

Research

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Pakistan: Badly in need of foreign assistance

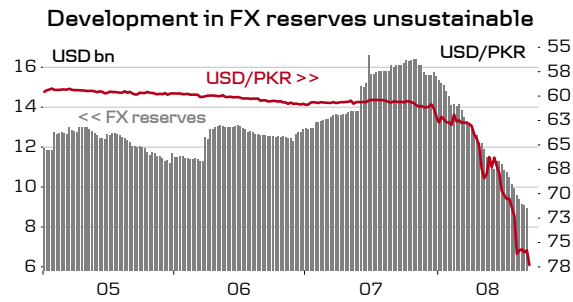
- The Pakistani economy has deteriorated sharply since late 2007 on the back of a poisonous cocktail of higher energy and food prices and political uncertainty. The current account deficit is approaching 10% of GDP and because of exploding expenditure on food and energy subsidies, the government budget deficit will most likely exceed 6% of GDP in 2008. Political uncertainty and a weak government have prevented the necessary adjustment in economic policy, thus contributing to the recent deterioration in the economy.
- The official FX reserves have more than halved since late 2007, and we estimate that the real FX reserves currently amount to less than USD 5bn. This is dangerously low in light of the monthly trade deficit currently being close to USD 2bn and the need to repay close to USD 1bn of foreign debt in early 2009. The risk of Pakistan defaulting on its foreign debt payments can no longer be ignored.
- Pakistan will need foreign assistance to avoid a default in its foreign debt and a sharp slow down in the economy. Because of Pakistan's importance in the war on terror, foreign assistance will probably be available. We see two possible solutions. First, Pakistan can ask the IMF for assistance. Access to IMF liquidity will most likely be conditional on some tightening of fiscal policy and include some restructuring on foreign debt payments. Second, Pakistan can be "bailed out" by Saudi Arabia and other Middle Eastern countries. This will probably include deferred payments for crude oil imports and some commitments on direct foreign investments in Pakistan.
- More political stability is a necessary condition for a sustainable development in Pakistan. This includes the formation of a majority government able to implement necessary adjustments in economic policy. Though Muslim fundamentalism might continue to be a destabilising force as a political force, it is becoming increasingly marginalised.

Increasing risk of default

FX reserves are dangerously low

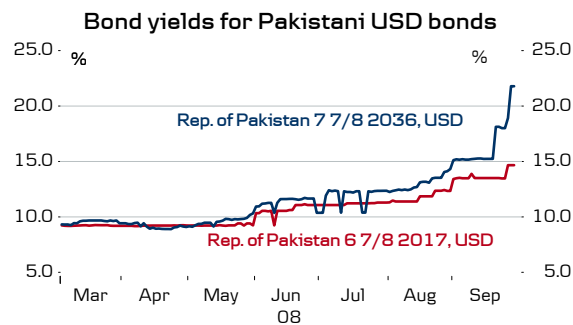
Since early this year the Pakistani economy has deteriorated sharply and it will probably need some kind of external assistance to avoid a collapse in the domestic economy and a default on its sovereign foreign debt. Since late 2007 the Pakistani rupee (PKR) has plunged by more than 30%

against USD and official FX reserves have nearly halved to just USD 8bn. Official FX reserves include about USD 3bn in private foreign currency deposits. Hence FX reserves in reality are probably less than USD 5bn. This is a dangerously low level in light of the monthly trade deficit currently running close to USD 2bn.



Source: Ecwin

In addition, Pakistan's foreign debt service is expected to increase to USD 3.2bn in 2009 from USD 2.0bn in 2008. This has increased fears that Pakistan will eventually default on its foreign sovereign debt. Standard & Poor's has twice this year downgraded Pakistan's foreign currency debt rating down from B+ to just CCC+, just three notches from actual default. Consequently yields on Pakistani USD bonds have soared in recent months as seen in the chart below.

