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Pakistan's Exchange Rate Policy

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Robert B. Bangs

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Establishment of the Moslem state of Pakistan from Indian territory in 1947 raised many fundamental economic problems. Among them were large scale resettlement of population, division of the assets and liabilities of the government of undivided India, and the creation of new trade, banking, and government institutions for Pakistan in the shortest possible time.

Geographically, Pakistan is an anomaly, with two distinct wings separated by more than 1,000 miles of alien territory. Economically the new country was almost wholly agricultural with few industrial facilities. West Pakistan is dependent on irrigation, not too densely populated (about 100 per square mile), grows cotton as a cash crop while consuming chiefly wheat, and normally has a food surplus. East Pakistan has a monsoon climate, is very densely populated (about 800 per square mile), grows jute as a cash crop while consuming chiefly rice, and normally was a food deficit area.

One persistent and difficult problem faced by Pakistan ever since its establishment as an independent nation has been highly volatile export earnings from jute and cotton, the two fibers that together have accounted for 80 per cent or more of the country's international trade receipts. In three trade years[1/] from 1948-49 through 1951-52, receipts from export sales of these two agricultural raw materials more than tripled; in the succeeding three years they were nearly halved. Because of such marked changes as these, a prime objective of the economic policies pursued by Pakistan during recent years has been so to diversify productive activity - including as a main element in this diversification rapid industrialization - as to make the nation's fortunes less vulnerable to fluctuations of price or volume in world commodity markets. As part of its economic effort, Pakistan has pursued an independent exchange rate policy - with what effect this paper seeks to determine.

Although a member of the sterling area, Pakistan did not devalue its currency in 1949 when the British pound changed parity. Most other sterling area currencies, including the Indian rupee, followed the pound. Thus, from September 18, 1949 to July 31, 1955, the Pakistan and Indian rupees were not in a 1 to 1 relationship. On the latter date, however, Pakistan reduced its currency by 30.5 per cent to parity with India's at the rate of PR 4.76 to $1 U.S. The country has consistently maintained a unitary exchange rate and has not resorted to multiple rates as have some other countries in temporary economic difficulties.

1/ The trade year runs from July 1 through June 30.

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Period of resistance to devaluation

Pakistan's initial decision in favor of non-devaluation was taken on the grounds (1) that the country did not yet suffer from a chronic balance of payments deficit, (2) that demand for its exports was relatively inelastic and would expand less than proportionately to lower unit prices, while supply of export commodities was similarly inelastic in the short run, and (3) that as a consequence of the devaluation of other sterling area currencies, prices of imported goods in Pakistan would fall (in terms of local currency), thus assisting the development program and helping to check the inflationary pressure that was then strong, particularly in East Pakistan.[1] The decision not to devalue was a bold calculated risk that many observers thought would end in failure. This risk was enhanced by India's reluctance to accept the appreciated rate and her trade retaliation measures against Pakistan. In all probability the appreciated rate could not have been maintained but for the upsurge in demand for jute and cotton that accompanied the outbreak of war in Korea.

As background to the non-devaluation decision it should be noted that following partition in 1947, Pakistan had regularly shipped more than one-half its total exports to India and had enjoyed a large active trade balance with that country.

The structure of trade between Pakistan and India for the trade year 1948-49 may be seen in the following figures (in millions of rupees):

	From West Pakistan	From East Pakistan	Total
Exports to India	321	772	1093
Imports from India	522	248	770
Balance	-201	+524	+323

By means of transport, this trade divided as follows, (in millions of rupees):

	By sea	By land	Total
Exports to India	243	850	1093
Imports from India	466	304	770

Source: T. M. Desai, Chapter on "Foreign Trade" in Economic Consequences of Divided India, (Edited by C. N. Vakil) 1950 pp. 432-33.

India settled her current accounts with Pakistan primarily by the transfer of blocked sterling and Indian currency notes. It was felt in Pakistan that non-availability of convertible currency in settlement of its trade with India was contributing to inflation in East Pakistan (which earned the whole of the trade surplus) and that a shift of some acreage from jute to rice cultivation would be desirable.

1/ Cf. A.F.A. Husain, "The Problem of the Ratio of the Pakistan Currency, Pakistan Economic Journal, March 1951, pp. 9-10.

