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Three Essays on Debt

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Table of Contents

Abstract 1

First Essay
External debt: What are the options? 2
Asad Sayeed

What should be Done? 6
Conclusion 7

Second Essay
Assigning responsibility for the "Economic Mess" 8
Kaiser Bengali

Third Essay
Its time to kick the aid habit 12
Shahrukh Rafi Khan

References 14

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Three Essays on Debt

Abstract

The Working Paper is a collection of three separate essays on how to deal with Pakistan's debt crisis. Sayeed suggests that the real solution rests in making realistic foreign policy changes which will provide Pakistan with the breathing space it needs to make the needed short and medium term structural changes. They include seriously addressing defense and non-development expenditures, which are needed to resolve the debt crisis. Bengali argues that the military government bears the substantial responsibility for the onset and perpetuation of the debt crisis and hence going back to and staying with political governments is necessary for seriously addressing these crises. Khan views "debt" to represent the "soft budget constraint", a concept that Janos Karnoi used to explain the inefficiency of Eastern and Central European firms. Thus, as long as the Pakistani government has an ability to turn to donors, it has less incentive to make the hard decisions or structural changes needed to resolve the debt crisis. In this regard, Khan recommends "cold turkey", a tried and tested method for breaking with addiction.

External debt: What are the options?

Asad Sayeed

After much ado, Pakistan has been given another dose of oxygen by the International Monetary Fund (IMF). While the standby agreement in its own right is of little value, its actual utility lies in the fact that it is a necessary signaling device to arrange for another debt reschedule from the Paris Club. There was no need otherwise to sweat so much for an IMF agreement as the economy had managed to trudge along in the last year and a half with virtually no multi-lateral assistance. The only difference was that since January 1999, the government has been living under a debt rescheduling arrangement which has reduced its immediate foreign exchange liabilities.

From the information available, this time the Paris Club will provide relief only for one year. As a result, next year around this time we will be in a similar situation for an IMF-inspired bailout. This circus is clearly indicative of the fact that Pakistan's external finances are unsustainable. A look at the sustainability profile of external debt servicing only – which is only one part of external liabilities – demonstrates the enormity of the situation. Debt servicing is said to be sustainable if the rate of growth of debt servicing (in $ terms) is equal to or less than the rate of growth in GDP (assuming that the elasticity of revenues to GDP is unity). Table 1 gives the data for the relevant variables.

Table 1: Average Annual Growth in Relevant Variables of Debt Sustainability

(in US$)

Year	Debt Servicing	GDP	Government Revenue
1991-98	15.37	6.62	3.78
1991-2000	9.03	5.01	2.92

Source: Various Issues of State Bank of Pakistan, Annual Report

We see that between 1991 and 1998, debt servicing grew at an average rate of 15.3% per annum while nominal GDP growth was confined to 6.6% and revenue growth was less than 4% for the same period. This demonstrates the extent to which the external debt burden is unsustainable. Even if the rescheduling years are included (1999-2000), the over all ratio remains unsustainable.

According to press reports, the Debt Management Committee formed by the Government has prescribed increasing exports and increasing revenues as the route to debt management. At best these prescriptions are medium to long term solutions. As we saw above, the severity of the situation demands a move away from such business as usual recommendations.

While the government may be in a state of denial on the debt issue, the seriousness of the situation is exemplified by the fact that small doses of IFI assistance, as arranged recently, are a lease on life for the economy. The battering that our national self-esteem undergoes at every round of negotiations with the International Financial Institution (IFI) is steadily fermenting popular resentment. The slogan that the IFIs are the one and only villain in this sordid drama of economic mismanagement is being raised by a number of groups; primarily the religious right. It is argued that if national pride is to be restored, then we should, once and for all, make a clean break from the clutches of the IFIs and western bi-laterals. In other words, we should default on our external obligations.

Before analysing the costs and benefits of the default option, Table 2 gives a descriptive picture of the balance of payments (BOP) situation as it existed in the year 1999-2000.

