Chapter 5

Domestic and External Debt

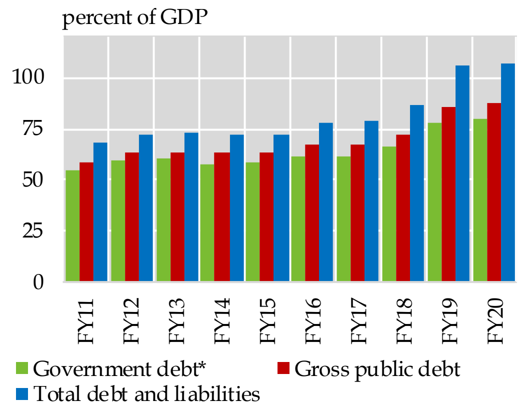
The pace of public debt accumulation slowed considerably during FY20, despite an almost unchanged fiscal position from last year. Utilization of accumulated government deposits, lower revaluation losses, and higher debt servicing helped control the speed of debt buildup during the year. More than two-third of the rise in public debt during FY20 emanated from government domestic debt. Importantly, the government adhered to its commitment of zero fresh borrowing from the central bank and relied on scheduled banks and non-banks for its financing needs. The year also saw a record surge in foreign investment in domestic debt instruments, though most of this capital reverted during the Covid-driven global sell-off. In dollar terms, the rise in external debt was relatively modest compared to last year. External debt sustainability indicators broadly improved during FY20 due to lower debt accumulation and the rise in the country's FX reserves. Pakistan also applied for the G-20 Debt Service Suspension Initiative (DSSI) in the last quarter of FY20, which eased pressures on debt servicing and provided fiscal space to spend on social and health sectors.

5 Domestic and External Debt

5.1 Public Debt

The increase in public debt during FY20 was less than half the increase recorded during FY19. Lower revaluation losses on the existing outstanding stock of public debt, and utilization of accumulated government deposits to finance a similar level of fiscal deficit in rupee terms, as last year, contained the overall rise in public debt during FY20. In terms of GDP, the gross public debt rose by 1.1 percentage points to 87.2 percent of GDP by end-June 2020 (**Figure 5.1**). A decline in economic activity and rising fiscal deficit, particularly in the later part of FY20 amid the Covid-19 outbreak, led to an increase in this ratio.

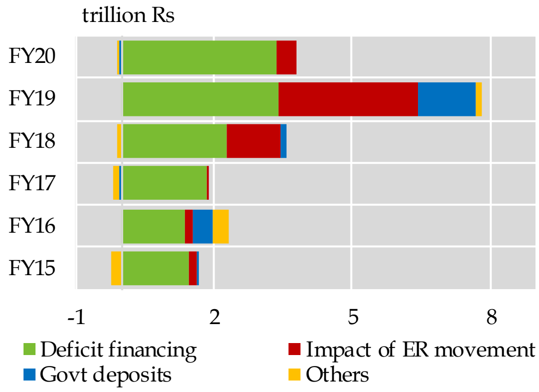
Debt Indicators **Figure 5.1**



*As per FRDLA
Source: State Bank of Pakistan

The increase in government debt as per the Fiscal Responsibility & Debt Limitation Act (FRDLA) definition was also negligible compared to last year.[1, 2] However, the debt-to-GDP ratio remained higher than the 60 percent limit envisaged in the Act.[3] Although the total debt and liabilities of the country also grew at a slower pace as compared to last year, total debt and liabilities as percent of GDP remained higher than 100 percent for the second consecutive year (**Table 5.1)**.

Composition of Increase in Public Debt **Figure 5.2**



Source: State Bank of Pakistan

Almost 90 percent of the public debt piled up during the year was utilized for deficit financing, while roughly 10 percent of the increase was attributed to the depreciation of the Pak rupee against the US dollar. It may be recalled that last year, approximately 40 percent of the rise in public debt alone was due to the Pak rupee depreciation, and a significant contribution had also come from the government's effort to build cash buffers with SBP (**Figure 5.2**).

From a liquidity management perspective, these buffers were important to maintain, as the government had committed to avoid borrowing from SBP, including rollovers. As it turned out, withdrawals from these deposits were imperative to meeting the government's

[1] As per the FRDL Act, 2005 amended in June 2017, "total debt of the government is the public debt less accumulated deposits of the Federal and Provincial Governments with the banking system.
[2] The ratio increased from 66.5 percent in FY18 to 77.7 percent in FY19 – an increase of 11.2 percentage points. In FY20, the ratio increased from 77.7 percent to 79.7 percent – an increase of 2.0 percentage points.
[3] According to the FRDLA, the total public debt shall be reduced to sixty percent of the estimated GDP beginning from FY17; ensuring that within a period of five financial years (beginning from FY19), total public debt shall be reduced by 0.5 percent every year.

