

9

External and Domestic Debt

Introduction

Pakistan's debt dynamics has undergone substantial changes in the last three years. Higher fiscal deficit led to accumulation of huge debt in absolute and relative terms. The debt profile moved towards shorter end of maturity as desperation to finance deficit through domestic sources owing to inadequacy of external financing. Therefore, developments in both external and domestic debt are of key concern to debt management. Excessive increase in debt has caused problems for Pakistan in the past, while imprudent domestic borrowing plagued the economy during 2010-11. Prudent and efficient debt management is required not only to ensure that present debt levels are kept under control, but also manage future repayment obligations. Prudent debt management practices could not undermine the importance of prudent fiscal and monetary policy. Even best debt management may not by itself avert any upheaval in case of poor macroeconomic policy sequencing.

The current fiscal year carried the legacy of high fiscal account deficits mainly driven by overrun in security related spending and revenue shortfalls owing to weaker economic activities. Stable exchange rate has helped in lower incidence of external debt in relation to GDP. On the internal front, borrowing from the State Bank of Pakistan continues to create problem as in the first half of 2010-11 increased substantially but in the Jan-March quarter witnessed retirement of SBP debt stock. The external sector remained comfortably placed as current account has recorded surplus in July-April 2010-11 and thus hemorrhage to foreign exchange reserves not only arrested but reserves crossed \$17.0 billion mark.

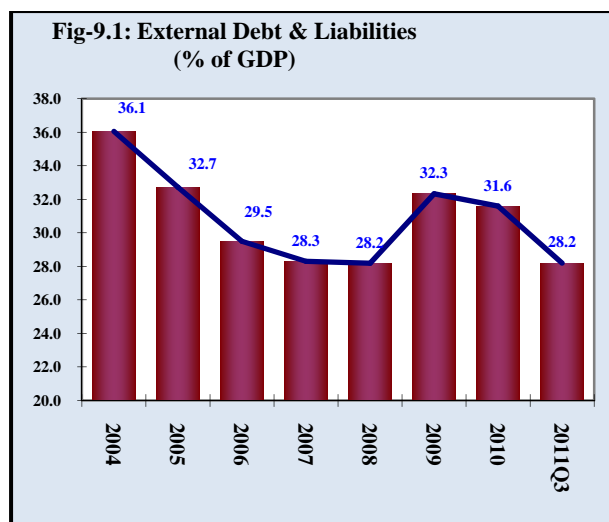
Inadequacy of external flows put onus of financing fiscal deficit on domestic sources of

financing. The domestic debt stock piled up by Rs.803.9 billion in July-March 2010-11.

External Debt and Liabilities

Gross external debt at a given point of time is the amount of disbursed and outstanding liabilities of residents of a country to non-residents. Countries use external debt in order to fill the gap between desired expenditure levels and domestically available resources. Governments also issue foreign currency debt in order to signal their commitment to stable exchange rates and prices. A key incentive for governments to use foreign debt heavily is that it minimizes current interest costs, but doing so leaves the country vulnerable to certain risks.

The government manages its debt in order to raise the required amount of resources subject to the lowest possible medium to long-term cost and consistent with a prudent degree of risk. Poor debt management poses risks for both the public and private sectors in the form of economic instability, insolvency, debt distress, and fiscal crisis. In order to prevent such eventuality, a government needs to identify the various risks to its debt stock, and formulate strategies to counter or minimize these risks. Risks can be classified into two main categories; market risk, and country specific risk. The stock of outstanding debt of any country is vulnerable to market risks regardless of the origin, size, average tenure, and other characteristics of the debt. Market risk is measured in terms of potential increase in debt servicing costs associated with changes in market conditions such as interest rate risk, exchange rate risk, and credit risk. Country specific factors include the economic, social, and political stability of the country, and general investor sentiment about the economy.



In addition to risk management, governments need to constantly monitor, sustain, and even enhance their debt carrying capacity. Furthermore, the borrowed resources must be utilized effectively and productively so that they generate economic activity. Prudent debt management is therefore, essential for preventing debt crisis. Empirical evidence suggests that external debt slows growth only if it crosses the threshold level of 50 percent of GDP or in net present value terms, 20-25 percent of GDP. Pakistan has experienced serious debt problems in the recent past and accordingly witnessed deterioration in the macroeconomic environment, leading to deceleration in investment rate and economic growth and the associated rise in the incidence of poverty.

External Debt & Liabilities (EDL) increased from US \$ 37.9 billion at end-June 2000, to \$

55.9 billion by the end of June 2010, and stood at \$ 59.5 at end-March, 2011. During the same period, EDL as a percentage of GDP decreased by 23.5 percentage points of GDP, falling from 51.7 percent on end-June 2000 to 28.2 percent by end-March 2011 as shown in Fig-9.1. During the last two years, EDL has increased in absolute terms, but decreased in relation to GDP. This shift in momentum has highlighted the crucial role played by current account deficit and exchange rate stability on a country's debt burden. Pakistan benefited from a relatively stable rupee and significant reduction in financing of current account which facilitated a reduction in the debt burden. Entering into the IMF Stand-by Arrangement (IMF SBA) program has enabled Pakistan to shore up foreign exchange reserves and prevent the economy from any further depreciation, but it has also translated into a significant increase in outstanding external debt. Focusing on the absolute increase in the outstanding stock of EDL can be misleading for two main reasons. Firstly, the outstanding stock of debt must be analyzed in relation to the size of the economy and its repayment capacity (in terms of GDP and other macroeconomic indicators). Secondly, the absolute change in EDL neglects classification between an actual increase in stock and increases caused by fluctuations in international exchange rates.

