7 Financial System Stability

7.1 Indicators of Macro-financial Vulnerability

It is well accepted among the economists that a stable and efficient financial sector promotes growth in the economy.[1] It is also proved that macroeconomic stability provides a better environment to financial sector that makes allocation of resources more efficient in an economy. Weaknesses in some segments of financial sector might lead to building up of pressures that could make the economy vulnerable to a financial crisis.[2] The economic causes of the financial crises during the last two decades and their negative impact on the economy reinforced the two-way causality between economic fundamentals and financial sector. It is, therefore, important to keep a close watch on vulnerable aspects of financial sector.

A number of variables that signify various aspects of vulnerability have been identified in different studies.[3] These include both domestic and external factors related to financial sector and the economy at large such as growth, inflation, budget deficit, equity prices, interest rates, money supply, exchange rate, debt, reserves, current account balance, credit, short-term inflows and so on.

Growth

Even a moderate but sustained economic growth promises prosperity for an economy. The negative shocks in economic growth generate large and persistent domestic balance sheet effects.[4] The mechanism of this is as follow: a temporary slowdown in the economy reduces the value of bank assets and creates bad loans as a result of bankruptcies of some loss making enterprises. In this situation banks are forced to call in the collateral at lower values. This causes deterioration in balance sheet of the banks that further cuts down banks' operational capacity. Since the liquidation of the assets is irreversible, when the shock is over, the negative effects of balance sheet become permanent. If it happens with many firms and many banks then a small productivity shock can develop into a deep banking crisis.

Moreover, a slowdown in real GDP growth and financial crisis are very likely in those economies that largely depend on their export earnings. These economies are very sensitive to a decline in their GDP. A negative shock may drastically reduce their exports that may significantly alter their exchange rate & terms of trade. As a result, many firms may find themselves in a position that they are unable to pay back their loans to the financial sector, resulting in unemployment and bankruptcies that may trigger a potential financial crisis.[5]

In Pakistan, although there was a slowdown observed in the economic growth during the last few years due to drought and some geo-political reasons, the growth performance on average was appreciable. The post-1998 period was critical in the sense that country was isolated at political level with multiple sanctions coupled with drought, domestic unrest, lagged impact of structural changes, speculative pressures on exchange rate etc. Despite various negative factors, GDP grew at a positive rate.

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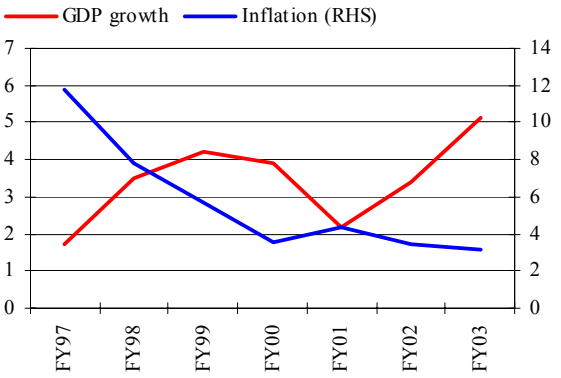
[1] For example, Khan, Mohsin S. (2002) "Inflation, Financial Deepening and Economic Growth", Banco de Mexico Conference on Macroeconomic Stability, Financial Markets and Economic Development, Mexico City, November 12-13.
[2] Montiel, Peter J. (2003) *Macroeconomics in Emerging Markets*, Cambridge University Press), p.126.
[3] For example, Hawkins, John and Klau, Marc (2000) *"Measuring Potential Vulnerabilities in Emerging Market Economies"* BIS Working Paper No.91, Bank for International Settlements, October.
[4] Zhu, Haibin (2003) *"Credit Constraints, financial liberalization and twin crises"*, BIS Working paper No. 124, Bank for International Settlements, January.
[5] Chile is a good example for this type of economy. Caballero, Ricardo J. (2002) *"Coping with Chile's External Vulnerability: A Financial Problem"*, Banco Central de Chile, November.

In this background, the current economic revival is a welcome sign (see **Figure 7.1**) and it is expected that the positive effects of higher growth rates would be transmitted to the financial institutions, as their balance sheets would improve. It would further contribute to soundness and stability of the financial sector.

Figure 7.1: Growth & Inflation (percent)



Inflation

Higher inflation distorts relative prices and makes investment decisions difficult due to irreversibility of project related investments thereby affecting growth negatively. High inflation also affects real interest rates and exchange rate as well; financial sector is sensitive to both of these variables. A very high inflation forces people to invest in real assets. Banks generally have mismatching of maturity between their assets and liabilities. If pressure builds up in the banking system for withdrawal of short-term liabilities, then it is impossible for the banks to liquidate their long-term assets without discounting. It may create a self-fulfilling banking crisis. Moreover, higher inflation raises the replacement cost of the assets while depreciation provisions are made on the basis of actual cost of the assets. As a result, the reported profits are overstated by the financial sector like all corporate entities. This makes it difficult to judge the health of the institutions on the basis of profit earnings and a simple analysis may lead to wrong conclusions.

Table 7.1: Major Macroeconomic Indicators of Financial Vulnerability

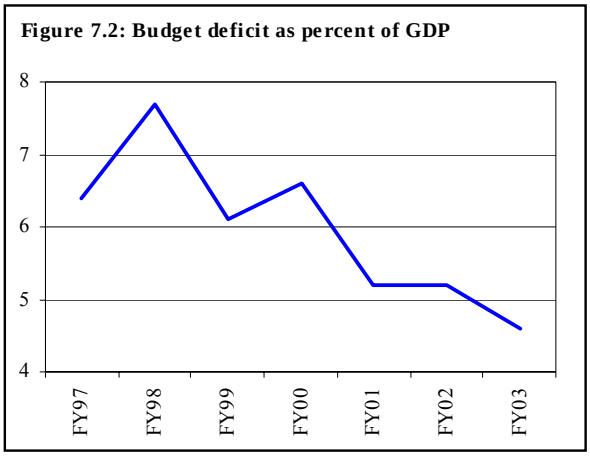
	Percent		as percent of GDP				Percent of total revenue	
	GDP growth	CPI Inflation	Budget deficit	Total debt	Domestic debt	External debt	Total debt servicing	Domestic debt servicing
FY97	1.7	11.8	6.4	93.1	42.8	49.6	66.6	34.1
FY98	3.5	7.8	7.7	95.1	44.4	50.1	64.2	39.8
FY99	4.2	5.7	6.1	104.2	47.4	54.9	73.2	38.2
FY00	3.9	3.6	6.6	106.0	50.2	53.5	71.5	42.7
FY01	2.2	4.4	5.2	113.5	50.6	60.2	61.5	35.3
FY02	3.4	3.5	5.2	104.3	47.3	55.3	69.1	32.0
FY03	5.1	3.1	4.4	95.1	46.1	48.0	42.3	28.0

In Pakistan, the most of the years during the 1990s witnessed double-digit inflation rates. Financial reforms that fueled the expansion of broader money, relatively lower GDP growth and continued depreciation of the rupee were also partly responsible for the higher inflation. However, inflationary pressures started to ease by FY97 and remained subdued since FY00 (see **Table 7.1**). The recent deceleration in inflation is mainly due to better food availability coupled with lower cost of production because of rupee appreciation. FY03 registered a 3.1 percent inflation, the lowest during the last 33 years. It may, therefore, be safely assumed that the present stability in the general price level assures that financial system is secure from any negative consequences of inflation.

Budget deficit

It is well known that fiscal imprudence can lead to a financial crisis.[6] In a situation when a central bank is defending fixed exchange rate regime (with limited reserves) and also fulfilling financing requirement of budget deficit, speculative attacks are almost certain due to conflicting objectives of

[6] This has happened in some Latin American countries, for example; Argentina, Brazil, Mexico and Chile in early 1980s. All these countries had large primary deficits against required surpluses. Montiel, Peter J. (2003) *Macroeconomics in Emerging Markets*, Cambridge Press.



the central bank. The sharp depletion of reserves may force a central bank to depreciate its currency that brings *twin crises* - a currency crisis and a banking crisis. Pakistan's engagement in various structural adjustment programs forced the government to observe the budget deficit target as a main conditionality. Although the government did not meet budget deficit targets most of the time, a gradual improvement in government behavior is, nevertheless, clearly visible (see **Figure 7.2**). In other words, government tried to enhance resources and contain its various expenditures. The recent decline in overall interest rate structure in the country is expected to extend help to the government to improve its performance further. The budget deficit as percent of GDP was recorded at 4.4 percent (revised budget estimates) during FY03 significantly lower than the 5.2 percent of GDP registered in FY02. Indeed, this improvement is appreciable as fiscal sector also contributed in overall macroeconomic stability. A lower budget deficit would not only help to decelerate the government debt (and future repayment obligations) but it would also help to achieve price stability and growth.

Debt and Debt Servicing

Debt sustainability is an important issue for the overall macroeconomic and financial stability. A very high outstanding level of debt suggests that the government has to make fiscal adjustments sooner or later, thus the credibility of the government becomes doubtful. It raises the cost of government borrowing due to addition of risk premium thus increasing debt-servicing bill also. Higher debt servicing puts pressures on government current expenditures and makes expenditure block more rigid and inflexible. The role of financial institutions becomes more vulnerable in this situation; a drastic unanticipated policy change to align government borrowings could severely disturb their short and medium-term operational strategies. It has also been observed that in case of sovereign default, financial system faced severe crises.

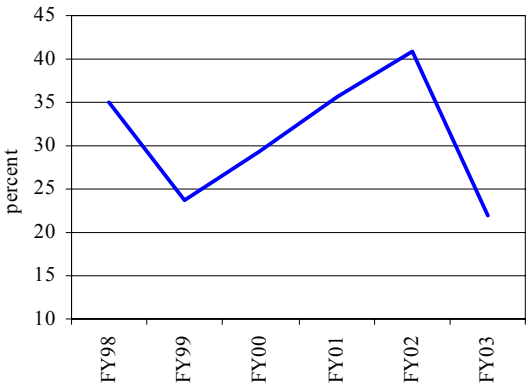
In Pakistan, total debt was persistently increasing over many years until FY01 and reached 113.5 percent of GDP. However FY02 saw a reversal in this trend. Total debt as percent of GDP fell gradually to 104.3 percent in FY02 and 95.1 percent in FY03. Both domestic and external debt recorded a fall, the latter being more pronounced. Domestic debt as percent of GDP fell from 50.6 percent in FY01 to 46.1 by FY03 while external debt as percent of GDP declined from 60.2 percent to 48.0 percent in the same period (see **Table 7.1**).

