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Economics Focus: Pakistan

The political challenges ahead

- **President Musharraf needs a friendly parliament to remain president and also to endorse his decision to dismiss the judiciary**
- **Bhutto's PPP is likely to do well on 18 February, but has still not indicated any pre-election alliance. Hence, calling the election is very difficult**
- **If Musharraf's ruling coalition wins a majority, Musharraf remains president but a hung parliament would be problematic; if the opposition secures a comfortable majority, Musharraf may have to step down**
- **We believe in neither case would Musharraf be able to have his actions against the judiciary endorsed, which means his future remains linked to the judiciary issue**
- **We do not see the political uncertainty easing after elections; however, we do see a stable government in place by mid-2008**

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Figure 1. Pakistan's Political Parties

Political Party	Leadership	Constituency	Backdrop
Pakistan Muslim League – Quaid-e-Azam (PML-Q)	Chaudry Shujaat Hussain and his cousin Chaudry Pervaiz Elahi	Strong in Punjab, presence in Sindh, Baluchistan & NWFP.	Formed in 2001 by members of the PML-N who sided with General Musharraf after Nawaz Sharif was sent into exile. Often known as the King's Party.
Pakistan Peoples Party (PPP)	Benazir Bhutto – now managed by husband Asif Ali Zardari. Zardari is standing in for their 19-year old son (Bilawal) who is expected to take over party leadership in a few years	Strong in Sindh, presence in Punjab, NWFP and Baluchistan.	Formed in 1967 by Zulfikar Ali Bhutto (ZAB), who is considered the first democratically elected PM. Uneasy relationship with the army after ZAB was hanged in 1979. Leadership passed on to his daughter – Benazir Bhutto (BB). BB was twice PM in the 1990s, but both governments were dismissed by army-backed Presidents.
Pakistan Muslim League – Nawaz Sharif (PML-N)	Nawaz Sharif and his brother Shabaz Sharif.	Strong in Punjab, presence in NWFP and Baluchistan.	Formed in 1993 to counter the PPP. Strong backing of the army, as Nawaz Sharif was a senior member of General Zia's government in the 1980s. Elected twice into power in the 1990s, Nawaz Sharif was removed from power by General Musharraf's coup in 1999. PML-N had close ties with the establishment, but there is a personal animosity with General Musharraf.
Muttahida Majlis-e-Amal (MMA)	Qazi Hussain (JI) and Fazl ur-Rahman (JUI).	Coalition of Islamist parties with strong presence in Baluchistan and NWFP.	Formed before the 2002 elections, when Islamists really came to prominence. Disproportionately high number of seats compared to number of votes. Historically, Islamist parties have polled poorly but have a strong public presence. Past ties with army date back to the 1970s.
Muttahida Qaumi Movement (MQM)	Altaf Hussain – in exile in London since 1991.	Dominant in the main cities of Sindh.	Party formed in 1984 for migrants from India who felt disenfranchised by Pakistani politics. Thought to have been encouraged by the army to neutralize the PPP in Sindh. The MQM has a powerful presence in Sindh and is seeking to go national.

Source: Citi.

Musharraf's political challenges

Musharraf needs to ensure his ruling coalition has a majority in the forthcoming election to remain president, and also needs a two-thirds majority in the new National Assembly to legitimize his decision to dismiss the judiciary.

Zardari takes charge of the PPP

The uncertainty following the Bhutto assassination arises from a potential split in the PPP. Zardari is trying to keep the party united and has played his cards well so far. He has not committed to any pre-election alliances.

Nawaz Sharif's waiting game

Sharif seems to have decided to focus his attention more on removing Musharraf by demanding the restoration of the judiciary, than on the forthcoming elections. If successful, this could weaken Musharraf and his ruling party (PML-Q), and improve his standing in the next election.

Scenarios for the forthcoming election results

Calling this election is very difficult. We do not see a postponement, and we expect the election will be reasonably free and fair. If Musharraf's ruling coalition is able to secure a majority, he remains president but a hung parliament would be difficult to manage. If the opposition secures a comfortable majority, Musharraf may be forced to step down. This would imply an extended period of political uncertainty, but we anticipate that a stable government should be in place by mid-2008.

