External debt and economic growth: trends and challenges – a case study of Pakistan (2000-2007)

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Introduction

Background

External debt plays both a positive and negative role in shaping economic growth, particularly of the developing countries. External debt is helpful when the government utilises it for investment-oriented projects such as power, infrastructure and the agricultural sector. On the other hand, it would affect negatively when it is used for private and public consumption purposes, which do not bring any return. Additionally, a low level of external debt impacts economic growth positively, but this relationship becomes negative at a higher level. The specific turning points are 35-40% of the debt-gross domestic product (GDP) ratio, and 160-170% of the export-debt ratio.[1]

Pakistan's external debt is seen to be the cause of all ills afflicting the economy. External debt increased from $19.200 billion in 1990 to $33.60 billion in 1999 and further to $37.362 billion by 2007. Moreover, in most of the fiscal years since independence, the government's revenue has less than its expenditure, which in turn would cause fiscal deficit which could be bridged through borrowing from both internal and external sources (debt). But the situation becomes worse when the country is unable to repay its debt servicing.

Shahid Hasan Khan, Special Assistant on Economic Affairs to the Prime Minister of Pakistan in the Benazir Bhuto government in 1993, said that "the fiscal deficit is the primary cause of all the ills of the economy. Consequently, any effort aimed at rehabilitating the economy would have the elimination of fiscal deficit as the number one item on the agenda."[2] Every single IMF and World Bank document on Pakistan also says that the external debt burden has been the primary cause of all the ills of economy, especially since the start of the structural adjustment programmes in 1988.[3]

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Pakistan's external debt liabilities reached unsustainable levels in late 1990's, and increased by $6 to 7 billion in 1998-99. When a country spends about 65% of its revenue to finance debt servicing, leaving aside only 30 to 35% of its revenue to spend on defence and development projects such as education, health, infrastructure and others, what would be its quality of education, standard of living, health, physical infrastructure and defence? Thus, it requires no rocket science to understand the implications of sustaining such a large external debt. Moreover, in return, the country's physical and social infrastructure and others projects are bound to suffer.[4]

On the external front, when a country spends $ 6 to 7 billion on debt servicing out of a total foreign exchange of $11 to 12 billion, leaving aside only $5 billion to finance import worth $9 to 7 billion, it is compelled to borrow at least $4 to 5 billion each year, which in turn enhances the fiscal deficit. To attract savings, the interest rate was set high, causing the crowding out of private investment from the economy. Nevertheless, the overall interest rate was still not favourable to attracting foreign investment. The total investment was thus declining in the 1990's, resulting in a fall in the major economic activity in the country.[5]

However, Musharraf's government took many steps to overcome this huge external debt including "the debt limitation law" which is designed to deal with reduction of this burden of external debt, starting in 2000. Furthermore, after 9/11, the world's strategic policies changed, and Pakistan became a front-line state in the global war on terror. Pakistan was consequently able either to write off or reschedule the external debt liabilities. The amount of remittances and foreign grants also increased manifold during this period. Pakistan was thus able to repay debt services and interest of the IMF and the World Bank.

Moreover, if the government is able to act upon the debt limitation law, which has been passed by parliament, it would be able to get rid of debt owed to both the IMF and the World Bank. However, there remains the need of encouraging sectors like industry and agriculture to meet the fiscal gap.

Objective

This paper is an effort to study the impact of external debt in shaping the economic growth in the case of Pakistan. It begins with the theory related to debt and how it impinges on the economy. The paper traces out the root of Pakistan's external debt and evaluates how external debt was successfully managed by addressing the different policies and trends since 2000; and also addresses the upcoming challenges for the new government.

Classification and Theoretical Framework

Composition of External Debt

Since external debt contains different elements, some definitional classifications are in order. External debt consists of both long-term and short/medium term debt.

Long-term debt is generally taken from the World Bank in the form of project aid and from the aid to Pakistan Development Forum. Its maturity period ranges from five to 30 years and is on concessional interest rates. Some loans of the IMF are also of a long term nature for balance of payments stabilisation purposes. Medium-term debt is of course for a shorter period, ranging from one to five years, and the interest charged is variable. Short term debt is borrowed from commercial sources and in most cases has to be repaid in one year. The minimum interest charged is the prevailing market interest rate.[6]

Theoretical Frame work

There are different views about government debt, but the most debated ones are the following:

Traditional View of Public Debt

According to this view, government borrowing reduces national savings and crowds out capital accumulation. The tax-cut financed through the government would stimulate consumer spending, and that would affect the economy in both the short term and long term.

