Pakistan's BoP: The Calm before the Storm

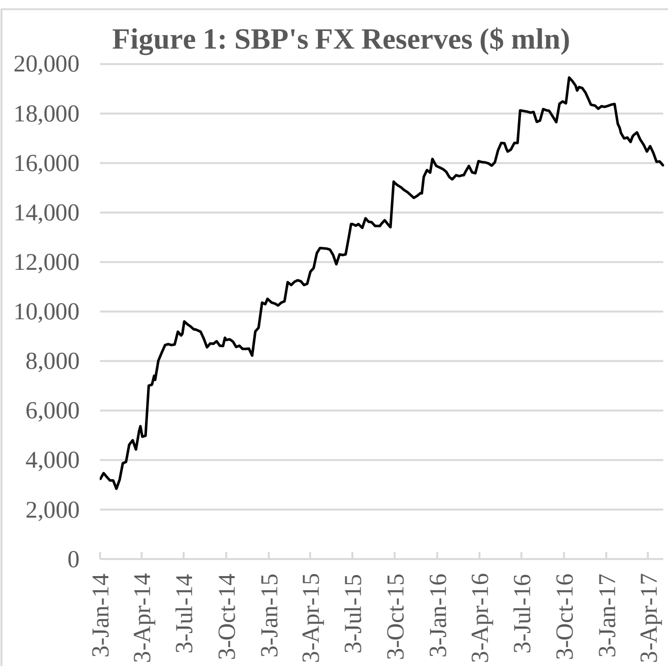
Mushtaq Khan & Danish Hyder, May 31, 2017

After years of comfort on the external sector, Pakistan is once again in familiar territory – concerns are growing about falling FX reserves and the sharp increase in the external deficit.[1] While Pakistan has frequently experienced BoP problems, this time around is likely to be quite different.

Pakistan has experienced a balance of payment (BoP) problem before (e.g. FY08 and FY12 – see **Table 1**), but this year's increase cannot be traced to the usual suspect – oil prices. To better appreciate how this BoP problem is different from previous years, several issues need to be considered: (1) how exports and remittances have fared, and what the outlook is; (2) what impact CPEC is having, and whether it can be managed; (3) previous BoP problems were soon followed by an IMF stabilization program – now we await a pre-election Budget; (4) with souring fundamentals and no IMF on the horizon, is it possible to even finance the external deficit? And (5) as the government gears up for general election in early 2018, whether we can expect corrective policy actions.

I. The current BoP

The country's BoP (July-April 2017) is clearly a growing concern: exports are down 1.3%, remittances are 2.8% lower, and imports have increased by 15.5% (compared to the same period in FY16). Hence, SBP's FX reserves have fallen over 10% since end-June 2016. As shown in **Table 1**, in aggregate terms, the current account deficit has tripled compared to the previous year.

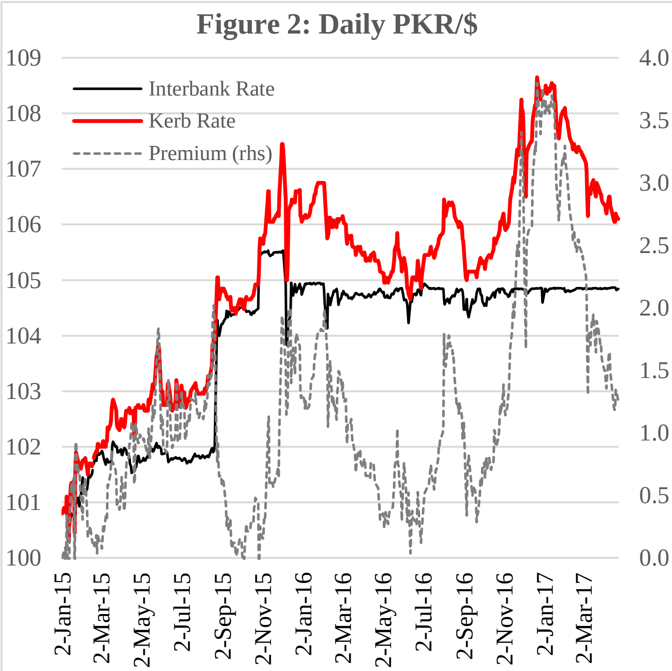


The steady decline in SBP's FX reserves is unnerving the market (see **Figure 1**). It appears the policy priority is to ensure that this slide is halted as it continues to undermine market confidence. However, even with the measures taken to narrow the external deficit (more later), the growing current account remains troubling.

Even though the authorities are aware the external deficit is gaining attention, the exchange rate has not reacted to the growing imbalance. From past experience, a persistent imbalance in the external sector is eventually reflected in the PKR-$ parity. The fact that the PKR has been within a very narrow band since August 2015 (**Figure 2**) has created a disconnect between what the government seeks, and what the market anticipates.

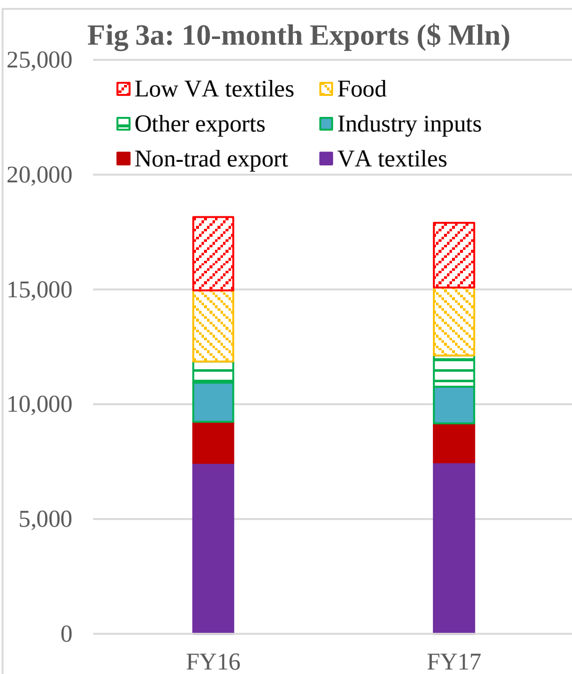
[1] Market sentiments have understandably changed this fiscal year. Looking at the key transactions in the foreign exchange (FX) interbank market (exports, imports and remittances), the first 10-months of FY16 showed a surplus above $ 1.4 bln, which has turned into a negative $ 4.3 bln this year.

