Chapter 9

Public Debt

9.1 Introduction

Effective management of public debt has been a prime challenge faced by developing as well as developed countries both having different implications. Empirical 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. Developing economies are growing faster than the developed ones, making it easier for the former to satisfy the condition and ride on a declining debt trajectory, leading to debt acting as a catalyst in the course of growth. Prudent utilization of debt leads to higher economic growth and it also helps the government to accomplish its social and developmental goals. The absence of such prudence results in high and unsustainable debt levels leaving country in higher debt servicing requirements, and lower developmental spending capabilities having serious repercussions for the economy. Given Pakistan's developing status, the need for effective debt management is of utmost importance as the country requires borrowing to enable its development agenda, accelerate the pace of economic growth without ignoring the intergenerational impact.

In Pakistan, the composition of public debt has witnessed major changes in past few years with increased reliance on domestic debt owing to lower external debt inflows. The composition of 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 entails high rollover and refinancing risk. Besides, the cost and stock of external public debt increased due to depreciation of Pak Rupee. The present government soon after assuming the charge, immediately took corrective measures to manage public debt portfolio effectively. Some of the significant actions taken by the government are as follow:

- Government developed its first Medium Term Debt Management Strategy (2014-18) that is closely linked to fiscal framework to guide the borrowing activities. The focus of the strategy is lengthening the maturity profile to reduce the refinancing risk along with sufficient provision of external inflows in the medium term to reduce the pressure on domestic resources keeping in view cost-risk tradeoffs.
- To broaden the investor base and have a liquid government securities market, trading of government debt instruments (Treasury Bills, Pakistan Investment Bonds and Government Ijara Sukuk) commenced on the stock exchanges. This has provided an additional investment channel to retail investors.
- A set of reforms initiated by the government to improve the fiscal health of the economy has brought strong support from multilateral and bilateral creditors. This is expected to strengthen confidence and catalyze additional support from development partners in the coming years which will also help in reducing the pressure on domestic resources.
- With increased external inflows, the government was able to boost its foreign exchange reserves vis-a'-vis improving exchange rate of Pak Rupee against major international currencies. This also contributed in reducing public external debt.
- Pakistan successfully tapped international capital markets after a gap of 7 years which highlights investors' confidence on country's leading economic indicators, external finances and structural reforms undertaken by the present government. The investor response was overwhelming with US$ 2 billion raised against the initial expectations of US$ 500 million. This transaction represented the largest ever international bond offering by Pakistan.

9.2 Public Debt

The portion of total debt which has a direct charge on government revenues as well as the debt obtained from IMF is taken as public debt. Public debt comprises domestic and external debt. 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.

Public debt stock reached at Rs.15,534 billion as at end March, 2014 representing an increase of Rs.1,168 billion or 8 percent higher with that of last fiscal year. The primary source of increase in public debt during first nine months of current fiscal year was in domestic debt that positioned at Rs.10,823 billion representing an increase of Rs.1,306 billion, whereas, external debt posed at Rs.4,711 billion representing a decrease of Rs.138 billion as compared to end June 2013. The decline in external debt during first nine months of current fiscal year is mainly attributed to net repayments and appreciation of Pak Rupee against US Dollar.

Table-9.1: Public Debt (1990-2014)

	1990	1995	2000	2005	2008	2009	2010	2011	2012 (P)	2013 (P)	2014* (P)
	(Rs. in billion)										
Domestic Debt	374	790	1,576	2,178	3,266	3,852	4,651	6,016	7,637	9,517	10,823
External Debt	428	873	1,442	1,913	2,778	3,776	4,260	4,685	5,016	4,849	4,711
Total Public Debt	801	1,662	3,018	4,091	6,044	7,629	8,911	10,700	12,653	14,366	15,534
	(In percent of GDP)										
Domestic Debt	42.8	42.3	41.2	33.5	30.7	29.2	31.3	32.9	38.1	42.3	42.6
External Debt	48.9	46.8	37.7	29.4	26.1	28.6	28.7	25.6	25.0	21.6	18.5
Total Public Debt	91.7	89.1	78.9	62.9	56.8	57.8	59.9	58.5	63.1	63.9	61.2
	(In percent of Revenue)										
Domestic Debt	235	245	308	242	218	208	224	267	298	319	-
External Debt	269	270	281	213	185	204	205	208	195	163	-
Total Public Debt	505	515	589	455	403	412	429	475	493	482	-
	(In percent of Total Debt)										
Domestic Debt	46.6	47.5	52.2	53.2	54.0	50.5	52.2	56.2	60.4	66.2	69.7
External Debt	53.4	52.5	47.8	46.8	46.0	49.5	47.8	43.8	39.6	33.8	30.3
Memo:											
Foreign Currency Debt (US$ in billion)	19.5	28.1	27.5	32.1	40.7	46.4	49.8	54.5	53.1	48.7	47.8
GDP (Rs. in billion)	874	1,866	3,826	6,500	10,638	13,200	14,867	18,276	20,047	22,489	25,402

P: Provisional, *: end March 2014
Source: Budget Wing, Economic Affairs Division, State Bank of Pakistan and Debt Policy Coordination Office Staff Calculations

Over the past few years, government relied mainly on the domestic borrowing which resulted in gradual increase of its share to around 70 percent of the total public debt as at end March, 2014 compared to 51 percent in 2008-09. The evolution of funding mix adopted during last few years showed an implicit borrowing strategy that increasingly relied on short-term domestic borrowing owing to insufficient external inflows. This reliance on short term domestic borrowing increased the exposure to refinancing and interest rate risks. Going forward, in order to effectively manage cost and risk of its public debt portfolio, the government has developed its first Medium Term Debt Management Strategy in April, 2014 (Box-1) to ensure that both the level and rate of growth in public debt is fundamentally sustainable and can be serviced under different circumstances while meeting cost and risk objectives. The Medium Term Debt Management Strategy contains a policy advice on an appropriate mix of financing from different sources with the spirit to uphold the integrity of the Fiscal Responsibility & Debt Limitation (FRDL) Act, 2005.

Box-1: Medium Term Debt Management Strategy (2014-18)

It is imperative to have a comprehensive debt management strategy aiming at debt sustainability and enhancing the debt servicing capacity of the country. Owing to its vital importance and indispensable nature, the government has developed its first Medium Term Debt Management Strategy (MTDS).The MTDS has following main objectives:

- Fulfil the financing needs of the government.
- Minimize the cost of debt while maintaining the acceptable level of risks.
- Facilitate the development of domestic debt market.

MTDS provides alternative strategies to meet the financing requirements of the government. Four different borrowing strategies have been assessed with associated costs and risks analysis under the alternative interest and exchange rates scenarios (Fig:9.1 and Fig:9.2). The cost and risk analysis is based on the existing debt cash flows, market and macroeconomic projections and alternative borrowing strategies. The robustness of alternative debt management strategies was evaluated by applying stress/shock scenarios for interest rates and exchange rates.

Strategy 1 (S1: Planned Strategy)

This strategy represents the borrowing from external and domestic sources as planned by the government for 2014 onwards. Gross external borrowing accounts on average 7 percent mainly through Eurobonds, commercial sources and project loans. The remaining 93 percent borrowing need is expected to be met by Market Treasury Bills (MTBs), Pakistan Investment Bonds (PIBs), 3 year Government Ijara Sukuk (GIS), National Savings Schemes (NSS) instruments and Market Related Treasury Bills (MRTBs).

