

## Economy

July 20, 2023

Pakistan Equities  
Economy

### Key Points

- Report released by the IMF this Tuesday includes current economic environment, actions taken by the government so far, estimates of key macroeconomic indicators, targets and benchmarks, key risks and required actions, and also emphasizes on climate change resilience.
- The key highlight of the report is timely and complete implementation of the recommended actions and advancing on critical structural reforms to reduce the vulnerabilities and create buffers for shocks.
- Key risks to the program implementation, growth and debt sustainability highlighted in the report include still high commodity prices and market-oriented exchange rate leading to persistent inflation, fiscal slippages, indecisive or delayed implementation of program targets and structural reforms, and risks to external financing amid high gross external financing requirements.
- In relation to stock market, key takeaways include higher than the consensus inflation projection (25.9%) fuelling expectations of further hike in interest rates, a continued slowdown in economic growth with real GDP growth expected at 2.5% and 3.6% expected for FY24 and FY25, respectively, and fixing of average premium between interbank and open market exchange rates at 1.25%.
- We remain neutral for the overall performance of the stock market while remaining optimistic on banks with expected hike in interest rates (MCB, UBL, and BAFL), oil & gas E&P, particularly OGDC with PHPL principal settlement of PKR82bn TFC (PKR19/shares for OGDC), HUBC and ENGRO with expected payments to CPEC IPPs.

### Key Data

KSE100 Index	45,095
KSE-All Share Value (PKRmn)	9,402
KSE-All Share Value (USDmn)	33.1
KSE-All Share Volume (Shmn)	245.5
Market Capitalization (PKRtn)	6.2
Market Capitalization (USDbn)	24.2
1Year High	45,971
1 Year Low	38,136

Source: PSX, Next Research

### Program modalities

IMF this Tuesday released the report containing IMF staff reports for the 9-month USD3bn Stand-by Arrangement (SBA) between Pakistan and the IMF after its approval by the IMF Executive Board on July 12, 2023. Pakistan has already received USD1.2bn as the first tranche of the program. The remaining two tranches of around USD0.7bn and USD1.1bn are expected to be received in Dec'23 and Mar'24, respectively, after performance reviews for quarters ending Sep'23 and Dec'23, respectively are concluded. Following the approval of the SBA, Pakistan also received USD2bn from Saudi Arabia and USD1bn from UAE, which would take Pakistan's foreign exchange reserves with the SBP to around USD10.7bn from USD4.5bn as on July 7, 2023. Report includes current economic environment, actions taken by the government so far, estimates of key macroeconomic indicators, targets and benchmarks, key risks and required actions, and emphasizes is also laid on climate change resilience. The key highlight of the report is timely and complete implementation of the recommended actions and advancing on critical structural reforms to reduce the vulnerabilities and create buffers for shocks.

### Quantitative Performance Criteria and Indicative Targets

	end-Sep'23	end-Dec'23
<b>Quantitative performance criteria</b>		
Floor on net international reserves of SBP (USDmn)	-14,500	-13,800
Ceiling on net domestic assets of the SBP (stock, PKRbn)	15,048	14,800
Ceiling on SBP's stock of net foreign currency swaps/forward position (negative, USDmn)	4,200	4,000
Ceiling on net government budgetary borrowing from the SBP (stock, PKRbn)	4,708	4,708
Ceiling on the general government primary budget deficit (cumulative, excl. grants, PKRbn)	-87	-1,232
Ceiling on the amount of government guarantees (stock, PKRbn)	4,000	4,050
Cumulative floor on targeted cash transfers spending (BISP) (PKRbn)	87.5	185.5

### II. Continuous Performance Criteria

Zero new flow of SBP's credit to general government	0	0
Zero ceiling on accumulation of external public payment arrears by the general government	0	0

### III. Indicative Targets

Cumulative floor on general government budgetary health and education spending (PKRbn)	465	1,031
Floor on net tax revenues collected by the FBR (cumulative, PKRbn)	1,977	4,425
Ceiling on net accumulation of tax refund arrears (cumulative, PKRbn)	32	43
Ceiling on power sector payment arrears (cumulative flow, PKRbn)	-155	64

Source: IMF, Next Research

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## Structural Conditionality

### Prior Actions (Met)

No.	Action	Rationale
1	Approval of FY24 budget in line with IMF staff agreement.	To ensure achievement of fiscal objectives.
2	Withdrawal of circular on prioritization in providing FX for certain types of imports.	To ensure market determined exchange rate.