The decision not to devalue led to a trade deadlock with India that persisted until February 1951. Trade was almost completely halted for 7 months but reopened in April 1950 on a limited basis under a trade agreement which provided for a balanced exchange. In the year following the non-devaluation decision Pakistan's exports to India fell to about one-third of the previous year's level. Nevertheless export earnings to the world at large increased, mainly as a result of the increase in demand flowing from the war in Korea. The shift from jute to rice cultivation did take place over two crop years with jute plantings being reduced more than 30 per cent.

The trade deadlock with India forced Pakistan to redirect her international trade geographically. This was successfully done with Japan replacing India as the best single customer. Japan bought mainly cotton while jute was sold chiefly in Europe. The rising price trend from mid-1950 aided considerably in this process. Export earnings rose more than 30 per cent in 1950 over 1949 with cotton sales showing the largest gain. Imports also increased rapidly in 1950, due in part to speculation that devaluation might be impending. In August, the Government took action to check this speculation by requiring 35 per cent advance deposits on new letters of credit opened and by raising this figure to 75 per cent in September. Nevertheless, the balance of payments was in deficit in both 1949 and 1950, although the deficit was reduced from nearly 50 per cent of trade earnings in the former year to less than 10 per cent in the latter. In this re-adjustment of trade West Pakistan was the principal gainer while East Pakistan suffered. Part of the trouble was that imports into East Pakistan were physically limited by inadequate port facilities.

In 1951, Pakistan achieved record export earnings more than double those of the previous year. Cotton prices virtually doubled while jute prices advanced about 60 per cent. Export sales were so brisk that the season ended with virtually no carryover of either fiber crop. Imports rose less rapidly and a balance of payments surplus amounting to nearly $180 million was realized - the first such surplus since partition. Trade with India expanded rapidly after India accepted the Pakistan exchange rate in February 1951 and this rate was also confirmed by the International Monetary Fund in March.

The fall in prices that followed the end of fighting in Korea initiated an abrupt worsening in the terms of trade for Pakistan. While import prices rose slightly, export prices were more than halved between mid-1951 and the end of 1952. Although physical quantities of both jute and cotton exported were at record levels in the fiscal year 1952-53, earnings from these shipments were down nearly 30 per cent from the previous year. An attempt to support agricultural prices in 1952 was unsuccessful and involved the Government in heavy losses. Moreover, the end of the Korean boom was followed immediately by two bad crop years in which heavy imports of wheat into West Pakistan were required to avoid widespread hunger.

Toward the end of 1952, after foreign exchange reserves had fallen to a low point of $173 million on August 6, tight import controls were imposed. This action was followed in 1953 by rapidly rising prices within Pakistan and by declining Government revenues which depended heavily on customs duties. The shortage of imports spurred industrial development within the country but this in turn required import programs to be heavily weighted in favor of capital equipment, spare parts, and industrial materials - further intensifying the shortage of consumer goods.

In 1954, the economic position of the country improved in some respects while worsening in others. The terms of trade remained unfavorable. Foreign exchange earnings fell short of expectations, forcing the Government to stretch out some development contracts. Hardships resulting from import restrictions led to rioting in East Pakistan and to an emergency easing of these restrictions. An urgent appeal for emergency aid was made to the U. S. On the brighter side, food crops were good in spite of drought and flood conditions and a small exportable surplus of rice became available. A balance of payments deficit equal to 13 per cent of export earnings was again recorded. From then on until the devaluation in 1955, Pakistan's dependence on exchange restrictions and foreign aid steadily increased. These pressures finally culminated in the 1955 devaluation.

In the press statement announcing devaluation, the Ministry of Finance gave as the principal reasons for the step the desire to insure reasonable returns to jute and cotton growers and to stimulate export of manufactured goods. The desire to reduce smuggling and other "leakages" of foreign exchange was also cited. In free markets, the Pakistan rupee was then quoted some 6 to 10 per cent below the Indian rupee in spite of officially being 30 per cent higher.

The 1955 devaluation was thus not undertaken in response to an immediate emergency but rather was in recognition that a structural difficulty existed in Pakistan's economic relations with the rest of the world. The economic object of the devaluation was to increase export earnings sufficiently to finance more of the economic development program on which the Nation had embarked and thus lessen dependence on foreign aid. If enough improvement in the balance of payments could be secured it was also hoped import restrictions might be relaxed slightly.

