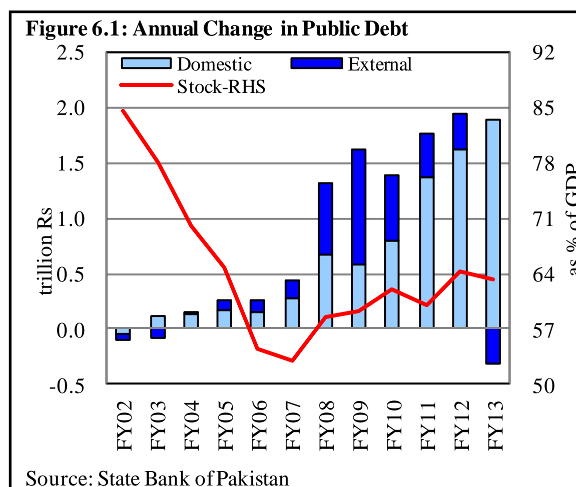
6 Domestic & External Debt

6.1 Overview [1]

Pakistan's public debt continued to be a major risk to the country's macroeconomic stability during FY13. While external inflows were squeezed further in FY13, domestic debt kept rising at an alarming pace (**Figure 6.1**). Furthermore, concerns about debt sustainability deepened with the growing burden of debt servicing.[2] Despite the one percentage point reduction during FY13, Pakistan's public debt is still 63.3 percent of GDP – higher than the ceiling of 60 percent under the Fiscal Responsibility and Debt Limitation Act (FRDL) of 2005.[3] Furthermore, the government could not observe the commitment of zero net quarterly borrowing from the central bank, which is stipulated in the SBP Act (amended in March 2012).

Figure 6.1: Annual Change in Public Debt



Source: State Bank of Pakistan

The country's debt dynamics did not improve despite a Rs 313 billion decline in Pakistan's *external* debt. With external sources of funding shrinking over the past several years, large repayments to the IMF and the depreciation of the Yen are driving the fall in external debt during FY13.[4] Domestic debt, on the other hand, recorded a substantial rise of Rs 1.9 trillion (YoY growth of 24.6 percent), which in turn, pushed the public debt stock to Rs 14.5 trillion by end-Jun 2013 (**Table 6.1**).

More importantly, the mounting domestic debt (which now makes up around two-third of the entire public debt, compared to 59 percent last year)[5] entails significant risks to Pakistan's fiscal and debt outlook. Two of the most important issues are:

(1) *Rise in the debt servicing burden:* Over reliance on domestic financing put a heavy burden on the country, as overall interest payments have surpassed both tax revenues (adjusted for provincial share) and development spending, during the past several years.[6,7] As a result, Pakistan's revenue deficit widened further in FY13, implying less fiscal space for development spending. Of course, if this continues, it will erode the debt repayment capacity of the economy, which by definition comes from generating economic growth and containing wasteful expenditures. Already, interest

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[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 Data Explanatory Notes 5(b), **Annexure A**.

[2] Overall debt servicing increased to 6.7 percent of GDP during FY13, compared to 6.3 percent in the previous year. The ratio of external debt servicing to foreign exchange earnings deteriorated to 12.0 percent on end-Jun 2013, compared to 9 percent, a year earlier. The ratio of overall interest payment to tax revenues (after adjusting for provincial share) deteriorated to 118.9 percent, from 103.9 percent in FY12.

[3] In an effort to ensure fiscal discipline, government adopted a 'rule based' fiscal policy stance in FY05 through the enactment of FRDL Act, which placed a limit of 60 percent of GDP on government debt to be reached by the end FY13.

[4] These transactional gains emerged from 19.8 percent depreciation in the value of Yen vis-à-vis US$ during FY13.

[5] Within domestic debt, over one-half of the entire increase in FY13 was contributed by short-term floating debt, which further reduced the maturity profile of Pakistan's total public debt.

[6] Over 90 percent of country's total interest payments constitute of payments on domestic debt.

[7] Although the growth in interest payments on domestic debt witnessed a slowdown in FY13, this was due to inflated interest payments of special savings accounts in FY12 (following the temporary ban on institutional investment in NSS). The absence of this one-off payment led to a lower growth in interest payment for FY13.

payments have pushed the country into a debt-trap, which implies that the government is consistently borrowing to finance its debt servicing (**Special Section 6.1**). The situation is likely to become more complicated with recent rise in policy rates, which may increase the interest expense of the government.

(2) *Worsening maturity profile increases roll-over and interest-rate risk:* Around 36 percent of Pakistan's public debt is made up of short-term domestic debt, which has to be rolled-over within one year. This means any re-pricing of this debt at higher interest rates, will further increase the debt servicing burden.

Table 6.1: Profile of Pakistan's Debt and Liabilities

	Billion Rupees			Percent of GDP		
	FY11	FY12	FY13	FY11	FY12	FY13
Total debt & liabilities	12,530	14,553	16,228	68.5	72.4	70.8
Public debt[1]	10,991	12,924	14,494	60.1	64.3	63.3
Total debt	11,908	13,888	15,531	65.1	69.1	67.8
Govt. domestic debt	6,012	7,638	9,521	32.9	38.0	41.6
PSEs domestic debt	412	281	312	2.3	1.4	1.4
External debt	5,485	5,969	5,698	30.0	29.7	24.9
Govt. external debt	3,988	4,364	4,311	21.8	21.7	18.8
IMF loans	769	694	435	4.2	3.5	1.9
PSEs external debt	117	144	209	0.6	0.7	0.9
Private sector external debt	470	513	463	2.6	2.6	2.0
Intercompany debt	141	253	280	0.8	1.3	1.2
Total liabilities	622	665	697	3.4	3.3	3.0
Domestic liabilities	399	438	470	2.2	2.2	2.1
External liabilities	222	227	227	1.2	1.1	1.0
Total debt servicing	1,017	1,266	1,542	5.6	6.3	6.7
Interest payment	807	972	1,053	4.4	4.8	4.6
Domestic debt	650	817	910	3.6	4.1	4.0
External debt[2]	91	90	89	0.5	0.4	0.4
Domestic liabilities	65	64	53	0.4	0.3	0.2
External liabilities	1	1	1.1	0.0	0.0	0.0
Repayment of principal (foreign)	210	294	489	1.1	1.5	2.1

