Approved For Release 2006/04/19 : CIA-RDP85T00875R001700050048-3

DOC/SER
OER/IM 73-51

Secret

25X1

Intelligence Memorandum

Pakistan: The Economy Under Bhutto

Secret

ER IM 73-51
July 1973

Copy No. 73

July 1973

Pakistan:
The Economy Under Bhutto

President Bhutto almost certainly will raise the subject of increased US economic assistance during his visit to Washington in mid-July. Since Bhutto assumed the presidency, Pakistan has chalked up some impressive economic gains, although serious problems persist. Among the gains:

- A substantial rupee devaluation and increased world demand for cotton, textiles, and rice – Pakistan's traditional exports – have combined to raise export earnings above those of the formerly united Pakistan.
- At the same time, the resumption of foreign aid and the short-term debt relief by the Consortium of Western creditors have allowed Pakistan to boost imports and to nearly triple its foreign exchange reserves.
- Islamabad claims it will achieve self-sufficiency in foodgrains starting in 1974.
- Industrial production has turned around in the first half of 1973, following a two-year industrial recession.

The generally favorable situation is, however, clouded by some serious economic problems:

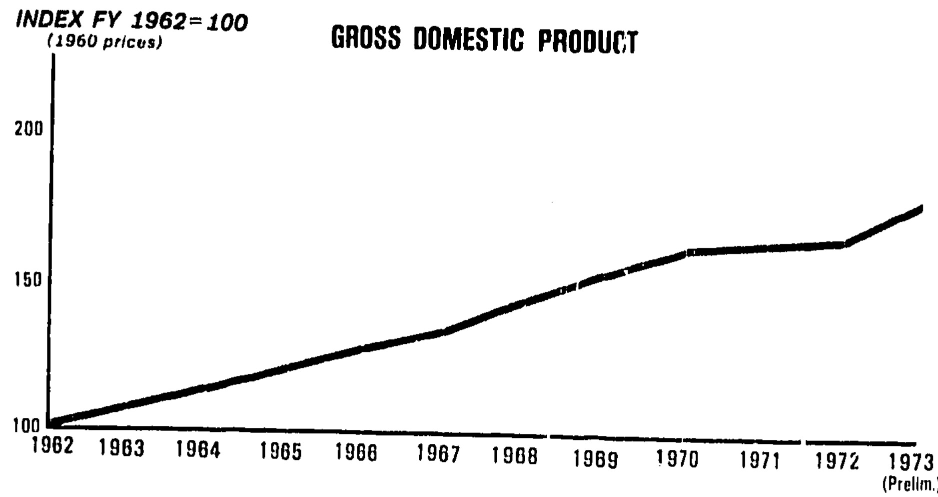
- Private investment, both domestic and foreign, continues to lag because of price and profit controls and because of industrial reform measures. The government now exercises management control in key heavy industries and utilities. Public investment has been held down by budgetary constraints.
- Rising foodgrain prices and a desire to maintain per capita consumption have prompted Islamabad to request one million tons of foodgrains from the United States under PL-480 for delivery in FY 1974.
- The burden of defense spending has increased since the loss of East Pakistan to about 8% of gross domestic product.
- Pakistan will require a long-term rescheduling of its foreign debts to avert an increase in debt service liabilities. The final division of its foreign debt obligations with Bangladesh is yet to be resolved, complicating Pakistan's relations with its creditors.

