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Research Article

Pakistan's External Debt Unsustainability and the Required Approach

*Muhammad Sikandar Ali Chaudary**

Abstract

The paper traces financial and non-financial variables that prompt external debt distress in Pakistan. It explains that the economic vulnerability emanates from macroeconomic imbalances and structural problems. The macroeconomic imbalances deeply connect with global oil crisis, the Russia-Ukraine war and non-compliance with mutually agreed International Monetary Fund (IMF) conditionalities in the short run. However, the structural reasons are rising oil expenses, growing domestic political scandals, increasing terrorist attacks, and high spending on military imports. The paper recommends formulating a publicly available blueprint i.e. theory of change to resolve Pakistan's increased reliance on transnational lenders, including the IMF. It should include innovative policies to initiate the green revolution that could replace intermittent nonrenewable resources to incrementally lower oil imports. Moreover, to increase growth in the non-military sector employing non-kinetic means and engaging transnational governance entities to resolve geopolitical conflicts would reduce reliance on military sector. The paper concludes that undergoing policy innovation for environmental and economic sustainability, is inevitable for gaining benefits from global renewable energy transition and avoiding debt distress.

Keywords: Environmental Sustainability, External Debt, Macroeconomic Stability, Economic Slowdown in Pakistan, Transnational Governance.

Introduction

The economic slowdown post-COVID-19 pandemic and consequent surge in oil prices triggered global economic crisis, given high level of economic integration and interdependence between the countries. Pakistan is extremely

* PhD scholar, International Relations, University of Sydney, Sydney, Australia.

vulnerable to such global economic shocks because its development strategies, domestic growth, energy import and disaster management highly depend on foreign borrowing. It has been categorized among the top 10biggest debtor countries, unfortunately.[1] The short-term sources of risk are volatile domestic political climate, global oil crisis and supply chain disruption due to Russia-Ukraine crisis, severely impacting Pakistan's macroeconomic stability.[2]

Furthermore, the monetary ramifications of floods in Sindh (causing USD 40 billion damages) in 2022 also resulted in liquidity issues and negatively affected an already chaotic debt-to-Gross Domestic Product (GDP) ratio. The devastating floods had severe consequences on critical transport networks, damaging around 400 bridges and approximately 13,000 km of highways. Additionally, about 2.2 million houses were affected, with one-third of them beyond repair. The floods also wreaked havoc on significant portions of the water and sanitation systems, leading to the spread of associated illnesses. The disaster resulted in the destruction of 1.2 million animals and submerged 45 percent of Pakistan's agriculture. Consequently, the 'growth stalled, inflation surged, international reserves dropped to very low levels, and fiscal and external pressures became acute,'[3] while inflation skyrocketed to 38 percent. To avert the exceptionally high economic risk that signaled insolvency, Pakistan reverted to the IMF to negotiate monetary stimulus package. After a series of rigorous talks, IMF agreed to disperse USD 3 billion to stabilize the country's macroeconomic indicators.

The lapses in domestic financial plans and drifts in national governance further augmented the debt distress. It is well established in the debt relief scholarship that the 'role of policies and institutions is much more important in low-income countries than in middle-income countries' for any debt relief efforts to take effect.[4] For example, disregarding the IMF's perspective antidote to cautiously allocate budget through implementing austerity measures and stringently maintaining foreign reserves at a benign limit, Pakistan injected a considerable relief package worth 237 billion PKR during Prime Minister Imran Khan's tenure (August 2018 to April 2022 and imported fuel with high tariffs.[5] After PM Imran Khan was deposed from the premiership through a vote of no confidence cobbled together by an all opposition parties coalition, Pakistan Democratic Movement – (PDM), the country drifted towards a political crisis that further dampened the confidence of foreign investors. During its 14-month long stay in the office, the successive PDM government struggled with the economy as well as its own survival as a political alliance. Currently, a caretaker government is in power and has several technocrats looking after the affairs of the state during the interim period before general elections. The economic trajectory has broadly remained the same, nonetheless.

There are various reasons for persistent borrowing over the medium and long terms including high current account deficits due to expensive oil imports; hefty interest payments; lower gross capital formation as a result of unorganized and unplanned IMF loan dispersals and huge defense expenditures.[6] The military expenditure retains a large percentage of the yearly budget because Pakistan shares an eastern border with a hostile neighbor India and is embroiled in a spate of domestic terrorist activity.

