Review of 2019

Mushtaq Khan, January 2, 2020

As the year ends, we thought it would be insightful to summarize the changing fortunes of Pakistan's economy during 2019. We will base our assessment on the monthly presentations we send to our clients, but within a narrative that captures our monthly assessment and our broader concerns. To structure this review, we will stay with the monthly chronology.

24 January 2019:

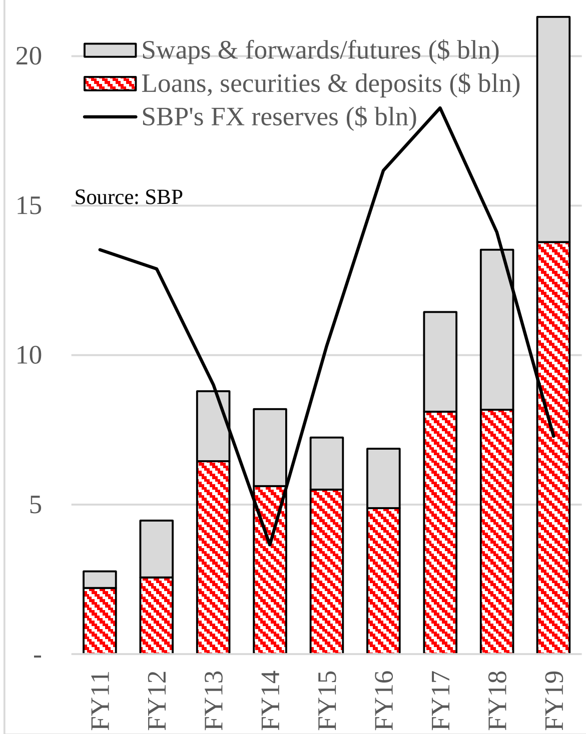
The ex-Finance Minister announced the 2nd mini-budget, which we think is populist and not serious about addressing the growing concerns of the market. There is little on how the government intends to narrow the external deficit, other than relying on the economic slowdown and soft oil prices. SBP's reserves have been depleting because bilateral loans are less frequent, but the government has still not committed to an IMF stabilization program.

The PKR/$ parity was still below 140/$, and banks were only investing in 3-month T-bills as they anticipated that SBP would increase interest rates to enter the IMF program. SBP's FX reserves by end-December 2018 were almost half what they were in December 2017, and only covered 1.6 months of imports.

20 February 2019:

Because of heavy external borrowing during 2018, Pakistan's dollar repayments for the next 12 months jumped from $ 13.5 bln in 2018, to $ 21.3 bln that will have to be paid in 2019 (see **Figure 1**). We argued that this requires urgent action even before the next IMF program (which we felt was inevitable). We were also concerned about the government's *growth-and-stabilization* policy, which we felt was unrealistic. We were equally concerned about the exponential growth of Pakistan's external debt, and urged the government to change its economic narrative (see **Figure 2**).

