

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

Social Origins of Debt Crises Reflections on Pakistan's Experience

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Overview

1. Summary Thesis
2. Evolution of Pakistan's Public Debt
3. Need for a Debtors' Perspective
4. Some Policy Implications



Summary Thesis

Sovereign debt crises are *financial and economic* crises, caused by deficiencies in *law, justice, and governance*, nationally and globally, which undermine *economic prosperity*, leading to *fiscal stress*, excessive *borrowing*, and a *spiraling debt crisis*.

The Circle of Justice

*“There can be no
state without an army,
No army without revenues,
No revenues without prosperity
No prosperity without justice
and good government.”*

- Governor of Egypt (ca. 640 CE)

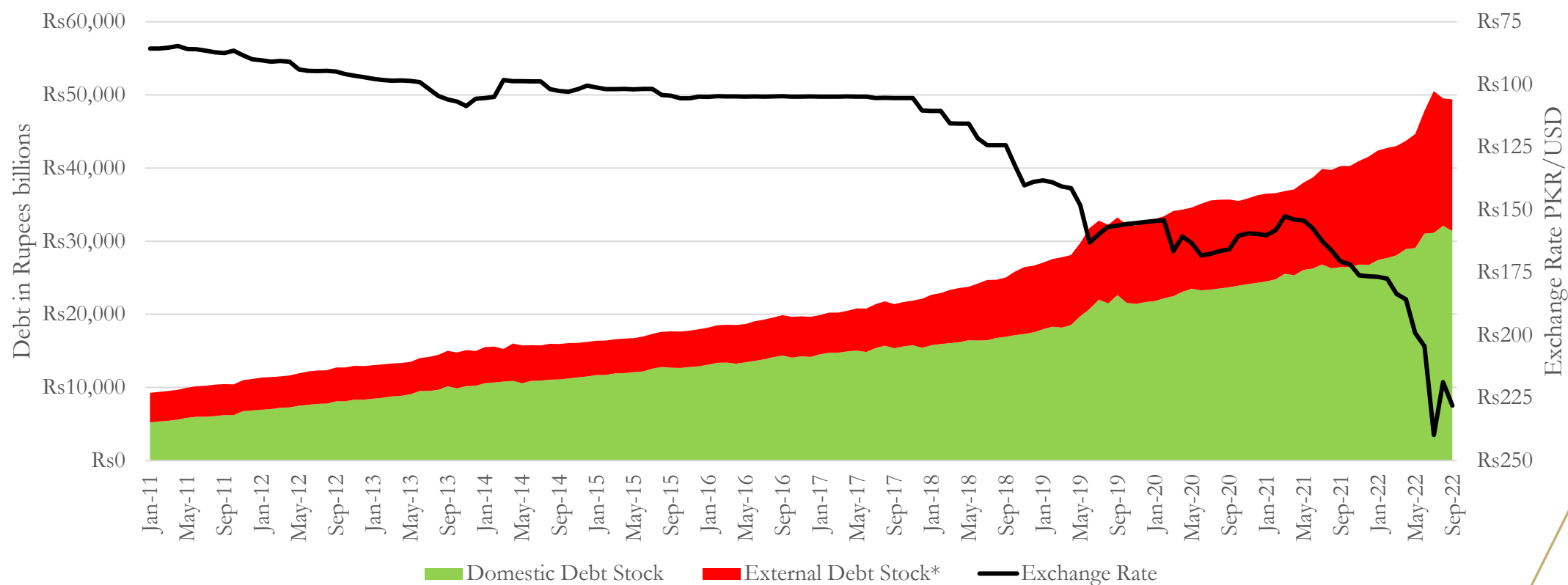


OUTLINE

1. Summary Thesis
2. **Evolution of Pakistan's Public Debt**
3. Need for a Debtors' Perspective
4. Some Policy Implications

2. Evolution of Pakistan's Public Debt

Pakistan's public debt is owed largely to domestic creditors (Although the share of foreign creditors is rising)



* External debt excludes IMF loans and foreign exchange liabilities.

