8 Domestic and External Debt

8.1 Overview

Despite a small increase in the overall debt stock during FY03, Pakistan's debt profile witnessed a significant improvement for the second successive year, with a sharp reduction in the cost of debt, a lengthening of the maturity profile, reduced dependence on external debt, as well as a sharp fall in the debt to GDP ratio.

In fact, the growth in Pakistan's overall debt stock has slowed significantly in recent years, driven primarily by the government's improved fiscal position, pre-payments of expensive debt and the strengthening of domestic currency. This was also evident in FY03, which saw the stock of public debt rise by only 1.0 percent (Rs 38.6 billion) by end-June 2003, pushing down the debt to GDP ratio from 104.3 percent in FY02 to 95.1 percent in FY03.

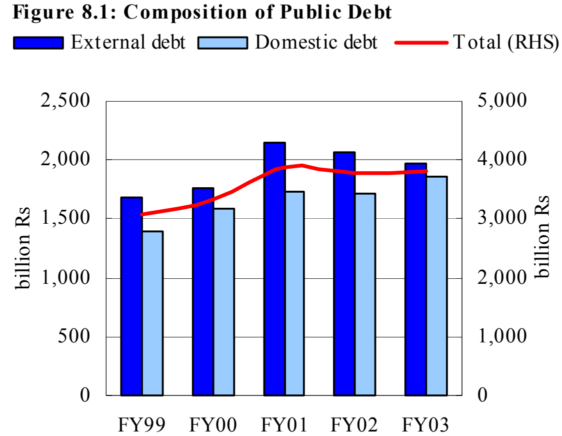
Moreover, the rise in the debt stock emanates entirely from a sharp 7.8 percent increase in domestic debt, as the rupee value of the country's external debt and explicit liabilities declined for the second successive year. In turn, all of the increase in domestic debt during FY03 stemmed entirely from long & medium-term debt (see **Table 8.1**). The latter, in particular, is certainly very commendable, given that domestic interest rates were at historical lows, however, the large share of relatively expensive borrowings through the NSS is a little disappointing.

Table 8.1: Changing Profile of Pakistan's Total Debt

	FY02	FY03	FY02	FY03
	billion Rupees		percent share	
Total debt	3,783.0	3,821.6	--	--
Domestic debt	1,717.9	1,852.4	45.4	48.5
External debt & explicit liabilities	2,065.1	1,969.3	54.6	51.5
External debt & explicit liabilities	2,065.1	1,969.3	--	--
Expensive	521.0	454.5	25.2	23.1
Soft	1,544.1	1,514.8	74.8	76.9
Domestic debt (maturity profile)	1,717.9	1,852.4	--	--
Long & medium-term	1,160.1	1,336.1	67.5	72.1
Short-term	557.8	516.3	32.5	27.9
Ownership of domestic debt	1,717.9	1,852.4	--	--
Bank	714.7	717.7	41.6	38.7
Non-bank	1,003.2	1,134.7	58.4	61.3

Also, given that the higher long & medium-term borrowings were, in part, substituting for a decline in the government T-bill stock, the share of short-term debt in the overall domestic debt dropped sharply. Furthermore, the ownership of the domestic debt also shifted, due to higher reliance on non-bank borrowings.

Figure 8.1: Composition of Public Debt

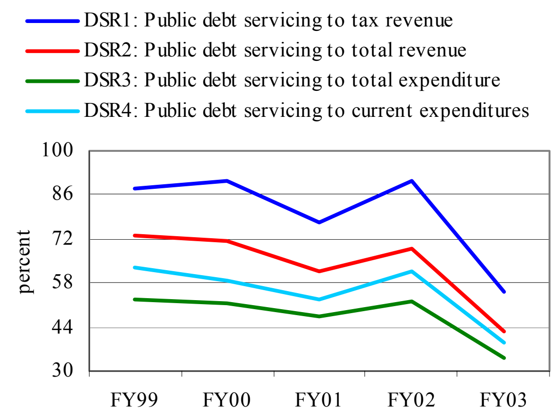


In terms of external debt, the most noteworthy development was the reduction of Rs 77.9 billion in external debt stock during FY03 (see **Figure 8.1**). However, it is pertinent to note that the FY03 reduction stems primarily from: (1) the write-off of bilateral debt totaling approximately US$ 1.0 billion by the US; (2) retirement of commercial loans; (3) repayment of first installment of Euro bonds; and (4) pre-payment of a portion of private commercial debt. Therefore, the quality of debt reduction in FY03 is significantly better than FY02 (which was only due to the

appreciation of rupee by 6.7 percent that offset a US$ 1.2 billion *rise* in the debt stock during the period).
The impact of the reduction in the stock of external debt was reinforced by: (1) the replacement of expensive external debt with cheaper borrowings, mainly due to substitution of non-concessional loans with soft loans from IFIs; and (2) re-profiling of bilateral (Paris Club) loans, that reduced its net present value by 32 percent. Also, the repayments of maturing 3-year Special US Dollar Bonds substantially reduced the stock of explicit liabilities by Rs 17.9 billion during FY03.

The above improvements, along with rising foreign exchange earnings (exports and remittances) during FY03, also enhanced the country's *capacity* of servicing external debt & liabilities. This improvement together with, the aggregate decline in the share of external debt and liabilities in Pakistan's overall debt profile makes its clear that the vulnerability of the economy to external shocks has reduced significantly during the year (see **Figure 8.1**). This trend is expected to gather further momentum with the likely pre-payment of private loans as well as the planned pre-mature retirement of expensive IFIs loans during FY04.

Figure 8.2: Public Debt Servicing Indicators



Not surprisingly, the substitution of expensive external debt with soft term debt, the re-profiling of bilateral debt from Paris Club and falling interest rates on domestic debt led to a notable improvement in all debt servicing ratios in FY03 (see **Figure 8.2**).

Despite the considerable improvement over the last few years, it is however, important to remember that the debt burden on Pakistan's economy is still significant.[1] It will require much effort and discipline over a number of years before the country returns to a sustainable debt path.

8.2 Domestic Debt

After an unusual dip in FY02,[2] public domestic debt resumed its traditional upward trend in FY03, rising by 7.8 percent to reach Rs 1852.4 billion at end-June 2003.[3] However, the FY03 growth rate is significantly lower than the double-digit average growth rate for the past five years (both excluding and including FY02).[4] This slowdown in the growth rate is attributable, *inter alia*, to: (1) greater fiscal discipline by the government and PSEs (which reduced funding requirements), as well as, (2) the increased availability of external financing (lowering the domestic financing requirements).

The other extremely significant gain during FY03 was the sharp plunge in the domestic debt servicing cost amidst a general decline in interest rates (see **Section 5.1.1**). This is most visible in short-term debt given that: (1) the decline in short-term interest rates was much greater; and that (2) the entire stock of the short-term debt was rolled-over as it matured during the year (since only a portion of

[1] According to S&P Pakistan's debt/GDP burden is amongst the worst for all rated sovereigns.
[2] During FY02, the domestic debt stock witnessed a Rs 13.1 billion decline rather than the customary rise, because of a Rs 193 billion one-time downward adjustment in the outstanding debt stock – for details, see *SBP Quarterly Report for Q2-FY02*.
[3] During FY03, outstanding General Provident Fund is also included in domestic debt stock and previous data is adjusted accordingly. Therefore, domestic debt stock is not comparable with numbers reported in previous SBP Annual Reports.
[4] Average growth rate was 15 per cent during FY92-FY01 period.

long-term debt was retried during FY03, the overall impact of lower interest rates on its stock was correspondingly smaller).