An interesting question on which to speculate is whether the amount of the devaluation in 1955 was sufficient to insure the results hoped for. Insofar as free market rates bear on this question, it would appear the devaluation was not sufficient. In January 1956, the Pakistan rupee was at roughly a 25 per cent discount compared to the Indian rupee in the Hong Kong market. This evidence is inconclusive, however, and the question really depends on the balance of payments effects achieved by Pakistan since devaluation in relation to the limited objectives of this policy.

Period since devaluation

Sufficient time has now elapsed since the devaluation of the Pakistan rupee to observe the effects of this action on the country's trade and payments position. In general, these effects have accorded with expectations, Exports have increased somewhat and imports have been curtailed, although far more by licensing restrictions than by higher prices. Foreign exchange reserves have stopped diminishing and been partially rebuilt, due, however, in large part to receipt of foreign aid rather than to changed terms of trade resulting from devaluation.

Following the devaluation in July 1955, overall export receipts in terms of dollars increased by 10 per cent in a year. Raw jute exports rose 14 per cent in quantity above the two preceding years while cotton exports were 25 per cent above the previous season. Average prices in foreign currency of these two fibers were slightly lower than a year earlier.

In local currency, Pakistan's export record before and after devaluation may be seen in the following table:

Principal Exports of Pakistan
(In millions of rupees)

	1st 6 months 1955	1st 6 months 1956
Raw jute	344	466
Raw cotton	199	258
Jute manufactures	12	51
Wool	28	29
Cotton manufactures	12	28
Skins	10	15
Tea	14	14
Hides	4	6
Other articles	50	88
Total	673	955

Since the devaluation amounted to 30 per cent and the overall trade gain in rupees was just over 40 per cent, there was a real increase in foreign exchange receipts of about 10 per cent. It is interesting to note that tea exports actually declined by approximately the amount of the devaluation.

The devaluation appears to have stimulated minor exports from Pakistan considerably. Manufactured products in particular became more competitive in world markets.

The other effect of devaluation - raising the cost of imports and hence reducing quantity - has been obscured by the tight import controls. Although private imports in dollar terms were reduced 18 per cent in the fiscal year 1955-56 following devaluation, import prices rose 50 per cent or by not too much more than the amount of the devaluation. Had import licenses been more freely available after than before devaluation, the cut in quantum of imports would perhaps have been less and the rise in prices smaller. However, devaluation has reduced the profits of importers as reflected in the value of import licenses.

The purely budgetary effect of devaluation has been to increase the income of the Government from customs and excise duties less than the cost of its imports has advanced in terms of local currency.

The so-called "profit" from devaluation, i.e., the restatement of foreign exchange reserves in local currency at the new rate, amounted to PR 345 million and was applied to reduction of Government indebtedness to the central bank.

Pakistan's balance of payments in the year following devaluation may be summarized as follows:

Pakistan: Sources and Uses of Foreign Exchange, 1955-56
(In millions of rupees)

Uses		Sources	
Consumer goods imports	275	Exports and invisibles	2075
Raw materials, fuel, and spares	480	Aid and loan arrivals	670
Govt. non-development and debt repayment	380	Private investment	50
Invisibles and deferred payments	400		
Foodgrain imports	285		
Development uses	575		
Increase in foreign exchange reserves	400		
Totals	2795		2795

Source: Planning Board estimates quoted in paper by Svend Laursen prepared for Pakistan Economic Association, December 1956.

Noteworthy in these estimates are the smallness of consumer goods imports and the fact that aid accounted for 24 per cent of all foreign exchange available. While not apparent from the statistics, it can be established from other evidence that total outlay on development decreased slightly in comparison with the year just preceding.

The effect of the devaluation in increasing production of export commodities was fairly small in the first year because plantings of agricultural crops had already taken place. However, cotton and jute did move more readily into export markets and no accumulation of unsold stocks occurred. In the 1956-57 crop year, plantings of cotton and jute have apparently increased only slightly, owing in part at least to high prices and local scarcity of food grains. For the short run at least, no spectacular rise in export earnings seems likely to take place as a result of the devaluation.

