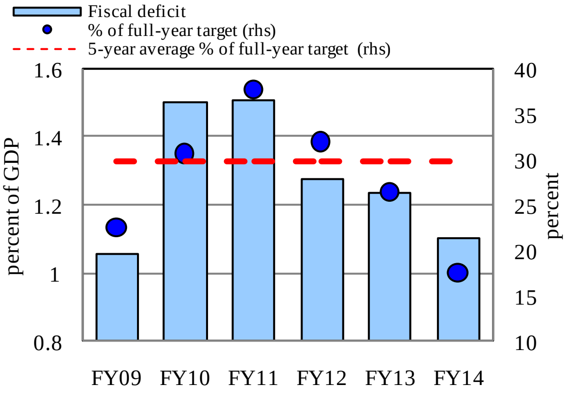
4 Fiscal Policy and Public Debt

4.1 Fiscal Operations

The budget estimates for FY14 envisage fiscal consolidation of 1.7 percent of GDP, which would reduce the budget deficit to 6.3 percent.[1] This is to be achieved through a number of measures, including: (i) an increase in power tariffs to phase out subsidies;[2] (ii) increase in various direct and indirect tax rates; (iii) agreement with the provinces that they post fiscal surpluses in FY14; and (iv) the auction of 3G licenses and divesture of public shares.[3]

Figure 4.1: Analysis of Fiscal Deficit in Q1



Source: Ministry of Finance

In Q1-FY14, the budget deficit narrowed to 1.1 percent of GDP, showing a 0.1 percentage point reduction over Q1-FY13. Furthermore, this deficit is well below the ceiling put in place as part of the IMF program, for end-September 2013.[4] More importantly, the deficit for the first quarter was 17.5 percent of the full-year target, which is significantly lower than the average in the previous 5 years (**Figure 4.1**).

The improvement in the fiscal accounts was a combination of a slowdown in spending, and an improvement in revenue collection (**Table 4.1**). While the increase in revenues was mainly an outcome of the increase in tax *rates* (e.g., GST) and certain one-off non-tax revenues, the retrenchment in spending came from the cumulative 300 bps reduction in the discount rate in FY13, which contributed to lower debt servicing during Q1-FY14 (**Section 4.3**). Furthermore,

[1] In FY13, fiscal deficit reached 8.0 percent of GDP.
[2] The government aims to eliminate power subsidies in the next three years.
[3] Budget estimates also included inflows under coalition support fund.
[4] Compared to the ceiling of Rs 419 billion set by the IMF, the actual budget deficit (excluding grants) was only Rs 297 billion in Q1-FY14. Including grants, the actual budget deficit was Rs 286.9 billion during the quarter.

provincial fiscal accounts also posted a notable improvement, as the provincial surplus was 12.1 percent higher in Q1-FY14 over the same period last year.

Notwithstanding the improved fiscal performance during Q1-FY14, a record Rs 1.0 trillion was added to the public debt during this period. While a part of the incremental debt was needed to finance the fiscal gap during the quarter, around 40 percent of the additional debt came from adverse exchange rate movements (**Section 4.4**).

Although the overall fiscal position during the first quarter of FY14 was encouraging, in our view, the full-year performance will depend on three factors: (i) level of subsidies and the possible need to again pay off the circular debt in the power sector; (ii) the performance of FBR; and (iii) the quantum of CSF and the inflow of 3G license auction proceeds.

Table 4.1: Summary of Fiscal Operations - Q1

billion Rupees

	Actual		Growth (%)	
	FY13	**FY14**	**FY13**	**FY14**
Total revenue	692.1	829.7	29.7	19.9
Tax revenue	451.3	537.1	10.3	19.0
Non-tax receipts	240.8	292.7	93.2	21.5
CSF	107.3	0.0		
Total expenditure	975.9	1,116.6	23.4	14.4
Current	812.4	868.4	23.7	6.9
Development & net lending	74.9	170.1	-14.6	127.3
Unidentified	88.7	78.1	90.6	-12.0
Overall Fiscal balance	**-283.8**	**-286.9**	**10.4**	**1.1**
Financing through:				
External resources	-1.6	-27.2		
Internal resources	285.4	314.1		
Banking system	151.5	198.0*		
Non-bank	133.9	116.1		
As % of GDP				
Overall fiscal balance	-1.2	-1.1		
Revenue balance	-0.5	-0.1		
Primary balance	0.1	0.1		

*The data on financing from domestic banking system reported by the Ministry of Finance is slightly different than what is reported in monetary survey (**Table 3.1**). Please see Data Explanatory Note No. 5 for details.

