FDL Finance for Development Lab

Resolving Pakistan's Debt Problems

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Abstract

Pakistan's latest economic crisis saw a further widening of already large fiscal and external deficits. With reserves falling to about two weeks' worth of imports and the interest bill on public debt eating up 60 percent of government revenue, default appeared imminent. However, the favorable debt structure, where most of the external obligations are to official creditors, combined with the adoption of corrective policy measures, has stabilized the economy for now. Looking ahead, sustained fiscal adjustment along with growth-enhancing investment and structural reforms are needed to strengthen debt sustainability. These steps will only be feasible if they are backed by sizable, coordinated liquidity support from bilateral and multilateral creditors at concessional interest rates. Inadequate official financing threatens to derail the ambitious reform plans agreed under the recently approved IMF program. A mechanism to increase transparency and thus facilitate the provision of the needed liquidity relief is put forward in this note[1]. Its success could serve as a model for other nations facing similar debt challenges.

[1] I would like to gratefully acknowledge, without implicating, helpful comments from Ishac Diwan, Research Director, and Martin Kessler, Executive Director, of the Finance for Development Lab, on earlier versions of this paper.

Introduction

Pakistan's inability to live within its means has resulted in persistent macroeconomic imbalances and necessitated numerous financial support programs with the International Monetary Fund (IMF). Large fiscal deficits year after year have translated into a rapidly rising public debt burden and a ballooning public interest bill. By 2022/23,[2] interest payments on public debt were eating away a whopping 60 percent of government revenue. On the external side, recurring current account deficits coupled with a strong rupee policy have led to sporadic devaluations whenever reserves drained to unusually low levels. Additionally, difficulties in refinancing external debt coming due have increased as the ratio of annual external amortization (principal repayments coming due) to reserves has grown over time.

The latest economic crisis gripping Pakistan germinated during the global pandemic, exacerbated by the commodity price shocks that followed the outbreak of the Russia-Ukraine war. Unaffordable policy support in the form of expanded government spending, especially through increased energy price subsidies and heavily subsidized bank loans via special credit schemes introduced by the central bank, further widened the already substantial fiscal and external deficits. By the middle of 2021/22, it became clear that these imbalances were unsustainable. The fiscal year ended with a budget deficit of almost 8 percent of GDP, an external current account deficit nearing 5 percent of GDP, alongside rapidly depleting reserves, and imports expanding at a 60 percent pace for part of the year. The sharp exchange rate depreciation necessitated by the crisis raised the rupee value of external debt and increased its share in total public debt. At present, public and publicly guaranteed debt amounts to 75 percent of GDP, of which about 40 percent is foreign currency debt owed to external creditors.

This dire situation has led many to wrongly advocate for debt default and restructuring as the right remedy for Pakistan, despite the significant pain and severe economic disruption it would cause to the country. Indeed, it seemed inevitable that Pakistan would have to follow the path of a growing number of heavily indebted emerging market economies by defaulting and seeking to restructure its debt. However, Pakistan's debt structure—with almost all interest payments directed towards domestic creditors and the bulk of its remaining external debt owed to official creditors—renders the potential gains from default/restructuring rather slim, while the associated costs are massive. Instead, a strategy to reduce the burden of the interest bill through fiscal adjustment, growth-enhancing investments, and structural reforms would be much more promising. However, it will only be feasible if it is backed by sizable, coordinated liquidity support from official creditors at concessional interest

[2] Pakistan's fiscal years run from July 1 to June 30.

rates. The recently approved IMF program envisages the right reforms, but insufficient concessional financing from official creditors threatens to derail it by forcing an unrealistic spending path. To encourage creditors to work together to deliver the support needed, a modest proposal for increased transparency surrounding the liquidity relief that needs to be provided is put forward below. The success of such an approach in Pakistan could well serve as a model for other countries encountering similar debt problems.

The rest of this paper is organized as follows: Part I analyzes the main threats to fiscal and external sustainability, focusing on the massive public interest bill and external debt amortization. Part II explores two possible solutions to address these sustainability challenges: the new IMF program and an alternative strategy, debt restructuring, which has recently gained traction. It explains why both solutions are unsuitable because they inflict unnecessary pain that would not be sustainable in itself. Part III proposes a less painful solution. On the macroeconomic front, a somewhat faster expansion in investment and social spending would boost growth, climate resilience, and public support for adjustment. This would be achievable through additional liquidity support from official creditors to ease the main pressures from the interest bill and external amortization schedule. The section concludes with a proposal for improved creditor coordination and concerted lending required to secure the essential liquidity support.

