Perspective on Pakistan's external sector

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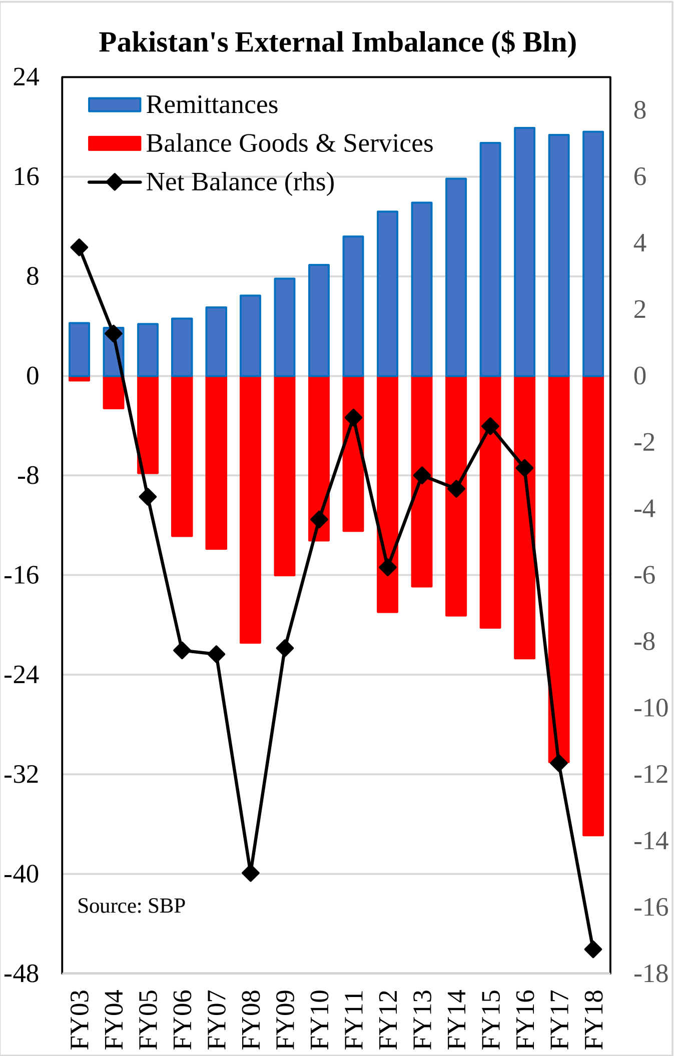
* The discussion about a possible change in the exchange rate regime, was based on the Author’s discussions with Mr Salim Raza (member EAC and ex-Governor SBP).

The argument

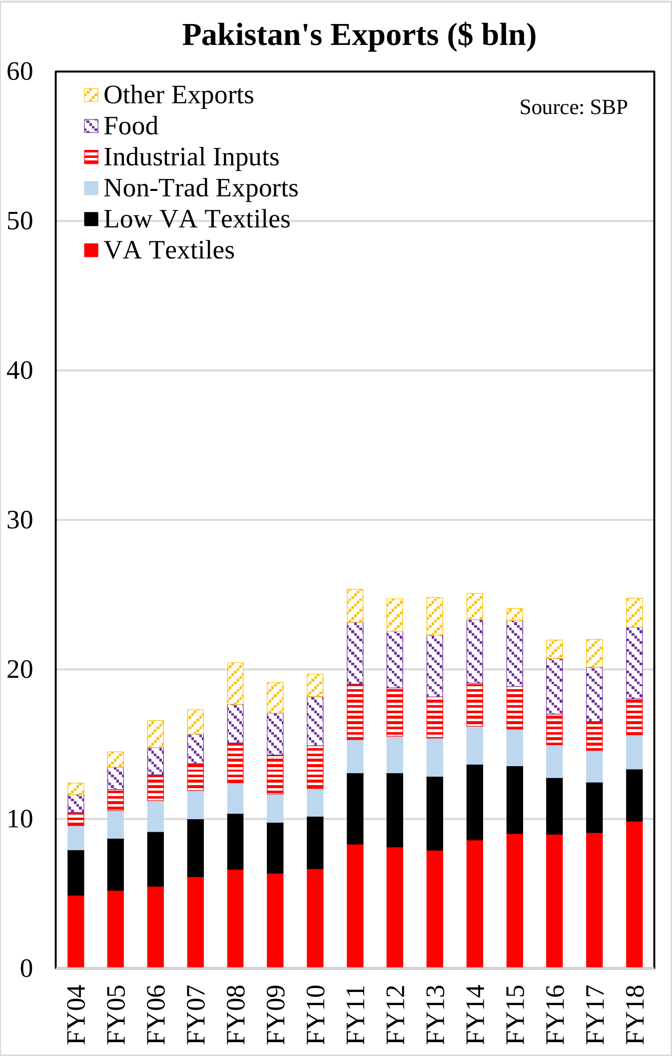
- The BoP crisis first manifested in FY17, and unlike the FY08 economic meltdown that was triggered by record high oil prices, this one is homegrown;
- Since Pakistan's main export is manpower, a better handle on the country's external vulnerability is to look at the Goods & Services (G&S) net balance and add remittances;
  - This reveals the recklessness of ex-FM Ishaq Dar's anti-export policies.
- Corrective steps to stabilize the external sector have not worked yet, which means more is required to change the mindset of the FX market;
- This will be disruptive (via a more flexible PKR), & GoP must ensure that supporting policies are also implemented to ensure results;
- Since the external sector is Pakistan's *Achilles' heel*, targeted policies are required to *structurally* narrow the trade deficit, especially if the country intends to shift back to a growth phase.

