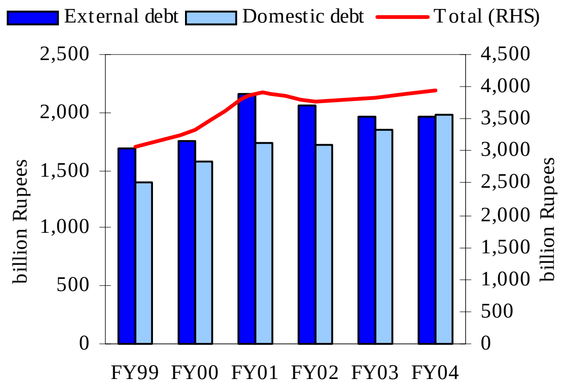
6 Domestic and External Debt

6.1 Overview

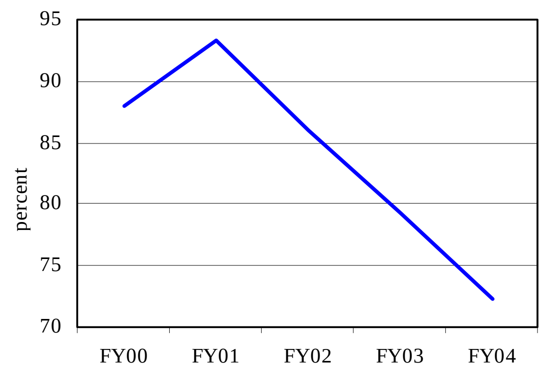
The debt profile of the country continued to improve for the third year in a row. Not only was the growth in the outstanding debt stock subdued, but the debt bearing capacity of the economy also increased. Moreover, the year saw an important structural development with the share of domestic debt rising to 50.1 percent of the total debt by end-FY04 (see **Figure 6.1**).

Figure 6.1: Composition of Debt



In terms of GDP, the burden of debt and its servicing has significantly declined in FY04. Specifically, overall debt to GDP ratio has dipped to 72.3 percent by end-FY04 from 93.3 percent in the FY01 (see **Figure 6.2**). The similar improvement in debt servicing to GDP and revenue ratios is also visible (see **Table 6.2**).

Figure 6.2: Total Debt as Percent of GDP



The deceleration in the growth of total debt principally reflects the reduction in the fiscal deficits. However, it is interesting to note that the Rs 122.3 billion rise in the debt stock during FY04 is lower than corresponding fiscal deficit of Rs 173.9 billion.[1]

These favorable changes in debt profile in the recent few years are largely attributable to: (1) increased repayment capacity of the country due to strong economic recovery, (2) subdued rise in debt supported by prudent debt management and improving fiscal discipline, and (3) low domestic interest rates.

Another notable improvement not captured in the above mentioned ratios is the impact of the substitution of expensive debt with cheaper borrowings. This was visible for both:

(1) *external debt* (e.g. the pre-payment of expensive ADB loans were partly substituted by soft loans– (see **Sub Section** on **Multilateral Debt**), and
(2) *domestic debt* (e.g. lower flows into the expensive NSS instruments were compensated by higher borrowings from relatively cheaper PIBs).

This is expected to slow the growth in debt servicing in future years.

[1] Theoretically, a change in debt stock of a country during a year should be equal to the budgetary balance of that year. However, differences can arise from revaluation of external debt (exchange rate gains/loses), quasi-fiscal activities of the government, financing of deficit from privatization proceeds, and other non-debt creating receipts.

The composition of overall debt indicates that the FY04 rise in overall debt stock came almost entirely from the domestic debt component, which saw an increase of Rs 121.7 billion while, the rise in the external debt (in rupee terms) in the same period was only Rs 9.8 billion (see **Table 6.1).** In fact, even this rise in external debt was solely on account of exchange rate adjustments as in US Dollar terms external debt actually fell by US$ 45.0 million in FY04.[2]

Table 6.1: Profile of Domestic and External Debt

billion Rupees

	FY00	FY01	FY02	FY03	FY04
Total debt	**3,336.8**	**3,884.5**	**3,783.0**	**3,824.0**	**3,946.3**
Domestic debt	1,578.8	1,731.0	1,717.9	1,853.7	1,975.4
	(47.3)	(44.6)	(45.4)	(48.5)	(50.1)
External debt	1,682.7	2,059.5	2,005.6	1,927.7	1,937.5
	(50.4)	(53.0)	(53.0)	(50.4)	(49.1)
Explicit Liabilities [a]	75.4	94.0	59.5	42.7	33.4
	(2.3)	(2.4)	(1.6)	(1.1)	(0.8)
Total debt servicing	**366.3**	**340.4**	**444.1**	**305.1**	**337.2**
Total interest payment	269.2	254.4	279.2	241.7	226.0
i. Domestic	218.7	195.4	212.5	189.0	182.0
ii. Foreign	44.9	51.3	61.1	49.2	41.0
iii. Explicit liabilities	5.6	7.8	5.6	3.5	3.0
Repayment of principal [b]	97.1	85.9	164.9	63.4	111.3
Debt as percent of GDP					
Total debt	88.0	93.3	85.9	79.3	72.3
Domestic debt	41.6	41.6	39.0	38.4	36.2
External debt	44.4	49.5	45.6	40.0	35.5
Explicit liabilities	2.0	2.3	1.4	0.9	0.6
Public debt	84.1	89.5	82.9	76.9	70.6
Ratio of public debt servicing to					
Tax revenue	90.3	77.1	92.9	55.1	55.2
Total revenue	71.5	61.5	71.2	42.5	42.2
Total expenditure	51.7	47.4	53.8	33.8	34.7
GDP	9.7	8.2	10.1	6.3	6.2
Current expenditure	58.5	52.7	63.4	37.8	42.9

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.

c) Figures in parentheses are shares in total debt.

Sources: i) SBP ii) MoF

6.2 Domestic Debt

Despite a one time-jump in the government's domestic borrowings (to fund the retirement of expensive external debt) the growth in domestic debt continued its medium term downtrend in FY04. The growth rate fell to 6.6 percent during FY04, significantly lower than the 7.9 percent growth in FY03.[3] This welcome development is largely supported by the improving fiscal discipline (in part

[2] Exchange rate movements culminating in revaluation gains/losses can play an important role in changing the overall debt profile. This is particularly true for country like Pakistan where not only is the outstanding debt is large, but the exchange rate fluctuations are also significant.

[3] To put this in perspective, the growth in domestic debt averaged approximately 12 percent in the preceding 10 years.

due to a fall in debt servicing costs), the availability of privatization proceeds to finance the budgetary deficit, as well as a rise in external funding.[4]

The moderation in the growth of domestic debt, together with the accelerating growth in the economy and the attendant rise in revenues meant that the economy's ability to service domestic debt improved substantially in FY04 for the second successive year (see **Figure 6.3**).

