Pakistan's economic flux is not business-as-usual

Mushtaq Khan, January 7, 2019

Something happened on December 26 that slipped below the radar – the Pakistan Investment Bond (PIB) experienced a sudden resurrection. Other than commercial banks and asset managers, few people take interest in the PIB, especially since the auction of these long-term government securities become dysfunctional in mid-2017.

This paper will focus on two issues: one, what is the policy thinking behind reviving the PIB; and two, what can we expect in the mini-budget that is to be announced in mid-January.

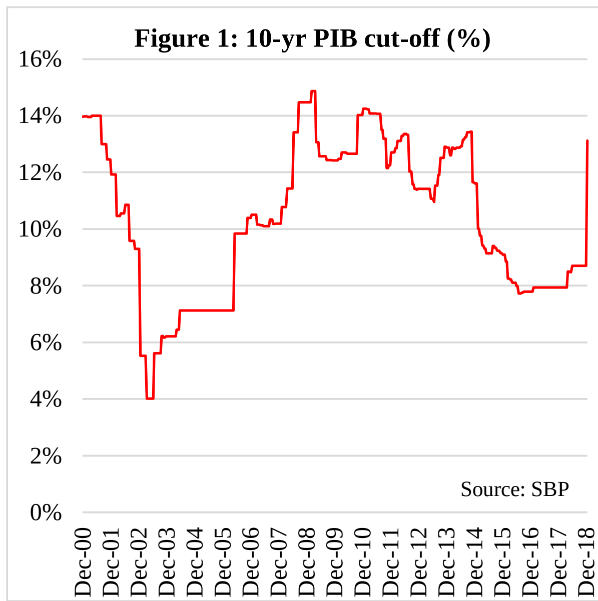
26 December 2018

What happened clearly indicates policy intent. After a string of failed auctions, the 3-year average cut-off yield increased from 7.47% (in the June 2018 auction) to 12.19%; for 5 and 10-year PIBs, the average yield increased from 9.25% (in September 2018) to 12.70%, while the 10-year yield increased from 8.70% (in June 2018) to 13.12%, respectively. The accumulated increase in interest rates was allowed (in one go) to be reflected in the PIB market (see **Figure 1**).

Table 1: Interest rates and the PKR/$ parity

	Discount Rate (%)	T-bill 3-m (%)	T-bill 6-m (%)	PIB 5-year (%)	PKR/$
Jun-17	6.25	5.99	6.01	6.90	105.31
Sep-17	6.25	5.99	6.01	6.90*	105.33
Dec-17	6.25	5.99	6.01*	6.90*	110.30
Mar-18	6.50	6.26	6.01*	6.90*	115.51
Jun-18	7.00	6.76	6.83*	8.48**	121.63
Sep-18	9.00	7.75	7.85*	9.25**	124.24
Dec-18	10.50	10.27	10.35	12.70	139.59

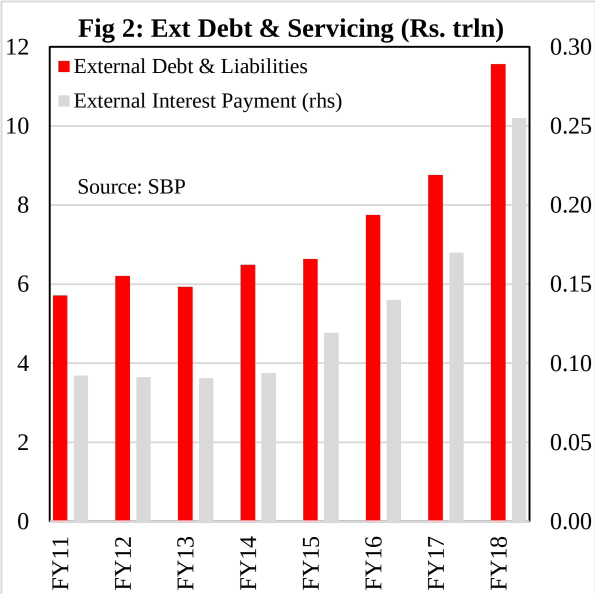
Source: SBP. * carried forward cut-offs. ** low participation

