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AN ANALYSIS OF PAKISTAN'S DEFAULT RISK: CURRENT STATUS AND FUTURE IMPLICATIONS

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Abstract

This paper provides an analysis of Pakistan's default risk, including an overview of the current economic situation and factors contributing to the risk. The statistics and data on Pakistan's perceived default risk, such as credit default swap (CDS) rates, are discussed. The analysis also includes an examination of Pakistan's ability to meet foreign debt obligations. The paper also examines past cases of default risk in Pakistan and possible solutions for mitigating future risk. The paper suggests that the country's default risk is currently high due to political instability, delays in IMF talks, weak foreign exchange reserves, and a lack of fiscal discipline and transparency in public spending. However, the paper also suggests that there are steps that can be taken to mitigate this risk, such as negotiating a bailout package with the IMF, implementing fiscal discipline and transparency measures, building stronger foreign exchange reserves, and encouraging foreign investment.

Keywords: Default Risk, Pakistan, IMF Bailout, Foreign Exchange Reserves, Fiscal Discipline

Introduction

Default risk, also known as credit risk, is the likelihood that a borrower will be unable to repay its debt obligations. This can occur due to a variety of factors, including economic downturns, political instability, and natural disasters. Default risk is of particular concern for countries, as a default on sovereign debt can have severe ramifications for both the country in question and the global economy (Asif & Asif, 2018).

The importance of understanding default risk cannot be overstated, as it plays a critical role in determining the cost of borrowing for countries and investors. A country with a high default risk will typically have to pay higher interest rates on its debt as investors demand a higher return to compensate for the increased risk. This can make it more difficult for the country to finance its expenses and can also lead to a spiral of economic decline (Asif & Hassan, 2018).

Argentina is a prominent instance of a nation that is vulnerable to default. In 2001, the country faced a severe economic crisis, which included a sharp devaluation of its currency and a default on its sovereign debt. This led to a prolonged period of

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economic turmoil and high inflation, with the country facing multiple defaults on its debt in the following years.

Another example is Greece, which in the year 2010 experienced a sovereign debt crisis. The country was unable to repay its debt, which led to a bailout package from the European Union and the International Monetary Fund. However, the terms of the bailout were highly controversial, and the country faced significant economic hardship as a result.

Rationale of the study

Pakistan has a history of default risk and has relied on international financial institutions such as the IMF for assistance in meeting its debt obligations. In recent years, the country's pending review with the IMF and weak foreign exchange reserves have increased the perceived risk of default, leading to concerns about the country's financial stability and its ability to meet its debt obligations in the future (Ullah & Khan, 2017).

Given the significance of this issue, it is important to analyze the current status of Pakistan's default risk and the potential implications for the country's economy and financial stability. This analysis will provide a comprehensive overview of the factors contributing to the default risk, as well as potential solutions and recommendations for reducing the risk in the future.

Problem Statement

Pakistan has a history of default risk and has relied on international financial institutions such as the IMF for assistance in meeting its debt obligations. Despite entering into a $6 billion IMF program in 2019, the country's ninth review with the IMF is currently pending. Its weak foreign exchange reserves have increased the perceived risk of default. This has raised concerns about the country's financial stability and its ability to meet its debt obligations in the future.

However, there is a lack of comprehensive analysis of the current status of Pakistan's default risk and the potential implications for the country's economy and financial stability. As a result, there is a need to analyze the factors contributing to the default risk, as well as potential solutions and recommendations for reducing the risk in the future.

Objective of the study

The purpose of this study is to fill this gap in the literature by conducting an in-depth analysis of Pakistan's default risk, including an examination of the current status of the country's economy, the factors contributing to the default risk, and the potential implications for the country's financial stability and economic growth. The study aims to provide valuable insights into the current state of the Pakistani economy and the potential risks and challenges that need to be addressed in order to ensure financial stability and sustainable economic growth in the future.

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Implication of the study

The study has important implications for policymakers, investors, and other stakeholders, as it will provide valuable insights into the current state of the Pakistani economy and the potential risks and challenges that need to be addressed in order to ensure financial stability and sustainable economic growth in the future.

