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Brief analysis of specific economic issues for providing useful input to policymakers

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Can Pakistan avert looming default?

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Summary

Over the past decade, Pakistan has experienced a steady rise in foreign debt, largely as a result of its poorly diversified economic structure. The country's default threat has been looming over after the first decade since independence. Amid these circumstances, the huge external debt repayment obligations remain a big challenge for the economy. This debt is also exacerbated by the effects of external factors such as the US's increase in interest rates, Russia's war on Ukraine, and the risks of a global recession.

This policy note aims to address the main challenges of the country's default risks and external factors that are pushing up the cost of debt servicing.

The country lacks a comprehensive debt strategy for structuring its debts. ICMA Policy Note recommends that proactive debt management policy approaches can mitigate the risks posed by a high level of debt and promote a sustainable and equitable recovery. Debt restructuring with creditors is an urgent necessity.

Debt managers, in tandem with the Central bank, regulatory institutions, supervisors, and market expectations, should continue to develop technical capacity in the public management framework that could enable them to closely monitor debt buildup and adopt better fiscal management practices.

To avoid default in the long run, the government must address long-standing structural weaknesses. The economic managers must put their reform focus on deeper economic challenges such as fiscal transparency, an even playing field for SOEs and public sector governance, strengthening economic and legal infrastructure, and ease of doing business. Especially, there is urgent need to accelerate our exports through diversification and product value addition and also by encouraging overseas Pakistanis to increase remittances to Pakistan.

Introduction

Crippled by the continuous drainage of foreign exchange reserves, the rapidly expanding fiscal deficit, higher international debt service obligations, and restrictions on import-related Letters of Credit (LCs), the alarm bells are ringing for the already-ailing Pakistan's economy as it seemingly edges closer to debt default. In addition to this, the hiatus of the ninth review of the International Monetary Fund (IMF) bailout program is making the situation worse.

Not too long ago, in July 2022, the fear of default hung over the nation due to severe external financing challenges, soaring inflation, surging import bills, dwindling foreign exchange reserves, and a tense domestic political landscape when higher interest rates in developed countries led to outflows of capital from developing countries, including Pakistan. Nevertheless, with the support of the IMF, the country escaped the immediate threat of default at the end of August 2022, when the Fund's program was revived. The executive board of the fund completed the combined seventh and eighth reviews under the Extended Fund Facility (EFF), allowing the country to draw around $1.1 billion, or SDR 894 million.

> "The fear of default has returned yet again, as depleting foreign exchange reserves have significantly reduced access to the dollar."

The fear of default has returned yet again, as depleting foreign exchange reserves have significantly reduced access to the dollar. To manage the gravity of this situation, the central bank (SBP) has imposed restrictions on the opening of LCs and Electronic Import Forms (EIFs) to save dollars. Many industries are now facing severe supply constraints due to a shortage of raw materials and are on the verge of discontinuing production. The traders, especially the importers, are staging protests across the country against the non-clearance of containers and embargo on LCs.

Unfortunately, Pakistan has been facing these challenges since its independence. It has failed to mobilize domestic resources due to its poorly diversified economic and export structure, making it vulnerable to global market fluctuations.

As a result, it has created an increasing need for external borrowing. While the country lies in a region where its geo-political importance remains crucial, whether in the context of the Cold War, the Soviet invasion of Afghanistan, or the post-9/11 war on terror, foreign inflows kept coming in. This indeed made it easier for policymakers to defer structural reform efforts when there was easy access to foreign capital. Now seems like the time to pay the price of this procrastination.

“Pakistan’s risk of defaulting on its debt increases as its total debt and liabilities as a percentage of GDP in FY22 was 89.2% as opposed to 85.7% in FY21.”

History shows that the danger of external debt default first appeared in 1996. Following the nuclear tests by Pakistan after India, the country faced a foreign debt crisis amid economic sanctions imposed by the western economies in mid-1998, and Pakistan went into a technical default (Hasan 1999). Against this background, the country with the Paris Club reached an agreement in January 1999 for debt relief and restructuring under the comparability of treatment with an amount of around $3 billion (Allen 2002).

Higher levels of external debt appear to have resulted in persistently low growth for a number of years, particularly for developing countries, as higher public external debt reduces savings and “crowds out” investment. This translates into a low level of capital, hence a negative impact on economic growth (Qureshi & Liaqat, 2020).

This Policy Note aims to address the threats of Pakistan’s default, which have been looming after the first decade since independence, through secondary data and literature. The following section begins by briefly discussing the main challenges and the brief history of the country’s default risks. The next section distills a thorough analysis of the current policies and data to highlight the issues and the costs associated with each. This focuses on providing specific details on whether it is efficient or inefficient in resolving the issue. The fourth section summarizes some conclusions and valuable recommendations for policy makers.

