The elusive Net International Reserves (NIR)

Mushtaq Khan, November 11, 2019

The IMF review mission has concluded its visit, and given the country a thumbs-up. Pakistan has met all the performance criteria "comfortably", and the signs of stabilization are now visible. As we had flagged earlier, the external deficit shows a significant narrowing and revenues have managed to stay reasonably close to the quarterly targets – the latter is quite impressive given the ambitious full-year target and the import compression that has hurt custom revenues. In terms of inflation, the IMF has revised down its inflation projection for the year from 13% to 11.8%, which falls within our projection that average inflation will be in the range of 11-12%. The next tranche of $ 450 mln is expected early next month.

This confirms that the program is on track and the IMF is now focused on issues that have less of a bearing of the country's macro-economy (e.g. the containment of the circular debt, ensuring minimum levels of social spending, greater autonomy for SBP, etc.). For many, this supports their view that the hard steps have been taken, and Pakistan's economy is on the mend. The fact that year-on-year inflation (using the old base) has posted the first significant fall in October 2019, reinforces the sense of optimism.[1]

While we agree there are clear signs that things are improving, we still think it is too early to declare victory. In this paper, we will focus on what to expect in the external sector. As highlighted in our October presentation, the fact that the EFF targets to build SBP's reserves to $ 11.2 bln by end-FY20, is insightful: against the IMF's import projections for FY21, this level of FX reserve will only cover 2½ months of imports, which is below its benchmark 3-month minimum coverage mandated on all member countries. This suggests that Pakistan will remain under pressure on the external sector for the rest of the fiscal year.[2]

The good news is that Pakistan has comfortably met the end-September NIR target – the IMF review mentioned the "higher than expected increase in SBP's net international reserves." However, as we have said before, the first quarter NIR target is easy: SBP is required to increase its NIR by about $ 7 bln in FY20, all of which is to come in the next three quarters. To achieve this, the market is talking about borrowing from the global markets (Eurobonds/Sukuk worth $ 1½-2 bln); a Panda bond worth about $ 300-400 mln; and proceeds from the sale of two LNG plants that could fetch $ 1½-2 bln.

As of November 1, SBP data shows that fresh inflows in fixed-income instruments (hot money) has generated about $ 484 mln so far in FY20. Since this money is not surrendered to SBP (it stays in the SCRA accounts), it does not count towards SBP's reserves. However, it does supply hard currency into the interbank market, which will help limit the use of SBP's reserves. If hot money is used to finance the external deficit (which will help protect SBP's reserves), a reversal of flows will have the opposite effect – it will create excess demand for $ in the interbank market, which will either force SBP to use its reserves or the PKR will have to weaken.

In our view, Pakistan should be able to meet the NIR targets, but it will not be easy. This means the external sector should be closely watched and the import compression must persist for the rest of the year. Unlike the other hard targets on Pakistan, tracking SBP's NIR is near impossible, as some of the data required to compute the NIR is not public information. In simple terms, SBP's NIR refers to foreign

[1] The new CPI basket is not usable as details of the various sub-indices are still not public.
[2] In the EFF, the reserve target is translated into quarterly floors for SBP's net international reserves (NIR). As a performance criteria, the NIR must be met: if not, a formal waiver from the IMF is required otherwise the program stalls.

currency that the central bank can use to intervene in the FX market, without undermining its ability to honor committed repayments.

The formal definition of the IMF's NIR is complicated, but in essence it looks at SBP's liquid reserves, and subtracts the following items:

- All committed FX repayments to bilateral and multilateral lenders in the next 12 months. If loans are rolled-over, this will not impact SBP's NIR as it impacts both sides (i.e. fresh inflow cancels repayment); if loans are rescheduled (i.e. loans repayments are extended beyond 1 year), this would increase SBP's NIR);
- All reserve-related FX liabilities (especially FX swaps, futures and forwards) that SBP must repay to commercial banks (this data is publically available);
- The stock of IMF's debt that Pakistan carries (available on a quarterly basis); and
- Any central bank placements of FX with SBP to shore up its reserves.

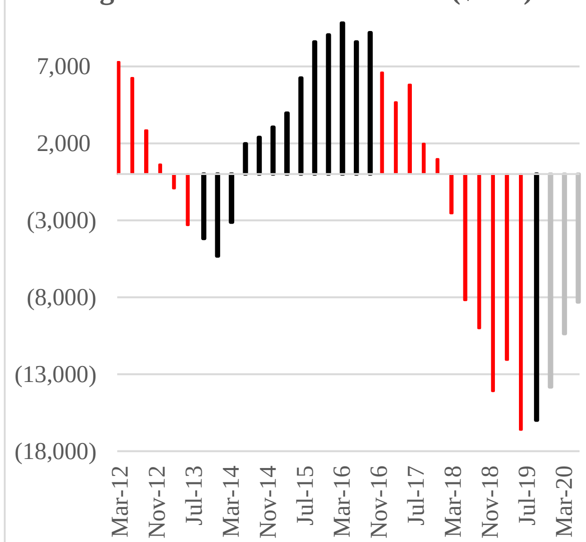
As stated in the EFF document released in early July, SBP's NIR was *negative* $ 17.7 bln at the end of June 2019.

