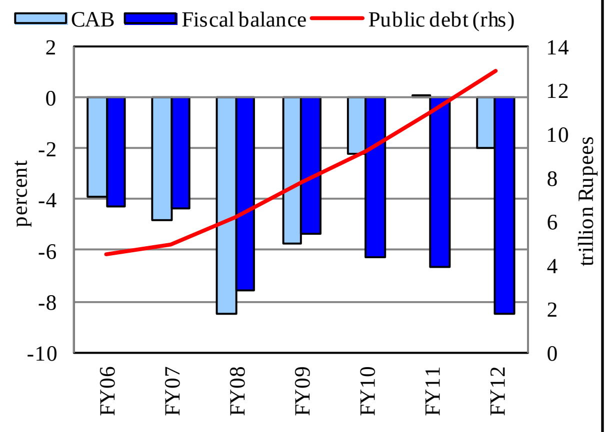
7 Domestic and External Debt

7.1 Overview[1]

The improvement in the government's debt burden last year proved short lived: public debt-to-GDP has increased to 62.6 percent in FY12, after falling in FY11.[2] With an increase of Rs 1.9 trillion during the year, Pakistan's total public debt now stands at Rs 12.9 trillion (**Figure 7.1**).[3] This sharp rise was due to a large fiscal deficit (including one-off payment for the settlement of PSE debt); and exchange losses stemming from the depreciation of the Pak Rupee.

Figure 7.1: Deficits and Public Debt Stock



Source: Ministry of Finance and SBP

Most of the increase in public debt was contributed by domestic debt:[4] its share has increased from 54.7 percent in FY11, to 59.1 percent in FY12 (**Table 7.1**). On the other hand, the stock of public external debt has declined by US$ 2 billion due to repayments to the IMF and currency revaluation impact. However, in Rupee terms, this stock has increased due to the depreciation of Pak Rupee against US Dollar in FY12.[5]

Since the persistently large fiscal deficits in the past few years have been financed primarily by costlier domestic sources, this has raised concerns regarding debt sustainability. In this context, two points are worth noting: firstly, within domestic sources, a heavy reliance on expensive short-term debt has increased the debt servicing burden of the country, and has also intensified roll-over and interest rate risks;[6] and secondly, Pakistan has been running a revenue deficit for the past six years, implying that a large part of public borrowings (that financed its current expenditures) did not add to the repayment capacity of the economy (**Figure 7.2**).[7] These debt dynamics indicate that Pakistan could move into a debt trap.[8]

Table 7.1: Public Debt Vulnerability Indicators

percent

	FY08	FY09	FY10	FY11	FY12
Public debt/GDP	60.7	61.6	62.4	60.9	62.6
Public debt/revenues	414.6	423.3	444.1	486.2	503.6
Domestic debt/total public debt	52.7	49.3	50.4	54.7	59.1
Floating debt/domestic debt	50.0	49.3	51.5	53.8	54.2

Source: State Bank of Pakistan

---

[1] This analysis is based on the SBP's definition of public debt, which is different from Ministry of Finance coverage of public debt. For details, see **Box 7.1**.
[2] In FY11, public debt-to-GDP had declined to 60.9 percent from 62.4 percent a year ago (see **Table 7.2**).
[3] According to Ministry of Finance, public debt has reached Rs 12.7 trillion by end June 2012.
[4] Around 84 percent of the entire increase in the public debt stock during FY12 was contributed by domestic debt, whereas the residual increase was caused by increase in Rupee value of external debt on account of depreciation of Pak Rupee.
[5] Countries normally contract debt in various currencies, which is converted into US Dollar at a particular point in time, for reporting purposes. The exchange rate movements of US Dollar against these currencies cause significant changes in the external debt stock of these countries, which is referred as currency revaluation impact.
[6] Debt servicing payments have surpassed government's tax revenue receipts (after adjusting for provincial share) since last year.
[7] Revenue balance is the gap between total revenue and current expenditures of the government. In FY12, the revenue deficit stood at 62.5 percent of the country's interest payments.
[8] Debt trap refers to a situation, when a country incurs a large amount of debt in comparison to its income. As a result, high interest payments prevent repayment of the principal. According to ADB (2002), the classic symptoms of debt trap include: falling investment rates, declining development and social spending by the government, and progressively lower rates of

Table 7.2: Profile of Pakistan's Debt and Liabilities

	FY10	FY11	FY12	FY10	FY11	FY12
	billion Rupees			percent of GDP		
Total debt & liabilities	10,702.2	12,530.0	14,587.0	72.3	69.5	70.6
Public debt[1]	9,229.1	10,990.7	12,924.3	62.4	60.9	62.6
Total debt	10,069.9	11,908.4	13,921.6	68.0	66.0	67.4
Govt. domestic debt[2]	4,650.8	6,012.2	7,638.3	31.4	33.3	37.0
PSEs domestic debt	375.0	411.5	281.1	2.5	2.3	1.4
External debt	5,040.8	5,484.7	6,002.3	34.1	30.4	29.1
Govt. external debt	3,667.1	3,987.7	4,364.5	24.8	22.1	21.1
IMF loans	690.3	768.7	694.3	4.7	4.3	3.4
PSEs external debt	131.2	116.6	144.2	0.9	0.6	0.7
Private sector external debt	386.2	470.4	600.6	2.6	2.6	2.9
Intercompany debt	166.1	141.2	198.7	1.1	0.8	1.0
Total liabilities	635.5	621.6	665.4	4.3	3.4	3.2
Domestic liabilities	414.6	399.5	438.1	2.8	2.2	2.1
External liabilities	220.9	222.1	227.3	1.5	1.2	1.1
Total debt servicing	978.4	1,017.4	1,260.2	6.6	5.6	6.1
Interest payment	715.0	807.1	966.3	4.8	4.5	4.7
Domestic debt	577.7	650.3	811.2	3.9	3.6	3.9
External debt[3]	82.9	90.6	89.8	0.6	0.5	0.4
Domestic liabilities	52.1	65.0	64.2	0.4	0.4	0.3
External liabilities	2.3	1.3	1.1	0.0	0.0	0.0
Repayment of principal (foreign)	263.4	210.3	294.0	1.8	1.2	1.4

