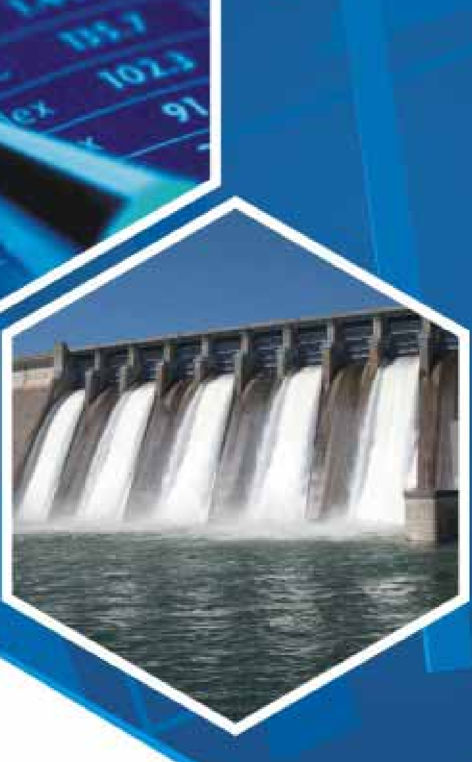
Debt Policy Statement
2012-13



Debt Policy Coordination Office
Ministry of Finance

Debt Policy Statement

2012-13

Debt Policy Coordination Office
Ministry of Finance

Table of Contents

Acknowledgements

This Policy Statement has been prepared to fulfil the requirement laid out under Section 7 of the Fiscal Responsibility and Debt Limitation Act 2005. I would like to acknowledge the input of various Ministries, Departments, Divisions and Agencies, particularly, timely data provision by Budget Wing (MoF), Economic Affairs Division. I would like to recognize the effort put in by Dr. Imtiaz Ahmed, Joint Secretary (DPCO), Muhammad Umar Zahid, Financial Analyst (DPCO) and Arsalan Ahmed, Financial Analyst (DPCO) in the realization of this comprehensive document.

Masroor Ahmed Qureshi
Director General
Debt Policy Coordination Office
Ministry of Finance

Lists of Tables & Figures

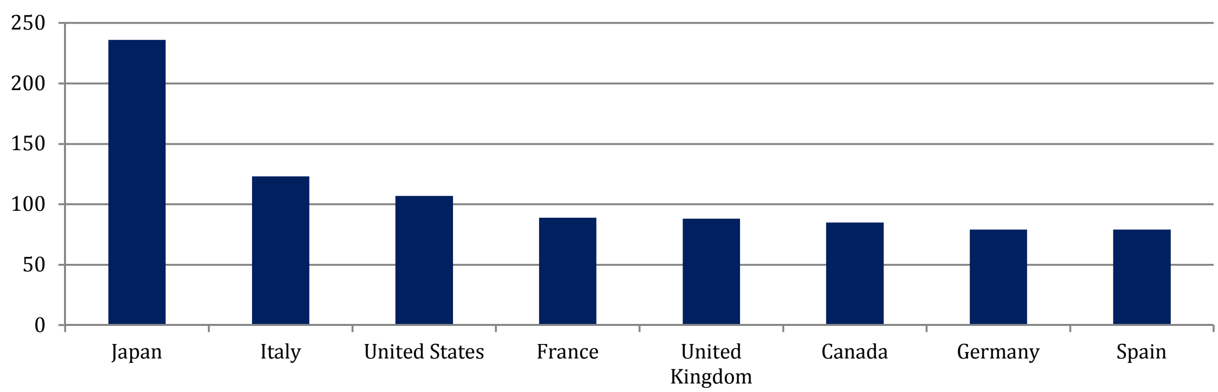
1 - Introduction

1.1. The relationship between debt and growth is not simple. There are many factors that matter for a country's growth and debt performance and there is no single threshold for debt ratios that can delineate the "bad" from the "good". Evidence suggests that a country's debt level positively impacts its growth even when it enters the threshold level if it is on a declining debt trajectory. As the global economy is immersed on a double track growth, developing countries are growing faster than developed countries, making it easier for developing countries to satisfy the condition and ride on declining debt trajectory and therefore enjoy a positive relationship between economic growth and debt levels. Debt would only act as a catalyst in the course of growth of a developing economy provided it is undertaken to facilitate a well thought out road map devised with due diligence.

1.2. Historically, numerous economies have seen debt burdens high or even higher than those prevailing today. A brief analysis of their history suggests three primary lessons. First, a growth supporting policy mix is inevitable for debt reduction and fiscal consolidation. Second, fiscal consolidation must emphasize persistent, structural reforms to public finances over temporary or short-lived fiscal measures. Third, reducing public debt is bound to be time consuming, especially in the context of a weak external environment.

1.3. Public debt in advanced economies achieved new highs. In Japan, the United States, and several European countries, it has exceeded 100 percent of GDP. Low growth, persistent fiscal deficits, high future and contingent liabilities stemming from subsidies and weak financial sectors have markedly heightened concerns about the sustainability of public finances. Dwindling sovereign ratings and higher borrowing costs are indicative of such concerns. Correcting fiscal imbalances and reducing public debt have therefore become high priorities.

Fig-1: Developed Economies - Public Debt as percent of GDP (2012)



Source: IMF Word Economic Outlook, October, 2012

1.4. The economy of Pakistan has witnessed moderate economic growth due to tough challenges on external and internal fronts in past years' including campaign against extremism, fragile law and order situation, continuing energy shortages, non-materialization of external inflows, unprecedented calamity of floods in 2010, torrential rain in Sindh in 2011 and increasing debt servicing requirement. The debt to GDP ratio has hovered around 60 percent since 2007-08. In order to fulfill the developing needs of Pakistan, absolute values of public debt has risen, while the GDP has also increased in juxtaposition.

1.5. The composition of public debt has witnessed major changes over past few years with increasing reliance on domestic debt owing to lower external debt flows. The composition of major components shaping the domestic debt portfolio has itself undergone a transformation from a high dominance of unfunded debt to an increasing dependence on short term floating debt which is a source of vulnerability as it entail high rollover and refinancing risk. In such cases, an increase in interest rates has an adverse fiscal impact. Maintaining exchange rate stability is also a pre-requisite for external debt sustainability i.e. on an average, 66 percent of total increase in external debt is caused by the unfavourable movement of exchange rates since 2007-08. Going forward, it highlights the importance of maintaining exchange rate stability and regaining growth momentum to reduce the impact of growing external indebtedness.

1.6. Government of Pakistan has embarked upon a rule based policy necessary for fiscal consolidation and debt management incorporated in Fiscal Responsibility and Debt Limitation Act (FRDLA), 2005. Such fiscal consolidation is marked by persistent, structural reforms to public finances over myopic fiscal measures. According to it, the following statement put out the total public debt in detail and highlights the portions where the government had been successful or failed in achieving the targets.

2 - Debt Policy Statement

2.1. The Debt Policy Statement is presented to fulfill the requirement in Section 7 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. 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.

3 - Principles of Sound Debt Management

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

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

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

3.4. 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.

3.5. 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.

4. Review of Public Debt

4.1. The total public debt stood at Rs.12,667 billion as on June 30, 2012, an increase of Rs.1,967 billion or 18.4 percent higher than the debt stock at the end of last fiscal year. This rise is mainly attributed to:

i. Slippages in both revenues and expenditures led to fiscal deficit at 1,370 billion or 6.6 percent of GDP.

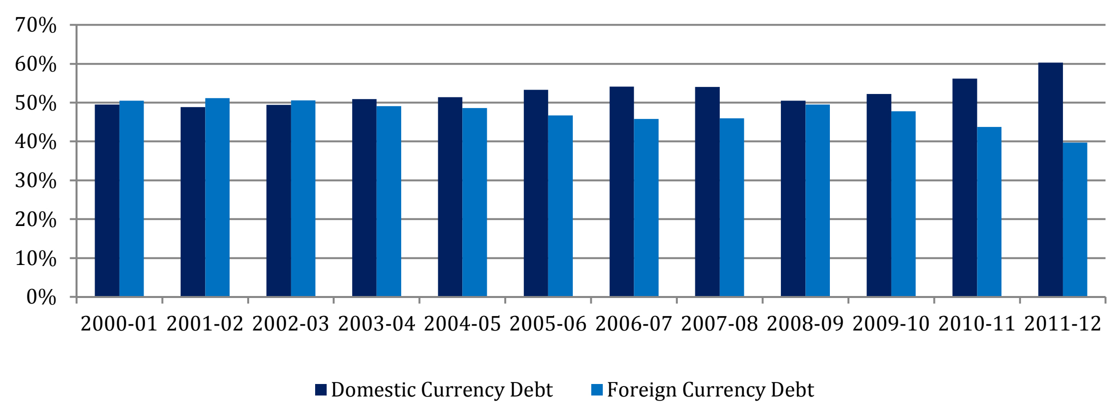
Increased demands on the government budget for purposes of interest servicing, security and subsidies which constituted 60.9 percent of the revenue meant that expenditure was fairly rigid even in the face of a committed effort to rationalize expenditure and curtail the fiscal deficit. Government borrowed Rs.1,241 billion from domestic sources and Rs.129 billion from external sources to finance its fiscal operations.

ii. In November 2011, government consolidated Rs.391 billion into public debt against the past years' unpaid subsidy claims of power and commodity sector.

iii. The remaining increase in public debt was caused by adverse movement of exchange rate on the external debt.

4.2. Historically, public debt stock accounted for almost the same burden from domestic and external sources. However, government has increasingly focused on the domestic part over the last few years owing to non-availability of sufficient external financing i.e. domestic borrowings inched up in share from 50.5 percent in 2008-09 to 60.3 percent of total public debt at the end of 2011-12.

Fig-2: Sources of Public Debt (Percent)



4.3. The external debt component grew by Rs.345 billion or 7.4 percent over last fiscal year. During 2011-12, appreciation of the US Dollar against other major currencies caused the foreign currency component of public debt to decrease by US$ 1,740 million, however, it was subdued by depreciation of Pak Rupee against US Dollar by 10 percent. This capital loss on foreign currency debt, however, is mitigated by the strong concessionality element associated with Pakistan's external loans. The impact of any currency shock should not be looked at in isolation, but rather be analyzed in the context of interest rate differential.

4.4. Total public debt stood at Rs.13,199 billion at the end of first quarter 2012-13, thereby, registered an increase of Rs.532

billion or 4.2 percent in first three months of current fiscal year. The government was able to contain fiscal deficit at 1.2 percent of GDP for July-September, 2012 largely because of Rs.109 billion provincial budget surpluses and US$ 1.12 billion reimbursed by the United States on account of the Coalition Support Fund (CSF) that helped restricted the growth in public debt. The primary source of increase in public debt during first quarter 2012-13 remained the local currency component that accounted for 91 percent of the total increase in public debt. The first quarter of the current fiscal year noticed a capital loss of US$ 721 million owing to US Dollar depreciation against other major international currencies.

