FLEDGLING ECONOMY, RISING DEBT; MORE OF IMF AHEAD??

INFONALYSIS

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Research & Development Cell

Karachi Chamber of Commerce & Industry

The gateway to economic prosperity…

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Transactions in the world today invariably involve a necessity for debt but this has to be kept to a minimum. An often quoted phrase, "it takes money to make money" implies that debt, if used efficiently, can become an efficient tool for boosting economic growth, development to foster and long-term prosperity of a country. However, it is unwise for an individual to live beyond his means, the same applies to a country whether it is developed or developing.

As debt levels rise, efficient management of public debt becomes more critical, especially for developing countries like Pakistan. This report is an effort to analyze the overall debt situation of Pakistan with a particular focus on evaluating the chances of being able to rein in the unabated rise of debt, or otherwise going for another IMF loan under prevailing and anticipated economic conditions.

So how much debt is Pakistan in exactly!!

Pakistan witnessed a pronounced rising trend in debt since FY07, at the onset of the global economic recession after which Pakistan entered into yet another IMF program. The quantum of the effect can be gauged from the fact that country's domestic debt has risen by a whopping 453% in the last 9 years to PKR 14.39Tn, while its external debt has surged by 151% during the period to PKR 5.52Tn, resulting in the total debt rising by 314% to PKR 19.9Tn. Debt accumulation has been growing at an average rate of ~16.5% in the 9 years of the two democratic rules and if the current pace continues, the loan would swell to an exorbitant level of PKR 76Tn by 2025.

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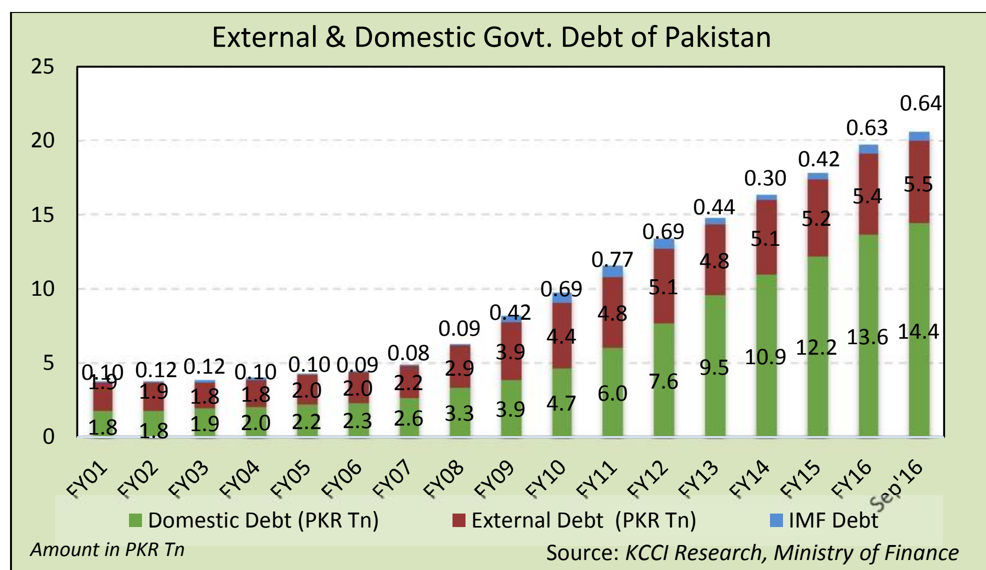
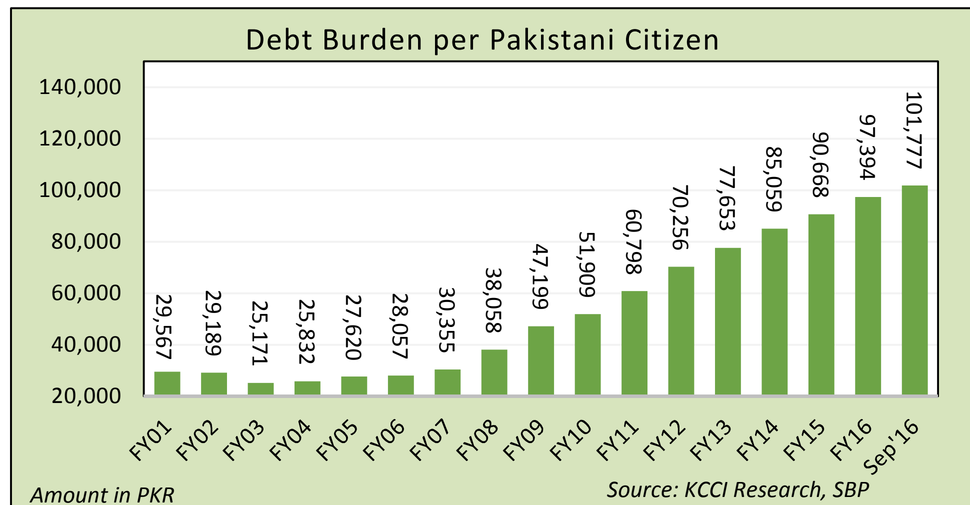
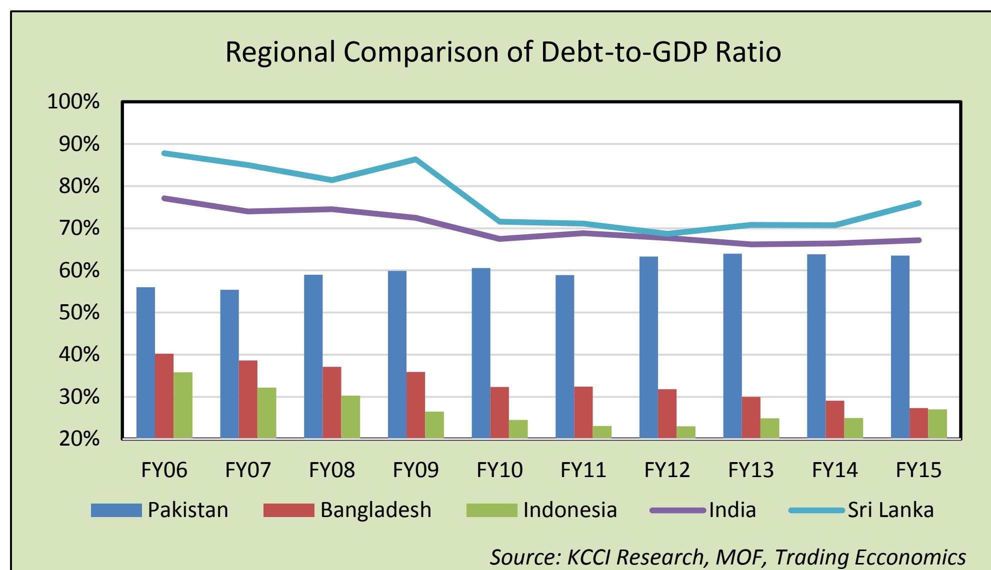