Table 8.2: Profile of Domestic and External Debt
billion Rupees

	FY99	FY00	FY01	FY02	FY03
Total debt	**3,077.0**	**3,336.8**	**3,884.5**	**3,783.0**	**3,821.6**
1. Domestic debt	**1,392.5**	**1,578.8**	**1,731.0**	**1,717.9**	**1,852.4**
	(45.5)	(47.3)	(44.6)	(45.4)	(48.5)
2. External debt	**1,614.4**	**1,682.7**	**2,059.5**	**2,005.6**	**1,927.7**
	(52.8)	(50.4)	(53.0)	(53.0)	(50.4)
3. Explicit liabilities [a]	**70.1**	**75.4**	**94.0**	**59.5**	**41.6**
	(2.3)	(2.3)	(2.4)	(1.6)	(1.1)
As percent of GDP					
Total debt	104.7	106.0	113.5	104.3	95.1
Domestic debt	47.4	50.2	50.6	47.3	46.1
External debt	54.9	53.5	60.2	55.3	48.0
Explicit liabilities	2.4	2.4	2.7	1.6	1.0
Total public debt servicing	**343.1**	**366.3**	**340.3**	**431.2**	**304.7**
Total public interest payment	220.1	269.2	254.4	266.3	241.3
i. Domestic	178.9	218.7	195.4	199.6	198.0
ii. Foreign	38.0	44.9	51.2	61.1	39.8
iii. Explicit liabilities	3.2	5.6	7.8	5.6	3.5
Repayment of principal [b]	123.0	97.1	85.9	164.9	63.4
Ratio of external debt servicing to					
Export earnings	35.3	36.5	38.0	44.8	28.8
Foreign exchange earnings	23.6	23.4	23.7	26.5	16.0
Ratio of total public debt servicing to					
Tax revenue	87.8	90.3	77.1	90.2	54.8
Total revenue	73.2	71.5	61.5	69.1	42.3
Total expenditure	53.0	51.7	47.4	52.2	33.9
Current expenditure	62.7	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 shares in total debt.

Sources: i) SBP ii) MoF

The term structure of the domestic debt also underwent a substantial change, with long-term debt constituting an increasing proportion of the public debt issued during FY03. In fact, the *entire* addition to the debt stock in FY03 stems from a rise in the long-term debt, which more than offset the reduction in short-term debt during the year. There are two important issues relating to this unusual shift in the borrowing pattern:

1) Given that long-term rates were currently at their lowest levels in past few decades, this could have extremely positive implications for the government's long-term debt servicing profile, if the fresh borrowings are used to retire the more expensive long-term debt, or for (long-term) project financing;

2) More importantly, however, there is a concern that a significant part of the abnormal jump in receipts under the NSS is only temporary. There is strong evidence that a significant component of the exceptional Rs 135.0 billion NSS receipts in FY03actually resulted from

investors' desire to take advantage of the differential between market driven interest rates and the administered rates on NSS instruments, which offered arbitrage opportunities. If so, much of the increase in the long-term debt stock could be reversed in FY04 due to rising short-term interest rates as well as regulatory action.[5]

Interestingly, the large change in the maturity profile of domestic debt is mirrored by the changes in the ownership pattern of domestic debt. This is not surprising, given that they both share a common denominator – the unusual jump in the NSS receipts that pushed up the share of NSS debt in total stock of domestic debt to 53.0 percent.[6]

Notwithstanding the above concerns, it is amply clear that during FY03 the slower rise in domestic debt, the fall in the debt servicing cost, and the lengthening of the maturity profile, in combination with the reasonably strong GDP growth, has led to a significant improvement in Pakistan's debt servicing capacity. The ratios of domestic debt to GDP and to tax revenue have continued to edge down during FY03 (see **Figure 8.3**).

Chart 1: Domestic Debt Profile in FY03

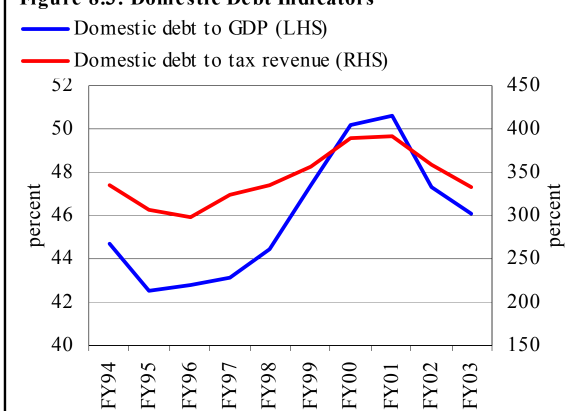
Tenor of debt	Category	Billion Rupees	Redemption
Short-term (one year or less) Rs 516.3 billion	Floating debt	516.3	Fixed maturity Rs 944.2 billion
Long-term (greater than one year) Rs 1336.1 billion	Permanent Debt	427.9	
	Unfunded debt	908.2	On demand Rs 908.2 billion

Note: Prize bonds are also included in permanent debt.

8.2.1 Composition of Domestic Debt

Domestic debt is classified into three categories largely according to the maturity structure of the debt instruments: (1) Floating debt comprises of short-term paper (T-bills), which is tradable in the market; (2) Permanent debt consists of long-term debt, but only some of these instruments are traded in the market; (3) Unfunded debt also comprises largely of long-term investments, but this is now targeted solely at individual investors, and is not traded in the market; the yields on these debt instruments do not always move in close correspondence with market rates (see **Chart 1**). Importantly, NSS instruments are available 'on tap' i.e., the government can only control their sale through indirect measures (changing tax structure, yields, etc.). Thus, any volatility in these flows can have serious repercussions for monetary management.

Figure 8.3: Domestic Debt Indicators



Permanent Debt

In absolute terms, permanent debt saw a net increase of Rs 59.9 billion (16.3 percent) during FY03 (see **Table 8.3**). As a result, the permanent debt to GDP ratio rose for a second year, reinforcing the FY02 reversal in the long-term trend. The ratio had earlier

[5] In fact, this view is strongly supported by the reported (first ever) negative growth in monthly NSS receipts during July 2003.

[6] To put this in perspective, the share of NSS debt in total debt had remained within the 40-49 percent range for the past five years. Largely reflecting this unusual jump in NSS receipts, the debt held by the banking sector declined for a second year in row.

persistently declined from 16.1 percent in FY94 to 8.2 percent in FY01 (see **Figure 8.4**). However, the FY03 rise in the permanent debt-to-GDP ratio is lower than that of FY02, because of smaller growth in net receipts and a larger GDP growth.

Table 8.3: Outstanding Level of Domestic Debt

billion Rupees

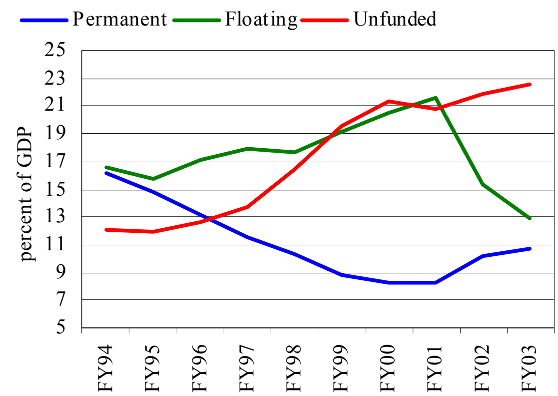
	FY99	FY00	FY01	FY02	FY03
Permanent debt	256.9	259.6	281.1	368.0	427.9
Floating debt	561.6	647.4	737.8	557.8	516.3
Unfunded debt	573.9	671.8	712.1	792.1	908.2
Total	1392.5	1578.8	1731.0	1717.9	1852.4

The lower growth in net receipt is due to the retirement of maturing bonds amounting to Rs 41.7 billion in FY03. These bonds, which are no longer issued, are Federal Investment Bonds, Market Loans and Bearer National Fund Bonds (BNFB). These retirements offset much of the growth in Pakistan Investment Bonds (PIBs)[7] as well as rising receipts through sales of Prize Bonds.[8]

Floating Debt

In sharp contrast to the Rs 134.5 billion surge in the outstanding domestic debt, the stock of floating debt dropped by Rs 41.5 billion during FY03. This is second successive year that the stock of floating debt has declined, taking the floating debt to GDP ratio to 12.8 percent, which is the lowest level since the inception of the government's market-based borrowings in 1991 (see **Figure 8.4**).

Figure 8.4: Compostion of Domestic Debt



However, while the FY02 fall was caused by a one-off accounting adjustment, the (smaller) FY03 decline reflects: (1) lower borrowing need of the government due to narrowing budget deficit; (2) the increased investors interest in long maturity debt in the face of declining interest rates (see **Table 8.3**) and, more importantly, (3) the strong inflows through external finance and NSS receipts.[9]

Unfunded Debt

The outstanding level of unfunded debt, largely comprising the NSS instruments, touched Rs 908.2 billion by end-FY03, with a sharp rise in net inflows of Rs 116.1 billion. As a result, the unfunded debt to GDP ratio increased to 22.6 percent (see **Figure 8.4**). This visible rise in unfunded debt reflects relatively higher profit rates on NSS; increased workers' remittances; and NSS arbitrage transactions.

