Strategy for External Debt Management 1999 – 2004

I am very pleased to welcome the Finance Minister to this Annual General Meeting of the Institute of Bankers. We have invited him particularly as he is a professional banker of international repute and he has now led our economic team for the last two years or so with distinction. We thought it would be appropriate for him to share his views with this large gathering of bankers.

In my two addresses to this august gathering in 2000 and 2001, I had presented before you annual reviews of the state of financial sector in this country. I could have maintained this tradition and presented the third annual review of the financial sector today. But I have instead decided to dwell on a topic which is very important to every citizen of Pakistan but is mired in a lot of obfuscation, technical jargon, speculation and thus has become very controversial. This topic is the external debt of Pakistan – an area of major concern to the State Bank of Pakistan in fulfilling its mandate to manage the foreign exchange of the country.

In the next half an hour or so I will make a modest attempt to shed some light on external debt of Pakistan in a language which is comprehensible to an ordinary citizen of Pakistan. I would like to quantify the magnitude of our debt, its historical context, the strategy we have developed to manage it, the results we have achieved so far and the actions we are contemplating in the next two years. The objective of this strategy is to ensure that Pakistan's debt service obligations in future can be met out of its own foreign exchange earnings without resorting to any exceptional financing from the IMF or further rescheduling by Paris Club or other creditors.

Why is debt (both external and domestic) a serious problem for Pakistan's economic management? First, it crowds out public finances by pre-empting 56 percent of budgetary revenues necessitating serious cut backs on essential public expenditures for promoting growth and poverty reduction. Second, it forces the economic managers to keep on borrowing for meeting even the non-development and recurrent expenditures to operate the state. Third, the annual external debt service payments falling due every year amount to \$ 6-7 billion which consume more than two-thirds of the export earnings. This burden is totally disproportionate to the capacity of any developing country in the world as it will pay most of its earnings to its creditors and will have very little left for imports of goods and services. Fourth, the stock of public debt as a percentage of revenues is over 600 percent which is clearly unsustainable. So is the stock of external debt which accounts for 240 percent of foreign exchange earnings in terms of net present value while the manageable limit is about 150 percent. There is a general agreement that this heavy burden of debt has been a result of large and persistent fiscal and current account balance of payments deficits; imprudent use of borrowed resources such as wasteful government spending, resort to borrowing for covering non-development needs, undertaking of low economic priority development projects and poor implementations of foreign aided projects, weakening of debt carrying capacity in terms of stagnation or decline in real government revenues and exports and the rising real cost of government borrowings both domestic and foreign. For the above reasons, it is imperative that Pakistan's economic managers have to find a sustainable and permanent solution to manage its debt.

Total sovereign external debt of Pakistan including foreign exchange liabilities more than doubled from less than \$ 10 billion in 1980 to \$ 20 billion in 1990 and further to \$ 42 billion in May 1998 just before the freezing of foreign currency accounts. This sharp rise pushed up the ratio of the total stock of external debt and liabilities (EDL) to foreign exchange earnings from less than 200 percent in 1980 to 232 percent in 1990 and 350 percent in 1998. The burden of debt service payments became even more onerous as it jumped from 18 percent in 1980 to 23.3 percent in 1990 to almost 60 percent in 1998.

What is the magnitude of the debt problem today? To answer this question, we have to first determine, in a comprehensive and complete manner, the entire stock of external debt and foreign exchange liabilities of the country. The confusion about the exact amount arises because partial measures of debt are used or some of the foreign exchange liabilities are excluded.

The first attempt at disclosing the complete picture of country's total external debt and liabilities was made in the 1999-2000 Annual Report of the State Bank of Pakistan. Since then this picture is updated and presented every year. As of end-June 2001, Pakistan's total external debt and liabilities stood at \$ 37.8 billion. Of this, public and publicly guaranteed debt i.e. the amount owed by the Government and public sector enterprises and autonomous bodies was \$ 26.8 billion. Private sector non-guaranteed debt was \$ 2.5 billion – these are the loans contracted by Hubco, ICI, Independent Power Producers (IPPs) and other private sector firms for establishing power, cement, fertilizer, chemical projects in the country. Foreign exchange to service these debts is provided by the State Bank of Pakistan. Short-term commercial debt and loans provided by Islamic Development Bank (IDB) for financing letters of credit for oil imports etc. was \$ 1.5

billion and the loans provided by IMF which are lent to the SBP were another $ 1.5 billion. These four components – Public and publicly guaranteed debt, Private non-guaranteed debt, short-term commercial debt and IMF loans comprise the external debt of Pakistan and totaled $ 32.3 billion.

