8 Domestic and External Debt

8.1 Overview

The persistent rise in the total debt over the last decades saw a notable reversal in trend during FY02, as the total debt stock edged down by Rs 105.5 billion; the year also witnessed an important shift in the term structures of both domestic and external debt towards longer tenors. The achievements reflect the country's adherence to the Debt Reduction and Management Strategy (DRMS)[1], as well as a one-off stock adjustment of domestic debt, enabling Pakistan to make concrete progress towards a sound and sustainable debt path.

On the external front, the successful completion of an IMF Stand-By Arrangement (SBA) restored Pakistan's credibility with International Financial Institutions (IFIs), and led to successful negotiations for a medium-term IMF assistance program, PRGF, as well as increased aid from other IFIs. Moreover, the decision to join the international war against terrorism revived the previously strained relations with bilateral creditors. This paved the way for the *stock* re-profiling of Pakistan's bilateral debt by the Paris Club creditors, on very generous terms. As a result, the net present value of Pakistan's external debt is expected to decline notably (see **Section 8.3** for details).

The domestic debt profile shows similar improvement. A one-time adjustment substantially reduced the stock of short-term debt (reducing the stream of future interest payments), and together with increased long-term borrowings, helped lengthen its maturity profile. Furthermore, improved exchange rate management and the spillover impact of external developments helped SBP to reduce the market-driven interest rates to all-time lows, fostering a sharp reduction in the cost of domestic debt.

While the above FY02 developments are quite commendable, it is necessary to emphasize that Pakistan still has a long way to go; an exit from the debt problems will require sustained macroeconomic discipline over a number of years.

At the close of FY02, total debt stood at Rs 3,760.5 billion and the total *debt to GDP* ratio declined from 113.2 percent to 102.0 percent (see **Table 8.1**). Of the three categories of Pakistan's total debt, the highest reduction was visible in external debt (Rs 53.9 billion) followed by explicit liabilities (Rs 34.6 billion), while domestic debt registered a smaller decline of Rs 17.0 billion during FY02.

In Rupee terms, the decline in external debt is entirely due to the appreciation of the Rupee, as the stock has actually increased in Dollar terms (by US$ 1,276 million). Nonetheless, the profile of the external debt stock reflects some qualitative improvement due to the re-profiling of bilateral debt, the retirement of expensive commercial debts, and increased reliance on soft credits from IFIs. As far as the explicit liabilities are concerned, the reduction of Rs 34.6 billion was mainly driven by the repayments of maturing 3-year Special US Dollar Bonds.

8.2 Domestic Debt

There is a distinct improvement in Pakistan's domestic debt profile during FY02, with a pause in the unremitting annual increase in public domestic debt, a perceptible decline in debt servicing costs, and an important shift in the term structure of the domestic debt. By end-June 2002 the total outstanding domestic debt was Rs 1695.5 billion, Rs 17.0 billion *lower* than the corresponding FY01 figure (see

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[1] Formulated in March 2001, DRMS envisages a reduction in the stock of external debt through restructuring of bilateral debt, and for arresting the growth of debt by the retirement of expensive debt and liabilities, and the acquisition of fresh loans on concessional terms etc.

Table 8.1: Profile of Domestic and External Debt
billion Rupees

	FY98	FY99	FY00	FY01	FY02
Total debt	**2,671.9**	**3,060.4**	**3,318.0**	**3,866.0**	**3,760.5**
1. Domestic debt	**1,176.2**	**1,375.9**	**1,559.9**	**1,712.5**	**1,695.5**
	(44.0)	(45.0)	(47.0)	(44.3)	(45.1)
2. External debt	**1,483.1**	**1,614.4**	**1,682.7**	**2,059.5**	**2,005.6**
	(55.5)	(52.8)	(50.7)	(53.3)	(53.3)
3. Explicit liabilities[1]	**12.6**	**70.1**	**75.4**	**94.0**	**59.4**
	(0.5)	(2.3)	(2.3)	(2.4)	(1.6)
Total debt as % of GDP	99.8	104.2	105.4	113.2	102.0
Domestic debt as % of GDP	43.9	46.8	49.6	50.1	46.0
External debt as % of GDP[2]	55.4	54.9	53.5	60.3	54.4
Explicit liabilities as % of GDP	0.5	2.4	2.4	2.8	1.6
Total debt servicing	**278.3**	**343.1**	**353.9**	**340.3**	**412.5**
Total interest payments	191.6	220.1	256.8	254.4	245.4
i. Domestic	160.1	178.9	206.3	195.4	179.1
ii. Foreign	28.7	38.0	44.9	51.2	60.8
iii. Explicit liabilities	2.8	3.2	5.6	7.8	5.6
Repayment of principal[3]	86.7	123.0	97.1	85.9	167.1
Ratio of external debt servicing to					
Export earnings	55.4	35.3	36.5	37.3	44.1
Foreign exchange earnings	34.9	23.6	23.4	23.3	26.1
Ratio of total debt servicing to					
Tax revenues	78.4	87.8	87.2	76.5	86.5
Total revenues	64.8	73.2	65.9	62.3	65.4
Total expenditures	43.9	53.0	47.6	46.8	47.2
Current expenditures	52.5	62.7	55.0	52.3	57.5

[1] Explicit liabilities include Special US $ Bonds, FEBCs, FCBCs and DBCs; of which Special US $ Bond is a foreign liability that is payable in foreign exchange, while FEBCs, FCBCs and DBCs are also foreign liabilities but are payable in Rupees.

[2] External debt to GDP ratio is not comparable to ratio calculated in **Table 8.8** due to a methodological difference. This ratio is calculated by converting the external debt into Pak Rupee using end-June exchange rates.

[3] Repayment of principal is the sum of repayment of long-term foreign debt and short-term credit.

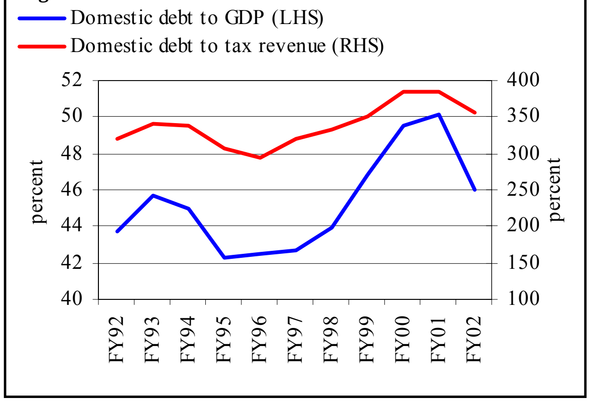
Note: Figures in parentheses are shares in total debt.

Sources: SBP & Ministry of Finance

Table 8.1). As detailed in **Section 8.2.1**, this was essentially due to a one-off stock adjustment, though it does have a continuing impact in the form of a lower stream of future interest payments. On the other hand, the rising share of long-term debt as well as the visible fall in the interest cost of domestic debt suggests a more definite improvement in the debt management (see **Section 8.2.2**).

As a result, most domestic debt indicators depict substantial improvement in FY02, e.g. the ratios of domestic debt to GDP, and to tax revenue, both witnessed sharp declines over FY01 figures (see **Figure 8.1**).

Figure 8.1: Domestic Debt Indicators



8.2.1 Adjustment in Debt Profile

The FY02 *fall* in the outstanding domestic debt creates some confusion in the presence of government's Rs 136.2 billion domestic borrowings to finance a portion of the budgetary deficit, i.e. contrary to standard theory, the FY02 change in domestic debt does not equate to the financing of budget deficit from domestic sources. The answer to this puzzle lies in a one-time adjustment in the *domestic* debt stock resulting from the rescheduling of the country's *external* debt, that has positive implications for the composition of the domestic debt stock as well as for the cost of servicing domestic debt.[2] Effectively, therefore, the adjustment acts as a *quasi-fiscal surplus*.

The roots of this change date back to the May 1998 economic sanctions imposed following Pakistan's nuclear test, which forced the government to declare a financial emergency. Trapped by a severe foreign exchange squeeze, the government decided to meet its external debt servicing obligations in Rupees instead of foreign currencies, at prevailing exchange rates. Accordingly, two new accounts, the "Special Account Debt Repayments I & II" were opened in July and December 1998 respectively.