Summary of Pakistan's Debt and Liabilities **Table 5.1**

billion Rupees

	Stock			Absolute change		Percent of GDP	
	FY18	FY19	FY20	FY19	FY20	FY19	FY20
A. Total debt and liabilities (sum I to IX)	29,879.4	40,223.1	44,563.9	10,343.8	4,340.8	105.9	106.8
B. Gross public debt (sum I to III)	24,952.9	32,707.9	36,397.0	7,755.0	3,689.2	86.1	87.2
C. Total debt of the government (I+II+III-X)*	23,024.0	29,520.7	33,250.8	6,496.8	3,730.1	77.7	79.7
I. Government domestic debt	16,416.3	20,731.8	23,281.0	4,315.5	2,549.3	54.6	55.8
II. Government external debt	7,795.8	11,055.1	11,824.5	3,259.3	769.4	29.1	28.3
III. Debt from IMF	740.8	921.0	1,291.5	180.2	370.5	2.4	3.1
IV. External liabilities	622.3	1,710.1	1,663.3	1,087.7	(46.8)	4.5	4.0
V. Private sector external debt	1,654.5	2,481.3	2,641.7	826.8	160.4	6.5	6.3
VI. PSEs external debt	324.6	630.6	823.9	305.9	193.4	1.7	2.0
VII. PSEs domestic debt	1,068.2	1,394.2	1,490.5	326.0	96.3	3.7	3.6
VIII. Commodity operations	819.7	756.4	813.4	(63.3)	57.0	2.0	1.9
IX. Intercompany external debt	437.2	542.7	734.0	105.5	191.3	1.4	1.8
X. Deposits with banking system	1,928.9	3,187.2	3,146.2	1,258.2	(41.0)	8.4	7.5

*As per FRDLA definition

Source: State Bank of Pakistan

cash needs during FY20. Particularly during the Covid period, i.e., Mar-Jun, nearly 53 percent of the budgetary borrowing from the banking system were in the form of withdrawals from government deposits held with the SBP. As a result, while the overall fiscal deficit increased by Rs 1.7 trillion during Q4 due to Covid-19 related expenditures, the public debt increased by Rs 1.1 trillion.

The composition of public debt indicates that more than two-third of the rise in FY20 emanated from government domestic debt; the share of the government external debt decreased, while debt from the IMF increased by Rs 0.4 trillion. Importantly, the maturity structure of the debt stock improved, as the government was able to mobilize most funds (96 percent of total increase in government debt) via long-term instruments. With this, the share of long-term debt in the outstanding stock of government debt reached 83.4 percent. It may be recalled that at the end of FY19, the government re-profiled the existing stock of SBP borrowing from short-term to long-term (1 to 10 years). This re-profiling had increased the share of long-term debt (permanent and unfunded) in total domestic debt from 46 percent at end-FY18 to 73 percent at end-FY19. The share of long-term debt further increased to 76 percent at the end of FY20. This structural shift in the composition of domestic debt reduced the rollover risks, besides improving the average time to maturity. From the demand perspective, the money market also remained keen on investing in government papers, as evident by the amount of offered bids, which rose significantly during FY20 (**Table 3.2 & 3.3, Chapter 3**). Even before the outbreak of Covid-19, the market was expecting a reversal in monetary tightening stance, which resulted in a renewed interest for PIBs and 12-month T-bills.

Although the rising share of long-term instruments is encouraging, the development of the capital market remains vital, as it would help reduce financial risks and diversify the investor base. In this context, a record increase in foreign investment in domestic debt instruments during FY20 was encouraging. This increase was attributed to the introduction of a market-based exchange rate system and investors' confidence in the domestic reform program supported by the IMF. The government had also initially planned to float sovereign bonds worth US$ 3.0 billion during FY20, but foreign investment in the local government securities,

Interest payments on Public Debt **Table 5.2**

billion Rupees

	FY16	FY17	FY18	FY19	FY20
A. Total interest payments (i+ii)	**1,263.4**	**1,349.0**	**1,499.9**	**2,091.1**	**2,619.7**
i. Servicing of external debt	112.6	128.2	177.3	270.3	306.6
ii. Servicing of domestic debt	1,150.8	1,220.8	1,322.6	1,820.8	2,313.1
B. External principal repayments	**335.3**	**544.3**	**450.2**	**974.0**	**1,362.4**
Total servicing of public debt (A+B)	**1,598.7**	**1,893.3**	**1,950.1**	**3,065.1**	**3,982.1**
Change in public debt	**2,296.5**	**1,732.0**	**3,544.2**	**7,755.0**	**3,689.2**
Interest payments as % of additional public debt	55.0	77.9	42.3	27.0	71.0

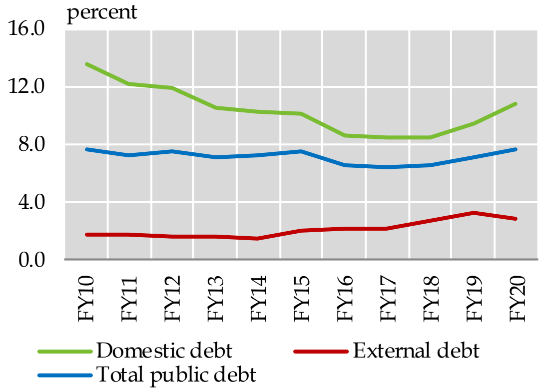
Source: Ministry of Finance

inflows from the IMF, bilateral and multilateral funding proved sufficient to finance a lower current account gap (**Chapter 6**). The international market dynamics also changed owing to Covid-19, and the government showed restraint in the issuance of sovereign bonds during FY20 because of unfavorable market conditions.

