

**RISK ANALYSIS ON  
EXTERNAL INDEBTEDNESS OF PAKISTAN**

Abdul Waheed\*

The rising burden of external debt and debt-service payments is becoming a constant source of concern for Pakistan. This paper has two-fold objectives. First, to present an external debt profile of the country, and second, to perform a risk analysis on external indebtedness using indicator approach. A review of the changes in the pattern and levels of external debt and a careful analysis of various debt burden and debt-service indicators reveal that Pakistan may have to deal with a growing debt problem. This conclusion is further strengthened when we look at the various key performance indicators. The paper supports the view that it is in the interest of the creditors to reduce the level of Pakistan's debt through voluntary debt forgiveness which will result in an increase in investment and growth in the country and, subsequently, increased debt-service payments to the creditors.

**1. INTRODUCTION**

Access to external finance is useful, and much more so is concessional finance. In theory, it adds to domestic savings and, by softening the foreign exchange constraint on imported capital goods and inputs,

---

\* PhD, fellow, Graduate School of International Development, Nagoya University, Japan.

permits a higher rate of investment. This latter, as the theory goes, leads to a higher rate of growth, a higher rate of domestic savings and a higher exports growth to convert savings into the foreign exchange required to service and repay the external debt.

With the above theoretical understanding, Pakistan started receiving foreign capital with a project aid of \$43 million in 1951/52, and went on to secure aid from multilateral and bilateral agencies. Despite repayments, a debt balance of as much as \$28 billion was outstanding at the end of March 2002. These figures only refer to public and publicly-guaranteed debt. Adding private non-guaranteed debt and foreign exchange liabilities, the total stock of external debt obligations as at the end of March 2002 was estimated at \$36.0 billion<sup>1</sup>.

The rising burden of external debt and debt-service payments is clearly reflected in the budget deficit and the current account deficit. Debt-servicing also assumes serious proportions. It represents 3.3 percent of GDP, 21.3 percent of export earnings and 13.8 percent of foreign exchange earnings. The composition of assistance has also changed markedly over time. Foreign aid in the form of grants and grant-like assistance (80 % during 1955-60) declined steadily (7 % in 2000/01) and was substituted by hard term loans and credits repayable in foreign currency with higher interest rates and shorter grace periods<sup>2</sup>. Similarly, over time, assistance also became donor-driven, i.e. on the pre-specified donors' terms and conditions. According to the World Bank (2001: 140), the debt indicators for Pakistan deteriorated and the country classified in the severely-indebted group of low-income countries.

---

<sup>1</sup> Government of Pakistan, Economic Survey, 2001/02.

<sup>2</sup> In general, financial aid comes in three categories: grants, loans and credits. While grants are not repayable, both loans and credits are to be re-paid along with interest within an agreed period. Loans entail relatively softer conditions than credit, which is advanced on higher interest rates and for a shorter duration.

It is well-recognised that the evaluation of a country's debt position and the determination of its debt-servicing capacity is a complex process. Although there is a large body of literature dealing with the development of a system of measurement for evaluating debt situations and determining critical levels of indebtedness, no commonly accepted single indicator exists (McDonald, 1982). Yet, practitioners are frequently called upon to make judgement on present and future debt situations. They approach this task in a pragmatic way, paying due respect to the theoretical and methodological issues on the one hand and to the actual circumstances on the other. The present paper also follows a pragmatic and eclectic approach in analysing the external debt situation of Pakistan. Since the determination of a country's debt-servicing capacity is largely judgmental rather than measurable, this paper will make such judgement in a well-informed way, using a number of straightforward indicators—and especially their change over time—to draw inferences on the economic burden of external debt.

The main body of the data is taken from the various issues of *Economic Survey* (Government of Pakistan). For cross-country data, we used *Global Development Finance, 2002* (The World Bank). The study period is from 1961/62 to 2000/01 (This is the latest fiscal year up to which all the required data are available in final form).

This paper is divided into five sections. Following the introduction, section 2 discusses the profile of external debt over the last four decades. Section 3 analyses various debt burden and debt-service indicators to perform a risk analysis. Section 4 evaluates various key performance indicators of Pakistan for the period 1980/81 to 2000/01 to supplement the findings of section 3. The last section assesses the future implications of past trends and summarises the results.

## **2. CHANGING PROFILE OF EXTERNAL DEBT**

### **2.1. Volume of the Debt**

Foreign economic assistance to Pakistan began in July 1951 and continued to grow in volume thereafter. The substantial increase in outstanding debt took place during the 1960s, especially during the second half of the decade when the rate of accumulation averaged about 24 percent per annum. By the end of December 1969, the external debt of Pakistan amounted to \$2.7 billion including the debt of East Pakistan, now Bangladesh. And by December 1971, the figure rose to \$3.6 billion of which \$0.6 billion were subsequently written off, being loans pertaining to projects visibly located in Bangladesh. The external debt accelerated further during the 1970s. The medium and long term outstanding debt repayable in foreign exchange increased to more than two-fold, from \$3.0 billion in December 1971 to \$6.3 billion in June 1977, which gives an average annual growth rate of about 11 percent per annum. Although the average growth rate has slackened since 1977/78,

about 6.5 percent per annum, indebtedness continued to rise. The disbursed and outstanding debt almost doubled from 1980/81 to 1990/91 and grew at an annual average rate of 6.2 percent during this period.

External debt has grown at an average rate of 5.5 percent per annum during the 1990s. Further analysis reveals that it has grown at an average annual rate of 8.0 percent during the period 1990/91-1994/95 but slowed down to an average rate of about 3.0 percent per annum during the period 1995/96-1999/2001. The slower rate of growth of medium and long-term outstanding debt during the second half of the 1990s suggests that Pakistan's reliance on short-term debt has increased. It is well recognised that reliance on short term borrowing is not a good sign as such type of loans involves short repayment periods and bears higher interest rates. Thus, such a shift in external borrowing may bear risks of liquidity problems.