ANALYSIS AND FINDING

Debt threat continues....

Pakistan’s debt story began in the last 75 years. Due to economic challenges, the country had to knock off the first IMF loan in 1958. The country has remained under the Fund’s shadow ever since, with a total of 22 programs. The previous government in Pakistan pursued its 22nd loan of $6 billion for the bailout program with the multilateral lender to curb the debt and hold off a balance of payments crisis.

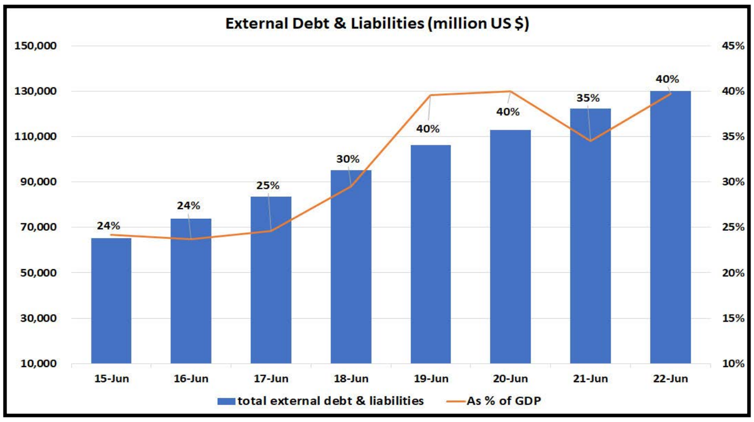
“IMF data shows that the country’s external debt repayment obligations are $73 billion from FY23 to FY25.”

It is prudent to mention that Pakistan ranks poorly on debt metrics. The total debt to GDP ratio, an economic barometer to determine the health of a nation’s economy, provides a seemingly accurate estimate of a country’s ability to pay back its current debts. Pakistan’s risk of defaulting on its debt increases as its total debt and liabilities as a percentage of GDP in FY22 was 89.2% as opposed to 85.7% in FY21. This ratio is above the benchmark of 77%, which could wreak havoc on its financial markets and economy.

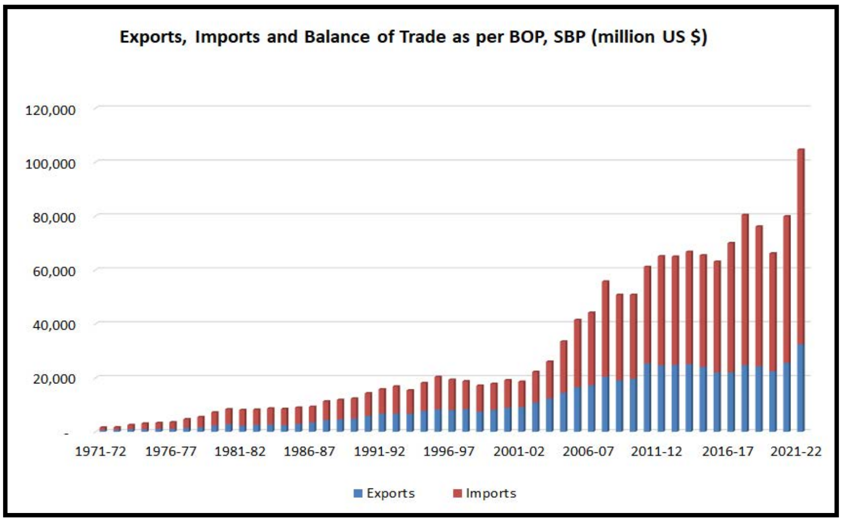
In some cases, the temporary higher debt-to-GDP ratio could benefit the economy in the long run if productive investments have been made in infrastructure or social spending, generating income in the future to pay off these debts with interest. However, it is the other way around in the case of Pakistan.

The IMF data shows that the country’s external debt repayment obligations are $73 billion from FY23 to FY25. The enormous debt repayment pressure is taking its toll, with the central bank’s forex reserves dwindling to $4.6 billion by January 13, 2023, barely covering one month of imports. This dwindling FX reserve also weighed on Pakistan’s rupee (PKR), as it has so far depreciated by more than 10% in the fiscal year to date (FYTD). Meanwhile, it keeps pushing up the cost of debt servicing. Consequently, this has further eroded the fiscal space needed to address the crisis.

The significant repayment is due to massive outstanding external debt and liabilities that reached $130 billion by FY22, up from $65 billion in FY15. Furthermore, a wide expansion in Current Account deficit (CAD), sluggish FDI, net outflows from equity securities, and a delay in the revival of the IMF program also contributed to a reduction in reserves.



