The Nature of Aid Dependence

Syed Akmal Hussain

Pakistan's debt servicing burden has once again reached unsustainable levels. As the exchange rate depreciates rapidly under balance of payments pressures the economic crisis deepens. Amidst the gathering storm the current high level of indebtedness has become a cause of concern for government, Parliament and the opposition parties. It may be helpful to examine the factors underlying the perennial problem of Pakistan's aid dependence to understand why such a crisis recurs with unsettling regularity.

Consider first, the magnitude of the debt crisis at hand. State Bank data shows that the total external debt and liabilities are now over USD 60 billion, while domestic debt at Rs.6,231 billion is even higher (USD 66 billion at the current exchange rate). The total debt and liabilities, domestic plus external are 67.4 percent of GDP. The stock of total debt may not be overwhelming. However, it is the annual flow of external debt servicing relative to the foreign exchange earning capacity that constitutes a crippling burden. The external debt servicing in 2011 was USD 8.86 billion which is equivalent to half the country's export earnings standing at USD 17.79 billion. Inspite of record levels of remittances, such a debt servicing burden is simply unsustainable: if Pakistan is to import key items such as fuel, fertilizers and cooking oil, so necessary for the functioning of the economy and society.

The fiscal picture is just as grim. The combined external and domestic debt servicing burden constitutes about 70 percent of the government's gross revenue receipts. Thus Pakistan is faced with a harsh fact: If the civilian government is to subsist, courts are to function, critical subsidies on food and fertilizers are to be provided, key ongoing public sector projects are to continue and armed forces personnel are to be paid salaries and their weapons maintained, then foreign aid is an urgent necessity at present.

Why is Pakistan so aid dependent? The answer lies in two features of an economic structure that has been shaped by successive elite based, rent seeking regimes in Pakistan's history: (a) The low domestic savings rate which at 12 percent of GDP is inadequate to finance the investment rate of 24 percent of GDP required to generate an annual economic growth rate of 6 percent. The resultant “savings gap” has historically been filled by foreign aid. Cheap loans based on foreign aid further reinforced the proclivity of the ruling elite for rents (unearned income) and ostentatious consumption rather than savings for investment. (b) The provision of direct and indirect subsidies together with import protection induced the emergence of a textile industry (predominant in the manufacturing sector), which tended to concentrate on the low value added end of the textile range and lacked international competitiveness. This set the mould of a manufacturing sector which was unable to diversify, take risks and innovate: hence its capacity to increase foreign exchange earnings for the country was severely constrained.

The low domestic savings rate on the one hand and a manufacturing sector that was unable to provide enough foreign exchange to finance the import requirements of a high growth trajectory on the other, precluded growth sustainability. Thus relatively high GDP growth could only be achieved during the military regimes of Ayub Khan, Zia-Ul-Haq and Musharraf respectively, when large foreign aid inflows were available. The structural constraint to the growth of foreign exchange earnings was manifested during each of these periods when balance of payments deficits built up rapidly. As aid declined in the subsequent periods of civilian government, so did GDP growth.

Pakistan's aid dependence is rooted in the very structure of the economy. It has been shaped by an institutional framework that restricts the process of savings and investments to the elite. Therefore aid dependence can be overcome only by restructuring the economy through an institutional change that enables the middle class and the poor to participate in the process of savings, investment and innovation.

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