Q3-FY19 Projections: A soft landing is no longer possible

Mushtaq Khan, February 13, 2019

Since the surprise PKR adjustment on 30 November, the currency has been stable. However, media updates and the government's narrative about the economy, make it very difficult to offer predictions for key policy instruments like the parity and interest rates. To take this paper forward, we will propose three alternative sets of projections (and consequences) and discuss what the trade-offs look like.

Backdrop

Looking at the past several months, the macro picture makes us less optimistic about GoP's ability to negotiate a soft landing with the IMF. To get this point across, we will list some of our concerns:

1. Pakistan's balance of payment (BoP) challenge is very serious. One could argue that Pakistan has not experienced an FX squeeze of this scale since the freeze of foreign currency accounts in May 1998, and General Musharraf's coup soon after (October 1999). As shown in **Figure 1**, committed FX repayments in 2019 are over $ 21 bln, when SBP's FX reserves were only $ 7.2 bln in end-2018. While many would argue that forwards and FX swaps with commercial banks are likely to be rolled-over, one must note the trajectory of these repayments in the past few years. As shown, SBP's FX reserves at the end of 2018 are inadequate to even meet loan repayments, and the shortfall is unprecedented. Marginal borrowings to shore up SBP's reserves have been driving the sharp increase in FX repayments (see **Figure 1**).

2. Although the government has not released its BoP projection for FY19, the commerce minister has said the current account deficit will narrow to a range of $ 14 to 15 bln, which will translate to an external deficit of 5% of GDP this year. As shown in **Figure 2**, even targeting an external gap of $ 14 bln, means that GoP will have to clamp down on the monthly current accounts deficits for the remaining part of the fiscal year.

Fig 1: FX repayments ($ bln)

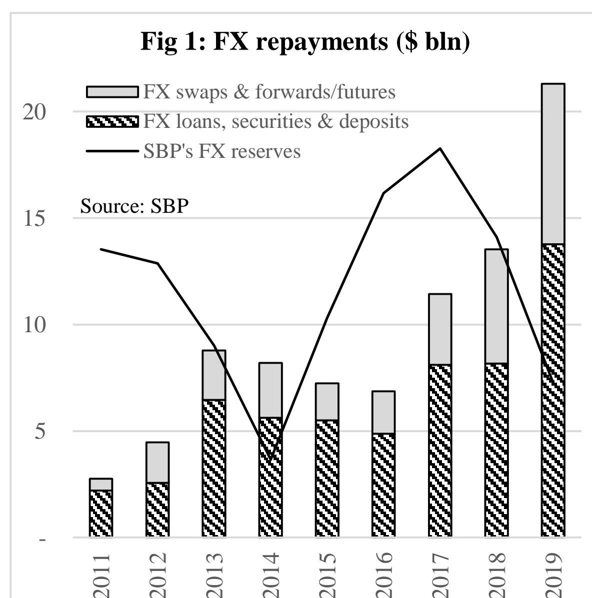
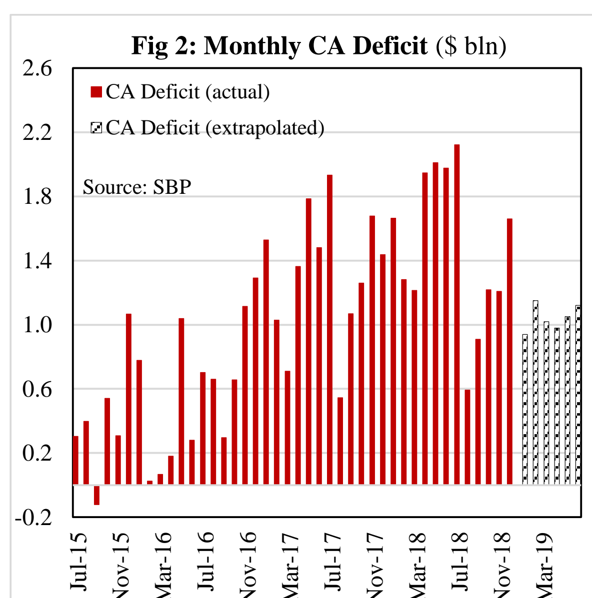


