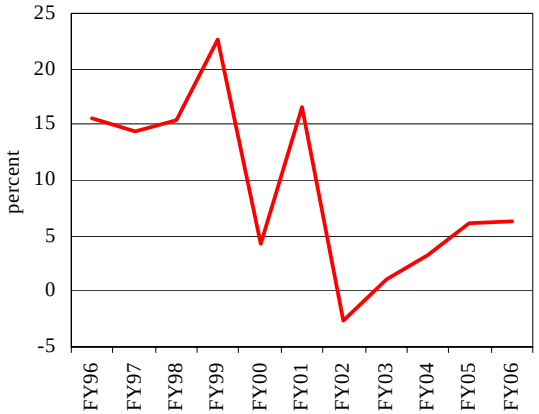
6 Domestic and External Debt

6.1 Overview

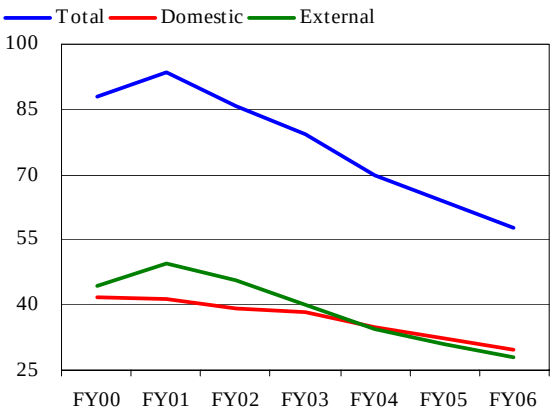
The outstanding stock of Pakistan's total debt and liabilities (TDL) witnessed moderate growth for yet another year in FY06. Specifically, the TDL rose by 6.3 percent (to reach Rs 4,456.5 billion) during FY06, only marginally higher than the 6.1 percent growth in FY05 (see **Figure 6.1**). The modest rise in TDL coupled with the strong growth in nominal GDP meant that the country's debt to GDP ratio fell significantly to 57.8 percent during FY06 from 63.7 percent in the preceding year, reflecting the continual improvement in the economy's ability to sustain debt.

Figure 6.1: Growth in Total Debt



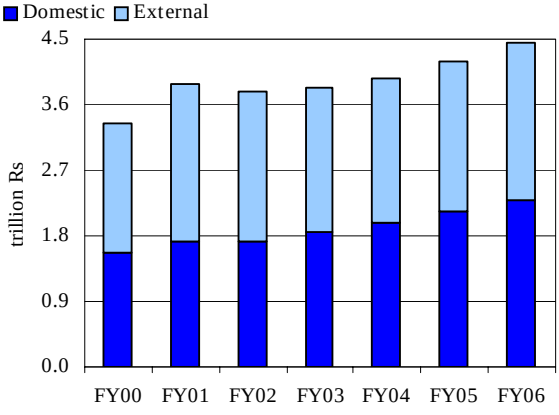
This is the fifth successive year that the debt to GDP ratio has improved. More significantly, this is the first time in more than two decades that the ratio has fallen below 60 percent (see **Figure 6.2**). In fact, "The Fiscal Responsibility and Debt Limitation Act, 2005"envisaged a debt to GDP ratio at 60 percent by FY13. Since this target has been surpassed by FY06, there is a need to set a lower target for future.

Figure 6.2: Debt as percent of GDP



The improvement in the debt to GDP ratio in FY06 contributed by both domestic and external debt; while both have growth in absolute terms, the rise in each case has been lower than the growth of the economy. However, the growth in domestic debt has been relatively faster than that of external debt. As a result of a stronger rise in domestic debt relative to external debt, the share of domestic debt in total debt & liabilities (TDL) increased further from 50.9 percent in FY05 to 51.3 percent by end FY06 (see **Figure 6.3**).

Figure 6.3: Stock of Debt



While, the uptrend in domestic interest rates certainly did lead to lower demand for long-term paper from financial institutions, the residual demand (particularly from corporates, which were not permitted to roll-over maturing investments in NSS instruments) was substantial. Unfortunately,

despite repeated urgings by the financial sector, the government refused to issue long-term paper in any appreciable quantity to offset these maturities. The only possible explanation for this puzzling behaviour is a short-sighted view, which favors the immediate reductions in fiscal costs, rather than focusing on the long-term benefits accruing to the economy through substantial issues of long-term government paper. For example, a liquid market for long-term government paper is a key to the development of the domestic capital market. The absence of substantive PIB issues also meant that the yields on NSS instruments also remained low, thereby causing an outflow of funds here as well. As a result, during FY06 the government was focused on increase its short-term borrowings to offset the fall in the stock of long-term debt, as well as for the FY06 domestic financing requirements. This meant that all of the Rs 160 billion FY06 increase in the form of domestic debt is in short-term debt. Consequently, the average maturity of domestic debt shortened, for the second successive year, in FY06 leaving the debt servicing costs relatively more sensitive to interest rate shocks (see **Table 6.1**).

Table 6.1: Domestic Debt[1]

billion Rupees

	FY05	FY06
	Gross payments	
Long-term	46.4	25.1
Short-term	1,917.4	1,872.1
	Gross receipts	
Long-term	0.8	21.0
Short-term	2,152.1	2,033.6

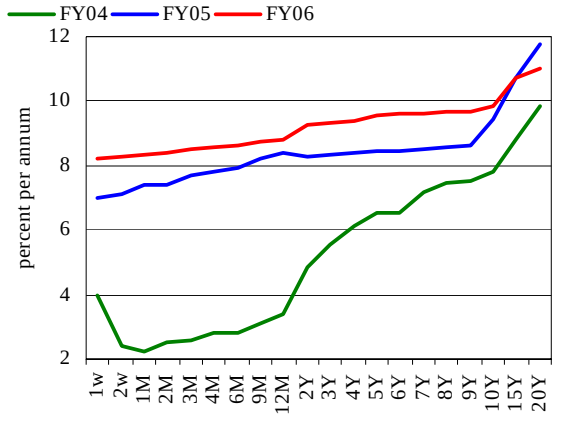
[1] Excluding NSS.

Interestingly, while the aggregate stock of domestic and external debt increased during FY06, and interest rates increased relative to the preceding year, the aggregate FY06 interest payments on this debt declined by Rs 20 billion compared to the previous year. This apparent anomaly is explained principally by the change in the term structure of domestic debt described earlier. However, a significant increase of Rs 25 billion in the repayment of the principal amount more than offset the gains of reduced interest payments during the year.

As a result, overall debt servicing witnessed a negligible rise of 1.9 percent in FY06 relative to a higher rise of 4.3 percent seen in the preceding year. Given a significantly higher growth in nominal GDP and revenue relative to debt servicing, the respective debt servicing ratios saw a substantial improvement during FY06.

However, it should be kept in mind that given continuation of SBP current monetary stance by keeping inter-bank money market relatively illiquid through conducting frequent OMO's would put upward pressures on short-term Rupee interest rates. This is also evident in a shift in the yield curve only at the short end during FY06 (see **Figure 6.4**). However, since these rates are significantly lower than the comparable rates on maturing long term debt, the debt servicing may reduce further going forward, despite a moderate increase in short term debt.