Table 6.2: Outstanding Level of Domestic Debt

billion Rupees

	FY01	FY02	FY03	FY04[P]
Permanent debt	281.1	368.0	427.9	536.8
Floating debt	737.8	557.8	516.3	542.9
Unfunded debt	712.1	792.1	909.5	895.6
Total	1,731.0	1,717.9	1,853.7	1,975.3
As percent of GDP				
Permanent debt	6.8	8.4	8.9	9.8
Floating debt	17.7	12.7	10.7	9.9
Unfunded debt	17.1	18.0	18.9	16.0
Total	41.6	39.0	38.4	35.8

Figure 6.3: Domestic Debt as percent of

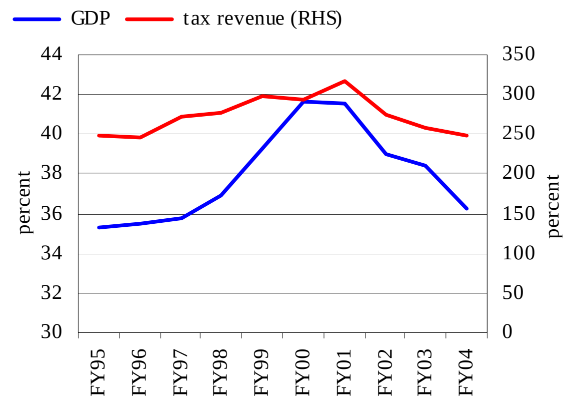
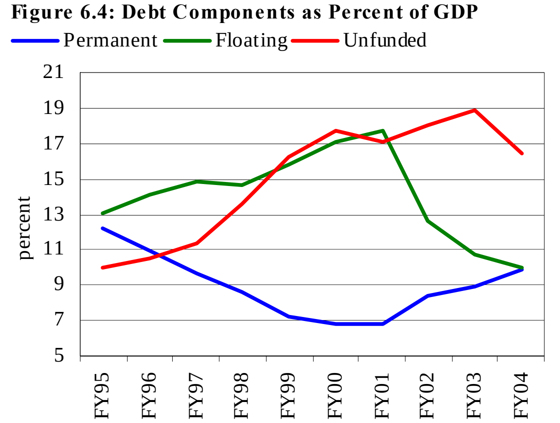


Figure 6.4: Debt Components as Percent of GDP



6.2.1 Composition of Domestic Debt

Although overall domestic debt to GDP ratio declined for the fourth year in row, the trends in the major sub-categories diverged (see **Figure 6.4**). These changes reflect positively on the government's debt profile.

The fall in the floating debt to GDP ratio indicates a lengthening of the maturity profile of domestic debt (suggesting that debt servicing costs will be relatively less sensitive to rising interest rates). Similarly, while the decline in the unfunded debt ratio has been largely offset by a rise in the permanent debt components, this too implies a fall in debt servicing costs (since permanent debt instruments carry relatively lower interest rates than comparable unfunded debt instruments). Thus, the improvement in the debt servicing capacity has been further helped by the changes in the composition of the domestic debt.

The changes in the debt stocks are explored in greater detail below:

Unfunded Debt

For the first time in the last three decades, FY04 witnessed a small (1.5 percent YoY) decline in the stock of unfunded debt, against the 14.8 percent YoY increase in FY03 and the average annual rise of 19.7 percent for the preceding 10 years. In absolute terms, the decline of Rs 13.9 billion in unfunded debt lowered the outstanding stock of unfunded debt to Rs 895.6 billion by end-FY04.

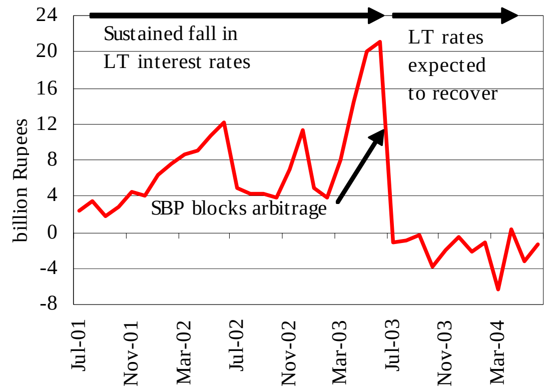
This dramatic shift in the flows of unfunded debt during FY04 is entirely due to dwindling net receipts from the National Savings Schemes (NSS), which constitute over 90 percent of the debt in this category.

[4] While net external aid inflows declined in FY04, the country issued a US$ 500 million sovereign Eurobond.

National Savings Schemes[5]

Net mobilization from NSS saw a decline of Rs 22.6 billion (2.6 percent YoY) during FY04 in sharp contrast to a rise of Rs 109 billion (14.7 percent YoY) in FY03. Moreover, a monthly breakup of NSS receipts indicates that net mobilizations from NSS remained negative throughout the year under review (see **Figure 6.5**).

Figure 6.5: Net Flows from NSS-FY02-FY04



As a result, the actual mobilization through NSS was negative with a massive shortfall of Rs 61.2 billion compared to the annual target of Rs 38.6 billion for FY04. Also, while receipts through all major instruments declined, the bulk of the shortfall was in SSC receipts (see **Table 6.3**).

Table 6.3: Target Vs Actual Net Flows in NSS During FY04

million Rupees

Instruments	Target	Actual	Difference
DSCs	11,700	3,264	-8,436
SSCs	26,900	-13,176	-40,076
RICs	-23,700	-48,868	-25,168
SSAs	1,500	2,042	542
PBAs	22,000	13,209	-8,791
Others	214	20,945	20,731
Total	**38,614**	**-22,584**	**-61,198**

Much of the fall in the net mobilization under NSS during FY04 can be explained by factors such as: (1) changes in interest rate expectations; (2) the inability of institutional investors to re-invest in these schemes; (3) restriction on sale of NSS instruments through banks (making these investments less readily accessible); and (4) possibly, the impact of the reversal of arbitrage transactions undertaken in FY03.

Table 6.4: Profit Rates on Major NSS and PIB

Percent

	National Savings Schemes			Pakistan Investment Bonds		
	DSC	SSC	RIC	10 Year	5 Year	3 Year
H1-FY00	15.97	14.33	16.00	--	--	--
H2-FY00	15.01	12.33	14.00	--	--	--
H1-FY01	14.01	11.17	12.48	--	--	--
H2-FY01	14.01	11.17	12.48	13.99	12.98	12.46
H1-FY02	15.01	12.37	12.48	12.46	12.07	11.59
H2-FY02	14.13	12.37	12.48	10.62	9.77	8.78
H1-FY03	11.61	10.47	10.56	8.14	7.34	6.66
H2-FY03	10.03	8.67	9.12	4.81	3.64	2.94
H1-FY04	8.50	7.67	7.68	6.20	5.04	4.02
H2-FY04	7.96	7.16	6.96	6.79	5.07	3.98

The fall in the rate of return on major NSS began in FY02, when these were linked through a formula with the yields of other government bonds that were traded in the market – the Pakistan Investment Bonds (PIBs) – of the same maturity (see **Table 6.4**). However, during the entire period, the yields on NSS remained higher than for other instruments. In fact, investment in NSS actually increased in FY02 and FY03 when interest rates were declining. The subsequent fall in net receipts seen in FY04 therefore seems more likely driven by hopes of a *rise* in rates in the months ahead. While the changing interest rate expectations probably played a major role in depressing SSC gross receipts, a significant contribution to the net decline of Rs 13.2 billion is also from pre-mature encashment; the gross retirements of the three-year SSCs in FY04 totaled Rs 82.8 billion, which are higher than the gross sales in FY01 (which would be normally mature in FY04). It is instructive to note that the arbitrage transactions that occurred in FY03 were principally through SSCs and these would be reversed in FY04.

[5] Here NSS do not include the Prize Bonds, as these are classified under the category of permanent debt.

