MOODY'S
RATINGS

Rating Action: Moody's Ratings upgrades Pakistan's ratings to Caa2; changes outlook to positive

28 Aug 2024

Singapore, August 28, 2024 -- Moody's Ratings (Moody's) has today upgraded the Government of Pakistan's local and foreign currency issuer and senior unsecured debt ratings to Caa2 from Caa3. We have also upgraded the rating for the senior unsecured MTN programme to (P)Caa2 from (P)Caa3. Concurrently, the outlook for Government of Pakistan is changed to positive from stable.

The upgrade to Caa2 reflects Pakistan's improving macroeconomic conditions and moderately better government liquidity and external positions, from very weak levels. Accordingly, Pakistan's default risk has reduced to a level consistent with a Caa2 rating. There is now greater certainty on Pakistan's sources of external financing, following the sovereign's staff-level agreement with the IMF on 12 July 2024 for a 37-month Extended Fund Facility (EFF) of $7 billion. We expect the IMF Board to approve the EFF in the next few weeks. Pakistan's foreign exchange reserves have about doubled since June 2023, although they remain below what is required to meet its external financing needs. The country remains reliant on timely financing from official partners to fully meet its external debt obligations. Pakistan's Caa2 rating continues to reflect Pakistan's very weak debt affordability, which drives high debt sustainability risk. We expect interest payments to continue absorbing about half of government revenue over the two to three years. The Caa2 rating also incorporates the country's weak governance and high political uncertainty.

The positive outlook reflects a balance of risks skewed to the upside. It captures the possibility that the government is able to further lower its government liquidity and external vulnerability risks, and achieve a better fiscal position than we currently expect, supported by the IMF programme. Sustained reform implementation, including revenue-raising measures, can increase the government revenue base and improve Pakistan's debt affordability. A record of completing IMF reviews on a timely manner would also allow Pakistan to continually unlock financing from official partners, sufficient to meet its external debt obligations and support further rebuilding of its foreign exchange reserves.

The upgrade to Caa2 from Caa3 rating also applies to the backed foreign currency senior unsecured ratings for The Pakistan Global Sukuk Programme Co Ltd. The associated payment obligations are, in our view, direct obligations of the Government of Pakistan. The outlook for The Pakistan Global Sukuk Programme Co Ltd is positive.

Concurrent to today's action, we have also raised Pakistan's local and foreign currency country ceilings to B3 and Caa2 from Caa1 and Caa3, respectively. The two-notch gap between the local currency ceiling and sovereign rating is driven by the government's relatively large footprint in the economy, weak institutions, and high political and external vulnerability risk. The two-notch gap between the foreign currency ceiling and the local currency ceiling reflects incomplete capital account convertibility and relatively weak policy effectiveness. It also takes into account material risks of transfer and convertibility restrictions being imposed.

Please click on this link https://www.moodys.com/viewresearchdoc.aspx?docid=PBC_ARFTL494378 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and identifies each affected issuer.

RATINGS RATIONALE

RATIONALE FOR THE UPGRADE TO Caa2

GOVERNMENT LIQUIDITY AND EXTERNAL VULNERABILITY RISKS HAVE REDUCED FROM VERY HIGH LEVELS, BUT NOT ELIMINATED

Our earlier concerns over very high risks of a balance of payments crisis materializing have diminished, although risks remain elevated as Pakistan continues to rely on timely and sufficient disbursement of financing from official partners.

There is now greater certainty over Pakistan's sources of financing to meet its needs over the next two to three years, following the IMF staff-level agreement reached on 12 July 2024. We expect the IMF Board to give its approval for the new 37-month Extended Fund Facility (EFF) worth $7 billion in the next few weeks. The IMF programme is likely to support Pakistan in unlocking additional financing from other multilateral and bilateral partners.

Pakistan's foreign exchange reserves have also about doubled since June 2023, owing to the country's creditable performance under the previous nine-month IMF Standby-Arrangement (SBA) that ended in April 2024, which has supported macroeconomic stability and driven renewed external financing for the country. Pakistan's foreign exchange reserves stood at $9.3 billion as of 16 August 2024, equivalent to just below two months imports. This compares with only $4.4 billion available at end-June 2023.

Nonetheless, Pakistan's foreign exchange reserves are well below what is required to meet its needs, underscoring the importance of steady progress with the IMF

programme to continually unlock financing to meet its needs. We estimate Pakistan's external financing needs to be about $26 billion for fiscal 2025 (ending June 2025), comprising of around $22 billion of external principal debt repayments in fiscal 2025 and another $4 billion (about 1% of GDP) to finance the current account deficit. Pakistan's financing needs for fiscal 2026-2027 will be similar.

We expect Pakistan to be able to cover its financing needs with funding from official partners, although there remains uncertainty around the government's ability to sustain reform implementation. The coalition government formed after elections held in February 2024 may not have sufficiently strong electoral mandate to continually implement revenue-raising measures without stoking social tensions. Slippages in reform implementation or results could lead to delays in or withdrawal of financing support from official partners.

GRADUAL FISCAL CONSOLIDATION UNDERWAY, ALTHOUGH DEBT AFFORDABILITY REMAINS VERY WEAK

Gradual fiscal consolidation is underway, but we expect Pakistan's debt affordability to remain very weak, driving high debt sustainability risk. With a large share of revenue going towards interest payments, the government's ability to spend on essential social and economic needs will remain constrained.

Interest payments consumed about 60% of government revenue in fiscal 2024. We expect interest payments to account for 55-60% of government revenue in fiscal 2025, before declining to about 45-50% in fiscal 2026-2027. At these levels, Pakistan's interest payments as a share of government revenue will still be one of the highest among rated sovereigns.

