MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes Pakistan's outlook to stable from negative, affirms B3 rating

02 Dec 2019

Singapore, December 02, 2019 -- Moody's Investors Service ("Moody's") has today affirmed the Government of Pakistan's local and foreign currency long-term issuer and senior unsecured debt ratings at B3 and changed the outlook to stable from negative.

The change in outlook to stable is driven by Moody's expectations that the balance of payments dynamics will continue to improve, supported by policy adjustments and currency flexibility. Such developments reduce external vulnerability risks, although foreign exchange reserve buffers remain low and will take time to rebuild. Moreover, while fiscal strength has weakened with higher debt levels largely as a result of currency depreciation, ongoing fiscal reforms, including through the country's International Monetary Fund (IMF) programme, will mitigate risks related to debt sustainability and government liquidity.

The rating affirmation reflects Pakistan's relatively large economy and robust long-term growth potential, coupled with ongoing institutional enhancements that raise policy credibility and effectiveness, albeit from a low starting point. These credit strengths are balanced against structural constraints to economic and export competitiveness, the government's low revenue generation capacity that weakens debt affordability, fiscal strength that will remain weak over the foreseeable future, as well as political and still-material external vulnerability risks.

Concurrently, Moody's has affirmed the B3 foreign currency senior unsecured ratings for The Second Pakistan Int'l Sukuk Co. Ltd. and The Third Pakistan International Sukuk Co Ltd. The associated payment obligations are, in Moody's view, direct obligations of the Government of Pakistan.

Pakistan's Ba3 local currency bond and deposit ceilings remain unchanged. The B2 foreign currency bond ceiling and the Caa1 foreign currency deposit ceiling are also unchanged. The short-term foreign currency bond and deposit ceilings remain unchanged at Not Prime. These ceilings act as a cap on the ratings that can be assigned to the obligations of other entities domiciled in the country.

RATINGS RATIONALE

RATIONALE FOR THE STABLE OUTLOOK

IMPROVING BALANCE OF PAYMENTS DYNAMICS REDUCE EXTERNAL VULNERABILITY RISKS, ALTHOUGH LOW FOREIGN EXCHANGE RESERVE BUFFERS WILL TAKE TIME TO REBUILD

Narrowing current account deficits, in combination with enhancements to the policy framework including currency flexibility, lower external vulnerability risks in Pakistan. However, foreign exchange reserve adequacy will take time to rebuild.

Moody's expects Pakistan's current account deficit to continue narrowing in the current and next fiscal year (ending June of each year), averaging around 2.2% of GDP, from more than 6% in fiscal 2018 (the year ending June 2018) and around 5% in fiscal 2019. Under Moody's baseline assumptions, subdued import growth will likely remain the main driver of narrowing current account deficits. In particular, the ongoing completion of power projects will reduce capital goods imports, while oil imports will remain structurally lower given the gradual transition in power generation away from diesel to coal, natural gas and hydropower. Currently tight monetary conditions and import tariffs on nonessential goods will also weigh on broader import demand for some time, although Moody's sees the possibility of monetary conditions easing when inflation gradually declines towards the end of the current fiscal year.

Moody's expects exports to gradually pick up on the back of the real exchange rate depreciation over the past 18 months, also contributing to narrower current account deficits. The government is focusing on raising the country's trade competitiveness and has recently rolled out a National Tariff Policy aimed at incentivising production for exports or import substitution. If effective, the policy, coupled with improvements in the terms of trade, will allow exports to grow more robustly. The substantial increase in power generation capacity over the past few years and improvements in domestic security have largely addressed two significant supply-side constraints and further support export-related investment and production.

Moody's expects policy enhancements, including strengthened central bank independence and the commitment to currency flexibility, to support the reduction in external vulnerability risks. In particular, the government is planning to introduce a new State Bank of Pakistan (SBP) Act to forbid central bank financing of government debt and clarify SBP's primary objective of price stability. The central bank has already stopped purchases of government debt in practice since the start of fiscal 2020. At the same time, it has strongly adhered to its commitment to a floating exchange rate regime since May 2019. These enhancements to the policy framework will foster confidence in the Pakistani rupee, while the use of the exchange rate as a shock absorber increases policy buffers.