## **2.2. Terms and Conditions**

According to Avramovic (1964: 32), the severest liquidity crises are caused by the concentration of maturities in a short period. If a debtor country has to repay a large proportion of its debt within a few years and if no foreign exchange reserve has been accumulated to enable the retirement of the debt and the creditors are not willing to undertake a refinancing of the debt, then, liquidity difficulties will be acute. In this case, a vicious circle of a sort exists. Creditors may be reluctant to reschedule the debt over a longer period because of their past experience: rescheduling would not help much if the debtor were to pile up new short term debts as soon as the existing ones have been funded. On the other hand, the debtor country, if unable to space the maturities over time, is almost compelled to resort to more short term borrowing, frequently at a

prohibitive interest rate, which, in turn, further deteriorates the country's debt structure.

Over time, the terms and conditions of foreign loans and credits to Pakistan became significantly harder. They were soft during the 1960s and 1970s but during the 1980s and the 1990s they were made somewhat harder. The rate of interest, which averaged about 4.6 percent during the 1950s, declined to 3.3 percent during the 1960s and 1970s, but increased to 4.8 percent and 4.4 percent during the 1980s and 1990s respectively. The payment period of the loans/credits during the 1950s was 21 years with a grace period of 2 years, which rose to 30 years with a grace period of 7 years during the 1960s. It was reduced to around 25 years with a grace period of 6 years during the 1970s. Repayment period, however, rose to 28 years including a grace period of 7 years in the 1980s, but declined to 21 years including a grace period of 6 years during 1990s. By and large, the hardening of the terms and conditions adversely affected Pakistan's external debt servicing capacity.

### **2.3. Composition of Assistance**

The composition of assistance has also markedly changed over time. In the early years, a substantial portion of foreign assistance, which was in the form of grants and grant-like assistance, steadily declined and was substituted by hard term loans repayable in foreign currency with higher interest rates and shorter grace periods. The share of grants and grant-like assistance in the total commitments was 80 percent during the First Five-Year Plan period (1955-60), but dropped to 46 percent during the Second Plan (1960-65), 31 percent during the Third Plan (1966-70), and 10 percent during the Fourth Plan (1971-75). However, its share increased to about 15 percent during the non-plan period (1976-78), 22 percent during the Fifth Plan period (1978-83) and 23 percent during the Sixth Plan period (1983-88). Thereafter, the share of grants and grant-like assistance continued to exhibit a declining trend, averaging 16 percent during Seventh Plan (1988-93) and only 9 percent during Eighth Plan (1994-99). It decreased to 7 percent during 2000/01. The sharp decline in the grant component of the foreign aid has been responsible for a large accumulation of external debt.

### **2.4. Debt-Service Payments**

The large accumulated amount of foreign debt has increased the liability of debt-service payments by many folds. The total debt-service payments (principal plus interest), which was only \$182 million in 1970/71, rose to \$603 million in 1980/81. Debt-service went up from \$761 million in 1984/85 to \$1.11 billion in 1987/88, and \$1.232 billion in 1989/90. It grew at an annual average rate of 8.3 percent during the period 1980/81-1990/91 and exhibited a rising trend in the 1990s, rising from \$1.316 billion in 1990/91 to \$1.961 billion in 2000/01.

Sustainable debt management is possible if the likely trajectory of resource inflows exceeds or at least converges on the likely trajectory of resource outflows. The important outflows are imports and debt servicing and the important inflows are exports and remittances. Based on these flows, we compared debt servicing with the sum of the remittances and export earnings minus the import bill. For most of the period it was negative. The worsening of this inflow/outflow balance resulted from both the decline in remittances and the deterioration of the balance of trade.



Thus, under these changed conditions of external debt profile and the consequent increase in debt burden and the uncertainty introduced by a large percentage of total loan being market-related, the pressure on liquidity increased considerably. The important conclusion to this section is that the country has built a large external debt over the last four decades. The facts discussed in this section reveal that if the debt accumulation is not checked, it might lead to serious economic hardships.

### **3. DEBT INDICATORS**

A debtor country's capacity for repayment of foreign debt and debt-service obligations depends largely on its own production and, ultimately, on its export earnings of foreign exchange. To determine the capacity to service external debt, some analysts engage in ratio analysis. Relating debt size to the relevant macro-economic aggregates, therefore, generates ratios or indicators that provide "various measures of the cost of servicing debt in terms of foreign exchange or output forgone". Similarly, there are some critical levels which, if exceeded, constitute a danger point.

In this section eight different indicators, namely (i) external debt: GNP ratio, (ii) external debt: export receipt ratio, (iii) debt-servicing: export receipt ratio, (iv) debt-servicing: GNP ratio, (v) interest payment: GNP ratio, (vi) interest payment: export receipt ratio, (vii) amortisation: disbursement ratio, and (viii) net transfer: GNP ratio, are examined to analyse the external indebtedness of Pakistan during the period from 1961/62 to 2000/01<sup>3</sup>.

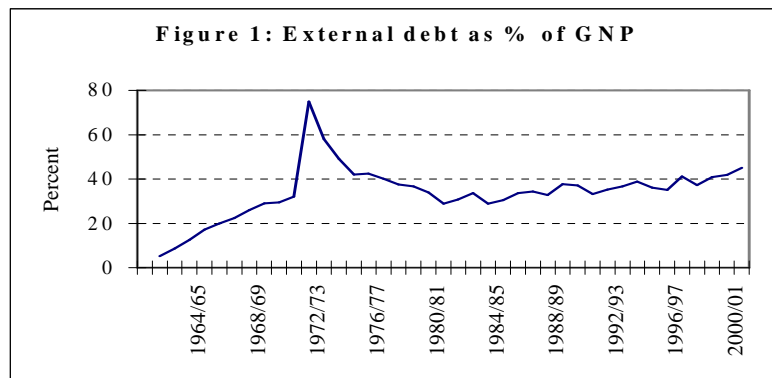
Although these conventional indicators of the capacity to handle external debt have little theoretical basis, they have become important indicators in the eyes of lenders, where each borrowing country is measured both against other countries and against its own past. This, in effect, makes them important to borrowers. A sharp increase in these indicators is taken as a warning signal even when they are relatively low initially.

---

<sup>3</sup> In selecting various debt indicators, consideration was given to those indicators that were frequently used in the previous studies and by the World Bank.

