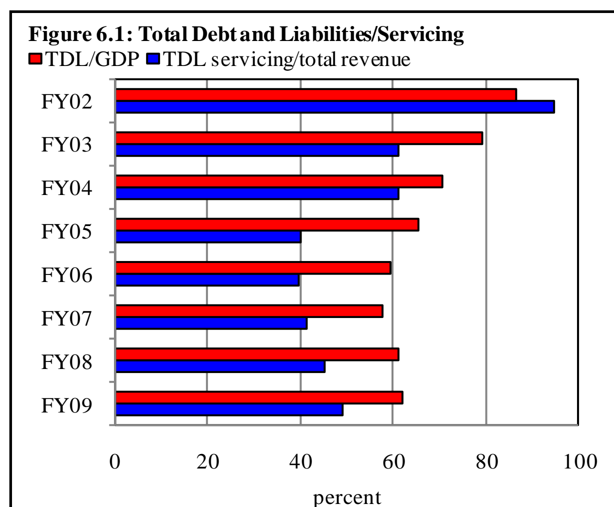
6 Domestic and External Debt

6.1 Overview

Pakistan's total debt and liabilities stock (TDL) recorded a substantial 27.0 percent increase in FY09, only slightly lower than the 27.4 percent growth in FY08. The continued strong growth in the stock of TDL in FY09, despite a relatively smaller fiscal deficit, reflects the fact that imbalances in the overall fiscal account as well as the country's current account are still large. It also incorporates the lower availability of non-debt creating flows, the impact of the build-up reserves flowing, increased inflows of multilateral assistances as well as increase in the rupee value of external debt due to adverse exchange rate movements. Consequently, overall debt sustainability indicators of the country remained under pressure for the second successive year in FY09 (see **Figure 6.1** & **Table 6.1**). In particular, while the ratio of total debt to GDP witnessed slight improvement during FY09, it is still significantly higher than the low of 57.2 percent of GDP recorded in FY07. Also, the ratio of debt servicing to total revenues, which reflects the government's capacity to service the country's debt, rose to 49.1 percent in FY09 from 45.3 percent in FY08.

Figure 6.1: Total Debt and Liabilities/Servicing



It is worth mentioning here that the Fiscal Responsibility and Debt Limitation Act (FRDL) 2005 envisages a debt to GDP ratio at 60.0 percent by FY13. The country's debt path witnessed a declining trend since FY01 with TDL to GDP ratio falling below 60.0 percent in FY06, well before the target year of FY13. The substantial widening of the twin deficits in FY08 and the continued imbalances during FY09 has reversed the declining trend, with the TDL to GDP ratio remaining over the 60.0 percent threshold since FY08. Also, the FRDL target of 2.5 percentage point reduction in the stock of TDL, as percent of GDP, in every financial year was not met for the second consecutive year. The deterioration in debt indicators necessitates an urgent revisit to the debt management policy for an early return to sustainable debt path.

While the increase in TDL stock in FY08 and the commensurate deterioration in the ratio of debt to GDP was contributed almost equally by domestic and external debt, the persistently high debt to GDP ratio during FY09 was essentially contributed by external debt. In fact, deceleration in the growth of domestic debt coupled with a larger growth in nominal GDP meant that the ratio of domestic debt to GDP fell to 29.4 percent during FY09 from 31.8 percent in the preceding year (see **Figure 6.2**). An anatomy of the deceleration in the growth of domestic debt shows a the sharp decline in the growth of MRTBs to 0.6 percent in FY09 from 143.6 percent a year

Figure 6.2: Trends in Debt (percent)

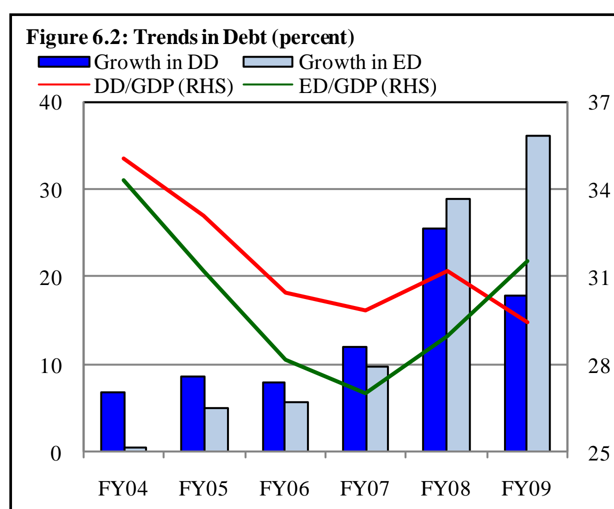


Table 6.1: Profile of Total Debt and Liabilities
billion Rupees

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Total debt & liabilities (TDL)	**3,856.1**	**3,863.8**	**3,998.4**	**4,263.7**	**4,549.2**	**5,036.5**	**6,418.1**	**8,151.4**
Growth rate	-4.2	0.2	3.5	6.6	6.7	10.7	27.4	27.0
Total debt (TD)	**3,723.5**	**3,781.4**	**3,917.0**	**4,181.6**	**4,468.6**	**4,956.9**	**6,302.3**	**7,982.6**
Growth rate	-1.8	1.6	3.6	6.8	6.9	10.9	27.1	26.7
Domestic debt	**1,717.9**	**1,853.7**	**1,979.5**	**2,149.9**	**2,321.7**	**2,600.6**	**3,266.1**	**3,852.6**
Growth rate	-0.8	7.9	6.8	8.6	8.0	12.0	25.6	18.0
Share in TD	46.1	49.0	50.5	51.4	52.0	52.5	51.8	48.3
External debt	**2,005.6**	**1,927.7**	**1,937.5**	**2,031.7**	**2,146.9**	**2,356.3**	**3,036.2**	**4,131.3**
Growth rate	-2.7	-3.9	0.5	4.9	5.7	9.8	28.9	36.1
Share in TD	53.9	51.0	49.5	48.6	48.0	47.5	48.2	51.8
Explicit liabilities *	**132.6**	**82.4**	**81.4**	**82.1**	**80.6**	**79.6**	**115.8**	**168.8**
Growth rate	-43.2	-37.8	-1.3	0.9	-1.8	-1.3	45.5	45.8
Total debt servicing	**592.4**	**440.4**	**492.1**	**358.9**	**424.7**	**538.5**	**679.9**	**938.2**
Total interest payment	276.8	243.2	241.8	236.3	293.9	425.5	548.4	662.1
Domestic	212.5	189.0	185.3	181.9	237.1	358.6	473.0	570.2
Foreign	51.3	48.1	51.2	49.1	50.5	61.1	70.7	87.4
Explicit liabilities	12.9	6.1	5.3	5.2	6.4	5.8	4.7	4.5
Repayment of principal (foreign)	315.7	197.2	250.3	122.6	130.7	112.9	131.5	276.2
Debt as percent of GDP	**-6.4**	**-6.1**	**-8.1**	**-5.1**	**-5.7**	**-1.8**	**3.3**	**0.8**
Total debt	83.6	77.6	69.4	64.3	58.6	57.2	61.3	61.0
Domestic debt	38.6	38.0	35.1	33.1	30.5	30.0	31.8	29.4
External debt	45.0	39.5	34.3	31.3	28.2	27.2	29.5	31.5
Explicit liabilities	3.0	1.7	1.4	1.3	1.1	0.9	1.1	1.3
Debt servicing as percent of								
Tax revenue	123.9	79.2	79.6	56.7	56.4	60.5	64.7	68.4
Total revenue	94.9	61.1	61.1	39.9	39.4	41.5	45.3	49.1
Total expenditure	71.7	49.0	52.3	32.1	30.3	32.1	29.9	38.6
Current expenditure	84.6	55.6	64.5	38.1	37.9	39.2	36.6	45.4
GDP	13.3	9.0	8.7	5.5	5.6	6.2	6.6	7.2