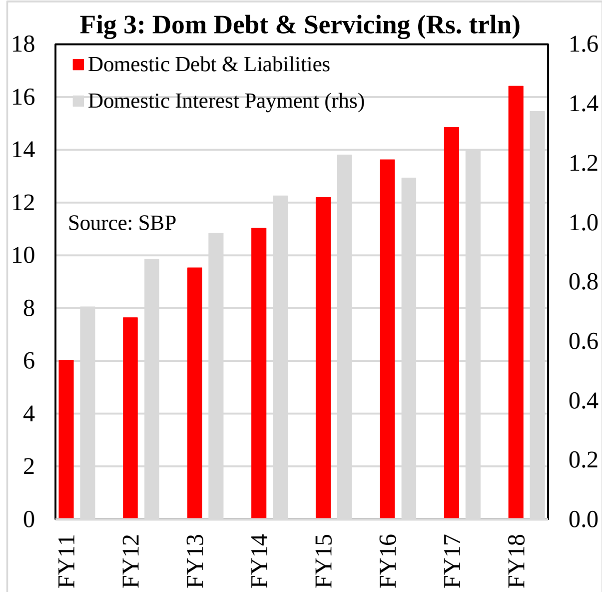


As shown **Table 1**, throughout most of 2018, banks lost interest in all government securities beyond 3-month maturity. Auctions of 6 and 12-month T-bills, and PIBs, received few serious bids which meant that previous cut-offs were carried forward for months.

Since July 2018, Pakistan's yield curve has been lifted up by 350-480 bps, which reflects a 50% increase in the discount rate during this period.[1] This means the debt servicing burden in FY19 will be quite a bit higher compared to the recent past. As shown in **Figures 2** and **3**, the Rupee debt servicing burden is expected to post exponential growth in FY19. The issue is whether this *policy-induced* pressure on debt servicing could further increase the fiscal deficit this year. This raises a simple question: if domestic demand is not sensitive to interest rates (and will not necessarily reduce imports), why the sharp increase in interest rates?

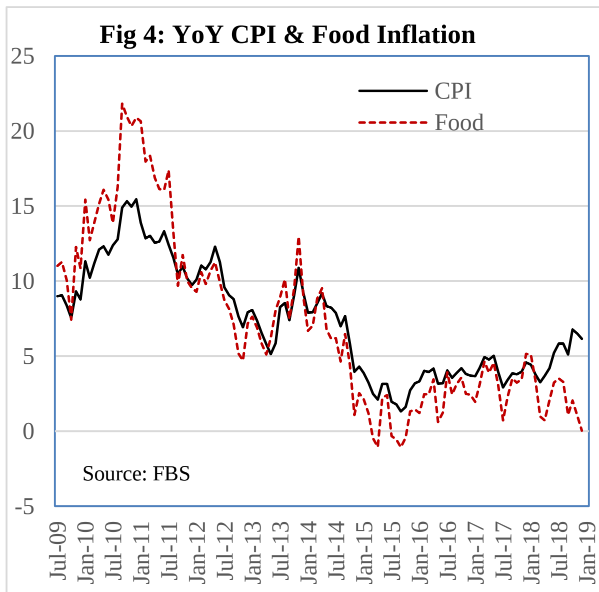
[1] While most people are aware of the sharp devaluation of the Rupee, it is important to realize that in FY19, the PKR has lost 15% of its value while interest rates have increased by 50%.





Inflation is not the reason

The auction results of December 26 are more surprising when one realizes that inflation is much below market expectations. Brokerage houses have expressed surprise at the subdued inflation, especially after the sharp devaluations in the past 6-7 months. This requires an explanation: as shown in **Figure 4**, the slowdown in headline inflation is coming primarily from food, which accounts for almost 35% of the CPI basket. As shown in **Figure 4**, the food sub-index posted zero YoY growth in December 2018. As we have argued in the past, retail fuel prices have a direct impact on basic food items. In effect, the government is using soft oil prices to reduce retail fuel prices, in the hope that this will reduce food inflation and cap headline inflation.



