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Optimizing Domestic Debt: A Fiscal Analysis Aligned with Pakistan's Budget

POLICY BRIEF: 05M-03/25

Path to Sustainable Debt Management

Lower the Policy Rate and Stimulate Private Sector Credit

Gradually reduce the policy rate from 12% to single digits to lower debt servicing costs and enhance access to credit for the private sector. Additionally, develop a robust bond market as a complementary mechanism for financing government borrowing.

Bringing Prudence in Debt Management

Prioritize long-term borrowing during low-interest periods and vice versa. Leverage floating rate instruments to manage interest rate volatility effectively to ensure cost-effective debt servicing solutions.

Strategic Reprofiling of Domestic Debt

Extend existing domestic debt maturities to mitigate cash flow pressures and reprofile existing high-interest bearing short-term loans into low-interest, long-term debt instruments to alleviate fiscal strain.

Debt-to-Equity Swaps for Circular Debt

Following the examples of China and Argentina, implement Debt-to-Equity Swaps for state-owned enterprises particularly in the energy sector, allowing creditors to acquire stakes in public companies to settle circular debt, and accelerate privatization.

Leverage Riba-Free Financing Alternatives

In line with the constitutional amendment for a riba-free economy, the government should prioritize riba-free financing by issuing Sukuk for development projects & exploring profit-sharing instruments to promote public-private investments through revenue-sharing models.

Devolution of Markup Payments

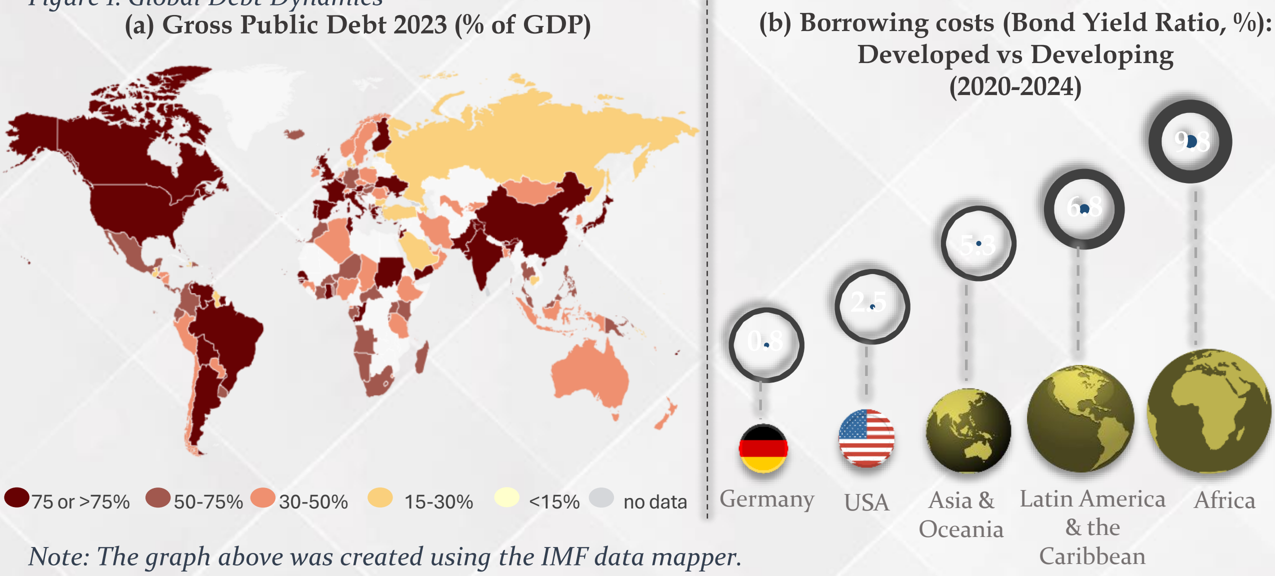
Devolve mark-up payments to provinces using the 7th NFC Vertical Distribution formula to reduce federal fiscal pressure, potentially lowering the federal deficit from 6.8% to 2.3% of GDP in FY2025.

1. Introduction

1.1. Global Debt at a Glance

The global world is plagued with a gigantic burden of public debt worth around $100 trillion approaching 93% of global GDP by 2024[1]. The COVID-19 pandemic has further exacerbated these challenges, increased debt pressures, and straining the fiscal capacity of developing countries. Figure 1(a) illustrates the international distribution of public debt as a percentage of GDP. Around 27% of the world's public debt is attributed to Asia and Oceania, 5% to Latin America and the Caribbean, and 2% to Africa. In addition, high borrowing costs exacerbate the debt phenomenon for developing nations as their borrowing rates are typically 2–4 times higher than those in the US and 6–12 times higher than in Germany[2] (Figure 1(b))—making it challenging for such nations to make productive investments to repay their debt burdens eventually trapping them in a vicious debt cycle.

Figure 1: Global Debt Dynamics



Note: The graph above was created using the IMF data mapper.
Source: IMF & UNCTAD

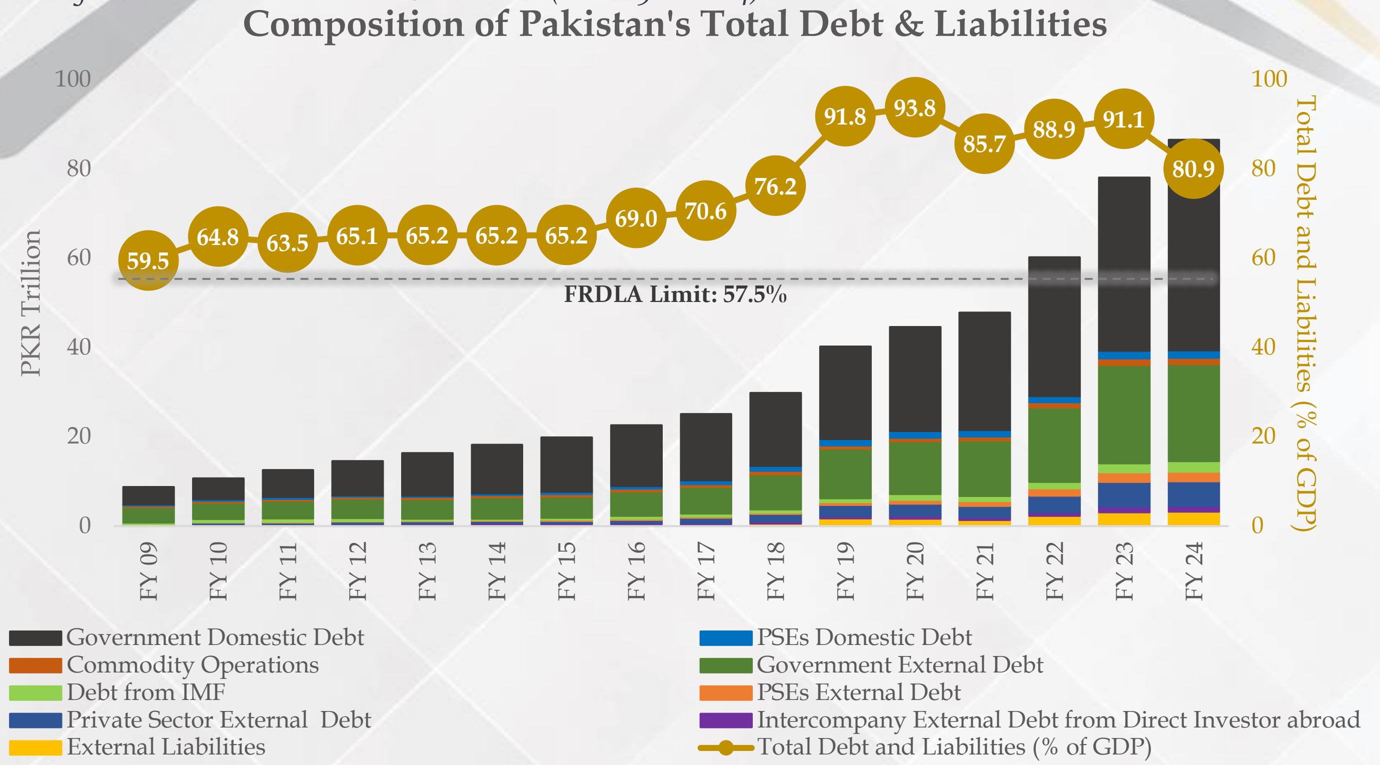
1.2. Pakistan's Debt – An Existential Threat

Pakistan's total debt and liabilities, encompassing both domestic and external, have grown significantly in recent years due to ongoing economic challenges and the need to finance the country's operations. Between FY 09 and FY 24, total debt and liabilities increased at an average annual rate of 15.3%, rising from PKR 8.7 trillion to PKR 85.5 trillion, outpacing revenue and economic growth. This escalating debt has become a central factor in shaping Pakistan's economic outlook.

