ARIF HABIB LIMITED

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Pakistan Economy
Debt reprofiling or restructuring?

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Bilateral debt reprofiling a viable option under IMF watch

As highlighted in our Report titled "IMF is here to stay for the long run" **dated December 22, 2022**, we alluded to the fact that Pakistan had no option but to stay engaged with the IMF for the long term to be able to manage its medium to long term external debt obligations. We believe reprofiling of USD 13bn of short term bilateral and commercial debt from friendly countries is a less disruptive option to effectively create some breathing space to put our financial house in order. That said, such a transaction shall only be possible once Pakistan signs up to new long-term agreement like SBA (Standby Agreement) likely post General Elections (due in Oct). Pakistan's bilateral creditors have it abundantly clear that Pakistan needs to remain under an IMF watch before they are willing to commit an additional funding and/or external support.

Debt restructuring discussions a little pre-mature

Persistent delays in resumption of the IMF 9th review have further deteriorated macroeconomic fundamentals with forex reserves falling to an alarmingly low level of USD 3.1bn (< 3 weeks of import cover). While the return of the IMF albeit after much delay is positive, Pakistan has a long way to go in order to address its macroeconomic vulnerabilities. In the midst of the precarious FX reserves situation and sizeable external repayment obligations over the next 3 years talks of debt restructuring have gathered momentum once again. We however view the discussions as a little premature given the costs attached with any such move. Moreover, if we take a more granular look at Pakistan's future external debt obligations, the major area of concern relates to USD 13bn annual rollover of short-term bilateral and commercial debt. Historically rolled over the quantum has grown 4x over the past 5 years and reprofiling it over a longer tenure shall create much needed "breathing space".

PKR to remain volatile but stabilize as flows materialize

After months of artificially managing the exchange rate, the government finally caved into IMF's key pre-condition to resume talks allowing PKR to float freely in late Jan. This led to PKR to depreciate a cumulative 17% since 25-Jan-2023 with PKR remaining volatile as FX reserves continue to hit new lows. Given the ongoing talks with the Fund until Feb 09 and negotiations on major fiscal reforms, we believe the PKR will continue to remain volatile in the short term stabilizing as IMF review concludes and other bilateral and multilateral flows start pouring in. Given significant deterioration in external reserves position and repayments of more than USD 2bn of commercial debt previously anticipated to be rolled over, we now expect Jun-23 and Dec-23 PKR/USD closing rate of 275 and 290 respectively.

Massive fiscal tightening to keep growth subdued

A major focus on IMF's staff level discussions is addressing the fiscal gaps including additional revenue measures such as increase in PDL on petroleum products, flood levy on imports, and additional taxes on banks etc. Moreover, addressing PKR 675bn worth of subsidy overruns and resolution of power and gas circular debts remain other key demands of the fund. While we expect the government to implement most of the additional taxation and administrative measures, given limited time between now and the year-end fiscal deficit is likely to remain elevated at ~6.8% of GDP (well above 4.9% budgeted). Fiscal tightening and impact of PKR depreciation is expected to keep inflation elevated which is likely to rise above 30% over the next few months and average 27% in FY23. In this backdrop SBP shall maintain a tight monetary policy and raise rates by another 100-200 bps before Jun-23 with gradual easing from 4Q2023 as inflationary pressures subside. In the backdrop of a further monetary and fiscal tightening, we estimate FY23E GDP growth to decline to 1.1% (FY22: 5.97%).

Return of the IMF is positive but a long way to go

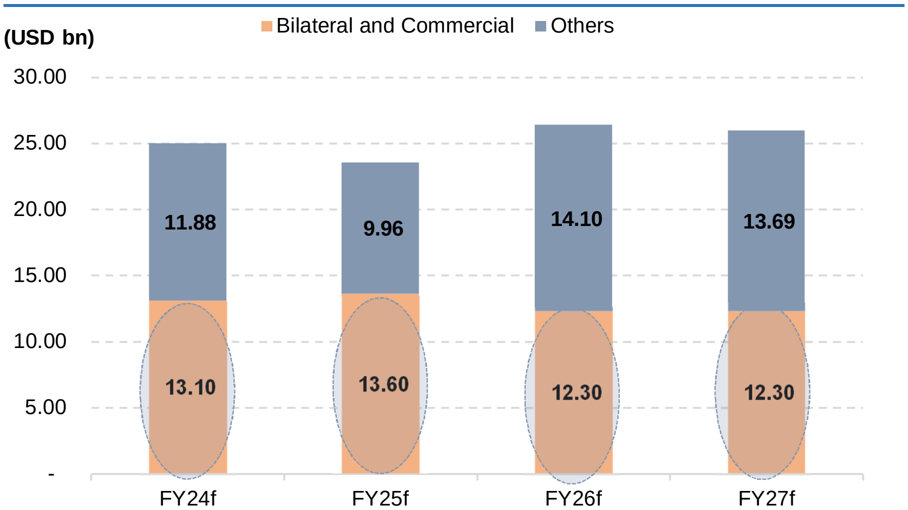
Delays in IMF's return has further deteriorated macros

