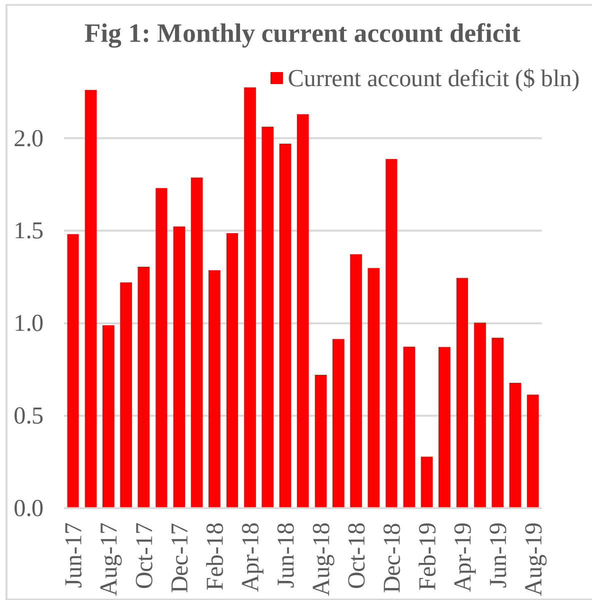
New challenges, same old story

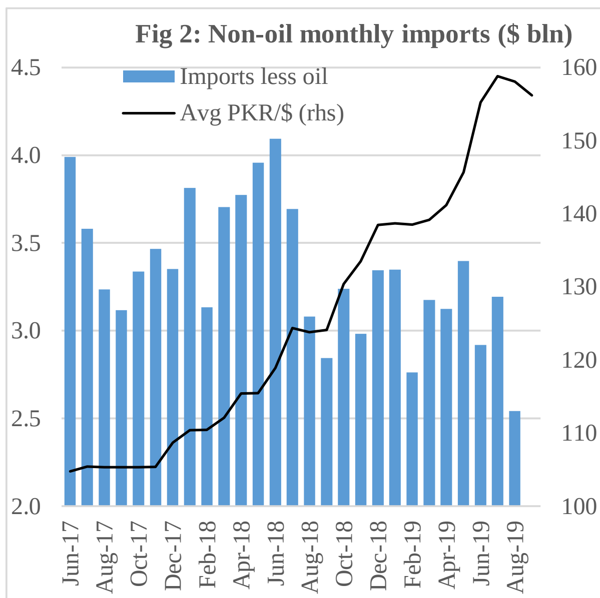
Mushtaq Khan, October 11, 2019

With escalating geopolitical developments, Pakistan's economy has been somewhat over-shadowed. With India's annexation of Kashmir over two months ago; Imran Khan's stirring UN speech; the Iran-Saudi standoff after the Aramco strike; Boris Johnson's chaotic management of Brexit; and the impeachment inquiry against President Trump, there is enough happening to keep the nation engaged. Or perhaps it's the sharp economic slowdown that is hurting all economic classes: people are increasingly uncomfortable talking about their personal finances, which is driving the issue under the radar.

This paper seeks to take stock of Pakistan's economy. We will focus on the stable Rupee and hopes that the painful adjustments are now behind us; Pakistan's enhanced global stature, which means an FATF blacklist is unlikely; and the broadly positive IMF review. We will then summarize our assessment of what lies ahead for the Rupee, interest rates, the BoP, and the unchanged FBR revenue target. The paper will also address the government's view that an economic recovery is beginning.

As part of the outlook, we will revisit CPEC (or CPEC 2.0 as the second stage is called) and ask whether the PTI government will do what previous governments have failed to do (documentation and stamping out corruption). At the risk of giving away our conclusion, there are new battles, but the underlying problems are the same. The issue is whether this government has the political will – and leadership – to push back against the resistance to structural reforms, or settle for a cosmetic middle-path that will bring us back to square one.