Fig 2: Monthly CA Deficit ($ bln)



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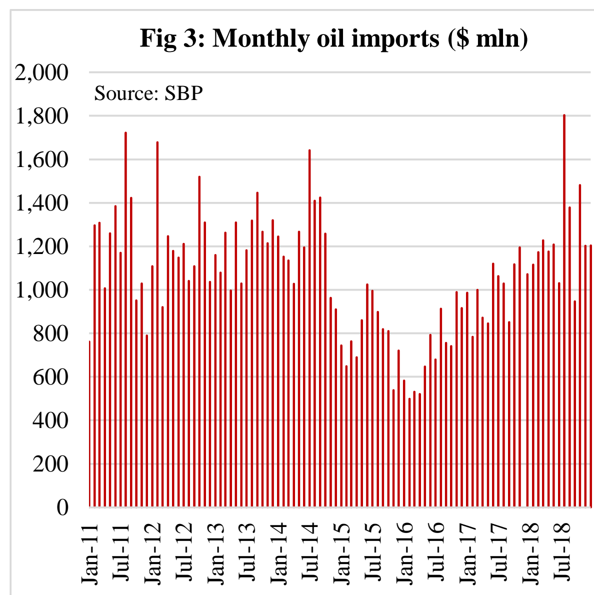
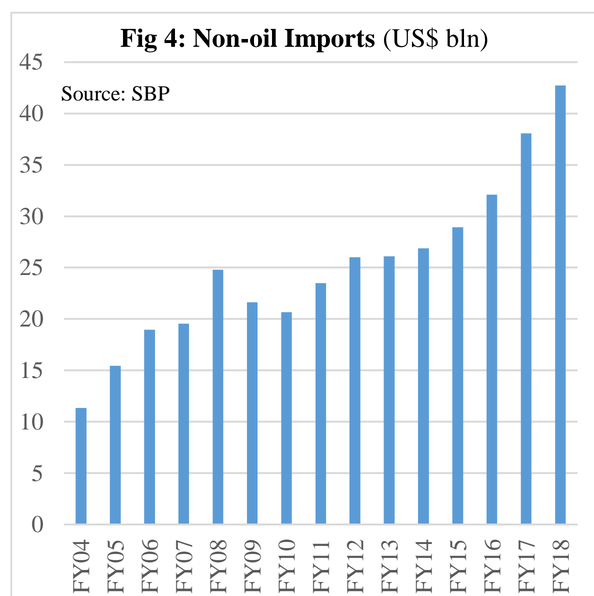
3. Some people take comfort that soft oil prices will help contain the external gap in FY19. **Figure 3** shows how the collapse in oil prices in mid-2014 created a fair amount of comfort, as oil is the country's single largest import. However, as shown in **Figure 4**, policymakers also need to focus on non-oil imports, which have posted strong growth since FY15. In effect, soft oil prices will not achieve the import contraction that the country needs.



4. In an earlier paper, we argued that the government could be using soft oil to reduce retail fuel prices, which helps keep inflation down – especially food inflation (*Pakistan's economic flux is not business-as-usual*, 7 January 2019). In our view, since the external sector is the most binding constraint on Pakistan's economy, policymakers may now have to increase retail fuel prices to reduce the country's import bill, even if this means that inflation will begin to rise.



5. Policy efforts to slow imports have not met with much success. This means a more concerted effort is needed, which could translate to a further increase in retail fuel prices and a weaker currency. What is particularly disappointing, is that Pakistan's exports in the first half of FY19, are almost the same as the year before, despite the sharp adjustment in the PKR in the past year. It is increasingly clear that policymakers need to reduce imports, even if this means slowing economic growth.

