6 Domestic and External Debt

6.1 Overview

The country's total debt and liabilities (TDL) witnessed a small increase during FY05 from Rs 3,950 billion to Rs 4,186 billion, i.e., an increase of 5.9 percent YoY, compared to a rise of just 3.3 percent YoY in the preceding year. However, this growth remains low compared to recent years (see **Figure 6.1**) and was comfortably outpaced by the nominal growth rate of 18.3 percent recorded by the economy. As a result, the country's debt bearing capacity improved during FY05, for the fourth successive year. In fact, by the end of the FY05, the TDL as a percentage of GDP fell to its lowest level for the last 20 years, i.e., to 64 percent in FY05 from 71 percent an year ago and 93 percent in FY01 (see **Figure 6.2**).

Figure 6.1: Growth in Total Debt (percent)

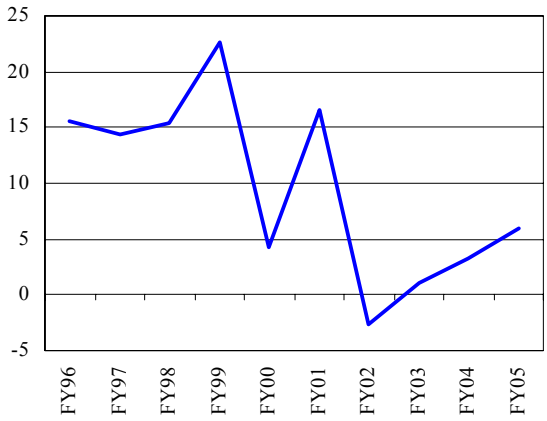
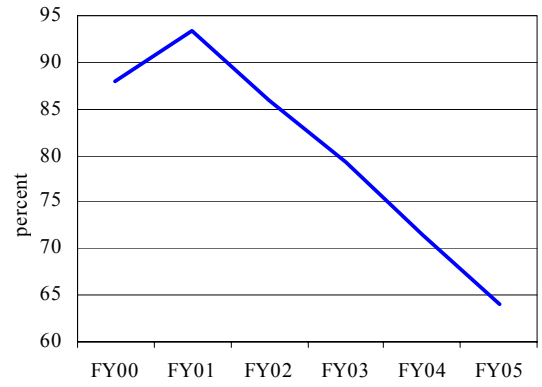
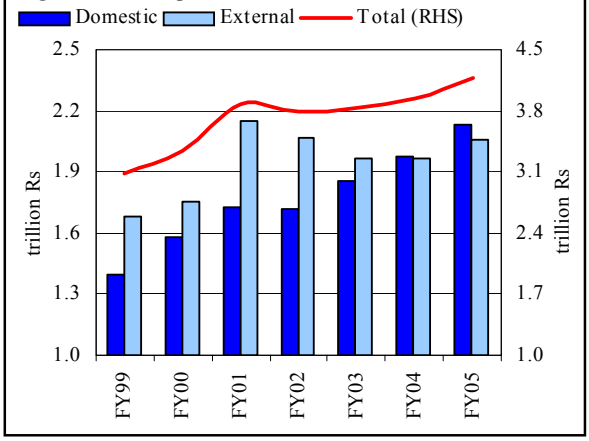


Figure 6.2: Total Debt as Percent of GDP



As in the preceding year, the major contribution to the FY05 growth in TDL came from domestic debt, but unlike FY04, there was also some increase in the stock of external debt (see **Figure 6.3**). The faster growth in domestic debt meant that its share in the country's TDL continued to increase, rising to 50.9 percent in FY05, up marginally from 50.1 percent in the preceding year. **Table 6.1** shows that all key indicators (such as public debt servicing to GDP ratio, public debt servicing to tax revenue ratio) have improved over the last five years, enhancing the country's capacity to carry debt and reducing its vulnerability to external shocks.

Figure 6.3: Composition of Debt



However, there was deterioration in one key indicator. Despite the fact that almost all of the increase in external debt was in longer tenors, the average maturity of Pakistan's TDL shortened a little during FY05. This was because, over 156.9 percent of the increase in domestic debt during the year constituted short-term issues, with the issue of long-term rupee debt being held to a mere Rs 0.8 billion during FY05, as against the Rs 107.7 billion issued in FY04. Indeed, since FY05 also saw substantial maturities of long tenor debt, the stock of long-term debt instruments declined.

A direct consequence of the shortening of the average maturity profile of domestic and external debt is that the vulnerability of debt servicing cost to interest rates shocks increased somewhat in FY05. This is because an increasing portion of the total debt stock was in short-term debt, and if interest rates in the economy rose, the *entire stock* of this debt would have to be rolled-over, as it matured, at the higher interest rate.

Notwithstanding the vulnerability to interest rate shocks in the long run, the sharp reduction in the maturity profile of domestic debt did help drive a fall in the government's debt servicing costs during FY05. This gain was further augmented by the relatively low prevailing international interest rates, and the retirement of expensive external debt, leading to a 7.0 percent YoY fall in the total interest payments on the country's TDL.

Table 6.1: Profile of Domestic and External Debt

billion Rupees

	FY01	FY02	FY03	FY04	FY05
Total debt	**3,884.5**	**3,783.0**	**3,824.0**	**3,949.9**	**4,186.5**
Domestic debt	1,731.0	1,717.9	1,853.7	1,979.5	2,129.1
	(45.4)	(48.5)	(50.1)	(50.9)	(50.9)
External debt	2,059.5	2,005.6	1,927.7	1,937.5	2,031.7
	(53.0)	(53.0)	(50.4)	(49.1)	(48.5)
Explicit liabilities [a]	94.0	59.5	42.7	32.9	25.7
	(2.4)	(1.6)	(1.1)	(0.8)	(0.6)
Total debt servicing	**340.4**	**444.1**	**305.1**	**337.2**	**267.9**
Total interest payment	254.4	279.2	241.7	226.0	210.2
i. Domestic	195.4	212.5	189.0	182.0	167.9
ii. Foreign	51.3	61.1	49.2	41.0	39.7
iii. Explicit liabilities	7.8	5.6	3.5	3.0	2.6
Repayment of principal [b]	85.9	164.9	63.4	111.3	57.7
As percent of GDP					
Total debt	93.3	85.9	79.3	71.4	63.9
Domestic debt	41.6	39.0	38.4	35.8	32.5
External debt	49.5	45.6	40.0	35.0	31.0
Explicit liabilities	2.3	1.4	0.9	0.6	0.4
Public debt	89.5	82.9	76.9	69.7	62.5
Ratio of public debt servicing to					
Tax revenue	77.1	92.9	55.1	55.2	40.6
Total revenue	61.5	71.2	42.5	42.2	31.5
Total expenditure	47.4	53.8	33.8	34.7	25.5
GDP	8.2	10.1	6.3	6.2	4.1
Current expenditure	52.7	63.4	37.8	42.9	28.4

a) Explicit Liabilities include Special US $ Bonds, FEBCs, FCBCs and DBCs; of which Special US$ Bond is a foreign liability, while FEBCs, FCBCs and DBCs are also foreign liabilities payable in Rupees.

b) Repayment of principal includes repayment of foreign debt and short-term credit.

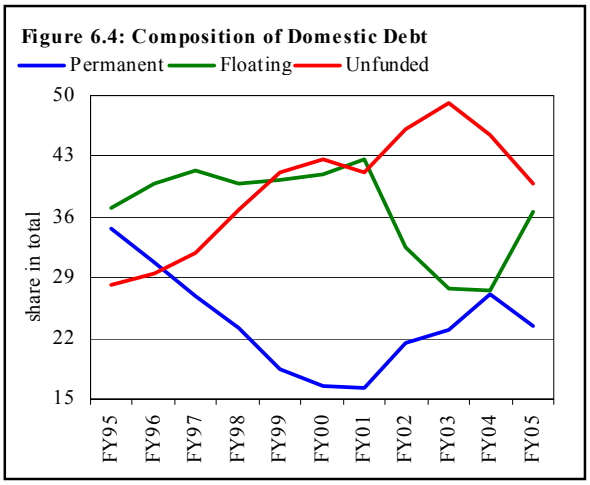
c) Figures in parentheses are shares in total debt.

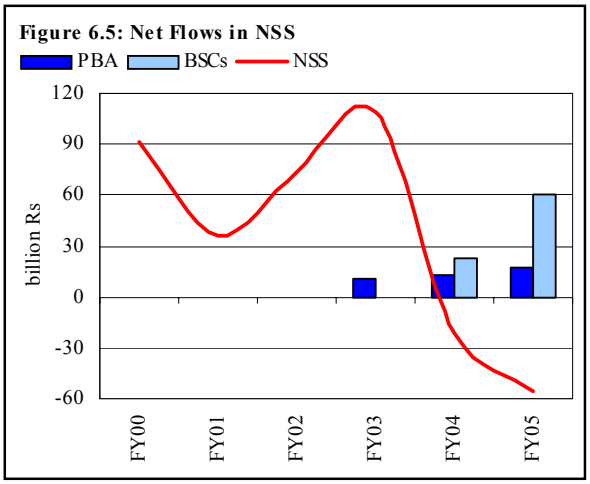
Sources: i) SBP ii) MoF

6.2 Domestic Debt

The outstanding stock of domestic debt rose by Rs 149.6 billion during FY05, compared to an increase of Rs 125.8 billion in the preceding year – the higher FY05 figure is primarily due to a larger rise in the nominal value of the fiscal deficit. However, it is important to note that this does not suggest fiscal indiscipline, since the budget deficit as a percent of GDP was low at 3.3 percent. In fact, this moderate growth of domestic debt compared to the trend growth rate of 1990s, together with

the increasing revenues and accelerating economic growth, implies that the economy's ability to service domestic debt has been improving for the last five years.





6.2.1 Composition of Domestic Debt

The increase in the domestic debt during FY05 was contributed entirely from a rise in the stock of *floating debt* during FY05, which more than offset a decline in stock in the other two debt classes, *permanent* and *unfunded*. As a result, the share of floating debt, which constitutes the short-term debt instruments, climbed to 36.5 percent (see **Figure 6.4**), reversing the very encouraging lengthening of the maturity profile of domestic debt seen in the past few years.

While the decline in the stock of unfunded debt was essentially due to low interest rates and the ban on institutional investments, the fall in stock of permanent debt stemmed from a surprising reluctance by the government to issue long-term PIBs[1].

This is probably a missed opportunity for the government, as the failure to issue long-term debt, at the bottom of the interest rate cycle (as is clear in hindsight), means that the interest payments on domestic debt will be marginally more vulnerable to adverse interest movements. The most probable reason for the reluctance to issue long-term debt seems to be higher term premium on these instruments. Indeed, the greater reliance on shorter tenor instruments probably did contribute to the containment of debt servicing costs during FY05; however, the continuous rolling over of a substantial amount of short-term debt is also a source of concern for short-term interest rate management.

