Q4-FY18 Macro Projections:[1]

The vicious twin deficits, Part 1

Mushtaq Khan[2], April 26, 2018

Most of FY18 has been characterized by the urgency to secure FX loans to finance the external deficit. What is new is the PKR adjustment in December 2017, and again in the third week of March 2018. This creates a difficult trade-off for the Government of Pakistan (GoP). It needs to borrow Dollars to slow the drawdown of its reserves, but as its external debt increases, a PKR devaluation to narrow the external gap will only increase the government's debt servicing. So a short-term measure to finance the external gap will only create more fiscal pressure in the future.

This adverse dynamic is exacerbated by policy urgency: a faster drawdown of SBP's reserves means greater urgency to borrow FX (which comes at a higher price); but the underlying urgency to borrow could be defused with greater effort to *narrow* the gap by (say) devaluing the currency further. While the currency adjustment may not immediately narrow the trade gap (the J curve effect), it will create an additional fiscal burden.

If the country continues to borrow, this creates an incentive not to devalue. But if the country doesn't devalue, it may not be able to narrow the external deficit, which means it has to continue to borrow, which also means it is more averse to devaluation. In effect, Pakistan has now entered this vicious cycle, and is struggling with a self-reinforcing twin deficit.

Box 1: Caretaker government & the IMF

1. By end April, the incumbent government will announce its federal budget as scheduled. As stated in our April presentation, this economic plan for FY19 lacks policy credibility, as the government has not addressed the BoP problem and remains adamant that an IMF stabilization programme is not required.
2. We assume the government steps down at the end of May 2018, which paves the way for a caretaker government to manage the country and oversee the next general elections. This should happen around the end of August 2018.
3. The caretaker government is given a 3 month term, and cannot commit the government to policies beyond its limited tenure.
4. However, given the difficult external situation and the momentum at which SBP's FX reserves will continue to fall (see **Figure 1**), the caretaker government should initiate talks with the IMF to provide some comfort to the market.
5. Since we assume the incumbent government will not take unpopular decisions in its last two months in power (in terms of the PKR or interest rates), this responsibility will fall on the caretakers. They will increase interest rates and depreciate the PKR after publicized discussions with the IMF.
6. Given the urgency to tackle the BoP problem, the caretaker government should get the endorsement of the main political parties to initiate talks with the IMF, with the understanding that the elected government will follow through with the IMF's policy prescriptions.
7. One of the first responsibilities of the newly elected government would be to start negotiating the next IMF programme. This is required to keep the market calm, and also to incorporate the stabilization programme into a more realistic FY19 federal budget.
8. In this revised budget, economic growth will be lower than what the forthcoming budget will promise. Barring a positive shock (e.g., another collapse in oil prices), Pakistan's BoP position will not be able to sustain high growth in FY19.

[1] This paper will be issued to only our *Interactive* and *Institutional* clients. For more details about the assumptions and methodology used to formulate our projections, please see our first projection paper (*Q3-FY18, Macro Projections: Stepping into the Unknown*, January 22, 2018).

[2] The author would like to thank Danish Hyder for many discussions on the subject, and also his invaluable assistance with the projections.

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What to expect in FY19

Box 1 lists possible developments that could pave the way for the next IMF programme. As stated in an earlier paper (*Pakistan's BoP, the IMF and China*, September 14, 2017), China would be eager to ensure that Pakistan's economy does not face a BoP crisis, but it would not step in and fund the external deficit. It our view, China is more interested in ensuring that Pakistan's policymakers take steps to narrow the external deficit, to a level where it can be financed without pushing the country further into an external debt trap. Real structural reforms are needed, and China knows it.

Since SBP's FX reserves are currently *encumbered* and will have to be paid off in FY19, hard measures (and creative steps) are required to overcome the impasse. The mismanagement of the external sector since FY15 – more specifically the manner in which the Rupee was managed by the ex-Finance Minister – can no longer be sustained. While many in the country are hoping that China will bail Pakistan out, as a long-term player, China knows that fundamentals have to be addressed, and there is no institution better suited to do this than the IMF.