Source: Ministry of Finance

As far as subsidies are concerned, the targeted reduction of 34.6 percent during the year, does not seem likely. We take this view because the level of subsidies in Q1-FY14 is almost at the previous year's level, despite the selective increase in power tariffs during the quarter.[5,6] Legal complications related to decisions on power tariffs, may continue to challenge the government's ability to reduce the subsidy burden.[7]

[5] Power tariffs for industrial users were raised in August 2013, whereas for the domestic consumers increase was made effective from November 2013.

[6] The increase in power tariffs is indeed welcome, but more concerted efforts are needed to be made in terms of bill collections, and minimizing transmission and distribution losses.

[7] The government first announced an increase in power tariffs in August 2013; however, this decision was partially rolled back for some large consumers (residential, commercial and bulk

In the case of tax revenues, while the collection performance has been encouraging so far, tax receipts still need to grow by 30.3 percent in the remaining part of the year, to meet the full-year target. This appears difficult, given FBR's performance in recent years.[8] The primary concern is that the increase in tax revenues was largely an outcome of tax rate increases in the 2013-14 Budget: in our view, a more sustainable solution would be improving the taxation system; eliminating loopholes in the tax machinery; and above all, widening the tax base. The IMF has also flagged the need to avoid a further rise in GST or income tax *rates* to achieve lower deficits, and to focus more on expanding the tax base by documenting the economy.[9]

The swing factor in the FY14 fiscal outcome, is the disbursement of CSF during the second quarter,[10] and the ground work required to realize the 3G auctions.[11] Another positive for the government is the resolution of legal issues related to the gas infrastructure development cess (GIDC),[12,13] and an increase in GIDC on gas consumers, as agreed with the IMF.[14] It is estimated that instead of Rs 38.0 billion envisaged in the 2013-14 Budget, the government may be able to collect as much as Rs 125.0 billion under this head. The downside risks to the full-year fiscal outcome include: below-target tax collections; re-emergence of the circular debt in the energy sector; and higher interest payments in the second half of the year. On balance, therefore, the SBP expects the fiscal deficit to lie in the range of 6 – 7 percent of GDP during FY14.

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consumers) due to legal issues. In October 2013, government was able to increase the power tariffs again.

[8] During the previous five years, average growth in FBR revenues during Oct-Jun has been 14.1 percent.

[9] IMF Country Report No. 14/1, dated January 2014, "First Review under the Extended Arrangement under the Extended Fund Facility, Request for Waiver of Nonobservance of a Performance Criterion and Modification of Performance Criteria".

[10] Pakistan received US$ 322.2 million under CSF in October 2013.

[11] The government of Pakistan has hired the international consultant in Q2-FY14, to conduct the 3G auction.

[12] GIDC was first introduced in 2011 through "Gas Infrastructure Development Cess Act 2011", primarily to finance the infrastructure development for the import of natural gas. It was estimated that around Rs 34 billion will be collected by the government annually under this head, which will finance the on-going infrastructure projects including Pakistan-Iran gas pipeline, and Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline.

[13] In July 2013, Peshawar High Court suspended the collection of GIDC by the government. This suspension was challenged by the government in the Supreme Court, which set aside the High Court decision, resulting in the resumption of GIDC.

[14] The government has increased the Gas Infrastructure Development Cess (GIDC) at end-December 2013 via SRO 1091(I) of 2013, of 31st December 2013. The government has increased the GIDC on fertilizer feedstock from Rs 197 / mmbtu to Rs 300 / mmbtu. Similarly, on power and industrial sector, the GIDC has been doubled from Rs 50 / mmbtu to Rs 100 / mmbtu.

4.2 Revenue

Total revenues posted an increase of 19.9 percent during Q1-FY14, compared to a 29.0 percent increase in Q1-FY13 (**Table 4.2**). This increase came from both tax and non-tax revenues.

Table 4.2: Tax and Non-tax Revenues –Q1
billion Rupees

	Actual		Change	
	FY13	**FY14**	**Abs.**	**%**
Tax revenue	**451.3**	**537.1**	**85.8**	**19.9**
Direct taxes	136.5	160.8	24.2	17.8
Taxes on goods & services	212.4	255.9	42.6	20.1
Excise duty	22.0	24.7	1.7	7.6
Sales tax	190.3	231.2	40.9	21.5
Taxes on international trade	50.8	52.8	2.0	3.9
Other taxes	28.7	42.8	14.0	48.9
Petroleum levy	22.8	25.8	2.9	12.9
Non-tax revenue	**240.8**	**292.7**	**51.8**	**21.5**
Interest and dividends	16.0	60.6	44.6	283.5
SBP profits	50.0	80.0	30.0	60.0
Defence (incl. CSF)	107.3	1.9	-105.3	-98.2
Dev. surcharge on gas	3.9	20.8	16.9	434.2
Royalties	14.8	19.2	4.3	29.3
Miscellaneous	49.1	110.3	61.2	124.7
of which				
Universal service fund	0	67.6	67.6	
Total revenue	**692.1**	**829.7**	**137.6**	**19.9**

Source: Ministry of Finance

FBR Taxes[15]

Given the stubbornly low tax-to-GDP ratio in Pakistan, the government's fiscal consolidation efforts are primarily focused on increasing tax revenues. The thrust of these efforts so far, has been on increasing the rate of various direct and indirect taxes (**Box 4.1**).