6. Fiscal pressures continue to mount, and without hard measures to generate additional revenues, the fiscal deficit could remain in the range of 6-7% of GDP in FY19. This, along with an external gap of 5%, means the twin deficit this year will remain above 10%, which is considered alarming. This means there will be a great deal of pressure on Pakistan's policymakers to ensure that the twin deficit is sharply narrowed in FY20, which could translate into *prior actions* on the PKR, utility tariffs (power and gas), higher retail fuel prices (even if global oil remains soft), and a further increase in interest rates.

Outlook scenarios

Media reports claim that the IMF has insisted that in view of past promises to reform the energy sector (which were not honored), GoP needs to increase tariffs on power and gas, and also ensure that loss-making power distribution companies sharply increase recoveries from their customers. There will also be a lot of focus on generating revenues from the un-taxed, and pushing for hard reforms on loss-making

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PSEs. Having said this, the real sticking point in the next program, is the manner in which Pakistan's policymakers intend to narrow the external deficit and simultaneously increase SBP net international reserves (NIR).[1] Most businesses know that increasing interest rates will not deter imports, and therefore expect much of the adjustment to come from a weaker PKR. The issue is how much, and when.

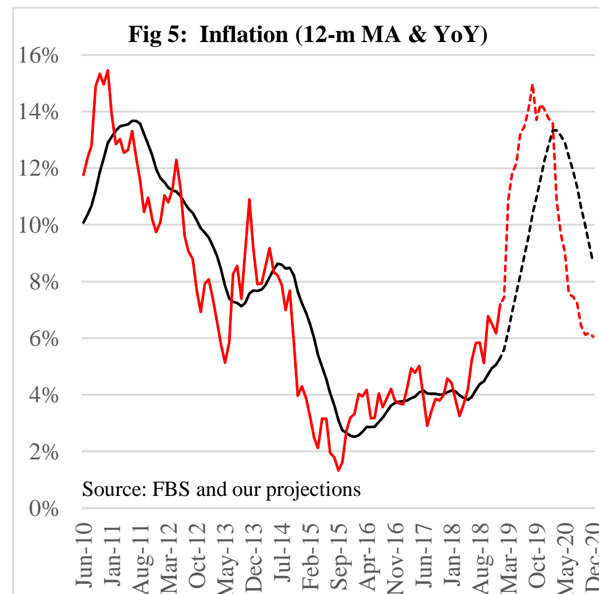

Fig 5: Inflation (12-m MA & YoY)
Source: FBS and our projections

Our model focuses on the *supply push* component of inflation, which we have argued is a more suitable way to model inflation in Pakistan. More specifically, we have said that price-setting behavior is strongly influenced by retail fuel prices and the PKR/$ parity. For key items in the average consumption basket (like transportation and utilities), the impact of an increase in utility rates and higher fuel prices, is straight-forward. With food accounting for 34% of the CPI basket, retail fuel has a direct impact on headline inflation because of transportation costs.[2]

Scenario 1: In this scenario we assume that Pakistan will have to implement certain *prior actions* on the currency and utility tariffs. Even with soft oil prices, we assume that policymakers will increase retail fuel prices to reduce the country's import bill for the remaining part of FY19. As shown in **Figure 5** (the dotted lines are projections), YoY inflation accelerates and touches 9.8% in March 2019 – by June 2019, average inflation is 7.6%, while the YoY rate is 11.0%.

