Policy Research Institute of Market Economy

آزادمعیشت۔خوشحال پاکستان

Prime Report

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Debt without Growth

Despite some reforms, Pakistan's economy on the track of high inflation, low growth and unsustainable debt.

Key Points

Positives	*Negatives*
• ***The government has stopped borrowing from the State Bank***	• ***Federal government violated three out of four provisions of FRDL***
• ***Re-profiling of domestic debt will help in managing public finances***	• ***Debt sustainability has deteriorated***

Introduction

Last month marked slightly over two years since the Pakistan Tehreek-e-Insaf (PTI) government was elected on the back of a transformative agenda, which aimed at eliminating structural inefficiencies in the economy. When the incumbent government came to power, the country was heavily indebted. One of the electoral promises was to reduce the debt burden. In this regard, PRIME is issuing a short report on assessing government's two-year performance in the domain of Public Debt.

Foreign Debt

External debt sustainability indicators witnessed deterioration.

Over the course of two years, Pakistan's foreign debt and liabilities have increased from $95.2 bn to $112.8 bn, an addition of $17.6 bn or 18.5 percent.[1] External public debt is recorded at $78 bn at end-June 2020 showing an increase of $4.5 bn during FY20. The pandemic caused the government to borrow an additional $3.7 bn worth of grants and loans from various countries to support the country's corona relief efforts. Despite paying $24.5 bn in interest and principal loans over the past two years, the foreign debt and liabilities continue to surge, suggesting the possibility of slipping into a debt trap. The overall rise is mainly attributable to current account deficit financing, increased debt servicing and depreciation of rupee, all of which have exposed the country to exchange rate risks.

1 *All quoted figures have been retrieved from State Bank of Pakistan and Debt Policy Coordination Office, Ministry of Finance.*

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During FY19 and FY20, the country received $16 bn and $13.2 bn worth of gross loans from bilateral and multilateral lenders including the International Monetary Fund (IMF) and commercial creditors. Borrowing from multilateral and bilateral sources still constitute 82 percent of external public debt portfolio as of end June 2020. Nonetheless, the second year of PTI government did witness a reduction in external borrowings.

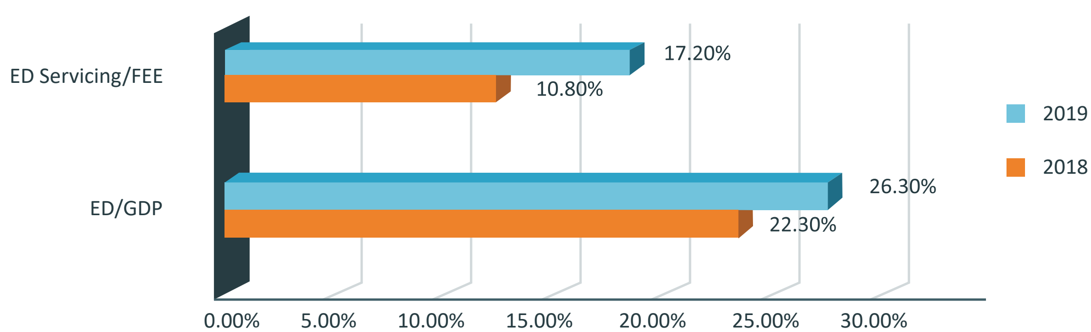
The PTI government, like its predecessors, has not been able to fully capitalize on non-debt creating inflows like exports, remittances and foreign direct investment. Consequently, debt servicing remains the largest expense in the federal budget. The government paid $11.9 bn in external debt servicing during FY20 which is 23 percent higher than the amount paid in FY19.

It is pertinent to mention that ever since the PTI government came to power, Pakistani rupee depreciated by 39 percent as a result of a move towards market exchange rate as part of the IMF programme. The weakening of rupee however, has increased the burden of foreign debt and liabilities. Each rupee loss vis-a-vis the US dollar adds around Rs. 100 bn to the debt stock. Between April 2019 and June 2020, the rupee lost over 25 rupees which raised the debt repayments by Rs. 2.5 tn.

It is interesting to note that in the previous Medium-Term Debt Management Strategy (MTDS) (FY16-FY19), the maximum threshold of external debt's share in total public debt was set at 35 percent. However, the PTI-led government has revised the benchmark to 40 percent in the new Medium-Term Debt Management Strategy (FY20-FY23). This reflects deterioration in other sources of foreign exchange earnings such as exports, remittances and foreign direct investment which will increase government's reliance on external debt.

