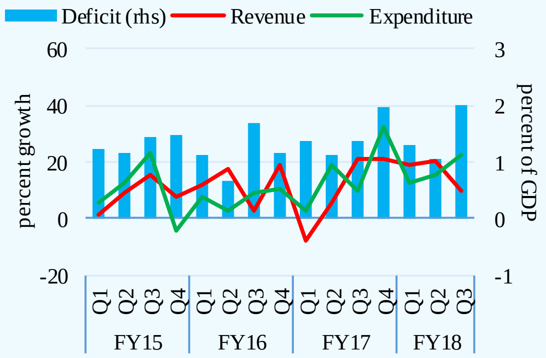
4 Fiscal Policy and Public Debt

4.1 Overview

The impressive growth in revenue collection witnessed during the first two quarters could not be sustained in Q3-FY18. Yet, on a cumulative basis during Jul-Mar FY18, it remained considerably higher compared to corresponding period of last year. On the other hand, building on the momentum seen in first two quarters, expenditures grew sharply in Q3-FY18 (**Figure 4.1**).

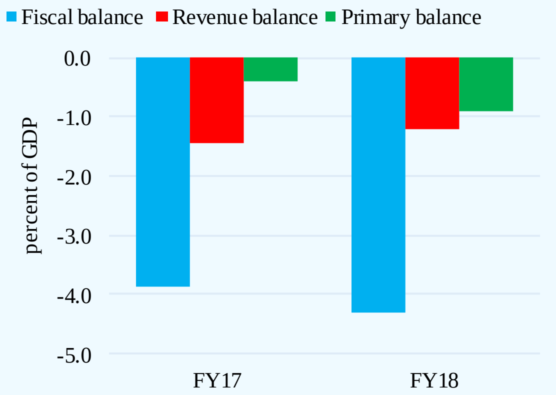
Figure 4.1 : Quarterly Trends in Revenue, Expenditure and Fiscal Deficit



Data source: Ministry of Finance

Together these have resulted in fiscal deficit rising to 4.3 percent of GDP during Jul-Mar FY18, against full year target of 4.1 percent and 3.9 percent deficit recorded in the corresponding period of last year. Similar to overall fiscal balance, the improvement in primary balance could not be sustained either, signifying that the non-interest expenditure grew at a faster pace relative to last year. The improvement in revenue balance, nevertheless, shows that revenue growth still managed to outpace the increase in current expenditures (**Figure 4.2**).

Figure 4.2: Fiscal Balance Indicators During Jul-Mar



Data source: Ministry of Finance, SBP calculations

Thus, acceleration in growth of expenditures was more due to development spending, both at federal and provincial level. The provincial governments in particular, revved up the pace of development spending to fast track completion of the ongoing projects before the term of current assemblies came to an end. The growth in federal development spending, albeit slightly lower compared to last year, still remained high, above 24 percent (**Table 4.1**).

Table 4.1: Summary of Fiscal Operations (Jul-Mar)
billion rupees

		Actual (Jul-Mar)		% of GDP		FY18		
	Budget FY18	**FY17**	**FY18**	**FY17**	**FY18**	**Q1**	**Q2**	**Q3**
A. Total revenue	6,167.2	3,145.5	3,650.0	9.8	10.6	1,025.1	1,359.6	1,265.3
Tax revenue	4,912.5	2,694.3	3,076.2	8.4	8.9	911.0	1,115.9	1,049.3
Non-tax revenue	1,254.7	451.2	573.8	1.4	1.7	114.0	243.8	216.0
B. Total expenditure	7,646.8	4,383.6	5,130.9	13.7	14.9	1,465.9	1,715.1	1,949.9
Current	5,393.9	3,605.1	4,075.4	11.3	11.8	1,241.0	1,304.2	1,530.2
Interest payments	*1,363.0*	*1,094.5*	*1,172.8*	3.4	3.4	*445.4*	*306.1*	*421.4*
Defence	920.2	*535.7*	*623.8*	1.7	1.8	*181.9*	*211.5*	*230.5*
Development	2,265.2	803.9	1,042.5	2.5	3.0	220.5	392.5	650.0
Net lending	-12.3	-34.2	9.2	-0.1	0.0	0.9	1.3	7.9
C. Statistical discrepancy	0.0	8.8	3.8	0.0	0.0	4.0	15.9	-16.1
Fiscal balance (A-B-C)	-1,479.6	-1,238.1	-1,480.9	-3.9	-4.3	-440.8	-355.5	-684.6
Revenue balance	773.3	-459.6	-425.5	-1.4	-1.2	-215.9	55.4	-264.9
Primary balance	-116.6	-143.6	-308.1	-0.4	-0.9	4.5	-49.4	-263.2
Financing	1,479.5	1,238.0	1,480.9	3.9	4.3	440.8	355.5	684.6
External sources	511.4	220.2	524.3	0.7	1.5	16.0	368.1	140.2
Domestic sources	968.1	1,017.9	956.6	3.2	2.8	425.0	-12.8	544.4
Banks	390.1	694.7	813.5	2.2	2.4	408.0	-76.2	481.8
Non-bank	528.0	323.2	143.1	1.0	0.4	17.0	63.4	62.7
Privatization	50.0	-	-	-	-	-	-	-
% Growth								
Total Revenue		6.2	16.0			18.9	20.5	9.6
Tax revenue		8.6	14.2			21.4	12.7	10.1
Non tax revenue		-6.2	27.2			2.2	76.8	7.1
Total Expenditure		10.4	17.0			12.8	15.1	22.3
Current		5.8	13.0			15.9	11.4	12.2
Development		14.9	29.7			15.4	28.4	39.8