Notwithstanding improved balance of payments dynamics, Pakistan's foreign exchange reserve adequacy remains low. Foreign exchange reserves have fluctuated around $7-8 billion over the past few months, sufficient to cover just 2-2.5 months of goods imports. Coverage of external debt due also remains low, with the country's External Vulnerability Indicator -- which measures the ratio of external debt due over the next fiscal year to foreign exchange reserves -- remaining around 160-180%.

The IMF programme, which commenced in July 2019, targets higher foreign exchange reserve levels and has unlocked significant external funding from multilateral partners including the Asian Development Bank and the World Bank. Nevertheless, unless the government can effectively mobilise private sector resources, foreign exchange reserves are unlikely to increase substantially from current levels.

ONGOING FISCAL REFORMS WILL GRADUALLY STRENGTHEN VERY WEAK GOVERNMENT FINANCES AND MITIGATE DEBT SUSTAINABILITY AND GOVERNMENT LIQUIDITY RISKS

On the fiscal side, Pakistan's metrics have weakened recently, with wider fiscal deficits and an increase in government debt burden largely as a result of currency depreciation over the course of fiscal 2019. However, Moody's expects ongoing fiscal reforms, anchored by the IMF programme and technical assistance from other development partners, to contribute to a gradual narrowing of fiscal deficits. The reforms would also mitigate debt sustainability and government liquidity risks.

Moody's expects the government's fiscal deficit to remain relatively wide at around 8.6% of GDP in fiscal 2020, compared to 8.9% in fiscal 2019, before narrowing to an average of around 7% over fiscal 2021-23. High interest payments owing to policy rate hikes will continue to weigh on government finances and significantly constrain fiscal flexibility. Meanwhile, government revenue as a share of GDP, while likely to increase, is growing from a lower base, having declined significantly in fiscal 2019.

To widen the tax net, the fiscal authorities have eliminated a number of tax exemptions and concessions and lowered the minimum threshold for personal income taxes. The authorities are also introducing automatic income tax filing to reduce tax evasion and applying the sales tax to a wider group of businesses. Support from the IMF and the World Bank will raise effectiveness of the revenue measures. However, Moody's estimates that the revenue growth targets set by the IMF programme are challenging to achieve in full in a subdued economic growth environment. In particular, Moody's expects Pakistan's GDP growth to slow to 2.9% in fiscal 2020 from 3.3% last fiscal year, given tight financial conditions that continue to weigh on domestic demand, before rising to 3.5% in fiscal 2021.

On the expenditure side, the government has introduced a new Public Financial Management (PFM) Act, which was approved in June 2019, to instill budget discipline. The PFM Act notably bars the use of supplementary budgets except in exceptional circumstances, introduces the use of a single Treasury account to better monitor cashflows, and prevents fiscal authorities from changing future tax policies without parliamentary approval. The Act is in line with IMF recommendations and serves as primary legislation that will be accompanied by other secondary legislation to increase fiscal policy effectiveness.

Given baseline assumptions of gradually narrowing fiscal deficits, Moody's expects the government's general government debt to slowly decline over the next few years to around 75-76% of GDP by 2023, still a high debt burden, from a peak of around 82-83% of GDP currently. Moody's projections are based on the assumption of relative exchange rate stability, particularly in comparison with the sharp exchange depreciation experienced between December 2017 and June 2019.

In addition to the gradual decline in the debt burden, the debt structure will also continue to become more favourable. The government has already reprofiled a substantial portion of domestic debt from short-term Treasury bills into longer-term floating rate bonds. This will reduce gross borrowing requirements to around

25% of GDP in fiscal 2020, from nearly 40% in the last fiscal year. The government is aiming to lengthen domestic maturities further and reduce its reliance on Treasury bills and floating rate debt. Moody's expects that banks and other domestic institutional investors will retain strong appetite for government securities. Lower gross borrowing requirements and exposure to floating rate liabilities sustained over time will reduce the government's exposure to liquidity and interest rate risks that is currently very high.

RATIONALE FOR THE RATING AFFIRMATION

The affirmation of Pakistan's B3 rating is underpinned by the country's relatively large economy and robust growth potential, coupled with ongoing enhancements to the institutional and policy framework that raise policy credibility and effectiveness, albeit from a low starting point. Pakistan's economy is among the largest across similarly rated peers, while we estimate its growth potential to be around 5%, higher than the median for B3 rated sovereigns.