It is expected that this downward trend would probably be continued as a result of: (1) repayments of expensive debt, (2) lower financing requirements of the government due to better revenue collections, and (3) decline in interest rates reduces the government expenditure on debt servicing obviating the need for incurring high fiscal deficit. As a result of decline in debt, debt servicing has shown a downward trend since FY01 (see **Section 7.5** for details).

In practice, the ability to service debt is a much more important factor than the outstanding level of debt, because immediate repayment requirements may create a havoc within a very short period of time. In other words, liquidity problems may put a country towards the direction of insolvency. Thus, debt-servicing ratios are extremely important to assess the pressures on the financial sector. Pakistan's total debt servicing as percent of GDP saw a notable improvement during last two years. Despite repayments of expensive loans, debt servicing as percent of GDP (including repayments of

principal amount) fell from 10.7 percent in FY02 to 6.3 percent in FY03. Debt servicing of external debt and liabilities (TDL) to total foreign exchange earnings (FEE) ratio was on a rising trend since FY99 (see **Figure 7.3**). It reached its peak at 40.9 percent in FY02, and then fell sharply to 22.0 percent by end-FY03 due to a combined impact of an increase in the foreign exchange earnings and a massive decline in external debt and liabilities. As the repayments of expensive debt and liabilities are in process, it is expected that this ratio will further improve in future. A lower and improved debt servicing TDL/FEE ratio assures that the current stream of forex earnings is sufficient to meet the country's debt servicing obligations. Domestic debt servicing to GDP ratio is also trending downward, it gradually fell from 6.9 percent in FY00 to 4.9 percent by FY03.

Figure 7.3: Debt Sericing of TDL to FEE Ratio



An improvement in debt and debt servicing is indeed a welcome sign, particularly this gain was achieved without painful fiscal adjustments. A better and disciplined fiscal sector would provide a congenial and unwavering environment to the financial sector. It is important to point out that the external accounts observed a massive structural change after the events of September 11. Recent period also saw a gradual revival in the domestic economic activities that have made the country's position with respect to most of the vulnerability indicators much better during FY03.

Table 7.2: Current Account, Capital Account and Forex Reserves Accumulation

million US$

	Current Account Balance	Capital Account Balance	Reserve Accumulation
FY99	-1,856	-2,278	824
FY00	-217	-4,177	71
FY01	326	-643	1,000
FY02	2,833	-1,107	2,792
FY03	4,028	113	5,210

Forex reserves

The level of foreign exchange reserves shows the ability of a country to meet its payment obligations, particularly in short-term. Pakistan's liquid forex reserves started to increase during FY99, but the pace of accumulation accelerated since FY01 due to increasing current account surpluses and declining capital account deficits (see **Table 7.2 & Box 1**). It resulted into a sharp improvement in the indicators related to reserves. Reserves to total external debt ratio, which was a mere 6.2 percent in FY99, rose sharply to a respectable 30.2 percent in FY03. Similarly, ratio of reserves to external liability rose from 42.9 percent in FY99 to above 504.9 percent by end FY03 (see **Table 7.3** and **Figure 7.4**). Moreover, liquid forex reserves in terms of weeks of imports also rose substantially from 6.8 weeks in FY00 to about 46.9 weeks by end of FY03. All these ratios suggest that there is no threat to financial sector as country has a comfortable level of liquid forex reserves to meet all short-term payments.

Figure 7.4: Reserve to Total External Debt (TED) and Liability Ratios (percent)

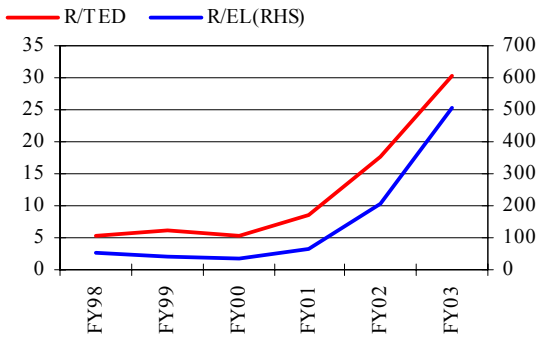


Table 7.3: Major External Indicators of Financial Vulnerability

	Percent				Percent of GDP		
	R/TED	R/EL	Reserves/Short term debt	Reserves coverage (weeks	Short-term Debt	Current account balance	External debt servicing to FEE
FY97	2.8	10.0	392.8	5.3	0.5	-5.7	39.3
FY98	3.5	35.5	982.1	4.8	0.3	-2.7	34.9
FY99	6.2	42.9	1,093.9	9.6	0.3	-3.2	23.6
FY00	5.2	34.7	762.3	6.8	0.2	-0.4	23.8
FY01	8.7	64.2	652.5	10.1	0.4	0.6	23.7
FY02	17.6	205.4	2,368.0	24.2	0.3	4.8	26.5
FY03	30.2	504.9	5,093.6	46.9	0.3	5.9	16.0

R = Reserves, TED = Total external debt, EL = External liabilities, FEE = Foreign exchange earnings.

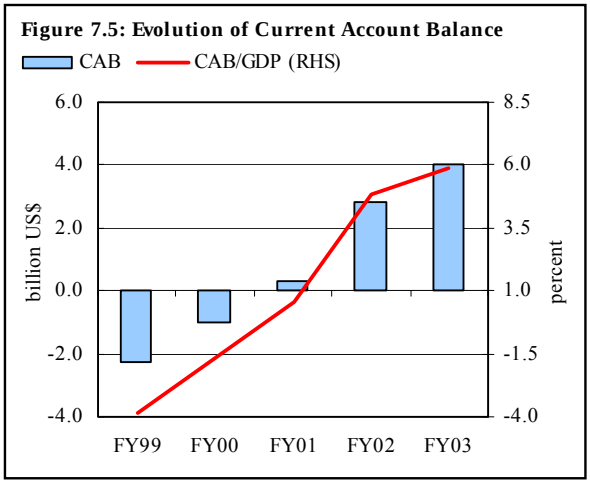
Short-term inflows

A major cause of financial crisis in many countries is an abrupt reversal of short-term inflows. Hence enormous short-term and portfolio related inflows are highly vulnerable and any reversal could potentially trigger a crisis. Most of the crises occurred as a result of capital account liberalization without appropriate regulatory and supervisory capabilities of the central banks. State Bank has strengthened and upgraded its on-site and off-site inspection and regulatory capabilities to meet the challenges of an open and globally integrated economic/financial system. Moreover, short-term inflows were historically negligible; therefore, an abrupt reversal in capital inflows is unlikely to cause significant effects.

Current account balance

Unbalanced composition of current account deficit, in addition to its high level may also cause to create disruption in the financial sector. More specifically if current account deficit is due more to consumption needs of an economy rather than the investment needs then it may become a source of financial vulnerability. In Pakistan, current account deficit remained high during the 1990s mainly due to trade deficit. Trade deficit as percent of current account balance on average was recorded at 182.7 percent during FY91-FY00.[7] However, current account balance witnessed a reversal since FY01 and continued to see improvements thereafter (see **Figure 7.5**).

Figure 7.5: Evolution of Current Account Balance



Consequently, current account surplus rose sharply from a mere 0.6 percent of GDP in FY01 to 5.9 percent mark during FY03. In this backdrop, Pakistan's financial sector has no direct threat of huge short-term repayments acquired due to financing of the current account deficits.

Exchange rate

Exchange rate misalignment is one of the major factors that motivate speculators to attack a currency. Currency board and fixed exchange rate regimes are more likely victims of this attack. The probability of a currency crisis (that leads to financial crisis) rises significantly when either or a

[7] Trade deficit also includes the impact of imports of investment related items such as capital goods and raw material for capital goods. However, the rise in the share of consumer goods and raw material for consumer goods in total imports during this period implies that higher trade deficit was mainly due to consumption.

combination of the following problems exist: weak economic fundamentals, sudden stop of inflows, depreciation of currency by major trading partners, sharp decline in exports and so on.

An overvalued exchange rate upsets the economy in many ways: tradables become expensive and non-tradables offers huge profit opportunities, this combination leads to decline in exports, credit crunch in the wake of reduced external inflows, increased government borrowing, rising debt and servicing burden, reduced accessibility to credit both from domestic and external sources in anticipation of likely default, and finally skyrocketing increase in interest rates to defend the exchange rate turns down the economy. In this situation, central bank's reserves usually deplete to finance government budget, higher imports and to defend the currency. Speculation and arbitrage opportunities finally ignite a currency crisis that very quickly turns into a banking crisis (dollarization causes bank run) and then into a full-fledged economic crisis.[8]

In Pakistan, exchange rate is floating since July 2000 and reasonably responding to market sentiments. Presently, real interest rates are also trending downward due to the changes in the overall structure of nominal interest rates (see **Figure 7.6**). It shows the confidence of the central bank that the currency is not overvalued. The rupee had seen a reversal after 9/11 and usual depreciation turned into a sharp appreciation (see **Figure 7.7**). Since October 2001, instead of protecting the rupee against depreciation, State Bank's market interventions aimed to decelerate the rupee appreciation. In addition, the level of reserves is on the rise (as a result of impressive export performance, unprecedented level of workers' remittances and some transitory inflows), which is providing further stability to rupee exchange rate. This situation is complimented by the ample liquidity available in the banking system, and a comfortable fiscal scenario in the country.