Table-9.1: Pakistan: External Debt and Liabilities

	End-June							2011Q3
	2004	2005	2006	2007	2008	2009	2010	
	(In billions of U.S. dollars)							
1. Public and Publicly Guaranteed debt	29.9	31.1	32.9	35.3	40.6	42.6	43.1	45.6
A. Medium and long term(>1 year)	29.9	30.8	32.7	35.3	39.5	41.1	42.3	44.6
B. Short Term (<1 year)	0.0	0.3	0.2	0.0	1.1	1.5	0.8	0.9
2. Private Non-guaranteed Debt (>1 yr)	1.7	1.3	1.6	2.3	2.9	3.3	3.4	3.8
3. IMF	1.8	1.6	1.5	1.4	1.3	5.1	8.1	8.9
Total External Debt (1 through 3)	33.4	34.0	36.0	39.0	44.9	51.1	54.6	58.3
Of Which Public	31.3	32.1	33.9	36.5	40.7	45.9	50.1	53.4
4. Foreign Exchange Liabilities	2.0	1.8	1.6	1.5	1.3	1.3	1.3	1.2
Total External Debt & Liabilities (1 through 4)	35.3	35.8	37.6	40.5	46.2	52.3	55.9	59.5
(of which) Public Debt	31.3	32.1	33.9	36.5	40.9	46.3	49.5	53.6

	End-June							2011Q3
	2004	2005	2006	2007	2008	2009	2010	
	(In percent of GDP)							
Total External Debt (1 through 3)	34.1	31.1	28.2	27.3	27.4	31.5	30.8	27.7
1. Public and Publically Guaranteed debt	30.6	28.4	25.8	24.7	24.8	26.3	24.3	21.6
A. Medium and long term(>1 year)	30.5	28.1	25.7	24.7	24.1	25.4	5494	5494
B. Short Term (<1 year)	0.0	0.2	0.1	0.0	0.7	0.9	6451	6451
3. IMF	1.8	1.5	1.2	1.0	0.8	3.2	4.6	4.2
Total External Debt	34.1	31.1	28.2	27.3	27.4	31.5	30.8	27.7
4. Foreign Exchange Liabilities	2.0	1.6	1.2	1.0	0.8	0.8	0.7	0.6
Total External Debt & Liabilities (1 through 4)	36.1	32.7	29.5	28.3	28.2	32.3	31.6	28.2
Memo:								
GDP (in billions of Rs.)	5641	6500	7623	8673	10243	12724	14837	18063
Exchange Rate (Rs./U.S. dollar, Period Avg.)	57.6	59.4	59.9	60.6	62.5	78.5	83.8	85.7
Exchange Rate (Rs./US\$, EOP)	57.9	59.7	60.2	60.6	68.3	81.4	85.5	85.3
GDP (in billions of U.S. dollars)	98.0	109.5	127.4	143.0	163.8	162.1	177.0	210.8

Source: State Bank of Pakistan

The big chunk of Pakistan's outstanding external debt is classified as public and publically guaranteed debt and accounts for 76.6 percent of the total outstanding EDL stock [See Table 9.2]. Out of the remaining amount 15.0 percent debt is owed to the IMF. Private non-guaranteed debt contributes 6.4 percent to the stock of EDL and another 2.0 percent contribution came from foreign exchange liabilities.

The following section highlights the developments in the various components of EDL during the first nine months of the outgoing fiscal year.

i. Public and Publicly Guaranteed Debt

Public and publicly guaranteed debt accounts for the largest share of 76.6 percent in EDL. This component is further classified into medium to long-term debt and short-term debt. During the first nine months of 2010-11, public and publicly guaranteed debt has increased by 5.8 percent or \$ 2.5 billion, rising from \$ 43.1 billion at end-June 2010 to \$ 45.6 billion by end-March 2011. Medium and long-term debt increased by \$ 2.3 billion during the same period. Short-term debt increased from \$ 793 million at end-June 2010 to \$ 916 by end-March 2011. This increase of \$ 123 million is on account of rollover of existing stock of by the Islamic Development Bank (IDB) debt.

ii. IMF Debt

At the end-March 2011, debt owed to IMF aggregated to \$8.9 billion (a growth of 10.7 percent) out of which US\$1,979 million accrued to the federal government. The remaining IMF funds were recorded on SBP books to strengthen the foreign exchange reserves of the country. During the current year, IMF gave \$452 million as Emergency and Natural Disaster Assistance (ENDA) for budgetary assistance.

iii Private non-guaranteed debt and Foreign Exchange Liabilities

The share of private non-guaranteed debt in Pakistan's total EDLs has historically been very small. Continuing with this trend, private/PSE non-guaranteed debt accounted for 6.4 percent of the outstanding stock of EDL by end-March 2011. The stock of private non-guaranteed debt increased by \$ 400 million; from \$ 3.4 billion in June 2010 to \$3.8 billion by end-March 2011, thereby reflecting borrowing for working capital requirements.

iv. Foreign exchange liabilities

The stock of Pakistan's foreign exchange liabilities (FEL) recorded slight decline in 2010-11. The net decline in foreign exchange liabilities was mainly due to reduction in the deposit of Central Bank of China.

Table 9.2: Structure of EDL (End Mar 11)

Component	% Share
Paris Club	25.4
Multilateral	42.3
Other Bilateral	4.4
Short-Term	1.5
Private Non-Guaranteed	6.4
IMF	15.0
Other	2.9
Forex Liabilities	2.0

Source: SBP

Impact of Exchange Rate Fluctuations

Pakistan's external debt is contracted and thus denominated in multiple currencies but for accounting conventions, it is reported in equivalent US dollar. Thus shifts in cross exchange rates among various currencies, especially against dollar are translated into changes in the dollar value of the outstanding stock of external debt. The change in the outstanding stock of the external debt is normally explained through new disbursements adjusted for amortization plus revaluation impact of non-US dollar debt. During July-March 2010-11, total disbursements amounted to \$ 1.409 billion and repayment of principal was amounting to \$ 1.781 billion. The net impact of these two factors

decreased the stock of public and publicly guaranteed debt (PPG) by \$ 372.6 million. The total translational loss on account of cross-currency movement against USD amounted to \$2.7 billion was neutralized by this outflow of \$372.6 million. The net addition of \$ 2.498 billion in the total external debt stock was the result of depreciation of US \$ against hard currencies like Japanese yen (JPY), Euro, SDR and others.

