PAKISTAN INVESTMENT RESEARCH

In Focus

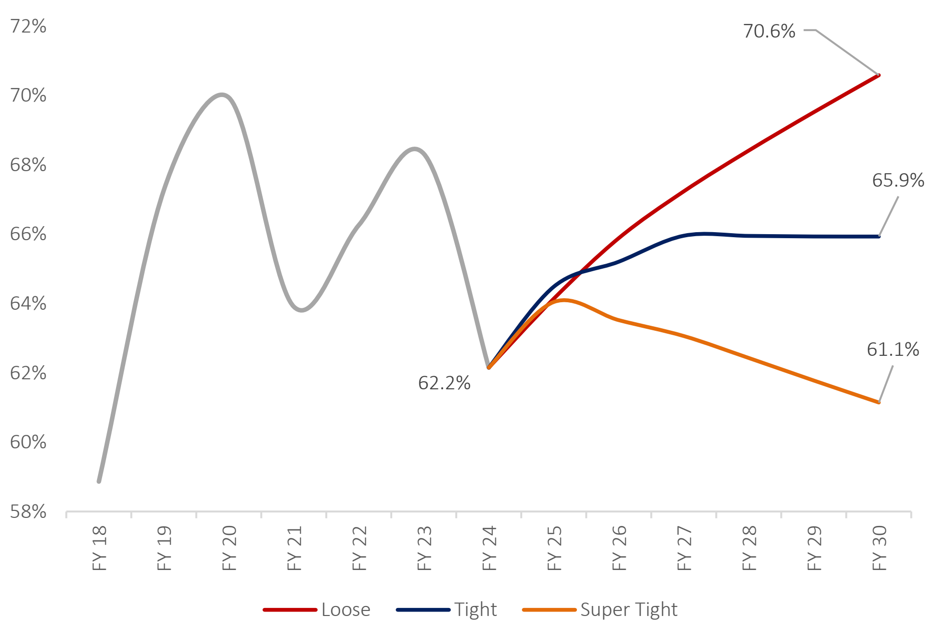
Pakistan Economy

Exploring Potential Pathways for Debt Sustainability

Thursday, March 7, 2024

- **Pakistan's debt-to-GDP ratio has worsened by 10 percentage points between FY18 and FY23, generating concerns over debt sustainability.**
- **We look at three potential paths for economic management up to 2030. Based on approaches to the exchange rate, monetary and fiscal policy, the path of real interest rates, the current account deficit, and GDP growth, we determine the resultant Debt / GDP forecast in three distinct scenarios.**
- **We name these scenarios: 1) loose management, 2) tight management and, 3) super tight management. The 2030 Debt / GDP ranges from 61.1% to 70.6%, depending on the policy path adopted.**
- **We see the tighter scenarios as more likely to occur, given that further leveraging would be unpalatable. In the absence of significant control over exports and CAD in the medium term, we believe fiscal policy will bear the brunt of the necessary adjustments.**
- **Our takeaway is that roughly PKR 2.0tn (2.0% of GDP) in new tax measures are needed to address debt sustainability issues and avoid further leveraging.**

Chart 1: Public Debt to GDP under different economic management scenarios



Source: BMA Research, PBS

Syavash Pahore
Deputy Head of Research
Tel: +44 7984 992801
E-mail: syavash.pahore@bmacapital.com
BMA Capital Management Ltd.

Scenario 1 (Loose management): This scenario represents historical government policy absent IMF's oversight. We assume a very aggressive monetary easing cycle, taking the **discount rate to 13% by July 2025** and real interest rates to 1.0%. **Nominal GDP growth would hover around 5.0% by FY27 and 6.0% by FY28**. The **CAD rises to 4.5% of GDP** over the forecasted period because of high growth. We forecast fiscal expenditures **at 8.0% of GDP** (vs. the current level of 6%; see Page 5 for rationale), and the primary deficit is at 1% of GDP without significant revenue measures.

External debt accumulation would be the sum of the current account deficit (I) and net reserve Increase. Under this scenario, external public debt doubles from 23.7% to 40.6%, although domestic public debt falls because of the high growth rate. This scenario is similar to FY18 – 23, during which the debt-to-GDP rose because of high external borrowing. Note that in all scenarios, restoration of FX reserves to the ideal USD 18-20bn level results in a 2pps increase in the debt-to-GDP ratio.