Figure 7.6: Real Interest Rates on Deposits

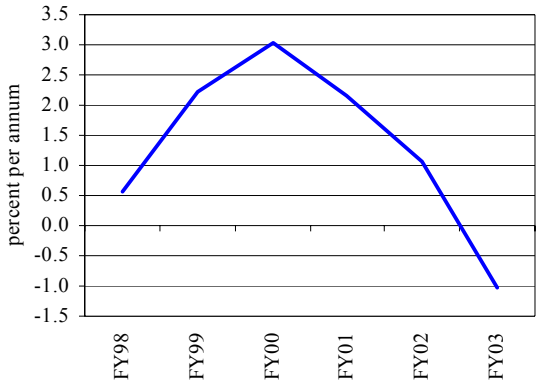
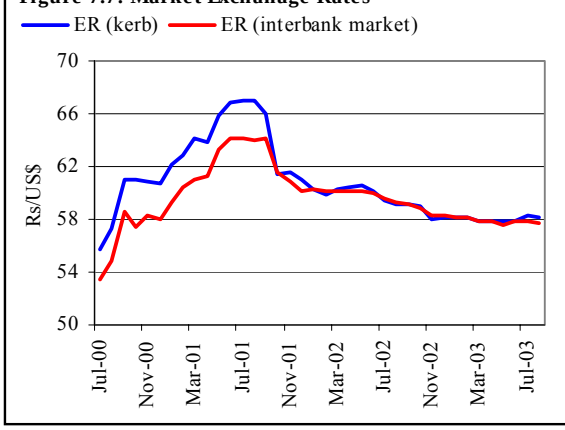


Figure 7.7: Market Exchanage Rates



In brief, exchange rate behavior with its allied indicators suggests that there are no negative pressures on the rupee in the forex market and there is no threat of any currency/ financial crisis in Pakistan.

The above analysis envisages that almost all macroeconomic indicators suggest that the Pakistan's financial sector is not vulnerable to any shock at least in the short and medium term horizon. The recent revival of the economy, unprecedented performance of the external sector, low inflation rates, decline in interest rate spread etc strengthened the country's financial position. Despite all these improvements, there is still a distinct need to follow conscious policies to keep budget deficit, current account balance and various debt indicators at sustainable levels.

[8] The collapse of currency board in Argentina (2002) is an episode of this type of crisis.

7.2 Impact of NPLs on Financial System Performance

Non-performing loans of the financial institutions, which surged up to Rs 286.9 billion by end 2000, witnessed a sharp reversal during 2002. As a result, NPLs in terms of both gross advances and GDP considerably declined (see **Table 7.4**). This improvement in NPLs is the upshot of a multi-pronged policy adopted to arrest the rising burden of NPLs on the financial institutions. This is also a clear indication that banking reforms implemented in 1997 have started to successfully stem the flow of non-performing loans and arrest the rise in the key ratios.

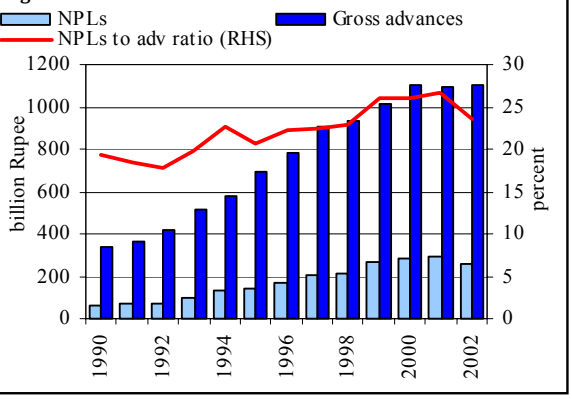
NPLs were one of the major factors that undermined the performance of the financial sector during 1990s. Both NPLs and its ratio to gross advances witnessed considerable rise during 1990s. A quick glance at **Figure 7.8** shows that the pace of rise was alarming toward the end of the decade. At one end, institutions were deprived off from their earning assets; on the other, provisioning cost was dragging down the profitability of financial sector. In order to cover this loss in earnings and additional cost, interest rate spread increased during 1990s, which is generally used as an indicator of financial sector efficiency. This rising intermediation cost was also not allowing the monetary policy to work efficiently. Especially in easy monetary policy scenario, lending rates were not very responsive. The fear that significant fall in deposit rates may affect deposit growth; banks were reluctant in reducing their lending rates in line with cuts in SBP repo rate. It is important to mention here that banks were facing problems in deposit mobilization after May 1998 that were overcome only after 2000 (see **Section 3.1**). Further, the preoccupation of some of the financial institutions in dealing with their bad portfolio did not allow these institutions to fully concentrate on fresh loaning.

Table 7.4: Non-Performing Loans

billion Rupees

	2000	2001	2002
Volume			
Scheduled banks	240.1	244.1	234.2
NBFIs	46.8	46.1	24.9
Financial sector	**286.9**	**290.2**	**259.2**
Share in NPLs			
Scheduled banks	83.7	84.1	90.4
NBFIs	16.3	15.9	9.6
Financial sector	**100.0**	**100.0**	**100.0**
NPLs As percent of			
GDP	9.1	8.5	7.1
Advances	26.0	26.6	23.5

Figure 7.8: NPLs of Financial Sector



Although the overall slowdown in economic activity, especially during last three years of 1990s, had a role to play in affecting the cash flows of borrowers and ultimately in piling-up the NPLs stock of financial intermediaries, the implementation of the most crucial set of reforms started since 1997 also contributed to this end. The spike in the NPLs of financial sector during 1999 was mainly attributed to the adoption of a vigorous standard of loan classification (a part of reform process started in 1997) and its strict enforcement by the SBP. It was observed that some of the public sector banks and DFIs were earlier reporting only default or overdue portion of their NPLs instead of outstanding amount of such loans. This improvement in the coverage and reporting of the NPLs resulted in further deterioration of asset quality indicators of financial institutions by 2000.

Table 7.5 will help to quantify the impact of NPLs on interest rate spread. The impact of NPLs pushed interest rate spread up within a range of 80 to 30 basis points. Furthermore, the impact was more severe during 1999 to 2001, primarily due to above-mentioned reasons. However, the situation

has substantially improved during 2002, particularly following a multi-pronged strategy to handle the outstanding stock of NPLs. The strategy includes: (a) pursuing banks and DFIs to accelerate recovery process; (b) establishment of Corporate and Industrial Restructuring Corporation (CIRC) to acquire NPLs of nationalized commercial banks and DFIs; (c) NAB to investigate and prosecute the cases of NPLs, particularly of willful defaulters; (d) the Committee for Revival of Sick Industrial Units (CRSIU); and (e) authorization to the Banks' Board of Directors to write-off loans in a transparent manner. All these measures have helped the financial institutions to clean their balance sheets. These also helped in reducing the impact of NPLs on the efficiency of the financial sector.

Table 7.5: Effect of NPLs on Interest Rate Spread

percent

	Yield			Interest rate spread		Spread caused by NPLs (in points)
	Actual	Adjusted	Cost	Actual	Adjusted	
1990	10.2	9.8	6.3	3.9	3.5	0.4
1991	10.1	9.6	5.8	4.3	3.8	0.4
1992	9.7	9.2	5.3	4.4	3.9	0.4
1993	10.9	10.4	6.1	4.8	4.3	0.5
1994	10.8	10.4	6.3	4.5	4.1	0.4
1995	11.7	11.3	6.9	4.8	4.4	0.5
1996	11.1	10.6	7.3	3.7	3.2	0.5
1997	12.8	12.2	8.3	4.5	3.8	0.7
1998	13.7	13.0	8.4	5.3	4.6	0.7
1999	12.7	12.0	7.4	5.3	4.7	0.7
2000	10.3	9.6	6.2	4.1	3.4	0.7
2001	10.9	10.2	5.8	5.1	4.4	0.8
2002	7.8	7.5	4.0	3.9	3.5	0.3

7.3 Financial Deepening and Intermediation

The importance of financial sector in economic development is generally accepted. The more developed financial sector works toward better allocation of scarce resources. Various indicators of financial deepening are reported to measure the level of financial development in an economy. Financial deepening reflects the role and efficiency of the financial sector. In particular, it shows the extent of penetration of basic products available in the financial sector in the economy at large. It also shows the confidence of economic agents in the stability and soundness of the financial system.

Monetary assets (M2) to GDP ratio

The most common indicator of financial sector deepening is the ratio of broad money (M2) to GDP. M2 to GDP ratio in Pakistan stagnated during FY01 at around its five-year (FY97-FY01) average of 44.2, then it rose sharply from 44.6 percent to the highest ever level of 48.5 percent in FY02 and 51.7 percent in FY03 (see **Table 7.6** and **Figure 7.9**). The proportionately higher increase in monetary assets in relation to GDP is mainly attributed to the developments after 9/11. Atypical expansionary behavior of net foreign assets due to forex inflows in terms of logistic support and diversion of workers' remittances from informal to banking channel were the major contributory factors. The subsequent appreciation of the rupee also made rupee deposits relatively more attractive. Some domestic factors, however, also played important role in this improvement. For example, lower interest rates and introduction of new financial products like credit cards by domestic private banks, debit cards, consumer financing, housing finance, Islamic financial products, etc. together with aggressive marketing strategies by the banks significantly contributed to the increase in outreach of financial services in the country (see **Section .2.2**).

Table 7.6: Indicators of Financial Deepening

percent

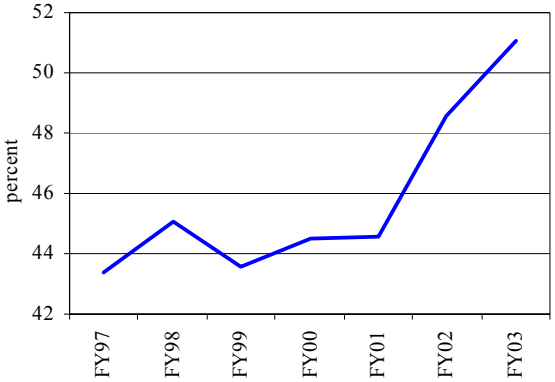
	FY00	FY01	FY02	FY03
M2 / GDP	44.5	44.6	48.5	51.7
Private sector credit / GDP	22.1	21.9	22.1	24.1
Money multiplier	2.8	2.9	3.0	3.1
Currency / M2	25.4	24.6	24.6	23.8
Currency / GDP	11.3	11.0	12.0	12.3
Currency / Total deposits	34.3	33.0	33.0	31.3
Currency / Rupee deposits	38.1	37.7	37.1	33.9

Private sector credit to GDP ratio

Another important indicator of financial deepening is the ratio of credit to private sector to GDP. It shows the ability of the financial sector to allocate funds to productive ends. In Pakistan, private

sector credit to GDP ratio is increasing gradually over time. Although financial sector is contributing more in the real economic activities, the process is extremely slow. The major reason is the availability of risk free government papers at relatively higher rates to individual investors under various NSS (see **Section 5.1**). As a result of recent changes in interest rate structure, it is expected that the private sector credit to GDP ratio would rise sharply in coming years. It implies, in other words, that the financial deepening would further increase in the economy.