### 3.1. External Debt: GNP Ratio (EDT/GNP)

Relating foreign debt to Gross National Product (GNP) gives an indication of the relative burden of debt in terms of output forgone. This ratio not only estimates the burden of debt on the productive capacity of a country, but also provides an insight into its degree of solvency. An increasing ratio of debt to GNP signifies that the rate of growth of the debt is higher than the rate of growth of the GNP, implying that the debt burden is increasing. A rising Debt-GNP ratio suggests a deterioration in creditworthiness as the country is supposed to sacrifice an increasing part of its total productive capacity to pay back its debt.

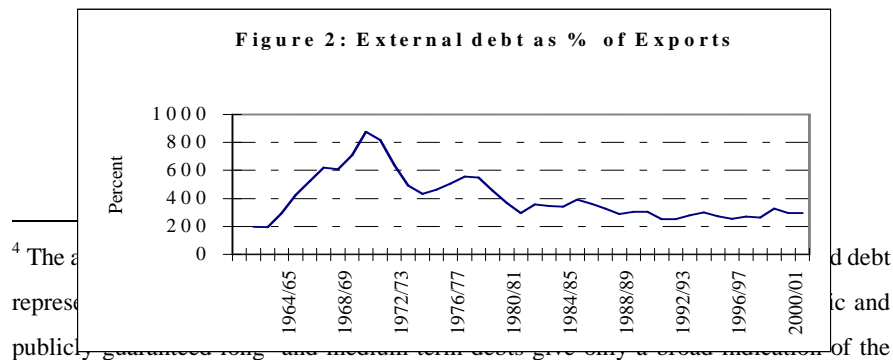


Recent literature on public debt has focused on the need to stabilise the Debt-GNP ratio and prevent its growth: the Debt-GNP (or Debt-GDP) ratio should approach a stationary value (Spaventa 1987:377). An even better scenario is when debt grows at a lower rate than that of the economy so that the Debt-GNP ratio decreases through time. When the debt stock of a country becomes too high with respect to its GNP, creditors no longer believe that the debt will be entirely repaid. Therefore, a *confidence crisis* follows and the debtor country is unable to obtain new loans.

Figure 1 shows the time path of long-term sovereign debt (public and publicly-guaranteed<sup>4</sup>) as a percent of GNP in Pakistan for the period 1961/62-2000/01. The ratio has an increasing trend<sup>5</sup>, which reflects a deterioration in creditworthiness. The World Bank's critical limit for this ratio is 50 percent<sup>6</sup>. During 2000/01, it was 53.8 percent, which is higher than the World Bank's limit. The current EDT/GNP ratio suggests that more than half of the productive capacity of the country will be required if the external debt is to be paid back today.

### 3.2. External Debt: Exports Receipt Ratio (EDT/XGS)

Since repayment of external debt is mostly financed out of export earnings, it follows that a debtor economy's capacity for repayment is indicated by external debt as a percentage of the volume of exports of goods and services. If the ratio of debt to exports continues to decline, the debt problem eventually becomes manageable as increased exports provide the earnings to meet debt payments. Conversely, a rising



changes in the external debt of Pakistan.

<sup>4</sup> The data represent public and publicly-guaranteed long- and medium-term debt. They are only a broad indication of the changes in the external debt of Pakistan.

<sup>5</sup> The period from 1971 to 1974 is an exceptional case, which witnessed oil crises, a civil war in Pakistan and a full-fledged war with India that resulted in the separation of East Pakistan as Bangladesh.

<sup>6</sup> World Bank, *Global Development Finance* 2002, Analysis & Summary Tables p.131.

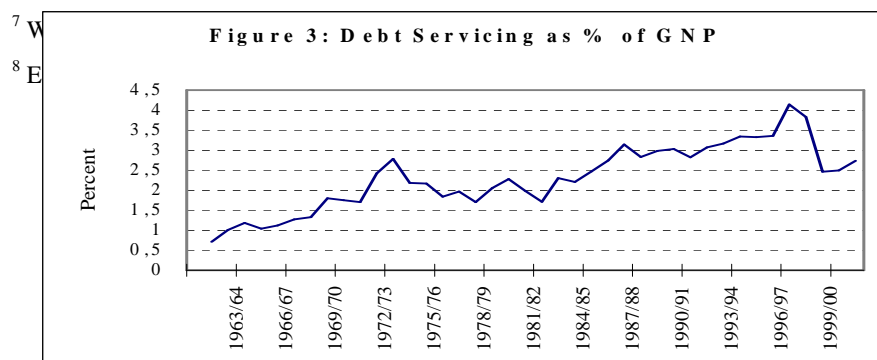
debt-exports ratio would reflect a growing imbalance that would cause to question the country's ability to maintain debt-service.

Pakistan debt/exports ratio was estimated as 300.6 percent during the year 2000/01, which is higher than the World Bank critical limit of 275 percent<sup>7</sup>. According to Erika (1993) the debt rate indicates the equivalent of years of exports required to repay a country's total outstanding debt. The mentioned debt rate means, therefore, that more than three years' export earnings would have been required to repay the country's debt in its entirety. From Figure 2, it is clear that this ratio remained high during the period under study. This indicates that Pakistan's capacity for repayment (indicated by EDT/XGS ratio) remained low during the said period.

### 3.3. Debt-Servicing: GNP Ratio (TDS/GNP)

By relating the total debt-service payments to GNP, we obtain a ratio which indicates the annual cost of debt-servicing in terms of output forgone. The ratio of debt-service payments to GNP takes into account the productive capacity of the whole economy and is a useful indicator because of its long-term implications for a country's debt-servicing capacity. The cost of debt-service is borne by the citizens of the debtor country in the form of reduced incomes, higher taxes and fees, reduced government services, and other adjustments that reduce levels of consumption.