Strategy 2 (S2: Lengthening of Maturity Profile - Fixed Rate Instruments)

This strategy represents the cost and risk scenario of debt portfolio by shifting part of MTBs to 10 year PIBs and increasing the external funding slightly at the same time. The additional external financing will be sought as per official estimate i.e. the higher project loans as compared to S1.

Strategy 3 (S3: Reliance on Short Term Domestic Instruments)

S3 assumes more reliance on domestic market and reduced external funding. Under this strategy, it is assumed that on an average, 97 percent of financing requirements would be derived from domestic sources mainly by issuance of MTBs and MRTBs.

Strategy 4 (S4: Lengthening of Maturity Profile - Floating Rate Instruments)

This strategy is similar to S2 in terms of share of domestic and external financing except a new instrument having 10 year maturity with floating rate is included.

The outcome of the above strategies is depicted through graphs below:

Fig-9.1: Debt to GDP
(as at end of 2017-18)

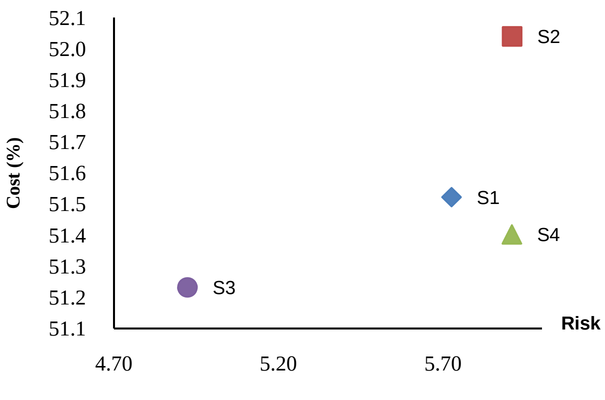
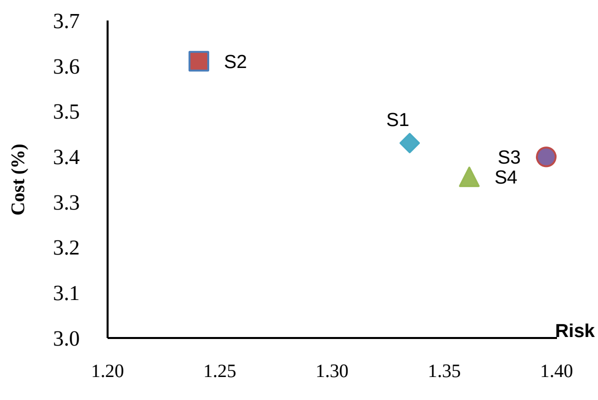


Fig-9.2: Interest to GDP
(as at end of 2017-18)



On the basis of cost and risk analysis of alternative strategies, a strategy, such as Strategy 3 (S3), with an increased reliance on domestic short term sources is least attractive. Strategy 2 (S2) and Strategy 4 (S4) assume lengthening of maturity profile by issuing fixed and floating rate instruments, respectively. Moreover, S2 and S4 have similar risk trend for debt to GDP as both have same share of external funding and thus foreign exchange risk is similar. Both S2 and S4 are targeting the reduction in refinancing risk. However, S2 is expected to result in greater average time to re-fixing i.e. there is less interest rate risk in case of S2 as compared with S4 owing to more financing through issuance of fixed interest rate instruments. The implementation of S2 seems feasible than others considering the current appetite for the fixed rate longer tenor instruments. This is further supported by the fact that the Government of Pakistan was able to raise substantial amount during 2013-14 through PIBs. In the light of above mentioned facts, S2 seems to be a preferential strategy for the government.

One of the objectives of MTDS is to facilitate the development of debt capital market. Accordingly, as a first step, the government has launched secondary market trading of Government Debt Securities at the stock exchanges in Pakistan in January, 2014 (Box-2). The trading in Government Debt Securities at the stock exchanges is considered to be an important breakthrough which can contribute significantly towards development of debt capital market which will play a pivotal role in obtaining long term financing for the government in future.

Box-2: Development of Debt Capital Market

- **Background**

  In accordance with the commitment of the government to develop debt capital market, secondary trading of Government Debt Securities (GDS) at the stock exchanges in Pakistan has been launched. The government has also approved the regulatory framework for trading of GDS.

- **Operational Framework**

  Initially Treasury Bills, Pakistan Investment Bonds and Government Ijara Sukuk are made available for trading at the stock exchange. The commercial banks designated as Primary Dealers (PDs) by SBP are allowed for direct proprietary trading and can also act as Market Maker in GDS. The stock brokers fulfilling specific eligibility criteria are allowed to trade in GDS on their own account and on behalf of their clients. The trading by brokers and their clients is subject to a pre-check by the stock exchange to ensure that only investors with sufficient cash and custody of GDS can execute trades on the stock exchange.

  The settlement of trades executed at KSE is performed through the Real Time Gross Settlement (RTGS) system of SBP. PDs settle their trades directly whereas the brokers and their clients utilize the services of Central Depository Company (CDC) and those commercial banks which enter into a service level agreement with the stock exchange for this purpose.

- **Advantages of GDS Trading**

  The trading in GDS at the stock exchanges is considered to be an important breakthrough which can contribute significantly towards development of debt capital market. Trading of GDS on the stock exchanges will provide an efficient and liquid secondary market to the investors where they can sell off GDS and realize their investments before maturity. The capital market will have a more market based yield curve and will provide a reliable benchmark for the pricing of these debt securities. This initiative is expected to increase depth in the debt market, paving the way to utilize stock exchanges as a medium for direct government borrowings from the general public.

Other Initiative for Development of Debt Capital Market

Government has also taken the following steps for the development of debt capital market:

- **Commercial Papers Regulations, 2013**

  Commercial Papers Regulations 2013 have been notified on December 04, 2013. Commercial Paper (CP) is an unsecured short term debt instrument issued by highly rated companies in the form of promissory note. In 2002, SECP had issued guidelines for issue of CPs. In order to appropriately regulate CP issues and to facilitate the CP issuers, the guidelines have been reviewed and replaced with the Regulations.

- **Code of Conduct for Credit Rating Agencies (CRAs)**

  In order to review the role and responsibilities of CRAs, SECP constituted a Committee having representation from SECP, SBP and both the domestic CRAs. SECP in light of the recommendations of the Committee reviewed the Code of Conduct for CRAs dated February 17, 2005 and replaced it with a new Code. The new Code dated January 13, 2014 has been framed in line with the international best practices. It is expected that compliance with the new Code will further improve the performance and credibility level of CRAs.

- **The Regulations for Issue of Sukuk**

  Sukuk is a financial product structured on the basis of Shariah concepts. In order to fairly regulate Sukuk issues and to facilitate the issuers & investors, SECP is working on formulation of Regulations for issuance of Sukuk. The first draft of the Regulations was notified which is being reviewed in light of the public comments. The Sukuk regulations are expected to be finalized by the end of June, 2014. The regulations will help in development and growth of Islamic capital market.

Public debt may be understated without reporting contingent liabilities. Contingent liabilities are conditional obligations that arise from past events that may require an outflow of resources embodying economic benefits based on the occurrence or non occurrence of one or more uncertain future events not wholly within the control of the government. Contingent liabilities are not added to the overall debt of the country, therefore, public disclosure of information about contingent liabilities is an essential component of fiscal transparency.

Contingent liabilities in Pakistan include explicit and implicit guarantees issued to Public Sector Enterprises (PSEs). During July-March, 2013-14, the government issued fresh/rollover guarantees aggregating to Rs.104 billion or 0.4 percent of GDP. The outstanding stock of government guarantees as at end March, 2014 is positioned at Rs.558 billion.

