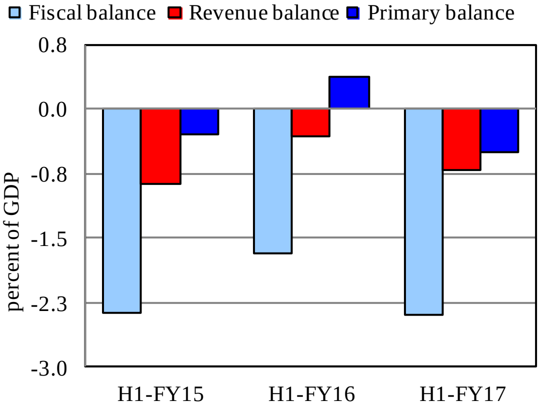
4 Fiscal Policy and Public Debt

4.1 Overview

Increase in development and security related expenditures amid a decline in revenue collection, has led to an increase in the fiscal deficit to 2.4 percent of GDP in H1-FY17 from 1.7 percent in the corresponding period of last year. The primary balance turned into a deficit of 0.5 percent of GDP in H1-FY17, from a surplus in FY16 **(Figure 4.1)**.

Figure 4.1: Fiscal Indicators



Source: Ministry of Finance

A sharp contraction in non-tax revenues, mainly on account of non-realization of Coalition Support Fund (CSF) and lower SBP profits dragged down the growth in total revenues during H1-FY17.[1] Moreover, despite higher collection in Q2-FY17, the growth in tax revenues remained lower than envisaged at the start of the fiscal year. This slowdown was broad-based, as the growth in both direct and indirect taxes was almost half their respective growth rates observed in the last year.

Here, it must be acknowledged that the slowdown in tax revenue collection is partly due to several tax incentives announced to promote investment and boost economic activity in the country; this includes the reduction in the corporate tax rate. Besides, in the wake of recently announced incentives – especially the export package and the tax exemptions for some CPEC-related projects – accelerating revenue collection during the remaining part of FY17 may also be challenging. [2]

[1] However, US$ 550 million were received under CSF in Q3-FY17.
[2] Under Prime Minister Package of Incentives for Exporters, the government: (i) allowed duty draw back up to 7.0 percent on the export of garments, home textiles, processed fabric, Greige fabric and yarn manufacturing cum exporters units (vide ministry of textile SRO No. 1(42) TID/17-RDA); (ii) exempted custom duty on import of raw material for textile (vide FBR S.R.O. No. 39(I)/2017); and, (iii) exempted sales tax on import of textile machinery (vide. FBR S.R.O. No.36 (I)/2017). Similarly,

On the expenditure side, due to higher security-related spending to further improve the overall law and order situation in the country, the trends in current expenditure observed in Q1-FY17 could not be sustained into Q2-FY17. Encouragingly, despite the fiscal strain, development spending was not compromised during the period (**Table 4.1**).

Similar to Q1-FY17, the government largely financed the fiscal deficit in the second quarter by borrowing from SBP, while making retirements to commercial banks. Moreover, sizeable financing was available from external and non-bank sources during H1-FY17. Interestingly, despite the higher fiscal deficit, the pace of accumulation of public debt remained lower than the last year. This reflects drawdown in government's deposits with the banking system, and revaluation gains on external debt.

4.2 Revenues

The total revenue collection declined by 0.7 percent during H1-FY17 after recording an increase of 14.6 percent in H1-FY16. This decline mainly stemmed from a 31.8 percent fall in non-tax revenues (on account of non-realization of CSF in H1-FY17, lower SBP profit, and decline in dividend income). Encouragingly the pace of tax collection recovered in the second quarter from Q1-FY17, though the cumulative growth in tax revenues remained considerably lower at 6.2 percent in H1-FY17 as compared to the 20.4 percent YoY increase realized last year (**Table 4.1**).[3] The slowdown largely came from the FBR's tax collection as provincial tax collection grew by 19.1 percent during H1-FY17, on top of 28.8 percent growth recorded in the last year.

FBR taxes

The growth in FBR's tax collection remained subdued at 7.0 percent during H1-FY17, against a robust 17.0 percent increase recorded in the corresponding period last year **(Table 4.2).** The recovery in direct taxes in Q2-FY17 was partially offset by a slowdown in indirect tax collection.

On the surface, the broad-based deceleration in both direct and indirect tax collection can be interpreted as an unintended consequence of fiscal measures to

vide FBR S.R.O. No.735 (I)/2016, Chinese construction companies were allowed income tax exemption under some CPEC projects.

[3] Tax collection grew by 8.2 percent in Q2-FY17, compared to the 3.2 percent increase recorded in Q1-FY17.