As a result, FBR taxes posted an increase of 17.0 percent during Q1-FY14, compared to a 7.9 percent increase in the same period last year. Most of this improvement came from indirect taxes, specifically from GST on domestic sales; just petroleum products and fertilizer contributed more than half of the increase in this segment. Revenues from GST on imports and custom duties however, remained sluggish during Q1-FY14, mainly due to a decline in the import of high-speed diesel (HSD) and automobiles (**Chapter 5**).

Direct tax collection also witnessed a 17.5 percent increase in the first quarter, mainly due to an increase in withholding tax collected on imports, telephone bills and salaries. In overall terms, FBR tax collections were 95 percent of the quarterly target in Q1-FY14, compared to 82.8 percent in the same period last year.

[15] The information used in this section is based on the revised FBR data, which was reported in the FBR Quarterly Review, Vol. 13, No.1 for Jul-Sep 2013.

Non-tax revenues

Despite the absence of CSF inflows during Q1-FY14, non-tax revenues recorded a 21.5 percent increase over the previous year. As mentioned before, this improvement came from a number of one-offs, including: Rs 56.7 billion mark-up received by the government from PSEs; [16] and a transfer of Rs 67.6 billion in Universal Service Fund (USF) and Research & Development Fund (RDF), from the Ministry of Information Technology to the federal consolidated fund (**Chapter 1**). Without these one-offs, non-tax revenues in Q1-FY14 would have been lower than in Q1-FY13.

Box 4.1: Tax Reforms Introduced in FY14[17]

In the federal budget 2013-14, various measures were announced to increase tax collection. These can broadly be classified into four categories; (i) increase in tax rate, (ii) broadening of the tax base, (iii) removing anomalies in the taxation system, (iv) improving tax compliance. In this regard, following changes have been introduced by FBR in the taxation system during the first quarter:

Revenue measures

Income\ Withholding tax

1. Withholding tax rate on mobile phone subscribers both prepaid and postpaid have been increased from 10 percent to 15 percent;
2. The rate of adjustable withholding tax on cash withdrawal increased from 0.2% to 0.3% on amount exceeding Rs.50,000 in a day;
3. Introduction of a 10 percent withholding tax (not adjustable) on dividends received by a corporate taxpayer;
4. Income tax on Builders @ Rs.25 per square feet of the constructed area sold and Land Developers @ Rs.50 per square yard of the area sold respectively have been levied;
5. The existing six slabs of tax on salary income are increased to twelve. The maximum rate of tax on salary income is progressively increased from an existing 20% to 30%;
6. The maximum tax rate on business income of non-corporate taxpayers is increased progressively to 35% on income exceeding Rs. 6 million from an existing maximum of 25%.

Sales tax

7. Standard tax rate is increased from 16 % to 17 %.
8. Further tax @ 1 % is levied where taxable supplies are made to unregistered persons.
9. An additional sales tax of 5% is levied through electricity and gas bills of those having commercial or industrial connections but remain unregistered.

FED

10. FED rate on cigarettes is simplified and re-structured, from three slabs based on a composite formula, to two slabs based on a specific rate;
11. The rate of federal excise duty on aerated beverages increased from 6% to 9% and introduction of capacity based taxation on aerated beverages to stop evasion and malpractices in the sector;

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[16] In Q1-FY14, federal government made Rs 138 billion non-cash adjustment of circular debt in the power sector. This receipt is a part of that adjustment.

[17] Sources: Finance Act 2013, FBR Quarterly Review, Vol. 13, No.1 for Jul-Sep 2013, Budget Speech 2013-14, FBR's Notes on clauses of Finance Bill 2013 and Grant Thornton Tax Memorandum 2013.

12. Federal Excise Duty @ 40 paisa per kg on imported seeds, Rs. 1/ per kg on locally produced oil purchased by a manufacturer of vegetable ghee and cooking oil in lieu of FED payable at production or manufacturing stage of vegetable ghee or cooking oil; [18]
13. Exemption of FED on cement, and services provided or rendered by Asset Management Companies is withdrawn;
14. The scope of chargeability of FED on financial services is expanded by making all kinds of financial services including banks, insurance companies, modarabas, musharikas, leasing companies, forex dealers, NBFIs, AMCs etc. falling under levy of 16% Federal Excise Duty.