Pakistan benefited from the exchange rate fluctuations for many years in the past, particularly when major currencies were depreciating against the dollar. Unfortunately, in the current fiscal year, Pakistan was on the receiving end of the valuation impact. For the period July-March 2010-11, the exchange rate applied was of end-June 2010 and end-March 2011. During reporting period July-March 2010-11, US dollar depreciated against Japanese yen, Euro and SDR by 8.1 percent, 14.3 percent and 8.2 percent, respectively. Thus the exchange rate movements during the period have caused changes in the reported US dollar equivalent amount of \$ 2.7 billion while net new disbursement impact was negative \$0.37 billion. The outstanding stock in yen, Euro and SDR witnessed a rise of \$906 million, \$832.8 million and 805 million, respectively because of massive appreciation of these currencies against US dollar [See Table-9.3].

Table-9.3: Translational Exchange Rate Loss

(\$ Million)

Currency	Outstanding Balance in BC	Exchange Rate as on 31.12.2008	Equivalent US\$	Exchange Rate 30.06.08	Equivalent US\$	Difference
1	2	3	4=2/3	5	6=2/5	7=4-6
Euro	4,336	0.704	6,161	0.814	5,329	833
JPY	1,139,233	82.870	13,747	88.715	12,841	906
SDR	7,541	0.631	11,957	0.676	11,152	805
US \$	11,430	1	11,430	1	11,430	0
	Others		2,373		2,206	167
	Total		45,668		42,959	2,710

BC: Base Currency

Source: EAD & Staff Calculations

Composition of Foreign Economic Assistance

The total amount of foreign economic assistance received in the first nine months of 2010-11 stood at \$ 1,409 million. The composition of this assistance is as follows:

i. Commitments

The commitments of foreign economic assistance were \$6,171 million during 2009-10, while during July-March 2010-11, total commitments amounted to \$2,845 million. About 65.4 percent

of the total commitments during July-March 2010-11 were from bilateral sources while 34.6 percent was from multilateral sources in the shape of project aid and non-project aid. The share of BOP/budgetary support in total non-project aid was 85 percent. The project aid accounted for 98 percent of commitments.

ii . Disbursements

Disbursement of foreign economic assistance during 2009-10 stood at \$3,667 million but decreased to \$1,409 million during July-March, 2010-11. During this period, disbursement for the project aid amounted to \$ 725.7 million or about 51.5 percent of the total disbursements. An amount of \$ 683 million was disbursed for non-project aid, claiming about 48 percent of total disbursements.

iii . Debt Servicing during 2010-11

The annual debt servicing payments stood at \$6327 million in 2001-02 with a rollover of \$2243 million however, combination of re-profiling of Paris Club bilateral debt on a long-term horizon, the substantial write-off of the US bilateral debt stock, the prepayment of expensive debt and the relative shift in contracting new loans on concessional terms, this amount was drastically reduced to around \$ 3 billion by 2007-08. As the debt burden of an economy rises, so do the obligations to make debt service payments. The debt obligations started building up since 2008-09 and reached to \$ 5.8 billion in 2009-10. Moreover, relatively high amount of \$7.8 billion has been paid during July-March 2010-11 which implies an increase of over one billion dollar in one year. Out of this amount, \$ 6.2 billion was paid on account of repayment of principal amounts. A significant proportion of this increase is due to repayment of short-term obligations of scheduled commercial bank amounting to \$ 4.3 billion which was not captured before July 2009. The amount rolled over decreased from \$ 1.7 billion in 2009-10 to \$ 756 million in July-March 2010-11 as IDB's short-term obligations were rolled over continuously in the past but not rolled over this year [See Table 9.4].

Table-9.4 Pakistan's External Debt and Liabilities Servicing (\$ Million)

Years	Actual	Amount	Total
	Amount Paid	Rolled Over	
2001-02	6327	2243	8570
2002-03	4349	1908	6257
2003-04	5274	1300	6574
2004-05	2965	1300	4265
2005-06	3115	1300	4415
2006-07	2977	1300	4277
2007-08	3161	1200	4361
2008-09	4747	1600	6347
2009-10	5787	1723	7510
2010-11*	7778	756	8534

* July-March

Source: State Bank of Pakistan

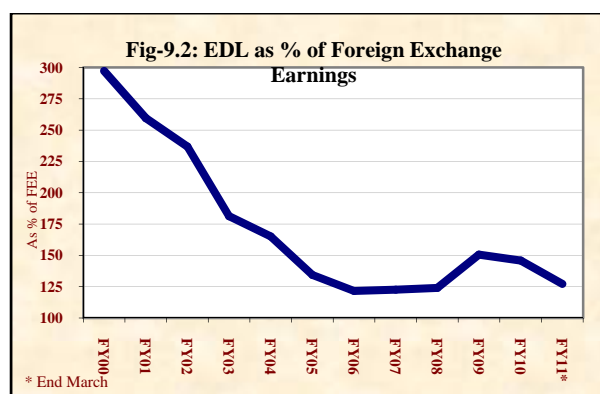
External Debt Sustainability

The idea of debt sustainability links the debt stock of a country to its repayment ability as gauged by various macroeconomic indicators. The difference between the total financing needs on the balance of payments and the projected capital inflows is known as the financing gap. In crude terms, if the financing gap is approaching zero in the long-term, debt is considered to be sustainable. Whereas if a financing gap exists, it can be filled by resorting to additional borrowing, rescheduling and debt reduction, or by accumulating arrears. Such measures lead to an escalating debt burden and eventual un-sustainability of debt.

