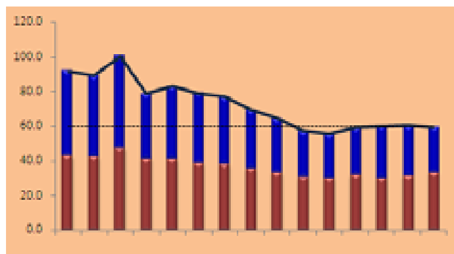
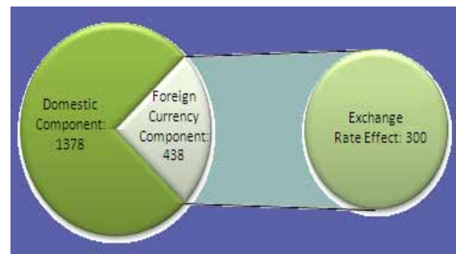
Government of Pakistan
Ministry of Finance

PAKISTAN
DEBT POLICY STATEMENT
2011-12





Debt Policy Coordination Office

2011-12

DEBT POLICY STATEMENT

DEBT POLICY
COORDINATION OFFICE

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List of Acronyms

BoP	Balance of Payments
CDNS	Central Directorate of National Savings
CDR	Currency-to-Deposit Ratio
DSC	Defence Savings Certificates
DPCO	Debt Policy Coordination Office
EAD	Economic Affairs Division
EDL	External Debt and Liabilities
ENDA	Emergency Natural Disaster Assistance
FDI	Foreign Direct Investment
FEE	Foreign Exchange Earnings
FELs	Foreign Exchange Liabilities
FER	Foreign Exchange Reserves
FRDL Act	Fiscal Responsibility and Debt Limitation Act
GDP	Gross Domestic Product
IDB	Islamic Development Bank
IMF	International Monetary Fund
KESC	Karachi Electric Supply Company
LTD	Long-term Debt
MRTB	Market Related Treasury Bills
MTB	Market Treasury Bill
NBP	National Bank of Pakistan
NHA	National Highway Authority
NSS	National Saving Schemes
PAF	Pakistan Air Force
PASSCO	Pakistan Agricultural Storage and Services Corporation Ltd.
PEPCO	Pakistan Electric Power Company
PIA	Pakistan International Airline
PIB	Pakistan Investment Bonds
PKR	Pakistani Rupee
PPA	Power Purchase Agreement
PPG	Public and Publically Guaranteed
PSEs	Public Sector Enterprises
PSM	Pakistan Steel Mills
SBA	Stand by Agreement
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
SFD	Saudi Fund for Development
STD	Short-term Debt
TCP	Trading Corporation of Pakistan
TIP	Telephone Industries of Pakistan
TPD	Total Public Debt
USD	United States Dollar
WAPDA	Water and Power Development Authority

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I. Introduction

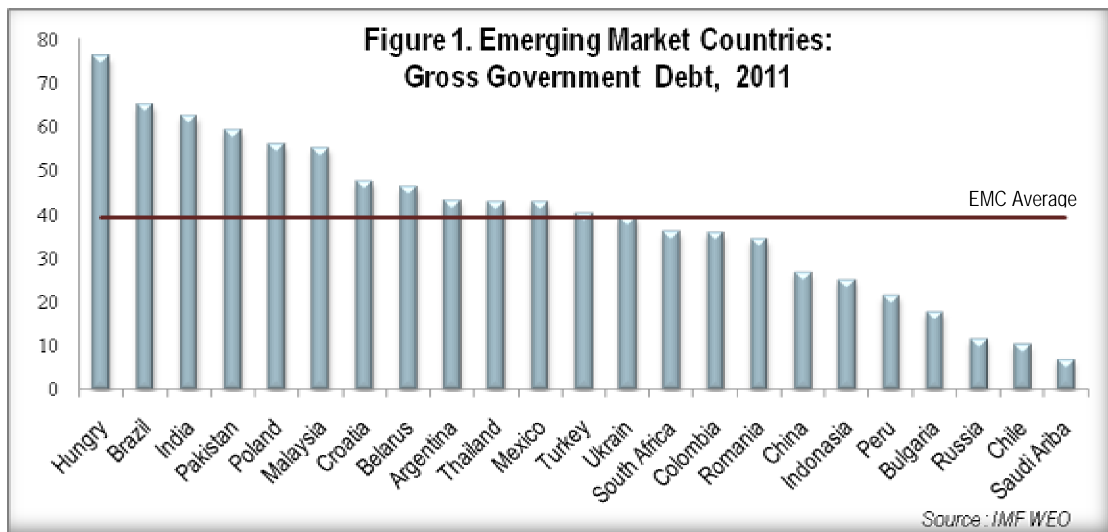
Accumulation in debt stock has been the prime problem faced by both developing and developed countries. Developing countries face this problem more often as they need to borrow to facilitate their development process and accelerate the pace of growth. However, the borrowed funds required to be allocated properly for the productive expenditures and in accordance to their repayment ability. Though debt is useful for the growth of the economy however dependence on debt must be closely monitored and proper strategy should be adopted for enhancing the repayment capability of the country. High and unsustainable levels of debt have serious repercussions for the economy in terms of heavy debt servicing and decreased developmental expenditures, essential to carry on the growth process. Besides, availability of lesser funds for investing in the economy and increase in taxes for repayment, hampers growth as it limits the productive investment, resulting in shrinking of the debt repayment capacity of the economy. It creates crowding out effect as well as has negative impact on the foreign and domestic investment and development plans of the government.

The fiscal and real sectors of the economy are strongly linked to internal and external debt through certain economic variables. On one hand, it appears that the budget deficit is the major cause of domestic debt. While, on the other hand, it turns out that the deficiency in savings and its effects on the balance of payments is the basis of foreign debt. Notwithstanding the rationale behind the occurrence of debt, the level and rate of growth of public debt should not unduly limit the country's monetary, fiscal and exchange rate flexibility. A sound debt management strategy ensures that ample financing is provided for development and growth objectives to be met. While a debt policy can guarantee the sustainability of a country's stock of debt, the need for these debt flows is eventually determined by fiscal and monetary stance along with developments on the external account. Conversely, the absence of prudent debt management will have serious consequences to effective monetary management as well as fiscal operations and will place an additional burden on the external account in the shape of a greater amount of resources being diverted to debt servicing. In essence, debt policy is a dynamic financing policy that has to react to implementation of various public policies and act as a constraint to public policy (over) ambitions.

For quite a few years, most of the countries of the world have made appropriate steps in order to manage and strategize their public debt. Proper debt sustainability analysis is conducted to keep the debt levels under check. It is important to note that any attempt to control the debt

stock, or the public sector deficit, too tightly may induce instability in other macroeconomic variables. There is a trade-off between ensuring intergenerational equity through fiscal responsibility and the goal of short term macroeconomic stabilization.

In recent past majority of the countries around the world have seen worsening of fiscal accounts and the consequent erosion in debt sustainability indicators as the aftermath of international debt and credit crisis of 2007-08.



Pakistan's debt dynamics has undergone substantial changes since FY2007. Higher fiscal deficit led to accumulation of huge debt both in absolute and relative terms. Due to non availability of sufficient funds from the external sources, the financing focus shifted towards domestic sources that led to shortening of maturity profile of public debt. A confluence of unfavourable factors including lower GDP growth, devastating floods, severe energy shortages, haemorrhaging PSEs, high inflation, weak security situation and global economic recession resulted in higher fiscal deficits in the recent past.

Financial discipline over a prolonged period is essential for maintaining macroeconomic stability in the economy. There is a general consensus that a persistent commitment to financial discipline can be achieved by following rule-based fiscal policy. Pakistan government also believes that and accordingly, a rule-based fiscal policy was formed and incorporated in the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005, which was passed by the Parliament in June 2005. This Act ensures responsible and accountable fiscal management by all governments, the present and the future — and would encourage informed public debate about fiscal policy. According to it, the following statement put out the total public debt in detail and

highlights the portions where the government had been successful or failed in achieving the targets.

II. Debt Policy Statement

The Debt Policy Statement is presented to fulfill the requirement in Section 7 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. The statement provides an overview of the public debt as well as external debt and liabilities and explains the changes to debt over the 2009-10.

Section 7 of FRDL Act 2005 requires that:

(1) The Federal Government shall cause to be laid before the National Assembly, the debt policy statement by the end of January of each year.

(2) The purpose of the debt policy statement is to allow the assessment of the Federal Government's debt policies against the principles of sound fiscal and debt management and debt reduction path.

(3) In particular and without prejudice to the provisions of sub-section (2) the debt policy statement shall, *inter alia*, contain –

- (a) Assessment of the Federal Government's success or failure in meeting the targets of total public debt to estimated gross domestic product for any given year as specified in the debt reduction path;
- (b) Evaluations of external and domestic borrowing strategies and provide advice on these strategies;
- (c) Evaluations of the nominal and real costs of external and domestic borrowing and suggest ways to contain these costs;
- (d) Analysis of the foreign currency exposure of Pakistan's external debt;
- (e) Consistent and authenticated information on public and external debt and guarantees issued by the Government with ex post facto budgetary out-turns of all guarantees and those of other such claims and commitments;
- (f) Information of all loan agreements contracted, disbursements made thereof and repayments made thereon, if any, by the Government during the fiscal year; and
- (g) Analysis of trends in public debt and external debt and steps taken to conform to the debt reduction path as well as suggestions for adjustments, if any, in the Federal Government's overall debt strategy.

III. Principles of Sound Debt Management

The modern theory for public debt sustainability discerns a fundamental relationship between economic stability and debt sustainability in a country. The inadequate debt management and a permanent and unlimited growth of debt to GDP ratio may result in some negative tendencies and changes in main macroeconomic indicators, like crowding out of investment, financial system instability, inflationary pressures, exchange rate fluctuations etc. There are also social and political implications of unsustainable debt burden. Persistent and high public debt calls for a large piece of budgetary resources for debt servicing. Ergo, the conventional wisdom focuses the management of debt, rather debt itself.

Debt is not a stigma in itself, yet the management of debt is important. Debt is an important measure of bridging the financing gaps. Prudent utilization of debt leads to higher economic growth and it also helps the government to accomplish its social and developmental goals. Comprehensive debt management is required on the part of government not only to keep the current levels of debt under control but also to fulfil the future repayment obligations. This does not subvert the importance of vigilant fiscal and monetary policies. The management of public debt also requires effective coordination with macroeconomic policies, including reserve management and exchange rate policy.

Domestic and external debt should be treated separately. Domestic debt is a charge on budget and must be serviced through government revenues and/or additional borrowings whereas external debt (both public and private), in addition to charge on revenues, is also a charge on balance of payment and must be serviced from foreign exchange earnings, reserve drawdown, and additional borrowings. Therefore the two should be managed separately to ensure fiscal and external account solvency. Each of these types of debt has its own benefits and drawbacks, with a trade-off between costs of borrowing and exposure to various types of risks that needs to be balanced in order to ensure ample and timely access to cost efficient funding. A comprehensive approach to managing domestic debt must place a high priority on the development of domestic capital markets, and avoid the crowding-out of the private sector.

The level of debt depends on the debt servicing capacity of the economy i.e. export earnings and revenue generation. The debt burden can be expressed in terms of stock ratio i.e. Debt to GDP, external Debt to GDP or flow ratios i.e. Debt to revenue, external Debt to Foreign exchange Earnings. It is common practice to measure public debt burden as a percentage of GDP; however, it makes more sense to measure debt burden in terms of flow ratios because

earning potential reflects more accurately on repayment capacity as GDP changes do not fully translate in to revenues particularly in case of Pakistan where taxation systems are inelastic and taxation machinery is weak.

As a rule of thumb, as long as the real growth of revenue is higher than the real growth of debt, the Debt to Revenue ratio will not increase. Crucially, future levels of debt hinge around the primary balance of the government. Mathematically, if the primary balance (fiscal deficit before interest payments) is zero and the growth in revenue is higher than the cost of invested funds, the debt burden will ease. Bridging the gap between revenues and non-interest expenditure, and ensuring a reduction (generation) in primary deficit (surplus) is an essential pre-requisite that facilitates debt management efforts.

