PAKISTAN

Debt Policy Statement

2009-10

Debt Policy Coordination Office
Ministry of Finance

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List of Acronyms

ADB	Asian Development Bank
BOP	Balance of Payment
BSC	Bahbood Savings Certificates
CDNS	Central Directorate of National Savings
CSF	Coalition Support Fund
DSC	Defence Savings Certificates
DPCO	Debt Policy Coordination Office
EAD	Economic Affairs Division
EDL	External Debt and Liabilities
EOP	End of Period
FEE	Foreign Exchange Earnings
FER	Foreign Exchange Reserves
FRDL Act	Fiscal Responsibility and Debt Limitation Act
GDP	Gross Domestic Product
GOP	Government of Pakistan
IDB	Islamic Development Bank
IFIs	International Financial Institutions
IMF	International Monetary Fund
IPPs	Independent Power Producers
MRTB	Market Related Treasury Bills
MTB	Market Treasury Bills
NIT	National Investment Trust
NSS	National Saving Schemes
PAF	Pakistan Air Force
PASSCO	Pakistan Agricultural Storage and Services Corporation Ltd.
PBA	Pensioners' Benefit Account
PEPCO	Pakistan Electric Power Company
PIA	Pakistan International Airline
PIB	Pakistan Investment Bonds
PPG	Public and Publically Guaranteed
PSDP	Public Sector Development Programme
PSEs	Public Sector Enterprises
REITs	Real Estate Investment Trusts
RIC	Regular Income Certificates
SA	Savings Account
SBA	Stand by Agreement
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
SSC&A	Special Savings Certificates and Accounts
STD	Short-term Debt
TCP	Trading Corporation of Pakistan
TPD	Total Public Debt
T-Bills	Market Treasury Bills
WAPDA	Water and Power Development Authority

I. Introduction

Governments of emerging economies are faced by a multitude of challenges while trying to achieve targets of economic growth and social development. An increasingly globalised international economic environment means a greater amount of exposure to external shocks, while the situation is compounded in some cases by a volatile socio-political landscape internally, as is the case with Pakistan. While catering to the demands placed by these shocks, and ensuring a sustainable level of economic growth and appropriate protection for the vulnerable section of society, a greater emphasis is placed on the financing of government operations. Hence, debt creating flows are a vital part of the financing mechanism of developing countries. On the downside, debt increases the vulnerability of these economies to macroeconomic shocks. Moreover, despite the heavier emphasis on debt as a source of financing, developing countries have a lower tolerance for high debt-to-GDP ratios. Thus, management of the long-term cost and sustainability of these flows is of extreme importance.

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.

The US subprime debacle that emanated in the second half of 2007 was ultimately transformed into a worldwide economic dilemma over a period of less than a year. As a result, economic growth rate projections have been revised down sharply for both developed and emerging economies. As governments around the world lowered interest rates and implemented expansionary fiscal measures to revitalize their economies, Pakistan underwent a phase of fiscal tightening and a

stringent monetary stance. The fiscal, monetary, and external debt policies of Pakistan have primarily been driven by the underlying need to resurrect significant macroeconomic imbalances in the domestic economy that were created over the last few years, rather than as a response to the financial crisis and global economic slowdown.

Less developed, *albeit* growing, linkages of domestic financial sector with international markets, a proactive and vigilant regulatory environment, and most importantly, no direct exposure to securitized instruments were some of the highlighted factors that have facilitated in obstructing the direct impact of the global financial crisis. However; **effects of the crisis have been felt, even though in a limited manner, by the real sectors of the economy through the trade balance; with a slowdown in global demand and fall in commodity prices having varying effects, and the capital account; with a significant reduction in private inflows to Pakistan.**

It is remarkable to note that Pakistan is among a handful of countries with a positive rate of growth, and among a very few with the lowest decline in real GDP growth as compared to other countries affected by the international financial catastrophe.

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 2008-09.

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

Prudent debt management is more of an art than science, therefore it is important to differentiate between debt operations and debt management. Debt operation is mechanical and relates to processing of debt, recording and its servicing; whereas debt management relates to managing the market risk embedded in the debt portfolio and optimizing its economic value.

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) is 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

Total public debt (TPD) is a measure of government indebtedness. It includes all government and government guaranteed Rupee debt as well as foreign currency denominated debt, excluding private sector external debt which is not guaranteed by the government.

Developments in TPD during 2008-09 have been driven mainly by a combination of five distinct factors. Increased demands on the government budget during 2008-09 for purposes of security and war on terror 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. The global economic slowdown, and the resultant fall in commodity prices, had a positive impact on Pakistan's trade balance. In addition to these external developments, import compression measures reduced the import bill significantly. Exports also witnessed a deceleration as demand from advanced economies contracted, along with a slump in domestic productivity. However, the fall in imports has outpaced the drop in exports. Still, a fairly high current account deficit, although falling, prevailed throughout the year.

Table 1. Public Debt, FY05-FY10Q1*

	FY05	FY06	FY07	FY08	FY09	FY10Q1*
(In billions of Rs.)						
Domestic Currency Debt	2152	2320	2600	3266	3853	4010
Foreign Currency Debt	1913	2041	2213	2739	3752	4090
Total Public Debt	4064	4361	4814	6005	7605	8100
(In percent of GDP)						
Rupees Debt	33.1	30.4	30.0	31.8	29.4	26.8
Foreign Currency Debt	29.4	26.8	25.5	26.6	28.7	27.3
Total Public Debt	62.5	57.2	55.5	58.4	58.1	54.1
(In percent of Revenue)						
Rupees Debt	239	215	200	218	208	183
Foreign Currency Debt	212	190	170	183	203	187
Total Public Debt	452	405	371	401	411	370
(In percent of Total Debt)						
Rupees Debt	52.9	53.2	54.0	54.4	50.7	49.5
Foreign Currency Debt	47.1	46.8	46.0	45.6	49.3	50.5
Memo:						
Foreign Currency Debt (in US$ Billion)	32.1	33.9	36.5	40.7	46.3	49.4
Exchange Rate (Rs./US$, E.O.P)	59.7	60.2	60.6	67.3	81.0	82.8
GDP (in Rs. Billion)	6500	7623	8673	10284	13095	14972**
Total Revenue (in Rs. Billion)	900	1077	1298	1499	1851	2187**

* Provisional
** Projected for FY10

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

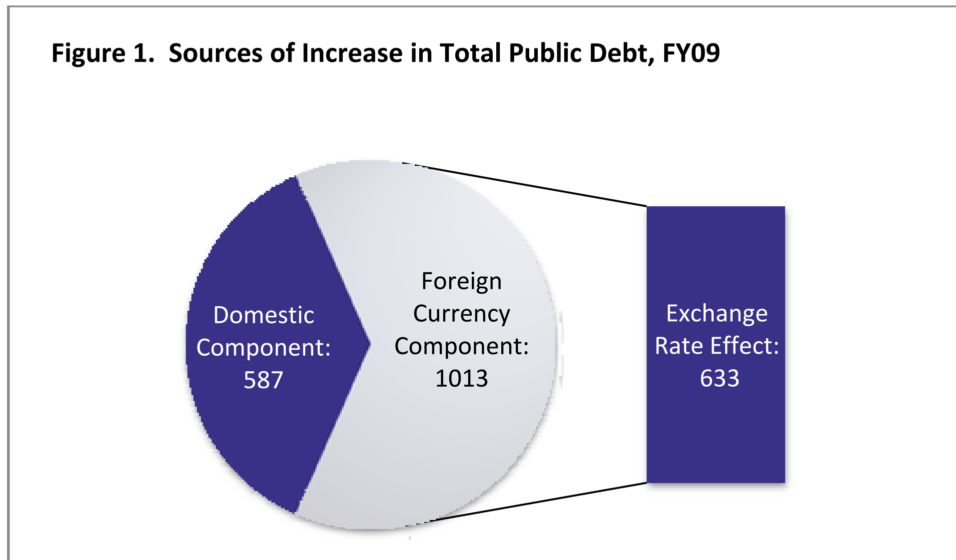
In the absence of ample domestic resources, and an unfavorable environment in international capital markets and limited foreign non-debt creating flows, the government entered into a Stand by Agreement (SBA) with the International Monetary Fund (IMF), paving the way for an inflow of financing to reverse a drawdown of foreign exchange reserves and provide much needed economic stability. Lastly, depreciation of the Rupee against the US dollar throughout the year ended in a substantial increase in the existing stock of foreign currency denominated public debt expressed in Rupee terms.

During the year 2008-09, total public debt increased by Rs 1,600 billion (26.6 percent). As of end-June 2009, Pakistan's total public debt stood at Rs 7,605 billion (See Table 1). Rupee denominated public debt increased from Rs 3,266 billion to Rs 3,853 billion during the same period, increasing by Rs 587 billion or 18 percent during the period. The increase in the domestic component of public debt accounted for 37 percent of the total increase in public debt.

The primary source of increase in public debt during 2008-09 has been a rapid increase in the foreign currency component which accounted for 63 percent of the total increase in TPD. This component grew by Rs 1,013 billion or 37 percent due to increased foreign public debt inflows on the one hand, and significant depreciation of the Rupee vs. the US dollar on the other hand. The rupee lost approximately 20 percent of its value against the US dollar during 2008-09. An increase of Rs 633 billion, approximately 39.6 percent of the total increase in TPD, was solely due to the depreciation of the Rupee against the US Dollar (See Figure 1). Furthermore, depreciation of the US Dollar against other major currencies caused the foreign currency component of public debt to increase by US $53 million. This capital loss on foreign currency debt, however, is mitigated by the strong concessionality element associated with Pakistan's external loans. Although the increase in the foreign currency component of TPD might appear to be alarming, it must be noted that the increased inflows mainly in the form of the IMF SBA have been used not to fund budgetary operations, but to strengthen Pakistan's foreign exchange reserves.

