DEBT SUSTAINABILITY ANALYSIS

1. **Pakistan's short-term growth prospects deteriorated because of the COVID-19 pandemic and its impact on the global economy**. Pakistan's real gross domestic product (GDP) declined by 0.4% in fiscal year (FY) 2020, the first economic contraction since FY1952, and growth is expected to remain subdued at 1.5% in FY2021. Assuming a gradual fading of the pandemic's impact, economic growth is expected to pick up and converge to 4.7% during FY2022–2026. Continuing currency depreciation is driving annual inflation (GDP deflator), which is expected to accelerate to 8.7% in FY2021–2023, before falling back to 6.2% in the medium term.

2. **International Monetary Fund's Extended Fund Facility puts Pakistan on a budget consolidation path while providing necessary fiscal stimulus.** Under the auspices of the extended fund facility (EFF), the International Monetary Fund (IMF) program aims at striking a balance between supporting the economy, ensuring debt sustainability, and introducing structural reforms to lay the foundations for strong and sustainable growth in the medium to long term. The EFF envisages measures to mobilize tax revenue and allows for a limited spending-based stimulus to cope with the pandemic's economic impacts.

3. To mitigate the adverse impacts of COVID-19 pandemic, the budget support by the IMF and other donors is critical in carrying out the necessary reforms and in improving macroeconomic stability. The key reforms such as consolidating autonomy of the State Bank of Pakistan, improving the management of state-owned enterprises, taxation reforms, and energy sector reforms will be critical in supporting the post-COVID-19 recovery. Under the IMF reform program, sustaining fiscal discipline while mobilizing revenues and controlling spending and improving expenditure efficiency, are expected to reduce the fiscal deficit from 8.0% of GDP during FY2020 to 2.9% of GDP by FY2026 (Table 1).

4. **Public debt is projected to climb in FY2020–2021 before falling back in the medium term**. Rise in primary and fiscal deficits, high borrowing costs, and currency depreciation pushed the public debt ratio from 67% of GDP in 2017 to nearly 76.2% in 2018. The latest IMF Staff Report (IMF Country Report No. 21/73, April 2021) suggests that due mainly to subdued economic growth and persistent budget deficits, debt-to-GDP ratio (including IMF lending) is expected to reach to 92.8% in FY2020 and 92.9% in FY2021. However, with stronger economic growth during FY2022–2026 along with fiscal consolidation under the auspices of EFF will put public debt onto a downward trend and the debt-to-GDP ratio is projected to decline to 88.2% in FY2022, 82.1% in FY2023, 77.7% in FY2024, 73.3% in FY2025 and to 69.2% by FY2026 (Table 1).

5. **Pakistan seeks to preserve the sustainability of its public debt with the support of IMF's EFF.** While public debt remains high, EFF's fiscal consolidation is deemed adequate towards reducing imbalances and debt levels in the medium term. Lower-than-expected real GDP growth during FY2020–2021, at 0.6% compared with 4.2% envisaged during FY2014–2019, would not alter the debt dynamics fundamentally. With the introduction of debt service suspension initiative amounting to $2.5 billion (0.9% of FY2021 GDP) and better cash and debt management, gross financing needs are projected to decline from 36.7% of GDP in FY2019 to 15.8% of GDP by FY2026. Moreover, with the rise in average time to maturity of domestic debt from 0.6 years to 2.6 years and reprofiling of government debt held by the State Bank of Pakistan into longer-term instruments is also expected to reduce the debt distress. The decline in the gross financing needs combined with improvement in the maturity structure of the public debt, the debt-to-GDP ratio is projected to decline and will remain sustainable.

6. **External indicators suggest that Pakistan's reserves position will be strengthened in the context of the EFF program.** Pakistan runs current account deficits while facing growing external debt service obligations. Before the pandemic, current account deficit was 5.2% of GDP in FY2018, and 3.5% of GDP in FY2019. Later, while current account balance deficit turned into a surplus of 0.3% during FY2020, but it basically reflects the underperformance of export sector and decline in imports due to lower domestic demand. Due to COVID-19 related containment measures, demand for exports declined by 7.5%, while reduced economic activity in the domestic economy resulted in lowering the demand for imports by 19.3%. In going forward, IMF and other multi-donor support will help improve the gross official reserves from $12.2 billion (2.7 months of imports) in FY2020 to $25.7 billion (3.5 months of imports) by 2026. Improved reserve position will provide the much-needed fiscal space to the government to mitigate the impact of external shocks.