Table 4.1: Summary of Fiscal Operations

		Actual		% of GDP*	
	Budget	**H1-FY16**	**H1-FY17**	**H1-FY16**	**H1-FY17**
A. Total revenue	5347.0	2,004.9	1,990.6	6.8	5.9
Tax revenue	4,306.0	1,639.1	1,741.2	5.5	5.2
Non-tax revenue	1,041.0	365.9	249.4	1.2	0.7
B. Total expenditure	6,623.0	2,520.1	2,789.7	8.5	8.3
Current	5,198.0	2,104.4	2,241.6	7.1	6.7
Interest payments	*1,360.0*	*632.4*	*647.4*	2.1	1.9
Defence	860.2	303.3	336.3	0.5	1.0
Development	1,435.0	426.2	497.4	1.4	1.5
Net lending	-10	-1.8	-6.4	0.0	0.0
C. Statistical discrepancy	0	-8.6	57.2	0.0	0.2
Fiscal balance (A-B-C)	-1,276.0	-515.2	-799.1	-1.7	-2.4
Revenue balance	149.0	-99.5	-251.0	-0.3	-0.7
Primary balance	84.0	117.2	-151.7	0.4	-0.5
Financing	1,276.0	515.2	799.1	1.7	2.4
External sources	234.0	203.2	240.9	0.7	0.7
Domestic sources	1,042.0	311.9	558.2	1.1	1.7
Banks	453.0	183.3	407.1	0.6	1.2
Non-bank	539.0	128.7	151.1	0.4	0.5
Privatization	50.0	0.0	0.0	0.0	0.0
% Growth					
Total Revenue		14.6	-0.7		
Tax revenue		20.4	6.2		
Non tax revenue		-5.7	-31.8		
Total Expenditure		5.0	10.7		
Current		5.8	6.5		
Development		32.6	16.7		

* Targeted GDP for FY17

Source: Ministry of Finance

support investment and economic activity in the country.[4, 5] It also highlights the continuing structural weaknesses in the tax system, which currently is narrowly

[4] The government offered tax incentives to the agriculture sector through sales tax exemption on pesticide and fertilizer. Similarly, five major exports-oriented sectors – textile, leather, surgical and sports goods, and carpets – were allowed zero-rating facility. In addition, petroleum prices were subsidized to provide relief to consumers. Moreover, customs duty on the import of raw cotton, staple, nylon and acrylic fibers was exempted (vide S.R.O. No. 39(I)/2017), and sales tax exemption was allowed on the import of new textile machinery (under SRO No.36 (I)/2017).

[5] Similarly, lower petroleum prices during the period have led to a decline in sales tax collection. An increase in FED on cigarettes resulted in increased usage of smuggled cigarettes (as also reflected in 31 percent decline in its production during H1-FY17) and a decrease in tax collection.

based and skewed towards indirect taxes. However, the government has taken a number of measures to improve the taxation structure, as a part of the continuous reforms agenda, encompassing both policy and administrative dimensions. Such efforts will go a long way in improving the country's tax system in years to come.

Table 4.2: FBR Tax Collection
billion rupees

	Budget FY17	Collections H1		% growth H1	
		FY16	**FY17**	**FY16**	**FY17**
Direct taxes	1,558.0	540.8	586.4	17.8	8.4
Indirect taxes	2,063.0	830.1	880.9	16.4	6.1
Customs duty	413.0	177.9	218.0	31.5	22.6
Sales tax	1,437.0	578.5	577.5	12.6	-0.2
FED	213.0	73.7	85.4	15.2	15.9
Total taxes	3,621.0	1,370.9	1,467.3	17.0	7.0

Source: Federal Board of Revenue

Direct taxes

Enabled by a sharp recovery in Q2-FY17, direct tax collection grew by 8.4 percent during H1-FY17; however, it still remained lower than the 17.8 percent increase recorded in H1-FY16.[6] It is worth mentioning that some slowdown in direct taxes was expected on account of reduction in the corporate tax rate. The other main factor was a decline in commercial banks' profits, and a moderate pace of increase in corporate profitability.[7]

Within the direct taxes, the growth in withholding tax (WHT), which accounts for 67 percent of direct taxes, decelerated to 10 percent in H1-FY17 from 20.0 percent in the last year. Similarly, growth in voluntary tax payments (with a 28 percent share) fell to 6.6 percent in H1-FY17 from 21.0 percent increase in the last year. Collection on demand was the only component that rebounded sharply, growing by 32.2 percent during H1-FY17 after declining 27.7 percent last year.[8] However, its share in direct taxes is only 5 percent.

Indirect taxes

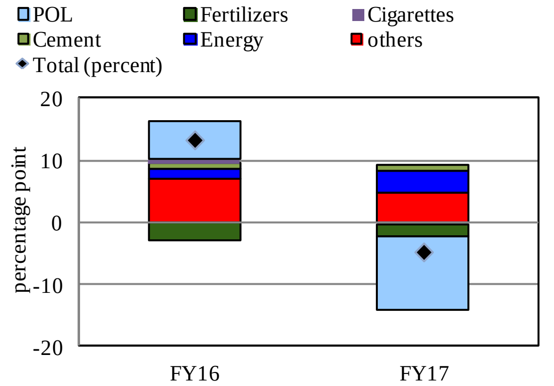
The growth in indirect tax collection in Q2-FY17 (at 1.6 percent) could not maintain the pace observed in the first quarter (12.2 percent). As a result, the half-

[6] Direct tax collection increased by 17.2 percent year-on-year in Q2-FY17 against a decline of 2.5 percent in Q1-FY17.
[7] However, corporate profitability seems to have recovered in the second quarter of FY17.
[8] This sharp increase can be attributed to the introduction of risk based audit, with audit of individuals more likely to evade taxes.

yearly growth fell to 6.1 percent from 16.4 percent last year. The major drag came from a decline in sales tax collection, which was partially offset by a steady growth in customs duty and federal excise duty.

