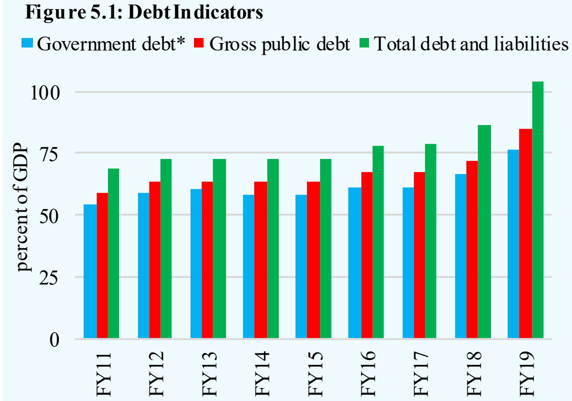
5 Domestic and External Debt

5.1 Overview

The pace of debt accumulation accelerated further in FY19 (**Figure 5.1**). In absolute terms, Pakistan's total debt and liabilities (TDL) increased by Rs 10.3 trillion, which was more than twice the accumulation in FY18. Despite high deficit in FY19, its contribution to the overall debt accumulation was limited to only a third; the rest was attributed to: (i) an upward revaluation of existing stock of external debt following the depreciation of the Pak rupee; (ii) foreign exchange inflows from Saudi Arabia, UAE and Qatar, for balance of payments support; and (iii) government borrowing over and above the budgetary requirements that remained in the deposits with the banking system (**Figure 5.2**).

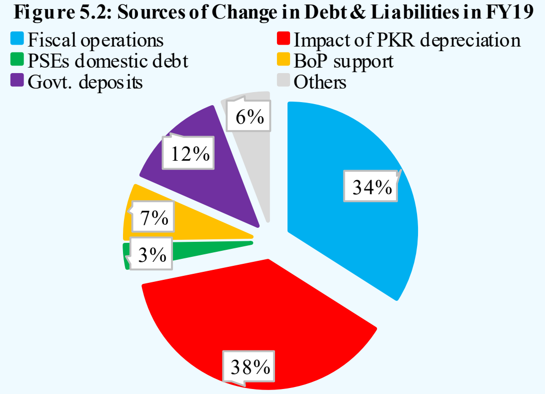
Figure 5.1: Debt Indicators



*As per FRDLA
Data sources: State Bank of Pakistan and Economic Affairs Division

The largest contribution to the TDL came from the gross public debt. Distributed almost evenly across domestic and external sources (**Figure 5.3**), the increase in gross public debt during FY19 was unprecedented and, even after adjusting for the impact of exchange rate-led revaluation, highlights serious concerns on the fiscal front. For one, total debt of the government (gross public debt minus government deposits) reached 76.6 percent of GDP at end FY19 – an increase of 10 percentage points in a year – far above the level prescribed under the (Amended) Fiscal Responsibility and Debt Limitation Act (FRDLA), 2017. In addition to government debt, debt incurred by public sector enterprises (PSEs) continued to move along an upward trajectory, as a number of energy-related PSEs struggled to acquire a semblance of financial viability; PSE debt as percent of GDP increased by another 1.3 percentage points during FY19.

Figure 5.2: Sources of Change in Debt & Liabilities in FY19

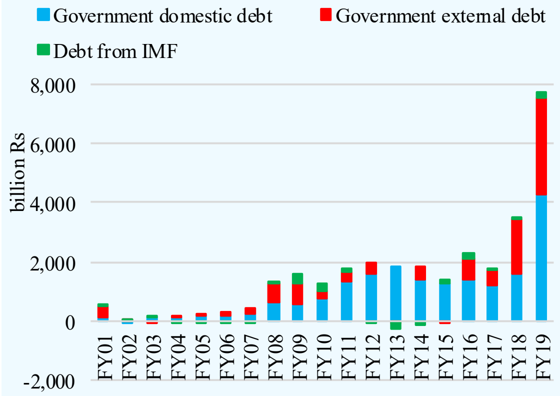


* in FY18, the impact of PKR depreciation stood at 35 percent
Data source: SBP staff calculations

