Q3-FY18 Macro Projections:[1]

Stepping into the Unknown

Dr Mushtaq Khan & Danish Hyder, January 22, 2018

While SBP is confident that Pakistan will be able to achieve 6 percent growth for the first time in more than a decade, the accompanying twin deficits are gaining more traction with the media. Although general elections are scheduled for 1H-FY19, op-eds focus on the growing uncertainty created by the stand-off between the judiciary and the country's political leadership. Furthermore, a leading opinion-former claims that the growing external threats to Pakistan (from the US and India, not to mention the split in the Middle East) require a strong, unified government, which the current political set-up may not be able to provide.

This adds to the multifaceted uncertainty as Pakistan enters 2018. In an earlier paper (*Could the next IMF program be decisive?* December 12, 2017), we argued that Pakistan has little choice but to approach the IMF. However, Trump's first Tweet of 2018 (stating that Pakistan is not a sincere partner in the US campaign against global terrorism) has created fresh anxiety in the market, as the IMF's willingness to engage with Pakistan has been put into doubt.

We feel the perceived uncertainty is not as debilitating as it appears to be. This is based on three factors: (1) domestic politics will take a backseat in policy formulation, as the country grapples with an impending BoP problem; (2) the institutional history between Pakistan and the IMF should ensure that the IFI will not snub Pakistan's request for help[2]; and (3) there are indications that Pakistan's policymakers have *already* revealed their willingness to enter an IMF program (more later).

Assumptions & Methodology

Unlike most predictive econometric models, our model is not mathematically complex, and will rely on period-specific assumptions about how key policy parameters/prices are likely to play out in 2018. Our primary focus will be on domestic inflation and Pakistan's BoP. This partial analysis means we will not use a general equilibrium model like the IMF's macro-framework (which is used by all central banks). This will allow us to focus specifically on cost factors (i.e. supply-push determinants of domestic inflation), interest rates, and quarterly BoP projections, which will, in turn, allow us to project the Rupee-Dollar parity, and the resulting level of SBP's FX reserves at quarter ends.[3]

It is important to realize that while Pakistan faces many economic challenges (e.g. loss-making PSEs; the dysfunctional power sector that creates a recurring circular debt; dwindling number of direct tax payers; a persistent fiscal deficit, etc.), when a BoP problem develops, it becomes the first (and only) policy priority. This is because a shortage of hard currency implies sovereign default or the inability to import goods & services that keep the economy functioning. So while Pakistan's policymakers can stall (or

[1] This paper is a new offering that will be issued in the first month of each quarter. As stated on our website (www.doctoredpapers.com), this product will only be offered to *Interactive* and *Institutional* clients. To balance the workload between content creation and client interface, we have limited the number of clients we can offer the abovementioned packages to. Subsequent quarterly projections will build on current estimates, in terms of more updated time-series data, and also refining underlying assumptions as Pakistan's macro picture becomes clearer.
[2] *The Parable of Pakistan and the IMF*, December 27, 2016.
[3] This is important as it signals the ease with which SBP releases FX for imports and/or repatriating profits abroad.

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window-dress) fiscal inadequacies, loss-making PSEs, or an inefficient power network, they simply have no wiggle-room when the country runs out of foreign exchange.

The fact that SBP's reserves continue to dwindle, will require a set of actions that are effectively independent of how Pakistan's politics plays out (see **Box 1**). As stated several times in our past papers, SBP's FX reserves are currently *encumbered* – i.e. these Dollars have been borrowed (often short-term) and will have to be paid off soon. This gives SBP very little room to manage the FX market, which means the strict management that SBP displayed since end 2013, is no longer possible.[4]

While approaching the IMF in an election year is politically difficult, this is precisely how BoP troubles in Pakistan dominate other policy/ political concerns.

Box 1: How the politics could play out

1. Pakistan's BoP position is not yet dire, but it's heading there. We don't think Pakistan can continue till end June 2018 without some external "policy guidance".
2. In the current political environment, SBP & MoF are unlikely to upset the status quo unless they are pushed to do so by an external agency.
3. China is unlikely to just give Pakistan a blank cheque, as this will reward reckless behavior.
4. After the Senate elections in March 2018, the current government could announce early elections and resign by end-March.
5. An interim government steps in and has to manage a precarious BoP – it reaches out to the IMF for guidance.
6. Unlike the general consensus, we do not think the IMF will ignore Pakistan (bureaucrats are not Trump fans, and the history between Pakistan and the IMF is too long to ignore). IMF advice is predictable: weaken the PKR; increase retail fuel prices; and if inflation rises too sharply, increase interest rates.
7. Although a formal program is not negotiated (an interim government does not have the mandate), the initial steps of a stabilization program are put into play. There is an understanding that the first line of business of the new "elected" government would be to visit Washington DC, to formalize the stabilization program.
8. Further borrowing is not allowed, as the IMF warns that Pakistan's external debt burden is almost unsustainable. Hence, SBP has no choice but to allow its FX reserves to fall below the minimum 3-month import cover.
9. China informally informs the new government that if Pakistan wants to be an equal partner in CPEC (and the changing global world order), it needs to gets its economy in order, and take hard steps it has avoided for decades. China says the IMF program is a good start, but that it needs to be implemented thoroughly despite the political pain.
10. The newly inducted government blames the mismanagement of the past decade for the need to take difficult steps.

