

Summary Report

Introduction

Pakistan faces grave debt problems that threaten the economic future of the country. These debt problems have been in the making for decades. The country is saddled with a large external debt and huge external service payments, which cannot be met without exceptional assistance from the IMF, World Bank and ADB and debt rescheduling from the Paris Club. It also has an enormous public debt burden (including the public portion of external debt and foreign exchange obligations), debt service payments for which pre-empt 60 percent of government revenues. By any reasonable measure of debt burden, (be it stock ratios - such as ratio of debt stock to GDP, exports, government revenues - or flow ratios - such as ratio of public debt service payments to government revenues or ratio of external debt payments to foreign exchange earnings), Pakistan's twin debt burdens are well beyond sustainable limits.

The problems of extraordinarily high public debt and very large external debt are the consequence of (a) large and persistent fiscal and current account balance of payments deficits, (b) imprudent use of borrowed resources, such as wasteful government spending, resort to borrowing for non-development expenditures, undertaking of low economic priority development projects, and poor implementation of foreign aided projects, (c) weakening debt carrying capacity in terms of stagnation or decline in real government revenues and exports, and (d) rising real cost of government borrowing both domestic and foreign.

The dynamics of debt growth have been changing. In the last few years, stagnation in government revenues and exports and rising cost of both domestic and external debt have gained in importance as the driving forces behind the rise in external and public debt burden growth. As a consequence, the debt burden growth was more rapid in the short span of time over the years 1996-1999, than in the entire decade of the 1980s.

Rationale for Borrowing

Borrowing domestically or abroad is a normal, indeed, necessary part of economic activity. Financial intermediation between lenders and borrowers, be they firms or governments,

improves the efficiency of resource allocation and growth. The economic rationale for debt creation is that borrowers can earn a higher economic return than the cost of invested funds and that these economic returns can then be translated into financial returns. Debt problems for governments arise if debt-servicing capacity does not keep pace with growth of debt. This may also be expressed as debt exceeding sustainable levels.

Sound debt management, like good economic management in general, is more of an art than a science. There can be and often is a debate on what ought to be an acceptable level of debt burden and which precise indicators should be used to measure this burden. The basic rules of prudent debt management relate growth of debt to that of debt servicing capacity, such as increase in export and government revenues. These basic rules cannot be ignored for any length of time.

Safe Limits of Debt

A portion of nominal debt is normally wiped out by inflation, which reduces the burden of real debt, and, therefore, a part of nominal interest payments in fact represents repayment of principal. In analyzing the burden of debt the focus should, therefore, be on the real magnitudes, that is, real interest rate (nominal interest rate minus the rate of inflation) and the real rate of growth of debt (nominal growth less the rate of inflation). If the real growth rate of debt exceeds the real growth rate of GDP or revenue, the debt-to-GDP or debt-to-revenue ratio will begin to rise and if this excess persists for a long time, the growth in debt burden will assume explosive proportions. Similarly, in the case of external debt, as long as growth rate of foreign exchange earnings exceeds the rate of growth of debt, the debt burden as a proportion of foreign exchange earnings will not go up.

The more sophisticated rules of debt management relate growth of debt burden to cost of borrowing. For instance, it can be mathematically demonstrated that if the primary fiscal deficit (i.e. deficit before interest payments) is zero, the ratio of public debt to revenues will not rise as long as the average real interest rate on debt does not exceed the real rate of growth of revenues. Similarly, if there is no current account balance of payments deficit, before interest payments, it can be shown that the ratio of external debt to foreign exchange will not increase as long as average real interest rate on debt does not exceed the real rate of growth of foreign exchange earnings. Quite obviously, therefore, the levels of deficits before interest payments, the costs of

borrowing, and rate of growth of revenues and foreign exchange earnings are critical determinants of trends in public and external debt burden.

But what are excessive levels of debt burden? If the debt is not concessional, public debt to revenue ratio should not normally exceed 250 percent and the ratio of external debt to foreign exchange earnings should not exceed 150 percent. With a moderate degree of concessionality of debt say 20-30 percent, these ratios should stay around 350 percent and 200 percent respectively. Similarly, it is normally considered desirable that external debt service payments not exceed 20-25 percent of foreign exchange earnings and similarly public debt service payments are kept below 25-30 percent of government revenues. (See **Box 1**)

Box 1 - Debt Sustainability Issues

Sound debt management, like good economic management in general, is more of an art rather than a science. The first important, and more subjective step is to specify the norms for prudent levels of borrowing in terms of one or more indicators of debt burden. The second more technical but fundamental step is to develop guidelines based on the relationship between key economic variables, most notably the rate of interest, the growth rates of GDP, government revenues and foreign exchange earnings, and the initial levels of fiscal and current account balance of payments deficit (excluding interest payments). Once the norms of acceptable debt burden have been specified, technical guidelines may be derived relatively easily.

Debt burden indicators are of two types (a) stock measures, which relate the value of a stock of outstanding debt to the annual level of key economic aggregates and (b) flow measures, which relate the value of annual debt service payments to the same economic aggregates. Stock measures of the external debt burdens are generally expressed in terms of ratios to GDP and ratio to annual foreign exchange earnings. Since these stock measures do not take into account the interest rate payable on debt and the maturity structure of the debt - very relevant factors influencing debt service payments - the better and more accurate measures give net present value of external debt (NPV) both as a percentage of GDP and as a percentage of foreign exchange earnings. Use of a discount rate reduces the burden of real debt payments in the outer years and also takes account of the concessionality of the various interest rates. Another stock measure is the ratio of short-term debt to total external debt. A high ratio of short-term debt sends a danger signal because a number of the debt crises in Latin American and more recently in Thailand and Korea have been triggered by the inability to roll over short-term debt (defined as debt with a maturity of one year or less) as it fell due. In the context of short-term debt or other short-term obligations, the level of foreign exchange reserves is an important indicator of the ability to withstand unexpected foreign exchange pressures.

The widely used measure in Pakistan and elsewhere to judge the stock of public debt (including public portion of external debt) is its ratio to GDP. Though it is common practice to measure the burden of public debt (as well as that of external debt) as a proportion of GDP, it makes more sense to use the yardstick of government revenues for monitoring changes in public debt burden. After all, GDP changes do not automatically translate into revenues, particularly in developing countries like Pakistan where the taxation machinery is weak and the taxation systems are inelastic. It is the expected growth in revenues which provides the capacity to service future debt payments. Here again if a lot of the foreign public debt is concessional it is desirable to use the net present value of public debt for determining the debt burden.

Box 1 contd.

Even with the best stock measures, however, total public debt as a proportion of revenues and the present value of external debt as a percentage of exports of goods and services must be supplemented by appropriate flow measures. In the case of external debt, the most frequently used measure is total annual debt service as a percentage of exports of goods and services. Public debt payments consist of two parts: debt service payments to foreigners for the external debt owed by the government, and interest and principal repayments to residents for the domestic debt held by the public sector. There is merit in considering only interest payments as domestic debt service burden. The rationale of this asymmetry is that since monetary authorities in the country have control over their own currency, the rolling over of domestic debt can be taken for granted, whereas, short of default, the governments have little control on the repayments obligations to foreigners. But irrespective of the definition of debt service used, the measurement of annual revenues pre-empted by debt service, whether domestic or foreign, is necessary to gauge the burden of public debt.

In the final analysis, the ability of a country to withstand debt crises depends on the confidence of the creditors and their willingness to roll over or reschedule debt payments due. However, clear debt sustainability benchmarks have been developed under the Heavily Indebted Poor Countries (HIPC) initiative. The suggested ratio limits for the stock of debt are:

- a) NPV of External Debt/Export of goods & services = 150 percent
- b) NPV of Public Debt/Government Revenue = 250 percent

While discussing the debt sustainability issue in this report, we have kept the above-mentioned benchmarks in mind. Since the concessional element in Pakistan's external debt is about 25 percent, we have used nominal value of external debt equal to 200 percent of foreign exchange earnings as the indicative sustainable limit. In setting the sustainable limit of public debt for Pakistan at 350 percent of government revenues, we have taken into account not only the concessionality of public foreign debt but also the fact that a part of public debt (less than 10 percent of the total) is held by the State Bank of Pakistan and thus, in some sense, is internal to the public sector.

Nature of Pakistan's Debt Problems

Pakistan, in reality, has not one but two debt problems. It has huge public debt and it has very large external debt. The fact that a large part of the public debt, now more than 50 per cent, is external in nature does not change the basic point that the public debt problem must be analyzed separately from the issues relating to external debt. The basic rationale of distinguishing external and public debt issues is that it is not debt per se that matters but the ability to service it. Public or government debt (including the public portion of external debt) is a charge on the budget and must be serviced from government revenues and/or additional borrowing whereas external debt, both public and private, is a claim on the balance of payments and must be serviced from foreign exchange earnings, reserves draw-down as well as additional foreign borrowing. A country can have a public debt problem and not an external debt problem or vice versa. It can, like Pakistan, have both problems but, as discussed below, the gravity and urgency of the two problems can differ significantly.

Defining Debt

A key recommendation of the Debt Committee is that in future, in providing debt statistics, measuring debt burden, analyzing debt problems, and formulating debt policy, these two facets of debt must conceptually be kept apart despite their many interfaces - notably the impact of fiscal deficits on levels of external borrowing and the consequences of exchange rate depreciation on the nominal value of public debt. At present there is considerable confusion, and there exists no clear concept of public debt. Government documents often refer to domestic debt and external debt and tend to imply that they should be added up to get an idea of national debt. Even the State Bank of Pakistan Annual Reports and some IMF reports have in the past tended to lump domestic debt with external debt, both public and private, to get an overall magnitude of debt. But this hybrid concept of debt does not make economic sense and can impede policy analysis.

Public debt should further distinguish between government debt and the debt of public corporations, whether or not guaranteed by the government. In the process, only that part of the external debt that is serviced through the budget should be included in government debt while external debt owed by public corporations (with or without government guarantee) should be shown separately. Private sector external debt should not be included in public debt figures. In providing the breakdown of government debt between rupee and foreign exchange debt, it is necessary to modify present practice, which lumps foreign exchange obligations to residents with domestic debt. Bearer certificates and special US dollar bonds owed to residents should be included as a part of the government external debt and not as government domestic debt. For the longer run, borrowing from residents in foreign exchange should be phased out. Only non-residents Pakistanis and resident or non-resident foreigners should be allowed to hold foreign currency deposits (See **Box 2**)

Using the suggested conceptual changes, adjusted figures for external obligations and government debt are summarized in **Tables 1** and **2**. These tables outline the build-up of external and public debt both in nominal terms and in relation to relevant debt burden indicators. The relative debt burden indicators have been expressed both as a percentage of GDP as well as percentage of foreign exchange earnings, in the case of foreign exchange obligations; and as percentage of total government revenue, for public debt. Use of government revenues and total foreign exchange earnings as denominators for assessing debt burden of public and external debt

respectively, is in the view of the Committee preferable to use of GDP for the purpose. Whilst GDP growth does not automatically translate into debt servicing capacity, government revenues and foreign exchange earnings provide much better measures of debt servicing capacity for government and external debt respectively. Further, it is necessary to derive the net present value of external debt obligations by using appropriate rates of discount to take account of the concessional element of borrowing abroad (notably Official Development Assistance) and then relate this net present value to foreign exchange earnings and/or revenues. It will be desirable to work out the net present value of external and public debt: there are indications that net present value calculations may tend to reduce the measured burden of external debt by about 25 percent and roughly reduce the burden of public debt by 15 percent.

Box 2 - Resident Foreign Currency Accounts

The Committee has considered the issue whether residents should be allowed to hold foreign currency accounts with some modified features, as per the present FE-25 scheme. However, on balance it believes that in the longer run the government should phase out all borrowing in foreign exchange from residents for the simple reason that it encourages the switch from rupee assets and thus undermines Pakistan's own currency. The past practice of not including foreign exchange obligations to residents in respect of foreign currency deposits as a part of total foreign exchange obligations contributed to the mishandling and ultimate freezing of foreign currency deposits.

Meanwhile, the Committee feels that the present government policy of not providing any undue encouragement to holders of new foreign currency deposits (FE-25) is a correct one. Furthermore, the policy of showing official foreign exchange reserves net of State Bank of Pakistan (SBP) obligations in respect of FE-25 deposits should continue. But now that SBP has increased confidence in its own prudential regulations and the management of commercial banks, especially publicly owned banks, it may wish to relax the condition of surrender of FE-25 deposits (to SBP itself) and leave the disposal of these deposits to the discretion of commercial banks while subjecting them, as at present, to normal statutory reserve requirements. For Pakistan, which has a large emigrant community interested in maintaining contacts with the home country, it makes sense to allow non-residents to hold foreign exchange deposits provided no special concessions are permitted. However, the case for allowing residents to hold FE-25 deposits does not exist because it unnecessarily encourages dollarization of the economy.

Debt Magnitudes & some International Comparisons

Table 1 indicates that total external debt obligations (including debt obligations to residents in foreign exchange) increased from less than US\$ 10 billion in June 1980 to nearly US\$ 20 billion in June 1990 and jumped up further to a peak of US\$ 43 billion in May 1998, just before economic sanctions were imposed following nuclear explosions, first by India and then by Pakistan. The stock of external debt (including debt obligation to residents) rose from less than 200 percent of total foreign exchange earnings in 1980 to 258 percent in 1990 and further to 364 percent in May 1998. The ratio of debt service payment due (i.e. before debt scheduling) to

foreign exchange earnings rose more sharply even from 18.3 percent in 1980 to 23.3 percent in 1990 and was already above 40 percent in 1997-98. The steep rise in debt service reflected a gradual hardening of terms of foreign loans (a moderate increase in interest rates and a shift towards shorter term debt) especially following the 1996 foreign exchange crisis, which necessitated large emergency high cost borrowing.

Following the fresh foreign exchange crisis triggered by economic sanctions, it became impossible to meet debt service payments, especially because short-term debt could not be rolled over, and there was a serious threat of a run on foreign currency deposits while the level of foreign exchange reserves was extremely low. The Government responded by freezing the foreign currency deposits of individual resident and non-residents and subsequently seeking help from the Paris Club to reschedule debt repayment (See **Box 3**). Even after extinguishing foreign exchange liabilities in respect of individual foreign currency accounts, (totaling US\$ 9 billion) Pakistan's external debt and foreign exchange obligations still stood at US\$ 35 billion in mid-2000, nearly 300 percent of total foreign exchange earnings.

Box 3 - Debt Relief

Following the events of May 1998 and imposition of sanctions, Pakistan could not cope with its external debt-servicing burden and foreign exchange obligations. The country, therefore, took action on several fronts:

- a) Besides freezing foreign currency withdrawal from bearer certificates and foreign currency deposits (FCDs) held by resident investors amounting to \$ 9 million in May 1998, the Government also froze all non-residents FCDs which amounted to \$ 2.4 billion. Subsequently, the country succeeded in rolling over non-resident institutional investor's funds worth \$ 1.5 billion. Other resident and non-resident investors were allowed to withdraw in local currency or to exchange FCDs with the special US bonds issued by GOP.
- b) In January, 1999, it sought and obtained relief on debt service from the Paris Club with respect to public and publicly guaranteed debt contracted prior to September, 1997 and falling due between January 1, 1999 and December 31, 2000 including arrears accumulated during the first half of 1999. This relief amounted to \$ 3.3 billion. Under the Paris Club agreement reached in January 1999, principal and interest payments due on public and publicly guaranteed debt up to the end of calendar year 2000 were agreed to be rescheduled with ODA (soft loans) being rescheduled over 20 years with 10 years grace while other loans such as export credits from bilateral donors were rescheduled over 18 years with 3-year grace.
- c) In December, 1999, Pakistan exchanged three existing Eurobonds worth about \$ 610 million on more favorable terms (3 years grace period, 6 years maturity and 10% coupon rates).
- d) In December, 1999, Pakistan also reached agreement with 8 commercial banks to restructure \$ 415 million medium-term commercial bank credits.
- e) Finally, Pakistan succeeded in rolling over short and medium-term liabilities amounting to \$ 300 million, held by other central banks.

In January 2001 the debt restructuring exercise in Paris Club was repeated, resulting in a debt relief of \$ 1.8 billion. This included \$ 0.7 billion amount that had technically fallen in arrears under the February 1999 Paris Club Agreement. The period covered is till 30-9-2001.

Table 1 - External Debt Growth and Burden

	End-June					\$ Billions		
	1980	1990	1995	1996	1997	1998	1999	2000
I. Public & Publicly Guaranteed (A to E)	9.65	19.13	27.52	27.63	28.30	28.84	29.12	29.62
A. Medium Long Term EAD	8.66	14.73	22.12	22.28	23.15	23.21	23.10	23.84
a. Multilateral	-	5.79	10.12	10.96	12.30	12.21	10.57	10.73
IDA	-	(2.01)	(3.03)	(3.42)	(3.84)	(3.55)	(2.70)	(2.86)
IBRD	-	(1.61)	(2.82)	(2.90)	(3.36)	(3.12)	(2.54)	(2.42)
ADB	-	(1.93)	(4.0)	(4.33)	(4.74)	(5.18)	(4.96)	(5.11)
b. Paris Club	-	8.09	10.96	10.29	9.86	9.85	11.38	11.94
c. Other bilateral	-	0.85	1.03	1.02	0.98	1.15	1.15	1.17
B. Other Medium & Long-Term	0	2.708	2.276	2.045	1.88	1.634	1.612	1.568
a. Euro bonds	0	0	0.15	0.3	0.76	0.63	0.61	0.61
b. Defence	N.A.	2.71	2.13	1.75	1.12	1.01	1.00	0.96
C. Short term Incl. IDB	0	0.798	1.361	1.520	1.119	1.398	1.312	1.230
a. Short term Commercial	0	0.675	1.232	1.328	0.828	1.225	1.16	1.10
b. IDB	0	0.123	0.129	0.192	0.291	0.173	0.152	0.13
D. IMF	0.735	0.667	1.630	1.535	1.316	1.415	1.825	1.550
E. Central Bank Deposits	0.260	0.224	0.135	0.250	0.835	1.183	1.270	1.435
II. Private Non-Guaranteed Debt	0.055	0.304	1.418	2.405	2.705	3.127	3.435	2.842
III. Debt Obligation to Residents in Foreign Exchange	0	0.438	0.589	0.496	0.414	0.328	1.360	1.444
Bearer Certificates	0	0.438	0.589	0.496	0.414	0.328	0.196	0.147
US\$ Bonds	0	0	0	0	0	0	1.164	1.297
IV. Other Foreign Obligations	0.115	2.116	6.575	8.305	9.843	10.91	1.380	1.072
A. Foreign Currency Accounts (FCAs)	0.115	2.116	6.575	8.305	9.843	10.91	1.380	1.072
a. FCAs Non-Residents (Institutional)	0	0	1.199	2.008	2.198	1.507	1.380	1.072
b. FCAs Non-Residents (Individual)	0	1.089	1.992	2.150	2.154	2.483	(1.114)	(0.569)
c. FCAs Residents (Individual)	0	1.027	3.384	4.147	5.491	6.920	(2.354)	(1.303)
B. FE-25 Deposits	0	0	0	0	0	0	(0.617)	(0.977)
Grand Total:	9.823	21.985	36.101	38.831	41.257	43.206	35.295	34.976

Note: Foreign Currency Accounts are included in foreign exchange obligations only upto May 1998 and then excluded from the total because they were frozen. The new FE-25 foreign exchange deposits are also not included in the total.