At its core, the deterioration in government debt indicators is primarily an outcome of incomplete structural reforms in fiscal and energy sectors and weak public financial management, which has widened the resource gap for the government. In particular, revenue deficit has steadily been increasing over the last 3 years, implying that the bulk of recent debt accumulation by the government was meant to finance its current expenditures, instead of adding to the repayment capacity of the economy. Similarly, the increase in primary deficit has also contributed, as the government is increasingly falling short of resources to service even the existing debt stock. In this context, an additional setback the government faced in FY19 was the steep rise in interest rates and depreciation of the Pak rupee, which escalated its debt-servicing burden; mark-up payments alone ate up 47 percent of the total tax revenues. With rising debt burden and its costly servicing, it has become challenging for the government to create space for spending on infrastructure, human capital development, and social protection, which are crucial for developing a competitive economy while achieving sustainable growth.

While addressing these challenges necessitates decisive fiscal reforms, especially on the revenue side, important developments took place in FY19 from debt management perspective. Most notable among these was the re-profiling of domestic debt towards the end of the year. Although the government relied heavily on direct short-term borrowing from the central bank through most of the year, which continued to shorten the average maturity of public debt, it replaced the stock of short-term MRTBs held by the SBP into long-term PIBs of various maturities. This re-profiling was put into effect in the month of June 2019, which took the share of long-term debt (permanent and unfunded) in total domestic debt from 45.8 percent at end FY18, to 73.4 percent at end FY19. While this structural shift would spread out maturity schedule of public debt and help alleviate the rollover risk for the government, debt servicing burden may become costlier to the tune of the spread between yields of 6-month MRTBs and PIBs.[1] Moreover, with expectations of interest rate hikes gradually fading away, commercial banks are also getting more inclined towards locking their funds in long-term instruments. Their participation in PIB auctions improved towards the end of FY19 and their outstanding investment in these instruments, after falling steadily over the past couple of years, posted an increase of Rs 425 billion in H2-FY19.

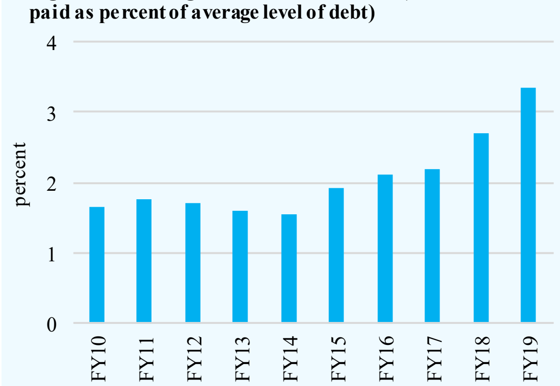
Figure 5.3: Composition of Change in Gross Public Debt



Data source: State Bank of Pakistan & Economic Affairs Division

As for the management of government external debt, multiple challenges continued to persist. First, the average cost of government external debt has increased with greater mobilization of commercial loans by the government over the past few years (**Figure 5.4**). In FY19 also, the share of commercial loans increased further to 12 percent of the government external debt by the end of the year (up from only 2.4 percent just three years ago).[2] Moreover, with most of the fresh loans being contracted at floating interest rates, future debt servicing is getting more vulnerable to the trends in global interest rates. Second, from sustainability perspective, relevant indicators show a deterioration in both debt bearing capacity and servicing capacity of the country. In fact, servicing of external debt has become a key source of the country's BoP needs

Figure 5.4: Average Cost of External Debt (actual interest paid as percent of average level of debt)



Data source: SBP staff calculations

[1] Since 70 percent of the MRTBs are converted into 10-year PIB with floating rate, the mark-up cost would subsequently change in accordance with the movement in overall interest rates in the economy.
[2] A growth of 20 percent in FY19.

down the road. Importantly, there is a need to shore up the level of country's foreign exchange reserves and earnings (exports and remittances) to smoothly pay off debt obligations.