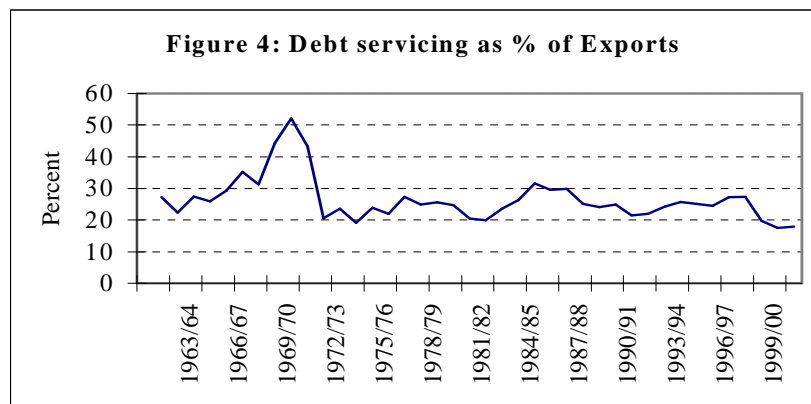
The ratio of debt-service payments<sup>8</sup> to GNP, as shown in Figure 3, has increased almost continuously over time, indicating the increased burden



of debt-service payments on the economy.

### 3.4. Debt-Servicing: Exports Receipt Ratio (TDS/XGS)

The crucial variable which affects economic performance and the ability of countries to continue to borrow is the debt-service ratio, measured as



the ratio of debt-service payments to exports earnings. This is a traditional indicator of creditworthiness. The higher the debt-service ratio, the greater will be the likelihood that, in the event of a severe and abrupt decline in export earnings, the country will no longer be able to meet debt-service obligations. Thus, the probability that a country will seek a rescheduling rises as its debt-service ratio rises.

Hence, this indicator measures possible liquidity as opposed to solvency problems faced by a particular country. According to Aliber (1980), changes in the TDS/XGS ratio does not indicate whether a country has borrowed too much or too little, but only that a crisis may occur at an unspecified future date if debt-service payments continue to grow relative to exports. Thirlwall (1995) concluded that risk of default is

strongly correlated with the size of the debt-service ratio.

It should also be noted here that export earnings are, naturally, required for other purposes, besides servicing external debt. In developing countries, foreign exchange earned from exports is mainly used to financing imports, especially those needed for development. Of course, the more exports revenue a country must devote to external debt servicing, the less can be devoted to other uses; and, consequently, the process of economic growth might be impaired.

In Pakistan, the debt-service ratio, however, has remained between 20 and 30 percent for the last three decades. This suggests that more than 20 percent of the country's export earnings are used for servicing the debt.

The debt-service ratio was 21.3 percent in 2000/01, which is lower than the World Bank critical ratio of 30 percent<sup>9</sup>. However, the increase in the same ratio in the periods 1996/97 (27.2 percent), and 1997/98 (27.3 percent) have not gone unnoticed by international lenders. As we already stated, no matter how low those ratios are, a sharp increase is considered as a warning sign.

### **3.5. Interest Payment: GNP Ratio (INT/GNP)**

Interest on foreign debt is the most rigid element of a country's balance of payments. Interest is contractually fixed and is a recurring charge on the economy regardless of the borrowers' fortunes. Any failure to pay this recurring charge adversely reflects on the government's ability to save and transfer savings, and thus inevitably undermines its credit standing.

The ratio of interest payments to GNP is often used to illustrate the debt-service burden on an economy's productive capacity. This also measures a country's capacity to generate real resources which can be used to finance imports and service debt<sup>10</sup>.

---

<sup>9</sup> World Bank, *Global Development Finance 2002*, Analysis & Summary Tables, p.131.

<sup>10</sup> World Bank, *World Development Report 1981*, p. 58.

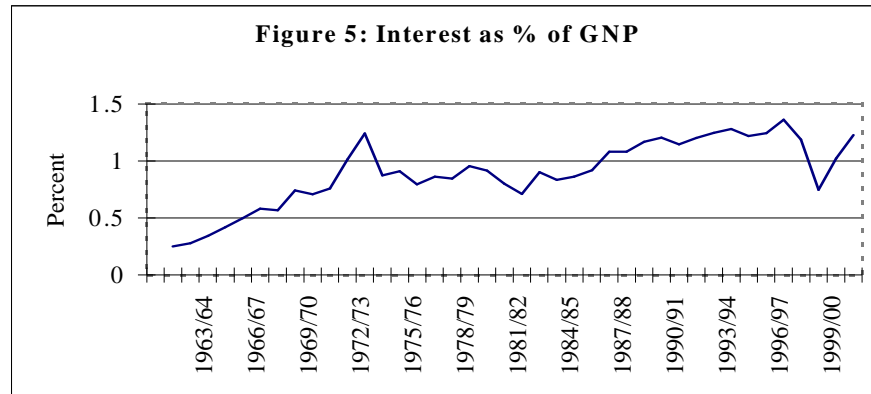


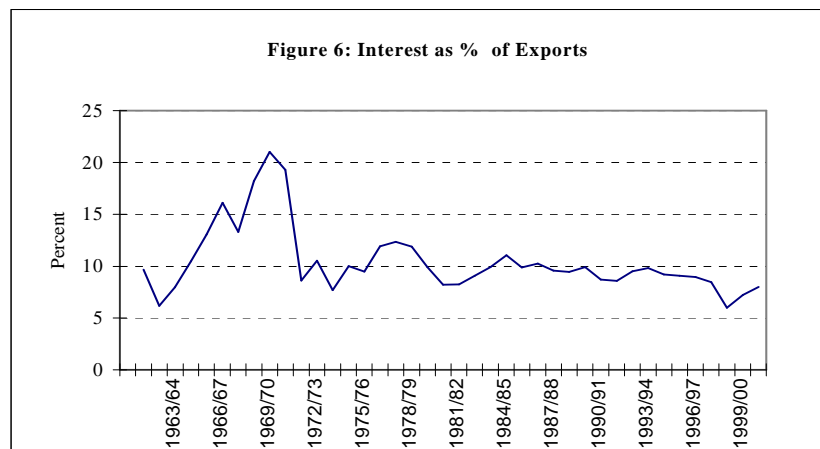
Figure 5 depicts a rising trend in the INT/GNP ratio, although it remained quite low (in the range of 0.2 to 1.4 percent) during the period under study, showing that interest payment is not putting so much burden on the productive capacity of the economy. However, this proposition needs to be examined carefully, keeping in view the unit of account in which the debt is determined in the loan agreements. Since external debt is contracted in foreign currency, it is fully indexed to exchange rate depreciation and, to the extent parity holds, to the changes in the domestic inflation rate. Thus, even though the explicit costs of external debt in terms of interest payments are low, there are significant implicit costs as the external debt in terms of Pak-rupee term keeps on rising with the depreciation of the exchange rate, even when net external borrowing is zero<sup>11</sup>.