Figure 6.4: Yield Curve



6.2 Domestic Debt

The stock of domestic debt witnessed a rise of 7.5 percent during FY06 equivalent to the average growth in domestic debt during the last three years (see **Table 6.2**). The government has been able to finance a large part of FY06 fiscal deficit through external borrowings as well as through privatization proceeds, therefore the financing required from domestic sources was relatively smaller. As a result, the domestic debt to GDP ratio saw a substantial improvement during FY06.

Table 6.2: Profile of Total Debt and Liabilities

billion Rupees

	FY00	FY01	FY02	FY03	FY04	FY05	FY06
Total debt	**3,334**	**3,886**	**3,783**	**3,824**	**3,949**	**4,191**	**4,457**
	4.3	16.6	-2.6	1.1	3.3	6.1	6.3
1. Domestic debt	**1,579**	**1,731**	**1,718**	**1,854**	**1,979**	**2,133**	**2,293**
	13.4	9.6	-0.8	7.9	6.8	7.8	7.5
	(47.4)	(44.5)	(45.4)	(48.5)	(50.1)	(50.9)	(51.4)
2. External debt	**1,680**	**2,061**	**2,006**	**1,928**	**1,938**	**2,032**	**2,148**
	(50.4)	(53.0)	(53.0)	(50.4)	(49.1)	(48.5)	(48.2)
3. Explicit liabilities [a]	**75**	**94**	**59**	**43**	**33**	**26**	**15**
	(2.3)	(2.4)	(1.6)	(1.1)	(0.8)	(0.6)	(0.3)
Total debt servicing	**371**	**346**	**439**	**300**	**300**	**313**	**319**
Total interest payment	274	250	274	235	230	257	237
Domestic	222	190	208	183	186	212	195
Foreign	47	51	61	49	41	43	42
Explicit Liabilities	6	8	6	4	3	3	0.4
Repayment of principal	97	96	165	64	70	56	81
Debt as percent of GDP							
Total debt	87.9	93.3	85.9	79.3	70.0	63.7	57.8
Domestic debt	41.6	41.6	39.0	38.4	35.1	32.4	29.7
External debt	44.3	49.5	45.6	40.0	34.4	30.9	27.9
Explicit liabilities	2.0	2.3	1.4	0.9	0.6	0.4	0.2
Public debt	84.0	89.6	82.9	76.9	68.3	62.5	56.7
Public debt servicing as percent of							
Tax revenue	91.5	78.3	91.8	53.9	49.3	47.5	39.6
Total revenue	72.4	62.5	70.3	41.6	37.9	34.8	29.6
Total expenditure	52.3	48.1	53.1	33.3	31.4	28.0	22.7
Current expenditure	59.2	53.5	62.7	37.8	38.7	33.2	28.4
GDP	9.8	8.3	10.0	6.2	5.3	4.8	4.1

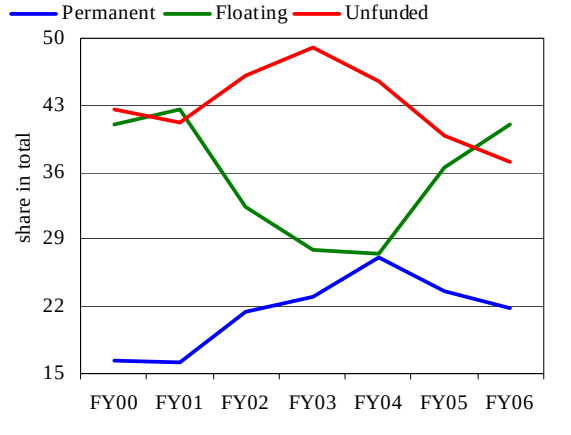
a) Explicit Liabilities include Special US $ Bonds, FEBCs, FCBCs and DBCs.

Figures in parentheses are shares in total debt. Sources: i) SBP, ii) DM Section, Finance Division

6.2.1 Composition of Domestic Debt

Due to persistent inflationary pressures in the economy since H2-FY04, expectations for an upward movement in interest rates were strengthening. Moreover, interest in long-term debt instruments muted due to rising short term interest rates and uncertainty about long-term rates. While the government was unable to mobilize a net surplus in National Savings Schemes (NSS), the only option left was to increase borrowing through short term government papers (i.e. treasury bills).

Figure 6.5: Composition of Domestic Debt



Consequently, as in the preceding year, *floating debt* contributed entirely in the addition of domestic debt during FY06, while the stock of the other two debt categories, *permanent* and *unfunded* remained almost unaltered. Therefore, the share of floating debt further increased to

41.0 percent during FY06 from 36.5 percent in FY05, whereas the shares of both permanent and unfunded debt declined for the third successive year (see **Figure 6.5**). The fall in stock of permanent debt is attributed to a lower mobilization of Rs 11.2 billion through only one auction of PIBs[1] during FY06, which was more than offset by maturities of more than double amount of PIBs and FIBs (Rs 22.9 billion) during the same period. Furthermore, the stock of unfunded debt marginally declined, although the government offered some more incentives on NSS during FY06. This was because an increase in gross receipts during FY06 was more than offset by larger maturities. One of the major factors for these higher maturities was that institutional investors were unable to roll-over their large maturing NSS holdings.

In addition, the significant decline of above 29 percent in SSCs (registered) for the second consecutive year during FY06 reveals that a substantial part of SSCs, which was used to avail arbitrage opportunity in FY03 and FY04, matured during FY05 and FY06.

Theoretically speaking, the institutional investors should have been diverted to PIB market as they were prohibited from buying NSS instruments during FY00. However, government was reluctant to issue PIBs in any significant quantity during both FY05 and FY06.

Some possible consequences of this policy could be:

(1) In case of adverse movements in short term interest rates, the debt servicing cost even in short term may become higher than the average for long term funds. This vulnerability is evident in the fact that as 6-month Treasury bill cost to the government recorded a cumulative increase of more than 650 basis points during FY05 and FY06. This cumulative increase is substantially higher than the differential of 10-year PIB cost and 6-month T-bill cost at the beginning of FY05 (nearly 437 basis points).

(2) A continuous rolling over of a substantial amount of short-term debt would add to volatility in short term interest rates. It would make monetary management difficult and complex as the central bank is trying to reduce volatility in interest rates.

Unfunded Debt

The stock of unfunded debt witnessed a decline for the third successive year during FY06. However, the Rs 1.5 billion decline in FY06 was quite low compared to decline of Rs 45.2 billion and Rs 10.3 billion during FY05 and FY04 respectively. More than 90 percent of unfunded debt consists of NSS; other contributors are GP Fund and Postal Life Insurance (PLI). While GP Fund recorded small changes during FY04-FY06, the PLI showed strong growth in the same period.

National Savings Schemes (NSS)[2]

In gross sales, almost every NSS instrument, fetched more money during FY06 compared to FY05, but the impact of this was more than offset by maturities. As a result, in net terms, the stock of NSS debt declined for the second consecutive year during FY06.

In net terms, while the newer instruments PBAs and BSCs together generated an amount of Rs 76.0 billion during FY06 as shown in **Table 6.3**, the four older instruments recoded a decline of Rs 81.3 billion in the same period (which was substantially smaller than decline of Rs 133.9 billion during FY05). The deceleration in the negative growth of older instruments indicates that the individual buyers are being re-diverted towards SSCs and DSCs mainly because of (1) the rate of return on NSS instruments were raised in FY06, (2) stability in the asset market that made NSS more competitive to other assets.