Data source: Ministry of Finance

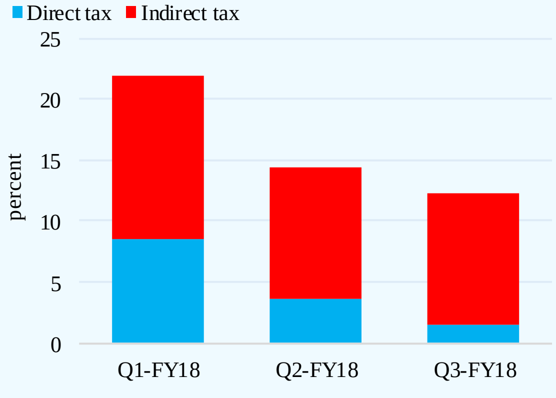
Meanwhile, growth in current expenditures, the major contributor in absolute terms, also increased sharply. Again, the major push came from higher provincial spending. The increase in federal current expenditures largely reflects higher spending related to debt servicing, defense, general public services[1], economic affairs[2], and public order and safety.

The pace of revenue collection, still quite high compared to last year, slowed down considerably in Q3-FY18 compared to the first two quarters. The major setback came from a slower growth in direct tax collection, owing to lower corporate profitabilty, especially banks's profitability. The indirect tax collection, on the other hand, has continued to remain buoyant on the back of robust growth in economic activity, strong domestic demand, and pass-through of rise in international commodity prices to domestic prices.

Growth in non-tax revenue also rebounded with a significant increase in provincial non-tax revenue on account of transfer of hydel profits. Higher mark-up income, dividend income and PTA/postal service profit also contributed to higher non-tax revenue during Jul-Mar FY18.

Yet, the the growth in overall revenue collection edged lower compared to that of expenditures during Jul-Mar FY18. The resultant higher financing requirement was mostly met through external sources and increased recourse to SBP borrowings. In case of external finance, government heavily relied on commercial loans and bonds. In addition, revaluation losses due to appreciation of major currencies against US$, along with depreciation of rupee, also added to external debt. This has led to a considerable increase in debt during Jul-Mar FY18, with record accumulation in Q3-FY18 since FY14.

Figure 4.3: Contribution to Growth in FBR Taxes



Data source: Federal Board of Revenue, SBP calculations

4.2 Revenue

The total revenue collection increased by 16.0 percent during Jul-Mar FY18 compared to 6.2 percent

[1] The general public services refer to the administrative activities of the provincial government such as handling executive and legislative organs, financial and fiscal affairs and transfers etc.
[2] This includes general economic affairs, commercial and labor affairs, agriculture, food, irrigation, etc.

growth realized in the same period of last year. The revenue growth was also broad-based, contributed by both tax (FBR and provincial) and non-tax revenues. While growth in revenue collection still remained impressive compared to last year, the pace slowed down considerably in Q3-FY18. This was primarily due to slower pace of FBR tax collection as growth in non-tax and provincial own tax collection remained strong.

FBR taxes

FBR tax collection grew by 15.8 percent during Jul-Mar FY18 compared to 8.6 percent growth last year. Though the growth was significantly higher compared to last year, its pace has consistently tapered off during 2nd and 3rd quarters of FY18. The major drag came from a slower growth in direct tax collection, while growth in indirect tax collection also weakened somewhat (**Figure 4.3**). The latter also reflects higher payment of tax refunds, especially to export-oriented industries, that increased by 34.4 percent (Rs 100.7 billion) during Jul-Mar FY18 (**Table 4.2**).

Table 4.2: FBR Tax Collection (Jul-Mar)
billion rupees

	Budget FY18	Collections		% Growth	
		FY17	**FY18**	**FY17**	**FY18**
Direct Taxes	1594.9	900.5	1001.4	11.2	11.2
Indirect Taxes	2418.1	1,368.2	1,626.4	7.0	18.9
Customs Duty	581.4	343.4	428.4	24.4	24.8
Sales Tax	1605.2	897.7	1,053.7	1.3	17.4
FED	231.5	127.2	144.3	8.6	13.5
Total Taxes	**4013.0**	**2,268.7**	**2,627.8**	**8.6**	**15.8**

Data source: Federal Board of Revenue and SBP's calculations

Direct taxes

The growth in direct tax collection decelerated to 9.3 percent in Q3-FY18 from 21.0 percent in first quarter. The cumulative growth however, remained at 11.2 during Jul-Mar FY18, same as witnessed during the corresponding period of last year. The voluntary payments (VP), having a share of 22.6 percent in total direct taxes, decreased by 3.1 percent during Jul-Mar FY18 compared to 7.7 percent increase in the corresponding period of last year.[3] The decline in FY18 can be attributed to reduction in corporate tax rate and lower bank profitability.[4] The

[3] The decline in VP was mainly concentrated in Q2 and Q3 FY18.
[4] Banking sector profit fell by 20 percent to Rs180.9 billion during Jul-Mar FY18 compared to Rs 226.9 billion in the corresponding period of last year.

impact of decline in VP on overall pace of direct tax collection during Jul-Mar FY18 was partially offset by higher withholding taxes and Collection on Demand (COD). Acceleration in growth of withholding taxes in particular reflects higher collection from rising trade volumes, contracts, salaries and dividend income (**Table 4.3**). The withholding taxes, also greatly benefited from the government's policy of differential taxation, especially in case of dividend income, registration of motor vehicles and sale and purchase of immoveable property etc.[5]

