Q2-FY19 Macro Projections: The near impossible balancing act

Mushtaq Khan, December 3, 2018

Unlike our past papers, we will discuss our macro projections at the end of this piece. We also want to start this paper by focusing on Egypt's economy. As many of our clients know, we delayed this piece in the hope that the IMF mission visit that ended on 20th November, would give us a better handle on what to expect. Since the talks with the IMF were "inconclusive", and the Christmas break is likely to slow operations in Washington DC till the second week of January, we cannot hold off any longer.

And then 30th November happened. The sudden slide of the PKR parity in the first few hours of trading took the Rupee as high as 144/$, which created a sense of panic within the State Bank of Pakistan (SBP). Market sources claim that SBP intervened in the interbank market, and this allowed the PKR to end the day in the range of 139 to 140/$. Later in the day, SBP announced a 150 bps increase in the benchmark interest rate, which was well above market expectations. Most analysts predicted a 100 bps increase, but after the shock PKR adjustment in the morning, the additional tightening made sense.

Sentiments in the FX market[1]

As we finalize this paper, the interbank is currently trading in the range of 137 to 138/$. If this becomes the new normal, then the PKR adjustment has moved the currency from 134 to 137½/$. In our view, as GoP/SBP and the IMF iron out program targets before the *Letter of Intent* (LoI) can be drafted, currency adjustment was expected. However, given the manner in which it was done, and the likelihood that the PKR will be adjusted again before the start of the IMF program (say in end-January 2019), two key points need to be understood:

1. The interbank PKR parity is set by the final trade at the end of the trading day. If market expectations are unhinged (i.e. the market does not have a sense of where the parity should be, or where SBP would like it to be), and importers are confident that they can pass-on the price increase without squeezing their profit margins, *and* if influential importers are convinced that the PKR parity could hit (say) 150/$… we have a problem. If market bids follow these importers and SBP is not signaling where it wants the parity to be, then the market will *overshoot* – or overreact. If this is the case, SBP would have to calm market expectations by intervening to push down the PKR/$ parity; and
2. For big-picture macro planning (especially for a three-year IMF program), both GoP/SBP and the IMF need a hard handle on the PKR/$ parity for quarter ends (if not month ends) for the next 12-18 months. This is necessary because the IMF's macroeconomic framework (which underpins SBP's annual projections for the country's BoP, money supply and FX reserve growth, and MoF/EAD's debt servicing projections that feed the fiscal projections) requires a credible set of numbers for: end month PKR/$; interest rates; GoP borrowing from the banking system and the monthly current account deficit. This is required to ensure that SBP's BoP projections are internally consistent with MoF's fiscal projections.

As we have discussed in the past, efforts to narrow the external deficit (e.g. by depreciating the currency or increasing interest rates) will increase fiscal pressure via debt servicing, and we should not focus on one at the direct expense of the other. In other words, we know that the twin deficit in FY18 was 12.7%

[1] This section was written after detailed discussions with Hanif Akhai, an adviser to **doctored papers** and the ex-Foreign Exchange adviser to SBP during the tumultuous period 1998-2000.

of GDP and the external deficit is more problematic. If bringing down the external deficit (from 6.1% of GDP in FY18 to a more sustainable 4.5%), pushes up the fiscal deficit (from 6.6% of GDP to, say 7.4 %), Pakistan's twin deficit this year may not narrow as required (in this case, it would only fall to 11.9% of GDP).[2]

Simply said, the value of the PKR/$ parity matters. Since it is a stylized fact that the PKR sets the tempo for inflation, and inflation sets the tempo for interest rates, the quantum of the currency devaluation will directly impact the setting of interest rates. Furthermore, the PKR parity itself and the level of interest rates will directly impact Pakistan's debt servicing, which has been driving Pakistan's fiscal deficit. So for a credible and tangible stabilization program (e.g. the twin deficits are brought down by at least 250-350 bps in the first year), the policy instruments used to narrow the external deficit must be carefully calibrated to ensure that they do not cause a fiscal blowout.