Table-1: Public Debt, 2008-2013*

	2008	2009	2010	2011	2012 (P)	2013*
	(Rs. in billion)					
Domestic Debt	3,266.0	3,852.5	4,651.4	6,015.5	7,637.0	8,120.7
External Debt	2,778.0	3,776.2	4,259.9	4,684.9	5,030.2	5,078.6
Total Public Debt	**6,044.0**	**7,628.6**	**8,911.3**	**10,700.5**	**12,667.2**	**13,199.3**
	(In percent of GDP)					
Domestic Debt	31.9	30.3	31.4	33.4	37.0	34.3
External Debt	27.1	29.7	28.8	26.0	24.4	21.5
Total Public Debt	**59.0**	**60.0**	**60.2**	**59.3**	**61.3**	**55.8**
	(In percent of Revenue)					
Domestic Debt	217.8	208.1	223.8	267.0	297.6	-
External Debt	185.3	204.0	205.0	208.0	196.0	-
Total Public Debt	**403.1**	**412.2**	**428.8**	**475.0**	**493.6**	-
	(In percent of Total Debt)					
Domestic Debt	54.0	50.5	52.2	56.2	60.3	61.5
External Debt	46.0	49.5	47.8	43.8	39.7	38.5
Memo:						
Foreign Currency Debt (US$ in billion)	40.7	46.4	49.8	54.5	53.2	53.6
Exchange Rate (Rs./US$, End of Period)	68.3	81.4	85.5	86.0	94.5	94.8
GDP (Rs. in billion)	10,242.8	12,724.0	14,804.0	18,033.0	20,654.0	23,655.0
Total Revenue (Rs. in billion)	1,499.4	1,850.9	2,078.2	2,252.9	2,566.5	-

P: Provisional
*end-September 2012

Source: Budget Wing, Economic Affairs Division, State Bank of Pakistan & Debt Policy Coordination Office Staff Calculations

Note: The Debt to GDP ratio would have been 59.4 percent in 2011-12 had the government not consolidated Rs.391 billion into Public Debt.

5 - Dynamics Of Public Debt Burden

5.1. Borrowing domestically or externally is normal, indeed, necessary part of economic activity. The economic rationale for debt creation is that borrowers can earn a higher economic return than the cost of invested funds and that these economic returns can then be translated into financial returns. Debt problems for governments arise if debt-servicing capacity does not keep pace with growth of debt. This may also be expressed as debt exceeding sustainable levels.

5.2. 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 the 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 the 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 into revenues, particularly in case of Pakistan where the taxation systems are inelastic and the taxation machinery is weak.

Table-2: Selected Debt Indicators

	2008	2009	2010	2011	2012
Real Growth of Public Debt	8.3	5.2	3.9	1.6	7.9
Real Growth of Revenues	(0.6)	2.9	(0.1)	(8.3)	3.9
Real Growth of Debt Burden	8.9	2.3	4.0	9.9	4.1
Revenue Balance / GDP*	(3.2)	(1.2)	(1.7)	(3.3)**	(2.5)***
Primary Balance / GDP*	(2.5)	(0.1)	(1.6)	(2.5)**	(2.2)***
Fiscal Balance / GDP	(7.6)	(5.3)	(6.3)	(6.0)**	(6.6)***
Real Growth in Non Interest Expenditure	17.7	(11.7)	11.1	(1.7)	1.1
Real Growth of GDP	3.7	1.7	3.1	3.0	3.7
Public Debt / GDP	59.0	60.0	60.2	59.3	61.3
Public Debt / Revenue	403.1	412.2	428.8	475.0	493.6
Debt Service / Revenue	37.2	46.6	40.4	38.0	39.9
Debt Service / GDP	5.5	6.8	5.7	4.7	5.0

*Adjusted for grants
**excludes arrears of electricity subsidies amounting Rs.120 billion
***excludes, "one off" payment of Rs.391 billion on account of debt consolidation

Source: Debt Policy Coordination Office Staff Calculations, Finance Division

5.3. Revenue balance is the total revenue adjusted for current expenditure. The revenue deficit stood at Rs.521 billion or 2.5 percent of GDP in 2011-12. .

5.4. Primary balance is the total revenue adjusted for non-interest expenditure. The primary deficit reached 2.2 percent of GDP at the end of June 2012.

5.5. Pakistan’s fiscal deficit over the last few years saw significant variation from its original targets. The fiscal deficit during 2011-12 is recorded at 6.6 percent of GDP (excluding “one off” payment of Rs.391 billion) against 6 percent (excluding “one off” payment of Rs.120 billion) during 2010-11. The higher fiscal deficit is adding to public debt and pre-empting a major chunk of revenues to service it i.e. for 2011-12, nearly 39.9 percent of total revenues have been consumed in debt servicing against a ratio of 38 percent in 2010-11. Moreover, financing mix of deficit is an area of concern as it is skewed towards domestic sources particularly on bank borrowing.

5.6 The real growth of debt (7.9 percent) has been greater than the real growth of revenues (3.9 percent); and, this complemented by the primary deficit resulted in increase of the debt burden during 2011-12. The public debt stood at 4.9 times of government revenues at the end of fiscal year 2011-12, ideally this ratio should be 3.5 times or lower.

Fig-3: Real Growth in Revenue, Public Debt and Debt Burden (percent)

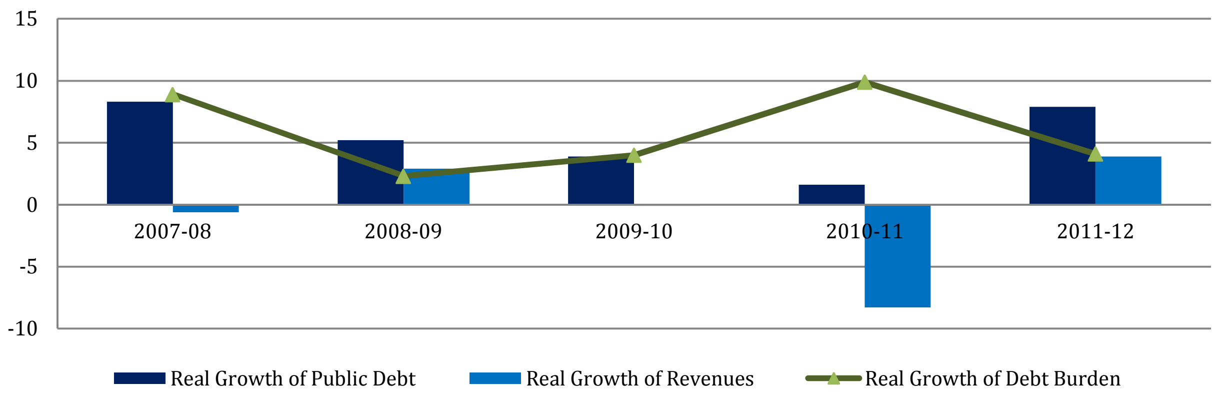
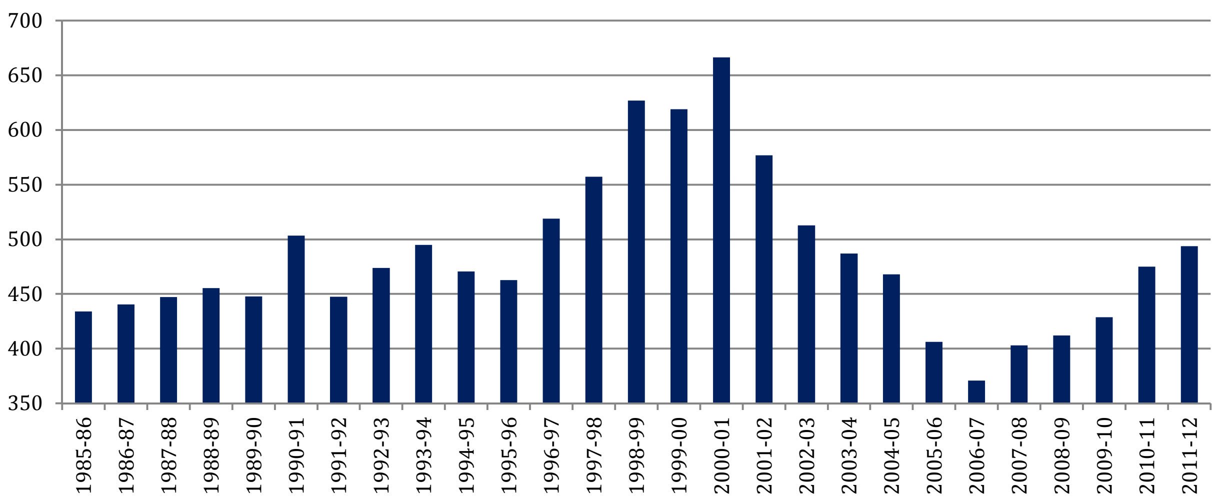
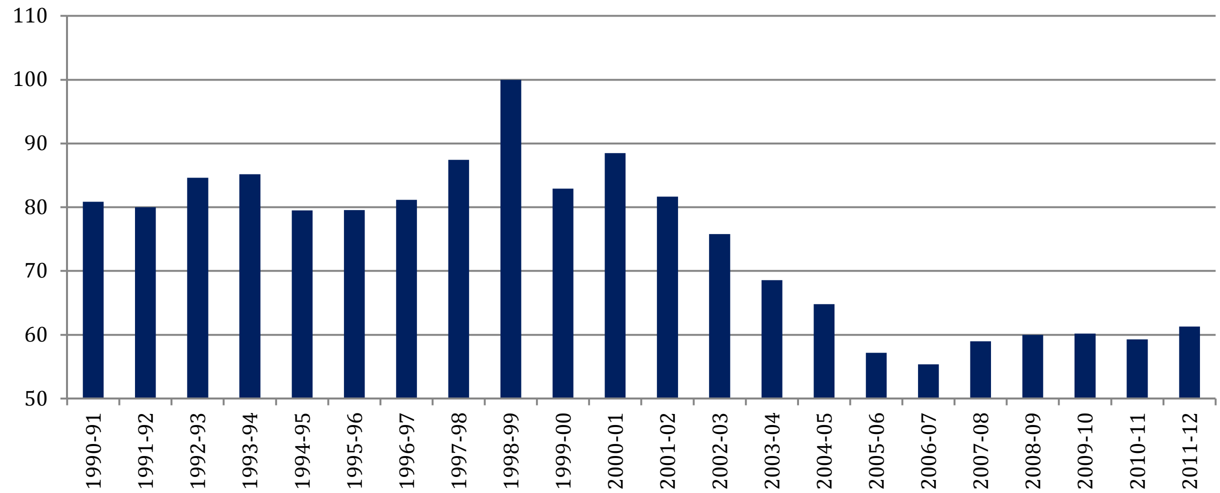


Fig-4: Public Debt (as percent to Revenue)



5.7. The government consolidated Rs.391 billion or 1.9 percent into public debt in 2011-12 against outstanding previous years subsidies related to the food and energy sectors due to which Public Debt to GDP exceeded the threshold (60 percent) and stood at 61.3 percent of the GDP. This would have been 59.4 percent had the government not consolidated Rs.391 billion into public debt.

