Trapped in Debt:
A Review of Pakistan's External Debt

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Trapped in Debt:
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ACRONYMS

ADB	Asian Development Bank
ADP	Annual Development Program
BOP	Balance Of Payments
CADTM	Committee for the Cancellation of the Third World Debt
CENTO	Central Treaty Organization
CNY	*Chinese Yuan*
CSA	Currency Swap Agreement
CSF	Coalition Support Fund
CSO	Civil Society Organisations
DAC	Development Assistance Committee
DFC	Development Finance Corporation
EAD	Economic Affairs Division
ED	External Debt
ERRA	Earthquake Reconstruction & Rehabilitation Authority
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FD	Finance Division
FDI	Foreign Direct Investment
FE	Foreign Exchange
GB	Gilgit-Baltistan
GDP	Gross Domestic Product
GST	General sales Tax
HIPC	Heavily Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
IPP	Institute of Public Policy
IR	Islamic Relief
JDC	Jubilee Debt Campaign
KA	*Kashmir Affairs*
MNC	Multinational Corporation
NDMA	National Disaster Management Authority
NHA	*National Highway Authority*
NPL	Non Performing Loans
NSS	National Savings Scheme
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PBC	People's Bank of *China*
PKR	*Pakistani Rupee*
PPP	Pakistan People's Party

PRGF	Poverty Reduction and Growth Facility
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
SBA	Stand-By Arrangements
SBP	State Bank of Pakistan
SEATO	Southeast Asia Treaty Organization
U.K.	United Kingdom
U.S.	United States of America
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
USD	Unites States Dollar
VAT	Value Added Tax
WB	*World Bank*
WDI	World Development Indicators
WOT	War on Terror
Yr	Year

Executive Summary

Pakistan, in recent years, has witnessed mounting levels of both external debt and domestic debt. The position with respect to external debt servicing depends upon the growth of exports and home remittances and containment of the current account deficits in the balance of payments. Despite growth of 6 percent in exports and 23 percent in home remittances during the first eight months of 2011-12, the current account deficit has widened to $3.0 billion as compared to $0.2 billion in the corresponding period of last year. On top of this the financial account of the balance of payments has turned negative due to the drying up of foreign direct investment and gross aid inflows in the presence of fixed debt repayments. Consequently, the overall balance of payments position has worsened sharply, leading to a depletion of foreign exchange reserves of the State bank by almost $2.7 billion from the level on June 30, 2011.

Beyond this, there is the prospect of increased pressure on foreign exchange reserves in a medium run setting with commencement of large debt repayments to the IMF. These are projected at $2.4 billion in 2012, $3.8 billion in 2013, $2.2 billion in 2014 and $0.5 billion in 2015. Overall, given even conservative projections, foreign exchange reserves of SBP which stood at close to $15 billion at the start of 2011-12 could fall below $11 billion by the end of the year. They could then decline to critically low levels in 2012-13, such that the foreign exchange cover of imports slips to below two months.

Given this state of affairs, government needs to implement strong policies for promoting macroeconomic stabilization, in particular, the foreign exchange position. However, the fear is that while the reform process has a gestation time and will bear fruit with a time lag, the masses of Pakistan may be overburdened and be denied of even the basics in life. As such, Pakistan will eventually need a measure of debt relief if an extremely painful process of adjustment is to be avoided with severely negative impact on living conditions of the people, especially the poor.

The objective of this study is to explore the case for, and the options of, relief of the external debt of Pakistan. In order to do so the report first looks into the factors responsible for the persistence of the debt problem and reviews the pattern of the country's external debt since the mid 1980s, in Chapters 1 and 2.

External debt of Pakistan consists primarily of medium and long term debt of the government with multilaterals (ADB, WB, IMF) and bilaterals who are members of the Paris Club. The outstanding amounts as of December 31, 2011 are $27.5 billion and $15.3 billion, equivalent to shares in total debt of 47 and 26 percent respectively. In addition, the debt of the SBP with IMF is $6.5 billion, representing 11 percent of the total debt.

We find that the country's level of debt has generally increased over the decades, at an average of more than 7 percent. In the previous decade, however, the trend has been somewhat different, with a fall in the total debt stock during 2002-03, followed by a rapid increase, with a growth of 6.7 percent. Examining the dynamics of the debt-to-GDP ratio, during 2000-02 there was an increase in the external debt to GDP ratio of 0.8 percent per annum. Moreover, low FDI and large exchange rate depreciation made conditions for debt reduction unfavourable for the economy. Circumstances improved following Pakistan's participation in the "War on Terror" in 2003, when the economy saw an influx of FDI from the United States, and consequently, some stability in the exchange rate. The country was in the position to bring down the external debt-to-GDP ratio on average by over 3 percentage points annually. However, the oil price shocks during 2008-9 led to a depletion of the foreign exchange reserves, and Pakistan had to go to the IMF for a large Stand-by facility. Over the last three years the non-interest current deficit has remained moderately high. During the decade there was also a sharp fall in food and non-food aid, while relief aid also went down. On the other hand project aid and BOP aid increased due to Pakistan's coalition with the US on the War on Terror, as well aid offered by multilateral organisations for post-disaster reconstruction aid, following the severe natural disasters that the country faced during the later years of the decade.

In Chapter 3 two approaches have been adopted to assess the sustainability level of the foreign debt in Pakistan: the first approach is based on the widely used traditional threshold debt ratios, also adopted by Ministry of Finance, IMF and World Bank. The second approach is based on the BOP projections under different scenarios in the medium term based on the application of the Macroeconomic Model of Pakistan developed by the Institute of Public Policy.

The report finds that external debt in the 80s and 90s was equivalent to about one-third to almost half of the country's economy. As a proportion of export earning; the ratio was about 300 percent and in proportion to reserves the ratio was over 1500 to 2000 percent, clearly demonstrating a heavy burden. Some moderation in the burden has been achieved in the new millennium, and external debt to GDP ratio has been brought down to 28 percent while external debt to export earnings and reserves has also declined to 188 and 397 respectively.

In the decade of the 80s and 90s, external debt servicing drained out over one-fourth of export earnings. In recent times, the burden of debt servicing has become more manageable. Debt servicing to GDP ratio fell to 2.3 percent and further to 1.6 percent while debt servicing to export earnings and debt servicing to reserves ratio showed a decline to 11 percent and 23 percent respectively. The most sensitive indicators appears to be debt servicing to reserves ratio and import cover ratio and the zero-order correlation coefficients presented for the period, 1981 to 2011 reveal that the two 'sensitive' indicators – import cover ratio and the external debt service to reserves ratio

– are fairly highly correlated. These are the primary indicators of debt sustainability in the Pakistani context.

In order to determine the future outlook for Pakistan's ability to meet its debt obligations a formal set of projections is made of the external balance of payments with the help of the IPP model. Even under conservative assumptions about the size of the current account deficit (given the prospect of high oil prices) it appears that the foreign exchange reserves could fall to critically low levels by the end of 2012-13, implying an import cover of less than one month.

Overall, the report concludes that there are serious issues of debt sustainability in the next two years. Clearly, out of box solutions will have to be found including the implementation of a strong domestic reforms agenda, especially focusing on the curtailment, both directly and indirectly, of the large trade deficit. In addition, unconventional and perhaps drastic options for management of the external debt will have to be explored of the type discussed in Chapter 6.

Chapter 4 examines the effect of foreign aid on Pakistan's economy. The report investigates the possibility of Pakistan suffering from the Dutch Disease, owing to the rapid inflow of imports caused by the exchange rate appreciation in 2003. A review the inflow of foreign aid and FDI into the country during the period, their effect on the nominal and real exchange rate, as well as the rapid increase in imports reveals that the country did indeed has experienced the Dutch Disease, suggesting that while capital inflows per se may not be bad, they should be managed through a policy of building up reserves rather than promoting a liberal import policy.

The report also analyses the relationship between domestic savings and foreign inflows in Pakistan. Evidence suggests that there has been a negative relationship between the two. Foreign inflows slacken saving effort and encourage an increase in consumption, thereby dampening public as well as private savings. Furthermore, it is observed that inflows have not been used in sectors which ensure maximum pay back in terms of enhancing the productive capacity and growth of the economy. Their impact on the people of Pakistan, especially the poor, to that extent is limited. The political implications of the inflows have also been significant. Governments particularly the dictator regimes have promoted donor geo-political objectives sometimes at the cost of indigenous interests. Also, we see evidence of a 'moral hazard' problem. Easy access to external inflows in such regimes has discouraged the motivation to bring about structural reforms, which inevitably are not costless but can put the country on more sound and strong foundations.

Chapter 5 make the plea that while the global community is reaping the fruits of globalisation and the prosperity which comes from it, Pakistani masses are handicapped because: first, the country has been a frontline state on the global 'war-on-terror'

(WOT). While the WOT will benefit all around the world, the costs are disproportionately borne by Pakistanis; second, Pakistan has been passing through a patch of bad luck. The country has experienced three major natural disasters in the last decade-massive earthquake in 2005 and major floods in two consecutive years 2010 and 2011 - which have left the country's severely damaged both in terms of loss of life and property, and also permanent losses of infrastructure; third, rising debt servicing is crowding-out expenditure on basic social infrastructure and therefore is limiting the opportunities not only for the current but also future generations; fourth, the benefits of the money spent have been pre-empted by the elite and have not benefited the middle or lower income groups in the country. Since repayment will burden these population segments, relief in debt will imply relief for the poor and the middle classes, and; finally the loan conditions have adversely affected the poor of the country. The new millennium started with the realization by the world leaders that globalization has the danger of enhancing inequalities across countries and across different strata within countries due to some government's lack of timely adaption to the changing economic environment. Such inequalities have to be addressed and eliminated.

To sum up, while Pakistan is not eligible for the HIPC initiative, a case for its debt relief can be based on other international schemes including Post-Catastrophe Initiative, where the donor agencies can consider debt cancellation due to Pakistan's natural disasters crises, State of Necessity, in accordance to under the International Human Rights Commission that suggests that indebted countries placed in a situation that makes it impossible for them to fulfil the very basic needs of their populations have a right to repudiate debts and structural adjustment programs and the events of Illegitimate Debts, granted to repressive regimes and/or where the money was used to fund projects which did little to benefit ordinary people.

The report concludes in Chapter 6 with a review of the results of former debt relief programs, and suggests other mechanisms that may improve the country's external debt situation. The report suggests the possibility of turning to the IMF for a debt rollover. This also has the potential of providing substantial cash-relief. Other possibilities include relief from the Paris Club, larger program funding from other multilaterals and currency swap agreements. The report recognizes that the overall costs of debt repudiation are potentially high, however the threat of default can be used as leverage to force creditors to negotiate debt relief, especially given Pakistan's geopolitical importance in the global war on terror.

In the breathing space provided by the debt relief, a strong and wide ranging reform agenda must be implemented which imposes most of the adjustment burden on the richer segment of society. This agenda will include proper valuation of the rupee, cutback on luxury imports through an enhancement in import margin requirements and imposition of regulatory duties, reduction in imports of arms and equipment by the defence establishment, resort to more progressive taxation, broad basing of direct

taxes, elimination of exemptions and concessions in the tax system, strong measures to curb tax evasion, enhance accountability and transparency while bringing back money made through corruption held abroad, impose austerity in public expenditure, restructure public enterprises, implement priority projects in the power and water sectors, expand targeted programs of social protection for the poor and so on. Unless this agenda is implemented with strong commitment and effectiveness Pakistan will merely postpone temporarily the day of reckoning.

Chapter 1
Introduction

1.1 Context of the Study

Debt continues to weigh down many developing countries, preventing them from being able to break out of an endless cycle of poverty and injustice. Most of these debts originated in the 1970s and 1980s, at the height of the cold war, when Western governments granted huge loans for political rather than sound economic reasons. Further, international banks who found themselves awash with deposits during periods of oil boom recklessly lent huge amounts to developing countries with little regard to risk management. The bubble burst due to a combination of high interest rates, declining world economy and drastic fall in commodity prices in the 1980s leading to a debt crisis. On the other hand, much of the money was lent to dictatorial regimes that used it for projects which are of little benefit to ordinary people and which, in fact, served to increase corruption and improper patronage.

As a result of their inability to repay the original debt, many developing countries were forced to obtain more loans and/or restructure their economies often at the expense of their own development. Islamic Relief (IR), following the Islamic approach of risk sharing between the lender and borrower, believes that the current debt burden of developing countries, which arose from irresponsible lending, is unjust and worsens poverty. IR joins with the Jubilee Debt Campaign (JDC) and other partners to call for their cancellation.

Within the last year there has been growing interest and activity among campaigners in Pakistan and Europe in relation to cancellation of Pakistan's external debt. This campaign, coordinated by the JDC in Europe and by its partner – the Committee for the Cancellation of the Third World Debt (CADTM) in Pakistan – was stepped up after the devastating flood disaster that the country experienced in 2010.

Pakistan's external debt is estimated to be almost a third of its GDP. Although the country has low per capita income and is highly indebted, it is not eligible for the so-called Heavily Indebted Poor Country (HIPC) initiative because it has recently been classified as middle income due to relatively high levels of per capita income, exports and foreign investment. The other reason it has not previously been eligible for HIPC is because the debt was viewed as payable by the IMF and World Bank (in terms of the net present value of the debt to exports or government revenue).

The objective of this study is to explore the case for, and the options of, relief of the external debt of Pakistan. We start with a brief on the background of the debt problem. An analysis is undertaken of the fiscal deficit, the overall size of public debt (domestic

and external) and the external sector in Section 1.2. The magnitude of the public debt is quantified in Section 1.3.

1.2 Trend in Fiscal Deficit

One of the major economic problems confronting policy makers in the country is the structural imbalance in public finances whereby expenditures consistently exceed revenues. This phenomenon is not a random event occurring in some years nor is it associated with particular regimes in the country. As can be seen from Table 1.1 budget deficit has been above 5 percent of the Gross Domestic Product (GDP) over the last 30 years, with the exception of some years in the last decade. As a percentage of the GDP, budget deficit peaked in 1990-91at 8 percent. Thereafter we do see some decline up to the middle of the last decade before it demonstrates a big upturn again.

Perhaps a more useful way of examining the structural fiscal imbalance is to see what has been happening to the primary budget deficit. Primary budget deficit is the overall budget deficit, net of interest payments. Increase in interest payment besides being a cause is also an effect of an increase in the budget deficit. Also, these payments introduce a strict rigidity on the expenditure side which restricts the remedial options available. Table 1.1 presents the trend in the primary and overall budget deficit. Clearly, the trend in the two deficits is somewhat different. In the 80s, the contribution of primary budget deficit to the overall budget deficit was larger. Since then, interest payments account for a major share of budget deficit. The primary deficit has been almost halved from about 3-4 percent to 1-2 percent of the GDP. In fact, there was a primary surplus in the late 90's and early 2000's. Overall, the trend clearly highlights that the rapid rise in interest payments is a major root cause of the fiscal imbalance in the country. If it can be sustained at the level of say 2008-09, then future reduction in the budget deficit will require scaling down of interest payments as a percent of GDP.

How has the decline in the primary budget deficit been achieved? Table 1.2 shows that public expenditures (net of interest payments) have always been higher than revenues. On an average, annual expenditures have been about 15 percent of GDP, while average revenue generation has been lower, at about 14 percent of GDP. The government has made little effort at enhancing revenues, while there has been success at bringing down current expenditure to narrow the fiscal gap. As such, the decline in the primary budget deficit is principally a consequence of a decline in expenditure-to-GDP ratio of almost 2 percentage points, from 17 percent of the GDP in 1983-84 to 15 percent in 2010-11. Expenditures, inclusive of interest payment, are clearly much higher, averaging at close to 20 percent.

Table 1.1
Trend in Budget Deficit

	(Rs. in Billion)			(As percent of GDP)		
Year	**Budget Deficit**	**Primary Deficit**	**Interest Payments**	**Budget Deficit**	**Primary Deficit**	**Interest Payments**
1983-84	27.7	13.6	14.1	5.5	2.7	2.8
1984-85	39.4	22.9	16.5	6.9	4.0	2.9
1985-86	44.6	24.9	19.7	6.8	3.8	3.0
1986-87	48.5	24.6	24.0	6.7	3.4	3.3
1987-88	63.4	30.1	33.2	7.7	3.7	4.1
1988-89	62.1	23.9	38.1	6.8	2.6	4.2
1989-90	59.9	14.6	45.3	5.9	1.4	4.4
1990-91	97.1	47.1	50.0	8.0	3.9	4.1
1991-92	104.9	42.5	62.4	7.3	2.9	4.3
1992-93	109.1	30.3	78.8	6.8	1.9	4.9
1993-94	94.2	3.3	90.9	5.0	0.2	4.8
1994-95	110.4	13.1	97.2	4.9	0.6	4.3
1995-96	149.8	17.3	132.5	5.9	0.7	5.2
1996-97	152.7	-8.5	161.2	5.2	-0.3	5.5
1997-98	204.6	2.2	202.4	6.4	0.1	6.3
1998-99	179.2	-40.9	220.1	5.1	-1.2	6.3
1999-00	172.3	-90.0	262.2	4.5	-2.4	6.9
2000-01	164.9	-84.4	249.3	4.0	-2.0	6.0
2001-02	201.9	-73.4	275.3	4.6	-1.7	6.3
2002-03	177.4	-50.4	227.8	3.6	-1.0	4.7
2003-04	162.0	-60.4	222.4	2.9	-1.1	3.9
2004-05	217.0	-17.8	234.8	3.3	-0.3	3.6
2005-06	325.3	65.3	260.0	4.3	0.9	3.4
2006-07	502.0	115.1	386.9	5.8	1.3	4.5
2007-08	777.2	267.6	509.6	7.6	2.6	5.0
2008-09	680.4	24.1	656.3	5.3	0.2	5.2
2009-10	929.1	286.8	642.3	6.3	1.9	4.3
2010-11	1194.4	496.3	698.1	6.6	2.7	3.9

Source: Pakistan Economic Survey,
State Bank of Pakistan
Fiscal Operations, Ministry of Finance

Table 1.2 Trend in Revenues and Expenditures						
	(Rs. in Billion)			(As percent of GDP)		
Year	**Revenues**	**Expenditures**	**Expenditures Net of Interest Payments**	**Revenues**	**Expenditures**	**Expenditures Net of Interest Payments**
1980-81	47.0	63.6	-	14.2	19.2	-
1981-82	51.9	71.0	-	13.5	18.5	-
1982-83	59.2	87.1	-	13.6	20.1	-
1983-84	72.3	100.0	85.9	14.4	19.9	17.1
1984-85	77.4	116.8	100.3	13.5	20.3	17.5
1985-86	89.9	134.5	114.7	13.8	20.6	17.6
1986-87	103.9	152.4	128.4	14.3	21.0	17.7
1987-88	117.0	180.4	147.1	14.3	22.1	18.0
1988-89	139.1	201.2	163.0	15.2	21.9	17.8
1989-90	158.8	218.7	173.4	15.6	21.4	17.0
1990-91	163.9	261.0	210.9	13.5	21.5	17.3
1991-92	216.6	321.5	259.1	15.0	22.3	17.9
1992-93	239.5	348.7	269.8	15.0	21.8	16.9
1993-94	270.7	364.9	274.0	14.4	19.5	14.6
1994-95	317.9	428.3	331.0	14.2	19.1	14.8
1995-96	368.3	518.1	385.6	14.4	20.3	15.1
1996-97	388.2	540.9	379.8	13.3	18.5	13.0
1997-98	429.5	634.0	431.7	13.5	19.9	13.5
1998-99	468.6	647.8	427.7	13.4	18.5	12.2
1999-00	536.8	709.1	446.9	14.0	18.5	11.7
2000-01	553.0	717.9	468.6	13.3	17.2	11.3
2001-02	624.4	826.3	551.0	14.2	18.8	12.5
2002-03	720.8	898.2	670.4	14.8	18.4	13.7
2003-04	794.0	956.0	733.6	14.1	16.9	13.0
2004-05	900.0	1117.0	882.2	13.8	17.2	13.6
2005-06	1076.6	1401.9	1141.9	14.1	18.4	15.0
2006-07	1298.0	1800.0	1413.1	15.0	20.8	16.3
2007-08	1499.4	2276.5	1767.0	14.6	22.2	17.3
2008-09	1850.9	2531.3	1875.0	14.5	19.9	14.7
2009-10	2078.2	3007.2	2365.0	14.0	20.3	15.9
2010-11	2252.9	3447.3	2749.2	12.5	19.1	15.2
Source: Pakistan Economic Survey, State Bank of Pakistan Fiscal Operations, Ministry of Finance						

What are the factors behind the trends in revenues and expenditures? Revenues of federal and provincial governments in Pakistan have remained largely stagnant, and in fact, have fallen in 2010-11. This is because tax revenues, which account for about 70

percent of total revenues, have not been able to increase at a faster rate than the GDP. Factors contributing to the low elasticity of taxes include narrow and non-buoyant tax bases, large number of exemptions, revenue leakages due to inefficient tax administration, evasion and corruption and low level of fiscal effort, particularly in the case of provincial governments.

As highlighted above, the decline in the growth rate of expenditures has been the key to the reduction of primary budget deficit in Pakistan. While this may be a favourable development from the budgetary point of view it needs to be emphasized that public expenditures, in particular on development, enhance the growth potential of the economy. This is the case because public sector continues to be the prime provider of the key economic and social infrastructure which constitutes an important pre-requisite to growth in any economy. Therefore, it is important that fiscal considerations do not totally overwhelm growth objectives. This is best achieved if fiscal concerns are addressed largely by reduction in non-productive expenditure and public sector development outlays are not severely curtailed.