There is another issue that complicates the management of the FX market: SBP's already low FX reserves. While we address this in more detail later in the paper (Net International Reserves), the policy decision to devalue the currency must be carefully *implemented*. We realize that SBP faces a steady outflow of hard currency because of the current account deficit, and that a weaker currency *should* narrow this outflow. However, if the transition is not well managed (e.g. the currency overshoots and this requires SBP to use more FX firepower to calm the market) then, even if the currency is weakened, this may not necessarily reduce the depletion of SBP's FX reserves. So even the act of making imports more expensive, may not discourage import demand.[3]

It is a known fact that countries with large and stubborn twin deficits cannot stabilize their economies without a degree of pain. The real issue is how much pain is necessary, and the ability of Pakistan's policymakers to minimize disruption as the IMF program begins. In our view, November 30 was not a good start.

In terms of the structure of the paper, we start by looking at Egypt's economy when it entered an IMF program in November 2016. We then talk about the more binding financial targets that Pakistan is likely to face as part of the IMF program. We end by discussing our monthly projections for the period November 2018 to December 2019 for the PKR/$ parity, retail PoL prices, inflation, interest rates, and a broader assessment of the likely current account and fiscal deficits in FY19.

What about Egypt

We cannot claim to be experts on Egypt's economy, but a big-picture assessment of what Egypt has experienced since 2010, is quite instructive. Like Pakistan, Egypt had little choice but to approach the IMF in 2016, and it also had the financial support of "friendly" countries. In our view, Egypt's case proves that friendly countries are not a substitute for the IMF, and soliciting money from friends will not solve the problem.

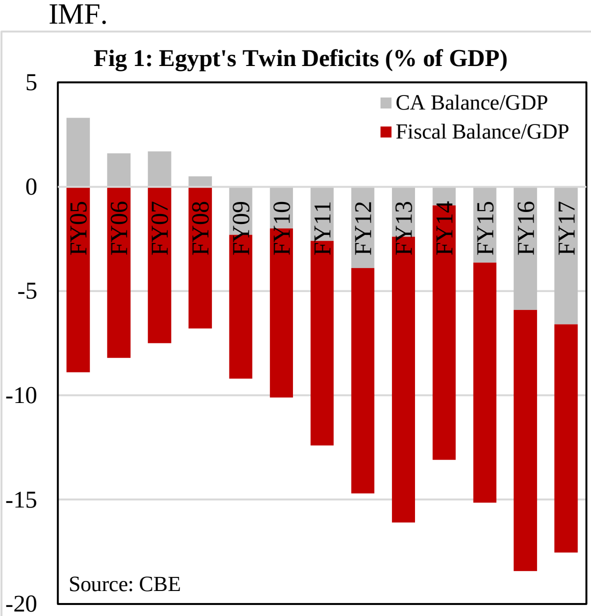
Egypt's case shows that Pakistan is not alone in dealing with stubborn structural problems. We would argue that Egypt's economic problems are deeper compared to Pakistan's, and its path to stabilization was much more disruptive vis-à-vis what we expect here. Having said this, we think domestic sentiments about the country's adjustment to stability, are misguidedly soft – namely, that it is business-as-usual on a

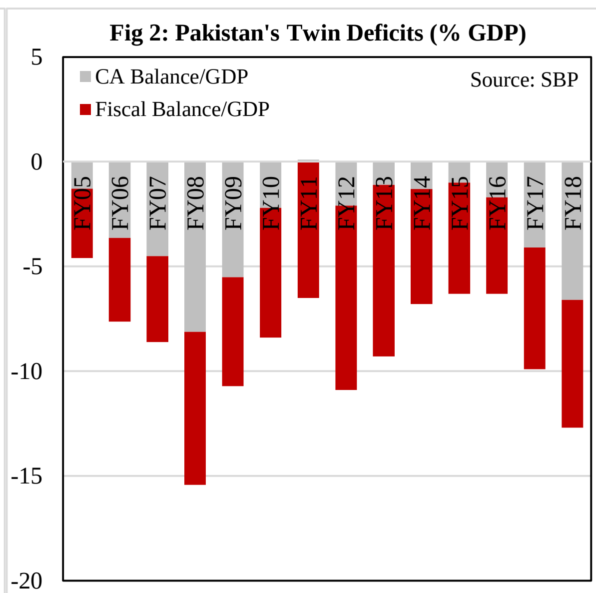
[2] One must realize that the parameter used to gauge the degree of stabilization is the twin deficits as a percentage of GDP.
[3] As discussed in point 1, if key importers are convinced that the PKR/$ parity could hit 150/$, they will continue to buy at the peak interbank rate (the overshoot) irrespective of the quantum of FX that SBP makes available to bring down the PKR/$ parity. In effect, if the authorities are unable to manage market expectations (e.g. lack of expertise or credibility), the stabilization process will not only be more disruptive to the economy, but it could also fail to narrow the twin deficits.

three year cycle. In our view, Pakistanis have perhaps forgotten that stabilization measures can be harsh and destabilizing.