Within two years, the share of external public debt in total debt increased from 32.2 percent to 36 percent. Although the government remains within the fixed thresholds of the MTDS (FY20-FY23), the risk indicators are certainly moving towards the upper limit. As far as external debt sustainability is concerned (refer to Figure 1), both the debt bearing and debt servicing capacity has deteriorated.

Figure 1: External Debt Sustainability Indicators



Note: ED = External Debt, FEE = Foreign Exchange Earnings
Source: Debt Policy Coordination Office, Ministry of Finance

Domestic Debt

Re-profiling of domestic debt portfolio curbed refinancing risk.

Public domestic debt increased from Rs. 16.4 tn to Rs. 23.3 tn between FY18 and FY20 while its share in total public debt increased to 64 percent. Domestic debt servicing increased by almost 29 percent during the two years of PTI-government. The cost of domestic debt servicing also witnessed a spike owing to the tight monetary policy stance which was adopted to ease depreciation and inflationary pressures.

One of the notable developments from debt management perspective in FY19 was the reprofiling of domestic debt, where government re-profiled the existing stock of State Bank of Pakistan (SBP) borrowing from short-term (6 months), medium-term and long-term (1 to 10 years). The re-profiling helped the government in reducing the rollover or refinancing risk of its domestic debt portfolio. Concurrently, a policy decision was taken to terminate borrowing from SBP. This stance was lauded by IMF since it demonstrated government's commitment to increased fiscal discipline and macroeconomic stability. So far Government has retired SBP's credit worth Rs.435 bn. It is hoped that the PTI continues with this policy throughout its term and future governments also adhere to it.

Due to re-profiling, average time to maturity of domestic debt portfolio significantly increased to 4.2 years at end June 2019 compared with 1.6 years in the preceding year. It is pertinent to note that 70 percent of the re-profiling of SBP borrowing was carried out through PIBs. Therefore, the government remained very close to maximum limit (65 percent) set for debt re-fixing or interest rate risk.

The incumbent government continues to rely heavily on government securities (81 percent of domestic debt) as against non-bank sources of debt (19 percent of domestic debt) which has resulted in crowding out of private investment and essential long-term financing for infrastructure projects, both of which are a prerequisite for supporting growth. Between FY19 and FY20, banks' lending to private sector decreased from Rs. 628 bn to Rs. 289 bn.

Pakistan's GDP grew by 1.9 percent during FY19 but shrank by 0.4 percent in FY20 mainly due to the pandemic. With this sluggish growth, huge increases in domestic debt is bound to invite criticism on government, which it is facing in reality. The argument that more debt is being acquired to service previously accumulated debt becomes weaker when economic growth numbers remain low. After all, a sound policy would not permit government to stock up domestic debt just to retire old debt.

Public Debt

Public debt management witnessed improvement in FY20.

The PTI-led government added Rs. 11.3 tn or 45.2 percent to the public debt in two years, which is more than Rs. 10.7 tn or 74.8 percent stocked by previous government in five years. As of June 2020, total public debt clocks at Rs. 36.3 tn while total debt and liabilities measure at Rs. 44.5 tn. Servicing of total debt and liabilities have also increased from Rs.3.1 tn to Rs. 4.4 tn between FY19 and FY20. The rising trend continues for circular debt which increased from Rs. 1.18 tn to Rs. 2.24 tn.