Why Pakistan will do the right thing

We base our optimism on three developments:

1. The pattern of government borrowing from the banking system has reversed in FY18, compared to the year before. The point to note is that during FY17, the government was borrowing heavily from SBP and retiring its debt to commercial banks, but is now borrowing from commercial banks. As in past IMF programs, one of the more binding quarterly targets is to balance the mix of borrowing between SBP and commercial banks.
2. The timing of the PKR adjustment in December 2017, also suggests that the IMF may have nudged SBP to show a degree of policy independence and depreciate the currency (this is understandable after SBP's embarrassing reversal of July 6, 2017[5]). As mentioned in our December 2017 presentation, we feel SBP has temporarily halted the slide in the PKR, for end-year optics. Since the

[4] This hubris in exchange rate management will be ex-Finance Minister Ishaq Dar's enduring legacy.

[5] If one recalls, SBP let the PKR parity weaken from 104.50/$ (to 108/$) and issued a press statement explaining why the change was necessary. The same afternoon, the ex-Finance Minister berated SBP in an impromptu press conference, and threatened to have the Acting Governor of SBP investigated. The next day, the PKR appreciated and settled at 105.50/$.

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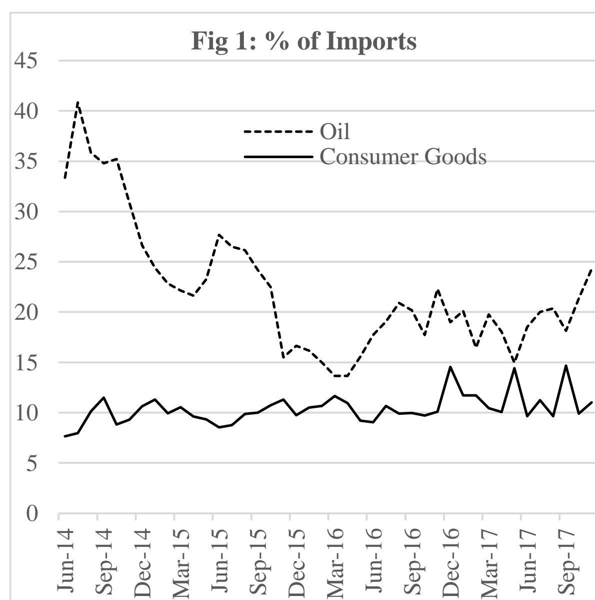
PKR parity is often analyzed with other key variables at the end of each quarter, perhaps the government wanted to stagger the adjustment.[6] If our view is correct, the PKR will again be allowed to weaken in early Q3-FY18, and not later in the quarter. A weaker PKR should reduce imports, which is required on an urgent basis.

3. A final point concerns the Finance Advisor's claim that Pakistan would not return to the global markets till the end of 2018. Volunteering this information, when SBP reserves have again started depleting (and the GoP maintaining a position not to approach the IMF), makes little sense. While some would argue that this hints at additional support from China, we disagree (*Pakistan's Balance of Payments, the IMF & China*, September 14, 2017).[7] In our view, perhaps the IMF informed the Pakistanis that the recent spate of external borrowing was inadvisable, and if it continues on this borrowing binge, the IMF could publically express its dissatisfaction. This alone would kill foreign appetite for Pakistani sovereign bonds.

Our Macro Projections

Our quarterly projections will be based on: (1) seasonally adjusted monthly inflation predictions, which will allow us to take a view on domestic interest rates; and (2) a quarterly assessment of Pakistan's BoP, which gives us a handle on SBP's FX reserves and a Dollar-Rupee parity that is consistent with our BoP projections. This means we need a clearly charted series of events/shocks that will influence these key macro variables.



Our Q3-FY18 projections are based on a very simple assumption: unpopular steps are now required to narrow the external deficit, as the run-rate posted in 1H-FY18, is not sustainable for the full fiscal year. As shown in **Figure 1**, oil and consumer/luxury imports have increased as a share of total imports since March 2016; this needs to be reduced to bring down the external deficit without disrupting the real economy. The trend in oil imports is worrying policymakers, not just because of the recent increase in global prices, but also the strong growth in the automobile sector over the past several years.