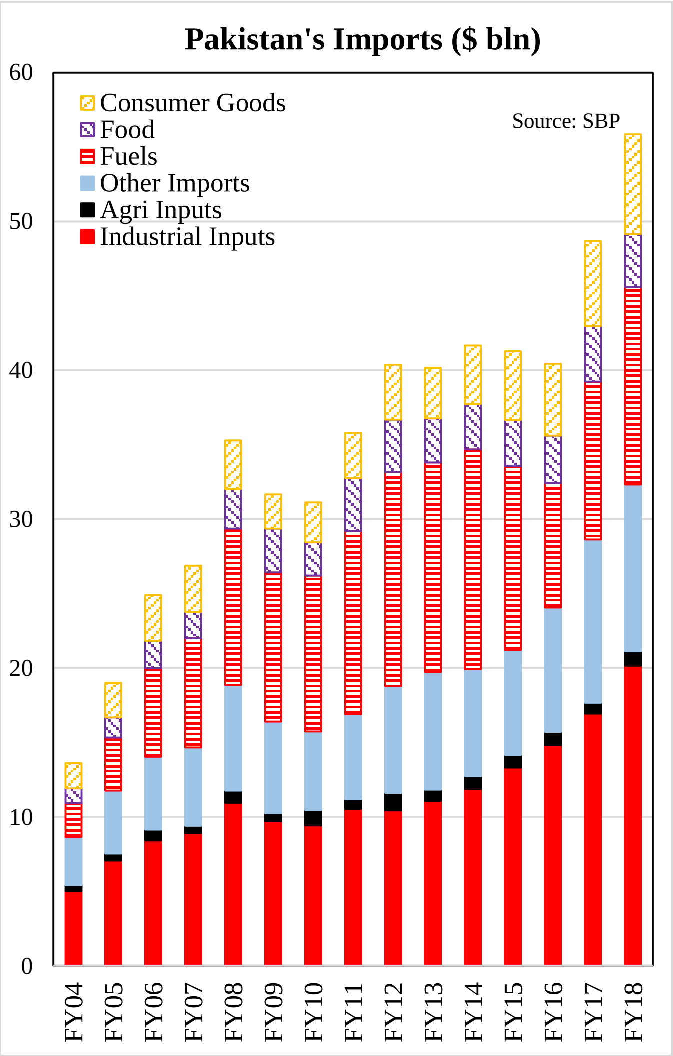
Genesis of the BoP crisis



- Most developing countries run a deficit on services, which is strongly correlated with economic growth;
- The growth years show a widening gap in G&S, even though remittances had plateaued since FY16;
- The consumer-led boom in 2005-2008, and record oil prices in 2008, pushed the BoP into a crisis in FY08. This required an emergency IMF program in late 2008, as did many oil importing countries;
- Net Balance stabilized between FY10 and FY16, after which things fell apart (pro-import/anti-export policies);
- This is not the full picture, as it does not account for the Primary Income balance. Nevertheless, sustainability implies that the G&S balance must shrink by $ 10-12 bln, which is extreme (but necessary);
- In some ways, this is an unprecedented external crisis (perhaps like May 1998);
- GoP has to focus on imports and push hard to increase remittances. This will slow growth, and force the government to change its narrative on the eocnbomy;
- Hard stabilization must be accompanied by a reform agenda that promises a return to better times.

Trade flows (history)





- As shown, exports used to be close to imports. So if you wanted to import, you had to export. This changed as remittances increased post 9/11;
- The fall in exports since FY15 can be traced to the anti-export policy of the previous government;
- Imports only narrowed in FY15 & FY16 because of the collapse of oil prices – not policy;
- Imports in FY17 & FY18 are simply not sustainable;
- Exports have recovered in FY18, but will take time to make the external sector sustainable;
- GoP needs to discourage imports.