In Pakistan's case, net SBP reserves in end-September, less committed repayments for the next 12 months, is *negative* $ 16 bln. This boils down to saying that Pakistan will have to draw down its reserves to zero, run a zero current account deficit for the next 12 months, *and then* borrow $ 16 billion just to be able to meet its repayment commitments for the period October 2019 to September 2020. This is clearly impossible, which means that much of Pakistan's bilateral repayments have been rolled-over or rescheduled. Since this information is not public, we are unable to calculate SBP's NIR.

Furthermore, there are *adjusters* on the NIR target. In formulating a country's BoP projections, the IMF staff and government officials discuss all potential inflows and quantify them. They then calculate outflows (committed repayments and the size of the external deficit) to arrive at the stock of central bank reserves. To ensure that the authorities take credible steps to narrow the external deficit, the IMF does not target the end-of-period FX reserves, as the country could borrow more (than agreed upon) and allow the external deficit to remain high. Adjusters make sure the country does not cheat: for example, if Pakistan expects China to lend it $ 1 bln in FY20, but we end up borrowing more (say $ 2 bln), then the NIR target is adjusted upwards by $ 1 bln. This also holds for Eurobonds/Sukuks, bilateral borrowing and all committed inflows from other IFIs.[3]

There is a good reason that NIR targets are hard to quantify: if the market were able to track SBP's NIR accurately on a month-to-month basis, it would be able to project what SBP's FX reserves should be at the end of the quarter. If SBP is struggling to meet the NIR target and the market knows the reserve level it must reach, this could distort the FX market, as

Fig 1: SBP's Net FX Reserves ($ bln)

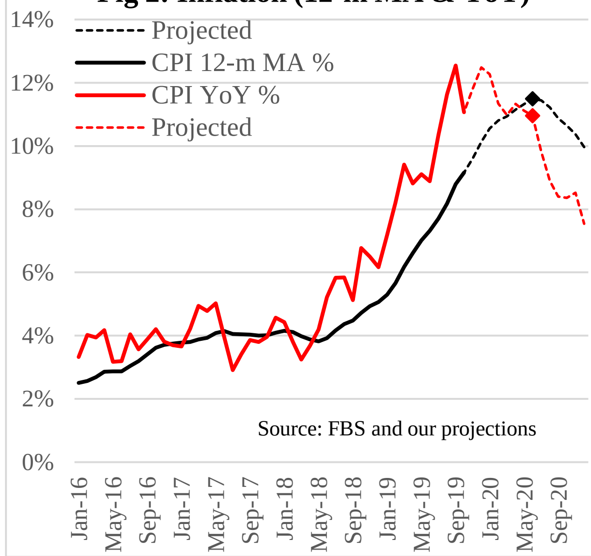


[3] Since we lack of information about the quantum of loans that have been rescheduled, or fresh inflows from IFIs and friendly countries, we cannot quantify the adjusters that directly impact end-quarter targets.

players would change their behavior vis-à-vis the buying and selling of FX in the interbank market.

Having said all this, it doesn't mean the market will remain clueless about what could happen on the FX side. In **Figure 1**, we use a simple proxy for NIR: SBP's liquid reserves less all committed FX repayments for the next 12 months (this includes both loans and FX liabilities that SBP is committed to repay). It is important to note that SBP's *net reserves* are largely negative, but begin to improve quite sharply when Pakistan is in an IMF program. In **Figure 1**, the red bars are when the country is not in an IMF program while the black bars are when Pakistan is in an IMF program. It shows the sharp focus on increasing net reserves, which after some inertia, begins to rise. It should also be noted, that unlike the previous IMF program, SBP's reserve position is far weaker now – net reserves by end-June 2019 was negative $ 16.6 bln, but only negative $ 3.3 bln in June 2013. The last three grey bars in **Figure 1** show what needs to happen to SBP's *net reserves* if it meets the NIR targets.[4] As shown, the adjustment in the next three quarters is quite steep.