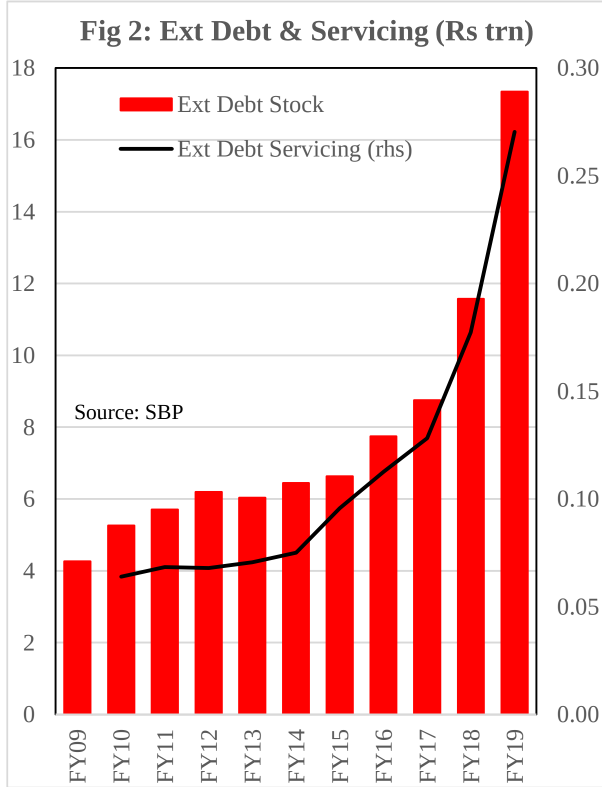
Fig 1: $ repayments next FY



We argued that a soft-landing was no longer possible, and advocated a more volatile PKR to break the import momentum – the gradual currency adjustments since December 2017 had not narrowed the trade deficit. We characterized the 50 bps interest rate increase a blunder, as it set expectations of further rate hikes without doing much to narrow the external deficit. In view of the unsustainable external deficit, we suggested three scenarios: (1) continue with gradual currency adjustments that may not deliver results; (2) larger adjustments with some volatility; and (3) a zero intervention strategy that could be destabilizing.

Responding to media reports that the IMF wanted real interest rates at 250-300 bps, we warned that this would create a fiscal blowout via rising debt servicing pressures, but do little to control inflation.

25 March 2019:



A World Bank report on Pakistan was uncharacteristically blunt as it talked about the "elite capture" of policymaking. It specifically listed the civil service; large landowners; industrialist and the military, as the key stakeholders that have been shaping economic policies to benefit their own commercial interests. The report also discussed rent seeking activities within the government. This political-economy analysis is refreshing and gave us hope that the next stabilization program would take on Pakistan's vested interests.

In the first eight months of FY19, the trade deficit only fell by 2.8% (compared to the corresponding period in FY18), which clearly showed that policies to narrow the external deficit had not worked. This is worrying as the current account deficit in FY18 was at a record high at $ 20 bln. We were also concerned that not enough was being done to narrow the fiscal deficit; while the full year target was 7.2% of GDP, the actual fiscal gap in FY19 was a massive 8.9%. Sarmaya-e-Pakistan was created to restructure loss-making PSEs, and a high-powered private sector board was selected to spearhead the effort. However, little has come out of this initiative (as from the Economic Advisory Council).

On a positive note, the PM announced that there was an urgent need to bring down Pakistan's debt, and this would be a KPI for the PTI government. During this month, the Pakistan Air Force defended the country by shooting down an intruding Indian fighter jet; Pakistan's PM gained international praise for handling the incident. We ended our assessment with two thoughts: one, given the heavy dollar repayments and the revenue shortage, the next IMF program would be tough; and two, the government had to confront the political resistance to restructure loss-making PSEs.

24 April 2019:

Asad Umar resigns as Finance Minister, just as the IMF mission is expected by the end of the month. We argued that resistance to Asad Umar's amnesty scheme within the PTI cabinet (for being too penal) could have been the trigger; subsequently, we heard that the ex-Finance Minister was not willing to accept some of the policy steps required by the IMF. The new Finance Adviser (Hafeez Shaikh) described the amnesty scheme as "too complicated", and reduced the penalties to the point that the new scheme is even sweeter than the PML-N version. We argued that PTI is shedding its campaign promises to hold people to account, as the vested interests were once again gaining control of policymaking. The recently announced export package (which allegedly was formulated by prominent exporters) reinforced this view.

We discussed the growing impact of the economic slowdown, as job losses and the fall in purchasing power, was hitting the retail sector across the country. With the approaching IMF mission, the rupee becomes more flexible, but with interest rates expected to increase, banks continue to shy away from lending to the government. We flag the importance of communicating SBP's monetary policy stance so that banks begin lending, and move into longer terms instruments.

22 May 2019:

There is a complete change in the economic team, and we expressed concern that the well regarded Finance Secretary (Yunas Dogar) was removed from his position. Although there was no official explanation for this decision, there were rumors he did not agree with some of the IMF's program targets. This created the impression that the new economic team may have over-committed to the IMF. Media reports that the IMF program would only be $ 7 bln, was viewed with disappointment.