Table 1.3
Financing of Budget Deficit

(%)

Year	Share of	
	External Financing	Internal Financing
1980-81	47.7	52.3
1981-82	31.1	68.9
1982-83	20.1	79.9
1983-84	19.9	80.1
1984-85	14.1	85.9
1985-86	20.6	79.4
1986-87	18.0	82.0
1987-88	22.0	78.0
1988-89	32.0	68.0
1989-90	40.9	59.1
1990-91	24.8	75.2
1991-92	20.0	80.0
1992-93	22.6	77.4
1993-94	26.7	73.3
1994-95	27.8	72.2
1995-96	20.7	79.3
1996-97	17.6	82.4
1997-98	18.9	81.1
1998-99	54.2	45.8
1999-00	33.8	66.2
2000-01	67.2	32.8
2001-02	43.5	56.5
2002-03	62.6	37.4
2003-04	-3.3	103.3
2004-05	55.5	44.5
2005-06	45.8	54.2
2006-07	39.0	61.0
2007-08	19.5	80.5
2008-09	22.0	78.0
2009-10	20.3	79.7
2010-11	9.0	91.0

Source: Pakistan Economic Survey, Ministry of Finance.
Fiscal Operations, Ministry of Finance.

The opposite has been happening in Pakistan. It appears that the strategy for controlling expenditure growth has focused largely on development expenditure which has resulted in about 10.5 percent annual growth in development outlays compared to 14.5 percent in non-interest current expenditure. Consequently, development expenditures have averaged at only about 4.4 percent of the GDP over the last three decades or so as compared to non-interest current expenditures at 11.6 percent. Rapid growth in

interest payments is also revealed by the high growth in interest payments during this period, of about 15.5 percent.

Table 1.3 gives the financing of the budget deficit. Governments over that last three decades have financed one-fifths and more of their budget deficit through external resources, principally through borrowing. It is only in the last year that less than 10 percent of the financing was external. It appears that governments have preferred external debt, if available, largely because it is less costly (in term of the rate of interest). However, external loans are more risky because their relative size increases with devaluation (if denominated in a foreign currency). And they create obligations for resources to leave the country – whereas repayments on domestic loans are more likely to stay in the country. This is why the balance of payments are important, and why the rest of the report focuses on external debt, especially in section 3.3.

1.3 Total Public Debt

Table 1.4
Trend in Overall Public Debt

Year	Total Public Debt* (Rs. Billion)	As % of GDP
		Total
1990-91	909.0	74.7
1991-92	1108.4	76.8
1992-93	1288.4	80.6
1993-94	1456.4	77.7
1994-95	1648.9	73.5
1995-96	1969.9	77.2
1996-97	2251.4	76.9
1997-98	2571.7	80.6
1998-99	3099.8	88.5
1999-00	3373.9	88.2
2000-01	3868.3	92.9
2001-02	3646.5	82.8
2002-03	3817.6	78.3
2003-04	4086.6	72.5
2004-05	4273.3	65.7
2005-06	4414.1	57.9
2006-07	4848.3	55.9
2007-08	6129.1	59.8
2008-09	7737.0	60.8
2009-10	9037.2	60.9
2010-11	10795.6	59.8

*Inclusive of liabilities
Source: Pakistan Economic Survey
Debt Policy Statement

The high levels of fiscal deficits have resulted in a high and mounting debt burden. Pakistan entered the 21st century with serious financial constraints – public debt was as high as 83 percent of its GDP at the end of 2000-01. Thereafter, there have been some positive developments, growth rate accelerated and most macroeconomic indicators improved. Public debt indicators also showed significant improvement. Modest growth in public debt, coupled with the strong growth in nominal GDP, led to a significant reduction in the public debt-to-GDP ratio, from 83 percent in fiscal year 2001-02 to 56 percent by the end of 2006-07. However since then fiscal policy has been accommodative to political exigencies as the government has extended whole sale subsidies on oil, electricity, food and fertilizer to protect the more vulnerable sections of the society from the effects of global commodity price shock. Higher security related expenditures supplemented by increased expenditures due to natural disasters led to rapid escalation of Total Public Debt as a percentage of GDP; reaching 61 percent by the end of 2010 (see Table 1.4).

The total public debt stood at Rs.10,709 billion as at June 30, 2011, an increase of Rs.1,788 billion or 20 percent higher than the debt stock at the end of last fiscal year. Developments in total public debt during 2010-11 have been driven mainly by a combination of five distinct factors. Increased demands on the government budget during 2010-11 for purposes of security meant that expenditure was fairly rigid even in the face of a committed effort to rationalize expenditure and curtail the fiscal deficit. Lower-than-expected GDP growth, acute energy shortages, and a high cost of doing business led to a revenue shortfall. The situation was further complicated by the devastating floods that put additional burden on fiscal operations; however higher international prices for textile products had a positive impact on Pakistan's trade balance. In addition to these external developments, import compression measures restricted the import bill significantly despite higher oil prices and the shift of power generation mix towards furnace oil.

The primary source of increase in public debt during 2010-11 has been a rapid increase in domestic debt that accounted for almost 76 percent of the total increase in public debt. The main reasons for this shift in borrowing were the non-materialization of privatization proceeds, slow disbursement from multilateral and bilateral donors, and higher than budgeted fiscal deficit.

The composition of domestic and foreign debt is given in Figure 1.1. In the 90s the major share, 51 percent, of total public debt was accounted by external debt. During the last decade the share has fallen somewhat to 44 percent by 2010-11. This is a reflection of limits to external borrowing and heavy reliance on creation of short-term domestic debt.

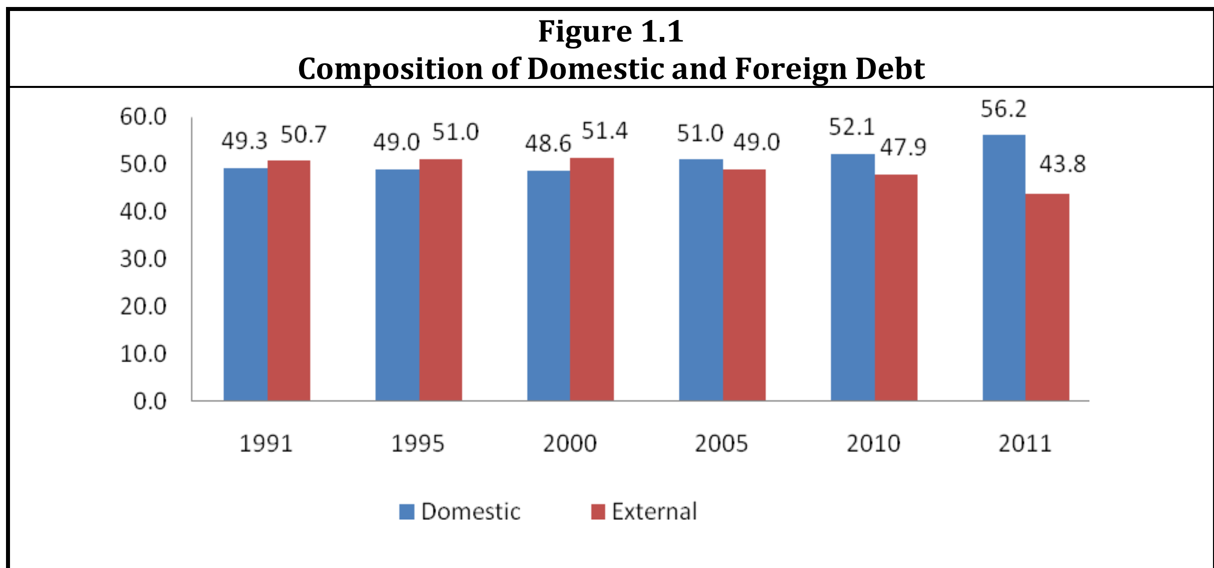


Figure 1.1
Composition of Domestic and Foreign Debt

In conclusion, Pakistan has been in a grip of high budget deficit over the last few decades. Consequently, the macroeconomic indicators show sign of stress. The overall debt burden is rapidly becoming unsustainable, debt servicing is pre-empting scarce resources resulting in inadequate investment in and maintenance of key economic and social infrastructure, the inflation rate is in double digits, interest rates are on the high side, adversely affecting investment and thereby the growth rate of the economy. The existing circular debt in the energy sector, which has already stressed economic activity, would further compound the problem. Additional complications would arise, especially for the poor and middle income classes, due to deterioration of public infrastructure and high food prices.

It is therefore essential to examine factors responsible for the persistence of the debt problem; in particular, a review of the external debt is essential to establish a case for and to explore mechanisms of finding debt relief. We start first with an analysis of the level and profile of external debt in Chapter 2. Chapter 3 discusses the important issue of debt sustainability. Projections are made of the external balance of payments. Chapter 4 analyses the implications of external flows of resources on Pakistan's economy. Chapter 5 develops a case for debt relief based on a number of factors like the costs of the war on terror and natural disasters. Finally, chapter 6 presents policy recommendations, specifically discussing possible mechanisms for debt relief to Pakistan.

Chapter 2
Level and Profile of External Debt

External debt is the total debt in a country that is owed to creditors outside the country. The debtors can be the government, corporations or private households. It includes money owed to private multi-national commercial banks, other governments, or international financial institutions such as the International Monetary Fund (IMF) and World Bank or bond flotation in the international capital market. The coverage of external debt by the World Bank/IMF and the State Bank of Pakistan, the Central Bank, is given in Box 2.1. We have adopted the definition of the World Bank/IMF which excludes external liabilities. External borrowings are closely linked to the deficit in the current account of the balance of payments. This relationship is examined in section 3.3.

Box 2.1
External Debt Definitions

World Bank: sum of public, publicly guaranteed and private nonguaranteed long-term debt, use of IMF credit, and short-term debt (maturity less than one year). IMF has the same definition.

[**Long-term Debt:** maturity of more than one year. It has three components-public, publicly guaranteed and private nonguaranteed.]

State Bank of Pakistan: quantifies external debt and liabilities. It includes public debt consisting of government debt, from IMF and foreign exchange liabilities; Public Sector Enterprises (PSE) guaranteed debt; PSE nonguaranteed debt and private nonguaranteed debt. It includes short term debt.

Pakistan Economic Survey:
Pakistan's external debt and liabilities include all foreign currency debt contracted by the public and private sector, as well as foreign exchange liabilities of the Central Bank. The primary source is State Bank of Pakistan (SBP) and Economic Affairs Division (EAD).

2.1 Size and Burden of External Debt

Table 2.1 presents the level of external debt of Pakistan over the last four decades as given in the World Bank's **World Development Indicators** database.

Historically, accumulation of debt has been on a rising trend, increasing at an annual rate of over 7 percent during the last four decades. Debt was 64 percent of the GDP in 1970-71. However, this ratio has declined to 28 percent by 2010-11. Pakistan historically had higher access to concessional aid than it does in recent times. Also, Pakistan's resort to short-term debt reached a peak in the late 80's and early 90's, at 12-18 percent of total debt. Otherwise, Pakistan has limited short-term debt to about 3-10 percent of its total debt.

Pakistan's debt stock, at the time of independence of East Pakistan, stood at $3406 million. It grew at a rate of 10.7 percent in the next five years to $5,409 million. A sharp rise of 18 percent is witnessed in 1975 and the subsequent years. A somewhat higher proportion of debt accumulated during the period, however, was concessional.

Table 2.1
Structure of External Debt

Years	External Debt (ED) ($ Million)	ED/GDP	Concessional Debt as percent of Total Debt	Short Term Debt as a percent of Total Debt
1970	3406	64.1	68.9	3.1
1971	3789	49.9	67.4	3.2
1972	4053	42.6	67.9	3.2
1973	4517	37.7	66.1	3.3
1974	5050	36.2	67.8	3.3
1975	5677	37.2	70.1	3.3
1976	6707	35.1	73.0	3.3
1977	7459	34.9	74.3	2.4
1978	8199	31.1	75.6	2.6
1979	8783	29.3	75.0	5.0
1980	9784	30.3	71.2	7.5
1981	10436	33.7	69.1	8.6
1982	11517	31.8	65.5	6.2
1983	11840	31.8	65.0	6.7
1984	12080	33.0	64.2	7.7
1985	13330	35.2	64.2	9.8
1986	14836	35.9	64.2	12.5
1987	16678	35.5	64.1	13.7
1988	16933	38.3	64.9	14.3
1989	18234	37.9	60.0	15.2
1990	20551	33.6	58.4	15.5
1991	23222	33.7	54.1	17.7
1992	24720	32.9	51.0	17.7
1993	24289	31.3	54.5	8.0
1994	27058	32.9	55.6	7.1
1995	29829	32.9	53.8	10.7
1996	29470	33.8	53.4	9.5
1997	29678	35.8	49.9	8.3
1998	31914	38.1	52.1	6.7
1999	33215	38.1	54.5	5.4
2000	32287	43.5	55.0	4.6
2001	31159	39.9	62.1	4.1
2002	33266	36.1	64.7	4.6
2003	35406	32.1	66.8	3.5
2004	35119	25.9	70.9	3.5
2005	32943	25.1	71.5	3.7
2006	35868	24.8	70.6	3.7
2007	40620	29.6	68.4	5.4
2008	48015	30.0	61.9	2.8
2009	53104	32.7	58.8	2.7
2010	57169	32.7	-	-
2011	58492*	27.8	-	-

Source: World Development Indicators 2010
*As of 30th June 2011

In the 1980's most of the developing countries around the world experienced an increase in debt accumulation. Pakistan was no exception. In some years, like 1986-87 and 1987-88, debt grew at 11.2 percent and 12.5 percent respectively. The structure of the debt also underwent some change, with an increase in short term loans as a percentage of GDP. Concessional loans as percentage of total debt declined from about 75 percent in 1979-80 to 65 percent in 1982-83. At the end of the decade debt stock stood at $18.23 billion.

The external debt increased at a somewhat moderate rate in the 90's. At the end of the decade it was $33.2 billion, equivalent to 45 percent of the GDP. The proportion of concessional loans (with long grace periods and low interest rates like IDA from the World Bank) fell further to 54 percent. It appears that the government resorted more to short-term borrowing in the beginning of decade as the rate with respect to GDP increased from 15 percent to over 17 percent from 1990-91 to 1991-92.

The new millennium saw a somewhat different trend as compared to the last decade. It started off with a debt stock of $32.2 billion in 2000 but in the next two years, 2001-02 and 2002-03, the debt stock experienced a negative growth and declined to $31.1 billion. However the very next year there was a jump with a growth of 6.7 percent. Pakistan, fortunately, had access to concessional debt in that period as is revealed by an increase in the proportion of concessional loans to over 71 percent by the middle of the decade. This was facilitated by Pakistan's participation in the war on terror. The trend changed towards the end of the decade with a more rapid accumulation of debt, and that also non concessional, which led to a decline in its proportion in total debt to about 59 percent. In 2010-11, total external debt stock stood at $ 58.5 billion.

2.2 Composition of External Debt

Table 2.2 shows that external debt of Pakistan consists primarily of medium and long term debt of the government with multilaterals (ADB, WB, IMF) and bilaterals who are members of the Paris Club. The outstanding amounts as of December 31, 2011 are $27.5 billion and $15.3 billion, equivalent to shares in total debt of 47 and 26 percent respectively. In addition, the debt of the SBP with IMF is $6.5 billion, representing 11 percent of the total debt.

It is of significance that short-term debt is very small at less than 1 percent of the outstanding debt. Also, private debt has a small share of 4 percent. Pakistan owes $2.3 billion to other bilaterals (outside the Paris Club). Also, in the mid-part of the last decade when the Pakistan economy was growing fast, Euro/Sukuk bonds were floated, the outstanding liability of which stands at $1.5 billion.

Turning to individual creditors the largest multilateral is ADB as of 30 June 2011 with outstanding loans to Pakistan of $12.3 billion, followed by IDA at $8.9 billion as shown in Table 2.3. The largest Paris bilateral is Japan at $7.8 billion. Among other bilaterals the largest creditor is China at $2.0 billion. The total amount owed to IMF by the government and SBP combined as of 30 June 2011 is $8.9 billion.

The implications of the profile of Pakistan's debt are that while vulnerability is reduced by the very limited stock of short term and private debt, the high level of dependence on multilaterals like the ADB, World Bank and IMF implies fixed obligations. Generally these agencies are seen as 'preferred creditors', especially in relation to private creditors and receive high priority in debt servicing if there is difficulty in honouring these obligations.

Table 2.2
Composition of
Outstanding External Debt of
Pakistan as of Dec 31 2011

($ Million)

	Outstanding Debt	Percentage
(1) Government Debt	**46020**	**79.5**
(a) Medium and Long Term (> 1 year)	**45624**	**78.8**
Paris Club	15298	26.4
Multilateral	25602	44.2
Other Bilateral	2339	4.0
Euro/Sukuk Bonds	1550	2.7
Others	835	1.44
(b) Short Term	**396**	**0.68**
(2)From IMF	**8444**	**14.6**
(a) of Federal Government	1916	3.3
(b) of Central Bank	6528	11.3
(3) Public Guaranteed[a] and Non-Guaranteed Debt	**1111**	**1.9**
(4) Private Non-Guaranteed Debt	**2313**	**4.0**
Total	**57888**	**100.0**

Source: SBP
[a] mostly public sector enterprises

2.3 Comparison of Level of External Debt

The level of external debt as of 2010 in selected developing countries, especially from South Asia, is presented in Table 2.4. Pakistan appears to be a relatively highly indebted country, at 32 percent compared to 19 percent for South Asian countries and 20 percent of the GDP for low and middle income countries. The external debt to GDP ratio is 17 percent in India, 25 percent in Bangladesh and 41percent in Sri Lanka.

In terms of debt servicing burden, Pakistan is in the intermediate range at 2.4 percent of the GDP compared to 1 percent in Bangladesh, 1.2 percent in India and 2.8 percent of GDP for the low and middle income countries.

Table 2.3
Major* Creditors of Pakistan
As of 30 June 2011

($ Million)

	Outstanding Debt	Percentage
Paris Club	**15463**	**29.2**
Japan	7853	14.8
France	2324	4.4
Germany	1945	3.7
USA	1490	2.8
Others	1871	3.5
Other Bilateral	**2666**	**5.0**
China	2020	3.8
Others	646	1.2
Multilateral	**34821**	**65.8**
ADB	12324	23.3
IDA	11149	21.0
IMF	8940	16.9
IBRD	1647	3.1
Others	761	1.4
Total Of Above	**52950**	**100.0**

Source: SBP, PES
* the outstanding debt of Pakistan to which exceeds $1 billion.

Table 2.4
Comparison of the External Debt and Debt Servicing to GDP Ratio in Selected Countries, 2010

	External Debt Servicing ($ Billion)	As % of GDP	External Debt ($ Billion)	GDP ($ Billion)	Percentage of Debt
Bangladesh	1.0	1.0	25.0	100.3	24.9
Egypt	3.0	1.4	34.8	218.9	15.9
India	20.1	1.2	290.3	1727.1	16.8
Indonesia	29.3	4.1	179.1	706.8	25.4
Pakistan	4.3	2.4	56.8	176.8	32.1
Philippines	12.9	6.5	72.3	199.5	36.2
Sri Lanka	1.4	3.0	20.4	46.9	41.1
Turkey	58.7	8.0	293.9	734.4	40.0
South Asia	**27.4**	**1.3**	**400.6**	**2090.4**	**19.2**
Low and Middle Income Countries	**583.3**	**2.8**	**4076.3**	**20070.6**	**20.3**

Source: WDI

2.4 Terms of New Loans

The World Development Indicators (2011) data base gives the terms of new loans contracted by Pakistan, shown in Table 2.5. The concessional element was high in earlier decades at almost 60 percent but fell sharply in the 90s and the earlier part of last decade. It has risen once again in recent years due, in particular, to the higher quantum of aid from the U.S. and grants from the U.K. Similarly, the average interest rate has changed in line with the concessional element.

The average maturity period of loans has fallen from over 33 years to 22 years by 2010, due, in particular, to the shortening of the grace periods. Consequently, the share of concessional debt has declined over the forty years.

Table 2.5 Terms of New Loans Contracted					
	1970	**1980**	**1990**	**2000**	**2010**
Average Grant Element (%)	59.0	62.2	35.5	20.7	55.1
Average Interest Rate (%)	2.7	2.5	5.2	6.2	2.3
Average Maturity Period (Yr)	33.5	35.5	22.9	12.8	22.0
Share of Concessional Debt (%)	68.9	71.2	58.4	55.0	59.1
Source: WDI					

The effectiveness of development assistance by donors is examined in-depth in sections 4.2 and 4.3.

2.5 Dynamics of External Debt to GDP Ratio

Pasha and Ghaus (1996) have analysed the pattern of change in the external debt-to-GDP ratio during the decade of the 70s. The first influencing factor was the massive devaluation. He concludes that during this period Pakistan experienced substantial non-interest current account deficits. By itself, this should have contributed significantly to raising the ratio. However, the ratio declined appreciably because the adverse implication of these deficits was more than offset by the contributions of a large negative real interest rate and GDP growth. The subsequent appreciation of the real exchange rate also contributed to a reduction in the external debt-to-GDP ratio.

Pasha and Ghaus (ibid) also conclude that between 1980-81 and 1994-95 the external debt-to-GDP ratio increased modestly by about 8 percentage points. Non-interest current account deficits alone could have increased this magnitude by almost three times as much while capital losses on external debt, due to real exchange rate depreciation, made an even larger contribution. But the increase in the ratio was held back dramatically by the fact that throughout the period the real interest rate on external debt was substantially below the real growth rate of the economy. The access of Pakistan to concessionary financing from multilateral and bilateral agencies was a major factor responsible for restricting the level of the external debt-to-GDP ratio. It is interesting to note that if the nominal interest rate on external debt had been higher by only one percentage point during the period then the ratio of external debt to GDP in 1994-95 would have been 10 percentage points higher, implying significantly higher level of foreign debt servicing.

The dynamics of the change in the external debt to GDP ratio for the last decade has been derived in the basis of the methodology developed by the IMF. This essentially involves decomposition of the change in the ratio due to the following:

a. the level of the non-interest current account deficit as a percentage of GDP
b. the level of non-debt creating capital inflows, especially foreign private investment, as a percentage of GDP

c. the endogenous dynamics of external debt to GDP ratio due to the interest payments on external debt, impact of real growth in the economy ad price and exchange rate changes
d. changes in the level of foreign exchange reserves and overall in net foreign assets.