	1980	1990	1995	1996	1997	1998	1999	2000
External Debt & Foreign Exchange Obligations as % of GDP	41.5	55.1	59.2	60.9	65.5	69.7	60.6	57.1
Foreign Exchange Earnings (Excl. Accrual to Residents FCAs)	199.9	257.6	301.7	322.9	357.3	363.8	330.7	281.4
Debt Service as % of F.E. Earnings	18.3	23.3	27.5	31.0	37.4	41.4	40.2	39.5
MEMO ITEMS								
Foreign Exchange Earnings (Excl. FCA Residents.)	4.914	8.534	11.965	12.026	11.547	11.876	10.672	12.431
GDP (\$ million)	23.655	39.902	61.004	63.744	63.014	61.983	58.212	61.303
Debt Service (\$ million)	0.899	2.078	3.291	3.734	4.316	4.912	4.295	4.905

The structural burden of overall public debt in Pakistan represents for the longer run an even more serious problem for policy makers than external debt alone, although the latter is the more pressing issue. Nominal public debt (including the public portion of external debt) grew from Rs.155 billion in 1980 to Rs. 802 billion in 1990 and to Rs. 3200 billion in 2000. Public debt burden has grown from 66 percent of GDP in 1980 to over 100 percent at present. **(Table 2)** But as mentioned above, the use of government revenues as denominator for assessing public debt burden is preferable to the use of GDP for the purpose. In terms of budgetary revenues, public debt is now 610 percent of revenues compared to 400 percent in 1980 and 470 percent in 1990. Total public debt service (before rescheduling) for the year 1999-00 was Rs. 355 billion or over 60 percent of total revenues. This includes interest on domestic debt and the public portion of external debt service payments. Clearly, these magnitudes far exceed sustainable levels.

Table 2 - Public Debt Burden and Growth

(Rs. in Billions)

	Mid 1980	Mid 1990	Mid 1996	Mid 1999	Mid 2000¹
Debt payable in rupees	<u>59.8</u> (38.5)	<u>373.6</u> (46.6)	<u>903.9</u> (47.7)	<u>1389.3</u> (46.8)	<u>1571.6</u> (49.2)
Debt payable in foreign exchange	95.6 (61.5)	428.5 (53.4)	992 (52.3)	1581.9 (53.2)	1624.5 (50.8)
Total Public Debt:	155.4	802.1	1895.9	2971.2	3196.1
Public Debt as % of GDP	66.3	93.7	88.5	102.0	100.7
Public Debt As % of Revenue	403.5	470.8	514.6	625.5	609.5
Public Debt Service As % of Revenue	19.6	35.7	46.0	61.0	60.3
GDP at market price (Rs. Billion)	234.2	855.9	2142	2913.5	3182.0
Total Revenue (Rs. Billion)	38.5	170.3	368.3	475.0	512.6

1. Provisional

Note: Figures in parentheses are shares in total debt

As **Table 3** below suggests, Pakistan has a higher public debt burden, by a large margin, than that of any large developed or developing country. It has a far more serious public debt problem than even India, which is the only large Asian country which has neglected fiscal adjustment and whose government finances are not in good shape. India's government debt to total revenues was 385 percent in 1998 compared to the figure of 625 percent for Pakistan in 1998-99.

Furthermore, the figures for public debt understate government liabilities because they do not include any estimate of the contingent liabilities of the Federal Government, which might materialize during the next few years. The contingent liabilities of the Federal Government include: liabilities in respect of guarantees given to IPPs and other private and public bodies; unfunded losses of public corporations including the Pakistan Steel Mill, KESC and WAPDA; and likely final losses of public sector owned banks, on account of bad loans. Unfortunately, Pakistan does not as yet have a system of fiscal contingency management. Public guarantees on contracts are given essentially on an ad hoc basis and occasionally, rates of return even on purely private investments are under-written without regard to fiscal consequences. As a result, the problems created by fiscal deficits have been compounded by claims on government resources arising out of explicit guarantees provided outside the budget or implicit contingent liabilities (bailouts) necessitated by economic failure of a large number of loss-making public corporations.

Table 3 - Public Debt Burden: International Comparisons

	Year	Total Debt As % of		Internal Debt As % of	
		GDP	Revenue	GDP	Revenue
South Asia					
India	1998	47.2	384.9	44.0	358.4
Sri Lanka	1998	91.1	528.3	45.7	264.8
Pakistan	1999	102.0	625.5	46.8	292.5
East Asia					
Indonesia	1996	23.9	141.1	0.0	0.1
South Korea	1998	15.2	71.5	9.8	46.0
Philippines	1994	56.4	285.5	37.7	190.7
Thailand	1998	14.6	93.9	9.3	59.5
Malaysia	1998	58.1	291.2	31.0	155.5
Latin America					
Mexico	1998	28.3	219.5	10.0	77.4
Chile	1998	13.9	60.2	10.4	45.2
Africa					
Nigeria	1998	N.A	377.3	N.A	330.3
Morocco	1995	79.4	272.6	33.3	114.4
Industrialized Nations					
USA	1999	40.1	199.7	26.4	131.5
Italy	1998	111.3	384.1	N.A	N.A
Spain	1998	56.9	268.4	43.0	202.8

Source: IMF International Financial Statistics, April 2000

International comparisons of external debt burden are presented in **Table 4**. In order to take account of the concessional element of borrowing abroad (notably through Official Development Assistance), comparisons are made in terms of the net present value of external debt obligations by using the appropriate rates of discount.

Table 4 - External Debt Burden: International Comparisons
(Calendar Year 1998)

	Net Present Value of Debt		Total Debt Servicing	
	As % of GNP	As % of Exports	As % of GNP	As % of Exports
South Asia				
India	20.0	143.0	2.8	20.6
Bangladesh	23.0	135.0	1.5	9.1
Sri Lanka	41.0	92.0	2.9	6.6
Pakistan	44.0	230.0	7.5	39.0
East Asia				
Indonesia	169.0	252.0	22.2	33.0
South Korea	43.0	84.0	6.5	12.9
Philippines	66.0	104.0	7.6	11.8
Thailand	76.0	123.0	11.8	19.2
Malaysia	69.0	66.0	4.7	8.7
Latin America				
Mexico	41.0	111.0	7.7	20.8
Brazil	29.0	340.0	6.3	74.1
Chile	48.0	183.0	5.9	22.3
Africa				
Egypt	29.0	128.0	2.1	9.5
Nigeria	76.0	250.0	3.4	11.2
Morocco	54.0	153.0	8.2	23.0

Source: World Bank: Global Development Finance, 2000.

The net present value of Pakistan's external debt is clearly much higher than South Asian and most East Asian countries. If we take account of Pakistan's foreign exchange obligations to residents and institutional holders of foreign currency accounts, Pakistan's external debt burden appears to be as high as Nigeria's and Indonesia's and only below that of Brazil's.

Recent Trends

That Pakistan has a huge external debt problem and a grave public debt problem is well known. It is not widely recognized, however, that public debt burden rose very sharply during 1996-1999 (from 515 percent to 625 percent of government revenues) in a short period of three years, which was a more rapid increase than in the entire decade of the 1980s. The external debt burden also increased modestly even though a part of foreign exchange liabilities were extinguished by the freezing of foreign currency accounts. (See discussion below)

Factors of Deepening Debt Burden

A fundamental source of Pakistan's economic problems and high debt burden is the persistence of a low rate of national saving (**Table 5**) for more than two decades.

Table 5 - Savings and Investments
(Selected Years)
As % of GDP

Years	Investment	Foreign Savings	National Savings
1949-50	4.1	2.0	2.0
1959-60	12.5	6.0	6.5
1964-65	21.1	10.5	10.6
1969-70	14.6	4.5	10.1
1980-81	17.3	3.4	13.9
1989-90	18.1	4.5	13.6
1995-96	19.0	7.2	11.8
1997-98	17.7	2.7	15.0
1998-99	15.0	3.8	11.1
1999-2000	15.0	1.6	13.3

Like many other developing countries Pakistan relied heavily on external sources in the 1950's and 1960's but unlike many other countries, it has not become more self-reliant since.

Table 6 - Government Savings *
(Annual Average)

Year	(Billion Rs.)	As % of GDP
1980-85	2.4	0.9
1985-90	-10.9	-1.6
1990-96	-33.2	-2.2
1996-99	-87.4	-3.2
1995-96	-55.3	2.6
1996-97	-74.1	3.1
1997-98	-99.5	3.7
1989-99	-88.6	3.0
1999-2000	-96.0	3.0

*Defined as excess of consolidated government revenue over current expenditure

Growing negative savings in the government sector, as manifested in the inability to cover defense and other non-development spending from current government revenues, has been the major contributing factor to poor national savings performance. The rate of private savings has actually gone up moderately over the last fifteen years, whilst negative government savings have averaged nearly Rs.90 billion per annum or 3.2 percent of GDP during the last four years (**Table 6**).

On the one hand, government non-development spending has risen sharply since the early 1980's mainly because of rising interest payments. On the other hand the tax revenue to GDP ratio has tended to decline: this ratio, at 12.7 percent in 1999-2000, was actually lower than in 1980-85. (**Table 7**) The tax base has remained narrow, tax machinery been both corrupt and ineffective and repeated attempts to raise revenues through additional taxation have largely failed.

It is hardly surprising, therefore, that fiscal deficits have persisted at a high level and public debt burden has grown steadily. Despite numerous IMF agreements since the early 1980's, there was little fiscal adjustment over the last two decades (**Table 7**). The average fiscal deficit, during the last five years, has been close to 7 percent of GDP.

Table 7 - Fiscal Indicators
(At 1999-2000 Prices)

Rs. Billion

	Tax Rev	Total Rev	Total Exp	Current Exp	Dev Exp	Fiscal Deficit	Primary Surplus/(Deficit)
1980-85	192.6	236.0	334.8	223.9	110.7	90.6	-65.4
	[13.5]	[16.6]	[23.6]	[15.9]	[7.9]	[6.4]	[-4.6]
1985-90	272.0	344.8	505.5	376.3	128.3	150.3	-92.2
	[14.1]	[17.9]	[26.3]	[19.5]	[6.7]	[7.8]	[-4.8]
1990-95	325.3	434.3	618.4	474.9	146.6	184.6	-47.8
	[13.1]	[17.5]	[25.0]	[19.2]	[5.9]	[7.5]	[-2.0]
1995-99	402.5	478.8	685.2	569.6	124.0	206.4	-7.0
	[13.8]	[16.4]	[23.5]	[19.5]	[4.3]	[7.1]	[-0.3]
1999-2000	406.8	524.4	730.7	642.2	95.6	206.3	37.0
	[12.8]	[16.5]	[23.0]	[20.2]	[3.0]	[6.5]	[1.2]
2003-04 ¹	565.7	681.4	797.2	662.1	135.0	115.7	47.2
	[14.7]	[17.7]	[20.7]	[17.2]	[3.5]	[3.0]	[2.5]
2009-10 ¹	923.1	1062.5	1163	911.9	251.1	100.4	90.4
	[16.5]	[19.0]	[20.8]	[16.3]	[4.5]	[1.8]	[1.6]
2003-04 ²	528.7	627.8	742.2	634.4	107.8	114.4	102.9
	[13.7]	[16.3]	[19.2]	[16.4]	[2.8]	[3.0]	[2.7]
2009-10 ²	774.5	896.2	991.4	832.7	158.7	95.2	100.4
	[13.9]	[16.1]	[17.8]	[14.9]	[2.8]	[1.7]	[1.8]
1) The projected figures assume strong fiscal adjustment with high revenue growth combined with high growth in social and development spending.							
2) Projections based on strong fiscal adjustment scenario, with moderate revenue and expenditure growth.							

Table 8 clearly brings out the changing dynamics of public debt growth and clearly highlights the two current problems: stagnant government revenues and high cost of borrowing.

- The very high growth rate of real debt in the 1980's did not immediately lead to a sharp rise in debt burden because revenues were rising, development spending was high, and growth rates of both revenues and GDP were strong. But it sowed the seeds of future trouble, with the unsound structure of taxation (which relied heavily on foreign trade taxes) and debt service payments gradually beginning to cut into development outlays.
- The sharp increase in public debt burden during 1996-1999 was mainly because growth in real revenues was negative. This was in contrast to real revenue growth of 8.2 percent per annum in the 1980s and 3.9 per annum percent during 1990-1996.
- Public debt is now driven largely by interest rate costs as the primary fiscal balance (i.e. balance before interest payments) is now in surplus. Unfortunately, the real borrowing costs of government debt rose sharply to 5 percent per annum during 1996-1999 (compared to 1-2 percent historically) reflecting the combined effect of slow down of both domestic and international inflation, while nominal interest rates on borrowing declined little, and real depreciation of the exchange rate, which increased the cost of servicing external debt. (See **Box 4**)

Table 8 – Dynamics of Public Debt Burden

	Primary Fiscal Deficit¹ As % of GDP	Real Cost ² Of Borrowing % per annum	Real Growth of Debt % per annum	Real Growth in Revenues % per annum	Real Growth of Debt Burden % per annum
1980's	4.7	2.5	9.9	8.2	1.6
1990-96	2.0	-0.5	5.7	3.9	1.8
1996-99	-0.3	5.2	5.8	-0.7	6.5
2000-04³	-2.5	4.4	2.7	6.8	-4.1
2004-10³	-1.5	2.5	-0.1	7.7	-7.5

¹ Deficits before interest payments. Does not include government's borrowing for off-budget purposes.

Minus sign denotes a surplus

² Includes capital losses on external debt.

³ 2000-10 projections are under High Revenue Scenario

Box 4 - Real Cost of Public Borrowing: Determinants and Trends

The real cost of domestic borrowing is the nominal interest rate minus the rate of inflation. As the table below indicates, the real costs of Pakistan's domestic debt have varied greatly over time. During the 1980's the average nominal cost of 7.7 percent per annum was largely offset by an inflation rate of 7.2 percent per annum. The real cost of domestic public debt was thus only 0.5 percent per annum. At first sight, this may appear surprising because the Government started paying very high nominal interest rates on National Saving Schemes (NSS) in the early 1980s while inflation was still relatively low. Two factors dampened the impact of high rates of return on NSS instruments on government interest payments. First, the initial weight of unfunded debt (borrowing through NSS) was small. Second, the reported interest payments on NSS were low because the bulk of this borrowing is in the form of zero coupon five or ten year certificates, the interest on which is recorded only where the term certificates are encashed. There is thus a considerable lag in interest payments. But the principal reason why government nominal and real interest rates were low in the 1980s was that the bulk of government borrowing was at less than market rates as all interest rates were administratively determined and government debt was sold in segmented markets. The large reserve requirements for commercial banks (5 percent cash reserve requirement and 30 per cent liquid asset requirement) forced them to buy low-interest Treasury paper.

Real Cost of Public Debt (% Per annum)

	<u>Real Cost of External Debt</u>	<u>Real Cost of Domestic Debt</u>	<u>Total Cost of Public Debt</u>
1980s	3.4	0.5	2.5
1990-96	-0.9	-0.3	-0.5
1996-99	5.4	4.9	5.2
2000-4(Projected)	4.4	4.4	4.4
2004-10(Projected)	1.8	3.4	2.5

Financial sector liberalization, initiated in 1989 with the assistance of the World Bank, led to a full market-based auction program for government borrowing. However, this liberalization was premature and ill timed because it assumed a quick reduction in fiscal deficit to sustainable levels (Hasan, 1998). Its impact, on the contrary, was to sharply raise the Government interest bill. Between 1987-88 and 1993-94 interest payments on domestic debt increased nearly trebled and the average nominal interest rate rose by 84 percent to 11.5 percent. Paradoxically, the much higher interest payments made the fiscal deficit reduction difficult and the Government resorted during 1990-1993 to very large borrowing from the banking system to finance the burgeoning deficit. The sharp acceleration in inflation during 1990-1996

ultimately wiped out the effect of higher nominal interest rates, so that average real interest rate on government domestic debt was slightly negative during 1990-1996 (**Table 17**).

For the most part of the last two decades, the real cost of government domestic borrowing has been negligible and, therefore, the growth in burden of public debt was moderated. The situation now is sharply different. The real cost of domestic borrowing jumped upto the average of 9 percent per annum over 1998-2000, as the inflation rate dropped and nominal interest rates stayed high. Even with the sharp reductions in the rates of return on NSS since May 1999, the average interest rate paid on these schemes will remain high for some years because of the very substantial time lags mentioned above. The Debt Committee is assuming that the real cost of government domestic borrowing can be brought down to 3-4 percent in the coming years mainly through a sharp reduction on rates offered for fresh borrowing.

The issue of interest payments on foreign debt has not received much attention, at least in relation to public debt. Nominal interest payments on foreign debt at Rs. 47 billion in 1999-00 were only a fraction of the interest payments on domestic debt of Rs. 198 billion. As a percentage of GDP, interest payments on foreign debt have rarely exceeded 1.5 percent. The average annual nominal interest rate on external debt until recently did not exceed 4 percent because in general Pakistan avoided high cost commercial borrowing till the mid-1990s. But just as in domestic debt, the relevant rate for external debt is the real rate of interest after allowing for international inflation. International inflation, already low in the 1980s, came down to zero during 1995-1999, implying a steady rise in the real interest rate on Pakistan's foreign debt in Dollars. Furthermore, there has been real devaluation of the Rupee, which increases the real interest rate by increasing the real burden of external debt. There has been, in fact, substantial real depreciation of the Rupee during the 1980s, relatively little change during 1990-1996 and significant real devaluation since then.

In estimating the real cost of foreign public debt, the Committee has added the capital loss on foreign exchange to the nominal interest payment on external debt and then adjusted this nominal cost for the rate of domestic inflation. The calculations suggest that real cost of external debt averaged 3.4 percent per annum during the 1980s. It has risen significantly since then, reflecting both low international inflation and the accelerated pace of real depreciation of the Rupee during the last few years. For the period 1996-1999, the real cost of external borrowing is estimated at 5.4 percent per annum, even higher than the high cost of domestic debt. In projecting future costs of external debt, it is necessary to take into account the expected changes in the nominal value of Pakistan's currency, which captures both the differential between international and domestic inflation and real depreciation, if any.

