

## **The Debt of the Nation**

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### **I. INTRODUCTION**

The debt of the nation comprises two parts, the external debt and the internal debt. After rapidly accumulating arrears of external debt in the post-sanctions period, Pakistan has had to seek re-scheduling of her external debt as part of a financing and reform package negotiated with the IMF. While re-scheduling has not been sought for the first time, the rising burden of this debt has generated a serious debate for the first time. In the heat of this debate, the heavier burden of the costlier internal debt has been nearly ignored. Although this paper takes account of the totality of the debt towards the end, its main focus is on the problem of external debt for reasons not only of its immediacy but the prospects of forced self-reliance raised by the financial and economic fall-out of the nuclear explosions of May 1998.

Section II looks for the data sources and discovers that there are as many sizes of the debt as there are sources. In its latest report, the State Bank of Pakistan (SBP) characterises the economy as “highly indebted” in terms of its external debt, while the latest *Economic Survey* (ES) does not consider the external debt as large as it appears. Section III analyses these claims in terms of the internationally recognised debt burden indicators. In Section IV, attention is devoted to debt sustainability criteria. Section V of the paper examines the question as to how debt, which also shows access to capital required for economic growth, was allowed to become a burden over time. The last Section presents main conclusions and suggests an agenda for action.

### **II. THE THREE SIZES OF EXTERNAL DEBT**

The last ES states: “While infusion of capital has undoubtedly contributed to growth and development, it has also led to growing indebtedness in absolute terms. The magnitude of the increase is not as large as it appears, if adjustment is made for inflation” [Pakistan (1998), p. 97]. In contrast, the SBP warns: “Seen in the context of

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*Author's Note:* This paper has been written in a personal capacity and I alone am responsible for the views expressed here. It is based on a presentation made to the Parliamentarians on November 25, 1998.

standard debt ratios, Pakistan has become a highly indebted developing country” [State Bank (1998), p. 105]. But the World Bank (WB) publication which is responsible for constructing the so-called standard debt ratios, places Pakistan in the category of “moderately indebted low income countries” [World Bank (1998), p. 76]. These differing interpretations of the debt burden, it must be noted for better or worse, are prior to the full reflection of the impact of the economic sanctions. As Table 1 shows, the three interpretations have different estimates of absolute burden.

Table 1  
*External Debt: Outstanding Stock\* and Servicing*  
 (Million US Dollars)

Years	ES	SBP	WB	Debt Service/Export Ratio (%)	
				ES	SBP
1954-55	24	—	—	0.7	—
1959-60	145	—	—	6.9	—
1964-65	1,021	—	—	25.9	—
1969-70	2,959	—	3,073	52.1	—
1977-78	7,189	—	—	24.9	—
1982-83	9,312	—	—	19.9	—
1987-88	12,913	—	16,984	25.1	—
1988-89	14,190	—	18,348	24.1	—
1989-90	15,094	15,247	20,663	24.9	32.6
1990-91	15,471	17,295	23,363	21.5	40.3
1991-92	17,361	19,629	24,918	21.9	42.2
1992-93	19,044	22,046	24,527	24.2	43.4
1993-94	20,322	24,482	27,359	25.7	54.5
1994-95	22,117	25,318	30,248	25.1	55.7
1995-96	22,275	27,094	29,901	24.5	52.3
1996-97	23,145	27,863	—	27.2	62.8
1997-98	22,838	29,715	—	27.7	56.3

Sources: Pakistan (1988, 1998, 1998a); State Bank (1995, 1996, 1997, 1998); World Bank (1996a, 1998a).

\*End of the period.

In the ES published by the Finance Division, the data presented do not give a complete picture of the total civilian external debt. The data cover only the public and publicly guaranteed long- and medium-term concessional debt (*i.e.* loans with a grant element of 25 percent or more) contracted by the Economic Affairs Division with official bilateral and multilateral creditors. The absolute burden has not changed much in recent years, but over time it grew rather rapidly. From 24 million dollars at the end of the Pre-Plan period in 1954-55, it rose sharply to six times at the end of the First Plan in 1959-60, seven times over the Second Plan, about three times over the Third Plan and about two and a half times by the end of Non-Plan period in 1977-78. The growth began to taper off during the subsequent Plans, but was still substantial: 30 percent over the Fifth Plan 1978-83, 37 percent over the Sixth Plan 1983-88, 47 percent over the Seventh Plan 1988-93. It is only in the Eighth Plan 1993-98 that the burden rose less sharply by 20 percent. But the cumulative burden had now become a hefty 22.8 billion dollar. And this was not all. The ES concept corresponded to the civilian external debt for a long time as debts other than long- and medium-term maturities became significant only later. Short-term borrowing had started in the wake of the first oil price shock in the early seventies,<sup>1</sup> but its share was not of much consequence till as late as 1989-90. Beyond that year, the ES concept cannot but mislead.

Until 1993-94, the SBP followed the ES concept. Since 1994-95, however, its annual reports have devoted an exclusive chapter to the question of debt and improved its coverage of external debt by first adding short-term debt contracted by the External Finance Wing of the Finance Division and subsequently the IMF, foreign private unguaranteed and commercial banks' credits.<sup>2</sup> In the nineties the difference between the two concepts has become too large to be disregarded. To give some idea in absolute terms. In 1997-98, the total outstanding debt in terms of the SBP definition was 29.7 billion dollars, *i.e.* almost 7 billion dollars higher than the ES definition. The SBP definition seems closest to the WB concept of the total debt stock [World Bank (1992), p.110], but not quite. As Table 1 indicates, the amount the SBP defines as the total outstanding debt stock at the end of 1997-98 had been surpassed, in the WB reckoning, in 1995-96. Like international trade, debt transactions are recorded on two sides and, verification should, therefore, not present insurmountable difficulties. As of now, there are three estimates of the size of the outstanding external debt, and there could be more.

