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Macroeconomic Management: Breaking out of the Debt Trap

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I. Introduction

It is remarkable that from a situation of default and unsustainable fiscal and balance of payments deficit only a few years back, Pakistan has come out of the debt trap, balance of payments turned surplus[1], and fiscal deficit has declined below 4 percent of GDP. However, sharp increase in the inflation rate, widening trade deficit and re-emergence of balance of payments deficit in the current year are quite worrisome.

With the widening of the balance of payments deficit and the possibility that fiscal deficit may start rising as the government provides for the higher levels of public expenditure, would the debt problem not emerge once again? Bilquees (2003) has examined the growth of debt over the 1980-81 to 2002-03 period by de-composing the effect of primary deficit, interest rates and exchange rate adjustments. She argues that primary deficits are basic to the growth of debt. Higher government public expenditure compared to its resources leads to higher domestic as well as external borrowings. The external borrowing with limited repayment capacity results in exchange rate depreciation with consequent implications for the debt. The differential between interest rates and growth of GDP also have implications for the debt but in Pakistan it did not result in rising debt ratio because the interest rates have always remained lower than the growth rate.

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[1] Surplus in balance of payments has been equivalent to 3.9 percent of GDP, foreign exchange reserves exceeded $12.5 billion, growth of exports accelerated to 13.0 percent, workers' remittances increased to $ 3.9 billion, the average interest rates fell to around 7.5 percent, and inflation rate has been around 4.6 percent during 2003-04. Real sector of the economy has also shown improved performance during the year: GDP registered growth rate of 6.4 percent while the investment increased form 16.4 to 18.1 percent of GDP.

Since growth of debt is influenced by primary deficit, interest rates and the exchange rate adjustment, the present study examines the fiscal, monetary and exchange rate policies pursued since 1987-88 when Pakistan signed its first stabilization program with the IMF. The plan of the paper is as follows. After this introductory section, Fiscal, monetary policies and exchange rate policies are examined in section II, III and IV. Trends in debt and debt servicing are reviewed in section V. Main conclusions are summarized in section VI.

II: Fiscal Policy

Unless fiscal deficit is financed through grants, it would result in rising public debt. However, the debt-GDP ratio would increase only if the fiscal deficit as a percentage of GDP exceeds the growth of GDP. In Pakistan, the total public debt is still rising but in recent years, the debt-GDP ratio has started declining.

Since 1987-88, when the fiscal deficit had increased to 8.5 percent of GDP and Pakistan signed the first IMF Stablization programs in 1987-88, she has been grappling with reducing the fiscal deficit. It is expected that the demand management policies in the form of contractionary fiscal and monetary policies would help in narrowing the investment-savings and the balance of payments gap[2]. Therefore, each of the IMF programs signed since 1987-88 called for further reduction in the fiscal deficit, though without much success.

Fiscal deficit until the late 1990s has been in almost all the years in excess of 6 percent of GDP. In 1999-2000 it was still 6.6 percent of GDP. It has gradually declined to 4.5 percent of GDP by 2002-03 and to 3.9 percent in 2003-04.[3] While there has been primary deficit upto 1995-96, it turned surplus in later years. During 2001-02, primary surplus was 2.5 percent of GDP, however, since then it has declined to 1.3 percent.

[2] The impact of fiscal deficit on the economy has been controversial. Keynesians maintain that stimulation of aggregate demand in the presence of excess capacity and unemployment through fiscal deficit results in higher levels of income and output. Neo-classicists believe that fiscal deficits have adverse implications for savings and growth. The Ricardians believe that fiscal deficits do not have any impact on growth.

[3] The National Accounts base has been changed since 1999-2000. The fiscal deficit as per new base declined from 3.7 in 2002-03 to 2.4 percent in 2003-04.