In the short term, higher consumer spending would raise the demand for goods and services, enhancing output and employment. However, the interest rate would also rise as investors compete for small levels of investment. In the long run, a smaller tax cut would mean a smaller capital stock and a higher external debt. Therefore, the output of a nation would be smaller, and the greater share of that output would be owed to foreigners.

The overall effect of tax cut on economic wellbeing is hard to judge. The present generation would get benefits from higher consumption and employment, despite higher inflation. The future generations would, however, bear much of the burden of the current budget deficit.[7]

Ricardian View of Public Debt

An alternative view called Ricardian Equivalence, questions this presumption. According to this view, people are rational; therefore, they base their spending not only on their current income but also on their future expected income. The rational consumer understands that government borrowing today means higher taxes in future. A tax cut financed through public debt does not reduce the tax burden; it merely reschedules it. Therefore, it could not encourage the consumer to spend more.[8]

Macroeconomic Implications

The budget deficit is responsible for high inflation, low growth, high current account deficit, and the crowding out of private investment and consumption. The relationship between deficit and other macroeconomic variables is said to depend on how the deficit is financed. This view holds that,

> Money creation leads to inflation. Domestic borrowing leads to a credit squeeze – through high interest rate or, when interest rates are fixed, through credit allocation and ever more stringent financial repression – and the crowding out of private investment and consumption. External borrowing leads to a current account deficit and appreciation of real exchange rate and sometimes to a balance of payments crisis (if foreign resources are run down) or an external debt crisis (if debt is too high).[9]

Trends in Pakistan's External Debt

Pakistan's Vicious Debt Trap (1999's)

The issue of high levels of indebtedness in developing countries received much attention in the second half of the 1990s from policy makers and public around the world. Pakistan's economy was also caught in a vicious debt trap, which had been haunting its policy makers and public throughout the period. Since the fiscal deficit, despite some reduction, was much higher than the growth rate of GDP, the external debt continued to rise at a rapid rate.

The external debt increased from $19.200 billion in 1990 to $33.60 billion in 1999. The magnitude of total outstanding debt and the per capita debt increased significantly, and Pakistan found it difficult to finance the debt, due to low GDP growth, which may have suggested that the debt was beyond reasonable and sustainable levels. The major causative factors for this increase were the rising level of current account deficit and a large fiscal deficit that raised the financing needs of the country.

Debt Management Policies

Pakistan has pursued a realistic debt strategy for the last six/seven years and succeeded in reducing the country's debt burden by almost one-half. External debt (both rupee and foreign currency) has been reduced from 79 per cent in end-June 2000 to 50.1 per cent of GDP by end-September 2007. Similarly, public debt as percentage of revenues (another indicator of debt burden) has declined from 589 per cent to 339 per cent during the same period. External debt and liabilities have also been reduced from almost 52 per cent of GDP to 28 per cent by the end of June 2007 and further to 25.7 per cent by end-September 2007.[10]

Debt Reduction and Management Committee Report

Against this background, the government initiated work on the preparation of a rule-based fiscal policy in early 2000. It appointed the debt reduction and management committee in early 2000 which submitted its report in March 2001. The report recommended revival of growth, reduction in future borrowing, bringing down the real cost of borrowing, divestiture of assets, improving the effectiveness of government expenditure, and improving the carrying capacity through growth in revenues, exports, remittances and other foreign receipts for resolution of the problem. It also came up with a short term strategy which called for rescheduling of $5.1 billion. While one can hardly disagree with the policy suggestions, the report failed to come out with concrete policy actions.[11]

Debt Policy Statement

The Fiscal Responsibility and Debt Limitation Act, 2005, was passed by parliament in June 2005. According to this legislation, all government departments are made responsible to ensure sound fiscal management, and they would also encourage informed public debate about fiscal policy. The act also requires government to be transparent about its short and long-term fiscal intensions and imposes high standards of fiscal disclosure. The statement provides an overview of the public debt as well as external debt and liabilities and explains the changes in the debt profile over the 2006-07 and early 2007-08 period.[12]