In addition to the above, Central Directorate of National Savings (CDNS) has introduced a new scheme during FY03 named "Pensioners Benefit Scheme" with effect from January 2003. As evident from its name, this scheme is especially tailored for the benefit of the pensioners and widows.[10] The

[7]The Pakistan Investment Bond is a relatively new market-based long-term government debt instrument. Through this instrument alone, the government's *gross* mobilization reached Rs 228.7 billion by the end-FY03, as institutional investors sought to lock-in rates in expectation of a continuing decline in interest rates.

[8] As its name suggests, the Prize Bond is a non-interest bearing instruments. Investors holding these bonds are offered prizes based on a draw (i.e., the instrument effectively acts as a perpetual lottery ticket).

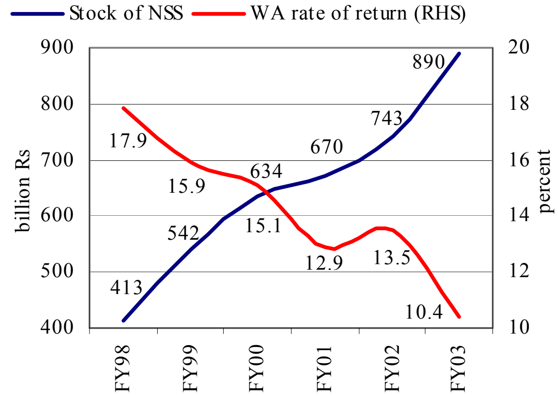
[9] These flows are largely driven by exogenous factors, and the government must per force adjust its T-bills borrowings according to these flows.

[10] The rationale of this scheme was to partially shield the retired government employees (who rely on the risk free government saving schemes) from the large reduction in yields in NSS instruments. Further, unfunded debt now also includes stock of General Provident Fund, with the average level of over Rs 18.0 billion since FY00. Earlier it was not included in this category.

scheme offers 11.04 percent rate of return and the maximum amount limit is Rs 1.0 million. During H2-FY03, account balance in the scheme has accumulated over Rs 10.0 billion.

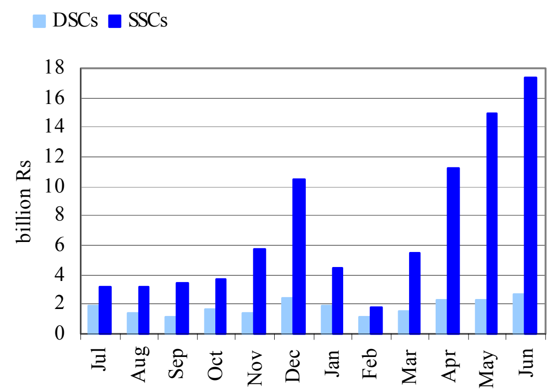
Interestingly, the outstanding investment in these instruments surged strongly (see **Figure 8.5**), despite: (1) profit rate cuts on all NSS instruments (see **Table 8.4**) inline with the FY00,[11] as well as (2) the imposition of a 10 percent withholding tax on profits from these schemes.

Figure 8.5: Stock of NSS and Rate of Return on NSS



Within NSS, it were the SSCs that have emerged as the most attractive instrument, witness massive inflows for second a year in succession (see **Figure 8.6**). This was an unusual shift in a sense as the DSCs were the most preferred instrument since early 1990s. This shift for FY02 was largely the result of higher interest rate differential between SSCs and DSCs, particularly during the second half of the year (see **Table 8.4**). But the large inflows during FY03 can be primarily attributed to the use of SSCs to take advantage of the arbitrage opportunity during the later half of FY03.

Figure 8.6: Net Inflows in DSCs Vs SSCs-FY03



The arbitrage position is overwhelmingly visible in the data for sale of SSCs through the bank outlets. Looking at **Figure 8.7**, gross sale of SSCs from bank outlets surged to Rs 86.7 billion by end-FY03 compared to Rs 32.6 billion a year before. Also, it may not be fair to attribute the entire rise of Rs 54.1 during FY03 billion as stemming from arbitrage, a portion may have come into SSCs due to relatively higher profit rates on these instruments and increased remittances. As an indirect and crude estimate, gross inflow into SSCs for FY03 on the basis of average growth of past five years, was Rs 48.9 billion higher as compared to the estimated base for FY03.

Table 8.4: Profit Rates on DSCs and SSCs

percent

	DSCs	SSCs
01-07-2001 to 31-12-2001	15.0	12.7
01-01-2002 to 30-06-2002	14.1	12.7
01-07-2002 to 31-12-2002	11.6	10.7
01-01-2003 to 30-06-2003	10.0	8.8

Compound annual average rates

8.2.2 Tenor of Domestic Debt

The tenor of domestic debt that started to shift in FY02 toward longer end, increased further during FY03 (see **Figure 8.8**). This change was facilitated by massive inflows in NSS (long and/or medium term debt) and retirement of T-bills (short-term debt). Additionally, the government also borrowed Rs 74.8 billion through PIBs.

[11] The profit rates on NSS witnessed three successive cuts from May 1999 to July 2000. However, rates were increased by around one percentage point with effect from July 2001 to offset the impact of 10 percent withholding tax imposed on these schemes effective from the same date.

This change in debt tenor has strong implications for debt management.[12] Had most of the money been borrowed from the substantially less expensive PIBs compared to the NSS of the same tenor, the benefits to the government would have been correspondingly even more pronounced.[13]

8.2.3 Classification of Domestic Debt by Owner

Domestic debt is broadly classified into two categories by ownership, i.e., by the banking and non-banking sectors. Although, the share of the banking sector in domestic debt has been declining since FY96, this trend was accentuated during FY02 and FY03 (see **Figure 8.9**).

Within the banking sector, the SBP reduced its holdings of government debt by over Rs 200 billion as a result of sterilization of foreign exchange purchases and retirement of Adhoc T-bills (see **Table 8.5**). The scheduled banks increased their share of government debt in FY03 by Rs 219.1 billion accounting for 84.7 percent of their domestic public debt holdings.

In sharp contrast to the banking sector, the debt holdings of the non-banking sector recorded an increase of Rs 131.5 billion during FY03 (see **Table 8.5**). Net inflows into NSS were Rs 135.8 billion compared to Rs 85 billion in the previous year and account for most of the increase in domestic debt.

8.2.4 Interest Payments on Domestic Debt

In contrast to FY02, which saw a rise of Rs 4.2 billion, interest payments on domestic debt recorded a decline of Rs 1.6 billion (0.8 percent) in FY03.[14] This fall in interest payments in the presence of rising stock of domestic debt was entirely driven by a sharp drop in the cost of floating debt (Rs 23.4 billion) (see **Table 8.6**).

Figure 8.7: Gross SSCs Moblization Through Banks

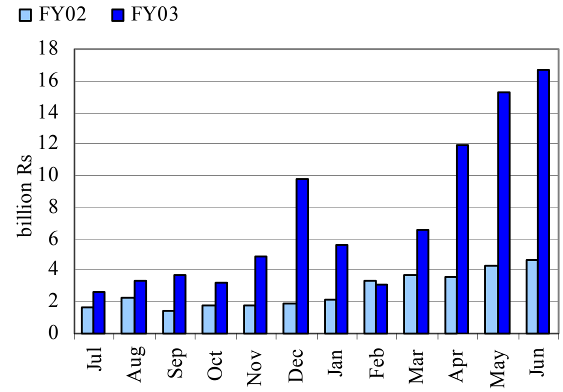


Figure 8.8: Long-Term vs Short-Term Debt

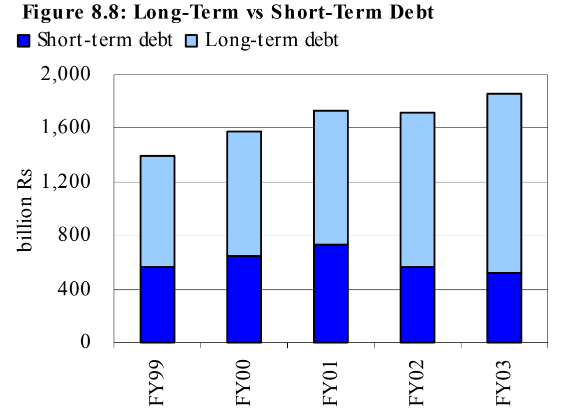
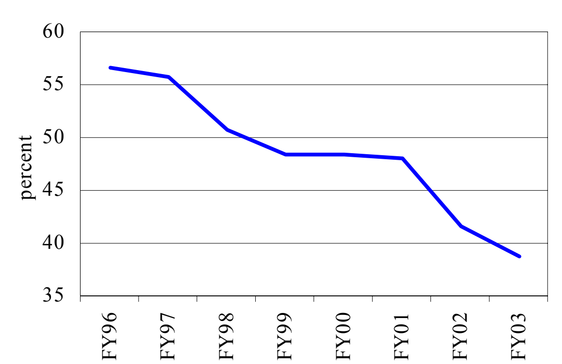