The BoP outlook

The main takeaways of this section are summarized below.

Problem:

1. After the collapse in global oil prices in mid-2014, SBP was able to hold the PKR parity and effortlessly build reserves;
2. The GoP shared this good fortune by passing on the windfall by sharply cutting retail fuel prices;

[6] After years of holding the Dollar-Rupee parity at 104-105/$, a very abrupt change in Q2-FY18, and little change in Q3-FY18, would not make for good optics.
[7] As discussed in this paper, while China will support Pakistan's economic revival, it will not do so with a blank cheque. If anything, China has a long-term interest in Pakistan's economy, and will want to ensure that our policymakers do the right thing, and not just make cosmetic changes, which require future bailouts.

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Pakistan's Balance of Payments							**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**		
BPM6	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**	**FY17**	**FY17**	**FY17**	**FY18**	**FY18**	**FY18**	**FY18**	**FY 17**	**FY 18**
Current Account	**214**	**(4,658)**	**(2,496)**	**(3,130)**	**(2,795)**	**(4,867)**	**(1,637)**	**(3,023)**	**(3,211)**	**(4,568)**	**(3,546)**	**(3,867)**	**(3,933)**	**(2,460)**	**(12,439)**	**(13,806)**
1. Good & Services	(12,456)	(18,957)	(16,919)	(19,240)	(20,237)	(22,689)	(6,422)	(7,176)	(7,660)	(9,601)	(8,539)	(8,344)	(8,107)	(7,281)	(30,859)	(32,271)
- Trade Balance	(10,427)	(15,652)	(15,355)	(16,590)	(17,267)	(19,283)	(5,265)	(6,077)	(7,056)	(8,170)	(7,272)	(7,046)	(6,847)	(6,168)	(26,568)	(27,333)
- Merchandise Exports	25,369	24,718	24,802	25,078	24,090	21,972	5,052	5,577	5,677	5,632	5,664	6,112	5,985	6,054	21,938	23,815
- Merchandise Imports	(35,796)	(40,370)	(40,157)	(41,668)	(41,357)	(41,255)	(10,317)	(11,654)	(12,733)	(13,802)	(12,936)	(13,158)	(12,832)	(12,222)	(48,506)	(51,148)
- Services Balance	(2,029)	(3,305)	(1,564)	(2,650)	(2,970)	(3,406)	(1,157)	(1,099)	(604)	(1,431)	(1,267)	(1,298)	(1,260)	(1,113)	(4,291)	(4,938)
2. Primary Income (net)	(3,017)	(3,245)	(3,669)	(3,955)	(4,599)	(5,347)	(992)	(1,426)	(998)	(1,623)	(1,022)	(1,455)	(1,813)	(1,611)	(5,039)	(5,901)
3. Secondary Income (net)	15,687	17,544	18,092	20,065	22,041	23,169	5,777	5,579	5,447	6,656	6,015	5,932	5,987	6,432	23,459	24,366
- Remittances	11,201	13,186	13,922	15,837	18,721	19,917	4,740	4,765	4,600	5,246	4,791	4,955	4,787	5,412	19,351	19,945
Capital Account	**161**	**183**	**264**	**1,857**	**375**	**273**	**82**	**30**	**148**	**79**	**104**	**45**	**0**	**0**	**339**	**149**
Financial Account	**2,101**	**1,280**	**549**	**5,553**	**5,074**	**6,790**	**1,932**	**2,798**	**1,639**	**3,607**	**1,634**	**3,877**	**1,595**	**1,315**	**9,976**	**8,421**
- Direct Investment	1,591	744	1,258	1,572	915	2,286	421	959	538	712	699	678	532	612	2,630	2,521
- Portfolio Investment	338	(144)	26	2,762	1,886	(429)	175	614	(133)	(891)	(98)	2,342	443	178	(234)	2,865
- Others	172	680	(735)	1,221	2,271	4,933	1,336	1,225	1,234	3,786	1,033	857	620	525	7,581	3,035
-Inflows	2,866	3,191	2,939	4,847	4,669	8,191	2,471	2,448	3,108	6,541	2,000	2,244	2,552	2,192	14,568	8,988
-Outflows	(2,466)	(2,215)	(2,900)	(3,709)	(3,659)	(3,479)	(1,259)	(782)	(2,059)	(1,630)	(1,692)	(916)	(1,932)	(1,667)	(5,730)	(6,207)
Errors & Omissions	**16**	**(80)**	**(309)**	**(422)**	**(8)**	**456**	**(100)**	**145**	**(417)**	**550**	**(339)**	**233**	**0**	**0**	**178**	**(106)**
Change in Reserves and IMF Funds	**2,492**	**(3,275)**	**(1,992)**	**3,858**	**2,646**	**2,652**	**277**	**(50)**	**(1,841)**	**(332)**	**(2,147)**	**288**	**(2,338)**	**(1,145)**	**(1,946)**	**(5,342)**
- Change in SBP reserves	2,225	(4,430)	(4,530)	3,285	4,595	4,661	379	(50)	(1,841)	(332)	(2,147)	288	(2,338)	(1,145)	(1,844)	(5,342)
- IMF Account	(267)	(1,155)	(2,538)	(573)	1,949	2,009	102	0	0	0	0	0	0	0	102	-
- Exceptional Financing							**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
SBP Reserves (gross)	**16,614**	**11,905**	**7,198**	**10,509**	**14,836**	**19,446**	**19,823**	**19,653**	**17,844**	**17,550**	**15,442**	**15,764**	**13,426**	**12,281**	**17,550**	**12,281**
SBP Reserves excl. CRR							**18491**	18272	16466	16144	**14,038**	**14,329**	**11,991**	**10,846**	**16,144**	**10,846**
Import Cover in months	**4.96**	**3.21**	**1.80**	**2.62**	**3.92**	**5.28**	**5.38**	**4.70**	**3.88**	**3.51**	**3.26**	**3.27**	**2.80**	**2.66**	**3.99**	**2.54**