Literature Review

In Pakistan's case, the country has been facing default risk for a long. In the past, Pakistan has had to rely on international financial institutions such as the IMF for assistance in meeting its debt obligations. In 2019, Pakistan entered into a $6 billion IMF program. However, the country's ninth review with the IMF is currently pending. The pending review and the country's weak foreign exchange reserves have increased the country's perceived risk of default.

Importance of Default Risk Management

Managing default risk is essential for countries and investors, as it can help to mitigate the potential negative consequences of a default. This can be done through a variety of measures, such as diversifying investments, hedging against currency risk, and implementing sound fiscal policies.

For countries, effective default risk management can include implementing structural reforms to improve the economy, building up foreign currency reserves, and maintaining a manageable debt-to-GDP ratio. In Pakistan's case, the government has been implementing structural reform to improve the economy. However, the results have not been very positive. The country's foreign currency reserves have also been dwindling, which has increased the country's default risk (Ahmed, 2018).

For investors, default risk management can include diversifying investments, performing credit analysis on potential investments, and purchasing credit default swaps or other financial derivatives to offset the risk of default. For countries, default risk management can include implementing sound economic policies, building up foreign currency reserves, and seeking financial assistance from international organizations such as the International Monetary Fund (IMF) to prevent a default on sovereign debt obligations (Dawn, 2022; Dawn, 2022).

According to data from independent brokerage house Arif Habib Limited, Pakistan has been facing persistent concerns about default risk in recent years (Arab News, 2022). As of December 2022, the country's perceived risk of default stood at 79.33 percent, which is a significant increase from the 7 percent default risk perception in March of the same year. The country's five-year credit-default swaps (CDS) also showed a single-day increase of 383.8 bps from 7,550 basis points (bps) on November 15 to 7,933 bps on November 16 (Arab News, 2022).

The primary factors contributing to Pakistan's default risk include political turmoil, weak foreign exchange reserves, and a delay in the ninth review of an International Monetary Fund (IMF) bailout package (Bloomberg, 2022). To mitigate the risk of default, Pakistan must secure the IMF review and the necessary funds, as

well as implement sound economic policies and address political uncertainty to restore investor confidence (Jamil & Tariq, 2018).

Argentina and Greece are examples of countries that have successfully navigated default risk. In Argentina's case, the country implemented economic reforms that helped stabilize the economy and restore investor confidence, leading to successful bond issuance and securing loans from international organizations (Arab News, 2022). On the other hand, Greece serves as a reminder of the potential consequences of not addressing and managing default risk.

One of the main drivers of default risk in Pakistan is the country's large and growing external debt. According to the State Bank of Pakistan, the country's total external debt and liabilities stood at $108.8 billion as of September 30, 2022, representing a significant increase from $96.2 billion in June 2018 (SBP, 2022). A significant portion of this debt is short-term, which increases the likelihood of a rollover risk, a situation where a country is unable to repay its debt as it comes due and must borrow more to repay it.

Another factor contributing to default risk in Pakistan is the country's widening fiscal deficit, which reached a record high of 7.1 percent of GDP in the fiscal year 2021 (Finance Ministry, 2022). This has led to a rapid accumulation of domestic debt, which stood at Rs 25.8 trillion (about $160 billion) as of September 30, 2022 (SBP, 2022). The high fiscal deficit, coupled with a low tax-to-GDP ratio, has put pressure on the government's ability to service its debt, increasing the risk of default.

To address these challenges and manage default risk, Pakistan needs to implement a comprehensive economic reform program that addresses structural issues such as tax reform, energy sector reform, and public financial management. The government should also focus on increasing its revenue collection and reducing its non-development expenditure. This will help create fiscal space and reduce the need for borrowing, thereby reducing the risk of default (Azam & Zaman, 2019).

In addition, Pakistan should also focus on increasing its foreign exchange reserves, which can help to mitigate the risk of default. The country has taken some steps in this direction, such as approaching friendly countries for financial assistance and seeking to increase exports. However, more needs to be done to address the underlying issues that are contributing to the country's default risk.

One of the main issues is the country's large fiscal deficit, which is driven by a combination of high current expenditure and low revenue collection. The government has been struggling to reduce its budget deficit as it continues to struggle with high levels of debt and interest payments. Additionally, the country's low economic growth rate has further exacerbated the problem, as it makes it more difficult for the government to generate revenue through taxes and economic activity.

