4 Fiscal Policy and Public Debt

4.1 Overview

The fiscal deficit was 1.3 percent of the GDP in Q1-FY17 – the highest quarterly deficit since FY12. The primary balance, which excludes interest payments, also posted a deficit of 0.1 percent of GDP after showing a surplus in the last four years consecutively (**Figure 4.1**).

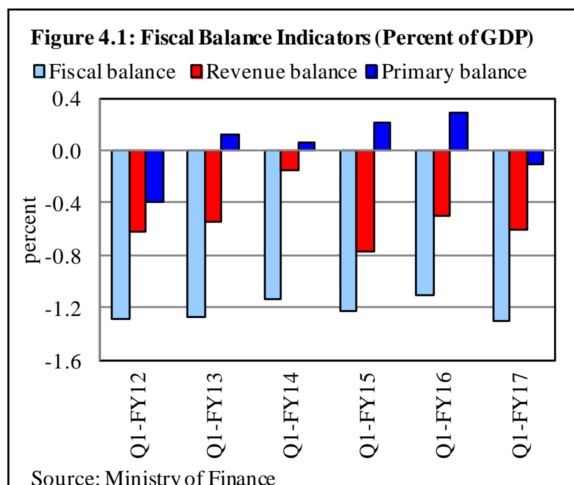

Figure 4.1: Fiscal Balance Indicators (Percent of GDP)

Source: Ministry of Finance

High fiscal deficit in Q1-FY17 was primarily an outcome of low revenue generation. The performance of revenue was not in line with the full year target of over 20 percent revenue growth. While tax collection also slowed down considerably, the major drag came from a sharp decline in non-tax revenues (**Table 4.1**).

Non-tax revenue declined mainly due to the absence of Coalition Support Fund (CSF) and lower SBP profit.[1] Furthermore, dividend income from Public Sector Enterprises (PSEs) declined by around 70 percent as a number of PSEs reported reduced profit in Q1-FY17.

Shortfall in revenue collection overshadowed a welcome decline in current expenditures. Encouragingly, development spending recorded an increase of 12.4 percent in Q1-FY17, on top of 47.4 percent increase in the last year. This indicates government's continued focus on achieving inclusive growth through infrastructure build-up and promotion of export oriented sectors as well as neglected agriculture sector.[2]

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[1] Pakistan received US$ 713 million as CSF in Q1-FY16. Similarly, SBP profit decline to Rs 39.4 billion in Q1-FY17 compared to Rs 67.6 billion in Q1-FY16.

[2] In FY17 budget, the government announced zero rating facility on purchase of raw materials to five major export oriented sectors including textile, leather, sports goods, surgical goods and carpets.

Table 4.1: Summary of Fiscal Operations
billion Rupees

	Budget FY17	Actual		% of GDP	
		Q1-FY16	Q1-FY17	Q1-FY16	Q1-FY17
A. Total revenue	5,347	937.0	862.2	3.2	2.6
Tax revenue	4,306	723.5	739.2	2.4	2.2
Non-tax revenue	1,041	213.5	123.1	0.7	0.4
B. Total expenditure	6,623	1,265.2	1,300.1	4.3	3.9
Current	5,198	1,085.2	1,070.7	3.7	3.2
Interest Payments	*1,360*	*415.9*	*414.3*	1.4	1.2
Development	1,435	169.9	191.1	0.6	0.6
Net lending	-10	-1.2	-0.3	0.0	0.0
C. Statistical discrepancy	0	11.2	38.6	0.0	0.1
Fiscal balance (A-B-C)	-1,276	-328.2	-437.9	-1.1	-1.3
Revenue balance	149	-148.2	-208.5	-0.5	-0.6
Primary balance	84	87.8	-23.6	0.3	-0.1
Financing	1,276	328.2	437.9	1.1	1.3
External sources	234	55.3	68.8	0.2	0.2
Domestic sources	1042	272.9	369.1	0.9	1.1
Banks	453	139.5	299.7	0.5	0.9
Non-bank	539	133.5	69.3	0.5	0.2
Privatization proceeds	50	-	-	-	-
% Growth					
Total Revenue	-	11.6	-8.0	-	-
Tax revenue	-	15.4	2.2	-	-
Non-tax revenue	-	0.3	-42.3	-	-
Total expenditure	-	7.5	2.8	-	-
Current	-	3.2	-1.3	-	-
Development	-	47.4	12.4	-	-