Sales tax collection, which accounts for 66 percent of indirect taxes, declined marginally by 0.2 percent during H1-FY17. The disaggregated analysis shows that drag was due to sharp decline in domestic sales tax collection by 4.7 percent. However, most of this was offset by a 3.7 percent increase in sales tax collection on imports. Major revenue spinners, including POL, fertilizer, and natural gas contributed to decline in domestic sales tax collection (**Figure 4.2**).[9] These more than offset higher sales tax collection from electrical energy and cement sectors. Improved electricity generation and steady growth in cement sales – reflecting ongoing work on several CPEC projects – led to higher collection from these segments.

Figure 4.2: Contribution in Growth of Domestic Sales Tax Collection (Jul-Dec)



Source: Federal Board of Revenue

The decline in collection from fertilizer was due to reduction in sales tax under the package announced for farmers last year under the agriculture package. Related to this, the decline in collection from natural gas was due to reduction in prices of the natural gas for feedstock.[10] In addition, an increase in FED on cigarettes resulted in loss of revenue from sales tax through lower sales of locally manufactured cigarettes.

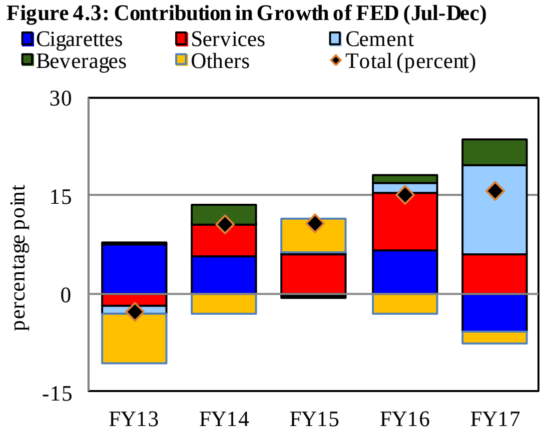
[9] The decline in sales tax collection from petroleum can be traced to the government's decision to keep fuel prices unchanged by absorbing the increase in international prices. This dented tax revenues through two ways: (a) lower revenues from the change in sales tax structure of POL from fixed rate to ad valorem (lower price means low revenues); and (b) lower revenues due to the decrease in sales tax rates.

[10] In April 2016, OGRA reduced feedstock prices for fertilizer manufacturers to Rs 123 per MMBTU from Rs 200, and it reduced fuel prices for electricity firms to Rs 400 from Rs 600 per MMBTU in December 2016.

Collection from customs duty grew by 22.6 percent during H1-FY17 compared to the 31.5 percent growth realized during the previous year. This sustained increase in customs duty was a natural outcome of the substantial increase in imports: both due to higher demand for machinery and raw materials and the increase in global commodity prices, mainly oil and cotton. Although the government announced some tax exemptions on CPEC-related machinery imports, its impact was not significant given the overall import volume. [11,12] Therefore, customs duty continues to remain a dependable source of revenue generation. Further, changes in tariff structure (especially for higher slabs) and an increase in rates for iron and steel also resulted in higher custom duty collection.[13,14]

FED collection grew by 15.9 percent during H1-FY17 compared to 15.2 percent growth in the last year (**Figure 4.3**). This steady increase was mainly contributed by higher production of cement and beverages.[15]

Figure 4.3: Contribution in Growth of FED (Jul-Dec)



Source: Federal Board of Revenue

As mentioned earlier, the increase in the FED rate on cigarettes reduced the demand for locally manufactured sticks and simultaneously boosted that for non-taxed/smuggled brands; ultimately collection from cigarettes (which constitutes around one third of overall FED collection), declined by 13.3 percent during H1-FY17. In response,

[11] The value of import (PBS) has grown by around 10 percent during H1-FY17. Specifically, import of machinery increased by 40.8 percent YoY in H1-FY17.
[12] Federal budget for FY17 reduced the custom duty on import of machinery and raw materials from 5 to 3 percent.
[13] In the Federal budget for FY17, the number of custom duty slabs was reduced to 4 from 5: (i) 2 percent and 5 percent slabs were merged into a new 3 percent slab; (ii) 10 and 15 percent slabs were replaced with new 11 and 16 percent slabs; and (iii) the 20 percent slab was kept unchanged.
[14] FBR vide S.R.O. No. 614(I)/2016 withdrew exemptions on the import of articles of iron and steel.
[15] Specifically, collection from cement grew 16.2 percent to Rs 28.6 billion during H1-FY17. Besides higher production, it also reflects the change in duty structure. In the budget FY17, the FED rate of 5 percent on retail cement prices was replaced with a fixed rate of Re 1/kg. Moreover, collection from beverages increased by over 40 percent (an outcome of both an increase in the FED rate and production). Similarly, collection from air travel services increased by 28.6 percent.

