

## **PART (I)**

# **CHAPTER 1** **INTRODUCTION**

As we enter the new century, international efforts converge to the fundamental objective of significantly reducing poverty across the world. It is commonly accepted that economic growth is needed to achieve this goal. But it is not clear how much growth is needed, and how much external financing is required to sustain higher growth. There is an extensive and growing literature on the impact of growth on poverty, and on the relationship between external debt and growth. However, there are very few studies that directly link the external debt and poverty of developing countries like Pakistan. This thesis thus endeavors to bring together the three areas of study for a developing country like Pakistan. The key objective is to investigate whether external debt plays a crucial role in influencing the growth and poverty levels in Pakistan.

It is the consensus that the large external debt is a major cause of poverty through its effects on economic growth and human development. Some have even advanced the hypothesis that external debt is the cause of poverty. But the results of this thesis are different from the consensus stated above. According to the results of the present thesis, the external indebtedness has a considerable contribution in reducing the poverty of Pakistan. However, it has no desirable impact on the growth. These results, together with the findings of Abrego and Ross (2001), comply with a new consensus (presented in the Monterrey Consensus and the Johannesburg Conference among the members of the international community): the longer-term goal being focused on is accelerated poverty reduction, which needs to be supported by additional aid flows and the borrowed foreign exchange, which are increasingly being provided in the form of grants and loans combined with debt relief for countries that can demonstrate effective utilization of these resources and maximize the profit to the poor.

The links between external debt, growth and poverty have been long debated by the economists and social scientists. Most studies suggest that the impact of external debt on growth occurs mostly through the investment channel. First, the servicing of heavy debt

may directly divert budgetary resources from investment necessary to stimulate economic growth (Krugman, 1988; Sachs, 1989). Second, high indebtedness discourages private sector-led investment and employment (and therefore, growth) owing to uncertainty about government action in serving the large external debt (Serven, 1997). Third, high indebtedness may lead to capital flight (Ajay and Khan, 2000). Finally, a country with high indebtedness is often perceived by international financial markets and donors as exhibiting problems of economic mismanagement and bad governance and therefore to be risky for investment. New flows of external resources to countries faced with large external debt should thus be curtailed.

Several other observers, notably international nongovernmental organizations (NGOs), have long argued that the large external debt is a major cause of poverty through its effects on economic growth and human development. Some have even advanced the hypothesis that external debt is the cause of poverty. Other empirical evidence (Barro,2000; Galor and Move, 2000) indicates that the level of external debt has an impact on economic growth, which, in turn, is found in many studies to be a key determinant of poverty. Hence external debt is likely to affect poverty through its impact on economic growth. However, the explicit link among indebtedness, growth and poverty has generally been lacking for the developing countries like Pakistan. This thesis particularly is an attempt to fill this void.

This study empirically explores the links through which external indebtedness has an impact upon the economic growth and poverty of Pakistan. The debt indicators are taken as the foreign debt servicing to GDP ratio and the foreign borrowing to GDP ratio. The poverty equation includes: the growth rate of real GDP, unemployment and literacy rate; and the economic growth is measured by the growth indicators like saving, growth rate of real capital stock (investment) and the growth rate of real per capita output.

The main findings confirm that, external indebtedness indicators have limited impact on the growth, but its impact on poverty is considerable. Yet, it is not clear to what extent

the external debt would be required that may boost the economic conditions, and that may lead to the target of halving extreme poverty in Pakistan.

The rest of the thesis is organized in two parts. First part presents the debt crises faced by the developing countries, the background of the external debt situation of Pakistan and the remedial measures adopted by the government of Pakistan to break free the debt trap. The second part represents all the main analysis and findings of the thesis.

In Part I, Section 1 show how the developing countries got into the debt trap for the first time. Section 2 relates the developing countries' debt crisis to the debt burden of Pakistan. Section 3 overviews the performance of Pakistan's economy from 1950 to 2000. Section 4 represents the external debt faced by the economy of Pakistan, and finally Section 5 represents the remedial measures adopted by the government of Pakistan to break free the debt trap.

In Part II, Section 6 provides an overview of empirical literature. Section 7 provides an overview of the theoretical foundation, the standard equation theories, estimated methods and the Model used for the analysis. Section 8 gives the description of the data used. Section 9 presents the estimated results, and finally, the section 10 presents the conclusion and discusses potential policy implication.

## **CHAPTER 2**

### **THE DEVELOPING COUNTRIES' DEBT CRISIS**

One of the most publicized features of the worldwide recession of the 1980-83 was the “debt crisis” of the developing countries. Within a short period of time, a number of developing countries switched from being sought-after and prized borrowers to uncredit worthy supplicants for rescheduling.

After the quadrupling of oil prices in 1973-74, the balance of payments of the oil importing countries was badly damaged. Therefore their balance of payments had to be financed by international debt, which exceeded sixty percent of total international indebtedness in 1980-82, and ended up being fifty percent of it in 1990.(Bernal,1987; Krueger,1987). These funds besides financing balance of payment deficits were also used for the financing of public expenditure and government guaranteed private projects.

After the 1979-82 round of further oil price increase, the world ended up with a severe recession accompanied by sharp declines in commodity price and heavy increase in real interest rate. These exogenous forces exerted additional pressure on the traditionally weak balance of payments of debtor countries, and combined with domestic mismanagement of resources led to the debt crisis in the 1980s (Krueger, 1989; Dornbusch, 1988). The apparent inability of most developing countries to repay gave rise to the fear of collapse of the entire international financial system and led to a series of debt rescheduling and forgiveness.

#### **2.1 The evolution of the international economy**

Private international markets were hardly functioning at the end of the Second World War, and virtually all international capital flows other than trade credit were official capital, mostly on concessional terms. Accompanying the revival of war-torn economies and liberalization of trade in the 1950s, private international capital flows grew rapidly. In that decade, some equity capital flowed to developing countries, but with that

exception, the main longer-term private flows were between North America and Western Europe.

While those flows continued to predominate in the 1960s, a few rapidly-growing developing countries, primarily in the Far East, began to borrow from private commercial banks abroad to supplement their domestic savings. With high-return investment and rapid growth, most of those countries were well able to service their debts and established excellent reputations as borrowers. To be sure, individual countries had encountered debt servicing difficulties: the Paris Club was formed in 1956 to reschedule Argentina debt, and met periodically after that when particular countries found themselves unable to sustain scheduled debt-servicing obligations. Although developing countries as a group continued to rely on official flows, a few shifted markedly towards the private international capital markets, and other began to borrow.

By 1970, it was estimated that developing countries as a group had a debt service ratio of 14.7 percent and that 50.9 percent of their debt was private (World Bank, 1985, p.24), although the variation among groups of developing countries was enormous. For example, only 7 percent of low-income Africa's debt was private, and debt servicing ranged from 6.1 percent in Africa to 18.1 percent for middle-income oil exporters.<sup>1</sup>

When the price of oil quadrupled in 1973-74, the oil exporting countries had large current account surpluses. At first they placed their receipts largely in short-term deposits in commercial banks in the major financial centers. While the major oil importing developed countries incurred large current account deficit in 1974 and 1975, their current account positions were relatively rapidly restored. For the oil importing developing countries, however, deficits were of longer duration, and financing by commercial banks rose sharply. The surpluses of the oil exporting countries were in effect recycled through the commercial banks to the oil importing developing countries.

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<sup>1</sup> Debt-service is defined as actual interest payments and scheduled amortization paid as a percentage of earning of foreign exchange from exports of goods and total service

Thus during the 1973-80 period, developing countries' long-term debt outstanding and disbursed grew at an average annual rate of 21.3 percent, with private debt growing by 24 percent annually and official debt growing by 17.6 percent.<sup>2</sup> Several factors, however, validated this performance: (1) between 1973 and 1980, developing countries' export prices increased at an average annual rate of 14.7 percent; (2) over the same period, the volume of exports from developing countries increased from an average at an average annual rate of 4.1 percent; (3) the interest rate charged on new public debt averaged 7 percent in 1974, 6.8 percent in 1976, and 7.9 percent in 1978; 23 percent of debt was at floating interest rate in 1976, and 27 percent in 1978, and 32 percent in 1979<sup>3</sup>.

As consequences of rapid growth in export earnings, higher-than anticipated inflation, and low nominal interest charges; the developing countries' debt-service ratio grew little during the 1970s. In 1978, the debt-service ratio for all developing countries stood at 18.4 percent (compared to 14.7 percent in 1970), and it fell to 16 percent by 1980. The developing countries' ratio of debt to exports was actually lower in 1980 than in 1970—debt was 109 percent of exports in 1970 and 90 percent of exports in 1980. Thus, although nominal debt grew almost five-fold between 1970 and 1980, the developing countries' growth and export performance, worldwide inflation, and negative real interest rates obscure the imminent emergence of difficulties.

However, again there were significant differences between countries. Some developing countries encountered debt-servicing difficulties at various times in 1970s: Argentina scheduled in 1976, Peru in 1978, Turkey in 1978, 1979 and 1980, to name just a few<sup>4(4)</sup>. Although aggregate debt indicators were acceptable, there were individual countries with unsatisfactory and unsustainable balance of payment positions where significant policy reforms were needed, along with debt rescheduling, to prevent further economic

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<sup>2</sup> Interestingly, the debt of middle income oil exporters grew at an average annual rate of 24.9 percent while that of middle-income oil exporters grew at 21.5 percent.

<sup>3</sup> All data are from world bank

<sup>4</sup> See World Bank (1985,p.28) for a chart indicating all rescheduling over the 1975-84 period

difficulties. This experience is significant both in pointing to the fact that debt-servicing that debt- servicing difficulties were not a new phenomena in the 1980s, and in creating problems for estimation of the relative contributions of different factor of debt difficulties.

To summarize: although some observers pointed with alarm to the rapid rate of increase in developing countries' debt after the oil price increase, most analysts regarded the increasing access to the private international financial market during the era as a symptoms of the successful growth of those countries. Although individual countries encountered debt-servicing difficulties, the combination of favorable world environment, relatively rapid growth of developing countries' exports, and worldwide inflation with negative real interest rates, all served to make the borrowing pattern seem sustainable.

The events of 1979-82 changed all that, with the second oil price increase, the OECD countries by and large adopted anti-inflationary macroeconomic policy stances, and the highest real rates of interest in the post war era. As contrasted with an average annual rate of increase of export unit values of 13.9 percent in the 1970-80 decade for the world as a whole, export unit vale actually fell at an average annual rate of 20.1 percent during the 1970—80 decade (and a rate of 15.5 percent even after 1974); from 1980 to 1983 it fell at an average rate of 1 percent.

Simultaneously, the average interest rates paid on new commitments rose from 7.9 percent in 1978 to a peak of 11.4 percent in 1981; for borrowers relying heavily on the private international markets, the jump was even sharper. For Brazil, for instance, the rate was 9.9 percent in 1978 and 15.3 percent in 1981. For all developing countries, interest payments on total long-term debt outstanding rose from \$16.8 billion in 1978 to \$48 billion by 1982, a sharp jump indeed.

All countries felt the impact of the worldwide recession of 1980-83. All significant borrowers had difficulties with debt servicing, and rates of real GNP growth fell almost everywhere. Some countries, including the Far Eastern exporters, Turkey (where debt

difficulties had become pressing in 1979-80 but where policy reform were so successful that credit worthiness was restored during the recession), and Columbia, avoided rescheduling and were able to maintain normal relations with their creditors. However, the vast majority of borrowers were unable to do so. And, even for most of the countries that maintained their access to credit markets, there were several years of significant adjustment and slower growth.

Some important questions are: what would have happened had the world economy continued along the path it appeared to be in the 1970s; to what extent was the debt-servicing simply the result of the recession with its associated slowdown of trade; or was it the higher interest rate that made the debt burden so onerous; and to what extent were debt problems the result of inappropriate monetary, fiscal exchange rate and trade policies that would have resulted in debt-servicing difficulties even with a normal international economy?

These are difficult questions, but quantitative answers for individual countries are urgently needed. In the next section we will try to answer some of those questions arise in the economy of Pakistan.



## **CHAPTER 3**

### **PAKISTAN'S ECONOMIC BACKDROP**

#### **3.1 Overview of economic performance**

Until the start of 1990s, Pakistan achieved an average annual rate of growth in real gross domestic product (GDP) of close to 6 percent. A remarkable feature of Pakistan's economic performance over this period is the fact that in only one instance did the economy records a negative growth rate- in 1952- indicating its underlying resilience. This economic performance was underpinned primarily by achievements in the decades of the 1960s and the 1980s, during which all sectors of the economy posted vigorous growth rates.

In terms of decade –wise performance, the 1980s witnessed the strongest average annual rates of growth in GDP, at 6.4 percent, followed by the 1960s, at 5.9 percent. The median rate of growth as well as the number of years during the decade in which aggregate growth exceeded 5 percent, as shown in the table 1, provides an indication of the robustness of the economic performance during these decades.

The strength of the economic performance in the 1960s and 1980s, in particular, was predicated largely on two distinct factors. Public investment in the irrigation-cum-water management system, particularly in creating the large reservoirs at Trbela and Mangla, was an important catalyst for productivity gains in agriculture in 1960s.As the consequence of the quantum increase on water storage capacity through the construction of dams, especially the above mentioned, and the resultant ability flows year round in the country's well developed irrigation system, Pakistan experienced a green revolution.