Unfunded Debt

In second successive year, the stock of unfunded debt continued its downward slide in FY05 (the FY04 decline was first decline in the last three decades). The decline of Rs 49.2 billion during FY05 was much larger than that of Rs 10.2 billion witnessed during FY04. In both years, the main cause was lower net sales of National Savings Schemes (NSS) instruments (discussed below); [2]

National Savings Schemes (NSS)

The net mobilization under all the instruments of NSS, except relatively new instruments (BSCs and PBAs), was once again negative in FY05, reinforcing the trend initiated last year (see **Figure 6.5**). The previously popular instruments – the DSCs, SSCs, and RICs – seem to have become less attractive for investors.

[1] Currently there are only two instruments of this category available for mobilizing funds for the government in which PIB is the major one.

[2] Here NSS does not include the Prize Bonds, as these are classified under the category of permanent debt.

The fall in the stock of DSCs probably reflects (1) the larger stock of issues in the mid-1990, that are now maturing, (2) the inability of institutional investors to roll over their holdings as they are no longer allowed to invest in NSS instruments; and, (3) the sharp decline in yields that have rendered NSS instruments less attractive for new purchases. The latter two reasons also account for the fall in the outstanding stock of the RIC and SSCs.

On the other hand, PBAs and BSCs accumulated a net aggregate increase of Rs 78.4 billion during this period whereas DSCs and SSCs together witnessed a decline of almost Rs 92.0 billion in the same period. As a result, the combined share of BSCs and PBAs registered a very sharp increase in NSS stocks from 5.5 percent to 16.0 percent whereas the combined share of RICs, SSCs and DSCs declined to 75.6 percent from 86.4 percent (see **Table 6.2**).

It is important to note that the government estimates (both initial and revised) for on-tap NSS net outflows were substantially smaller than actual outflows during FY05 (see **Table 6.3**). As a result, the government financing requirement from the banking system increased sharply during this period.

Rate of Returns

As discussed in the *SBP Annual Report for FY04*, the linkage of rates of return on NSS instruments with the PIB yields has helped in reducing the interest rate distortions in the economy. Since the government rejected all the bids in every auction during FY05, the benchmark yield on PIBs remained unchanged. As a result, the rates of return on NSS instruments were kept unchanged as well.

Floating Debt and Permanent Debt

The stock of floating debt continued to rise in FY05 also and reached Rs 778.2 billion. However, the stock of permanent debt declined by Rs 35.9 billion, in comparison with a steady average increase of Rs 56.0 billion per annum during the last 5 years. The decline was seen across all major components of permanent debt except prize bonds. The

Table 6.2: Shares of Major NSS Instruments

percent

	FY04	FY05
DSCs	37.5	39.1
SSCs	33.8	25.5
RICs	15.1	11.0
BSCs	2.7	10.7
Special Savings Accounts	7.6	7.9
PBAs	2.8	5.3
Others	0.4	0.4

Table 6.3: Net Flows in NSS during FY05 (Estimates vs Actual)

billion Rupees

	Estimates		
Instruments	**Budget**	**Revised**	**Actual FY05**
Savings Accounts	-3.7	-2.4	-2.1
PBAs	16.0	20.1	17.7
DSCs	5.0	-6.7	-8.7
BSCs	20.0	66.9	60.7
SSCs	-11.0	-58.8	-83.2
RICs	-40.0	-45.0	-40.5
Other	0.04	0.1	0.1
Total	**-13.6**	**-25.8**	**-56.0**

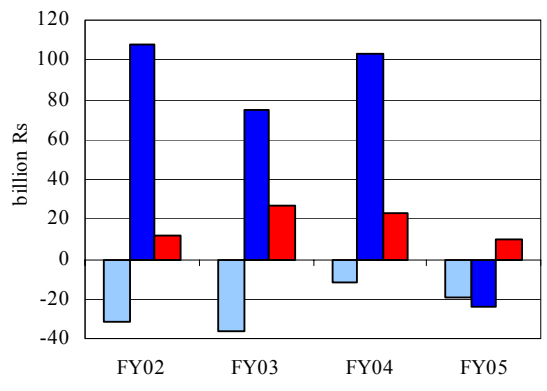
Source: Central Directorate of National Savings

Table 6.4: Rates of Return on Major NSS Instruments

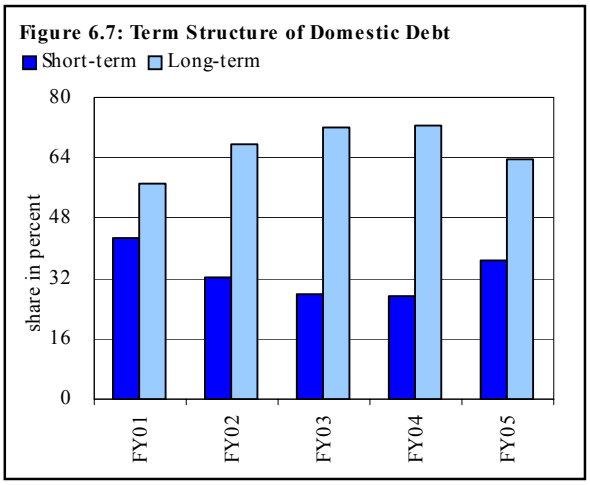
percent

	National Savings Schemes			
	DSC	**SSC**	**RIC**	**PBA**
H1-FY03	11.61	10.47	10.56	
H2-FY03	10.03	8.67	9.12	11.04
H1-FY04	8.50	7.67	7.68	10.08
H2-FY04	7.96	7.16	6.96	10.08
H1-FY05	8.15	6.95	6.84	10.08
H2-FY05	8.15	6.95	5.70	10.08

Figure 6.6: Net Flows in PIBs, FIBs and PBs



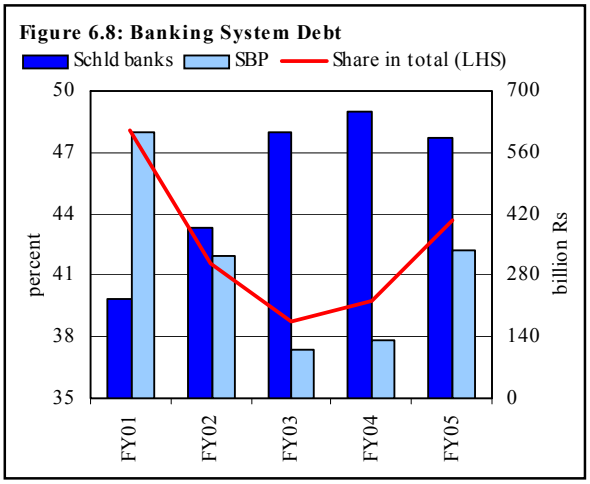
increase of Rs 9.7 billion in the stock of prize bonds was far smaller than the outflow from maturing FIBs and PIBs (see **Figure 6.6**).



6.2.2 Tenor of Domestic Debt

The developments during FY05 changed the trend in the term structure of the domestic debt as the share of short term debt that was declining since end-FY01 started rising (see **Figure 6.7**). As a consequence of a rise of Rs 234.8 billion in short term domestic debt, its share in total debt rose to 36.5 percent in FY05 from 27.5 percent in the previous year. Not only did the share of long term debt decline during FY05, its stock also declined for the first time in the last ten years.

This change has reduced government debt servicing cost as low cost treasury bills replaced expensive FIBs, PIBs and other NSS instruments. However, this shift also means that the government's debt servicing costs are now more vulnerable to adverse movements in short term interest rates.



6.2.3 Debt Servicing

The government strategy to substitute the long-term domestic debt by short-term debt, meant that government's domestic debt servicing cost continued to fall in FY05. While the 2.6 percent YoY decline seen in FY05 is lower than the 14.6 percent YoY decline in FY04 (see **Table 6.5**), this must be viewed in the context of the rising stock of the debt as well as the shift in the composition of the stock towards short-term debt.

This is evident from **Table 6.5**, which shows an increase in the interest payments on floating debt, while those on permanent debt and unfunded debt declined. The latter was due to a combination of: (1) maturities of expensive long term debt issued in past years; and (2) the net decline in the stock of long-term domestic debt.

Table 6.5: Interest Payments on Domestic Debt

billion Rupees

	FY01	FY02	FY03	FY04	FY05
Permanent debt	40.7	44.5	50.2	54.2	52.1
Floating debt	53.2	53.3	27.0	15.6	20.1
Unfunded debt	82.6	85.0	84.8	90.1	84.0
Others	18.8	29.7	27.0	1.6	1.1
Total	195.4	212.5	189.0	161.5	157.3

Others include provincial governments' interest payments, commission, fee etc.

Source: Ministry of Finance

6.2.4 Classification of Domestic Debt by Owner

The share of domestic debt held by banks increased for a second successive year in FY05, at the expense of non-banks (see **Figure 6.8**). While the rise in the share of banking system debt during FY04 was due to increased investment of scheduled banks in PIBs, and the massive government short term borrowing from the SBP, the FY05 rise was primarily due to the heavy reliance of the government on borrowings from SBP. In both years, the stock of non-bank debt declined.

In absolute terms, the SBP T-bill holdings reached Rs 337.7 billion by the end-FY05 after touching an (annual) low of Rs 110.1 billion at end-FY03. It is important to note that the banking system's holdings of domestic debt has again climbed to 50 percent mark after falling as low as 38.7 percent by end-FY03.

6.3 External Debt

The stock of external debt and liabilities (EDL) witnessed a marginal rise of US$ 576 million (1.6 percent YoY) during FY05, reversing the steady downtrend visible since FY99 (see **Table 6.8**). This rise was realized despite a fall of US$ 154 million in external liabilities as well as the US$ 495 million debt waiver provided by the USA during the year, and had only a negligible contribution from exchange rate fluctuations. In other words, the increase was mainly due to fresh inflows, including: (1) inflows from multilateral creditors, especially International Development Agency (IDA), and Islamic Development Bank (IDB); and (2) the issuance of an Islamic bond (*sukuk)* in the international capital market (see **Table 6.6**). However, this increase in the debt stock in FY05 had no significant negative impact on the country's debt profile; indeed, to the contrary, there appears to be a distinct improvement in the composition of the debt profile during the period. Not only did the share of expensive EDL fall during FY05, the maturity profile of the debt stock also improved due to the receipts of long-term loans, on concessional terms. These improvements, together with strong growth in nominal GDP and foreign exchange earnings contributed to a significant betterment in the country's ability to service external debt, for the fourth successive year.