If food inflation remains on this trajectory, headline inflation will continue to surprise on the downside. This can be seen in **Figure 5**, which tracks the YoY growth of the food and transportation sub-indices, and the corresponding change in retail fuel prices. **Figure 5** shows that the trajectory of retail fuel prices and the transportation sub-index is closely aligned, which makes intuitive sense. What is more interesting, is the impact of these two on the food sub-index: as shown in **Figure 5**, the trajectory of fuel and transportation costs does influence the food sub-index. This means the 7% reduction in fuel prices in recent months, should pull down transportation costs in January and dampen food prices. In effect, the surprising softness in headline inflation is likely to persist.

Orthodox economists would argue that to gauge the *demand-pull* pressure that supposedly determines inflation, one must strip out food and energy from the consumption basket. As shown in **Figure 6**, the relationship between headline inflation and the more specialized sub-index (non-food; non-energy –

NFNE) does exist, but is weaker and can diverge for a limited period of time.[2] Having said this, if headline inflation remains low in the next few months, NFNE inflation is likely to taper off.

While the distinction between headline and NFNE inflation is important, two points need to be noted. In an earlier paper I wrote while at the central bank in 2015[3], our findings showed that the PKR parity and retail fuel prices are key determinants of price-setting behavior in Pakistan.[4] So if food and fuel inflation is being managed, this should dampen retail prices across the board. The next point is more important from a political-economy perspective: what really hurts in rising inflation are food and fuel prices, as these are basic necessities that disproportionately hurt the poor and middle class. So by specifically targeting food and fuel, the authorities are using a clever strategy to keep public sentiments in check. In effect, the government is using low oil prices to strike a balance between managing inflation (by cutting fuel prices) and managing the country's oil import bill.[5]

Fig 5: YoY PoL, Food & Transport

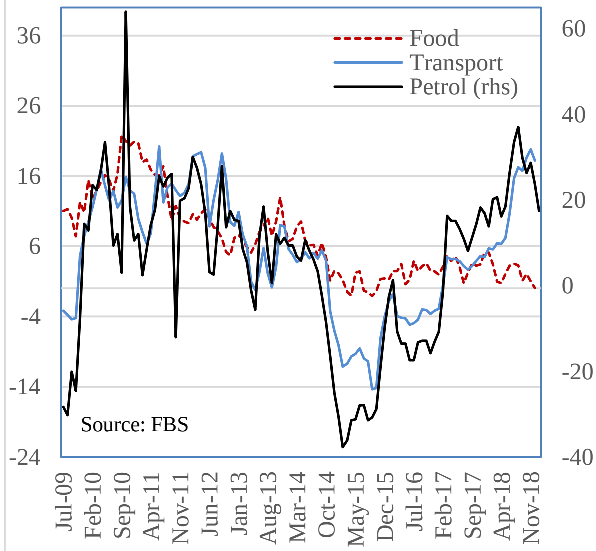
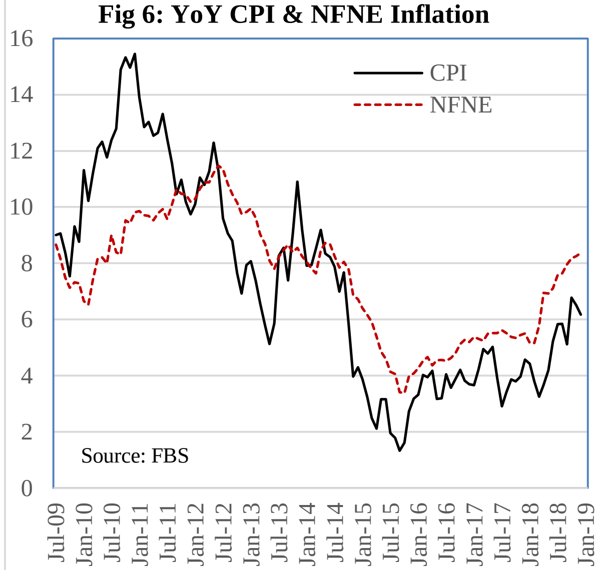


Fig 6: YoY CPI & NFNE Inflation



Why increase interest rates?