Source: Ministry of Finance

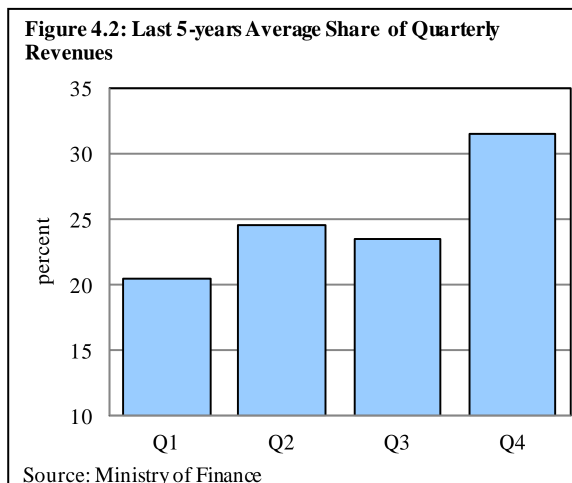
The fiscal deficit in Q1-FY17 was predominantly financed through SBP borrowings. Although financing from external sources increased, the non-bank financing fell to almost half in Q1-FY17 compared to the level in Q1-FY16. The total public debt increased by Rs 866.1 billion during Q1-FY17, reaching Rs 20.5 trillion as of end-September 2016. Most of this increase, about 88 percent, was due to domestic debt. In particular, government mobilized more financing through short-term papers.

4.2 Revenues

The revenue collection declined by 8.0 percent during Q1-FY17, compared to 11.6 percent increase in the corresponding period of last year. This decline in revenue was primarily due to a sharp contraction of 42.3 percent in non-tax revenues (mainly due to absence of CSF and lower SBP profit), while growth in tax

revenues also slowed down considerably to 2.2 percent during Q1-FY17. Therefore, revenue collection during the quarter remained well below expectations, achieving only 16.0 percent of the overall target for FY17. The seasonal pattern shows the revenue collection during Q1 is usually little over 20 percent of the annual target (**Figure 4.2**).

Figure 4.2: Last 5-years Average Share of Quarterly Revenues



Source: Ministry of Finance

The shortfall in first quarter implies that a much higher growth, 27.8 percent, is required in subsequent quarters to achieve the annual target of Rs 5,347 billion, which appears challenging.

FBR taxes

FBR taxes, which constitute around 85 percent of the total (federal and provincial) tax collection, witnessed a slowdown during Q1-FY17 (**Table 4.2**). The major drag came from a decline of 3.4 percent in direct taxes. A combination of factors has contributed to this slowdown in FBR tax collection, including: (i) low corporate profitability combined with government's decision to reduce the corporate tax rate by 1 percent;[3] (ii) exemption in taxes on green-field industrial undertakings; (iii) increase in tax credits for employment generation, BMR and enlistment on stock exchange; (iv) government's decision to keep POL prices

Table 4.2: FBR Tax Collection
billion Rupees

	Budget FY17	Q1-FY16	Q1-FY17	Percent Growth	
				Q1-FY16	Q1-FY17
Direct Taxes	1558.0	239.7	231.6	26.3	-3.4
Indirect Taxes	2063.0	350.5	393.4	0.7	12.2
Customs Duty	413.0	79.6	100.9	23.4	26.7
Sales Tax	1437.0	243.4	261.5	-5.7	7.4
FED	213.0	27.5	31.1	8.2	13.0
Total Taxes	**3621.0**	**590.2**	**625.0**	**9.7**	**5.9**

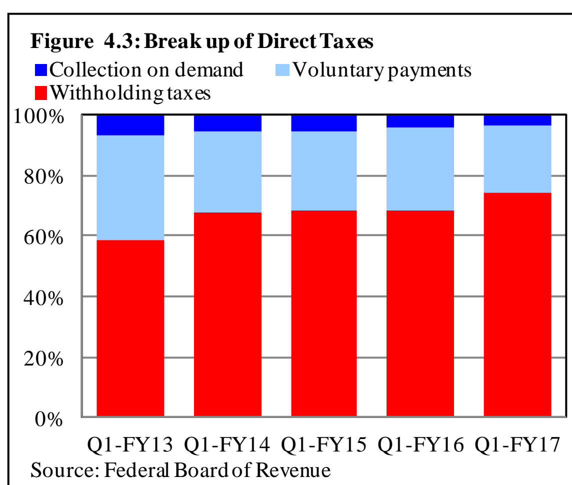
Sources: Federal Board of Revenue

[3] In particular, banks' profitability decreased by about 11.9 percent in Q1-FY17.

unchanged in the face of increase in international crude prices, and; (v) decline in production of cigarettes following increase in excise duty. Here, it is important to acknowledge that despite some adverse implications of these initiatives in the short run, they are expected to contribute favorably by stimulating economic growth and increasing the size of the overall tax base, going forward.