Figure 8.9: Debt Held by the Banking Sector



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[12] If the government is mobilizing long-term debt to retire existing stock of expensive debt, than it is understandable, as the government will be taking advantage of all time low interest rates.

[13] For example, the government can borrow through T-bills at average cost of around 2 percent instead of borrowing through NSS, which is a relatively expensive source of the government debt.

[14] Interestingly, while the stock of domestic debt saw a decline of Rs 13.1 billion during FY02, the revised debt-servicing figure actually shows a rise of Rs 4.2 billion during FY02. This paradoxical outcome is largely explainable by cash based accounting practices (for details see SBP Annual Report for FY02).

An increase in the interest paid on the other components of domestic debt could not offset this saving fully.

The decline in *interest payments on floating debt* is more pronounced (44.0 percent) when seen in relation to the change in stock of debt, which saw a smaller decline of 7.4 percent. The steeper fall in interest payments is largely a result of the re-pricing of the entire stock at the low prevailing interest rates. Furthermore, a significant portion of the decline this year has occurred due to the cash accounting practice that had inflated the FY02 interest payments.[15]

Interest payments on permanent debt surged to Rs 52.4 billion during FY03, up by Rs 7.9 billion in FY02, since only a portion of the older borrowings matured in FY03. This rise is primarily the result of the government's increased borrowing of long/medium term debt through PIBs and maturing expensive FIBs. Furthermore, the previous outstanding level of permanent debt also means that the average cost of permanent debt has not declined substantially.

Table 8.5: Domestic Debt by Owners

billion Rupees

	FY00	FY01	FY02	FY03
Bank Debt	**764.9**	**832.7**	**714.7**	**717.7**
Scheduled Banks	213.5	228.1	388.5	607.6
SBP	551.4	604.6	326.2	110.1
Non-bank Debt	**813.9**	**898.3**	**1003.2**	**1,134.7**
NSS	715.0	761.7	846.6	982.5
Others	98.9	136.6	156.6	152.2
Total	**1,578.8**	**1,731.0**	**1,717.9**	**1,852.4**

Table 8.6: Interest Payments

billion Rupees

	FY00	FY01	FY02*	FY03**
Permanent debt	54.8	40.7	44.5	52.4
Floating debt	58.3	53.2	53.3	29.9
Unfunded debt	105.5	101.4	101.8	115.8
Total	218.7	195.4	199.6	198.0

Note: Data on 'permanent debt' exclude interest payments on FEBC, US$ bearer certificates, FCBCs and Special US $ bonds as these bonds are classified as explicit liabilities. Data on interest payments on unfunded debt include provincial interest payments, commissions, charges, and printing charges.
Others include provincial governments' interest payments, commissions, fees, etc.

*: Data on Federal interest payments are taken from ABS FY03

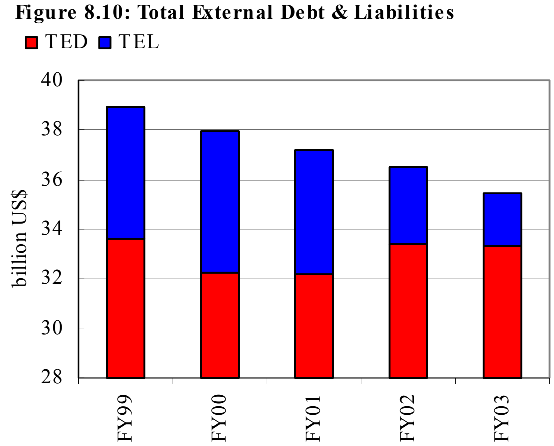
**: Latest data received from Ministry of Finance

Finally, there was a rise of Rs 14.0 billion in *interest payments on unfunded debt*. This category lumps together interest paid on provincial loans and aggregate interest paid on NSS instruments. Excluding the provincial interest payments, it emerges that the interest paid on NSS is little changed from the preceding year, as would be expected, since the low interest rates prevalent during FY03 would only impact the cost of incremental investments.

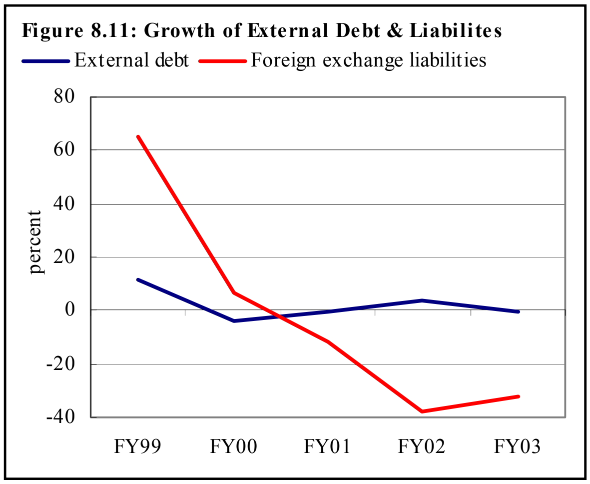
8.3 External Debt

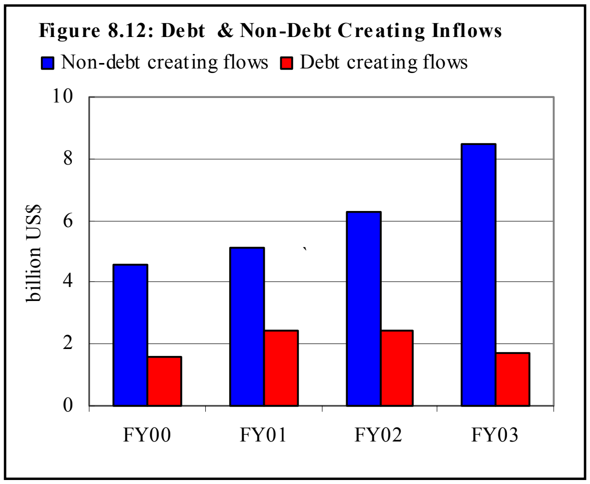
Pakistan's Total External Debt and Liabilities (TDL) fell for the fourth successive year in FY03. In fact, the 2.8 percent decline in the TDL amounting to US$ 1.0 billion during the year, reduced the outstanding stock to US$ 35.5 billion by end-June 2003 (see **Table 8.7**). As in the previous years, this TDL reduction was led by a decline in Total External Liabilities (TEL), but this year it was also supported by a slight decline in Total External Debt (TED) (see **Figure 8.10 & Figure 8.11**).

Figure 8.10: Total External Debt & Liabilities



[15] During FY02, the government had to bring forward a considerable amount of interest payments on T-bills sold out during FY01, and maturing around July 2002. As a result, the interest payments on floating debt for FY02 stayed approximately at its previous level despite Rs 180.0 billion decline in outstanding stock. This higher base for interest payments on floating debt for FY02 caused a visible change in interest payment for FY03.





The decline in TEL in FY03 has taken place as a result of the retirement of all liabilities related to foreign currency accounts, encashment of government forex bonds and the extinguishing of most outstanding swap transactions.