Persistent delays in resumption of the IMF 9th review have further deteriorated macroeconomic indicators with forex reserves falling to an alarmingly low level of USD 3.1bn (less than 3 weeks of import cover) and the lowest levels since Feb 2014. In the midst of the precarious FX reserves situation and sizeable external repayment obligations over the next 3 years (USD 73bn over FY24-26) discussions on debt restructuring have gathered momentum once again.

Debt restructuring discussions appear overhyped

Before we deliberate on the need for external debt restructuring, it is important to analyze structure of external debt and debt servicing obligations over the next 3 years. Out of the total debt servicing obligations of USD 73bn approximately USD 39 bn are short term bilateral borrowings mainly from friendly countries (Saudi Arabia, China and UAE) and their commercial banks. In essence the total quantum of borrowing is USD 13bn which is projected to be rolled over annually. Prior to FY23, most of these was successfully rolled over on an annual basis however delays with the IMF program led to around USD 2.5bn of commercial loans being repaid. If we exclude this USD 13bn, the annual repayment obligation falls to around USD 11-12bn which appears manageable in our view given we remain in the IMF program.

Figure: External Debt Repayment Obligations



Source (s): IMF, AHL Research

It is also important to highlight that broader debt restructuring is extremely challenging with the high costs associated with any such move outweighing any potential benefits. The much-hyped G-20 Common Framework for Debt Treatments (CF) to support low-income countries beyond Debt Service Suspension Initiative (DSSI) has failed to take off given non participation of some bilateral and private creditors. Only three countries Chad, Ethopia and Zambia have applied for debt restructuring under CF and none has accomplished any relief thus far.

What is debt reprofiling, how it differs from restructuring?

Debt reprofiling transactions change debt maturities to a later date without making any changes to coupons or interest payments. This provides the country time to put its financial house in order with good prospect for recovery without debt relief. According to IMF, given their less disruptive potential debt reprofiling could effectively create "breathing space" and address sustainability issues earlier and in a sustainable way. A restructuring, in contract, imposes direct losses on creditors through the reduction of the coupon or principal of debt to lower a government's debt to GDP ratio or interest expense burden. In terms of historical examples, in an exception access context, Uruguay successful agreed to a debt reprofiling with its private creditors in May 2003, while a more recent example in a normal context is that of Mongolia in 2017 under an EFF program.

A new IMF program a must for bilateral debt reprofiling

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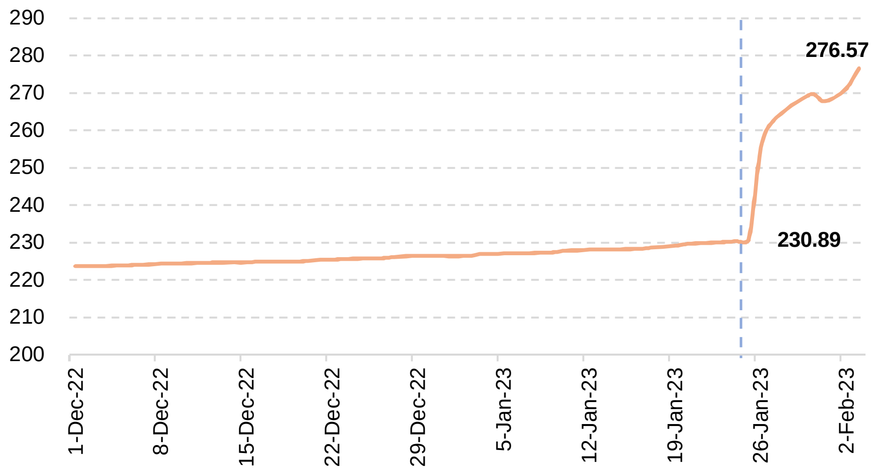
PKR to remain volatile but eventually stabilize