The public debt problem has been greatly aggravated by declining effectiveness of use of resources, both borrowed and domestic, during the last decade or so. This has several aspects. There has been a serious upsetting of the balance between defense and development since the early 1980s. The share of development in total government spending, which was 40 percent in 1980 and 25 percent in 1990, declined to 13 percent in 2000. **(Table 9)** Almost all of the increase in share of interest payments has come at the cost of development. While defense spending in constant prices more than doubled between 1980-81 and 1999-00, real development expenditure actually declined over that period.

Government borrowing for consumption has grown steadily during the last fifteen years. As mentioned above, parts of the fiscal deficits were used to finance government consumption rather than investment. It is evident that even with the given level of fiscal deficits, the debt burden would have been lower if the entire borrowing had been used to finance public development spending, because higher public investment would have contributed to higher GDP and government revenue growth.

Table 9 - Pattern of Public Expenditures
(At 1999-2000 Prices)

(Rs. Billion)

Year	Interest Payments	Defence	Development	Other	Total
1980-81	26.5 [9.3]	68.8 [24.0]	116.0 [40.5]	74.6 [26.1]	285.9 [100.0]
1984-85	56.2 [14.1]	108.7 [27.3]	112.8 [28.3]	120.6 [30.3]	398.3 [100.0]
1989-90	116.3 [21.1]	146.2 [26.5]	139.7 [25.3]	149.7 [27.1]	551.9 [100.0]
1995-96	174.6 [25.6]	159.0 [23.1]	147.6 [18.2]	234.2 [33.1]	715.5 [100.0]
1997-98	241.1 [33.9]	148.6 [23.5]	114.8 [18.0]	207.6 [24.6]	685.1 [100.0]
1998-99	219.5 [34.7]	147.7 [23.3]	112.2 [16.1]	190.8 [25.9]	670.2 [100.0]
1999-2000	243.3 [33.3]	150.4 [20.6]	95.6 [13.1]	241.4 [33.0]	730.7 [100.0]
2003-04¹	212.9 [26.7]	150.4 [18.9]	135.0 [16.9]	298.8 [37.5]	797.2 [100.0]
2009-10¹	190.8 [16.4]	167.4 [14.4]	251.1 [21.6]	553.7 [47.6]	1162.9 [100.0]
1. On the basis of high revenue and high growth scenario. On the basis of moderate-revenue and moderate-expenditure projections for 2003-2010 are given below:					
2003-04	217.1 [29.3]	148.8 [20.0]	107.8 [14.5]	268.6 [36.2]	742.2 [100.0]
2009-10	195.6 [19.7]	159.0 [16.0]	159.0 [16.0]	478.0 [48.2]	991.5 [100.0]

Figures in parentheses are % of total expenditure.

Worse, there are many cases of low priority projects having been undertaken on political and other considerations. Motorways, Saindak copper and Tamir-i-Watan program are some of the more obvious examples of misallocated resources. In other cases, large and important projects, notably Left Bank Outfall Drain (LBOD), National Drainage Program (NDP), Chashma Right Bank Canal Project and Social Action Program (SAP) have not had the desired impact because of poor design or feasibility, poor coordination, delays in implementation or leakages in the system. Deterioration in the development impact of spending, at a time when the overall public investment rate was declining sharply, has played havoc with the economy, depressing the growth rate, causing serious shortages of infrastructure and limiting progress towards meeting social goals. There are widespread complaints about the dominant role and poor quality of foreign consultants, the growing role of donor agencies in the selection of projects, inadequate consultation with provincial governments, and unnecessary proliferation of umbrella projects. But at the heart of these failures to efficiently use public development resources are either political interventions, bypassing established procedures to ensure financial and economic discipline, or grave weaknesses in the public sector institutional capacity to prepare, monitor, and implement projects, and a tendency for top-down decision making and increasing centralization of powers in the Federal Government.

Roots of External Debt Problem

Large as the public debt in Pakistan is, the debt crisis was essentially triggered by the unsustainability of the level of the current account balance of payments deficits and the pattern of their financing in the 1990s.

During the ten years 1990-1999, Pakistan ran current account balance of payments deficits (despite accruals of Resident Foreign Currency Deposits, (RFCDs) of US\$ 6.8 billion) totaling over US\$25 billion, or an average of 4.8 percent of GDP. If accruals to RFCDs are treated as borrowings rather than earnings, as they should have been, the cumulative current account deficit during the 1990s was US\$ 32 billion, or over 6 percent of GDP. This means that about one third of total investment was financed from external borrowing as against slightly over 20 percent in the 1980s. The levels of current account deficit incurred in the 1990s are not sustainable even with a very rapid expansion of exports. And in Pakistan, export and remittances growth slowed down substantially in the first half of the 1990s, and has since stagnated.

Box 5 - Social Action Programme (SAP)

This report has stressed the importance of borrowing judiciously and using borrowed funds with utmost efficiency and effectiveness. When this principle is not adhered to, there is an increase in debt with meager economic outcomes in terms of growth, exports and revenues; and thus the debt burden increases. The Committee has identified a number of examples where the choice of projects was poor. The Social Action Program (SAP-I) represents another kind of failure: failure of implementation.

Despite an annual average growth rate of the economy around 6% over the decade 1980-1990, the fruits of growth did not trickle sufficiently down, leaving a large number of households poor. It was against this background that SAP-I was conceived and launched by the Government in 1992-93, initially with its own resources and subsequently with support from donors in 1993-94. An outlay of Rs.127 billion for 3 years was provided by the World Bank, Asian Development Bank, Netherlands and UK, with GOP and donors shares at 75% and 25% respectively.

The program addressed four important sectors, viz. primary education, basic healthcare, population welfare and rural water supply & sanitation. Despite substantial allocation of resources, improvement in institutional capacity was not satisfactory, problems of teacher absenteeism, deployment of quality teachers, lack of accountability, non-adherence to site-selection criteria, and dropout rates remained endemic. Some physical asset creation occurred, but operational and procedural bottlenecks impeded efficiency, accessibility and quality of services. Further, local communities, NGOS and private sector were not involved in SAP-I in any meaningful manner. Finally, bureaucratic procedures and delays hampered donor financing.

In order to correct some of these problems and accelerate the pace of human development, the Government launched a 5½ years SAP-II beginning in January 1997, at a total cost of Rs.499 billion of which Rs.101 billion was to come from the international community. The program comprises a wider scope and several new initiatives, in education (addition of middle schools), health (tuberculosis and referral hospitals) and provision of water supply (extended to include urban slums).

There is general agreement that performance outcomes, financing and governance under SAP have been disappointing thus far. The overarching goal of SAP is to improve access and quality of basic social services, and any meaningful review of progress to date must be based on an analysis of outcomes in education, health, population, and rural water supply & sanitation. The availability of PIHS data for 1998-99 makes possible an analysis of outcome trends from the start of the program. These data show that education outcomes have not improved during the SAP-I years. In health, some improvements in core health status indicators has occurred, but utilization of government primary health facilities is still low. There have been satisfactory fertility outcomes in the population sector. RWSS performance data show some increase in access to clean water in rural areas, but the situation is still far from ideal.

Overall, it appears that despite the Social Action Program and complementary sector investment projects, improvement in public service delivery is either not being achieved, or is occurring at a very slow pace. This is especially perturbing in education, where almost half the population of school-going age is not enrolled in public schools. Those who can afford it, and also some who cannot, are turning to the private sector.

In face of sizeable current account balance of payments deficits, poor export performance in the 1990s (**Table 10**), declining remittances and a decline in total foreign exchange earnings, from US\$ 12.8 billion in 1996 to US\$ 11.2 billion in 1999, not only aggravated the external debt burden but also adversely affected public debt. Furthermore, the frequent depreciation of the exchange rate in recent years, necessitated by the balance of payments crises, has directly added to rupee value of public foreign debt. Indeed, capital losses on foreign exchange have been as important a source of public debt growth as fiscal deficits.

There were two fundamental causes of very disappointing export performance in the 1990s. First, structural weaknesses in Pakistan's industry and exports (excessive reliance on cotton-based textiles, subsidized till late-1980s due to the export duty on cotton), hampered export development. Thus, upon curbing of subsidy on raw cotton, the textile industry found it difficult to face competitive pressure. Second, because of the ready availability of foreign exchange through Foreign Currency Deposits (FCDs), there were lags in adjustment of the exchange rate to high domestic rate of inflation, which contributed to erosion of export competitiveness. FCDs were essentially short-term obligations of the country to deposit holders, and therefore a certain proportion of FCDs should have been kept as reserves. However, all FCDs were used to finance the external sector deficits in the 1990s.

The alarm bells on external debt did not ring partly because until 1996 only about half of the balance of payments financing required resulted in an increase in external debt, the rest being financed from accruals to resident and non-resident foreign currency deposits and direct, portfolio and IPPs-related foreign investment. Net foreign investment inflows in the five years 1993-1998 alone amounted to US\$ 6.5 billion. The consequences of the large exceptional financing, being notably FCDs and foreign investments in the energy sector, with guaranteed off-take and guaranteed price for electricity sales, on the long-term balance of payments situation were apparently not carefully considered either by the Government or the World Bank and IMF. In general, Pakistan needed external adjustment as much as it needed the fiscal adjustment that was so much the focus of IMF agreements for more than a decade. But until recently, the balance of payments targets suggested by IMF were much less stringent than fiscal targets. Indeed, the 1997

IMF agreement considered a current account balance of payments deficit of roughly 6 percent of GDP (*before* accruals to RFCDs) quite feasible for 1997-98.

Table 10 - Exports, Imports and Trade Deficit (US\$ Million)

Year	Exports	Imports	Trade Deficit
1980-81	2958 [10.5]	5409 [19.3]	2451 [8.7]
1984-85	2491 [8.0]	5906 [19.0]	3415 [11.0]
1989-90	4954 [12.4]	6935 [17.4]	1981 [5.0]
1994-95	8137 [13.3]	10394 [17.0]	2257 [3.7]
1995-96	8707 [13.7]	11805 [18.5]	3098 [4.9]
1996-97	8320 [13.2]	11894 [18.9]	3574 [5.7]
1997-98	8628 [13.9]	10118 [16.3]	1490 [2.4]
1998-99	7779 [13.4]	9432 [16.2]	1653 [2.8]
1999-2000	8569 [14.0]	10309 [16.8]	1740 [2.8]

Figures in parentheses are as % of GDP

The Government, IMF and World Bank were too sanguine about the prospects of large additions to resident foreign currency deposits though it had been evident for some time that a major factor in their increase was the large implicit subsidy provided by the State Bank of Pakistan through foreign exchange risk cover at a rate much below the expected depreciation of the Rupee. The decline in export earnings after 1995 should also have raised concerns about the desirability of further large increases in external obligations. Specifically, the large repayment obligations related to IPPs should have been explored in the context of the medium term balance of payments before making irrevocable commitments. That there was a policy failure on many fronts is evident from the

fact that not only was reliance on external flows excessive, but also these flows were used to finance consumption rather than investment. In relation to GDP, much larger current account balance of payments deficits were run in the 1990s compared to the 1980s. Nonetheless, the investment rate actually tended to decline in the 1990s.

Thus, the lessons from Pakistan's experience with external debt are the rather obvious ones: (a) debt problems can also arise if non-debt flows are either unsustainable or too costly; and (b) debt problems cannot be separated from broader issues of economic strategy and management.

The full impact of payments to IPPs on the balance of payments is yet to be felt, given that the Hubco dispute has been settled only recently and all projects have not yet been completed. Notwithstanding this, investment income payments (including interest payments) had risen from US\$ 1.3 billion in 1991-92 to US\$ 2.5 billion in 1997-98. According to various estimates the total impact of IPPs will be to increase them by US\$ 1.0 billion annually.

Table 11 - Dynamics of External Debt Burden

Period	Non-Interest Current Account Deficit/Surplus	Real Cost of Borrowing	Real Growth of External Debt	Real Growth in Foreign Exchange Earnings	Growth in External Debt Burden
1980s	-2.9	2.0	6.4	4.7	1.7
1990-96	-2.5	2.8	6.9	5.4	1.5
1996-99	-1.3	4.0	7.6	0.1	7.5

Unit value of imports of industrialized countries at 1980=100 has been used as deflator. Narrow definition of debt, excluding all forex accounts, is used. External debt burden growth is thus understated for the 1990s.

The above table emphasizes the pronounced relative deterioration in the external debt situation during 1996-1999. During this period the real interest rate on external debt rose while real growth in foreign exchange earnings turned negative. Behind these economic aggregates, the real problems have been: (a) poor economic management; (b) over reliance on external resources, especially during the last decade; (c) neglect of domestic savings; (d) less than effective use of borrowed resources; and (e) in extreme cases, borrowing for sustaining consumption rather than investment. Given the enormous current account balance of payments deficits and the very fragile pattern of their financing through RFCs, there was a certain

inevitability about Pakistan's foreign exchange crisis. The imposition of economic sanctions in June 1998 merely accelerated its arrival.

Consequences of High Debt Burden

The single biggest consequence of the high and growing public and external debt burdens has been a sharp slow down of Pakistan's economic growth from over 6 percent per annum in the 1980s to less than 4 percent in late-1990s. This in turn has led to a sharp increase in the incidence of poverty. But it is also true that slow growth has compounded the debt problem because debt-servicing capacity has been adversely affected. The links between high debt burden and slow growth need to be understood better.

Because self reliance is being forced on Pakistan by: (a) the overhang of heavy debt service payments; (b) limited ability to contract fresh borrowing on market terms; (c) unfavorable climate for foreign investment; and last but not least (d) drying up of sources of concessional assistance due to political factors, domestic investment will have to rely almost entirely on national savings during the next few years. Unfortunately, the national saving rate has actually declined in recent years.

Foreign savings which accounted for over 30% of our investment during the 1990s, due to rising debt service payments, came down sharply to a little over 10% of investment in 1999-00. A further decline in foreign savings (current account balance of payment deficit including official transfers) by 2003-04 is likely and only about 5% of investment will therefore be financed from external sources in 2000-2004. This will clearly slow down recovery of investment unless national savings register a sharp increase.

On the domestic side, the steady rise in interest payments on government debt to an all-time peak of 7.6% of GDP (or 33 percent total government expenditures) in 1999-00 has had a devastating impact on public development spending.

Finally, domestic and foreign private investment is being discouraged by:

- Large government domestic borrowing, which is keeping the real interest rates high.

- The shortage of complementary infrastructure and inadequate skill development, attributable directly to shortage of fiscal resources.
- Limited access to international capital markets and increased uncertainty among foreign investors on account of external debt rescheduling and the prospect of additional debt rescheduling.

Debt Trap

There is little doubt that Pakistan is in the firm grip of a debt trap. The country is caught in the vicious circle of high debt payments leading to stagnation in investment and growth, with low growth, in turn, limiting the capacity to service debt and reduce debt burden.

Inherent Dangers

Can Pakistan break this vicious circle? Certainly, if it tries hard and remains on the course of reform and adjustment. But the past record is not encouraging. Little fiscal adjustment was undertaken over the last two decades. There has been virtually no reduction in fiscal deficit, and negative government savings have increased steadily, where development has borne the brunt of relative cuts in non-interest spending.

The consequences of not dealing effectively with debt problems would be disastrous for the economic and political future of the country. Worst-case scenarios are easily imaginable, where rising debt burden would lead to:

- Further slow down in growth.
- Large scale printing of money (if revenues do not rise), leading to a rising rate of inflation.
- Consequent free-fall in the value of the Rupee.
- On the external side, default or technical default, triggering economic isolation and forcing reliance on economic controls.
- Adverse impact on flows of trade and technology.

Need for a Multiprong Strategy

The present burdens of both public and external debt are totally unsustainable. Currently it is not possible to meet our external debt service obligations without seeking debt rescheduling from the Paris Club and exceptional assistance from the IMF, World Bank and ADB. On the domestic side, even though the fiscal position now shows a primary surplus, huge interest

payments on rupee debt are keeping government internal borrowing requirements and real interest costs high. Clearly, the external debt burden needs to be brought down so that Pakistan does not need exceptional financing from the international financial institutions (IFIs) and periodic rescheduling from the Paris Club. Similarly, it is desirable that real, if not nominal, growth in government domestic debt, come down to zero in order to relieve the pressure on domestic interest rates and capital markets.

Since, the debt problem has risen because of policy failures on a broad front and over a sustained period, there is no quick fix for debt reduction. The satisfactory resolution of debt problems will take both time and aggressive policy actions. Moreover, desirable though it is, the reduction of debt to sustainable levels cannot be the only economic goal. There is also an urgent need to revive economic growth has slowed down on a trend basis to 4 percent annum. As mentioned earlier, the slow down in growth is on the one hand a major consequence of the sharply rising debt burden and, on the other hand, compounding the debt problem by adversely affecting debt service capacity. In order to free itself from the debt trap, Pakistan needs an integrated economic revival and debt reduction strategy. The twin goals of this strategy should be (a) a notable reduction in debt burden, and (b) a significant increase in the growth rate over the medium term. In the short-run of two to three years, some difficult trade-offs between debt reduction and economic growth will be unavoidable. But the Committee is confident that with strong financial discipline, forceful structural reforms and improved governance, economic growth can be revived to a sound 5.5 percent per annum by 2003-04. At the same time, real external debt burden can be reduced by 25-30 percent and the need for exceptional assistance from the IMF and Paris Club rescheduling phased out by 2004. In the second half of this decade, economic growth can recover to over six percent per annum while public debt burden can be brought sharply down by 2010.

Growth Revival and Debt Reduction

An integrated economic revival and debt reduction strategy should have the following eight interrelated elements:

- Reviving economic growth notwithstanding financial constraints, by focusing on improvements in factor productivity through both structural reforms and improved governance. The most promising sectors for expansion are agriculture, manufactured exports and oil and gas.

- Improving debt carrying capacity through growth in exports, remittances and other foreign receipts, and growth in government revenues.
- Reducing the rate of future borrowing by reducing the fiscal and current account balance of payments deficits, and reducing the large losses of state owned enterprises that augment the budget deficit.
- Working towards an agreement with IMF for Poverty Reduction and Growth Facility (PRGF) for 2001-2004, which will also ensure: (a) exceptional financing needed from other multilateral organizations, (b) debt rescheduling from bilateral sources, and (c) reasonable risk rating in international financial markets.
- Bringing down the real cost of government borrowing, especially domestic borrowing.
- Accelerating the process of privatization and private sector development. Improving the climate for domestic and foreign investment, increasing attractiveness of foreign private investment flows especially for export-oriented activities, and reducing incentives for flight of capital abroad.
- Improving the effectiveness of government expenditures especially the use of borrowed resources, specifically through elimination of government borrowing for non-development expenditures and more effective use of foreign aid.
- Adopting a medium and long-term debt strategy with clearly defined goals of debt burden reduction and putting into place debt management and monitoring systems to effectively review and monitor progress on debt including on contingency management in the context of a rolling medium-term macroeconomic framework.