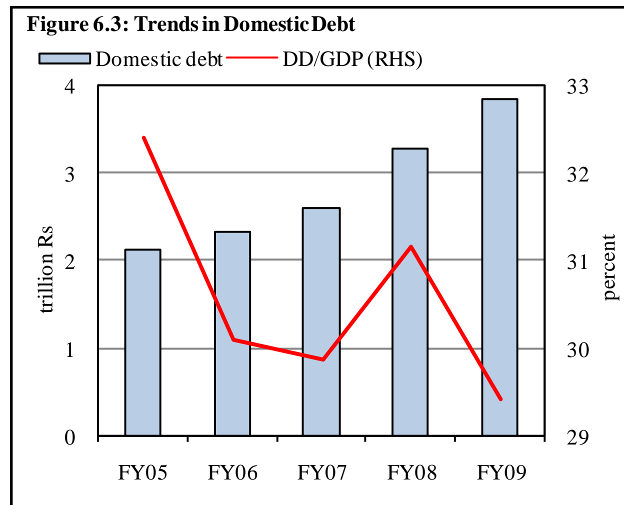
* Explicit liabilities include all foreign liabilities owned by the country.
Note: Rupee value of external debt for each year computed by applying the corresponding average annual exchange to the end-June stock.
Sources: i) SBP, ii) DM section, Finance division

earlier, a direct result of limit imposed on government borrowing from SBP under IMF program. While the decline in the growth of domestic debt is significant, the rise is still quite strong compared to historic trends.

The outstanding stock of external debt swelled by a whopping Rs 1095.1 billion in FY09, registering a growth of 36.1 percent against 28.9 percent in FY08. The major causative factors for the sharp rise in external debt were: (a) the IMF loan disbursement of US$ 3.8 billion during FY09; and (b) ADB loan disbursement of US$ 1.5 billion in the same period. As a result of stronger rise in external debt relative to domestic debt, the share of external debt in total debt increased from 48.2 percent in FY08 to 51.8 percent in FY09.

6.2 Domestic Debt

Pakistan's domestic debt stock stood at Rs 3.8 trillion at end-June 2009; registering a growth of 18.0 percent compared to 25.6 percent increase in FY08. The decline in growth of domestic debt seems to be consistent with the 2.4 percentage point fall in the fiscal deficit in FY09 and has restored the declining trend of domestic debt to GDP ratio, which saw a temporary reversal in FY08 (see **Figure 6.3**).



Even so, the rise in domestic debt is still quite high compared to debt growth trends in Pakistan (the average growth over FY01-FY08 stands at 9.7 percent). This reflects non realization of the privatization proceeds and reduced availability of net external financing due to increase in external debt repayments on maturing stock of foreign currency bonds. Furthermore, a larger budget deficit target for FY10, coupled with uncertainty over expected external financing and forecast of lower growth in nominal GDP pose high risk of deteriorating trends of domestic debt in FY10.

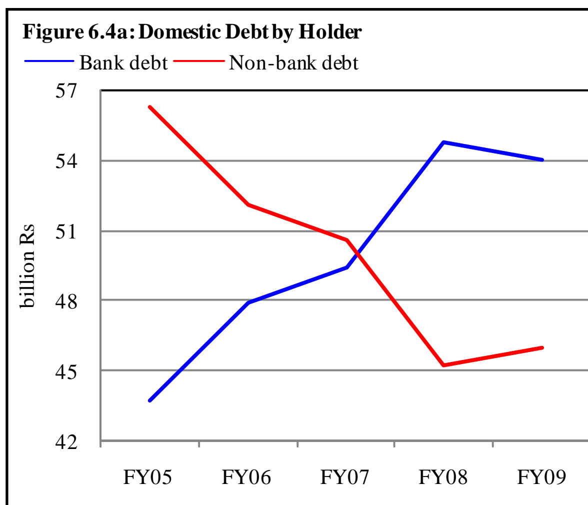
Composition of Domestic Debt

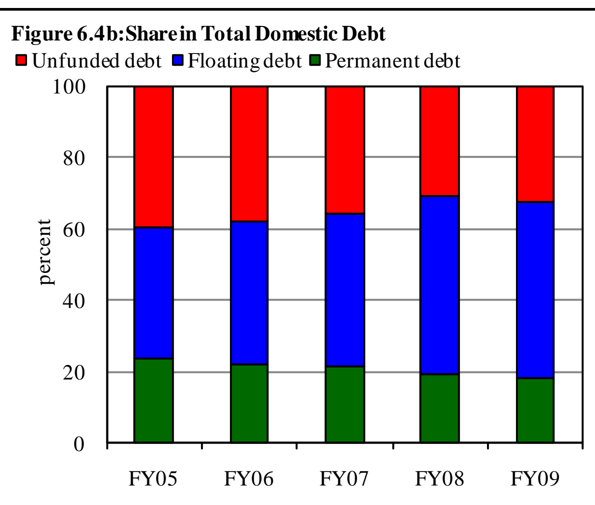
Domestic financing of the FY09 budget deficit saw a welcome shift away from central bank borrowing. The exceptionally high borrowing from SBP in FY08 had profound impact on the structure of domestic debt with SBP holding major share in banking system debt. While net addition to MRTBs was very small during FY09, the presence of huge stock created last year resulted in persistence of SBP dominance in banking sector debt (see **Table 6.2**). Moreover, scheduled banks' increased participation in T-bills auctions funded Rs 259.2 billion government budget deficit in FY09 compared to net retirement of Rs 119.1 billion in FY08. Consequently, the dominance of banking sector debt in total domestic debt sustained for the second consecutive year

Table 6.2: Structure of Domestic Debt

stock in billion Rupees, growth in percent

	Debt stock			Growth	
	FY07	**FY08**	**FY09**	**FY08**	**FY09**
Permanent	553.0	608.4	678.0	10.0	11.5
Floating	1,107.7	1,637.4	1,904.0	47.8	16.3
of which					
MTBs	*656.1*	*537.0*	*796.1*	-18.1	48.3
MRTBs	*451.5*	*1,100.4*	*1,107.9*	143.6	0.6
Unfunded	940.0	1,020.4	1,269.2	8.6	24.4
Domestic debt	2,600.6	3,266.1	3,851.3	25.6	17.9





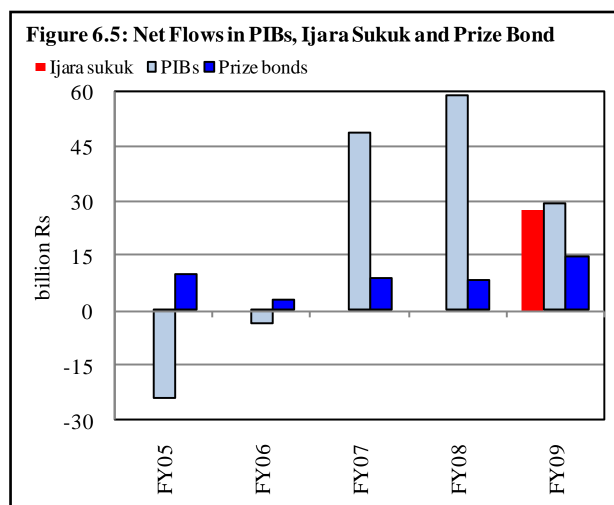
(see **Figure 6.4a &b**). Unfunded debt grew by an impressive 24.4 percent in FY09. The net addition of Rs 248.9 billion to the stock of unfunded debt in FY09 is unprecedented. The extraordinarily large inflows in NSS schemes during FY09 reversed the declining share of unfunded debt in total domestic debt. Specifically, at end-June 2009, the share of unfunded debt in total domestic debt rose to 33.0 percent compared to 31.2 percent a year earlier.

Permanent Debt

The outstanding stock of permanent debt rose by 11.5 percent in FY09 compared to 10.0 percent a year earlier. Despite this acceleration, the declining trend of the share of permanent debt in total domestic debt remained unbroken during FY09.