After months of artificially managing the exchange rate, the government finally caved into IMF's key pre-condition to resume talks allowing PKR to float freely in late Jan. This led to PKR to depreciate a cumulative 17% since 25-Jan-2023 with PKR remaining volatile as FX reserves continue to hit new lows (USD 3.1bn: less than 3 weeks of import cover). Given the ongoing talks with the Fund until Feb 09 and negotiations on major fiscal reforms, we believe the PKR will continue to remain volatile in the short-term stabilizing as IMF review concludes and other bilateral and multilateral flows start pouring in. Given significant deterioration in external reserves position and repayments of more than USD 2bn of commercial debt previously anticipated to be rolled over, we now expect Jun-23 and Dec-23 PKR/USD closing rate of 275 and 290 respectively.

Figure: PKR has depreciated 17% against USD since 25-Jan-2023



Source (s): SBP, AHL Research

Current account deficit to trend lower amid weak demand

A combination of contractionary fiscal as well as monetary policies together with strict administrative controls have successfully curtailed aggregate demand, which in effect has managed to lower significantly reduced the Current Account Deficit (-60% in 1HFY23). We expect the trade deficit to continue at a declining trend, led by incentives for export-oriented sectors, impact of lower oil prices and volumes on the import bill and a slowdown in imports such as machinery. On the export front, downside risk remains mainly the global recession that is likely to dent the overall jump in exports. A key risk that has emerged on the current account in the recent months is the deteriorating trend in remittances (-19% YoY in Dec'22), which is expected to improve following free-float of the PKR in late January. Moreover, despite the expected slow-down in export, we expect the trade deficit to be neutered (to an extent) by the services and income leg. To note, in addition to this funding gap, SBP is also expecting Pakistan's current account deficit to be below USD 9bn for FY23. However, we expect current account of around USD 5.3bn (~1.5% of GDP) in FY23E and remain under USD 5bn (1.5% of GDP) in FY24 as well. Our view is premised on a combination of contractionary fiscal and monetary policies which would keep the overall business activities and domestic demand subdued as well as a host of administrative measures to keep FX outflows in check.

Debt reprofiling or restructuring?

Exhibit: Current Account Balance

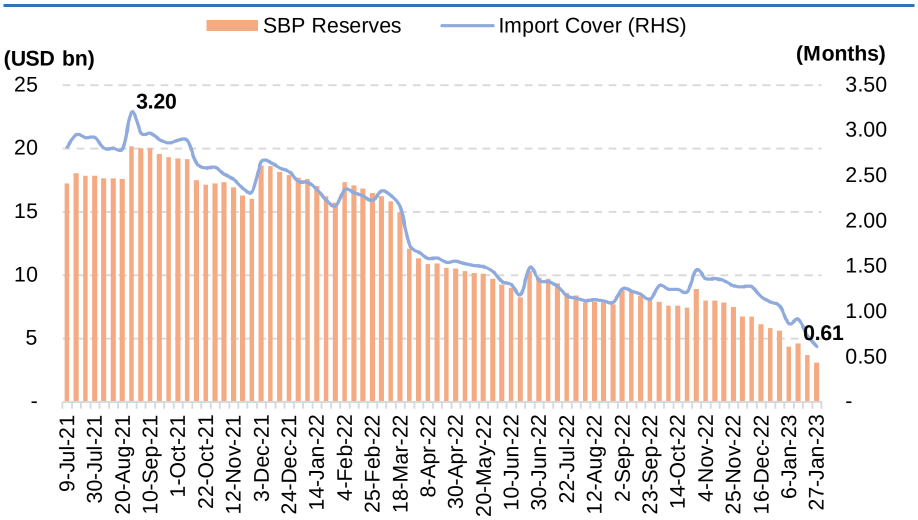
USD mn	FY19a	FY20a	FY21a	FY22a	FY23e	FY24f
Current Account Balance	(13,434)	(4,449)	(2,820)	(17,405)	(5,326)	(4,959)
% of GDP	-4.2%	-1.5%	-0.8%	-4.6%	-1.5%	-1.5%
Exports of Goods	24,257	22,536	25,639	32,471	28,238	28,975
Imports of Goods	51,869	43,645	54,273	72,152	54,769	58,024
Balance on Trade in Goods	(27,612)	(21,109)	(28,634)	(39,681)	(26,531)	(29,049)
Exports of Services	5,966	5,437	5,945	6,950	7,098	7,453
Imports of Services	10,936	8,753	8,461	11,969	9,159	10,912
Balance on Trade in Services	(4,970)	(3,316)	(2,516)	(5,019)	(2,060)	(3,458)
Balance on Trade in Goods and Services	(32,582)	(24,425)	(31,150)	(44,700)	(28,591)	(32,507)
Balance on Primary Income	(5,610)	(5,459)	(4,400)	(5,296)	(6,719)	(6,268)
Balance on Secondary Income	24,758	25,435	32,730	32,591	29,984	33,816
Workers' Remittances	21,740	23,131	29,450	31,279	28,672	30,637