In terms of a backdrop to Egypt's economic troubles, the following timeline should be helpful:

- The current government of President Abdel Fattah El-Sisi (a former army general who overthrew the elected government in July 2013) is effectively a continuation of the governance structure put into place by Gamal Nasser in 1952. An army officer and avowed socialist, Nasser created a welfare state with political power firmly in the hands of the Egyptian army;
- In January 2011, the Arab Spring took hold in Cairo;
- In February 2011, President Hosni Mubarak (who ruled for 30 years) was forced to resign and the Egyptian army took charge;
- In June 2012, in what many consider the first free and fair elections in Egyptian history, Mohamed Morsi of the Muslim Brotherhood (MB) was elected president. However, Morsi's government had powerful enemies from the very start: Egypt's economic elite; the state bureaucracy; military leaders who had enriched themselves; Christian Coptics; secularists and women's movements;
- As an advocate of the Muslim Brotherhood, Qatar's government came to Morsi's support and pledged an $ 18 bln assistance package for the next five years (2012 – 2017);
- In July 2013, martial law was imposed by General Sisi, and President Morsi was arrested. Saudi Arabia and the UAE welcomed the change, as did the US government. Saudi Arabia pledged $ 5 bln (later increased to $ 25 bln) and the UAE pledged $ 3 bln (later increased to $ 7 bln);
- The UAE also partnered with President Sisi's anti-Muslim Brotherhood campaign, and coordinated its strategy for Libya's future with the Egyptian government;
- In June 2014, General Sisi was elected president with a 90% plus majority as the MB boycotted the general elections;
- Subsequent mismanagement created an economic crisis in the autumn of 2016, and despite generous financial assistance from Saudi and the UAE, Egypt entered a $ 12 bln three-year program with the IMF.