Figure 7.9: Ratio of M2 to GDP



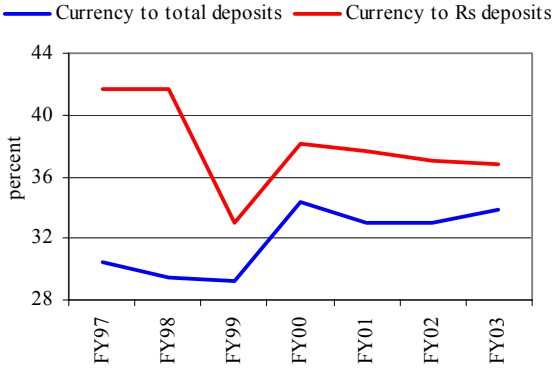
Money multiplier

Money multiplier also shows the level of stability and policy responsiveness of the financial sector. A high but stable money multiplier reflects a well-behaved financial sector with a higher degree of responsiveness of the financial sector to the policy changes of the central banks. An unstable or low money multiplier mainly indicates the shallowness of the financial sector and an opaque monetary policy transmission mechanism. In Pakistan, money multiplier was upward trending until FY98 and reached its peak of 3.3, then it gradually fell to 2.8 in FY00. During FY00-FY03 period, money multiplier remained relatively stable (having low standard deviation compared with the corresponding period). Money multiplier gradually rose from 2.9 in FY01 to 3.1 by FY03. This movement shows SBP efforts to keep the growth of reserve money in line with an unusual growth in monetary assets due to an unprecedented expansion in net foreign assets of SBP. In absence of SBP active monetary management, the reserve money growth would be much higher that might have spurred inflationary pressures in the economy.

Financial intermediation

The level of financial intermediation shows the confidence in the banking system. This could be measured by using currency to M2 ratio or currency to deposits ratio. Currency to M2 ratio fell marginally from 25.4 percent in FY00 to 24.6 percent in FY01 and remained at the same level in FY02 then fell again to 23.8 in FY03. It shows higher intermediation in FY02 that implies people preference to hold lower cash compared to the bank deposits. The improvement in FY03 is also attributed to increasing use of ATMs and other means of electronic banking.

Figure 7.10: Ratios of Deposits

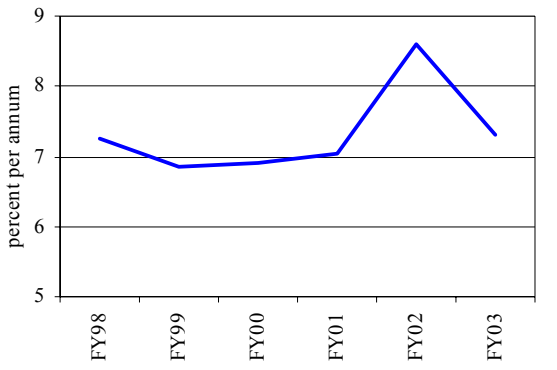


Currency to total deposits and currency to rupee deposits also show the level of intermediation. However, the comparison of these two ratios is interesting to gauge the relative attraction for rupee or foreign currency deposits. The gap between the two was on rising trend until FY98 because of lucrative returns on foreign currency deposits *plus* capital gains on account of usual rupee depreciation (see **Figure 7.10**). Foreign currency deposits, however became less attractive since May 1998 and the gap between currency to total deposits and currency to rupee deposits ratios substantially narrowed. A positive attribute of decline in the ratio of currency to (rupee) time deposits is that it shows confidence in the financial institutions, soundness of rupee and its exchange rate over a longer time horizon.

Financial efficiency

Narrowing of banking spread indicates improvement in financial efficiency. Although banking spread rose sharply during the early reform period and remained very high till June 2002, it recently, observed a decline as a result of 5-time downward adjustments in the discount rate by SBP. While banks were initially hesitant to reduce their lending rates in response to reduction in discount rate, nevertheless, the rates of return on deposits were adjusted spontaneously. It, therefore, initially resulted into a sharp rise in the banking spread during FY02 (see **Figure 7.11**). However, SBP pursuit of keeping an easy monetary stance amidst ample liquidity (which obviously augmented competition) in the banking system forced a more pronounced decline in the lending rates during FY03.

Figure 7.11: Banking Spread



While an isolated analysis of Pakistan could tell the improvement or deterioration in the financial sector over time, a comparison of different indicators of financial deepening of some countries would certainly be more instructive. A group of different Asian countries (India, Bangladesh, Sri Lanka, Philippines, Thailand, Malaysia, Turkey and South Korea) was selected to perform a peer comparison. The group is heterogeneous, as selected countries have different per capita income and their financial sectors represent diversified level of development. This comparison would show relative standing of Pakistan vis-à-vis other countries at the similar stage of development and evaluation against relatively developed countries would reveal future prospects for the financial development in Pakistan.

Table 7.7 shows that Pakistan's financial depth in terms of M2/GDP ratio is significantly lower than those of Malaysia, Thailand and Korea, while it is marginally lower as compared with Turkey, India and Philippines. M2/GDP ratio in Pakistan is higher than that of Bangladesh and Sri Lanka. The lower M2/GDP ratio in Pakistan is a reflection of a large informal sector in the economy. The imposition of sales tax and increasing documentation would probably raise this ratio to a comparable level with other countries at low and middle stage of development.

Table 7.7: Indicators of Financial Depth & Efficiency - 2001

percent

	Pakistan[3]	India[1]	Bangladesh	Sri Lanka	Philippines	Thailand	Turkey	Malaysia	S. Korea
M2 / GDP	51.7	56.0	37.2	39.2	58.8	104.0	60.1	106.7	85.8
Currency / M2	23.8	17.4	13.6	11.9	9.1	8.3	4.2	6.2	4.0
Currency / GDP	12.3	9.8	5.0	4.7	5.3	8.6	2.5	6.6	3.4
Money multiplier	3.1	4.1	4.2	4.9	6.1	8.6	5.9	4.5	14.2
Demand deposits / Total deposits	38.5	14.9	14.0	11.7	9.9	2.8	6.2	17.5	7.8
Time deposits / Total deposits	61.5 [4]	85.1	86.0	88.3	90.1	97.2	93.8	82.5	92.2
Private credit / Total credit	63.1	54.4	69.1	60.0	60.7	73.4	28.3	91.7	97.6
Private credit / GDP	24.1	29.0	26.7	28.3	35.5	74.0	19.9	108.9	97.8
Banking spread	7.3	4.1[2]	7.3	8.4	3.7	4.7	NA	3.3	1.9

Source: International Financial Statistics, IMF, March 2003. [1] Data pertains to year 2000. [2] Reserve Bank of India.
[3] *Source: Economic Survey 2002-03 and SBP;* Provisional; data pertains to 2003.
[4] A major part of saving deposits in Pakistan is included in demand deposits, therefore, this number is probably not strictly comparable with others reported in the Table.

The situation becomes even worse if the ratios of currency to M2 and currency to GDP are compared. A higher currency ratio with respect to either M2 or GDP shows that the use of financial institutions and their services is rather restricted. It implies that the financial institutions are not reaching larger segments of the economy. Pakistan has the highest currency to M2 ratio (23.8 percent) and currency to GDP ratio (12.3 percent) in the peer group, followed by India with big margins. While these ratios are in single digit in the case of Philippines, Thailand, Malaysia and Korea.

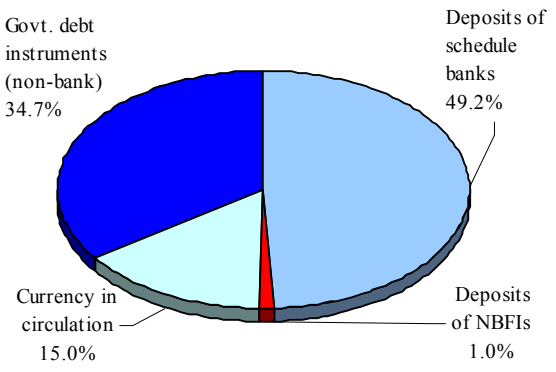
The share of time deposits in total deposits shows the savings behavior in the economy. Pakistan is at the bottom in the selected group of countries in terms of lower share of time deposits in total deposits. Similarly, Pakistan has the lowest money multiplier that shows relatively lesser effectiveness of the changes in the reserve money by SBP on monetary assets (M2).

Higher allocation of credit to the private sector shows the use of limited and precious financial resources to the most productive ends. In terms of private sector credit to total credit, Pakistan is relatively better off as compared with India, Sri Lanka, Turkey and Philippines, but other countries are extending much higher credit to the private sector. However, private sector to GDP ratio reveals a dismal situation, a very low ratio put Pakistan at the second position after Turkey. In Pakistan, it is probably a reflection of huge budget deficits during the last two decades that directed credit to finance government's budgetary requirements. As government fiscal discipline gets entrenched in Pakistan, this ratio is likely to improve further. Similarly, Turkey is also running huge budget deficits, and despite having a developed financial sector, private sector is unable to fetch a respectable share in total available credit.

Banking spread (or intermediation cost) is a measure of efficiency of the financial institutions. A higher spread shows a less efficient financial system. Pakistan had a very high spread till 2001, however, recent developments in external and monetary sector helped the banking system to brought down the banking spread to 7.3 percent in FY03 due to a more pronounced decline in lending rates than rates on deposits. Specifically, a sharp slide in the rate of returns on government papers made this customary investment avenue unattractive for the banks. In fact, ample liquidity forced banks to introduce new financial products and explore new market segments such as consumer financing. Although lending rates fell significantly, intense competition improved the banks' efficiency and profitability. In this background, it is expected that further improvement would be realized in financial sector efficiency in terms of lower intermediation cost.

In brief, presently Pakistan's financial sector has still a long way to go to catch up with other countries in the region with the similar economic characteristics. However, recent structural changes, developments in the financial sector, economic revival and stronger rupee if sustained will make it possible for Pakistan to substantially improve its position at least in relation to most of the countries with the same per capita income.

Figure 7.12: Structure of Financial Savings during FY02



7.4 Financial Savings

The financial savings consists of the deposits of the scheduled banks, deposits of NBFIs, government debt instruments (non-bank) and currency in circulation. As a proportion to GDP there was a significant improvement in the overall financial savings during FY01 and FY02 (see **Figure 7.12**). Financial savings flow to GDP, which

was 5.5 percent in FY00, moved up to 5.8 percent by FY01 and further to 8.5 percent during FY02, the highest figure reached during the last four years (see **Table 7.8**). A similar improvement was also witnessed in the stock of financial savings in most of the component items except that for NBFIs.