While the government's fiscal balance reflected steady payments over the years, these *notional* external debt repayments only led to rising Rupee balances in the Special Accounts. Thus, by the time these accounts were eventually terminated in July 2001, these had accumulated to a very substantial Rs 194.6 billion. It is important to note that these notional payments had no monetary impact; while the payments were funded via budgetary borrowings from SBP and led to the increase in the SBP T-bill holdings (i.e. the SBP assets rose), the monetary impact was sterilized by keeping the borrowed funds in the reserved special accounts (i.e. an increase in SBP liabilities).

In fact, it was the rising fiscal burden of what were essentially notional payments that eventually persuaded an accounting change leading to the cancellation of a portion of the domestic debt stock against the accrued Rupees in the Special Accounts, reducing at a stroke the size of the domestic debt. It must be noted that these fiscal adjustments left the accrued external liability unaffected, until it too was eliminated through rescheduling of external debt, and the receipt of grants during FY02.

8.2.2 Composition of Domestic Debt

Pakistan's public domestic debt is divided into three categories, largely based on the maturity structure of the instruments.

<table>
<tr><th>Tenor of debt</th><th>Category</th><th>Billion Rupees</th><th>Redemption</th></tr>
<tr><td>Short term (one year or less) Rs557.8 billion</td><td>Floating debt</td><td>557.8</td><td rowspan="2">Fixed maturity Rs925.8 billion</td></tr>
<tr><td rowspan="2">Long term (greater than one year) Rs1137.7 billion</td><td>Permanent Debt</td><td>368.0</td></tr>
<tr><td>Unfunded debt</td><td>769.7</td><td>On demand Rs769.7 billion</td></tr>
</table>

Note: Prize bonds are also included in permanent debt.

As can be seen from **Figure 8.2**, the composition of domestic debt has seen significant changes in FY02. The year saw a reversal of the steady up-trend in the share of short-term debt, helped by the retirement of MRTBs as well as the greater market interest in PIBs.

This points to greater stability in the government's funding cycle. Moreover, the fact that a larger portion of fresh long-term borrowings was through PIBs means that the government is locking-in the benefit of historically low interest rates. To put this in perspective, one of the important reasons for

[2] A more detailed discussion on this issue is provided in a special section on Domestic Debt in SBP Second *Quarterly Report* for FY02.

the government's inability to reduce its debt servicing costs significantly over the last few years, is the lingering impact of very expensive long-term debt taken in earlier years.

Figure 8.2: Long Term Debt

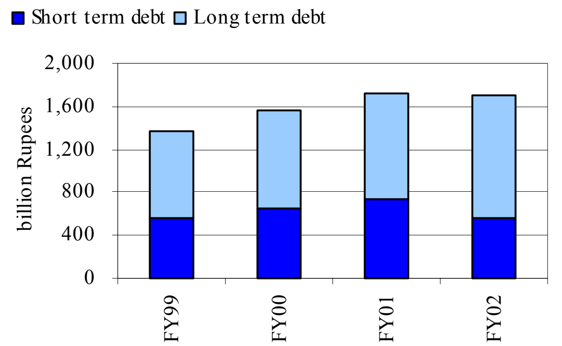
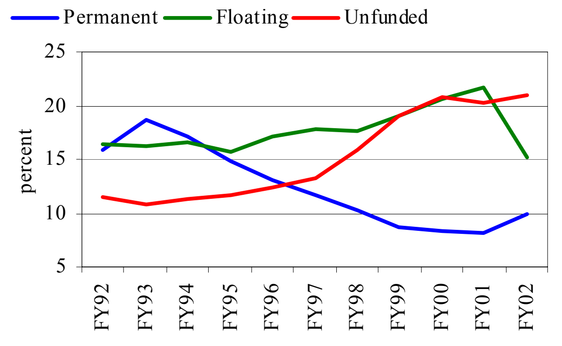


Figure 8.3: Debt Components as Percent of GDP



Permanent Debt

The permanent debt to GDP ratio has persistently declined from over 18.0 percent in FY93 to only 8.2 percent in FY01, before spiking again to 10.0 percent during FY02 (see **Figure 8.3**). This declining trend was largely attributed to maturing market loans, Bearer National Fund Bonds (BNFB), and Federal Government Bonds. Specifically, the total outstanding balance of these instruments has gone down from Rs 58.8 billion in FY92 to Rs 15.1 billion in FY02. Maturing Federal Investment Bonds (with no fresh sale since FY98) have also played a role in dragging down the permanent debt to GDP ratio.

However, the FY02 reversal of the declining trend is largely attributable to the introduction of the "Pakistan Investment Bond", which was heavily subscribed by the market. During FY02, the government mobilized over Rs 100.0 billion from this instrument alone, causing an increase in the permanent debt to GDP ratio. The successful launch of this instrument not only set a market-based long-term benchmark yield, but also helped the government to finance its budgetary requirements with stable long-term debt.[3] In absolute terms, the permanent debt saw a net increase of Rs 86.9 billion during the year, compared to a Rs 21.5 billion rise in FY01 (see **Table 8.2**).

Floating Debt

In sharp contrast to previous years, the outstanding level of floating debt has witnessed a reduction of Rs 180 billion during FY02 (see **Table 8.2**). This massive retirement is the result of a variety of factors, including the termination of the Special Account for debt repayments and bilateral grants from friendly countries. As a result, the floating debt to GDP ratio has declined by 6.5 percentage points in just one year (see **Figure 8.3**).

Table 8.2: Outstanding Level of Domestic Debt

billion Rupees

	FY99	FY00	FY01	FY02
A. Permanent debt	256.9	259.6	281.1	368.0
B. Floating debt	561.6	647.4	737.8	557.8
C. Unfunded debt	557.4	652.9	693.7	769.7
Total (A+B+C)	1,375.9	1,559.9	1,712.5	1,695.5
As percent of GDP				
A. Permanent debt	8.7	8.2	8.2	10.0
B. Floating debt	19.1	20.6	21.6	15.1
C. Unfunded debt	19.0	20.7	20.3	20.9
Total (A+B+C)	46.8	49.6	50.1	46.0

Unfunded Debt

Unfunded debt largely comprises of instruments offered by Central Directorate of National Savings (CDNS). The outstanding level of unfunded debt touched the level of Rs 769.7 during FY02, with a net inflow of Rs 76.0 billion. As can be seen from **Figure 8.3**, the unfunded debt to GDP ratio has

[3] For detailed discussion on PIBs, please see section on **Money Market**.

witnessed a continual increase from FY93 to FY00, largely on account of higher profit rates relative to other government debt instruments, despite the absence of incremental risk factors.

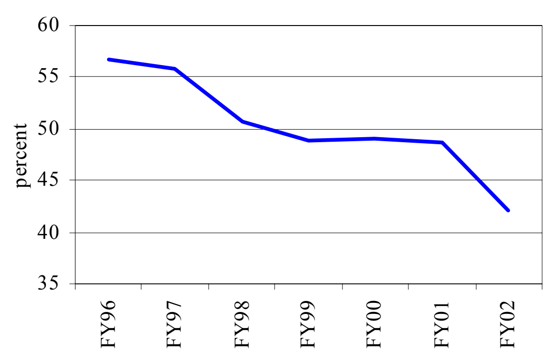
Realizing the dis-intermediary impact of higher profit rates of National Savings Scheme (NSS), as well as its distortionary implications for monetary policy, the NSS instruments have been restructured during the last three years. Their profit structure has been drastically changed and the profit income has been brought under the tax net. More specifically, the profit rates on Defense Saving Certificates (DSCs) have been linked with market based PIBs and are subject to revision after every six-month.

Furthermore, the institutional investment in NSS was banned before the launch of PIBs. This specific measure coupled with reduction in profit rates resulted in lower net inflows in these schemes (compared to average inflows in earlier years) during FY00 and FY01, which helped to arrest the increasing share of unfunded debt. However, unfunded debt to GDP ratio has again slightly increased during FY02 largely on account of higher inflows in NSS, which almost doubled as compared to last year.[4] The FY02 jump appears to reflect both, the external account improvement and the fact that rates on NSS instruments did not adequately mirror the decline in market-based instruments.

8.2.3 Classification of Domestic Debt by Owner

Domestic debt is broadly classified into two categories by ownership, i.e. by the banking and non-banking sectors. Although, the share of the banking sector in domestic debt has been declining since FY96, this trend was more pronounced during FY02 (see **Figure 8.4**), mainly due to a large one-off retirement of SBP T-Bills. The increased borrowings from non-banking sources were largely driven by higher inflows in the NSS and the sale of PIBs to non-banks.