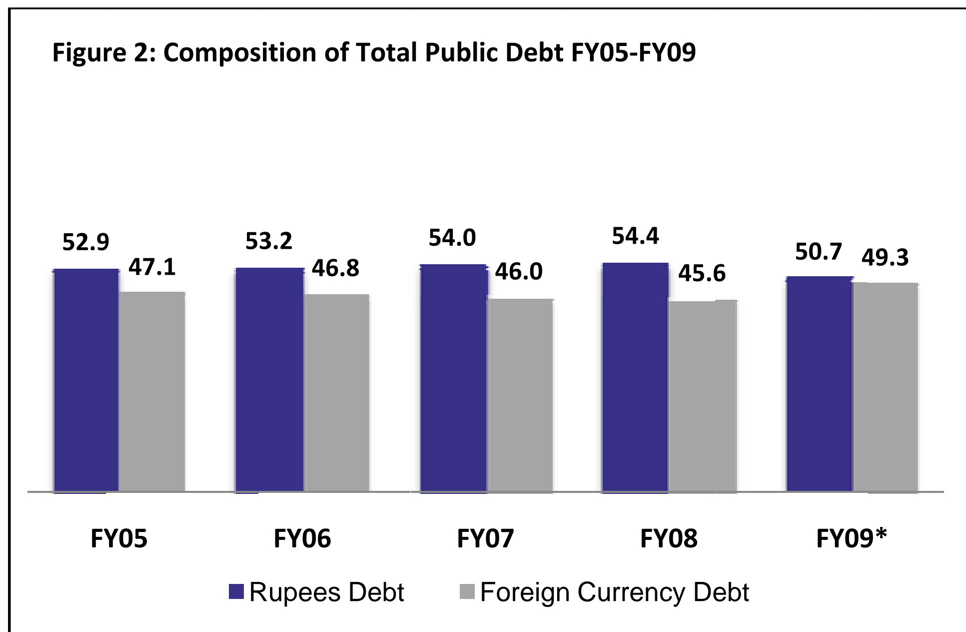
Similar changes have been witnessed to the stock of Pakistan's TPD during the first three months of the current fiscal year. Outstanding TPD rose to Rs 8,100 billion, registering an increase of Rs 495 billion or 6.5 percent, mostly on account of considerable inflows of foreign currency denominated debt. Disbursements under the third tranche of the IMF-SBA and from multilaterals caused the foreign currency component of TPD to increase by Rs. 338 billion by end-September 2009. The funds from the IMF SBA have been used primarily to shore up the foreign exchange reserves of the country. However, out of the third tranche of US$ 1.2 billion which was disbursed in August 2009,

Figure 1. Sources of Increase in Total Public Debt, FY09



approximately $745 million has been allocated for budget financing. Depreciation of the rupee against the US dollar caused the foreign currency component to increase by Rs. 91 billion, approximately 18.4 percent of the total increase in TPD. The remaining increase of approximately Rs. 157 billion was on account of domestic borrowing.

Figure 2: Composition of Total Public Debt FY05-FY09



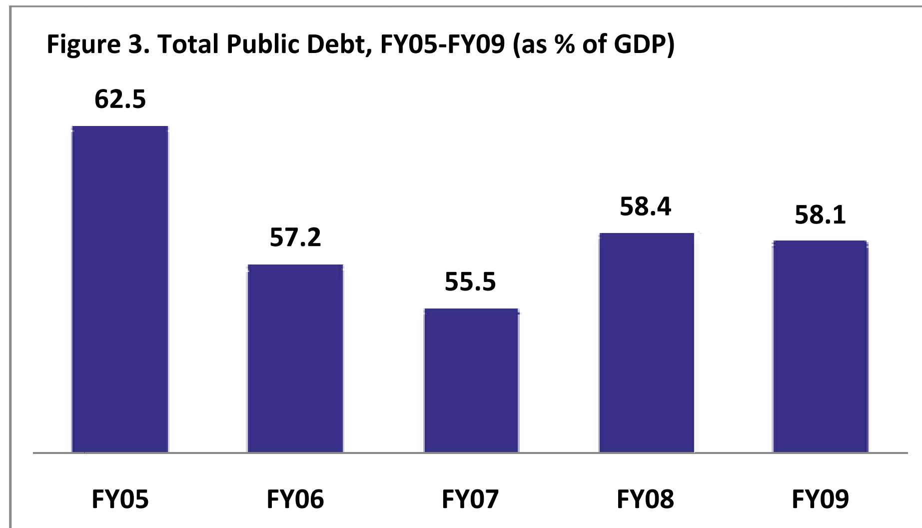
The composition of TPD underwent a significant shift during 2008-09; as the share of foreign currency denominated debt increased for the first time since 2001-02, rising from 45.6 percent of TPD in 2007-08 to 49.3 percent in 2008-09. The share of Rupee denominated debt at 50.7 percent of TPD is significantly lower than the contribution of 54.4 percent during 2007-08 (See Figure 2). A coordinated effort to reduce borrowing from the State Bank of Pakistan (SBP) and substantial foreign currency inflows through the IMF SBA program to avert a BoP crisis, are the major causes behind this shift in composition. While limiting the increases in SBP borrowing will help in controlling inflationary pressures, the increase in foreign currency component will leave the economy more vulnerable to external shocks, specifically, the effect of Rupee depreciation on the outstanding stock of TPD. However, the impact of any currency shock should not be looked at in isolation, but rather be analyzed in the context of interest rate differential.

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.

Total public debt as a percentage of GDP was as high as 62.5 percent at the end of 2004-05, but steadily reduced to 55.5 percent by the end of 2006-07. Following the volatile economic conditions witnessed in 2007-08 accentuated by policy inaction on key expenditures (i.e. energy subsidy), a burgeoning fiscal deficit led to a rapid escalation of TPD as a percentage of GDP, reaching 58.4 percent by end-June 2007-08. Fiscal consolidation, rationalization of expenditure, and a net zero quarterly limit on borrowing from the SBP have all assisted in restraining total public debt to GDP ratio even in the face of lower than expected growth. By end-June 2009, TPD stood at 58.1 percent of GDP.

A similar historic trend is seen in TPD as a percentage of Government Revenues, with TPD falling from as high as 4.52 times of the Government Revenues in 2004-05 to 3.71 times by 2006-07. However due to the prevalent conditions in the economy, both domestic and international, TPD increased to 4.01 times of Government Revenues by the end of 2007-08. Government policies restricted the increase in TPD during 2008-09, but less than expected tax collection has further deteriorated this indicator to 4.11 times, i.e. TPD is now more than four times the government’s tax revenue.



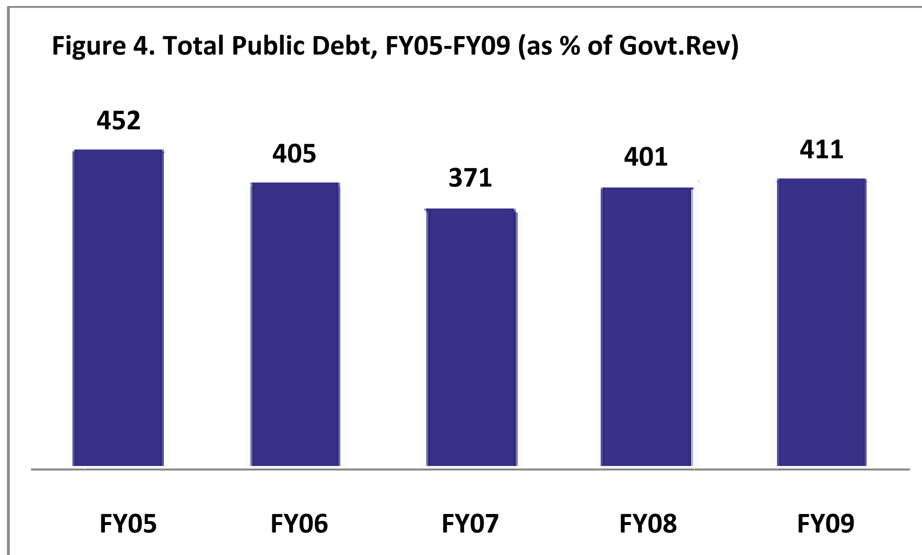


Table 2 depicts trends in various indicators in real terms (after adjusting for changes in price level). During the last two years, real GDP growth has not translated into increased revenue collection. Thus, in order to effectively measure the level of indebtedness of the government, it is prudent to analyze total public debt as a percentage of total revenues. Although total public debt has been constantly increasing in nominal terms, the trend of negative growth of the debt burden has only been reversed in the previous two years. A closer look at the dynamics of the debt burden points towards lackluster growth in real revenues as the main cause of the deterioration of this indicator.

Table 2. Selected Debt Indicators				
	FY06	**FY07**	**FY08**	**FY09**
Real Growth of Public Debt	-3.2%	2.6%	8.5%	1.7%
Real Growth of Revenues	9.1%	12.9%	-0.7%	-1.5%
Real Growth in Non Interest Expenditure	16.5%	6.7%	9.0%	-19.2%
Real Growth of GDP	5.8%	6.8%	4.1%	2.0%
Public Debt/GDP	57.2%	55.5%	58.4%	58.1%
Public Debt/Revenue	405.3	370.8	400.5	410.9
Debt Service/Revenue	39.4%	41.5%	45.3%	43.5%

Source: Budget Wing, SBP and DPCO staff calculations

As shown in **Table 3**, real growth in revenues was encouraging during 2005-06 and 2006-07, however, revenue collection suffered a reduction in real terms during 2007-08 and 2008-09. Coinciding with the drop in real revenue growth, total public debt which shrunk by 3.2 percent in 2005-06, began to increase in the following years. The unprecedented events of 2007-08, and the heavy and sustained borrowing to cover a widening fiscal deficit led to an 8.5 percent growth of TPD in real terms, whereas real revenue growth was negative. During 2008-09, the governments efforts to restrict ballooning of the fiscal deficit and place limits on borrowing from the central bank helped in restraining growth of TPD to 1.7 percent in real terms (High inflation throughout the year also assisted in keeping real growth of TPD marginal). However, due to the economic slowdown and security and power situation in the country, real growth of revenues remained well below that of TPD at -1.5 percent for the year. The bottom line impact also remained visible due to unreleased Coalition Support Fund (CSF) as expenditure, on this front, has already been incurred. The combination of an increasing level of debt and negative growth of revenues in real terms has meant that the debt burden of the economy has increased sharply in the previous two years, posting real growth of 9.2 percent and 3.2 percent during 2007-08 and 2008-09 respectively. The growing debt burden of the government highlights the importance of increased revenue generation going forward. As witnessed during 2008-09, 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.

Table 3. Real Growth of Debt Burden			
	Real Growth of Revenues	Real Growth of Debt	Real Growth of Debt Burden
FY06	9.1%	-3.2%	-12.3%
FY07	12.9%	2.6%	-10.3%
FY08	-0.7%	8.5%	9.2%
FY09	-1.5%	1.7%	3.2%

Source: DPCO staff calculations

Although this gap has largely been reduced in the fiscal year 2008-09, 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. Similarly, debt service as a percentage of total revenue witnessed a substantial increase in 2007-08 due to growing debt obligations and negative real growth of revenues. However, low international interest rate environment and high inflation has meant that in 2008-09, debt service to revenue has receded to 43.5 percent as compared to 45.3 percent in 2007-08.