### III. DEBT BURDEN INDICATORS

These absolute numbers of outstanding debt stock are scary, but nothing meaningful can be said about the burden of debt without any reference to the means to

<sup>1</sup>Pakistan (1975).

<sup>2</sup>Foreign Currency Accounts (FCAs), constituting around 30 percent of the total debt, are not included in the SBP definition of external debt. Nonetheless, the FCAs constituted a short-term liability contributing to the vulnerability of the balance of payments.

repay debt. Table 1 also gives debt service/export ratios according to the ES as well as the SBP definition. While these ratios seem ominous when compared over time or across countries, it is still not possible to draw any useful conclusions about the burden of debt. It requires some critical value which the countries must move past to enter the danger zone. In the heyday of development economics, as also during the “golden age” of growth in the sixties, a debt service/export ratio of 20 percent was considered “tolerable”. By this yardstick, even the lower ES estimates suggest a perpetually intolerable level of debt burden through nearly the whole period.

A single-factoral explanation of the debt burden is no better than any other single-factoral theory. With workers’ remittances assuming as much significance as exports, if not more, even the denominator required re-defining. Understandably, the SBP employs, in addition to debt service/export ratio, the debt service/foreign exchange earnings ratio and the outstanding debt/GDP ratio as debt burden indicators. It concludes:

Seen in the context of standard debt ratios, Pakistan has become a highly indebted developing country. Pakistan’s ratio of external debt to exports of goods and services (including workers’ remittances) at 256.1 percent during 1997-98 was much higher than 135.8 percent of developing countries and 186.7 percent<sup>3</sup> of South Asia, as a group. Similarly, debt service ratio at the level of 40.8 percent was also higher when compared with 17.0 percent<sup>3</sup> [*sic.*] of developing countries and 21.5 percent<sup>3</sup> [*sic.*] of South Asia. Pakistan’s external debt and debt service ratios also exceeded the prescribed debt sustainability normal limits of 225-250 percent and 20-25 percent [State Bank (1998), p.105].

This is a remarkable statement as it does not follow from the information given by the SBP and presented in Table 2. It will be seen that Table 2 does not even report debt/foreign exchange earnings ratio; and the figure of 256.1 percent has not been sourced. We have worked out this ratio by using the SBP data in Table 3 below. It reveals that this ratio has never been at this level. Table 2 reports debt service/foreign exchange earnings ratio, but not the figure of 40.8 percent either for 1997-98 or as an average of three years, which is a standard practice. The source of the critical values for the two debt burden indicators, the so-called “prescribed debt sustainability normal limits of 225-250 percent and 20-25 percent”, is not revealed either. The categorisation of “highly indebted developing country” is nowhere to be found in the literature.

<sup>3</sup>“Average of two latest available years, i.e., 1996 and 1997.” [Footnote in original].

Table 2

*SBP: External Debt and Service Ratios*

(Percent)

Years	Outstanding Debt/GDP Ratio	Debt Service/Foreign Exchange Earnings Ratio
1989-90	38.8	18.8
1990-91	37.9	24.2
1991-92	40.3	24.9
	(39.0)	(22.6)
1992-93	44.6	27.4
	(40.9)	(25.5)
1993-94	47.6	33.4
	(44.2)	(28.6)
1994-95	41.7	34.9
	(44.6)	(31.9)
1995-96	43.9	33.9
	(44.4)	(32.1)
1996-97	46.9	39.3
	(44.2)	(36.0)
1997-98	49.5	35.5
	(46.8)	(36.2)

*Source:* State Bank (1995,1996,1997,1998).

*Note:* Parentheses show three-year averages.

A short history of the evolution of debt burden indicators will not be out of place. The first multi-factoral attempt to estimate the degree of indebtedness was made in 1990. Four debt burden indicators were identified for low income countries like Pakistan—debt/GNP ratio, debt/foreign exchange earnings ratio, debt service/foreign exchange earnings ratio and interest payments/foreign exchange earnings ratio. GNP rather than GDP was used because the foreign exchange earnings consisted of export of goods and services including workers' remittances. The degree of indebtedness was estimated on the basis of a set of critical values. At the highest level of indebtedness, a country was categorised as Severely Indebted Low Income Country (SILIC) if at least three of its indicators exceeded the following set of critical values: debt/GNP ratio of 50 percent; debt/foreign exchange earnings ratio of 275 percent; debt service/foreign exchange earnings ratio of 30 percent; and interest payments/foreign exchange ratio of 20 percent. At the middle level of indebtedness, a country was categorised as

Moderately Indebted Low Income Country (MILIC) if at least three of the debt indicators stood above 60 percent of their critical values. All others were placed at the lowest level of indebtedness as Less Indebted Low Income Countries (LILICs). [World Bank (1990), Appendix III].

Using SBP data, we estimate the four debt burden ratios in Table 3 to assess the degree of indebtedness of Pakistan. We use actual rather than the next-year's scheduled debt service data as the country met its liabilities fully for the period under report. Basing the degree of indebtedness on the single latest year can be distorted. In particular, export earnings are prone to serious fluctuations. In World Bank (1992), the methodology was changed again to normalise the debt burden indicators by the application of three-year averages. We follow the changed methodology as well in Table 3.