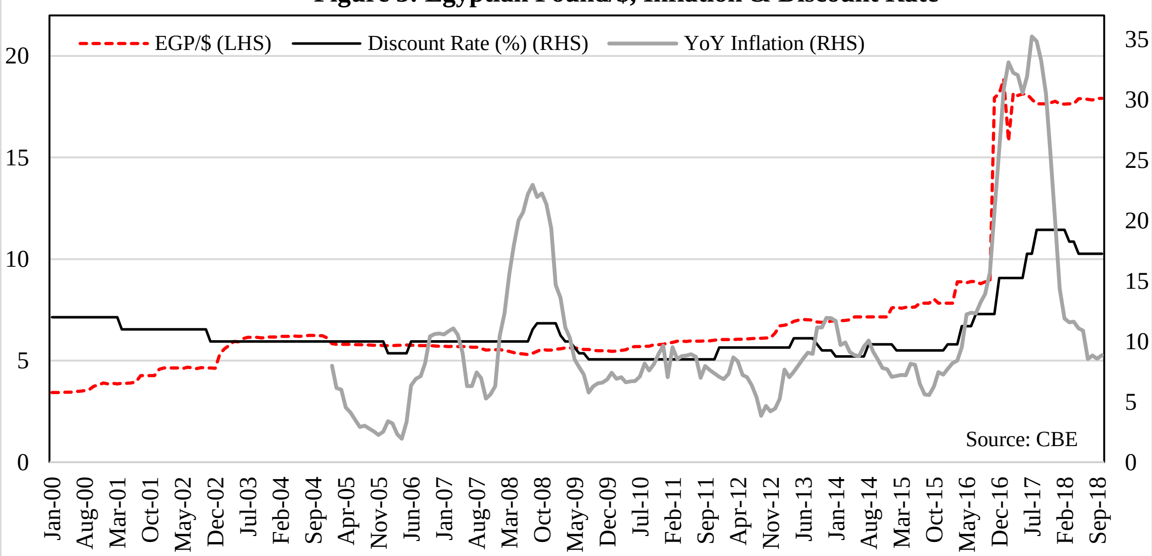




As shown in **Figures 1** & **2**, Egypt's fiscal problems are far more serious than Pakistan's – for the period FY05 to FY17, the average fiscal deficit in Egypt was 9.8% of GDP, while Pakistan's was only 5.5%. Egypt's economic weakness can be traced to the massive subsidy program provided by the government, which ensures the subsidized availability of sugar, cooking oil, fuel, bread and even tobacco products.[4] As shown in **Figure 3**, the Egyptian Pound (EGP) adjusted quite significantly as the country entered the IMF program in November 2016. The repercussions on the Egyptian economy are listed below:

- In March 2016, the EGP was devalued by 13.4% against the US$;
- In November 2016, the EGP was further devalued by a massive 102% (for some perspective, if we think in terms of the PKR/$ parity, this translates to a change from Rs 140/$ to 283/$ in *one* month). As shown in **Figure 3**, the EGP/$ parity remains at this level;
- The currency disruption took a toll on inflation, which increased from 8.4% in March 2016 to 20.7% in November 2016 (this momentum peaked in July 2017 when year-on-year inflation exceeded 35%);
- This also impacted Egyptian interest rates. Benchmark interest rates increased from 9.75% in March 2016, and peaked at 19.25% in July 2017; and
- Although Egypt's macro indicators have returned to more "normal" levels, the economic disruption since March 2016 cannot be downplayed, and still lingers.

Figure 3: Egyptian Pound/$, Inflation & Discount Rate



What does this mean for Pakistan?

Countries with large twin deficits must implement hard measures to stabilize the economy, and assistance from friendly countries is not the solution. This makes sense as friendly countries will not endorse poor domestic economic policies, as this creates expectations that future assistance will be forthcoming. In our view, the real issue is whether Pakistan's next program could be as disruptive as the Egyptian one.

As shown in **Figure 2**, Pakistan's twin deficits are not as dire as Egypt's. Pakistan's fiscal problem is stubborn, but it is the external sector that created the current crisis. Even before the decision to approach the IMF, the GoP had already taken significant steps to slow import demand by devaluing the PKR/$ and increasing interest rates. Both the previous and current governments realized the gravity of Pakistan's BoP position and took corrective steps. The issue is how much more is required?

Pakistan will be asked to narrow both its external and fiscal deficits. On the fiscal side, there will be equal emphasis on reducing subsidies (via the power sector and loss-making SOEs) and increasing direct tax revenues by bringing more people into the tax net. On the more problematic external sector, the focus

[4] The Arab Center (a think tank in Washington DC) claims that more than 70% of the Egyptian population is directly dependent on the state for these essential products.

will be on narrowing the current account deficit so that SBP's *free* FX reserves are sufficient and do not disrupt international trade/capital flows.

Net International Reserves (NIR)

At the risk of making too fine a point, the next IMF program will hinge on Pakistan meeting quarterly targets for SBP's net international reserves (NIR). NIR is a standardized parameter created by the IMF, which seeks to quantify the unencumbered FX reserves of the monetary authority (central bank), which can be used to meet external debt/liability obligations, service payments, royalty/profit repatriation, import payments and to intervene in the FX market. NIR is based on the stock of international reserves at any point in time, *adjusted* by the central bank's committed FX inflows and outflows in the next 12 months.[5]

To astute observers, it will not be surprising that Pakistan's NIR has been *negative* since early 2017.[6] In the most recent data release, SBP has shown that as of end-September 2018, net FX reserves were $ 8.4 bln, but its committed debt repayments for the next 12 months were $ 11.2 bln, while FX swaps that must be returned to commercial banks amounted to $ 7.2 bln. This means that as of end-September, SBP's free reserves were *negative* 10 bln. This translates to the following: even if the CA gap in the period October 2018 to September 2019 was zero and SBP drew down its FX reserves to zero, Pakistan would have to borrow $ 10 bln just to honor its external repayments.

The NIR is relevant for two reasons: (1) SBP's FX reserves must increase during the course of the program to achieve the 3-month minimum import coverage the IMF mandates; and (2) Chinese assistance is more likely to be realized in terms of *increasing* SBP's NIR by rescheduling or rolling-over sovereign and commercial debts from China. For example, if a Chinese SOE agrees to reschedule a $ 1 bln loan that is due in the next 12 months, SBP's NIR automatically increases by $ 1 bln. Clearly, this is neither easy nor forthcoming, but it does give Pakistan an avenue to address a key weakness in its economy.

