Year-end assessment of 2018

Mushtaq Khan, December 27, 2018

It's a corporate ritual at this time of the year, to summarize what happened. Perhaps it's the fact that markets slow down or bonus decisions are made, so we thought it would be helpful to summarize the eventful 2018, and use this to flag specific issues that are likely to shape Pakistan's economy in 2019.

Summary of 2018

We will only focus on our papers (and projections) to put forward a chronological order of what happened in the year. This will reveal how our narrative on Pakistan's economy has evolved during the course of the year. Those who are familiar with our past papers may skip to page 4 (Assessment).

1. January 2018 (projections 3Q-FY18). We state that Pakistan would be in an IMF program in FY19, which is likely to play out. With PKR weakness and rising PoL prices, we project average inflation by end-FY19 at 8-9%. In terms of the PKR, from a rate of 110.5/$ at end December 2017, we project the currency at 118.6/$ in June 2018 and 124.4/$ in December 2018. We also predict that interest rates would increase by 100-125 bps in FY19, which is soon proven wrong;

2. January 2018. We use the surprise increase in interest rates (by 25 bps) to argue that this indicates change in policy sentiment, as the government effectively dismisses the possibility of a pre-election economic boom. We also argue that this policy change would make it easier to work towards an IMF program;

3. February 2018. We shift attention to the US economy, to reveal the policy contradiction between the expansionary fiscal policy (tax cuts and proposed infrastructure build) and the US Fed's monetary tightening. We suggest that if the US market falters, this may trigger a blame-game by President Trump against the Fed, which could seriously jeopardize global markets. Trump's attack on the Fed came later in 2018, as all asset classes show a downturn in 2018. The expected Fed tightening in December 2018 could provoke a more consequential tussle between the White House and the Federal Reserve;

4. February 2018. We admit that FATF could be used by the US government to put pressure on Pakistan via closer scrutiny of banking transactions, lower appetite for Pakistani bonds and by destabilizing the local kerb market. However, we conclude that FATF's concerns will not impede the path to the IMF program, and will support the changes that Pakistan needs to implement to check capital flight.[1]

5. March 2018. We discuss President Trump's use of trade tariffs as bargaining chips that will be used in subsequent bilateral negotiations. We predict that as his presidency enters its second half and Trump's focus shifts to domestic affairs, he will continue to use trade barriers even if this goes against the interests of the moneyed elite;

[1] We *now* emphasize that the lack of public debate about FATF is perhaps driven by the true point of contention between Pakistan and the US (i.e. OECD): the financing details of extremist religious groups that are based in the country. In our view, the changes required in the monitoring of FX inflows and outflows, are something that SBP would willingly accept as it would make FX management easier. However, the underlying politics of investigating terrorist financing in Pakistan, creates a far more complex issue to navigate.

6. March 2018. We use the IMF's post-program monitoring (PPM) report as a reality check against the picture painted by the government as it approaches the general elections. The PPM acknowledges the lapses of the past program, which suggests that the next program will be much tougher. We also argue that the next program will be different as it will focus on issues like documentation, real estate holdings and the country's unsustainable external debt. We are surprised by the IMF's neutral-to-positive stance on CPEC, which contradicts the media's assessment that the IMF has not been supportive of this mega project;

7. April 2018. We build on our March paper to state that global trade patterns in the 21st century are unsustainable. More specifically, the lopsided trade imbalance between China and the US cannot last much longer, with one being the consumer and the other the producer. We argue that while a trade war (triggered by the US) is provocative and inefficient, it could be helpful to *reset* trade ties between the two superpowers. This suits Trump politically (*Make America Great Again*), and will also help China shift its engine of growth from exports to the West to domestic consumption. In a bipolar world order, we suggest that a degree of economic independence (distance) between the US and China, is perhaps required for this system to be sustainable;

8. April 2018 (projections 4Q-FY18). We show that Pakistan is already caught in self-enforcing twin deficits, but underestimate the size of the current account deficit at only $ 15.3 bln in FY18 (the actual gap was $ 19 bln). Against a parity of 115.5/$ in March 2018, we project the PKR at 118.5/$ in June 2018 and 124.9/$ by December 2018, which are conservative estimates with hindsight. Our average inflation projection for FY19 shifts to the range of 7-8%, which shows that subsequent events have been more disruptive than we had anticipated;