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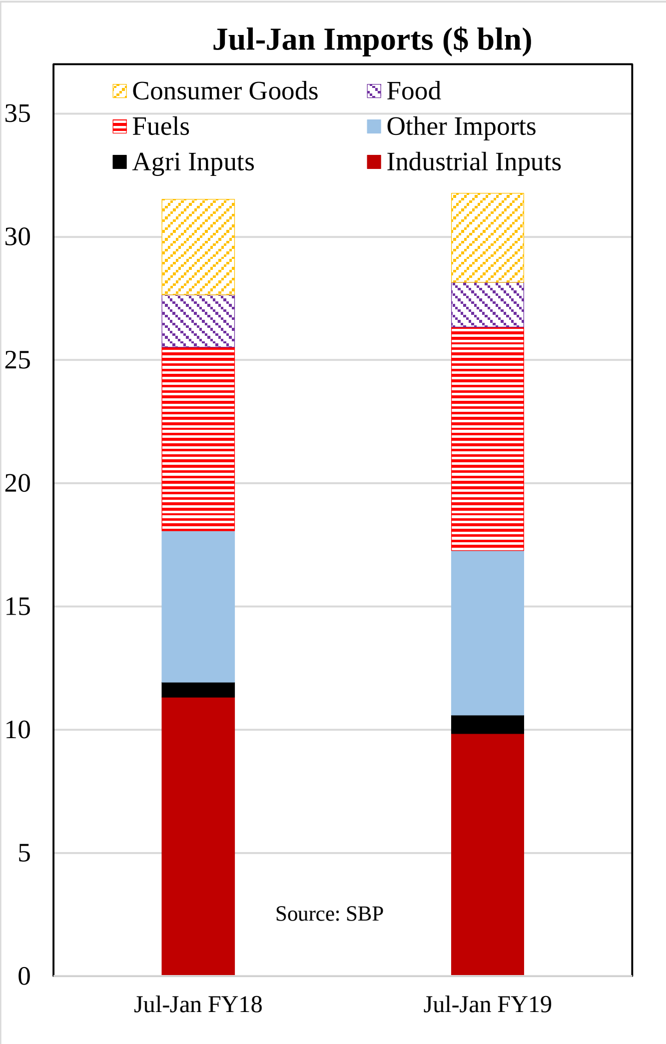
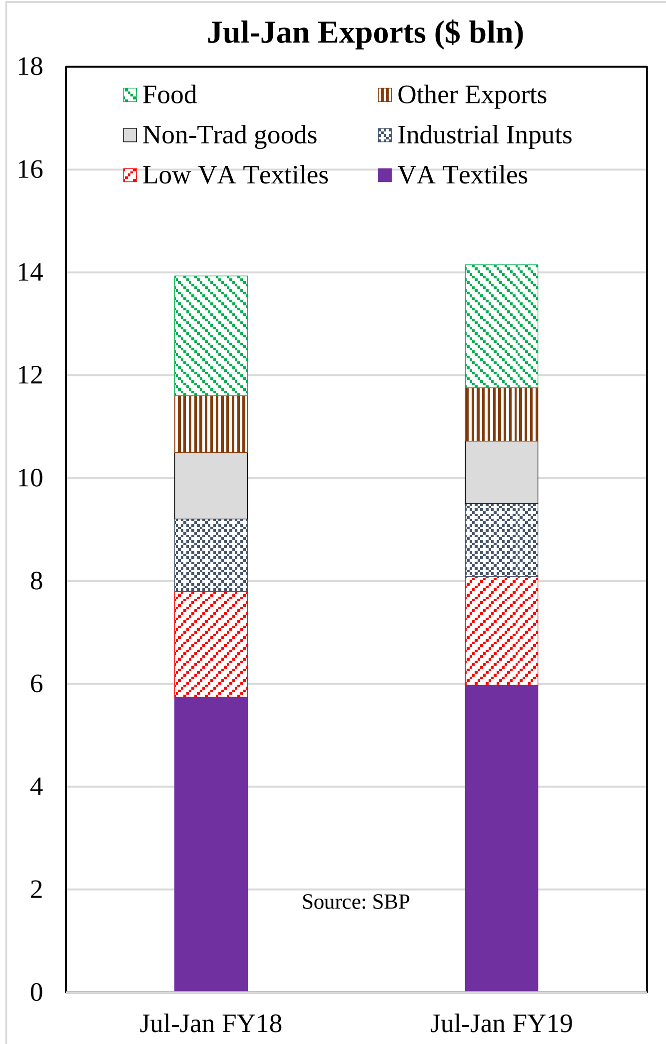
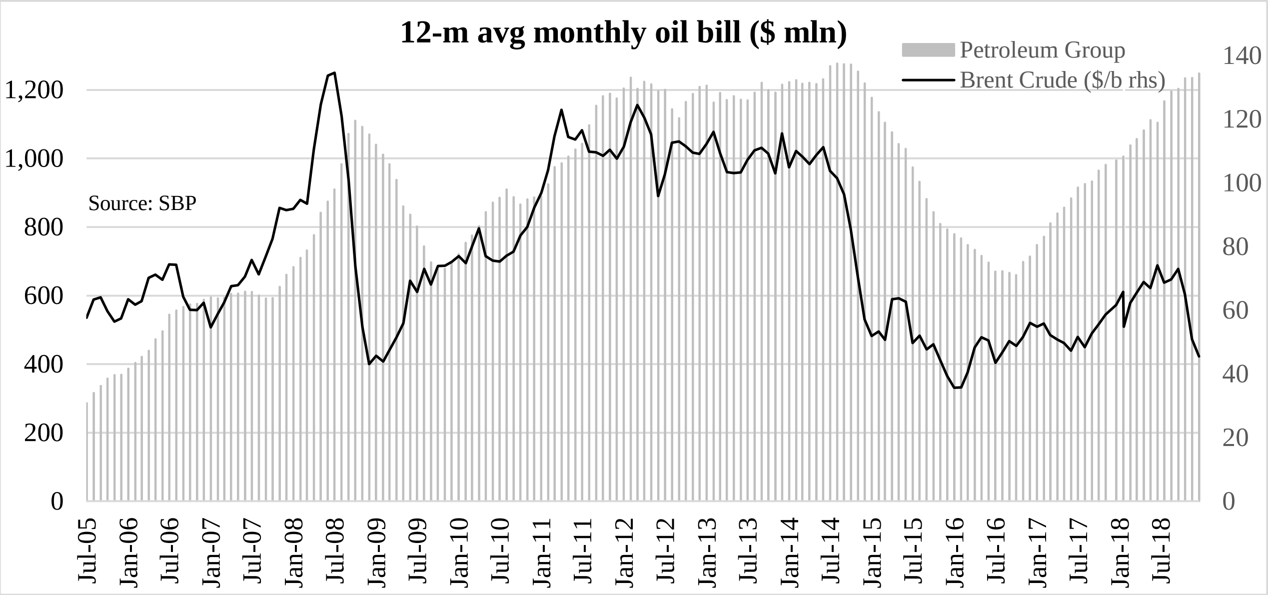
Trade flows (FY19)