1. Public debt include Govt. Domestic Debt, Govt. External Debt, IMF loans & External Liabilities
2. Principal repayment of scheduled bank is excluded from the analysis.
Source: State Bank of Pakistan

Comparing with other countries, Pakistan's government debt is significantly above the average for emerging and low income countries (**Table 6.2**). It also shows that unlike other emerging economies, Pakistan's debt burden is rising. Such mounting debt will have adverse consequences for the economy: it will hold back economic growth; limit the scope for discretionary (monetary and fiscal) policies; increase vulnerability to exogenous shocks; raise the tax burden on captive payers, which will discourage investment; and create more uncertainty in the economy.

Table 6.2: General Government Debt
percent of GDP

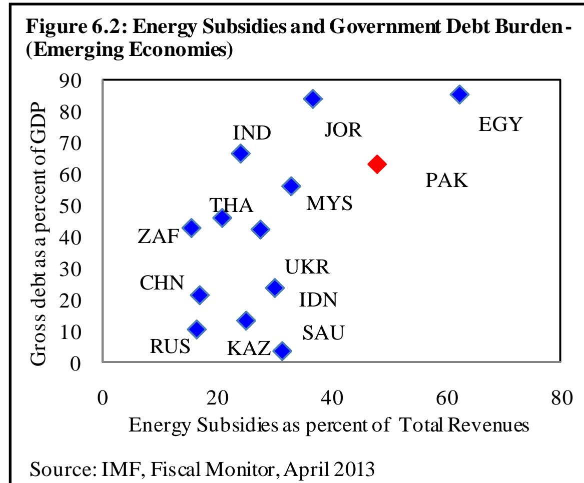
	2011	2012	2013
Advanced economies	105.5	110.2	109.3
Euro area	88.1	92.9	95.0
Emerging market economies	36.7	35.2	34.3
China	25.5	22.8	21.3
India	66.4	66.8	66.4
Pakistan	60.1	64.3	63.2
Low income countries	41.1	42.5	42.0

Source: IMF, Fiscal Monitor, April 2013

To mitigate these risks, there is an urgent need to initiate comprehensive fiscal reforms to raise revenues, restructure loss-making PSEs, and contain untargeted subsidies. In this regard, one of the key areas to focus on is the energy sector. Untargeted energy subsidies were responsible for the persistently large fiscal deficits in the past several years, and growth in the country's domestic debt

burden – around one-third of the total increase in domestic debt in the past two years, can be directly traced to power subsidies alone.[8] In fact, Pakistan is one of the few developing economies, which continues to subsidize energy despite carrying a large debt burden (**Figure 6.2**).[9]

Figure 6.2: Energy Subsidies and Government Debt Burden-(Emerging Economies)

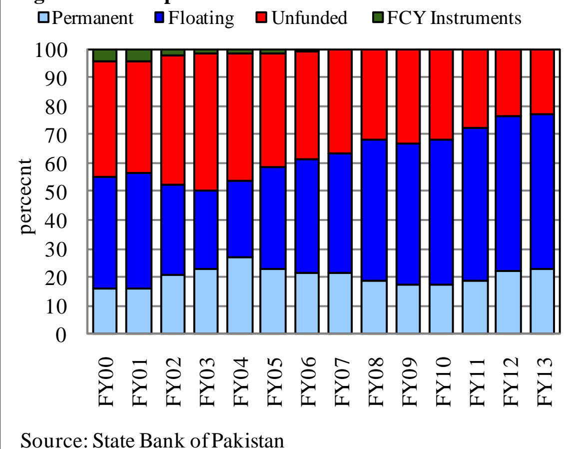


Source: IMF, Fiscal Monitor, April 2013

6.2 Domestic Debt

A large fiscal deficit and the absence of external inflows, resulted in an exceptional Rs 1.9 trillion increase in the stock of domestic debt, which reached 41.6 percent of GDP by end-June 2013, from 38.0 percent a year earlier (**Table 6.1**). In line with the past trends, the bulk of this increase is in short-term floating debt (**Table 6.3** & **Figure 6.3**). Given the fiscal rigidities that will take time to resolve, there is an urgent need to develop a long-term debt market to *rebalance* the maturity profile of Pakistan's domestic debt.

Figure 6.3: Composition of Domestic Debt



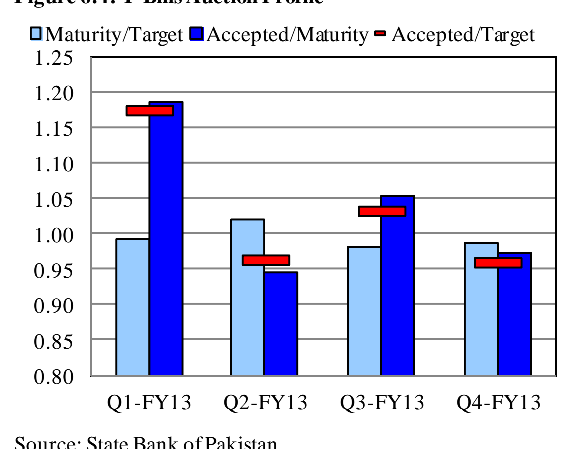
Source: State Bank of Pakistan

Government and central bank borrowing

Although the government committed to keep its net quarterly borrowing from the central bank at zero, SBP's contribution to short-term debt remained at par with commercial banks.

