7 Domestic and External Debt

7.1 Overview

Despite a sharp improvement in current account balance in FY11, the rise in Pakistan's total debt and liabilities (TDL) of Rs 1.8 trillion during the year to Rs 12.1 trillion, is a reflection of deteriorating fiscal imbalances (**Figure 7.1**). Changes in the Rupee value of external debt due to revaluation changes and increased borrowing of loss making Public Sector Enterprises (PSEs) also contributed to the rise in the debt burden. These accumulating TDL impose large costs on the productive resources of the economy; debt servicing of TDL reached Rs 1.0 trillion in FY11, which was 5.8 percent of GDP.[1]

Figure 7.1: Macro Imbalances and Stock of Debt & Liabilities

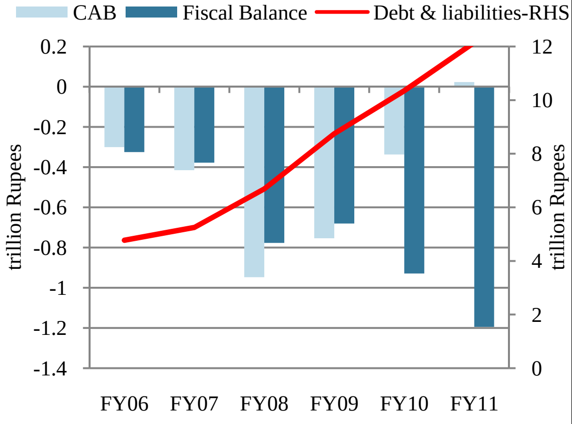
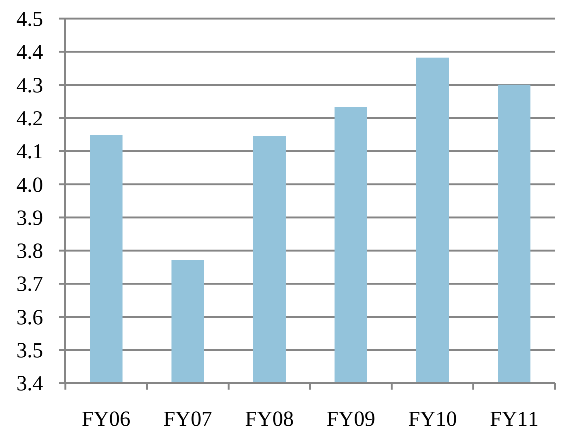


Figure 7.2: Public Debt to Revenue Ratio



Within TDL, public debt accounted for 90.5 percent as of end FY11, and its servicing eats up 43.7 percent of government revenues for the year. This limits the government's ability to use fiscal policy as a countercyclical tool. The composition of government expenditure reveals that expenditure on public sector development programs are less than the interest payments on public debt. This, along with the revenue deficit leaves little room for the government to use fiscal policy to support slowing economic growth at this critical juncture.

While there is no doubt that debt burden is limiting the fiscal space, absolute debt numbers seem manageable when seen in terms of nominal GDP; which is often used as a proxy for the repayment capacity of the country. An annual increase of 17.4 percent in the stock of

[1] It is important to note that schedule banks' debt servicing of external borrowing is excluded from this analysis. In fact, scheduled banks' external debt is included in Pakistan's external debt and liabilities (EDL) from Q1-FY10. While this inclusion has little impact on the outstanding amount of Pakistan's EDL (0.4 percent of EDL), it has strong implications for Pakistan's servicing of EDL. Scheduled banks' external borrowing is very short term in nature, and is primarily for managing their nostro accounts. Scheduled banks' repayment of principal on account of external borrowing stood at US$ 4.9 billion in FY11 (1.7 times of repayments of principal on EDL). In sharp contrast to this, scheduled banks interest payments on external debt were only 0.6 percent of overall interest payments on EDL. Against this backdrop, inclusion of scheduled banks' debt servicing on external borrowing will clearly distort the analysis of external debt servicing.

TDL was outpaced by 21.7 percent growth in nominal GDP for the year. As a result the TDL to GDP ratio fell by 2.5 percentage points to 67.2 percent during the year (**Table 7.2**). Within TDL, the public debt to GDP ratio stood at 60.9 percent, which is close to the 60 percent debt burden limit (to be achieved by FY13) under the Fiscal Responsibility and Debt Limitation Act (FRDL) 2005. In the context of looming sovereign debt crises at the international level, it is also a source of comfort to note that - at least on face value - Pakistan's debt to GDP ratio is nowhere close to heavily indebted European countries, especially Italy and Greece (**Table 7.1**). In fact, Pakistan's debt to GDP ratio is almost half of the European countries and around one-third of Japan's equivalent ratio.