9.2.1 Dynamics of Public Debt Burden

Borrowing is beneficial for economic development of any country as long as it is undertaken to facilitate the well thought out road map devised with due diligence. The economic rationale for debt creation is that borrowers can earn a higher economic return than the cost of invested funds and those economic returns can 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.

The debt burden can be described with many parameters and there is no single threshold for debt ratios that can delineate the "bad" from the "good" e.g. 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 etc. The more important rule about limiting public debt growth must be expressed in relation to revenue growth. If the primary deficit is zero, the ratio of public debt to revenues will not grow as long as the rate of growth of debt does not exceeds the rate of growth of revenues. Similarly, if the growth in Foreign Exchange Earnings (FEE) exceeds the growth in External Debt and Liabilities (EDL), the ratio of EDL-to-FEE will continue to decline.

Table-9.2: Selected Public Debt Indicators (in percentage)

	2008	2009	2010	2011	2012	2013	2014 (Jul-Mar)
Revenue Balance / GDP*	(3.1)	(1.2)	(1.7)	(3.3) [a]	(4.5) [b]	(2.9) [c]	(1.6)
Primary Balance / GDP*	(2.4)	(0.1)	(1.6)	(2.5) [a]	(4.2) [b]	(3.6) [c]	0.4
Fiscal Balance / GDP	(7.3)	(5.2)	(6.2)	(6.5) [a]	(8.8) [b]	(8.2) [c]	(3.2)
Public Debt / GDP	56.8	57.8	59.9	58.5	63.1	63.9	61.2
Public Debt / Revenue	403.1	412.2	428.8	475.0	493.0	481.7	-
Debt Service / Revenue	37.2	46.6	40.4	38.0	39.9	40.5	46.6
Debt Service / GDP	5.2	6.5	5.6	4.7	5.1	5.4	4.5

Source: Debt Policy Coordination Office Staff Calculations, Finance Division

*Adjusted for grants

[a] includes arrears of electricity subsidies amounting Rs.120 billion or 0.7 percent of GDP

[b] includes "one off" payment of Rs.391 billion on account of debt consolidation or 2 percent of GDP

[c] includes payment for the resolution of the circular debt amounting Rs.322 billion or 1.4 percent of GDP

Revenue balance is the total revenues less current expenditure. Zero revenue balance means borrowings are only utilized towards financing the development needs of the country. Revenue deficit was recorded at Rs.649 billion or 2.9 percent of GDP in 2012-13. This revenue shortfall over current expenditure is a reflection of non-availability of fiscal space for undertaking development spending. The revenue deficit as a percent of GDP stood at 1.6 percent during July -March, 2013-14 compared with 2.2 percent of GDP during the same period last year.

Primary balance is the total revenues minus non-interest expenditure or fiscal deficit before interest payments. A negative primary balance essentially implies that the government is borrowing to pay interest on the debt stock. During July-March, 2013-14, the government was able to achieve a primary surplus of Rs.110 billion or 0.4 percent of GDP through improved revenue collection and rationalization of non-interest expenditure which facilitated the debt management efforts. In comparison, the government witnessed a primary deficit of 1.1 percent of GDP during the same period last year.

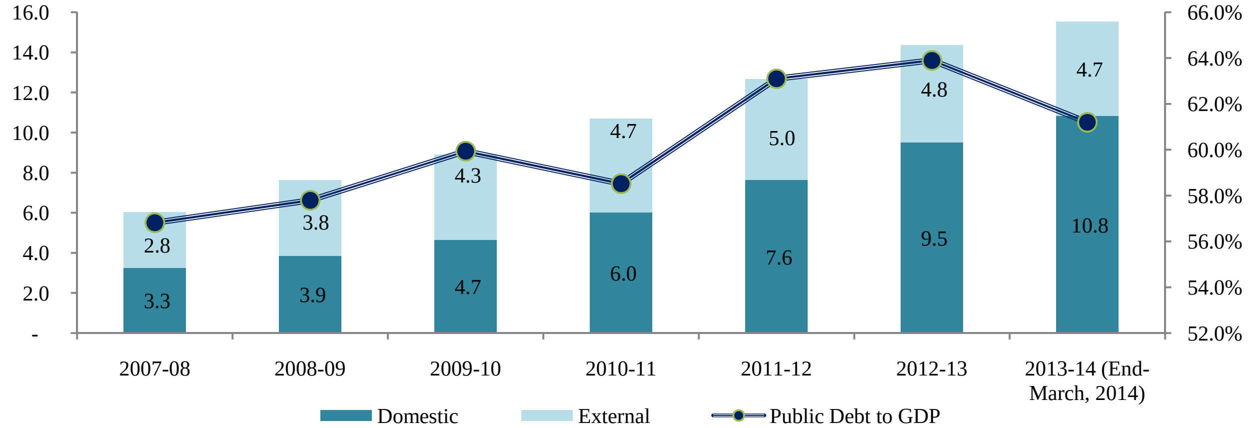
Pakistan's fiscal deficit saw significant variation from its original targets over the last few years. The fiscal deficit during 2012-13 was recorded at 8.2 percent of GDP (including payment of Rs.322 billion on account of settlement of circular debt) against the budgeted estimate of 4.7 percent. The deviation from initial estimates was mainly on account of three factors: (i) higher than budgeted subsidies; (ii) higher than budgeted interest payments owing to increased domestic borrowings;

(iii) lower than target FBR tax revenues. During July-March, 2013-14, fiscal deficit reached at 3.2 percent of GDP compared with 4.7 percent of GDP during the same period last year. This reduction in fiscal deficit came from slowdown in spending and an increase in revenues.

The higher fiscal deficit during last few years has increased the public debt and resultantly the government has to allocate more resources towards public debt servicing i.e. around 47 percent of total revenues have been consumed in debt servicing during first nine months of current fiscal year.

Public debt as a percent of GDP stood at 61.2 percent of GDP by end March 2014 compared with 63.9 percent of GDP at the end of last fiscal year.

Fig-9.3: Evolution of Public Debt
(LHS:in trillion of PKR) (RHS:percent of GDP)



9.2.2 Servicing of Public Debt

Public debt services provides information of the resources that a country has to allocate to service its debts and the burden it may impose through crowding out other uses of financial resources. Comparing debt service to a country's repayment capacity yields the best indicator for analyzing whether a country is likely to face debt-servicing difficulties in a given period.

During July - March, 2013-14, public debt servicing reached at Rs.1,155 billion against the annual budgeted estimate of Rs.1,561 billion. Public debt servicing consumed nearly 47 percent of total revenues during July - March, 2013-14 against a ratio of 44 percent during the same period last year. Ideally, this ratio should be below 30 percent to allow the government to allocate more resources towards social and poverty related expenditures.

Table-9.3: Public Debt Servicing (Rs. in billion)

	2013-14 (July-March)			
	Budgeted	**Actual**	**Percent of Revenue**	**Percent of Current Expenditure**
Servicing of External Debt	89.0	54.1	2.2	1.9
Repayment of External Debt	407.7	246.2	9.9	8.5
Servicing of Domestic Debt	1,064.5	855.0	34.5	29.4
Servicing of Public Debt	**1,561.2**	**1,155.3**	**46.6**	**39.8**

Source: Budget Wing and Debt Policy Coordination Office Staff Calculations, Finance Division

Out of total, domestic debt servicing was Rs.855 billion against Rs.725 billion paid during the same period last year. Further analysis of domestic debt servicing revealed that large portion was paid against Treasury Bills (260 billion), Market Related Treasury Bills (181 billion), Pakistan Investment Bonds (Rs. 147 billion) etc.