[1] Public debt include govt. domestic debt, govt. external debt, IMF loans & external liabilities

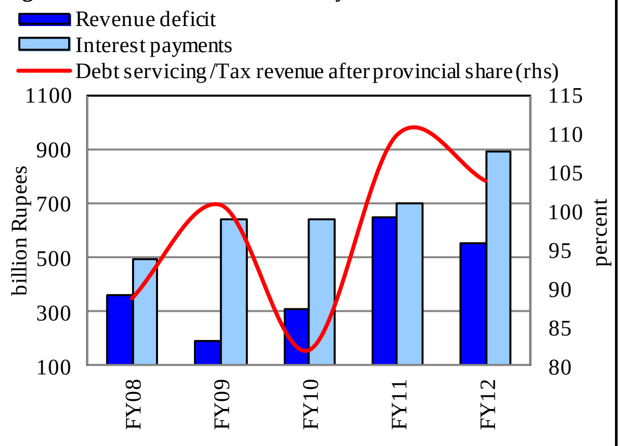
[2] Domestic debt also includes Rupee value of FEBCs, FCBCs, DBCs and Special US Dollar Bonds held by the residents

[3] Principal repayment of scheduled bank is excluded from the analysis.

Source: State Bank of Pakistan

In this context, it is not surprising to see the current level of Pakistan's debt stock *above* domestic and international standards. Specifically, public debt in Pakistan is subject to limits prescribed in the FRDL Act (2005), which places a ceiling on the public debt-to-GDP ratio of 60 percent by end FY13, which is to be achieved by running a positive revenue balance after 2008.[9] A public debt-to-GDP ratio of 62.6 percent in FY12, along with persistent revenue deficits, reflects the need for a significant fiscal adjustment in FY13.[10] Similarly, this ratio is also higher than the threshold level identified by the IMF.[11] In addition, an international comparison shows

Figure 7.2: Public Debt Vulnerability Indicators



Source: Ministry of Finance

GDP growth. These factors further weaken macroeconomic performance of the country, making the servicing of debt even more difficult.

[9] The Act also envisages an annual 2.5 percentage point reduction in this ratio after achieving the 60 percent benchmark by end FY13.

[10] Although the condition for 60 percent of debt-to-GDP ratio was met ahead of schedule in FY06, this achievement could not be sustained.

[11] IMF (2011), "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis", Fiscal Affairs Department and the Strategy Policy and Review Department. According to IMF, at a public debt level of 60 percent of GDP, detailed analysis of risks to sustainability arising from high debt levels should be conducted.

that Pakistan's gross debt is higher than the average for both emerging, as well as low-income economies (**Table 7.3**). However, Pakistan fares better than many European countries. In our view, the on-going Euro crisis is likely to persist as most European countries are still struggling to contain their massive debt-to-GDP ratios (**Table 7.4**).

Stepping back, Pakistan's external vulnerability has also increased during FY12; as in the absence of sufficient external inflows, the repayment burden of external debt (along with the financing of current account deficit) fell on the country's FX reserves.[12] This resulted in downgrading of Pakistan's sovereign credit rating to its lowest level, Caa1, by Moody's in July 2012.[13]

These challenges to the macroeconomic stability of the country, emphasize the need for fiscal consolidation. It is important to realize that a country cannot continue increasing its debt stock without a commensurate increase in its repayment capacity. Global experience shows that failing to adhere to this simple principle, has led to several episodes of defaults, on both external and domestic debts (**Box 7.3**).[14]

Box 7.1: Public Debt – Differences in SBP & MoF Definition

According to SBP data, public debt reached Rs 12.9 trillion by end June 2012, while the Ministry of Finance has reported public debt at Rs 12.7 trillion for the same period (**Table 7.1.1 & 7.1.2**). This disparity in debt numbers is due to differences in coverage of public debt reported by the two organizations.

The SBP follows IMF guidelines for compiling public debt, which state, "public sector includes the general government, monetary authorities, and those entities in the banking and other sectors that are public corporations."[15]

Thus, public debt reported by SBP, is composed of four broad categories: (i) government domestic debt; (ii) government external debt; (iii) IMF loans; and (iv) external liabilities. It may be noted, however, that due to the unavailability of detailed information, SBP public debt numbers do not include PSE's debt.