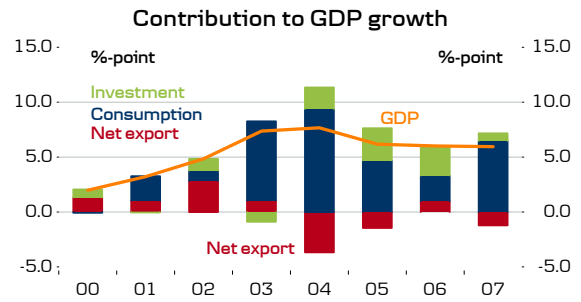


Source: Bloomberg

Pakistan not a new Asian miracle

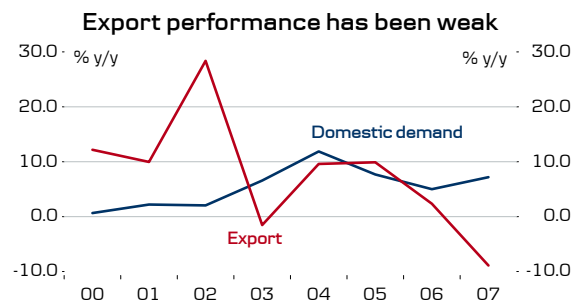
On the surface Pakistan's economy has performed well in recent years. Since 2003 GDP growth on average has been about 7%, far outpacing the 4% average GDP growth experienced during the 1990s. However, growth has mainly been driven by domestic demand. Especially investment demand has picked up supported by strong foreign direct investment especially from the Middle East. However, while the investment-ratio has increased to more than 20% of GDP it is still too low to make 7% GDP growth sustainable in the long run.¹

¹ In comparison, investment in India is close to 35% of GDP.



Source: Ecwin

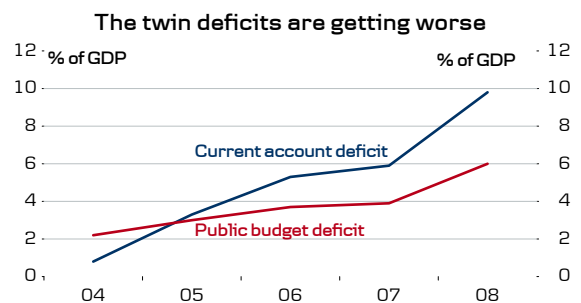
Pakistan is not a typical Asian growth story in the sense that unlike most other Asian countries its growth has not been export driven. FDI has mainly gone into real estate and the service sector, such as telecommunication. Hence FDI has really not aided in improving the competitiveness of the manufacturing sector. On the contrary, Pakistan's competitiveness has deteriorated in recent years and export growth has slowed sharply.



Source: Ecwin

Twin deficits are getting worse...

On top of that, public finances have deteriorated despite strong growth in recent years. Political uncertainty and weak governments are the main explanation (see *Politics in Pakistan* below).



Note: Deficits for 2008 are calculated for H1 08. Source: Ecwin and own calculations

The worsening twin deficits (current account and public finances) have left Pakistan's very vulnerable and ill suited to deal with the current financial

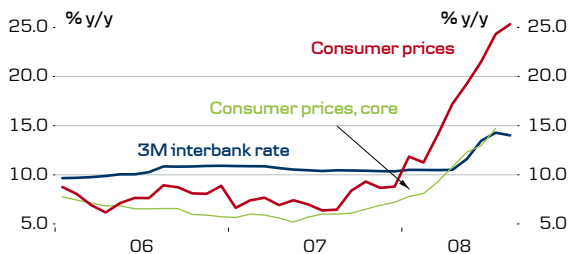
turmoil and the sharp rise in crude oil and food prices during the past year. Pakistan imports about 75% of its domestic oil consumption and higher crude oil prices have contributed significantly to the recent deterioration in the current account. In H1 08 the current account deficit was close to 10% of GDP

Public finances have been another victim of higher crude oil and food prices, because of substantial subsidies on both energy and food prices. We estimate that the general government fiscal deficit in H1 08 was close to 6% of GDP (see chart above).

Inflation has soared

In addition inflation has soared from about 7% in late 2007 to more than 25% in August. The rise in inflation has been exacerbated by the sharp depreciation in PKR. In addition State Bank of Pakistan (SBP) has only increased policy rates modestly in response to the jump in inflation and real money market interest rates remain highly negative. Despite growth slowing, it will be difficult for SBP to follow other Asian central banks' recent easing measure as long as the value of PKR continues to slide on the FX market.

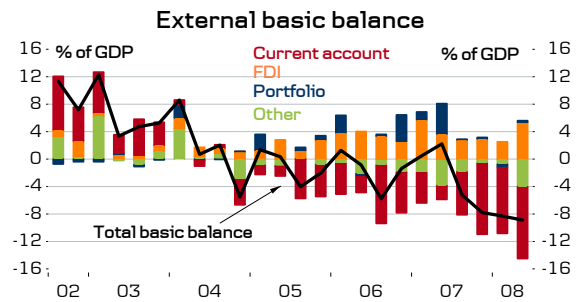
Is inflation getting out of control?