In our view, China will insist that our policymakers step up and take the bitter medicine (i.e., implement the hard reforms), instead of hand waving and colluding with the IMF (*The Parable of Pakistan and the IMF*, December 27, 2016). With the changing geopolitical landscape, it is also unlikely that the IMF will allow Pakistan to take the easy way out, and fake progress on structural reforms. This means the next IMF programme should be much harder than previous programmes.

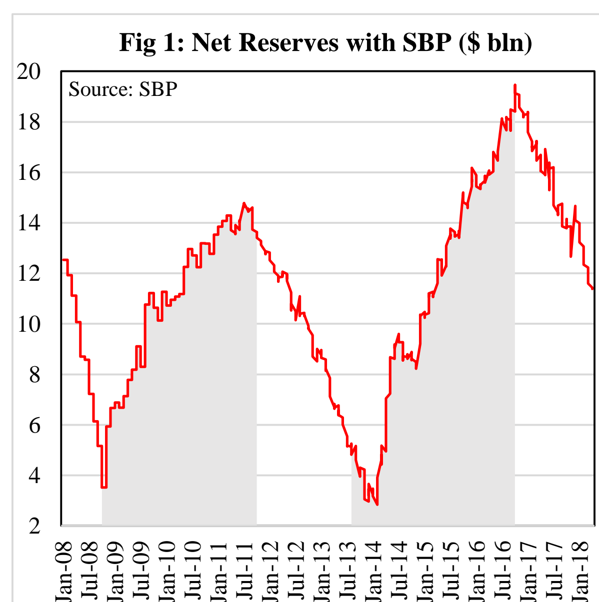

Figure 1 shows SBP's net FX reserves. It is interesting to note that during the past two IMF programmes, SBP's reserves increased sharply, but fell equally sharply when the programmes ended (the shaded areas are the past two programmes). With the rapid buildup of external debt in FY17 and FY18, the repayment stream in FY19 and FY20 is likely to be heavy. If Pakistan starts with low import coverage, the IMF stabilization programme will focus primarily on the external side, while ensuring that the fiscal side does not add to the pressure that already exists on the BoP front.

Figure 1 also suggests that the next stabilization programme is unlikely to be generous enough to spike SBP's reserves as in the past.[3] In our view, the primary focus will be on narrowing the trade deficit, so that fresh inflows from the IMF, the other IFIs, bilateral loans and commercial borrowings, are sufficient to repay existing loans, finance the current account deficit, *and* still increase SBP's reserves to more comfortable levels.

This is a tall order that requires very hard limits on the trade deficit, as the country cannot keep borrowing to finance what is effectively "current" consumption. Even if the authorities correctly talk about the import of machinery (needed for domestic investment, e.g. CPEC), Pakistan may be at the stage where even borrowing for investment doesn't make commercial sense – i.e., the stream of repayments in the

[3] By keeping initial tranches (Dollar inflows) small, the IMF will maintain a tight leash on Pakistan's policymakers to ensure they remain focused and disciplined.

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next few years is so high that potential lenders may not be convinced that even with higher future Dollar revenues, the borrower is an acceptable credit risk. More simply, the borrower's debt may already be deemed unsustainable.

If Pakistan seeks to achieve some semblance of normality in its economy (and keep CPEC humming, albeit at a slowed pace), our policymakers will need to think out of the box.

What's possible?

There are two options to escape an unsustainable external deficit: secure Dollar financing that does not add to the country's external debt (e.g., Amnesty scheme for expat Pakistanis); or narrow the trade deficit quite sharply (increase exports *and* reduce imports). Since the Amnesty scheme is currently marred by political confusion, we will wait for more clarity before making our assessment. Furthermore, as we expect little from the forthcoming budget regarding how the government intends to manage the external sector in FY19 (and SBP will not formally release its BoP projections till Q1-FY19), a more detailed assessment of how Pakistan will narrow – or finance – the external deficit will follow soon.

One thing is clear: Pakistan will need to narrow the trade deficit *and* generate non-debt creating financing of the external deficit at the same time.