Current issues

After a tumultuous Q4-FY19, the relative calm in the FX market is now taken for granted. By end-June 2019, the market was talking about a parity of 180/$ by the end of 2019, but now people are talking about 165-170/$ by the end of June 2020. The reason for this optimism is obvious: **Figure 1** shows that the monthly external gap has narrowed significantly. With a smaller gap to finance, SBP has actually allowed the Rupee to appreciate. As shown in **Figure 2**, non-oil imports have been falling since mid-2018, which suggests that the exchange rate adjustments have reduced import demand. Most observers agree that domestic demand has been sharply curtailed by the rising cost of imported goods (and materials), regulations about documentation (mandatory CNIC for commercial transactions) and efforts to penalize non-filers. With the on-going NAB investigation on past LNG deals, there is a sense of unease in both the private and public sectors.

The economic slowdown has given rise to expectations that interest rates will be cut next month, and the government will soon launch a growth phase. As we have argued before, it is still too early to declare victory on the economic front, but the growing pressure on the government to revive the economy cannot be dismissed, or ignored.

As shown in **Table 1**, the real sector has experienced a sharp slowdown in FY19, and FY20 continues to reflect this trend. Anecdotal evidence paints an alarming picture of an economic slowdown that is impacting all sectors of the economy, with job losses and rising inflation stoking public anger and desperation. In our view, the upbeat IMF assessment of the EFF may have been intentional to ease pressure on the government, even though the MoF mismanaged the fiscal data in negotiations during May/June 2019.

Table 1: Large Scale Manufacturing

LSM Sectors	Weights	FY18	FY19	Jul-20
	(%)	growth	growth	growth
Textiles	**20.91**	**0.49**	**(0.19)**	**0.12**
- Yarn	12.96	0.06	0.04	0.41
- Cloth	7.19	0.04	0.22	0.15
Food, Bev, Tobacco	**12.37**	**2.96**	**(7.20)**	**(7.92)**
- Cigarettes	2.13	71.98	2.83	(39.63)
- Cooking oil	2.23	0.68	2.10	(5.46)
- Vegetable ghee	1.14	10.67	(2.81)	1.91
Petroleum products	5.41	13.24	(8.35)	(25.12)
Chemicals	**1.72**	**(0.29)**	**(3.60)**	**(5.94)**
Automobiles	**4.61**	**17.82**	**(11.78)**	**(27.40)**
- Cars & jeeps	2.82	21.35	(6.21)	(23.17)
- Motorcycles	0.61	12.97	(12.93)	(24.41)
- Tractors	0.47	33.20	(30.59)	(38.33)
Iron/Steel	**5.39**	**21.78**	**(11.21)**	**(15.44)**
- H/C, sheets & coils	2.28	17.35	3.00	0.25
- Billets/Ingots	1.52	26.52	(25.30)	(31.19)
Fertilizer	**4.44**	**(9.88)**	**7.68**	**16.34**
Electronics	**1.96**	**97.11**	**12.53**	**67.23**
Leather	**0.86**	**(10.63)**	**2.31**	**1.39**
Engineering products	**0.40**	**12.64**	**6.48**	**8.10**
Cement	5.30	11.14	(2.98)	(0.13)
Total LSM		**6.38**	**(3.64)**	**(3.28)**

Source: SBP

In the EFF document released in early July, the fiscal deficit in FY19 was projected at 6.8% of GDP, but was later revised to a record breaking 8.9% in late August. Hence, we thought the IMF would revise its fiscal targets for FY20, but it hasn't. The FBR revenue target remains at Rs 5.5 trn, which was ambitious to start with it. Perhaps the IMF decided that since they were misled by MoF, and the Finance Advisor signed off on the EFF targets, it was up to the Pakistani authorities to figure a way out.

Despite this issue, the market is taking comfort from the narrowing BoP, which is feeding the view that Pakistan should soon return to growth.

Finally, there is a sense that Pakistan will remain on the FATF's grey-list, which means more time for compliance and no break with the global community. This outlook builds on Pakistan's enhanced global stature following the UN General Assembly meeting in September, and the Saudi/American request that Pakistan help defuse tensions between Iran and Saudi Arabia (*Could Pakistan resolve the Iran-Saudi standoff?* September 310, 2019).

What we expect

Since there are so many moving parts at the macro level, we will give our outlook on key economic indicators and highlight some of our assumptions:

1. PKR-Dollar parity & inflation:

We start with the assumption that the narrowing current account deficit (CAD), is driven by falling demand and not only because of the depreciated Rupee. One could argue that despite the appreciation of the Rupee since late-June, this has not increased domestic demand and (so far) has not translated into higher imports (see **Figure 2**). It also suggests that even with more restrained adjustments of the PKR, Pakistan's CAD should remain below $ 7 bln for the full year (see **Table 2**).

