Egypt, Turkey & Pakistan: Uncanny similarities & sobering lessons

Mushtaq Khan, August 17, 2019

As Pakistan embarks on the 39-month Extended Fund Facility (EFF), many have asked what's in store for the country. In our last paper (*IMF's EFF: Different or more of the same?* 30 July 2019), we focused on program details to assess the credibility of the 3-year program, and also looked at specific conditions that Pakistan must meet in FY20.

In analyzing Egypt's own 3-year EFF, which has recently ended, we find an insightful case study on what to expect in Pakistan's program. In this paper we will: (1) highlight the similarities and differences between the two countries; (2) summarize some independent commentaries on Egypt's IMF program, which started in November 2016; (3) look at how Egypt's economy has fared; (4) discuss geopolitical dynamics that have influenced Egypt's program, and could impact our program; (5) look at Turkey's vulnerability as it has fallen out of favor with global markets; and (6) end with a brief summary of the paper and some concluding thoughts.

Egypt & Pakistan

Other than the obvious similarities, like the level of economic and social developments (Egypt has an edge), population (Pakistan is more than twice Egypt's size), a prominent military establishment, and being predominantly Muslim, **Box 1** lists some of the other factors that create a remarkable parallel.

Box 1: Similarities between Pakistan & Egypt

For the sake of brevity, we will simply list the factors in no particular order:

1. Both countries posted unsustainable twin deficits (fiscal and external), which necessitated IMF programs;
2. Both countries have dangerous debt dynamics;
3. Both economies are heavily import-dependent, with stagnant exports;
4. Both Egypt and Pakistan have large undocumented economies. Hence, direct tax collections lag behind peer countries;
5. Both countries show high income disparities, with a significant fraction of the population living below the poverty line;
6. Both economies have a long history with IMF programs, and rate high in the IMF's list of the "most frequent" users;
7. Both Egypt and Pakistan have been ruled by the military. Unlike Pakistan, Egypt is currently managed by a military government;
8. Both countries have a rapidly growing young population, which requires high economic growth to create jobs;
9. Both Egyptians and Pakistanis suffer from poor access to, and quality of, social services like education, health and housing;
10. Both economies suffer from endemic corruption, not just in the government but also in the private sector;
11. Both countries export labor, and are dependent on remittances to finance their chronic trade deficits;
12. Both economies suffer from stubborn government expenditures. More specifically, debt servicing, government salaries, subsidies and defence expenditures account for over 80% of government spending;
13. Both countries have militaries that are active in their economies;
14. Both Egypt and Pakistan reached out to friendly countries for help before agreeing to an IMF stabilization program;
15. Both EFFs have almost identical goals: (a) a flexible exchange rate; (b) to strengthen tax revenues; (c) to reduce energy subsidies; (d) to protect social development; and (e) to boost growth via structural reforms; and
16. In terms of the IMF programs, both countries: (a) cannot impose regulations to reduce imports; (b) have front-loaded currency and interest rate adjustments; and (3) the IMF programs only account for a small fraction of each country's FX needs.

For many of us who focus only on Pakistan's economy, **Box 1** is almost unnerving.

However, one must also flush out the differences, which is shown in **Box 2**. While the similarities appear to overshadow the differences, the diverging geopolitical alignment of the two countries has influenced the manner in which the IMF programs have been implemented. Also, while Egypt's fiscal problems are deeper and have not really been addressed by its EFF, Egypt's external sector is more buoyant because of tourism and Suez Canal revenues.

Box 2: Differences between Pakistan & Egypt

With no ranking, the differences are:

1. Pakistan's economy is not dominated by the government to the same extent as is Egypt;
2. Egypt's subsidies are higher and include more items like power, fuel, bread, and till recently – cigarettes. Hence, Egypt posted much larger fiscal deficits than Pakistan;
3. The Egyptian military is growing its presence in the economy, having privileged access to FX and fiscal incentives (and other perks) that are not available to private sector firms. In Pakistan, the military has grass-root support as it stands alert against a larger and increasingly belligerent India;
4. Unlike Pakistan, Egypt earns significant foreign exchange from tourism and Suez Canal revenues;
5. Egypt currently has one of the most lucrative *carry trades* in the world; and
6. While Egypt remains firms in the US camp (with financial assistance from Saudi and the UAE), Pakistan has shifted to the Chinese camp but also avails assistance from Saudi and the UAE.

Before looking at how Egypt has fared since November 2016, it is insightful to look at independent commentaries on Egypt's economy before and during the program.

Comparing commentaries

Newsprint and cable channels carry an unending series of commentaries on the state of Pakistan's economy. For those who follow these stories, the views on Egypt's economy could create a sense of déjà vu.

We will focus on two articles: one written before the start of Egypt's IMF program; and the other written in August 2019, as the program came to a "successful" end.

1. *Egypt Today*, 26 September 2016 (www.egypttoday.com/Article/10/3170/What-Will-The-IMF-Loan-Mean-For-Egypt). This article by Bahaa Ghaffar, is based on interviews and contains some memorable quotes and insights:

