

SBP Staff Notes

04/16

Perspectives on Public Debt Sustainability

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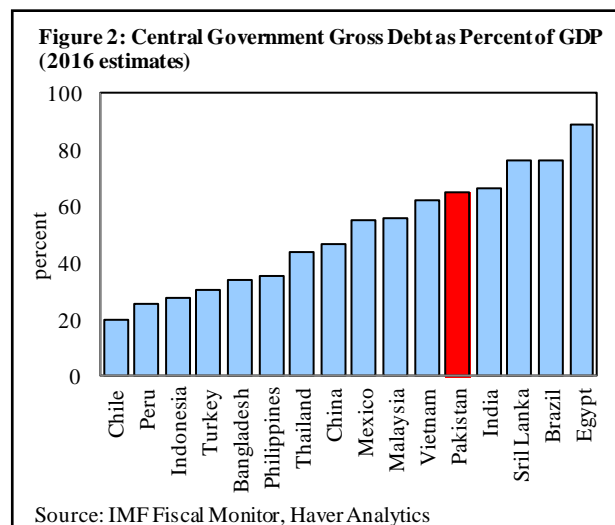
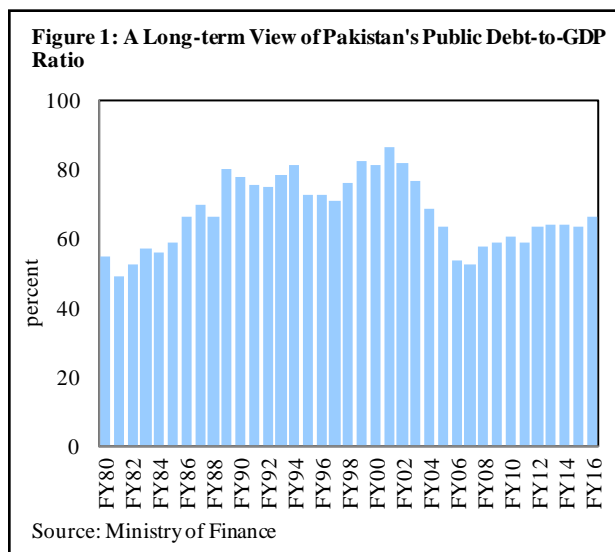
I. Introduction

Pakistan's public debt to GDP ratio has been hovering around 65 percent over the past five years (**Figure 1**). The current level of this ratio, though higher than the trough seen in 2007, is lower relative to where it had stayed throughout 1980s and 90s. Compared to other emerging market economies, Pakistan's standing is mixed: it has a lower debt-to-GDP ratio compared to India, Brazil, Sri Lanka and Egypt, but higher compared to most East Asian and Latin American countries (**Figure 2**). That said, an important aspect is that the public-debt to GDP ratio in Pakistan represents a deviation from the ceilings prescribed under the FRDL Act, which has been in place since 2005.

While comparisons presented above are important to put debt numbers into perspective, these do not speak anything significant about the sustainability. For instance, we cannot infer from **Figure 2** that Pakistan's public debt is more sustainable than Sri Lanka's or Egypt's, or less sustainable than Philippines. By the same token, the statutory slippage *per se* does not indicate looming debt distress.

At its core, the term debt sustainability refers to a situation in which a "borrower is expected to be able to continue servicing its debts without an unrealistically large future correction to the balance of income and expenditure."¹ As such, for public debt to be sustainable, the following conditions are required: (i) debt restructuring is not needed at the current level, nor is it expected to be needed; (ii) the economic growth rate exceeds the average servicing cost, or, if it does not, then primary fiscal surpluses are being generated that are sufficient to keep the debt/GDP ratio at least constant; (iii) the borrower does not keep on indefinitely accumulating debt faster than its capacity to service these debts; and most importantly, (iv) creditors must expect that the government will make the fiscal adjustment required to stabilize its debt-to-GDP ratio at some point in future.²

Therefore, in addition to rigorous quantitative assessment, several subjective factors also matter for debt sustainability analysis: the government's *resolve* to generate sufficient primary surpluses, and *expectations* of creditors, etc. The futuristic aspects of these factors make the sustainability analysis somewhat complex. However, past trends, current dynamics (risk indicators), performance of primary and revenue balances, and country comparisons/experiences, provide some indication of existing comforts and vulnerabilities; this section analyzes Pakistan's debt profile on similar lines. While some important parameters have already been discussed in SBP's Annual Report of 2015-16, this note will present a longer term perspective of these trends;