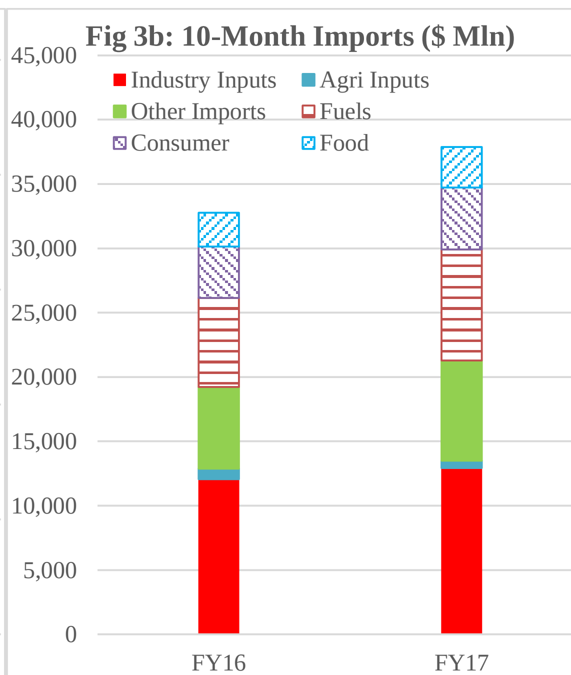
Table 1: Pakistan's Balance of Payments (US$ mln)																
BoP BPM6	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**	**FY16**	**Jul/Apr 16**	**Jul/Apr 17**
Current Account	**4,070**	**1,811**	**(1,534)**	**(4,990)**	**(6,878)**	**(13,874)**	**(9,261)**	**(3,946)**	**214**	**(4,658)**	**(2,496)**	**(3,130)**	**(2,709)**	**(3,394)**	**(2,378)**	**(7,247)**
1. Good & Services	(361)	(2,595)	(7,807)	(12,871)	(13,881)	(21,427)	(16,008)	(13,226)	(12,456)	(18,957)	(16,919)	(19,240)	(20,154)	(21,442)	(16,856)	(22,252)
- Trade Balance	(359)	(1,257)	(4,450)	(8,321)	(9,572)	(14,834)	(12,540)	(11,452)	(10,427)	(15,652)	(15,355)	(16,590)	(17,191)	(18,478)	(14,613)	(19,936)
- Merchandise Exports	10,974	12,461	14,481	16,572	17,301	20,448	19,126	19,680	25,369	24,718	24,802	25,078	24,089	21,972	18,146	17,912
** Value-added Textiles*		4,889	5,213	5,492	6,124	6,635	6,369	6,676	8,321	8,128	7,905	8,599	9,015	8,970	6,691	6,755
- Merchandise Imports	11,333	13,718	18,931	24,893	26,873	35,282	31,665	31,132	35,796	40,370	40,157	41,668	41,280	40,450	32,759	37,848
** Oil Imports*		2,264	3,550	5,956	7,346	10,496	10,032	10,463	12,317	14,368	14,066	14,774	12,344	8,360	6,398	7,768
- Services Balance	(2)	(1,338)	(3,357)	(4,550)	(4,309)	(6,593)	(3,468)	(1,774)	(2,029)	(3,305)	(1,564)	(2,650)	(2,963)	(2,964)	(2,243)	(2,316)
2. Primary Income (net)	(2,211)	(2,207)	(2,386)	(2,667)	(3,582)	(3,923)	(4,407)	(3,282)	(3,017)	(3,245)	(3,669)	(3,955)	(4,595)	(5,335)	(4,322)	(3,652)
3. Secondry Income (net)	6,642	6,613	8,659	10,548	10,585	11,476	11,154	12,562	15,687	17,544	18,092	20,065	22,040	23,383	18,800	18,657
- Remittances	4,237	3,871	4,168	4,600	5,494	6,451	7,811	8,906	11,201	13,186	13,922	15,837	18,721	19,917	16,045	15,597
Capital Account	**1,133**	**82**	**685**	**241**	**304**	**121**	**455**	**175**	**161**	**183**	**264**	**1,857**	**375**	**273**	**239**	**303**
Financial Account	**487**	**1,211**	**(563)**	**(5,473)**	**(9,972)**	**(8,131)**	**(5,632)**	**(5,097)**	**(2,101)**	**(1,280)**	**(549)**	**(5,553)**	**(4,996)**	**(5,605)**	**(3,228)**	**(5,428)**
- Direct Investment	(771)	(906)	(1,459)	(3,450)	(5,026)	(5,335)	(3,695)	(2,075)	(1,591)	(744)	(1,258)	(1,572)	(850)	(1,885)	(1,520)	(1,645)
- Portfolio Investment	239	(314)	(620)	(986)	(3,283)	(32)	1,073	65	(338)	144	(26)	(2,762)	(1,884)	429	449	(629)
- Others	1,019	2,431	1,516	(1,037)	(1,663)	(2,764)	(3,010)	(3,087)	(172)	(680)	735	(1,221)	(2,260)	(4,149)	(2,157)	(3,154)
Errors & Omissions	**523**	**222**	**(7)**	**253**	**179**	**257**	**118**	**(60)**	**16**	**(80)**	**(309)**	**(422)**	**(16)**	**168**	**(198)**	**(495)**
Reserve Assets	**5,239**	**904**	**(293)**	**977**	**3,577**	**(5,365)**	**(3,056)**	**1,266**	**2,492**	**(3,275)**	**(1,992)**	**3,858**	**2,646**	**2,652**	**891**	**(2,011)**
SBP Reserves (gross)	**10,727**	**11,182**	**10,687**	**11,542**	**15,070**	**9,539**	**10,257**	**13,953**	**16,614**	**11,905**	**7,198**	**10,509**	**14,836**	**19,446**	**17,223**	**17,453**



It doesn't help that the US Dollar is gaining strength, and will only get stronger as the Fed increases interest rates. With Pakistan's general elections scheduled for the 2nd quarter of 2018, policymakers are on a tight timeline. They would be wary of adjusting the PKR-$ parity for fear that this could unhinge the country's macro stability.

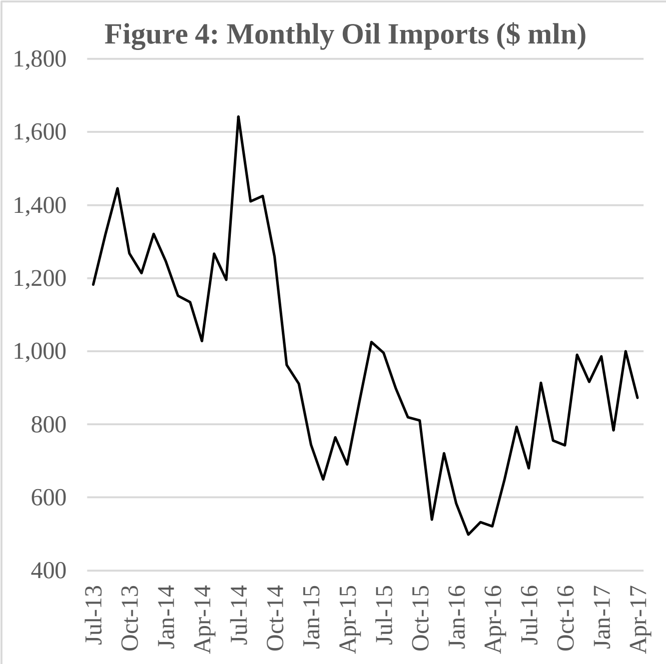
Despite IMF efforts to emphasize interest rates as Pakistan's "nominal anchor", the market realizes the PKR-$ parity is far more relevant in determining how people set their expectations about inflation and future interest rates. The market's view is that SBP will persist in holding the PKR parity at current levels, to keep inflation and interest rates at current levels. However, the market is concerned that as the external deficit continues to deplete SBP's FX reserves, the central bank's ability to manage the FX market is being undermined.