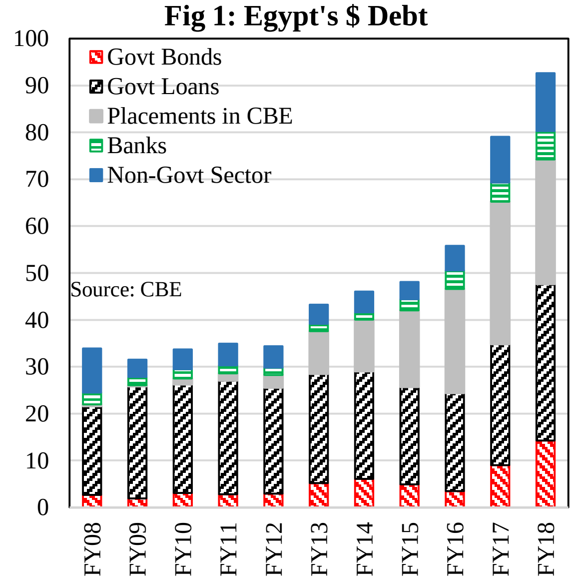
- "I haven't really been following the news. I don't know about this IMF organization, but I've heard we are getting $ 12 billion from abroad. Didn't we just get $ 9 billion last year? Where did that go? Where are the improvements? Health and education, food and drink, electricity and gas – everything is getting more expensive. The rich are getting richer and the poor are getting poorer." A random *office peon who was clearing up coffee cups.*
- *Up until recently, Egypt had turned to the Gulf for aid to the tune of about $ 30 bln over the last couple of years. With the government's hands tied, a nation wary of IMF funding in the past has nowhere else to turn. Any worries that IMF provisions go against the principles of national sovereignty seem to have been set aside.* Ghaffar.
- *The [IMF] program calls for the reduction of energy subsidies, namely raising electricity prices for households by an average of 42 percent, and eliminating industrial subsidies. It also calls for freezing government wages and imposing a value-added tax and further devaluing the Egyptian pound while encouraging internal and external loans.* Ghaffar.
- "We are unfortunately in a situation where we have very few options. Egypt is in need of external help. It's quite necessary at this stage because Egypt needs to try to close a big financing gap. It needs the money, it needs the advice and it needs the support of other institutions, not just the IMF. It also needs donor countries outside the IMF because the financing needs are actually much bigger than those $ 12 billion." Ziad Bahaa El Din, ex deputy prime minister for economic development.

- "The government had an opportunity to present a more ambitious reform program to parliament, which it did not. The presented program was modest in its targets regarding fiscal consolidation, public debt reduction and currency stability. A combination of this modest program and reluctance on the part of the GCC to provide Egypt with further unconditional financial support meant that going to the IMF was inevitable." Ahmed Galal, former finance minister.
- "Economically, this program may bring some positives, such as attracting foreign investment into the stock market. But I think there will be more disadvantages." Adbel-Khalek, economics professor, Cairo University.
- *Will the loan be enough? The short answer is no.* Ghaffar.
- "We've been postponing. A lot of reforms agreed upon with the IMF are ones the government has been talking about for ages. We've all known the government will apply the VAT – it's been on the table forever. They haven't taken any serious steps to implement it. Civil service [reforms] has been on the table forever. In terms of tax restructuring, there has been talk of increasing the tax base or the source of tax. Encouraging more of the informal sector to be formalized in order to raise more taxes – we've been talking forever about all of these things, but there have been no serious steps taken by the government to actually implement these reforms." Radwa El-Swaify, head of research, Pharos Holding.
- "Once its signed [the EFF], it's extremely important that society as a whole keeps on putting pressure on the government to reveal information and to declare what is going on, to help us monitor the progress of this program – and to help us evaluate if some aspects could be better handled. I think it would be a very grave mistake to think it's all a yes or no situation, and that once the deed is done and the agreement is signed we can just forget all about discussing it." Ziad Bahaa El Din.

2. *Middle East Eye*, 6 August 2019 (https://www.middleeasteye.net/news/egypt-and-imf-success-or-failure). This article was written by Tom Stevenson:

- *Traders win, Egyptians lose. Over the past three years, Egypt's external debts have skyrocketed. The devaluation of the Egyptian pound has meant substantial profits for international currency traders, but living conditions for most of the population have deteriorated.* Stevenson (see **Figure 1**).
- "Many of the structural constraints facing the economy remain in place and will be extremely difficult to overcome." Jason Tuvey, senior EM economist, Capital Economics.
- In July 2019 a World Bank report was cited by Stevenson to say: *It [WB report] noted that the devaluation had not led to the growth of non-oil exports, and that Egypt will need to achieve GDP growth well above the current projected rate of 5.5 percent to provide jobs for a growing population.* Stevenson.
- *Overall, most Egyptians have seen their real incomes fall, leaving them with less purchasing power. This is in large part a result of IMF reforms, which saw the Egyptian government hike prices on cooking gas and oil, electricity and basic food stuffs such as bread, milk, and lentils. Meanwhile, carry traders who borrow at low rates in dollars and then convert into local currencies to buy bonds with high interest rates have flocked to Egypt's market. According to Bloomberg data, Egypt's carry trade has been the most profitable in the world this year.* Stevenson.

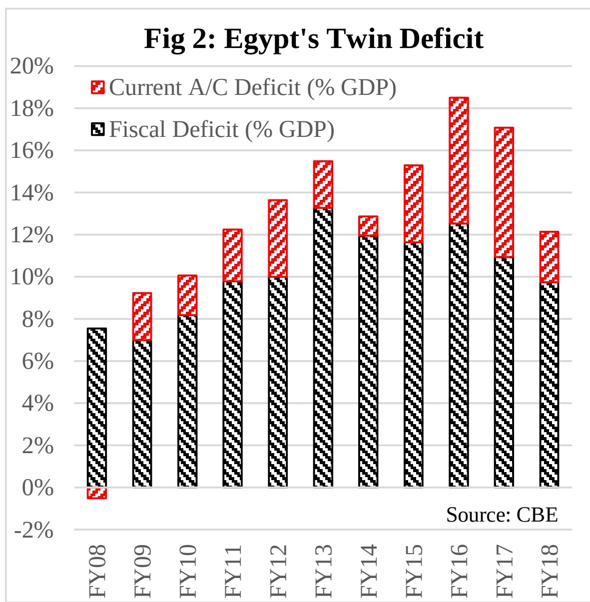
Fig 1: Egypt's $ Debt



- *Businesses owned by the military have also been granted an exemption from a value-added tax levied on consumer goods introduced under the IMF programme*. Stevenson.
- *While Egypt's borrowing from the IMF and other international financial institutions comes at low interest rates, its debt to international capital markets are not so soft…. On 19 February [2019], the government borrowed $ 4 bn on the bond markets for between five to thirty years at around 7 percent interest [in dollar terms]*. Stevenson.
- *Egypt's dramatic increase in international borrowing since 2016 comes with risk…. Egypt may not be at risk of a balance of payment crisis – when it would be unable to pay for essential imports or service its debts – in the short term so long as the central bank maintains its dollar reserves*. Stevenson, summarizing the views of Pascal Devaux, senior economist, BNP Paribas (underline mine).
- *With the end of the IMF programme, Egypt's economy still faces a range of risks to its long-term health. A pull back from global financial institutions or an increase in funding costs for Egypt's external debts could put the economy at serious risk*. Stevenson.
- "We think that vested interests, including from within the regime, will be difficult to overcome and will continue to stifle structural reforms." Jason Tuvey, senior EM economist, Capital Economics.