Table-1: Budgetary Deficit in Pakistan (as percentage of GDP)

	Total Revenues	Tax Revenues	Public Expenditures				Budgetary Deficits	Primary Deficit
			Total	Non-Develop-ment	Interest Payment	Develop-ment		
1987-88	17.3	13.8	26.7	19.8	6.9	6.9	8.5	1.6
1990-91	16.9	12.7	25.7	19.3	4.9	6.4	8.8	3.9
1995-96	17.9	14.4	24.4	20.0	6.2	4.4	6.5	0.3
1998-99	15.9	13.2	22.0	18.6	7.5	3.4	6.1	-1.4
1999-00	16.3	12.9	22.5	19.9	8.3	2.6	6.6	-1.7
2000-01	16.2	12.9	21.0	18.9	7.3	2.1	5.2	-2.1
2001-02	17.2	13.2	22.8	19.3	7.1	3.5	5.2	-2.5
2002-03	17.7	13.6	22.2	19.8	5.9	3.2	4.5	-1.4
2003-04	18.0	13.7	21.9	17.7	5.2	3.5	3.9	-1.3

Source: *Pakistan Economic Survey* and Supplements, various issues and *Annual Report of State Bank of Pakistan,* 2003-04.

A number of factors have been responsible for the decline in the fiscal deficit during 2002-03 and 2003-04. These include debt reprofiling, slow growth of public debt, decline in the interest rates, reduction in development expenditure, and an increase in the non-tax revenues.[4] Whereas reduction in fiscal deficit is quite welcome, it needs to be underscored that it has been due to reduction in the public expenditure rather than an increase in resource mobilization. Tax-GDP ratio in 2003-04 is a little lower than in 1987-88, while total Revenue-GDP ratio shows slight improvement. However, public expenditure declined sharply from 26.7 to 21.9 percent. Whereas non-development expenditure has remained somewhat constant up to 2002-03, there has been sharp decline in development expenditure. The development expenditures help in improving physical infrastructure and social services such as primary education, basic health care, safe water and sanitation which in turn helps in the growth of output and employment generation. The declining level of public expenditure especially development expenditure, therefore, has serious implications for the economy. The public expenditure will have to be increased and unless there is resource mobilization, the fiscal deficit would

[4] The tax-GDP ratio, however, has remained somewhat constant.

start increasing once again. We may also note that though overall fiscal deficit has declined, the deficit on current account hardly shows any decline.

With the rising interest rates both within the country and outside, increase in public expenditure, the instability in non-tax revenues, and the declining impact of the debt rescheduling on fiscal situation there is a need for a bolder strategy for reduction in the fiscal deficit and the only viable solution for reduction in the fiscal deficit is resource mobilization by making the tax structure elastic.

Whereas over the 1990s the direct tax structure was marred by withholding taxes that made most of such taxes essentially an indirect tax, the replacement of such taxes with the proper income taxes would help in improving the elasticity of the tax structure. Structural changes within the indirect taxes also hold promise for higher tax revenues. As the tariff rates have been reduced share of custom duties in total tax revenue has shown a declining trend. From 40.7 percent in 1987-88, the share declined to 10.4 percent in 2001-02, but increased to 12.7 percent in 2002-03 and further to 14.7 percent in 2003-04 because of increase in imports. Whereas share of excise duties has declined to just 7.4 percent that of sales taxes increased from just 9.3 percent in 1987-88 to 36.0 percent by 2003-04. The improved tax structure through better tax administration and widening the tax net would result in higher tax revenue.

Table-2; Tax Structure of Pakistan
(%age share of tax revenues)

Years	Direct Taxes	Indirect Taxes			
		Total	Tariffs	Sales	Excise Duties
1987-88	13.3	86.7	40.7	9.3	18.8
1990-91	16.0	84.0	38.9	13.0	19.3
1995-96	26.2	73.8	29.1	16.3	17.0
1998-99	27.0	73.0	20.1	17.6	16.0
1999-00	28.5	72.3	15.2	28.8	14.1
2000-01	29.1	75.8	14.7	34.8	11.4
2001-02	30.8	69.4	10.0	34.9	10.2
2002-03	27.7	72.3	12.5	35.6	8.6
2003-04	29.6	70.4	14.7	36.0	7.4

Source: Based on data derived from *Pakistan Economic Survey*, various issues.