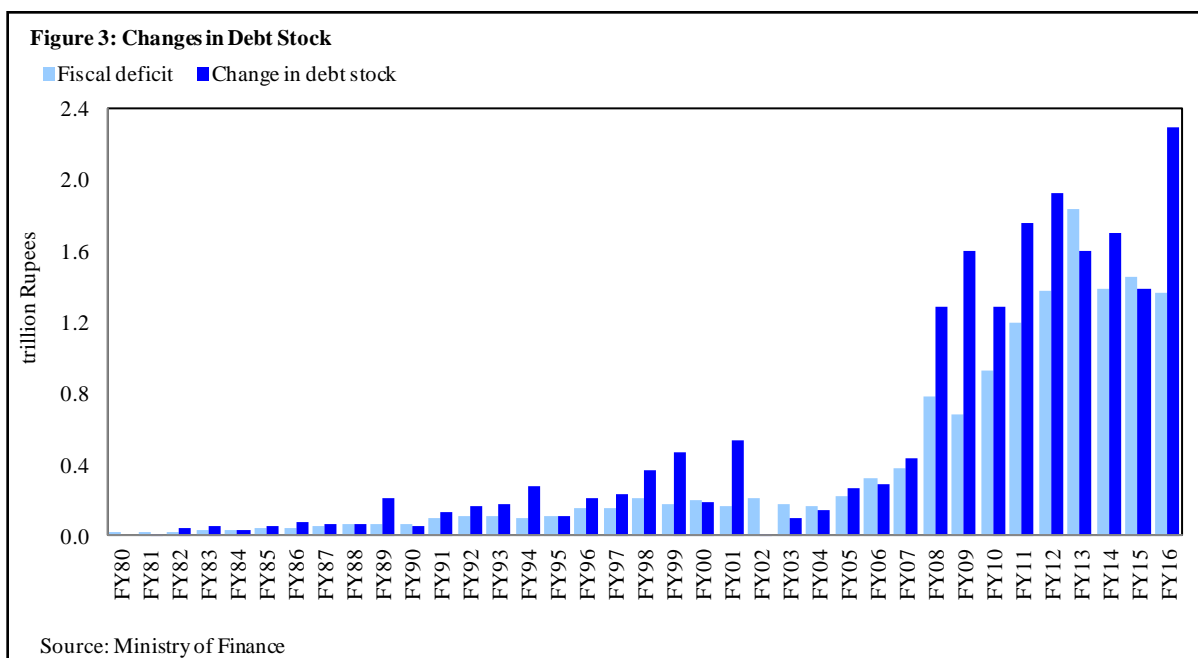
¹ International Monetary Fund "Assessing Sustainability" Prepared by the Policy Development and Review Department, approved by Timothy Geithner, May 28, 2002

² Montiel, Peter (2011), "Macroeconomics in Emerging Markets", Cambridge University Press, 2nd Edition.

revisit theoretical considerations on the subject; evaluate the nature of debt ceiling; and review externalities associated with a high volume of public debt.

Why has Pakistan's public debt burden grown over the last decade?

It began with a sharp increase in global commodity prices in FY08. The government's subsidy expenditure quadrupled during this year (from less than 1 percent to 4.1 percent of GDP): prices of oil and fertilizers increased dramatically in the global market but the government decided to keep these unchanged in the domestic market. The overall fiscal deficit rose by an unprecedented Rs 400 billion over the previous year to reach Rs 777 billion in FY08 (**Figure 3**).³ As a result, the government's financing needs increased, which were met from both domestic and external sources (mainly long-term loans from multilaterals). A sharp depreciation of the PKR in the last quarter of FY08 also contributed significantly to a rise of Rs 664 billion in total public debt during the year. By the end of FY08, in response to inflation touching double digits after almost a decade, SBP had raised policy interest rate to a decade-high level of 12.0 percent. This, along with a rise in the maturity of external loans, meant that the government's interest expense was set to increase.



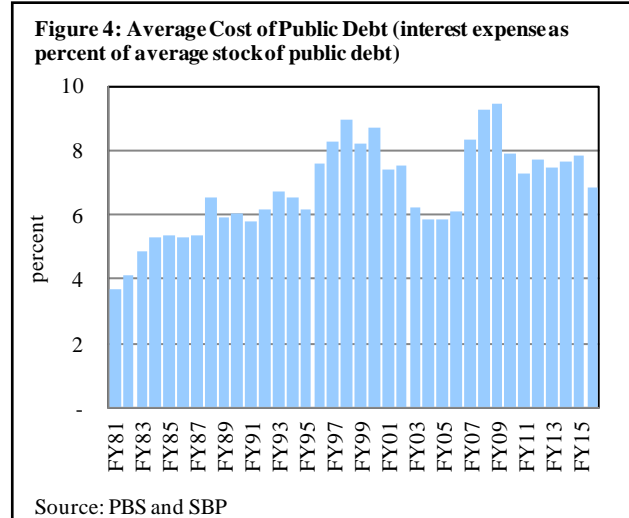
The next year (FY09), interest expenses ate up 50 percent of tax revenues. The overall fiscal deficit shrank in nominal terms (from Rs 777 billion in FY08, to Rs 680 billion in FY09). This consolidation owed primarily to expenditures containment, particularly subsidies (that were cut from 4.1 percent of GDP to 1.7 percent). However, fiscal consolidation did not help contain the growth in public debt; the *increase* in public debt during FY09 was higher than the preceding year, as Pakistan had to borrow US\$ 3.7 billion from the IMF under the Stand-by Agreement (SBA) for balance of payment support.