The large net negative flows of 5-year RICs however, probably owe more to normal retirements. Receipts through RICs had jumped sharply in FY99, and a corresponding jump in maturities was to be expected in FY04. It is worth noting that reinvestment of maturing RICs would expected to be lower than maturities, as (1) institutional investors could not reinvest, and (2) for individuals, the returns on competing financial instruments (for example Bahbood Savings Certificates and Pensioners Benefit Accounts) were higher. Moreover, even for individuals, a complete switch would not be expected, due to investment limits on these new schemes. This view is supported by the FY04 data (See **Figure 6.6),** which appears to indicate a limited substitution between RICs and new schemes viz. *Pensioners Benefit Accounts* (PBAs) and *Bahbood Savings Certificates* (BSCs) which collectively increased by Rs 35.9 billion.[6]

Figure 6.6: Net flows in RICs vs BSCs and PBAs in FY04

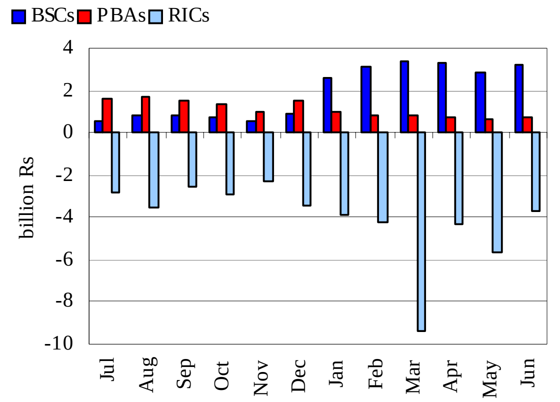
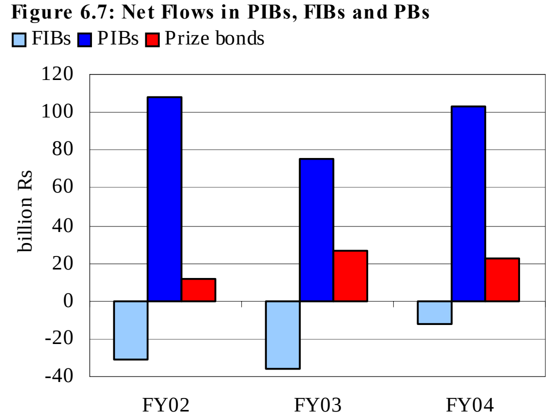


Figure 6.7: Net Flows in PIBs, FIBs and PBs



Permanent Debt

In absolute terms, the stock of permanent debt rose to Rs 536.8 billion by end-FY04, up a stunning Rs 108.9 billion from end-FY03. This increase accounts for 88.3 percent of the total rise in domestic debt during the year and is nearly twice the increase seen in FY03.

In turn, the breakup of permanent debt shows that almost the entire rise in permanent debt was from Pakistan Investment Bonds (PIBs), which recorded a net increase of Rs 103 billion during FY04.[7] This was supported by a smaller rise in receipts from prize bonds, which netted Rs 22.8 billion (see **Figure 6.7**).[8]

The surge in the outstanding stock owes to both the net decline in unfunded debt (that increased the government's borrowing requirements) and as well as the strong appetite for PIBs, particularly from financial institutions.

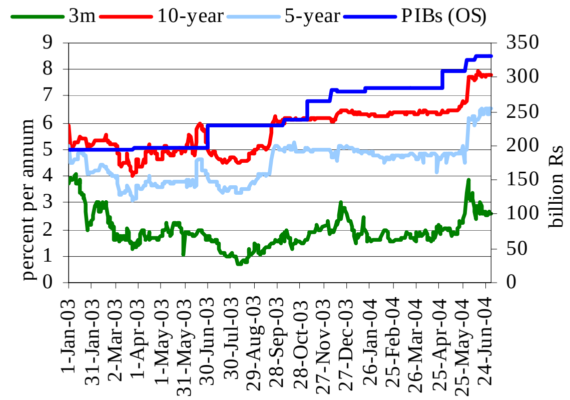
The latter was driven by both the possibility of garnering capital gains (as LT interest declined) as well as the profitable spread between the relatively high returns on the long-term PIBs and the low cost of funding thorough purchases from the interbank market (see **Figure 6.8**). This view is supported by the sharp drops in demand for PIBs as long term interest moved up (raising the risk of large capital losses).

[6] These two schemes, which offer higher returns compared to other government securities, were introduced to partially insulate the incomes of retired government employees and widows, from the sharp fall in interest rates. As the schemes targeted only the less wealthy individuals in this segment, the permissible investment limits were kept at Rs 2 million and Rs 1 million respectively.

[7] Pakistan Investment Bond is the only long-term tradable debt instrument of medium to long term maturity.

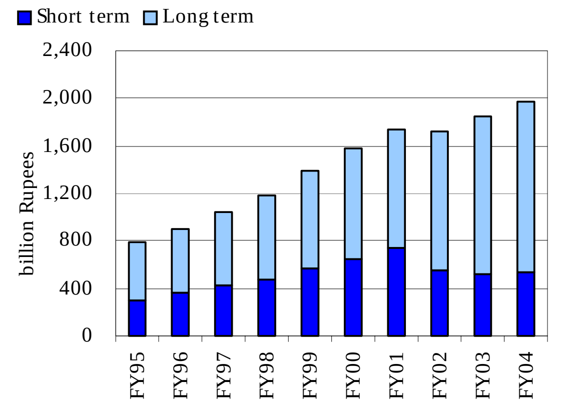
[8] While other instruments like market loans, Federal Investment Bonds etc. are no longer issued and hence showing net retirements

From the perspective of the government, the exceptionally large PIB issues in FY04 allowed it to lock-in long terms funds at very low rates (reducing the vulnerability of debt servicing costs to movements in interest rates).



Floating Debt

After showing a declining trend during the last two years, floating debt increased by Rs 26.7 billion to reach Rs 542.9 billion by end-FY04. The break up of floating debt indicates a shift in the government borrowing from the scheduled banks to the SBP. Specifically, while the government borrowing from the SBP recorded a rise of 84.0 billion during FY04, the government retired t-bills worth Rs 57.3 billion held by the scheduled banks.



6.2.2 Tenor of Domestic Debt

Corresponding to the above developments, changes in the tenor of debt are also visible. The short-term debt has increased by Rs 26.7 billion during FY04 in contrast to the decline for the last two consecutive years (see **Figure 6.9**). But the share of long-term debt in total domestic debt has been increasing since FY02.

Within long-term debt, the most important development is the relative shift of the government borrowing from expensive DSCs and SSCs to comparatively cheaper PIBs. The net increase of Rs 103 billion in the outstanding stock of PIBs is in sharp contrast of net Rs 9.9 billion reduction in the stock of DSCs and SSCs during FY04. This implies that the government was not only able to benefit from the low interest rate regime, but also to improve its debt maturity profile.

Table 6.5: Domestic Debt by Owners

billion Rupees

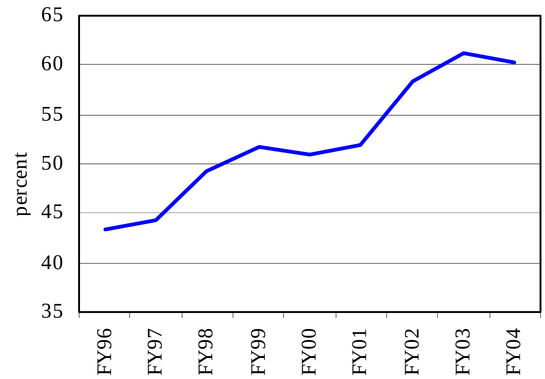
	FY00	FY01	FY02	FY03	FY04
Bank Debt	**764.9**	**832.7**	**714.7**	**717.7**	**785.4**
Scheduled Banks	213.5	228.1	388.5	607.6	652.2
SBP	551.4	604.6	326.2	110.1	133.3
Non-bank Debt	**795.0**	**898.3**	**1,003.2**	**1,136.0**	**1,189.9**
NSS	715.0	761.7	846.6	982.5	982.7
Others	80.1	136.6	156.6	153.5	207.2
Total	**1,559.9**	**1,731.0**	**1,717.9**	**1,853.7**	**1,975.4**

6.2.3 Classification of Domestic Debt by Owner

Domestic debt can broadly be classified into bank and non-bank debt according to the ownership profile of the debt. The share of bank debt, which had declined considerably during the last two years, increased slightly during FY04. Within the banking sector, both SBP and scheduled banks increased their holding of government debt by Rs 67.8 billion, moving their combined share to 39.8 percent of domestic debt from 38.7 percent last year (see **Table 6.5**). This rise in bank debt is the result of increased investment of scheduled banks in PIBs and the massive government short term borrowing from the SBP.