Fig-5: Public Debt (as percent to GDP)



6.- Servicing of Public Debt

6.1. Increase 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 future. In order to meet debt servicing obligations, an extra burden is placed on limited government resources and may costs in the shape of foregone public investment or expenditure in other sectors of the economy.

Table-3: Public Debt Servicing (2011-12)

	Budgeted	Actual	% of Revenue	% of Current Expenditure
	(Rs. in billion)			
Servicing of External Debt	76.3	67.9	2.6	2.2
Repayment of External Loans	243.2	135.3	5.3	4.3
Servicing of Domestic Debt	714.7	821.1	32.0	26.3
Servicing of Public Debt	**1,034.2**	**1,024.3**	**39.9**	**32.8**

Source: Budget Wing & Debt Policy Coordination Office Staff Calculations

6.2. In 2011-12, public debt serving stood at Rs.1,024 billion against Rs.856 billion paid during the last fiscal year. Public debt servicing consumed nearly 39.9 percent of total revenues in 2011-12 against a ratio of 38 percent in last fiscal year. Out of total, domestic debt servicing stood at Rs.821 billion against the budgeted estimate of Rs.715 billion.

Table-4: Break-up of Domestic Debt Servicing (2011-12)

	Budgeted	Actual
	(Rs. in billion)	
1- Permanent Debt	**104.9**	**142.8**
- Prize Bonds	24.4	26.9
- Pakistan Investment Bonds	54.9	81.7
- Government Ijara Sukuk	24.1	32.6
- Others	1.5	1.6
2- Floating Debt	**345.9**	**379.5**
- Treasury Bills	195.9	214.5
- Market Related Treasury Bills	150.0	165.0
3- Unfunded Debt	**262.3**	**298.0**
- National Saving Schemes	253.9	298.0
- Others (Postal Life Insurance, Provident Funds)	8.5	0.0
4- Others	**1.5**	**1.5**
Total (1+2+3+4)	**714.7**	**821.1**

Source: Budget Wing, Finance Division

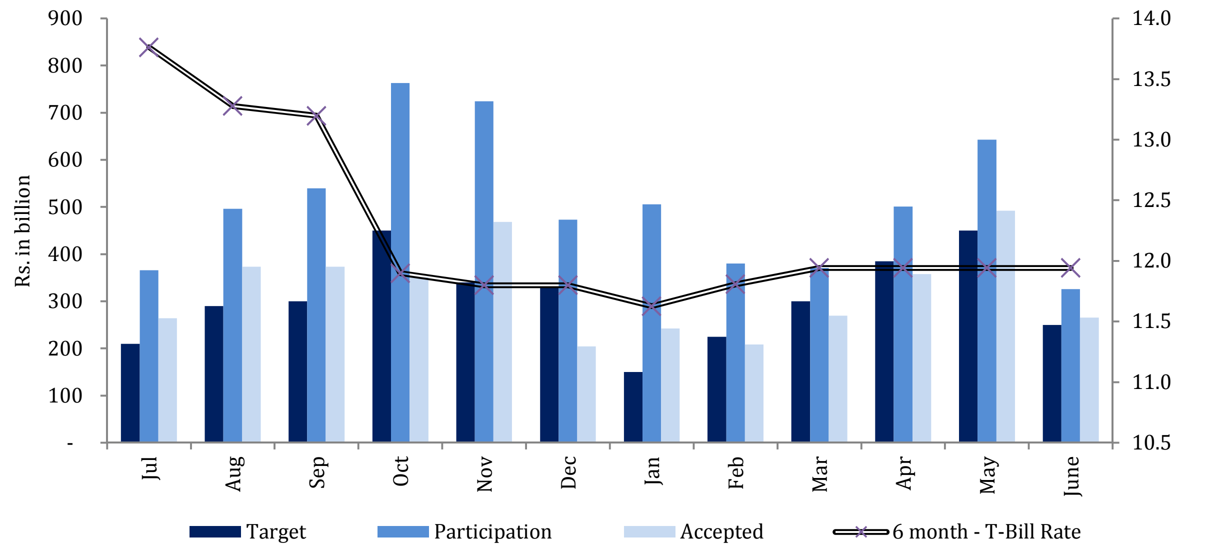
6.3. Out of total repayment of foreign loans, government paid Rs.97 billion and 37 billion to multilateral and bilateral donors respectively.

7 - Domestic Debt

7.1. Pakistan's domestic debt comprises permanent debt (medium and long-term), floating debt (short-term) and unfunded debt (made up of the various instruments available under the National Savings Scheme) having shares of 22.2 percent, 54.2 percent and 23.5 percent respectively in total domestic debt as on June 30, 2012. Permanent Debt mainly consists of medium to long term instruments including Pakistan Investment Bonds (PIBs), Government Ijara Sukuk bond, Prize Bond etc. 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). Treasury Bills are zero coupon or discounted instruments issued in tenors of 3 months (introduced in 1997), 6 months (introduced in 1990) and 12 months (introduced in 1997). Unfunded Debt made up of the various instruments available under the National Savings Scheme (NSS). A number of different schemes are offered under NSS in the investment horizon of 3 years to 10 years.

7.2. Domestic debt stood at Rs.7,637 billion as on June 30, 2012, an increase of Rs.1,621 billion or 27 percent as compared to 2010-11. This increase mainly stems from net issuance of Treasury bills (Rs.466 billion), Market Related Treasury Bills (Rs.442 billion), PIBs (Rs.356 billion) and Government Ijara Sukuk (Rs.159 billion). 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 the auctions of T-Bills, PIBs and Government Ijara Sukuk.

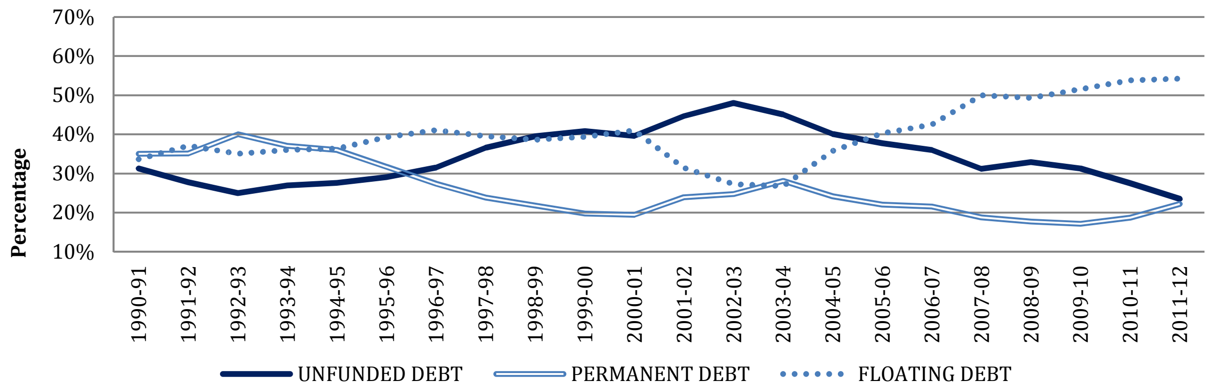
Fig-6: Auction Profile of T-Bills, PIBs and GIS (2011-12)



7.3. In relation to GDP, the domestic debt stood at 37 percent which is higher than end-June 2011 level of 33.4 percent. The focus on deficit financing through internal sources owing to lower external receipts has been the major cause. The composition of major components shaping the domestic debt portfolio has undergone a transformation from a high dominance of unfunded debt to an increasing dependence on floating component of the domestic debt. The unfunded category comprising about 44.6 percent of the aggregate domestic debt stock in 2001-02 has declined to 23.5 percent by 2011-12. Contrary to this, the share of floating debt to total domestic debt has reached 54.2 percent by end-June 2012 as compared to 31.4 percent in 2001-02 indicating an over reliance on shorter duration instruments.

7.4. The growing share of floating debt in total domestic debt in recent years has meant an inordinate reliance on the shorter end of the sovereign yield curve. Debt structures that 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 will have adverse fiscal impact. Debt structures that are too short or allow for bumps in the maturity profile can potentially generate confidence crises, fuelled by investors' concerns that the government will not have sufficient funds to repay its obligations when they fall due.

Fig-7: Composition of Domestic Debt



7.5. As on June 30, 2012, duration of domestic debt stood at 1.9 years – excluding SBP Market Related Treasury Bills (MRTBs) – and duration including MRTBs stood at 1.6 years. Out of total domestic debt, Rs.2,461 billion or 32.2 percent of total domestic debt has maturity of less than a year which is causing lower duration and also raises the rollover or refinancing risk for the government. If outstanding MRTBs for the amount of Rs.1,759 billion are also included, 55.3 percent of total domestic debt would have a maturity of less than a year.

Table-5: Outstanding Domestic Debt **(Rs. in billion)**

	2008	2009	2010	2011	2012(P)	2013*
Permanent Debt	**616.8**	**685.9**	**797.7**	**1125.6**	**1,696.9**	**1,846.9**
Market Loans	2.9	2.9	2.9	2.9	2.9	2.9
Government Bonds	9.4	7.3	7.2	0.7	0.7	0.7
Prize Bonds	182.8	197.4	236.0	277.1	333.4	350.5
Foreign Exchange Bearer Certificates	0.2	0.2	0.1	0.1	0.1	0.1
Bearer National Fund Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Federal Investment Bonds	1.0	1.0	0.0	0.0	0.0	0.0
Special National Fund Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Foreign Currency Bearer Certificates	0.0	0.0	0.0	0.0	0.0	0.0
U.S. Dollar Bearer Certificates	0.0	0.0	0.0	0.0	0.0	0.0
Special U.S. Dollar Bonds	8.3	7.7	2.7	1.0	0.9	0.9
Government Bonds Issued to SLIC	0.6	0.6	0.6	0.6	0.6	0.6
Pakistan Investment Bonds (PIB)	411.6	441.0	505.9	618.5	974.7	1,075.0
Government Bonds issued to HBL	0.0	0.0	0.0	0.0	-	-
GOP Ijara Sukuk	0.0	27.8	42.2	224.6	383.5	416.2
Floating Debt	**1,637.4**	**1,904.0**	**2,399.1**	**3,235.4**	**4,143.1**	**4,339.0**
Treasury Bills through Auction	536.4	796.1	1,274.1	1,817.6	2,383.4	2,759.6
Rollover of Treasury Bills discounted SBP	0.6	0.5	0.5	0.5	0.5	0.5
Treasury Bills purchased by SBP (MRTBs)	1,100.4	1,107.3	1,124.4	1,417.3	1,759.2	1,578.9
Unfunded Debt	**1,020.4**	**1,270.5**	**1,457.5**	**1,655.8**	**1,798.0**	**1,935.8**