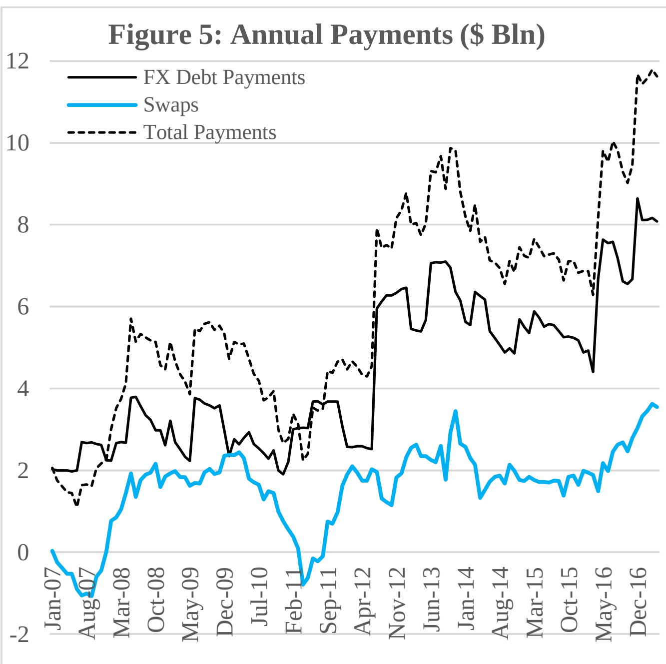




This is understandable, given the trade flows in the first 10-months of FY17 (**Figure 3a & b**). The record high trade deficit is primarily driven by unproductive imports – consumer goods and oil. The issue is, stagnant export revenues and remittances in FY17 have not been addressed.[2]

[2] Although global oil prices have increased somewhat since early 2016, it is the quantum of imports that has once again pushed Pakistan's monthly oil bill north of US 1 billion (see **Figure 4**). In our view, global oil prices are likely to remain range-bound between $ 50 to $ 60/barrel for the foreseeable future.





Pakistan's trade fundamentals are not helped by committed FX repayments. SBP data shows that Pakistan will have to repay US$ 11.6 billion by end-April 2018 (see **Figure 5)**. The repayment spikes in 2016 are a source of concern, as they will have to be compensated by fresh inflows in 2017. Given public criticism of the expensive money borrowed in the last Eurobond, the government should be concerned about future FX borrowings.

On the export side, the picture remains bleak. Low value-added textiles continue to shrink, as production units in Punjab have shut-down. Unable to compete against micro-fiber and lured by investment in domestic real estate, Pakistan appears to be witnessing the gradual demise of its traditional export sector. While many higher value-added textile producers claim this was inevitable because of their lack of effort to upgrade and compete globally, the fact that garment/made-ups are themselves investing in local real estate, is a frightening precedent. If this trend continues, it could permanently damage Pakistan's ability to export (and import).

Measures taken so far

The government has taken remedial steps to contain the external deficit: retail PoL prices have been increased by 9-10% since early January 2017 to reduce demand (even though oil prices have not trended up since December 2016)[3]; and SBP imposed cash margins on select imports in February. By imposing cash margins on high-end consumer items, SBP seeks to contain the growth of consumer imports without directly impacting headline CPI (the 404 items chosen are not in the CPI basket). Conservatively, since these items account for about US$ 3 billion per annum, cash margins may reduce Pakistan's import bill by US$ 900 to 1,200 million. Given the expected size of the current account deficit in FY17, these savings will certainly not be enough to calm the market.

[3] The gradual increase in retail fuel prices could not have been an easy decision, as it will put upward pressure on inflation. Policymakers are aware that the fall in inflation since Q4-2014 came primarily from the sharp reduction in retail fuel prices from Rs 105.5 in end-June 2014, to 67.79 by end January 2015. Furthermore, the subsequent fall in interest rates helped contain domestic debt servicing, which helped reduce the fiscal deficit.

But when questioned about the hesitation to devalue the PKR, the government is likely to respond by asking whether a weaker Rupee would increase exports or remittances (which is unlikely at this stage), increase foreign investment (again a no), or reduce imports. While many will argue that a weaker PKR should reduce Pakistan's import bill, the government is likely to say that the resulting increase in imported inflation is not acceptable.

While we sympathize with the government's point of view, holding the PKR parity will not address the growing anxiety in the FX market – it also does not help exports. Eventually the market itself may force an adjustment. If this were to happen, the resulting spike in inflation would reverse the easy macro conditions that have existed since mid-2014. It would also require active management of inflationary expectations, as well as dealing with the fiscal pressures created by the increase in domestic debt servicing. This may not allow the government to enter the forthcoming elections from a position of strength.

In effect, SBP is facing a delicate balancing act. It needs to reduce FX outflows while ensuring that the increase in retail fuel prices doesn't trigger a sharp increase in inflation. The government must also closely watch the kerb market to ensure that Dollar buying is contained – as past experience shows, an increase in the kerb premium reinforces the view that a PKR devaluation is imminent.[4]

II. What more may need to be done?

The day-to-day management of the FX market appears quite straightforward. Averaging out the daily volatility in inflows and outflows, the Dollar deficit in the interbank market is being met with SBP carrying out FX swaps with local banks and drawing down its reserves. The increase in the outstanding volume of one-sided FX swaps from $ 2.46 bln in end-October 2016 to $ 3.63 bln by end-March 2017, is an indication of the gap that *has* been filled so far.[5] In addition to this, since July 2016, SBP has depleted its FX reserves by $ 2 bln to meet the external deficit (see **Table 1**).

Some additional out-of-the-box options are available to narrow the external gap or to finance it:

1. Securitize future remittances:

The easiest way to do this is to target worker remittances coming from the GCC. However, the political/media backlash would be heavy, and the cost to the country when net remittances fall in the future, would be difficult to manage for the newly elected government. Since securitization is effectively delaying the inevitable, and the incumbent government appears likely to win the forthcoming elections, this may not be a wise option.