In a word, Pakistan has made fairly good progress since devaluation but is still far from having solved her underlying economic problems. Most pressing among these problems is to increase food production. A new five year development program extending through 1960 is now being considered. This plan, in common with most other development plans of Asian countries, exhibits a substantial foreign exchange gap to be filled by outside assistance and an inflationary gap in domestic finance.

With the bulk of export earnings still deriving from sales of jute and cotton, Pakistan continues to be heavily dependent on world fiber demand and price trends, although less so than in earlier years.[1/] Chronic food shortages are also an ever present factor upsetting financial plans. While good progress in industrial development has been made in recent years, agricultural progress is less evident. It is therefore understandable that the current development plan lays heavy stress on agricultural improvement.

As the development expenditures to be made by Pakistan over the next few years will dominate other influences bearing on the country's economic position, it is important to notice the main features of the proposals now being circulated.

Current development plan

An earlier six year development program for Pakistan was drawn up in 1950 as part of the Colombo Plan but this program merely outlined general objectives and was flawed by numerous errors and omissions. It quickly became obsolete and was replaced in 1951 by a two year priority program in which major attention was given to industry and mining. A number of projects in transport and power generation were also included but relatively little was provided for agriculture. In 1952, the Pakistan Industrial Development Corporation was established to handle the bulk of public investment in industrial projects. By early 1957, this agency had invested more than PR 500 million in more than 40 projects, some of which are being resold to private investors. In 1953, a Planning Board was established. The plan worked out by this agency with foreign help is the one now under consideration.

1/ In his budget speech in February 1957, the Finance Minister estimated that manufactured products now account for 11 per cent of total export earnings as against only 2 per cent two years ago.

The five year development plan now being considered contemplates public outlays averaging PR 1.6 billion ($336 million) per year, about 2 1/2 times the preplan level, plus private investment averaging PR 7 billion ($147 million) per year, about 50 per cent above the preplan level. Roughly half the total cost is estimated to be in foreign exchange.

The distribution of expected public investment by sector is as follows:

	Per cent
Water and power development	32.0
Transport and communications	20.2
Industry (including mining)	13.2
Agriculture (including forestry and fishing)	10.9
Housing and settlements	9.5
Education and training	7.1
All other programs	7.1

The private investment program, although not capable of being planned in the same detail as public investment, shows the following expected distribution:

	Per cent
Industry	42
Services, commerce, construction	34
Transport and communications	14
Mining	10

If fully carried out, the plan would raise national product in constant prices nearly 4 per cent per year, generate a 30 per cent increase in export earnings, and provide about 2 million new jobs - roughly matching the expected increase in the labor force.

A crucial feature of the plan is its reliance on external sources of finance. About 80 per cent of the foreign exchange required will have to come from sources other than the country's own earnings. These sources include loans, foreign investment, and economic aid.

The World Bank, following a detailed on-the-scene review of Pakistan's development plan, concluded recently that the plan is a balanced one, well suited to the needs and resources of the country, but that personnel and organization would be more likely to limit the plan's execution than finance and that 6 or 7 years rather than 5 would probably be required to achieve the goals set.

The development plan has been criticized within the country as providing too little investment for East Pakistan, although it is questionable whether this wing could utilize additional funds effectively.

However, because the present Government's political strength rests mainly on this area, it is likely that revisions in the plan as it develops will favor the eastern sector.

In view of the plan's dependence on outside finance, special importance attaches to balance of payments projections for the life of the plan and beyond. The Pakistan Planning Board's figures for the period through 1959-60 show a steady increase in receipts amounting to about 30 per cent over 5 years, a gradually declining level of imports for purposes other than development, and development imports reaching a peak in 1957-58 about 45 per cent above 1955-56 and thereafter slowly declining. The foreign exchange deficit is more than 50 per cent of receipts in 1957-58 but thereafter declines to about 25 per cent of receipts by 1959-60.

In working over these projections the World Bank has concluded the receipts estimates are conservative and has raised them slightly. The projection of a declining trend in non-development payments was felt to be unrealistic, especially if allowance is made for debt service and retirement of suppliers' credits. Both sets of projections visualize continued austerity in imports of consumer goods with the Bank being slightly less restrictive than the Planning Board. Neither projection allows for the inevitable increase in import demand that will accompany the rise in incomes induced by the expansion in investment. Inflationary pressure will have to be countered by some other means such as fiscal or monetary policy.