Source (s): SBP, AHL Research

Forex reserves to improve but full recovery to take time

While we expect reserves to start improving once IMF staff level agreement is reach in the coming days, full recovery towards more comfortable levels (2-3 months of import cover) is likely to take time. This is due to a combination of USD 400-500 mn of monthly C/A deficit, USD 3-4bn backlog relating to containers stuck on ports as well as USD 1-2bn of proceeds relating to foreigner dividend and capital repatriations. We expect forex reserves to rise to USD 6.6bn by end-June (1.2 months import cover) gradually increasing to around USD 12-14bn by June 2024 (2.0-2.5 months of import cover).

Figure: SBP reserves declined to USD 3.1bn (~18 days of imports)



Source (s): SBP, AHL Research

Massive fiscal consolidation on the cards

Targeting revenue gaps via host of new taxes

A major focus on IMF's staff level discussions is addressing the fiscal gaps including revenue shortfall in both tax and non-tax revenue heads as well removal of unbudgeted subsidies worth more than PKR 600bn in the power sector. According to media reports, IMF has asked the government to impose additional taxes to address the tax revenue shortfall of around PKR 200-300bn. While the government is looking at implementing a host of measures including i) raising excise duties across multiple segments, ii) imposition of flood levy, iii) taxation on banking profits and WHT on banking transactions, iv) CVT on motor vehicles and v) increase in PDL on petroleum products, IMF appears not convinced. It is reportedly asking the government to also remove tax exemptions and increase standard rate of GST by 1% to 18%.

Exhibit: Revenue collection through taxation measures

Measure	Amount (PKR bn)
1. Withholding tax on banking transactions of non-filers.	45
2. Flood levy (3%).	60
3. Capital value tax rates on imported and locally-assembled vehicles.	10
4. Tax on banks' foreign exchange income	20
5. Increase in federal excise duty (FED) on sugar drinks.	60
6. Increase in federal excise duty (FED) on cigarettes.	25-30
7. Increase in the rates on advance tax on the purchase/sale of the immovable property.	20-30
8. Withdrawal of sales tax exemptions on the import of raw materials/inputs used in the manufacturing of export goods under the "export-facilitation scheme".	20-25
Total	**280**

Source (s): Media, AHL Research

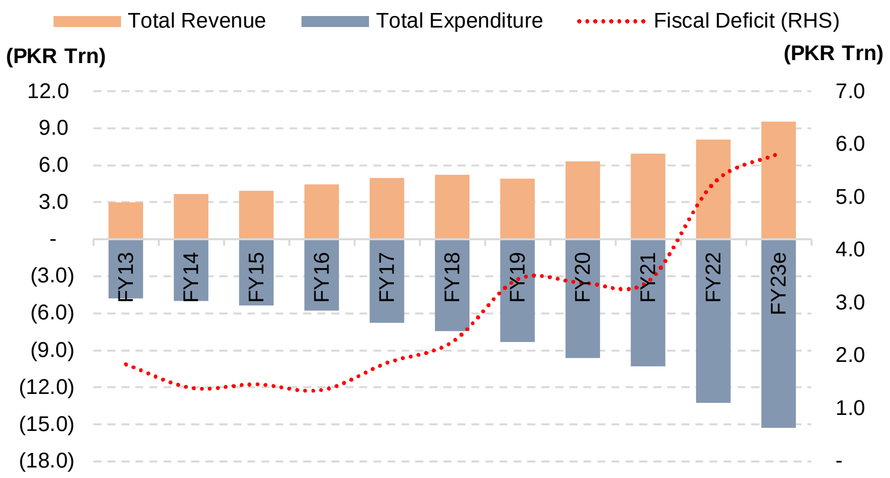
Addressing unbudgeted subsidies

In addition to plugging the revenue shortfall, IMF has been particularly concerned on the rising stock of circular debt in both power and gas sectors with more than PKR 600 bn of unbudgeted power subsidies. IMF had raised serious deficiencies in the government's Circular Debt Management Plan (CDMP) of PKR 952 bn and has advocated a one-time cleanup by imposing additional tariffs something the government has been trying to resist advocating a more phased withdrawal of the subsidy. Moreover, removal of PKR 100bn of power subsidy to exports (PKR 50bn disbursed thus far) and 60-70% increase in gas tariffs to clear the outstanding circular debt of PKR 543bn is on the cards as well.