[1] Currently there are only two instruments of this category available for mobilizing funds for the government in which PIB is the major one.

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

As a result of these developments, the shares of BSCs and PBAs in NSS stocks during FY06 increased further. While the share of former nearly doubled during FY06, reaching 15.3 percent, the share of latter also rose to 6.2 percent by end of FY06. On the other hand, the shares of SSC, DSCs and RICs declined (see **Table 6.4**).

Table 6.3: Gross Sales of Major NSS Instruments
billion Rupees

			YoY change	
	FY05	FY06	Absolute	Percent
DSCs	15.3	17.5	2.2	14.1
SSCs	54.4	87.5	33.1	60.8
RICs	11.0	16.2	5.3	48.0
Saving A/c	36.2	39.8	3.5	9.7
Special Saving A/c	18.4	25.3	6.9	37.8
BSCs	66.0	76.5	10.5	15.9
PBAs	21.4	23.4	2.0	9.3
Others	-3.7	-3.6	0.1	-3.0
Total	*219.0*	*282.5*	*63.5*	*29.0*

Table 6.4: Major NSS Instruments (stocks)
billion Rupees

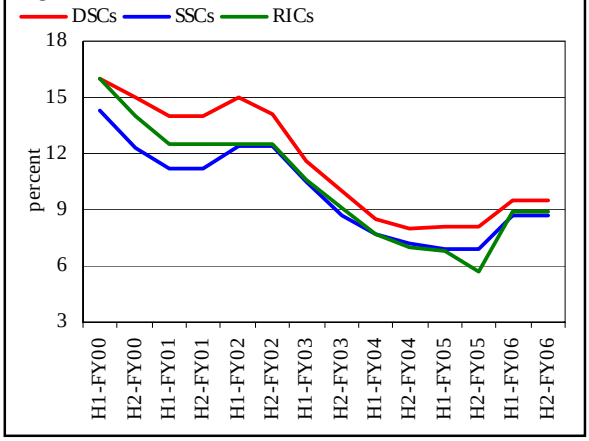
	FY03	FY04	FY05	FY06
DSCs	309.0	312.2	303.5	296.1
RICs	175.0	125.9	85.2	70.1
SSCs	294.4	281.2	197.9	140.4
Savings/Special Saving A/c	61.1	63.3	61.8	58.5
PBAs	10.2	23.4	41.1	57.5
BSCs		22.7	83.3	143.0
others	132.8	155.7	165.6	168.9

Rate of Returns

The rate of return on NSS revised upward on the basis of secondary market yield in the beginning of FY06, since no PIB auction was held during the last two years. However, by May FY06, government decided to held an auction of PIB and subsequently rate of return on NSS were revised again on the basis of benchmark PIB rates.

The rise in the NSS rates was inevitable given (1) persistent high inflation that made the real return on NSS negative and (2) lower mobilization of funds under NSS than anticipated. As a result, the rate of return on almost every instrument was raised by more than 100 basis points. The strongest rise was in the rate of return on 3-year SSCs the yield on which was raised by nearly 180 basis points. Similarly, the rate of return on PBAs, with relatively higher rate of returns on them, was further raised by nearly 100 basis points (see **Figure 6.6**). However, despite this increase, the real rate of return on NSS was very low.

Figure 6.6: Rates of Return on NSS



Floating and Permanent Debt

While the stock of *permanent debt* witnessed a negligible decline during FY06 relative to a significant fall in FY05, the stock of *floating debt* continued to rise in FY06 for the third successive year. Other than prize bonds, no other instrument in permanent debt registered an increase during FY06.[3]

Particularly noteworthy is the continuing decline in the stock of tradable long term government paper (such as PIBs and FIBs). After an increase of Rs 103.0 billion during FY04, due to the absence of large PIB auctions and continuing maturity of older issues of both FIBs and PIBs, their share in permanent debt continues to decline. Indeed there was only one successful PIB auction in FY06 worth Rs 11.2 billion against maturities of Rs 15 billion (see **Figure 6.7**).

[3] In fact, growth in prize bonds also saw a deceleration during FY06.

6.2.2 Classification of Domestic Debt by Owner

The share of banking system debt in domestic debt witnessed an increase during FY06, for the third consecutive year (see **Figure 6.8**). This rise is entirely owed to a massive net government borrowing of Rs 377.9 billion from SBP during FY05 and FY06, as against a decline of Rs 62.6 billion in the scheduled bank debt in this period.

In particular, the stock of scheduled banks debt has declined since FY05 mainly because of (1) unsuccessful auctions of PIBs during FY05-FY06 and simultaneously maturing FIBs and PIBs in the same period and, (2) because the SBP has been making efforts to moderate the rise in short term interest rates, which resulted in smaller acceptance of T-bills in auctions during most of FY05 and FY06.

Figure 6.7: Net Flows in PIBs, FIBs and PBs

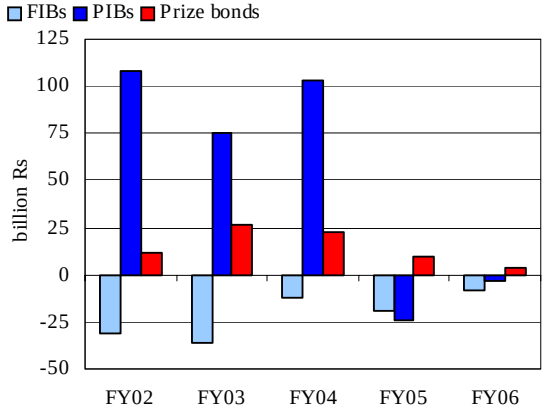
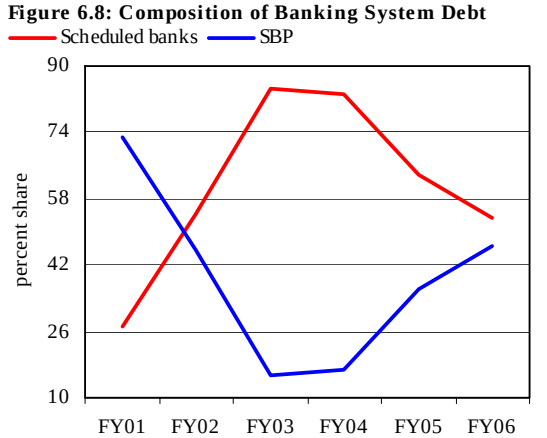


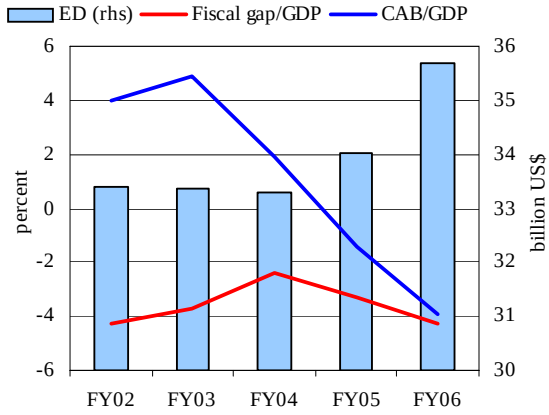
Figure 6.8: Composition of Banking System Debt



6.3 External Debt

Pakistan's External Debt and Liabilities (EDL) increased by US$ 1.4 billion in FY06 to reach US$ 37.3 billion (see **Table 6.5**). The 4.0 percent YoY rise in the EDL was despite a significant fall of 11.7 percent YoY in external liabilities. The rise in the EDL reflects recourse to external sources for financing part of the increase in the fiscal and current account deficits. Specifically, fiscal deficit which was 3.3 percent of GDP in FY05 rose to 4.2 percent of GDP in FY06, due to an increase in the earthquake relief and rehabilitation expenditures. The current account deficit on the other hand, deteriorated from 1.4 percent of GDP in FY05 to 3.9 percent of GDP in FY06 due to continuous surge in import growth (see **Figure 6.9**).