To put things in perspective, the amount of debt which every Pakistani owes has escalated to a mammoth PKR 101,777 till Sep'16 which was just PKR 29,567 in 2001 and PKR 30,355 in 2007.

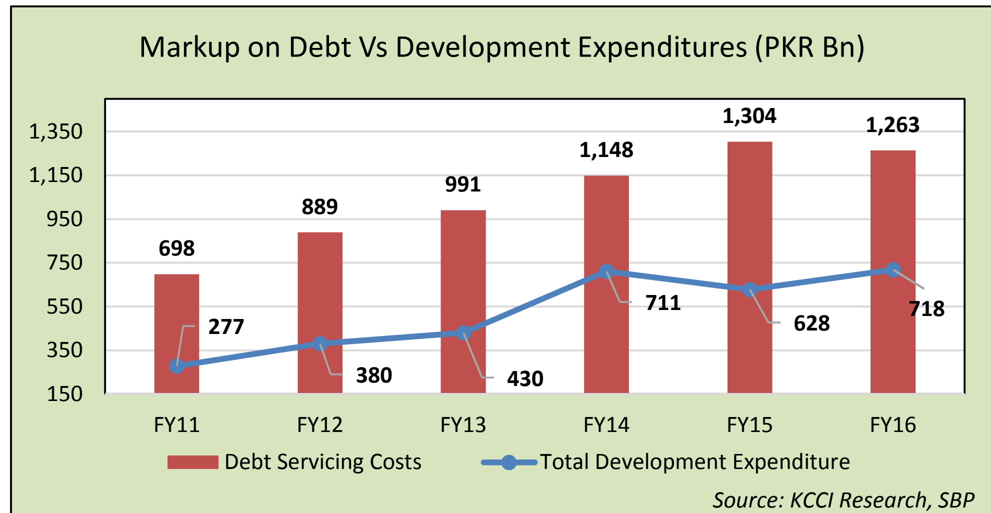


Pakistan's Debt-to-GDP is on a rise from 55.4% in 2007 to 67.8% in 2016, an increase of 12.4%. The country has also long been violating its debt limit of 60% of its GDP as stipulated under the Fiscal Debt Limitation Act.