Loose Management	FY 22	FY 23	FY 24	FY 25	FY 26	FY 27	FY 28	FY 29	FY 30
Discount Rate	10.9%	19.3%	21.8%	15.5%	13.0%	11.0%	11.0%	11.0%	11.0%
GDP Deflator	13.8%	26.5%	22.9%	12.3%	12.1%	10.0%	10.0%	10.0%	10.0%
Real Interest Rate (A)	-2.8%	-7.3%	-1.2%	3.2%	0.9%	1.0%	1.0%	1.0%	1.0%
Nominal GDP Growth	19.9%	26.3%	24.9%	15.3%	16.1%	15.0%	16.0%	16.0%	16.0%
Real GDP Growth (B)	6.2%	-0.2%	2.0%	3.0%	4.0%	5.0%	6.0%	6.0%	6.0%
C = A - B	9.0%	7.1%	3.2%	-0.2%	3.1%	4.0%	5.0%	5.0%	5.0%
USD/PKR	205	280	280	308	339	373	410	451	496
Depreciation %	30%	37%	0%	10%	10%	10%	10%	10%	10%
Net Federal Revenue % of GDP (D)	5.6%	5.5%	6.3%	5.8%	7.0%	7.1%	7.1%	7.1%	7.0%
Expenditure Ex-Debt % of GDP (E)	9.2%	6.5%	6.1%	6.5%	8.0%	8.0%	8.0%	8.0%	8.0%
Debt Servicing % of GDP (F)	4.8%	6.9%	8.6%	6.4%	5.3%	4.2%	3.8%	3.6%	3.4%
Fiscal Balance G = (D - E - F)	-8.4%	-7.9%	-8.5%	-6.6%	-5.8%	-4.6%	-4.2%	-4.0%	-3.9%
Primary Fiscal Balance H = (D - E)	-3.6%	-1.0%	0.2%	-0.7%	-1.0%	-0.9%	-0.9%	-0.9%	-1.0%
Current Account Deficit (I)	17	4	2	12	17	17	21	22	23
CAD % of GDP J = (I / K)	5.2%	1.2%	0.4%	3.0%	4.0%	4.0%	4.5%	4.5%	4.5%
GDP (USD BN) (K)	327	302	377	395	417	436	460	485	511
Total FX Reserves	15	9	8	12	14	15	16	17	18
Net Reserve Increase			(1)	4	2	1	1	1	1
Debt USD BN:									
Domestic Public Debt (L)	152	139	166	171	176	178	181	183	185
Domestic Public Assets (M)	24	18	21	22	24	26	28	30	32
External Public Debt (N)	89	86	89	105	123	141	162	184	208
Net Public Debt O = (L - M + N)	217	206	235	254	275	293	315	337	361
Debt to GDP:									
Domestic Public Debt (L/K)	46.4%	45.9%	43.9%	43.3%	42.3%	40.9%	39.3%	37.7%	36.2%
Domestic Public Assets (M/K)	7.2%	6.0%	5.5%	5.7%	5.8%	5.9%	6.0%	6.1%	6.2%
External Public Debt (M/K)	27.1%	28.5%	23.7%	26.5%	29.4%	32.3%	35.2%	38.0%	40.6%
Net Public Debt (O/K)	66.3%	68.3%	62.2%	64.1%	65.9%	67.2%	68.4%	69.5%	70.6%

Scenario 2 (Tight Management): We modify Scenario 1 by assuming a gradual monetary easing path but with the same end result of a 1.0% RIR. **GDP growth tops at 5.0%** instead of 6.0%, and the CAD settles at 3.0% of GDP (requiring unofficial import controls). The FX reserves rise from USD 9bn to USD 18bn, and additional CAD financing takes the external-debt-to-GDP ratio to 35.7% instead of 40.6% as in Scenario 1. Meanwhile, domestic debt leverage remains unchanged.

This scenario is a highly unlikely trifecta of low real rates, high growth, and controlled CAD. In our report "Higher For Longer Rates", we explained why a 2.0 – 3.0% real interest rate differential is the norm under IMF programs. A controlled CAD amid recovering GDP growth is unlikely, given the IMF's insistence on trade liberalization. Under the current SBA, the authorities have committed to removing the 100% cash margin requirement for imports, likely adding to pressure on the import bill. In this scenario, we assume an additional 0.5% of GDP taxation measures over Scenario 1 to reduce the primary deficit to 0.5%.