The BoP outlook

Table 1 contains hard data till Q3-FY18, and Q4 is projected. The main takeaways from the table are summarized below:

- Other than the two episodes where SBP allowed the PKR to depreciate, little else signals that the government is keen to rein in imports. In fact, the decision not to increase interest rates in March 2018, and the cut in retail fuel prices in early April, will not help narrow the trade deficit.
- In an earlier note, we had stated that the IMF's projected CA deficit (at $ 15.7 billion) is too large. After months of policy inaction (and some contradictory signals – see above point), our projections have moved closer to the IMF's. As shown in **Table 1**, the projected external gap of $ 15.3 billion is three times as large as in FY16.
- We project that textile exports show a strong recovery after remaining stagnant for the past six years (see **Table 1**). This is based on the time-lag between export orders and realized proceeds – we assume the 9.5 percent PKR adjustment since December 2017 helped.
- We also show that import growth is relatively contained in FY18, but still posts an increase of 13.9%. Q4 imports are often the highest during the year, and we assume that most importers are aware that FY19 will be tough, so they frontload their requirements before year end. As shown in **Table 2**, the projected PKR deprecation in June 2018 will do little to dent the pace of imports in Q4-FY18.
- We show that remittances in FY18 finally break the $ 20 billion barrier. This is driven more by the growing fear of expat Pakistanis about the possible change in FCA regulations, than the health of the GCC economies. Furthermore, we also assume higher inflows into non-resident FCAs, which is reflected in net inflows of *secondary income* (see **Table 1**).
- Despite this upside, the current account deficit is large, and cannot be financed as it was in FY17. The *financial account* is lower despite the Eurobond/Sukuk issued earlier in the year, and this is primarily because the GoP is unable to secure sufficient multilateral and bilateral funding.
- As a result, the buildup in SBP's FX reserves during FY15 and FY16, is being reversed with a particularly sharp fall in FY18. The projected $ 6.3 billion drawdown in SBP's reserves pushes net FX reserves below $ 10 billion, which is just above 2 months of import coverage.