Custom Duty

15. In FY14 budget custom duty has been reduced on several items including hybrid cars and energy savers but nothing new has been introduced whereas duty is increased on betel nuts by 5% and betel leaves from Rs.200/kg to Rs. 300/kg.

Measures to improve compliance

1. Each banking company shall provide the FBR a list containing particulars of deposits of one million or more on monthly basis;
2. FBR is empowered to levy and collect sales tax on production capacity or on fixed basis;
3. In order to improve compliance and discourage corruption a reward incentive for officers of the FBR has been introduced;
4. Regulatory control on exempt/concessionary import of agricultural machinery, tourism sector, packaging industry and pharmaceutical sector is being strengthened to ensure the benefit to bonafide importers only;
5. Introduction of WeBoc a new monitoring system for imported items. It is an automated and transparent system which will minimizes interaction between taxpayers and tax collectors, thereby minimizing malpractices;
6. FBR empowered to monitor production, sales, clearance, stocks or any other activity through electronic monitoring;
7. The obligation to file tax return made compulsory in the case of an industrial and commercial electricity consumer where annual electricity bill exceeds Rs. 500,000 as against Rs. 1,000,000 per annum presently.

4.3 Expenditure

Along with enhancing revenues, the government needed to cut down expenditures as part of the fiscal consolidation strategy. On the face of it, the fiscal authorities appear to have made some headway in achieving this objective, as the growth in current expenditures declined to almost one-fourth of what was observed in Q1-FY13.[19] This was made possible due to a significant reduction in interest rates, which lowered interest payments during Q1-FY14. Other than this, subsidies were almost at the same level as last year, while non-interest non-subsidy current expenditures[20] recorded a 16.9 percent growth against 5.2 percent during the same period last year (**Table 4.3**). The increase in non-interest, non-subsidy expenses

[18] Earlier imported seeds were exempt from any tax or duty while locally produced seed oil was subject to 16 percent tax which was hurting the local farmers.

[19] Current spending posted 6.9 percent increase in Q1-FY14, compared to the 23.7 percent raise witnessed in the same period last year.

[20] Non-interest non-subsidy current spending is the current spending excluding interest payments and subsidies.

in the first quarter was on account of an increment in the ad hoc relief to government employees, and pensions of government and defense employees. Within development expenditures, net lending to PSEs showed an abnormal increase in Q1-FY14, due to a lumpy adjustment of circular debt during this period.[21] Furthermore, federal PSDP also posted healthy growth during the quarter.

As discussed earlier, the government's ability to contain its expenditures hinges on the level of subsidies and payments to settle the circular debt in the power sector. To resolve this recurring problem, the government raised power tariffs for industrial users.[22] The impact of this is not yet apparent, as the volume of subsidies in the power sector during Q1-FY14, remains almost at the same level as last year. Furthermore, as mentioned earlier a circular debt has re-appeared after a large adjustment in June 2013 (**Chapter 1**).

Table 4.3: Analysis of Fiscal Spending - Q1
billion Rupees

	Absolute		% of BE*	
	FY13	FY14	FY13	FY14
Current expenditures	**812.4**	**868.4**	**33.9**	**30.7**
of which				
Interest payment	312.8	301.1	33.8	26.1
Subsidies	58.0	59.0	27.8	24.5
Non-interest non-subsidy	441.5	508.2	35.0	35.4
Development expenditures	**74.9**	**170.1**	**12.7**	**21.6**
PSDP	30.3	44.9	8.4	8.3
Grants to provinces & other exp. incl.net lending	44.6	125.2	4.2	13.2
Unidentified	89.7	78.1	--	--
Total	**975.9**	**1,116.6**	**32.7**	**30.9**
Total expenditures, adjusting for circular debt settlement	975.9	978.6	32.6	27.0

*BE: Budget estimates
Source: Ministry of Finance

In overall terms, despite the year-on-year slowdown, fiscal expenditures during the first quarter were around 30.9 percent of the budget estimate for the entire year. Given the progressive increase in spending during the course of the year, the fiscal authorities may find it difficult to contain spending within the annual target.