Table 3

*Debt Burden Indicators: SBP Data, WB Methodology*

Years	Debt/GNP Ratio	(Percent)		
		Debt/Foreign Exchange Earnings Ratio	Debt Service/ Foreign Exchange Earnings Ratio	Interest Payments/ Foreign Exchange Earnings Ratio
1989-90	36.7	178.5	18.8	6.9
1990-91	37.1	175.9	24.2	7.2
1991-92	39.8	171.3	24.9	6.7
	(37.9)	(175.2)	(22.6)	(6.9)
1992-93	41.6	205.2	27.4	7.6
	(39.5)	(184.1)	(25.5)	(7.2)
1993-94	47.0	226.1	33.4	8.2
	(43.0)	(200.9)	(28.6)	(7.5)
1994-95	41.7	204.3	34.9	8.2
	(43.4)	(211.9)	(31.9)	(8.0)
1995-96	42.1	211.3	33.9	8.5
	(43.6)	(213.9)	(32.1)	(8.3)
1996-97	43.8	215.4	39.3	8.1
	(42.5)	(210.3)	(36.0)	(8.3)
1997-98	46.7	222.6	35.5	8.3
	(44.1)	(216.4)	(36.2)	(8.3)

Source: State Bank (1995,1996,1997,1998).

Note: Parentheses show three-year averages.

Results contrary to the SBP conclusions emerge from Table 3. Only one indicator, i. e., debt service/foreign exchange earnings ratio is above the critical value for 1997 as well as the average for 1995–98. On this basis, Pakistan is not a SILIC or what the SBP calls a “highly indebted country”. It is rather a MILIC, as three indicators

—debt/GNP ratio, debt/foreign exchange earnings ratio and debt service/foreign exchange earnings ratio—record values above 60 percent of the critical values for the SILIC category, for the last year singly as well as the average for 1995–98. In fact, Pakistan has remained a MILIC throughout the period reported in the table, with debt/foreign exchange earnings ratio being the problem area.

The debt picture becomes worse in terms of the World Bank data. This is witnessed in Table 4. Take 1993-94: debt/GNP ratio, debt/foreign exchange earnings ratio and debt service/foreign exchange earnings ratio were all above the critical values. But this was an exceptional year, as debt rose by 11.6 percent following an increase in debt flows of 25.6 percent. Debt servicing shot up by 45.3 percent. While the numerator grew sharply, the denominator in these cases, i.e., foreign exchange earnings, actually suffered a decline. Similarly, as GNP also increased by only about half a percent, the denominator grew far less than the numerator so that the debt/GNP ratio recorded its worst critical value. But for this unusual year, when Pakistan could be described as a SILIC, the average picture portrayed her as MILIC. It seems the average debt burden ratios are tending towards a SILIC status towards the end of the period and may well corroborate the definite conclusion drawn by the SBP, but the latest available World Bank documentation stops at 1995-96. So what is the basis of the SBP conclusion?

One possibility is that the SBP has prepared its estimation on the basis of the latest methodology which has recourse to present valuation. The nominal basis of earlier methodology emphasised short term liquidity more than the underlying solvency. While the ratios of debt service and interest payments to foreign exchange earnings are good indicators of the state of liquidity, debt/GNP and debt/foreign exchange earnings ratios do not properly indicate long-term solvency. Static in nature, these ratios fail to allow for variation in borrowing terms. They assume similar term structures and interest rates. Clearly, different borrowing terms lead to different degrees of indebtedness, even if the two debt ratios are the same. On the other hand, debt service/foreign exchange ratio though allows for concessionality, blows out of proportion shorter term structures. Thus it gives the impression that a country with smaller graces and maturities will have greater debt service difficulties than a country with longer graces and maturities. This is not necessarily the case if the country involved has no difficulty in rolling-over.

A country's long-term solvency and debt service reality is better captured by the present value (PV) of scheduled debt service than the nominal value of debt.<sup>4</sup> The ratio of present to the nominal value of the debt measures the degree of concessionality. If the present value is higher relative to the nominal value, the degree of concessionality is lower. This happens when the interest rate is higher than the discount rate. The World Bank adopted the new methodology in 1992-93, the year with which the SBP started its holistic debt series. The present value was arrived at by discounting future debt service-

<sup>4</sup>This cannot account for the debt service problems arising from the government budget constraint. Not only that there must be an income and an ability to convert it into foreign currency, there must also be the ability to tax that income. Further, fiscal stress resulting from free convertibility into foreign currencies and internal debt servicing difficulties may impact on the capacity to service external debt without showing up in the balance of payments.

