Pakistan

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Pakistan has gradually made progress with economic reform since the IMF programme was agreed in 2013. Economic growth continues to inch-up and the external balances have improved, which has been greeted by a sovereign upgrade by one external rating agency. Resilience is slowly improving reflected in rising scores on several governance indicators. Although the political situation has stabilized, security and regional geopolitical risk remains high.

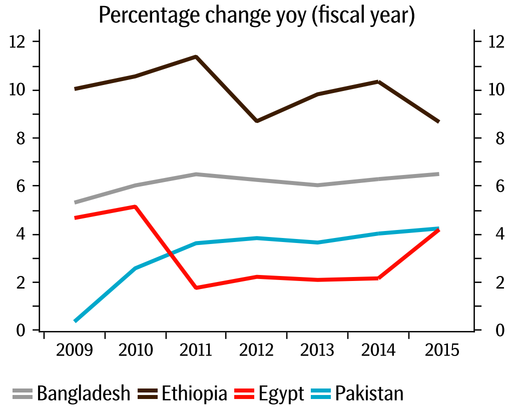
Country Risk Analysis

Economic growth accelerating gradually. Average economic growth in the past 5 years has been just below 4% which is on the low side compared to other economies in a similar risk class and those at a similar level of development. Some acceleration in activity was seen in the past fiscal year ending in July when real GDP expanded 4.2%, up from 4% in the previous year. Still, growth rates are slightly less than we expected a year ago.

Improvements to the energy supply, low oil prices and investment activity related to the energy and infrastructure project "China-Pakistan Economic Corridor" (see box) will contribute to lifting growth further next year. Our forecaster, Oxford Economics expects real GDP growth to accelerate to 5% which is slightly more optimistic than the IMF but lower than the government forecast of 5.5%.

Real GDP

Percentage change yoy (fiscal year)



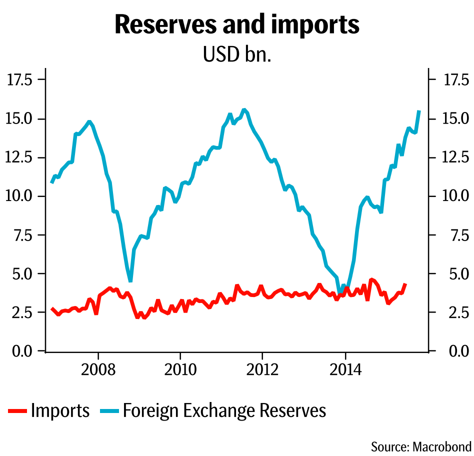
Source: IMF, WEO

Lower inflation and interest rates.
Inflation has declined during the past year on the back of lower food and energy prices. Following the multi-year lows of 1.3% in September, inflation is expected to rise as favourable base effects drop out and to average about 5% in 2016. In response to the falling inflation, the central bank started to cut interest rates at the end of 2014. Policy rates were cut significantly during 2015 to the current 6%.

IMF programme broadly on track. The Stand-By Arrangement with the IMF agreed in 2013 is progressing, albeit with some hick-ups. Considerable progress has been made with a wide range of structural reforms, including on privatization and institutional and energy sector reform. Implementation of the Fund programme has also led to more sound and credible economic policies and has most likely contributed to the improvements seen in several governance indicators. While the authorities recently missed performance criteria relating to the fiscal deficit and net domestic assets, it seems likely that the next loan tranche will be released shortly. We base our country risk assessment on the assumption of a continued timely implementation of the IMF programme bearing in mind the country's poor implementation record of previous programmes.

External balances continue to improve. Pakistan's twin deficits that have been spooking investors for many years are slowly becoming slightly less menacing ghosts. The current account balance has improved lately with the deficit falling below 1% of GDP in the past fiscal year. Low oil prices and a solid flow of remittances have contributed to the shrinking deficit. Meanwhile, foreign direct investment (FDI) and portfolio flows have been weak recently. Looking ahead, higher costs for capital goods imports is likely to raise the current account deficit again. At the same time, foreign investment is expected to pick-up although remain at very low levels expressed as a share of GDP. Hence, intact IMF funding will remain key for financing the small current account deficit.