Steps towards the next IMF program were seen in the month: the rupee was weakened on May 16, 17, 20 and 21, and the monetary policy decision was brought forward to May 20, when SBP surprised the market by raising interest rates by 150 bps. The focus on stabilization was now clear, as the slowdown in LSM spread to food processing, autos, metals, electronics and cement. We discussed the economic challenges facing the country: one, the rupee needed to be depreciated to narrow the external deficit, but this would stoke inflation; and two, how rising inflation would compel SBP to further increase interest rates, but this would only add to fiscal pressures. The $ 1.24 bln current account deficit in April, did not help market sentiments.

In view of the daunting challenges ahead and the change in economic team, our outlook became pessimistic. We suggested that SBP should signal the end of the tightening cycle, and consider an anti-import public campaign and/or think about rationing fuel. With a small IMF program and depleting FX reserves, our rupee projections were 158-159/$ for June 2019, which could weaken further to 185/$ by December 2019. The resulting inflation would touch 17-18% in FY20, which meant further interest rate hikes. We argued that this situation cannot be resolved by prices alone (interest rates or the rupee parity) but needed structural changes in Pakistan's tradable sector. We suggested that CPEC should be customized to resolve Pakistan's structural trade deficit.

20 June 2019:

Hafeez Shaikh announced a realistic federal budget, which prioritizes stabilization over growth. But the 34% projected increase in FBR revenues – during a recession – was largely dismissed as too optimistic. With SBP chasing inflation (raising interest rates as inflation increased), we feared this could put further pressure on the fiscal side. We warned that 1H-FY20 would be tough, perhaps as challenging as the period after the freezing of FCAs in May 1998.

We disagreed with the SBP governor's comment that if financing is available, the external deficit is sustainable. We argue against further borrowing and attracting hot money (carry trades), and suggested that the projected $ 7 bln CA deficit for FY20 was too generous. Since the IMF program details could not be released until the program was approved by the IMF board in early July, the underlying macro outlook remains uncertain. We argued that further Rupee weakening in end-June was expected (to secure the board's approval), and suggested a parity of 159.9/$ by end-June 2019 – SBP took it to 163-164/$ on June 28, but dropped it immediately afterwards (see **Figure 3**).

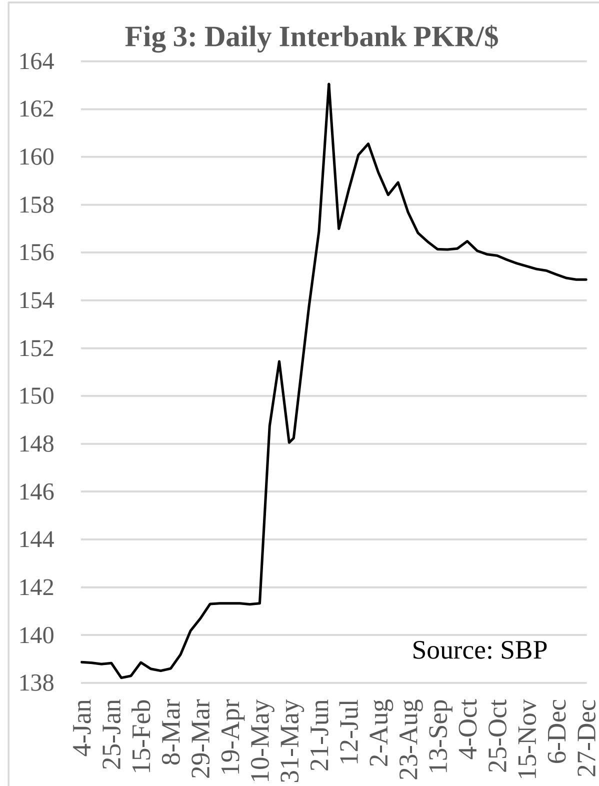
With mounting debt servicing, we predicted a token interest rate increase in July, and recommended that SBP signal that this would be the end of the tightening cycle. We were wildly off the mark about the likelihood of external financing in FY20: "*Issue is: after an outflow of $ 1.2 bln this year* [FY19], *can we expect portfolio inflows in a recessionary economy with a weakening Rupee?"*

We had clearly overlooked the pivotal role of carry trades.