Table 4

*Debt Burden Indicators: WB Data, WB Methodology*

Years	Debt/GNP Ratio	(Percent)		
		Debt/Foreign Exchange Earnings Ratio	Debt Service/ Foreign Exchange Earnings Ratio	Interest Payments/ Foreign Exchange Earnings Ratio
1969-70	30.6	350.0	24.8	8.8
1979-80	42.4	208.7	18.3	7.9
1981-82	38.3	215.0	15.6	7.7
1984-85	40.4	228.0	24.2	8.5
1985-86	43.1	228.6	25.4	9.0
1986-87	47.1	246.2	26.8	9.1
	(43.5)	(234.3)	(25.5)	(8.9)
1987-88	(42.3)	231.2	24.7	8.9
	(44.2)	(235.3)	(25.6)	(9.0)
1988-89	44.1	241.0	24.2	10.1
	(45.3)	(239.5)	(25.2)	(9.4)
1989-90	49.5	250.0	23.3	10.2
	(45.3)	(240.7)	(24.1)	(9.7)
1990-91	50.0	249.1	20.9	9.2
	(47.9)	(246.7)	(22.8)	(9.8)
1991-92	50.5	254.0	23.8	9.0
	(50.0)	(251.0)	(22.7)	(9.5)
1992-93	47.0	246.0	23.9	8.7
	(49.2)	(249.7)	(22.9)	(9.0)
1993-94	52.2	276.0	35.0	10.1
	(50.0)	(258.7)	(27.6)	(9.3)
1994-95	49.5	252.8	26.6	10.0
	(49.6)	(258.3)	(28.5)	(9.6)
1995-96	46.3	250.5	27.4	10.0
	(49.3)	(259.8)	(29.7)	(10.0)

Source: World Bank (1992a,1993,1994,1996a,1998a).

Note: Parentheses show three-year averages.

interest payments and amortisation for 40 years. Four types of discount rates were applied. Multilateral credits were discounted by the latest World Bank lending rate, bulk of the other credits by the interest rates charged by OECD countries on their guaranteed export credits and the rest by the OECD average interest rate. The IMF lending was discounted at the SDR lending rate. The calculation is obvious in the case of fixed-rate loans, the base rate such as LIBOR is projected as discount rate in the case of variable rate loans. Another advantage of this methodology is that discount rates vary with the currency composition of debt.



Instead of the four ratios used in the earlier methodology, the indebtedness categories are defined on the basis of critical values of two ratios—the ratio of present value of debt service to GNP and to foreign exchange earnings. The former is the broadest measure of the capacity to repay and the later of the ability to provide the required foreign exchange. The respective critical values are 80 percent and 220 percent. If in a country either of the two ratios has a three-year average above the critical value, it is categorised as SILIC. To be a MILIC, one of the two ratios must exceed 60 percent of the critical value [World Bank (1992)].

In effect, a MILIC country would have to average a PV/GNP ratio of above 48 percent or PV/foreign exchange earnings ratio of above 132 percent. Table 5 presents the debt burden ratios estimated on the basis of the new methodology based on present valuation. It will be seen that PV/foreign exchange earnings ratio is above 132 percent but less than 220 percent, while PV/GNP ratio is less than 48 percent. Until 1995-96, Pakistan was thus a MILIC, not a SILIC. Data for subsequent years have not yet been published by the World Bank. The presumption that the ratio of 256.1 percent quoted by the SBP may be a present value estimate for 1997-98 or a three-year average for PV/Foreign Exchange Earnings, is not plausible; it is too out of line with the trend.

Table 5

*Debt Burden Indicators: Present Value Estimates*

Three-Year Periods	Present Value/ GNP Ratio	Present Value/ Foreign Exchange Earnings Ratio	(Percent)
1990–93	37	187	
1991–94	39	204	
1993–96	39	206	

Source: World Bank (1992,1993,1994,1996,1998).

Note: Parentheses show three-year averages.

#### IV. DEBT SUSTAINABILITY

In 1996, the Debt Initiative for Heavily Indebted Poor Countries (HIPC) was launched. Three important considerations determined the development of this initiative. First, debt relief provided under existing arrangements (Paris Club, etc) did not necessarily lead to eventual exit from debt rescheduling. The reason for the return to rescheduling was not always a bad track record of policy performance. Hence the second consideration, that debt sustainability *per se* had to be made an explicit objective of policy. This required, as a third consideration, the participation of all creditors, including multilaterals who are traditionally averse to debt rescheduling, so that the costs are appropriately apportioned. The overall objective is to remove debt as a constraint on

growth by reducing it to a sustainable level.

Numbering 41 and located mostly in Africa, the HIPC's were found to be debilitated by an unsustainable burden of debt. In their case, the median ratio of present value of debt to foreign exchange earnings was as high as 340 percent. The target of sustainability was defined as a range of 200-250 percent for the PV/foreign exchange earnings ratio and 20-25 percent for debt service ratio. Actual targets are arrived at by carrying out country-specific analysis of debt sustainability. But the experience shows that countries in these ranges can hope to meet their current and future liabilities without recourse to rescheduling or accumulation of arrears. Debt sustainability means a permanent exit from rescheduling. The condition to achieve this in the case of private/commercial debt is to ensure that the voluntary debt growth never exceeds interest rate. Sustainability of debt from public sources requires policies to achieve a healthy balance of payments. [Claessens *et al.* (1996) and Cuddington 1997)].

HIPC's are the poorest of the low income countries. Pakistan is a low income country, but the available data do not place her the category of HIPC's. The SBP modifies the sustainability criteria for HIPC's and calls it prescribed, but without saying whose prescription it is. It states: "Pakistan's external debt and debt service ratios also exceeded the prescribed debt sustainability normal limits of 225-250 and 20-25 percent respectively." The lower limit of 200 percent for HIPC's has thus been raised to 225 percent for the debt ratio while the range of the debt service ratio has been kept as it is. As the SBP reports Pakistan's debt ratio and debt service ratio to be 256.1 percent and 40.8 percent in 1997-98, which are above the critical values, the country is categorised as "a highly indebted developing country".