2. Announce an Amnesty scheme:

Another option is to tap into the vast sums of undeclared wealth that Pakistanis hold abroad. Whether it is in the form of real estate; bank balances or money invested in foreign markets and businesses, most of

[4] The low kerb premium in recent weeks is a quandary. Some say it's the seasonal increase in FX inflows from the GCC because of Ramadan, while others claim this reflects active management to dispel market concerns. These same sources also say that such micro-management is sufficient evidence that the authorities are very concerned about what could happen in the FX market.
[5] One must realize that during the IMF program that ended in September 2016, there was a $ 2.1 bln ceiling on FX swaps that SBP could carry at any point in time.

this wealth is unlikely to be traced to legitimate overseas sources– this means the accumulated money was sourced out of Pakistan.[6]

Tapping into this wealth implies that some form of amnesty scheme would have to be offered to errant Pakistanis. There are two issues here: (1) ensure this is not viewed as forgiveness for past misdeeds (the penalty for full disclosure cannot be paltry, as this penalizes honest tax payers, and could encourage them to move below the fiscal radar); and (2) not view this as a one-off inflow of "tax revenues", but a steady source of FX (and tax revenues) with incentives for Pakistanis to bring back this wealth into the country. Political expediency in policy formulation should be avoided at all costs.

However, on the back of the critical judgment against the sitting Prime Minister and his family recently issued by a special bench of Supreme Court Justices (and the on-going Joint Investigation Team), getting an Amnesty scheme endorsed by the National Assembly will be very difficult. Opposition political parties have already sensed the weakness of the ruling party, and will surely oppose such an Amnesty scheme on the grounds that it seeks to whitewash the past sins of all political insiders, just as the sitting government seeks to quash Panama-Gate.

<u>3. Regulate all official imports:</u>

Impose a temporary requirement that each import L/C above a certain amount (say $ 5 mln) needs SBP approval. Just the inconvenience (i.e. paperwork) should discourage some imports, which would delay import payments and smooth them out overtime.

<u>4. Carefully monitor the kerb premium:</u>

To ease pressure on the kerb market, SBP has already taken some of the following steps:

- Stricter border controls with Afghanistan. It is well known that Afghani importers often need to pre-fund imports to open an L/C, which means there is a stream of Dollar outflows secured from Pakistan's kerb market that is used to pay for *official* Afghan imports;
- Temporarily stop the use of Pakistan-based credit cards from making international payments (e.g. on Alibaba, Amazon, etc.), as the underlying Dollar payments are sourced from the kerb market;
- Clamp down on travel groups that arrange Umra/Dubai deals against PKR payment, as the underlying Dollars are also sourced from the kerb market;[7]
- Reduce the Dollar limit that Pakistanis can carry on their trips abroad (and enforce it); &
- Strictly monitor Exchange Companies (ECs), to ensure that precautionary purchase of Dollars or attempts to shift money overseas is discouraged. This could be done with stern warnings that stringent KYC (*know-your-customer*) requirements are now in place overseas.

<u>5. Manage outflows from FCAs:</u>

A more controversial option is to temporarily suspend the ability of Resident Foreign Currency Account (RFCA) holders, to remit hard currency overseas. It is a stylized fact that FX outflows via this avenue are significant, and the Dollars purchased locally to remit overseas, may be the single largest source of demand for cash Dollars in Pakistan's kerb market.

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[6] The US State Department recently stated that Pakistan accounts for about $ 10 billion annual outflows, where the source of this money, and eventual usage, is not properly documented. In the absence of such information, foreign authorities cannot be blamed for assuming the worst, especially given Pakistan's checkered history with terror-related activities.

[7] SBP has recently instructed banks to restrict overseas travel for its employees, as this adds to Dollar purchases from the kerb market.

Deep-rooted problems in the external sector

We will now discuss long-term challenges to the sustainability of Pakistan's BoP deficit. The first, namely falling exports, is a perennial problem coming to a head. The second – CPEC – is a more recent development, but its successful implementation depends on the external sector's viability.

Trade Fundamentals:

In the past, Pakistan's BoP worries were largely driven by a sharp increase in oil imports, which could not be matched by export receipts. This time around, it's the fall in exports and remittances. As shown in **Figure 6**, Pakistan's exports have not only stagnated since FY12, but low value-added exports (*yarn /gray cloth*, *non-traditional exports* and *industrial exports*) have fallen in Dollar terms in FY16.

Structural impediments are the most commonly cited reasons for Pakistan's sluggish export performance. This entails issues of power availability; security concerns that delay timely production and dispatch of export orders; under-developed relationships with foreign retailers as they refuse to visit Pakistan (again, security concerns); a stagnant menu of export items; and overdue export rebates from the government.[8]

What is generally ignored are the *behavioral* reasons for stagnant (and now falling) exports.

In our discussions with the large export houses in Punjab, we learned of several behavioral factors that more fully explain the recent slump in Pakistan's exports:

1. Domestic investment opportunities. In view of far more lucrative domestic investment opportunities, many of Pakistan's prominent export houses have branched off into real estate development; buying empty plots of land (for capital gains); and investment in the domestic stock exchange. In effect, some of the most dynamic exporters in the country have shifted their focus away from their core business.
2. Inability to adapt. With the commercial success of micro-fiber (a cheaper substitute to coarse cotton that is made of polyester), many of Pakistan's low-value added textile exporters shut down their operations and moved into domestic investment opportunities.
3. Lack of innovation. This was cited by the more dynamic exporters as one of the main reasons that Pakistani exporters have not been able to climb up the value chain. They claimed that most traditional textile exporters did not bother with in-house *research & development*; new product development; expanding their client base; or seeking JV partners who could help them upgrade their product offerings.
4. Outdated management techniques. This specifically refers to family-owned textile exporters who are not willing to corporatize their operations for fear of losing management control. There may also be an element of not wanting to disclose financials. And
5. Policy influence. Many of the established textile exporters have cultivated strong in-roads into the government, which allows them to influence policies to their advantage. This meant that instead of improving internal efficiencies, low value-added exporters protect their ample margins by securing cheap inputs and fiscal incentives.

[8] This last point undermines the credibility of the *export packages* that are often issued, which are based on export rebates that are not realized even years after the exports are made. While exporters still show pending rebates as receivables in their balance sheets, fresh investment in their core business (exports) is understandably not forthcoming.