Table 5.1: Summary of Pakistan's Debt and Liabilities
trillion Rupees

	Stock			Percent of GDP		Absolute change	
	FY17	FY18	FY19	FY18	FY19	FY18	FY19
A. Total Debt and Liabilities (sum I to IX)	25.1	29.9	40.2	86.3	104.3	4.8	10.3
B. Gross Public Debt (sum I to III)	21.4	25.0	32.7	72.1	84.8	3.5	7.8
Total Debt of the Government (I+II+III-X)	19.6	23.0	29.5	66.5	76.6	3.4	6.5
I. Government Domestic Debt	14.8	16.4	20.7	47.4	53.8	1.6	4.3
II. Government External Debt	5.9	7.8	11.1	22.5	28.7	1.9	3.3
of which exchange rate impact						1.3	2.8
III. Debt from IMF	0.6	0.7	0.9	2.1	2.4	0.1	0.2
IV. External Liabilities	0.4	0.6	1.7	1.8	4.4	0.2	1.1
V. Private Sector External Debt	1.2	1.7	2.5	4.8	6.4	0.5	0.8
VI. PSEs External Debt	0.3	0.3	0.7	0.9	1.7	0.0	0.3
VII. PSEs Domestic Debt	0.8	1.1	1.4	3.1	3.6	0.2	0.3
VIII. Commodity Operations	0.7	0.8	0.8	2.4	2.0	0.1	(0.1)
IX. Intercompany External Debt	0.4	0.4	0.5	1.3	1.4	0.1	0.1
X. Deposits with banking system	1.8	1.9	3.2	5.6	8.3	0.1	1.3

Data source: State Bank of Pakistan

In this context, the 39-month extended fund facility agreement with the IMF will be helpful in plugging the financing gap. On the external front, narrowing of current account deficit during FY19 is quite encouraging, and with ongoing stabilization measures in place (including the flexible exchange rate regime), the BoP situation is expected to improve further. Nonetheless, significant consolidation is needed on the fiscal front, as cuts in development expenditure alone would not be enough to control the size of primary deficit. Focus should be to increase revenues along with reduction in current expenditures to control the pace of the debt accumulation. Moreover, rationalization of energy sector policies and improving the governance of PSEs should also top the reform agenda of the government to cut down PSE debt.

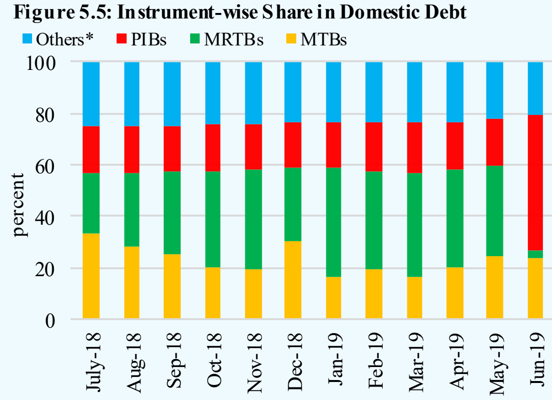
5.2 Domestic Debt

The stock of government domestic debt reached Rs 20.7 trillion at the end of FY19 compared to Rs 16.4 trillion a year earlier (**Table 5.1**). In terms of growth, domestic debt increased by 26.3 percent – more than double the pace in FY18 (**Table 5.2**).

Changing Dynamics of Government Domestic Debt

In FY19, the government mainly relied on permanent debt, which recorded a marked increase of Rs 7.4 trillion compared to a decline of 0.9 trillion during FY18. This was in contrast with previous years, in which the share of floating debt was the largest.[3] Even until May

Figure 5.5: Instrument-wise Share in Domestic Debt



* Others mainly include prize bonds and NSS
Data source: State Bank of Pakistan

[3] In addition, Rs 177.8 billion domestic debt was created on account of Bai-Muajjal of Sukuk.

2019, the government relied mainly on short-term borrowing from the central bank through MRTBs (**Figure 5.5**). This borrowing from the central bank helped the government to make retirements to the commercial banks. Nonetheless, at the very end of FY19, the central government re-profiled its short-term domestic debt by issuing long-term PIBs to the central bank. As a result, some risk indicators (including the share of domestic debt maturing in 1-year) declined, and average time to maturity improved, which is going to bring-down the need for frequent roll-over of this debt. Furthermore, as this re-profiling was done on floating rates, the direction of interest rates in the future would determine the implications for fiscal and monetary management.