These debt burden indicators for 1997-98 (the source of which is not clear as SBP's own data throws different estimates in Table 3 above) are then compared by the SBP with the average ratios estimated by the World Bank for developing countries (135.8 and 17.0 percent) and South Asia (186.7 and 21.5 percent) for 1995-96 and 1996-97 to conclude that Pakistan fares far worse than these regions. Table 6 reports the available data on all the analytical classifications of countries and the World Bank data on Pakistan to show that such indeed is the case. Pakistan's debt/foreign exchange earnings ratio is lower only than the worst cases of Severely Indebted Low Income Countries (SILICs) and the Heavily Indebted Poor Countries (HIPC's). As already noted, the World Bank classifies Pakistan as a Moderately Indebted Low Income Country (MILIC), but its average debt/foreign exchange earnings ratio of 251.6 percent is considerably higher than the average of 208.5 for MILICs for 1994-95 and 1995-96.

The position in the case of debt service/foreign exchange earnings ratio is much more alarming. Notwithstanding the very high SBP estimate of 40.8 percent, Table 6 shows that the average of 27 percent for Pakistan estimated by the World Bank is the highest for all types of country classification. It seems the SBP overstates the debt service ratio of 40.8 percent, as also the estimates for other years in Table 3 above, by including, for some inexplicable reasons, the principal repayments for short-term debt, which are normally rolled over.

Table 6  
*Comparative Debt Burden Indicators*

Indicator/Country Classification	(Percent)			
	1994-95	1995-96	1996-97	Two-year Average
<b>Debt/Foreign Exchange</b>				
<b>Earnings Ratio</b>				
All Developing Countries	–	137.4	134.3	135.8
Low-income Countries	–	158.7	149.5	154.1
<b>Severely Indebted Low-income Countries (SILICs)</b>	458.1	361.7	–	409.1
<b>Moderately Indebted Low-income Countries (MILICs)</b>	219.8	197.2	–	208.5
Other Developing Countries	84.7	79.2	–	81.9
Heavily Indebted Poor Countries (HIPC)s	455.6	424.4	–	440.0
Sub-Saharan Africa	–	221.6	201.7	211.6
South Asia	–	193.6	179.8	186.7
Pakistan	252.8	250.5	–	251.6
<b>Debt Service/Foreign Exchange Earnings Ratio</b>				
All Developing Countries	–	17.2	16.7	16.9
Low Income Countries	–	13.3	12.9	13.1
<b>Severely Indebted Low-income Countries (SILICs)</b>	19.9	15.3	–	17.6
<b>Moderately Indebted Low-income Countries (MILICs)</b>	25.5	22.9	–	24.2
Other Developing Countries	8.8	8.0	–	8.4
Heavily Indebted Poor Countries (HIPC)s	26.6	27.4	–	27.0
Sub-Saharan Africa	30.1	22.3	–	26.2

South Asia	–	14.2	11.5	12.8
Pakistan	–	22.0	21.0	21.5

Source: World Bank (1998, 1998a).

## V. THE ACCUMULATION OF BURDEN

Access to external finance is useful, and concessional finance much more so. In theory, it adds to domestic saving and by softening the foreign exchange constraint on imported capital goods and inputs, permits a higher rate of investment. This higher rate of investment, as the story goes, leads to a higher rate of growth, a higher rate of domestic saving and a higher export growth to convert saving into foreign exchange required to service debts. Although foreign aid to Pakistan had started in 1950 and agreements were signed in all its forms within two years,<sup>5</sup> it was however during its Second Five Year Plan 1960–65 that she became a widely quoted model of effective borrowing for development. The rate of investment rose sharply from 11.8 percent to 18.3 percent, with one-third of the total and one-half of the public sector investment financed by external resources. The result was an impressive rate of growth, a jump in the rate of domestic saving from 8.8 percent to 11.7 percent and an export growth of 7 percent per annum compared to the target of 3 percent. The Plan ended with a manageable debt service ratio of 9.9 percent.

Not only that everything was according to the script, it was much better. Just when the planners were confidently preparing the Third Plan 1965–70 for a “take-off into self-sustained growth”, something beyond the pale of economics happened to derail the economy for decades to come. Perfectly timed for the launch of the Third Plan on July 1, 1965 the Aid-to-Pakistan Consortium met in May and judged Pakistan’s request for some 500 million dollars for the first year fit to be recommended to the pledging session, which would be held on July 21, 1965. It was postponed to September 21 at the behest of the United States which had provided half of the funding for the Second Plan, one-fourth of it in grants and the balance largely as concessional credits. Contrary to common perception, the immediate reason was not the war with India which broke out later in September of the same year, but Pakistan’s contacts with the leaders of the Non-Aligned movement. It was not understood as well at that time as it is now and, in any case, not stated as clearly as now that development aid flows in a political framework.<sup>6</sup> As a matter of fact, the pledging session was not held before November 1966.

A reduction of 27 percent in external resources during the Third Plan checked the momentum of investment generated by the Second Plan. The rate of investment fell from 18.3 percent achieved in the terminal year of the Second Plan to 14.3 percent by the end of the Third Plan in 1969-70. Domestic saving rate declined from 11.7 percent

<sup>5</sup>Foreign aid started with the Colombo Plan in 1950 in the form of grants. The first technical assistance agreement was signed with the United States on February 2, 1951, the first project loan with the World Bank on March 27, 1952 and the first commodity loan with the US-EXIM on September 17, 1952. [Pakistan (1969)]

<sup>6</sup>For instance, an important reason cited for falling net concessional assistance is “the declining strategic and military importance of development aid since the end of the cold war” [World Bank (1998), p.49].

to 10.7 percent. With uncertain aid horizon, five-year investment planning effectively came to an end, giving way to the more operational annual plans and medium-term sectoral programmes such as the wheat self-sufficiency programme. With continuing clouds over the aid horizon, and ever hardening terms, even the pretence of five year plans was given up after the Third Plan.