International reserves rising steadily. Two government bond issuances, steady flows of remittances and disbursements under the IMF programme have contributed to lifting reserves in the past two years. They now cover nearly 4 months of imports. This is well in line with other countries in the same risk class. Reserves are expected to rise further in the next few years although they may not fully keep up pace with rising imports. While this is positive, the events in 2013 when the country due to dwindling reserves nearly was unable to repay the IMF show that the situation can change very quickly.



<u>China-Pakistan Economic Corridor</u>
The corridor will connect Western China with Southern Pakistan via rail, road, and an oil and gas pipeline. The project has been under discussion for many years as China has sought for ways to shorten transport routes for energy imports from the Middle East and also to get direct access to the Indian Ocean. At the same time, Pakistan has huge need to improve its infrastructure and raise power generation capacity. The initial investments in energy and infrastructure in Pakistan pledged by China total USD 45 bn of which the lion share is in energy projects. All transport infrastructure projects are scheduled to be completed by 2017-2018 but other projects span a period up to 2030.

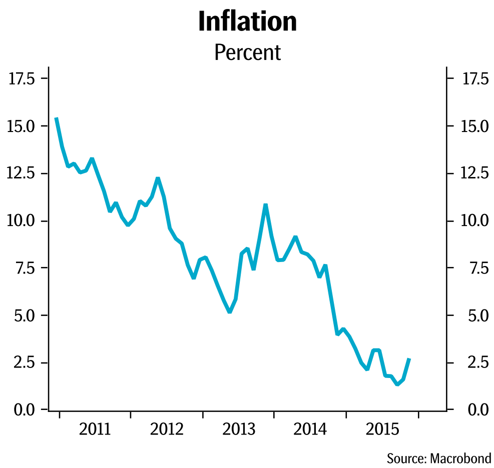
An obvious immediate implication of the construction activity will be to raise the amount of foreign direct investment in the economy. China is already today the single most important foreign investor in Pakistan. The Corridor is likely to also increase bilateral trade between the two. The IMF notes that the Corridor has the potential to raise Pakistan's productivity and economic growth over the medium-term. The main effects will come through boosting the economy's supply side by providing better power generation capacity and improving physical infrastructure.

Moderate external debt. External debt has remained fairly stable in the past two years at 60-65% of GDP. Most of this is government debt and on concessional terms from multilateral or bilateral donors. The average maturity is relatively long.

Fiscal policy not as tight as expected. Fiscal consolidation continues, albeit at a more gradual pace than expected a year ago. The general government deficit declined to 5.4% of GDP from 5.7% in the previous fiscal year. The IMF programme's target of 5% was missed as federal revenues, among other items, were lower than budgeted. The government aims at a 4.3% deficit for the FY 2015/16 whereas our house forecasters Oxford Economics are less optimistic. Pakistan suffers from chronically low government revenues that are highly dependent on taxes. Although continued progress has been made in the past year in broadening the tax base, revenues are just 13-14% of GDP which is among the lowest of all countries we cover. Moreover, one third of the revenues are consumed by interest expenses.

Government debt stable at about 65% of GDP. After bringing the government debt down from above 80% of GDP in 2000, the ratio has stabilized at about 65% in the past few years. This is on the higher side compared to most other countries in the similar risk class. About one third of the debt is denominated in foreign currency, according to Moody's, making the debt service sensitive to fluctuations in the exchange rate. Furthermore, although the average maturity on domestic debt has risen marginally, nearly one half has a maturity of one year or less. This naturally increases the government's vulnerability to roll-over risk. The IMF expects debt as a share of GDP to decline only marginally in the next few years.