Figure 8.4: Debt Held by the Banking Sector



Debt Held by the Banking Sector

Compared to an increase of Rs 67.8 billion during FY01, the banks' holdings of government debt saw a steep decline of Rs 118.0 billion during FY02 (see **Table 8.3**).

Table 8.3: Domestic Debt by Owners

billion Rupees

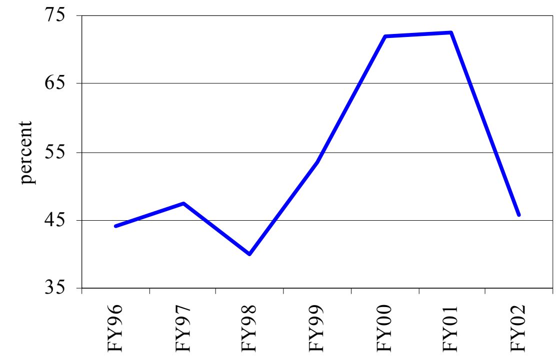
	FY99	FY00	FY01	FY02
Bank debt	**673.6**	**764.9**	**832.7**	**714.7**
Scheduled banks	314.0	213.5	228.1	388.5
SBP	359.5	551.4	604.6	326.2
Non-bank debt	**702.4**	**795.0**	**879.8**	**980.8**
NSS	542.4	633.8	670.2	741.2
Others	160.0	161.2	209.7	239.6
Total	**1,375.9**	**1,559.9**	**1,712.5**	**1,695.5**

Interestingly, this decline was not equally shared within the banking sector, as debt holdings of SBP declined sharply, while holdings of commercial banks rose by a smaller amount (see **Figure 8.5**). More specifically, the SBP holdings of government paper plummeted by Rs 278.4 billion during FY02, while commercial banks holdings surged up by Rs 160.4 billion over the same period. This drastic shift of government debt from SBP to commercial banks is largely attributed to two factors: (1) the government retired *Market Related T-Bills for replenishment* and *Adhoc T-Bills*, both of which are held entirely by the SBP, and (2) the easy monetary policy, coupled with large foreign exchange inflows, helped the government in re-pricing a portion of its outstanding

[4] This is because NSS rates have not weakened in correspondence with the declining yields on comparable market based instruments.

domestic debt through higher borrowing from commercial banks and an offsetting decline in SBP debt.[5]

Figure 8.5: Share of SBP in Debt Holdings of Banking Sector



Debt Held by the Non-banking Sector

In sharp contrast to the banking sector, the debt holdings of the non-banking sector recorded an increase of around Rs 101 billion during FY02 (see **Table 8.3**). This was primarily driven by higher inflows in NSS and Prize bonds.

Net inflows in NSS stood at Rs 71 billion during FY02, which is almost double as compared to a year ago. This increase is mainly attributable to higher national savings and rise in profit rates on these schemes. The instrument-wise mobilization reveals an interesting development as this increase was largely driven by higher amount in SSCs instead of DSCs, which had been the preferred instrument in past years. This departure from trend is quite visible in **Table 8.4**, as net inflows in SSCs during FY02 constitute around 50 percent of total inflows in NSS.

Table 8.4: Net Inflows in Major NSS

billion Rupees

	FY99	FY00	FY01	FY02
DSCs	38.3	41.2	16.6	21.2
SSCs	30.0	-14.7	9.4	36.3
RICs	59.1	26.1	8.6	10.9

The unusual shift from DSCs to SSCs appears to be the result of changing profit rates on these schemes. The government announced revised profit rates twice in the year under review; first with effect from July 1, 2001 to December 31, 2001 (for H1-FY02) and second with effect from January 1, 2002 to June 30, 2002 (for H2-FY02). In first revision, the compound profit rates on DSCs and SSCs were increased by about one percentage point to compensate for a withholding tax imposed with effect from July 1, 2001 (see **Table 8.5**).

Table 8.5: Profit Rates on DSCs and SSCs[1]

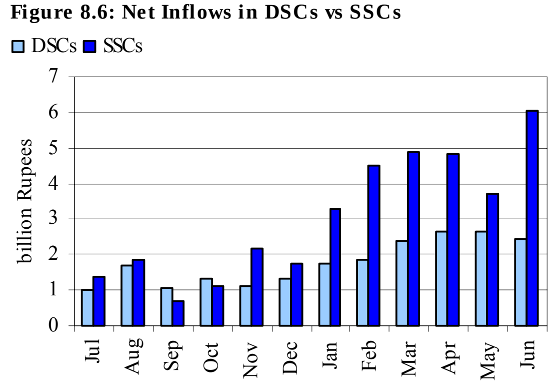
percent

	DSCs	SSCs
01-07-2000 to 30-06-2001	14.0	11.3
01-07-2001 to 31-12-2001	15.0	12.6
01-01-2002 to 30-06-2002	14.1	12.6

[1]: Compound annual average rates

During the second revision, the government reduced the profit rates on DSCs by one percentage point, following the reduction in PIBs coupon rates with effect from November 6, 2001, while the profit rates on SSCs were kept unchanged. This rendered the SSCs relatively more attractive as compared to DSCs, increasing their sales in the following months (see **Figure 8.6**).

Figure 8.6: Net Inflows in DSCs vs SSCs



Furthermore, this pattern of inflows for SSCs was also traceable in overall inflows in NSS. Specifically, investment in NSS stood at Rs 21.2 billion during H1-FY02, which was only

[5] For details, Please see section on **Money and Credit**.

27.9 percent of total net inflows for the year. The larger portion of FY02 NSS inflows was received in H2-FY02 when SSC rates were relatively more attractive.

8.2.4 Interest Payments on Domestic Debt

Interest payments on domestic debt for FY02 recorded an 8.3 percent decline (Rs 16.3 billion in absolute terms) over the preceding year. This was entirely driven by a massive fall in the cost of unfunded debt. The decline in interest payments on floating debt was almost negligible, while interest expenses on permanent debt *increased* by Rs 2.2 billion (see **Table 8.6**).

The rise in FY02 interest payments on permanent debt stems from rising stock of this component, as elaborated in **Sections 8.2.3**. Specifically, interest payments on PIBs rose sharply to Rs 8.5 billion as compared to only Rs 0.9 billion in FY01. Additional contributions to the rise were from interest payable on other maturing government bonds, and on liabilities of Pakistan Steel Mills.

Table 8.6: Interest Payments

billion Rupees

	FY99	FY00	FY01[1]	FY02[2]
Permanent debt	38.002	54.809	40.675	42.848
Floating debt	63.422	58.344	53.239	53.189
Unfunded debt	77.462	93.168	101.479	83.044
Total	178.886	206.321	195.393	179.081

Note: Data on 'permanent debt' exclude interest payments on FEBC, US$ bearer certificates, FCBCs and Special US $ bonds as these bonds are classified as explicit liabilities. Data on interest payments on unfunded debt include provincial interest payments, commissions, charges, and printing charges.

[1]: Data on Federal interest payments are taken from ABS FY03

[2]: Latest data received from Ministry of Finance

Source: Ministry of Finance

The marginal decline of Rs 50 million in the interest paid on floating debt calls for an explanation, given that the outstanding debt saw a steep fall of Rs 180 billion and that FY02 interest rates were lower. The apparent contradiction is explained by the accounting treatment; since the interest is computed on a cash basis, the cost shifts from one year to year. If we adjust the *accrued* interest of Rs 14.4 billion on MRTBs, the interest payments on floating debt drops to Rs 38.8 billion, which is substantially lower than both, the budget estimates and the interest cost for FY01.

Interest payments on unfunded debt include interest payment of provincial governments, commissions, charges and the printing costs of debt instruments. During FY02, these were Rs 18.4 billion lower than in the previous year; in fact, the fall was even higher than the fall recorded in overall interest payments on domestic debt. This suggests that a portion of this saving was offset by higher interest payments on permanent debt (see **Table 8.6**). Also, a compositional breakdown of the interest on unfounded debt shows that interest payments on NSS actually increased during FY02 (compared to FY01) but remained significantly below the budget target. This relatively low increase, despite heavy inflows in these schemes during FY02, is simply because the initial payments on the incremental NSS inflows will fall due in FY03 and beyond.