Table 7.1: Central Government Debt as percent of GDP

	2006	2007	2008	2009
US	46	47	55	67
Japan	151	150	158	174
UK	47	48	58	73
France	68	67	73	84
Italy	110	105	108	119
Greece	127	123	125	140
Ireland	29	28	49	71
Portugal	70	68	72	84
Spain	34	30	34	46
India	59	56	56	53
Pakistan*	56	60	61	61

* SBP calculations

Source: World Development Indicators 2011

Table 7.2: Profile of Pakistan's Debt and Liabilities

	billion Rupees			*percent of GDP*		
	FY09	**FY10**	**FY11**	**FY09**	**FY10**	**FY11**
Total Debt & Liabilities	8,746.1	10,346.1	12,146.1	68.7	69.7	67.2
Govt./Public Debt[1]	7,835.3	9,232.2	10,995.5	61.6	62.2	60.9
Total Debt	8,306.4	9,710.7	11,524.5	65.3	65.5	63.8
Govt. Domestic Debt[2]	3,860.7	4,654.0	6,017.0	30.3	31.4	33.3
PSEs Domestic Debt	290.0	375.0	411.5	2.3	2.5	2.3
External Debt	4,155.7	4,681.6	5,096.0	32.7	31.6	28.2
Govt. External Debt	3,452.1	3,667.1	3,987.8	27.1	24.7	22.1
IMF loans	419.0	690.3	768.7	3.3	4.7	4.3
PSEs External Debt	87.0	106.5	91.1	0.7	0.7	0.5
Private Sector External Debt	197.6	217.8	248.4	1.6	1.5	1.4
Total Liabilities	439.9	510.5	485.5	3.5	3.4	2.7
Domestic liabilities	336.2	414.6	399.5	2.6	2.8	2.2
External Liabilities	103.7	220.8	220.0	0.8	1.5	1.2
Total Debt & Liabilities Servicing	969.6	1014.3	1,050.0	7.6	6.8	5.8
Interest Payment	687.5	714.4	805.8	5.4	4.8	4.5
Domestic Debt	570.6	577.7	649.9	4.5	3.9	3.6
External Debt[3]	89.4	82.3	89.6	0.7	0.6	0.5
Domestic Liabilities	25.8	52.1	65.0	0.2	0.4	0.4
External Liabilities	1.7	2.3	1.3	0.0	0.0	0.0
Repayment of Principal (Foreign)	282.1	299.9	244.2	2.2	2.0	1.4

1 Public debt include Govt. Domestic Debt, Govt. External Debt & IMF loans

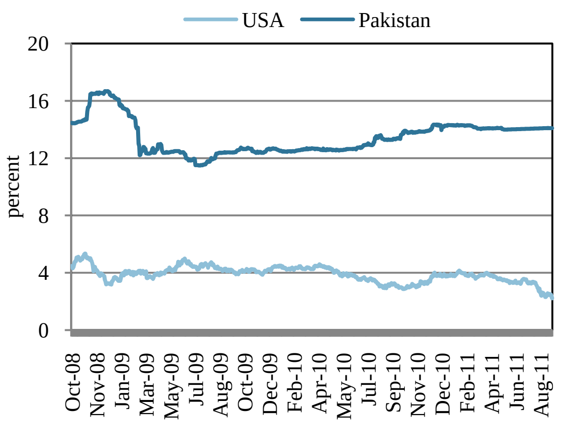
2. Domestic debt also includes Rupee value of FEBCs, FCBCs, DBCs and Special US Dollar Bonds holds by the residents

3. Interest payment and repayment of scheduled bank is excluded for the analysis.

Source: State Bank of Pakistan

However, further analysis suggests that there is little room for complacency. Firstly, the government was unable to contain its revenue deficit (gap between revenues and current expenditures) for yet another year. The FRDL act requires the government to maintain a revenue surplus from FY08 onwards. The persistence of a revenue deficit means that the government is not only borrowing for its development expenditures, but also for the financing of its current expenditures. Secondly, real GDP growth was only 2.4 percent in FY11. This implies that the strong growth in nominal GDP was driven primarily by inflationary pressures in the economy. Thirdly, the stock of public debt is a direct charge on government revenues. The rising burden of public debt on the exchequer is visible from the ratio of public debt to government revenues for recent years (**Figure 7.1**). This ratio is well above the level achieved in FY07, before the onset of the economic downturn.

Figure 7.3: 10-Year Sovereign Bond Yields



Source: Bloomberg

As for international comparison is concerned, Pakistan still have the opportunity to manage its debt burden without having significant implications for overall economic management. This is particularly true in case of external debt as various indicators of external debt sustainability improved in FY11. Compared to this, the debt ridden European countries mentioned earlier are left with little room to maneuver policy in managing their economies.[2] While the relative ease in managing debt is a source of comfort for Pakistan, there is need for caution, as: (a) more than 80 percent of debt crisis at international level came at a debt to GDP ratio of less than 60 percent; (b) debt crises around the globe are inextricably linked to a loss of confidence - already low in Pakistan's case; and (c) the composition of debt and debt management strategy of the government can seriously undermine the significance of debt sustainability indicators such as the debt to GDP ratio. Cross-country differences are already clear from Pakistan's sovereign rating. Pakistan is assigned a lower rating compared to other regional countries.[3] Low confidence of international investors in Pakistan's case is also evident from the large differential in 10-year sovereign bond yields of Pakistan and the USA (**Figure 7.3**). The spread between US and Pakistani bonds is essentially a reflection of high country risk for Pakistan.