As reflected in the maturity-to-target ratio of close to one, government was aiming to simply roll-over the existing T-bills during FY13 (**Figure 6.4**). Market conditions were supportive during the first quarter, as the government mopped-up more than the targeted amount from commercial banks, which helped it meet the limit of zero quarterly borrowing from the central bank in Q1-FY13.

Figure 6.4: T-Bills Auction Profile



Source: State Bank of Pakistan

Market dynamics, however, changed in subsequent quarters, as banks were sensing higher interest rates in view of large funding needs of the government. As a result, the financing burden fell on SBP, as the accepted-to-maturity ratio fell quite sharply in Q2-FY13 (**Figure 6.4**).[10] Furthermore, unexpected fiscal slippages also increased the government's reliance on SBP funding. Hence, the government borrowed a hefty Rs 530.7 billion from SBP in the fourth quarter alone, which also includes the settlement of circular debt.

[8] This also includes the settlement of circular debt in these years.

[9] This comparison includes following emerging economies: Egypt (EGY), Pakistan (PAK), Jordan (JOR), S. Arabia (SAU), India (IND), Indonesia (IDN), Malaysia (MYS), Ukraine (UKR), Kazakhstan (KAZ), Russia (RUS), China (CHN), Thailand (THA) and South Africa (ZAF).

[10] As witnessed from the ratio of accepted-to-maturity, due to higher rates demanded by the banks, the government was not able to roll-over the entire amount in the auctions held in the second and final quarter of FY13.

Table 6.3: Position of Domestic Debt

billion Rupee

Debt instrument	Outstanding Stock			Interest Payments		
	FY12	FY13	Δ	FY12	FY13	Δ
A. Permanent debt	1,695.9	2,174.5	478.6	141.7	193.2	51.5
Of which						
GOP Ijara sukuk 3yrs	383.5	459.2	75.6	32.6	42.8	10.2
Pakistan investment bonds (PIBs)	974.7	1,321.6	346.9	81.7	117.8	36.0
Prize bonds	333.4	389.6	56.2	27.3	32.6	5.3
B. Floating debt (short-term debt)	4,142.9	5,195.4	1,052.5	377.1	480.8	103.6
Market treasury bills	2,383.2	2,920.2	537.0	202.8	303.0	100.2
Market related treasury bills (MRTBs)	1,759.7	2,275.2	515.5	174.4	177.8	3.4
C. Unfunded Debt	1,798.0	2,146.5	348.5	298.0	236.2	-61.8
Of which						
Defense saving certificates	241.8	271.7	29.9	70.8	46.6	-24.3
Special savings certificates (registered)	341.8	388.2	46.4	86.7	41.6	-45.0
Regular income certificates	226.6	262.6	36.0	25.5	30.0	4.5
Behbood savings certificates	480.8	528.4	47.6	69.8	75.9	6.2
Pensioners' benefit account	162.3	179.9	17.5	23.9	26.1	2.2
D. Foreign currency instruments[1]	1.4	4.5	3.1	0.0	0.0	0.0
Total domestic debt (A+B+C+D)	7,638.3	9,520.9	1,882.7	816.9	910.3	93.4

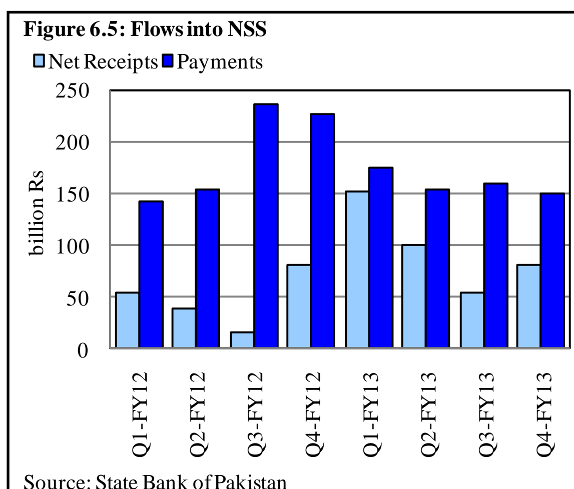
[1] It includes FEBCs, FCBCs, DBCs and Special US Dollar Bonds held by the residents.

Source: State Bank of Pakistan

Net inflows into NSS post an increase

The burden on the banking system would have been larger, had NSS not helped meet the governments resource needs. Mobilization through NSS more than doubled to Rs 386.0 billion during FY13, from Rs 188.4 billion last year. It may be recalled that the government had banned institutional investment in NSS in April 2011. The resulting encashment during the second half of FY12, led to lower repayment claims in FY13. Meanwhile, gross inflows in NSS improved after April 2012, when the government allowed selected institutional investment in NSS (**Figure 6.5**).

Figure 6.5: Flows into NSS



Source: State Bank of Pakistan

In terms of composition, more than half of the incremental mobilization went into Special Savings Account, mainly reflecting investment by institutions. Inflows into Behbood Savings Certificates (BSCs) and Pensioner Benefit Accounts (PBAs), which aim at mobilizing funds from widows, senior citizens and pensioners, stayed almost at the last year's level. Even after three downward revisions in the profit rates on NSS during the FY13, these saving schemes still offer the best fixed-income returns in the country.

PIBs continue to grow strongly

The stock of permanent debt recorded a 28.2 percent growth in FY13, on account of greater mobilization through PIBs. Initially, expectations that the accommodative monetary policy would continue incentivized banks to invest in PIBs. However, as market sentiment changed in response to

growing fiscal borrowing and deteriorating external account (which instilled a sense that Pakistan would return to IMF), banks shifted away from PIBs. Hence, the realized amounts were short of target during Q2-FY13; and, in the third quarter, banks showed no interest in PIBs (**Figure 6.6**).