Egypt's assessment in 2016 shows an uncanny similarity to Pakistan. As our past papers have documented, the parallels with Pakistan are striking: (1) our domestic and external debts have increased sharply in the last couple of years; (2) like Egypt, Pakistan first turned to friendly GCC countries – and China – for assistance; (3) once the IMF agreement was signed, few people complained that Pakistan had lost sovereignty over its economic policies; (4) as in Egypt, prior actions focused on a market-determined Rupee, higher utility rates, and an increase in interest rates; (5) the $ 6 bln from the IMF is insufficient given Pakistan's known FX needs for the next three years; and (6) the current reform agenda has been tried in past programs, leaving analysts frustrated about the lack of tangible progress in the decades of economic reforms.

Egypt's post-program assessment is equally disappointing. As discussed in the August 2019 assessment, the following questions need to be considered: (1) could Pakistan's external debt become even more unsustainable? (2) will this EFF succeed in resolving the structural problems that have plagued the country for decades? (3) will exports outpace imports with a market-determined exchange rate? (4) will Pakistan attract short-term foreign investment, which may benefit some segments of the economy, but do little to jumpstart the real economy? and (5) could such inflows constrain policymaking, whereby adjustments in the currency force SBP to increase interest rates to ensure that *carry trades* remain in Pakistan?

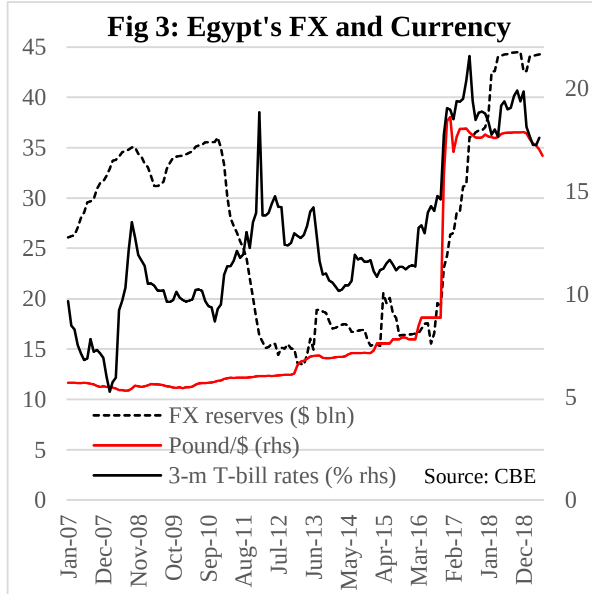


Egypt's economic performance

Figure 2 shows why Egypt needed to stabilize its economy. Its twin deficits were unsustainable, and the growing shortage of FX necessitated an IMF program (the financing from friendly countries did little to resolve the underlying problems). The IMF has a rule-of-thumb that if the twin deficit is above 10% of

GDP, the authorities need to take decisive actions. As shown in **Figure 2**, Egypt had sustained 10% plus twin deficits for many years before it returned to the IMF.

Figure 3 tells a more interesting story. A sharp fall in FX reserves followed the Arab Spring that swept through North Africa in 2011. The resulting political turmoil ended Hosni Mubarak's 30 year reign and paved the way for the first free elections in Egypt's modern history.



Only after a significant loss of FX reserves did CBE begin to devalue the Pound; as shown in **Figure 3**, these adjustments were small and half-hearted. CBE's volatile FX reserves from 2011 to 2016, reflect the inflows from friendly countries that were little more than short-term fixes. By early FY17 (August to October 2016), the growing BoP problem manifested itself in the parallel FX market, where the Egyptian Pound started trading at premiums of 50-100% over the official exchange rate. As shown in **Figure 3**, although CBE started to devalue the currency more aggressively in 2016, this did little to calm the market.

A *prior action* to let the currency be market determined, pushed the Egyptian Pound from an average rate of EP 8.8/$ in October 2016, to EP 15.8/$ and 18.4/$ in November and December 2016, respectively. The point to note, is the kerb premium provided a ball-park estimate for where the Pound should be. Unable to intervene in the FX market, CBE sharply increased interest rates to support the Pound (see **Figure 3**).

Table 1 shows the impact of the IMF program on Egypt's BoP. The current account deficit fell sharply in FY17 and FY18, but this was not driven by a narrowing trade deficit, but an increase in remittances (FY17 and FY18), an equally large increase in tourism (FY18), and a stead inflow of revenues from the Suez Canal.

It is interesting to note that despite an 81% devaluation of the Pound in FY17 (compared to the average rate in FY16), Egypt's imports increased by almost 3% in FY17, and a further 7% in FY18. This lends support to our repeated concern that despite the adjustments in the Rupee since December 2017, Pakistan's trade flows have not changed much. The issue is: will Pakistan's imports eventually respond, or could the country's BoP remain problematic despite an IMF program?