The Plan's balance of payments projections do not allow for food-grain exports either for current consumption or reserve stocks whereas the Bank calculates that nearly PR 2 billion ($420 million) will be required for this purpose over the five year period. Thus the Bank reaches a larger overall foreign exchange deficit that the Plan in spite of higher earnings and lower development expenditures forecasts.

A revision of the Planning Board projections early in 1957 brings their figures slightly closer to the Bank's calculations but still omits the heavy outlay for foodgrain imports the Bank feels will be required. Much of this food deficit, if it develops, will probably be met by sales of U. S. agricultural surplus for local currency. This postpones but does not solve the balance of payments problem.

While these projections naturally are subject to wide margins of error, both as to details and overall trends, they constitute the best judgments available at the moment as to the nature and dimensions of the probable foreign exchange gap. Clearly a heavy inflow of foreign aid is essential to carry out the development plan and only a minor part of this aid has already been committed.

Foreign aid allocated to Pakistan from all sources in the five years 1951-52 through 1955-56 has totalled more than $500 million, of which less than 60 per cent had actually been received by the end of the period and the balance was in the "pipeline" awaiting delivery. If the development plan goals are fulfilled as projected, approximately $900 million in outside assistance will be required in the period through 1960. To this must be added foodgrain requirements not now foreseen.

The special problem of foodgrains

Reference has been made to the recurrent food shortages that have troubled Pakistan and made necessary emergency imports from time to time. A major objective of the development plan is to raise foodgrain production by 1959-60 13 per cent above the average output for the 1948-55 period, which was just under 12.9 million tons per year but with substantial variations (roughly 10 per cent) about this annual average. About 1/3 of the planned increase is to come from expanded acreage while 2/3 is to come from improved yields per acre.

The difficulty of reaching this objective may be seen in the fact that since 1948 no clear evidence of a rising trend in foodgrain production is apparent. Meanwhile population has been steadily increasing. Moreover, 1955-56 production was well below the average of earlier years.

Past production has provided only a modest per capita ration of about 14 ounces of foodgrains per day. The Plan hopes to raise this to 14.5 ounces. Such an increase is likely to be smaller than the expansion in demand that will be generated by the investment program. Thus the prospect remains for continued dependence on foodgrain imports and higher prices of foodgrains. This symbolizes the inflationary impact of the development program since foodgrains are the principal element in consumer expenditure and hence in living cost indices.

Even if the production goals of the agricultural plan are achieved, foodgrain imports averaging at least 600,000 tons per year will be required through 1960 to maintain present living standards. With modest increases in consumption permitted, as must be assumed if economic stability is to be maintained, imports might well be more than double this amount - say in the neighborhood of 1.5 million tons per year.

Perhaps the crucial point is that foodgrain import requirements will gradually diminish over the life of the plan if production goals are reached whereas if production remains stagnant at the level realized since 1948, import requirements will steadily expand over the life of the development program.

The recent record provides little ground for optimism that the food problem will actually be solved according to schedule. The 1955-56 winter rice crop in East Pakistan fell short by amounts variously estimated at up to 1 million tons. Emergency imports of 600,000 tons were made in

1956 to prevent famine but in spite of these imports free market prices of rice rose more than 60 per cent during the first 3 quarters of the year. The Army had to be pressed into emergency service to distribute rice equitably.

Similarly, in West Pakistan wheat supplies proved inadequate and the price rose nearly 40 per cent between December 1955 and December 1956. Emergency imports were required including 117,000 tons purchased with the country's own foreign exchange reserves. The food crisis was an important factor leading to the change in cabinet in September 1956. Recent estimates indicate that wheat import requirements for 1957-58 will be at least 500,000 tons with no provision for reserve stock accumulation and considerably in excess of this if stocks are rebuilt as they should be.

As a result of the 1956 experience and the outlook for future production, the Planning Board by year end had revised its foreign exchange projections to take account of the fact that about $60 million per year in foodgrain imports (not previously provided for) would probably be needed over the life of the development program. This will either require additional foreign aid in that amount or, if the aid is not forthcoming, require that development expenditures be reduced by 20 per cent or more to accommodate this additional drain on external resources.