Table 1: Price Shocks

	Month end PKR/$	Fuel/ltr (Rs) Super
Jul-18	121.63	99.50
Aug-18	124.25	95.24
Sep-18	124.24	92.83
Oct-18	132.55	92.83
Nov-18	140.27	97.83
Dec-18	138.79	95.83
Jan-19	138.26	90.97
Feb-19	139.01	90.38
Mar-19	144.90	94.67
Apr-19	145.01	97.05
May-19	145.20	97.19
Jun-19	150.08	98.08
Jul-19	150.09	98.08
Aug-19	151.77	99.03
Sep-19	152.50	100.89
Oct-19	152.65	100.89
Nov-19	152.93	101.24
Dec-19	152.94	101.70

Table 1 shows that corrective steps are front-loaded and will spark this inflation. However, unlike the next two scenarios, SBP maintains control of the currency by intervening to reduce volatility. In view of the price actions shown in **Table 1**, YoY inflation will peak at 12.7% in September 2019, while average inflation will peak at 11.2% by February 2020 (see **Figure 5**). The increase in inflation is primarily driven by food, utilities and transportation (these three subgroups account for over 71% of the entire CPI basket).

As shown in **Figure 6**, the increase in retail fuel prices and concurrent weakening of the Rupee, sets food inflation on a very sharp upward trajectory. This will be the most problematic part of the stabilization program, but it is not unprecedented – the 2008 IMF program and the recovery of global oil prices, had pushed up food inflation to above 20% in late 2010.

As shown in **Figures 6** & **7**, the projected inflation in utilities and transportation, is basically a continuation of the forces that are already in

[1] NIR is not improved by short-term borrowing that is repayable in the next 12 months. From our calculation, NIR stood at *negative* $ 14.1 bln at the end of 2018.
[2] For all three scenarios we assume that oil prices are range bound between $ 60-70/b during 2019. In all scenarios, we assume that Pakistan will be in an IMF program before the end of FY19.

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play. **Figure 7** shows that inflation in utilities has already posted a sharp increase since September 2018, when YoY inflation was stable around 6 percent. Our model simply extends the upward trend using the price shocks shown in **Table 1**.

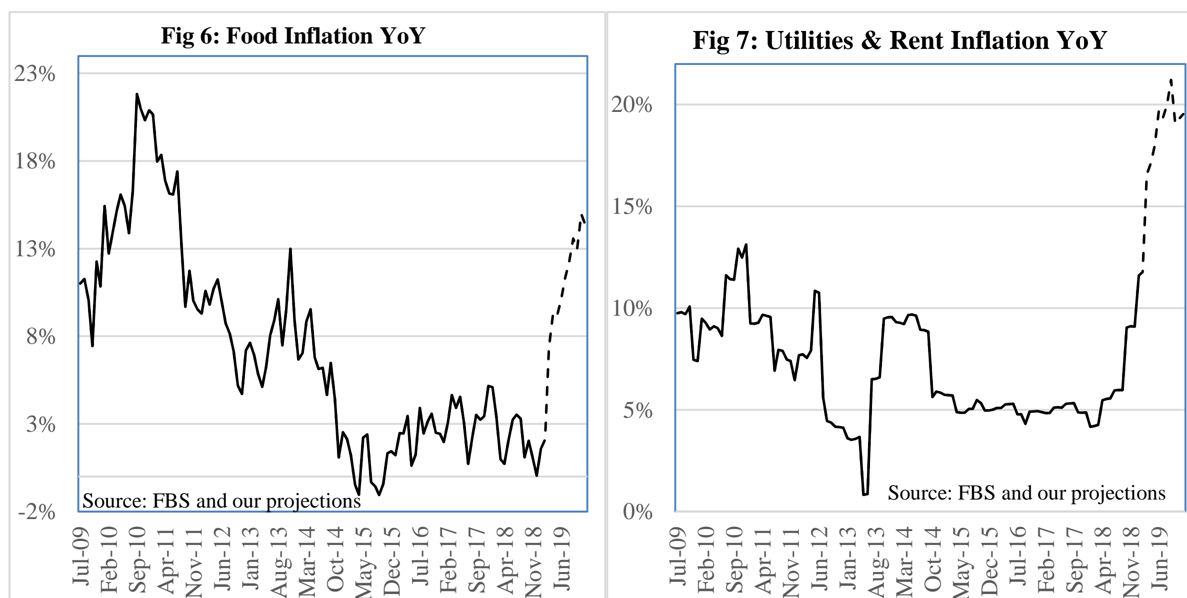
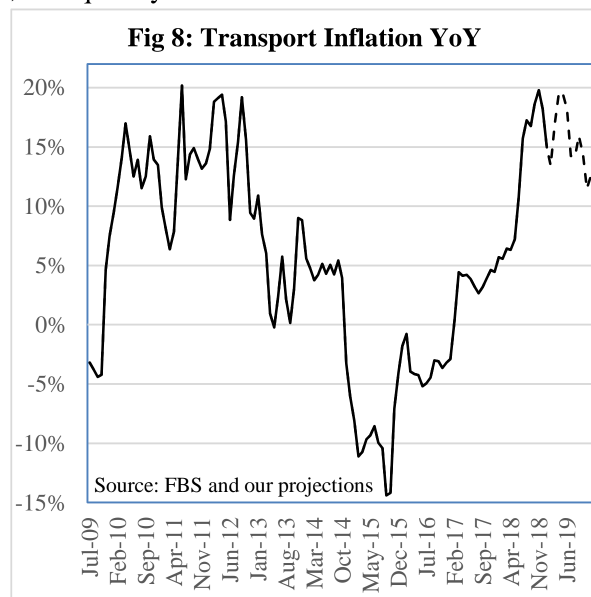