Figure 6.9: Causative Factors of External Debt



During the last two years, although the total outstanding debt stock has gone up by approximately US$ 2.4 billion, the rise has not adversely affected the country's debt profile. This is primarily due to improvement in the maturity profile of the debt stock, as most of the new receipts were of long-term concessional nature (see **Figure 6.10**).[4] However, with almost quarter of the debt stock on floating rates by end of FY06, the rise in the benchmark (LIBOR or US T-bills) interest rates or devaluation of the domestic currency to correct the external imbalance

[4] Non-concessional loans are defined as loans that cost at least 50 basis points above the 6-month US$ Libor rates.

could very easily increase the debt servicing cost substantially. This in turn would add to the fiscal deficit (see **Box 6.1**).

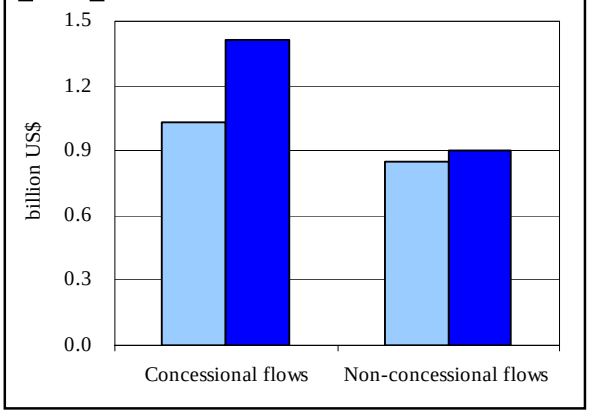
Table 6.5: Pakistan's External Debt and Liabilities
million US Dollars

	FY03	FY04	FY05	FY06P	% change in FY06 over FY05
I. Public and publicly guaranteed debt	**29,232**	**29,875**	**31,084**	**32,603**	**4.89**
A. Medium and long term(>1 year)	**29,045**	**29,853**	**30,813**	**32,407**	**5.17**
Paris club	12,607	13,558	13,014	12,831	(1.41)
Multilateral	14,950	14,349	15,358	16,527	7.61
Other bilateral	512	720	805	847	5.19
Euro bonds/Sukuk	482	824	1,266	1,908	50.68
Military debt	263	204	188	130	(31.01)
Commercial loans/credits	231	198	182	165	(9.18)
B. Short-term (<1 year)	**187**	**22**	**271**	**196**	**(27.68)**
IDB	187	22	271	196	(27.68)
II. Private non-guaranteed debts	**2,028**	**1,670**	**1,342**	**1,585**	**18.11**
Private loans/credits	2,028	1,670	1,342	1,585	18.11
III. IMF	**2,092**	**1,762**	**1,611**	**1,491**	**(7.45)**
Total external debt (I to III)	**33,352**	**33,307**	**34,037**	**35,679**	**4.82**
IV. Foreign exchange liabilities	**2,122**	**1,951**	**1,797**	**1,586**	**(11.74)**
Special U.S dollar bonds	696	552	421	247	(41.33)
Foreign currency bonds (NHA / NC)	175	153	131	109	(16.79)
National debt retirement program	6	1	0	0	-
Central bank deposits	700	700	700	700	-
NBP (BOC deposits)	500	500	500	500	-
Other liabilities (SWAP)	45	45	45	30	(33.33)
Total external debt and liabilities (I to IV)	**35,474**	**35,258**	**35,834**	**37,265**	**3.99**
FEBCs/FCBCs/DBCs (payable in Rs)	*42*	22	10	7	(32.04)

P: Provisional
Source: State Bank of Pakistan

During FY06, Pakistan acquired US$ 3.4 billion fresh long-term loan, of which US$ 1.7 billion reflects the long-term flows from ADB and the World Bank. Of the total disbursement from the ADB and World Bank, US$ 672 million were specifically earthquake related loans. Besides loans from ADB and World Bank, Pakistan also received grants for earth quake relief from other sources, including mainly china (US$ 33 million), and Turkey (US$ 30 million). Total grants for the earthquake relief amounted to US$ 146.8 million.[56] It may be important to note here, that during FY06 approximately US$ 1.7 billion of loans were committed by the international donors for earth quake fund, while the actual disbursement was limited to US$ 768 million.

Figure 6.10: Composition of Major Inflows



During FY06 Pakistan once again accessed the global bond market to rise funding through the issuance of the Euro Bonds.

[5] The total grant committed under earth quake was US$ 273.5 million during FY06.
[6] These numbers do not necessarily matched with the BOP numbers.

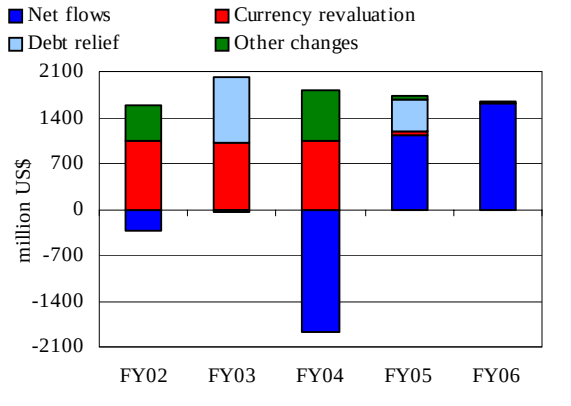
Pakistan not only successfully generated inflows of, US$ 800 million from this issuance, but also established a long-term sovereign benchmark that would help local corporates access global capital markets. The FY06 issuance consists of 10-year bonds of US$ 500 million, and US$ 300 million in 30-year bonds. Finally, in FY06 the private sector also registered fresh loan of US$522 million primarily on account of the long-term loans to the communication sector, and to Pakistan International Airline (PIA) for the purchase of aircraft.

Box 6.1: Impact of rising global interest rate and exchange rate adjustments on external debt profile

Rising international interest rate and adverse movements in the cross country exchange rates are the two main sources through which country's external debt is exposed to global financial shocks. In fact, any country would become more vulnerable to interest rate fluctuation, if a large proportion of country's debt is priced on floating rate. On the other hand, the adverse movement in the exchange rate influences the debt stock through valuation channel. Mostly countries borrow in various currencies and for reporting purposes all amount are converted into the US dollar at a particular point in time at the applicable exchange rate. Thus, any movements in the exchange rate of US dollar against these currencies cause significant changes in the total external debt stock.

Besides exchange movements also have implications for the Fiscal side. The devaluation of the domestic currency increases the domestic cost of the external debt and thus adding to fiscal burden.

Figure 6.1.1: Impact of Currency Revaluation on Changes in External Debt



In context of Pakistan, approximately 24 percent of the country's debt is on floating rates; mostly linked to 6-month US$ Libor rate. Thus in case of any rise in US interest rate the debt servicing cost of the country would automatically increase.