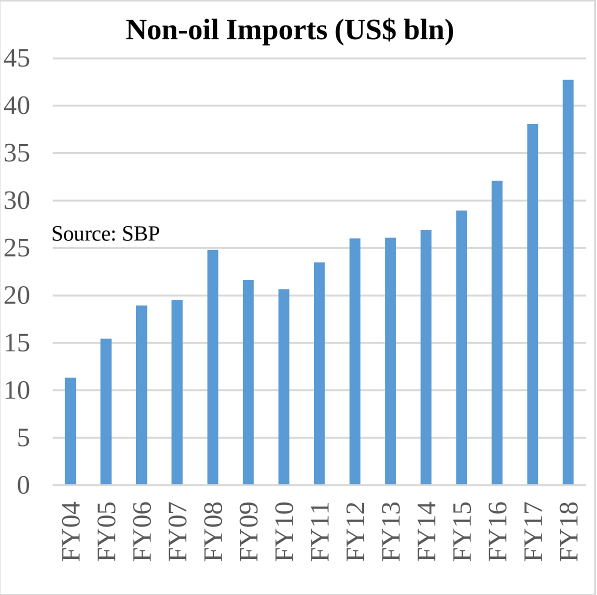




- Not much change in the quantum/composition of exports & imports despite the PKR devaluations and increase in interest rates;
- Trade deficit has actually increased in FY19. A strange *business-as-usual* sentiment despite the on-going BoP crisis;
- Going forward, soft oil prices will narrow CA deficit, but Saudi oil facility is not a solution. Its just financing;
- Despite the political pain, retail fuel prices will have to be increased;
- A gradualist approach will only prolong the uncertainty;
- Hard steps now required, and so is a change in the GoP’s narrative.