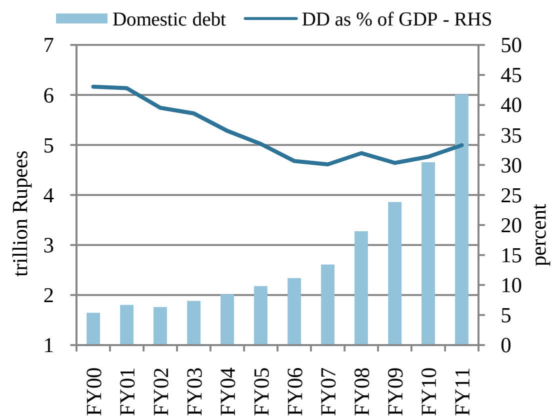
While the discussion on overall debt is instructive, the government requires different debt management policies to deal with domestic and external debt. The broad composition of Pakistan's TDL indicates that domestic debt and liabilities (DDL) reached Rs 6.8 trillion by end FY11, compared to Rs 5.4 trillion last year.[4] This sharp increase in DDL during the year is

[2] Heavily indebted European countries are in the process of debt crisis management. These countries are unable to resolve their issues without the help of their creditors. The IFIs and EU have linked their bailout packages to drastic fiscal consolidation. The short term pain of these measures which deal with debt crisis is now clear. . Compared to these countries, Pakistan has sometime to manage its debt problems. There is no immediate risk of default. However, failure to deal with underlying structural weakness (low tax revenues, fiscal slippages and weak governance) in this year will potentially expose the country to debt problems in the future.
[3] Pakistan's sovereign rating is 'B negative', which is lower than 'BBB negative' for India; 'BB negative' for Bangladesh; and 'B plus' for Sri Lanka.
[4] Domestic debt and liabilities comprise government domestic debt, borrowing of PSE and loans for commodity operations.

attributed to a deceleration in foreign exchange inflows for budgetary finance,[5] suspension of IMF's SBA program, and increased demand for funds to finance the widening fiscal deficit in absolute terms. This situation forced the government to rely on domestic resources for the financing of its fiscal and quasi-fiscal activities. As a result, the DDL to GDP ratio reached 37.8 percent of nominal GDP by end FY11. Further details of DDL suggest that the government's reliance on short term borrowing has increased significantly over the last three years; exposing it to rollover and re-pricing risks.

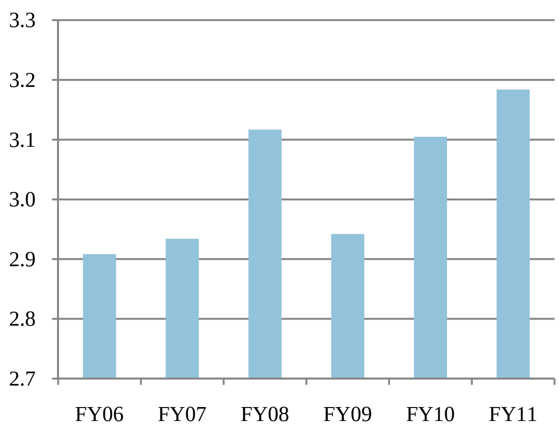
Compared to the sharp increase in DDL, external debt and liabilities (EDL) saw an expansion of Rs 415.6 billion (YoY increase of 8.5 percent) during the year to reach Rs 5.3 trillion. Among causal factors, the impact of exchange rate movements (especially depreciation of US$ against other major currencies) explains more than 90 percent of the change in EDL. Specifically, exchange losses on loans held by the Paris Club, multilateral creditors and the IMF were a significant factor. Further details reveal that Pakistan's EDL comprise mainly of long term debt from international financial institutions (IFIs), multilateral and bilateral. The share of short-term external debt (less-than-one-year maturity) was only 1.5 percent in total EDL. While this situation bodes well for the management of EDL from a market risk point of view, it leaves the country vulnerable to external creditors. Specifically, the role of IFIs in economic management of the country grows. The various conditionalities under the IMF's SBA program, and demands for a 'letter of comfort' by other IFIs and creditors are an indication of their role in the economic management of Pakistan.

Figure 7.4: Domestic Debt



Source: Bloomberg

Figure 7.5: Domestic Debt to Tax Revenue Ratio



7.2 Domestic Debt

A sharp reduction in external financing of the fiscal deficit in FY11 exerted significant pressure on domestic sources of funding. Data show that only 9 percent of fiscal deficit in FY11 was financed through external borrowing. In absolute terms, the government borrowed Rs 1.4 trillion from the domestic sources in FY11. As a result, the stock of domestic debt reached Rs 6.0 trillion (**Figure 7.4**), indicating YoY increase of 29.3 percent during the year. This expansion in government borrowing is not only a drag on private economic activities, but also has strong implications for the use of fiscal policy as a macroeconomic stabilization tool.

Firstly, the pace of increase in domestic debt is unsustainable, as the outstanding amount has witnessed an average annual growth of

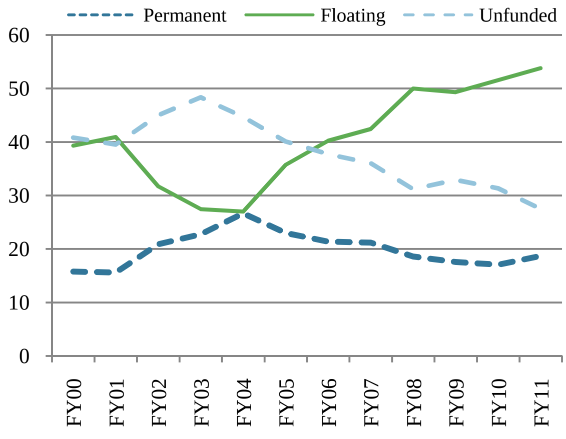
[5] The net external financing for FY11 budgetary gap stood at Rs 107.7 billion compared, which was only 9.0 percent of the deficit for the year.

