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# RISKS TO WATCH

# PAKISTAN

August's catastrophic floods in **Pakistan** sharply raised the risk level in a country already contending with widespread insurgency, a feckless government and an economy propped up with aid. Few foreign portfolio investors have significant holdings, and local investors tend to be less sensitive to risk.

## IMPACT OF THE FLOODS

Pakistan's floods displaced millions of people, and destroyed crops and livestock. The government has estimated direct loss to the economy of almost \$10 billion, far short of the initial damage estimates of \$43 billion - almost a quarter of Pakistan's 2009/10 GDP. The IMF offered \$450 million in emergency aid to cope with the immediate impact of the disaster.

But the longer term consequences also pose major risks for investors in the region and for geopolitical stability. The competence of the government of President Asif Ali Zardari once again has been found wanting -- its response to the crisis was widely condemned as inadequate, and this was compounded by the fact that Zardari left the country during a critical period in the unfolding catastrophe for a visit to Europe that included a helicopter trip to inspect his French chateau. Popular anger with the government continues to grow, with the lack of basic services in the rural areas a source of great frustration. The military is seen as having provided a much more organised and efficient response, and the crisis has certainly strengthened the hand of the Pakistani armed forces in their perennial power struggle with civilian politicians.

But the greatest beneficiaries of the crisis may well be the Pakistani Taliban and other radical groups, which provided well organised aid to flood victims in several areas. With the civilian government weaker than ever and anti-government sentiment running high, this is a situation that extremist militant groups can exploit to increase their influence and territorial grip.

### What to watch:

- Political fallout. How badly will Zardari be damaged by popular anger at the government's response to the crisis? Will it allow the military even more autonomy from civilian control?
- Economic impact. Growth this year had been forecast at 4.5 percent in the current fiscal year, but because of the floods this has been cut to 2 to 3 percent.
- Security implications. To what extent will the misery, dislocation and anti-government anger caused by the floods allow extremist groups to gather strength?

## INTERNAL SECURITY

Large swathes of **Pakistan** remain outside government control, run by the **Taliban and tribal leaders**. Last year's military campaign to roll back Taliban territorial gains saw some successes, but insurgents have shown they can **launch major attacks** in urban, industrial and commercial centres with relative impunity. The U.S. troop surge in Afghanistan could also cause more instability in Pakistan's border regions.



Anila, a flood victim, holds up a plate of food as others queue in a makeshift relief camp in Sukkur  
REUTERS/Akhtar Soomro

### What to watch:

- Ability of militants to launch attacks. Several assaults on military facilities in particular have shown the continued ability of Taliban militants to attack even protected targets. There is no sign of a sustained improvement in security despite offensives against the Taliban. Pakistan's markets have long grown accustomed to the level of violence and bomb attacks will not have a significant short-run impact on prices unless key government or military leaders are killed. Investors are more sensitive to attacks in Karachi, the commercial hub and home to the main financial markets, the central bank and the main port, but several recent bomb attacks did not spark heavy selling. However, investment will be deterred by continued instability, with negative implications for long-term growth.
- Safety of Pakistan's **nuclear arsenal**. Pakistan's poor record of preventing attacks on even secure military targets has raised concern that militants could penetrate a nuclear facility. Analysts say while there is minimal risk insurgents could get their hands on a nuclear missile, a potential danger is that they could steal some fissile material which could be used to build a **"dirty bomb"**. This scenario would unsettle markets not just in Pakistan but also in India.

## RISK DATA

<b>Sovereign foreign currency:</b>	
S&P	B- (stable)
Moody's	B3 (stable)
<b>World Governance Indicators:</b>	
Voice & Accountability	20.9
Political Stability	0.5
Govt Effectiveness	19.0
Regulatory Quality	33.3
Rule of Law	19.3
Control of Corruption	13.3
<b>Eurasia Group:</b>	
GPRI score	41
<b>IHS Global Insight</b>	
Country risk	3.99
Sovereign	CCC (stable)
<b>Economist Intelligence Unit</b>	
Sovereign risk	CCC
Political risk	CC
Country risk	CCC

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## EXTERNAL SECURITY

Relations with India have entered an uncertain phase. Recent talks between the countries' foreign ministers produced no progress and may even have moved relations backwards. Unrest in areas of Kashmir under Indian rule has raised tensions.