Not only did the SBA program increase the external debt burden, it also caused a shift in the pattern of domestic borrowing: since the program put limits on the government's borrowing from SBP, the government had to resort to commercial banks to meet budgetary requirements. The 6-month T-bill cut-off rate

³ In the hindsight, this situation was a stroke of bad luck: commodity prices spiked abruptly, and before the government could take a firm decision on subsidies, this burden built up. Probably the indecisiveness of the government could be traced to political turmoil the country was going through during the second half of 2007 (the interim government took over in Nov 2007; elections took place in Feb 2008; and the new government took over in Mar 2008). Between Jul 2007 and Mar 2008, oil prices posted an increase of 49 percent, whereas between Mar 2008 and Jun 2008 (the first three months of the new government), oil prices increased by another 29 percent.

dramatically increased from 9.6 percent to 12.9 percent during the year. This pushed up the average cost of public debt to a record-high level (**Figure 4**).

Fiscal management remained difficult in the subsequent two years (FY10 and FY11), due to various factors. These included worsening law and order situation in the country that necessitated higher spending on defence and security; unprecedented floods in July and August 2010, which required allocation of sizable resources for rehabilitation of victims; and continued inefficiencies in the energy sector that inflated subsidy expenses and also led to piling up of payable subsidies to the energy sector value chain (circular debt). Meanwhile, interest expense on accumulated debt continued to consume around 43 percent of tax collection. Nonetheless, public debt to GDP ratio continued to hover closely around the statutory ceiling of 60 percent by the end of FY11.



Settlement of circular debt put pressure on fiscal account in FY12 and FY13. The government paid Rs 391 billion to settle the inter-corporate debt of energy-related PSEs in FY12, whereas it paid an additional Rs 322.2 billion in FY13 to settle the circular debt. Technically speaking, these were the government's pending liabilities, which should have been accounted for in previous years' fiscal operations. The overall fiscal deficit escalated to 6.8 percent of GDP in FY12, and to a decades-high of 8.2 percent in FY13. It was this period when the public debt to GDP ratio went on a significant departure from the statutory ceiling and hit 64.0 percent at end FY13.

Fiscal consolidation was supported by the IMF program during FY14-16. The fiscal deficit during this period came down to only 5.1 percent of GDP on average, compared to 7.2 percent in the preceding three years (i.e., FY11-13). A major support came from the Extended Fund Facility program of the IMF, initiated in September 2013, which had put several structural benchmarks for fiscal performance via enhanced tax reforms, expenditure containment and privatization of loss-making PSEs. The impact of improvement on fiscal front was evident in a relatively stable public debt level during FY14 and 15 (when it stayed at around 63.3 percent of GDP); however, in FY16, the debt burden grew sharply to reach to 66.5 percent, due to revaluation losses and excessive borrowings.

II. Assessing debt sustainability

This section will be analyzing the debt sustainability from following perspectives: liquidity; solvency; statutory ceiling; and externalities.

A. Liquidity

Liquidity problems emerge for public debt sustainability if the liquid assets/available financing of the government are insufficient to meet or roll-over maturing liabilities. Similar to most developing economies, the liquidity risk for Pakistan's debt management pertains primarily to the external debt. The reason is straightforward: servicing and repayment of the external debt has to be made from only the FX component of the country's resources; this may be done through reserves draw-down; fresh borrowings; and FX earnings (export receipts, remittances, etc.). Domestic debt does not typically entail repayment issues because it can easily be rolled over (most of the times), and in worst cases, can be repaid via printing of money.⁴ This is the

⁴ This does not imply that domestic debt can be accumulated indefinitely: there are very strong negative externalities associated, which weaken economic growth.

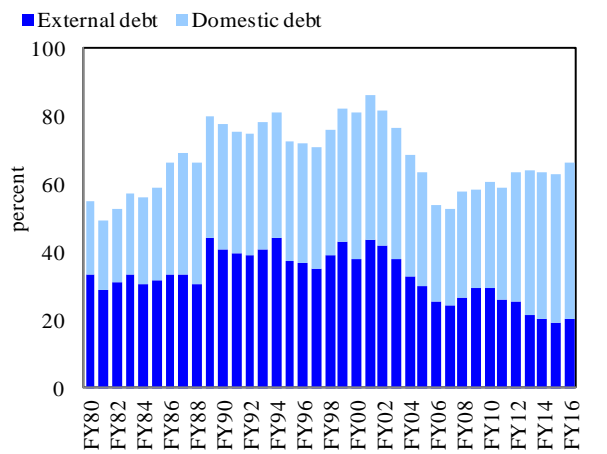
reason why sovereign defaults on the domestic debt had been quite rare over the past 60 years or so.⁵ Defaults on the external debt, on the other hand, have been quite common over the same period; this debt is not only a burden on fiscal sources, but also on balance of payments.

Encouragingly, Pakistan's external debt-to-GDP ratio has been falling consistently over the last 6 years (Figure 5). The level seen at end 2015 is less than half the level seen in 1998, when Pakistan had faced a full-blown FX crisis (FX accounts were frozen; a big chunk of external debt had to be rescheduled; commercial bank credits were restructured; and central bank liabilities were rolled over). Presently, Pakistan can be counted among those emerging market and developing countries, where external debt constitutes a relatively small proportion of the total public debt (Figure 6).