Table 6.6: Sources of Increase in External Debt- FY05

Share/growth: percent; Absolute change: million US$

	Growth	Absolute Δ	Share in absolute Δ
Paris club	-4.0	-547.2	-75.0
Multilateral	7.0	1009.0	138.3
IDA	*10.5*	*632.0*	*62.6*
ADB	*8.9*	*495.0*	*49.1*
Sukuk/ Euro	53.6	442.0	60.6
IDB	1131.8	249.0	34.1
Private loans/credits	-19.6	-328.0	-44.9
IMF	-8.6	-151.0	-20.7
Others	5.0	56.0	7.7
Total external debt	**2.19**	**729.80**	**100.0**

Table 6.7: Classification of the New External Borrowings in FY05

	Inflows million US$	Interest rates		Tenor		Classification
		Contracted	Current	Payment	Grace period	
World Bank						
IDA	573	0.75%	0.75%	25 Years	10 Years	Concessional
IBRD	202	Libor[1] + 50 bps	4.11	12 Years	8 Years	Non-concessional
Sukuk	600	Libor + 220 bps	5.91	5 Years	-	Non-concessional
ADB (Major loans)	283	Libor[2] + 60 bps	0.67	12 Years	3 Years	Concessional
	50	Libor[3] + 60 bps	4.21	12 Years	3 Years	Non-concessional

[1,3] US$ based Libor rate

[2] Yen based Libor rate

While the emergence of external account deficits in FY05 did not allow the large pre-payments of expensive external debt as in FY04, the normal retirement of EDL (including expensive ones) together with the fact that the larger part of fresh loans was on concessional terms (see **Table 6.7**), meant that the share of expensive debt in Pakistan total stock of EDL declined in FY05. In fact, the trend decline in the share of expensive debt helped the country to lower its debt servicing costs, even though international interest rates rose.

Table 6.8: Pakistan's External Debt & Liabilities

million US Dollar

	FY01	FY02	FY03	FY04p	FY05p	%. change FY05 over FY04
I. Public and publicly guaranteed debt	**28,165**	**29,235**	**29,232**	**29,875**	**31,084**	**4.05**
A. Medium and long term(>1 year)	**27,908**	**29,052**	**29,045**	**29,853**	**30,813**	**3.22**
Paris club	11,845	12,516	12,607	13,565	13,018	(4.03)
Multilateral	13,310	14,331	14,950	14,349	15,358	7.03
Other bilateral	451	429	512	713	801	12.34
Euro bonds/Saindak Bonds/Sukuk	645	643	482	824	1,266	53.64
Military debt	554	819	263	204	188	(7.84)
Commercial Loans/credits	1,103	314	231	198	182	(8.08)
B. Short-term (<1 year)	257	183	187	22	271	1,131.82
IDB	257	183	187	22	271	1,131.82
II. Private non-guaranteed debts	**2,450**	**2,226**	**2,028**	**1,670**	**1,342**	**(19.64)**
Medium and long-term (>1 year)	2,450	2,226	2,028	1,670	1,342	(19.64)
Private loans/credits	2,450	2,226	2,028	1,670	1,342	(19.64)
III. IMF	**1,529**	**1,939**	**2,092**	**1,762**	**1,611**	**(8.57)**
Total external debt (I to III)	**32,144**	**33,400**	**33,352**	**33,307**	**34,037**	**2.19**
IV. Foreign exchange liabilities	**5,015**	**3,132**	**2,122**	**1,951**	**1,797**	**(7.89)**
Foreign currency accounts	1,100	406	-	-	-	-
FE–45 deposits	774	234	-	-	-	-
FE-31 deposits (incremental)	-	-	-	-	-	-
FE-13 deposits	326	172	-	-	-	-
Special U.S dollar bonds	1,376	924	696	552	421	(23.73)
National debt retirement program	150	75	6	1	-	(100.00)
Foreign currency bonds (NHA / NC)	219	197	175	153	131	(14.38)
Central bank deposits	700	750	700	700	700	-
NBP (BOC deposits)	749	280	500	500	500	-
Other liabilities (SWAP)	721	500	45	45	45	-
Total external debt & liabilities (I to IV)	**37,159**	**36,532**	**35,474**	**35,258**	**35,834**	**1.63**
FEBCs/FCBCs/DBCs (payable in Rs.)	*90*	*66*	*42*	*22*	*10*	*(53.18)*

P: Provisional

Source: State Bank of Pakistan

Of the total new debt inflows of US$ 1,848 million in FY05, a large proportion, i.e., US$ 996 million or 53.9 percent was obtained at concessional terms, while the non-concessional loans (defined as loans that cost at least 50 basis points above the 6-month US$ Libor rates) amounted to 46.1 percent (see **Table 6.8**). Even the non-concessional loans from ADB and IBRD had tenors extending to 12 years with grace periods of 3 and 8 years respectively.

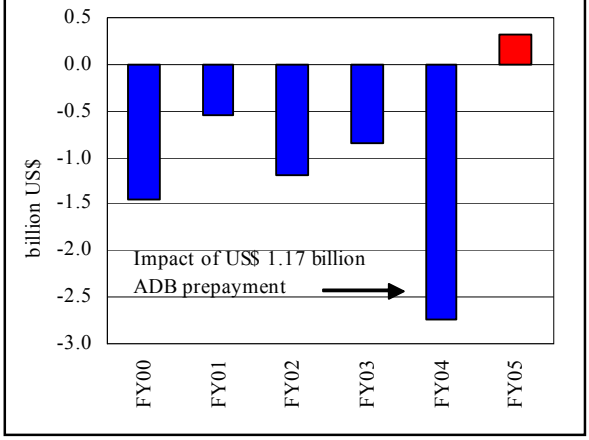
The US$ 600 million Islamic sovereign debt issue (*Sukuk)* was floated for the purpose of maintaining a continued presence in the international capital markets, diversifying investors' base and drawing attention to the positive economic story of Pakistan. As the US$ 500 million sovereign Eurobond was successful in attaining these objectives, the government continued with this strategy by entering the market through a new instrument. The strength of Pakistan's paper can be gauged by the fact that the spreads have tightened and sukuk is currently trading at 110 basis points above US$ Libor in the secondary market. In fact, sovereign debt issues provide checks on the macro performance of the

government. Any laxity in macro discipline would have immediate impact on the spread charged by the secondary market on Pakistan's sovereign paper.

Pakistan successfully completed PRGF program of the IMF by the end of 2004. Having drawn down 10 tranches, Pakistan decided to forego the remaining two tranches voluntarily after the IMF review was completed in December 2004. This was the second agreement that was successfully implemented, in succession to the Stand By Arrangement (SBA) in 2001. This achievement helped in reestablishing the country's credibility vis-à-vis international financial institutions.[3] In this context, it is worth mentioning that Standard & Poor has upgraded country's credit rating from B+ in FY04 to B+ Stable in FY05.

Finally, the large volume of external debt inflows (multilateral, *sukuk*, IDB) during FY05 was higher than the outflows on account of repayment of principal and interest; thereby turning the net transfers positive for the first time after five years (see **Figure 6.9**).

Figure 6.9: Net Transfers



A critical appraisal of the external debt should not focus on the increase in the absolute stock but on the ease with which the country can service its debt, i.e., its debt carrying capacity. The rise in the country's national income and foreign exchange earnings were much higher than the absolute increase in debt stocks in FY05. As **Table 6.9** clearly demonstrates almost all debt and debt servicing indicators have shown significant improvement in FY05 relative to the preceding year, and more importantly, compared to the fiscal year 2001 when the country faced serious difficulties in meeting its obligations due (i.e., in absence of re-profiling).

Table 6.9: Selected External debt/Liabilities Indicators

	Total external debt to			RES/TED	Total external debt & liabilities to			RES/TDL	RES/ST	DS/FEE	DS/XGS
	GDP	EE	FEE		GDP	EE	FEE				
FY01	49.5	359.8	224.2	5.2	57.2	416.0	259.2	4.5	6.5	23.7	32.7
FY02	45.6	365.4	216.1	13.0	49.8	399.7	236.4	11.9	23.7	26.5	36.7
FY03	40.0	306.3	169.7	28.6	42.5	325.8	180.5	26.9	51.0	16.0	22.8
FY04	35.0	268.7	155.2	31.7	37.1	284.5	164.3	30.0	480.2	23.2	32.5
FY05	31.0	236.8	127.9	28.8	32.6	249.3	134.7	27.3	36.13	10.2	15.0

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

TED: Total External Debt; TDL: Total external debt & liabilities; RES: Foreign Exchange Reserves; EE: Export earnings

FEE: Foreign exchange earnings; DS: Debt servicing; XGS: Export of good & services

The exceptions to this trend were the reserves to total external debt ratio and the reserves to short-term debt ratio which witnessed a fall during the year due to a decline in SBP reserves and the rising short term debt stock (on account of higher inflows from IDB for oil import financing). On the other hand, debt servicing ratios improved considerably during FY05 due to the absence of prepayment of expensive loans that had worsened the ratio in FY04.

[3] During the period 1989-1999, Pakistan signed 13 agreements with the IMF; out of these, 3 were one tranche facilities, 2 were completed with the delay of one year each, and the remaining 8 programs were suspended.

6.3.1 Composition of External Debt and Liabilities

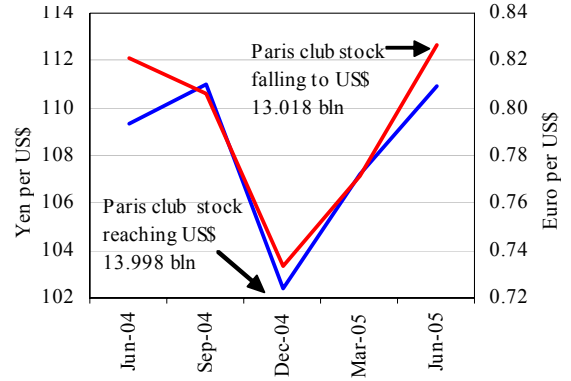
Paris club & other bilateral

Paris club debt stock recorded a significant decline during FY05, thus breaking from the continuously rising trend visible since FY02.

The US$ 547 million fall in the debt owed to the Paris club creditors was principally driven by the debt relief of US$ 495 million provided by the US,[4] and the first installment (of approximately US$ 128 million) of the capitalized interest payable under the 2001 rescheduling agreement.[5] The US$ 88 million rise in the stock of *other bilateral debt* was principally due to higher receipts from China. The major projects for which these loans were acquired include: the Gwadar deep water port project (US$ 36.8 million) and acquisition of railway locomotives (US$ 23.95 million).

Apart from these developments, the net impact of currency revaluation on Paris club debt stock during FY05 was almost negligible. The substantial depreciation of the US dollar against euro and yen led to a considerable rise in the debt stock during H1-FY05, but the subsequent reversal of US dollar against these currencies during H2-FY05 almost nullified this increase (see **Figure 6.10**). Consequently, the average currency revaluation impact for the whole of FY05 was just US$ 7 million as compared to the US$ 928 million increase reported for H1-FY05.

Figure 6.10: Exchange Rate Movements Impacting Stock of Paris Club Debt



Multilateral

The US$ 1 billion of new flows from the multilateral institutions was used for the following purposes:

- A total of US$ 576 million from ADB for the projects such as, US$ 87 million for the *Access to Justice Program*, US$ 128 million for *Decentralization Support Program*, US$ 68 million for *Balochistan Resource Management Program,* and US$ 50 million for *Rural Finance Sector Development.*

- US$ 202 million from IBRD as *Banking Sector Development Policy Loan.*

- US$ 573 million from IDA for *Poverty Reduction & Support Credit Program* (US$ 303 million), *Banking Sector Restructuring and Privatization Project* (US$ 122 million), and *Banking Sector Development Plan Loan* (US$ 99 million).