Table 7.8: Financial Savings

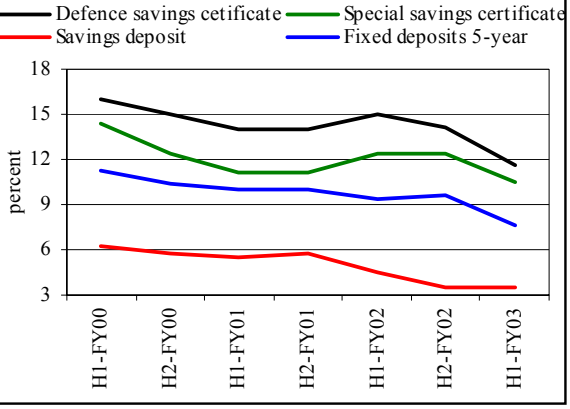
	FY98	FY99	FY00	FY01	FY02
Financial Savings (billion Rupees)	2011	2207	2380	2579	2887
Stock as percent of financial savings					
Deposits of schedule banks*	52.3	50.4	47.9	49.5	49.2
Deposits of NBFIs	4.7	3.9	3.0	1.1	1.0
Govt. debt instruments (non-bank)	29.4	32.6	34.2	34.8	34.7
National savings scheme	24.1	29.7	31.6	31.2	31.0
Other securities	5.4	2.9	2.6	3.7	3.7
Currency in circulation	13.6	13.0	14.9	14.6	15.0
Financial savings	100	100	100	100	100
Stock as percent of GDP					
Deposits of schedule banks	39.2	37.9	36.2	37.3	39.2
Deposits of NBFIs	3.5	3.0	2.2	0.8	0.8
Govt. debt instruments (non-bank)	22.1	24.5	25.9	26.2	27.6
National savings scheme	18.1	22.3	23.9	23.5	24.7
Other securities	4.0	2.2	1.9	2.8	3.0
Currency in circulation	10.2	9.8	11.3	11.0	12.0
Financial savings	75.1	75.1	75.6	75.3	79.6
Flows as percent of GDP					
Deposits of schedule banks	4.2	2.1	0.9	4.0	4.0
Deposits of NBFIs	-0.4	-0.3	-0.5	-1.2	0.0
Govt.debt instruments (non-bank)	4.3	4.3	3.0	2.5	2.9
National savings scheme	4.2	5.8	3.1	1.5	2.5
Other securities	0.2	-1.5	-0.1	1.0	0.4
Currency in circulation	1.1	0.5	2.2	0.6	1.6
Financial savings	9.2	6.7	5.5	5.8	8.5
National savings	14.6	11.7	14.1	15.0	14.3

*The total deposits of the scheduled bank's may not tally with the deposits reflected in their balance sheets due to difference in classification.

The data in **Table 7.8** shows that the share of the non-bank (mainly NSS) has risen from 29.4 percent to almost 34.7 percent during the last five years. While the deposits of banks and non-bank financial institutions have declined form 57.0 percent to 50.2 percent. This shows the continued relative attraction of the NSS instruments relative to bank deposits.
This was despite the fact that in the post 2001 period deposits were built up by the increasing inflow of remittances that substantially increased the liquidity available in the financial system. Other factors that helped boost the deposit growth included aggressive competition among banks, better payment facilities and significant degree of financial innovation.

The deposits of the scheduled banks still form the largest component of financial savings. As a percent to GDP, it increased from 36.2 percent in FY00 to 37.3 percent in FY01 and then 39.2 percent in FY02. However, there occurred a gradual decline in the ratio of time deposit to total deposits, which in FY02, were below the level attained two years earlier, indicating weakening of the intermediation process in the banking system. The low returns on deposits by bank vis-à-vis national savings scheme seem to be the prime reason (see **Figure 7.13**).

Figure 7.13:Profit Rates on NSS vs Bank Deposits



Non-bank financial institutions (NBFIs) are also a vital segment of the financial system in our country. These institutions operate within the financial sector to provide various services including accepting deposits of different maturities. Although non-bank financial institutions have grown in numbers, the performance in terms of saving mobilization deteriorated over the years. The NBFIs share of savings that peaked at 5.9 in FY97 has since then shown a declining trend. As a proportion of total financial savings it was about 3.0 percent in FY00, which in subsequent years gradually eroded to 1.1 percent in FY01 and then to 1.0 per cent in FY02.

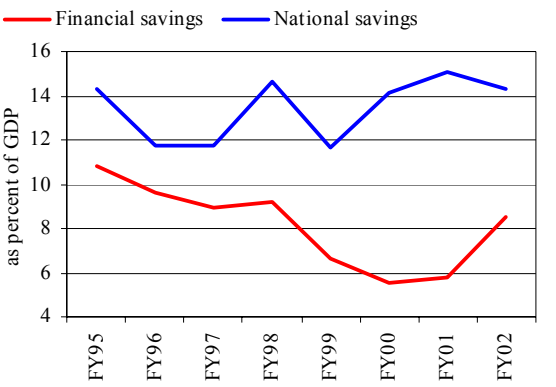
An interesting development was seen in currency in circulation that followed a declining trend in FY01 that reversed during FY02. Thus the share of the currency in circulation in financial savings that has declined to 14.6 percent in FY01, recorded an increase of 15.0 percent during FY02. The declining trend in currency in circulation during FY01 reflected the ploughing back of the savings into banking and non-banking channels that have shown an increase.

It may be pointed out that in FY00 currency in circulation recorded a higher growth of 23.6 percent mainly because of the documentation drive, UN sanction against Afghanistan and subsequent holding of currency by traders for precautionary purposes. The increase in currency in circulation in FY02, especially in relation to GDP, partly indicates rising liquidity in financial system that also helped deposit growth.

The government debt instruments (non-bank investment) continued to be a significant part of the overall financial savings. As shown in **Table.7.8**, the share of these instruments in financial savings increased from 34.2 percent in FY00 to 34.7 percent in FY02. As a ratio to GDP both the flow and stock remained higher than the FY00. It may be noted that the NSS forms the largest component of government debt instrument (non-bank investment). Over the period the share of NSS has gradually increased. Although the yield on NSS had come down, the stock ratio has shown an upward trend during the period under review. There was a substantial expansion in NSS as reflected in the 17.4 percent compound growth during 1993-2002. Reasons included the more favorable yield/interest rate on NSS together with the absence of risk as against the deposits rate offered by banking sector (see **Figure 7.13**). To contain the process on disintermedition, many steps were taken to rationalize the rate of return on NSS in line with the banking system (see **Section 4.2** for details).

The **Figure 7.14** shows the trend of financial savings from FY95 though FY02. It is seen that over this period, the financial savings have been low, averaging only 8.1 percent of GDP. However, it does show an upward trend during the FY00 and FY02. Interestingly national savings and financial savings growth rates show considerable fluctuation but no strong trend either way.

Figure 7.14: National and Financial Savings



7.5 Public Debt Vulnerability Issues

The most notable development related to Pakistan's financial stability during FY01-03 was the containment of debt stock and debt vulnerability as reflected by the reduction in total debt in terms of GDP and the improving debt servicing ratios (see **Table 7.9**). In Rupee terms, total debt stood at Rs 3,821.6 billion in FY03 showing a reduction of Rs 62.9 billion during the last two years. Accordingly, the burden of total debt in terms of GDP declined from 106.0 percent in FY00 to 95.1 percent in FY03. In addition, retirement of expensive external debt and falling interest rates on domestic debt led to a notable reduction in public debt servicing burden from 71.5 percent of total revenue in FY00 to 42.3 percent in FY03. The resulting fiscal space allowed the government to increase the much-needed development outlays, which is expected to propel the growth process in

Pakistan.[9] The achievements reflect the country's adherence to the Debt Reduction and Management Strategy (DRMS) [10], which aimed to turn Pakistan on a sound and sustainable debt path.

Table 7.9: Profile of Domestic and External Debt

billion Rupees

Debt Indicators	FY90	FY00	FY01	FY02	FY03[P]
Total debt	**835.0**	**3,336.8**	**3,884.5**	**3,783.0**	**3,821.6**
	(97.6)	(106.0)	(113.5)	(104.3)	(95.1)
Domestic debt	**378.4**	**1,578.8**	**1,731.0**	**1,717.9**	**1,852.4**
	(44.2)	(50.2)	(50.6)	(47.3)	(46.1)
External debt	**448.9**	**1,682.7**	**2,059.5**	**2,005.6**	**1,927.7**
	(52.4)	(53.5)	(60.2)	(55.3)	(48.0)
Explicit liabilities [a]	**7.8**	**75.4**	**94.0**	**59.5**	**41.6**
	(0.9)	(2.4)	(2.7)	(1.6)	(1.0)
Total public debt servicing	**66.7**	**366.3**	**340.3**	**431.2**	**304.7**
Total public interest payment	47.3	269.2	254.4	266.3	241.3
i. Domestic	35.3	218.7	195.4	199.6	198.0
ii. Foreign	11.4	44.9	51.2	61.1	39.8
iii. Explicit liabilities	0.6	5.6	7.8	5.6	3.5
Repayment of principal [b]	19.4	97.1	85.9	164.9	63.4
Ratio of total public debt servicing to					
Tax revenue	55.9	90.3	77.1	90.2	54.8
Total revenue	40.3	71.5	61.5	69.1	42.3
Total expenditure	30.1	51.7	47.4	52.2	33.9
Current expenditure	40.3	58.5	52.7	61.6	39.0

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

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

Figures in parentheses are ratios as percentage to GDP.

P: Provisional Sources: i) SBP ii) MoF

On the domestic side, Pakistan has achieved considerable success by reducing outstanding stock of domestic debt as percentage of GDP for the second consecutive year. From 50.6 percent of GDP in FY01, the outstanding domestic debt has declined to 46.1 percent of GDP in FY03. Lower budgetary borrowing requirements from the banking sector and the extraordinary influx of market liquidity due

to heavy external inflows not only helped SBP to reduce the market-driven interest rates to historic low levels but also enabled the government to reduce the short-term debt through retiring its debt stock held by SBP.