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Table 1: BoP Projections							Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
BoP 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)**	**(1,660)**	**(3,063)**	**(3,267)**	**(4,631)**	**(3,546)**	**(4,374)**	**(4,109)**	**(3,277)**	**(12,621)**	**(15,306)**
1. Good & Services	(12,456)	(18,957)	(16,919)	(19,240)	(20,237)	(22,689)	(6,438)	(7,208)	(7,712)	(9,661)	(8,539)	(8,776)	(8,835)	(9,221)	(31,019)	(35,371)
- Trade Balance	(10,427)	(15,652)	(15,355)	(16,590)	(17,267)	(19,283)	(5,276)	(6,107)	(7,096)	(8,201)	(7,272)	(7,371)	(7,659)	(7,976)	(26,680)	(30,278)
- Merchandise Exports	25,369	24,718	24,802	25,078	24,090	21,972	5,054	5,577	5,683	5,689	5,664	6,131	6,472	6,911	22,003	25,178
* Textile Exports	13,076	13,068	12,832	13,659	13,540	12,756	3,064	3,037	3,244	3,106	3,264	3,312	3,411	4,067	12,451	14,054
- Merchandise Imports	(35,796)	(40,370)	(40,157)	(41,668)	(41,357)	(41,255)	(10,330)	(11,684)	(12,779)	(13,890)	(12,936)	(13,502)	(14,131)	(14,887)	(48,683)	(55,456)
* Oil Imports	(12,317)	(14,368)	(14,066)	(14,774)	(12,344)	(8,360)	(2,349)	(2,649)	(2,771)	(2,838)	(2,945)	(3,385)	(3,517)	(3,885)	(10,607)	(13,732)
- Services Balance	(2,029)	(3,305)	(1,564)	(2,650)	(2,970)	(3,406)	(1,162)	(1,101)	(616)	(1,460)	(1,267)	(1,405)	(1,176)	(1,245)	(4,339)	(5,093)
2. Primary Income (net)	(3,017)	(3,245)	(3,669)	(3,955)	(4,599)	(5,347)	(993)	(1,426)	(1,005)	(1,624)	(1,022)	(1,489)	(1,039)	(1,145)	(5,048)	(4,695)
3. Secondary Income (net)	15,687	17,544	18,092	20,065	22,041	23,169	5,771	5,571	5,450	6,654	6,015	5,891	5,765	7,089	23,446	24,760
- Remittances	11,201	13,186	13,922	15,837	18,721	19,917	4,740	4,765	4,599	5,247	4,791	4,955	4,862	5,687	19,351	20,295
Capital Account	**161**	**183**	**264**	**1,857**	**375**	**273**	**95**	**30**	**159**	**91**	**104**	**54**	**127**	**87**	**375**	**372**
Financial Account	**2,101**	**1,280**	**549**	**5,553**	**5,074**	**6,790**	**1,941**	**2,817**	**1,556**	**3,884**	**1,634**	**4,730**	**1,227**	**1,577**	**10,198**	**9,168**
- Direct Investment	1,591	744	1,258	1,572	915	2,286	422	967	538	736	699	790	599	416	2,663	2,504
- Portfolio Investment	338	(144)	26	2,762	1,886	(429)	175	615	(134)	(906)	(98)	2,338	42	586	(250)	2,868
- Others	172	680	(735)	1,221	2,271	4,933	1,344	1,235	1,152	4,054	1,033	1,602	586	575	7,785	3,796
-Inflows	2,866	3,191	2,939	4,847	4,669	8,191	2,603	2,461	3,216	6,768	2,745	2,959	1,561	3,126	15,048	10,391
-Outflows	(2,466)	(2,215)	(2,900)	(3,709)	(3,659)	(3,479)	(1,259)	(1,228)	(2,064)	(2,709)	(1,712)	(1,359)	(977)	(2,551)	(7,260)	(6,599)
Errors & Omissions	**16**	**(80)**	**(309)**	**(422)**	**(8)**	**456**	**(99)**	**166**	**(289)**	**324**	**(339)**	**(123)**	**246**	**(311)**	**102**	**(527)**
Change in Reserves and IMF Fund	**2,492**	**(3,275)**	**(1,992)**	**3,858**	**2,646**	**2,652**	**277**	**(50)**	**(1,841)**	**(332)**	**(2,147)**	**287**	**(2,509)**	**(1,924)**	**(1,946)**	**(6,293)**
- Change in SBP reserves	2,225	(4,430)	(4,530)	3,285	4,595	4,661	379	(50)	(1,841)	(332)	(2,147)	287	(2,549)	(1,924)	(1,844)	(6,333)
- IMF Account	(267)	(1,155)	(2,538)	(573)	1,949	2,009	102	0	0	0	0	0	(40)	0	102	(40)
- Exceptional Financing	0	0	0	0	0	0	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**	**13,300**	**11,376**	**17,550**	**11,376**
SBP Reserves (net)	14,022	10,803	6,008	9,033	13,088	16,819	18,491	18,272	16,466	16,144	13,857	14,107	11,602	9,823	16,144	**9,823**
Import Cover in months	**4.96**	**3.21**	**1.80**	**2.62**	**3.92**	**5.28**	**5.37**	**4.69**	**3.87**	**3.49**	**3.21**	**3.13**	**2.46**	**1.98**	**3.98**	**2.13**

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We will only project the BoP for FY18, as the outlook for FY19 will hinge on the government's discussions with the IMF. Nevertheless, for our inflation outlook, we have made certain assumptions about the PKR and retail fuel prices up to March 2019 (see **Table 2**). We operate with the assumption that the GoP will have to pull back imports sharply in FY19, which will raise inflation and dampen growth.