Table 2: Inflows and Outflows 1999-2000

(US$ millions)

Heads	Inflows	Outflows
Current Account		
Merchandise Trade	8163	9598
Shipments	51	801
Other Transportation	734	640
Travel	76	218
Investment Income	117	2133
Others	521	473
Unrequited Transfers	**3075**	**45**
Worker's Remittances	983	
Foreign Currency Accounts-Residents	322	
Outright Purchases	1634	
Official	136	
Capital Account		
Foreign Direct Investment	472	-
Portfolio Investment	-	550
Long Term Capital – Official	2094	1982
Long Term Capital-Others	324	589
Short Term-Official	117	524
Short Term-Others	-	2752
Total	**15,744**	**20,305**
Balance		**-4,561**

Source: State Bank of Pakistan, Annual Report 2000, Table 8.2. Page 94

We see that in the previous fiscal year, the overall BOP deficit was $ 4.56 billion. According to the State Bank, this is inclusive of the rescheduled amount of $ 2.5 billion which was not paid but was accounted for nonetheless.

We present two default scenarios. In scenario 1, the country defaults only on its external debt liabilities. This will mean that all short and long term debt servicing to the IFIs, the bi-laterals and commercial creditors are stopped forthwith. All other foreign exchange commitments with regard to imports, shipments, transportation, travel, non-official debt and service payments in terms of repatriation of profits and royalties by MNCs and joint venture undertakings continue. Apart from payments on principal foreign debt, all other transactions remain intact in the capital account. We assume, rather conservatively, that there will be no punitive action against Pakistan by the multilaterals and all trade-related and other commercial transactions will continue as before with the only exception that project aid provided by official donors will stop. Table 3 shows that this mode of default will still leave a BOP deficit of US $3.47 billion.

Table 3: Scenario 1: Default on Publicly Guaranteed Debt Only

(US$ millions)

Heads	Inflows	Outflows
Current Account		
Merchandise Trade	8163	9598
Shipments	51	801
Other Transportation	734	640
Travel	76	218
Investment Income	0	1086
Others	521	473
Unrequited Transfers	**2939**	**45**
Worker's Remittances	983	
Foreign Currency Accounts-Residents	322	
Outright Purchases	1634	
Capital Account		
Foreign Direct Investment	472	-
Portfolio Investment	-	550
Long Term Capital – Official	0	0
Long Term Capital-Others	324	589
Short Term-Official	0	0
Short Term-Others	-	2752
Total	**13,280**	**16,752**
Balance		**-3,472**

Source: See Table 2.

The extent to which financial liberalisation has opened up the Pakistani economy over the last few years is indicated by the fact that a total official debt moratorium still leaves the economy with an unserviceable BOP deficit. This deficit can only be financed through a mixture of some commercial borrowing and the issue of foreign exchange bonds of different hues. Even if we assume that the government will be able to raise the requisite dollars from the international market, it will be done in a situation where the country credit rating would have deteriorated significantly. Any loan thus raised to meet the BOP deficit will be at much more onerous terms (both in terms of the rate of interest and the maturity of the loan) than acquired earlier. The stiffer terms attached to raising the existing BOP deficit might cancel out (or at least significantly reduce) the benefit of default on publicly guaranteed debt.

In sum, the argument that default on publicly guaranteed debt will create a BOP surplus and allow business as usual to continue is not borne out even by the extremely optimistic and least retaliation assumption on the BOP position as it prevails.

Scenario 2 is more extreme. In this scenario, we assume that apart from trade and transport related flows, all other payments are stopped. The assumption on the inflows side is again extremely conservative. We assume that foreign remittances continue as do normal trading patterns inclusive of related shipment and transportation costs. We anticipate that new FCAs and foreign exchange bonds will not be honoured. As Table 4 shows, even in this extreme situation, the BOP only registers a meager surplus of $339 million.

Table 4: Scenario 2: Default on All Foreign Exchange Liabilities

(US$ million)

Heads	**Inflows**	**Outflows**
Current Account		
Merchandise Trade	8163	9598
Shipments	51	801
Other Transportation	734	640
Travel	76	218
Investment Income	0	0
Others	0	0
Unrequited Transfers	**2617**	**45**
Worker's Remittances	983	
Foreign Currency Accounts-Residents	0	
Outright Purchases	1634	
Capital Account		
Foreign Direct Investment	0	-
Portfolio Investment	-	0
Long Term Capital – Official	0	0
Long Term Capital-Others	0	0
Short Term-Official	0	0
Short Term-Others	-	0
Total	**11,641**	**11,302**
Balance		**339**

Source: see Table 2.