In overall terms, debt sustainability indicators showed improvement during FY20, with a slowdown in fresh accumulation and the rise in the country's foreign exchange reserves. Nonetheless, concerted efforts are needed to entrench debt sustainability, place the debt-to-GDP ratio on a firm declining path, and improve the overall debt management framework. In this context, the foremost requirement is to incur primary surpluses, so that the government can generate funds to service debt obligations. It must be noted here that the volume of interest payments on public debt increased sharply during FY20, and was equivalent to more than 70 percent of the additional public debt accumulation (**Table 5.2**).

On average, during the last five years, overall interest payments stood at around 4-5 percent of GDP each year, eating up more than one-third of country's total revenues. The higher servicing requirements represent not just a persistent rise in the stock of public debt, but also the increase in the average cost of borrowing over the past few years (**Figure 5.3**).[4]

Average Cost of Public Debt* **Figure 5.3**



* Actual interest paid as percent of average level of debt

Source: SBP staff calculations

More recently, the retirement of expensive commercial loans from foreign sources and reengagement with IFIs will help improve the cost structure of public debt. On the domestic front, the steep decline in the policy rate during the Covid-19 crisis may also help reduce the average cost of domestic debt.

5.2 Domestic Debt

The government domestic debt increased by Rs 2.5 trillion during FY20, compared to a rise of Rs 4.3 trillion last year (**Figure 5.4**). Relatively lower volume of deficit financing from internal sources and utilization of existing cash buffers helped contain the pace of domestic debt accumulation. It may be noted that during FY19, the government

[4] The effective interest rate (average cost of borrowing) is calculated as the ratio of the interest bill in period t and the stock of public debt (average of debt stocks in t and t-1).Source: M. M. Badia, P. Medas, P. Gupta, and Y. Xiang (2020). *Debt is Not Free*. IMF Working Paper WP/20/1. Washington, DC: International Monetary Fund.

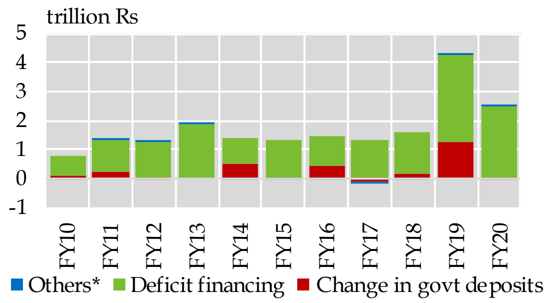
Instrument-wise change in Government Domestic Debt **Table 5.3**

billion Rupees; share in percent

	Stock			Flow		Share in total stock	
	FY18	FY19	FY20	FY19	FY20	FY19	FY20
Domestic debt	16,416.3	20,731.8	23,281.0	4,315.5	2,549.3	100.0	100.0
Permanent debt	4,653.8	12,080.0	14,023.5	7,426.2	1,943.4	58.3	60.2
o/w PIBs	3,413.3	10,933.2	12,886.0	7,519.9	1,952.8	52.7	55.3
Ijara Sukuk	385.4	71.0	198.2	-314.4	127.2	0.3	0.9
Prize bonds	851.0	893.9	734.1	42.9	-159.8	4.3	3.2
Floating debt	8,889.0	5,500.6	5,578.3	-3,388.4	77.7	26.5	24.0
o/w MTBs	5,294.8	4,930.5	5,577.1	-364.4	646.7	23.8	24.0
MRTBs	3,594.2	570.2	1.2	-3,024.0	-569.0	2.8	0.0
Unfunded debt	2,868.1	3,144.1	3,672.1	276.0	528.0	15.2	15.8

Source: State Bank of Pakistan

Sources of Change in Government Domestic Debt **Figure 5.4**



* Difference between the face value and the realized value of PIBs issued during the said period.

Source: State Bank of Pakistan

created substantial cash buffers (deposits with the banking system) to pay off future maturing debt obligations. The government used these deposits during FY20, which reduced its need for fresh borrowing as compared to FY19.

Zero fresh borrowing from the central bank

Importantly, the government adhered to its commitment of zero fresh borrowing from the central bank, and was also able to pay off maturing debt obligations to the central bank.[5] Resultantly, the share of SBP in the government's domestic debt decreased in FY20. Scheduled banks financed the bulk of the government's funding requirements, and as a result, the share of scheduled banks in total domestic debt increased from 33 percent during FY19 to 40 percent during FY20. The government also mobilized funds through non-banks, but their contribution was slightly lower than last year.