Table-5: Outstanding Domestic Debt						(Rs. in billion)
	2008	2009	2010	2011	2012(P)	2013*
Defence Savings Certificates	284.6	257.2	224.7	234.5	241.8	259.7
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	27.7	16.8	17.8	17.2	21.2	19.1
Mahana Amadni Account	2.5	2.4	2.2	2.1	2.0	2.0
Postal Life Insurance	67.1	67.1	67.1	67.1	67.1	67.1
Special Savings Certificates and Accounts	227.6	377.7	470.9	529.1	537.4	624.2
Regular Income Scheme	51.0	91.1	135.6	182.6	226.6	238.7
Pensioners' Benefit Account	87.7	109.9	128.0	146.0	162.3	167.0
Bahbood Savings Certificates	229.0	307.5	366.8	428.5	480.8	496.6
National Savings Bonds	-	-	3.6	3.6	3.6	3.6
G.P. Fund	42.5	40.1	39.9	44.3	54.5	55.0
Short Term Savings Certificates	-	-	-	-	-	2.2
Total Domestic Debt	**3,274.5**	**3,860.4**	**4,654.3**	**6,016.7**	**7,638.1**	**8,121.7**
Total Domestic Debt (excluding foreign currency debt included in external debt)	**3,266.0**	**3,852.5**	**4,651.4**	**6,015.5**	**7,637.0**	**8,120.7**

P: Provisional

*end-September,2012

Source: State Bank of Pakistan, Budget Wing & Debt Policy Coordination Office Staff Calculations

The following section highlights the developments in the various components of domestic debt during 2011-12.

I. Permanent Debt

7.6. The share of permanent debt in the government's total domestic debt stood at Rs.1,696 billion as at end-June 2012 compared to Rs.1,124 billion in 2010-11 registering an increase of Rs.571 billion. The share of permanent debt in total domestic debt inched up from 18.7 percent in 2010-11 to 22.2 percent at end June, 2012. Sizeable receipts from Government Ijara Sukuk bond and Pakistan Investment Bonds contributed to this expansion. Government mopped up net of retirement Rs.159 billion through successful auctions of Ijara Sukuk bond and Rs.356 billion through Pakistan Investment Bonds during 2011-12.

II. Floating Debt

7.7. Floating Debt share in overall public debt and domestic debt stood at 32.7 percent and 54.2 percent respectively as at end-June 2012. During 2011-12, the floating debt grew by Rs.908 billion or 28 percent. Around 56 percent of the total increase in government domestic debt stock was contributed by floating debt instruments during 2011-12. Much of the proceeds accrued through Market Treasury Bills (MTBs) as Rs.466 billion was added to the stock of June 30, 2011. On the other hand, government borrowed Rs.442 billion by issuing Market Related Treasury Bills (MRTBs) to SBP.

III. Unfunded Debt

7.8. The share of unfunded debt in the government's domestic debt stood at Rs.1,798 billion or 23.5 percent on end-June 2012. The stock of unfunded debt increased by Rs.142 billion or 8.6 percent compared to 2010-11. Net receipts in Regular Income Scheme were up by 24.1 percent, as the stock increased from Rs.183 billion in 2010-11 to Rs.227 billion at end-June 2012. Special NSS Schemes including Bahbood Savings Certificates and Pensioner's Benefits Accounts registered a combined increase of Rs.69 billion or 11.9 percent as compared with 2010-11.

7.9. CDNS plays an important role in mobilizing retail savings in the economy. Over past few years, government took various measures to rationalize the National Savings Schemes including linkage of profit rates on major NSS instruments with PIBs yield, levy of withholding tax on profits, service charges/penalty interest on early redemption and introduction of several new schemes to meet the diverse investor base demand. However, interest rate arbitrage – due to time lag involved in resetting the profit rates – and put option embedded in most of NSS instruments remained the source of vulnerability.

7.10. The rate setting should be dynamic and more closely aligned to the domestic market yield curve. Government should also 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 restructuring – capacity building and conversion of CDNS into vibrant customer centric distribution channel for government debt instruments – and complete automation of CDNS operations. Given the huge potential of mobilizing domestic savings, a restructured and well-equipped CDNS can be strategically used to promote outreach of financial services to remote areas.

Table-6: Causative Factors in Change in Stock of Domestic Debt (Rs. in billion)

	Stock	Stock	Receipts	Repayments	Net Investment
	2010-11	2011-12	(in 2011-12)		
Permanent Debt	**1,125.6**	**1,696.9**	**947.4**	**376.1**	**571.4**
Market Loans	2.9	2.9	-	-	-
Government Bond	0.7	0.7	-	-	-
Prize Bonds	277.1	333.4	162.2	105.9	56.3
Foreign Exchange Bearer Certificates	0.1	0.1	-	0.0	(0.0)
Bearer National Fund Bonds	0.0	0.0	-	-	-
Federal Investment Bonds	0.0	0.0	-	-	-
Special National Fund Bonds	0.0	0.0	-	-	-
Foreign Currency Bearer Certificates	0.0	0.0	-	0.0	(0.0)
U.S. Dollar Bearer Certificates	0.0	0.0	-	-	-
Special U.S. Dollar Bonds	1.0	0.9	-	0.1	(0.1)
Government Bonds Issued to SLIC	0.6	0.6	-	-	-
Pakistan Investment Bonds (PIBs)	618.5	974.7	598.4	242.2	356.2

Table-6: Causative Factors in Change in Stock of Domestic Debt (Rs. in billion)

	Stock	Stock	Receipts	Repayments	Net Investment
	2010-11	2011-12	(in 2011-12)		
Government Bonds issued to HBL	-	-	-	-	-
GOP Ijara Sukuk	224.6	383.5	186.8	27.8	158.9
Floating Debt	**3,235.4**	**4,143.1**	**6,833.4**	**5,925.6**	**907.8**
Treasury Bills through Auction	1,817.6	2,383.4	3,569.9	3,104.3	465.6
Rollover of Treasury Bills discounted SBP	0.5	0.5	-	-	-
Treasury Bills purchased by SBP (MRTBs)	1,317.0	1,759.2	3,263.5	2,821.3	442.2
Outright Sale of MTBs	100.3	-	-	-	-
Unfunded Debt	**1,655.8**	**1,798.0**	**796.9**	**654.6**	**142.2**
Defence Savings Certificates	234.5	241.8	50.4	43.1	7.3
Khas Deposit Certificates and Accounts	0.6	0.6	-	0.0	(0.0)
National Deposit Certificates	0.0	0.0	-	0.0	(0.0)
Savings Accounts	17.2	21.2	202.4	198.4	4.0
Mahana Amdani Account	2.1	2.0	0.4	0.5	(0.1)
Postal Life Insurance	67.1	67.1	-	-	-
Special Savings Certificates and Accounts	529.1	537.4	298.6	290.4	8.3
Regular Income Scheme	182.6	226.6	83.3	39.4	44.0
Pensioners' Benefit Account	146.0	162.3	34.4	18.0	16.4
Bahbood Savings Certificates	428.5	480.8	115.7	63.4	52.3
National Savings Bonds	3.6	3.6	-	-	-
G.P. Fund	44.3	54.5	11.6	1.4	10.2
Total Domestic Debt	**6,016.7**	**7,638.1**	**8,577.6**	**6,956.3**	**1,621.3**

Source: Budget Wing, Finance Division

7 (i) - Implications of Amendments in SBP Act

7.11. To check high borrowings, the Government promulgated an amendment in the State Bank of Pakistan Act, whereby it has committed (a) net zero quarterly borrowing from SBP baring ways and means limit and (b) repay SBP outstanding debt as of April 2011 in next 8 years. The government borrowed Rs.507.5 billion from SBP during 2011-12 as compared to retirement of Rs.17 billion during 2010-11. Moreover, total government borrowing from the State Bank stood at Rs.1,662 billion as on June 30, 2012. As required by the SBP Act, an average annual repayment of Rs.238 billion is essential for the next seven years to retire the outstanding debt stock prior to 30th April 2019. This will require higher generation of revenues and/or higher mobilization of external flows.

7 (ii) - Domestic Debt during Jul-Sep 2012

7.12. The domestic debt stood at Rs.8,121 billion at the end of the first quarter of 2012-13, representing a net increase of Rs.484 billion during the first three months of the current fiscal year. This increase mainly stems from a healthy issuance of market debt namely Treasury bills (Rs.376 billion) and PIBs (Rs.100 billion). The instruments under the NSS umbrella contributed Rs.86 billion to the total stock of domestic debt, bulk of which comes from the Special Savings Certificates, Defence Savings Certificates and Behbood Savings Certificates. The net retirement of SBP credit stood at Rs.412 billion during first quarter of 2012-13.

7.13. With a view to introduce more short term investment avenues, CDNS has launched Short Term Savings Certificates (STSC) in the first quarter of 2012-13 having maturities of 3, 6 and 12 months. The certificate is a replica of T-Bills for common savers, however, rate of return is priced @ 95% of comparable T-Bills of relevant maturities. The premature redemption facility is being offered to investors for resolving the liquidity issues, however, no profit will be paid in case of early redemption. Apart from providing competitive and market based return to common savers, the certificate would act as catalyst to shift the borrowing paradigm from inflationary and costly bank borrowing to non-inflationary and cost effective non-bank borrowing. An amount of Rs.2.2 billion was invested in Short Term Savings Certificates as on September 30, 2012.

8 - External Debt and Liabilities

8.1. Pakistan's External Debt and Liabilities (EDL) include all foreign currency debt contracted by the public and private sector, as well as foreign exchange liabilities of the Central Bank. EDL has been dominated by Public and Publically Guaranteed Debt having share of 70.4 percent. Debt obligations of the private sector are fairly limited and have been a minor proportion of EDL (6.8 percent). Borrowing from IMF contributed 11.1 percent in EDL Stock which was intended for Balance of Payment (BoP) support and is reflected in foreign currency reserves of the country.

8.2. EDL stock was recorded at US$ 65.8 billion as on June 2012, represented a decrease of US$ 0.5 billion as compared to 2011-12 majorly due to repayment of IMF loans and appreciation of US$ against other major currencies. As a percentage of GDP in dollar terms, EDL stock was down by 300 basis points in 2011-12 compared to 2010-11 and approximated to 28.5 percent. The stock of bilateral debt increased by US$ 96 million, whereas, multilateral debt witnessed a decrease of US$ 431 million during 2011-12. The outstanding stock of private sector debt increased by US$ 131 million and stood at US$ 4.5 billion. Additionally, an amount of US$ 500 million was arranged through bilateral sources to supplement Pakistan's foreign exchange reserves.

8.3. The first quarter of 2012-13 observed an increase of US$ 726 million in public and publically guaranteed debt and aggregated to US$ 47.1 billion. Multilateral and Bilateral Loans showed cumulative increase of US$ 703 million during first three months of 2012-13. IMF outstanding debt showed a decrease of US$ 333 million in the first quarter of 2012-13.