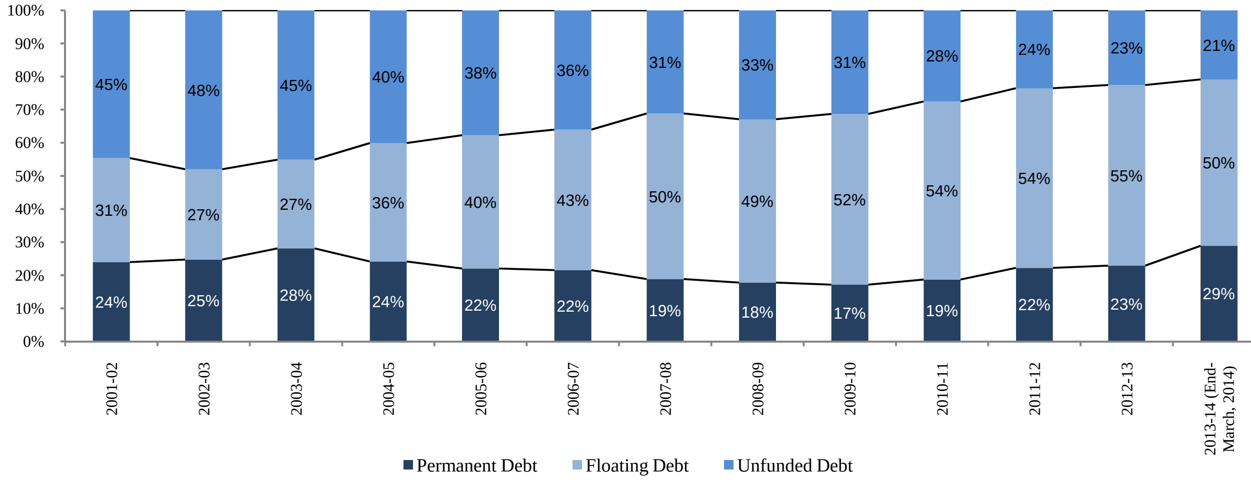
9.3 Domestic Debt

The use of domestic sources to borrow funds has various implications for the economy. Domestic borrowing plays a vital role in stimulating investment and private savings as well as strengthening domestic financial markets, since it provides depth and liquidity to the markets. The downside risks include higher interest rates which might stunt growth, the creation of inflationary pressure in an economy, and the possible crowding-out of the private sector. Therefore, any debt strategy should balance the risks to its debt stock by focusing on a mix of both domestic and external sources while borrowing funds.

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 Schemes). 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 45 percent of the aggregate domestic debt stock in 2001-02 has declined to 21 percent by end March, 2014. Contrary to this, the share of floating debt to total domestic debt has reached 50 percent by end-March, 2014 as compared with 31 percent in 2001-02 indicating reliance on shorter duration instruments which exposed the government to refinancing risk. Refinancing risk is probably the most significant risk in Pakistan's debt portfolio. Debt structures that rely heavily on short-term instruments are sources of vulnerability as short maturities entail high rollover and refinancing risk. In such cases, an increase in interest rates has an adverse fiscal impact.

Trends in domestic debt are discussed in the following graph:

Fig-9.4: Composition of Domestic Debt



As at end March 2014, duration of domestic debt stood at approximately 2 years. Out of total domestic debt (excluding Market Related Treasury Bills), Rs.2,773 billion or 26 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 Market Related Treasury Bills for the amount of Rs.2,776 billion are also included, around 51 percent of total domestic debt would have a maturity of less than a year. The estimate of duration may be a little inconsistent owing to the non-availability of actual maturity profile of National Savings Schemes (NSS) and manual operations of Central Directorate of National Savings (CDNS). A behavioral analysis was undertaken to estimate the maturity of NSS instruments.

9.3.1 Outstanding Domestic Debt

Total domestic debt was positioned at Rs.10,823 billion at end March 2014, representing an increase of Rs.1,306 billion in first nine months of current fiscal year. This increase mainly stems from net issuance of Pakistan Investment Bonds amounting Rs.1,043 billion. In relation to GDP, the domestic debt stood at 42.6 percent. The domestic debt grew by 14 percent in first nine months of current fiscal year.

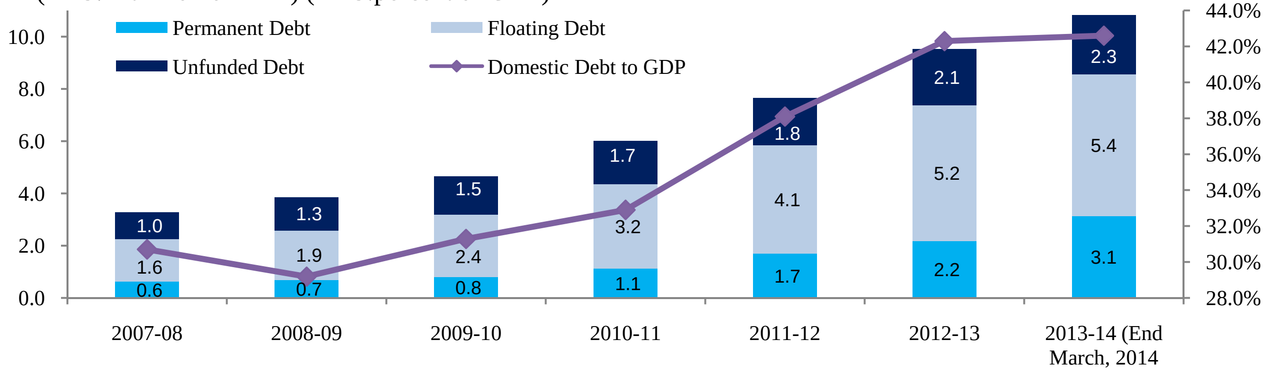
Following section highlights the developments in the various components of domestic debt during first nine months of outgoing fiscal year.

I. Permanent Debt

Permanent debt mainly consists of medium to long term instruments including Pakistan Investment Bonds, Government Ijara Sukuk bond, Prize Bond etc. PIBs are non-callable instruments, with fixed and semi-annual coupon payment. PIBs are issued in tenors of 3, 5, 10 and 20 years maturity. The 3, 5 and 10 years tenors are most liquid. Government Ijara Sukuk are medium term Shariah compliant bonds currently issued in 3 years tenor. The purpose of issuance was to raise money from Islamic banking which has grown substantially in Pakistan in past few years.

The total amount of permanent debt in the total domestic debt stood at Rs.3,128 billion as at end March 2014, representing an increase of Rs.948 billion or 44 percent higher than the stock at the end of last fiscal year. Around 73 percent of the total increase in domestic debt stock was contributed by permanent debt during first nine months of current fiscal year.

Fig-9.5: Evolution of Domestic Debt
(LHS:in trillion of PKR) (RHS:percent of GDP)



Government mopped up net of retirement Rs.1,043 billion through successful auctions of PIBs in first nine months of current fiscal year. Most of the proceeds through PIBs were witnessed in the third quarter of current fiscal year. The detailed analysis depicts that in anticipation of an increase in interest rates, market participation in PIBs auctions remained moderate in first quarter. However, in line with the government commitment to lengthen the maturity profile of domestic debt, the market responded positively from second quarter onwards which led to an unprecedented mobilization through PIBs. Prize bonds stock were increased by Rs.42 billion, whereas, stock of Government Ijara Sukuk witnessed a decrease of Rs.137 billion during first nine months of current fiscal year.