Pakistan did contract fresh loans during FY03, but these were on concessional terms (see **Figure 8.12**). In any case, debt creating flows were, in aggregate, lower than in FY02. In other word, the near stability in Pakistan's TED relative to FY02 stems from the retirement of more expensive debt,[16] the write-off of bilateral debt totaling approximately US$ 1.0 billion by the US, and the pre-payment of a portion of private commercial debt.

Pakistan's lower dependence on external debt, in turn, is mainly on account of a sharp jump in non-debt creating inflows[17] (see **Figure 8.12**), as well as a drop in the country's debt servicing costs arising from: (1) the completion of the Paris club debt re-profiling agreements, during FY03;[18] and (2) lower international interest rates.

Moreover, the unprecedented foreign exchange reserves[19] enabled a further consolidation of external debt through repayment of maturing expensive debt & liabilities. In this regard, government has drawn a strategy to repay the pre-mature expensive loans of IFIs. Meanwhile, SBP has also permitted prepayment of foreign private loan, which may also reduce future debt servicing costs.

8.3.1 External Debt Indicators

All key indicators of Pakistan's debt and liability in FY03 suggest a declining debt burden, and continuing improvement in the country's solvency and liquidity position (see **Table 8.8**).

Total external debt to GDP ratio provides some indication of the potential to service external debt by switching resources from production of domestic goods to the production of exports.[20] The decreasing stock of debt and liabilities in absolute terms coupled with the higher GDP growth rate improved the ratios of TED and TDL to GDP during FY03.

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[16] This includes the scheduled repayments related to the sovereign bond, IMF and other multilateral debt, etc. It is also worth noting that even the US$ 1.2 billion increase in FY02 debt stock comprised of loans on very soft terms.
[17] These flows are portfolio and foreign direct investments as well as the current account surplus.
[18] The Paris Club re-profiling led to a substantial 32 percent reduction in the NPV of Paris Club external debt stock of Pakistan.
[19] The value of net debt reduced to US$ 23.4 billion at end-June FY03 from US$ 28.6 billion at end June FY02.
[20] See "External Debt Statistics, Guide for Compilers and Users", (2003), IMF.

The hefty inflows of remittances augmented by the higher export earnings improved the ratios of TED/FEE and TDL/FEE. Similarly, ratio of foreign exchange reserves to TDL improved from 13.2 percent in FY02 to 28.2 percent in FY03.

Table 8.7: Pakistan's External Debt & Liabilities
million US Dollar

		FY00	FY01	FY02	FY03[P]
I.	**Public and publicly guaranteed debt**	**27,862**	**28,183**	**29,235**	**29,232**
	A. Medium and long-term (> 1 year)	**27,732**	**27,910**	**29,052**	**29,045**
	Paris club	12,428	11,847	12,516	12,607
	Multilateral	12,292	13,310	14,331	14,950
	Other bilateral	639	451	429	512
	Euro bonds	620	645	643	482
	Military debt	653	554	819	263
	Commercial loans/credits	1,100	1,103	314	231
	B. Short-term (≤ 1 year)	**130**	**273**	**183**	**187**
	IDB	130	273	183	187
II.	**Private non-guaranteed debts**	**2,842**	**2,450**	**2,226**	**2,028**
	Medium and long-term (> 1 year)	2,842	2,450	2,226	2,028
	Private loans/credits	2,842	2,450	2,226	2,028
III.	**IMF**	**1,550**	**1,529**	**1,939**	**2,092**
Total external debt (I to III)		**32,254**	**32,162**	**33,400**	**33,352**
IV.	**Foreign exchange liabilities**	**5,664**	**5,015**	**3,132**	**2,122**
	Foreign currency accounts	1,733	1,100	406	0
	FE-45	1,072	774	234	0
	FE-31 deposits (incremental)	300	326	172	0
	FE-13	361	-	-	-
	Special US Dollar Bonds	1,297	1,376	924	696
	National debt retirement program	156	150	75	6
	Foreign currency bonds (NHA)	241	219	197	175
	Central bank deposits	700	700	750	700
	NBP (BOC deposits)	781	749	500	500
	Others liabilities	756	721	280	45
Total external debt and liabilities (I to IV)		**37,918**	**37,177**	**36,532**	**35,474**
FEBCs/FCBCs/DBCs (payable in Rs)		**148**	**90**	**66**	**42**

P: Provisional
Source: State Bank of Pakistan

The spectacular export performance bolstered the ratio of TED/EE, while the record current account balance of US$ 4.0 billion and the lower interest payments show further improvement in the non-interest current account balance.

The ratio of external debt servicing to export of goods & services is an indicator of debt sustainability and it indicates how much of a country's exports of goods & services revenue will be used up in servicing its debt. As a result of a reduction in stock of expensive debt coupled with the lower international interest rates and increased performance of exports of goods and services, the DS/XGS ratio fell substantially during FY03 (see **Table 8.8**).

The ratio of foreign exchange reserves to short-term debt is an important indicator of reserve adequacy especially for countries maintaining access to international capital market. A smaller reserve to short-term debt ratio is associated with a greater vulnerability to shocks. **Figure 8.13** reflects marked improvement in debt paying capacity during FY03, mainly due to substantial level of reserves and retirement of short-term liabilities.

Table 8.8: Selected External Debt/Liabilities Indicators

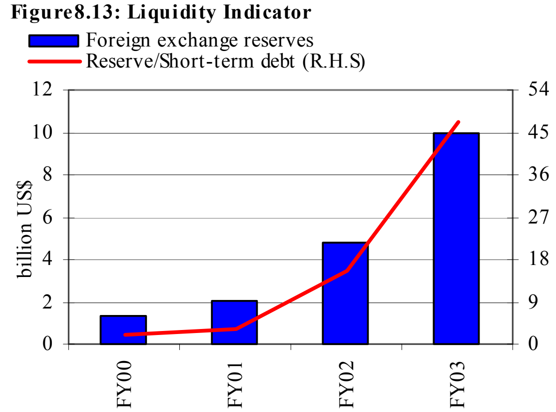
	Total External Debt to			RES/ TED	Total External Debt & Liabilities to			RES/ TDL	DS/ XGS	Non-interest current account balance (million US Dollar)
	GDP *	EE	FEE		GDP	EE	FEE			
FY98	48.5	356.5	224.9	3.1	53.7	394.7	249.1	2.8	46.0	-3,421
FY99	57.4	446.4	298.9	5.1	66.4	517.0	346.2	4.4	29.7	-457
FY00	53.1	395.1	252.9	4.2	62.4	464.5	297.3	3.6	31.6	1,381
FY01	54.9	360.0	224.3	6.5	63.6	416.2	259.3	5.6	32.7	1,874
FY02	56.6	365.7	216.1	14.4	62.1	400.0	236.4	13.2	36.7	4,299
FY03	48.5	364.7	171.8	30.0	51.6	387.9	182.7	28.2	22.8	5,131

Note: Foreign Exchange Earnings is the sum of earnings from goods, services, and income (credit entry from Item A in Table 9.2 of Statistical Annexure) and private transfer (credit entry from Item B.7 in Table 9.2 of Statistical Annexure).
* External debt to GDP ratio is not comparable to ratio calculated in **Table 8.2** due to a methodological difference. This ratio is calculated by converting the GDP into US$ using average exchange rates during FY03.
TED: Total external debt; TDL: Total external debt & liabilities; RES: Foreign exchange reserves; EE: Export earnings; FEE: Foreign exchange earnings; DS: Debt servicing; XGS: Exports of goods & services.

8.3.2 Structure of External Debt and Liabilities

The accelerated payments of external liabilities in the last few years have brought about a situation where 94 percent of EDL in FY03 consisted of external debt (see **Table 8.7**). Fortunately, the medium and long-term debt now accounts for four-fifth of the external debt stock. The two major classes of creditors are multilateral institutions and official bilateral creditors (see **Figure 8.14**).

Figure8.13: Liquidity Indicator

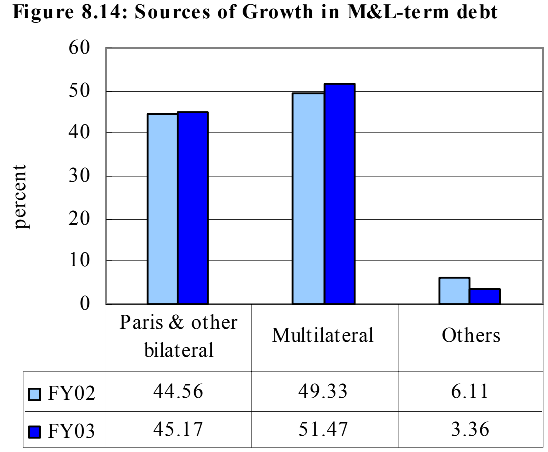


Paris club & other bilateral debt

The stock of Paris club and other bilateral creditors increased by US$ 174 million to US$ 13.1 billion at end-June FY03.