Table-7: Pakistan External Debt and Liabilities

	2008	2009	2010	2011	2012 (P)	2013*
	(US$ in billion)					
1. Public and Publically Guaranteed Debt	**40.6**	**42.6**	**43.1**	**46.5**	**46.3**	**47.1**
i) Public debt	40.4	42.4	42.9	46.4	46.1	46.9
A. Medium and Long Term(>1 year)	39.7	41.8	42.1	45.7	45.7	46.4
Paris Club	13.9	14.0	14.0	15.5	15.0	15.3
Multilateral	21.4	23.0	23.7	25.8	25.4	25.7
Other Bilateral	1.1	1.4	1.8	1.9	2.5	2.6
Euro Bonds/Saindak Bonds	2.7	2.2	1.6	1.6	1.6	1.6
Military Debt	0.0	0.2	0.2	0.1	0.1	0.1
Commercial Loans/Credits	0.1	0.2	-	-	-	-
Local Currency Bonds	0.0	-	0.0	0.0	-	-
Saudi Fund for Development	-	-	0.2	0.2	0.2	0.2
SAFE China Deposits	-	0.5	0.5	0.5	1.0	1.0
NBP/BOC Deposits	0.4	0.3	0.2	0.1	-	-
B. Short Term (<1 year)	0.7	0.7	0.9	0.6	0.4	0.4
IDB	0.7	0.7	0.8	0.6	0.4	0.4
Local Currency Securities (T-Bills)	0.0	-	0.1	0.0	0.0	0.0
ii) Publicly guaranteed debt	0.2	0.2	0.2	0.1	0.2	0.2
Paris Club	-	-	-	-	-	-
Multilateral	0.1	0.1	0.1	0.0	0.0	0.0
Other Bilateral	0.1	0.1	0.0	0.0	0.2	0.2
Commercial Loans/Credits	0.0	-	0.1	-	-	-
Saindak Bonds	-	-	-	-	-	-
2. Private Non-Guaranteed Debt (>1 year)	**1.9**	**2.4**	**3.8**	**4.4**	**4.5**	**4.5**
3. Public Sector Enterprises (PSEs Debt)	**1.0**	**0.9**	**1.4**	**1.3**	**1.3**	**1.4**
4. IMF	**1.3**	**5.1**	**8.1**	**8.9**	**7.3**	**7.0**
of which Central Government	-	-	1.1	2.0	1.9	1.9
Monetary Authorities	1.3	5.1	7.0	6.9	5.4	5.1
5. Banks	**-**	**-**	**0.7**	**1.1**	**1.8**	**1.8**
Borrowing	-	-	0.2	0.4	0.9	0.8
Nonresident Deposits (LCY & FCY)	-	-	0.6	0.7	1.0	1.0
6. Debt liabilities to direct investors - intercompany debt	**-**	**-**	**1.9**	**1.6**	**2.1**	**2.1**
Total External Debt (1 through 6)	**44.9**	**51.1**	**59.0**	**63.8**	**63.4**	**63.8**
7. Foreign Exchange Liabilities	1.3	1.3	2.6	2.6	2.4	2.4
Total External Debt & Liabilities (1 through 7)	**46.2**	**52.3**	**61.6**	**66.4**	**65.8**	**66.2**
(of which) Public Debt	**40.7**	**46.4**	**49.8**	**54.5**	**53.2**	**53.6**
Official Liquid Reserves	8.6	9.1	13.0	14.8	10.8	10.4

Table-7: Pakistan External Debt and Liabilities

	2008	2009	2010	2011	2012 (P)	2013*
	(US$ in billion)					
(in percent of GDP)						
Total External Debt (1 through 6)	**27.4**	**31.6**	**33.4**	**30.3**	**27.4**	**25.5**
1. Public and Publically Guaranteed Debt	24.9	26.3	24.4	22.0	20.0	18.8
A. Medium and Long Term(>1 year)	24.3	25.8	23.8	21.7	19.8	18.6
B. Short Term (<1 year)	0.4	0.4	0.5	0.3	0.2	0.2
2. Private Sector Debt	1.1	1.5	2.1	2.1	1.9	1.8
3. Public Sector Enterprises (PSEs) Debt	0.6	0.6	0.8	0.6	0.6	0.5
4. IMF	0.8	3.2	4.6	4.2	3.2	2.8
5. Banks	0.0	0.0	0.4	0.5	0.8	0.7
6. Debt liabilities to direct investors - Intercompany debt	0.0	0.0	1.1	0.8	0.9	0.8
7. Foreign Exchange Liabilities	0.8	0.8	1.5	1.2	1.0	1.0
Total External Debt & Liabilities (1 through 7)	**28.2**	**32.3**	**34.9**	**31.5**	**28.5**	**26.5**
Official Liquid Reserves	5.2	5.6	7.3	7.0	4.7	4.1
Memo:						
GDP (Rs. in billion)	10,242.8	12,724.0	14,804.0	18,033.0	20,654.0	23,655.0
Exchange Rate (Rs./US$, Period Average)	62.7	78.7	83.9	85.6	94.3	94.6
Exchange Rate (Rs./US$, End of Period)	68.3	81.4	85.5	86.0	94.5	94.8
GDP (US dollars in billion)	163.5	161.8	176.5	210.8	231.2	249.9

P: Provisional

*end-September,2012

Source: State Bank of Pakistan, Economic Affairs Division & Debt Policy Coordination Office Staff Calculations

8.4. The following section highlights the developments in the various components of EDL during 2011-12.

I. Public and Publicly Guaranteed Debt (PPG)

8.5. Public and publicly guaranteed debt is dominated by the loans from bilateral and multilateral donors having largest share of 70.4 percent in EDL. Multilateral debt is the largest component of Pakistan's EDL. It witnessed a decrease of US$ 431 million during 2011-12. The project-based nature of loans contracted under this category hinges on Pakistan's ability to instill project efficiency.

8.6. Debt from bilateral sources is the second largest component of EDL and includes loans contracted with Paris Club countries and other countries outside the Paris Club. The stock of bilateral debt went up by US$ 96 million during 2011-12.

II. <u>IMF Debt</u>

8.7. At the end-June 2012, debt owed to IMF aggregated up to US$ 7.3 billion out of which US$ 1.9 billion accrued to the federal government. The remaining IMF funds were recorded on SBP books to strengthen the foreign exchange reserves of the country. During 2011-12, no fresh disbursements were received from IMF, however, an amount of US$ 1.15 billion was repaid.

8 (i) - Composition of Foreign Economic Assistance

8.8. The total amount of foreign economic assistance received in 2011-12 stood at US$ 3,042 million. The composition of this assistance is as follows:

I. Commitments

8.9. The commitments of foreign economic assistance were US$ 4,580 million in 2010-11, while in 2011-12, total commitments amounted to US$ 4,620 million. About 71 percent of total commitments were in the shape of project aid while the remaining comprised non-project aid. Out of total non-project aid, share of BOP/budgetary support was 84.8 percent.

II. Disbursements

8.10. In 2011-12, disbursements of US$ 3,042 million were for different purposes like Project Aid (US$ 1,610 million), Balance of Payment (US$ 697 million) and relief (US$ 736 million). Project aid accounted for 52.9 percent of the total disbursements.

8 (ii) - External Debt & Liabilities Servicing

8.11. During 2011-12, external debt servicing summed to US$ 6,051 billion that is 11.3 percent higher than the previous year. A segregation of this aggregate number shows a payment US$ 3,489 billion in respect of maturing EDL stock while interest payments were US$ 1,019 million. US$ 1,543 million was rolled-over.

8.12. Among the principal repayments, US$ 1,090 of multilateral debt and US$ 1,154 million of IMF accounted for most of the share. Similarly, hefty interest payments worth US$ 1,019 million on foreign currency public debt contributed to the bottom line. In 2011-12, the central bank deposits were mostly rolled-over. Notwithstanding, with the IMF-Stand by Agreement (SBA) repayments, debt servicing will further increase in next two fiscal years.

Table-8: Pakistan's Public External Debt Servicing

Years	Actual Amount Paid	Amount Rolled Over	Total
(US Dollar in million)			
2007-08	3,182.6	1,200.0	4,382.6
2008-09	4,747.2	1,600.0	6,347.2
2009-10	4,607.0	1,723.0	6,330.0
2010-11	3,947.7	1,488.0	5,435.7
2011-12	4507.7	1,543.0	6,050.7
2012-13*	1,120.0	700.0	1,820.0

*July-September, 2012

Source: State Bank of Pakistan and Debt Policy Coordination Office Staff Calculations

8.13. During July-September, 2012, the servicing on external debt was recorded at US$ 1,820 million. Out of the grand total, principal repayments were US$ 916 million and interest payments were 204 million. The roll-overs amounted to US$ 700 million in the first quarter of 2012-13.

8 (iii) - Currency Movements and Translational Impact

8.14. In Pakistan, external loans are contracted in various currencies and disbursements are effectively converted into Pak Rupee. As Pak Rupee is not an internationally traded currency, the other currencies are bought and sold via selling and buying of US Dollar. Hence, the currency exposure of foreign debt originates from two sources: US Dollar/other foreign currencies and Pak Rupee/US Dollar. This two-pronged exchange rate risk has been a major source of increase in the stock of EDL over a period of time in contrast to actual inflows.

8.15. During 2011-12, appreciation of the US Dollar against other major currencies caused the foreign currency component of public debt to decrease by US $1,740 million, however, it was restrained by depreciation of Pak Rupee against US Dollar by 10 percent. The first quarter of the current fiscal year noticed a capital loss of US$ 721 million owing to US Dollar depreciation against other major international currencies.