Source: SBP. Shaded data in Q3 & Q4-FY18 are our projections.

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3. The resulting fall in inflation (and corresponding interest rate cuts) improved sentiments, and boosted consumption spending;
4. While exports stagnated (but exporters were happy enough making more money in local real estate development than in their core business), imports increased;
5. This increase in imports coincided with CPEC taking root, which pushed the import bill further up;
6. Things started getting uncomfortable for the market in late 2016, when SBP's FX reserves began to slide;
7. This was compounded by the increase in global oil prices starting mid-2017;
8. Instead of taking remedial steps to manage this problem, the former Finance Minister staked his reputation on holding the PKR parity fixed, which meant that the external deficit continued to increase. To get by, the government simply borrowed more;
9. Although the PKR has finally been allowed to weaken in December 2017, further action is required as the current trajectory of Pakistan's BoP is not sustainable.

Outlook:

1. We project that the price increases shown in **Table 1** are able to slow imports and encourage exports. With the projected depreciation of the PKR in Q3-FY18, importers should ease the front-loading that has taken place in Q1 and Q2 of this fiscal year. Furthermore, the heavy import of power generation machinery in FY17 (as part of CPEC) has largely stopped, which means machinery imports in FY18 should ease. In view of these factors, the projected FY18 current account deficit is $ 13.8 bln;
2. According to our projections, remittances are marginally up this year compared to FY17;
3. With heavy CPEC-related imports easing somewhat, we predict FDI flows are marginally lower compared to the previous year;
4. There is a sharp reversal in portfolio inflows to a positive $ 2.9 bln. This is primarily because of the $ 2.5 bln mobilized via the Sukuk/Eurobond in December 2017, but also because of net positive portfolio inflows that have been driving the bull-run in the PSX;
5. We see a paring down of external borrowing in FY18 (*Other Investments* from $ 7.6 bln to $ 3 bln) for two reasons: (1) fresh inflows from IFIs slow as they seek an underlying IMF program before lending more; and (2) commercial lenders are likely to back down when faced with a change in government, and some uncertainty about when the next IMF program will start;
6. This pushes the overall balance to negative $ 5.3 bln, which brings down SBP's import coverage to only 2½ months. This means managing the FX market becomes quite challenging in 2H-FY18.

Table 1: Price Shocks

	Month end PKR/$	Fuel/ltr (Rs) Super
Jan-17	104.7437	68.04
Feb-17	104.7447	70.29
Mar-17	104.7437	73.00
Apr-17	104.7073	74.00
May-17	104.7593	74.00
Jun-17	104.7907	72.80
Jul-17	105.3210	71.30
Aug-17	105.2641	69.50
Sep-17	105.3328	71.50
Oct-17	105.3441	73.50
Nov-17	105.3955	75.99
Dec-17	110.5124	77.47
Jan-18	112.0724	81.53
Feb-18	113.3424	83.68
Mar-18	114.4024	84.93
Apr-18	115.7524	87.36
May-18	116.8924	90.82
Jun-18	118.5624	94.24
Jul-18	119.4424	96.66
Aug-18	120.4924	97.72
Sep-18	121.8124	99.59
Oct-18	122.6624	100.85
Nov-18	123.7424	102.82
Dec-18	124.3924	104.48

The inflation outlook

Table 1 lists key prices that have a significant impact on domestic inflation. The Dollar-Rupee parity is a benchmark that impacts all imported items; retail fuel prices (PoL) on the other hand, directly impact food prices and transportation – both have significant weight in the CPI; PoL is also commonly used by retailers to set prices. While readers are likely to fixate on projected