However, when it comes to the sustainability of external debt, there is little information that can be gathered from these proportions. In fact, the 'threshold' size beyond which a credit event *can* take place, varies from country to country, and also from time to time for a certain country. For instance, at the beginning of the 1989 credit event in Jordan, the size of its external debt was 179.5 percent of GDP; however, Albania faced crisis with a debt burden of only 45.8 percent a year later (Table 1). Similarly, Peru defaulted on its external payments with a debt burden of only 62 percent in 1984, though it had defaulted just six years ago when its burden had reached 80.9 percent.

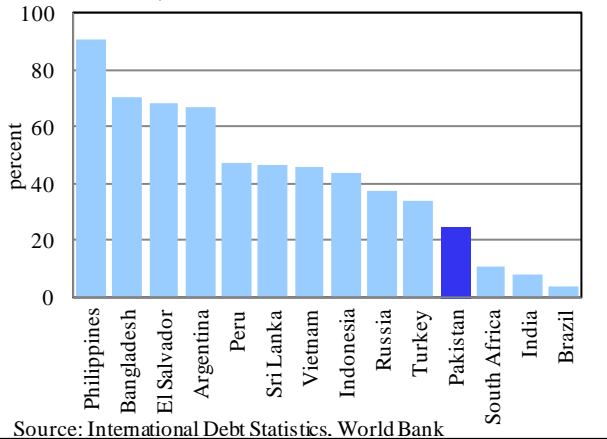
Instead of size, two factors matter for gauging the liquidity comfort: the existing FX cover; and the future expected balance of payments. As for the FX cover, Pakistan's outlook undoubtedly shows immense improvement compared to what it was before the EFF program; however, this improvement does not also imply comfort.⁶ Presently, SBP's FX reserves cover 24.9 percent of the external debt, which is lower than other emerging economies (Table 2). It implies that there is a need to generate additional FX surpluses *in the future* to pay off over three-fourth of the *existing* debt. More importantly these surpluses should be generated via FX earnings (exports of goods and services, and remittances), not borrowings.

Figure 5: Composition of Public Debt (% of GDP)



Source: Ministry of Finance

Figure 6: Share of External Debt in Total Public Debt (end-December 2015)



Source: International Debt Statistics, World Bank

⁵ A couple of episodes of default on domestic debt, however, are noteworthy: (i) in 1990, the Brazilian government had abrogated the inflation indexation clauses in the original debt contracts; and (ii) in 1998-99 Russian government had unilaterally extended bond maturities: it restructured all ruble denominated debt falling due between August 19, 1998 and December 31, 1999 (except paper held by households and the central bank) amounting to 10.8 percent of GDP.

⁶ From only 9.9 percent in FY13, the ratio of SBP reserves to total external debt and liabilities has increased to 24.9 percent at end FY16.

Table 1: External Debt Burden at the Beginning of Credit Event

		External debt to GNP in initial year	External debt to exports in initial year			External debt to GNP in initial year	External debt to exports in initial year
Albania	1990	45.8	616.3	Jordan	1989	179.5	234.2
Argentina	1982	55.1	447.3	Mexico	1982	46.7	279.3
	2001	53.3	458.1	Morocco	1983	87	305.6
Bolivia	1980	92.5	246.4	Panama	1983	88.1	162
Brazil	1983	50.1	393.6	Peru	1978	80.9	388.5
Bulgaria	1990	57.1	154		1984	62	288.9
Chile	1972	31.1	n.a.	Philippines	1983	70.6	278.1
	1983	96.4	358.6	Poland	1981	n.a.	108.1
Costa Rica	1981	136.9	267	Romania	1982	n.a.	73.1
Dominican Rep.	1982	31.8	183.4	Russia	1991	12.5	n.a.
	1982	60.1	281.8		1998	58.5	179.9
Ecuador	1999	89.2	239.3	Trinidad	1989	48.1	112.8
Egypt	1984	112	282.6	Turkey	1978	21	374.2
Guyana	1982	214.3	337.7	Uruguay	1983	63.7	204
Honduras	1981	61.5	182.8	Venezuela	1982	48.6	220.9
Iran	1992	42.5	77.7		1995	44.1	147.2
Jamaica	1978	48.5	103.9				

Source: Reproduced from Montiel, Peter (2011), "Macroeconomics in Emerging Markets", Cambridge University Press, 2nd Edition.

From practical aspects, a better indication of FX strain is the size of upcoming external debt servicing, relative to available SBP FX reserves. Pakistan's position was quite vulnerable at the start of EFF program, as the scheduled repayments (especially to the IMF) during FY14 were more than the available SBP reserves at the start of the year (end-June 2013). Importantly, expected disbursements were not sufficient to make up for lumpy repayments. However, the country's re-engagement with the IMF from September 2013 onwards, along with the comfort it gave to other IFIs, ensured timely settlement of all the dues. Since then, the servicing of Pakistan's external debt is less of a burden.