7. **Financial assistance from ADB and other donors will not impair debt sustainability in Pakistan**. The proposed Asian Development Bank's (ADB) APVAX loans, totaling $500 million and on broadly concessional terms, **r**epresent only 0.2% of the country's outstanding public debt stock of $254 billion during FY2020. Additional loans approved or under proposal by the IMF ($500 million) would add another 0.2% to the public debt stock. While providing critical countercyclical support to the economy, these loans will neither affect the debt ratio nor increase the annual debt service obligations of the government significantly. External lending from IMF, the World Bank, Asian Infrastructure Investment Bank (AIIB) and other donors would ramp up public debt to 92.9% of GDP in FY2021, however, with economic recovery and fiscal consolidation, the debt-to-GDP ratio will gradually decline to 77.7% in FY2024 and further to 69.2% by FY2026 (Table 1, baseline scenario). The major contributory factors towards debt-to-GDP ratio in the baseline are given in Table 2 and Figure 1. In addition to these loans, additional lending of $500 million from ADB (total loan scenario) would marginally push the public debt-to-GDP ratio higher than the baseline but will converge to 69.5% by 2026 (Table-3).

8. **Public debt sustainability**: Under the total loan scenario, total public debt will remain sustainable, however, in going forward, macro-fiscal shocks will continue to pose threat to debt sustainability. For example, if the key variables such as real GDP growth, inflation, primary balance, and effective interest rate are assumed to grow at their historical trends, public debt-to-GDP ratio exceeds the baseline scenario and will reach 90% of GDP by FY2026. This is reflected as historical scenario in Table-3 and Figure 2. Similarly, if primary deficit is assumed to remain at its level of 1.0% of GDP in FY2021, the resulting debt trajectory will still be higher than the baseline and debt-to-GDP ratio will reach 80% by FY2020. The analysis also reveals that in a combined macro-fiscal shock scenario, total public debt-to-GDP ratio is expected to rise from 92.9% in FY2021 to 103.6% in FY2022, before gradually coming down to 93% by FY2026.

9. The analysis reveals that the debt-to-GDP ratio in the historical scenario, constant primary balance scenario, and combined macro-fiscal shock scenario will exceed the 70% threshold and thereby jeopardize the debt sustainability. Moreover, while the debt-to-GDP ratio in the baseline scenario decline from 92.9% in FY2020 to 69.2% by FY2026, it remains elevated than the 70% threshold during FY2020-FY2025. Although, the government has so far been successful to secure external financing to meet the financing gap, nevertheless, lower-than-expected economic growth, rise in primary deficit, increase in real interest rate, the surge in contingent liabilities, and exchange rate depreciation have the potential in widening the financing gap and thereby jeopardizing debt sustainability. The analysis suggests that despite an improvement in the debt profile, macro-fiscal shocks and a rise in contingent liabilities from loss-making state-owned enterprises (SOEs) continue to pose a fiscal risk. Therefore, the government will need to monitor

these fiscal risks and remain committed to fiscal consolidation to maintain macroeconomic stability to ensure debt sustainability (Figure 2).

10. **External debt sustainability**. Although, Pakistan's capacity to repay its obligations on external debts remains adequate, however, it is subject to risks emanating from inadequate export receipts, rise in imports, exchange rate shocks and low foreign exchange reserves. In the post-COVID-19 environment, with exports picking up, stronger economic growth will also increase demand for imports. External debt, under the program scenario, is projected to rise to 42.1% of GDP in FY2021 compared to pre-COVID-19, 37.5% envisaged during FY2019, but is expected to decline to 36.6% by FY2026 (Table 4).

11. External debt is more vulnerable to exchange rate shocks. The results of the simulations suggests that a 30% depreciation of Rupee against US dollar in FY2021, will increase the external debt-to-GDP ratio from 42.1% in FY2021 to 65.5% in FY2022. Although, external debt-to-GDP ratio, thereafter, decline to 57% by FY2026 but will remain higher than the program scenario. In combined shock scenario, wherein shocks are applied to real interest rate, GDP growth rate and current account balance, external debt is projected to rise to 40% by FY2026. Similarly, in historical scenario which assumes that the key variables including real GDP growth, nominal interest rate, dollar deflator growth and current account continue to grow at their historical rates, external debt will rise to 47% of GDP by FY2026 compared to 36.6% in program scenario. The analysis, therefore, suggests that external debt is highly sensitive to changes in exchange rate, economic growth, and current account balance (Figure 3).