The agenda outlined above is extremely tough. It will require single-mindedness, a strong will to stay the course and determined efforts to overcome implementation problems. Pakistan's history is littered with failures of important economic initiatives. Nothing less than a major break from the past is needed to rectify major policy mistakes. Skepticism abounds but the Committee is confident that the Government will be able to successfully implement the integrated economic revival and debt reduction strategy provided (a) it pursue macro-adjustment and structural reforms single-mindedly (b) improves governance (c) strengthens public institutions for development significantly, and (d) strongly resists pressures from well established vested economic interests, namely redundant employees in the public sector, recipients of economic rents in the private sector, corrupt officials, especially in the tax and police department, and labor unions.

The Committee recognizes that the Government is already emphasizing many elements of the above strategy. It is focusing on the reduction of fiscal deficits, mobilization of government revenues, expansion of exports, privatization and strengthening of oil & gas and information technology sectors. It is also attaching high importance to maintaining a program with the IMF with a view to moving towards a three year Poverty Reduction and Growth Facility (PRGF) which will provide the basis for exceptional assistance from the World Bank and ADB and further rescheduling from the Paris Club till 2004.

However, actual progress is still impeded by the interrelated problems of implementation, very limited institutional capacity and poor governance. Even though many of the elements of debt reduction strategy (expanding exports, raising revenue, improving private investment) are closely linked to broader issues of economic management and governance, it is beyond the scope and capacity of the Committee to deal in depth with this large range of issues. The main focus of the Summary Report is to define realistic objectives of external and public debt reduction, identifying the means to achieve those objectives and putting them in the context of other economic goals. The Committee is stressing the need to adopt a medium and long-term debt strategy with clearly defined goals of debt reduction, arrangements for contingency management and an institutional framework to monitor and review progress towards debt reduction goals. But since debt management is intimately connected with overall economic management, analysis, findings, and recommendations are made in the context of an overall macroeconomic framework.

Revival of Growth with Financial Constraints

Since strong economic growth, accompanied by an expanding level of government revenues and foreign exchange earnings, is essential for reducing not only the present debt burden but also for creating capacity for future borrowing, the acceleration of growth initially to 5.5 percent per annum by 2003-04 and further to over 6 percent in the second half of the decade deserves high priority. The dilemma is that the recovery of investment rate would at best be slow (the ratio of investment of GDP is projected to increase from 15 percent to 16.8 percent over 2000-2004).

The challenge before the Government is to use the improvements in productivity and better governance to achieve acceleration in growth. In principle, this should not be difficult because economic resources have not been used very efficiently in the past and poor governance

hampered the effectiveness of delivery of public services. Agriculture, manufactured exports, information technology and oil & gas should be the leading edge of growth. In all these sectors, a number of policy steps can contribute to reviving growth in the short to medium term even without a lot of new investment. For instance, agricultural output can be expanded by (a) better use of existing water resources through improved canal irrigation and maintenance, and (b) providing better incentives for water use and on farm development by sharply raising water rates. Similarly, a forceful use of the regulatory authority can help reduce adulteration in seeds, pesticides and fertilizers. In industry, the Government needs to be highly selective in reviving sick industrial units. Closing down unviable plants and avoiding use of scarce resources on sick or nearly dead units will force attention on new economically profitable avenues of exports and industry. Policy focus on value-added exports and a move away from cotton yarn would also help. In general also, the objective in the export field should be increasing unit values as well as volumes. In the oil and gas field, gas price adjustments and firm commitment to full gas price deregulation over the next two to three years will not only speed up privatization and accelerate gas development but also result more immediately in a more rational use of energy.

Table 12 - Macroeconomic Projections

	1980's	1990-95	1995-99	1999-2000	2000-2004	2004-10
Real GDP Growth	6.5	4.9	4.0	4.8	4.8	6.2
Inflation	7.7	11.5	9.8	3.6	5.6	6.1
As % of GDP						
Investment	18.7	19.5	17.6	15.0	15.9	19.7
National Savings	14.8	14.8	12.9	13.4	15.0	17.9
Foreign Savings ¹	3.9	4.7	4.7	1.6	0.9	1.8
ICOR²	2.8	3.7	4.0	2.8	3.1	2.9

¹ Defined as the current account balance of payments deficit.

² Incremental capital-output ratio

Another area where much more can be achieved, with a given amount of resources, is public spending on education and health. Without major structural improvements, including much greater autonomy and higher cost recovery, momentum in these sectors will continue to move towards the high cost but relatively high quality private sector in education and health. The government should use its plans to devolve authority to local level for massive decentralization of education and health services.

The macroeconomic scenario presented in Table 12 tries to balance a number of economic goals that may conflict, at least in the short run. The scenario provides for acceleration of annual economic growth from around 4 percent at present to 5.0 percent in 2001-2003 and 6.2 percent over 2004-2010, while the strategy and economic projections underpinning the scenario target significant reductions in external and public debt burdens over time (See **Box 6**). Economic growth during the next few years will continue to be constrained by the relatively low rate of investment in relation to GDP. The average investment rate over 2000-2004 will be barely 16 percent against an average of over 18 percent in the 1990s. The reduction in the investment rate reflects, among other things, a reduction in the availability of external resources as a result of the heavy burden of external debt payments.

Reliance on external resources to finance over 30 percent of investment in the 1990s was both unsustainable and undesirable. Our macroeconomic scenario assumes that Pakistan will have to manage with very limited net foreign savings (that is, current account balance of payments deficit) over 2000-2004, but restoration of external debt equilibrium thereafter will enable larger inflow of both external loans and foreign private investment. Specifically, it is assumed that the current account balance of payments deficit will continue to decline till 2004, because of external financial constraints, but will gradually increase to 3% of GDP by the end of the decade with reasonable export growth. Still, reliance on foreign savings will be less than 10 percent of total projected investment during 2004-2010. Thus the pattern of development will tend towards self-reliance. Investment is thus projected to average 19.7% of GDP during 2004-2010, slightly higher than the previous peak of 19.5 percent during 1990-1995.

The investment recovery, combined with expected improvements in productivity, could push the GDP growth rate to 6.6 percent per annum by 2009-10. Pakistan's population growth rate is expected to drop gradually from the present level of 2.2 percent to 1.8 percent per annum by 2009-10, reflecting the demographic transition that has begun, to maintain which, aggressive policy steps to further female education, public awareness and provide extended family planning services are necessary. There are thus good prospects of achieving a per capita GDP growth rate of over 4 percent per annum in the second half of this decade.

The viability of the critical short-to-medium term scenario depends on three key conditions materializing, namely (a) a significant national saving effort, (b) broad international

support to meet the large overhang of external debt payments, and (c) major improvements in productivity.

The scenario for 2000-2004 assumes that the national saving rate will increase from 13.4 percent of GDP in 1999-00 to 16.7 percent in 2003-04, implying a marginal saving rate of over 30 percent. This improvement in saving is feasible because it is projected to come mainly through turning the large Government revenue deficit (3.7 percent of GDP in 1999-00) to a small surplus by 2003-04 (see discussion below). The task of putting a financial package together so that Pakistan can meet its external obligations in an orderly fashion is also discussed at length later in the report. An equally big challenge will be to bring about distinct improvements in productivity. As Table 12 indicates, the basic assumption is that the incremental capital-output ratio which increased sharply in the 1990s, denoting inefficient use of resources, can come down at least partly towards the historical average as a result of structural policy and governance improvements.

Box 6 - Key Assumptions of Macroeconomic Framework

Pakistan is currently experiencing deceleration in economic growth. Real GDP grew by an average rate of 6.1 percent in the 1980s but slowed to an average of 4.9 percent during 1990-1995 and further to 4.0 percent during 1995-2000. The Committee envisages that the economy will revive gradually with real GDP growing by 5.5 percent in 2003-04 and further by 6.6 percent in 2009-10. The Committee has noted that unrealistic growth targets were set in the past, which could not be realized, in the process undermining the Government's credibility. Consequently, although these growth targets may appear low, the Committee believes that taking the economy from a low and declining growth path to a relatively higher and sustainable path will not be a meager achievement. Indeed, it will still require a significant improvement in the marginal efficiency of capital. We have assumed that the Incremental Capital Output Ratio (ICOR), 3.0 during 2000, will show significant improvement over the trend (around 3.8) in the 1990s.

Investment in the medium-term (2003-04) will remain constrained by balance of payments developments. The current account deficit as percentage of GDP will decline to a low level by 2003-04. As a result, only limited foreign savings will be available to supplement national savings to maintain a higher level of investment. Investment is thus projected to increase from the current level of 15 percent of GDP to 16.8 percent by 2003-04, and 22.6 percent by 2009-10. Of this, public sector investment is projected to rise from the current level of 5.3 percent of GDP to 5.8 percent by 2003-04, and thereafter to 8.0 percent by 2009-10. The private sector share is estimated to rise from the current 8.1 percent to 9.5 percent of GDP by 2003-04 and further to 13.1 percent by 2009-10.

With foreign savings remaining low until 2003-04, it is largely national savings through which domestic investment must be financed in the medium-term. Savings as percentage of GDP are projected to rise from 13.4 percent currently to 16.7 percent by 2003-04 and 19.6 percent by 2009-10, with an implied marginal saving ratio close to 30 percent. It is desirable that government dissaving ultimately be eliminated.

Inflation in Pakistan has come down to 3.6 percent in 1999-00 from a double-digit average in the 1990s. It is projected to remain close to 6.0 percent over the forecast period. With fiscal improvement and prudent monetary management, limiting inflation to 6.0 percent per annum should be attainable.

While the productivity improvements required are substantial, there is at least a historical precedent. Pakistan needs to learn from its own experience in the second half of the 1960s when very high growth rates were achieved notwithstanding a sharp decline in the investment rate. The growth in that period was made possible in part by the spread of green revolution. The task now is to utilize the potential in agriculture, manufactured exports and information technology and the unutilized economic capacity in power and industry to bring about significant increases in output. There is also the need to keep strict control of longer-term investment projects that will not necessarily aid growth in the short run.

The risks that the desired acceleration in the medium-term growth rate will not materialize are considerable. They arise from the possibility that domestic policy actions especially on the implementation side will not be forceful or speedy enough. They also arise from the danger that international response to Pakistan's external debt problem will not be adequate. If the growth rate does not recover, there will be major negative consequences for employment and welfare of the poor and the risk of political instability will grow. But if Pakistan can safely navigate the turbulent economic waters during the difficult transition period of next three to four years, it will have laid the basis of high, self-sustaining and equitable economic growth.

Centrality of Fiscal and External Adjustment

The first and most immediate step towards reducing the debt burden is to implement the extremely tough fiscal and external adjustment, implied in the recent agreement with IMF, and follow it up with a longer-term agreement under a three-year PRGF. With this, Pakistan can reasonably hope to eliminate the need for further IMF programs. In the meantime, however, an IMF program is a pre-condition for present debt rescheduling.

If the Government wishes to eliminate the need for an IMF program, it has absolutely no alternative to implementing the adjustment measures, which are in Pakistan's long-term economic interest. **Table 13** summarizes the nature of the fiscal adjustment needed, which is

centered on reduction of the fiscal deficit from 6.5% of GDP in 1999-00 to 3.0 percent by 2003-04. The toughness of the fiscal and external adjustment can be seen from the fact that it requires:

- A nearly 75% increase in government tax revenues from Rs. 407 billion to Rs. 704 billion over a three-year period, raising the tax revenue to GDP ratio from 12.8% in 1999-00 to 14.7% in 2003-04.
- A dramatic improvement in exports (f.o.b.) from US\$ 8.2 billion in 1999-00 to US\$ 12.0 billion in 2003-04, raising the share of merchandise exports from 13.3% of GDP to 17% over the period. In incremental terms, this will require that well over one third of the additional output of the country during 2001-2004 be exported. But it must be emphasized that merchandise exports actually stagnated during 1996-2000 and Pakistan lost its market share.
- A substantial relative reduction in share of defense spending from 4.7% of GDP in 1999-00 to 3.9% in 2003-04, implying no increase in security-related expenditures in real terms.
- Elimination of sizeable negative government savings or borrowing for non-development expenditure, including defense, in three years.

Even if we assume that the Government will take tough measures, it cannot be safely ensured that key variables in external debt (such as net export, differences between the interest rate and growth rate of foreign exchange earnings, accumulation of foreign reserves or other capital inflows) and in the public debt (such as primary fiscal surplus, difference between interest rate and growth rate of public revenue and exchange rate valuation effects) will remain on the required growth paths to achieve the postulated outcomes. As discussed below, there is a need to undertake risk management and make contingency plans to deal with shortfalls in key targets. This is also the reason why the Debt Committee has worked with two fiscal variants of the macroeconomic scenario. (See discussion below)

Public Debt Burden Reduction

Pakistan's public debt problem has less immediacy than its external debt problem. Indeed some may argue that because the domestic part of public debt can always be rolled over relatively easily, and in the worst-case scenario can be repaid through printing of money, it does not pose a serious problem. This reasoning is flawed because it ignores that a large part (51%) of the *public* debt is external in nature and payable in foreign exchange. Furthermore, repaying public debt by printing money will have serious inflationary consequences for the economy, especially for the poor.

The dynamics of recent debt growth also suggest that the public debt problem is relatively more intractable. Four factors deserve attention in this regard. First, the fiscal deficit is still high (6.5 percent of GDP in 1999-00 compared with an average of 7 percent during the last five years) while the external current account balance has already come down drastically (1.6 percent of GDP in 1999-00, compared with 4.7 percent of GDP during the last five years). Second, the effective real cost of borrowing of domestic debt, which peaked at nearly 9 percent during 1998-2000 will remain high in the near future. The continued high interest payments on Defense Saving Certificates, interest on which is accounted on cash rather than accrual basis, will remain a drag on public debt for many years to come, notwithstanding the sharp cuts in rates of return since May 1999. Third, the large expected fiscal contingency payments (mainly on account of losses of PSEs) will continue to exert an upward pressure on government domestic borrowing. Fourth, the relative contribution that privatization proceeds can make towards reducing public domestic debt is smaller than that in the case of external debt. Total public debt is close to Rs 3200 billion while net proceeds from privatization are not likely to exceed Rs 200 billion in the next five years.

Formulation of a public debt reduction strategy must be in the context of a macroeconomic framework to ensure consistency of debt reduction goals with projections for key macroeconomic aggregates like growth, inflation, investment, government revenues, expenditures, fiscal deficit, and the balance of payments. The Committee has analyzed the prospects of public debt burden reduction with the help of its medium-to-long-run macroeconomic scenario presented above, but with two fiscal variants. In both variants the fiscal adjustment in terms of reduction of fiscal deficit is the same. The overall fiscal deficit is assumed to decline from the current level of 6.5 percent of GDP to 3.0 percent by 2003-04 (a reduction of 3.5 percentage points in four years) and further to 1.8 percent by 2009-10. It may be pointed out that the long-run sustainable fiscal deficit may be in the range of 3 to 4 percent by GDP for Pakistan. However, we have envisaged that fiscal deficit must decline and remain below 3 percent of GDP till such time that the public debt burden stabilizes at a manageable level.

The first fiscal scenario assumes major fiscal efforts in terms of mobilizing tax revenue and prudent expenditure management (**Table 13**). It also assumes that higher resource mobilization efforts will enable the Government to enhance public sector development programs and social sector spending relatively quickly. This strategy is consistent with the Government's

resolve to improve social indicators, arrest rising trends in poverty, take the economy gradually to a higher growth path, and reduce the debt burden to sustainable levels.

The second fiscal scenario assumes a relatively modest tax effort on fiscal front. It also assumes that institutional capacity, which has been eroded over the years for a variety of reasons, will improve only gradually. In other words, the Government's ability to collect taxes on the one hand and spend money efficiently effectively on the other will remain a major issue, at least in the medium-term.

Having carefully considered options, including possible trade-offs between debt reduction and economic revival in the short-to-medium term, the Committee is of the view that orderly reduction of public debt burden to a sustainable level of 350 percent of government revenue will take a decade even under the high revenue scenario. Reduction in public debt burden at a faster pace as compared to the one presented in **Table 14** could either hurt economic growth or result in a higher rate of inflation.

Key assumptions of the high revenue and high expenditure fiscal adjustment scenario are:

- Increasing total revenue at an average rate of 12.8 percent over the next four years (up to 2003-04). Revenue must increase thereafter at an average rate of 14.2 percent per annum. Total revenue should increase by 50.0 percent in the next four years and double in the remaining six years. Tax revenues as percentage of GDP grow from 12.8 percent in 1999-2000 to 14.7 percent in 2003-4 and 16.5 percent in 2009-10.
- Major efforts to contain expenditure at least over the next four years (up to 2003-04) are envisaged. Total expenditure increases by an average rate of almost 8 percent per annum over the next four years and 13.0 percent during the remainder forecast period. Fortunately, this adjustment is greatly helped by the declining share of interest payments in total government expenditure.
- Maintaining expenditure restraint still makes it possible to bring about significant changes in the composition of expenditure. While development expenditure must increase gradually from 3.0 percent of GDP to 3.5 percent by 2003-04 and 4.5 percent by 2009-10, current expenditure will decline significantly from 20.2 percent of GDP to 17.2 percent by 2003-04 (a reduction of 3 percentage point in four years) and further to 16.3 percent by 2009-10.
- Major success in curtailing current expenditure will come from a significant reduction in interest payments. As percentage of GDP, interest payments must decline from the current level of 7.6 percent to 5.4 percent of 2003-04 (a

reduction of 2.2 percentage points in four years) and further to 3.3 percent by 2009-10. The sharp reduction in interest payments is made possible both by reduced level of debt, change in its composition towards concessional external debt and reduction in interest rate on domestic borrowing (real interest rate declines from 10 percent in 1999-2000 to 4.5 percent by 2003-04 and further to 3.5 percent by 2009-10).

- The sharp reduction in interest payments makes it possible to generate primary surplus to the extent of 2.5 percent of GDP by 2003-04. The primary surplus will continue, therefore, albeit at a more modest pace, helping stabilize the debt burden of the economy.
- More importantly, revenue deficit must turn into surplus by 2003-04 and the surplus continues to rise. This means that borrowing for current consumption will be eliminated by 2003-04. The surplus in revenue account will help to increase national savings to finance domestic investment.

