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AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM MEMORANDUM

FY 1970

PAKISTAN ANNEX

BEST AVAILABLE

DEPARTMENT OF STATE

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PAKISTAN

FY 1970 PROGRAM MEMORANDUM

INDUSTRY

APPENDIX D

There is little change in the basic difficulties confronting effective industrial development in Pakistan described in the Program Memorandum for 1969. The list is long: fluctuating flows of materials for production, especially imports; small and over-protected domestic markets for capital goods; inadequate managerial and entrepreneurial skills; lack of standardization, modern engineering methods, or quality control; lack of competition in a goods hungry domestic consumption market; inadequate project preparation; difficulties in obtaining risk capital; and a wide variety of incentive, stimulating and directive devices, patched together over time to meet one need after another. In East Pakistan the difficulties are greater, the milieu less attractive for investment, despite the effort to increase the inducements, and the ability to put up mountable projects for private investment evidently poorer.

Against this catalog of deficiencies must be weighted the creation of an expanding industrial establishment in the twenty years since independence which accounts for a constantly rising share, now about 12 percent, of a much larger gross national product, and which also now accounts for almost half of merchandise exports. While cotton textiles production is still the predominant industrial activity, a considerable diversity has developed.

Pioneering investment undertaken with public sponsorship and with varying degrees of public participation has been disposed of to private investors in very significant measure. A lively and eager investment interest has grown up, not merely among the major commercial and industrial families, but in a significant area of smaller enterprises, and among middle class savers who look to institutional channels to put their funds to productive use.

At the same time, the availability and cost of foreign exchange and the profit·bility of the investment process itself has encouraged capital expansion even when existing capacity was significantly less than reasonably utilized. Even allowing for the gross inadequacy of the data flows from which attempts are made to measure the situation, it should be no surprise that the picture is a very mixed one; some plants operate three shifts and are able to sell everything they make to domestic or export markets; they may be located in close proximity to others which cannot be operated at efficient levels. Low operating levels in many cases can be attributed mainly to lack of imported supplies; on the other hand, if supplies were adequate for some plants it is possible they might swamp the domestic market and would have little competitive effectiveness as exporters. Large modern capital facilities go along with small poorly equipped shops whose numbers and output have yet to be adequately counted.

Capacity estimates are inflated by inclusion of plant which is obsolete and expensive to operate in relation to the quality and market possibilities of its product. Such plants are rated equally with the best in the calculation. At the same time there is understatement of operating needs since most projections of import requirements for operating materials are derived from estimates of one-shift capacity operation. The impact of foreign exchange shortages on capacity use is also different in plants with a mixed production than the effect in one-product situations. Plants predominantly dependent on domestic supplies may still be affected by missing bottleneck items, break-downs requiring spares etc.

The problems of industrial efficiency and development investment are not susceptible to rapid elimination. Old, ill-sited plants and poorly chosen processes would inhibit attaining the 20 percent increase in efficiency of capital to output ratios which would in principle be possible if the average of best practice enterprises could be made to prevail generally. Some enterprises may be closer to limits imposed by availability of labor and management skills than is generally realized.

During this third year of the Third Plan industrial output has continued to grow, not as much as the 11 percent expected earlier, when there was still hope for higher imports to arrive during FY 1968, but still over 8 percent for the group as a whole, and between 10 and 11 percent for large scale manufacturing. It is hard to determine the actual amount of private investment, but it is clear that there has been some lagging, particularly in East Pakistan. There is no expectation that the Industrial Investment Schedule will be taken up by the end of the Third Plan, but by contrast with the expectations for shortfalls of public sector development expenditure, a significant part of it in industrial projects, the private sector as a whole, combining industry with other activities, looks likely to come much closer to plan expenditure targets and may even reach them. The major holdbacks are likely to be in foreign exchange dependent investment.