Table 5.2: Government Domestic Debt

billion Rupees; growth in percent

	Stock			Flow		Growth	
	FY17	FY18	FY19	FY18	FY19	FY18	FY19
Domestic debt	14,849.2	16,416.3	20,731.8	1,567.1	4,315.5	10.6	26.3
Permanent debt	5,528.4	4,653.8	12,080.1	(874.6)	7,426.3	(15.8)	159.6
o/w PIBs	4,391.8	3,413.3	10,933.2	(978.5)	7,519.9	(22.3)	220.3
Ijara Sukuk	385.4	385.4	71.0	-	(314.4)	-	(81.6)
Prize Bonds	747.1	851.0	893.9	103.9	42.9	13.9	5.0
Floating debt	6,550.9	8,889.0	5,500.6	2,338.1	(3,388.4)	35.7	(38.1)
o/w MTBs	4,082.0	5,294.8	4,929.6	1,212.8	(365.2)	29.7	(6.9)
MRTBs	2,468.9	3,594.2	571.0	1,125.3	(3,023.2)	45.6	(84.1)
Unfunded debt	2,765.3	2,868.1	3,144.1	102.8	276.0	3.7	9.6

Data source: Ministry of Finance Budget Wing

Government domestic debt from non-bank increased in absolute terms

Government domestic debt owed to non-banks increased by Rs 0.8 trillion during FY19, more than double the increase of Rs 0.3 trillion a year earlier. Non-bank institutions made investments in government securities (mainly PIBs) due to high rate of return. Similarly, higher profit rates in FY19 kept the savings schemes attractive (**Table 5.3**). Net inflows in various NSS increased by Rs 306.3 billion in FY19. A disaggregated analysis shows that gross inflows in major schemes increased; however, considerable retirements led to a fall in net terms in case of Special Saving Accounts (SSA). Since the profit rate on Behbood Savings Certificate (BSC) is high and it is also exempted from withholding tax (WHT), perhaps holders of Special Savings Accounts are switching their funds in BSC.

Table 5.3: National Saving Schemes and Profit Rates

billion Rupees; profit rates in percent

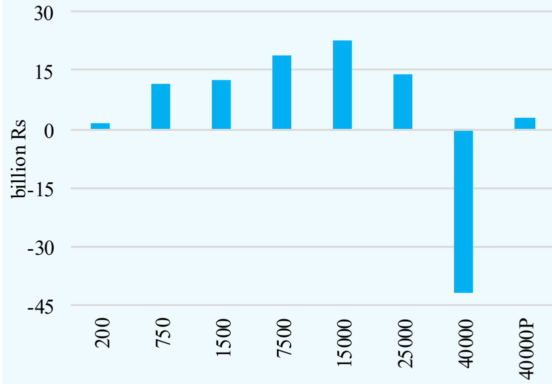
	FY19		Profit rates*	
	Gross inflows	Net Inflows	FY18	FY19
Defense Saving Certificates	135.3	57.3	8.1	12.5
Special Savings Certificate	463.0	31.8	6.6	11.4
Regular Income Certificates	414.6	142.1	7.6	11.2
Behbood Savings Certificates	375.6	119.6	10.8	14.3
Special Savings Accounts	519.1	(132.5)	6.6	11.4
Pensioner's Benefit Account	124.1	43.6	10.1	14.3
NSS	2,357.6	306.3	NA	NA
Prize bonds (including premium prize bonds)	154.5	42.9	NA	NA

*Profit rates at end of fiscal year

Data source: Central Directorate of National Savings

Prize bonds recorded a marginal rise of Rs 42.9 billion in FY19. All denominations recorded net inflows, barring the denomination of Rs. 40,000 prize bonds (**Figure 5.6**). In an effort to enhance documentation of the economy, the government notified withdrawal of Rs. 40,000 denomination national prize bond from circulation on 24th June 2019.[4] The holders of prize bonds were given three options: 1) conversion to premium prize bonds; 2) replacement with special savings certificate/defense savings certificates; or 3) encashment at face value (transfer of proceeds to the bond-holders bank account).[5] As an initial investigation, the trend of shifting towards premium prize bonds of same denomination has emerged. Monthly analysis of the premium prize bonds shows that out of the total investment of Rs 2.8 billion in FY19, more than half of the investments were made in June 2019, perhaps indicating that bond holders opted to convert the old prize bonds with the premium bonds. Some evidence suggests that many bond-holders also preferred to encash these bonds. As a result, a sharp increase in deposits during the last week of June 2019 was witnessed.