External Debt Sustainability (2000-2007)

Such policies and the country's improved economic performance (due to sustained high GDP growth rates since 2000) have reduced country's eligibility for concessional financing from Asian Development Fund (ADF). Moreover, the country has also shown an improvement in the maturity profile of its debt stock in 2007. A significant share of the inflow of the floating rate loans during the year had long maturity ranging from 15 to 25 years. Similarly, a large share of the fixed rate loan received from International Development Association (IDA) and ADF during 2007 was on concessional terms having a long maturity ranging from 30 to 40 years. In addition, since 2004, the External Debt Liability (EDL) to GDP ratio indicates that Pakistan's external debt is not all that heavy and continued to improve (see Table-1).

Table-1: Trends in External Debt Sustainability Indicators, 2000-2007

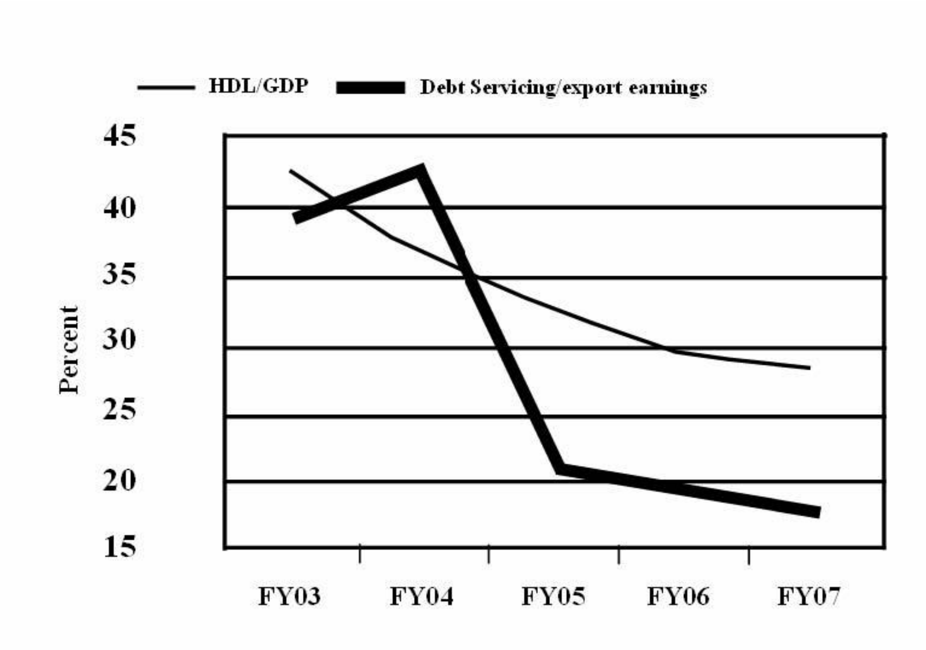
Years	EDL	EDL/GDP	EDL/FEE	EDL/FER
		Percent		Ratio
2000	37.9	51.7	297.2	19.3
2001	38.9	52.1	259.5	11.5
2002	37.16	50.9	236.8	5.8
2003	35.47	43.1	181.2	3.3
2004	35.26	36.7	164.7	3
2005	35.85	32.7	134.3	2.7
2006	37.24	29.4	120.1	2.9
2007*	38.86	27.1	119.7	2.8

*. *End March 2007.* **Source:** *Pakistan Economic Survey*, State Bank of Pakistan, Annual Report 2007**.** EDL: External Debt and Liability, FEE: Foreign Exchange Earning, FER: Foreign Exchange Reserves

Despite the increase in total external debt and liability (EDL) from $37.9 in 2000 to $38.86 billion in 2007, the ratio of EDL to GDP retained a falling trend since 2000 (see Figure-1). The fall in this ratio, due to high GDP growth, suggests an improved potential of the economy to generate resources to service the fiscal deficit.

The ratio of debt servicing to export earnings is also evidence of improvement during 2007 as compared to 2006. As export earnings keep on growing but at a slow rate, the debt servicing burden is not likely to cause deterioration in the ratio of debt servicing/export earnings in the current years; but, if export momentum is not restored through export diversification, it would be difficult to sustain it.