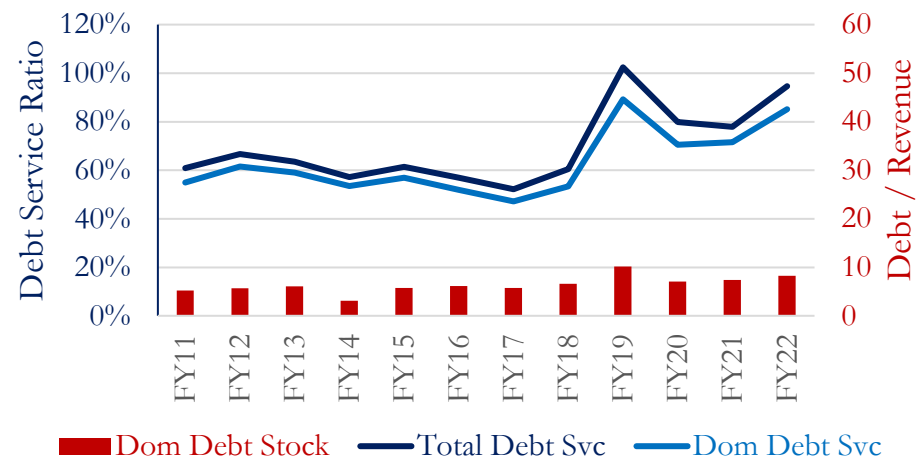
Source: State Bank of Pakistan.

Debt service now exhausts 95% of net federal revenues

Foreign exchange pressures reflect deterioration in the pace and quality of economic growth

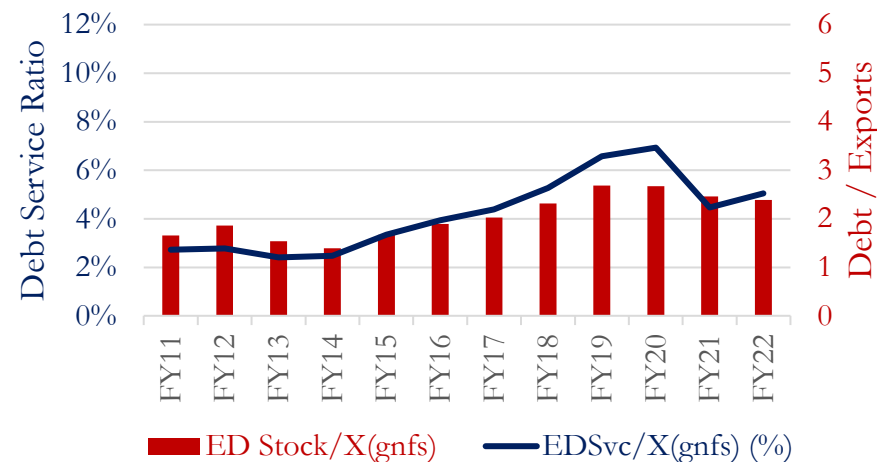
THE DEBT CRISIS IN PAKISTAN IS A CRISIS OF DOMESTIC PUBLIC DEBT (OWED TO BANKS)

Federal Government Domestic Debt Stock & Total & Domestic Debt Svc as Ratios of Net Revenues



THE FOREIGN EXCHANGE CRISIS IS NOT A FISCAL, BUT AN ECONOMIC CRISIS

Federal Government External Debt Stock and Debt Service as Ratios of Export Receipts