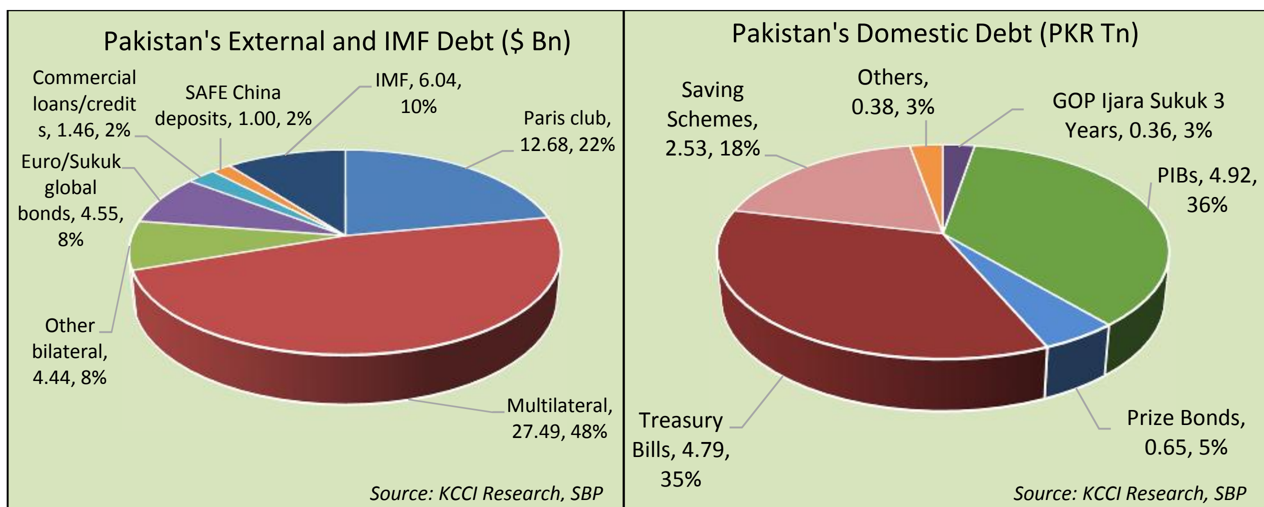
As depicted in below chart, while other regional countries show a largely downward trend in their Debt-to-GDP ratios, Pakistan's Debt-to-GDP is on a rise from 55.4% in 2007 to 67.8% in 2016, an increase of 12.4% (Debt-to-GDP ratio is a comparable indicator of a country's self–reliance on its production of goods and services for paying off its debt obligations). The country has also long been violating its debt limit of 60% of its GDP as stipulated under the Fiscal Debt Limitation Act.



In terms of paying interest costs on its debt, Pakistan spent nearly 33% of its total revenue in public debt servicing in FY15, amounting to an all-time high value of PKR 1.3Tn!! The amount was reduced to PKR 1.26Tn in FY16 or 28% of revenue while the govt. has allocated an amount of PKR 1.29Tn for FY17. Of the overall debt servicing in FY16, 91% comprised of domestic debt while external debt servicing stood at 9%.



Exorbitant interest payments obligations have trimmed down the capacity of the government to allocate sufficient resources towards the direly needed social and infrastructure development.



The country has signed 5 Standby Arrangements, 3 Extended Credit Facilities, 3 Extended Fund Facilities and 1 Structural Adjustment Facility Commitment with the IMF in the last three decades.

Pakistan faced weak economic situations right from its onset forcing it to opt for foreign support in form of loans. But what was supposed to be a short term measure unfortunately became an easy way out and instead of bringing in stringent reforms to manage budget deficits, improve balance of payment position and direct the country towards economic prosperity, govts. after govts. sought additional loans from IMF, World Bank and other sources.

Pakistan: IMF's top borrower in the region

The country has signed 5 Standby Arrangements, 3 Extended Credit Facilities, 3 Extended Fund Facilities and 1 Structural Adjustment Facility Commitment with the IMF in the last three decades in order to stabilize its fiscal and foreign account positions (depicted in the table below) taking the total no. of loan programs to 12. In contrast, India signed just one facility with the IMF in 1991, Bangladesh has had three facilities since 1990, Sri Lanka has had two while Nepal has taken a total of three, making Pakistan the top IMF borrower in the region.

Pakistan's Borrowings from IMF in last three decades

Facility		Date of Arrangement	Date of Expiration or Cancellation	Amount Agreed	Amount Drawn
SBA	Standby Arrangement	28-Dec-88	30-Nov-90	273.15	194.48
SA	Structural Adjustment Facility Commitment	28-Dec-88	27-Dec-91	382.41	382.41
SBA	Standby Arrangement	16-Sep-93	22-Feb-94	265.40	88.00
ECF	Extended Credit Facility	22-Feb-94	13-Dec-95	606.60	172.20
EFF	Extended Fund Facility	22-Feb-94	13-Dec-95	379.10	123.20
SBA	Standby Arrangement	13-Dec-95	30-Sep-97	562.59	294.69
ECF	Extended Credit Facility	20-Oct-97	19-Oct-00	682.38	265.37
EFF	Extended Fund Facility	20-Oct-97	19-Oct-00	454.92	113.74
SBA	Standby Arrangement	29-Nov-00	30-Sep-01	465.00	465.00
ECF	Extended Credit Facility	6-Dec-01	5-Dec-04	1,033.70	861.42
SBA	Standby Arrangement	24-Nov-08	30-Sep-11	7,235.90	4,936.04
EFF	Extended Fund Facility	4-Sep-13	3-Sep-16	4,393.00	4,396.00

Source: *KCCI Research, IMF;(Amount in Mn SDR)*

Why did Pakistan need the last two arrangements?