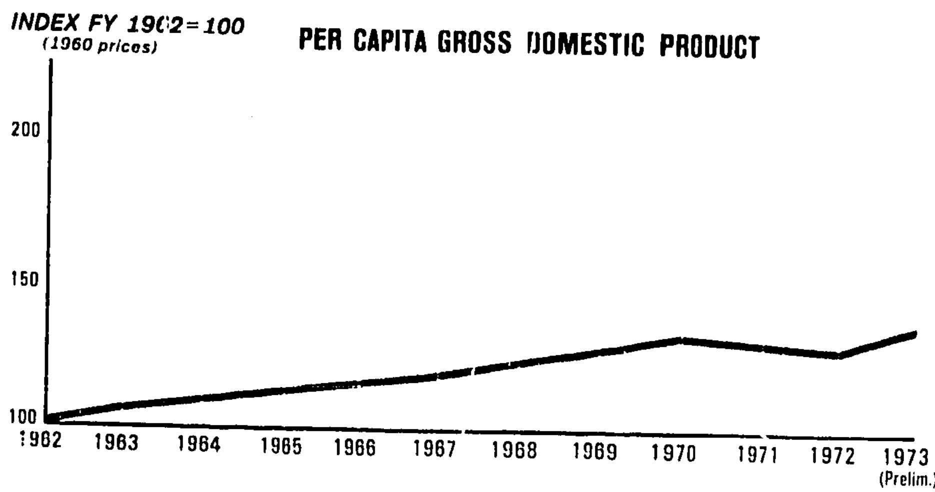
Net economic aid received by Pakistan in FY 1973 was an estimated $325 million, compared with $290 million a year earlier. The Western Consortium has been providing close to 90% of this aid. The United States alone has been providing 23% – mainly PL-480 wheat and other food – not counting US assistance channeled through multilateral agencies and US technical assistance.

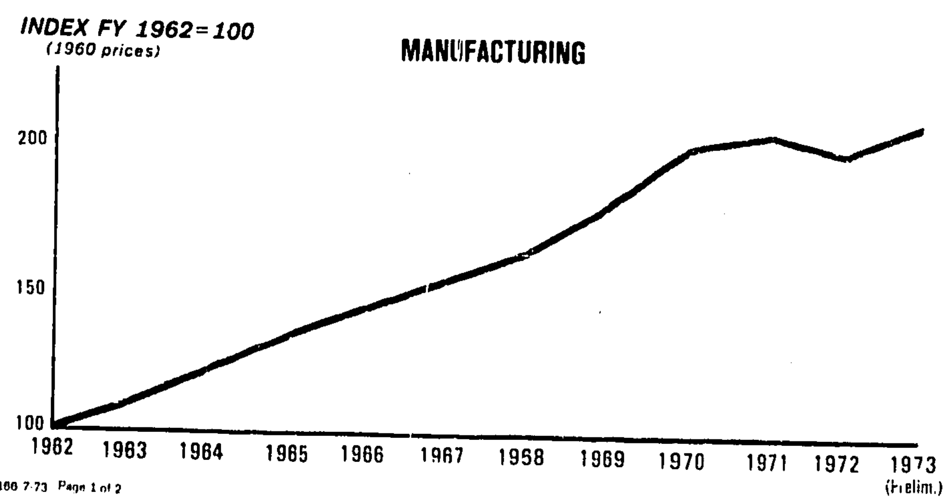
Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted] 25X1

PAKISTAN: Economic Indicators

(Fiscal year ends 30 June of stated year)