Figure-1: External Debt Trends



Source: *State Bank of Pakistan Annual Report, 2007.*

Moreover, the ratio of external debt to total revenue receipts is showing a falling trend which reflects the country's improved ability to service its external debt stock (see Table-1).

Causes of Debt Reduction

Because of various reasons, external debt has declined from 51.7 per cent in 1999 to 27.1 per cent in 2007. Following are some of the factors, along with the above mentioned policies, that account for the turnaround:

There was a high rate of growth of real output which permitted a fairly rapid expansion of both interest-bearing and non-interestbearing debt without recourse to inflation.

Writing off some debt and converting some into debt-social sector spending swap.

Receipt of grants as budget support.

Rising remittances have improved the balance of payments situation and has allowed the government to pay back expensive loans and improve the liquidity situation.

Smaller budget deficit; and reduction in interest rates.[13]

This situation is to some extent satisfactory when compared to the 1990's decade. But, ongoing economic growth is based on foreign direct investment (FDI), foreign aid and remittances which are not adequate indicators of economic growth. These indicators have boosted the economy at the time of their inflow, but the situation may easily reverse, leaving a wide gap. Moreover, Pakistan's economy is based on consumption, led by a credit-card mindset, rather than the fundamental economic principles of growth through savings, expansion and production.

Therefore, there remains the need for further reforms and sound policies to make a strong industrial and agriculture base and to enable the country repay some of its debt servicing. However, it would be very difficult in the upcoming years to repay the debt servicing of both current and rescheduled debt of the Paris club of 2003-04.

Macroeconomic Performance and Debt Sustainability

Pakistan's debt burden is often estimated in terms of its repayment capacity. Therefore, there is a need to constantly monitor the country's macroeconomic performance to evaluate its debt repayment capacity. In this regard, the ratio of external debt and liabilities to foreign exchange earnings indicators does not take into account a number of other factors such as political uncertainty, domestic inflation, etc., which can also negatively impact the country's debt repayment capacity.

External Debt Servicing Vulnerability Index

In this regard, Abdullah (1985)[14] has constructed an index by incorporating macroeconomic performance of the country with its external debt servicing capacity by taking into account various macroeconomic indicators such as reserves, exports, inflation and political environment. The aim is to prepare an early warning signal that can indicate any weakness in the country's debt repayment capacity.

The index is constructed by taking the weighted average of the following ratios:

The ratio of international reserves held by the country with the level of reserves in the preceding year – this ratio depicts changes in the country's international liquidity position. A higher value of this ratio reflects rising stock of the country's international reserves and thus its higher ability to repay foreign liabilities.

The ratio of growth in exports to growth in country's external debt – that gauges changes in country's debt repayment capacity. A larger value of this ratio and thus a faster growth in exports as compared to external debt indicates a stronger debt repayment capacity.

The ratio of inflation in the previous period with the rate of inflation in the current period – a smaller number reflects erosion in the country's debt repayment capacity caused by higher inflation. Higher inflation leads to a rise in the debt servicing cost of a country by causing exchange rate depreciation.

The ratio of exports in the current period with exports in the preceding period – this ratio captures changes in a major source of a country's foreign exchange earnings that in turn impacts country's debt repayment capacity.

Table-2: Computation of External Debt Servicing Vulnerability Index for Pakistan

	Reserves ratio	Exports/EDL * growth ratio	Inflation ratio	Exports ratio	Weighted average	Political stability	Index
1997	**1.9**	**2.6**	**1.4**	**1.6**	**7.5**	**1.0**	**8.5**
1998	**1.4**	**2.4**	**2.3**	**1.4**	**7.5**	**1.0**	**8.5**
1999	**3.7**	**2.0**	**2.0**	**1.4**	**9.1**	**1.0**	**10.1**
2000	**1.5**	**2.9**	**2.3**	**1.7**	**8.4**	**2.5**	**10.9**
2001	**4.2**	**2.7**	**1.3**	**1.6**	**9.8**	**2.0**	**11.8**
2002	**6.4**	**2.4**	**1.9**	**1.5**	**12.2**	**1.0**	**13.2**
2003	**5.5**	**3.1**	**1.7**	**1.8**	**12.1**	**2.0**	**14.1**
2004	**2.8**	**2.8**	**1.0**	**1.7**	**8.2**	**2.0**	**10.2**
2005	**2.3**	**2.9**	**0.7**	**1.8**	**7.7**	**2.0**	**9.7**
2006	**2.7**	**2.7**	**1.8**	**1.7**	**9.0**	**1.5**	**10.5**
2007	**3.1**	**2.4**	**1.5**	**1.6**	**8.6**	**1.0**	**9.6**
*** External debt and liabilities**							