### 3.6. Interest Payments: Exports Receipt Ratio (INT/XGS)

<sup>11</sup> The exchange rate was Rs. 4.77 per \$ in 1961/62 and remained stable till 1980 (Rs. 9.91 per \$). However, during the 1980s and 1990s, there was a sharp depreciation leading to Rs. 22.42 per \$ in 1990/91 and Rs. 60 per \$ in 2001/02.



For defining a country as severely-indebted, the World Bank uses the ratio of accrued interest to exports, with a warning line of 20 percent<sup>12</sup>. This ratio is also referred to as interest-service ratio. It is perhaps a better indicator of a country's debt-servicing capacity than the debt-service ratio because creditors are more concerned with a country's ability to service

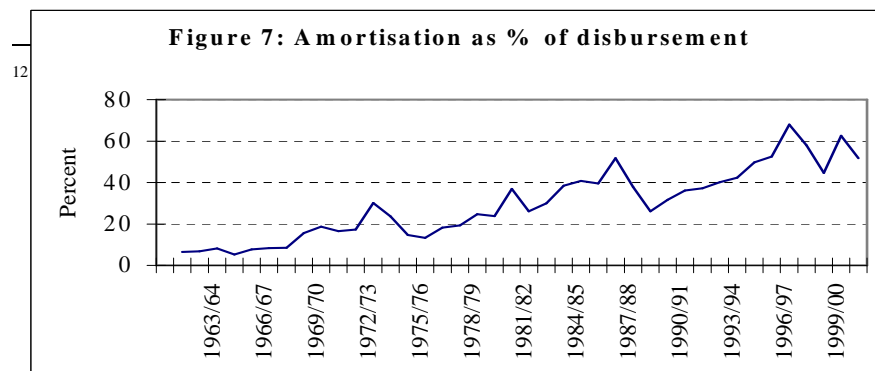


its interest obligations than to pay back the principal.

Figure 6 indicates that the interest-service ratio increased sharply in the sixties and reached its highest value, i. e. 21 percent, in 1969/70. During the seventies, eighties and nineties, however, it averaged 10.1, 9.5 and 8.5 percent respectively.

### 3.7. Amortisation: Disbursement Ratio (AMOR/DISB)

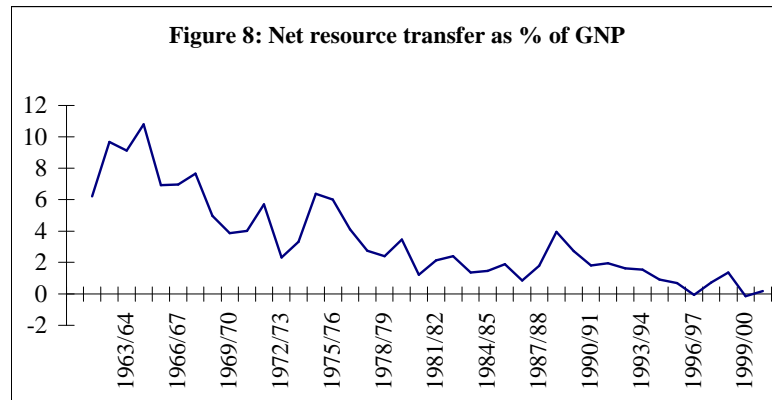
The amortisation (principal) to disbursement ratio reflects a partial relief on a country's resources as new loans are used to roll over the previous ones.



For Pakistan, this ratio has an increasing trend (Figure 7) during the period under study. This means that the economy will have to sacrifice more of its own resources to pay the amortisation. This also reflects an immediate burden on the economy's resources to finance the amortisation.

### **3.8. Net Transfer: GNP Ratio (NTR/GNP)**

Net transfer is the difference between disbursement and debt-servicing (Disbursement during period  $t$  - total debt-service payments in period  $t$ ). Relating this difference to GNP generates what is known as net resource transfer ratio. The magnitude of net resource transfer relative to GNP was highest in 1964/65 (10.79 percent). Since then, it showed a fluctuating decreasing trend. By 1999/00, it reached alarmingly low levels, i.e. -0.15 percent. Due to rapid increase in debt-servicing liabilities, the contribution of foreign savings in Pakistan declined over time.



### 3.9. External Debt Ranking of South Asian Association for Regional Cooperation (SAARC) Countries

In order to make an external debt ranking of SAARC countries, the absolute value of debt stocks and flows as well as debt burden indicators are used in this study. It is clear from Table-1 that Pakistan ranks first in

**Table 1: External Debt Ranking of the SAARC Countries**

SAARC	Stocks			Flows			Ratios					
	EDT	LTD	STD	INT	TDS	NTR	EDT/ GNI	EDT/ XGS	TDS/ GNI	TDS/ XGS	INT/ GNI	INT/ XGS
Pakistan	2	2	2	2	1	7	2	1	1	1	1	1
India	1	1	1	1	2	1	7	4	4	2	4	2
Sri Lanka	4	4	3	6	4	3	1	6	2	3	2	3
Bhutan	7	6	7	7	7	5	4	5	7	7	6	7
Bangladesh	3	3	4	3	3	2	6	3	6	4	6	4
Maldives	6	7	6	5	6	6	5	7	3	6	3	6
Nepal	5	5	5	4	6	4	3	2	5	5	4	5

Note: The World Bank started using Gross National Income (GNI) instead of GNP from 2002.

Source: This ranking is based on the data obtained from The World Bank, *Global*

*Development Finance* 2002, country tables.

all debt indicators except the EDT/GNI ratio. It also ranks first in total debt-service flows. Pakistan's net resource transfer is negative and ranks lowest among SAARC countries. In terms of debt stocks (long and short-term) and interest flows, it stands second among the SAARC countries. It should be noted that this ranking of Pakistan is after rescheduling of debt and service payments<sup>13</sup>.