Table 4.3: Break-up of Direct Taxes Jul-Mar FY18

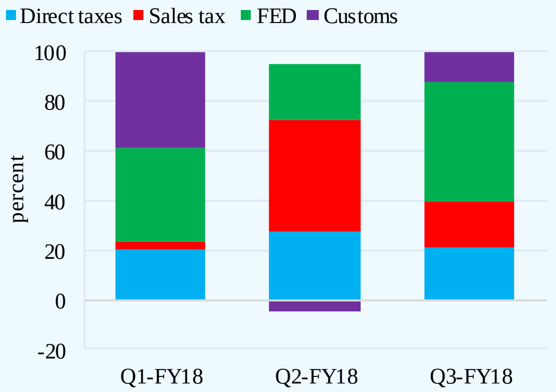
billion rupees

	Actual		Growth	
	FY17	FY18	FY17	FY18
I. Collection on demand	**51.9**	**68.4**	**9.9**	**32.0**
II. Voluntary payments	**247.7**	**240.0**	**7.7**	**-3.1**
III. Withholding taxes	**645.7**	**749.7**	**12.3**	**16.1**
Imports and exports	159.0	180.0	7.4	13.2
Contracts	165.2	194.6	14.7	17.8
Salary	75.2	95.2	19.3	26.6
Interest & securities	31.0	32.3	-15.8	6.7
Cash withdrawal	21.8	25.1	4.1	15.4
Dividends	31.0	39.3	24.4	27.0
Electric bills	17.9	24.0	-3.2	33.9
Telephone	36.8	38.0	8.9	3.3
Others	106.6	119.0	26.8	11.6

Data source: Federal Board of Revenue

Differential taxation was aimed at increasing cost for non-filers besides encouraging them to file tax returns and become part of the formal system. This intervention, to some extent, helped increase number of tax filers. In addition, FBR drive for broadening of tax base has helped in bringing filers into the tax net.[6] Despite these efforts, however, the number of tax filers continue to remain small compared to size of the

Figure 4.4: Contribution to Growth in FBR Taxes



Data source: Federal Board of Revenue, SBP calculations

[5] However, it continues to have negative implications for financial intermediation as reflected in the increase in the currency-to-deposit ratio since its scope was extended to include financial transactions in 2015.

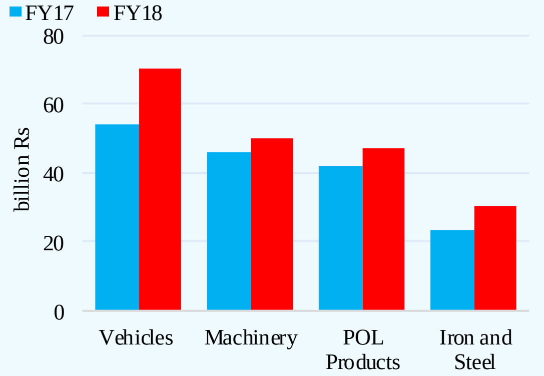
[6] According to FBR, the number of tax filers have crossed 1.3 million. Specifically, the campaign to broaden tax base has added 0.2 million new tax filers during FY14 to FY17 in response to 0.5 million notices served to potential tax payers.

population.

Indirect taxes
The indirect tax collection grew by 18.9 percent during Jul-Mar FY18, compared to a subdued growth of 7.0 percent in last year. This sharp growth was supported by all segments – sales tax, customs, and FED – in line with strong domestic demand and increased sale volumes, surge in imports, and better manufacturing activity. The major contribution, nevertheless, came from a rebound in sales tax collection (**Figure 4.4)**.

Sales tax collection recovered strongly, growing by 17.4 percent during Jul-Mar FY18 against a marginal increase of 1.3 percent in the corresponding period of last year. It generally reflects increase in domestic demand supported by sustained expansion in real economic activity, which has resulted in substantial rise in domestic sales as well as imports. It can also be attributed to higher domestic prices of petroleum products as government promptly passed on the increase in international oil prices to domestic consumers. Moreover, rationalization of sales tax rates on petroleum products at the time of rising sales also contributed to higher collection, especially in Q3-FY18.[7]

Figure 4.5: Revenue Spinners of Custom Duty during Jul-Mar



Data source: Federal Board of Revenue

Substantial rise in imports and increase in regulatory duty helped to keep the growth momentum of custom duty collection, that grew by 24.8 percent in Jul-Mar FY18, on top of 24.4 percent in the same period last year. Depreciation of rupee also contributed to higher custom duty collection by increasing the landed price of imports. Largely, higher import of vehicles, POL products and iron and steel contributed to increase in custom duty collection during Jul-Mar FY18 (**Figure 4.5**). It is also worth mentioning that the prime objective of

[7] FBR vide SROs 1331(I)/2017 dated 31st December 2017;SRO 98(I)/2018 dated 31st January 2018; and SRO 265(I) 2018 dated 28th February 2018; raised sales tax rate on Kerosene and Light Diesel Oil up to 17 percent from previously applicable zero percent.

increase in regulatory duty was to address pressures on balance of payments and revenue collection was only a by-product.
Likewise, collection from federal excise duty grew by 13.5 percent during Jul-Mar FY18 compared to 8.6 percent growth observed in the corresponding period of last year. This acceleration can be attributed to increase in production of cement and cigarettes. Higher collection from cement reflects both increase in demand for cement and an upward revision in duty structure. Similarly in case of cigarettes, introduction of three-tier duty structure has helped partially recover FED collection.

<u>Non-tax revenue</u>

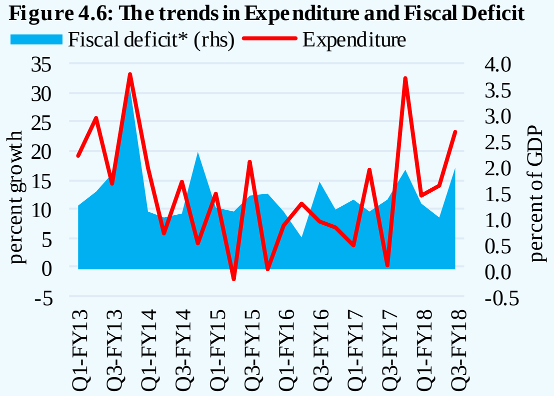
The non-tax revenue grew by 27.2 percent during Jul-Mar FY18 compared to a decline of 6.2 percent in the same period of last year. The growth looks impressive in the absence of CSF and given the SBP profit was almost same as in last year. In fact, the growth in non-tax revenue largely owes to one-off increase in provincial non-tax revenue – transfer of hydel profits to provinces (mainly Punjab and KP). Moreover, receipts from mark-up, dividend income, and profits of PTA/post office were also higher during Jul-Mar FY18 (**Table 4.4**).