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

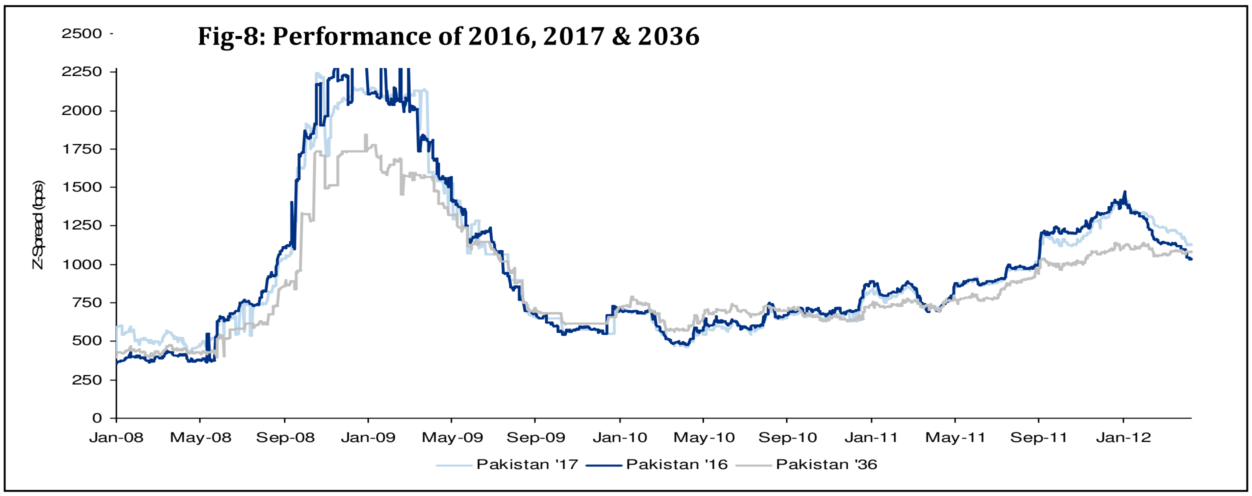
8 (iv) - <u>Performance of 2016, 2017 & 2036 Eurobonds</u>

8.17. Pakistan has witnessed a decrease in spreads on its 2016, 2017 and 2036 Eurobonds since mid-year in 2011-12 with bond yields benefitting from the rally in credit spreads, with shorter dated bonds now trading below 10 percent for the first time since May 2011. The 2016 Eurobond was trading at a spread of UST + 893 basis points with the 2017 Eurobond trading at UST + 840 basis points and 2036 Eurobond trading at UST + 817 basis points. This was against spread levels in July 2012 of more than 1000 basis points over UST for all three Eurobonds. The improved trajectory of trading levels for these Eurobonds despite Moody's downgrade of Pakistan's sovereign credit rating in mid-year suggests confidence of International investors in Pakistan's credit. The outlook was further affirmed by Standard and Poor's which maintained its stable outlook on the country's credit. The following table contains the latest position of bond issued by Pakistan along with their current yield:

Table-9: Performance of 2016, 2017 & 2036 Eurobonds

Issuer	Ratings (Moody's/S&P)	Coupon (%)	Maturity	Spread over UST (bps)	Yield (%)
Pakistan	Caa1/B-	7.125	Mar 2016	893	9.593
Pakistan	Caa1/B-	6.875	Jun 2017	840	9.057
Pakistan	Caa1/B-	7.875	Mar 2036	817	10.974

Source: Citi and Bloomberg, as on November 7th, 2012



8. (v) External Sector Assessment

8.18 Current account posted a deficit of US$ 4.6 billion (2 percent of GDP) during 2011-12 against a surplus of US$ 214 million (0.1 percent of GDP) during 2010-11 despite exports remaining at almost same level as 2010-11 and swelling inflows in remittances. Overall balance of external account stood at US$ -3.3 billion (1.4 percent of GDP) in 2011-12 against US$ 2.5 billion (1.2 percent of GDP) in the same period last year.

Table-10: Components of Foreign Exchange Earnings & Payments (US Dollar in billion)

	2008	2009	2010	2011	2012
Foreign Exchange Earnings	**37.2**	**35.4**	**38.1**	**47.7**	**47.9**
Goods: Exports f.o.b	20.4	19.1	19.7	25.4	24.7
Services: Credit	3.6	4.1	5.2	5.7	5.0

Table-10: Components of Foreign Exchange Earnings & Payments (US Dollar in billion)	2008	2009	2010	2011	2012
Income: Credit	1.6	0.9	0.6	0.7	0.8
Current Transfers	11.6	11.3	12.7	15.9	17.4
Of which Workers Remittances	6.5	7.8	8.9	11.2	13.2
Foreign Exchange Payments	**51.1**	**44.6**	**42.1**	**47.4**	**52.4**
Goods: Imports f.o.b	35.4	31.7	31.2	35.9	40.1
Services: Debit	10.0	7.5	6.9	7.7	8.0
Income: Debit	5.5	5.3	3.8	3.7	4.2
Of which Interest Payments	2.2	1.9	1.5	1.5	1.8
Current Transfers: Debit	0.1	0.1	0.1	0.1	0.1

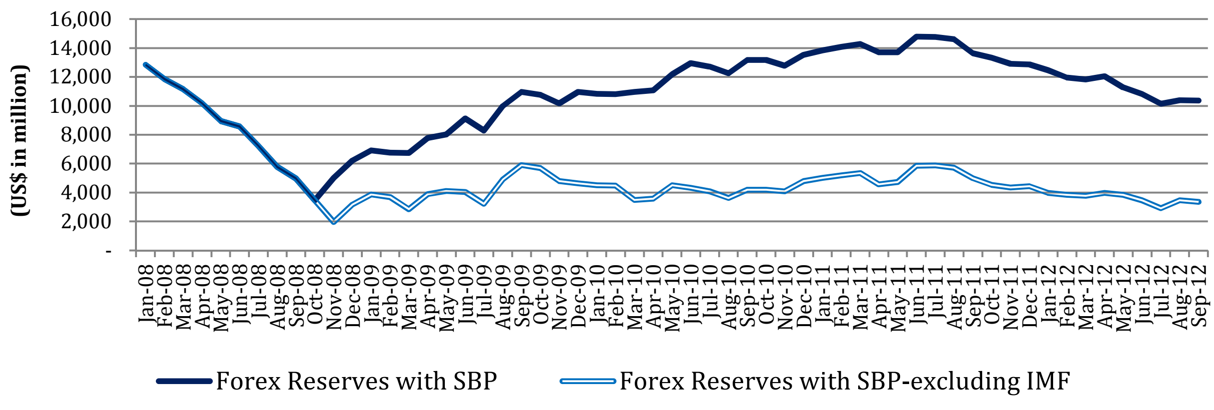
Source: State Bank of Pakistan and Debt Policy Coordination Office Staff Calculations

8.19. The net inflows in financial account continued to fall which was around 5 billion in 2009-10. Net inflows in financial account saw a fall of 29 percent reaching at US$ 1.5 billion in fiscal year 2011-12 against US$ 2.1 billion during the corresponding period last year. Falling disbursements in long term program loans were supplemented by release of project loans during 2011-2012. The overall long term disbursements fell by 10.4 percent during 2011-2012. Net portfolio investments posted an outflow of US$ 133 million during fiscal year 2011-12 against an inflow of US$ 345 million during the corresponding period last year. Foreign direct investment decreased by another 50 percent to US$ 812 million during 2011-2012 owing to deteriorated law and order situation, weak economic activities and energy crises.

8.20. First quarter of 2012-2013 took a promising start as current account registered a surplus of US$ 435 million mainly due to reimbursement of US$ 1.12 billion by the United States against CSF. Import of goods fell by 6.6 percent while export of goods fell by 2.4 percent. Export of services registered a growth of 78 percent during July-September, 2012 over the corresponding period last year.

8.21. Rationalizing prices of crude oil in international market are providing relief to Pakistan's import bill. Meanwhile higher remittances continue to provide boost to current account, as remittances increased by 9 percent during first quarter of 2012-13. Government's strong commitment to route inflows through formal sector has yielded positive and impressive results.

Fig-9: Foreign Exchange Reserves



8.22. Financial account witnessed decrease of US$ 33 million during first quarter of 2012-13 on account of subdued foreign direct investment and no disbursements in program loans. FDI continued its slide in first quarter of 2012-13 as it decreased by 55 percent. Foreign exchange reserves continue to slip on back of IMF repayments during July-September, 2012. At the end of first quarter of 2012-13, reserves stood at $14.9 billion.

8 (vi) - External Debt Sustainability

8.23. Analysis of the current account deficit provides important clues as to the future direction of the external debt path. Higher current account deficit in the absence of offsetting increase in current transfers and non-debt creating capital flows can add to the stock of external debt. Similarly, any increase in interest rates and exchange rate depreciation will increase the debt servicing cost of the country and will affect the sovereign debt portfolio. External Debt and Liabilities expressed as a percentage of GDP might be a common means of measuring the indebtedness of an economy, but repayment capacity is more accurately captured through expressing the levels of debt as a percentage of the economy's foreign exchange earnings and reserves. In order to ensure sustainability, government can assign threshold levels to the debt stock as a ratio of economic indicators and comparison with international thresholds provides insight into a country's debt position.

Table-11: External Debt Sustainability

(In percent)	2008	2009	2010	2011	2012
Non Interest Current Account/GDP	(7.2)	(4.5)	(1.4)	0.8	(1.2)
Growth in Exports	18.2	(6.4)	2.9	28.9	(2.8)
Growth in Imports	31.2	(10.3)	(1.7)	14.9	11.9
Growth in EDL	14.9	13.4	17.6	7.8	(0.8)
Growth in FEE	12.8	(5.1)	7.9	25.1	0.3
Growth in Non Interest Foreign Currency Payments	27.2	(12.8)	(4.9)	13.3	10.1
EDL/FEE (times)	1.2	1.5	1.6	1.4	1.4

Table-11: External Debt Sustainability

(In percent)	2008	2009	2010	2011	2012
EDL/FER (times)	4.0	4.2	3.7	3.6	4.3
EDL/GDP	28.2	32.3	34.9	31.5	28.5
EDL Servicing/FEE	11.8	18.0	16.6	11.4	12.7
Rollover Ratio (Principal Repayments/Disbursements) public debt	41.7	60.9	54.4	82.3	71.8

FEE: Foreign Exchange Earnings; **EDL:** External Debt and Liabilities; **FER:** Foreign Exchange Reserves

Source: Debt Policy Coordination Office Staff Calculations, Finance Division

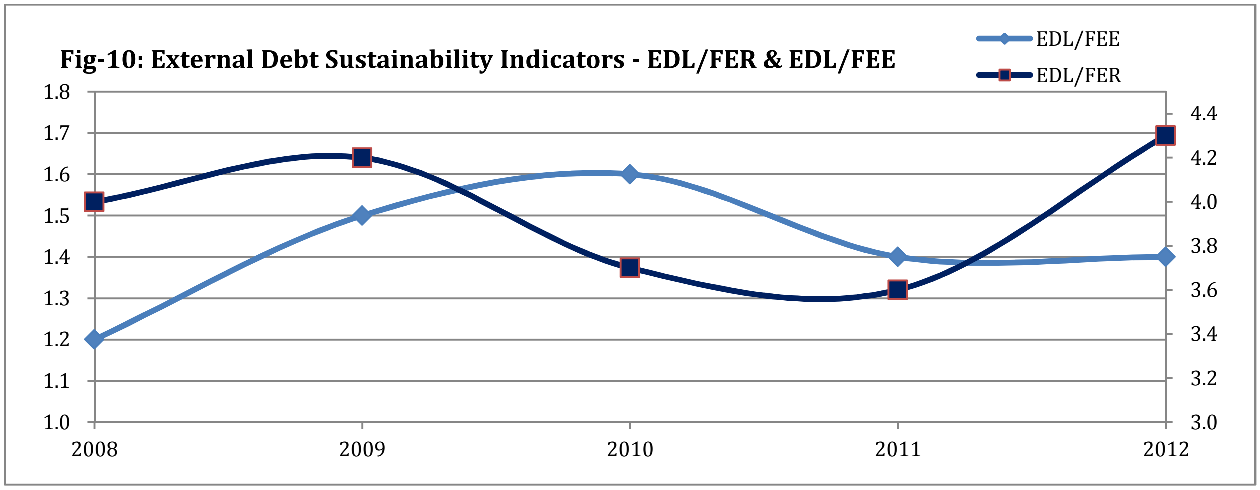
8.24. During 2010-11, the non interest current account showed a surplus of 0.8 percent of nominal GDP because of improved trade balance (higher cotton prices) and higher inflows in remittances. This indicator showed a downward trend in 2011-12 by recording a deficit of 1.2 percent of nominal GDP owing to high value of oil imports.