#### **4. KEY PERFORMANCE INDICATORS**

Of course, all the indicators discussed in the previous section are important, but neither the history of rescheduling nor the econometric analysis of default functions indicates a definitive number of debt burden ratios. Therefore, increase in these ratios might be a warning against a debt crisis. However, in the past, because of re-negotiation cases, there was a large variance in those ratios. Therefore, other factors must be considered in performing a country risk analysis. As suggested by Meier (1995), "beyond ratios, country risk analysis should monitor some 'key performance indicators' that will indicate how national economic management is affecting the growth of the economy and capacity to service the debt". In this study we used four key performance indicators, namely (i) Current Account Balance: GDP ratio, (ii) Fiscal Account Balance: GDP ratio, (iii) National Savings: GDP ratio and (iv) Total Investment: GDP ratio in order to supplement our risk analysis of the previous section.

##### **4.1. Current Account Balance**

Since independence, Pakistan's economy has been experiencing an

---

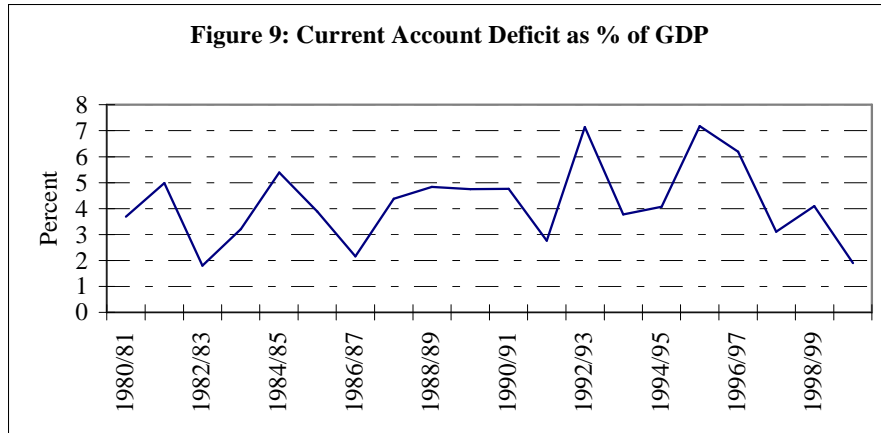
<sup>13</sup> Pakistan's external debt has been rescheduled three times through Paris Club creditors since January 1999.

external balance deficit<sup>14</sup>. The country's terms of trade deteriorated seriously following the inflationary rise in the prices of major imports in 1972/73, especially crude petroleum oil, chemical fertiliser, food grains, edible oils and capital goods. As self-sufficiency in food was not yet achieved, food imports constituted a significant item of the imports bill. Exports, on the other hand, did not increase due to the relatively smaller increase in their prices, inelastic demand and tariff and non-tariff barriers. Thus, the gap between export earnings and import expenditures was to be met through foreign assistance.

Figure 9 shows the time path of current account deficits for the period 1980/81-1999/2000. It reveals that current account deficit remained quite large throughout the period. The recent improvement in the current account deficit was possible mainly due to reduced interest payments on a certain portion of the debt under various rescheduling agreements.

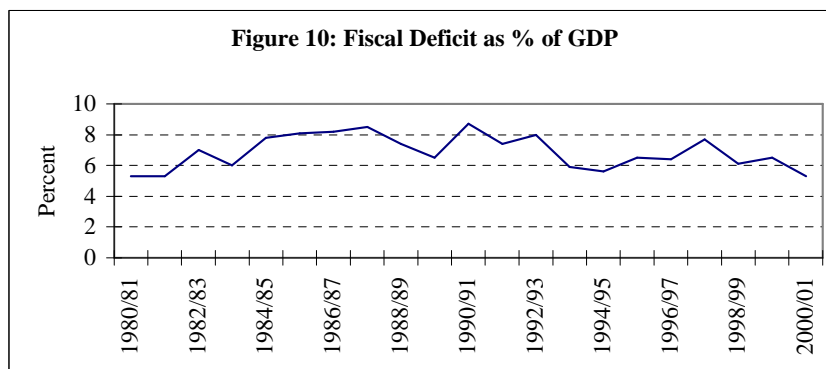
---

<sup>14</sup> However, there are three occasions when the external balance recorded a surplus. The first was in 1947/48 when the import requirements of the newly born country were not yet well defined. The Second was in 1950/51, caused by the Korean War boom leading to an increase in the international prices of Pakistan's major primary commodities. The third was the devaluation of Pakistan's rupee in May 1972 and the diversion of exports from former East Pakistan to foreign markets that helped achieve a surplus in 1972/73.



#### 4.2. Fiscal Account Balance

Pakistan also suffered from a long, persistent fiscal deficit reaching a maximum of 8.8 percent of GDP in 1990-91 (as shown in Figure 10). Although in recent years the deficit declined, it should be noted that this improvement occurred on account of reduced public expenditures on consumption and especially investment.



Primary fiscal account deficit<sup>15</sup> is another indicator of the fiscal health of a country. In Pakistan, the said account was in deficit in 17 years out of the last 20 years despite numerous budgetary and post-budgetary measures taken every year. Primary deficit, which averaged 3.3 percent of GDP in the 1980s, declined to 1.8 percent in the first half of the 1990s and further improved to surplus (to the extent of 0.6 percent of GDP) in the second half. This reveals that Pakistan's fiscal deficit was interest-payment-driven during the second half of the 1990s. It also reveals that the total revenue was more than sufficient to finance non-interest total expenditure.

#### **4.3. National Savings and Investment**

Pakistan's savings record is not very encouraging and national savings averaged 13.9 percent of GDP for the last two decades, which is far below the average of 20 percent in the developing countries.

---

<sup>15</sup> Primary fiscal account surplus/deficit is equal to total revenue minus total non-interest expenditure.