8.3 External Debt

The considerable improvement in Pakistan's external debt and liabilities (EDL) profile during FY02 reflects the country's adherence to the Debt Reduction and Management Strategy (DRMS). This period witnessed a reversal in the country's EDL trend through a US$ 0.6 billion reduction to US$ 36.5 billion. There was also a visible shift in its maturity profile and the cost structure (see **Table 8.7**). Within the EDL, while the debt burden has increased by US$ 1.3 billion, this is on very concessional terms and is more than offset by a US$ 1.9 billion fall in liabilities.

The EDL reduction in FY02 is quite creditable, but there is no room for complacency. Given the magnitude of the external debt burden, sustained macroeconomic discipline will be required over a number of years before Pakistan can completely extricate itself from the debt trap. Also, it must be

Table 8.7: Pakistan's External Debt and Liabilities
million US Dollar

	FY99	FY00	FY01	FY02 P
I. Public and publicly guaranteed debt	**26,025**	**27,862**	**28,145**	**29,235**
A. Medium and long term (> 1 year)	**25,873**	**27,732**	**27,888**	**29,052**
Paris club	11,873	12,428	11,822	12,516
Multilateral	10,599	12,292	13,343	14,331
Other bilateral	629	639	421	429
Eurobonds	608	620	645	643
Military debt	1,004	653	554	819
Commercial loans/credits	1,160	1,100	1,103	314
B. Short-Term (≤ 1 year)	**152**	**130**	**257**	**183**
IDB	152	130	257	183
II. Private non-guaranteed debts	**3,435**	**2,842**	**2,450**	**2,226**
Medium and long term (> 1 year)	3,435	2,842	2,450	2,256
Private loans/credits	3,435	2,842	2,450	2,256
III. IMF	**1,825**	**1,550**	**1,529**	**1,939**
Total external debt	**31,285**	**32,254**	**32,124**	**33,400**
IV. Foreign exchange liabilities	**5,315**	**5,664**	**5,015**	**3,132**
Foreign currency accounts	1,719	1,733	1,100	406
FE-45	1,380	1,072	774	234
FE-31 deposits (incremental)	272	300	326	172
FE-13	67	361	-	-
Special US Dollar bonds	1,164	1,297	1,376	924
National debt retirement program	196	156	150	75
Foreign currency bonds (NHA)	263	241	219	197
Central bank deposits	700	700	700	750
NBP/BOC deposits	616	781	749	500
Others liabilities	657	756	721	280
Total external debt and liabilities (I to IV)	**36,600**	**37,918**	**37,139**	**36,532**
FCBCs/FEBCs/DBCs (payable in Rupee)	**195**	**148**	**90**	**66**

P: Provisional

Note: Due to changes in definitions (as explained **in Sections 8.3**) the data in this table is not directly comparable with data presented in earlier Annual Reports

noted that a substantial part of the FY02 improvement is based on improved debt management rather than a very strong growth of the domestic economy.

Nonetheless, Pakistan did achieve a number of milestones during FY02 that will help the transition towards a sounder and more sustainable debt path:

1. The successful completion of an IMF Stand-By Arrangement (SBA) considerably restored Pakistan's credibility with IFIs by demonstrating the government's commitment to the reform agenda.
2. The government's decision to join the international war against terrorism also revived our previously strained relationships with major bilateral creditor countries. As a result, Pakistan received improved access to some key markets and saw the removal of a number of economic sanctions imposed after nuclear test and the military takeover in October, 1999.
3. These steps paved the way for the successful negotiation of a relatively generous medium-term PRGF and also led to additional assistance and support from bilateral creditors and IFIs, as reflected by the higher FY02 receipts on account of non-food aid (see **Table 9.1**).

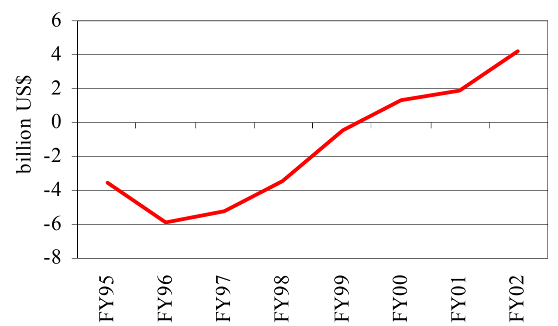
4. The restructuring of Pakistan's bilateral debt by Paris Club creditors was also on very generous terms[6]; the sharp reduction in the Net Present Value (NPV) of external debt (between 28 to 44 percent) was achieved without the stigma of a HIPC restructuring.[7]
5. Pakistan also posted a record current account surplus of US$ 2.7 billion during FY02. This was instrumental to the accumulation of the SBP foreign exchange reserves to an all-time high of US$ 4.8 billion by end-June 2002, as well as facilitating the retirement of the more expensive external debt and liabilities.
6. Finally, the unprecedented appreciation of Rupee/Dollar parity by 6.7 percent, and resulting end to devaluation expectations (evident in the virtual disappearance of the kerb market premium) carries major positive direct[8] and indirect[9] connotations.

8.3.1 External Debt Indicators

A majority of Pakistan's debt indicators witnessed an improvement during FY02.

External debt ratios show a mixed performance in FY02. The increase in soft loans worsened some debt indicators, while others saw dramatic improvements due to a jump in remittances, and the rise in net receipts under the services account. The *debt to GDP* and *debt to export earnings* ratios worsened, but despite the increased debt, the *TED/ FEE* ratio decreased (see **Table 8.8**). Similarly, an unprecedented US$ 4.8 billion accumulation of foreign exchange reserves increased the *RES/TED* ratio.

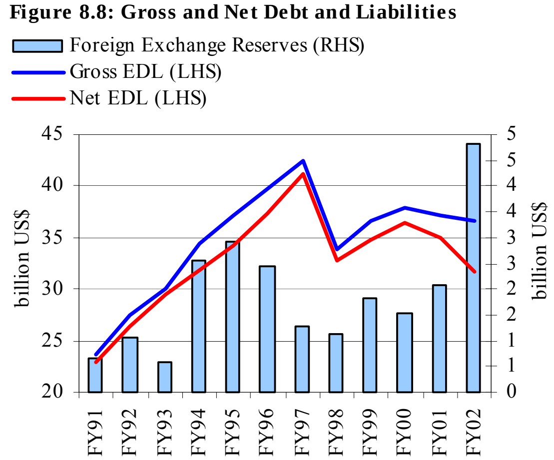
Figure 8.7: Non-interest Current Account Balance



By contrast, since the liabilities have decreased in absolute terms, all of the liability indicators show an unambiguous positive change in FY02. The record level of foreign exchange reserve build up during FY02 also bolstered the ratio of *foreign exchange reserves to EDL*, which improved from 5.6 percent in FY01 to 13.5 percent during FY02.

Another important indicator of a country's external debt profile is *the non-interest current account* balance. It reflects a turnaround from negative to positive balance since FY00, which shows the concerted efforts of current government to bring strength and stability to external sector and check the

Figure 8.8: Gross and Net Debt and Liabilities



[6] One can say that if the September incident had not occurred, Pakistan would have performed well and thus to be granted PRGF and restructuring from Paris Club but might be on bit harder terms.
[7] In a sense this is beneficial for Pakistan as the restructuring terms for Heavily Indebted Poor Countries (HIPC), restrict borrowings on normal terms from IBRD, ADB or market sources. Pakistan is the only fourth country in world to be granted such generous terms.
[8] Not only did the rupee cost of external debt servicing declined, foreign currency liabilities also fell sharply (as investors preferred to encash their holdings in Rupees)
[9] The improved external account contributed to the easing of monetary policy and a consequent decline in the cost of servicing domestic debt.

growth of un-sustainable external debt (see **Figure 8.7**).

Net External Debt & Liabilities

This is computed by subtracting the entire stock of a country's EDL from its liquid foreign exchange reserves, and it simply measures the country's immediate ability to redeem its EDL. Thus the smaller the value of this indicator, the better off the country is. The sharp US$ 3.3 billion improvement in this indicator during FY02 mirrors the unprecedented accumulation of foreign exchange reserves as well as a complementary decline in the country's EDL (see **Figure 8.8**).