Impact on bond pricing

The series of political shocks since mid-2007 have led to an undervaluation of Pakistani Eurobonds, in our view. We expect prices to continue to react to negative political news beyond the 18 February elections. However, we believe the fundamentals remain strong, and we are confident that prices will rally once the political uncertainty ends.

Musharraf's political challenges

Political uncertainty is likely even after the 18 February elections...

The political uncertainty following Bhutto's assassination is likely to persist after the 18 February general elections. It is still not clear how the Pakistan Peoples Party (PPP – Benazir Bhutto's party) will position itself vis-à-vis Musharraf's party (PML-Q). In our view, allegations of pre-election rigging may grow stronger as the election draws closer, since the composition of the new parliament will have an important bearing on whether Musharraf is likely to retain his position as president. Musharraf remains under pressure from the opposition parties, which are likely to demand that the new Electoral College endorse him as president.¹ This means Musharraf has a keen interest in ensuring that his party and its coalition partners have a majority in the new elections.

...as Musharraf needs a majority in the new Electoral College to remain president

This is the underlying reason why many analysts and opposition politicians have flagged the possibility of pre-election rigging. Musharraf's government has repeatedly promised that elections will be free and fair, which is to be expected since there is strong international pressure on Musharraf to ensure this; furthermore, the presence of international observers will not allow for irregularities. President Musharraf has said that army personnel will be at each polling station, which should be a source of comfort for most Pakistanis. However, the opposition parties have been saying the elections are likely to be rigged before 18 February.²

Musharraf also needs a two-thirds majority in the National Assembly to legalize his 3 November actions. This may be harder to achieve

There is however another complication, since Musharraf's decision to impose a state of emergency on 3 November still needs to be ratified by the new National Assembly. As he had done after taking over power in October 1999, a Provisional Constitutional Order (PCO) issued by Musharraf as the "Chief Executive", temporarily superseded Pakistan's constitution, but had to be ratified by the parliament. This was done in December 2003 after Musharraf had secured the support of the Islamist party (MMA) for his ruling coalition. This time around, however, getting a two-thirds majority in the new parliament may not be as easy. The two main opposition parties are better prepared and could still unite against the PML-Q, while the Islamist coalition has been split and only one group is likely to support Musharraf.

¹ This includes the National Assembly, the four Provincial Assemblies and the Senate. The 18 February election will determine the composition of the new National Assembly and the four Provincial Assemblies.

² Before her assassination on 27 December, Benazir Bhutto was planning to release a 200-page dossier about how the government was intending to rig the elections. Although this story dropped under the radar soon after her assassination, we believe this issue could resurface in the next few weeks.

Zardari takes charge of the PPP

The uncertainty following Bhutto's assassination arises from the potential for a split in her party (PPP)...

... as there is some discontent with Zardari's leadership

A split is unlikely till after the election results are announced

Zardari has so far surprised analysts with his political skills, but has not positioned the PPP with either the ruling or opposition parties

In our view, the issue of who is responsible for Bhutto's assassination is not the point; the conspiracy theories surrounding her death serve little purpose. However, we believe Bhutto's untimely death could split the PPP, which in turn could impact Musharraf's political future and change the dynamics of Pakistani politics.

Unlike other opposition parties, Benazir Bhutto was the PPP. Senior leadership had little say in party decisions since the PPP's mass popularity was anchored to Benazir Bhutto herself. Her death introduces the likelihood that the party could split, especially since her husband and current acting party leader, Asif Ali Zardari, is a divisive character with a chequered past. There is also a sense that some members of the PPP have doubts about Benazir's decision to nominate Zardari as PPP's leader, since her will has not been made public or shared with senior members of the PPP.³ Although Benazir and Zardari's son (Bilawal) has been made co-chairman of the PPP, all concerned realize that Zardari now calls the shots.

We believe a split in the PPP could benefit the "establishment", which in the past has successfully split other political parties like the MQM in 1995, and the PML in 2001.⁴ As things stand, there is no power struggle within the PPP, and we expect nothing is likely to happen until after the elections. Bhutto's unique role in the PPP was such that all aspiring party candidates can be expected to use her memory to gain public support, and internal differences that could lose votes for the party are not likely to be aired publicly. In our view, after securing a strong number of seats (perhaps the largest number – see Figure 2), the situation could change if PPP winners use their seats to demand a more inclusive party leadership. These MPs could also be enticed by other political parties to break with Zardari's PPP.