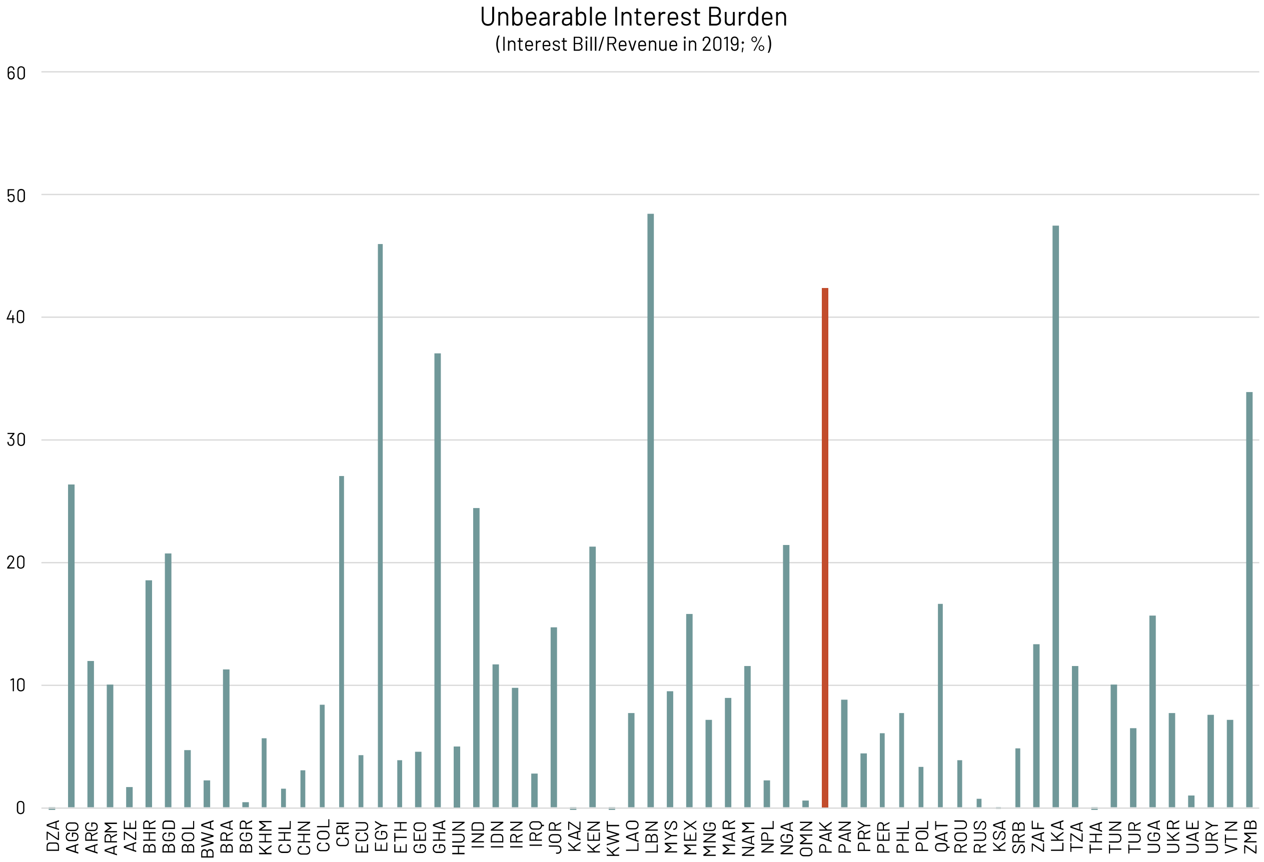
1. State of play: fiscal and external sustainability pressure points

The primary threat to fiscal sustainability is the colossal public interest bill, while external sustainability is jeopardized by the extremely high annual debt amortization schedule.