23.3 percent during the last four years. This stock of debt has to be serviced primarily by government revenue receipts, which have been growing at an average rate of 17.6 percent over the same period. The rise in the domestic debt to tax revenue ratio demonstrates these concerns (**Figure 7.5**).

Secondly, large-scale government borrowing from domestic sources entails crowding out of private sector activities. Government borrowings from commercial banks increased by Rs 590.2 billion during FY11 compared to an increase in private sector credit of Rs 121.3 billion. While demand for credit by the private sector is understandably lower due to persistent energy shortages, security concerns and overall uncertainty in the economy; there is little doubt that government borrowing is distorting credit conditions for the private sector. In a sense, the government is a captive borrower for the banks. This leaves little incentive for the banks to deal with private sector, where risks are already high on account of prevailing economic downturn.[6] In these settings, banks have become excessively risk averse, while their nature of business is to deal with risks.

While it is important to analyze changes in overall domestic debt to evaluate the burden on government revenues; changes in the composition of debt further complicates debt management. **Figure 7.6** depicts that the government's reliance on short-term debt—known as floating debt—has significantly increased in recent years. Specifically, floating debt now accounts for 53.8 percent of total outstanding debt as of end FY11. This implies the government is heavily exposed to rollover and interest rate risks.

Figure 7.6: Major Components of Domestic Debt



Rollover risk: The composition of domestic debt indicates that the government has borrowed Rs 3.2 trillion through t-bills, which have a maximum maturity of one-year. Without getting into details, this implies the government will have to rollover its entire stock of floating debt at least once in FY12. Furthermore, the ownership structure of floating debt reveals that the SBP's t-bill holdings, stood at Rs 1.4 trillion, account for 40.8 percent of total floating debt, this complicates monetary management for the SBP.[7] The rollover of t-bills amounting to Rs 1.8 trillion held by scheduled banks could also pose challenges. The gross borrowing requirement for FY12 will increase further as the government will require funds to finance its budgetary gap for the year as well. Any squeeze in liquidity conditions such as those experienced in Sep-Oct 2008, or a slowdown in growth of bank's deposits (a prime source of funding for the banking system in Pakistan) will disrupt the smooth flow of funds towards the government sector; and could also pose risks to financial stability. Under normal circumstances, possible increase in private sector credit especially for working capital in FY12 could complicate liquidity management.

Interest rate Risk: In addition to rollover risk, the government's reliance on short-term borrowing exposes it to considerable interest rate or re-pricing risk. Specifically, the entire stock

[6] It is pertinent to mention here that continued government borrowing from the banking system will seriously undermine financial stability in the years to come. In particular, the facility to earn double-digit returns from risk free avenue would seriously impair the risk-management ability of the banking system.
[7] See Chapter on Inflation and Monetary Policy for details.

of t-bills must be re-priced at least once in a year. While a reduction in interest rates will reduce interest payments for the government; the reverse is the case when interest rates rise (more on this issue later). Simple arithmetic shows that the government's interest payments on floating debt (as of end June 2011) will change by approximately Rs 30 billion in response to a100 bps change in interest rate over a period of two years.

7.2.1 Medium to Long-Term Domestic debt

A notable development during FY11 was the rise of Rs 330.2 billion in the stock of permanent debt, against an increase of Rs 116.2 billion in FY10 (**Table 7.3**). Details show that around 89.5 percent of this increase came from medium to long term marketable government securities (Ijara Sukuk & PIBs). This is a welcome development, and will not only help in increasing the average maturity of domestic debt, but also help in the development of a domestic bond market.

Another significant change in permanent debt is related to the increase of Rs 41.1 billion in the stock of prize bonds during the year to Rs 277.1 billion. An important feature of prize bonds is the implicit 'put option' attached to this financial instrument. Therefore, investors have the right to redeem this instrument at their will. While proceeds from prize bond make a significant contribution towards financing of deficit, their use complicates, both, government debt management, and liquidity management by the SBP.

7.2.2 Unfunded Debt

This component of domestic debt largely comprises financial instruments known as National Savings Schemes (NSS). The government was able to mobilize Rs 193.9 billion through NSS (excluding Prize bonds), which accounts for 14.2 percent of the increase in domestic debt during the year. An upward revision in profit rates from 120 to 160 bps on major savings schemes in FY11, along with lower returns on bank deposits, attracted investors to place their funds in these schemes. As a result, the stock of unfunded debt reached Rs 1,655.8 billion by end FY11, which was 27.5 percent of outstanding domestic debt (**Table 7.3**).

A disaggregated analysis of fund mobilization shows that the three major schemes (Special Savings Certificates, Regular Income Certificates, Bahbood Savings Certificates) account for 78.1 percent of investments in NSS during FY11; compared to a 60.1 percent share of these schemes in outstanding amount. In particular, the Bahbood Savings Certificate (BSC) is the most attractive scheme; it yields tax and Zakat free monthly returns to widows and senior citizens. Currently, a BSC of Rs 100,000/- offers a monthly return of Rs 1,200 (14.48 percent per annum).

While good profit and the risk-free nature of NSS help the government in financing its budgetary requirements, the use of these instruments entails negative implications for the economy as a whole. Firstly, NSS is a costly source of funding for the government. Profit rates on major NSS are generally higher than on market-based government debt securities of similar tenor. Secondly, NSS is not a stable source of funding for the government; early encashment facility on NSS further complicates debt management for the government. Finally, reliance on NSS undermines the development of a domestic bond market by providing high risk-free returns to investors.