Fiscal deficit to remain elevated around 6.8% of GDP

Despite host of additional revenue and subsidy reduction measures likely to revive the IMF program, we expect fiscal deficit (as a % of GDP) to clock-in at 6.8% in FY23E, well above the budgeted target of 4.9%. This would be mainly on account of higher markup expense due to rising interest rates and PKR devaluation which we estimate to rise to PKR 5.1trn (6.0% of GDP) versus PKR 3.8trn (budgeted). Moreover, civil administration running expenses, pensions and defense expenditure is likely to remain ahead of budgetary targets amid higher than anticipated inflationary pressures. We do expect some breather from a cut in federal development expenditure.

Figure: Pakistan's Fiscal Deficit – Trend and Forecast



Source (s): MoF, AHL Research

Inflation - Peaking or Persisting?

The beat goes on with Pakistan's headline inflation continuing to run away from the State Bank's inflation expectation of 21-23%. All key measures of inflation despite being at multi decade highs are likely to continue to surprise on the upside. There are risks of inflation persisting instead of peaking, resulting in the outlook of (initially expected) moderating inflation rates in remainder of FY23 being tempered by some consumer prices still being higher and also above historical averages. We see risk of persistent inflation from the inter-connected multiple inflation drivers including (all of the below stated measures to be taken to ensure IMF program is on track):

- Increase in fuel prices amid weaker currency and higher PDL,
- Expected upward revision of gas tariff (assumed a 69% jump in Feb'23),
- Impact of currency depreciation,
- Further hike in electricity charges (modelled PKR 7.5/kWh in Feb'23) and,
- Likely imposition of GST on petroleum products.

Inflation remained elevated since the beginning of FY23, averaging around 25% YoY in the first half. However, with measures stated above, further upturn is expected in months to follow. During remainder of FY23, the contribution of energy prices is expected to increase, followed by food prices that are unlikely to turnaround in near-term. We see headline inflation averaging above 26% YoY for FY23. Moreover, the core index will be higher on average this year than last year. In summary, a real "normalization" of the inflation scenario is only expected in FY24. We have considered three alternative assumptions regarding GST:

- A scenario which assumes no GST on petroleum products in remainder of FY23,
- A scenario which includes 10% GST on petroleum products in remainder of FY23, and
- Lastly a case which includes 17% GST on petroleum products in remainder of FY23, i.e., full pass-on of sales tax to the consumer.

The effect of aforementioned three scenario on inflation has been illustrated in the table below:

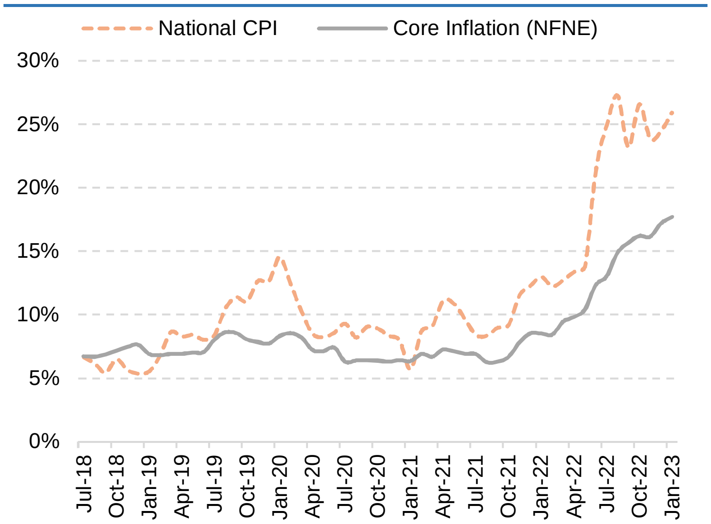
Exhibit: Inflation Sensitivity

	Feb-23	Mar-23	Apr-23	May-23	Jun-23	FY23e Average	FY24f Average
0% GST	32.2%	30.4%	29.7%	29.4%	22.1%	**26.7%**	**11.1%**
10% GST	33.1%	31.3%	30.5%	30.3%	22.9%	**27.0%**	**10.8%**
17% GST	33.7%	31.9%	31.1%	30.9%	23.5%	**27.3%**	**10.6%**