For FY17, scheduled servicing (both principal and interest) to external lenders is equivalent to 46.1 percent of SBP reserves available at end June FY16. Here it is important to mention that while some of the maturing liabilities are expected to get rolled over conveniently, the government is also expecting fresh disbursements of around Rs 819.6 billion in FY17 (Table 3). This suggests that though the net FX position in FY17 might not be an issue, the external debt stock would continue to increase, adding up to the servicing cost in the future. Moreover, a big chunk of financing is being expected from the market (i.e., borrowing from commercial banks and via bond issuance). These borrowings entail higher cost than multilateral and bilateral loans.

Table 2: Key Indicators of External Debt (ED)

percent	ED to GNI	ED servicing to exports	Reserves to ED stock
Pakistan	23.9	19.3	24.9
India	22.7	18.6	65.5
Indonesia	34.1	23.1	37.1
Bangladesh	18.8	5.2	62.4
Philippines	22.7	7.5	92.8
Turkey	51.6	25	26.2
<i>South Asia</i>	23.5	17.5	58.5
<i>Latin America</i>	29.5	15.6	53.5
<i>Low & middle-income</i>	22.2	8.9	113.5

Source: International Debt Statistics, World Bank

Table 3: Estimates of Foreign Assistance

billion Rupees	FY16	FY17
ADB	134	110.6
Sovereign bond	52.2	105.5
IDA	179.5	155
IDB	114.7	49.7
China	144.5	60.4
Saudi Arabia	4.5	2.1
Commercial banks	102.6	211.5
Others	127.8	124.9
Total external financing	859.7	819.6

Source: Budget documents for 2016-17

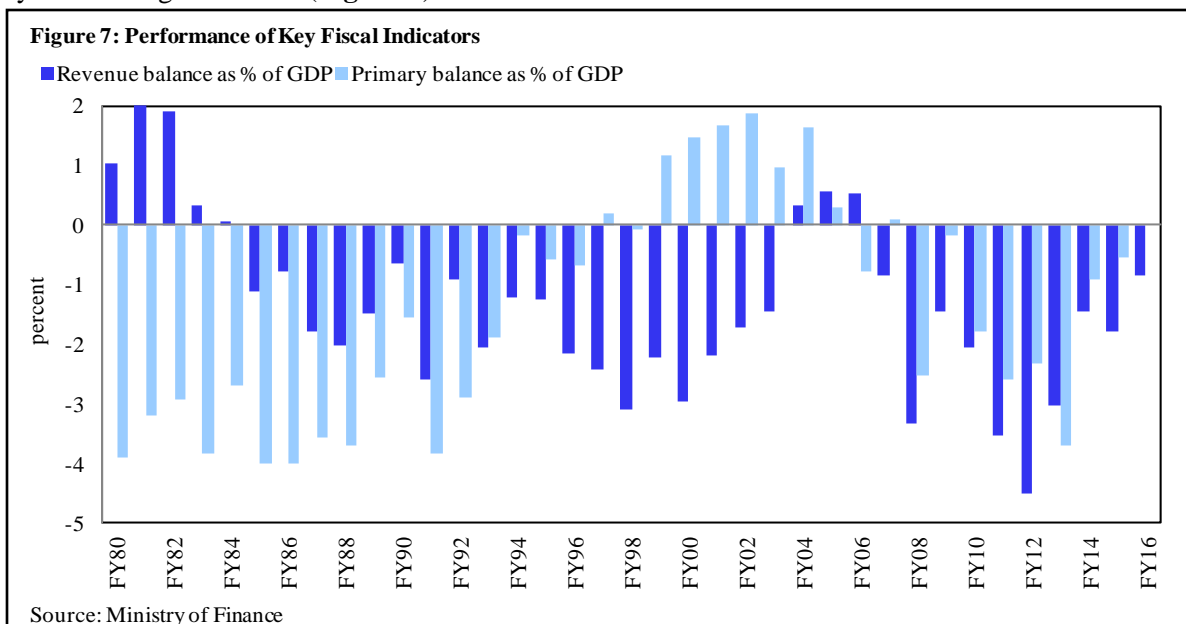
B. Solvency

The solvency constraint requires that the discounted value of future primary balances should be at least equal to the initial public debt. This means that if a government is initially running primary deficits and has a stock of initial debt, it needs to run primary surpluses over time to remain solvent. This criterion, however, has been termed quite loose and purely theoretical by some (e.g., Roubini, 2001), since it allows a country to run very large primary deficits for a very long time if it could *credibly* commit to run primary surpluses in ‘an uncertain vague future’ to satisfy the condition.⁷

From a practical perspective, therefore, a *non-increasing public debt to GDP ratio* is seen as a sufficient condition for sustainability: a country is likely to remain solvent as long as the ratio is *not* growing.⁸ However, Montiel (2013) goes a step further to say that even if the public debt to GDP ratio is *currently* increasing, the solvency condition can still be satisfied *as long as its creditors expect it to make the fiscal adjustment required to stabilize its debt-GDP ratio at some point in the future*. The bottom line is that irrespective of the size, if the public debt to GDP ratio is stable, and creditors are willing to roll-over the old debt and/or issue new one, governments remain solvent.⁹ Therefore, we will discuss the solvency issue from both perspectives: the stability in public debt to GDP ratio, as well as creditors’ ability and willingness to lend.