Being cognizant of these issues, the government has implemented various institutional reforms in the previous decade. The most important was to link the returns on major NSS instruments with the interest rate paid on market based debt instruments of the same tenor. However, this link has weakened with the passage of time as, mobilization through BSC and Pensioner's Benefit Accounts has increased. These two schemes jointly account for 34.8 percent of unfunded debt and have no link to market based debt instruments. It is important to note that institutions are not allowed to invest in these two schemes. On these lines, one of the possible ways to restructure the NSS is to ring fence all of its instruments from the regular financial markets by restricting institutional investments. Specifically, participation in all schemes should be restricted to widows, senior citizens, and disabled persons.

Table 7.3: Position of Domestic Debt
billion Rupees

Debt Instrument	Outstanding Stock			Interest Payments		
	FY09	**FY10**	**FY11**	**FY09**	**FY10**	**FY11**
A. Permanent Debt	678.0	794.3	1,124.4	57.0	74.3	91.8
Of which						
GOP Ijara Sukuk 3yrs	27.8	42.2	224.6	0.9	4.4	11.2
Pakistan Investment Bonds (PIBs)	441.0	505.3	618.5	41.3	50.3	57.3
Prize Bonds	197.4	236.0	277.1	14.0	18.8	22.8
B. Floating Debt	1,904.0	2,399.1	3,235.4	227.2	241.1	361.4
Of which						
Market Treasury Bills	796.1	1,227.4	1,817.6	71.8	101.1	191.9
Market Related Treasury Bills	1,107.9	1,124.9	1,317.5	155.4	140.0	169.5
C. Unfunded Debt	1,270.5	1,457.5	1,655.8	286.0	262.1	194.7
Of which						
Defense Saving Certificates	257.2	224.7	234.3	207.1	146.9	55.0
S. Savings Certificates - Registered	288.8	350.6	394.7	16.7	20.7	24.3
Regular Income Certificates	91.1	135.6	182.6	6.8	14.3	19.3
Behbood Savings Certificates	307.5	366.8	428.5	33.8	52.8	61.0
Pensioners' Benefit Account	109.9	128.0	146.0	12.8	18.9	21.4
D. Foreign Currency Instruments *	8.1	3.1	1.4	0.4	0.2	0.1
Total Domestic Debt (A+B+C+D)	3,860.8	4,654.0	6,017.0	570.6	577.7	648.0

* These include FEBCs, FCBCs, DBCs and Special US Dollar Bonds held by the residents.

Source: State Bank of Pakistan

7.2.3 Interest Payments on Domestic Debt

Interest payments on domestic debt rose to Rs 649.9 billion in FY11 compared to Rs 577.7 billion in the previous year. This increase was largely due to the sharp increase in short term government borrowing during FY11 discussed earlier, and a re-pricing of the accumulated stock of floating debt as of end FY10. The entire of stock of Rs 2.4 trillion at the beginning of the year was rolled over during FY11 on higher interest rates, as the SBP policy rate rose by150 bps during H1-FY11. Specifically, the interest on floating debt jumped to Rs 361.4 billion; this represents YoY growth of 49.9 percent (**Table 7.3**).

Interest payments on permanent debt also grew by 23.6 percent in FY11, on account of both volume and price effects. As mentioned earlier, the governments' permanent debt increased following the various auctions of marketable government securities (PIBs/Sukuk). Prevailing high interest rates also contributed to increase in interest payments.

Despite the increase in the stock of unfunded debt, interest payments on NSS (net of prize bonds) declined for the second year in a row. This seems surprising, at least on face value, as the profit rates on key NSS were revised upward in FY11. Details suggest that this is explained by the nature of NSS. In particular, the maturity of costly bullet bonds (namely Defense Savings Certificates issued in second half of the 1990s) kept the debt servicing on overall unfunded debt high in recent years. Furthermore, funds mobilized by DSCs in FY10 & FY11 entail no immediate interest payment due to the bullet nature of these certificates. Cash based accounting system and profit disbursement pattern (annual or six monthly) on other savings schemes also play an important role in shifting interest payments from one year to another year.

7.3 External Debt and Liabilities

Pakistan's total external debt and liabilities (EDL) witnessed a rise of US$4.5 billion during the year to reach US$ 61.8 billion by end FY11.[8] Factors contributing to this increase in FY11 were the cross-currency movement of exchange rates and government loans to deal with devastating floods at the beginning of the year. The external debt adjusted for revaluation losses shows an increase of just US$ 1.1 billion (YoY increase of 2.0 percent) in FY11. This implies that foreign currency loans in FY11 were used largely for repayments of maturing external loans. Specifically, the ratio of principal repayments of the government loans for budgetary support to disbursements stood at 72.3 percent for FY11. It is worth noting that the higher principal repayments to disbursement ratio was primarily due to low disbursements; as principal repayments for FY11 were also lower compared to the previous two years. Among other factors, a suspension of the IMF's SBA played a key role in lower disbursement for FY11.

7.3.1 Sustainability of External Debt and Liabilities

Regardless of the underlying factors, changes in EDL have important implications for the sustainability of external debt. A moderate rise in EDL, along with a marked improvement in external accounts in FY11 exerted a favorable impact on key indicators of external debt sustainability (**Table 7.4**).

