Euler Hermes Economic Research

Country Report

Pakistan

Politically and economically vulnerable

General Information

GDP	USD231.182bn (World ranking 44, World Bank 2012)
Population	179.16 million (World ranking 6, World Bank 2012)
Form of state	Federal Republic
Head of government	Mohammad Nawaz SHARIF
Next elections	2018, presidential

Strengths

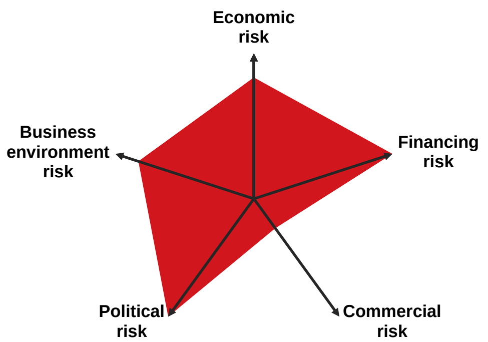
- Large domestic market
- Despite often strained relations, support remains available from the US and multilateral agencies (IMF)
- Improved relations with India
- Strong hard currency remittances

Weaknesses

- Susceptibility to natural disasters and dependence on rain-fed agriculture
- More frequent protests since the summer 2014
- Poor domestic and regional security (border with Afghanistan)
- Low per capita income and high poverty levels
- Large fiscal and trade account deficits
- Weak business environment

Country Rating

D4



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
United States	13%	1	23%	China
China	11%	2	12%	Saudi Arabia
United Arab Emirates	9%	3	12%	United Arab Emirates
Afghanistan	8%	4	6%	Kuwait
United Kingdom	4%	5	4%	Malaysia

By product (% of total)

Exports		Rank		Imports
Yarns Fabrics	20%	1	20%	Refined Petroleum Products
Carpets	12%	2	11%	Crude Oil
Cereals	8%	3	5%	Fats
Clothing	7%	4	5%	Yarns Fabrics
Knitwear	7%	5	4%	Basic Organic Chemicals

Source: Chelem (2012)

Continued low growth in 2014

GDP growth averaged 3.8% over the past 10 years, well below what is needed to provide for jobs and reduce poverty. Growth is hampered by security concerns, a difficult business environment with intermittent power supplies and a highly regulated market. Moreover, frequent protests against the Prime minister were held this summer in Islamabad and tensions are still high. This raises concerns as the country is prone to military coups, with three successful coups (and many more attempts) since 1958.

Private sector credit shows encouraging signs, accelerating by +11% y/y in July 2014 (compared to +1.4% y/y one year earlier). Domestic demand is expected to strengthen during the next fiscal year but remain constrained by the ongoing structural reforms and fiscal adjustment.

In FY2014 (from July 2013 to June 2014), GDP is estimated to remain below the long-term trend, of 3.8% reaching +3.5% in FY2014, before picking-up slightly to 4.0% in FY2015 benefitting from the rise in global demand and more credible macroeconomic policies such as more fiscal discipline and cautious monetary stance.

A cautious monetary stance to curb inflationary pressures

Monetary policy framework is improving. The State Bank of Pakistan is studying adopting an inflation targeting framework and its independence should be reinforced in the medium term. Inflationary pressures have receded in FY2014 following monetary tightening. Inflation rose to +10.9% y/y in November 2013 from +9% y/y one month earlier, this led the central bank to hike its policy rate from 9.5% to 10%. Inflation is expected to decelerate in FY2015 to +8.2% (from +8.8% in FY2014) with positive real interest rates indeed to encourage macro stability, capital inflows and higher savings.

Poor public finances

Thanks to the implementation of important fiscal reforms, the fiscal deficit reached -5.3% of GDP in FY2014 from -7.8% in FY2013. Pakistan's expenditures (21% of GDP in FY2014) are mostly devoted to debt servicing (33%), the military (18%) and subsidies on oil and gas (approximately 10%). On the revenue side (13% of GDP), only 1% of the population pays taxes and the hidden economy is widespread.

Bold measures to limit the fiscal deficit have been announced by the government in its FY2015 budget: (i) only 0.6% of GDP has been allocated to power subsidies in the new budget, compared to 1.2% of GDP in FY2014 budget; (ii) to increase revenue the government plans to expand the tax-base, mainly through eliminating tax-exemptions and concessions; (iii) several state-owned enterprises should be privatized, reducing the fiscal drag as the government had largely supported them through subsidies and loan guarantees. The IMF program assumes that the fiscal adjustment will bring the fiscal deficit to -3.5% of GDP in FY2015 and FY2016.

Gross debt reached 63% of GDP in FY2013 (IMF definition) and is expected to remain elevated in the coming years. Approximately 23% of this debt is financed externally.

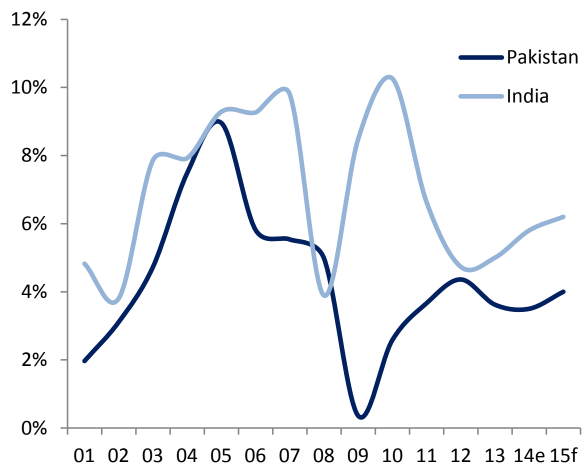
Key economic forecasts

	FY12*	FY13	FY14e	FY15f
GDP growth (% change)	4.4	3.6	3.5	4.0
Inflation (year average)	11.0	7.4	8.8	8.2
Fiscal balance (% of GDP)	-8.4	-7.8	-5.3	4.2
Public debt (% of GDP)	63.8	63.1	63.7	62.4
Current account (% of GDP)	-2.1	-1.0	-0.9	-1.0
External debt (% of GDP)	28.8	26.8	26.7	27.3