FBR started a crackdown against illicit cigarettes to harness the true revenue potential from this source.[16]

Non-tax revenues

Non-tax revenues declined by 31.8 percent during H1-FY17 compared to a fall of 5.7 percent recorded in the last year. This sharp decrease was broad-based except for increase in mark-up income, passport fee and others. As mentioned earlier, non-receipt of CSF in H1-FY17 remained the major drag, while SBP profit and dividend income also remained considerably lower as compared to last year (**Table 4.3**).

Table 4.3: Non-tax Revenues

billion rupees

	Budget FY17	Actual H1	
		FY16	FY17
Mark-up (PSEs & others)	81.1	2.2	8.9
Dividends	85.0	31.4	12.2
SBP profits	280.0	122.6	87.8
Defense (incl. CSF)	171.0	78.2	4.6
Profits from post office/PTA	81.0	5.3	0.6
Royalties on gas & oil	43.0	31.5	24.4
Passport & other fees	25.0	6.2	7.1
Discount retained on crude oil	10.0	4.2	3.6
Windfall levy	10.0	1.4	0.5
Other	254.9	82.8	99.7
Total non-tax revenue	**1,041.0**	**365.9**	**249.4**

Source: Ministry of Finance

SBP profit declined by 28.4 percent in H1-FY17 due to lower interest rates and reduced stock of government borrowing from SBP during the previous two fiscal years.[17] Similarly, market reports suggest that some Public Sector Enterprises (PSEs) reported decline in their profits during the first two quarters of FY17, leading to lower dividend income for the government.

4.3 Expenditures

Consolidated fiscal spending grew sharply by 10.7 percent during H1-FY17 compared to the 5.0 percent growth realized in previous year. This acceleration in expenditure growth was mostly due to 6.5 percent increase in current expenditures, which account for 80 percent of total expenditures. Development spending also increased but at a lower rate of 16.7 percent relative to the 32.6 percent increase witnessed in last year.

The higher growth in current expenditures was largely due to an increase in spending on defense and maintenance of public order and safety. On an

[16] FBR constituted a joint committee to curb the manufacturing/trading of illicit cigarettes in its 2nd Chief Commissioner Conference held on 6th January 2017 (Source: http://download1.fbr.gov.pk/Docs/20171271511821401DecisionsTakenRegardingTobaccoSector.pdf)

[17] During FY15 and FY16, government had retired Rs 434 billion and Rs 475 billion respectively.

encouraging note, the rise in interest payments was contained to just 2.4 percent during H1-FY17, against an increase of 10.4 percent seen in H1-FY16 (**Table 4.4**). The moderate increase in interest payments (despite lower interest rates) was due to elevated debt stocks during the period.

A break up of Public Sector Development Program (PSDP) reveals that infrastructure development, power generation, and social sector remained the top priority of the federal government during H1-FY17. In this regard, Rs 80.1 billion were released for the construction of roads and highways, Rs 54.3 billion for power related projects; and Rs 14 billion for the development of railways. Apart from this, Rs 20.8 billion were spent on development of special areas including AJK, Gilgit-Baltistan and FATA; another Rs 42.6 billion was released for the rehabilitation of temporarily displaced persons and Rs 20 billion for achieving Sustainable Development Goals (SDGs).[18]

Table 4.4: Fiscal Spending During H1
billion rupees

	Actual		% Growth	
	FY16	**FY17**	**FY16**	**FY17**
Current expenditures	**2104.4**	**2241.6**	**5.8**	**6.5**
Federal	1436.7	1473.5	3.7	2.6
Interest payment	632.4	647.4	10.4	2.4
Defense	303.3	336.3	-8.0	10.9
Public order and safety	47.0	51.4	7.3	9.4
Others	454.0	438.4	3.3	-3.4
Provincial	667.7	768.1	10.7	15.0
Development expenditures	**426.2**	**497.4**	**32.6**	**16.7**
PSDP	378.0	445.7	40.3	17.9
Federal	155.8	198.3	24.1	27.3
Provincial	222.1	247.4	54.3	11.4
Others (incl. BISP)	48.2	51.7	-7.3	7.2
Net lending	**-1.8**	**-6.4**	**-118.8**	**256.9**
Statistical discrepancy	**-8.6**	**57.2**	**-110.6**	**-765.1**
Total expenditure	**2520.2**	**2781.8**	**5.0**	**10.7**

Source: Ministry of Finance

4.4 Provincial fiscal operations

The overall provincial surplus reached Rs 90.6 billion in H1-FY17 -approximately one-fourth of the full-year target of Rs 339 billion; this was down sharply from the surplus of Rs 208.6 billion that the provinces had provided in H1-FY16 (**Table 4.5**). The YoY decline in the consolidated provincial surplus in H1-FY17 was due to a deficit of Rs 32.9 billion shown by Punjab; simultaneously, Sindh and KPK also posted lower surpluses as compared to last year.