Tight Management	FY 22	FY 23	FY 24	FY 25	FY 26	FY 27	FY 28	FY 29	FY 30
Discount Rate	10.9%	19.3%	21.8%	16.5%	14.0%	11.5%	11.0%	11.0%	11.0%
GDP Deflator	13.8%	26.5%	22.9%	12.3%	12.1%	10.0%	10.0%	10.0%	10.0%
Real Interest Rate (A)	-2.8%	-7.3%	-1.2%	4.2%	1.9%	1.5%	1.0%	1.0%	1.0%
Nominal GDP Growth	19.9%	26.3%	24.9%	16.3%	16.1%	15.0%	16.0%	16.0%	16.0%
Real GDP Growth (B)	6.2%	-0.2%	2.0%	3.0%	4.0%	4.0%	5.0%	5.0%	5.0%
C = A - B	9.0%	7.1%	3.2%	-1.2%	2.1%	2.5%	4.0%	4.0%	4.0%
USD/PKR	205	280	280	308	339	373	410	451	496
Depreciation %	30%	37%	0%	10%	10%	10%	10%	10%	10%
Net Federal Revenue % of GDP (D)	5.6%	5.5%	6.3%	6.3%	7.5%	7.6%	7.6%	7.6%	7.6%
Expenditure Ex-Debt % of GDP (E)	9.2%	6.5%	6.1%	6.5%	8.0%	8.0%	8.0%	8.0%	8.0%
Debt Servicing % of GDP (F)	4.8%	6.9%	8.6%	6.4%	5.3%	4.2%	3.8%	3.7%	3.5%
Fiscal Balance G = (D - E - F)	-8.4%	-7.9%	-8.5%	-6.6%	-5.8%	-4.6%	-4.3%	-4.1%	-3.9%
Primary Fiscal Balance H = (D - E)	-3.6%	-1.0%	0.2%	-0.2%	-0.5%	-0.4%	-0.4%	-0.4%	-0.4%
Current Account Deficit (I)	17	4	2	12	13	13	14	14	15
CAD % of GDP J = (I / K)	5.2%	1.2%	0.4%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
GDP (USD BN) (K)	327	302	377	395	417	432	452	472	494
Total FX Reserves	15	9	8	12	14	15	16	17	18
Net Reserve Increase			(1)	4	2	1	1	1	1
Debt USD BN:									
Domestic Public Debt (L)	152	139	166	173	177	178	178	178	178
Domestic Public Assets (M)	24	18	21	23	24	25	26	28	29
External Public Debt (N)	89	86	89	105	119	132	146	161	176
Net Public Debt O = (L - M + N)	217	206	235	255	272	285	298	312	326
Debt to GDP:									
Domestic Public Debt (L/K)	46.4%	45.9%	43.9%	43.7%	42.5%	41.2%	39.5%	37.7%	36.1%
Domestic Public Assets (M/K)	7.2%	6.0%	5.5%	5.7%	5.8%	5.8%	5.8%	5.8%	5.8%
External Public Debt (M/K)	27.1%	28.5%	23.7%	26.5%	28.4%	30.5%	32.3%	34.0%	35.7%
Net Public Debt (O/K)	66.3%	68.3%	62.2%	64.5%	65.2%	66.0%	66.0%	65.9%	65.9%

Scenario 3 (Tight Management): We assume another 0.5% of GDP additional taxation measures over Scenario 2, for a total of 2% additional taxation. We also reduce fiscal expenditures by 0.5% to **attain a 0.5% primary surplus**. Consistent with a 3.0% CAD estimate and fiscal control, we estimate a lower GDP growth number. We also assume less currency devaluation to reduce the external debt-to-GDP ratio, requiring strict monitoring of the CAD. In this scenario, our **debt-to-GDP ratio falls slightly from 62.2% in FY24 to 61.1% in FY30.**