Whereas restructuring of CBR and improvements in tax administration was expected to result in higher tax revenues, growth of GDP especially in the large manufacturing sector has not been accompanied with a sharp increase in tax revenues. For example, in 2003-04, the nominal GDP grew at a rate of 13.2 percent and manufacturing output from where most of the indirect taxes are collected, grew at a rate of 21.7 percent, the tax revenues increased by just 8.7 percent. Moreover, as Table 3 shows, the tax revenues are not correlated with growth.

Table-3: Growth of Tax Revenues

Year	Percentage growth of federal tax revenue	Percentage growth of total tax revenue	Growth rate of GDP in nominal terms	Growth rate of large scale manufacturing in nominal terms
1998-99	10.9	10.1	9.8	6.9
1999-00	3.7	3.8	6.5	10.3
2000-01	9.2	8.9	9.7	21.3
2001-02	8.7	8.3	5.7	3.2
2002-03	16.3	16.3	9.5	13.5
2003-04	8.7	9.5	13.2	21.7

In view of the slow growth of revenues and need for higher public expenditures, the fiscal deficit can be kept in safe limits only if resource mobilization is pursued vigorously.

III. Monetary Policy

Fiscal deficit and money supply are interrelated. The pursuit of monetary policy is rather difficult when the financing of the fiscal deficit absorbs a large proportion of the increase in credit. Fortunately because of the decline in the fiscal deficit in recent years there is little demand by the public sector for bank credit[5] and that has made it easier for the State Bank of Pakistan to meet the credit needs of the private sector at low interest rates without worrying too much about inflationary tendencies in the economy. For example in 1998-99 money supply was contained but credit to the private sector increased sharply. However in the next three years, credit demand of the private sector slackened due to various reasons resulting in excess liquidity with the banks.

[5] In some of the years, the government retired the bank debt.

Money supply increased very sharply in the 2001-04 period, because of sharp increase in the foreign assets as the State Bank of Pakistan purchased foreign exchange from the banks and open market. Despite the sterilization money supply increased at rather high rates of 15.4, 18.0 and 19.4 percent in 2001-02, 2002-03 and 2003-04 percent respectively.

Table-4: Growth Rate of Money Supply
(Percent)

Years	Public Sector Borrowing	Budgetary Support	Private Sector	Money Supply (M2)
1987-88	17.3	13.3	13.4	12.2
1997-98	8.4	9.5	13.8	14.5
1998-99	-11.8	-13.6	17.1	6.2
1999-00	13.3	7.9	3.2	9.4
2000-01	-7.1	-6.0	8.2	9.0
2001-02	3.7	2.9	2.5	15.4
2002-03	-10.9	-9.9	16.1	18.0
2003-04	9.7	12.5	30.1	19.6

Source: *Pakistan Economic Survey*, various issues.

The increase in money supply did not result in a sharp reduction in the interest rates. The average interest rates on advances declined from 14 percent in 2001 to 7.5 percent by June 2004. Over the same period, call money rate had declined from 9.0 to 1.9 percent. The weighted average yield on treasury bills declined from 12.0 to less than 2.2 percent. Decline in interest rates positively impacted the fiscal situation.

While the expansion in credit helped in reducing the interest rates, it could have pushed up the inflation rate. Surprisingly, despite high growth rate of money supply in 2001-02, 2002-03 and 2003-04, the inflation rates have been quite moderate. However, by March 2005, it had increased to double digit. Contraction of money supplies to control the inflation would push up the rate of interest. It would have serious implications for the fiscal deficit which would rise with high interest rates and in turn increase the debt once again. The rising interest rates would also impact the growth rates of GDP and investments.

Table-5: Inflation Rates

Period	Consumer Price Index	Wholesale Price Index	GDP Deflator
1987-88	6.3	10.0	9.6
1996-97	11.8	13.0	13.3
1997-98	7.8	6.6	7.7
1998-99	5.7	6.3	5.9
1999-00	3.6	1.8	2.8
2000-01	4.4	6.2	7.8
2001-02	3.5	2.1	2,5
2002-03	3.1	5.6	4.1
2003-04	4.6	7.9	6.8

Source: *Pakistan Economic Survey*, various issues.

