

Pakistan Economy

Pakistan upgraded to CCC+ by Fitch

- Fitch Ratings after a gap of twelve months has upgraded Pakistan's Long-term Foreign-Currency Issuer Default Rating (IDR) to CCC+ to CCC.
- Improving access to external funding prospects is one of the reasons behind the ratings upgrade, to recall; Pakistan signed an SLA with IMF for a 37-month long US\$ 7bn, which improves the prospects of external financing.
- The upgrade is also because of the structural reforms Pakistan has undertaken in the FY25 budget, pertaining to the energy sector, taxation system and state-owned entities.
- Other reasons for the ratings upgrade include the narrower external deficit; Pakistan reported one of its lowest Current Account Deficit (CAD) of US\$ 700mn in FY24. Foreign reserves of SBP have witnessed an increasing trend, fiscal consolidation, and Pakistan being successfully able to complete its 9-month Stand-by agreement with IMF.

We highlight some of the key points from the Fitch Ratings report:

Fitch Ratings upgraded Pakistan's long-term foreign currency issuer default rating (IDR) to CCC+ from CCC.

Fitch Ratings has upgraded Pakistan's Long-Term Foreign-Currency Issuer Default Rating (IDR) from 'CCC' to 'CCC+', marking the first since Jul-23 (previously 'CCC' in December 2023). This upgrade is attributed to the following factors:

1. Enhanced external funding prospects

The upgrade indicates increased confidence in the continued availability of external funding, following Pakistan's staff-level agreement (SLA) with the IMF on a new 37-month, USD 7 billion Extended Fund Facility (EFF). Pakistan's strong performance under the previous, shorter-term IMF arrangement helped reduce fiscal deficits and replenish foreign exchange reserves, with further progress expected. However, Pakistan's significant funding requirements pose a risk if challenging reforms are not effectively implemented, which could negatively impact program performance and funding.

On 12 July, Pakistan and the IMF reached a staff-level agreement (SLA). Before the IMF Board can approve it, which is expected by the end of August, the government needs to secure new funding assurances from bilateral partners, primarily Saudi Arabia, the UAE, and China, amounting to approximately USD 4 billion to 5 billion over

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the duration of the EFF. This is considered achievable due to the strong history of support and the significant policy measures included in the recent budget for the fiscal year ending June 2025 (FY25).

2. Ambitious Reforms

Under the new Extended Fund Facility (EFF), the government plans to address longstanding issues in Pakistan's tax system, energy sector, and state-owned enterprises. There is also a commitment to exchange rate flexibility and enhancing the monetary policy framework. The goal is to raise tax revenues by 3 percentage points of GDP from under 9% in FY24, partly by increasing taxes on the influential agricultural sector, which will require provincial legislation. In April, Pakistan successfully concluded its nine-month Stand-by Arrangement with the IMF. Over the past year, the government increased taxes, reduced spending, and raised the prices of electricity, gas, and petrol. Additionally, the government nearly closed the gap between interbank and parallel market exchange rates by cracking down on the black market and regulating exchange houses.

3. Narrower External Deficit

We project that the current account deficit (CAD) will remain relatively low at around USD 4 billion (approximately 1% of GDP) in FY25, following about USD 700 million in FY24, due to tight financing conditions and weak domestic demand. The significant reduction in the CAD from over USD 17 billion in FY22 has been driven by contractionary economic and fiscal policies, lower commodity prices, and rupee depreciation. Foreign exchange shortages have eased with remittances returning to the official banking system, reversing their decline in the second half of 2022.

4. Large Funding Needs

In addition to addressing the current account deficits, the authorities must manage over USD 22 billion in external public debt maturities in FY25. Of this amount, USD 13 billion consists of bilateral deposits and loans that are typically rolled over, including nearly USD 4 billion owed by the State Bank of Pakistan (SBP). The remaining maturing debt includes nearly USD 4 billion from Chinese commercial banks and another USD 4 billion from multilateral creditors. Pakistan's next international bond maturity is scheduled for September 2025.

The government has identified over USD 24 billion in gross external financing, primarily from bilateral and multilateral sources. This figure excludes potential bond issuance or the renewal of the oil facility with Saudi Arabia but includes a potential Panda bond issuance. Additional funding could also come from foreign direct investment, non-resident portfolio inflows, and climate-related finance, which present further opportunities for the funding plan.

5. Reserves are recovering but still low

The State Bank of Pakistan (SBP) is replenishing its foreign exchange reserves with new funding inflows and modest current account deficits. Official gross reserves, including gold, increased to over USD 15 billion by June 2024 (equivalent to about three months of imports) from nearly USD 10 billion at the end of June 2023. These reserves are expected to rise to nearly USD 22 billion by the end of FY26, approaching their peak in 2021. The SBP's net liquid foreign exchange reserves (excluding gold and banks' FX reserve deposits) recovered to over USD 9 billion by June 2024. Additionally, the SBP has reduced its forward liabilities to local banks and is nearing a balanced net foreign asset/liability position.

6. Fiscal Consolidation

The FY25 budget incorporates half of the revenue measures planned under the Extended Fund Facility (EFF). Developed in collaboration with IMF staff, the budget projects a headline deficit of 5.9% of GDP and a primary surplus of 2.0% (compared to the FY24 estimates of 7.4% and 0.4%, respectively). Our projections, assuming partial implementation of these measures, estimate a primary surplus of 0.8% of GDP and an overall fiscal deficit of 6.9% of GDP for FY25. This is expected to improve to 1.3% and 6% of GDP, respectively, by FY26. In addition to tax reforms, the budget anticipates a doubling of SBP dividends to 2% of GDP and an increase in provincial surpluses to 1% of GDP.

7. Political Challenges

The narrow results of the February elections resulted in a less decisive mandate for Prime Minister Shehbaz Sharif's PMLN party. Following a recent Supreme Court decision that reallocated reserved seats to independents associated with former Prime Minister Imran Khan's PTI party, the PMLN and its allies hold only a slim majority in the National Assembly. Although Imran Khan has been imprisoned since May 2023, he continues to maintain significant popularity.

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