In conjunction with the foregoing, Political stability (especially of the 1960s, despite the 1965 war with India) and perceived industry- friendly policy of the government of the time applied a strong spur to fixed investment by the private sector This process was interrupted in 1970s,first due to a war with India and the events leading up to the creation of Bangladesh, in 1971, and subsequently by the nationalization campaign of Prime minister Zulfeqar Ail Bhutto in 1974.The change of government through an army

coupled by General Ziaul haq—followed street protests against the alleged rigging of the 1977 elections—gradually restored the impetus to fixed investment by the private and public sectors, respectively. The sustained rise in investment through the 1980s and was, however, interrupted at the end of the decade when suspicion about the development of Pakistan’s nuclear program strained relationship with United States, leading to a crippling round of sanctions. In addition, the economy faced political turbulence as the country made an uneasy transition to democracy in the 1990s, with four elections conducted and eight government installed between 1988 and 1997(including transitional administrations entrusted with preparing for general elections).

Previous episodes of the withdrawal or absence of external flows appear to have seriously undermined economic prospects subsequently, highlighting the economy’s extraordinary dependence over a sustained period of time on external resources of finance growth. This not surprisingly, given the weak domestic saving ratio, which has averaged 13.8 percent of the GDP during the 1990s, compared to an average of over 31 percent of GDP of low-income countries, including the people’s Republic of China and India. For financial year 2003, the saving is estimated at 15.2 percent of GDP. Notwithstanding the drag on growth induced by the low domestic saving rats, the growth – performance of the economy over the 1960s and 1980s more than doubled per-capita incomes in real term during the 30 –year period, financial years 1960-89, from Rs1,760 to Rs 4,380 (at financial year 1981 prices)

### **3.2 Economic performance in the 1990s**

In contrast to the decades of the 1960s and 1980s, growth in the 1990s remained, on balance, substantially below-trend, lagging even the tepid performance of the 1970s. The average annual aggregate growth rate declined for the decade as a whole to 4.6 percent. Splitting the period into two five-year halves reveals that, for financial years 1990-94, average GDP growth per year was recorded at 4.3 percent. Barring the 1950s, the latter represents the weakest 5-year performance in Pakistan’s history. What is of greater

concern is the fact that the growth rates for the first two years of the current decade indicate a reinforcement of the declining trend.

Of equally concern is the fact that, on at least four occasions during the last decade, growth in per-capita income was either negative or only marginally positive. Not surprisingly, given this weak performance, statistics indicate a doubling of poverty levels in the country during this period, from roughly 18 million people in 1988, the number of people below the income poverty line had increased to nearly 44 million by the close of the decade.

The slow down of in economic growth in Pakistan during this period occurred in the backdrop of a macroeconomic context that had been burdened by the significant imbalances induced by fiscal imprudence of successive governments since the 1980s, and number of subsequent endogenous and exogenous negative shocks. The latter included, inter alia, and external financial constraints imposed by the Pressler amendment, protracted civil strife in Karachi, and political uncertainty with the associated policy inconsistencies that was the result of an un easy transition to democracy in the 1990s.

The combination of fiscal indiscipline and unfavorable shocks resulted in stubbornly high fiscal and current account deficit, leading to unsustainable public debt, domestic as well as external and holding hostage of both public finances and policy-making by the consequent magnitude of debt servicing. As a result of these persistent weaknesses, Pakistan's investment climate deteriorated, leading to capital flight and fairly erosion of investor confidence over a period of time.

### **3.3 Recent Experience**

The change of government in 1999 appears to have marked a fundamental turning point in the Pakistan's history of structural adjustment and reform implementation. Prior to this, the country had embarked on an ambitious and wide-ranging program of deregulation and disinvestments in the early 1990s; this had failed, however, due to weak

implementation and supply- side focus provide what was needed to control the growing structural imbalances.

In the second term of Prime Minister Nawaz Sharif, beginning 1997, another effort was made to address the fundamental weaknesses of the economy under the aegis of a medium-term International Monetary Fund (IMF) program. Key success included the granting of statutory autonomy to the central bank, hard ceiling on government bank borrowing, and financial sector reforms involving over 25000 lay-offs in state- owned banks after the induction of private sector management. In addition, defense expenditures were capped in real terms between 1997 and 1999.

However, despite these successes, the lack of forward movement in a number of critical areas remained an ongoing impediment to the structural reforms effort. The documentation of the economy through the imposition of a retail tax remains hostage to political consideration, as did efforts to bring incomes in the agricultural sector under the tax net. The privatization drive was not fully geared up, despite the appointment of internationally reputed financial advisor. In addition, the banking system's nexus with the political establishment was not severed leading to non-implementation of recovery laws and a build-up in non-performing loans.

As a result, many observers viewed the abrupt change of government in October 1999 as a crucial opportunity to break from the past and start anew on terms of addressing the underlying structural imbalances. The new military government's aggressive loan recovery drive and concerted effort to formalize Pakistan's sizeable black economy through a tax survey were the first positive indication in this regard.

In addition the economic revival plan announced by the Chief Executive, General Musharraf, in December 1999 reinforced the view that this government intended to pursue structural reforms, under the overall frame work of an IMF program.>This corroborated the positive signal that was generated by the appointment of the economic

and finance team ; key figures of the team was pro-reform individuals with impeccable market credentials, most notable the finance minister and the central bank governor.

### **3.4 Pakistan's economy, Pre-September 11**

Prior to the unfortunate spate of events beginning September 11, 2001, Pakistan was on the threshold of receiving the final tranche under a \$596 million Stand By Arrangement (SBA) from IMF. In numerous arrangements with the funds in 1990s, Pakistan had failed to complete a single program. Given the extent of forward movement that had taken place in the area of structural reforms over the last two years, it appeared that Pakistan would qualify for the poverty reduction and Growth Facility (PRGF) before that end of 2001. This development would have been expected to impart stability to the external account in the medium term by providing for enhanced assistance from the international financial institutions (IFIs), as well as significantly improving Pakistan's standing in the international markets.

Key successes under the SBA included:

- Deregulation of the energy sector in terms of allowing private sector imports as well as price setting for most petroleum products

- Implementation of statutory income tax on agriculture

- A move to a freely-floating exchange rate.

- Fiscal and monetary tightening

- Posting a surplus on the external current account

- Further liberalization of the trade regime

- Extension of General Sales Tax (GST) to large retailers.

- A freeze in real terms on budgetary outlays relating to defense.

- Promulgation of a new, tougher foreclosure law to effect loans recoveries.

## Reform of civil service and pension rules.

In addition, the government launched a massive tax documentation exercise that is estimated to have added 134,000 new income taxpayers—an addition of approximately 7.5 percent to the existing base—and 30,000 new sales tax payers—an increase of approximately 40 percent—during 2000 and 2001. Partly as a result of these initiatives, the government succeeded in posting a fiscal adjustment of over 1 percent point of GDO within a year, with the budget deficit declining in 2001 to provisional 5.3 percent GDP from 6.5 percent a year earlier, the lowest since 1981.

A key required action under the IMF program, as well as for the release of power sector loans from the World Bank, was the resolution of the previous government's long running disputes with the independent power producers (IPPs), especially with the 1,292-megawatt (MW) Hub Power Company (Hubcoo). The effective resolution of these disputes was the central point of the new government's economic agenda. In the next phase of reforms in the power sector, the government is committed to further revamp the two-state owned power utilities, Water and Power Development Authority (WAPDA) and Karachi Electric Supply Corporation (KESE), and to initiate the sell off process of identified power generation assets of WAPDA

More importantly, the first concrete steps were taken towards containing the runaway growth of public debt. For the first time, a debt exit program was formalized that provided a medium-term framework for reducing the stock of debt to more manageable levels. A primary budget surplus of 1.4 percent of GDP was recorded in 2001, while the external current account recorded a surplus of 0.6 percent of GDP, with export posting an impressive in volume terms ranging from 3 percent to 34 percent, as shown in figure 4. To complement these effects, a pragmatic management of interest rate was being conducted, especially with regard to Government-run National Saving Schemes (NSS).

An area of visible success was the reduction in the fragility of the external account, despite adverse terms of trade. Official net international reserve closed at level of \$1.7 billion in 2001 from \$1.2 billion a year earlier.

The tangible improvement in Pakistan's macroeconomic outlook had begun to reflect in a substantial run-up in the price of the country's lone sovereign bond issue in the international bond market—the 10 percent 05 Euro-bond note—from October 2000 onwards. As a result the sovereign's spread over the 5-year US treasury note firmed significantly, reaching round 1,550 points in May 2001, from an approximate level of 1,860 basis points at the time of issue in December 1999.

However, despite the substantial positives in Pakistan's recent economic performance, and significant forward movement in furthering the reform agenda, the lack of robust private sector investment response remained a cause for concern. With regard to structural reforms, the missing element was a fundamental restructuring of state-owned enterprises, where policy implementation did not appear to be adequate. Thus, on balance, on the September 11 while the economy appeared poised for recovery, there were significant remaining challenges

### **3.5 Pakistan's Economy, Post- September 11**

Global developments since September 11 did not inflict as much overall damage to Pakistan's economy as had been feared. With regard to economic performance, two broad themes emerged post-September 11: while the real sector weakened, the external account experienced a counter-intuitive strengthening. However contrary to earlier expectations, the slow down in the real sector was neither precipitous nor export-led. Public financing, on the other hand, experienced a degree of stress induced by sluggish economic conditions in the country in the immediate aftermath of the war in Afghanistan.

After being provided a firm base for a turn around—with improving domestic investor sentiment and favorable external conditions—the economy appeared to be poised for a rebound in the early part of the 2002. The successful restart of the Government's privatization program—with the Rs7.4 billion (approximately \$122 million) sell-off of Pak-Saudi Fertilizer and the Government's working interest in nine oil and gas fields for \$ 176 million—underscore the improvement in the country's investment outlook.

However, the spate of bombings and attacks targeting foreigners, believed to be the work of extremists opposed to the Government's decision to support the international coalition against terrorism, in conjunction with the sharp escalation in tensions between Pakistan and India, combined to interrupt the process of economic recovery. Furthermore, the continuation of the drought –like conditions for three years in large parts of the country suppressed growth in the agriculture sector, damping over all GDP growth. In addition, the uncertainties associated with the run-up to general elections in October, 2002 and the transitions to a successor political set-up, have also begun to contribute to investor hesitation.

Nevertheless, on the whole, Pakistan's economy appears to have exceptional challenges to face emanating from a wide variety of sources in the up-coming years.

External Account. On the external front, contrary to expectation of substantial adverse fallout of the country's balance of payments in the immediate aftermath of September 11, Pakistan's position, in fact, progressively strengthened. The total gross international reserves ( including bank holdings of foreign currency ) rose from \$3.3 billion in 15 September, 2001 to \$4.8 billion at the end of December, 2001., and closed the financial year ( end-June 2002) at a record \$6.6 billion, with reserves held by the central bank at \$4.8 billion. At this level, gross official reserves covered over 20 weeks of projected imports and provide short-term debt coverage 12 times far higher than at any time in the recent past.

Large current transfers—both official as well as private—post-September 11 provided the underpinning for the turnaround in the external account. As a result, Pakistan rupee appreciated by 8 percent against the US dollars in the open market, in the process virtually eliminating the differential prevailing in the two exchange markets, inter bank and open (or kerb)

The improvement in the external account during 2002 took place largely on account of the following factors:

- 1) An increase of \$1,302 million, or 120 percent, in worker remittances during July to June 2002. Although remittances from the source countries witnessed an increased, the



bulk came from the USA and UAE. An initial trigger appears to be the greater scrutiny of informal channels of money transfer (referred to as hundi in the subcontinent) by the international community in its fight against financing of global terrorism, which prompted a switching by expatriate Pakistanis from unofficial channels to formal banking means>subsequently, the virtual elimination of the premium historically commanded by the open market exchange reduced the incentives for agents to use informal means of transferring funds.

2) A near doubling of official current transfers, from \$839 to \$ 1,469 million (an increase of \$630 million). This increase pertained primarily to the disbursement of cash budgetary grants by the US and certain other countries to compensate Pakistan for fiscal losses on account of the US-led campaign in Afghanistan.

3) A decline of \$393 millions in the import bill, almost entirely on account of lower payments for oil. Oil import declined by \$560 million in 2002 compared to 2001, while non-oil imports rose by \$165 million.

Contrary to popular perception, outright purchases of hard currency by State bank of Pakistan (SBP) from the open market were not a major factor in the improved balance of payment position, declining by 36 percent in 2002 over the previous year. A further positive point to emerge was the rise in foreign direct investment (FDI) for the period under review, which recorded a 50 percent increase.

As combined result of the factor listed, the current account recorded an unprecedented surplus of over \$2.7 billion for 2002. The current account balance adjusted for SBP purchases stood at surplus nearly \$1.4 billion during 2002 compared to a deficit of \$1.8 billion in the corresponding period of 2001. With these developments the country's gross official international reserves, held by SBP, recorded sharp increases post-September 2001, building on the trend of accumulation begun in April 2001 and playing an important role in improving investors sentiments.

## **CHAPTER 4**

### **PAKISTAN'S EXTERNAL DEBT PROFILE**

Dependence on international trade is determined by the size of the economy and the trade and investment policies a country pursues. Pakistan, being a medium sized developing country has to rely on international trade to a large extent not only to meet its requirements of capital, intermediate and consumer goods but also to provide an important outlet to its surplus output. Unfortunately, the developed countries have put tariffs and non-tariffs barriers on Pakistan's exports which constrains potential for generating surpluses, where we have definite competitive advantages, and thereby availability of foreign exchange. Despite the fact that Pakistan's foreign exchange earnings are not sufficient to finance its imports, Pakistan is pursuing a liberalized import policy in the belief that freer trade policy enhances welfare of the masses of not only this country but all over the world. As a result of this Pakistan economy is experiencing deficit in its external balance since independence. However, there are three occasions when the balance of trade was recorded a surplus. The first was in 1947-48 when the import requirements of the newly born country were not yet well defined. Second, in 1950-51, caused by a Korean War boom leading to an increase in the international prices of Pakistan's major primary commodities. Third, it was the devaluation of Pakistan rupee in May 1972 and diversion of exports from former East Pakistan to foreign markets that helped achieve a surplus in 1972-73. Thus the gap between export earning and import expenditures was not met through external borrowings

Pakistan began to receive foreign economic assistance from July 1951, which continued to grow in volume thereafter. The substantial increase did take place in outstanding debt during the 1960s, especially during the second half of the decade when the rate of accumulation averaged about 24 per cent per annum. At the end of December 1969, the external debt of Pakistan amounted to \$2.7 billions including the debt of Bangladesh while by December 1971, the figure rose to \$3.6 billions of which \$0.6 billion were subsequently taken off as these loans connected to projects visibly located in Bangladesh. The rising trend of external debt accelerated further during the 1970s. The long term

outstanding debt repayable in foreign exchange increased by more than double, from \$3 billion in December 1971 to \$6.3 billion in June 1977 which gives an average annual growth rate of about 11 per cent per annum. Although the average growth rate had slackened since 1977-78, about 6.5 per cent per annum, the indebtedness continued to rise. The disbursed and outstanding debt almost doubled over from 1980-81 to 1990-91 and grew at annual average rate of 6.2 percent during this period.