Source (s): PBS, AHL Research

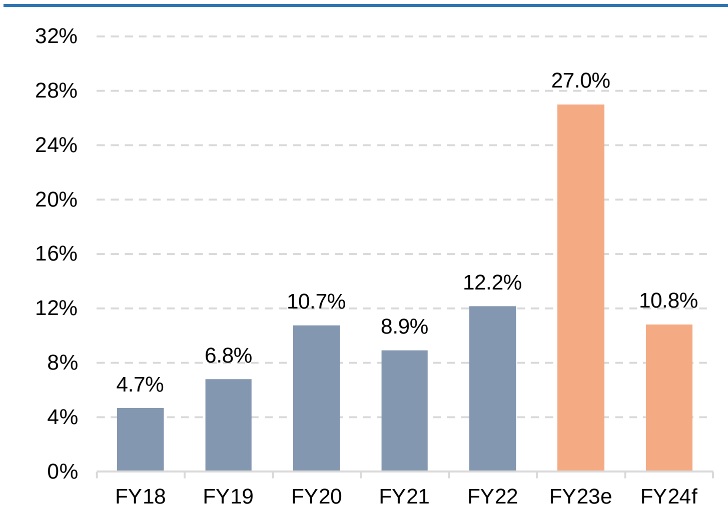
Based on the assumptions stated earlier, we expect inflation to remain north of 30% in the upcoming months before gradually coming down to early twenties by the end of FY23. With this, average inflation for FY23 is likely to clock-in at historic high level, above 27% YoY. To recall, last time inflation crossed 20% mark was back in FY09 (~21% YoY).

Figure: National CPI vs Core Inflation (NFNE)