Oil is necessary, but not sufficient





- Monthly oil import bill is at the same level as when oil prices were $ 110/b;
- The monthly bill is expected to fall from Feb 2019, but it reveals that the quantum of oil imports has increased. This means the lagged impact of the fall in oil prices will not reduce the country's monthly oil import bill as much;
- GoP therefore needs to reduce non-oil imports;
- GoP's $ 14-15 bln CA deficit target for FY19, is too generous;
- With a fiscal problem brewing, GoP should change its narrative and focus more on stabilization, the need to reign in imports and the forthcoming IMF program.

Rethinking the currency regime

1. Why this is required & what it entails

- To narrow the unsustainable trade deficit, the PKR/$ parity needs to be more flexible and market determined;
- This will create a degree of currency volatility & hopefully sideline some importers. GoP urgently needs to change the expectations and dynamics in the FX market;
- This will also unleash inflation and impose a degree of economic hardship;
- SBP should be committed to a new FX regime, and must be as ***transparent*** as possible to change sentiments and create confidence in the FX market;
- GoP should formulate a new narrative about why these changes are required; &
- To defuse public anger, GoP should announce a holistic economic vision for its remaining term in power (discussed later).

2. How this could be implemented

- Call in the dominant FX players and explain what is going to happen;
- Move towards a two-way dialogue with the market, compared to the one-sided instructions that currently prevails;
- Limit SBP intervention to curb excessive volatility (both ways), but not to target a level. Explain to banks that a degree of currency volatility is expected, and they should manage their client's expectations;
- SBP may adopt a fixed modest budget for FX intervention, and not exceed this limit. If market pressures persist, let the PKR adjust;
- SBP may justify this move as required to meet the IMF's NIR targets, which seeks to build FX reserves;
- Disciplined SBP management in the first few days is ***critical*** as it will anchor the market's behavior. This means SBP must allow for some volatility and actively manage those banks that are creating volatility.