Pakistan's accumulated disbursed and outstanding external debt (short, medium and long term) stood at \$30 billion at the end of June 1999. External debt has grown at an average rate of 5.2 per cent per annum during the first nine years of the 1990s. Further breakdown of the period reveals that that external debt has grown at an average rate of 9.3 per cent during 1990-91 to 1994-95. While the rate of accumulation slowed down to an average of almost one per cent per annum during 1995-96 to 1998-99. (Finance and Markets 2000)

The composition of assistance has also markedly changed over time. In the early years, substantial portion of foreign assistance, which was in the shape of grant, and grant-like assistance, has steadily declined and substituted by hard term loans repayable in foreign currency at higher interest rates and shorter grace periods. The share of grant and grant-like assistance in the total commitment was 80 per cent during the First Five Years Plan period (1955-60) which dropped to 46 percent during the Second Plan (1960-65), 31 per cent during the Third Plan (1965-70), 10 per cent during the Forth Plan (1975-78). However, due to relief assistance for Afghan refugees, its share increased slightly to about 22 per cent during the Fifth Plan period (1978-83) and 23 per cent during the Sixth Plan period (1983-88). But it fell again to 16 per cent during Seventh Plan period (1988-93). The share of grant that was 9 per cent during 1996-97, further decreased to 6 per cent of total commitment in 1997-98, due to lesser availability from the donors.

The large accumulated amount of foreign debt has increased the liability of debt service payment of manifold. The total debt service payments (principal plus interest) which were only \$182 million in 1970-71 rose to \$603 million in 1980 -81. Debt service went

up to \$ 761 million in 1984-85, \$1.11 billion in 1987-88, and \$1.232 billion in 199-90. The debt servicing liabilities exhibits a rising trend in 1990s, rising from \$1.316 billion in 1990-91 to \$2.577 billion in 1998-99, thus registering an average increase of 8.8 per cent per annum (Finance and Markets 2000).

Accumulation of external debt, higher const of borrowings and lower maturity of loans are mainly responsible for steady increase in debt servicing liability. Debt servicing as a percentage of foreign exchange earnings has increased from 13.7 per cent in 1990-91 to 23.3 percent in 1998-99. Further more, as a percentage of export earning debt servicing also increased during 1990s, increasing from 212.5 per cent in 190-91 to 32 per cent in 1998-99 which is higher than the sustainable limits of 20-25 percent. Debt servicing as percentage of GDP has also rose from 2.9 percent in 1990-91 to 3.9 percent in 1998-99. What is disturbing to note is that almost one third of exports earning is now being consumed for debt servicing.

Several factors have contributed to this high rate of debt accumulation. The increase in volume of foreign assistance is due to a continuing shift in the composition of aid from grant and grant-like assistance to loan and credit repayable. The extraordinary circumstances marking the word economy since 1973 have the increase in oil prices, inflation and recession in the developed market economies. The combination of these factors led to the general deterioration in the external payment position of the non-oil exporting developing countries and forced many of them to borrow heavily or reduce their reserves. Along with many non-oil exporting developing countries, Pakistan also suffered from these international events of exceptional nature which imposed severe strains on its balance- of – payments position, hampered its development effort, and led to a marked increase in the volume of international indebtedness as well as its debt servicing liabilities.

While Pakistan's development performance was adversely affected by a hostile international environment, it also simultaneously contains adversities, which aggravated the stresses and strains in its economy. Firs, agriculture suffered from extreme floods,

droughts, and Terbela mishaps and pest attacks, which reduced our exportable surplus and resulted in higher imports. Production of wheat also suffered necessitating large imports of this commodity from abroad, partly under the long-term programme and partly by short-term borrowing. In the first seven years of 1970s, marked slowdown in growth of domestic product was one of the factors causing large balance of payment deficits necessitating an increase in foreign loans.

Given the export performance of Pakistan, it is proposed that Pakistan should increase its exports, which can decrease its borrowing, by a substantial amount. For this purpose, there is a need for increasing not only the quantity of exports but also their range, because our exports are limited mainly cotton, rice, leather and carpets, etc. Hence, the growth of exports can also be achieved by exploring new avenues for exportable products. Thus, diversification of exports seems to be rational policy targets. Projects selected should be export oriented or for technological up-gradation to improve quality and competitiveness of Pakistan's exports abroad.

Reduction in imports, other than capital goods and raw material, is also expected to attenuate real debt. There are several areas of imports, which could be curtailed without any special disturbance. It may be noted, that Pakistan is predominantly an agricultural economy with more than 50 per cent of its labor force directly employed in agriculture, 70 percent of population is dependent on this sector and 24 percent of Pakistan's GDP is derived from agriculture. Nonetheless, she is importing wheat, edible oil, lentils and other agriculture products to meet the domestic demand for these commodities. Besides, several agricultural inputs like fertilizers, pesticides and machinery, etc. are also imported which can be substituted by domestic production. We have to keep the oil import bill within manageable limits. The short-term measures of containing the growth of demand for oil and oil products as well as medium to long-term measures to set up the domestic production of oil, all have equal importance. As an immediate measure the natural gas could be substituted to take place petroleum whenever possible. As far as commercial borrowing is concerned, it should be restored on a limited scale. Borrowing units should be allowed access to markets only for financing of imports requirements and not as a

substitute for domestic financing either because external funds are cheaper or because they are readily available. By reducing imports and increasing exports simultaneously, Pakistan can substantially reduce its dependence on foreign loans.

The rapid growth of external debt and debt servicing burden is both a cause and symptom of developmental and non-developmental expenditures in recent years. The basic cause is the deteriorating rate of saving and the consequent widening of savings and investment gap and the way in which the gap is financed. Since the basic short fall is on government account, the widening gap between the saving and investment has a counterpart in government's fiscal deficits. It is the widening fiscal deficit, which have been spilling into current account deficits necessitating increased external resources inflow, and partly resulting in increased internal liabilities of Government of Pakistan through internal borrowings from public and financial institutions, mainly the State Bank of Pakistan. Thus the reduction in the current account deficit would require corresponding reduction in fiscal deficit, adoption of measures to stimulate savings and for their effective and efficient use. Reducing budget deficit will help bring down the rates of monetary and credit expansion and will help to curb inflationary pressure. Failure to progress in inflationary front is one of the most disturbing economic features of the Pakistan economy. This failure has hindered the task of reviving investment and hence improving resource allocation. Better price stability, accompanied by realistic interest rate, could unlock savings that are presently in unproductive forms

The vicious circle of large fiscal deficits, large debts- both internal and external- large debt service payments, large balance of payment deficits, increase in money supply, consequent inflation, continues depreciation of rupee to maintain competitive ness of exports in the face of internal inflation has become almost a built in feature of the financial scenario in Pakistan in recent years. We have to break the back of the vicious circle through sheer dent of fiscal discipline, lesser borrowing, both internal and external, control of inflation by having tight control over money supply. It is recommended that it is high time that Pakistan realizes this disease now rather than wait until it spread across the economy.

## **4.1 Pakistan's Recent Trends of the Debt Burden**

Pakistan has experienced a mounting debt burden since the start of the 1980s. Inadequate policy effort through much of the 1990s towards controlling the growing magnitude and seriousness of the problem resulted in the country becoming mired in a debt trap with the associated symptoms: falling rates of investment, declining development and social spending by the Government, and progressively lower rate of GDP growth. BY the end of the decade the country's total outstanding stock of borrowing; both from residents and non-residents sources had quadrupled in absolute terms to the equivalent of 118 percent of the GDP.

By end-June 2001, Pakistan's total outstanding debt had peaked at Rs4, 210 billion or 123.2 percent of GDP. Since then, the country's level of indebtedness measured in Pakistan rupee terms has declined materially, with a total debt stock falling by end-June 2002 to Rs3, 970.1 billion or 106.5 percent of 2002 GDP. This has occurred as a combined result of an earlier that anticipated pay-off associated with vigorous policy effort to stabilize the debt situation and a confluence of favorable factors on the external account front, including the impact of currency appreciation

As pointed out in various studies, most notably the report published by the Debt Reduction and Management Committee (DRMC), Government of Pakistan in March 2001, over the course of 1990s Pakistan has begin to face a twin debt burden, on both the public and external debt fronts. Since servicing the public debt requires the generation and appropriation of resources in domestic currency, for the conduct of policy analysis it should be viewed distinctly from external debt, where the ability to service given level of debt is contingent on the ability to generate foreign exchange receipts. Hence, it is conceivable that the country faces an unsustainable situation with regard to servicing its external debt, while the overall charge on the budget on the servicing public debt payments remains within manageable limits

In case of Pakistan, however, it is apparent that the debt burden on both fronts, public as well as external, had become unsustainable during the 1990s. From the level of 56 percent of GDP and 317 percent of total revenues in 1980, public debt stock had propelled to 92 percent of GDP and 505 percent of total revenues by 1990, according to the figure compiled by DRMC. By the end of 1999, public debt had risen to 112 percent of GDP and 700 percent of total revenue. Interest payment on public debt consumed close to 30 percent of total revenue in 1990; by 2000, this figure had shot up to 47 percent, virtually crowding out (in conjunction with defense spending) other critical expenditures. Since then, however, the charge on revenue on account of interest payments has begun to decrease steadily, declining to 40 percent by 2002.

Total external debt, on the other hand, stood at 55 percent of GDP and 258 percent of current account earnings in 1990. By 1999, this stock had risen to 61 percent of GDP and 326 percent of current account earnings. During 2002, external debt declines materially, both as percentage of GDP; falling to 57 percent, as well as proportion of current account earnings, declining to 250 percent.

Despite the fact that the magnitude of outstanding debt is large by any measure—as percentage of GDP or total government revenues, for example—the country’s reported level of indebtedness has been significantly understated in the past on account of at least three factors:

- 1) Distinction between debt and liabilities in recording and reporting of the country’s external debt.

Contrary to the international convention on the measurement and presentation of external debt statistics, Pakistani authorities have, in the past, made distinction between debt and liabilities for the purpose of recording and reporting the country’s external debt. The inclusion only of debt in the outstanding total precluded the large stock of payment liabilities, such as foreign currency deposits, to which the government had increasingly been taking recourse in the 1990s in order to finance the external current account deficits. At its peak, in May 1998, the stock of foreign currency (FCY) liabilities totaled \$11



billion. In addition, prior to 2000, the outstanding of military debt was not reported by the government, resulting in a lower than actual published figure of total external debt. As a result of greater transparency and accuracy in the recording of outstanding debt, SBP has begun to disclose and include military debt as well as major portions of foreign currency (FCY) liabilities in its reporting of total external liabilities. In addition, in many cases the authorities have correctly re-categorized foreign currency (FCY) payment liabilities owed to residents as part of domestic debt.

However, at least two categories are still not being captured in the official debt statistics: The stock of frozen resident foreign currency accounts (RFCAs), and the cash reserve requirement (CRR) under the FE25 deposits of the banking system, which resides with SBP under statutory requirements. In aggregate, these amounted to \$1,161 million as of end-March 2002 (approximately RS69.8 billion) and needed to be added to the domestic debt stock for more accurate reporting.

2) Exclusion of Government's explicit contingent liabilities, comprising potential claims on the budget arising from a variety of events where specific outcomes have been underwritten by Government of Pakistan.

Even in case where Government has begun servicing the debt—either interest or principal payments—on behalf of the original obligor (such as in the case of Pakistan Steel Mills), the total stock of borrowing of the public sector entity concerned is not reflected in the debt owed by Government of Pakistan.

The Government's explicit contingent liabilities represent a potential charge on the budget, and amounted to 10.7 percent of GDP (approximately Rs337 billion) as of 30 June 2000.

3) Exclusion of borrowings of Government-owned publicly sector entities from total public debt.

The incomplete coverage of all relevant categories in the recording and reporting of debt in the past has been the result of the lack of coherent debt management structure and

system, responsible for the negotiation, recording, reporting and monitoring of both public and private debt. To compound matters, weak institutional capacity has resulted in a widely differing picture of Pakistan's actual indebtedness even across national sources, such as the Ministry of Finance and SBP. The relatively recent effort under the aegis of the Debt Reduction and Management Committee and SBP to reconcile debt statistics should be formalized expeditiously under the planned Debt Management Office, the creation of which has been delayed and needs to be prioritized by the Government.

Of the total outstanding debt, external debt comprised 53 percent as of end-June 2002, while the domestic debt accounted for the balance. In comparison, external debt comprised 62 percent of total outstanding stocks in 1980 with the share of domestic debt at under 39 percent. The bulk of the country's outstanding debt is public and publicly guaranteed (collectively referred to as public debt), which constituted 97 percent of the total as of end-June 2002.