Exchange rate on the other hand, had inflated the stock of debt more aggressively in recent past due weakening of the US$ against other major currencies. As evident from **Figure 6.1.1** that currency revaluation had added approximately US$ 1 billion to the debt stock from FY02 to FY04. However, from FY05 due to strengthening of US dollar against major currencies, the impact of the revaluation has gone down significantly to US$ 68 million. Along with the cross country exchange rate movement, changes country's own currency parity vis a vie US$ can also impact the debt stock. **Table 6.1.1** shows that devaluation of the domestic currency by one rupee would increase the country's debt by around Rs.36 billion. It is therefore not surprising, that the policy option of devaluing the domestic currency in the wake of huge current account deficit has not been exercised.

Table 6.1.1: Impact of 1 percent Depreciation

ED in mln US$	35,679
Debt servicing in mln US$	2,799
Impact of depreciation on debt stock (in million Rs)	
ED	35,679
Debt servicing	2,799

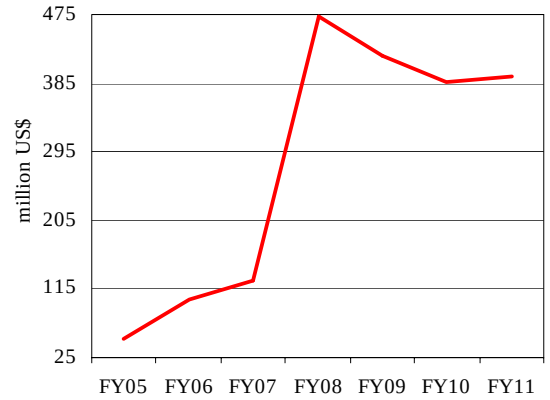
In addition, the noteworthy development on the external front is the increased country's credit rating form B2 to Ba3 by Moody's. As a result, Pakistan's sovereign rating is now only 3 notches below Investment Grade (see **Box 6.2**). Recently, both S&P and Moodys have placed Pakistan's sovereign rating on review for possible upgrades.

In contrast to FY05, the debt servicing recorded a marginal increase of US$ 82 million in FY06. This increase was partly due to the principal payment of capitalized interest under the rescheduling agreement reached in 2001.

In this regard, it would be pertinent to mention that going forward, in short to medium term, the country could experience higher debt servicing pressure as a result of bunching of various principal payments, including; (1) remaining semi annual principal installment on capitalized interest; the last tranche of which would be in FY08; (2) repayment of Euro bond & Sukuk issued in FY04 and FY05

respectively; (3) principal repayment on non-ODA loans starting from FY08; and (4) routine payments on various loans disbursed since September 1997 (see **Figure 6.11**).[7]

Figure 6.11: Due Payments of Rescheduled Debt 2001



6.3.1 Debt Dynamics

The dynamics of the external debt burden can be easily gauged through different debt indicators, which are crucial to develop a system of early warning signals for potential debt-related risk such as debt crisis or debt servicing difficulties. Broadly, there are two types of debt indicators i.e. solvency and liquidity that assess the country's debt sustainability position. The solvency indicators such as; debt to GDP, debt to Foreign Exchange Earning (FEE) and Debt Servicing (DS) to FEE, reflect the country's ability to service its external obligation on a continuing basis. While, the liquidity indicators such as; reserves to short-term debt and reserves to total debt reflect the country's liquid asset that affect the ability to service its immediate external liabilities.

Box 6.2: Improved sovereign bond rating of the country

The foreign currency rating is a forward-looking estimate of default probability, reflecting the country's capacity to payback its foreign debt. International credit agencies such as Standard & Poor's and Moody's Investors Services consider all significant factors, economic, financial, social, and political in determining these ratings. A change in the credit rating of a country may occur due to new information that alters the rating agencies view regarding the risk profile of the country, in addition, the ratings may also change due to change in the rating methodology of the credit agency.

In this context, the credit ratings agency Moody's has raised Pakistan's rating for foreign currency ceiling[1] for bonds from B2 to Ba3 (stable outlook) in May 2006. This change is a consequence of the revision in the assessment methodology of agency. Therefore, it would be pertinent to elaborate on this development.

Earlier, while accessing this ceiling Moody's methodology had assumed that a foreign currency bond default by the government would automatically terminate the foreign currency payments of all other domestic issuers within the country. However, with the liberalization of international capital markets, and expansion in the private bond market, it was increasingly found that sovereign default was not necessarily accompanied by private default, and therefore risk of the private and sovereign default had to be accessed separately. Consequently, Moody's foreign currency ceiling has been revised to reflect the lower risk of default associated with the private debt. As a result of the lowering of the private default risk, the overall risk profile of the countries has also improved. This has increased the foreign currency ceiling of a number of countries resulting in the upgrading of their bond ratings.[2]

Pakistan's rating also benefited from this change, rising from B2 to Ba3 reflecting the fact that while the country defaulted on its sovereign debt in 1999 and approached its lenders for rescheduling of its debt, the private sector debt remained unaffected and continued to honor their debt obligations. However, this change only reflects a change the view of Pakistan's existing risk factors rather than an improvement in its macroeconomic profile. In addition, on account of improved debt ratios and substantial economic growth, Moody's has placed Pakistan for a possible upgrade for foreign and local currency government bonds.

[1]*Foreign currency ceiling can be defined as a measure of the ability and willingness of a country's central bank to make foreign exchange available to service the foreign currency debt obligations of issuers domiciled in the country* (see Using External Credit Support To Mitigate Sovereign Risk).

[2]As a result of this revised approach, 70 countries ceiling have been upgraded by at least one-notch.

[7] When a debtor country first meets with Paris Club creditors, the "cutoff date" is defined and is not to be changed in subsequent Paris club treatments; this means that credits granted after cutoff date are not subject to future rescheduling, in case of Pakistan the cutoff date was September 1997.

Table 6.6 provides a detailed analysis of these indicators for Pakistan. All indicators show significant improvement in FY06 relative to previous years. Specifically, during FY06 country registered a sharp acceleration in the national income growth which comfortably outpaced the growth in the stock of EDL and thus led to decrease the ratio of debt to GDP in the same period. In fact, the improvement in this indicator also reflects some indication of the potential to service external debt by switching resources from production of domestic goods to the production of exports.[8]

Table 6.6: Selected External Debt/Liabilities Indicators

percent

	Total external debt to				Total external debt & liabilities to					
	GDP	EE	FEE	RES/TED	GDP	EE	FEE	RES/TEL	RES/STD *	DS/FEE
FY02	45.6	365.4	216.1	13.0	49.8	399.7	236.4	11.9	23.7	26.5
FY03	40.0	306.3	169.7	28.6	42.5	325.8	180.5	26.9	51.0	16.0
FY04	34	268.7	155.2	31.7	36.4	284.5	164.3	30.0	480.2	23.2
FY05	31	236.4	127.3	28.8	32.5	248.8	134.0	27	36.1	10.2
FY06	28	218.6	115.4	30.2	29.1	228.3	120.5	29	54.9	9.1

Note: Foreign Exchange Earnings is the sum of earnings from goods, services, and income and private transfers (credit entry from BPM-5)
TED: Total External Debt; TDL: Total External Debt & Liabilities; RES: Foreign Exchange Reserves; EE: Export Earnings; FEE: Foreign Exchange Earning; DS: Debt servicing;
* In absolute term

The hefty inflows of remittances coupled with the higher Export Earnings (EE) improved the ratio of debt to FEE and debt to EE respectively during FY06. Similarly, the ratio of DS to FEE, which shows that how vulnerable the payment of debt service obligation is to an unexpected fall in FEE of the country, fell substantially in FY06 on account of higher foreign exchange earning.