Source: *Calculations based on data obtained from Statistics Department, State Bank of Pakistan.*

Weights assigned to the first two ratios are 2.5 each; while for the last two, they are 1.5 each. The higher weights for the first two ratios suggest their importance in impacting the country's debt repayment capacity. The political environment of also affects a country's foreign exchange earning capacity that in turn determines its debt repayment capacity.

Table-2.1: Interpretation of Results

Score	Interpretation
<6 6 -8 8 -10 10 > 10	**High likelihood of default Serious oncoming problems. Deterioration in debt servicing capacity No significant change in debt servicing profile Improvement in debt servicing profile**

Source: *Abdullah (1985) External Debt Vulnerability Index*

The external debt servicing vulnerability index is given in Table-2 and its interpretation in Table-2.1. It is also important to note that the results of this exercise will change significantly with the change of weights assigned to these ratios. Here the weights assigned for the calculation of this index are taken from Abdullah (1985) since the results that he obtained by using these weights passed the test of reality for 20 major debtor countries in Latin America, Asia, Africa and the Middle East.[15]

According to this index, Pakistan witnessed deterioration in its debt servicing profile before 1999 (see Table-2). Conversely, the situation started to recover mostly due to a significant rise in the stock of country's international reserves (due to remittances, foreign aid and privatisation) and growth in exports from 2000 onward, as shown in Table-2. The score on the vulnerability index after reaching its highest value in 2003 began falling during 2004-2007 but remained in the vicinity of 10, reflecting no significant change in the country's debt repayment profile.

The fall in the value of the index during 2004 to 2007 can be attributed to the following factors:

A fall in the reserve ratio that was caused by prepayment of expensive external debt in 2004 and subsequent pressure on the reserves due to a sharp rise in imports.

Rise in inflationary pressures in the country 2003 onwards that caused a fall in the ratio of inflation in the previous period compared to that in the current period.

Inability in expanding the tax base, despite growth in incomes, by not being able to diversify the tax base to raise revenues.

In addition, the loss in the value of the index in 2007 is due to rising political uncertainty, as most ratios of macroeconomic performance of the country are satisfactory to support the debt burden. Due to political instability and poor law and order situation, foreign investment declined by about $2 billion, or 44 per cent, from $4.62 billion, during eight months of the fiscal year 2007-08.[16] Thus, the index highlights the need for political stability in the country in order to avoid any change in the perception of the creditors that can adversely affect the country's debt repayment capacity.

Challenges Ahead

As most of the highly indebted poor countries (HIPCs) are unable to sustain their debt repayment capacity, they face the challenge of balancing the potential risks of external borrowing against the benefits. Debt burden is an important factor in assessing these risks, but it is not the only factor that can effect it, as much of the upsurge in the debt burden in the HIPCs from the 1985 to 1995 was due to their weak policy and institutional frameworks, low capacity for debt management, lack of export diversification, and limited fiscal revenue capacity.[17]

Thus, according to the above framework, Pakistan is still facing many challenges. The current account deficit widened further in 2007-08, the tax-to-GDP ratio is still very low, and inflation remained persistently high, showing only a sluggish decline in 2007. The economy would continue to grow strongly during the 2008 fiscal year, but external current account deficit and inflation would be the key challenges to the economy.[18]

The following would be the main challenges for the new government:

Debt Servicing Liability

In the coming years, the country is likely to face a higher burden of debt-servicing as repayments of the rescheduled non-ODA Paris club debt stock would resume from the 2008 financial year. The maturities of the Eurobond issued in 2004 financial year, and Sukuk issued in 2005 financial year would become due in the 2009 and 2010 financial year, respectively.[19] Therefore, heavy debt service liabilities would take a big chunk of national income. In addition, interest payments on various Eurobonds, issued recently, are likely to add to debt-servicing burden in the coming years.