Table 7.4: Indicators of External Debt Sustainability

	FY08	FY09	FY10	FY11
TED/GDP	26.9	30.7	29.8	27.5
EDL/GDP	27.7	31.5	31.2	28.7
IP/FEE	3.4	3.3	2.7	2.2
EDS/FEE	8.7	13.4	12.0	8.2
IP/XE	6.1	6.1	5.2	4.2
EDS/XE	15.6	24.8	23.3	15.5
STD/TED	4.3	3.6	3.5	2.6
STD/RES	16.5	14.4	11.2	8.2
(STD+CAB)/RES	136.5	86.6	31.9	6.8
WoM	17.0	21.0	28.2	27.9

TED: Total External Debt; EDL: External Debt and Liabilities; IP: Interest Payments; EDS- External Debt Servicing; IP- Interest Payments; STD; Short Term Debt; CAB- Current Account Balance; WoM- Weeks of Imports; FEE- Foreign Exchange Earnings; XE- Exports Earnings; RES- Foreign Exchange Reserves.

Source: Analyst Estimates

- An ease in the overall debt burden is visible from the 2.5 percentage point decline in the EDL-to-GDP ratio to 28.7 percent: a level observed before the onset of the current economic downturn.
- Improvement in the debt bearing capacity of the economy is also evident from indicators like foreign exchange earnings (FEE). Both, interest payment to FEE, and external debt servicing to FEE ratios improved in FY11. All time high workers' remittances and strong growth in export proceeds were catalyst to over 20 percent YoY growth in FEE.
- External debt sustainability indicators in terms of foreign exchange reserves also improved in FY11. Specifically, short-term debt, interest payments and debt servicing to reserve ratios improved in FY11. Given the suspension of the IMF program (an important source of a strengthening of the reserve position); an improvement in the reserve ratios is a welcome development. Data on reserves show that SBP reserve saw an expansion of US$ 2.5 billion during the year due to: (1) a marked improvement in

[8] It may be noted that changes in EDL in PKR and US$ terms paint a slightly different picture. Specifically, the PKR value of EDL indicates deceleration in growth from 15.1 percent in FY10 to 8.5 percent in FY11. On the other hand, US$ value of EDL shows a deceleration in growth from 9.6 percent in FY10 to 7.8 percent in FY11. These difference in growth rates are the upshot of movement in PKR against US$. Exchange rate movements reveal that PKR depreciated around 5 percent against US$ in FY10 compared to less than 1 percent in FY11.

current account balance; and (2) SBP FX purchases in a bid to contain excessive volatility in the FX market.

Changes in underlying structure of EDL also point to an improvement in debt sustainability and ease in external debt management. First, Pakistan's EDL are of medium to long-term maturity. The share of short-term EDL in the total further declined in FY11 (**Table 7.4**). Second, Pakistan's EDL are dominated by long term loans from IFIs, multilateral and Paris Club. On the other hand, the share of sovereign bonds (market-based external debt) in public debt was only 2.7 percent as of end FY11. These characteristics of EDL along with improvements in various debt indicators reflect the sustainability of the EDL at least in the short run. However, there is a need to diversify the source of external borrowings, as the heavy reliance on few multilateral and bilateral donors provides leverage to creditors for intervening in economic management of the recipient countries.

Disbursements in FY11

While the government's funding requirements increased substantially due to the devastating floods in Q1-FY11, disbursements of foreign assistance (including both foreign grants and foreign loans) declined when compared to the previous year. Specifically, disbursements of foreign assistance for FY11 stood at US$ 2.5 billion against disbursements of US$ 3.7 billion in FY10 (**Table 7.5**).

Table 7.5: Disbursement of Foreign Assistance
million US dollars

	Grants	Loans	Total
FY09			
Commitments	594.4	5,394.3	5,988.7
Disbursement	570.1	4,092.2	4,662.3
FY10			
Commitments	1,606.4	5,137.0	6,743.5
Disbursement	648.0	3,015.0	3,663.0
FY11			
Commitments	1,841.6	2,738.2	4,579.8
Disbursement	625.9	1,922.1	2,548.0

Source: State Bank of Pakistan

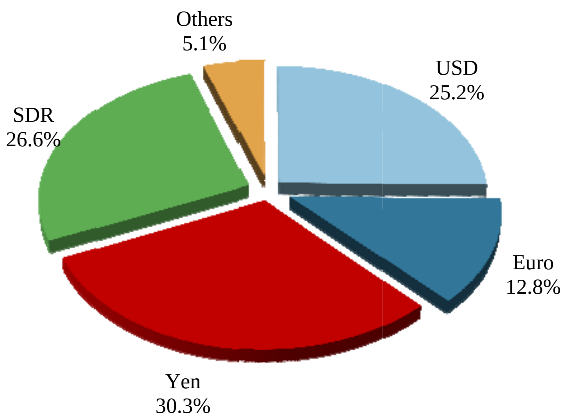
Within foreign assistance, disbursements of grants in FY11 were only 34 percent of commitments, while loan disbursements stood at 70.2 percent of commitments. A donor-wise composition of grants shows that bilateral grants were 87.8 percent of total grants in FY11: a reflection on bilateral relations. In particular, bilateral grants were largely provided by the USA and UK, which together accounted for 78 percent of total grants disbursements.

In sharp contrast to grants, loan disbursements from multilateral sources were 71.5 percent of total loan disbursements in FY11. Donor-wise data show that loans by Asian Development Bank (ADB), International Development Association (IDA) and Islamic Development Bank (IDB) for project financing, floods related activities and balance of payment, accounted for 68.1 percent of loan disbursements in FY11.