A. On the fiscal side, Pakistan faces a major interest bill problem

The inability to raise revenue to match spending needs has been a perpetual problem in Pakistan. Large shortfalls year in and year out resulted in a steady buildup in public debt, which by the end of 2018/19 amounted to almost 80 percent of GDP and almost seven times the government's annual revenue receipts (11.3 percent of GDP). In that same year, the last before the pandemic, the government's spending (at 19.1 percent of GDP) exceeded its revenue by a whopping two-thirds. Both ratios (to revenue) were among the highest across emerging market economies worldwide.

Figure 1: Interest burden compared



Source: IMF World Economic Outlook Database, April 2024. For presentation ease, zero is shown for countries with negative net interest bill (e.g., oil exporting

As debt mounted, so did the interest bill that the government had to pay on that debt. By 2018/19, the interest bill was eating up more than 40 percent of the government's revenue receipts. In other words, close to half of the government's intake was being spent on paying interest on money borrowed to pay for past spending, leaving little to meet present spending needs without issuing even more debt. Insights from other countries suggest that it is rare to sustain a ratio of interest bill to revenues above 25 percent for an extended period. Indeed, in the decade preceding the global pandemic, only four emerging market/developing economies other than Pakistan, out of a sample of 60+ countries, reached or exceeded 40 percent. Out of these, only one exceeded 30 percent, and merely 3 others went beyond 25 percent between 2010 and 2019. Consequently, international evidence suggests that it is important not to let the interest-revenue ratio rise above 25 percent. By contrast, Pakistan saw this ratio soar to 60 percent in the last two years, marking one of the highest levels globally. The situation is undoubtedly unsustainable, both fiscally and in terms of social stability.

B. External debt repayments have become challenging to manage

Pakistani policymakers' preference for cheap imports, traditionally financed by aid inflows but increasingly also commercial borrowing, has led to prolonged bouts of exchange rate overvaluation. During periods of commodity price spikes (especially of oil prices[3]), lower aid flows, or loss of access to international financial markets, the persistently low official reserves became critically depleted. This situation triggered significant devaluations of the rupee, economic growth downturns, and recourse to IMF-supported programs to access financing.

In the last episode, Pakistan's foreign exchange reserves dropped steadily and rapidly after mid-2021, and access to private external financing dried up. By June 2023, reserves were down to under $4 billion, equivalent to just half a month of imports and only a tiny fraction of the gross financing needs for the coming year of over $20 billion. A significant immediate cause was the surge in import growth during the pandemic, fuelled by extensive subsidized credit schemes at that time. Increased external borrowing, temporary relief from the Debt Service Suspension Initiative (DSSI) offered by wealthy nations, and emergency IMF financing during the pandemic provided the foreign exchange for this external shopping spree.[4]

Then came the reckoning. The DSSI ended, and market financing dried up. So did new bilateral and multilateral lending. The commodity price shocks in the wake of the Russia-Ukraine war exacerbated the problem by raising the value of imports, especially petroleum. In addition to a sharp rupee depreciation, severe controls on imports had to be imposed to manage the balance of payments crisis. That, in turn, hit economic activity very hard but the loss of reserves continued. Inflation shot up to 38 percent.

[3] Petroleum imports generally account for 20-40 percent of Pakistan's total merchandise imports.
[4] Around $3.7 billion in debt service payments were deferred under the DSSI. The IMF disbursed $1.4 billion under its emergency financing facility and another $2.8 billion via an SDR allocation.

Table 1: Gross external financing requirements

(In $ billions)	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29
Gross External Financing Requirement	23.9	20.4	18.8	20.1	23.7	24.6	23.2
(in % of GDP)	7.1	5.4	4.7	4.9	5.5	5.3	4.6
Current account deficit	3.3	0.7	3.6	3.8	3.6	4.5	4.8
Amortization	20.6	19.7	15.2	16.3	20.1	20.2	18.5
Public Sector	15.9	15.2	11.4	12.2	15.8	15.7	13.8
excl IMF	15.0	13.5	9.9	11.6	14.7	13.6	12.1
IMF repurchases	1.0	1.6	1.5	0.6	1.1	2.2	1.7
Private Sector	4.6	4.5	3.8	4.1	4.3	4.4	4.6
Gross Official Reserves	4.5	9.4	12.8	15.5	20.2	22.5	25.4

Source: IMF Staff Report, September 2024.

