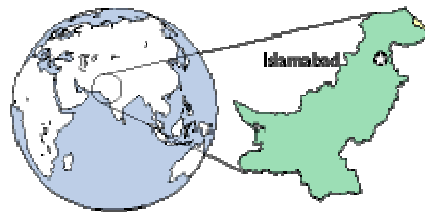


COUNTRY REVIEW

Pakistan



19 March 2010

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EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

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Strengths

- There appears to be political commitment to economic reform, even if implementation is slowed through the need to satisfy a variety of party-based and other vested interests
- Support of the military reduces the risk of political collapse in the event of a change of leadership
- Improved relations with India
- Strong US and multilateral support

Weaknesses

- Susceptibility to natural disasters and dependence on rain-fed agriculture
- Lingering concern relating to presidential succession
- Weak coalition governments tend to limit progress in relation to the reform process
- Poor domestic and regional (border with Afghanistan) security
- Low (but slowly improving) per capita incomes and high poverty levels tend to fuel resentment that can be harnessed by extremists
- The fiscal and external accounts remain fragile
- Weak structural business environment

Key Risks

- Domestic (fragile politics) and regional (border with Afghanistan and terrorist attacks) issues
- Withdrawal of international aid and funding (high severity/low risk)

Country Risk Assessment

Ratings	Pakistan		Median Grade D	Peers		
	Latest	Previous		Bangladesh	Kazakhstan	Sri Lanka
Systemic Political Risk:	P4	P3-	P3-	P4	P3-	P3+
Systemic Economic Risk:	E5	E6	E6	E5	E6	E5
ME rating:	ME5	ME6	ME6	ME5	ME6	ME5
<i>Structure</i>	5.7	6.0	6.0	6.0	4.0	5.0
<i>Policy</i>	6.0	6.0	5.6	6.0	5.6	6.0
<i>Solvency</i>	4.6	4.8	4.3	3.2	5.5	3.5
<i>External Liquidity</i>	3.8	5.8	4.3	2.8	5.2	5.8
SBE rating:	SBE5	SBE4	SBE6	SBE5	SBE5	SBE3
COUNTRY GRADE:	D	D	D	D	D	C

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Islamabad
Population:	176.95 mn (2008)
GDP:	USD 146068 mn (2008)
Currency:	Rupee (PKR)
Form of state:	Islamic Republic
Head of state:	President Asif Ali Zardari
Head of government:	PM Yusuf Raza Gilani
Next elections:	Legislature by October 2012; presidential by September 2013

Major Industries (% of GDP at market prices, 2009e)	Global Assumptions	2009	2010f	
Agriculture	21.0%	Real GDP grth (% yr/yr) *	-3.9	0.9
Industry	24.0%	Inflation (% , av) *	-0.1	1.3
Services	55.0%	Dated Brent (USD/b)	61.0	72.0
		* major economies		

Main Exports (% of total, 2009e)		Main Imports (% of total, 2009e)	
Clothing	20.0%	Fuels & minerals	29.0%
Cotton fabrics	11.0%	Machinery & transport equipment	23.0%
Rice	11.0%	Chemicals	15.0%
		Manufactured goods	10.0%
Lead Export Markets (% of total exports, 2007)		Lead Import Markets (% of total imports, 2007)	
US	18.0%	China	16.2%
UAE	10.4%	Saudi Arabia	10.9%
Afghanistan	8.5%	UAE	10.1%
China	5.2%	US	5.7%

Basic indicators

Selected economic indicators	2006	2007	2008	2009e	2010f
Nominal GDP (USD mn)	126,482	142,791	146,068	160,257	165,116
Population (mn)	169.47	173.18	176.95	180.80	184.74
GDP per capita (USD)	746	825	825	886	894
Real GDP growth (% yr/yr)	6.2	5.6	2.0	3.7	2.5
Inflation (% , average)	7.9	7.6	20.3	13.6	10.0
Fiscal balance (% of GDP)	-4.3	-4.6	-7.8	-5.3	-5.6
Current account balance (% of GDP)	-5.3	-5.8	-10.5	-2.0	-2.5
External debt/GDP (%)	28.5	28.5	33.8	34.2	35.9
External debt/Exports of goods & services (%)	110.9	118.0	130.1	150.1	148.3
Debt-service ratio (%)	7.1	7.5	7.8	8.9	10.0
Foreign exchange reserves (USD mn)	11,328	13,829	7,011	9,938	10,000
Import cover (months)	3.5	3.9	1.6	3.1	2.7
Exchange rate assumption, PKR:USD (av)	60.3	60.7	70.4	81.7	86.0
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