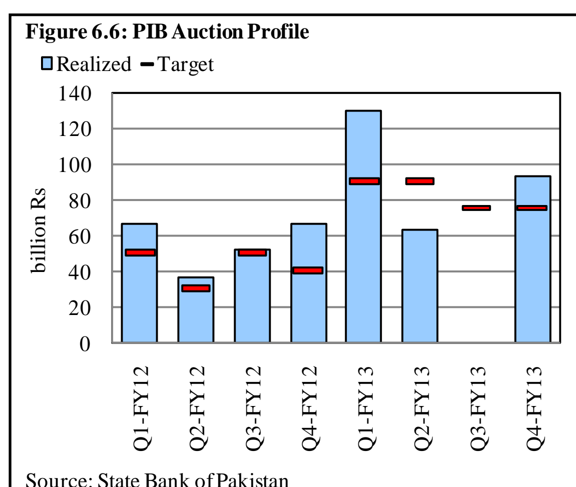


Figure 6.6: PIB Auction Profile

Source: State Bank of Pakistan

An unanticipated steep fall in headline CPI in the last quarter, once again made long-term investment an attractive option for banks. Consequently, mobilization through PIBs slightly exceeded the target. In overall terms, government raised Rs 286.9 billion through PIBs during FY13, compared to Rs 221 billion mobilized last year.

Interest Payments on Domestic Debt[11]

Surprisingly, growth in interest payments on domestic debt slowed during FY13, compared to last year (**Figure 6.7**). Further analysis shows that the absence of large interest payments on Special Savings Accounts (as was the case in FY12, due to a temporary ban on institutional investment in NSS) explains the lower debt servicing in FY13. Another factor was the easing policy rates since August 2011.

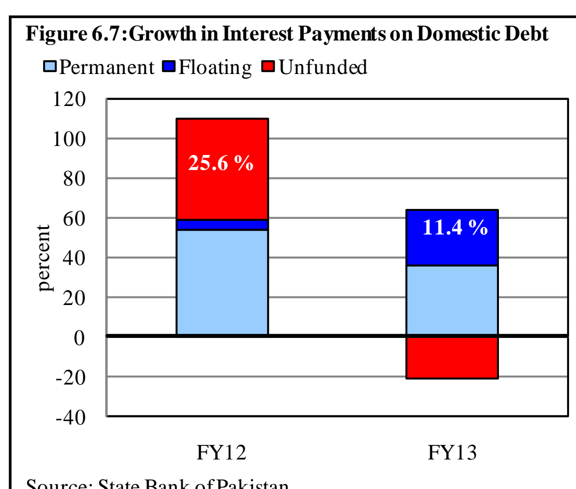


Figure 6.7: Growth in Interest Payments on Domestic Debt

Source: State Bank of Pakistan

Looking ahead, pressures from interest payments are likely to resurface next year, reflecting the steep growth in short-term domestic debt during FY13. According to our estimates, payments on T-bills and PIBs issued in FY13 alone, would inflate interest payments by Rs 277.5 billion in FY14 – an amount which is almost one-third of the entire interest expense on domestic debt during FY13. Unless we introduce comprehensive reforms in fiscal policies and domestic debt management, the deficit-debt spiral will remain an overarching risk to economic stability.

[11] This analysis is based on SBP's numbers for interest payments on domestic debt, which do not match with the information provided by MoF. For details, see Data Explanatory Notes 5(c), **Annexure A**.

6.3 External Debt & Liabilities

Pakistan's stock of external debt & liabilities (EDL) recorded a significant *decline* of US$ 5.7 billion during the year, reaching US$ 59.8 billion as of end-Jun 2013 (**Table 6.4**). This was the largest ever drop in a single year, and can be traced to the US$ 2.9 billion repayment to the IMF; and the US$ 2.7 billion transactional gain due to the depreciation of the Japanese Yen. [12] Notwithstanding this fall in EDL stock, the country's external debt repayment capacity weakened, as foreign exchange earnings could not keep pace with the external debt repayments in FY13.[13]

Table 6.4: Pakistan's External Debt and Liabilities
billion US$

	FY10	FY11	FY12	FY13	Abs change (FY13 over FY12)
External Public debt (1+2+3)	**53.6**	**57.9**	**55.9**	**50.2**	**-5.7**
(1) Government debt	42.9	46.4	46.1	43.5	-2.6
(i) Long term(>1 year)	42.1	45.7	45.7	43.5	-2.3
of which					
Paris club	14.0	15.5	15.0	13.5	-1.5
Multilateral	23.7	25.8	25.4	24.2	-1.2
Bilateral	1.8	1.9	2.5	2.9	0.5
Euro/Sukuk global bonds	1.6	1.6	1.6	1.6	0.0
(ii) Short term (<1 year)	0.9	0.6	0.4	0.0	-0.4
(2) From IMF	8.1	8.9	7.3	4.4	-3.0
(i) Federal government	1.1	2.0	1.9	1.7	-0.2
(ii) Central bank	7.0	6.9	5.4	2.7	-2.8
(3) Foreign exchange liabilities	2.6	2.6	2.4	2.3	-0.1
(4) Public sector enterprises (PSEs)	1.5	1.4	1.5	2.1	0.6
(i) Guaranteed debt	0.2	0.1	0.2	0.9	0.6
(ii) Non guaranteed debt1	1.4	1.3	1.3	1.2	0.0
(5) Banks	0.7	1.1	1.8	1.6	-0.3
(i) Borrowing	0.2	0.4	0.9	0.7	-0.2
(ii) Nonresident deposits (LCY & FCY)	0.6	0.7	1.0	0.8	-0.1
(6) Private Sector	3.8	4.4	3.6	3.1	-0.5
(i) Non guaranteed debt	3.8	4.4	3.6	3.1	-0.5
(a) Loans	2.2	2.4	2.4	2.0	-0.5
(b) non-guaranteed bonds	0.1	0.1	0.1	0.1	0.0
(c) Trade credits	1.4	1.6	0.7	0.7	0.0
(d) Other debt liabilities	0.1	0.3	0.3	0.3	0.0
(7) Debt liabilities to direct investors - Intercompany debt	1.9	1.6	2.7	2.8	0.2
Total external debt & liabilities (1+2+3+4+5+6+7)	**61.6**	**66.4**	**65.5**	**59.8**	**-5.7**

Source: Economic Affairs Division & State Bank of Pakistan.