[18] Source: PSDP 2016-17, status of releases as on 06-01-2017, Ministry of Planning, Development & Reform. The sum of these numbers may not tally with the PSDP data shown in Table 4.4, which also includes provincial PSDP (for which breakup is not available).

Table 4.5: Provincial Fiscal Operations
billion rupees

	Punjab	Sindh	KPK	Balochistan	Total
H1-FY17					
A. Total revenue	503.5	293.5	159.6	107.6	1064.2
Share in federal revenue	410.4	220.6	136.8	99.4	867.1
Taxes	71.4	64.3	7.0	3.0	145.7
Non-taxes	12.4	3.5	17.5	2.0	35.4
Federal loans and transfers	9.3	5.1	-1.7	3.3	15.9
B. Total expenditure	490.2	263.2	193.6	75.0	1022.0
Current	348.6	210.8	146.6	68.6	774.6
Development	141.7	52.4	47.0	6.3	247.4
Gap (A-B)	13.3	30.2	-34.0	32.6	42.2
Financing (overall Balance)	**32.9**	**-37.4**	**-49.6**	**-36.4**	**-90.6**
H1-FY16					
A. Total revenue	496.8	293.0	165.0	96.2	1051.0
Share in federal revenue	415.6	227.1	140.0	85.4	868.1
Taxes	60.7	53.9	6.0	1.8	122.4
Non-taxes	15.7	2.5	10.9	2.1	31.3
Federal loans and transfers	4.7	9.5	8.1	6.9	29.2
B. Total expenditure	453.8	215.6	148.6	77.8	895.8
Current	312.4	178.7	116.5	66.0	673.7
Development	141.4	38.8	32.1	11.8	224.1
Gap (A-B)	43.0	77.4	16.4	18.4	155.2
Financing (overall Balance)	**-36.0**	**-88.9**	**-62.0**	**-21.7**	**-208.6**

* Negative sign in financing means surplus.
Source: Ministry of Finance

On the revenue side, provincial collections increased by 17.2 percent on account of gradually rising collection from sales tax on services, followed by stamp duty and motor vehicle tax. Against expectations, collection from property taxes decreased by 6.8 percent, taking hit from property tax collection in Punjab. Relatively subdued market activity following the revision in property valuation rates could be a possible cause of this decline.

On the expenditure side, a major reason for the reduction in the provincial surplus was a sharp 15 percent increase in spending by provinces in H1-FY17; this was particularly true for Sindh and KPK. In addition, spending on ongoing infrastructure development projects increased by 10.4 percent. On the contrary, Balochistan posted a higher surplus due to lower development spending.

4.5 Public debt

Despite a higher fiscal deficit, the pace of public debt accumulation slowed down in H1-FY17 compared to the last year. Encouragingly, this slowdown was broad-based and largely driven by net retirements during Q2-FY17 (**Table 4.6**). The decline in external debt was mainly due to revaluation gains, while drawdown in government deposits with the banking system helped to contain its borrowing from domestic sources in the second quarter.

Table 4.6: Pakistan's Public Debt Profile

billion rupees

	Stock		Share in total		Flow			
					H1		FY17	
	Jun-16	Dec-16	Jun-16	Dec-16	FY16	FY17	Q1	Q2
Gross Public debt (FRDLA definition)*	1,9676.7	20,272.2	100.0	100.0	1,095.5	595.5	866.1	-270.6
Govt. domestic debt	13,625.9	14,192.6	69.2	70.0	687.1	566.7	759.8	-193.2
Govt. external debt	5,417.7	5,460.7	27.5	26.9	303.0	43.0	97.3	-54.4
Debt from the IMF	633.1	619.0	3.2	3.1	105.5	-14.1	8.9	-23.0
External liabilities	377.1	365.0			2.2	-12.2	-1.1	-11.1
Net public debt**	17,823.2	18,385.7			706.3	562.4	458.0	103.6

*Fiscal Responsibility and Debt Limitation Act, 2005 (FRDLA) was amended in June 2016 to define "Total Public Debt" as "The debt of the government serviced out of consolidated fund and debts owed to International Monetary Fund (IMF)".

**Gross public debt minus government deposits with the banking system.

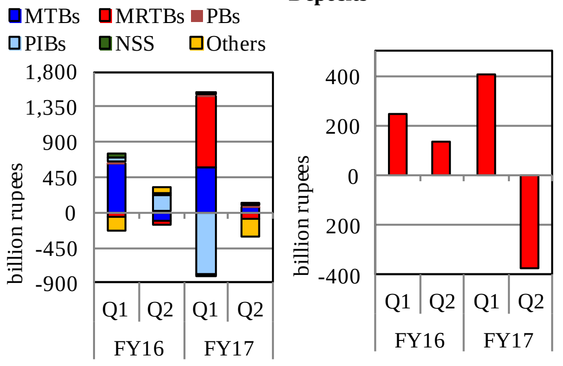
Source: State Bank of Pakistan

Domestic debt

Domestic debt increased by Rs 566.7 billion in H1-FY17, lower than the accumulation of Rs 687.1 billion witnessed in the same period last year. The entire increase came from short-term debt, as there was net retirement of long-term debt during the period.