Zardari is no doubt aware that the PPP could split, and has recently shifted his base to Lahore. This could be an effort to show PPP's "national character", since the PPP is primarily associated with the province of Sindh. In our view, Zardari is playing more on the memory of Benazir's father (Zulfikar Ali Bhutto) – the charismatic founder of the PPP – to justify his leadership, than his dead wife or his custodial role of their 19-year old son.⁵ The decision to move to Lahore also plays to Zulfikar Ali Bhutto's past; despite not being Punjabi, Zulfikar Ali Bhutto enjoyed immense popular support in the capital of Punjab.

³ Benazir may have been concerned that criticism about her bloodline claim to PPP leadership was undermining the democratic credentials of the party – she was, after all, chairperson for life. Nevertheless, in our view, she wanted her son, Bilawal, to eventually take over the party leadership. Since her son is only 19, the safest way to ensure that others would not sideline him in the PPP, was to entrust this to her husband. Despite the fact that Zardari may have been a political liability to Benazir Bhutto during her two terms as PM, we believe Zardari's "temporary" leadership, and his ability to get his way, is the only guarantee that Bilawal's claim to party leadership would be secure.

⁴ The PML was split in 2001/02 when Musharraf prepared for the October 2002 elections. This resulted in the creation of the PML-Q (Musharraf's party), and the remaining group that did not side with General Musharraf created the PML-N.

⁵ Perhaps Zardari views this as a safer bet to stay above the rifts that have opened up within the Bhutto family challenging Benazir's decision to pass on the leadership of the PPP to her son. However, since these groups are not part of the PPP, we do not feel this will pose a threat to the party.

He has reached out to senior party leaders who had become estranged from Benazir Bhutto

Zardari has also been conciliatory with prominent members of the PPP. Within days of taking charge, Zardari formally announced that the vice chairman (Makdoom Amin Fahim) would be the PPP's candidate for prime minister (PM). Furthermore, unlike Benazir Bhutto's estranged relationship with another popular leader (barrister Aitzaz Ahsan), Zardari has approached Mr Ahsan to become his chief political adviser.⁶ Mr Ahsan successfully fought the legal case to have the former Chief Justice Iftikhar Chaudry re-instated after President Musharraf dismissed him in March 2007. In doing so, Mr Ahsan (who is also the president of the Pakistan Bar Association) captured the political limelight, which explains why he was arrested soon after the imposition of emergency rule on 3 November. However, his growing popularity had become a source of concern for Benazir, who feared that his public profile could challenge her leadership of the party.

Zardari is also wooing the lawyers, who have been agitating to remove Musharraf from power

As the de facto leader of the lawyer's movement against Musharraf, Mr Ahsan has repeatedly said the new judiciary is not constitutional and General Musharraf's decision to dismiss the Supreme Court judges was illegal.⁷ The point to be made is that while Benazir kept her distance from Mr Ahsan and could not support his demand for the restoration of the previous judiciary, Zardari is not similarly constrained.⁸ Furthermore, Zardari has also realized that he could fortify his political position if he has the support of the lawyers' movement. According to *The News* (11 January), Zardari has agreed to Mr Ahsan's demand about restoring the previous judiciary, but has said this would only be announced after the elections. So far, Zardari has not announced any alliance with the opposition parties or Musharraf's PML-Q.

If the PPP does well in the elections, Zardari could become an important player in Pakistani politics

In our view, Zardari is playing a smart political strategy that could allow him to capitalize on the popular cause of the judiciary, align himself with the well respected Mr Ahsan, retain Makdoom Amin Fahim's support by keeping him as the PM candidate, and still have the option to choose political allies after the elections. If Zardari continues to use Zulfikar Ali Bhutto's legacy as his political platform, he may be able to retain the support of the masses that have loyally supported the Bhutto name. This leaves Zardari in a strong political position in the run-up to the elections. In terms of a potential split in the PPP after the election results are announced, Zardari could threaten dissenting PPP leaders that if they tried to split the party and form a coalition with Musharraf's party, he would use the power of the Bhutto name to discredit them politically.

⁶ Mr Ahsan is a senior member of the PPP and had served as a federal minister in Benazir's previous government.