## Structural Benchmarks

No.	Action	Date
<b>Fiscal</b>		
1	Commit to not grant further tax amnesties.	Continuous
2	Avoid the practice of issuing new preferential tax treatments or exemptions.	Continuous
3	Issuance by the Central Monitoring Unit of its first period report on the performance of SOEs using latest available data, to the Federal Government.	end-Dec'23
<b>Social</b>		
4	Inflation adjustment of the unconditional cash transfer (Kafalat).	end-Jan'24
<b>Monetary and Financial</b>		
5	Average premium between the inter-bank and open market rate will be no more than 1.25% during any consecutive 5 business day period.	Continuous
6	Submission to Parliament of amendments to align Pakistan's early intervention, bank resolution, and crisis management arrangements with international good practices, in line with IMF staff recommendations.	end-Dec'23
<b>Energy Sector and SOEs</b>		
7	Notification of the annual rebasing for FY24 to take effect on July 1, 2023.	end-Jul'23
8	Improve SOEs' governance by: i) operationalizing the recently approved SOE law in to a policy that clarifies ownership arrangements and the division of roles within the Federal Government, and ii) amending the Acts of four selected SOEs to make the new SOE law fully applicable to those SOEs.	end-Nov'23
<b>Climate</b>		
9	Cabinet adoption of a Climate-PIMA and PIMA action plan.	end-Dec'23
<b>Economic Statistics</b>		
10	Compilation and dissemination of Quarterly National Accounts for FY24Q1 and revised annual estimates for FY23.	end-Nov'23

Source: IMF, Next Research

## Estimates of Pakistan key macroeconomic indicators

As we highlighted in our note after the press release on July 13, 2023, most of the estimates for Pakistan's key macroeconomic indicators are close to the Government and our estimates and general consensus. The two major differences are the real GDP growth, which is estimated at -0.5% for FY23 and 2.5% for FY24 whereas the Government's provisional estimates for FY23 suggest a growth of 0.3% in real GDP. The Government also projects a growth of 3.5% for FY24, which we believe is on a higher side and we agree with the estimate of the IMF for real GDP growth for FY24 and beyond. The other variable is inflation, which is estimated at 25.9% for FY24 whereas general consensus including government estimates is in the range of 20-21% and hence real interest rates are already in the positive territory on a forward-looking basis considering consensus estimates. IMF report highlights that the framework assumes that strong policy implementation and timely external financing would reduce near-term uncertainty and help the real economy to gradually stabilize and recover, where the downside risks to the baseline and program implementation are exceptionally high.

### Pakistan's Key Macroeconomic Indicators

	FY22	FY23	FY24P	FY25P	FY26P	FY27P	FY28P
Real GDP growth (%)	6.1	-0.5	2.5	3.6	4.5	5.0	5.0
Inflation (average)	12.1	29.6	25.9	11.4	7.4	6.5	6.5
Budget balance (% of GDP)	-7.9	-7.6	-7.5	-6.7	-5.3	-4.7	-4.2
Primary balance (% of GDP)	-3.1	-1.0	0.4	0.4	0.4	0.4	0.4
External Debt (% of GDP)	32.1	36.4	37.3	36.8	35.2	33.5	31.7
Gen. Govt. Debt (% of GDP)	76.1	77.4	70.9	68.5	67.3	65.1	63.1
Broad Money (YoY change)	13.6	13.3	14.5	16.0	n/a	n/a	n/a
Private credit (YoY change)	21.1	1.0	8.0	15.0	n/a	n/a	n/a
Current Account Balance (% of GDP)	-4.6	-1.2	-1.8	-0.2	-1.7	-1.7	-1.7

Source: IMF, Next Research

## Balance of Payments and exchange rate

As per the IMF report, Pakistan needs to repay USD114bn during the next five years from FY24 to FY28. Pakistan external debt stood at USD101bn at the end of Dec'22, where the major portion is payable to China (24%), World Bank (18%), other multilaterals (19%). With estimated CAD of ~1.7% of GDP per year, total gross external financing requirements swell to USD149bn during the period. The IMF advocates for an unrestricted import mechanism and market-oriented exchange rate mechanism to work as an absorber of external shocks and vulnerabilities. As a prior action Pakistan government has agreed for the market-oriented exchange rate where as a continuous structural benchmark, IMF has fixed average premium between the interbank and open market exchange rates at 1.25%.