In addition to this, external debt, the country owed $ 5.5 billion in form of foreign exchange liabilities to residents, non-residents and institutions. Of this amount, almost $ 1.5 billion are deposits maintained by various central banks at SBP, $ 1.4 billion are Special US dollar bonds converted from frozen foreign currency accounts, $ 1 billion are in form of FE 45 and FE 31 deposits and the remaining amount is swap funds, Qarz-utaro mulk sawaro scheme (NDRP), Foreign currency bonds etc. Overall, the total external debt and foreign exchange liabilities at the end of the fiscal year 2000-01 were $ 37.8 billion. It will be pertinent to mention that Pakistan borrows in various currencies but the stock of debt is denominated in US dollars. So if yen and European currencies appreciated it has an adverse impact on Pakistan's debt obligations as the amount of US dollars required to pay the same fixed amount of debt in yen and European currencies is higher than originally contracted. In 2000-01, for example, our stock of debt and liabilities would have been $ 36.3 billion only if there was no revaluation on account of currency movements. In other words, we had to pay $ 1.5 billion extra out of our resources not because we borrowed this additional amount but because the value of the stock went up in terms of US dollars. I dwell on this point very deliberately because a lot of commentators and columnists without analyzing the facts attribute any rise in stock of debt to the Government's tendency to indulge in borrowing.

Let me now first deal with our public and publicly guaranteed debt of $ 26.8 billion. This consists of bilateral debt of $ 12.5 billion and multilateral debt of $ 14.3 billion and its payment is entirely the responsibility of the Government of Pakistan. Bilateral debt is owed to the governments of developed countries and has been the focus of attention in the recent years because of its rescheduling by Paris Club since 1998-99. In January 1999, the Paris Club rescheduled an amount of $ 3.3 billion under Houston terms. What did it mean in layman's terms? All flows of debt servicing which were to be paid by Pakistan between January 1999 and December 31, 2000 including arrears accumulated during the first half of 1999 were postponed. But at the end of this period i.e. December 31, 2000 these postponed amounts were to be paid during next 15 to 20 years depending on whether the debt was ODA (concessional) or non-ODA (non-concessional) after a grace period. As you can see, this flow rescheduling does not reduce the obligations of Pakistan but only provides a temporary reprieve.

The present Government was keen to obtain a more permanent and sustainable solution to our bilateral debt. So on December 13, 2001 Pakistani delegation under the able leadership of Finance Minister Mr. Shaukat Aziz was able to obtain both a relief in debt stock as well as debt flows. Unlike the past rescheduling, the relief was applicable to entire bilateral debt stock of $ 12.5 billion (ODA US $ 8.8 billion and non-ODA US $ 3.6 billion). The agreement granted a repayment period for 38 years with 15 years as grace period on ODA credit and 23 years with 5 years grace period for non-ODA credits. This stock reprofiling or relief in practical terms or reduction in net present value in economists' terms implies that the obligations of Pakistan have been reduced by 30 percent. To put it very crudely if we had to pay equivalent of $ 12.5 billion before this agreement we will now pay equivalent of $ 8.85 billion only. But this is not the end of the story. The other component of debt relief will become visible when interest rates on these loans are negotiated with each bilateral government. Under various assumptions of interest rate restructuring it is quite possible that we can obtain additional reduction in net present value terms of 20 percent. If we are successful in obtaining this amount of reduction in interest rate it will tantamount to our stock of debt being reduced by one half. For the purists and the economists let me submit that the present discounted value of streams of payments due on this bilateral stock of debt will be halved. For the layman and to put it crudely this means that in future instead of servicing the stock of debt of $ 12.5 billion we will be servicing the stock of only $ 6.25 billion if the required interest rate reduction is granted by the bilateral creditors.