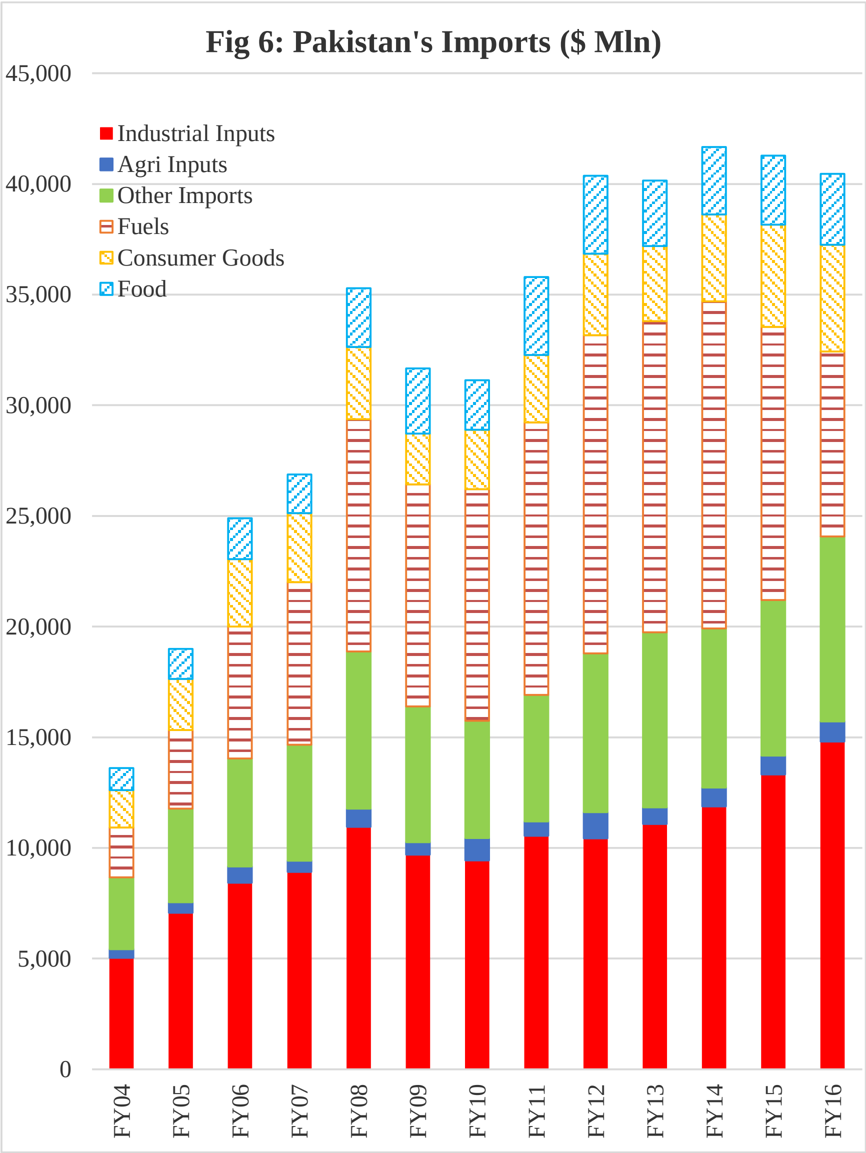
Fig 6: Pakistan's Imports ($ Mln)
45,000
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
Industrial Inputs
Agri Inputs
Other Imports
Fuels
Consumer Goods
Food
FY04
FY05
FY06
FY07
FY08
FY09
FY10
FY11
FY12
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FY15
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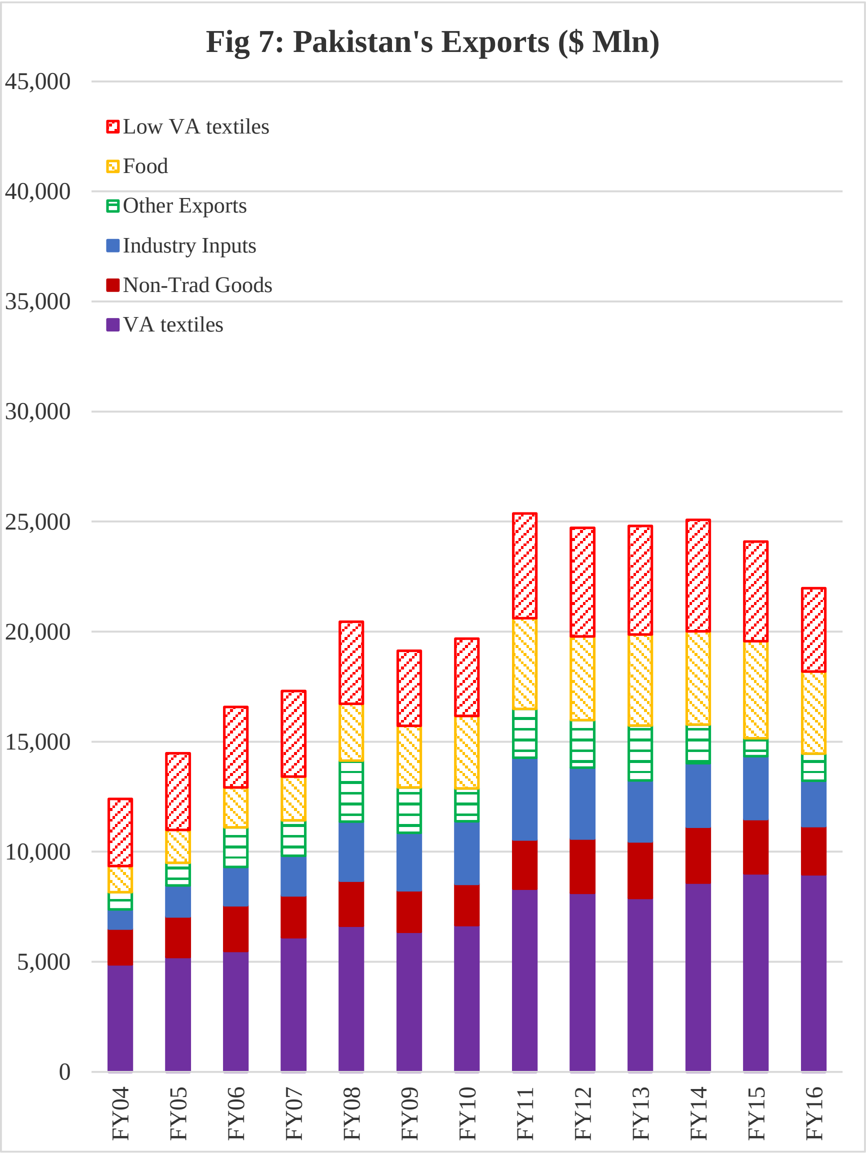
Fig 7: Pakistan's Exports ($ Mln)
45,000
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
Low VA textiles
Food
Other Exports
Industry Inputs
Non-Trad Goods
VA textiles
FY04
FY05
FY06
FY07
FY08
FY09
FY10
FY11
FY12
FY13
FY14
FY15
FY16

The massive returns in real estate investment (which are possible because of the gross under-valuation of residential and commercial properties), have made this very lucrative for those who can put up the initial investments. While this makes sense from the perspective of the individual exporter, from the perspective of the country, this trend has serious adverse consequences.

