Pakistan's Balance of Payments, the IMF & China

Mushtaq Khan & Danish Hyder, September 14, 2017

We have been concerned about this issue since May 2017.[1] Since then, BoP concerns have become a regular feature in the print media. Looking deeper into the issue, we believe there is a sense of false comfort regarding the size of SBP's FX reserves.[2] As shown, SBP's "ample" FX reserves are largely spoken for, which limits the central bank's ability to defend the current PKR parity. In other words, the external deficit is simply too large to be financed by SBP itself.

Clearly, the thinking in government circles is that Pakistan will borrow fresh money in FY18 to shore up its liquid reserves, so that trade transactions are conducted smoothly. One must realize that as an import-dependent country, a large share of Pakistan's manufacturing sector (including our mainstay exports) will not be able to operate effectively if required imports are delayed, or unavailable.

Policy comfort is missing as the government appears to be consumed by political challenges created by the dismissal of PM Nawaz Sharif. A further complication is that the PML-N government is gearing up for elections in mid-2018, and would not want to disturb the economy by adjusting the parity. In this environment, an open dialogue about resolving the external sector issue will be considered inadvisable – it could be used against the sitting government.

There are other signs of despair coming from the government: (1) the U-turn that SBP took with the PKR/$ parity on July 6th; (2) in a rare interview with the media, the new SBP Governor claimed that the current drain of its FX reserves should not be viewed negatively, but seen in the context of a strong economy[3]; and (3) on September 14th, the Ministry of Finance (MoF) rejected the option to devalue the Rupee, opting instead for increasing tariffs on non-essential imports.[4] In our view, as with the cash margins imposed in February, selectively increasing tariffs is not likely to meaningfully narrow the external deficit.

The market has also not been comforted by these events. Given the political sensitivity of addressing this problem head-on, the market is simply waiting for something to happen.[5]

We propose three possible scenarios, which are detailed in **Table 1** (page 8):

- Scenario 1: Delay the crisis till FY19;

[1] Pakistan's BoP: the Calm before the Storm (May 2017). Economics Research Group, Bank Alfalah Ltd.
[2] According to SBP data, its reserves were $ 16.4 bln at end-May 2017 (this is excluding cash holdings against outstanding FCAs mobilized by commercial banks). As of end-May, Dollar swaps with commercial banks were $ 3.9 bln, which means the available amount with SBP is $ 12.5 bln. Taking into account FE-3 placements with SBP by commercial banks, this is a further $ 3.3 bln, which means SBP's unencumbered FX reserves were only $ 9.2 bln. Against this, scheduled sovereign debt payments due in the period June 2017 – May 2018 are $ 7.2 bln. So the remaining balance is just above $ 2 bln.
[3] The Governor also claimed that the depletion of its reserves will stop with a revival of exports, but did not elaborate on what could bring about such a revival.
[4] The three options considered were: (1) a 9% devaluation of the PKR; (2) increasing the scope of the 100% cash margin on certain imports; and (3) increasing tariffs on non-essential imports. The third option was chosen; the reason for rejecting the cash margin option was IMF displeasure that was aired in the last Article IV discussions. This is strange, as the IMF would be equally opposed to increasing tariffs selectively, as this too distorts trade flows. The IMF's proposed solution – a devaluation – was flatly rejected by the FM.
[5] A public dialogue about the external sector may not be in the country's best interest. However, we feel there should be an understanding amongst prominent businessmen about how things will play out. Since we do not see this (and these businesses are the largest importers), it creates an environment where a currency adjustment (when it happens) is likely to be disruptive.

- Scenario 2: Pre-empt the crisis in FY18;
- Scenario 3: Stumble into the crisis in FY18.