An important element in the foodgrain problem has been the Government's policy of using subsidies to keep prices low. This has lessened the incentive of farmers to grow food in place of cash crops. Since partition the yield per acre of foodgrains has generally diminished while that of cash crops have generally increased. The trend can only be reversed by more realistic pricing.

Another measure of the foodgrain problem may be seen in the fact that over 15 per cent of the budget deficit in 1956-57 was attributable to subsidized low selling prices for imported foodgrains. This deficit in turn was the major factor in the 14 per cent increase in money supply within Pakistan during the year. Near the end of the year, sharp increases in the controlled prices for wheat and rice greatly decreased this burden on the budget but shifted it, of course, to the consumer.

It should be apparent from this brief discussion of Pakistan's development plans that foreign exchange availability has rightly been regarded as the chief financial limitation on the rate of capital investment the country can attain. Equally important, however, is the domestic financing of the investment program. To what extent is this inflationary and how will it affect the willingness and ability of the people of Pakistan to provide the necessary savings? For perspective on this question we turn to the budgetary position and the relation of the money supply to price trends.

Budgetary position

Like many other Asian countries, Pakistan uses a budget in which ordinary and capital expenditures are separated. The ordinary budget has been regularly balanced since partition but the capital budget has been dependent chiefly on loans and foreign aid. Certain military outlays are included in the capital budget as are loans to the provincial governments.

Budget deficits have been relatively large in relation to total expenditure as the following table shows:

Pakistan: Central Government Budget Deficits or Surpluses as Per Cent of Total Expenditures

1948-49	deficit 35 per cent
1949-50	deficit 32 per cent
1950-51	surplus 14 per cent
1951-52	surplus 12 per cent
1952-53	deficit 33 per cent
1953-54	surplus 24 per cent
1954-55	deficit 25 per cent
1955-56	deficit 42 per cent

These budget deficits have been financed chiefly by borrowing from the banking system and by foreign aid.

The budget estimates for the current fiscal year and that recently proposed for the next fiscal year show the following sources and uses of funds:

Pakistan: Central Government Budget for Fiscal 1956-57 and Fiscal 1957-58 1/
(In millions of rupees)

	1956-57		1957-58	
Revenue		1304		1392
Customs	474		439	
Income tax	205		213	
Excise and sales taxes	252		281	
Other	373		401	
Proposed new taxes	-		58	
Ordinary expenditure		1305		1392
Defense	794		810	
Civil administration	311		350	
Other	200		232	
Capital expenditure		1297		2098
Development	1041		1414	
Defense and other	256		684	
Deficit		1297		2098

1/ The fiscal year runs from April 1 to March 31. The budget classification for these years differs slightly from that in effect for earlier years because of changes made under the new constitution.

Noteworthy are the relatively large size of defense and development outlays. Available data covering the first half of the present budget year indicate that revenues have been lagging while expenditures have been overrunning the estimates. Instead of a balance on revenue account the Government now expects a small deficit. Capital expenditure, however, will be smaller than originally planned, leaving the total deficit relatively unchanged. About 35 per cent of the deficit will be covered by foreign loans and grants leaving 65 per cent dependent on borrowing.

The proposed budget for next year contemplates another step-up in development outlay and an even larger deficit. Roughly half the development spending will be in the form of loans and grants to the provinces. Although more than one-fourth the prospective deficit will be covered by foreign aid, the uncovered portion is certain to contribute heavily to additional inflationary pressure within the country.

To balance the revenue budget next year the Minister of Finance recently proposed new excise taxes on tobacco, motor fuel, tea, textiles and cement as well as some realignment of income tax rates and a special levy on foreign exchange for travel abroad. Because of unfavorable public reaction, the tea and cement taxes and the levy on travel money were withdrawn a few days later.

The tax structure is still quite regressive with the main reliance on indirect taxes, although income taxation is becoming increasingly prominent. The income tax has high rates but is imperfectly administered. High exemptions relative to per capita income restrict this tax to only a fraction of one per cent of the population.

The Central Government shares certain revenues under its administration with the Provincial Governments - namely the excise on transportation, some export duties, and the estate tax. These governments in turn have virtually exclusive jurisdiction over agricultural property taxation. The Provincial Governments have fairly heavy development expenditures and limited fiscal capacity so they are dependent on loans and grants from the center.