Encouragingly, in contrast to the previous year, the accumulation of international reserves improved the debt repayment capacity as reflected from the rising ratio of reserves to total external debt in FY06. While the ratio of foreign exchange reserves to short-term debt which is an important indicator of reserves adequacy also reflects remarkable improvement, rising to 54.9 in FY06 as against to 36.1 in previous year. It may be pertinent to note, that the smaller reserve to short-term debt ratio is associated with a greater vulnerability to shocks.

6.3.2 Structure of External debt and Liabilities

Paris Club and Other Bilateral Debt

As in the previous year, the outstanding stock of Paris club debt declined in FY06. As seen in **Table 6.7**, the larger contribution to the FY05 fall was principally due to a debt write-off of US$ 495 million by the US, and normal principal repayments, that overshadowed the inflows. In contrast, the reduction during FY06 reflects a number of factors, including scheduled repayments, as well as the impact of favorable currency movements, which reduced the US dollar value of the debt denominated in Euros and yen[9], as well as the partly repayment of the capitalized interest under the 2001 debt rescheduling agreement.[10] The net impact of these comfortably offset the receipts of concessional loans totaling US$ 177 million from bilateral creditors during FY06 (including an earthquake relief loan of US$ 96 million from Japan).

[8] See "External Debt Statistics, Guide for Compilers and Users", (2003), IMF.
[9] The strengthening of the US dollar against euro and yen, which started in December 2004 and continued till the H1-FY06 had led to a considerable decline in the debt stock due to revaluation. With dollar weakening in the second half of FY06, the overall impact of revaluation on the declining of Paris club debt was limited to US$ 103 million.
[10] For detail see **Box 6.4.**

However, the stock of other bilateral debt increased a little in both FY05 and FY06. In the former period, the outstanding stock by end-FY05 increased by US$ 85 million YoY, principally due to adverse exchange movements. On the other hand, in the latter period, favorable exchange movements meant that the outstanding stock at end-FY06 grew by only US$ 42 million YoY, although net inflows of US$ 67 million for FY06, were almost unchanged from the previous year. A significant part of the FY06 loans (approximately US$ 64 million) were acquired from China for power projects.

Table 6.7: Causative Factors of Paris Club Stock

million US dollars

	FY05	FY06
Disbursement	70	177
Repayment of principal	-152	-257
Of which:		
Repayment of capitalized interest	48	102
Exchange rate changes	7	-103
Debt relief	-495	0

Table 6.8: Detail of Earthquake loans from ADB and World Bank

Donor Agency	Amount committed	Interest rate	Tenor		Amount Disbursed as on 30-6-06	Nature	
			Payment	Grace period		Original	Renewed
	85	during grace 1% after grace 1.5%	15 Years	5 Years	Fully disbursed		√
ADB	226	during grace 1% after grace 1.5%	30 Years	10 Years	35	√	
IBRD	100	US libor + 50 bps	10 Years	5 Years	15	√	
	413	0.75%	25 Years	10 Years	326	√	
	150	0.75%	25 Years	10 Years	Fully disbursed		√
	50	0.75%	25 Years	10 Years	Fully disbursed		√
IDA	101	0.75%	25 Years	10 Years	10		√

US 6-month libor rate for FY06 is 5.49, thus the actual rate on this loan is 6 percent

Multilateral

The stock of multilateral debt reached US$ 17 billion by end of FY06, recording a YoY growth of 7.6 percent. Of the fresh US$ 1.7 billion disbursements during the year, US$ 672 million was on account of the earthquake relief fund.

Within the earthquake related loans, US$ 537 million received from IDA and US$ 120 from ADB were on concessional rates, while the US$15 million from IBRD was disbursed as a non-concessional loan (see **Table 6.8**). In addition, ADB and IDA loans also included the renewal of some credit lines that had been completely exhausted earlier. The remaining *multilateral* loans disbursed in FY06 were mainly for poverty reduction programs and to support economic reforms, etc. (see **Box 6.3**).

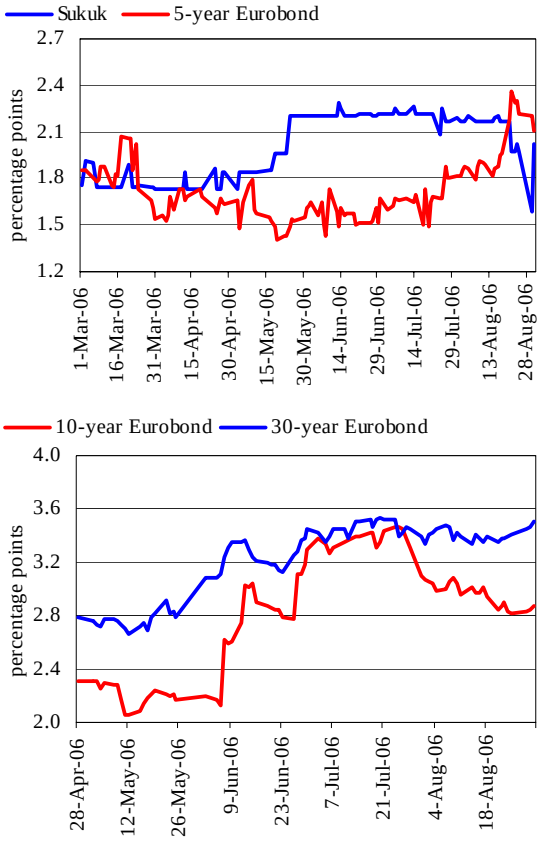
Sovereign Bonds (Eurobonds & Sukuk)

Pakistan's successful FY04 5-year note had marked Pakistan's first attempt to tap the international capital markets following the FY00 debt restructuring and subsequent economic recovery. The success of this offering encouraged additional offerings in FY05 and FY06, leading to annual increases in the outstanding stock of sovereign bonds by US$ 442 million and US$ 641.6 million respectively. The issuances in each of the years offset the impact of scheduled principal repayments on older sovereign issues.

While FY05 had seen Pakistan offering a US$ 600 million Sukuk, the success of the earlier FY04 Eurobond encouraged the government to re-enter the market in FY06, through longer tenor instruments, in order to set a benchmark for term borrowings by domestic companies from the international capital markets. Accordingly, Pakistan issued two new Eurobonds in FY06: (1) a 10 year-bond of US$ 500 million, and; (2) a US$ 300 million 30-years offering.

While, these issues were also well received, the performance of the bonds has deteriorated somewhat subsequently, with spreads to UST widening. A part of this increase in the spread simply reflects that increased sensitivity to risk in the wake of the volatility in US bond market, which had led to a general sell-off in emerging markets debt in May 2006. As a result, the spread on emerging market debt have gradually increased, and the Pakistani sovereign issues also suffered this fate (see **Figure 6.12**).