A number of uninformed cynics have commented that we have failed to match the terms obtained by Egypt in the post-Gulf war period. I am sorry to disappoint them but except for the large military debt which they owed to the United States the treatment of their civilian bilateral debt was no different from what we have obtained. In fact Pakistan is the fourth country after Egypt, Poland and Yugoslavia to obtain this exceptional treatment without being classified a HPIC or highly indebted poor country.

The above calculations, of course, do not reflect what President Musharraf has been able to secure from the U.S. Administration during his recent visit. Under the U.S. laws if the bilateral debt owed to the U.S. Government is to be written off, written down or cancelled, the Congress has to appropriate an amount equivalent to the net present value of the contracted debt as a budgetary grant to offset the write off or cancellation or reduction of debt. In case of Pakistan, the calculations made by the U.S. Treasury shows that the debt stock can be reduced by $ 1 billion if $ 200 million is provided up-front in the budget for this purpose. This is the essence of the proposal which the U.S. Administration is going to present to the Congress. Some other creditor countries such as Canada, Italy, have agreed to swap their debt for grants to support spending on education, health and social sectors. If that happens, the amount of outstanding debt stock will be further reduced.

I have taken a lot of time to dwell on the bilateral debt but I am sure you will be curious to know how this reprofiling of debt stock or reduction in net present value helps us in our debt strategy.

First of all, as I see it, the debt stock reprofiling will allow us the freedom to exit from the IMF after the present Poverty Reduction and Growth Facility (PRGF) program is completed. As I have pointed out in my earlier public speeches the main motivation for Pakistan to approach the IMF has been our inability to service our external debt fully. Under the present scenario when we have obtained a more permanent reduction in our debt servicing obligations for the future the pressure to negotiate another agreement with the IMF has eased unless we once again mess up our economic management or some other unforeseen external shock hits us intensely.

Second, this debt relief will also provide some fiscal space and allow the Government of Pakistan to accelerate its public investment expenditure and thus trigger a multiplier effect on the rest of the economy. As empirical studies have shown there is strong complementarity between public and private investment and we hope that private investment will be crowded-in. There is an urgent need to increase investment, growth rate and employment in the economy and this debt relief should provide the impetus.

Third, the creditworthiness indicators of Pakistan have improved significantly since Paris Club agreement was reached. Creditors and foreign investors are now more confident that Pakistan will have the capacity to meet its new obligations without much difficulty. As you may have seen, Moody's has already upgraded the credit rating of Pakistan to B3. The spreads of Pakistan Eurobond have tightened reflecting the positive market sentiment and improved creditworthiness of the country.

But let me caution you that we are not going to stop at this bilateral debt relief and become smug and complacent about it. Far from it, I see this as a critical first element of our pro-active debt management strategy. What are the other elements of this strategy?

The second element is that while we will be paying back non-concessional loans obtained in the past from the World Bank, Asian Development Bank and IMF we will be contracting new loans on concessional terms. We have already done this in case of the World Bank which is providing credits on IDA terms – zero interest rate, 0.75% service charge, 10year grace period and 30-35 years repayment period. The Bank has increased the annual volume of these concessional loans to Pakistan and we hope that this trend will continue in the next 3 years. The IMF's latest PRGF has also been provided to us on concessional terms compared to the stand-by arrangements we had negotiated in 2000. The Asian Development Bank has committed to increase its assistance to $ 1 billion annually and the mix of the assistance is shifting gradually from ordinary Capital Resources to concessional resources of Asian Development Fund (ADF) but given the current interest rate scenario the non-ADF terms are also not too onerous. So what does all this imply? While multilateral debt cannot be rescheduled or reprofiled we are substituting hard term loans by soft term loans and thus reducing the overall burden of debt servicing.

Third, we have faithfully desisted from contracting commercial loans or short term loans. In the past, our reserves were built up mainly by borrowing commercially and thus adding to our stock of debt as well as raising our debt service obligations. I am glad to report to you that we have built up our reserves slowly and gradually without any commercial borrowing but by mopping up excess supply of foreign currencies available in the open market and now the inter-bank market. In fact we are making best efforts to repay our existing commercial and short term loans as fast as possible so that we can be relieved of this burden.