8.3.2 Size & Structure of External Debt and Liabilities

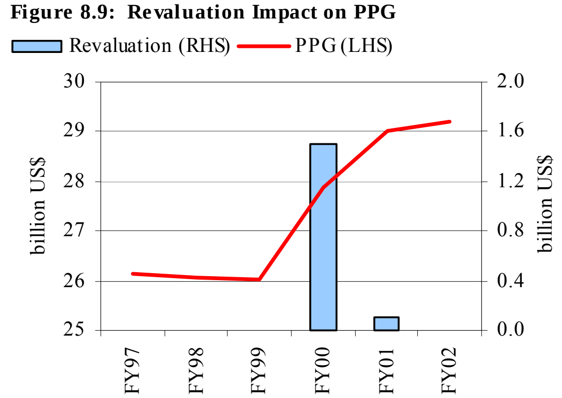
Prior to discussing the components of Pakistan's external debt and liabilities, it is important to note that the definitions of external debt and liabilities have undergone a small modification in FY02. Specifically, NHA bonds, central bank deposits and NBP/BOC deposits of different maturity, that were earlier components of external debt, have been re-classified as external liabilities. The change simply recognizes that funds under these heads were repeatedly rolled over and *effectively* had no definite repayments schedule. Accordingly, the data in **Table 8.7** has been adjusted to make it comparable over the years.

The following coverage of the components of EDL is based on the revised definitions. As mentioned earlier, according to provisional estimates, Pakistan's total external debt and liabilities declined by 1.6 percent to US$ 36.5 billion during FY02 (See **Table 8.7**). This was achieved principally due to the retirement of commercial and private loans/credits, IDB credits, foreign currency accounts, special US$ bonds, National Debt Retirement Program (NDRP), other liabilities and NBP deposits.

Public and Publicly Guaranteed Debt [10]

This is the single largest component with an 88 percent share in the Pakistan's total external debt. However, before discussing the PPG debt in detail, it is essential to highlight the issue of revaluation, which increased the stock of PPG significantly during the last three years.

Figure 8.9: Revaluation Impact on PPG



All data related to public and publicly guaranteed debt published in the report is taken from Economic Affairs Division (EAD). EAD data diverges significantly from creditor's external debt stock primarily due to the revaluation treatment. The main reason for this difference is that such loans are denominated in different currencies and these amounts were converted into the US dollar to report the outstanding stock at a particular point in time. Although EAD valued the disbursement and repayments at current exchange rates, but this revaluation had not been applied to previous debt stocks. Hence, past discrepancies in cross rate were corrected and an up-dated value of stock of debt was derived (for more detail, see External debt section in SBP *Annual Report* for FY01). In order to remove these discrepancies, the EAD carried out a revaluation of Pakistan's PPG debt during FY01, that increased the stock debt significantly (see **Figure 8.9**).

[10] This PPG debt owned by the government, public sector enterprises and autonomous bodies.

Table 8.8: Selected External Debt/Liabilities Indicators

	Total external debt to				Total external debt and liabilities (EDL) to				Non-interest current account balance
	GDP	EE	FEE	RES/TED	GDP	EE	FEE	RES/TEL	(million US Dollar)
FY95	47.7	371.4	232.9	9.5	61.4	479.0	300.3	7.4	-3,583
FY96	47.1	358.3	232.2	6.9	91.6	695.9	451.0	3.6	-5,923
FY97	48.4	372.6	233.4	4.0	68.0	523.3	327.7	2.9	-5,274
FY98	49.4	363.0	229.0	3.0	52.2	383.9	242.2	2.9	-3,421
FY99	53.4	415.6	278.2	5.5	62.5	486.2	325.5	4.7	-457
FY00	53.1	395.1	252.9	4.2	62.4	464.5	297.3	3.6	1,381
FY01	55.1	359.6	224.1	6.5	63.7	415.8	259.0	5.6	1,874
FY02	56.7	365.7	216.4	14.4	60.3	389.1	230.2	13.5	4,208

Note: Foreign Exchange Earnings is the sum of earnings from Goods, services, and income (credit entry from Item A: BOP-IMF/92) and private transfers (credit entry from Item B.7: BOP-IMF/92).

TED: Total External Debt

TEL: Total External Liabilities

RES: Foreign Exchange Reserves

EE: Export Earnings

FEE: Foreign Exchange Earnings

Despite this revaluation, some differences remained between EAD and creditors' book numbers, and the EAD finally reconciled the numbers in FY02 adopting the information provided by the creditor agencies during FY02. Since the EAD has already revalued the debt stock to a major extent, the adoption of creditors' number has a minor impact on total stock of debt during FY02. However, the IMF debt is denominated in SDRs and the value of IMF outstanding debt recorded an increase of US$ 103 million in FY02 due to valuation change in SDR/US Dollar parity.

Within total external debt, long-term public & publicly guaranteed debt has the dominant share due to heavy reliance on the official sources of financing (see **Table 8.9**); of this, 93 percent is from multilateral and bilateral sources. Multilateral claims are dominated by loans from IBRD, IDA and ADB, which constituted 98 percent of multilateral loans. The Paris Club creditors own 37.5 percent of the country's outstanding debt obligations. The bulk of these loans are from Japan, US, Germany and France.

It is evident that multilateral credit rose from US$ 10.6 billion in FY99 to 13.3 in FY01 mainly due to revaluation while the increase during FY02 was US$ 1.0 billion (see **Table 8.7**).

Table 8.9: Pakistan's External Debt: Share-wise

percent

	FY99	FY00	FY01	FY02
I. PPG guaranteed debt	**83.2**	**86.4**	**87.6**	**87.5**
A.MT/LT (> 1 year)	82.7	86.0	86.8	87.0
Paris club	38.0	38.5	36.8	37.5
Multilateral	33.9	38.1	41.5	42.9
Other bilateral	2.0	2.0	1.3	1.3
Eurobonds	1.9	1.9	2.0	1.9
Military debt	3.2	2.0	1.7	2.5
Commercial loans/credits	3.7	3.4	3.4	0.9
B.ST (≤ 1 year)	0.5	0.4	0.8	0.5
IDB	0.5	0.4	0.8	0.5
II. Private non-guaranteed debts	**11.0**	**8.8**	**7.6**	**6.7**
Private loans/credits	11.0	8.8	7.6	6.7
III IMF	**5.8**	**4.8**	**4.8**	**5.8**
Total External Debt	100	100	100	100

However, one of the positive aspects with respect to multilateral debt was the shift from 'hard' to 'soft' loans. More specifically, Pakistan contracted soft loans from IDA at zero interest rates with a 35-38 year maturity, and paid back US$ 0.9 billion in expensive loan of IBRD. This substitution of debt from hard to soft debt is one of the key elements of the DRMS. As a part of this strategy, the following inflows were realized from World Bank and ADB during FY02:

- US$ 510 million from the World Bank (specifically IDA). This loan has maturities between 30-35 years, 10-year grace period and service charges of 0.75 percent. It aims to support structural reforms in Pakistan and focuses on governance, economic growth and the delivery of social services.
- Another loan of US$ 188 million was also realized under the Banking Sector Adjustment Credit from World Bank, the facility aims to support the restructuring process of the financial system.
- A tranche of US$ 50 million under the Trade Export Promotion and Industry Program Loan of the ADB, which was approved on March 31, 1999. The facility aims to support the private sector exports by focusing on trade liberalization, financing, facilitation for trade and export, and the privatization of manufacturing units.
- US$ 100 million from the Asian Development Bank (ADB) under the Legal Reforms Program Loan. Approved on December 20, 2001, the facility aims to support a strengthening of the legal system to improve legal protection for all, and especially for the poor and other vulnerable groups.
- First tranche of US$ 35.0 million realized during current fiscal year from ADB's under Road Sector Development Program (RSDP) to uplift the roads in Pakistan. Approved on December 19, 2001, RSDP consists of a US$ 50 million policy loan to support national reforms and a US$ 150 million investment loan for a Provincial Sector Development Project. The program is taking a sequential approach, starting with Sindh province and to be extended to other provinces later on. The investment project will improve 164 km of provincial highways and 1,200 km of rural access roads in Sindh province. This rehabilitation will enhance communication between farm communities and market centers, as well as provide much-needed access to villagers for education and health facilities, and job opportunities in urban areas.

Commercial Loans/Credits
These comprise loans guaranteed directly by the federal government. Other than the oil import facilities, these are mostly cash disbursing facilities for BOP support received in one or multiple tranches, having maturities of less than two-years. The total stock of commercial loans and credit fell significantly, from US$ 1.1 billion in FY01 to US$ 0.3 billion during FY02, due to the repayments of PTMA credits.[11] The outstanding end-FY02 figure includes the amounts due under the Pakistan Trade Maintenance Agreement (PTMA), PTCL securitization and new loans contracted during last year, etc.