In order to ensure sustainability, developing countries can place limits on debt obligations, given the level of capital inflows. These limits are set by assigning threshold levels to the debt stock as a ratio of economic indicators that represent the repayment capacity of the economy, such as GDP, foreign exchange reserves and foreign exchange earnings. Calculation of these indicators and subsequent comparison with international thresholds provides insight into a country's debt position. They can be used to monitor the sustainability of debt as well as an early warning system for debt distress and sustainability issues. The indicators can be divided into two groups, nominal indicators which are useful in analyzing the debt position at any given time as well as historical trends, and present value indicators which are useful in measuring current and future debt payments. By using present value indicators, it is possible to analyze future debt obligations in current terms, and project the impact they will

have on the country's debt burden and sustainability.

Most of the indicators of Pakistan's debt have been exhibiting a declining trend since 2001-02 onwards, with a trivial u-turn in the most difficult year of recent economic history i.e. 2007-08, especially indicators that analyze debt in relation to foreign exchange reserves. Due to sustainable debt policies and favorable rescheduling of debt, external debt and liabilities (EDL) as a percentage of GDP declined from 51.7 percent in end-June 2000 to 31.6 percent by the end of June 2010, a decline of 20.1 percentage points. By end-March 2011, EDL as a percent of GDP stood at 28.2 percent, thereby showing a decrease of 3.4 percentage points in one year. This improvement is mainly due to faster growth in nominal GDP in relation to slower growth in external debt.



EDL as a percentage of Foreign Exchange Earnings (FEE) gives a measure of a country's debt repayment capacity by comparing levels of external debt to the sum of exports, services receipts, and private unrequited transfers. EDL as a percent of FEE stood at 297.2 percent by the end of 1999-2000, and witnessed a sustained decline till end-June 2006 where it reached 121.6 percent; a reduction of 175.6 percentage points in six years. The pendulum swung to other side and EDL in relation to FEE surged to 150.6 by end-June 2009. However, it started declining since then and decreased to 127.2 percent by end-March 2011. The rise between 2006 and 2009 was mainly due to falling exports and rising debt stock, however, reversal came as a result of buoyancy in the external sector and lower growth in the EDL. The improvement of this ratio

suggests that Pakistan's stock of external debt and liabilities is growing at a slower rate than its foreign exchange earnings [See Table 9.5].

Table-9.5: External Debt Sustainability Indicators

Year	EDL/ GDP	EDL/ FEE	EDL/ FER	STD/EDL
	(Percent)		Ratio	(Percent)
FY00	51.7	297.2	17.5	3.2
FY01	52.1	259.5	11.4	3.7
FY02	50.9	236.8	5.7	1.4
FY03	43.1	181.2	3.3	1.2
FY04	36.7	165.0	2.9	0.6
FY05	32.7	134.3	2.9	0.8
FY06	29.4	121.6	2.8	0.4
FY07	28.3	122.6	2.5	0.1
FY08	28.2	124.0	4.0	2.4
FY09	32.3	150.6	4.2	2.8
FY10	31.6	146.6	3.3	1.4
FY11*	28.2	127.2	3.4	1.5

* End March 2011 Source: EA Wing and SBP Bulletins

EDL: External Debt and Liabilities, FEE: Foreign Exchange Earnings, FER: Foreign Exchange Reserves, STD: Short-term Debt, INT: Interest Payments and CAR: Current Account Receipts

As a multiple of Gross Foreign Exchange Reserves (FER), EDL witnessed a sustained decrease from 17.5 1999-2000 to 2.5 by end-June 2007. The improvement of this ratio was due to a reduction in the stock of external debt coupled with a significant increase in reserves. However, EDL as a multiple of FER has increased from 2.5 by the end of 2006-07 to 4.2 in 2008-09 mainly because of depletion of reserves and accumulation of EDL. On the onset of SBA in 2008, the ratio further declined to 3.3 in 2009-10 as EDL growth slowed and foreign exchange reserves shored up. By end-March 2011, the ratio deteriorated slightly to 3.4 mainly because of stagnation in reserves in relation to modest growth in EDL. Given the current domestic and international financial environment, any sustained increase in debt of the magnitude observed during 2007-08 and 2008-09 needs to be in conjunction with a growth of reserves which guarantees the country's capacity to repay the debt. Failure to match further increases in debt stock with higher reserves will

bring Pakistan's level of external debt close to unsustainable levels.

Pakistan's level of Short Term Debt (STD) as a percentage of EDL has historically been lower than most other developing countries. The ratio improved to 3.7 percent in 2000-01 to just 0.1 percent in 2006-07. However, during the BOP crisis like situation in 2007-08 and 2008-09, the ratio once again bounced back to 2.8 percent. The previous fiscal year 2009-10 has seen an improvement in STD as a percentage of EDL to 1.4 percent which inched up to 1.5 percent for the first nine months of 2010-11. This was primarily because of rollover of short-term financing provided earlier by the Islamic Development Bank.

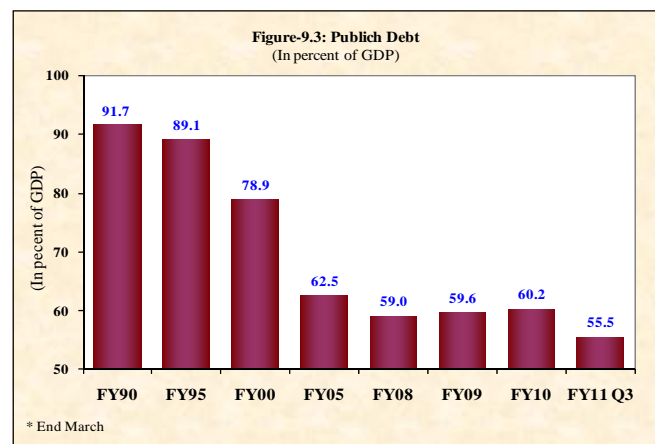
PUBLIC DEBT

Public debt refers to all debt owed directly by the government originating from domestic and external sources. It consists of debt denominated in Rupees as well as foreign currency. Management of public debt poses policymakers with key challenges and trade-offs. Debt is an essential tool in ensuring required levels of investment and expenditure on programs aimed at boosting productivity, economic growth, economic and social development, and the alleviation of poverty. However, accruing an excessive amount of debt has dire consequences for any economy by creating the future obligation to make repayments. Increase in public debt can lead to inflationary pressures on the economy if the source of the increase is domestic borrowing. Additionally, increasing proportions of government resources directed towards debt servicing in the future hinder allocation of funds to other sectors of the economy.