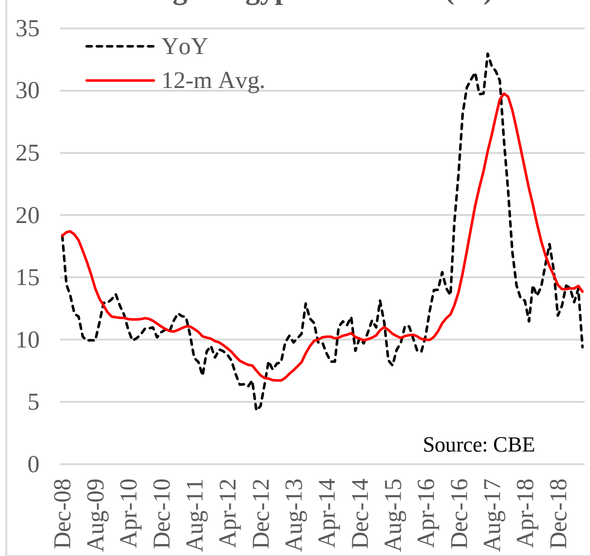
Egypt's *Financial Account* is equally interesting. The country has been posting strong inflows since FY15, but the composition has changed significantly in the last two years. As shown in **Table 1**, *Other Investments (net)* posted heavy inflows in FY15 and FY16, which reflects government borrowing from friendly countries. This changed in FY17 and FY18, where *Portfolio Investments* took charge of the hard currency that Egypt needed. Portfolio inflows come from retail foreign investors in Egyptian T-bills, Eurobonds and the stock market. As these inflows gained momentum, the Egyptian government eased its borrowing. As a result, Egypt's *Overall Balance* posted healthy inflows in FY17 and FY18 (see **Table 1**), which pushed CBE's FX reserves to record highs.

	Table 1: Egypt's Balance of Payments ($ bln)										
	FY08	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**	**FY18**
Current Account	**0.89**	**(4.42)**	**(4.32)**	**(6.09)**	**(10.15)**	**(6.39)**	**(2.78)**	**(12.14)**	**(19.83)**	**(14.39)**	**(5.96)**
% GDP (%)	*-0.52%*	*2.23%*	*1.88%*	*2.45%*	*3.63%*	*2.22%*	*0.91%*	*3.66%*	*5.97%*	*6.14%*	*2.38%*
1. Trade Balance	(23.42)	(25.17)	(25.12)	(27.10)	(34.14)	(30.69)	(34.16)	(39.06)	(38.68)	(37.27)	(37.28)
- Merchandise Exports	29.36	25.17	23.87	26.99	25.07	26.99	26.02	22.25	18.70	21.73	25.83
- Merchandise Imports	52.77	50.34	48.99	54.10	59.21	57.68	60.18	61.31	57.39	59.00	63.10
2. Services Balance (net)	14.97	12.50	10.34	7.88	5.58	5.04	8.27	10.74	6.53	5.61	11.12
- Suez Canal revenues	5.16	4.72	4.52	5.05	5.21	5.03	5.37	5.36	5.12	4.95	5.71
- Tourism revenues	10.83	10.49	11.59	10.59	9.42	9.75	5.07	7.37	3.77	4.38	9.80
3. Primary Income (net)*	na	na	na	na	na	na	(7.26)	(5.70)	(4.47)	(4.57)	(6.28)
4. Secondary Income (net)	9.34	8.25	10.46	13.14	18.41	19.26	30.37	21.88	16.79	21.84	26.47
- Remittances	8.56	7.81	9.75	12.59	17.97	18.67	18.52	19.33	17.08	21.82	26.39
Capital Account	**0.00**	**(0.00)**	**(0.04)**	**(0.03)**	**(0.10)**	**(0.09)**	**0.19**	**(0.12)**	**(0.14)**	**(0.11)**	**(0.15)**
Financial Account	**7.56**	**2.29**	**9.02**	**(4.17)**	**1.12**	**9.86**	**5.00**	**18.05**	**21.32**	**31.13**	**22.15**
- Direct Investment	12.12	6.77	5.78	1.23	3.73	3.57	3.85	6.16	6.77	7.76	7.45
- Portfolio Investment	(2.33)	(9.62)	7.36	(2.67)	(5.17)	1.50	1.30	(0.59)	(1.09)	16.19	12.07
- Other Investments	(2.24)	5.14	(4.12)	(2.73)	2.56	4.79	(0.16)	12.49	15.64	7.18	2.62
Errors & Omissions	**(3.03)**	**(1.24)**	**(1.31)**	**0.53**	**(2.16)**	**(3.15)**	**(0.93)**	**(2.06)**	**(4.16)**	**(2.90)**	**(3.25)**
Overall Balance	**5.42**	**(3.38)**	**3.36**	**(9.75)**	**(11.28)**	**0.24**	**1.48**	**3.72**	**(2.81)**	**13.72**	**12.79**
- Change in reserves	6.07	(2.89)	3.89	(7.87)	(11.71)	0.52	1.24	2.28	(2.04)	13.61	13.01
Central bank reserves (stock)	34.10	31.21	35.10	27.23	15.52	16.04	17.28	19.56	17.52	31.13	44.14

Source: Central Bank of Egypt; * before FY14, primary balance was part of the services account.

While the EFF has shown impressive results (i.e. a narrowing external deficit and a consistent increase in CBE's reserves), a deeper look shows that Egypt's trade fundamentals have not improved much, and the growing stock of *hot money* means that Egyptian policymakers must now cater to the sentiments of foreign traders.[1] As highlighted in the commentaries, there is a perception that the EFF has benefitted foreign traders and local banks, over the interests of the average Egyptian, who has struggled with inflation and the economic slowdown (see **Figure 4**). In our view, the inflationary burden was unavoidable as subsidies were bankrupting the Egyptian government; the improvement in the external sector, on the other hand, is more suspect.

Fig 4: Egypt's Inflation (%)



This concern is reflected in **Figure 1**, which shows a sharp increase in Egypt's external debt in FY17 and FY18. The need to shore up Egypt's FX reserves is shown by the hard currency placements in CBE, which are part of the carry trades. The EFF has effectively shifted the sourcing of FX to private foreign investors. As discussed earlier, while the IFI's financial support was cheap, the market debt is not, especially if it's long-term borrowing.

The disparate impact of the IMF program is gaining traction. As shown in **Figures 3** & **4**, Egypt's inflation was triggered by the currency adjustment in November 2016, which necessitated a tight monetary policy. This inflationary spike was anticipated as the IMF program eliminated subsidies on gas

[1] As shown in **Table 1**, the narrowing of the current account deficit since FY16 is only because of the increase in remittances and tourism.

and power tariffs as prior actions. However, the increase in retail fuel prices only took place on 5 July 2019: fuel prices were increased by 16-23%, while the price of cooking gas increased by 30%. Sources claim that these price increases were held back to better manage public sentiments. With this increase in retail fuel prices, we expect inflation to start increasing again (see **Figure 4**).