A 9-month IMF Stand-by Arrangement[5] (SBA) agreed in July 2023 provided some near-term breathing room. Thanks to the accompanying rollover of bilateral and multilateral financing flows and the normalization of global commodity prices, especially oil prices, reserves have recovered to over $10 billion, while controls on imports have been eased. The pressure on the exchange rate has abated, with the rupee remaining stable against the dollar. Inflation has moderated to 7 percent. Nevertheless, the public sector continues to face external amortization payments of around $14 billion annually for the next five years, which represents the bulk of an annual gross external financing requirement of about $22 billion.[6]

[5] Stand-By Arrangements are IMF programs which provide short-term financing to address temporary balance of payments pressures

[6] According to IMF projections, of the $22 billion annual average external financing requirement over the next five years, $14 billion is public sector debt amortization, including repayments to the IMF.

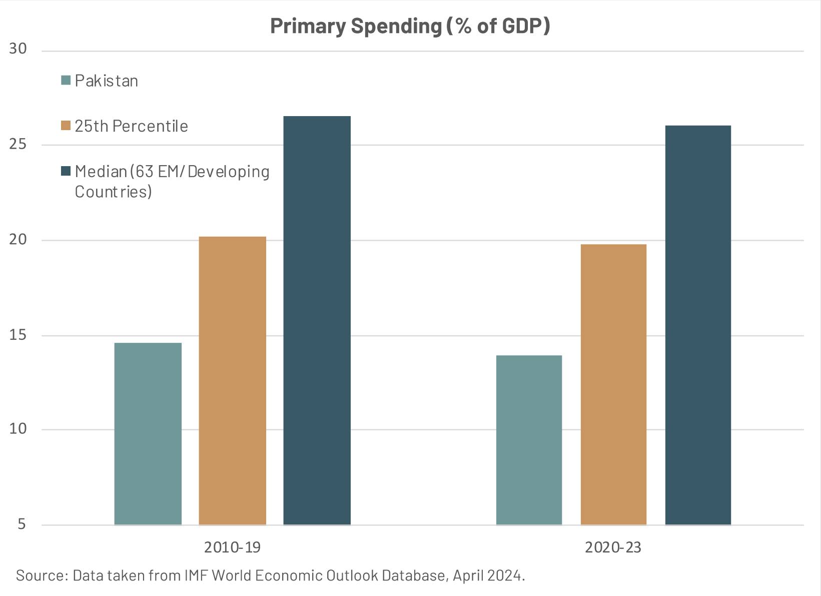
II. Navigating painful choices: “between a rock and a hard place”

Two solutions to address the interest bill and external amortization problems have been put forward. The first consists of a new 37-month IMF adjustment program under its Extended Fund Facility (EFF) and got underway in September 2024 as a successor to the SBA mentioned in the previous section. The second, a scenario in which Pakistan restructures its debt, has been proposed by some observers. Both are excessively painful and would generate serious social sustainability risks.

A. The new EFF program leaves unsolved the interest bill problem

The EFF program[7] aims to tackle Pakistan’s oppressive interest burden by reducing the need to borrow. At the same time, it seeks to ensure that official creditors, to whom the bulk of amortization payments are due, maintain their exposure by at least rolling over their debt over the duration of the program. The rollover appears feasible since the bulk of the repayments due are owed to official creditors. It is, therefore, reasonable to expect that they will maintain their exposures as long as the Fund program remains on track since they will be assured that sound macroeconomic policies are being followed. Nevertheless, even with the amortization problem addressed, the interest bill problem still needs to be solved.

The fiscal adjustment under the new EFF program outlines a very tight primary spending envelope, which heightens risks to both economic growth and social sustainability. Even though a modest increase in expenditures is anticipated compared to the severely restricted levels caused by the interest bill crisis in 2022/23 and 2023/24, primary spending—that is, spending excluding interest—is projected to remain below 14 percent of GDP over the next five years. This would be even lower than the 2010-19 and 2020-23 averages in Pakistan. The primary spending gap against other emerging markets/developing countries would not narrow at all. Given such a tight envelope, the much-needed expansion in social and infrastructure spending would not be possible, nor would there be

