It has also been argued that transparency was inadequate, resulting in foreign lenders failing to appreciate the extent to which the countries had already borrowed abroad and accumulated short-term foreign exchange debts. And Paul Krugman (1998) has emphasised the role of explicit and implicit guarantees in creating moral hazard and generating asset price bubbles. All of these factors may well have contributed to the problem. Nevertheless, a consideration of which countries succumbed to the crisis, and which succeeded in riding it out, makes it difficult to believe that any of these was the critical factor. Consider the 13 economies listed below (the 13 major Asian developing economies between Pakistan and Korea), which are divided between those that fell victim to the crisis and those that did not according to whether GDP growth is believed to have been negative or positive in 1998.

Negative growth in 1998:<sup>5</sup>

Hong Kong  
Indonesia  
Korea  
Malaysia  
Thailand

<sup>5</sup>Estimates made in late 1998 and presented in World Bank, *Global Economic Prospects*, Dec. 1998.

**Marginally negative growth in 1998:**

Philippines

Singapore

**Positive growth in 1998:**

Bangladesh

China

India

Pakistan

Sri Lanka

Taiwan

Now ask what the countries within each group have in common but that distinguishes between the first and last groups. It is surely not the quality of bank supervision, which is notoriously bad in several of the non-crisis (positive growth) countries, is probably somewhat better on average in the crisis countries, and is famous for its excellence in one of them, namely Hong Kong. Nor is it transparency, which is, once again, somewhat less of a problem in the crisis countries. Nor is it the extent to which banks enjoy implicit guarantees, which is at least as strong in South Asia as elsewhere. And it is certainly not the strength of the macroeconomic fundamentals. Neither, for that matter, is it the exchange-rate regime, which involved a loose form of dollar pegging in most of the countries. The one feature that discriminates correctly between the two groups is whether or not they had liberalised the capital account of the balance of payments. (Malaysia had made some effort to limit short-term capital inflows in the past, but its regime was still more liberal than that which prevailed in any of the non-crisis countries prior to its imposition of comprehensive capital controls in August 1998).

It is well known that the abolition of capital controls has often been followed by a large inflow of capital. Moreover, this inflow has typically been disproportionately in the form of short-term capital, which is the form that foreign lenders often seem most willing to supply, presumably believing that it gives them the opportunity of liquidating their position if things begin to go wrong (a belief that cannot be simultaneously right for the majority of them, at least without a bailout from the international community). Hence it seems all too easy to believe that the observed association between the absence of capital controls and the occurrence of financial crisis was causal and not merely coincidental. This conclusion is reinforced by the reflection that an abrupt reversal of capital flows usually involves an outflow of capital owned by residents ("capital flight") as well as that owned by foreigners, a flow that is facilitated by an absence of capital controls.

Moreover, attempts at empirical measurement of the growth benefit of capital account convertibility have, at least so far, failed [Alesina, Grilli, and Milesi-Ferretti (1994) and Rodrik (1998)]. Of course, it is important to understand that rejection of

capital account convertibility does not imply rejecting opportunities to borrow abroad; it is perfectly possible to free long-term capital flows even while maintaining restrictions on inflows of short-term loans of the sort that have wrought devastation elsewhere. My view is that such limitations are best achieved via the sort of reserve requirements on foreign capital inflows that have been imposed by Chile and Colombia, and that countries will be well-advised to maintain such restrictions unless and until the negotiations on a new international financial architecture succeed in persuading Northern investors to adopt practices that threaten less instability than resulted from past investment practices.

### **CURRENT ACCOUNT TARGETS**

However, Pakistan's short-run problem is unlikely to be one of discouraging excessive capital inflows in any form; indeed, I doubt if this will figure among its problems even in the medium run. It is surely necessary for Pakistan to escape from its dependence on inflows of short-term capital (formerly in the form of foreign currency deposits) that were being used to finance the current account deficit prior to the imposition of sanctions. This is not just because the need to freeze the foreign currency deposits is likely to limit future access to that particular source of foreign exchange, but also because short-term borrowing is inherently a fragile way of financing a deficit. In the Pakistani case, it also seems to have been an expensive way. Since the outlook for secure inflows, of FDI or long-term capital, seems pretty bleak for some time to come, I would argue that Pakistan needs to be targeting a major and sustained improvement in its current account balance over the next several years. Achieving this will require the restoration of export dynamism, as was discussed earlier; doing so while allowing a much-needed increase in domestic investment will require also a major improvement in savings performance if investment is to increase rather than be cut back even further.