Super Tight Management	FY 22	FY 23	FY 24	FY 25	FY 26	FY 27	FY 28	FY 29	FY 30
Discount Rate	10.9%	19.3%	21.8%	16.5%	14.0%	11.5%	11.0%	11.0%	11.0%
GDP Deflator	13.8%	26.5%	22.9%	12.3%	12.1%	10.0%	10.0%	10.0%	10.0%
Real Interest Rate (A)	-2.8%	-7.3%	-1.2%	4.2%	1.9%	1.5%	1.0%	1.0%	1.0%
Nominal GDP Growth	19.9%	26.3%	24.9%	15.3%	16.1%	14.0%	14.0%	14.0%	14.0%
Real GDP Growth (B)	6.2%	-0.2%	2.0%	3.0%	4.0%	4.0%	4.0%	4.0%	4.0%
C = A - B	9.0%	7.1%	3.2%	-1.2%	2.1%	2.5%	3.0%	3.0%	3.0%
USD/PKR	205	280	280	308	333	359	388	419	453
Depreciation %	30%	37%	0%	10%	8%	8%	8%	8%	8%
Net Federal Revenue % of GDP (D)	5.6%	5.5%	6.3%	7.8%	8.0%	8.1%	8.1%	8.1%	8.1%
Expenditure Ex-Debt % of GDP (E)	9.2%	6.5%	6.1%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%
Debt Servicing % of GDP (F)	4.8%	6.9%	8.6%	6.3%	5.1%	4.0%	3.5%	3.3%	3.1%
Fiscal Balance G = (D - E - F)	-8.4%	-7.9%	-8.5%	-6.0%	-4.6%	-3.4%	-3.0%	-2.7%	-2.5%
Primary Fiscal Balance H = (D - E)	-3.6%	-1.0%	0.2%	0.3%	0.5%	0.6%	0.6%	0.6%	0.6%
Current Account Deficit (I)	17	4	2	12	13	13	14	15	16
CAD % of GDP J = (I / K)	5.2%	1.2%	0.4%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
GDP (USD BN) (K)	327	302	377	395	425	448	473	500	527
Total FX Reserves	15	9	8	12	14	15	16	17	18
Net Reserve Increase			(1)	4	2	1	1	1	1
Debt USD BN:									
Domestic Public Debt (L)	152	139	166	171	175	175	174	173	171
Domestic Public Assets (M)	24	18	21	22	24	25	26	27	28
External Public Debt (N)	89	86	89	105	119	133	148	163	180
Net Public Debt O = (L - M + N)	217	206	235	253	270	283	295	309	322
Debt to GDP:									
Domestic Public Debt (L/K)	46.4%	45.9%	43.9%	43.2%	41.1%	39.0%	36.7%	34.5%	32.5%
Domestic Public Assets (M/K)	7.2%	6.0%	5.5%	5.7%	5.6%	5.6%	5.5%	5.5%	5.4%
External Public Debt (M/K)	27.1%	28.5%	23.7%	26.5%	28.0%	29.6%	31.2%	32.7%	34.1%
Net Public Debt (O/K)	66.3%	68.3%	62.2%	64.0%	63.5%	63.1%	62.4%	61.8%	61.1%

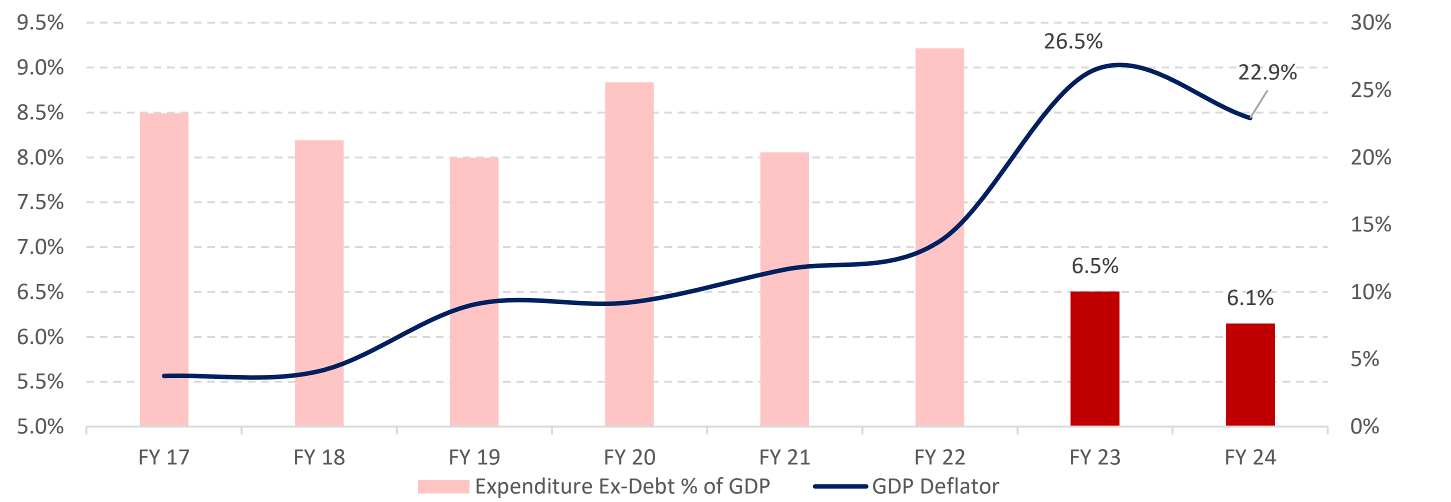
A note on sudden de-leveraging: Currency stability in the face of high nominal GDP growth can result in abrupt movements in the debt-to-GDP ratio. During FY20 – 21, debt ratio fell from 69.9% to 63.9% as nominal GDP grew 17% while the currency appreciated 6%. We see a similar case moving from FY23 to FY24 wherein a combination of high nominal GDP and absence of currency devaluation may contribute to a reduction in the debt-to-GDP.