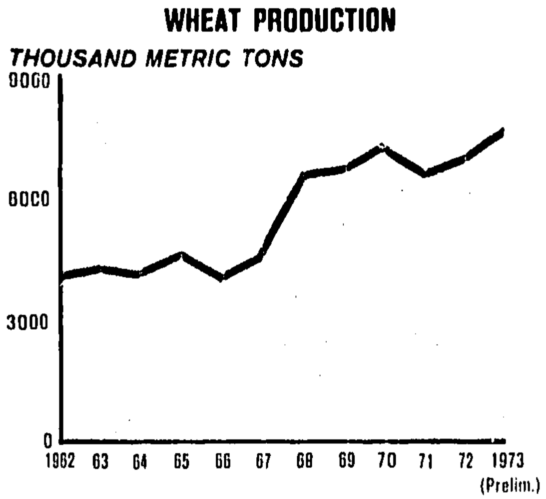


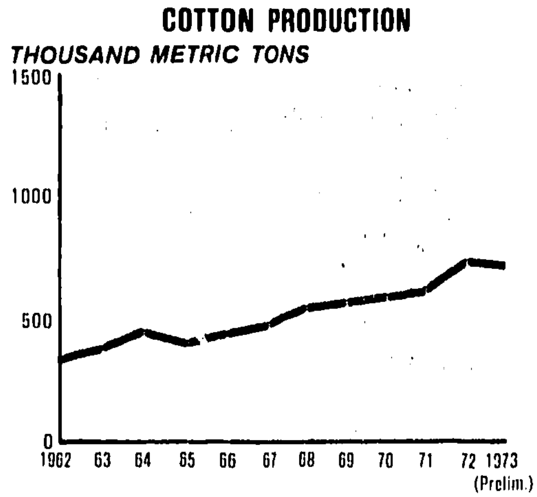


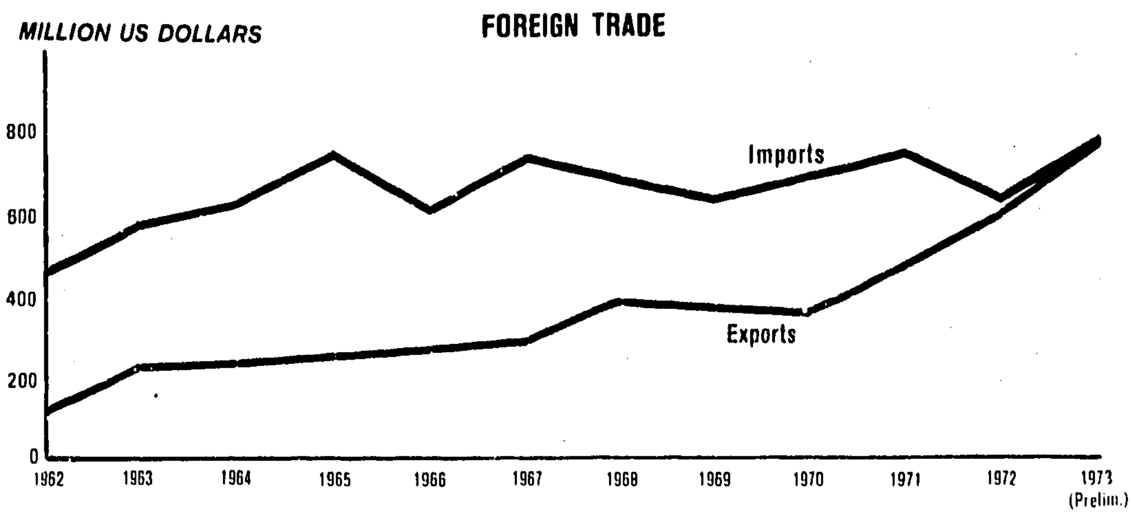


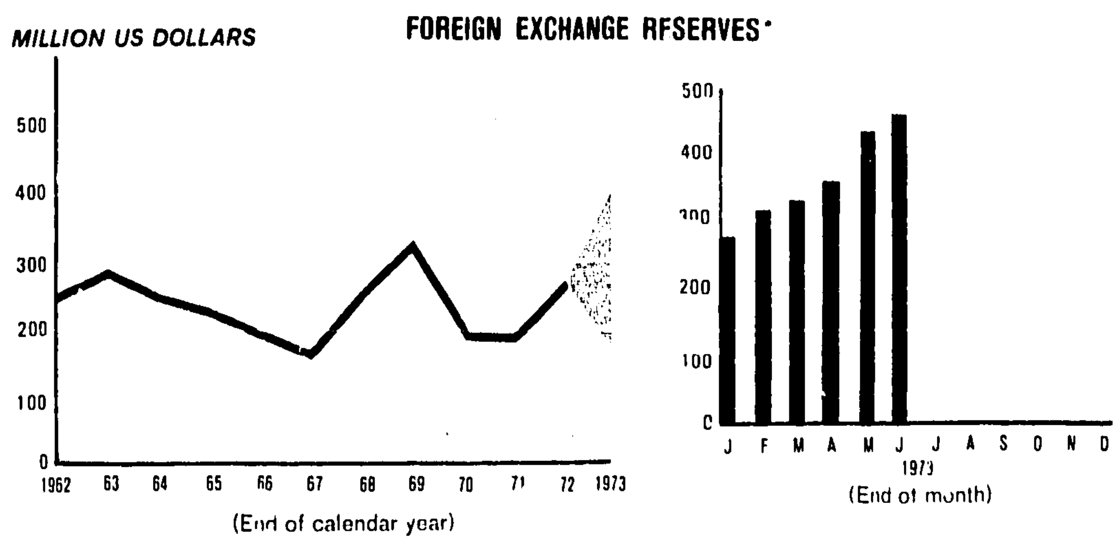
516166 7-73 Page 1 of 2

PAKISTAN: Economic Indicators









516166 7-73 Page 2 of 2

*Includes east wing reserves through December 1971.

