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PAKISTAN: DOWNGRADE FROM CATEGORY 6/7 TO 7/7 FOR MLT POLITICAL RISK

23/03/2023

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Highlights

- Pakistan finds itself in an acute political, financial and socioeconomic crisis.
- Successive large shocks have been fatal for Pakistan's economy, plunging it into a balance of payments crisis.
- Shortages of foreign currency and basic goods, along with heavy post-flooding reconstruction costs, have forced Islamabad to seek significant external support.
- Pakistan is on the verge of sovereign debt default amid poor liquidity and unsustainable public finances, which will require bailout and debt restructuring.
- Credendo has downgraded Pakistan's MLT political risk rating to 7/7.

Pros

- Economic and financial support from close ally China
- Ample workers' remittances from the Gulf

Cons

- Unsustainable public finances
- High external financial needs
- Vulnerable to costly energy imports
- Frequent political instability

Head of State

- President Arif Alvi

Head of Government

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Population

- 225.2 million

GDP per capita

- USD 1,500

Income group

- Lower-middle

Main export products

- Private transfers (51% of total current account receipts), manufactured goods (33%), food (7.6%), IT services (3.8%)

Pakistan faces a high risk of debt default in 2023

Pakistan is in the middle of a multi-crisis situation – economic, financial, social and political – which has been worsening each month and might result in sovereign debt default. Pakistan won't be able to exit the vicious debt trap of IMF bailouts and new foreign loans without deep reforms and significant financial support, including public debt restructuring, because the challenges have simply become too high to overcome alone and in a sustainable way. A further request for IMF support is likely at some point after the 2023 elections. Looking back over Pakistan's recent history, exacerbated by the succession of some highly unfortunate large shocks, this outcome is inevitable. Pakistan does indeed have a long history of IMF loans and bailouts, and the current three-year programme (its 23rd since 1950), started in July 2019 according to the same terms as previous programmes, with the aim of repairing large balance of payments imbalances and poor public finances, and generating more foreign exchange reserves. This support highlights structural weaknesses such as high dependence

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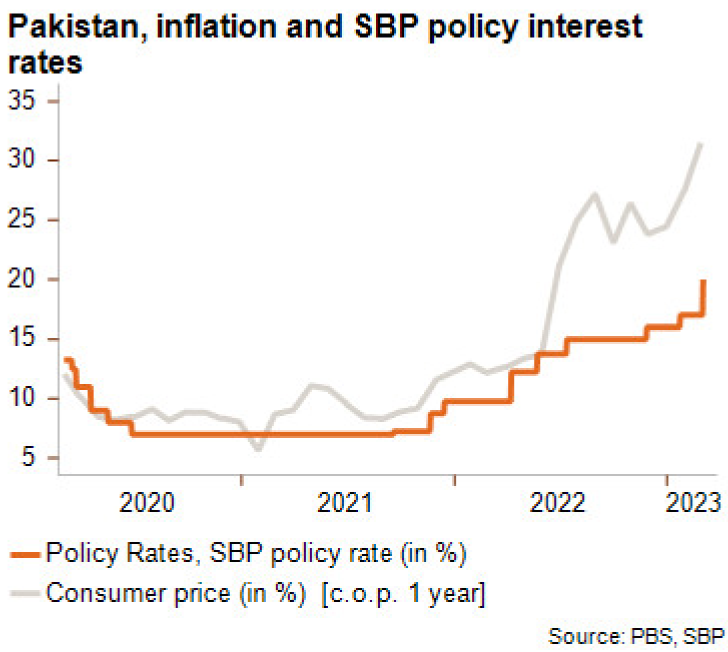
A balance of payments crisis after a succession of large shocks

Following the shock of Covid-19 in 2020-2021, Pakistan's weakened economy was hit hard by the fallout from the war in Ukraine in 2022.



High inflation (31.5% in February, i.e. lower only than Sri Lanka and Laos in Asia; see above graph showing the evolution of consumer price and the central bank's interest rates) and a soaring current account deficit (from 0.9% to 4.7% of GDP between FY21 and FY22, see below graph), driven by more expensive food and fuel imports, were the two most evident consequences. Pakistan is very dependent on energy imports (more than 25% of imports of goods) and wheat imports, and thus has been impacted by higher prices resulting from the conflict in Ukraine. This is particularly apparent as the Pakistani rupee has been trading at a historic low against the US dollar, which has made those essential imports much more expensive in local currency – thus fuelling inflation.