### **CONCLUDING REMARKS**

While Pakistan's current economic position is undoubtedly difficult, it is not obviously worse than that of other countries (for example, Taiwan in the late 1950, or Korea in the early 1960s, or Indonesia or Singapore in the late 1960s) at the time when they succeeded in engineering major policy changes that laid the basis for their future prosperity. One of the dimensions in which a clear policy stance will be needed is with regard to Pakistan's international economic relations. I have argued that there would be great economic benefits from a policy of deep regional integration, if that proves politically possible, and that such an economic initiative could in turn improve the prospects for political cooperation in the way that happened in Europe. The second-best trade policy, if regional cooperation proves impractical, would be close to free trade, which would eliminate the anti-export bias

from which Pakistan has suffered in the past. Either option would help to make Pakistan an attractive export platform, which might help to attract FDI, specially from expatriate Pakistanis. Reestablishing Pakistan's credentials in the eyes of potential foreign investors also needs a determined effort to establish the rule of law. Finally, I argued that Pakistan needs to achieve a major and sustained improvement in its current account so as to relieve itself from dependence on inflows of short-term capital, and that subsequently, when foreign capital wants to come in, it will be important to make sure that the form of capital inflow is a relatively stable one so that the danger of a future crisis is minimised.

If such an international agenda were complemented by an effort to increase savings, by a resumption of progress in privatisation and liberalisation of the domestic economy, and by a serious attempt to address what I earlier characterised as "Mahbub ul Haq's Agenda", I see no reason why Pakistan's progress in the next half-century should not be a lot more impressive than that during its first 50 years.

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# Comments

## 1.

It is a pleasure an honour to discuss this paper. John Williamson's writings, when he was not in the World Bank, were part of our education. He coined the phrase "Washington consensus" to describe a body of economics practiced at the Bretton Wood institutions. I am not sure whether John is a part of the Washington consensus now, but his early writings certainly provide a beacon to those who need to analyse the limitations of the economic framework that underlies the policy advice rendered by the IMF and the World Bank. I must also compliment him on the brevity of his paper, and the clarity of his arguments.

Although I share most of John Williamson's prejudices on policy, and am also sympathetic to Moclowsky's argument that much of economic analysis is rhetoric in disguise, I find that I am not persuaded by many of the conclusions that Williamson draws in his paper. I believe that this is because I read the data differently, and view some of his historical analogies as strained.

Throughout the paper, John Williamson's first instincts are always right. He notes the difficult geo-political position of Pakistan, he notes the near impossibility of trade with India, and he notes the importance of domestic problems, and perhaps even their paramourcy. Yet, it seems that in spite of all the accumulation of evidence to the contrary, he still clings to the belief that fixing macroeconomic policies and maintaining an open trading system can solve any economic problem.

Let me address each of the seven conclusions that Williamson makes in his paper. The first one is that while Pakistan's current position is not difficult, it is no worse than that of other countries. This does not persuade me. Pakistan's current position is difficult, and this temporary reprieve merely buys us a window for about a year. Larry Summers' famous remark that all Mr Clinton asked him to do was to keep Pakistan afloat for 12 months is corroborated by this morning's papers. It turns out that the Paris Club is thinking of an 18-month consolidation period rather the 4 years that been talked about. Unlike Williamson, I do not think that Pakistan's situation is comparable to that of Korea, Taiwan, Indonesia or Singapore in the 1950's and 1960s.

Williamson implied that the presence of open markets was the main difference between Pakistan and the countries mentioned, and went on to suggest that Pakistan needed to open its markets. However, savings and investment are two factors that distinguish Pakistan from these countries. Korea and Indonesia in the late 1950s and

1960s, and Singapore in the 1960s, exhibited saving and investment rates that were about twice those in Pakistan today. More importantly, the level of the external debt of Pakistan is much higher than that of Korea, Indonesia, or Singapore—whether as the stock of debt outstanding, or as a ratio of exports.

Also, during the Cold War, the US underwrote the military expenditures of all of these countries, especially Taiwan and Korea. In the 1950's and 1960's, US financial aid to Korea and Taiwan was much greater than the aid given to Pakistan. These countries were also allowed greater access to OECD markets, since they were seen as America's allies against communism. Though the Cold War is over, the liberal access to OECD markets that Korea and Taiwan enjoyed still persists. This kind of freedom is still not available with Pakistan. The parallel that Williamson draws between Pakistan's economic situation and that of Korea, Taiwan, Indonesia, or Singapore does not stand up under closer scrutiny.

Williamson goes on to say that Pakistan needs to adopt a clear policy stance regarding its international economic relations, especially with India. In Pakistan's case the position of the US will largely dictate the policy stance that Pakistan will have available to it, and that position at the moment seems quite restrictive. In this vein, Williamson argues that there would be great economic benefits from a policy of deep regional integration. Once again, I disagree with Williamson. I think SAARC is doomed to failure for a variety of reasons. I do not think that the relationship of Pakistan and India can be compared to that of France and Germany. If anything, Catholic France and Protestant Germany, and Sunni Pakistan and Shia Iran would be a much more apt comparison. The relationship between Pakistan and India today is radically different from the one between two components of European Christendom.