⁷ It is important to recall that Pervez Musharraf imposed a state of emergency and dismissed the Supreme Court when he was Army Chief, and not President.

⁸ Re-instating the previous judiciary would have put Bhutto at loggerheads with President Musharraf, since the dismissed Supreme Court judges had already ruled the 3 November decision was illegal. If returned to power, this judiciary could charge President Musharraf with treason since he abrogated the constitution by declaring emergency rule.

Nawaz Sharif's waiting game

Nawaz Sharif seems to prioritize the end of Musharraf's rule over his own role in the forthcoming elections

We believe Nawaz Sharif has always wanted to boycott the forthcoming elections. He appears to hold the view that, if the main opposition parties refused to take part, this would discredit the elections and force Musharraf to step down. As expected, PML-N's top leadership (Nawaz and Shabaz Sharif) were disqualified from participating, but it was only the pressure from other party leaders to keep a presence in the new parliament which convinced Nawaz Sharif to participate. Immediately after Benazir Bhutto's assassination, Nawaz Sharif again announced his intention to boycott the elections, but this time it was the insistence of the PPP (supposedly from Zardari) that he again agreed to allow his party to take part. It is interesting to note that both the Sharif brothers have not challenged their disqualification, and have shown a remarkable degree of compassion for the PPP. After Bhutto's assassination, Nawaz Sharif also said the forthcoming elections belong to the PPP. In the weeks before her death, Sharif had been in negotiations with Benazir Bhutto on how to field their candidates to maximize their chances against the ruling coalition.

This is smart political thinking since Nawaz Sharif needs to sideline Musharraf to strengthen his own political party

This backseat role makes sense for the Sharif brothers. The animosity they have toward Musharraf has two roots: the manner in which the Sharif family was sent into exile; and the fact that the ruling party (PML-Q) was carved out of their party after their departure. The Sharif brothers are perhaps counting on the possibility that Musharraf's position will become weaker in the new parliament, while they themselves need time to re-build their power base after eight years in exile. If the new parliament is less supportive of Musharraf and his public popularity does not improve, this could taint the leadership of the PML-Q. If this were to happen, the Sharif brothers would find it easier to win back the support of PML-Q MPs.

This explains Sharif's one-point agenda to restore the previous judiciary

We believe this explains Nawaz Sharif's one-point agenda – the restoration of the judiciary. He knows that if the previous judiciary were to be restored, this would effectively end Musharraf's political future. This is why PML-N will insist that beyond getting a simple majority to retain his presidency, Musharraf must also gather a two-thirds majority in the National Assembly to justify his action to dismiss the judiciary. The Sharif brothers could also be thinking that depending on the composition of the new parliament and the degree of polarization regarding Musharraf's future, the next government may not last its full term.

In the worst case, Musharraf may have to step down; in the best case, the new government is unlikely to last five years

If a shaky start for the new parliament creates resentment against Musharraf, he could either voluntarily step down to defuse the situation or, in the extreme case, the army could intervene and schedule new elections. If Musharraf does step down as President, opposition MPs are likely to demand fresh elections to neutralize the role of the PML-Q.

Scenarios for the forthcoming election results

Although there is some talk about a further postponement of the forthcoming elections, we do not think this will happen as it risks further damaging Musharraf's credibility and undermining the chances of the PML-Q. Furthermore, we do not see a scenario of heavy rigging in favour the ruling party, as this could outrage opposition parties, taint Musharraf's image overseas and could bring people out into the streets. International support for Musharraf is a critical strength for him since his domestic popularity has suffered since he imposed emergency rule – under these circumstances, Musharraf may not be willing to take such a chance. In our view, if the PPP and PML-N refuse to accept the results of the elections, the resulting stalemate in the political process could further damage Musharraf's standing, perhaps expediting his exit.

Given the international and domestic scrutiny, Musharraf cannot allow for much election rigging

After the election results are announced, we expect a degree of criticism from the opposition parties with complaints about the biased Election Commission, and the charge that local government administrators are sympathetic to the PML-Q.

However, we hope the main opposition parties will not reject the results outright. To ensure that the results are accepted, especially with the presence of international election observers, Musharraf's ruling party cannot afford to be too heavy handed.