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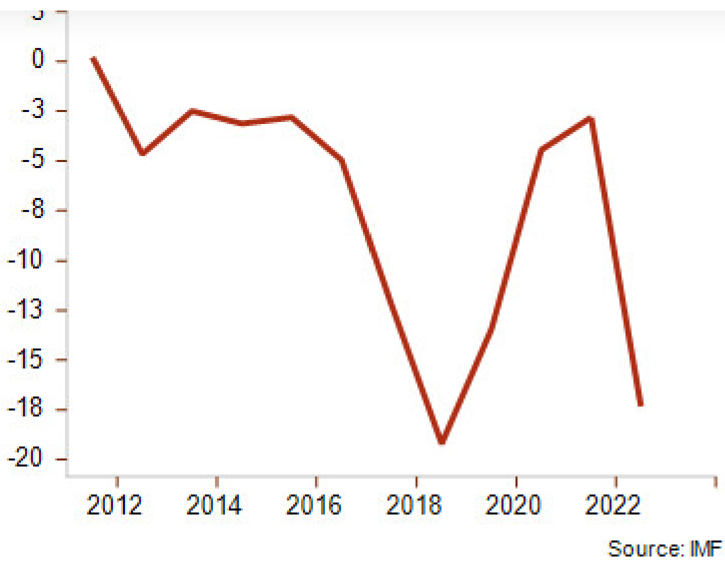
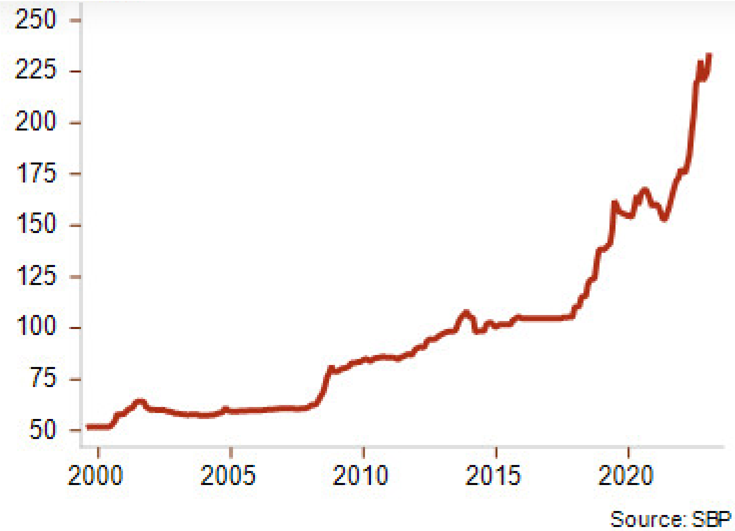


The balance of payments crisis – despite record remittances from the Gulf on which Pakistan is reliant for about half of its current account receipts – has exacerbated the social dimension of the economic crisis, with unrest driven by the high cost of living and shortages of basic goods. As a result, external liquidity has been on a constant depleting trend since autumn 2021, which has gradually affected import payments and led to sharp import restrictions (including fuel) and sizeable power cuts.

Urgent need of external financial support

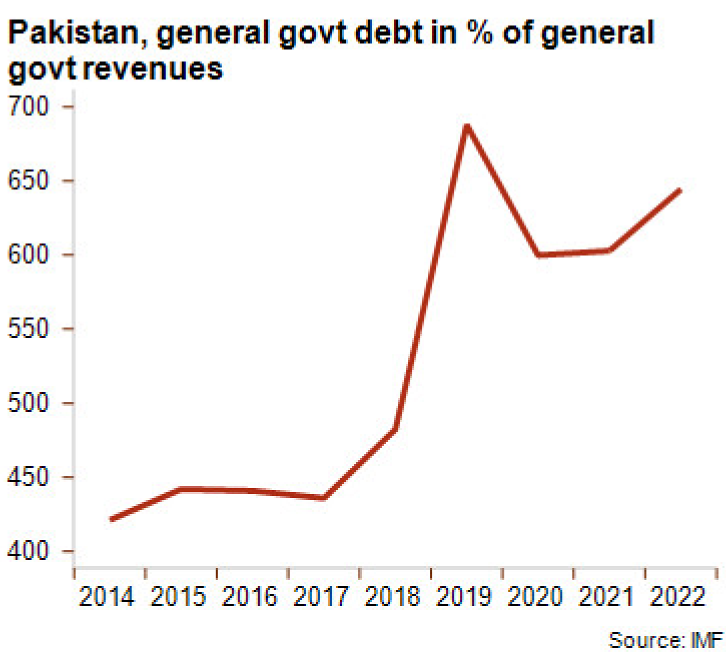
Within this very difficult economic context, record monsoon floods in summer 2022 devastated one third of the territory, affecting infrastructure and key exports such as agricultural crops and cotton used for textiles. This was a fatal blow for Pakistan's economy, taking it from a precarious to an inextricable situation. With a struggling economy – potentially contracting this FY23 – and existing difficulties in financing imports due to dwindling liquidity, the authorities cannot afford to finance the estimated USD 30 billion of reconstruction costs. Therefore, international donors pledged to donate about USD 10 billion, China and MENA partners committed to alleviate financial strains through various forms of support and the IMF programme resumed in August – allowing for an immediate disbursement – and was extended until June 2023. However, this broad support will not help prevent financial hardship. Meanwhile, the authorities are trying to secure another IMF loan tranche. At the end of January, they liberalised the exchange rate of the Pakistani rupee, leading to a sharp 14% depreciation against the US dollar, and then cut fuel subsidies and decided on extra tax increases.