On the other hand, the improvement in Egypt's credit ratings and the inflow of foreign investment, has been a boon for the stock market, Egyptian banks and the economic elite.

The IMF has expressed satisfaction with the 3-year EFF, and recently released the last tranche of $ 2 bln. With CBE's liquid FX reserves at $ 44 bln, Egypt decided not to avail the last $ 2 bln tranche, which means the EFF is now complete. For its part, the IMF's press release of 24 July 2019 says:

1. Macroeconomic stability has been achieved and this should attract investments;
2. The current account has been sharply reduced and CBE's FX reserves are at a record high;
3. Economic growth has recovered and inflation is heading towards single digits; and
4. By eliminating subsidies, resource allocation has improved, which should usher in a period of sustainable growth and employment generation.

The IMF review ends with two vaguely defined priorities that the Egyptian authorities should pursue: "First, to cement the hard-won gains in stabilizing the economy. And second, to accelerate reforms to unleash the economy's potential, making the private sector the engine of growth."[2]

It is tempting to imagine Egypt's experience being replayed in Pakistan. While credit rating agencies, the IMF and Egypt's elite, have good reasons to be satisfied with the country's economic recovery, there are telltale signs that things could be unravelling. Real growth is not expected to achieve the 5.9% target in FY19; the Pound is appreciating despite the fact that the current account deficit is increasing; Egypt's trade deficit is growing as its economy recovers; military-owned businesses are increasing their control of the economy; and observers are alarmed by an economy that is split into the elite (those who can afford the austerity, and gain from the foreign investment and tourism) and the vast majority of Egyptians, who face a stagnant economy and declining purchasing power. With Egypt's economy shrinking by almost 30% in dollar terms in FY17, coupled with the sharp increase in its external debt, Egypt's *external debt as a percentage of GDP* increased from 16.8% in FY16 to 37.0% in FY18. When viewed by foreign investors, these metrics can be off-putting.

Many commentators feel that Egypt will soon return to the IMF. It is important to realize that the IMF's primary objective is to stabilize the macro economy, and this has been done by eliminating subsidies and encouraging debt and non-debt inflows into the country. The short-term pain is eventually overcome, but the structural problems remain. As explained in a previous paper (*The Parable of Pakistan and the IMF*, 27 December 2016), this creates a mutual dependency between the country and the IMF, which manifests in short-term reforms, a BoP crisis, and an eventual return to the IMF.

Will Pakistan go down this route again? The short answer is: hopefully not.

Geopolitical divergence

The protracted negotiations with the IMF resulted in a complete change in Pakistan's economic team. Furthermore, the prior actions that have been taken, suggest that Pakistan negotiated from a position of weakness. In our past papers, we were specifically concerned about the NIR targets, and questioned whether SBP would be able to meet the end-December 2019 target. We have changed our view after Imran Khan's meeting with President Trump on 22 July, and now think Pakistan has a one year window,

[2] https://www.imf.org/en/News/Articles/2019/07/24/na072419-egypt-a-path-forward-for-economic-prosperity.

in which to address the structural problems, while the IMF remains supportive. Our argument is that President Trump needs to disengage from Afghanistan before November 2020, which means the US needs a friendly Pakistan to successfully end America's longest war.

What happens afterwards? Unlike Egypt, Pakistan is now on the wrong side of the US. Pakistan's geopolitical alignment with China, its neutrality in the Saudi-Iran standoff, and growing tensions with India, have fundamentally changed the country's relationship with the US. This is especially relevant as the US-China trade war escalates and now threatens the global economy. In this tense geopolitical standoff, if Pakistan's misses key targets after the first year, IMF waivers may not be forthcoming.

Nevertheless, we think this vulnerability should be viewed positively. Egypt's economy is mired in a state-run mindset, with the military playing an opportunistic role in replacing the private sector. Furthermore, Egypt's public sentiments are not at ease with the military-led Sisi government, especially after his term extension, the hardship of the IMF program, and the military's role in the Egyptian economy. Some Egyptians also resent the financial dependency on Saudi Arabia, which at the time of Gamal Abdel Naseer was viewed with derision.

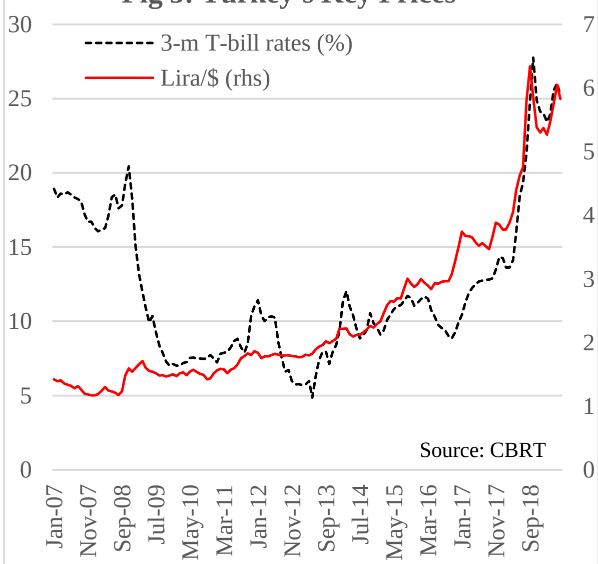
The current perception is that the IMF needs to keep Egypt's economy afloat and not put too much pressure on the Sisi government; it will also ensure that funding channels from Saudi Arabia and the UAE remain active. In effect, by refusing to challenge the status quo, and yet giving Egypt a thumbs-up, the IMF is facilitating the goals of its powerful patrons (the US and Saudi Arabia), even if this doesn't help the Egyptian economy.

These geopolitical forces will not work for Pakistan after the US withdraws from Afghanistan. To get a better handle on a country that has fallen out of favor, Turkey is a useful example.