Fiscal Expenditures excl. Debt Servicing: In Scenario 1 and 2, we assume fiscal expenditures excl. debt Servicing is at 8.0% of GDP, and in Scenario 3, we project a 7.5% of GDP figure. In FY23, this number was 6.5% and may fall to 6.1% in FY24. Because of high double digit inflation and muted nominal growth, current expenditures have shrunk significantly in real terms. This scenario represents a significant risk when expenditures mean revert. Within this head, subsidies and grants combined were 15% of the total in FY16 and currently stand at 38%.

Given other expenditures should mean revert at some point, subsidies and grants should fall to make space for normalized expenditures. This scenario underlies the basis for our 8.0% of GDP assumption for fiscal expenditures excl. debt servicing in the medium to long term.

As explained in our previous report, "Higher For Longer", we expect the IMF to aggressively push for reducing subsidies and grants and therefore expect administered prices such as electricity to rise significantly during the program, contributing to inflation and higher rates.

Chart 2: Real expenditures have fallen and should mean revert to 8.0% of GDP



Source: BMA Research, PBS

Implications for fiscal policy: Deleveraging requires significant and urgent efforts to raise tax collection to avoid the Debt to GDP ratio rising beyond 70%; the government may introduce additional taxation measures to offset the collection deficits. News reports suggest the reimposition of ADR tax on banks, reduction in subsidies, implementation of fixed electricity charges, lending-related taxes for the banking sector, and additional taxes for the salaried class by reducing slabs.

We believe these measures are likely and expect significant taxation-related measures in the next budget. We think that monetary easing is likely to be gradual while the GDP growth rate could be lower. Increasing exports will be difficult given the sharp rise in administered energy prices. Industrial consumers need to be cross-subsidized by raising bills on domestic consumers. This is a hard pill that the government has to swallow to grow exports sustainably.

Data from other countries on debt sustainability: We look at 36 emerging market defaults and their external debt to GDP and external debt / exports Ratio. The latter is more useful as the level of exports determines debt repayment capacity in the absence of any other major inflows. As shown on the next page, in the year of default, external debt to GDP averages 68% while external debt to exports averages 229%.

Including private and public external debt of USD 128bn (since both have to be financed the distinction between public and private does not matter), the external debt to GDP ratio stands at 42%. External debt to exports, based on 12-month trailing exports, stands at 425%. After including remittances, the ratio drops to 229%.