Those measures, combined with rising goods shortages, might further increase inflation and policy interest rates (raised to 20% on 2 March, still well below inflation).

Public finances are unsustainable

Even if Islamabad is actively exploiting all available options to buy time, Pakistan is on the verge of a sovereign debt default. Its public finances are extremely weak, with public debt (77.8% of GDP) having reached nearly 650% of government revenues in FY22 (see the graph below) and interest payments culminating at around 40% of government revenues (the world's third highest level after Sri Lanka and Ghana). In other terms, public debt and interest charges, swollen by interest rate increases, are too heavy and government revenues are too low. This has become unbearable in the medium to long term (MLT), without drastic reforms and a large debt relief to put public debt on a sustainable path.



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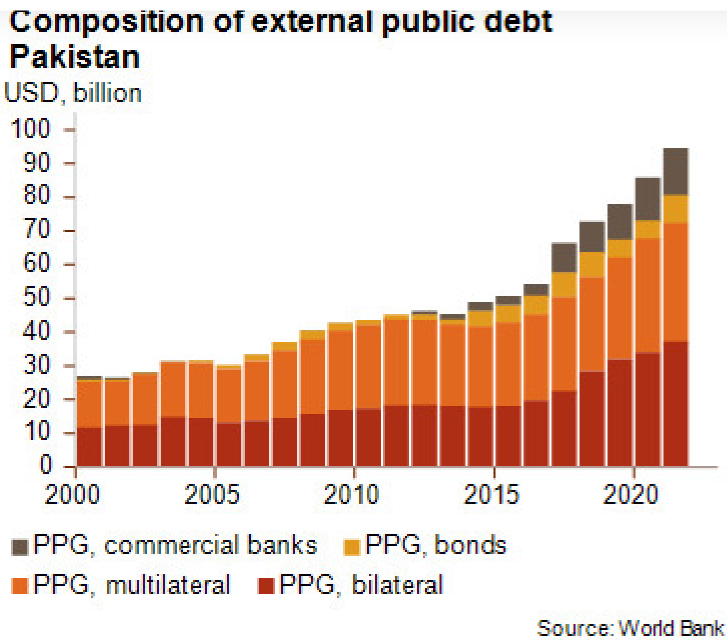
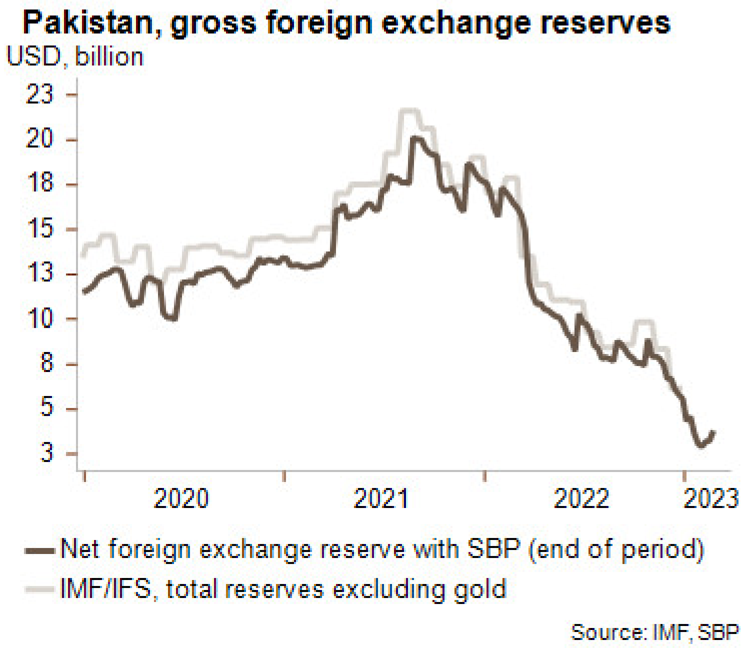