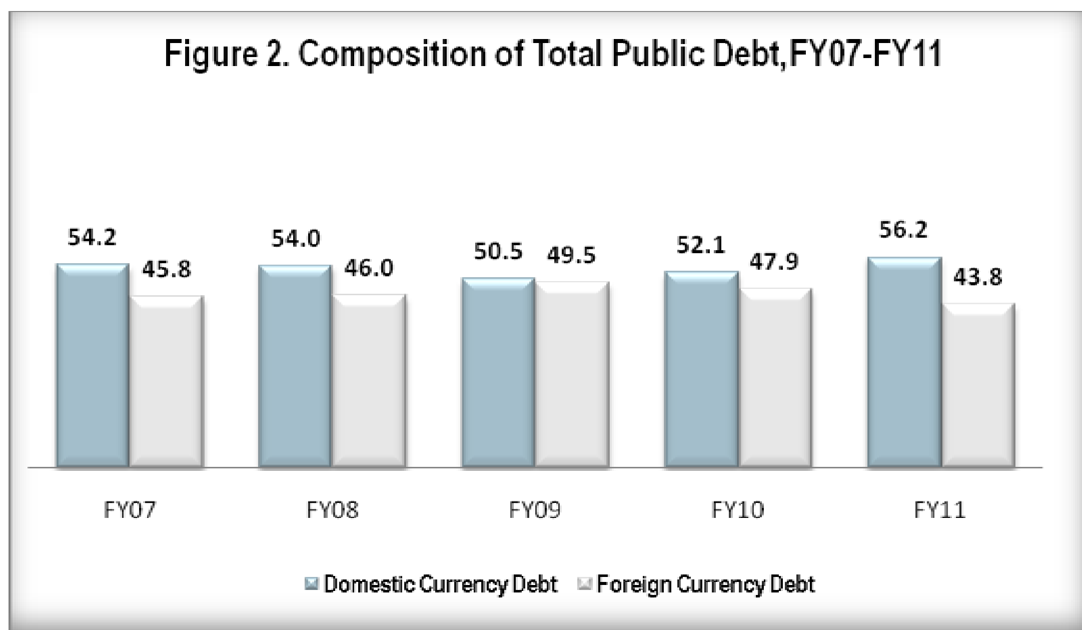
Managing the levels of external debt, and the risks associated with them pose policy makers with a different set of challenges. In this case, if the growth in Foreign Exchange Earnings (FEE) exceeds the growth in External Debt, the ratio of EDL-to-FEE will continue to decline. Although external debt expressed as a percentage of GDP and export earnings depicts the levels and burden of external debt, a clear insight in to the future path of debt is gained by analyzing the non-interest current account deficit. A nil current account deficit before interest payment and higher growth in FEE compared to the interest rate paid on EDL will ensure a decline in EDL-to-FEE over time. Focusing on limiting the non-interest current account deficit, while ensuring that the cost of borrowing is kept at a minimum restricts the increases in debt levels in the medium to long-term; while partially mitigates the inherent risks of external borrowing.

IV. Review of Public Debt

Pakistan entered the 21 Century with serious financial constraints; public debt was as high as 83 percent of its GDP at the end of FY2001. Pakistan's economy has experienced a turnaround since 2000, growth has accelerated, and most macroeconomic indicators have improved. Public debt indicators have also shown significant improvement. Modest growth in public debt, coupled with the strong growth in nominal GDP, led to a significant reduction in public debt to GDP ratio, from 79% in fiscal year 2001-02 to 55.4 percent by the end of FY2007. However since FY07, fiscal policy became subservient to political exigencies as government extended whole-sale subsidies on oil, electricity, food and fertilizer to protect the more vulnerable sections of the society from the effects of global commodity shock. Higher security related expenditures supplemented by policy inaction on key expenditures plus increased expenditures due to natural disasters led to rapid escalation of Total Public Debt as a percentage of GDP, reaching 60

percent by the end of FY2010. However, the same was 59.3 percent at the end of fiscal year 2011; this would have been 58.2 percent had the government not maintained credit balance with SBP on June 30, 2011.

The total public debt stood at Rs.10,709 billion as at June 30, 2011, an increase of Rs.1,788 billion or 20 percent higher than the debt stock at the end of last fiscal year. Government borrowed Rs.1,086 billion from domestic sources and Rs.62 billion from external sources to finance the fiscal operations. Approximately, US$ 3.3 billion were added to the external debt stock owing to depreciation of US Dollar against other major international currencies and around Rs.27 billion were added by depreciation of Pak Rupee against US Dollar by meagre 0.6 percent. In May 2011, government paid Rs. 120 billion against the un-paid tariff differential subsidy of past years to PEPCO.

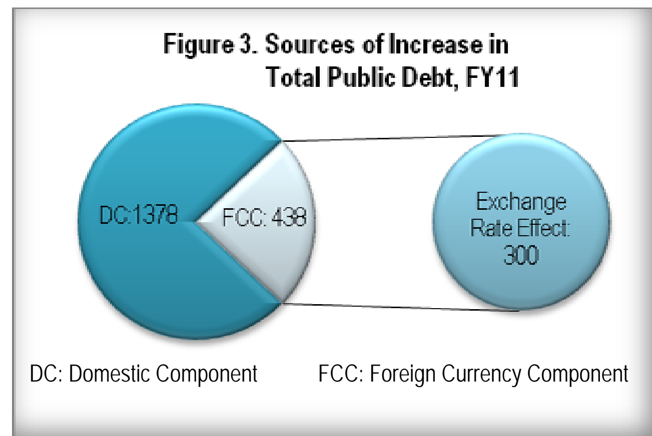


Developments in TPD during 2010-11 have been driven mainly by a combination of five distinct factors. Increased demands on the government budget during 2010-11 for purposes of security meant that expenditure was fairly rigid even in the face of a committed effort to rationalize expenditure and curtail the fiscal deficit. Secondly, lower than expected GDP growth, acute energy shortages, and a high cost of doing business led to a revenue shortfall, situation was further complicated by the devastating floods that put additional burden on fiscal operations. Higher international prices for textile products had a positive impact on Pakistan's trade balance. In addition to these external developments, import compression measures restricted

the import bill significantly despite higher oil prices and shift of power generation mix towards furnace oil.

Slippages in both revenues and expenditures led to FY2011 budget deficit missing the target. Gross revenue collection (tax and non-tax) was 12% lower than the budgeted target while total expenditures (current and development), adjusted for one off payment of energy subsidies pertaining to previous years, were 2.4% higher than budgetary estimates. FBR tax collection fell 6.5% short of target while non-tax revenues were 22.7% less than target due to non-realization of expected 3G license receipts and lower logistical support receipts from the US. On the other hand, expenditure exceeded the target due to higher subsidies and flood related spending despite PSDP spending being 24% lower than the budgeted target.

The primary source of increase in public debt during 2010-11 has been a rapid increase in local currency component that accounted for almost 76 percent of the total increase in TPD. The main reasons for this shift in borrowing were the non-materialization of privatization proceeds, slow disbursement from multilateral and bilateral donors, and higher than budgeted fiscal deficit.



The external debt component grew by Rs. 424 billion or 24 percent due to increased foreign public debt inflows on the one hand, and depreciation of US dollar against other major currencies on the other hand. Rupee lost approximately 0.6 percent of its value against the US dollar during 2010-11. Depreciation of the US Dollar against other major currencies caused the foreign currency component of public debt to increase by approximately US $3,300 million. This capital loss on foreign currency debt, however, is mitigated by the strong concessionality element associated with Pakistan's external loans. The impact of any currency shock should not be looked at in isolation, but rather be analyzed in the context of interest rate differential.

TPD stood at Rs. 10,996 billion at the end of first quarter FY2012, registering an increase of Rs. 287 billion or 2.7 percent in first three months of the current fiscal year. During the first quarter FY2012, US $ appreciated against other major currencies and registered a meagre capital gain of approximately US $ 50 million, however Pak Rupee lost its value against US Dollar by 1.7%.

Government was able to contain the fiscal deficit for the first quarter at 1.2 percent of GDP against 1.6 percent in same period last fiscal year that helped restricted the growth in public debt.

A significant positive masked by overall weak fiscal numbers is the distinct uptrend in FBR tax collection since 4QFY2011. Helped by withdrawal of GST exemption on several sectors and levy of one-off flood surcharge, FBR tax collection grew by 28.4% in 4QFY2011. However, the trend has continued into FY2012 with FBR tax collection increasing by 21% during Jul-Dec'2011 despite shifting of GST collection on certain service to the provinces.

Table 1. Public Debt, FY07-FY12*

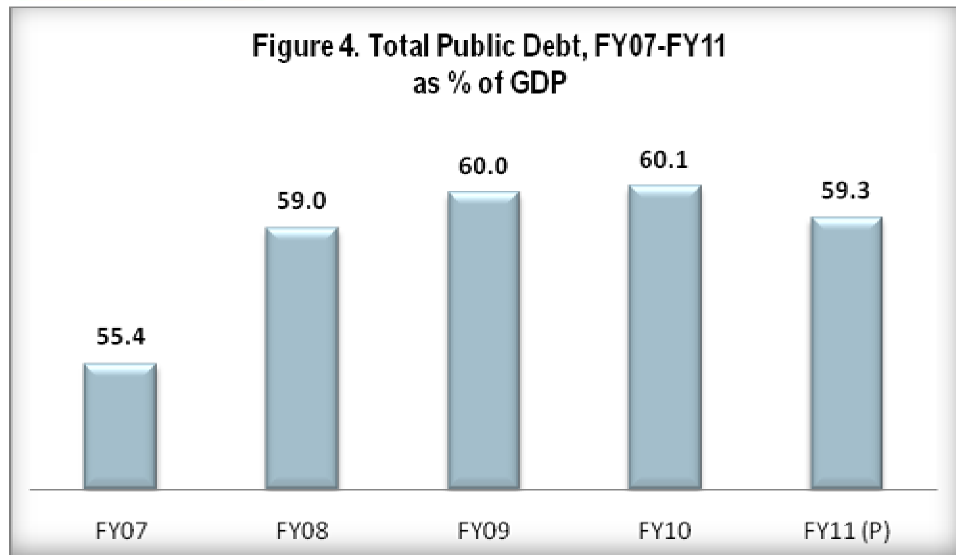
	FY07	FY08	FY09	FY10	FY11 (P)	FY12*
	(In billions of Rs.)					
Domestic Currency Debt	2,601	3,266	3,852	4,651	6,014	6,223
Foreign Currency Debt	2,201	2,778	3,776	4,270	4,694	4,773
Total Public Debt	**4,802**	**6,044**	**7,629**	**8,921**	**10,709**	**10,996**
	(In percent of GDP)					
Domestic Currency Debt	30.0	31.9	30.3	31.3	33.3	29.8
Foreign Currency Debt	25.4	27.1	29.7	28.8	26.0	22.8
Total Public Debt	**55.4**	**59.0**	**60.0**	**60.1**	**59.3**	**52.6**
	(In percent of Revenue)					
Domestic Currency Debt	200	218	208	224	266	250
Foreign Currency Debt	170	185	204	205	208	192
Total Public Debt	**370**	**403**	**412**	**429**	**474**	**442**
	(In percent of Total Debt)					
Domestic Currency Debt	54.2	54.0	50.5	52.1	56.2	56.6
Foreign Currency Debt	45.8	46.0	49.5	47.9	43.8	43.4
Memo:						
Foreign Currency Debt (in US$ Billion)	36.4	40.7	46.4	50.0	54.6	54.6
Exchange Rate (Rs./US$, E.O.P)	60.4	68.3	81.4	85.5	86.0	87.5
GDP (in Rs. Billion)	8,673	10,243	12,724	14,837	18,063	20,905
Total Revenue (in Rs. Billion)	1,298	1,499	1,851	2,078	2,261	2,485

P: Provisional
*end-September 2011

Source: EAD, SBP, Budget Wing, MoF and DPCO staff calculations

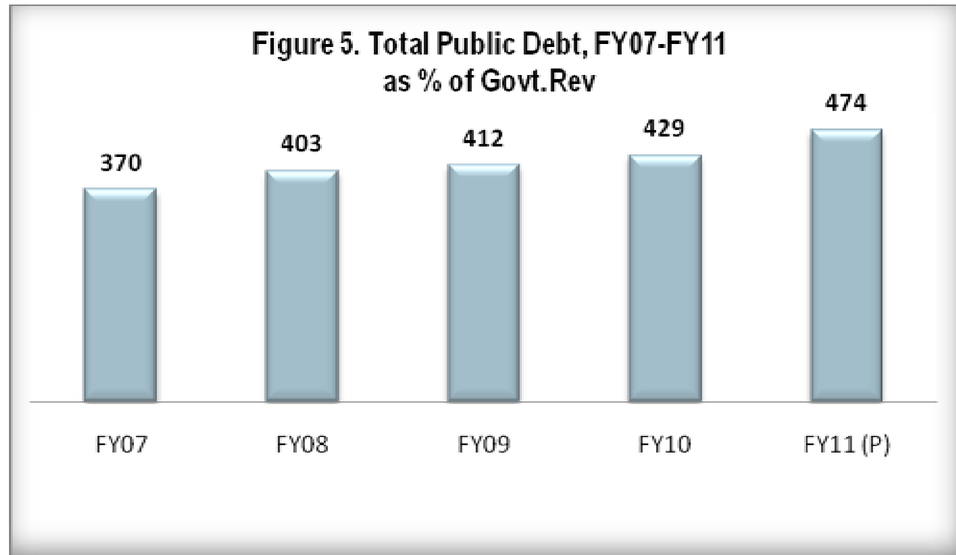
IV.i. Dynamics of Public Debt Burden

Borrowing is necessary for economic development of any country as long as the economic returns are higher than the cost of invested funds. As mentioned earlier, the level of debt depends on the debt servicing capacity of the economy, i.e., export earnings and revenue generation.