**Table 13 - Strong Fiscal Adjustment
(High Revenues and High Social and Development Expenditure Scenario)**

(Rs in Billion)

	1998-99	1999-2000	2003-2004	2009-2010
Total Revenue	475	524	847	1885
	(16.3)	(16.5)	(17.6)	(19.0)
- Tax Revenue	389	407	704	1638
	(13.3)	(12.8)	(14.7)	(16.5)
Total Expenditure	651	731	991	2063
	(22.4)	(23.0)	(20.7)	(20.8)
Current Expenditure	564	642	823	1618
	(19.3)	(20.2)	(17.2)	(16.3)
- Interest Payments	213	243	262	326
	(7.3)	(7.6)	(5.4)	(3.3)
- Defense	144	150.0	187.0	297.0
	(4.9)	(4.7)	(3.9)	(3.0)
- Others	207	249.0	374.0	995.0
	(7.1)	(7.8)	(7.8)	(10.0)
Development Expenditure	109	96.0	168.0	445.0
	(3.7)	(3.0)	(3.5)	(4.5)
Fiscal Deficit	-176.3	-206.3	-143.9	-178.1
	(6.0)	(6.5)	(3.0)	(1.8)
Revenue Deficit/Surplus	-88.6	-117.8	24.0	267.3
	(3.0)	(3.7)	(0.5)	(2.7)
Primary Surplus	37.0	37.0	120.9	160.4
	(1.3)	(1.1)	(2.5)	(1.6)
Total Public Debt	2971	3196	4414	6256
	(102.0)	(100.4)	(92.0)	(63.2)
- Foreign Debt	1582	1625	2533	3900

	(154.3)	(51.0)	(52.8)	(39.4)
- Domestic Debt	1389	1572	1882	2356
	(47.7)	(49.4)	(39.2)	(23.8)
As % of Total Revenue				
Total Debt	626	610	521	332
Domestic Debt	293	300	222	125

Estimates above do not include allowance for either contingency payments or privatization receipts. Contingency payments over the four years 2000-4 may be as large as Rs.100 billion. However, they will be more than offset by privatization receipts, which could total nearly Rs 200 billion even after allowing 10% of the total for poverty reduction
Note: Figures in parenthesis are percentage of GDP

As a result of the fiscal developments outlined in Table 13, public debt burden declines in an orderly fashion without jeopardizing growth and macroeconomic stability. Domestic debt declines sharply from the existing level of 49.4 percent of GDP to 39.2 percent by 2003-04 (a reduction of ten percentage points in four years) and further to 23.8 percent by 2009-10. As a percentage of total revenue, domestic debt declines from the current level of 300 percent to 222 percent by 2003-04 and further to 125 percent by 2009-10. Total public debt burden also declines sequentially, from the current level of 100 percent of GDP to 92 percent by 2003-04 and further to 63.2 percent by 2009-10. As percentage of total revenue, total public debt declines from 610 percent to 521 percent by 2003-04 and further to 332 percent by 2009-10.

Table 14 presents the more modest tax and expenditure scenario. Key elements of this scenario are:

- Total revenue increases at an average rate of 10.8 percent per annum over the next four years (up to 2003-04) and by 13.4 percent per annum during the remainder period of forecast. Tax revenues as percentage of GDP grow from 12.8 percent in 1999-00 to 13.9 percent in 2003-04 and 14.6 percent in 2009-10.
- Total expenditure increases at an average rate of 6.3 percent per annum over the next four years and by 10.2 percent per annum during the next six years. Development expenditure remains at 3.0 percent of GDP by 2003-04 and gradually increases to 3.5 percent of GDP by 2009-10.
- Development expenditure increases at an average rate of 10.8 percent over the next four years but accelerates to an average rate of 15.8 percent thereafter. The acceleration at the later part of the forecast period is based on the assumption that institutional capacity will improve gradually.

As per the projections in Table 14, public debt burden will not reach a sustainable level of 350 percent of total revenue in one decade. Domestic debt as a percentage of total revenue declines from the current level of 300 percent to 238 percent (as opposed to 222 percent in the first scenario) by 2003-04 and further to 140 percent (as compared to 125 percent in the first

scenario) by 2009-10. Similarly, total public debt as a percentage of total revenue declines from the existing level of 610 percent to 559 percent (as compared to 521 percent in the first scenario) by 2003-04 and further to 373 percent (as compared to 332 percent) by 2009-10. Since institutional weaknesses in spending money efficiently constrain the revenue effort and debt burden reduction, it is highly desirable to improve institutional capacity especially through the devolution plan.

**Table 14 - Strong Fiscal Adjustment
(Moderate Revenue and Moderate Development and Social Expenditure Scenario)**

(Rs in Billion)

	1998-99	1999-2000	2003-2004	2009-2010
Total Revenue	475	524	790	1677
	(16.3)	(16.5)	(16.5)	(16.9)
- Tax Revenue	389	407	665	1449
	(13.3)	(12.8)	(13.9)	(14.6)
Total Expenditure	651	731	934	1855
	(22.4)	(23.0)	(19.5)	(18.7)
Current Expenditure	564	642	790	1508
	(19.3)	(20.2)	(16.5)	(15.2)
- Interest Payments	213	243	262	326
	(7.3)	(7.6)	(5.4)	(3.3)
- Defense	144	150	187	297
	(4.9)	(4.7)	(3.9)	(3.0)
- Others	207	249	341	885
	(7.1)	(7.8)	(7.1)	(8.9)
Development Expenditure	109	96	144	346
	(3.7)	(3.0)	(3.0)	(3.5)
Fiscal Deficit	-176.3	-206.3	-143.9	-178.1
	(6.0)	(6.5)	(3.0)	(1.8)
Revenue Deficit/Surplus	-88.6	-117.8	0	168.3
	(3.0)	(3.7)	0.0	(1.7)
Primary Surplus	37.0	37.0	120.9	160.4
	(1.3)	(1.1)	(2.5)	(1.6)
Total Public Debt	2971	3196	4414	6256
	(102.0)	(100.4)	(92.0)	(63.2)
- Foreign Debt	1582	1625	2533	3900
	(54.3)	(51.0)	(52.8)	(39.4)
- Domestic Debt	1389	1572	1882	2356
	(47.7)	(49.4)	(39.2)	(23.8)
As % of Total Revenue				
Total Debt	626	610	570	373
Domestic Debt	293	300	239	140

Estimates above do not include allowance for either contingency payments or privatization receipts. Contingency payments over the four years 2000-4 may be as large as Rs.100 billion. However, they will be more than offset by privatization receipts, which could total nearly Rs 200 billion even after allowing 10% of the total for poverty reduction

Note: Figures in parenthesis are percentage of GDP

Table 15 illustrates that, should these projections be realized, interest payments will decline from 33.3 to 16.4%, whilst defense will fall from 20.6 to 14.4% of public expenditure. Development expenditure will thus have space to rise from the current 13.1 to a healthier 21.6%.

Table 15

Structure of Public Expenditure:						Rs Billions
High Revenue/High Social and Development Expenditure Scenario						
	1980-1981	1989-1990	1998-1999	1999-2000	2003-2004	2009-2010
Interest Payments	5 (9.3)	47 (21.2)	213 (32.8)	243 (33.3)	265 (26.7)	339 (16.4)
Defense	13 (24)	59 (26.5)	144 (22.0)	150 (20.6)	187 (18.9)	297 (14.4)
Other Current Expenditure	18 (32.1)	60 (27.1)	185 (28.5)	242 (33.0)	371 (37.5)	982 (47.6)
Development Expenditure	19 (34.6)	56 (25.3)	109 (16.7)	96 (13.1)	168 (16.9)	445 (21.6)
Total	55 (100.0)	222 (100.0)	651 (100.0)	731 (100.0)	991 (100.0)	2063 (100.0)

Figures in parentheses are percentage shares in total

Table 16 highlights the projected trend in domestic public debt in real terms, provided the assumed strong adjustment takes place. It shows that real domestic debt will gradually decline over 2000-10. Thus the Government will not be a net borrower in real terms and this will have a great salutary effect on domestic borrowing costs. The decline in real domestic debt is made possible by the expected exceptional assistance by international organizations for the balance of payments. This will help relieve pressure on government domestic borrowing given the level of planned fiscal deficits

Table 16

Trends in Domestic Public Debt			Rs Billions
Years	Rs in Constant 1999-00 Prices	As % of GDP	As % of Revenues
1979-80	341	39	155
1989-90	1012	47	245
1995-96	1205	42	219
1999-00	1572	49	300
2003-04¹	1521	39	222
2009-10¹	1453	24	125

1. Projected

Contingent Liabilities and Fiscal Risks

It is widely believed that limiting the fiscal deficit can contain public debt. However, planned fiscal deficit reductions may be compromised on account of contingent liabilities. These liabilities either show up as (hidden) borrowing outside the budget, or enter the budget through lower receivables (versus potential) or higher payables. Therefore, unless the fiscal impact of contingent liabilities is taken into account, the illusion of fiscal adjustment may create a sense of complacency.

The Government has to assume responsibility for all contingent liabilities in one form or other. It has, however, no system for managing them, and has yet even to consolidate these obligations and their total magnitude en bloc, for inclusion in overall fiscal analysis and expenditure planning. According to our estimates, actual contingency payments amounted to over Rs. 55 billion during 1998-2000. We also believe that expected contingency payments over the next three years may add Rs. 66 billion to the real burden of debt.

A unique feature of contingent liabilities is the time lag with which such unexpected forms of public financing requirements arise. Contingent fiscal risks may continue to accumulate before they are realized and thus require substantial government financing. In this respect, government guarantees are extremely important. A government's commitment to accept obligations contingent on future events amounts to a hidden subsidy that may cause a major unexpected drain on government finances in the future. This implicit subsidy arising from government guarantees has ranged from 0.2% of GDP in 1996 to 1.2% of GDP in 1998, according to our estimates.

While looking at contingent fiscal risks, we have based our analysis on both explicit and implicit contingent liabilities. As it turns out they mainly arise from losses incurred by public sector enterprises which, as in the past, and continue to exert major claims on the budget. Public corporations like TCP, CCP, CEC, RECP, Saindak etc. had been incurring substantial losses and huge operating deficits. To cover their losses government guaranteed bonds were issued, which assigned to the government the responsibility of repaying either a part (only interest payments) or the entire amount (interest and principal payments) owed on account of these bonds if the corporations could not service these bonds themselves. But from the very outset, these corporations could not service these bonds and the Government had to take over the entire

liability. As the situation stands today, the Government is servicing the entire amount payable on these bonds. Since (interest and principal) payments on these loans and bonds are now being serviced from the budget, amounting to almost Rs. 50 billion, they should be considered a part of public debt, especially as this amount is likely to increase substantially in the coming years.

In addition, Pakistan Steel Mill had taken out government guaranteed loans, which it could not service. These (non-performing) loans, of around Rs. 19 billion, represent an explicit contingent liability, which will now have to be serviced with Government support. The restructuring of Pakistan Steel Mill is underway and government is trying to ensure that the entire burden of its non-performing loans (NPLs) should not fall on the budget. However, the Pakistan Steel Mill loan portfolio represents a significant risk of exerting future claims on the budget.

Estimates of contingency payments should also include such implicit contingent liabilities like Government bailout of even non-guaranteed debt obligations of strategically important state corporations and authorities, like WAPDA and KESC. Even if these corporations have huge losses and cannot meet their obligations, the Government cannot allow them to close down and declare bankruptcy, necessitating that the Government come forward to provide massive financial relief to para-statal enterprises, as has occurred a number of times.

During 1999-00, WAPDA had outstanding debt servicing liabilities (DSL) to the Government of around Rs. 36.4 billion, which it could not meet owing to a number of reasons: payments to IPPs and higher fuel cost being two major ones, plus the associated effect of exchange rate depreciation. A debt-for-equity swap was thus introduced, which effectively wiped out WAPDA's liabilities to the Government for 1999-00, by reducing its receivables.

This transaction was shown as an investment in Government accounts, but was actually a permanent reduction in the Government's receivables by Rs. 36.4 billion, thus lowering its net worth. Clearly, subsequent steps have to be taken to ensure that the need for another such equity injection, or some other form of bailout, does not arise. Though WAPDA's restructuring is well underway and it is believed that the need for further financial relief will not arise, the risk of such a possibility still exists. According to WAPDA's own projections it believes that it will enjoy cash surpluses during the period upto 2000-03. However, we are of the view that those estimates

may have been based on assumptions of lower fuel prices and consequently lower payments to IPPs. Using revised estimates of WAPDA's payments to IPPs provided by WAPDA, we have estimated a significant cash deficit for WAPDA over the next three years. Although, this entire amount may not have to be picked up by the Government, the risk of a considerable additional claim remains.

The case of KESC is even more complicated as it faces an estimated cash shortfall of Rs. 56 billion till 2002-03. This shortfall will principally be met by three means. First, through the conversion of Rs. 22 billion worth of subordinate loan and DSL into equity. Second, by arranging a bridge financing facility of Rs. 9.6 billion, through Muslim Commercial Bank (MCB), with an explicit guarantee by the Government for payment without recourse to KESC; and rolling over existing guarantees of Rs. 8 billion. Third, redemption of Term Financing Certificates (TFCs) worth Rs. 11.5 billion through the issuance of 10-year bonds with a government guarantee. The last two avenues of bailout fall in the ambit of explicit contingent liabilities as they make the Government contractually liable for these liabilities. The bonds worth Rs. 11.5 billion for to redeem TFCs, though approved, have not yet been issued, and therefore not included in our calculation of contingent liabilities, as their terms and conditions have not been finalized.

Unfunded losses of public sector banks, to the tune of Rs. 57 billion (in 1997-98), are another source of implicit contingent liability, which may ultimately fall on the State Bank of Pakistan (SBP). In that case, it will be reflected in lower SBP profits and non-tax revenue receipts of the Government.

If the Government wants to bring about real fiscal adjustment, the root cause of these public sector corporations' losses must also be tackled by comprehensive restructuring, introduction of corporate management structures, and ultimate privatization. Till then, the effect of such unexpected hits on the budget will have to be taken into account and analyzed for future budgetary planning.

Box 7 - Losses of State Enterprises

There is a general belief that growth of public debt can be curtailed by containing the fiscal deficit. However, this may not always be possible, on account of contingent liabilities. These are Government commitments (contractually binding or otherwise) outside the budget, which are dependent upon future events that may or may not materialize. Contingent liabilities may continue to accumulate over time and ultimately add to public debt, thereby thwarting efforts at containing public debt by limiting the fiscal deficit. The contingent liabilities of the Federal Government mainly emanate from losses of public sector corporations and banks. During 1999-00 losses of major state owned corporations amounted to around Rs. 28 billion, some of which entered the budget while the rest remained outside it. It is expected that these losses will be even higher during 2000-01 and ultimately increasing the debt burden.

Losses of Public Sector Corporations

(Rs. Millions)

	Loss 1999-00	Cumulative Loss 1999-00	Projected Loss 2000-01
Pakistan International Airlines (PIA)	1,172	7,046	N.A.
Pakistan Steel Mill	1,341	9,526	N.A.
Karachi Electric Supply Corporation (KESC)	12,768	37,186	11,979
Water and Power Development Authority (WAPDA)	8,527 ¹	N.A.	12,397
Pakistan Railways (PR)	2,773.6	27,918	4,155.8
Others²	1,236.3	10,438.7	N.A.
TOTAL	27,817.9	92,114.7	28,531.8

Source: Ministry of Finance

1. Government converted WAPDA's pending debt servicing liability of Rs 36.4 billion into equity, during 1999-00. The loss of Rs. 8,527 million was achieved in spite of the equity injection.

2. Include: Pakistan National Shipping Corporation (PNSC), Karachi Steel and Engineering Works (KS&EW), Utility Stores Corporation (USC), Heavy Mechanical Corporation (HMC), State Engineering Corporation (SEC), Pakistan Engineering Corporation (PEC), Heavy Engineering Complex (HEC), Pakistan Broadcasting Corporation (PBC), and Pakistan Tourism Development Corporation (PTDC).

For example, Pakistan Steel had been incurring huge losses for years, to cover which it accumulated Government guaranteed liabilities of Rs. 19 billion towards five commercial banks by 1999, which it subsequently could not service. The Government, therefore, initiated a process of financial restructuring of Pakistan Steel and divided the entire liability into two portfolios of Rs. 11.3 billion (principal payments) and Rs. 7.7 billion (interest payments). The Government decided to take upon itself the responsibility of repayment of the latter (interest) portfolio, directing Pakistan Steel to initiate payments from its own resources on the former (principal) portfolio when it falls due. It is not clear, however, that Pakistan Steel will be able to meet this financial commitment.

In addition to such contractually guaranteed liabilities there are other (non-guaranteed) liabilities falling due on strategically important corporations, which are equally significant. This is because the Government cannot allow these corporations (especially banks) to fail (or shut down) even if they face financial ruin, as closure may result in significant disruption of economic activity. Thus bailout of such

corporations, which are too important to fail, will also lead to a rise in public debt burden. This was clearly demonstrated in the recent bailout of KESC, which had been facing severe financial difficulties since the mid 1990s and an estimated cash shortfall of Rs. 56 billion till 2002-03. In order to keep KESC solvent till then, the Government has adopted a three-pronged approach. First, Rs. 22 billion of its debt obligations have been converted into equity, thereby effectively writing them off at Government expense. Second, Term Financing Certificates (TFCs) worth Rs. 11.5 billion are in the process of being redeemed through issuance of ten-year government guaranteed bonds, thereby raising the specter of future government outlays. And third, by arranging a bridge financing facility of \$225 million from the ADB

to allow KESC to cover its losses, increasing direct government liabilities commensurately. All this has been done to keep KESC afloat though the effect of these actions will be to raise the level of public debt.

Then there is the WAPDA bailout of 1999-00. During 1999-00, WAPDA had outstanding DSL (debt servicing liabilities) to the Government of about Rs. 36.4 billion it could not meet. A debt-for-equity swap was thus orchestrated, which effectively wiped off WAPDA's liabilities to the government for 1999-00. This transaction was shown as an investment expense in government accounts, but was actually a permanent reduction in government receivables by Rs. 36.4 billion and thus a lower net worth. Both in the case of WAPDA and KESC subsequent steps need to be taken to ensure that need for another such, or some other form of, bail out does not arise. Though, restructuring of both these corporations is well underway and it is believed that the need for further such financial restructurings will not arise, however the risk of such a possibility, and a substantial rise in claims on government exchequer, still remains.

The banking sector's non-performing loans (NPLs) are another source of debt-creating contingent liability for the Government. In December 2000 NPLs of the banking sector amounted to Rs. 282 billion. Though the present Government initiated an effective loan recovery drive after taking over, the ratio of NPLs to total advances went up between end-June 1998 and end-December 2000, from 25.8 to 27 percent. This is, however, a reflection of tighter prudential regulations of the State Bank of Pakistan (SBP) on specialized banks and DFIs, to provide accurate records of their lending operations. Notwithstanding this, as of end-December 2000, banks and DFIs were holding provisions of only Rs 133 billion, covering around 47 percent of their classified portions, which constitutes a significant risk and may necessitate equity injections in publicly owned banks to meet prudential regulations. In 1998, United Bank Limited (UBL) received an equity injection of Rs. 21 billion while Habib Bank Limited (HBL) received Rs. 9.7 billion. During 2000, UBL and HBL had requested significant additional equity injections. Even though these injections are ostensibly a Government investment, it is actually a form of fiscal loss, with a distinct possibility that the Government may not be able to recover these investments. They will ultimately be covered by raising debt or reflected in lower SBP profits and Government non-tax revenue receipts.