Though any attempt at guessing the damage that will be done to the foreign trade sector and to the economy in general is always hazardous, it can be reasonably assumed that the modest surplus acquired will fritter away swiftly. It is also reasonable to assume that business as usual will come to a halt. In such a situation, foreign banks and MNCs will most probably curtail their operations a great deal, foreign inflows into the stock market will cease and, it follows, letters of credit for imports will not be opened. All imports, therefore, will have to be on cash basis.

We have optimistically also assumed that cash purchases from the open market will continue. In a tight BOP situation, open market purchase of dollars will also increase, but it ought to be remembered that the extent of the increase is capped by the demand for rupees generated internationally. High inflation, firstly as a result of a significant devaluation initiated to cap imports, and then as a result of inflationary expectations, will be the first economic indicator to be affected adversely. The impact on growth and distribution (especially on the salaried class) will be, to say the least, substantial.

The extreme picture painted in scenario 2 may be worth opting for if there is a consensus across the country that national self respect is important enough to defy, so to speak, an increasingly globalised world. Clearly such a consensus does not exist in Pakistan and the burden of such policies will only result in increasing authoritarianism by the rich and the powerful to protect their own interests and assets.

Obviously there are a number of other partial default options that fall between the scenarios presented above. The point is that, in all these situations, the costs far outweigh the benefits.

What Should Be Done?

External debt and its servicing is not only an economic issue but a political one. It is inter-linked with the political economy of international power relations and international financial structures. If this proposition is accepted, then the existing policy postures in Pakistan pose a peculiar dilemma. If Pakistan's economic and foreign relations are conceptualised as lying on a spectrum of globalisation, Pakistan's foreign policy resides at the anti-globalisation end of the spectrum, whereas the country's economic policy is at the pro-globalisation end of the spectrum. Obviously, such a contradictory external posture is not sustainable for any country; much less a highly indebted country with a precarious macro economy.

The first task, therefore, should be to move in on the spectrum from either side; i.e. adopt a foreign policy which is less isolationist and militant in posture and an economic policy which is less financially exposed to the rest of the world. The former will entail stopping official sponsorship of the Jehad in Kashmir and other parts of the world, de-recognition of the Taliban regime in Afghanistan, signing the CTBT and the return to representative rule in Pakistan. These, incidentally, are some of the non-economic conditionalities that stand in the way of Pakistan getting favourable treatment from the foreign donors also. These issues have always remained outside the purview of any meaningful national debate under the garb of 'national security.' Given their interlinkage with economic security, the entire concept of national security requires a re-definition. On the economic front, financial openness in terms of extra-ordinary liberties in the current account need to be gradually reigned in so that non-debt related foreign exchange liabilities reduce over time.

A move towards a more globally friendly foreign policy will help the debt situation in the short run. It will provide more degrees of freedom for the government to negotiate a 5-7 year debt reschedule which is necessary to bring about requisite restructuring of the economy to meet these debt obligations at a future date. The government will also have to negotiate the creation of more fiscal space so that necessary public investment is made (both physical and human) which is central to any restructuring which aims at meeting external debt liabilities in the future. In the short run this can only be done through reducing military expenditure as a result of the peace dividend that comes about once the foreign policy is reoriented.

In the medium to long-run, the habit of debt-based public investment will have to be done away with. As it stands today, more than two thirds of Pakistan's ADP is donor driven. Roughly one third of this amount is directly given as project aid by the World Bank, the ADB and other bi-laterals. The rest is the matching rupee component provided by the government. Apart from adding to the existing debt stock, project aid also takes away the autonomy from the state to devise its own projects and monitor them. At the present level of the ADP, doing away with project aid will require switching 30 percent of non-development expenditure towards public investment.