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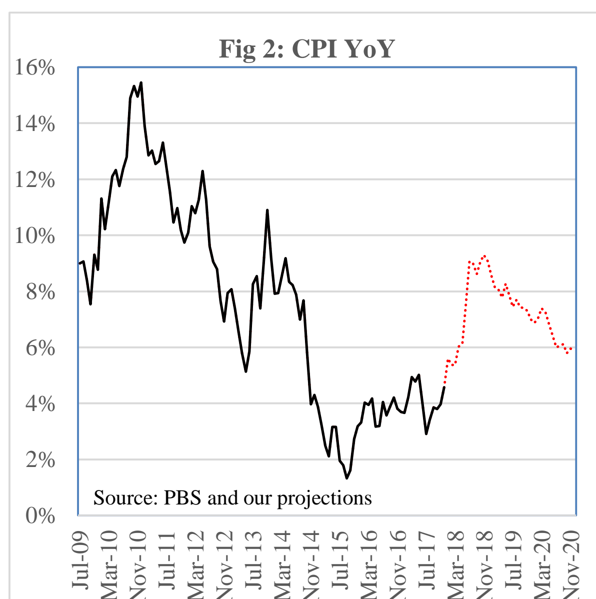
prices (especially the PKR), the point of this exercise is not to call future values of the PKR, but to gauge how a certain quantum of depreciation will impact headline inflation.

The most direct impact of currency depreciation and an increase in retail fuel prices, will be on key sub-indices like food, utilities/fuel, and transportation. The PKR adjustment is required to narrow the external deficit, and to rectify the *real* appreciation of the currency after years of holding it in a narrow range. We assume the PKR adjustment in 2018 is gradual so that exporters do not have to share the currency advantage with their clients overseas.

The increase in retail fuel prices since September 2017 can be traced to the increase in global oil prices. While **Table 1** shows retail fuel prices in Pakistan increasing throughout 2018, this is driven more by the need to contain oil imports (into the country) than a persistent increase in global oil prices. While the global market appears to be reacting to the drawdown in global oil reserves and Russia's decision to cut production, we still feel Brent crude will not exceed $ 70/b as the market fundamentals that have weathered supply shocks since early 2015, are likely to place a cap on oil prices.



Our inflation projections are drawn out to December 2020, to show what the likely steady state inflation rate could be after the shocks in 2018 have had a chance to play out. This means that we have only shocked the system for the 12 months of calendar 2018, and allowed seasonal factors (and some random shocks) in 2019 and 2020 to determine where the various price sub-indices are likely to settle.

Projected inflation:

As shown in **Figure 2**, we see a continuation of the upward trend in YoY inflation, which started in August 2017. As seen in **Table 1**, this is largely driven by the increase in retail fuel prices. The 12-month moving average inflation rate (which is what GoP/SBP focusses on), peaks in mid-2019 as the price shocks of 2018 settle (see **Figure 3**). The point estimates shown in **Figure 3**, show the average inflation rates for the fiscal years FY18 to FY20. So while FY19 will end on a sour note with average inflation at 8.3 percent, as things settle, we expect average inflation to be 7 percent in FY20.

Although it is hard to predict price shocks in 2019 (and beyond), our projections reveal that after Pakistan's macro economy stabilizes, the country is heading towards an inflation rate in the range of 7-8 percent per annum. One must realize that this predictive range assumes that the measures taken in 2018 (to narrow the external sector) are sufficient, and Pakistan's BoP becomes more sustainable in 2H-FY19 (January to June 2019).

The point to note, is that changes in the trajectory of inflation tend to over/under-shoot. This means that policy shocks (PKR and PoL) have an exaggerated impact soon after they are imposed, and it takes a period of time for things to settle down.

Figure 3 has some interesting insights about the sharp fall in inflation between July 2011 and July 2013, and again between July 2014 and January 2016. The point of discussing these periods is to create a sense