Unlike Q1-FY17, when the government had mobilized substantial funding through T-bills and made hefty retirements of PIBs, Q2-FY17 witnessed only a marginal increase in the stock of T-bills and almost no change in PIBs. Moreover, the government retired maturing Sukuk of Rs 212 billion and MRTBs worth Rs 94.1 billion, which led to an overall decline in the domestic debt. To meet its budgetary requirements, the government utilized its deposits with the banking system. As evident in **Figure 4.4**, these declined by

Figure 4.4: Change in Domestic Debt



Source: State Bank of Pakistan & Central Directorate of National Savings

Rs 374.2 billion during Q2-FY17, after rising by Rs 407.3 billion in Q1-FY17.

The bidding pattern of government securities in Q2-FY17 suggests that banks were expecting an increase in interest rates in view of the YoY increase in inflation and the widening of the current account deficit. In this backdrop, banks offered only Rs 234.6 billion in PIBs in Q2-FY17, compared with Rs 1.7 trillion offered for T-bills in the same period (**Table 4.7**). Within T-bills, around two-third of the amount was offered in 3-month tenor.

Table 4.7: PIB and T-bills Auction Profile*

billion rupees

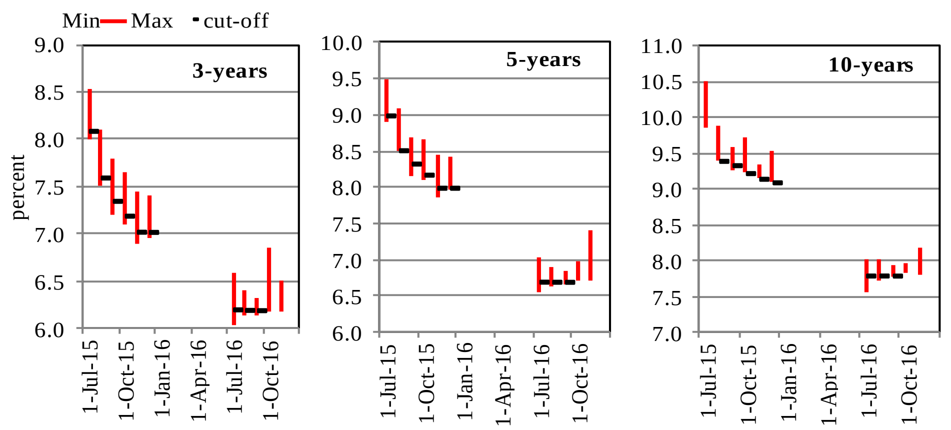
	Target	Offer	Accepted	Maturity**
Q1-FY17				
T-bills	1,450.0	3,065.9	1680.4	1,178.0
PIBs	300.0	995.3	678.5	1683.9
Total	**1,750.0**	**4,061.2**	**2358.9**	**2,861.9**
Q2-FY17				
T-bills	1,300.0	1,695.8	1048.4	1,058.4
PIBs	200.0	234.6	0	35.5
Total	**1,500.0**	**1,930.4**	**1048.4**	**1,093.9**
Grand total H1-FY17	**3,250.0**	**5,991.6**	**3407.3**	**3,955.8**

* Face value and competitive bids only; ** Principal plus coupon payments for PIBs

Source: State Bank of Pakistan

Understandably, the minimum rate asked by banks in the two auctions conducted in Q2-FY17 was higher than the last cut-off rates (**Figure 4.5**). Any acceptance in these PIB auctions may have signaled a reversal in long-term interest rates, which, in turn, would have had implications for the market's short-term interest rate expectations.

Figure 4.5: Bid-pattern in PIB Auction



Fund mobilization through NSS

Unfunded debt, mainly comprising National Savings Schemes (NSS), continued to slide in H1-FY17 (**Table 4.8**), as returns offered on most of the instruments remained relatively lower than in previous years**.** In H1-FY17, the government mobilized Rs 338 billion in gross terms through NSS, substantially lower than the Rs 412 billion realized in H1-FY16.

An instrument-wise breakup shows that Behbood Saving Certificate (BSC) was the major contributor. This is understandable, as this scheme not only offers relatively higher returns but is also exempted from withholding tax and Zakat deduction.

Table 4.8: Receipts under NSS Instruments
billion rupees

	H1-FY15		H1-FY16		H1-FY17	
	Gross	**Net**	**Gross**	**Net**	**Gross**	**Net**
DSC	23.7	8.6	13.3	1.1	25.2	13.4
SSC	124.0	28.0	87.1	4.9	41.1	-5.2
RIC	85.3	40.3	35.3	-5.3	24.8	-15.9
BSC	68.0	26.5	80.3	39.5	75.5	31.2
SSA	96.9	54.6	77.1	25.3	38.0	18.2
Others	107.6	9.6	119.0	11.8	133.4	12.2
Total	505.4	167.5	412.1	78.9	338.0	53.8

Source: Central Directorate of National Savings (CDNS)

Among other schemes, DSC attracted higher inflows during the period, partly due the higher returns it offers over longer tenor.[19] While the government frequently revised DSC rates down to align them with the relevant rates on PIBs, these are still higher than market return on longer tenor PIBs.