Moving on to trade policy, one of the most disturbing parts of Williamson's paper is the part about the anti-export bias and the statement that Pakistan has been import substituting. Although this is a commonly held opinion, it has no factual basis. No empirical study has established that Pakistan has always been import substituting. On the contrary, in 1970, the World Bank report authored by Dragoslav Avramovic stated that the distinctive feature of much of Pakistan's industrial growth has been its export orientation. While the initial phase of industrialisation was of an import substitution nature, this gave way (around the late 1950s) to a continuing rapid expansion of production for export. Between 1960 and 1968, aggregate exports have risen by 8 percent per annum. Almost all of this export growth has been due to the expansion of sales of manufacturers. Pakistan is one of the few developing countries in which industrialisation has been accomplished by such a rapid transformation of the export structure.

The World Bank, in the late 1950s and 1960s regarded Pakistan as an export promoting country. The growth rate in Pakistan may have fallen now, but this fall is not, as Williamson seems to suggest, a logical conclusion to a history of import substitution. There is substantial data available to back Avramovic's report. In his

1976 study, Geisinger allocated sources of growth between export promotion and import substitution. In the case of Pakistan, he attributed a ratio of 24:23 to export promotion and import substitution in the late 1950s. Between 1959 and 1963, export promotion was given a value of 5 and import substitution a value of -1. Between 1963 and 1970, the figures were 17 percent for export promotion and 13 percent for import substitution.

Dr Kamal updated this work in 1993. He too found that in the 1970s, the ratio that could be attributed to export promotion was larger than that to import substitution—the ratio being 11:10. In the early 1980s it was 8 and 9 the first period in which Kamal's estimates show import substitution as being higher than export promotion. But from 1988 to 1991 his estimates were 15 percent for export promotion and -12 percent for import substitution.

Zafar Mahmood, a distinguished PIDE scholar who has studied anti-export bias in Pakistan, presented a paper yesterday in which he said that since 1992-93 the anti-export bias has been of the order of 20 percent. Namely, that the effective exchange rate for exports is 20 percent higher than that for imports. By definition, an "export-promoting" regime is one in which the two are equal. In his paper, Williamson advocates that he is willing to live with import tariffs of 10 percent nominally. Allowing for margin of error, one can say that Pakistan is certainly an export-promoting country. So I am not persuaded by Williamson's statement that there is an anti-export bias in Pakistan, and that it is historical, and perennial.

Before turning to portfolio flows, I also welcome Williamson's statement that Pakistan should strive to establish the rule of law. This is something that all of us in Pakistan heartily endorse. One of the problems that you can help us with is the persistent tendency of international financial institutions to undermine the rule of law. In today's newspaper, Paris Club members expressed their satisfaction about the government's undermining the rule of law by disregarding the orders of the Lahore High Court and appealing against the foreign currency agency agreements. Now the rule of law as I understand it has to do with law, all law, and a respect for judiciary and judicial judgements. However, in its operations, the Bank routinely asks that laws be waived on one pretext or another. I would heartily recommend that the bank respect legal judgements and refrain from asking the government to coerce the judiciary to bring about judgements favourable to foreign investors. As you know the law requires that power rates be raised only after a public hearing. Today, in order to appease the IMF, the government raises power rates without a hearing by NEPRA. I think that the IMF should make it part of their conditionality that power rates be raised only after the rule of law has been respected and public hearing have been conducted under NEPRA.

Like Williamson's recommendation that the rule of law be maintained, your recommendations on portfolio flows will be agreed upon by most. Mohsin Khan, in his paper yesterday, within the limits imposed by his institutional affiliations, seemed

to suggest that capital flows had been too much of a good thing. I would like to hear the opinions of both the distinguished Chairman of this session and John Williamson on this. It seems to me that a tax on portfolio investment withdrawal, in the manner of some Latin American countries, would be a good thing for Pakistan. Would the Bank support this kind of initiative?

I would also like to see some proposals on what kind of restrictions there should be on foreign currency accounts. I do not believe that it is a good idea for the government to open new foreign currency accounts, and certainly, if the Bank were to throw its weight behind this proposition, the government would place restrictions on open as new foreign currency accounts. There is no reason why the government should be allowed to grant tax amnesty schemes that undermine the rule of law—the Income Tax Act for instance—in an attempt to raise revenues to service external debt. On this too, I would like to hear from the World Bank.