Although the share of the non-banking sector in total domestic debt has declined in FY04, it still dominates the profile of the total domestic debt (see **Figure 6.10**). The FY04 marginal decline is largely attributable to the net outflows of Rs 22.6 billion from NSS.

Figure 6.10: Debt Held by the Non-Bank



6.2.4 Interest Payments on Domestic Debt
The interest paid on domestic debt continued to decline for the second successive year. However, the fall of Rs 6.7 billion (3.5 percent YoY) during FY04 was smaller than the decline of Rs 23.6 billion (11.1 percent) recorded in FY03 (see **Table 6.6**).

The fall in the *interest payments of floating debt* contributed most to the improvement. This is not surprising given that the cost of the entire stock of these short-term instruments declined sharply during FY04. *Interest payments on unfunded* debt also showed a minor decline of 0.4 percent YoY in FY04. The slow growth in the outstanding stock of NSS and decline in interest rates during last three years have cut down the interest payments of medium-term instruments like SSCs and RICs under this category. However, higher interest payments on account of DSCs off set the part of the gains.

Table 6.6: Interest Payments on Domestic Debt

billion Rupees

	FY00	FY01	FY02	FY03	FY04
Permanent debt	54.8	40.7	44.5	50.2	56.4
Floating debt	58.3	53.2	53.3	27.0	16.1
Unfunded debt	87.2	82.6	85.0	84.8	84.5
Others	18.3	18.8	29.7	27.0	25.3
Total	218.7	195.4	212.5	189.0	182.3

Data on Permanent Debt exclude Interest Payment on FEBC, US $ Bearer Certificates, FCBC and Special US $ Bonds as these bonds are classified as explicit liabilities.
Others include provincial governments' interest payments, commission, fee etc.

Source: Ministry of Finance

It is important to note that the funds mobilized by the government through DSCs during FY94 were at higher rates of interest. As their maturity is falling during FY04, it has raised the interest payments under this head. Moreover, the greater proportion of relatively high yielding DSCs sold FY95 onwards meant that interest payments in this head would not decline in proportion to the fall in average interest rates in the economy.

The only rise witnessed in the domestic interest payment came from the *interest payments on permanent debt*. It showed an absolute increase of Rs 6.3 billion in FY04 compared with the increase of Rs 5.6 billion last year. The increased interest payments in this category owes primarily to the strong rise in the total outstanding stock of PIBs. Thus, even as the offered yields on the instruments declined in recent years, the cumulative coupon payments continued to rise.

6.3. External Debt
In absolute terms, Pakistan’s total external debt and liabilities (TDL) saw a marginal decline in FY04, dropping by 0.61 percent to US$ 35.2 billion (see **Table 6.7**). As in the preceding year, this outcome was mostly due to a reduction in total external liabilities (TEL) with a minor contribution from a net decline in total external debt (TED).

The lower fall in the external liabilities was to be expected as most of the expensive liabilities had already experienced sharp reductions in the preceding year, leaving lesser room for any further drop during FY04. In fact, practically the US$ 171 million decline is primarily due to maturing Special

Table 6.7: Pakistan's External Debt & Liabilities
million US Dollar

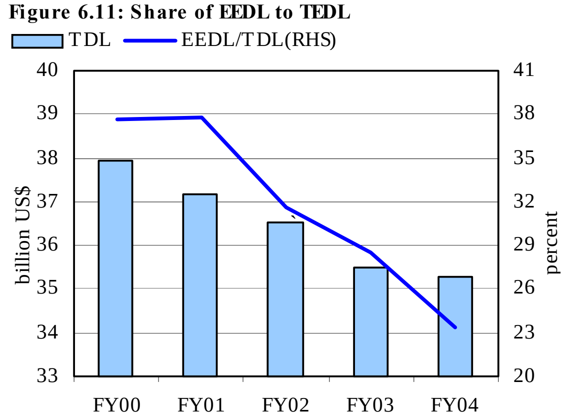
	FY01	FY02	FY03	FY04p
I. Public and publicly guaranteed debt	**28,145**	**29,235**	**29,232**	**29,875**
A. Medium and long term (>1 year)	**27,888**	**29,052**	**29,045**	**29,853**
Paris club	11,822	12,516	12,607	13,558
Multilateral	13,343	14,331	14,950	14,349
Other bilateral	421	429	512	720
Euro bonds/Saindak Bonds	645	643	482	824
Military debt	554	819	263	204
Commercial Loans/credits	1,103	314	231	198
B. Short-term (<1 year)	**257**	**183**	**187**	**22**
IDB	257	183	187	22
II. Private non-guaranteed debts	**2,450**	**2,226**	**2,028**	**1,670**
Medium and long-term (>1 year)	2,450	2,226	2,028	1,670
Private loans/credits	2,450	2,226	2,028	1,670
III. IMF	**1,529**	**1,939**	**2,092**	**1,762**
Total external debt (I to III)	**32,124**	**33,400**	**33,352**	**33,307**
IV. Foreign exchange liabilities	**5,015**	**3,132**	**2,122**	**1,951**
Foreign currency accounts	1,100	406	-	-
FE – 45	774	234	-	-
FE - 31 deposits (incremental)	-	-	-	-
FE-13	326	172	-	-
Special U.S dollar bonds	1,376	924	696	552
National debt retirement program	150	75	6	1
Foreign currency bonds (NHA / NC)	219	197	175	153
Central bank deposits	700	750	700	700
NBP (BOC deposits)	749	280	500	500
Other liabilities (SWAP)	721	500	45	45
Total external debt and liabilities (I to IV)	**37,139**	**36,532**	**35,474**	**35,258**
FEBCs/FCBCs/DBCs (payable in Rs.)	*90*	*66*	*42*	22

P: Provisional
Source: State Bank of Pakistan

US$ bonds. On the other hand, the negligible fall in external debt appears surprising in light of the large pre-payments of public and private loans in FY04 and requires an explanation.

In fact, the impact of the pre-payment of official & private commercial debt,[9] and scheduled retirement of expensive loans[10] was offset by the disbursement of fresh inflows (approx. US$ 2.2 billion), interest capitalization (US$ 306 million) and, most importantly, the revaluation impact (US$ 1 billion) on the stock of non-US$ denominated debt (mainly Paris Club debt).

Figure 6.11: Share of EEDL to TEDL



However, while the stock of TED did not change significantly, the pre-payments did contribute to a significant reduction in the outstanding stock of Expensive External Debt and Liabilities (EEDL), the share of which in

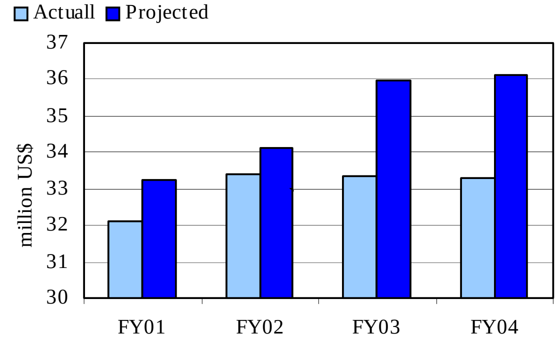
[9] These pre-payments include US$ 350 million by PARCO to JBIC, US$ 1.17 billion to ADB loan, and US$ 65.8 million of private non-guaranteed debt.
[10] This includes the schedule repayment of IMF, commercial loans & credits, short-term IDB and other bilateral and multilateral debt.