Turkey's fall from grace

Like Egypt, Turkey's economy is facing serious challenges. Turkey's last IMF program ended in 2008, after which it relied heavily on international capital markets (specifically foreign banks) to finance large external deficits. As shown in **Table 2**, Turkey's current account deficits have been much larger than Egypt's and Pakistan's. The *Financial Account* posted heavy inflows from 2010 to 2014, but as these inflows eased, Turkey's economic vulnerability was exposed.

Fig 5: Turkey's Key Prices

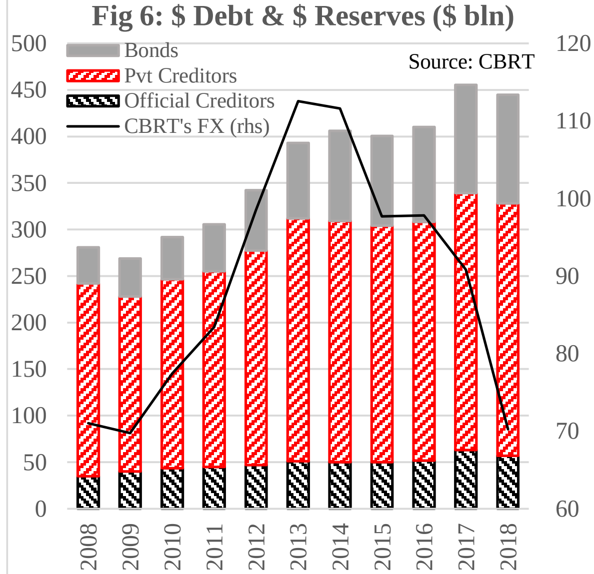


What makes Turkey different from other emerging market (EM) countries, is the level of integration with the international capital markets. As shown in **Figure 5**, the stability of the Turkish Lira till 2015 and Turkey's EU prospects (which are now dead), encouraged foreign banks to lend to Turkish banks, which in turn, allowed Turkish corporates to borrow hard currency ($ and €) at much lower interest rates. The resulting construction boom allowed Turkey to post strong economic growth, high FX reserves, and a level of macro stability that made it a darling for foreign investors.

	Table 2: Turkey's Balance of Payments ($ bln)										
end-December	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Current Account	**(39.60)**	**(11.55)**	**(44.88)**	**(74.81)**	**(48.31)**	**(64.17)**	**(43.81)**	**(32.55)**	**(33.55)**	**(41.67)**	**(27.21)**
% GDP (%)	*5.13%*	*1.79%*	*5.82%*	*8.99%*	*5.54%*	*6.76%*	*4.70%*	*3.79%*	*3.89%*	*4.91%*	*3.49%*
1. Trade Balance	(52.92)	(24.76)	(56.33)	(89.16)	(65.37)	(79.92)	(63.59)	(48.13)	(40.89)	(58.96)	(41.81)
- Merchandise Exports	140.91	109.73	120.99	142.39	161.95	161.79	168.93	151.97	150.16	166.16	174.60
- Merchandise Imports	193.82	134.49	177.32	231.55	227.32	241.71	232.52	200.10	191.05	225.11	216.41
2. Services Balance (net)	18.74	18.54	16.49	19.88	22.20	23.09	26.48	23.82	14.85	25.61	25.46
- Tourism revenues	23.37	22.98	22.59	25.05	25.35	28.00	29.55	26.62	18.74	22.48	25.22
3. Primary Income (net)	(7.60)	(7.66)	(6.52)	(7.25)	(6.59)	(8.62)	(8.21)	(9.69)	(9.18)	(11.04)	(11.72)
4. Secondary Income (net)	2.19	2.33	1.48	1.72	1.45	1.28	1.51	1.44	1.67	2.71	0.87
Capital Account	**(0.06)**	**(0.04)**	**(0.05)**	**(0.03)**	**(0.06)**	**(0.10)**	**(0.07)**	**(0.02)**	**0.02**	**0.02**	**0.06**
Financial Account	**34.76**	**9.88**	**60.10**	**67.15**	**72.67**	**73.46**	**42.69**	**10.84**	**22.83**	**38.51**	**(2.23)**
- Direct Investment	17.30	7.03	7.62	13.81	9.64	9.93	6.29	14.18	10.81	8.85	9.41
- Portfolio Investment	(5.01)	0.23	16.08	22.20	41.03	24.02	20.22	(15.46)	6.34	24.48	(3.12)
- Other Investments	22.47	2.62	36.40	31.13	22.00	39.51	16.19	12.12	5.67	5.19	(8.52)
Errors & Omissions	**1.96**	**2.31**	**(0.46)**	**8.30**	**(1.82)**	**1.04**	**0.52**	**9.49**	**11.10**	**0.61**	**19.04**
Overall Balance	**(2.77)**	**0.92**	**14.97**	**1.01**	**22.82**	**10.77**	**(0.48)**	**(11.83)**	**0.81**	**(8.21)**	**(10.38)**
- Change in reserves	(1.06)	0.11	12.81	(1.81)	20.81	9.91	(0.47)	(11.83)	0.81	(8.21)	(10.38)
Central bank reserves (stock)	71.01	69.75	77.46	83.43	98.5	112.57	111.59	97.71	97.81	90.81	70.22

Source: Central Bank of the Republic of Turkey (CBRT)

Fig 6: $ Debt & $ Reserves ($ bln)



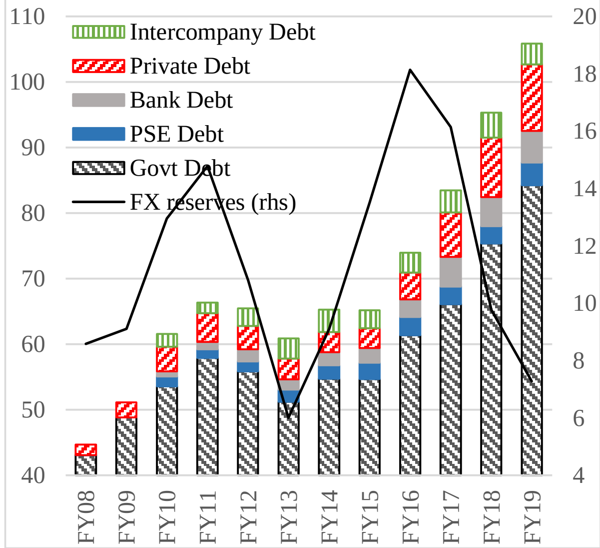
Turkey's external debt increased sharply from 2010 to 2017 (see **Figure 6**). However, the country started facing headwinds in 2014 as Turkey's policy on Syria diverged from US interests, and President Erdogan's image in the West started to sour. Then there was the failed military coup in 2016, the subsequent state of emergency, and the constitutional referendum that granted greater power to Erdogan. Within the span of a few years, Turkey's global image underwent a complete reversal. It should be noted that the bulk of Turkey's external debt comes from private foreign investors (primarily banks), and the bulk of this debt is held by Turkish corporates.