23 July 2019:

A 39-month Extended Fund Facility is approved on July 3rd. The program is built on six key elements:

- Fiscal consolidation;
- Supportive social spending;
- Flexible exchange rate to restore competitiveness;
- Energy sector reforms to eliminate quasi-fiscal losses;
- Structural reforms through strengthening institutions; &
- Strong financial assistance from Pakistan's friends to "support the EFF."



This EFF is different for three reasons: (1) greater reliance on friendly countries to compensate for less funding from the IMF; (2) focus on overcoming the entrenched resistance to structural reforms; and (3) the need to document the economy. However, we were disappointed that the EFF did not impose the need to create a digital master file (fiscal cadaster), which had been hinted at earlier. The stock market does not rally after the EFF is announced, as it knows there are tough times ahead.

SBP increased interest rates by 100 bps, which was larger than the market's expectations and traced to the EFF. While program targets for SBP's NIR are ambitious in FY20, even by end-June 2020, SBP reserves would only cover 2.5 months of imports (which is below the IMF's 3-month benchmark). This means Pakistan's external sector will remain tight for the entire fiscal year.

Program details covering the period till FY24, reveal that the IMF assumes the rupee-dollar parity would *average* 171.3/$ in FY20 and 184.2/$ in FY21. This reinforces the view that the external sector will be hard to manage for the next two years, and also suggests that inflation will remain elevated. The EFF also shows that the bulk of external financing will come from FDI and portfolio inflows. We are surprised by this optimism, but assume it is because Pakistan's external debt is already too large (see **Figure 2**), and if it wants to run a CA deficit for the next four years, it cannot simply borrow.

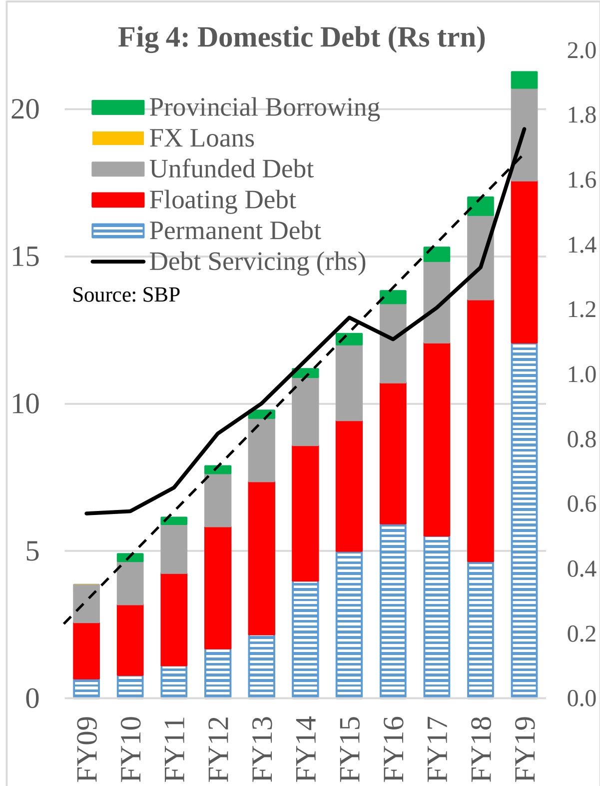
The revenue targets for FY20 are very ambitious, and program details do not show any concrete steps to achieve them. The document shows that real fiscal contraction will only take hold in FY22.

PM Imran Khan visits Washington DC and has a good meeting with President Trump. The latter wants to end US involvement in Afghanistan to boost his reelections chances in November 2020, which means Pakistan should have US support till mid-2020.

