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THE IMPACT OF GOVERNANCE ON EXTERNAL  
DEBT BURDEN IN PAKISTAN

*This study is an attempt to analyze the governance as a causative factor responsible for high external debt accumulation in Pakistan. Using annual data for the period 1990-2008, Granger causality test is employed to investigate the causal relationship between governance and burden of external debt. Our results show that political stability may help to forecast burden of external debt whereas voice and accountability (VA) appears to be an insignificant variable. Sustained efforts on political, economic and institutional fronts can help the economy to overcome the problems which have emerged because of high burden of external debt.*

*Keywords:* economic growth; external debt; political stability; Granger causality; corruption.

Асма Аван, Набіла Асхар, Хафіз ур Реман  
ВПЛИВ ЯКОСТІ УПРАВЛІННЯ КРАЇНОЮ  
НА ЗОВНІШНІЙ БОРГ ПАКИСТАНУ

*У статті зроблено спробу проаналізувати управління країною як ключовий фактор у збільшенні зовнішнього боргу Пакистану. Для аналізу даних за 1990-2008 рр. застосовано тест причинності Грейнджера. Його результати показали, що політична стабільність суттєво впливає на об'єм зовнішнього боргу, одночасно право голосу та прозорість мають вплив несуттєвий. Тільки послідовні політичні, економічні та інституційні заходи можуть допомогти економіці вирішити проблему зовнішнього боргу.*

*Ключові слова:* економічний рост; зовнішній борг; політична стабільність; причинність за Грейнджером; корупція.

Табл. 5. Літ. 37.

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ВЛИЯНИЕ КАЧЕСТВА УПРАВЛЕНИЯ СТРАНОЙ  
НА ВНЕШНИЙ ДОЛГ ПАКИСТАНА

*В статье сделана попытка проанализировать управление страной как ключевой фактор в наращивании внешнего долга Пакистана. Для анализа данных за 1990-2008 гг. применен тест причинности Грейнджера. Его результаты показали, что политическая стабильность существенно влияет на объемы внешнего долга, в то время как право голоса и прозрачность – незначительно. Только последовательные политические, экономические и институционные меры могут помочь экономике решить проблему внешнего долга.*

*Ключевые слова:* экономический рост; внешний долг; политическая стабильность; причинность за Грейнджером; коррупция.

**Introduction.** Today the burning issue for researchers and policy makers around the country is rapid surge in external debt which requires serious efforts to achieve sustainable economic growth. They believe that rising burden of debt along with the debt servicing difficulties over the years is a major hurdle on the way of economic

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growth for Pakistan<sup>4</sup>. They point out that fiscal indiscipline, persistent trade gap, massive depreciation of exchange rate, saving investment gap are the major factors responsible for slow growth of the economy over time. The sustainable solution of massive foreign burden of debt of Pakistan calls for detailed analysis of foreign debt trend, causative factors and its implications for economic growth. Various studies identify many causative factors responsible for sharp rise in the growth in external debt of Pakistan over the years. Besides other determinants, weak governance is also regarded as responsible for low economic growth and external debt build-up. During the last two decades, the quality of governance has become a major concern for researchers and policy makers. There is ample literature that tests the relationship between governance and macroeconomic variables like poverty, economic growth and economic inequality. To the best of our knowledge, we hardly find any study that relates debt accumulation with governance<sup>5</sup> in the context of Pakistan's economy. This study is an attempt to bridge this gap in the existing literature related to Pakistani economy as it tries to explore linkages between debt and governance.

Effective use of external resources to achieve rapid economic growth and to produce positive outcomes requires good governance as it plays a significant role in economic prosperity and stability of the country. Various studies show that better governance can exert positive impact on economic growth through improving capital market and provide better climate for investment in an economy. In Pakistan, frequently turnover of governments results in low investment and poor institutional development which in turn aggravates external indebtedness. Financial experts, economists and social scientists, while analyzing the economic conditions hold various governments responsible for rowing the economy into the swamp of foreign debt (for details see Afzal et al., 2006). Political instability, corruption and poor governance have forced the government to receive foreign loans even on hard conditions that exerted bad impact on the process of economic development<sup>6</sup>. Unfortunately, Pakistan remained a candidate of weak governance for the last several years as political stability, civic norms, trust and social capital have eroded with the passage of time. According to Transparency International's report for 2010, Pakistan is more corrupt today than it was previously. Pakistan moved up the corruption ladder from 42nd rung in 2009 to 34th in 2010. The perception of corruption caused a drop in foreign direct investment to \$ 2.21 bln. during 2009-10<sup>7</sup>. The increase in corruption and deteriorating trend of governance had bad impact on the performance of the country, resulting in a sharp increase of external debt over time.