As shown in **Figure 6** and **Table 2**, Turkey's current account deficits could not be financed by FX inflows, and its central bank's FX reserves started to fall in 2015. This took a dramatic turn in 2018, when there was a "sudden stop" in the financial account (see **Table 2**). The Institute of International Finance (IIF) claims that Turkey's strong growth in the past decade was driven by Turkish corporates borrowing in hard currency. However, this growth momentum took a toll on the BoP and depleted the Central Bank of the Republic of Turkey's (CBRT's) FX reserves. As often happens in global markets, when investors get jittery, they act in unison – this occurred in 2018 (see **Table 2**).

With a brewing BoP crisis, CBRT had little choice but to depreciate the Lira (see **Figure 5**). CBRT responded to the weakening currency by increasing interest rates, which we assume was to protect carry trades. So while Turkey's FX reserves may appear healthy, CBRT has to be very vigilant to ensure that foreign banks and traders do not pull out their money, and push Turkey into a full-blown BoP crisis.

The IMF projects that the Turkish economy will contract in 2019, and Bloomberg claims that Turkey needs to repay $ 25 bln and € 15.6 bln in 2019 alone. By the end of 2018, Turkish corporates owed over $ 270 bln, and servicing this debt becomes harder as the Lira loses value. In our view, the source of Turkey's economic problems is clear enough: the private sector borrowed FX at low interest rates and invested primarily in construction, which *only* generates Turkish Lira; hence, when FX inflows dried-up and CBRT's reserves started to fall, the resulting currency crisis made corporate debt repayments even more difficult. As a result, many Turkish companies are going bankrupt, and the Turkish economy has stalled.

Fig 7: $ Debt & $ Reserves ($ bln)



Before concluding the paper, let's look at how Pakistan stacks up against these distressed economies. As shown in **Figure 7**, Pakistan's external debt has increased rapidly, but SBP's FX reserves have been falling since FY17. As part of the EFF (see **Table 3**), SBP's reserves are projected to increase, but we think this would be matched by a sharp increase in Pakistan's external debt. Something similar happened in Egypt in FY17 and FY18 (see **Figure 1**).

Table 3: Pakistan's Balance of Payments ($ bln)

	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24
Current Account	**(3.13)**	**(2.80)**	**(4.87)**	**(12.62)**	**(19.90)**	**(13.59)**	**(6.70)**	**(5.49)**	**(5.27)**	**(5.31)**	**(6.08)**
% GDP (%)	*1.28%*	*1.03%*	*1.75%*	*4.14%*	*6.32%*	*4.78%*	*2.59%*	*2.01%*	*1.79%*	*1.68%*	*1.79%*
1. Trade Balance	(16.59)	(17.27)	(19.28)	(26.68)	(31.82)	(28.22)	(24.89)	(24.46)	(25.06)	(25.66)	(26.85)
- Merchandise Exports	25.08	24.09	21.97	22.00	24.77	24.22	26.83	29.46	31.71	34.11	36.70
- Merchandise Imports	41.67	41.36	41.26	48.68	56.59	52.44	51.73	53.92	56.76	59.77	63.54
2. Services Balance (net)	(2.65)	(2.97)	(3.41)	(4.34)	(6.07)	(4.27)	(2.02)	(1.87)	(1.83)	(1.78)	(1.64)
3. Primary Income (net)	(3.96)	(4.60)	(5.35)	(5.05)	(5.48)	(5.74)	(5.46)	(5.94)	(6.35)	(7.06)	(8.05)
4. Secondary Income (net)	20.07	22.04	23.17	23.45	23.48	24.64	25.67	26.78	27.96	29.19	30.46
- Remittances	15.84	18.72	19.92	19.35	19.91	21.84	22.54	23.62	24.73	25.87	27.03
Capital Account	**1.86**	**0.38**	**0.27**	**0.38**	**0.38**	**0.27**	**0.69**	**0.61**	**0.57**	**0.58**	**0.49**
Financial Account	**5.55**	**5.07**	**6.79**	**10.20**	**14.30**	**12.22**	**8.74**	**7.93**	**8.58**	**11.00**	**9.83**
- Direct Investment	1.57	0.92	2.29	2.66	3.46	1.73	2.09	2.85	3.61	4.38	5.04
- Portfolio Investment	2.76	1.89	(0.43)	(0.25)	2.26	(1.26)	0.33	1.86	2.04	2.33	2.33
- Other Investments	1.22	2.27	4.93	7.79	8.58	11.76	6.32	3.22	2.92	4.29	2.46
Errors & Omissions	**(0.42)**	**(0.01)**	**0.46**	**0.10**	**(0.92)**	**(0.45)**	-	-	-	-	-
Overall Balance	**3.86**	**2.65**	**2.65**	**(1.95)**	**(6.14)**	**(1.55)**	**(2.74)**	**(3.05)**	**(3.87)**	**(6.27)**	**(4.23)**
- Change in reserves	3.29	4.60	4.66	(1.84)	(6.23)	(1.93)	4.36	3.28	4.42	5.98	3.18
Central bank reserves (stock)	9.10	13.53	18.14	16.14	9.77	7.84	12.20	15.48	19.91	25.88	29.07

Source: State Bank of Pakistan

Table 3 shows that Pakistan will rely increasingly on DFI and portfolio inflows. This is deemed necessary to finance the external deficit, build SBP's reserves, and most importantly, to make Pakistan's external debt more *sustainable*. Ostensibly, these inflows are not debt-creating, but one must realize that $ inflows in the PSX or government T-bills, create an FX *liability* on SBP, which the central bank must honor when foreign investors decide to pull their money out. As we have seen in both Egypt and Turkey, once such inflows have been realized, this creates pressure on the central bank to maintain its FX reserves to keep foreign investors comfortable. This comfort is necessary to roll-over as much of the investment as possible, which compels the central bank to ensure that their dollar returns are protected. If the external deficit weakens the local currency, this reduces the dollar returns to foreign investors; to ensure that this money does not leave the country, interest rates have to increase.