The stock of total external debt & liabilities (TDL) witnessed a reduction of nearly 6.9 percent by US$ 2.4 billion to US$ 35.5 billion during FY01-FY03. Over the last few years, a number of structural changes have led to a major re-profiling of TDL whereby the share of *expensive* TDL has

[9] Higher expenditure on servicing debt burden inevitably imposes constraints on economy's growth prospects as they drain the nation's resources and curtail the possibilities of their use on social uplift and economic development.

[10] Formulated in March 2001, DRMS envisaged a reduction in the stock of external debt through restructuring of bilateral debt, the acquisition of fresh loans on concessional terms, the containment of fiscal & current account deficit and the rationalization of NSS rates. Furthermore it also proposed to use privatization sale proceeds to retire external debt and remained committed with IMF program.

declined compared to soft term TDL[11]. Both these initiatives were made possible through a combination of rescheduling, debt write-off from US, UK and Sweden, increased availability of foreign exchange reserves and contraction of soft loans from IFIs. Unprecedented forex reserves provided the opportunity for the premature repayments of expensive external debt. In this regard, the government is preparing a strategy to retire the expensive multilateral debt while SBP has already paid the expensive commercial external debt and allowed the pre-mature payments with regard to private loans/credits. As far as the explicit liabilities are concerned, the repayments of maturing 3 Special US Dollar Bonds mainly reduced the stock of explicit liabilities by Rs 52.4 billion during FY01-FY03.

Domestic Debt

Domestic adjustments arising out of rescheduling of external debt[12] and SBP policy of sterilizing its forex market purchases, increased access to cheaper external sources and relatively better fiscal position of the government led to a distinct improvement in the level of total domestic debt during FY01-FY03. The stock of domestic debt grew by a mere 6.9 percent per annum during this period as against per annum growth of 15.4 percent during the decade of 1990s. Accordingly, the burden of domestic debt in terms of GDP declined to 46.1 percent in FY03 as compared to 50.2 percent in FY00 (see **Table 7.9**). Similarly, the stock of domestic debt in terms of total revenue also dropped from 308.1 percent in FY00 to 257.0 percent in FY03. This is indeed good news as the stock of Pakistan's domestic debt, absolute as well as relative to the national income, had been on the rise since 1995 (see **Figure 7.15**).

Figure 7.15: Outstanding Level of Domestic Debt

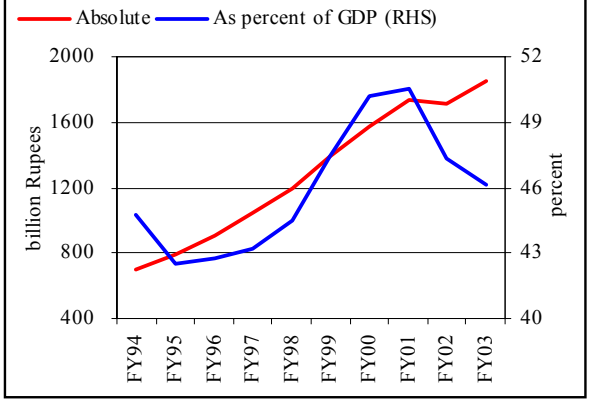


Table 7.10: Maturity Profile of Domestic Debt

percent of GDP

	FY90	FY00	FY01	FY02	FY03
Outstanding debt levels (end-period, billion Rupees)	378.0	1,578.8	1,731.0	1,717.9	1,852.4
Short-term debt	16.9	20.6	21.6	15.4	12.8
Medium & long-term debt	27.3	29.6	29.0	32.0	33.3
NSS	18.3	22.7	22.3	23.3	24.5
PIBs	--	0.0	1.3	4.2	5.7
Others	9.0	6.9	5.4	4.4	3.1

In addition, the maturity profile of domestic debt indicates that this deceleration in growth has been brought about by a substantial reduction in country's short-term debt. Specifically, the amount of short-term debt declined from 21.6 percent of GDP in FY01 to 12.8 percent of GDP in FY03 (see **Table 7.10**). However, it must be noted that this has arisen due essentially to one-time adjustments in the short-term debt and does not reflect a deliberate move towards long-term financing of the budget deficit. Moreover, given the term structure of interest rates, this shift in maturity of

[11] In addition to the current PRGF from IMF (which is on concessional terms compared to the SBA), the World Bank is also providing credit on IDA terms (zero interest rate, 0.75 percent service charge, 10 year grace period and 30-35 years repayment period). Furthermore, ADB is not only increasing its annual assistance to Pakistan, but also shifting gradually from ordinary capital resources to concessional resources of Asian Development Fund. As a matter of definition, a foreign loan is termed expensive if its cost is greater than the average return on foreign exchange reserves.

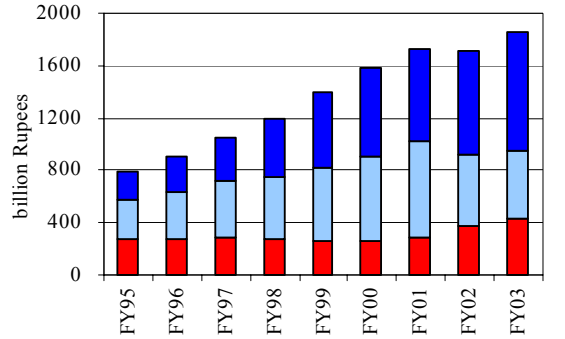
[12] The roots of this adjustment date back to the May 1998 economic sanctions imposed following Pakistan's nuclear tests. Trapped with foreign exchange squeeze, the government decided to meet its external debt servicing obligations in Rupees instead of foreign currencies, at prevailing exchange rates. Accordingly, Special Accounts for Debt Repayment were opened with SBP and rupee equivalent of debt servicing of external obligations was deposited in these accounts. With rescheduling of external debt, the need to continue with these accounts vanished. It was therefore decide to close down these accounts and adjust the amount therein with repayment of treasury bills held by SBP. Accordingly, MRTBs valuing Rs.193 billion were retired in FY02 against the amount in the Special Accounts (for details, refer to the special section on Domestic Debt in SBP Second Quarterly Report for 2001-02).

domestic debt cannot be characterized a welcome development as the government has borrowed at high cost (long-term) and retired cheap (short-term).

A component-wise analysis further reveals some interesting facts on the structure and sustainability of Pakistan's domestic debt. Firstly, floating debt recorded a sudden fall during the period under review for two distinct reasons: (1) government's decision to retire its debt held by SBP out of the funds received from USA and closure of Special Account-Debt Repayments subsequent to the rescheduling of Pakistan's external debt, and (2) SBP strategy to use new issues of T-bills as an instrument of sterilizing its purchases of foreign exchange from the interbank market and subsequent retirement by government of SBP stock of MRTBs and Adhoc treasury bills (for discussion on sterilization policy, see **Section 6.1**).

Secondly, thanks to the introduction of Pakistan Investment Bonds (PIBs) in December 2000[13], the share of permanent debt in total domestic debt has taken a hop over the period under review. As a result, in terms of GDP, permanent debt, which accounted for 8.2 percent in FY00, rose to more than 10 percent in FY03 (see **Figure 7.16**). Given that PIBs carry market rates of return and are not redeemable before maturity, fresh long-term borrowings through PIB means that the government is locking-in the benefit of historically low interest rates. This, in turn, implies reduced burden of servicing permanent debt over the coming years.

Figure 7.16: Structure of Domestic Debt



Moreover, realizing the adverse impact of higher inflows in NSS instruments on the composition of financial savings, and its implications for efficient debt management and fiscal planning, the government undertook a number of non-price and price corrections in the structure of these schemes[14]. As a result, the stock of unfunded debt has shown signs of a relatively lower growth during FY01-FY03 after a period of unabated inflows in NSS schemes (see **Figure 7.16**). Specifically, unfunded debt grew by 14.1 percent per annum during FY01-FY03 against a 17.0 percent per annum increase during 1990s. Still, the outstanding stock of NSS comprises of more than 73 percent of the medium and long-term domestic debt in FY03 (see **Table 7.10**). Given the high cost implications of these schemes, there is a pressing need to cap further inflows in NSS and substitute with a new market based instrument of NSS supplemented with PIBs as the principal source of non-bank financing of budget deficit. This, however, requires: (1) major transformation in the structure of NSS schemes, and (2) more concerted efforts to force primary dealers to develop an active secondary market of PIBs.

Indicators of servicing burden of domestic debt are presented in **Table 7.11**. Encouragingly, the effective rates of return on each category of debt have significantly declined during FY01-FY03 due to: (1) maturity of expensive long-term debt, (2) repeated cuts in NSS rates and (3) drastic reduction in the rates of return in auctions of treasury bills during FY03. Apparently, unfunded debt carried the

[13] Launched with the objective of providing for the long-term financing needs of the government as well as setting benchmark interest rates for long-term securities, PIBs have attracted the banks and non-banks alike in the absence of other avenues of risk-free investment (for details, see **Section 5.1.2**).

[14] These included elimination of institutional access to NSS, substantial reduction in rates of return, linking these rates with interest rates on PIBs, removing tax exemptions and imposition of penalty on early encashment of these instruments (for a detailed discussion on reforms in NSS, see **Chapter 5**).

highest effective rate of return in FY03 (12.3 percent per annum) compared to other components of domestic debt (5.3 percent per annum for floating debt and 11.9 percent per annum for permanent debt). However, this is entirely due to soaring interest payments on account of provincial loans and other charges. Adjusting for these, effective rate of return on NSS instruments falls to 8.8 percent per annum in FY03.

Table 7.11: Servicing Burden of Domestic Debt

	FY90	FY00	FY01	FY02	FY03
As percent of GDP					
Domestic debt	4.3	6.9	5.7	5.5	4.9
Permanent debt	1.2	1.7	1.2	1.2	1.3
Floating debt	0.7	1.9	1.6	1.5	0.7
Unfunded debt	2.3	3.4	3.0	2.8	2.9
excl. provincial & others	2.0	2.8	2.4	2.3	2.1
As percent of total revenue					
Domestic debt	23.0	42.7	35.3	32.0	28.0
Permanent debt	6.7	10.7	7.4	7.1	7.4
Floating debt	3.7	11.4	9.6	8.5	4.2
Unfunded debt	12.5	20.6	18.4	16.3	16.4
excl. provincial & others	10.7	17.0	14.9	13.6	12.0
As percent of debt level					
Domestic debt	9.6	13.9	11.3	11.6	10.9
Permanent debt	11.3	21.1	14.5	12.1	12.2
Floating debt	4.1	9.0	7.2	9.6	5.8
Unfunded debt	14.3	15.7	14.2	12.9	1.8
excl. provincial & others	12.3	13.0	11.6	10.7	9.4

Note: Interest on unfunded debt include provincial payments as well as other charges and payments

The effective rate of return on floating debt has moved according to changes in market interest rates and financing needs of government budget deficit. Rising interest rates during whole of FY01 exerted upward pressure on effective rate of return on floating debt for FY02 despite significant reduction in the level of outstanding debt during this period. However, the subsequent declining trend in market rates of return during FY02, with these rates touching their lowest levels in FY03, knocked down the effective rate of return on floating debt to just 5.3 percent per annum in FY03.