Furthermore, worker remittances that have always saved the country, may no longer be able to do so. The new normal in oil prices, means inward remittances from the GCC will not be able to grow the way they have in the past 15 years. The fact that remittances have not fallen off a cliff can perhaps be traced to overseas savings being brought back to the country, but the gradual fall in future inflows is likely to persist in the coming years.

Overall, Pakistan's ability to generate foreign currency is being squeezed from both sources. The rapid increase in the country's external debt is an indication of policymakers' refusal to take decisive steps to correct the growing imbalance in the country's external account. Since this external debt has to be repaid in hard currency, unless urgent steps are taken to revive Pakistan's ability to generate hard currency, its ability to borrow FX to finance the external deficit will also evaporate quite quickly.

This raises the question: if exports have been stagnant for the past five years, why has this issue not generated more urgency to resolve it? The answer is simple: till this fiscal year, Pakistan's BoP deficit has been quite small and easy to finance. In fact, the sharp fall in oil prices in mid-2014 (and the steady growth in remittances) created enough comfort that policymakers did not focus on stagnant exports. **Figure 7** clearly shows how the shrinking oil bill not only allowed for higher non-oil imports, but also helped bring down the annual import bill. In this period, SBP was able to build its FX reserves even as the country's export base had shifted its commercial interest towards domestic investment opportunities (this is especially visible in low-value added textiles).

The issue is whether these exporters will return to textiles in the near future.

Despite the challenging export environment, one cannot place all the blame on imports. In our view, there are *productive* imports and *unproductive* imports, where the former are intermediate/final goods that are required for domestic investment. Although imports of food and fuels are necessities, we still classify them as unproductive imports as these do not generate future economic activity.

Productive imports (*industrial & agri inputs*, and *miscellaneous & other imports* – solid colors in **Figure 7**) have increased since FY11, and accelerated in FY16. Many analyst including SBP have linked this to the on-going projects that are part of CPEC. This is a good sign, but the timing is problematic. This difficulty has been flagged somewhat indirectly by the central bank.[9]

Is CPEC a solution or part of the problem?

CPEC is a long-term economic partnership between Pakistan and China. In our view, the successful implementation of this project hinges on the institutional strength of Pakistan's public sector enterprises (PSEs) and regulators, and domestic agencies tasked to implement this project. While China's economic

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[9] In the 2nd Quarterly Report, SBP makes an insightful point that the gap between trade data generated by SBP (based on banking channel flows) and that available from Customs, is abnormally large. It is also shown that this discrepancy is most pronounced in machinery imports, specifically power generating machinery. This implies two things: one, SBP's import data understates total imports into the country; and two, the "larger" import bill (which is not drawing down official FX reserves) is on behalf of CPEC projects. While many analysts view this discrepancy negatively (in terms of the heavier expected repayments in the future), we see this as proof that CPEC-related projects are proceeding rapidly, which should put the country on a stronger economic trajectory.

dominance should allay any doubts about our Chinese counterparts, Pakistan has seen its institutions being systematically degraded by endemic corruption, nepotism and political interference.

Box 1: Pakistan's dysfunctional political system

As a backdrop to Pakistan's economic weakness, it is important to understand its political system. Since the early 1970s, Pakistan's political class has been extractive. Winning elections is almost viewed as a business, where the payoffs come from rent-seeking, crony capitalism and kickbacks from large public investment projects. The accumulated wealth of the main political families has grown on the basis of dynastic politics, where eligibility to hold top public office is based on one's parent having held this position in the past.

Furthermore, in a country where education is low priority and tribal loyalties still dominate, political families have cultivated loyal vote banks, which give entrenched politicians a perpetual presence in the political system – with little, or no accountability. In this setting, the low priority attached to education has a sinister purpose – it perpetuates political dynasties that are voted in by ill-informed constituents.

Having said this, Pakistan's history has been punctuated by several periods of military rule, which were welcomed because of domestic frustration and global events (e.g. the Soviet invasion in 1979 that legitimized General Zia's tenure, and 9/11 that allowed General Musharraf to stay in power for eight years). Pakistan returned to a democratic order when global favor turned sour. While two political families have taken turns in power since 1988, after the end of General Musharraf's term in 2008, the two families decided not to conduct witch-hunts against one another, and focus instead on grooming the next generation of leaders for the highest political office in the country.

While the world has moved on, Pakistan's political class has not. As a result, many in Pakistan have given up on the political process, with some opting to emigrate out of the country. In other words, they feel the Social Contract in Pakistan has been shredded, while the political families appear incapable, or unwilling, to mend the frayed relationship between the people of Pakistan and their elected representatives.

The impetus for this institutional weakness can be traced to the political dynamics in the country (see **Box 1**). Pakistan's public institutions (e.g. PIA, Pakistan Railways, heavy industry, regulators, judicial and enforcement agencies) have been politicized and weakened for several decades. Political patronage has overstaffed PSEs, reduced efficiency and imposed heavy losses on a revenue-strapped government. One must realize that weak public institutions are easier to manipulate and extract value from.

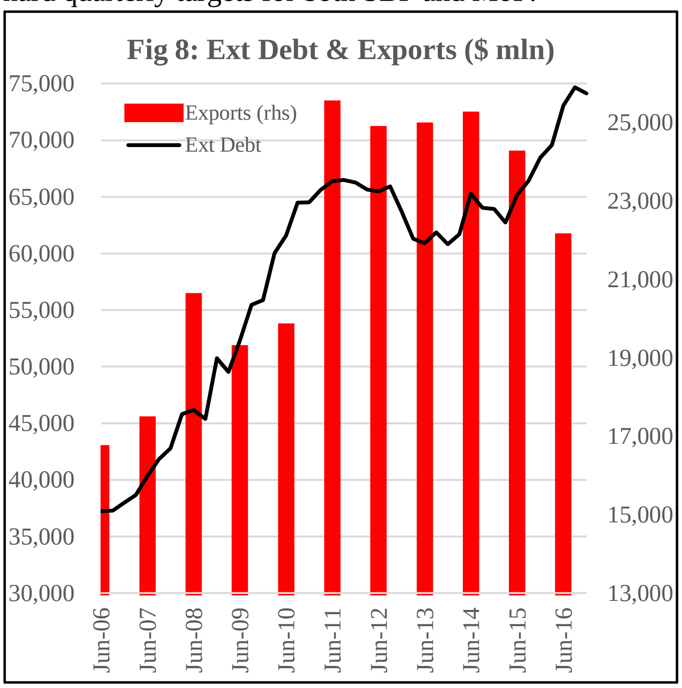
As a result, while Pakistan has been implementing structural reform programs since the late 1980s, there is little to show for it. The undocumented economy continues to thrive and is now driving the formal economy. For the most part, Pakistanis do not accept the obligation to pay taxes, which is a reflection of our tattered Social Contract.