On Williamson's suggestions for current account improvement, I will return to the beginning of his paper, where he has mentioned some domestic policies. I would like to see a meaningful debt rescheduling proposal for a structural reform of the budget, and one that is backed by the IMF, or the Bank or both. This kind of proposal should include both debt write-off and debt rescheduling. The technicality that IBRD eligible countries are not eligible for HIPC initiatives could be waived.

In sum, I think that the paper on Pakistan and the world economy did confine John Williamson to address the topics on the balance of payments side. In the condition of Pakistan, it is really domestic policies that are primary, and within domestic policies the choices on the budget will dictate the choices on trade strategy. Unless we decide what those choices are, the idea of regional trade integration or of an open trade policy, which I believe we are already pursuing may not be sufficient to move Pakistan away from the brink of disaster on which it stands.

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## 2.

This is an interesting paper in a very important area crucial to the future of Pakistan's economy. It discusses three main issues viz. policy reforms including human resource development, regional grouping including SAARC vis-à-vis unilateral liberalisation of trade regimes, and role of foreign private investment in economic development. These issues need to be widely debated in Pakistan for higher level of economic development in both the short as well as long run.

The policy reforms suggested in the study aim at efficient production, higher level of exports and human development. The paper rightly argues that for efficient production import substitution policy needs to be replaced with the export orientation policy. Import liberalisation and appropriate exchange rate mechanism would result in a reduction in anti-export bias. While one can hardly disagree with the prescription, a sharp reduction in import duties may mean closure of even those industries in which the country has potential comparative advantage. The producers who have been protected behind steep walls for so long needs to be provided sufficient time for improving productivity and compete with the imported products. Similarly, the exchange rate policy needs to be aggressively pursued and changes should be made by taking into consideration reduction in import duties, relative rate of inflation and the response of balance of payments to the real devaluation.

Human resource development has been one of the main factors in constraining growth in the past. While the importance of human resource development cannot be over-emphasised, just elementary education, basic health, reduction in fertility and potable water and sewage though necessary is not sufficient. The process through which human resources impact on the growth needs to be spelled out and policy needs to be formulated accordingly. We may note that it is the skill development that constrains the investment and in the plan for human resource development it should be kept in view.

That international trade results in higher level of welfare is quite well known. The author argues that Pakistan's international trade is low and that in turn is due to low trade with India. While no doubt trade with India would result in higher level of trade but in view of India's restrictive trade regime the possibilities of increasing trade with India is limited. SAARC could provide a framework for trade expansion but unfortunately hostilities between Pakistan and India does not hold much promise. The author argues that trade between Pakistan and India may help in improving the political climate as it happened in Europe but the prospects seem to be bleak. Why India's trade with other countries of the region is also low can only be explained by India's restrictive trade regime.

The author forcefully argues that regional co-operation especially between Pakistan and India would result in improvement in the engineering industry. This is because networking in the engineering industry is quite important. While this is true, the fact remains that the Indian engineering industry has wide experience and Pakistan's engineering industry is in the infancy and opening up of trade may imply closure of such industries. Safeguards against injury to the industries may have to be put in and India shall have to abandon its protectionist policies if SAARC has to be successful.

Whereas Pakistan is also a member of ECO the study only discusses co-operation amongst SAARC. The paper gives an impression as if ECO will have little impact on Pakistan's trade. Why this should be so when there is wide scope for trading between Pakistan and other ECO countries. The trade between Central Asian Republics, Turkey, Iran, Afghanistan and Pakistan can also bring both static and dynamic benefits to the ECO countries.

The author rightly points out that co-operation implies that at least two countries are willing to co-operate but they may not be willing to co-operate. In that case author points out that Pakistan should unilaterally liberalise its import regime. While this may mean that Pakistan has access to the least cost imports how would that ensure free access to Pakistani exporters in regional market. Would it not be useful that Pakistan hold on the concessions until the other regional countries also agree to open up their trade regimes.

Pakistan encourages foreign private investment by removing all the constraints on the setting of the industries and providing incentives. Foreign investment increased sharply in the 90s until the IPP issue and the sanctions were imposed on Pakistan. The author discusses the immesrising growth following foreign private investment in protected economic activities but does not develop the argument sufficiently. What will be the benefit of private foreign investment to the country if outflows exceed the inflows and other benefit arising from transfer of technology, exports, better administration etc are also denied.

Most important omission in the study is that it does not talk about WTO. This is going to shape the future not only of Pakistan but also of all the countries of the world. What are the prospects of Pakistani exports and what needs to be done to derive the maximum benefit from the WTO has not been discussed. Similarly the agreement on services, foreign private investment and intellectual property rights has not been examined in the study.

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