Table 2		Scen 1	Scen 2	Scen 3
Balance of Payments	**FY 17**	**FY18**	**FY18**	**FY18**
A. Current Account (1+2+3)	**(12,120)**	**(17,951)**	**(11,666)**	**(9,241)**
1. Good & Services	(30,533)	(35,112)	(28,974)	(27,150)
- Trade Balance	(26,896)	(31,104)	(25,091)	(23,641)
- Merchandise Exports	21,686	21,285	22,575	20,646
* Textile Exports	12,453	11,568	13,381	10,958
- Merchandise Imports	(48,582)	(52,389)	(47,666)	(44,287)
* Oil Imports	(10,607)	(11,425)	(10,221)	(9,845)
- Services Balance	(3,637)	(4,008)	(3,883)	(3,509)
2. Primary Income (net)	(4,755)	(5,543)	(5,293)	(4,782)
3. Secondary Income (net)	23,168	22,704	22,601	22,691
- Remittances	19,303	18,874	18,604	18,468
B. Capital Account	**337**	**391**	**391**	**391**
C. Financial Account	**9,586**	**11,699**	**8,461**	**4,192**
- Direct Investment	2,311	2,445	2,436	2,314
- Portfolio Investment	(234)	629	1,178	(897)
- Others	7,509	8,625	4,847	2,775
D. Errors & Omissions	**251**	**(11)**	**(11)**	**(11)**
Overall balance (A+B+C+D)	**(1,946)**	**(5,872)**	**(2,825)**	**(4,669)**
- Change in SBP reserves	(1,844)	(3,372)	(2,079)	(2,861)
- IMF Account	102	0	746	1,308
- RMB swaps	0	2,500	0	500
SBP Reserves excl. CRR	**16,144**	**12,772**	**14,065**	**13,283**
Import Cover in months	3.99	2.93	3.54	3.60
PKR end period	104.79	105.80	117.30	125.80
Discount Rate end period	6.25	6.25	8.25	10.00

Balance of Payment Scenarios:

Before discussing these scenarios (**Table 1** shows the assumptions and likely implications, and **Table 2** formalizes how the BoP may appear), certain issues need to be clarified:

IMF's willingness to help. As a global lender of last resort, we assume the IMF steps up when Pakistan seeks its assistance. This can also be justified by noting that the role of the Asian Infrastructure Investment Bank (AIIB) is not to stabilize a country facing a BoP crisis. Furthermore, the IMF will resist being perceived as subservient to the Trump Administration, and have to acknowledge that Pakistan is one of its most frequent clients.

Credibility of the projections. What happened in the past is a useful guide in formulating projections (see **Table 3**). Policy inertia and Pakistan's import-dependency, suggests that drastic changes in exports/imports are not likely unless there is a crisis;[6] &

Amnesty Scheme. We have not accounted for a possible amnesty scheme in FY18, which media channels have hinted at. In our view, to announce an amnesty scheme at this point in time is not only unwise (especially after the HBL issue in New York, and the disqualification of the PM, and the corresponding NAB references for money laundering), but would lack credibility with ex-pat Pakistanis.

The key takeaways from **Table 2** are as follows:

Scenario 1 shows what could happen if the government is somehow able to maintain its current policy stance. The goal is to maintain the macro calm and launch populist policies that will help its chances in the 2018 elections. The resulting boost to the domestic economy stokes import demand, which we have shown would increase imports by almost 8% in FY18. To make ends meet, GoP is able to secure a healthy pipeline of fresh borrowings during the course of the year, but the external gap is so large that it requires RMB swaps (from China) to maintain the minimum level of FX reserves. Despite all these efforts, SBP's reserves drop by $ 3.4 bln during the course of the year.

[6] As shown in **Scenario 3**, the 23.5% narrowing of the CA deficit in FY18, is only matched by the disruption in FY09 (FY08 is remembered for the macro meltdown, with policy changes required even in FY09 – see **Table 3**). This reveals the level of upheaval that is possible under Scenarios 3.

Given the government's firm commitment to a strong PKR, and SBP's ability to cajole the market to behave, we give this scenario a 35% probability of being realized.