The debt composition has shifted, with total domestic debt reaching PKR 50.6 trillion in FY24, while external debt stood at PKR 36.5 trillion. Despite efforts to manage debt sustainability risks, the total debt & liabilities-to-GDP ratio has risen from 59.5% in FY 09 to 80.9% in FY 24, underscoring growing fiscal pressures and the urgent need for more effective debt management strategies.

[1] https://www.weforum.org/stories/2024/10/imf-global-debt-and-other-economy-stories-21-october/
[2] https://unctad.org/publication/world-of-debt

Figure 2: Pakistan's Total Debt & Liabilities (FY 2009-FY 2024)

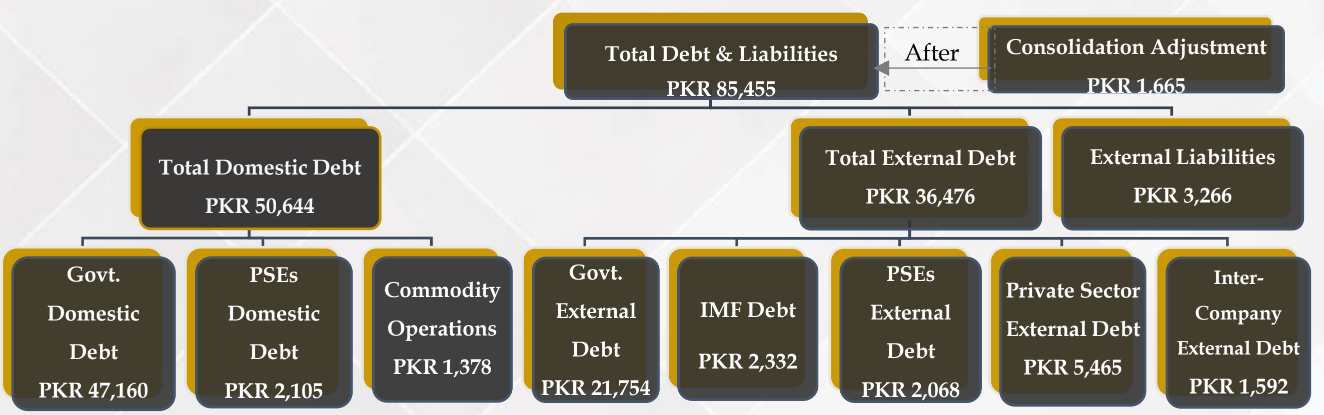


Source: State Bank of Pakistan (SBP)

1.3. Pakistan's Debt Composition

The debt classification in Pakistan is somewhat intricated, with various subcategories, overlapping definitions, and liabilities such as government guarantees adding to the overall debt structure. The chart below outlines the break-up of Pakistan's total debt and liabilities in FY 24.

Flow Chart 1: Structure of Pakistan's Total Debt and Liabilities (PKR in Billion)



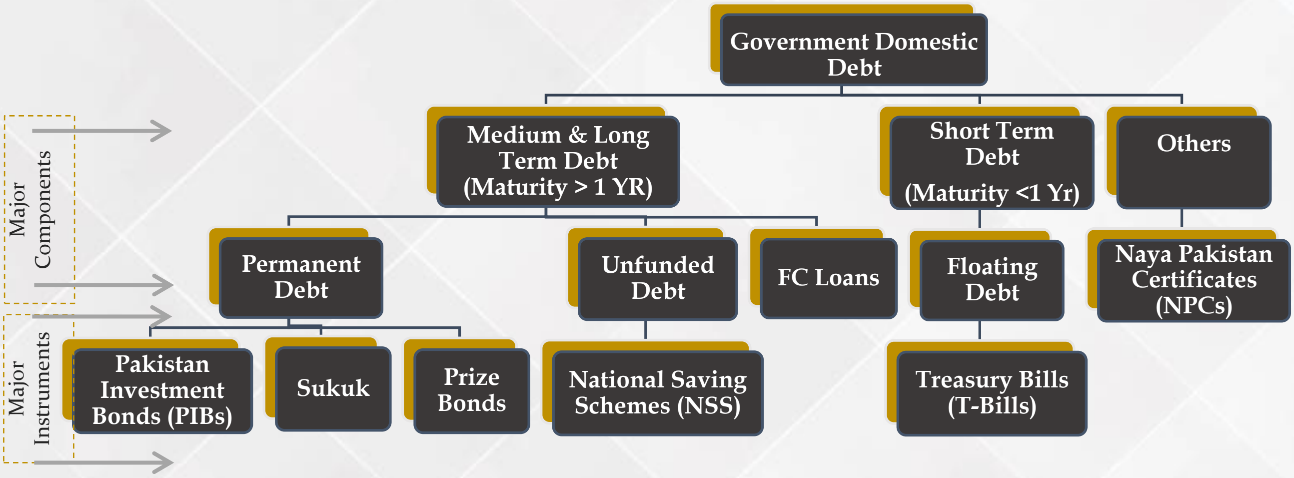
Gross Public Debt = Govt's Domestic Debt + Govt's External Debt + IMF Debt = PKR 71,246 Bn	**As % of GDP= 67.5%**
Total Govt Debt (As per FRDLA)= Gross Public Debt – Govt. Deposits in Banks = PKR 65,105 Bn	**As % of GDP= 61.6%**

Note: Values are updated as of Jun 24, PSE stands for Public Sector Enterprises.
Govt. Bank Deposits = PKR 6,141 Bn in FY24
Source: State Bank of Pakistan.

2. Overview of Domestic Debt

Domestic debt, unlike external debt, does not expose country to exchange rate risk. However, its rising share has intensified the overall debt burden. No political regime in Pakistan has yet succeeded in reducing the national debt; instead, debt levels have consistently increased, passing larger financial burdens onto successive governments. Concerns are growing over the surging government domestic debt, which reached PKR 47.2 trillion in FY 24. The chart below provides a breakdown of Pakistan's domestic debt burden, highlighting its maturity profile and the primary instruments used for internal borrowing.

Flow Chart 2: Classification of Government Domestic Debt



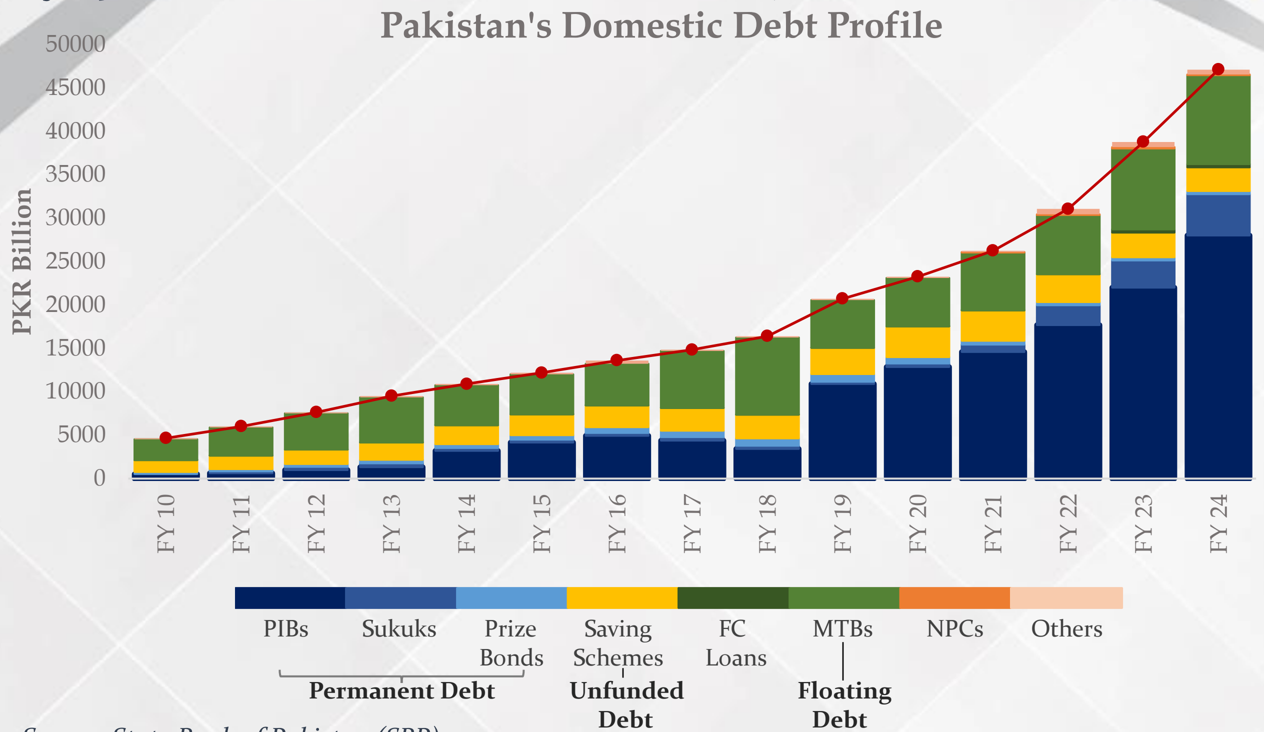
FC = Foreign Currency, NPCs = Naya Pakistan Certificates (NPCs)
Source: State Bank of Pakistan (SBP) and Debt Management Office (DMO)

