Breaking the debt lock

The Annual Debt Review & Public Debt Burden FY2019-20 – a publication from the Debt Policy Coordination Office, Ministry of Finance – reports that the total public debt-to-GDP ratio for Pakistan has increased from 86.1 percent in June 2019 to 87.2 percent in June 2020.

This report is published as a requirement under the Fiscal Responsibility and Debt Limitation Act, 2005 (amended July 2017) generally termed as FRDL-2005. The FRDL-2005 states that there is a debt sustainability limit of 60 percent of GDP now and by 2032-33 it is required to be 50 percent or below as a percentage of GDP.

Fiscal policy provides the leverage to the government for borrowing against the fiscal deficits aiming at higher economic growth or providing cushion in economically bad times. At low levels of sovereign indebtedness, an increase in the proportion of public debt-to-GDP could promote economic growth. However, at high levels of sovereign indebtedness, an increase in this proportion could hurt economic growth.

Debt can have nonlinear impacts on economic growth. At unsustainable levels of debt, the causality runs from growth to debt. Further debt servicing can further increase fiscal woes, making it dynamically inconsistent. In other words; "As long as the cost of borrowing is less than the economic growth, the debt burden will not rise."

Pakistan's economy has a stunted growth owing to structural problems. There is a shift in the economic policies undertaken by the present government as witnessed by a readjustment in the fiscal and monetary policies. The stabilization process is supported by the IMF's 39-months Extended Fund Facility (EFF) arrangement program started in July 2019. Stabilization measures were implemented to reduce the twin deficits (trade and budget deficits) which have corresponding relation with debt levels. However, the Covid-19 outbreak has had a devastating impact on Pakistan's economy for FY20.

As per the Pakistan Economic Survey 2019-20, "the economy was transitioning from stabilization to growth, the outbreak of Coronavirus (Covid-19) during the second half of current fiscal year brought multifaceted challenges for Pakistan to preserve the economic gains achieved as a result of various efforts to improve the fundamentals of the economy had a profound impact on economic activity during the year."

However, due to effective policies such as 'smart lockdown' and now 'micro-smart lockdown', comprehensive fiscal and monetary policy initiatives and social protection services have helped the economy get back on to the recovery path. The monthly Economic Update & Outlook, September 2020, by the Economic Adviser's Wing, Ministry of Finance reports that recovery is observed for July and August FY 2021.

However, mounting debt poses a challenge in this recovery and ultimately is a sustainable growth challenge. Within this fiscal constraint, the government has to work through sound fiscal and monetary management. Macro-economic policy managers can target the fiscal surpluses or economic growth or both for achieving a sustainable debt path.

The Pakistan Institute of Development Economics (PIDE) has project debt sustainability thresholds for real economic growth while undertaking debt sustainability analysis in case of Pakistan. The study considers three scenarios for primary balance and identifies the potential growth targets which would make Pakistan's debt levels sustainable. First, when primary balance is zero; the minimum growth must be greater than real interest rates. Second, when primary balance is -2.2 (which is the average of last ten years); the threshold level of economic growth is 4.5 percent plus population growth (roughly 6.6 percent). And, third, when primary balance is -4.3 (which is the historic high of last ten years); the threshold level of economic growth is 6.8 percent plus population growth (roughly 8.9 percent).

In such a fluid situation where the pandemic has severely affected transactions (through compression in consumer demand and uncertainty for the business sector), policy frameworks have to be responsive to the need of higher economic growth. For example, the tax policy should aim at the revival of growth.

As indicated by Dr. Nadeem ul Haq (‘Doing Development Better: Analyzing the PSDP’, PIDE Policy Viewpoint No. 11,2020), the current growth model of bricks and mortar through reliance on PSDP-induced economic activity is not sustainable and needs to change.

Given the government’s limited fiscal space, if the country has to achieve the stipulated growth targets and break the debt-lock then the broader focus should be on encouraging markets to increase transactions by simplifying the regulatory frameworks.

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