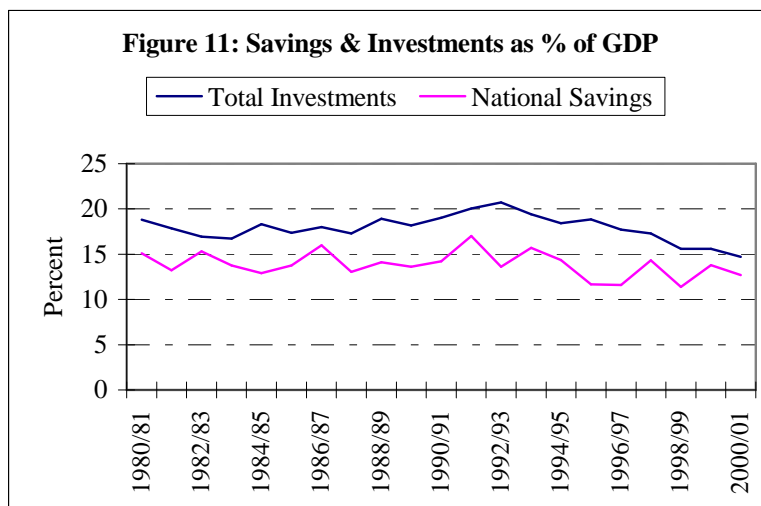


Figure 11 shows that savings in Pakistan have almost always remained less than investment. Thus, external debt accumulation is a mirror image of the domestic resource gap which is the essence of what is known as the two-gap model<sup>16</sup>. It is also important to note that the domestic resource gap has shrunk in recent years due to a slowdown in investment rather than a much-needed improvement in the saving rate.

It is well recognised that, irrespective of ideological differences, all schools of thought agree that economic growth is directly influenced by and strongly correlated with savings and investments. The savings and investment statistics for Pakistan show a continuous decline.

## 5. CONCLUSION AND DISCUSSION

The purpose of this paper has been to examine the various aspects of growth and burden of Pakistan's external indebtedness during the last

<sup>16</sup> For the two-gap model, see Chenery & Strout (1966).



four decades on the one hand, and to perform a risk analysis using indicator approach, on the other. The results of the study are summarised as follows:

1. A review of Pakistan's external debt profile shows that the country has accumulated a large amount of debt over time. The rising burden of external debt and debt-service payments is clearly reflected on the budget and the current account deficits. Debt-servicing also assumes serious proportions. The composition of assistance has also changed markedly over time. The share of soft loans has steadily declined and was substituted by hard term loans and credits repayable in foreign currency with higher interest rates and shorter grace periods. Thus, not only is Pakistan heavily-indebted, but also the changing terms and conditions of the debt are going to make it much harder for the country to get out of the debt burden.

2. The above conclusion further strengthens when we look at the key performance indicators. The study supports the view that the debt situation will deepen if the current trend persists. The interpretation seems consistent with high fiscal and current account deficits, and very low savings and investment ratios. All these factors are indicative of additional financial and economic pressures on the country.

According to economic theory, for a country to get rid of the debt burden, three conditions need to be fulfilled: first, the savings gap should in due course be reversed (marginal propensity to save must be greater than average propensity to save); second, foreign exchange gap should be reversed (either by increasing exports or compressing imports) and finally,

the funds should be invested in projects which yield a rate of return greater than the interest rate on the debt.

By implication, a debt-servicing problem necessarily arises when one or more of these conditions is not fulfilled. Failure to develop a local capital market and reluctance to push domestic interest rates above the rate of inflation (so that real domestic interest rates are not negative) may militate against closing the saving gap. The temptation to maintain an overvalued exchange rate may reduce international competitiveness, and the nature of the commodity produced, the demand for which is both price and income inelastic, prevents countries from turning around their current accounts. And using borrowed funds in areas that do not promote growth means that, even if the savings and foreign exchange gaps can be closed, overseas borrowing still ultimately constitutes a drain in the economy. Such areas include current expenditure and prestige capital projects which turn out to be “white elephants”, as well as channeling the borrowed funds into the foreign exchange market to support an overvalued exchange rate, thereby allowing the rural and urban elites to import luxury consumer goods and engage in capital flight.

The condition necessary for successful debt repayment may also be violated by external factors beyond the control of the country. A marked deterioration in terms of trade, a sharp rise in the interest rate and input prices, and trade barriers have far-reaching effects on a country's capacity to service its debt and get rid of its debt problem.

It is now widely accepted that high-accumulated external debt is a major cause of the stunted economic growth in Pakistan. According to Griffin & Enos (1970), loans were made in the past but repayments occupy the future. What happened in the past is history and what happens

in the future is politics—and there is a great difference between politics and history. Thus, the debt problem is becoming a political issue and an increasing number of economists and policy makers are advocating a more political approach to the debt problem.

There is also a need for debt reduction and debt relief facility, by the bilateral and multilateral donor agencies, to extend further assistance to Pakistan. The rationale for this choice is two-fold: (1) the required debt-service payments for Pakistan are so large that prospects for a return to a faster growth path are not bright, even if the country adopts tough adjustment programmes; and (2) the existence of a large external debt inhibits private investment and discourages the government from adopting adjustment programmes because of the uncertainties and adverse incentive effects they may create. The genesis of the debilitating effect of external public debt on economic growth lies in Krugman's (1988) argument that high governmental debt-service payments require high tax rates, which in turn discourage capital formation and repatriation of outflowed capital. Thus, it is in the interest of creditors to reduce the level of debt through voluntary debt forgiveness. This will result in an increase in investment and growth and, subsequently, increased debt-service payments to creditors.

## **REFERENCES**

Akbar, M. (1995), "Does Aid Distort Development? A Case Study of Pakistan," *The Asian Economic Review*, Vol. XXXVII, No. 2, pp. 358-369.

Aliber, R. Z. (1980), "A Conceptual Approach to the Analysis of External Debt of the Developing Countries." World Bank Staff Working Paper No. 421, pp.1-25.

Avramovic, D. et al. (1964), *Economic Growth and External Debt*, Baltimore, Johns Hopkins Press.

Burkey, A. A. (2000), "Governance of Foreign Aid and its Impact on Poverty in Pakistan: A Critical Review." LEAD Pakistan Occasional Paper, No.9, pp.1-30.

Burney N. A. (1988), "Determinant of Debt Problem in Pakistan and its Debt Servicing Capacity." *The Pakistan Development Review*, Vol. XXVII, No. 4, pp. 805-816.