Provincial fiscal operations

Provincial fiscal position improved further during Q1-FY14, with a 12.1 percent improvement in the surplus over Q1-FY13 (**Table 4.4**). This improvement was brought about by a 50.0 percent increase in revenues during Q1-FY14, over the same period last year. Major share of this increase came from Punjab, on the back of a rise in sales tax collection on services.[23] Moreover, KPK – following on the

[21] The government made a Rs 138 billion circular debt adjustment in Q1-FY14. This was the non-cash segment of the settlement, which was made in June 2013.
[22] Power tariffs for domestic consumers were also raised in November 2013.
[23] Punjab started collection of sales tax on services since last year.

footsteps of Sindh and Punjab, also established its revenue authority in August 2013. This is likely to further improve provincial revenues going forward.[24]

Table 4.4: Provincial Fiscal Operations – Q1
billion Rupees

	Punjab		Sindh		KPK		Balochistan		All provinces	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
Total revenue	**159.3**	**164.6**	**103.5**	**113.8**	**51.3**	**62.7**	**38.9**	**47.3**	**353.0**	**388.4**
Share in federal revenue	128.7	136.4	73.0	93.0	43.3	51.5	32.8	41.8	277.8	322.7
Taxes	10.8	22.5	16.3	17.0	0.9	2.3	0.2	0.3	28.2	42.1
Non-taxes	12.3	5.5	9.2	0.9	1.3	3.2	1.6	1.2	24.4	10.7
Federal loans & transfers	7.6	0.1	5.0	3.0	5.8	5.8	4.3	4.0	22.7	12.9
Total expenditure	**105.8**	**117.3**	**66.1**	**80.7**	**49.9**	**44.9**	**22.7**	**23.9**	**244.5**	**266.8**
Current	87.6	102.1	61.7	69.3	37.9	38.3	19.2	22.5	206.5	232.2
Development	18.2	15.1	4.4	11.5	12.0	6.6	3.4	1.4	38.0	34.6
Overall balance	**53.6**	**47.3**	**37.4**	**33.1**	**1.4**	**17.8**	**16.2**	**23.4**	**108.5**	**121.6**
Financing *	-30.5	-27.1	-29.6	-28.9	-10.4	-11.7	-15.0	-24.7	-85.4	-92.4

* Numbers of overall balance and financing do not match due to statistical discrepancies. The financing numbers give actual budgetary position of provinces.

Source: Ministry of Finance

On the spending side, a rise in salaries and pensions of government employees, increased provincial current expenditures. A part of this increase, however, was offset by a drop in the development spending in all provinces, with the exception of Sindh.

4.4 Public Debt

With the addition of Rs 1.0 trillion during Q1-FY14, Pakistan's public debt stock rose to Rs 15.5 trillion at end-September 2013 (**Table 4.5**). This was the highest ever increase in any single quarter of a year, and was driven by both domestic and external debt. Given the risk of debt trap facing the economy, the need for immediate implementation of broad-based fiscal reforms can hardly be over emphasized. It is only through a concerted fiscal reform agenda that the country's public debt-to-GDP ratio can be brought on a firmly declining path.

Table 4.5: Pakistan's Public Debt Profile
billion Rupees

	Jun-13	**Sep-13**	**Change**
Public Debt	14,494.0	15,514.5	1,020.4
Public domestic debt	9,520.9	10,154.9	634.0
Public external debt	4,973.1	5,359.5	386.4
Government external debt	4,311.1	4,672.2	361.1
Debt from the IMF	434.8	441.3	6.5
External liabilities	227.2	246.1	18.9

Source: State Bank of Pakistan

[24] With the transfer of sales tax collection on services to provinces under the 18th amendment, Sindh and Punjab have already started collections since FY12 and FY13, whereas KPK also established its Revenue Authority in August 2013.

This said, around 40 percent of the addition in public debt originated from PKR depreciation, which inflated the external debt during Q1-FY14. More specifically, Rupee depreciation against US Dollar resulted in Rs 348.3 billion increase in the Rupee value of external debt, whereas depreciation of US Dollar against Japanese Yen further added Rs 58 billion to the public debt stock in this period. As regards the domestic debt, the increase came primarily from budgetary borrowings from SBP to finance the fiscal gap. However, it should be noted that the *increase* in domestic debt far exceeded actual budgetary requirements during the quarter; financing of the government from domestic sources was Rs 314.1 billion,[25] but domestic debt shows an increase of Rs 634.0 billion during the quarter. This difference arose mainly because the government borrowed *more* funds than it actually required, and placed the additional funds in its deposits held by SBP.[26] Therefore, the increase in debt stock represents *gross* budgetary borrowings, whereas the deficit financing is based on *net* budgetary borrowings – excluding government deposits.[27]

Over-reliance on domestic short-term financing resources remains a challenge for policy makers. Unlike the case of other emerging economies where the bulk of the domestic debt is held by non-bank institutions and foreign residents, two-thirds of Pakistan's domestic debt stock is held by domestic commercial banks alone. This is despite various initiatives to encourage non-bank investment in floating & permanent debt securities.[28]

As far as foreign investment in domestic debt is concerned, uncertainty about final tax liabilities and various country-specific risks have kept foreign ownership of Rupee debt securities at a very lower level (**Box 4.2**). As has been mentioned in previous SBP reports, this increases the vulnerability of Pakistan's public debt, as it gives rise to roll-over and interest-rate risk. This risk realized to some extent during the first quarter of FY14.