Pakistan has received considerable amount of external debt hoping it will increase the pace of economic growth through bridging the resource gap. It was believed that sustained economic growth would reduce the dependence on foreign loans ultimately making Pakistan politically stable and economically self-sufficient.

<sup>4</sup> See, for example, Pervez Hasan (1999), A. Aqeel and M. Nishat (2000), Talat Anwar (2002), Ghulam Mohey-ud-Din (2005), Tahir Mahmood and Shahnaz A. Rauf (2008).

<sup>5</sup> Governance means to ensure productive and transparent use of funds, establish rule of law, strengthen anti-corruption and provide public services to all.

<sup>6</sup> Political stability contributes positively to the development process of an economy. However, the use of borrowed resources, particularly foreign debt, for achieving political stability serves as growth inhibiting activity in the long run (for details see Alesina et al., 1996; Fosu, 1992; Barro, 1991).

<sup>7</sup> For details see The Dawn, 27th October 2010.

However, the reality turned out to be totally different. The government of Pakistan has failed to build a self-sustaining system and institutions through its reliance on the short-term solutions which hampered the process of economic growth. Presently, the country has received foreign loans ignoring the fact that economic growth depends on efficient and effective use of foreign and domestic resources. In 1997, the World Bank categorized Pakistan as moderately indebted country whereas in 2001 it was ranked as severely indebted nation. Pakistan was ranked again moderately indebted country between 2002 and 2005. Since 2008 Pakistan has been receiving heavy doses of foreign loans from IMF, World Bank and other international financial institutions as its foreign exchange reserves declined sharply. Pakistan's foreign debt has reached the alarming level which can be a threat to economic growth and country's sovereignty.

An overview of the external debt over 60 years reveals that Pakistan has received heavy doses of foreign loans. During 1950s and 1960s there was a substantial rise in the inflow of foreign resources. The external debt rose from \$500 mln. to \$2,700 mln. In 1970s Pakistan received external loans for financing the import bills. At the end of 1970s, total external debt reached at \$8,625 mln. In 1980s, Pakistan received hard loans for financing various development projects and short-term loans for balance of payments (BOP) support and as a result the total external debt reached to \$ 16,885 million. In 1990s, Pakistan external debt reached the unsustainable level due to a number of factors, i.e. increased reliance on short-term loans, sanctions imposed on Pakistan after nuclear test, rapid turnover of governments and large accumulated debt servicing obligations. Pakistan's total external debt reached \$38.9 bln. by the end of 1999. During the first half of 2000s, reduction in external debt burden was observed due to significant debt rescheduling by Paris and London clubs, debt management and increased inflow of workers' remittances after 9/11. Furthermore, because of Pakistan's support for US in anti-terror campaign, there was a heavy inflow of foreign resources. The total external debt rose to \$40.3 bln. by the end of June 2007, an increase of only \$1.4 bln. in 8 years. During the last 3 years, the external debt liabilities surged from \$40.3 bln. to \$55.6 bln. — an increase of \$15.3 bln. in 3 years<sup>8</sup>. The rising external debt servicing obligations caused many problems like crowding out of public finance, non-availability of enough funds for other affairs of the economy and severe burden on the BOP.

Historical statistics on the external debt servicing (long and medium term external debt) as a percentage of exports receipts indicates high burden of external debt. In 1960s, on average, external debt servicing as a percentage of export receipts was 28.98% per annum which declined to 23.11% per annum and rose to 25.52% in 1980s. During 1990s, it was 23.47% per annum. In the first half of 2000s, it was reduced to 16.14% per annum. As a result of exorbitant increase of the external debt in the past 3 years, the debt servicing rose from \$2.87 bln. in 2006-07 to \$5.64 bln. in 2009-10. Debt servicing was 16.6% of the total export earnings in 2006-07 which rose to 29% in 2009-10. On the other hand, the growth performance of Pakistan remained quite unimpressive during the past 5 years. During the first half of 2000s Pakistan reported high growth performance. In 2006, the growth rate of the economy was 6.2% which reduced to 2.0% in 2008 accompanied with over \$44 bln. of total external debt.