Amongst the principal factors for the rapid build-up in the public debt during this period were persistent—and largely unattended—weaknesses in public finance. While the growth in the real GDP and government revenue were fairly robust over the 1980s growth in expenditure outstripped both. Thus, from a revenue surplus position in the early part of the 1980s, the Government begins running revenue deficits (defined as total revenue less current expenditure) by the latter part of the decade. This development in Pakistan's public finances was largely in line with the experience of other developing countries where the availability of financing encouraged governments to run large fiscal deficits. During the 1980s Pakistan experienced a large inflow of external assistance from the west due to its front-line status in the war against the Soviet Union's occupation of Afghanistan.

To compound the problem, Government began taking increasing resource to the costliest segment of domestic nonblank borrowing, National Saving Scheme, to finance its incremental needs.

In 1990s, however, the dynamics of public debt growth underwent a qualitative change. The key drivers of debt accumulation during this period were low real growth in government revenues for the first half of the decade—which turned negative in the 1996-99 period—in conjunction with a sharp increases in the real cost of borrowing. The latter development occurred on the back of declining inflation while nominal yields on the government borrowing remained high. In case of external debt, the contributory factors were raising non-interest current account deficits and high interest rate casts. During the latter part of the 19990s, significant portion of the increase in the external debt stocks in Pakistan rupee terms occurred due to currency valuation effects.

The worsening debt stock position over the years is mirrored in the steep deterioration in the debt-servicing burden. From 64 percent in 1990, total reported public debt rose to 87 percent of consolidated tax revenue by 2002, after peaking at 88 percent in 1999. In terms of total revenues, reported public debt service shot up from 36 percent in 1990 to 65 percent by 2002. During this period, interest payment on public debt rose 5.7 percent to 6.6 percent of GDP, after peaking at 8.2 percent of GDP in 2002. Similarly, according to DRMC, external debt service rose from 23 percent of current account earnings in 1990 to 40 percent by 2000.

However, according to the SBP data, the full burden of servicing both debt and foreign currency FCY liabilities had risen to an unprecedented 70 percent of current account earnings by 200. During 2002, total debt service in foreign exchange recorded substantial fall, declining to 61 percent of current account earnings.

As of end-June 2001, Pakistan's total outstanding stock of external debt and liabilities mounted to \$34.5 billion equivalent to 66 percent of GDP and an estimated 290 percent of total foreign exchange earnings. According to IMF, the net present value NPV external public debt stood at 260 percent of foreign exchange earnings.

The total external debt stood at \$35.1 billion by den-2002, having increased from \$20.4 billion in 1990. The country's level of external indebtedness experienced a sharp increase

during the first half of the 1990s, with total outstanding debt rising by 43 percent in the first five years of the decade. The bulk of increase for the period 1990-2002 has been recorded under multilateral, which constituted the large category by the end of 2001.

As noted earlier, in the past, the measurement of country's external indebtedness where payments were dominated in foreign currency, irrespective of creditor's residency—focused on the stock of outstanding external debt, excluding foreign currency (FCY) liabilities. This significantly understated the true magnitude of Pakistan's payment obligations in the foreign currency.

With the lowering of assistance-related flows to the country after the imposition of US sanctions under the Pressler amendment in 1990, the country's reliance on foreign currency FCY liabilities from both resident and non-resident sources to finance its balance of payments grew in magnitude, mainly centered on inflows into onshore foreign currency accounts (FCAs). Between 1990 and 1997, the fastest growing segment (in percentage terms) of payment obligations in foreign currency (FCY) pertained to liabilities. In absolute terms, the stock of foreign currency (FCY) liabilities increased by \$8.6 billion during this period, compared to an increase of \$10.9 billion in the stock of external debt.

After this peak—at the time of the conduct of nuclear tests by Pakistan on 28 May 1998—liabilities in foreign exchange amounted to \$11 billion, equivalent to 19 percent of GDP, 35 percent of the stock of external debt, and 900 percent of gross international liquid reserves. The progressively higher degree of payment stress induced by the reliance on foreign currency (FCY) liabilities during the 1990s is not sufficiently evident in the stock data. According to SBP, for 2001, the share of FCY liability-related debt servicing in the total (inclusive of reschedule/ rolled-over amount) was over 32 percent, at \$2.5 billion. While the data of the previous years is incomplete, given the much larger outstanding stock of liabilities in prior years, it appears reasonable to conclude that that the contribution of foreign currency (FCY) liability-related servicing was substantial.

Hence it had become clear, even prior to the conduct of nuclear test in May 1998, that the level of sovereign payment obligation being carried by Pakistan was unsustainable and was inducing distortions in the policy framework aimed at ensuring that inflow remained higher than outflow. The country's vulnerability to negative shocks was very high, both in absolute terms as well as in relation to its peers. The nuclearization of south Asia and the regime of international sanctions that followed provided one such shock.

The uncertain political and economic situation resulting from the conduct of nuclear tests by the India and Pakistan in rapid succession in 1998 stocked fears of massive capital flight from the country, mainly in the form of withdrawals from onshore Resident Foreign Currency Accounts (RFCAs). At the time, these amounted to \$7.1 billion and were the largest component of FCY liabilities. In response to these concerns, the Government froze the operations of FCAs in hard currency on 28th May 1998, offering account holders the option to either convert their outstanding balances into Pakistan rupee at the special exchange rate, or to opt for a Government of-backed US dollar dominated bond redeemable in 5, 7, or 10 years.

The bulk of resident FCA holders opted for conversion to Pakistan rupees. As a result, the stock of FCY liabilities payable in foreign exchange declined from \$11 billion to \$1.8 billion by the end-June 1998, with the residual representing unconverted balances. Despite the extinguishing of a large portion of its FCY liabilities, Pakistan's payment vulnerabilities remained, accounted by the cut-off in external assistance under the US-enforced regime of economic sanctions. With the eventual return to the fold of an IMF program in 1999, Pakistan received the first of the three back-to-back debt rescheduling arrangements under the aegis of the Paris Club. These arrangements with the Paris Club underpinned a restructuring or roll over of a wide array of payment liabilities.

As noted earlier, by end-June 2002, the stock of external-cum-liabilities had declined from its end-June 2001 level. In nominal Pakistani rupee terms, external debt declined 5.3 percent, while as percentage of GDP the reduction was almost 9 percentage points, from

65 percent to 57 percent of GDP. The salutary reduction in external debt occurred on the back of the following factors:

- An appreciation of 7 percent in the value of Pakistan rupee versus the US Dollar;
- Nominal growth of 6.4% in GDP during 2002; and
- With the rapid accumulation on international reserves during the course of 2002, accelerated repayment of a portion of outstanding FCY liabilities by the central bank.

One facet of Pakistan's growing vulnerability on the external account through the 1990s is not fully captured in the debt statistics for the period. As it accumulated external debt, the country began incurring a cost, albeit one that was not immediately evident at the time. While the terms at which the commercial credit was made available became increasingly advert, both in terms of higher interest rates as well as shorter tenure, it appeared that the country had also started to face a degree of credit-rationing on the part of international institutional lenders.

By 1998, even prior to the nuclear tests, Pakistan's ability to access international private capital had become restricted to a diminishing pool of investors /lenders. After the freezing of Foreign Currency Accounts in May 1998, access to international private had all but come to a halt. This is demonstrated by the response of inverters to the launch of the \$1.5 billion Pakistan fund in the Gulf region in September 1998, with the initial commitment to subscribe by the Islamic Development Bank (IDB) of \$ 200 million. According to the report at the time, despite an offered interest rate din the region of 17 percent and the use of a "Green Shoe" option of IDB, the fund failed to attract subscription.

In terms of the external debt profile, medium-and long-term debt dominates the outstanding stock, accounting for almost 85 percent of the total as of 30 June 2002, according to SBP. While private sector debt has grown manifold during this period, the bulk of the outstanding stock remains public debt--barring two intervening years, the share of private debt in the total has remained well under 10 percent. In the past, prior to the liberalization undertaken under the recent IMF program, the operation of exchange controls in the absence of capital account convertibility and severely limited the external debt-raising ability of the private sector.

Of the total, the largest segment comprises of debt owed to multilateral creditors (39 percent), followed by the share of bilateral creditors (35 percent), which is almost entirely accounted for by the Paris Club. Over the years, multilateral debt has grown more rapidly than bilateral debt. In terms of currency composition, over 41 percent of the long0term as of 2000 was denominated in US dollars, according to World Bank data, with multiple currency debt at 28 percent and debt at Japanese yen at 17 percent.

Over the years, the aggregate share of concessional debt has declined sharply. Long-term concessional debt has declined from a peak of 83 percent of the outstanding stock in 1980 to 62 percent by 2000, according to World Bank. On appoint-to-point basis (i.e., 1980 versus 2000), the share of concessional debt owed to multilateral creditors has decline modestly, from 62 percent to 61 percent; however, there had been wide variations in the intervening years. While the concessional portion of multilateral debt declined between 1980s and 1990s, hitting a low of 53 percent in 1993, it has increased steadily since. On the other hand, the share of concessional lending in bilateral debt has steadily decreased from 96 percent in 108 to 85 percent in 2000.

The proportion o concessional lending in new disbursement of public and publicly garneted debt captures the dwindling share of debt on concessional terms. Hence, from a level of 61 percent in 1980, the share of concessional debt in fresh lending declined to 27 percent by 1999. In 2000 it picked up to 47 percent. Between 1980 and 1999, concessional flows under multilateral assistance declined from 64 percent to 34 percent,

while under bilateral assistance, the decline was more pronounced—from 85 percent to 16 percent.

The adverse change on the profile of new assistance is further illustrated by the average maturity of new lending dropped from over 35 years in 1980 to 13 years in 2000, the average grace period declined from over 8 years to slightly above 3 years. In addition, the grant element in new lending decreased from 62 percent in 1980 to less than 21 percent by 2000.

Measured in terms of foreign exchange receipts, by 2000, Pakistan was straddled with a substantially higher external debt burden—both in terms of outstanding stocks as well as debt servicing—than even the world’s most highly indebted countries as categorized by the World Bank. While on average, the stock of external debt amounted to 238 percent of current foreign exchange receipts for heavily indebted countries, for Pakistan, it stood at 300 percent. External debt service in Pakistan’s case consumed almost 27 percent of current foreign exchange receipts compared to slightly over 19 percent for heavily indebted countries.



## **CHAPTER 5**

# **DEBT EXIT STRATEGY OF THE GOVERNMENT OF PAKISTAN**

In January 2000, a few months after assuming office, the government set up the high-level Debt Reduction and Management Committee to design a strategy to reduce the debt burden and to suggest an efficient debt management system. In February 2001, the Committee presented its summary report to the Cabinet, the broad thrust of which was approved.

The broad findings of the Committee were that Pakistan had an unsustainable debt burden. By any measure, on both a stock and flow (servicing) basis, the country had amongst the highest debt burden in the world. The debt burden has had far-reaching ramifications on economic growth, rates of investment, as well as on poverty levels since the 1980s. The problem was more severe than indicated, since the recognized debt stock did not take into account the contingent liabilities of the Government, which in the Committee's estimation could cross Rs100 billion in 2001.

In terms of evolution of debt crisis, the Committee felt that it was a result of poor economic decisions, postponed reforms, and weak governance over a sustained period. As a consequence, it felt that there was no easy solution; hence a satisfactory resolution will take both time and aggressive policy actions. According to the Committee's conclusion (which- predated the current arrangement with IMF and the ongoing round of rescheduling from the Paris Club), in order to meet the growing external debt service payments over the period July 2000 June 2004, exceptional financing from IFIs and further rescheduling from Paris Club would be required.

The committee's key recommendations were:

Pakistan needs to develop and pursue a debt reduction and management strategy that is integrated with an economic revival plan and macroeconomic framework. However, in

the medium-term (up to around three years), there will be a trade-off between the objectives of debt reduction and economic growth. Nevertheless, with strong financial discipline, forceful structural reforms and improved governance, economic growth can be revived to a sound level of 5.5 percent per annum by 2003-04.

Default on debt is not a viable option. In addition, debt reduction is not practical, due to two reasons:

Pakistan is not an International Development (IDA)-only country, which is an essential prerequisite to qualify for debt reduction under the Heavily Indebted Poor Countries (HIPC) initiative;

Japan, which is Pakistan's largest bilateral donor, opposes debt reduction in principal.

Clearly defined debt reduction goals should be made a part of the Government's overall strategy. The 10-year macroeconomic framework under preparation by the government's Planning Commission should incorporate the following reduction targets:

Reducing the external debt burden to 200 percent of foreign exchange earnings by 2005;  
Reducing public debt burden to 350 percent of government revenues by 2010 (from 610 percent).

In essence three-pronged strategy was proposed:

1) Reducing the incremental addition to the stock of debt through:

A lowering of the fiscal deficit to 3 percent of GDP by 2004, and to 2 percent by 2010;  
Capping debt reliance on external resources at 10 percent of total investment;  
Ensuring that the Government eliminates borrowings for non-development spending by 2004.

2) Reducing the debt servicing cost by:

Ensuring new borrowings from IFIs is concessional (up to \$6 billion sought);  
Privatization proceeds (up to 90 percent) to be earmarked for debt retirement.

Lowering cost of domestic debt;

Government of Pakistan to aim to reduce domestic borrowing costs in real terms to 34 percent per annum, from prevailing average of 9 percent.

3) Increasing debt servicing capacity through:

Increasing exports by 50 percent by 2004 (to \$12 billion), and Government revenues by 60 percent;

Holding defense-spending constant in real terms until 2004;

Increasing efficiency of usage of funds/loans.