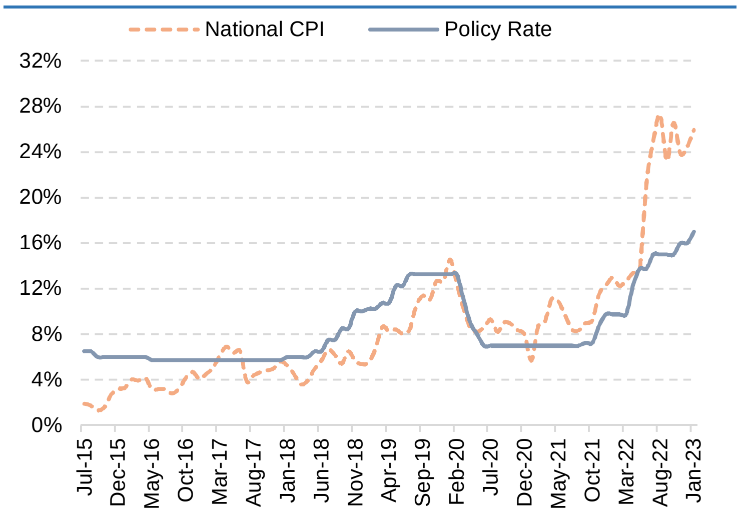
Source (s): PBS, AHL Research

Figure: National CPI – Trend and Forecast



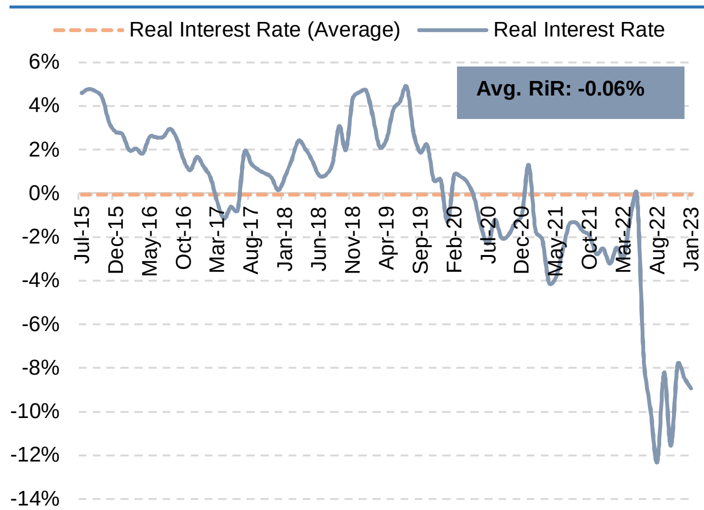
Source (s): PBS, AHL Research

Figure: National CPI vs Policy Rate



Source (s): PBS, SBP, AHL Research

Figure: Real Interest Rate

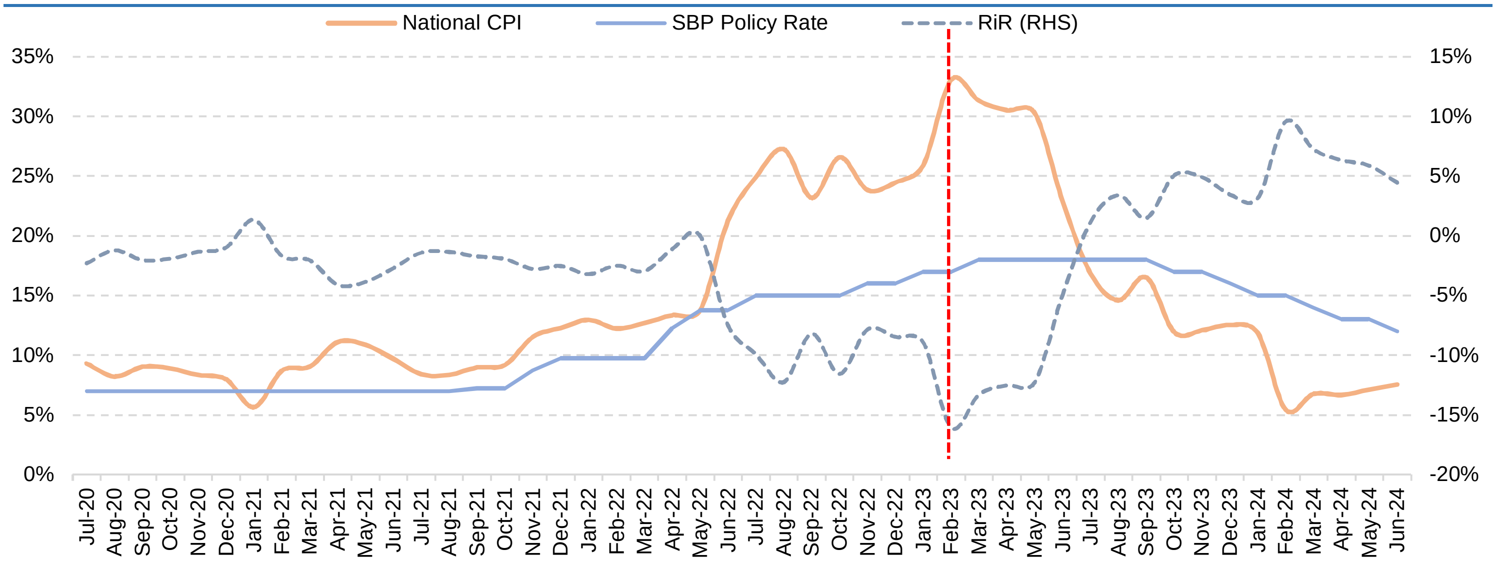


Source (s): PBS, SBP, AHL Research

Not steering away from hawkish monetary policy

We expect the government to implement remaining revenue and fiscal consolidation measures in the coming weeks to address the concerns raised by the IMF and pave the way for the completion of the 9th review and release of ~USD 1.2bn tranche in 1QCY23. Overall, given the backdrop of uncertainty on resumption of IMF program and the pressure that is taking place on the economic outlook, we re-iterate our long-held view that the SBP would not steer away from the hawkish monetary policy stance. To recall, in the monetary policy meeting held last month, the State Bank of Pakistan (SBP) increased the benchmark policy rate by 100bps to 17%, highest since Oct'97. It highlighted in its statement that persistently high levels of CPI were noted and could pick up higher if not "unchecked." Hence, the committee felt strongly that inflation must be anchored, as the long term costs of letting it become entrenched outweighs the immediate costs of bringing it down, so as to embark on a path of price stability and sustainable growth. We expect SBP to continue increasing policy rates before reaching desired policy rate levels. Another 100-200bps hike seems inevitable from the current level (before Jun'23). However, as the inflation starts to cool-off towards the tail end of CY23, we expect SBP to resort to loosening, most likely in the 4Q2023.