In FY 24, permanent debt, floating debt, and unfunded debt comprised 71.4%, 21.7%, and 5.9% of Pakistan's domestic debt, respectively. Permanent debt experienced substantial growth, rising from PKR 0.8 trillion in FY10 to PKR 33.7 trillion in FY24, largely due to instruments like Pakistan Investment Bonds (PIBs), Sukuk, and Prize Bonds. Medium- to long-term permanent debt (PIBs and Sukuks) is issued with either fixed or floating coupon rates, providing flexibility in managing interest rate fluctuations. [3]

Conversely, while floating debt—including Treasury Bills (T-Bills)—expanded from PKR 2.4 trillion to PKR 10.2 trillion, its share dropped from 51.5% to 21.7% during FY 10 to FY 24. Unfunded debt, primarily made up of National Savings Schemes (NSS), peaked at PKR 3.7 trillion in FY20 before declining to PKR 2.8 trillion in FY24. Additionally, foreign currency loans and Naya Pakistan Certificates (NPCs) accounted for around 1% of the domestic debt portfolio. Since FY18, the government's domestic debt has surged, climbing from PKR 16.4 trillion to PKR 47.2 trillion by FY24.

[3] https://www.finance.gov.pk/dpco/Debt_Bulletin_Jul_Dec_2022.pdf

Figure 3: Government Domestic Debt in Pakistan (FY2010 – FY2024)

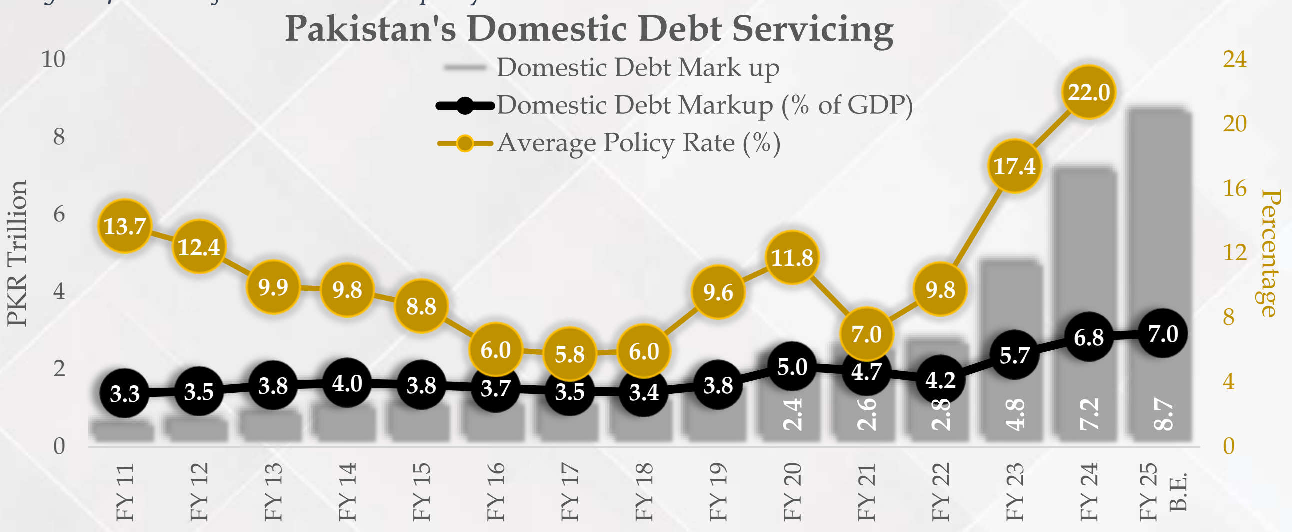


Source: State Bank of Pakistan (SBP)

2.1. Domestic Debt Servicing Costs

Debt repayments have spiraled into a vicious cycle, driven by the reliance on short-term, high-interest loans maturing one after another. Domestic debt servicing now consumes over 80% of the total debt service obligations funded by the budget. Between FY 2011 and FY 2024, Pakistan's domestic debt mark-up expanded at a compound annual growth rate (CAGR) of 20.3%, underscoring significant fiscal pressure. Debt servicing soared from PKR 0.7 trillion in FY 2011 to a projected PKR 8.7 trillion by FY 2025. As a percentage of GDP, this burden has nearly doubled, rising from 3.3% in FY 2011 to 6.8% in FY24 and is projected to be 7.0% in FY 2025. Persistently high domestic policy rates have only intensified the strain.

Figure 4: Trend of Domestic Markup Payments



Source: State Bank of Pakistan (SBP) & Ministry of Finance (MoF)

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2.2. Key Domestic Debt Indicators

The table below highlights a concerning rise in Pakistan's domestic debt from FY10 to FY24, with total domestic debt peaking at 53.8% of GDP in FY20. Additionally, debt servicing costs have surged dramatically, consuming 106.5% of net revenues in FY24, more than double the 42.7% in FY10. This sharp increase in debt servicing severely constrains fiscal space, making it harder for the government to fund development initiatives. The declining share of short-term debt, coupled with persistently high interest rates in the past few years, underscores the need for more sustainable debt management strategies.

Table 1: Magnitude of Domestic Debt-related Risks

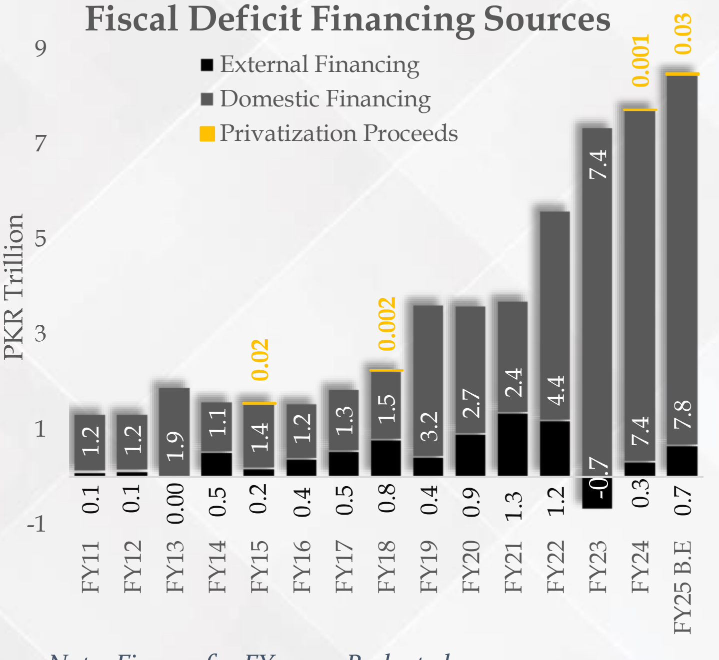
Indicator	FY10	FY15	FY20	FY24
As % of GDP				
Government Domestic Debt	28.2	40.1	49.0	44.7
Public Domestic Debt	30.5	41.6	52.1	46.6
Total Domestic Debt	33.0	43.4	53.8	48.0
As % of Net Revenues				
Domestic Debt Markup Payments	42.7	49.2	76.5	106.5
As % of Government Domestic Debt				
Medium & Long-Term Debt	48.5	62.2	76.0	78.1
Short Term Debt	51.5	37.8	24.0	21.7
NPCs	0.0	0.0	0.0	0.2

NPCs = Naya Pakistan Certificates (NPCs)
Notes: 1. Public Domestic Debt includes Govt. Domestic Debt & PSEs Domestic Debt
2. Total Domestic Debt includes Public Domestic Debt & Commodity Operations
Source: State Bank of Pakistan (SBP) and Federal Budgets

2.3. Growing Reliance on Domestic Debt for Fiscal Deficit Management

While external debt and IMF programs have, regrettably, become the cornerstone of fulfilling Pakistan's external obligations, domestic borrowing is the primary mechanism for addressing the government's fiscal needs. On average, domestic borrowing contributed around 83.6% to the financing required to support the government's budget from FY11 to FY25 which mostly includes bank borrowing (T-bills and Government Securities) and saving schemes. Pakistan's fiscal deficit worsened to 7.4% of GDP in FY 2024 from 7.1% and 7.0% in FY 2022 and FY 2023, respectively; this is higher than the allowed limit of 3.5% under Fiscal Responsibility and Debt Limitation Act (FRDLA, 2005).