<sup>8</sup> Ashfaq H. Khan, "Debt, debt and more debt." *The News*, 7 September, 2010, p. 8.

The comparative analysis of debt burden of South Asian countries reveals that among these countries Pakistan's external debt burden remained unsustainable most of the time period, see Table 1.

**Table 1. Comparing Pakistan with South Asian Countries in Terms of Selected Debt Indicators (%), 1985-2008**

	Years					
	1985	1990	1995	2000	2005	2008
EDT/XGS						
Bangladesh	373.7	427.9	269.8	169.9	184.89	148.61
Bhutan	25.7	88.0	117.2	145.9	—	95.90
India	258.7	325.4	207.0	131.8	—	79.13
Maldives	90.73	42.64	77.42	37.07	79.95	93.21
Nepal	182.4	366.6	214.1	194.2	260.71	243.44
Pakistan	218.6	231.2	249.6	289.8	189.08	229.76
Sri Lanka	182.8	210.4	149.1	119.4	—	148.87
EDT/GNI						
Bangladesh	30.3	40.4	40.7	32.1	28.38	28.34
Bhutan	5.6	31.4	38.7	47.6	82.45	57.07
India	18.1	26.7	26.9	21.8	14.60	18.66
Maldives	—	—	—	35.24	51.14	87.64
Nepal	22.5	45.1	54.9	51.6	39.75	31.94
Pakistan	40.0	49.5	49.5	45.9	29.36	31.32
Sri Lanka	59.5	74.5	65.1	59.9	47.54	42.32

Source: World Bank, Global Development Finance.

Note: EDT/XGS (external debt as a ratio of exports of goods and services) and EDT/GNI (external debt as a ratio of gross national income).

Critical ratios of external debt can be considered as an important tool to judge relative burden of external debt on an economy<sup>9</sup>. In terms of EXT/XGS Bangladesh has faced unsustainable levels of external debt in the past but gradually improved and in 2008 its stock of external debt reached the manageable level. Bhutan and Maldives burdens of external debt remained sustainable throughout the period. India faced huge burden of external debt during 1985-95 but thereafter its debt reached the manageable level. Nepal and Pakistan both faced severe burden of debt during 1985-2008 and their debt remained unsustainable most of the time period. Sri Lanka's burden of external debt crossed its threshold level in 1990 but later on its debt became sustainable again.

In terms of EDT/GNI, beside other South Asian countries, Pakistan faced continuous unsustainability of external debt in 1985-2008, except 2005. India's external debt burden remained sustainable during 1995-2008. Bangladesh also faced severe incidence of debt between 1990-95 but after that its debt remained at the manageable level. From the above, it can be easily observed that the burden of external debt in Pakistan remained unsustainable most of the time period. Researchers and policy makers in Pakistan believe that the surge in external debt in the past two decades is because of weak governance of the economy and they put blame on various governments which accepted foreign loans with hard and unfavourable conditions attached.

<sup>9</sup> According to Patillo et al. (2002), critical ratio of external debt to exports is 160-170% and debt to GNP ratio is 35%-40%. If value of debt indicator exceeds its respective critical value, then on the average the impact of external debt on economic growth will be negative and it also represents the absence of debt sustainability.

**Model Specification and Data Sources.** The issue of good governance has gained significant importance recently as it is widely believed to speed up the process of economic growth through proper use of available resources. Kraay (2002) and Kaufmann (2003) support the positive relationship between growth and governance. According to ADB Report for 1995, good governance is mainly determined by accountability, predictability, participation and transparency. UNDP (1997) viewed governance in terms of exercising political, administrative and economic powers for raising the pace of economic development. Governance indicators developed by Kaufmann et al. (2006) lay emphasis on three dimensions of governance, i.e. political governance, economic governance and institutional governance.

This study analyzes the impact of political, economic and institutional governance on external debt of Pakistan. In political governance, voice and accountability (VA) and political instability are included. Voice and accountability include not only civil, political, human and media rights but also participation of citizens in the selection of a government. Political instability is measured by the effects of violent means on government (for example, terrorism). Economic governance includes government effectiveness and regulatory quality, both are related to formulation and implementation of good macro-economic policies raising the pace of economic growth. Institutional governance includes rule for law and control of corruption. It is measured by law and order condition of a country, quality of courts and police and control of corruption.