To date, the persistent budget deficits have had smaller inflationary effects than might have been expected - principally because of the heavy inflow of foreign aid. While money supply has expanded fairly rapidly - for example by 20 per cent in fiscal 1955-56 and by 11 per cent in the year ended September 30, 1956, living costs have risen only about 10 per cent since 1951 and have actually declined a little from the 1954 peak during 1955 and early 1956. Since mid 1956, however, they have risen rapidly as a result of the foodgrain shortage. Available indices do not fully reflect the advance in living costs because they exclude imported goods and are based on government controlled prices that are in practice often exceeded.

In the past, the tendency for Government deficits to raise money supply has been partly offset by deficits on international account. In 1956, however, the foreign accounts were balanced and a slight accumulation of reserves occurred. In addition, expansion of bank credit, which occurs seasonally in the fourth quarter, was particularly large during 1956. Total bank credit reached an all time high at the end of the year.

It would appear, then, that Pakistan is now undergoing an inflationary spiral although to date this spiral has been fairly effectively suppressed by price controls and other means. Stronger fiscal and monetary measures are needed and have been promised for the near future. Without these measures the advantages gained by Pakistan in the 1955 devaluation may soon be lost through rising domestic prices.

The Suez closure has delayed both export and import shipments and raised prices. Import licenses issued for the latter half of 1956 were extended because of shipping delays and the new import program for the first half of 1957 gives special consideration to the Eastern wing. Although foreign exchange reserves dropped only moderately in the final quarter of 1956, outstanding letters of credit rose rapidly indicating a delay in payments. Jute prices rose slightly while cotton prices were steady. On balance, the canal stoppage has probably worsened Pakistan's payments position for 1957.

The record and the outlook

In the opinion of most Pakistan observers, the two decisions concerning the exchange rate - not to devalue in 1949 and to devalue unilaterally in 1955, have been fully justified by ensuing events. While the success of the earlier non-devaluation policy was largely fortuitous, it did assist the country in its early efforts toward industrialization and did help to prevent a boom in consumer goods imports from accompanying the boom in export trade brought on by the Korean war. For some time prior to 1955, however, it was clear that Pakistan could not maintain this appreciated rate indefinitely in the face of steadily worsening terms of trade. These terms of trade began to deteriorate in the spring of 1951 and aside from a brief improvement in 1954, have been steadily worsening every since.

In the face of a very uncertain world market for its agricultural raw material exports, Pakistan has been pursuing the only course it considers feasible of trying to develop industry and to diversify its export trade. It has made important progress in this direction. A large part of its jute exports now leave the country in finished form rather than as raw material. Likewise a growing proportion of its cotton exports now take the form of finished products. Moreover, non-agricultural exports have been steadily increasing in importance and in 1956 amounted to 17 per cent of total trade earnings.

In the three years prior to the 1955 devaluation, it became clear that the country's exports were increasingly non-competitive in world markets. The devaluation partially corrected this problem and gave a temporary stimulus to export trade although Pakistan was not in a position to capitalize very heavily on this fact in the first few months. Because imports were so heavily restricted by license limitations, the effect of the devaluation in increasing import costs contributed less to restoration of equilibrium than it could have with a freer trade pattern.

The main problem Pakistan must overcome in the months ahead is to prevent such a degree of inflation as will make inevitable another devaluation at some future time. There is no sign that this danger is as yet imminent, but like every country embarking on an ambitious development program, Pakistan has several years yet to go before large increases in output resulting from the present heavy investment expenditures begin to be realized. Meantime, the investment outlays are expanding incomes with little likelihood that these increased incomes can be matched by increased consumer goods imports. A program of heavy forced savings is being required of the people with little prospect that this period will ease soon.

Although Pakistan has made excellent progress during recent years in its industrial program it is lagging badly in the still more important job of producing adequate food supplies. Until this latter problem can be overcome there is little prospect of reduced dependence on foreign aid.

The number of economic controls still in effect make it difficult to judge whether the present exchange rate is a proper one for the long period. It seems at the moment to give exports a competitive position in world markets but does not make imports sufficiently expensive.