TDL declined sharply in FY04 (see **Figure 6.11**).

During the last three years, Pakistan has been able to contain growth in the external debt burden. This performance is quite remarkable when we compare the current external debt stock with the projections made in the Debt Management and Reduction Strategy (see **Figure 6.12**).

Other important developments regarding Pakistan external debt during FY04 are the following:

Figure 6.12: External Debt Stock



Note: Projections are based on Report of the Debt Management Strategy, 2001

1. Pakistan re-entered in the international capital market with the issuance of a five-year Eurobond amounting to US$ 500 million. In addition to providing a source of funding, the issuance of euro bond also forces a self-monitoring mechanism on economic performance; a well-distributed sovereign issue (particularly if held by institutional investors that closely monitor their holdings), becomes an important benchmark for sovereign risk.

2. During FY04, Pakistan substituted hard-term debt with soft-term debt. In particular, Pakistan contracted fresh soft loans from IDA and paid back US$ 1.17 billion expensive loan to ADB.

3. Pakistan has also benefited from upward revision in its credit rating by Moody's investor services that raised country's long-term foreign currency debt to B2 from B3.

4. Finally, in August 2004, the US government wrote-off US$ 495 million debt to Pakistan. This increased the total debt relief from USA during last three years to US$ 1.495 billion (see **Table 6.8**). However, the resulting decline in total outstanding stock with USA was not fully realized as it was marginally offset by other charges.[11]

Table 6.8 Impact of US Debt Write-off
million US$

Stock as on end June-01	**2722**
Inflow	10
Repayment of Principal	-23
Debt relief	-1495
Other charges	347
Exchange rate fluctuation	0
Stock as on end Sep-04	**1561**
Stock as on end Sep-04 (without charges)	1214

6.3.1 External Debt Indicators

As evident from **Table 6.9**, all indicators of external debt sustainability exhibited significant improvement during FY04. The sharp improvement is more visible in indicators relating to external liabilities. The rise in net private transfers and higher exports led to increase in foreign exchange earnings during FY04. This in turn improved the ratios of external debt and external liabilities with foreign exchange earnings during the year (see **Figure 6.13**). Similarly, the recorded level of foreign exchange reserves in FY04 further raised the reserves to external debt ratio during FY04.

In terms of short-term debt, the massive retirement of ADB & Commercial loans remarkably improved with foreign exchange reserves in FY04. While the ratio of debt servicing to exports of good & services worsened during FY04, this was essentially due to a one-time effect caused by the large prepayment of expensive loans.

[11] Other charges include interest rate capitalization, deferred payments and impact of debt rescheduling.

Table 6.9: Selected External Debt/Liabilities Indicators

	Total External debt to			RES/TED	Total External Debt & Liabilities to			RES/TDL	DS/XGS	RES/ST	Non-interest Current Account Balance (million US Dollar)
	GDP	EE	FEE		GDP	EE	FEE				
FY00	43.9	393.1	252.4	3.1	51.8	462.9	297.3	2.6	31.6	1.4	1,381
FY01	45.1	359.8	224.2	5.2	52.1	415.8	259.0	4.5	32.7	2.5	1,874
FY02	46.6	365.4	216.1	13.0	51.0	399.7	236.4	11.9	36.7	14.0	4,303
FY03	40.5	306.3	169.7	28.6	43.1	325.8	180.5	26.9	22.8	44.8	5,310
FY04	35.1	268.7	155.1	31.7	37.2	284.5	164.1	29.9	32.5	479.7	2,757

Note: Foreign Exchange Earnings is the sum of earning from Goods, services, and income (credit entry from Item A:BOP-IMF/92) and private transfer

TED: Total external debt; TDL: Total external debt & liabilities; RES: Foreign exchange reserves; EE: export earnings

FEE: Foreign Exchange Earnings; DS: Debt servicing; XGS: Export of good & services

6.3.2 Composition of External Debt & Liabilities

As explained earlier, despite the retirement of expensive official and private debt, Pakistan's total external debt decreased only marginally (by US$ 45 million) in FY04. With external liabilities still falling, the TED to TDL ratio has risen marginally to 94.5 percent during FY04.

Within the external debt, the dominant share remains with Public & Publicly guaranteed debt (PPG), which rose to 89.7 percent of the total (see **Table 6.10**). In turn, the increase in PPG emanates entirely from the increase in stock of *Paris Club, Other bilateral* debt as well as the Eurobond (from US$ 500 million sovereign issue in February 2004).

Figure 6.13: Indicators of External Debt & Liabilities

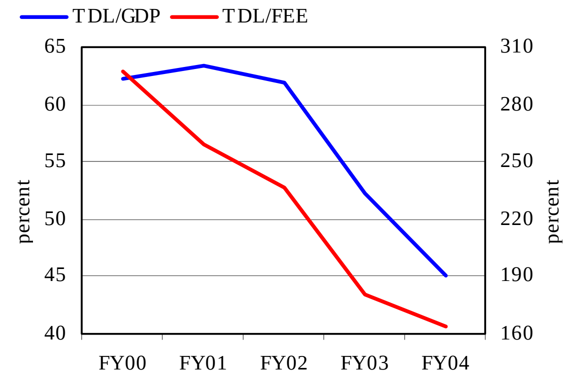


Table 6.10: Composition of Pakistan's External Debt
percent

	FY01	FY02	FY03	FY04
I. PPG debt	**87.61**	**87.53**	**87.65**	**89.70**
A. MT/LT (>1 year)	86.81	86.98	87.09	89.63
Paris club	36.80	37.47	37.80	40.71
Multilateral	41.54	42.91	44.82	43.08
Other bilateral	1.31	1.28	1.54	2.16
Euro bonds/Saindak Bonds	2.01	1.93	1.45	2.47
Military debt	1.72	2.45	0.79	0.61
Commercial Loans/credits	3.43	0.94	0.69	0.59
B. ST (<1 year)	0.80	0.55	0.56	0.07
IDB	0.80	0.55	0.56	0.07
II. Private non-guaranteed debt	**7.63**	**6.66**	**6.08**	**5.01**
Private loans/credits	7.63	6.66	6.08	5.01
III. IMF	**4.76**	**5.81**	**6.27**	**5.29**
Total external debt	100	100	100	100

Paris Club & Other bilateral

The outstanding stock of debt owed to *Paris Club* and *Other bilateral* creditors witnessed a rise of US$ 1.16 billion during FY04 to reach US$ 14.3 billion (see **Table 6.7**). It is clear from **Table 6.11** that the increase in stock was not only due to the fresh disbursements but also factors such as revaluation of debt, as well as other charges contributed to the higher stock of Paris club and other bilateral debt. The latter includes interest rate capitalization, deferred payments, and the impact of the FY02 debt rescheduling agreement.