The fiscal straitjacket of rising debt service and defence expenditure originated in the Third Plan period. Between 1959-60 and 1967-68, 35 percent of investment and 48 percent of total imports were financed by foreign assistance. The economy had become “increasingly aid-addicted” and the rate of economic growth “fluctuated with the inflow of aid, reducing the domestic effort to a residual claimant” [Tahir (1970, 1974)]. Within a decade the debt burden had entered the danger zone, despite high economic growth. Table 7 traces the movement of the debt service ratio. It will be seen that the increase in debt servicing overwhelmed the increase in foreign exchange earnings, leading to an ever increasing share of foreign exchange earnings consumed by debt servicing.

Table 7  
*External Debt Burden in the Growing Sixties*

Years	Increase in Debt Servicing	Increase in Foreign Exchange Earnings	(Percent)
			Debt Service Ratio
1960-61	—	—	3.6
1961-62	78.5	4.6	6.2
1962-63	55.1	16.0	8.2
1963-64	29.5	−0.1	10.7
1964-65	1.2	9.2	9.9
1965-66	18.4	9.1	10.7
1966-67	29.9	6.0	13.1
1967-68	13.3	10.0	13.5
1968-69	42.3	10.2	17.5
1969-70	13.8	2.1	19.5
1970-71	23.4	−4.5	25.3
1971-72	15.9	−3.0	30.1

Source: Pakistan (1971, 1972).

A debate on the socio-political and economic costs of debt had begun in the sixties. Chaudhri Muhammad Ali, a former prime minister, censured the military regime of Ayub Khan for mortgaging the future of the country. At the academic level, Power (1963) observed: “It is fair to say that in Pakistan the mobilisation of domestic resources

has never had first priority.” Griffin (1965) showed that the stagnating wheat output was associated with imports from the United States under PL-480. Edible oils output met with similar fate. The government response was three-fold. First, availability of foreign assistance was an indication of the world confidence in the economy of Pakistan. Secondly, aid was being utilised effectively, as indicated by a high rate of growth. Third, the debt liability arising from aid inflow was not beyond the capacity to repay. It was estimated that every 100 dollars received in aid added 33 dollars to income, a significant part in the form of exports to enable debt servicing [Pakistan (1968, 1969)]. The Perspective Plan 1965–85 announced with the Third Plan included elimination of dependence on aid among its objectives. In 1968, the objectives announced for the Fourth Plan 1970–75 talked of increasing self-reliance. [Pakistan (1965, 1968a)] The realisation of these objectives was envisaged as declining requirements of aid for investment and ignored the debt burden implications [Rahman (1967)].<sup>7</sup>

In effect, perspective and five-year planning had become only academic exercises since 1968-69, when annual plans became the cutting edge of planning to adjust to uncertainties of aid. The planners learned, to their cost, that doing well and effective utilisation were not the only criteria for uninterrupted aid flows. While aid continued to be the starting point for planning future investment, annual plans came handy whenever aid disruption forced revisions. In the later event, investment invariably fell. The country took a long time to recover to the investment rate achieved at the end of the Second Plan and the years of slid-back far outnumber the years when it was surpassed. The efforts to pick up the slack caused by aid shortfalls were weak, with costlier internal debt substituting for the external debt more often than a broad-based approach to mobilising public revenues and saving. The only attempt made to reduce somewhat the vulnerability associated with aid was to diversify the sources of aid. Thus in the first two years of the Third Plan, the share of non-Consortium sources in total aid rose to 33 percent from only 3 percent in the Second Plan period.

A number of factors were responsible for the rising debt service ratio. As the outstanding debt rose with the increasing translation of commitments into disbursements, interest payments went up. With the expiry of grace periods, repayments fell due. Most important, at a time when net transfers on debt began to decline, grants shrank in tandem. From being a multiple of the debt flow in the Pre-Second Plan period, the grants started to trail behind the debt flows since the middle of the Second Plan to eventually become a trickle towards the end of the Third Plan. The percent share of net transfers in the debt flow came down from the range of eighties in the period up to the Second Plan to the seventies and the sixties in the Third Plan. Table 8 illustrates these changes.

<sup>7</sup>See also Naqvi (1971).

Table 8  
*Net Transfer of Resources in the Sixties*

(Million US\$)				
	Disbursement on Long- and Medium-term Debt (Million US \$)	Net Transfer on Debt	Grants	Total Transfer
<b>Pre-Second Plan (1951–60)</b>	<b>192</b>	<b>160</b> (83.3)	<b>650</b>	<b>810</b>
1960-61	111	94 (84.7)	231	325
1961-62	138	107 (77.5)	166	273
1962-63	258	211 (81.8)	243	454
1963-64	315	253 (80.3)	226	479
1964-65	410	348 (84.9)	296	644
<b>Second Plan (1960–65)</b>	<b>1232</b>	<b>973</b> (79.0)	<b>1162</b>	<b>2135</b>
1965-66	392	318 (81.1)	141	459
1966-67	432	336 (77.8)	191	527
1967-68	506	398 (78.7)	223	621
1968-69	493	335 (68.0)	101	436
1969-70	501	325 (64.9)	63	388
<b>Third Plan (1965–70)</b>	<b>2324</b>	<b>1712</b> (73.7)	<b>719</b>	<b>2431</b>

Source: Pakistan (1998b).