In fact, inflows increased substantially, mainly due to: (1) the capitalization of 20 percent of the accrued interest for FY03 following the 2002-Paris Club debt re-profiling; (2) reclassification of the re-profiled military loans into Paris club and other bilateral debt stock (as a result, the stock of military debt fell from US$ 819 million in FY02 to US$ 263 million during FY03); and, (3) fresh disbursement by bilateral creditors. However, the net impact of these inflows was blunted by a US$ 1.0 billion debt write-off[21] by the US.[22]

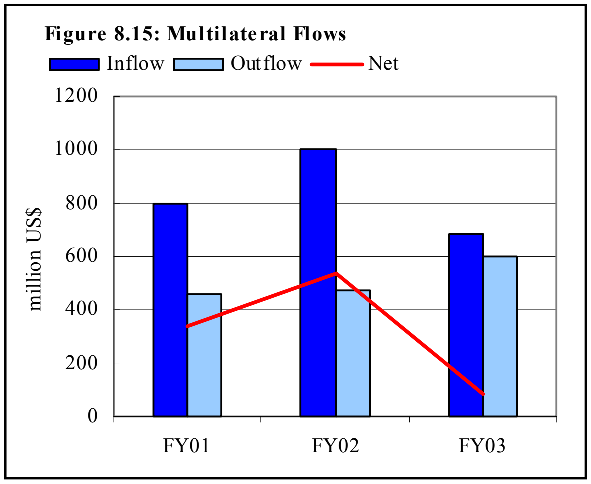
Figure 8.14: Sources of Growth in M&L-term debt



[21] Over the last two years the Paris club creditors, Denmark and Commonwealth Development Corporation (CDC) of the UK have waived off their entire outstanding debt of US$ 48 million while Netherlands has also given remission in debt service payment.
[22] The stock of US debt thereby fell to US$ 1,928 million at end-June 2003.

Multilateral debt

As a result of net inflows of US$ 87.5 million, the stock of multilateral loans rose by 4.3 percent during FY03, which was lower than the 8.0 percent growth registered in FY02 (see **Figure 8.15**). During FY03, the disbursement of soft loans was around US$ 685 million as compared to US$ 1,005.6 million in FY02, mainly due to the lower commitment in current year from IFIs.



The following inflows have been realized from IDA and ADB:

- US$ 106 million from IDA (World Bank) disbursed under Sindh Structural Adjustment Credit. The facility aims to support the economic reform program of the province, and focuses on the delivery of public services and infrastructure improvements.
- Another IDA loan of US$ 95 million was realized under the NWFP Structural Adjustment Credit. It aims to strengthen governance, social reform program, as well as fiscal and financial management reforms aimed at increasing revenues.
- US$ 102 million from the Asian Development Bank (ADB) under the programme of Rural Finance Sector Development. The goal of this programme is to ensure permanent access to institutional financial services for a majority of rural households at minimal transaction cost. The facility aims to establish a sustainable Rural Finance (RF) system for providing affordable financial services with emphasis on middle and lower segments of the RF markets.
- ADB disbursed US$ 52 million and US$ 78 million under Agricultural Sector Programme loan-II. This Program aims to improve agricultural productivity and profitability. It includes specific reform measures to (i) promote efficient markets for the major commodities, including wheat, cotton, rice, sugar, fertilizer, and seed; and (ii) strengthen support services in small farmer extension and training, research, and regulation to improve quality control.

Private Loans

These comprise of private foreign currency loans from banks/financial institution, and supplier's credits carrying a convertibility guarantee by the SBP. The stock of private loans & credits[23] witnessed a net decline of US$ 198 million to reach US$ 2 billion during FY03, despite a jump in inflows. Of the outstanding stock loans totaling approximately US$ 945 million carry an average cost of 7.79 percent while the remaining loans totaling US$ 889 million, are floating rate loans (see **Table 8.9**).

Table 8.9: Composition of Private Loans & Credits

million US Dollar

Sector	Outstanding Stock	Fixed Rate in Percent	Outstanding amount	Floating Rate
Power	499.0	3-12	821.0	libor+0.5 - libor+3.5
Fertilizer	154.0	6-11	-	-
Chemical	86.0	7-10	28.0	libor+1.5 - libor+3.5
Cement	91.6	6-12	1.6	libor + 2
Textile	67.0	5-11	5.7	libor+1.5 - libor+3.3
Communication	-	-	20.0	libor+1.5
Others	47.7	9.6	12.9	libor+1.5 - libor+6
Total	945.3		889.2	

The unusually large inflow of US$ 392 million is mainly due to the disbursement of a long-term loan to PIA and a US$ 30 million textile sector loan. On the other hand, the repayments of private loans and credits inched up in FY03; these repayments

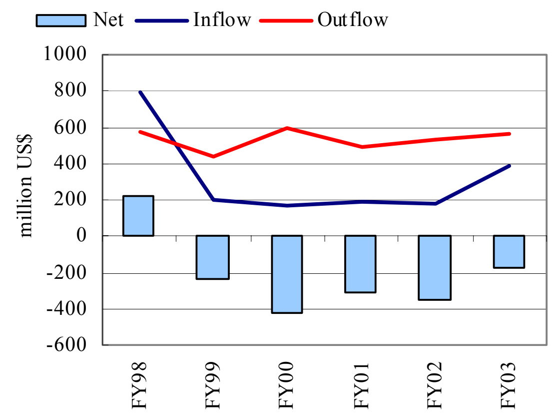
[23] The repayment period of these loans should not be less than five years with interest payable on half yearly basis.

not only included the scheduled payments but also pre-payments of private commercial loans (see **Figure 8.16**).

It may be recalled that following the substantial improvement in the country's forex reserves, the SBP had allowed the private sector to take advantage of prevailing low rupee interest rates, and substitute their expensive forex loans with rupee credit. This led to the pre-payments of loans totaling US$ 79.0 million during FY03 (see **Table 8.10**).

Pre-payment applications for loan worth another US$ 12.3 million are in the pipeline.

Figure 8.16: Private Loans and Credits



IMF

Although, the FY03 inflows remained almost unchanged from the previous year, outflows increased by 88 percent to US$ 459 million (see **Figure 8.17**).

Table 8.10: Prepayment of Foreign Private Loan
million US Dollar

Sector	Interest rate (percent)	Prepayment
Cement	6-9	61.0
Storage facilities (fixed rate)	Libor+4	2.7
Storage facilities (floating rate)	9.8	3.6
Financial business	6-8	7.0
Oil & gas exploration	Libor+2.75	4.7
Total		79.0

The latter included the repayment of expensive IMF loans such as Contingency and Compensatory Fund Facility (CCFF), and Stand By Agreement (SBA)[24] (see **Figure 8.18**). As a result, the debt stock with IMF grew merely by 7.8 percent during FY03 compared with a sharp rise of 27.0 percent last year.