Materialization of roll-over risk in short-term floating debt

Anticipating a hike in the policy rate, banks were largely shy from participating in T-bill auctions throughout Q1-FY14 (**Chapter 3**). Resultantly, the government

[25]We get this number by adding net decline of Rs 27.2 billion in external financing, to Rs 286.9 billion budget deficit during the quarter.

[26] Government's deposits with SBP increased by Rs 384.6 billion during Q1-FY14.

[27]The domestic debt stock as on end-October 2014 shows a Rs 264 billion decline, compared to the end-September 2013 position. This is mainly due to the retirement of government debt owed to the central bank.

[28] To diversify the debt market, SBP allowed participation of individuals and small institutional investors in both MTBs and PIB auctions by non-competitive bids, through its circulars FSCD Circular No.07 &18, dated June 06, 2009, and December 04, 2010.

had to depend on the central bank to finance its debt payments to commercial banks, at the cost of breaching the limit of zero quarterly borrowings. However, the government also had to observe the limit placed by IMF on its net quarterly borrowings from SBP. In this regard, the increase in the discount rate on September 13, 2013, helped the government in reviving commercial bank's interest in T-bill auctions. In the last T-bill auction in the first quarter of FY14, the government was able to mobilize Rs 515.9 billion – the highest ever amount raised in a single auction. This helped the fiscal authorities meet the IMF's end-September limit on net government borrowing from SBP, retiring a part of central bank debt, and by increasing government deposits with the central bank.

PIBs were not attractive in Q1-FY14

The stock of PIBs recorded a slight decline during Q1-FY14, compared to the end-June position. This was due to a fall in PIB holdings by commercial banks, as they shifted a part of their holdings to insurance companies and other NBFIs.[29]

Changing sentiments about the discount rate, and banks' already high exposure in the PIBs, discouraged further investments during Q1-FY14. Even the 50 bps increase in the policy rate, during the first quarter, was not enough to revive interest in PIBs; the offered amounts remained well below target in all the auctions held during the quarter (**Chapter 3**).[30] On the other hand, the government was not inclined towards long-term borrowing, and did not accept the full amount offered in these auctions.[31] It must be noted that this trend was reversed from Q2-FY14 onwards: a total of Rs 105.6 billion was raised in three PIB auctions held during the quarter. Result of the auction held on 30th January 2014 was even more encouraging, in which, the government raised Rs 195.8 billion.

Falling returns, discouraged investment in NSS

Following the selective resumption of institutional investment in April 2012, gross inflows remained buoyant for a few months in FY13. However, with the reduction in profit rates on January 1, 2013, this temporary spurt appears to have stalled (**Figure 4.2**). In fact, with the next reduction in rates in July 2013, returns on NSS were at their lowest level in the past nine years. With ongoing maturities, net mobilization fell during Q1-FY14.

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[29] Unlike T-bills stock that has around 90 percent holding by commercial banks, PIBs have almost equal ownership of bank and non-bank institutions.

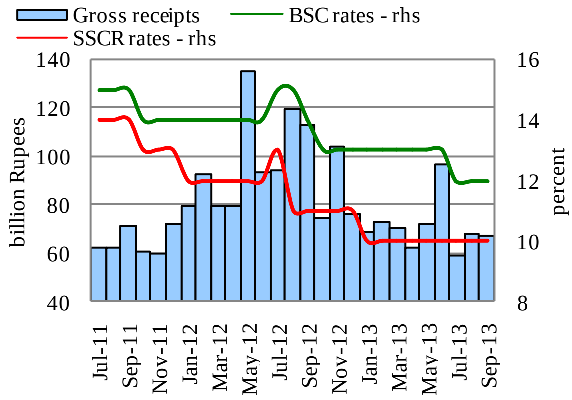
[30] The offer-to-target ratio stood at 0.57 during Q1-FY14.

[31] Against the offer of Rs 85.5 billion, the government raised Rs 65.9 billion in the PIB auctions during Q1-FY14.