Exchange rate movement and changes in EDL

The importance of currency composition of external debt has significantly increased in recent years; as foreign currency markets remained volatile following the financial crisis of 2008. The currency composition reveals that 94.9 percent of Pakistan's EDL are denominated in four major currencies i.e. US$, Yen, Euros and SDRs (**Figure 7.7**). Exchange rate movements (appreciation/depreciation) of the US$ against other major currencies (Yen, Euro & SDR) have a significant effect on the stock of EDL, as it is used as a base currency. An impact analysis of exchange rate movements indicates that 97 percent of increase in public debt during FY11 was due to *transactional losses*.[9,10] In absolute terms, *transactional losses* for FY11 stood at US$ 3.3 billion (**Table 7.6**). The depreciation of US$ against Japanese Yen alone inflated public debt by US$ 3.1 billion.

Figure 7.7: Currency Composition of Public Debt



Non-guaranteed external debt (NGE debt)

Despite low international interest rates and stable exchange rate, the private sector external borrowing for investment activities remained subdued. The YoY growth in NGE debt continued to decelerate as the outstanding stock of NGE debt grew marginally by 2.3 percent in FY11 to US$ 3.7 billion.[11] This was considerably lower than the YoY increase of 8.7 percent in the previous year. Moreover, almost half the growth in FY11 came from increased short-term borrowing of scheduled banks to manage their nostro accounts. It appears that lackluster domestic economic activities, heightened security concerns, persistent energy shortages and excess capacity in the manufacturing sector has kept the corporate sector away from undertaking new investments in recent years.

Table 7.6: Impact of Exchange Rate Variation on EDL
million US dollars

	Japanese	Euro	SDRs	Overall
FY08	1,327	873	676	3,113
FY09	1,347	-625	-505	36
FY10	985	-776	-542	-303
FY11	1,314	896	938	3349

Source: Analyst Estimates

IMF loans

The outstanding stock of IMF loans increased by US$ 0.8 billion in FY11 to reach US$ 8.9 billion (**Table 7.7**). This increase in IMF loans during FY11 was substantially lower than the US$ 2.9 billion rise in the previous year. This reduction in inflows was primarily the result of a suspension of IMF SBA due to delays in implementing fiscal reforms. Moreover, IMF loan disbursements during FY11 were essentially for meeting emergency requirements of the government in the wake of devastating floods in first quarter of the year. The final tranche of the SBA loan is still pending with the IMF and unlikely to be disbursed.

[9] This also explains the government's heavy reliance on domestic resources for financing its deficit in FY11.
[10] A change in the external debt stock on account of converting EDL denominated in different currencies to a base currency (US$ in case of Pakistan) is known as Transactional changes (gains/losses).
[11] It may be noted that foreign private loans generally constitutes a small fraction of Pakistan's EDL. In recent past, the mobile network companies borrowed from abroad to benefit from low interest rates at internationally.

Although IMF loans constitute only 14.9 percent of Pakistan's EDL as of end FY11, the real value of the IMF program for Pakistan is that a number of other multilateral and IFI program loans are implicitly linked to the IMF's endorsement as discussed earlier. This was the major reason for low debt & non-debt creating inflows during FY11.

Table 7.7: Pakistan's External Debt and Liabilities
billion US dollars

	FY06	FY07	FY08	FY09	FY10	FY11
1) Public debt (a+b+c)	35.3	37.8	43.1	48.8	53.6	57.9
a) Government Debt	33.0	35.6	40.4	42.4	42.9	46.4
i). Medium and long term (>1 year)	32.8	35.6	39.7	41.8	42.1	45.8
of which						
Paris club	12.8	12.7	13.9	14.0	14.0	15.5
Multilateral	16.6	18.5	21.4	23.0	23.7	25.8
Other bilateral	0.7	0.9	1.1	1.4	1.8	1.9
Euro/Sukuk global bonds	1.9	2.7	2.7	2.2	1.6	1.6
ii). Short term (<1 year)	0.2	0.0	0.7	0.7	0.8	0.6
b. From IMF	1.5	1.4	1.3	5.1	8.1	8.9
c. Foreign exchange liabilities	0.8	0.8	1.3	1.3	2.6	2.6
2. PSE guaranteed debt	0.3	0.2	0.2	0.2	0.2	0.1
3. PSE non-guaranteed debt[1]	0.6	1.0	1.0	0.9	1.1	1.0
4.Scheduled banks' borrowing[2]	-	-	-	-	0.2	0.4
5. Private non-guaranteed debt (M & LT > 1year)	1.0	1.0	1.6	2.3	2.2	2.4
6. Private non-guaranteed bonds[3]	-	0.3	0.3	0.1	0.1	0.1
Total external debt (1+2+3+4+5+6)	37.2	40.3	46.2	52.3	57.4	61.8

[1] Data revised from July09 due to enhanced coverage of PSEs

[2] Scheduled banks' borrowing captured from July-Sep 09.

[3] Local currency bonds of public sector and private non-guaranteed bonds have been captured from third and fourth quarter of FY07 respectively.

Source: State Bank of Pakistan

Foreign exchange liabilities

Outstanding amount of foreign exchange liabilities (excluding allocation of SDR) continued to decline for the 4th year in a row. The stock of FX liabilities (net of SDRs) was US$ 1.0 billion by end FY11, with a share of only 1.7 percent in overall EDL. Currently, FX liabilities only comprise deposits of various central banks and allocation of SDRs.