It is important to recall that from the debt management perspective, the government started to build up its deposits from FY19 onwards so that maturing obligations could be smoothly paid off in the absence of borrowing from the central bank. Effective utilization of these cash buffers also facilitated the government to partially compensate the rising fiscal deficit owing to Covid-19 in Q4-FY20.

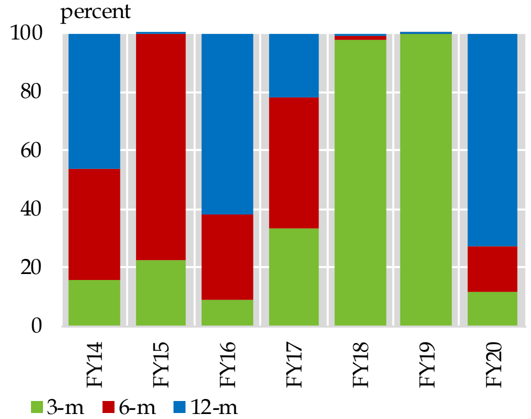
Maturity profile improved further

More than two-third of the rise in domestic debt came from permanent debt, which includes longer tenor instruments like PIBs, Ijara Sukuk and prize bonds (**Table 5.3**). Within floating debt, the government was able to lengthen the maturity profile. The share of 3m T-bills in total outstanding stock of T-bills declined, whereas that of 6m and 12m instruments increased during FY20 (**Figure 5.5**).

Foreign investment in local government securities recorded an uptick, particularly in H1-FY20. Investment by non-banks in government securities was also seen during

[5] The government retired Rs 0.6 trillion worth of securities that were held by the central bank.

Share in Outstanding Stock of T-bills Figure 5.5

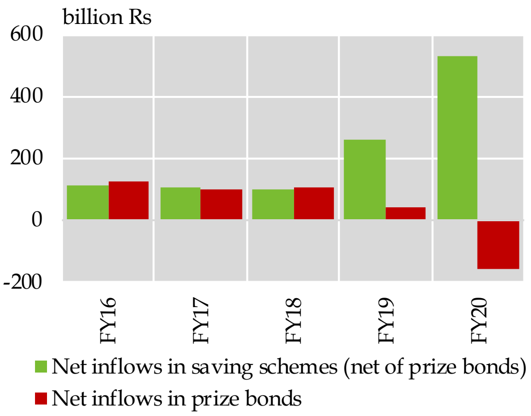


Source: State Bank of Pakistan

FY20. Active participation of foreign investors and non-banks helped in bringing down the yields, where there was no change in the policy rate in the initial part of FY20. From March 2020 onwards, a sharp reduction in the policy rate itself further shifted the entire yield curve downwards (**Chapter 3**).

Regarding PIBs, the government mobilized funds worth Rs 2.0 trillion (net of maturity) during FY20, compared to only Rs 0.3 trillion during FY19. This sharp increase in accumulation of funds via PIBs is attributed to: (1) reintroduction of the 15-year fixed-coupon PIB in April 2020; (2) introduction of new 3-year and 5-year floating rate PIBs in June 2020; and (3) acceptance of bids for 20Y PIBs after a gap of more than 5 years.

Net Inflows in Saving Schemes Figure 5.6



Source: Central Directorate of National Savings

From the demand perspective, the competitive offers increased compared to last year, indicating market's interest in the long-term instruments, keeping in view the high level of long-term rates and the anticipation of monetary easing. From the start of FY20, the volume of offers remained high, but subsequently as the yields started declining, bids for PIBs dropped as well. However, the dynamics changed once again as the process of monetary easing started a little earlier than market expectations due to Covid-19, which led to high investment in PIBs in Q4.

The government also issued Shariah-compliant debt instruments to meet its financing needs. Consequently, the share of Ijara Sukuk in the government domestic debt increased from 0.3 percent in FY19 to 0.9 percent in FY20. The diversification of debt instruments bodes well from the debt management perspective. Importantly, such instruments are also attractive for Islamic banks to park their excess liquidity.[6]

Profit Rates and Investment in NSS Instruments Table 5.4

billion Rupees

	FY18	FY19	FY20	FY20	
	Profit rates* (%)			Gross inflows	Net inflows
DSC	7.8	10.0	10.1	149.9	97.8
BSC	9.7	11.8	11.9	235.3	83.4
RIC	7.1	9.6	10.0	205.8	82.2
SSC	6.3	8.6	9.7	37.4	19.3
PBA	9.7	11.8	11.9	78.9	33.8

* Average profit rates during the year

Source: Central Directorate of National Savings

Inflows in saving schemes doubled in FY20

Net inflows in saving schemes (net of prize bonds) doubled mainly due to higher profit rates offered during FY20 (**Figure 5.6 & Table 5.4**). In contrast, prize bonds recorded net outflows. It is important to recall here that ever since the discontinuation of Rs 40,000 denomination bond at the end of FY19, net

[6] Debt of PSEs also increased in FY20, as the government raised Rs 200 billion through Sukuk to transfer costly Central Power Purchase Agency payables to the Power Holding Private Limited (PHPL).