At times it is the inefficiency of public sector corporations (PSCs) that is responsible for these losses, but that is not always the case. There are pricing issues as well that sometimes lie behind these losses. The most pertinent example relates to the issue of automatic fuel price adjustment clause for WAPDA. This clause will allow WAPDA to adjust electricity tariffs in line with changes in fuel prices. However, in order to keep electricity prices low, NEPRA has disallowed WAPDA from making this automatic adjustment, thereby forcing it to bear the brunt of any fuel price increases. This is an inefficient way of subsidizing electricity at WAPDA's expense. If the Government wants to subsidize consumers, it should be explicitly financed from the budget and not through indirect means, which leads to losses and contingent liabilities. The only way to mitigate risk of contingent liabilities therefore is to tackle the root cause of these PSCs' losses. Introduction of corporate management structures through comprehensive restructuring is helpful, but privatization is the most effective way to stop the accumulation of losses and liabilities. Till then the effect of such unexpected hits on the budget will have to be taken into account and incorporated, from the very outset, in the design and implementation of policies.

Fiscal Contingency Management

There is an urgent need to strengthen and consolidate institutional arrangements for contingency management.

Clearly, the information base in the Ministry of Finance about guarantees, both issued and outstanding, is less than satisfactory. Therefore, it is imperative that responsibility for

identification, measurement and reporting of all contingent explicit and implicit liabilities should be strengthened within the Budget Wing. As a first step we suggest that the Secretary General Finance should address a letter to all Financial Advisors in various Ministries to elicit information on guarantees and commitments on contracts, loans and investment projects with a time frame. This information should be accompanied with some assessment of the risks associated with guarantees and their likelihood of being called. Furthermore, a committee headed by the Additional Finance Secretary (Budget) should be set up to collate, examine and analyze this information, which should form base for a new Contingency Cell in the Budget Wing.

Provision of guarantees should be by stipulation of a high-level authority, such as the Cabinet or ECC, but only after its likely impact on Government finances and debt has been duly analyzed through explicit cost-benefit considerations, on an accrual rather than cash accounting basis.

Moreover, provisions (through creation of a guarantee reserve fund or guarantee cover) should also be made in the budget to cover risks associated with Rupee and foreign exchange guarantees. This would serve to cover any (potential) future claims emerging from the guarantees.

In the past, guarantees have even been issued to non-public entities like Army Welfare Trust and Pak-Arab Refinery, without an assessment of the impact that such contingency commitments may have on the budget. Though the AWT guarantee has not yet been called, the amount has already been rolled over once. Moreover, as part of the official petroleum policy, oil refineries have been guaranteed an annual rate of return of about 20%. However, the fiscal implications of these guarantees are not clear. Experience with guarantees to IPPs and other private sector companies suggests a high degree of wariness for the future about private sector guarantees. The entire policy of guaranteeing financial outcomes for private projects needs to be reconsidered. Such guarantees should only be considered in exceptional cases where there is a clear and dominant gain accruing to the Government from the issue. Monetary limits should be placed on total government exposure, for example, ceilings on total guarantees outstanding, as a percentage of government revenues.

Issues in Privatization

A promising avenue of reducing the outstanding debt is the allocation of a large part of the privatization proceeds for the retirement of debt. According to the Privatization Ordinance 2000, 90% of the proceeds of privatization will be used for debt retirement, and the balance of 10% will be utilized for poverty alleviation.

The medium term program drawn up by the Privatization Commission for the next three years rightly focuses on the sale of major assets in telecommunications, oil and gas, power and banking sectors, including giants of PTCL, PPL, OGDC, PSO, KESC, HBL and UBL.

Though the overall contribution of privatization revenues to debt retirement will be modest:

- Accelerated privatization is absolutely essential for tiding over the current payment crisis.
- It will also have important signaling value for the role of the private sector and will generate confidence.
- It will help reduce the losses of public sector corporations, which have contributed to public debt build up in the past.
- It will enhance the quantity and quality of goods and services in the country.
- Ensure that federal investigation teams carry out their work with an open mind and in a professional manner so as not to demoralize staff and prevent them from taking decisions based on sound business practices.

The goal should be to mobilize at least US\$ 3 billion over the next 3 years and to use the privatization proceeds partly to retire high-interest short-term external debt partly to build up foreign exchange reserves.

There are significant problems and policy issues which need to be resolved speedily if the opportunities that privatization offers for relieving the balance of payments constraint, improving economic efficiency and stimulating both domestic and foreign private investment are to be reasonably exploited.

These include:

- Dismantling the Gas Price Agreement of PPL and raising PPL wellhead prices to the levels facing private gas producers.
- Firm commitment to full gas price deregulation over the next 3 years. Any subsidies to consumers should come from for the budget. To minimize the budgetary impact, this requires raising the average gas price by about 50 percent in real terms over 3 years. The producer and consumer price adjustments are necessary not only for speedy privatization but also for accelerated gas development and more rational use of energy, factors which can make a powerful contribution to the balance of payment improvement.
- The need for a clear and unequivocal commitment to privatization of PTCL and OGDC and overcoming the resistance of management and labor with a firm hand.
- Strengthening the regulatory framework for telecommunications, power, and gas, establishing the regulatory agency for petroleum, and staffing regulatory agencies with competent people who are supportive of private participation in their sectors.
- Resolving some tax issues affecting the banking industry that are hampering the sale of HBL and UBL, increasing the flexibility of banks to shut down branches, and permitting majority foreign ownership of banks.

Box 8 - Privatization, Foreign Private Investment & the Balance of Payments

Accelerated privatization in Pakistan is critical at this stage to give a strong signal to the private sector, both domestic and foreign, that the Government wants to shed direct public sector industries and is genuinely committed to private sector development. Privatization will also help to improve efficiency, reduce losses in the public sector and help mobilize foreign exchange resources to retire debt and build up foreign exchange reserves. Foreign private investment should particularly be encouraged in areas of technology transfer and export development. It is also hoped that foreign companies buying Pakistani industrial and commercial assets will expand capacity and undertake new investment.

But while foreign investment flows for acquisition of existing or new assets will stimulate investment and growth, they will also entail profit transfers, which will have a negative impact on the balance of payments. If foreign investment is guaranteed a high rate of return, as with IPPs, the balance of payments impact can be relatively severe and rather quick. If on the other hand, foreign investment interests facilitate technological improvements, promote exports and reinvestment the balance of payments will improve. Sale of existing assets to foreigners will also generate profit transfers abroad. The sale of very profitable companies may fetch a high price but will not increase investment income payments. In any case, the likely impact of growing stock of foreign investment, including privatization sales, deserves as much attention as the debt stock. The census of Foreign Private Investment undertaken by the State Bank of Pakistan should be strengthened and used to analyze future non-interest investment income payments on a regular basis, so that there are no surprises for the balance of payments.

Issues in Resource Mobilization

Revenue mobilization is perhaps the most challenging task before the Government and is certainly receiving the most economic attention.

Broadening the tax base, documenting the economy, making sales taxation effective and improving confidence in the tax system and administration through major streamlining and restructuring are rightly being emphasized.

Because revenue mobilization targets are quite ambitious, the Government will need to ensure that larger revenues are raised in a fashion that long-term goals of elastic and a fair, growth-promoting system of taxation are not sacrificed. In other words, the Government may not be able to avoid some conflict between short and long-term goals in taxation.

Adequate taxation of the rich, especially of luxury consumption or windfall gains (through capital gains tax) deserves attention. Fairness and equitable income distribution issues also suggest the need to examine the incidence and impact of higher resource mobilization on various income groups.

Greater cost recovery in education, health and provision of irrigation water is another important source of resource mobilization. Finally, anti-smuggling efforts need to be redoubled, since smuggling constitutes a major source of revenue and foreign exchange loss and adverse impact on domestic industrial output.

Issues in Export Development

Even though foreign borrowing was clearly excessive in 1990s, Pakistan's foreign exchange crises during the decade would not have been so severe if exports had not stagnated after the mid-1990s. Looking to the future, simply curbing the current account balance payment deficits will not solve Pakistan's external debt problems. Export expansion must provide the basis both of increase in debt carrying capacity and financing additional imports, especially the capital goods imports so essential for reviving economic growth.

As mentioned earlier, the Committee has assumed that merchandise exports will grow by nearly 50 percent over 2000-2004 to US\$ 12 billion. Some part of this increase will be simple recovery of the ground lost during 1995-2000. Even so, the assumption of over 10 percent annual growth in nominal terms for the next 4 years cannot be taken for granted. The present Government has already taken a number of initiatives in the export field, notably streamlining

the system of import duty refunds, greater focus on export potential by the Ministry of Commerce, and strengthening of the Export Promotion Bureau. But Pakistan still seems to lack a conviction and long-term vision that will place exports at the centre of the country's economic plans. A strategic approach must come to grips with the extreme weakness of Pakistan's present export structure, its heavy dependence on cotton-based exports and export policy failures of the past, and must clearly spell out the policy changes needed to increase Pakistan's share in world exports, especially in manufactured goods.

There are three basic reasons that Pakistan did not make fuller use of the opportunities offered by the explosive growth in world trade in manufactured goods over the last three decades. First, exports were never given the priority they deserved. Secondly, there has been a strong anti-export bias due to trade policy distortions resulting from relatively high duties on intermediate products. Third, there has been an excessive preoccupation with industrialization based on domestic raw materials. (Hasan, 1998)

The fundamental policies concerning exports, therefore, need to be set aright. First, exports must be a national priority and not considered as a residue. The talk of an exportable surplus, clearly implies concern with meeting domestic market need first. Second, the competitiveness of our exports has to be ensured at all times. In the 1990s, the exchange rate adjustments needed because of the higher relative rate of Pakistan's inflation tended to be delayed, negatively impacting export development. Exchange rate policy now is soundly based. The Committee has assumed that market-based exchange rate adjustment will be frequent and will have a modest element of real devaluation, necessary in the next few years to provide a push to diversification of exports. However, it should be recognized that a country's competitiveness in exports is not only a matter of the exchange rate but also depends on national productivity and non-economic factors such as product quality, reliability of delivery, etc. Considering that devaluation also has costs in terms of higher inflation and higher fiscal burden, the approach to improving competitiveness must be broad-based, encompassing issues of human development, labor skills and domestic costs of utilities as well.

Third, a policy goal should be to further reduce the anti-export bias by lowering duties on intermediate products. Pakistan must also explore the possibilities of creating virtual free trade zones as the present system of duty drawbacks works imperfectly at best. (Khan, 1998)

Fourth, the major weaknesses in Pakistan's exports and industrial structure need to be remedied by targeting foreign investment especially from the newly industrialized countries to promote technology and exports.

Fifth, the opportunities that will be available to relatively newcomers like Pakistan after the expiry of multi-fibre agreement in a few years must be fully explored through a strategy such as Textile Vision 2005, preparation by firms to maintain international quality standards and rapid achievement of ISO conformity by export oriented enterprises. It is important for Pakistan to search for new markets through scientific market research and strengthened professional capacity of the Export Promotion Bureau.

Sixth, there is also a need especially to review and improve labor laws and policies and facilitate the availability of trained and skilled manpower, which is likely to become the biggest constraint on future development of exports.

Issues in Cost of Borrowing

As mentioned earlier, borrowing costs are driving the growth of public debt, since the Government is now generating significant primary surpluses for the first time in Pakistan's financial history.

Public debt growth cannot be slowed without reducing the real cost of government domestic debt, which averaged nearly 9 percent per annum during 1998-99 and 1999-00 (**Table 17**). The norm should be 3 to 4 percent per annum.

The problem centers on the high cost of borrowing under the National Saving Schemes (NSS). On the initial assumption that NSS serves a population of small, relatively unsophisticated savers (such as widows, orphans and pensioners), who are unlikely to place their funds with banks or other financial institutions, rates of return on these instruments have tended to be set arbitrarily and on the high side. Initially, limits were placed on size of holding but were later withdrawn. In the 1980s, as budget deficits grew, reliance on NSS instruments increased and these certificates were made extremely attractive through highly positive tax-free real returns. Naturally this attracted major institutional investors. Peaking during the period end-1996 to mid-1999, compound rates on Defense Savings Certificates (DSCs) of 10 years maturity

were 18.04%, when held to maturity. The latest yields on 10-year DSCs held to maturity are 14% per annum. Yields on these bonds are tax-free except Zakat payable. The implied yield for 5 years is 12.9% per annum

Despite the sharp reductions made in rates on NSS instruments during the past two months, real tax-free long-term rates of return remain at nearly 8 percent (assuming inflation rate of 6 percent per annum). These returns on safe assets are high by international standards. Undoubtedly, the reductions in rates of return on NSS have not been popular and the Government must do a better job of educating the public in this regard. In any case, it is clear that the bulk of public debt interest payments go to Pakistanis and unless these payments can be reduced, the domestic debt problem cannot be solved. The recent decision to apply withholding tax to new issues of NSS certificates from July 2000 is welcome.

Table 17 - Nominal and Real Interest Rates: Domestic Public Debt

Year	Stock of Domestic Debt ²	Interest Payments	Nominal Interest Rate	Price Change	Real Interest Rate
	(Rs. Billion, end of period)		(% Per annum)		
1980s	353.4	35.9	7.7	7.2	0.5
1990-96	846.8	104.5	10.9	11.2	-0.3
1996-99	1124.7	175.3	13.9	9.0	4.9
1998-99	1288.2	175.3	13.6	5.9	7.7
1999-2000 ¹	1480.5	198.4	13.4	3.5	9.9

1. Provisional

2. Stock of debt each year is estimated by averaging previous year and closing years outstanding levels

There is an urgent need to broaden domestic debt instruments, reduce reliance on high cost National Saving Schemes and restructure the latter so that returns correspond to a market-based yield curve, based on Federal Investment Bonds. It is important to be aware, however, that these measures will only affect future unfunded debt obligations. Since reductions in NSS rates apply to new investments, the effect on overall cost of servicing will be incremental, materializing in full only when the existing stock of NSS is run down.

Further, there is a strong probability that the cuts in NSS rates already implemented will produce a “lock-in” effect, whereby investors forgo discounting of higher-yielding assets, for as long as the final maturity. Thus, a decline in gross mobilization, due to both lower rates offered and the banning of institutional investment in NSS bonds in the last fiscal year, may still result in a less than corresponding decline in net mobilization.

Significant reductions in the real costs of government domestic borrowing will be possible only when fresh government borrowing and the real value of domestic debt begin to decline. This will be a credible prospect only if tough fiscal adjustment can be implemented successfully during the next three years.

In general, the average cost of foreign borrowing by Pakistan has not been high. Average nominal costs till the mid-1990s were in the range of 3 to 4 percent per annum and even with international inflation dropping to 1 to 2 percent per annum recently, the majority of external debt remains concessional.

Despite foreign borrowing by Pakistan largely being on concessional terms, there has also been excessive reliance on normal term borrowing from the World Bank and ADB. As a result, multilateral debt service payments will average US\$ 1.3 billion per annum over the next several years and are the most inflexible part of our foreign exchange obligations. Efforts need to be made to reduce the relative burden of multilateral debt service over time by:

- Seeking much higher IDA and Asian Development Fund allocations from the World Bank and ADB on creditworthiness grounds. (If the desired soft blend is not available, Pakistan must necessarily reduce overall borrowing from these institutions to minimal levels.)
- Confining limited normal term borrowing from these institutions to non-project assistance alone.
- Phasing out borrowing from international organizations for local currency costs due to high indirect costs of foreign aided projects involving largely local currency costs. Evidence of such indirect costs is found in widespread complaints about the over-design of projects and highly paid foreign consultants who are often not needed for relatively simple infrastructure projects.

Box 9 - Pakistan Investment Bonds

The segmented market from which the Government borrows, comprising the commercial financial institutions (FIs) and the non-bank National Savings Schemes (NSS), is a deliberate (though, not well thought-out) result of the rates of return offered on NSS instruments. Arbitrariness in the setting of NSS rates and increased reliance on them to finance budget deficits in the last decade, led to excessively high returns on NSS assets and correspondingly higher interest payments on public domestic debt. In the absence of restrictions on individual and institutional holdings of these assets and availability of NSS certificates “on tap”, these rates have posed a problematic benchmark for term deposit rates offered by FIs, and the cost at which corporate and private borrowers can access longer term funds. NSS instruments also have an edge over commercial schemes, in that they are largely tax exempt, except for payable Zakat. The freezing of foreign currency accounts in May 1998 heightened the level of competition for domestic rupee funds in the financial sector, since commercial FIs (specifically private and foreign banks) relied mainly on foreign currency deposits to drive deposit growth. Tax and Zakat exemption on Real Income Certificates (RICs) purchases from converted funds, effectively provided a facility for converting these frozen accounts into NSS holdings, pitching commercial FIs directly against the NSS.

Concern over excessive rates offered on NSS instruments mounted in 1999, specifically as inflation declined, which led to reduction in rates. Fresh institutional investment in NSS was banned in April 2000, followed by a further reduction in rates. Interim recommendations of the Debt Reduction and Management Committee included another decrease in NSS rates by at least two percent as well as the development of a market-based yield curve. The rising debt burden and distortionary effect of excessive NSS rates on deposit mobilization in the financial sector have made manifestly clear the need to develop a long-term investment option for institutional savers. A market yield curve, based on a restructured federal investment bond, would serve this need and provide a benchmark for commercial lending as well as deepen the corporate debt market.

The Government therefore decided to renew issue of federal investment bonds through the State Bank of Pakistan (SBP) and to link savings rates (on Defense Savings Certificates from January 2001, and other instruments from the beginning of FY02) to such a market yield curve – to contain overall government borrowing. Benchmarking NSS rates thus will, moreover, ensure a level playing field for all debt instruments in the financial sector, achieving greater allocative efficiency. Finally, the need to develop an efficient secondary market for newly issued bonds is also clear, in order to rationalize unit costs of government borrowing, and bring them to competitive levels.

SBP has conducted three auctions of the Pakistan Investment Bond (PIB), since November 2000. These bonds are offered for maturities of three, five and ten years, with returns payable bi-annually and withholding tax applicable at ten percent. Rates have ranged from 12.5% on the 3-year maturity, 13% on 5-year, and 14% on the 10-year bond; with SBP raising Rs 4.0 billion, Rs 10 billion and Rs 15 billion in November, December and February, respectively. PIBs are eligible for discounting, repurchasing option (repo) transactions and may be held against statutory liquidity requirements (SLR). They have thus been launched as a relatively liquid asset, to deliver a market-based yield curve and enhance the competitiveness and efficiency of the financial sector in mobilizing and allocating funds. For progress on reducing the increment to public domestic debt, however, it remains for regulatory authorities to link NSS rates to this new benchmark.

Effectiveness of Public Spending

As mentioned above, poor use of borrowed resources has also been a major factor in the emergence of debt problems. How can the use of public resources be made more effective in future? A sub-committee of the Debt Committee headed by Secretary, Planning and including

Secretary Economic Affairs and Provincial Representatives among others, has examined the subject and made suggestions.