The origin of current fiscal predicament can be traced back to FY2006-07 when government extended wholesale subsidies with a view to protect more vulnerable segments of the society from the effects of global commodity price shock. However, such measures actually resulted in pressure on balance of payments, fiscal account (in shape start of circular debt build-up) and banking system liquidity. The economy finally paid the cost in shape of currency devaluation with rupee losing more than a third of its value, inflation reaching multi-decade highs of 25 percent in 2nd quarter of FY2008, benchmark interest rates being hiked to 15 percent and GDP growth falling to 3.7 percent in FY2008 and further to 1.7 percent in FY2009 from an average of 6.8 percent during FY2003-07. Nevertheless, post FY2006 events taught a very expensive lesson on the need to maintain fiscal discipline as measures haphazardly designed to provide 'relief' eventually caused more 'pain' for the public in general. As a result of this crises public debt to GDP ratio shot up to 59 percent in FY2008 from 54.4 percent in FY2007, since then it is hovering around 60 percent.

A more accurate measure to country's indebtedness is Total Public Debt in terms of total revenues. As mentioned earlier if the primary balance (fiscal deficit before interest payments) is zero and the real growth in revenue is higher than the real growth in debt, the debt burden will ease. Pakistan saw a primary surplus in FY2004, since then it is running a primary deficit, in FY2009 government was able to bring the deficit down to 0.1 percent of GDP from 2.5 percent in FY2008 as a result of fiscal consolidation and rationalization of expenditure. However since FY2010, owing to increased security expenditure, unsustainable food and energy subsidies and great floods of 2010, fiscal adjustment path was reversed and the primary deficit reached 2.5 percent of GDP at the end of June 2011.



Similar pattern was witnessed in terms of real growth of revenues, from high of 11.9 percent in FY2007 it declined to -8.4 percent in FY2011. On the other hand a gradual decline in real growth of debt has been witnessed since FY2008. However, the real growth of debt has been greater than the real growth of revenues complemented by primary deficit resulted in increase of debt burden and public debt stood at 4.7 times of government revenues at the end of FY2011. This ratio is gradually deteriorating over a period of time and government must take corrective measures to reverse this trend and bring this ratio down to acceptable threshold of 3.5 times.

Table 2. Selected Debt Indicators

	FY07	FY08	FY09	FY10	FY11
Real Growth of Public Debt	2.3	8.3	5.2	4.5	1.1
Real Growth of Revenues	11.9	-0.6	2.9	0.3	-8.4
Real Growth in Non Interest Expenditure	14.1	7.4	-11.7	11.6	-1.9
Real Growth of GDP	6.8	3.7	1.7	3.8	2.4
Public Debt/GDP	60.1	59.0	60.0	60.1	59.3
Public Debt/Revenue	370.0	403.1	412.1	429.0	474.3
Debt Service/Revenue	33.8	37.2	46.6	40.4	37.7

Source: Budget Wing, SBP and DPCO staff calculations

The growing debt burden of the government highlights the importance of increased revenue generation going forward. As witnessed during 2010-11, even relatively weak real growth of the level of debt can severely increase the debt burden of the economy if revenue collection in real terms is not up to par. Government needs to shore up revenue efforts quickly, given the fact that future payments on account of IMF SBA will increase the quantum of debt servicing, ultimately increasing pressure on government resources.

Debt service as a percentage of total revenue witnessed a decline though still higher than the acceptable threshold. Ideally, this ratio should be below 30 percent to allow government to allocate more resources towards social and poverty related expenditure.

Table 3. Real Growth of Public Debt Burden

	Real Growth of Revenues	Real Growth of Public Debt	Public Debt Burden
FY07	11.9	2.3	-9.7
FY08	-0.6	8.3	8.9
FY09	2.9	5.2	2.3
FY10	0.3	4.3	4.0
FY11	-8.4	1.1	9.5

Source: DPCO staff calculations

IV.ii. Servicing of Public Debt

Increases in the outstanding stock of Total Public Debt have implications for the economy in the shape of a greater amount of resource allocation towards debt servicing in the future. In order to meet debt servicing obligations, an extra burden is placed on limited government resources and might have costs in the shape of foregone public investment or expenditure in other sectors of the economy.

Table 4. Public Debt Servicing, 2010-11

	Budgeted (in billions of Rs.)	Actual	% of Govt Revenues	% of Current Expenditure
Servicing of Foreign Debt	76.8	68.4	3.0	2.4
Repayment of Foreign Loans	174.4	154.2	6.8	5.3
Servicing of Domestic Debt	621.8	629.7	27.9	21.7
Servicing of Public Debt	**872.9**	**852.2**	**37.7**	**29.4**

Source: DPCO staff calculations

During the year 2010-11, servicing of public debt amounted to Rs 852.2 billion as opposed to a budgeted amount of Rs 872.9 billion (See **Table 4**). The saving of Rs 20.7 billion has mostly been due to stable dollar rupee parity, which reduced the amount used for interest and principal repayments of foreign loans in rupee terms. Repayment of foreign loans stood at Rs 154.2 billion as opposed to a target of Rs 174.4 billion; while interest payments on foreign loans, which were budgeted at Rs 76.8 billion, reached to Rs 68.4 billion by end-June 2011. An amount of Rs 629.7 billion was spent on account of servicing of domestic debt against the budgeted estimate of Rs 621.8 billion. The

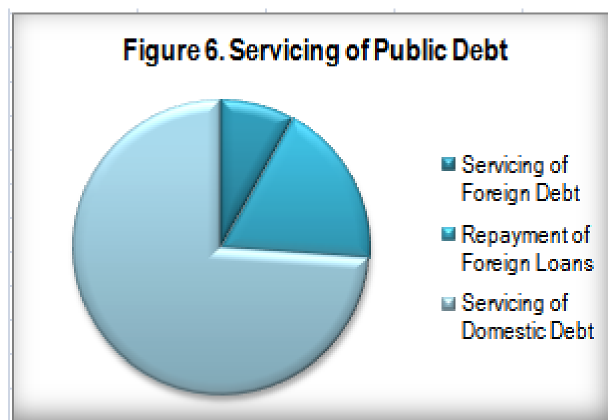


Figure 6. Servicing of Public Debt

increase in domestic debt servicing is partly the result of a tight monetary stance taken in order to arrest the monetary overhang caused by previous policies.

The increase in the total public debt has implications for the economy in the form of increased debt servicing in the future. In order to meet these obligations an additional burden is placed on the limited resources of the government which may result in extraction of recourses from the developmental programmes and hence hamper growth.

IV.iii. Medium Term Macroeconomic Framework

Projections for key macroeconomic variables are given below;

Economic Growth: GDP growth is expected to be around 3.8 percent for FY12, with growth momentum increasing in the following years, reaching 4.7 percent GDP growth by FY14.

Inflation: Current projections indicate that inflationary pressures from within and outside the economy will subside in the medium-term, with increase in CPI falling to 12.0 percent in FY12, and further to 9.5 percent in FY13. The rate of increase in CPI is projected to fall to 8.0 percent by FY14.

Revenues: One of the main premises of the medium-term macroeconomic framework is healthy growth in government revenues. On the basis of successful implementation of tax and tax administration reforms, revenues are expected to grow by an average of 17 percent per year (in nominal terms) over the next three years.

Expenditure: On the other hand, expenditures are expected to be growing at a slower pace till FY14. The quantum of increase is projected to be higher in FY14 owing to an increased outlay on development projects.

Fiscal Balance: On the back of successful reforms in revenue generation, public sector enterprises, and a shift from general to targeted subsidies, the fiscal deficit is projected to decline to 3.0 percent by FY14.

Trade & Current Account Balance: Exports are expected to increase by an average 5.1 percent over FY12-FY14 while growth in imports is projected to increase to 7.5 percent during the same period resulting in an increase in the current account deficit in the medium-term.

Public Debt: Twin deficits in the medium-term mean that the public debt is bound to rise and hence, the projected annual growth in the next three years is nearly 7.4 percent. The emphasis has largely been placed on domestic sources to finance the fiscal deficits in the medium term.

External Debt: The outstanding stock is projected to remain flat once the IMF repayments are initiated in FY12, with a marginal decrease in stock projected for FY14. Excluding IMF SBA, the framework envisages gross disbursement of external debt to average at approximately US$ 0.6 billion during the next three years.

IV.iv. Debt Sustainability Analysis

Crucially, future levels of debt hinge around the primary balance of the government. Mathematically, if the primary balance (fiscal deficit before interest payments) is zero and the growth in revenue is higher than the cost of invested funds, the debt burden will ease. Bridging the gap between revenues and non-interest expenditure, and ensuring a reduction (generation) in primary deficit (surplus) is an essential pre-requisite that facilitates debt management efforts.

Table 5. Debt Sustainability Analysis

Base Line	FY11	FY12	FY13	FY14
Primary Balance/GDP	-2.5	-0.3	-0.1	-0.4
Real Growth of Public Debt	1.1	0.9	-2.0	-2.4
Real Growth of Revenue	-8.4	9.3	5.1	3.4
Total Public Debt/Revenue	473.4	437.2	407.6	384.8
Debt Service/Revenue	37.7	41.2	46.2	40.4
Non-Interest CA/GDP	-0.8	0.4	0.8	1.2
Growth in EDL	8.1	1.8	-2.1	-4.0
Growth in FEE	24.6	4.1	6.0	5.7
EDL/FEE	126.5	123.6	114.1	103.7
EDL Service/FEE	11.4	9.7	13.0	13.1
Debt Burden	9.4	-8.3	-7.1	-5.8
Fiscal Deficit/GDP	6.6	4.7	4.2	3.7
Total Public Debt/GDP	59.3	57.9	54.2	50.4

Source: DPCO staff calculations

The targeted achievement of a near zero primary deficit in the medium-term will pave the way for limiting a rise in the debt stock of the country. A decline in the real growth of public debt is envisaged in the medium term on the assumption that strict fiscal discipline is accompanied by robust real growth in revenue collection. Key to the successful implementation of the medium-term framework and its envisaged impact on debt is that revenue collection will experience real growth over and above real growth in the debt stock. It is worth-mentioning here that the country is already at higher than acceptable benchmark levels. Any deviation from the medium-term framework will adversely affect the country's debt path. The ability of provinces to generate a surplus is critical to this scenario. As a percentage of government revenues, total public debt is projected to decline annually in the medium-term due to significant repayments and a simultaneous increase

in revenues. Similarly, debt service exhibits an inclining trend in the framework owing to repayment of IMF-SBA, afterwards bringing this indicator down to acceptable threshold.

A stable but significant non-interest current account deficit is expected to persist in the medium-term. Growth in external debt will be driven by underlying disbursements and repayments to the fund. The external debt of the country is projected to decline once the IMF payouts begin. The sustainability of the external debt stock is envisaged through growth in foreign exchange earnings surpassing that of external debt in the medium-term. Servicing of external debt is expected to increase due to IMF-SBA repayment as a percentage of the country's foreign exchange earnings. Any slippage in the external account will put pressure on the balance of payments that will in turn jeopardize the currency parity.

The debt burden of the country is projected to decline in the medium-term on the back of successful revenue generation efforts and implementation of tax administration reform. The pace of decline in the debt burden is expected to increase once new revenue measures are implemented. Based on these assumptions, and in the presence of stable economic growth, total public debt is expected to decline as a percentage of GDP. It is important to note that throughout the medium-term framework, the level of public debt remains below the threshold of 60 percent of GDP as prescribed under the FRDL Act 2005.

IV.v. Risks to the Macroeconomic Framework & Structural Factors

The debt dynamics of the country can be altered by risks to key macroeconomic indicators in the medium term. The macroeconomic framework envisages strict financial discipline under a declining inflationary environment. Any deviation or adverse movement of fiscal and monetary assumptions poses significant risks to the sustainability of the medium-term macroeconomic framework.