12. **Conclusions**. The debt sustainability analysis suggests that the maturity structure of public debt has improved, and Pakistan's gross financing needs are also expected to decline in the medium term. This will make the public debt-to-GDP ratio sustainable. However, the sustainability of debt will continue to hinge upon the prospects of maintaining sufficient fiscal buffers and macroeconomic stability. Although total loan scenario projects a decline in the public debt-to-GDP ratio from 93.2% in FY2021 to 69.5% by FY2026, nevertheless, the debt-to-GDP ratio remains higher than the threshold of 70% during FY2020-FY2025. The sustainability of debt trajectory will depend on the prospects of economic growth, changes in primary and fiscal deficits, and real interest rate and exchange rate depreciation. Uncertainty about domestic economic recovery, trade, remittances inflows, and delay in reforms could weaken policy implementation and undermine Pakistan's adjustment and recovery path as well as debt sustainability.

13. The government will need to monitor the trends in primary deficits and remain committed to fiscal consolidations. The availability of adequate concessional financing will play a critical role in government's ability to meet fiscal consolidation targets and reducing the debt distress. The analysis reveals that external debt will also remain sustainable; however, risks remain high in the short and medium term. For example, a significant depreciation of the exchange rate has the potential to cause the debt-to-GDP ratio to breach the debt threshold. To mitigate the adverse shocks, the government should remain committed to reforms and in improving exports performance and foreign exchange reserves.

Table 1 and 2: Pakistan, Public Debt Sustainability Assessment

(variable expressed in percentage of GDP, unless otherwise indicated)

Table 1: Baseline Scenario

	Actual						Est.	Forecast						Average
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	21-26
Nominal gross public debt [1]	63.5	63.3	67.6	67.0	76.2	90.7	92.8	92.9	88.2	82.1	77.7	73.3	69.2	80.6
Macroeconomic Indicators														
Real GDP Growth (%)	4.1	4.1	4.6	5.2	5.5	1.9	-0.4	1.5	4.0	4.5	5.0	5.0	5.0	4.2
Inflation (%, based on GDP Deflator)	8.1	4.8	1.3	2.4	8.4	7.6	10.3	8.1	9.4	8.6	6.2	6.2	6.4	7.5
Nominal GDP growth (%)	12.4	9.0	5.9	7.7	14.4	9.7	9.9	9.7	13.7	13.5	11.5	11.5	11.7	
Effective interest rate (%)						8.4	8.1	7.9	6.9	7.0	6.8	6.7	6.8	
Fiscal Indicators (General Government)														
Revenue	15.2	14.5	15.5	15.5	15.2	13.0	15.1	15.8	17.0	17.5	17.6	17.6	17.6	17.2
Primary Expenditure	15.5	15.0	15.6	17.1	17.3	16.5	16.8	16.8	16.6	15.9	15.9	15.9	16.0	16.2
Interest Payments	4.6	4.8	4.3	4.2	4.3	5.5	6.3	6.1	5.9	5.5	5.6	5.2	4.6	5.5
Overall Balance	-4.9	-5.3	-4.4	-5.8	-6.4	-9.0	-8.0	-7.1	-5.5	-3.9	-3.9	-3.5	-2.9	-4.5

Source: Derived from IMF Article IV, IMF Country Report No. 21/73, April 2021.

[1] Indicate coverage of public sector, e.g., general government General government and government guaranteed debt (incl. IMF)

Table 2: Baseline Scenario – Contribution to Changes in Public Debt

	Actual						Est.	Forecast						Cum-mulative
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	21-26
Change in Public Debt	-0.4	-0.1	4.3	-0.6	9.2	14.5	2.1	0.1	-4.7	-6.1	-4.4	-4.4	-4.1	-23.6
Identified debt-creating flows	-0.4	-0.1	4.3	-0.6	9.2	14.5	2.0	0.1	-4.7	-6.1	-4.4	-4.4	-4.1	-23.6
Primary deficit	0.3	0.5	0.1	1.5	2.1	3.5	1.7	1.0	-0.4	-1.6	-1.7	-1.7	-1.6	-6.0
Automatic debt dynamics [2]	-1.7	-0.7	1.2	-1.7	-0.2	6.7	0.0	-1.5	-5.6	-5.1	-3.5	-3.4	-3.2	-22.3
Contribution from interest rate/growth differential [3]	-2.8	-0.4	0.7	-1.8	-1.1	-0.9	-1.5	-1.5	-5.6	-5.1	-3.5	-3.4	-3.2	-22.3
Of which contribution from real interest rate	-0.3	2.0	3.4	1.5	2.4	0.4	-1.8	-0.3	-2.4	-1.5	0.2	0.1	0.1	-3.8
Of which contribution from real GDP growth	-2.5	-2.5	-2.8	-3.4	-3.5	-1.3	0.3	-1.3	-3.2	-3.5	-3.7	-3.5	-3.3	-18.5
Contribution from exchange rate depreciation [4]	1.1	-0.3	0.5	0.1	0.9	7.6	1.5	0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	1.0	0.1	3.1	-0.4	2.7	3.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes	0.0	0.0	0.0	0.0	4.6	1.0	0.4	0.6	1.3	0.6	0.8	0.7	0.7	4.7