Development in the aftermath of September 11 have had fundamental bearing on the intended path of debt reduction as envisaged in early 2001. Despite the positive shock associated with the large quantum of assistance received, it is noteworthy that Government of Pakistan appears committed to adhering to the critical element of its debt exit strategy. The reliance on the external commercial borrowings has been capped, while interest rate on domestic debt have been lowered significantly since July 2001 on the back of an easier monetary stance (by approximately 6 percent points on treasury bills, and between 4 percent and 5 percent on NSS instruments). In addition, the government has begun to pay-down its foreign currency liabilities, using the substantially improved external account position since the latter part of 2001. Finally the Government has also begun the process of ensuring that new, incremental borrowing is on concessional terms, including from the IFIs.

To ensure the continuation of the fiscal discipline necessary to achieve debt sustainability in the medium term, the Government has circulated a draft Fiscal Responsibility and Debt Limitation Ordinance, 2002 for comments. The main objective of the proposed legislation is to ensure that “the Federal Government shall pursue its policy objectives in accordance with the principals of sound fiscal and debt management.” In order to ensure this objective, the Ordinance binds the Federal Government to “take all the appropriate measures to eliminate the revenue deficit, reduce total public debt and maintain it with in

prudent limits there of.”. the following critical milestone and targets are set in the proposed Ordinances:

Reducing the revenue deficit to nil not later than 30<sup>th</sup> June 2007 and there after maintaining a revenue surplus;

Ensuring that 30<sup>th</sup> June 2012 the total public debt is brought to below 60 percent of GDP and there after does not exceed this level;

Ensuring that in every financial year, the total public debt is reduced by no less than 2.5 percent of the GDP for the year, provided social and poverty-related expenditures (as defined in the Ordinance) are not reduced below 4 percent of GDP in any year;

Placing the ceiling on the issuance of new guarantees, including for Pakistan rupee lending, bond rates of return, output purchase agreement, and all the claims and commitments that may be prescribed from time to time, at the equivalent of 2 percent of GDP for the year.

An escape clause is also provided in the Ordinance wherein the Federal Government can depart temporarily from the laid down principles of sound fiscal and debt management. However any such departure can only be on account of “ national Security” or in response to a natural calamity, as determined by the National Assembly, and must be temporary.

## **PART (II)**

## **CHAPTER 6**

### **LITERATURE REVIEW**

Most of the empirical studies found one or more debt variables to be significantly and negatively correlated with investment and growth, for example, Bornnsztein (1990) for the Philippines, Lyoha (2000) for sub-Saharan African countries, Elbadawi and others (1997) for the sub-Saharan African countries, Wete (2001) for Kenya. Similar results were found by Degele (1992), Osei (1995), Mbire and Ating (1997) and Ajayi and Khan (2000). The debt-to-long run relationship was analyzed by Choen (1993, 1997), and Choen and Sachs (1986).

Notwithstanding the attractiveness of the debt overhang hypothesis as an explanation high debt low growth nexus, empirical evidence of the effects of a debt overhang has been mixed. Claessens (1990) found that five of the 29 middle-income countries in his sample was on the wrong side of the Laffar debt Curve, suggesting that the partial debt reduction would increase the expected repayment to the creditors. For middle-income countries, Warner (1992) concludes that the debt crises did not depress investment, while Cohen (1993) found that it was the crowding out effect of current debt servicing that was significant. Oaks and Van Wijnbergen (1995) concluded that overhang did not exist for Mexico.

Several other studies concluded that it is difficult to disentangle the impact of debt variables on growth and the role of debt overhang from other factors on growth and that debt burden can negatively impact other factors ( for example, debt can affect domestic real interest rates which can impact on investment and growth).

The second difficulty relates to the crowding out effect: most studies on investment equations do not distinguish between these two effects. In this context, statistically significant debt variables do not isolate the debt overhang effect. To distinguish between these two affects both contemporaneous debts service and variable capturing the burden

of future debt service such as the debt stock or the net present value of future debt service should be included in the regression analysis. By this methodology, Greene and Villaneuva (1991) found evidence of debt overhang, while Savvides (1992) found that although debt service crowded out investment, the ratio of debt to GNP had a negative but insignificant coefficient, thereby indicating no debt overhang effects.

In recent study, Patilo and others (2002) show that for the 93 developing countries that they examine, there seem to be a nonlinear, Laffar-type relationship between debt and growth. They find that the average impact of external debt on per capita growth appears to be negative for the net present value (NPV) of debt levels above 160-179 percent of exports and 35 to 40 percent of GNP. Further more their results suggest that doubling debt levels slows per capita GNP growth between one half a full percentage points.

The first study on Pakistan's external debt by Rehman (1967) was based on a very simple forecasting model. Naqvi (1970), besides updating the forecast for resource deficit, the level of government borrowing and the size of public debt for the period 1965-85, also provided the theoretical underpinnings to understand the dynamic structure of government borrowings and public debt through the two-gap model. This study was conducted at a time when the size of the public debt, particularly the domestic debt, was still relatively small; and, hence, the two-gap model provided a reasonably a sound analytical framework.

A more recent study by Chudhary (1989) also follows the two-gap model to forecast Pakistan's external debt. As we shall explain below, in the presence of large domestic debt, the analysis based on the two-gap model does not fully highlights all the constraints and the options available to the policy makers. Further more, his theoretical structure does not explicitly take into account price inflation and exchange rate depreciation because at the time of this study the inflation rate was negligible and the exchange rate was fixed. Another study by Burney (1989), employs a two-gap model to explore the determinants of the debt-GDP ratio. He predicts that unless the overall saving rate in the

economy increases, Pakistan's debt problem is likely to get more severe in the near future.

However, the two-gap model has its limitations. In particular it does not distinguish the contributions of the public and private sector to the overall resource deficit; but making such a distinction is important because the resource inflow to finance the budget deficit is usually in the form of loans, while the one that balances the private sector's account is mostly in the form of direct or equity investment. As pointed by Klein (1991), two forms of capital have different implications for the borrowers as well as for the lenders. The debt servicing payments associated with loan capital are fixed and must be honored in time, except in the event of default. The lender, however, is unable to withdraw capital at will. The equity capital is risky for lenders because its rate of return is variable and the payment can be postponed. On the other hand, the lender can also withdraw capital at any time. Khan (1991) draws a parallel between international capital and the institution of share cropping. While debt capital is analogous to a rental contract, direct foreign investment through multinational can be seen similar to wage contract. Thus, as is well known from the agricultural economic literature, debt and equity are two alternative contractual arrangements on risk sharing and relative merits of two types of capital would depend on attitudes towards risk.

It is, therefore, more convenient to have a three-gap model which splits the domestic resource gap into public and private sector's gap. This extension makes it possible to address the resource deficit issue. One can, for example, study the effects of changes in fiscal parameters and disinvestment in public sector on the domestic and/or foreign deficits.

The most recent and in-depth study about Pakistan's debt profile has done by Ahmand (2001). In his study he exposed various dimensions of the debt problems in Pakistan, with particular emphasis on the institutional framework in which debt is managed, issues in the measurement of the debt burden, economic and social costs of the debt overhang and pros and cons of alternative solution strategies. In addition, he has tested the different

aspects of debt situations in Pakistan using the two-gap model as well as the three-gap model. In another paper Ahmed, E (1997) he showed the dynamic interplay between various types of resource deficit—the current account and budget deficits, the net foreign and domestic borrowings, and foreign and domestic debts. He analyses the effects of six different policy options on these deficits: an increase in the growth rate of the economy, an increase in taxes, a decrease in government consumption expenditure, an equal decrease in taxes and government consumption expenditure, an increase in private savings and a decrease in government's share in investment expenditure (privatization). The results show that although these policies are useful in controlling the size of the external and domestic debt or to increase the growth rate of national income, none of them is effective in achieving all the objectives simultaneously

The paper recommends two policy mixes. First one recommends setting the target of 5.7 percent annual growth rate in the GDP and recommends an increase in taxes, a decrease in government consumption expenditure, a decrease in government's share in investment and the pegging of the growth of foreign reserves. This policy mix results in a substantial reduction in domestic and foreign debt.

The second one policy mix, which more emphasizes on foreign debt, does not recommend increase in taxes; instead it focuses on increasing private savings through various means such as a faster growth rate of the economy, freezing the tax/GDP ratio, privatization of government enterprises and other structural reforms. It is shown that such a policy mix results in a rapid decrease in foreign borrowing and a moderate decrease in domestic borrowings so much so that in the year 2019-20 Pakistan's foreign debt starts to decrease. Such policies also bring significant gains in terms of achieving a higher per capita income.

In Ahmand, E (2000) using a three-gap simultaneous model, he shows that the privatization sale of public assets to domestic investors can ease the burden of public borrowing and debt but it has no effect on foreign borrowings and debt. But for the reduction of the size of the external borrowings and debt, the paper highly recommends



the sale of public assets to foreign investors. Furthermore the paper discusses the benefits and demerits of the privatization. The paper says that the privatization is advantageous if the share of public sector in the productive investment is reduced on a permanent basis. On the other hand, sale of large scale of public assets within a short period of time can not solve Pakistan's debt problem.

In two other studies Ahmed [(1996) and (1996b)], using a three model gap, shows the implication of policy options for the expected time path of foreign and domestic debt in future. The policy option includes changes in average tax rate, government consumption expenditure and the share of public sector on aggregate investment expenditure; a balanced budget reduction in the size of government; and the sale of public sector enterprises to foreign investors.

Another excellent study Ahmed, E (2000) analyses public debt situation in Pakistan and assesses the effectiveness of alternative policy measures in controlling the size of public debt, borrowing, the current account budget and external imbalances. For unified analysis of internal and external debt the study used a three-gap model of macroeconomic equilibrium that fully integrates the current and capital account of the transaction taking place between the private and public sector and with of the world.

The study anticipates that Pakistan's external debt position will further deteriorate in the future, while the position of internal debt will not improve either. A large budget deficit is likely to continue posing problems in external borrowing arrangement with the IMF. The rising internal borrowing is expected to squeeze the private sector even further and therefore the level of economic activity will remain low. Despite slight improvement in external borrowing, the position of expected debt is expected to worsen due to depreciation of the rupee.

Although the study does not support the pessimistic view that the debt situation will accelerate to a major crises, it does not point out that the anticipated debt scenario can be maintained by accepting sluggish economic growth and economic like situation. This in

turn means that the productive capacities of the country remain will remain under-utilized and thus the productivity of capital will remain low.

The most important conclusion that emerges from the analysis is that Pakistan's public debt is the result of low saving and poor productivity in the economy, especially in the public sector, and any sustainable solution to the problem must address these very issues. Further more, the debt accumulation process involves complex dynamics and it cannot be solved in one step no matter how big the step might be. Thus the suggestion like debt rescheduling and or whole sale privatization are merely the self-deception, and have no useful purpose unless they can be linked to the core issues of low savings and productivity.

In search of an effective debt retirement strategy the study experiments with alternative policy packages that combine a number of policy instruments to address all the dimension of the issue. This painstaking exercise produces debt retirement strategies that are expected to produce fruitful results on all accounts. The proposed policy package envisages 6% annual growth in real income, as opposed to the current growth rate of 4%. It recommend the placement of public investment by private domestic investment to restrict public sector activity mainly to macroeconomic management and provision of such activities that fall into to the category of public or merit goods or have serious distributional implications. The package also recommends a gradual increase in taxes and a cut in public consumption expenditure. It is recommended that the growth rate of money supply and foreign exchange reserves be pegged to GDP, after increasing foreign reserves to 4% percent of GDP. With the resulting stability in the price level and the exchange rate, a better budget position and the declining role of the public sector, it is expected that the real interest rate on domestic saving instruments will rise and the private sector will gain confidence. The package mainly focuses on the immediate targets of improving productivity and savings in the public and private sectors, and it does not depend on foreign investment, remittances and any concessions or grants from outside. The proposed policy package is expected to result in substantial gain on all accounts. It would reduce the current account external deficit quite significantly and turn the current

account budget deficit into a surplus. Within 15 or 20 years, Pakistan will become a net lender and the public sector will have excess capital to lend to private sector, though internal and external debt will remain positive in the next 25 years.

Numbers of studies have also tested the impact of aid, instead of external debt, on growth and poverty. There is not much difference between external debt and aid, except that the aid is a concessional loan in which interest rate is set below the market rate and/or part of the principal amount may or may not be forgiven. Grants, on the other hand, are different from both external debt and aid. In the case of grants there may not have any interest rates and the principal amount may not be demanded back.

Since there is not much difference between external debt and aid, it is worth while to examine its empirical literature in order to explore the impact of external debt on growth and poverty.

The fundamental idea of aid is transfer of resources on concessional terms i.e. on terms more generous or “softer” than loans obtainable in the world’s capital markets (Nafziger, 1990). The word aid can also be used as official development assistance (ODA). The money volume of official development assistance includes bilateral grants, loans, and technical assistance as well as the multilateral flows. Foreign aid qualifies as ODA on three criteria; a) it has to be undertaken by official agencies; b) it has to seek promotion of economic development and welfare as its main objective; and c) it should have a grant element of twenty five percent or more. The grant element measures the degree of concessionality of an aid transfer compared with market terms, which are normally taken to include a rate of interest of 10 percent (Meir, 1990).

Thus, an outright grant of aid has a 100 percent grant element; a loan at the market interest rate has a zero grant element; a soft loan will lie somewhere in between. The maturity of a loan (the number of years over which it is repaid) and its grace period (the interval before repayment starts) also affect the measured grant element. This definition

of aid excludes some concessional flows, namely those of the private voluntary agencies (Meir, 1990).

In principle, the definition of foreign aid should include all government resource transfers from one country to another. However this is not the case. Many resource transfers can take a disguised form like granting of preferential tariffs by developed countries to Third World exports of manufactured goods. This permits less developed countries to sell their manufactured products in the markets of developed countries at prices higher than would otherwise be possible. Consequently less developed countries enjoy net gains that amount to real resource transfers to them. Such implicit capital transfers, or disguised flows, should be counted in quantifying foreign aid flows. Normally, however, they are not included in foreign aid. In any case, economists have defined any flow of capital to LDCs that meets the above-mentioned three criteria (a, b and c) as foreign aid (Adelman and Chenry, 1966; Pack and Pack, 1990; Mosley, 1995).