Table 4.4: Non-tax Revenues (Jul-Mar)
billion rupees

		Actual	
	Budget FY18	FY17	FY18
Mark-up (PSEs & others)	96.0	12.1	21.7
Dividends	93.3	22.1	33.6
SBP profits	260.0	144.8	143.2
Defense (incl. CSF)	141.8	64.4	9.3
Profits from post office/PTA (3G)	11.3	0.7	8.8
Royalties on gas & oil	58.5	40.3	42.4
Passport & other fees	28.0	13.6	11.9
Discount retained	10.0	5.9	6.5
Windfall levy	8.0	1.0	2.3
Other*	547.8	146.3	294.1
Total non-tax revenue	**1,254.7**	**451.2**	**573.8**

* Includes provincial non-tax revenue
Data source: Ministry of Finance

Figure 4.6: The trends in Expenditure and Fiscal Deficit



* The negative value means surplus
Data source: Ministry of Finance, SBP calculations

4.3 Expenditures

The overall fiscal spending grew sharply by 17.2 percent, almost three times the growth observed during the corresponding period of last year. This was broad-based as both current and development expenditures were significantly higher across federal and the provincial governments **(Table 4.5)**.

Quarter-wise data reveals that the acceleration in expenditure growth mainly came from a jump in spending by 23.4 percent in Q3-FY18 **(Figure 4.6)**.

Table 4.5: Analysis of Fiscal Spending
billion rupees

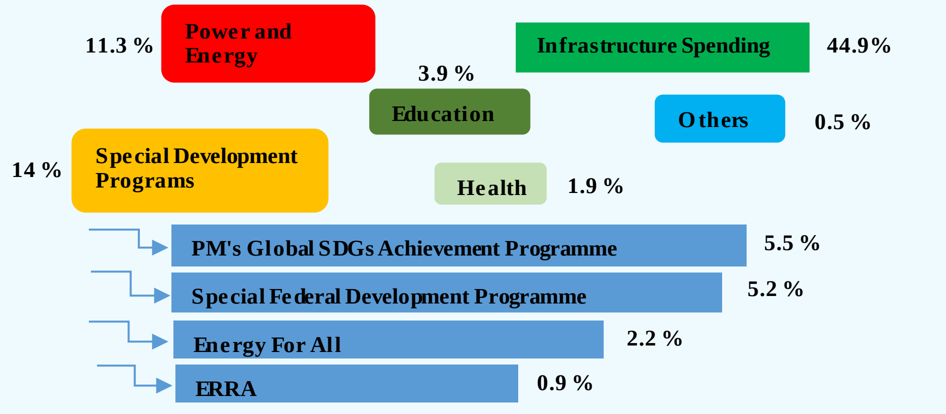
	Jul-Mar		Abs. change	Growth	
	FY17	FY18		FY17	FY18
Current expenditures	**3,605.1**	**4,075.4**	**470.3**	**5.8**	**13.0**
Federal	2,439.3	2,653.3	214.0	**3.0**	**8.8**
of which					
Interest payments	1,094.5	1,172.8	78.4	1.4	7.2
(i) Domestic Debt Servicing	1,009.9	1,071.4	61.5	0.7	6.1
(ii) Foreign Debt Servicing	84.6	101.4	16.8	10.5	19.9
Defense	535.7	623.8	88.2	10.9	16.5
Public order and safety	81.9	94.0	12.1	8.6	14.8
Others	727.3	762.7	35.4	-0.5	4.9
Provincial	1,165.8	1,422.1	256.3	12.3	22.0
Development expenditures	**803.9**	**1,042.5**	**238.6**	**14.9**	**29.7**
PSDP	764.6	980.5	215.9	22.7	28.2
Federal	324.0	402.8	78.8	28.9	24.3
Provincial	422.7	577.8	155.1	13.6	36.7
Others (including BISP)	57.2	61.9	4.7	-24.7	8.3
Net lending	**-34.2**	**9.2**	43.4	-417.0	126.8
Total Expenditure*	**4374.7**	**5127.1**	**752.4**	**6.3**	**17.2**

* Excluding statistical discrepancy
Data source: Ministry of Finance

The disaggregated data further shows that provinces contributed the most to improvement in growth of current expenditures. The overall current expenditures grew by 13.0 percent as compared to 5.8 percent recorded last year. The federal current expenditures, being larger in absolute terms, increased by 8.8 percent mainly due to higher interest payments and security-related spending. Going forward, higher interest payments could narrow space for development spending for sustaining higher growth in medium term.

Similar to current expenditures, acceleration in growth of development expenditures was also spearheaded by higher spending from provinces, though growth in federal spending also remained high above 24 percent. Higher development spending mainly reflects government's efforts to complete ongoing development projects before the term of current assemblies comes to an end. The breakup of PSDP releases shows that the major chunk of PSDP was allocated for infrastructure development followed by *Special Development Programs'*, and *Power and Energy* **(Figure 4.7)**.

