HOW TO AVOID A LOST DECADE

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Without debt relief, Pakistan risks a major social upheaval. Here is how to deliver it.

According to the Economist magazine, 53 countries are currently at serious risk of debt distress. Spanning Asia, Africa and Latin America, a billion people live in these countries, and they account for 20 percent of global GDP. Without urgent debt relief, these countries could disintegrate socially, with massive global spillovers in terms of migration and security. A lost decade for development, or worse, would beckon. Pakistan, the fifth most populous country in the world, is one of these countries.

It is regrettable, then, that at this crucial juncture, the international architecture for debt restructuring has stalled. This reflects the complexities of a new world order, in which China has emerged as a major new official creditor, alongside traditional players like Europe and the United States. This architecture urgently needs a revamp, animated by the same spirit of cooperation and benevolence that characterised the postwar period.

In the last fifty years, two generous episodes of debt relief helped rescue several emerging markets and developing economies: the Brady Plan that ended the debt crisis across Latin America in the 1980s and the HIPC initiative that benefited the most heavily-indebted poor countries in Africa and Asia in the late 1990s. Neither of these remarkable breakthroughs would have been possible without the leading economy in the world, the United States, playing a crucial leadership role in forging a consensus on debt relief among diverse creditors.

A similar show of global leadership is urgently needed by major official creditors today, notably Europe, the United States and China as well as multilateral lenders like the IMF and the World Bank. The good news is that the recent Spring Meetings of the IMF and the World Bank have generated optimism that such a coordinated response might be forthcoming after all. Going forward, a grand bargain could be struck whereby debt relief is tied to trackable climate change mitigation and adaptation actions that debtor countries would need to take. As a result, a critical global public good would also be served in the process, to the benefit of citizens all over the world.

Within this fraught global context, let us consider the case for debt relief in Pakistan and how it could be executed. My thoughts below have benefited from the excellent omnibus, "Sovereign Debt: A Guide for Economists and Practitioners" edited by my friend Ali Abbas, a debt expert at the IMF.

For each of the next five years, Pakistan owes the world USD 25 billion in principal repayments. It will also need at least USD 10 billion to finance its current account deficit, bringing total external financing needs to USD 35 billion a year between now and 2027. We have foreign exchange reserves of just USD 3 billion. For each of the next five years, the government needs to pay 5 percent of GDP in interest payments on the debt it owes to residents and foreigners. Our total tax take is only 10 percent of GDP.

Let both those facts sink in. And then quickly realize that the centre cannot hold. For starters, there is no way we can meet our external financing needs without

incurring more government debt. This is because, unlike proper emerging markets, we do not attract any meaningful foreign direct investment (FDI) and our private sector does not generate inflows from abroad.
However, at 78 percent of GDP, our government debt is already approaching levels considered excessive for an emerging market. As a result, borrowing abroad at a reasonable cost is getting increasingly difficult and the overhang from this debt is weighing on domestic investment, which remains stuck at 15 percent of GDP.

Equally, there is no way the government can devote half its tax take to debt servicing and still have enough left over to meet other critical expenses like public wages and pensions, infrastructure, social spending, and defence.

We could, of course, delude ourselves and try to kick the can down the road. We can pretend that we will magically grow our exports, remittances and taxes overnight while shrinking our imports and spending. In their desperation for a bail-out and to avoid admitting past mistakes on debt accumulation, there is real danger that this is what our policy makers will agree with the IMF.

But that would be a recipe for disaster. It has not worked anywhere in the world and it will not work in Pakistan. It would impose unbearable austerity on a population already reeling from 30 percent inflation, a poverty rate of 40 percent on the World Bank's USD 3.65 a day definition, and biblical flooding that has left 30 million people homeless. It would be foolish, reckless and politically impossible to deliver – potentially sparking a major social revolt.

Instead, it would be far better to accept that government debt in Pakistan is no longer sustainable. So where would this admission leave us? Our airwaves are currently dominated by a false choice between default and paying all our debts on time, even at the cost of endless austerity.

But there is a third option. It involves pre-emptively restructuring our government debt, in a way that immediately and adequately frees up resources to be deployed to cushion the current slowdown and implement much needed structural reforms. We would not miss any debt repayment (the definition of a default) but would renegotiate the terms of our existing debt with our creditors such that these repayments become less onerous. While this could take some time and may lead to arrears, the IMF and financial markets would be forgiving as long as these negotiations were being conducted in good faith and would help to make our debt sustainable again.

