HOW DEBT CREATES DIFFICULTIES FOR THE ECONOMY?

By

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Pakistan's debt situation reached unsustainable level by 1999 because of persistence of large fiscal and current account deficits during the last two decades. The "twin deficits" resulted in an explosive accumulation of both domestic and external debt. Domestic debt grew at an average annual rate of almost 28 per cent during the first half of the 80's; 22 percent during the second half and 16 percent during the first nine years of the 90's. In other words; Pakistan's total external debt and foreign exchange liabilities which stood at $ 9 billion in 1980-81, reached almost $ 22 billion by the end of the 80's and by 97-98 touched a high figure of $ 42.7 billion.

The external debt and foreign exchange liabilities grew at an average rate of 2.0 per cent per annum in the first half of the 80's, 17.7 per cent in the second half; and 6.5 percent during the nine years of the 90's.Such a sharp build up in both domestic and external debt have had serious implications for the country's budgetary as well as balance of payments situation. In 80-81,debt servicing as percentage of total revenue was 11.6 percent, reached 38 per cent by the end of the 80's and was further up to 64 per cent by 98-99. Similarly, over the years, Pakistan's external debt servicing liability continued to rise as high as $ 6 to 7 billion by 98-99. When a nation spends about two thirds of its revenue to finance one budgetary items, leaving aside only one third of revenue to be spent on defense, civil administration, development projects, education, health, etc, what would be the state of country's education, health, physical infrastructure and defense? It requires no rocket science to understand the implications of sustaining such a large debt. Country's physical and social infrastructure, and irrigation system were bound to deteriorate. How can the government continue to provide raise in government servants' salaries, which are undoubtedly highly underpaid? This resulted in deterioration in governance.

On the external front, when a nation is spending $ 6 to 7 billion on debt servicing out of total foreign exchange earnings of $ 11 to 12 billion (exports, private transfers, and other receipts) how can it finance imports worth $ 9 to 10 billion? Naturally, it had to go with a begging bowl to borrow $ 5 to 6 billion every year. How can it maintain its financial sovereignty with a begging bowl in its hand? This, I leave to the judgement of the readers. The reasons why Pakistan landed in such a difficult environment are straightforward. As a country, Pakistan has sustained a large deficit (on average 7 per cent of GDP) for a very long time. The size of the deficit which Pakistan sustained was twice as high as the average of the Asian developing countries. Once again, it needs no rocket science to understand that from where a large revenue- expenditure gap could be met. Naturally, the government had to borrow for a long period of time and lived far beyond its means, thinking that perhaps this is the life style of the people of Pakistan. They totally forgot that they are maintaining a life style on borrowed resources. What happens when a government borrows to meet the revenue -expenditure gap? Naturally the debt will accumulate.

The stock of public debt (debt payable in rupees and foreign debt in rupee terms) stood at Rs 155 billion by end of the 1970's and by end of the 80's another Rs 646 billion was added which caused public debt to rise at Rs 801 billion. But by end of the 90's, another Rs 2430 billion was added to the public debt, which stood at Rs 3231 billion.The absolute number of public debt is not much of interest. What is more damaging is the burden of the public debt, which means as percentage of GDP or total revenue. At the end of 70's, the public debt was 56 per cent of GDP or 317 per cent of total revenue. It rose to 92 per cent of GDP or 505 per cent of the revenue by the end of the 80's.It was over 100 per cent of GDP and 630 per cent of the revenues by the end of the 90's. By any standard, this was horrifying number for any country. It was horrifying because almost two-third of the revenues were consumed for debt servicing alone which forced the government to cut Public Sector Development Program(PSDP). The country's infrastructure, both physical and human, started deteriorating because allocation to these sectors were started declining as percentage of GDP. Since the private sector and the public sector investments are complementary in nature, the decline in public sector investment also resulted in decline in private sector investment. Therefore, total investment which used to be 19 to 20 per cent of GDP in early 90's continued to decelerate and reached 15-16 percent level by the end of the 90s’.

Adverse law and order situation in most part of the 90's, as well as inconsistencies in policies, frequent adjustments in exchange rate, senseless taxation and freezing of foreign currency accounts badly damaged investors confidence. Furthermore in an environment of large fiscal deficits, the government had to borrow heavily from the banking system to finance its fiscal deficit pushing interest rates in the range of 14 to 20 percent. On the other hand, the government continued to offer very high interest rates on various instruments of National Savings Scheme(NSS) to attract resources in this scheme as it was the major source of government borrowing from the non-bank sources. That's why during the 80's and 90's the rates of return on various NSS instruments were exceptionally high. Consequently the overall interest rates were not conducive for attracting investment in the country. Because of the crowding out on the one hand and decline in public sector investment on the other, the total investment continued to decline in the 1990s resulting in slowing down of economic activity in the country. Slower growth in the economy also reduced the employment generation capacity of the economy. The obvious outcome has been the rise in poverty. It is axiomatic that declining investment and growth was the mirror image of the prevailing macro economic environment in the 1990s. It should be noted that rise in poverty in the 90's was the outcome of a process. When the country is passing through phases of macro-economic instability, declining growth and poor governance, their adverse impact on the life of the common man will be felt for quite some time. Because of macro economic instability, declining investment and growth in Pakistan the level of poverty continued to rise from 26.1 per cent in 90-91 to 30.6 in 1998-99.