Figure 8.17: Position with IMF

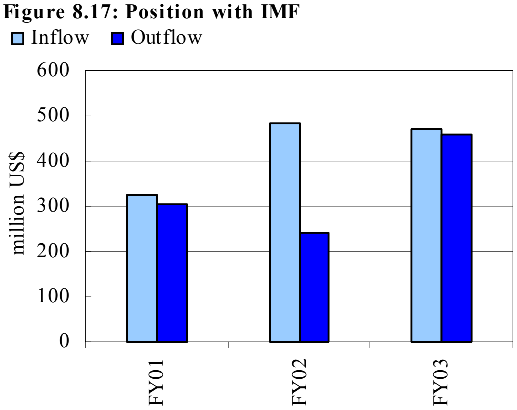
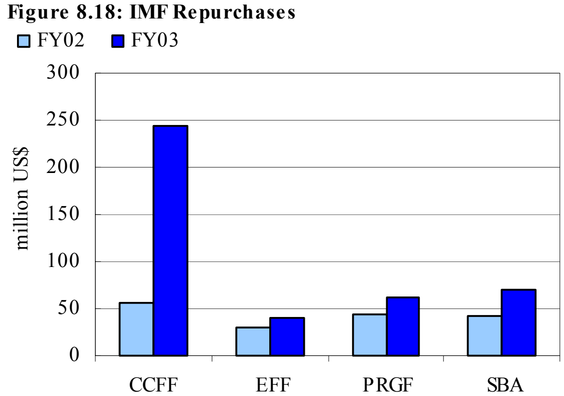


Figure 8.18: IMF Repurchases



8.4 External Liabilities

Pakistan's total external liabilites saw a net decline of US$ 1.0 billion during FY03, reducing the outstanding stock from 3.1 billion by end-June 2002 to 2.1 billion by end-June 2003. As in the previous year, the decline in total external liabilites witnessed during FY03 is dominated by a drawdown of foreign currency deposits, the extinguishing of outstanding swap transactions and the encashment and/or maturities of Special US Dollar Bonds. In fact, the steady decline in the TDL

[24] The CCFF and SBA carry weekly SDR interest rate and basic rate + 150 basic point respectively. These may be targeted for the pre-payment of expensive debt by the government.

over the last three years has contributed significantly to the fall in Pakistan debt servicing costs (see **Figure 8.10**).

Another significnt feature of the FY03 fall in the external liabilites was that most of the liabilites were extinguished through rupee payments (Special US Dollar Bonds, NDRP, and swaps). Similarly, the retirement of FE 31 reflected a shift in deposits to FE-25 deposits, and therefore did not entail an outflow of forex funds.

Foreign Currency Accounts

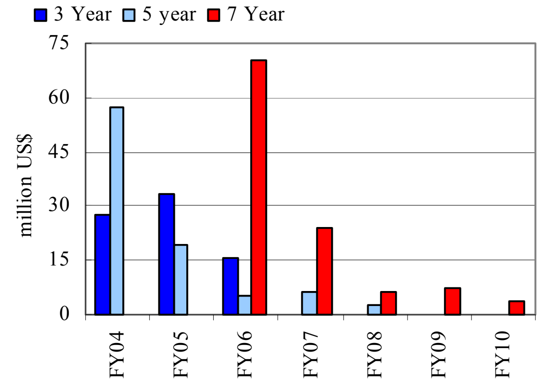
A noteworthy development for FY03 is the retirement of the entire outstanding stock of liabilities pertaining to foreign currency deposits. The FE-45[25] institutional deposits were matured and redeemed in foreign curency. By contrast, the elimination of the FE-31 deposits was generally through their conversion into FE-25 deposits. While the latter are not included in the SBP forex reserves, this shift does not impact Pakistan's aggregate forex reserves.[26]

Special US Dollar Bonds[27]

The outstanding stock of Special US dollar bonds totaled to US$ 696 million by end-June 2003, that is 24.7 percent lower than the US$ 924 million at end-June 2002 level.

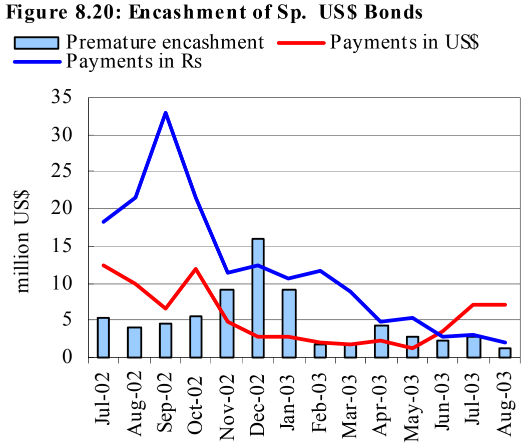
Most of the Special US$ bonds were issued between FY99 and FY00, typically with a 3-year tenor with corresponding maturities in FY02 and FY03. Interestingly, of the maturing bonds, substantial amounts have yet to be withdrawn. In other words, a significant portion of the outstanding stock of Special US Dollar Bonds carries no interest burden (see **Figure 8.19**).

Figure 8.19: Maturity Structure of Special US Dollar Bonds



The encashment of special US dollar bonds (see **Figure 8.20**) shows a significant change over the entire period of FY03. Initially, maturing bonds were predominantly redeemed in rupees as: (1) the rupee was appreciating, rendering US dollar assets relatively unattractive; and (2) the government was paying a 5 percent bonus on redemption in rupees.

Figure 8.20: Encashment of Sp. US$ Bonds



While the October 2002 end to the bonus significantly reduced rupee redemptions at maturity, expectations of a stronger rupee meant that rupee redemptions nonetheless remained higher than forex redemptions at maturity; also, the premature redemptions

[25] These deposits carry interest payments at LIBOR + 1 percent. Rupee liquidity and forward cover (at 5.5 percent) was provided to mobilizing banks. The payment made in this account is scheduled retirement.
[26] Pakistan's forex reserves = SBP reserves + Fe-25 forex deposits with the banks.
[27] This scheme was launched in July 1998, which offered 3,5 and 7 years dollar dominated instruments with interest rate payable half yearly at LIBOR + 1.0, 1.5 and 2.0 percent respectively.

continued to gather pace. However, as the appreciation of the rupee decelerated in H2-FY03, the monthly pre-mature encashment fell sharply relative to H1-FY03.

Finally, the pickup in the US dollar redemptions at maturity after May 2003 depicted the revival of kerb premium, which meant that investors could encash their maturing bonds and sell in the kerb market to get higher returns.

Table 8.11: Structure of Deposits Placed with SBP
million US Dollar

Deposit	Amount	Interest Rate	No. of time rollover	Final Maturity
Kuwait	250	4%	3	Aug-04
UAE	150	US 3-month T-bill rate +margin	3	Dec-03
do	300	do	3	Jul-05
BOC	150	Libor+1%	3	Feb-05
do	200	do	3	May-05
do	150	do	4	Feb-05
Total	1,200			

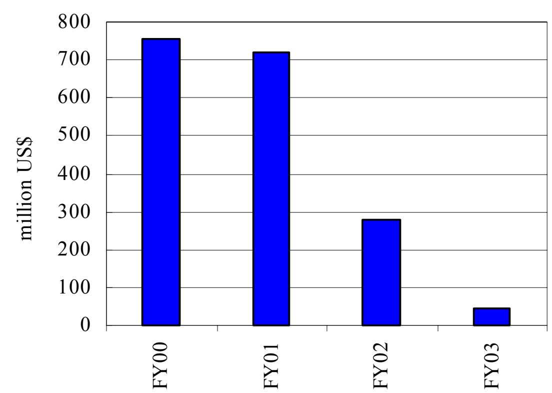
Source: Account department, SBP.

Central Banks & Bank of China (BOC) Deposits

The outstanding stock of these deposits decreased by US$ 50 million to US$ 1200 million in FY03 over FY02 due to the premature repayment of Libya deposit.[28]

These relatively high-cost deposits were mobilized in 1998 when Pakistan was facing acute shortage of forex reserves, and were thereafter rolled-over repeatedly (see **Table 8.11**). Thus, now that Pakistan has extremely healthy forex reserves, it would seem prudent to retire these liabilities.

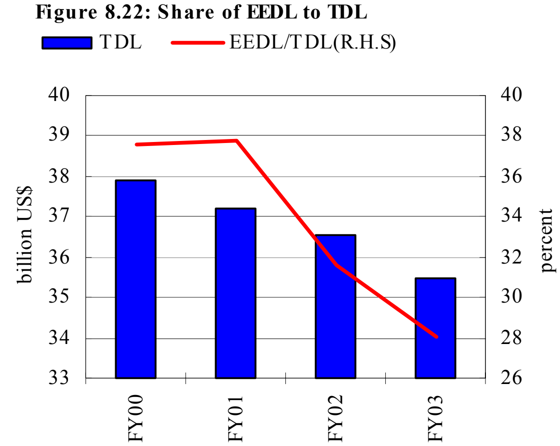
Figure 8.21: Outstanding Stock of Swaps



Other Liabilities (swap)

In view of the comfortable forex reserves position, swaps totaling US$ 235 million were retired during FY03. As a result, by end-June FY03, the outstanding stock of swaps had declined to a mere US$ 45 million (see **Figure 8.21**).