IV. Exchange Rate Policy

The exchange rate is also a crucial variable in debt dynamics. Bilquees (2003) noted that in a few years, the entire increase in debt burden may be attributed to the exchange rate change. Because of the double digit inflation rates in the 1990s, Pakistan had to devalue her currency. However, she did not devalue enough to compensate for the increase in the relative inflation rate and resultantly, real exchange rate by 1997-98 had in fact appreciated by 8.7 percent. Over the 1999-2002 period, however, there has been real devaluation. Since then the Pak rupee has appreciated against the dollar though the currency has depreciated against other major currencies of the world.

During 1998-99 when sanctions were imposed on Pakistan, both export and imports went down rather significantly. Whereas exports gradually increased and during 2002-03 it grew at a rate of 19.1 percent and in 2003-04 further by 13.8 percent, imports stagnated due to low levels of economic activity. However, both in 2002-03 and 2003-04 imports increased by 20.1 percent resulting in an increase in the trade deficit. Because of a sharp increase in workers' remittances and decline in interest payments, the current account balance of payments in the years 2001-02, 2002-03 and 2003-04 turned surplus. During the first 9 months of the 2004-05 fiscal year the trade deficit has increased to $4.2 billion and the balance of payments has turned deficit. To the extent the increase in deficit reflects the increase in imports of machinery it is quite welcome. However, if most of the growth in imports does not add to the productive capacity it may be reflecting the diversion of domestic demand to imported goods resulting in higher external debt in the short, medium as well as long run.

Table-6: Trends in Balance of Payments

(Million $)

Years	Exports	Imports	Trade Balance	Remittances	Current Account Deficit
1987-88	4362	6919	2557	2013	1682
1995-96	8311	12015	3704	1461	4575
1998-99	7528	9613	2085	1060	2429
1999-00	8190	9602	1412	983	1143
2000-01	8933	10202	1269	1087	513
2001-02	9140	9434	294	2389	-1338
2002-03	10889	11333	444	4237	-3028
2003-04	12395	13607	1212	3871	-1313

Source: *Pakistan Economic Survey,* various issues.

Foreign exchange reserves lend stability of the exchange rate. Foreign exchange reserves in Pakistan have been traditionally low; and they rarely crossed $ 2 billion. Whenever the reserves fell, Pakistan had to devalue her currency. After the sanctions in 1998 the reserves had been hovering around $ 1 billion and with rather high debt servicing Pakistan was on the verge of default. However, in the post-2001 period, because of reduction in trade deficit, the sharp increase in workers remittances, deposit of overseas Pakistanis and the capital inflows, foreign exchange reserves have increased sharply. The foreign exchange reserves have crossed $12.5 billion of which around $ 10 billion are owned by the State Bank of Pakistan and the remaining are resident and non-resident accounts with commercial banks. Higher reserves resulting in stability of exchange rates have also helped Pakistan in the resolution of the debt problem.

V: Trends in Debt and Debt Servicing

The debt problem has been haunting Pakistani policy makers throughout the 1990s. Since the fiscal deficit despite some reduction until recently was much higher than the growth rate of GDP, the public debt continued to rise at a rapid rate. The public debt increased from Rs.538 billion in 1987-88 to Rs.3,077 billion in 1998-99 and further to Rs.3,783 billion by

2000-01 i.e. 79.8, 104.7 and 113.5 percent of GDP respectively. The internal debt increased from Rs.290.1 billion in 1987-88 to Rs.1392.5 billion in 1998-99 and further to Rs.1731 billion by 2000-01. Similarly, external obligations increased from Rs.247.9 billion in 1987/88, to 1614.4 billion in 1998-99, and to 2059.5 billion in 2000-01.Whereas public debt, internal or external debt is a problem, it is the external debt which has stronger bearings on the economy.

The fact that the magnitude of total outstanding debt and even the per capita debt increased significantly and Pakistan found it difficult to finance the debt may suggest that the debt is beyond tolerable and sustainable levels. The present value of debt as a percentage of GDP shown in Table-8 indicates that Pakistan's debt is not all that heavy. It is not the debt burden that is excessive, it is the difficulty to finance the short term debt which has been a major problem.