Having said this, we expect some Rupee weakness in the remaining part of the fiscal year. One should realize that the IMF board signed off on the EFF in early July, knowing that the Rupee ended FY19 at a parity of 163/$. In our view, this was an unspoken but understood action to show the IMF board that MoF/SBP was willing to weaken the Rupee. Looking ahead, when the IMF begins working on next year's program targets, it will need to show that the Rupee has *further* weakened (albeit to a lesser extent) as the external sector was the primary reason for Pakistan's return to the IMF. We assume a further 5-8% adjustment over the end-FY19 parity, which means the Rupee could end the fiscal year in the range of 171/176/$. As shown in **Table 3**, we have settled at 174/$ as the average PKR parity in June 2020.

Table 2: Pakistan's Balance of Payments

US$ mln	FY17	FY18	FY19	FY20
Current Account	**(12,621)**	**(19,897)**	**(13,587)**	**(6,695)**
- CA as a % of GDP	4.14%	6.32%	4.78%	2.59%
Trade Balance (net)	***(26,680)***	***(31,824)***	***(28,219)***	***(24,891)***
- Merchandise Exports	22,003	24,768	24,217	26,834
- Merchandise Imports	48,683	56,592	52,436	51,725
Services Balance (net)	***(4,339)***	***(6,068)***	***(4,265)***	***(2,022)***
Primary Income (net)	***(5,048)***	***(5,484)***	***(5,744)***	***(5,456)***
**** Interest payments***	***(3,056)***	***(3,056)***	***(2,978)***	***(3,570)***
**** Return on DFI***	***(3,217)***	***(3,217)***	***(2,560)***	***(2,643)***
Secondary Income (net)	***23,446***	***23,479***	***24,641***	***25,674***
- Remittances	19,351	19,914	21,842	22,538
Capital Account	**375**	**376**	**266**	**690**
Financial Account	**10,198**	**14,300**	**12,223**	**8,744**
- Direct Investment (net)	2,663	3,461	1,729	2,094
- Portfolio Investment (net)	(250)	2,257	(1,262)	333
- Other Investmens (net)	7,785	8,582	11,756	6,317
* SBP	4	1,548	5,495	(4,000)
* GoP	4,971	4,894	3,904	8,133
* Banks	(1,631)	109	(217)	1,259
* Others	2,298	2,522	2,432	1,567
Errors & Omissions	**102**	**(920)**	**(454)**	**-**
Overall Balance	**1,946**	**6,141**	**1,552**	**(2,739)**
- Change in SBP reserves	1,844	6,227	1,928	(4,364)
End-year official FX reserves	16,141	9,789	6,824	11,187
External debt (stock)	83,477	95,342	104,165	112,538

Source: IMF's EFF and SBP

This currency stability is an important consideration for Pakistan's policymakers. As we have said before, the PKR parity is Pakistan's *nominal anchor*, which means currency weakness is seen as a leading indicator for higher inflation. To dampen inflationary expectations, SBP needs to keep the Rupee stable, or let it appreciate. This links up with another nominal anchor in Pakistan: retail and wholesale price-setting behavior is strongly influenced by retail fuel prices. This means that even if global oil prices are stable, Rupee weakness will force the regulator to increase fuel prices, which in turn, is used to justify price increases in other goods and services.

Compared to our previous projections that were based on the EFF document, we have lowered the Rupee devaluations in the remaining part of FY20. Since this positively impacts retail fuel prices, both factors have pushed down our inflation projection for the year to a range of 11-12 % (see **Figure 3**). Job losses and lower demand, coupled with the stability of fuel prices and the PKR, suggests that YoY inflation has perhaps peaked at 12.5 % (see **Table 3** and **Figure 3**). However, for institutions like SBP and the IMF, what counts is average inflation, which will continue to rise well into 2020. With lower than anticipated inflation, this gives SBP some leeway to consider reversing its tight monetary policy stance that was required to secure the EFF.