Table 2: Price Shocks		
	Month end PKR/$	Fuel/ltr (Rs) Super
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	110.3007	77.47
Jan-18	110.4207	77.47
Feb-18	110.4510	84.51
Mar-18	115.5052	88.07
Apr-18	115.5852	86.00
May-18	115.6252	87.94
Jun-18	118.4752	91.76
Jul-18	119.3552	93.18
Aug-18	119.8052	93.73
Sep-18	121.0652	95.98
Oct-18	123.5152	99.44
Nov-18	123.5952	100.71
Dec-18	124.8452	103.17
Jan-19	125.2952	103.61
Feb-19	125.6752	104.46
Mar-19	126.7152	107.35

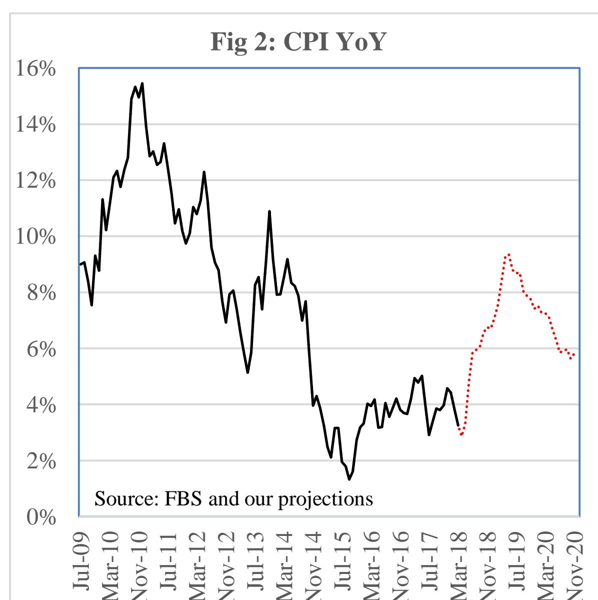
The inflation outlook

Our methodology is based on the conceptual view that inflation in Pakistan is driven primarily by administered prices (e.g., the PKR, retail fuel prices), which are used as benchmarks by economic agents to price their own products. This differs from the conventional view that inflation is driven by demand pressures (and monetary factors), which are strongly influenced by domestic interest rates. This demand driven view of inflation makes more sense in developed countries, where interest rates have a very direct impact on individual spending behavior.

As shown in **Figure 2** and **Figure 3**, Pakistan will enter a higher inflation trajectory in FY19. It should be noted that policymakers focus on the average inflation data (**Figure 3**) to decide what to do about interest rates, and what to target for the forthcoming year. It is interesting to note that the surprise dip in YoY inflation from January to March 2018 (which incidentally was used to justify the interest rate status quo in March), will continue to dampen the average inflation rate for the remaining part of FY18.

Figure 3 shows that the average inflation for FY18 will be 3.75 percent. However, with the anticipated increase in the PKR and retail fuel prices by the caretaker government in June 2018, we expect inflationary expectations to change significantly in FY19.

As shown in **Table 2**, the incumbent government is likely to increase retail fuel prices (a bit) to reflect global oil prices that are at a 3-year high. Since end quarter numbers are important for local and foreign analysts (& the IMF), the caretaker government is likely to adjust *both* the PKR and fuel prices to set the momentum for the required narrowing of the BoP in FY19. We also assume that by the time the newly elected government takes charge (early September), most of the programme details have already been sorted out. Hence, the new programme could begin in October 2018.



Once the inflation momentum takes hold, average inflation is likely to begin a steep rise. As we discussed in our earlier paper (*Q3-FY18 Macro Projections: Stepping into the Unknown*), when facing stubborn twin deficits, a country tends to