II. Floating Debt

Floating debt consists of short term domestic borrowing instruments such as Treasury Bills and State Bank borrowing through the purchase of Market Related Treasury Bills. 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). The share of 3 months, 6 months and 12 months maturity in total Treasury Bills portfolio was 48 percent, 14 percent and 38 percent respectively as at end March 2014. In order to raise short term liquidity, the government borrows from the domestic banks through auction in the form of Treasury Bills. The auction of Treasury Bills is arranged by the State Bank of Pakistan (SBP) twice a month.

Floating debt share in overall public debt and domestic debt stood at 35 percent and 50 percent respectively at end March 2014, while, it was at 36 percent and 55 percent respectively at the end of last fiscal year. During July-March, 2013-14, the floating debt grew by Rs.244 billion compared with Rs.633 billion during the same period last year.

III. Unfunded Debt

Unfunded debt made up of the various instruments available under the National Savings Schemes. The total share of unfunded debt in the government's domestic debt stood at Rs.2,260 billion or 21 percent at the end of March, 2014.

Net mobilization through unfunded debt during first nine months of current fiscal year stood at Rs.113 billion compared with Rs.266 billion during the same period last year. In terms of composition, most of the incremental mobilization went into Bahbood Savings Certificates (Rs.41 billion) and Regular Income Certificates (Rs.34 billion).

CDNS plays an important role in mobilizing retail savings in the economy. Government took various measures to rationalize the NSS 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, the rate setting on NSS should be more dynamic and closely aligned to the domestic market yield curve to avoid interest rate arbitrage. NSS instruments also need to be integrated into mainstream capital markets by making them tradable and by withdrawing the implicit put option, which is a potential source of liquidity problems for 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-9.4: Outstanding Domestic Debt (Rs. in billion)

	2008	2009	2010	2011	2012(P)	2013(P)	2014(P)*
Permanent Debt	**616.8**	**685.9**	**797.7**	**1,125.6**	**1,696.9**	**2,179.2**	**3,127.5**
Market Loans	2.9	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	0.7
Prize Bonds	182.8	197.4	236.0	277.1	333.4	389.6	431.1
Foreign Exchange Bearer Certificates	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Bearer National Fund Bonds	0.0	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	0.0
Special National Fund Bonds	0.0	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	0.0
U.S. Dollar Bearer Certificates	0.0	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	4.2	4.4
Government Bonds Issued to SLIC	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Pakistan Investment Bonds (PIBs)	411.6	441.0	505.9	618.5	974.7	1,321.8	2,365.0
Government Ijara Sukuk	-	27.8	42.2	224.6	383.5	459.2	322.6
Floating Debt	**1,637.4**	**1,904.0**	**2,399.1**	**3,235.4**	**4,143.1**	**5,196.2**	**5,440.4**
Treasury Bills	536.4	796.1	1,274.1	1,817.6	2,383.4	2,921.0	2,664.2
Rollover of Treasury Bills discounted SBP	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Market Related Treasury Bills (MRTBs)	1,100.4	1,107.3	1,124.4	1,417.3	1,759.2	2,274.7	2,775.7
Unfunded Debt	**1,020.4**	**1,270.5**	**1,457.5**	**1,655.8**	**1,798.0**	**2,146.5**	**2,259.8**
Defence Savings Certificates	284.6	257.2	224.7	234.5	241.8	271.7	280.6
Khas Deposit Certificates and Accounts	0.6	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	0.0
Savings Accounts	27.7	16.8	17.8	17.2	21.2	22.3	25.6
Mahana Amadni Account	2.5	2.4	2.2	2.1	2.0	2.0	2.3
Postal Life Insurance	67.1	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	734.6	742.2
Regular Income Scheme	51.0	91.1	135.6	182.6	226.6	262.6	296.4
Pensioners' Benefit Account	87.7	109.9	128.0	146.0	162.3	179.9	193.5
Bahbood Savings Certificates	229.0	307.5	366.8	428.5	480.8	528.4	569.4
National Savings Bonds	-	-	3.6	3.6	3.6	0.2	0.2
G.P. Fund	42.5	40.1	39.9	44.3	54.5	73.1	78.7
Short Term Savings Certificates	-	-	-	-	-	4.0	3.1
Total Domestic Debt	**3,274.5**	**3,860.4**	**4,654.3**	**6,016.7**	**7,638.1**	**9,521.9**	**10,827.8**
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**	**9,517.4**	**10,823.2**

Source: State Bank of Pakistan, Budget Wing and Debt Policy Coordination Office Staff Calculations
P: Provisional, *: end March,2014

9.4 External Debt and Liabilities

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 State Bank of Pakistan. There is an inherent capital loss associated with the debt denominated in foreign currency, however, it is mitigated by the strong concessionality element (low cost and long tenors). The impact of any currency shock should not be looked at in isolation, but rather be analyzed in the context of interest rate differential.

As on March 31, 2014, EDL has been dominated by Public and Publically Guaranteed debt having share of 73 percent mainly owing to current account deficit which is financed through loans from multilateral and bilateral donors. Debt obligations of the private sector are fairly limited and have been a minor proportion of EDL (5 percent). Borrowing from IMF contributed 6 percent in EDL stock as compared with 7 percent at the end of last fiscal year owing to net repayments during first nine months of current fiscal year. The composition and structure of EDL as at end March, 2014 is depicted through Fig-9.6.

EDL stock was recorded at US$ 61.8 billion as on March 31, 2014. Out of total EDL, public external debt amounted to US$ 47.8 billion. EDL stock increased by US$ 906 million during first nine months of current fiscal year. Out of this total increase, US$ 275 million was contributed by translational loss on account of cross-currency movement against US Dollar.

IMF has approved three years Extended Fund Facility program for Pakistan on September 04, 2013 for SDR 4.4 (US$ 6.64) billion against which US$ 1,657 million was disbursed in the first nine months of current fiscal year. Total disbursements excluding IMF were US$ 2,301 million during first nine months of current fiscal year compared with US$ 1,782 million during the same period last year.