Table 3: Balance of Payments

$ mln	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Current Account	**(6,878)**	**(13,874)**	**(9,261)**	**(3,946)**	**214**	**(4,658)**	**(2,496)**	**(3,130)**	**(2,795)**	**(4,867)**	**(12,120)**
1. Good & Services	(13,881)	(21,427)	(16,008)	(13,226)	(12,456)	(18,957)	(16,919)	(19,240)	(20,237)	(22,689)	(30,533)
- Trade Balance	(9,572)	(14,834)	(12,540)	(11,452)	(10,427)	(15,652)	(15,355)	(16,590)	(17,267)	(19,283)	(26,896)
- Merchandise Exports	17,301	20,448	19,126	19,680	25,369	24,718	24,802	25,078	24,090	21,972	21,686
* Textile Exports	10,011	10,354	9,776	10,182	13,076	13,068	12,832	13,659	13,540	12,756	12,453
- Merchandise Imports	(26,873)	(35,282)	(31,665)	(31,132)	(35,796)	(40,370)	(40,157)	(41,668)	(41,357)	(41,255)	(48,582)
* Oil Imports	(7,346)	(10,496)	(10,032)	(10,463)	(12,317)	(14,368)	(14,066)	(14,774)	(12,344)	(8,360)	(10,607)
- Services Balance	(4,309)	(6,593)	(3,468)	(1,774)	(2,029)	(3,305)	(1,564)	(2,650)	(2,970)	(3,406)	(3,637)
2. Primary Income (net)	(3,582)	(3,923)	(4,407)	(3,282)	(3,017)	(3,245)	(3,669)	(3,955)	(4,599)	(5,347)	(4,755)
3. Secondary Income (net)	10,585	11,476	11,154	12,562	15,687	17,544	18,092	20,065	22,041	23,169	23,168
- Remittances	5,494	6,451	7,811	8,906	11,201	13,186	13,922	15,837	18,721	19,917	19,303
Capital Account	**304**	**121**	**455**	**175**	**161**	**183**	**264**	**1,857**	**375**	**273**	**337**
Financial Account	**9,972**	**8,131**	**5,632**	**5,097**	**2,101**	**1,280**	**549**	**5,553**	**5,074**	**6,790**	**9,586**
- Direct Investment	5,026	5,335	3,695	2,075	1,591	744	1,258	1,572	915	2,286	2,311
- Portfolio Investment	3,283	32	(1,073)	(65)	338	(144)	26	2,762	1,886	(429)	(234)
- Others	1,663	2,764	3,010	3,087	172	680	(735)	1,221	2,271	4,933	7,509
Errors & Omissions	**179**	**257**	**118**	**(60)**	**16**	**(80)**	**(309)**	**(422)**	**(8)**	**456**	**251**
Overall Balance	**3,577**	**(5,365)**	**(3,056)**	**1,266**	**2,492**	**(3,275)**	**(1,992)**	**3,858**	**2,646**	**2,652**	**(1,946)**
- Change in SBP reserves	3,557	(5,538)	635	4,063	2,225	(4,430)	(4,530)	3,285	4,595	4,661	(1,844)
- IMF Account	(120)	(173)	3,691	2,174	(267)	(1,155)	(2,538)	(573)	1,949	2,009	102
- Exceptional Financing	100	0	0	623	0	0	0	0	0	0	0
SBP Reserves (gross)	15,070	9,539	10,257	13,953	16,614	11,905	7,198	10,509	14,836	19,446	17,550
SBP Reserves excl. CRR	14,275	8,582	9,110	12,958	14,784	10,803	6,008	9,098	13,526	18,143	16,144
Memo Items											
-Import Coverage (months)	6.37	2.92	3.45	4.99	4.96	3.21	1.80	2.62	3.92	5.28	3.99
-PKR end period	60.44	68.17	81.26	85.33	85.94	94.42	98.91	98.91	101.73	104.65	104.79
-Discount Rate end period	9.50	12.00	14.00	12.50	14.00	12.00	9.00	10.00	7.00	6.25	6.25
-π CPI 12-M MA	7.80	12.00	20.80	10.08	13.67	11.01	7.40	8.62	4.56	2.87	3.81
-POL prices end period (Rs)	37.73	55.14	55.71	75.72	94.11	99.69	104.60	109.34	87.12	72.52	81.40
-Ext debt & Liabilities	40,323	46,161	52,331	64,500	66,260	63,683	60,814	63,923	68,452	73,872	77,616*
* March 2017											

Scenario 2 is characterized by an insufficient pipeline of commercial financing, which forces SBP to take corrective steps to preempt a full blown FX crisis. We assume the PKR parity is adjusted in Q2-FY18 in consultation with the IMF, which allows for a calm adjustment to the target rate of 114-115/$. This, coupled with monetary tightening and fiscal restraint, effectively halts the populist policies. With the IMF assumed to be on board in January 2018, and demand management in place, the external deficit is brought down so that Pakistan does not need RMB swaps from China. By year end, the PKR is at 117.3/$, and interest rates have been increased by 200 bps during the course of the year.

Since the current government appears absolutely uninterested in a PKR adjustment, we give this scenario a probability of only 5%.