Constant reliance on transnational lenders such as IMF to resolve the debt distress also limits the country's agency to engineer its national economic policies independently. Consequently, it often has to revise its economic and political trajectory against the guiding benchmarks laid down by transnational public and commercial lenders. Such engagement strips away the economic and political sovereignty of the state to determine its own course of actions. Empirical studies and cross-country literature indicate that the IMF programs in developing countries do not obtain expected results. To relieve Pakistan from the stronghold of IMF and recourse the country towards debt sustainability so it can implement global best practices to upturn the chaotic economic situation, this identifies determinants of debt trap and recommends policy initiatives.[7]

The paper discusses the parameters for debt sustainability. Next, it provides an overview of Pakistan's present and future economic prospects. Following this, it outlines the methodological approach adopted and presents three sub-questions for investigation. Before conclusion, it presents the factors contributing to debt distress in Pakistan and offers recommendations to facilitate the country toward achieving debt sustainability in both, the short and long term.

When is Debt Distress Sustainable?

The Executive Board of the IMF defines debt sustainability as: [8]

> Public debt can be regarded as sustainable when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenario is economically and politically feasible, such that the level of debt is consistent

with an acceptably low rollover risk and with preserving potential growth at a satisfactory level.

The core tenant of IMF's definition of debt sustainability is to assess a country's fiscal account situation after the debt relief i.e., its solvency and liquidity scenario. A government is solvent if the value of its present assets are roughly the same size as its current debt burden plus its capacity to finance future expenses.[9] The World Bank recently published Debt Sustainability Framework (DSF) to examine debt dynamics (solvency and liquidity) for low-income countries. The DSF is a composite indicator that permutes World Bank's index of the quality of policies and institutions i.e. Country Policy and Institutional Assessment (CPIA), GDP growth, the share of remittances over GDP—i.e. ratio of remittances to GDP (REM/GDP— international reserves over imports, and world GDP growth. Zanna et al., simplify the purpose of the DSF as a quantitative metric that calculates net worth increase due to debt service in a country's future fiscal surplus, without raising expenditure or broadening the tax base. 'Conversely, if net worth declines, some supporting fiscal adjustment is required to maintain solvency and prevent explosive growth in government debt.'[10]

Pakistan's Economic Outlook

IMF projected that the GDP would dwindle by 0.5 percent in the fiscal year (FY) 2023. Its recent report mentions that the economic risk resulted from slowed economic activity due to import restrictions, State Bank of Pakistan's (SBP's) unclear monetary policy, untargeted subsidies and unbudgeted expenses in managing natural disasters (such as floods, earthquakes etc.).

Table 1: Selected Indicators for Pakistan's Economic Outlook

	2017-18	2018-19	2019-20	2020-21	2021-22
GDP growth (percent)	5.5	2.1	-0.5	3.9	4.0
Inflation Consumer Price Index (CPI)	3.9	6.7	10.7	8.9	9.4
Fiscal deficit (percent GDP)	6.4	9.0	8.0	7.1	6.9
Current account deficit	6.1	4.9	1.7	0.6	4.0

(percent GDP)					
Official reserves (USD billion)	9.8	7.3	12.2	17.3	21.2
External debt-end of period (percent GDP)	30.0	37.4	41.6	39.1	40.6
External Debt Servicing (EDS) – PKR billion (USD million)	112.6 (1214)	128.2 (1400)	177.3 (1787)		

Source: IMF, *Pakistan: 2021 Article IV Consultation, Sixth Review Under the Extended Arrangement Under the Extended Fund Facility, and Requests for Waivers of Applicability and Nonobservance of Performance Criteria and Rephasing of Access*.

Table 2: Projected Indicators for Pakistan's Economic Outlook

	2022-23	2023-24	2024-25	2025-26
GDP growth (percent)	4.5	5.0	5.0	5.0
Inflation CPI	7.8	6.5	6.5	6.5
Fiscal deficit (percent GDP)	4.4	4.4	3.9	3.5
Current Account Deficit (CAD) (percent GDP)	3.5	3.3	3.0	2.7
Official reserves (USD billion)	20.7	20.1	20.9	23.1
External Debt-end of period (percent GDP)	40.1	39.1	37.7	35.2

Source: IMF, *Pakistan: Request for an Extended Arrangement Under the Extended Fund Facility*.