The results, based on estimates by IMF, are given in Table 2.6 for the last decade. Different periods can be distinguished as follows:

Table 2.6
Dynamics of the Evolution of the External Debt-to-GDP Ratio in Different Periods
Cumulative for Period

(%)

	2001-01 and 2001-02 2 years	2002-03 to 2007-08 6 years	2008-09 to 2010-11 3 years
Change in External Debt to GDP Ratio	**1.7** (0.8)*	**-19.5** (-3.2)	**1.4** (0.5)
Due to:			
Non-Interest Current Account Deficit	**-4.9** (-2.4)	**4.7** (0.8)	**4.3** (1.4)
Net FDI	**-1.0** (-0.5)	**-14.6** (-2.4)	**-4.4** (-1.5)
Endogenous Debt Dynamics	**5.3** (2.7)	**-16.4** (-2.7)	**-4.0** (-1.3)
• Contribution from nominal interest rate	4.2 (2.1)	6.7 (1.1)	3.5 (1.2)
• Contribution from real GDP growth	-2.5 (-1.2)	-10.2 (-1.7)	-2.9 (-1.0)
• Contribution from price and exchange rate changes	2.2 (1.1)	-12.8 (-2.1)	-4.6 (-1.5)
Residual (change in FE reserves)	**+2.2** (1.1)	**6.8** (1.1)	**5.5** (1.8)

Source: IMF
* figures in brackets are annual averages

2000-01 and 2001-02

These are the initial years of the military government of General Parvez Musharraf when Pakistan was recovering from the nuclear sanctions in 1998 and foreign aid was limited. There was a modest increase in the external debt to GDP ratio of 0.8 percent per annum. The non-interest current account was in surplus due to containment of imports caused by large depreciation in the value of the rupee. The contribution of Foreign Direct Investment (FDI) was limited. The endogenous debt dynamics was unfavourable due to interest payments and big exchange rate depreciation, as discussed earlier.

2002-03 to 2007-08
This period commenced by Pakistan's participation in the war against terror and a transition to a quasi-democratic government under Parvez Musharraf. The non-interest current account deficit deteriorated substantially in this period, especially in 2007-08 due to the hike in oil prices. However, the FDI level multiplied during this period. The endogenous debt dynamics was favourable due to the high growth rate of the economy and exchange rate stability. Consequently, it was possible not only to build-up foreign exchange reserves but also to bring down the external debt-to-GDP ratio on average by over 3 percentage points annually.

2008-09 to 2010-11
Following the elections in early 2008, there was a transition to a coalition government headed by the PPP. Foreign exchange reserves which had built up substantially suffered severe depletion due to oil price shock in 2008 and Pakistan had to go to the IMF for a large Stand-by facility. Over the last three years the non-interest current deficit has remained moderately high, although conditions improved dramatically in 2010-11 when a surplus was recorded due to exceptional buoyancy in exports and home remittances.

The endogenous debt dynamics was not so favourable due to the sharp fall in the GDP growth rate to 3 percent from over 7 percent in the previous period. Emphasis was also placed on a relatively large accumulation of foreign exchange reserves. As such, there was a modest increase in the external debt-to-GDP ratio. Overall from 2000-01 to 2010-11 the ratio has fallen sharply by over 16 percentage points.

2.6 Type of Foreign Aid

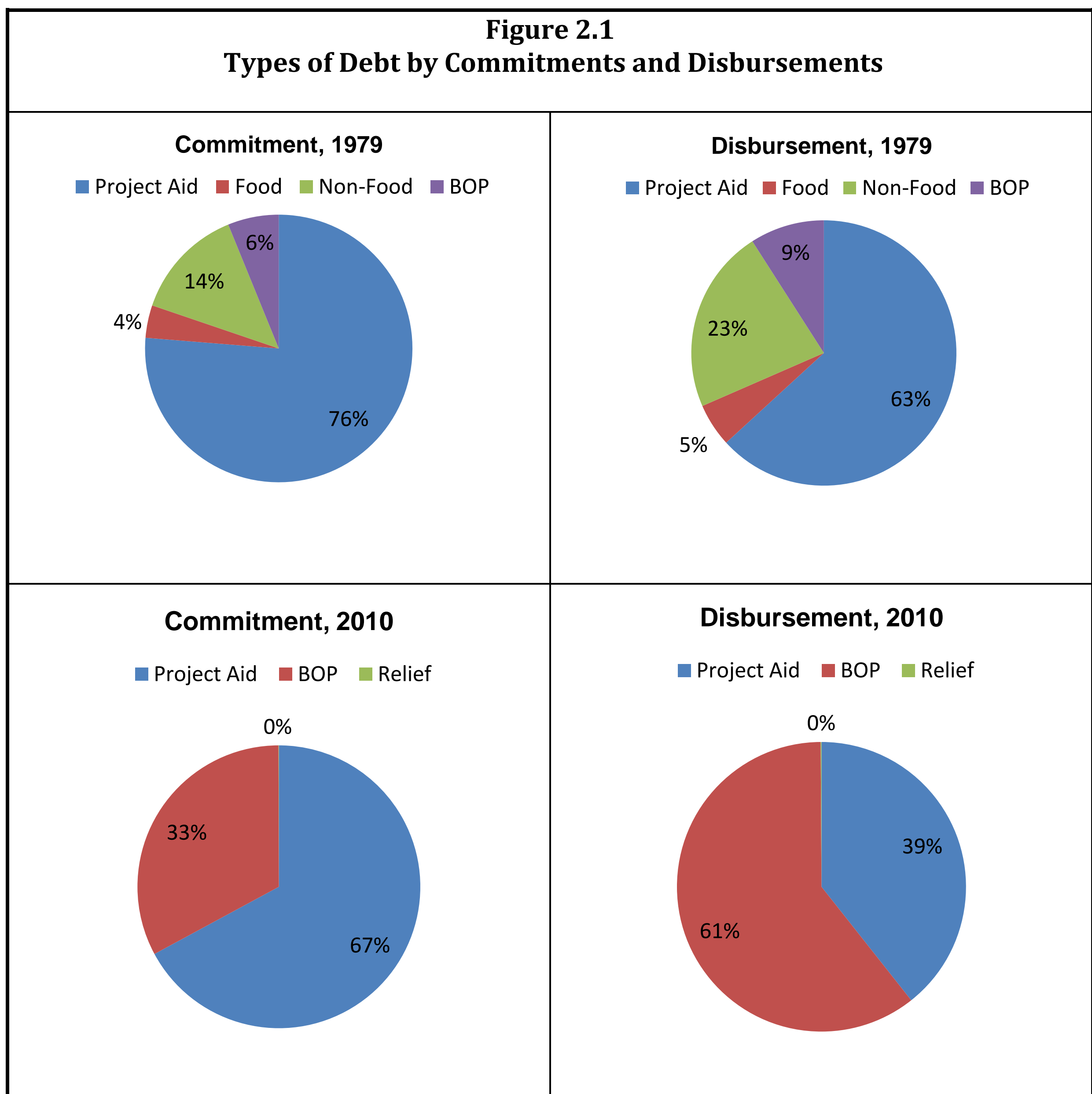
The next question is what type of loans and grants has the government received over the years? To better understand the pattern of Pakistan's aid flows and debt accumulation it is important to look into the different sectors that the aid and loans are utilised on.

Currently, 62 percent of the committed flow and 66 percent of the disbursements are project related flows. Non-Project aid, which can be either for food, balance of payments support, relief or non-food aid accounted for the remaining 38 percent and 34 percent in the case of commitments or disbursements (see Figure 2.1).

There appears to be a linkage between the type of aid that the country receives and the geo-political interests of the donor agencies. Table 2.7 presents an illustration of how the pattern of aid has varied with the changes in relationship of Pakistan with other nations and multilateral organisations in the last three decades.

In the 1980s the country received a considerable amount of loans, mostly in the form of project aid and non-food aid, which reflects USA interests during the Afghan War. Accordingly, relief aid was also high in those years, which largely comprised of Afghan Refugees Relief Assistance. The country also obtained IMF loans to finance BOP needs and to pay off old debts in 1988-89 and 1990-91. For most of the two decades otherwise, there were no loans for BOP. The non-food and relief loans generally went down after the mid-90s with the cessation of the war, coupled with the reduction of foreign aid from USA to Pakistan following the Pressler Amendment and the sanctions imposed in the aftermath of nuclear tests in the late 90s.

Figure 2.1
Types of Debt by Commitments and Disbursements



However, during the 1993-2003 period the disbursements of project-based loans increased, exceeding the amount of commitments. In 1998, for example, the

commitment for project aid was $776 million whereas the amount disbursed was $1,552 million.

In the last decade food and non-food aid fell to almost nil for most years, while relief aid also went down. On the other hand project aid and BOP aid increased, which may be accredited to 9/11 and the US's relations with Pakistan, as well as aid from international agencies for post-disaster reconstruction and rehabilitation following the earthquake of 2005.

Table 2.7
Type of Inflows of Aid
(Grants and Loans)

(Million USD)

Year	Project Aid		Non-Project Aid								Total	
			NON FOOD		FOOD		BOP		RELIEF			
	Commitments	Disbursements	Commitments	Disbursements	Commitments	Disbursements	Commitments	Disbursements	Commitments	Disbursements	Commitments	Disburs-ements
1979	1,064	599	190	213	55	50	86	86	0	0	1,395	948
1980	1,002	808	121	161	55	21	419	419	61	61	1,658	1,470
1981	591	676	182	103	73	66	16	16	111	111	973	972
1982	887	536	320	174	110	89	10	10	293	293	1,620	1,102
1983	1,115	744	174	299	120	80	0	0	178	178	1,587	1,301
1984	1,580	695	166	149	88	177	0	0	155	155	1,989	1,176
1985	1,804	903	161	125	196	79	0	0	150	150	2,311	1,257
1986	1,810	1,055	186	93	163	245	0	0	135	135	2,294	1,528
1987	2,035	1,006	331	205	130	57	0	0	130	130	2,626	1,398
1988	1,903	1,223	390	219	230	218	0	0	164	164	2,687	1,824
1989	1,979	1,262	663	537	392	542	146*	146*	132	132	3,312	2,619
1990	2,623	1,312	201	386	258	287	217*	217*	140	140	3,439	2,342
1991	1,935	1,408	346	451	134	136	50	50	111	111	2,576	2,156
1992	2,219	1,766	43	316	322	284	0	0	105	105	2,689	2,471
1993	1,204	1,895	182	232	454	309	0	0	57	57	1,897	2,493
1994	1,822	1,961	-	15	329	251	411	303	19	19	2,581	2,549
1995	2,714	2,079	3	23	279	258	0	211	29	29	3,025	2,600
1996	2,219	2,151	57	21	395	383	0	0	10	10	2,681	2,565
1997	1,351	1,821	1	1	405	409	0	0	2	2	1,759	2,233
1998	776	1,552	1	1	578	622	750	625	1	1	2,106	2,801
1999	1,382	1,620	-	-	185	270	650	550	2	2	2,219	2,442
2000	527	1,263	0	0	567	100	284	385	2	2	1,380	1,750
2001	407	1,030	0	0	81	23	1,128	1,128	21	5	1,637	2,186
2002	970	741	0	0	40	114	2,590	1,880	0	21	3,600	2,756
2003	547	846	0	0	0	9	1,236	1,057	11	8	1,794	1,920
2004	1,210	622	0	0	0	0	1,263	755	2	3	2,475	1,380
2005	2,026	918	0	0	0	0	1,202	1,803	0	2	3,228	2,723
2006	3,258	2,084	0	0	22	10	1,225	1,262	1	1	4,506	3,357
2007	1,365	1,308	133	0	0	12	2,649	2,058	3	3	4,151	3,381
2008	2,440	1,565	0	80	0	0	1,310	2,013	2	2	3,752	3,660
2009	2,296	1,272	125	175	18	0	3,947	3,238	2	2	6,388	4,688
2010	3,175	840	0	0	0	0	1,553	1,293	2	2	4,730	2,135

*: IMF Loan
Note: Project Aid includes Commitments and Disbursements for Earthquake Rehabilitation & Construction Source
BOP includes Commitment and Disbursements for IDB Short Term and Tokyo Pledges
Source: Pakistan Economic Survey

2.7 Inflow of Foreign Assistance by Regime

Pakistan has alternated between democratic and military regimes over the last 64 years since Independence. There is a popular perception that aid inflows in military regimes have been higher than when the country makes a transition to a democratic setup and that, consequently, the GDP growth rate is higher. Is this perception borne out by the facts?

Table 2.8 presents the magnitude of net aid inflows indifferent periods. Broadly speaking, the secular long term trend is for net foreign assistance to decline as a percentage of GDP over the last five decades, although there are substantial year-to-year variations.

The principal conclusions that emerge from the analysis of aid inflows in different regimes are as follows:

(i) The net flow of foreign assistance was indeed the highest as a percentage of the GDP in the 60s under the military regime of Ayub Khan, at over 7 percent. During this period, Pakistan was a member of military pacts with the USA in organizations like the CENTO and SEATO. With the onset of the process of industrialization and the green revolution in agriculture, the GDP growth rate was high at over 7 percent in the 60s.

(ii) Beyond the 60s, there appears to be little correlation between the level of foreign assistance and the type of regime.

(iii) Democratic governments have been more successful in diversifying sources of foreign aid. The Bhutto government in the 70s was able to get more support from Islamic countries in the wake of the phenomenal jump in oil prices in 1973. Similarly, the Benazir Bhutto and Nawaz Sharif governments were able to build a stronger economic relationship with bilaterals like China and Saudi Arabia, who are not members of the Paris Club.

(iv) Significant assistance, especially from the US, has been linked primarily to security considerations. First, Pakistan supported US strongly in the Cold War. Second, Pakistan actively supported the Afghan freedom fighters in the liberation war in the 80s against Soviet occupation. Third, after 9/11 Pakistan became an active participant in the war on terror with the US. This has led to substantial inflows since 2002 of grant assistance from US through the Coalition Support Fund (CSF) as compensation for costs incurred by the Pakistan army in war operations in the North of Pakistan and the prospect of more aid under the Kerry-Lugar Bill.

(v) Interestingly, if there is a correlation it is in the share of grants in total inflow and the type of regimes. As shown in Table 2.8 these tend to be higher in military regimes at about one fifth to one third, as compared to the share in the ZA Bhutto period in the 70s and in the 90s. During the last few years the grant component has remained high because of grants from the CSF. Therefore, we have the conclusion that given the level of inflows the resulting debt obligations have been reduced during military regimes by a larger grant component.

Table 2.8 Foreign Assistance in Different Regimes			
	Net Annual Inflow of Grants and Loans		Grant Component as % of Inflow
	Annual Average ($ Million)	% of GDP	
1960-71 Military Regime of Ayub Khan – Yahya Khan	**458**	**7.1**	**34.5**
1972[a]-1977 Democratic Regime of ZA Bhutto	**490**	**4.4**	**11.1**
1978[a]-1988 Military Regime of Zia-ul-Haq	**849**	**3.0**	**24.1**
1989[a]-1999 Democratic Regimes of Benazir Bhutto and Nawaz Sharif	**1020**	**1.9**	**13.6**
2000[a]-2008 Military Regime of Parvez Musharraf	**1517**	**1.4**	**32.8**
2009-10 Democratic Regime of Raza Gillani	**1561**	**0.9**	**29.0**

2.8 Conditions of Multilateral Organizations

Governments in Pakistan have generally acquired external debt from multilateral donors on conditions relating to reform of fiscal policy, monetary policy, exchange rate policy and governance. Appendix Table A 2.2 gives detail on the conditions accepted by Pakistan in the last SBA with IMF.

A popular area of attention of IMF is on the fiscal side, principally curtailment of budget deficit. While some of the suggested structural reforms are needed in the economy, their contextualization, pace, and sequencing may put the economy under pressure and may easily become counterproductive. In particular, the conditions may put a heavier burden on the poor. This issue is taken up in the next chapter.

2.9 Issues in Debt Management

The responsibility for debt management in Pakistan lies mainly with the Ministry of Finance. Two divisions, namely the Economic Affairs Division (EAD) and Finance Division (FD), maintain relevant information on almost all aspects of debt management. The State Bank of Pakistan (SBP) also maintains debt-related data along with the Central Directorate of National Savings. Debt management, planning, and policies at the Ministry of Finance are coordinated with the SBP.

However, debt management in Pakistan is lacking in many respects, such as poor coordination across debt management agencies, lack of long-term planning, and a piecemeal approach to the problem. Donor agencies might also be blamed for imposing unrealistic conditions and for following their agenda without fully appreciating the ground realities (Ahmed, 2011). As noted in the report by the Debt Reduction and Management Committee (Government of Pakistan, 2001), in practice debt management is segmented into many departments with poor coordination and information flows.

Economic problems in Pakistan including the debt issue are often only addressed in crisis-like situations. As a result, solution strategies often seek short-term results that, in most cases, have adverse long-term consequences.

Foreign loans and other debt obligations of the Government of Pakistan are contracted in various currencies. The bulk of these loans (approximately 93 percent) are in the international currencies. For reporting purposes, the outstanding balance of these loans is converted into US Dollar. Hence, movement in the US Dollar vs. third currency exchange rates has a significant impact on Pakistan's outstanding stock of external debt. Depreciation of the dollar causes an increase in the outstanding stock, while appreciation leads to a decrease.

During the course of 2010-11, currency movements caused an increase of approximately US$ 3.3 billion in Pakistan's outstanding external debt. On the contrary, first quarter of the current fiscal year registered a decrease of US$ 44.7 million in external debt owing to currency movements.

Managing foreign exchange risk is a fundamental component of a prudent debt management strategy. Careful management of currency risk has been increasingly mandated by sovereigns, especially after the currency-crisis episodes of the last decade and the consequent heightened international attention on accounting and balance sheet risks. A comprehensive foreign exchange risk management programme requires establishing and implementing sound and prudent foreign exchange risk management policies and control procedures. The external debt portfolio of Pakistan is contracted in 20 different currencies and the historical losses borne by Pakistan in this respect call for a sophisticated currency hedging framework to be installed within the government. If we analyse the currency movements over a longer period of last 20 years, the cost of foreign currency borrowing adjusted for exchange rates movement has been 1.5 percent lower than the average domestic interest rates, in view of the concessional character of those loans and not because of good debt management

Chapter 3
Debt Sustainability Analysis

3.1 Indicators of Debt Sustainability

This chapter adopts two approaches to assess the sustainability level of the foreign debt in Pakistan: the first approach is based on the widely used traditional threshold debt ratios, also adopted by Ministry of Finance, and the IMF (as in the recent report following Article IV consultations) . The second approach is based on the BOP projections under different scenarios in the medium term based on the application of the Macroeconomic Model of Pakistan developed by Institute of Public Policy, BNU. The section attempts to examine whether Pakistan would be able to service its external debt obligations in coming years.

Sustainability of debt has been defined as: "*Sustainable debt is the level of debt which allows a debtor country to meet its current and future debt service obligations in full, without recourse to further debt relief or rescheduling, avoiding accumulation of arrears, while allowing an acceptable level of economic growth. (UNCTAD/UNDP, 1996)"*

There are various indicators for determining a sustainable level of external debt with each containing specific messages. These indicators are in the form of ratios of different macroeconomic indicators and can be thought of as measures of the country's "solvency" in that they consider the stock of debt at certain time in relation to the country's ability to generate resources to repay the outstanding balance. Examples of debt burden indicators include the following:

a. Foreign debt to GDP ratio
b. Foreign debt to export ratio
c. Foreign debt to total reserves

A second set of indicators focuses on the short-term liquidity requirements of the country with respect to its debt service obligations. They are also a measure of the costs of debt and the ability of countries to pay. These indicators are useful early-warning signs of debt service problems. Examples of liquidity monitoring indicators include the following:

a. Foreign debt service to GDP ratio,
b. Foreign debt service to exports ratio,
c. Foreign debt service to Total Reserves,

The above magnitudes are quantified for Pakistan from 1981 onwards in Table 3.1. External debt service (repayment plus interest) to revenues is also a useful measure and currently stands at less than 15 percent. External debt in the 80s and 90s was equivalent to about one-third to almost half of the country's economy. As a proportion of export earning; the ratio was about 300 percent, clearly demonstrating a heavy burden. Another, perhaps more disturbing statistics was that at times, external debt was over 1500 to 2000 percent of the size of the country's reserves.