Prudent management of public debt requires that fiscal operations be carefully planned, placing a limit on present and future fiscal deficits in order to reduce borrowing requirements. Similarly, non-debt creating foreign inflows need to be encouraged to keep the foreign currency component of public debt in check. Additionally, exchange rate stability is crucial as depreciation of

domestic currency increases the foreign currency component of public debt significantly.

A European debt crisis has reinforced the need to manage public debt prudently as many countries fell into the debt trap. Many advanced countries have witnessed a significant rise in public debt in 2010 that had never been experienced in the absence of a major war. Public debt in advanced economies is projected to rise from an average of about 73 percent of GDP at end 2007 to about 108 percent of GDP at end 2015. Public debt has also increased in some emerging economies (in central and Eastern Europe) during the recession, although these economies have not been hit as hard as advanced economies. However, the emerging economies tend to have a lower debt tolerance, mainly due to narrower and more volatile revenue bases.



Pakistan has been spared from the gravity of the current global crisis, and the impact on the financial sector has been limited, waiving any need for a stimulus package or large fiscal outlay. However, the debt dynamics have been witnessing gradual erosion since 2007-08. The improving debt dynamics has been reversed and the total public debt-to-GDP ratio has hovered around 60 percent for the past three years. Country's debt position deteriorated due to a number of domestic issues and the international credit crisis. The public debt to GDP ratio has declined to 55.7 percent by end-March 2011 mainly because of high nominal GDP growth.

Table-9.6: Trends in Public Debt

	FY80	FY90	FY95	FY00	FY05	FY08	FY09	FY10	FY11 Q ₃
	(In billions of Rs.)								
Domestic Currency Debt		374	790	1576	2152	3267	3852	4651	5461
Foreign Currency Debt		428	873	1442	1913	2780	3736	4284	4559
Total Public Debt		801	1662	3018	4064	6047	7588	8935	10020
	(In percent of GDP)								
Rupees Debt		42.8	42.3	41.2	33.1	31.9	30.3	31.3	30.2
Foreign Currency Debt		48.9	46.8	37.7	29.4	27.1	29.4	28.9	25.2
Total Public Debt		91.7	89.1	78.9	62.5	59.0	59.6	60.2	55.5
	(In percent of Revenue)								
Rupees Debt		235	245	308	239	218	208	224	228
Foreign Currency Debt		269	270	281	213	185	202	206	191
Total Public Debt		505	515	589	452	403	410	430	419
	(In percent of Total Debt)								
Rupees Debt		46.6	47.5	52.2	52.9	54.0	50.8	52.0	54.5
Foreign Currency Debt		53.4	52.5	47.8	47.1	46.0	49.2	48.0	45.5
Memo:									
Foreign Currency Debt (\$ Billion)		19.5	28.1	27.5	32.1	40.7	45.9	50.1	53.4
Exchange Rate (Rs./U.S.\$, E.O.P)		21.9	31.1	52.5	59.7	68.3	81.4	85.5	85.3
GDP (in Rs. Billion)		874	1866	3826	6500	10243	12724	14837	18063
Total Revenue (in Rs. Billion)		159	323	513	900	1499	1851	2078	2393

* End-March

Source: SBP and EA Wing Calculations.

i . Total Outstanding Public Debt

Total public debt increased by Rs 1162 billion in the first nine months of 2010-11, reaching a total outstanding amount of Rs. 1,002,0 billion; an increase of 13.1 percent in nominal terms. The primary source of increase in public debt during July-March, 2011 has been a sharp rise in local currency component that accounted for 69.7 percent of the total increase in total public debt. This was primarily due to the slower disbursement from multilateral and bilateral donors and higher than budgeted fiscal deficit. The external debt component grew by Rs 275 billion or 6.4 percent partially due to increased foreign public debt inflows and partly because of cross-currency translation effect. Public debt as percent of GDP has decreased to 55.5 percent by end-March 2011 after hovering around to 60 percent of GDP for two years.

The structure of public debt has also experienced subtle changes since 2001-02. The focus has been

shifted more towards domestic borrowings which inched up its share from 48.9 percent in 2001-02 to 54.5 percent at end March, 2010-11. The massive borrowing from the SBP has not only fueled inflationary pressures in the economy but also responsible for fiscal indiscipline resulting in dire consequences for debt management. The government has placed a restraint of net zero quarterly borrowing from the State Bank of Pakistan (SBP).

ii . Dynamics of Public Debt Burden

To look on the real incidence of the debt burden, it is useful to analyze the debt burden in the context of other macroeconomic indicators. Changes in the public debt burden of an economy are influenced by the cost associated with borrowing funds, the rate of inflation, and the real growth rates of public debt and government revenues. Periods of higher cost of borrowing coupled with higher growth rates of public debt in periods where growth of revenues was relatively

stagnant have yielded an increase in the public debt burden.

If we look debt burden of Pakistan in historical context, the rise appears to be largely contributed by the high real cost of borrowing and stagnant government revenue. Total public debt consists of debt payable in rupees and debt payable in foreign exchange. The real cost of borrowing for these two components of public debt is measured differently [as shown in Table-9.7]. The real cost of Pakistan's domestic debt has varied substantially over time. The inflation is a crucial component in the determinant of real cost of borrowing while depreciation affects positively to real cost of borrowing on external debt. During the first five years of the decade (2000-05), the real cost of borrowing for domestic debt was 4.2 percent owing to lower inflation but in the second half (2005-10) the real cost of borrowing declined to negative 1.3 percent partly due to rising inflationary pressures in the economy as well as the declining nominal cost of borrowing. The enormous inflationary pressure in the current year has helped the government in reducing real cost of borrowing substantially.