Our basic recommendation is to extend the control of the Planning Commission over agencies that in the past were able to bypass general planning procedures because of the special status granted to them (this we understand has already been done). In addition we wish to make three recommendations for more effective use of resources in the public sector and better programming of foreign aided projects:

- i) Since the present public sector development program is over-extended and money is being spent thinly on projects, it is recommended that attempts should be made to consolidate the program by reducing its size by 10 to 15 percent through elimination of low priority projects or components, projects which have serious implementation problems or projects which do not have the strong support of implementation agencies.
- ii) The above exercises should not be restricted to domestically funded projects but should also cover foreign-aided projects. The present pipeline of undisbursed foreign loans is around US\$ 6 billion. Our suggestion is to cut 10 to 15 percent of the pipeline by applying the same criteria as in (i). Secretary Planning has already undertaken tentative steps in this regard.
- iii) It is also worth considering whether all new projects can be put on hold for the next 2 to 3 years, except in exceptional circumstances, thus enabling the process of consolidation and focus on high priority spending to proceed.

In addition, as suggested above, the Government needs to be highly selective in foreign borrowing for projects, which are disbursed mainly in local currency and should phase out such lending, the direct and indirect costs of which are perceived to be high. Also complaints about performance of donor agencies and foreign consultants and their high cost are widespread, though lack of institutional capacity in the Government may be the real problem. Professional capacities in Government, especially in economic fields but not confined to economists, have been greatly run down.

The task of inducting more and high level professional staff in the Finance, Planning and Economic Affairs Divisions should not await general civil service reform. Although the present economic team of technocrats offers a unique opportunity for effective reform, it cannot be fully exploited if professional staff is not available for critical analysis, planning and problem solving on the implementation side.

Implementation capacities are weak in the Provinces also, though Punjab and Sindh appear relatively well placed with the authority given to Additional Chief Secretaries, Planning and Development. The Ministry of Finance should support efforts to broaden the base of professional expertise both at the center and in the provinces.

Tackling External Debt Overhang

The most immediate economic problem facing Pakistan is to cope with the mountain of external debt service payments due during the next few years. On the assumption that deposits of foreign government and central banks (currently US\$ 1.4 billion) and Special US\$ bonds owed to residents (US\$ 1.3 billion) will be rolled over, debt service payments due are estimated at US\$ 11 billion for the two years July 2000 - June 2002, and approximately another US\$ 10 billion in the subsequent two years. These huge external debt repayments due, totaling nearly US\$ 21 billion¹ over 2000-04, would pre-empt a large part (at least over one-third) of foreign exchange earnings, even assuming a robust expansion in exports.

Faced with the prospect of making these heavy debt payments and generating current account surpluses (before interest payments)² or net resource transfers to the outside world at least for a few years, it is hardly surprising that voices are being raised in favor of external debt default. Those suggesting this option argue that, instead of undergoing the rigors of a difficult adjustment process under the watchful eye of the IMF and other creditors, Pakistan should consider simply putting a moratorium on its external debt service obligations till such time as the foreign exchange situation improves. Having carefully reviewed international experience in this regard, the Committee feels strongly that a debt moratorium or default cannot really be considered an option. A default may appear, at first sight, to provide short-term relief by reducing the modest net transfer of resources abroad, compared to an IMF-assisted adjustment scenario, but in fact will render incalculable harm to both short-term and long-term interests of the country. (See **Box 10**).

¹ These include amounts recently agreed to be rescheduled by the Paris Club members

² The concept of non-interest current account balance of payments surplus corresponds to the concept of primary surplus in the fiscal accounts.

Box 10 - Some Frequently Asked Questions about External Debt

Q. Will Pakistan not save very large amounts of foreign exchange by renegeing on its external payment obligations even though there may be a cost of debt default in terms of loss of confidence in Pakistan and drying up of fresh flows of capital?

A. As **Table 18** suggests, the external debt service obligations are estimated at US\$ 20.6 billion during 2000-04. However, only a very small part, only US\$ 3 billion, or about 15% of the total, will be generated from resource transfer to the outside world. In the financing plan suggested in Table 18, the rest of the non-interest current account surplus of US\$ 3.8 billion and privatization proceeds of US\$ 3 billion will be used to increase foreign exchange reserves. The 'cost' of this modest resource transfer of resources in the medium term must be weighed against the serious disruption to the economy and the prospect that a debt default will foreclose the possibility of obtaining substantial net transfers of resources from abroad in the future. There is no reason that a financially stable Pakistan cannot prudently attract US\$ 1 – 2 billion annually in net transfers in the latter part of this decade through foreign private investment, concessional multilateral and bilateral assistance and private inflows.

Q. Why does Pakistan have to put up with the IMF conditionalities? Why cannot it walk away from the IMF?

A. The International Monetary Fund (IMF) is the international agency charged with providing balance payment support to member countries in order to enable them to cope with foreign exchange crises. It, however, provides financial assistance by insisting that economic policies be put in place, which will remove the source of external payments, disequilibria. As the rules of the international financing system have evolved, the maintenance of a satisfactory program with the IMF is a pre-condition for obtaining exceptional balance of payment assistance from the World Bank, the Asian Development Bank, and bilateral sources. The private sector also looks to a country's relationship with IMF as an indicator of the financial health of the economy. Admittedly, the size of IMF's own assistance is not always large. Pakistan, for instance, can expect only moderate net disbursements from the IMF under the PRGF (Poverty Reduction and Growth Facility) or other facilities. However, the Paris Club rescheduling and other exceptional assistance needed will not be available to Pakistan if an IMF program is not in place. Walking away from the IMF will thus greatly increase the danger of default.

Q. Has Pakistan not repaid its external debt already in terms of very high interest payments?

A. It is a popular misconception that the average terms of Pakistan's external debt have been onerous. A large part of Pakistan's medium and long-term debt from multilateral and bilateral sources has been on concessional terms i.e. on low interest rates and with long maturities. At least till the mid 1990s when the foreign exchange crisis began to erupt, the high cost and relatively short-term external borrowing by the Pakistan Government was quite limited. It is only in recently years that a resort to expensive short-term funds became necessary in order to avoid default. However, even with the increase in share of more expensive loans from private sources, the average nominal interest rate on outstanding external debt and other foreign exchange obligations does not exceed 5 percent. If average international inflation is assumed at 2 percent per annum, the real cost of external debt is around 3 percent per annum. Moreover, with the restructuring of external debt which is proposed, the average nominal cost of external debt should return to approximately 3 - 4 percent per annum in three or four years i.e. 1 – 2 percent per annum in real terms, the level that prevailed in the beginning of 1990s.

Default is not an Option

Basically, a willful default will trigger a complex chain of retaliatory actions on the part of the international community as foreign creditors seek to obtain satisfaction of their claims by seeking to impound the country's assets, whether moveable (e.g., PIA planes) or immovable property (e.g., embassy buildings), under well-established legal procedures recognized by courts of law the world over.

As consequence of debt default, short-term growth will suffer because not only will normal trade relations be disrupted but domestic investor confidence will also be adversely affected, inducing capital flight and thus further pressuring the exchange rate. The medium and long-term development will be even more severely impacted because Pakistan will be shutting itself off from international flows of capital and technology. It must be realized that net resource transfer that Pakistan is being forced to generate for the next few years would not be a permanent feature of our balance of payments. Beyond the transition period of external debt consolidation, it should be possible to run moderate non-interest current account balance of payments deficits of 1 to 2 percent per annum (especially if exports are expanding vigorously) financed largely by foreign private investment and prudent levels of net public and private borrowing. These positive resource transfers after 2005 will help supplement domestic savings moderately without changing the essential character of a self-reliant growth strategy for the future. Moreover, Pakistan cannot afford to isolate itself from the international community at a time when knowledge is becoming a key determinant of growth and information technology exports offer an important source of increasing foreign exchange earnings.

Restoring External Debt Equilibrium: An Exit Strategy

The Government fully recognizes the above arguments against default, is committed to honoring its external debt obligations and appears determined to follow strong macroeconomic adjustment policies. It is serious about reducing the large macro-imbalances, especially on the fiscal side. Policies of fiscal restraint, which are clearly in Pakistan's long term interest, will not only help to create conditions for price and exchange rate stability but also provide a boost to economic growth through creating confidence in Pakistan's currency, discouraging capital outflows, and encouraging foreign private investment. They will, above all, lay the basis for

elimination of the need for IMF assistance in about three years and obviate the need to obtain additional debt rescheduling after mid-2004.

Meanwhile, the daunting external financing challenge remains. Large scale exceptional assistance from the IMF, World Bank, ADB and hopefully some bilateral donors, additional debt relief, large privatization receipts, and sizeable non-interest current account surpluses will all be needed to meet debt service payments and build up foreign exchange reserves to adequate levels.

Box 11 - Elements of an Exit Strategy

Pakistan has needed fairly regular access to the IMF during the last two decades. In the last few years, the maintenance of a program with the IMF has been a condition for obtaining debt relief from the Paris Club. Pakistan will continue to need financial assistance from the IMF during the next three years which combined with further debt relief from the Paris Club should enable it to meet its external debt obligations. The country, however, needs to clearly define the goal of an "Exit Strategy" from the IMF. The Debt Committee believes that it should be possible to eliminate the recourse to fresh IMF assistance after the next PRGF (Poverty Reduction and Growth Facility) from the IMF which hopefully will be successfully negotiated by the middle of 2001 and would provide the basis of IMF assistance and further debt relief from the Paris Club for another three years ending in 2004.

The goals of an "Exit Strategy" should be:

- (i) No need for further assistance from the IMF beyond the proposed PRGF;
- (ii) No need for any additional debt relief after 2004
- (iii) Reduction in the external debt burden to the sustainable level of 200% of foreign exchange earnings by mid-2005,
- (iv) Ability to withstand unexpected economic shocks by building gross foreign exchange reserves to US\$ 5.0 billion by mid-2004, and
- (v) Limiting short term debt i.e. debt with a maturity of less than one year, to less than 10% of total external foreign debt obligations.

The main instruments for reducing Pakistan's external debt burden sharply and eliminating the need for further fresh injections from the IMF will be:

- i) sharp improvement in the trade account through both export expansion and import saving,
- ii) large scale privatization sales to foreigners,
- iii) further restructuring of Paris Club debt,
- iv) exceptionally quick disbursing assistance from IMF and other multilateral and bilateral sources notably, World Bank and Asian Development Bank (ADB) almost entirely on soft terms, and
- v) retirement of relatively expensive external debt.

Pakistan has historically run large current account balance of payments deficits (before interest payment). In others words, it has received large net resource transfers from abroad. During the years 1995-1998, this deficit averaged US\$ 1.7 billion per annum (including accrual to foreign currency deposits). It dropped to US\$ 0.7 billion in 1998-99 and was replaced by a surplus of over US\$ 0.7 billion in 1999-2000. There is need to increase this surplus gradually over US\$ 1.0 billion by 2003-04 through both expanding exports vigorously and slowing down the rate of growth of imports. But as discussed elsewhere (see **Box 10**), this resource transfer abroad can then gradually be reduced and turned into net resource transfer from abroad in the latter part of this decade.

The reduction in burden of external debt to sustainable level requires that much of the new foreign borrowing during the next few years be on concessional terms. Pakistan's indebtedness to multilateral

institutions is high and because IBRD and ADB do not reschedule loans, the multilateral debt service is the most inflexible part of Pakistan's debt service. The disbursed and outstanding loans from IBRD and ADB (own capital resources) stood at US\$ 2.4 billion and US\$ 2.1 billion respectively at the end of 2000. A government policy objective for the medium term should be to gradually reduce or at least contain the outstanding normal term debt to IBRD and ADB. Pakistan needs to largely eliminate its normal term fresh borrowing from World Bank and ADB for the next three to four years. The IBRD and normal terms ADB borrowing, if any, should be confined to non-project assistance i.e. for meeting the financing gap. There should be no borrowing for projects on hard terms for a few years.

Inadequacy of gross foreign exchange reserves has been a major source of Pakistan's foreign exchange difficulties. The building up of foreign exchange reserves level to US\$ 5 billion or equal to at least four months' foreign exchange payments is highly desirable. The foreign exchange reserve target needs to be pursued even at the cost of some loss of short-term momentum in growth of imports and investment because both domestic capital flight and foreign private investment decisions are significantly affected by a country's level of foreign exchange reserves and its perceived ability to withstand economic shocks.

Table 18 - Sources and uses of Foreign Exchange
An Illustrative Scenario: July 2000 – June 2004

(US\$ Billion)

Sources		Uses	
Non-Interest Current Account Surplus	3.8	Debt Service Payments ¹	20.6
Normal disbursement of medium and long term loans	6.2		
Net Foreign Private Investment	2.5	Increase in Foreign Exchange Reserves	3.8
Rescheduling from Paris Club & Non-Consortium Debt Countries	5.1		
Privatization Proceeds	3.0		
Exceptional quick disbursing Assistance from IMF/World Bank/ADB	6.0		
Trade Finance	0.3		
Least Possible Shortfalls	-2.5		
Total:	24.4		24.4

1. Incl. Payments due to institutional investors of FCAs; but assuming automatic rollover of deposits of foreign central banks with SBP, as well as special US\$ bonds owed to residents.

Table 18 shows the broad ranging efforts needed to meet Pakistan's external financing needs in the period up to mid-2004. First and foremost, Pakistan will have to generate a surplus in the non-interest current account of the balance of payments of nearly US\$ 1 billion annually over 2000-04 or about 1.5% of G.D.P. This will be in sharp contrast to average annual resource deficits of US\$ 1.5 billion, about 3 percent of GDP, run in the 1990s and will require major export expansion as well as substantial import saving. In addition, the Government should mobilize at

least US\$ 3 billion from privatization sales to foreigners. Even so, Pakistan will need exceptional assistance of US\$ 6 billion from IMF (mainly under PRGF), World Bank and ADB and debt rescheduling totaling about US\$ 5 billion (including the amount recently agreed by the Paris Club). If the latter flows do not materialize, Pakistan will not be able to meet its debt obligations even if it succeeds in implementing a strong adjustment program. It is also important that exceptional assistance for the period 2000-04 be available almost entirely on concessional terms to soften the present onerous burden of multilateral debt service. If this does not occur, multilateral debt service payments will become extraordinarily large, in relative terms.

It is of course in Pakistan's interest to reduce the present value of debt outstanding to multilateral institutions, but by improving the mix of assistance, the IBRD and the ADB can also reduce their exposure in Pakistan and increase their flexibility in responding to the country's future development needs. Without formally seeking to become an IDA only country, Pakistan should strive that 80-90% of its annual borrowing needs from the World Bank, estimated by the Committee at US\$ 700 million, be met from IDA resources at least for the next few years. An equivalent treatment of ADB will be required, annual borrowing from which is estimated at least at US\$ 600 million. In addition, about two-thirds of total assistance from World Bank and ADB will need to be in the form of quick disbursing assistance.

The Debt Committee recognizes that the scale, pattern and terms of the exceptional assistance it is proposing will require changes in current policies of the World Bank and ADB towards Pakistan. We propose that IDA allocate US\$ 600 million annually for Pakistan during the next four years, well above the average annual IDA allocation of US\$ 215 million during the years 1996-1999. (Only US\$ 86 million was committed from IDA in the two years 1998-99 and 1999-00). We also propose that two-thirds of IDA assistance be in the form of quick disbursing policy loans or non-project assistance. At present IDA quick disbursing lending is confined to the social sector for the blend countries, i.e. countries receiving both IBRD and IDA funds.

We further propose that Pakistan seek US\$ 400 million annually in the next four years from ADF, compared to the average of around US\$ 300 million from the soft window of the ADB, and that two-thirds of this assistance be in quick disbursing policy related loans. We assume that IBRD and ADB normal term loans will be limited to US\$ 100 million each annually and will be confined to quick disbursing assistance. In other words, borrowing for projects would

be moderate at best and that too only under IDA or ADF. The exceptions to policy required in the World Bank group and ADB are justified in our view by the fact that Pakistan's external debt burden is extremely high and in many aspects matches that of the HIPC countries, and the financing gap that Pakistan will face despite a major domestic adjustment effort, is huge. As mentioned above, if Pakistan is not able to meet this gap on the scale and terms suggested above, it may have no option except to seek an IDA-only status and apply for debt reduction rather than debt rescheduling from the Paris Club. In the absence of a suitable response from World Bank and ADB, large-scale negative net transfers to multilateral institutions will continue and compound the problems of making other debt service payments.

Box 12 - The Heavily Indebted Poor Countries (HIPC) Initiative

The debt crisis of the 1980s prompted the international financial community to help debtor countries in reducing their debt burden through the provision of concessional financing from international financial institutions (IFIs), debt relief from official creditors in the context of Paris Club rescheduling, and, in some cases, through bilateral actions by the creditors. While these approaches were quite successful in alleviating the external debt burden of many middle-income countries, many poor countries, especially in sub-Saharan Africa, continued to suffer from heavy external debt burdens and grinding poverty levels. In order to tackle the problems of these Heavily Indebted Poor Countries (HIPCs), the World Bank and the IMF jointly launched the HPIIC initiative in September 1996. The key objective of the initiative, as it was originally conceived was to reduce the debt burden of eligible HIPCs to a "sustainable" level in a reasonably short period of time.

A country can be considered to have achieved external debt sustainability if it acquires the ability to meet its current and future external debt service obligations in full, without recourse to rescheduling of debt or the accumulation of arrears, and without adversely affecting its growth. The initiative envisages, among other things, additional debt relief on top of existing (traditional) mechanisms which include: (a) the adoption of stabilization and economic reform programme supported by concessional loans from the IMF and World Bank: in support of these programmes (b) flow-rescheduling with Paris Club Creditors on concessional terms (such as a 67% net present value reduction under Naples terms), to be followed by (c) a stock-of-debt option after three years of good track record under both the IMF and rescheduling agreements, (d) agreement by the debtor country to seek at least comparable terms on debt owed to non-Paris Club bilateral and commercial creditors and to seek bilateral debt forgiveness of official development assistance; and (e) new financing on appropriate concessionary terms.

Eligibility for receiving exceptional assistance is limited to countries eligible for International Development Assistance (IDA) credit from the World Bank and for the Enhanced Structural Adjustment Facility (ESAF)—now being transformed into Poverty Reduction and Growth Facility (PRGF)—that have established strong track record of performance but are not expected to achieve a sustainable external debt situation even after the full use of traditional debt relief mechanisms.

The key indicators of external debt sustainability in the original initiative was to bring the ratio of the net present value (NPV)* of debt to exports to a range of 200 to 240 percent. In addition, countries with very open economies (defined as those with export-to-GDP ratio of at least 40% and making strong efforts to generate revenue (indicated by fiscal revenues of at least 2% of GDP) could also be considered eligible if the NPV of their debt exceeded 280 percent of government revenues.