2. *Domestic interest rates*

At this stage it is important to make a distinction between a token interest rate cut, and a more meaningful easing of monetary policy that paves the way for economic growth. Despite the improvement in the BoP and a lower inflation forecast, we don't think Pakistan can embark on a growth phase in FY20. From our own experience and that of other import-dependent countries, Pakistan cannot afford a growth phase with a weak BoP, unless the country experiences a positive external shock.

However, looking at the behavior of the bond market – specifically the 10-year PIB – it appears that an interest rate cut has already been factored in. 10-year yields have fallen by almost 200 bps in the past two months, as institutional investors are desperate to purchase 10-year PIBs. This means the yield curve is now more acutely inverted, which indicates that the market expects interest rates to fall soon, and perhaps quite sharply. While we agree that interest rates have peaked, we are not convinced that SBP will shift to an easing monetary policy stance this year. In our view, the market's *irrational exuberance* is driven by insurance & pension funds that have decided that fixed-income assets are a better bet than equities. Furthermore, these institutional investors are not required to mark-to-market their asset holdings, which means they have little to lose if there is a reversal in rates.

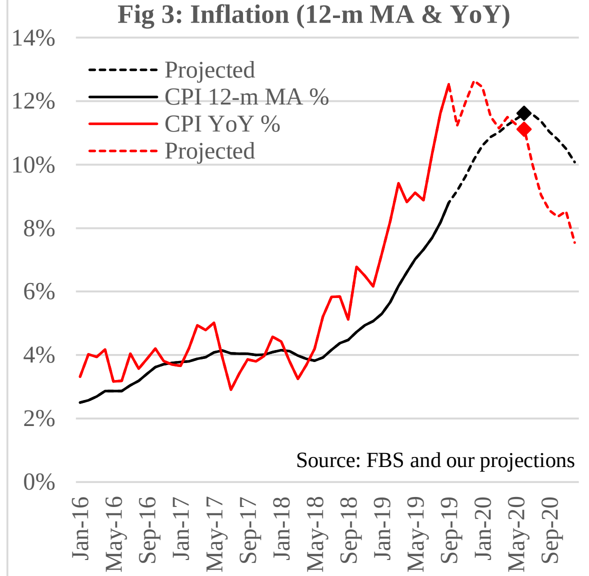
Commercial banks, on the other hand, are more vulnerable to price reversals. While the more risk averse banks still remain shy of long-term PIBs, the smaller, yield-hungry banks are buying in the secondary market. In our view, SBP should be more careful about managing the market's interest rate expectations, or it may create a panic in the smaller undercapitalized banks.

The smart thing to do is to stay committed to stabilization till end FY20. While the EFF has many quantitative and qualitative targets for FY20, we think the most pressing (difficult) ones will be to generate adequate fiscal revenues, and build SBP's FX reserves (net international reserves – NIR). In the prelude to September's monetary policy announcement, SBP's Governor was quoted several times emphasizing the need to build Pakistan's FX reserves. As shown in **Figure 4**, while SBP's reserves have increased with the EFF, the pace of accumulation is much slower than in the last program (shaded periods show an on-going IMF program). In our view, the growing focus on SBP's FX reserves is a subtle reminder that Pakistan's BoP problem has not been solved yet. As discussed in an earlier paper (*IMF's EFF: Different or more of the same?* July 30, 2019), the NIR targets for October to June 2020, require SBP to