However, as argued above, any substantial restructuring of the economy will require enhancing the level of public investment substantially. The overall fiscal effort towards the development budget will have to be much more than 30 percent of the existing level of ADP. A combination of increased revenue, through broadening the tax net rather than deepening the taxation effort on existing tax payers, as well as re-switching expenditure from defence, are the only options in this regard.

Conclusion

Given the severity of the debt situation in Pakistan, it is clear that business as usual solutions will not work. Extreme solutions, such as a unilateral default, runs the risk of further endangering the economic security of the people. Only by adopting a rational and consistent posture on the foreign policy front can Pakistan gain the requisite degrees of freedom to start resolving its external debt problem. Of course, the existing fiscal status quo which is heavily tilted towards defence on the expenditure side and exclusion from the tax net of powerful lobbies on the revenue side also needs to be altered if debt dependence is to be eliminated.

Assigning responsibility for the "Economic Mess"

Kaiser Bengali

That Pakistan's economy is in dire straits is an accepted fact. However, the factors contributing to this state of affairs are debatable. Reasons bandied about vary from the nationalization of industries and banks in the 1970s to the corruption of politicians, particularly the two elected Prime Ministers, in the 1990s. Unconcealed efforts are also made to insinuate that elected governments are generally responsible for "messing up" the economy and that military intervention is rendered inevitable and actually desirable to clean up the "mess". No empirical analysis has, however, been presented to establish any of these factors as being responsible for the economic crises.

This brief note attempts to show that the roots of the crises do not lie in such personalized factors as depicted above, but in nature and content of economic policies followed by successive regimes. The analysis is carried out for the period 1972 to 1998, divided into the democratic period of 1972-1977 under Prime Minister Zulfiqar Ali Bhutto, the military period of 1977-1988 under General Ziaul Haq, and the post-military period of 1988-1998 under Benazir Bhutto and Nawaz Sharif. The analysis looks at the behaviour of revenues and expenditure, types of expenditure, and domestic and foreign debt.

Table 1 shows that, in the democratic period of 1972-1977, current revenues and expenditures grew at the annual average 6.9 percent and 4.3 percent, respectively; thus, generating a current account surplus for investment in development, which grew at the rate of 20.7 percent per annum. The corresponding growth in gross domestic capital formation (GDCF) was recorded at 18 percent per annum. It is worth noting that defence expenditures during this period declined by 1.1 percent per annum.

Table 1: Comparative Public Finance Statistics (Democratic, Military & Post-Military Periods)

(Million Rs.)

Year	Revenues	Expenditures (Current)	Expenditures (Development)	Expenditures (Defence)	GDCF	Development Expenditure/GDP
1972-73						
Nominal	8424	8619	4770	4440	8489	7.8
Real	8424	8619	4770	4440	8489	
% Growth	--	--	--	--	--	--
1976-77						
Nominal	20702	19180	19007	7987	30925	14.0
Real	11018	10208	10115	4251	16458	
% Growth	6.9	4.3	20.7	-1.1	18.0	
1987-88						
Nominal	121240	145652	56113	45295	111266	9.3
Real	29335	35241	13577	10959	26921	
% Growth	9.3	11.9	2.7	9.0	4.6	
1998-99						
Nominal	464400	574700	111400	143500	385492	4.1
Real	39001	49326	9561	12317	33086	
% Growth	2.6	3.1	-3.1	1.1	1.9	

Note: -- = Data not available and not applicable.

In the military period of 1977-1988, current revenues and expenditures grew at the annual average rate of 9.3 percent and 11.9 percent, respectively. Two points are noteworthy. First, although revenue growth was higher than in the democratic period by about one-third, expenditure growth was nearly three times higher. The bulk of this growth was on account of defence expenditure, which grew at 9 percent per annum. Resultantly, expenditures outstripped revenues, leading to a current account deficit. The implication was that, not only revenue surpluses were no longer available for investment in development, current expenditures were financed out of bank and non-bank borrowings. Not surprisingly, development expenditure growth declined from 20.7 percent to 2.7 percent and the rate of GDCF declined from 18 percent to 4.6 percent.