Following a comprehensive review of the HIPC initiative in early 1999, jointly undertaken by the World Bank and IMF, a number of modifications to the original initiative were made in which: (a) the NPV of debt-to-export target was reduced to a single target of 150 percent from the 200-250 percent range, (b) the NPV of debt-to-fiscal-revenue was reduced to 250% from 280% and (c) the eligibility thresholds for the openness of the economy (indicated by exports-to-GDP ratio) was brought down from 40 to 30 percent and for the revenue effort from 20 to 15% of GDP.

The revised initiative is called the Enhanced HIPC Initiative that requires a nationally owned, comprehensive poverty reduction strategy paper (PRSP), for future lending to low-income member countries through PRGF. Furthermore, greater emphasis is being placed on good governance, especially full transparency and effective monitoring of government budget and the efficiency of social expenditures.

* This is the sum of future debt service obligations (interest and principal) on existing debt, discounted at the market interest rate. Whenever the interest rate on loan is lower than the market rate, the resulting NPV of debt is smaller than its face value, with the difference reflecting the grant element.

The Committee recognizes that large-scale disbursements from multilateral resources will further increase preferred creditors' exposure in Pakistan, which is already high. But this, hopefully temporary, increase in exposure must be viewed in the context of Pakistan substantially reducing its external debt burden and thus minimizing the risk of default.

On the Pakistan side also, substantial effort will be necessary to develop policy packages that could be supported by quick disbursing assistance from World Bank and ADB. These loan requests must try to be innovative and should include seeking of financing for time-slices of important programs such as irrigation rehabilitation and maintenance, poverty alleviation, etc. In all, ten to twelve policy operations may be needed over the next 4 years to negotiate adequate support from the World Bank and the ADB.

The above analysis suggests that in order to avoid default Pakistan will need to make strong policy efforts to expand exports, achieve significant import substitution and increase private transfers. This effort will have to be supplemented by large-scale international support. Clearly, the financing scenario is not without risk. Resource surpluses of the magnitude envisaged might not materialize either because of shortfall in export targets, unfavorable trends in remittances or further deterioration in terms of trade. Privatization proceeds may not be forthcoming - either because of international conditions or slow domestic implementation of the program. Similarly, international exceptional assistance and debt relief may not be available in a timely fashion.

But while it will not be easy, a fundamental transformation of the external debt position can be reached in three to four years, provided strong domestic policy action is combined with requisite international support. Restoring external debt equilibrium will enable Pakistan to manage its external finances without the help of IMF program for the first time in twenty years. It will also signal a new era of self-reliance. The critical elements of this 'Exit Strategy' are summarized in **Box 11**, above.

Risk Management

In order to minimize risk of financial shortfall and deal with possible economic shocks, such as harvest failures or further terms of trade deterioration, it is proposed that foreign exchange reserves be built up over time to around US\$ 5 billion, equivalent to at least three months of foreign exchange payments from 1 month equivalent in mid-2000. Furthermore, we have made contingency provision of US\$ 2.5 billion or about 10 percent of gross external finance requirements as possible shortfalls in sources of financing for 2001-2004. Aiming at an even higher level of privatization receipts, considered feasible by many, would be another way of building a further cushion into the financing plan. But even these measures will not totally eliminate the risk of a persistent foreign exchange crisis simply because the overhang of external debt payments is so large and the financing plan relies on a very diverse set of national and international policy actions and initiatives. On the domestic side, there is little room for further maneuver. The economic adjustment scenarios that the Committee has sketched out envisage only a modest economic upturn in terms of recovery of the rate of investment and growth. Any further economic tightening will set back government efforts to reverse the increasing incidence of poverty and could invite serious political unrest. So the question arises, what additional steps can be taken to strengthen the financing picture? First, political efforts must continue to resolve the issues that have led to virtual drying up of bilateral concessional assistance. Second, the Committee believes that if Pakistan can demonstrate that continuing debt problems are not because of any failure of domestic adjustment efforts, a case could be made to donors for softer terms of rescheduling combined with some debt reduction. For instance, if necessary, Paris Club could be approached to provide Naples terms instead of the Houston terms granted so far, for the next rescheduling period 2002-04 and to combine it with reduction of two-thirds of debt stock at the end of the rescheduling period. The cost of seeking Naples Terms, however, would be to formally accept that Pakistan is not creditworthy and cannot, in the foreseeable future, borrow on normal terms from IBRD, ADB or market sources. There could also be an impact of debt

reduction on new assistance from bilateral sources which otherwise could hopefully be resumed in the near future. Another problem is that more concessional terms or debt reduction, as against normal Paris Club rescheduling, while reducing net present value of debt significantly, will not in themselves make an additional contribution to meeting the financing gap in the short-to-medium term. If Naples Terms and debt reduction result in actually reducing the availability of new finance from other multilateral, bilateral or private sources, the immediate financing problem might be aggravated. However, if the financing plan is in jeopardy in any event and orderly reduction in external debt burden cannot be achieved through the scenarios outlined above, the option of seeking softer terms and debt reduction from Paris Club should not be foreclosed. **(Box 13)**

Box 13 - Debt Reduction versus Debt Rescheduling

Pakistan will of course benefit from debt reduction instead of debt rescheduling. However, there are many practical difficulties in obtaining debt reduction. Pakistan does not at present qualify for the broad initiative known as HPIC debt reduction. The countries included in this list are, in general, poorer and more heavily indebted than Pakistan and are clearly non-creditworthy. At present Pakistan is not an IDA only country i.e. still has some creditworthiness.

Even if Pakistan was to seek an IDA only status, it is not clear that it may qualify under HPIC initiative because it may not meet the test of no other debt solution being available. In any cases the funding available for HPIC is inadequate for countries already covered. Softer term of re-scheduling from the Paris Club combined with debt reduction under Naples terms rather than Houston Terms will be desirable but one problem here again is that Pakistan is not an IDA only country. Furthermore, Paris Club debt is less than one third of Pakistan's total external debt. Pakistan's debt to the multilateral institutions is very high and these institutions do not give relief, with the exception of HPIC umbrella. Other major creditors, apart from the private sector, are residents and foreign governments who hold deposits with the central banks. Nearly 45 percent of our Paris Club debt is owed to Japan which frowns upon any debt reduction. Debt reduction reduces the NPV (net present value) of external debt but does not help meet the immediate financing gap, indeed may hinder it.

The Debt Committee has adopted a pragmatic approach:

- It has not ruled out the possibility of seeking softer terms from the Paris Club.
- It is recommending that all of the exceptional assistance from international organizations be on soft terms and fresh borrowing from IBRD and ADB (own capital resources) be minimal.
- It is recommending the exploring of bilateral initiatives (additional concessional assistance from Japan) and unilateral debt reduction from USA, Germany, France, Canada and other major creditors.

Desirable Outcomes

The Committee hopes, however, that its suggested policy goals and financing targets can be met without compromising Pakistan's creditworthiness and seeking formal debt reduction. On our assumptions, external debt and foreign exchange obligations in absolute terms will increase only moderately from US\$ 35 billion in mid-2000 to US\$ 37 billion in mid-2005. If foreign exchange reserves are taken into account, net external debt will decline by US\$ 2 billion to about US\$ 32 billion over the period. As a percentage of foreign exchange earnings, total foreign exchange obligations will drop from 281 percent in mid-2000 to 200 percent in 2005 (See **Table 19**). However, it must again be emphasized that this assumes not only a moderation in the rate of growth of external debt but also a more than 50 percent expansion in merchandise exports from US\$ 8.2 billion in 1999-00 to US\$ 12.0 billion in 2003-04.

Table 19 - Future External Debt Growth and Burden

(US\$ Millions)

	2000	2001	2002	2003	2004	2005
A. External Debt	32460	33226	34107	35969	36109	35363
B. Debt Obligation to Residents in Forex						
Bearer Certificates	147	108	74	53	36	15
US\$ Bonds	1297	1297	1297	1297	1297	1297
Total (B)	1444	1405	1371	1350	1333	1312
C. External Debt, Incl. Obligations to Residents	33904	34631	35478	37319	37442	36675
Other Foreign Obligations						
FCAs (Institutional)	1072	796	392	0	0	0
Total (C)	34976	35427	35870	37319	37442	36675
External Debt as % of Foreign Exchange Earnings (excl. accruals to FCAs)	281.4	265.3	247.7	238.3	221	200.6
Debt Service	39.5	38.4	40.1	32.9	28.3	24.4

If one makes the plausible assumptions that (a) most of the expensive debt will be retired first (b) average terms of multilateral assistance will soften, and (c) Paris Club rescheduling will have at least some concessional element, the drop in net present value of external debt will be greater than that in the nominal external debt burden indicator. Though precise calculations are not yet possible, net present value of Pakistan's external debt may begin to approach the desirable level of 150 percent of foreign exchange earnings by 2005 provided strong action is taken on terms of new official debt and export targets materialize. The ratio of external debt service payments to foreign exchange earnings will drop from the peak of nearly 40 percent in 1998-99 to less than 25 percent in 2003-04. The proportion of short-term debt in total debt will

also come down. It may become feasible for Pakistan to gradually retire the remaining high cost short-term deposits from foreign governments if foreign exchange reserves continue to grow.

Reduce Risks and Ensure a Soft Landing

Since a soft landing cannot be taken for granted, what can the Government do to reduce risks of major economic and social disruption? Success of current Government efforts in three areas, namely greater domestic revenue mobilization, rapid export development and accelerated privatization, will be critical for both revival of growth and reduction of debt burden. However, there cannot be any assurance that in the real world all targets can be met and policies be implemented effectively and efficiently. For example, the anticipated privatization proceeds may not materialize or export earnings may fall short of assumed levels. Under these circumstances, we cannot achieve reserve build-up targets or continue to service all categories of debt as previously planned. Consequently, the strategy will have to be readjusted by, for example, giving priority to projects related to the most costly short-term debt or reducing the foreign exchange reserves target.

Therefore, there should be definite contingency plans to deal with shortfalls in certain critical variables such as exports and revenue targets and privatization proceeds through curtailment of expenditures and imports. With the best of intentions and efforts to reduce the risks of financial management, there remains a possibility that soft landing scenarios will not work. The economic team must be ready to deal with situations of panic and technical default.

If technical default does occur despite policy efforts or if there is a break in relations with IMF, public opinion should be mobilized to reinforce:

- Additional taxation and/or control of consumption of luxury items;
- Strong cuts in non-development spending
- Giving even higher priority to efficient import substitution in energy and edible oils.

The build up of foreign exchange reserves from the present low level to at least US\$ 2.5 billion by the middle of 2003 deserves high priority. With Pakistan's open capital account, the level of foreign exchange reserves is probably one of the biggest elements influencing confidence in the currency and thus private capital movements.

Improving Institutional Arrangements for Debt Management

Considering the depth of Pakistan's debt problems, and the steady growth of debt burden over two decades, it is surprising that no comprehensive debt management strategy or debt management system exists. Previous attempts by Dr. Hafeez Pasha and Dr. Ishrat Hussain unfortunately had limited policy impact and certainly did not result in any improvement in institutional arrangements for debt management.

One of the fears of the Debt Committee is that its report will meet a similar fate. It is important, therefore, that this report not only be considered at the policy level but also that it be published and made public in Urdu and English. When the report is available, dissemination of its findings, conclusions and recommendations should be undertaken as a tool for training for concerned staff as well as the education of the public. More importantly, it is critical that strong institutional arrangements be put in place to deal with issues of debt strategy, debt burden, borrowing options, costs of borrowing etc.

Problems with the Present Institutional Arrangements

Fairly comprehensive and reasonably up-to-date information on debt is available in various parts of the Ministry of Finance (MoF), Economic Affairs Division (EAD), State Bank of Pakistan and the Central Directorate of National Savings (CDMA). The problems are that

- reconciliation among data from the various sources is not always complete or timely.
- data gathering and entry except in the Economic Affairs Division, is done almost entirely on a manual basis. Access across agencies to computers is non-existent.
- the data are fragmented and do not flow across smoothly even within the wings of MoF.
- Computer Centers in EAD and Budget Wing of MoF are faced with shortage of trained staff and computer professionals. The problem is especially acute in EAD, which houses a sophisticated debt management computer system, DMFA. Also, computerization at CDNS is extremely basic and requires upgrading for timely and adequate information flows.

Due to all of the above and the fact that a conceptual framework for debt management has not been developed, available information is not brought to bear on economic policy-making. Indeed, as mentioned above, no debt management strategy guidelines exist.

There is also no fiscal contingency management system: ad-hoc decisions are taken and provisions made for guarantees that fall due when large losses materialize in PSCs. Legal and administrative arrangements for a modern debt management system have also yet to be developed.

The substantial technical assistance provided to EAD by ADB could have been used more effectively. The World Bank financed PIFRA project, which involves computerization of the financial management information system, introduction of accrual based accounting principles and restructuring of the Pakistan Audit Department has also experienced implementation problems.

There seems to be limited staff-work dealing with country assistance strategy issues with the World Bank and ADB. It is not clear how the senior economic managers are advised on issues such as the IDA and IBRD blend and how they are supported in discussions.

Similarly, there seems to be limited capacity to deal with issues of currency mix of external borrowing and issues relating to access to international capital markets.

Because of the almost persistent foreign exchange crisis since 1996, the government stance on external borrowing has been largely reactive and there has been no clearly defined government policy about limits on short term debt and desired level of foreign exchange reserves, though the latter are much discussed and agreed upon in the context of an IMF program. Specifying government policy on foreign exchange reserves and short-term debt needs to be a part of debt strategy formulation.

On the domestic side, as mentioned earlier, the heavy and growing reliance on NSS is both undesirable and costly.

- Even though rates of return on the various national schemes have been reduced several times during the last 18 months, the real cost of these schemes remains high.
- More importantly, because the schemes are on tap, the Government is largely passive in its domestic borrowing strategy.

- Given that the Government is a prime and risk-free borrower and can obtain funds at cheaper rates than those available to certain public sector corporations, a study is required to determine whether: (a) a ceiling is needed on the magnitude of savings that could be used to finance the budget deficits and (b) additional sums mobilized through saving instruments might be on-lent to public sector enterprises at mutually agreed terms.
- Finally, determination of rates of return on national saving schemes has been largely ad hoc.

There is need for a conceptual framework for setting the rates of return and guidelines for amounts to be mobilized under NSS.

- The Government has already agreed that returns from NSS will be subject to withholding tax of 10 percent, as applied to other financial instruments.
- It has also been agreed that federal investment bonds, which are now being developed by the State Bank of Pakistan, (**Box 9**) should set the yield curve and NSS rates should be adjusted frequently to correspond in defined relationship to this yield curve.

Elements of New Debt Management System

The above analysis suggests that improvement in debt management requires attack on various fronts of debt policy formulation and institutional reforms (including additions to capacity) in various parts of Ministry of Finance, Economic Affairs Division, Central Directorate of National Savings and State Bank of Pakistan. The following listing of steps for better debt policy formulation and institutional strengthening is by no means exhaustive.

First and foremost, Pakistan needs a debt burden reduction strategy with defined goals of external and public debt reduction over the medium and long term. Based on the recommendations of the Debt Committee, the Government should adopt a debt strategy and debt management guidelines including norms for acceptable cost of external and internal borrowing, limitations on short-term debt, level of foreign exchange reserves, etc.

Implementation of a debt burden reduction strategy, however, has to be integral to an overall economic strategy, the clearest manifestation of which should be in a 3 to 4 year rolling macroeconomic framework.

There is urgent need to strengthen macroeconomic work in Government, which is presently fragmented among the Planning Commission and various Wings of the Ministry of

Finance and the State Bank of Pakistan. It will not be wrong to say that at present the only authoritative medium-term framework is the one developed by IMF teams in the context of Fund arrangements after extensive discussions with the Government. This situation is clearly not satisfactory.

The Government must have at all times a comprehensive three-year rolling economic framework including details of financing, borrowing plans and debt trends. For the immediate future, a rolling macroeconomic framework for 2001-2004 may be prepared by the Planning Commission, for review and critique by the Ministry of Finance, State Bank of Pakistan, etc., considered and endorsed by the ECC and then presented to the IMF for discussion in the context of the forthcoming PRGF negotiations. It should be clear, however, that as long as the IMF program remains in place there would only be one macro framework – that agreed with the IMF.

Debt policy work needs to be strengthened in the various part of the Ministry of Finance including the External Finance Wing and Budget Wing. Policy analysis in respect of national saving schemes should be done in the Budget Wing but the National Savings Directorate will have to be organized to generate the relevant information in a timely fashion. There is a particularly urgent need to estimate interest payments likely to be made on maturing NSS certificates over the next few years by adopting a clear methodology.

Before any decisions on institutional arrangement are made, agreement will be required on the various debt concepts and fiscal contingency management. The recommendations of the Debt Committee in this regard will have to be operationalized and the format and content of future debt reports to be generated agreed upon.

Debt Policy Coordination Office

Given the paramount urgency of dealing effectively with Pakistan's debt problems, there is need for a high level Debt Policy Coordination Office, attached to the top management of the Ministry of Finance. It will

- Coordinate preparation and regular updating of a comprehensive macroeconomic framework in consultation with other parts of the Ministry of Finance, Planning Commission, Federal & Provincial Governments and the State Bank of Pakistan.

- Submit an annual report on implementation of agreed debt strategy to the Cabinet or Economic Coordination Committee, on changes in national debt burden and need, if any, to make adjustments in debt strategy.
- Provide leadership on debt data questions and ensure compliance with agreed reporting requirements.
- Give policy advice on external borrowing and internal borrowing strategies and make recommendations on reducing cost of borrowing, and keeping it low and consistent with a prudent degree of risk.
- Monitor the implementation of contingency management arrangements, which should be located in the Budget Wing.

The Debt Policy Coordination office (DPCO) should be headed by a highly qualified macroeconomist with broad international experience of economic policy and debt issues. He should be a contract employee on a two-year (renewable) contract, with emoluments in the grade of an M-I. He will report to the top management of the Ministry of Finance.

In addition to setting up the DPCO, there is need for strengthening macroeconomic analysis capacity in the Economic Adviser's Wing and debt management capacity in the External and Budget Wings of the Ministry of Finance, Economic Affairs Division, State Bank of Pakistan and National Directorate of Savings.

Partial funding for staffing and system components for DPCO is available from ADB T.A. project during 2000-01. But on a normal basis an annual budget Rs. 10-15 million will be required. Finally, three points need to be emphasized:

- Since debt strategy must be an integral part of overall economic strategy, the location of the DPCO in the Ministry of Finance and its heavy economic focus makes sense.
- However, the role of DPCO must evolve over time as debt burden declines and access to capital markets gradually becomes the principal means of external borrowing.
- The setting up of the DPCO would only be a first, albeit, important step towards modern debt management, which requires across-the-board institutional improvements in systems policy analysis and review in all parts of the Government dealing with debt issues.
- The DPCO would serve as a nerve center through its linkages with the EAD, External Finance Wing (MoF), Budget Wing (MoF), SBP and CDNS informational databases.

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