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, 2008-09 (Rs. Billion)

	Budgeted	Actual	% of Government Revenues	% of Current Expenditure
Servicing of Foreign Debt	64.1	69.4	3.7%	3.4%
Repayment of Foreign Loans	96.2	158.4	8.6%	7.8%
Servicing of Domestic Debt	459.1	580.0	31.3%	28.4%
Servicing of Public Debt	619.4	807.8	43.6%	39.6%

Source: DPCO staff calculations

During the year 2008-09, servicing of public debt amounted to Rs 807.8 billion as opposed to a budgeted amount of Rs 619.4 billion (See **Table 4**). The slippage of Rs 188.4 billion has mostly been due to depreciation of the rupee, which increased the amount used for interest and principal repayments of foreign loans in rupee terms. The more than budgeted increase in fiscal deficit of 2007-08 also translated into higher debt servicing. Repayment of foreign loans stood at Rs 158.4 billion as opposed to a target of Rs 96.2 billion; while interest payments on foreign loans, which were budgeted at Rs 64 billion, reached to Rs 69.4 billion by end-June 2009. At its root, the currency depreciation, which led to the slippages in debt servicing targets, should be viewed as an adjustment against the unsustainable parity of the Rupee vis-à-vis the US dollar witnessed during 2001-2007. An amount of Rs 580 billion was spent on account of servicing of domestic debt against

the budgeted estimate of Rs 459.1 billion. The 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. Additionally, the high cost zero-coupon Defence Savings Certificates (DSCs) sold in the late 1990s led to an inaccurate budgeting on interest payments. These instruments started maturing in the last three years, undermining the servicing of domestic debt in the initial years of their issue but inflated the service payments on domestic front in recent years as the interest is paid at maturity.

Table 5 presents domestic debt servicing, actual and budgeted, on various key instruments of market debt and NSS.

Table 5. Interest Payments on Major Domestic Debt Instruments, FY05-FY09 (in millions of Rs.)

Instruments	FY05		FY06		FY07		FY08		FY09	
	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget
PIBs	32,449	28,755	29,424	30,759	34,132	28,612	39,498	30,803	42,571	40,671
FIBs	4,486	4,051	2,028	1,757	1,771	761	378	130	141	0
MTBs	10,602	12,396	19,608	18,866	40,206	31,496	59,086	33,378	71,757	52,656
MRTBs	8,780	7,719	32,534	17,398	46,725	19,280	45,398	21,332	146,000	76,205
NSS	98,084	87,111	84,778	96,911	180,652	90,453	272,512	215,518	290,813	267,837

Source: Budget Wing, MoF

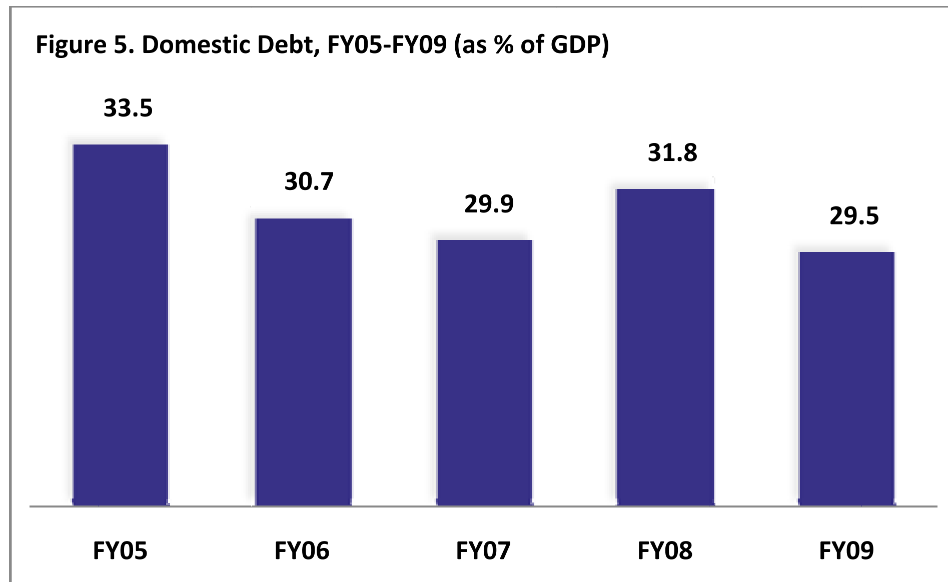
V. Domestic Debt

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.

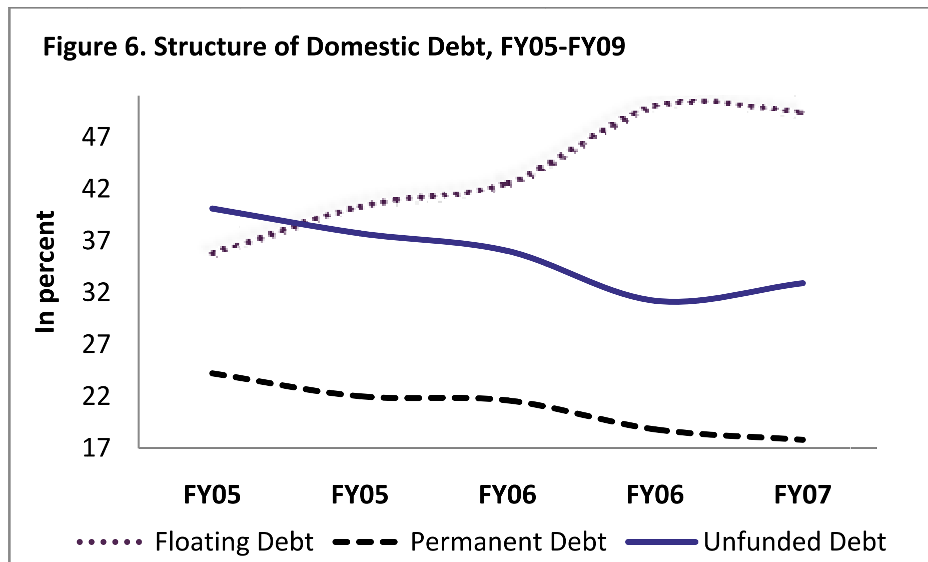
Figure 5. Domestic Debt, FY05-FY09 (as % of GDP)



As for Pakistan, domestic debt as a percentage of GDP declined steadily from 33.5 percent in 2004-05 to 29.9 percent in 2006-07 in response to a number of factors. Understated fiscal deficits have been an underlying theme behind a reduction in this ratio of domestic debt to GDP over the last few years owing to their capitalization in the books of power sector entities (in the form of mushrooming contingent liabilities), and issuance of zero coupon DSCs coupled with sporadic reclamation on NSS instruments. The fiscal year 2007-08 was a period of extraordinary events emerging from both local and international horizons, as a result of which this debt indicator surged by 1.9 percentage points (See **Figure 5**). However, this ratio is expected to retain its previous descending tendency in the coming years as it dropped to 29.5 percent for the fiscal year 2008-09 (a decrease of 2.3 percentage points on a Y-o-Y basis). The stock of domestic debt rose by Rs 586 billion during 2008-09 as compared to Rs 664.2 billion in the last year and ended at Rs 3,860.4 billion. A fall in budgetary borrowing from the central bank on account of a policy of net zero quarterly borrowing from the SBP adopted by the government was a restrictive factor on the gigantic increase in absolute flows of domestic debt during 2008-09.

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.

Figure 6. Structure of Domestic Debt, FY05-FY09



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. Continuing this trend, the contribution of permanent debt shrank to 17.8 percent as on end June 2009 compared to 18.8 percent in 2007-08. On the contrary, the share of unfunded debt in total domestic debt increased by 1.7 percentage points, due to a substantial augmentation of 24.5 percent during 2008-09. Even though floating debt witnessed a mammoth reduction in its growth, it is still the major constituent in the stock of domestic debt fetching 49.3 percent in the grand total (See **Figure 6**). However, the share of floating debt in total domestic debt decreased by a meager 0.7 percentage point during 2008-09.

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.

Table 6 shows a detailed break-up within each category.

Table 6. Outstanding Domestic Debt, FY05-FY10 (in billions of Rs.)						
	FY05	**FY06**	**FY07**	**FY08**	**FY09**	**FY10***
Permanent Debt	**526.3**	**514.9**	**562.7**	**616.8**	**685.9**	**725.0**
Market Loans	2.9	2.9	2.9	2.9	2.9	2.9
Government Bond	9.5	9.6	9.6	9.3	7.3	7.3
Prize Bonds	162.2	165.5	174.5	182.8	197.4	207.4
Foreign Exchange Bearer Certificates	0.6	0.3	0.2	0.2	0.2	0.1
Bearer National Fund Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Federal Investment Bonds	14.5	6.6	3.1	0.9	1.0	0.0
Special National Fund Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Foreign Currency Bearer Certificates	0.1	0.1	0.1	0.1	0.1	0.1
U.S. Dollar Bearer Certificates	0.2	0.0	0.0	0.2	0.0	0.0
Special U.S. Dollar Bonds	25.1	14.8	9.4	8.2	7.7	7.7
Government Bonds Issued to SLIC	3.6	1.5	0.6	0.6	0.6	0.6
Pakistan Investment Bonds (PIB)	307.6	303.8	352.5	411.6	441.0	456.7
Government Bonds issued to HBL	0.0	9.8	9.8	0.0	0.0	0.0
GOP Ijara Sukuk	0.0	0.0	0.0	0.0	27.8	42.2
Floating Debt	**778.2**	**940.2**	**1,107.6**	**1,637.4**	**1,904.1**	**1,970.5**
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	452.7	432.1	655.5	536.4	795.6	959.1
Rollover of Treasury Bills discounted SBP	0.6	0.6	0.6	0.6	0.6	0.6
Treasury Bills purchased by SBP (MRTBs)	324.9	507.5	451.5	1,052.6	1,107.3	1,010.2
Outright Sale of MTBs	0.0	0.0	0.0	47.8	0.6	0.6
Unfunded Debt	**873.2**	**881.7**	**940.0**	**1,020.3**	**1,270.5**	**1,322.5**
Defence Savings Certificates	303.5	295.9	289.0	284.6	257.2	233.2
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	9.1	8.8	18.7	27.7	16.8	15.6