The post-military period should ideally be disaggregated into the two periods each under the PPP and the PML. This is not possible given the extremely short durations of each regime and the lags in policy impacts. Which means that an action under one regime will deliver results in the next. As such, responsibility cannot be fixed. Thus the post-military period needs to be seen as one period.

In the post-military period of 1988-1998, current revenues and expenditures grew at the annual average rate of 2.6 percent and 3.1 percent, respectively. Thus, expenditure growth continued to exceed revenue growth, although by a far smaller margin. Defence expenditures also continued to rise, although by 1.1 percent only. The combination of low revenue growth and expenditure growth in excess of revenues led to an actual decline in development expenditure of 3.1 percent, with the consequential nominal GDCF growth of 1.9 percent only.

A perusal of the trend in development expenditure to GDP ratio shows that Prime Minister Zulfiqar Ali Bhutto inherited a development expenditure to GDP ratio of 7.8 percent and raised it to 14.0 percent by the time he was forced to exit. By contrast, General Ziaul Haq left it at 9.3 percent by the time of his death. The post-military regimes of Benazir Bhutto and Nawaz Sharif brought it down further to 4.1 percent.

An analysis of debt statistics are presented in Table 2 below.

Table 2: Comparative Debt Statistics
(Democratic, Military & Post-Military Period)

Year	Domestic Debt (Million Rs)	Foreign Debt (Million US $)	Domestic/GDP ratio	Foreign Debt/GDP ratio	Foreign Debt/GDP* ratio
1972-73					
Nominal	17820	4137	29.3	67.4	67.4
Real	17820	--	--	--	--
% Growth	--	--	--	--	--
1976-77					
Nominal	32700	6705	24.1	48.9	62.8
Real	17403	--	--	--	--
% Growth	-0.6	12.8	--	--	--
1987-88					
Nominal	290097	15350	48.3	45.0	64.4
Real	70190	--	--	--	--
% Growth	13.5	7.8	--	--	--
1998-99					
Nominal	1375900	30328	50.8	56.0	56.0
Real	118093	--	--	--	--
% Growth	4.8	6.4	--	--	--

Note: -- = Data not available and not applicable.

Table 2 above shows that domestic debt declined by 0.6 percent per annum in the democratic period, but increased by 13.5 percent per annum in the military period and by 4.8 percent per annum in the post-military period. Thus, while Prime Minister Zulfiqar Ali Bhutto inherited a Domestic Debt to GDP ratio of 29.3 percent, he left it at 24.1 percent. By contrast, General Ziaul Haq inherited it at 24.1 percent and left it at 48.3 percent by the time of his death. The post-military regimes of Benazir Bhutto and Nawaz Sharif have raised it marginally to 50.8 percent.

Foreign Debt increased 12.8 percent during the democratic period, 7.8 percent during the military period, and 6.4 percent during the post-military period. The Foreign Debt to GDP ratio is calculated by two methods. One using the official exchange rate and the other using the black/market rates. Based on the former, the analysis shows that Zulfiqar Ali Bhutto inherited a Foreign Debt to GDP ratio of 67.4 percent and left it at 48.9 percent, General Ziaul Haq inherited it at 48.9 percent and left it at 45.0 percent, and the post-military regimes of Benazir Bhutto and Nawaz Sharif inherited at 45.0 percent and raised it to 56.0 percent. The inter-temporal comparability of these ratios is, however, problematic since the exchange rate up to 1991 was controlled and the official rate was lower than the (black) market rate. Thus, using the market rate for the entire period 1972-1999, the respective Foreign Debt to GDP ratios appear as follows: Zulfiqar Ali Bhutto inherited a Foreign Debt to GDP ratio of 67.4 percent and left it at 62.8 percent, General Ziaul Haq inherited it at 62.8 percent and left it at 64.4 percent, and the post-military regimes of Benazir Bhutto and Nawaz Sharif inherited at 64.4 percent and left it at 56.0 percent.