Within permanent debt, a major development in FY09 was the introduction of Ijara Sukuk Bonds. Government was able to mobilize Rs 27 billion through Ijara Sukuk bond during FY09. Although PIB retained its dominant share in permanent debt, net addition to its stock was lower compared to the previous couple of years (see **Figure 6.5**). Additionally, mobilization through prize bonds saw a significant improvement, adding Rs 14.6 billion in FY09 compared to Rs 8.3 billion in FY08.

Figure 6.5: Net Flows in PIBs, Ijara Sukuk and Prize Bond



Floating Debt

Floating debt, comprising solely of treasury bills, swelled by 16.3 percent in FY09 compared to 47.8 percent last year. The sharp deceleration in the rise in floating debt stemmed from treasury bills for replenishment which grew by only 0.7 percent in FY09 compared to 143.7 percent a year earlier. The virtual halt in the growth of MRTBs during FY09 reflects the successful implementation of the limit on government borrowing from the central bank under Stand-by Arrangement with the IMF.

In contrast, commercial banks' holding of treasury bills increased by 48.3 percent in FY09 compared to 18.2 percent decline in FY08. The reversal emanated from increased participation of the commercial banks in T-bills auction due to: (a) expectation of downward movement in policy rate under easing inflation expectations, and (b) decline in the demand of credit by the private sector. As a result, the government was able to mobilize Rs 259.2 billion from the commercial banks in FY09.

Unfunded Debt

Unfunded debt comprises mainly of national savings schemes of the CDNS. The stock of unfunded debt rose by a record Rs 248.9 billion in FY09, reflecting a growth of 24.4 percent compared to 8.6 percent last year. The historic rise in net flows through NSS was largely on account of heavy inflows in Special Saving Certificates (SSC), Behbood Saving Certificates (BSC), and Regular Income Certificates (RIC) (see **Table 6.3**). Together, these three instruments fetched Rs 247.2 billion in FY09, which constitutes almost 99 percent of total net flows through NSS instruments.

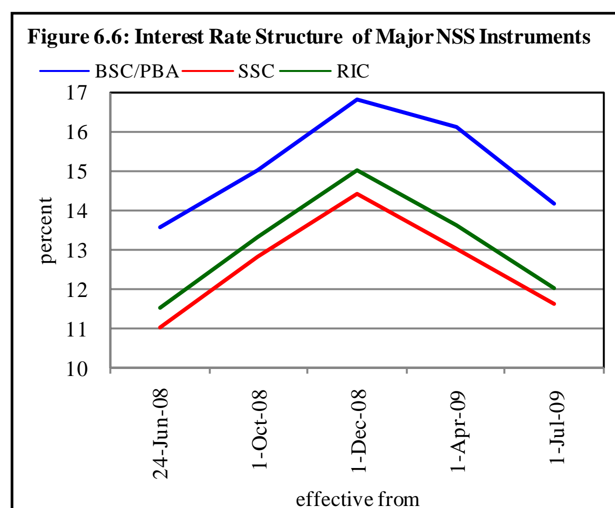
Table 6.3: Profile of Unfunded Debt

	Debt (billion Rupees)				**Financing** (billion Rupees)		**Growth** (percent)	
	FY06	**FY07**	**FY08**	**FY09**	**FY08**	**FY09**	**FY08**	**FY09**
Certificates	**649.0**	**677.5**	**725.6**	**945.7**	**48.0**	**220.1**	**7.1**	**30.3**
of which								
DSC	295.9	289.0	284.6	257.6	-4.3	-27.0	-1.5	-9.5
SSC	140.1	146.8	160.6	289.2	13.8	128.6	9.4	80.1
RIC	69.7	51.3	51.0	91.0	-0.3	40.0	-0.5	78.4
BSC	143.0	190.2	229.0	307.5	38.8	78.5	20.4	34.3
Accounts	**121.1**	**152.0**	**185.2**	**216.4**	**33.2**	**31.2**	**21.8**	**16.8**
of which								
SA	8.7	18.7	27.7	16.1	9.0	-11.6	48.1	-41.9
SSA	52.1	61.5	67.0	87.6	5.5	20.6	9.0	30.8
MAA	2.4	2.5	2.5	2.4	0.0	0.0	-1.0	-2.0
PBA	57.5	69.0	87.7	109.9	18.7	22.2	27.1	25.3
Postal life	**67.1**	**67.1**	**67.1**	**67.1**	**0.0**	**0.0**	**0.0**	**0.0**
GP fund	**44.5**	**43.3**	**42.5**	**40.1**	**-0.8**	**-2.4**	**-1.9**	**-5.7**
Total	**881.7**	**940.0**	**1020.4**	**1269.2**	**80.4**	**248.9**	**8.6**	**24.4**

Notes: DSC: Defence Saving Certificate, SSC: Special Saving Certificate, RIC: Regular Income Certificate, BSC: Behbood Saving Certificates, SSA: Special Saving Account, MAA: Mahana Aamdani Accounts, PBA: Pensionaers Benefit Account.

It is important to note that Behbood Saving Certificates is a special investment scheme designed to target small investors. The government offered relatively higher interest rates on BSC among other NSS instruments throughout FY09 (see **Figure 6.6**). This had made possible for the government to mobilize reasonable amount through this instrument. Also the government provided free conversion facility for existing holders of BSC toward higher profit rates w.e.f. February 1, 2009. This decision has further boosted the inflows through this scheme.

Figure 6.6: Interest Rate Structure of Major NSS Instruments



Net inflows through SSC remained extraordinarily high during FY09. This was probably due to heavy institutional investment by some public sectors organizations. Despite higher interest rate offered by RIC, heavy institutional investment in SSC was probably due to: (a) investment in SSC offer free encashment facility at any time after one month of date of purchase whereas RIC is subject to service charges at specified rates of the face value; and (b) the profit earned from investment in SSC is exempted from withholding tax provided investment remains in specified limit, while in case of RIC the profit earned is subject to deduction of 10 percent withholding tax at source.

Interest payments on domestic debt

Debt servicing on domestic debt increased by 29.8 percent to reach at Rs 570.2 billion in FY09 compared to Rs 440.3 billion last year. A larger growth in interest amount compared to debt stock pushed the effective interest rate to 14.9 percent in FY09 from 13.1 percent in FY08 (see **Figure 6.7**).

The rise in interest payments on domestic debt is largely attributable to heavy interest payments on floating debt. However, higher interest rates on NSS instruments and a large debt stock meant that interest payment on unfunded debt constituted the single largest component of total domestic debt servicing.

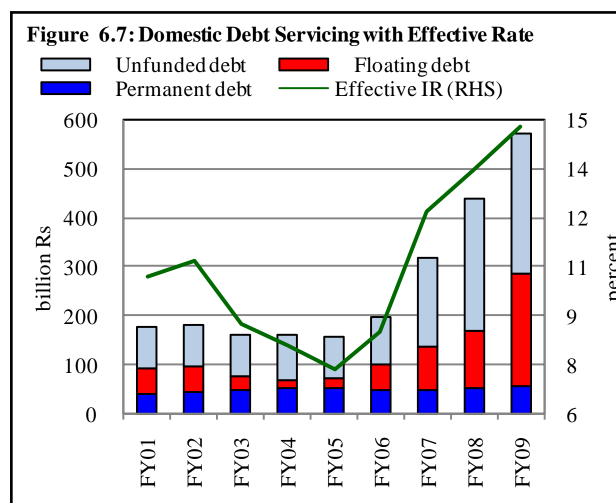


Figure 6.7: Domestic Debt Servicing with Effective Rate

The breakup of domestic debt servicing data reveals that the interest payments on permanent debt have moved in tandem with its share in total outstanding stock of domestic debt. On the other hand the interest cost of floating debt has doubled in FY09 (see **Figure 6.8**). The increase in interest payments on floating debt largely stemmed from the phenomenal rise in servicing cost of MRTBs, with its stock at Rs 1.1 trillion as on June 30, 2009. While policy interest rate has seen a gradual decline since April 2009, the fact that the existing stock of MRTBs is not expected to be retired anytime soon suggest substantial interest cost of floating debt in FY10 as well.