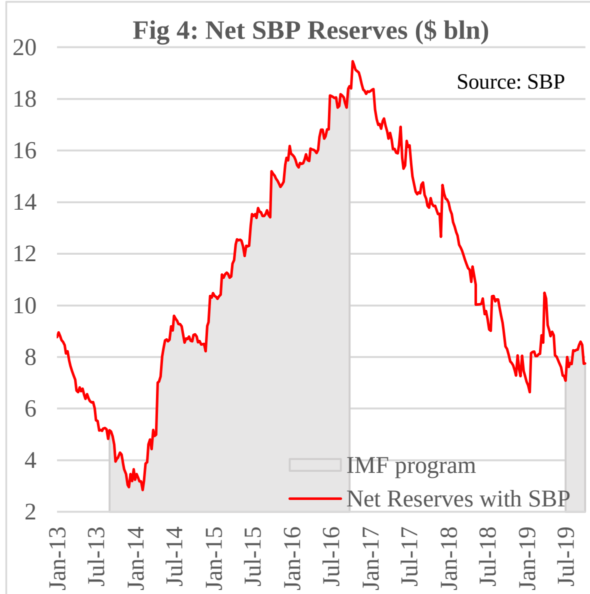
Table 3: Price Shocks

	Average PKR/$	Fuel/ltr (Rs) Super
Jul-18	121.6337	99.50
Aug-18	124.2460	95.24
Sep-18	124.2374	92.83
Oct-18	132.5482	92.83
Nov-18	140.2686	97.83
Dec-18	138.7922	95.83
Jan-19	138.2553	90.97
Feb-19	139.0557	90.38
Mar-19	140.7009	92.89
Apr-19	141.1646	98.89
May-19	145.6922	108.42
Jun-19	155.2491	112.68
Jul-19	158.8297	112.68
Aug-19	158.0770	117.83
Sep-19	156.1764	113.24
Oct-19	156.8264	113.24
Nov-19	158.9064	113.79
Dec-19	163.7934	113.79
Jan-20	163.3373	115.54
Feb-20	163.6457	115.54
Mar-20	166.7711	117.21
Apr-20	169.1186	117.21
May-20	169.7734	119.29
Jun-20	174.0879	119.29

Fig 3: Inflation (12-m MA & YoY)



increase its unencumbered reserves by almost $ 7.7 bln. As a comparison, in the first quarter of FY20, SBP's FX reserves increased by only $ 461 mln.



Nevertheless, given the mounting pressure about the economic slowdown, SBP may consider a token cut in rates (say 25-50 bps) to shore up the stock market, but not enough to signal the start of a growth phase. The central bank could justify this tempered cut with the argument that the FBR revenue target in FY20, coupled with the absolute ban on borrowing from SBP, means that a significant cut in interest rates is not possible. Instead of harping on about its inflation outlook, SBP should focus on the fiscal side to justify its monetary policy stance.[1]

3. FBR's revenue targets

The market's interest rate outlook should be anchored to a more realistic assessment of Pakistan's economy. The fiscal side is frightening: the deficit was 8.9% of GDP last year, driven by an 11.5 % increase in expenditures, and a 6.3 % fall in revenues.[2] Since the visiting IMF mission retained the Rs 5.5 trn FBR target for the year (which remains an indicative target in the EFF), this means that FBR must increase revenues by a whopping *43.7%* over what it was able to collect in FY19. For an economy in recession, this target is almost absurd.[3]

With government borrowing likely to increase this fiscal year, banks will remain dependent on SBP's open market operations (OMOs) for liquidity to fund the government. This cannot sit well with the IMF, which can rightly say that one-sided OMOs are distorting the money market. In view of the likely fiscal pressure and the artificial availability of financing, SBP should not ease its monetary policy in FY20 (barring a token cut to shore up sentiments).

4. SBP's FX reserves

As stated earlier, the NIR targets for the remaining part of FY20 are challenging. Since the EFF's external targets are negotiated on the basis of a comprehensive assessment of what Pakistan is likely to receive and repay, the $ 6.7 bln current account target for FY20 takes into account the $ 7 bln increase in SBP's FX reserves during the fiscal year. It also means that a significant chunk of debt repayments in FY20 have already been rescheduled.[4]

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[1] This is where the single-minded and misguided focus on inflation in setting interest rates, lets down the central bank.

[2] The increase in expenditures was driven by the 39.4% increase in debt servicing in FY19, which can be traced to the sharp increase in interest rates required to secure the EFF.

[3] In recent days, the government has claimed that non-tax revenues in Q1-FY20 are substantially above last year, which gives it hope that the FBR revenue target for FY20 will be met. While we also expect SBP profits to recover this year, and cell-phone licenses should further help non-tax revenues, the Rs 5.5 trn target will not be possible without tax revenues. With imports constrained by a lack of foreign exchange, custom duties will not be forthcoming. This means FBR will have to push sales and direct taxes, which means persisting with the documentation drive.