Table 7.3: International Comparison - Gross Debt/GDP

percent

	2008	2009	2010	2011	2012
Low income countries	39.1	41.3	38.6	38.2	39.5
Advanced economies	81.5	93.0	99.3	103.5	106.5
Emerging economies	34.7	36.7	41.0	37.6	35.7
China	17.0	17.7	33.5	25.8	22.0
India	74.7	75.0	69.4	68.1	67.6
Pakistan*	60.7	61.6	62.4	60.9	62.6

*Data for Pakistan pertains to fiscal year.

Source: Fiscal Monitor, Balancing Fiscal Policy Risks, April 2012, IMF & State Bank of Pakistan

Table 7.4: Government Debt-to-GDP Ratio in European Countries

percent

	2011	2012
United Kingdom	82.5	88.4
Austria	72.2	73.9
Belgium	98.5	99.1
France	86.1	88.2
Germany	81.2	82.2
Greece	165.4	162.6
Ireland	108.2	117.6
Italy	120.1	125.8
Netherlands	66.2	70.1
Portugal	107.8	114.4
Spain	68.5	90.3

Source: IMF and Bloomberg

Table 7.1.1: Public Debt -Ministry of Finance

billion Rupees

	FY09	FY10	FY11	FY12
Public debt (I+II)	**7,595**	**8,938**	**10,709**	**12,661**
I. External debt	3,736	4,284	4,694	5,023
II. Government domestic debt	3859	4,654	6,015	7,638
Public debt/GDP	**59.7**	**60.4**	**59.4**	**61.3**

Source: Pakistan Economic Survey 2011-12 and Ministry of Finance

Table 7.1.2: Public Debt - SBP

billion Rupees

	FY09	FY10	FY11	FY12
I. Government external debt (i+ii+iii)	3,452.0	3,667.1	3,987.7	4,364.5
i. Medium & long-term	3,382.7	3,580.1	3,921.0	4,318.7
ii. Military	16.2	14.3	11.6	9.7
iii. Short-term debt	53.1	72.7	55.0	36.1
II. From IMF	419.0	690.3	768.7	694.3
III. External liabilities	103.7	220.9	222.1	227.3
IV. Government domestic debt	3,860.7	4,650.8	6,012.2	7,638.3
Public debt (I+II+III+IV)	**7,835.3**	**9,229.1**	**10,990.7**	**12,924.3**
Public debt/GDP	**61.6**	**62.4**	**60.9**	**62.6**

Source: State Bank of Pakistan

[12] Country's FX reserves fell from the level of 27.8 weeks of imports in FY11, to 19.9 weeks of imports in FY12.
[13] This is the lowest rating assigned to Pakistan since 1999, by Moody's.
[14] (IMF 2008), "Staff Guidance Note on Debt Sustainability Analysis for Market Access Countries", Prepared by the Policy Development and Review Department
[15] Source: IMF (2003), "External Debt Statistics, Guide for Compilers and Users."

While both MoF and SBP follow the same definition of government domestic debt, the coverage of government external debt compiled by MoF differs from that of SBP. Specifically, MoF does not include short-term debt, military debt and external liabilities in its compilation of the government external debt. As a result, overall public debt numbers from these two organizations do not match.

7.2 Domestic Debt

As discussed earlier, a large fiscal deficit has resulted in Rs 1.6 trillion increase in the country's domestic debt during FY12 (**Table 7.5**). More than half of this increase came from short-term debt, as the government borrowed heavily from the domestic banking system (**Table 7.6**).

Table 7.6: Government Primary Auction Details for FY12

billion Rupees

	Target	Offered	Accepted
T-bills	3,345.0	4,773.6	2,854.6
PIBs	185.0	325.0	221.0
Ijara	150.0	248.3	186.8
Total	**3,680.0**	**5,346.9**	**3,262.4**

Source: State Bank of Pakistan

Table 7.5: Position of Domestic Debt

billion Rupees

	Outstanding Stock			Interest Payments		
Debt Instrument	**FY11**	**FY12**	**Change**	**FY11**	**FY12**	**Change**
A. Permanent debt	1,122.4	1,695.9	573.5	91.8	136.0	44.2
Of which						
GOP ijara sukuk 3yrs	224.6	383.5	158.9	11.2	26.9	15.6
Pakistan investment bonds (PIBs)	616.4	974.7	358.3	57.3	81.7	24.5
Prize bonds	277.1	333.4	56.3	22.8	27.3	4.5
B. Floating debt	3,232.6	4,142.9	910.3	361.4	377.1	15.7
Market treasury bills	1,814.8	2,383.2	568.4	191.9	202.8	10.8
Market related treasury bills (MRTBs)	1,417.8	1,759.7	341.9	169.5	174.4	4.9
C. Unfunded debt	1,655.8	1,798.0	142.2	197.0	298.0	101.0
Of which						
Defense saving certificates	234.5	241.8	7.3	55.9	70.8	14.9
Special savings certificates (registered)	394.6	341.8	-52.8	24.3	86.7	62.4
Regular income certificates	182.6	226.6	44.0	19.3	25.5	6.2
Behbood savings certificates	428.5	480.8	52.3	61.0	69.8	8.8
Pensioners' benefit account	146.0	162.3	16.4	21.4	23.9	2.6
D. Foreign currency instruments *	1.4	1.4	0.0	0.1	0.0	-0.1
Total domestic debt (A+B+C+D)	6,012.2	7,638.3	1,626.1	650.3	811.2	160.9