Table 6. Outstanding Domestic Debt, FY05-FY10 (in billions of Rs.)						
	FY05	**FY06**	**FY07**	**FY08**	**FY09**	**FY10***
Mahana Amadni Account	2.4	2.4	2.5	2.5	2.4	2.3
Postal Life Insurance	56.3	67.1	67.1	67.1	67.1	67.1
Special Savings Certificates and Accounts	250.7	192.2	208.3	227.6	377.7	427.4
Regular Income Scheme	85.2	69.7	51.3	51.0	91.1	102.7
Pensioners' Benefit Account	41.1	57.5	69.0	87.7	109.9	113.9
Bahbood Savings Certificates	83.3	143.0	190.2	229.0	307.5	320.7
G.P. Fund	41.0	44.5	43.3	42.5	40.1	39.1
Total Domestic Debt	**2,177.6**	**2,336.9**	**2,610.3**	**3,274.5**	**3,860.4**	**4,018.0**
Total Domestic Debt (excluding foreign						
currency debt included in external debt)	**2,151.6**	**2,321.7**	**2,600.6**	**3,265.8**	**3,852.5**	**4,010.1**
*end- Sep'09	Source: SBP, Budget Wing, MoF and DPCO staff calculations					

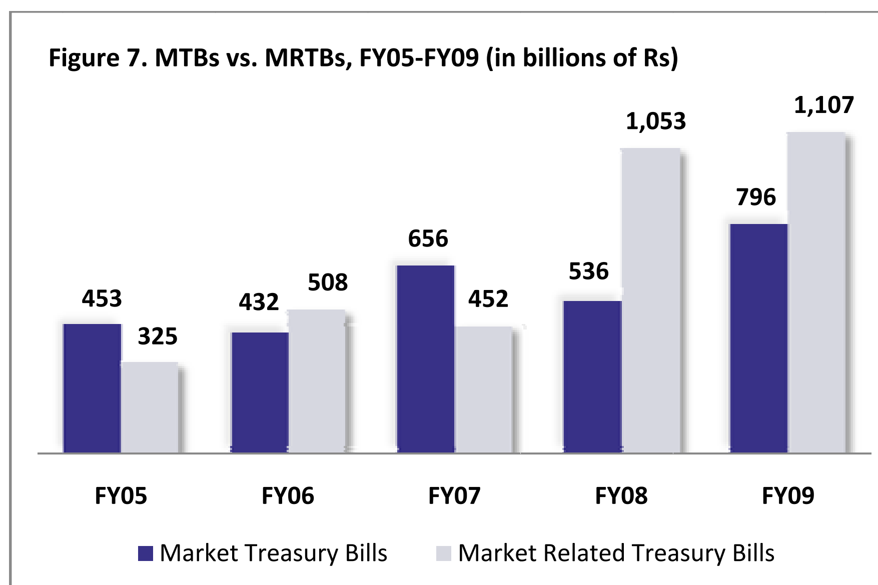
Permanent Debt: The outstanding stock of permanent debt was up by 11.2 percent, registering a net addition of Rs 69.1 billion in 2008-09. Sizeable receipts from Ijara Sukuk bond contributed to this expansion. The government mopped up Rs 27.8 billion through three successful auctions of Ijara Sukuk bond during the fiscal year 2008-09. Four Pakistan Investment Bond (PIB) auctions were conducted by the SBP during 2008-09 lifting Rs 71.2 billion from the market. However, large repayments of approximately Rs 42 billion slashed net proceeds to merely Rs 29.3 billion. Prize bonds observed a rise of 8 percent in its stock during the period under review.

A dearth of private sector credit demand during 2008-09 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 and the benchmark yield curve was further fragmented by including a new tenor of 7 years during 2008-09. A valuable diversification to market debt during the same year was the Government of Pakistan Ijara Sukuk bond with an inherent objective of providing a Shariah-complaint paper to the nascent Islamic market.

During 2008-09, major policy steps were taken to clearly distinguish debt creation from monetary policy execution. Firstly, publication of an annual auction calendar for government securities and its revision on a quarterly (in case of MTBs) or half-yearly (for PIBs) basis has infused predictability in the market. Furthermore, adherence to pre-announced auction targets and a shift towards volume

based approach rater then rate targeting will strengthen the price discovery mechanism going forward. Lastly, the transfer of decision making responsibility for cut-off yields in primary auction of T-bills and PIBs from SBP to Ministry of Finance will help in improving monetary policy transmission as changes in cut-off yields will not be interpreted as monetary policy signals. This measure will also emphasize the importance of coordination between fiscal, monetary and debt policies. Lack of coordination will hinder the policy objectives of the monetary authority while creating distortions in the market.

Floating Debt: Floating debt recorded an enlargement of 16.3 percent during 2008-09 compared to 47.8 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 borrowed only Rs 54.7 billion during the fiscal year.* As a result, **the stock of MRTBs was increased by only 5.2 percent in 2008-09, compared to a massive growth of 133 percent in 2007-08.**



The outstanding stock of Treasury bills through auction increased by 48.3 percent in 2008-09, 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 7. Causative Factors in Change in Stock of Domestic Debt, FY09 (in billions of Rs.)					
	Stock	Stock	Receipts	Repayments	Net Investment
	(End FY08)	(End FY09)	(in FY09)		
Permanent Debt	**616.8**	**685.9**	**239.2**	**170.0**	**69.2**
Market Loans	2.9	2.9	0.0	0.0	0.0
Government Bond	9.3	7.3	0.0	2.1	-2.1
Prize Bonds	182.8	197.4	105.9	91.2	14.7
Foreign Exchange Bearer Certificates	0.2	0.2	0.0	0.0	0.0
Bearer National Fund Bonds	0.0	0.0	0.0	0.0	0.0
Federal Investment Bonds	0.9	1.0	0.0	0.0	0.0
Special National Fund Bonds	0.0	0.0	0.0	0.0	0.0
Foreign Currency Bearer Certificates	0.1	0.1	0.0	0.0	0.0
U.S. Dollar Bearer Certificates	0.2	0.0	0.0	0.0	0.0
Special U.S. Dollar Bonds	8.2	7.7	1.4	2.0	-0.6
Government Bonds Issued to SLIC	0.6	0.6	0.0	0.0	0.0
Pakistan Investment Bonds (PIB)	411.6	441.0	104.1	74.7	29.4
Government Bonds issued to HBL	0.0	0.0	0.0	0.0	0.0
GOP Ijara Sukuk	0.0	27.8	27.8	0.0	27.8
Floating Debt	**1,637.4**	**1,904.1**	**4,308.3**	**4,041.6**	**266.7**
Ad hoc Treasury Bills	0.0	0.0	0.0	0.0	0.0
Treasury Bills on Tap	0.0	0.0	0.0	0.0	0.0
Treasury Bills through Auction	536.4	795.6	1,590.4	1,331.3	259.1
Rollover of Treasury Bills discounted SBP	0.6	0.6	0.1	0.1	0.0
Treasury Bills purchased by SBP (MRTBs)	1,052.6	1,107.3	2,610.1	2,555.4	54.7
Outright Sale of MTBs	47.8	0.6	107.7	154.8	-47.1
Unfunded Debt	**1,020.3**	**1,270.5**	**1,124.9**	**874.6**	**250.3**
Defence Savings Certificates	284.6	257.2	65.7	93.1	-27.4
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	27.7	16.8	159.2	170.1	-10.9
Mahana Amadni Account	2.5	2.4	0.1	0.1	0.0
Postal Life Insurance	67.1	67.1	0.0	0.0	0.0
Special Savings Certificates and Accounts	227.6	377.7	382.2	232.2	150.0
Regular Income Scheme	51.0	91.1	87.5	47.4	40.1
Pensioners' Benefit Account	87.7	109.9	114.5	92.2	22.3
Bahbood Savings Certificates	229.0	307.5	314.3	235.7	78.6
G.P. Fund	42.5	40.1	1.4	3.8	-2.4
Total Domestic Debt	**3,274.5**	**3,860.4**	**5,672.4**	**5,086.2**	**586.2**

Source: Budget Wing, MoF and DPCO staff calculations

Unfunded Debt: During 2008-09, major NSS instruments witnessed considerable expansion except Defence Savings Certificates and Savings Accounts. The stock of unfunded debt stood at Rs 1,270.5 billion as of June 30, 2009 recording a healthy growth of 24.5 percent. Special Savings Certificates and Accounts topped the list with a net investment of Rs 150 billion during 2008-09. This extraordinary increase might be an upshot of an assumption that profit rates will be reduced in line with falling interest rates. Even though Bahbood Savings Certificates attracted massive gross receipts in 2008-09, huge repayments lowered net inflow from this scheme to Rs 78.6 billion.

During the course of the year 2008-09, 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. The profit rates on major NSS instruments have been increased thrice in 2008-09. However, in the last quarter of 2008-09, the drop in interest rates on sovereign paper has led the government to cut down the profit rates by 70-140 basis points.

Figure 8. Regular and Targeted NSS Schemes, FY05-FY09

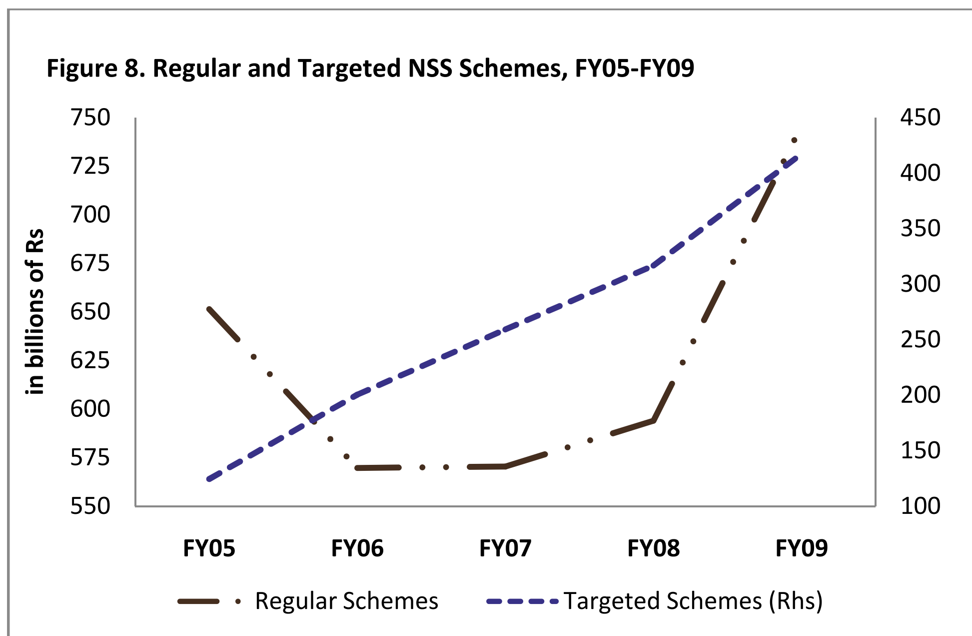


Figure 8 depicts a comparison of the regular (DSC, SSC&A, RIC and SA) and targeted (BSC and PBA) NSS instruments. The stock of PBA and BSC stood at Rs 417.4 billion at the end of 2008-09 and achieved an average growth rate of 58.8 percent in the last five years. During 2008-09 alone, the PBA scheme experienced an increase of 25.3 percent with the growth rate in BSC hovering around 34.3 percent. Conversely, the outstanding debt against regular instruments grew by just 3.6 percent

during FY05-FY09. This divergent performance of the two NSS heads explains the uncompetitive nature of regular NSS instruments. It is worth mentioning here that **in absence of security net the government tries to provide subsidy to the aging segment of the population through these targeted NSS instruments by offering 14.16 percent per annum** (annualized return of 15.12 percent per annum), **a subsidy element of 201 bps in comparison to the rate on a 10-year DSC of 12.15 percent.**

It is important to note that funds raised through National Saving Schemes (NSS) contribute 38% of the total domestic debt. 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.