The Third Plan was to have seen the initial drive for a heavier industrial base. Much of this, especially activity depending on public sector initiative, has been delayed and the post 1965 adjustment was meant to give priority to projects with shorter construction time, less dependence on foreign exchange and contributing more support to agriculture. These tenets are incorporated in the guide to industrial investment policy which the Government of Pakistan is following at present: The encouragement of private sector investment in those industrial sub-sectors which are: (a) export-oriented, (b) import-substituting, or (c) devoted to supplying production requirements for agriculture, or (d) process agricultural products. An effort was made to select activity based on domestic raw materials and to cut down on investment dependent on a heavy continuing proportion of imports. Obviously these guidelines are broader and more significant than whether priority should be given to investing in production of consumer goods, producer's intermediates, or capital goods. Along with these guides there is a clear principle to make public investments in major industry to the extent that the private sector does not fulfill the requirements of the country and to the extent to which foreign governments make available project assistance for long gestation public sector activities. Private failure to fulfill interests identified in the investment schedules, or activities requiring a total investment which the government has concluded exceeds the private competence result in a public effort to fill the gap.

By and large the dogmatic schools which have to be placated in some other countries with the assurance that the public is not surrendering its role when a major activity goes private have little force here Mixed public-private investment companies were used, disposals of profitable enterprises have occurred and such major new investment as fertilizer production will have its major new capacity, ultimately 6 to 7 times last year's level of production, from privately initiated investment. On the other hand, projects will go where the aid is and some other donors have fewer qualms than the United States about whether an investment is public or private. Bloc donors have a positive bias in favor of public activity and a willingness to associate themselves in principle with large scale industrial enterprises, such as they have undertaken in their own homelands, leaving the argument about impelementation details for later disposal.

For the Fourth Plan Pakistan is just beginning the work to shape the targets for its industrial effort. Over the next year or two it will attempt to determine the scale and the preferred areas for that activity, as well as to identify the policies that it should use to encourage these events. At the same time forerunners of the policy of the future are already beginning to appear, spurred by the exceptional agricultural promise of increasing crops and higher productivity in foodgrains already evident in West Pakistan and from interest in vegetable and fruit crops in East Pakistan.

The postponed questions of the industrial structure will therefore be debated not only in theoretical and aggregate terms but also in terms of the practical choices to be made given earnings and probable availability of aid. To the extent the Mission sees a new direction it stems from the intuitive grasp for the benefits of agricultural growth. Initially this is easy enough to see in terms of supplying the needs of agricultural production, but that would be a very lopsided view of industrial development. Industrial growth based on the processing requirements of agriculture has to have a significantly diversified base of agricultural production. It seems unlikely that nutrition-oriented diversified agriculture, which requires a quite sophisticated organization of cultivation practices as well as adaptive research in new varieties, will make that much advance during the next few years. Like the Government of Pakistan, the Mission also has a predilection to encourage export-oriented industrial growth, which in the testing process may yield more realistic market-confirmed decisions and greater freedom of choice for Pakistan at an earlier stage of its development.

In the review of methods and inducements which the Government of Pakistan will carry out, it must seek better means to encourage desired investment than have been relied on up to now. At present, for investment which does not require foreign exchange for either equipment or raw materials, no "approval" or official sanction is required, and only an information record of its establishment and manufacturing capacity need be filed with the Provincial Department of Industries and the Investment Promotion Bureau. The various financial incentives to encourage investment, and the differential incentives for preferred activity and in favor of East Pakistan are available for such investment as does not require foreign exchange just as for investment which does.

For activities dependent on foreign exchange the procedure remains more elaborate. Overall investment targets by industry outlined periodically in the Comprehensive Industrial Investment Schedule are meant to encourage the investor and to guide the sanctioning authorities, whose considerations are coordinated through a central coordinating committee on which the principal private sector financing groups are also represented. A review of the deficiencies of the process in 1967 led the Economic Coordinating Committee to establish a list of priority industries, but this was still a long way from making the process effective. The schedule can clearly have discouraging effects on private investment choices, but the fact that an activity is on the schedule or obtains a sanction is not enough to assure the investment will take place.

There has been no orderly process to monitor utilization of sanctions.* Short of a special survey it would be difficult to define the actual investment outcome of the last few years of sanctions. If the investment objectives are considered valid goals, then a more effective process for sponsoring and encouraging the undertakings is needed. If the process is meaningless, as is the implication if the investment goals are altered after the fact to match the results, then the process is an excessive administrative burden and impediment to carrying out private investment. Complete elimination of guidance or review is not a realistic target as long as foreign aid contributions remain subject to the special considerations relating to the interests and requirements of the donors. Some freer means of assuring due consideration to the various interests involved needs to be found.