9. May 2018. We see President Trump's decision to scrap the Iran nuclear deal as a trigger that could reshape the entire Middle East. While the White House may have gambled that the pain imposed on Iranians may be sufficient to initiate regime change, the more likely outcome is that Iran will double down and try to isolate the US. This is impossible given the global dominance of the US dollar, but Iran will use China, Russia and the disgruntled EU, to create an alternative payment system that is not controlled unilaterally by Washington D.C. We conclude by urging that Pakistan remain neutral in the Saudi-Iran stand-off;

10. May 2018. We argue that Pakistan's macro economy is now so imbalanced that the next stabilization program will have to be customized. Orthodox measures to slow demand (weaker PKR and rising interest rates) could blow out the fiscal side and increase the political cost of economic reforms. We build on our suggestion to focus on documentation, real estate holdings and a fair Amnesty Scheme. For the first time, we propose the need to rethink the China-Pakistan FTA, and suggest shifting the focus of CPEC to strengthen Pakistan's external sector;

11. June 2018. We highlight the 180-degree change in the bureaucracy's economic outlook after the Interim government takes charge. While we agree with the "new" economic outlook, we highlight the institutional failure to manage the country's economic trajectory when it was less painful to do so. We talk specifically about the need to strengthen state institutions as part of the next phase of economic reforms;

12. June 2018. We focus on the summit meeting between President Trump and Kim Jong-Un to show how mainstream media is no longer objective in its coverage of US politics. This explains why liberal-leaning audiences are dumbfounded that Donald Trump is able to continue his outlandish rhetoric and actions. The danger is that media outlets like CNN and The New York Times are creating a more divisive US, which means the two sides will remain disconnected. We predict a bitterly contested mid-term election in the US, and show concern that if the Republicans retain their majority in Congress (the House and the Senate), Trump's reelection in 2020 is more likely;

13. July 2018. We are surprised by the 100 bps increase in interest rates in end-June, and the subsequent weakening of the PKR in mid-July. This means we will have to revisit our macro projections, but it reinforces our concern about the fiscal implications. We argue that this interest rate increase before the elections has been done with some understanding with the IMF (in our view, the interim government does not have the mandate to make such policy changes). We conclude that the new government will not have much of a honeymoon period;

14. August 2018. This report was written for the Asian Development Bank, Islamabad. In standalone boxes, we talk about: (1) the economic challenge posed by a politicized bureaucracy; (2) how accountability will impose a short-term economic cost; (3) the outlook for CPEC; and (4) why FATF induced changes will help SBP better manage the PKR/$ parity. We discount US efforts to politicize the IMF and CPEC, and predict that the new PTI government has little choice but to approach the IMF. We conclude by saying that it is not clear whether the new government will embrace disruptive economic reforms, which is the only way to tackle stubborn problems;

15. August 2018 (projections Q1-FY19). These projections were dovetailed into the abovementioned ADB paper. Our inflation projection increases from 7-8% (in April 2018) to 8-9%, and we predict the PKR/$ parity (which was 124.3/$ in July 2018) at 134.3/$ in December 2018 and 140.4/$ for June 2019;

16. September 2018. We argue that the first few statements by the new government has left the market confused. It has questioned whether Pakistan really needs the IMF, and suggested that parliament must debate this option. In our view, this creates deceptive options that muddy the waters, and all the while the country's BoP position continues to deteriorate. We state that Pakistan needs both assistance from China and an IMF program; policymakers must also be clear that financing the macro imbalances is not solving the underlying problems. With countries like Turkey and Argentina in turmoil, Pakistan's macro calm cannot be taken for granted;

17. October 2018. We called this paper: *The Last IMF Program?* By end-September, significant changes in the PKR parity and interest rates reveal that Pakistan is poised to enter an IMF program. We suggest that these orthodox policy steps should be enhanced to include: (1) system-wide documentation to raise revenues; (2) discussions with China to make Pakistan's external sector more sustainable; (3) the formulation of an industrial policy; (4) institutional strengthening; and (5) hard steps to stop the hemorrhaging in the power sector. These changes will be disruptive, but are now necessary;

18. November 2018. We weigh in on the Khashoggi murder, with the suggestion that this could be a tipping point in the Middle East. If Saudi Arabia falters, the entire Gulf and Arab world could be

thrown into turmoil. We predict the Saudi crown prince (MBS) will step down; the Yemen war will end; and the anti-Iran rhetoric will be toned down. We also suggest that Turkey will bring Iran back into the global order. If Pakistan remains neutral, the potential changes in the ME should not adversely impact the country;