Although Pakistan was relatively less affected by the global financial crisis of 2008, a steep rise in fuel prices increased the country's oil import bill, leading

Debt from IMF makes the most headlines; IMF extends loans after in-depth assessments of Pakistan's economy, sets criteria to qualify for subsequent loan tranches and continues to monitor the country's economic indicators.

it to a precarious balance of payment situation. Foreign exchange reserves dropped to a record low level, forcing the govt. to opt for IMF SBA (Stand-By Arrangement) agreement under which the IMF agreed to lend the country SDR 7,235.90Mn (equivalent to $ 10.7Bn) in Nov'08. But, due to the stringent requirements of the Fund and the govt.'s failure to meet IMF targets, it could only manage to secure SDR 4,396Mn (equivalent to $ 7.6Bn) under the arrangement.

Yet again in 2013, due to distressing balance of payment position, steep devaluation of the rupee and to avoid a possible default on payments, Pakistan's govt. inked an EFF (Extended Fund Facility) credit facility with IMF to seek financing of SDR 4,393.00Mn (equivalent to $ 6.8Bn). The whole credit amount has been received, with Pakistan meeting most of the IMF requirements. Interestingly, none of the loans in the past accounted for that much enormous amount as taken in 2008 and 2013 under the two facilities.

There is always a catch associated with an IMF program: IMF lending conditions mostly focus on stabilization at the expense of economic growth, which more often than not result in high taxes and low public spending.

Pakistan and the IMF Conditions

Of the external debt, the debt from IMF makes the most headlines. The reason being that the IMF extends loans after in-depth assessments of Pakistan's economy, sets criteria to qualify for subsequent loan tranches and continues to monitor the country's economic indicators during the course of the loan arrangement. This improves the confidence of other lenders in the global markets to extend further loans to country.

However, there is always a catch associated with an IMF program: IMF lending conditions mostly focus on stabilization at the expense of economic growth, which more often than not result in high taxes and low public spending, thus stifling the economy. IMF policies allow very little breathing space for govts. to implement their own policies, policies which may be better for its people and its businesses.

By the end of October 2016, Pakistan managed to conclude the IMF's EFF program making strenuous efforts to meet most of the IMF's conditions.

So how has Pakistan benefitted from the IMF program?

By the end of October 2016, Pakistan managed to conclude the IMF's EFF program making strenuous efforts to meet most of the IMF's conditions. At the conclusion of the IMF's EFF program, the IMF stated that, Pakistan's macroeconomic resilience has improved and short-term vulnerabilities to

external shocks have declined, laying foundations for higher, more sustainable, and inclusive growth.

As per IMF, since the start of the program in Sep'13, the economic situation of Pakistan improved in the following area:

- Inflation declined significantly, both owing to improved monetary and fiscal policies and a marked decline in global oil prices.
- Fiscal deficit reduced, helped by sizeable growth in tax revenue.
- Social safety nets supporting the poor (BISP) strengthened and stipends increased by over 60 percent.
- Though country's foreign exchange reserves, while having tripled over the program period, have not yet reached comfortable levels.
- In addition, appreciation of the rupee against the USD has negatively affected trade competitiveness (in terms of exports). Therefore, further accumulation of foreign exchange reserves is needed to bolster buffers against external shocks, strengthen investor confidence, and support private sector-led growth.
- Regulatory reforms and improved energy sector performance have slowed the accumulation of circular debt and have resulted in lower load shedding.
- Regulations to fight money-laundering and financing of terrorism have been strengthened.
- Despite some delays, the govt. is working towards restructuring and divesting ailing Public Sector Enterprises (PSEs).
- However, public debt remains high and further fiscal consolidation is needed to reduce fiscal vulnerabilities.

While Pakistan has achieved betterment in different areas of its economy, the quantum of debt incurred remains a cause of concern for the global lender.

As the risk of a country defaulting on its debt service obligation increases, the country tends to lose its social, economic and political power.

Burgeoning debt awaits repayments

The clock is ticking fast and debt is to be repaid in due course. It is yet to be seen how the govt. will arrange debt repayments, especially when exports and FDI inflows are not picking up at the desired pace. More importantly, as the risk of a country defaulting on its debt service obligation increases, the country tends to lose its social, economic and political power.

The timeline of upcoming major loan repayments are as under:-

- The repayment of rescheduled Paris Club debt, amounting to $ 8.3Bn, under Official Development Assistance (ODA) will start from FY17.
- Repayments of the recently concluded IMF - EFF program amounting to $ 6.67Bn will begin from Mar'18.
- $ 750Mn 10-year Eurobond issued in FY07 is maturing in May'17.
- $ 1.0Bn 5-year Eurobond issued in Apr'14 is maturing in Apr'19.
- $ 1.0Bn 5-year Sukuk Islamic Bond issued in Nov'14 is maturing in Nov'19.

This money that has to be paid back to the lenders with additional cost of mark-up. If so, has this debt been effectively utilized in projects which would enhance the capability of the country to repay this debt or as before, it would simply be passed on to general public and registered businesses later in the form of tax hikes, further discouraging any potential business startups or expansions in Pakistan. The question still remains, will govt. be able to hold on to its claims of not needing support of IMF in future!!