8.25. EDL as a percentage of 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. A generally acceptable threshold requires a country's EDL to remain below 2 times of FEE. Improvement was observed in the EDL-to-FEE ratio, which was 1.4 times in 2010-11 compared to 1.6 in 2009-10 at the back of strong workers' remittances and a positive turn-around in export earnings. 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. During 2011-12, the EDL remained at 1.4 times of FEE.

8.26. A decrease in EDL in relations to Foreign Exchange Reserves reflects the consolidation of foreign exchange reserves and a general improvement of the country's repayment capacity or vice versa. On the onset of IMF-SBA, the ratio declined to 3.7 in 2009-10 as EDL growth slowed and foreign exchange reserves shored up. The ratio was 4.3 as of June 2012 primarily due to repayment IMF-SBA.

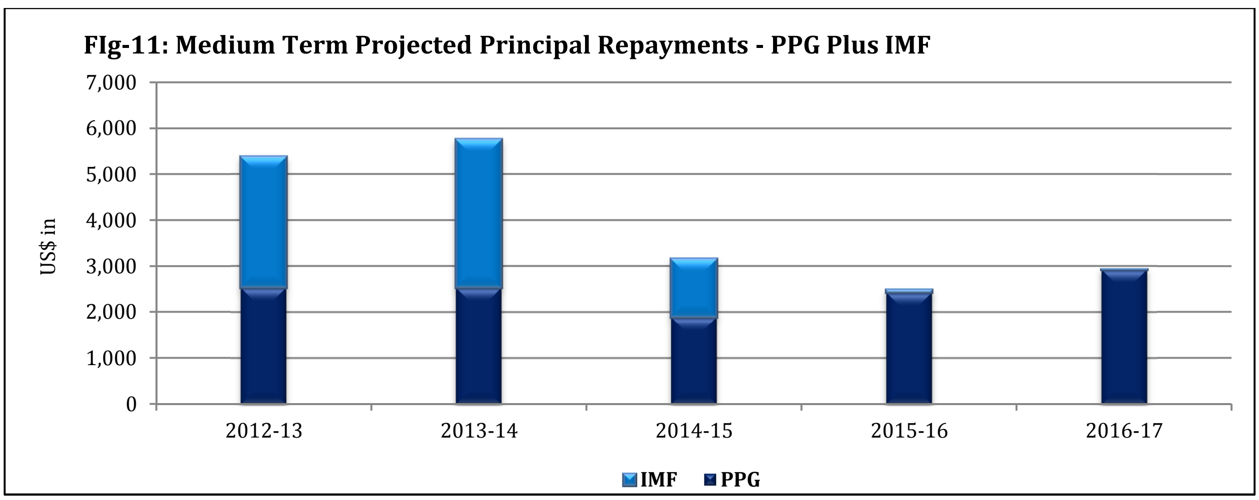
8.27. A major improvement has been witnessed in EDL-to-GDP ratio as it improves from 34.9 percent in 2009-10 to 31.5 percent in 2010-11. By end-June 2012, EDL as a percent of GDP further improved and stood at 28.5 percent. This improvement is mainly due to faster growth in nominal GDP in relation to slower growth in external debt.

8.28. External Debt Servicing as a percentage of Foreign Exchange Earnings stood at 12.7 percent at the end of 2011-12 as compared with 11.4 percent in last fiscal year. A generally acceptable threshold requires a country's EDL servicing to remain below 20 percent of FEE. As hefty repayments against IMF-SBA are expected in next two fiscal years, this indicator will further increase. It requires serious efforts to enhance the export earnings if Pakistan is to remain under the accepted threshold.



8 (vii) - Maturity Profile External Debt

8.29. The Average Time to Maturity (ATM) of Public and Publically Guaranteed Debt was 11.4 years as of June 30, 2012. The ATM including IMF loans stood at 10 years. The ATM reduced with the inclusion of IMF loans as hefty repayments against IMF loans are expected in next two fiscal years.



9 - <u>Guarantees</u>

9.1. Guarantees are contingent liabilities that come into play on the occurrence of an event covered by the guarantee. However, such off-balance sheet transactions cannot be overlooked in order to gain a holistic view of a country's fiscal position and unveil the hidden risks associated with the obligations made by the government outside the budget. Similarly, reported debt levels of a sovereign may be understated owing to the non-inclusion of guarantees, explicit or implicit, which may materialize in future.

9.2. The sovereign guarantee is normally extended for the purpose of improving financial viability of projects or activities undertaken by government entities with significant social and economic benefits. It enables public sector companies to raise resources at lower interest charges or on more favourable terms and in some cases, allows to fulfill the requirement where sovereign guarantee is a precondition for concessional loans from bilateral/ multilateral agencies to sub-sovereign borrowers.

9.3. However, there are costs associated with the provision of government guarantees. In the case of Pakistan, these include, for instance, explicit and implicit guarantees issued to Public Sector Enterprises (PSEs) and unfunded losses of state owned entities such as Pakistan Steel Mill, PIA and power sector companies. During the fiscal year 2011-12, the Government of Pakistan issued fresh/rollover guarantees aggregating to Rs.203 billion. This issuance amounted to 1 percent of GDP.

Table-12: New Guarantees Issued (2011-12)

Name of Organization	**Amount (Rs. in billion)**
PIA	9.5
Pakistan Steel Mills	8.9
Pakistan Textile City	1.5
Zarai Taraqiati Bank Ltd	3.0
Power Holding (Pvt) Ltd	136.5
Central Power Generation Company Limited	43.9
Grand Total	**203.2**

Source: Debt Policy Coordination Office, Finance Division

9.4. Public disclosure of information about guarantees is an essential component of fiscal transparency, but it is more important to reflect the impact of financial risk associated with guarantees in the fiscal account. The outstanding contingent liabilities as of June 30, 2012 stood at Rs.516.5 billion. This includes the stock of explicit debt guarantees in both domestic and foreign currencies that appear in the accounting books of PSEs. The Rupee guarantees accounted for 54.5 percent of the total stock.

9.5. Other than the publically guaranteed debt of PSEs, government issues counter guarantees against the commodity financing operations undertaken by federal and provincial government agencies. Commodity financing is secured against hypothecation of commodities and a letter of comfort from the government. For 2011-12, Rs.12.3 billion worth of additional guarantees were issued against commodity financing operations.

Table-13: Guarantees Outstanding as on September 30, 2012 - (Provisional)	
(Rs. in billion)	
Outstanding Guarantees extended to PSEs	518.3
-Domestic Currency	273.8
-Foreign Currency	244.4
Memo:	
Foreign Currency (US$ Million)	2,578.1

Source: Debt Policy Coordination Office, Finance Division

10. Report on Compliance with FRDL Act 2005

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

10.2. The FRDL Act 2005 requires the following:

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

Revenue balance has been in negative since 2006 because of increasing exogenous and endogenous challenges highlight above.

Table-14: Revenue Balance (Percent of GDP)

Revenue Balance*	2006	2007	2008	2009	2010	2011	2012
	-0.1	-0.6	-3.2	-1.2	-1.7	-3.3**	-2.5***

**Adjusted for grants*
***excludes arrears of electricity subsidies amounting Rs.120 billion*
****excludes, "one off" payment of Rs.391 billion on account of debt consolidation*

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

10.3. The government consolidated Rs.391 billion or 1.9 percent into public debt in 2011-12 against outstanding previous years subsidies related to the food and energy sectors due to which Public Debt to GDP stood at 61.3 percent of GDP at end June 2012. It would have been 59.4 percent of GDP if Rs.391 billion was not consolidated. It is important to note that the Fiscal Responsibility and Debt Limitation Act (FRDLA) - 2005 requires debt ceiling of 60 percent of GDP by end-June 2013.

10.4. The public debt also includes loans from IMF amounting to US$7.3 billion or 3.2 percent of the GDP as on June 30, 2012. The borrowing from IMF is only utilized towards Balance of Payment support and is reflected in foreign currency reserves of the country.

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

Table-15: Debt to GDP **(Rs. in billion)**

	2006	2007	2008	2009	2010	2011	2012
Domestic Currency Debt	2,321.7	2,600.6	3,266.0	3,852.5	4,651.4	6,015.5	7,637.0
Foreign Currency Debt	2,037.6	2,201.2	2,778.0	3,776.2	4,259.9	4,684.9	5,030.2
Total Public Debt	**4,359.3**	**4801.8**	**6,044.0**	**7,628.6**	**8,911.3**	**10,700.5**	**12,667.2**
GDP	7,623.2	8673.0	10,242.8	12,724.0	14,804.0	18,033.0	20,654.0
Total Public Debt (as percent of GDP)	**57.2**	**55.4**	**59.0**	**60.0**	**60.2**	**59.3**	**61.3**

10.5. The condition of reducing debt to GDP by 2.5 percent annually was envisaged in the FRDLA, 2005 to achieve the core objective of reducing Debt to GDP below 60 percent by the end of 2012-13.

10.6. Social and poverty alleviation related expenditure (as given by pro-poor budgetary expenditure excluding non-development outlays on law and order) remained at 8.2 percent of GDP. Additionally, expenditure on health and education stood at 0.7 percent and 2.1 percent of GDP. The (FRDLA) - 2005 stipulates that the spending on health and education shall be doubled to 1 percent and 3.2 percent respectively in ten years beginning from 1st July, 2003.

Table-16: Social Sector Expenditure

	2006	2007	2008	2009	2010	2011	2012
Social sector and poverty related expenditure (as percent of GDP)	4.9	4.9	9.3	6.9	6.7	6.0	8.2
Expenditure on education (as percent of GDP)	1.9	1.9	1.8	1.9	1.8	1.8	2.1
Expenditure on health (as percent of GDP)	0.5	0.6	0.6	0.7	0.8	0.6	0.7

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

10.7. New guarantees including rollovers, issued by the government in 2011-12 amounted to Rs.203 billion or 1 percent of GDP. The government also issued additional guarantees equivalent to 0.1 percent of GDP for commodity financing operations.