26 August 2019:

In an unexpected move with retroactive impact, GoP's borrowing from SBP is converted from 6-month T-bills into PIBs, which sharply increases the maturity of GoP's domestic debt (see the increase in permanent debt during FY19 in **Figure 4**). This changes the interest rate outlook, and institutional investors pour into PIBs and reduce long-term yields. This inverts the yield curve, which creates the impression that the stabilization phase is over. SBP's governor makes several public statements about the need to attract carry trades, as domestic interest rates are gaining the attention of foreign fund managers.

We argue that this change in sentiment is not based on fundamentals, and it is too early to claim that Pakistan's economy has stabilized. In view of NIR targets in December and March 2020, we anticipate pressure on the Rupee in the period Oct-Dec 2019, which could reverse the interest rate outlook. Having said this, FY20 starts well with a CA deficit of $ 579 mln, which is consistent with the full fiscal year target. This is driven by imports, specifically the oil bill that is half of what was posted in July 2018.



The 3.6% fall in LSM in FY19 compared to a growth of 6.4% in FY18, shows the extent of the economic slowdown. Using the IMF's assumption for the average rupee parity in FY20, we project the rupee at 174/$ by December 2019 and 181/$ in June 2020. At these parities, our projected average inflation in FY20 is 12½%, which is in between the IMF and SBP's projections. We argue that interest rates have maxed out, and revenue mobilization will become increasingly challenging.

27 September 2019:

The fiscal deficit in FY19 is revised up to 8.9% of GDP. This shocking number was driven by below target tax collection and higher spending. We were surprised that the visiting IMF mission did not change the FY20 revenue target, which now looks even more unrealistic. CA deficit is again small, and we argue this is driven by the overall economic slowdown more so than the higher cost of imports.[1] Private sector credit off-take is low, reflecting the slowdown and high interest rates.

We flag the appreciating rupee with some concern (see **Figure 3**), as this undermines SBP's reserve build-up and could incentivize imports. We remind readers that the NIR targets are ambitious for Q2 and Q3-FY20, which could put pressure on the rupee. We conclude by claiming that while market sentiments have improved, this is premature. Local media takes a dim view of the growing inflow of hot money; we argue that this new player in the FX market is creating a false sense of health regarding the economy.

On the global stage, India's annexation of Kashmir and the strike against Aramco's refining capacity, creates more tension in the region. PM Imran Khan makes an impressive speech at the UN, and is asked by the Saudi Crown Prince and President Trump to intermediate between the Kingdom and Iran. Impeachment hearing begin against President Trump, which means he will focus on US politics rather than global affairs. Despite these shocks, oil prices remain soft, which is a source of comfort for Pakistan.

[1] In theoretical terms, the income effect is

23 October 2019:

CA deficit continued to impress as imports shrink. Pakistan is to remain on the grey-list till February 2020, and we do not expect Pakistan will be blacklisted. The second stage of CPEC is discussed in the media, but not with the sense of prominence it carried 4 years ago. Fiscal revenues are surprisingly robust despite the economic slowdown. However, with twin deficits at 12.9% and 13.7% of GDP in FY18 and FY19, respectively, we are more cautious compared to prevailing market sentiments. We argue that expectations of a rate cut are misplaced when one considers the temporary improvement in the external deficit and record fiscal deficit in FY19.