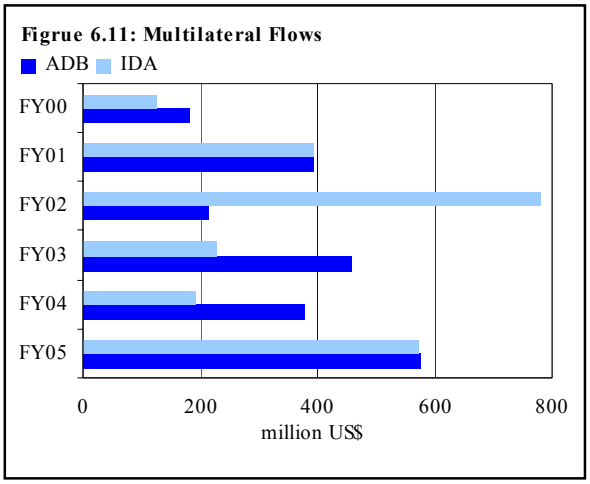
In fact, IDA is the largest source of multilateral debt to the country accounting for approximately 43 percent of the *multilateral* debt stock in FY05, followed by the ADB. **Figure 6.11** shows the comparison of ADB and IDA debt flows during the last five years. The higher IDA receipts in most

[4] This debt relief was an independent decision of the US that did not impact the overall credit arrangements with the other Paris club members.

[5] Under the 2001 rescheduling agreement, all interest payments owed to Paris club creditors (falling between 30th November, 2001 and 30th June, 2002) along with the 20 percent annual interest accrued on restructured debt for FY03 and FY04 were deferred and capitalized in the Paris club debt stock. The repayments had to be made in four equal and successive semi-annual installments starting from May 31, 2005.

years is an encouraging development, since IDA loans are soft term and concessional, whereas loans from ADB are also mostly concessional.[6]

Table 6.10 provides sector wise details of the IDA loan commitments during the last five years. A bulk of these loan commitments were made for the *Structural Adjustment programmes*, *Poverty Alleviation Projects* along with *Financial Sector Restructuring*.



- The *Structural Adjustments Credits* aimed at enhancing growth by fiscal consolidation, building the base for export growth, increasing revenue mobilization, improving governance, human development and creation of employment.

- The *Poverty Alleviation Fund Project* focused on providing small loans for the purpose of poverty reduction through employment generation. The *Poverty Reduction Support Credit Project* aimed at accelerating economic growth while maintaining macro stability by improving governance and devolution, investing in human capital and targeting the poor.

- The key objective of the *Banking Sector Restructuring and Privatization Project* was to help country in continuing implementation of its banking reforms. Major elements were staff rationalization by nationalized commercial banks and National Development Finance Corporation (NDFC) through voluntary separation scheme, NDFC amalgamation into NBP, completion of MCB and ABL privatization and other policy measures. *Banking Sector Development Policy Loan* aimed at supporting government towards improved governance through the privatization of United Bank Limited (UBL), Habib Bank Limited (HBL) and resolution of the Allied Bank Limited (ABL) besides other measures.

Sukuk

After the successful launch of a Eurobond in FY04, the government decided to issue US$ 600 million Islamic bond (*sukuk)* in FY05. The motivation for countries to launch bonds is aptly described in **Box 6.3.1**.

Given the relative rarity of the sovereign Islamic debt issues, Pakistan's US$ 600 million *sukuk* offering evoked considerable investor interest, with subscriptions of US$ 1.2 billion. The issue was priced at a margin of US$ LIBOR+220 basis points, and the secondary market price reveals that *sukuk* is being traded favorably in the market since issuance (for details see section on ***Foreign Portfolio Investment*** in ***BOP***). The investor base was quite wide; divided among the Middle East and Far East institutional investors, fund manager and central banks.

Short-term-IDB

After declining substantially during FY04, the stock of IDB loans rose substantially during FY05. The short-term IDB loans are obtained largely for financing oil and fertilizer imports, and the rise is a consequence of the termination of the *Saudi Oil Facility* (a grant that covered a major share of oil imports) in FY04, and the extraordinary hike in oil prices in the global market (see **Figure 6.12**).

[6] In ADB outstanding stock for FY05 only one loan amounting to US$ 152 million is classified as non-concessional. The contracted rate for this loan was 6 month Libor plus 60 basis points; that makes the current rate 4.21 percent.

Table 6.10: IDA Loans Contracted During 2000-05

million US $

Terms: 10 Years Grace 25 Year Repayment 0.75 % Interest

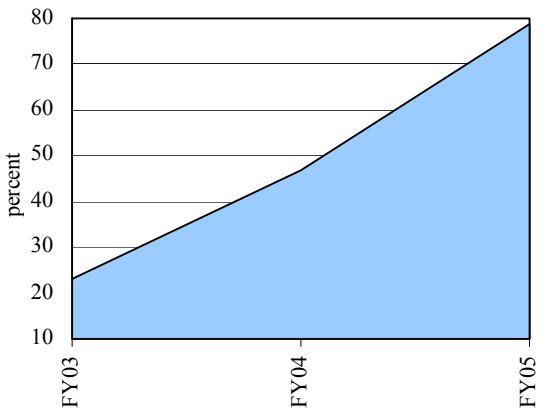
Program	Program Period	Amount Committed	Amount Disbursed as on 30-06-05
Structural adjustment credit			
Second Structural Adjustment Credit	FY02	510.5	Fully disbursed
Sindh Structural Adjustment Credit Project	FY03	104.7	Fully disbursed
NWFP Structural Adjustment Credit Project	FY03	94.3	Fully disbursed
NWFP Structural Adjustment Credit II	FY05	90.8	
Human development and poverty			
Poverty Reduction Support Credit Project	FY05	301.1	Fully disbursed
Second Poverty Alleviation Fund Project	FY04-09	249.7	85.0
Finance			
Banking Sector Restructuring and Privatization Project	FY02-05	304.9	Fully disbursed
Banking Sector Development Policy Loan	FY05-06	99.6	99.4
Banking sector technical assistance project	FY03-08	28.3	11.3
Education			
Punjab Education	FY04-05	105.1	Fully disbursed
National Education Assessment System	FY04-08	3.9	0.4
Transport and communication			
Highway Rehabilitation	FY04-09	158.5	28.0
Good governance			
Tax Administration Reform (FY05-10)	FY05-10	81.8	6.3
Public Sector Capacity Building Project	FY04-10	53.7	9.9
Advance for Preparation of Tax	FY02-05	2.9	Fully disbursed
Industry			
Trade & Transport Facilitation	FY01-06	2.9	2.8
Water			
Sindh-On Farm	FY05-09	60.1	2.9
NWFP-on farm water management project	FY02-06	21.4	5.7
Social welfare			
NWFP Community Infrastructure	FY05-10	37.2	2.2
AKJ Community Infrastructure	FY03-07	21.3	5.9
Health and Nutrition			
HIV/AIDS	FY04-09	29.0	4.0
Partnership for Polio Eradication Project	FY04-06	22.0	21.1
Polio Eradication Project	FY03-06	20.8	20.8

Source: EAD

Box 6.3.1: Why Bond Finance?

International scenario: According to the Global Development Finance report for 2005, there have been significant changes in the composition of developing countries' external debt following the financial crisis of 1990s. One such shift is the rising share of bond finances and short-term bank credit in the total external debt stock of economies hit by the financial crisis; the share of bond debt and short term credit rose from 29 percent in 1990 to 45 percent in 2003, whereas bond debt alone witnessed a significant expansion in its share to 27 percent in 2003 from only 4 percent in 1990.[7] The underlying cause of such structural shift was the reduced availability of official external financing[8] following the financial crisis that led the borrowing countries to resort to market based credit, with greater emphasis on bond finance.[9]

Figure 6.3.1: Substitution of Bond Finance for IMF Loans



Pakistan's case: Pakistan also joined the stream of the countries opting for bond finance. During FY05, the country made second appearance in the international capital market within two years, by issuing a US$ 600 million Islamic bond named sukuk. Given that Pakistan has foreign exchange reserves equivalent to around 24 weeks of imports,[10] the purpose of going to the international capital market was not raising funds. Instead, it was a major policy decision that aimed at attaining some long term objectives:

Firstly, this issuance allowed Pakistan to maintain a continued presence in the international capital market for the projection of country's strong economic position. This was necessary for the country as it has successfully exited from the PRGF program of the IMF and has decided not to enter any successor IMF program. The exit from the IMF program is no doubt a reflection of the considerable improvement of country's economic fundamentals and will provide it much needed independence in setting the orientation of its policies; however this has also placed greater responsibility on policy makers to ensure that the economy will continue to follow macro discipline achieved under the IMF program. The financing through sovereign foreign currency debt instruments will be helpful in ensuring monitoring on the economic performance as these instruments become a benchmark of sovereign risk.

Secondly, the projection of country's strong economic position will help in improving its risk perceptions in the international market. This is evident from improvement in country's credit ratings from B+ in FY04 to B+ Stable in FY05 (by S& P). This in the presence of a permanent contact with the international investors will go a long way in increasing the flow of much needed foreign direct investment to the country. Reportedly in order to maintain market presence, government has planned to make one such appearance annually in the international market to remain in touch with the international investors.

Finally, as country has now completely graduated out of the IMF programmes, there may also be a need to diversify financing resources. In this scenario bond financing provides one such alternative. **Figure 6.3.1** shows growing importance of bond finance as compared to IMF loans. This can be concluded that bond financing is substituting for both roles of IMF including economic monitoring and provision of funds.

IMF

With the receipt of the tenth tranche of the PRGF facility in FY05, Pakistan successfully exited the IMF program. The absence of additional tranches and the scheduled repayments on earlier IMF loans, reduced the outstanding stock of this debt by 8.6 percent to US$1.6 billions during FY05.

The largest repayment during FY05 was for the SBA facility, thus reducing the share of non-concessional debt in IMF loans from 17 percent to 2 percent (see **Figure 6.13**). Currently 91 percent of the total outstanding debt stock is under the concessional facility, i.e., PRGF. As far as other

[7] Source: "Global Development Finance 2005: Mobilizing Finance and Managing Vulnerability", World Bank Publication.
[8] On account of financial crisis in 1990s, official sources of credit to crisis countries diverted to other destinations in order to avoid losses from countries' inability to service their debts.
[9] Most notable among the countries that witnessed this shift towards bond finance are Brazil, Argentina, Chile, Columbia, Poland, Panama, etc.
[10] This number pertains to August 2005.

facilities are concerned, CCFF was fully repurchased during FY04 whereas the stock of EFF has now also been reduced significantly.

Private loan

Private loans continued their downward movement for yet another year, witnessing a US$ 328 million fall during FY05. As shown in **Figure 6.14**, this was largely due to higher repayments by the power sector coupled with very few new inflows (*for further discussion on private loans see* ***Special Section 1***).

