PAKISTAN

DEFAULT RISK REMAINS VERY HIGH

Over the past twelve months, the economic situation in Pakistan has deteriorated dramatically. The government has been facing a balance-of-payments crisis and, as a result, has had to take extensive measures to try to contain the drop in its foreign exchange reserves and fulfil the IMF's requirements in order to receive the funds needed to avoid defaulting on its external debt. Restrictions on imports, the sharp rise in policy rates, the depreciation of the rupee and the dramatic cut in budget spending have significantly hindered economic growth and triggered a very sharp rise in inflationary pressures. Since February 2023, the external position has improved very slightly. However, it is still very fragile and the default risk remains very high.

A VERY HIGH EXTERNAL REFINANCING RISK

Pakistan's external accounts, which are structurally very weak, have deteriorated significantly over the past 18 months, leaving the country on the brink of a balance-of-payments crisis. By late March 2023, its external liquidity had stabilised, but the country's refinancing risks were still very high.

Pakistan is vulnerable to the external environment. It relies on loans provided by bilateral and multilateral creditors to cover its significant external financing needs. Its current account deficit is structurally far too high (3.1% of GDP over the 2017-2021 period) compared to its foreign direct investment (FDI), which nowhere near cover it, with FDI only standing at 0.7% of GDP on average over the last five years. Furthermore, the short-term external-debt repayments are structurally much higher than the foreign exchange reserves.

Structurally weak, external accounts have weakened further due to the unfavourable external environment. As early as mid-2021, the country's external accounts started to deteriorate as a result of i) the sharp increase in imports caused by the economic recovery and, in particular, the upturn in demand for capital goods and ii) its rising oil bill (prices and volumes have increased).

The balance of payments deteriorated further as a result of all commodity prices rising due to the conflict in Ukraine. In the fiscal year (FY) 2021/2022 (ending in late June 2022), the current account deficit increased by 3.8 pp to 4.6% of GDP. Foreign exchange reserves fell by 45%.

Since summer 2022, the current account deficit has dropped sharply thanks notably to measures introduced by the government to contain the drop in its foreign exchange reserves. Restrictions on imported goods (between May and July 2022, only so-called "essential goods" could be imported) and the ban on banks opening letters of credit to companies in sectors that were deemed non-strategic between May and December 2022 (i.e. all sectors, except for energy and food), cut imports by 29.7% between Q2 and Q4 2022. Therefore, despite the decline in exports (due to constraints on industrial production and the drop in cereal and cotton sales as a result of the floods in October 2022), the current account deficit stood at just USD 1.1 billion in Q4 2022, compared to USD 4.3 billion in Q2 2022. Furthermore, even though all import restrictions were officially lifted in January 2023, in reality, the low level of foreign exchange reserves continued to restrict company imports.

Despite the very sharp drop in the current account deficit (forecasted to fall to 1.5% of GDP in FY2022/2023) and despite loans received from the IMF and international organisations in autumn 2022 (USD 2.7 billion), the country's foreign exchange reserves did not stop falling and stood at an equivalent of less than three weeks of imports by early February 2023. This downturn was fuelled by shrinking FDI (down 40% in the first eight months of FY2022/2023), external debt repayments and central bank interventions.

The situation has very slightly improved since mid-February. The government finally bowed to the IMF's demand to implement a free-floating rupee system and received further loans from China, its main bilateral creditor. On 31 March, FX reserves reached USD 4.2 billion, up USD 1.1 billion from its low level recorded in February 2023. However,

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth (%) (1)	-0.9	5.7	6.0	1.0	4.0
Inflation (CPI, year average, %) (1)	10.7	8.9	12.2	30.0	20.0
Gen. Gov. balance / GDP (%) (1)	-7.1	-6.1	-7.9	-7.1	-6.3
Gen. Gov. debt / GDP (%) (1)	76.6	71.5	73.5	75.6	71.0
Current account balance / GDP (%) (1)	-1.5	-0.8	-4.6	-1.5	-3.2
External debt / GDP (%) (1)	37.6	35.1	34.6	45.0	41.6
Forex reserves (USD bn) (1)	12.1	17.3	9.8	12.0	14.0
Forex reserves, in months of imports (1)	2.9	3.3	1.3	2.0	2.0

TABLE 1

(1) FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1
e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

PAKISTAN: FX RESERVES AND CURRENT ACCOUNT BALANCE

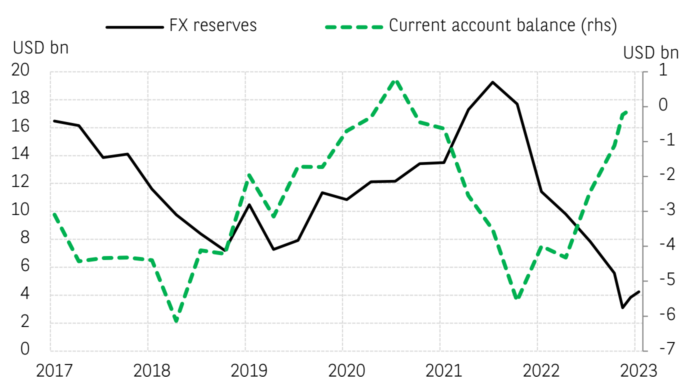

CHART 1

SOURCE: SBP

they are still far below their August 2021 levels (USD 20.1 billion) and nowhere near cover the country's external financing needs, which, according to the IMF, are estimated to stand at USD 7 billion for the April-June 2023 period alone (USD 5 billion according to estimates from Pakistan's Ministry of Finance with maturing loans with China and Gulf States having already been renewed).