Dallar and Kraay (2000) have recently defined the view that growth is highly beneficial to poverty reduction. And Collier and Dollar (1999) focusing mainly on the growth channel, have claimed that Aid can have a great impact on poverty reduction provided it has the support of a stable policy environment.

Hanmer et al (1999) have provided estimates of the growth rates required to achieve the internationally agreed target of halving extreme poverty by 2015 in each developing region of the world. However, the growth rates these authors estimate through moderately high in most cases, are extremely high for those regions that has historically witnessed a high degree of income inequality.

Indeed, Killick and White (1999) have argued that growth alone will not be sufficient to reduce poverty. Particularly in Africa, while White and Anderson (2000) have suggested that a strategy that combines growth and better income distribution can have a better result in terms of poverty reduction.

There is increasing empirical evidence that economic growth plays a key role in poverty reduction. Dollar and Kraay (2001) summed it up best with the title of their paper, 'Growth is good for the poor'. However, there is still an on going debate on the extent to which growth actually affects poverty. For example, Ghura and others (2002) question the extent to which the income of the poorest one-fifth of the population grows in direct proportion to average income. Using fairly robust statistical methods, they identified what they call, 'super pro-poor', conditions on top of growth itself. Thus contrary to Dollar and Kraay, they find that the average growth of income does not lead to a one-to-one increase of the income of the poorest quintiles.

In some studies aid refers conclusively to the long-term development assistance and not to emergency or relief aid, although official contributions for such purposes are included in the overall figures of aid. Thus official financial flows are traditionally classified as concessional on the basis of Official Development Assistance (ODA) classification of the Organisation of Economic Co-operation and Development (OECD). Thus aid flows are traditionally measured by the corresponding net ODA statistics.

According to Chang, Arias and Servén (1999) the methodology underlying net ODA aggregates suffers from a number of shortcomings. They argued that conventional measures of aid are not designed to estimate the overall aid content of financial flows. Furthermore, they typically overstate the grant elements of concessional loans, thus understating relative aid flows to recipients getting mostly grants and the aid flows from donors giving mostly grants (and loans in high-yield currencies). Chang, Fernández-Arias, and Servén analyze the methodological shortcomings of conventional measures of aid and propose a new approach, which measures official aid flows as the sum of grants and the grant-equivalents of official loans (in a new aggregate they call Effective Development Assistance (EDA)).

It is important to note that all the past important research published on aid (Cassen et al., 1986; Riddell, 1987; Mosely, 1987; Kruger, 1989; Browne, 1990) expresses reservations

about performance and ability of aid in alleviating poverty despite its being otherwise pro-poor. Having oscillated between extremes of optimism and pessimism, the debate over the effectiveness of foreign aid has now saddled on pragmatic views, in which it is accepted that while aid can be effective at micro-level it may not be so at the macro-level. Most findings on aid effectiveness at micro-level favor aid whereas most of them at macro-level do not favor aid. Most of the literature has considered the issue of the effectiveness of foreign aid from a project perspective.<sup>5</sup> The studies find that foreign aid-based projects have either ignored the poor, or in some cases have actually contributed to their poverty.

Thus, a large part of literature on aid effectiveness may be classified in various ways. However, its most important classification is with reference to microeconomic evaluation of projects and macroeconomic assessment of aid's impact. On the whole, microeconomic evaluations of aid have reported its economic rates of return well in excess of market interest rates (Cassen, 1986). But these evaluations relate only to individual projects and so they do not represent the overall picture of the effectiveness of foreign aid. However, the macroeconomic work on aid effectiveness, with the early exception of Papanek (1973), Stoneman (1975), Dowling et al. (1983) and Gupta and Islam (1983), unanimously hold that the linkage between aid inflows and formation of physical or material capital in the recipient country is complex, in particular because of the possibility of aid inflows substituting for capital formation in the public or private sector of the recipient country (Riddle, 1987; Mosley, 1987; Adams et al, 1990; Newly, 1990; White, 1992).

There are two distinctive groups of economists with diametrically opposed notions about the relationship between external debt and economic growth. These groups also differ on the modus operandi of adoption of debt strategies and other international facilities for debt relief. Sachs (1990) and Kenen (1990) take a hard line view and explain with the

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<sup>5</sup> White (1992) and Mosley (1995) give explanations of Macro-Micro paradox in the effectiveness of foreign aid.

help of a neat analytical framework that external debt overhang is a major cause of stunted economic growth experienced by heavily indebted countries of the world. Hence there is an urgent need for debt reduction and debt relief facility to unshackle economic growth of such countries. Bullock and Rogoff (1990), on the other hand, argue that the external debts of developing countries are symptoms of poor economic management and performance rather than a primary cause of stifled growth.<sup>6</sup> The subject of the effect of foreign aid on economic growth is important but its theoretical and empirical positions can be quite diverse.<sup>7</sup> Direct empirical assessments on the issue seem to give different results.

There is great divergence of opinion as to how, aside from the motives for which foreign aid is given, foreign aid is theoretically helpful to a nation. The basis for the economic theory behind aid giving and the relationship between foreign assistance and economic development was laid out in Chenery and Strout (1966). They used a variation of Harrod-Domar growth model wherein the rate of economic growth is a function of rate of savings and the incremental capital output ratio. They construct what became known as “two-gap” model, which shows that growth can be limited by savings and foreign exchange constraints. The theory suggests that foreign assistance i.e. the injection of foreign savings can relieve some of the problems and increase the pace of economic growth.

There has been much debate as to the validity of Chenery and Strout’s basic assumption that foreign assistance eases the savings constraint on growth by providing resources for investment that can supplement domestic resources, and thus raise the growth rate. Giiffin finds that foreign capital tends to be used to increase consumption and not investment, and may actually “reduce domestic savings by stimulating the consumption of importable and exportable”.

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<sup>6</sup> Two more papers, one by Gang and Khan (1988), the other by Cashel-Cordo and Graig (1986) deal with the issues of debt management empirically, at a very high level of aggregation.

<sup>7</sup> Review of empirical aid literature emphasize the need for time series analysis of individual countries (Riddle, 1987 and Mosley, 1987)

Griffin and Enos (1970) estimate regression equations to show that foreign savings often supplant rather than supplement or increase domestic savings. Private domestic savings may decline, if, for example, soft financing from aid pushes down the market interest rate. They find “no support for the view that aid encourages growth” (if growth is related to the assistance received). They contend that “in general, foreign assistance is not associated with progress, and in deed may deter it”, by lowering domestic savings, distorting the composition of investment and thus raising the capital-output ratio, “frustrating the emergence of an indigenous entrepreneurial class, and by inhibiting institutional reforms”.

In addition, other studies (e.g. Riddell 1987) find that there is no particular or predictable effect on domestic savings from an inflow of capital resources. The evidence of economic performance of most countries receiving aid in the 1980s is that aid has not promoted significant economic growth (Cassen, et al. 1986).<sup>8</sup> Papanek (1972) finds that quantitative analyses do not support a “negative causal relationship between foreign inflows and savings,” but that causality is more complex than many studies have assumed, that a more sophisticated saving function is needed, and that the relationship should be explored for individual countries and not across countries.

According to Riddell (1987), the debate about the theoretical assumption behind aid-giving has led to several changes in the presentation of the theory – the possibility of consumption-leakage has been added to the model, and there is at least recognition that assumptions about the role of recipient governments acting to maximize growth need to be questioned if not revised. In response to the critiques, Chenry and Carter (1973), for example, find that when there are other constraints in addition to or instead of the savings gap (in particular a trade constraint), a negative relationship between foreign capital inflow and domestic savings can be expected. They suggest, however, that the relationship is only indirect, and that though consumption will be raised, there will still be

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<sup>8</sup> In the 1960s and 1970s, however, the evidence was more ambiguous. There were some success stories from aid. Chenry and Carter, for example, were able to say in 1973 that despite the problems or weaknesses of aid, “the overall performance of developing countries has generally lived up to the expectations of the early 1960s” i.e. aid can promote growth.



investment and the “productivity of external capital” will be “very high”. They conclude that majority of cases are those where aid-supported growth has raised saving rates.

Bornschiefer, Chase-Dunn and Robinson (1978) come to somewhat different conclusions. They review the research on aid and add their own analyses to conclude that the short-term flows of foreign direct investment and aid tend to increase the relative rate of economic growth, but that the cumulative long-term effects of stocks of foreign aid and investment decrease the relative rate of economic growth. Further, the negative long-term effects are stronger within the richer developing countries than in the poorer ones.

There are also questions about the political-economic consequences of receiving aid and engaging in external financing relations. However, there are no clear-cut answers to all the questions related to aid and its effectiveness. Any evidence, empirical or theoretical, that exists of aid relationship to growth is ambiguous.

The debate on foreign aid, savings and GDP growth basically revolves around dual gap model based on the Harrod-Domar growth model, which has been central to the analysis of macroeconomic impact of foreign aid. The Harrod-Domar dual gap model, in which the shortage of capital assumes the critical constraint on growth, is applied to show how the lack of capital could make its impact felt in one of the two ways: one through the saving gap and the other through the foreign exchange gap. In the presence of saving gap the macro impact of foreign aid is straightforward. Aid provides a one-for-one increment to the capital stock, which in turn leads directly to a higher growth rate. A foreign exchange constraint applies where export earnings are insufficient to cover the bill for imports required to complementing domestic capital in production. It is clear that aid will have a larger impact when a foreign exchange constitutes a binding constraint as it not only brings additional capital but also allows domestic capital that is otherwise redundant to be brought into production (White, 1992).

However, critics (e.g. Joshi, 1970; Findlay, 1973; Lele and Goldsmith, 1989; Barro, 1991; Fischer, 1991; Levine and Reneltt, 1992) have pointed out a number of inadequacies in the model that help explain why aid does not automatically lead to higher

growth. It is unrealistic to assume that aid will provide a one-to-one increment to the capital stock, as there is a range of mechanisms through which aid may displace domestic capital accumulation.<sup>9</sup>

Indeed, a simple correlation between aid inflows and growth performance is puzzling in itself. Critics have pointed to a number of inadequacies in Harrod-Domar model that help explain why aid does not automatically lead to higher growth (Griffin, 1970; Mosely, 1980, 1987; Mosely and Hudson, 1984; White, 1992a). Three of these criticisms are as follows. First, the models that are used in such studies are sticky, with no substitution in production (either between factors to relieve capital shortage or to reallocate factors between sectors). This point was made in the early literature (e.g. Joshi, 1970 and Findlay, 1970) but was not picked-up by the main body of aid effectiveness debate. Second, the Harrod-Domar model is too simplistic a representation of the growth process: many other factors like human capital affect growth. Finally the two-gap model does not incorporate any mechanism by which aid may not be matched by one-for-one increase in investment, government development expenditures or foreign exchange.

The theoretical basis of radical position in the saving debate is usually associated with Keith Griffin (1970) and Griffin and Enos (1970). They argued that an anticipated aid inflow will be treated as an increase in income and thus allocated between both saving and consumption unless the marginal propensity to save is one. Therefore investment will rise by less than the value of the aid inflow. By national accounting conventions, the aid inflow constitutes foreign savings and as total savings have not risen by this whole amount, domestic savings must have fallen. There is, therefore, a negative relationship between aid and domestic savings, which has already been confirmed from regression analyses of both cross-section and time-series data (for example Areskoug, 1969, 1973; Chenry and Eckstein, 1970; Griffin, 1970; Stewart, 1971; Weisskopf, 1972; Grinols and Bhagwati, 1976; Mosely, 1980; Cassen, 1989; White, 1990).

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<sup>9</sup> For example, a negative relationship may exist between an aid inflow and private investment. There can be possibility that public investment is sufficiently more productive than private investment.

Although major proportion of literature on the saving debate of aid's impact is empirical, the original argument has some theoretical problems (Papanek, 1972; El Shibly, 1984; Rahman, 1984; Bowles, 1987; and Morriset, 1989). First, there are conditions regarding the relative importance of aid in funding investment or development expenditures etc; under which aid will simply not be fungible in the way suggested by radicals. Second, simple macroeconomic theory would imply that there would be an aid multiplier of greater than unity, so that the income will rise more than the value of the aid inflow. Under such circumstances aid can increase current consumption without decreasing domestic savings. However, whether or not this is actually the case is a matter of empirical investigation.

The failure to explain adequately the mechanism through which aid will displace savings has been partly remedied by models that explicitly show the behavior of recipient government. The original work in this regard was put forward by Heller (1975) and further modified by Mosely (1987). In these models, government maximizes a loss function comprising a range of target variables like government investment and consumption (development and non-development), borrowing and taxes. The theoretical expectation is that the aid inflow will be spread across this range of uses, thus confirming the view that aid will not simply add to investment.

The existing empirical literature, which accounts for a recent surge in the macroeconomics of aid, is yet inconclusive (White, 1992). Much effort has been made at the macro level by donors in an attempt to persuade recipients to reform their economic policy on the presumption that this will have a favorable impact on saving, investment, exports and other social indicators, and thus on aid effectiveness. However, we have little information on whether or not this has in fact happened. And, in spite of the bleak macroeconomic evidence on the performance of aid so far, all prescriptions for Pakistan at least, recommend that its problem can be eased if there is an increase in aid flows. It seems urgent to ascertain whether this presents a potentially meaningful strategy, or simply the triumph of hope over experience.