During the first five years of the current decade (2000-05), the real cost of borrowing for foreign exchange denominated loan increased to 0.2 percent mainly because of lower inflation and rupee appreciation. However, it turned to negative 4.3 percent in the second half (2005-10). During 2005-10, the massive depreciation of rupee along with higher inflation contributed to negative incidence of real cost of borrowing. The low implied cost of external borrowing has contributed to overall declining trend in real cost of borrowing during the last ten years

Table 9.7: Real Cost of Borrowing (Percent)

	External Debt	Domestic Debt	Public Debt
1980s	3.4	1.0	2.3
1990s	2.7	3.2	2.9
1990-I	-3.0	-1.9	-2.4
1990-II	-5.5	5.7	5.6
2000-05	0.2	4.2	2.9
2005-10	-4.3	-1.3	-0.4
2010-11*	-17.3	-6.9	-10.7

Source: EA Wing calculations

* July 2005 – March 2011

Table-9.8: Dynamics of Public Debt Burden

	Primary Fiscal Balance (Percent of GDP)	Real Cost of Borrowing	Real Growth of Debt	Real Growth of Revenues	Real Growth of Debt Burden
		(Percent per year)			
1980s	-3.7	2.3	10.6	7.6	3.0
1990s	-0.3	2.9	4.9	2.9	2.0
1990-I	-1.8	-2.4	3.6	3.2	0.4
1990-II	1.1	5.6	6.2	2.5	3.7
2000-05	0.6	2.9	0.3	5.8	-5.5
2005-10	-1.1	-0.5	3.3	4.6	-1.3
2010-11*	-1.1	-10.7	-4.8	-0.6	-10.0

Source: EA Wing calculations

* Jul-Mar 2010-11.

As a result of the sharp fluctuation in the real cost of borrowing for both domestic and foreign debt, the dynamics of the growth in public debt also changed over the last two decades. The changing dynamics of public debt is well-documented in Table-9.8. The economy generated primary fiscal surplus in the first five years (2000-05) owing to lower interest payments in the period. However, it

turned into deficit in the period (2005-10). The primary deficit is likely to follow its pattern of last five years. The real growth of debt registered an increase of 0.3 percent in 2000-05 which accelerated to 3.3 percent in 2005-10. However, owing to very high inflation the real growth in debt witnessed huge negative growth of 4.8 percent. This proves the point that how inflation

helps debtors at the expense of lender. The revenues kept healthy average growth rate of 5.8 and 4.6 percent in these two time periods. The combined effect of healthy growth in revenues and modest growth in real debt growth resulted in a sharp decline in the country's debt burden during the last ten years. In order to assess the cost of borrowing, an implied interest rate is calculated as interest payments in 2010-11 divided by the stock at the end of previous financial year. In the 2010-11 the real revenue witnessed negative growth of 0.6 percent against 4.6 percent real decrease in public debt.

An analysis of the dynamics of the public debt burden provides useful lessons for policy-makers to manage the country's public debt. First, every effort should be made to maintain a primary surplus in the budget. Second, the interest rate and inflation environment should remain benign. Third, the pace of revenue growth must continue to rise to increase the debt carrying capacity of the country. Center to all these lessons is the pursuance of prudent monetary, fiscal and exchange rate policies which are complementary in nature for prudent debt management in any country.

In order to increase the public debt to GDP ratio, the growth in public debt needs to exceed the nominal growth of GDP. This implies that inflation is a key factor in determining the movements of this ratio. If the price level is high, nominal GDP is inflated, and the accumulation of debt is outpaced by the nominal growth rate of GDP. In inflationary times, real interest rates are also lower, leading to a further reduction in the debt burden. During the current fiscal year (2010-11), the nominal growth rate of GDP has been 22 percent, whereas growth in the stock of public debt was 13 percent, leading to a reduction in the public debt-to-GDP ratio by 4.8 percentage points.

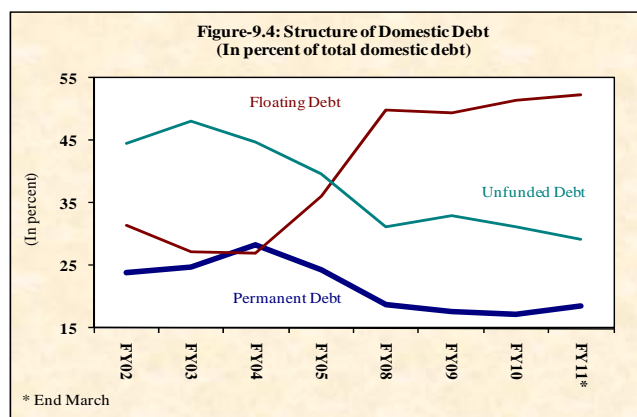
Domestic Debt

Domestic debt has always been fundamental part of a government's borrowing strategy. A government faces an inter-temporal trade-off between short-term and long-term costs that should be managed carefully. Excessive reliance on short-term paper may leave a government

vulnerable to volatile debt service costs in the event of rising interest rates, and the risk of default in case a government cannot rollover its debts at any cost. On the other hand, over reliance on longer-term fixed rate financing also carries risks, because it tempts governments to deflate the value of such debt in real terms by initiating surprise inflation. The government in the current fiscal year benefited from enormous surge in inflation as debt-to-GDP ratio went down instead of absolute nominal borrowing of just below half a trillion.

Over the medium term, a strategy for developing the market for government securities can relieve constraints and permit the issuance of a less risky debt structure, and this should be reflected in the overall debt management strategy. The diversification of domestic debt may also lessen pressure on external borrowing as well. In this context, gradual increases in the maturity of new fixed rate domestic currency debt issues may raise cost in the short run, but they reduce rollover risk and often constitute important steps in developing domestic debt markets.

In Pakistan, borrowing from domestic and external sources account for almost same stake in overall debt. In fact, government has increasingly focused on the domestic part over the last few years. This tendency is portrayed by a growing contribution of domestic debt mainly because of non-availability of the external financing.