With inflation being managed in this manner, the sharp increase in interest rates is primarily driven by the need to manage Pakistan's domestic debt, which has become increasingly short-term. As shown in **Figure 7**, the investment pattern of commercial banks shifted into 3-month T-bills, as the market expected an increase in interest rates. By the start of 2018, banks had started using their maturing funds (from 6 and 12-month T-bills, and maturing PIBs) and placing them only in 3-months instruments. As this played out across the banking system, mobilization became increasingly seasonal, with a distinct 3-month gap (see **Figure 7**). This concentration resulted in a sharp increase in the volumes invested, and has enhanced the interest rate risk for the entire financial system. This complicates macro management, and should figure prominently in the next stabilization program.

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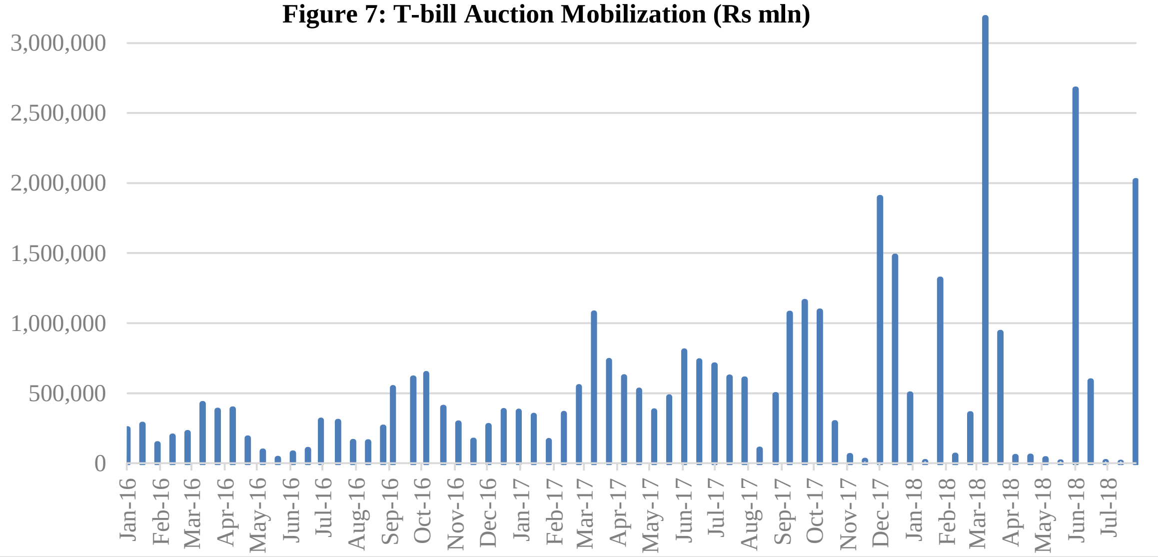
[2] A split is beginning to open up in recent months, as the authorities focus on fuel and food inflation to manage headline CPI.
[3] http://www.sbp.org.pk/publications/staff-notes/PKR-Inflation%20StaffNotes-June%202015.pdf.
[4] This basically means that wholesalers and retailers anchor their pricing decisions on key prices like the PKR/$ parity and retail fuel prices. So even if items are domestically produced and transportation costs are a small fraction of the cost of production, retailers can justify price increases by appealing to the rising cost of living, which is reflected by a weaker currency and fuel price increases.
[5] In terms of orthodoxy, fuel prices should be increased in a stabilization program to narrow the external deficit. However, since the government must manage the twin deficits together, if the currency-driven inflation can be neutralized using retail fuel prices, then policymakers can be more restrained in using interest rates, which will help the fiscal side. In our view, reducing retail fuel prices in December and January will not be a deal-breaker with the IMF.

