COUNTRY RISK CATEGORY

7

OF 7

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Pakistan

COUNTRY ANALYST

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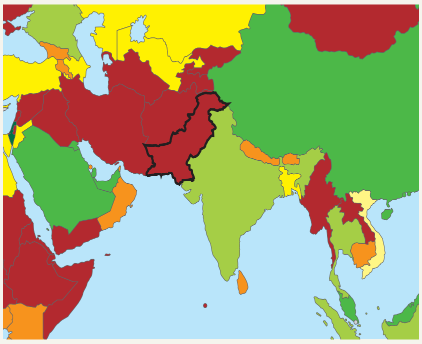
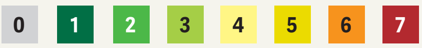
Basic facts (2020)

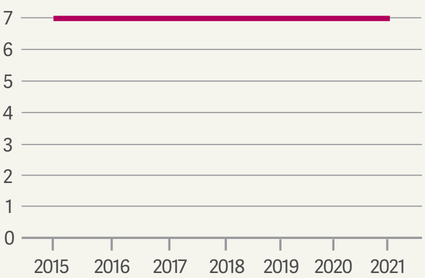
Population: 209 million
GDP, nominal: USD 263 billion
GDP/capita: USD 1 260





The country risk categories are arranged on a scale from 0 to 7. The lower the figure, the better the country's creditworthiness

Country classification history



Source: EKN

Strengths

- Strategic interest from China, translating into investments and financing opportunities
- Strong relationships with bilateral donors and development banks
- Growth potential with a large domestic economy and young population
- Significant inflow of remittances.

Weaknesses

- Inherent risk of political instability, given social tensions, the geo-political situation and the military's influence in economics and politics
- Fragile economic stability due to weak public finances and external balances
- Challenging business environment and extensive corruption.

Potential for strengthened growth prospects

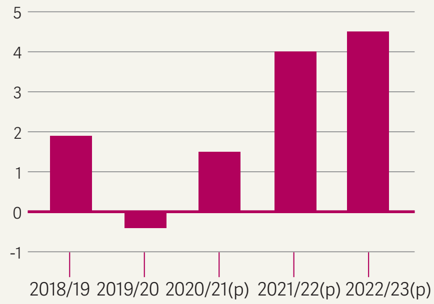
Pakistan has a large economy with a GDP of USD 276 billion (2020) and the world's 5th largest population of about 210 million, factors that create some resilience and growth potential. The economy is driven by household consumption expenditures equivalent to 80% of GDP. Consumption is stabilised by robust inflows of remittances from Pakistanis abroad amounting to about 10% of GDP. The flows, more than half of which originate in the Gulf states, are the country's primary currency earners. The services sector accounts for 60% of GDP, while manufacturing and the export sector are underdeveloped and represent a low13% and 10% of GDP, respectively.

As one of the poorest countries in Asia, Pakistan faces a number of structural challenges, not the least in creating jobs for a growing youthful population. The agricultural sector accounts for 20% of GDP but employs 40% of the labour force. Weak institutional settings and a difficult business climate are reflected in low levels of investment and government revenues, which in turn contribute to infrastructural weaknesses. The banking sector is relatively stable, although it is highly exposed to the Sovereign while lending to the private sector is limited. An inherent risk of political instability persists given geopolitical, religious, and social tensions. With militant Islamism and armed conflict in parts of the country, Pakistan is one of the more violent countries in the world. Furthermore, the military and a dynastic political elite, whose special interests are at times at odds with much-needed reforms, have strong influence over politics and polices. The situation undermines the ability to sustainably pursue a disciplined economic policy. This contributes to the country's economic vulnerability, reflected in high government debt, high external financing needs, and relatively weak international reserves. Nevertheless, several trends give hope that the country's growth potential may be on the verge of strengthening. Firstly, some improvements can be noted in the domestic security situation since 2014, even if the trend seems more driven by increased military activity than by addressing the underlying causes. Secondly, extensive investments in infrastructure have been underway for a few years now, which in the long term could eliminate infrastructure bottlenecks. The bulk of the debt is being financed under the China-Pakistan Economic Corridor (CPEC). Finally, in 2019 Pakistan launched a reform programme with i.a. a more market-driven exchange rate and fiscal reforms. The reform policies are supported by an IMF agreement (July 2019-Sept 2022), and may eventually contribute to strengthened public finances and a more stable macroeconomic environment.