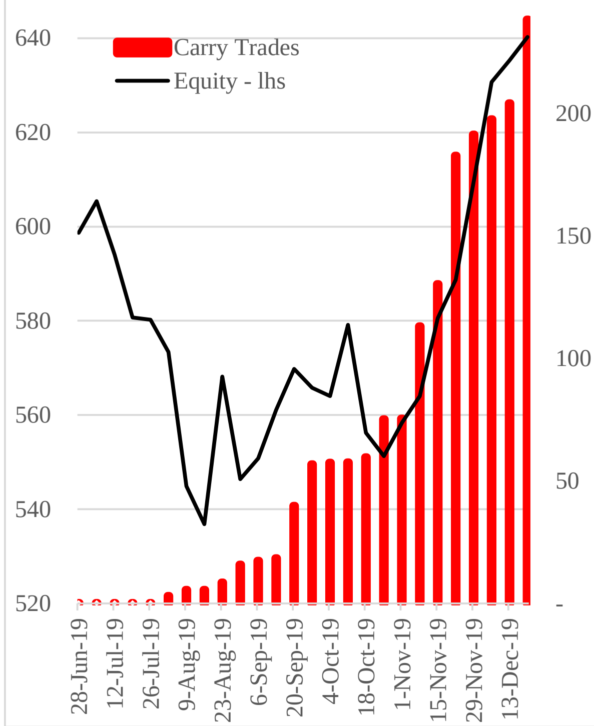
Carry trades help the external sector, but the volumes are small. Non-oil imports post a declining trend since May 2019, a clear reflection of the economic slowdown. However, the appreciating rupee so soon after the sharp depreciations in May/June, could create confusion about where the economy is heading. We urge a stronger commitment to stabilization in FY20, and a planned growth phrase in FY21 that is anchored to CPEC 2.0.

The downside to cultivating a one-dimensional narrative about interest rates only being used to fight inflation, is that if inflation begins to fall (which we anticipate), SBP will be pressured to cut rates. Our model shows that YoY inflation has peaked at 12.5% in the month of September.

22 November 2019:

The most decisive development in the month, was the sharp increase in hot money flows (see **Figure 5**). This coincided with a $ 99 mln CA *surplus* posted in the October, and the IMF's endorsement of the first quarter of the EFF. As expected, YoY inflation dipped down and the stock market began to rally. There is a palpable sense of optimism about the economy, as we admit that the economic outlook has changed in just one month.

Fig 5: SCRA o/s stocks (Rs bln)

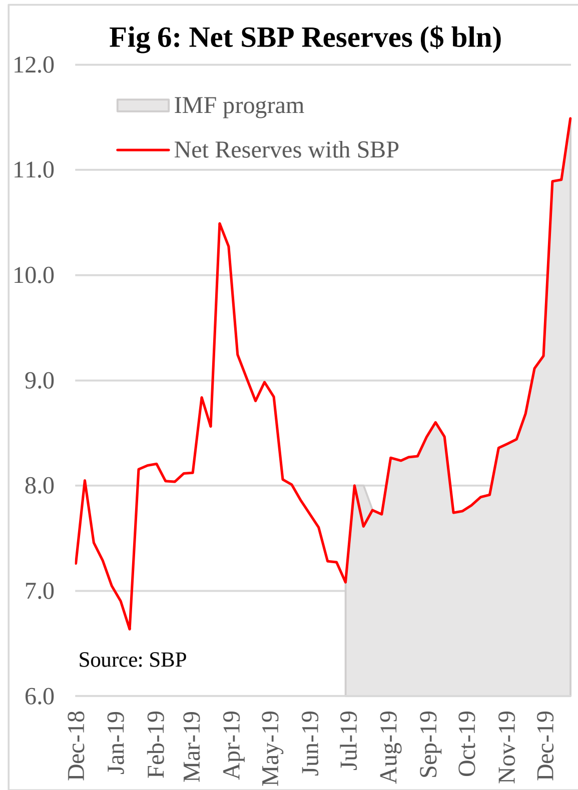


The carry trades (though risky) bring many positives: (1) they allow SBP to buy dollars to build reserves and appreciate the rupee; (2) they provide deficit financing, which means less crowding out; (3) they generate rupee liquidity, which means SBP can reduce its OMOs; and (4) they do not increase Pakistan's external debt. The appreciating rupee, rising SBP reserves and the easing of FX rules, improve market sentiments. Foreign appetite is strong because of high interest rates, the appreciating rupee, and the fact that foreign fund managers must diversify their investment portfolios. In view of all these positives, SBP appears increasingly focused on carry trades, which suggests that interest rates will not be cut aggressively and the rupee will be carefully managed to protect their margins.