Another key issue that is contributing to Pakistan's default risk is the country's high levels of external debt. As of 2019, Pakistan's external debt stood at around $82 billion, with $35 billion of that being short-term debt that is due within the next year. This high level of external debt puts a significant strain on the country's foreign exchange reserves, which have been dwindling in recent years (World Bank, 2022).

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To address these issues and reduce the country's default risk, the government has been working on a number of initiatives. One of the most important is to secure a new loan from the International Monetary Fund (IMF). As of December 2022, Pakistan is currently in negotiations with the IMF for a $1.18 billion loan as part of a larger $6 billion package. This loan would help the country to shore up its foreign exchange reserves and address its fiscal deficit.

In addition to seeking financial assistance from the IMF, Pakistan has also been seeking to boost its exports in order to increase its foreign exchange earnings. This includes efforts to increase exports of traditional products such as textiles and agriculture, as well as focusing on new export markets such as China. The country has also been working to attract foreign investment through initiatives such as the China-Pakistan Economic Corridor (CPEC), which aims to create new infrastructure and development projects in the country.

Despite these efforts, it is important to note that reducing default risk is a long-term process and will require sustained efforts over time. The government will need to continue to focus on addressing the underlying issues that are contributing to the country's default risk, such as fiscal deficit and external debt, while also working to boost economic growth and attract foreign investment (International et al., 2013; International et al., 2022).

Current Default Risk Situation in Pakistan

Overview of Pakistan's Economic Situation

Pakistan's economy has been facing several challenges in recent years, including high inflation, a large trade deficit, and low foreign currency reserves. These factors have contributed to an increase in the country's perceived default risk.

Factors Contributing to Default Risk

One of the main factors contributing to Pakistan's default risk is the country's high level of debt. As of December 2022, Pakistan's total debt stood at around $104 billion, with external debt accounting for around $64 billion of that total. The country's large debt burden has made it difficult for Pakistan to meet its foreign debt obligations, which has led to an increase in default risk.

Another factor contributing to the risk of default is Pakistan's weak economic growth. The country's GDP growth rate has been consistently below 5% in recent years, making it difficult for the government to generate enough revenue to pay off its debt.

Statistics and Data on Pakistan's Perceived Default Risk

According to data from independent brokerage house Arif Habib Limited, Pakistan's perceived risk of default stood at 79.33% as of November 2022. This is a significant increase from the 7% default risk perception in March 2022. The country's five-year credit-default swaps (CDS) also rose from 7,550 basis points (bps) on

November 15 to 7,933 bps on November 16, constituting a single-day increase of 383.8 bps.

Analysis of Pakistan's Ability to Meet Foreign Debt Obligations

Pakistan's ability to meet its foreign debt obligations is also in question, as the country's gross official foreign exchange reserves have slipped to $6 billion as of December 2022. This, coupled with net external debt repayment requirements of about $4.5 billion for the period between January and March, puts the country at a high risk of default. Furthermore, Pakistan's credit default swap (CDS) rates have increased, indicating a higher perceived risk of default. As of December 2022, Pakistan's 5-year CDS rate stood at 739.4 basis points, up from 627.4 basis points in November 2022.

One of the main factors contributing to Pakistan's default risk is its current economic situation. The country has been facing a balance of payments crisis, with its current account deficit widening and foreign currency reserves dwindling. This has been exacerbated by the COVID-19 pandemic, which has led to a decline in exports and remittances. Additionally, the country's high public debt-to-GDP ratio, which stood at 81.5% in 2021, is also a concern.

Another contributing factor is the ongoing political uncertainty in the country. The recent change in government and the ongoing power struggle between the government and the opposition have led to a lack of clear economic policy direction. This has resulted in a lack of investor confidence and has made it difficult for the government to secure funding from international financial institutions.

The government has attempted to address these issues by approaching friendly countries for financial assistance and seeking a new program with the International Monetary Fund (IMF). However, these efforts have yet to stabilize the economy and address the underlying issues fully.