Monetary policy framework more effective. Since our last review, reforms, such as the establishment of an independent monetary policy council and the introduction of an interest rate corridor has made the monetary policy framework more credible and effective. These measures should facilitate liquidity management in the interbank market and may ultimately help anchor inflation expectations.



Political risk remains high. The domestic political situation has remained relatively stable since the democratic elections in 2013. Recent local election results also showed strong support for the government. Following one of the most deadly terrorist attacks in Pakistan in 2014, the government stepped up its fight against extremists. The result has been a much lower frequency of militant attacks, but concerns remain over the sustainability of the operation's success once the army winds down operations. The events also showed the government's strong and increasing dependence on the army for national security and for foreign policy. Political volatility and the risk of internal security threats in the form of terrorist and sectarian violence will remain high.

Banking system indicators see small improvements. Most aggregate bank sector indicators are relatively sound, benefiting from the past couple of years' of reform. Capital adequacy ratios have risen in the past year to about 17% while profit growth remains strong. The bank sector's nonperforming loans (NPLs) has declined marginally in the past year and stood at just above 12% of total loans in

June 2015. Banks still have a significant exposure to the government and public sector enterprises implying some concentration risk.

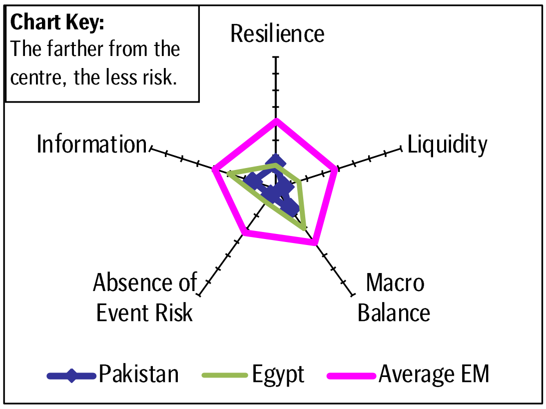
Moody's raised Pakistan's government bond rating one notch in June 2015 based on the improving external liquidity and progress on structural reform under the IMF programme. We share most of their reasoning.

Positive outlook. Given Pakistan's low level of development, expectations of economic growth inching up towards 6% in a few years is not unrealistic. A necessary condition is that investment activity which has been very low since the global financial crisis picks up. Although there will be many challenges on the road to implementing the CPEC, we expect that it will be an important driver behind rising investment and FDI. A continued implementation of the IMF programme is also expected to continue to yield improvements to economic policy and to various areas of governance. We assume that government balances improve over the medium term as the tax base is broadened and tax compliance is being improved.

Risks to the positive main scenario related to failure of IMF programme. One of the most important risks to our rather benign outlook is if the authorities, for domestic or externally related reasons, fail to stick to the IMF programme. Here the country's track record is not impressive. This could of course have serious negative economic and financial consequences. Another important risk is that of increased political instability that translates to economic or financial instability.

Pakistan: Risk Profile

Key ratios	2015
Population (Mn)	44
GDP/capita (USD)	1 367
Real GDP (% chg)	4.2
Inflation (%)	2.6
Current Account (% of GDP)	-0.5
Reserves/imports (months)	4
Budget balance (% of GDP)	-5.3
Government debt (% of GDP)	65



External Ratings:
Fitch: B / Stable
Moody's: B3/Stable
S&P: B- / Positive

Peers:
Ethiopia
Nigeria
Egypt

Graph: Pakistan is weaker than our average emerging market. Event risk is particularly high due to the lack of control of all parts of the country.