- *Stability of public debt*

An important element of debt reduction or stabilization strategy is to accumulate revenue surpluses that guarantee the use of public debt solely for development purposes. A major reason behind a high debt-to-GDP ratio in Pakistan is the incurrence of revenue deficit over the past 9 years; persistence in this deficit implies that a large part of public borrowings (that financed government’s current expenditures) did not add to the repayment capacity of the economy. Another factor that contributed in deteriorating the debt burden in the country is the incurrence of primary deficits; the government has not been able to generate sufficient resources to pay off existing debt stock (**Figure 7**).



⁷ Roubini, Nouriel “Debt Sustainability: How to Assess Whether a Country is Insolvent”, Stern School of Business, New York University, December 20, 2001.

⁸ This criterion is related to the “resource balance gap”. More specifically, “a country where the public debt to GDP ratio is growing, the fiscal “primary gap” is the difference between the fiscal primary balance and the primary balance required to stabilize the debt to GDP ratio. Such required primary surplus will be larger, the bigger the public debt to GDP ratio and the differential between the real interest rate and the growth rate of the economy”.

⁹ Since these judgments are made in the *present* on the basis of projections of the resources that will be available to the government in the *future* for servicing debt, solvency assessments are inherently forward-looking exercises.

In the past 3 years, both the primary and revenue deficits have declined appreciably; however, the impact of this fiscal improvement did not help reduce the public debt, which continued to rise. As discussed in the Annual Report of 2015-16, this may be attributed to the absence of a centralized mechanism of government deposits with the banking system that caused budgetary borrowings to rise in excess of actual fiscal needs.

In addition to fiscal adjustment, stabilizing the public debt also requires managing its average cost. SBP has brought down domestic interest rates quite sharply over the past couple of years; this has led to a significant reduction in the average cost of debt. Meanwhile, the share of external debt has also inched up in the overall public debt during FY16, which also contributed to this reduction. Importantly, the average cost of public debt (the country's financing need) has mostly remained less than the nominal GDP growth (the resource base).

- *Creditors' ability and willingness to lend*

This discussion should be grounded on the key question: is there a reason to believe that creditors would not roll-over the government of Pakistan debt, or wouldn't issue additional debt? For external debt, the key consideration of the lenders is to check whether the country would be able to generate FX resources (via exports and FDI) sufficient to make smooth repayments. In this context, IFIs and rating agencies have started to take a positive view of Pakistan lately, following the improvement in security situation in the country as well as ease in energy and infrastructure constraints faced by businesses.

As far as domestic debt is concerned, creditors would not expect anything unprecedented; domestic debt obligations have always been honored by the government of Pakistan. However, there is a possibility that creditors may not be in a position to roll-over old debt due to unavailability of funds. Take the example of commercial banks: these institutions would be reluctant to lend to the government if there is insufficient liquidity in the interbank market; or if they prefer a certain maturity of papers to invest (depending upon their expectations of interest rates); or, if they are looking forward to interest rates higher than what the government has willingly offered.¹⁰

From an operational perspective, most of these risks have not posed a serious concern yet. When liquidity is short in the market, SBP injects funds. As for maturity, if banks are uninterested in investing in a certain tenor, the government can always announce auction for the maturity which most market players are interested in. The only glitch the government may face is when the market expects or demands a higher interest rate – the so-called re-pricing risk (or the market risk). Borrowing at a higher rate does resolve the liquidity concerns of the government in the current period, but increases the cost of debt in the future.¹¹ In a worst-case scenario, when no other lender is willing to lend, the government can borrow directly from SBP.¹²

Presently, the average time to maturity of Pakistan's public debt is 4 years; this mainly represents 40.3 percent the debt maturing in one year period (**Table 4**). These statistics are much better compared to only 3

Table 4: Risk indicators of Pakistan's Public Debt

	2013	2015	2016
Refinancing risk			
Avg. time to maturity (no. of years)	4.5	4.3	4.1
External	10.1	9.4	8.9
Domestic	1.8	2.3	2.1
Debt maturing in 1 year (% of total)	46	36.2	40.3
External	8.9	8.1	11.3
Domestic	47.3	46.0	51.9
Re-fixing risk			
Avg. time to re-fixing (no. of years)	4.2	4.1	3.8
Debt re-fixing in one year (% of total)	52.4	40	44.4
External	22.2	20.6	23.4
Domestic	67.2	47.7	52.8
Fixed rate debt (% of total)	54	65.8	67.6

Source: Debt Policy Coordination Office, MoF

¹⁰ The first two possibilities together are typically termed as re-financing (or the rollover) risk, whereas the latter possibility is commonly known as re-pricing risk. In general, shorter the maturity profile of public debt, larger the risk pertaining to refinancing and re-pricing.

¹¹ Presently, over half of the domestic debt and 44.4 percent of the total public debt needs to be re-fixed within one year.

¹² However, continuous borrowing from SBP not only complicates liquidity management in the interbank, but may also fuel inflation and inflationary expectations. Since direct borrowing from SBP is most inflationary in nature, legal bindings are in place to contain its size.

years back, when 46.0 percent of the debt was to be matured within a year. Nonetheless, there is still a scope for further lengthening the maturity profile of public debt to reduce the associated risks. For instance, the proportion of India's public debt maturing in one year was only 4.0 percent at end- CY 2015, whereas in Brazil, the same was 21.6 percent.