Institutional enhancements including increased central bank independence and the implementation of the new PFM Act, effective fiscal 2020, also raise monetary and fiscal policy credibility and effectiveness. Moody's expects the government to introduce and approve a new SBP Act within fiscal 2020, which will forbid central bank financing of government debt and reinforce price stability as the central bank's primary objective.

These credit strengths are balanced against structural constraints to economic and export competitiveness, the government's low revenue generation capacity that weakens debt affordability, as well as political and still-material external vulnerability risks. Economic and export competitiveness has been hampered by supply-side challenges, although power sector projects, including through the China-Pakistan Economic Corridor, have largely addressed chronic power shortages, domestic security has improved significantly in recent years, and ongoing investments in transport infrastructure will improve its quality and connectivity. Meanwhile, political risks remain material, despite a gradual normalisation of the working relationship between the federal government and the military and judiciary, as the institutional structure involves provincial level implementation of some fiscal and development policies, including services and property tax administration and the management of special economic zones.

As discussed above, the government's narrow revenue base and low foreign exchange reserve adequacy remain credit challenges.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Environmental considerations are material to Pakistan's credit profile, as it is vulnerable to climate change risk. With varied climates across the nation, Pakistan is significantly exposed to extreme weather events, including tropical cyclones, drought, floods and extreme temperatures. In particular, the magnitude and dispersion of seasonal monsoon rainfall influence the agricultural sector growth and rural household consumption. While the agricultural sector accounts for around 20% of GDP and exports, it accounts for slightly over 40% of total employment. Overall, around 70% of the entire population lives in rural areas. As a result, both droughts and floods can create economic, fiscal and social costs for the sovereign.

Social considerations are relevant to Pakistan's credit profile. Access to quality healthcare, education and utilities such as electricity and water remains limited, especially in rural areas, although the government is addressing these issues as a key priority through its Ehsaas programme that is aimed at reducing poverty and inequality, strengthening social safety nets, and promoting human capital development. The country's young and growing population presents both opportunities and challenges. The United Nations projects an annual increase of around 3 million in Pakistan's working age population over the next 20 years.

Governance considerations are material to Pakistan's credit profile. International surveys of various indicators of governance point to weak rule of law and control of corruption, as well as limited government effectiveness. These weaknesses are balanced against a lengthening track record of effective checks and balances and judicial independence for the level of development in the country.

WHAT COULD CHANGE THE RATING UP

Upward pressure on Pakistan's rating would develop if ongoing fiscal reforms were to raise the government's revenue base and debt affordability, and lower its debt burden markedly beyond Moody's current expectations. Further reduction in external vulnerability risks, including through higher levels of foreign exchange reserve adequacy and/or increased economic competitiveness that were to lift export prospects, would also put upward pressure on the rating.

WHAT COULD CHANGE THE RATING DOWN

Downward pressure on the rating would stem from renewed deterioration in Pakistan's external position, including through a significant widening of the current account deficit and erosion of foreign exchange reserve buffers, which would threaten the government's external repayment capacity and heighten liquidity risks. A continued rise in the government's debt burden, without prospects for stabilisation over the medium term, would also put downward pressure on the rating.

GDP per capita (PPP basis, US$): 5,690 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 5.5% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 5.2% (2018 Actual)

Gen. Gov. Financial Balance/GDP: -6.4% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -6.3% (2018 Actual) (also known as External Balance)

External debt/GDP: 30.2% (2018 Actual)

Level of economic development: Moderate level of economic resilience

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 27 November 2019, a rating committee was called to discuss the rating of the Pakistan, Government of. The main points raised during the discussion were: The issuer's institutional strength/framework have materially increased. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. Other views raised included: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this credit rating action, and whose ratings may change as a result of this credit rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Christian Fang
Asst Vice President - Analyst
Sovereign Risk Group
Moody's Investors Service Singapore Pte. Ltd.
50 Raffles Place #23-06
Singapore Land Tower
Singapore 48623
Singapore
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077

Marie Diron
MD - Sovereign Risk
Sovereign Risk Group
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077

Releasing Office:
Moody's Investors Service Singapore Pte. Ltd.
50 Raffles Place #23-06
Singapore Land Tower
Singapore 48623
Singapore
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077