Let us consider how this might work. Today, Pakistan's domestic government debt is around 50 percent of GDP and mainly held by our banks. At the same time, Pakistan's external government debt stands at around 28 percent of GDP or USD 100 billion. Around fourth-fifths of this external debt is owed to the official sector, split roughly evenly between multilaterals (like the IMF, World Bank and ADB) and bilaterals (countries like China, Saudi Arabia and the United States). The remaining one-fifth is commercial, again roughly evenly split between Eurobond/Sukuk issuances and borrowing from Chinese and Middle Eastern banks. By region, we owe roughly one-third of our external debt to China and 10 percent to the old-boys network of the Paris Club, which includes Europe and the USA.

In considering how a debt restructuring can be implemented, there are always two key considerations. First, which creditors to include. Second, how to distribute the debt relief evenly across these creditors, including whether to impose a haircut (a cut in the nominal value of the debt), a reduction in coupon payments (interest and principal repayments), or a lighter re-profiling (a lengthening of maturities, with no change in the principal or interest payments).

With regard to the first consideration, a key issue will be whether to include domestic debt. While it is external debt that is most difficult for us to service since it requires foreign exchange, we could create much more fiscal space by including domestic debt in the restructuring effort. Indeed, judging from the position that China has taken in other ongoing debt restructuring efforts, we may need to include domestic debt. This is tricky and should be very carefully evaluated, as it would involve domestic banks and could risk their balance sheets if done in too cavalier a fashion. Moreover, the burden of domestic debt can also be reduced by alternative means, including by maintaining low interest rates, inflating it away, and imposing additional taxes on the banking sector. That said, if we do choose to go down this route, there are successful precedents, including Jamaica (2010, 2013) and Uruguay (2003). As discussed in Ali's book, these were largely voluntary debt exchanges, featuring diverse strategies including haircuts, reductions in coupons and maturity extensions.

Beyond this, there will also be pressure to include all external creditors. On the official side, the IMF will be excluded due to its senior creditor nature. However, others like the World Bank and Asian Development Bank have a murkier status and could be pushed to at least roll-over debt service falling due to them and possibly even provide additional long-term concessional funds, as part of a comprehensive debt renegotiation with all of Pakistan's external creditors. Indeed, even the IMF has de facto provided debt relief as part of the 1996 HIPC and 2005 MDRI initiatives.

As an aside, we should note that Pakistan has benefited from such generosity in the past. We were part of the HIPC initiative in the early 2000s, when geopolitical winds were blowing in our favour during the Musharraf era. With both multilaterals and the Paris Club (representing our major official creditor at the time) voluntarily participating, our government debt was slashed from 72 percent of GDP in 2001 to only 47 percent by 2007. Regrettably, instead of using this new-found fiscal space to enact difficult structural reforms to boost investment and grow exports, we wasted it on promoting consumption and running huge fiscal deficits. We must not repeat this folly if we are once again granted debt relief.

Next, our USD 20 billion of commercial debt would need to be addressed. These negotiations can take longer but the ability to convene creditor committees and invoke 'collective action clauses' mean that they no longer can be dragged out indefinitely. Without including private debt in the debt restructuring, official bilateral creditors will never come on-board. But once they do, it is heartening to note that official bilateral debt has been frequently restructured across the world.

The major issue on the official bilateral side will be how to convince China to join the effort. As a newcomer to the debt game, China is still learning the ropes. To date, it has remained wary of both existing Western-dominated mechanisms for official debt restructuring like the Paris Club, as well as fall-out at home from being perceived as having made bad loans in its extensive lending operations around the world.

But it is imperative for China to show global leadership at this critical juncture. As explained above, bringing domestic debt and multilaterals into a comprehensive operation may help coax China to join the overall debt restructuring effort. In addition, given Pakistan's special relationship with the Chinese, diplomatic channels can also be leveraged beyond purely economic and technocratic discussions.

If all else fails, in order to address China's concerns related to confidentiality and creating a precedent for other indebted countries, a side deal could be cut with China alone without the need to involve other creditors. Provided the operation is ambitious enough, this could work on its own given that almost one-third of our external debt is owed to China.

So there you have it. For such a debt restructuring to work, the government will need to be proactive and hire professional services. Done well, it could be a game-changer for Pakistan, freeing up vital financing space in the order of USD 30-40 billion over the next 2-3 years and preventing mindless austerity. Delayed or executed poorly, it could backfire. The stakes are high and the hour is getting late.

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