Projected Payments to the IMF (as of September 30, 2016)			
Year	**US$ Mn**	**Year**	**US$ Mn**
2017	81.07	2025	440.68
2018	288.86	2026	101.84
2019	656.20	2027	0.40
2020	975.88	2028	0.40
2021	1,107.87	2029	0.40

2022	1,013.40	2030	0.40
2023	1,044.56	2031	0.40
2024	825.02	Total	6,537.37

Note: SDR1 = US$ 1.395810 on Sep 30th'16

Source: KCCI Research, IMF

CPEC is an investment or a debt?

Pakistan will see a surge in FDI during the early years of CPEC but the import requirements will offset a significant share of inflows. And the actual problems would begin when it starts to repay its CPEC debts!!

CPEC is marketed by the government as a game changer for the Pakistan's economy. CPEC is a $ 51.5Bn project under which all the projects are to be financed by Chinese banks to Chinese investors in Pakistan. Out of $51Bn, $ 10.6Bn is allocated for infrastructure development which would be financed by Govt. to Govt. loan arrangements on the basis of 1.6% interest p.a. payable in 25 years. These infrastructure developments would add additional $ 10.6Bn into the national debt. Moreover, electricity generation projects valuing about $ 35Bn would be financed at 4.95% interest p.a. (Libor 0.5% + spread of 4.50%) along with guaranteed rate of return on equity varying from 27% to 30.65%, all repayable in dollars. Although the debt burden would increase further under the CPEC project, the adverse impact is expected to be mitigated to a considerable extent by the economic activity generated as a result of this project.

The IMF has also issued reports regarding the economic risks involving CPEC. According to it, Pakistan will see surge in FDI during the early years of the project but the import requirements of these projects will offset a significant share of these inflows, such that the current account deficit would widen. And the actual problems would begin when it starts to repay its CPEC debts!!

The actual problems for Pakistan would begin when it starts to repay its CPEC debts, says the IMF.

Pakistan no longer needs IMF!! Really!!

It is hard to absorb government's claims that Pakistan no longer needs support from IMF. Economic indicators are contradicting these statements because the factors which forced Pakistan to opt for IMF support in the first place have not fully been rectified; Furthermore repaying $ 3.5-4Bn every year without taking fresh debt for the next many years is an onerous proposition, which Pakistan looks unlikely to achieve. We look at some of the reasons why and suggest ways to avert the crises like situation to emerge.

Pakistan closed FY16 at a 6-year low export figure of $ 21.97Bn. Textiles are passing through difficult times due to tough competition from India, China and Bangladesh.

Exports are not picking up

Exports are depicting a declining trend, where Pakistan closed FY16 at a 6-year low export figure of $ 21.97Bn. Textile, Pakistan's mainstay having 60% share in Pakistan's overall exports is passing through difficult time due to tough competition from India, China and Bangladesh. In case this trend continues, Pakistan would have difficulty in meeting it balance of payments requirements without opting for further loans. Therefore, exports need to be boosted on priority basis for sustainable economic development and lower the dependence on further loans.

Remittance growth is stalling

Foreign remittance has been a lifesaving drug for the economy, eventually helping in reducing poverty, improving the living standards of the recipient families, preventing balance of payment crises, building foreign exchange reserves and provided stability in exchange rates, but it appears to be in short supply in the near term owing to job cuts in the Middle East and overall economic slowdown in the EU. Policy makers should take into account that it is very likely that remittances will not be able to cushion the current account and boost the country's forex reserves to the extent that it is doing now.

World Bank has projected average oil prices of $53.2/bbl. $59.9/bbl. and $62.7/bbl. for 2017, 2018 and 2019, respectively, which could elevate total oil import bill by 48% till 2019.

Higher oil prices on the cards

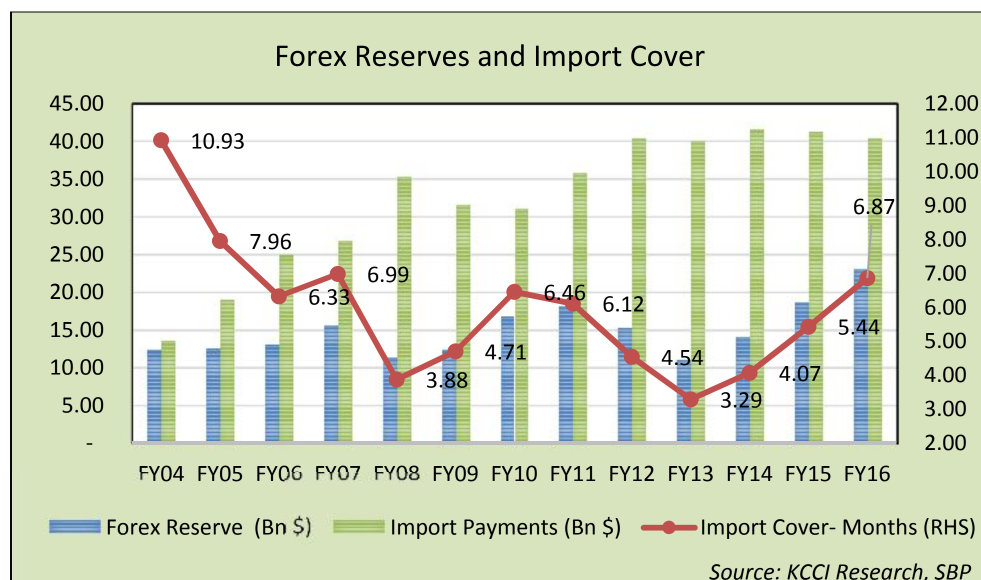
Pakistan highly depends on imported petroleum products for its energy needs, perpetually exposing itself to the risk of high oil prices and foreign currency risks. Forecasts by World Bank have projected average oil prices of $53.2/bbl. $59.9/bbl. and $62.7/bbl. for 2017, 2018 and 2019, respectively. If oil reaches as per the predicted prices of World Bank, it would increase the total oil import bill by 48% till 2019. Coupled with rising debt servicing, increased import of oil would result in sharp decline in forex reserves unless it is either supported by further loans, increase in exports or investments. While a drop in forex reserve may also devalue local currency, further increasing the burdens of import bill, foreign loans and current account deficit.