The above analysis shows that the democratic period of Prime Minister Zulfiqar Ali Bhutto constitutes the ‘golden era’ of economic development in Pakistan. In this period, current expenditure grew at less than current revenue, defence expenditure declined, development expenditure and Gross Development Capital Formation grew, respectively, at 20.7 percent and 18 percent per annum. On the debt front, domestic debt declined marginally by 0.6 percent and the Domestic Debt to GDP ratio declined by over 5 percentage points. Foreign Debt increased by 12.8 percent, but the Foreign Debt to GDP ratio declined nearly 5 percentage points on account of higher GDP growth.

The military period of General Ziaul Haq can be classified as the ‘dark age’ of economic management. Current expenditure exceeded current revenue, resulting in a current account deficit for the first time in Pakistan’s history. The surge in current expenditure was led by defence expenditure, which increased at a phenomenal 9 percent per annum. Development expenditure and Gross Domestic Capital Formation growth plummeted to 2.7 percent and 4.6 percent, respectively. The defence expenditure-led current account deficit was financed by debt. Not surprisingly, domestic debt grew at a high 13.5 percent per annum, leading to the doubling of the Domestic Debt to GDP ratio from 24.1 percent to 48.3 percent between 1977 and 1988. Foreign debt grew at a relatively lower 7.8 percent. The Foreign Debt to GDP ratio at the official exchange rate declined by 4 percentage points; however, calculated at the market exchange rate, the ratio increased from 62.8 to 64.4 percent.

The post-military period constitutes the era, whence the country struggled to recover from the ravages of the military period. Government expenditure has a dynamic of its own. Expenditure heads once created have continued to be fed. Their abolition requires considerable political strength, which successive governments did not possess. Thus, expenditure growth continued to exceed revenue growth and the dominance of the military over elected governments ensured that defence expenditure continued to grow; albeit at a lower rate of 1.1 percent. Development expenditure actually declined by 3.1 percent per annum and Gross Domestic Capital Formation grew at 1.9 percent only. Given the severe constraints, however, the performance on the debt front is commendable. Domestic and foreign debt grew, respectively, at 4.8

percent and 6.4 percent only. The domestic Debt to GDP ratio grew slightly from 48.3 to 50.8 percent and the Foreign Debt to GDP ratio actually fell from 64.4 to 56.0 percent.

The analysis, based on empirical facts, demonstrates that the responsibility for "messing up" the economy lies primarily and squarely upon the military period of 1977-1988 under General Ziaul Haq. The post-military period regimes of Benazir Bhutto and Nawaz Sharif, much maligned for economic mismanagement and corruption, actually emerge as having managed the economy quite well, given the state in which they inherited it and the severe constraints in terms of policy options that they were operating under.

Its time to kick the aid habit

Shahrukh Rafi Khan

If aid helps in building institutions, infrastructure and other capacity, one should expect to see the amount of aid sought and the debt burden incurred decline over time. If that does not happen, either the aid is not being used wisely or it embodies growth retarding features or both. Either way, a society confronting the problem of a persistent and growing debt burden has to find a solution.

There is little encouraging that can be said about how the terms on which Pakistan receives aid over time have changed. This picture is quite starkly presented in Table 1 below.

Table 1: Terms of debt

Years	Average interest rate	Average market interest rate@	Average maturity period years	Average grant element	Concessional aid as a % of total
1972 - 73 /	4	NA	28	48	73
1976 - 77	-	-	-	-	-
1976 - 78 /	5	11.2	27	42	69
1987 - 88	-	-	-	-	-
1988 - 89 /	5	6.7	22	37	56
1992 - 93	-	-	-	-	-
1994 - 95 /	5	5.9	19	32	53
1998 - 99	-	-	-	-	-

Source: World Debt Tables 1999, World Bank, p. 426.
Notes: @ = LIBOR for one year $ deposits, International Financial Statistics Yearbook 1998, IMF, Washington, D.C, p. 44

Concessional aid as a percentage of the total has steadily declined, the average interest rate has increased and come very close to the market rate, the maturity period has decreased, and hence, the grant element has progressively decreased.

In view of the above, it is not surprising that Pakistan's debt burden has increased as indicated below in Table 2.