This is happening in Egypt and Turkey (**Figure 3** & **5**), where interest rates have been used to support the local currency, even though it is harming the local economy. In Pakistan, the use of interest rates to support the Rupee has already started (see **Figure 8**). This will remain in play as the government has agreed (with the IMF) to maintain a positive real interest rate *benchmark*. As shown in **Figure 9**, as the weakening Rupee stokes inflation, SBP will be compelled to increase interest rates (*Chasing inflation will unhinge the macro economy*, 16 July 2019). If Pakistan begins to attract foreign investment in government T-bills, SBP could become even more responsive (in using interest rates) to protect the financial interests of foreign investors.

Fig 8: Pakistan's Key Prices

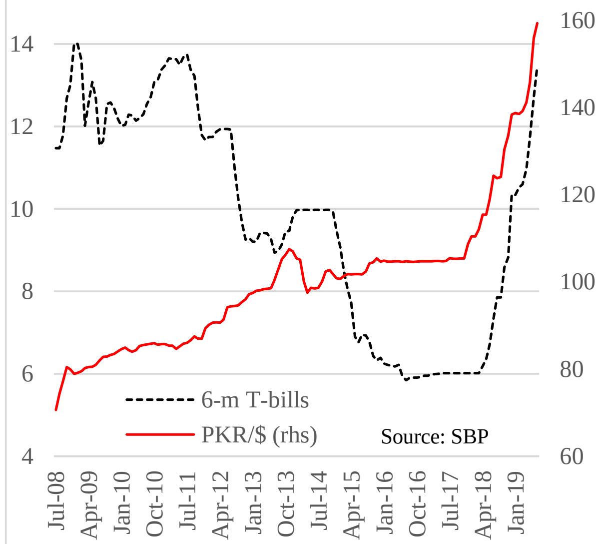
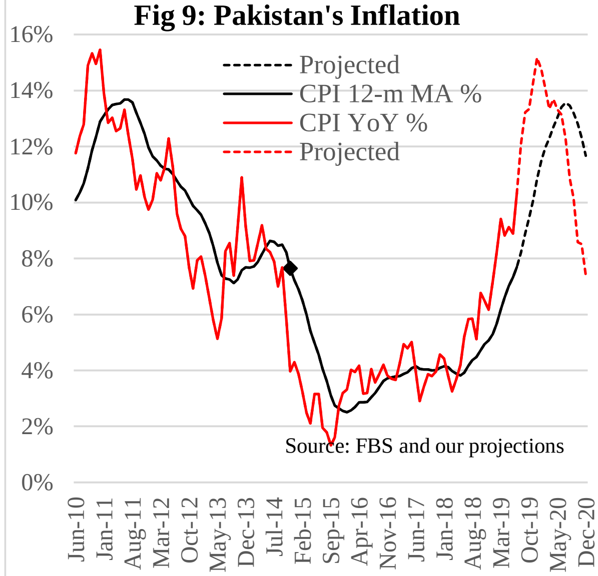


Fig 9: Pakistan's Inflation



Conclusion

This paper shows that Pakistan's economic challenges are not unique. In our view, the most striking insight from this cross-country comparison, is that economic stabilization can take place without any tangible improvement in the underlying economy. Egypt remains import-dependent, and the needed economic growth is threatening to push the country back into another BoP problem. Furthermore, any exogenous shock that undermines Egypt's economic outlook (from the perspective of foreign investors) could easily become self-fulfilling.

As seen in Egypt and Turkey, international capital markets and the private sector cannot – and will not – solve a country's structural problems. At best, they will benefit from the dysfunction; at worst, they will shape government policies to suit their financial interests. In our view, structural changes cannot be achieved by setting the *right prices*, in the hope that the private sector will do the heavy lifting.

As Pakistan settles into its own EFF, higher inflation and rising interest rates will slow the economy, and this slowdown is needed to stabilize the external sector. Since the EFF clearly prioritizes stabilization over structural reforms, it falls upon Pakistan's policymakers to ensure that staying on track with the IMF program is not the government's only goal. As the external sector is Pakistan's *Achille's heel*, its import-dependency must be targeted by policy intervention, and not just postponed by slowing growth. This is all the more important if the country needs sustainable growth rates of 6% plus.

Since Pakistan's economy is structurally deficient at many levels, expecting exports to pull the country out of the BoP crisis, is not just wishful, but counterproductive – it deflects attention away from Pakistan's import-dependency. If the trade deficit is not sharply curtailed, and Pakistan begins to tap into the international capital markets, policymakers may simply settle in terms of borrowing more. Therefore, there is an urgent need to keep a watchful eye on this issue before the country's economic policies become hostage to foreign investor sentiments.

As discussed in our last paper (*IMF's EFF: Different or more of the same?* 30 July 2019), the EFF sets heavy stabilization targets but is light on structural changes. Hence, Pakistan's policymakers must ensure that the country's urgent economic needs (e.g. import substitution, an industrial policy that creates jobs, documentation, sufficient taxes and the urgent need to post an external surplus) are not left unaddressed as policymakers focus on stabilization alone. While the EFF should stabilize Pakistan's economy, we cannot rely on the IMF to fix Pakistan's structural deficiencies. As we have been saying for several years now, we think a suitably tweaked CPEC could be the solution.