Apart from decline in direct taxes, the share of withholding taxes (WHT) continues to get bigger, rising to 75 percent of direct taxes in Q1-FY17. On the other hand, the shares of Voluntary Payments and Collection on Demand in direct taxes are declining (**Figure 4.3**). The increase in the share of withholding taxes has strong implications for low income people due to its regressive nature, as businesses re-price their products to pass it on to the consumers.[4]

Figure 4.3: Break up of Direct Taxes



Source: Federal Board of Revenue

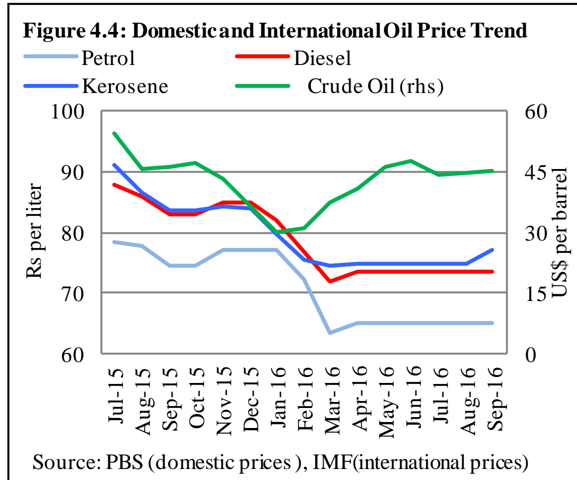
Within the FBR tax collection, the decline in direct taxes was more than compensated by a broad-based recovery in indirect taxes, which grew by 12.2 percent during Q1-FY17 compared to a mere 0.7 percent growth in Q1-FY16. A sharp increase in collection of custom duty by 26.7 percent during Q1-FY17, on top of 23.4 percent in the same quarter last year, is explained by: (i) increase in imports (especially related to construction, power and transport); (ii) simplification of tariff slabs, and; (iii) increase in custom duty, especially for higher tariff slabs.[5]

It is worth noting that sales tax collection increased by 7.4 percent during Q1-FY17 against a decline of 5.7 percent observed during Q1-FY16, despite a sharp decline of 33.8 percent in domestic sales tax collection from petroleum.[6] The decline in the latter, notwithstanding increase in petroleum sale by 20 percent, can

[4] Anecdotal evidence suggests that low income segment suffers the most from WHT due to less flexibility in the choice of their consumption of basic necessities and life cycle emergencies.
[5] The value of import has grown by 10.5 percent during Q1-FY17.
[6] Petroleum accounts for one third of total domestic sales tax collection.

be traced to FBR's decision to switch to ad-valorem tax from the fixed rate.[7] Second, and more importantly, government kept domestic petroleum prices unchanged and absorbed the incremental increase in crude oil prices in terms of lower effective tax on petroleum products (**Figure 4.4**). In fact, the recovery in sales tax collection, besides showing the impact of changes in taxes and tax rates, indicates increase in domestic demand and improving real economic activity.[8]

Figure 4.4: Domestic and International Oil Price Trend



Source: PBS (domestic prices), IMF(international prices)

Likewise, an increase of 13 percent in FED during Q1-FY17, compared to 8.2 percent growth observed during the same period in the previous year, reflects improved production of manufactured goods (mainly cement and beverages) and increase in travel services, which together constituted around two third of FED collection during Q1-FY17.[9] However, collection from cigarettes fell to almost half during Q1-FY17 compared to the corresponding period last year.[10]

Non-tax revenues

Non-tax revenues declined by 42.3 percent during Q1-FY17 compared to 0.3 percent increase in previous year (**Table 4.3**). A number of factors have contributed to this sharp decline. The main among these include the absence of Coalition Support Fund (CSF) and a decline in SBP profit. It is important to note that Pakistan received Rs 73.4 billion under CSF in Q1-FY16. The SBP profit

[7] FBR vide SRO 490(I) 2016 dated June 30, 2016.

[8] For instance, in budget FY17, 8 percent FED applicable on sugar was replaced with an 8 percent sales tax. Similarly, sales tax on imported mobiles has been increased from Rs 500 to Rs 1000 for medium category, for high category it is revised upward to Rs 1500 from Rs 1000 while for the low category it is kept unchanged at Rs 300.

[9] In budget FY17, the existing FED applicable on 5 percent of retail price of cement is replaced with fixed rate basis to Rs 1/kg.

[10] This decline in collection from cigarettes was due to: (i) pre-budget expectations of increase in tariff/excise duty, which fueled storage of cigarette to exploit higher margins – reducing thereby new production temporarily; and (ii) widening of price differential between tax paid and non paid brands spurred the demand for the latter.

also declined to Rs 39.4 billion in Q1-FY17 compared to Rs 67.6 billion last year, mainly driven by reduction in government borrowing from SBP by end-FY16.