Narrative Appraisal

In the 1980s, debt service intermediaries became prominent and debt dispersals gained the status of policy instrument in developing countries. Therefore, to analyze the debt determinants of low-income countries since 1980s, a comprehensive review was conducted for this study.[11] Further, a review of the literature[12] revealed the following financial and non-financial variables that constrained Pakistan in debt distress: (1) not complying with IMF conditions in the previous arrangements; (2) importing tons of oil, whose price has soared due to supply chain disruption (in the wake of Russia-Ukraine war and ensuing global oil crisis) that negatively impacted the balance of payment standings; (3) high defense spending due to terrorism and a war-prone tense border with its eastern neighbor, India; (4) domestic political crisis; and 5) bare minimum climate resilience to avert floods in rural areas.[13] These findings raised new questions regarding the approaches to transform the country. The final methodological step entailed bifurcating between short-term and structural sources of risk as identified in the literature. The key concerns focused on the strategies for Pakistan to avoid its future reliance on IMF; its transition towards a green revolution to incrementally lower oil imports and avert the balance of payment deficit in the long run; and a practical solution for the government to respond to the high military expenditure to contain terrorism and the army excursions on its borders. The following discussion delves into each of these questions successively.

Debt Determinants and Reformation Trajectory

Pakistan Financial Policies and IMF Conditionalities: Need for a Theory of Change, Logic Model and Program Evaluation

Since its membership in 1950, Pakistan has entered into 23 agreements with the IMF. The first agreement i.e. Extended Fund Facility (EFF) arrangement was signed with the Fund during the government of General Zia-ul-Haq in 1980; earlier it had Standby Arrangements with IMF (1958-1957), given country's ongoing economic ignominy.[14] The evaluation of the EFF program, which was completed in July 2022, also revealed that the country failed to establish quarterly cut-off point for maintaining international reserves, controlling dispersion of untargeted subsidies, and increasing registered taxpayers. While it is true that Pakistan remained unsuccessful in complying with the IMF targets owing to various factors beyond its control—such as the Ukrainian invasion which adversely impacted the exchange rate and consequently ruptured the supply chains that increased food and fuel prices; COVID-19 pandemic and consequent slowdown in economy, among others—the recent assessments also repeatedly mention government's inability in devising and implementing appropriate policies for debt sustainability and economic recovery. Therefore, the recent Standby Agreement (SBA) report, released by IMF on July 12, 2023, requires Pakistan to introduce extensive structural reforms to 'build climate resilience, enhance safety nets, strengthen governance, including of state-owned enterprises, and improve the business environment by creating a level-playing-field for investment and trade are necessary for job creation and raising inclusive growth'.[15]

The best practice to upturn the economic downfall in the short run depends on the efficiency of the government to incorporate IMF's recommendations in realization of domestic needs, potential, and long-term impacts. The IMF framework has to be adopted with a national approach to carve the way out of the reliance on the Fund, leading towards sustainable domestic progress. It is important that Pakistan repays the debt amount in timely installments to avoid default, cumbersome renegotiations, and time-consuming rescheduling. Pakistan also needs to continuously expand its tax base and provide more resources to the government to enable 'higher infrastructure and social spending while strengthening public finances,' in the short-run.[16] This goal can be actualized by strategic efforts designed to target high-income earners and those who own accumulated wealth. Such efforts should be coupled with the IMF's plan to cap state expenditures to approximately 16 percent of the GDP. This means ensuring the fuel subsidies are gradually terminated from the state expenditure and welfare to the most vulnerable is dispersed according to a plan that would help them become self-sustainable. However, to offset reliance on IMF in the long run requires evidence-based policymaking i.e., a shift in focus from inputs to outcomes and results.[17] In the long run, Pakistan should aim to upgrade towards a circular economy to use resources in efficiently for the longest possible time. In a circular economy, '[t]he resources circulate through various processes, being reused, repaired, redesigned or remanufactured, which reduces the need for new raw materials and minimizes waste.[18]

Currently, Pakistan lacks a publicly available theory of change (TOC) and logic model to guide its journey towards debt sustainability. In policy analysis, a TOC is essential to develop a theoretical understanding of how the intended outcomes of a proposed governmental policy or initiative can be realized. It essentially explains the underlying presumptions, convictions, and reasoning behind the targeted change and how various program elements work together to bring about that change. It provides a roadmap for effectively developing and putting into practice strategies by assisting stakeholders in understanding the desired results and the relationships between various elements of an intervention.

