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Debt situation

Recently, the central bank has published the data on federal government debt. This is a fairly grim reading. The federal government debt stock rose from Rs24.2 trillion as on 3-6-2018 to Rs31.8 trillion as on 30-6-2019, showing an increase of a staggering Rs7.6 trillion or 31 percent. At a GDP of 38.6 trillion, this comes as 82.4 percent of GDP. This is an unprecedented increase in a single year. It is necessary, therefore, to examine the causes that have led to such an increase.

At the outset, we look at the two major components of debt, domestic and external. The domestic debt increased from Rs16.4 trillion to Rs20.7 trillion, showing an increase of Rs4.3 trillion or 26 percent. On the other hand, the external debt rose from Rs7.8 trillion to Rs11.1 trillion, showing an increase of Rs3.3 trillion or 42 percent. Therefore, the domestic debt contributed a larger increase of 57 percent compared to 43 percent from the external debt.

The increase in domestic debt is due to two factors. One, a rising fiscal deficit met primarily through domestic borrowings as the avenues for foreign borrowings were limited. (We would try to estimate the deficit from the data of central government debt in a short while). Two, because of the interest rate increases. The last fiscal year has seen an unprecedented increase in the interest rate. Starting from 6.5 percent at the beginning of the fiscal year, the interest rate has increased to 12.25 percent at the close, nearly doubling. If we take an average of 10 percent for the whole year, the price effect of marginal change in the interest rate of 3.5 percent on the opening stock of Rs16.4 trillion, would be Rs574 billion. We may also add another Rs151 billion on account of marginal increase in debt by the same interest rate increase. This gives us Rs725 as the immediate cost of increased interest rate on debt accumulation.

It should be noted that the increase in domestic debt is not related to changes in the exchange rate. Accordingly, the increase is contributed essentially by the fiscal deficit during the year. There is one adjustment that we need to make, namely the increase in government deposits in the banking system which are subtracted from the gross deficit. This number would be known only after the Finance Division releases the data on the fiscal operations at the end of the month.

We now examine the impact of devaluation. Based on the budget documents, Pakistan has borrowed Rs1403 billion in external loans while it has paid back Rs929 billion in foreign loans. This gives us a net external borrowing of Rs474 billion. Subtracting this from Rs3300 billion, leaves Rs2826 billion as the capital loss on external debt. This is again an unprecedented capital loss due to exchange rate devaluation which depreciated from Rs124.5 to Rs163 per dollar during the fiscal year.

We now turn to work out the deficit implicit in the above numbers. We have to subtract two factors from Rs7.6 trillion which is the marginal increase in gross debt, namely devaluation and increased government deposits in the banking system, to arrive at the deficit. The devaluation we have worked out at Rs2826 billion so subtracting it from Rs7600 billion gives us Rs4774 billion. This is still too high to be the deficit for the year. The number of government deposits is not available until the end of the month.

In a tweet, the Minister for EAD, Hammad Azhar, has indicated that the increase in deposits was Rs1.2 trillion. This is a phenomenal number of deposits to have been accumulated in a single year. We take it for now without any comment. Subtracting it from Rs4774 billion gives us Rs3574 billion. This is, therefore, the deficit estimate. But this surpasses all expectations held in the past. This is 9.3 percent of GDP, clearly the highest in the recent history of the country. The budget estimate, in the first mini-budget given in October, was 5.1 percent.

We are, however, not surprised on this outcome given the fiscal slippages occurred during the year. The tax revenue shortfall was Rs580 billion or 1.5 percent. On the non-tax revenue side there are reports of at least Rs150 billion in shortfall. This would add another 0.4 percent to revenue shortfall taking it to 1.9 percent. On the expenditure side, the revenue shortfall was made up by extra borrowings and at a much higher interest rate. The budget estimate had indicated that interest expenditure would be of Rs1987 billion. It was budgeted at Rs1842 billion in the 'mini-budget'. With the conditions finally obtaining, this number could be as high as Rs2600 billion, which means an over-run of Rs758 billion or nearly 2 percent of GDP. This adds up to 3.9 percent, which is close to the estimated deficit.

It is curious to compare these numbers with those that have gone in the IMF programming. In Table-4a, the general government debt is projected at Rs28.9 trillion, which is off by Rs2.9 trillion compared to the actual of Rs31.8 trillion. The fiscal deficit is estimated at Rs2815 billion, which is off by Rs759 compared to the actual of Rs3574 billion, which is nearly 2 percent of GDP.

Such major differences in Fund projections are unprecedented. It is equally difficult to fathom whether this could happen during the period after the program was negotiated on 10-5-2019. The financing data must have revealed the true state of affairs unless of course at the closing hours it was decided to incorporate off-budget items in the budget. Such an adjustment, however, is not possible without its disclosure to the IMF and its incorporation in the budgetary numbers in the program and public announcement of large payments to whoever those were due.

We finally turn to another important development which was not announced publicly. This relates to the conversion of the government debt owed to SBP from short-term market treasury bills (MRTBs) to longer maturity and more expensive PIBs. The long-term investment in government bonds was Rs3.8 trillion at the close of June 2018, which has shot up to Rs11.2 trillion as on 30-6-2019. With a stroke of pen, the structure of debt has been corrected in favor of long term maturities. Alas, this is not a very convincing act. First, this is a change that must have required amendment in rules, which otherwise stipulated that unsold bills would be picked up by the central bank and would be remunerated at the cut-off yield. Second, the MRTBs held by the central bank are not part of the re-financing risk as they would continue to hold it if not purchased by others. Third, the cost of bonds is significantly higher and would unnecessarily add to the higher interest payments in the budget. Mercifully, the largest chunk is taken as floating debt otherwise the cost would have been colossal. Fourth, this is not a settlement of government debt owed to the central bank. That indebtedness continues to remain in the books. Finally, a more elaborate system of retirement would be required compared to retirement of TBs when foreign flows began to retire domestic debt. The priority was given to SBP debt to be retired but with long-term bonds, it is not clear how this would be done. In fact, it should continue to be the case that bonds would be retired irrespective of whether or not their maturities are due.

In closing, the government should ask some serious questions from the last year experience of economic management. Evidently, huge adjustments have been made in interest rate and exchange rate but they have not had the desired impact on the fiscal side as well as on external side. If anything, these balances have deteriorated. Exports have come down and modest import adjustment has occurred on the value side. On the fiscal side, it is difficult to claim if ever there was an attempt to bring fiscal discipline. Going ahead, there is an ever greater risk of slippage because the base-line was significantly off-line, even in the Fund program.

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