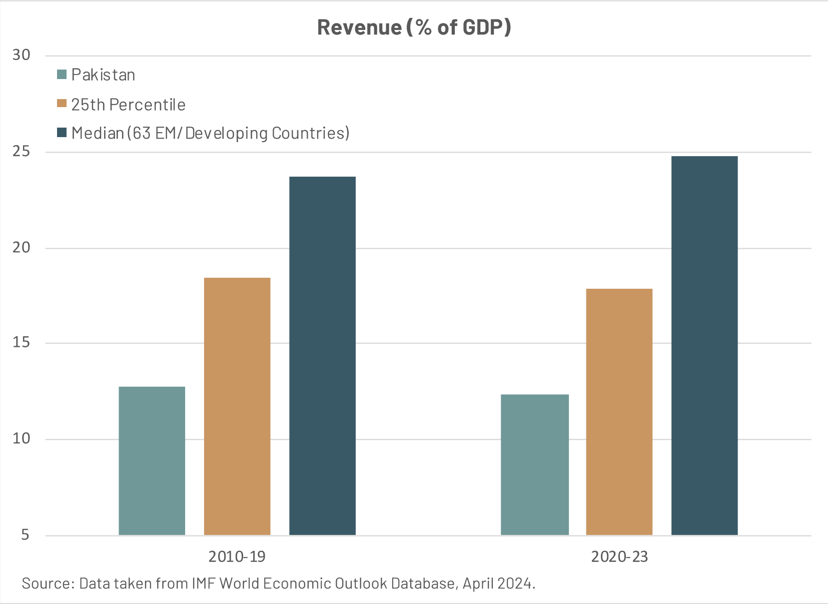


Source: Data taken from IMF World Economic Outlook Database, April 2024.

[7] Extended Fund Facility programs are longer-term arrangements designed to address protracted balance-of-payments pressures

room to undertake necessary public investment in climate resilience. In this environment, economic growth is likely to be anemic at best, and achieving the program's target growth rate of 4.5 percent over the medium term—somewhat higher than Pakistan's long-term average of 3.6 percent—seems very difficult.

Such a compressed spending plan could also jeopardize the ambitious revenue agenda. The program calls for an increase in tax revenue by about 3 percentage points of GDP over three years but with little further improvement in subsequent years. This increase would rightly come from broadening the tax base to include sectors that are currently undertaxed and improving tax administration. The planned measures would close about one-half of the gap with the lowest quartile (25th percentile) of emerging markets/developing economies. However, in the context of low growth and restricted social and investment spending due to stringent spending limits, public support for this strategy will be very challenging to sustain.



Source: Data taken from IMF World Economic Outlook Database, April 2024.

With external (official) creditors only rolling over (rather than increasing) their exposures, almost all of the government's new financing needs are expected to be met through domestic sources under the EFF program. The overall budget deficit is projected to narrow steadily from 6.7 percent of GDP in 2023/24 to under 3 percent by 2028/29. Over the next 5-year period, external financing is projected to average only about 7 percent of the total need. Hence, not only will the tight constraint on public spending hold back investment, but the sizable recourse to domestic financing by the government will crowd out the private sector's access to financing from the domestic financial system. External public debt (excluding guarantees) is projected to increase by 10 percent, from $94 billion at end-2023/24 to

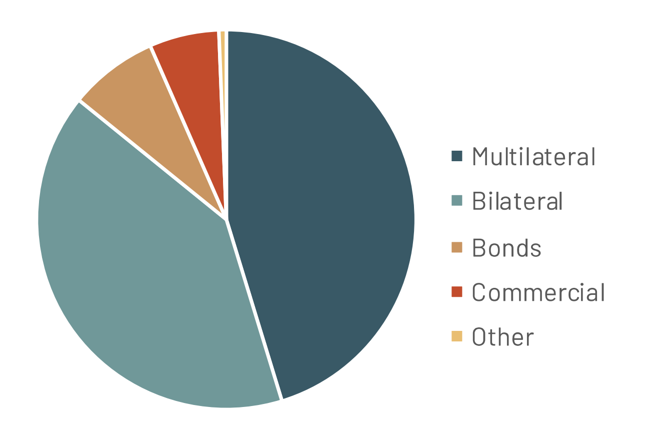
$104 billion by end-2028/29, with private creditors projected to increase their exposure and official creditors to cut theirs.[8]

Despite the narrower budget deficit, the government's interest bill will not come down to below 30 percent, even after five years. With the envisaged fiscal adjustment, the public debt to GDP ratio is projected to decline to under 65 percent by 2028/29. Economic growth would recover to 4.5 percent over the medium term, about 1 percentage point higher than the historical average, as fiscal drag wanes and structural reforms boost productivity. However, with the bulk of financing coming from domestic market sources and very little from concessional external sources, the effective cost of financing will remain relatively high. Even if the government achieves the targeted expansion in revenue and economic growth, the share of the interest bill in revenue will remain above 30 percent as far out as 2028/29.