Public external debt & liabilities

In H1-FY17, Pakistan's external debt growth slowed considerably, primarily due to currency revaluation gains. Therefore, external debt increased merely by US$ 129.8 million despite the government availing a cumulative US$ 2.7 billion from Sukuk bond, commercial borrowings, and loans from China (**Table 4.9**).

Table 4.9: Pakistan's Public External Debt & Liabilities
million US$

					H1	
	Jun-15	**Dec-15**	**Jun-16**	**Dec-16**	**FY16**	**FY17**
Public external debt	54,673.6	56,985.4	61,356.7	61,486.5	2,312.8	129.8
Government debt	46,861.2	48,375.6	51,713.7	52,098.7	1,514.4	385.1
IMF	4,103.0	4,988.6	6,043.0	5,905.6	885.6	-137.3
External liabilities	3,709.4	3,621.2	3,600.0	3,482.1	-88.2	-117.9

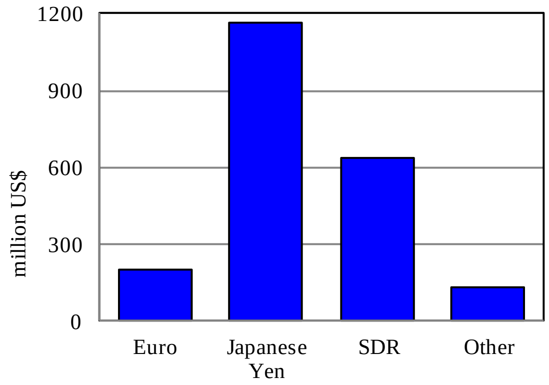
Source: State Bank of Pakistan

The impact of fresh external borrowing was largely offset by revaluation gains of approximately US$ 2.1 billion during H1-FY17. Out of this, the major

[19] DSC offers low return in initial five years and higher return in the final five years

contribution came from depreciation of Japanese Yen against the US Dollar (**Figure 4.6**).

Figure 4.6: Currency Revaluation Gains During H1-FY17



Source: Economic Affairs Division

While inflows from multilateral institutions declined in H1-FY17, the government borrowed substantially from commercial banks. In addition to US$ 1.0 billion raised through Sukuk, the government also borrowed US$ 900 million from foreign commercial banks (**Table 4.10**). Besides, disbursements from China increased by US$ 286 million over last year, and reached US$ 848 million in H1-FY17. This occurred in tandem with a pick-up in CPEC-related economic activities in the country.

Table 4.10: External Loan Disbursement

million US$

	H1-FY16	H1-FY17	Absolute Δ
ADB	607.4	674.6	67.2
IDA	594.9	72.3	-522.6
IDB	39.3	30.2	-9.1
IBRD	36.2	127.5	91.3
IDB (short term)	378.5	212.4	-166.1
China	556.4	848.0	291.6
Japan	26.5	42.8	16.3
Euro/Sukuk bond	500.0	1000.0	500.0
Commercial banks	956.1	900.0	-56.1
Others	91.9	45.1	-46.8
Total	**3787.2**	**3952.9**	**165.7**

Source: Economic Affairs Division

The government's increased reliance on commercial borrowings shows its inclination to benefit from the prevailing low interest rate environment in the global financial market. Particularly, the bonds issuance in recent years, not only curtailed the overall debt servicing cost, but also created a benchmark for future sovereign issuance (**Box 4.1**).

Box 4.1: Improving Pakistani Bond Yields in the International Market

Before FY14, Pakistan was largely relying on domestic borrowings to meet its budgetary requirements. With the implementation of critical reforms under the IMF's Extended Fund Facility (EFF), the confidence of investors in general and lenders in particular improved. Along with the revival of multilateral and bilateral flows, the country issued sovereign bonds of longer maturities, worth a cumulative US$ 4.5 billion (**Table 4.1.1**).

Out of the total, US$ 3 billion are of 10-year maturity, while the rest are of 5-year maturity. All the bonds have bullet repayment features and were oversubscribed at the time of issuance. The coupon payments on each bond are made semi-annually and the coupon rates vary according to global conditions, maturity, and the country's economic situation and the credit rating at the time of issue.

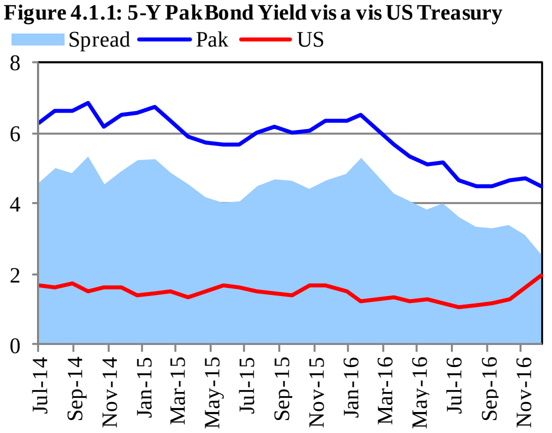
Table 4.1.1: Sovereign Bonds Issuance
value: million US$, yield in percent