19. <u>November 2018</u>. Despite the GoP vacillating between the IMF and friendly countries, it is increasingly clear that both are required. Saudi assistance has shored up sentiments, but China's more cautious response has raised concern. We build on our previous narrative that China's guidance and assistance is required, while Saudi support will allow SBP to manage the FX market. We end by saying that more clarity is required to keep the markets calm;

20. <u>December 2018 (projections Q2-FY19)</u>. The events of November 30 catch the market off guard. The PKR/$ parity lost Rs 10/$ in a matter of an hour before SBP stepped in to stabilize the currency at 138/$ – later the same day, SBP increased interest rates by 150 bps. Our previous assessment was that the GoP wanted the PKR at 137-140/$ by end-FY19, while the IMF wanted 145-150/$, which means GoP has conceded. We discuss Egypt's stabilization experience in 2016, and argue that Pakistan's program should not be as disruptive. We also suggest that SBP's reserve build-up will be the most binding quarterly target, while revenue targets will be monitored via primary deficit targets. In terms of inflation, we increase our projection for FY19 to a range of 8½-9½%. In terms of the currency that was 140.3/$ in November 2018, we project the parity to be 145.5/$ in June 2019 and 148.5/$ in December 2019. For the remaining part of FY19, we expect a further 100-200 bps increase in interest rates.

Assessment

As our narrative shows, we have been anticipating an IMF program throughout 2018, claiming it was "inevitable" back in October 2017. Looking at our papers, certain trends characterize 2018:

- External sector concerns have dominated fiscal challenges;
- The elections in July were conducted in a period of economic stress, which meant the country could not afford populist policies to influence public opinion;
- The signal that Pakistan was heading towards a stabilization program was first seen in early 2018, when SBP surprised the market with a 25 bps increase in interest rates in February;
- By May 2018, we realized that a standard IMF stabilization program (like the previous two) would not be enough. We proposed unorthodox policies to more accurately value real estate holdings and bilateral efforts to narrow the trade deficit and create a more sustainable economic partnership with China;
- We also conceded that our macro projections were initially conservative, and had to be adjusted to keep pace with SBP's more aggressive changes in interest rates and the PKR/$ parity; &
- The PTI government took charge of a structurally weak economy, but it did not properly manage market sentiments. Pakistan has been conditioned by past IMF programs, and the market views abrupt changes in the PKR/$ parity and interest rates as an indication of an upcoming IMF program. However, the Finance Minister's ambiguity about the need for the IMF just created confusion.

Undocumented economy

While we feel that the bulk of the currency and interest rate adjustments have already taken place, we expect a further devaluation and another interest rate hike before the program starts. Unlike the previous two programs, this one will hurt as the steps already taken (and not just economic policies) will directly impact the undocumented economy. The combined impact of the following factors cannot be ignored:

1. The Amnesty Scheme that ended in June 2018. This means greater scrutiny of the tax forms of those individuals who availed the scheme;
2. The focus on Pakistanis with overseas bank accounts and properties. Making this list public (which is now making the rounds on social media) implies that these individuals will be more apprehensive about spending and investing, especially in the undocumented sector;
3. This sentiment is reinforced by the anti-encroachment drive in Pakistan's main cities. In our view, this is a significant move as undocumented retailers have thrived in connivance with local regulatory and enforcement agencies. Other than job losses, this policy will discourage investment in the undocumented sector;
4. SBP has tightened the monitoring of cash dollar transactions that use foreign currency accounts. This means FX outflows should fall, which will curb capital flight;
5. With the OECD's emphasis on money laundering and terrorist financing, it is now much harder (and riskier) to send money overseas. The Hundi/Hawala network in Pakistan has been weakened significantly. In effect, undocumented wealth cannot be invested or consumed in Pakistan, and is not allowed to leave the country;
6. The accountability drive that targets top politicians will sharply reduce their "undocumented" financial transactions. Zardari and the Sharif family have dominated the country's politics since the 1980s, but they are also equally significant investors in the undocumented economy. Unlike these two political parties, PTI has few reservations about clamping down on the informal economy;[2]
7. If the PTI government pushes for more accurate real estate valuation (as proposed in the previous Amnesty Scheme), this avenue to hide money/wealth will no longer be available; and
8. The next IMF program will entail the creation of a fiscal cadaster, which is a digital ledger of each Pakistani and the assets (financial or real) that this individual owns. This documentation exercise will go a long way towards expanding the direct tax base.