Even though there is not much difference between external debt and aid-- except that the aid is a concessional loan in which interest rate is set below the market rate and/or part of the principal amount may or may not be forgiven--,surprisingly, we know little about aid's macroeconomic impact of Pakistan. Though donors have become increasingly interested in macroeconomic environment in which their aid is being used, yet they apprise and evaluate their aid mainly at the microeconomic level and tend to ignore the possible macroeconomic impacts of aid on Pakistan, which cannot be ignored if we are exploring the debt problems.

A few earlier empirical studies on the debt problem in Pakistan have been conducted in the framework of two-gap models and thus they focus only on the foreign debt problem [(example, Naqvi (1970), Chaudhary (1988), and Burney (1988)].

## **CHAPTER 7**

### **THEORETICAL FOUNDATION**

This section identifies the direct and indirect transmission channel through which high external indebtedness impacts upon economic growth, human development and poverty. It explains both the theoretical and empirical literature in order to inform the development of a testable empirical model.

External indebtedness is likely to affect poverty indirectly through its impact on economic growth and directly by reducing government resources that are available for poverty related spending.

#### **7.1 External Indebtedness, Growth, and Poverty**

Studies investigating the link between external debt and growth place a great emphasis on the role of investment. Large debt stock are typically expected to lower growth through the channel of reduced investment which is usually described by the debt overhand hypothesis (Krugman,1988;Sach,1989).Outstanding debt ultimately becomes so large that investment will be inefficiently low without sizeable debt or debt service reduction (Claessens and Diwan ,1989 Claessens and others, 1989 and 2000) .The burden of large debt sooner or later can lead to extreme scarcity in liquidity, negatively impacting upon capital formation, growth, and consumption. The incentive effect of this hypothesis refers to the low public and private investment because a larger and larger share of resources is transferred abroad for debt servicing. In other words some of the returns from investing in the domestic economy are effectively taxed away.

Another strand of the debt overhand theory emphasizes the point that large debt stock increase expenditure that debt service tends to be financed by distortionary measures (inflation, tax or cuts in public investment) as in Agner and Montiel 1996. Under such uncertainty, private investors will prefer to exercise their options of waiting (Serven,

1997) and may choose to invest less or divert their resources towards quick financial returns with high risk or resort to transfer their money abroad (capital flight).

The original laffer curve (Cline, 1995) graphs the expected repayment against the face value of debt service. It shows that as outstanding debt increases beyond a threshold level, the expected repayment begin to fall due to the adverse effect mentioned above, Patrillo and others (2002).

## **7.2 Direct impact of External Indebtedness on Poverty**

First, the crowding-out effect of debt service payment on social spending is a plausible channel. Underlying the debt relief debate is the belief that the fiscal resources released by the debt relief will be channeled towards social sectors. The assertion is that debt relief will lead to increased public spending on improving the access to and quality of health, education, water, sanitation and other essential services to the poor. The key assumption is that an increase in social spending leads to better social outcomes Ropes (2000), based on a study on 48 sub-Saharan African countries for the period 1980-99 found that absolute social spending allocations are paramount in determining social outcomes. Thus, a key component of poverty reduction strategies in low income countries is for countries to focus on “investing on people”. Increase pre-poor spending is widely regarded as crucial for low income countries to achieve the Millennium Development Goal (MDG), which includes goals for reducing child and infant mortality rates and improving education enrollment rates. In this context, high level of indebtedness, due to high debt service, is assumed to lead to a reduction in available resources to meet the need of poor.

Second , as we have already mentioned, a country with high indebtedness is often perceived by international financial markets and donors as exhibiting problems of economic mismanagement and bad governance, and therefore risky for investment. High indebtedness could then lead to a decline in new flows of external resources. As a result, poverty-related spending could be curtailed. In the long run, the impact of the reduction in investment in social sector would affect poverty through income. However, in the short run, reducing investment in social sectors would affect directly health and education outcomes.

### 7.3. Model Specification

The guidance from the past empirical studies and the transmission mechanism through which external indebtedness affects growth and poverty indicates that there are direct and indirect linkages between debt and growth, and between debt and poverty.

Using the guidance from the literature reviews, theoretical linkages between debt, growth and poverty and standard equation theories, we hope to shed some empirical light on this issue with reference to Pakistan. In order to investigate the impact of external debt on the growth and poverty, I have tried a number of specifications and found the following models satisfactory in terms of different tests:

$$S/Y = \alpha_0 + \alpha_1(\Delta Y/Y) + \alpha_2(Y/POP) + \alpha_3(R) + \alpha_4(FDS/Y) + \alpha_5(FB/Y) + \varepsilon \text{-----(1)}$$

$$(\Delta K/K) = \beta_0 + \beta_1(\Delta Y/Y)_{-1} - \beta_2(R) + \beta_3(FDS/Y) + \beta_4(FB/Y) + \beta_5(\Delta K/K)_{-1} + \varepsilon \text{-----(2)}$$

$$\Delta Y/POP = \theta_0 + \theta_1(\Delta K/K) + \theta_2(FDS/Y) + \theta_3(FB/Y) + \varepsilon \text{----- (3)}$$

$$GINI = \gamma_0 + \gamma_1(\Delta Y/Y) + \gamma_2(U) + \gamma_3(FDS/Y) + \gamma_4(FB/Y) + \gamma_5(\varepsilon)_{-1} + \varepsilon \text{-----(4)}$$

$$POV = \delta_0 - \delta_1(\Delta Y/Y) + \delta_2(U) - \delta_3(LITR) - \delta_4(FDS/Y) - \delta_5(FB/Y) + \varepsilon \text{-----(5)}$$

The above models have been estimated by using impact of foreign debt servicing and foreign borrowing on

- 1) Savings rate
- 2) Investment
- 3) Per capita GDP growth
- 4) Income distribution and
- 5) Poverty

Where

$S/Y$  is the saving to GDP ratio

$(\Delta Y/Y)$  is the growth rate of real GDP

$(Y/POP)$  is the per capita real GDP

$(R)$  is the real interest rate on bank deposit

$FDS/Y$  is the foreign debt servicing to GDP ratio

$FB/Y$  is the foreign borrowing to GDP ratio and  $\varepsilon$  is the error term

$(\Delta K/K)$  is the growth rate of real capital stock

$(\Delta Y/Y)_{-1}$  is the lagged growth rate of real GDP

$(\Delta K/K)_{-1}$  is the lagged growth rate of real capital stock and  $\varepsilon$  is the error term

$(\Delta Y/POP)$  is growth in output per capita

$(\Delta K/K)$  is growth in real per capita capital stock

GINI is the Gini Index of Household income

$(\Delta Y/Y)$  is the growth rate of real GDP

$(U)$  is the Unemployment rate

$\varepsilon_{-1}$  is the lagged error term and  $\varepsilon$  is error term.

POV is the head count of poverty index of household income

$(\Delta Y/Y)$  is the growth rate of real GDP

(LITR) the literacy rate

Our empirical specifications allow us to identify the relationship between external debt, growth and poverty. We estimate equation (1) using the simple ordinary least square (OLS) with different measures of savings (growth rate of real GDP, per capita real GDP and real interest rate on bank deposits) and indebtedness (foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio).



We also estimate equation (2) using the simple ordinary least square (OLS) with different measures of investment (lagged growth rate of real capital stock and real interest rate on bank deposits) and debt indicators (foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio).

Similarly, equation (3) is estimated using the (OLS) with different measures of output per capita growth (growth in real per capita capital stock) and debt indicators.

Ginin coefficient is also estimated using the (OLS), in equation (4), with the measures of growth rate on real GDP and unemployment with the debt indicators.

Finally, poverty is estimated with the debt indicators using the (OLS) in equation (5). Growth rate of real GDP, unemployment and literacy rate are used as the the poverty measures.

#### **7.4. Relationship with the Standard Equation Theories.**

We have simply used the model from the standard equation theories with a slight augmentation of external debt indicators as explanatory variables..

In the economic literature saving is said to be affected by per capita income and interest rate. By adding debt indicators, like foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio, and experimenting with different specifications of saving function, we have found the specifications (equation 1) as a good approximation of the saving behavior in Pakistan.

Another important indicator, in fact, engine of growth is investment in physical capital. In order to investigate the impact of external indebtedness on investment, we have simply introduced the debt indicators in the standard model of investment (equation 2).

Theoretically, the economic growth is a complex phenomenon and is affected by a plethora of variables ranging from economic variables like savings, investment, openness

and term of trade to social and political variables like health, education, law and order, good governance, political stability, etc. In equation 3, some of the important variables, presented in the standard equations, are missing. We had included some other variables as explanatory variables in the beginning but later found them insignificant. One possible reason might be the high correlation of such variables with investment. Since we have included physical investment in our growth model, we expect that the impact of other determinants of growth have been captured by the investment.

To investigate the impact of indebtedness on the income distribution, we have we have used Gini coefficient proxy for income distribution (equation 4). The other candidates for determinant of income distribution are growth and unemployment.

Growth is expected to affect Gini coefficient negatively, implying improvement in income distribution. On the other hand, unemployment is expected to worsen the income distribution, as the standard theory implies. We have simply included the external debt indicators with the expectation that the external indebtedness will worsen the income distribution, i.e, Gini coefficient will increase with the increase of indebtedness.

Finally, in the poverty function, we have used the standard specifications and found them good approximation of the actual behavior of poverty in Pakistan (equation 5).

## **CHAPTER 8**

### **DATA ANALYSES**

In order to see the impact of external debt on the growth, we have used the growth indicators like savings, investment and real GDP growth rate. On the other hand, to see the impact to external debt on poverty, we have used the poverty indicators like unemployment, literacy rate and the growth rate of real GDP.

One measure of saving has generally been in terms of real GDP growth rate, real interest rate on banks, and per capita real GDP. We have used the similar indicators, but simply added foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio to see its influence on savings

Measure of investment is highly dependent on the lagged growth rate of real GDP and real interest rate on bank deposit and the lagged growth rate of real capital stock. Since several studies have show that these indicators could be used to measure the variation in the investment, we have used the similar indicators with an exception of foreign debt servicing to GDP rate and foreign borrowing to GDP ratio to see its impact on the investment.

Growth rate of output per capita is closely related to the growth rate of real capital stock. We have used the similar indicator for our analysis. To see the impact of external debt on the growth in output per capita, we have added foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio.

Gini index of household income or income inequality is generally measured with the growth rate of real GDP and the unemployment rate. And if we add foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio to the relationship, the influence to external debt on income inequality can easily be found.

One measure of poverty has generally been in terms of consumption or income. The most widely used poverty indicators are the headcount income index, per capita GNP, and per

capita GDP corrected for purchasing power parity (PPP). However, new perspectives on the causes and manifestations of poverty have shown that the poverty is a multidimensional phenomenon, and can be expressed in terms of income, and basic needs such as access to health services, unemployment, and education. Three standard human development indicators of poverty have been measured in this study: unemployment, literacy and the growth rate of real GDP. Several studies have shown that these indicators could be used to measure the variations in the physical well-being of people, and that in many countries health and education indicators are worse for the income poor than for the income-nonpoor.

In line with empirical practice, we are rather agnostic on what is the best indicator is amenable to a different interpretation. We therefore use two different external debt indicators. First, we use the foreign debt servicing to GDP ratio, which is useful indicator to asses the over all resource basis available to the country. And since the face value of the external debt stock is generally not a good measure of a country's debt burden when a significant part of the debt is concessional, i.e., contain a grant element, as is usually the case for the debt contracted by low income countries, it is not taken into consideration. We will also use foreign borrowing to GDP ratio. This ratio is key variable in debt sustainability analysis, especially within the HIPC (Highly Indebted Poor Countries). These two ratios will help isolate any debt overhang effect.

The analysis uses annual data for Pakistan over the period of 1972-2002. The main data comprises the three growth indicators saving investment and per capita GDP (saving includes growth rate of real GDP, per capita real GDP and real interest rate on bank deposits; investment includes lagged growth rate of real GDP, real interest rate on bank deposits and lagged growth rate of real capital stock; and per capita GDP includes growth rate of real capital stock), and two external debt indicators foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio.

Various sources are used to gather the data. Investment, saving, growth in output per capita, growth rate of real GDP and real interest rates are from States Bank of Pakistan'

annual report 2003. Unemployment, growth rate of real capital stock, lagged growth rate of real GDP, foreign borrowing to GDP ratio, Gini coefficient and foreign debt servicing to GDP ratio are from Economic Survey Review of Pakistan 2003. Poverty and literacy are from the World Bank Tables 2003 and the IFS 2003. The unavailable data of Poverty was calculated by the linear interpolation. The years of unavailable data are given below:

1972—1978

1980—1983

## 8.1 Correlation Results

Before taking regression analyses, it is appropriate to see the correlation among the variables to be included in the model. It gives us the idea of the extent and direction of relationship among the variables. We have calculated pair wise correlation coefficients of the key variables of our model, shown in the table 8.1.

The table shows that almost all the variables are highly or moderately correlated with foreign borrowing and foreign debt. The only exception is the interest rate, which is not as correlated with foreign borrowing as the rest of the variables do. However, it is interesting to see that the poverty has negative correlation with the both indicators of indebtedness.