Figure 4.7: The Development Spending during Jul-Mar FY18 (as percent of total PSDP spending)



Data source: PSDP Releases as on 30-03-2018

Moreover, growth in other development expenditures, especially aimed at poverty reduction, also rebounded with 8.3 percent increase against a decline of 24.7 percent recorded last year.[8]

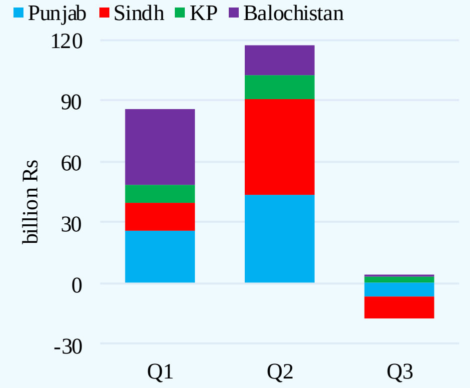
4.4 Provincial Fiscal Operations

The provinces posted a combined surplus of Rs 191.1 billion during Jul-Mar FY18, down from Rs 227.6 billion in the corresponding period of last year. All the provinces, except for Balochistan, recorded decline in surplus (**Table 4.6**). Quarter-wise data shows that the drag came in Q3-FY18, when provincial expenditures grew sharply (38.3 percent) against a relatively slower revenue growth in the quarter **(Figure 4.8** and **4.9).**

As discussed in **Section 4.3**, a sharp increase in both current and development expenditure led to a 25.8 percent increase in provincial expenditure during Jul-Mar FY18 compared to 12.6 percent increase in last year (**Table 4.5 and 4.6**).

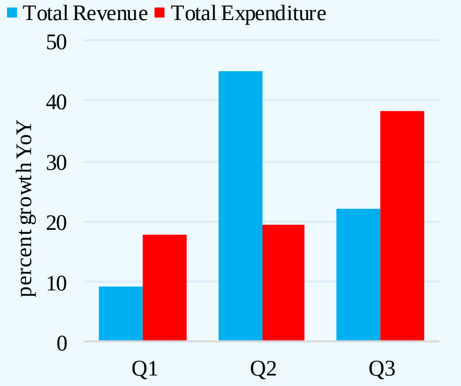
[8] This was due to higher allocation under Poverty Reduction Strategy Paper (PRSP) for both federal and provincial levels during Jul-Dec FY18 that are more concentrated on education and infrastructure projects.

Figure 4.8: Province-wise Surplus* During FY18



* Negative financing numbers represents surplus
Data source: Ministry of Finance

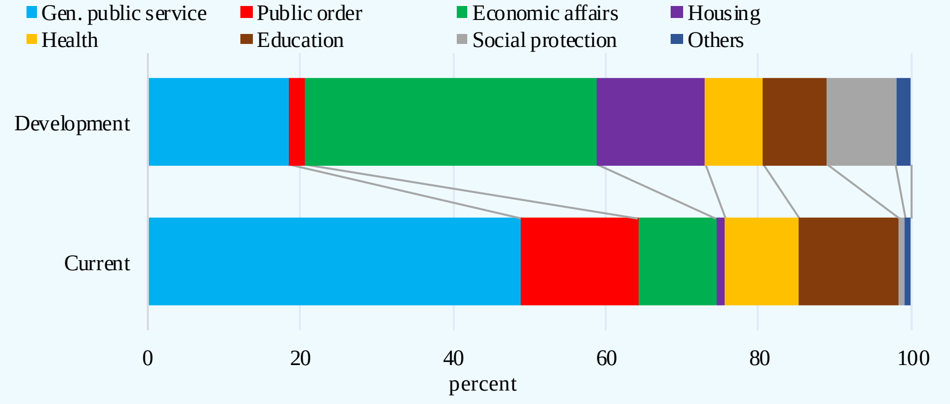
Figure 4.9: Provincial Fiscal Position During FY18



Data source: Ministry of Finance, SBP calculations

The composition of provincial expenditures elucidates that most of the current and development expenditures were allocated towards general public service and economic affairs followed by public order, housing, education, and social protection (**Figure 4.10**).

Figure 4.10: Provincial Expenditures During Jul-Mar FY18



Data source: Ministry of Finance

On the other hand, lower provincial revenue in Q3-FY18 was mainly because of a negligible growth in federal transfers; these were significantly higher in Q2-FY18, bolstered by higher federal revenue receipts. In contrast, provincial own revenue maintained the growth momentum, rising to Rs 233.3 billion in Q3-FY18. Yet, on a cumulative basis during Jul-Mar FY18, revenue collection increased by 25.8

percent compared to 13.7 percent reported in last year. The higher growth during Jul-Mar FY18 was mainly supported by provincial own revenue collection and federal loans and transfers **(Table 4.6)**.

Though growth in provincial revenue collection remained strong during Jul-Mar FY18, it was mainly supported by higher growth in non-tax revenue (**Table 4.6**). Slight deceleration in growth of tax revenue was mainly due to a slower growth in GSTS, motor vehicle tax, and other miscellaneous taxes. However, collection from stamp duties recorded a sharp increase of Rs 44.9 billion while excise duties rebounded during the period under review that followed trends in domestic production.