Disbursements[14]

Disbursements from external creditors stood at US$ 2.5 billion during FY13, against US$ 2.6 billion last year. New loan commitments from both bilateral and multilateral creditors witnessed a sharp dip this year. Nevertheless, the overall inflows remained almost at the last year's level, due to

[12] 24.7 percent of Pakistan's public & publicly guaranteed external debt is contracted in Japanese Yen. During FY13, 19.8 percent depreciation in the value of Yen vs. US$ resulted in US$ 2.7 billion reduction in country's external debt stock.
[13] The ratio of external debt servicing to foreign exchange earnings deteriorated to 12.0 percent at end-Jun 2013, compared to 9 percent as of end-June 2012.
[14] The data in this section pertains to public and publicly guaranteed debt from bilateral and multilateral creditors.

disbursements on loans committed in previous years (**Table 6.5**). Most importantly, owing to the bulky repayments to IMF, in net terms, Pakistan witnessed a hefty US$ 2.7 billion outflows to the IFIs (including IMF) during FY13.

6.3.1 Sustainability of External Debt & Liabilities

Sustainability of EDL is gauged from solvency and liquidity indicators. The solvency indicators, like debt-to-GDP, debt-to-Foreign Exchange Earning (FEE), and Debt Servicing (DS)-to-FEE, reflect the country's ability to service its external payments on an *ongoing* basis. Liquidity indicators, on the other hand, indicate the country's ability to service its *immediate* external liabilities – these measures include reserves to short-term debt, and reserves to total debt, etc.

Pakistan's external debt sustainability indicators present a mixed picture in FY13. A sharp dip in the EDL stock resulted in an improvement in the country's debt carrying capacity, but larger external debt repayments that outpaced the foreign exchange earnings (FEE), led to deterioration in the country's debt repayment capacity (**Table 6.6**).

Furthermore, owing to large repayments to the IMF, Pakistan's FX reserves came under pressure, as its import coverage dropped from 19.7 weeks as of end-June 2012, to 14.3 weeks by end-June 2013. On a positive note, the repayment of a short-term loan (US$ 390.3 million) to IDB improved other liquidity indicators for the country.

Table 6.5: External Loans Inflows - Commitments & Actual

million US$

	FY12		FY13	
	C/M[1]	Actual	C/M	Actual
Bilateral	**1,013.9**	**1,400.9**	**636.9**	**1,150.8**
of which				
China	851.1	1,042.2	448.0	843.5
Japan	62.8	202.5	--	128.4
S. Arabia	100.0	128.8	100.0	61.2
Multilateral	**3,004.2**	**1,231.9**	**640.7**	**1,349.1**
of which				
ADB	504.9	402.5	170.8	424.8
IBRD	500.0	92.2	--	85.0
IDA	1,703.3	567.5	242.9	473.0
IDB	256.0	149.8	227.0	256.0
IFAD	40.0	10.8	--	5.4
Total	**4,018.1**	**2,632.8**	**1,277.6**	**2,499.9**

Source: EAD Status Report FY12 & FY13

[1]C/M: Commitment

Table 6.6.: Indicators of External Debt Sustainability

	FY10	FY11	FY12	FY13
Solvency Indicators				
TED/GDP	33.3	29.8	28.0	24.3
EDL/GDP	34.7	31.1	29.1	25.3
IP/FEE	2.7	2.3	2.1	1.9
EDS/FEE	11.0	7.5	9.0	12.0
IP/XE	5.2	4.2	5.6	3.8
EDS/XE	21.0	13.9	23.5	24.0
Liquidity Indicators				
STD/TED	1.4	1.0	0.6	0.01
RES/STD	19.7	28.5	40.1	1,372.3
WoM	28.0	26.6	19.7	14.3

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

Source: SBP calculations

6.3.2 External Debt Servicing

Led by lumpy US$ 3.0 billion repayments to the IMF during FY13, servicing of EDL recorded a significant 38.6 percent increase this year (**Table 6.7**). This was the first time the country made such a large principal repayments in a single year. This is important to flag here: while these heavy repayments to the IMF will go on till FY15, servicing of the rescheduled Paris Club credit, will start from FY17.[15,16]

[15] Pakistan has to repay US$ 2.9 billion and US$ 1.3 billion to IMF during FY14 & FY15.

[16] Pakistan entered into a debt rescheduling agreement for its entire stock of US$ 12.5 billion owed to the Paris Club creditors in December 2001. This included US$ 8.8 billion of ODA (Official development assistance credits with low interest rates) loans and US$ 3.6 billion non-ODA loans. Due to Pakistan's increased geo-political importance post September 11, the country was able to obtain very generous terms for this rescheduling. This agreement granted a repayment period for 38 years (with 15 years as grace period) on ODA credit, meaning that the first payment of the restructured amount will be made in May 2017 (end of the grace period) and the final payment is to be made in November