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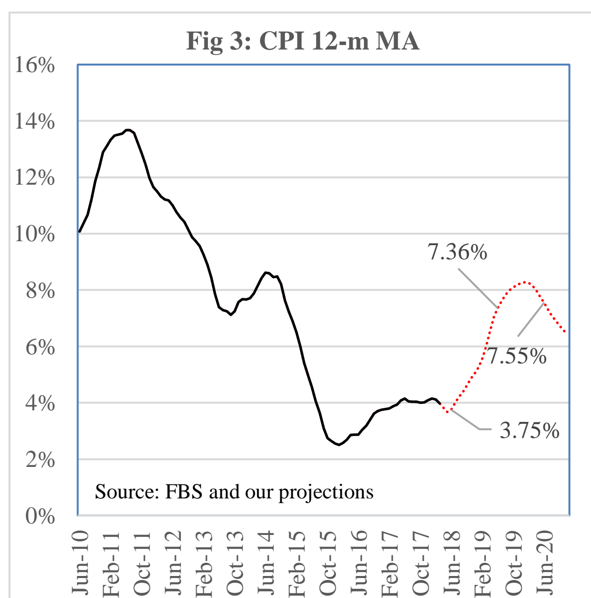
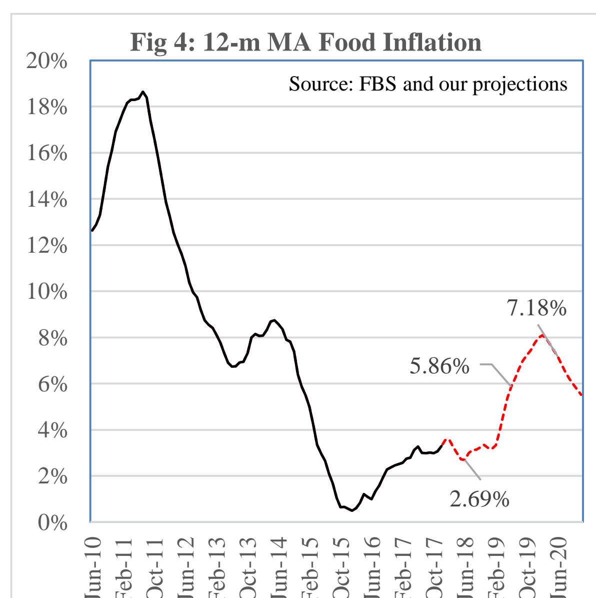
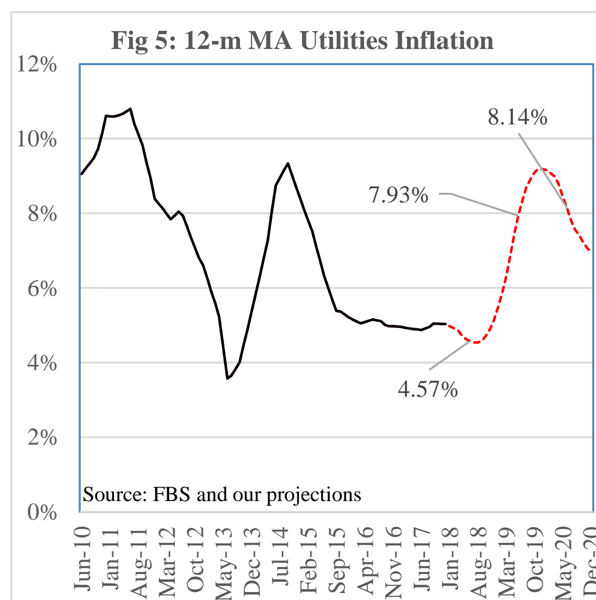
experience higher inflation unless some other factor intervenes. The sub-four percent inflation since mid-2015, was driven by the sharp fall in global oil prices. Now that the country has used up the BoP space this created and oil prices are once again above $ 70/b (and the twin deficits are back because of the absence of structural reforms in the past 3-4 years), the increase in inflation is inevitable.





As shown in **Figure 3**, our projections suggest that average inflation in FY19 will be 7.4 percent. **Figures 4** to **6** show why this increase will take place, as heavyweights in the CPI basket (food, utilities and transportation) are directly impacted by the PKR and retail fuel prices. Add to this the growing circular debt (which will have to be settled early in the IMF programme), and it is highly likely that the IMF will demand an increase in utility rates. The combination of PKR, PoL and more expensive utilities, is sufficient to push Pakistan into a more familiar inflationary environment. As shown in **Figure 6**, the sharp upward trajectory has been in play for a while.



As we will discuss below, this increase in inflation may not provoke a commensurate increase in domestic interest rates.

The interest rate outlook

The manner in which interest rates could change, will be strongly influenced by the debt servicing implications of using interest rates as a policy tool. **Figure 7** shows how Pakistan's market debt has increased since mid-2010. What is problematic is the period after mid-2016: as interest rates bottomed out, fresh investment in PIBs collapsed. What **Figure 7** does not show, is how the composition of outstanding T-bills has changed sharply in the past several years. As Pakistan' BoP position deteriorated in FY17 and FY18, commercial banks realized that it was only a matter of time before SBP would have to increase interest rates. Hence, commercial banks shifted into 3-month T-bills, with this trend gaining greater urgency after the two interest rate surprises in January and March 2018.