The solution is to better manage market expectations (regarding interest rates), and incentivize banks into longer-term instruments. However, banks will continue to invest in 3-month T-bills until they are convinced that SBP's monetary policy tightening cycle is over. In our view, this is the goal of the sharp increase in PIB rates in December 2018. By front-loading the interest rate adjustment, the authorities are hoping that banks (and other investors) realize that it is time to get into long-term paper.

Figure 7: T-bill Auction Mobilization (Rs mln)



How could this play out? Clearly the government would like to retain interest rates at current levels, and subdued inflation could justify this policy stance.[6] The issue is whether banks would simply wait-and-see and keep investing in 3-month T-bills. If they do, this would force SBP to again increase interest rates. While this would appear to favor commercial banks, one must realize that banks are increasingly concerned that a further increase in interest rates could create pressures on their balance sheets. More specifically, a further increase in interest rates could: (1) add to the mounting losses on existing holdings of PIBs, especially for under-capitalized banks; and (2) create non-performing loans in the more expensive consumer products, as repayment costs increase while the economy slows. Of the two, the capital losses on PIB holdings is likely to deter SBP from more aggressive interest rate hikes.

If commercial bank participation in the next PIB auction is strong (which is more likely if the IMF program is a sure thing), the 150 bps increase in interest rates on November 30 may be the end of the tightening cycle.

Is a no-IMF option feasible?

One of the reasons the market is still so uncertain about 2019, is the on-going media debate over whether Pakistan should approach the IMF program or rely instead on friends and "homegrown" solutions to get over the BoP crisis. As we discussed in an earlier paper (*Q2-FY19 Macro Projections: The near impossible balancing act*, 3 December 2018), this is a misinformed debate. Egypt's experience in 2016 clearly suggests that getting assistance from friendly countries cannot be the solution to structural economic problems. More simply, financing the macro gaps only provides breathing space, and the

[6] With the discount rate at 10.5%, if average inflation settles in the range of 7-8% by June 2019, SBP's justification to hold rates at current levels is quite strong.

economy will not take real comfort from short-term measures. What is needed are hard steps to reduce both the external and fiscal deficits.

This will not be easy without the policy guidance and endorsement of the IMF. Some have argued that if Pakistan's policymakers somehow develop the discipline to take the same path (as required in an IMF program) but without a formal program, this would uplift Pakistan's sovereignty. On paper it could, but this would create further complications.

To better understand the relevance of engaging with the IMF, one should view this IFI as the world's central bank. In any individual country, the central bank ensures that all licensed banks operate using the same financial conventions and follow certain guidelines. This facilitates interbank activity, which creates a financial web that ties together all commercial entities in the country. It also gives legal/financial recourse if commercial transactions are disrupted. In simple terms, without a central bank, commercial activity would be limited to those commercial entities that use the same bank. This would splinter the economy and severely curtail economic activity within the country.

If Pakistan opts to avoid the IMF, most foreign investors would reconsider the risk of remaining in the country.[7] Without established norms on how to manage the economy, foreign investors would lose confidence about Pakistan's outlook. And it gets worse: even established trading relationships between Pakistani and foreign companies could suffer. Foreign sellers will start looking for other markets for their exports, or seek alternative suppliers for what they import from Pakistan. In effect, disengaging from the IMF is tantamount to disengaging from the global community – it's not about accepting the IMF's *dictation*, but adopting conventions and practices that will allow Pakistan to interact with other countries. The debate about the IMF must be better informed.

What to expect in the mini-budget

The market is keen to know what the Finance Minister will say in the mini-budget. Well into the seventh month of the fiscal year, Pakistan's policymakers have yet to disclose their full year projections for the country's BoP and fiscal accounts for FY19. The growing discontent within commercial circles, implies that the government should address the following issues: (1) the forthcoming IMF program; (2) new revenue measures in 2019; (3) the status of ex-pat Pakistanis; and (4) the economic disruption created by the accountability derive.

1. ***The IMF program:***
   The uncertainty about where the government stands vis-à-vis the IMF, must be settled to calm the markets. As we have argued in the past year, the telltale signs of preparing the country for a stabilization program are clear enough, with the adjustment in PIB rates being the latest.