* It includes FEBCs, FCBCs, DBCs and Special US Dollar Bonds held by the residents.
Source: State Bank of Pakistan

7.2.1 Floating Debt

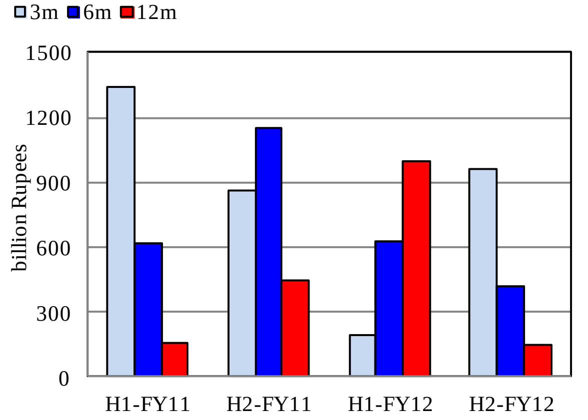
The share of floating debt in domestic debt has reached to 54.2 percent by end FY12; the increase of Rs 910.3 billion includes Rs 195 billion for the settlement of circular debt discussed earlier.[16]

Bank investment in T-bills saw two distinct patterns during FY12. In the first half of the year, following a cut in the policy rate, banks shifted their investment towards 12-month T-bills, to lock-in longer-term assets in anticipation of a further decline in interest rates. However, in the second half of the year, concerns over a weak external position and persistence in inflation, raised expectations of status quo in the policy rate, which prompted banks to shift towards 3-month T-bills (**Figure 7.3**)[17].

[16] Of the total settlement of Rs 391 billion, Rs 195 billion were raised by issuing 12-month T-bills.
[17] By end-June 2012, the share of 3-month securities in the outstanding T-bills stock stood at 25 percent, compared to a mere 8.4 percent in the same period last year.

As shown in **Table 7.5**, even though banks *offered* above-target amounts in the T-bill auctions, the government did not adhere to these targets, and borrowed much less. This was due to higher rates demanded by the banks, which the government was not comfortable with. As a result, the government's reliance on borrowing from the central bank increased during FY12: after retiring Rs 103 billion to SBP during Q1-FY12, the government breached its commitment of zero quarterly borrowing from SBP in the fourth quarter after the amendment in the SBP Act.

Figure 7.3: Realized Amount in T-bill Auctions



Source: State Bank of Pakistan

7.2.2 Permanent Debt

Permanent debt increased by Rs 573.5 billion during FY12 that includes Rs 195 billion worth of 5-year PIBs for the settlement of circular debt (**Table 7.4**). Furthermore, the stock of prize bonds also increased by Rs 56.3 billion due to strong public interest in the newly introduced Rs 25,000 denominated bond during the year. While some of this increase could be attributed to substitution from other securities, we believe that fresh mobilization has taken place as this denomination appears to meet investors' needs.

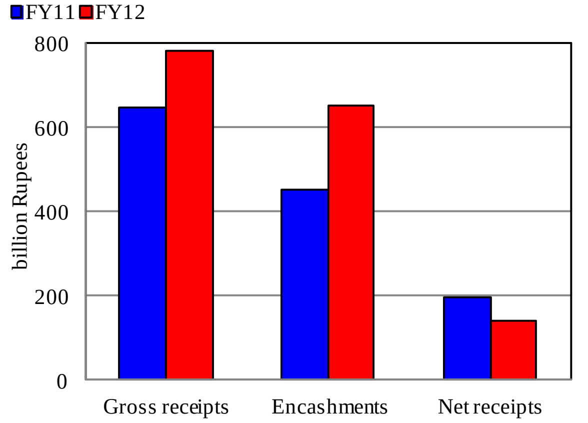
7.2.3 Unfunded debt

Pakistan's unfunded debt increased by Rs 142.2 billion during FY12, which was smaller than FY11, despite higher gross NSS inflows during FY12. This was primarily due to higher encashments by institutional investors, who were barred from participating in these schemes from April 2011 (**Figure 7.4**).

Gross receipts in NSS were higher despite two downward revisions in the rates in October 2011 and January 2012. This probably reflects the fact that even lower rates were attractive to investors compared with alternative bank deposits (**Table 7.7**).[18]

Furthermore, to boost private savings in the country and reduce government dependence on the bank borrowing, the Central Directorate of National Savings (CDNS) has launched certificates of shorter maturities, i.e., 3-month, 6-month and 12-month, from 1st July, 2012. While this initiative will help in mobilizing funds, it carries the risk of reducing the average maturity of borrowing through NSS.

Figure 7.4: NSS Flows



Source: Central Directorate of National Savings

Table 7.7: Rates of Return on Major NSS Instruments

percent

	RICs	PBAs	BSCs	SAs
Jul-11	13.44	15.36	15.36	9.00
Oct-11	12.60	14.40	14.40	8.50
Jan-12	11.76	13.86	13.86	8.25
Apr-12	12.12	14.28	14.28	8.40
Jul-12	12.36	14.64	14.64	8.65

Source: Central Directorate of National Savings

[18] The rates on NSS were, however, revised upward during April 2012 and July 2012.