Table 3.1
Magnitude of Different Debt Sustainability Indicators, 1981 to 2011

(%)

Year	Import Cover Ratio (months)	External Debt-to-GDP Ratio	External Debt-to-Reserves Ratio	External Debt to Exports of Goods and Services Ratio	External Debt Service to GDP Ratio	External Debt Service to Reserves Ratio	External Debt Service to Exports of Goods and Service Ratio
1981	0.90	37.17	1447.65	308.15	3.23	125.82	26.78
1982	1.29	37.51	1190.15	365.38	2.85	90.54	27.80
1983	1.76	41.31	600.89	323.62	4.68	68.07	36.66
1984	3.22	38.81	1167.70	367.90	4.00	120.39	37.93
1985	1.75	42.85	1652.62	380.27	4.61	177.77	40.90
1986	1.35	46.55	2094.38	367.95	5.10	229.38	40.30
1987	1.12	50.05	3326.28	338.75	5.50	365.52	37.22
1988	0.70	44.09	4298.40	321.10	4.82	470.43	35.14
1989	0.52	45.47	3509.12	304.15	4.60	354.98	30.77
1990	0.61	51.46	6957.95	301.25	4.75	642.73	27.83
1991	0.32	51.25	4423.76	293.29	4.31	372.39	24.69
1992	0.51	51.10	2922.94	293.31	4.77	272.66	27.36
1993	0.85	47.52	2043.80	292.36	4.63	199.12	28.48
1994	1.21	52.65	932.74	308.06	6.65	117.72	38.88
1995	2.48	49.75	1741.02	295.38	5.30	185.57	31.48
1996	1.33	47.01	5429.36	282.88	5.19	599.35	31.23
1997	0.49	48.07	2511.86	300.85	6.54	341.74	40.93
1998	1.19	51.80	3133.64	348.11	3.69	223.52	24.83
1999	1.06	53.74	2239.12	374.10	4.66	194.25	32.45
2000	1.49	44.26	2162.89	323.47	3.86	188.63	28.21
2001	1.50	43.79	869.92	299.01	4.14	82.31	28.29
2002	3.45	46.42	415.52	273.77	3.99	35.76	23.56
2003	6.35	43.25	329.07	242.66	3.69	28.06	20.69
2004	5.96	36.62	366.18	223.62	4.36	43.63	26.64
2005	4.02	30.63	334.56	175.64	2.22	24.27	12.74
2006	3.43	28.79	318.03	178.60	1.81	19.97	11.22
2007	3.69	29.01	295.72	189.16	1.85	18.83	12.05
2008	3.52	29.93	681.90	192.56	1.84	41.94	11.84
2009	2.45	33.73	482.30	244.46	2.16	30.88	15.65
2010	3.40	32.10	395.74	203.68	2.45	30.24	15.56
2011*	4.07	27.82	396.67	187.93	1.63	23.26	11.06

Source: WDI

Some moderation in the burden has been achieved in the new millennium. External debt to GDP ratio has been brought down to 28 percent while external debt to export earnings and reserves has also declined to 188 and 397 respectively. Turning next to debt servicing, the high ratio of external debt servicing to exports illustrates the high burden of debt servicing on the external sector. In the decade of the 80s and 90s, external debt servicing drained out over one-fourth of export earnings. Compared to this, the average value of this ratio for Asian and African countries at comparable level of development was about 20 percent. As such, viewed internationally Pakistan has historically carried a somewhat higher than a normal burden of debt servicing. The increase in the burden has partially been a consequence of the rapid increase in some years in external debt repayment.

In recent times, the burden of debt servicing has fallen, Debt servicing to GDP ratio fell to 2.3 percent and further to 1.6 percent while debt servicing to export earnings and debt servicing to reserves ratio showed a decline to 11 percent and 23 percent respectively. Foreign sale of assets and privatization, especially in the banking, telecom and oil and gas sectors, contributed over $4 billion to the buildup of foreign exchange reserves. Therefore, by the end of 2010-11 over one-fourth of foreign exchange reserves were due to sale of assets to foreign entities.

During the last year, 2011, non interest current account showed a surplus of 0.9 percent of nominal GDP, compared to a deficit of 1.4 percent recorded in 2010. Similarly, the foreign exchange earnings of the country were up by 24.6 percent whereas the non-interest foreign currency payments were up less by 12.3 percent. These positive developments on the balance of payments front, besides other factors, culminated in an apparent improvement in the level of debt sustainability.

3.2. Choice of Debt Sustainability Indicators

Among the indicators identified above the basic question is which indicators are more 'sensitive' in highlighting emerging difficulties in servicing obligations and conduct of international trade without any liquidity problems. An insight can be gained into the value of indicators in serving as early warning system by looking into the value of indicators in years when Pakistan faced financial difficulties and generally had to seek support from the IMF during these years. These difficulties were visible in the period, 1988 to 1993, when Pakistan signed various IMF agreements and in the late 90s, especially in the period after the imposition of nuclear sanctions and in 2008 when Pakistan signed a large SBA with the IMF.

We have added to Table 3.2 another indicator, the import cover ratio, which indicates the number of months of imports that can be financed by foreign exchange reserves. Turning to conventional ratios first the indicator, external debt to GDP ratio, did not show any exceptional build up to the crises years. As opposed to this, the external debt to reserves ratio did attain very high levels in the difficult years, although it is not clear

what the ceiling to this ratio is beyond which it can be said that a country is entering a period when the level of debt becomes unsustainable.

Turning to ratios related to external debt service, the only sensitive indicator appears to be the external debt service to reserves ratio which attained exceptionally high levels in the late 80s, early 90s and in years 1996 and 1997. Here again, the problem is one of determining the ceiling level of this indicator to signal an impending crisis.

The sensitive indicator which appears to work the best is the import cover ratio. The historical experience of Pakistan indicates that when this ratio comes close the minimum level of one month then severe financial difficulties are likely to be experienced. This was the case from 1988 to 1993 and in 1997 to 1999.

How well do the various indicators correlate with each other? The zero-order correlation coefficients are presented for the period, 1981 to 2011. The two 'sensitive' indicators – import cover ratio and the external debt service to reserves ratio – are fairly highly correlated. We suggest that these are the primary indicators of debt sustainability in the Pakistani context, along with the trend in the balance of payment position.

Table 3.2
Zero-Order Correlation Coefficients Matrix among Debt-Sustainability Indicators

	Import Cover Ratio	External Debt-to-GDP Ratio	External Debt-to-Reserves Ratio	External Debt to Exports of Goods and Services Ratio	External Debt Service to GDP Ratio	External Debt Service to Reserves Ratio	External Debt Service to Exports of Goods and Service Ratio
Import Cover Ratio	1.000	-0.596	-0.654	-0.620	-0.491	-0.647	-0.523
External Debt-to-GDP Ratio		1.000	0.623	0.670	0.836	0.620	0.673
External Debt-to-Reserves Ratio			1.000	0.392	0.479	0.979	0.368
External Debt to Exports of Goods and Services Ratio				1.000	0.605	0.396	0.841
External Debt Service to GDP Ratio					1.000	0.574	0.875
External Debt Service to Reserves Ratio						1.000	0.462
External Debt Service to Exports of Goods and Service Ratio							1.000

3.3 Balance of Payments Projections

A look at the indicators of debt sustainability for 2010-11 generally reveals an improvement. There does not appear to be an imminent problem in the short to medium term. However, we believe that there are no grounds for complacency. Almost 60 percent of the foreign exchange reserves consist of the outstanding stock of the IMF loan under the SBA received since 2008. This has led to an improvement artificially in the key ratios – import cover ratio and reserves ratios. The time has come now for repayment of this loan, between 2011-12 and 2013-14, as per the schedule given in Table 3.3.

Table 3.3
Repayment Schedule of the IMF Loan

($ Million)

	Repayment of IMF Loan	Normal Debt Repayment	Total Debt Repayment	(3) as proportion of (2)
	(1)	(2)	(3)	
2010-11	177	2303	2480 (9.9)	1.077
2011-12	1202	2469	3671 (14.9)	1.489
2012-13	2953	2619	5572 (21.5)	1.887
2013-14	3381	2489	6230 (22.9)	2.186
2014-15	1338	2913	4251 (14.9)	1.459

Source: IMF
Figures in brackets are percentage of projected exports

Therefore, there is likely to be a quantum jump in the level of debt repayments from 2011-12 to 2014-15. At the peak, these are likely to be more than twice the 'normal' debt repayment. In fact, total debt repayment as a percentage of exports is likely to be over 22 percent during the next two years This could put serious pressure on the level of foreign exchange reserves in the next few years and raise issues of debt sustainability. In order to determine the future outlook for Pakistan's ability to meet its debt obligations a formal set of projections is made of the external balance of payments with the help of the IPP model.

Table 3.4
Magnitude of Key* Debt Sustainability Indicators in 2011-12 and 2012-13

	(Projected)	
	2011-12	2012-13
Import-Cover Ratio (mths)	2.55	0.90
Debt Servicing** to Reserves Ratio (%)	36.00	151.94

* as identified in Chapter ____
** including debt repayment to IMF

We have made balance of payments projections up to 2012-13 in a 'business as usual' scenario. The summary results are given in Table 3.4 and the detailed projections in Table 3.5. Even under conservative assumptions about the size of the current account deficit (given the prospect of high oil prices) it appears that the foreign exchange reserves could fall to critically low levels by the end of 2012-13, implying an import cover of less than one month, as shown in Table 3.4.

There are a number of reasons for the prospect of a precipitous decline in reserves. First, in 2011-12 prices of the major export, textiles, have fallen sharply and are unlikely to fully recover in 2012-13. Second, as identified above, the oil import bill is showing a big increase in 2012-13. Third, inflows of program funding from ADB and World Bank have been affected in the absence of a letter of comfort from the IMF after Pakistan's exit prematurely from the SBA due to lack of fulfillment of some major conditions. In fact, the recently released staff report on Article IV consultation warns of 'serious downside risks' to the economy of Pakistan. Further, many bilaterals have been discouraged by the poor record of governance over the last four years of the incumbent government. The rupee has started falling, in the first eight months of 2011-12; it has fallen to Rs. 91 per dollar from below Rs. 86 to the dollar and could start plummeting by early 2013.

Overall, there are serious issues of debt sustainability in the next two years. Clearly, out of box solutions will have to be found including the implementation of a strong domestic reforms agenda, especially focusing on the curtailment, both directly and indirectly, of the large trade deficit. In addition, unconventional and perhaps drastic options for management of the external debt will have to be explored of the type discussed in Chapter 6.

Table 3.5
Balance of Payments Projection
and FE Reserves Position
(Summary)

($ Million)

	2011-12 (first seven months)	2011-12 (IMF Projection)	2011-12 (Likely by IPP)	2012-13 (Projection by IPP)
A. Current Account Balance	-2633	-4771	-5214	-5773
B. Financial & Capital Account Balance[a]	267	3675	1837	2188
C. Overall Balance	-2366	-1096	-3377	-3585
D. Use of Fund Credit	-176	-1202	-1202	-2953
E. Change in FE Reserves	-2542	-2298	-4579	-6538
F. Level of FE Reserves	12242 (11897)*	12486	10205	3667
G. Months of Import Cover			2.4	0.8

Table 3.6
Balance of Payments Projections
(Detailed)

(million $)

	2011-12 (first seven months)	2011-12 (IMF Projection)	2011-12 (Likely by IPP)	2012-13 (Projection by IPP)
A. Current Account Balance	**-2633**	**-4771**	**-5214**	**-5773**
Trade Balance	**-9057**	**-14043**	**-15480**	**-16524**
Exports	14100	24981	24677[a]	25911[g]
Imports	-23157	-39024	-40165[b]	-42165[h]
Services Balance	**-1639**	**-3279**	**-3279**	**-3500**
Income balance	**-1747**	**-3392**	**-3392**	**-3600**
Transfers	**9894**	**15944**	**16937**	**17581**
Remittances	7436	11761	12881[c]	13525[i]
Official Transfers	**84**	**-**	**-**	**-**
B. Capital Account	**76**	**104**	**104**	**100**
C. Financial Account	**149**	**3623**	**1733**	**2088**
FDI	**542**	**1750**	**929**[d]	**900**
Portfolio Investment	**-141**	**300**	**0**[e]	**0**
General Government	**193**	**1233**	**700**[f]	**688**
Disbursement	1007	3703	3169	3307
Amortization	814	-2469	-2469	-2619
Others	**-445**	**340**	**0**	**500**
D. Net Errors and Omissions	**42**	**-52**	**0**	**0**
E. Overall Balance	**-2366**	**-1096**	**-3377**	**-3585**
F. Use of Fund Credit	**0**	**-1202**	**-1202**	**-2953**
G. Change in FE Reserves		**-2298**	**-4579**	**-6538**
H. Level of Reserves	**12418**	**12486**	**10205**	**3667**

Chapter 4
Implications of External Financial Inflows

Previous chapters have demonstrated that external debt has historically put the country's economy under pressure. The pressure, in all likelihood, is going to be more severe in the next few years when the IMF loan is to be paid back. Over the next three years the IMF SBA has to be repaid in instalments. The question that we attempt to answer in this chapter is: what have been the implications of the external financial inflows on the economy. We answer the question by looking at: whether there is any evidence of Pakistan suffering from the Dutch Disease in periods of large inflows; impact of foreign aid on domestic savings, the utilization of external inflows and their implications.

4.1: External Inflows and the 'Dutch Disease'

'Dutch disease' is defined as a situation where large inflows into the economy bring about an appreciation in the value of the currency. This results in a loss of competitiveness of exports and an upsurge in imports. Consequently, the deficit in the balance of trade rises rapidly eventually reaching unsustainable levels.

We establish below that the economy of Pakistan may have been infected by the Dutch Disease from 2002-03 to 2007-08, the peak years of the Musharraf era. As shown in Table 4.1, inflows increased rapidly from 2002-03 to 2006-07, reaching a peak of over $21 billion in the latter year, due particularly to the remarkable buoyancy in private capital inflows (largely FDI) and current transfers (mostly home remittances). A large part of the FDI consisted of privatisation receipts and portfolio inflows which are generally not accompanied by higher imports although there could be higher repatriation of profits. There has been some decline in the overall inflow after 2006-07, especially in FDI due to security conditions and the quality of governance in Pakistan. The modest recovery in 2010-11 is largely due to the buoyancy in home remittances.

The movement in the nominal and real exchange rate is shown in Table 4.2. The currency depreciated sharply in 2000-01 and 2002-03, falling cumulatively in the two years by almost 19 percent. Thereafter due to substantially larger inflows, the value of the currency increased by over 6 percent in 2003-04. In fact, the real exchange rate showed an appreciation of as much as 33 percent by 2007-08. There are clear indications of the Dutch disease during these years. Since then there was a significant devaluation in 2008-09 due to the burgeoning trade deficit.

The impact of the rupee appreciation on the balance of trade is shown in Table 4.3. The remarkable upsurge in imports is clearly visible which almost quadrupled between 2001-

02 and 2007-08 while exports doubled. Consequently, there was a massive increase in the trade deficit from about $1 billion to $20 billion.

The basic conclusion is that capital inflows should be managed well such that the problem of Dutch disease is avoided, especially by preventing appreciation of the currency, through a policy of building up reserves rather than promote a very liberal import policy. Otherwise, there is the danger that the trade deficit eventually becomes too large and unsustainable, necessitating resort to high cost borrowing to avoid severe depletion of reserves.

Table 4.1
Inflows into Pakistan

($ Million)

	Private Transfers[a] (Net)	Public Capital[b] (Net)	Private Capital[b] (Net)	Special Grant[d]	Total
1999-2000	3063	-748	-2504	-	-189
2000-01	3898	577	-380	-	4095
2001-02	4249	532	-144	-	4637
2002-03	5737	290	612	300	6939
2003-04	6116	-986	331	724	6185
2004-05	8440	1813	374	884	11511
2005-06	9914	2308	3936	1128	17286
2006-07	10102	2180	7826	1312	21420
2007-08	11048	2240	6187	759	20234
2008-09	11019	2643	3805	939	18406
2009-10	12562	1642	2086	1379	17669
2010-11	15823	234	1872	827	18756

[a] mostly home remittances
[b] mostly loans and grants
[c] mostly FDI and portfolio flows
[d] from CSF

Table 4.2 Nominal and Real Exchange Rate				
	Nominal Exchange Rate (Rs/$)	**Index of Nominal Exchange Rate (1999-2000 = 100)**	**Consumer Price Index (1999-2000 = 100)**	**Real Exchange Rate (Index) (1999-2000 = 100)**
1999-2000	51.77	100.00	100.00	100.00
2000-01	58.44	112.88	104.40	108.12
2001-02	61.42	118.60	108.10	109.71
2002-03	58.50	113.00	111.45	101.39
2003-04	57.57	111.20	116.55	95.40
2004-05	59.36	114.66	127.35	90.04
2005-06	59.86	115.63	137.43	84.14
2006-07	60.63	117.11	148.12	79.06
2007-08	62.54	120.80	165.90	72.81
2008-09	78.50	151.63	200.35	75.69
2009-10	83.80	161.87	220.59	73.30
2010-11	85.50	165.15	250.72	65.87

Table 4.3 BALANCE OF TRADE 1999-2000 TO 2010-11 ($ Million)			
	Exports	**Imports**	**Balance of Trade**
1999-2000	8569	10309	-1690
2000-01	9202	10729	-1476
2001-02	9135	10339	-1146
2002-03	11160	1220	-1015
2003-04	12313	15591	-2377
2004-05	14391	20598	-6184
2005-06	16451	28580	-12011
2006-07	16976	30539	-13046
2007-08	19052	39965	-20197
2008-09	17688	34882	-16891
2009-10	19290	34710	-15163
2010-11	25356	35872	-10516

4.2: External Inflows and Domestic Savings

One of the arguments for the need to borrow from the external resources comes from *The Two Gap Model*. Developing countries like Pakistan, where the level of incomes are generally low, have low saving rates and thus low rate of investment that translates into low tax base and eventually lower levels of government revenues. The theory of Two Gap Model suggests that the economic development policy focuses on two constraints: the need for savings to finance investment, and the need for foreign exchange to finance imports.

The Two-Gap Model suggests that developing countries have to rely on the foreign inflows to fill these two gaps. These may take the form of FDI, export credit, project/non-project assistance, technical assistance and emergency relief etc. Pakistan and many other low income countries have relied more on the foreign inflows in the form of grants, aid and loans whereas East Asian countries have benefited from FDI. Unfortunately Pakistan due to macroeconomic imbalances, poor infrastructure and large fiscal/budget deficit has been unable to attract foreign direct investment, except in some years.

Theoretically, foreign inflows do not necessarily cause a decrease in the domestic savings even if the foreign inflows are used for consumption purposes because that will put pressure on the domestic productions of goods and services. Hence the inflows can lead to an increase in investment and depending upon the economy's saving function can increase the domestic savings. However, domestic supply constraint may limit the increase in prices of non tradable goods relative to those of tradables[1] (Nushiwat, 2007).The fall in the output and exports may decrease domestic savings.

As such, there are growing concerns, particularly over the last three decades or so, of these countries being in a vicious circle whereby more borrowings will crowd out domestic savings. There is extensive literature that provides evidence that foreign aid and domestic savings are negatively correlated, including Griffin and Enos (1970), Weisskopf (1972), and Khan & Rahim (1993).

Pakistan has not been able to mobilise domestic resources and has a history of low saving rates, currently being at 10% in 2010. As compared to Pakistan the East Asian economies like Singapore, Malaysia and Indonesia have domestic savings of 52%, 32% and 34% respectively. Is there empirical evidence in Pakistan that domestic savings are being crowded out by foreign inflows?

In order to estimate the relationship between the domestic savings we estimate the following model:

$$DS/_{GDP} = f(NODA, WR, GSHARE, \bar{R}, RPCI, FD)$$

where:

$DS/_{GDP}$	=	Savings Rate
NODA	=	Net Official Development Assistance/GDP
WR	=	Workers' Remittances/GDP
GSHARE	=	Growth Rate of the Share Price Index
$\bar{R}$	=	Real Rate of Interest
RPCI	=	Real Per Capita Income

[1] The phenomenon of Dutch Disease

FD = Fiscal Deficit

Results of the regression are presented in Box 4.1. The results show that domestic savings in Pakistan over the last three decades have been significantly influenced by net official development assistance as a percentage of GDP (NODA), workers' remittances (WR) and growth rate of share price index (GSHARE). Other exogenous variables specified in the equation turned out to be insignificant.

Results show a negative impact of foreign inflows on domestic savings. These inflows may be either in the form of Official Development Assistance or worker's remittances, both seem to have a negative impact on the domestic efforts at resource mobilisation. Estimates indicate that a 1 percent increase in the foreign assistance as percentage of GDP decreases the domestic savings by 0.8 percent of GDP, while a 1 percent of the GDP increase in workers' remittances decreases domestic savings by 1.1 percent of the GDP. As opposed to these, the share price index is positively correlated with domestic savings. The increase in the domestic savings from 2001 to 2003 during the Parvez Musharraf's regime when there was overall improvement in the macroeconomic indicators and an increase in the business confidence, is captured by the Dummy variable D_3. On the whole the regression is able to explain 77 percent of variation in domestic savings in Pakistan.

Box 4.1
Regression Results of Determinants of Domestic Savings

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	16.92914	1.291036	13.11283	0.0000
NODA	-0.812448	0.605472	-1.841843	0.1052
WR	-1.095358	0.201160	-5.445215	0.0000
GSHARE	0.023218	0.012541	1.851320	0.0770
D3	5.487715	1.238000	4.432727	0.0002
R-squared	0.776050	Mean dependent var		11.39625
Adjusted R-squared	0.737102	S.D. dependent var		4.270656
F-statistic	19.92532	Durbin-Watson stat		1.536471
Prob(F-statistic)	0.000000			

Overall, the analysis indicates a negative relationship between domestic savings and foreign inflows in Pakistan. Clearly by making more resources available, ODA, along with remittances and private capital inflows, slackens the saving effort and encourages an increase in consumption, thereby dampening public as well as private savings.

4.3 Utilization of External Assistance

We next turn to another important question: what is the external assistance used for? To attempt an answer to this, we analyse the country's Public Sector Development Programme (PSDP) which allocates resources to development projects at both the federal and the provincial levels, for different sectors of the economy. This section draws on the PSDP (2011) report prepared by the IPP for the Planning Commission of Pakistan.

Looking first at the trend in commitments and disbursements of foreign aid during the last decade, new commitments were very low in the aftermath of the nuclear sanctions imposed in 1998. Following 9/11, however, commitments started increasing, reaching a peak of over $3.7 billion in 2009-10. As compared to the build up of commitments, disbursements have shown a sharp decline since 2005-06. The basic question is why in the presence of large commitments, disbursements have been low. Is this a reflection of the decline in capacity to absorb aid? Has this been caused by the sharp cutback in the size of the PSDP which has limited the availability of rupee counterpart funding to match the availability of donor assistance? Alternatively, has program funding floundered due to lack of implementation of reforms or changes in the composition of the PSDP towards projects which traditionally do not attract donor funding?