Note: Parentheses represent net transfer on debt as a percentage of debt flow.

A mid-plan development of note in the Third Plan period was the fact, visible in Table 8, that total transfers fell below the debt flow to start a trend that in time would become irreversible. Not only the grants became a smaller proportion of the gross flow, average interest rate also rose significantly from 2.6 to 3.9 percent. In May 1968, the Ayub Government formally lodged a request for debt relief, not with the Paris Club, but the Paris-based Aid-to-Pakistan Consortium [Tahir (1998)]. The confidence exuded earlier about the impact of aid was now on the wane. In less than a year, the government

fell and with it the edifice of foreign-assisted growth. Pakistan found strength in its case in the Pearson Commission Report, which towards the end of the sixties emphasised debt relief as a legitimate form of aid. The Consortium met in February 1970 to consider a report prepared by the World Bank. But no decision was taken. Meanwhile, the Bangladesh crisis disrupted exports and the debt service ratio shot up to 25.3 percent in 1970-71 and to over 30 percent in 1971-72. Conversions of debt service falling due between May 1 to October 31, 1971 on selected bilateral loans under the aegis of the Consortium were suspended. The suspension continued till an interim agreement was finalised in May 1972, after the break-up of the country.

While the debt crisis of the sixties resulted from the political and strategic developments of 1965 leading to the compositional shift away from grants, the non-Plan period of the seventies witnessed an attempt to force up the rate of investment through accelerated debt financing, internal and external, of lumpy capital-intensive projects. There were shifts from bilateral to multilateral debt, from non-project to slow-disbursing project assistance and the beginning of short-term commercial debt and medium-term borrowing from Islamic countries. The impact on debt servicing though restrained by the various debt relief arrangements secured by the country,<sup>8</sup> was a 240 percent increase in seven years.

Another military government had taken over when debt relief arrangements expired in June 1978, with net transfers dipping to less than 50 percent of the gross disbursement. The political climate changed again in the wake of the Afghan crisis. Debt relief was made available yet again in 1981-82 for 18 months, but it could not stop the net transfers from falling to as low as 13 percent in 1983-84. The return of the United States with a package of 3.2 billion dollars for 1982-87 and the Consortium assistance for Afghan refugees improved the proportion of grants and thus the net transfer. The percentage of grants in disbursements improved from 11 percent in the non-Plan period to an average of 28 percent while the US assistance lasted. The first package was followed by another six-year package of 4.02 billion dollars in 1988-93, only to be abandoned in 1990 after the loss of the U.S. interest in Afghanistan, an inevitable outcome of the withdrawal of the Soviet troops and the end of the cold war. Debt service ratio thus remained within manageable limits during the presence of the USAID. A debt forgiveness would perhaps have significantly reduced the possibility of a future debt crisis.

An important fact to note about this period of generous aid is that internal debt burden surpassed the external debt. From the point of view of vulnerability and external dependence, internal debt need not be as worrisome as external debt. It does not lead to transfer of wealth abroad; the nation owes it to itself. It may cause inflation and redistribute wealth from the poor to the rich [Tahir (1996)], not a very laudable effect, but still a supposedly manageable internal problem. However, it has led to a substitution of loan finance for tax finance, which adversely influences growth as well as solvency.

<sup>8</sup>See Pakistan (1983a) for a note on various reschedulings.



The large bulk of aid was project aid, which was mostly utilised on undertakings with a reasonable expectation of returns. About half of the aid was committed to agriculture, water and power, which are sectors with high economic returns. It is the lax tax effort that is perpetuating a fiscal deficit and a habituation of borrowing. In fact the increasing role of short term borrowing has been encouraged by costlier domestic financing. Short term external borrowing has exceeded the long term borrowing.

Table 9 shows the process that has led to the present debt crisis. It uses the available World Bank data to illustrate the point, rather than the latest SBP and ES data to protect definitional and conceptual consistency. It shows an erratic picture of the flow of long and medium term debt since 1988-89, the first year of the Seventh Plan. However, due to rising debt service, the net transfers on this debt have become very small. In fact the position of Table 8 above has been reversed. In the sixties, grants in the beginning were higher than the debt flows; later they were higher than net transfers

Table 9

*Net Transfer of Resources in the Sixties*

(Million US\$)

Period	Disbursement on Long- and Medium- term Debt	Net Transfer on Long- and Medium- term Debt	Net Transfer on Short-term Debt	Grants	Total
<b>Seventh Plan 1988-93</b>	<b>12586</b>	<b>3165</b> (25.1)	<b>-1509</b>	<b>1695</b>	<b>3351</b>
1988-89	2373	789	84	381	1254
1989-90	1766	104 (5.9)	150	324	578
1990-91	2308	582 (25.2)	714	479	1775
1991-92	2923	781 (26.7)	71	310	1162
1992-93	3216	909 (28.3)	-2528	201	-1418
<b>Eighth Plan 1993-96</b>	<b>10946</b>	<b>1563</b> (14.3)	<b>332</b>	<b>588</b>	<b>2483</b>
1993-94	4039	681 (16.9)	-118	199	762
1994-95	3292	318 (9.7)	1094	188	1600
1995-96	3615	564 (15.6)	-644	201	121

*Source:* World Bank (1998).