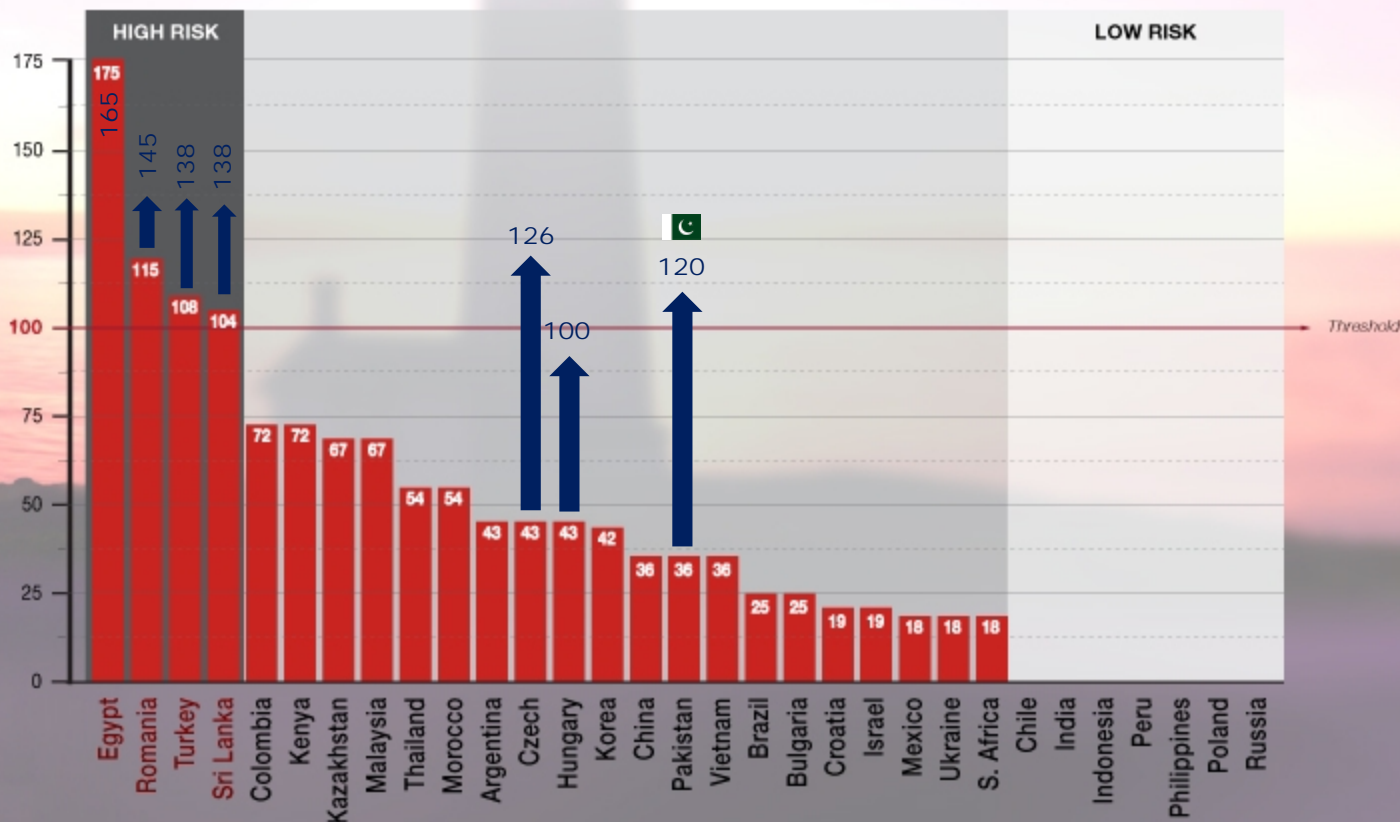


Note: Numbers on the right Y-axis show the stock of debt as a multiple of annual revenue (left graph), or of annual exports of goods and non-factor services (right graph)

Risk of Currency Crisis in Pakistan (November 2022)

Damocles:
Nomura's early warning indicator of exchange rate crisis

Latest Damocles score
November 2021 | November 2022



32 emerging markets



8 key indicators

6 Single indicators

- FX reserves / imports
- Short-term external debt, % of exports
- FX reserves / short-term external debt
- Broad money / FX reserves
- Real short-term market interest rate
- 1y non-FDI gross inflows less Δ FX reserves, % GDP

2 Joint indicators

- Fiscal balance and current account
- REER % deviation from 5y average and current account



Noise-to-signal approach



64% chance of currency crisis in following 12 months if score breaches 100 (based on the past 61 crisis)