Washington has been trying with some success to persuade Pakistan to focus on the Taliban threat within its borders rather than the perceived external threat from India. But with many groups in Pakistan still sworn to launch more attacks in India, particularly over disputed Kashmir, there is constant risk of another sudden chill in relations. With two nuclear-armed powers facing off, there is also the risk an accident or misunderstanding escalates into major conflict.

Relations with Afghanistan could also be better. President Hamid Karzai called for NATO attacks on Taliban sanctuaries in Pakistan after the release of tens of thousands of classified U.S. military reports by the website WikiLeaks that appeared to implicate Pakistan's spy agency, Inter-Services Intelligence, in supporting the Afghan Taliban. Pakistan reacted with denials and fury.

### What to watch:

- Attacks in India. Any attack with Pakistani fingerprints could spark a serious confrontation, pushing down markets on both sides of the border.
- Any progress on talks. India has been reluctant to broaden the agenda to problems such as Kashmir until more is done in Pakistan to deal with those behind the Mumbai attacks.

## GOVERNMENT EFFECTIVENESS

The government has limited control over the military, and has also been undermined by tussles with the judiciary. It has been relatively ineffective in tackling corruption and reforming the economy. President Asif Ali Zardari has signed into law constitutional amendments transferring important powers he held to the prime minister and parliament. This should go some way to disarming his critics. But the government remains weak and prone to splits. Problems in formulating and implementing policy will continue to act as a drag on investment. The impact of the floods will only worsen the situation.

### What to watch:

- Changes in political balance of power. Markets will be watching manoeuvring by opposition parties and the military to gauge the possibility of a challenge to the government. Most analysts expect the government to remain in power for now, but distracted from reforms because of its focus on survival.
- A December decision by the Supreme Court that a 2007 amnesty decree was unconstitutional has opened some close allies of Zardari to charges, further weakening the government and distracting from policymaking. Zardari, though protected from old charges by presidential immunity, could face legal challenges to his eligibility to be president. Such challenges would likely unnerve investors, not because Zardari is seen as indispensable but because political turmoil would distract the government from efforts to improve security and the economy.

## ECONOMIC REFORM AND INFRASTRUCTURE

Pakistan's economy is propped up by an \$11 billion loan programme from the International Monetary Fund as well as aid from donors like the United States desperate to avoid the country becoming a failed state. The country's 2010/11 budget, released in June, was an austere and unpopular one, attempting to balance conditions from the IMF with the needs of a desperately poor populace. Since then, the floods have dealt another severe economic blow, and Pakistan is in talks with the IMF on relaxing some of the loan conditions. In general, the IMF has been tolerant despite Pakistan's regular slippage on targets, particularly fiscal goals. Under the programme, Pakistan pledged to implement tax and energy sector reforms, demonstrate fiscal discipline, and give full autonomy to the State Bank of Pakistan.

### What to watch:

- Status of IMF loan disbursements. To be eligible for the sixth tranche of the loan, Pakistan working to implement a reformed general sales tax by Jan. 1 and eliminate electricity subsidies. These will prove unpopular and may not make it out of parliament. It has also cut development expenditure to bring down the fiscal deficit, which could imperil future economic growth. The budget deficit in fiscal 2010/11 is projected at 5 percent to 6 percent of GDP following the floods, compared with an earlier target of 4 percent..

## RISK DATA

<b>JLT Group</b>	
Strikes, riots & civil unrest	9
Terrorism	9
War & civil war	8
Economic risk	7
Currency risk	8
Sovereign risk	8
Expropriation	6
Contract repudiation risk	7
Legal & regulatory risk	7
<b>Coface</b>	
Country rating	D
Business climate	C
<b>Transparency International</b>	
Corruption Perceptions Index Score	2.4
Rank (of 180)	139
<b>World Bank Doing Business</b>	
Rank (of 183)	85
<b>WEF Global Competitiveness</b>	
Score	3.48
Rank (of 133)	123
<b>Reporters Sans Frontières</b>	
World Press Freedom Index Score	56.17
Rank (of 175)	151

## KEY DATES

- **January 1, 2011**  
Deadline for reformed sales tax to be implemented
- **January 1, 2011**  
Nuclear-armed Pakistan and India exchange lists of civilian nuclear facilities