Turning specifically to project aid, Table 4.4 shows that in absolute terms, donor assistance for projects in the federal PSDP has declined from $816 million in 2004-05 to $349 million in 2009-10. The share of foreign aid in financing the PSDP was almost 38 percent in 2002-03, which declined to only 10 percent in 2007-08. It has since shown some recovery, reaching 17 percent by 2010-11. However, over the decade, the contribution of foreign aid to financing the PSDP has fallen.

Table 4.4
Foreign Aid in the Federal PSDP

Year	Foreign Aid in Cost		Foreign Aid in Allocation	
	%	Rs. Billion	%	Rs. Billion
2003	-	-	37.5	33.8
2004	25.2	321	23.9	38.2
2005	27.5	374.3	24.1	48.7
2006	28.2	388.3	20.2	41.2
2007	21.1	492.6	13.6	36.4
2008	17.7	445.3	9.7	32.5
2009	19.1	629.6	12.2	26.7
2010	26.3	1,112.60	13.5	40.5
2011	28.1	1,219.00	16.7	30

Source: IPP (2011)

Turning to the donor financing of the national PSDP (Federal plus Provincial plus ERRA) a similar trend is observed. From 37 percent in 2002-03, the share of foreign aid has fallen to 15 percent in 2010-11. It is expected to decline further to 11 percent in 2011-12.
Looking at the share of foreign aid in provincial PSDP/ADPs, it remains higher than that for the Federal government up to 2008-09. Thereafter, during the last two years it has fallen below the latter. In 2010-11 only 12 percent of the ADPs of the four Provincial

Governments combined were financed by donors. This raises the question of whether these governments are now facing special problems in attracting and utilizing donor assistance.

An analysis of the multilateral and bilateral aid provided for the PSDP of 2011-12 revealed that out of the total of 1207 development schemes, 234 were partially financed by foreign loans. Of these, 107 schemes were directed towards infrastructural development, 102 towards social development and 25 schemes for other divisions, as revealed by Table 4.5. That is, over one-third of the projects in infrastructural development were designed to receive foreign financing, whereas less than one-fourth of the social development projects were receiving the funds. Furthermore, out of the total share of the funds, only 13% was allocated to social development. Given Pakistan's growing poverty, and the fact that the country is targeting for the achievement of the Millennium Development Goals, there should have been more focus on social development.

In terms of sectoral share, in infrastructural development the power sector, communications and railways received the highest amount of foreign funding. Within the social sector, the foreign funding was primarily focused on higher education.

Table 4.5 Foreign Aid by Division, 2011-12								
		Number of Schemes			Allocation (Rs. Billion)			
		Foreign Aided*	Total	Foreign as % of Total	Number of Schemes Receiving Aid Allocation	Foreign	Total	Foreign as % of Total
Infrastructure Development		**107**	**318**	**33.6**	**50**	**29.8**	**147**	**20.3**
1	Water & Power Division (Water Sector)	7	70	10.0	12**	1.9	36.1	5.2
2	Water & Power Division (Power Sector)	58	83	69.9	24	13.4	32.5	41.1
3	Pakistan Atomic Energy Commission	2	25	8.0	2	5.8	22.0	26.4
4	Pakistan Nuclear Regulatory Authority	0	5	0.0	0	0.0	0.4	0.0
5	Petroleum & Natural Resources Division	1	7	14.3	0	0.0	0.2	0.0
6	Communications Division (Including NHA)	23	96	24.0	9	6.3	40.1	15.6
7	Ports & Shipping Division	0	3	0.0	0	0.0	0.7	0.0
8	Railways Division	16	29	55.2	3	2.5	15.0	16.7
Social Development		**102**	**439**	**23.2**	**14**	**4.6**	**119.6**	**3.9**
9	Special Programme	0	2	0.0	0	0.0	33.0	0.0
10	Finance Division	5	73	6.8	2	1.1	10.4	11.0
11	Higher Education Commission	80	172	46.5	1	0.1	14.0	0.8
12	Information Technology & Telecommunications Division	2	69	2.9	0	0.0	0.8	0.0
13	Science & Technological Research Division	0	51	0.0	0	0.0	1.1	0.0
14	KA & GB Division	8	25	32.0	5	0.8	18.0	4.3
15	States & Frontier Regions Division	0	1	0.0	1	0.5	10.0	4.8
16	Statistics Division	0	3	0.0	1	0.1	0.3	19.8
17	Planning & Development Division	7	43	16.3	4	2.1	32.0	6.4
Others Divisions		**25**	**450**	**5.6**	**12**	**2**	**23**	**8.7**
18	Interior Division	8	135	5.9	3	0.1	5.8	0.9
19	Industries & Production Division	0	52	0.0	0	0.0	2.1	0.0
20	Defence Division	6	35	17.1	3	0.3	3.8	8.5
21	Cabinet Division	0	21	0.0	0	0.0	2.7	0.0
22	Commerce Division	2	7	28.6	1	0.1	0.4	11.8
23	Capital Administration and Development Division	0	30	0.0	0	0.0	0.7	0.0
24	Ministry of Foreign Affairs	0	2	0.0	0	0.0	0.3	0.0
25	Narcotics Control Division	4	14	28.6	3	0.2	0.5	35.6
26	Information & Broadcasting Division	3	45	6.7	0	0.0	0.6	0.0
27	Establishment Division	0	5	0.0	0	0.0	0.0	0.0
28	Law. Justice & Parliamentary Affairs Division	0	5	0.0	0	0.0	1.2	0.0
29	Revenue Division	1	38	2.6	1	1.4	2.0	71.2
30	Defence Production Division	0	2	0.0	0	0.0	1.5	0.0
31	Textile Industry Division	1	5	20.0	1	0.0	0.2	13.3
32	Economic Affairs Division	0	2	0.0	0	0.0	0.2	0.0
33	Housing & Works Division	0	49	0.0	0	0.0	1.4	0.0
34	Inter Provincial Coordination Division	0	3	0.0	0	0.0	0.1	0.0
GRAND TOTAL		**234**	**1207**	**19.4**	**76**	**36.5**	**290**	**12.6**

Source: PSDP (2011)

* Projects which show foreign loans in estimated cost.

** For this division, the number of schemes for which foreign aid allocation is expected are 12 while the number of schemes for which foreign cost component is shown are 7.

The report also concludes that donors tended to put most of their focus on a handful of projects, for example those related to the power sector, at the expense of other areas that needed more attention. The 10 largest schemes, in terms of the expected amount of foreign funding, take up 53% of the total aid inflow in the program. The top 20 schemes, out of a total of 76, take up 70% of the total aid, as presented in Table 4.6.

Table 4.6
Size Distribution of Foreign Aided Projects
(as per the original PSDP of 2010-11)

(Rs. Millions)

Sr. No	Division	Scheme	Allocation		
			Foreign Aid	**Rupee**	**Total**
1	Pakistan Atomic Energy Commission	Chashma Nuclear Power Project (C3 and C4)	7,510	2,816	10,341
2	Pakistan Atomic Energy Commission	Chashma Nuclear Power Project C-II	2,212	554	2,766
3	Communications (NHA)	Faisalabad – Khanewal Expressway E-4	1,646	247	1,893
4	Railways	Procurement/Manufacture of 75 New D.E. Locos	1,359	800	2,159
5	Health	Health System Strengthening and Policy Programme	1,340	70	1,410
6	Health	National Maternal, Neo Natal and Child Health Programme	1,235	1,046	2,281
7	Kashmir Affairs	43.5 Jagan Hydro Power Project	1,235	0	1,235
8	Railways	Replacement of Old Signaling Gear (Khanewal Section)	1,200	617	1,817
9	Water & Power (WAPDA)	Neelum Jhelum Hydropower Project	1,103	13,597	14,700
10	States & Frontier Regions	FATA Special Programme	1,096	7,135	8,231
		Total (Top 10 Projects)*	**19,936**	**26,882**	**46,833**
		Total PSDP	**37,584**	**242,415**	**280,000**
	% Share	**Top 10 Projects**	**53%**		
		Top 20 projects	**71%**		

Source: P&D Division
* Projects are arranged according to their foreign aid/loan component of allocation to projects

Overall, the sectoral priorities in aid by multilateral and bilateral agencies are given in Box 4.2. The World Bank and the bilateral donors are focusing more on social development while Asian Development Bank has tended to concentrate more on infrastructure and the productive sectors.

The Report undertakes an analysis of the linkage between the PSDP projects and growth. It concludes that while infrastructure matters from the viewpoint of growth, both

investments in power generation and in enhancing the availability of water for agriculture have significant effects on growth. However, in the Pakistani setting, development outlays on expanding/upgrading the road network do not seem to confer significant visible benefits. Within the PSDP, the sector actually receiving the largest allocation currently in the area of infrastructure development is communications (mostly highways). There is a case for changing this priority and diverting resources away from communications to water and power to achieve a bigger impact on GDP growth, within a given size of PSDP.

Box 4.2
Sectoral Priorities in Aid by Multilateral and Bilateral Agencies

During the last two years, IBRD/IDA loans approved by the World Bank for Pakistan have had the following sectoral composition: social development, 47 percent; infrastructure, 24 percent and others (including disaster related assistance), 29 percent. The sectoral distribution of cumulative lending by the Asian Development Bank to Pakistan is as follows: social development, 10 percent; infrastructure, 46 percent; productive sectors, 21 percent and others, 23 percent. According to OECD-DAC data, sectoral composition of ODA by bilateral donors to Pakistan in 2008 and 2009 is as follows: social development, 45 percent; infrastructure, 25 percent; productive activities, 8 percent; others (including humanitarian assistance), 22 percent. Therefore, while World Bank and the bilateral donors are focusing more on social development, ADB has tended to concentrate more on infrastructure and the productive sectors.

The report also undertakes a component of costs analysis of existing portfolios of projects. The question is how much of the development outlay reaches the people in terms of direct expenditure on the provision of services. This is an important question as the objective must be to ensure that the maximum part of the PSDP is used for conferring benefits to the people.

Box 4.3 indicates the various types of leakages that create a wedge between the initial PSDP allocation and the amount finally spent on the provision of services. Overall, the conclusion is it appears that the estimates of the leakages range from 29.1 percent to 37.5 percent. Therefore, for every 100 rupees allocated from the PSDP 63 to 75

Box 4.3
Leakage from Development Allocation of Rs 100

(Rs)

	Estimate	
	High	**Low**
• Overhead Costs of Projects Execution	8.1	8.1
• Contingency & Miscellaneous (Potential Savings)	5.0	2.5
• Duties on Machinery and Equipment	1.4	1.4
• Commissions on Machinery and Equipment	1.3	-
• Taxes and IDC on Civil Works	11.6	11.6
• Corruption Payments	4.6	-
• Transfer Payments for Land Acquisition, etc.	5.5	5.5
Total Leakage	**37.5**	**29.1**
Amount for Service Provision	**62.5**	**70.9**

Source: PSDP (2011)

rupees eventually reach the people. This implies that if Rs. 300 billion is the size of the PSDP, than an amount of Rs. 76 to Rs. 112 billion is not of direct benefit to the people.

4.4 Donor-Driven Priorities in Development Plans

The previous section discussed the limited outcome of foreign aid on the economy. What further dampens any directional economic growth is the fact that in many situations the aid given for development projects is invested on donor-driven priorities. Such projects may not be the best investment for the recipient country. The OECD, in its recent study "2010 DAC Report on Multilateral Aid", has expressed a similar view, where it states that multilateral organisations like the United Nations earmark their aid funds for specific types of projects, so that their policies for aid allocation are very prescriptive and donor-driven rather than based on the recipient countries' needs and preferences. The report further states that earmarking funds for project-specific aid increases the transaction cost of aid between the international organisations and donor countries, and at the same time it weakens the recipient countries' ownership of aid.

Donor agencies tend to concentrate on developing specific sectors. As highlighted earlier, the World Bank and several bilateral donors generally show an interest in developing the social sector of economies, while the Asian Development Bank focuses on providing aid for infrastructure and productive sectors. The sectoral distribution of loans by the Agencies is presented earlier in Box 4.2.

In Pakistan's context of how donor aid earmarked for certain purposes undermines aid effectiveness, a good example is the flood disaster of 2010, when the allocated funds could not be used to address other pressing issues that flood victims were faced with, even when funds were available elsewhere in the UN System. That restriction impeded the aid process as a number of issues resulting from the floods, but not directly related to the flood, could not be funded. Projects such as those based on climatic change alleviation and adaptation need to essentially be country-owned and inclusive instead of being donor-driven. Ideally, such funds should provide external resources to help a country's development strategy via making use of the country's intrinsic facilities.

Foreign relations may play a significant role in determining the form of aid a country receives. Donor countries often provide aid on the basis of their geopolitical interests in the recipient country, and hence their assistance tends to be short-sighted. Projects funded by them are set up to delivery immediate results, thus focus moves away from capacity-building and long term sustainable growth. This was the case of the United State's aid for disaster management and rehabilitation during the Afghan War of the 1970s. The relief aid

went down soon after the war ended, leaving Pakistan to deal with a substantial refugee crisis.

Another example perhaps is Pakistan's Social Action Program (SAP) of 1993. It was a five year project directed towards improving the conditions of the basic social services of the country at that time, including education, health and empowerment of the underprivileged population. The program was funded by the government as well as the World Bank, and had the primary aim of increasing public spending on social services.

Unfortunately, the program, although very extensive and well formulated initially, was largely unsuccessful. Experts feel that the main cause of this was the difference in the priorities of the Bank and the government administration. Policymakers in Pakistan could not reconcile with the donor governments' Bank-supported reform programs in alleviating poverty. Burki (2002) gives a comprehensive analysis of this, stating that "the Bank groups began to aggressively pursue a development agenda that did not win easy ownership amongst Pakistani policymakers" (see Box 4.4).

Box 4.4 Governments and World Bank's Sectoral Priorities in Loans		
Period	**Government's Priorities**	**World Bank Group's Priorities**
1951-58	• Refugee rehabilitation • Rapid industrialization to deal with the scarcities created by a trade war with India • Maintenance and improvement of irrigation infrastructure inherited from the British	• Transport infrastructure • Irrigation • Capital for industrialization through public sector intermediaries (development finance corporation)
1958-69	• Industrialization by guiding private sector intro various industries • Generating rural employment • Creating rural infrastructure such as farm to market roads • Increasing agricultural productivity	• Irrigation • Development Finance Corporation • Transport (highways, railways) • Natural gas development • Education • Food storage
1969-77	• Nationalization of large privately owned financial and commercial houses • Nationalization of some private schools and colleges • Public sector investment in large industrial enterprises	• Further expansion of DFC programs • New sectors introduced in to lending programs including livestock, seed development, and urban sewerage • First program loan aimed at supporting policy reform
1977-88	• Revitalization of the private sector • Expansion of public sector expenditure by heavy domestic borrowing • Introduction of some Islamic features into the economy	• New set of activities supported by the Bank, continuing the earlier tradition • Decision to phase out the support of public sector expenditures in salinity control and reclamation
1988-99	• Initial opening of the economy to the outside • Removal of controls on private sector investment • Initiation of a program of privatization • Further progress with Islamization • Use of public sector banks and corporations for political purposes • Expenditure on large projects of dubious economic value • Policy to encourage private sector participation in power generation	• Social action programs launched to address the problem of persistent social backwardness • Policy advice on improving the efficiency of public sector enterprises • Policy advice and lending for power generation by the private sector
1999-2002	• Successful implementation of a program aimed at stabilization • Sharp reduction in public sector expenditures including those on • development • Establishment of local governments with power to tax and spend	• Refocusing Bank Group's lending to promote economic, social, and institutional reforms • Technical advice on reforming the Central Board of revenues • Policy advice, technical assistance and financial support to the province

In order to strengthen country ownership of development plans and ensure better application of their operational policy, several multilateral organisations have established their own principles that allow them to disburse development funds efficiently. The OECD's Development Assistance Committee (DAC) designed the Paris Declaration on Aid Effectiveness in 2005, with the following objectives:

• *Ownership:*	Effective leadership from developing countries
• *Mutual Alignment*	
• *Harmonization of donors:*	Planning, funding and implementing development programs, as well as managing for results
• *Mutual accountability*	Improvement of transparency both from donors and recipients

Similarly the World Bank designed the Good Practice Principles for strengthening the quality of the Bank's development policy lending in 2005-06:

• *Ownership*:	Reinforce country ownership
• *Harmonization*	Agree up-front with governments and other financial partners on a coordinated accountability framework
• *Customization*	Customize the accountability framework and modalities of Bank support to country circumstances.
• *Criticality*	Choose only actions critical for achieving results as conditions for disbursement.
• *Transparency and predictability*	Conduct transparent progress reviews conducive to predictable and performance-based financial support.

In a study conducted by the Bank on the review of its good practice principles in 2007, it was noted that civil society organisations (CSOs) involved in development programs of recipient countries, notably Pakistan, doubted that ownership had increased in the recent years, since the CSOs contribution in designing policies and projects was kept to a minimum. Simultaneously, CSOs felt that the donors "could do more to harmonize their support, which all parties thought was fragmented and relied on different instruments." (World Bank, 2007). In particular the CSOs felt that in offering their support to Pakistan the bilateral donors had a political agenda rather than an interest in socioeconomic improvements, which naturally limited possibilities of harmonization between the country and the donors. Furthermore, policy makers argued that country ownership of programs could increase if donor agencies focused on improving local capacity. The report revealed that there was a feeling among local authorities that while the Bank provided financial and analytical assistance in designing development programs, it needed to allow greater involvement of government counterpart and other local experts in drafting the programs.

In order to improve the effectiveness of aid, attempts to do so should not just focus on the policy agenda associated with aid but also on the nature of the relationship between the donor and recipient itself. Foreign aid can significantly help improve the economy if a complete rethinking of these two factors is agreed upon. Aid recipients should be bequeathed greater ownership over the design of domestic policy. At the same time, the political economy of the developing country determines the distributive outcomes of policy, and often the nature of the aid relationship impinges on it; restoration of recipient

ownership over aid policy needs to take that in account. Most contemporary discussions on aid appear to overlook this dimension of political economy.

To conclude, foreign inflows while bridging the saving-investment and external gap in Pakistan have had some not so positive implications. These include the ‘Dutch-disease’ phenomenon and the adverse impact on mobilization of domestic savings. Also, inflows have not been used in sectors which ensure maximum pay back in terms of enhancing the productive capacity and growth of the economy partially because of donor priorities. Their impact on the people of Pakistan, especially the poor, to that extent is limited. The political implications of the inflows have also been significant. Governments particularly the dictator regimes have promoted donor geo-political objectives sometimes at the cost of indigenous interests. Also, we see evidence of a ‘moral hazard’ problem. Easy access to external inflows in such regimes has discouraged the motivation to bring about structural reforms, which inevitably are not costless but can put the country on more sound and strong foundations.

Chapter 5
The Case for Debt Relief for Pakistan

The previous chapters have demonstrated that the burden of external debt has not only put the economy under increasing stress, it has had, along with other foreign inflows, some undesirable consequences, (like the Dutch Disease, affect on domestic savings) compromising the benefits conferred in terms of boosting the economic momentum and production capacity. Consequently, the country has had limited success in permanently overcoming the vices of poverty and inadequate opportunities for the poor and vulnerable sectors of society. The monies have been spent; in almost half of the forty year period analyzed by military regimes; on sectors/projects which either did not enhance the productive capacity of the economy as it could have; on priorities less reflective of indigenous need and priorities than the donor community, and, have only partially benefited the poor and lower income segments of the population.

The argument can perhaps be made that while the global community is embarking on the road to prosperity, the people of Pakistan lag behind, partly due to policies adopted by leaders who did not fully live up to the aspirations of the people. Pakistan's growth rate is currently one-third of India and almost half of Bangladesh. The common man of Pakistan needs the opportunity provided by a level playing field to improve his being. The level playing field comprises, among other things, proper education and health facilities, energy (power and gas) to turn the wheels of industry, irrigation water for a farmer's fields and safety for his life and property. Pakistan needs to embark on an economic structural reform program and needs financial space to be able to do so. Although it has low per capita income and is highly indebted (with a debt-to GDP ratio of 60 percent), it is not eligible for the Heavily Indebted Poor Country (HIPC) initiative because it has recently been classed as middle income. However, debt relief can provide Pakistan the needed financial space which can facilitate the country come out of its current economic plight.

Though not on HIPC bases, Pakistan's case for debt relief can be made on a number of other grounds as follows:

i. The country has been a frontline state on the global 'war-on-terror' (WOT). While the WOT will benefit all around the world, the costs are disproportionately borne by Pakistanis.
ii. Pakistan has been passing through a patch of bad luck. The country has experienced three major natural disasters in the last decade-massive earthquake in 2005 and major floods in two consecutive years 2010 and 2011 - which have left the country's severely damaged both in terms of loss of life and property, and also permanent losses of infrastructure. Total assistance received by Pakistan for relief and

reconstruction after the earthquake in 2005 and the floods in 2010 is estimated at close to $2 billion including special emergency assistance from the IMF of $ 451 million in 2010-11.Overall, the loan component of funding for natural disasters during the last decade is 30 percent.

iii. Rising debt servicing is crowding-out expenditure on basic social infrastructure and therefore is limiting the opportunities not only for the current but also future generations.
iv. The benefits of the money spent have been pre-empted by the elite and have not benefited the middle or lower income groups in the country. Since repayment will burden these population segments, relief in debt will imply relief for the poor and the middle classes.
v. Finally the loan conditions have adversely affected the poor of the country. The new millennium started with the realization by the world leaders that globalization has the danger of enhancing inequalities across countries and across different strata within countries due to some government's lack of timely adaption to the changing economic environment. Such inequalities have to be addressed and eliminated. The 192 heads of States signed the Millennium Declaration, which stands out as a milestone in history.

We further develop these arguments in the subsequent sectors.