Developments on the fiscal front over the last two decades considerably changed the composition of expenditure in Pakistan which has had serious implications for overall economic situation. As Pakistan continued to sustain large fiscal deficits, the need for financing the deficit also rose that changed the composition of the expenditure in favour of current expenditure and away from development expenditure. In 1980-81, current and development expenditures were 59 per cent and 41 per cent respectively, of total expenditure .By 1989-90, their shares changed drastically to 75 per cent and 25 per cent respectively. By the end of the 90's, the current expenditure was as high as 88 per cent while development expenditure shrank to only 12 per cent.

The various composition of expenditure also continued to change over the years. The share of defense in total expenditure was 24 per cent in 1980-81 while interest payment accounted for only 9 per cent and development budget was 41 per cent of total expenditure. By the end of 1980's, defense spending increased marginally to 26 percent from 24 percent in beginning of 80's. The share of interest payments more than doubled during this period from 9 per cent to 21 per cent. Development spending continued to shrink from 41 per cent to 25 percent. In other words, interest payment was taking over development expenditure in the country. As Pakistan entered the decade of the 90's the composition of expenditure continued to deteriorate. Interest payments increased further to 33 per cent of total expenditure by the end of the 90's, while development spending decline to 13 per cent and defense spending also shrank to 20 per cent .The onslaught of rising interest payments continued to crowd out not only development spending but defense spending as well. It is beyond doubt that Pakistan's fiscal crises in the 80's and the 90's were interest payment driven. Interest payments, which used to be Rs 6 billion in 80-81 as compared with 15 billion on defense spending and 26 billion of development spending, out performed both by a wide margin. By 93-94 interest payment and defense budget came at par at Rs 91 billion but interest payment surpassed development spending at Rs 71 billion and then there was no looking back thereafter. Interest payments continued to soar and by end of the 90s these were as high as Rs 243 billion against Rs 151 billion for defense and Rs 88 billion for development.

Let us clear our mind and remove any misconception, if there is, regarding the defense budget. The root cause of fiscal crisis in Pakistan has been ever growing interest payment and not defense spending. Why interest payment soared? First, Pakistan sustained a very large fiscal deficit for a very long period of time. Second, the fiscal deficit was financed at a very high cost, primarily from National Savings Schemes. Third, wrong sequencing of banking sector reform added fuel to the fire. While there was nothing wrong in banking sector adjustment loan, as it was intended to improve the efficiency of the banking system, it was the wrong sequencing that aggravated the fiscal situation of Pakistan. Prior to reform the government used to borrow from the banking system at a very low interest rate (2.5 per cent after tax) but after the launching of reform, Pakistan started auctioning its debt in the market and all of a sudden it was borrowing at 13 to 14 per cent to meet its revenue- expenditure gap from the banking system. It created severe problems because the government was borrowing at 16 to 17 per cent from the National Savings Scheme but with the reform, it was also borrowing at 13 to 14 per cent from the banking system as well. Therefore, the interest payments started ballooning, surpassing all other components of the expenditures. The successive governments had no choice but to curtail development spending, thereby restraining the country's future growth potential. It is precisely the reason as to why investment and growth slowed in the 90's .How on earth one should expect that this process of two decades could be reversed in two to three years. It almost took two decades to bring the country to low investment low growth mode and rising poverty. Is it humanly possible to take the investment and growth to the levels of the 1980s in a short period of three years? I leave it to the readers to decide.

Let me turn to the external side of the economy. Pakistan sustained a current account deficit of 4 percent of GDP in the 80s, 4.5 per cent in the first half of the 90s and 5.2 per cent during 95-96 and 98-99. But if we exclude Foreign Currency Accounts, which used to appear above the line in the BOP, then current account deficit presents a horrible state of affairs in the BOP. Pakistan's current account deficit averaged more than 6 per cent during 90 to 99. This is a huge number for a poor country like Pakistan. Naturally when a country sustains such a large gap in external accounts, it has to borrow to fill this gap. As stated at the outset, Pakistan’s external debt and foreign exchange liability continued to rise reaching as high as $ 38 billion by 98-99. Pakistan’s export remained stagnant around $ 8 billion for 6 years in a row. In the mean time inflow of workers remittances also continue to decline from $ 1.9 billion to less than one billion dollars. On the other hand Pakistan's external debt and foreign exchange liability continued to rise, therefore, the country's debt carrying capacity started eroding. In 1980-81, external debt liability as percentage of foreign exchange earnings was 147 per cent, by the end of the 80s it stood at 257 per cent. As we entered into the 90s, the debt burden deteriorated and by 98-99 it stood at 335 per cent. In other words, Pakistan's external debt burden was even worse than many countries that qualified for HIPCs initiative. This suggest that Pakistan was in league with countries like Liberia, Congo, Malawi, Rwanda etc. This was the state of affairs on external front. Every year the country needed $ 6 to 7 billion to finance debt servicing on external account. Surely this was unsustainable situation. Pakistan almost lost its financial sovereignty. Credit rating in international capital market was at its lowest. No country or institution was ready to lend to Pakistan because of its fragile balance of payment position. No nation can survive as a sovereign state in such circumstances.