External Liabilities

Pakistan's external liabilities recorded a US$ 154 million fall during FY05, to reach US$ 1.8 billion by end FY05. The fall was largely due to the encashment of the 3-Year Special US Dollar Bonds.

Special US Dollar Bonds

The outstanding stock of Special US Dollar bonds witnessed a US$ 131 million fall during FY05 due to higher encashment of 3-Year Special US Dollar bonds. Most of the Special US$ bonds that were issued between FY99 and FY00, had a three-year maturity period, with substantial maturities falling due in FY02. However, keeping in view the weak foreign exchange reserves position at that time, the SBP gave two incentives to the bond holders: (1) a 5 percent bonus on rupee redemptions; or (2) an attractive reinvestment option.[11] Most of the bond holders opted for the second option. As shown in **Figure 6.15**, it is the amount reinvested in FY02 that fell due in FY05, thus causing a significant reduction in Special US$ bond stock. Interestingly, within the outstanding stock of 3-Year US$ bonds, a significant portion carries no interest burden – this comprises bonds that fell due in FY02 & FY03 but were neither encashed nor rolled over.

Figure 6.12: IDB Loans & Saudi Oil Facility

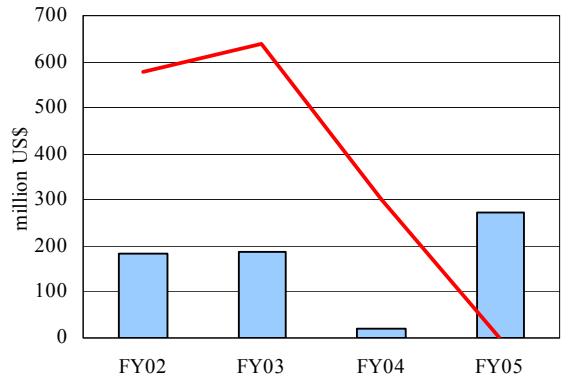


Figure 6.13: Position with IMF (End June 2005)

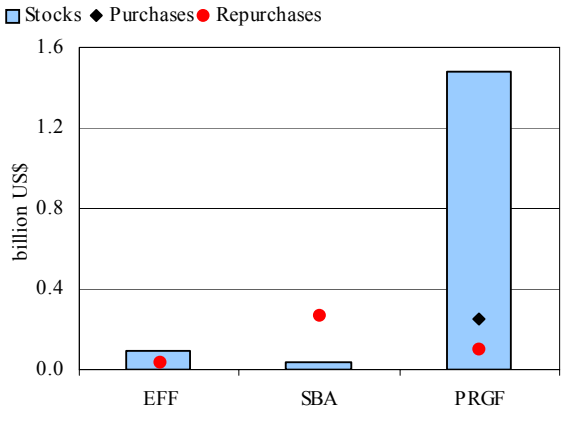
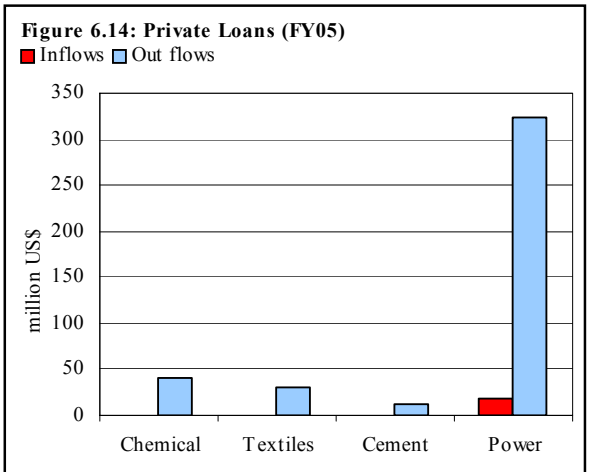


Figure 6.14: Private Loans (FY05)



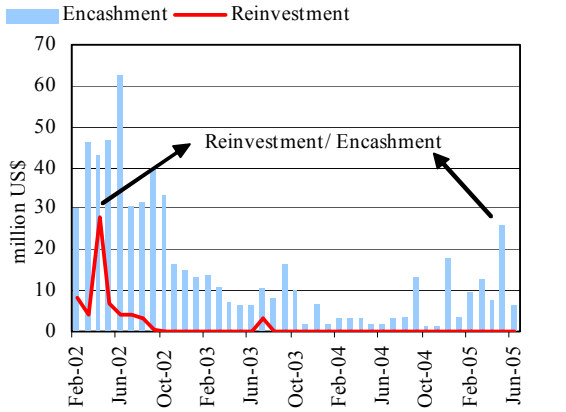
6.3.2 External Debt and Liabilities Servicing

Pakistan's debt servicing capacity further improved as, in the absence of any large prepayments during FY05, the country witnessed a substantial fall of US$ 2.3 billion in the servicing of its external

[11] The face value of the bond could be reinvested for another 3-years period (from the date of redemption) at LIBOR + 2 percent.

debt and liabilities (see **Table 6.11**). The largest fall in debt servicing was seen for multilateral creditors, followed by Paris club creditors. It may be recalled that the large payments during FY04 were due to the pre-payment of expensive debt by the government (US$ 1.17 billion to the ADB) and by PARCO (US$ 325 million) respectively.

Figure 6.15: 3-Year Special US$ Bonds



The combination of re-profiling of Paris club bilateral debt on a long term time horizon, the substantial write off of the US bilateral debt stock, the prepayment to ADB and private external creditors, the extinguishing of external liabilities during the preceding years and the relative shift in contracting new loans on concessional terms has begun to show beneficial effects. The annual debt servicing payments made during the past five years averaged about US$ 5 billion. But this amount has now come down to US$ 2.9 billion and this favorable trend is expected to persist in the coming years, thus insulating the economic managers from the fears of future payment crises. As long as the country pursues a sensible policy in managing its external debt and does not indulge in excessive borrowings for unproductive or consumption purposes, the debt servicing ratio will continue to fall in the coming years. The ratios will decline because the country's income and foreign exchange earnings are expected to grow faster than the growth in debt servicing payments. The space provided by these favorable ratios can be utilized for contracting new loans at concessional terms for investment in infrastructure and human development thus reinforcing the trends of higher growth and large exchange earning stream.

Table 6.11 : Pakistan's External Debt and Liabilities Servicing
million US $

	FY03		FY04		FY05	
	Actual paid	**Rescheduled/ Rollover**	**Actual paid**	**Rescheduled/ Rollover**	**Actual paid**	**Rescheduled/ Rollover**
1. Public and publicly guaranteed debt	1,861	1,008	3,526	100	1,811	100
A. Medium and long term (> 1 year)	1,671	1,008	3,330	100	1,803	100
Paris club	302	761	834	-	533	-
Principal	110	486	519	-	152	-
Interest	192	275	316	-	381	-
Multilateral	952	-	2,126	-	899	-
Principal	630	-	1,802	-	692	-
Interest	321	-	324	-	207	-
Other bilateral	96	26	59	-	52	-
Principal	71	22	42	-	27	-
Interest	25	4	18	-	25	-
Eurobonds	223	-	197	-	217	-
Principal	162	-	158	-	158	-
Interest	62	-	39	-	60	-
Military debt	-	122	74	-	79	-
Principal	-	101	59	-	67	-
Interest	-	21	15	-	12	-
Commercial loans/credits	98	100	39	100	23	100
Principal	84	100	33	100	16	100
Interest	14	-	6	-	6	-
B. Short-term (≤ 1 year)	190	-	196	-	9	-
IDB	190	-	196	-	9	-
Principal	183	-	191	-	8	-
Interest	7	-	5	-	0	-
2. Private non-guaranteed debts	834	-	744	-	482	-
Private loans/credits (M&LT>1 yr)	834	-	744	-	482	-
Principal	663	-	613	-	374	-
Interest	171	-	131	-	109	-
3. IMF	459	-	699	-	423	-
Repurchases / principal	419	-	674	-	400	-
Charges / interest	40	-	26	-	23	-
Total debt servicing (1 thru 3)	3,154	1,008	4,969	100	2,716	100
4. Central bank deposits	71	400	15	700	24	700
Principal	50	400	-	700	-	700
Interest	21	-	15	-	24	-
5. NBP/BOC deposits	18	500	15	500	16	500
Principal	-	500	-	500	-	500
Interest	18	-	15	-	16	-
6. Special US$ bonds	316	-	197	-	163	-
Principal	283	-	167	-	130	-
Interest	33	-	30	-	33	-
7. Foreign currency loan bonds (NHA)	29	-	27	-	-	-
Principal	22	-	22	-	22	-
Interest	7	-	5	-	3	-
8. Swaps	235	-	-	-	-	-
9. FCAs	412	-	1	-	1	-
FE-45 (institutional)	238	-	-	-	-	-
Principal	234	-	-	-	-	-
Interest	4	-	-	-	-	-
FE-13 (interest)	2	-	1	-	1	-
FE-31	171	-	-	-	-	-
10. NDRP	69	-	4	-	1	-
11. FEBCs/FCBCs/DBCs	46	-	47		19	-
Principal	26	-	21		8	-
Interest	20	-	26		11	-
Total (1 thru 11)	4,349	1,908	5,274	1,300	2,965	1,300

p: Provisional

Special Section 6.1: Private Un-Guaranteed External Debt of Pakistan

While the total external debt, particularly the one that is held by the public sector, is discussed more often in Pakistan, little attention is paid to external debt contracted and owed by the private sector.[12] The private sector external debt can be classified into two broad categories; namely, guaranteed debt and un-guaranteed debt (see **Box 6.1.1** for definition). However, as the private external debt *guaranteed* by the public sector becomes a direct contingent liability[13] on government's budget accounts, this is reported under the category of public and publicly guaranteed debt. This note therefore focuses on *un-guaranteed* part of the private debt.

In Pakistan, private *un-guaranteed debt* includes debt acquired by Pakistan International Airlines (PIA) and other private sector. The debt held by the PIA (mainly for the purchase of aircrafts and other equipments) is not registered with SBP. *Other private sector debt* which is registered with the central bank is further classified into three major categories: (1) buyer's credit, (2) suppliers credit, and (3) commercial credits (see **Box 6.1.2** for more details).

The outstanding stock of the private *un-guaranteed* debt was US$ 1.34 billion at end-June 2005 (see **Table 6.1.1**). Out of that, PIA held 26 percent share and another 68 percent comprises of commercial credit, mainly representing debt held by Independent Power Projects (IPPs).

Box 6.1.1: Defining Private External Debt?
According to IMF Balance of Payments Manual, 5th Edition "*Gross private sector external debt, at any given time, is the outstanding amount of those current and not contingent liabilities that require payment(s) of interest and/ or principal by the debtor at some point(s) in the future and that are owed to non-resident by private residents of an economy".*

According to a guide on external debt statistics by the IMF, *publicly guaranteed private sector external debt* is one servicing of which is contractually guaranteed by a public entity resident in the same economy as the debtor. In the case of *partially* guaranteed external debt, only the guaranteed payments are included within *publicly guaranteed external debt*

On the other hand, external debt of the private sector that is not contractually guaranteed by the public sector resident in the same economy is classified as *non guaranteed private sector external debt*.