5.1 Costs of the Global 'War on Terror'

Following 9/11, and Pakistan's involvement in the global initiative against terror, an important problem that has come to lime light is the growing presence of extremist elements in the society. An increasing number of the people in the country believe that the present structure of the society is not serving their interests and presents to them a future they are unlikely to be satisfied as they are willing to resort to almost any means, even to limit less violence to disturb the existing social order. They are aggrieved about certain global developments and feel victimized by the global efforts aimed at ensuring "world (excluding them) safety and prosperity". The recent developments in Swat which have resulted in a move towards the adoption of a legal system that stands apart from the one followed in the other parts of the country is one manifestation of the growing influence of the extremist forces. The reach of these extremist elements in the society may expand further. Failure of the economy to provide adequately for the people at the bottom end of the income scale or living in the more backward regions of the country accelerates the rise of extremism. The failure of the political system which does not have the institutions the disaffected can use to voice their discontent further increases the sense of alienation and marginalization.

The acts of terrorism are further aggregating the economic stress by leading to loss of life and property, driving away both domestic and foreign investors, increasing the fiscal needs through enhanced expenditures on security, diverting resources from productive uses and increasing the cost of doing business. Security breakdown, not only aggregates the economic crises but in facts, feeds into and compounds some of the other problems facing the country, like political instability and governance decay. The latter impact results in challenges to the writ of the government.

Until recently, the focus on the ‘War on Terror’ was largely on highlighting the benefits in terms of increased support from the international community, especially the USA. But increasingly there is concern that the costs of participation are rising exponentially and leading to severe dislocation of economic activity and unacceptably high losses of life and property. Conceptually, these costs can be classified into a number of categories, largely depending on their nature (direct and indirect) and on the time period examined (immediate, medium-term or long-term). The decision to participate in the 'War on Terror' did lead to a major outpouring of international support to Pakistan. In 2001 Pakistan was emerging from a tough stabilization program with the IMF which in the process of reducing macroeconomic imbalances had, more or less, 'suffocated' the process of growth. Per capita income was stagnant and there had been a substantial increase in unemployment and poverty. Foreign exchange resources were scarce and at the beginning of 2001-02, were enough only to finance three months of imports of goods and services.

Participation in the war effort led to a substantial increase in the inflow of concessional assistance, especially in the form of grants from the USA. As shown in Table5.1, since 2001-02 Pakistan has cumulatively received $ 12.2 billion funding from the USA. This has consisted primarily (almost 70 percent), of reimbursement for the costs incurred by the military in counterterrorism operations in the North of the country. Development and economic assistance has aggregated to $ 3.2 billion during the period. Therefore, the direct contribution to the growth process in the country has been limited. However, the overall assistance; including the funding of military operations (mostly incurred in local currency); contributed to a rapid build-up in the foreign exchange reserves of the country. These reserves increased to $ 12 billion by the end of 2003-04.

The consequence was not only the alleviation of the foreign exchange constraint to growth but also the associated rapid expansion in money supply this led to a precipitous fall in interest rates and stimulated aggregate demand in the economy. The economy went back, after a long time, on to the path of rapid growth from 2003-04 onwards, averaging a GDP growth rate almost of 7 percent.

TABLE 5.1 US Funding to Pakistan Since 2001 ($ million)								
Purpose	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**Cumulative**
Military	1465	1473	782	1273	1218	1095	1387	8694
Law Enforcement	100	32	36	40	46	31	31	318
Development &economics	665	258	304	405	677	442	445	3194
Diplomacy	3	4	7	6	9	9	1	39
Total	2232	1767	1129	1724	1951	1578	1866	12245

Source: US Government Accountability Office, Securing, Stabilizing and Developing Pakistan's Border with Afghanistan, February 2009

But the large inflows of aid, along with higher remittances and, more recently, foreign direct investment, led to symptoms of 'Dutch Disease' in the Pakistani economy as already discussed in the previous chapter. The benefits have largely been frittered away in rising consumption levels, especially of the richer sections of Pakistani society.

Turning next to the costs, which hinge on the level of incidence of the acts of terrorism in the country, the trend in the number and incidence of these acts is also a basic indicator of the lack of success of the counter-terrorism strategy.

Table 5.2
Terrorist Attacks in Pakistan 2005-08

Years	Number of Attacks	Killed	Injured
2005	254	216	571
2006	675	907	1,543
2007	1,503	3,448	5,353
2008	2,577	7,997	9,670
2009	2,586	3,021	7,334
2010	2113	2913	5824
2011	1966	2391	4389
2012	134	207	369
Total	**11808**	**21100**	**35053**

The Pakistan Security Report prepared by the Pakistan Institute of Peace Studies (PIPS) quantifies carefully the incidence of terrorism in the country on the basis of day to-day monitoring of the national and local print and electronic media. The estimated number of attacks over the period 2005 to 2010 along with the numbers killed and injured is given in Table 5.2. There have been a total of about 1200 attacks in the seven year period, killing more than 21000 people and leaving more than 35000 injured. The bulk of the incidents were in the nature of terrorist attacks. In 2010 an estimated 2913 people were killed in these terrorist attacks and 5824 were injured. In addition, 'operational attacks' (security force's operations against terrorists) have led to 2007 deaths and 887 injured (mostly 'collateral' damage) in 2010. According to some estimates, missile attacks by US drones have killed almost 961 innocent civilians in 2010.

The Ministry of Finance of the GOP has prepared estimates of the cost of the 'War on Terror' to Pakistan in the PRSP-II document. The following indirect costs have been identified in addition to the direct costs: (i) Delay in implementation of development projects in affected areas, like NWFP and FATA, leading to cost overruns. (ii) Increasing uncertainty leading to capital flight and affecting FDI. (iii) Slowing down of domestic economic activity. (iv) Excessive increase in the country's credit risk, making borrowing very expensive. (v) Increased unemployment in affected regions. (vi) Costs of displacement of local population.

According to Table 5.3, costs of the 'War on Terror' are expected to approach Rs. 678 billion (approximately $8.4 billion) in 2008-09, equivalent to over 5 percent of the projected GDP. Indirect costs on account of loss of exports, foreign investment, industrial output, etc., represent bulk of the costs, with a share of over 83 percent. Cumulatively, according to government the cumulative cost of the 'War on Terror' since 2004-05 is $ 31.4 billion, substantially in excess of the flow of concessional assistance estimated at about $ 1.7 billion annually, but this still remains substantially less than the costs of the 'War on Terror'.

Table 5.3
Costs of War on terror to Pakistan

(Rs in Billion)

	2001-02	2002-03	2004-05	2005-06	2007-08	Cumulative
Direct cost (Rs in Billion)	67.1	78.1	108.5	108.5	114.0	14.1
Indirect cost (Rs in Billion)	192.0	222.7	278.4	375.8	563.8	30.9
Total (Rs Billion)	259.1	300.8	360.9	484.4	677.8	27.2
Percent of GDP	4365	5025	5752	7744	8368	17.7
	4.0	3.9	4.1	4.6	5.1	

IPP has also estimated the cost of terrorism comprising both the direct and indirect costs. The direct costs include: value of human lives lost or injuries; property or infrastructure destroyed or damaged; and enhanced spending on security. Indirect cost includes costs to local economies, costs of greater uncertainty and risk perceptions; higher transaction costs and psychological costs. Taking the Prime Minister's compensation formula to affected families as the basis of estimating damage to human lives or injury damages to property in mega-attacks (estimates are not available for smaller ones) and the 62 percentage higher defence expenditures due to the WOT, 48 percent higher provincial government expenditures on security with addition. Costs on private security, the total direct costs of terrorism are estimated at Rs 150 billion for 2008 (see Box 5.1). Despite the conservative and incomplete nature of these estimates, they work out to be significantly greater than government's estimates of direct costs in 2007-08 of about Rs. 109 billion.

Turning next to indirect costs the overall costs for terrorism for 2008 is estimated at Rs. 230 billion, bulk of which is due to the higher risk perception and uncertainty of the economy (see Box 5.2). The implications of higher transaction costs due to terrorism in the form of delays in the movement of consignments, costs of maintaining of higher inventories and larger time costs at airports etc. have not been quantified due to lack of data.

BOX 5.1
Direct Costs of Terrorism

	(Rs in Billion)
• Potential costs of compensation of victims	3
• Costs of damage to property and infrastructure	8
• Higher cost of defence	109
• Higher cost of police	21
• Higher cost of private security	8
Total direct cost	**149**
SAY	**Rs 150 Billion**

Overall the total costs of terrorism in Pakistan are high, estimated at Rs 380 billion, at the 2007-08 base. A subsequent study by SPDC (2011) estimates the costs to be about Rs 500 billion in 2009. The distributional consequences of these costs on the 'War on Terror' need to be highlighted. Higher security expenditures run the risk of 'crowding out' other expenditures related to the provision of basic social and economic services and thereby having on adverse impact especially on the lower income groups. This is mitigated partly by the reimbursement from the USA of the additional military expenses but remains a real threat in the context of higher expenditures on law and order (especially police) by the provincial governments.

BOX 5.2
INDIRECT COSTS OF TERRORISM

	(Rs in Billion)
Cost of Local Economies	
Loss of economic growth in NWFP and FATA	40
Cost of IDPs	2
Cost of Higher Risk Perception and Uncertainty	
Fall in private investment	52
Fall in stock market capitalization	120
Decline in travel and tourism	4
Fall in Hotel occupancy and income from Associated services	10
Rise in insurance Costs	3
Total Indirect Costs	231
SAY	Rs 230 Billion

Beyond this, the negative implications for the relatively poor include the loss of property and livelihoods in the affected areas which are among the most backward regions of the country, primarily as a consequence of dislocation of economic activity, including in the labour-intensive sector of tourism. The human dimension is manifested most acutely not only in the loss of life but also in the emergence of large numbers of IDPs.

For the relatively well-off, the costs consist of foregone investment opportunities and decline in wealth associated with the fall in share values, due to heightened levels of risk and uncertainty. There are also higher costs to the corporate sector in the form of larger premia for insurance coverage and increased transaction costs.

An important conclusion that emerges from the analysis is that Pakistan has been substantial undercompensated for participation in the 'War on Terror' with the cost three times of the assistance concession received. The compensation has been limited largely to reimbursement only for the costs of military operations. This, at least, partly explains the lack of some ownership of the war effort. Our past experience with utilization of the concessional support is not very positive as demonstrated earlier. From the viewpoint of achieving sustainable higher growth and promoting employment, especially for alleviating poverty, it is perhaps better if Pakistan is provided relief through other mechanism like debt relief and preferential access to markets, especially for textiles, in the USA, EU and Japan. As for as trade access is concerned while the proposal for Reconstruction Opportunity Zones (ROZs) in the affected areas, enjoying preferential access, is worthy, it is unlikely that in the short run much investment will be diverted to these areas despite the incentive given the prevailing situation. The facility may be extended to other backward regions also fiscal space created by debt relief can be used for public investments in infrastructure and basic services and employment-intensive public works in affected areas which are cleared up either through military operations or peace agreements in order to provide an early 'peace dividend'. At the national as well as local level, the problem of militancy can be tackled effectively by fast implementation of a Youth Skill Development and Employment Program, which aims to absorb the over 1.5 million unemployed youth in the country.

To conclude, the analysis in this section amply demonstrates that the country is paying a heavy price for the delay in the effective resolution of these enormous challenges facing it. Potentially, GDP could have been higher by almost Rs. 380 billion if the problems of security were not adversely impacting on the economy. The concomitant repercussions for exports, employment and poverty are also sizable. Any further inaction or inadequate/inappropriate policy action can further frustrate the country's growth potential, which it can ill afford in these times of increasingly unfavourable global developments. Global action of relief on Pakistan's debt can be one way of acknowledging Pakistanis' sacrifice for the World Community and be a partial compensation particularly for the young and the poor.

5.2. Economic Costs of Natural Disasters

Pakistan unfortunately during the last decade experienced several natural disasters including the drought of 2001, earthquake of 2005, cyclones of 2007 and floods in 2010 and 2011. The floods of 2011 and 2010 were among the worst natural disasters seen in Pakistan's history. In 2010 approximately one-fifth of the country was underwater, starting from Khyber Pakhtunkhwa in the North to the Arabian Sea in the South.

Natural disasters not only result in a loss of lives, damage to the infrastructure and loss in economic enterprise, but they also lead to homelessness, as those affected are forced to abandon their homes and in most cases lose their income generating assets. In the absence of efforts to rehabilitate the displaced population, there is an increase in the spread of disease, heightening health and food insecurity. Therefore, insecurity in terms of economic, health, personal, and food security is heightened in the event of natural disasters.

Natural disasters also place significant burden on the state, as it has to provide for relief, rehabilitation and reconstruction. This leads to diversion of funds from other areas; the opportunity cost of such diversion is very high for developing countries like Pakistan. The frequency of natural disasters in Pakistan and the extent of damage they cause are given in Table 5.4. The damages were in the shape of loss of human lives and private property; destruction of infrastructure; damage to standing crops and livestock, homelessness and internally displaced people.

Table 5.4
Costs of Natural Disasters in Pakistan

(in millions)

Natural Disaster	Affected (Number in Millions)	Killed (Number in Thousands)	Economic Costs (Million US$)
Floods (2010)	20.2	2.0	9500
Earthquake	5.1	73.3	5300
Storm	1.7	N.A	1620
Drought	2.2	N.A	247

Taking a closer look at each of these, the Asian Development Bank (ADB) and the World Bank undertook a Damage and Needs Assessment of the 2010 floods. The estimated damage from the floods stood at $10.1 billion or 5.8 percent of GNP in 2009-10, with the reconstruction costs ranging from $8.7 billion to $10.9 billion. This includes both the direct and indirect damage to physical and social Infrastructure and economic sectors. The capital loss was around 4 percent of GDP for 2009-10.

Growth rates are expected to be low until the damages are repaired, by at least 1.0 percent to 1.3 percent per annum. The rate of growth in the coming years would depend on the seriousness and efficiency with which the reconstruction done, with the expectation that the reconstruction expenditure is there in addition to the normal investment spending.

Overall, the damage caused by the Earthquake of 2005 was less severe than the floods of 2010. The most badly affected areas were Azad Jammu and Kashmir, and Khyber Pakhtunkhwa. It left at least 73,000 dead and more than 3.3 million people homeless, and the greatest damage and reconstruction costs were on housing. The highest economic damage was in the transport and the agriculture and livestock sector. The reconstruction of the infrastructure continues till today.

Table 5.5
Estimate of Total Damage Costs by Sector, December 2010

Sector	Direct Damage (Rs. Mil)	Indirect Losses (Rs. Mil)	Total Damage	
			PKR millions	USD millions
1. Social Infrastructure				
Private Housing	91,843	43,171	135,014	1,588
Health	1,562	2,661	4,222	50
Education	22,047	4,418	26,464	311
Subtotal	**115,451**	**50,249**	**165,700**	**1,949**
2. Physical Infrastructure				
Irrigation & Flood management	23,600	-	23,600	278
Transport & Communication	62,491	50,420	112,911	1,328
Water Supply & Sanitation	3,194	6,112	9,306	109
Energy	13,184	13,116	26,300	309
Subtotal	**102,469**	**69,648**	**172,117**	**2,025**
3. Economic Sectors				
Agriculture, Livestock & Fisheries	315,547	113,257	428,805	5,045
Private Sector & Industries	14,463	9,468	23,932	282
Financial Sector	110	57,141	57,251	674
Subtotal	**330,120**	**176,866**	**509,987**	**6,000**
4. Cross Cutting Sectors				
Governance	3,141	2,835	5,976	70
Environment	992	-	992	12
Subtotal	**4,133**	**2,835**	**6,968**	**82**
Total	**552,173**	**302,599**	**854,771**	**10,056**

Source: ADB and World Bank (2010) *Pakistan Floods, Preliminary Damage and Needs Assessment*

The incidence of drought in Pakistan is increasing insecurity, due to less hydropower generation. Around 60 percent of the area of the country is classified as arid, receiving less than 200 mm of rainfall. The primary arid rangelands include Cholistan, D.G.Khan, Kohistan, Tharparkar and Western Baluchistan. The volume of rainfall and variability is high both for Baluchistan and Sindh.

Table 5.6
Summary of losses during 2011 floods in Sindh

People affected	8,188,177
Area affected (Acres)	6,589,141
Crops affected (Acres)	2,166,623
Houses damaged	1,499,507
People killed	389
People injured	745
Cattle head perished	67,608

Source: NDMA

Pakistan has intermittently been suffering from severe drought since 1998. As a consequence of drought the growth rates of crops, both major and minor have shown a downward trend. As estimated in Table 5.7, the growth rate of major and minor crops in 2000-01 declined by 13.7 percentage points, and 7 percentage points respectively, due to the severe drought. The impact of drought persisted in the following year.

Consequently, the drought has been very costly for the country, as it has resulted in a loss of Rs. 260 billion to the economy in reduced agricultural output. The total loss from major and minor crops for 2000-01 was 171 billion, while it stood at 89 billion for 2001-02.

Table 5.7
Reduction in Growth Rates as a Consequence of Drought

	2000-01 (percent)	**2001-02 (percent)**
Major crops	- 13.7	-6.3
Minor crops	-7.0	-7.1

Source: Authors calculations based on Economic Survey.

Pakistan has throughout its history been hit by severe cyclones which have caused large scale damage. The coastal belt of Pakistan is extremely vulnerable to cyclones and storms. Fourteen cyclones have been reported between 1971 and 2001. The cyclone of 1999 in Thatta and Badin districts killed around 168 people and nearly 0.6 million were affected.

More recently, in 2005, Pakistan was stuck by cyclone Yemyin. This cyclone and subsequent floods affected around 2.5 million people in the south and central parts of Baluchistan and adjoining regions of Sindh. Given the nature of the terrain, water cascaded down the hills towards the Indus and Arabian Sea. Table 5.8 provides estimates of loss of lives and infrastructure for both Balochistan and Sindh.

According to UNDP (2012) the impact of global climate change on Pakistan is likely to be an increase in the variability of monsoon rains and enhancement in the frequency and severity of extreme events such as floods and droughts. This tendency has already become visible in the last decade.

Table 5.8 Damage Caused By Cyclone Yemyin			
Effect	**Balochistan**	**Sindh**	**Total**
Villages affected	5000	1449	6449
Houses destroyed	41718	29878	71596
Population affected	2 million	500000	2.5 million
No of deaths	205	215	420
Persons missing	80	29	109
Relief camps	21	0	21
Population in relief camps	7182	0	7182
Source: NDMA, Flood update 20 September 2007.			

5.3: Rising Debt Servicing and 'Crowding Out' of Expenditure on Basic Social Services

Debt servicing annually takes up a sizable percentage of Pakistan's budget at the expense of other important outlays. The inadequate attention given to the social spending is readily apparent in the government's pattern of the foreign aid allocations to development projects; for example lower priority given to social development than infrastructure etc. However, it is also markedly visible in the low budgetary allocation to the sector. The country's focus on health and education expenditure has been extremely low throughout much of its history. Furthermore, in its current state of stress, the country's financial priority is in financing the fiscal and Balance of Payments deficits, including external and domestic debt servicing and social sectors, despite their low level, have been put in the backburner.

Composition of public expenditures is presented in Table 5.9. Historically 75-85 percent of total expenditure has been recurrent in nature. Developmental expenditure, therefore, has remained 15-25 percent of total consolidated federal and provincial government expenditures. Within the current expenditures, Defence has pre-empted about one-fourth to one-third of expenditures with the exception of the last few years. Though declining in their share overtime, defence expenditure continued to remain protected in Pakistan. Interest payments, also, have remained protected. These have also historically been close to one-fourth of expenditures, increasing to a maximum of over 40 percent of the current expenditures in 1999-2000. Expenditure on general administration is also non-discretionary and in that respect has a prior lien on public expenditure. This implies that over the last thirty year period, 60 to 70 percent of current expenditures have been pre-empted by three major heads – defence, interest payments and general administration – and therefore not available for provision of services to the citizens.

Table 5.9

Composition of Expenditures by Federal and Provincial Governments

(Rs. Billions)

		As percent of Total Expenditure		As percent of Current Expenditures						
Year	**Consolidated Total Expenditure**	**Development Expenditure**	**Current Expenditure**	**Defence Expenditure**	**Interest Payment**	**Current Subsidies**	**General Administration**	**Social Sectors Expenditure**	**Other Current Expenditure**	**Sum of (5)+(6)+(8)**
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1983-84	100.0	28.1	71.9	37.2	19.7	6.5	8.3	13.6	14.7	65.2
1984-85	116.8	28.3	71.7	38.0	19.7	6.4	7.8	12.5	15.5	65.5
1985-86	134.5	29.6	70.4	37.6	20.8	6.0	7.8	13.1	14.7	66.2
1986-87	152.4	23.8	76.2	35.6	20.6	5.0	8.9	13.3	16.6	65.1
1987-88	180.4	25.9	74.1	35.2	24.9	5.9	6.4	12.9	14.7	66.5
1988-89	201.2	23.9	76.1	33.4	25.0	8.7	6.7	12.6	13.8	65.1
1989-90	218.7	25.1	74.9	35.4	27.7	6.7	6.3	12.0	11.9	69.4
1990-91	261.0	25.0	75.0	33.0	25.6	5.5	6.9	14.4	14.7	65.5
1991-92	321.5	28.4	71.6	32.9	27.2	3.4	7.8	19.7	9.0	67.9
1992-93	348.7	21.9	78.1	32.1	28.9	2.7	7.5	20.0	8.8	68.5
1993-94	364.9	19.6	80.4	31.3	30.9	1.7	8.7	19.3	8.1	70.9
1994-95	428.3	19.2	80.8	30.2	28.1	1.9	9.9	20.0	9.9	68.2
1995-96	518.1	18.2	81.8	28.2	31.3	2.5	11.3	17.5	9.2	70.8
1996-97	540.9	15.8	84.2	28.0	35.3	2.6	10.1	16.1	7.8	73.4
1997-98	634.0	16.4	83.6	25.7	37.0	1.7	11.6	16.0	8.0	74.3
1998-99	647.8	15.5	84.5	26.2	38.9	2.7	12.1	16.5	3.4	77.2
1999-00	709.1	11.7	88.3	24.0	40.9	3.7	11.6	14.4	5.2	76.5
2000-01	717.9	10.1	89.9	20.3	37.1	4.5	15.6	14.0	8.4	73.0
2001-02	826.3	15.3	84.7	21.3	35.8	4.2	13.0	13.0	12.8	70.1
2002-03	898.2	11.9	88.1	20.2	25.3	7.2	12.7	13.4	21.4	58.2
2003-04	956.0	18.9	81.1	23.9	25.3	8.8	15.5	17.3	9.3	64.7
2004-05	1,117.0	22.6	77.4	24.5	24.3	7.7	15.1	17.1	11.3	63.9
2005-06	1,401.9	26.2	73.8	23.3	22.9	9.8	15.8	21.0	7.2	62.0
2006-07	1,800.0	23.6	76.4	18.2	26.8	5.5	16.4	16.9	16.3	61.4
2007-08	2,276.5	18.6	81.4	15.0	26.4	22.9	19.9	15.5	0.4	61.3
2008-09	2,531.3	19.3	80.7	16.2	31.3	11.1	17.1	18.0	6.4	64.6
2009-10	3,007.2	20.7	79.3	15.7	26.9	9.5	14.9	16.9	16.0	57.5
2010-11	3,447.3	14.9	85.1	15.4	23.8	4.6	12.4	15.4	28.5	51.6

Source: Pakistan Economic Survey, Ministry of Finance.
Fiscal Operations, Ministry of Finance.