7.3 Interest Payments on Domestic Debt

Interest payments on domestic debt rose by 24.7 percent during FY12. However, nearly one-third of the total increase (Rs 811.2 billion) was due to encashment by institutional investors from NSS, specifically SSCs (**Table 7.5**). Previously, institutional investors were reinvesting interest payments on these certificates, but due to the ban on their participation, large withdrawals were seen during the year. Furthermore, concentrated payments on PIBs due in Q4-FY12, increased interest payments on permanent debt in FY12.

7.4 External Debt & Liabilities

The stock of external debt & liabilities (EDL) fell by US$ 569 million to reach US$ 65.8 billion by end-June 2012 (**Table 7.8**).[19] Currency revaluation, and a sizeable increase in debt repayment, explains this fall.[20]

Table 7.8: Pakistan's External Debt and Liabilities

billion US$

	FY11	FY12	Abs Δ
Public debt (1+2+3)	**57.9**	**55.9**	**-2.0**
1. Government debt	46.4	46.1	-0.3
i) Long term(>1 year)	45.7	45.7	0.0
of which			
Paris club	15.5	15.0	-0.4
Multilateral	25.8	25.4	-0.4
Bilateral	1.9	2.5	0.5
Euro/Sukuk global bonds	1.6	1.6	0.0
ii) Short term (<1 year)	0.6	0.4	-0.3
2. From IMF	8.9	7.3	-1.6
i) Federal government	2.0	1.9	-0.1
ii) Central bank	6.9	5.4	-1.5
3. Foreign exchange liabilities	2.6	2.4	-0.2
4. Public sector enterprises (PSEs)	1.4	1.5	0.2
i) Guaranteed debt	0.1	0.2	0.1
ii) Non guaranteed debt	1.3	1.3	0.0
5.Banks	1.1	1.8	0.7
i) Borrowing	0.4	0.9	0.5
ii) Nonresident deposits (LCY & FCY)	0.7	1.0	0.3
6. Private sector	4.4	4.5	0.1
i) Non guaranteed debt	4.4	4.5	0.1
Loans	2.4	2.2	-0.1
Non-guaranteed bonds	0.1	0.1	0.0
Trade credits	1.6	1.6	0.0
Other debt liabilities	0.3	0.3	0.0
7. Debt liabilities to direct investors	1.6	2.1	0.5
Total external debt (1+2+3+4+5+6+7)	**66.4**	**65.8**	**(0.6)**

Source: For serial no. 1 & 2, with the exception of 2.i & 4.i Economic Affairs Division, rest from State Bank of Pakistan.

7.4.1 Sustainability of External Debt & Liabilities

The evaluation of a country's external debt sustainability includes an assessment of its debt carrying capacity as indicated by solvency indicators, as well as the ability to meet immediate external liabilities (as measured by liquidity indicators). On a positive note, following the decline in EDL stock, Pakistan's external debt burden fell from 31.5 percent of GDP in FY11, to 28.5 percent in FY12 (**Table 7.9**). However, this improvement was not reflected in a reduction in debt servicing burden, since debt servicing ratios to foreign exchange earnings (FEE) and export earnings (XE) deteriorated this year. While the debt repayment to IMF led to a 21.2 percent increase in debt servicing, FEE grew by only 0.6 percent during the year (largely on account of declining export earnings).

Furthermore, the country's foreign exchange reserves also came under pressure in FY12, as *reserve adequacy* in relation to the short-term debt and current account deficit – as shown by the ratio (STD+CAB)/RES – deteriorated (**Table 7.9**).[21]

[19] SBP has enhanced the coverage of external debt statistics, according to the IMF external debt guide (2003). The additional data includes: (i) short term local currency securities held by the government (ii) over draft balances of PSEs (iii) local and foreign currency deposits held by non-residents (iv) private sector trade credits (e) liabilities of pension funds & life insurance companies to non-residents, claims on non-life companies; capital subscriptions to international non-monetary organizations, etc., and (v) debt liabilities to direct investors.

[20] Exchange rate revaluation resulted in US$ 1.3 billion transactional gain for Pakistan during FY12. Currency composition of external debt revealed that 11 percent of public external debt stock is denominated in Euros. Therefore, a large 13.1 depreciation in the value of Euro vs. US Dollar resulted in US$ 767 million fall in the external debt stock during FY12. In addition, the appreciation of US Dollar against SDRs resulted in a further US$ 662 million transactional gain during this year.

[21] The dip in this ratio during FY11 was mainly due to a surplus in current account.

Non-interest current account deficit is an important determinant of a country's external debt burden. In the absence of a commensurate increase in non-debt creating capital inflows, the rise in the current account deficit translates into an increase in debt stock of a country (or depletion of foreign exchange reserves). In FY12, as external loan inflows were not forthcoming, the current account deficit along with payments of external debt, led to a fall in the country's FX reserve from 27.8 weeks at end-June 2011, to 19.9 weeks by end-June 2012 (**Table 7.9**). Thus, despite a fall in external indebtedness, Pakistan's external vulnerability increased during FY12.