But this is only part of the picture. Irrespective of the NIR targets set for the first few quarters of the stabilization program, the GoP/SBP would still have to narrow the monthly current account deficit to stay on track. This is where further PKR adjustments come into the picture.

The Impossible Trinity

Economic theory states that a country cannot control capital flows, domestic interest rates and the exchange rate at the *same time* – one of these three must strike the equilibrium. As discussed in our November 2018 presentation, in Pakistan's case, the *Impossible Trinity* states that if SBP's FX reserves are to increase by a certain amount and the central bank wants to control interest rates, then the Rupee must be determined by the market to achieve the increase in reserves.

In other words, if SBP is struggling to increase its unencumbered reserves (NIR), and knows that a further hike in interest rates will not curb import demand, it will have little choice but to devalue the PKR to the

[5] In computing this number, the IMF: (1) subtracts the stock of FX swaps that must be repaid by the central bank in the next year; (2) subtracts all debt obligations that also fall in the next 12 months; (3) ensures a standardized method to value hard currency stocks that it controls; (4) accounts for FX derivatives and forward commitments made by the central bank, the federal government and all public sector enterprises (PSEs) that carry government guaranteed FX debts/obligations; (5) all FX dealings by the GoP that are not recorded (i.e., off balance sheet items); (6) all FX placements from friendly central banks; and (7) IMF placements with the central bank (i.e. IMF loans that come with the stabilization package). NIR also includes the country's stock of gold and undrawn credit-lines available to the government.

[6] In our July 2018 presentation, we showed that as of end-May 2018, SBP's unencumbered (free) FX reserves were *negative* $ 6.6 bln. Clearly, Pakistan's external debt burden is unsustainable.

point where import demand is strongly curtailed and SBP's FX reserves are protected (and perhaps increased). However, such a sudden currency adjustment could destabilize the economy.

The *Trinity* concept and Pakistan's past interaction with the IMF, has created the impression that in the initial stages of the stabilization program, SBP will not be allowed to use its FX reserves to intervene in the interbank market. Needless to say, this fills Pakistan's importers with dread. As seen by the exchange rate adjustments in October and November 2018, if SBP does not guide the FX market, a sense of panic takes hold and the Rupee loses a great deal of value in a very short period of time. As things stand, the FX market has been *conditioned* to expect central bank guidance, and if this stabilizing influence is abruptly removed, the currency could be unhinged.[7] What happened on November 30 is a case in point.

The near impossible balancing act

The goals of the IMF are clear enough – it must ensure that Pakistan's external sector is sustainable, and the country is able to meet all its contractual FX obligations. Only this can calm Pakistan's trading partners and foreign investment in the country. The goal of the PTI government is also clear – the GoP needs an IMF program to stabilize the economy and create confidence, but it also wants to minimize the pain on the average Pakistani.

This means that the GoP/SBP will not want a significant adjustment of the PKR. In our view, the authorities want just enough PKR adjustment to increase SBP's unencumbered reserves without disrupting the economy. As discussed in a paper I wrote while at the State Bank of Pakistan (*The PKR and Price Setting Behavior*, Staff Notes 02/15, SBP, June 2015[8]), the PKR/$ is the most closely watched *price* in Pakistan, and changes in the PKR/$ parity strongly influence the price-setting behavior of wholesalers and retailers.[9]

It is also a known fact that when faced with rising inflation, SBP has no option but to increase interest rates. So a weaker currency means higher retail fuel prices, rising inflation and an interest rate hike. None of these repercussions would please the general public, and will most likely expose the government to a coordinated attack by opposition parties. After just 100 days in office, the PTI government is understandably reluctant to adjust the PKR in a manner the IMF prefers. In response to the events of November 30, the Prime Minister (on December 3) expressed his disappointment with how the Rupee was adjusted.