Table 4.6: Provincial Fiscal Operations during Jul-Mar
billion rupees

	Punjab	Sindh	KP	Balochistan	Total	Growth
FY18						
A. Total Revenue	1036.0	603.1	361.4	184.1	2184.6	25.8
Provincial share in federal revenue	801.7	418.1	269.3	159.9	1648.9	16.0
Provincial Revenue (I+II)	221.2	156.2	81.2	15.6	474.2	63.6
I. Taxes	141.2	119.3	13.0	6.5	280.0	21.4
II. Non-tax revenue	80.0	36.9	68.2	9.1	194.2	227.5
Fed loans and transfers	13.1	28.9	10.9	8.6	61.5	154.1
B. Total expenditure	1018.8	529.1	321.4	141.2	2010.4	25.8
Current**	659.5	413.9	237.7	121.6	1432.7	21.8
Development	359.3	115.2	83.7	19.6	577.8	36.7
Gap (A-B)	17.3	74.1	40.0	42.9	174.2	26.6
Financing* (overall balance)	**-62.8**	**-50.0**	**-24.5**	**-53.8**	**-191.1**	**-16.1**
FY17						
A. Total Revenue	808.4	500.3	263.1	164.3	1736.1	13.7
Provincial share in federal revenue	665.6	382.2	224.3	150.0	1422.1	13.5
Provincial Revenue (I+II)	132.8	107.4	41.3	8.3	289.8	25.2
I. Taxes	112.3	101.7	12.1	4.5	230.5	23.5
II. Non-tax revenue	20.6	5.7	29.2	3.9	59.3	32.6
Fed loans and transfers	10.0	10.7	-2.4	5.9	24.2	-42.4
B. Total expenditure	723.0	455.5	290.2	129.8	1598.5	12.6
Current**	484.0	363.4	216.4	112.1	1175.9	12.3
Development	239.1	92.1	73.8	17.7	422.7	13.6
Gap (A-B)	85.4	44.8	-27.1	34.5	137.6	28.2
Financing* (overall balance)	**-82.7**	**-41.9**	**-67.0**	**-36.0**	**-227.6**	**2.9**

*Negative sign in financing means surplus. ** Current expenditure data may not match with those given in Table 4.5 as numbers reported here includes the markup payments to federal government.
Data source: Ministry of Finance and SBP calculations

Provincial non-tax revenue jumped by Rs 134.9 billion on account of transfer of profits from hydroelectricity (mainly to Punjab and KP) and PSDP grants. A strong showing by non-tax revenue contributed significantly to 63.6 percent growth in provincial revenue during Jul-Mar FY18 **(Table 4.6)**.

4.5 Public debt

Both a large fiscal deficit and widening of current account deficit led to a considerable accumulation in public debt during Jul-Mar FY18, which was more than double the increase recorded in the corresponding period of last year. Most of the addition in debt was concentrated in third quarter of FY18, Rs 1.3 trillion, the highest increase seen in a quarter since FY14.[9] Moreover, external debt contributed the most to overall rise in debt during Jul-Mar FY18. This is in contrast to last year when 90 percent of the increase was due to domestic debt in the same period (**Table 4.7**).

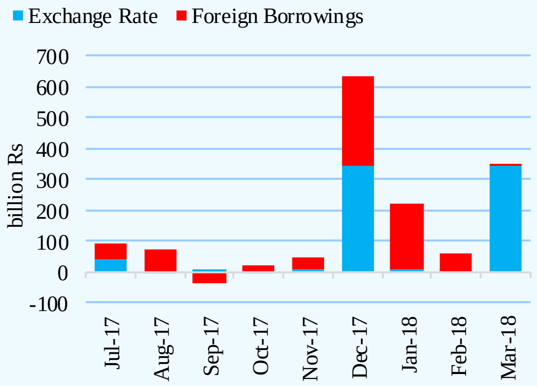
Table 4.7: Pakistan's Public Debt Profile
billion rupees

	Stock		Flow				
			Jul-Mar		FY18		
	Jun-17	Mar-18	FY17	FY18	Q1	Q2	Q3
Gross Public Debt	**21,408.7**	**24,076.3**	**1,197.2**	**2,667.6**	**651.2**	**761.0**	**1,255.5**
Domestic debt	14,849.2	16,074.1	1,120.1	1,224.8	526.3	61.9	636.7
External debt	5,918.7	7,269.6	83.8	1,350.9	111.1	662.8	577.0
Debt from the IMF	640.8	732.6	-6.7	91.9	13.8	36.3	41.8
External liabilities	373.8	432.0	-9.0	58.1	6.3	23.1	28.7
Total Debt of the Government*	19,635.4	22,059.7	1,070.8	2,424.3	558.8	685.1	1,180.4

*Gross public debt minus government deposits with the banking system.
Data source: State Bank of Pakistan

Besides higher external financing needs, revaluation losses due to appreciation of major international currencies against US$ also added to the external debt in dollar terms. At the same time, depreciation of Pak rupee further increased external debt in rupee terms (**Figure 4.11**). The combined impact of currency changes (both PKR and other currencies

Figure 4.11: PKR Depreciation and External Debt



Data source: State Bank of Pakistan & Economic Affairs Division

[9] Previously, the highest increase in gross public debt was recorded in Q1-FY14, when debt increased by a little less than Rs 1 trillion.

against US$) added around 2.1 percent in overall debt/GDP ratio.

With these developments, gross public debt rose by Rs 2.7 trillion during Jul-Mar FY18 to reach Rs 24.1 trillion as of end-March 2018. Within gross public debt, the government debt increased by Rs 2.4 trillion to reach Rs 22.0 trillion as of end-March 2018.

Domestic debt

With an addition of Rs 1.2 trillion, domestic debt reached 16.1 trillion as of end-March 2018. The entire increase in domestic debt during the period came from short-term debt, mostly in 3-month T-bills, as the government retired maturing longer-term debt (**Table 4.8**).