External Debt & Liabilities

Despite repaying US$ 1.3 billion, Pakistan's public external debt & liabilities increased in Q1-FY14 (**Table 4.6**). The depreciation of US Dollar against major currencies, created a significant exchange loss for Pakistan, which resulted in a US$ 548.5 million addition in the debt stock during the quarter.[32]

Figure 4.2: Gross NSS Inflows and Major Profit Rates



Source:State Bank of Pakistan, CDNS

The phase of declining external debt, which was observed during the past few years, ended with the Extended Fund Facility (EFF) from the IMF. Inflows from the IMF, and other multilateral creditors, are likely to add to Pakistan's external debt going forward. This said, a rise in the external debt and depletion in FX reserves, reduced the external debt servicing capacity of the economy in the first three months of FY14 (**Table 4.7**).

Table 4.6: Pakistan's Public External Debt & Liabilities

million US$

	Jun-13	Sep-13	Change
Public external debt & liabilities	50,176	50,560	385
Government debt	43,496	44,076	580
IMF	4,387	4,163	-224
External Liabilities	2,292	2,321	29
Debt servicing/FX earnings	12.0	12.9	

Source: State Bank of Pakistan

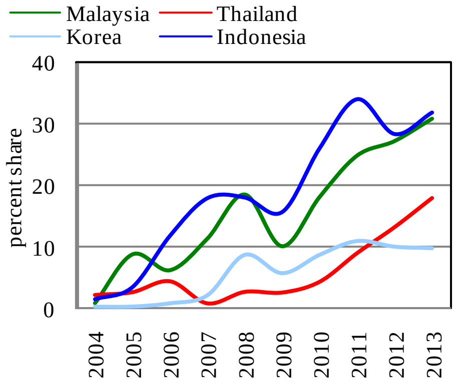
Box 4.2: Interest Rate Movements and Capital Inflows to Pakistan

Capital inflows to a country can be categorized as FDI, portfolio investment; external loans, remittances and external investment in debt securities. Typically, a rise in interest rates in the host country, is said to attract a higher stream of foreign capital inflows, however, this relationship does not always hold: FDI and portfolio investment display a negative relationship, whereas remittances and external debt are not sensitive to the interest rate movements. This leaves foreign investment in local debt securities (bond market) as the only category that merits consideration, while analyzing the impact of interest rate movements.

Pakistan's Case: Unlike the experience of other emerging economies that have a noticeable share of international investment in local currency bond markets, Pakistan receives only sparse external inflows into its domestic debt securities (**Figure 4.1.1**). To put things into perspective, FY11 witnessed highest foreign inflows in T-bills amounting to US$ 212 million, which constituted a mere 0.9 percent of the T-bills stock on end-June 2011. On the other hand foreign investment in PIBs has never crossed even US$ 100 million benchmark in a year (**Figure 4.1.2**). The data on international

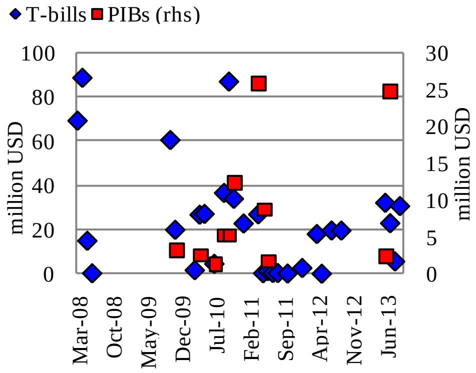
[32] US Dollar depreciated against Euro, Japanese Yen and SDRs during this period.

Figure 4.1.1: Foreign Holdings in Local Currency Government Bonds



Source: http://asianbondsonline.adb.org

Figure 4.1.2: Foreign Inflows in Pakistan Local Currency Debt Securities



Source: State Bank of Pakistan

investment in NSS is not available, but anecdotal evidence indicates only nominal foreign participation in these schemes.[33]

This sluggishness can be traced to a number of issues. In the literature, in addition to interest rate differential, strong economic fundamentals -stable exchange rate and inflation[34] - and extent of bond market development[35] are cited as important factors underpinning foreign inflows into local debt markets Burger and Warnock (2004).[36] The performance of Pakistan's economy on these counts, however, has remained unsatisfactory. In the period of last ten years, exchange rate has experienced various bouts of volatility, whereas inflation has mostly remained in double digits (**Figure 4.1.3**). As regards the development of the bond market, while the size of the domestic debt market has increased with government's growing dependence on internal resources for financing the fiscal deficit, the composition of domestic debt has shifted towards short-term floating debt. This not only hampers the liquidity of the long-term debt market, but also restricts development of bench-mark bonds. This is in sharp contrast to the situation in other

Table 4.1.1: Sovereign Ratings by Moody's (2013)

	Outlook
Pakistan	Negative
Malaysia	Stable
Thailand	Stable
Indonesia	Stable
Korea	Stable