Scenario 3 shows what happens when Pakistan faces an FX crisis sometime in Q3-FY18. Like **Scenario 2**, the government realizes that it won't be able to borrow as much as needed, but still lives in hope. So instead of taking preemptive steps (like talking to the IMF or adjusting the PKR), the government persists till the FX market unhinges itself. The resulting disruption to the economy is debilitating, and both imports and exports fall – as does economic growth. The CA deficit shrinks by almost 24% compared to FY17, and the 12% projected fall in textile exports, requires urgent steps to rehabilitate Pakistan's ability to export. With the disruption of trade flows, foreign investors exit the PSX, waiting for a better time to re-enter. IMF support is assumed to be higher than in **Scenario 2**, but SBP's FX reserves still end the year at $ 13.3 bln. The PKR ends the year at 125.4/$, and the resulting increase in inflation (and the need to quash import demand) forces SBP to increase interest rates by 375 bps during the course of the year.

Ineffectual steps to reduce imports in FY18 (which clearly will not be appreciated by the IMF, and may not even be effective), suggests that the external deficit will continue to unnerve the market. Hence, we assign this scenario the highest probability of 60%.

Except in **Scenario 1**, we claim that the compulsions of the external sector dominate the aspirations of Pakistan's political class. This means that once the FX market reaches a point of no-return, the pre-election strategy of the incumbent government (and opposition parties) is thrown out of the window.

China figures quite prominently in all three scenarios: (1) Chinese imports have been driving up the country's trade deficit[7]; (2) Chinese investment now appears to be the mainstay of incoming FDI; (3) commercial loans from Chinese banks appear to be the swing factor in FY17 (and **Scenario 1** in FY18); and (4) as shown in **Scenario 1**, the Bank of China's RMB swaps shore up SBP's reserves so that commercial lenders continue lending to Pakistan.

Finally, if China is as serious about ensuring the success of CPEC, as Pakistan is *wishful* about it, the long-term sustainability of Pakistan's external sector should be as important to Chinese policymakers, as it should be for ours. China's investment is just that – a financial investment that imposes an obligation on Pakistan.

China – the X-Factor in FY19

Despite China's growing impact on the external sector, there is much confusion about the precise role that China will play. Some view China as the country's savior, which will use its ample resources to ensure that Pakistan's economy is not disrupted – others fear that Chinese commercial loans (imposed on Pakistan), will only add to the country's BoP worries.

Given this divergence in sentiments, there is a need for clarity about China's relations with Pakistan. More specifically, how will this relationship impact our economy, and what does China expect in return? This need for clarity gains urgency, as many think Pakistan's dependence is shifting away from the IMF (and the Washington Consensus) towards China (and the AIIB). CPEC and Gwadar Port are often cited as proof of Pakistan's re-alignment in the global geo-political order.

To evaluate what could happen with a *longer-term* perspective, we would suggest the options listed below. While a combination of the three options could materialize, the distinction is useful to better understand how China approaches its relationship with Pakistan:

[7] As things stand, Pakistan's trading relationship with China is lop-sided: while Chinese imports accounted for 22% of the total in FY17, in terms of the trade deficit, China accounts for over one-third of the total gap. As CPEC takes hold, this dependency (and lop-sidedness) is likely to increase.

A. China has our back – always. China takes the responsibility to step up and take care of Pakistan whenever it experiences a BoP problem (it effectively replaces the IMF). In view of the external debt burden that already exists, this financing must be a combination of grants and low-cost funding.

B. China treats Pakistan as a purely commercial venture. This means that Pakistan is able to secure FX (from China) to meet its obligations, but does so knowing that this financing will have to be paid back – and in full. Since Pakistan's ability to repay its FX obligations is already strained, this creates two sub-options:

B1: Sell Pakistani assets to China: Without improving the country's capacity to generate FX (not further borrowing), Chinese commercial debt becomes so heavy that the GoP has little choice but to swap this debt into equity. One could imagine a Chinese equity stake in state-owned companies, government land or securing a subsidized lease on Gwadar Port; or

B2: Enhance Pakistan's repayment capacity: In this case, China gets directly involved to ensure that Pakistan is able to create new exports that are primarily destined for China. Given the lop-sided trade flows between the two countries, this may have to be supplemented with import restrictions on Chinese goods entering Pakistan. A good starting point is for China to suggest that the China-Pakistan Free Trade Agreement (FTA) be re-negotiated to give more concessions to Pakistan.