Let's assume Pakistan and the IMF agree on program details and the case is taken to the IMF board by mid-January 2019, and is approved (the approval should be automatic if the case is brought to the board). Pakistan is likely to agree to some adjustment of the PKR as a *prior action* to enter the program, but for the rest of the program, PKR adjustments are likely to be the last resort to manage the external sector gap. Fortunately there are several factors that could help Pakistan manage the near impossible balancing act to meet quarterly NIR targets:

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[7] In past IMF programs, an effort was made by the Fund to shift Pakistan's nominal anchor from the PKR/$ parity to interest rates. The nominal anchor refers to the key indicator that the market uses to determine its price-setting behavior, or the policy lever that sets the market's inflationary expectations. Unfortunately, the market still views the PKR/$ as the economy's nominal anchor.

[8] http://www.sbp.org.pk/publications/staff-notes/PKR-Inflation%20StaffNotes-June%202015.pdf

[9] The mechanics are simple: to justify an increase in price to a disgruntled consumer, the retailer will justify the price increase as necessary because the Rupee is weaker. It is irrelevant if the product being sold is imported or uses imported inputs – it's just used as an excuse to satisfy the consumer that the price increase is justified. As discussed in this SBP Staff Note, retail fuel price is another policy instrument that retailers use to justify price increases.

1. The 32-33% devaluation of the PKR since December 2017 should help squeeze the monthly trade deficit;
2. Remittances should continue to show strong growth in the remaining part of FY19, as anxious Pakistanis with overseas assets seek to avoid legal entanglements in Pakistan;
3. If avenues of capital flight from Pakistan are strictly monitored, this will automatically increase official remittances into the country[10];
4. If global oil prices stay soft in the remaining part of FY19, this will go a long way towards containing Pakistan's oil import bill in FY19; and
5. If push comes to shove, piecemeal Chinese assistance vis-à-vis SBP's NIR should help meet IMF targets.

Table 1: Price Shocks		
	Month end PKR/$	Fuel/ltr (Rs) Super
Jan-18	110.4207	77.47
Feb-18	110.4510	84.51
Mar-18	115.5052	88.07
Apr-18	115.7006	86.00
May-18	115.7074	87.70
Jun-18	121.6337	91.96
Jul-18	121.6337	95.24
Aug-18	124.2460	95.24
Sep-18	124.2374	92.83
Oct-18	132.5482	92.83
Nov-18	140.2686	97.83
Dec-18	139.5886	95.83
Jan-19	141.5686	98.71
Feb-19	141.7186	98.71
Mar-19	143.6086	100.60
Apr-19	143.8186	100.60
May-19	144.5086	101.24
Jun-19	145.4886	102.13
Jul-19	145.4986	102.13
Aug-19	145.7786	103.08
Sep-19	146.8086	104.94
Oct-19	146.9586	104.94
Nov-19	147.4386	105.29
Dec-19	148.4686	106.45

Before November 30, we assumed that the GoP/SBP would have a decisive say on how they would like to manage the economic stabilization, as long as the IMF's NIR requirements are being met. This sentiment has changed. In early press reports about the talks between Pakistan and the IMF, there was a view that SBP was looking at a PKR parity of 137, while the IMF was looking at 145/$. What happened last Friday suggests that the IMF has gotten its way. With some transactions conducted at 145/$ on November 30, 145/$ appears to be where the PKR will end the current fiscal year.