It then comes down to the composition of the new parliament. In our view, as incumbents, the ruling party (PML-Q) and its coalition member (the MQM) are likely to do well, but PML-Q may lose seats to the two main opposition parties. Since the results are so difficult to call, we outline two possible scenarios: (1) where the ruling part does well compared to the main opposition parties; and (2) where the main opposition parties are able to secure the top two positions. The point of this exercise is not to predict the election outcome, but to analyze potential consequences from two distinct scenarios.

Election outcomes and possible scenarios

Figure 2. Election Outcome on National Assembly Seats

Ranking 2002	% of votes	Seats	Seats	Seats 2008	Seats 2008
	2002	2002	2004*	Scenario I	Scenario II
Pakistan Muslim League (Q)	25.7	126	148	107	70
Pakistan Peoples Party	25.8	81	81	101	108
MMA (Religious coalition)**	11.3	63	63	27	27
Pakistan Muslim League (N)	9.4	19	19	49	79
MQM	3.1	17	17	18	18
National Alliance*	4.6	16	0	0	0
Others	20.1	20	14	40	40
Total		342	342	342	342

Source: National Assembly of Pakistan website. * National Alliance and factions of the PML that were included in "Others" united with the PML-Q in 2004. ** The religious coalition has already split, but the largest member JUI-F will participate in the elections as the MMA.

Some salient features of Figure 2 are:

No party is likely to secure a majority; PPP should do well; Islamist party should lose seats and independents should gain. Swing factor is the performance of the two PMLs

- 1 We do not see any single party being able to secure a simple majority, which means Pakistan is likely to have a hung parliament and a coalition government;
- 2 Under both scenarios, we see the PPP doing well: in Scenario I, PML-Q will have the largest number of seats followed closely by the PPP; in Scenario II, the opposition parties will secure the largest number of seats, with the PPP in front;
- 3 The Islamist coalition has already been disbanded, which is why the projected number of seats is much lower. Also, since the participating Islamist party (JUI-F) is likely to side with Musharraf's ruling party, it may not be able to secure as many seats from NWFP and Baluchistan as it did in 2002;
- 4 MQM will be able to retain its seats in the main cities in Sindh, and could add one in lower Punjab; and
- 5 There is likely to be an increase in the number of independents and small political parties that could win seats. We believe a sense of public frustration with established political parties, and the growing role of media in shaping public opinion, could give smaller parties and independent candidates a better chance against the well-organized machinery of the larger parties.

Scenario I:

Scenario I will secure Musharraf as president, but the hung parliament may be difficult to manage

Musharraf's ruling party is able to secure the largest number of seats, followed closely by the PPP. Combined with the JUI-F and the MQM, the PML-Q would be in a position to form a government with the help of half the independents (a simple majority requires 172 seats). Assuming that the composition of the Provincial Assemblies broadly reflects the outcome of the National Assembly, this would make it relatively straightforward for the new Electoral Collage to endorse Musharraf as president. Furthermore, as the dominant coalition member, the PML-Q will form the government. However, depending on how fickle the independents are, the resulting government could be weak, especially if the PPP and PML-N join forces to form a combined opposition.

However, if there is a major split in the PPP after the elections, this could help the ruling coalition since it would give them more seats to play with. As discussed earlier, if the anti-Zardari group sides with the PML-Q, this would strengthen Musharraf's government. However, in our view, this could also make the parliament more fractious and difficult to manage.

Scenario II:

Scenario II could force Musharraf to step down, result in another election, but create a more stable government

If the main opposition parties like the PPP and PML-N secure more votes than the PML-Q, the story could be very different. In this case, even with a split in the PPP, the PML-Q may find it very difficult to form a government since it would have to lure the PPP splinter group with important positions in the new government, which may not be acceptable to the PML-Q. In Scenario II, the more likely coalition could be between the PPP and the PML-N. With a comfortable majority, the PPP/PML-N coalition is likely to first challenge Musharraf's presidency, which means he may have to step down as president. If Musharraf were to exit the political scene, we could see defections from the PML-Q, either to become independents or to join the PPP or the PML-N. Since the PML-Q is effectively the king's party – Musharraf being the king – we believe the PML-Q is unlikely to survive without Musharraf.