IDB Credits
The IDB does not provide any cash disbursing loans, but finances the import of crude oil and fertilizer. The closing stock of this debt fell by US$ 74 million during the year to US$ 183 million at end-June 2002.

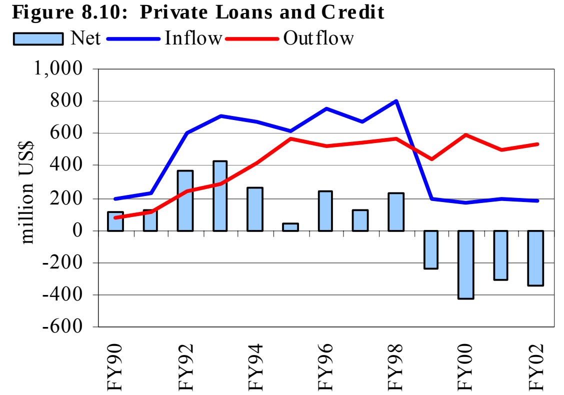
Private Loan/Credits
These are mainly "Supplier's Credit Schemes" (SCS) and "Pay as You Earn" (PAYE) credits and are contracted by private sector from multilateral sources, NCBs, and Export Credit Agencies in OECD countries. The federal government does not directly guarantee these loans, but convertibility is guaranteed by the SBP.

[11] The PTMA refers to Pakistan Trade Maintenance Agreements. Pakistan contracted this debt during 1990s to finance the huge current account deficit. However, after the nuclear test in 1998, which exposed Pakistan's inability to repay its debt following the economic sanctions from its major sovereign creditors. The country approached Paris Club to reschedule our bilateral debt during FY99, which in turn also invoked the comparability clause to private and commercial creditors. Therefore, we also rescheduled PTMA credits from "London Club" in December 1999.

While the schemes still exist, they have been effectively dormant after the imposition of economic sanctions following the nuclear test in 1998. More specifically, there was an embargo on deferred payment PAYE and SCS from donor countries as well as the difficulties in exchange risk coverage from SBP. The net outflows under these schemes over the years confirm the above point (see **Figure 8.10**). However, in light of the recent lifting of the relevant economic sanctions, these schemes could be reactivated.

The end-FY02 stock stood at US$ 2.2 billion as compared to US$ 2.5 billion last year. A breakup of the amount by economic groups shows that the largest component accrues to the Power sector (mainly IPPs), with the Cement sector a distant second.

Figure 8.10: Private Loans and Credit



IMF

The stock of debt from IMF increased from US$ 1.5 billion to US$ 1.9 billion during FY02. This is the upshot of the disbursements on account of SBA, PRGF and valuation changes (for details, see section on *Transactions with IMF* in **Chapter 9**).

External Liabilities

The most noteworthy development is the retirement of external liabilities by US$ 1.9 billion during FY02. The end-June FY02 stock of external liabilities is US$ 3.1 billion as compared to US$ 5.0 billion last year.

Foreign Currency Accounts

Due to the hefty increase in foreign exchange reserves, SBP returned the FE-31 and FE-13 (part of FE-25 placed with SBP previously) to the mobilizing commercial banks, while the stock of FE-45 deposits fell from US$ 1.1 billion to US$ 0.4 billion during FY02 due to hard currency payments.[12 &13]

Special US Dollar Bonds

As of end-June 2002, the outstanding stock amounted to US$ 0.9 billion as compared to US$ 1.4 billion at end-FY01 (see **Table 8.7**).[14] The majority of the bonds issued had a maturity of 3-years. Thus, as the initial maturities fell due in FY02, the SBP sought to protect its fragile foreign exchange reserves by offering (1) 5 percent bonus to bond-holder opting for Rupee redemptions keeping in view the kerb premium, and (2) an attractive reinvestment option, i.e., the face value of the bond could be re-invested for a further 3 years (from the date of redemption) at LIBOR + 2 percent.

The reinvestment option was relatively more attractive as compared to Rupee redemption bonus till November 2001 when the kerb premium collapsed. After the collapse of kerb premium the incentives to dollarize faded and bondholders increasingly availed the option of redemption in Rupees with 5

[12] Originally solicited under circular FE 45 of 1995, these deposits carry interest payments at LIBOR + 0.75. Rupee liquidity and forward cover (at 5.5 percent) is provided to mobilizing banks against these deposits.
[13] These represent the incremental deposits in the old FCA scheme. As was the case with the frozen FCAs, commercial banks are provided Rupee liquidity against these deposits at the prevailing interbank exchange rate, and mobilizing banks are permitted to purchase forward cover at a rate of 8 percent per annum.
[14] After the freeze of FCAs following the nuclear test, the Government of Pakistan launched the Special US Dollar Bond scheme in July 1998. This scheme offered 3, 5 and 7 years Dollar denominated instruments with interest payable half yearly at LIBOR + 1, 1.5 and 2 percent, respectively. These bonds could be purchased against frozen FCAs, FCBCs, DBCs, or by surrendering hard currency.

percent redemption bonus. Although the SBP withdrew the premium by March 2002, these Rupee redemptions continued apace in subsequent months (see **Table 8.10**).

National Debt Retirement Program (NDRP)

NDRP was launched on February 27, 1997 to solicit funds from non-resident Pakistanis (NRPs) towards retiring the country's external debt. Resident Pakistanis were also allowed to participate in the scheme using their foreign currency accounts, FEBCs, FCBCs, traveler cheques, remittance from abroad or by surrendering hard currency.[15] The bulk of funds mobilized under NDRP scheme was placed in 5-year maturity of profit bearing deposits. These expensive liabilities are expected to be retired as they mature. The end-June 2002 stock of NDRP is reported at US$ 75 million, down 50 percent from end FY01 level.

Table 8.10: Encashment and Reinvestment of Maturing 3-Years Special US$ Bonds

million US Dollar

	Maturity	Repayment			Reinvestment
		US$	Converted into Pak Rs	5% Bonus	
Oct-01	0.1	0.0	0.1	0.0	0.0
Nov-01	38.9	0.3	3.4	0.2	15.1
Dec-01	89.7	5.0	44.0	2.2	21.2
Jan-02	70.5	4.8	124.8	6.2	4.9
Feb-02	28.7	1.9	28.8	1.4	7.6
Mar-02	45.4	1.6	44.3	2.2	2.9
Apr-02	71.5	13.3	29.8	1.5	2.9
May-02	96.7	16.5	30.0	-	5.8
Jun-02	61.5	14.9	47.8	-	3.3
Jul-02	30.3	12.4	18.1	-	1.4
Total	**533.3**	**70.6**	**371.0**	**13.8**	**65.1**

Source: Karachi and Lahore offices of SBP

NHA Bonds

The end-June 2002 stock of NHA bonds is US$ 197 million as compared to US$ 219 million last year due to the normal repayments of these bonds.

Central Bank Deposits (CBD)

These comprise of deposits by central banks of various friendly countries (UAE: US$ 450 million and Kuwait: US$ 250 million) placed with SBP at end-June FY01.[16] The stock of these placements increased during FY02 as Libya also placed a deposit of US$ 50 million in December 2001.

NBP/BOC Deposits

These comprised NBP Bahrain and Bank of China deposits. The end-June 2002 stock of these deposits is US$ 500 million as compared to US$ 750 million last year. During FY02, Pakistan retired the two deposits of NBP Bahrain of US$ 46 million (placed with GOP) and US$ 203 million (placed with SBP). The remaining outstanding amount is a Bank of China deposit.

Others Liabilities

These comprise of swaps from various commercial banks and moneychangers. The stock of these swaps declined by US$ 441 million during FY02, as Pakistan repaid all the swaps to moneychangers, the remaining stock of US$ 280 million is owned to various commercial banks.

8.3.3 External Debt and Liability Servicing

Following the acute balance of payments difficulties after the nuclear detonations in May 1998, Pakistan has received two back-to-back rescheduling (January 1999 and January 2000), the first of which was accompanied by a rescheduling by the *quasi* London Club creditors (December 1999).[17]

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[15] For details, please see FE Circular 2 of February 24, 1997.