**Pakistan Gross External Financing Requirements and Sources (USDmn)**

	FY22	FY23	FY24P	FY25P	FY26P	FY27P	FY28P
Current Account Deficit	17,405	4,020	6,424	6,462	7,139	7,285	7,945
Public debt amortization	11,333	15,010	14,499	13,223	18,081	13,970	16,255
Private sector debt amortization	4,640	5,594	5,779	5,945	6,102	6,263	6,423
IMF repurchases	1,015	969	1,659	1,538	574	1,372	2,232
<b>Gross external financing requirements</b>	<b>34,393</b>	<b>25,593</b>	<b>28,361</b>	<b>27,168</b>	<b>31,896</b>	<b>28,890</b>	<b>32,855</b>
FDI (net)	1,635	-6	173	1,526	1,861	2,250	2,689
Private sector creditors	11,500	9,386	9,663	18,054	21,035	18,468	21,474
Official non-IMF creditors	10,022	8,807	20,132	11,338	10,157	9,214	9,148
Other net capital inflows	-60	475	300	157	97	78	30
IMF SDR allocation	2,767	0	0	0	0	0	0
<b>Available financing</b>	<b>25,864</b>	<b>18,662</b>	<b>30,268</b>	<b>31,075</b>	<b>33,150</b>	<b>30,010</b>	<b>33,341</b>
Remaining financing need	8,529	6,931	-1,907	-3,907	-1,254	-1,120	-486
Borrowing from IMF	1,053	1,166	3,019	0	0	0	0
<b>Reserve Assets</b>	<b>-7,476</b>	<b>-5,765</b>	<b>4,926</b>	<b>3,907</b>	<b>1,254</b>	<b>1,120</b>	<b>486</b>
<b>Gross official reserves (USDbn)</b>	<b>9.8</b>	<b>4.0</b>	<b>9.0</b>	<b>12.9</b>	<b>14.1</b>	<b>15.2</b>	<b>15.7</b>

Source: IMF, Next Research

## Fiscal consolidation necessitated

IMF always lays high emphasis on fiscal consolidation and maintaining a primary surplus. Primary surplus for FY24 and beyond is targeted at 0.4% of GDP as compared to a 1% deficit estimated for FY23. The government has already implemented budget recommendations of the IMF staff as part of prior actions for the SBA. These recommendations included strengthening tax revenues to 10.3% of GDP compared to 10% estimated for FY23, with measures worth over PKR254bn and containing primary expenditure including lower subsidies, in order to create space to scale up investment in social and development sectors. The government has also agreed to discontinue disbursement of unbudgeted amounts through supplementary grants. Broad-based reforms are emphasized to continue to improve the fiscal framework that include strengthening revenue administration including bringing in 300k individuals in PIT through the use of data on the withholding tax of businesses, third-party data, and physical surveys, bring the service sector, notably retailers, into the tax net by making better use of data, and progress on the roll-out of track-and-trace system.

## Improving management of public finances

Operationalization of the Central Monitoring Unit and issuance of its first report on performance of SOEs, along with fully operationalization of Treasury Single Account (TSA-2) by end-Oct'23, are in progress. Although the new Debt Management Office (DMO) is formally in place, following the passage of Amendments to the Fiscal Responsibility and Debt Limitation Act, supported by World Bank and IMF, important resources to make it fully functional are lacking. Some progress has been made with the cabinet approval of DMO rules and the appointment of a new Director General in Feb'23, but to overcome long-standing institutional and technical capacity weaknesses, it will be critical to i) provide adequate resources for DMO staffing, and ii) effectively empower the DMO to implement the agreed medium-term debt management strategy (MTDS), which will be updated annually. The IMF staff also signifies lengthening the maturity profile of public debt as well as managing the cost-risk trade-off of fixed-rate versus floating-rate long-dated debt as a key step.

## Debt sustainability – Risks have substantially increased

The staff highlighted difficult sociopolitical climate, including persistent political volatility, as a key risk to policy implementation, which could undermine Pakistan's adjustment path and growth potential.

External shocks, advanced-economy financial tightening, geopolitical tensions, delayed reform efforts, and still high commodity prices, could affect the availability of external financing, negatively impacting debt sustainability of the country considering huge repayment requirements. Close program monitoring, and financing assurances from key lenders mitigate those risks to some extent. Under a smooth program implementation, IMF projects Pakistan's general government debt to come down from 77.4% in FY23 to 70.9% and 68.5% in FY24 and FY25, respectively.

### Monetary policy

The IMF staff highlighted pauses in monetary tightening and drastic increase in the size of OMOs led to loose monetary conditions and high inflation expectations, and emphasized on maintaining a tight monetary policy. It emphasized that the SBP will need to continue its tightening cycle to re-anchor expectations given that inflationary pressures are expected to persist due to the impacts of exchange rate corrections. IMF projects FY24 inflation at 25.9% compared to 20-21% general consensus. Considering IMF's estimate for inflation, Pakistan has negative real interest rates of ~4% on forward-looking basis (22%-26%=-4%). In the upcoming monetary policy committee meeting on July 31, 2023, a hike of 100-150bps can therefore not be ruled out. Prior to this report, the general market view was that the interest rates have peaked-out and a reversal may be seen from 3QFY24.