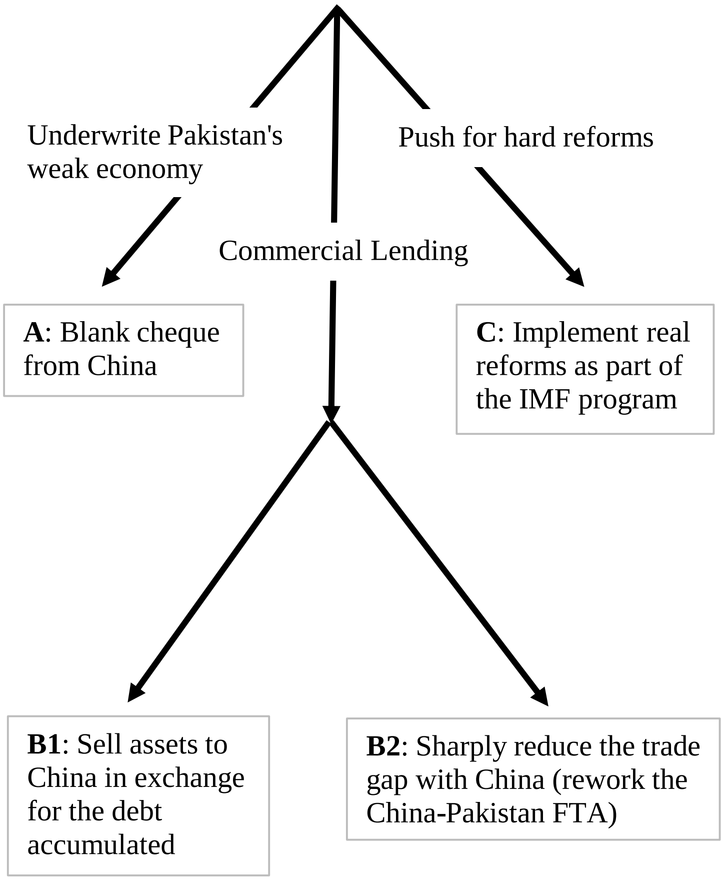
C. China urges Pakistan to get serious with economic reforms. In this option, we assume that China doesn't get financially involved in FY18, but relies on the IMF to put Pakistan's economy on sounder footing (this is shown in **Scenarios 2** & **3**). Unlike the past, however, with the stakes that much higher, China takes a more direct role in urging Pakistan's policymakers to take the hard steps that are required.[8] China will hope that if Pakistan plays it straight and truly resolves the structural problems in the country, it should finally move away from the IMF. This is important, as CPEC's prospects could be hampered if Pakistan again faces a BoP problem, and the resulting stabilization program cannot accommodate CPEC as planned.

The options available to China are shown in **Figure 1**. The table in **Figure 1** shows how different stakeholders would rank the four options. Pakistan Status Quo, refers to the existing mindset of our policymakers: they would prioritize easy access to FX so they need to do little; their least preferred option is to be forced to undertake hard reforms.

A more enlightened policy mindset (Pakistan Reformed), would first make the country self-sufficient (option C). It would view least favorably a blank cheque from China (option A) as this would destroy the resolve and moral compass of the country.

[8] The reason IMF reforms have failed since the late 1980s, is because Pakistan has been half-hearted in implementing reforms that have a political cost (see our December 2016 paper – The Parable of Pakistan and the IMF).

Figure 1: How could China help Pakistan?



	Pakistan Status Quo	Pakistan Reformed	China
Most Preferred	**A**	**C**	**B2**
Preferred	**B2**	**B2**	**B1**
Less Preferred	**B1**	**B1**	**C**
Least Preferred	**C**	**A**	**A**

From its own perspective, China would ideally want to own key assets in Pakistan (option B1). However, it should realize that even if GoP were to sell key assets to China, this could create public resentment in Pakistan, which will undermine the long-term viability of CPEC. Hence, we assume that China prefers a special trading relationship with Pakistan (option B2), over acquiring the crown jewels in the country (option B1). We also assume that China would not want to bail out an undisciplined Pakistan on a perpetual basis (option A). As shown, China prefers to keep Pakistan somewhat dependent on its goodwill (option B2), over making the country self-sufficient (option C).