Table 7.9: Indicators of External Debt Sustainability

	FY08	FY09	FY10	FY11	FY12
Solvency indicators					
TED/GDP*	--	--	33.4	30.3	27.4
EDL/GDP*	--	--	34.9	31.5	28.5
IP/FEE	3.4	3.3	2.7	2.3	2.2
EDS/FEE	8.7	13.5	12.2	7.5	9.0
IP/XE	6.1	6.1	5.2	4.2	5.5
EDS/XE	15.6	24.8	23.3	13.9	23.3
Liquidity indicators					
STD/TED*	--	--	3.3	2.6	2.0
RES/STD*	--	--	8.7	11.7	12.0
(STD+CAB)/RES*	--	--	34.9	7.5	38.8
WoM (number)	17	21.1	28.2	27.8	19.9

TED: Total External Debt; EDL: External Debt and Liabilities; IP: Interest Payments; EDS- External Debt Servicing; IP- Interest Payments; STD; Short Term Debt; CAB- Current Account Balance; WoM- Weeks of Imports; FEE- Foreign Exchange Earnings; XE- Exports Earnings; RES- Overall Reserves

*Debt data according to new coverage, not available before FY10.

Source: State Bank of Pakistan calculations

Furthermore, a regional comparison of Pakistan's external debt also highlights some concerns. According to the Global Development Finance (2012), Pakistan's external debt (while declining) is higher than the average South Asian and developing economies. Similarly, debt servicing claims a larger share of export earnings in the case of Pakistan, compared to developing and South Asian countries, whereas FX reserves-to-external debt, is also below the comparison countries (**Figure 7.5**).

Disbursements

Disbursements by external creditors recorded a welcome 19.0 percent YoY increase in FY12. According to the donor-wise composition, while bilateral loan inflows recorded a sharp 59.3 percent increase during FY12, inflows from the multilateral creditors, particularly IDA & ADB declined (**Table 7.10**). The increase from bilateral creditors, largely owes to the provision of a medium-term (2-years) BoP support from China in June 2012. Excluding this, inflows of external loans fell by 0.6 percent, compared to last year.

Table 7.10: Net External Flows from Major IFIs

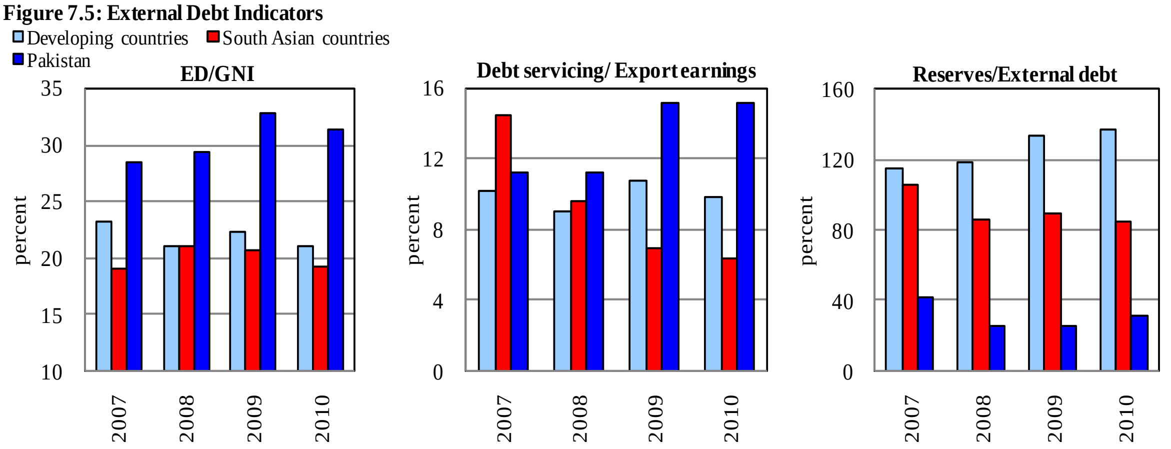
million US$

	FY09	FY10	FY11	FY12
ADB	1,019.4	323.3	-231.6	-400.0
IDA	622.9	453.4	540.8	290.4
IDB (LT)*	62.6	126.6	40.2	138.4
IDB(ST)**	-280.0	201.1	-353.7	-23.0
IMF	3639.0	2054.0	-440.0	-1,319.0

*Long-term, **Short-term

Source: State Bank of Pakistan and Economic Affairs Division

Figure 7.5: External Debt Indicators



Source: Global Development Finance (2012)

In overall terms, against the total commitments of US$ 4.0 billion, actual inflows stood at US$ 3.0 billion during this year (**Figure 7.11**). In particular, program loans recorded a sharp decline during FY12. It is important to mention here, that the suspension of IMF's SBA is a key factor in the declining program loan inflows. These inflows are long-term in nature, involve strict scrutiny at the time of disbursement, and are generally linked to the IMF's endorsement. The suspension of the IMF program in FY11, and slow progress of fiscal reforms are responsible for dwindling inflows.

7.4.2 External Debt Servicing

As expected, Pakistan's external debt servicing recorded a significant US$ 784.5 million increase during FY12 (**Table 7.12**). Within that, while the interest payments on external loans witnessed a YoY decline, repayments of *principal* surged due to the repayment to the IMF.[22] This increase in debt servicing, in the presence of negligible growth in foreign exchange earnings, reduced the country's debt servicing capacity during the year (**Figure 7.6**).

On the upside, Pakistan was able to roll-over central bank deposits worth US$ 1.0 billion, as well as US$ 543 million owed to IDB during FY12. In the absence of these arrangements, the debt servicing burden would have been even higher.