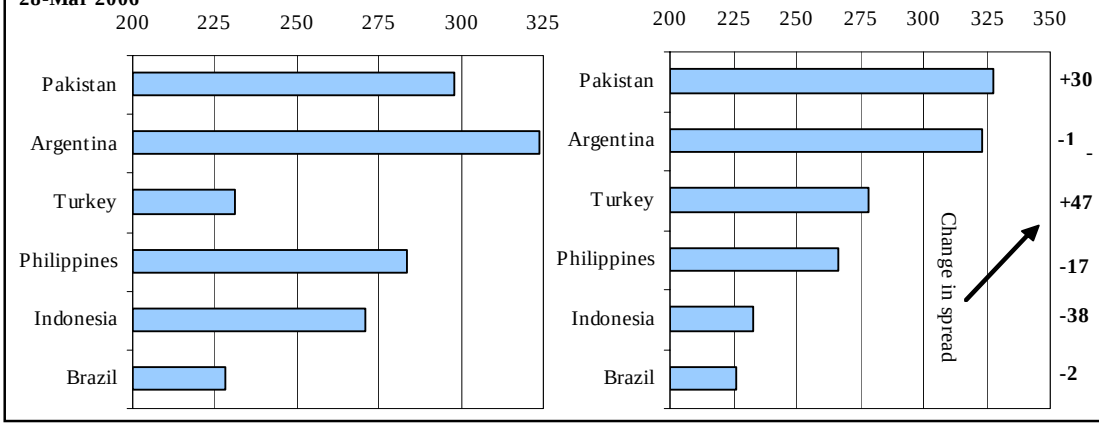
Figure 6.12: Performance of Pakistani Bonds over Respective Benchmark Rates



However, a closer look at the secondary market performance of Pakistan's 30-year bond, in particular, shows that the widening of the spread for Pakistan's bonds has been greater than for other comparable emerging market sovereign issuer, such as Philippines, Indonesia, Brazil, etc. (see **Figure 6.13**). A possible explanation for this is that the perceived country risk for Pakistan has increased following the deterioration in some key macroeconomic indicators, such as the widening fiscal and current account deficits.

Looking at the payments, the FY06 US$ 155.5 million outflow under this head reflects the final principal repayment on the US$ 620 million consolidated bond, structured in 2000 following the restructuring of Pakistan's outstanding debt issues[11]. As a result, principal re-payments under this head would reappear only in FY08 and FY09, on as the FY04 Eurobond and FY05 Sukuk issues mature.

Figure 6.13: Sovereign Spread of Emerging Economies



[11] These included: US $300 million euro bond; US $150 million of Pakistan floating-rate notes; and $160 million of Pakistan telecommunications company's exchangeable bonds.

Box 6.3: Loans disbursed from the ADB and World Bank
During FY06, ADB disbursed two loans of US$ 60 and 70 million for social services program to the Punjab and Sindh governmenst respectively. The key objectives of these loans were to improve the quality of human capital, specifically people's education and health, for a large majority of population of Punjab and Sindh respectively.

Another ADB loan of US$80 million was realized under the financial markets and governance program. This program was design to support poverty reduction indirectly by facilitating growth and employment creation as well as social protection. The key objective of the program was to (i) strengthen market soundness, stability and investor confidence through improved governance, transparency and risk management; (ii) improved availability and access to financial instruments for savings and investment and related services; (iii) improve market efficiency and attractiveness to issuers and investors, including institutional and foreign investors.

In addition, US$ 199 million was received under the Punjab educational sector reform from World Bank. The facility aims to focus on: (i) public finance reforms to increase public spending for education and to ensure fiscal sustainability; (ii) reforms that strengthen devolution and improve the fiduciary environment and governance; and (iii) education sector reforms to improve quality, access, and sector governance. World Bank also disbursed a loan of US$ 102 million for Punjab irrigation/policy-II and US$ 69.5 million for NWFP (SAC-II-III)/policy.

Short-term IDB

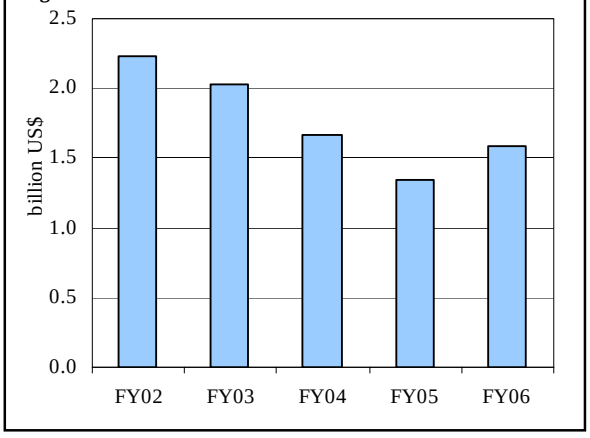
The Islamic Development Bank (IDB) disbursements mainly comprise short-term loans for financing imports of oil and fertilizer. After termination of the Saudi Oil Facility[12] since FY04, Pakistan has turned to IDB short-term lending to support part of its oil purchases. During FY06 the fresh inflows under short-term financing decline to US$ 194 million as compared to US$ 271 million last year. On the other hand, due to loan maturities outflows under this category recorded a jump of US$ 271 million, bringing down the stock of short-term loans by a net US$ 75 million during FY06.

Private Loan

After witnessing a net downward trend since FY00, Private sector loans increased by a net US$ 243 million in FY06, to reach US$ 1.6 billion (see **Figure 6.14**). This increase was due to unusually large inflows of US$ 552 million, of which US$ 189 million was contracted by the communication sector and a US$ 332 million long-term loan was contracted by Pakistan International Airlines. Moreover some inflows were also witnessed in the textile, storage facility and financial business.

Specifically, during FY06 two privately owned mobile companies contracted five new loans out of which four were fully disbursed in FY06. Detailed analysis of the profile of private loans shows that these loans were mostly denominated in Euros and were priced on floating rates at a premium of 40-250 basis points to Euribor. Private loans may rise further in coming years as many of the cell phone companies are aggressively expanding coverage and capacity and some are now seeking funding from the international capital markets.[13]

Figure 6.14: Stock of Private Loans



[12] Saudi Oil Facility (SOF) was a grant disbursed by Saudi Arab for the oil imports. This facility was terminated in February 2004.
[13] This is because of the presumed first mover advantage to operator that can lock in customer (due to the inconvenience of the changing number). However, it will be interesting to see whether the advantage still persists once PTA introduce the planned number portability which could dramatically reduce this cost of shifting operators.

On the other hand, the year also saw outflows totaling US$ 314 million, largely on account of in debt repayment of US$ 220 million by the power sector.

External Liabilities

Pakistan's external liabilities declined further by US$ 211 million to reach US$ 1.6 billion by end of FY06. This decline was mainly due to the persistent encashment of Special US Dollar bonds, as result of which their stock has depleted to mere US$ 247 million. The continuation of this trend is likely to further reduce the stock of external liabilities in coming years. However, it may be noted that even if external liabilities on account of NHA bonds and Special US dollar bond are completely paid off, a substantial portion (approximately 76 percent of current level) of the external liabilities is likely to remain as these are central bank deposits of some friendly countries, which have been regularly rolled-over since FY99.[14]

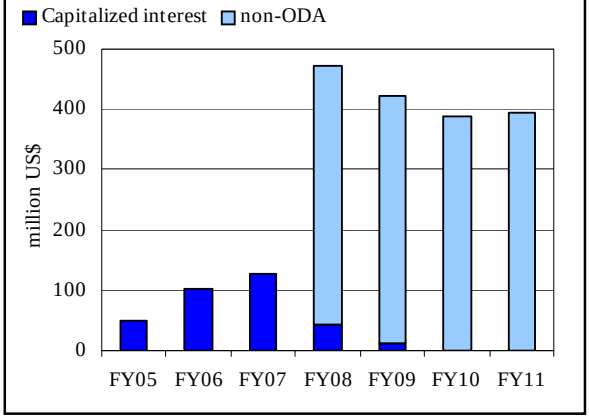
Box 6.4: Impact of deferred payments on external debt servicing

Since FY02, Paris club debt servicing has been reduced sharply as a result of the re-profiling of bilateral debt in December 2001. However, in FY06 the debt repayment started rising which was primarily due to the principal repayment of capitalized interest. In this backdrop, while analyzing the short to medium term debt servicing burden, it would be pertinent to examine the impact of these repayments also.