Source: Ecwin

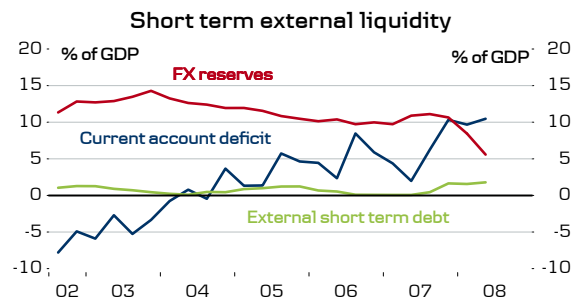
How vulnerable is Pakistan?

To get an idea of how vulnerable Pakistan's external position is, we look at its external basic balance and its short term liquidity. As seen in the chart below Pakistan's basic balance has deteriorated sharply since mid 2007 mainly due to a significant increase in the current account deficit. The deterioration in the current account started in 2004, when Pakistan's export performance weakened and domestic demand accelerated. However, until 2007 the increase in the current account deficit was broadly offset by strong FDI and portfolio inflows.



Source: Ecwin and own calculations

Although Pakistan's short term debt is less than 2% of GDP, its external liquidity position is still very weak because FX reserves are only about 5% of GDP and declining fast. In light of external basic balance outflows of about 8% of GDP (see chart above) and a current account deficit of close to 10% of GDP, this is obviously inadequate.



Source: Ecwin

Hence, Pakistan is in urgent need to rebuild its FX reserves, or otherwise there is a real possibility it will not be able to service its foreign debt in 2009.

Badly in need of foreign assistance

Pakistan needs two things in the current situation:

- On the political front the formation of a government with a stable majority in the parliament and the ability to make the necessary adjustments in economic policy, including tightening fiscal policy (see *Politics in Pakistan* for description of the current political situation).
- Some kind of foreign assistance to rebuild FX reserves and regain market confidence in PKR.

Regarding foreign assistance we see two possible solutions.

- Pakistan goes to the IMF and asks for assistance. Most likely IMF assistance will be

conditional on tighter fiscal policy (elimination of energy subsidies) and privatisations. In addition it will most likely involve some restructuring of foreign debt and hence technically default.

- Pakistan will be "bailed out" by Middle Eastern countries by extending credit and making commitments on FDIs into Pakistan (see *Politics in Pakistan* below description of Middle Eastern political interest in Pakistan).

The Middle Eastern "bail out" option might in the short run be the most attractive solution for Pakistani politicians as it is less conditional. However, the big advantage of a conditional IMF-sponsored relief package is that it will increase international financial markets' confidence in economic policy

President Zadari has publicly stated that he will not go to the IMF and at least for now it looks as if he is praying for a Middle Eastern "bail-out". Saudi Arabia has extended a helping hand by agreeing in principle to defer payments for crude oil sales to Pakistan expected to be worth about \$5.9bn during the current 2008/09 fiscal year. In addition different Middle Eastern countries have committed different FDIs into infrastructure and there are negotiations of investment into oilfields in Pakistan.

The assistance from the Middle East is important and might ease the pressure on Pakistan in the short run. In addition the recent sharp decline in crude oil prices will start to ease pressure on the current account next year. The main problem is that the assistance from the Middle East has probably postponed necessary adjustments in fiscal policy and eventually the Middle Eastern countries might lose patience.

However with Pakistan a nuclear power, and in light of its importance for the war on terror, both the West and Middle East will probably not allow a complete collapse in Pakistan's economy. Hence a disorderly default and hard contraction in Pakistan's economy is in nobody's interest. If Pakistan defaults it would most likely be in connection with some kind of restructuring of its foreign debt.

Politics in Pakistan

Life after general Musharraf

With General Musharraf's resignation as both military commander and president, the military has left the political stage to politicians and democracy is again trying to find its footing. The West and the US has at least temporarily lost some influence, and policy will increasingly be guided by domestic opinion. With political parties still jockeying for power, Pakistan for the moment has been left in a political vacuum, making it difficult to make the necessary adjustments in economic policy.

Musharraf-Bhutto alliance unravels

General Musharraf was elected president of Pakistan in October 2007. However his appointment was regarded as unconstitutional by the Supreme Court. Hence, in November Musharraf declared a state of emergency and Supreme Court judges were fired just before the Supreme Court was about to rule on the legality of Musharraf's appointment as president.

However, the US administration was getting increasingly concerned about Musharraf's authoritarian measures and was putting pressure on him to let the general elections planned for January 2008 go ahead. In the end USA brokered an agreement between Musharraf and Benazir Bhutto and her Pakistan Peoples Party (PPP). According to this agreement Bhutto would be allowed to return to Pakistan and corruption charges against her would be dropped allowing her to run for parliament and possibly become new Prime Minister. In return it is believed that Bhutto and PPP accepted that Musharraf could stay as President. With the assassination of Bhutto in December 2008 the political deal between Bhutto and Musharraf gradually started to unravel. While Asif Ali Zadari, the widower of assassinated Benazir Bhutto, overtook the leadership PPP, his commitment to the Musharraf-Bhutto agreement was unclear.