Outstanding Domestic Debt

The total domestic debt is positioned at Rs 5462.2 billion at end-March 2011 which implies net

addition of Rs.803.9 billion in the nine months of the current fiscal year. In relation to GDP the domestic debt stood at 30.2 percent of GDP which is lower than end-June 2010 level at 31.4 percent. The domestic debt grew by 17.3 percent which is lower than last years' growth of 20.7 percent. The focus on deficit financing through internal sources owing to non-availability of external receipts has been the major cause.

The composition of major components shaping the domestic debt portfolio has undergone a complete transformation from a high dominance of unfunded debt to an increasing dependence on floating component of domestic debt. Since 2004, the unfunded category comprising about 45 percent of the aggregate debt stock has declined to 29.3 percent of the total during July-March, 2011. The share of permanent debt has also decreased over the same period and it stood at 18.5 percent by end-March 2011. Contrary to this, the share of floating debt (short term domestic debt) increased from 27 percent in the period 2004 to 52.2 percent at end-March 2011. The growing share of short-term debt is worrisome. A detailed explanation of each section follows:

i. Permanent Debt

The stock of permanent debt consists of various medium to long term instruments at the government's disposal outside the National Savings Scheme. These include Pakistan Investment Bonds (PIBs), Prize Bonds, and *Ijara Sukuk* apart from such discontinued schemes as Federal Investment Bonds. At the end of March 2011, permanent debt stood at Rs 1,008.8 billion, exhibiting an increase of Rs. 206.8 billion or 25.8 percent up from the previous fiscal year.

A larger share of this increase was contributed by receipts in PIBs, followed by prize bonds. Within permanent debt, PIBs were the most ample component. In the absence of any large PIB maturity during the year, only Rs 56 billion were fetched from the market. During fiscal year 2009-10, SBP increased the share of non-competitive bids from 10-15 percent in order to encourage non financial institutions and individuals to invest in government securities, thereby broadening the distribution base. Similarly, a new three-year issue of *Ijara sukuk* bond was launched in November 2010, after a gap of thirteen months. During July-March, 2011 a sum of Rs. 136.6 billion was raised through this issue.

Table 9.9. Trends in Domestic Debt

	FY02	FY03	FY04	FY05	FY08	FY09	FY10	FY11*
	(In billions of Rs.)							
Permanent Debt	424.8	468.8	570.0	526.2	617.1	685.7	802.0	1008.8
Floating Debt	557.8	516.3	542.9	778.2	1637.0	1904.6	2399.1	2853.9
Unfunded Debt	792.1	909.5	899.2	854.0	1021.3	1269.8	1457.2	1599.5
Total	1774.7	1894.5	2012.2	2158.4	3275.4	3860.1	4658.3	5462.2
	(In percent of GDP)							
Permanent Debt	9.7	9.7	10.1	8.1	6.0	5.4	5.4	5.6
Floating Debt	12.7	10.7	9.6	12.0	16.0	15.0	16.2	15.8
Unfunded Debt	18.0	18.9	15.9	13.1	10.0	10.0	9.8	8.9
Total	40.3	39.3	35.7	33.2	32.0	30.3	31.4	30.2
	(In percent of Total Debt)							
Permanent Debt	23.9	24.7	28.3	24.4	18.8	17.8	17.2	18.5
Floating Debt	31.4	27.3	27.0	36.1	50.0	49.3	51.5	52.2
Unfunded Debt	44.6	48.0	44.7	39.6	31.2	32.9	31.3	29.3
Memo:								
GDP (in billion of RS.)	4401.7	4822.8	5641	6500	10243	12724	14837	18063

* End-March

Source: Budget Wing, Ministry of Finance

The purpose of issuance was to raise money from Islamic banking which has grown substantially in Pakistan in recent years. Moreover, issuance of *Sukuk* has emerged out as an acceptable addition

to limited investment avenues for Islamic banks to meet their SLR eligibility.

ii . Floating Debt

Floating debt consists of short term domestic borrowing instruments such as Treasury Bills and central bank borrowing through the purchase of Market Related Treasury Bills (MRTBs). During July-March, 2011, the floating debt grew by 19 percent. Around 56.6 percent of the total increase in government debt stock was contributed by floating debt instruments during July-March, 2011.

Much of the proceeds accrued through Market Treasury Bills (MTBs) as Rs 410.2 billion was added to the stock of June 30, 2010. On the other hand, government borrowed Rs 44.8 billion by issuing Market Related Treasury Bills (MRTBs) to SBP. The growing share of floating debt in total domestic debt in recent years has shown an inordinate reliance on the shorter end of the sovereign yields curve. Debt structures rely heavily on short-term instruments are sources of vulnerability, because short average maturities entail high rollover and refinancing risk. In such cases, an increase in interest rates can have an adverse fiscal impact.

iii . Unfunded Debt

The wide array of instruments that fall under the National Savings Scheme is referred to as unfunded debt. The stock of unfunded debt stood at Rs 1599.5 billion on end-March 2011, having increased by Rs 142.3 billion or 9.8 percent in nine months as compared to 14.7 percent in fiscal year 2010. Net receipts in Regular Income Scheme were up by 26.5 percent in July-march, 2011, as the stock increased from Rs.135.6 billion in June, 2010 to Rs.171.5 billion at end-March 2011. Special Saving Certificates and Accounts witnessed relatively weak investment of Rs 45.1 billion when analyzed against the net receipts of Rs 93.2 billion in 2009-10.

Special NSS instruments (Bahbood Savings Certificates and Pensioner's Benefits Accounts) exhibited a tedious performance as Rs 59 billion were mobilized in July-March 2011 as compared to Rs 77.4 billion in 2009-10. Rates of return on NSS instruments were revised upwards in October 2010 and January 2011 in response to an increase in the benchmark discount rate.