Figure 5: Financing Sources of Budget Deficit in Pakistan



Note: Figures for FY25 are Budgeted.
Source: State Bank of Pakistan & Federal Budget FY25

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Figure 5 illustrates the rising dependence on domestic sources over time, underscoring the increasing role of internal borrowing in managing the fiscal deficit. This shift toward domestic funding aligns with the country's medium-term debt strategy, aimed at mitigating external risks associated with exchange rate fluctuations. However, it also calls for a more detailed examination of the specific budget areas where domestic borrowing is allocated to ensure these funds are used efficiently and productively.

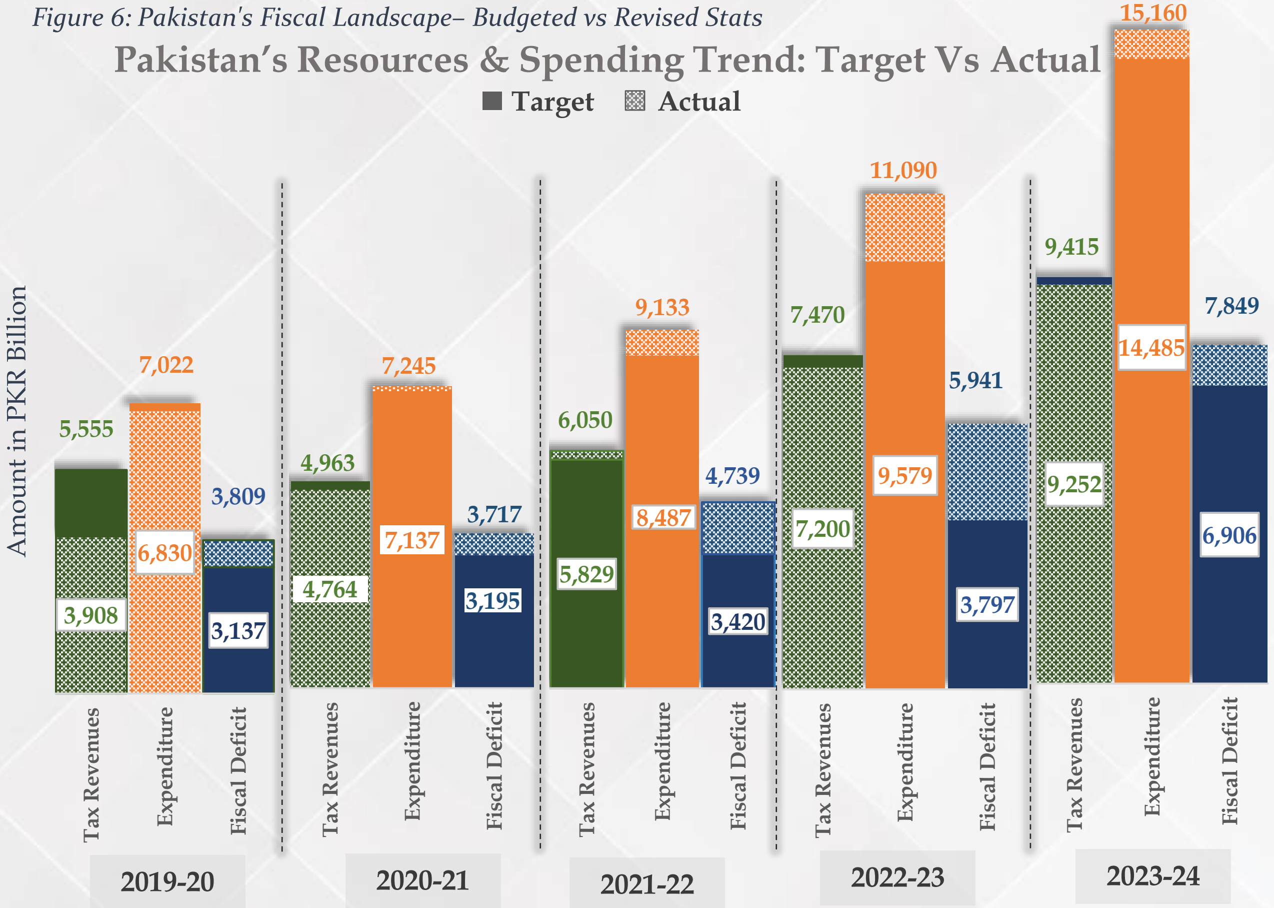
2.4. Drivers of Accumulated Domestic Debt over the years:

While external borrowing is driven by factors like exchange rate fluctuations and an import-dependent economy, domestic debt accumulation arises from rising fiscal deficits, short-term borrowing practices, and insufficient revenue generation. These underlying causes are discussed in more detail below.

a. Persistent Fiscal Imbalances: The Revenue-Expenditure Gap

Pakistan's fiscal management has consistently struggled to align revenue collection with expenditure, as illustrated in the graph below. In FY20, actual revenues were below target, with expenditures slightly lower than expected. Nevertheless, the fiscal deficit exceeded projections. By FY 24, revenue collection had improved, but expenditures continued to surpass forecasts, leading to a persistent fiscal deficit. Even in years where expenditures were under target, these are significantly higher, causing deficits to widen and necessitating further borrowing. These trends underscore the ongoing challenges in managing fiscal imbalances and their role in the accumulation of domestic debt.

Figure 6: Pakistan's Fiscal Landscape– Budgeted vs Revised Stats



Note: Actual Values for 2020-2021 have been taken from Fiscal Operations.
Source: Federal Budget's Various Issues

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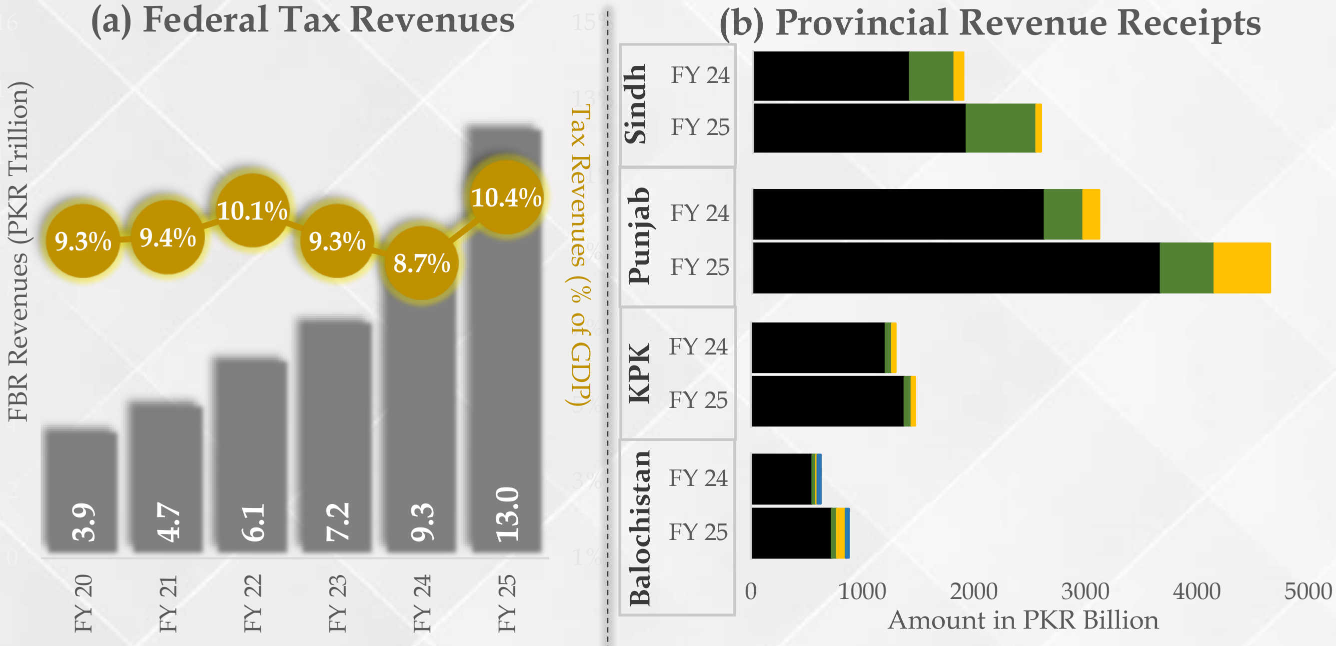
b. Tax Collection Challenges and Inadequate Provincial Efforts