B. Would debt restructuring be any better?

Recognizing the painful fiscal adjustment path ahead, and the risks to growth and social sustainability that come with it, some observers have advocated for an alternative strategy that entails debt restructuring.[9] The idea is to avoid or at least reduce the need for painful fiscal measures while solving the external amortization problem by forcing an extension of the repayment schedule by nonpayment (or threat of nonpayment).

External Debt (share; end-2023)



Source, IMF Staff Report, September 2024.

The impact of restructuring external debt will be minimal to address the interest problem. Instead, it would create other difficulties. Over 85 percent of the interest bill arises from domestic debt obligations. Even if interest payments on external debt are completely halted, the interest burden would not be substantially reduced. Moreover, defaulting on or

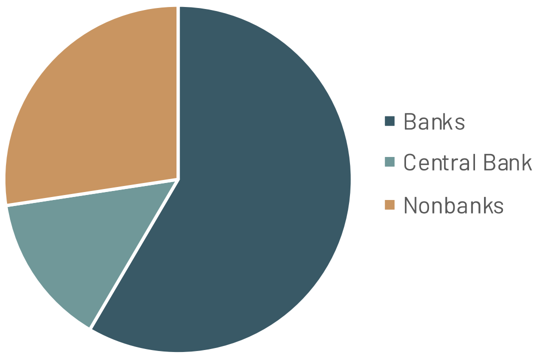
[8] Data on projected changes in exposures of specific creditors, even groups of creditors, are not available in the IMF Staff Report nor in official publications. The large projected disbursements from private creditors as a whole to the public sector, especially in the outer years of the projection horizon, imply that official creditors collectively are projected to cut their exposure.

[9] See, for example, M. Syed, "Break the taboos propping up unsustainable debt," (The Economist, 28 August 2024) and S. Kathuria, "Pakistan Should Restructure its Debt Now," (Project Syndicate, 25 September 2024). By contrast, R. Riazuddin and S. Zaheer, "Debt Management and Sustainability Issues in Pakistan," (Consortium for Development Policy Research (CDPR) and Finance for Development Lab (FDL), Paris School of Economics, 2024), in a much more careful analysis of the data, conclude that Pakistan can avoid the pain of debt restructuring but will remain dependent on friendly countries for liquidity support.

restructuring external debt would impose large costs on the economy in terms of impaired trade relations (since trade credits would dry up) and potential seizure of foreign assets (by foreign creditors seeking compensation). Since the bulk of the external debt is to official creditors, default on debt obligations to them could also hurt diplomatic relations with friendly countries and impair access to loans and projects from multilateral institutions such as the World Bank, the Asian Development Bank, etc.

As for restructuring domestic debt, it could lower the interest bill meaningfully but would create major economic and financial disruptions that would overwhelm any gains. Close to 60 percent of the government's domestic debt is held by banks, and in turn, banks' holdings of government obligations represent around 60 percent of their total assets. Hence, any restructuring would have to touch debt held by banks, and any haircut on such debt will directly affect the financial health of the banking system. Just a 10 percent haircut would wipe out the entire capital base of the banking system as a whole, though, of course, the impact on individual banks would vary. In such circumstances, the dislocations across the economy would be severe, hitting not only the banks' shareholders but probably also depositors and other holders of government debt, such as households, as well as insurance and pension funds. Thus, domestic debt restructuring should be seen as a solution of last resort, when no other, better options exist. That is probably why domestic debt restructuring is very rarely seen across the world.

Domestic Debt (share; end-2023)



Source, IMF Staff Report, September 2024.