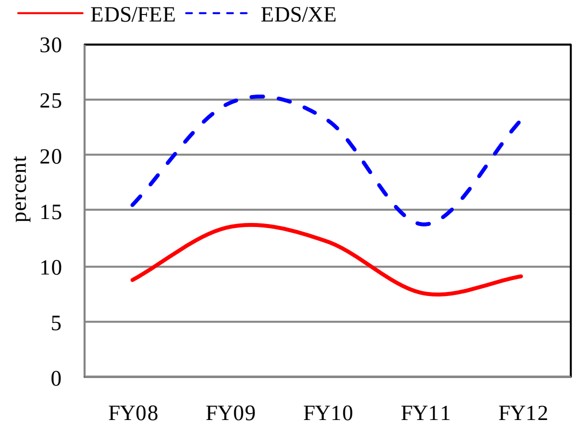
Table 7.11: Loan Disbursements

million US$

	FY11	FY12	Abs Δ
Bilateral	**1,096.8**	**1,747.5**	**650.8**
of which			
China	314.1	1,047.6	733.6
Japan	167.2	227.3	60.0
UK	117.6	171.8	54.2
Multilateral	**1,451.2**	**1,284.5**	**-166.6**
of which			
ADB	497.4	417.8	-79.5
IDA	791.5	575.4	-216.2
IDB	55.0	149.6	94.6
Total	2,548.0	3,032.1	484.1

Source: Economic Affairs Division

Figure 7.6: Detrioration in Pakistan's Debt Servicing Capacity



Source: State Bank od Pakistan

[22] Importantly, the amortization of IMF loans is likely to keep debt servicing high till FY15.

Table 7.12: External Debt Servicing
million US$

	FY07	FY08	FY09	FY10	FY11	FY12
i. Public debt (a+b+c)	**2,031.3**	**2,377.1**	**3,130.7**	**3,321.9**	**2,826.6**	**3,657.0**
Principal	1,120.8	1,372.7	2,162.9	2,445.1	1,881.7	2,800.0
Interest	910.5	1,004.4	967.9	876.9	944.9	892.6
a. Govt. debt	1,833.3	2,128.1	2,822.7	2,784.1	2,247.9	2,263.0
Principal	978.8	1,177.7	1,930.9	2,053.4	1,491.5	1,546.3
Interest	854.5	950.4	891.9	730.7	756.5	716.7
b. IMF loans	143.0	191.0	264.0	359.4	441.8	1317.8
Principal	120.0	173.0	210.0	239.8	268.2	1153.7
Interest	23.0	18.0	54.0	119.6	173.6	164.1
c. FX Liabilities	55.0	58.0	44.0	178.4	136.9	111.8
Principal	22.0	22.0	22.0	151.9	122.0	100
Interest	33.0	36.0	22.0	26.5	14.9	11.8
ii. PSEs debt	**270.1**	**252.7**	**236.9**	**351.9**	**358.9**	**248.9**
Principal	200.7	171.0	176.8	290.4	310.1	211.0
Interest	69.3	81.7	60.1	61.4	48.7	38.0
iii. Private sector debt	**382.7**	**484.8**	**628.6**	**457.0**	**321.0**	**349.5**
Principal	271.6	323	497.8	388.2	247.2	265.3
Interest	111.1	161.8	130.8	68.8	73.8	84.1
External debt (i+ii+iii)	**2,684.0**	**3,114.6**	**3,996.2**	**4,130.8**	**3,506.5**	**4,291.0**
Principal	1,593.1	1,866.7	2,837.4	3,123.6	2,439.0	3,276.3
Interest	1,090.9	1,247.8	1,158.8	1,007.1	1,067.5	1,014.7

Source: State Bank of Pakistan

Box 7.2: Domestic Debt Burden: Early Warning Signs for Pakistan

International Experience: Difficulties in raising external financing have led to large increases in domestic debt burden in a number of countries. According to Reinhart & Rogoff (2008), domestic debt accounted for almost two-third of total public debt for a sample of 64 emerging and advanced countries, during the period 1914-2007. Contrary to the popular belief, that governments *always* honor their domestic liabilities, an excessive reliance on expensive domestic borrowing has led to a large number of sovereign defaults on domestic debt.[24]

Table 7.2.1: Early Warning Signs[23]
percent

Indicators	Threshold
Fiscal deficit/GDP	3
Public debt servicing/government revenues	15
Public domestic debt/government revenues	200

Given the risks to macroeconomic stability from excessive reliance of the government on domestic borrowing, this is pertinent to assess the sustainability of a country's domestic debt burden also. A detailed survey of literature provides a set of indicators for assessment of fiscal and debt sustainability in member countries (**Table 7.2.1**). Furthermore, the literature also highlights the growth supporting effects of a moderate level of domestic debt, through the channels of improved monetary policy; broader financial market development; strengthened domestic institutions and enhanced private savings and financial intermediation. In this regard, Abbas and Christensen (2007) finds that the domestic debt above 35 percent of bank deposits can hurt economic growth.[25] These benchmarks can be used as early warning signals for the assessment of Pakistan's fiscal and domestic debt sustainability.

Pakistan's Scenario: Pakistan's case is not an exception to international experience. A sharp increase in the fiscal deficit, coupled with unavailability of external financing, has led to a rising domestic debt burden over the past few years. In particular, the share of domestic debt in total public debt has risen from 49.3 percent in FY09 to 59.1 percent in FY12.