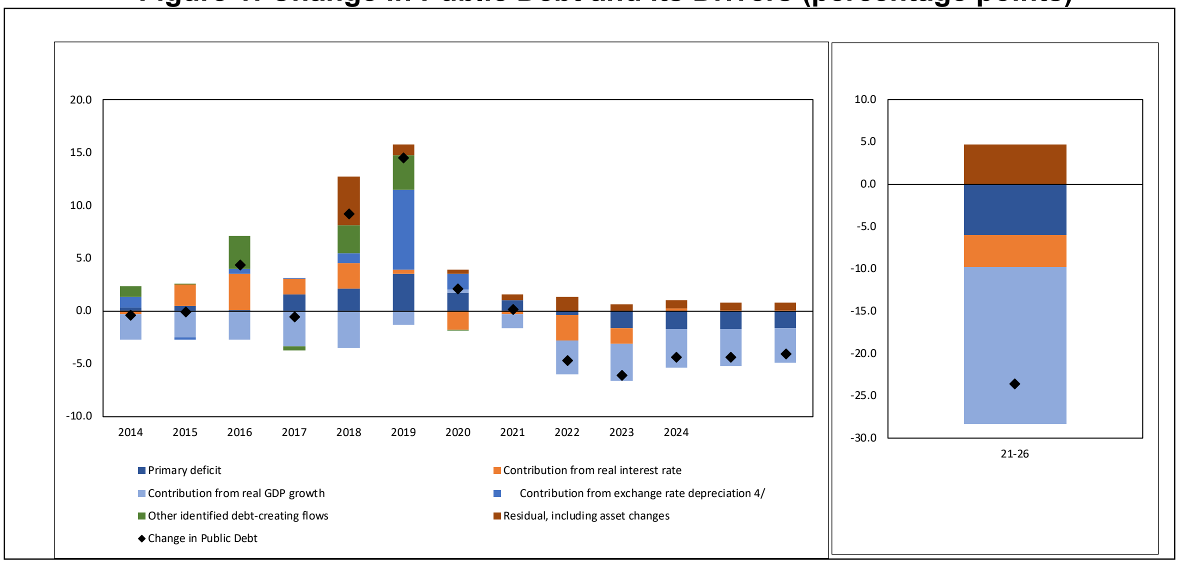
Source: Derived from IMF Article IV, IMF Country Report No. 21/73, April 2021.

[1] Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation

[2] The real interest rate contribution is derived from the denominator in footnote 2 as r - π (1+g) and the real growth contribution as -g.

[3] The exchange rate contribution is derived from the numerator in footnote 2 as ae(1+r).

Figure 1: Change in Public Debt and its Drivers (percentage points)



Source: Derived from IMF Article IV, IMF Country Report No. 21/73, April 2021.

Table 3: Public Debt (in percent of GDP)

	2019	2020	2021	2022	2023	2024	2025	2026
Baseline Scenario[1]	90.7	92.8	92.9	88.2	82.1	77.7	73.3	69.2
Total Loan Scenario[2]	90.7	92.8	93.2	88.5	82.4	78.0	73.6	69.5
Historical Scenario	90.7	92.8	92.9	90.7	89.3	89.8	90.4	90.0
Constant Primary Balance Scenario	90.7	92.8	92.9	89.0	85.5	83.3	82.0	80.0
Combined Macro-Fiscal Shock	90.7	92.8	92.9	103.6	100.6	97.5	95.0	93.0