Trade Imbalances

Pakistan's economy has amassed a huge trade deficit, with imports twice the exports, which presents a great challenge to the country's economy for the upcoming budget. Pakistan now faces an all-time high trade deficit. Adjusting the import and export structures would remain the technique to balance international income and expenses.

Inflation

According to Governor State Bank of Pakistan, key risks to the inflation outlook appeared to be energy and food staple expenses in the wake of rising international prices. Therefore, enhancing production in financial year 2008 would be critical for easing production of the supply constraints, both to ease inflationary pressures and to provide for export growth.[20]

Political Uncertainty

As already noted, political uncertainty has an impact on capital inflows which in return may curtail investment, dragging down economic performance. That in turn causes revenue shortfalls due to slow economic activity. Expenditure overruns may also limit fiscal space and reduce public investment, which may affect private investment and growth.

Foreign Direct Investment

Although the FDI increased during the last five years which is encouraging, it has remained stuck to only three sectors (IT/telecom, banking and financial services and energy) which yielded unexpectedly high returns to the investors. These same sectors would remain attractive to foreign investors in future as well. Furthermore, political instability and security concerns are the major reasons for the record decline in portfolio inflows, as foreign investors are reluctant to invest in the equity market.

Tax Structure

The current fiscal deficit is due to the inability of the government to expand its tax base, despite growth in incomes in terms of revenue collected. In addition, the government has not been able to diversify the tax base. It is difficult to believe that even now, highly profitable forms of earning wealth, such as agriculture and service sectors, and especially oil companies, banks and financial institutions, portfolio investments, withdrawl of portfolio investments from Pakistan and real estate, are exempt from substantive taxes.

Export Diversification

Pakistan's exports continue to stagnate and have not diversified. Considering that, any figure showing exports needs to be seen in the light of imports and a country's trade and balance of payments; on both counts, Pakistan's statistics are far worse than they have ever been.

Devaluation of Rupee

If the rupee is devalued or is floated down or if the dollar becomes stronger in the international market, the rupee cost of the foreign debt goes up and the government has to mobilise more rupees to repay the old loans. At the moment, the government is buying dollars at almost Rs. 61 to service foreign loans obtained at Rs. 9.90 for a dollar or a little more in the 1980s.

Hence, debt sustainability can be enhanced by implementing structural reforms designed to improve institutional frameworks. That includes initiatives aimed to promote trade, advance export diversification, augment capacity for debt management; raise fiscal revenue capacity by tax diversification, and improve the investment climate through political stability and sound institutions. On the base of such policies, countries can enhance debt sustainability by enhancing foreign reserves to levels that provide adequate insurance against external shocks, and by pursuing macroeconomic policies that aim to maintain a low and stable inflation environment, along with a sound fiscal framework.

Conclusion

Pakistan's external debt has shown a healthy improvement since 2000. The total external debt liabilities which were equal to 51.7 per cent of its GDP in 2000 came down to 27.1 per cent of the GDP in 2007. This reduction has been backed by debt management policies; in particular, the Debt Limitation Act, 2005; along with a manifold increase in remittances, foreign aid, FDI and privatisation revenues. Debt repayments had been the biggest constraint on the economy in the previous decade of 1990's, and that was the main reason for the economy performing poorly in the 1990s. The situation is, therefore, satisfactory to some extent as compared to the 1990's on account of Pakistan's repayment capacity.

Despite this improved situation, the government would in future be unable to sustain the repayment capacity, as the ongoing economic growth is based on consumption rather than the fundamental economic principles of growth through savings, expansion and production, which in turn breed returns in the shape of reserves. Moreover, Pakistan's economy is based on FDI, foreign aid and remittances, which are not the real indicators of economic growth. Therefore, it would be very difficult in the upcoming years to repay the debt servicing of both current and rescheduled debt of the Paris club. Currently, foreign investment has declined by about $2 billion, or 44%, from $4.62 billion due to political uncertainty and a poor law and order situation in the current financial year 2007
08.[21]

Without making a strong economic base by focusing on industry and the agriculture sector, along with political stability, a country cannot rely on sources like foreign direct investment, remittances and foreign aid to meet the fiscal gap. Therefore, the new government needs to upgrade industries and enhance agricultural production while reducing the trade deficit, which in turn would reduce the external debt burden.

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