Issue Year	Bond	Tenor	Maturity	Value	Yield at issue	Yield at 31 December 2015	Yield at 31 December 2016
FY14	Euro	5- years	Apr-19	1000	7.3	6.2	4.7
	Euro	10- years	Apr-24	1000	8.3	7.8	6.7
FY15	Sukuk	5- years	Dec-19	1000	6.8	6.2	4.5
FY16	Euro	10- years	Sep-25	500	8.3	7.8	6.8
FY17	Sukuk	5- years	Oct-21	1000	5.5		5.0

Source: Bloomberg

While the coupon on sovereign bonds is fixed, the price in the secondary market fluctuates with market conditions, like the current interest rate, market liquidity, issuer country's outlook and the maturity of bond. After issuance, Pakistani bonds are being traded at a higher price than the issuance price and their yields have fallen accordingly (**Figure 4.1.1**).

Figure 4.1.1: 5-Y PakBond Yield vis a vis US Treasury



Source: Bloomberg

What are the factors behind the falling bond yields?

- After the global financial crises of 2008, international bond issuances rose significantly. While developed countries were lowering interest rates to boost aggregate demand, investors were in search of high yield assets. At the same time, a number of advanced economies were in turbulence; this resulted in a shift in investors' capital from advanced to developing economies.
- These developments resulted in availability of ample liquidity in the international capital market, and spurred investors to go for relatively riskier asset classes.[20] As a result, many developing countries tapped international capital markets to benefit from the low interest rate environment.
- In Pakistan's case, the improvement in credit rating also helped mobilize resources at relatively lower rates. **Table 4.1.2** shows that the credit rating agencies upgraded the

[20] Sovereign debt issuances declined significantly during the financial crisis, when investors preferred to stay away from risky assets.

country's sovereign rating, reaching B3 and B by Moody's and S&P respectively.[21] The oversubscription in almost all bond issues suggests that the country has secured a minimum credit rating required for investors' comfort; this also paved the way for future bond issuances.

- The country's macroeconomic fundamentals improved under the IMF's EFF. In particular, improvement in the fiscal and external accounts and low inflation promoted investor confidence and led to lowering of yield on the sovereign bonds.

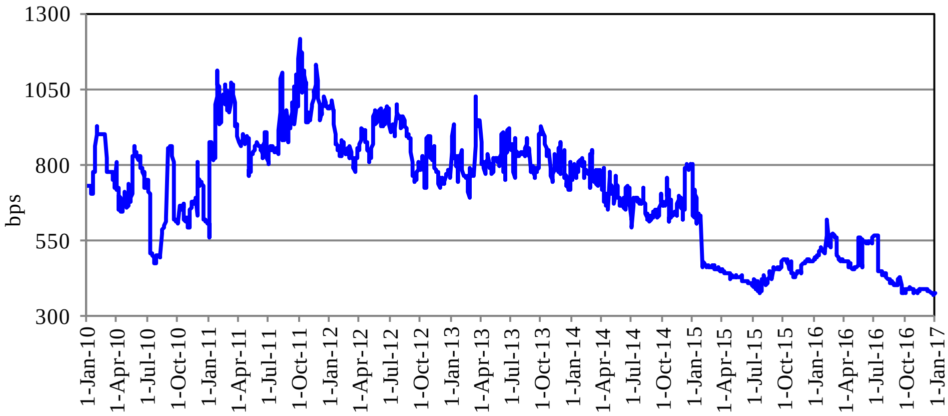
Table 4.1.2:Pakistan's Sovereign Ratings

Date	Rating	Outlook
Moody		
27-Apr-16	B3	Stable
11-Jun-15	B3	Positive
25-Mar-15	Caa1	Positive
14-Jul-14	Caa1	Stable
25-Nov-13	Caa1	Negative
S&P		
30-Oct-16	B	Stable
5-May-15	B-	Positive
1-Aug-13	B-	Stable

Source: Bloomberg

Credit default swap (CDS) , another measure of the country's default risk, also fell significantly (**Figure 4.1.2**).[22] Importantly, Pakistan's CDS stood at 368 bps in January 2017, down from a peak of 1,219 bps in 2011.[23] As mentioned earlier, turbulence in some European countries and ample liquidity due to quantitative easing by the US resulted in an overall decline in CDS. However, a slight uptick in the CDS was observed during the second half of FY16, when the US Fed increased its federal funds rate.

Figure 4.1.2: CDS for Pakistan



Source: Bloomberg

[21] Since the credit rating agencies assess the current economic health and future prospects of a country, an upgrade sends a positive signal to investors.
[22] A credit default swap (CDS) is a financial swap agreement that the seller will compensate the buyer in the event of a loan default.
[23] Our analysis of CDS focuses on 5-year CDS, the most liquid part of the market.

These are the welcome developments in the context of new issuance in the international market. However, the changing trends in international capital markets could have some implications in future. For instance, the recent tightening of monetary policy in US might affect prices of the sovereign bonds. This could also lead to increase in yield on current issues and thus, may affect the terms of new bond issuances.