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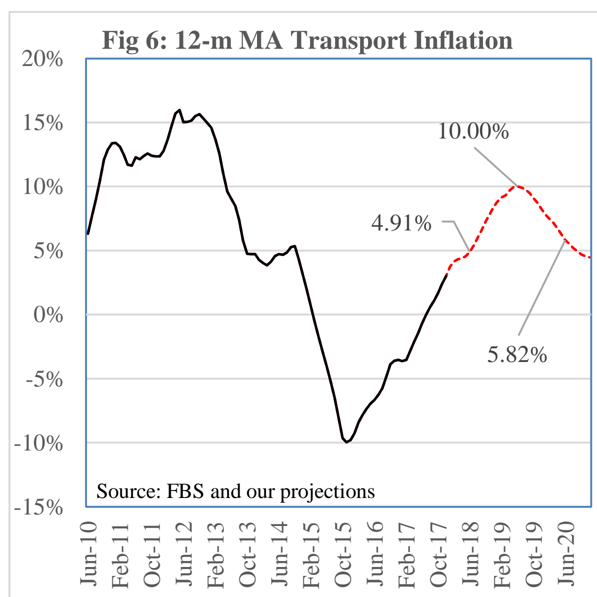

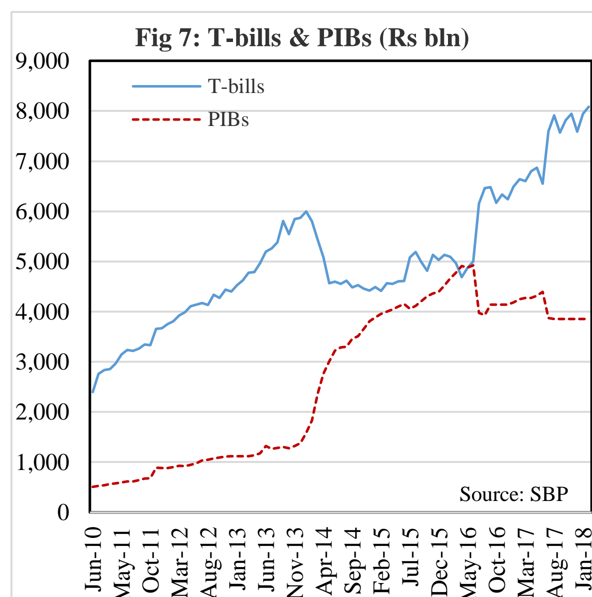

As things stand, the average maturity of T-bills is almost down to 3 months. This raises a very serious challenge for the government and the IMF: if interest rates are increased to signal stabilization (to slow growth and reduce imports), this would increase domestic debt servicing after 3 months. If this is coupled with a weaker PKR (which translates into higher PKR payments to meet scheduled FX repayments), this could blow out the fiscal side. The sheer quantum of debt accumulated in the past two years (both domestic and external – see **Figure 8**) implies that soon after the stabilization programme begins, Pakistan could experience acute fiscal pressure on account of overall debt servicing.

This potential debt blow-out (Ishaq Dar's legacy) will force the IMF and the GoP to be more conservative about how much they can increase domestic interest rates, and also the level of PKR depreciation.

In terms of the outlook, we too would be cautious about interest rates. In our view, the caretaker government could increase interest rates by 50 bps during its three month term (as a signal of the future direction), and leave it to the newly elected government (and the IMF) to determine interest rates during the next stabilization programme.

Conclusion

Soliciting IMF help to tackle the country's twin deficits is familiar territory. But doing this so soon after the "successful" completion of the last IMF programme (which ended in September 2016), without an adverse shock that justifies this assistance, is uncharted territory. One must realize that Pakistan's BoP problem did not just suddenly appear, but has been brewing for the past two years. Putting yourself in the IMF's shoes, this begs the question: why didn't the government (or the central bank) do something to address the problem? And if the preferred solution was simply to finance the country out of this impasse, what were our policymakers thinking?