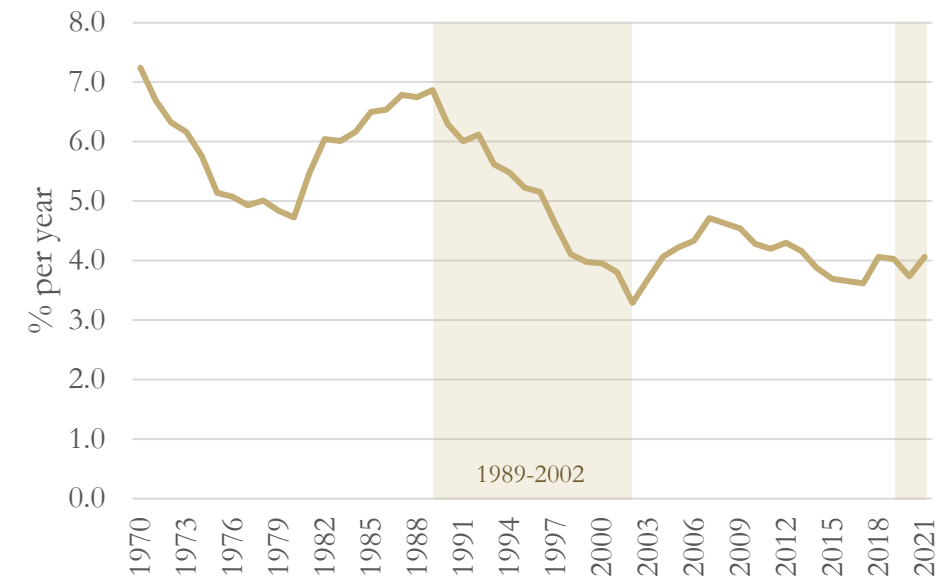
In the absence of the infrastructure of law and governance, lawless liberalization led to a sharp fall in economic growth from 1989, as government was scaled back

THE IMPACT OF NEOLIBERAL POLICIES IN PAKISTAN, 1989-NOW

IMF Agreements:

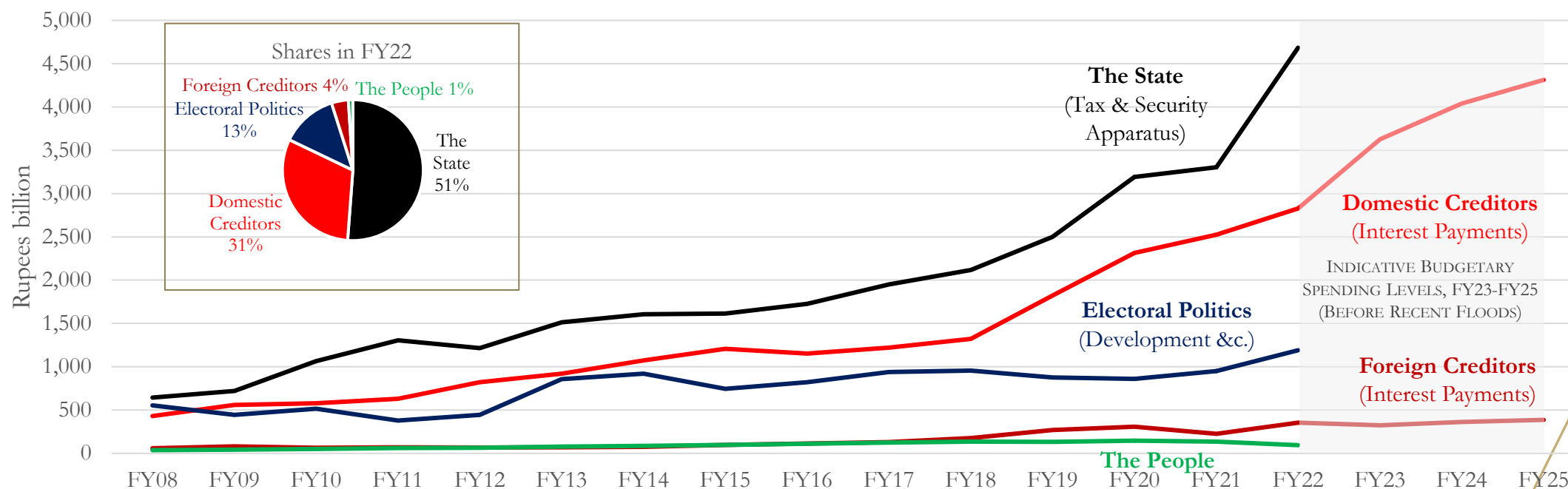
1988: Standby Agreement/Structural Adjustment Facility
1991: Structural Adjustment Facility (SAF)
1993: Standby Agreement
1994: Enhanced SAF (ESAF)/EFF
1995: Standby Agreement
1997: Enhanced SAF (ESAF)/EFF
2000: Standby Agreement
2004: *Pakistan exits from the IMF*
2008: Standby Arrangement
2013: Extended Fund Facility
2019: Extended Fund Facility (Still in effect)