Figure 5.6: Net Inflows in Prize Bonds in FY19



Data source: Central Directorate of National Savings

Table 5.4: Pakistan's External Debt and Liabilities
billion US dollars

	End-June Stock			Absolute change					
						FY19			
	FY17	FY18	FY19	FY18	FY19	Q1	Q2	Q3	Q4
Total external debt & liabilities (sum 1 to 7)	**83.4**	**95.2**	**106.3**	**11.8**	**11.1**	**1.3**	**2.5**	**6.8**	**0.5**
External public debt & liabilities (1+2+3)	66.1	75.4	83.9	9.3	8.6	1.0	2.1	5.8	-0.3
External Public debt (1+2)	62.5	70.2	73.4	7.7	3.2	1.1	0.1	2.7	-0.7
1. Government external debt	56.4	64.1	67.8	7.7	3.7	1.2	0.2	2.8	-0.6
i) Long term (>1 year)	55.5	62.5	66.5	7.0	4.0	1.5	0.5	2.8	-0.8
of which									
Paris club	12.0	11.6	11.2	-0.3	-0.4	-0.1	-0.1	-0.1	0.0
Multilateral	27.6	28.1	27.8	0.5	-0.3	-0.5	0.1	-0.3	0.4
Other bilateral	6.3	8.7	12.7	2.4	4.0	2.2	0.5	1.1	0.2
Commercial loans/credits	4.8	6.8	8.5	2.0	1.7	0.0	0.0	2.1	-0.4
Euro/Sukuk global bonds	4.8	7.3	6.3	2.5	-1.0	0.0	0.0	0.0	-1.0
ii) Short term (<1 year)	0.9	1.6	1.3	0.7	-0.4	-0.3	-0.3	0.1	0.2
2. From IMF	6.1	6.1	5.6	0.0	-0.4	-0.1	-0.1	-0.1	-0.1
3. Foreign exchange liabilities	3.6	5.1	10.5	1.6	5.4	-0.1	2.0	3.1	0.4
4. Public sector enterprises (PSEs)	2.7	2.7	4.0	0.0	1.3	0.0	-0.1	0.8	0.6
5. Commercial banks	4.5	4.4	4.7	-0.1	0.3	0.0	0.3	0.1	-0.1
6. Private sector	6.8	9.2	10.4	2.4	1.2	0.2	0.7	0.1	0.2
7. Debt liabilities to direct investors	3.4	3.6	3.3	0.2	-0.3	0.0	-0.5	0.1	0.1

Data source: State Bank of Pakistan and Economic Affairs Division

[4] The main purpose was to enhance documentation of the economy.
[5] SBP-BSC Circular No. CMD/GSSAD/PBU/PB-1/87525/2019 - Withdrawal of Rs. 40,000 Denomination NPBs from Circulation

5.3 External Debt and Liabilities

Total external debt & liabilities (EDL) reached US$ 106.3 billion by end June 2019, an increase of US$ 11.1 billion compared to an increase of US$ 11.8 billion a year earlier (**Table 5.4**). One-half of this increase in FY19 is owed to BoP support from friendly countries (Saudi Arabia, UAE and Qatar). As pointed out earlier, these inflows are held in the form of deposits with the central bank and it led to an increase in the foreign exchange liabilities of the country. Nonetheless, net revaluation gains (in dollar terms) due to depreciation of major currencies (Euro and Yuan) against the US$ and sizeable amortization controlled the pace of debt accumulation to some extent in FY19.[6] Major part of amortization consists of Euro/Sukuk bond and long-tern commercial loans. The government was also able to retire its short-term debt worth US$ 0.4 billion, compared to net accumulation of US$ 0.7 billion in FY18. Although the government anticipated to raise additional support by launching Pakistan Banao Certificates (PBCs) during Q2-FY19, it managed to raise only US$ 26.0 million from PBCs (for details, see **Chapter 6**).