Complementing this theory, a program logic model (PLM) offers a detailed outline of the required resources throughout the program, sub-initiatives, and their expected results and outcomes over time. Unlike the TOC, the PLM is time-bound, comprising numerous elements and specific practical targets. To facilitate a well-organized program implementation, subsequent evaluation is crucial. Evaluation in policy studies involves a systematic and objective assessment of government initiatives to determine whether the projects are achieving the desired outcomes. This evaluation process aids in understanding the effectiveness and impact of policies and initiatives, providing valuable insights for informed decision-making and continuous improvement.[19] The robust evidence generated by impact evaluations is increasingly serving as a foundation for greater accountability, innovation, and learning.[20] A step-by-step publicly available theory and logic model of how the policymakers plan to restructure the economy away from IMF reliance and towards economic growth in the future can restore the confidence of the foreign investors and resolve balance of payments (BOP) deficits. A possible theory to enable Pakistan to achieve its identified goal of becoming economically resilient is outlined in Table 3.

Table 3: Theory of Change for Pakistan's Debt Sustainability

1.What is the problem that needs to be solved?	**2.Who is the audience?**	**3.What is the entry point to reach key audience?**	**4.What steps are needed to bring about change?**	**5.What is the measurable effect of the proposed work?**	**6.What are the short term benefits of the work?**	**7.What is the long-term change or goal desired?**
-How to end Pakistan's reliance on IMF and other transnational lenders to make external debt level sustainable?	-Pakistani nationals -International investors	-Avid communication and awareness among the nationals -Cross-communication between state departments	-Diplomatic efforts to scale down hostility with India -Public participation for environmental sustainability -Disaster management -Social Cohesion Measures -Implementing IMF conditionalities	-Decrease in military budget through smart strategies -Reserves for disaster management through international donors and grants -Installation of green energy sources	-Restore the confidence of foreign investors -Save the economy from bankruptcy -Initiate the green revolution	-Ending reliance on IMF deals and negotiations -Less import of expensive petrochemicals -Reserves for disaster management -Decrease in military spending -BOP surplus -Debt sustainability -Greater governme

			-Move towards circular economy -Expanding tax base -Benefit from previously untested ways to bring foreign reserves (e.g., remittance economy)	-Widening registered taxpayer's base -Tolerance and Inclusivity		ntal accountability -Economic growth
Key Assumptions	**Key Assumptions**	**Key Assumptions**	**Key Assumptions**	**Key Assumptions**	**Key Assumptions**	**Stakeholders**
Only if: -Government decides to discuss ways to use the recent IMF financial stimulus effectively and strategically	Only if: -People trust the government and act on its guidelines	Only if: -State institutions agree to engage in diplomatic missions -Environmental resilience or initiation of green revolution is considered important by the state -	Only if: -People are willing to work towards the common good -Government engages in extensive communication and awareness campaigns -Government is willing to include people towards environmental decisionmaking	Only if:	Only if:	

Phasing Out Nonrenewable Energy Through Transformative Climate Governance for Balance of Payments Surplus: Participatory Processes

Oil and energy imports have inflated the current account deficit for Pakistan in the recent past. For the FY 2022, the current account deficit surged by USD 2.3 billion due to petrochemical imports. Simultaneously, the State Bank of Pakistan (SBP) reported that the non-oil imports have slowed down. Hence, the empirical evidence points out that Pakistan needs to phase out nonrenewable energy imports if it wants to report a positive change in the balance of payments.