### Energy sector reforms

**Power sector subsidies and CD resolution:** IMF has been advocating for implementation of energy sector reforms to make this sector viable and improve the cashflow positions of the energy sector companies and reduce the strain of heavy and untargeted subsidies on fiscal accounts and public finances. The cabinet is expected to adopt an updated FY24 Circular Debt Management Plan (CDMP) in Jul'23 with measures to help contain FY24 power sector subsidy to PKR976bn, which will also allow CD stock payments of PKR392bn to fill the projected FY24 CD flow of PKR392bn and stabilize the FY24 CD stock at its expected end-FY23 level of PKR2.4tn. CD stock payments of PKR392bn would include PHPL principal settlements (PKR82bn) and payments to GPPs and CPEC IPPs (PKR310bn). We understand that the PKR82bn PHPL principal settlement would be aimed at the TFC that OGDC has invested in 2013. This translates to PKR19/ share impact for OGDC.

**Power sector efficiency:** The IMF staff emphasized on timely alignment of power tariffs with cost recovery levels along the established tariff structure that protects the poor through lifeline and protected tariffs. Staff stressed that regular tariff adjustments in line with established formulas for the one annual rebasing (AR) (one due in Jul'23 with recommended increase of PKR7/kwh, end-Jul'23 structural benchmark), four quarterly tariff adjustments (QTAs), and twelve monthly fuel price adjustments (FPAs) per year are critical to implement the CDMP, and halt CD accumulation. The staff also emphasized among other steps, to renegotiate remaining PPAs in return for clearing unguaranteed CPPA arrears, convert publicly-guaranteed PHPL debt into cheaper public debt (along the 10-year repayment plan), expand renewable energy capacity, and improve distribution efficiencies.

**Natural Gas:** The IMF staff emphasized on the importance of regular biannual (Jan. and Jul.) end-user gas price adjustments, as per the established formulas and timelines based on international oil prices. The staff encouraged the authorities to work with the World Bank on: (i) preparing guidelines for OGRA to implement the weighted-average cost of gas pricing (WACOG) law for which was adopted in Mar'22. Implementation of WACOG would benefit manufacturers operating in the northern region and utilizing imported RLNG, prices of which would come down.

### Financial sector risks highlighted

The IMF report highlights: i) the profitability of the banking sector has increased amid higher interest rates, ii) CAR at the end of Mar'23 stood at 16.3%, deteriorating by 0.7% from Dec'23, and iii) NPLs rose to 7.8% while NPL provisioning stood high at 90.7%, although 11 out of 32 banks reported NPLs above 10%. It also highlighted that banks are exposed to sovereign risk, given the high and growing share of government debt in their asset portfolio. The banking systems' sovereign exposure has grown from 48% of assets at end-FY21 to 51.6% at end-Mar'23, while banks accounted for 50% of the government's financing in 1HFY23. The IMF report highlights that the banking sector appears stable, but the full impact of the economic downturn has yet to materialize. The IMF staff emphasized on enhanced monitoring of the banking sector with timely and resolute actions for regulatory non-compliance for capital requirements, and foreign currency exposures. The authorities committed to



address high levels of NPLs in some banks through bank-specific plans and to allow for the write-off of fully provisioned NPLs, in addition to resolving other matters including the two under-capitalized private sector banks.

### Investment perspective

The report generally comes in-line with expectations focusing more towards implementation of market-oriented exchange rate, financing assurances by bilateral partners, implementation of program targets and structural reforms along with energy sector reforms, and risks to debt sustainability. IMF also advocated a tightening monetary stance in its previous reviews and discussions also depending upon inflation out-turns. With FY24 projected inflation of 25.9% by IMF, risks of further hike in interest rates have increased as on a forward-looking basis, real interest rates are still negative considering IMF inflation forecast. This bodes well for the bankin sector with MCB, UBL and BAFL as our preferred picks from the sector. Impending energy sector reforms and payments against arears for circular debt, would keep the energy sector stocks in limelight. We particularly highlight OGDC with the expected receipt of PKR82bn as PHPL principal settlement. We also highlight HUBC and ENGRO as beneficiaries of payments to CPEC IPPs. Implementation of WACOG would benefit north based manufacturers using RLNG with DOL and TGL among the beneficiaries. Overall the market is likely to remain skeptical after gaining around 10% from the date of announcement of the new SBA, with expected devaluation and monetary tightening.



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Where;

$R$  = Expected Dividend Yield + Expected Capital Gain

$R'$  is before tax

Investment horizon is between six months to twelve months

Ratings are updated regularly based on the latest developments in the economy/sector/company, changes in stock prices, and changes in analyst's assumptions.

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