Fig-9.6: Composition of External Debt and Liabilities - March 31, 2014

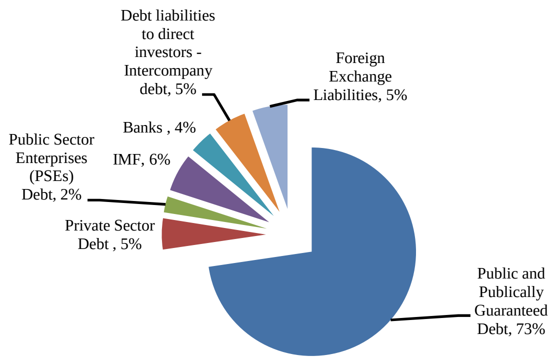


Table-9.5: Pakistan External Debt and Liabilities

	2008	2009	2010	2011	2012 (P)	2013 (P)	2014 (P)*
	(US$ in billion)						
1. Public and Publically Guaranteed Debt	**40.6**	**42.6**	**43.1**	**46.5**	**46.4**	**44.4**	**44.9**
i) Public debt	**40.4**	**42.4**	**42.9**	**46.4**	**46.2**	**43.5**	**44.5**
A. Medium and Long Term(>1 year)	**39.7**	**41.8**	**42.1**	**45.7**	**45.6**	**43.5**	**44.0**
Paris Club	13.9	14.0	14.0	15.5	15.0	13.5	13.5
Multilateral	21.4	23.0	23.7	25.8	25.3	24.2	24.2
Other Bilateral	1.1	1.4	1.8	1.9	2.5	2.9	3.4
Euro Bonds/Saindak Bonds	2.7	2.2	1.6	1.6	1.6	1.6	1.6
Military Debt	0.0	0.2	0.2	0.1	0.1	0.1	0.1
Commercial Loans/Credits	0.1	0.2	-	-	-	-	0.2
Local Currency Bonds	0.0	-	0.0	0.0	-	0.0	-
Saudi Fund for Development	-	-	0.2	0.2	0.2	0.2	0.2
SAFE China Deposits	-	0.5	0.5	0.5	1.0	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**	**0.5**	**0.0**	**0.5**
Commercial Loans/Credits	-	-	-	-	-	-	0.2
IDB	0.7	0.7	0.8	0.6	0.5	-	0.3
Local Currency Securities (T-Bills)	0.0	-	0.1	0.0	0.0	0.0	0.1
ii) Publicly Guaranteed Debt	**0.2**	**0.2**	**0.2**	**0.1**	**0.2**	**0.9**	**0.4**
A. Medium and Long Term(>1 year)	0.2	0.2	0.2	0.1	0.2	0.9	0.4
Paris Club	-	-	-	-	-	-	-
Multilateral	0.1	0.1	0.1	0.0	0.0	0.3	0.0
Other Bilateral	0.1	0.1	0.0	0.0	0.2	0.6	0.4
Commercial Loans/Credits	0.0	-	0.1	-	-	-	-
Saindak Bonds	-	-	-	-	-	-	-
B. Short Term (<1 year)	-	-	-	-	-	-	-
IDB	-	-	-	-	-	-	-
2. Private Non-Guaranteed Debt (>1 year)	**1.9**	**2.4**	**3.8**	**4.4**	**3.6**	**3.1**	**3.0**
3. Public Sector Enterprises (PSEs Debt)	**1.0**	**0.9**	**1.4**	**1.3**	**1.3**	**1.2**	**1.5**
4. IMF	**1.3**	**5.1**	**8.1**	**8.9**	**7.3**	**4.4**	**3.6**
of which Central Government	-	-	1.1	2.0	1.9	1.7	1.0
Monetary Authorities	1.3	5.1	7.0	6.9	5.4	2.7	2.6

Table-9.5: Pakistan External Debt and Liabilities

	2008	2009	2010	2011	2012 (P)	2013 (P)	2014 (P)*
5. Banks	**-**	**-**	**0.7**	**1.1**	**1.8**	**1.6**	**2.2**
Borrowing	-	-	0.2	0.4	0.9	0.7	1.3
Nonresident Deposits (LCY & FCY)	-	-	0.6	0.7	1.0	0.8	0.9
6. Debt liabilities to direct investors - intercompany debt	**-**	**-**	**1.9**	**1.6**	**2.7**	**3.1**	**3.1**
Total External Debt (1 to 6)	**44.9**	**51.1**	**59.0**	**63.8**	**63.1**	**57.8**	**58.4**
7. Foreign Exchange Liabilities	1.3	1.3	2.6	2.6	2.4	3.1	3.4
Total External Debt & Liabilities (1 to 7)	**46.2**	**52.3**	**61.6**	**66.4**	**65.5**	**60.9**	**61.8**
(of which) Public Debt	**40.7**	**46.4**	**49.8**	**54.5**	**53.1**	**48.7**	**47.8**
Official Liquid Reserves	8.6	9.1	13.0	14.8	10.9	6.0	5.4

Source: State Bank of Pakistan, Economic Affairs Division and Debt Policy Coordination Office Staff Calculations
P: Provisional, *: end March,2014

Following section highlights the developments in the various components of EDL during first nine months of the current fiscal year:

I. Public and Publicly Guaranteed Debt (PPG)

Public and publicly guaranteed debt is dominated by the loans from bilateral and multilateral donors having largest share of 66 percent in EDL as on March 31, 2014. Multilateral debt is the largest component of Pakistan's EDL. The stock of multilateral debt remained almost at the same level as on June 30, 2013. The project-based nature of loans contracted under this category hinges on Pakistan's ability to instill project efficiency. Debt from bilateral sources includes loan contracted with Paris Club countries and other countries outside the Paris Club. It is second largest component of Pakistan's EDL. It witnessed an increase of US$ 0.4 billion during first nine months of current fiscal year.

II. IMF Debt

IMF has approved three years Extended Fund Facility program for Pakistan on September 04, 2013 amounting to SDR 4.4 (US$ 6.64) billion which will be disbursed in three years. It will support country's economic reform program to promote inclusive growth.

As at end March, 2014, debt owed to IMF aggregated up to US$ 3.6 billion out of which US$ 1 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 first nine months of current fiscal year, US$ 1,657 million was received against Extended Fund Facility program, whereas, US$ 2,519 million was repaid during the same period.

9.4.1 Composition of Foreign Economic Assistance

Total amount of US$ 2,301 million was received in the first nine months of current fiscal year against foreign economic assistance. The composition of this assistance is as follows:

I. Commitments

The commitments of foreign economic assistance were US$ 2,660 million during 2012-13, while during July-March, 2013-14, total commitments amounted to US$ 8,996 million. About 91 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 85 percent.

II. Disbursements

During July-March, 2013-14, disbursements of US$ 2,301 million were for different purposes like Project Aid (US$ 1,321 million), Non-Food Aid (US$ 50 million), Programme-Loans/Budgetary Support (US$ 828 million) and relief (US$ 102 million). Project aid accounted for 57 percent of the total disbursements.

9.4.2 External Debt Servicing

Total EDL servicing was US$ 7,185 million during 2012-13. The EDL servicing recorded a significant increase of 19 percent during 2012-13 which was led by repayments of around US$ 3 billion against IMF loans. A segregation of this amount showed payment of US$ 5,553 million against maturing EDL stock while interest payments were US$ 933 million and US$ 700 million was rolled-over.

Among the principal repayments, US$ 1,155 million of multilateral debt and US$ 2,899 million of IMF accounted for most of the share. This was the first time the country made such large principal repayments in a single year.

Table-9.6: Pakistan's Public External Debt Servicing (US Dollar in million)

Years	Actual Amount Paid	Amount Rolled Over	Total
2008	3,182.6	1,200.0	4,382.6
2009	4,747.2	1,600.0	6,347.2
2010	4,607.0	1,723.0	6,330.0
2011	3,947.7	1,488.0	5,435.7
2012	4,507.3	1,543.0	6,050.3
2013	6,485.1	700.0	7,185.1
2014*	5,388.3	-	5,388.3

Source: State Bank of Pakistan and Debt Policy Coordination Office Staff Calculations
*July-March

During July-March, 2013-14, the servicing on external debt was recorded at US$ 5,388 million. An amount of US$ 4,747 million was paid against principal, out of which, US$ 2,519 million was against IMF loans. Interest payments were recorded at US$ 642 million during first nine months of current fiscal year.

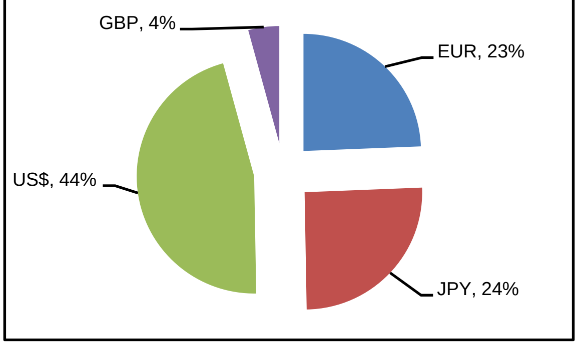
9.4.3 Impact of Exchange Rate Fluctuations

In Pakistan, external loans are contracted in various currencies but 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.

As at end March, 2014, around 95 percent of total external debt is contracted in 4 major currencies (adjusted for Special Drawing Rights) as depicted in the graph 9.7.