The government is still awaiting the findings of the ninth review of the Extended Fund Facility with the IMF, which has been suspended since November 2022, as the government was failing to comply with the fund's budgetary consolidation requirements. The findings of the review could release an equivalent of USD 1.2 billion out of the USD 2.6 billion which the country is still entitled to receive by the end of the current programme (which was initially scheduled for June 2023). The disbursement of credit lines could also enable Pakistan to obtain additional loans worth USD 3.5 billion from bilateral lenders (Saudi Arabia and the United Arab Emirates, in particular) and USD 3.5 billion from multilateral lenders.

Even though the risk of defaulting on external sovereign debt has abated slightly (at least temporarily), there is still a high chance of a default occurring. Rating agencies and the IMF estimate that Pakistan's external financing needs will be around USD 30 billion per year over the next three budget years (including a single payment of USD 20-25 billion to service its external debt), whereas its foreign exchange reserves may only stand at USD 12 billion at the end of June. Whether it can cover its short and medium-term foreign currency financing needs will be strongly determined by whether it can obtain further foreign loans. The unstable political climate and the very high yields on government bonds are stopping the government from issuing bonds on the international financial markets at this present time (ten-year yields stood at 15.8% in late March 2023).

SHARP SLOWDOWN IN ECONOMIC GROWTH

Economic growth in the FY2022/2023 is expected to slow to just 1%, compared to 6% in the previous fiscal year. Domestic demand has been hit hard by rising interest rates (the central bank hiked its repo rate by 1025 bp between April 2022 and March 2023), the sharp rise in domestic prices (+26.2% between July 2022 and February 2023) and supply constraints linked to the import restrictions. Furthermore, in order to fulfil the IMF's requirements and consolidate its public finances, the government was forced to abolish all of its subsidies, on energy prices in particular, severely harming the industrial sector, whose production costs have skyrocketed. In addition, the sizeable depreciation of the rupee against the dollar (-34.2% in February yoy) has also increased the cost of imported raw materials and has further weakened the financial position of households and companies. Finally, agricultural production (22.7% of GDP) and cotton production in particular, which are vital for the textile industry (exports of textile and cotton products accounted for 46% and 11.8% of the country's total exports in 2021) plummeted as a result of the October 2022 floods.

ONGOING FISCAL CONSOLIDATION

Public finances are structurally weak due to i) high fiscal deficit and debt levels (over the past five years, the fiscal deficit reached an average of 7.7% of GDP and debt stood at 71.4% of GDP in June 2022), ii) a narrow fiscal base, iii) a very high burden of interest on debt (39.6% of revenues), which is also vulnerable to interest rate fluctuations (19% of domestic debt is variable rate). In addition, over the past five years,

PAKISTAN: INFLATION, POLICY RATE AND EXCHANGE RATE

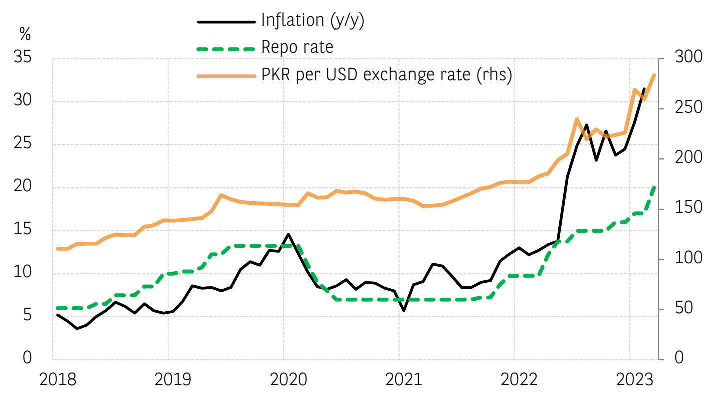

CHART 2 SOURCE: SBP

the government's debt exposure to exchange rate shocks has increased as the share of external debt rose by 7.3 pp to 37.7% of total debt in January 2023.

During the FY2021/2022, public finances deteriorated further (the deficit increased by 1.8 pp to 7.9% of GDP) as the Ministry of Finance heavily subsidised energy and food prices while increasing civil servants' salaries and introducing numerous tax exemptions.

Since summer 2022, the government has adopted a restrictive fiscal policy in order to consolidate its finances and therefore fulfil the IMF's requirements. Electricity and gas subsidies have been abolished, fuel prices have been increased and tax exemptions have been scrapped completely. During the first half of the current fiscal year, fiscal receipts increased by 18.8% compared to the same period in the previous year, despite the economic slowdown. Albeit declining, the fiscal deficit is expected to remain close to 7% of GDP in FY2022/2023, due to, in particular, a sharp rise in the debt-servicing burden (+1 pp to 5.8% of GDP), which will increase to 46.9% of revenue, a very high level.

However, the economic climate is forcing the government to temper its restrictive fiscal stance with the announcement of petrol subsidies for the poorest households in mid-March. If this measure is confirmed, it could once again delay the release of the funds by the IMF. However, there is no guarantee that this will keep the government in office following the general election scheduled for October 2023. Should a new party end up forming a government after this election, it could jeopardize a further IMF support programme, which yet would play a vital role in avoiding the risk of a sovereign default on its external debt.

Johanna MELKA
johanna.melka@bnpparibas.com