[16] The UAE deposits were originally placed in FY97 and FY98 but have been rolled-over indefinitely. The deposit from Kuwait Monetary Authority had also been originally placed for two years in FY98 but has been rolled-over for two years.

[17] Debt restructuring is different from rescheduling as: (1) it provides relief in the form of reduction in NPV of external debt; (2) interest rate on the outstanding loans is on concessional terms; and (3) the consolidation period is much longer.

However, even after the recent consolidation period that ended in September 2001, Pakistan was still unable to rebuild its debt repayments capacity, and was therefore, again forced to approach Paris Club creditors for yet another restructuring. In view of Pakistan's strict adherence to the IMF reform program during FY01, the response was very positive.

Table 8.11: Salient Features of Paris Club Restructuring

Loan Group	Debt Restructured	Consolidation Date(s)	Interest rate	Grace	Maturity	Repayment Profile
Paris club eligible bilateral pre-cutoff bilateral concessional loans	Reschedule stock	As of Nov. 2001	Original interest rate; interest rates on Japanese loans reduced to 2.4 percent	15 years	38 years	Each payments Each semester
Paris club eligible bilateral pre-cutoff bilateral non-concessional loans	Reschedule stock	As of Nov. 2001	Loan currency specific CIRR rate or equivalent proxy	5 years	23 years	Paris club provided repayment Profile
Paris club Concessional Pre. Restructure debt Jan. 1999 & Jan. 2001	Reschedule stock	As of Nov. 2001	Original interest rate; interest rates on Japanese loans reduced to 2.4 percent	15 years	38 years	Each payments each semester
Paris club Non-Concessional PRD Jan. 1999 and Jan. 2001	Reschedule stock	As of Nov. 2001	Loan currency specific CIRR rate or equivalent proxy	5 years	23 years	Paris club provided repayment Profile
Non-Paris club bilateral pre-cutoff bilateral concessional & non-concessional	Reschedule stock	As of Nov. 2001	Original interest Rate	15 years	38 years	Each payments Each semester
Cash-flow relief maturities on post cut off dates	Defer 100 percent Principal and interest	Dec. 2001 to June 2002	Market rate	3 years	5 years	4 equal payments each semester
Cash-flow relief interest payments due on restructure amounts	Capitalize 100 percent interest	Dec. 2001 to June 2002	Market rate	3 years	5 years	4 equal payments each semester
	Capitalize 20 percent interest	July 2002 to June 2003	Market rate	3 years	5 years	4 equal payments each semester
	Capitalize 20 percent interest	July 2003 to June 2004	Market rate	3 years	5 years	4 equal payments each semester

The Paris Club offered very generous terms; in contrast to the previous two rescheduling agreements that provided relief *only* in terms of debt flows (as per *Houston terms*), the existing arrangement is applicable to the entire stock of US$ 12.5 billion of Pakistan's bilateral debt owned by Paris Club creditors.[18]

Consequently, this provided an implied debt reduction without having a HIPC status, which is generally associated with *Naples terms*.[19] The other salient features of current restructuring can be gleaned from **Table 8.11**.

In overall terms, despite the restructuring, Pakistan's external debt and liabilities servicing increased from US$ 5.1 billion to US$ 6.3 billion during FY02 (see **Table 8.12**). The most noteworthy

[18] This comprised ODA: US$ 8.8 billion, non-ODA: US$ 3.6 billion, and arrears of US$ 77 million. In this regard, "official development assistance (ODA)" is defined by the OECD as credits with a low interest rate and aimed at development.
[19] In a sense this is beneficial for Pakistan as HIPC status restricts borrowings on normal terms from IBRD, ADB or market sources.

Table 8.12: Pakistan's External Debt and Liabilities Servicing (New Format)
million US Dollar

	FY00		FY01 ᵖ		FY02 ᵖ	
	Actual paid	**Rescheduled/ Rollover**	**Actual paid**	**Rescheduled/ Rollover**	**Actual paid**	**Rescheduled/ Rollover**
1. Public and publicly guaranteed debt	**1,871**	**2,209**	**2,401**	**1,119**	**3,055**	**1,208**
A. Medium and long term (> 1 year)	1,723	2,209	2,209	1,119	2,631	1,208
Paris club	423	1,149	438	934	187	1,094
Principal	308	851	221	681	71	652
Interest	115	298	217	253	116	442
Multilateral	938	0	910	0	903	0
Principal	556	0	572	0	583	0
Interest	382	0	338	0	320	0
Other bilateral	40	132	221	68	124	32
Principal	29	104	180	55	100	25
Interest	11	28	41	13	24	7
Eurobonds	62	610	62	0	67	0
Principal	0	610	0	0	3	0
Interest	62	0	62	0	64	0
Military debt	49	166	56	117	24	82
Principal	49	130	56	92	19	63
Interest	0	36	0	25	5	19
Commercial loans/credits	211	152	522	0	1,326	0
Principal	59	152	445	0	1,283	0
Interest	152	0	77	0	43	0
B. Short-term (≤ 1 year)	148	0	192	0	424	0
IDB	148	0	192	0	424	0
Principal	141	0	184	0	403	0
Interest	7	0	8	0	21	0
2. Private non-guaranteed debts	**838**	**0**	**696**	**0**	**795**	**0**
A. Medium and long term (> 1 year)	838	0	696	0	795	0
Private loans/credits	838	0	696	0	795	0
Principal	590	0	500	0	586	0
Interest	248	0	196	0	209	0
B. Short-term (≤ 1 year)	0	0	0	0	0	0
3. IMF	**340**	**0**	**299**	**0**	**247**	**0**
Repurchases / principal	280	0	239	0	194	0
Charges / interest	60	0	60	0	53	0
Total debt servicing (1 thru 3)	**3,049**	**2,209**	**3,396**	**1,119**	**4,097**	**1,208**
4. Central bank deposits	**43**	**300**	**46**	**400**	**38**	**300**
Principal	0	300	0	400	0	300
Interest	43	0	46	0	38	0
5. NBP/BOC deposits	**64**	**500**	**209**	**500**	**287**	**500**
Principal	10	500	147	500	249	350
Interest	54	0	62	0	38	150
6. Special US$ bonds	**86**	**0**	**104**	**0**	**537**	**0**
Principal	0	0	0	0	470	0
Interest	86	0	104	0	67	0
7. Foreign currency loan bonds (NHA)	**39**	**0**	**39**	**0**	**38**	**0**
Principal	22	0	22	0	22	0
Interest	17	0	17	0	16	0
8. Swaps	**0**	**0**	**866**	**0**	**441**	**0**
9. FCAs	**392**	**1,072**	**365**	**776**	**777**	**235**
FE-45 (institutional)	383	1,072	347	776	569	235
Principal	308	1,072	295	776	544	235
Interest	75	0	52	0	25	0
FE-13 (interest)	9	0	18	0	4	0
FE-31	0	0	0	0	204	0
10. NDRP	**0**	**0**	**0**	**0**	**62**	**0**
11. FEBCs/FCBCs/DBCs	**83**	**0**	**76**	**0**	**50**	**0**
Principal	48	0	39	0	27	0
Interest	35	0	37	0	23	0
Total (1 through 11)	**3,756**	**4,081**	**5,101**	**2,795**	**6,327**	**2,243**

ᵖ: Provisional

developments are the reduction of US$ 1.9 billion in total external liabilities during FY02, the immediate cash relief from Paris Club creditors by deferring all the interest and principal repayments due on the post cut-off date during November to June 2002.[20] On the other hand, the rescheduled and rollover amount decreased from US$ 2.8 billion to US$ 2.2 billion due to the lower rollover of external liabilities (FE-45 and CBD) in FY02 as against the case in FY01. In case of external debt, the rescheduling of all bilateral loans (pre and post cut-off date) from Paris Club increased the rescheduled amount marginally.

Financial Saving from the Current Restructuring of Paris Club Debt [21]

The realized financial savings from the current restructuring will, of course, depend on the interest rate negotiated with individual creditor countries.[22] However, **Table 8.13** presents an indicative implied debt reduction that is computed on the basis of various assumed interest rates both for ODA and non-ODA creditors.