*Fiscal years run from July to June. For example FY2012 runs from July 2011 to June 2012

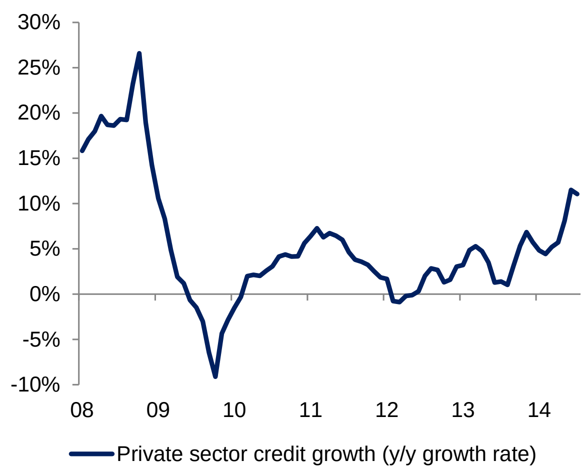
Sources: National sources, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Credit to the private sector (y/y)



Sources: National sources, IHS, Euler Hermes

High remittances inflows mitigate the large trade deficit

Pakistan relies heavily on petroleum and oil products (one third of total imports) and is thus subject to oil prices volatility. Pakistan's export side are mostly primary products, with the textile industry (yarns, carpets, knitwear...) accounting for approximately 50% of total exports. The trade deficit is expected to widen in FY2014 to approximately -8% of GDP (from -7.5% of GDP in FY2013). This large trade deficit is however compensated by strong remittances inflows (circa USD15 bn in FY2014). The current account deficit is thus estimated at -0.9% of GDP for FY2014 (from 1% of GDP in FY2013). Understandably, FDI inflows are still weak and account for only 0.5% of GDP in FY2014.

Foreign exchange reserves are recovering but are still low

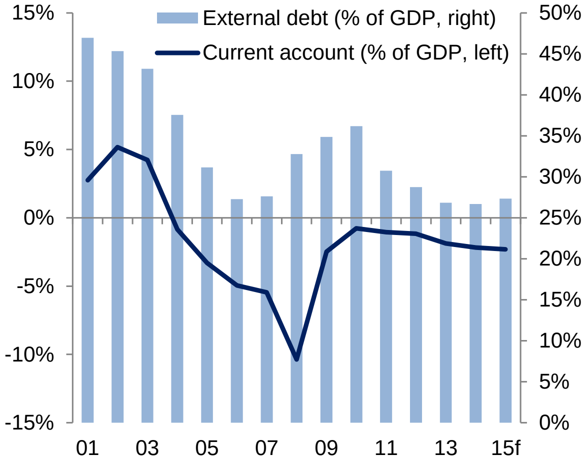
The IMF approved a USD6.6 bn three-year extended fund-facility in September 2013 to support Pakistani's external position. The repayment period will only start in 2018 and last until 2023, at a 3% interest rate. Important debt service continues to be a drag on Pakistan's fiscal deficit as it covers circa 25% of exports of goods and services in FY2014.

Better monetary management has seen foreign reserves recover. In January 2014, reserves reached USD4.7 bn (covering approximately 1 month of imports) but reserves have more than doubled to USD10.8 bn (covering 2.5 months of imports). This level remains very weak and requires further progress. We view acceptable import cover as above 3 months and risk of balance of payment crisis should not be overruled. Foreign reserves have seen plenty of volatility in the past decade and we would be more comfortable with a greater buffer and stability coupled with improvement.

Political outlook re main fragile

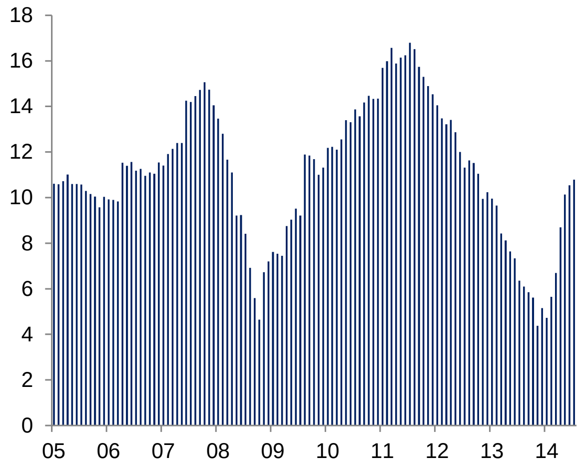
Although in 2013 Pakistan experienced for the first time a handover from one civilian administration to another following a full term in office, political stability remains fragile. Civilian governments to date have been characterised by fractious personality-based politics and by corruption scandals and PM Nawaz Sharif government is currently facing frequent protests. Until now, the strong military has refrained from direct involvement in government but remains a key source of power and the risk of military coup has not entirely disappeared. Stability and security are also constrained by regional and terrorist factors, with neighbouring Afghanistan and India maintaining the potential for conflict.

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves (USD bn)



Sources: National sources, IHS, Euler Hermes

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