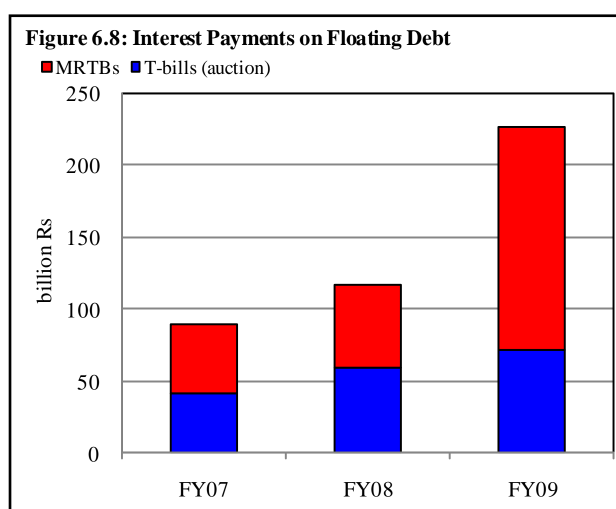


Figure 6.8: Interest Payments on Floating Debt

The debt servicing cost on unfunded debt stood at Rs 264.5 billion, registering a growth of 2.8 percent in FY09. The interest payment on the matured stock of the DSC still constitutes a major share in the total interest payments on unfunded debt. However its share has declined to 78.3 percent in FY09 from 84.6 last year. On the other hand the interest payments on BSC and SSC increased significantly in FY09. This seems to be consistent with its rising share in outstanding stock of unfunded debt.

6.3 External Debt

The widening of the twin deficits during the last couple of years has led to significant rise in Pakistan external debt and liabilities, which increased by US$ 4.6 billion in FY08 alone (see **Figure 6.9**). The factors leading to deterioration in the Pakistan's external debt and liabilities position further intensified in FY09 as international financial crisis deepened.

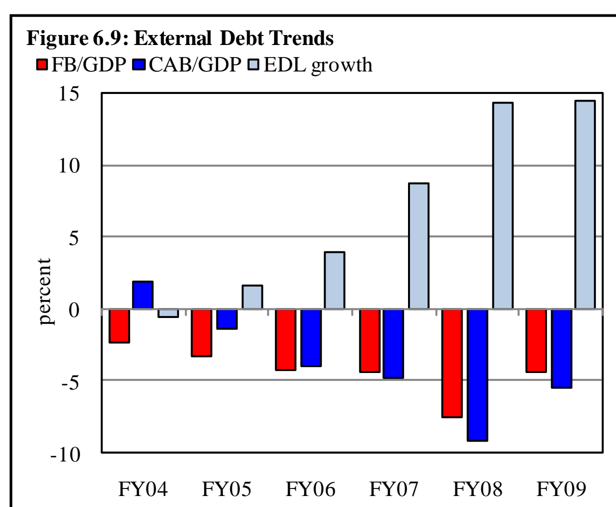


Figure 6.9: External Debt Trends

The global financial and economic crisis has affected Pakistan's economy in more than one ways. On one hand, the fall in demand in Europe and America has resulted in sharp decline of 5.6 percent in Pakistan's export earnings in FY09 (first such contraction in a decade). On

the other hand, financial flows (including non-debt creating flows), which had hitherto helped finance Pakistan's large current account deficit, declined significantly. Portfolio investment alone recorded an outflow of more than US$ 1.0 billion, while the FDI declined by 31.2 percent during FY09. Global financial crisis also restricted country's ability to tap international capital markets.

The sharp rise in trade deficit, and fall in the financial inflows led to loss of around 60 percent of Pakistan's reserves in just 11 months. The fall in the country's foreign exchange reserves severely

Table 6.4: Pakistan's External Debt and Liabilities
Value and absolute change in million US Dollar

	FY08	FY09 P	Absolute change	Percentage change
1. Public and publically guaranteed debt	**40,242**	**42,267**	**2,025**	**5.0**
A. Medium and long term(>1 year)	39,529	41,616	2,086	5.3
Paris club	13,928	13,998	70	4.3
Multilateral	21,581	23,103	1,522	7.1
Other bilateral	1,190	1,999	809	68.0
Euro bonds/saindak bonds	2,650	2,150	-500	-18.9
Military debt	41	199	158	385.4
Commercial loans/credits	124	166	42	33.9
Local currency bonds (TBs & PIBs)	15	0	-15	-100.0
B. Short term (<1 year)	713	652	-61	-8.6
IDB	713	652	-61	-8.6
2. Private non-guaranteed debts (M<:>1 yr)	**2612**	**3,208**	**596**	**22.8**
3. Private non-guaranteed bonds	**275**	**137**	**-138**	**-50.2**
4. IMF	**1337**	**5148**	**3,811**	**285.0**
Total external debt (1 through 4)	**44,466**	**50,760**	**6,294**	**14.2**
5. Foreign exchange liabilities*	**1,696**	**2,074**	**378**	**22.3**
Foreign currency bonds (NHA)	66	44	-22	-33.0
Central bank deposits	1,200	1,700	500	41.7
NBP/BOC deposits	400	300	-100	-25.0
Other liabilities (SWAPS)	30	30	-	-
Total external debt and liabilities (1 through 5) *	**46,161**	**52,834**	**6,673**	**14.5**

* Excluding FEBCs/FCBCs & DBCs P: provisional

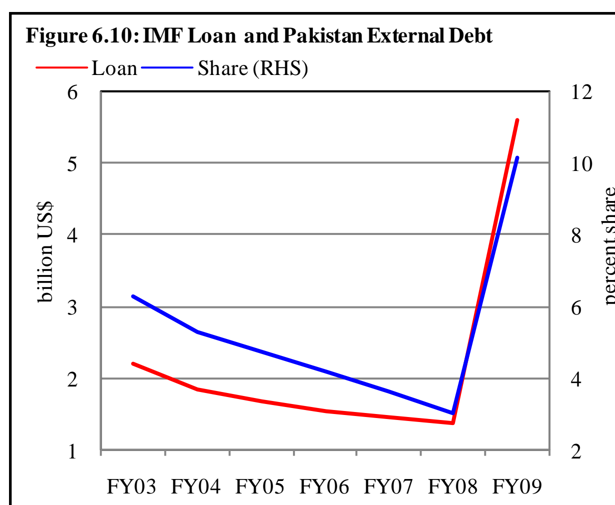
impaired the country's ability to meet its external obligation. This was reflected in sharp rise in yield spread (yield difference of Pakistan and US bonds) of 5-years, 10-years and 30-years international bond (during FY09, the yield of Pakistani bonds increased by around 45 percent on average).

With donors, friends and other IFIs reluctant to come forward without the IMF endorsement, Pakistan's credit ratings were further downgraded to CCC+ with negative outlook.[1] Thus, Pakistan had little option but to enter into a macroeconomic stabilization program with the support of the IMF. Following this, Pakistan saw a substantial increase in assistance from the IMF, as well as other IFIs and bilateral sources. Pakistan, thus added further US$ 6.5 billion to its debt stock in FY09, taking to US$ 52.8 billion (see **Table 6.4**).

The structure of the external debt with respect to public guaranteed and private debt remained almost same as in FY08 with private debt having 6.9 percent share in total external debt. Within public guaranteed debt, share of IMF debt increased from 3.3 percent in FY08 to 12.2 percent in FY09 (see **Figure 6.10**). The major portion of the 22.8 percent rise in the private debt was contracted by

[1] Nov 14, 2008.

telecommunication sector. The maturity composition of outstanding public & public guaranteed debt also remained unchanged in FY09 with 98 percent comprising of medium & long term debt (MLTD).



As far as the currency composition of EDL is concerned, more than ninety percent of the debt was denominated in four currencies; US dollar, Japanese yen, Euro and Special Drawing Right (SDR). It may be pointed out that currency composition has significant impact on the debt stock due to valuation changes that arise from appreciation/ depreciation of the respective currencies vis a vis US dollar. Valuation loss was relatively moderate at US$ 36.1 million in FY09 due to the appreciation of US dollar against the major currencies (except yen and yuan) compared to huge loss of US$ 3.2 billion during FY09 (see **Box 6.1**).