III. Exploring a third path: a more realistic macroeconomic strategy with a supportive financing framework

There is a better, less painful way to simultaneously tackle Pakistan's oppressive interest burden and hefty amortization schedule. This approach would entail a more realistic adjustment in spending, which would be made possible by expanded concessional liquidity support from official creditors. This would lead to higher investment and better social sector outcomes, reducing implementation risks. Additionally, a mechanism to enhance debt-related data transparency would promote necessary coordination among creditors.

A. The macroeconomic strategy

Increasing revenue meaningfully should be feasible. At around 12.5 percent of GDP, Pakistan's revenue collection is presently among the weakest in the world. Only one in every hundred Pakistanis is an active personal income tax filer (as of 2021). The retail and agricultural sectors together account for almost half of the economy but pay virtually no income tax. Property tax collection is also very low, as is taxation of real estate and construction services. Serious and sustained efforts to broaden the tax base to cover these and other undertaxed sectors could boost revenue substantially. Reforming federal-provincial fiscal arrangements to give provinces more incentive to mobilize revenue would also help.

Thus, it is reasonable to target closing one half of the revenue gap (amounting to about 3 percentage points of GDP) with the lowest quartile (25th percentile) among emerging markets/developing economies in three years, as is intended under the EFF program. In fact, it is reasonable to close the entire gap (6 percentage points) in 5-6 years. That would imply a revenue ratio around 18 percent by 2028/29.

Primary spending is very low, too, in comparison with other countries, so there is no room for additional saving in aggregate through expenditure cuts. But the quality of spending is weak as well. More than 1 percent of GDP is spent on untargeted subsidies, and inefficient state enterprises consume considerable budgetary resources. Spending more wisely is clearly necessary. However, with poverty incidence desperately high, health and education indicators—especially for the poor—abysmally low, and massive climate-resilient infrastructure requirements to support economic growth, more needs to be spent.

Devoting one-half of additional revenue to meeting primary spending needs and the other half to reducing borrowing would strike a reasonable balance. Even with 3 percent of GDP more primary spending in 5-6 years, Pakistan would only close one-half of the primary spending gap relative to the lowest quartile among emerging markets/developing economies. Spending less than that does not seem socially sustainable.

Lower borrowing by the government would put downward pressure on interest rates, which are already coming down as disinflation proceeds.[10] The resulting expanded availability of bank credit to the private sector at a lower cost would support investment and growth. However, given the very low level of public and private investment at present—2 percent and 12 percent of GDP, respectively—the boost would not be sufficient to improve growth and employment prospects meaningfully. Without much improvement at the macroeconomic level, the extended fiscal austerity drive would carry a high risk of social instability, which could derail the adjustment and possibly force a more painful default/restructuring outcome.

B. Concerted liquidity support

A much better—and less risky—scenario would be one in which official creditors, acting in concert, commit to not only rolling over their loans but incrementally (and proportionally) increasing their exposures at concessional interest rates over the next 5-6 years. Such inflows would foster higher investment, thereby unlocking more rapid economic growth and allowing public debt to become self-sustaining, with the public interest bill dropping below 25 percent of revenue by 2028/29.[11] Bilateral and multilateral creditors' combined exposure was about $90 billion at the end of 2023/24, and the interest on it could amount to roughly $3 billion/year (estimated based on past average effective interest rates). If the exposure were increased by 20 percent over 5-6 years, and in addition, all the interest due was capitalized, the resulting net transfer would amount to about $6 billion/year (1-1½ percent of GDP/year).[12] The resulting "crowding in" of private investment from the lower public sector domestic borrowing need—even without any additional boost from lower interest rates—would imply a substantial cumulative impact on private investment.

This favorable scenario is possible only if deep structural reforms are undertaken along with the fiscal adjustment. In addition to broadening the tax base and reforming federal-provincial fiscal responsibilities, serious progress must be made to address the cost side of the energy sector to

[10] If inflation can be kept at 5-7 percent and assuming a real interest rate of 2-3 percent, bringing the domestic interest bill down to around 4 percent of GDP in three years (compared to 7 percent in 2023/24) seems feasible.

[11] Economic growth will be higher if primary spending, especially public infrastructure and climate resilience expenditures, are higher, even without assuming an additional positive effect on productivity. The impact on the budget balance would be mostly offset by the lower interest bill due to the increased concessional financing. Hence, the envisaged decline in the public debt ratio to below 65 percent would still materialize.