Easing the transition, but staying firm

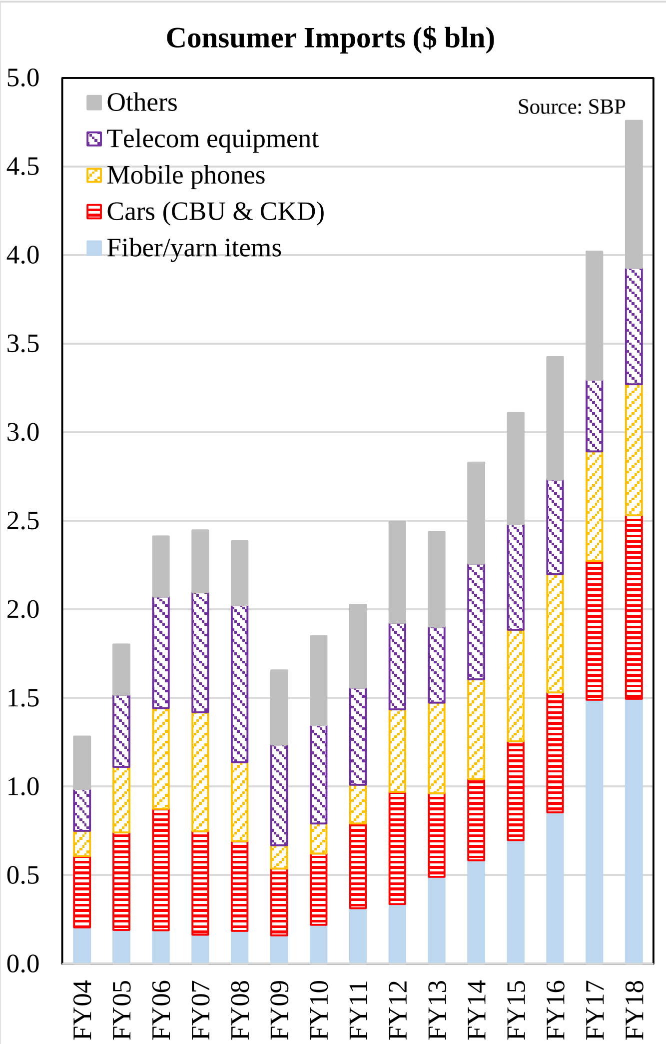
3. Supportive Policies - Signal

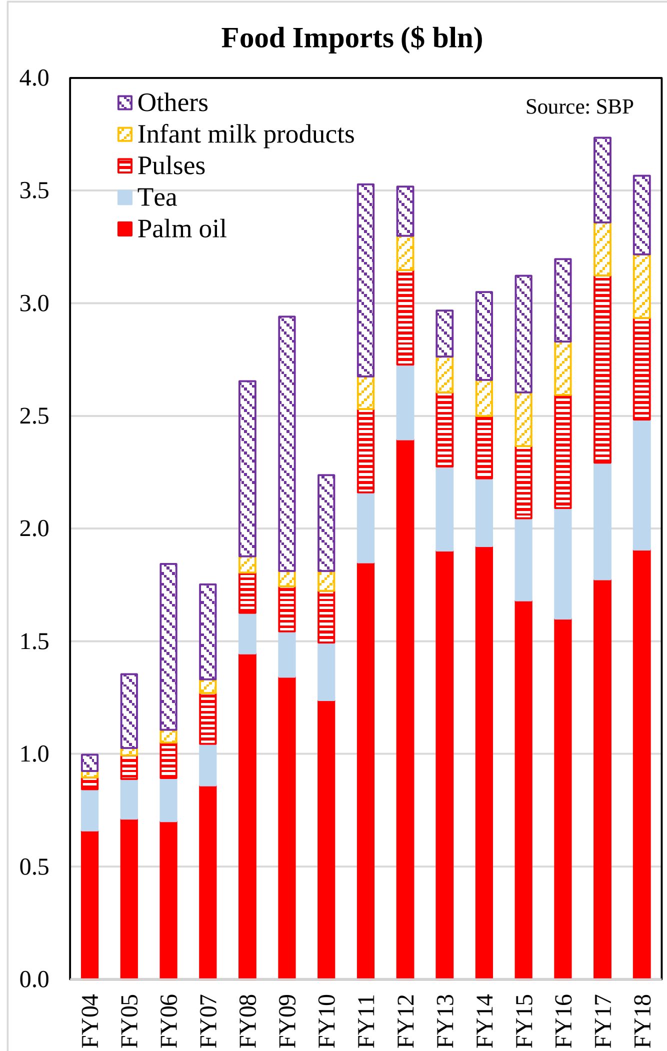
- Sharply increase interest rates as a **temporary measure** to support the floating PKR;
- Closely monitor the activities of the Foreign Exchange Companies by forcing AML, CTF and KYC compliance to bring FECs *at par* with commercial banks;
- SBP could temporarily ban the cash handling of Dollars to discourage Dollarization;
- Announce a comprehensive audit of Pakistan Customs to investigate the extent of over/under invoicing of trade flows (just this threat should help curb corrupt practices);
- Stop the release of containers that are not supported by bank L/Cs to discourage cash imports of luxury products; &
- To even out the impact of the hardship, a symbolic move to halt the import of super luxury items should be considered; &
- Change the GoP's narrative about the economy. State that import containment & export growth are now critical for Pakistan's MT prospects.

4. Commitment to Change

- This change in FX management should not be seen as a temporary measure. SBP should not revert to old practices if its FX reserves become comfortable or the IMF program ends:
  - Must resist the temptation to return to Dar's disastrous PKR policy.
- While disruptive, currency volatility is a necessary part of this transition;
- Strict internal discipline is required to limit SBP intervention:
  - IMF's NIR targets will help keep SBP in check;
  - SBP must categorically avoid talking about a desired level, and also any discussion about the level of over-valuation of the PKR (e.g. REER).
- Any hint of a desired level will push banks to test SBP, which will hurt the transition;
- Future inflows should not influence SBP's FX management. It must remain within its intervention ***war-chest***; &
- SBP must change the manner in which it interacts with commercial banks.