Domestic Debt during Jul-Sep 2009

The domestic debt stood at Rs. 4,018 billion at the end of the first quarter of 2009-10, representing an increase of Rs. 157.6 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. 163.5 billion), PIBs (Rs. 15.7 billion) and Ijara Sukuk (Rs. 14.4 billion). Notably, this quarter witnessed a massive retirement in the stock of central bank borrowing, MRTBs, to the tune of Rs. 97.1 billion. The instruments under the NSS umbrella contributed Rs. 52 billion to the total stock of domestic debt, bulk of which comes from the Special Savings Certificates and Accounts.

Duration of domestic debt at ***2.25 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.

The SBP has recently launched first-ever Electronic Bond Trading Platform (e-bond). This Platform will enhance investor base of the sovereign debt market and is expected to foster a brisk environment for the development of secondary market activities. This Platform will serve as a central database for all fixed income activities in the country resulting in improved price discovery and liquidity in the government securities. This in turn will facilitate the investors to benchmark on their upcoming funding requirements. The introduction of this Platform would definitely pave the way forward for the development of non-bank debt markets and non-bank savings and investment instruments - an essential need in order to deepen and diversify debt markets. Electronic Bond Trading Platform will also provide international investors an additional window to access the country's financial markets thereby bringing it on the radar of international financial markets.

VI. External Debt & Liabilities

The stabilization and recovery efforts underpinning the performance of Pakistan's economy in 2008-09 have had a substantial impact on the country's external debt stock. A major contribution to the increase in the stock of outstanding debt has been made by the financing provided under the SBA with the IMF. Simultaneous with the increase in stock, volatile domestic and international

conditions have weakened economic growth and foreign exchange earnings, resulting in a significant increase in the debt burden.

Table 8. Pakistan: External Debt and Liabilities

	FY05	FY06	FY07	FY08	FY09	FY10Q1*
	(In billions of U.S. dollars)					
1. Public and Publically Guaranteed Debt	31.1	32.8	35.3	40.2	42.2	43.9
A. Medium and Long Term(>1 year)	30.8	32.6	35.3	39.5	41.6	43.3
Paris Club	13.0	12.8	12.7	13.9	14.0	14.7
Multilateral	15.4	16.8	18.7	21.6	23.1	24.1
Other Bilateral	0.8	0.8	1.0	1.2	2.0	2.0
Euro Bonds/Saindak Bonds	1.3	1.9	2.7	2.7	2.2	2.2
Military Debt	0.2	0.1	0.1	0.0	0.2	0.2
Commercial Loans/Credits	0.2	0.2	0.1	0.1	0.2	0.2
B. Short Term (<1 year)	0.3	0.2	0.0	0.7	0.7	0.6
IDB	0.3	0.2	0.0	0.7	0.7	0.6
2. Private Non-Guaranteed Debt (>1 year)	1.3	1.6	2.3	2.9	3.3	3.3
3. IMF	1.6	1.5	1.4	1.3	5.1	6.4
Total External Debt (1 through 3)	**34.0**	**35.9**	**39.0**	**44.5**	**50.7**	**53.7**
(of which) Public	***32.1***	***33.8***	***36.5***	***40.7***	***46.3***	***49.4***
4. Foreign Exchange Liabilities	1.4	1.3	1.3	1.7	2.1	1.4
Total External Debt & Liabilities (1 through 4)	**35.4**	**37.2**	**40.3**	**46.2**	**52.8**	**55.1**
(of which) Public Debt	32.1	33.8	36.5	40.7	46.3	49.4
Official Liquid Reserves	9.8	10.8	13.3	8.6	9.1	11.2
	(In percent of GDP)					
Total External Debt (1 through 3)	**31.1**	**28.2**	**27.3**	**27.0**	**30.4**	**30.4**
1. Public and Publically Guaranteed Debt	28.4	25.8	24.7	24.5	25.3	24.8
A. Medium and Long Term(>1 year)	28.1	25.6	24.7	24.0	24.9	24.5
B. Short Term (<1 year)	0.2	0.1	0.0	0.4	0.4	0.3
3. IMF	1.5	1.2	1.0	0.8	3.1	3.6
4. Foreign Exchange Liabilities	1.3	1.1	0.9	1.0	1.2	0.8
Total External Debt & Liabilities (1 through 4)	**32.3**	**29.2**	**28.2**	**28.1**	**31.6**	**31.2**
Official Liquid Reserves	9.0	8.5	9.3	5.2	5.5	6.3
Memo:						
GDP (in billions of Rs.)	6,500	7,623	8,673	10,284	13,095	14,972
Exchange Rate (Rs./US$, Period Avg.)	59.4	59.9	60.6	62.5	78.5	84.7
Exchange Rate (Rs./US$, EOP)	59.7	60.2	60.6	67.3	81.0	82.8
GDP (in billions of US dollars)	109.5	127.4	143.0	164.5	166.8	176.8**

* Provisional

Source: State Bank of Pakistan, Economic Affairs Division and DPCO staff calculations

*** Projected for FY10*

The total stock of Pakistan's outstanding EDL has increased by US$ 6.6 billion or 14.3 percent. The largest net yearly increase since the turn of the century saw the stock of outstanding EDL rise from US$ 46.2 billion at the end of 2007-08, to US$ 52.8 billion by the end of 2008-09 (See **Table 8**). The increase in debt has mostly been in the form of loans, primarily the IMF SBA, whereas the outstanding stock of bonds has been reduced by US$ 515 million owing to the repayment of Eurobond made in February 2009. A key feature of the financing received through the IMF-SBA is that these funds are parked in the foreign currency reserves held by the SBP, to insulate the economy from pressure on the external account and consolidate reserves. However, a small proportion of the funds disbursed under the IMF-SBA have been allocated for budgetary financing as of August 2009.

The more than budgeted increase in external debt resulted from the uncertain and unprecedented conditions prevailing in the economy. Falling commodity prices were primarily responsible for a reduction in Pakistan's import bill; however, a slowdown in partner economies coupled with unfavorable domestic environment causing a slowdown of exports resulted in a decreased but persistent current account deficit. Non-debt creating external flows also fell victim to the turmoil in international markets, drying up a valuable source of funds for the economy. In the backdrop of this deficit, in addition to unexpected domestic expenditure requirements, a greater need for financing has been met by a more than expected increase in external debt.

A detailed review of developments in the various components of Pakistan's EDL is given below:

Public and Publically Guaranteed Debt

Public and Publically Guaranteed (PPG) debt is the largest component of Pakistan's EDL, and comprises all of the government's external debt obligations with the exception of funding received through the IMF. Loans and bonds extended to the private sector with the Government of Pakistan as a guarantor are also included in this category.

During 2008-09, Public and Publically Guaranteed debt increased by US$ 2 billion or 5 percent to reach US$ 42.23 billion. Despite an increase in its stock, PPG debt now accounts for 80 percent of total EDL as compared to a share of 87 percent at the end of 2007-08. This is due to the substantial increase in IMF debt.

PPG debt consists of medium to long-term debt and short-term debt. Debt flows from multilateral donors, Paris club countries, and bilateral agreements with other countries are encapsulated in

medium to long-term debt. This category increased by US$ 2.04 billion during 2008-09, with increased flows from multilateral agencies being the prime source. The stock of multilateral debt has increased by US$ 1.48 billion in 2008-09. The only significant reduction was seen in the stock of Eurobond debt, owing to the repayment of the 2009 Eurobond in February.

Pakistan regularly accesses short-term external financing through the Islamic Development Bank. The outstanding stock of short-term IDB debt at the end of 2008-09 was US$ 661 million, US$ 52 million lower than the previous year.

Table 9. Composition of EDL*, FY09

Component	Percent
Public & Publicly Guaranteed	80.0%
Paris Club	78.7%
Multilateral	26.5%
Other Bilateral	3.8%
Short Term	1.3%
Other	4.8%
Private Non-Guaranteed	6.3%
IMF	9.8%
Foreign Exchange Liabilities	3.9%
Memo:	
Total EDL (In billions of US$)	52.79

Source:DPCO staff calculations

*EDL: External Debt & Liabilities

The outstanding stock of PPG external debt consists of debt with floating and fixed rates of interest. Fixed rates reduce the volatility of future interest payments, and insulate the stock of outstanding debt from rate increases in international markets. However, fixed rates limit the government's ability to benefit from downward rate movements. Such benefits are fully captured by having floating rate debt, at the additional risk of future uncertainty. Pakistan's outstanding PPG debt consists mostly of fixed rate debt which amounts to US$ 32 billion or 76.5 percent. Out of this amount, US$ 1.23 billion is classified as interest free. The remaining US$ 9.9 billion or 23.5 percent of outstanding PPG debt is subject to floating rates.

Private Non-Guaranteed Debt and Foreign Exchange Liabilities

External debt contracted by the private sector in the absence of a Government of Pakistan guarantee is classified as private non-guaranteed debt. This consists of medium to long-term loans as well as international bond issuances. The stock of private non-guaranteed debt witnessed an increase of US$ 457 million or 15.8 percent. During 2008-09, Foreign Exchange Liabilities increased by US$ 253 million or 13.9 percent to reach a total outstanding amount of US$ 2.1 billion. This addition was solely on account of a US$ 500 million increase in Central Bank Deposits while all other heads witnessed a decrease.