Table 6.7: External Debt Servicing

million US$

	FY08	FY09	FY10	FY11	FY12	FY13
i. External public debt (a+b+c)	**2,377.1**	**3,130.7**	**3,321.9**	**2,826.4**	**3,692.6**	**5,316.4**
Principal	1,372.7	2,162.9	2,445.1	1,881.6	2,800.0	4,504.3
Interest	1,004.4	967.9	876.9	944.9	892.6	812.0
a. Govt. debt	2,128.1	2,822.7	2,784.1	2,247.8	2,263.0	2,205.3
Principal	1,177.7	1,930.9	2,053.4	1,491.3	1,546.3	1,505.4
Interest	950.4	891.9	730.7	756.4	716.7	699.9
b. IMF loans	191.0	264.0	359.4	441.8	1,317.9	2,999.4
Principal	173.0	210.0	239.8	268.2	1,153.7	2,898.9
Interest	18.0	54.0	119.6	173.6	164.1	100.5
c. Forex liabilities	58.0	44.0	178.4	136.9	111.8	111.6
Principal	22.0	22.0	151.9	122.0	100.0	100.0
Interest	36.0	22.0	26.5	14.9	11.8	11.6
ii. PSEs debt	**252.7**	**236.9**	**351.9**	**358.9**	**248.9**	**281.4**
Principal	171.0	176.8	290.4	310.1	211.0	238.8
Interest	81.7	60.1	61.4	48.7	38.0	42.6
iii. Private sector debt	**484.8**	**628.6**	**481.2**	**346.1**	**370.8**	**381.3**
Principal	323.0	497.8	404.5	266.1	282.9	303.3
Interest	161.8	130.8	76.7	80.1	88.0	78.1
External debt (i+ii+iii)	**3,114.6**	**3,996.2**	**4,155.0**	**3,531.4**	**4,312.4**	**5,979.1**
Principal	1,866.7	2,837.4	3,139.9	2,457.8	3,276.3	5,046.4
Interest	1,247.8	1,158.8	1,015.0	1,073.7	1,018.5	932.7

Source: State Bank of Pakistan

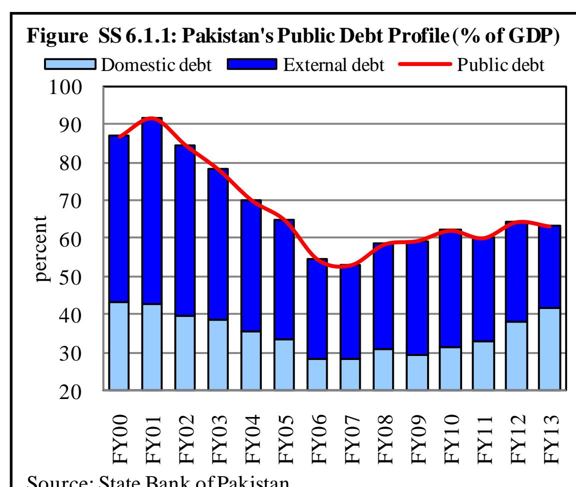
2039 (end of the repayment period). Furthermore, Pakistan also obtained US$ 1.5 billion debt write-off from the US during FY03-05.

Special Section 6.1: Debt Trap – GDP Growth is the Way Out. [17]

Backdrop

The debt burden is a chronic ailment in Pakistan's economy (**Figure SS 6.1.1**). The difficulties in servicing Pakistan's external debt have forced the government to reschedule with Paris Club creditors on multiple occasions.[18] The last restructuring in December 2001, was termed an *exit rescheduling*, as the terms were designed so that Pakistan could exit the external debt trap. As shown in **Figure SS 6.1.1**, the sharp fall in external debt from FY02 to FY07, can be traced to the rescheduling in December 2001. Since then, however, the deterioration in macroeconomic fundamentals has again triggered a surge in public debt, which has more than doubled during the period FY08-13.[19] Unlike the previous trend, when the size of external debt required decisive steps to resolve the problem, the current risk is originating from the country's domestic debt.

Figure SS 6.1.1: Pakistan's Public Debt Profile (% of GDP)



Source: State Bank of Pakistan

Unlike the pre-9/11 debt problem that manifested primarily on the country's BoP, the high dependence on domestic debt is aggravating the fiscal outlook. This is because the surge in debt servicing, which is not supported by a corresponding improvement in tax revenues, is leading to large fiscal imbalances that have to be financed from domestic sources. Resultantly, Pakistan is approaching the situation of a debt trap (**Box SS 6.1.1**), where the government is meeting its debt servicing requirements by borrowing more. This note attempts to investigate this issue in some detail.

Box SS 6.1.1: Theoretical Perspectives on Debt Trap

Debt trap is defined in the literature in the following manner:

- "A situation when a country's cost of capital exceeds its economic growth for a protracted period…"[20] In simpler terms, this is a situation when the average real interest rate on debt is higher than the real GDP growth of a country (which determines debt repayment capacity). This happens because uncertainty about the government's ability to repay debt causes lenders to demand higher rates, which raises the debt servicing burden to an extent that it squeezes resources for public investment causing permanent loss of country's debt repayment capacity.
- A situation when a high level of existing outstanding debt inflates interest payments, which in turn, leads to widening of overall budget deficit that has to be financed by even more borrowing, leading to further additions in the debt stock. Such a pattern results in permanently large increases in the debt stock.[21]
- A generalized debt crisis is also defined as a situation when debt servicing claim a growing portion of current revenues, and becomes a leading factor for undertaking new borrowing. In the effort to meet mounting servicing

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[17] This special section was written by Sabina Khurram Jafri.

[18] Pakistan has entered into debt rescheduling arrangements with the Paris Club creditors in FY72, FY74, FY81, FY99, FY01 and FY02. Last time Pakistan entered into a debt rescheduling agreement with the Paris club creditors in December 2001. This also paved the way for pre-payment of expensive debt, loan write-offs and adjustment in the domestic debt stock. For details see Special Sections 1 & 2 in *SBP's 2nd Quarterly Report* for FY02.

[19] The international oil price shock of FY08 and the consequent emergence of circular debt have caused significant expansion in Pakistan's fiscal deficit during FY08-13. Average fiscal deficit rose to 6.8 percent of GDP during FY08-13, compared to 3.7 percent of GDP during FY01-07. This, along with the international recession that resulted in large external imbalances, has led to significant additions in country's public debt stock since FY07. Current account deficit averaged at 5.5 percent of GDP between FY08-10.