The narrowing CA deficit (down $ 4 bln) is primarily driven by import compression (which is down by $ 4.4 bln). SBP's reserves begin to grow and the appreciating rupee and soft oil prices, have deflated inflationary expectations. Despite the incentives given to exporters, textiles remain stagnant. We argue that policymakers must rethink their export policy, and look for new products and new export markets.

With stabilization in hand, our inflation projections are reduced again – to 11%. With food inflation above 13% in Sept and Oct 2019, we argue that managing food inflation has become a policy priority. This means currency stability and keeping transportation costs low, are important goals.

We end with a few key messages: (1) Asad Umar's induction as Planning Minister, could prioritize CPEC and a planned growth phase in 2020; (2) how SBP manages the carry trades will determine the country's economic outlook; and (3) the IMF cannot accept the appreciating rupee simply because a new source of dollars has been activated. We feel SBP will have to rethink its exchange rate policy as the NIR targets become tougher.



23 December 2019:

The economy stabilized and SBP's FX reserves cross $ 10 bln (see **Figure 6**). The stock market continued to rally, crossing 41,000. With 3-month carry trades to be rolled-over, we do not expect interest rates to be cut in January 2020. As of 27 December, $ 1.43 bln has been invested in T-bills and $ 10.3 mln in PIBs. The rupee continued to appreciate and is now below 155/$.

As we anticipated, the latest IMF report signals some concern about the appreciating rupee. Hence, SBP is likely to become more aggressive in buying dollars to build reserves in 2020. The CA continued to impress, and the fall in the external deficit (down by $ 4.9 bln in the first five months of FY20) was driven by the $ 4.9 bln fall in imports. For the first time in the EFF, Pakistan's BoP showed a healthy growth in SBP's reserves, which can be traced to portfolio inflows (i.e. carry trades).

Inflationary pressures continued to fall, and the MoF stated that inflation will be lower than projected. However, this will create pressure on SBP to cut interest rates – we argue that SBP must change its monetary policy narrative to deflect criticism that high interest rates are hurting the economy. We also urge the government to adopt *pro-market* policies over *pro-business* policies that protect/support existing businesses. We argue that pro-business policies will not allow Pakistan to break out of its structural constraints, while pro-market policies that encourage new players into the system would make the economy more competitive.

On a final note, we expressed concern about the clash between the judiciary and the military. This was revealed by the CJP's reservations about the COAS's term extension, and the incendiary language used in the treason conviction of General Musharraf. We were also dismayed by the last minute decision not to attend the Malaysian summit of Islamic countries. PM Imran Khan was keen to attend, but was allegedly held back by the Saudi government. Media reports claimed that Pakistan was threatened by the withdrawal of Saudi financial assistance, and the possible expulsion of Pakistani workers from the Kingdom. This reveals how Pakistan's economic weakness has compromised its policy independence. We argue that this embarrassment may motivate the PTI government to take hard steps to make the country's economy less vulnerable to external pressures.

Assessment of 2019

2019 has witnessed a significant change in sentiments. The year started with a sense of despair, as SBP's FX reserves had fallen to half the level in end-2017. The government had still not decided to approach the IMF, and was borrowing from friendly countries to finance the external deficit. The government only committed to an IMF program in April, after Asad Umar resigned and a new economic team took charge.

Till mid-2019, the depreciating rupee and interest rate hikes did little to change the composition and quantum of Pakistan's imports and exports. The record $ 31.9 bln trade deficit in FY18, only narrowed to $ 29.5 bln in FY19, and most of this improvement was because of a lower oil bill. However, by the start of FY20, the sharp economic slowdown reduced import demand and brought the CA deficit under control.

The IMF program that was signed in early July 2019, gave the market a better handle on what to expect. We were disappointed that the program was not customized, as the narrative from the IFIs was uncharacteristically honest about the institutional and political resistance to structural reforms. We were hopeful that documentation would be a key condition in the EFF, but this was not the case.