ZULFIQAR ALI BHUTTO
PRESIDENT OF PAKISTAN

DISCUSSION

Background[1]

1. In December 1971, President Bhutto inherited an economy in the midst of an industrial recession. The recession had been triggered in the late 1960s, when net foreign aid declined, defense spending increased, and public investment had to be cut back. Private investment also had declined as a result of tight credit policies and growing political uncertainty. A more immediate cause of the lack of confidence by investors was the defeat by India and the loss of markets in the former east wing.

2. Per capita gross domestic product (GDP), which had increased at an average annual rate of almost 4% between FY 1962 and FY 1970,[2] actually declined in FY 1971. Investment as a share of GDP fell from 18% in the early 1960s to about 14% during FYs 1965-70. The downturn had been accompanied by increasing demands from workers, tenant farmers, and students for fulfillment of the government's longstanding pledges of greater economic equality.

3. The agricultural breakthrough of the late 1960s, achieved through the use of technology associated with the Green Revolution, bogged down after 1970. The wheat harvest in the spring of 1971, hard hit by drought, was 11% smaller than in 1970. Wheat is Pakistan's staple food crop, accounting for about two-thirds of total foodgrain production. Sugarcane production also declined by 12%. Cotton production, on the other hand, was at a record high because high cotton prices provided an incentive for farmers to plant more land to cotton. Moreover, cotton requires less irrigation than competing crops such as sugarcane.

4. Until the 1971 civil war, a large volume of trade moved between the east and west wings. Tea, jute manufactures, paper, matches, and spices from the east wing were exchanged for rice, tobacco, vegetable oils and oil seeds, raw cotton, cotton yarn and fabrics, cement, and other industrial products from the west wing. This trade benefited both wings by providing protected markets for various goods and holding down the foreign exchange costs of imports. The loss of the east wing in December 1971 immediately reduced the size of Pakistan's domestic market and forced further retrenchment in the already depressed industrial sector.

1. For economic indicators of Pakistan's performance during fiscal years 1962-73, see the Appendix.
2. Fiscal years end 30 June of the stated year.

5. Pakistan's international financial position had been under severe pressure in 1970 and 1971 because of an expansion in import requirements and an increase in the cost of servicing foreign debt. Following the outbreak of Pakistan's civil war in March 1971, most foreign donors curtailed new aid commitments. This action produced additional stress on Pakistan's foreign exchange reserves, which had already dropped about 45% during the preceding year. To arrest the decline in reserves, Islamabad imposed limits on imports, principally industrial raw materials and capital goods, and in May 1971 declared a moratorium on most foreign debt service payments. During 1971, Pakistan still was able to draw on a substantial amount of economic aid already in the pipeline. Furthermore, Pakistan's exports increased 27% in FY 1971 as dislocations in interwing trade forced sellers to redirect many goods to foreign markets. In December 1971, foreign exchange reserves were $181 million, about the same as a year earlier.

6. Military operations in the east wing and the buildup along the west wing's border with India in 1971 led to a sharp expansion in military spending. With the loss of more than half the nation's population, per capita military expenditures had more than doubled. Foreign exchange outlays for defense were now absorbing at least 20% of Pakistan's foreign exchange earnings, compared with 17% previously.

Bhutto Takes Control

7. The economy of Pakistan has made impressive strides during Bhutto's first 18 months in power. Real growth in GDP in FY 1973 is estimated by Islamabad at 6.5%. The country has managed to redirect most of its former interwing trade, raise wheat production to a new record, attain at least partial recovery from the industrial recession, expand exports to record levels, and re-establish ties with foreign aid donors. President Bhutto has taken an active and personal hand in economic affairs, including some decisive reform measures. Conflicts already have arisen, however, over interrelated and competing government policies, particularly in the case of inflation and private investment.