Figure 7(a) illustrates a steady rise in Pakistan's tax revenue, from PKR 3.9 trillion in FY 20 to an estimated PKR 13.0 trillion by FY 25. However, the tax-to-GDP ratio remains well below the World Bank's recommended 15% threshold, fluctuating between 8.7% and 10.4%. This persistent gap highlights critical challenges in revenue mobilization, largely due to insufficient provincial tax collection efforts, especially in under-taxed sectors like agriculture and real estate. At the federal level, tax evasion and frequent exemptions granted in budgets further undermine revenue growth. On the provincial front, the lack of taxation reforms and misaligned tax rates with international standards have further hindered revenue generation. Provinces remain heavily dependent on federal transfers, with negligible contributions from their primary revenue sources, such as agriculture tax income and property taxes, as depicted in Figure 7(b) below. Consequently, the government increasingly relies on domestic borrowing to bridge fiscal deficits, exacerbating the debt burden.

Figure 7: Pakistan's Tax Collection Efforts – Federal & Provincial Revenues



Note: Figures for FY25 are budgeted values.
Source: Federal & Provincial Ministries of Finance

c. Higher Interest Rates and Monetary Tightening

Pakistan's domestic debt has sharply increased over recent years, driven by high policy rates amid rising inflation. The graph (Figure 8) illustrates how the policy rate, intended to control inflation as a contractionary measure, failed to contain price pressures effectively from FY 18 to FY 24.

A disconnect between monetary and fiscal policies has exacerbated these challenges, as high interest rates, have escalated borrowing costs, further inflating the domestic debt burden. By FY 24, both high inflation and policy rates were placing significant strain on fiscal policy. Notably, the Ministry of Finance estimates that every 50 basis point (bps) increase in the policy rate adds approximately PKR 300 billion to domestic debt, underscoring the substantial impact of interest rates on debt levels. [4]

[4] https://www.brecorder.com/news/40266558#:~:text=ISLAMABAD:%20The%20Finance%20Ministry%20has%20disclosed%20that,the%20verge%20of%20collapse%2C%20let%20alone%20growth.

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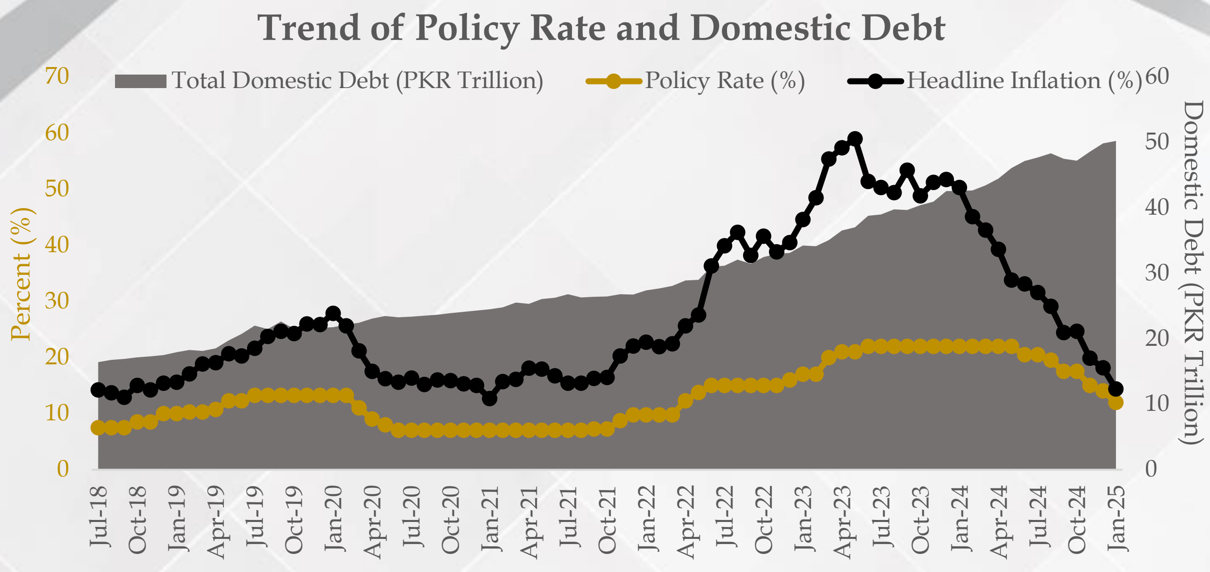
Figure 8: Lack of Coordination between Monetary and Fiscal Policies

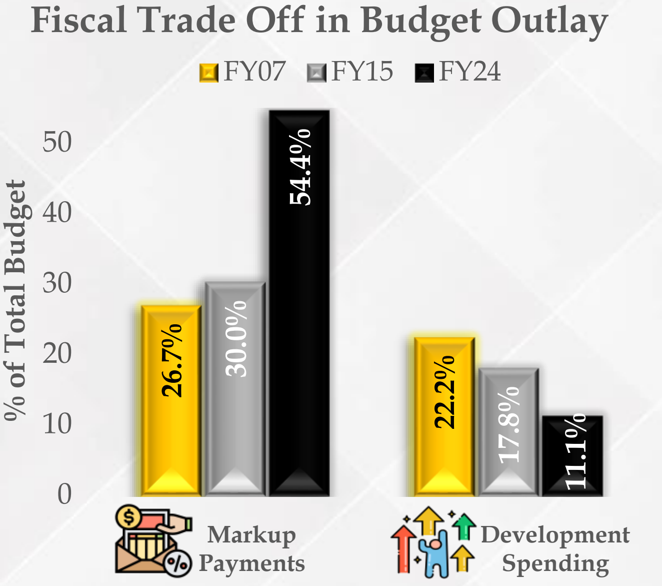


Source: State Bank of Pakistan (SBP) and Ministry of Finance (MoF)

3. Allocation of Borrowed Funds - Fiscal Priorities

Pakistan's budget allocation reveals a strong emphasis on non-development spending, with a significant share consumed by key expenditure areas. The largest portion is dedicated to mark-up payments, which rose from 26.7% to 54.4% of the total budget between FY07 and FY24, reflecting mounting resource strain due to rising debt obligations. This focus on non-productive sectors limits investment in productive sectors and social development, as highlighted by the reduction in development spending from 22.2% in FY 07 to just 11.1% in FY 24 (Figure 9).

Figure 9: Decline in Development Budget over the years



Source: Pakistan Economic Survey and Various Issues of Federal Budget

Table 2 sheds light on other expenditures and their share in the federal budget over the last decade. Defense spending, following markup payments, accounts for 13.0% of current expenditures in FY24, with a CAGR of 11.1% over the past decade. Although subsidies and pensions represent smaller shares, contributing 7.5% and 5.8% to current expenditures (and 7.1% and 5.4% of the total budget, respectively), they are growing rapidly, with CAGRs of 17.9% and 15.8% during FY15 and FY24.

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Table 2: Fiscal Priorities reflecting in Federal Budgets

Budget Heads	Share in Current Expenditures		Share in Total Budget		CAGR (FY15-FY24)
	FY 15	FY 24	FY 15	FY 24	
Markup Payments	36.5%	58.0%	30.0%	54.4%	23.1%
Defense	20.7%	13.0%	17.0%	12.2%	11.1%
Subsidies	7.0%	7.5%	5.7%	7.1%	17.9%
Pension	6.3%	5.8%	5.2%	5.4%	15.8%