Table 2: Debt burden

Period	Nominal end period debt (billion $s)	Average debt/GNP ratio	Average debt service/export ratio
1972 – 73 /	6.8	57	21
1976 – 77	-	-	-
1977 – 78 /	13.9	42	20
1987 – 88	-	-	-
1988 – 89 /	20.4	48	24
1992 – 93	-	-	-
1994 – 95 /	32.2	51	30
1998 – 99	-	-	-

Source: World Debt Tables 1999, World Bank, p.426.

Thus Pakistan's debt, the debt/GDP ratio, debt-service/export ratio have increased comparing 1972-73 / 1976-77 as the base period compared to the 1994-95 / 1998-99 period.

Sustainable debt management is possible if the likely trajectory of resource inflows will exceed, or at least converge on, the likely trajectory of resource outflows. The important outflows are imports and debt servicing and the important inflows are exports and remittances.[1] Based on these flows, we compute a crude debt non-sustainability index defined as the sum of remittances and export revenues minus debt servicing and the import bill, as a percentage of GNP.

Table 3: Debt non-sustainability ratio

(million $)

	1980	1990	1997
Total debt service	870	1,926	4,071
Imports	6,042	10,425	16,743
Exports	3,010	6,325	9,936
Remittances	1,748	1,942	1,409
Net outflow [(1+2)-(3+4)]	-2,154	-4,084	-9,469
GNP	23,409	39,044	60,850
Debt non-sustainability ratio [(6/7 * (100)]	9.2	10.5	15.6

Source: World Debt Tables 1999, World Bank, p. 426.

As a percentage of the GNP, the net outflows amounted to 9.2 percent in 1980, increased to 10.5 in 1990 and sharply increased to 15.6 percent by 1997. Assuming this trend will continue, as is suggested by Tables 1 and 2, Pakistan is in a non - sustainable situation with regards to managing its debt.

Using data from 1972-73 and 1992-93, we used two simple approaches to test the association of aid and economic growth. First, we used the Granger causality test and established that the direction of association was from aid to growth and that the impact was negative. Second, we estimated an aggregate production function, using the same data, and showed that a 10 percent increase in aid resulted in a decline of the growth rate by 0.4 percent. We did an extensive sensitivity analysis and established that our finding was robust.

At first, our findings about the negative and statistically robust negative impact of aid on economic growth may appear odd. In fact, one could argue that these results imply that Pakistan would be progressively better off the more of its resources it gifted to another country. But such an argument represents a fundamental misunderstanding about the nature of aid. Aid represents a package including policy parameters such as prescriptions about fiscal, trade and exchange rate policy. Had these policies suited Pakistan's economic environment, aid would have positively impacted GDP growth.

There are several factors that could neutralize the effectiveness of aid. These include public sector inefficiency including blockages, misuse, leakages, unsound prestige projects and the lack of government-donor coordination. Tying and consulting siphons away up to 40 percent of the real value of aid and hence also neutralizes it. However, the negative effect is premised on other reasons such as the growth retarding policies, such as ill-timed financial sector and exchange rate liberalization, the negative aid-saving association and the negative impact of commodity aid on local production.

1 A host of other flows that are not as important, such as transport, shipment and travel, are ignored.

Surprisingly, the notion that aid to the public sector inducing inefficiency by providing a soft - budget constraint has not been discussed in the literature. This concept was originated by Kornoi (1986) and is widely viewed as an important explanatory factor in the failing of socialist economies. The extension of this concept to aid-recipient governments seems quite self-evident, and this may be the most important explanatory factor in explaining the negative growth-aid association. The public choice literature, which discusses inefficient rent-seeking and empire building, also provides a rationale for this association in so far as aid enables inefficient administrative structures to survive.

Our economic reasoning clearly points to the need to break the habit. We do not advocate default on either moral or economic grounds. However, if we view aid as a drug, the question is whether one should use the sudden “cold turkey” approach or the gradualist “nicotine patch” approach. The nicotine patch only works if there is a will to give up the drug. However, if the will to give up is there, one really does not need the nicotine patch. Thus I would advocate immediately ceasing taking more loans. Grants may be forthcoming if Pakistan adopts the right policies domestically and in foreign policy terms. This would provide the space necessary to seek a lasting and just peace based on the aspirations of the Kashmiri people, cut military and other non-productive expenditure and raise revenues.

References

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