The underlying catalyst in the creation of fiscal space in the medium-term is an envisaged robust growth in revenue collection. Failure in implementing various measures to enhance revenue collection and in meeting the target set for the coming year poses a major risk to the soundness of the framework. If a shortfall is offset by an adjustment in expenditure, the debt carrying capacity of the economy may be restricted as a result of lower levels of future growth.

With regard to expenditure, higher than expected outlays similar to those witnessed on account of security related expenditure and power sector subsidies in recent years will maintain pressure

on debt creation, threatening the envisaged reduction in the debt burden and inflationary pressures.

In addition to the threat posed by slippages on account of revenue collection and expenditure, there is also a significant risk posed to the medium-term framework by the envisaged fiscal discipline of the provinces. If the assumed provincial surpluses are not achieved, the fiscal deficit target will be compromised, adding pressure on debt creation.

Changes in the deficit financing may also alter the medium-term framework. In case of non-materialization of envisaged foreign financing will add pressure on domestic sources and also will have negative consequences for interest rates, private sector credit provision, inflation, and debt servicing.

On the external account, a high current account in the absence of offsetting increases to current transfers and non-debt creating capital flows can add to the stock of external debt. Similarly, any increase in interest rates and exchange rate depreciation will increase the debt servicing cost of the country and will affect the sovereign debt portfolio. Together, these changes culminate into a visible increase in the public debt stock. Further, in case of added pressure on balance of payments due to international commodity prices (specifically oil prices), non-availability of foreign currency flows will adversely impact the currency parity and foreign currency reserve position of the country.

IV.v. Sensitivity Analysis

When subjected to isolated shocks, the medium-term sustainability of the country's debt burden is most susceptible to an increased non-interest current account deficit. With regards to fiscal account, a failure to increase revenue generation substantially results in increased primary and fiscal deficits. However, none of these shocks threatens the declining trend in the country's debt burden and associated indicators as long as the revenue-expenditure gap does not unduly disturb the underlying fiscal discipline. While the debt stock may not be vulnerable to individual shocks, a culmination of negative developments on the external and fiscal accounts highlights the threat to medium-term debt sustainability.

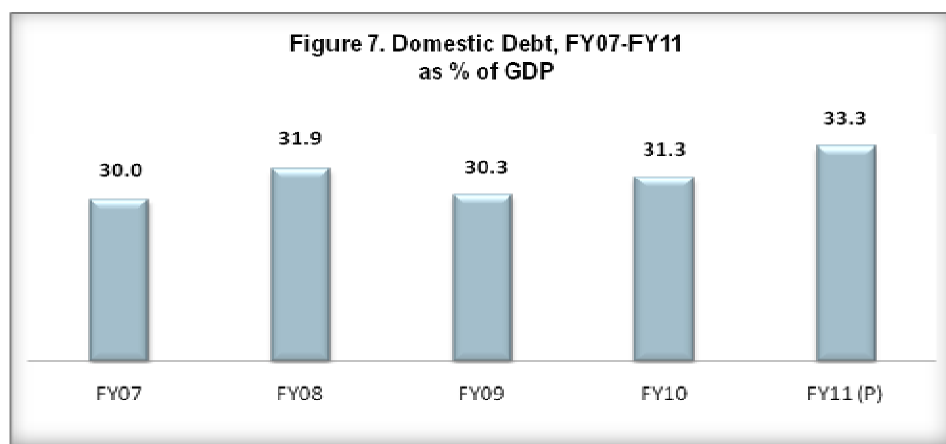
A combined shock to these variables will largely erode the fiscal stability and debt dynamics of the country, and will place the economy on an increasing debt path. More specifically, under such circumstances, not only will the targeted achievement of primary balance be jeopardized,

but the falling trend in the debt burden will be reversed. The public debt-to GDP will increase to 65.2 percent by FY14, breaching the limit imposed by FRDL Act 2005.

V. Domestic Debt

Domestic debt is widely perceived as being an endogenous rather than an exogenous policy choice variable and hence, a country's issuance capacity in this regard is determined by the level of income, pool of savings and institutional quality. Moreover, the budget deficit can be covered directly through money creation by the central bank or by increased credit of the banking system. Excessive monetary financing translates into excess overall demand and inflation. Compared to borrowing from the central bank, market-based domestic borrowing adds more to macroeconomic stability, low inflation and reduced exposure to external real and domestic monetary shocks, domestic savings generation and private investment. Hence, governments by and large, opt for a market-based domestic borrowing strategy in order to develop domestic financial markets.

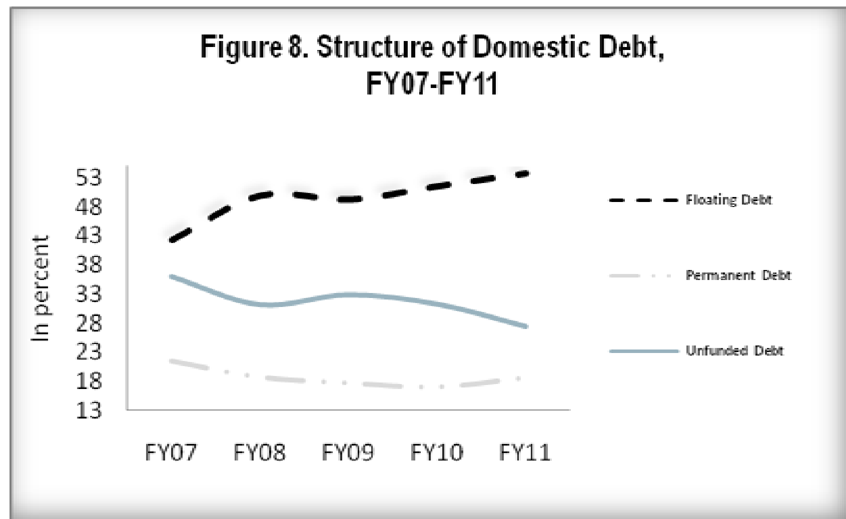
On the downside, though, a broad expansion in domestic debt poses significant negative connotations for private investment, fiscal sustainability and ultimately economic growth and poverty reduction in case of thin financial markets and poor debt management capacity. Additionally, given access to cheap external finance, in the form of concessionary loans and grants from international financial institutions, governments preferably avoid seemingly expensive domestic borrowing. Nonetheless, liquid domestic debt markets can help strengthen money and debt capital markets, boost private savings, and stimulate investment.



Domestic debt consists of three main categories: permanent debt, floating debt, and unfunded debt. Permanent debt includes instruments for medium to long-term debt such as Pakistan

Investment Bonds (PIBs) while the short-term borrowing needs of the government are catered to by floating debt which includes Treasury Bills. Unfunded debt is made up of the various instruments available under the National Savings Scheme (NSS) which is an on-tap source of financing.

The share of permanent debt in total domestic debt is continuously declining since 2004-05 owing to irregular and thin issuance at the longer end of the sovereign yield curve. This declining trend was reversed in FY2011 with the debt management strategy to lengthen the maturity profile of domestic debt. Contribution of permanent debt to total domestic debt stock increased to 19 percent in FY2011 from 17 percent in FY2010. On the contrary, the share of unfunded debt in total domestic debt increased by 3 percentage points, due to heavy reliance on government to borrow in floating debt to meet the fiscal deficit and payment of Rs. 120 billion against past years unpaid power tariff differential subsidy through floating treasury bills. Share of floating debt to total domestic increased to 54 percent in FY2011 from 52 percent in last fiscal year.

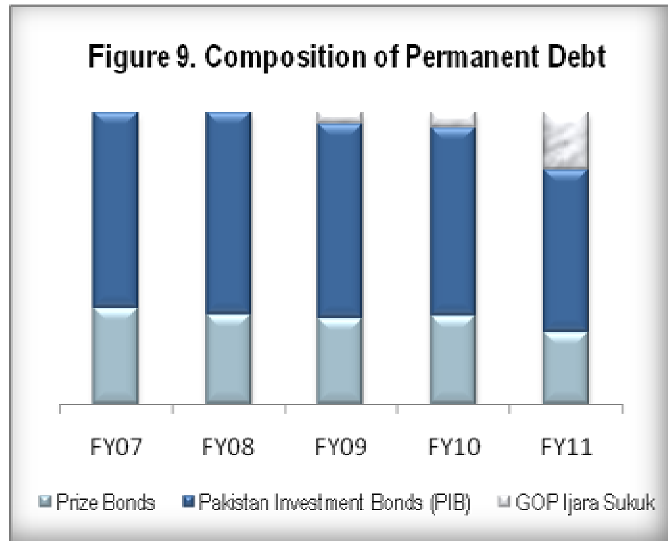


This imbalance in the term structure of domestic debt needs to be addressed as undue reliance on short-term sources of financing raises the rollover or refinancing risk for the government. Failure to issue new debt in order to mature a large amount of outstanding short term debt may trigger a liquidity or debt rollover crisis. The increase in frequency of such operations (due to their short term nature) coupled with any adverse rise in interest rates may leave the government vulnerable to high cost of debt. Below is a detailed analysis of domestic debt categories:

V.i. Permanent Debt

The outstanding stock of permanent debt grew by 41 percent over last fiscal year, registering a net addition of Rs 327.6 billion in 2010-11. Sizeable receipts from Government Ijara Sukuk bond and Pakistan Investment Bonds contributed to this expansion.

Government mopped up net of retirement Rs 182.4 billion through successful auctions of Ijara Sukuk bond and Rs. 112.3 billion through Pakistan Investment Bonds during fiscal year 2011. Prize bonds observed a rise of 17 percent in its stock during the period under review.



A dearth of private sector credit demand during 2010-11 and banks' preference of risk-free sovereign credit in view of mushrooming non-performing loans augured well for the government securities market and overwhelming participation was witnessed in their auctions. Notably, the coupon rates on PIBs were increased in line with market expectations.

V.ii. Floating Debt

Floating debt recorded an enlargement of 35 percent during 2010-11 compared to 26 percent in the previous fiscal year. Keeping in view the negative consequences of monetization of the fiscal deficit, the government has adhered strictly to the "net zero quarterly borrowing limits" from the SBP and retired Rs 32 billion during the fiscal year.

The outstanding stock of Treasury bills through auction increased by 43 percent in 2010-11, as commercial banks' interest in government paper revived. This preference for T-bills was an outcome of a number of factors including increase in risk aversion, low demand for credit from the private sector and the market expectation of reduction in policy rate.