Rapid Adjustment to Loss of East Wing

8. The loss of the east wing in December 1971 involved the poorest, most densely populated, and economically stagnant region of the former united Pakistan, a region that promised to be a growing claimant on foreign aid receipts and a declining net earner of foreign exchange. Having lost more than half its population, the Pakistan that remained was considerably less dependent on foodgrain imports, had a reasonably well-developed modern industry, and was able to draw on a sophisticated entrepreneurial class.

9. Following the loss of the east wing and the complete halt in interwing trade, Pakistan apparently was successful in redirecting former interwing exports to foreign markets. By the end of 1972, about 60% of commodities formerly sold to the east wing reportedly had been switched to foreign countries. This was achieved principally because of rising world demand for cotton, textiles, and rice. About 15% of the commodities previously traded interwing, including edible oils, foodgrains, and sugar, were absorbed domestically because of production shortfalls.

Wheat Production Up; Imports Still Needed

10. Wheat production increased by 5% in FY 1972 and by an estimated 10% in FY 1973. Nevertheless, large quantities have been imported, and the government is seeking additional imports for FY 1974. Shortages in government ration shops and abortive government attempts to control the market prices of wheat and flour underlie the unusually large import requirements.

11. Government-sanctioned ration shops distribute 15%-20% of Pakistan's wheat supply to the low income populace at controlled prices. Until March 1973, the official wheat procurement price paid farmers remained fixed and matched the price charged consumers in the ration shops. The government subsidized the transportation, storage, and other overhead costs. At least 80% of the country's wheat, however, is sold on the open market. As a result of rapidly rising open market prices during 1972, the official procurement price attracted few sellers. The government was able to procure only about 200,000 metric tons of wheat from the 1972 crop, compared with more than 800,000 tons the previous year.

12. Unable to obtain a sufficient supply of domestic wheat for the ration shops, the government resorted to large-scale wheat imports to hold down domestic foodgrain prices and insure an adequate supply, especially to the urban poor. Since early 1972, Pakistan has contracted for 1.35 million tons of wheat under US PL-480 and more than 100,000 tons from other sources. The import requirement for FY 1974 has been set by Islamabad at 1.3 million tons. Islamabad finally increased the procurement price of wheat by one-third in April 1973 to increase collections from the 1973 wheat harvest. The increase should induce farmers to sell more of their produce to the government, which may bring domestic wheat collections to one million tons in 1973.

13. Foodgrain policies are designed not only to insure the minimum nutritional requirements of the populace but also to continue the expansion of per capita wheat consumption that began in the mid-1960s. The extensive wheat imports more than offset crop shortfalls in FY 1973. In spite of

increased payments to farmers of almost $15 per ton and the doubling of the cost per ton of wheat imported during the past year, the government has not increased the retail price of wheat and atta (wheat flour) charged consumers in the ration shops. The cost to the government of this subsidy is largely offset by the immediate revenue from domestic sales of aid-financed imported wheat.

Industrial Recovery Uneven; Investment Constrained

14. Industrial production reportedly increased by about 6% during FY 1973, following the decline of 4% in the previous fiscal year. Most of the increase is attributable to the use of existing capacity rather than to new investment. Investment is still being constrained by uncertainty concerning the direction of government economic reforms and by large-scale strikes and slowdowns that took place during the second half of 1972. Moreover, capital goods imports declined by 20% in FY 1973.

15. The uncertainty of investors was prolonged by government measures taken against the country's major entrepreneurs. The Bhutto regime, upon assuming power in December 1971, began attacking the country's leading industrialists – the so-called "22 families" – by demanding the repatriation of their assets held abroad, seizing their passports, and making token arrests. These actions were intended to demonstrate the government's desire for social reform and, at the same time, to weaken Bhutto's domestic opposition. Subsequently, in January 1972 the government assumed control over 31 major industrial enterprises in ten basic heavy industries. The action fell short of nationalization because shareholders retained their shares and proprietary rights. Smaller units in these industries remained in private hands; public control over the larger units permitted the government to influence pricing and marketing for all firms. The takeover still left about 80% of all industrial assets under private control.