As expected, improvement in the level of total domestic debt and a fall in the average rates of return on debt instruments have translated into reduced burden of servicing domestic debt during FY01-FY03. In terms of GDP, servicing burden of domestic debt declined from 6.9 percent in FY00 to 4.9 percent in FY03. Likewise, domestic debt servicing in terms of total revenue fell from 42.7 percent in FY00 to 28.0 percent in FY03.

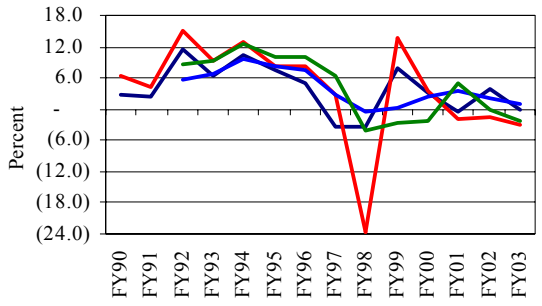
The shifts in the servicing burden of debt components attest to the changing structure of domestic debt as mentioned above. In terms of GDP, interest payments on permanent debt moved down from 1.7 during FY00 to 1.3 percent during FY03 despite continued maturity of expensive debt, reflecting a turnaround in the size of this category following the introduction of PIBs. On the other hand, interest payments on floating debt declined from 1.9 percent of GDP in FY00 to 0.7 percent in FY03. This substantial fall in servicing burden of floating debt emanates from the heavy retirement of MRTBs and fall in rates of return on T-bills to historic low levels. Similarly, following the continued reductions in rates of return on NSS instruments starting May 1999, interest payments on unfunded debt have tended to exhibit a declining trend. In terms of GDP, servicing burden of unfunded debt accounted for 2.9 percent in FY03 against 3.4 percent in FY00.

External Debt Vulnerability

The most noteworthy development related to Pakistan's total external debt & liabilities during the last three year was containment of external debt vulnerability as reflected by improving debt ratios and reversal in the growth of total external debt (TED) and total external debt & liabilities (TDL) (see **Figure 7.17**). The stock of TDL declined by US$ 2.4 billion to US$ 35.5 billion during FY01-FY03 (see **Table 7.12**). Over the last few years, a number of structural changes have occurred in Pakistan's external debt profile. The most significant changes are: (i) substitution of non-concessional loans from IFIs by soft term loans; (ii) reprofiling of bilateral loans from Paris Club on the most generous terms which significantly reduced the net present value of Pakistan's external debt; (iii) write-off of bilateral

debt from US (partial), UK and Sweden; (iv) rising exports and foreign exchange earnings enhanced the capacity of servicing external debt & liabilities; and (v) unprecedented forex reserves provided the opportunity for the premature repayments of expensive external debt. These changes, which reflect the country's adherence to the Debt Reduction and Management Strategy (DRMS), put Pakistan on the way of sound and sustainable debt path.

Figure 7.17: Growth of Pakistan's External Debt & Liabilites



External Debt Stock Position

Pakistan's total external debt (TED) at the end-June 2003 was US$ 33.4 billion while the total external liabilities (TEL) stood at US$ 2.1 billion (see **Table 7.12**). Although the stock of external debt increased by US$ 1.1 billion during FY01-FY03, it was more than offset by a US$ 3.5 billion fall

Table 7.12: Pakistan's External Debt & Liabilities

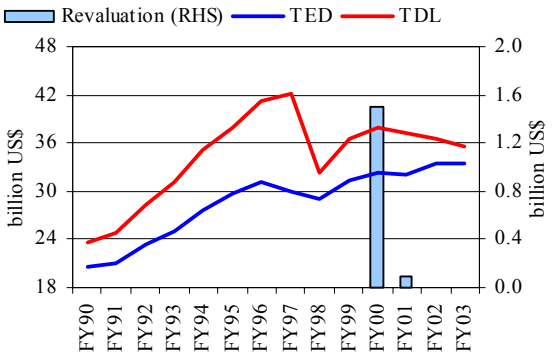
million US Dollar

	FY90	FY00	FY01[R]	FY02[P]	FY 03 [P]	Absolute Change during FY03 over FY00
I. Public and Publicly Guaranteed Debt	**19,406**	**27,862**	**28,145**	**29,235**	**29,232**	**1,370**
A. Medium and Long term (> 1 year)	19,283	27,732	27,888	29,052	29,045	1,313
Paris club	8,089	12,428	11,822	12,516	12,607	179
Multilateral	6,593	12,292	13,343	14,331	14,950	2,658
Other Bilateral	1,218	639	421	429	512	(127)
Euro bonds/Saindak Bonds	-	620	645	643	482	(138)
Military debt	2,708	653	554	819	263	(390)
Commercial Loans/Credits	675	1,100	1,103	314	231	(869)
B. Short-Term (≤ 1 year)	123	130	257	183	187	57
IDB	123	130	257	183	187	57
II. Private non-guaranteed Debts	**304**	**2,842**	**2,450**	**2,226**	**2,028**	**(814)**
Medium and Long term (> 1 year)	304	2,842	2,450	2,226	2,028	(814)
Private Loans/Credits	304	2,842	2,450	2,226	2,028	(814)
III. IMF	**839**	**1,550**	**1,529**	**1,939**	**2,092**	**542**
Total External Debt (I to III)	**20,549**	**32,254**	**32,124**	**33,400**	**33,352**	**1,098**
IV. Total External Liabilities	**3,156**	**5,664**	**5,015**	**3,132**	**2,123**	**(3,541)**
Foreign Currency Accounts	**2,116**	1,733	1,100	406	0	(1,733)
FE-45	1,089	1,072	774	234	-	(1,072)
FE-31 Deposits (incremental)	-	300	326	172	-	(300)
FE-13	-	361	-	-	-	(361)
FCAs prior to freeze	1,027	-	-	-	-	-
Special US Dollar Bonds	-	1,297	1,376	924	696	(601)
National Debt Retirement Program	-	156	150	75	7	(149)
Foreign Currency Bonds (NHA)	461	241	219	197	175	(66)
Central Bank Deposits	94	700	700	750	700	0
NBP/BOC deposits	130	781	749	500	500	(281)
Others Liabilities (SWAPS)	0	756	721	280	45	(711)
Total External Debt & Liabilities (I to IV)	**23,705**	**37,918**	**37,139**	**36,532**	**35,475**	**(2,443)**
FEBCs/FCBCs/DBCs (payable in Rs.)	355	148	*90*	*66*	*42*	**(106)**

R: Revised, P: Provisional

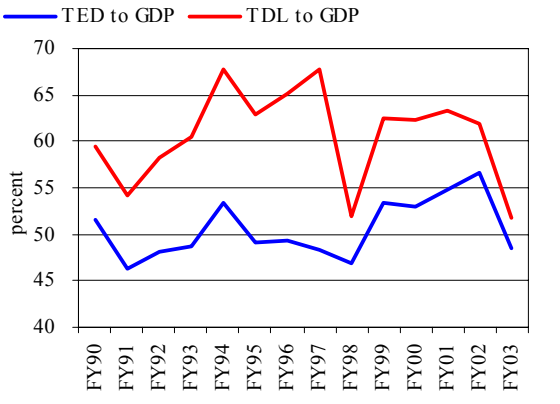
in foreign exchange liabilities. At the same time, the stock of other bilateral countries debt, Eurobonds, military debt, commercial and private loans/credits declined as Pakistan paid back US$ 2.3 billion during last three year. An interesting analysis emerges, when the compound growth rate of external debt during FY01-FY03 was compared with the growth rate witnessed during the decade of 1990s. Specifically, the average compound growth of external debt during last three years was 1.1 percent, which is well below the average compound growth of 4.6 percent witnessed during the last decade. As the stock of external debt during FY00 also included US$ 1.5 billion revaluation impact, adjusting for this decreases the compound growth rate to 4.1 percent per year during 1990s (see **Figure 7.18**).

Figure 7.18: Pakistan's External Debt & Liabilites Stock



The accumulation of external debt during the decade of 1990s was the result of higher fiscal deficit and chronic imbalances in the external sector. Specifically, large current account deficits, stagnant export revenues and declining worker remittances forced Pakistan into a debt trap. Extensive borrowings were made to finance the large current account deficit from long-term loans from bilateral countries & IFIs, resident and non-resident foreign currency accounts (FCAs) and expensive short-term commercial credit until 1998. After the nuclear test, the suspension of resident FCAs and the sanctions imposed by the major donor countries exposed the vulnerability to external debt. Consequently, Pakistan was unable to meet the external financing that led to three consecutive debt rescheduling from Paris Club within a span of five years.[15]

Figure 7.19: Debt Burden Indicators



As far as total external debt & liabilities (TDL) are concerned, until the suspension of resident FCAs in June 1998, the stock of these liabilities increased sharply. These liabilities decreased sharply thereafter, as reflected by a sharp dip in stock of TDL and the ratio of TDL to GDP (see **Figure 7.18** & **Figure 7.19**). Subsequent permission to convert FCAs into Special US $ Bonds picked up the ratio of TDL to GDP later on (see **Figure 7.19**). Furthermore, the placement of deposits with SBP from central banks of UAE and Kuwait and the contraction of swaps also contributed in the increase of TDL to GDP ratio. However, the stock of TDL declined sharply by US$ 2.4 billion during the last three years due to the repayments of maturing external liabilities and pre-mature repayments of swaps. The reversal of devaluation expectations of Rupee/Dollar parity after the September 11 also led to reversal of dollarization process in Pakistan which specifically eased the repayments of maturing Special US $ Bonds, NDRP and swaps. The bulk of these liabilities were paid in Pak Rupee as the bondholders and swap counterparties preferred to take rupee instead of

[15] Since 1998, the first rescheduling covered US$ 3.3 billion payments falling due between Jan. 1999 and Dec. 2000; the second restructuring of debt covered about US$ 1.8 billion payments falling due between Dec. 2000 and Sep. 2001; while the third and most recent rescheduling covered the entire pre-cut off debt stock of US$ 12.5 billion.

hard currency in order to avoid the risk of appreciating Rupee/Dollar parity. Additionally, the comfortable forex reserve position made it possible to repay the non-resident FCAs into hard currency and payback the FE-31 deposits to mobilizing commercial banks.