After the nuclear detonation in 1998 Pakistan had faced acute balance of payments difficulties and thus heavily relied on external sources to finance its deficit. At that time, around one-half of the country's foreign exchange earnings were required to service the external debt payments and country was heading towards insolvency. In response to the situation, Pakistan was forced to approach bilateral creditors for rescheduling its debt and received two back-to-back rescheduling of external debt (one in January 1999 and other in January 2001). However, even at the end of consolidation period in September 2001, it was unable to rebuild its debt repayment capacity and was therefore, yet again forced to seek relief from the Paris club in December 2001.

The re-profiling of Paris club bilateral debt stock of US$ 12.5 billion and cash flow relief in FY02 provided a major respite to the country by reducing the debt servicing burden.[15] Of the total US$ 12.5 billion, US$ 8.8 billion is ODA and US$ 3.6 billion is non-ODA loans.[16] Moreover, December 2001 rescheduling agreement also granted immediate cash relief by deferring (1) all amount of interest and principal payments falling between 30th November, 2001 and 30th June, 2002; and (2) 20 percent of annual interest accrued on restructured debt for FY03 and FY04. It was decided that all interest amounts would be capitalized in the Paris club debt stock and the principal repayments of these amounts would start from 31st May, 2005 with four equal and successive semi-annual installments.

Figure 6.4.1: Break-up of Due Debt Payments of Rescheduled Debt 2001



It is evident from **Figure 6.4.1** that from FY05 Pakistan has started paying the principal on account of capitalized interest, while the principal repayment of non-ODA loans which will start from FY08 further add another approximately US$ 430.6 million on the account of Paris club debt servicing in the same period.

[14] Central Bank deposits comprise of various friendly countries deposits (UAE: US$ 450 million placed in FY97 and FY98 and Kuwait: US$ 250 million placed in FY98).

[15] In contrast to previous two back-to-back rescheduling of external debt, in January 1999 and 2000, that provided releif only in terms of debt flows, 2001 debt restructuing also provided reduction in the net present value of the debt stock; for detail see Annual report FY02.

[16] ODA (official development assistance) is defined by OECD countries as credit with low interest rate aimed to be used for development purpose. The grace period for the ODA portion was fixed at 15 years, with maturity extended to 38 years; whereas for the non-concessional loans i.e. non-ODA, the grace period was fixed at 5 years with maturiy of 23 years.

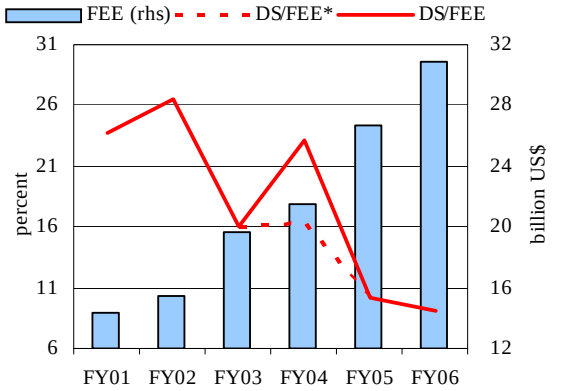
Table 6.9: Pakistan's External Debt and Liabilities Servicing
million US Dollars

	FY04	FY05	FY06
1.Public and publicly guaranteed	**3,526**	**1,812**	**2,242**
Principal	2,803	1,120	1,504
Interest	723	691	738
A. Medium and long term (> 1 year)	**3,330**	**1,803**	**1,958**
Principal	2,612	1,112	1,233
Interest	718	691	725
Paris club	**834**	**533**	**614**
Principal	519	152	257
Interest	316	381	356
Multilateral	**2,126**	**899**	**888**
Principal	1,802	692	661
Interest	324	207	227
Other bilateral	**59**	**52**	**115**
Principal	42	27	80
Interest	18	25	35
Eurobonds & Sendik metal	**197**	**218**	**250**
Principal	158	158	159
Interest	39	60	91
Military	**74**	**79**	**69**
Principal	59	67	60
Interest	15	12	9
Commercial loans /credits**	**39**	**22**	**23**
Principal	33	16	16
Interest	6	6	7
B. Short-term (< I year) IDB	**196**	**9**	**284**
Principal	191	8	271
Interest	5	0	14
2. Private loans (non-guaranteed)	**744**	**482**	**398**
Principal	613	374	314
Interest	131	109	85
3. IMF	**699**	**423**	**159**
Repurchases /principal	674	400	143
Charges /interest	26	23	16
Total debt servicing (I+II+III+IV)	**4,969**	**2,717**	**2,799**
Principal	4,090	1,894	1,960
Interest	880	823	839
4. Central bank deposits	**15**	**25**	**34**
Principal	0	0	0
Interest	15	25	34
5. NBP /BOC beposits	**15**	**16**	**28**
Principal	0	0	0
Interest	15	16	28
6. Special $ bonds	**197**	**163**	**202**
Principal	167	130	174
Interest	30	33	28
7. Foreign currency loans bonds (NHA)	**27**	**25**	**26**
Principal	22	22	22
Interest	5	3	4
9.FCAs	**1**	**1**	**3**
FE-13 (Interest)	1	1	3
10.NDRP	**4**	**1**	**0**
11.FEBC/FCBC/DBC	**47**	**19**	**18**
Principal	21	8	9
Interest	26	11	9
TOTAL:	**5,274**	**2,966**	**3,110**
Principal	4,303	2,055	2,165
Interest	972	912	945

External Debt and Liabilities Servicing

For analytical appraisal of external debt burden of any country, one of the most crucial indicators is its debt carrying capacity. The country's capacity to pay back its foreign debt can be gauged from the debt servicing to foreign exchange earning ratio. It is evident from the **Figure 6.15**, that during past few years the debt servicing indicator improved significantly, as growth in foreign exchange earning outpaced the growth in debt servicing payments. While the lower growth in debt servicing during FY02 onwards was brought about by debt re-scheduling from the Paris club in December 2001, the rise during FY04 was due to the pre-payment of expensive debt.[17]

Figure 6.15: Debt Servicing Indicators



In contrast to the pervious year, during FY06 Pakistan's debt and liabilities servicing witnessed a marginal rise of US$ 144 million (see **Table 6.9**). This increase was primarily seen for IDB short-term credit and bilateral creditors. With in the bilateral creditors, the higher payment of US$ 81 million to Paris club donors was expected on account of principal payments of the capitalized interest under the 2001 rescheduling agreement (see **Box 6.4**).

[17] US$ 1.17 billion to the ADB and US$ 325 million reflects PARCO.