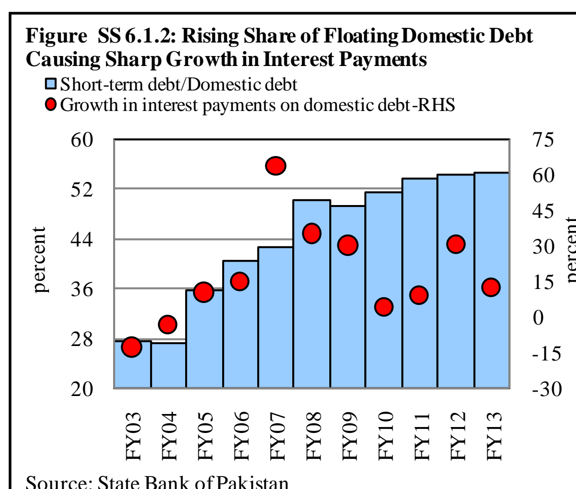
[20] Gave, Charles, "Debt Traps: A Refresher", GK Research. In this report Charles Gave has explained the concept of debt trap as explained by Lord Keynes.

[21] Pasha. Hafiz. A & Ghaus. A. F. Aisha (1996), "Growth of Public Debt and Debt Servicing in Pakistan." SPDC, Research Report.

obligations, borrowers engage in dis-investement, which results in deterioration in the economic and social infrastructure. Ultimately real output falls, which exacerbates the debt burden and the cycle continues.[22]

Debt burden is growing and shifting towards the short term:
Large external and fiscal imbalances have resulted in significant additions to the country's public debt since FY07. Due to the unavailability of external financing, the composition of Pakistan's public debt is shifting towards domestic debt and furthermore into short-term T-bills.[23] Floating debt now constitutes 54.6 percent of domestic debt, compared to over 25 percent in FY04. The rising share of short-term debt raises concerns about debt sustainability due to increasing roll-over and interest rate risks, and the usefulness of the yield curve for pricing long term private sector borrowing.[24] Also, in terms of cost, domestic financing is more expensive compared to external borrowing, which has led to a sharp increase in interest payments in the past few years (**Figure SS 6.1.2**).[25,26] Looking at the average annual growth in the last five years, domestic debt servicing has grown by 16.1 percent.

Figure SS 6.1.2: Rising Share of Floating Domestic Debt Causing Sharp Growth in Interest Payments



Source: State Bank of Pakistan

Real interest rate is not the problem: Lower nominal interest rates and higher inflation can help contain the real debt burden, by ensuring lower cost of borrowing and erosion in the real value of debt.[27] However, despite negative real interest rates, this channel has not helped ameliorate the debt burden in Pakistan for a number of reasons:[28,29] First, whether interest rates have been negative or positive in real terms, has not changed the government's borrowing pattern.[30] Second, the government and SBP have never endorsed an intentional policy to keep inflation high to reduce the debt servicing burden. And third, excessive borrowing from the domestic banking system has

[22] Girvan, Norman (1999), "Jamaica's Internal Debt Trap: An Interpretation". Norman Girvan has published extensively on the political economy of development in the Caribbean countries.
[23] The share of domestic debt in total public debt increased to 65.7 percent in FY13, compared to 46.6 percent in FY01.
[24] The yield curve serves as a benchmark for pricing project and infrastructure financing. A steep increase in short term debt (less than one year maturity), together with a thin PIB market in recent years, has weakened the information content of the long-end of the yield curve.
[25] Although external borrowing is subject to exchange rate risk, external borrowing is cheaper than domestic financing of deficit, due to significant difference between average interest rate on external and domestic borrowing. Specifically, the average interest rate on domestic debt stood at 15 percent during FY08-FY12, whereas the same was mere 2.1 percent on foreign debt, during this period.
[26] Interest payments on domestic debt constitute around 93 percent share in total interest payment on debt. The growth in interest payments on domestic debt recorded a sharp slowdown in FY10 and FY11. This was due to fall in payments on DSCs.
[27] Source: Cherif, Reda and Hasanov, Fuad (2012), "Public Debt Dynamics: The Effects of Austerity, Inflation, and Growth Shocks", IMF Working Paper, WP/12/230.
[28] The average real interest on public debt during (FY08-12) stood at negative 3.9 percent, compared to a real GDP growth of 3.2 percent in the same period.
[29] As is the case in other emerging and low-income countries, the average real interest rate on public debt is negative in Pakistan, and therefore widely below the growth rate of the economy. This phenomenon is largely associated with financial repression, captive and distorted markets in these countries (see Escolano, Shabunina, and Woo (2011), "The Puzzle of Persistently Negative Interest Rate-Growth Differentials: Financial Repression or Income Catch-Up", IMF Working Paper, WP/11/260). According to their findings, the interest rate-growth differential shows strong correlation with GDP per capita – on average, this differential has been around 1 percentage point for large advanced economies during 1999-2008, but below -7 percentage points among non-advanced economies.
[30] For detailed discussion, see Special Section 3.1, "Macroeconomic Dynamics with a Dominant Borrower (Government)', in SBP's *3rd Quarterly Report for FY13.*

squeezed out the private sector, which in turn, has lowered growth prospects in the country. As we have seen in the past several years, the rate of economic growth is not sufficient to improve the country's capacity to meet its debt payments.

Debt servicing is eating into long-term growth: Tax revenues have failed to keep pace with the sharp increase in debt servicing. Following are some important stylized facts about interest payments in Pakistan:

- It consumes more than one-third of the country's total revenues (**Figure SS 6.1.3**);
- It has surpassed tax collection (after adjusting for provincial shares) since FY11 (**Figure SS 6.1.3**);
- It constitutes roughly one-fifth of total fiscal expenditures by the government (**Figure SS 6.1.4**);
- It has consistently exceeded development spending since FY11 (**Figure SS 6.1.4**); and
- It claims a greater share of tax revenues, compared to most other countries (**Figure SS 6.1.5**).