IMF Debt

The reliance on the IMF SBA to achieve Balance of Payment (BOP) support and economic stabilization has been the major factor behind the increase in Pakistan's external debt and liabilities throughout 2008-09. Having reached an agreement in November 2009, the IMF released a first tranche of SDR 2.067 in November 2008 and following a successful first review, a second tranche of SDR 568 million in April 2009. The stock of outstanding IMF debt at the end of 2007-08 (prior to the SBA) was US$ 1.34 billion and consisted mostly of funds availed through the Poverty Reduction and Growth Facility. However, by the end of 2008-09, the stock of IMF debt increased by US$3.8 billion or 285 percent to reach US$ 5.15 billion.

External Debt & Liabilities during Jul-Sep 2009

Developments in EDL during the first quarter of 2009-10 were dominated by disbursement of the third tranche under the IMF-SBA. A tranche of approximately US$ 1.2 billion was released on the 7th of August, 2009. Consequently, Pakistan's outstanding EDL increased by $US 2.3 billion or 4.5 percent during July-September 2009 and stood at US$ 55.1 as of end-September 2009. A key characteristic of the third tranche of the IMF-SBA is that approximately US$ 745 (65 percent of the third tranche) has been allocated for budget financing as opposed to the previous tranches which were strictly for BoP support. The remaining increase was seen in the stock of Multilateral debt which increased by approximately US$ 1 billion owing to disbursements from the World Bank and the ADB. As a percentage of projected GDP, EDL stood at 31.2 percent at the end of Q1FY10, a decrease of 0.4 percentage points.

Although no new threats to the sustainability of Pakistan's debt stock have emerged in the first three months of the current fiscal year, the recent trend towards a shift in emphasis towards external debt in-flows is highly visible.

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 2008-09, currency movements caused an increase of approximately US$ 53 million in Pakistan's outstanding EDL

The transactional loss during the first three months of the current fiscal year 2009-10 touched to about US$1.37 billion out of an increase of a total US$ 2.3 billion in the stock of EDL (about 60 percent of the addition in the stock during Q1FY10). Although the translational losses suffered during 2008-09 were relatively small, *the magnitude of such losses in the first quarter of the current year highlights the urgent need on the part of the government to hedge its foreign currency exposure*.

External Debt Servicing

During 2008-09, servicing of external debt and liabilities amounted to US$ 4.5 billion, showing an increase of US$ 1.4 billion from the previous year. Additionally, the amount rolled over stood at US$ 1.6 billion. Repayment of Eurobond in February 2009 is the major reason behind this significant increase in external debt servicing during 2008-09. Out of the total servicing of US$ 4.5 billion, US$ 3.4 billion was for repayment of principal amounts while the remaining US$1.1 billion was on account of interest payments.

Table 10. Pakistan's External Debt Servicing

Years	Actual Amount Paid	Amount Rolled Over	($millions) Total
2004-05	2,783	1,300	4,083
2005-06	2,896	1,300	4,196
2006-07	2,870	1,300	4,170
2007-08	3,122	1,200	4,322
2008-09	4,522	1,600	6,122
Jul-Sep 2009-10	1,192	450	1,642

Source: State Bank of Pakistan

The bulk of the servicing, US$ 3.5 billion was on account of Public and publically guaranteed debt whereas servicing of Private non-guaranteed debt amounted to US$ 604 million. The servicing of IMF debt stood at US$ 264 million, but will increase substantially once repayments of the newly disbursed amounts commence.

During the first three months of the current fiscal year, external debt servicing stood at US$ 1.19 billion out of which US$ 988 million was repayment of principal amount, whereas US$ 204 million was on account of interest payments.

External Debt Sustainability

During the course of the 2007-08 and 2008-09, two distinct factors have highlighted the continuing importance of debt inflows to developing countries. Firstly, the oil price shock witnessed in 2007-08 severely impacted the external account of oil importing countries, leading to a greater financing requirement, and a subsequent need to fund the requirement through debt creating inflows. The second factor, in the shape of a deceleration of global trade due to the financial crisis and ensuing economic slowdown, has had a similar effect but is not limited to developing countries only. In addition to these global themes, the security situation in Pakistan and the drying up of foreign non debt creating flows has placed an added burden on debt to finance economic activity.

Pakistan's ***exports*** underwent an average growth of 7.8 percent over the period of FY06-FY09, while ***imports*** expanded by 15.5 percent annually during the same period. This gap eventually transformed to a huge deficit on external account and hence, put an additional stress on debt creation in the absence of healthy non-debt inflows. Corresponding to the growth in exports, ***foreign exchange earnings*** observed annual growth of 7.6 percent. On the other hand, ***foreign currency payments adjusted for interest payments*** grew by a hefty 13.7 percent over 2006-2009. The components of foreign exchange earnings and payments and their underlying trends are shown in **Table 11.** This indicator only registered a negative growth of 13 percent in the fiscal year 2008-09. The persistence of a significant gap between foreign exchange earnings and payments will have severe consequences for the economy. Under strenuous conditions (such as exogenous external shocks), the divide between earnings and payments might lead to a balance of payment crisis and severely challenge the integrity of the domestic currency. Pakistan's ***EDL*** recorded an average growth of 10 percent in the last four years. However, the pace of growth has slowed down to 12.7 percent in the fiscal year 2008-09 as compared to 14.3 percent in 2007-08.

Analysis of nominal values of the stock of debt is useful in determining trends and changes within the stock of debt, and identifying the source of increase and decrease. However, the true impact of debt levels, and an accurate assessment of the indebtedness of an economy can only be recorded through an analysis of debt levels in relation to key macroeconomic indicators and ratios. Depicting the trend in these ratios and calculations, and identifying the underlying factors in their movement

in the past, present, and future allow policymakers to judge whether the stock of existing debt is at sustainable levels or not.

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

	FY05	FY06	FY07	FY08	FY09
Foreign Exchange Earnings	27,006	31,761	33,016	37,301	35,477
Goods: Exports f.o.b	14,482	16,553	17,278	20,427	19,212
Services: Credit	3,319	3,769	4,140	3,589	4,043
Income: Credit	437	784	940	1,613	902
Current Transfers	8,768	10,655	10,658	11,672	11,320
Of which Workers Remittances	4,168	4,600	5,494	6,451	7,811
Foreign Exchange Payments	28,540	36,751	39,894	51,121	44,338
Goods: Imports f.o.b	18,996	24,994	26,989	35,397	31,668
Services: Debit	6,612	8,199	8,310	10,046	7,325
Income: Debit	2,823	3,451	4,522	5,536	5,239
Of which Interest Payments	1,037	1,248	1,417	2,175	1,873
Current Transfers: Debit	109	107	73	142	106

Source: SBP and DPCO staff calculations

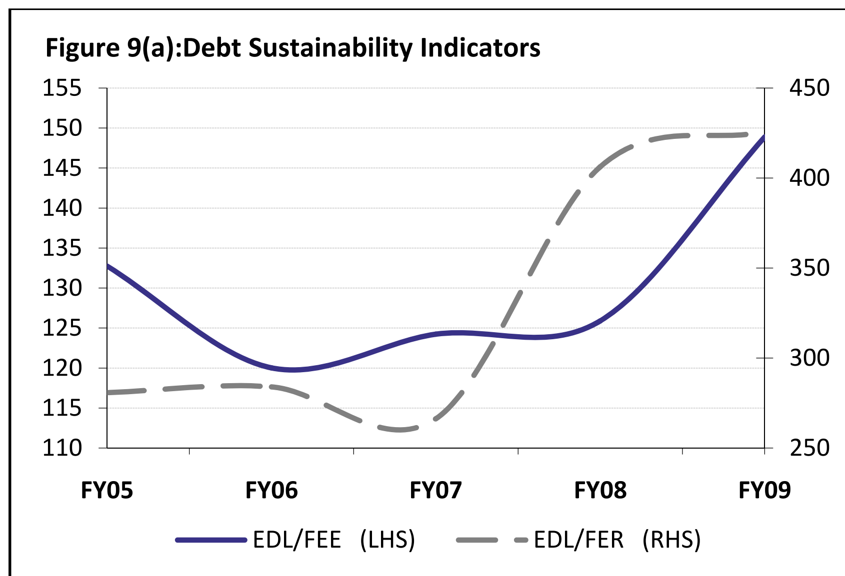
Table 12. External Debt Sustainability: FY06 - FY09 (in percent)

External Debt Indicators	FY 06	FY 07	FY 08	FY 09
Growth in Exports	14.9	4.4	18.2	-6.4
Growth in Imports	33.3	8.0	31.2	-10.3
Growth in EDL	5.0	7.7	14.3	12.7
Growth in FEE	16.3	5.3	13.0	-4.3
Growth in Non Interest Foreign Currency Payments	30.9	8.4	28.4	-12.9
Int. Pmt./FEE	2.9	3.4	3.4	3.2
EDL Servicing/FEE	9.3	8.8	8.5	12.7
STD/FEE	0.5	0.1	1.9	1.9
STD/LTD	0.5	0.1	1.7	1.4
EDL/FEE	120.0	124.2	125.9	148.9
EDL/Exports	227.0	234.0	227.0	273.0
EDL/FER	283.9	266.3	406.3	425.7
EDL/GDP	29.2	28.2	28.1	31.7
Non Interest Current Account Balance/GDP	-3.0	-3.8	-7.1	-4.2
EDL/TPD	51.4	50.8	51.7	56.2
Rollover Ratio (Principal Repayments/Disbursements)	62.8	53.9	52.8	42.3

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

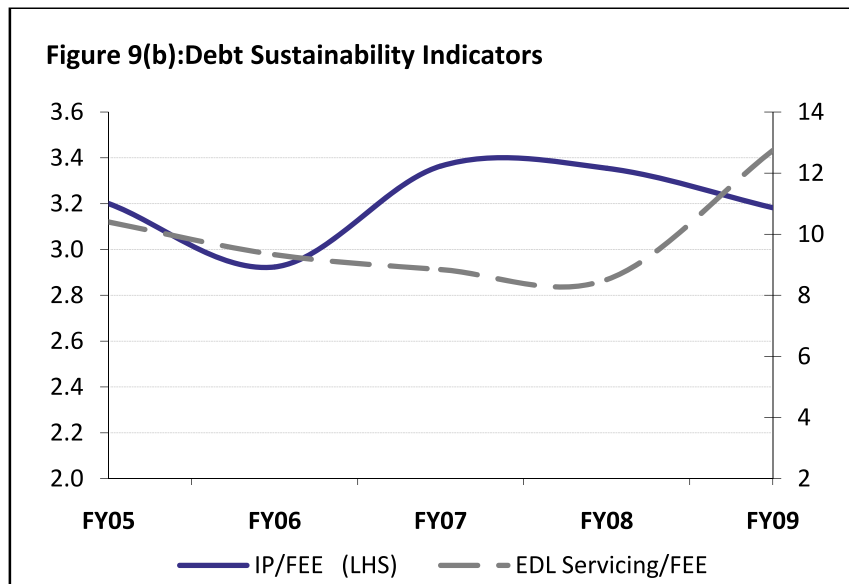
Source: EA Wing, SBP & DPCO staff calculations

The external debt burden of Pakistan as given by ***EDL-to-GDP*** has historically been decreasing. However, the pace of decrease slowed down in 2007-08 owing to a combination of increasing commodity prices, depreciation of the dollar against other international currencies, and depreciation of the rupee against the dollar. This downward trend has been reversed in 2008-09 as lower than anticipated GDP growth of 2 percent along with substantial inflows of foreign debt (mainly in the shape of the IMF SBA) has caused EDL as a percentage of GDP to increase from 28.1 percent in 2007-08 to 31.7 percent by end-June 2009.