Table-7: Outstanding Total Debt as Percentage of GDP

Country	**Debt as Percentage of GDP**	
	2000	**2002**
Pakistan	45.0	45.0
Ethiopia	52.0	63.0
Argentina	56.0	66.0
Vietnam	36.0	35.0
Brazil	39.0	48.0
Bangladesh	20.0	22.0
India	-	17.0
Sri Lanka	44.0	48.0
Egypt	23.0	28.0
Indonesia	96.0	89.0
Philippines	64.0	77.0
Morocco	49.0	51.0
Jordan	90.0	83.0
Turkey	57.0	77.0
Thailand	64.0	49.0
Malaysia	52.0	57.0
Tunisia	57.0	65.0
Kenya	39.0	40.0
Nigeria	74.0	82.0

Source: *World Development Report*: 2003, 2004 and 2005.

Another way of examining whether the debt has been in tolerable limits or not is to estimate the debt Laffer Curve. Choudhary and Anwar (2002) using the debt Laffer curve show that Pakistan's debt is not that high that the creditors could write off at least a part of the debt and would also gain in the process. The debt problem of Pakistan has been its lack of capacity- to finance debt servicing. Increasing reliance on short/medium-term financing to meet external obligations in the 1990s resulted in a sharp increase in debt servicing. For example, in FY96/97, short/medium-term debt represented about 18 per cent of Pakistan's external liability and accounted for over 55 per cent of the debt servicing cost. The debt servicing accounted for as much as 62.1 percent of the total exports and 46.0 percent of total foreign exchange earnings in 1996-97 (see Table-8).

Table-8: Profile of Domestic and External Debt

(Rs. billion)

	1997-98	1998-99	1999-2000	2000-01
Total Debt Servicing	278.3	343.1	353.9	325.0
Total interest payment	191.6	220.1	256.8	237.1
Domestic	160.1	178.9	206.3	178.8
Foreign	28.7	38.0	44.9	50.5
Explicit liabilities	2.8	3.2	5.6	7.8
Repayment of principal	86.7	123.0	97.1	87.9
Ratio of external debt servicing to				
Export earnings	55.4	35.3	36.5	37.4
Foreign exchange earnings	34.9	23.6	23.4	23.3
Ratio of total debt servicing to				
Tax revenue	78.4	87.8	87.2	68.9
Total revenue	64.8	73.2	65.9	57.0
Total expenditure	43.9	53.0	47.6	49.5
Current expenditure	52.5	62.7	55.0	49.3

Source: State Bank of Pakistan, *Annual Report 2000-01.*

The Government appointed the Debt Reduction and Management Committee in early 2000 which submitted its report in March 2001 [Government of Pakistan (2001)]. The Report suggested revival of growth, reduction in future borrowing, bringing down the real cost of borrowing, divestiture of assets, improving the effectiveness of government expenditure, and improving the carrying capacity through growth in revenues, exports, remittances and other foreign receipts for resolution of the problem. It also came up with a short term strategy which called for rescheduling of $5.1 billion. While one can hardly disagree with the policy suggestions the Report failed to come out with concrete policy actions.

Because of various reasons public debt has declined to 79.3 and 72.3 percent in 2002-03 and 2003-04 respectively. Following are some of the factors for the turn around:

- Writing off some debt and converting some into debt-social sector spending swap. Pakistan got a debt relief amounting to $ 1495 from the USA;
- Receipt of grants as budget support;
- Rising remittances have improved the balance of payments situation and has allowed the government to pay back expensive loans and improve the liquidity situation;
- Appreciation of the rupee against the dollar has also meant a reduction in the foreign debt denominated in local currency;
- Smaller budget deficit; and
- Reduction in interest rates.