Figure 8 makes an even stronger point: YoY inflation in transportation has already touched 20% in November 2018, and despite the likely increase in PoL prices, inflation in the transportation sector is projected to fall. The point that needs to be made, is that underlying inflationary forces already exist in the system, and the price actions shown in **Table 1**, will quickly take root.



In terms of interest rates, if SBP seeks to target real positive interest rates and knows it must front-load its monetary policy actions, then the discount rate could be increased by a further 75-100 bps.

In **Scenario 1**, the narrowing of the BoP would be less than the next two scenarios. This means that SBP's FX reserves would not build as quickly as desired, and some loans that are due in 2019 may have to be rolled-over (**Figure 1**).

Compared to the next two scenarios, **Scenario 1** would be the least disruptive path forward, and would also be preferred by commercial banks. In an environment of slowing economic growth and rising inflation, loan repayments (especially on consumer loans and credit to SMEs) become more difficult. If interest rates are also increased, banks could experience system-wide loan delinquencies and defaults.

In this scenario, economic growth is likely to slow to a range of 3½ - 4½%, and this slowdown will not be short-lived. Since the pipeline of FX repayments is huge, rehabilitating the external sector will take time as policymakers will have to stay disciplined (throughout FY20) to ensure that Pakistan is able to build an adequate buffer of FX reserves.

Scenario 2: In this scenario, we assume that GoP, its creditors and the IMF, all agree that a more significant improvement is required. As shown in **Table 2**, GoP signals its intent by sharply adjusting both the currency and retail fuel prices from February to April, to ensure that the trade deficit is narrowed. This could change sentiments in the FX market, and it will certainly spark inflation. As shown in **Figure 9**, YoY inflation will be at 11.8% by March, while average inflation for FY19 will settle at 8.7% (YoY inflation will be 14.3% by June 2019).[3] This increase in inflation will force SBP to further increase interest rates, which could be as much as 250-300 bps. Pre-emptive action on interest rates will signal a policy priority to stabilize the economy, and real growth could fall below 3½ %.