In short, the country was facing serious macro-economic imbalances, both domestic and external debt reached unsustainable level, two-thirds of government revenues were being used to finance debt servicing, the BOP was extremely fragile, foreign exchange reserves were poised on a knife's edge; exports were stagnating, tax collection was rising at a much slower pace and was not sufficient to finance recurring expenditure, investment and growth were on declining path, poverty was rising, relations with IFI's were in total disarrays and poor governance was beginning to be the norm. Three and a half years ago country faced with multi-dimensional challenges. How to stabilize country's debt situation with a view to restoring macroeconomic stability; how to revive economic growth; how to improve investors confidence; how to arrest rising trend in poverty; how to improve governance; how to restore Pakistan's financial sovereignty and how to restore relationship with IFIs. The government at that time, after long debate, came to realize that the route cause of deteriorating macroeconomic environment has been the growing debt problem. Therefore the first and foremost challenge was to bring the debt situation under control. Debt situation was seen as mother of all economic ills. Reducing “twin deficits”, fiscal and current account deficit, became the central objective of the government's macro-economic policies. However, this was not regarded as panacea to resolve all our economic problems because it was realized that Pakistan's economic problems were structural in nature. Therefore, wide ranging reforms were needed in almost every sector of economy to enhance economic incentives, improve resource allocations and remove impediments to private sector developments. Sustaining high economic growth, low inflation and a viable external balance of payment can not be achieved without reducing twin deficits on the one hand and removing structural bottlenecks on the other.

In this background a concerted effort was made during the last three and half years which still continues today with elected government of Prime Minister Jamali. Where do we stand today? Notwithstanding various exogenous shocks of extraordinary nature such as persistent of catastrophic drought for 2 to 3 years, events of 9/11 and events of December 13, leading to unprecedented massing of troops by India on Pakistan borders, the country's economy has made significant progress. The economy is now more stable. Economic policies are transparent, confidence of the private sector has been restored to a larger extent; ex-patriate Pakistanis are bringing their capital back; remittances crossing 4 billion dollars; export reaching 11 billion dollars; stock market index rising from 1000 points to 3400 points; real GDP growth has picked up and entered into 5.0 percent mode, growth in industrial production touching double-digit, agriculture is also showing recovery, the rising trend in poverty appears to have been arrested, BOP has never be in such a comfortable position; current account surplus now stands at $ 2.7 billion; foreign exchange reserves stand at $ 10.6 billion, sufficient to finance 11 months of imports; exchange rate is stable and inflation is low at 3.2 per cent; domestic and external debt has declined, fiscal deficit has been lowered, tax collection is growing, governance has improved and corruption at top level in the government has being eliminated; Pakistan is now in a position to pre-pay $ 4.5 billion high cost debt ahead of time; and lastly, Pakistan's credit rating in international capital market has improved.

On the fiscal side, allocations to development and defense are now same i.e. around Rs 160 billion in 2003-04. Interest payment has started declining, it was as high as Rs 240 billion in 1999-2000 and declined to Rs 210 in 2003-04. Composition of expenditure has also started changing in favour of development spending. Current expenditure now stands at 83 per cent as oppose to 88 per cent previously. Interests payments were drastically reduced to 22.4 per cent from 33 per cent in the past. Most importantly public debt as percentage of GDP, which was over 100 percent a few years back, has declined to 91 per cent. Similarly public debt has percentage of total revenue which was as high as 633 per cent has come down to 516 per cent. Most importantly, the external debt and foreign exchange liabilities have declined from $ 38 billion to 35 billion. The burden of external debt has also been reduced drastically. External debt and liabilities as percentage of foreign exchange earnings that was as high as 335 per cent has decline to 187 per cent. It is a major turning point in the country's history. Pakistan has come out from the league of HIPC like Rwanda, Malawi, Liberia, and is moving towards a sustainable debt situation.

These improvements notwithstanding, Pakistan still faces many challenges. First and foremost is to sustain and build on the current gains. Second, raise the investment level to sustain higher growth. Third, reduce unemployment and alleviate poverty. Fourth, to improve the country's social indicators, that is, to minimize the social gap and fifth is to improve the financial health of the public sector enterprises. The country has just begun to recover from its difficult past. There is no room for complacency. The democratically elected government is fully cognizant of the challenges ahead and is committed to keep good policies on track. The Federal Budget 2003-04 exhibits the government's commitment towards creating jobs, reducing poverty, improving the lives of the common, reducing social gap and at the same time maintaining macroeconomic stability. The recent approval of the Fiscal Responsibility Law by the Cabinet is a clear signal that the government believes in transparency and financial discipline. A democratically elected government committing to pursue a transparent and rule-based fiscal policy is a major departure from the past. This augurs well for the country and ensures that in the next five years, Pakistan is likely to achieve a sustainable level of debt.