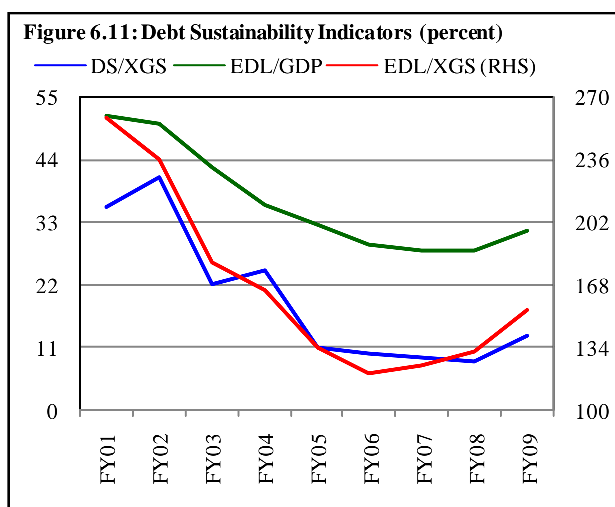
Box 6.1: Exchange Rate Variations and Impact on External Debt
Change in EDL has two components: (a) change in the debt stock due to addition or retirement of debt , and (b) change in debt stock due to conversion of debt denominated in different currencies to Base Currency (BC), which occurs due to appreciation/ depreciation of BC vis a vis other currencies. These are usually referred to as Translational change (gain/loss). Although Pakistan's external debt is denominated in different currencies, it is reported in UD dollar, US$ is thus the BC. The development (positive/negative) in UD dollar with respect to major currencies has significant impact on Pakistan's external debt.

Analysis shows that during FY09, Pakistan's EDL rose by US$ 6645.7 million, out of this US$ 36.1 million or 0.5 percent was due to exchange rate changes, as the US dollar appreciation and remaining US$ 6609.5 million was attributed to the new disbursements. The depreciation of dollar against Japanese yen alone caused US$ 1347.5 million increase in US dollar repaying of Pakistan's external debt, however, appreciation of dollar against Euro and SDR gave US$ 1129.6 million collective valuation gain to Pakistan. As the two off set each other, impact in US$ terms on Pakistan's external debt and liabilities was limited to US$ 36.1 million.

In contrast, valuation changes raised the EDL, in US dollar term, by US$ 3.1 billion in FY08 as US$ weakened against all major currencies. Specifically, out of total increase of US$ 5801.2 million in EDL in FY08, US$ 3113.2 million or 53.7 percent was contributed by depreciation of US dollar over major international currencies, while remaining US$ 2688.0 million was on account of new loans. Out of total valuation increase of US$ 3113.2 million in FY08, more than 90 percent was attributed to depreciation of US dollar against Yen, Euro and SDR.

Debt Sustainability Indicators

Most of the debt sustainability indicators recorded deterioration during FY09 (see **Table 6.5**). EDL as a percent of GDP (EDL/GDP) rose significantly during FY09- a result of a smaller GDP growth of 1.4 percent in US$ terms relative to a substantial increase of 14 percent in EDL during FY09. This rise in EDL/GDP ratio was in contrast to the falling trend seen during the last eight years, i.e. FY01-FY08 (see **Figure 6.11**). Similarly, debt service ratio, which measures the capacity of an economy to service its debt through its export earnings, also took a U-



turn in FY09. This deterioration was due to 56.9 percent increase in debt payments (principal as well as interest) and fall in country's export earnings. In contrast, due to decline in the current account deficit and fall in the short term debt in the second half of FY09, current account balance and short term loan to reserve ratio (CAB+STD)/RES), improved significantly.

Table 6.5: External Debt Sustainability Indicators

	FY05	FY06	FY07	FY08	FY09
TED/GDP	31.1	28.0	27.3	27.1	30.5
IP/XGS	3.4	3.0	3.4	3.1	3.3
DS/XGS	11.1	10.0	9.2	8.6	13.2
TED/XGS	127.3	114.8	120.1	126.8	148.0
TED/TR	224.5	198.3	182.2	185.7	220.6
Res/STD	36.2	63.7	533.8	12.0	14.0
Res/M	51.6	43.1	49.4	24.2	28.7
IP/Res	9.3	8.8	8.3	12.9	12.4
STD/ED	0.8	0.5	0.1	1.6	1.3
(STD+CAB)/Res	18.4	47.9	51.7	170.1	104.3
WOM	35	27.8	30.6	16.8	20.3

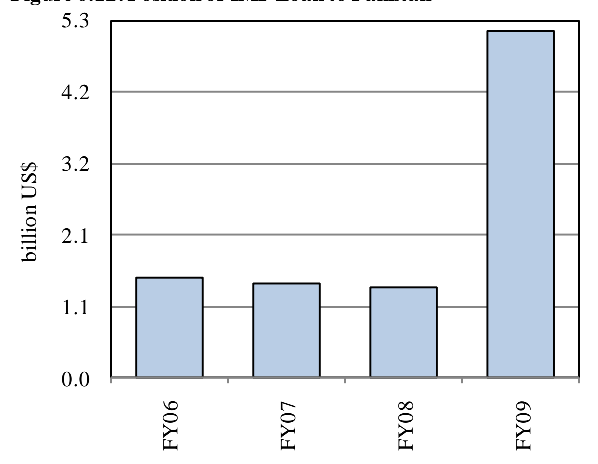
All values except for exports and trade balance are in percent while these are in billion US$. Res-foreign exchange reserves held by SBP, STD-short term debt, M-imports of goods & services, IP-interest payments, TED-external debt, and CAB-current account balances, WOM-weeks of imports, TR-total revenue, XGS-exports of goods and services, GDP-gross domestic products.

Structure of External Debt and Liabilities

International Monetary Fund (IMF) Debt

The rise in debt stock of IMF by US$ 3.8 billion was the major factor for rise in total debt stock during FY09 (see **Figure 6.12**). As discussed earlier, facing severe balance of payments problems the government had approached the IMF for a US$7.6 billion Stand-By Arrangement (SBA) loan which was approved by the IMF board in November 2008. The IMF has also acceded to government of Pakistan's additional request for US$3.2 billion[2], which has increased the total assistance to $11.3 billion (for details see **Box-6.2**).

Figure 6.12: Position of IMF Loan to Pakistan



Box 6.2: IMF Stand-By Arrangement and IMF Overhaul of Lending Framework

Pakistan's economic situation aggravated significantly in FY08 and in the initial months of FY09 due to domestic and external factors. Unfavorable law &order situation, international price shocks (oil and food) and global financial crises created a lot of problems such as slower growth, hike in prices and deterioration in the external balances. During this period, foreign exchange reserves of SBP declined from highest level of US$ 14243million on October 31, 2007 to US$ 3260 million on November 6, 2008. Subsequently, credit rating agency Moody's downgraded Pakistan's rating from B2 to B3 negative in October 2008 (same rating received by Pakistan on May 28, 1998 post-nuclear tests), which had increased the threat of defaulting. To overcome these problems, government of Pakistan has signed a 23-months SBA program with IMF in November 2008. The main objectives of SBA were restoration of macroeconomic stability and restoring confidence of the investor in the economy.