Table 2: Price Shocks		
	Month end PKR/$	Fuel/ltr (Rs) Super
Jul-18	121.63	99.50
Aug-18	124.25	95.24
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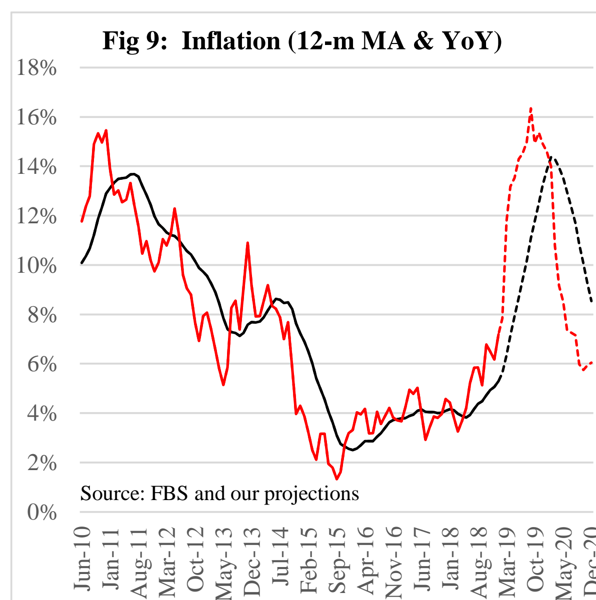
Oct-18	132.55	92.83
Nov-18	140.27	97.83
Dec-18	138.79	95.83
Jan-19	138.26	90.97
Feb-19	141.51	90.38
Mar-19	150.40	94.67
Apr-19	153.51	99.05
May-19	153.70	99.19
Jun-19	156.58	100.08
Jul-19	156.59	100.08
Aug-19	157.27	101.03
Sep-19	161.20	102.89
Oct-19	160.55	102.89
Nov-19	159.87	103.24
Dec-19	157.98	103.70

As shown in **Table 2**, the PKR could hit 157/$ by the end of FY19, which is a clear signal that FY20's external gap is to be brought down sharply. However, as shown in Figures **10** & **11**, a weaker currency and the interest rate increase will exponentially increase debt payments on both Pakistan's external and domestic debt. Although the IMF will focus on the primary balance (i.e. the fiscal deficit excluding debt servicing) as part of its quarterly targets, this suggests that the fiscal deficit may not narrow much in FY20. Nevertheless, with a much smaller external deficit and some limit on the fiscal gap, we expect the twin deficit to be below 10% of GDP in FY20.

Unlike **Scenario 1**, the currency movements shown in **Table 2**, do not reflect a *managed* adjustment of the PKR: SBP does not intervene as much as it currently does, which should create an element of volatility during the course of the month. For example, in the month of June 2019, the PKR/$ parity may even touch 163/$ but settles at 156.6/$ by the end of the month. This currency volatility could compel importers to slow their commercial activity and wait for more certainty. In our view, a degree of currency volatility may create an anti-import environment that could narrow the market imbalance, and ease pressure on the parity. It should also put a stop to the marginal borrowing required to keep SBP's FX reserves from falling to dangerously low levels.



We propose that the differentiating factor between **Scenarios 1** & **2**, is how much leeway SBP has in managing the interbank FX market. A view is gaining traction that the IMF is unhappy about SBP's strict management of the currency, which means it has squandered borrowed money to keep the currency stable.

[3] The inflation momentum will peak in FY20, with YoY inflation touching 16.3% in September 2019, while the 12-month moving average inflation rate will peak at 14.4% in February 2020 (see **Figure 9**).

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One idea is that the IMF will insist that SBP may be allowed to intervene in the FX market (to reduce volatility), but it must remain within a specified budget – more simply, it can only intervene using a certain quantum of hard currency. This means that if market pressures persist, then SBP will have to let the currency weaken, as opposed to fighting the market and depleting its reserves. As we have shown in **Table 2**, currency volatility discourages importers and this eventually allows the PKR to appreciate in Q3-2019.

Scenario 3: This is the nightmare scenario. **Table 3** shows the hard measures taken by the GoP from February right up to June 2019. The urgency to bring down the external deficit is viewed as the only policy priority, and the consequences on inflation are significant (see **Figure 12**). The currency is more or less freely floated and remains quite volatile, creating a strong anti-import bias that is able to sharply curtail imports. However, as shown in **Table 3**, as the external deficit begins to narrow, sentiments in the FX market could change to the point that in the early part of FY20, the PKR begins to appreciate.