   We realize that returning to the IMF will be politically sensitive. The opposition will seize the opportunity to gain political mileage, while local media will portray this as a reversal of the government's earlier statements. In our view, the government should broach this issue using the country's growing indebtedness as the theme. This will weave in past economic mismanagement, reckless borrowing by the previous government, and how overcoming this debt burden will require hard steps and some pain.

[7] Without the IMF, the ADB and the World Bank will also stop their operations in Pakistan. Not only does this mean that their financial/technical assistance would stop, but they would eventually also wrap up their operations in the country. For a country facing a significant FX shortage, this is not the direction to take.

While this government is justified in blaming past governments for the poor state of the economy, it must also highlight how the current behavior of people and institutions is exacerbating the problem. More specifically, the government should flag the circular debt problem, and explain its real causes: (1) people & public institutions that refuse to pay their bills; (2) the widespread theft of power; (3) officials who use load-shedding to settle political scores; and (4) previous governments that refused to increase tariffs (fearing a public backlash) without thinking of the burden this would create for future governments. By explain these issues, the government should focus on eliminating the circular debt and signal that loss-making SOEs will no longer be allowed to burden the country.[8]

The government should also remind people that many of them do not pay taxes; hide their wealth; stash their ill-gotten wealth overseas; and use their influence to enhance their personal wealth. With the onset of the IMF program, the narrative on Pakistan's economy needs to change, and blame must be apportioned.

2. ***New revenue measures:***
As a prelude to the next IMF program, the FM would have to announce new revenue measures. This is a decisive moment to spell out the economic path ahead, and the government should raise this issue by asking a simple question: why does Pakistan regularly beg for money from either the IMF or friendly countries? This could build on the earlier theme that Pakistan is now too heavily indebted and has no choice but to take this course of action.

To escape the vicious begging-bowl cycle, the government should state that the strategy on tax non-filers will be further strengthened and strictly enforced. This will be opposed by powerful business groups, but this course of action is justified. The reason Pakistan is always looking for financial handouts is because Pakistanis live beyond their means, and this behavior must stop. The FM should state that non-filers cannot hide from the federal government, and in return, all efforts will be made to simplify the registration process and ensure that tax officials do not harass businessmen. Perhaps a simplified flat tax may be considered at the initial stages, to ensure that all commercial ventures are regularized and documented.

The government could signal its intent by acting on the previous government's Amnesty Scheme. In it, the PML-N government proposed a policy framework to improve the accuracy of all real estate valuations in the country. By using the PML-N's Amnesty Scheme, the PTI government should be able to push back the political opposition. It should also make a simple observation that most Pakistanis save in real estate, and these are grossly undervalued. This allows people to hide their wealth, even if a significant majority of homeowners (and businessmen) have nothing to hide.

To emphasize the need to target non-payers (or non-filers), the government should not increase taxes on captive payers, and instead acknowledge their patriotism as an example for other Pakistanis.

3. ***Expat Pakistanis:***
While the list of Pakistanis with overseas assets has been making the rounds in social media, little has been disclosed about what these Pakistanis must do to regularize their assets. This issue could be addressed by describing expat Pakistanis as a national asset. The message should be clear: expat Pakistanis have significant wealth and should be encouraged to invest part of their wealth in the country. The government should announce a special scheme to regularize overseas assets, and

[8] The government should also use the mini-budget to unveil its plan for loss-making SOEs. It has already revealed that it is not in favor of outright privatization, but instead prefers an interim solution whereby SOEs are taken away from the direct control of line Ministries. These SOEs could be placed in a sovereign wealth fund (SWF) that is professionally managed and free of political interference.

incentivize Pakistanis to bring back their money to the country. Special access to real estate projects, a Diaspora Bond and dollar-hedged Rupee bonds, are ideas that may appeal to expats.