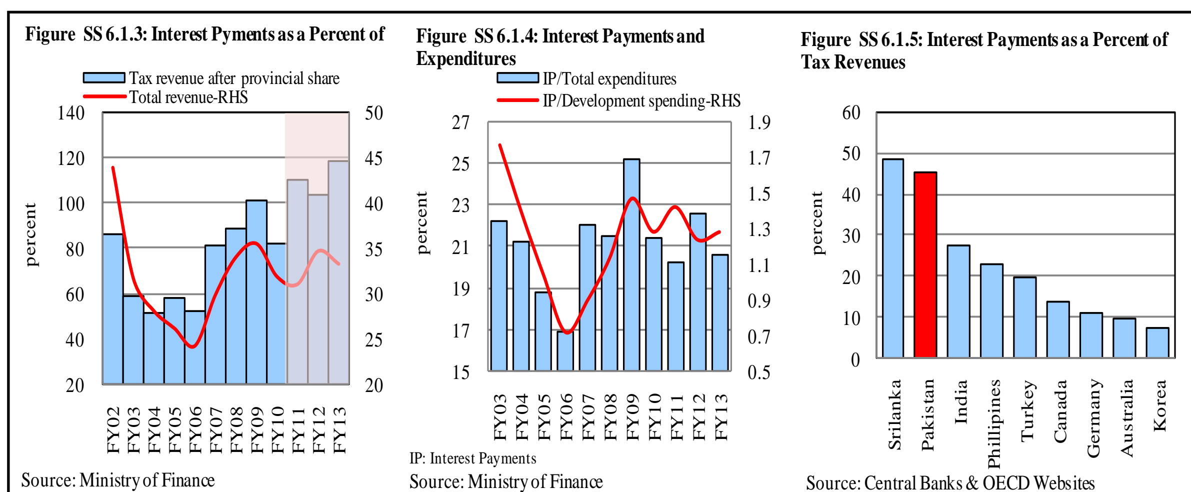


Figure SS 6.1.3: Interest Pyments as a Percent of
Source: Ministry of Finance

Figure SS 6.1.4: Interest Payments and Expenditures
Source: Ministry of Finance

Figure SS 6.1.5: Interest Payments as a Percent of Tax Revenues
Source: Central Banks & OECD Websites

This situation has created persistently large fiscal deficits, which have to be financed by short-term domestic financing; this further increases the debt servicing burden. Furthermore, large claims of debt servicing on fiscal resources, have resulted in excessive containment of public investment. This reveals that inadequate fiscal reforms, have not only aggravated the government's debt burden and undermined debt servicing capacity, but has also reduced development spending that will keep Pakistan on a sub-optimal growth path.

Negative primary and revenue balances are growing: The primary balance (the difference between revenues and non-interest expenditures) has been negative since FY06, which implies that the government is not only financing its debt servicing requirements, but also a part of current spending (**Figure SS 6.1.7**). Furthermore, the revenue balance (which reflects the difference between total revenue and current expenditures) shows the availability of public resources for development spending during a year. Pakistan is consistently recording a negative revenue balance since FY05, which explains why the country's investment rates has fallen to unsustainable levels

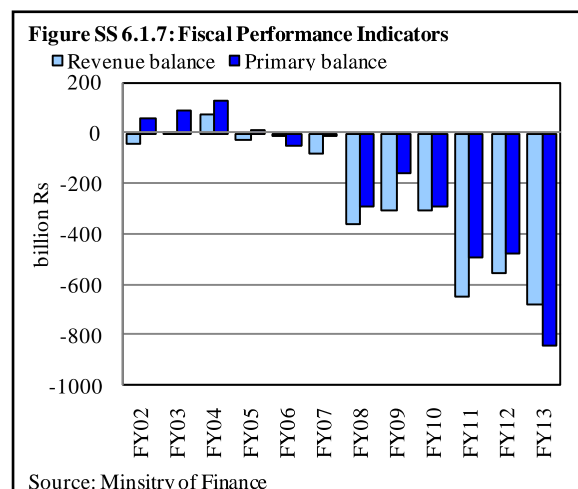


Figure SS 6.1.7: Fiscal Performance Indicators
Source: Minsitry of Finance

(**Figure SS 6.1.7**).

Conclusion:
This analysis shows that Pakistan is effectively in a debt-deficit spiral. Our findings can be summarized as follows: (1) Pakistan is unable to meet growing debt service payments by its tax revenues, which is further widening the fiscal deficit; (2) large fiscal imbalances have resulted in a sharp increase in the stock of public debt, which entails a heavier debt servicing burden in the future; (3) deficit financing is primarily met through costly short-term borrowing from the banking system, which is squeezing out private sector investment; and (4) increasing interest payments have constrained development spending, which dampens the country's growth prospects and its debt repayment capacity.

The assessment also shows that Pakistan experienced a similar problem in the early 2000s, which resulted in a comprehensive restructuring of its Paris Club debt in December 2001. The challenge now is with Pakistan's domestic debt, which is putting immense pressure on the fiscal side. Although preliminary steps have been taken to reduce subsidies and increase fiscal revenues,[31] one must realize that the external debt restructuring in late 2001 entailed write-offs and a reduction in the net present value of Pakistan's external debt. Unless very ambitious fiscal reforms are undertaken that can guarantee results, the country's domestic debt dynamics will not converge (i.e., it will continue to grow at a compounded rate) until administrative measures are adopted. In this regard, while the IMF program should help contain the stock of domestic debt, the real solution to this issue is sustained economic growth.

[31] For details see **Chapter 3 & Chapter 5**.