Embarking on this strategy will clearly make welfare spending unaffordable, as the expected increase in interest rates (which could be as much as 500-600 bps to keep real interest rates positive) will not allow for much discretionary spending. As shown in **Figures 10** & **11**, multiple factors will cause debt servicing in FY19 to go off the charts – quite literally:

- The magnitude of the exchange rate adjustment since July 2018;
- The increase in interest rates since July 2018;
- The very short-term maturity of Pakistan's market debt; &
- The size and maturity of the BoP support that Pakistan has received from friendly countries.

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The only good news from **Scenario 3**, is that the fiscal squeeze will become so acute that GoP will have no choice but to go after the un-taxed economy, with a sense of urgency that this country has never seen before. In our view, the economic disruption and public anger could strengthen the resolve of the PTI government to push for documentation and forcibly induct all commercial interests into the tax net. While disruptive, this creates an atmosphere where radical steps can be taken.

Table 3: Price Shocks		
	Month end PKR/$	Fuel/ltr (Rs) Super
Jul-18	121.63	99.50
Aug-18	124.25	95.24
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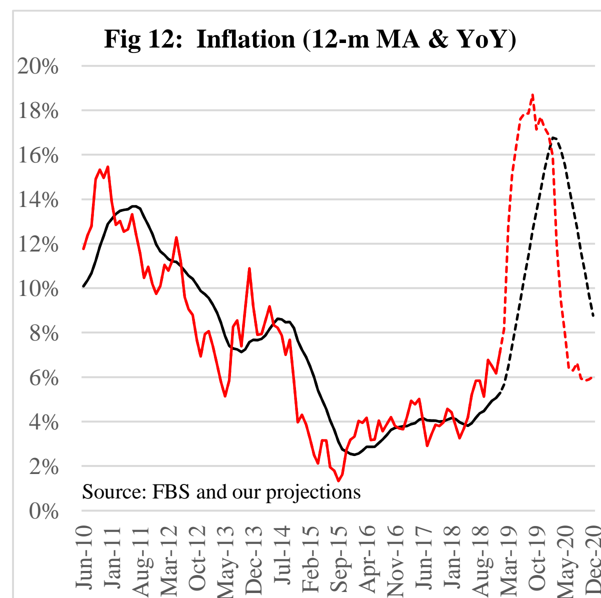
Feb-19	143.51	90.38
Mar-19	156.40	99.67
Apr-19	165.51	106.05
May-19	171.70	108.19
Jun-19	177.58	109.08
Jul-19	177.59	109.08
Aug-19	174.91	110.03
Sep-19	175.14	111.89
Oct-19	173.49	111.89
Nov-19	173.77	112.24
Dec-19	171.78	112.70

To summarize, we feel the current economic situation may not be rectified by **Scenario 1**, which is a more energized version of what SBP/MoF have been doing for quite some time. While the IMF's active engagement in Pakistan would be a step in the right direction, the external sector will remain stressed. More specifically, if SBP continues to micromanage the FX market, this will do little to change the behavior of importers. In effect, Pakistan's recovery from the BoP crisis will be much slower and this may not sit well with our creditors.

In our view, GoP may have pushed for some version of **Scenario 1**, but the IMF did not accept. **Scenario 2** is more disruptive, but it carries the possibility of changing mindsets and reversing market sentiments. As we have argued, a degree of currency volatility is likely to rehabilitate the external sector more quickly. In effect, **Scenario 2** has the advantage that the pain will be up-front, but once Pakistan's economic agents change their behavior, policymakers will be able to chart out a more sustainable path forward.

Scenario 3 is simply too disruptive and will be politically challenging.



Does it have to be painful?

The short answer is… yes.