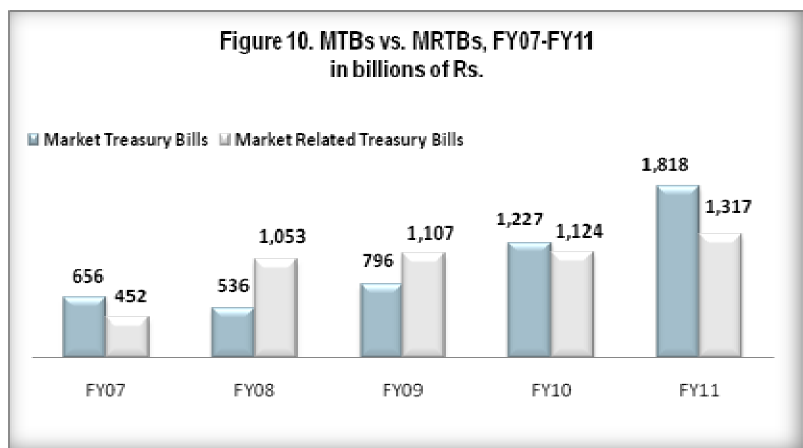


Table 6. Outstanding Domestic Debt, FY07-FY12* (in billions of Rs.)	FY07	FY08	FY09	FY10	FY11(P)	FY12*
Permanent Debt	**562.7**	**616.6**	**685.9**	**797.1**	**1,125.3**	**1,181.8**
Market Loans	2.9	2.9	2.9	2.9	2.9	2.9
Government Bond	9.6	9.3	7.3	7.2	0.7	0.7
Prize Bonds	174.5	182.8	197.4	236.0	277.1	287.6
Foreign Exchange Bearer Certificates	0.2	0.2	0.2	0.1	0.1	0.1
Bearer National Fund Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Federal Investment Bonds	3.1	0.9	1.0	0.0	0.0	0.0
Special National Fund Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Foreign Currency Bearer Certificates	0.0	0.0	0.0	0.0	0.0	0.0
U.S. Dollar Bearer Certificates	0.0	0.0	0.0	0.0	0.0	0.0
Special U.S. Dollar Bonds	9.4	8.2	7.7	2.7	1.0	0.9
Government Bonds Issued to SLIC	0.6	0.6	0.6	0.6	0.6	0.6
Pakistan Investment Bonds (PIB)	352.5	411.6	441.0	505.3	618.2	670.7
Government Bonds issued to HBL	9.8	0.0	0.0	0.0	0.0	0.0
GOP Ijara Sukuk	0.0	0.0	27.8	42.2	224.6	218.1
Floating Debt	**1,107.6**	**1,637.4**	**1,904.1**	**2,399.1**	**3,235.4**	**3,341.9**
Ad hoc Treasury Bills	0.0	0.0	0.0	0.0	0.0	0.0
Treasury Bills on Tap	0.0	0.0	0.0	0.0	0.0	0.0
Treasury Bills through Auction	655.5	536.4	795.6	1,274.1	1,817.6	2,108.2
Rollover of Treasury Bills discounted SBP	0.6	0.6	0.6	0.5	0.5	0.5
Treasury Bills purchased by SBP (MRTBs)	451.5	1,052.6	1,107.3	1,077.7	1,317.0	1,202.9
Outright Sale of MTBs	0.0	47.8	0.6	46.7	100.3	30.3
Unfunded Debt	**940.0**	**1,020.3**	**1,270.5**	**1,457.6**	**1,655.8**	**1,700.6**
Defence Savings Certificates	289.0	284.6	257.2	224.9	234.5	236.4
Khas Deposit Certificates and Accounts	0.6	0.6	0.6	0.6	0.6	0.6
National Deposit Certificates	0.0	0.0	0.0	0.0	0.0	0.0
Savings Accounts	18.7	27.7	16.8	17.8	17.2	15.7
Mahana Amadni Account	2.5	2.5	2.4	2.2	2.1	2.1
Postal Life Insurance	67.1	67.1	67.1	67.1	67.1	67.1
Special Savings Certificates and Accounts	208.3	227.6	377.7	470.9	529.1	540.4
Regular Income Scheme	51.3	51.0	91.1	135.6	182.6	195.6
Pensioners' Benefit Account	69.0	87.7	109.9	128.0	146.0	149.9
Bahbood Savings Certificates	190.2	229.0	307.5	366.8	428.5	443.6
National Savings Bonds	0.0	0.0	0.0	3.6	3.6	3.6
G.P. Fund	43.3	42.5	40.1	39.9	44.3	45.4
		0.085	0.245	0.147	0.136	
Total Domestic Debt	**2,610.3**	**3,274.3**	**3,860.4**	**4,653.8**	**6,016.4**	**6,224.3**
Total Domestic Debt (excluding foreign currency debt included in external debt)	2,600.6	3,265.8	3,852.5	4,650.9	6,015.2	6,223.1

P: Provisional * end-September'11
Source: SBP, Budget Wing, MoF and DPCO staff calculations

V.iii. Unfunded Debt

During 2010-11, major NSS instruments witnessed considerable expansion except Defense Savings Certificates and Savings Accounts. The stock of unfunded debt stood at Rs 1,655.8

billion as of June 30, 2011 recording a healthy growth of 14 percent. Bahbood Savings Certificates and Special Savings Certificates Accounts topped the list with a net investment of Rs 61.7 billion and Rs. 58.2 billion respectively during 2010-11.

Table 7. Causative Factors in Change in Stock of Domestic Debt, FY11 (in billions of Rs.)

	Stock	Stock	Receipts	Repayments	Net Investment
	(End FY10)	(End FY11)		(in FY11)	
Permanent Debt	**797.7**	**1125.3**	**730.8**	**403.3**	**327.6**
Market Loans	2.9	2.9	0.0	0.0	0.0
Government Bond	7.2	0.7	0.0	6.5	-6.5
Prize Bonds	236.0	277.1	138.9	97.8	41.1
Foreign Exchange Bearer Certificates	0.1	0.1	0.0	0.0	0.0
Bearer National Fund Bonds	0.0	0.0	0.0	0.0	0.0
Federal Investment Bonds	0.0	0.0	0.0	0.0	0.0
Special National Fund Bonds	0.0	0.0	0.0	0.0	0.0
Foreign Currency Bearer Certificates	0.0	0.0	0.0	0.0	0.0
U.S. Dollar Bearer Certificates	0.0	0.0	0.0	0.0	0.0
Special U.S. Dollar Bonds	2.7	1.0	0.0	1.7	-1.7
Government Bonds Issued to SLIC	0.6	0.6	0.0	0.0	0.0
Pakistan Investment Bonds (PIB)	505.9	618.2	409.6	297.3	112.3
Government Bonds issued to HBL	0.0		0.0	0.0	0.0
GOP Ijara Sukuk	42.2	224.6	182.4	0.0	182.4
Floating Debt	**2,399.1**	**3,235.4**	**6,948.3**	**6,112.0**	**836.3**
Treasury Bills through Auction	1,274.1	1817.6	3,807.1	3,263.6	543.5
Rollover of Treasury Bills discounted SBP	0.5	0.5	0.0	0.0	0.0
Treasury Bills purchased by SBP (MRTBs)	1,124.4	1317.0	3,018.4	2,825.8	192.6
Outright Sale of MTBs		100.3	122.9	22.6	100.3
Unfunded Debt	**1,457.5**	**1654.7**	**652.0**	**454.8**	**197.2**
Defence Savings Certificates	224.7	234.3	49.9	40.3	9.6
Khas Deposit Certificates and Accounts	0.6	0.6	0.0	0.0	0.0
National Deposit Certificates	0.0	0.0	0.0	0.0	0.0
Savings Accounts	17.8	16.2	177.5	179.2	-1.6
Mahana Amadni Account	2.2	2.2	2.2	2.2	0.0
Postal Life Insurance	67.1	67.1	0.0	0.0	0.0
Special Savings Certificates and Accounts	470.9	529.2	189.3	131.1	58.2
Regular Income Scheme	135.6	182.6	78.6	31.7	46.9
Pensioners' Benefit Account	128.0	146.0	34.0	16.1	17.9
Bahbood Savings Certificates	366.8	428.5	114.4	52.7	61.7
National Savings Bonds	3.6	3.6	0.0	0.0	0.0
G.P. Fund	39.9	44.3	6.1	1.7	4.4
Total Domestic Debt	**4,654.3**	**6,015.3**	**8,331.1**	**6,970.1**	**1,361.0**

Source: Budget Wing, MoF and DPCO staff calculations

During the course of the year 2010-11, the rate of return on these instruments has been linked with the yield on long term government paper such as PIBs. Moreover, price setting is being done on a quarterly basis.

It is important to note that funds raised through National Saving Schemes (NSS) contribute 28 percent of the total domestic debt down 10 percentage points from FY2006. Central Directorate of National Savings (CDNS) is a major source for Government to mobilizing domestic retail savings. Government need to strengthen the capacity building of CDNS with a view to restructured and converted CDNS into vibrant customer centric distribution channel for government debt instruments. Transfer pricing mechanism may be introduced to induce efficiency.

The rates offered on various NSS are aligned with the government bonds (PIBs), however the time lag involved in resetting profit rates is a major source of interest rate arbitrage. The rate setting should be dynamic and more closely aligned to the domestic market yield curve. Furthermore, the put option embedded in most of the NSS is a potential source of severe liquidity crises. The Government should immediately stop this practice and create instrument liquidity by developing secondary market for NSS instruments to ensure long term liquidity to the government. A pre-requisite in this regard, however, is a complete automation of CDNS operations.

V.iv. Domestic Debt during Jul-Sep 2011

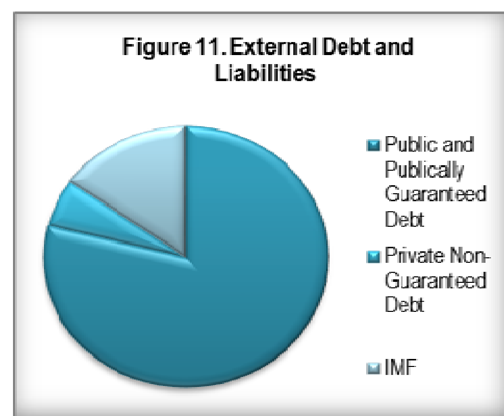
The domestic debt stood at Rs. 6,223 billion at the end of the first quarter of 2011-12, representing an increase of Rs. 208 billion during the first three months of the current fiscal year. This increase stems from a healthy issuance of market debt namely Treasury bills (Rs. 290.6 billion) and PIBs (Rs. 52.5 billion). Notably, this quarter witnessed a massive retirement of Rs. 104 billion in the stock of central bank borrowing. The instruments under the NSS umbrella contributed Rs. 45 billion to the total stock of domestic debt, bulk of which comes from the Special Savings Certificates, Bahbood Savings Certificates and Regular Income Certificates.

Duration of domestic debt at 2.15 years is fairly low given the fact that government funding requirements are generally long term. This estimate of duration may be little inconsistent owing to non-availability of actual maturity profile of NSS and manual operations of CDNS. A behavioral analysis was undertaken to estimate the maturity of NSS instruments. Generally, it is the government’s desire to incur the lowest annual debt servicing cost while ignoring portfolio risks. It is important for the government to take necessary measures to lengthen the maturity

profile of domestic debt. Though this may result in additional debt servicing cost in the short term, it would certainly help in reducing the associated liquidity and refinancing risks in the domestic debt portfolio.

The domestic debt portfolio contains a number of instruments under the same credit risk and maturity horizons. Presently the government borrows through wholesale and retail markets, as well as in the form of government guaranteed loans carrying different rates for the same underlying sovereign risk. This high fragmentation of instruments present in the government debt market cause distortion in the benchmark yield curve and hence, hinder the development of domestic debt capital markets. The debt capital markets are still at its infancy and need to be aggressively developed. As part of it, transparency in fiscal data, a consistent debt management strategy, a level playing field for all investor groups and an efficient transaction mechanism are some of the important preconditions to start with. The government is geared towards improving the liquidity of benchmark issues in the market as previous issues are consistently being re-opened since 2006.

VI. External Debt & Liabilities



The country's External Debt and Liabilities (EDL) stock was recorded at US$ 60.1 billion as of June 30, 2011. During 2010-11, US$ 4.5 billion was added to the stock resulting in a growth of 8.1 percent. Bulk of this increase was contributed by depreciation of US Dollar against other major international currencies. A surplus current account led by strong export growth primarily because of higher cotton prices in the international markets, low debt and non-debt creating foreign were responsible for this muted growth of EDL adjusted for currency movement. There was no fresh disbursement under IMF-SBA during the period under review whereas other heads underwent minor changes. As a percentage of GDP in dollar terms, the EDL was down by 290 bps in 2010-11 compared to 2009-10 and approximated to 28.5 percent.

Below is a detailed analysis of each category within EDL.