Table 4.3: Non-tax Revenues
billion Rupees

	Budget FY17	Actual	
		Q1-FY16	Q1-FY17
Mark-up (PSEs and others)	81.1	0.9	0.8
Dividends	85.0	16.3	5.0
SBP profits	280.0	67.6	39.4
Defence (including CSF)	171.0	75.7	1.7
Profits from post office/PTA (3G)	81.0	0.0	0.1
Royalties on gas and oil	43.0	17.6	14.3
Passport and other fees	25.0	3.4	2.6
Discount retained on crude oil	10.0	2.1	2.1
Windfall levy against crude oil	10.0	1.0	0.3
Others	254.9	28.8	56.9
Total non-tax revenue	**1,041.0**	**213.5**	**123.1**

Source: Ministry of Finance

Furthermore, dividend income from PSEs declined by around 70 percent in Q1-FY17. A number of PSEs, including OGDCL, PPL, SNGPL, FFC, and PSEL, reported reduced profit in Q1-FY17. The prevailing low oil price also dented the profitability of oil and gas companies and affected royalties on oil and gas as well as windfall levy on crude oil.[11]

4.3 Expenditures

The consolidated fiscal spending increased marginally by 0.6 percent in Q1-FY17 compared to 7.1 percent growth registered in Q1-FY16. This was primarily due to decline in current expenditure as growth in development expenditure remained robust (**Table 4.4**). The current expenditure of both federal and provincial governments registered a decline in Q1-FY17.

The consolidated current expenditure in Q1-FY17 decreased by 1.3 percent, mainly due to a marginal decline in the interest payments and other expenditure including subsidies.[12] In spite of lower interest rate environment, the interest

[11] Although oil prices were rising, these remained lower on average in Q1-FY17 compared to the average price in Q1-FY16.
[12] Other expenditures mostly consist of salaries and wages and subsidies. As salaries and pension benefits were set to increase after announcement of 10 percent increase in basic pay and pensions from 1st July 2016 in the FY17 budget, this decline was more probably due to reduction in subsidies in Q1-FY17.

payment decreased by a mere Rs 1.7 billion during Q1-FY17.[13] This is mainly because of accumulation in public debt stock, which rose to Rs 19.7 trillion by end-June 2016.

Table 4.4: Analysis of Fiscal Spending
billion Rupees

	Actual			Growth	
	Q1-FY15	**Q1-FY16**	**Q1-Y17**	**FY16**	**FY17**
Current expenditures	**1050.1**	**1085.2**	**1,070.7**	**3.3**	**-1.3**
Federal	772.1	768.2	757.8	-0.5	-1.4
Interest payment	*394.5*	*415.9*	*414.3*	*5.4*	*-0.4*
Defense	164.6	145.6	151.5	-11.5	4.0
Public order and safety	21.3	21.8	24.0	2.4	10.5
Others	191.8	184.9	168.0	-3.6	-9.1
Provincial	278.0	317.0	312.9	14.0	-1.3
Development expenditures	**115.7**	**169.9**	**191.1**	**46.9**	**12.4**
PSDP	93.0	146.4	167.1	57.4	14.2
Federal	39.6	71.3	64.1	80.0	-10.1
Provincial	53.4	75.1	103.0	40.6	37.2
Others (including BISP)	22.3	23.6	24.0	6.0	1.6
Net lending	**4.8**	**-1.2**	**-0.3**	**-123.9**	**-77.2**
Total	**1170.6**	**1254.0**	**1261.6**	**7.1**	**0.6**

Source: Ministry of Finance

Development expenditure

A breakup of Public Sector Development Program (PSDP) shows that growth in overall development spending was led by a substantial increase in spending by provincial governments. Provincial governments spent Rs 27.9 billion more during Q1-FY17, while federal government spending declined by Rs 7.2 billion during Q1-FY17 compared to the last year.

Detailed data on federal PSDP releases indicates that government is maintaining focus on infrastructure and social development. Reflecting government priorities, most of the spending was earmarked for infrastructure improvement (Rs 18.9 billion), higher education (Rs 4.3 billion), and health services (Rs 5.5 billion). The sustained increase in development spending bodes well for long term growth potential of the country.

[13] While weighted average cut-off rates on T-bills declined by 102 bps in FY16, the interest payments on the PIBs issued in 2013-14 are higher as the letter were issued at higher rates.

4.4 Provincial fiscal operations

As per FY17 budget, provinces are expected to show a combined surplus of Rs 339.0 billion during FY17; about 63 percent higher than the surplus posted in FY16. In Q1-FY17, provinces posted a surplus of Rs 108.5 billion, around one third of its FY17 target. This upbeat surplus was achieved with over 40 percent increase in federal transfers to the provinces, complemented by containment of current expenditures. In addition, provincial revenue collection also recorded an uptick, mainly on the back of property taxes and continuing broadening of sales tax on services.