[12] Individual creditors that are unable to increase exposure in line with the collective effort could instead be asked to offer maturity extensions and further interest discounts so their effective support matches that of the creditors providing concessional liquidity support.

reverse the buildup of the massive circular debt while offering some relief to consumers.[13] Both the quality and the quantity of spending on the social sector—health, education, population planning, and income support—need to be enhanced. Devolving this spending to the provincial and sub-provincial levels, with suitable checks, would improve the effectiveness of expenditures and possibly earn greater social acceptance of the fiscal adjustment. Privatizing inefficient state enterprises is also critical to free up budget resources and to promote better service provision.

New external financing must be obtained at low cost to achieve interest bill sustainability. Moreover, the financing should be focused on infrastructure and climate resilience projects in order to enhance growth and employment prospects. Some external financing could even be used to retire, at a discount, carbon-emitting energy projects that are no longer competitive against clean solar alternatives ("stranded assets") but remain in place to help defray the related debt service costs. Such financing could also help address the circular debt problem plaguing the energy sector. In order to bring the interest bill-revenue ratio to 25 percent in 5-6 years, only concessional external finance—probably at no more than 3-4 percent in dollar terms—should be availed, and market financing, though access to it will likely reopen as a track record under the EFF program is established, should be eschewed until the interest bill dips below 25 percent of revenue.[14] Given the poor track record of past public investment projects and the need to improve public investment management, direct bilateral and multilateral creditor project involvement seems necessary to support project selection and implementation. Indeed, the switch to quick-disbursing budget support instead of project loans by multilateral institutions in Pakistan in the past was accompanied by real exchange rate appreciation and stagnation of manufacturing and exports.[15]

C. A modest transparency proposal to facilitate lender coordination

Official creditors recognize the need for concerted lending to Pakistan in the near and medium term to keep debt manageable. This recognition was reflected most recently in 12-month-ahead financing assurances provided at the time of the EFF program approval. At this stage, however, lenders have generally not offered net new flows of the scale needed to achieve the "more promising" scenario

[13] Circular debt, or the stock of payment arrears in the power sector, amounted to 4 percent of GDP at end-2023/24. The payment arrears arise from various types of line losses, non-recoveries/non-payments of bills, late payment surcharges, delays in subsidy payments, delays in tariff determinations, etc. According to the Pakistan Government's Memorandum accompanying the IMF's September 2024 Staff Report, these arrears have historically been driven by the failure of tariffs to keep pace with prices; inefficient management of distribution and transmission companies; undercollections; and delayed maintenance coupled with weak transmission and distribution infrastructure.

[14] Under the EFF program, the external public debt ratio would decline to near 20 percent of GDP but the interest bill-revenue ratio would remain over 30 percent even in 2028/29 (the end of the projection horizon). With $36 billion more external financing (cumulatively) at concessional terms, and corresponding lower domestic borrowing at market rates, the interest-revenue ratio would drop to below 25 percent while external public debt would remain manageable—below 30 percent of GDP.

[15] F. Iqbal and I. Nabi, "Pakistan's External Debt Dilemma," Center for Global Development (CGD), Consortium for Development Policy Research (CDPR) and Finance for Development Lab (FDL), Paris School of Economics, 2024.

described above. To the extent this reluctance is due to a collective action problem—whereby each creditor would be willing to provide support commensurate with its own exposure if it was sure all others were doing so too—greater transparency about exposures, loan terms, and planned flows could be instrumental in achieving the better outcome.

Currently, it is difficult, if not impossible, to ascertain the magnitude of net new flows from each major creditor last year, as well as projected figures for this year. Similarly, data on the effective interest rates charged and the total interest paid to each creditor is not publicly disclosed. If such data were publicly available, each creditor would be incentivized to behave responsibly because failure to do so would quickly become evident to all others. Specifically, publishing data on amortization, new loans, and interest payments received (from which the effective interest rate on outstanding debt can readily be calculated and compared across lenders) for the past year and projected for the coming year by each of the key multilateral (IMF, World Bank, Asian Development Bank, etc) and bilateral creditors would suffice. The IMF is well-positioned to compile and publish this information in its reports. Doing so would foster peer pressure among creditors to behave in concert for their mutual benefit and for the benefit of Pakistan. If successful in Pakistan, other countries with similar debt difficulties would also benefit from such debt data transparency.

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