The economic managers have never made any true efforts to transform the import-led, consumption-oriented economy into an export-led growth country. Consequently, the unreasonable gap between imports and exports keeps growing, contributing to the present economic woes. From FY1971 to 2001, this gap grew by 2.5 times (152%), while it widened by a whopping 134 times during FY2002-2022 due to exorbitant imports that reached $72 billion.



If we further dig into the other root causes of the default threat, there are some external causes too. The rise in interest rate by the U.S. Federal Reserve, the risk of a global recession, rising commodity prices, and maturing debt obligations further weakened the Pakistani Rupee. And on top of that, Russia's invasion of Ukraine has choked off global food supplies, resulting in an uptick in prices and disruption of energy supplies such as natural gas and oil.

Persistent fiscal and widening current account deficit and growing losses from several major state-owned enterprises (SOEs) have led to debt accumulation for quite a while and put pressure on debt sustainability. If a nation meets its maturity obligations without rescheduling debt and compromising on economic growth, this external debt is considered sustainable (O. Kidochukwu 2015).

Several shocks can trigger a crisis, but high debt levels allow one to arise suddenly and intensify rapidly. Rising public debt places constraints on fiscal policy when there is a dire need to address new challenges or crises (World Bank 2015). Hence, the country struggles the most with limited fiscal space and options to refinance maturing debt obligations in the international financial markets.

In the next part of this policy note, ICMA would like to use the opportunity to address challenges related to debt or financial crises that could threaten Pakistan's future economy.

Is Pakistan going to default?

The country, with a history of boom-and-bust economic cycles, has again reached a point where economic and financial stability are at greater risk as investors have concerns that the nation cannot afford to pay the bonds. To offset this risk, the lenders require higher yields, making it more costly for the country to refinance its debts.

> "The nation is encountering a severe economic crisis in an environment of political mayhem and uncertainty."

Recently, S&P Global Ratings downgraded Pakistan's long-term sovereign credit ratings by one notch to CCC+ from B to reflect a continued weakening of the country's external, fiscal, and economic metrics. Fitch Ratings and Moody's Investors Service, two global ratings agencies, already ranked the nation's $7.8 billion in foreign bonds at seven notches below investment grade, the equivalent of S&P's CCC+ rating, on par with El Salvador and Ukraine.

According to S&P, the country's tax-to-GDP ratio is too low. The Federal Board of Revenue (FBR) has projected this ratio at 9.5% for the ongoing fiscal year 2022–2023 as opposed to 8.5% in the last fiscal year. To be sure, a higher tax-to-GDP ratio is a success story for any country, as it allows governments to rely on domestic resources rather than external sources of revenue while also ensuring adequate funds to meet the country's development and social expenditure needs. Poor debt management and low government revenues due to inefficient tax policies are also causes of fiscal weaknesses.

The nation is encountering a severe economic crisis in an environment of political mayhem and uncertainty. All the more reason why analysts suggest that the country will not be able to make these payments.

If the country cannot afford to keep rolling over its debt, consequently, it will default, wherein investors' fears will become a self-fulfilling prophecy. Undoubtedly, the consequences for Pakistan would be appalling, both in terms of economic hardships and its reputation, if it defaults. Then there might be a complete collapse of markets and international economic sentiments towards the defaulting government's financial position, with an inability to borrow from global markets or institutions except at the most punishing interest rates. This would damage the social fabric of the country as well.

> "ICMA is of the view that Pakistan is not going to default on its debt repayments despite facing daunting economic challenges."

Pakistan may end up avoiding default ...

However, ICMA is of the view that Pakistan is not going to default on its debt repayments despite facing daunting economic challenges. The commitments made by the multilateral and bilateral partners to support Pakistan in this devastating situation made it possible for the country to avert the threat of sovereign default on its loans in the next few months. Not to forget, the government has successfully averted the possibility of a short-term default after the payment of a $1 billion international bond.

The government is making all-out efforts to put the economy back on track. Recently, a $3 billion commitment from the United Arab Emirates (UAE), including $1 billion fresh loan and roll over of existing $2 billion debt, would provide some breathing space.

Meanwhile, some recent developments on external avenues are also welcoming as the government has inked a deal with the Saudi Fund for Development (SFD) that will finance oil derivatives amounting to $1 billion. It also agreed to fund $1bn worth of oil imports on deferred payment.

Besides, at the Geneva Climate Conference, the Islamic Development Bank (IDB) pledged to finance $4.2 billion over the next three years to rebuild Pakistan's economy on a sustainable footing after the distressing effects of torrential rain and flash floods.