Box 6.1.2: Classification of Private un-guaranteed debt:
1. Buyer's Credit: Buyer's credits are export loans obtained from the overseas purchaser of goods or services, this type of loans involves lender, borrower and supplier of goods or services. The supplier being paid in cash by the lender and loan is being created against the borrower to the lender.

2. Supplier's Credit: Supplier's credits are export credits extended by the suppliers of goods or services to an overseas purchaser, i.e. borrower directly. In supplier's credits two parties are involved borrower and lender. The maturity of all these loans is greater than or equal to 5 year.

3. Commercial Credits: These are foreign private loan in which disbursements are received in cash and utilization of loans is at borrower's own choice. These loans are generally received from commercial banks through FCA under special permission.

The outstanding stock of private sector debt rose during the 1990s mainly due to the liberal energy policy adopted in 1994 that allowed IPPs to acquire huge foreign currency debt. These debt led to rise in the outstanding stock to its peak level of US$ 3.4 billion at end-June 1999 (see **Figure 6.1.1**). Thereafter, the share of private unguaranteed debt has been falling gradually from 10.2 percent of the total external debt at end-June 1999 to 3.9 percent (US$1.3 billions) at end-June 2005.

[12] The private sector comprises incorporated enterprises (including corporations, joint stock companies, limited liability companies, co-operatives, or other business organizations recognized as independent legal entities by virtue of registration of company or similar acts, laws or regulations), unincorporated enterprises, non profit organizations, individuals and households. Enterprises in which the majority of shares or ownership is held by the private sector are considered as part of private sector.

[13] Contingent liabilities are obligations arising from a particular discrete event(s), which may or may not occur, and can be distinguished from current financial claims (and external debt), in that one or more conditions or events must be fulfilled before a financial transaction takes place.

To the extent, (1) the private sector is more efficient in utilization of resources; and (2) foreign currency loans reflect the confidence of foreign lenders on private entrepreneurs, the decline in private sector debt stock may sound counter intuitive. However, one should realize that the decision of the private sector to borrow in foreign currency would depend on relative cost of foreign borrowing or holding foreign loans against the domestic loan. There are several legitimate explanations for this falling stock of private un-guaranteed debt:

1. One major reason for the fall in the outstanding private un-guaranteed debt was impact of the economic sanctions following the nuclear detonation in May 1998. The resulting severe balance of payment constraints discouraged creditors from extending new private loans.

2. The, government's decision to reschedule the external debt also dampened the supply of loans guaranteed by export credit agencies of major OECD countries until more recently (see **Table 6.1.2**).

3. Following the major improvement in the external account position by the end of 2001, the government allowed prepayment of private loans. Since then, around US$ 152 million have been prepaid, mostly in the cement sector (US$ 92 million) (see **Table6.1.3**).

4. More importantly, the fall in suppliers' credit could simply reflect the cheap availability of domestic financing and lower cost of borrowing from domestic sources.

Figure 6.1.1: Private Un-guaranteed Debt

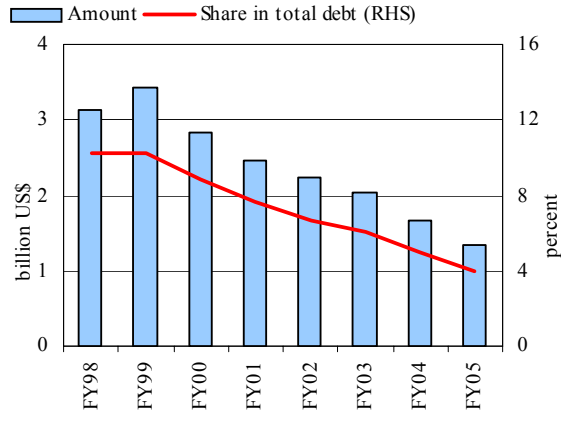


Table 6.1.1: Foreign Private Un-Guaranteed Debt

(End June, 2005)

	Outstanding position (million US$)	Percentage share in total
PIA	344.6	26%
Other	997.3	74%
Buyers' credit	*62.3*	5%
Suppliers' credit	*19.6*	1%
Commercial credit	*915.4*	68%
Total	1,341.9	

Table 6.1.2: Causative Factor for Private Un-guaranteed External Debt

million US$

Opening Stock as on 30th June, 1999	3435.6
Inflows	1538.7
Outflows	3319.6
Change due to exchange rate	-80.9
Rescheduling	-231.2
Closing stock as on 30th June, 2005	1,341.9

Table 6.1.3: Prepayment of Private Un-guaranteed Debt

million US$

Year	Prepayment
FY03	83.59
FY04	68.23
FY05	0.96
Total	**152.78**

There is a negative impact of US$ 80 million on account of valuation changes (see **Table 6.1.3**). This reflects the impact of exchange rate movement of major currencies vis-à-vis the US Dollar. In this regard, the currency profile of private external debt reveals that only 12 percent of the private un-guaranteed debt is in currencies other than the US Dollar (see **Table 6.1.4**).

Approximately, 65 percent of the private un-guaranteed debt is of maturity of 10-15 years (see **Table 6.1.5**). This may reflect the impact of pre-payment as well as the overall slowdown in *fresh* private sector un-guaranteed loans over the years.

Sector-wise breakup

The sector-wise break up identifies power sector as the major recipient of private external debt, followed by PIA; together they account for 86 percent of the total private debt. – see **Table 6.1.6**). As discussed earlier, the power policy introduced in 1994 was well received by foreign investors, mostly from the US and UK, and consequently substantial loans were contracted by IPPs during this period. However, as these loans matured, the stock of private external debt in the power sector has been falling, dropping to US$ 812.5 million at end-June 2005 from US$ 1487 million at end-June 2002.

In the cement sector, the stock of private *unguaranteed* debt has been declining due to pre-payments during FY03 and FY04. The outstanding debt stock in the fertilizer sector has also fallen due to rescheduling exercise that led to reclassification of this stock as public debt. By contrast, the fall in the debt stock of the chemical sector is on account of scheduled payments.

On the other hand, external debt held by PIA had increased in FY03 and FY04 due to fresh loans for the purchase of aircraft and other equipment. An interesting development is the new loan of US$ 287 millions in telecommunication sector that was registered last year with SBP; however, this amount is yet to be realized.[14]

The creditor wise break up shows that the major lenders of private debt belong to Paris club countries having 77 percent share of the total private debt (see **Table 6.1.7**).

U.S.A. with 52 percent of the total private debt is the largest creditor to the private sector in Pakistan. Other major lenders are the IFC and U.K. respectively.

Table 6.1.4: Currency wise composition

Currency	Outstanding	Percentage
US Dollar	1181.7	88.1
Pound Sterling	8.6	0.6
Swiss Franc	1.7	0.1
Japanese Yen	114.3	8.5
Euro	35.6	2.7
Grand Total	**1341.9**	**100.0**

Table 6.1.5: Maturity Profile

	Percentage
05-10 year	19.2
10-15 year	65.1
15-20 year	15.7
Total	100.0

Table 6.1.6: Sector-wise Classification of Private Debt

million US$

Economic Sector	June, 2002	June, 2003	June, 2004	June, 2005
Power	1,487.3	1,321.0	1,056.9	812.5
	(66.8%)	(65.1%)	(63.3%)	(60.6%)
Cement	204.2	98.1	40.5	32.8
	(9.2%)	(4.8%)	(2.4%)	(2.4%)
Fertilizers	176.8	154.4	--	--
	(7.9%)	(7.6%)	(0.0%)	(0.0%)
Chemicals	112.5	114.4	95.3	61.0
	(5.1%)	(5.6%)	(5.7%)	(4.5%)
Textiles	59.4	68.4	64.4	54.6
	(2.7%)	(3.4%)	(3.9%)	(4.1%)
PIA	51.7	189.2	383.2	344.6
	(2.3%)	(9.3%)	(22.9%)	(25.7%)
Others	134.2	82.5	30.0	36.3
	(6.0%)	(4.1%)	(1.8%)	(2.7%)
Total	**2,226.1**	**2,028.0**	**1,670.3**	**1,341.8**

Figure in parentheses are share in total

Table 6.1.7: Source of Private Un-guaranteed Debt

End June, million US$

	2002	2003	2004	2005
Paris club	1,654.7	1,555.3	1,317.8	1,039.2
Multilateral	508.8	412.1	340.9	297.2
Other bilateral	62.6	60.4	11.4	5.4
Total	2,226.1	2,027.7	1,670.1	1,341.9

Interest cost

The private external debt can also be classified in terms of its pricing modes. As on 30th June 2005, US$ 831.6 million or 62 percent of the private debt carries floating interest rates, which in most of the cases is linked to 6-month Libor (see **Table 6.1.8**).

[14] During FY05, new loans amounting to US$ 299 million were registered with SBP. Of that, US$ 287 million were meant for the telecommunication sector and the remaining US$ 12 million were for storage facilities.

The weighted average interest rate[15] on private external loans varies within the ranges of 4.5-6.2 percent during the last three fiscal years. However, it is evident from **Figure 6.1.2** that cost of fixed interest rate loans is higher than the floating interest rate loans. Moreover, as floating rate loans carry larger share in overall private loans, the rise in weighted average cost of private loans closely follows the trend in market interest rates, linked with Libor in the international market.

Table 6.1.8: Break up of Private Un-guaranteed External Debt on the Basis of Interest Rate

End June, million US$

	Outstanding	Percentage
Fixed rate	510.3	38.0
Floating rate	831.6	62.0
Total	1,341.9	100.0

Figure 6.1.2: Weighted Average Interest Rate on Private Unguaranteed External Debt

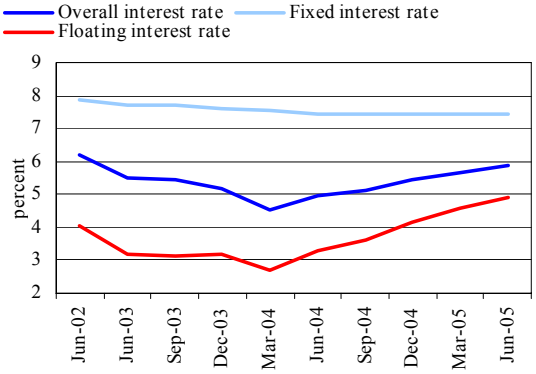
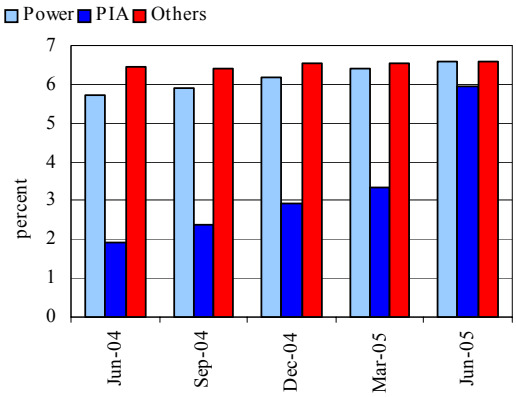


Figure 6.1.3: Sector-wise Average Interest



A sector-wise break up of interest cost on private loans reveals that borrowing by the PIA is relatively inexpensive. On the other hand, most of power sector loans are on floating rate (see **Figure 6.1.3**).