With this backdrop, we argue that if CPEC is to succeed, it requires decisive changes in how our external sector is managed.[10] What follows are a set of assumption and observations that chart out one sustainable trajectory that may unfold:

1. CPEC is a commercial undertaking that is primarily planned by the Chinese government.
2. It entails the immediate engagement of Chinese companies, which will invest in Pakistan in return for a regular stream of hard currency earnings that is repatriated to China.

[10] Subsequent steps are also required on the fiscal side to increase the direct tax net and increase documentation of the economy. However, for any of this to work, the weakness in public institutions and PSEs would have to be addressed urgently. Only then would investors (domestic and foreign) trust the formulation and consistency of economic policies. This check against political interference will be strongly resisted by Pakistan's political class.

3. CPEC will roll-out in stages. As of now, power projects, the Gwadar Port and parts of the Kashgar-Gwadar route are being constructed. This meets the key goals of the two countries: Pakistan needs to upgrade its energy infrastructure (not just more power being generated, but an efficient transmission and distribution system); and China wants to secure a presence at Gwadar port, and to connect Kashgar to Gwadar. We will call the current scope of the project *CPEC-lite*.
4. The full CPEC will require greater foreign investment, which will entail heavier FX outflows in the future. Given Pakistan's BoP outlook, it is not possible to embark on the entire CPEC.
5. We assume that participating Chinese companies are aware of Pakistan's BoP, and will seek sovereign guarantees from GoP. However, given Pakistan's checkered track-record with the sovereign guarantees issues to the IPPs in the 1990s, these Chinese companies may seek *additional* insurance against exchange rate risk (i.e., the possibility that even if the domestic investment is able to generate sufficient PKR revenues, SBP does not have the comfort in its FX reserves to honor hard currency repatriations).
6. We also assume that AIIB provides this FX guarantee to Chinese firms, but at a cost. AIIB could try to price in Pakistan FX risk based on existing CDS rates, but we feel this will only increase the premium it charges, which could make the projects unfeasible. In our view, AIIB would have to intervene more directly within SBP (and perhaps MoF) to manage FX risk parameters, so as to make ongoing CPEC projects commercially viable. This may appear draconian (i.e. foreign interference in sovereign institutions), but we would argue that this is about the same as an IMF program that sets hard quarterly targets for both SBP and MoF.



7. AIIB realizes that the trend shown in **Figure 8** cannot be sustained (i.e., a structural reduction in export revenues that is financed by external sources). In simple terms, Pakistan needs to generate additional FX revenues to service on-going CPEC projects, which means the country needs additional export *capacity*.
8. Given the state of our export sector and the stream of FX outflows that the government has committed to, we assume that Chinese companies are required to upgrade Pakistan's export sector. In effect, CPEC would have to shift its focus to exports, if the project is to be commercially viable.
9. With Pakistan's poor agri yields (for food and non-food crops), the easiest way forward for CPEC is to invest in large-scale farming that is able to address the country's stagnant cotton and food production. In terms of enhancing exports, this could be complemented by setting up large-scale production units to manufacture cotton yarn and gray-cloth.[11]

[11] China's presence in our export sector has several advantages: (1) access to global markets; (2) ability to achieve economies of scale; (3) to move up the value chain in garments and textiles; and (4) improved quality control, manpower training and marketing.

10. These new units could either be green-field projects started by Chinese firms, JVs with Pakistani firms, or Chinese investors buying out existing export capacity in the country. Perhaps the vacuum created by the gradual demise of traditional Pakistani exporters, could be filled by Chinese investors.
11. As further insurance, China could become a committed importer of this additional yarn and gray-cloth, which would increase Pakistan's export revenues. China could use this raw material to set-up value-added textile units in and around Kashgar to help its under-developed Western provinces.[12]
12. Since creating this export base will take time (and Pakistan is already facing a BoP problem), AIIB would have to be involved quite soon to guide SBP in terms of managing Pakistan's FX regime.

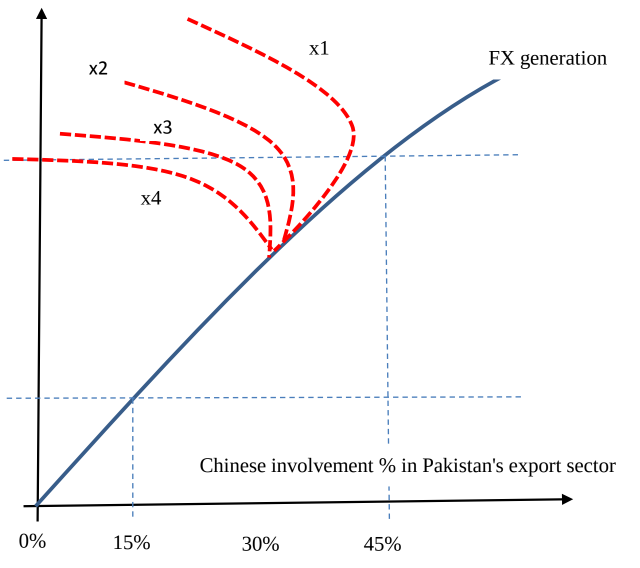


Figure 9

We present this assessment (with hypothetical numbers) in **Figure 9**. On the horizontal axis, we plot the share of Pakistan's export sector that is upgraded using Chinese help (this could include processed foods; low value-added textiles and rice).[13] On the vertical axis, we chart the scale of CPEC that can be serviced (using Pakistan's FX *revenues*) on a sustainable basis – this specifically caters to future FX payments that are linked to CPEC investments. **Figure 9** shows that the greater the scale of Chinese involvement in Pakistan's export sector, the more fully Pakistan can embark on CPEC projects.

The red dotted lines in **Figure 9** show what could happen if a new breed of Pakistani entrepreneurs either set-up new export units (that generate FX), or are able (and willing) to buy-back greater control of the Chinese-managed exporting units. As Pakistani exporters adopt best practices and carve out new export niches, the FX generation curve could shift from x1 to x3. This simply shows that as Pakistani exporters become more efficient and enterprising, they are able to dilute the Chinese stake in Pakistan's export sector. As shown by x4 in **Figure 9**, Pakistani exporters could become effective enough to service the entire CPEC without any Chinese participation in our export sector.

Is CPEC a new East India Company?