These objectives are associated with the conditionality targets and policies set by the government of Pakistan and IMF, which focus on quarterly quantitative targets for: government borrowing from SBP, budget deficit, international reserves, NDA of SBP, commitments for improvement in banking and tax legislation, strengthening the social safety net for poor household, phasing out of electricity subsidies, elimination of oil subsidies, reducing the SBP intervention in foreign exchange market and working toward elimination of inter-corporate circular debt. IMF financing through SBA will help to

2 On August 7, 2009, the Executive Board of IMF has agreed to increase lending by $3.2 billion, after a request from the Pakistan government to meet the country's increased balance of payments needs resulting from higher oil prices. Pakistan will also benefit from the proposed allocation of SDR, which will supplement its reserves. About $1.4 billion of the new IMF resources will be available, on a temporary basis, for budget financing during 2009/10. The main purpose is to provide bridge financing until donor support pledged at an April donors conference in Tokyo arrives. Donors pledged $5.7 billion to Pakistan over three years.

restore the macroeconomic stability and investor confidence. It will also help to fill the external financing gap, rebuilding international reserves and catalyze further external sources from development partners, which will enhance Pakistan capacity to spend more on development programs. The preliminary encouraging results of SBA are appearing in the form of rebuilding of international reserves, which rose to US$ 12354 million at the end of June 2009, decline in current account deficit and fiscal deficit as percent of GDP and improvement in credit rating of Pakistan. Moody's Investors Service raised Pakistan's ratings on its foreign currency denominated sovereign debt from B3 with 'negative' outlook to B3 with 'stable' outlook.

Emerging market and developing nations are facing increasing problems from the global disaster. As the crisis lingers on, many countries find it hard to pursue their economic plan. In these conditions IMF financing can help to control the cost of external shocks. The IMF Board has approved a major ***Overhaul to the Fund's lending Framework*** on March 24, 2009. The changes to the IMF's lending framework include:

Modernizing conditionality The IMF aims to ensure that conditions linked to IMF loan are focused and presented varying strengths of member country's policies and fundamentals. This modernization is to be achieved through preset qualification criteria rather than traditional conditionality. In addition, structure reforms will be monitored in the context of program reviews rather than use of structural performance criteria, which started to discontinue from May 1, 2009 for all IMF loans including for programs with low income countries. In new lending framework, there is no need for formal waivers, if a country fails to meet a structural reform by a specific date.

Flexible Credit Line (FCL) The IMF introduced this new credit line to give a large financing to members with strong fundamental and policies that meet the strict qualification criteria. The design of FCL relates to its uncapped access, its long repayment terms (3.25- 5 years), its unrestricted renewals, and its dual use for contingent and actual balance of payments needs.

Enhancing Stand-By Arrangements (SBA) IMF new lending framework also provides flexibility in lending to countries which may not qualify for the FCL and need such facility. These countries can use the High Access Precautionary SBAs (HAPAs) as a regular lending window. Like the FCL, HAPAs take account of country specific circumstances, policies and external environment.

Doubling Lending Access Limits Normal access limits for countries are being doubled. The new annual and cumulative access limits to non-concessional lending are 200 and 600 percent of quota. These limits give more confidence to countries to meet their financing through the availability of more resources.

Simplifying Cost and Maturity Structures To create the right incentives for borrowing from the fund, the cost and maturity structures for high access and precautionary Fund lending are also being overhauled. The elimination of time based repurchase expectation policy is replaced by the introduction of a new time-based surcharge, which together with streamlined level based surcharges, will help mitigate credit risks without increasing the cost of borrowing to countries that make timely repayment to the Fund.

Simplifying Lending Toolkit Some facilities not used recently such as Supplemental Reserve Facility, Compensatory Financing Facility are being eliminated.
With the introduction of these reforms, countries can now perform more effectively with the IMF on crisis prevention and crisis resolution. Once the credit line has been approved, a country can draw on it without having to meet specific policy goals.

Multilateral Debt (other than IMF)

The multilateral debt increased by US$ 1.5 billion during FY09, this rise was almost entirely on account of the rise in ADB debt, which increased by US$ 1.5 billion in FY09 compared with US$ 2.3 billion increase in FY08. Most of this additional loan was in the form of project loans. These project included power transmission improvement, development of renewable energy program, road development program in Punjab and NWFP, environmental improvement programs in urban areas, and rural development projects for Baluchistan. During the next five year (2009-13), ADB has agreed to provide US$ 4.4 billion assistance to Pakistan to achieve sustained economic growth and reduce poverty (**for details see Box 3**). Contrary to ADB, the total stock of IDB, IBRD and others decline by US$ 279 million during FY09 compare to a net addition of US$ 601 million in the previous year (see **Figure 6.13**).

Paris Club and Other Bilateral Debt

The outstanding debt of Paris club which consist of 19 members[3] registered US$ 70 million increase during FY09 over FY08. Among the Paris Club, Japan was the only country whose contribution increased by US$ 719 million during FY09. Consequently, the share of Japan in outstanding Paris club debt increased to 46.7 percent from 43.1 percent in FY08. The increase in loan from Japan was offset by the decline in loans from all others member countries of the Paris Club. The major part of this reduction was on the account of interest payments which accounts for 65 percent of debt servicing payments to Paris Club. The loans from Japan were for development of middle level education, rehabilitation of irrigation system and improvement in electricity transmission system.

Box 6.3: Country Partnership Strategy 2009-13

Government of Pakistan and ADB have designed a major new strategic partnership aimed at promoting inclusive and sustainable economic growth through structural reforms and investment in energy and infrastructure sectors. Asian Development Bank (ADB) in this regard has agreed to provide US$ 4.4 billion for this Country Partnership Strategy (CPS) 2009-13. The main objectives of CPS are to support Pakistan's efforts to achieve sustained economic growth and reduce poverty.

The main strategic areas under CPS 2009-13 have been identified as development of energy, Infrastructure, reforms, urban services. Investments to increase energy security and efficiency, investments to improve transport mainly the National Trade Corridor Program and irrigation facilities, assistance to bring down market distortions and institutional bottlenecks, improve public financial resource management, develop the private sector and bring about structural transformation. Under the urban services, primary interventions in cities and secondary towns to be made to improve basic services such as water, wastewater management and urban transport facilities.

Source: Country Partnership Strategy Pakistan 2009-13, March 2009, Asian Development Bank

The debt stock from other bilateral countries rose by US$ 808 million during FY09 over FY08. China, with more than 70 percent share in other bilateral debt was the major provider of this inflow for Chashma Nuclear Power Plant, Railway Engines, etc. After China, Saudi Arabia and UAE were the other major providers sharing more than 23 percent of other bilateral debt in FY09. These loans were mainly for imports of goods used as an input in agriculture sector and water supply projects.

Figure 6.13: Composition of Change in Multilateral Debt

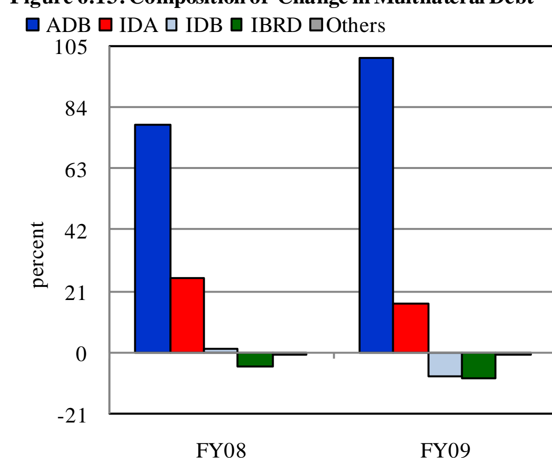
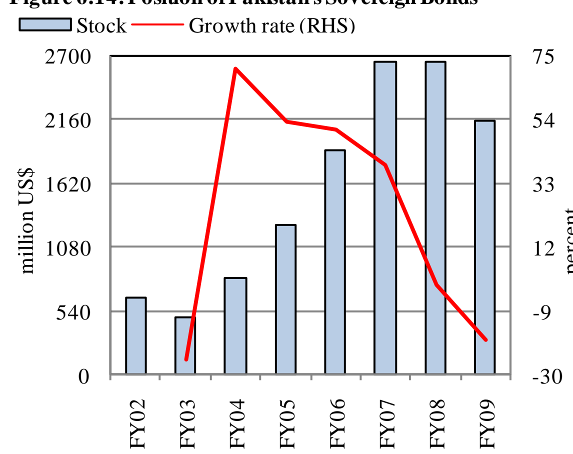


Figure 6.14: Position of Pakistan's Sovereign Bonds



Sovereign Bonds

The outstanding amount of Pakistani sovereign bonds declined by 18.9 percent up to end-June 2009 over last year; with an absolute fall of US$ 500 million (see **Figure 6.14**) on account of principle payment of five year Eurobond, which was launched by Pakistan on February 12, 2004. Due to macroeconomic imbalances, political uncertainty, war against terrorist and global financial crises,

[3] Australia, Austria, Belgium, Canada, Denmark, Finland, France Germany, Italy, Japan Korea, Netherlands, Norway Russia, Spain, Sweden, Switzerland, UK and USA are the member of Paris Club.