C. Evaluating the statutory ceiling

Not many countries in the world have national debt rules in place (**Table 5**). Among the emerging market world, Brazil, Pakistan, Indonesia and Malaysia are the only four countries with explicit statutory cap on public debt levels.¹³ Interestingly, these are the countries (but not the only ones) that have been through some sort of debt distress during the past 20 years.

Not all debt ceilings have been established in a similar way and have similar implications. For instance, some countries do not have explicit legal commitments for debt ceilings and are relying only on political commitments (like in Canada and Cape Verde). Some countries do have legal commitments but their nature differs: for instance, debt ceilings have been established under the constitution in Hungary and Poland, whereas in Pakistan and Malaysia, the ceiling is established under statute such as the fiscal responsibility law. In a number of countries like Argentina, Brazil, Japan, New Zealand, and Spain, *annual* debt ceilings are established by the parliament under the annual budget/appropriations act. Naturally, constitutional amendments are more stringent than other laws. In addition to national ceilings, there are also in place supranational rules. Most prominent among these is the 60 percent ceiling on countries within the European Union, under the ambit of Maastricht criterion.

In terms of enforcement also, different practices are in use; for instance in Brazil, federal, state, and municipal audit courts are each required to warn their constituents when the debt and contingent liabilities reach over 90 percent of their respective limits under the Fiscal Responsibility Law. However, such formal enforcement procedures are not in place either in Indonesia, Malaysia or Pakistan. It is because of this very difference in the legal frameworks for public debt management, that some governments are very particular about staying within limits whereas others go astray off and on. As shown in **Figure 8**, Indonesia certainly appears to be the most disciplined (almost under leveraged) country, whereas Portugal has over-stretched its borrowing limits big time. EU countries are no different: most of the governments in this region are currently in breach of the Maastricht criterion (**Figure 9**).

In this background, the present run over from the debt ceiling per se does not raise alarm. But at the same time, complacency is also not warranted. After all, the FRDL Act was promulgated as an effective instrument to instill fiscal discipline in a credible, predictable and transparent manner. Not only has the debt-to-GDP ratio remained above the prescribed level of 60 percent over the implementation period, the debt reduction path of 2.5 percent of GDP was also not followed. Furthermore, the revenue balance has stayed in deficit ever since the Act set a principle of generating surplus in this account. It is important to recall that this Act does not provide any enforcement criteria; the whole idea was to exercise fiscal discipline from within, under the premises that honoring the statutory bindings fortifies the credibility of the government.¹⁴ Despite having no

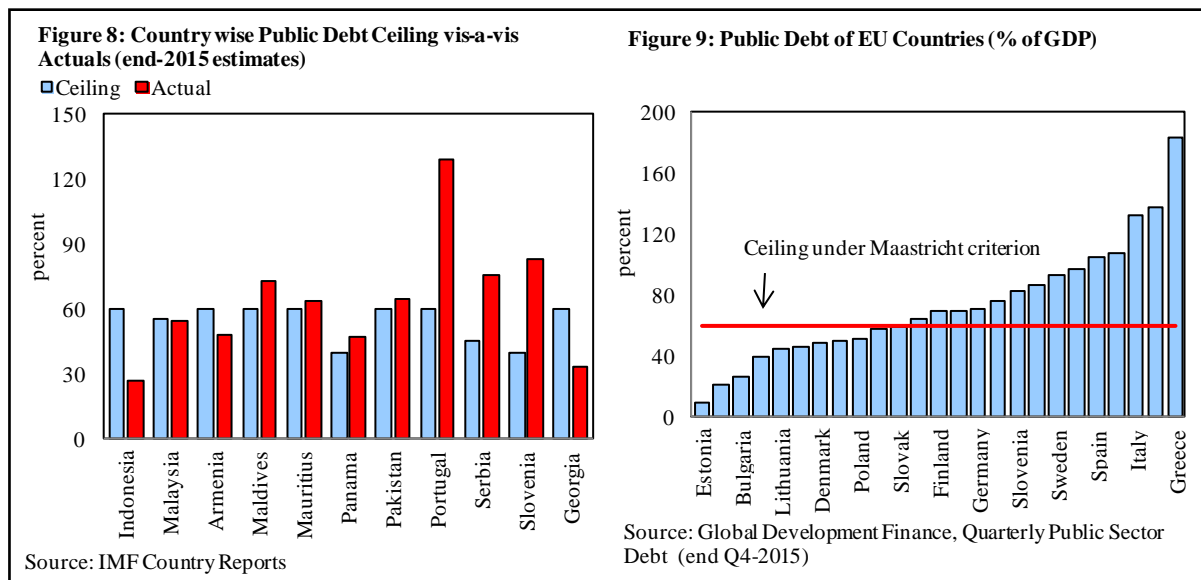
Table 5: Countries with National Debt Rules

Countries	Year of implementation	Countries	Year of implementation
Armenia	2008	Liberia	2009
Australia	1998	Malaysia	1959
Brazil	2000	Maldives	2013
Cape Verde	1998	Mauritius	2008
Georgia	2013	Montenegro	2014
Indonesia	2004	Namibia	2001
Jamaica	2010	New Zealand	1994
Kenya	1997	Pakistan	2005
Kosovo	2010	Panama	2002, 2009
Sri Lanka	2003	Serbia	2011

Source: IMF

¹³ "Fiscal Rules at a Glance" IMF, April 2015, authored by Elva Bova, Tidiane Kinda, Priscilla Muthoora, and Frederik Toscani. This background document updates IMF Working Paper 12/273 "Fiscal Rules at a Glance: Country Details from a New Dataset," by Nina Budina, Tidiane Kinda, Andrea Schaechter, and Anke Weber.