Most of Pakistan's governance indicators declined continuously from 1996 to 2007-08. In 1996, percentile rank of Pakistan in terms of VA was 26.8% which declined to 19.2% in 2008. The rank of political stability was 19.1% in 1996 which reduced to 1.4% in 2008. This indicates an increase in political instability in the country over the period. However, improvement in regulatory quality is observed during 1996 and 2008. The percentile rank of regulatory quality improved from 28.8% to 34.8% during the same period. The government effectiveness declined from 32.2% in 1996 to 25.6% in 2008. As far as institutional governance is concerned, it deteriorated during the period of 1996-2008 because rule of law and control of corruption exhibit declining trend during the same period.

This study is an attempt to investigate various governance indicators as possible factors behind foreign indebtedness. The data on governance indicators have been collected from World Governance Indicators by World Bank for the period 1990 to 2008<sup>10</sup>. The governance indicators are measured in units ranging from -2.5 to 2.5. These point estimates are rescaled and ranked in percentile<sup>11</sup>. The variable total external debt (in million \$) is taken from various issues of Pakistan Economic Survey. The following models are formulated to capture the impact of political, economic and institutional governance on foreign debt. All variables are taken in log form.

**Model 1. Political Governance and External Debt**

$$\ln ED_t = \gamma_0 + \gamma_1 \ln VA_{1t} + \gamma_2 \ln PS_{2t} + \varepsilon_t,$$

where:

$ED_t$  = External debt (in \$ million)

<sup>10</sup> The selection of time period depended on the data availability.

<sup>11</sup> Point estimates ranked 0 to 100 percentile. Lower percentile is an indication of poor governance whereas higher percentile means better governance.

$VA_t$  = Voice and accountability (in %)

$PS_t$  = Political stability (in %)

$\ln$  = Natural logarithm

### Model 2. Economic Governance and External Debt

$$\ln ED_t = \gamma_0 + \gamma_1 \ln GE_{1t} + \gamma_2 \ln RQ_{2t} + \varepsilon_t,$$

where:

$ED_t$  = External debt (in \$ million)

$GE_t$  = Government effectiveness (in %)

$RQ_t$  = Regulatory quality (in %)

$\ln$  = Natural logarithm

### Model 3. Institutional Governance and External Debt

$$\ln ED_t = \gamma_0 + \gamma_1 \ln ROL_{1t} + \gamma_2 \ln COC_{2t} + \varepsilon_t,$$

where:

$ED_t$  = External debt (in \$ million)

$ROL_t$  = Rule of law (in %)

$COC_t$  = Control of Corruption (in %)

$\ln$  = Natural logarithm

**The Results.** In this study, we use Granger causality test which is considered appropriate for small sample while observing the impact of governance on the external debt accumulation. The results of the granger causality are reported in Table 2.

**Table 2. Granger Causality Results Between Foreign Debt and Political Governance Indicators 1990-2008**

Null Hypothesis	Granger Causality Estimates		
	No. of Lags	F-statistic	Probability
$\ln VA \rightarrow \ln ED$	1	0.59	0.46
$\ln ED \rightarrow \ln VA$	1	2.17	0.17
$\ln PS \rightarrow \ln ED$	1	7.11*	0.03*
$\ln ED \rightarrow \ln PS$	1	0.60	0.46
$\ln PS \rightarrow \ln VA$	1	0.05	0.83
$\ln VA \rightarrow \ln PS$	1	0.21	0.66

Where  $\ln$  represents natural logarithm, VA represents voice and accountability, ED represents external debt, PS represents political stability.

Note:  $\rightarrow$  indicates that first variable does not Granger cause the second and

\* indicates the rejection of null hypothesis.

The results presented in Table 2 reveal the presence of unilateral causality running from political stability to external debt. It means that this variable may help forecasting external debt burden whereas voice and accountability (VA) have insignificant relationship with external debt and will not help forecasting the external debt burden. For investigating the magnitude of the above mentioned relationship, Ordinary Least Square (OLS) is employed and the results are presented in Table 3.

**Table 3. OLS Estimate 1990-2008 Dependent Variable: ln ED and Independent Variable: ln PS**

Variable	Ordinary Least Squares Estimate			
	Coefficient	Standard Error	t-stat	Probability
ln PS	-0.12	0.02	-5.85*	0.01
Constant	4.63	0.02	241.17*	0.00

$R^2 = 0.76$ ,  $\bar{R}^2 = 0.73$ , DW-stat = 1.97, F-stat = 34.23 and Prob (F-stat) = 0.01

Note: \* shows that variable is significant.