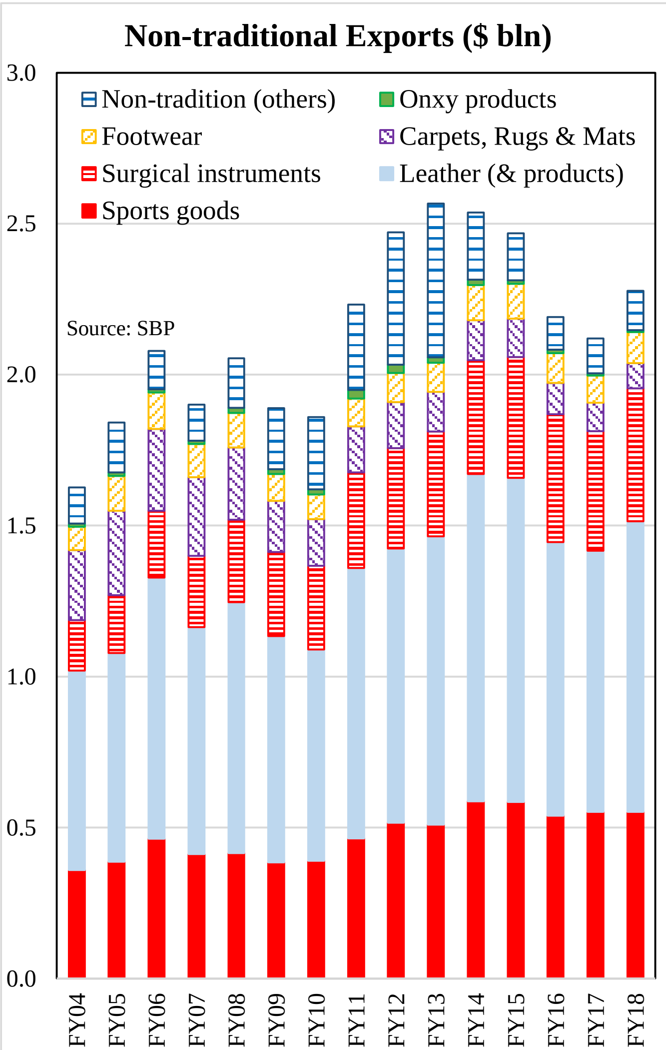
Need to chip away at imports

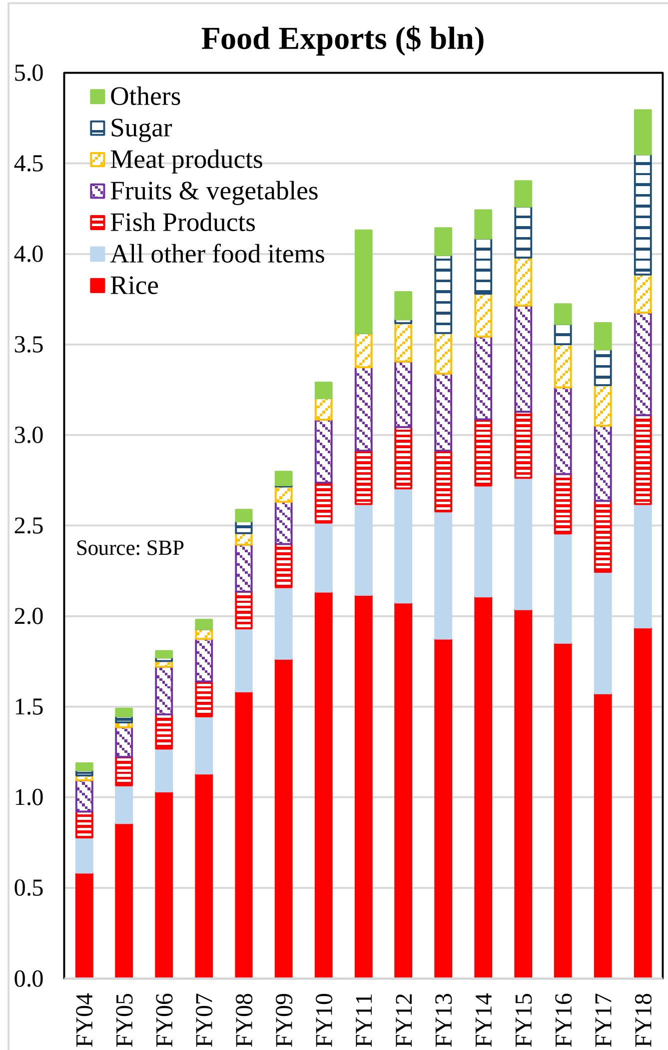




- Consider import substitution for mobile phones, electronics & light engineering goods:
  - This should be part of CPEC and the SEZs.
- Luxury imports should be penalized to signal intent (e.g. clothing, high-end consumer products, luxury cars);
- Food imports should be reduced for national security (esp. staples like edible oil, tea, pulses);
- This could be integrated into a comprehensive Food Policy, which ensures that future BoP problems do not disrupt the country’s food supply chain;
- Dependency on imported edible oil and pulses should be first priority.