[23] Sources: (i) Buti Marco and Noord Paul van den (2004), "Fiscal policy in EMU: Rules, discretion and political incentives", European commission, Directorate-General for Economic and Financial affairs. Economic papers; (ii) Heavily Indebted Poor Countries Capacity Building Programme (2009), "Debt Sustainability Indicators", www.development-finance.org/.../83-debt-sustainability-indicators-2009-02.html; (iii) A study on "domestic debt sustainability" by Macroeconomic and Finance Management Institute of Eastern and Southern Africa –MEFMI (2002).

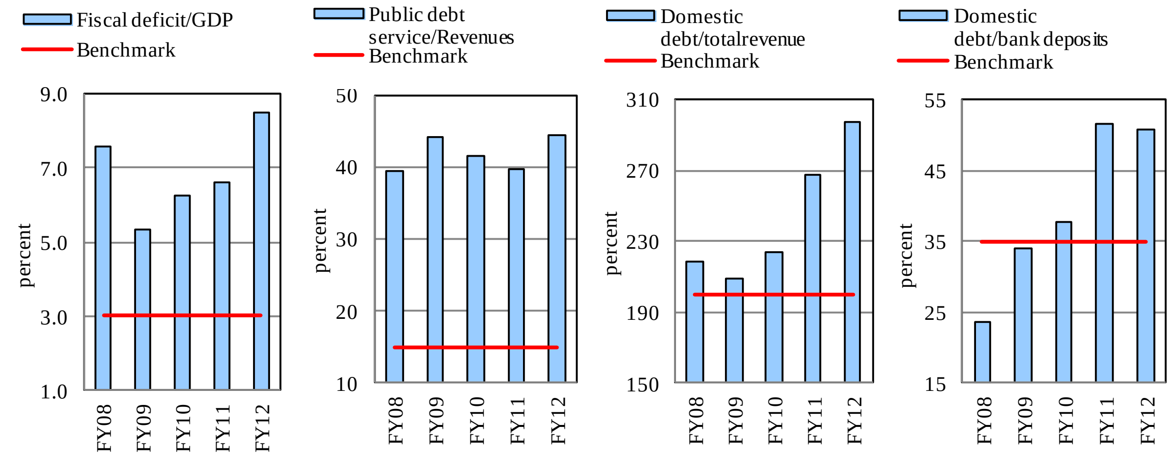
[24] According to Reinhart & Rogoff (2008), during the period of 1914-2007, there have been 68 cases of defaults on domestic debt. These defaults took place through a number of mechanisms ranging from forcible conversions to suspension of payments.

[25] For obtaining consistent data series on domestic debt across the sample countries, Abbas and Christensen (2007) defined domestic debt as banks' and other banking institutions' claims on central government.

A comparison of Pakistan's fiscal and debt indicators with the earlier identified benchmarks presents a gloomy picture. The country's fiscal deficit is above the threshold level by a wide margin, and the servicing of public debt takes away a growing share of revenues as compared to the benchmark level. Similarly, due to a sharp increase in country's domestic debt, the ratio of domestic debt-to-total revenues has witnessed significant deterioration since FY10 (**Figure 7.2.1**). Finally, domestic debt, calculated as banks' and other depository institution's claims on the government is also above the benchmark. This shows that excessive reliance on the banking system for budgetary borrowing has reached the level where the growth distorting effects of domestic debt in the form of crowding-out of private sector, debt sustainability issues, inflation, etc., start to emerge.

This situation indicates the need for introducing stringent fiscal discipline. In this regard, Pakistan has adopted a 'rule based fiscal policy stance' since 2005. The fiscal policy rules/targets were incorporated in the 'Fiscal Responsibility and Debt Limitation (FRDL) Act, which was passed by the Parliament in 2005. This act laid down specific targets for fiscal and debt indicators, along with clearly mentioned timelines. In addition, the recent amendment in the SBP Act in March 2012 – that places limits on government borrowing from the central bank – is also an attempt in this direction.

Figure 7.2.1: Domestic Debt Sustainability - Early Warning Signs



Source: Analyst estimates

Therefore, the early warning indicators identified in this section are an addition to the existing stock of fiscal rules for the government. International experience suggests that a failure to introduce reforms can lead the country to a serious macroeconomic crisis.

References:

- Reinhart Carmen M. and Rogoff Kenneth S. (2008), "The forgotten history of domestic debt", NBER Working Paper 13946.
- Abbas S. M. Ali and Christensen Jakob E (2007), "The role of domestic debt markets in economic growth: An empirical investigation for low-income countries and emerging markets", IMF Working Paper, WP/07/127
- Buti Marco and Noord Paul van den (2004), "Fiscal policy in EMU: Rules, discretion and political incentives", European commission, Directorate-General for Economic and Financial affairs. Economic papers.
- Heavily Indebted Poor Countries Capacity Building Programme (2009), "Debt Sustainability Indicators", www.development-finance.org/.../83-debt-sustainability-indicators-2009-02.html
- Macroeconomic and Finance Management Institute of Eastern and Southern Africa (2002), "Sustainability of Domestic Debt", www.mefmi.org/.../pub-2002-study-sustainability-of-domestic-debt.pdf