Pakistan's External Debt and Liabilities **Table 5.5**

billion US$

	End-June Stock			Absolute change					
	FY18	FY19	FY20	FY19	FY20	FY20 Q1	FY20 Q2	FY20 Q3	FY20 Q4
Total external debt & liabilities (sum 1 to 7)	**95.2**	**106.3**	**112.9**	**11.1**	**6.5**	**0.7**	**3.7**	**-0.8**	**2.9**
External public debt & liabilities (1+2+3)	**75.4**	**83.9**	**87.9**	**8.6**	**3.9**	**0.6**	**3.1**	**-1.3**	**1.5**
External public debt (1+2)	**70.2**	**73.4**	**78.0**	**3.2**	**4.5**	**0.7**	**3.6**	**-1.2**	**1.5**
1. Government external debt	64.1	67.8	70.3	3.7	2.5	0.0	3.2	-0.9	0.3
i) Long term (>1 year)	62.5	66.5	68.8	4.0	2.2	-0.3	1.9	-0.8	1.4
of which	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Paris club	11.6	11.2	10.9	-0.4	-0.3	-0.2	-0.2	-0.1	0.1
Multilateral	28.1	27.8	30.9	-0.3	3.1	0.3	1.3	-0.5	2.0
Other bilateral	8.7	12.7	13.4	4.0	0.7	0.1	0.4	0.1	0.1
Euro/Sukuk global bonds	7.3	6.3	5.3	-1.0	-1.0	0.0	-1.0	0.0	0.0
Commercial loans/credits	6.8	8.5	8.1	1.7	-0.4	-0.5	1.3	-0.3	-0.9
ii) Short term (<1 year)	1.6	1.3	1.5	-0.4	0.3	0.3	1.2	-0.1	-1.1
of which									
Multilateral	1.0	0.8	0.8	-0.2	0.0	0.1	0.0	0.1	-0.2
Commercial loans	0.7	0.5	0.1	-0.2	-0.3	-0.2	0.0	0.0	-0.1
Local currency securities (Tbills)	0.0	0.0	0.6	0.0	0.6	0.4	1.2	-0.2	-0.8
2. From IMF	6.1	5.6	7.7	-0.4	2.0	0.7	0.4	-0.3	1.2
3. Foreign exchange liabilities	5.1	10.5	9.9	5.4	-0.6	-0.1	-0.4	-0.1	0.0
4. Public sector enterprises (PSEs)	2.7	3.9	4.9	1.2	1.0	-0.1	0.0	-0.3	1.4
5. Commercial banks	4.4	4.7	4.6	0.3	-0.1	-0.4	0.1	0.2	0.0
6. Private sector	9.2	10.5	11.1	1.3	0.6	0.4	0.1	0.2	-0.1
7. Debt liabilities to direct investors	3.6	3.3	4.4	-0.3	1.0	0.3	0.2	0.4	0.1

Source: State Bank of Pakistan and Economic Affairs Division

flows have declined in this category. While most of the holders of Rs 40,000-denomination bond opted for encashment, anecdotal evidence suggests that a fraction of the holders converted these bonds into other instruments under the NSS.[7]

5.3 External Debt & Liabilities

Pakistan's total external debt and liabilities (EDL) increased by US$ 6.5 billion during FY20 compared to a rise of US$ 11.1 billion during FY19 (**Table 5.5**). This slowdown in external debt accumulation was attributed to a marked contraction in the current account deficit; revaluation gains of US$ 0.4 billion on the outstanding stock of external debt; and higher debt repayments during the year.[8] Bifurcation of external debt & liabilities indicates that the share of short-term debt increased marginally during FY20, which was primarily attributed to foreign investment in local government securities. On a positive note, share of multilateral loans rose, whereas the share of commercial loans – which are relatively expensive – declined. Lastly, the share of loans from the IMF also increased during FY20, which not only included the tranches received under the Extended Fund Facility (EFF), but also the inflow of US$ 1.4 billion under the Rapid Financing Instrument (RFI) following the Covid-19 crisis.

[7] Some holders also likely replaced the old bonds with the newly introduced premium prize bonds.
[8] The US Dollar appreciation against the SDR, Chinese Yuan and Euro, led to revaluation gains of US$ 0.2 billion, US$ 0.1 billion, and US$ 0.05 billion, respectively in FY20.