Source: Federal Budgets Documents of Various Issues

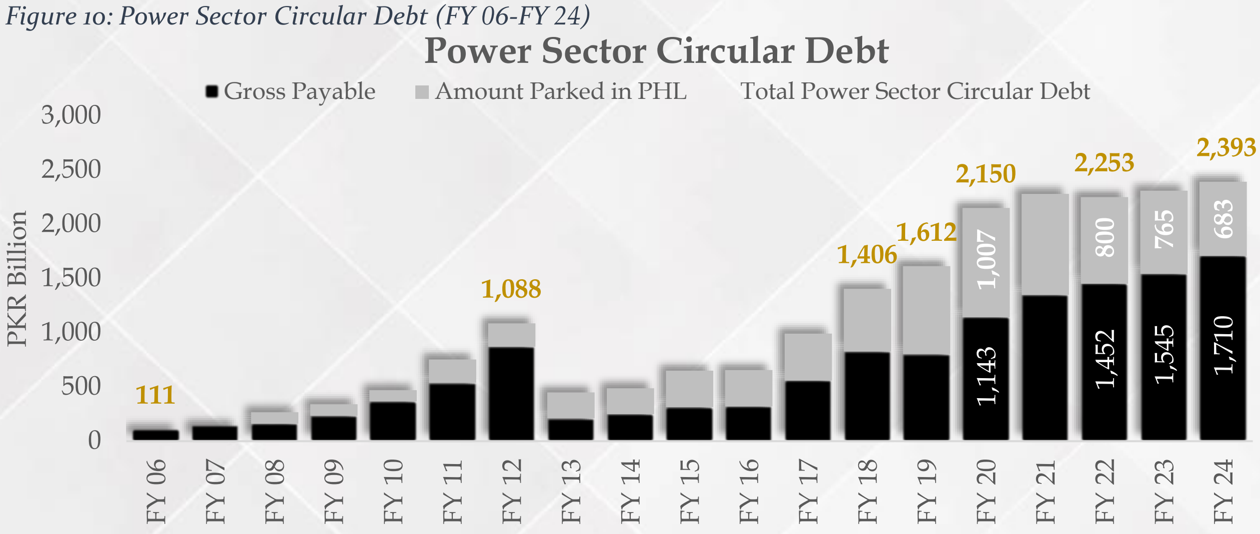
4. Circular Debt

Circular debt in Pakistan's energy sector affects the entire supply chain, from generation to billing, creating financial strain among power producers like GENCOs, IPPs, and distributors such as DISCOs and K-Electric. This debt cycle leads to liquidity crises, undermining operational stability and affecting Pakistan's economic health.

4.1. Power Circular Debt

The escalating circular debt in Pakistan's energy sector reflects a critical financial crisis, with the total debt reaching PKR 2.4 trillion as of FY 2024, up from PKR 1.6 trillion in FY 2019. The power sector circular debt in Pakistan is categorized into Gross Payables and Amount Parked in PHL as shown in the graph below.

Figure 10: Power Sector Circular Debt (FY 06-FY 24)



Note: Gross Payable includes payments payable from GENCOs to fuel suppliers and Payable to Power Producers

Source: PIDE 2024 & Pakistan's Ministry of Energy (Power Division)

Factors Contributing to Circular Debt:

- **Transmission & Distribution (T&D) Losses:** Pakistan's energy sector faces significant 18.31% T&D losses (as per NEPRA Report 2024) due to DISCOS inefficiencies, poor energy infrastructure, and power theft, severely impacting revenue.

[5] https://file.pide.org.pk/pdfpideresearch/wp-2024-2-power-sector-debt-and-pakistans-economy.pdf

- **Delayed Tariff Adjustments & Collection Shortfall:** Delays in adjusting tariffs prevent full cost recovery, creating financial imbalances for distribution companies.
- **Uniform Tariff Policy & Govt. Subsidies:** A uniform tariff across regions for consumers, despite varying costs for DISCOs, results in revenue shortfalls for distribution companies. Regular Government subsidies aimed at recoveries reduce distribution companies' efficiency and increase reliance on state support, worsening debt.
- **Rising IPP Costs and Capacity Inefficiencies:** Between FY 19 and FY 24, IPPs' energy purchase price (EPP) rose by 48.8% and capacity purchase price (CPP) by 211.0%. No adequate audits to assess IPPs' capacity have also contributed to the circular debt.

This escalation in debt highlights the urgent need for reforms in pricing and cost recovery mechanisms to stabilize the energy sector. Table 3 shows the further breakup of changes in the circular debt during the FY 22-FY 24 period.

Table 3: Break-up of Change in Power Sector's CD (FY 2022-FY 2024)

S. No.	Increase / Decrease in Circular Debt (CD) (Amount in PKR Billion)	FY22	FY23	FY24
1	Budgeted but unreleased subsidies	(12)	-	-
2	Unclaimed subsidies	(133)	(70)	(63.00)
3	Interest Charges (PHL + IPPs)	134	143	138.00
4	Pending Generation Cost (QTAs+ FCA)	414	250	145.00
5	Non-Payment by KE	107	(53)	(155.00)
6	DISCO Losses Inefficiency	133	160	276.00
7	DISCO Under recoveries	180	236	315.00
8	Other Adjustments (Prior Year Recovery, etc.)	(285)	(447)	(198.00)
	Sub-total (a)	**536**	**220**	457
	Payment through Fiscal Space			
9	PHL Principal Repayments	(130)	(35)	(82)
10	PHL unpaid markup	-	-	-
11	Stock Payments	(434)	(127)	(292)
	Sub-total (b)	**(564)**	**(162)**	(374)
	Net Increase/Decrease in CD Flow (a+b)	**(27)**	**57**	83

Note: KE = K-Electric, QTA= Quarterly Tariff Adjustments, FCA = Fuel Cost Adjustment, Source: Pakistan's Ministry of Energy (Power Division)

Recent Government Initiatives:

- Renegotiation with IPP agreements to shift from the 'take-or-pay' model to a 'take-and-pay' model, where payments are made only for electricity produced and consumed, unlike the previous system that required payment regardless of demand.
- Approval of Circular Debt Management Plan 2024-25 aims to reduce financial liabilities in the power sector under the IMF program. The plan allows distribution companies to achieve 90% recoveries and line losses up to 17.3%, exceeding NEPRA's 11.4% limit. [6]

[6] https://tribune.com.pk/story/2507469/circular-debt-to-hit-rs243tr-next-year

4.2 Gas Circular Debt

The circular debt in Pakistan's gas sector has nearly doubled, rising from Rs. 350 billion in 2018 to Rs. 650 billion in 2021.[7] Similar to the power sector, T&D (transmission and distribution) losses are a major contributor, leading to high Unaccounted-for Gas (UFG) costs and unpaid Subsidies from the government. OGRA reports that these UFG losses are higher in Pakistan than in other developing nations (SBP, 2024). Beyond these, following key issues drive this rising gas circular debt.

- **The absence of gas price increases** from 2013 to 2017, despite rising production costs, led to unfunded subsidies and significant revenue shortfalls. Despite recent price adjustments under the Government's pricing policies since FY2019, the increase is insufficient to fill the gap.
- **Misclassification of Liquefied Natural Gas (LNG) as petrol** instead of including it in the gas basket for calculating the weighted average cost of gas (WACOG).[8] This misclassification has hindered effective cost recovery, making RLNG prices significantly higher than those of locally produced gas.
- **Cross Subsidization and Diversion of RLPG to Consumers:** In Pakistan, residential and agricultural sectors benefit from significantly subsidized energy rates, unlike the commercial and industrial sectors, which bear higher costs. Compared to other lower-middle-income countries, Pakistan's extensive subsidies impose greater financial pressure on public finances and energy providers.

Rising debt has increasingly strained upstream companies like OGDCL, and PPL, and suppliers such as PSO, inflating their receivables and weakening their ability to invest, expand, and meet foreign obligations. Although the Weighted Average Cost of Gas (WACOG) law was passed in 2022 to address pricing disparities by incorporating RLNG costs, its implementation has been delayed for over two and a half years, perpetuating the circular debt cycle in the gas sector.