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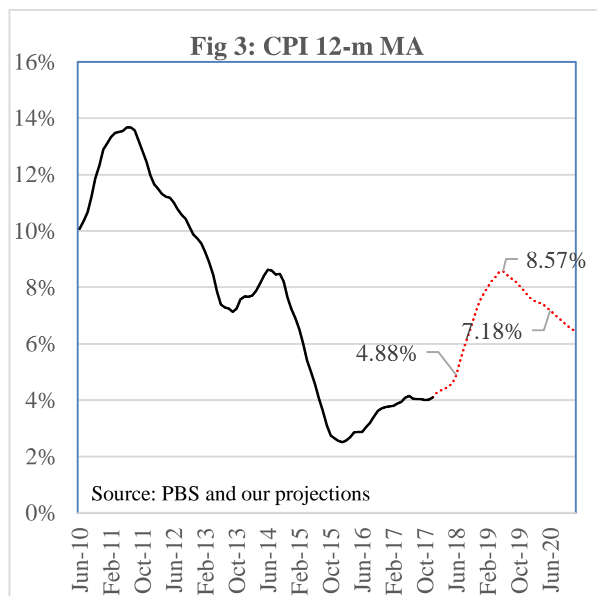
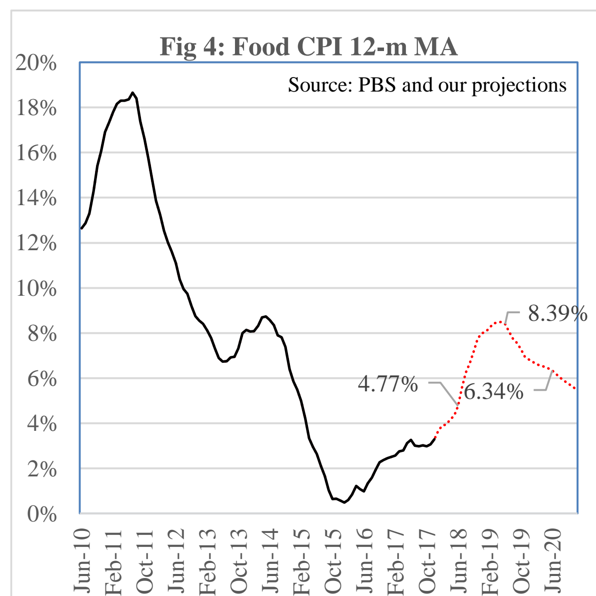
of how inflation rates can change quite sharply, and how just one factor could overshadow others in driving the inflationary trend. For example, during 2011-2013, although the PKR weakened consistently during the period – and retail fuel prices reflected this adjustment – inflation still fell. In the second period, just the fall in retail fuel prices and a stable PKR, created an equally strong disinflationary environment.

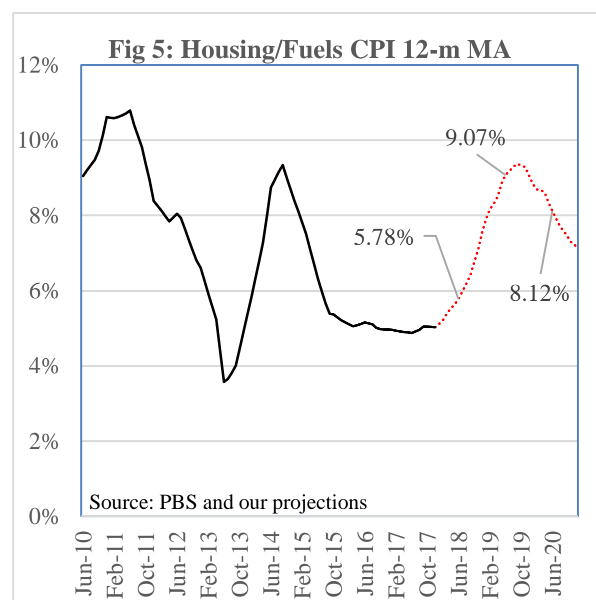




July 2011 to July 2013: The sharp fall in inflation from 13.7 to 7.3 percent, was primarily driven by food inflation, which had peaked at 18.7 percent in July 2011 and fell sharply thereafter (**Figure 4**). This also shows how powerful the base effect can be in exaggerating the fall in average inflation rates;

1. This same trend is visible in housing/fuels during this period (**Figure 5**), which has a weight of 29.4 percent in the CPI basket; &
2. There was a mild downward trend in transportation in this period (**Figure 6**).

It is interesting to note that during this period, oil prices were well above $ 100/b, and both PKR/$ and PoL prices increased. Hence, the sharp fall in headline inflation can be traced to food prices, and a very strong base effect. In 2018, both the base effect and the increase in month-on-month inflation (by sub-indices) will create an accelerated upward trend in inflation, which will be fully felt in FY19.