Fresh Disbursement

Over the last three years, the declining proportion of fresh inflows in total outstanding stock of Paris club is the reflection of the lower volume of commitments. Thus, during FY04 the disbursement of loans from Japan, Germany, France and USA contributed marginally towards the increase in stock of Paris club, while during the same period a total of US$ 519 million were repaid as principal amount of

Tale 6.11: Causative factors for the rise in Stock
million US$

	Paris Club	Multilateral	Other bilateral	Total
Stock as on end June-01	**11,845**	**13,310**	**451**	**25,606**
Inflow	175	1,240	7	1,422
Repayment of Principal	-71	-583	-100	-754
Debt relief	0	0	0	0
Other changes	192	0	67	259
Exchange rate fluctuation	375	364	0	739
Stock as on end June-02	**12,516**	**14,331**	**425**	**27,272**
Inflow	165	920	120	1,205
Repayment of Principal	-110	-630	-71	-811
Debt relief	-1,000	0	0	-1,000
Other changes	492	0	38	530
Exchange rate fluctuation	544	329	0	873
Stock as on end June-03	**12,607**	**14,950**	**512**	**28,069**
Inflow	55	784	101	940
Repayment of Principal	-519	-1,802	-42	-2,363
Debt relief	0	0	0	0
Other changes	817	0	149	966
Exchange rate fluctuation	598	417	0	1,015
Stock as on end June-04	**13,558**	**14,349**	**720**	**28,627**

the loan. These payments not only included the schedule payments but also pre-payment of US$ 325 million to Japan Bank of International Corporation (which was carried out in June 2004).[12]

As far as the stock of other bilateral debt is concerned, the disbursement from China under transportation & communication of US$ 47.46 million for railway and US$ 36.8 million for the Gawadar deep-water project increased the outstanding stock in FY04, despite the retirement of loans worth US$ 42 million during the period.

Impact of Capitalization of interest rate

It was decided in December 2001 rescheduling agreement that the deferred amount of interest payments[13] would be capitalized in the Paris club debt stock, and the repayments of these amounts would start from May 31, 2005 with four equal and successive semi-annual installments.

Accordingly, the deferred payments on newly structured and post-cut off date debt (i.e. September 1997) were capitalized in Paris club debt stock of FY04, inflating the stock of Paris club debt by US$ 306 million this year. Interestingly, out of total interest payments bunched up in FY04, the larger amount of payments (US$ 187 million) pertains to FY02, which should more appropriately be included in the corresponding debt stock for that year.

Currency Valuation

One of the prime reasons that increased the Paris club debt stock in FY04 is the revaluation of non-US$ debt. Typically, the loans are denominated in different currencies, but for reporting purposes all amounts are converted into the US Dollar equivalents at the applicable exchange rates at particular

[12] In June 1998, the Japan Bank of International Corporation granted a loan in two tranches for the establishment of PARCO mid-country refinery. The first tranche of US$ 199.9 million was carrying a fixed rate of Libor 6 month +1 and had maturity between June 2001 and December 2004. The other tranche of US$ 299.9 million was at a fixed rate of 7 percent with maturity profile ranging between FY2005 and FY2011.

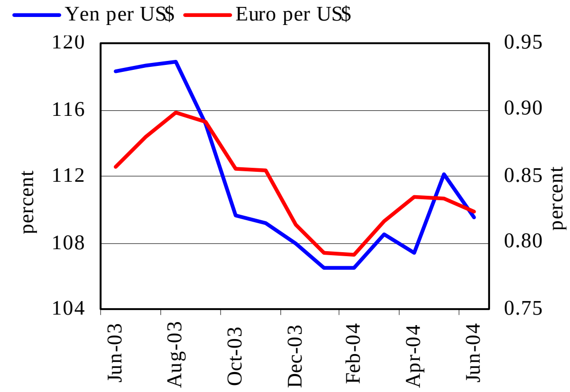
[13] According to the agreement, all interest payments falling between 30th November, 2001 and 30th June 30, 2002 and 20 percent of annual interest accrued on restructured debt for FY03 and FY04 had been deferred.

point in time. Thus exchange rate movements can cause changes in the reported US Dollar equivalents over time. It is this effect that has led to inflation of the total external debt in FY04. Since the currency profile of Paris club debt includes large debt dominated in Euro and Yen, the depreciation of US Dollar against these currencies inflated the US Dollar value of Pakistan's Paris Club debt. The US Dollar lost 4.8 percent against Euro and 8 percent against Yen during FY04 (see **Figure 6.14**).

Re-classification of debt

Another reason for rise in debt owed to Paris Club is the transfer of the re-profiled private un-guaranteed loan.[14] Since, this is merely a re-classification of the existing debt, the overall debt stock remains unaffected. The outstanding stock of Paris club debt also includes the arrears of rescheduling agreement (portion of which had been added in FY03 stock). This added US$ 511 million to the total in FY04.

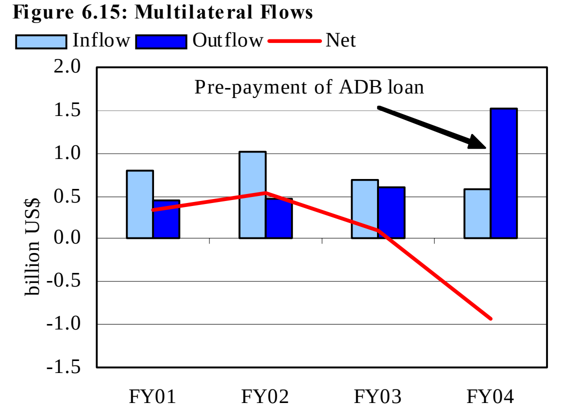
Figure 6.14: Exchange Rate Movement



Multilateral debt

The prepayment of multilateral expensive loans as well as lower fresh disbursements of loans in FY04, reduced the stock of multilateral debt by 4 percent YoY compared to an increase of 4.3 percent in FY03 (see **Figure 6.15**).

Figure 6.15: Multilateral Flows



Of the total disbursement in FY04, the fresh commitment of soft loans was US$ 572.9 million from ADB and IDA. This includes the following:

- Asian Development Bank (ADB) disbursed a fresh loan of US$ 101 million under the Punjab Resource Management Programme. The goal of the program is to support poverty reduction through good governance by emphasizing on improving the public sector resource management.

- Another ADB loan of US$ 99 million was realized under Decentralization Support Program. The facility aims to provide (i) sufficient and effective federal support for devolution and related reforms; (ii) effective and sustainable province-local intergovernmental relations, and (iii) local government planning and fiscal management systems. This program would result in efficient and equitable delivery of services according to clearly established norms of public participation, access to information and accountability.

- ADB also disbursed US$ 66 million under the Sindh Devolved Social Programme. The main purpose of the programme is to improve people's education and health, thereby helping to reduce poverty and gender imbalances.

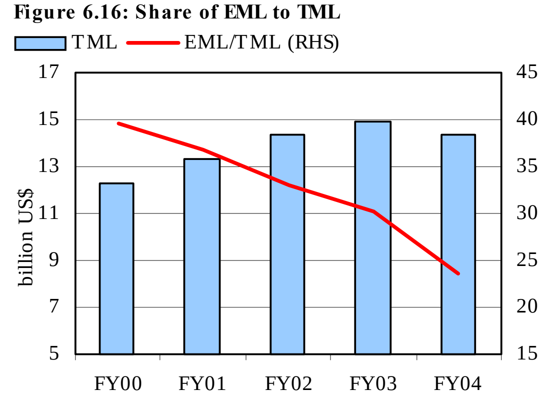
[14] A part of private loan was re-classified as bilateral debt following its rescheduling.

- Interestingly, Pakistan received three single tranche fresh programme loans from the World Bank during FY04. Specifically, IDA (World Bank) disbursed a new loan of US$ 101 million under Punjab Education Reform Adjustment Credit. The purpose of the education reform is to provide financing for the Province of Punjab, which has embarked on a wide-ranging reform agenda to improve fiscal management, promote devolution and improve service delivery.