There is a lively discussion in Pakistan about whether CPEC is simply a reincarnation of the East India Company. Media reports about guaranteed Dollar returns on CPEC projects, the one-sided compromise between China and Sri Lanka on the Hambantota Port, and anecdotal evidence that cheap Chinese goods are driving out Pakistani producers; have created the view that CPEC will undermine Pakistan's domestic economy. We do not find this plausible for several reasons: (1) China needs perpetual access to Gwadar port for geopolitical reasons and cannot afford to alienate (or subjugate) Pakistan; (2) a comprehensive

[12] Many Pakistanis are dismayed that such plans prioritize China's economy over Pakistan's. This is a somewhat naïve perspective when one considers that OBOR is a Chinese initiative, and its primary goals are to benefit the Chinese people. Partnering countries in OBOR stand to gain from the spillovers – it would be wrong to assume that OBOR (or CPEC) has been designed to help partnering countries.

[13] This excludes cottage industries that produce non-traditional exports (e.g. surgical tools, sports goods, leather products, etc.) and small-scale software developers, which are too small for Chinese investment.

and internally consistent vision of CPEC has not been revealed yet, as reported by a news story in Dawn (Dawn 18th May 2017, Khurram Husain, aka Dawn Leaks 2); and (3) China needs a strong partner in Pakistan to counter the growing ambitions of India in South Asia.

Since the Chinese are long-term planners and have a unique approach to economic development, and with the global world order changing, Pakistan is too geographically important to be exploited. As discussed earlier, the Chinese may have to play a role to strengthen key institutions in Pakistan's economy. One must realize that a country with Pakistan's temperament is quite capable of showing its displeasure to China by shutting down the CPEC artery to Gwadar port. Since Gwadar is a geopolitical play for China, it is unlikely that things could become so soured.

For decades, Pakistan has been trying to solicit foreign investment with little success. The real problem has not been a lack of policy focus, but that foreign investors are not interested in a country unless it has the potential to generate FX revenues – this has always been Pakistan's weakness. With inadequate FX revenues, foreign investors have always remained shy. What needs to be understood is simple enough: only by sustainably increasing the stream of future export revenues, will Pakistan be an attractive destination for foreign investment. CPEC (and China) is no different.

Could Pakistan return to the IMF?

In the past, when Pakistan experienced a BoP problem, it was expected that the issue would be resolved in the form of a stabilization progran with the IMF.[14] This time around, the outlook is clouded by two factors: one, the government is gearing up for election in 2018 and the FY18 Budget is being formulated accordingly; and two, with CPEC taking hold, there are concerns whether the IMF would be as supportive of CPEC as the GoP – and the Pakistan Army – are. Although we do not see the IMF opposing CPEC explicitly, it is likely to caution the government about the pace at which this project is progressing. The point of sensitivity is whether China would appreciate an external agency influencing what is effectively a bilateral investment agenda.[15]

Conclusion

For the sake of brevity, we will simply summarize the main takeaways of this paper.

1. Pakistani exporters appear to be dispirited. The backbone of Pakistan's textile sector (cotton yarn and gray cloth) has buckled with the introduction of micro fiber, and they have not tried to reassert themselves. Many businesses have simply found far more profitable investment opportunities within Pakistan, specifically in real estate and the stock market. Accumulating rebates and a controlled PKR are threatening the more dynamic exporters, who could lose interest in their core business. While seeking higher returns makes sense for individual companies, for the country as a whole, this would severely curtail its ability to import, which would have dire consequences. As discussed, this situation has crept-up on Pakistani policymakers in FY17.

[14] In the macro meltdown in 2008, Pakistan entered into detailed discussions with the IMF during the course of the problem , which resulted in a US$ 7.6 billion 2-year Standby Arrangement (SBA) in November 2008. The external sector problem that started in FY12 was managed domestically, till a 3-year Enhanced Fund Facility (EFF) worth $ 6.6 billion was inked in September 2013.

[15] There is also the political dimension of the advice given by the IMF (a representative of the Washington Consensus) and how the Chinese approach economic development and reforms. As discussed earlier, there is a view that the Asian Infrastructure Investment Bank (AIIB) could become more active in Pakistan via CPEC.

If the government is unable to revive and jump-start Pakistan's exports (which exporters say is almost impossible), the country will have little choice but to slash imports or move aggressively towards import-substitution.

2. Foreign investment will not be forthcoming if the country's FX earnings are not projected to increase (and on a sustainable basis). Borrowing hard currency to shore up SBP's reserves will not be sufficient to give foreign investors much comfort – very obviously, borrowing to repay past debts is not sustainable.[16] CPEC is different, and is perhaps being perceived inaccurately by most Pakistanis. China's interest in Pakistan is not primarily based on its economic potential – China has strategic and geopolitical reasons to implement CPEC. However, this still remains an ambitious agenda for Chinese foreign investment, and not bi-lateral assistance from a friendly country. This explains the confusion surrounding the FX burden of CPEC.
   In our view, historically close ties between the two countries are not likely to soften the attitude of Chinese companies or its government. Pakistan would need to step up in terms of generating FX if CPEC is to be implemented successfully, even if this means letting Chinese companies take the lead in reviving Pakistan's exports. In effect, CPEC itself would have to change and start focusing on Pakistan's exports to make it a more sustainable undertaking.

3. Chronic structural problems in Pakistan's economy have not been resolved despite decades of economic reforms. In fact, during this period, public institutions have been weakened (e.g. regulators, price setting agencies, local governments) and the state of PSEs has deteriorated further (e.g. PIA, Pakistan Railways & Pakistan Steel Mills). Aside from Pakistan's macro weakness, it is unclear whether these institutions could even support the implementation of CPEC. As discussed earlier, *CPEC-lite* is a more likely outcome, which may suit China (a fully functional port at Gwadar and a land-route from Kashgar), but Pakistan may not gain much for its domestic economy. To really benefit from this project, Pakistan would have to restructure its export sector and rebuild its public institutions with a sense of urgency that is perhaps unprecedented.

The confluence of domestic and global factors, has created a perfect storm for Pakistan. The changing global order is playing out in front of us, and Pakistan is in good company with China. However, if Pakistan is to get a seat on the big table, it cannot afford to muddle through as it has for decades. When the current government takes pride in saying that Pakistan will not need an IMF program till 2019, one can imagine the disappointment of the Chinese planners. Pakistan's policymakers need to take stock (and advantage) of the changing global realities – if they don't, the country will be left behind.

[16] Some will argue that the international rating agencies (like Fitch and Moody's) have given Pakistan a positive assessment in recent months, given its rising growth trajectory and the re-entry into MSCI's Emerging Market category. In our view, this may not be sufficient to counter the fundamental challenges that Pakistan's economy currently faces. We also do not expect large portfolio inflows with MSCI, as the domestic market is already pumped up with domestic investors anticipating the external inflows. If anything, market sources expect a correction is due in the KSE-100 index.