4.3. Commodity Circular Debt

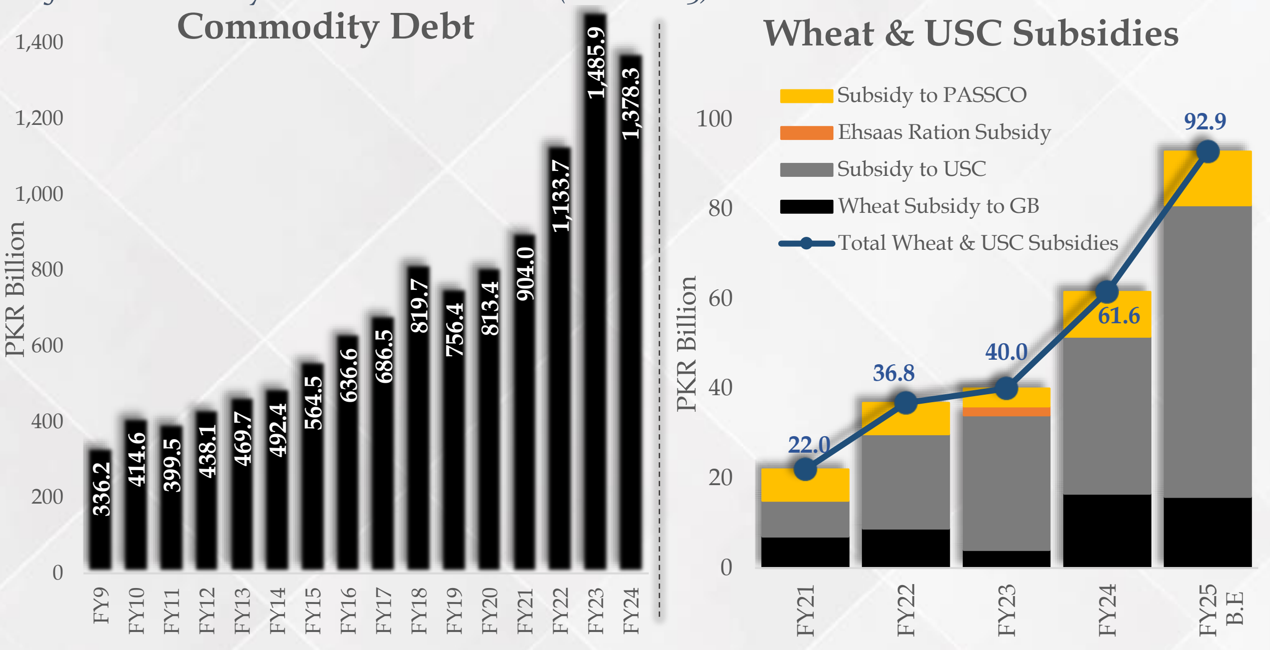
Pakistan's commodity operations debt has shown a consistent increase from PKR 336.2 billion in FY09 to a peak of PKR 1,485.9 billion in FY23, before slightly declining to PKR 1,378.3 billion in FY24 due to partial federal payments (SBP). This debt growth, driven by a growing population and stagnant productivity, has been exacerbated by provincial governments' inability to retire loans due to unpaid federal subsidies.

A significant share of this debt is linked to circular debt from wheat procurement, as wheat accounts for 72% of Pakistan's food basket. According to an estimate (PIDE, 2024), circular debt from wheat procurement alone amounts to Rs. 906.7 billion, of which Rs. 680 Bn stems from Punjab.[9] According to the Punjab Government, Punjab contributing 75% of local wheat production, faced a wheat-related debt of Rs. 629 billion by FY22, projected to rise to Rs. 940 billion by Q4FY23 and Rs. 1,150 billion by Q4FY24, representing over 50% of government revenues. Despite provincial government purchases to ensure farmer

[7] https://www.finance.gov.pk/survey/chapter_22/PES14-ENERGY.pdf
[8] https://www.brecorder.com/news/40312514#:~:text=Circular%20debt%20in%20the%20gas,which%20includes%20theft%20and%20leakages.
[9] https://pide.org.pk/research/the-cost-of-government-interference-in-agricultural-markets/

profits, the support often fails to reach them effectively, resulting in additional subsidies in the form of donations and support at Utility Stores Corporation (USC) outlets for deserving people. Figure 11 shows a steady increase in wheat and USC subsidies from FY21 to FY25, with the most notable growth between FY23 and FY25.

Figure 11: Commodity debt and wheat subsidies (FY 09-FY 25)



Source: State Bank of Pakistan (SBP) and Various Issues of Federal Budget

5. Fiscal Risk Exposure through Government Guarantees

According to the Federal Budget 2024-25, the government's outstanding guarantees on behalf of Public Sector Enterprises (PSEs) have risen significantly over the years, reaching PKR 3.5 trillion in FY24 (as of March 2024), driven mainly by the power sector, which remains the largest contributor to fiscal risk. Guarantees linked to commodity operations are excluded from this limit. These guarantees (domestic and external) help PSEs obtain loans on more favorable terms and are sometimes required for concessional financing from international agencies. This increasing trend underscores the need for a robust framework to manage public sector obligations and mitigate fiscal exposure.

The Fiscal Responsibility and Debt Limitation (FRDL) Amendment Act 2005 sets an annual cap for new government guarantees, including rollovers, at 2% of GDP (flow ceiling), with the total guarantee stock capped at 10% of GDP (stock ceiling). Federal government exposure to SOEs, in the form of outstanding stock of these guarantees, stood at 3.3% of GDP in March FY24. These guarantees are not initially included in Pakistan's total debt statistics, which stood at 80.9% of GDP in FY24. However, if these guarantees are accounted for, the debt level increases significantly to 84.2% of GDP in FY24.

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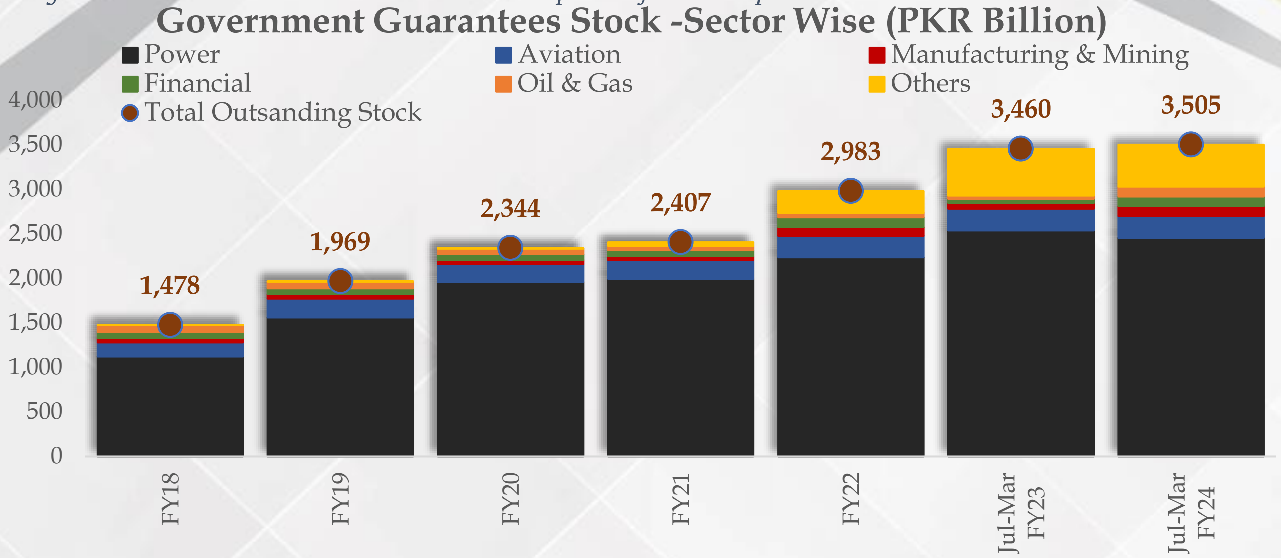
Figure 12: Sector-Wise Public Guarantees – Snapshot of Fiscal Exposure



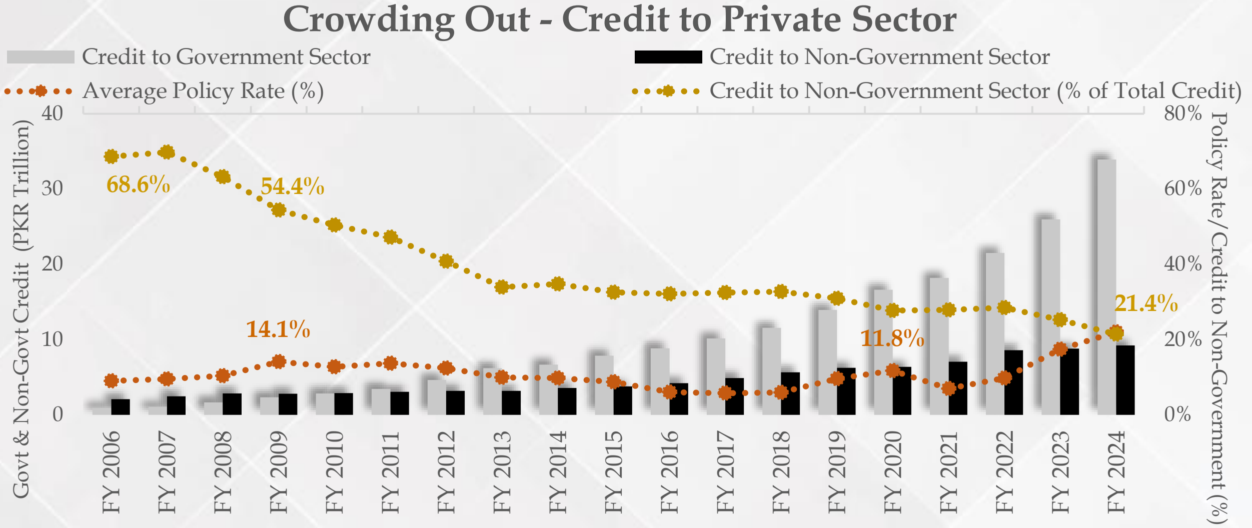
Note: The graph above includes both domestic and external guarantees.
Source: Fiscal Risk Statement FY23-24 and Federal Budget FY24-25

6. The Trade-Off between Domestic Borrowing and Private Sector Credit

Pakistan has been facing inflationary pressures in the recent past and has implemented contractionary monetary policies, especially in FY24, leading to higher domestic debt servicing costs and an increased domestic debt stock, which has further widened budget deficits. With domestic mark-up payments rising to 6.8% of GDP in FY24 and limited external financing options, the government has resorted to extensive domestic borrowing to fund its deficit. The share of credit to the non-government sector dropped significantly from 28.5% to 21.4% between June 2022 and June 2024.