Pakistan is currently facing a high risk of default due to its economic situation and political uncertainty. The country needs to take urgent action to address these issues and implement structural reforms to improve its economic fundamentals. This includes addressing its balance of payments crisis, reducing its public debt-to-GDP ratio, and implementing policies to increase exports and attract foreign investment. Furthermore, the government needs to provide a clear direction for economic policy and create a stable political environment to restore investor confidence and secure funding from international financial institutions (Rana, 2022).

Research Methodology

A qualitative research methodology was used for analyzing Pakistan's default risk, as it allows for a more in-depth exploration of the topic through the collection of non-numerical data. The research design involves in-depth interviews with experts in finance and economics, a review of relevant literature, and the development of a conceptual framework for understanding the current status of Pakistan's default risk and its future implications. It also analyzes literature collected through secondary sources. i.e., reports, research articles, published books, and institutional websites.

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Discussion on Factors Contributing to Pakistan's Default Risk

Political Uncertainty and Instability

Political instability and uncertainty can have a major impact on a country's economy, and this is certainly the case for Pakistan. The country has a history of military coups and periods of political turmoil, and this has contributed to a lack of consistency and predictability in economic policies. This can make it difficult for investors and businesses to plan for the future and can also lead to a lack of confidence in the country's ability to meet its foreign debt obligations.

Delay in IMF Talks and Bailout Package

Pakistan has been in talks with the International Monetary Fund (IMF) for a bailout package to help address its economic challenges. However, these talks have been delayed, and this has contributed to concerns about the country's ability to meet its debt obligations. This is because the IMF is often seen as the lender of last resort, and when other lenders see that a country is not receiving support from the IMF, they may be less likely to provide loans.

Weak Foreign Exchange Reserves

Pakistan's foreign exchange reserves have been a major concern for some time. These reserves are an important buffer that can be used to meet whopping foreign debt obligations, and they have been dwindling in recent years. As of December 2022, Pakistan's gross official foreign exchange reserves slipped to $6 billion, increasing the country's risk of default once again.

Lack of Fiscal Discipline and Transparency in Public Spending

Pakistan has also faced challenges in terms of fiscal discipline and transparency in public spending. The government has been criticized for not having a clear and consistent fiscal policy and for not being transparent about how it uses public funds. This can lead to concerns about the country's ability to meet its impending debt obligations, as investors may be uncertain about how their money is being used.

Case Studies of Past Default Risks in Pakistan

1998 Default Risk and its Impact on the Economy

In the late 1990s, Pakistan faced a severe balance of payments crisis and was on the brink of defaulting on its sovereign debt. The crisis was caused by a combination of factors, including a sharp decline in foreign exchange reserves, high fiscal deficits, and a lack of investor confidence.

The government at the time approached the International Monetary Fund (IMF) for a bailout package, which included a series of austerity measures and economic reforms. However, the implementation of these measures was slow, and the country defaulted on its debt in 1998.

The default had a significant impact on the economy, with GDP growth slowing down, inflation rising, and the Pakistani rupee depreciating sharply. The country also faced a shortage of foreign exchange, which led to a decline in imports and a slowdown in industrial production.

However, Pakistan was able to avoid a complete default by rescheduling its debt with the help of friendly countries such as Saudi Arabia and China. The government also implemented a series of economic reforms, such as privatizing state-owned enterprises and reducing subsidies, which helped to stabilize the economy over time.

2013 Default Risk and its Resolution

In 2013, Pakistan faced another default risk, this time caused by a widening current account deficit, a decline in foreign exchange reserves, and a lack of investor confidence. The government at the time approached the IMF for a bailout package, which included a series of austerity measures and economic reforms.

To avoid default, the government implemented a series of measures, including devaluing the rupee, raising interest rates, and cutting government spending. The government also implemented a series of structural reforms, such as privatizing state-owned enterprises and reducing subsidies, which helped to stabilize the economy over time.

The government's efforts to avoid default, along with support from friendly countries, helped to stabilize the economy and restore investor confidence. The country was able to avoid default, and the economy began to recover over the next few years.

Possible Solutions to Mitigate Default Risk in Pakistan

In this section, we will explore possible solutions to mitigate default risk in Pakistan, including negotiating with the IMF for a bailout package, implementing fiscal discipline and transparency measures, developing a stronger foreign exchange reserve, and encouraging foreign investment.