The general election was postponed and eventually went ahead in February 2008. As is usually the case in Pakistan the parliament ended up very fragmented with none of the three major groupings ending up with a majority (see text box for description of the major political parties)

Major political parties

Pakistan Peoples Party (PPP): As mentioned above this is the party of deceased Benazir Bhutto. PPP could be regarded as a center party and is probably the most secular of the major parties. PPP won the February election gaining 124 seats of 340 possible in the new parliament.

Pakistan Muslim League – N (PML-N): This is the party of the former Prime Minister Nawaz Sharif who until recently has been exiled in Saudi Arabia pending corruption charges. PML-N is a center-right party. PML-N is the second largest party in the new parliament gaining 91 seats.

Pakistan Muslim League – Q (PML-Q): This is a break away from PML (N) and has been a staunch supporter of general Pervez Musharraf. Like PML-N it is a center-right party. It was the single biggest party in the old parliament but was reduced to only 54 seats in the new parliament.

Muttahida Majlis-e-Amal (MMA) is an alliance between four religious parties. They are considered pro-Taliban and have been against the anti-terror campaigns in the regions bordering Afghanistan. MMA was a major loser in the 2008 general election gaining only 3 seats in the parliament. Hence Islamic fundamentalism is no major force at the national level. However still an important force in the smaller Northern provinces.

Weak PPP government after general election

Following the February general election, PPP and PML (N) entered into a coalition government of convenience. The two former main opponents in Pakistani politics were mainly united in their common opposition against President Musharraf. However, PML (N) soon left the government, returning to opposition as the new government failed to reinstate the Supreme Court judges fired by Musharraf during the state of emergency. Still Musharraf in August was forced to resign under impeach pressure from both the government and the opposition. In September PPP-leader Zardari was elected president and PPP now controls both the government and the presidential post

At the moment we have a weak minority PPP-government. As long as the government does not have reliable majority in the parliament it will be very difficult to make important decisions on economic

policy. Ultimately PML-Q (the former supporters of Musharraf) will probably be kingmakers. Most members in PML-Q prefer to co-operate with PML-N. However, the US is currently trying to reinvent the old Musharraf-Bhutto alliance by talking PML-Q into supporting the PPP-government.

A military coup looks unlikely. The new top military commander, General Ashfaq Kayani, is trying to recast the Pakistani military in a less political and economic role. Kayani is believed to have been instrumental in forcing Musharraf to negotiate with Bhutto. In addition Kayani has ordered military personnel not to be involved in politics and has advocated the sale of companies owned by the military.

Islamic fundamentalism being marginalized

As a political force, Islamic fundamentalism is being increasingly marginalized in Pakistan. They suffered a heavy defeat in the February general election and lost power in the North West Frontier Region province bordering Afghanistan. Thus Pakistan is unlikely to turn into an Islamic fundamentalist state. However, with a weak government and the economy possibly starting to collapse there is increasing risk that the government could lose control of tribal areas bordering Afghanistan. In addition with Islamic fundamentalism becoming politically more and more marginalized, there is the risk they will increasingly turn to terror and become an even more destabilizing force.

Pakistan following a more independent line

The US has at least in the short run lost some influence on the developments in Pakistan. The US's strategy was based on Musharraf as president continuing to exert control over the army and the intelligence service and Benazir Bhutto as prime minister gradually giving political leadership democratic legitimacy. With both Musharraf and Bhutto away this strategy is in tatters. Both President Zardari and the new top military commander, General Kayani, appear to have adopted a more independent line relative to the US. The recent tensions between the US and Pakistani military at the Afghan border partly reflects this development. In an unusually harsh statement General Kayani said that his forces would not tolerate such incursions and would defend the country's sovereignty "at all costs."

Middle East has considerable interest in stabilizing Pakistan

Finally, it is important to be aware of the special relationship between Pakistan and Saudi Arabia (and the Middle East in general) with Pakistan providing military support in return for fiscal support. For example, Saudi Arabia has indirectly supported Pakistan's nuclear program. In 1999 when Pakistan was imposed economic sanctions after test firing a nuclear bomb, Saudi Arabia provided considerable relief to Pakistan by providing free oil. While it has not been confirmed officially, it is generally believed that Pakistan has promised its nuclear program will provide a security umbrella for Saudi Arabia if needed. Thus Saudi Arabia and the Middle East probably have a considerable interest in stabilizing Pakistan economically.

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