We believe these dynamics could temporarily stall any potential splintering of the PPP. Once the dust has settled after Musharraf's exit, dissenting members of the PPP could consider different coalition permutations to try and form a government. This might mean the initial PPP/PML-N government could be short lived, but a post-Musharraf government that includes one group of the splintered PPP is likely to be more stable.

Two-thirds majority to endorse the state of emergency

Securing a two-thirds majority is likely to be very difficult, which means Musharraf will be hounded by his decision to dismiss the judiciary

Following through with Scenario I, and assuming that Musharraf's ruling party is able to lure a sizeable portion of the PPP as a coalition partner, President Musharraf still has to gather a two-thirds majority (228 seats) to legitimize his actions of 3 November – specifically, the dismissal of the Supreme Court judges. We believe this would be difficult, as it requires that the ruling coalition (the PML-Q, MQM and JUI-F) must have the support of all independents and also ensure that a sizeable fraction of PPP MPs (at least 36) support Musharraf's decision to suspend the judiciary.⁹ If the ruling coalition were unable to secure a two-thirds majority, the judiciary issue could continue to undermine Musharraf's legitimacy as president.¹⁰

Impact on bond pricing

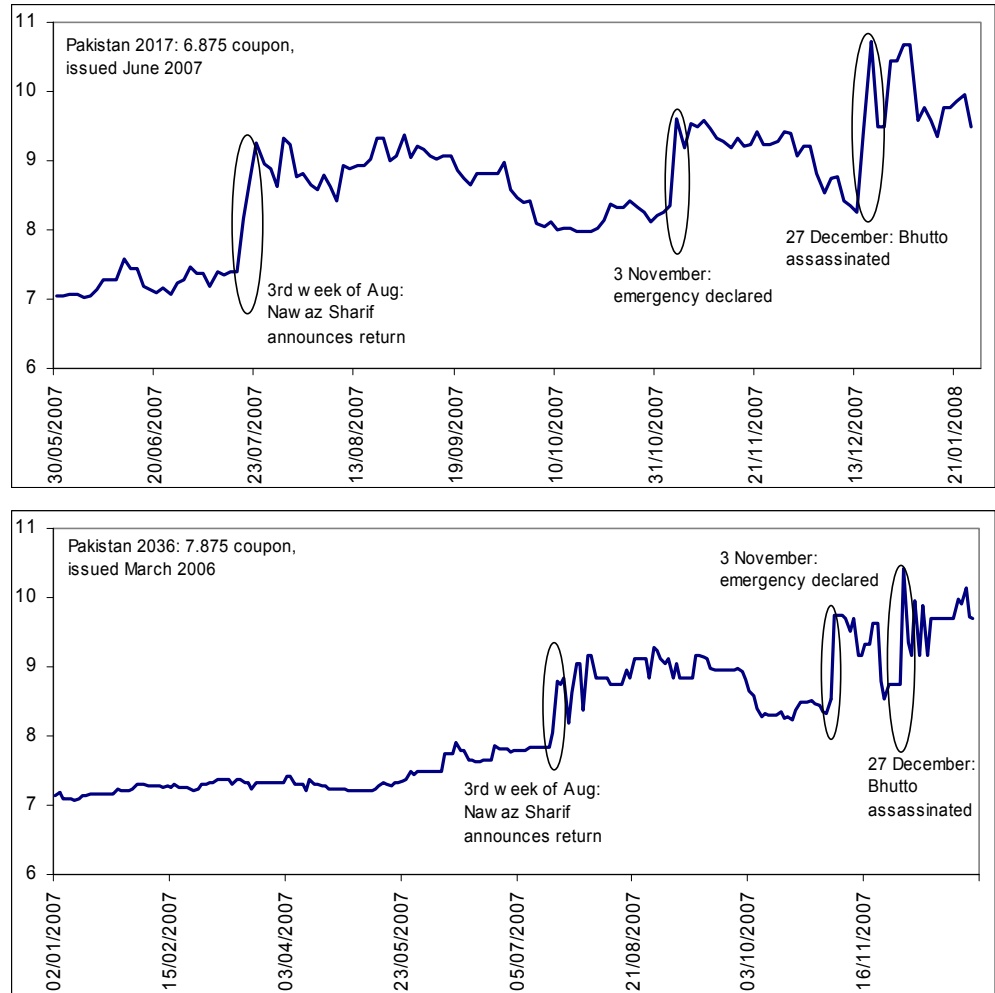
Bond pricing has been driven by political shocks...