From this list, we get a clear sense the government has decided to clamp down on undocumented economic activity. As we have argued before, this would be the most effective way to reduce demand pressure in Pakistan's economy, which is the end-goal of a stabilization program (*Could the next IMF Program be decisive?* December 12, 2017). There are two reasons for this: one, the stabilization program to reduce demand pressures dovetails nicely with the documentation drive and the on-going accountability; and two, these policy measures operate on *sentiments* that do not require a proactive policy stance.

More specifically, documentation and accountability is likely to dampen sentiments, which in turn will reduce demand pressure and compliment the IMF's use of more orthodox tools to stabilize the economy (e.g. PKR/$, interest rates and new revenue measures). If the government continues to push documentation and accountability, this should reduce the twin deficits without excessive use of the abovementioned stabilization tools.

In terms of the second point, our argument is that by announcing a policy direction (i.e. documentation and accountability) the government can rely on supporting institutions to deliver results. For example, NAB and the Judiciary have made significant progress on high-level accountability cases, which will play out on *their* institutional strength and credibility – there is no role for the government. Similarly, if the

[2] We would also argue that the previous governments of Asif Zardari and Nawaz Sharif also entered IMF programs in their first year in power, but since their personal business interests were largely in the undocumented sector, their financial interests were protected from the IMF's austerity.

government announced a policy for real estate valuation, or how to regularize overseas properties, or to create a NADRA-based fiscal cadaster, it will be up to the implementing institutions (with GoP oversight) to deliver.

More simply, if people are convinced that this policy direction will be carried forward, that in itself should be sufficient to get the desired results. In effect, the on-going accountability of political stalwarts, and the conviction that this will be carried forward till the corruption references are fully prosecuted, should undermine confidence in the undocumented economy. This in turn will narrow the twin deficits and increase the chances of a successful stabilization program.

While the undocumented sector operates beyond policy/regulatory control, the spillover from these businesses directly impacts the formal economy. In our view, most construction activity in Pakistan operates in the undocumented sector, which would make this the main avenue to deploy/invest black money in the economy. In addition to construction, retailers of household goods & services (e.g. clothing, electronics, kitchen appliances, supermarkets, restaurants, furniture and fixtures, etc.) are also more comfortable operating in the undocumented sector. Both construction and retail directly impact a host of ancillary industries like cement, steel, chemicals, cables, consumer durables and the skilled/unskilled labor markets. If such investment slows, the formal economy will be impacted.[3]

There are signs that consumer demand has slowed and jobs are being lost. In our view, as Pakistan prepares to enter the IMF program, the official narrative will change to explain the economic slowdown as a spillover from the documentation and accountability drives. While the economic slowdown will be disappointing and (to some extent) unprecedented, one must realize that this is precisely the end goal of economic stabilization. In our view, to manage the likely uproar from opposition parties, the government should not focus so much on the IMF program, but rather the documentation and accountability drive to justify the economic pain, and to explain why politicians are so upset.[4] This pain will have an upside: a real slowdown in economic activity will translate to lower cash imports (and outright smuggling), which should create a dollar surplus in the country.[5]

Outlook – Global

2019 will not just be tough for Pakistan, but could be quite destabilizing for the world. We will touch on our main concerns by country.

The United States

President Trump will start his third year facing a confrontational House of Representatives; multiple federal investigations into his private and public dealings; the likely imposition of US sanctions on Saudi Arabia; a significant weakening of his cabinet; a possible reversal in *Pax Americana*; and revelations from the Mueller investigation. As we have discussed before, impeachment proceedings are now more

[3] Job losses in the informal economy mean lower consumption spending; households will delay lumpy purchases (consumer durables, autos, home improvement, travel, etc.); and ancillary industries (and their suppliers) will experience a fall in demand. This in turn will result in more job losses, as the secondary impact ripples across the economy.
[4] An argument could be made that political opposition to economic hardship is driven more by the need to stop the accountability drive, than concern for the common man. One could also argue that the pain is now required because of the economic mismanagement of the past.
[5] Fewer cash imports and less smuggling will reduce the demand for dollars (in Pakistan), which will be supported by lower capital flight. With dollar inflows into the country remaining at the same pace (informal remittances), this should create a dollar surplus that will eventually enter the interbank market. So the economic slowdown would not only reduce the demand for dollars, but it could also increase the supply of hard currency in the local markets.

likely than in the past two years. In our view, American politics will become even more divisive as President Trump seeks a second term in power.

The smart money is on a one-term presidency, but the American establishment may angle for impeachment to limit the damage that President Trump has done to the US on the global stage. Unfortunately, with mainstream media infatuated with President Trump – who is a master at playing the media to energize his political base – the world will be exposed to even more dysfunction.