- In addition, US$ 90 million was realized under North West Frontier Province (NWFP) Second Structural Adjustment Credit Project (SAC II) from IDA. It supports implementation of the government's medium-term reform program over the period FY02 - FY05. The reform program is based on following five pillars: (a) fiscal reforms; (b) public financial management and accountability reforms, (c) reforms to accelerate human development and improve service delivery in key sectors (especially basic social services); (d) governance reforms to achieve an efficient, accountable, and service oriented civil service; and (e) promoting growth and private sector development.

- Additionally, Pakistan also received a one-tranche disbursement of US$ 300 million from World Bank in September 2004 under the Poverty Reduction Support Credit. This facility focuses on accelerating economic growth, maintaining macro stability, by improving governance and devolution, and investing in human capital.

Figure 6.16: Share of EML to TML



Retirement of expensive multilateral debt
With the prepayment of US$ 1.17 billion of expensive loan owed to ADB, the share of expensive multilateral loan (EML) in total multilateral (TML) fell sharply (see **Figure 6.16**). The loans that were retired carried a fixed rate ranging between 6.3 to 11 percent with weighted average rate of 6.8 percent. With this pre-payment, Pakistan recorded a saving of US$ 300 million against future interest payments of these loans. Importantly, this payment did not disrupt flows in the inter-bank market as SBP financed this transaction from its sinking fund.

Net transfers
As discussed earlier, the pre-payment of official loans during FY04 led to higher outflows of Public & Publicly guaranteed loans. Consequently, the net external transfer turned into negative for the first time since FY97 (see **Figure 6.17**).

Figure 6.17 suggests a visible decline in both inflows as well as outflows. On the payment side in particular, the actual liability of the country reduced considerably due to back-to-back rescheduling arrangement with the Paris club. The sharp jump in net transfer during FY02 is mainly due to a US grant and consessional program loans from multilateral credits, which have been declining in subsequent years.

Short-term Loan (IDB)
The outstanding stock of IDB declined substantially by 88 percent to US$ 22 million in FY04. These loans are provided to finance the import of crude oil and fertilizer.

Private Loans
Despite a steady increase in fresh inflows, the stock of private loans & credits recorded a net 17.6 percent YoY decline to reach US$ 1.6 billion by end-June 2004. The inflow of US$ 503 million during the year mainly reflects the disbursement of US$ 350 million from the US Exim Bank to PIA. On the other hand, the increase in payments to US$ 617 million in FY04 includes pre-payment of private loans totaling US$ 65.8 million (see **Figure 6.18**).

Pre-Payment of Private Loans & Credits
In view of lower Rupee interest rates and higher foreign exchange reserves, SBP allowed the private sector in December 2002 to payoff their expensive forex liabilities by substituting it with cheaper Rupee credit. In this connection, a total of US$ 157.9 million of private loan has been repaid by end-June 2004 (see **Table 6.12**). Interestingly, most of pre-payments are concentrated in the cement sector. It may be pointed out that the pre-payment can be financed either by company's own resources or through bank borrowing. In the cement sector, approximately US$ 85.5 million loans were retired by substituting with cheaper domestic credit.

Figure 6.17: Net Transfers

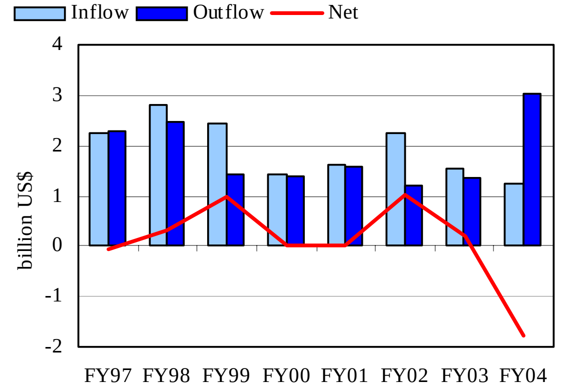


Figure 6.18: Private Loans and Credit

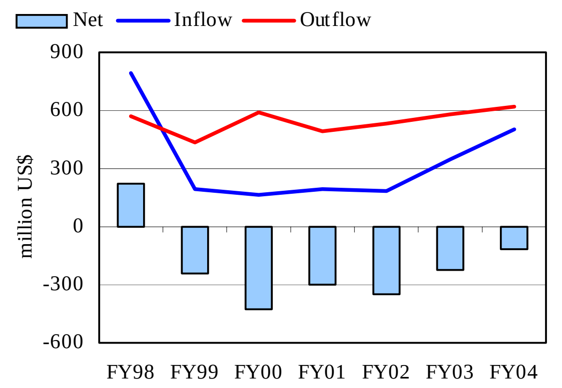


Table 6.12: Prepayment of Foreign Private Loan
million US Dollar

Sector	FY03	FY04	Total
Cement	60.9	44.6	105.5
Chemical	-	8.6	8.6
Oil & gas exploration	4.8	-	4.8
Textile	3.8	4.0	7.8
Financial business	14.4	0.8	15.2
Storage facility	6.4	7.8	14.2
Others	1.8	-	1.8
Total	**92.0**	**65.8**	**157.9**

Transaction with IMF
During FY04, the stock of IMF loans declined 15 percent YoY to reach US$ 1.76 billion. In net terms, inflow of US$ 247 million was more than offset by repurchases (repayment) of US$ 699 million; thereby resulting in higher net outflows of US$ 452 million during FY04 (see **Figure 6.19**). As a result of the massive outflow in FY04 (largely Stand By Agreement loans – see **Figure 6.20**), the share of expensive loans in total stock of IMF loans fell sharply. In addition, during the current year Pakistan has fully repurchased the IMF facility of CCFF.

Euro bond
For the first time since 1998, Pakistan returned to the international market with a 5-year US$ 500 million sovereign Eurobond issue due 2009.[15] The four times over subscription on face of strong demand reflects the enhanced investors' confidence following a buildup of forex reserves, improved

[15] For more detail see second quarterly report FY04.

credit rating and reduction in country risk. The latter is also evident from the secondary market prices of Eurobond that has traded broadly favorably since flotation.

Figure 6.19: Position with IMF

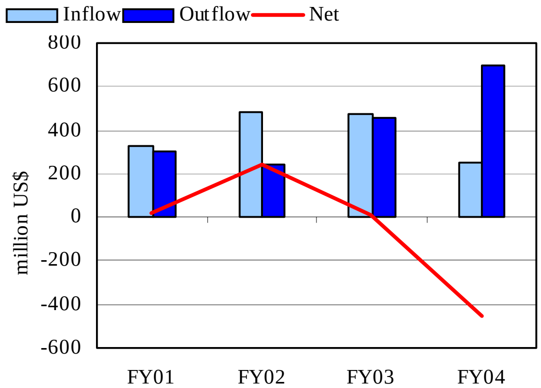
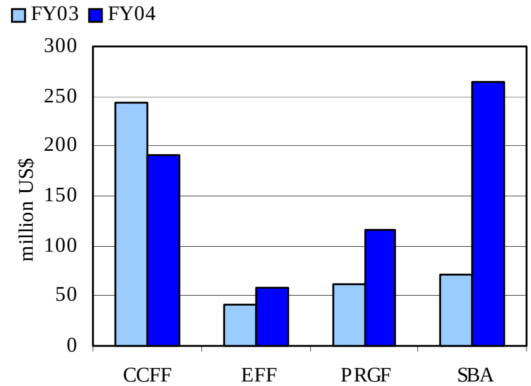
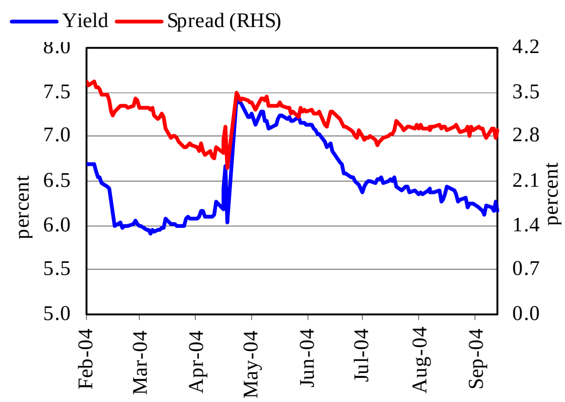


Figure 6.20: IMF Repurchases



The difference between Eurobond yield and US treasury (spread) also reflect the improvement in the country risk. The trends in Eurobond yields show an abrupt upward adjustment on May 11, 2004. This sharp movement is largely due to expectations of an increase in US Fed rates. Consequently, the bond started trading at a discount between 11th May and 2nd July 2004 (i.e., trading price was less than the issuance price).[16] This is supported by the fact that yields on sovereign bonds of other developing countries also experienced similar movement (see **Figure 6.21**).