The OLS results show there exists negative and significant relationship between political stability and accumulation of debt burden which means higher political stability leads to less debt burden and vice versa. Highly significant coefficient is an indication that 1% increase in political stability reduces the external debt burden by 0.12%.  $R^2 = 0.76$  means that 76% of the total variations in the dependent variable is explained by political stability. F-statistics indicates the overall goodness of fit of the model. The Durbin Watson statistics 1.97 is an indication of the absence of serial correlation.

For observing the relationship between external debt and indicators of economic governance Granger causality test is employed. The results of Granger causality are presented in Table 4.

**Table 4. Granger Causality Results Between Foreign Debt and Economic Governance Indicators 1990-2008**

Null Hypothesis	Granger Causality Estimates		
	No. of Lags	F-statistic	Probability
ln GE → ln ED	1	0.11	0.74
ln ED → ln GE	1	1.21	0.30
ln RQ → ln ED	1	0.15	0.71
ln ED → ln RQ	1	5.10*	0.05*
ln RQ → ln GE	1	5.40*	0.04*
ln GE → ln RQ	1	1.14	0.31

ln represents natural logarithm, GE represents government effectiveness, ED represents external debt, RQ represents regulatory quality.

Note: → indicates that first variable does not Granger cause the second and

\* indicates the rejection of null hypothesis.

The results show there are unidirectional causalities running from external debt to regulatory quality and also from regulatory quality to government effectiveness. From this analysis it can be concluded that external debt may affect ability of the government regarding formulation and implementation of the policies designed for economic prosperity. The results reported in Table 5 show there exists no relationship between institutional governance and external debt as the study fails to find Granger causal relationship between the variables.

This study aims to analyze the relationship between governance and external debt burden in the context of Pakistan using annual data for the period 1990-2008. The results show that political instability appeared to be one of the major determinants which deters the process of economic growth in the country and is also responsible for huge burden of external debt (more than \$50 bln.). Political instability negatively and significantly affects the external debt accumulation. Granger causality

results show that external debt affects the formulation and implementation of policies designed for development purposes.

**Table 5. Granger Causality Results Between Foreign Debt and Institutional Governance Indicators 1990-2008**

Null Hypothesis	Granger Causality Estimates		
	No. of Lags	F-statistic	Probability
$\ln \text{ ROL} \rightarrow \ln \text{ ED}$	1	1.85	0.21
$\ln \text{ ED} \rightarrow \ln \text{ ROL}$	1	1.65	0.23
$\ln \text{ COC} \rightarrow \ln \text{ ED}$	1	0.50	0.05
$\ln \text{ ED} \rightarrow \ln \text{ COC}$	1	0.09	0.76
$\ln \text{ COC} \rightarrow \ln \text{ ROL}$	1	0.01	0.98
$\ln \text{ ROL} \rightarrow \ln \text{ COC}$	1	0.03	0.87

$\ln$  represents natural logarithm, ROL represents rule of law, ED represents external debt, COC represents control of corruption.

Note:  $\rightarrow$  indicates that first variable does not Granger cause the second.

**Conclusions and Suggestions.** From the above analysis it can be concluded that in Pakistan political instability results in high debt accumulation. This leads to higher debt servicing bringing up financial constraints for the economy. The results of this study are consistent with the political and economic situation in the country. Political instability and poor governance appeared to be the major hurdle in the way of domestic resource mobilization which results in accumulation of external debt over time. Furthermore, political instability has bad impact on the continuity of economic policies formulated and implemented for economic prosperity. The quality of good governance was compromised in Pakistan in the absence of political stability due to which the available resources are not used properly hampering the economic growth.

The empirical findings of this study call for effective measures to be taken to bring the economy out of the debt trap. Improvement in transparency, accountability and reduction of corruption are considered to be essential and require good governance. Factors responsible for political instability need to be tackled on priority basis and coordinated efforts on economic, institutional and social front are needed to remove the bottlenecks which cause high burden of debt. Removal of terrorism, corruption, and proper implementation of economic policies must be given emphasis.

In Pakistan, the deteriorating law and order condition has affected the living conditions of the people adversely. Sound law and order in the country is the need of hour for raising the pace of economic development through securing individual and property rights, attracting foreign investors and providing strong incentives to domestic investors. This will boost economic activity, generate employment opportunities and help to reduce poverty and external debt. As the first step towards economic prosperity, the government of Pakistan has to play its role effectively in providing safe economic, political and social environment to its citizens.

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