[4] In managing the external sector, policymakers would have realized that Pakistan cannot meet the $ 15.5 bln loan repayments in FY20. After maximizing the debt relief from friendly countries, policymakers need to figure out how much the IFIs and global markets could provide during the year. Then they need to decide how far they could squeeze the current account. What is left over is the projected buildup in SBP's FX reserves. Clearly the math did not allow SBP to reach the 3-month import coverage the IMF insists on (see **Table 2**).

Based on the IMF's BoP projections for FY20, the reserve buildup is to come from FDI and portfolio inflows, with a smaller role for bilateral/multilateral inflows (see **Table 2**). While the reserve build up this year appears to be significant, it will barely cover 2½ months of next year's projected imports. This is below the IMF's 3-month benchmark, which means that Pakistan's external sector management will be very tight this year. As in past IMF programs, the government will seek to tap global capital markets early in the program, which is likely to happen in Q2-FY20. Once it is done, Pakistan would not be able to return to the global market for the remaining part of the year. It also means that for the EFF's NIR target, Pakistan would have to ensure that any borrowed money would only be repaid *after* June 2021 (if not, the money would not be part of SBP's NIR).

Pakistan will therefore have to rely on FDI and retail portfolio inflows to increase its NIR by $ 3.5 bln and $ 2 bln in Q3 and Q4-FY20, respectively. This is where things get tricky: SBP data shows that in the months of August and September, foreign investment in T-bills and PIBs increased by about $ 363 mln from negligible levels. This is the inflow of *hot money* so far, and people are talking about a possible cut in interest rates. Even a token cut could undermine SBP's efforts to attract more money this year. This means the pressure to build SBP's reserves would fall on FDI.

We are not aware of pipeline projects in CPEC, but are optimistic that the renewal of the 4G licenses, the new 5G network, and GCC investment in oil refineries, would bring in some FDI. Given the level of coordination amongst the IFIs, pipeline flows from multilaterals have already been factored into this year's EFF targets. The point to make is that barring unplanned FX inflows, and the limited reserve coverage at the end of FY20, Pakistan's BoP simply cannot afford a growth phase this year. Furthermore, if the current account deficit begins to increase and this eats into SBP's reserves, it will surely stress policymakers in the second half of FY20. If pushed hard, SBP may have to narrow the current account more aggressively, which means the Rupee could come under pressure later in the fiscal year (see **Table 3**).

CPEC 2.0

PM Imran Khan has just returned from a visit to China. Media coverage has focused on China's support for Pakistan's stance on the annexation of Kashmir, and has also promised to help Pakistan overcome its economic challenges. We have reason to be optimistic about the second phase of CPEC. As we have discussed in the past, the original plan for CPEC was hijacked by the previous government with a single-minded focus on power generation. People are now talking about these as *early harvest* projects that will sustain the more direct investment in roads/rails, special economic zones (SEZs), port facilities and labor training institutions.

In a paper we wrote in 2016 (*One Belt, One Road: Building Asia on China's Strength,* June 14, 2016) we argued that CPEC could become a blueprint for Pakistan's industrial policy. In subsequent papers we argued that for a country of Pakistan's size, socioeconomic development and structural weakness, Pakistan needs an industrial policy to create jobs, improve human capital, and move towards import substitution. We stated that CPEC could be a game changer if it shifts Pakistan's economic fundamentals onto a sounder footing. We also said that China does not view Pakistan only as a commercial opportunity, but as part of the larger geopolitical advantages for both countries. In our view, China does not have to resort to *debt diplomacy* in its relationship with Pakistan: the creation of a bipolar world order is such that it creates mutual gains that go beyond financial and commercial interests.

At this point in time, CPEC 2.0 gives Pakistan's economy a unique opportunity. Keeping the EFF to one side (while ensuring that all targets are met), CPEC 2.0 is the only option Pakistan has to jumpstart the economy without undermining the stabilization process. More specifically, the second stage of CPEC should focus on joint-ventures in the manufacturing sector, with a specific interest in import substitution. If these ventures are financed by FDI, it would help meet NIR targets and also avoid digging Pakistan further into debt. As shown in **Table 2**, despite the external debt that Pakistan is already struggling with, the IMF projects that this debt will continue to grow in the years ahead.[5]

It almost seems too good to be true: operating under heavy constraints and a restive population, CPEC 2.0 is an opportunity to generate jobs, enhance human capital, and make Pakistan's external sectors more sustainable. While we are optimistic that these positives could change the trajectory of Pakistan's economy, policymakers still need to tackle stubborn imbalances that keep pushing us to the IMF.