Pakistan could not issue any new bond in the international market against a target of Rs 31.2[4] billion from international markets by issuance of Sukuk/global bonds in FY09. In FY10 the government of Pakistan has again targeted to collect Rs 41.2 billion from issuance of Euro bonds, which does not appear to be feasible in the current scenario (see **Box 6.4**).

Box 6.4: Performance of Pakistani Bonds in the International Market

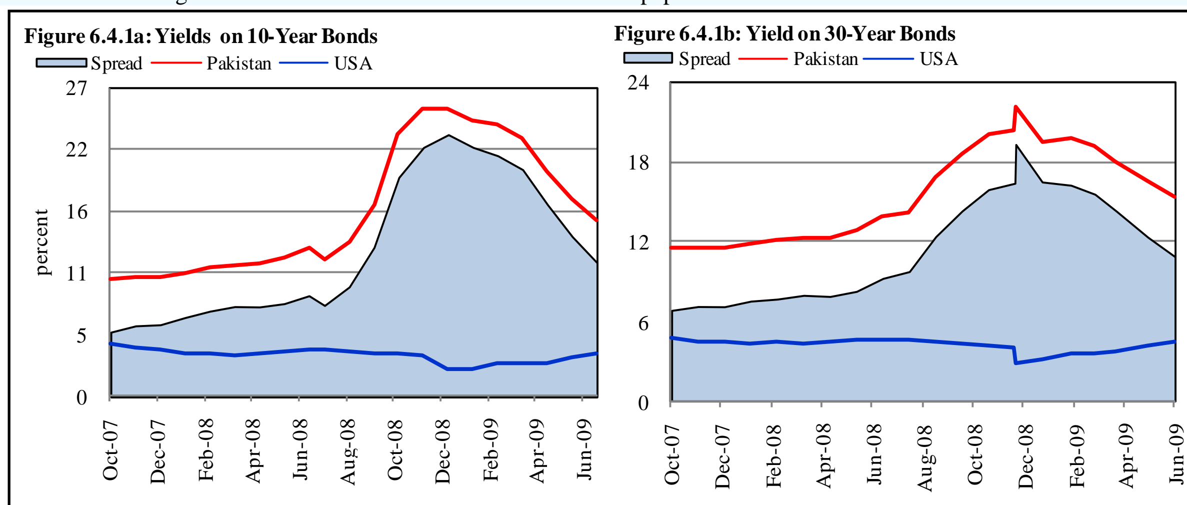
Government of Pakistan has launched five bonds of 5, 10, and 30 years maturity with total amount of US$ 2650 million during FY04 to FY07 (see **Table 6.4.1**). In annual budget 2009-10, government has again planned to collect Rs 41.2 billion (around US$500 million) from international capital market through the issuance of Euro bond. It may be pointed out that in FY08 and FY09 also, Pakistan had targeted generate Rs 62.5 billion through issuance of sovereign bond but was unable to achieve this. In the prevailing depressed situation both on the domestic and external front, rising external financing through launch of bonds is not likely to happen.

Table 6.4.1: Performance of Various Sovereign Bonds

value: million US Dollar, yield in percent

Issue Year	Bond	Tenor	Maturity	Value	Yield at issue	Yield at 30 June 2008	Yield at 30 June 2009
FY04	Euro	5- years	Feb-2009	500	6 m Libor + 323 bps (6.75%)	9.877	Matured
FY05	Sukuk	-do-	Jan-2010	600	6 m Libor + 220 bps		
FY06	Euro	10-years	Mar-2016	500	10 years US t-bill + 240 bps (7.125%)	11.568	15.288
	Euro	30-years	Mar-2036	300	30 year US t-bill + 302 bps (7.875%)	9.252	15.041
FY07	Euro	10-years	June-2017	750	10 year US t-bill + 200 bps (6.875 %)	10.066	14.202

In these circumstances it is important to analyze the cost of issuance of new papers in international markets. The cost of raising funds through external sources depends on number of things including (a) inflation outlook, (b) expected stance of domestic monetary policy, (c) sovereign credit ratings etc. All these factors affect the cost of issuance of new bonds over the benchmark risk free securities. The components of risk/premium are: currency (risk) premium, default (risk) premium; and jurisdiction (onshore-offshore) premium. These factors are usually considered by investors while making investment plans. The cost of issuance of new bonds in international markets can be estimated by yield differential of present Pakistani instruments having different maturities with the USA commercial papers of same tenors in debt market.



Yield on all Pakistani bonds increased in FY09, especially in the first six months of FY09: spreads (yield difference between Pakistani and USA bonds) rose sharply. In case of spread between Pakistan 10-years euro bond and US bond of same tenors reached 22.83 percentage points at end December 2008 from 8.81 percentage points at end June 2008. Widening spread reflect the state of both US and Pak economies: decline in yield of US bonds due to fall in federal fund rate[5] from 2.0 percent in June 2008 to 0.25 percent in December, 2008, 499 basis points fall in inflation rate in USA economy, rising political instability, worsened law & order situation and macroeconomic imbalances in Pakistan (as evident from high twin deficits

[4] As per Annual Budget 2008-09.

[5] The federal fund rate:- this is the rate banks charge each other for overnight loans of reserves. FED rate dropped by 175 basis points from 2.0 percent rate on June 25, 2008 to 0.25 percent rate on December 16, 2008.

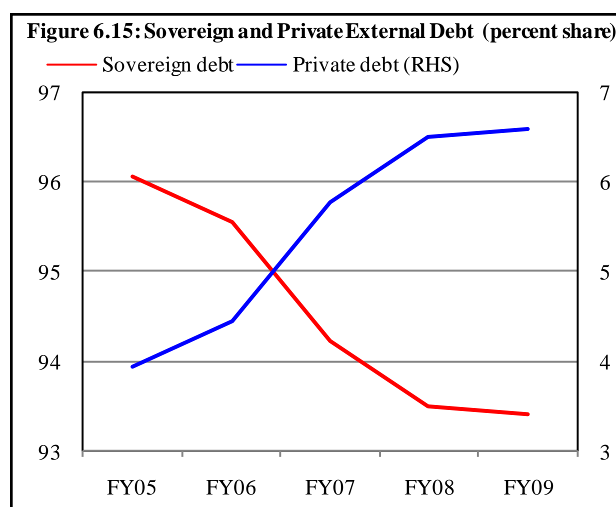
and high inflation environment), which has increased the country risk of Pakistan as shown by the downgrading of the country's credit rating[6] by both Moody's and S&P. In contrast to H1FY09, the spread declined to 11.68 percentage points in June 2009. Narrowing spread shows the situation in USA and Pakistan economies: fall in yield of Pakistan bonds due to reduction in policy rate, stable inflation rate, improvement in micro imbalances, negative growth, deflation and stable fed rate in USA economy. Similar to 10-year bond, yield on Pakistani 30-years bonds also increased in debt market in H1FY09 and decline in the second half of FY09. The spread (between Pakistan and USA) on 30-years bond reached 19.36 percentage points in December 2008 and decline to 10.88 percentage points in June 2009(**Figure 6.4.1a & 6.4.1b**).

Performance examination of Pakistani bonds in the international bonds markets suggests that it is not right time to raise capital from international market in current scenario. If the situation improved in the time ahead, Pakistan may launch bonds in international market.