Trends in new borrowing

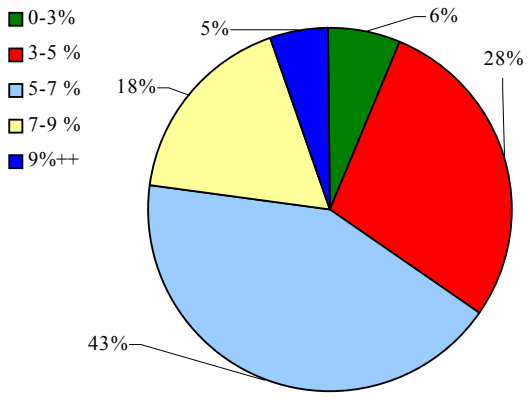
The interest rates on loan amount agreed during the specific period can also be useful to analyze the cost of newly registered loans. Weighted average interest rates on new borrowings have been calculated for each financial year by taking the loan amounts as weight since FY00. The estimated weighted average interest rates on new borrowings are showing a decreasing trend, mainly reflecting the impact of low interest rate environment in the international market (see **Table 6.1.9**).

Table 6.1.9: Weighted Average Interest Rates on New Borrowings

	Interest Rates		Interest Rates
FY00	7.84	FY03	6.83
FY01	7.92	FY04	3.88
FY02	5.68	FY05	3.6

Frequency distribution of weighted average interest rates as on 31st March, 2005 into different categories is presented by **Figure 6.1.4**. The frequency distribution shows that modal class is 5 to 7 and almost 43.5 percent of total loans fall in this class.

Figure 6.1.4: Distribution of Loans According to Interest Rates



[15] See **Box 6.1.3** for explanation of the weighted average interest rates.

Box 6.1.3: Weighted Average Interest Rates Methodology/ Data and Composition

The weights represent the value of each borrowing as a percentage of the total debt. For calculating the weighted average interest rates the relevant interest rate level for each loan is affected by whether it has a fixed- or variable-linked interest rate. If the interest rate is contractually fixed, for the computation of weighted average interest rates that rate is used. For variable-rate loans, the rate of interest on each loan is the rate occurring on the reference day. Weighted averages interest rates for private un-guaranteed debt are calculated by using the formula.

$$\text{Weighted average interest rate} = \Sigma Wi * Ii / \Sigma Wi$$

Where Wi is the weight indicating the outstanding loan amount as at the reference day and Ii is interest rate of the same date.

Special Section 6.2: External Debt and Liabilities – A Long Term Perspective

Backdrop

Pakistan has traditionally relied on external sources of finance to support its economic development. This strategy has led to sharp increase in country's burden of external debt and liabilities (EDL) that reached record US$ 38.92 billion in FY99.[16] At this level, the stock of EDL was more than 50 percent of the size of the economy and over 300 percent of the country's foreign exchange earnings. The resulting weakening debt repayment capacity was evident from the fact that around one-half of country's foreign exchange earnings were required to service the external debt payments due. Certainly this situation was not sustainable as the country was heading towards insolvency.

In response to this situation, a comprehensive 'Debt Burden Reduction and Management Strategy' was formulated in 2001 with a view to bring the debt burden within sustainable limits. This strategy together with favorable macroeconomic developments was effective in reducing the debt burden as by end-June 2005, stock of total EDL fell to US$ 35.8 billion which is equivalent to 32 percent of GDP. Similarly, debt burden also declined to 135 percent of foreign exchange earnings during FY05 (see **Table 6.2.1**) and debt servicing in FY05 accounted for 10.2 percent of foreign exchange earnings-a comparable portion for any debtor country.

Table 6.2.1: Comparison of Targets for Debt Reduction Strategy Against Performance

Targets	Time Frame	Status-FY05
Moderation in the growth of external debt & liabilities.	EDL stock ≤ US$ 37 billion in FY05.	EDL stock US$ 35.8 billion in FY05
EDL/FEE	200 percent in FY05	134.7 percent in FY05
Eliminating the need for assistance from IMF after the PRGF facility (2001-04)	Year 2004	Achieved
Eliminating the need for external debt rescheduling from the Paris club	Year 2004	Achieved
Conditions for Macroeconomic Frame work.		
1- Reduction in fiscal deficits.		Fiscal deficit fell from 4.3 percent in FY01 to 3 percent of GDP in FY05
2- Rise in government revenues.		Government revenues stayed at 13 percent of GDP
3- Exports to reach US$ 12 billion in FY04.		Achieved
4-Reduction in cost of government borrowing		Interest payments on debt servicing fell from 7 percent to 3.4 percent of GDP
5-Assistance from IMF, World bank and ADB on concessional terms		Achieved
6-Multiyear rescheduling from Paris club.		Achieved

Source: A Debt Burden Reduction and Management Strategy: Summary Report. Finance Division, Government of Pakistan

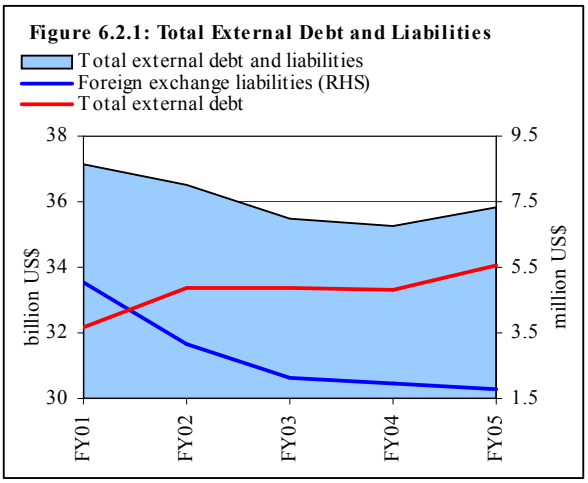
However, while the fall in country's total EDL stock has been due to the lessening burden of external liabilities[17] (on account of diminishing foreign currency accounts as well as US dollar bonds), there is a visible slowdown in the growth of external debt stock during this period (see **Figure 6.2.1**). In this background, the objective of this section is to take stock of broad policy initiatives meant to pull out the country from an imminent debt trap.

The overall improvement in total EDL stock was brought about through a debt re-scheduling from the Paris club and substitution of non-concessional for concessional loans from IFIs.

[16]Prior to FY00, the coverage of the foreign exchange burden of the country was limited as the reported numbers for external obligations did not include external liabilities (foreign currency deposits of resident as well as non-residents and deposits of other central banks). Similarly military debt was also kept secret. In FY00, SBP revised the reporting framework, and accordingly stock of external debt and liabilities was updated since FY95 on the basis of the expanded definition (see ***SBP First Quarterly Report for FY01***).

[17] Foreign exchange liabilities fell from US$ 5 billion in FY01 to US$ 1.8 billion in FY05.

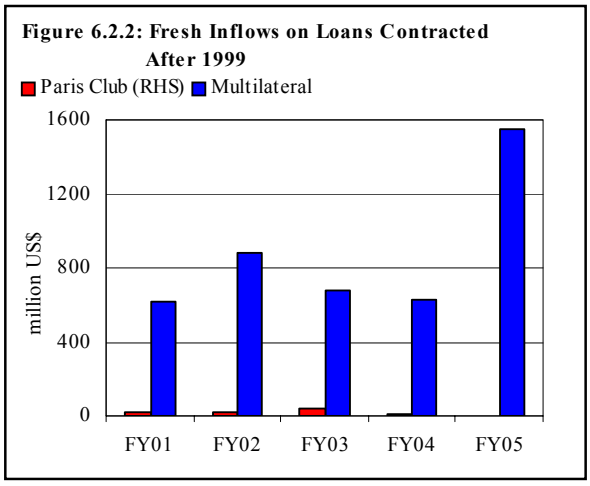
In addition, improvement in the external account has allowed Pakistan to pre-pay its expensive external debt.



1. Paris club - Re-profiling

Pakistan gained a major respite in FY02 when it succeeded in obtaining a very generous debt-reprofiling for entire outstanding external debt stock of US$ 12.5 billion owed to the Paris club. It may be pointed out that Pakistan had earlier received two back-to-back rescheduling of external debt (one in January 1999 and other in January 2000). But these concessions were providing relief only in terms of debt flows; there was no reduction in the net present value of the debt stock.

In contrast, terms agreed in FY02 led to fall in NPV of the debt stock. The grace period for the ODA[18,19] portion was fixed at 15 years, with maturity extended to 38 years; whereas for the non-concessional loans, the grace period was fixed at 5 years with maturiy of 23 years. This debt re-profiling has greatly reduced country's debt servicing burden.



2. Move towards concessional/soft loans

Another major policy initiative was to gradually change the composition of external debt towards more concessional loans. Consequently, most of the fresh inflows since FY01 are from multilateral creditors which generally offer more concessional terms. Within multilateral creditors, IDA is the largest lender to the country. This is encouraging as the loans

Table 6.2.2: Changes in Pakistan's External Debt & Liabilities

million US$

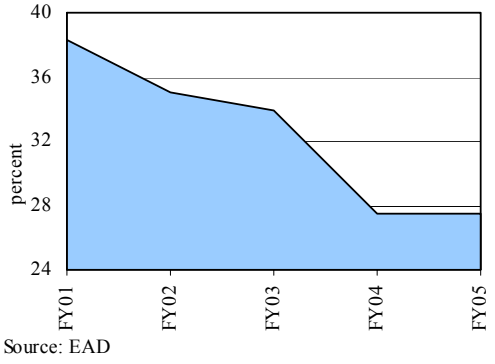
	Paris Club	Multilateral	Other bilateral	Others	Total ext. debt	Total ext. debts/liab.
Opening balance as on 30/06/2000	**12,428**	**12,234**	**639**	**6895**	**32,196**	**37,860**
Inflows	687	5,909	350	6,377	13,323	14,570
Disbursement on new loans contracted since 1999	92	4,356	292	6,352	11,092	12,339
Disbursement on pre 1999 loans	595	1,553	58	25	2,231	2,231
Repayment of principal	-1,050	-4,287	-435	-8,171	-13,943	-18,673
Debt relief	-1,495	0	0	0	-1,495	-1,495
Other changes	1,786	0	260	-457	1,589	1,208
Exchange rate fluctuation	662	1,502	-13	216	2,367	2,364
Closing Stock as on 31/06/2005	**13,018**	**15,358**	**801**	**4860**	**34,037**	**35,834**

Source: Statistics Department, SBP

[18] ODA (official development assistance) is defined by OECD countries as credits with low interest rate aimed to be used for development purpose.