It is important to realize that option B2 entails a cost on China – cheap Chinese imports into Pakistan (that are hurting local industry) are halted, while policymakers (in both countries) make a concerted effort to ensure they have identified goods that Pakistan can produce, which China needs. In effect, option B2 reveals the largess that China offers Pakistan to create a dependable trading partner.[9]

A final point about these options. Although the four options available to China, have been shown to be mutually exclusive, this is not how things are likely to play out. For example, if China opts for a specific option – say option B2 – this strategy could have elements of option A (occasional cheap loans to help Pakistan overcome a short-term BoP problem), option C (urge Pakistan's policymakers to broaden the tax net; fix the energy sector; restructure loss-making PSEs; and strengthen key institutions), and option B1 (buy certain Pakistani assets, without creating the impression that China is buying out the entire country).

This is in keeping with China's heuristic approach to economic reforms.[10]

[9] This is directed development, which should not be dismissed out of hand.
[10] One Belt, One Road: Building Asia on China's Strength (August 2016). Economic Research Group, Bank Alfalah Ltd.

Conclusion

Pakistan's external sector is again facing a challenge. This time around, most of the blame should be placed on domestic policies, as there were no adverse external shocks (like a sharp increase in international oil prices). Unfortunately, the lack of policy action in the past year, is also understandable because of the forthcoming elections – the incumbent government clearly wants to use the macro stability in FY14-FY17 to win in FY19. Furthermore, Pakistan's strained relations with the US (which could influence its interface with the IMF) and the downward trajectory of remittances (and stagnant exports), suggests that the required correction in the economy, is not going to be easy.

The probabilities we have assigned to the three scenarios, underpin this bleak outlook. One must realize that **Scenario 1** is contingent on fresh borrowing that is sufficient to finance the CA deficit. However, if SBP efforts to curb non-essential imports (e.g. cash margins or selective tariffs) do not narrow the CA deficit as much as they hope – or GoP is unable to secure enough funding to avoid a market panic – the likelihood of **Scenario 1** falls below 35%. What is insightful, is that even if the probability of **Scenario 1** falls, this would not impact the probability of **Scenario 2**; more simply, the government would *still* avoid **Scenario 2** as it would be too embarrassing to adjust the PKR parity after so many statements against it (i.e. **Scenario 2** would remain at 5%). This means the country will end up with **Scenario 3**, as this becomes more likely to happen as the year goes by.

Counting on China to bail us out, is a bit naive.[11] This is not to say that Pakistan's relationship with China lacks substance, or that CPEC is just to show the world that China has "arrived". We would argue that China has a much greater stake in CPEC than its financial investment in Pakistan – access to the Arabian Sea has significant strategic value for China. However, China is a long-term player, and is likely to be quite disappointed with the short-term nature of policymaking in Pakistan. To become a dependable economic partner, Pakistan's economy has to be properly grounded.

In addition to revamping Pakistan's external sector to avoid repeated BoP problems and keep CPEC on track, *political will* is required to reform the country's energy sector, increase direct taxes, and address the utter lack of documentation in economic transactions. A critical starting point is to strengthen key economic institutions, and change the mindset of Pakistan's policymakers.

In our view, China has a role to play in this transition.

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[11] One could see this playing out in **Scenario 3**. An FX crisis would invariably raise expectations in Pakistan that China would step in (and deposit say $ 5 bln with SBP). However, as discussed earlier, this is not likely as China may not be interested in short-term relief, but longer-term structural assistance. In this case, the IMF is likely to step in to stabilize the FX market in FY18, while China would consider deeper trade ties to help Pakistan out (option B2).