This is a good opportunity for me to clarify the difference between the concept of net and gross external debt. In October 1999, we had our foreign exchange reserves which were an amalgam of SBP's own reserves and the foreign currency deposits of resident and non-resident Pakistanis. These gross reserves at that time stood at $ 1.3 billion. If our gross external debt and liabilities were $ 38.3 billion at that time our net external debt and liabilities amounted to $ 37 billion. Since April 2001, we have made a radical change in our approach to reserves management. The SBP has returned all foreign currency deposits to the commercial banks and asked them to manage these deposits themselves subject to prudential norms. We have also withdrawn the circular that had made these deposits to be mandatorily surrendered to the SBP. Since then, we report our reserves in two parts – those held by the SBP and those held by the banks. In

April 2001, the SBP's own reserves were only $ 1 billion out of the total gross reserves of about $ 2 billion. As of today, SBP's reserves have reached $ 3.4 billion. If our gross external debt and liabilities today are $ 37.8 billion, in fact our net debt and liabilities are only $ 34.4 billion. Comparing apples with apples our net external debt and liabilities have been reduced between October 1999 and March 2002 from $ 37 billion to $ $ 34.4 billion – a saving of $ 2.6 billion. Imagine for a moment that if the currency revaluation of debt stock had not taken place our debt stock would have been less than $ 33 billion – a reduction of $ 4 billion in all. This is for the first time in the history of Pakistan that we are witnessing a reduction in our external debt obligations. You may recall that in the 1990s these obligations rose from $ 20 billion to $ 30 billion and this does not include the foreign currency deposits which were frozen in May 1998.

This brings me to the fourth element of our debt management strategy. We expect that by June 2002 we would have extinguished our Trade Maintenance facility, paid 50 percent of FE 45 deposits, eliminated swaps, and returned FE-31 deposits to the banks. We have contracted new loans from multilateral institutions in this period also. But taking the cumulative position of inflows and repayments we estimate that the gross stock of external debt and liabilities at the end of June 2002, our gross stock will be $ 36.2 billion and net stock will be slightly less than $ 33 billion. We will endeavour to bring about further reduction in gross stock to $ 35.2 billion by end-June 2004 (net stock will be $ 31 billion) mainly by gradually reducing our foreign exchange liabilities. As you will notice our external debt will keep on rising as we have every intention to keep on borrowing new concessional loans from multilateral institutions. There is nothing intrinsically wrong for developing countries to borrow provided these loans are utilized for productive purposes and contribute to economic growth.

How do we propose to achieve this target of reduction in gross sock? There are many skeptics who will jump in their seats and argue that this is an impossible task. But the serious minded analysts and economists will soon realize that the critical link to this reduction in debt stock lies in the non-interest current account surplus. For the past two years we have been successful in generating these surpluses and this year not only that we have non-interest current account surplus but a surplus on combined current and capital accounts for the period July – December 2002. I do not, for a moment, consider this as a structural shift in our balance of payments situation although I am encouraged by the underlying parameters behind this shift. The future evolution of our current account balance will depend upon the growth in our exports, the ease with which imports can be substituted, the price movement of petroleum products and more important the workers' remittances. Under most conservative assumptions by the Debt Management Committee we should be able to generate $ 4.2 billion of non-interest current account surplus in the next 3 years as compared to $ 2.8 billion achieved in the last 2 years. This assumption is based on workers' remittances inflows of $ 1.2 - $ 1.4 billion annually. As you are aware these remittances have already reached $ 1.1 billion in the first seven months of this fiscal year. I do not think I need repeat here the Export Development Strategy which has been outlined by the Government. We can all debate about its feasibility in view of the uncertainty arising out of adverse external environment but it is a separate topic by itself. I will only like to reiterate here that the implementation of this strategy and the achievement of export targets is an integral part of our debt strategy and if we fail in boosting our exports this will have a serious set back in meeting the goals of debt strategy.

I am also deliberately excluding any privatization proceeds likely to be received in foreign exchange in these calculations. The Debt Management Committee has taken into account a net inflow of $ 3 billion between 2000 – 2004 as these proceeds. But I am not yet sure that this amount will in fact accrue and hence I consider it safe to exclude these proceeds from the calculation of debt stock reduction. To the extent these privatization receipts are in fact realized the extent of stock reduction will be much rapid than what I have presented before you today.

