FY19 starts with a bang

Mushtaq Khan, July 16, 2018

On July 14, the State Bank of Pakistan surprised the market with a larger than expected increase in interest rates. The 100 bps hike has been linked with the twin deficits and the rise in year-on-year inflation for the month of June. Two days later, SBP let the PKR adjust further, with the currency closing at 128/$. So far, the caretaker government has increased interest rates by 100 bps and weakened the PKR by over Rs 12/$.

While we had projected that the caretaker government would take these steps, we are surprised at the magnitude of the adjustments. In our last projections paper (*The vicious twin deficits, Part 1*, April 26, 2018), we had anticipated that the caretakers would increase interest rates by 50 bps and depreciate the Rupee from 115-116 to around 118-119/$. Our past papers had been flagging the challenges facing Pakistan's economy for some time (especially the precarious external sector), but the manner of the adjustments suggest that the authorities are now struggling to control the market.

This is somewhat surprising as the initial statements by the caretaker Finance Minister (Shamshad Akhtar) suggested that the caretakers would simply manage the ship and leave course correction for the next elected government. It now appears the course is being changed, and this is only possible – given the limited mandate of the caretaker set-up – if there is across-the-board buy-in from aspiring political parties. In an earlier paper (*Could the next IMF program be decisive*? 12 December, 2017) we talked about the need for an IMF stabilization program; in it we stated that the outcome of the 2018 elections is *effectively* irrelevant, as the new government will have little choice but to adopt strict austerity. There will be no honeymoon period.

Ms Akhtar has recently stated that while the caretaker government does not have the mandate to negotiate with the IMF, this administration is creating the groundwork for the next government.[1]

Projecting FY19

By the end of this month, SBP's BoP data for FY18 should be released, which would allow us to prepare our *1Q-FY19 Macro Projections*. However, with the outcome of the July 25 elections still in much doubt, we will wait for the initial assessment of the next economic team before committing to our FY19 projections. Subsequent predictions will clearly be shaped by the negotiations and the targets agreed upon for the next IMF program.

Our conservative projections for the PKR and interest rates, were driven by our concern that key variables like the size of the external & domestic debt, and the growing fiscal deficit (driven by debt servicing), would limit how much leeway policymakers would have to adjust the PKR and how high they could raise interest rates. The actions taken by SBP in the past few days, do not suggest a coordinated action plan – the PKR adjustment today implies that SBP's inflation projection for FY19 (6-7%) that was announced in the 14 July Monetary Policy Statement (MPS), may have to be adjusted upwards after today's PKR adjustment.

It is clear that the IMF wanted serious adjustments in the PKR, and some interest rate signal that the twin deficits need to be narrowed sharply. The issue is how much of this adjustment has already been done by

[1] This was covered by the Express Tribune on 14 July 2018.

the caretaker government, and what is in store when the next government takes charge. Most observers agree that the weaker PKR should narrow the trade deficit after a time lag. However, a sharply weaker PKR will immediately impact month-on-month inflation and shape the market's interest rate expectations, which in turn will complicate economic management, and the design of the next stabilization program.

Table 1: M2 and Borrowing Growth (Rs. bln)

	FY14	FY15	FY16	FY17	FY18*
Increase in credit:					
- Net credit to the private sector	422	224	446	748	768
- Net GoP borrowing	288	933	861	1,136	1,495
Increase in money supply (M2):	1,109	1,316	1,543	1,756	1,544
Growth:					
% growth in net credit to the private sector	*12.6%*	*5.9%*	*11.2%*	*16.8%*	*14.8%*
% growth in net GoP borrowing	*5.0%*	*15.5%*	*12.4%*	*14.5%*	*16.7%*
% growth in M2	*12.5%*	*13.2%*	*13.7%*	*13.7%*	*10.6%*
Discount rate	9.50%	6.50%	5.75%	5.75%	6.50%
Change in discount rate for the year	*1.00%*	*-3.00%*	*-0.75%*	*0.00%*	*0.75%*
Average inflation rate for the year	8.62%	4.56%	2.87%	4.15%	3.92%

Source: SBP. *As of June 29, 2018

As shown in **Table 1**, the growth in money supply in the recent past has been quite restrained. What is more insightful, is the fact that during this period, it is government borrowing that is driving the increase in domestic liquidity and not private sector credit. While an increase in interest rates should reduce demand pressures, in the case of Pakistan (where government borrowing is *insensitive* to interest rates), increasing interest rates will not necessarily reduce the future growth of money supply, but will have an immediate impact on domestic debt servicing. If commercial banks expect a further increase in interest rates – and act accordingly – this will compel SBP to increase interest rates in September as inflation begins to edge up. This will not help narrow the fiscal deficit in FY19.

SBP has already stated that the fiscal deficit in FY18 will be much larger than the government's target of 5.5% (it is expected to be around 6.8% of GDP). With a current account deficit now expected to be as large as $ 17-18 billion, the next stabilization program will not be easy. Accounting for the circular debt that would have to be paid off as part of the stabilization program, the fiscal gap in FY19 will be larger in percentage terms than in FY18. With the market now expecting a further increase in interest rates, debt servicing will continue to overwhelm the fiscal accounts. While this will cheer up the banks, it will put tremendous pressure on the next government to stop the hemorrhaging in the power sector and also to increase the tax base quite aggressively.

This means the next several years will be difficult, and the next stabilization program will not be as easy as the last IMF program.

Outlook

As discussed in our past papers, economic compulsions – especially on the BoP side – tend to dominate political developments. Although uncertainty about the outcome of the forthcoming elections is very high, there is no buzz on the streets about what is likely to happen. Business concerns cite that political uncertainty is influencing their outlook, but there is a more pervasive sense of gloom about issues like consumer sentiments, inflation, the weakness of the Rupee, and how the filer/non-filer distinction will play out.

More specifically, there is a sense of regret about the institutional decay in the government machinery, not just in terms of short-sighted policymaking, but the experience of interacting with this machinery. Corruption and the growing presence of informal wealth are often cited as the root cause for this outlook. In our view, since most business concerns are familiar with Pakistan's frequent BoP problems, there is a feeling of *déjà vu* – of going back to square one. So even the promise of a new government in two weeks does not appear to be relevant to change sentiments.

With a 16% adjustment of the Rupee in the past four months, and high global oil prices that are likely to be passed on to retail consumers, public sentiments are likely to sour further. With the on-going investigation into corrupt practices by members of the political elite, pre-election spending by the main political parties appears to be hampered. This, and the challenging economic outlook, could explain the fatalistic sense of calm in the country.