Table 4.5: Provincial Fiscal Operations
billion Rupees

	Punjab	Sindh	KPK	Balochistan	Total
Q1-FY17					
A. Total revenue	242.4	134.6	66.9	55.8	499.7
Share in federal revenue	194.5	104.7	65.2	52.0	416.5
Taxes	36.0	14.3	1.4	1.3	53.0
Non-taxes	10.9	13.0	1.7	1.0	26.6
Federal loans and transfers	1.0	2.5	-1.4	1.5	3.7
B. Total expenditure	192.9	102.7	92.5	31.1	419.2
Current	139.4	78.7	68.3	29.7	316.2
Development	53.5	23.9	24.2	1.4	103.0
Gap (A-B)	49.4	31.9	-25.6	24.7	80.5
Financing (overall balance)	**-2.2**	**-38.8**	**-42.8**	**-24.9**	**-108.5**
Q1-FY16					
A. Total revenue	167.7	103.4	55.1	39.8	366.0
Share in federal revenue	134.2	72.9	46.3	35.5	288.9
Taxes	28.8	27.0	3.0	0.4	59.2
Non-taxes	7.0	1.4	5.2	1.2	14.9
Federal loans and transfers	-2.3	2.0	0.6	2.6	3.0
B. Total expenditure	196.2	101.9	58.4	38.4	395.0
Current	145.8	88.3	50.0	35.8	319.9
Development	50.5	13.6	8.4	2.6	75.1
Gap (A-B)	-28.5	1.5	-3.3	1.4	-29.0
Financing (overall balance)	**31.3**	**-5.4**	**-13.0**	**-20.2**	**-7.4**

Source: Ministry of Finance

Provinces are increasingly strengthening their revenue collection machineries, especially for sales tax collection on services to uplift their revenue collection and gradually decrease their reliance on federal government transfers. Accordingly, all the provinces were able to improve their revenue position though the progress seems marginal as their share in overall collection continues to be very small.

On expenditures side, provinces contained their current expenditures to create more fiscal space for enhanced development spending, which recorded over 37 percent increase during Q1-FY17 as compared to last year (**Table 4.5**).

4.5 Public debt

Pakistan's public debt stock increased by Rs 866.1 billion during Q1-FY17, reaching Rs 20.5 trillion as of end-September 2016 (**Table 4.6**). This addition to public debt in Q1-FY17 was significantly higher than the Rs 762.5 billion increase in last year, and was mostly driven by government borrowing from domestic sources. This increase in public debt reflects relatively higher fiscal deficit during Q1-FY17, and the buildup of government deposits. Moreover, there was a marked shift in the maturity profile of domestic debt (from long to short maturities) during the quarter.

Table 4.6: Pakistan's Public Debt Profile
billion Rupees

	Stock				Flow	
	Jun-15	**Sep-15**	**Jun-16**	**Sep-16**	**FY16**	**FY17**
Public Debt	**17380.2**	**18142.6**	**19676.7**	**20542.8**	**762.5**	**866.1**
Domestic debt	12192.5	12714.6	13625.9	14385.8	522.1	759.8
Government external debt	4770.0	4952.7	5417.7	5515.0	182.7	97.3
Debt from the IMF	417.6	475.3	633.1	642.0	57.7	8.9

Source: State Bank of Pakistan

Domestic debt

Pakistan's domestic debt expanded by Rs 759.8 billion in Q1-FY17, compared to an increase of Rs 522.1 billion in the same period last year. Unlike the previous year, when the onus of deficit financing fell on scheduled banks, a significant part of the budget deficit in Q1-FY17 was financed through SBP borrowings (**Table 4.7**).[14]

In terms of maturity structure, the increase in the domestic debt during Q1-FY17 was mainly due to rise in the stock of floating debt, which more than offset a decline in permanent debt during Q1-FY17. With an unprecedented increase of Rs 1.5 trillion in Q1-FY17, the share of short term debt has jumped to 45.1 percent by

[14] Government borrowed Rs 567.8 billion (on cash basis) from SBP during Q1-FY17, which was higher than the fiscal deficit in the quarter. Part of this borrowing was used to retire scheduled bank borrowing.

end September 2016, from 36.7 percent three months ago.[15] This led to a shortening of maturity profile of the domestic debt.[16]

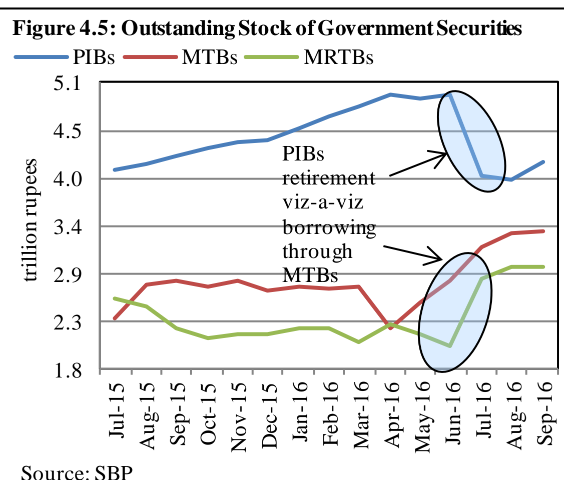
Table 4.7: Change in Government Domestic Debt Stock (Q1)
billion Rupees