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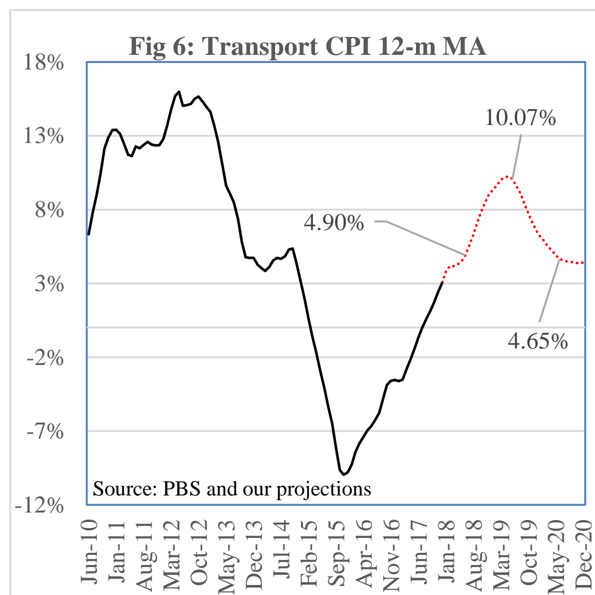
July 2014 to January 2016: During this period, headline inflation fell from 8.6 to 2.5 percent per annum. Food, transportation and clothing, factored heavily in driving the index down. The following points are noteworthy:



1. The PKR was strictly managed and only weakened by 6.3 percent, compared to the abovementioned period, when it lost 18.4 percent of its value against the Dollar; and
2. Retail fuel prices fell very sharply, posting a fall of 30 percent till end January 2016, and a 42 percent fall till end March 2016. This boosted public sentiments and did not allow the average retailer to increase prices as they had become accustomed to doing. What is even more significant is that global oil prices fell by about 72 percent during this period, which allowed SBP to effortlessly manage the PKR-parity and simultaneously build FX reserves, while the government happily reduced PoL prices to dampen inflationary sentiments and lower interest rates.

Compared to the previous episode (2011-2013), this sharp fall in inflation was driven primarily by oil prices. As we have argued in past papers, the macro stability the country enjoyed in 2014-2016, can be traced (ultimately) to global oil prices that were passed on to retail customers.

Looking ahead:

Pakistan's policymakers have few options but to reduce imports while being cognizant of the growth momentum in manufacturing – this means a weaker PKR and higher PoL prices that will increase inflation, but not stall the real economy. This will not be a popular policy choice, but without significant inflows of fresh hard currency in the remaining part of FY18, there really are no good options left.

This return to a higher inflationary trajectory should not be viewed as abnormal – if anything, we would argue that the low inflation we have seen in the past two-and-a-half years has been abnormal. Already we are witnessing an upward trajectory in inflation for food, transport, education, restaurants and miscellaneous items. Concerns about a weakening Rupee, a loose fiscal policy before the general elections, and a low inflation base, are beginning to change inflationary expectations.

More fundamentally, countries experience high inflation rates because of structural weaknesses in their economies. A persistent current account deficit should result in a weakening currency and imported inflation; while a weak fiscal system (persistent deficits) creates rising levels of government borrowing (both external and internal), which should push up interest rates and squeeze development spending – the latter results in lower economic growth. Money supply growing faster than the real economy lays the groundwork for sustainable high inflation. A final point can also be made: with low FX reserves, the central bank does not have the buffer to shelter local consumers from price shocks, which we know will stoke inflationary expectations.

The upshot is that unless Pakistan can credibly tackle its structurally weak economy, it will have to live with high inflation.

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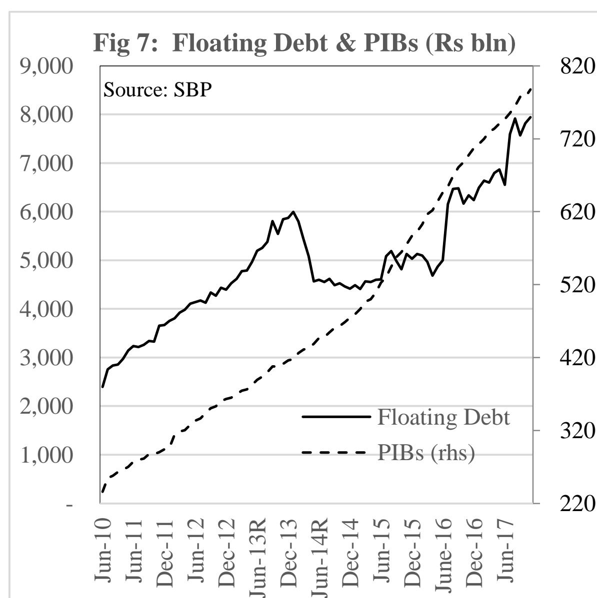
The interest rate outlook

Since the market associates interest rate movements with the inflation trajectory, and our projections suggest that the average inflation rate for FY18 will be 4.9 percent, we do not see an increase in interest rates in FY18. Inflation would still be within the government target for the year (5 percent), and arguments could be made that the real interest rates in the country are in the range of 3-4 percent, which is deemed safe. It would also be a difficult step to take as SBP appears quite confident that real growth could achieve the coveted 6 percent benchmark that was set at the start of the fiscal year.