In FY24, Pakistan's monetary tightening reached a peak with a policy rate of 22%, a sharp decline in the non-government sector's share of total credit can be witnessed, dropping from 68.6% in FY06 to just 21.4% in FY24.

Figure 13: Borrowings from Banks in Pakistan (FY 2006-FY 2024)



Source: State Bank of Pakistan (SBP) and Authors' Estimates

7. Alternate Debt Solutions: Lessons from Global Practices

7.1. Debt to Equity Swap Approach

Debt-to-equity swaps have been widely used by developing countries to manage sovereign debt by converting it into ownership stakes through privatization, stock investment, or direct investment (IMF,1994).[10] According to World Bank, Argentina initiated debt-to-equity programs in the 1990s privatizing major public assets such as its national phone company and airline.[11] Following its 2001 default, Argentina launched additional swap programs, allowing creditors to gain stakes in public assets. Recently, Argentina also employed debt swaps for domestic debt management, reducing approximately 7.4 trillion pesos ($30 billion).

Similarly, China launched a debt-for-equity swap program in 1999, to address high corporate debt, especially in state-owned enterprises (SOEs).[12] The government set up four asset management companies (AMCs) to absorb roughly $60 billion of non-performing loans from major state-owned banks. These AMCs converted these debts into equity in struggling SOEs, allowing banks to clear bad debts off their balance sheets, aimed to restructure these SOEs, holding the equity for about 10 years with the goal of eventual sale and recovery.

7.2. Islamic Financing Models

Islamic and even some Western countries are increasingly adopting interest-free financing alternatives for their increasing expenditures. Malaysia, a global leader in Islamic finance, frequently issues Sukuk bonds to fund public infrastructure, energy, healthcare, and green projects like water management. By 2023, the Government Investment Issue (MGII)—long-term, Murabaha-based, interest-free securities—constituted 40% of Malaysia's total Islamic bonds. [13] Similarly, Indonesia has pioneered the use of Cash Waqf-linked Sukuks since 2020 to finance social assistance and disaster-resilience initiatives, alongside Project-Based Sukuks primarily funding infrastructure development projects linked with project revenues.

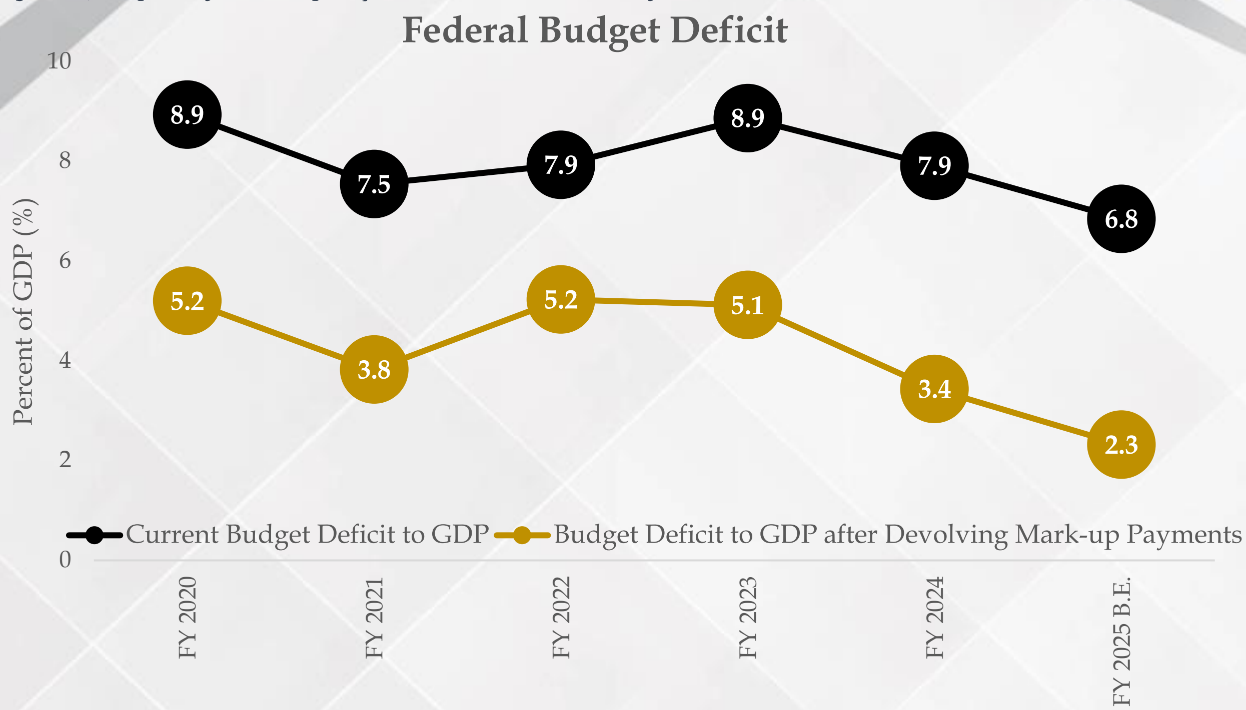
Pakistan can draw lessons from these models to align with its recent constitutional amendments, shifting to riba-free and Islamic revenue-sharing mechanisms for development projects. With an estimated PKR 300-400 Billion potential in revenue-generating projects, Pakistan can effectively finance these initiatives through revenue-sharing Sukuks.

8. Fiscal Decentralization: An Approach to Alleviate Debt Burden

The net revenue receipts of the Federal Government are insufficient to cover debt servicing, with mark-up payments budgeted for FY2025 amounting to around 106.5% of net federal revenues. This leaves the government with minimal fiscal space for expenditures without resorting to further borrowing. Since public debt management is included in the Federal Legislative List Part II, sharing the burden of mark-up payments with provinces based

[10] https://www.elibrary.imf.org/display/book/9781557753069/ch006.xml#:~:text=The%20debt%2Dequity%20swap%20is,holding%20debt%20has%20three%20choices.
[11] https://documents1.worldbank.org/curated/zh/687431478251632624/pdf/109387-BRI-WBG-PUBLIC-date-04-01-1993-Equity-Swaps.pdf
[12] https://www.piie.com/blogs/china-economic-watch/tracking-chinas-debt-equity-swap-program-great-cry-and-little-wool
[13] http://www.xinhuanet.com/english/2018-07/23/c_137342760.htm

Figure 14: Impact of Mark-Up Payments Devolution on Deficit to GDP Ratio



Note: FY21 estimates are based on budgeted values instead of revised figures due to the unavailability of fiscal deficit data in the Federal Budget Document FY2021-22.
Source: Various Issues of Federal Budget and Authors' Calculation

on the 7th NFC formula could significantly reduce the federal deficit-to-GDP ratio by nearly two-thirds (as illustrated in the figure above), potentially alleviating the country's ongoing fiscal pressures and reducing the risk of default.

10. Conclusion

Pakistan's rising domestic debt has become a significant challenge to the country's fiscal stability. The growing debt burden, driven by increasing debt servicing costs and inefficiencies in key sectors like power, demands urgent attention and strategic reforms. Addressing these issues will require a comprehensive approach, including expanding the tax base, prioritizing long-term borrowing over short-term measures, and implementing structural reforms in sectors like energy. Improved fiscal management and more accurate forecasting are essential for stabilizing the economy and reducing fiscal pressures. Merely employing the monetary policy (policy rate cuts) will not suffice in mitigating the higher borrowing costs, signaling the necessity for more comprehensive measures to effectively address Pakistan's fiscal challenges. Effective implementation of these measures will be crucial for achieving sustainable growth and preventing further escalation of the debt burden.