Table 8: Pakistan: External Debt and Liabilities

	FY07	FY08	FY09	FY10	FY11(P)	FY12*
			(in billions of USD)			
1. Public and Publically Guaranteed Debt	35.8	40.6	42.6	43.2	46.6	46.7
i) Public debt	35.8	40.6	42.6	43.1	46.5	46.6
A. Medium and Long Term(>1 year)	35.8	39.9	41.9	42.3	45.9	46.0
Paris Club	12.7	13.9	14.0	14.0	15.5	15.6
Multilateral	18.7	21.6	23.1	23.8	25.9	25.7
Other Bilateral	1.0	1.2	1.5	1.8	2.0	2.2
Euro Bonds/Saindak Bonds	2.7	2.7	2.2	1.6	1.6	1.6
Military Debt	0.1	0.0	0.2	0.2	0.1	0.1
Commercial Loans/Credits	0.1	0.1	0.2	0.1		
Local Currency Bonds	0.0	0.0		0.1	0.1	0.1
Saudi Fund for Development (SFD)				0.2	0.2	0.2
SAFE China Deposits			0.5	0.5	0.5	0.5
NBP/BOC Deposits	0.5	0.4	0.3	0.2	0.1	0.0
B. Short Term (<1 year)	0.0	0.7	0.7	0.8	0.6	0.6
IDB	0.0	0.7	0.7	0.8	0.6	0.6
ii) Publicly guaranteed debt	0.0	0.0	0.0	0.1	0.1	0.1
Paris Club				0.0	0.0	0.0
Multilateral				0.1	0.1	0.1
Other Bilateral				0.0	0.0	0.0
Commercial Loans/Credits						
Saindak Bonds						
2. Private Non-Guaranteed Debt (>1 year)	2.0	2.9	3.3	3.2	3.5	3.4
3. IMF	1.4	1.3	5.1	8.1	8.9	8.7
of which Central Govt.				1.1	2.0	1.9
Monetary Authorities	1.4	1.3	5.1	7.0	6.9	6.7
4. Scheduled Banks' Borrowing				0.1	0.1	0.6
Total External Debt (1 through 4)	**39.2**	**44.9**	**51.1**	**54.5**	**59.1**	**59.3**
5. Foreign Exchange Liabilities	1.0	1.4	1.4	1.1	1.0	1.0
Total External Debt & Liabilities (1 through 5)	**40.2**	**46.3**	**52.4**	**55.6**	**60.1**	**60.3**
(of which) Public Debt	*36.4*	*40.7*	*46.4*	*50.0*	*54.6*	*54.6*
Official Liquid Reserves	14.3	8.7	9.5	13.1	14.8	13.7
			(in percent of GDP)			
Total External Debt (1 through 4)	**27.4**	**27.4**	**31.5**	**30.8**	**28.0**	**24.8**
1. Public and Publically Guaranteed Debt	25.0	24.8	26.3	24.4	22.0	19.5
A. Medium and Long Term(>1 year)	25.0	24.4	25.9	23.9	21.7	19.2
B. Short Term (<1 year)	0.0	0.4	0.4	0.4	0.3	0.2
3. IMF	1.0	0.8	3.2	4.6	4.2	3.6
4. Foreign Exchange Liabilities	0.7	0.9	0.8	0.6	0.5	0.4
Total External Debt & Liabilities (1 through 5)	**28.1**	**28.3**	**32.3**	**31.4**	**28.5**	**25.2**
Official Liquid Reserves	10.0	5.3	5.9	7.4	7.0	5.7
Memo:						
GDP (in billions of Rs.)	8,673	10,243	12,724	14,837	18,063	20,905
Exchange Rate (Rs./US$, Period Avg.)	60.6	62.5	78.5	83.8	85.5	86.8
Exchange Rate (Rs./US$, EOP)	60.4	68.3	81.4	85.5	86.0	87.5
GDP (in billions of US dollars)	143.0	163.8	162.1	177.0	211.3	239.0

* end-September 20111
P : Provisional
Source: SBP, EAD and DPCO staff calculations

Vi.i. Public and Publically Guaranteed Debt

Public and Publically Guaranteed (PPG) debt was US$ 46.6 billion at end-June 2011, up by US$ 3.4 billion against FY2009-10. This lower growth of 7.8 percent has restrained the overall

increase in the stock of EDL nonetheless, the PPG debt still accounts for a major portion of EDL amounting to 77.4 percent for 2010-11, up by 0.4 percentage points in comparison to 2009-10. Bulk of this increase is contributed by exchange rate movement and not by fresh disbursements. There has been a repayment of USD 75 million and USD 100 million of commercial loans and NBP/Bank of China deposits respectively.

Table 9. Composition of EDL, FY11

Component	Percent
Public & Publicly Guaranteed	77.4
Paris Club	25.7
Multilateral	43.0
Other Bilateral	3.3
Short Term	1.0
Other	4.2
Private Non-Guaranteed	5.8
IMF	14.9
Foreign Exchange Liabilities	1.7
Memo:	
Total EDL (in billions of US$)	60.1

Source: DPCO staff calculations

USD 185 million worth of short term debt guaranteed by Islamic Development Bank was repaid. The stock of publically guaranteed debt decreased by 11 percent and rested at USD 105 million at the end of FY2010-11, as compared to USD 118 million last year. This has mainly emanated because no new commercial loan was raised and other bilateral were repaid.

VI.ii. Private Non-Guaranteed Debt

The outstanding stock of private non-guaranteed debt increased by only US $ 315 million at the end the fiscal year 2010-11 at US$ 3.483 million. Slower economic activity, prolonged power outages and deteriorating security situation has held back the corporate sector to embark upon any fresh investment and hence, shrinkage in financing needs to be met through external sources was apparent in the form of diminishing private sector debt.

VI.iii. IMF Debt

Pakistan entered in to Stand by Arrangement with IMF in 2008; during the fiscal year under review no fresh disbursements were made rather repaid US $ 267 million to IMF.

VI.iv. Foreign Exchange Liabilities

Foreign Exchange Liabilities (FEL) mainly comprise of central bank deposits and foreign currency bonds. FEL decreased by 9.1 percent in FY2010-11 and summed to US$ 1.0 billion at end-June 2011.

VI.v. External Debt & Liabilities during Jul-Sep 2010

The first quarter of FY2011-12 observed an increase of USD 93 million in public and publically guaranteed debt and aggregated to USD 46.7 billion. The increase has mostly been registered in the stock of medium and long term debt which increased by USD 142 million. The Paris club and other bilateral loan showed increase of USD 387 million which was nullified by the repayment of multilateral loans and NBP deposit of USD 246 million. EDL grew by USD 179 million and increased to USD 60.3 billion during the first three months of current fiscal year.

The first quarter of the current fiscal year noticed a meagre capital gain of US $ 44.7 million owing to US Dollar appreciation against other major international currencies.

VI.vi. Currency Movements and Translational Impact

Foreign loans and other debt obligations of the Government of Pakistan are contracted in various currencies. The bulk of these loans (approximately 93 percent) are in three major international currencies. For reporting purposes, the outstanding balance of these loans is converted into US Dollar. Hence, movement in the US Dollar vs. third currency exchange rates has a significant impact on Pakistan's outstanding stock of external debt. Depreciation of the dollar will cause an increase in the outstanding stock, while appreciation will cause a decrease.

During the course of 2010-11, currency movements caused an increase of approximately US$ 3.3 billion in Pakistan's outstanding EDL. On the contrary, first quarter of the current fiscal year registered a decrease of US$ 44.7 million in EDL owing to currency movements.

Managing foreign exchange risk is a fundamental component of a prudent debt management strategy. Careful management of currency risk has been increasingly mandated by sovereigns, especially after the currency-crisis episodes of the last decade and the consequent heightened international attention on accounting and balance sheet risks. A comprehensive foreign exchange risk management programme requires establishing and implementing sound and prudent foreign exchange risk management policies and control procedures. The external debt portfolio of Pakistan is contracted in 20 different currencies and the historical losses borne by Pakistan in this respect call for a sophisticated currency hedging framework to be installed within the government. If we analyse the currency movements over a longer period of last 20 years, the cost of foreign currency borrowing adjusted for exchange rates movement has been 1.5 percent lower than the average domestic interest rates.

VI.vii. External Debt Servicing

During FY2010-11, external debt servicing summed to US$ 4,799 million that is 14.3 percent lower than the previous year. A segregation of this aggregate number shows a payment of US$ 2,348 million in respect of maturing EDL stock while interest payments were US$ 963 million. US$ 1,488 million was rolled-over.

Among the principal repayments, US$ 980 million of multilateral debt and US$ 325 million of Islamic Development Bank accounted for most of the share. Similarly, hefty interest payments worth of US$ 963 million on foreign currency public debt contributed to the bottom line. In FY2010-11, the central bank deposits were mostly rolled-over.

During July-September 2011, the servicing on external debt was recorded at US$ 1.356 billion. Out of the grand total, principal repayments were US$ 475 million and interest payments were 181 million. The roll-overs amounted to US$ 700 million in the first quarter of 2011-12.

Table 10. Pakistan's Public External Debt Servicing

Years	Actual Amount Paid	Amount Rolled Over	Total
	(in millions of USD)		
2006-07	2,326	1,300	3,626
2007-08	2,558	1,200	3,758
2008-09	3,986	1,600	5,586
2009-10	3,880	1,723	5,603
2010-11	3,311	1,488	4,799
2011-12*	656	700	1,356

*July-September 2011
Source: State Bank of Pakistan

Over the last three years, the debt servicing levels have notably increased. Notwithstanding, with the IMF-SBA repayments set to initiate in the second half of FY 2011-12, the servicing will increase to much higher levels.

VII. External Sector Assessment

Current account showed resilient performance despite different odds by posting a surplus of USD 268million (0.13% of GDP) during fiscal year 2010-11 against a deficit of USD 3.94billion (2.2% of GDP) during fiscal year 2009-10 on account of improved trade balance (higher cotton prices) and swelling inflows in remittances. It was for the first time after fiscal year 2003-04 that Pakistan managed to post a current account surplus. Benefitting from this surplus, overall balance of external account stood at USD 2.4billion (1.2% of GDP) in fiscal year 2011 against USD 1.2billion (0.72% of GDP) in the same period last year.

After global economic downturn of 2008, trade volumes started to deteriorate in fiscal year 2009-10, however as economic activities showed improvements in fiscal year 2011, trade volumes showed signs of recovery. Developing countries, including Pakistan, benefitted from economic recovery in developed world as it boosted its exports during fiscal year 2010-11. Despite escalating oil prices during fiscal year 2010-11, higher commodity prices of cotton and strong global demand helped Pakistan trade account. Cotton prices soared from USD 83/lb in Mar-10 to a high of USD 243/lb in Mar-11. Trade deficit decreased by 9 percent during fiscal year 2010-11 from USD 11.5Billion (-6.5% of GDP) in FY2009-10 to USD 10.4Billion (-5.0% of GDP). A 29% increase in exports, mainly driven by higher contributions from textile and food group surpassed the increase of 15% in imports (on account of higher global crude oil prices) during fiscal year 2010-11. In addition to improved trade balance, increasing influx of remittance further helped current account. Remittances jumped up to USD 11.2billion in fiscal year 2010-11 against USD 8.9billion in last year, registering a robust growth of 26%. Channelizing remittances into formal sector along with greater outreach of banks overseas contributed towards strong remittances growth.

Table 11. Components of Foreign Exchange Earnings & Payments (in billions of US$)

	FY07	FY08	FY09	FY10	FY11
Foreign Exchange Earnings	**33.0**	**37.2**	**35.4**	**38.1**	**47.5**
Goods: Exports f.o.b	17.3	20.4	19.1	19.7	25.4
Services: Credit	4.1	3.6	4.1	5.2	5.5
Income: Credit	0.9	1.6	0.9	0.6	0.7
Current Transfers	10.7	11.6	11.3	12.7	15.9
Of which Workers Remittances	5.5	6.5	7.8	8.9	11.2
Foreign Exchange Payments	**39.9**	**51.1**	**44.6**	**42.1**	**47.1**
Goods: Imports f.o.b	27.0	35.4	31.7	31.2	35.7
Services: Debit	8.3	10.0	7.5	6.9	7.6
Income: Debit	4.5	5.5	5.3	3.8	3.7
Of which Interest Payments	1.4	2.2	1.9	1.5	1.5
Current Transfers: Debit	0.1	0.1	0.1	0.1	0.1

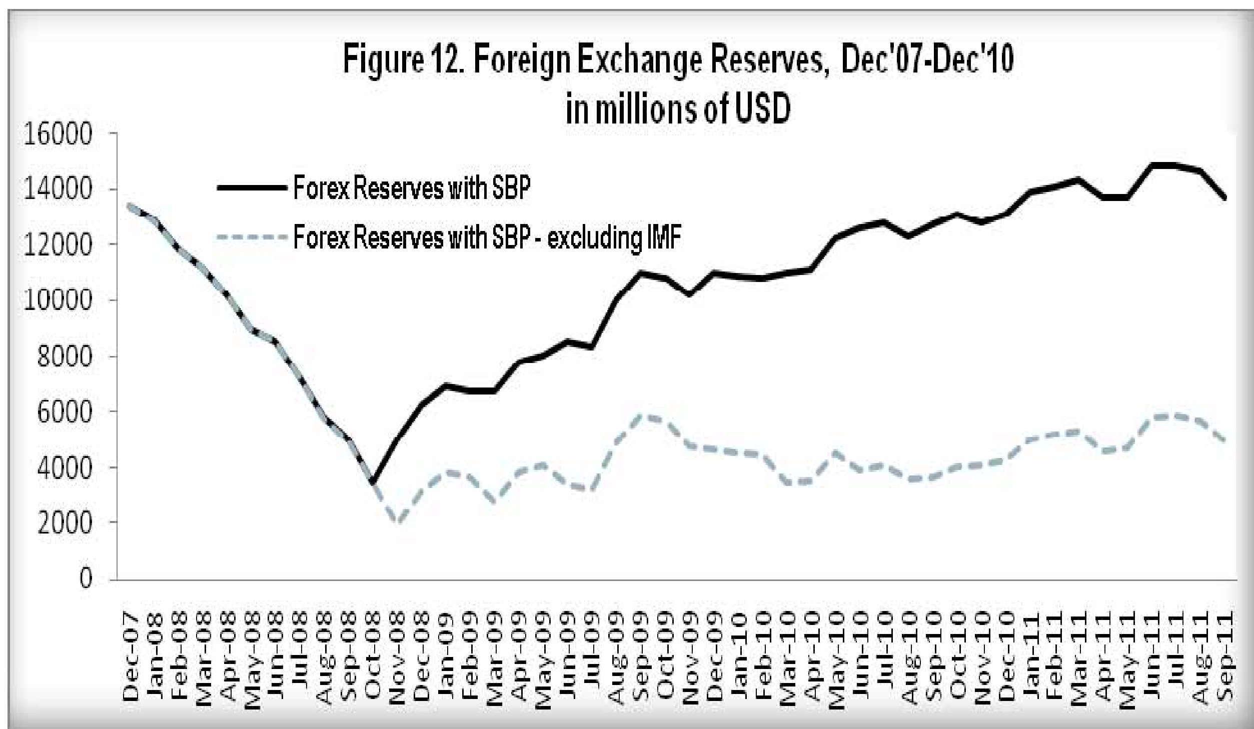
Source: SBP and DPCO staff calculations

Exports amounted to USD 25.4 billion in fiscal year 2010-11 against USD 19.7 billion in the corresponding period last year. High commodity prices amid demand recovery in international market resulted in improved growth in exports. Textile sector, a major contributor of exports witnessed a positive growth of 29%, showing a quantum increase of USD 2.9billion. Low value added textile products saw healthy export growth, as raw cotton and cotton yarn increased by