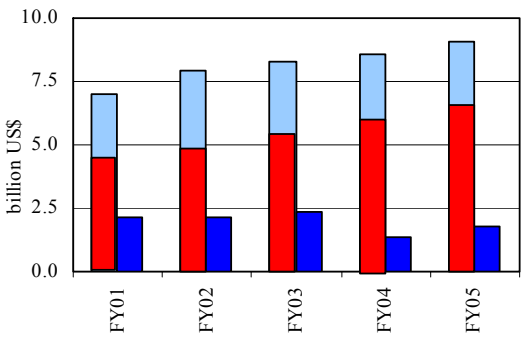
offered by IDA are highly concessional. As evident from **Figure 6.2.2**, fresh commitments from Paris club have almost completely withered as shown by negligible inflows on loan commitments after 1999 (see **Table 6.2.2**). This suggests substitution of the loans from Paris club creditors with that of multilateral creditors.

Figure 6.2.3: A: Share of Expensive Loans in Multilateral Stock



Source: EAD

B: Composition of Multilateral Debt



3 Falling share of expensive multilateral loans:

The drastic improvement in the external account and resulting build up of foreign exchange reserves, allowed Pakistan to make pre-mature payment of expensive external debt. In the multilateral debt stock, share of expensive loans witnessed significant fall between FY01-05. This was largely due to falling share of expensive ADB loans after the prepayment of US$ 1.17 billion expensive debt in FY04. In addition to this, the debt stock owed to IBRD is also falling in the absence of fresh inflows; thus causing a fall in the share of expensive loans in the multilateral debt stock (see **Figure 6.2.3 A & B**). However the effect of these positive developments was diluted due to the ***currency revlauation impact***. This happens because foreign loans are also contracted in currencies other than the US dollar.

However, for reporting purpose, these loans are converted into the US dollar at a particular point of time. Thus, the depreciation of the US$ against other currencies leads to higher US$ value of such loans (see **Box 6.2.1**).

In case of Pakistan, a significant share of country's external debt is denominated in yen and euro.[20] The depreciation of dollar against these currencies led to significant revaluation of country's external debt stock during FY02-04. Sometimes, the revaluation impct offsets the impact of many positive developments taking place in the extrenal debt sector (see

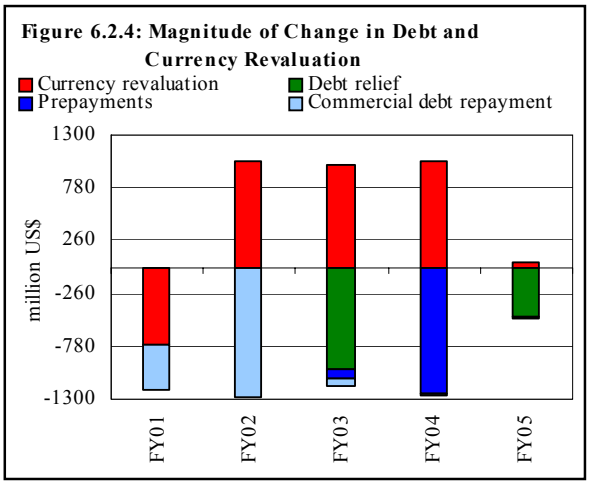
Box 6.2.1: Currency Valuation Impact - International Scenario

Currency revauation effects are one way thorugh which countries are exposed to the international financial environment. Countries normally contract debts in various currencies and for reporting purposes this is converted into the US dollar at a particular point in time. Around 40 percent of developing countries debt is denominated in nondollar currencies. And, the exchange rate movements of US dollar against these currencies cause significant changes in the external debt stock of these countries. As a matter of fact, at times these currency effects almost nullify the actual changes taking place in the debt flows. During FY02 the impact of debt reduction in a number of countries, e.g. Argentina, Indonesia and Morocco was significantly diluted due to these exchange rate fluctutaions. In Argentina repayments and debt restructuring led to a US$ 5.4 billion decline in the outstanding debt stock in 2002, while the cross currency revaluations raised the price of that debt by almost US$ 7 billion. Similarly in Brazil, debt repayments amounted to US$ 1.4 billion during 2002, however currency valautions led to a US$ 4.2 billion rise in the debt stock.

Source: "Global Development Finance 2005: Mobilizing Finance and Managing Vulnerability", World Bank Publication.

[19] Out of the total outstanding stock of Paris-club i.e. US$ 12.5 billion, ODA had a share of 70.4 percent.
[20] During FY04 and FY05 around 30 percent of country's external debt stock was denominated in yen and euro.

Figure 6.2.4). As a matter of fact during the period FY01-FY04, the stock of external has raised around US$ 3 billion just because of the currency revaluation. Had there been no currency revaluation the actual stock of external debt at end June 2005 would have been US$ 32.8 billion- a reduction of almost US$ 5 billion compared to the stock outstanding at end June 2001.



Vulnerability indicators of EDL stock

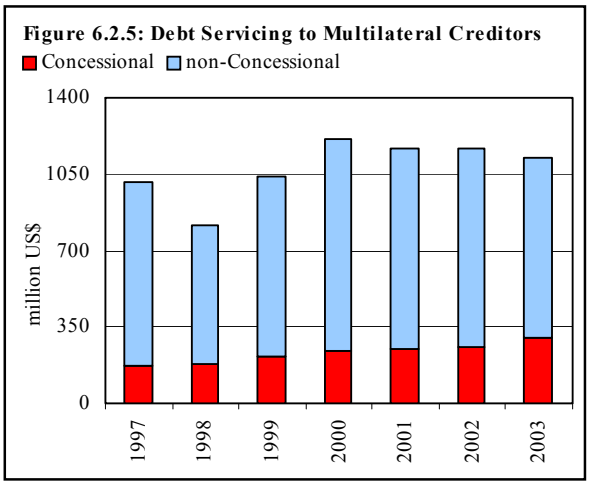
The adjustments taking place in the EDL stock have considerably improved the vulnerability indicators as compared to the late 1990's. The stock of non-concessional along with interest sensitive debt that includes short term and variable interest debt are facing continuous fall (see **Table 6.2.3**). In addition to this due to the accumulation of large international reserves, the debt payment capacity has also improved as reflected from the falling ratio of interest rates to international reserves. Further, the huge share of multilateral debt servicing in total debt servicing is due to a higher proportion of non-concessional loans; however, payments are following a declining trend (see **Figure 6.2.5**).

Table 6.2.3: Vulnerability Coefficients of Pakistan's Debt

	1997	1998	1999	2000	2001	2002	2003
Current account deficit/GNI	2.8	3.6	1.5	0.1	2.7	5.6	4.5
Non-concessional debt/total debt	50	47.8	45.4	45	38	35.5	33.5
Variable interest rate debt/total debt	29.9	30.2	26.4	27.9	22.9	24.9	25.3
Short term debt/total debt	8.2	6.7	5.4	4.6	4.1	4.6	3.4
Multilateral debt service/total debt service	24.8	35.7	35.5	42.4	39.1	41.1	37.1
Aggregate net resource flow/GNP	4.6	2.5	2.6	1.2	2.4	2.2	2.1
Interest payments/international reserves	68.8	52.6	49.5	47.2	20.5	9.5	7.2

Source: Global Development Finance: Mobilizing Finance and Managing Vulnerability, 2005. Volume II, World Bank

The aggregate net resource flows from external creditors have gradually declined due to reduced flows of official as well as private flows[21]. This implies that in view of falling inflows from external sources a larger share of investment in the country is being financed through domestic sources and the reliance on external sources has been considerably reduced. As far as rising ratio of current account deficit to GDP is concerned this is largely due to higher trade deficits caused by higher growth of investment related imports (for details see ***Section on BOP in Chapter 7***).



[21] The official flows include debt flows from multilateral and bilateral creditors along with official grants, whereas private flows include FDI, portfolio equity flows, debt flows from commercial banks, bonds, and private creditors.

Table 6.2.4: Composition of Pakistan's External Debt & Liabilities

million US$

	Paris Club	Multilateral	Other bilateral	Others	Total external debt	Total external debts/liab.
Opening balance as on 30/06/2000	**12,428**	**12,234**	**639**	**6,895**	**32,196**	**37,860**
Inflows	205	1,240	19	1,389	2,853	3,904
Disbursement on new loans contracted since 1999	23	618	0	1364	2005	3056
Disbursement on pre 1999 loans	182	622	19	25	848	848
Repayment of Principal	-221	-572	-180	-1422	-2395	-3725
Debt relief	0	0	0	0	0	0
Other changes	278	0	13	-43	248	-119
Exchange rate fluctuation	-845	408	-40	-281	-758	-761
Closing stock as on 30/06/ 2001	**11,845**	**13,310**	**451**	**6,583**	**32,144**	**37,159**
Inflows	175	1240	7	1,494	2,916	3,034
Disbursement on new loans contracted since 1999	21	880	0	1,494	2,395	2,513
Disbursement on pre 1999 loans	154	360	7	0	521	521
Repayment of Principal	-71	-583	-100	-2,490	-3,244	-5,232
Debt relief	0	0	0	0	0	0
Other changes	205	0	58	285	548	535
Exchange rate fluctuation	375	364	0	297	1036	1036
Closing stock as on 30/06/2002	**12,529**	**14,331**	**416**	**6,124**	**33,400**	**36,532**
Inflows	165	920	120	1092	2297	2352
Disbursement on new loans contracted since 1999	38	680	111	1092	1921	1976
Disbursement on pre 1999 loans	127	240	9	0	376	376
Repayment of Principal	-110	-630	-71	-1511	-2322	-3387
Debt relief	-1000	0	0	0	-1000	-1000
Other changes	489	0	37	-554	-28	-28
Exchange rate fluctuation	544	329	0	132	1005	1005
Closing Stock as on 30/06/2003	**12,617**	**14,950**	**502**	**5,283**	**33,352**	**35,474**
Inflows	72	797	101	1,256	2,226	2,249
Disbursement on new loans contracted since 1999	9	628	87	1,256	1,980	2,003
Disbursement on pre 1999 loans	63	169	14	0	246	246
Repayment of Principal	-519	-1,802	-42	-1,725	-4,088	-4,281
Debt relief	0	0	0	0	0	0
Other changes	814	0	152	-182	784	783
Exchange rate fluctuation	581	404	0	49	1,034	1,034
Closing Stock as on 30/06/2004	**13,565**	**14,349**	**713**	**4,681**	**33,308**	**35,259**
Inflows	70	1,712	103	1,146	3,031	3,031
Disbursement on new loans contracted since 1999	1	1,550	94	1,146	2,791	2,791
Disbursement on pre 1999 loans	69	162	9	0	240	240
Repayment of Principal	-129	-700	-42	-1,023	-1,894	-2,048
Debt relief	-495	0	0	0	-495	-495
Other changes	0	0	0	37	37	37
Exchange rate fluctuation	7	-3	27	19	50	50
Closing Stock as on 31/06/2005	**13,018**	**15,358**	**801**	**4,860**	**34,037**	**35,834**