Table 4.8:Absolute Change in Government Domestic Debt
billion rupees

	FY17	FY18	FY18		
	Jul-March		Q1	Q2	Q3
Government domestic debt	**1,120.10**	**1,224.8**	**526.3**	**61.9**	**636.7**
Permanent debt	-561.8	-999.3	-510.5	15.2	-503.9
of which					
PIBs	-644.9	-1,067.7	-541.0	0.0	-526.8
Prize bond	83.1	68.5	30.4	15.2	22.9
Floating debt	1599.9	2,174.7	1,017.8	20.4	1,136.5
of which					
MTBs	1077.9	-57.0	745.9	1.8	-804.7
MRTBs	734.6	2,231.7	271.9	-188.7	2,148.5
Unfunded debt	82	49.0	19.0	26.1	3.8
Foreign currency loans	0	0.4	0.0	0.2	0.2

Data source: State Bank of Pakistan

Continuing the trends observed in Q2-FY18, banks remained reluctant to invest in long-term government securities in anticipation of increase in interest rates. This was particularly reflected in PIB auctions where the offered amount was about a quarter of the target and only a fraction of maturities in Q3-FY18 (**Table 4.9**). Against this, the government rejected all the bids as banks demanded higher rates. As shown in **Figure 4.12**, there was a clear upward shift in yield curve since December 2017; the situation did not change much after 25 bps increase in the policy rate in January 2018.

Table 4.9: Auction of Government Securities*
ratios

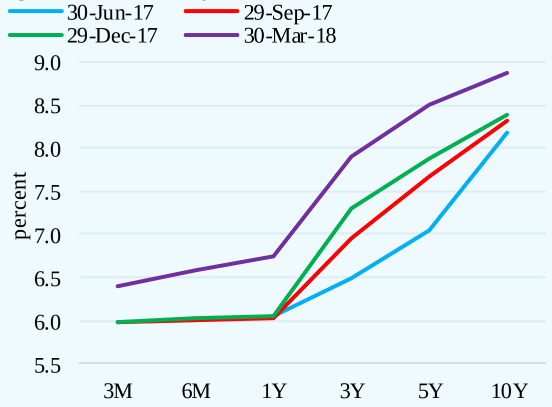
	Offer/ maturity	Target/ maturity	Accepted/ maturity
T-bills			
Q1-FY18	1.2	1.1	1.2
Q2-FY18	1.3	1.0	1.0
Q3-FY18	1.1	1.1	0.8
PIBs			
Q1-FY18	0.2	0.5	0.1
Q2-FY18			
Q3-FY18	0.1	0.4	0.0

* Face value in case of offer and accepted amounts. Moreover, accepted amount is only from competitive bids.

Data source: State Bank of Pakistan

In case of T-bills too, the offers from commercial banks were heavily tilted towards 3-month tenor, and also at relatively higher rates. These factors made it hard for the government to raise the targeted amount, which also included incremental amounts, over and above maturities during the quarter. Similar to commercial banks, the non-bank entities also shifted their investment towards short-term bills.

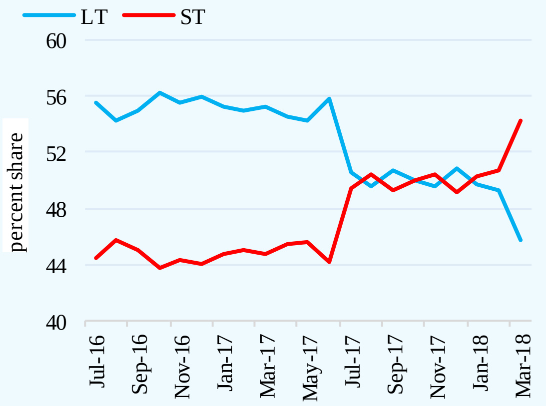
Figure 4.12: Secondary Market Yield Curve



Data source: MUFAP

In this backdrop, for retirement of maturing long-term government securities and to meet its additional financing requirement, government heavily relied on SBP borrowings. This led to the highest ever creation of MRTBs, Rs 2.1 trillion, in a single quarter since FY14, pushing the outstanding stock of MRTBs to a record Rs 4.7 trillion. As a result, the share of MRTBs in domestic debt rose to 29.2 percent in March 2018 from 16.5 in December 2017.

Figure 4.13: Composition of Domestic Debt



Data source: State Bank of Pakistan

The resulting surge in stock of 3-month T-bills and MRTBs led to a significant increase in the share of short-term debt in overall domestic debt (**Figure 4.13**). Though these developments bode well in terms of debt servicing cost, the rollover risk has increased.[10]

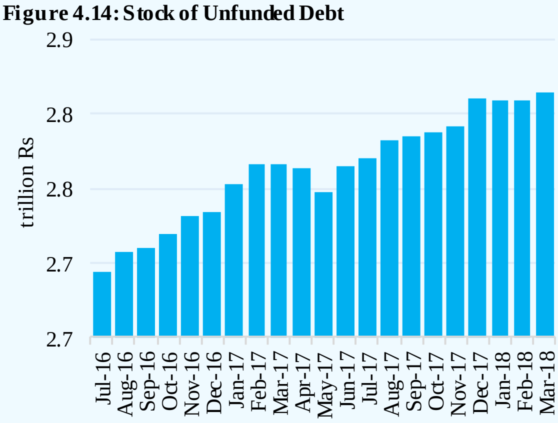
Unfunded debt:

The stock of unfunded debt increased only moderately during third quarter of FY18 (**Figure 4.14**). The increase was primarily driven by inflow under Behbood saving certificates and pensioner's benefit account, while other major schemes

[10] To revive commercial bank's interest in PIBs, the government has recently decided to issue PIBs on floating rates (Source: State Bank of Pakistan, DMMD Circular No. 09 of 2018)

recorded net retirement during the period. This is despite several efforts by CDNS to attract savers, and largely reflects lower rates of return. As SBP has increased the policy rate cumulatively by 75 bps since January 2018, a concurrent increase in NSS rates may revive savers' interest going forward.