Fig 2: Inflation (12-m MA & YoY)

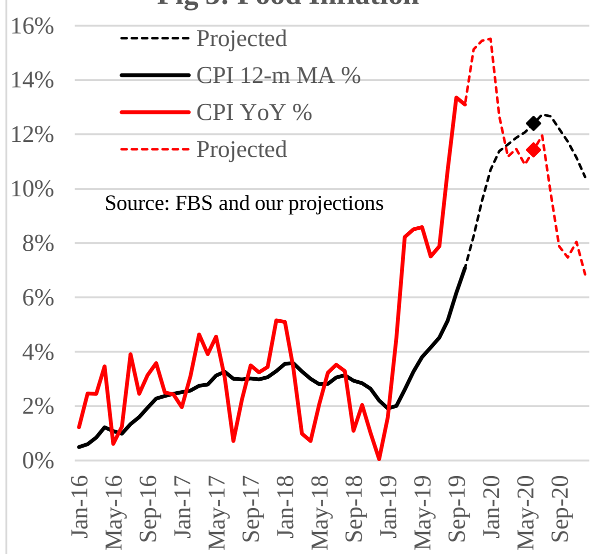


To put this into context, the slight improvement by end-September 2019 (the last black bar in **Figure 1**), takes into account the sharp reduction in the current account deficit in FY20. What the grey bars show is the pace of improvement required in the remaining three quarters of this fiscal year. We can be sure that SBP's *net reserves* will eventually become positive during the course of the 39-month EFF, which means unless there is a structural improvement in Pakistan's external sector, the country will remain stressed by the shortage of foreign exchange throughout the program.

Interest rates

As discussed earlier, we will base our inflation projections on the 2007-08 index. As shown in **Figure 2**, September's YoY inflation of 12.5% is perhaps the peak, after the upward trend witnessed since March 2018. With a stable Rupee and retail fuel prices, not to mention the overall slowdown in economic activities, it is safe to say that the inflationary momentum has eased and will create less pressure going forward.

Fig 3: Food Inflation



However, the challenges remain. Looking at the sub-indices, food inflation is very high (and could increase further), as is clothing/footware and hotels /restaurants (see **Figures 3, 4** & **5**). This hurts the average Pakistani and creates political pressure, which explains why the PM has threatened to take stern action against hoarders who manipulate retail prices.

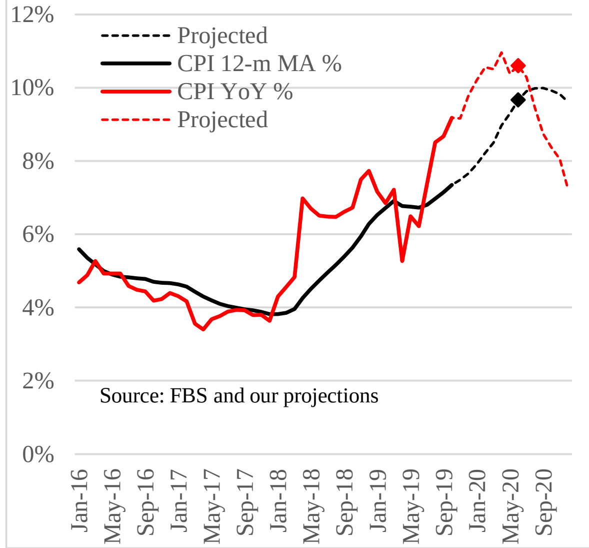
[4] One must state that while the end-September and end-December 2019 NIR targets are performance criteria (i.e. hard targets), the NIR for end-March and end-June 2020 are indicative targets, which will firm up as the program proceeds.

However, YoY inflation will begin to fall, driven by utilities, rent, furniture, household items and transportation costs. This makes intuitive sense as the hard adjustments to qualify for the EFF have been taken, and further steps do not appear necessary. Global oil prices will help keep retail fuel prices stable.

With mounting pressure to show some good news, MoF may nudge SBP to cut interest rates this month. As we have argued, cutting rates in 2H-FY20 will be difficult because of the borrowing pressure that is likely to materialize with revenue slippages. With a ban on central bank financing and no change in the FBR revenue target, SBP will be unable to cut rates in 2H-FY20 as it needs to ensure that banks continue to fund the government. Hence, we stand by our view that a token interest rate cut is possible, but a more meaningful cut is not possible this year. A large cut could increases imports and undermine SBP's ability to meet its ambitious NIR targets.