The reform program is entering a difficult phase

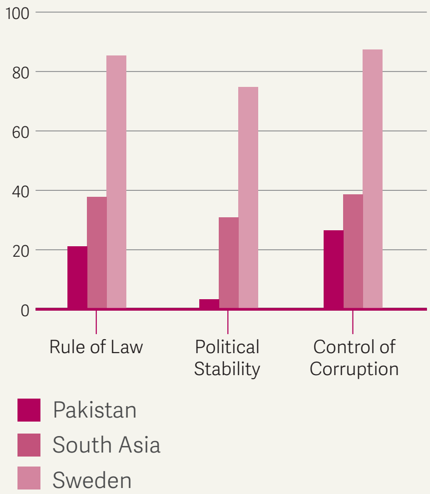
Pakistan's economy has fared relatively well through the coronavirus pandemic, despite severe pressures in the form of increased poverty and unemployment. The downturn in the economy has been mild due to that the authorities avoided prolonged nationwide lockdowns in favour of more targeted restrictions. In the FY20 financial year (July 2019-June 2020), GDP shrank by 0.4%. For FY21, weak growth of slightly over 1% is expected after a third wave of Covid infection cases in the spring dampened the recovery. In the forecast lies a GDP growth gradually increasing from 3-4% FY22 to 4-5% the years thereafter. On the other hand, the

GDP growth (fixed prices, % per annum)



Source: IMF WEO April 2021, Pakistan fiscal year (june-july)

Business environment



Ranking from 0 (worst) to 100 (best)

Source: The World Bank

prospects for growth are uncertain as the pandemic is not over and it may be well into 2022 before a majority of the population has been vaccinated.

The reforms launched in 2019 contribute to the fact that governmental and external debt will no longer increase at the same rate as they did a couple of years ago. Debt ratios relative to GDP are expected to start to decline as growth recovers from the pandemic. However multi-year reform efforts are needed to clean up public finances. Government debt, including guarantees, amounts to over 90% of GDP and interest expenditure consumes over 40% of government revenues. The IMF programme was paused in spring 2020, but resumed in April 2021. Several politically sensitive reforms remain, such as improved tax collection, increased electricity tariffs, and reforms of loss-making state-owned enterprises. These are measures that the country has not been quite able to implement under previous IMF agreements. Without its own majority in Parliament, the leading governing party is dependent on fragile alliances. This risks hampering the ability to push through reforms, and highlights the implementation risks in the IMF programme.

Pakistan's external finances remain fragile. Current account deficits, and low international reserves relative to future debt maturities, make it critical to continuously secure multilateral and bilateral financing, not the least from the IMF and China, the country's largest lender. However, the situation has improved on several fronts. Current account deficits have declined, partly due to a weaker exchange rate along with robust remittances. The working relationship with the IMF helped the country issue international bonds in the first half of 2021, for the first time in over three years. Also, the relationships with the important Gulf states appear to be on the mend. With the support of multilaterals, China and temporary debt relief from the Paris Club, the country's external financing needs for FY22 look set to being secured, while international reserves are gradually increasing. In the long run, the primary challenge is to realize the returns from the major debtfinanced infrastructure investments of recent years, in terms of growth dynamics and competitiveness. This is critical to ensure that the country will be able to manage the debt repayments expected to start in the next 3-5 years. With about two years to go until the next parliamentary elections, and the IMF agreement as an anchor for economic policy, there is a prospect that the country's creditworthiness could eventually be strengthened.