*Note:* Parentheses represent net transfer on debt as a percentage of debt flow.

on debt and thus enabled debt service payments. Now debt service of the less expensive long and medium term debt has to be arranged by net transfer on the relatively more expensive short term debt. Borrowing short to service past borrowing is the classical debt trap, as ensuring net transfers on short term debt leads the economy into a liquidity crisis, which eventually tells on credit ratings as the market develops serious doubts about the fundamentals and ultimate solvency of the economy. In the event rescheduling becomes inescapable although the world system lets this happen only when it perceives a minimal presence of moral hazard.

## VI. CONCLUSIONS AND AN AGENDA FOR ACTION

Before we can even begin to address a problem, there must be access to reliable and useable information. The first, and the most obvious, conclusion of the paper relates to data, which present more than one estimates of the external debt. Information is also lacking on features which have assumed considerable significance in recent years. Currency composition, variable interest borrowing, short term debt, unguaranteed debt are some examples. Secondly, debt is not, nor it has been, an explicit concern of policy or planning. Governments in Pakistan have responded to the debt situation only in times of political emergencies and arranged fire fighting for what is invariably perceived as a liquidity crisis. Hence the search for remedies within the confines of aid-debt matrix. Ensuring a net inflow until the next “liquidity crisis” with negative transfers belongs to this genre.<sup>9</sup> The original budget for 1998-99 illustrates the point. It required a net inflow of only Rs 14.7 billion. But for the nuclear explosions, this would have been available and there would be no crisis. That this would entail a gross inflow of Rs 142 billion, more than half of it short-term, was not a matter for the moment. Thirdly, and consequently, the existing institutional structure dealing with questions of debt came to be designed without an architect. Fourthly, the debt questions, even when there is limited convertibility, require a holistic approach. The financing of fiscal deficit would still need Rs 128.5 billion of internal debt. If the issue of external vulnerability is a solvency issue, then the separability of two kinds of debt is of no help. Finally, this paper is not arguing against contracting debt, external or internal. Access to capital is important. All that is being said is that the nation must think up some safe limits—in the interest of protecting national priorities.

The following agenda for action is proposed, not as an exhaustive set, but a basis for debate.

<sup>9</sup>A pioneer in development had pointed out a long time ago that the world capitalist system is, in the ultimate analysis, only interested in keeping the borrower current on interest payments. See Rosenstein-Rodan (1944); also Tahir (1997). Keynes had argued that the way to deal with debtor countries was not to squeeze “reparations” but to start “Marshall Plans”.

- One: A central agency must collect, collate and project debt information. It should be professionally staffed by market analysts on currencies, debt and capital, lawyers and financial economists.
- Two: The debt agency should furnish an informed basis for decisions on all debts by an inter-agency committee drawn from concerned Divisions/SBP.
- Three: Decisions of the inter-agency committee should be made within the framework of a statutory limitation on debt.
- Four: Privatisation should exclusively focus on debt for equity swaps .
- Five: Some other swaps should also be explored. For instance, debt for poverty alleviation, debt for social action, debt for good governance.
- Six: All aid negotiations, it must be understood, are in effect debt negotiations. Debt reduction should be an explicit objective and debt management policy an important part of economic management so as to access foreign capital without jeopardising the budget and the balance of payments.

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## Comments

The paper presented by Pervez Tahir is a useful contribution to the understanding of debt problem in Pakistan. In particular, the paper provides a great deal of information on the current state of the debt problem that is not readily available from the published data sources. Some of the important points that the author has made are highlighted below.

The study provides an excellent historic background to the way debt has accumulated in Pakistan since 1950s and pinpoints economic and political events associated with various turning points in the history of debt accumulation in Pakistan. The paper presents an objective analysis of the problem with no particular bias. For example, while it is mentioned that various data sources provide quite different statistics, the paper does not recommend in favour of any particular data source. The paper follows a positivistic approach to the problem and does not criticise any particular data source.

The second point that the study makes is that debt reduction has never been a serious objective of economic planning and policy. Rather debt has been used as an instrument for achieving other targets. This strategy is obviously not the most appropriate one and the policy-makers can no longer afford to by-pass the core issue of sustainability in designing economic policies.

An important message of the study is that non-availability of consistent and reliable data is a major problem, not only for the policy-makers, but also for those who find the subject worth analysing. As is well known, the problem of data inconsistency is not confined to debt statistics. Neither does it arise just because there are more than one data sources. Apart from differences between *Economic Survey* (Finance Division) and *Annual Report* (State Bank of Pakistan), for example, there are at least apparent inconsistencies within one document as well. This is especially true if one tries to analyse debt problem by relating current account gap with the domestic resource gaps in the public and private sectors. Although most of the difficulties result from differences in definitions, the explanatory notes do not guide sufficiently. For example it is almost impossible to reconcile statistics in sections on national income accounts, balance of payments and public finance of *Economic Survey* with one another.

The author recommends setting-up a central agency to collect and compile debt statistics. However, this recommendation runs contrary to the conclusion of the study that data inconsistency is a major problem in analysing debt problem. One of the main reasons for data inconsistency is that there are more than one departments that compile data. The State Bank of Pakistan and Economic Advisor's Wing that

publish *Annual Report* and *Economics Survey*, respectively are after all central agencies and having another one is likely to add to the confusion. What is needed is a clear description of how data are compiled and the dissemination of information necessary to reconcile the so-called statistical discrepancies.

There is not much to criticise in the paper. It is very clearly written and follows a set objective. However the study is confined to descriptive analysis and does not include any economic modelling exercise that would have added value to the research.

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