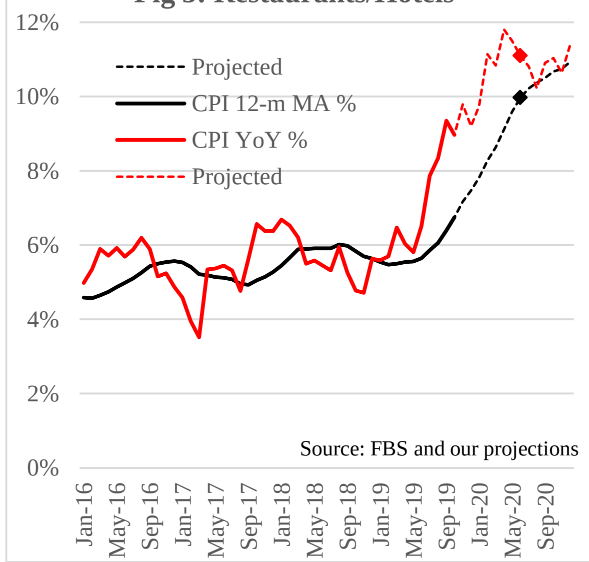
Figure 6 shows SBP's liquid reserves. Despite the narrowing external deficit in FY20, SBP's reserves have not increased much since the start of the EFF. It shows that IFI inflows (recall the disappointing size of the EFF program) will not build up the central bank's reserves, which means that Pakistan will have to borrow to build its reserves.[5] One must also realize that rescheduled loans simply delay repayments: as shown in **Figure 1**, the stream of $ repayments is now at unprecedented levels and will keep Pakistan dollar-short for many years in the future.

Fig 4: Clothing/Footware



Source: FBS and our projections

Fig 5: Restaurants/Hotels



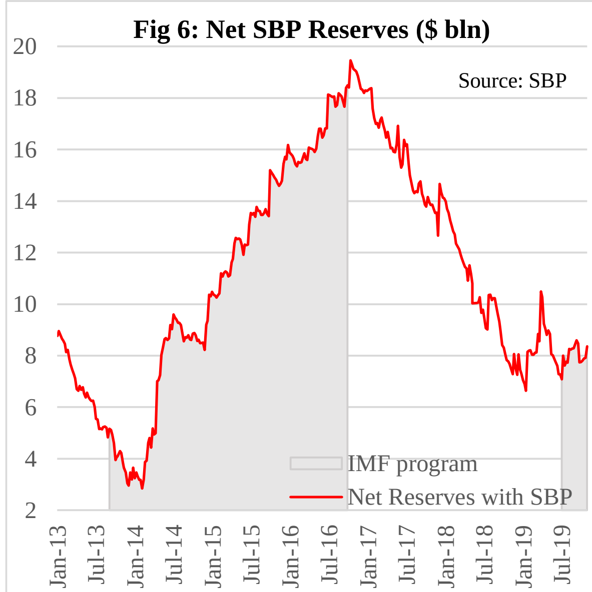
Source: FBS and our projections

With the on-going need to compress imports, SBP can only afford a token cut to keep the stock market bullish. Furthermore, the central bank should make it clear that further cuts are unlikely as fiscal pressures in 2020 will not allow for further monetary easing.

In simple terms, SBP must change its narrative on interest rates and inflation. If it continues to focus only on inflation (as it was during the tightening phase), then it will not be able to change the market's expectations. SBP must therefore change its focus to the fiscal side, stating that in a market driven primary auction system, interest rates are determined by the demand and supply of government T-bills. If the fiscal deficit is not brought down sharply in 2020, the government will have to increase its borrowing from commercial banks. While this could put upward pressure on interest rates (which we think is unlikely), the government cannot increase its borrowing and cut interest rates at the same time.

[5] This creates a trade-off. Increasing FX reserves is a source of comfort, but the rising external debt is not. The authorities need to find a balance between the two.

Conclusion



The damage done by Ishaq Dar's policy to subsidize imports, has created a degree of import-dependency that will be very painful to overcome. With Pakistan's rapidly growing external debt (which will continue to grow in the next several years) and its mounting repayment stream, Pakistan cannot afford to grow its economy unless there are structural changes in the tradable sector. In our view, these structural changes cannot be achieved by setting the "right" prices (i.e. a market driven exchange rate or market determined interest rates). This change requires a more interventionist role for the government.

This poses an interesting question: while Pakistan's economic team has achieved the "right" prices and stabilization has gained traction, do they have the mandate (or the inclination) to go beyond stabilization? Actively championing import substitution will not be endorsed by the IMF (or the other IFIs), while pushing for economic growth via the second stage of CPEC, will not generate much enthusiasm from the Washington Consensus. This means the default option is to proceed with the EFF and soft-pedal CPEC, even if growth remains barely above Pakistan's *organic* growth rate (i.e. the increase in population and livestock in the country).

The constraints of the external sector are only the most immediate: creating jobs, upgrading the country's infrastructure and improving social development, are far more challenging tasks. With a heavy debt overhang, 5-6% economic growth is not possible unless policymakers address Pakistan's import dependency. As we have been saying since 2015-16, CPEC could become a vehicle for structural change and economic growth, without necessarily breaching stabilization measures. But this requires bilateral planning and a calibrated launch of CPEC 2.0 in the guise of Pakistan's new industrial policy. Given how the wind is blowing, we are not convinced our policymakers are up to the challenge.