The difficulties in East Pakistan seem to call for a stronger more focused effort to help formulate effective and productive investment proposals and to present them in saleable fashion to sources of investment capital. The United States interest in such a process need not be confined to such capital activity as it might have an interest in financing. Furthermore the non-project financing the United States provides is one of the most effective means of encouraging and supporting private sector development in small scale investment, which can be quite responsive to local growth. It also gives opportunities to new producers which large scale major capital intensive plant using sophisticated technology may not

The effect of changes in import costs of both capital and raw materials under the import policy adjustments made during FY 1968 and in July 1968 is not yet known. The experience to date, narrow though it is, suggests that the increases of 16 to 32 percent in cost of capital

* See footnote page 7

described in the Program Memorandum (Annex I-5) have had some effect in causing investors to re-examine their projects, even where their arrangements were considerably advanced, to see whether some domestic alternative could be found. The increased direct cost of raw materials to the direct importer (first-range transactions) is also no doubt forcing a review of investment and profitability considerations, especially since the funding situation precluded any significant rise in availabilities, such as had occurred with the liberalizing actions of FY 1965, and improvements for industrial users would have to come in the main from rearrangements within the total import bill.

The very changes in import policy which are regarded as the main hope for improved, more productive, and more economically efficient allocation of foreign exchange have been the occasion for complaints from East Pakistan. Many proposals and schemes to foster industry urge forms of subsidy and incentives which entail the grave danger of repeating the history of some of the mistakes made in West Pakistan's industrial investment, and of giving undue support to activity that might have little prospect of reaching independent viability

Among the considerations worth concentrated examination for East Pakistan are a) the highly productive opportunities that can be expected to grow rapidly in agriculture-related investment, much of it breaking new ground for all Pakistan, some of it surely able to benefit in East Pakistan from the experience of the earlier growth in West Pakistan; b) the prospects for smaller scale industry, with its generally more labor-intensive patterns, associated with smaller scale agricultural holdings and greater density and concentration of population, rather than major showpiece capital establishments; c) the need for stronger and more focused research effort on East Pakistan products for domestic use and export, ex. jute, timber, etc.; d) the problems of adequately anticipating the needs for "infrastructure" —physical facilities and human resources. (farm to market communic-ations, power, transport etc. all of which are also problems for West Pakistan development.)

At this point in the considerations it must be plainly admitted the Mission does not yet have a firm policy view for industrial development —either for the undertakings of Pakistani planners or for the activity of the Mission during the Fourth Plan. The studies the Mission has already committed for study of future agricultural patterns are a necessary base for any sensible patterns for industry.

We also hope to undertake further analysis for direct industrial interests and to ecnourage, support and share in such activity in the Government planning effort. We have a particular interest in the export/investment interplay which we expect will grow, as well as in the prospective need for increased industrial output to meet agricultural production and consumption demand. We also believe a generally higher level of service needs can be expected in the Fourth Plan which will reguire appropriate investment plans.

Over the next eighteen months we will be working with agencies of the Pakistan Government and its advisors to complete this analysis and to determine how the Mission can best influence and aid industrial development in the two Wings. United States aid may be better handled in this context if the United States does not attempt to act as the retailer of smaller projects but through support for established, adapted or new financial institutions or intermediaries, and through United States program lending. A role for technical aid and support for feasibility work and project preparation is also a major USAID area of interest. The education program will also have a contribution to make to help Pakistan meet the problems of industrial expansion. We shall need additional staff skills that can be obtained from consultant services to examine these issues and help us reach an appropriate policy and program structure in respect to investment objectives and methods of attaining the desired results.

Footnote 1 from D-5 - One problem in estimating the volume of investment is that issuance of an investment sanction in Pakistan is the occasion for intensive project review by the Government. This can be very time-consuming, and the outcome for the investor is often uncertain. The usual role of an investment sanction in budget processes in or out of Government elsewhere, is to provide the final check on whether the applicant is in fact ready to spend the funds which are about to be earmarked for his project. This check is meant to insure that funds which could be used for other purposes are not tied up in an account for an activity which actually will not spend them during the current accounting period. The only issue before the sanctioning body should then be whether the project is ready to disburse funds, questions of project justification having been ruled on in previous and more intensive reviews. Used in this manner, investment sanctions can provide a fairly accurate reading of the amount of investment actually occurring or expected in any given period. In Pakistan however the investment sanction seems not to have this definitive character.