The military has played a high profile role in the political evolution of the country, which has been volatile and often violent. **Periods of civilian government are characterised by fractious personality-based politics and by corruption scandals**, while domestic tensions between Sunni and Shia Muslims have fuelled civil unrest. Strong leadership is a requisite to unite the country—as perhaps was indicated by the tacit acceptance by the US of former-President Pervez Musharraf’s dual role as military and civil leader, until domestic pressures forced a division of those responsibilities that still exists. However, without the direct personal support of the military, the position of Musharraf’s successor, President Asif Ali Zardari (widower of Benazir Bhutto), is fragile and the Pakistan People’s Party (PPP)-led government appears vulnerable. Zardari does not wield the same power as did Musharraf and both the prime minister (currently Yusuf Raza Gilani, who now has control of the nuclear command structure, previously in the hands of the president) and the new head of the military (General Ashfaq Kiyani) are building strong power bases. **A coup remains a high risk, although a non-civilian government would provide difficulties in relationships with the donor community** and some funding could be withdrawn. Accordingly, if the military steps in, either through a coup or to maintain stability following an assassination or other political change, then it is likely to be a ST move and a civilian democracy would probably be re-instated, although perhaps with some delay.

Tensions between the leading political parties—particularly between the PPP and the Pakistan Muslim League-Nawaz (PML-N)—and among them and the judiciary add a further dimension to domestic uncertainties and to a lacklustre performance in relation to policy implementation. **Government effectiveness continues to be undermined by domestic political squabbles and competing centres of power at a time when national security should be taking precedence.** Accordingly, it is unlikely—despite claims of politicians and the military—that there will be meaningful progress in the short- and medium-terms in the battle against militant Islamic terrorism.

Some areas within the country (including Baluchistan and Waziristan) have **allegiances to tribal and regional factions rather than the central government** in Islamabad. Security issues along the Afghan border and within Pakistan’s adjoining provinces (the Federally Administered Tribal Areas, as well as Baluchistan) indicate the pressing need for firm leadership. Moreover, there is widespread public opposition to a pro-US stance, especially in the pro-Taliban Islamist heartlands in the west of the country. Political assassination is not uncommon, with the head of state a potential target. There are therefore concerns relating to succession, particularly given the country’s tendency to favour charismatic leaders and/or family affiliations. As stated above, **in the event of an assassination it is very likely that the military will provide continuity** and, in need, field another presidential candidate from its own ranks—that person would have to stand down from the military, thereby causing some constitutional conflict.

Since 2001, bilateral **relations with India have improved** and current Indian PM Manmohan Singh and former president Musharraf made progress with several confidence-building issues, particularly trade. Even over the disputed area of Kashmir the two countries are now able to negotiate relatively unacrimoniously and some transport links have been re-established. While the India-Pakistan “roadmap” for peace is fraught with potential stumbling blocks, such as periodic terrorist attacks with accusations of state-sponsored training or participation of nationals of the other country (as in the Mumbai bombings of end-2008), regional security issues are now less likely to result in significant military activity, although the underlying bilateral enmity will take a long time to dissipate. Despite some lingering concerns relating to the country’s export of nuclear technology and expertise, **wider international relations have improved** since the 1990s. This reflects Pakistan’s support for the west’s anti-terror activities and the United States has classified the country as a “major non-Nato ally”, including involvement in security issues relating to bordering Afghanistan. Both sides are aware of the strategic importance of Pakistan in the battle with militant extremists, in general, and al-Qaida, in particular. Military, economic and financial ties with the United States have been formalised and Pakistan is currently being more successful in keeping to the conditions and targets that accompany IMF funding.

Economic Stability

Pakistan is classified as a low-income, moderately-indebted and largely agrarian economy—**agriculture directly accounts for around 21% of GDP**—with annual per capita GDP currently around USD800-900. Development indicators are poor and annual average long-term growth of real GDP per capita of 2.5% is well below a level consistent with meaningful poverty reduction, particularly as LT annual population growth is around 2.3%. With a large population (over 180mn), low incomes

and extensive poverty, GDP needs to expand by at least 5% each year to maintain positive human development. Low growth fosters an environment of political, social and religious unrest.

In the period 1991-2002, annual GDP growth averaged only 3.7% but this increased to 6.3% in 2003-07 as improved national security (closer ties with India) coincided with rapid expansion in global economic and trading activity. However, since then, severe disruption to the economy has resulted from (a) political paralysis from the time of declaration of a state of emergency in November 2007 and (b) the impact of the global financial crisis and recession in major markets, so that annual **GDP growth in 2008-10 is likely to be range-bound at 2-4%**, even with an improved cotton crop, nascent indications of a pick-up in manufacturing (the sector returned to growth in August 2009 after 13 consecutive months of contraction) and continued international assistance.