Forex reserves built on debt are temporary

High forex reserves help boost foreign investor confidence, stabilize the local currency, while also acting as a cushion against external economic shocks. It enables businesses to plan their imports and exports accordingly.

Pakistan managed to upstretched its reserves to $ 23Bn in FY16. Consequently, the import cover increased to around 7 months of imports from 3 months in 2013.

Pakistan, long struggling with its foreign exchange reserves, managed to upstretched its reserves to $ 23Bn in FY16, mainly on the basis of borrowing and/or grants from multilateral lending agencies (IMF, World Bank, ADB etc.) and donations from friendly countries (Saudi Arabia), in addition to a steady growth in home remittances. Consequently, the import cover has increased to around 7 months of imports from 3 months in 2013 when it was facing a serious balance of payment crisis. (Import coverage signifies how many months of imports can a country manage from its forex reserves). The global average import coverage ratio stands at around 15 months.

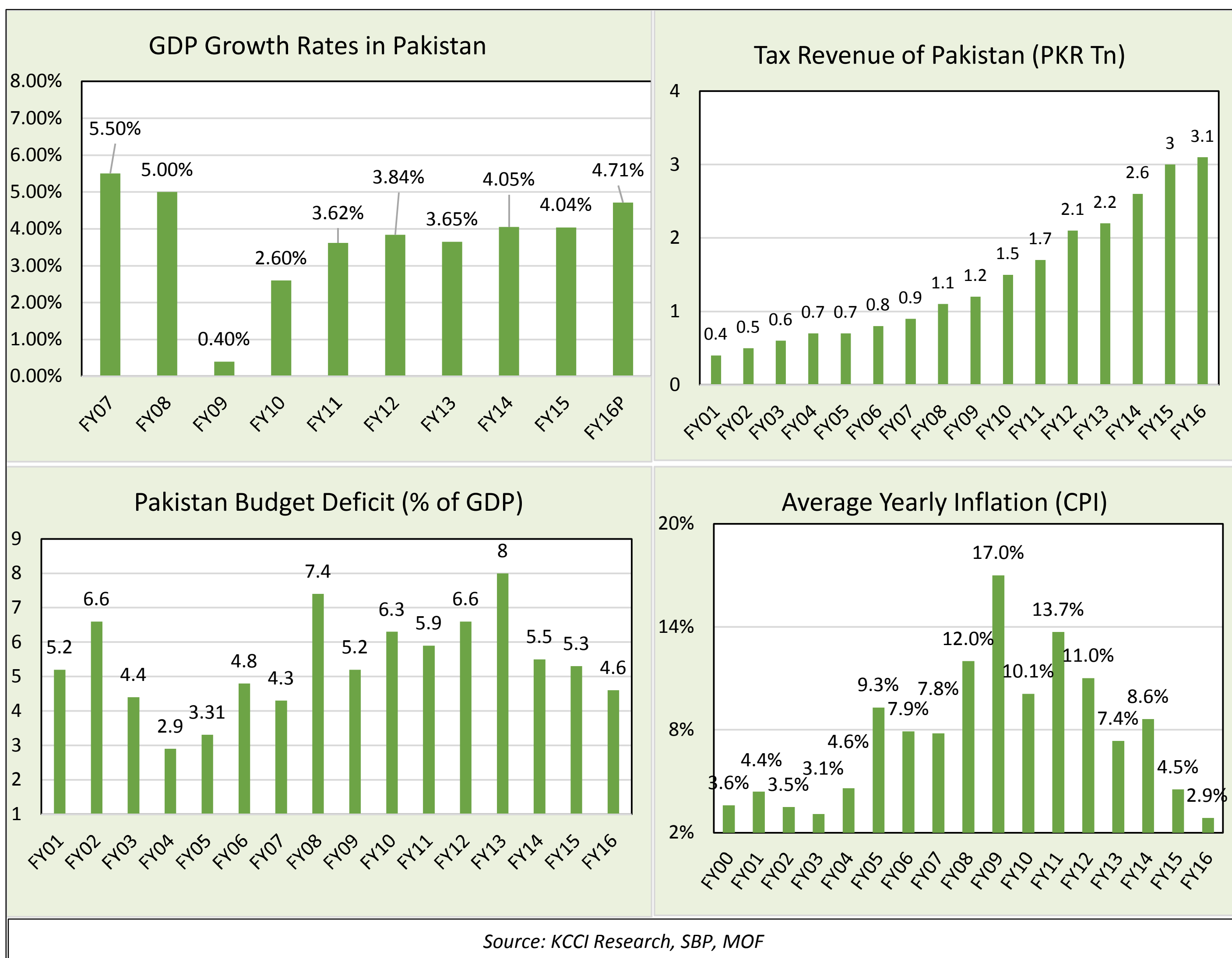


Source: KCCI Research, SBP

However, it would be difficult to sustain the level of forex reserves in the back drop of declining exports, rising trade deficits, stalling remittances, low FDI, higher anticipated international oil prices and heavy debt repayments, signaling more debt accumulation ahead.

The recent Greece crisis is a perfect example of how an unprecedented rise in debt has a domino effect on the overall economic system of a country. The main factors due to which Greece fell into default were poor GDP growth, rampant corruption, tax avoidance, excess government spending leading to current account and fiscal deficits and above all high government debt. Unfortunately, all of the adverse factors that led Greece into crises have also become much pronounced in Pakistan.

Therefore, policy makers should instead focus on steady and sustainable indigenous growth in reserves instead of ad-hoc measures like loans for pushing reserves high for a short period of time.



Source: KCCI Research, SBP, MOF

Budget Deficit still out of control

In line with higher tax collection requirements, the FBR collected tax in excess of PKR 3.130Tn in FY16, surpassing its revenue target of PKR 3.10Tn for the year. The country's budget deficit, though lower than previous years, still needs to be curtailed further. The lower fiscal deficit of 4.6% for FY16 against