During first nine months of current fiscal year, depreciation of the US Dollar against other major currencies caused the foreign currency component of public debt to increase by US$ 275 million. Appreciation of Euro and Special Drawing Rights against US Dollar contributed in translational loss of US$ 269 million and US$ 455 million, respectively. However, this loss was reduced by US$ 431 million due to appreciation of US Dollar against Japanese Yen.

Fig-9.7: Currency Wise Composition of External Debt - March 31, 2014

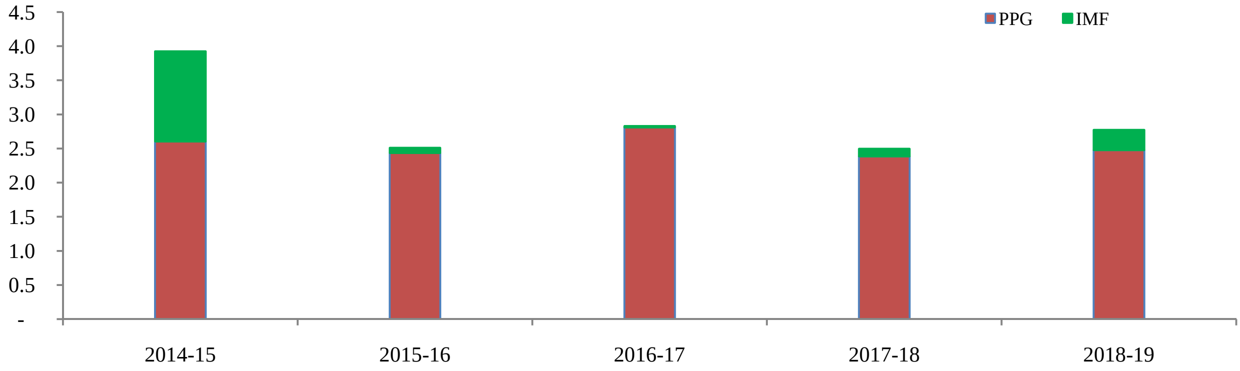


Managing foreign exchange risk is a fundamental component of a prudent debt management strategy. A comprehensive foreign exchange risk management requires establishing and implementing sound and prudent foreign exchange risk management policies and control procedures. If currency movements over a longer period of last 20 years is analyzed, 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 government adopted a currency hedging framework.

9.4.4 Maturity Profile of External Debt

Average Time to Maturity (ATM) of Public and Publically Guaranteed debt was approximately 10.8 years as of March 31, 2014. The ATM including IMF loans stood at 10.3 years. The ATM reduced with the inclusion of IMF loans as heavy repayments against these loans are due in 2014-15 with comparatively reduced projected outflows thereon.

Fig-9.8: Medium Term Projected Principal Repayments (US$ in billion)



9.4.5 External Debt Sustainability

Managing the levels of external debt and the risks associated with them pose policy makers with a different set of challenges. A key component of external debt sustainability analysis is to estimate the path of a country's external debt stock over time. The increase in interest rates, depreciation of exchange rate and higher current account deficit can increase stock of external debt. In crisis situations, countries can have recourse to debt restructuring or reduction, but such action cannot be a regular means of dealing with external financing problems, as it affects access to new financing. Thus, a good tracking system in the form of debt sustainability analysis based on key macroeconomic indicators can predict and prevent debt problems.

Analysis of the current account deficit provides important clues as to the future direction of the external debt path. Higher current account in the absence of offsetting increases to current transfers and non-debt creating capital flows can add to the stock of external debt. Similarly, any increase in interest rates and exchange rate depreciation will increase the debt servicing cost of the country and will affect the public external 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 foreign exchange reserves. In this case, if the growth in FEE exceeds the growth in EDL, the ratio of EDL-to-FEE will continue to decline.

Table-9.7: External Debt Sustainability

(In percent)	2008	2009	2010	2011	2012	2013	2014*
Non Interest Current Account/GDP	(6.9)	(4.4)	(1.4)	0.8	(1.3)	(0.5)	(0.5)
Growth in Exports	18.2	(6.4)	2.9	28.9	(2.6)	0.4	3.2[(1)]
Growth in Imports	31.2	(10.3)	(1.7)	14.9	12.8	(0.6)	3.7[(1)]
Growth in EDL	14.9	13.4	17.6	7.8	(1.3)	(8.7)	(0.9)[(1)]
Growth in FEE	12.8	(5.1)	7.9	25.1	1.1	4.1	0.2[(1)]
Growth in Non Interest Foreign Currency Payments	27.2	(12.8)	(4.9)	13.3	11.4	0.4	2.4[(1)]
EDL/FEE (times)	1.2	1.5	1.6	1.4	1.4	1.2	1.6
EDL/FER (times)	4.0	4.2	3.7	3.6	4.3	5.4	6.0
EDL/GDP	27.1	31.1	34.7	31.0	29.2	26.1	25.2
EDL Servicing/FEE	11.8	18.0	16.6	11.4	12.5	14.3	14.2

Source: Debt Policy Coordination Office Staff Calculations, Finance Division
*: end March, 2014.
[(1)]: Growth compared to equivalent period in 2013
FEE: Foreign Exchange Earnings; EDL: External Debt and Liabilities; FER: Foreign Exchange Reserves

Due to improved trade balance (higher cotton prices) in 2010-11, non interest current account showed a surplus of 0.8 percent of nominal GDP. Afterwards, non interest current account posted a deficit of 1.3 percent and 0.5 percent of GDP in 2011-12 and 2012-13, respectively owing to high value of oil imports. During first nine months of current fiscal year, non interest current account showed a deficit of 0.5 percent of GDP as compared with a deficit of 0.2 percent during the same period last year.

EDL as a percentage of FEE gives a measure of a country's debt repayment capacity. Pakistan's EDL and its servicing in terms of FEE stood at 1.2 times and 14.3 percent during 2012-13 which is within the acceptable threshold of 2 times and 20 percent. During first nine months of current fiscal year, EDL and its servicing in terms of FEE stood at 1.6 times and 14.2 percent, respectively.

A decrease in EDL in relation 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 improved slightly in 2010-11 mainly because of stagnation in reserves and lower growth in EDL stock. However, it showed downward trend during last two years and recorded at 5.4 times as on June 30, 2013 mainly because of drawdown on reserves owing to repayments of IMF loans and other lower non-debt creating flows. During first nine months of current fiscal year, this ratio was further deteriorated and recorded at 6 times as compared with 5 times during the same period last year.

EDL as a percent of GDP stood at 26.1 percent by end June, 2013 compared with 29.2 percent in 2011-12. This improvement was mainly due to hefty repayment against IMF loans and translational gain on account of US Dollar appreciation against other major currencies. By end March 2014, EDL as a percent of GDP further improved and stood at 25.2 percent mainly again due to hefty repayments against IMF loans and faster growth in nominal GDP in relation to slower growth in external debt.