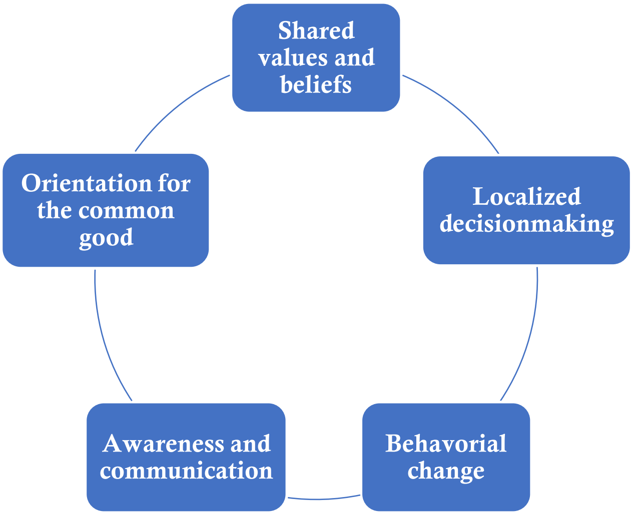
The environmental and economic cost of sole reliance on fossil fuels is enormous for the world. The solution to supplement overuse of oil consumption, contain CO_2 emissions, alter citizen behavioral acumen and embark Pakistan towards securable energy supply requires immediate commitment towards the installation of renewable energy supplies. Pakistan should also partake in the global sustainable transformation. 'The spread of renewable energies will increase electrification and stimulate cross-border trade in electricity.'[21]

The forthcoming global energy transition and governance regime will be based on changes in energy-producing and energy-consuming countries. Countries that currently import oil can reorient their energy use by innovating in low-carbon technologies. Pakistan can use the Chinese model to fully adopt and accelerate the green revolution in its national parameters. Chinese model based itself on state-led approaches for installing renewable energy resources. That includes secure seed funding for the private sector and communication campaigns shift towards low-carbon technologies.[22]

The challenge for Pakistan, like many other developing countries, is 'to assemble all the actors, layers and levels to get together and disperse a coherent mix of policies appropriate for the scale and period of application and consistent with the national social, cultural, historical and political context'.[23] The internalization of national issues has also called upon renewed trans-governmental dynamics where state moderators intermingle with their peers for collaboration purposes on common good problems.[24] That means any country planning solar energy transformation can take advantage of the best and worst case examples for an efficient, productive and impactful transition. Therefore, Pakistan can develop strong alliances with many countries that have advanced in solar energy development such as Germany and the United States (US). Such a solution will not only make a good use of the common rules of the global markets, but also avoid the dilemma of the government regulators, who often lack the expertise and resources to deal with increasingly complex regulatory tasks.[25] Such partnership could also emanate from the concept of sovereign transnational administrative frameworks, where the skills of international organizations are meaningful to construct, execute and examine regional and global policies.[26]

While Pakistan is categorized among the lowest emitters of carbon, its compliance with the international standards can revamp the national environmental and economic setup.[27] To address the climate crisis requires citizens' collective behavioral change and participation in governmental decision-making for transformation towards a sustainable and carbon-neutral society.[28] The sustainability initiatives for resilience on private and public property require citizens to alter their role as consumers, members of civil society, agents of change, activists, voters, and public-spirited individuals.[29] Governmental authorities can partner with citizens to formulate grassroots narrative on finding ways to achieve climate change mitigation and adaptation goals. Public participation or citizen engagement is one of the common practices. Its most integral tenets are bringing people together for deliberations on issues of public importance based on their values and lead to positive changes for the overall well-being of the society (see Figure 1).

Figure 1: Components of Public Participation for Environmental Resilience



Source: Thomas C. Beierle, *Democracy in Practice Public Participation in Environmental Decisions* (New York: Routledge, 2010).

Taking Advantage of Transnational Governance and Social Cohesion Measures to Lower Defense Expenditures

Pakistan's continuous tensions with its Eastern neighbor India, owing to various reasons, but primarily over the longstanding dispute of Jammu and Kashmir (J&K)—one of the most pernicious interstate conflicts globally—has always remained a cause for Pakistan to prioritize its security needs. Lately, however, the extremist groups that took roots in a post-9/11 environment with their presence throughout the country and focal settlements in the northwestern areas of the country, resulted in huge fiscal spending in the defense sector.[30]

Significant military spending has a positive relationship with economic growth when countries house a full operational defense.[31] While Pakistan has no military industry, it depends on the top global sellers such as the US and Russia for 'purchases and maintenance of larger, more technologically advanced and costly military hardware.'[32] Designating a high proportion of budget for military does not result in substantial benefits for the economy and an increase of one percent in military spending only results in around a 0.04 percent increase in real GDP.[33] Another research on military spending also showed that an 'increase in military expenditure increased the external debt of selected South Asian countries [including Pakistan] by 2.07 percent of GDP.'[34] Military expenditures can also be reduced through the use of smart technologies and strategies.