¹⁴ As noted in the Debt Policy Statement of 2006-07, "The government believes that there is no alternative to a rule-based fiscal policy. Accordingly, a rule-based fiscal policy, enshrined in the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005, was passed by the Parliament in June 2005. This Act ensures responsible and accountable fiscal management by all governments – the present and the

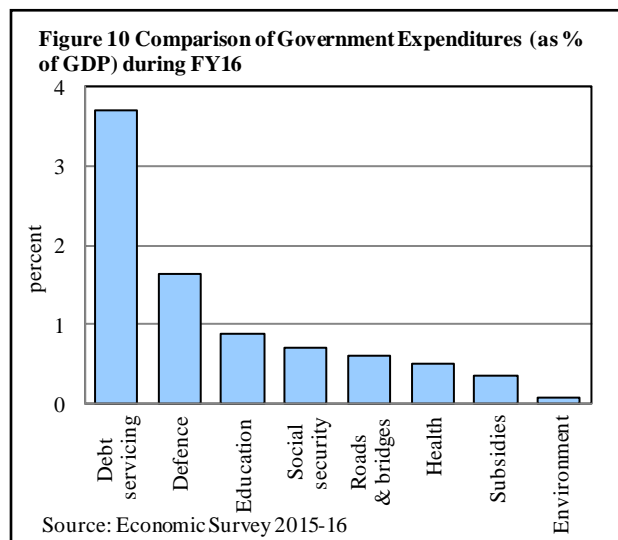


explicit penalties, the cost of this indiscipline is still high. On average, the government's interest expenses consumed over 33 percent of total revenues; 44 percent of tax revenues; and 28.4 percent of total current expenditures in the last three years (FY14-16). With such a burden on exchequer, debt servicing has become the single-most important limitation on public spending. Back in 1980s and 90s also, when this burden grew phenomenally, all other expenditures were heavily compromised, especially PSDP spending.

Here it is important to recall that the FRDL Act was not just about putting debt and fiscal ceilings in place. It had also put great responsibility of social spending on governments. In fact, the reduction in debt burden was envisaged to be replaced with a rise in government spending on social and poverty alleviation related expenses; the Act states:

"...provided that the social and poverty alleviation related expenditures are not reduced below 4.5% of the estimated gross GDP for any given year and budgetary allocation to education and health, will be doubled from the existing levels in terms of percentage of GDP during the next ten years". This much-needed substitution still eludes the country: public health spending has remained stagnant at around 0.6 percent of GDP all through these years.

Education spending has increased from 1.8 percent in FY05 to 2.2 percent of GDP in FY15 (**Figure 10**). Pakistan's social infrastructure failed to progress at a desired pace and has been left behind by many developing countries; this, in our view, is the actual cost of running over the debt ceiling.¹⁵



III. Conclusion

future — and would encourage informed public debate about fiscal policy. It requires the government to be transparent about its short and long term fiscal intentions and imposes high standards of fiscal disclosure. Given the difficult past of Pakistan's macroeconomic environment during the 1990s, a rule-based fiscal policy was considered essential for maintaining macroeconomic stability and promoting growth on a sustained basis."

¹⁵ Other important externality associated with public debt is the possible crowding out of private investment, especially when the government borrows heavily from commercial banks. Inflationary pressures also build up when fiscal deficits are monetized. These issues regularly come under discussion in SBP's Annual and Quarterly Reports on the State of Pakistan's Economy.

Public debt sustainability requires an objective assessment of key trends and vulnerabilities. This evaluation must be done in entirety, as resting the analysis on few selected indicators is a compromise on the assessment. As things stand, public debt dynamics do not suggest a disturbing situation; domestic debt in particular does not pose any imminent risk on solvency or liquidity front.

Although the country has sufficient FX reserves at hands to make up for scheduled repayments for the next five years, risks linger. Pakistan must generate surpluses in the external account in order to pay off and service external debt *without* creating additional debt. Therefore, concerted efforts are needed at national level to boost exports and other foreign exchange earnings to ensure smooth repayments in the future.

Public financial management needs to be strengthened further and the debt level needs to be cut down, as the large volume of servicing is eating away a big chunk of country's scarce resources. As mentioned earlier, prudent cash flow management is needed to avoid unnecessary borrowings. Moreover, fiscal reforms should be expedited with increased focus on expanding the tax net; enhancing tax efforts; privatizing loss-making PSEs; and curbing inefficiencies.

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