Figure 4.14: Stock of Unfunded Debt



Data source: CDNS

<u>External Public Debt</u>

External debt rose by US$ 6.7 billion during Jul-Mar FY18, to reach US$ 69.3 billion as of end March 2018 (**Table 4.10**). Along with higher external borrowings, revaluation losses due to appreciation of major borrowing currencies against US dollar also added to external debt in US$. During Jul-Mar FY18, these losses added US$ 1.7 billion to country's external debt. Out of this, around US$ 1.0 billion was realized in Q3-FY18 alone, when Japanese Yen and SDR – having a combined share of around 40 percent in external debt – appreciated by 5.6 and 2.0 percent respectively.

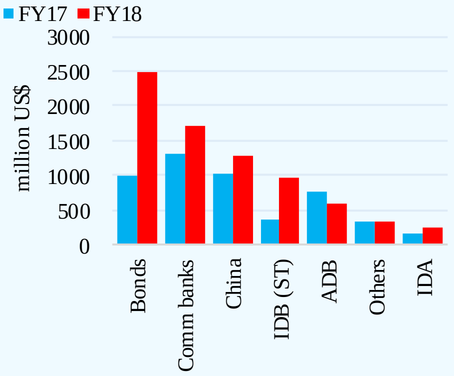
Table 4.10: Public External Debt & Liabilities

billion US dollars

	Stock		Flows				
	End-period		Jul-Mar		FY18		
	Jun-17	Mar-18	FY17	FY18	Q1	Q2	Q3
External public debt & liabilities (i+ii+iii)	66.1	73.0	0.6	6.9	0.9	3.5	2.5
External Public debt (i+ii)	62.5	69.3	0.7	6.7	0.9	3.5	2.4
i. Government debt	56.4	62.9	0.8	6.5	0.8	3.4	2.3
Of which;							
Paris club	12.0	12.3	-0.8	0.4	0.1	-0.2	0.4
Multilateral	27.6	28.4	-0.4	0.8	0.3	0.0	0.5
Other bilateral	5.8	7.2	0.8	1.4	0.4	0.2	0.7
Euro/Sukuk bonds	4.8	7.3	1.0	2.5	0.0	2.5	0.0
Commercial loans	4.8	5.7	1.3	0.9	-0.1	0.5	0.5
Short term	0.9	1.5	-0.5	0.6	0.0	0.4	0.2
ii. IMF	6.1	6.3	-0.1	0.2	0.1	0.0	0.1
iii. Foreign exchange liabilities	3.6	3.7	-0.1	0.2	0.0	0.0	0.1

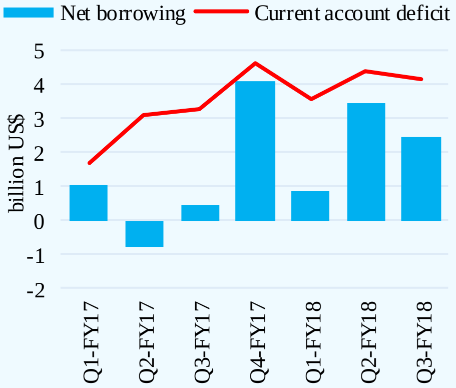
Data source: State Bank of Pakistan and Economic Affairs Division

Figure 4.15: Entity-wise External Borrowing (Gross) During Jul-Mar



Data source: State Bank of Pakistan

Figure 4.16: Net Borrowing viz-a-viz Financing Needs



Data source: State Bank of Pakistan

The gross external disbursement recorded US$ 2.6 billion YoY increase to reach US$ 7.6 billion during Jul-Mar FY18. More than half of the inflows were in the form of commercial borrowings by the government (US$ 1.7 billion from banks and US$ 2.5 billion from Sukuk and Eurobonds). Moreover, CPEC related inflows from China recorded moderate increase, while loans from multilateral donors remained almost at last year's level. (**Figure 4.15**). Overall, most of increase in debt during Jul-Mar FY18 was in the form of non-project loans, with its share rising to 70 percent in Jul-Mar FY18 from 50 percent in the same period last year. Such large borrowing primarily reflects requirements arising from financing of widened current account deficit **(Figure 4.16)**.

Table 4.11: Servicing of Public External Debt during Jul-Mar
million US dollars

	FY17	FY18	Change
Principal (Long-term)			
i. Government debt	2,045.5	2,045.3	-0.2
of which			
Paris club	153.8	321.8	168.0
Multilateral	999.6	1,069.6	70.0
Other bilateral	233.4	190.1	-43.3
Euro/Sukuk bonds	0.0	0.0	0.0
SAFE China deposits	500.0	0.0	-500.0
Commercial loans	138.8	463.9	325.1
ii IMF	0.0	43.6	43.6
iii. External liabilities	0.0	0.0	0.0
I. Total (i+ii+iii)	2,045.5	2,088.9	43.3
Interest			
i. Government debt	814.1	997.6	183.5
of which			
Paris club	129.6	128.2	-1.4
Multilateral	233.3	273.0	39.7
Other bilateral	166.8	190.6	23.9
Euro/Sukuk bonds	201.9	171.9	-29.9
SAFE China deposits	10.3	0.0	-10.3
Commercial loans	43.1	177.9	134.8
ii. IMF	60.9	94.6	33.7
iii External liabilities	55.7	16.3	-39.4
II. Total (i+ii+iii)	930.7	1,108.5	177.8
Grand Total (I+II)	**2,976.2**	**3,197.4**	**221.2**

Data source: State Bank of Pakistan

External debt servicing was up by US$ 221.2 million only, reaching US$ 3.2 billion during Jul-Mar FY18 (**Table 4.11**). This was mainly due to higher interest payments, as the principal repayment recorded only a marginal increase. Repayment to both multilateral donors and the commercial lenders increased significantly during the period.

The interest payments grew quite significantly, particularly to commercial banks and multilateral/bilateral donors, in line with recent borrowing trends. Along with the higher borrowing amount, increase in the benchmark rate i.e. LIBOR, at which most debt is contracted, also contributed to higher interest payments this year.