External Debt Servicing **Table 5.6**

million US$

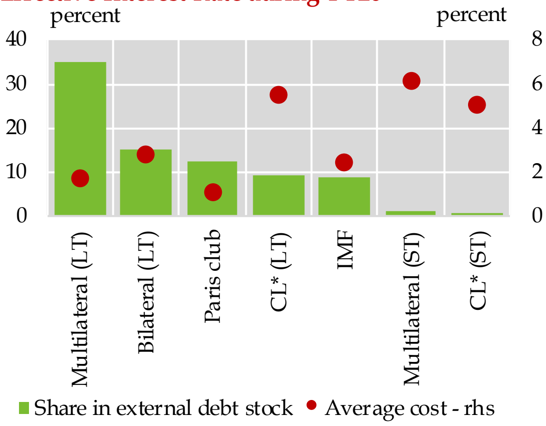
	Principal			Interest		
	FY18	FY19	FY20	FY18	FY19	FY20
1. Public external debt & liabilities	2,704.2	5,817.9	8,362.4	1,786.5	2,290.1	2,352.1
Multilateral	1,316.6	1,375.3	1,455.1	418.6	492.1	525.8
Other bilateral	182.0	329.4	407.2	203.3	310.1	364.4
Euro/Sukuk global bonds	0.0	1,000.0	1,000.0	422.8	502.7	396.0
Commercial loans /credits	488.9	2,097.0	3,879.3	270.4	423.5	466.1
External liabilities	0.0	0.0	500.0	102.8	187.3	320.1
Others	716.7	1,016.2	1,120.7	368.6	374.3	279.8
2. PSEs debt	297.8	223.7	437.2	78.5	130.4	137.8
3.Scheduled banks' borrowing	1.0	2.7	9.8	61.3	71.9	80.9
4. Private sector debt	322.7	482.9	816.8	391.2	458.9	662.3
5. Total external debt and liabilities (sum 1 to 4)	3,325.7	6,527.2	9,626.2	2,317.5	2,951.2	3,233.1
Memorandum Items						
Short term debt servicing - Principal						
Government debt	1,486.3	1,537.1	1,180.9			
PSEs non-guaranteed debt	33.7	0.0	12.0			
Private non-guaranteed debt	332.2	573.9	525.8			

Source: State Bank of Pakistan

Composition and average cost of borrowing of external debt turned favorable

The composition of external debt improved as the share of long-term multilateral loans in outstanding stock of external debt increased. From the debt management perspective, long-term multilateral loans are preferable, as they entail lower cost on average compared to commercial and bilateral loans (**Figure 5.7**).

Share in External Debt and Effective Interest Rate during FY20 **Figure 5.7**

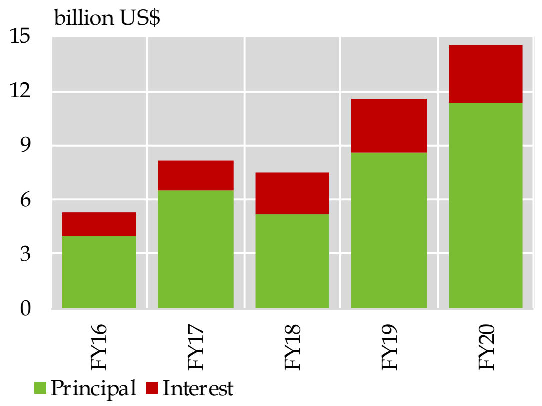


* Commercial Loans

Source: Economics Affairs Division and SBP

External debt servicing rose further during FY20 (**Figure 5.8**). Both principal and interest payments increased. Given the level of foreign exchange reserves at the start of FY20, maturing obligations seemed high.