In terms of terrorism, which is the second major cause of military spending, it needs to be underscored that terrorism-related policies need to have a social aspect to them. Social cohesive measures can bring sectarian, linguistic, and ethnic groups closer to each other and nurture tolerance in society. Schiefer and Noll charted out three key dimensions of social cohesion, namely social relations; sense of belonging; and orientation towards the common good. Social relations constitute mutual trust, shared priorities, and diversity. The dimension of connectedness pertains to national identity, faith in the political system, and fairness of treatment, whereas the common good stream espouses helping others and respecting the law. Schiefer and Noll argue that three elements of social cohesion, which are often incorporated, namely (in)equality, quality of life, and shared values, should however be taken as 'antecedents or consequences of social cohesion, rather than inherent essential components.'[35]

There are strict anti-pluralist boundaries among South Asian countries. The essential step in the rescue mission entails resolving geopolitical conflicts through dialogue and engaging global governance entities. [36] For instance, the Kashmir issue needs to be resolved as per the UN resolutions which call for a plebiscite ensuring Kashmiris' right of self-determination.. Global governance is a response to problems that transcend national boundaries and call for collective action.[37] Moreover, the global policymaking depends on organizations, institutions, networks and individuals to determine and execute global policy tasks.

Conclusion

The paper presents a three-pronged argument on the ways in which Pakistan can improve its external debt portfolio. The first sub-argument concentrates on adhering to the IMF austerity guidelines alongside drafting a comprehensive plan on ways to reduce the Pakistan's reliance on IMF's packages. The other two sub-arguments concentrate on determinants of expansive external debt distress: oil imports and less military expenditures. If Pakistan does not align its national brand with global change, finding strategic partners for international relations (and other national policies) will not be easy. The argument in this paper aligns with Fuenfschilling and Truffner who point out that the transformation to a circular economy is not easy as it requires disruption on many tangents, changing consumer thinking, and reformulating supply structures.[38] Large-scale socio-institutional re-assortment in a limited time will require radical actions in the form of new laws and policies.[39] The government of the Netherlands could be used as a case study to set up primary objectives for undergoing this transition.[40] Its agenda included reducing raw material demand by increasing efficiency, replacing fossil fuels with sustainably produced raw materials, developing low carbon production methods, and promoting informed consumption.[41]

The International Energy Agency (IEA) recommends conducting a substantial review of how energy is produced and consumed at each stage of production, in addition to an analysis of how resources are impacted. The Intergovernmental Panel for Climate Change (IPCC) report outlines the dimensions that require attention in the command and control framework of the governments for transition towards greener options. One of these dimensions is carbon pricing, comprising of cap and trade systems, carbon taxes and other economic instruments such as fuel taxes, different subventions to renewable energy. The dimension regarding regulatory approaches covers energy efficiency standards, command-and-control, mandatory decommissioning of old plants. Next, information programs-related dimension focuses on addressing issues related to behavior, lifestyle and culture. Addressing administrative and political barriers including through international cooperation, also fall under this framework.[42]

In contrast to the command-and-control toolkit, Mitchell et al. bring attention to substantive measures related to research, development and demonstration. These include academic funding, grants, incubation support, research centers, public-private partnerships, prizes, tax credits, voucher schemes, venture capital, soft and convertible loans etc. In the same vein, fiscal incentives such as grants, energy production payments, rebates, changes in depreciation, and tax credits and reductions, could be introduced. Regarding public finance, reforms related to investments, guarantees, loans, and procurements need consideration. Finally, reforms in regulations regarding quantity or quality driven, e.g. renewable portfolio standards, tendering and bidding, feed-in tariffs, green purchasing and labelling, net metering, priority to gain access to networks or dispatch should be considered.[43] The recent IPCC report points out that all metrics used to trace improvements have uncertainties, limitations and other shortcomings. However, these strategies are adopted by countries already leading the transformation towards environmental sustainability and circular economy.[44]

Pakistan needs to put its efforts together with a vision to end reliance on mechanisms of external support and use the current IMF support to the journey of transformation into a self-reliant economy. For doing this, a holistic approach is needed which accommodates the financial, strategic, and social aspects to divert its resources and expenses toward national development and progress.

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