Table-17: New Guarantees Issued **(Rs. in billion)**

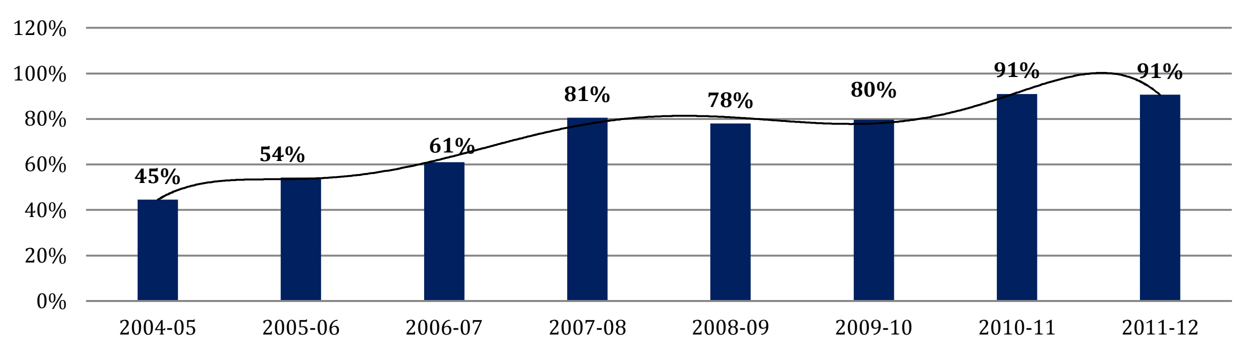
	2006	2007	2008	2009	2010	2011	2012
New guarantees issued	14.0	140.7	138.8	276.3	224.0	62.4	203.2
(as percent of GDP)	**0.2**	**1.6**	**1.4**	**2.2**	**1.5**	**0.3**	**1.0**

10.8 Since last few years, Pakistan is faced with serious challenges both at domestic and international fronts. Higher security related expenditure, energy shortages, higher food and energy subsidies in wake of higher international commodity prices and non-materialization of committed receipts exerted enormous pressure on government's limited resources. Given the severity of these challenges, the government was able to manage fiscal deficits at reasonable levels.

11- Debt Strategy

11.1. Due to non-availability of sufficient external inflows, the financing focus shifted towards domestic sources that led to shortening of maturity profile of the public debt. This avenue is costly as this borrowing is conducive to inflationary pressures and at the same time, translates into higher debt servicing in view of higher domestic interest rates. Moreover, such practice crowds out the private sector credit demands.

Fig-12: Domestic Financing of Fiscal Deficit, FY05 - FY12



11 (i) - Critical Issues Facing the Systemic Liquidity in Pakistan

I. Financing of Fiscal Deficit

11.2. Since 2007-08, Government has been financing around 85 percent of fiscal deficit through domestic sources owing to considerable reduction in foreign currency debt creating flows. This has put pressure on domestic liquidity and shrinking Net Foreign Assets (NFA) of the banking system has further compounded the situation. The NFA shrunk by Rs.248 billion during 2011-12 and Rs.46 billion in first half of the current fiscal year. This factor combined the risk averseness on part of banks is crowding out private sector credit availability.

II. Government borrowing from SBP

11.3. In 2011-12, Government borrowed Rs.507.5 billion from SBP to finance its fiscal deficit. As on September 30, 2012, the outstanding stock of SBP credit was Rs.1,250 billion compared with Rs.1,662 billion as on June 30, 2012, registered a net retirement of Rs.412 billion during first quarter of 2012-13.

III. Currency in Circulation

11.5. As at end December 2012, currency in circulation stood at 30.2 percent of the commercial bank deposits.

IV. SBP Act

11.6. Government passed an amendment in the SBP Act, whereby it has committed a) net zero quarterly borrowing from SBP baring ways and means limit and b) repay SBP outstanding debt as of April 2011 in next 8 years.

V. NFC Award

11.7. Under the 7th NFC award, around 70 percent of the total revenues are down streamed to provinces both directly and indirectly. The Federal Government is left with only 30 percent of the total revenues, whereas, expenditure on interest servicing, security and subsidies on food & energy constitute 60.9 percent of the total revenues. Furthermore, total revenues also include SBP profit that will start declining once government start repayment of SBP debt as envisaged in the SBP Act and reduction in domestic interest rates. This essentially means that the consolidated fiscal deficit of the country will remain on the higher side till such time the revenue generation efforts bear fruits and the tax to GDP ratio is increased.

VI. Underdeveloped Domestic Debt Capital Markets:

11.8. Debt Capital Market in Pakistan is fairly underdeveloped both in terms of infrastructure and human capital. This will continue to be a major hindrance for the government to finance its increasing borrowing requirements.

11 (ii) - Potential Funding Sources

I. Multilateral/Bilateral Agencies

11.9. In the recent past, Pakistan has not been able to get any fresh program loan.

The fresh funds flowing through the pipeline of project loans are barely enough to meet the repayment obligations of the contracted loans.

II. International Debt Capital Markets

11.10. Pakistan has not tapped this source since 2007. In presence of ample liquidity in the International Debt and Capital Market, government may consider launching foreign currency bond and structure the instrument keeping in view the risk averseness of international investors. One option could be an insurance wrapped bond or a partial credit guaranteed instrument secured against guarantee of any internationally reputable institution.

III. Domestic Wholesale Markets

11.11. These markets are key source of funding for the government. A combination of factors including money supply, currency in circulation and private sector credit demand drive the liquidity position of these markets.

IV. Retail Markets

11.12. Presently, government is taping this source through CDNS that has limited reach with only 380 branches. Recently, in collaboration with SBP, a marketing campaign is launched to market other government debt instruments to retail investors through commercial bank branches. In the recent past, wealth creation has been concentrated in the rural economy by means of higher agriculture output prices. This can be a potential key source of funding in the future.

11 (iii) - Proposed Strategy

11.13. The proposed strategy will help spur the economic growth and provide needed support to balance of payment.

I. Augment Domestic Liquidity Envelop

- **Reduce Currency in Circulation:** It is generally believed that imposition of withholding tax on cash withdrawals from banks has contributed towards increase in currency circulation. Government may consider abolishing this tax, as the net contribution of this tax is negligible when compared with the potential benefits of reduction in currency in circulation. Furthermore, SBP has allowed mobile banking that will increase banking penetration in the rural sector that is expected to slow down the pace of growth in currency in circulation.
- **Diversify Investor Base:** SBP has been requested to strengthen its efforts in terms of marketing campaign of T-bills, PIBs and Sukuks to retail investors through the branches of commercial banks across Pakistan especially in the sub-urban areas. This initiative will reduce government borrowing

demand from the wholesale markets.

II. Increase Foreign Currency Flows both Debt and non-Debt Creating

- **Market Domestic Debt Instruments to NRPs and other investors:** Government may market domestic debt instruments to non-resident Pakistanis and other institutional investors in Gulf, European and US markets, given the interest rate differential that may be an attraction to overseas investors.
- **Early Completion of Donor Funded Projects:** Relevant government agencies have been asked to strengthen project-monitoring mechanism and ensure timely completion of projects and remove bottlenecks for release of loan tranches. A concentrated effort may yield substantial flows.
- **International Debt Capital Markets:** Government may consider launching insurance wrapped US Dollar denominated bond in international market or a partial credit guaranteed instrument by an internationally reputable institution to raise sizable flows.
- **Strengthen Pakistan Remittance Initiative:** It is estimated that with better policy coordination between Ministry of Finance and SBP, the monthly remittances flows can be considerably increased in the medium term from an average of US$ 1.1 billion during 2011-12.
- **Borrowing from Multilateral/ Bilateral Sources:** Government is working on a plan to revive the much needed program loans.

11 (iv) - Development of Domestic Debt Capital Markets

11.14. Government has been focusing on following areas to provide enabling environment for development of domestic debt capital markets,

- **Consistent and Transparent Debt Management Strategy:** There has been a policy shift in public debt auctions from rate chasing to volume targeting. Since 2010, government has been successful in adhering to pre-announced auction targets. This policy shift allowed government to borrow averaging 25 percent of incremental domestic borrowing in longer tenors since 2010-11 compared to fewer than 10 percent in the past. However, the duration of domestic debt is on decline because of higher domestic borrowing and running off of portfolio. The proposed strategy to fund 25 to 30 percent of fiscal deficit from foreign sources supplemented by government borrowing in longer tenors will increase the duration of domestic debt portfolio.

- **Level Playing Field for All Investor Groups:** Government has, to a greater extent, addressed the issues concerning National Saving Schemes (NSS) to eliminate the interest rate arbitrage. Institutional investors except pension and provident funds are restricted to invest in these schemes.
- **Comprehensive Disclosure of Government Fiscal Position:** Government has started comprehensive disclosure of fiscal accounts on quarterly basis with a time lag of 1-2 months. This has helped markets to accurately predict government borrowing needs.
- **Liquidity in Government Benchmark Securities:** Government has started reopening older issues to maintain enough liquidity in the benchmark issues. Furthermore, since last few years, only one issue of bond is auctioned during the entire fiscal year to ensure ample issue liquidity.

11 (v) - Strengthening Debt Management Function

11.15. For prudent debt management, it is important to centralize the debt management function. 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. Government realizes the need and accordingly taking steps to centralize the decision making process in the initial phase.

12 - <u>Conclusion</u>

12.1 Host of internal and external factors i.e. higher energy and food subsidies to protect the vulnerable section of the society, growing security spending needs, floods and higher international commodity prices contributed towards higher fiscal deficits in the recent years. This has increased the public debt in absolute terms; however, public debt expressed in terms of GDP has hovered around 60 percent since 2006-07. During 2011-12, government consolidated debt of power and commodity sector companies amounting to Rs.391 billion or 1.9 percent of GDP into public debt. Had the government not consolidated the PSE debt, the Debt to GDP would have been 59.4 percent in 2011-12.

12.2 Soundness of Pakistan’s debt position, as given by various sustainability ratios, 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. Government is making concentrated efforts to increase the revenues and rationalize current expenditure to reduce the debt burden and improve the debt carrying capacity of the country to finance the growth and development needs.

12.3 Pakistan's external debt and liabilities and its servicing in terms of foreign exchange earnings stood within the acceptable threshold of 2 times and debt servicing below 20 percent of foreign exchange earnings. Government is taking necessary measures to mobilize foreign currency flows to manage the debt repayment of IMF due in next two fiscal years.

12.4 Divergent trends between growth in foreign exchange earnings and government revenues on one hand, and foreign exchange payments and expenditure on the other hand, point towards underlying structural issues. Government is focusing on increasing export receipts and other foreign currency non-debt creating flows 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.

12.5 Debt reduction to sustainable levels can only be achieved with persistent economic growth. The slowdown in growth results in rising debt burden and reducing debt-servicing capacity of the country. It is important for the government to adopt an integrated approach for economic revival and debt reduction strategy, which will require some difficult trade-offs in the short-term, thus implementing structural reforms that boost potential growth, is a key to ensure debt sustainability.

finance.gov.pk