48.63% and 44.33% respectively during fiscal year 2010-11, while cotton cloth also posted a healthy growth of 30% during the same period. High value added product knitwear and bed wear also registered a growth of 31% and 23.5% respectively, while towels showed a growth of 5% during fiscal year 2010-11. Higher cotton prices in international market, improved demand in US, UK and currency appreciation of competitors all contributed towards improvement in textile exports.

Import increased by 15% to reach at USD 35.7 billion in fiscal year 2010-11 against USD 31.2billion during the corresponding period last year on account of higher crude oil and commodity prices coupled with improved domestic demand.

Net inflows in financial account saw a substantial fall of 59% reaching at USD 2billion in fiscal year 2010-11 against USD 5billion during the corresponding period last year. Disbursements of long term loans contributed the most in decline of inflows as it decreased by 33% during fiscal year 2010-11, taking decline in total disbursement to 43% during the same period. Net portfolio investment provided some respite as it posted an inflow of USD 338million during fiscal year 2010-11 against an outflow of USD 65million during the corresponding period last year. Deteriorating law and order situation, weak economic activity and energy crises had a toll on foreign direct investment, which decreased by 24% during fiscal year 2010-11.



Improved balance of payment on account of current account surplus in fiscal year 2010-11 contributed towards higher foreign exchange reserves. June 2011 saw Pakistan foreign exchange reserves reaching a record high of USD 18.2billion, with SBP holding USD 14.8billion while banks held USD 3.4billion. Building on improved current account position and reserves, Pakistan rupee remained stable during fiscal year 2010-11, unlike previous fiscal year where rupee depreciated substantially. Rupee/USD lost by 0.6% in fiscal year 2010-11 against 5% in the same period last year.

Gains from last fiscal year surplus quickly reversed in first quarter of fiscal year 2011-12 as current account deficit amounting to USD 1.3bn was registered during the period on account of higher imports. Imports saw a hefty increase of 24% in July-Sep 2011-12 meanwhile exports managed to grow by 16% during the period under review. Increasing prices of crude oil in international market burden Pakistan's import bill as was seen in the price of Arab light oil which increased from an average price of USD 73.9/bbl in first quarter fiscal year 2010-11 to an average price of USD 108.3/bbl in July-Sep 2011-12. Meanwhile higher remittances continue to provide cushion to current account deficit, as remittances increased by 25% during first quarter fiscal year 2011-12. Government's strong commitment to route inflows through formal sector has yielded positive and impressive results.

Financial account saw a decrease of 25% during first quarter fiscal year 2011-12 on account increasingly subdued foreign direct investment, outflows from portfolio account and fewer disbursements in loan programs. FDI continued its slide in first quarter of current fiscal year as it decreased by 29% under period review.

After touch an all time high foreign exchange reserves of 18.3billion during the first month of current fiscal year, reserves slipped in during the month August and September. At the end of first quarter current fiscal year, reserves stood at 17.3billion, increased payments for oil bill during the period under review resulted in lower foreign exchange reserves. Decrease in foreign exchange reserves will have a toll on local currency; however its impact is witness with a lag. During first quarter fiscal year 2011-12 USD/PKR stood at 86.8 against USD/PKR of 85.7 in the same period last year.

VIII. External Debt Sustainability

During 2010-11, non interest current account showed a surplus of 0.9 percent of nominal GDP, a deficit of 1.4 percent recorded in FY2010. Similarly, the foreign exchange earnings of the

country were up by 24.6 percent whereas the non-interest foreign currency payments were up by 12.3 percent. These positive developments on the balance of payments front, besides other factors, culminated into a restrained growth of 8.1 percent in the country's external debt and liabilities stock as opposed to a high average growth of 12 percent over the last three years (FY2008 and FY2010).

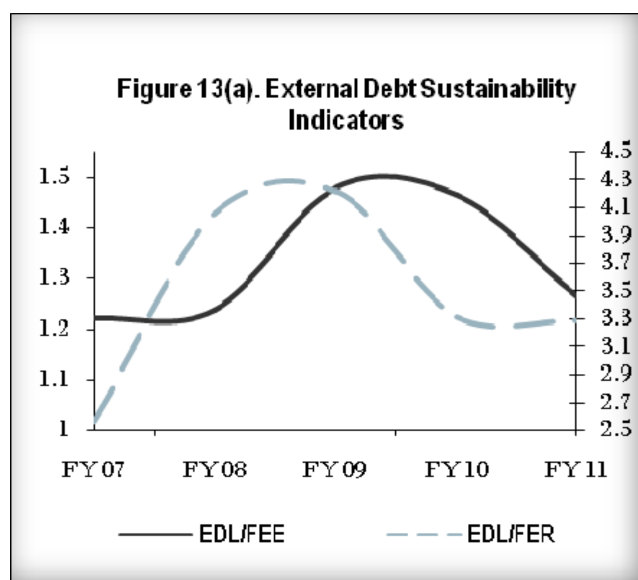
Table 12. External Debt Sustainability: FY07 - FY11 (in percent)

External Debt Indicators	FY 07	FY 08	FY 09	FY 10	FY 11
Non Interest Current Account/GDP	3.8	7.1	4.5	1.4	-0.9
Growth in Exports	4.4	18.2	-6.4	2.9	29.3
Growth in Imports	8.0	31.2	-10.3	-1.7	14.5
Growth in EDL	7.9	15.2	13.3	6.1	8.1
Growth in FEE	4.0	13.0	-5.2	7.9	24.6
Growth in Non Interest Foreign Currency Payments	8.5	27.0	-12.7	-4.9	12.3
EDL Servicing/FEE	12.6	11.7	18.0	16.5	11.4
EDL/FEE (times)	1.22	1.24	1.48	1.46	1.26
EDL/GDP	28.1	28.3	32.4	31.5	28.5
Rollover Ratio (Principal Repayments/Disbursements) public debt	41.0	22.5	37.7	56.6	90.3

FEE: Foreign Exchange Earnings; **STD:** Short-term Debt; **EDL:** External Debt and Liabilities; **LTD:** Long-term Debt; **TPD:** Total Public Debt; **FER:** Foreign Exchange Reserves

Source: EAD, SBP & DPCO staff calculations

The fiscal year 2010-11 saw an improvement in the external debt sustainability indicators in comparison to the preceding year. A major respite has been witnessed in the EDL-to-GDP ratio as it improves from 31.5 percent in FY2009-10 to 28.5 percent in FY2010-11. Improvement has also been observed in the EDL-to-FEE that stood at 1.26 times in FY2010-11 as compared to 1.46 times in FY2009-10 at the back of strong workers' remittances and a positive turn-around in export earnings. A generally acceptable threshold requires a country's EDL to remain below 2 times of FEE.



External Debt Servicing as a percentage of Foreign Exchange Earnings has been declining since FY2010 and stood at 11.4 percent during FY2011. Pakistan is gradually approaching the internationally acceptable percentage (20 percent) in terms of this indicator. The current levels of servicing are bound to increase as IMF-SBA

repayments initiate in FY2012, that require serious efforts to enhance the export earnings if Pakistan is to remain under the accepted threshold.

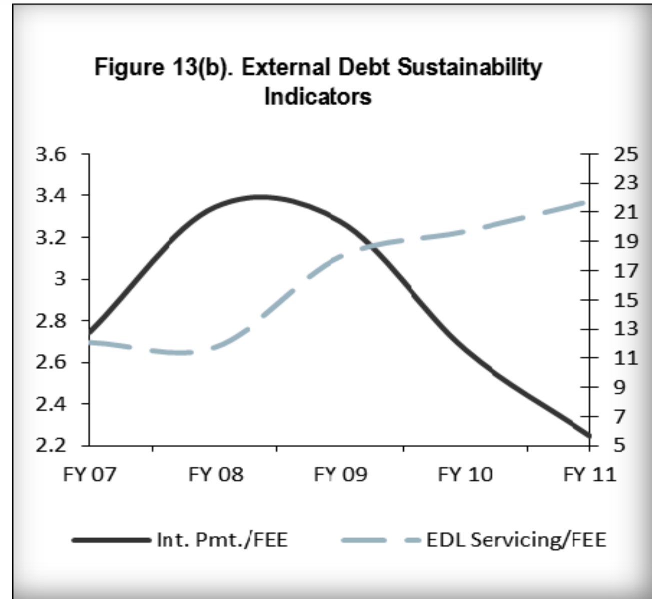


Figure 13(b). External Debt Sustainability Indicators

The roll-over ratio has deteriorated in FY2011 as opposed to the previous fiscal year. The Principal repayments-to-Disbursements ratio was 56.6 percent in FY2010 that increased to 90.3 percent in FY2011. This means that most of the disbursed amounts were used up in paying off the maturing external debt. This is a serious situation that requires urgent attention of the policy makers as was evident from shrinking of Net Foreign Assets of the banking system since start of the current fiscal year that put pressure on both domestic interest rates and currency parity. It is imperative for the government to take corrective measures to attract debt and non-debt creating foreign currency flows.

IX. Guarantees

Guarantees are contingent liabilities that come into play on the occurrence of an event covered by the guarantee. Since guarantees result in increase in contingent liability, they should be examined in the same manner as a proposal for a loan, taking into account, inter alia, the credit-worthiness of the borrower, the amount and risks sought to be covered by a sovereign guarantee, the terms of the borrowing, the justification and public purpose to be served, probabilities that various commitments will become due and possible costs of such liabilities, etc.

The sovereign guarantee is normally extended for the purpose of achieving the following objectives:-

(i) To improve financial viability of projects or activities undertaken by government entities with significant social and economic benefits;

(ii) To enable public sector companies to raise resources at lower interest charges or on more favorable terms;

(iii) To fulfill the requirement in cases where sovereign guarantee is a precondition for concessional loans from bilateral/multilateral agencies to sub-sovereign borrowers.

However, there are also costs associated with the provision of government guarantees. Hence, such off-balance sheet transactions cannot be overlooked in order to gain a holistic view of a country's fiscal position and unveil the hidden risks associated with the obligations made by the government outside the budget. Similarly, reported debt levels of a sovereign may be understated owing to the non-inclusion of guarantees, explicit or implicit, which may materialize in future. In the case of Pakistan, these include, for instance, explicit and implicit guarantees issued to Public Sector Enterprises (PSEs) and unfunded losses of state owned entities such as Pakistan Steel Mill, PIA, WAPDA, PEPCO, Railways, etc. During the fiscal year 20010-11, the Government of Pakistan issued guarantees aggregating to Rs. 62.4 billion (See Table 13). This issuance amounted to 0.35 percent of GDP.

Table 13. Guarantees Issued, FY11

Name of Organization	Amount (in billions of Rs.)
WAPDA	6.45
TCP	8.57
Pakistan Stone Development Company	0.40
PIA	4.50
Pakistan Navy	42.47
Grand Total	**62.38**
	(In percent of GDP)
Grand Total	**0.35%**
Memo:	
GDP (in billions of Rs.)	18,063

Source: DPCO staff calculations

Public disclosure of information about guarantees is an essential component of fiscal transparency, but it is more important to reflect the impact of financial risk associated with guarantees in the fiscal account. The outstanding contingent liabilities as of June 30, 2011 stood at Rs. 555.5 billion. This includes the stock of explicit debt guarantees in both domestic and foreign currencies that appear in the accounting books of PSEs. The Rupee guarantees accounted for 54.4 percent of the total stock.