Expenditure on defence comes out to be roughly three times that on education. Government spending on health, education and debt servicing is presented in Table 5.10. Currently debt servicing accounts for about 5 percent of the country's GDP. Combined expenditure on education and health is only about half of what the government is currently spending on debt servicing. Clearly public debt is diverting the economy's resources away from the provision of basic social necessities to the citizens. Despite being low, expenditure on health and education fail to show consistent rising trend overtime. The consequence is that only about 57 percent of Pakistanis are literate, about half have not been enrolled in schools and colleges, one-fourth of children in rural areas are not fully immunized, about half of pregnant women in rural areas do not have access to pre-natal care, 75 out of the 1000 live births do not live beyond the first year, just over one-third of the population has access to safe drinking water and 50 million Pakistanis are living in abject poverty.

Table 5.10
Government spending on different sectors (as percent of GDP)

Years	Health Expenditure	Expenditure on education	Debt Servicing
2000	-	-	-
2001	0.72	1.82	5.92
2002	0.59	1.79	6.18
2003	0.58	1.86	4.67
2004	0.57	2.2	3.94
2005	0.57	2.15	3.61
2006	0.51	2.24	3.41
2007	0.57	2.5	4.46
2008	0.57	2.47	4.97
2009	0.56	2.1	5.16

Source: Economic Survey

Not only is there evidence that debt servicing is diverting scarce national resources away from social sectors, some of the loan conditions are also disproportionately affecting the poor. For example, one of the conditions of the IMF's SBA focuses on the reduction in the current expenditure through elimination of oil and electricity subsidies. This would lead to electricity and oil becoming expensive. Inflationary pressures are clearly going to hit the poor hardest. The rise in interest rates along with shortages in infrastructure currently gripping the country has dampened chances of Pakistan achieving high growth in the near future. The SBA condition which has led to a decline in development expenditure ensures that a fiscal stimulus can also not be provided to boost the growth rate. The pre-mature end to the SBA can be attributed to the failure of Pakistan to implement the condition relating to the introduction of a broad based VAT on goods and services.

5.4 Pre-emption of Benefits by the Elite

It has been established that the inflow of foreign assistance in the past has been only partially beneficial for Pakistan's economy due to improper allocation to projects and leakages. Another problem which needs some attention is whatever growth has taken place has perhaps disproportionately benefited the richer segments of society. The growth spurt

of the 2000s provides testimony of the enrichment of the elite and neglect of the poor due to the prevailing government policies.

During the years 2002-2006, economic development took place in services sector, principally banking and telecommunication. Other areas which experienced growth were private businesses, particularly real estate. Investments took place in the services sector or in the production of services that neither provided employment for the poor nor helped improve their lifestyles. Table 5.11 shows how the share of services sector increased during the decade. In contrast, the agriculture sector actually decreased from 1999 to 2008, from 27.0 percent to 20.3 percent of GDP. The manufacturing sector also experienced an increase over the period, yet its overall contribution to GDP was low, at about 17 percent.

Table 5.11
Sectoral Shares in Value Added

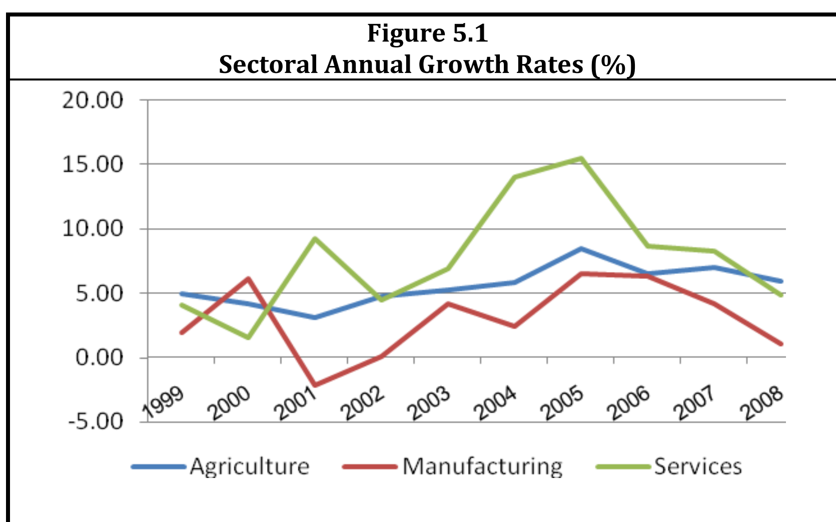
(Percent)

	Agriculture	Manufacturing	Services
1999	27.03	15.48	49.23
2000	25.93	14.68	50.74
2001	24.09	15.50	51.89
2002	23.35	15.50	52.78
2003	23.36	16.00	52.73
2004	22.18	17.19	50.83
2005	21.47	18.56	51.43
2006	20.36	19.15	52.77
2007	20.46	19.03	52.64
2008	20.33	19.66	52.88
2009	21.56	17.09	53.71
2010	21.18	16.84	53.39

Source: World Development Indicators

The declining shares of growth in the agricultural and the manufacturing sectors are explained by the varying growth rate of the sectors, presented in Figure 5.1, the services sector was at its peak during the years of high economic growth, experiencing an increase of up to 15.6 percent in 2005. The agriculture sector barely grew 4 percent in the same time, while the manufacturing sector's growth stalled sharply from 6.09 percent to 0.1 percent and back to 6.48 percent in 2005 before decreasing again to 1.04 percent in 2008.

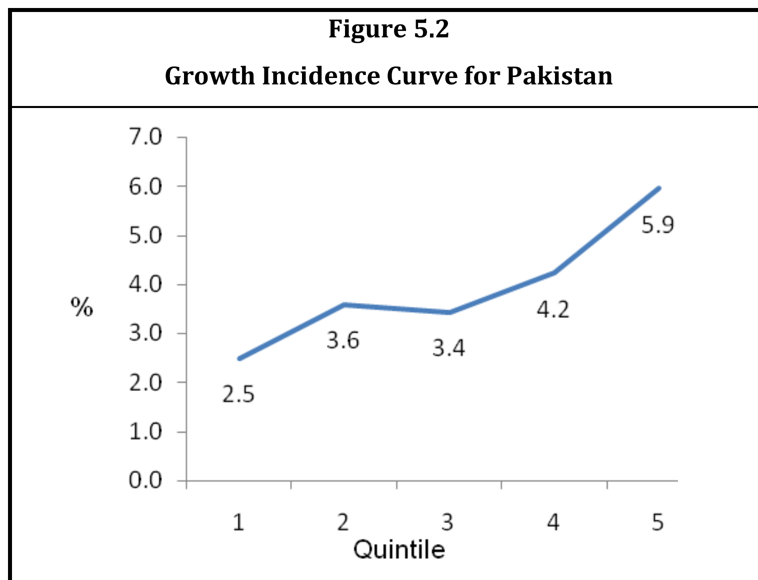
Figure 5.1
Sectoral Annual Growth Rates (%)



The pattern of growth resulted in a worsening of the income divide within the population. The situation can be studied with the help of a Growth Incidence Curve (GIC) for the period 2002-2008, which give the trend in income growth within the rich, middle and poor households, and helps determine whether growth has been higher for some segments of society compared to others.

Figure 5.2

Growth Incidence Curve for Pakistan



The country's population is divided into five income groups, or quintiles, in ascending order of their average income. The slope of the curve indicates the degree of growth experienced by households in each quintile. The rising gradient of the curve implies increasing inequality across the quintiles. The growth rate of the bottom 20 percent of population was the lowest. The curve provides clear insight into the distribution of growth across population in the last millennium (See figure 5.2). The flatness of the curve from the second quintile to the fourth quintile shows that the middle income households falling within this category saw less growth over the years. On the other hand, the richest 20 percent of the population, in the fifth quintile, saw high growth rates.

Further proof of the skewed distribution of economic prosperity and well being is reflected by the high rate of imports during period (discussed in Chapter 4). The consumer items imported during the period were mainly luxury commodities. Such a pattern of trade diverted the economy away from productive investment, and while it may have improved the living standards of the rich it had no significant impact on the poor. Table 5.12 gives a list of the commodities which were imported in the decade. The figures explain the conspicuous consumption of the rich class, with items like textiles and vehicles being particularly notable, collectively costing of over $ 2.4 billion in 2006 and $3 billion in 2010.
One other feature which indicates that the benefits of prosperity brought, in part, by foreign inflows were pre-emptied by the elite is the substitution of domestic public resources. During Musharraf's presidency the government granted citizens with income tax exemptions and wealth tax exemptions. Income tax rates for higher income was brought down the main beneficiaries of such policies were, once again, the elite. Implementation of the policies reduced a substantial amount of potential revenue from the high-income strata

that would have assisted in sustaining the economic growth seen in the 2002-2006 period, and reduced the government's need to rely on foreign inflows.

Table 5.12
Composition of Imports

($ in Millions)

Commodities	2004	2005	2006	2007	2008	2009	2010
Edible Fruits and Nuts	20	48	49	61	67	65	71
Coffee, Tea, Mate and Spices	229	229	245	217	271	267	358
Prepared Foodstuffs; Beverages, Spirits, Vinegar and Tobacco	104	522	921	237	222	382	1045
Textiles and Textile Articles	1117	1051	1147	1483	1869	1297	2008
Footwear, Headgear, Umbrellas, Walking Sticks etc.	8	10	12	13	18	18	24
Vehicles other than Railway/ Tramway Rolling Stock	884	1149	1285	1169	988	689	1039
Optical, Photographic, Cinematographer, Measuring, Checking, Precision Apparatus	300	306	341	370	489	409	303
Miscellaneous Manufactured Articles	40	48	61	69	89	77	92
Works of Arts, Collectors, Pieces, Antiques and Special Transactions NES	655	604	1037	1056	1021	1067	984

Source: State Bank of Pakistan

The statistics show how detrimental the Pakistani government's policies were, as opposed to the India's strategy of using the growth spurt to its advantage. Pakistan's direct tax collection as a percentage of the total taxes actually fell during the period of high growth, particularly between 2003 and 2006. The values rose after 2007, following the change of the government; the highest amount of the direct tax collected as a percentage taxes was 38.5 percent in 2009. In contrast to this, India's direct tax collection smoothly grew over the years, going from 36 percent to 57 percent of total taxes over decade. As consequence, India's tax-to-GDP ratio increased, while Pakistan's fell.

The economic boost in the early years of the decade encouraged investment in the stock market. The banking sector, in particular, brought some sizeable investment through their investment companies. This brought about an increase in the stock market's growth rate from 14 percent in 2001-02 to around 20 percent in 2002-03; and the growth pattern continued till 2006-07.

However this activity was mainly margin trading that caused speculation and over-trading by investors. It created an artificial boom in the market, which further encouraged banks to engage in consumer financing. While this did benefit certain consumer goods sectors, the overall effect of the stock market bubble was detrimental to many companies. When the

rates eventually fell, investors – particularly those with small investors – who had over extended their positions, experienced heavy losses. While corporate profits rose for some companies, small investors only achieved temporary benefits as the increased stock prices were artificially inflated. Similar to the stock market bubble, real estate also experienced a boom in the urban sector. Clearly the main beneficiaries of this situation were the elite who were able to engage in increased consumption spending on luxury goods and services.

To conclude, although Pakistan is not eligible for the HIPC initiative, a case for its debt relief can be based on other international schemes which include:

- **Post-Catastrophe Initiative** which recommends that the International Monetary Fund (IMF) – Pakistan's largest creditor – considers debt cancellation for poor countries in which natural disasters have created substantial balance of payment needs and where the resources freed up by debt relief are critical for meeting these needs. The country has been afflicted with severe natural disasters that included devastating drought, cyclone, earth quake and floods.

- **State of Necessity** which is a principle enunciated by the International Human Rights Commission, suggests that indebted countries placed in a situation that makes it impossible for them to fulfil the very basic needs of their populations (health, education, food, water, housing, etc) have a right to repudiate debts and structural adjustment programmes. A similar position has also been taken by the UN Commission on International Law.

- **Pakistan's contribution to global security and the impact of the war in Afghanistan** has taken an enormous and disproportionate toll on the country's finances, and economic and social development. The total economic cost is estimated to be in the region of $17 billion annually.

- **Illegitimate Debts** exist where loans have been granted to repressive regimes and/or where the money was used to fund projects which did nothing to benefit ordinary people but rather served to increase corruption and improper patronage. Debt relief has always focused on the borrower; it can be argued that non-payment of illegitimate debt is necessary to discipline lenders and prevent future lending to oppressive dictators. Clearly a significant proportion of Pakistan's external loans were obtained during the dictatorial regimes of Generals Zia ul Haq and Parvez Musharraf, as highlighted in section 2.7.

Chapter 6
Policy Recommendations:
Potential Mechanisms of Debt Relief to Pakistan

We come to the final chapter which focuses on the set of policy recommendations for debt relief to Pakistan. Section 6.1 discusses whether Pakistan needs debt relief or not. Section6.2 highlights the historical experience of Pakistan with debt relief. Section 6.3 presents the case for debt repudiation, followed in Section 6.4 by estimation of benefits to Pakistan of seeking debt relief from the Paris Club. Section 6.5 explores the scope for currency swap agreements. Section 6.6 examines the implications of seeking a debt rollover, especially from the IMF, and the impact of potential conditions in such an arrangement. Finally, in Section 6.7 the key elements of the recommended strategy are outlined.

6.1. Does Pakistan need Debt Relief?

Chapter 2 has demonstrated that the indicators of debt sustainability have shown improvement and do not yet contain any warning signals. **Prima facie,** in the face of these indicators Pakistan is not a candidate for debt relief. But what is not so visible is that the foreign exchange reserves of the country have been artificially bolstered by the substantial amount of IMF money parked with the Central Bank, which has almost trebled reserves. As of 1 March 2012 if the quantum of IMF loans is excluded the net reserves of SBP stand at about $3 billion, less than one month of imports.

Also, the time has come to repay the IMF loan under the SBA, between 2011-12 and 2014-15. The repayment is $ 1.2 billion in 2011-12, $ 3.0 billion in 2012-13, $ 3.4 billion in 2013-14 and $ 1.4 billion in 2014-15, leading to substantial enhancement in debt repayment by more than twice the normal levels during these years. The balance of payments projections in the business as usual scenario, presented in Chapter 3, indicate that the import cover ratio of reserves could fall below one month by the end of 2012-13, that is, in the next fifteen months. Pakistan could enter a period of great financial difficulties with depletion of reserves along with the plummeting of the rupee.

The prospects of enhanced capital inflows in the short run are not good because of, first, the premature exit from the IMF program in October 2011, due to failure to implement some key conditions and, second, in view of the currently strained relations with the US. Already, there are some initial indications of a flight of capital as demonstrated by negative portfolio flows and FDI has collapsed to a very low level. Further, the currency has depreciated by Rs 5 to the dollar, equivalent to a devaluation of 6 percent in the last eight months.

Therefore, in view of impending developments, Pakistan has to begin exploring avenues of debt relief before conditions become very difficult and a rapidly depreciating currency leads to an upsurge in the rate of inflation, thereby imposing hardships on the people. It is essential for early action on this front because the government is otherwise preoccupied with the election process, with elections due by March 2013.

6.2. Historical Experience of Debt Relief

Pakistan generally has a good record of servicing its external debt obligations. The only period in which the country had difficulty in making the due payments is after the imposition of sanctions following the nuclear blasts in May 1998, in reaction to earlier blasts by India. Pakistan's reserves were low at that time at below $1 billion and were further depleted by withdrawal from FCAs. Pakistan was operating under the Enhanced Structural Adjustment Facility (ESAF) with the IMF. This facility was suspended by the Fund under US pressure.

Pakistan was left with no option but to make exceptional financing arrangements with creditors in the form of accumulation of arrears. These amounted annually to $3.9 billion in 1998-99 and 1999-2000 respectively, $0.7 billion in 2001-02 and $0.1 billion in 2002-03. However, provision was made for deposit of the rupee equivalent of the arrears with SBP so that in budgetary terms there was no reduction in debt servicing obligations. The expectation was that the rupee accounts deposited would be converted at an appropriate time. This is what happened in 2003-04, when there was a large outflow on the public account.

Simultaneously, Pakistan received some cash support from Islamic countries like Kuwait and a large oil facility with Saudi Arabia which helped in containing the oil import bill. Pakistan adopted a series of policy measures including a dual exchange rate regime, large margin requirements on imports, taxation of petroleum products, deferment of public sector imports, etc.

Subsequently, Pakistan also sought some relief from bilaterals who are members of the Paris Club. This could be attempted only after the resumption of a relationship with the IMF in the form of the PRGF. The participating creditor countries decided to grant cash-flow relief between November 30, 2001 and November 2002 to the maturity of cut-off date debts as well as the interest payments due on the restructured amounts. During the following two years, 20 percent of interest payments were also deferred. This represented cash-flow relief of about $250 million annually. It was also expected that debt swap agreements would be reached by individual bilaterals.

6.3. The Case for Debt Repudiation

The basic question is what are the benefits and costs to Pakistan of adopting a policy of debt repudiation, say after 2012-13. Debt repudiation emerges as an option when net capital inflows become negative and the country could apparently save foreign exchange under such a policy. Pakistan is rapidly approaching this position. Table 6.1 indicates that the net inflow could become negative in 2011-12. The net inflow is defined as gross disbursement of external funds less the debt servicing liabilities. Therefore, examination of this extreme option has become relevant. Pakistan is effectively in a "debt trap", whereby new loans have to be taken to repay old loans.

Pakistan, of course, can argue (as done in detail in Chapter 5) that the country is paying a high cost for pursuing the global war in terror and that the support from the international community is only a small fraction of this cost. For example, the Friends of Pakistan have not honoured the commitments they made in Tokyo in 2009. If the country collapses financially then this could strengthen the extremists and militant elements. Also, Pakistan has faced a series of mega natural disasters including the earthquake in 2005 and the devastating floods in 2010 and 2011. Further, the present democratically elected government can legitimately argue that the funds received during the military regimes (especially in the Zia ulHaq and Musharraf eras) were primarily for security purposes and not for development. These funds were also pre-empted largely by the elite and, therefore, there exists a strong case for these loans to be written off. In effect, it needs to be recognized that the country is too large and of too much strategic importance to be allowed to implode.

But there are well-defined costs of debt repudiation. Pakistan has always prided itself in honoring its external debt obligations and the only time it has technically defaulted is when sanctions were imposed on it. However, perceptions about Pakistan generally are already quite negative internationally and there is the likelihood that debt repudiation would lead to Pakistan being declared a 'failed state'. This would imply a drying of other inflows, including FDI, and heightened perceptions of risk could motivate a large-scale capital flight from the country, not only of portfolio money but also by the liquidation of assets by MNCs. Access to international capital markets would be precluded for a long time. The substantial transfer of home remittances by expatriate workers could also be affected, as happened for some time after 1998. Further, it would become difficult to conduct normal international trade transactions (due to difficulty in opening LCs for imports) leading to shortages of essential commodities within the country. Overall, the costs of debt repudiation are potentially very high and this should be considered only as the last option. But the threat of

default can be used as leverage to force creditors to negotiate debt relief, especially given Pakistan's geopolitical importance in the global war on terror.

Table 6.1
Trend in Gross and Net Aid Inflow to the Government*

($ Million)

	Gross Disbursements	Debt Repayment	Interest Payment	Net[a] Inflow as % of Gross Inflow (1)	Net[b] Inflow as % of Gross Inflow (2)
1969-70	564	105	71	81.4	68.8
1979-80	1470	350	234	76.2	60.3
1989-90	2342	741	491	68.4	47.4
1999-2000	1490	893	508	40.0	6.0
2000-01	1846	974	583	47.2	15.7
2001-02	2423	745	462	69.3	50.2
2002-03	1729	793	546	54.1	22.6
2003-04	1372	2336	659	-70.3	-118.3
2004-05	2452	871	600	64.5	40.0
2005-06	3163	982	599	69.0	50.0
2006-07	3356	968	644	71.1	52.0
2007-08	3160	1062	704	66.4	44.1
2008-09	4032	2195	693	45.5	28.4
2009-10*	3921	1767	845	54.9	33.4
2010-11*	2979	1491	870	49.9	20.7
2011-12**	3156	2672	838	15.3	-11.2

Source: Pakistan Economic Survey
* from Federal Budget Documents
** as contained in the Federal Budget of 2011-12
[a] Net Inflow = Debt Disbursement – Repayment
[b] Net Inflow = Debt Disbursement – Repayment – interest Payment

Borensztein and Panizza (2008) have identified the costs of sovereign default in an IMF Working Paper as reputational costs, international trade exclusion costs, political costs to the authorities and costs to the domestic financial system. The costs of debt repudiation are high for Pakistan in terms of, first, the reputational risk. There is a growing perception internationally that Pakistan is a "failing state" and if we dishonour our debt repayment obligations then in all likelihood we will be declared a "failed state" and become completely isolated. Second, the risk of a breakdown in our international trade is very high and if we are unable to import essential commodities like food, oil, medicines, fertilizer, etc., then the negative impact on the economy and on the quality of life of the people could be very high. This could lead to anarchy and chaos, some of which we are already seeing in the large-scale power riots in the country, which will provide fertile ground for increased activity by the militants and extremists.