Table-9: Profile of Domestic and External Debt

	FY 99	FY OO	FY 01	FY 02	FY 03	FY 04
Total Debt	3,077.0	3,336.8	3,884,5	3,783.0	3,824.0	3946.3
1. Domestic Debt	1,392.5	1,578.8	1,731.0	1,717.9	1,852.4	1975.4
2. External Debt	1,614.4	1,682.7	2,059.5	2,005.6	1,927.7	1937.5
3. Explicit liabilities[a]	70.1	75.4	94.0	59.5	41.6	33.4
As Percent of GDP						
Total Debt	104.7	88.0	93.3	85.9	793	72.3
Domestic Debt	47.4	41.6	41.6	39.0	38.4	36.2
External Debt	54.9	44.4	49.5	45.6	40.0	35.5
Explicit liabilities	2.4	2,0	2.3	1.4	0.9	0.6
Total Public Debt Servicing	**343.1**	**366.3**	**340.3**	**431.2**	**304.7**	**337.2**
Total Public Interest Payments	220.1	269.2	254.4	279.2	241.7	226.0
i. Domestic	178.9	1218,7	195.4	212.5	189.0	182.0
ii. Foreicn	38.0	44.9	51.3	61.1	49.2	41.0
iii. Explicit liabilities	3.2	5.6	7.8	5.6	3.5	3.0
Repayment of Principal[b]	123.0	97.1	85.9	164.9	63.4	111.3
Ratio of External Debt Servicing to						
Export Earnings	31.6	36.5	32.7	36.7	22.8	32.5
Foreign Exchange Earnings	23.6	23.4	20.4	21.7	12.6	18.8
Ratio of Total Public Debt Servicing to						
Tax revenue	87.8	90.3	77.1	90.2	55.1	55.2
Total revenue	73.2	71.5	61.5	71.2	42.5	42.2
Total expenditure	53.0	51.7	47.4	53.8	33.8	34.7
Current expenditure	62.7	58.5	52.7	63.4	37.8	42.9

Source: State Bank of Pakistan, *Annual Report, 2002-03 and 2003-04.*

Since raising of loans help in alienating the resource constraint, the rising debt levels should not create problems if the loans were properly utilized. For example, if it is assumed thut the entire capital inflows are used only for investment purposes, then the foreien aid on average would have been responsible for one-fifth of GDP growth. However the assumption may not be tenable if foreign capital inflows result in higher level of private and public consumption and as such the savings rate falls. For example, see Bhagwati (1970), Chaudhary and Hamid (1987), Griffin and Enos (1970), Mosley (1987) and Nabi and Hamid (1991). By regressing the savings rates against the foreign capital inflows along with other variables that affect savings behavior, it has been found that foreign capital inflows have entirely been used to finance consumption in Pakistan [See Kemal (1997). The increase in foreign capital has resulted in lowering savings by the same magnitude and as such foreign aid may have contributed almost nothing to growth. Siddiqui and Malik (2001) estimate directly the impact of debt on growth rates and argue that debt accumulation and growth has a non-linear relationship. Up to a certain level the impact is positive and beyond a threshold level the relationship turns negative.

Why are the loans not properly utilized? There are at least four major reasons for improper use of loans, viz. the donor's agenda; corruption; capital flight; and the adverse impact of loans on domestic savings. Whereas the donor agencies play an important role in economic development by providing the requisite finances, they also influence the policies and agenda of the government through choice of projects and technology, programs, economic strategy and consequently the levels of efficiency, employment, poverty, and income distribution. That sovereignty is compromised has been extensively analyzed. For example, see Corbo and Suh (1992), Jain and Bongorals (1994), Banuri, Khan, and Mahmood (1997), Kemal (1994), Killick (1995), Park (1995), Mcgillivary et al (1995), Morrissey (1995) Pasha (1995), Cameron (1995), Tetzlaff (1995), and Reiger (1995). Tying of aid to sources and to certain projects reduces the utility of aid and it may not generate sufficient output and exports for debt repayment.

Corruption is widespread and a substantial part of the resources earmarked for development projects are misused [see World Bank (2001)]. Widespread corruption in Pakistan is well reflected in the large number of cases being investigated by the National Accountability Bureau. We may note that a part of the money obtained through corrupt practices is used in conspicuous consumption, while the remaining money leaves the country.