16. In February 1972 the government increased labor's role in labor-management disputes, generating increased labor unrest. A number of strikes during 1972 further impeded industrial recovery until late in the year, when the government took strong action against labor, including the use of police and paramilitary forces at the Landhi cotton and textile mills in Karachi. Slowdowns and stoppages on the docks in Karachi congested operations, delaying needed industrial imports and prompting international shippers to threaten a surcharge on goods through the port. In other moves against the private sector, Islamabad restricted interlocking directorates and managements, nationalized life insurance companies, and imposed more stringent controls over banking operations.

17. By the fall of 1972 the government realized that its industrial reform program was discouraging investment and thus limiting industrial recovery. Promises were made that no further nationalization of business enterprises was immediately contemplated. Nevertheless, government procrastination and intransigence in dealing with the business community, including foreign investors, have continued to impede new investment. Foreign investors in particular have been experiencing difficulty in remitting sufficient rupee profits since devaluation because of the government's failure (a) to lift contractual restrictions on the maximum permissible rupee repatriation and (b) to raise product prices to cover the increased cost of imported capital goods.

Mounting Inflation

18. The rupee devaluation, monetary expansion, and various commodity shortages have led to sharp price increases. The urban consumer price index increased by 19% between July 1972 and April 1973. Subsequently, prices have risen even further. The rupee devaluation of 57% in May 1972 boosted import costs, necessitating upward adjustments in many prices. The money supply was expanded by 14% during the first nine months of FY 1973 to finance deficit spending and to provide additional credits for exporters. Large increases in exports during the past two years reduced domestic supplies of several commodities, thus contributing to higher prices for both consumers and industry. In June 1973, in an effort to boost domestic supplies, trim excess export profits, and expand government revenue, the government raised export duties on cotton, wool, yarn, cloth, and several other commodities. The government also announced an easing of import restrictions to allow additional goods to enter the domestic market.

High Defense Expenditures a Constraint on Development

19. Pakistan's military spending has continued well above pre-war levels under Bhutto, as follows:

Fiscal Year	Billion Rupees
1969	2.4
1970	2.7
1971	3.2
1972	3.7
1973	4.4
1974	4.2 (budget)

Military expenditures of 4.4 billion rupees in FY 1973 were the equivalent of almost 8% of gross domestic product and 31% of central government expenditures. Foreign exchange outlays for military purposes were equivalent to more than 15% of the country's export earnings. President Bhutto has expressed a desire to reduce defense outlays, including a reduction in personnel strength. Since December 1971, however, Pakistan has sought to restore its military capabilities and strengthen its armed forces beyond pre-war levels. Pakistan believes the continued Indian arms procurement program is directed against its own national interests. Although Pakistan can not expect to approach absolute military parity with India, the government apparently feels compelled to maximize its capabilities for military deterrence and defense.

20. Since coming to power in December 1971, Bhutto has concluded major arms agreements with foreign suppliers and has sought additional sophisticated weaponry. China, for example, has agreed to supply tanks, artillery, other ground force weapons, jet bombers, and naval craft valued at $75 million or more. [redacted] 25X1

Meanwhile, both Peking and Paris are continuing deliveries under earlier arms accords. The United Kingdom has agreed to sell antisubmarine warfare helicopters to Pakistan, and negotiations for two British frigates are under way. The United States has lifted its restrictions on the shipment of lethal end-items to Pakistan on a one-time basis, enabling Islamabad to take delivery of 300 armored personnel carriers and spare parts ordered before 1971. Other arms suppliers have concluded agreements with Islamabad for ground force weaponry, military vehicles, ammunition, and spare parts.

21. A large portion of these military acquisitions are financed under medium-term and long-term credits, so that the impact on Pakistan's economy is deferred. Some or all of the Chinese equipment may even be supplied as grant aid. Nevertheless, cash purchases, downpayments for new aid-financed equipment, and debt repayments for equipment previously received almost certainly have boosted foreign exchange outlays for armaments well beyond earlier levels.

22. Continuing high military expenditures, by reducing the resources available for the Annual Development Plan (ADP), have resulted in increased reliance on foreign economic assistance. Foreign sources accounted for 73% of ADP funding in FY 1973 and are expected to provide 67% in FY 1974, compared with 42% in FY 1971 and 34% in FY 1970.