Furthermore, as shown in **Figure 7**, Pakistan's market debt has been increasing rapidly since mid-2015, while benchmark rates have been held steady since mid-2016. A premature increase in interest rates would put immense pressure on the fiscal side, as it would complicate fiscal management and could result in a sharp curtailment in development spending. In our view, the IMF would be willing to let interest rates stay steady for the remaining part of FY18, instead focusing on the external sector.

What happens in FY19 is a different story. Our projections show a steep increase in inflation next fiscal year, which may coincide with an IMF stabilization program. Since the average inflation rate is projected to increase from 4.9 to 8.6 percent during the course of FY19, we would predict a staggered 100-125 bps increase in the discount rate in FY19. While program negotiations will determine the timing of the rate increases, the manner in which it will be implemented is pretty straightforward as discussed below.

Over the past several years, SBP's one-sided injection of liquidity into the money market has allowed banks to lend to the private sector and also lend to the government (so instead of mobilizing customer deposits, banks would simply bid for SBP-generated liquidity). This artificial liquidity has also allowed SBP to keep interest rates low. In response, the IMF would simply have to state that the outstanding volume of open market operations (OMOs) should be brought down during the course of the program. This will automatically increase money market rates, which banks will use to bid up T-bill yields. GoP will not be able to keep rates down, as the IMF is also likely to insist that government borrowing must move towards banks to make interest rates more reflective of the supply and demand for credit.

Conclusion

From our projections, it is clear that 2018 will be a transition year for Pakistan. The external sector requires urgent attention, and the steps that need to be taken will increase inflation and interest rates. We also envisage an IMF program sometime in Q1-FY19, and believe that this economic urgency will trump political developments (which at this point appear very chaotic and uncertain).

While the structural weaknesses in the external and fiscal sectors will push Pakistan into a higher inflationary trajectory for the next several years, we also think the next IMF program could be a turning point for the country. Changing geo-political realities will force Pakistan's policymakers to be more sincere in addressing the economic challenges. The next government (whatever its composition) will

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have to tackle sacred cows like documentation, addressing the undervaluation of real estate, political interference in regulatory agencies, restructuring the power distribution network, fixing PIA and Pakistan Railways, and forcing wealthy individuals into the tax net. We also see an export-focused CPEC being revealed soon, which will create more goodwill for this undertaking.

To summarize our thoughts, while the loss of macro stability will create uncertainty and require careful management, this transition was long overdue. The past economic calm was primarily because of the sharp fall in global oil prices, and although we do not see oil prices spiking to previous highs, the looming BoP crisis will force policymakers to focus on the real problems that have been ignored during the past 3 to 4 years.

That alone is good news.

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Appendix: Necessary reforms beyond managing the BoP

While some steps have been taken to narrow the external deficit, more is required. Policymakers will also begin discussions about sequencing other policy changes to support the recovering external sector. This would include: (1) broadening the direct tax net to reduce aggregate demand; (2) accurately documenting all commercial transactions, so that policymakers have a policy handle on household wealth; and (3) restructuring PSEs to reduce the fiscal burden they impose (e.g. the power sector, PIA and Pakistan Railways). Most significantly, point 2 entails the proper valuation of real estate in Pakistan, which is grossly undervalued and may constitute the largest single repository of (untaxable) Pakistani wealth.

While these measures should help reduce imports, it is also important to consolidate the scope and pace of CPEC-related projects, so that the FX liability that has been created, can be sustained from SBP's FX reserves. As discussed in an earlier paper (*Pakistan's BoP: The Calm before the Storm*, May 31, 2017), CPEC could gain some favor with the IMF when its export focus is finally revealed.

Finally, there is a strong sense that institutional decay has become widespread in Pakistan, even during the period of the past two IMF programs. Hence, we expect reforms to focus on restructuring and upgrading regulatory agencies and policymaking bodies (e.g. SBP, SECP, MoF, FBR, Nepra, Ogra, etc.), to ensure that self-serving political agendas do not have the final say on economic policies.

The abovementioned measures are likely to fall under the IMF umbrella. However, many Pakistanis are pinning their hopes on an amnesty scheme for external assets held by Pakistanis, which could unleash an avalanche of hard currency; this is expected to solve the country's BoP problem for years to come. While we do not doubt that significant Pakistani wealth has been kept outside the country, we doubt Pakistanis would be keen to bring this wealth back to the country. While some may, especially those who are already on the radar of international agencies, whether the vast majority does so will depend on the nature of this amnesty scheme and the credibility of the government that announces it.[8]

[8] The specifics of the amnesty scheme are hard to get a handle on, but it should be clear that only a credible government at the start of its term, would be able to launch it effortlessly. As this entails a return of money back into the country, perhaps the IMF could guide Pakistan (as it does other developing countries) about how best to do this.

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