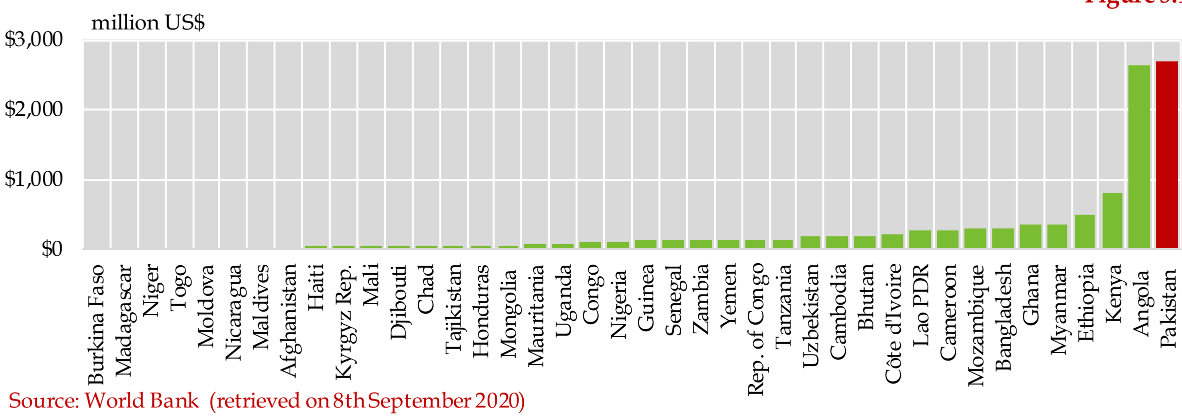
External Debt Servicing **Figure 5.8**



Source: State Bank of Pakistan

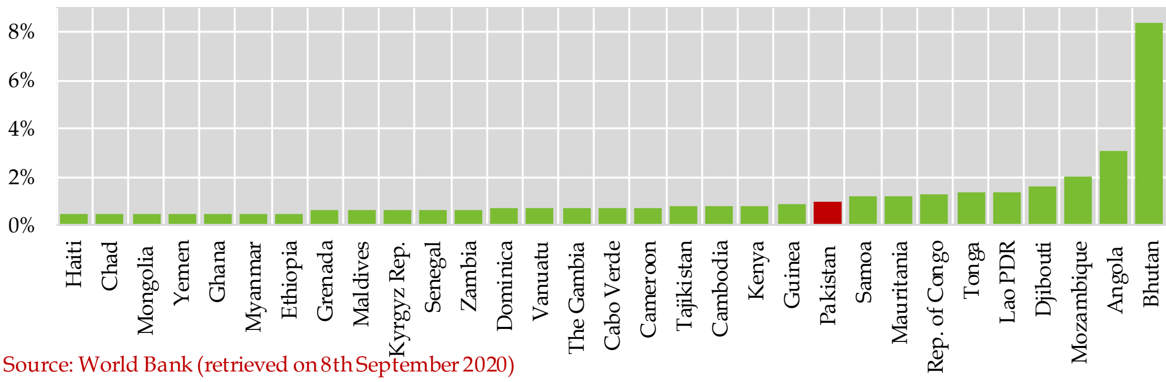
However, the improvement in foreign exchange reserves owing to better external sector position helped in smoothly paying off the debt repayments. Disaggregated analysis indicates that principal repayments of multilateral loans, external liabilities, commercial loans, and Sukuk contributed the most in external debt servicing during FY20 (**Table 5.6**). Principal repayments by the PSEs and private sector also increased during FY20 compared to during FY19. Regarding interest payments, multilateral, commercial and

Potential Savings from Debt Service Suspension Initiative **Figure 5.9a**



Source: World Bank (retrieved on 8th September 2020)

Potential Savings from Debt Service Suspention Initiative as percent of GDP **Figure 5.9b**



Source: World Bank (retrieved on 8th September 2020)

external liabilities had the largest share in the public external debt and liabilities. Interest payments on private sector external debt also rose during FY20.

Participation in the Debt Service Suspension Initiative (DSSI)

In April 2020, the Debt Service Suspension Initiative (DSSI) was launched to grant debt-service suspension (time-bound) to the poorest countries to facilitate them in managing the adverse impact of Covid-19. The key objective of DSSI is to enable an effective crisis response, in which borrowers are required to utilize the freed-up resources to increase spending on social and health fronts. Furthermore, countries are also committed to limit their non-concessional borrowings, other than the agreements under this initiative or in compliance with limits agreed under an IMF Program or the World Bank's policy on non-concessional borrowing. This implies that access to commercial and bilateral loans are limited, which bodes well from debt management perspective because these loans have usually a high cost of borrowing.

Pakistan applied for the DSSI in the last quarter of FY20. Collectively, Pakistan is estimated to get debt relief (potential DSSI savings) of US$ 2.7 billion, or around 1 percent of its GDP.[9] In a global context, Pakistan is likely to benefit the most from potential savings under the DSSI (**Figure 5.9a**). The total volume of debt relief under DSSI stands at US$ 11.5 billion, out of which Pakistan's share alone is around 23 percent. The share of other countries is negligible relative to Pakistan, with the exception of Angola. In

[9] As on September 8, 2020, source: https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative.

Indicators of External Debt Sustainability **Table 5.7**

percent

	Jun-16	Jun-17	Jun-18	Jun-19	Jun-20	Change
Solvency indicators						
Total external debt and liabilities/GDP	26.6	27.4	33.4	45.7	45.5	▲
Public external debt/GDP	20.8	20.5	24.7	31.5	31.2	▲
Total reserves/total external debt & liabilities	31.2	25.6	17.2	13.6	16.7	▲
SBP reserves/total external debt & liabilities	24.5	19.3	10.3	6.9	11.1	▲
External debt servicing/FX earnings	10.4	15.7	13.6	20.8	26.8	▼
External debt servicing/export earnings	19.4	29.6	24.4	38.3	52.1	▼
Liquidity indicators						
Short-term public external debt/PEDL	2.8	1.3	2.1	1.5	1.8	▼
Short-term external public debt/total reserves	7.3	4.1	9.9	8.7	8.2	▲
Short-term public external debt/SBP reserves	9.3	5.5	16.6	17.4	12.3	▲
▲ improvement ▼ deterioration						

Source: EAD, SBP, PBS, SBP staff calculations

terms of percent of GDP as well, Pakistan is among the top-10 DSSI beneficiaries (**Figure 5.9b**). This debt relief will not only ease pressures on debt servicing but also create the needed fiscal space to mitigate the impact of Covid-19 in Pakistan. Lastly, participation in this initiative would further improve the debt sustainability indicators of Pakistan.