	Net flows	
	FY16	FY17
Government domestic debt	**522.1**	**759.8**
Institution- wise		
A. Through banking system	393.5	697.0
From scheduled banks	451.7	-214.9
From SBP	-58.2	911.9
B. Through non-bank debt	128.4	62.8
C. Foreign currency instruments	0.1	0.0
Instrument- wise		
A. Permanent debt	90.8	-746.2
B. Floating debt	377.4	1480.0
C. Unfunded debt	53.7	26.0
D. Foreign currency Instruments	0.1	0.0

Source: State Bank of Pakistan

Within short term borrowings, MRTBs held by SBP were the main source of financing during Q1-FY17. Although the government kept additional budgetary borrowing from SBP at zero level till June 2016, it borrowed from SBP in July 2016 to settle maturing amount of Rs 1.2 trillion of PIBs (**Figure 4.5**).[17] [18] However, the government reduced its reliance on SBP borrowing in later months of the quarter, gradually shifting financing to scheduled banks.

Figure 4.5: Outstanding Stock of Government Securities



Source: SBP

Like the previous year, the commercial banks continued to lock in their funds in risk-free government securities. Within government securities, however, the bid pattern was tilted more towards 3-month and 6-month T-bills as market was not expecting the interest

[15] Long term debt is the sum of permanent and unfunded debt, whereas the short term debt constitutes only floating debt.
[16] The monthly breakup of the data shows that the share of PIBs in domestic debt increased to 29.4 percent in October 2016 from 28.7 percent in July 2016.
[17] In order to strengthen the secondary market, Fresh PIBs are generally issued once a year, and the same issue is reopened in subsequent auctions of the PIBs. Coupon payments on PIBs are made at a fixed rate on semi-annual basis. It implies that the maturities of 3-Year PIBs (Rs 1.2 trillion, with fresh issue in July 2013) issued during FY14 fell in July 2016.
[18] Total PIBs maturities stood at RS 1.4 trillion during Q1-FY17.

rate to fall further (**Table 4.8**).

Another key factor for banks' preference for T-bills over PIBs was the decline in the term premium for PIBs. On average, the term premium fell by around 100 bps from December 2015 to September 2016 (**Figure 4.6**). In addition, the non-bank financial institutions also substituted their investment in PIBs with T-bills.[19] Resultantly, the share of T-bills in total domestic debt has jumped to 23.2 percent by end-September 2016 from 20.3 percent at end-June 2016.

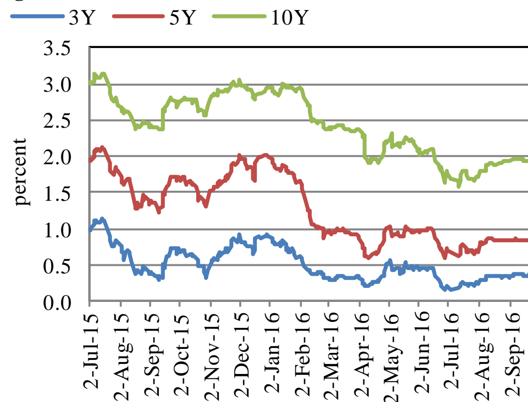
Table 4.8: Auction Profile of Government Securities (Jul-Sep)

ratios

	PIBs		T-bills	
	FY16	FY17	FY16	FY17
Offer/Target	4.0	3.5	1.2	2.0
Offer/Maturity	0.8	0.7	1.6	2.5
Accepted/Target	1.1	2.3	1.1	1.1
Accepted/Offer	0.3	0.6	1.0	0.5
Accepted/maturity	1.3	0.5	1.5	1.4

Source: State Bank of Pakistan

Figure 4.6: Term Premium w.r.t 3-Month T-bills



Source: MUFAP

Unfunded debt

The downward revision in NSS rates continued to dampen the net investment in NSS instruments, which recorded an increase of only Rs 26.8 billion during Q1-FY17, almost half the increase seen in the same period last year (**Table 4.9**). The composition of NSS indicates that all major schemes, except for Defense Saving Certificate (DSC), witnessed decline in inflows during the quarter. The major contribution came from Behbood Saving Certificate (BSC) that is being exempted

Table 4.9: Net Receipts under NSS Instruments (Jul-Sep)

billion rupees

	FY14	FY15	FY16	FY17
DSC	1.7	3.2	0.6	4.3
SSC	3.7	17.1	7.3	-0.7
RIC	5.0	14.6	-2.8	-9.7
BSC	11.0	15.2	22.6	18.6
SSA	3.8	-2.4	19.7	8.3
Others	0.4	4.4	5.7	5.9
Total	**25.6**	**52.1**	**53.1**	**26.8**

DSC: Defence Saving Certificates, SSC: Special Saving Certificate, RIC: Regular Income Certificate, BSC: Behbood Saving Certificates, SSA: Special Saving Accounts

Source: Central Directorate of National Savings (CDNS)

[19] As on September 2016, Non-bank's holding of PIBs fell by 7 percent year-on-year, whereas T-bills holdings went up by 40 percent.

from withholding tax and Zakat. At the same time, Special Saving Scheme (SSC) and Regular Income Certificate (RIC) witnessed net retirements during the period. It is worth noting that share of NSS in domestic debt stock has been falling persistently. This trend needs to be reversed in order to reduce government's reliance on borrowing from banks and external sources (**Box 4.1**).