Other than the publically guaranteed debt of PSEs, Government Issue counter guarantees against the commodity financing operations undertaken by TCP, PASSCO, and provincial governments. Commodity financing is secured against hypothecation of commodities and letter of comfort from the Finance Division. For 2010-11, Rs. 62.4 billion worth of new guarantees

were issued on behalf of commodity financing operations, translating into 0.5 percent of the nominal output.

Table 14. Guarantees Outstanding as of September 30, 2011 (Rs. Billion)	
Outstanding Guarantees extended to PSEs	555.5
-Domestic Currency	302.2
-Foreign Currency	253.4
Memo:	
Foreign Currency (US$ Million)	2,896.4

Source: DPCO

X. Report on Compliance with FRDL Act 2005

The Fiscal Responsibility and Debt Limitation (FRDL) Act, 2005 was approved on 13 June 2005. The FRDL Act, 2005 requires that the federal government take measures to reduce total public debt and maintain it within prudent limits thereof. The following sections identifies the various limits prescribed by the FRDL Act 2005 and reports on progress thereof.

The FRDL Act 2005 requires the following:

(1) Reducing the revenue deficit to nil not later than the thirtieth June, 2008 and thereafter maintaining a revenue surplus

As of June 30, 2011, the revenue deficit approximated to Rs. 595 billion or 3.3 percent of GDP.

	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
Revenue Balance	-1.5%	0.3%	0.5%	1.0%	-0.6%	-3.2%	-1.2%	-2.4%	-3.3%

(2) Ensure "that within a period of ten financial year, beginning from the first July, 2003 and ending on thirtieth June, 2013, the total public debt at the end of the tenth financial year does not exceed sixty percent of the estimated gross domestic product for that year and thereafter maintaining the total public debt below sixty percent of gross domestic product for any given year."

As of 30th June 2011, the total public debt stood at 59.3 percent of GDP. It must be noted here that the limit of 60 percent of total public debt-to-GDP is applicable from the fiscal year 2012-13 onwards.

	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
	(in billions of Rs)								
Domestic Currency Debt	1,852	1,995	2152	2322	2601	3266	3852	4651	6015
Foreign Currency Debt	1,771	1,816	1,913	2,038	2201	2778	3776	4270	4694
Total Public Debt	**3,623**	**3,810**	**4,065**	**4,359**	**4802**	**6044**	**7629**	**8921**	**10709**
GDP	4,876	5,641	6,500	7,623	8673	10243	12724	14837	18063
Total Public Debt (as % of GDP)	**74.3**	**67.6**	**62.5**	**57.2**	**55.4**	**59.0**	**60.0**	**60.1**	**59.3**

(3) Ensure "that in every financial year, beginning from the first July, 2003, and ending on the thirtieth June 2013, the total public debt is reduced by no less than two and a half percent of the estimated gross domestic product for any given year, provided that social and poverty alleviation related expenditures are not reduced below 4.5 percent of the estimated gross domestic product for any given year and budgetary allocation to education and health, will be doubled from the existing level in terms of percentage of gross domestic product during the next ten years."

During the fiscal year 2010-11, the Debt to GDP ratio was reduced by 0.8 percent. Social and poverty alleviation related expenditure (as given by pro-poor budgetary expenditure excluding non-development outlays on law and order) remained at 6.9 percent of GDP in 2010-11. Additionally, expenditure on health and education in 2010-11 amounted to 0.6 percent and 1.8 percent of GDP respectively.

	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
Social sector and poverty related expenditure (as % of GDP)	3.6	3.9	4.2	4.9	4.9	9.3	6.9	6.7	6.9
Expenditure on education (as % of GDP)	1.6	1.7	1.8	1.9	1.9	1.8	1.9	1.8	1.8
Expenditure on health (as % of GDP)	0.5	0.5	0.5	0.5	0.6	0.6	0.7	0.8	0.6

(4) Not issue "new guarantees, including those for rupee lending, bonds, rates of return, output purchase agreements and all other claims and commitments that may be prescribed, from time to time, for any amount exceeding two percent of the estimated gross domestic product in any financial year: Provided that the renewal of existing guarantees shall be considered as issuing a new guarantee."

New guarantees issued by the government in 2010-11 amounted to Rs. 62.4 billion or 0.35 percent of GDP. The government also issued letter of comfort equivalent to 0.5 percent of GDP against commodity finance.

Since last few years Pakistan is faced with serious challenges both at domestic and international fronts. Serious internal security situation, energy shortages, severe floods and rising inflation combined with global economic & credit crises and higher commodity prices have all put enormous pressure on government's limited fiscal resources. Given the severity of these constraints the government has been able to manage the fiscal deficits at reasonable levels though was unable to fully comply with some provisions of FRDLA 2005. However, the government remains fully committed to adhere to all the provisions of FRDLA 2005 in future.

XI. Debt Strategy

With a view to improve the quality of debt management operations, government, for the first time, adopted a comprehensive debt management strategy for fiscal year 2010-11. The key focus of the strategy was to;

- Explore foreign currency borrowing avenues, and
- Augment the domestic liquidity

Quantitative Targets

External Sources; US $500-1,000 million from international debt capital markets.

Domestic Sources;

Table 15. Domestic Portfolio Mix (Rs. Billion)	
Short term	**91**
Treasury Bills	91
Long Term	**408**
Pakistan Investment Bonds	100
GOP Ijara Sukuk	68
National Saving Schemes & Others	240
Total Domestic Borrowings	**499**

Government issued a request for proposal to raise US$500 million through issuance of exchangeable bonds of OGDCL and a consortium of leading international institutions was assigned the task, however government did not get a favorable response from the international capital markets owing to Euro zone credit & debt crises and general risk averseness on part of investors for sovereign debt / equity linked structures. Resultantly, the focus shifted towards borrowing from the domestic sources.

Government borrowed Rs.527bn in long term against a target of Rs.408bn; higher demand for Islamic instruments, favorable liquidity conditions and low private sector credit demand owing to lower economic growth helped the government to raise long term debt. Government borrowed Rs569bn in the shorter tenors against the target of Rs.91bn, higher fiscal deficit contributed by increased security spending, higher energy & food subsidies, non-materialization of defense and privatization receipts, lower revenue collections, floods in Sindh and payment of Rs.120bn to clear the energy subsidy claims of past years were the main reasons for this high short term borrowings.

With a view to develop domestic debt markets by broadening the investor base, government removed the taxation anomalies in the Finance Bill 2012 to provide level playing field to retail investors in government market debt instruments. A comprehensive campaign on government debt instruments will be launched soon to create awareness amongst retail investors regarding investment options in government securities. Furthermore, to attract the offshore investors to invest in domestic debt markets, relevant changes were made through the Finance Bill 2012. Results of these initiatives would be visible in FY2012.

Table 16. Funding Plan, FY11 (Rs. Billion)

	Plan	Actual	Variance
T-Bills	91	569	478
PIBs	100	112	12
Sukuk	68	182	114
CDNS	240	233	-7
Domestic Currency	499	1,096	597
Foreign Currency	92	46	-46
Grants	94	52	-42
Total Borrowing	685	1,194	509
Fiscal Deficit (PKR)	685	1,194	509
Fiscal Deficit* (% of GDP)	4.0%	6.6%	2.6%
GDP	16,975	18,036	

* includes grants and 120 billion one-off expense

Ministry of Finance intends to develop a comprehensive strategy to deepen the domestic debt capital markets in collaboration with Securities Exchange Commission of Pakistan, State Bank of Pakistan and other stake holders.

Furthermore, steps may be taken to augment the domestic resource envelop. One way could be to reduce currency to deposit ratio (CDR) that currently hovers around 30 percent, highest in the region. With money multiplier over 3 times, a small reduction in CDR can significantly add to resource envelop. Ministry of Finance in consultation with SBP shall work out a plan to address this issue.

A major second source of supplementing domestic liquidity could be to unlock personal equity. Banking penetration is comparatively lower in the rural economy owing to non-documentation/non-valuation of real estate in rural areas. Measures shall be taken to incentivize

the rural public to borrow against their assets. This will not only help in supplementing liquidity but also provide needed stimulus to domestic demand of goods and services.

Recent developments in Net Foreign Assets, whereby it has shrunk considerable during the FY2012, immediate action on the proposed measures for augmentation of domestic resource envelop has become critical, else government will be forced to continue to borrow from SBP that will not only be inflationary but also complicate management of monetary policy and keep the domestic interest rates on the higher side.

XII. Concluding Remarks

Increased pressure on government's limited financial resources from higher security related expenditures and unsustainable power & food subsidies have resulted in higher fiscal deficits in the recent path, situation is further compounded by weak taxation machinery. Recent levels of high public debt and large external debt are results of persistent fiscal and current account deficits, non-optimal utilization of financial resources, diminishing debt carrying capacity and rising cost of borrowing.

Public debt to GDP ratio declined by a 0.8 percentage point to stand at 59.3 percent during FY2011, below the ceiling of 60 percent envisaged in the FRDL Act 2005. Fiscal control and a limit on borrowing from SBP facilitated this reduction. However, public debt to GDP may be understated as this ratio does not include any estimates of contingent liabilities, which might materialize in future. Unfortunately, government has not installed any system to quantify and manage the fiscal impact of these contingent liabilities, rather these liabilities are created essentially on an ad hoc basis and without regard to fiscal consequences.

Soundness of Pakistan's debt position, as given by various sustainability ratios, while deteriorating slightly in the previous fiscal year, remains higher than the internationally accepted thresholds. Total Public debt levels around 3.5 times and debt servicing below 30 percent of government revenue are generally believed to be within the bounds of sustainability. Total public debt in terms of revenues has increased to 4.7 times during 2010-11, as opposed to 4.3 times in the previous fiscal year whereas the debt serving to revenue has declined to 37.7 percent in 2010-11 from 40.4 percent in 2009-10. Regardless, the widening gap between the real growth of revenues and real growth of Total Public Debt needs to be aggressively addressed to reduce the debt burden and improve the debt carrying capacity of the country to finance the growth and development needs.

Pakistan's external debt and debt servicing in terms of foreign exchange earnings stood at 1.3 times and 11.4 percent during 2010-11 compared to 1.5 times and 16.5 percent respectively in 2009-10, within the acceptable threshold of 2 times and debt servicing below 20 percent of foreign exchange earnings. However, repayment of IMF debt starting from 2HFY2012 will put pressure on external debt servicing in coming years, therefore it is imperative for the government to take measures for attracting both debt and non-debt foreign currency flows. In the current global economic scenario it will be uphill task for the government to manage external account solvency.

Divergent trends between growth in foreign exchange earnings and government revenues on one hand, and foreign exchange payments and expenditure on the other hand, point towards underlying structural issues which need to be addressed. Export receipts and other foreign currency non-debt creating flows need to be increased above and beyond the growth of foreign exchange payments and growth of external debt and liabilities. By doing so, the government will be able to restrict the non-interest current account deficit, and ensure the sustainability of present levels of external debt. Failure to arrest the widening gap between foreign exchange inflows and outflows will severely hamper the government's room to manoeuvre in case of future external shocks and may possibly lead to a balance of payment crisis and explosive debt path.

The difference between revenues and expenditure and their growth rate poses similar problems for public debt management. To limit the growth of public debt burden and to avoid future debt traps, it is essential that significant real growth in revenues is achieved while undertaking a simultaneous rationalization of expenditure. It must be noted however that rationalization of expenditure should not adversely affect outlays under the PSDP as they are essential in ensuring future economic growth and social welfare. Debt reduction to sustainable levels cannot be achieved without persistent economic growth. The slowdown in growth is a major consequence of rising debt burden and simultaneously adversely impacts the debt servicing capacity of the economy. Therefore it is important for the government to adopt an integrated approach for economic revival and debt reduction strategy, which will require some difficult trade-offs in the short-term, thus implementing structural reforms that boost potential growth is a key to ensure debt sustainability.

Given the impact international exchange rate movements (US Dollar vis-à-vis other international currencies) have historically had on external debt, and the significant translational losses

suffered in the fiscal year 2011, the government should take measures to mitigate the market risk factor of external borrowing by planning to implement a broad-based currency and interest rate hedging strategy and ensuring exchange rate stability.

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