Table 8.13: Financial Impact of Restructuring of Paris Club Debt

	Interest rate		Saving over		NPV of debt before restructuring	Expected NPV of debt after restructuring	Expected NPV reduction
	ODA	Non-ODA	PRGF	Grace period			
	percent		million US Dollar				percent
Scenario I	1.0	3.	2,971	11,06(	12,599	7,112	44
Scenario II	1.5	3.	2,848	9,88(	12,599	8,090	36
Scenario III	2.3	4.	2,711	8,541	12,599	9,029	28

This NPV reduction of bilateral debt together with the exceptional increase in foreign exchange reserves would not only improve Pakistan's liquidity position, but also provide an opportunity to exit from IMF programs after the completion of the PRGF. Furthermore, the fiscal space provided by the restructuring would allow the government to increase development expenditures.

8.3.4 External Debt Sustainability

"External Debt Sustainability measures the country's ability to repay debt in relation to its earning capacity."

The debt sustainability is investigated using an analytical framework adopted from Cohen (1985) (for more detail on indices, see **Box 1**). If the value of the index turns out to be negative it means that the interest rate on external debt is less than the export earnings, which indicates that country is solvent. In case of positive number, the country is insolvent, as it is not

Box 8.1: Cohen's Solvency Index

Cohen (1985)[1] used following ratios to compute the solvency index for developing countries. The formula of Cohen's index is:

b1 = (R – X)/(1 + X) * Debt/GDP ratio (A)

b2 = (R – X)/(1 + X) * Debt/EE ratio (B)

where R is real average interest rate on external debt, X: growth rate of export earnings.

A simple solvency condition compares the growth rate of exports and real interest rate. A country is said to be insolvent if R is greater than real growth of exports. However, Cohen suggests that this is a simplistic and inadequate method of determining insolvency because a country is not necessarily insolvent as long as it satisfies the condition that PV of future debt tends toward zero in the long term. This index assumes that a country is interested in maintaining the variable at some constant level in order to be creditworthy. So it is essential to generate enough trade surpluses, represented by ***b***, to maintain a given level of debt to GDP ratio or Debt to EE. Therefore, ***b*** is a level of trade surplus or maximum proportion of resources above that a country would rather default than remain solvent.

[1]: Cohen, D. (1985), "How to Evaluate the Solvency of an Indebted Nation" *Economic Policy*, Vol. 1, No.1.

[20] When a debtor country first meets with Paris Club creditors, the "cutoff date" is defined and is not to be changed in subsequent Paris Club treatments; this means that credits granted after cutoff date are not subject to future rescheduling, thereby protecting credits granted by Paris Club creditors after a rescheduling.

[21] The financial impact or saving is measured by comparing the cash flow with that of the same stock of debt prior to the restructuring exercise.

[22] According to the Paris Club restructuring agreements, Pakistan has to negotiate the interest rate with individual member before the September 2002. However, the GOP has requested the Paris Club to extend this date upto December 2002.

earning enough resources to pay off its debt obligation. If a country pays all interest falling due every period, the value of debt remains constant. If an indebted country neither pays its debt nor makes the associated interest payments, the debt grows at the rate of interest. The central focus of Cohen's analysis is on the minimum level of debt repayments that keeps the debt to exports or debt to GDP ratios constant.

The Cohen's solvency indices computed for Pakistan are presented in **Table 8.14**. The total time period from FY81 to FY02 has divided into four sub-periods FY81-88, FY89-96, FY97-99 and FY00 -FY02. The indices imply that on average Pakistan was solvent throughout FY1981-88 due to the healthy real growth of exports. In second sub-period from FY89 to FY96, Pakistan remained solvent due to the buoyant growth of exports in FY91 and again in FY96. The solvency condition deteriorated during FY97-FY99 and reached a peak as shown by the index value of 8.4 in FY99. However, the solvency condition for Pakistan improved to –1.3 from 6.0 during FY00-02 despite the revaluation of external debt which increased the debt to GDP ratio from 53.1 percent to 56.6 in FY01.

Table 8.14: Cohen's Solvency Index for Pakistan

	TED to GDP	TED to EE	Real exports growth rate	Real interest rate	Solvency index	
					b1=(r-x)/(1+x)*Dg	b2=(r-x)/(1+x)*Dx
FY81	35.[illegible]	360.3	0.237	-0.063	-8.5	-87.2
FY85	39.2	486.1	-0.096	0.002	4.3	52.8
FY90	52.[illegible]	414.2	0.058	-0.022	-4.0	-31.5
FY97	48.4	372.6	-0.127	0.012	7.7	59.5
FY98	49.4	363.0	-0.012	0.023	1.7	12.8
FY99	53.4	415.6	-0.126	0.012	8.4	65.7
FY00	53.1	395.1	0.080	0.007	-3.6	-26.6
FY01	56.6	369.4	0.053	0.016	-2.0	-13.0
FY02	55.1	364.7	0.001	0.031	1.7	11.0
Averages						
FY81-88	*38.8*	*418.9*	*0.087*	*-0.008*	*-2.9*	*-25.1*
FY89-96	*49.5*	*381.1*	*0.052*	*-0.003*	*-2.3*	*-17.4*
FY97-99	*50.4*	*383.7*	*-0.088*	*0.016*	*6.0*	*46.0*
FY00-02	*54.9*	*376.4*	*0.045*	*0.018*	*-1.3*	*-9.5*

8.3.5 Future Debt Reduction Strategy

As can be seen from **Table 8.11** and **Table 8.13**, Pakistan expects to achieve an NPV reduction of between 28 to 44 percent, from recent restructuring from Paris Club creditors. The expected write off of US$ 1 billion from US, which is in addition to the Paris Club restructuring, will further reduce the external debt burden.[23]

At the same time, since multilateral debt (from the IFIs) cannot be rescheduled or re-profiled, non-concessional loans from the World Bank, Asian Development Bank and IMF are being substituted by new loans on easier terms.[24]

[23] Under the US laws, the congress has to appropriate US$ 200 million in the budget which is equivalent to NPV of US$ 1 billion over 20 years.

[24] In addition to the current PRGF from IMF (which is on concessional terms compared to the SBA), the World Bank is also providing credit on IDA terms (zero interest rate, 0.75 percent service charge, 10 year grace period and 30-35 years repayment period). Furthermore, ADB is not only increasing its annual assistance to Pakistan, but also shifting gradually from ordinary capital resources to concessional resources of Asian Development Fund.

Unlike the recent past, when the buildup of foreign currency reserves was largely due to commercial borrowings, the present government is focusing more on retiring expensive short-term commercial debt as reflected from the retirement of US$ 1.9 billion during FY02.

In this backdrop, **Table 8.15** projects Pakistan's stock of external debt and liabilities from FY03 to FY04.[25] As evident from this table, by June 2003, FE-45, FE-31 and NDRP would be liquidated; BOC and Central Bank Deposits would be partially repaid; first installment of Eurobonds US$ 155 million would be paid and the stock of Private loans/credits and defense would also decline.

Table 8.15: Revised External Debt Stocks: Published in DRMS (Summary Report)
million US Dollar

	End-June 2001 Revised	End-June 2002 Revised	End-June 2003 Projected	End-June 2004 Projected
Medium & long-term EAD[1]	25,586	27,276	28,170	29,062
IMF	1,529	1,939	2,115	2,168
Short-term commercial & IDB	1,360	497	940	837
Euro & Saindak bonds	645	643	485	327
Defense	554	819	543	543
Private loans un-guaranteed	2,450	2,226	1,853	1,626
NBP (BOC) deposits	500	500	300	-
NBP deposits with SBP	203	-	-	-
NBP deposits with GOP	46	-	-	-
Central bank deposits	700	750	400	-
Special US$ bonds	1,376	924	472	344
FE-45	774	234	-	
FE-31	326	172	-	
Bearer certificates				
NHA bonds	219	197	175	153
SWAP	721	280	177	175
NDRP	150	75	-	-
Total	**37,139**	**36,532**	**35,630**	**35,235**

[1] EAD: Economic Affair Division, Ministry of Finance

The actual stock of Medium & long-term debt (EAD) increased mainly due to the revaluation of debt and availability of highly concessional loans from World Bank and ADB.

In overall terms, the total stock of Pakistan's external debt and liabilities should gradually decline. In this regard, the current account surplus posted during the last two years and the substantial gains from recent developments in the external sector (higher worker remittances, forex reserves build up etc.) are very encouraging.

[25] These estimates, which are based on the Report prepared by Debt Reduction and Management Committee, also include other external debt and liabilities like NBP (Government) deposits, FE 31, FCL bonds, Swaps and NDRP.