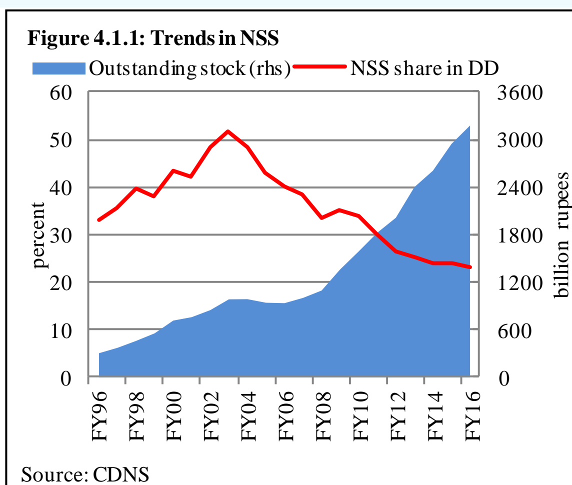
Box 4.1: Resource Mobilization via NSS Instruments

The retail debt instruments are issued with the objective to diversify savings instruments and broaden participation in secondary bond market, besides providing alternative source of financing deficit. While issuing retail debt instruments, the developing economies take into account multiple objectives of promotion of saving habit, mobilization of savings for financing economic development, social security, etc.

Retail debt instruments are considered effective in enhancing savings in low or middle income countries like Pakistan. It is particularly true in case of countries where the financial sector struggles to reach out to remote areas. These instruments also help the government reduce its dependence on external finance, which is prone to risks from movements in international currencies. However, these are also criticized due to: (i) high cost involved in mobilization of savings from a large and dispersed retail clients' base; (ii) difficulty for financial sector to compete with the financial products offered by the state, and; (iii) effect on liquidity in government bond market in case of increase in share of non-tradable bonds.

Although retail debt instruments were there even before the creation of Pakistan, NSS were reinvigorated in early 1990s with the objective to broaden the funding base and encourage and mobilize savings. Initially, NSS instruments attracted retail investors as return was ad-hoc and set higher than market rates. However, in 2000, the government linked the rate of return on NSS instruments with rates on PIBs. Market based rates on NSS, as result, led to a decline in the NSS investment over time. Since then, the share of NSS has been falling consistently (**Figure 4.1.1**). Currently, it stands at 20 percent of the outstanding domestic debt stock.

Figure 4.1.1: Trends in NSS



Source: CDNS

How to increase savings through NSS?

In Pakistan, a major chunk of the deficit is financed through borrowing from the commercial banks. Government's increased reliance on bank borrowing, combined with banks' preference to invest in government securities, affects banks' lending to the private sector. This warrants efforts to revive the alternate funding through NSS.

Below are some recommendations to increase NSS inflows through introduction of new retail instruments as well as changes in the existing ones:

Expanding distribution network: Distribution is an important factor in mobilizing funds through retail debt issuing activity. In areas without national saving centers and/or banks, the NSS instruments could be offered to general public through retail shops offering some money transfer facility or through better marketing and optimally utilizing the existing setup of Pakistan Post Offices.

Allowing flexibility on premature withdrawal: Anecdotal evidence suggests that some retail savers do not want to lock in their savings for a longer period, and hold cash to meet expenses related to children's education or marriage, etc. Therefore, offering an option to withdraw investment without much cost in terms of forgone interest – that is, offering return on pro-rata basis – could encourage that segment to invest in NSS instruments and withdraw when the need arises.

Islamic bonds (floating rate/asset based): A large segment of the population in Pakistan does not like to keep their savings in bank accounts or invest in NSS instruments to avoid interest. Introduction of retail products on the lines of Ijara Sukuk might attract such small savers who prefer to invest in instruments based on the principles of Islamic finance.

Electronic retail system: The objective to design electronic retail debt instruments is to reach the investors who consider it cumbersome to go to a bank or national saving centre. Although the individuals in Pakistan have direct access to primary market of government securities through Investor Portfolio Services Account, no such facility is available for non-tradable retail debt instruments. The introduction of electronic retail system to subscribe retail debt instruments or withdraw their investment would not only attract more retail investors but also could make it a relatively cost-efficient option.