9.5 Pakistan's Link with International Capital Market

Pakistan has successfully tapped international capital market after a gap of 7 years which highlights investors' confidence in the recent changes in country's leading economic indicators, external finances and structural reforms undertaken by the government. Against the initial expectations of raising US$ 500 million, the investor response was overwhelmingly strong and the order-books were oversubscribed consisting of over 400 orders from high quality investors. After a careful consideration, it was decided to raise financing of US$ 2 billion including US$ 1 billion each in 5 and 10 years tenor with coupon at 7.25 percent and 8.25 percent, respectively. The transaction represents the largest ever international bond offering by Pakistan. The region and investor wise break-up of these bonds are depicted through the following graphs:

Fig-9.9: Distribution of 5 Years Bonds Across Geographical Regions

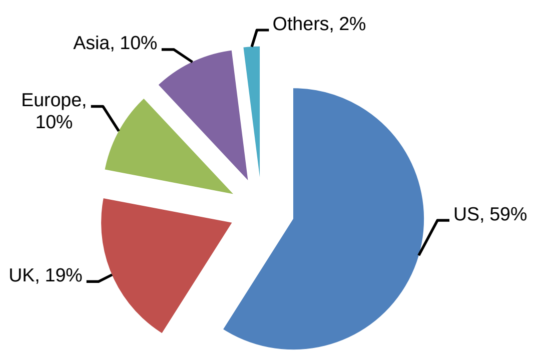


Fig-9.10: Distribution of 10 Years Bonds Geographical Region

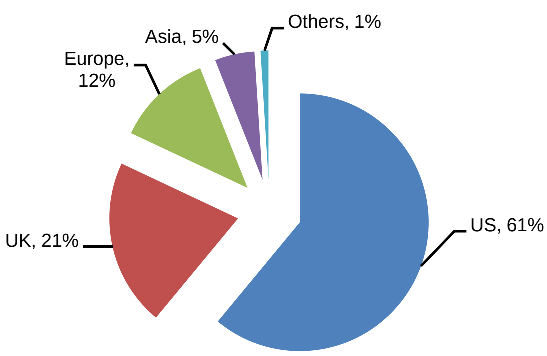


Fig-9.11 - Distribution of 5 Years Bonds Across Investors

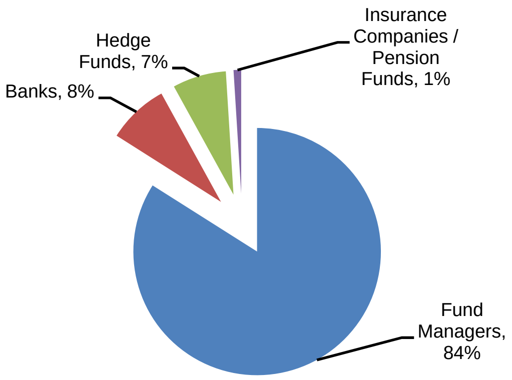
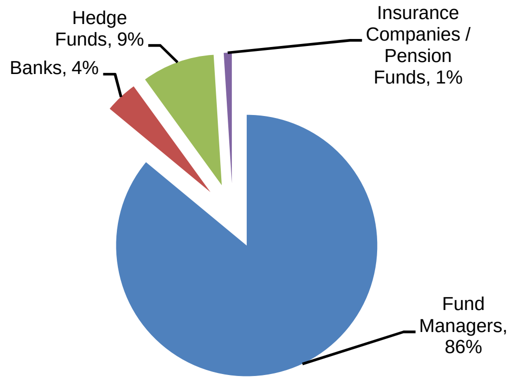


Fig:-9.12 - Distribution of 10 Years Bonds Across Investors



Pakistan's bonds have performed well in secondary market with spreads and yields of the recently issued bonds have tightened since issue.

Table-9.8: Selected Secondary Market Benchmarks

Issuer	Ratings (Moody's/S&P)	Coupon (%)	Maturity	Yield (%)
Pakistan	Caa1/B-	7.125	March 2016	6.266
Pakistan	Caa1/B-	6.875	June 2017	6.598
Pakistan	Caa1/B-	7.250	April 2019	7.248
Pakistan	Caa1/B-	8.250	April 2024	8.399
Pakistan	Caa1/B-	7.875	March 2036	9.392

Source: Bloomberg as on May 06, 2014

Fig - 9.13 Spread Performance of Pakistan Eurobond

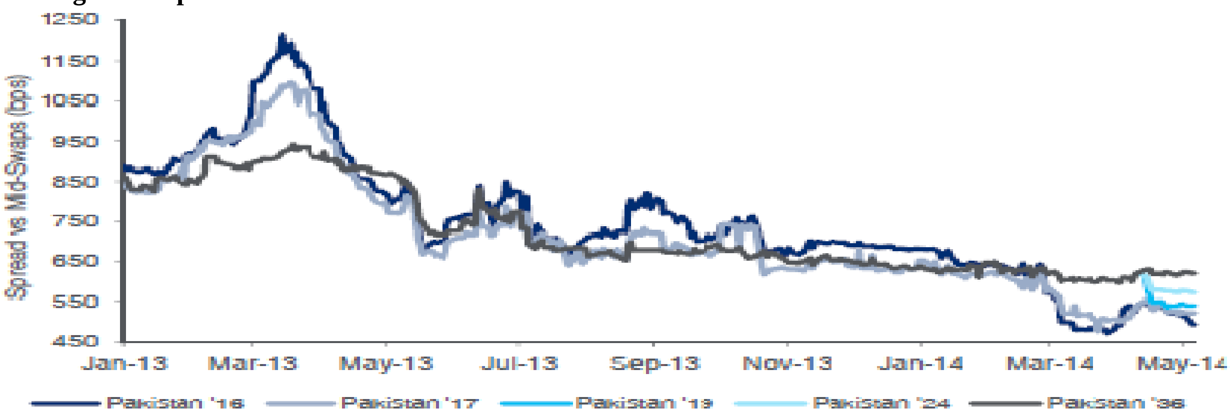
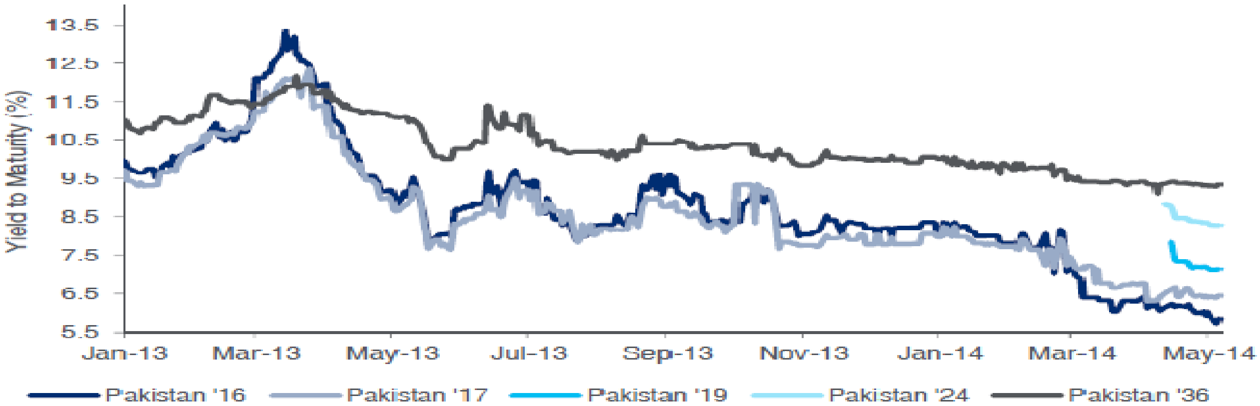


Fig - 9.14 Yield Performance of Pakistan Eurobond



9.6 Conclusion

Present government is committed to accomplish objectives outlined in Fiscal Responsibility and Debt Limitation Act, 2005. Accordingly, it has taken various corrective measures to effectively manage public debt portfolio. Going forward, the prime objectives of public debt management include: (i) fulfilling the financing needs of the government keeping in view cost-risk tradeoffs; (ii) development of domestic debt market (iii) lengthening of maturities of debt instruments; and (iv) stimulation of external inflows. Further, it is important for the government to adopt an integrated approach for economic revival and debt reduction, 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