Figure 8.22: Share of EEDL to TDL



8.5 Expensive External Debt & Liabilities

The accumulation of foreign exchange reserves provided an opportunity to retire Pakistan's Expensive External Debt and Liabilities (EEDL) (see **Figure 8.22**).[29]

Out of total TDL of US$ 35.5 billion, US$ 9.9 billion comprised Expensive External Debt and Liabilities (EEDL). Of this, the Expensive External Liabilities (EEL) amount to US$ 2.1 billion and Expensive External Debt (EED) to US$ 7.9 billion (see **Table 8.12**). The decline in EED in FY03 was almost entirely achieved through normal (scheduled)

[28] Central bank of Libya placed a deposit of US$ 50 million at a rate of 4.50 percent in November 2001 for three years.
[29] External debt and Liabilities are said to be expensive if their cost is greater than the average return on forex reserves. However since the figure fluctuates over time, a benchmark rate of 2 percent has been made for the analysis.

payments of IMF expensive loans and commercial loans and some premature repayments of foreign private loans (see **Table 8.12** and **Figure 8.23**). The liquidation of the private foreign currency deposits contributed to the decline of EEL.

Table 8.12: Pakistan's Expensive External Debt & Liabilities
million US Dollar

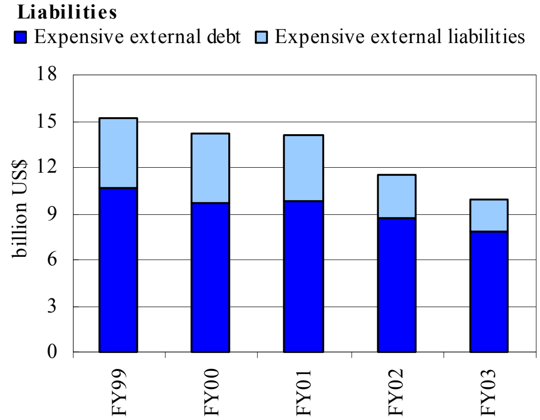
Categories	Stock as on end June FY99	FY00	FY01	FY02	FY03	Current interest rates (%)	Original contracted rates
PPG M/LT	6,827	6,684	6,927	5,831	5,525		
ADB	1,980	2,032	2,167	2,156	2,291	6.0-11	6.0-11%
IBRD	2,896	2,773	2,713	2,510	2,310	6.75-7.50	6.75-7.50%
IFAD	31	29	26	25	24	4	4%
Eurobonds	608	620	645	643	482	10	10
Commercial loans/credits	1,160	1,100	1,103	314	231	2.95	Libor + 1 to Libor + 2.65%
IDB	152	130	273	183	187	2.62	Libor + 1.5
Private loans/credits	3,435	2,842	2,450	2,226	2,028	5.9	B/w 12.5 & Libor + 6%
IMF: SBA	340	183	359	619	310	3.04	Basic rate + 150 basis point
Expensive external debt	10,602	9,709	9,736	8,676	7,863		
Expensive external liabilities	4,348	4,247	3,968	2,680	2,077		
FE- 45	1,380	1,072	774	234	0	2.12	Libor + 1 %; FC: 5.5%
NDRP	225	156	150	75	6	8.25 (avg)	7.5 to 9.0%
Special US dollar bonds	1,164	1,297	1,376	924	696	2.62	B/w Libor + 1% & Libor + 2%
Central bank deposits	700	700	700	750	700	2.05	UAE: 450 @ US T-Bill rate + margin and Kuwait: 250 @ 4%
NBP (BOC)	616	781	749	500	500	3	Libor + 1%
FCY bonds (NHA)	263	241	219	197	175	2.12	Libor + 1%
Expensive external debt & liabilities (EEDL)	14,950	13,956	13,704	11,356	9,940		
Total external debt & liabilities (TDL)	36,600	37,918	37,177	36,532	35,474		
EEDL as percent of TDL	41.6	37.6	37.7	31.6	28.0		

Six-month Libor: 1.1239 percent (June 2003); FC: Forward Cover; 6-month US T-bill: 0.94 (June 2003) and margin varies.
Where: PPG: Public & Publicly Guaranteed

8.6 External Debt and Liability Servicing

During FY03, Pakistan's external debt and liabilities servicing was lowered to US$ 4.3 billion, 31.7 percent decline from US$ 6.3 billion for FY02 (See **Table 8.13**). This is mainly due to the lower payments made on commercial loans & credits, IDB short-term loans and foreign currency accounts. The huge payments of the latter in previous years had substantially reduced their stock and, in turn, decreased the debt servicing liabilities in FY03.

Figure 8.23: Stock of Expensive External Debt & Liabilities



Moreover, the overall amount under '*rescheduling and rollover*' decreased from US$ 2.2 billion to US$ 1.9 billion, because: (1) 20 percent of the debt servicing on post-cutoff debt stock was capitalized in FY03, as against the 100 percent relief (from Nov-Jun) provided in FY02; and (2) as agreed in the earlier years, the SBP paid off the FE-45 deposits that had been rolled-over in FY02.

Table 8.13: Pakistan's External Debt and Liabilities Servicing

million US Dollar

	FY01		FY02		FY03[P]	
	Actual paid	**Rescheduled/ Rollover**	**Actual paid**	**Rescheduled/ Rollover**	**Actual paid**	**Rescheduled/ Rollover**
1. Public and publicly guaranteed debt	2,401	1,119	3,055	1,208	1,858	1,008
A. Medium and long-term (> 1 year)	2,209	1,119	2,631	1,208	1,668	1,008
Paris club	438	934	187	1,094	301	761
Principal	221	681	71	652	110	486
Interest	217	253	116	442	191	275
Multilateral	910	-	903	-	950	-
Principal	572	-	583	-	630	-
Interest	338	-	320	-	320	-
Other bilateral	221	68	124	32	96	26
Principal	180	55	100	25	71	22
Interest	41	13	24	7	25	4
Eurobonds	62	-	67	-	223	-
Principal	-	-	3	-	162	-
Interest	62	-	64	-	62	-
Military debt	56	117	24	82	-	122
Principal	56	92	19	63	-	101
Interest	-	25	5	19	-	21
Commercial loans/credits	522	-	1,326	-	98	100
Principal	445	-	1,283	-	84	100
Interest	77	-	43	-	14	-
B. Short-term (≤ 1 year)	192	-	424	-	190	-
IDB	192	-	424	-	190	-
Principal	184	-	403	-	183	-
Interest	8	-	21	-	7	-
2. Private non-guaranteed debts	696	-	795	-	816	-
Private loans/credits (M&LT>1 yr)	696	-	795	-	816	-
Principal	500	-	586	-	646	-
Interest	196	-	209	-	170	-
3. IMF	299	-	247	-	459	-
Repurchases / principal	239	-	194	-	419	-
Charges / interest	60	-	53	-	40	-
Total debt servicing (1 thru 3)	3,396	1,119	4,097	1,208	3,133	1,008
4. Central bank deposits	46	400	38	300	71	400
Principal	-	400	-	300	50	400
Interest	46	-	38	-	21	-
5. NBP/BOC deposits	209	500	287	500	18	500
Principal	147	500	249	350	-	500
Interest	62	-	38	150	18	-
6. Special US$ bonds	104	-	537	-	297	-
Principal	-	-	470	-	260	-
Interest	104	-	67	-	36	-
7. Foreign currency loan bonds (NHA)	39	-	38	-	29	-
Principal	22	-	22	-	22	-
Interest	17	-	16	-	7	-
8. Swaps	866	-	441	-	235	-
9. FCAs	365	776	777	235	411	-
FE-45 (institutional)	347	776	569	235	238	-
Principal	295	776	540	235	234	-
Interest	52	-	29	-	4	-
FE-13 (Interest)	18	-	4	-	2	-
FE-31	-	-	204	-	171	-
10. NDRP	-	-	62	-	69	-
11. FEBCs/FCBCs/DBCs	76	-	50	-	46	-
Principal	39	-	27	-	26	-
Interest	37	-	23	-	20	-
Total (1 to 11)	5,101	2,795	6,327	2,243	4,310	1,908

P: Provisional