Pakistan's foreign exchange earnings have been falling due to sluggish performance of exports and volatile capital flows, leading to a deterioration of ***EDL-to-FEE***. External Debt and Liabilities are now 148.9 percent of foreign exchange earnings as compared to 125.9 percent in 2007-08, an increase of 23 percentage points. Likewise, ***EDL-to-Exports*** stand at 273 percent currently, declining by 46 percentage points in a year. Repayment capacity as gauged by ***EDL-to-FER*** ratio was severely hindered in 2007-08 as a combination of domestic and external factors led to a rapid drawdown of reserves. By end-June 2009, EDL stood at 425.7 percent of foreign exchange reserves as compared to 406.3 percent at the same time last year. However, strengthening of reserves due to advantageous developments on the trade balance, inflow of funds through the IMF SBA, and encouraging performance of workers' remittances has stemmed the pace of increase of this indicator.

A simultaneous deterioration of these indicators points towards the growing indebtedness of the country, and increases the economy's vulnerability to external economic shocks. Going forward, it highlights the importance of maintaining exchange rate stability and regaining growth momentum to reduce the impact of growing external indebtedness. The consolidation of Pakistan's foreign exchange reserves is an encouraging sign, but prudent debt management is needed to contain and eliminate the risks that accompany the rising external debt burden of the country.

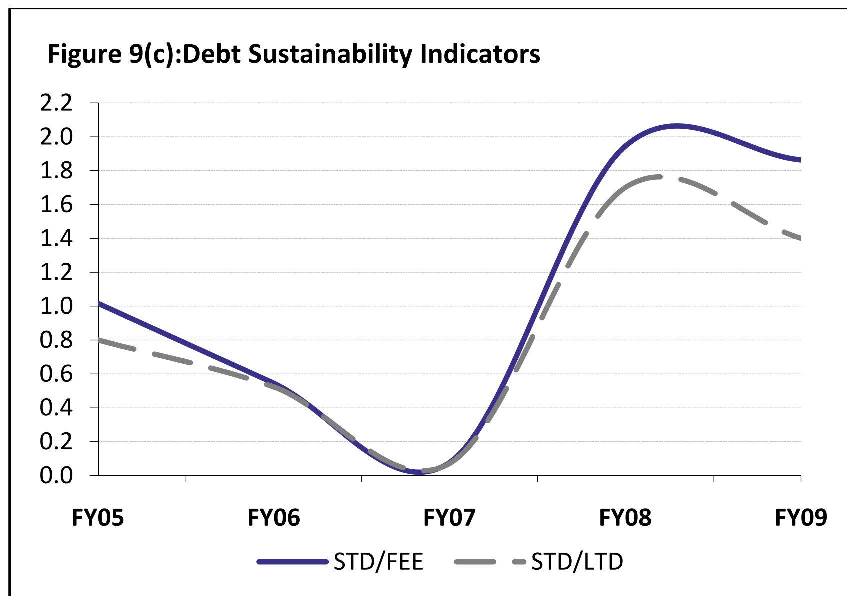


Debt service ratios as given by interest payments and total foreign debt servicing as percentages of FEE have maintained relatively stable as the majority of Pakistan's external loans are on fixed interest rates. ***Interest payments-to-FEE***, which stood at 3.4 percent at the end of 2007-08, has reduced to 3.2 percent by end-June 2009, mainly due to the low interest rate environment witnessed globally. ***EDL servicing-to- FEE***, at 12.7 percent at the end of 2008-09 increased to its highest level since 2004-05 mainly due to Eurobond repayments made in February 2009.

Short-term debt has historically been an insignificant portion of Pakistan's total EDL. However, beginning in 2006-07, there has been a sharp rise in short-term financing, which has resulted in ***STD-to-FEE*** rising to 1.9 percent while as a percentage of long-term debt, STD is now 1.4 percent.

The ***rollover ratio***, approximated by repayments divided by disbursements, gauges the capacity of disbursed amounts in a given fiscal year to service amortization due for that year. In Pakistan, this ratio has improved from 62.8 percent in 2005-06 to 42.3 percent in 2008-09 meaning thereby that

a smaller proportion of new disbursements are absorbed for repayment purposes. However, the main factor behind the change in this ratio is an increase in disbursements (mainly received under the IMF-SBA) as opposed to a reduction in repayments.



The ***current account balance adjusted for interest payments*** has remained in deficit throughout FY06-FY09. This indicator, however, has improved from a negative 7.1 percent in 2007-08 to - 4.2 percent in 2008-09. The persistence of a high non interest current account deficit is an influential element in the context of escalating debt burden of Pakistan. This also highlights the fact that Pakistan will continue to be vulnerable to international shocks. A credit crunch or any reduction in non-debt creating flows may trigger balance of payment crises in future.

The external debt burden in unsustainable by any measure and require government's immediate attention. The government must formulate a medium term strategy to reduce the non-interest current account deficit in next 2 – 3 years.

VII. Guarantees

Contingent liabilities are costs which the government will have to pay if a particular event occurs. These are obligations triggered by a discrete but uncertain event. Relative to government policies, the probability of a contingency occurring and the magnitude of the required public outlays are

exogenous (such as natural disasters) or endogenous (such as implications of market institutions and government programs for moral hazard in the markets). Contingent liabilities are therefore not recognized as direct liabilities. However contingent government liabilities are associated with major hidden fiscal risks. The two types of contingent liabilities encompass explicit liabilities defined by a contract or a law; and implicit ones that represent moral obligation for the government based on public expectations and political pressures.

A common example of an explicit contingent liability is a government-guaranteed loan. At the time a guarantee is entered into there is no liability for the government, since this is contingent upon the borrower failing to repay the loan as contracted. However, in the event of default, the lender can invoke the guarantee and the government will be obliged to repay the amount of the loan still outstanding. At that point, the contingent liability will become an actual liability of the government, and a payment must be made. These guarantees support specific policy objectives by creating financial incentives, without an immediate financial outlay. However, when these contractual guarantees are realized, the government faces significant fiscal costs at the expense of other outlays. Thus an analysis of the country's fiscal position and debt sustainability is incomplete if it skips over obligations made by the government outside the budget. Levels of public debt may be understated as they do not include any estimates of contingent guarantees, which might materialize in future. These include explicit and implicit guarantees issued to IPPs and other private and public entities; unfunded losses of public sector entities i.e. Pakistan Steel Mill, PIA, WAPDA, PEPCO, Railways, etc.

Table 13. Guarantees Issued, FY09

Name of Organization	Amount (in billions of Rs.)
PIA	25.0
P.A.F Shahbaz Air H.Q	1.0
WAPDA	228.3
NIT	20.0
Total	274.3
	(In percent of GDP)
Total	2.09%
Memo:	
GDP (in billions of Rs.)	13095

Source: Budget Wing, EF Wing, and CF Wing

As shown in **Table 13**, new guarantees issued by the government to Public Sector Enterprises in 2008-09 amounted to Rs 274.3 billion or 2.09 percent of GDP, which was higher than the stipulated limit of 2 percent imposed by the Fiscal Responsibility and Debt Limitation Act 2005.

Finance Division has been issuing continuing 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. The quantum of these guarantees depends on the supply-demand gap of various commodities, their price stabilization objectives, volume procured, and domestic and international prices, therefore these guarantees were never included in the limit of 2 percent imposed by the FRDL Act 2005. For 2008-09, Rs. 192.6 billion worth of new guarantees were issued on behalf of commodity financing operations.

The government intends to introduce world class warehousing facilities in the near future that will allow the entities involved in the commodity operations to secure financing against the warehouse receipt without explicit guarantee or letter of comfort from the government.

The government should restrain issuing new guarantees in bulk and instead, **advise the public sector entities to explore alternative sources of funding, i.e., issuing Real Estate Investment Trust (REIT) units, securitization, etc, in an attempt to improve their solvency positions.** In addition to these explicit contingent liabilities, the records of which are being maintained at the Ministry of Finance, there is a need to quantify various implicit guarantees embedded in many government contracts. A holistic view of any expected drain on government resources in future can be achieved through this exercise.

VIII. Report on Compliance with FRDL Act 2005

The Fiscal Responsibility and Debt Limitation (FRDL) Act, 2005 was approved on 13 June 2005. It requires the government to take measures to reduce total public debt and maintain it within prudent limit thereof. The following section identifies the various limits set by the FRDL Act 2005 and reports progress of the government in meeting those targets.

The FRDL Act 2005 requires the following:

> ***(1) 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."***

Government has already met and actually exceeded the requirement on the level of public debt as a percentage of GDP. The Government has achieved the goal of reducing public debt as percentage of GDP below 60 percent well ahead of time. Furthermore, this limit has been realized within three financial years instead of ten years as envisaged by the FRDL Act. At the beginning of July 2003, the total public debt stood at 75.1 percent of GDP while at the end of June 2009, the same figure stood at 58.1 percent of GDP.

> ***(2) 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."***

This requirement of the FRDL Act 2005 was meant to be a vehicle in achieving the more important target of reducing the public debt-to-GDP ratio to less than 60 percent within a ten year span. Achieving the target of debt-to-GDP ratio ahead of time notwithstanding, the reversal of the declining trend in debt burden during 2007-08 and again in 2008-09 is a cause for concern. The government should be vigilant in ensuring that the rise in the debt to GDP ratio during 2007-08 is not allowed to continue otherwise it will breach the 60 percent targeted level as required by the FRDL Act 2005. Public debt stood at 58.4 percent of GDP by end June 2008, and declined to 58.1 percent by end-June 2009. Fiscal restraint and a limit on borrowing from SBP enabled the government to reduce the public debt-to-GDP ratio following the increase in 2007-08, thus avoiding a sustained deterioration of this indicator.