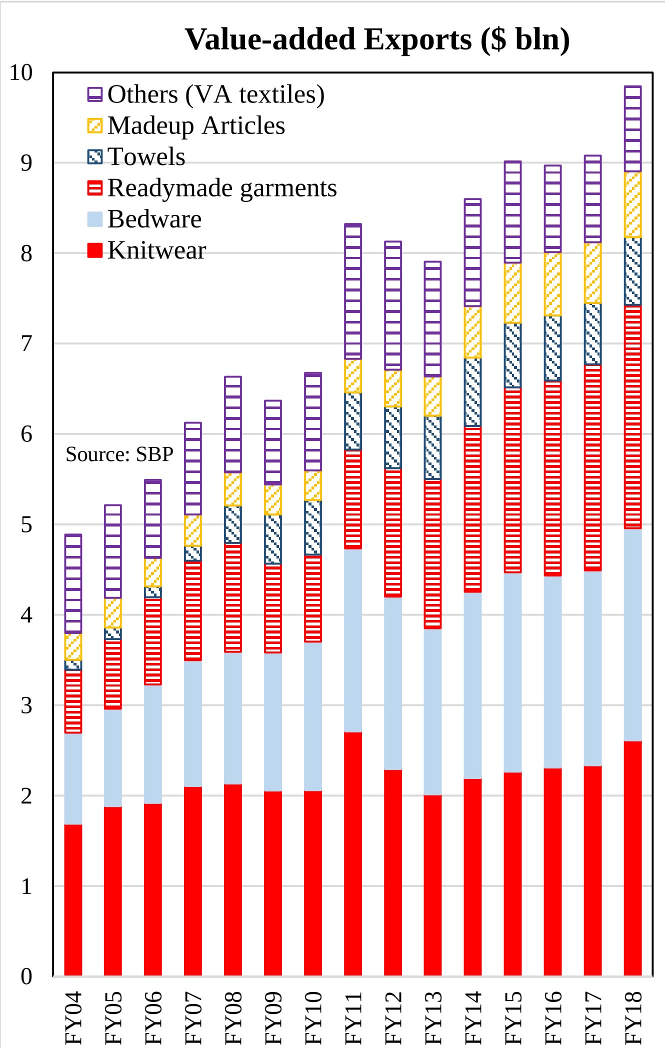
Focus on non-traditional exports





- GoP has ignored exports that Pakistan was once famous for:
  - Onyx; carpets; footwear have fallen since FY04;
  - Surgical tools and sports goods have been stagnant since FY14.
- These are cottage industries that generate jobs & can create niche markets. Policymakers need to reach out to them;
- Food exports have great potential, but should not entail a subsidy to export (e.g. sugar);
- Produce has huge potential, if farmers & livestock managers adopt:
  - Mechanization, focus on yield, document produce, and invest in better packaging & marketing.
- These ideas need proper research to develop them into actionable steps.

Value-added textile exports



- Recovery in FY18 is heartening after the previous government's anti-export policies (FY15-FY17);
- But FY19 only shows a mild improvement over FY18:
  - Must understand exporters' concerns (e.g. energy cost or availability; capacity constraints; issue of competitiveness; obstacles to moving up the VA chain; etc.).
- Supportive policies have been implemented by the PTI govt, but a more rigorous assessment is needed to gauge why previous policies (to enhance exports) have failed;
- Policymakers must evaluate whether the CPEC umbrella could be used to revamp and upgrade Pakistan's textile sector:
  - China has economies of scale in spinning & weaving;
  - China's labor is now more expensive;
  - JVs with Chinese companies that integrate our textile units into China's global supply chain;
  - GoP should discuss how the planned SEZs could focus on exports to the Middle East, Africa & Europe; &
  - The need for training institutions for Pakistani labor.
- GoP should categorically state that CPEC will fail unless its shifts its focus to exports. Both Pakistan & China have a stake to ensure that this mega-project succeeds.

Conclusion

- Remedial steps to narrow the BoP have not worked so far:
  - Soft oil prices will help going forward, but this is not enough;
  - GoP may have to shock the system to change the mindsets of importers & exporters.
- A more flexible exchange rate will create volatility and generate public anger, so this needs to be supported by other policy steps and a change in narrative:
  - This transition will be formalized with the IMF program;
  - PKR flexibility must be supported by other measures that clamp down on $ leakages, Dollarization and corruption in Pakistan Customs. The pain of this transition must be felt across the social divide;
- To manage public opinion, GoP should announce a coherent economic vision:
  - The need to make CPEC export-oriented; an industrial policy that seeks to create jobs and generate exports; a labor policy that focuses on training & welfare (i.e. education, health, housing); a trade policy that goes beyond stabilization; an active role for state-run DFIs; and an agriculture policy that is not politically driven, but focuses on efficiency & protecting Pakistan's food supply chain from price shocks.
- Targeted intervention to increase non-traditional exports, coupled with an element of import substitution (in collaboration with China):
  - Reduce food imports (edible oil, pulses & tea); increase food exports (fresh and processed foods); encourage Chinese companies to set up manufacturing units in Pakistan instead of exporting to us.
- These reforms will be resisted, but GoP must stand firm:
  - PTI's top leadership should return to campaign promises to clean up the system, eliminate corruption, hold people accountable and activate the country's youth; as…
  - Self-serving politicians, the moneyed interests and the bureaucracy are the real obstacles.