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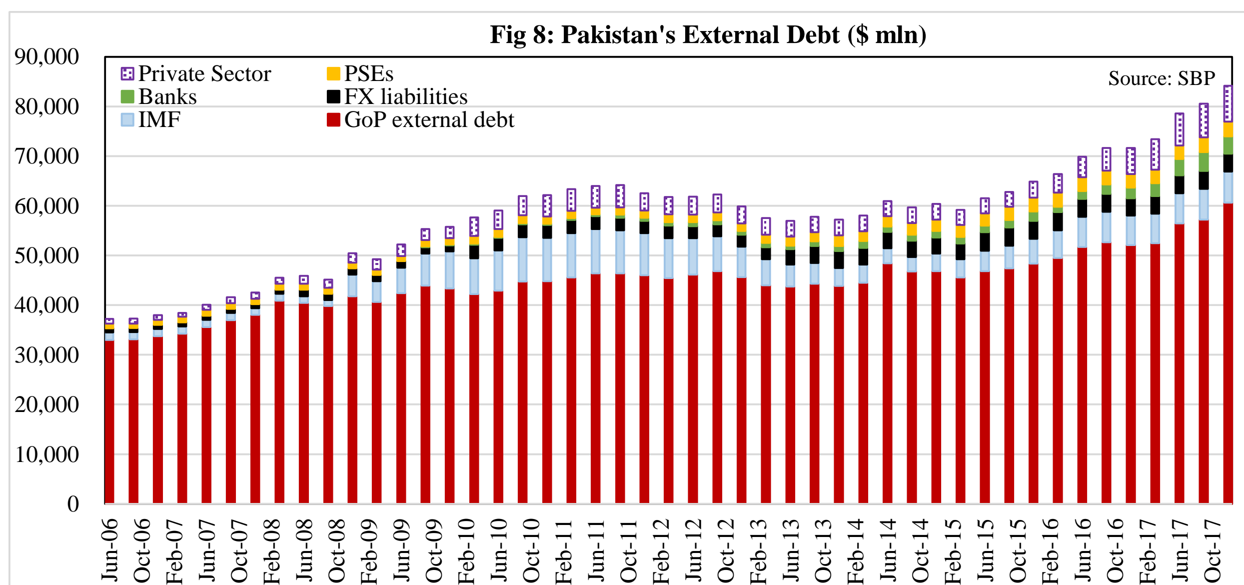

In our view, the situation now is so precarious, that standard policy fixes are compromised. For example, when an external sector problem is already spilling into the fiscal side, how much can the currency be weakened when the country is already stressed by debt servicing? Or, if there is a need to increase interest rates to reduce aggregate demand (to narrow the external deficit), but the government has already been borrowing heavily (and the market knows the central bank has kept interest rates artificially low), this would automatically create tremendous fiscal pressure, as the maturity of the country's domestic debt is already so low.[4]

This translates into a scenario wherein a remedial policy step could actually worsen the situation, and require even more draconian policy measures. So even well-meaning policy efforts to narrow the twin deficits, could in fact make things worse.

This is an issue we will analyze in more detail in our next paper (*The vicious twin deficits, Part 2*). We would only hint that this impasse means something unorthodox is required; something the IMF will have to endorse even if the required steps do not exist in its playbook. In our view, the policy focus should be on a credible and staggered Amnesty scheme, and a total rewrite of the Pakistan-China trade agreement. We resist calling it a FTA, as the required trade agreement would have little to do with the principles of free trade.

Till then, expect BoP worries to continue, while inflation returns to more familiar levels.

[4] On principle, our policymakers should have adjusted the PKR when the external gap was too large, irrespective of the fiscal burden this would create. The desperate borrowing to finance the external gap was unwise, which was subsequently used to justify keeping the PKR stable. It's like asking someone who has put on too much weight and cannot fit into his/her clothes, not to diet but to buy a larger size. Once the larger size wardrobe is bought, you tell him or her not to diet because the larger clothes would be wasted.