Foreign Exchange Reserves Reach Record Levels

23. Pakistan's international financial position has improved markedly under Bhutto's management. Foreign exchange reserves have nearly tripled

since December 1971, approaching the $500 million mark in late June 1973. The improvement is attributable primarily to record export earnings, restoration of foreign economic aid – which financed about one-half of Pakistan's imports in FY 1973 – and short-term debt relief.

Expansion of Exports

24. The successful redirection of interwing trade, coupled with the substantial rupee devaluation, has greatly improved Pakistan's export performance. The devaluation made Pakistani commodities more competitive on world markets; export earnings, which had already increased by 27% in FY 1971, rose by 33% in FY 1972 to a record $589 million. Export earnings reached $590 million during the first ten months of FY 1973 and probably exceeded $750 million for the entire fiscal year. This last figure is higher than the combined annual earnings of the former united Pakistan.

25. Raw cotton and textiles accounted for almost four-fifths of the increase in export earnings in FY 1972. Shortages of cotton on the international market boosted world demand and prices, leading to a massive $110 million increase in Pakistan's cotton exports in FY 1972 alone. Cotton exports leveled off during FY 1973, whereas textile exports increased by 43% and rice exports by 80%. The government took control of the rice trade in 1972 in order to prevent smuggling through private channels to India and Afghanistan and thus to insure maximum receipt of hard currencies for the public coffers. Subsequently, international rice prices increased sufficiently to insure that private traders in Pakistan would sell rice on the regular world market, and Islamabad again sanctioned private rice exports. (Private rice exporters must register their sales contracts with the State Bank and exchange their hard currency earnings for rupees.) The value of processed agricultural products entering the export trade, such as leather and woolen carpets, also increased substantially.

Imports Up Also, Largely Aid-Financed

26. Foreign economic aid financed roughly one-half of Pakistan's imports in FY 1973. Islamabad has estimated disbursements of foreign economic aid at $389 million in FY 1973 (excluding Indus Basin/Tarbela Dam funds[3]) and is projecting aid receipts at $427 million in FY 1974. Pakistan's imports reached a record $775 million in FY 1973, some 24% above the previous year. The increase resulted mainly from increases in foodgrain imports, and from imports of items previously provided by the

3. The Indus Basin/Tarbela Dam Project is financed by a separate consortium of foreign donors under the aegis of the World Bank. Pakistan receives about $100 million per year from this consortium.

east wing. Imports of food, edible oils, and live animals in July-December 1972 exceeded the value of similar imports for the whole of FY 1972. Meanwhile, the value of machinery, transport equipment, and manufactured goods imported in July-December 1972 declined by 14% from the corresponding period of the previous year and by almost 40% from two years earlier. The rupee costs of importing industrial machinery and raw materials since devaluation has increased sharply. This increase, together with general business uncertainty, tended to discourage industrial imports.

Payments on East Wing Debts Deferred by Interim Debt Relief

27. Islamabad is still responsible for the debt to the Western Consortium[4] incurred by the former united Pakistan. By December 1972 the debt had reached about $3.75 billion. Even allowing for the partial unilateral debt moratorium declared by Pakistan in May 1971, debt repayments amounted to 22% of export earnings in FY 1972. Without the unilateral action taken by Islamabad, scheduled payments would have cost Pakistan a massive 44% of its export earnings. After a one-year moratorium, Islamabad agreed to resume debt servicing in May 1972, including the temporary servicing of debts to the Consortium accrued in the former east wing. Consortium aid was resumed, and short-term debt relief of about $235 million – 56% of scheduled repayments – was granted for payments due to the Consortium between May 1971 and June 1973. Several non-Consortium countries also granted debt relief and resumed aid activities. In spite of debt relief and increased exports, debt repayments still took 24% of export earnings in FY 1973.

28. In March 1973, Islamabad informed the Consortium that it did not intend to pay for East Pakistan's debts after June 1973 and claimed that this responsibility should pass to Bangladesh. The Pakistan government also renewed its longstanding request to the Consortium for long-term debt relief on that portion of the debt arising from credits used in West Pakistan. The Consortium rejected Pakistan's proposals and in June 1973 offered a compromise formula proposed by the United States to avert a debt default by Pakistan and a threatened cutoff of new aid commitments, which creditors wish to avoid.