We were surprised the rupee was allowed to appreciate so soon into the EFF. The 163/$ parity at the end of June 2019, was allowed to appreciate to 154.9/$ by the end of 2019. Since the economic slowdown did the heavy lifting to narrow the external deficit, we assume the rupee was appreciated to create a sense of calm, defuse inflationary expectations and protect carry trades.

Market sentiments changed in August, when GoP changed the nature of its borrowing from SBP with a simple stroke of the pen. One month into the EFF, and the market started talking about a cut in interest rates. However, FX reserves were not building, and in view of the NIR targets in 2H-FY20, we expected significant rupee weakness in the remaining part of the year. The shocking admission that the fiscal deficit was 8.9% of GDP in FY19, against a target of 7.2%, was embarrassing for MoF, but the IMF refused to change its revenue target for the year. We assume this was the price the authorities would have to pay for their unrealistic predictions even as late as May 2019.

On the positive side, the external deficit continued to narrow, and PM Imran Khan's speech at the UN cemented his stature in the global arena. Furthermore, with President Trump and MBS asking the PM to mediate between the Saudi Arabia and Iran, Pakistan's global stature continued to rise. By September, we started flagging the appreciation of the rupee, and urged caution as this could generate import demand and reverse the narrowing external deficit.

At the same time, we highlighted the risks of attracting carry trades, but the volumes realized were too small to be of concern. We also called the 12.5% YoY inflation in September as the peak, and brought down our full year inflation projection to a range of 11-12%.

In November, the economic outlook totally changed as carry trades increased sharply (see **Figure 5**). At this point, we realized the gradual appreciation of the rupee was also designed to retain such investment. SBP's reserves started to increase, which allowed it to ease restrictions in the FX market. Carry trades were making the NIR targets easier and also injected domestic liquidity into the money market. We urged caution since this comfort could lull policymakers into a false sense of well-being, and trigger a premature growth phase. We questioned whether the IMF would approve of SBP's currency management; we argued that since carry trades are a new source of dollars and have not changed Pakistan's fundamentals, they should not be allowed to change the trajectory of the rupee-dollar parity.

Conclusion

Pakistan ended 2019 on a positive note: inflation is heading down, the rupee is appreciating, FX reserves are building and the stock market is rallying. The IMF's update in December 2019 was surprising; it confirmed that the end-September targets were all met, but many structural benchmarks were missed – it also highlighted the elevated risks that still remain. In our view, this should caution policymakers not to be too quick to declare victory and work towards the program targets in 2H-FY20.

If conditions turn sour (say carry trades plateau or the monthly CA deficit begins to increase) the NIR targets will become more challenging. This will compel SBP to depreciate the rupee and/or tightening liquidity, which will change market sentiments and key projections like inflation, the rupee-dollar parity and interest rates. This will return the policy focus to stabilization, which means structural changes and planned development would be pushed to the back-burner.

As things stand, market sentiments are bullish and people expect a growth phase to take hold in 2020. This has been reinforced by the recent statement by the PM that 2020 would be a year of prosperity. On the other hand, the EFF program targets are tougher in the second half of FY20, and the IMF has reminded us that risks remain elevated. In our view, two factors are primarily responsible for the significant improvement in market sentiments during 2019: the narrowing CA deficit, and the inflow of carry trades. These factors are still in play but could trend the other way, which is why it is so difficult to predict what will happen in the remaining part of the fiscal year.

Despite this uncertainty, we would urge two things: one, the planning function at GoP be revived and start to shape the country's economic policies; and two, the MoF and SBP should be cautious about what they signal. In terms of the latter, a premature growth phase would hurt the government's policy credibility as it could undermine the IMF program. What the market needs is clarity on the following questions: Can Pakistan's economy afford a growth phase so soon into the stabilization program? When will interest rates be brought down, and by how much? What exactly is the thinking behind SBP's exchange rate policy? Does FBR have a plan to meet its ambitious revenue target in FY20?

With the government promising growth this year, and the EFF targets pointing in the other direction, policymakers will struggle to formulate a coherent economic narrative for 2020.