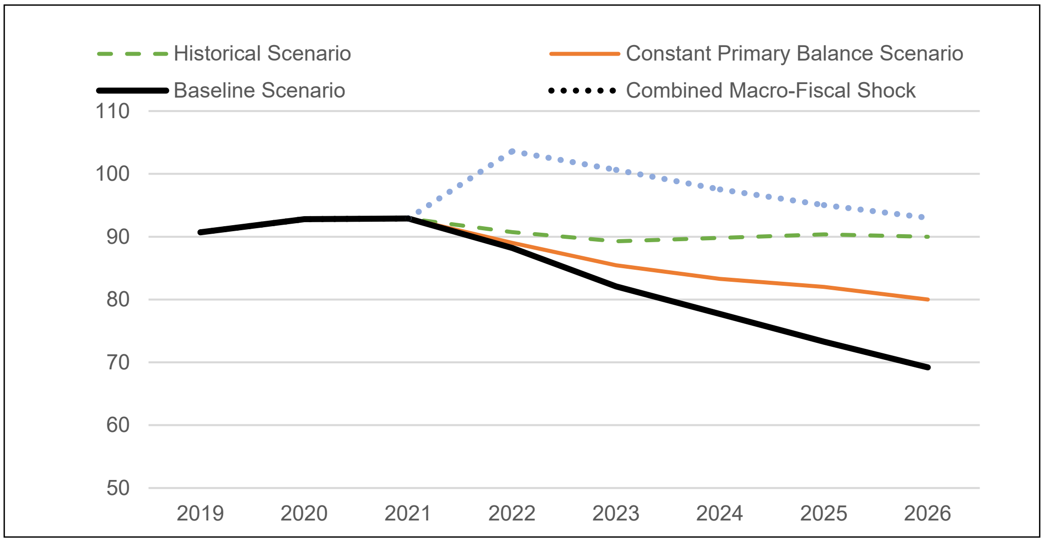
1. Includes external lending from IMF, AIIB and other donors except ADB.
2. Baseline plus ADB lending of $500 million.
Source: ADB staff estimates based on IMF Country Report No. 21/73, April 2021.

Table 4: External Debt (in percent of GDP)

	2019	2020	2021	2022	2023	2024	2025	2026
Program Scenario	37.5	41.3	42.1	41.7	40.3	39.2	38.8	36.6
Historical Scenario	37.5	41.3	42.1	44.4	45.4	46.3	47.8	47.0
Combined Shock Scanario	37.5	41.3	42.1	42.5	41.7	41.3	41.7	40.0
Real Depreciation Shock (30%)	37.5	41.3	42.1	65.5	63.3	61.9	61.4	57.0

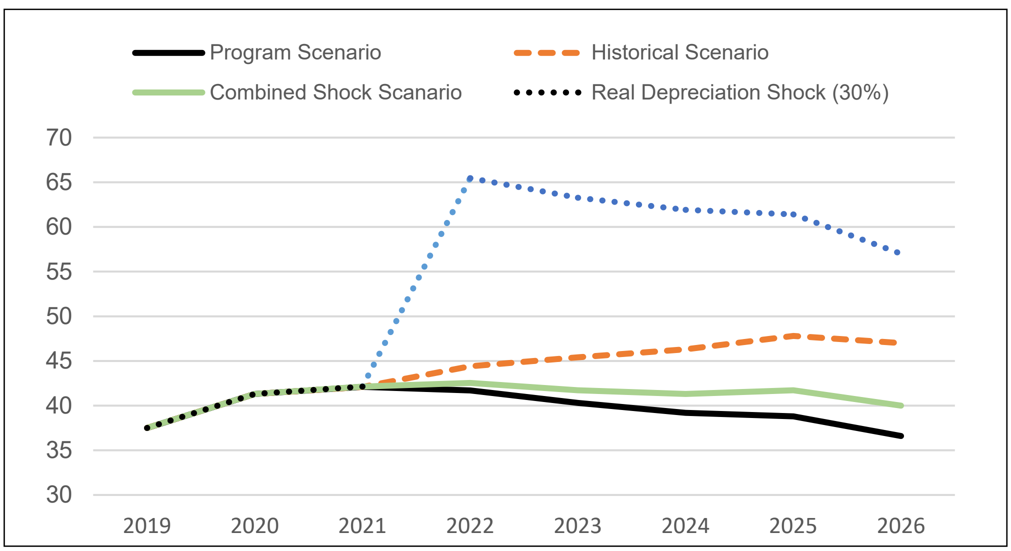
Source: Computations based on IMF Country Report No. 21/73, April 2021.

Figure 2: Public Debt Distress and Alternative Scenarios
(in percent of GDP)



Source: Derived from IMF Article IV, IMF Country Report No. 21/73, April 2021.

Figure 3: External Debt Sustainability
(in percent of GDP)



Source: Derived from IMF Article IV, IMF Country Report No. 21/73, April 2021.