6.4. Debt Relief by Paris Club

The outstanding debt currently with the bilaterals in the Paris Club is $15.4 billion, equivalent to 29 percent of the total debt. The Paris Club has developed a new approach, called the Evian approach to deal with non-HIPC countries like Pakistan.

Paris Club creditors have agreed to adopt a more tailored response to ensure that debt restructuring:

- is granted only in case of imminent default and is not considered by debtor countries as an alternative to more expensive sources of financing;
- provides debtor countries with a debt treatment that reflects their financial needs and the objective of ensuring long lasting debt sustainability

When a country approaches the Paris Club, the sustainability of its debt would be examined in coordination with the IMF according to its standard debt sustainability analysis to see whether there might be a sustainability concerns in addition to financing needs. Specific attention would be paid on the evolution of debt ratios over time as well as on the debtor country's economic potential; its efforts to adjust fiscal policy; the existence, durability and magnitude of an external shock; the assumptions and variables underlying the IMF baseline scenario; the debtor's previous recourse to Paris Club and the likelihood of future recourse. If a sustainability issue is identified, Paris Club creditors will develop their own view on the debt sustainability analysis in close coordination with the IMF.

For countries who face a liquidity problem but are considered to be on a sustainable debt path, the Paris Club would design debt treatments on the basis of the existing terms. However, Paris Club creditors agree that all the range of options should be built-into the terms, including through shorter grace period and maturities, would be used to adapt the debt treatment to the financial situation of the debtor country. Countries with the most serious debt problems will be dealt more effectively under the new options for debt treatment. For other countries, the most generous implementation of existing terms would only be used when justified.

For countries whose debt has been assessed by the IMF and the Paris Club creditor countries as unsustainable, who are committed to the policies that will secure an exit from the Paris Club in the framework of their IMF arrangements, and who will seek comparable treatment from their other external creditors, including the private sector, Paris Club creditors have agreed that they will participate in a comprehensive debt treatment exercise. However, according to usual Paris Club practices, eligibility to a comprehensive debt treatment is to be decided on a case-by-case basis.

In such cases, debt treatment would be delivered according to a specific process designed to maintain a strong link with economic performance and public debt management. The process could have three stages. In the first stage, the country would have first an IMF arrangement and the Paris Club would grant a flow treatment. This stage, whose length could range from one to three years according to the past performance of the debtor country, would enable the debtor country to establish a satisfactory track record in implementing an IMF program and in paying Paris Club creditors. In the second stage, the country would have a second agreement with the IMF and could receive the first phase of an exit treatment granted by the Paris Club. In the third stage, the Paris Club could complete the exit treatment based on the full implementation of the successor IMF program and a satisfactory payment record with the Paris Club. The country would thus only fully benefit from the exit if it maintains its track record over time.

In this context, coordination between official and other creditors, notably private creditors, is particularly important. The Paris Club has taken a number of steps to increase transparency of its procedures over the past years, notably through meetings with private sector representatives and better information provided on its web site; it will continue to explore ways to enhance its transparency. In addition, the dialogue should continue and could take the form of early discussions with the private sector on the issue of the comparability of treatment of their respective claims. Such early discussions could take place when the share of private external debt is considered as significant, comparability of treatment constitutes an issue, when private creditors indicate their willingness to participate in the restoration of debt sustainability in good faith and when comprehensive debt treatment in envisaged.

As identified above, for Pakistan to qualify for special treatment by the Paris Club it has to fulfill two conditions, first, it must be close to default and, second, it must have an operative program with the IMF with an agreed framework for policy actions and key targets. Also, while the share of debt with bilaterals in the Paris Club is relatively large, the potential maximum cash relief annually is about $500 million, equivalent to only 13 percent of the total external debt servicing liability.

6.5. Currency Swaps

Currency swaps have emerged as a promising, although limited, sources for providing relief to a country's foreign exchange resources. Recently, Pakistan has signed a significant currency swap arrangement with China after such an agreement, albeit smaller, with Turkey. The advantages of a currency swap arrangement are that it could not only enhance bilateral trade but also the prospect of increasing investment in the country. The CSA with

China has been executed for a tenor of three years in respective local currencies, Pakistani rupee of Rs 140 billion and Chinese Yuan of 10 billion (equivalent to $1.5 billion).

Since the CSA is a bilateral financial transaction, all terms & conditions apply equally to both countries and the pricing is based on standard market benchmarks which are widely acceptable in the respective domestic markets of the two countries. The following are more details on the structure of the transaction:

1. Both Central Banks will have the ability to draw on the swap line any time during the tenor of the swap.
2. SBP can purchase CNY from PBC against its local currency (PKR), and repurchase its local currency with the same CNY on a predetermined maturity date and exchange rate. Similarly PBC can also purchase PKR against CNY. Standard market pricing will apply on the date of utilization. Like any swap, the pricing is linked to interest rates differentials between the two currencies.
3. However, drawing under the swap line by either central bank will be contingent in 1) bilateral trade being denominated in local currencies, or 2) financing of direct investment between the two currencies.

China has significant investments in various projects in Pakistan and rupee proceeds of the swap can be channelized to such long term projects in Pakistan via Chinese banks.

6.6. Debt Rollover

The case for debt rollover is strong in the event of a severe bunching of future debt service payments as will happen in the case of Pakistan from 2011-12 to 2014-15, due to repayment of funds obtained from the IMF under the last SBA. Therefore, a debt rollover can primarily serve the purpose of smoothing over time the debt service payments and stretching them over a longer period while serious reforms are undertaken to increase the capacity to service debt in future years.

Debt servicing will peak in 2012-13 and 2013-14. Therefore, it may become essential for Pakistan to reenter into negotiations with IMF on a new facility, preferably by late 2012. The IMF staff assessment report of February 27, 2012, following the Article IV consultation states the following:

> "Pakistan's recent economic performance and prospects have suffered from difficult political and security conditions, natural disasters, and shortcomings in the institutions and policy framework ……................"

IMF sees the outlook for Pakistan's economy as follows:

> **"On current policies, Pakistan's near- and medium-term prospects are not good .... There are considerable downside risks to the sombre baseline"**

The Fund has identified a series of critical policy actions and structural reforms for medium-run prospects are to improve. These are listed below:

i. Devaluation to the extent of about 10%
ii. Restoration of recent tax exemptions, rate reductions and zero rating like reintroducing the special excise duty and income tax surcharge and raising the sales tax rate.
iii. Reduction in non-wage current expenditure; reduction of non-power subsidies (e.g. wheat, fertilizers)
iv. Minimize the electricity subsidy
v. Keep provincial budgets in surplus
vi. Another attempt to implement the reformed and integrated GST
vii. Adopt a broader income tax regime and property taxes
viii. Phase out of commodity operations
ix. Extend debt maturities
x. Greater autonomy of SBP
xi. Problem of rising NPLs, strengthening of regulations and restructuring of weak banks; establishment of courts to speed up recovery of loans
xii. Privatisation of loss-making PSEs

Therefore, before agreeing to a new SBA the Fund may insist on some prior actions like a devaluation of the currency, taxation measures and a hike in interest rates. This is likely in view of the low level of credibility of Pakistan, as indicated by the failure to meet its commitments for reform in the previous SBA.

Our estimates are that the size of the SBA would have to about $4 billion to ensure a smoothing out of the net debt repayments to the IMF of about $1.5 billion annually, which is considered as sustainable in light of the BOP projections. Also, this will lead to a stretching out of the repayments from four to eight years.

The debt rollover option is perhaps the most feasible option and promises substantially more financing than other options like going back to Paris Club or currency swap arrangements. However, it runs the risk of imposing severe hardships, in the process of fulfilment of the conditions, on the people of Pakistan who have already seen almost five years of rising levels of depravation and poverty in the presence of double-digit inflation and low growth in real incomes.

Therefore, any future IMF program must have a **human face** and impose the burden of adjustment on richer sections of society. This will include, first, enhancement in the levy of direct taxes on income and property, with broad-basing particularly to agricultural incomes and improvements in the quality of tax administration to reduce evasion. Second, indirect taxes need to be extended to sectors with progressive incidence like selected services. Third, extravagance and waste in public expenditure must be removed. Fourth, the large subsidies in the power sector have to be better targeted. Also, any withdrawal in the wheat subsidy will have to be complemented by a larger social protection program. Fifth, the need for a large devaluation of the rupee could be reduced by imposition of larger margins for financing and regulatory duties on non-essential imports. Sixth, sub-national governments will have to display fiscal prudence and demonstrate greater efficiency in the delivery of basic services. Finally, privatisation of less-making PSEs, leading to large-scale retrenchment of workers, must be accompanied by proper severance payments.

6.7 Conclusions

In conclusion, we hope that Pakistan can avoid reaching a position of external debt unsustainability in the next few years. If, however, seeking debt relief becomes inevitable then the most feasible option appears to be to go back to IMF, the international lender of last resort, to achieve effectively a debt rollover. This also has the potential of providing substantial cash-relief. The presence of an IMF program will also increase the probability of other arrangements like larger program funding from other multilaterals, relief from the Paris Club and currency swap agreements. Of course, Pakistan will welcome and appreciate voluntary debt cancellation by creditors in view of the persuasive case made in Chapter 5 and its geo-political importance.

In the breathing space provided by the debt rollover, as emphasized earlier, a strong and wide ranging reform agenda must be implemented which imposes most of the adjustment burden on the richer segment of society. This agenda will include proper valuation of the rupee, cutback on luxury imports through an enhancement in import margin requirements and imposition of regulatory duties, reduction in imports of arms and equipment by the defence establishment, resort to more progressive taxation, broad basing of direct taxes, elimination of exemptions and concessions in the tax system, strong measures to curb tax evasion, enhance accountability and transparency while bringing back money made through corruption held abroad, impose austerity in public expenditure, restructure public enterprises, implement priority projects in the power and water sectors, expand targeted programs of social protection for the poor and so on. Unless this agenda is implemented with strong commitment and effectiveness Pakistan will merely postpone temporarily the day of reckoning.

Appendix

Appendix A2.1: Net Bilateral Aid flows from DAC Donors

(Million USD)

Donor	Australia	Austria	Belgium	Canada	EU Institutes	Switzer-land	Germany	Denmark	Spain	Finland	France	UK	Greece	Ireland	Italy	Japan	Luxembourg	Holland	Norway	New Zealand	Portugal	Sweden	US	Total
1970	2.08	4.66	2.1	44.9	4.12	0.37	37.29	1	0	0	2.8	21.4	0	0	0.02	39.55	0	4.23	3.06	0	0	10.07	211	389
1971	1.27	0.06	2.2	34.73	4.08	0.87	66.8	1.75	0	0.2	3.6	18.29	0	0	16.8	35.03	0	1.85	0.16	0	0	9.08	168	365
1972	1.61	0	0.48	14.46	2.51	1.75	41.61	0.81	0	0	1.16	17.85	0	0	36.91	5.97	0	1.61	0.18	0.16	0	1.17	149	277
1973	2.55	0	5.24	18.83	6.47	0.63	6.63	2.95	0	0.03	2.1	10.77	0	0	16.89	14.28	0	4.57	1.72	0.15	0	0.56	120	214
1974	9.09	0.69	5.83	31.41	11.35	0.43	76.4	1.11	0	0	8.08	14.34	0	0	0.04	25.31	0	14.86	4.34	0.03	0	0.2	73	277
1975	4.13	-0.69	4.26	64.56	24.61	12.19	51.22	1.32	0	0.03	18.14	14.55	0	0	9.61	18.53	0	11.07	6.08	1.57	0	4.56	154	400
1976	5.23	1.74	4.2	35.72	9.81	14.52	-8.25	0.34	0	0.03	28.3	15.16	0	0	5.2	17.52	0	19.59	7.09	0.4	0	2.45	203	362
1977	3.11	0.38	0.09	67.53	8.85	3.84	38.54	1.82	0	0	21.7	24.95	0	0	4.59	28.72	0	28.71	7.37	0.07	0	2.33	88	331
1978	3.55	0.18	4.76	73.23	14.16	3.31	42.6	2.88	0	0	24.95	30.05	0	0	7.02	46.89	0	36.85	13.17	0.02	0	9.95	80	394
1979	5.63	0.12	5.15	55.69	18.51	0.51	19.1	25.09	0	0.01	14.82	48.12	0	0	0.46	168.3	0	23.58	13.41	0.02	0	9.68	29	436
1980	6.57	0.09	5.02	28.41	13.79	1.31	25.68	2.67	0	0.13	14.2	43.7	0	0	-2.9	112.4	0	31.24	16.46	0.02	0	12.15	42	353
1981	17.17	0.12	-0.2	51.56	22.32	2	33.51	3.49	0	0.16	16.91	42.71	0	0	-0.81	117.7	0	20.91	13.29	0.02	0	10.65	92	444
1982	4.63	0.11	-0.24	48.48	0.78	3.43	30.52	1.48	0	0.29	23.89	25.57	0	0	-2.37	95.28	0	34.69	13.27	0.01	0	9.31	112	401
1983	6.69	0.12	-0.39	55.02	8.54	1.89	9.05	0.11	0	0.14	10.05	18.09	0	0	-0.42	72.77	0	9	11.95	0.02	0	1.02	59	263
1984	0.76	0.09	6.37	53.69	11.25	5.22	34.6	0	0	0.17	8.17	17.8	0	0	0.27	67.03	0	10.19	11.12	0.02	0	0.71	87	314
1985	3.62	0.09	-0.2	58.44	1.01	3.79	73.99	-0.25	0	0.35	5.44	15.4	0	0	4.58	93.31	0	14.08	9.79	0.01	0	1.42	144	429
1986	0.54	0.24	-1.01	44.36	8.3	5.33	74.89	-0.26	0	0.27	15.11	23.5	0	0	62.65	151.5	0	23.03	15.18	0.04	0	0.97	194	619
1987	0.58	0.5	0.3	37.99	4.61	11.6	50.5	-0.25	0	0.56	34.06	29.3	0	0.01	16.05	126.6	0	27.94	10.71	0.03	0	4.16	90	445
1988	0.75	0.31	-1.65	64.4	1.88	6.59	96.56	-0.28	0	0.47	60.7	33.78	0	0.01	59	302.1	0	27.18	10.79	0.01	0	3.9	339	1006
1989	5.44	0.62	-1.69	35.31	12.85	5.8	54.22	-0.94	0.01	0.93	19.52	41.38	0	0	36.26	177.4	0	26.61	7.32	0.02	0	10.9	263	696
1990	8.25	2.69	0.55	28.43	15.1	9.62	124.1	-0.8	0	2.26	5.67	54.4	0	0	13.79	193.5	0	26.83	14.95	0.1	0	2.15	167	669
1991	4.94	5.58	3.73	39.35	24.97	13.99	79.26	0.25	0.06	2.1	-0.81	40.54	0	0.02	-2.64	127.3	0	29.6	10.96	0.04	0	3.14	114	497
1992	3.48	1.38	-0.62	21.99	30.58	18.06	79.64	-1.68	0	1.57	40.28	33.03	0	0.08	-3.13	173.3	0	36.32	23.78	0.09	0	2.84	39	501
1993	3.77	1.85	-1.57	10.08	22.75	11.68	38.51	-1.03	0	0.57	75.3	31.3	0	0.04	44.55	188.4	0	21.13	8.22	0.09	0	3.29	54	513
1994	5.77	0.95	6.86	4.55	18.72	14.41	86.54	-0.58	0	0.58	105.7	36.47	0	0.04	-4.03	271.0	0	19.33	10.27	0.14	0	3.41	-53	528
1995	4.45	1.41	-2.71	3.25	12.56	12.73	21.43	3.31	10.64	1.63	38.94	53.07	0	0.09	4.44	241.0	0	26.38	8.43	0.14	0	13.4	-82	373
1996	4.03	0.23	-5.48	9.65	28.36	13.66	15.82	3.23	21.97	1.51	5.35	61.36	0	0.18	-4.9	282.2	0	15.85	6.79	0.2	0	7.91	-101	367
1997	1.81	0.24	-2.33	18.01	21.84	10.13	-26.5	-2.65	5.36	1.24	-5.06	42.51	0.03	0.21	-6.13	92.16	0	17.24	6.41	0.25	0	1.75	-76	101
1998	1.84	0.7	0.08	16.09	19.2	10.06	-21.2	-0.17	3.95	0.98	9.08	46.36	0.05	0.07	-8.4	491.5	0	16.8	5.33	0.32	0	2.01	-40.7	557
1999	2.01	2.42	0.08	12.08	19.82	8.75	83.43	-1.5	4.88	1.03	8.17	39.48	0.03	0.1	0.37	169.7	0	23.21	4.65	0.14	0	1.19	74.9	456
2000	2.02	1.12	0.07	13.07	33.05	8.9	2.43	-0.14	0.79	1.03	19.63	23.72	0.11	0.08	5.78	280.3	0	19.06	6.67	0.22	0	1.68	88.4	509
2001	2.16	1.19	0.07	13.92	49.95	8.91	20.1	-0.76	3.55	0.87	13.85	27.39	0.14	0.11	6.55	211.4	0.22	17.95	5.51	0.25	0	1.06	775.6	1,164
2002	1.53	0.69	0.82	7.77	42.64	9.87	76.18	-1.19	0.74	1.14	2.45	66.9	0.07	0.64	0.31	301.2	0	12.2	10.28	0.39	0	1.56	208.9	745
2003	3.26	1.13	0.06	13.25	33.37	13.28	-4.66	-7.9	0.92	1.06	11.73	112.1	0.34	0.57	3.81	266.2	0	6.87	9.96	0.4	0	1.56	102.2	571
2004	4.82	1.8	0.06	15.53	43.1	12.78	20.41	-0.45	0.07	0.88	5.11	90.82	0.28	0.77	0.09	134.1	0	7.85	8.1	0.22	0	2.06	76.9	426
2005	17.31	6.9	1.02	51.08	43.02	19.4	34.11	4.21	4.6	13.29	19.68	63.12	3.81	10.83	-0.8	73.78	4.35	43.13	82.68	1.76	0.01	9.14	323	833
2006	29.4	1.79	4.99	43.44	57.86	17.67	59.47	-4.52	0.43	9.89	15.83	203.2	0.59	3.98	3.07	225.1	1.13	20.77	18.67	0.6	0	11.77	477.7	1,207
2007	9.7	2.72	1.19	44.71	67.86	17.16	62.43	-0.44	5.67	7.57	52.44	197.8	0.93	2.73	2.73	53.24	0.43	36.19	30.82	0.59	0	14.18	433.5	1,048
2008	27.13	3.58	0.53	41.56	62.67	17.01	89.03	0.01	3.28	2.36	9.37	260.3	0.34	2.7	3.87	34.24	0.61	31.14	29.84	0.21	0	8.97	350.6	981
2009	42.21	3.17	2.68	41.88	97.63	19.02	107.4	4.76	13.68	8.14	8.75	217.5	1.14	3.36	9.08	131.4	1.51	38.94	46.57	0.77	0	13.59	613.0	1,428

Source: World Development Indicators 2010

Appendix A2.2
Loan Conditions of Multilateral Organisations

IMF's Conditions on the Stand-By Agreement of 2008-09	
Type of Reform	***Conditions***
Fiscal Consolidation	• Reduction of fiscal deficit from 7.4percent of the GDP in 2007-08 to 4.2 percent by 2009 and to 3.3 percent by 2010; via the following measures: o Increase in tax revenue by 0.6 percentage points of the GDP, o Increase in the average base tariff. o Reduction in non-interest current expenditure, by eliminating oil and electricity subsidies o Reduction in domestically-financed development spending through better project prioritization. • Further reduction in the fiscal deficit to 2–2½ percent of the GDP by 2012-13, by increasing tax revenue further.
Increasing Tax Revenue	• Establishment of an integrated tax administration organization at the Federal Board of Revenue (FBR) integrating both the income tax and sales tax administration. • Audits to be reintroduced as part of a risk-based audit strategy. • Harmonize income tax and GST laws, including for tax administration purposes, and reduce exemptions for both taxes • Excises on tobacco to be increased in the context of the 2009-10 budget. • Implementation of a full VAT with minimal exemptions
Fiscal Borrowing	• Limiting SBP financing of the budget to zero on a cumulative basis during 2008-09 • The fiscal deficit would be fully financed by: o Available external disbursements; o The acceleration of the privatization process; o Issuance of treasury bills; o Other domestic financing instruments such as National Savings Scheme (NSS).
Social Protection	• Introduction of a social safety net to protect vulnerable groups that might be adversely affected by the economic slowdown. • The increase in social safety net spending from 0.6 percentage points of GDP, to 0.9 percent of GDP • With the World Bank assistance, the government would prepare an action plan for the adoption of specific measures by March 2009
Tightening of Monetary Policy	• State Bank of Pakistan would increase the discount rate to 15 percent • Bringing inflation rates, and allowing the government to place T-bills and other securities with commercial banks in order to avoid further central bank financing of the budget.
Flexible Exchange Rate Policy	• The foreign exchange market would be designed to meet the program's reserve targets (including the provision of foreign exchange for oil imports) • Phasing out SBP's provision of foreign exchange for oil imports • Elimination of all exchange restrictions o No new exchange restrictions or multiple currency practices will be introduced
Source: IMF (2008)	

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