target of 4.3% was achieved through inflating revenue figures by withholding sales tax refunds of PKR 270Bn, collecting advance tax worth PKR 230Bn and enforcing petroleum levies worth PKR 950Bn, and thereafter showing statistical discrepancy of PKR 212Bn!! In response, the IMF called out for showing vigilance in budget execution over such "large" statistical errors.

To meet the extra burden of interest costs and principal repayments, govt. tends to further milk taxes from businesses and the public at large. In order to maintain their profits and viability, businesses have no other option but to increase product prices.

For FY17, the government has projected an ambitious revenue target of PKR 3.621Tn for FY17, an increase of around PKR 500Bn or 16% increase over FY16. Already the revenue collection has fallen short by PKR 117Bn in 5MFY17.

On the expenditure side, loss making Public Sector Enterprises (PSEs) are making even higher losses and consuming funds that could have been used for the debt repayment or the technological advancement of sectors that have been ignored in the past.

High debt increases taxes

To meet the extra burden of interest costs and principal repayments, the govt. tends to further milk taxes from businesses and the public at large. In order to maintain their profits and viability, businesses have no other option but to increase product prices. Hence, rising inflation, increased taxes, and higher costs of debt severely affect all facets of the economy, implying more and more taxes from its people.

IMF in its report "Unlocking Pakistan's tax potential" revealed that Pakistan has the potential to raise its tax to 22% of its GDP from 11% but the reasons for missing this target are generous tax concessions and exemptions, weak and fragmented revenue administrations, and structural economic deficiencies. Best case for Pakistan is to stop relying on indirect taxes and bring those in tax net who are constantly avoiding it e.g. agricultural and real estate sectors.

Forcibly collecting advance taxes, imposing mini-budgets from time to time, and withholding tax refunds of compliant tax payers to show higher levels of tax collection could not be called a sustainable tax regime, and steps must be taken to genuinely improve tax collection.

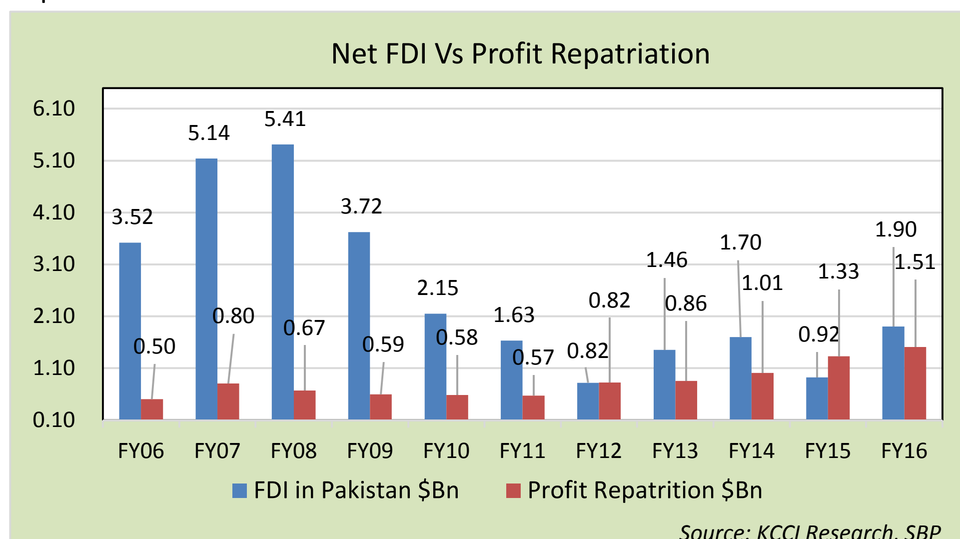
Forcibly collecting advance taxes, imposing mini-budgets from time to time, and withholding tax refunds of compliant tax payers could not be called a sustainable tax regime.