Chaudhry, M. A. and Sh. Shahbaz A. (1993), "Pakistan's Foreign Dependence, Its Capacity for Debt Repayment and Future Prospects," *Pakistan Economic and Social Review*, Vol. XXXI, No. 1, pp. 39-62.

Chaudhry, M. A. and Sh. Shabaz, A. (1996), "The Bomb of Foreign Debt: Is there any way to escape? A Case Study of Pakistan," *Pakistan Journal of Applied Economics*, Vol. XII, No. 1, pp. 67-84.

Chenery, H. B. and Strout, A. (1966), "Foreign Assistance and Economic Development," *American Economic Review*, Vol. 56, No. 4, pp. 679-733.

Dhonte, P. (1975), "Describing External Debt Situation: A Roll-Over Approach," *IMF Staff Papers*, vol. XXII, No. 1, pp. 159-186.

Dornbusch, R. (1993), *Stabilization, Debt, and Reform*, New York; Harvester Wheatsheaf.

Eatzaz, A. (2001), "Getting Out of Debt Trap: Simulating Debt Retirement Strategies for Pakistan." LEAD Pakistan Occasional Paper No. 12 pp. 1-46.

Erika Platte (1993), "China's Foreign Debt," *Pacific Affairs*, Vol. 66, No. 6, pp. 481-495.

Gafar, S. J. (1986), "The Impact of External Factors on the Debt Burden and Import Capacity of Developing Countries," *The Indian Economic Journal*, Vol. 33, No. 3, pp. 35-45.

Geiger, L. T. (1990), "Debt and Economic Development in Latin America," *The Journal of Developing Areas*, Vol. 24, No. 2, pp. 181-191.

Government of Pakistan, *Economic Survey*, various issues, Islamabad, Finance Division.

Griffen, K. B. and Enos, J. L. (1970), "Foreign Assistance; Objectives and Consequences," *Economic Development and Cultural Change*, Vol. 18, No. 3, pp. 313-327.

Hamilton, J. D. and Flavin, M. A. (1980), "On the Limitations of Government Borrowing: A Framework for Empirical Testing," *American Economic Review*, Vol. 76, pp. 808-819.

Hirshhorn, E. (1984), "Rational Expectation and the Effects of Government Debt," *Journal of Monetary Economics*, Vol. 14, pp. 55-70.

Hughes H. (1979), "Debt and Development: The Role of Foreign Capital in Economic Growth," *World Development*, Vol. 7, No.2, pp. 95-122.

Jang, C. J. and W. D. McMillin, (1983), "The Macroeconomic Effects of Government Debt in Korea," *Applied Economics*, Vol. 25, pp. 35-42.

Karagol, E. (2002), "The Causality Analysis of External Debt Service and GNP; The Case of Turkey." *Central Bank Review*, Vol. 2, No.1, pp. 39-64.

Khan. H. A. and Hoshino, E. (1992), "Impact of Foreign Aid on the Fiscal Behaviour of LDC Governments," *World Development*, Vol. 20, No. 10, pp.148-58.

Khan. S. R. (1997), "Has Aid Helped in Pakistan?" *The Pakistan Development Review*, Vol. 36, No. 4, Part-II, pp. 947-957.

Krugman, P. (1988), "Financing VS Forgiving a Debt Overhang," *Journal of Development Economics*, Vol. 29, pp. 253-268.

Lee, Jungsoo (1983), "The External Debt Servicing Capacity of Asian Developing Countries." *Asian Development Review*, Vol. 1, No.2, pp. 66-82.

Marcel, F. (1996), "Sovereign Debt, Structural Adjustment, and Conditionality," *Journal of Development Economics*, Vol. 50, pp. 313-335.

McDonald, D. C. (1982), "Debt Capacity and Developing Countries Borrowing: A Survey of Literature," IMF Staff Papers, Vol. 29.

Meier G. M. (1995), *Leading Issues in Economic Development*, sixth edition, Oxford University Press.

Metwally, M. M. and Denis O'Brien (1994), "The Debt-Servicing Problem of Some Asian Countries," *The Indian Economic Journal*, Vol. 41, No. 3, pp. 98-110.

Mukherjee, C., White H., and Wuyts, M., (1998), *Econometrics and Data Analysis for Developing Countries*, New York, Routledge.

Schelzig, W. M. (1989), "The Changing External Debt Situation in the Asian and Pacific Region," *Asian Development Review*, Vol. 7, pp. 70-97.

Shariff, I. (1987), "External Debt and Policy Issues in the Developing Countries," *The Indian Economic Journal*, Vol. 34, No. 3, pp. 86-91.

Spaventa, L. (1987), "The Growth of Public Debt," *IMF Staff Papers*, Vol. 34, No.2.

Thirlwall, A. P. (1995), *The Economics of Growth & Development: Selected Essays of A. P. Thirlwall*, Aldershot (U.K.); Edward Elgar Publishing Ltd.

Vernon W. R. (1989), "Why Foreign Economic Assistance?" *Economic Development and Cultural Change*, Vol. 37, No. 3, pp. 410-424.

Waheed, A. (2002), "Being Led into a Debt Trap!" paper presented in the 3<sup>rd</sup> Special Study Meeting of The Japan Society for International Development held in the Graduate School of International Development, Nagoya University, Japan- 29<sup>th</sup> June 2002.

Waheed, A. (2000), "Pakistan's External Debt Profile", *Pakistan & Gulf Economist*, Vol. XIX, No. 19 & 20, May 8-21, 2000.

Were M. (2001), "The Impact of External Debt on Economic Growth and Private Investments in Kenya: An Empirical Assessment." A paper presented at the Wider Development Conference on Debt Relief, 7-18 August 2001, Helsinki.

World Bank (2002a), *Global Development Finance, Country Tables*, Washington D.C. The World Bank.

----- (2002b), *Global Development Finance, Analysis and Summary Tables*, Washington D.C. The World Bank.



----- (2001), Global Development Finance, Analysis and Summary Tables, Washington D.C. The World Bank.

----- (1981), World Development Report, Washington D.C. The World Bank.