Improved macro-economic data in 2000-06 and a more positive perception of the country's outlook enabled Pakistan to return to the international capital markets in 2004 with the issue of USD500mn in eurobonds. At that stage, foreign debt rescheduling and write-offs, as well as increased grant inflows, had eased financing needs and public debt, although high at around 50% of GDP, was on a downtrend. However, a combination of natural disasters (October 2005 earthquake), political machinations and onset of the global financial crisis and associated downturn in most major importing markets and in world trade led to a **serious deterioration in economic conditions**. In 2008, against a background of Musharraf stepping down and Zardari becoming president (Bhutto was assassinated in December 2007), GDP growth fell to only 2% and fiscal and current account deficits surged. **With foreign exchange reserves falling from almost USD14bn at end-2007 to USD5.4bn by Q3 2008 (less than one month of import cover), a default beckoned**. It was only when sufficient political resolve was garnered to accept international assistance that some relief was engendered—an IMF-sponsored USD7.6bn two-year support package in November 2008, with USD3.1bn disbursable immediately to strengthen the reserves, restored some stability. Since then, a further USD3.7bn was added to the programme in August 2009 and the US Congress approved a five-year USD7.5bn aid package, suggesting that the international community will remain supportive. There is an associated risk to such support in that high-level funding may reduce the drive to implement deep structural reforms, although the IMF will closely monitor the adjustment process and make recommendations accordingly, with funding implications.

The current account of the balance of payments registered surpluses in the first four years of the last decade, peaking at 5.3% in 2002/03, following a long period of deficits. The improvement stemmed from an export surge, particularly in the textiles sector, falling interest costs and rapid growth in net remittances. However, relatively high energy prices in 2005-08 boosted import costs at a time when export receipts were adversely affected by the withdrawal of the Multi Fibre Arrangement, which provided beneficial access to western clothing markets. Accordingly, the current account returned to deficit in 2004/05, with shortfalls equivalent to over 5% of GDP in 2006 and 2007 and over 10% in 2008. **We forecast an improvement in the current account deficit, with a shortfall equivalent to around 2.5% of GDP in 2010**, partly reflecting cutbacks in imports but also a rebuilding of inflows of workers' and other remittances.

Foreign exchange reserves were around USD10.3bn in January 2010, almost double the level of the nadir at Q3 2008, and provided an **import cover of almost three months**. **However, this largely reflects inflows of external assistance**, some (but weakened) net inward FDI (mainly from the US, UK, Netherlands and the UAE) and continuing reduced outgoings because of foreign debt rescheduling and forgiveness. Following a 2001 Paris Club debt rescheduling of USD12.5bn of official obligations and significant bilateral write-offs, foreign debt repayments were reduced substantially. Total foreign debt is now equivalent to 34-36% of GDP and 145-150% of export earnings, compared with 69% and 252% in 2000/01, prior to the debt rescheduling. Over the same period, the debt service ratio has been reduced to 9-10%, compared with 34%. **Although much improved, foreign debt ratios and repayment obligations remain a constraint on economic development**.

Structural Business Environment

The structural **business environment is well below the average** of the countries we assess. The UN Human Development Index 2009 ranks Pakistan 141 out of 182 countries assessed, below India, Cambodia and Yemen. Life expectancy is 66 years, adult literacy is 54% and 10% of the population does not have access to an improved water supply. The Heritage Foundation 2010 Index of Economic Freedom (IEF) categorises Pakistan as 'Mostly Unfree' and assigns it a ranking of 117 out of 179 countries surveyed, below Brazil, Indonesia and Gabon but above Senegal, Sri Lanka and Yemen. The IEF notes a wide range of institutional weaknesses, high tariff and other barriers to trade

and a complex and inefficient tax system. Additionally, the IEF indicates that “considerable corruption” affects the judiciary and civil service. Transparency International’s Corruption Perception Index 2009 gives Pakistan a lowly ranking of 139 out of 180, below Nigeria, Uganda and Bangladesh but above Philippines, Nepal and Cameroon. According to the World Bank’s Doing Business Survey 2010, Pakistan ranks 85 out of 183 countries in terms of the ease of doing business, below Albania and El Salvador but above Dominican Republic, Serbia and China. Enforcing contracts involves more procedures than the average for the region but the time involved and cost are both lower than the regional averages. Effectiveness of insolvency legislation is much better than the regional average, although well behind that of the OECD in terms of time involved and recovery rate (although the costs can be half of those within the OECD area).

The financial sector is being modernised and has undertaken restructuring—the **state-dominated banking sector is being opened up to private sector influences through organisational consolidation, increased transparency and an improved regulatory framework**. Nevertheless, the state retains a majority stake in the largest commercial bank, controls several specialised institutions and the overall sector remains vulnerable to government influence. With only a limited exposure to structured financial products, the banking system experienced little direct impact from the global financial crisis, although some signs of a deterioration in asset quality emerged and **NPLs increased to an estimated 10% of total loans in H1 2009**.

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Charts