LONG-RUN ECONOMIC GROWTH (10-YEAR MOVING AVERAGE OF ANNUAL GDP GROWTH)



In the space created, domestic banks have captured the state
They have been and may be the largest beneficiaries of any debt relief

Beneficiaries of (Debt-Financed) Public Spending The State, its Creditors, Electoral Politics, and People's Welfare



Source: Based on Ministry of Finance statistics (FY08-FY22: Fiscal Operations, Table 4); indicative projections are from the *Medium-Term Budget Strategy Paper 2022-23 - 2024-25*.

“This super flood is driven by climate change — the causes are international.”

— Julien Harneis, UN humanitarian coordinator in Pakistan

- COUNTRY UNDER WATER: ONE-THIRD
- TOTAL DAMAGE: \$14.9 BILLION
- TOTAL LOSSES: \$15.2 BILLION
- PERSONS AFFECTED: 33 MILLION
- PERSONS DISPLACED: 8 MILLION



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3. Need for a Debtors' Perspective

Debt-financed growth is neither necessary nor sufficient for development

The discourse on debt needs to move away from capital fundamentalism to a holistic view of development

CAPITAL FUNDAMENTALISM (BORROW > INVEST > GROW)

- Economic *development* is adequately reflected in economic *growth*.
- Capital formation (*investment*) is the secret to growth.
- So, nations, short of savings, should *borrow* to invest and grow (and service the debt from the benefits of growth).
- This leads to a near-exclusive focus on *finance* as the key to growth.

ECONOMIC DEVELOPMENT WAS AN EVENT IN EUROPEAN HISTORY

- Both *growth* and *capital formation* are byproducts of economic *development*, which refers to the rise of *democratic capitalism* in 19th century Europe, and the preceding moral revolution in which *secular-rationalism* triumphed over ecclesial Christianity.
- So, to replicate these developments, simultaneous progress must be made on all three fronts. The economy is not separable from politics, or the prior shift in the moral imagination.



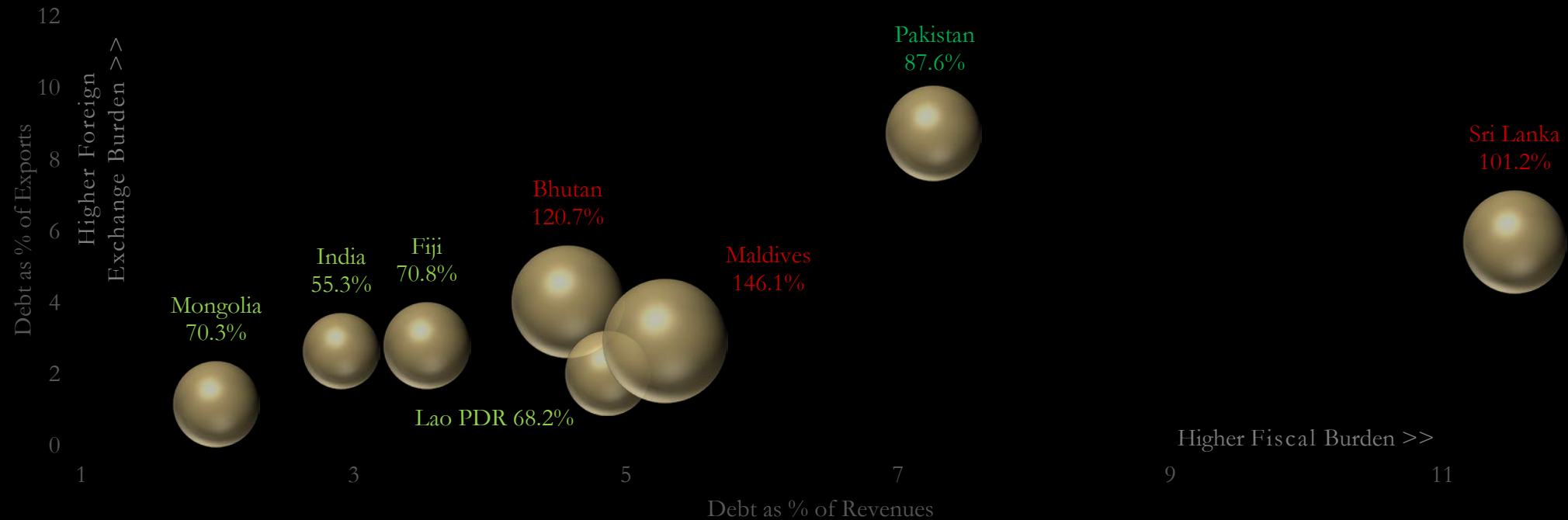
The IMF/WB Debt Sustainability Analysis (DSA) Framework is flawed