China's share in gross disbursements continued to dominate

In gross terms, the country received US$ 10.5 billion in FY19 compared to US$ 10.9 billion a year earlier. China's share in these disbursements increased further in FY19 as the country received both commercial and bilateral loans. Gross disbursements from ADB and IDB (short-term) were lower compared to FY18 (see **Table 6.5** in **Chapter 6**).

External debt servicing increased

Pakistan's external debt servicing increased in FY19 (**Table 5.5**). Around two-third of the principal repayments were made to commercial lenders and Euro/Sukuk bond. A large part of these loans were on floating rates, hence the rise in the benchmark rate (i.e. LIBOR) led to a substantial increase in interest payments as well.

5.4 External Debt Sustainability

Analysis of external debt sustainability indicators shows a deterioration in solvency indicators (debt bearing capacity). The most common measure used to assess debt-bearing capacity is the external debt and liabilities to GDP ratio, which increased to 45.0 percent by end-June 2019. (**Table 5.6**). Similarly, other solvency indicators also deteriorated as the pace of external debt accumulation more

Table 5.5: External Debt Servicing

million US dollars

	Principal			Interest		
	FY17	FY18	FY19	FY17	FY18	FY19
1. Public external debt	3,733.8	2,704.2	5,819.6	1,389.5	1,786.5	2,288.2
Paris club	411.8	610.9	639.2	242.0	240.3	229.7
Multilateral	1,255.2	1,316.6	1,378.7	295.3	357.4	439.2
Other Bilateral	788.0	182.0	329.4	198.9	203.3	310.1
Euro/Sukuk global bonds	750.0	0.0	1,000.0	366.4	422.8	502.7
Commercial loans /credits	488.8	488.9	2,097.0	73.0	270.4	423.5
Others	40.0	105.9	375.2	179.7	292.4	382.9
2. External liabilities	0.0	0.0	0.0	86.6	102.8	187.3
3. PSEs debt	289.0	297.8	223.7	35.1	78.5	130.4
4.Scheduled banks' borrowing	0.0	1.0	2.7	23.2	61.3	71.9
5. Private sector debt	416.6	322.7	497.5	165.9	391.2	443.0
6. Total external debt and liabilities (sum 1 to 5)	4,439.4	3,325.7	6,543.5	1,623.9	2,317.5	2,933.4

Data source: State Bank of Pakistan

[6] Euro depreciated by 2.3 percent against US$, while Chinese yuan depreciated against US$ by 3.5 percent in FY19.

than offset the marginal growth in FX earnings. Going forward, further improvement in current account balance and realization of non-debt flows (foreign direct and portfolio investments) is expected on the back of correction in exchange rate and initiation of the IMF extended fund facility. With a rise in FX earnings, debt repayment would become easier and external debt sustainability would improve.

Table 5.6: Indicators of External Debt Sustainability

percent

	Jun-14	Jun-15	Jun-16	Jun-17	Jun-18	Jun-19
Solvency indicators						
Total external debt and liabilities/GDP	25.6	24.2	26.6	27.4	33.5	45.0
Public external debt/GDP	20.2	18.9	20.8	20.5	24.7	31.1
Total reserves/total external debt & liabilities	21.7	28.7	31.2	25.7	17.2	13.6
SBP reserves/total external debt & liabilities	13.9	20.8	24.5	19.3	10.3	6.8
External debt servicing/FX earnings	13.7	10.2	10.4	15.7	13.8	21.0
External debt servicing/export earnings	23.0	18.0	19.4	29.6	24.9	39.1
Liquidity indicators						
Short-term external public debt/PEDL	1.3	1.9	2.8	1.3	2.1	1.5
Short-term external public debt/total reserves	5.2	5.4	7.3	4.1	9.9	8.7
Short-term external public debt/SBP reserves	8.0	7.5	9.3	5.5	16.6	17.4

Data source: State Bank of Pakistan Calculations