Consider the following facts:

1. Pakistan is an import-dependent country but doesn't generate enough FX revenues to import what it needs (and wants);
2. A significant share of imports are luxury goods, which the elite feel they are entitled to – and rich enough to afford – without thinking about whether the country can sustain these consumption patterns;
3. Pakistan needs to maintain its FX reserves to sustain its pipeline of imports and repayments, which means it keeps borrowing. This is tantamount to an individual who borrows money not just to finance his current consumption, but also to meet his interest payments. Clearly this is unsustainable;
4. Despite hearing about *export-led* growth since the mid-1990s, our export performance shows that Pakistan has failed spectacularly. Yet, few are interested in understanding why previous policies have failed, while policymakers keep proposing the same incentives that exporters eagerly lobby for. It is almost as if the country refuses to learn from its past mistakes; &

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5. Pakistan's external debt has now become so heavy that the next IMF program should not be viewed as an avenue to continue importing good needed to sustain the domestic economy, but as a way to ensure that SBP has enough hard currency to meet its sovereign obligations.

Some would argue that Pakistan needs to return to old-fashioned import controls like punitive tariffs on luxury imports; sizeable cash margins on all imports; import permission from SBP; or even a return to import licenses as an incentive for exporters. Many would argue that such measures will find little favor with the IMF or with Pakistan's main trading partners. In our view, people must realize that saying farewell to the IMF may be a popular political slogan, but it also means that Pakistan will become isolated from the global economy – something this import-dependent country cannot afford. Finally, people must realize that economic arguments that developing countries can (and should) rely on "foreign savings" to climb up the "development ladder", are a distortion of what really happens.

Pakistan does not borrow hard currency to invest in commercial or industrial ventures – it borrows to repay debts, import fuel or to finance an external deficit that includes a significant component of luxury items. More simply, *foreign savings* are not used for *domestic investments* (especially those that generate foreign exchange revenues). Lukewarm interest in Pakistani debt is a clear signal that "foreign savers" want higher returns because they doubt whether Pakistan will use their savings wisely, and whether they will be repaid. Eventually our friends will also stop lending to finance our consumption.

An unsustainable external debt is a warning before the system collapses.

Conclusion

We have flagged the anti-export bias of the previous government (May 2017); how China and CPEC could be an integral part of a customized solution (September 2017); the need for an IMF program (December 2017); what the next IMF program should focus on (March 2018); and how the PTI government should navigate the economy (August 2018). We were also confident that Pakistan would be in an IMF program during 2018.

While we have been off the mark with our predictions, our macro projections, dating back to January 2018, have been consistent. As we expected a degree of policy pre-emption to enter a stabilization program quickly (to avoid a desperate entry later), our macro projections on the PKR and interest rates were less elevated. During the course of 2018, our projections on the currency and interest rates became less optimistic as the path forward remained unclear, while the cost of this hesitation mounted. In 2019, we cannot propose just one scenario: there is simply too much uncertainty while the country's vulnerability is getting worse.

Our outlook has soured for several reasons: (1) GoP has been unable to contain imports; (2) SBP has been unable to shift Pakistan's domestic debt towards longer term instruments; and (3) the spate of external borrowing has been so acute, that Pakistan is now unable to meet its external obligations without seeking to reschedule. In our view, **Scenario 1** may not have sufficient bite to stabilize the external sector and/or give much comfort to our creditors. Hence, we think **Scenario 2** is the more likely outlook, whereby the PKR/$ parity could hit 155-160/$ by the end of June 2019. While this may appear extreme, so is Pakistan's BoP.

Before dismissing **Scenario 3** as being too draconian to be contemplated, there is some value to shock therapy. The current policy complacency is disappointing and there is a cost attached to the resulting uncertainty. Pakistan's sovereign debt has recently been downgraded by S&Ps, which means future borrowing will be more expensive. Worse still, since the appetite for imports remains strong despite the

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devaluations and interest rate hikes, future policies will have to be harder to get the message across. While the pain and disruption will entail a heavy political price for PTI, it also affords the government an opportunity to take a firm stance against political opponents and corruption, and move closer to its campaign promises.

Unfortunately, the economy will just have to roll with the punches and hope for the best.

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