7.3.2 External Debt Servicing

Despite modest increase in Pakistan's external debt & liabilities (EDL) in FY11, debt servicing on EDL declined for the second year in a row. Specifically, debt servicing fell by US$ 0.7 billion during the year to US$ 3.9 billion.[12] A bifurcation of this aggregate number into repayment of principal and interest on EDL reveals that the entire reduction was attributed to a decline in repayment of principal, while the latter saw a rise of US$ 55.2 million (YoY growth of 5 percent) during the year (**Table 7.8**).

[12] Please see foot note 2.

Table 7.8: External Debt Servicing
million US dollars

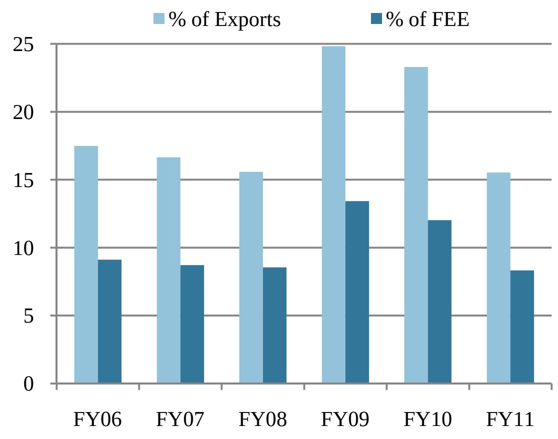
	FY06	FY07	FY08	FY09	FY10	FY11
I. Public Debt (a+b+c)	**2,368.4**	**2,223.3**	**2,445.1**	**3,881.7**	**3,671.8**	**3,153.0**
Principal	1,569.4	1,312.8	1,440.7	2,913.9	2,795.0	2,206.8
Interest	799.0	910.5	1,004.4	967.9	876.9	946.2
a. Govt. Debt	2,149.4	2,025.3	2,196.1	3,573.7	3,134.0	2,574.4
Principal	1,404.4	1,170.8	1,245.7	2,681.9	2,403.3	1,816.6
Interest	745.0	854.5	950.4	891.9	730.7	757.8
b. IMF loans	159.0	143.0	191.0	264.0	359.4	441.8
Principal	143.0	120.0	173.0	210.0	239.8	268.2
Interest	16.0	23.0	18.0	54.0	119.6	173.6
c. FX Liabilities	60.0	55.0	58.0	44.0	178.4	136.9
Principal	22.0	22.0	22.0	22.0	151.9	122.0
Interest	38.0	33.0	36.0	22.0	26.5	14.9
II. PSEs Debt	**174.5**	**270.1**	**252.7**	**236.9**	**454.0**	**448.3**
Principal	144.0	200.7	171.0	176.8	392.5	401.3
Interest	30.6	69.3	81.7	60.1	61.4	47.1
III. Private Sector Debt	**351.6**	**382.7**	**484.8**	**628.6**	**457.0**	**316.1**
Principal	275	271.6	323	497.8	388.17	247.0
Interest	76.6	111.1	161.8	130.8	68.1	69.1
External Debt (I+II+III)	**2,894.6**	**2,876.0**	**3,182.6**	**4,747.2**	**4,582.8**	**3,917.4**
Principal	1,988.4	1,785.1	1,934.7	3,588.4	3,575.7	2,855.1
Interest	906.1	1,090.9	1,247.8	1,158.8	1,007.1	1,062.3

Source: State Bank of Pakistan

Distribution of repayments by borrowers indicates that the government repaid US$ 1.8 billion of its external loans in FY11 to multilateral, bilateral, Paris club and the IDB. These accounted for over 92.7 percent of government debt repayments during the year. Compared to the previous year, a major difference was the absence of any repayment on account of marketable sovereign Pakistani bonds (Euro/Sukuk bounds) and commercial banks. This was the major reason for a decrease in repayment of principal in FY11.

Another important point to note is the impact of rescheduling or rollover of external debt on the debt servicing. In FY11, central banks of friendly countries rolled over their deposits worth US$ 1.1 billion. The IDB also rolled over a maturing loan of 0.6 billion. This re-profiling eased the country's debt servicing burden by US$ 1.7 billion. In the absence of this rescheduling or rollover the debt servicing on external debt would have been US$ 5.6 billion, against actual payments of US$ 3.9 billion.

Figure 7.8: External Debt Servicing



Following the decline in debt servicing, key indicators of the debt servicing burden on Pakistan's economy improved in FY11. Specifically, overall debt servicing as a percentage of exports, and foreign exchange earnings, declined to levels last seen in FY06 and FY07 (**Figure 7.8**). While this is a notable development for FY11, the continuation of this impressive improvement in FY12 faces significant risks. First, there is likely to be an increase in overall debt servicing for FY12 due to repayment of IMF

SBA loans starting from second half of the year (**Table 7.9**). Secondly, growth in FEE is expected to decelerate in FY12 to more sustainable level compared to the YoY increase of 25.1 percent seen in FY11.

Table 7.9: Repayments of IMF Loans
million US dollars

	Principal	Interest	Total
FY12	1,203.0	188.5	1,391.5
FY13	2,955.6	138.8	3,094.3
FY14	3,383.7	55.9	3,439.5
FY15	1,338.9	15.8	1,354.7
FY16	59.4	1.0	60.4

Note: The projected payments are based on Stock of June 2011.
The June end conversion rate for SDR into US$ is used.

Source: State Bank of Pakistan

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