Business environment

Pakistan's business environment is considered difficult but with a positive trend. In order to increase the country's low levels of investment, strengthen the competitiveness of the export industry, and create jobs, the government that took office in 2018 has made the business environment one of its priorities. The agenda includes reforms to increase access to finance for SMEs and a review for the purpose of streamlining the regulatory and administrative processes. In 2019, measures were taken in this direction, with the objective to simplify applications for licences and permits, customs clearance procedures, etc., with i.a. increased digitisation. The progress made in this regard made Pakistan one of the top climbers in the World Bank's Ease of Doing Business Index (DBI) rankings that year, ranking 108th out of 190 countries (147, 2018). DBI ranks Pakistan 111 in terms of time and costs associated with import and export procedures and logistics. The performance indicates a significant potential for improvement. Among the challenges are a large inefficient state-owned enterprises sector,

Pakistan

Swedish export to Pakistan

	MSEK
2020	2 148
2019	3 647
2018	3 134
2017	2 129
2016	2 036

Source: SCB

EKN:s exposure

	MSEK
Guarantees	4 136
Offers	1 534

weak public institutions, and corruption that is high according to Transparency International's Corruption Perceptions Index. In 2020, the country's ranking fell to 124 out of 180 countries (117 in 2018). This is weaker than the average ranking for Asian emerging and developing economies (90). In the World Bank's Worldwide Governance Indicators (WGI), the performance of economic institutions is about 50% below the regional average.

From EKN's credit risk perspective, key aspects of the business environment are related to the degree of predictability, stability and quality, in regulations that affect our obligors' business operations as well as in the country's legal and institutional environment that affect the position of creditors. According to the WGI, the quality of the regulatory environment is significantly weaker than the average in the region. The regulations themselves are reported to be relatively modern, market-based, and well developed in some respects compared to other emerging countries. Challenges lies in the implementation as well as in weak harmonization of regulations and application among the country's provinces. EKN has limited experience in debt recovery in Pakistan. On the legal side however, Pakistan fares better in a regional comparison. While DBI indicates that the time it takes to resolve a commercial dispute via court litigation tends to be long the recovery rate at corporate bankruptcies (in collateralized transactions) is estimated at 43%. This is in line with the regional average (40%).

In the corporate sector, family-owned conglomerates tend to dominate among larger companies. Access to financial information is relatively good for banks, larger companies, and publically listed companies. These prepare financial reports in accordance with the IFRS international standard. Since 2015, smaller companies are also able to report according to IFRS. Since 2018 the country has been placed on the Financial Action Task Force (FATF) grey list for deficiencies in its counter-terrorist financing and anti-money laundering regimes. In order to reduce the risk of international banks cutting back on their relationships with the country's banks, with the negative consequences for international payments that would follow, Pakistan is following an action plan. In the FATF evaluation in February 2021, the country remains on the list but significant progress is noted (out of 27 points, FATF 24 is considered mostly fixed). The next evaluation will take place in October 2021, but Pakistan has flagged that more time will be needed to address the remaining points.

EKN:s policy

EKN has placed Pakistan in country risk category 7 (out of 0 to 7) since 2011. Normal risk assessment applies to transactions with the Ministry of Finance, banks, and companies. This means that there are no predetermined limitations in the issuance of guarantees and that the transactions are assessed on their own merits without specific requirements or preconditions.

For governmental buyers there are requirements for a letter of credit guarantee, or a bank, or state guarantee.

EKN:s commitment and experience

For the period 2016-20, EKN issued guarantees in 295 transactions for 37 exporters for SEK 4.1 billion. That is an increase from the previous 5-year period (SEK 2.6 billion). The flow is dominated by state-related counterparties and telecoms. SMEs account for 6%. However, more than half of the guarantee volume relates to transactions with credit terms of less than one year, of which 20 % relates to letter of credit guarantees where EKN shares the risk with banks confirming letters of credit on behalf of the Swedish exporter and where the counterparty risk rests with Pakistani banks. EKN's outstanding guarantees amount to SEK 5.6 billion. State-related counterparties dominate. The telecom and power sectors together account for about 10%.

EKN's payment experience has been good, with a few losses due to claims in recent years. Delays in payment are less common. Of the guarantees issued during the period 2016-20, there were delays in payment in 5% of them (as per May 2021). This is partly explained by the high proportion of letter of credit guarantees. Excluding these, the proportion rises to 18%. The delays in payment lasted 88 days on average. Over the past 5 years, EKN has settled claims in one transaction. Debts owed by the Pakistani State are under a Paris Club Agreement and amount to slightly over SEK 460 million. They relate to renegotiations with the country's external lenders in 1999- 2001. During the pandemic, Pakistan chose to take advantage of the possibility of the deferral of debt service payments under the G20 Debt Initiative (DSSI). The deferral relates to maturity under the Paris Club Agreement during the period 2020-21.