Figure 6.21: Eurobond Yield and Spread



In April, for the first time, government entered in the international derivative market to swap the Eurobond from a fixed to a floating interest rate. Pakistan completed a deal with Standard Chartered Bank at a rate of 6-month US Dollar LIBOR plus 3.2275 percent over the life of the bond with an upper limit for an unexpected sharp rise in interest rate. Thus, Pakistan indirectly reduced its interest cost from the original fixed rate to floating rate as long as the short-term rates remained favorable.

6.4 External Liabilities

The stock of foreign exchange liabilities declined substantially by US$ 171 million to US$ 1.9 billion by end June-04 which was largely due to the encashment of Special US Dollar bond (see **Table 6.7**).

Special US Dollar bond

The outstanding stock of special US Dollar bond witnessed a reduction of US$ 144 million to US$ 552 million in FY04. However, the reduction was caused by the encashment of 5-year bond (see **Figure 6.22**). On the other hand, the repayment of 3-year Special US Dollar bond remained lower as

[16] The spread however, remained lower than that at issuance (370 bps over US treasuries).

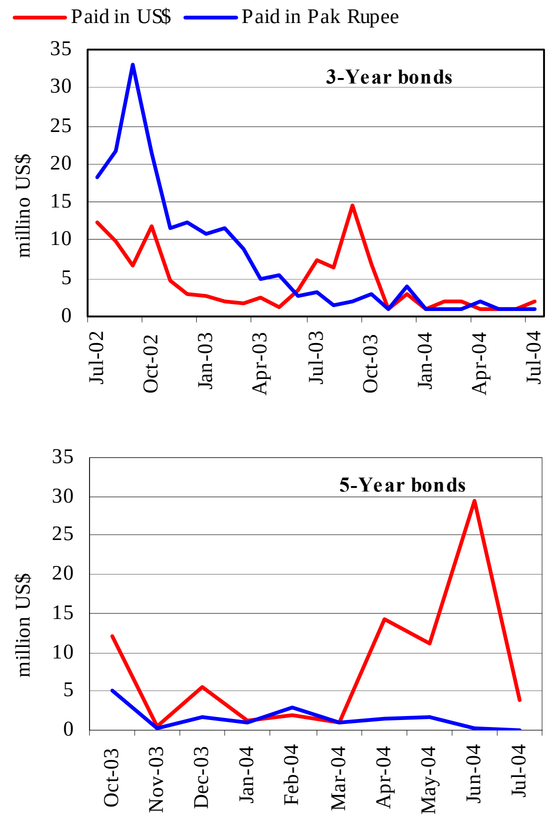
most of the bonds issued between FY99 and FY00 matured in FY02 and FY03 respectively (see **Figure 6.22**).

During the past few years the appreciation of Dollar and the government incentive had made the Rupee encashment more attractive.[17] However, FY04 witnessed redemption in US Dollars. This was mainly due to (1) expectation for Rupee depreciation against US Dollar, which actually provided an incentive to the bond holder to encash their bonds in Dollar and maximize their profit by selling in the kerb market, and (2) the incentive given by the government in October 2003 for premature encashment in US Dollar.

6.5 External Debt and Liability Servicing

The servicing of Pakistan's external debt and liabilities increased by 21 percent to US$ 5.2 billion in FY04 (see **Table 6.13**). The main reason for this rise was the huge repayment of multilateral as well as bilateral loans, retirement of IDB short-term loans and IMF repurchases. On the other hand, the rescheduling and rollover amount was lowered to US$ 1.3 billion during FY04.

Figure 6.22: Encashment of Special US Dollar



[17] In the past, the government was paying Rs 5 bonus on Rupee encashment, which was withdrawn in October 2002.

Table 6.13: Pakistan's External Debt and Liabilities Servicing
million US $

	FY02		FY03		FY04p	
	Actual paid	Rescheduled/ Rollover	Actual paid	Rescheduled/ Rollover	Actual paid	Rescheduled/ Rollover
1. Public and publicly guaranteed debt	3,055	1,208	1,861	1,008	3,526	100
A. Medium and long term (> 1 year)	2,631	1,208	1,671	1,008	3,330	100
Paris club	187	1,094	302	761	834	-
Principal	71	652	110	486	519	-
Interest	116	442	192	275	316	-
Multilateral	903	-	952	-	2,126	-
Principal	583	-	630	-	1,802	-
Interest	320	-	321	-	324	-
Other bilateral	124	32	96	26	59	-
Principal	100	25	71	22	42	-
Interest	24	7	25	4	18	-
Eurobonds	67	-	223	-	197	-
Principal	3	-	162	-	158	-
Interest	64	-	62	-	39	-
Military debt	24	82	-	122	74	-
Principal	19	63	-	101	59	-
Interest	5	19	-	21	15	-
Commercial loans/credits	1,326	-	98	100	39	100
Principal	1,283	-	84	100	33	100
Interest	43	-	14	-	6	-
B. Short-term (≤ 1 year)	424	-	190	-	196	-
IDB	424	-	190	-	196	-
Principal	403	-	183	-	191	-
Interest	21	-	7	-	5	-
2. Private non-guaranteed debts	795	-	834	-	748	-
Private loans/credits (M&LT>1 yr)	795	-	834	-	748	-
Principal	586	-	663	-	617	-
Interest	209	-	171	-	131	-
3. IMF	247	-	459	-	699	-
Repurchases / principal	194	-	419	-	674	-
Charges / interest	53	-	40	-	26	-
Total debt servicing (1 thru 3)	4,097	1,208	3,154	1,008	4,973	100
4. Central bank deposits	38	300	71	400	15	700
Principal	-	300	50	400	-	700
Interest	38	-	21	-	15	-
5. NBP/BOC deposits	287	500	18	500	15	500
Principal	249	350	-	500	-	500
Interest	38	150	18	-	15	-
6. Special US$ bonds	537	-	316	-	197	-
Principal	470	-	283	-	167	-
Interest	67	-	33	-	30	-
7. Foreign currency loan bonds (NHA)	38	-	29	-	27	-
Principal	22	-	22	-	22	-
Interest	16	-	7	-	5	-
8. Swaps	441	-	235	-	-	-
9. FCAs	777	235	412	-	1	-
FE-45 (institutional)	569	235	238	-	-	-
Principal	540	235	234	-	-	-
Interest	29	-	4	-	-	-
FE-13 (Interest)	4	-	2	-	1	-
FE-31	204	-	171	-	-	-
10. NDRP	62	-	69	-	4	-
11. FEBCs/FCBCs/DBCs	50	-	46	-	47	
Principal	27	-	26	-	21	
Interest	23	-	20	-	26	
Total (1 thru 11)	6,327	2,243	4,349	1,908	5,279	1,300

p: Provisional

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