

## Debt in Pakistan: Sustainable or Not?

The developing countries are in debt trap. They need external funds since they cannot generate adequate resources domestically to achieve economic growth to improve their livelihood. In general, the government use three methods to finance their expenditures, they may increase the taxes, can print the money, and borrow the money. Due to variety of advantages of borrowing the governments prefer to borrow. Therefore, they borrow from external resources and in curdebt. Most of the times, the repayments are not easy for them, and they face debt sustainability issues, and consequently, it hits the economic growth process.

The countries incur debt due to the shortage of local finances. It is a norm in the life of countries that they incur debts. But the important question is how much is too much? That is, how much debt is beneficial for the countries and after what limit it is dangerous for the economies. It depends on the debt sustainability of the country. When a country is able to meet all its payment obligations, current and future, without taking exceptional finances from the external resources without being default is known as debt sustainable country. The sustainability of the debt of a country depends on the number of factors like the quality of institutions, debt management capacity and macroeconomic fundamentals, that is, economic growth.

There are a number of studies which give the various criteria for the sustainability of the debt which depend on the size of the economy, capacity of repayments, credit rating and various other indicators. However, the seminal study of Reinhart and Rogoff (2010) got colossal attention in this regard, which claimed that a debt to GDP ratio, which is higher than 90 %, negatively hurts economic growth. Then plenty of literature is produced to evaluate this claim. This study also links the debt sustainability with GDP growth. The literature further suggests that the tax rate increase to substitute the debt will not make a reasonable attempt in lower-income countries. However, improvement in the economic environment to create an investment-friendly environment is suggested.

Therefore, the debt-growth nexus remains a widely discussed issue in the empirical literature of economics and finance. The empirical literature can be divided into three main categories: linear negative relationship, positive linear relationship, and nonlinear relationship. Linear positive relationship implies that a country grows as the level of debt increases. Theoretically, it is an ideal condition since the economy can increase debt to encounter their developmental goals, such as developing their physical and human infrastructure. Conversely, a negative link guides that an economy's growth declines when it increases its public debt. When the debt may affect both positively and negatively, then it is known nonlinear relationship.

### Debt Sustainability in Pakistan

The debt to GDP ratio has continuously increased in Pakistan's last ten years (see figure 1). Therefore, the question of fiscal sustainability is quite relevant here. Notably, we need to understand how the debt to GDP ratio will remain in a manageable range. The Fiscal Responsibility and Debt Limitation (FRDL) act suggests that the debt should remain around 60 percent of the GDP. The debt management in Pakistan is somewhat a complex issue in Pakistan (see box 1).

According to the International Monetary Fund (IMF) suggestion the calculation of the debt sustainability depend on three important variables, interest rate, GDP growth rates and the existing debt of GDP ratio. The higher interest rate implies that higher debt servicing, which adversely affects the debt dynamics. On the other hand, higher economic growth means a lower debt to GDP ratio. Therefore, as long as the cost of borrowing is less than the economic growth, the debt burden will not rise. Consequently, debt sustainability will be questionable in lower economic growth and high-interest rate environment in Pakistan.

Jalil (2020) develops several scenarios, based on some assumptions, to evaluate the case of Pakistan. More clearly, what should be the threshold level of economic growth to be solvent. The conclusion of the study is that at least 8 percent economic growth is required for the sustainable debt.

## Conclusion

We see overwhelming evidence from the literature that there is a negative relationship between debt and economic growth. In the backdrop of Pakistan's current public debt trajectory, these outcomes should be worrisome for the policymakers and the public. There is no confusion that the lower economic growth will significantly negatively impact the living of the population of Pakistan. On the other hand, high economic growth will help to reduce the debt to GDP ratios. Therefore, the policymakers should adopt a new growth strategy based on a market-friendly, investment-friendly, and transaction friendly environment.

### *Box 1: Existing Structure of Public Debt Management in Pakistan:*

Debt management in Pakistan is scattered among various institutions and entities, most of them within Ministry of Finance. Debt management includes:

**Budget Wing** and Debt Policy Coordination Office (DPCO) carries out front office function of domestic wholesale borrowing (regarding target maturity, tenors to be offered, financing plan, estimated deficit and auction target) in consultation with State Bank of Pakistan (SBP), while SBP carries out the back-office functions of domestic debt management. Budget Wing and DPCO also approve the profit rates to be paid on the instruments issued by the CDNS.

**Central Directorate** of National Savings (CDNS) raises funding for the government in the domestic retail market (National Saving Schemes). It operates a substantial network of savings centers and also distributes products instruments through post offices and commercial banks. It handles all administrative actions associated with its instruments including selling, encashment, registration and debt servicing.

**External Finance Wing** deals with IMF, and carries out front office function for contracting debt from international commercial sources.

**Economic Affairs Division (EAD)** is responsible for raising external funds, both grants and loans, from multilateral and bilateral creditors and manages the debt management system (Debt Management and Financial Analysis System - DMFAS) in use for all external debt.

**Debt Policy Coordination Office (DPCO)** is organized under a separate law entitled Fiscal Responsibility and Debt Limitation Act (FRDLA). The office is responsible from preparing a debt reduction path, providing policy advice on domestic and external borrowing, monitoring and evaluating the debt reduction path and debt management strategy, providing consistent and authenticated information of government debt and guarantees and maintaining a centralized and updated record of government debt and guarantees. Agreements for guarantees on external loans are prepared and issued by the External Finance (EF) Wing, while agreements for guarantees on domestic loans are prepared and issued by the Corporate Finance (CF) Wing. DPCO gives concurrence as per FRDL Act and compiles the information regarding these guarantees. DPCO also performs front office function for contracting debt from international capital market.

To further elucidate, debt management functions in Pakistan are significantly fragmented as:

(i) Borrowing function split into five units:

- I. Economic Affairs Division (EAD).
- II. External Finance Wing.
- III. Budget Wing.
- IV. Central Directorate of National Savings (CDNS).
- V. Debt Policy Coordination Office.

(ii) Debt operations, which pertains to debt recording and servicing is split into three units:

- I. Economic Affairs Division (EAD).
- II. Central Directorate of national Savings (CDNS).
- III. State Bank of Pakistan (SBP).
- iii) Risk management (Middle Office) function is being fulfilled by DPCO.

## The debt to GDP ratio in Pakistan