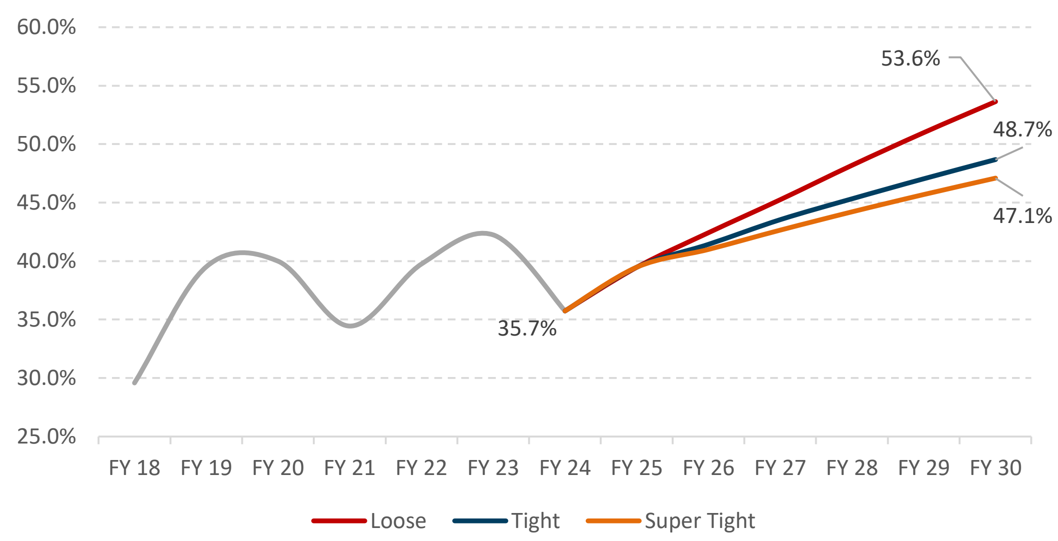
External Debt to GDP and Exports in year of default	Year	External Debt / GDP	External Debt / Exports
Ecuador	2008	30.0%	74.6%
Uruguay	2003	95.3%	334.4%
Argentina	2001	57.4%	409.8%
Ecuador	2000	107.3%	181.5%
Russian Federation	1998	30.5%	109.8%
Iran	1992	41.8%	77.6%
Russian Federation	1991	12.3%	n.a
Albania	1990	16.6%	98.6%
Bulgaria	1990	57.1%	154.0%
Iraq	1990	n.a	n.a
Jordan	1989	181.9%	234.2%
Trinidad and Tobago	1989	48.5%	103.6%
South Africa	1985	n.a	n.a
Ecuador	1984	68.0%	271.5%
Egypt	1984	112.7%	282.6%
Peru	1984	65.6%	288.9%
Brazil	1983	50.1%	393.6%
Chile	1983	96.5%	358.6%
Morocco	1983	86.6%	305.6%

External Debt to GDP and Exports in year of default	Year	External Debt / GDP	External Debt / Exports
Panama	1983	n.a	56.8%
Philippines	1983	74.0%	278.1%
Uruguay	1983	63.7%	204.0%
Argentina	1982	55.1%	447.3%
Dominican Republic	1982	32.7%	183.3%
Guyana	1982	237.6%	337.7%
Mexico	1982	46.9%	279.3%
Romania	1982	20.3%	73.1%
Venezuela	1982	40.1%	131.0%
Costa Rica	1981	136.9%	267.0%
Honduras	1981	63.5%	182.8%
Poland	1981	26.8%	108.1%
Bolivia	1980	97.1%	246.4%
Jamaica	1978	48.6%	103.9%
Peru	1978	80.9%	388.5%
Turkey	1978	21.0%	374.2%
Chile	1972	31.8%	n.a
Average		67.7%	229.4%
Pakistan (Current)		42.0%	425.0%

Source: Reinhart, Rogoff, and Savastano (2003) & World Bank.
Pakistan numbers based on private + public external debt. Debt / Exports, accounting for remittances, falls to 228%.

Any discussion on debt sustainability is incomplete without mentioning non-public external debt. Between FY16 and FY23, external non-public debt, comprising external private debt and PSE debt, has risen from USD 16bn to USD 42bn. Much of this debt is CPEC-related and has failed to offer affordable energy and increased exports to finance it. While fiscal reform is the need of the moment and relatively easier to manage, external debt accumulation remains a potent risk over the medium term.

Chart 2: Total (Public + Private) External Debt / GDP under the three scenarios



Source: BMA Research, PBS

Implications for equity strategy: The market was fixated on elections and the incoming disinflation. One event is behind us while disinflation, through the high-base effect, is playing out. The attention now must shift to the IMF program, the policy regime that will be in place in the next few years, and how investors might navigate it.

We believe additional taxation is almost a certainty, although it remains to be seen how the tax burden is distributed. The new budget will influence the market's performance for the remainder of 2024 and it remains to be seen if the current account deficit can be kept in check amidst economic recovery. We think the IMF's insistence on abolishing all forms of import controls, although in line with the spirit of trade liberalization, is inappropriate given Pakistan's current predicament and how the authorities navigate this particular area will have implications for how the economy is to be managed.

Given the risks, we advocate a preference for energy and electricity firms that may benefit from rollbacks in subsidies/grants and an increase in electricity/gas prices. We also continue to prefer Banks as we believe monetary easing is likely to be gradual. The economic environment remains restrictive for cyclical firms and import-driven sectors, and as a result, equity returns may continue to be concentrated in large caps.

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Old rating system

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)