Table 1: Possible Scenarios for Pakistan's External Sector

Possible Scenarios:	Impact:
Scenario 1 (Delay the crisis till FY19): • GoP is able to secure a pipeline of fresh borrowings that is large enough to finance the external gap; • However, its needs periodic top-ups from China, in the form of RMB swaps to ensure that its import coverage is above the minimum (there is a risk that if reserves fall too low, pipeline inflows could dry up); • GoP is able to sustain populist policies during the year, shoring up its chances in the 2018 elections; • To retain "market confidence", SBP retains its PKR parity; • Interest rates and inflation remain at current levels.	• The CA deficit increases to \$ 17.9 bln; imports rise by 8%, while exports fall mildly; • The trade deficit increases by about 16%, and the CA deficit is 48% higher in FY18; • The artificial calm in the FX market incentivizes foreign companies to repatriate as much hard currency out of the country as possible (primary income outflows rise by over 16%); • Remittances fall by 2% because of the on-going slowdown in the GCC; • FX inflows that finance the external deficit (the Financial Account), increase quite sharply by 22%. This reflects greater reliance on commercial borrowings, robust Chinese investment in CPEC (FDI), and the sukuk offering (Portfolio Investment); • But these FX inflows are unable to finance the CA deficit; • The Overall Balance increases sharply compared to FY17.[12] A larger OB makes it harder to manage the FX market; • This management requires occasional RMB swaps, which total \$ 2.5 bln for the full year;[13] • Despite this, SBP's FX reserves fall by \$ 3.4 bln during the year.
Scenario 2 (Pre-empt the crisis in FY18): • GoP/SBP realize their pipeline is not enough to finance the CA, and fear a FX crisis; • They start talks with the IMF about a course correction; • SBP adjusts the PKR parity to 114-115/\$ in one shot in Q2-FY18;[14] • The IMF applauds the move, and a formal program starts in January 2018; • SBP further tightens monetary policy in 2H-FY18 to show flexibility and stability; • A further IMF condition is to end populist policies.	• The CA deficit is brought down to \$ 11.7 bln; • Imports only fall by 2% (inelastic demand), but exports increase by 4%; • Remittances slip slightly, as some workers opt for a better rate in the parallel FX market; • The Financial Account is 12% less compared to Scenario 1. This is because GoP is less compelled to borrow; • With BoP assistance from the IMF, and a smaller external deficit, Pakistan does not have to rely on China for RMB swaps; • The PKR parity ends the year at 117.30/\$, while the discount rate is 8.25% to show the stabilization measures that are implemented.

[12] The Overall Balance refers to the CA deficit *plus* the financing available during the year; it shows how the external sector impacts the central bank's FX reserves. In other words, if the country is able to solicit more funding (as shown in the Financial Account) than the CA gap, the central bank would increase its FX reserves. In effect, the OB determines how the country's FX reserves will change during the course of the year, which strongly influences market sentiments.

[13] This refers to a bilateral agreement between China and Pakistan, whereby the two central banks agree to swap their local currencies to facilitate bilateral trade (without having to transact in a third currency). This makes sense as Pakistan's trade deficit with China has increased very sharply in the past several years. In the last four years, Pakistan's trade deficit with China has increased by almost 340% to reach $ 8.9 bln in FY17. Given this imbalance, the RMB held by SBP is drawn down much faster than the drawdown by the Chinese central bank. Since the RMB is almost a hard currency, it is quite valid for SBP to include the RMB swaps as part of SBP's liquid reserves.

[14] In our view, the FX market adjusts to the target PKR rate within hours, but importers may not be convinced that this adjustment is sufficient. Faced with growing demand for $ even at the target rate, SBP has no choice but to use its monetary policy to discipline the FX market. By sucking out PKR liquidity from the market, SBP is able to arrest the rapid bidding war for $s. To meet stabilization goals, *prior actions* are demanded by the IMF: (1) increase interest rates by a further 50 bps; and (2) depreciate the PKR by a further 2-3 % (which means a range of 117-118/$).

Scenario 3 (Stumble into a crisis in FY18): • Despite insufficient fresh borrowings, GoP stays with the fixed parity and its populist policies; • With the persistent depletion of FX reserves, the market forces a change in the parity in Q3-FY18;[15] • In this emergency, SBP stops selling $s except for essential imports. This prolongs the panic; • Pakistan rushes to the IMF for an emergency program; • IMF insists on tough steps and removing distortions in the trade regime (i.e. no multiple exchange rates; no negative lists; no preferred imports); • Pakistan's economy is disrupted in Q4-FY18, but this bring stability.	• The CA deficit shrinks to $ 9.2 bln; • Imports are hit hard, which also disrupts exports in Q4-FY18. The CA shrinks by almost 24% compared to FY17, and economic growth suffers; • With the sharp economic slowdown in Q4-FY18, both the *services* and *primary income* balances narrow (see **Table 2**). This adjustment may not appear commensurate to the declines in goods (exports and imports), but this adjustment is concentrated in the latter part of FY18; • This crisis deters commercial lending to the government, even before the parity is unhinged. This is reflected in a sharp fall in *Others* in the Financial Account; • The BoP crisis is also shown in the net outflows in portfolio investment, despite the successful sukuk ($ 900 mln). This means foreign investors exit the PSX en masse; • This emergency stabilization also means IMF inflows are higher than in Scenarios 2; • As shown in **Table 2**, the PKR experiences a 20% depreciation during FY18, and the discount rate ends the year at 10%.

[15] This could be triggered by a sudden fall in SBP reserves, a negative statement by the IMF, or a market rumor that gains traction.