Table 8.1 Correlation Results

		B	FD	GINI	I	R	LITR	POV	SERV	SN	UM	YR
Borrowing	B	1.00	0.79	0.74	0.82	0.17	0.91	-0.59	0.68	0.80	0.80	0.91
Foreign Debt	FD		1.00	0.82	0.98	0.38	0.89	-0.26	0.88	0.98	0.76	0.92
Gini	GINI			1.00	0.68	0.18	0.87	-0.42	0.60	0.74	0.82	0.63
Investment	I				1.00	0.56	0.93	-0.33	0.93	0.99	0.84	0.95
Interest rate	R					1.00	0.35	-0.11	0.52	0.51	0.35	0.59
Literacy	LITR						1.00	-0.63	0.81	0.93	0.91	0.99
Poverty	POV							1.00	-0.25	-0.33	-0.64	-0.57
Servicing	SERV								1.00	0.86	0.68	0.85
Saving national	SN									1.00	0.78	0.93
Unemployment	UM										1.00	0.92
GDP	YR											1.00

0 to 0.25 --->no correlation

0.25 to 0.50 ----> low correlation

0.50 to 0.75 -----> moderate correlation

0.75 to 1 -----> high correlation

## **CHAPTER 9**

### **ESTIMATION RESULTS**

The OLS results for the basic model confirm that saving is related positively to the growth rate of GDP growth, real per capita GDP, real interest rate on bank deposits and the two debt indicators: foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio (Table 9.1). Since the measure of savings are statistically significant and positively related, suggesting that a 100 percent increase in GDP growth lead to about 48 percent increase in Savings, and 100 percent point increase in interest on deposits leads to 0.23 percent increase in savings. The important thing to note is that the two debt indicators are positively related but not statistically significant, i.e. the t statistic of foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio are 1.539 and 0.194 respectively, which is far less than 2 and is, therefore, not significant. It simply implies the foreign debt servicing and foreign debt borrowing have no impact on Savings.

DW Statistic is pretty close to 2, which is relevant. R-squared is 0.7087, which implies that the model explains 71 percent of the variation in Savings.

The results in the (Table 9.2) confirm that the growth rate of real capital stock is related positively to the lagged growth rate of real GDP, lagged growth rate of real capital stock, foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio. But it is negatively correlated with real interest rate on bank advances.

The positive relationship of investment with the lagged growth rate of GDP and the significance of its t-statistics implies that a 100 percent increase in the lagged growth rate of GDP lead to a 22 percent increase in investment. Similarly, investment is positively correlated with the lagged growth rate of real capital stock and statistically significant. The results show that a 100 percent increase in lagged growth rate of real capital stock lead to 61 percent increase in investment. As far as real interest rate on bank advances is concerned, it is negatively correlated with investment but it is not statistically significant. Once again, t-statistic is not significant in cases of debt indicators. It represents that

foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio have no impact on the growth rate of real capital stock.

DW Statistic is very close to 2, and the R squared implies that the model explains 88 percent of the variation in investment.

The OLS results of the growth model confirms that the growth in output per capita is related positively with the growth rate of real capital stock and is statistically significant . As far as debt indicators are concerned, they are negatively correlated with real per capita output and are not statistically significant (table 9.3).

The positive correlation of growth in real per capita output with growth in real per capita capital stock and its statistical significance implies that a 100 percent increase in real per capita capital stock leads 90 percent increase in the growth rate of real per capita output. The foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio, on the other hand, related negatively with the growth rate of real per capita output and are statistically insignificant, which implies that the debt indicators have no impact on the growth rate of real per capita output

DW Statistic in growth equation is also close to 2, and the R squared represents that the growth model explains 25 percent of variation.

The results of the Gini index of household income are presented in (table 9.4). We find that the Gini coefficient is negatively correlated with the growth rate of real GDP and is statistically insignificant. It is positively correlated and statistically significant with the unemployment rate. The debt indicators, foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio, related positively with the Gini index of household income, but statistically they are insignificant.

The positive relationship and the statistic significance of the Gini coefficient with the unemployment rate indicates that a 100 percent increase in the unemployment rate has an

influence of only 1 percent increase in the Gini index of household income. The debt indicators, like the rest of the results, have no impact on the Gini coefficient, because they are statistically insignificant.

DW Statistic is 0.5 short to 2, which is relevant. R squared says that the model explain 83 percent of the variation in the income inequality.

Finally, the results of headcount poverty index of household income are shown in (table 9.5) and are different from the rest so far presented above. The coefficients on one of the two debt indicators are statistically significant and negative suggesting that high external indebtedness is negatively related to poverty. Similarly, the coefficient on the growth rate of real GDP and literacy rate are statistically significant and negatively correlated with poverty suggesting that high literacy rate and growth rate of real GDP impacts negatively on poverty. Unemployment on the other hand, is, of course, positively correlated with poverty index of household income, but it is statistically insignificant.

The negative relationships and the statistic significance of growth rate of real GDP with the poverty indicate that an increase in real GDP growth would decrease 1.54 % (Since the denominator is too small, 154 is divided by 100). Similarly, the negative correlation of literacy rate with the poverty and its statistical significance shows that an increase in literacy rate would decrease 0.79% of poverty. The unemployment is positively related with poverty, but its statistical insignificance shows that it doesn't have any impact on poverty.

The results are consistent across the debt indicators. The entire coefficient on debt indicators, foreign debt servicing to GDP ratio and foreign borrowing to GDP ratio, are negative, but only the foreign borrowing to GDP is statistically significant with poverty, suggesting that an increase in foreign borrowing to GDP ratio would lead to a decline in poverty by 0.73% in Pakistan.



The results clearly show that although the foreign debt has no impact on the growth, it seems to help reduction in the poverty in Pakistan.

One possible explanation is that the successful impact on the growth through the external debt is a long and complex process that depends on many other factors such as the quality of governance in a country and adopting policies that promote growth.

Compared with these factors, borrowed foreign exchange is much less important in determining whether a country will achieve a long term economic growth. However, external financing is likely to be the most helpful if the debtor country maintains stable and honest government and, most of all, adopt out-ward looking economic policies. But, on the other hand, it may weaken the growth gradually if a debtor country is unlikely or unwilling to make necessary policies.

The Congressional Budget Office (CBO)'s review of the development literature suggests that the way a country is governed can have 3 key characteristics that will affect its economic growth.

- 1) Countries that have enjoyed a high measure of political stability and social order are more likely to develop than countries that have experienced instability and chaos.
- 2) The less self-serving the officials of a developing country's government, the more likely that country is to achieve long-term development.
- 3) Successful development usually depends on the existence of functioning governmental institutions that can support a growing economy.

Political instability, not surprisingly, is likely to hinder economic growth. Studies have shown that countries in which political authority has broken down are less likely to achieve improvements in human welfare and growth. Tussle with the neighboring country may also cause destruction in the economy. It is likely to hinder productive activities by raising the economic risk that potential investor face. In contrast, countries

that have smoothly functioning and stable political system without any tussle with their neighboring countries tend to be more capable of pursuing a program of development.

Honest and capable government appears to be an important component of development. In its absence, government officials may pursue policies that damage the economy simply because those policies benefit them and others with political and economic power. Moreover, government official may take bribes and kickbacks or even misappropriate funds to their own accounts. In either case, the external resource of financing is not contributing to the economy's productive capacity; even worse, it is creating inefficiency elsewhere in the economy.

Some experts argue that governmental institutions that can support economic activities are important to the growth and development. Those institutions can be classified as two different types: the laws, and other rules that foster economic activity; and formal organizations such as a central bank.

The first type of institution usually includes mechanism that protects property rights, make and enforce contract, organize a system of national currency, create a system of tax collection, or provide the regulatory framework for things like a banking system or stock exchange. They are the rules of the game—the institution that make the economic system less arbitrary, lower the economic risk in investing in productive activities, and facilitate economic interaction. They reduce the transaction cost of economic activity.

The second types are institutions most people think of –formal organizations. Some of them implement the system of laws, such as a Police force and an independent judicial system. In countries that lack an impartial judicial system, potential entrepreneurs—foreign or domestic—are likely to be discouraged from starting businesses or expanding existing ones. Such institution also includes financial organizations—a central bank, for example. Most developing countries have such organization today, but as late as the 1970s, not all did. Even a uniform language is an innovation that may promote development by making it easier for people to engage in commerce.

Pakistan still has long way to go in improving the functions of the governmental organizations, removing the political instability and thereby getting the honest and capable administration. Till then the borrowed foreign exchange would continuously be used for personal benefits and, thereby, would never influence the economic growth of Pakistan like presented by the results of the present study.

The results clearly show that the external indebtedness has favorable influence on the poverty of Pakistan but not on the growth.

One possible explanation is that the foreign resources are usually available in social sectors which directly help poor segments of the society. The donors of foreign aid like World Bank usually urge the recipient countries to adopt pro-poor policies and they are usually ready to finance such policies.

Table 9.1: Parameter Estimates of the Saving Equation

(Dependent Variable is saving to GDP ratio)

Variable	Coefficient	t-Statistic	Probability
Intercept	0.0593	3.392	0.0024
Growth rate of real GDP	0.4764	3.564	0.0016
Per capita real GDP	0.0000	1.679	0.1061
Real interest rate on bank deposits	0.0023	3.719	0.0011
Foreign debt servicing to GDP ratio	0.6635	1.539	0.1370
Foreign borrowing to GDP ratio	0.0213	0.194	0.8481
R-squared	0.7087		
DW Statistic	1.8024		
Sample size	30		

Table 9.2: Parameter Estimates of the Investment Equation

(Dependent Variable is growth rate of real capital stock)

Variable	Coefficient	t-Statistic	Probability
Intercept	0.0000	-0.004	0.9969
Lagged growth rate of real GDP	0.2238	3.998	0.0006
Real interest rate on bank advances	-0.0002	-1.135	0.2680
Foreign debt servicing to GDP ratio	0.0012	0.011	0.9915
Foreign borrowing to GDP ratio	0.0491	1.749	0.0936
Lagged growth rate of real capital stock	0.6122	5.843	0.0000
R-squared	0.8815		
DW Statistic	1.9299		
Sample size	30		

Table 9.3: Parameter Estimates of the Growth Equation

(Dependent Variable is growth rate of real per capita output)

Variable	Coefficient	t-Statistic	Probability
Intercept	0.0374	2.651	0.0135
Growth rate of real per capita capital stock	0.9013	2.886	0.0078
Foreign debt servicing to GDP ratio	-0.5737	-1.372	0.1818
Foreign borrowing to GDP ratio	-0.2238	-1.664	0.1082
R-squared	0.2582		
Durbin-Watson stat	1.7026		
Sample size	30		

Table 9.4: Parameter Estimates of the Income Inequality Equation

(Dependent Variable is Gini Index of household income)

Variable	Coefficient	t-Statistic	Probability
Intercept	0.3263	27.970	0.0000
Growth rate of real GDP	-0.0021	-0.022	0.9828
Unemployment rate	0.0101	4.793	0.0001
Foreign debt servicing to GDP ratio	0.2619	1.071	0.2946
Foreign borrowing to GDP ratio	0.0576	1.006	0.3244
MA(1)	0.5729	2.774	0.0106
R-squared	0.8395		
DW Statistic	1.5939		
Sample size	30		

Table 9.5: Parameter Estimates of the Poverty Equation

(Dependent variable is headcount poverty index of household income)

Variable	Coefficient	t-Statistic	Probability
Intercept	62.6409	12.236	0.0000
Growth rate of real GDP	-154.4613	-4.532	0.0001
Unemployment rate	1.9376	1.754	0.0922
Literacy rate	-0.7981	-2.345	0.0276
Foreign debt servicing to GDP ratio	-96.8845	-0.829	0.4150
Foreign borrowing to GDP ratio	-73.4894	-2.603	0.0156
R-squared	0.7245		
DW Statistic	1.3437		
Sample size	30		



## **CHAPTER 10**

### **CONCLUSION**

The key objective of this thesis was to establish whether external debt plays a crucial role in influencing the growth and poverty levels of Pakistan. A number of international NGOs have categorically stated that debt caused poverty. This thesis seeks to contribute to this debate as well as to the literature on growth and external debt. There is an extensive and growing literature on the impact of growth on poverty, and on the relationship between external debt and growth. However, there are very few studies that directly link the external debt and poverty of developing country like Pakistan. This thesis thus endeavors to bring together the three complex relationships and explores their impact for Pakistan.

The main findings of the thesis confirm that the indebtedness of Pakistan has a favorable impact on poverty. However, high debt services and related external debt indicators have an adverse impact on the growth indicators, such as Savings, Investment and real per capita output growth. The most statistically significant relationship is that between foreign borrowing to GDP ratio and Poverty. We find that an increase in the foreign borrowing to GDP ratio declines the poverty by 0.73 %.

The main findings are contradicting some studies and consensus in the literature, such as Pattilo and others (2002), and Dollar and Kraay (2001), who say that the large external debt is a major cause of poverty through its effects on economic growth and human development, and that the impact of external debt on poverty is not vigorously expressed. The contradiction suggests that focusing exclusively on external debt reduction is probably not a very effective way to reduce poverty.

According to the results of a present thesis, in line with the findings of Abrego and Ross (2001), in order to reduce poverty, the key policy option is to focus on factors that hinder or obstruct the progress or movement of growth, not merely on the debt reduction. The

results comply with a new consensus (The Monterrey Consensus presented in the Johannesburg Conference among the members of the international community): the longer-term goal being focused on is accelerated poverty reduction, which needs to be supported by additional aid flows and the borrowed foreign exchange, which are increasingly being provided in the form of grants and loans combined with debt relief for countries that can demonstrate effective utilization of these resources and maximize the profit to the poor.

According to the results of the present thesis the foreign debt has no impact on the economics growth, but it seems to help reduction in the poverty in Pakistan.

One possible explanation is that the successful impact on the growth through the external debt is a long and complex process that depends on many other factors such as the quality of governance in a country and adopting policies that promote growth.

Compared with these factors, borrowed foreign exchange is much less important in determining whether a country will achieve a long term economic growth. However, external financing is likely to be the most helpful if the debtor country maintains stable and honest government and, most of all, adopt out-ward looking economic policies. But, on the other hand, it may weaken the growth gradually if a debtor country is unlikely or unwilling to make necessary policies.

On the other hand, the results show that the external indebtedness has favorable influence on the poverty of Pakistan. This could be because the foreign resources are usually available in social sectors which directly help poor segments of the society. The donors of foreign aid like World Bank usually urge the recipient countries to adopt pro-poor policies and they are usually ready to finance such policies.

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