Pakistan has huge space in getting rid of cumbersome regulations and make tax regimes simple which would build business confidence, thus prompting improved economic conditions. Improved economic activity itself is cause for

higher tax collection, while lower govt. debt would inevitably put less pressure on the govt. to increase taxes (as debt servicing requirements would be low).

Crowding out of private investment

In the long run, public debt that's too large can act like driving with the emergency brakes on. Public borrowing from domestic financial sources crowds out private sector investment as does a govt. shift away from public development spending, because private investors tend to emulate govt. investment In different projects. Required rate of return of private investors and lending institutions goes higher due to increased risks associated with default, thus making housing, personal financing and auto loans more expensive.



Higher repatriation on FDI

Multinationals firms operating in Pakistan although are a source of technology transfer and often provide healthy FDI in the country, but it is the repatriation that hurts the economy.

Pakistan's net FDI inflows have largely been range bound over the years, but what is a cause of grave concern is that profits and dividends repatriated by foreign investors in Pakistan is on an inclining trend, sometimes even exceeding the FDI. Repatriations of foreign companies working in Pakistan to their principals abroad have nearly trebled in the last 5 years. Multinationals firms operating in Pakistan although are a source of technology transfer and often provide healthy FDI in the country, but it is the repatriation that hurts the economy.

Politically stable countries tend to attract 67% more foreign investments than politically unstable countries.

Low levels of investments

Long awaited CPEC has been initiated and investment related to it has already started to come into Pakistan but FDIs are stagnant; besides Pakistan is largely focusing on receiving investments from a single country instead of its tapping investment potential from many other countries.

In term of making Pakistan business friendly and attracting more and more private investments, Pakistan still ranks in the lowest quartile (144th in 190 countries in Ease of Doing Business rankings), (for full report, please read: "*Doing Business in Pakistan - Reform to rise through the Ranks*" by KCCI Research) indicating that the government is still not making enough efforts in this regard. Political stability, ease of doing business, corruption free environment and improved law and order are prerequisites for attracting foreign investors. According to a World Bank survey, politically stable countries tend to attract 67% more foreign investments than politically unstable countries.

Eradicating Corruption – Enough of it, already

Corruption has always been a major problem for Pakistan and even after self-claimed efforts of eradicating corruption from Pakistan, no material change has been observed so-far regardless of change in governments. Transparency International ranks Pakistan 117th least corrupt country amongst 175 countries in its 2015 report.

The fact is that the FBR, as it presently stands, is still more akin to an out-of-date body than it is to a modern automated tax collecting authority. Allegations of corruption abound, with entire networks of officers who are hired through political influence who are seeking to support one another in collecting graft for themselves rather than taxes for the national exchequer.

Pakistan has so far spent $ 118Bn on war on terror which is about 65% of its total debt, and 229% of planned CPEC investments, yet the collateral damage is even higher.

Terrorism – No more please

Terrorism has always played its role to ruin Pakistan's economy and tarnish its international image. Pakistan has so far spent $ 118Bn on war on terror which is about 65% of its total debt, and 229% of planned CPEC investments, yet the collateral damage is even higher. Pakistan has made significant progress in controlling terrorism across the country and more specifically in Karachi. This is a great achievement for the law and enforcement agencies and government because this would unlock true potential of CPEC and linked business activities

but much work is left to be done because it still exists to some extent and influences the decision making of foreign investors. Unless terrorism ends, Pakistan's economy will not be able to move in full gear.

Reforms needed to avert debt crises!!

To have a sustainable economic prosperity it is important to further strengthen public finances and external buffers, broaden the tax net, and improve public financial management.

Canada was facing double-digit budget deficit in the 1990s. By introducing deep budget cuts of 20% within the period of four years, the nation reduced its budget deficit to zero within 3 years and cut its public debt by 1/3 within 5 years.

There should be a concerted effort by the government to cut unnecessary spending. There was a time when Sweden was very close to financial collapse by 1994. However, by late 90s the country was able to achieve balanced budget through a combination of spending cuts and tax increases.

On a similar note, Canada was facing double-digit budget deficit in the 1990s. By introducing deep budget cuts of 20% within the period of four years, the nation reduced its budget deficit to zero within 3 years and cut its public debt by 1/3 within 5 years. The country did this without raising taxes.

Moreover, the economic managers should also strengthen the monetary policy framework, address losses in PSEs or privatize them, complete the energy sector reforms, and accelerate competitiveness-enhancing improvements of the business climate, including the trade regime. The govt. would do well by inducing more and more economic activity and relying less on debt if it wants a self-sufficient economy.

As someone rightly said:

"The present generation does not have the right to burden the next generation with heavy debts. "

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