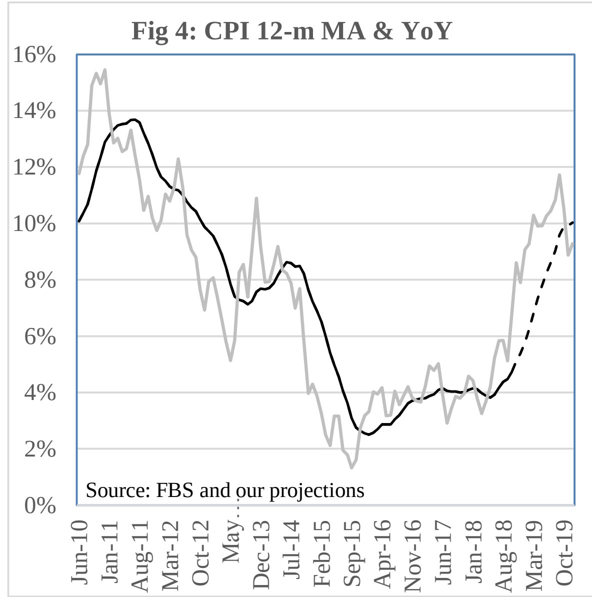
Macro projections

Table 1 contains our key projections on the PKR.[11] Some may argue that we have understated the likely PKR weakness, and the Rupee may exceed 150/$ by the end of FY19. Our partial equilibrium analysis proposes a managed PKR that could narrow the current account deficit to (say) $ 13-14 bln in FY19, and also increase SBP's net reserves to cover three months of import at the end of the program's first year (say December 2019).[12] Our external sector projections are based on the assumption that subsequent stabilization measures will be more gradual (unlike November 30), and with the help of the points listed above, they could narrow Pakistan's twin deficit to around 10% of GDP in FY19, and perhaps about 6-7% by FY21.

Retail fuel prices are projected on the assumption that Brent crude would be in the range of $ 60-70/b during 2019. The gradual increase in PoL shown in **Table 1**, is driven primarily by the devaluation of the PKR. Since we have argued that the PKR parity and retail PoL strongly influence price-setting behavior, on the basis of the projections shown in **Table 1**, we project inflation as shown in **Figure 4**. The dark line shows the average inflation rate, and the dotted line is our projection till December 2019. Hence, we project the average inflation in FY19 in the range of 8½-9½% (the 12-month moving average inflation

[10] Capital flight is possible because inward remittances that use the Hundi/Hawala system, are held back in the GCC, and transferred to overseas bank accounts. If AML/CFT concerns stop this capital flight, remittance inflows (into Pakistan) via foreign exchange companies will materialize in the interbank market and be counted as remittances.
[11] In our last projections paper (*The Challenges Facing Pakistan's Economy*, 15 August 2018), we had predicted the PKR/$ in June 2019 at 140.35/$ and PoL at Rs 118.61/ltr. So while our currency forecasts have not changed much in the past 3 months, we have reduced the projected increase in retail fuel prices. The latter is because the global oil price trajectory has changed.
[12] This refers to SBP's net FX reserves and not NIR.

rate in June 2019), but the YoY inflation is likely to exceed 10% as it pulls the average inflation to levels last seen in 2014 (see the gray line in **Figure 4**).



With the inflation projections shown in **Figure 4**, we expect the discount rate to be in the range of 11-12% by June 2019.[13] This means a further 100-200 bps increase in interest rates in the remaining part of FY19. In view of the expected import compression to bring the external deficit to a more manageable level, we expect real economic growth to be in the range of 3 - 4 % in FY19. Given the debt servicing pressure that is building up this fiscal year, we do not expect the fiscal deficit to be lower than the 5.1% of GDP target that currently stands – we think a range of 6 - 7 % of GDP would be more realistic. Finally, with the cumulative depreciation of the PKR and the projected fall in the current account deficit, we are hoping that the external deficit would be in the range of 4 - 5 % of GDP.

What we have projected would certainly be a less disruptive stabilization process, compared to what Egypt experienced in late 2016. We acknowledge a conservative bent to our projections, and realize that things may not pan out as we hope. For example, if the IMF is more adamant about how SBP can, or cannot, manage the PKR, and this results in a weaker currency than shown in **Table 1**, then this will push inflation above what we show in **Figure 4**. Higher inflation means interest rates will also be higher than we expect, which means aggregate growth will slip below 4% and banks could be threatened by the incidence of non-performing loans.

However, before this economic pain is fully realized, there will be a fair bit of political turmoil that could undermine the PTI government's ability to manage Pakistan's economy. Furthermore, such a disruptive stabilization could endanger the IMF program itself.

Conclusion

Projecting key macro variables without a master-plan (e.g. a credible budget for FY19 or IMF program details) is more about a leap of faith than analytical acumen. While our narrative is less disruptive than other alternatives, clients should be aware that countries with stubborn economic difficulties have experienced very disruptive macro conditions. We have discussed the case of Egypt, but countries like Turkey and Argentina are in the midst of very challenging economic conditions as well. As Pakistanis gear up for a harsher economic reality, some thought should be given to the difficulties experienced by the Egyptians in late 2016. We are not alone.

If the stabilization process is not too disruptive, the government should be able to move forward with structural reforms. If it is, the government is likely to be too distracted with fire-fighting to achieve any results.

[13] We expect SBP to front-load the interest rate increases so that it can signal the end of the monetary tightening cycle to the market.