Source: Bloomberg

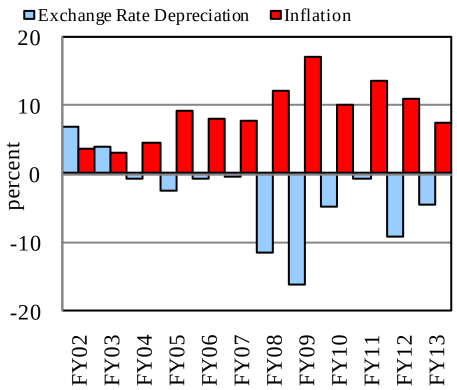
[33] To attract inflows from non-resident Pakistanis, CDNS has so far made formal arrangements with only two countries, namely Bahrain and UAE.

[34] Sharp fluctuations in exchange rate induce volatility in returns on local currency bonds, and hence discourage foreign investors. Similarly, high inflation undermines the purchasing power of funds invested in host country, and discourages foreign investment (Source: Kaur and Dhillon, 2010).

[35] The extent of bond market development can be gauged from the size of the market, composition of bonds in terms of maturities, type of instrument, investor base diversity; and market liquidity (source: Mehrotra, Miyajima & Villar, "Developments of domestic government bond markets in EMEs and their implications", BIS Paper No 67, 2012.

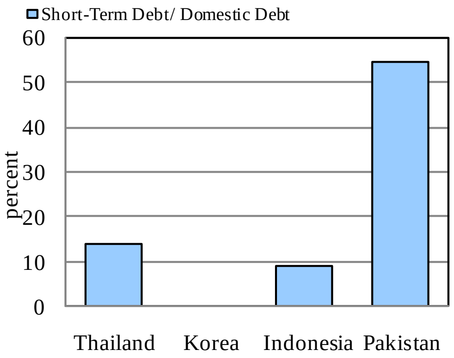
[36] Burger and Warnock (2004), "Foreign participation in local currency bond markets", http://faculty.darden.virginia.edu/

Figure 4.1.3: Trends in Inflation and Exchange Rate Depreciation



Source: SBP

Figure 4.1.4: Extent of Domestic Bond Market Development



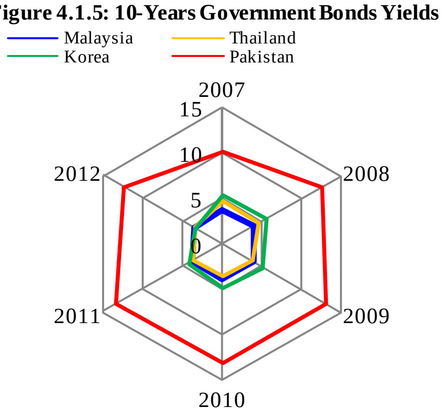
Mehrota, Miyajima and Agustin Villar (2012), BIS Paper No. 67

emerging markets, which largely depend on long-term fix rate bonds for the financing of fiscal deficits (**Figure 4.1.4**).

In addition to these factors, security concerns and political uncertainty are some other important deterrents to foreign inflows in Pakistan's debt market. This can also be seen from the lower sovereign ratings assigned to Pakistan by the international rating agencies e.g., Moody's vis-a vis other countries (**Table 4.1.1**). Resultantly, despite much attractive yields on Pakistan's long term bonds compared to other emerging economies, the country is not able to attract external inflows (**Figure 4.1.5**). In fact, our in-house estimates indicate that despite the large depreciation of Rupee against US$, investment in Pakistan's long term bonds is a profitable option for international investors (**Figure 4.1.6**); however, the numerous issues discussed above have stymied this avenue of foreign inflows for the country.

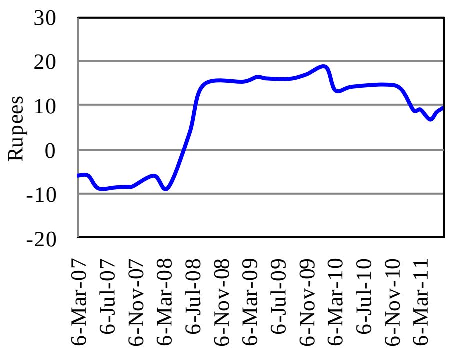
In this scenario this can be safely concluded that a rise in the domestic interest rates is not likely to boost capital inflows to the domestic bond market. On the other hand, this can discourage the

Figure 4.1.5: 10-Years Government Bonds Yields



Source: Haver Analytics, SBP

Figure 4.1.6: Hypothetical Returns on US$ 1 Investment in 3-year PIBs



Source: SBP in-house estimates

external inflows to the equity market, by negatively impacting the performance of domestic stock market.