1. It defines sustainable debt in real (i.e., price-deflated) terms, when it is contracted and paid for in nominal (i.e., money) terms.
2. It measures debt capacity by real GDP, an indicator of *potential* (not *actual*) capacity.
3. Actual debt burden and stress would be better reflected by public debt and debt service as ratios of public revenues; external debt and debt service, as ratios of export receipts.

Alternative Indicators of Debt Burden

Pakistan is most foreign exchange burdened, and second most fiscally burdened country

IMF Debt-Sustainability-Analysis Higher-Scrutiny Countries in the Asia & Pacific Region
(Size of bubble, shown below country names, is central government debt as a ratio of GDP)



Source: Calculations based on IMF/WB data.

The 'r minus g' rule is bad policy

Policy Implication of Rule: If real rate of interest is less than the real rate of economic growth, then borrowing all you can will not create debt difficulties.

The Rule is good textbook economics but is a recipe for policy disaster—again, because debt is serviced in nominal, not real terms.

So, unless the increased growth is captured in increased public revenue and exports, not at all certain, it will lead to fiscal and foreign exchange difficulties.

at constr.

$$\underbrace{B_t - B_{t-1}}_{\text{deficits in year } t} = \underbrace{r B_{t-1}}_{\text{interest}}$$

$$\Rightarrow B_t = (1 + r) B_{t-1}$$

remarks

deficit (flow, $B_t - B_{t-1}$) v.s. de
evolution of debt-to-GDP ratio

$$\underbrace{\frac{B_t}{Y_t} - \frac{B_{t-1}}{Y_{t-1}}}_{\text{change in debt ratio}} = (r - g) \underbrace{\frac{B_{t-1}}{Y_{t-1}}}_{\text{initial debt ratio}}$$

- Fiscal policy (changes in (G_t, T_t) to achieve v.s. automatic stabilizer

A large black triangle on the right side of the slide, pointing downwards. Inside this triangle, there are two smaller gold-outlined triangles: one at the top pointing downwards and one at the bottom pointing upwards. A gold-outlined triangle is also partially visible on the right edge of the slide.

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4. Some Policy Implications

Key Priorities for Pakistan

(Broad Implications)

ONE:

Get organized & take back control of policymaking; rebuild the bureaucracy

TWO:

Protect external solvency (Stop capital flight, limit wasteful borrowing, & return undisbursed loans for loss-making projects)

THREE:

Restore domestic solvency (Restructure domestic public debt)

FOUR:

Revive domestic private and public investment

FIVE:

Create stable politics (Promote Inclusive Development)

SIX:

Promote social cohesion (Build Forward Fairer)

How Can Multilateral Stakeholders Help

Put Some Teeth in Implementing Selected SDG 16 Targets

- Promote the rule of law at the national and international levels and ensure equal access to justice for all.
- Substantially reduce corruption and bribery in all their forms.
- Develop effective, accountable and transparent institutions at all levels.
- Ensure responsive, inclusive, participatory and representative decision-making at all levels.
- Broaden and strengthen the participation of developing countries in the institutions of global governance.

What can ESCAP do?

Provide intellectual leadership to develop a debtors' view on policy and analysis of inclusive, resilient, fairer, sustainable development:

1. Identify barriers to inclusion and policies to overcome them.
2. Delink loss and damage funds from climate resilience initiatives.
3. Work for a fairer international financial architecture.



Thank You

Presentation at UN ESCAP Expert Group Meeting on
Public Debt and Sustainable Financing in Asia and Pacific
Session 3: Policies to prevent and resolve public debt crises



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