Social sector and poverty related expenditure (as given by Pro-poor budgetary expenditure excluding outlays on law and order) remained well above the target of 4.5 percent of GDP as laid out in the FRDL Act 2005. These expenditures stood at **6.7 percent of GDP in 2008-09;** a remarkable fact given the higher amount of outlays required on behalf of law and order. However, expenditure on health and education remains a cause for concern. The FRDL Act 2005 requires that these outlays as a percentage of GDP reach 1.18 and 3.72 percent of GDP respectively by 2013; effectively doubling the allocation towards these sectors from the levels of 2002-03. In sharp contrast to the target, expenditure on health and education in 2008-09 at 0.3 percent and 1.5 percent respectively, has been lower than 2002-03. If the government is to meet this target, it is necessary that

superfluous expenditure be substituted with targeted and effective investments in health and education.

> ***(3) 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 to Public Sector Enterprises in 2008-09 amounted to Rs 274.3 billion or 2.09 percent of GDP, which was higher than the stipulated limit of 2 percent imposed by the Fiscal Responsibility and Debt Limitation Act 2005. Finance Division has been issuing continuing 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. The quantum of these guarantees depends on the supply-demand gap of various commodities, their price stabilization objectives, volume procured, and domestic and international prices, therefore these guarantees were never included in the limit of 2 percent imposed by the FRDL Act 2005. For 2008-09, Rs. 192.6 billion worth of new guarantees were issued on behalf of commodity financing operations.

The government intends to introduce world class warehousing facilities in the near future that will allow the entities involved in the commodity operations to secure financing against the warehouse receipt without explicit guarantee or letter of comfort from the government.

IX. Debt Strategy

Recovery of growth momentum and economic development are the key themes being pursued by the government for fiscal year 2009-10. In order to achieve these goals, and to provide significant relief to the vulnerable sections of society, an increase in development expenditure to stimulate economic activity is envisaged. Prudent debt policies and management are vital to the performance of most developing countries, and a greater emphasis has to be placed on these areas under the current circumstances. Lower than anticipated GDP growth in the previous fiscal year has meant that any planned outlay of funds cannot be met by simultaneous increases in tax revenue. Coupled with the additional demand placed on government resources by the security situation in the country, these factors have meant that any increases in expenditure will have to be financed

through debt creation. This environment of low revenue collection, pressure on expenditure and a significant fiscal deficit will only be sustainable in the presence of a comprehensive debt strategy. In essence, debt policies pursued during the year will determine the success of meeting the government's increased financing requirement in a cost efficient way while reducing inherent risks to an agreeable level.

Presently, debt strategy exercised by the government is restricted to specific nominal levels of debt, and the break-up of financing between external, domestic bank sources, and non-bank sources that is laid out in the federal budget annually. The budget contains a breakdown of financing between foreign currency and domestic currency component. The domestic debt is further divided into market debt (namely MTBs and PIBs) and national savings without any consideration to the tenor, timing and cost of funds. For 2009-10, the federal budget focuses on non-bank domestic sources for budgetary financing. However, the on-tap nature of NSS instruments hinders the alignment of this category of public debt to the budgeted amounts.

During 2009-10, debt creating external inflows are likely to be dominated by disbursements under the IMF SBA. Furthermore, financing through pledges made during the Friends of Democratic Pakistan conference in Tokyo is expected to begin flowing in during the current fiscal year. However, as funds under the IMF SBA are primarily for BOP support, and the exact time frame for the arrival of Tokyo pledges is uncertain, the government intends to meet its external financing requirement by contracting new loans to augment disbursements from existing loans as well as the Tokyo pledges. These newly contracted loans will mostly be long-term concessional financing provided by multilaterals. As regards the market debt, the government is aware of the importance of accessing international capital markets, and remains committed to maintaining its presence in those markets. To facilitate such financing, the government will continue to monitor the international financial environment and maintain an effective communication channel with the investors in order to utilize any windows that might present a chance to proceed with issuances at a low cost.

Currency movements and associated loss/gains have been a constant theme in the past. The government's approach to limiting the impact of interest and exchange rate movements is two pronged: firstly, **the government plans to develop and implement a comprehensive currency and interest rate hedging strategy to monitor, assess, and minimize losses from potential movements in international currency**; secondly, maintaining strong foreign exchange reserves and a stable exchange rate vis-à-vis the US dollar will limit undue increases in foreign currency denominated

external debt (in rupee terms). In this regard, the newly formed Debt Management Committee has been mandated to oversee the exercise to minimize exchange and interest rate risks.

There exists no clear and formal debt strategy and the entire process lacks cohesive vision. Rudimentary debt operations are carried out by different agencies with little or no coordination. Similarly, the government debt instruments offered to the market are fragmented and provide different returns for the same credit quality and maturity. Furthermore, guidelines for the regulation of significant contingent liabilities, in the shape of provision of government guarantees, are neglected. Under these circumstances, it is difficult to set and more importantly, achieve debt management objectives/benchmarks. It is important to note that while the federal budget identifies the levels of various sources of debt, no guidelines are provided with regards to optimal currency mix, distribution of tenor, and the exact timing of issuance. Presently, the only benchmarks present against which debt operations in the country can be measured are the level of debt-to-GDP (60 percent as laid out in the FRDL Act 2005) and the 2 percent of GDP limit placed on issuance of new guarantees. There is a need to formulate and adopt a holistic debt management strategy, a critical prerequisite of which is the centralization of debt management, decision making and implementation. By doing so, the government will be able to enhance policy coordination, and provide guidelines for the levels of debt as well as constitute strategic benchmarks for an optimal government debt portfolio. Strategic benchmarks must include, in addition to the debt-to-GDP levels, measures of debt service burdens, external sector solvency, refinancing ceilings, and considerations of currency and interest rate composition. The Debt Management Committee has begun a consultative process to establish these benchmarks.

X. Concluding Remarks

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. During 2008-09, public debt rose by 26.6 percent and rested at Rs 7,605 billion as of June 30, 2009. This addition largely stems from the entry of Pakistan to the IMF SBA and hence an augmentation of US$ 3.8 billion to the stock of IMF in the external debt. Currency depreciation also played a significant role in this increase. The frequent depreciation of the exchange rate in recent years, necessitated by the Balance of Payments crisis, has directly added to rupee value of public foreign debt. Indeed, capital losses on foreign exchange have been as important a source of public debt growth as fiscal deficits. The inflows through NSS continue to dominate the domestic debt category after the government put a halt on central bank borrowing.

However, the public debt to GDP ratio declined by a 0.3 percentage point to stand at 58.1 percent that is well 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 guarantees, 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 4.1 times during 2008-09, as opposed to 4.0 times in the previous fiscal year whereas the debt serving to revenue has declined to 43.5 percent in 2008-09 from 45.3 percent in 2007/08. 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 1.49 times and 12.7 percent during 2008-09 compared to 1.26 times and 8.5 percent respectively in 2007-08. Though deteriorating, but still within the acceptable international threshold of 2 times and debt servicing below 20 percent of foreign exchange earnings. However, the much higher growth in foreign exchange payments is resulting in persistent non-interest current account deficit, which is not sustainable in the long term and may trigger currency crises as witnessed in the recent past.

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 directional issues which need to be addressed. Furthermore, it is not possible to meet our external debt service obligations without seeking assistance from multilateral institutions. On the domestic side, even though the fiscal position has shown some improvement over the last fiscal year (as well as achieving a reduction in primary deficit), high domestic debt servicing is translating in to higher domestic borrowing and higher interest cost (as shown in **Table 14**).

Table 14. Domestic Borrowing and Servicing, FY05-FY09 (in billions of Rs.)					
	FY05	**FY06**	**FY07**	**FY08**	**FY09**
Domestic Borrowing	165.4	159.5	273.2	664.4	586.2
Servicing on Domestic Debt	176.3	202.5	326.9	442.6	580.5
Source: Budget Wing, MoF					

Clearly, the external debt burden needs to be brought down so that Pakistan does not need exceptional financing from the international financial institutions (IFIs). Similarly it is desirable that zero real growth, if not nominal, be achieved in government domestic debt in order to relieve the pressure on domestic interest rates and capital markets. 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 maneuver 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 can not be achieved without persistent economic growth. The slow down 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.

Analysis of the country's fiscal position and debt sustainability is incomplete if it skips over obligations made by the government outside the budget. Levels of public debt may be understated as they do not include any estimates of contingent guarantees, which might materialize in future. These include explicit and implicit guarantees issued to IPPs and other private and public entities; unfunded losses of public sector entities i.e. Pakistan Steel Mill, PIA, WAPDA, PEPCO, Railways, etc. There is a need to quantify various implicit guarantees embedded in many government contracts. A

holistic view of any expected drain on government resources in future can be achieved through this exercise.

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 first three months of the current fiscal year, 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.

For prudent debt management, it is important to centralize the debt management function, i.e., responsibility for decision making and implementation is not spread across several government departments. At present, the debt management function is fragmented and performed by different agencies with weak coordination resulting in lack of cohesive vision, exposure to financial market shocks, underdevelopment of domestic debt capital markets and higher debt servicing cost. In order to foster the development of the debt capital markets of Pakistan, attention should be directed towards increasing the breadth and depth of the government securities market, which in turn, will serve as a benchmark for corporate issues and infrastructure financing. Although the cut-off decisions in primary auction of T-bills and PIBs now originate from the Ministry of Finance, any lapse in the linkage between government domestic debt considerations and monetary policy objectives will lead to a distortion. Hence, this policy shift calls for an even higher emphasis on coordination between fiscal, monetary and debt policies. On the other hand, the duration of the domestic debt is estimated to be around 2.25 years which needs to be extended in order to correct the imbalance in the composition of domestic debt.

National Saving Schemes (NSS) constitute 38 percent of the total domestic debt. 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 restructure and convert the directorate into vibrant customer centric distribution channel for government debt instruments. Transfer pricing mechanism may be introduced to induce efficiency. 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.

Going forward, a development-oriented budget for 2009-10 calls for a greater creation of debt, unless strict measures to increase the tax-to-GDP ratio on the internal front are taken. The emphasis placed on debt creating will be even greater if the Tokyo pledges fail to materialize within the course of the year. In the light of these actual developments and potential hazards, high caution on the part of the government is needed to pursue a sustainable debt policy and formulate a dynamic medium term debt strategy aligned with fiscal, monetary and exchange rate policies.