Foreign Private Loans/Bonds

The outstanding foreign private loans increased by net inflow of US$ 596 million in FY09 over the stock in FY08. The share of foreign private loans in overall debt almost remained at the same level as in the previous year (see **Figure 6.15**). The major portion of private debt was for the expansion of mobile network. The stock of private bonds, on the other hand, fell by US$ 138 million, with 50.2 percent decline during FY09 as compare to 10.0 percent growth during last year. A mobile company has taken the advantage of current lower prices situation in bonds market and bought back about 55 percent of issued bonds from the market. These bonds[7] were issued for the development of construction and telecommunication sector, having 5-years maturity.

Figure 6.15: Sovereign and Private External Debt (percent share)



Foreign Exchange Liabilities

The stock of Pakistan's foreign exchange liabilities recorded a 19.5 percent growth in FY09 compared to 23.3 percent in the previous year. The net rise in foreign liabilities was shared by rising stock of central bank deposits and falling of NBP/BOC deposit along with falling stock of NHA bonds.

The stock of central bank deposits reached to US$ 1700 million at the end-June 2009 with 41.7 percent growth in FY09 due to rise in the deposit of central bank of China with US$ 500 million. In contrast to central bank deposits, the stock of NBP/BOC deposits and *NHA bonds* declined by US$ 122 million on account of the payment of annual installment to BOC in the first quarter of each fiscal year and US$ 22 million of NHA[8] bonds.

External Debt and Liabilities Servicing

Pakistan debt servicing of external debt and liabilities reached US$ 4691 million at the end-June of 2009, which is 54.8 percent higher than debt servicing of preceding year (see **Figure 6.16a &**

[6] On Decmber 12, 2008 Moody's Investor Service and Standard and Poor's lowered the sovereign rating of Pakistan from B2 to B3, which reflects the increase in high risk obligations.

[7] Originally, the mobile company has issued private bonds of US$ 250 million for the development of telecommunication sector in FY09. The remaining bonds will be matured in 2013.The company had issued the bonds at one US dollar and buyback at the rate of 0.7 US dollar.

[8] NHA 20-year tenor bonds were issued in 1991. Payment of these bonds is made to a banking consortium in first quarter of each fiscal year and the last payment under this account will be due in FY10.

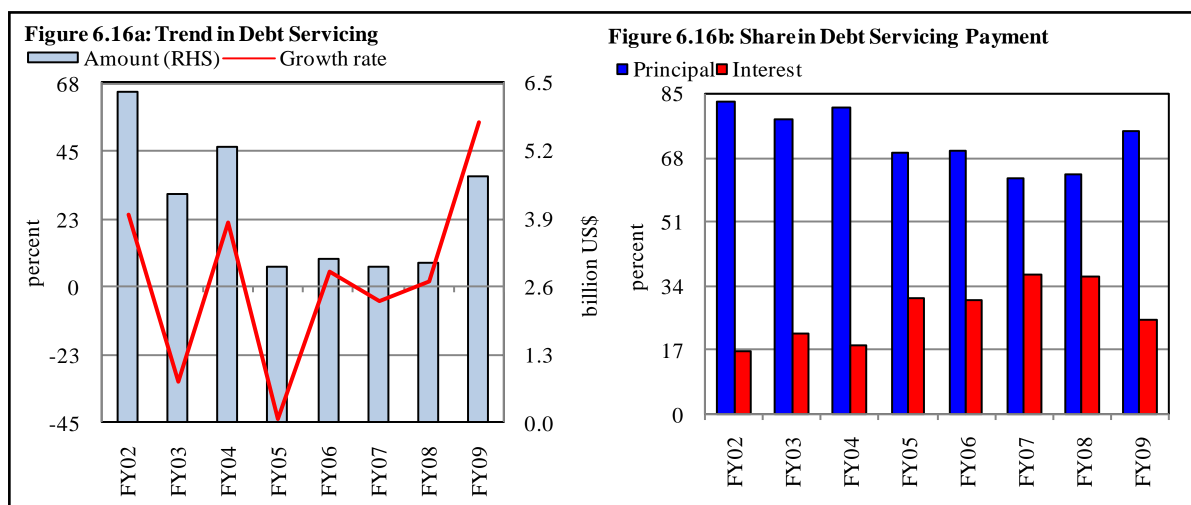
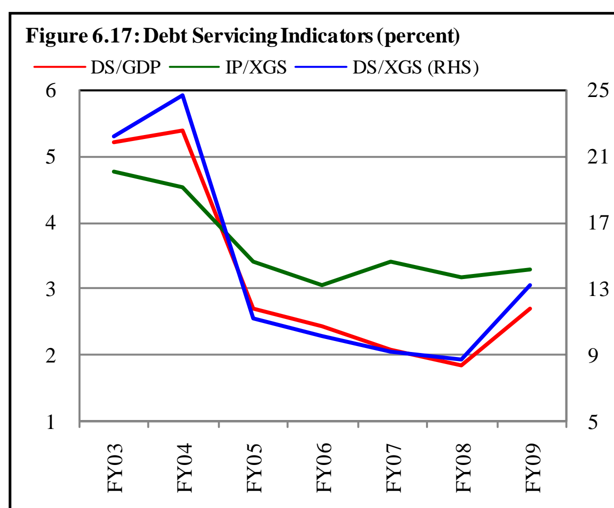


Table 6.7). This increase came due to rise in maturity of external debt owed to multilateral agencies, Eurobonds, Paris club lenders, short term loyalty as well as maturities of private non-guaranteed debt. Within the multilateral payments, the major receivers were IDA, IDB and IBRD. In the same way, the increase in servicing of foreign liabilities reflected the re-payments of Bank of China and NHA bonds. In debt servicing payment, FY09 is the third consecutive year in which the share of principal payment has increased significantly (see **Figure 6.16b**), which reflects that in coming quarter more debt will become matured.



As far as the debt servicing indicators such as debt servicing to GDP ratio and debt servicing to XGS are concerned, deterioration was seen in both indicators, particularly in debt servicing to GDP ratio during FY09 (See **Figure 6.17**).

Table 6.6: Pakistan's External Debt and Liabilities Servicing

million US Dollar

	FY08		FY09	
	Actual paid	**Rescheduled/rollover**	**Actual paid**	**Rescheduled/rollover**
1.Public and publicly guaranteed	2,026.0	100.0	3,477.0	100.0
Principal	1,187.5	100.0	2,599.0	100.0
Interest	838.5	0.0	878.0	0.0
2. Private non-guaranteed	595.9	0.0	604.0	0.0
Principal	408.0	0.0	462.0	0.0
Interest	187.9	0.0	142.0	0.0
3. IMF	182.4	0.0	264.0	0.0
Principal	173.5	0.0	210.0	0.0
Interest	8.9	0.0	54.0	0.0
Total debt servicing (1-3)	**2,804.3**	**100.0**	**4,345.0**	**100.0**
Principal	1,769.1	100.0	3,271.0	100.0
Interest	1,035.2	0.0	1,074.0	0.0
4. Central bank deposits	34.7	700.0	35.0	1,200.0
Principal	0.0	700.0	0.0	1,200.0
Interest	34.7	0.0	35.0	0.0
5. NBP /BOC deposits	116.5	400.0	258.0	300.0
Principal	100.0	400.0	200.0	300.0
Interest	16.5	0.0	58.0	0.0
6. Foreign currency loans bonds (NHA)	27.9	0.0	52.0	0.0
Principal	21.9	0.0	44.0	0.0
Interest	6.0	0.0	8.0	0.0
7.FEBC/FCBC/DBC	5.2	0.0	1.0	0.0
Principal	0.0	0.0	1.0	0.0
Interest	5.2	0.0	0.0	0.0
TOTAL (1-7)	**3,029.7**	**1,200.0**	**4,691.0**	**1,600.0**
Principal	1,925.8	1,200.0	3,516.0	1,600.0
Interest	1,103.9	0.0	1,175.0	0.0

Source: Statistics Department, State Bank of Pakistan