Negotiating with IMF for a Bailout Package

One of the most important steps that Pakistan can take to mitigate default risk is to negotiate with the International Monetary Fund (IMF) for a bailout package. The country has been in talks with the IMF for a $6 billion bailout package to address its balance of payments crisis, but so far, these talks have not yielded any results.

Negotiating with the IMF for a bailout package would provide Pakistan with the necessary funds to meet its immediate debt obligations and stabilize its economy. However, it is important to note that a bailout package from the IMF would come with strict conditions, such as implementing fiscal austerity measures, increasing tax revenues, and implementing structural reforms.

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Implementing Fiscal Discipline and Transparency Measures

Another important step that Pakistan can take to mitigate default risk is to implement fiscal discipline and transparency measures. This would involve reducing government spending and increasing tax revenues, as well as implementing measures to promote transparency in public spending.

Fiscal discipline and transparency measures would help to address the underlying issues that are contributing to default risk in Pakistan, such as lack of fiscal discipline and transparency in public spending. This would be a crucial step in stabilizing the economy and reducing default risk.

Developing a Stronger Foreign Exchange Reserve

A strong foreign exchange reserve is crucial for a country's ability to meet its debt obligations. Pakistan's foreign exchange reserves have been dwindling in recent years, which has increased the country's risk of default.

To mitigate this risk, Pakistan must take steps to develop a stronger foreign exchange reserve. This could involve increasing exports, reducing imports, and encouraging foreign investment. Additionally, Pakistan may also seek financial assistance from friendly nations, as it has done in the past.

Encouraging Foreign Investment

Encouraging foreign investment is another important step that Pakistan can take to mitigate default risk. Foreign investment would provide Pakistan with the necessary funds to meet its debt obligations and stabilize its economy.

To encourage foreign investment, Pakistan would need to create a stable and predictable investment environment. This would involve implementing policies to promote economic growth, such as reducing red tape, providing tax incentives, and improving infrastructure. Additionally, Pakistan could also work to improve its political and security situation, as these factors can have a major impact on foreign investment (Ahmed & Nawaz, 2019).

Conclusion

Pakistan's economic situation has been precarious for some time, with many factors contributing to the country's default risk. These include political uncertainty and instability, delays in IMF talks and bailout packages, weak foreign exchange reserves, and a lack of fiscal discipline and transparency in public spending. In addition, Pakistan has a history of defaulting on its sovereign debt, with past defaults occurring in 1998 and 2013.

Default risk in Pakistan is a significant concern for both the government and investors. The country's economic situation is currently precarious, with several factors contributing to the risk of default. Political uncertainty and instability, delays in IMF talks and bailout packages, weak foreign exchange reserves, and a lack of fiscal discipline and transparency in public spending are all contributing to the risk of default.

In order to address these issues, the government needs to take many steps. Firstly, it needs to create a more stable political environment, which will help to increase investor confidence. Secondly, it needs to work more closely with the IMF and other international financial institutions to secure funding and support. Thirdly, it needs to take steps to strengthen its foreign exchange reserves, such as by increasing exports and diversifying its economy. Finally, it needs to implement more stringent fiscal policies and increase transparency in public spending to restore investor confidence and improve the country's overall economic situation.

While default risk in Pakistan is a significant concern, it is not an inevitable outcome. With the right policies and actions, the government can work to mitigate the risk and put the country on a more sustainable economic path.

Recommendations for Mitigating Default Risk in Pakistan

To mitigate default risk in Pakistan, the country must take steps to negotiate a bailout package with the IMF and implement measures to improve fiscal discipline and transparency. This could include efforts to increase exports, attract foreign investment, and build up foreign exchange reserves. Additionally, the government should work to address the underlying issues that are contributing to the country's economic instability, such as political uncertainty and lack of transparency in public spending.

Limitations of the study

The availability of accurate and reliable data on the Pakistani economy and financial sector may be limited, which could affect the validity of the findings.

Possible Scenarios for the Future

The future outlook for Pakistan's default risk is uncertain. On the one hand, if the country can successfully negotiate a bailout package with the IMF and implement measures to improve fiscal discipline and transparency, it may be able to mitigate its default risk. On the other hand, if these efforts are not successful and the country continues to struggle with weak foreign exchange reserves and political instability, it may be at a higher risk of defaulting on its debt.

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