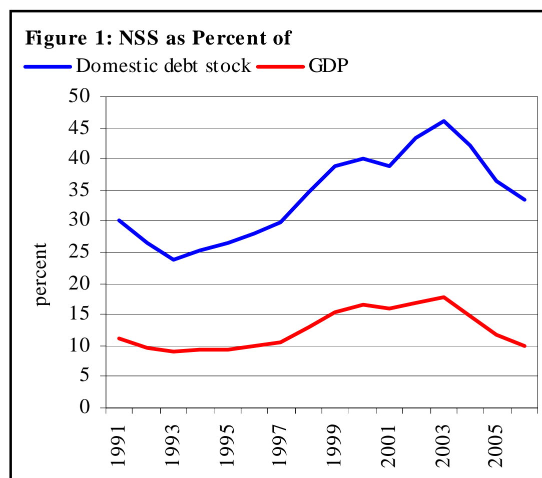
Special Section 1: National Saving Schemes in Pakistan



Following the offer of exceptionally high (and above-market returns), the National Saving Schemes attracted significant investment throughout the 1990s. This led to a number of problems, such as: (1) a sharp rise in the government cost of financing its deficit; (2) as the instruments were available 'on tap', the flows were not predictable and made the government funding cost volatile;[1] (3) the inherent volatility in these flows, and consequent uncertainty over the government funding requirement from the banking system added difficulty in formulating stable monetary policies; (4) the administered nature of NSS profit rates was a major source of distortion in the term structure of interest rates;[2] (5) as these instruments were not traded (i.e., price discovery was not possible), these did not form benchmarks for corporate debt; and finally (6) the implicit put option (the bonds could be substituted at any time) meant that corporate issues would have to be priced at much higher yields to compete with NSS instruments. In effect, this ensured that the domestic debt market would remain moribund.

In the light of these issues, the government finally initiated NSS reforms in 2000 and onwards: (1) in March 2000, government barred all types of institutional investment in NSS; (2) in the same year, government issued the long-term debt instrument, i.e., Pakistan Investment Bonds (PIBs);[3, 4] and finally, (3) the government linked the NSS rates with the rates on PIBs.

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[1] This could theoretically even lead to a situation where a sharp increase in relatively expensive NSS finance could compel government to retire its relatively cheaper bank credit.

[2] The differential between the returns on bank deposits and the NSS, in addition to tax free status of NSS profit and 'implicit put option', had led to massive dis-intermediation in the economy and weakening of SBP's role as a monetary authority.

[3] In December 2000 government issued the 3-, 5- and 10-year Pakistan Investment Bonds (PIBs) and effectively extended the yield curve to 20-years in January 2004.

[4] It was also likely that resources mobilized through PIBs would be used to mitigate the impact of expected large maturities of NSS instruments in the absence of institutional investment. In fact, the

While the NSS rates were related to the PIB rates, the linkage was weak due to considerable lags in the adjustment of rates of return.[5] In a falling interest rate scenario, rate of return on NSS instruments becomes relatively attractive,[6] but becomes less so when rates are expected to rise.

Thus, as a result of the combined impact of the ban on institutional investment, fall in returns on NSS and checks on arbitrage opportunities, the growth in NSS investments fell and eventually became negative in FY05. Thus, the need to fund NSS outflows put further pressures on the budget financing.

In the meanwhile, the long-term issues by the government were few and of limited size (except for Jumbo issues of FY05). It appears that the government was reluctant to increase long-term interest rates inline with market expectations (probably to reduce the cost of its borrowing). In fact, the lack of government's enthusiasm to borrow through PIBs was evident even when the short-term interest (in T-bills auctions) stabilized and market interest in the long-term paper re-emerged in FY06.[7] It seems that the government's apparent objective of reducing interest cost (even at the cost of increased interest rate risk) triumphed over the need to develop long term debt market (and attendant gains by encouraging a vibrant institutions investors market and derivative market).[8]

Thus, the unwillingness on the part of the government to issue long-term PIBs led to a situation where the government was unable to generate sufficient resources to meet upcoming large NSS maturities. Furthermore, since PIBs provided a much needed funds to the government for the financing of its budgetary gap (particularly in the face of net outflows under NSS), the limited supply of PIB issues unnecessarily increased the government's reliance on the short-term bank borrowings, particularly from the central bank. Indeed, the rise in government borrowing from the central bank in FY06 essentially mirrors the net maturities of long term FIBs/PIBs.

PIBs, particularly 10-year bonds were successful as the major demand came from maturities of (10-year maturity) Defense Saving Certificates issued by NSS.

[5] NSS rates are reviewed on half yearly basis; once in January and then in July every year.

[6] It was one of the reasons that despite restriction on institutional investment in NSS, inflows remained strong in this scheme during FY02 and FY03 reflecting mainly the arbitrage opportunities that emerged as an outcome of wide interest rate differential between NSS rates and banks' lending rates on loans secured against NSS instruments.

[7] Only one auction with a target of Rs 10 billion was conducted during the year.

[8] This is also evident from the pace of reforms (aimed at strengthening institutions such as Employees Old Age Benefit Institutions (EOBI), Provident funds, insurance companies) which remained very gradual.

Indeed even the limited reforms of the late 1990s and early 2000 in NSS have not been sustained. Instead, the government chose to increase the non-bank borrowing by removing the restriction on institutional investment in NSS.

Nonetheless, this decision is a major policy reversal and has significant implications for the banking industry and domestic debt market. It is likely that, over time, institutional investors would prefer the NSS instruments over terms deposits with banks as NSS instruments are risk free, and have implicit put option, i.e., institutions can avoid revaluation losses under rising interest rate as these instrument can be easily liquidated and reinvested at higher yields. Thus, institutional investment in NSS will shift medium term funds away from the banking sector, which in turn may exert an upward pressure on market interest rates. Further, this also has implications for the volatility in government funding cost and expectations for interest rate changes.

This decision also has significant implications for the development of long-term debt market. As mentioned earlier, facilitating growth of long-term debt market was one of the key motives for putting ban on institutional investment in NSS as this was likely to shift institution's demand for long-term debt instruments[9] towards private corporate sector bonds [10] and long-term financing products by banks. Thus, the removal of ban on institutional investment in NSS, not only restricts the development of long term products by banks but also adversely impacts the corporate debt market.[11]

Ostensibly, one of the motives for this decision was to reduce the government reliance on borrowing from the central bank. It can however be argued that the dependence on SBP borrowings would have been reduced even by frequent issues of tradable instruments (such as PIBs) which would have also acted as a benchmark for corporate debt.

In conclusion, the decision to re-allow institutional investment in NSS is a setback to financial sector reforms. Further, there is a risk that this decision will not add substantially to an immediate increase in NSS net receipts even as it hurts the prospects of developing the domestic debt market.

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[9] The government had already stopped issuing the long-term Federal Investment Bonds in June 1998

[10] NSS instruments had been offering zero risk yields that were much higher than corporate borrowing rates. On the other hand, issuance of corporate bonds involved relatively high issuance and taxation costs.

[11] Efforts to develop long-term debt market get set back due to limited issues of long-term PIB instruments during FY05 and FY06 that rendered benchmark rate for longer-end of the yield curve non-representative.