Over the past few months, the risk of debt default has increased due to a challenging debt service well above low foreign-exchange reserves and to high interest rates. Islamabad's hope lies in external support from two key players: the IMF and China. A large IMF bailout is not realistic in the near term given the challenging political situation, while austerity measures are likely to trigger an escalation of social unrest and business disruption, increasing the already high levels of political uncertainty and instability. Any bailout would have to be combined with a public debt restructuring that would affect domestic (the banking sector) and external creditors. As for China's assistance and given the huge amounts at stake, the approach of Pakistan's largest bilateral creditor, with an 80% share, has remained unchanged to date and is sticking to its usual tools of additional loans, foreign direct investment (FDI) and debt rollover or debt maturity extension. Moreover, in the foreseeable future, Islamabad cannot count on any export boost to reverse the liquidity depletion after the severe flooding that harmed economic activity and structures. Of course, multilateral institutions, China and the USA won't let Pakistan down given the necessity to stabilise this large nuclearised and strategic country in the region, but ensuring MLT public debt sustainability will require more than new external loans and debt maturity extensions. This is further emphasised given how climate change is darkening the long-term outlook. In the future, unless precise and broad adjustments are made, a repetition of extreme natural disasters like the floods of 2022 risks making Pakistan's economy structurally fully reliant on external financial support.

Challenging debt repayments amid a deep liquidity crisis

Except in FY21 and FY22, external debt – predominantly public – has been on a constant upward trend since 2016, driven by Chinese loans and new government borrowing to meet rising external financing needs. In FY23, after having obtained new external loans, ratios are expected to rise again. The jump in external debt from 2016 to 2020 was a result of the huge (USD 65 billion) China-Pakistan Economic Corridor, the flagship of China's Belt and Road Initiative (BRI). Consequently, in just a few years, China became Pakistan's dominant creditor, representing 30% of total external debt. Pakistan's ample external financing needs surged after the economy was hit hard by multiple shocks, and the country received temporary relief in imports, and the situation has worsened since then.



This steady depletion has led to foreign currency shortages, thereby leading the authorities to prioritise access for imports of basic goods. With a strong US dollar and high energy prices weighting on fuel imports, large reconstruction costs requiring high imports of (capital) goods and high debt repayments ahead clouding the country's solvency, liquidity will remain under pressure and in crisis. Those risks could be exacerbated during potential public debt restructuring talks taking place in a politically unstable context. In the meantime, support will come from multilateral institutions, firstly the Asian Development Bank (ADB), and bilateral creditors, whereas commercial borrowing is no longer considered due to prohibitive long-term government bond yields (at 15%). A bailout and public debt restructuring, which would help improve Pakistan's MLT public debt sustainability, are not on the table yet but it's probably just a question of time. Therefore, Credendo downgraded Pakistan's MLT political risk to 7/7.

Escalation of political instability and security risks

The domestic political situation is very strained. Parliament's decision to oust the popular former PM Imran Khan from power in April 2021, as well as the latter's rallies to call for snap elections, and the population being hit by a sharp increase in the cost of living and various shortages of basic goods have all led to frequent and mass anti-government protests. Although PM Sharif has so far resisted those pressures, Khan might win the next elections, though this would likely be against the backdrop of an even worse and more challenging socioeconomic environment. It remains to be seen how the powerful army will react to this potential outcome given their soured bilateral relations. Looking ahead, recurrent economic difficulties and political tensions will continue to fuel political instability.

The overall domestic environment is complicated by internal security risks, which have once again become a central concern for Islamabad. Since the Taliban's return to power in Afghanistan in 2021, political violence has increased sharply with rising terrorist attacks from long talks with the government failed to produce any outcome. The recent terrorist attack – the worst in years – targeting security forces in the northern city of Peshawar, showed the heightened risks of a resumed full insurgency from the TPP. There is therefore a fear of returning to the instability of the 2010s, when the Islamist insurgency was only defeated in 2016 after a major military operation. This being said, Khan's re-election might pave the way to renewed negotiations with the TPP and a potential peace deal, for example one that includes a broader implementation of Sharia law, which could reduce political violence. This prospect is nevertheless clouded by the army's resistance to a deal with the TPP and its resolve to fight TPP militants sheltering in Afghanistan.

Closing ties with large powers

While relations with Afghanistan have deteriorated, they have stabilised with India, which can be explained by Pakistan's other current priorities. However, this could fall apart at any time in the future due to permanent conflictual issues, particularly concerning Kashmir and water access. On the positive side for Pakistan, the country continues to rely closely on China, its strong ally. Moreover, given the strained relations with Kabul, Islamabad has been benefiting from improved transactional ties with the USA – explained by Pakistan's dire financial situation – which, even after a chaotic withdrawal from Afghanistan, remains active in the region. This can be explained by the security and geopolitical context, as – given its status as a nuclear-weapon state – Pakistan is of strategic importance in Asia in the process of building a new world order.

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