Figure: Real Interest Rate – Trend and Forecast

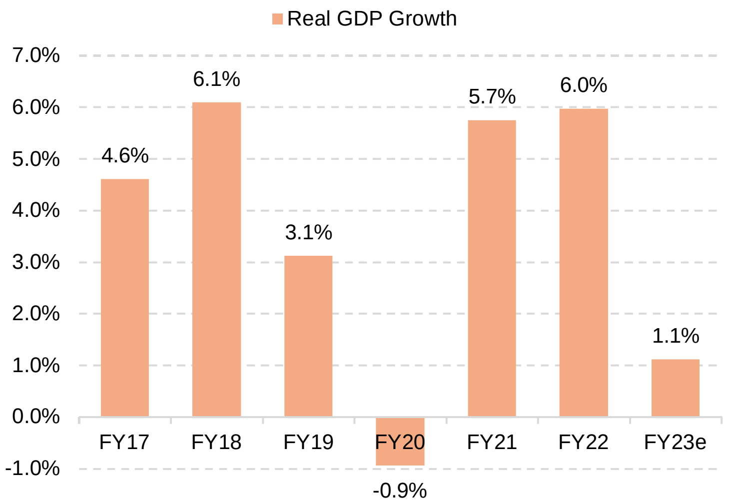


Source (s): SBP, PBS, AHL Research

Growth marred by tight macroeconomic policies

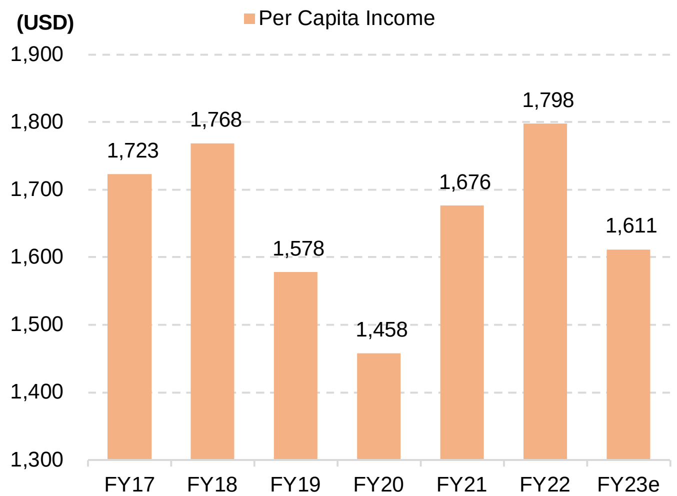
Record macro uncertainty, extreme inflation, and a less supportive policy backdrop have conspired to shift economic growth lower. We expect economic growth to remain subdued in FY23E (1.1%) a sharp decline from 6.0% in FY22. Standing in 3QFY23, the economic and geopolitical landscape remains challenging and the near-term outlook is just as murky. While we are not forecasting a recession, a fragile economy leaves little room for error. The rapid increase in international as well as domestic energy and food prices, has created stubbornly high inflation, leading to a tightening of economic and financial conditions and an abrupt slowdown in the overall economic growth. All said, we expect industrial sector (-6.8%) and agriculture sector (-0.68%) to drive GDP weakness with modest growth in services (4.4%). The industrial sector continues to struggle with tight macro-economic policies and resultant demand destruction playing a major role in suppressing its performance. Latest trends in LSM and high frequency indicators such as cement offtake, auto sales, petroleum products sales, textile sales, also signal at a decline in overall industrial growth during the remaining part of the year. Moreover, the negative impact of floods on crops, livestock and overall productivity remains undeniable.

Figure: GDP growth



Source (s): Pakistan Economic Survey, AHL Research

Figure: Per Capita GDP (in USD)



Source (s): Pakistan Economic Survey, AHL Research

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Rating	Description
BUY	Upside* of subject security(ies) is more than +15% from last closing of market price(s)
HOLD	Upside* of subject security(ies) is between -15% and +15% from last closing of market price(s)
SELL	Upside* of subject security(ies) is less than -15% from last closing of market price(s)

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AHL Research uses the following valuation technique(s) to arrive at the period end target prices;

- **Discounted Cash Flow (DCF)**
- **Dividend Discounted Model (DDM)**
- **Sum of the Parts (SoTP)**
- **Justified Price to Book (JPTB)**
- **Reserved Base Valuation (RBV)**

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- **Market risk**
- **Interest Rate Risk**
- **Exchange Rate (Currency) Risk**

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