Tax exemption on return for a minimum investment: The return/profit on most NSS instruments are subject to withholding taxes, except for BSC and PBA. To attract more investment from small savers, return on some minimum level of investment can be exempted from the withholding tax.

Inflation-indexed bonds: In countries where inflation is relatively high and volatile, people would want to protect the purchasing power of their assets. In inflation-indexed bonds, both the capital and coupon are linked to the consumer price inflation. Many countries, such as US, UK, Japan and South Africa, offer inflation indexed retail bonds to the savers. However, the disadvantage to government for issuing such bonds is the increase in cost with the increase in inflation.

Exchange rate indexed bonds: Some investors are more concerned about the value of their assets in terms of foreign currency. To make debt instruments attractive to such investors, creating a linkage to an international currency might be an alternate option. Such bonds are generally denominated in domestic currency but the coupon and capital amount are linked to an international currency. Thus, the government does not need to have foreign exchange to serve this type of debt.

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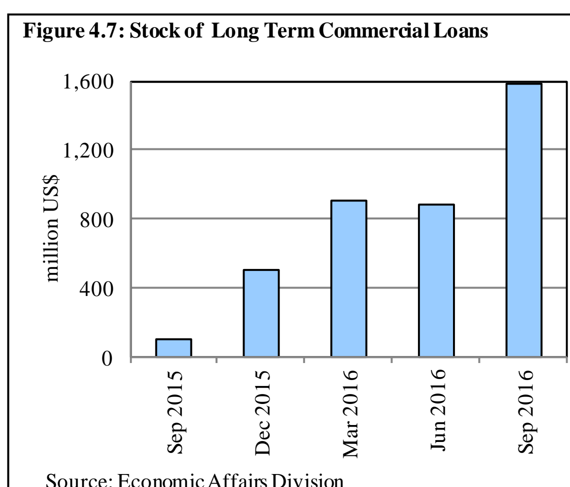
External debt[20]

External debt & liabilities recorded an increase of US$ 1.0 billion during the quarter, reaching US$ 62.4 billion by end-September 2016. Although the debt repayment to IFIs increased significantly during this period, the debt stock rose mainly on account of US$ 701 million long term commercial loans and US$ 312 million from bilateral creditors (**Table 4.10**).

Figure 4.7: Stock of Long Term Commercial Loans



Source: Economic Affairs Division

On a positive note, the government made a net retirement of US$ 315 million short term commercial loans, switching them with more long term commercial loans from foreign banks to benefit from prevailing low global interest rate environment (**Figure 4.7**). Moreover, it reduces the rollover risk.

Table 4.10: External Debt and Liabilities

billion US$

	Jun-16	Sep-16	Change
A. Government debt	51.7	52.7	0.96
Paris club	12.7	12.8	0.11
Multilateral	26.4	26.2	-0.21
Other bilateral	4.5	4.8	0.31
Commercial loans (LT)	0.88	1.6	0.70
IDB(ST)	1.1	1.4	0.27
Commercial loans(ST)	0.58	0.26	-0.31
B. Debt from IMF	6.0	6.1	0.88
C. External Liabilities	3.6	3.6	0
Total	61.4	62.4	1.0

Source: State Bank of Pakistan

The data of gross disbursement of external loans shows that the country received an amount of US$ 1.8 billion in Q1-FY17, compared to only US$ 1.6 billion last year (**Table 4.11**).[21] Among bilateral creditors, the major increase came from CPEC related disbursements. At the same time, the gross inflows from multilateral donors recorded marginal

[20] This section focuses on debt and liabilities of the public sector only. As per FRDL, the external debt of the public sector includes government debt and debt from IMF. The detailed information on external debt is available on SBP website: http://www.sbp.org.pk/ecodata/pakdebt.pdf

[21] This excludes inflows from IMF during the quarter.

increase during the quarter. However, heavy repayment to these donors led to overall net retirement during the period.

Table 4.11: External Loan Inflows during Jul-Sep
US$ million

	FY16			FY17		
	Gross Inflow	**Outflow***	**Net Inflows**	**Gross Inflow**	**Outflow***	**Net Inflows**
ADB	83.2	190.5	-107.3	115.8	236.8	-121.1
IBRD	33.1	75.2	-42.1	16.9	70.1	-53.2
IDA	30.1	111.9	-81.8	39.3	135.7	-96.4
IDB (ST)	51.7	12.0	39.7	212.4	54.2	158.2
China	255.6	117.6	138.0	404.8	125.6	279.1
Commercial Banks	513.3	207.7	305.5	900.0	276.0	624.0
Bond	499.4	29.6	469.7	0.0	11.8	-11.8
Others	226.3	263.3	-71.8	122.4	106.6	15.7
Total	**1692.7**	**1008.0**	**649.9**	**1811.4**	**1016.9**	**794.6**

*: Principal plus interest payments.
Source: Economic Affairs Division