Domestic Debt Burden

During 1999-2000 to 2005-06, fiscal control and soaring growth rates surfaced out to be prime reasons behind shrinkage in interest payments as a percentage of major macroeconomic indicators analogous to a cut in the external debt. Since 2006-07, domestic debt witnessed a sharp rise with consequent build-up in the interest payments. Interest payments as percent of GDP has peaked to 4.4 percent of GDP in 2008-09 but since then declined persistently to 2.5 percent of GDP in 2010-11. This also incorporates impact of higher nominal GDP growth. Higher fiscal deficit and enormous slippages in the revenue and expenditure targets remained key problems. Supplementing to the intensity of the situation was a policy overhang and the monetization of the deficit through central bank borrowings.

Interest payments as a percentage of revenue (tax as well as total revenue) gauge the absorbing capacity of government revenues in terms of interest payments on domestic debt. The growth in revenues outperformed that of interest obligations, resulting in a diminution of interest payment as a percent of tax revenue from 51.8 percent in 1999-2000, to 25.2 percent in 2005-06. Since then a persistent rise in interest-to-tax revenues ratio led to reach at peak of 46.4 percent in 2008-09. Higher nominal growth in tax revenues muted the rise and the ratio declined to 25.2 percent during July-March 2010-11. Interest payments as a percentage of total revenues attenuated from 41 percent in 1999-2000 to 18.8 percent in 2005-06 but bounced back to 30.2 percent in 2008-09 only to decrease to 19.1 percent in 2010-11.

Pakistan's Link with International Capital Market

The crisis gripping financial markets worldwide has meant that capital flows have all but dried up. As uncertainty about risk prevails and investors look to shore up their losses, capital flows to emerging markets have been curtailed. Sovereigns have, in most cases, been deterred from new issuances by market sentiment in the aftermath of European debt crisis. Global bond issuances have slowed down. Spreads on emerging market sovereign bonds have also widened substantially,

making access to financing through capital markets, if available at all, very costly. The Emerging Market Bond Index, a benchmark index for measuring the total return performance of international government bonds issued by emerging market countries, has increased, implying an increase in costs for tapping international debt capital markets. As negative sentiments prevail, the situation for Pakistan is compounded by weaker economic performance in 2010-11 and a highly volatile domestic security situation. The spread on Pakistani sovereign bonds as given by the EMBI have gone up by 860 bps and have a rating of B3/B-. Given the severity of the crisis in international markets, and hesitance with respect to investor confidence, Pakistan has not issued any new instruments since 2006. However, following the government's

stabilization program and a restoration of economic fundamentals, signs of recovery are visible, just as the global economy has exhibited momentum in the revival process. The government plans to continue to tap the global capital markets, when conditions are more favorable, with the aim of establishing a benchmark for Pakistan and to assure global investors of Pakistan's commitment to the development of its capital market. Given the performance and prospects of oil and gas sector in Pakistan, the government is closing an OGDCL exchangeable bond of USD 500 million before the end of this fiscal. By regaining investor confidence and being active in international debt capital markets, spreads on Pakistani paper can be narrowed, providing the government with greater financing options.

Table-9.10: Domestic Debt & Domestic Interest Payments Burden

Year	Domestic Outstanding Debt	Interest Payments	Domestic Interest Payment (in percent of)				
			Tax Revenue	Total Revenue	Total Expenditure	Current Expenditure	GDP
			(Rs. billions)		(Percent)		
2001-02	1774.7	189.5	39.6	30.4	22.9	27.1	4.3
2002-03	1894.5	166.9	30.0	23.2	18.6	21.1	3.4
2003-04	2012.2	161.5	26.4	20.3	16.9	20.8	2.9
2004-05	2158.4	176.3	26.7	19.6	15.8	20.4	2.7
2005-06	2336.8	191.4	25.2	18.8	14.4	19.6	2.7
2006-07	2610.3	318.9	32.3	22.1	16.0	20.9	3.7
2007-08	3274.6	430.2	40.9	28.7	18.9	23.2	4.2
2008-09	3860.4	558.7	46.4	30.2	22.1	27.4	4.4
2009-10	4653.8	578.3	38.6	27.9	19.2	23.3	3.9
2010-11*	5462.2	457.0	25.2	19.1	13.8	16.5	2.5

* End March

Source: Budget Wing (MoF) and EA Wing

Recent Performance of 2017 and 2036 Eurobonds

In line with developments in global debt capital markets, Pakistan has witnessed an increase in spreads on its 2016, 2017 and 2036 Eurobonds in the first nine months of 2010-11. Though some stability has been regained due to initiatives taken

by the government under IMF SBA, it has not been enough to overcome the negative sentiment surrounding markets in general and the socio-political risk associated with Pakistan. In the absence of a credit rating upgrade for Pakistan, as compared to the issue spread of UST + 200 bps, the 2017 bond is trading currently at a spread of UST +860 bps [Table 9.11].

Table-9.11: Selected Secondary Market Benchmarks (as of May 23, 2011)

Issuer	Ratings (Moody's/S&P)	Coupon (%)	Maturity	Spread over UST (bps)	Bid - Yield (%)
Pakistan	B3/B-	7.125	Oct 2016	824	10.043
Pakistan	B3/B-	6.875	Jan 2017	860	10.406
Pakistan	B3/B-	7.875	Jun 2036	681	11.086
Philippines	Ba3/BB	8.000	Jan 2016	104	2.842
Vietnam	B1/BB-	6.875	Jan 2016	383	5.632
Indonesia	Ba1/BB	11.625	Mar 2019	141	4.564
Sri Lanka	NR/B+	7.400	Jan 2015	278	4.583

Source: Bloomberg, JP Morgan May23, 2011

The 2036 bond, as compared to the issue spread of UST + 302bps and a spread of 1361 bps last year, is trading currently at a spread of UST + 681 bps. The 2036 bond was the

longest ever tenor achieved by Pakistan. Both the 10 and 30 year offerings were debut offerings for Pakistan which extended the yield curve to 30 years.