Table 7.13: Debt Stock Indicators

	Total External Debt to			RES / TED	Total External Debt & Liabilities to			RES / TDL	Total Debt Servicing to	
	GDP	Export Earnings	Foreign Exchange Earnings		GDP	Export Earnings	Foreign Exchange Earnings		Export Earnings	Foreign Exchange Earnings
FY90	51.5	416.7	240.3	2.6	59.4	480.6	277.2	2.2	43.9	25.3
FY98	46.8	344.2	217.2	3.2	52.0	382.4	241.3	2.9	55.4	34.9
FY00	53.1	393.8	252.3	4.2	62.4	463.0	296.6	3.6	37.2	23.8
FY01	54.8	359.6	224.1	6.5	63.4	415.8	259.0	5.6	38.0	23.7
FY02	56.6	365.4	216.1	13.0	61.9	399.7	236.4	11.9	44.8	26.5
FY03	48.6	306.3	170.0	28.6	51.7	325.8	180.9	26.9	28.8	16.0

Note: Foreign Exchange Earnings is the sum of earning from Goods, services, and income and private transfer.
Abbreviations: TED: Total External Debt; TDL: Total External Debt & Liabilities; RES: Foreign Exchange Reserves.

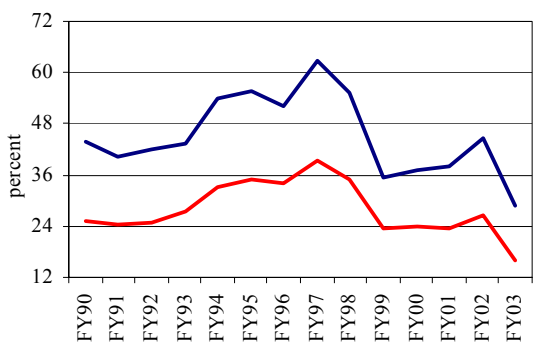
External Debt Burden and Sustainability Indicators

A number of ratios related with both debt stock and debt servicing are often used to assess the burden and vulnerability of external debt of any given country. Debt-stock indicators are generally used to assess potential solvency concerns, providing information about future debt-servicing commitments and prospective payment difficulties while the debt-service indicators measure the extent to which debt service crowds out alternative uses of resources - namely development expenditures and imports.

Various debt stock and debt servicing indicators are used to glean the extent of debt burden and debt repayment capacity for Pakistan (see **Table 7.13**). The concerted efforts of the government to contain the fiscal and current account deficit during the last three years made the economy less vulnerable to External debt as reflected by the improvement in all total external debt (TED) ratios (see **Table 7.13** & **Figure 7.19**). Similarly, an unprecedented accumulation of foreign exchange reserves during the last three years increased the forex reserves to total external debt (*RES/TED)* ratio. In case of total external debt & liabilities (TDL), since the liabilities have decreased in absolute terms during FY01-FY03, all of the liability indicators showed improvement during FY01-FY03 (see **Table 7.13**).

Looking at **Figure 7.20**, two ratios of external debt servicing worsened during FY91-FY97 but improved later on mainly due to rescheduling of bilateral debt from Paris Club. However, these ratios again worsened during FY02 despite the increasing workers' remittances. The main reason for this deterioration was that the bulk of commercial loans & credits were paid during FY02. In FY03, lower stock of expensive debt coupled with the lower international interest rates and increasing foreign exchange and export earnings improved these ratios as reflected by the dip in these indicators (see **Figure 7.20**).

Figure 7.20: External Debt Vulnerbility Indicators



7.6 Conclusion

The most noteworthy development related to Pakistan's financial stability during FY01-FY03 was the containment of debt vulnerability and improvement in debt servicing ratios. In Rupee terms, total debt

has shown a reduction of Rs.62.9 billion during the last two years. Total debt in terms of GDP declined from 106 percent in FY00 to 95.1 percent in FY03. Debt servicing burden also declined from 71.5 percent to 42.3 percent of total revenue during the same period. The stock of total external debt and liabilities declined by US$ 2.4 billion during this period to US $ 35.5 billion. The annual average compound rate of growth of external debt during last three years was only 1.1 percent compared with 4.6 percent witnessed during the last decade. These changes reflect a prudent external debt management on the part of the government that has put Pakistan on the path of a sustainable debt.

Although there was a slowdown in economic growth during FY00 and FY01 due to drought and geopolitical situation and the current growth rate is still lower than the average observed in 1980s, the turnaround that started in FY02 and accentuated in FY03 is likely to support the financial system in its move towards soundness. Macroeconomic environment in terms of inflation, budget deficit, debt servicing, forex reserves, BOP situation and the exchange rate trends is also supportive for the financial sector. Exchange rate behaviour with its allied indicators suggests that there is neither any negative pressure on the rupee in the forex market nor there is a threat of any financial crisis. NPLs of the financial institutions, which surged upto Rs.286.9 billion by end CY00, witnessed a sharp reversal during CY02. As a result, NPLs in terms of GDP have declined from 9.1 percent to 7.1 percent in the same period.

Various indicators of financial deepening and intermediation also registered improvements but the financial system of Pakistan still lags behind countries of a select peer group in many respects. Financial sector has still a long way to go to catch up with other countries in the region with similar economic characteristics. However, recent structural changes, economic revival and stronger rupee if sustained will make it possible for Pakistan to substantially improve its position at least in relation to most of the countries with the same per capita income.

Box 1:How were the Foreign Exchange Reserves Accumulated?

The most noteworthy development in Pakistan's macroeconomic fundamentals during the last three years was the unprecedented accumulation of SBP's foreign exchange reserves. Specifically, net foreign exchange reserves increased to US$ 9.6 billion at end-June 2003 from US$ 1.0 billion at end June 2000.

Contrary to popular perceptions, forex reserves started to increase well before the September 11 incident as shown by the accumulation of US$ 726 million during FY01 (see **Table 7.1**). This was the reflection of the turnaround in current account balance and resumption of IFIs assistance after the signing of Standby Arrangement (SBA) with IMF in November 2000.

Table 7.1: Causative Factors of Foreign Exchange Reserves Accumulation

million US Dollar

	FY 01	FY 02	FY 03 P
Opening Balance	1,358	2,084	4,809
Net exports of goods & services (exclu. interest payments)	-2,234	-579	-468
Private transfers	3,940	4,289	5,796
Of which:			
Workers' remittances	*1,087*	*2,390*	*4,237*
Kerb market purchases	*2,157*	*1,376*	*0*
Export of currencies	*0*	*0*	*429*
Foreign exchange companies	*0*	*0*	*273*
Resident FCAs	*534*	*485*	*159*
Official grants	842	1,500	1,014
Foreign direct investment	323	483	798
Debt servicing (Net of disbursement)	-1,657	-2,415	-1,200
Profit & dividend outflows	-301	-457	-631
Purchase of crude oil	-312	-394	-473
Foreign exchange trade financing (net)	0	0	607
Others	125	298	502
Change during the years	**726**	**2,725**	**5,945**
Ending Balance	2,084	4,809	10,754
CRR	395	472	468
Sinking Fund	0	0	730
Net Reserves of SBP	**1,689**	**4,337**	**9,556**

P: Provisional

However, the accretion of foreign exchange reserves was not only much larger but also occurred at a sharper rate during the last two years. It is evident from **Table 7.1** that despite the higher outflows of *'profit & dividend'* and *'purchase of crude oil'*[1] during the last two years, a number of factors contributed in the unprecedented accumulation of forex reserves:

(1) The most prominent factor was the increase in *'private transfers'* mainly from the surge in remittances from expatriate Pakistani workers. The international crackdown against the informal channel following the September 11 incident discouraged the transfers through the hundi channel. Therefore, the increased use of formal banking channel by the expatriate Pakistanis for transferring their remittances contributed US$ 7.7 billion during last two year. Furthermore, the establishment of Foreign Exchange Companies (FECs) during FY03 also helped finance 48.7 percent of travel expenditures.

(2) The sharp increase in net exports of goods & services (excluding interest payments) relative to the average deficit of US$ 3.3 billion during the decade of 1990s also eased the payment pressure significantly during the last two years (see **Table 7.1**). Specifically, the FY02 improvement was mainly due to the lower international oil prices, which translated into lower imports bill, while the increase in FY03 was achieved on the basis of strong exports growth. The logistic support of around US$ 1,147 million during the last two years also made a significant contribution in this sharp improvement.

(3) The windfall gain, like the US$ 600 million US cash grant (recorded in *official grants*) also contributed to the increase in forex reserves and also helped in offsetting the losses to some extent, which Pakistan experienced during the war in Afghanistan due to export order cancellation, higher war risk premium and losses in tax collections. While the Saudi Oil Facility (SOF), recorded in *official grants*, also continued to finance around 50 percent of crude oil import bill.

[1] Purchase of crude oil reflects the amount paid by the Government for the crude oil extracted in Pakistan by the foreign companies.

(4) The foreign exchange lending extended to exporters from commercial banks, totaling US$ 1.2 billion during the last two years also increased the SBP's forex reserves. However it is essentially a change in the ownership of forex reserves from commercial banks to SBP,[1] as the foreign currency amount lent to exporters is sold in the interbank market, which is then purchased by the SBP.

(5) The debt servicing (net of disbursement) also declined significantly, mainly due to the higher disbursement of IFIs assistance on soft terms during the last two years. Additionally, the debt servicing payments do not reflect the actual outflows mainly due to the reprofiling of external debt. In fact, around US$ 3.2 billion, to Paris club creditors during the last three years was not actually paid due to agreed reprofiling. This, in turn, led to higher accumulation of SBP's forex reserves.

(6) The upward trend in foreign direct investment, during the last two years, also contributed US$ 1.3 billion in forex reserves buildup.

[1] SBP has also built up a sinking fund of US$ 730 million through the purchases of foreign currency lending from the interbank market for extinguishing central banks deposits placed with SBP.