Pakistan's government debt to GDP is high, albeit slowly declining, on the back of high nominal GDP growth and modest fiscal consolidation. The government seeks to achieve significant fiscal consolidation mainly through increases in tax revenue, which it projects would be 40% higher in fiscal 2025 than a year ago in nominal terms. The government estimates its fiscal deficit at 5.9% of GDP and primary surplus at 2.0% for fiscal 2025 (fiscal 2024: 6.8% deficit and 0.9% surplus, respectively).

We expect the pace of fiscal consolidation to be slower than the government envisages, as large and successive tax increases could drive an increase in social tensions, leading the government to temper its pace of fiscal consolidation. We project a larger fiscal deficit of about 6.5% of GDP and smaller primary surplus of around 0.5-1% of GDP for fiscal 2025.

RATIONALE FOR POSITIVE OUTLOOK

The positive outlook reflects a balance of risks skewed to the upside. It captures the possibility that the government further reduces its government liquidity and external vulnerability risks, and achieves a better fiscal position than we currently expect.

A building track-record of reforms that effectively stabilize the economy and public finances could unlock more financing for Pakistan, securing the sovereign's external position more robustly than we currently expect. In addition, the governments of Saudi Arabia and the United Arab Emirates have collectively pledged to invest $15 billion in Pakistan, which if realized, would significantly bolster Pakistan's foreign exchange reserves.

Moreover, the government aims to broaden its revenue base, through measures that include raising taxes on the agriculture, retail and export sectors. If these measures are implemented and sustained, they may improve Pakistan's debt affordability more significantly than we forecast.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Pakistan's CIS-5 credit impact score reflects its very high exposure to social and environmental risks, as well as its weak governance profile. Pakistan's weak governance and institutions and its very weak fiscal strength constrain the government's capacity to address environment and social risks.

Pakistan's E-5 issuer profile score for environmental risk reflects Pakistan's vulnerability to climate change and the limited supply of clean, fresh and safe water. Pakistan drains a significant proportion of its scarce fresh water resources every year, and a large share of its population is exposed to unsafe drinking water. Water utility services tend to be intermittent, because of high leakage levels and limited supply. The inadequate quality of drinking water has health and economic consequences for Pakistan, such as contributing to stunting which undermines human capital. With varied climates across the nation, Pakistan is significantly exposed to extreme weather events, including tropical cyclones, drought, floods and extreme temperatures. Vulnerability to extreme climate events can create significant economic, fiscal and social costs for the sovereign, as demonstrated by the severe floods that occurred in 2022.

Pakistan has a S-5 issuer profile score for social risk. Very low incomes as well as limited access to quality healthcare, basic services, housing and education, especially in rural areas, together with safety concerns, are important social issues. Social risks have increased alongside persistent upward pressures on inflation. Households are likely to continue facing difficult economic conditions in the foreseeable future. As a significant share of revenue goes towards interest payments, it will increasingly constrain the government's capacity to service its debt while also meeting the population's essential social spending needs.

Pakistan has a G-4 issuer profile score for governance risk. International surveys of various indicators of governance, while showing some early signs of improvement, continue to point to weak rule of law and control of corruption, as well as limited government effectiveness. Fiscal policy effectiveness is particularly low, resulting in a persistently narrow revenue base that constrains the government's capacity to

address the country's needs.

GDP per capita (PPP basis, US$): 6,791 (2023) (also known as Per Capita Income)

Real GDP growth (% change): -0.2% (2023) (also known as GDP Growth)

Inflation Rate (CPI, % change June/June): 29.4% (2023)

Gen. Gov. Financial Balance/GDP: -7.7% (2023) (also known as Fiscal Balance)

Current Account Balance/GDP: -1% (2023) (also known as External Balance)

External debt/GDP: 36.8% (2023)

Economic resiliency: ba3

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 23 August 2024, 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 economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially increased. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

FACTORS THAT COULD LEAD TO AN UPGRADE

The rating would likely be upgraded if Pakistan's government liquidity and external vulnerability risks decreased more significantly and durably than we currently expect. This could come from a record of completing IMF reviews in a timely manner that indicates the government's ability to sustain reform implementation, leading to continued inflows of external financing from official partners sufficient to meet its needs while supporting some rebuilding of the foreign exchange reserves. A record of fiscal consolidation on a sustained basis, including through implementing revenue-raising measures, pointing to a meaningful improvement in debt affordability would also be credit positive.

FACTORS THAT COULD LEAD TO A DOWNGRADE

The outlook would likely be changed to stable if further reductions in government liquidity and external vulnerability risks are unlikely to materialize. This could come from signs that the sovereign is unable to drive consistent increases in its foreign

exchange reserves, while also meeting its external debt obligations.

The rating would likely be downgraded if there were evidence of a renewed increase in government liquidity or external vulnerability risks. This could come from financing strains due to delays in or withdrawal of support from multilateral and bilateral partners. An increase in social and political risks that disrupted policymaking and undermined Pakistan's ability to secure financing would also be credit negative.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819 . Alternatively, please see the Rating Methodologies page on https://ratings.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.

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Grace Lim
Analyst
Sovereign Risk Group
Moody's Investors Service Singapore Pte. Ltd.
71 Robinson Road #05-01/02
Singapore, 068895
Singapore
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077

Gene Fang
Associate Managing Director
Sovereign Risk Group

JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077

Releasing Office:
Moody's Investors Service Singapore Pte. Ltd.
71 Robinson Road #05-01/02
Singapore, 068895
Singapore
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077

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