How will these political developments impact Pakistan's Eurobonds? As shown in Figure 3, bond prices have reacted sharply to specific developments: (1) during the third week of August 2007, when the pending return of the Sharif brothers has sparked concern within the PML-Q about its (and Musharraf's) political future; (2) when Musharraf declared a state of emergency on 3 November; and (3) the assassination of Benazir Bhutto on 27 December 2007, which ended any hopes for a Musharraf-Bhutto alliance.

⁹ We think it is highly unlikely that a significant number of MPs from the PPP would defect from the Zardari-Bilawal faction of the PPP, and do not see Zardari siding with Musharraf to give him the two-third majority. In our view, Zardari's political legitimacy is based on the Bhutto name, and both Zulfikar Ali Bhutto and his daughter (Benazir) have always had an uneasy relationship with the army. Therefore, Zardari would have to continue to keep some distance from Musharraf, and certainly not endorse his emergency rule.

¹⁰ The existing Supreme Court would not be in a position to hear challenges against the 3 November actions taken by Musharraf, since this judiciary itself was created by 3 November decision to emergency rule. Without a two-thirds majority, the legality of the steps taken during the state of emergency would push the country into a strange legal limbo.

Figure 3. Yield on Pakistan's Eurobonds



Source: Reuters.

... which are likely to continue well into 2008

The quick succession of these developments has not allowed sufficient time for the bonds to return to previous levels. Hence, Pakistani bonds appear to have lost value consistently and, in our view, have been under-valued since mid-August 2007. As economic fundamentals are not driving prices, and with general elections less than a month away, we expect prices to remain soft. Bond prices are likely to soften or rally depending on the stream of political news coming out of Pakistan.

Depending on the election results, this uncertainty could continue well into the second half of 2008

In our view, these chronological scenarios could affect prices:

Event	Impact on prices
▪ Relative calm in the lead-up to the elections:	mild positive;
▪ PPP steps up criticism about pre-election rigging:	mild negative;
▪ Smooth elections on 18 February:	mild positive;
▪ Skirmishes on election day:	negative;
▪ Opposition parties reject results and call for street agitation; international observers give a mixed assessment of the elections:	strong negative;
▪ Ruling coalition gets majority; Musharraf remains president and opposition parties accept election results:	strong positive;
▪ Opposition parties secure a majority; Musharraf is forced to step down and the ruling party (PML-Q) begins to break up:	strong negative;
▪ Another parliamentary election is called for after Musharraf steps down, and the PPP and PML-N are able to increase their seats:	none;
▪ Depending on the results of the second elections, a stable coalition is formed in the post-Musharraf period:	strong positive.

However, we are confident that once a stable government is in place, bond prices will rally

We believe bond pricing is currently linked to Musharraf's future, which means prices will react adversely if Musharraf's future is undermined by subsequent events. If Scenario II plays out, we believe the initial reaction is likely to be strongly negative. However, with Musharraf's departure, we feel the PML-Q will also break up and the main opposition parties (PPP and PML-N) will demand fresh elections. By then, the political environment will again see two dominant parties seeking coalition parties. We believe this could allow for the creation of a stable government, as the underlying uncertainty about Musharraf's future would no longer be an issue.

Conclusion

Although Pakistan's economy will face new challenges going forward, we still feel the performance of its Eurobonds is largely driven by political noise. Pakistan's stock of market debt is only 6.6% of total external debt which, at US\$ 38.7 billion in end FY07, is only 26.9% of GDP. Furthermore, total reserves are still comfortable at \$15.2 billion on 28 January 2008, and it is highly unlikely that any future government can afford to ignore the interests of foreign investors. However, political uncertainty is likely to persist well after the 18 February elections and, depending on the outcome, a stable government may not materialize until the second half of 2008. Nevertheless, we feel that prices are likely to rally and yields will settle at levels that existed before August 2007. Although entry points are hard to pin down, the scenarios listed above could be a useful guide. However, on an investment horizon of longer than a year, we view Pakistan as a strong buy at current prices.

Disclosure Appendix A1

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