Pakistan: Key Economic Indicators

	2011	2012	2013	2014	2015	2016	2017	2018
Macroeconomic								
GDP (% chg)	3.6%	3.8%	3.7%	4.0%	4.2%	5.0%	5.6%	5.7%
GDP (USD bn)	212	215	220	248	258	267	304	334
GDP/capita (USD)	1 218	1 209	1 214	1 339	1 367	1 384	1 545	1 667
Investments/GDP	13%	13%	13%	13%	14%	14%	14%	15%
Trade/GDP (%)	37%	37%	36%	33%	30%	31%	31%	32%
Money & Prices								
CPI inflation (%)	11.9%	9.7%	7.7%	7.2%	2.6%	4.9%	5.0%	4.0%
Exchange rate, USD, average	86	93	102	101	106	113	110	110
Interest rate, 3 months	13.1%	11.0%	9.3%	9.9%	7.4%	7.6%	7.8%	7.5%
Government Finances								
Budget balance/GDP	-6.5%	-6.8%	-8.5%	-5.7%	-5.3%	-4.9%	-4.0%	-3.1%
Govt debt/GDP	60%	64%	65%	65%	65%	64%	61%	59%
Balance of Payments (USD bn)								
Current account	-2.3	-2.4	-4.0	-3.5	-1.3	-1.5	-3.0	-4.1
as % of GDP	-1.1%	-1.1%	-1.8%	-1.4%	-0.5%	-0.6%	-1.0%	-1.2%
Export of goods	30.0	31.4	30.1	30.6	28.9	31.2	35.4	40.9
Imports of goods	48.0	48.9	48.7	51.1	48.0	51.7	58.7	66.5
Other CA flows, net	16	15	15	17	18	19	20	21
FDI, net	1.3	0.8	1.1	1.7	1.3	1.4	1.7	1.9
Loan repayments	2.9	3.5	5.6	4.5	5.2	0.0	0.0	0.0
Other capital flows, net	2	-6	-12	-1	5	3	3	6
Chg in intl reserves	3.5	-3.8	-9.2	1.7	9.9	3.2	1.3	3.4
External Debt & Liquidity (USD bn)								
Total debt	64	61	56	61	61	61	62	63
o/w short term debt	2.5	2.6	1.9	1.9	1.9	1.9	1.9	1.9
Reserves	13.5	9.3	4.3	11.1	14.2	14.3	15.6	--
Reserves, months import coverage	3.3	2.3	1.0	3.1	4.3	4.0	3.8	--
Oil price (Brent)	$109	$99	$54	$53	$59	$63	$68	$72

Source: OEF (Oxford Economic Forecasting) and SEB estimates

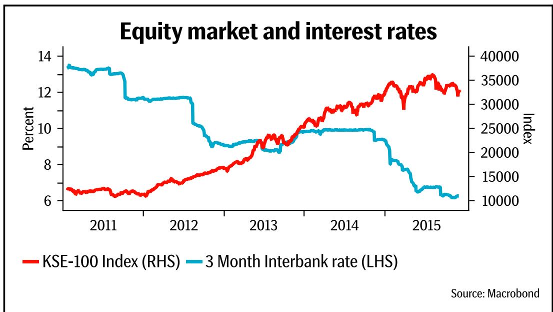
Rating history (eoy)	2011	2012	2013	2014
Fitch				B
Moody's			Caa1	Caa1
S&P			B-	B-

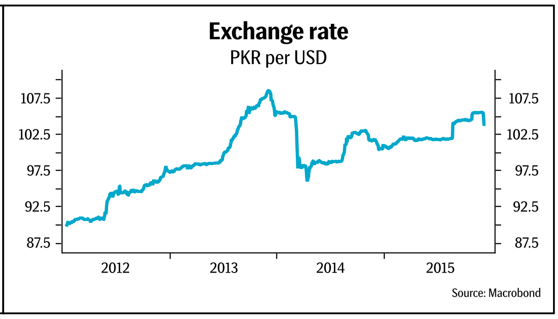
Type of government: Multi-party presidential system

Next elections: Legislative elections 2018, presidential elections 2018

Other:

Latest IMF arrangements 2013, 36 month Extended Fund Facility





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