Dornbusch (1985) and Ize and Ortiz (1986) argue that currency over-valuation, threat of devaluation and increasing domestic financial instability results in capital flight. While these are important issues in capital flight, there are many other motives that lead to capital flight. For example, corruption money may leave the country to avoid any accountability because the corrupt feel that such money is safer abroad. Similarly, domestic producers may use foreign resources to fund domestic investment and invest their own resources abroad even if the return is lower outside the country as long as they earn more than the cost of funds. Moreover, when implicit or explicit public guarantees create interdependence among private investors, a move by one borrower that increases the likelihood of its own default increases the expected tax obligations of other borrowers and by placing these funds abroad, they escape increased tax payment[6].

How the debt crisis impacts growth has been widely discussed in the literature [For example, see Williamson (1989), Ahmed and Summers (1992), Fishlow (1985), and Lustig (1999)]. Whenever the debt crisis assumes significant proportions, the resource inflows dry out and there is a negative transfer of resources from the debtor countries. The investment tends to fall as the debt rises beyond safe limits, investible resources fall due to a sharp increase in debt servicing, investors lose confidence, demand falls to low levels, interest rates start rising and there is a massive capital flight.

Does the writing-off or rescheduling of debt resolve the debt problem? While it provides the breathing space, it hardly resolves the crisis. The debt crisis is not resolved until the debt situation is such that there is confidence in the country's ability to service its debt over time under a reasonable range of economic conditions, and the debt burden must not leave the debtor in a state of long term stagnancy [see Fisher (1987)]. The efficient and pragmatic resolution of the debt crisis as pointed by Carmicael (1999) is the one that stimulates investment and, through investment, economic growth; lowers protection; and reforms are instituted at both the macro economic level (especially fiscal restraint and sound management of exchange rates) and the microeconomic level (liberalization of markets, removal of distortions).

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[6] Eaton (1987) and Khan and Haque (1985) argue that there is an asymmetric risk of expropriation facing domestic and foreign investors. Domestic investors invest abroad and they finance their investments from borrowing abroad especially when the debt is guaranteed by the government.

VI. Conclusions

The major conclusions of the study are summarized below:

1. Whereas Pakistan has been able to avoid the debt crisis the sharp increase in the inflation rate, widening of trade deficit and re-emergence of balance of payments is threatening the stability of the economy;

2. The three main contributing factors to the increase in public debt are the primary fiscal deficit, interest rate-growth differential and exchange rate changes;

3. Fiscal deficit until the late 1990s has been in excess of 6 percent of GDP but declined to 3.9 percent in 2003-04. Since 1998-99, there has been primary surplus though the surplus has shown a declining trend since 2001-02;

4. The fiscal deficit has declined because of debt reprofiling, slow growth of public debt, decline in interest rates, reduction in development expenditure and an increase in non-tax revenues;

5. Since social and physical infrastructures need considerable improvements, the only viable solution for reduction in the fiscal deficit is resource mobilization by making the tax structure elastic;

6. Tax revenues and growth do not seem to be correlated in Pakistan. Compared to nominal growth of 13.2 percent in GDP and 21.7 percent in manufacturing output, tax revenues increased by only 9.3 percent in 2003-04;

7. Sharp increase in money supply has led to sharp reduction in the interest rates with positive implications for the fiscal deficit but it has generated inflation during the current year;

8. Increase in foreign exchange reserves have helped in the stabilization of the rupee against the dollar and that has positively impacted the debt situation;

9. Whereas external debt had risen to around $ 29 billion in 2000, the present value of debt compared to many countries shows that Pakistan's situation has not been all that bad. However, it was debt servicing that created the problems. The debt servicing accounted

for as much as 62.1 percent of total exports and 46.0 percent of total foreign exchange earnings in 1996-97;

10. The total debt has stabilized in the last couple of years and as a percentage of GDP the total debt has declined to 79.3 and 72.3 percent respectively in the last couple of years. A number of factors have been responsible for this turn around which include writing-off some debt and converting some into debt-social sector spending; grants for budgetary support; appreciation of the rupee against the dollar; smaller budget deficit, reduction in the interest rate, increase in remittances that improved the balance of payments situation and enabled the government to pay back the expensive loans; and

11. The debt crisis emerges because the loans are not properly utilized and there are at least four major reasons for improper use of loans, viz. the donor's agenda; corruption; capital flight; and the adverse impact of loans on domestic savings.

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