5.4 External Debt Sustainability

Persistent fiscal and current account deficits have led to debt accumulation over the years putting pressures on debt sustainability. External debt is considered sustainable if a country can meet its maturing obligations without debt rescheduling and without compromising on economic growth.[10] Broadly, two types of indicators assess the external debt sustainability: liquidity indicators and solvency indicators (that includes both debt bearing and debt servicing capacity of the country). The former look at the repayment capacity to meet the short-term obligations, while the latter take into consideration the long-term debt bearing capacity of the country. Majority of the indicators recorded an improvement compared to FY19 (**Table 5.7**). This improvement was primarily attributed to lower debt accumulation and an increase in foreign exchange reserves.

Debt bearing capacity shows an improvement

The most common measure used to assess debt-bearing capacity is the external debt and liabilities to GDP ratio, which improved marginally to 45.5 percent by end-June 2020 from 45.7 percent by end-June 2019 (**Table 5.7**). The indicator shows that the growth in nominal GDP outpaced the growth in external debt and liabilities during FY20. As highlighted earlier, the reduction in current account deficit and higher amortization contained the growth in external debt and liabilities. However, it is also important to emphasize that this ratio has been consistently increasing over the last few years: it increased from 26.6 percent during FY16 to 45.5 percent during FY20 (**Table 5.7**). This indicates that the cumulative growth in external debt surpassed the nominal GDP growth during this period.

Similar to the overall external debt & liabilities to GDP ratio, the public external debt to GDP ratio declined slightly during FY20. This improvement again is attributed to a deceleration in the pace of public debt accumulation. However, this ratio has also

[10] O. Kidochukwu. (2015). "IMF Recommended Debt Sustainability Threshold for Nigeria. Is it Growth Augmenting? An Optimization Algorithm Approach," *OIDA International Journal of Sustainable Development*. 8(11): 81-90.

been consistently rising i.e. from 20.8 percent in FY16 to 31.2 percent in FY20 (**Table 5.7**). Other measures of solvency, including foreign exchange reserves to total external debt & liabilities (TEDL), and SBP foreign exchange reserves to TEDL also recorded significant improvements during FY20 compared to FY19. The country was able to increase its foreign exchange reserves during FY20 on the back of a sharp contraction in current account deficit, along with inflows received from IMF and other multilateral lenders. The rise in foreign exchange reserves was more than enough to compensate the rise in total external debt & liabilities during the year.

Debt servicing capacity deteriorated

Two ratios are used to gauge the debt servicing capacity of the country, i.e. external debt servicing to exports and external debt servicing to foreign exchange earnings during a year. External debt servicing to exports ratio shows that out of 1 US dollar earned from exports, 0.52 cents were used for debt servicing in FY20. Similarly, the ratio of external debt servicing to foreign exchange earnings shows that out of 1 US dollar of foreign exchange earnings, 0.26 cents were used for external debt servicing. [11]

The rise in these ratios is attributed to large debt repayments made during the year. In addition, marginal declines in exports and foreign exchange earnings during the year also contributed to the deterioration of debt servicing capacity. These ratios have been consistently increasing over the past few years, indicating the growing burden of debt repayments (**Table 5.7**). The ratios of debt servicing capacity have more than doubled during the last five years, reflecting the urgent need to boost export and other earnings.

Liquidity indicators largely improved

Liquidity indicators, which are used to assess the ability to meet short-term obligations, largely present a positive picture, with two out of the three indicators recording an improvement during FY20 (**Table 5.7**). The ratios of short-term external debt to total reserves and SBP reserves improved due to the buildup of foreign exchange reserves during the year. Here, it is also important to highlight that the ratio of short-term external public debt to total reserves is in single digits, implying that the country's reserves were sufficient to meet the obligations maturing within a year. In simple terms, only 8.2 percent of the total reserves were required to meet the short-term obligations at end- FY20 (**Table 5.7**).

The share of short-term external public debt in total external debt rose marginally from 1.5 percent to 1.8 percent. However, this rise was mainly due to foreign investment in short-term local government securities. As this investment is treated as part of short-term external debt, the ratio increased during FY20. Encouragingly, the share of short-term bilateral loans declined during the year. Short-term loans are risky as they carry rollover risk, hence the decline in their share is a positive development from the debt management perspective.

To ensure external debt sustainability, it is imperative to increase revenues to minimize pressures on the fiscal front, and to boost exports and remittances to ensure smooth repayments of external debt without creating additional debt. In the absence of non-debt creating capital inflows, the rise in the current account deficit translates into higher debt stock of a country (or depletion of foreign exchange reserves). In this context, emphasis on viable export promotion policies, attracting non-debt flows, and stimulating domestic investment and growth is important to improve the debt servicing capacity and debt sustainability of the country.

[11] FX earnings include exports of goods & services, primary income credits and secondary income credits.