29. The formula calls for Pakistan's continued acceptance until June 1974 of all debt liabilities, while creditors attempt an acceptable division of the debt. In the interim, the Consortium would grant Pakistan short-term

4. The United States, the United Kingdom, West Germany, Japan, Canada, Italy, France, the Netherlands, Belgium, Sweden, Norway, the Asian Development Bank, and the World Bank and its affiliates (IDA and IFC).

debt relief similar to that accorded in 1972; this relief would cover all repayments due on the Bangladesh portion of the debt, as determined by Pakistan and each of its creditors. At the end of this period, Pakistan would be absolved of responsibility for further servicing of debts on projects located in Bangladesh, but Islamabad would have to continue servicing non-project debts of the former east wing. Following the debt division, the Consortium would consider long-term debt rescheduling for Pakistan.

30. The formula provides for a settlement without requiring direct negotiations between Islamabad and Dacca. Some of the economic arrangements will prove burdensome for Pakistan. For example, the acceptance of more than $700 million of east wing commodity aid debts would increase Pakistan's liability to 8.5% of the total debt. Even though repayment of this additional amount will be deferred, it will impose a future liability on Islamabad and may pose political problems for President Bhutto. The Consortium can offer Pakistan no guarantee that Bangladesh will accept its liability for pre-independence project debts; some creditors would have to continue holding Pakistan liable. Pakistan has reluctantly accepted this interim solution. The inability to resolve the division of commodity aid liabilities before June 1974, however, may cause another debt default crisis. The subject of long-term debt relief is likely to be an important topic for discussion during President Bhutto's visit to the United States in July 1973.

APPENDIX

Pakistan: Economic Indicators, by Fiscal Year[1]

	Unit of Measure	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973[2]
Gross domestic product	Million rupees (1960 prices)	17,810	19,118	20,336	22,007	23,092	24,068	25,911	27,576	29,474	29,697	30,068	32,022
Population[3]	Million persons	49.1	50.3	51.6	52.9	54.3	55.7	57.1	58.7	60.3	61.9	63.5	65.3
Per capita gross domestic product	1962=100 (1960 prices)	100	105	109	115	117	119	125	130	135	132	131	135
Defense expenditures	Million rupees	1,192	961	1,211	1,262	2,855	2,294	2,186	2,427	2,749	3,202	3,726	4,440
Exports[4]	Million US $	114	210	226	239	253	272	391	370	350	443	589	766
Imports[4]	Million US $	470	588	626	771	605	761	699	640	690	756	623	775
Trade balance[4]	Million US $	-356	-378	-400	-532	-352	-489	-308	-270	-340	-313	-34	-9
Foreign exchange reserves[5] (end of calendar year)	Million US $	260	298	244	220	198	156	239	324	182	181	273	—[6]
Manufacturing production	Million rupees (1960 prices)	2,576	2,863	3,186	3,501	3,799	4,012	4,267	4,634	5,156	5,300	5,097	5,418
Cotton cloth production	Thousand square yards	639,117	671,727	693,161	714,755	651,358	683,619	714,825	710,245	725,421	787,313	734,000	N.A.
Wheat production	Thousand metric tons	4,027	4,170	4,162	4,591	3,916	4,335	6,419	6,618	7,295	6,477	6,808	7,519
Cotton production	Thousand metric tons	324	366	419	377	415	463	517	526	537	543	708	702
Sugarcane production	Thousand metric tons	14,357	18,440	[illegible]	18,669	22,311	21,983	18,660	21,972	[illegible]	23,168	19,964	21,407

1. The fiscal year ends 30 June of the stated year.
2. Preliminary.
3. Estimates based on the 1972 census.
4. Excluding trade with East Pakistan.
5. Including reserves of East Pakistan until December 1971.
6. Foreign exchange reserves for 1973 are as follows (end of month data): January, $287 million; February, $322 million; March, $343 million; April, $370 million; May, $440 million; and June, $468 million.

Approved For Release 2006/04/19 : CIA-RDP85T00875R001700050048-3