4. ***Accountability:***
   Against the backdrop of the verdict against Nawaz Sharif and his family, and the on-going case against Asif Zardari (and his family), the government should restate its commitment to persist with the accountability drive. Building on its campaign promise to hold people accountable for corruption, the PTI government should state that no one will be spared: from the rich and powerful to the more modest businessmen.

   The government should use the mini-budget to address the growing resentment against the anti-encroachment drive in Pakistan's main cities. The FM should state that his government is not anti-business, but will insist on regularizing all commercial ventures operating in the country. An argument should be made that undocumented businesses are only able to exist by bribing local regulators and law enforcement agents. The government should emphasize how this weakens local governments and undermines the rule of law in commercial areas. It should also state that the anti-encroachment drive is only meant to regularize businesses, and efforts will be made to facilitate their relocation. The end-goal is to change their business model, and ensure that these businesses are registered with the local authorities.

   On a similar theme, the government should state that there will be closer scrutiny of banking transactions, to ensure that money laundering is put to an end. The use of cash and benami bank accounts should be actively discouraged, and banks/regulators should be put on notice that complicity will be severely punished. In our view, this should also satisfy the concerns of the OECD, which have been expressed via the FATF.

To summarize this discussion, the government should use the mini-budget to clarify issues that are undermining confidence in its policymaking. If this is done properly, the government could prepare the country for economic hardship with a sense of hope that the stubborn problems are finally being addressed. While we expect opposition parties to seize upon the economic slowdown to attack the government, if the PTI government puts forward a sincere and comprehensive vision of what it seeks to achieve, the public is likely to accept the hard times that lay ahead. But it is important to show interim results and to keep these economic issues front-and-center in the public eye.

More than just cleaning up

The issues discussed above are like housekeeping tasks – issues that have been raised but not settled. So while some of these issues are necessary to calm business sentiments, and other issues just require clarity, none of the four reveal an economic direction for the country. In our view, the previous two governments did little more than address glaring problems (e.g. the power shortage, shoring up SBP's FX reserves, addressing the mismanagement of public funds, etc.) or launch populist schemes (e.g. the Benazir Income Support Program, public transport schemes in Lahore and Islamabad, etc.). This needs to be addressed.

With CPEC taking root in the past 3-4 years, the PTI government should formulate a more ambitious economic vision to create jobs, train and retool Pakistan's labor force, identify sectors of special interest, and lay out a plan for Pakistan's young population. In a paper we wrote two years ago (*Does Pakistan need an Industrial Policy?* 5 January 2017) we argued that CPEC could become a blueprint for an industrial policy that is championed by development finance institutions (DFIs). We argue that CPEC's original design focused on industrial cities, training institutes for labor, road-rail links, and upgrading our ports and storage facilities. In effect, the goal was to make Pakistan a regional trading hub with an indigenous industrial base.

The PTI government (same as the previous two) has shown that it is committed to CPEC as an enduring partnership between Pakistan and China. We think the mini-budget would be an ideal opportunity to remind people about what CPEC seeks to achieve, and how this could anchor Pakistan's long-term economic growth. By championing CPEC, this government should be able to blunt political opposition and show the world that Pakistan is now looking East.

Concluding thoughts

Pakistan's economy is in flux, but it's not business-as-usual. Many are understandably disappointed that the PTI government has adopted a hesitant – and, some would argue, incompetent – strategy to stabilize the economy. We argue that Asad Umar's team needs to clear up certain uncertainties (starting with the IMF), and show the government's commitment to stay the course with accountability and documentation. In our view, the economic hardship that is currently experienced, while necessary, could be better managed.

The momentum that appears to have taken hold, should shake up the business model that has dominated Pakistan's commercial sector. Businessmen must be told that the old rules of business have changed, and the transition – while disruptive – will create a more robust framework for future growth. In the interim period, Pakistan should be grateful that key friends have stepped up to allow its economy to operate smoothly till the stabilization takes hold. However, the government should not back off from the path it has taken. There will be political and economic disruption, but this is to be expected when such momentous changes are being implemented.

The PTI government should stay the course with accountability and documentation, and formulate an ambitious industrial policy to show what is possible.