Resistance to reforms

Just to be clear: structural reforms are not about new policies, regulations and laws, nor is it about creating new institutions – structural reforms are primarily about changing bad behavior. CPEC 2.0 could revamp our external sector (*Pakistan's BoP: The Calm before the Storm*, May 31, 2017), and give us an industrial policy (*Does Pakistan need an Industrial Policy?* January 5, 2017), but it cannot help on the fiscal side. CPEC cannot change the Pakistani mindset that refuses to document economic/commercial transactions, and to grossly understate individual wealth. It also cannot force people to file their taxes.[6]

There is significant resistance to documentation by traders and businesses. By threatening strikes and intentionally reducing investment and employment, this group is effectively blackmailing the government to back off from its documentation drive. Similarly, efforts to investigate corruption and white-collar crimes, has painted NAB as the main impediment to commercial activity by both the private and public sector. While many Pakistanis will talk passionately about how corruption is endemic and must be rooted out, when an effort is made to hold people to account, it is criticized as heavy-handed, discriminatory and partisan. While we concede that these matters are sensitive and there are always two sides to a story, to express anger at the entire effort, is tantamount to condoning bad behavior.[7]

Conclusion

The IMF's Extended Fund Facility was approved on July 3, and by mid-September the market wanted SBP to cut interest rates. We concede that hard stabilization measures were taken before the EFF started, but we think it is too early to say Pakistan's economy has stabilized. In our view, while the IMF wants to see Pakistan succeed in the on-going EFF, it is unlikely to be as accommodating as it was during the last program (2013-16).

The sharp contraction in the real sector is generating anger in the business community, and the rise in inflation is hurting the rest. The need for "good news" is palpable and understandable, but this is precisely where policy discipline is required. The 200 bps fall in long-term yields is partially because of an unexpected policy change (to shift GoP borrowing from SBP into longer maturity PIBs), but largely

[5] In an earlier paper (*Egypt, Turkey & Pakistan: Uncanny similarities & sobering lessons*, August 17, 2019), we showed that Egypt's external debt increased by over 66% in the first two years of their EFF, which ended in mid-2019.

[6] In a recent statement by the Chinese Ambassador in Pakistan, Mr. Jing said recently that CPEC would bring prosperity to Pakistan but CPEC alone is not the solution. He said that Pakistan's policymakers must address deeply engrained structural impediments that have held back Pakistan's economic development for decades.

[7] In the distinction between private and public interest, Pakistanis – like most others – will chose their own interests. We would argue that if corruption is endemic in the country, and people have been operating in this environment for decades, then most commercial players may well have skeletons in their own closets. They would therefore be sympathetic to the views of those who are currently being investigated. However, the key to accountability is that the inconvenience, the loss of face and possible fines imposed on bad actors, is a deterrent against similar behavior in the future. Structural reforms are notoriously difficult to implement because changing people's behavior is not easy. It requires sweeping policy changes, serious intent and strong political leadership – it cannot be left to technocrats, as economic reforms require campaigns to gain public support.

driven by wishful thinking. In our view, the fiscal side is still vulnerable and the external sector could become challenging in Q3 and Q4-FY20. The fact that the EFF only targets 2½ months on import cover after a full year in the program, clearly suggests that the external sector will remain stressed in FY20. For an import-dependent country like Pakistan, economic growth is not possible with a stressed BoP.

However, if Pakistan's leadership can secure a fully-funded CPEC 2.0, the country could get the best of both worlds – a boost to economic growth while narrowing the twin deficits. This may seem impossible – and perhaps it is – because of what is required from our end. Pakistan's policymakers must stay firm on its documentation drive; it must stop the hemorrhaging in PSEs; it must reduce bureaucratic impediments/ interference in the economy; it must continue its anti-corruption drive; it must strengthen state institutions and regulators; and it must win public support to clean up the economy.

It is always hard to change bad habits, but it is not impossible.