So far I have concentrated on absolute amounts and carried out the discussion in terms of absolute amounts. This is the popular tendency in Pakistan because every body who speaks about our debt problem is always concerned about this so-called $ 38 billion problem.

It is not right to get embroiled in the absolute amounts of debt – because this doesn't, by itself, mean very much. What is important is to address the following questions: (a) how to reduce the burden of stock of external debt measured in terms of GDP and foreign exchange earnings to sustainable levels (b) how to align the debt service payment streams annually with the capacity to generate foreign exchange earnings and (c) how to lower the ratio of public debt service to budgetary revenues.

Table II presents the actual outcome and the projections for the years 2000 – 2004. These projections indicate that under a set of conservative assumptions it is possible to achieve these three objectives. But we should also recognize that there are downside risks associated with these projections. In case the reform and adjustment program is abandoned prematurely and we fall back to the old days of unproductive expenditures, low resource mobilization, selective exemptions and concessions to the privileged few, anti-export bias in our policies through fixed exchange rate and controls on allocation of foreign exchange, proliferation of state owned enterprises and poor economic governance I can assure you that not only will we never be able to meet these projections but get further caught into a much harsher debt trap. We would have once again lost our hard earned credibility vis a vis international creditor community, scared genuine and legitimate businessmen and exporters, entangled economic decision making into politics and the results of this foray should be obvious to every one.

On the other hand we have just got some breathing space which we should utilize wisely and judiciously in order to restructure our economy in fundamental ways, reorder private-public sector relationships to maximize benefits for the entire economy, revitalize our decaying institutions by upgrading human resources and technology, deregulate the businesses from excessive bureaucratic controls, privatize loss making state enterprises, liberalize trade and capital flows and assimilate new technology and organizational innovations. Debt management process itself should be more inclusive and professionally operated. This is a daunting agenda which is not easy to accomplish and will require concerted and continuous efforts by both the policy makers as well as private entrepreneurs without any hiatus or slack. But I am convinced that this is the agenda which will not only help us reduce our debt burden but also revive economic growth with poverty alleviation and enable Pakistan to derive maximum benefits from globalization. The choice, ladies and gentlemen, is quite stark before us. We can either fall back to the old ways of doing things and get marginalized and become one of the poorest countries in the world or we accept the challenges of hard work, enterprise, trust, good governance and pave the way for Pakistan to become a modern, progressive, Islamic Welfare state participating as a responsible member of new global order. As you know well my preference and wish is quite obvious. I hope that the majority of Pakistanis will also opt for this choice.

TABLE 1

PAKISTAN'S EXTERNAL DEBT AND LIABILITIES

($ billion)

	1990	1995	1997	1999	2000	2001
I. Public and Publicly Guaranteed Debt	19.191	26.246	27.182	26.904	29.189	29.989
II. Private Non-Guaranteed Debt	.304	1.418	2.705	3.435	2.842	2.45
III. Central Bank Deposits	0.094	.105	.150	.700	.700	.700
IV. IMF	.839	1.63	1.316	1.825	1.55	1.529
Total External Debt	20.428	29.399	31.353	32.864	34.281	34.668
V. Foreign Exchange Liabilities	2.471	7.764	11.011	3.736	3.942	3.746
Total External Liabilities (I+II+III+IV+V)	**22.899**	**37.163**	**42.364**	**36.60**	**38.223**	**38.414**

TABLE II

EXTERNAL DEBT AND LIABILITIES BURDEN

(Projections)

($ billion)

	2000	2001	2002	2003	2004
A. External Debt	32.4	32.8	33.5	34.1	34.5
B. F.C Liabilities	5.0	5.0	2.8	1.7	0.7
Total Gross Debt and Liabilities	37.4	37.8	36.3	35.8	35.2
As % of GDP	61.1	61.7	56.9	53.6	49.5
As % of Foreign Exchange Earnings	**294**	**270**	**242**	**222**	**201**
Debt Service as % of Foreign Exchange Earnings	**29.5**	**36.5**	**26.9**	**24.2**	**23.9**