> IMF remains the best option available to the ailing economy under strain.

France, a bilateral partner, also came forward to support Pakistan in its talks with financial institutions and promised to contribute $10 million towards rebuilding efforts.
Most importantly, the IMF remains the best option available to the ailing economy under strain. Hence, the government is committed to revive the stalled IMF program under EFF.

Some concrete steps are needed to be taken to avoid this situation in the long run. Following the identified challenges, the ICMA policy paper puts forward some recommendations on how they could be addressed by the government and economic policymakers.

Policy Recommendations

Debt Management

Pakistan lacks a comprehensive debt strategy for structuring its debts. This policy brief suggests that the government can avoid a default-like crisis in the long run if the following proactive debt management policy approaches are considered by the authorities as a way to mitigate the risks posed by a high level of debt and achieve a sustainable and equitable recovery.

- The government must have strong coordination with creditors to restructure its debts with bilateral partners, especially China, which forms 30% of the government's external debt. If the government capitalizes on its long -standing allies, China, Saudi Arabia and the United Arab Emirates (UAE) at the earliest, it would help contain contagion risks.

- Proactive debt management approaches can help ensure the government allocates the funds wisely. It will also enable more careful management of the opportunities, costs, and risks of different sources of borrowing.

- No doubt, there is considerable room for improvement in debt transparency. Debt managers, in tandem with the central bank, regulatory institutions, supervisors, and market expectations, should continue to develop technical capacity in the public management framework that could enable them to closely monitor debt buildup and adopt better fiscal management practices.

Structural Reforms

To avoid default in the long run, the government must address long-standing structural weaknesses. The economic managers must put their reform focus on deeper economic challenges such as fiscal transparency, an even playing field for SOEs and public sector governance, strengthening economic and legal infrastructure, and ease of doing business.

- The underlying government primary surplus indicates a dire need to reinforce fiscal discipline with strong revenue collections and sharp spending cuts for debt sustainability. This can be achieved by broadening the tax base and through an effective, efficient, and equitable tax policy to increase the tax-to-GDP ratio. The economic managers must identify which sectors are taking undue advantage and the repercussions on total revenue.

> To avoid default in the long run, the government must address long-standing structural weaknesses.

- It is imperative to create space for much-needed social and infrastructure expenditures. Supported by transparent fiscal consolidation, the ratio of public debt to GDP can follow a downward trajectory. As the IMF projected, it can fall to 60% by FY2027 provided the government continues to advance fiscal reforms.

- The continuation of high tariffs on luxury imported items is an effective way to reduce the fiscal deficit and external account pressures. Meanwhile, the government must ration and rationalize energy consumption, i.e., limit energy consumption, promote the use of renewable energy sources, and domestic energy sources would be a critical solution to rising import bills.

- To implement structural policies, the ICMA policy note considers that the government can privatize many loss-making SOEs to promote competition, transparency and governance, helping limit fiscal risks and channel debt reduction. Nonetheless, structural reforms are not necessary to be carried out through privatization. The government can still maintain its holdings and take steps to make them more competitive not only in the domestic market but also in the international market.

Exports and Remittances- lifelines

Draining foreign exchange reserves has substantially reduced access to the dollar. In an attempt to manage the gravity of the situation, the State Bank of Pakistan (SBP) curtailed imports through restrictions on LCs. However, this imposition has a multiplier effect, resulting in greater economic costs in terms of disruption in industrial output, massive layouts, as well as a decline in exports.

> “The government must take pro-business measures to improve the performance of export-oriented industries by withdrawing import restrictions on raw materials to keep their production wheels turning.”

The government must take pro-business measures to improve the performance of export-oriented industries by withdrawing import restrictions on raw materials to keep their production wheels turning.

The growing disparity between open market and interbank exchange rates is also the reason why exporters delay the inflows due to expectations of further depreciation of the rupee and the high premiums offered by informal channels. In addition to this, remittances, the backbone of Pakistan's cash flow, have largely been affected due to the growing gap between official and informal (Hawala/Hundi) channels.

ICMA believes that adequate policies related to foreign exchange reserves can also play an important role in increasing the room for maneuvering for the government to meet its fiscal obligations during economic and financial shocks, such as preserving market-determined exchange rates. The government must maintain it, as it serves as an important buffer against external shocks during heightened uncertainty and maintains competitiveness. It would help exports and remittances perform better.

Furthermore, the ICMA policy note considers that repayment vulnerabilities can be reduced by diversifying exports, which are highly vulnerable to changes in commodity prices. The country needs to facilitate bank credit to productive small and medium enterprises on reasonable terms to boost trade volume. Even an increase in openness to trade will lead to specialization through comparative advantage.

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