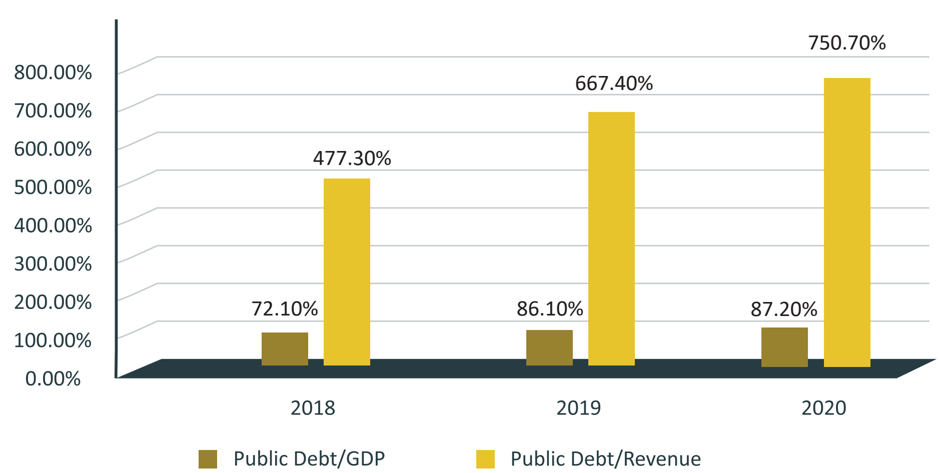
The burgeoning public debt in the first year was a result of currency devaluation and a buildup of Rs. 1.2 tn cash buffer. The accumulation in public debt has been lower in the second year of PTI's government owing to a shift in domestic portfolio, exchange rate stability, introduction of new debt instruments and improvements in primary deficit. In its defense, the government has blamed the flawed exchange rate policy for the surge in public debt during its first year and claimed that in the second year, the increase has relatively been less due to the consolidated efforts of IMF and the government. Nonetheless, IMF has still advised the country to reduce reliance on short-term borrowing and switch to long-term borrowing due to which the stock of Pakistan Investment Bonds is likely to increase from Rs. 12.4 tn to Rs. 16.9 tn.

It is pertinent to note that government has breached 3 out of 4 targets under the Fiscal Responsibility and Debt Limitation Act (FRDL), 2005. It has complied with only one target which is the issuance of new guarantees equivalent to under 2 percent of GDP. The violated targets include:

1. The current debt-to-GDP ratio exceeding the 60 percent limit,
2. Each year the public debt increased by more than 0.5 percent
3. Fiscal deficit as a percentage of GDP in both years (8.9 percent in FY19 and 8.1 percent in FY20) exceeded 4 percent threshold of FRDL

Despite the rising debt figures in absolute amounts, it is pertinent to assess other indicators that relate total public debt to total revenues and GDP (see Figure 2). These indicators as highlighted by Dr. Ishrat Husain during PRIME's 4th National Debt Conference (2017) dictate sustainability of public debt. As evident, public debt-to-revenue ratio increased significantly during 2018-20 due to revenue shortfall and increased borrowings.

Figure 2: Public Debt Sustainability Indicators



Source: Debt Policy Coordination Office & Pakistan Economic Survey 2019-20, Ministry of Finance.

Between 2018-20, total public debt-to-GDP ratio increased from 72.1 percent to 87.2 percent. Ministry of Finance cited two reasons for this, both of which relate to IMF's programme:

1. Depreciation of Rupee
2. Tight monetary policy resulting in high interest rate of 13.25 percent, which lasted till March 2020

The rising debt-to-GDP ratio remains of concern as country's growth figure remains low following the onset of COVID-19. According to World Bank's latest report on South Asia, Pakistan's projected economic growth is 0.5 percent for FY21, which is lowest in South Asia and far lower than the annual average of 4 percent that the country maintained over last three years.

In order to contain circular debt, Economic Coordination Committee (ECC) recently approved an increase in tariff rate for electricity (17percent) and gas (14 percent) so as to generate revenues for power and gas companies. However, the cabinet put off the implementation of new power rates. Now the IMF is insisting on the implementation of new power rates along with tax rationalization as a means of reviving country's stalled IMF programme.

Conclusion

Debt without growth remains a daunting challenge.

Total public debt has increased over the last two years owing to plethora of factors such as high debt servicing, persistence of primary deficit, shift towards floating exchange rate and a tight monetary policy. However, public debt management did improve during PTI's second year, where efforts were made to change overall debt profile. In this regard, the domestic debt portfolio was shifted from short-term to medium- and long-term which reduced the government's rollover risk. Concurrently, decision was taken to terminate borrowing from SBP – a stance that was acclaimed by IMF. Notwithstanding, the increase in debt stock and debt servicing continue to pose a major threat to government's exchequer. With World Banks' projected economic growth of 0.5 percent, the burgeoning debt-to-GDP ratio would be unsustainable, provided the stock of public debt is not curtailed in a timely manner. However, this would be possible only if the root causes of debt accumulation – revenue and foreign currency shortfall – are handled more efficiently.