In our view, if President Trump is able to serve out his first term, his instinct to fight back will further split the country (perhaps irreparably). In a paper we wrote in 2016 (*The Trump Phenomenon*, September 28, 2016), we argued that Donald Trump's presidential campaign had changed the American political landscape, and this could change the face of the Republican Party. If the latter pushes back, Trump could carve out a new political party that is built on his populist views. This means Donald Trump will pull out all the stops, even if this damages the US further.

On the economy, the outlook is equally disruptive. The manner in which US asset values have fallen in late 2018, has brought forward predictions of the next economic downturn from 2020, to 2019. The mixed signals from US fiscal and monetary policies, and President Trump's recent attack on the US Fed, could trigger a collapse of the US stock market. The confrontation between the President and the Fed is likely to escalate in 2019. While US economic numbers still look good, one needs to analyze the composition of job growth, the lopsided role of tech companies[6], the growing income inequality, and realize that the bull-run since 2008 is the second longest in US history. Understandably, many are bracing for an abrupt downslide.

Britain and Brexit

The chaos in Westminster is now confusing to the point that people have lost track of the issue, and what the two sides are arguing about. With the March 2019 deadline fast approaching, there appear to be three options: (1) a no-deal Brexit; (2) another referendum that many think will keep Britain within the EU; and (3) a half-way deal championed by PM Theresa May (a bit of Brexit and a bit of Remain).

Most analysts agree that a no-deal Brexit would be very disruptive, with long traffic jams as trucks pile up on both sides of the English Channel. Media channels are already talking about the possible shortages of basic food items, and how the price of sandwiches could shoot up. A no-deal Brexit also means that global banks will have to shift their operations to Europe, which will adversely impact the City of London.

The likely result on a second referendum on Brexit, is not as clear as many think. The conventional wisdom is that since Britons now realize the severe economic consequences of leaving the EU, many will change their vote and *Remain*. However, a second vote will surely enrage Brexiters, and open up the debate that the moneyed interests are undermining Britain's democracy. As we had discussed in our 2016 paper (*Brexit: Why the 23rd Referendum is just the beginning*, June 14, 2016), the decision to leave or remain is not driven by subtle economic arguments, but more primal sentiments about immigrants (from Eastern Europe) taking away blue-collar jobs, and the change in British culture. We fear that if this debate is rekindled, rightwing politics could surface in Britain, as it has in several European countries.

Then there is the Theresa May solution, which she intends to propose to the EU. This *deal* is off to a poor start as PM May opted not to table it for a parliamentary vote. In simple terms, the deal seeks to satisfy

[6] US stocks have been driven by a narrow band of tech companies that are known as FANGs (Facebook, Amazon, Netflix & Google). Other sectors have not fared too well.

both sides: to maintain free trade (and surrender some sovereignty to the EU on these matters) but retain control on immigration from EU countries.

But there is a flaw in this argument. Even if the purists in Britain were to accept this half-way solution, it is unlikely the EU parliament would accept. In our view, if the EU accepts Britain's special request, other members of the EU (especially those countries that are being targeted by British controls) would demand equal treatment against Britons, and propose even harder limits on immigration from non-EU countries. One must realize that European sentiments have soured since the inflow of Syrian refugees, and the manner in which the EU handles Brexit will be used by political parties to further their nationalist agendas.

In our view, the real fear is if British politicians mismanage Brexit, this could further polarize the British people. As discussed in our 2016 paper, the decision to leave the EU was driven by public sentiments that the fall in living standard in England can be traced to blue collar immigrants, affluent foreigners (who are buying out most of central London), and the creation of high-skilled (high paying) jobs Britons cannot get. If anything, the period since the Brexit decision has seen these concerns spread to the US and the EU. If this debate escalates, we fear that xenophobic and nativist arguments could gain traction in Britain.

In view of all this, a hard Brexit is the more likely outcome. This assumes that Brexiters are able to sway public opinion, and the possibility that Britons could begin to embrace the trade disruption. A *be-British; buy-British* slogan could be used to justify the economic disruption, and even a city as cosmopolitan as London may have to emphasize its Britishness.

The European Union

What happens in Britain will impact the EU. If Britain has a hard Brexit, the resulting nationalism could be used by rightwing political parties (in the continent) to harden their demands. As things stand, the EU is already at the edge:

- The Italian government is openly defying EU limits on government spending and tax collection targets. Beyond the fiscal limits, this nationalist agenda is also at odds with another fundamental requirement for a common currency – free immigration flows. In effect, the Euro's *Achilles heel* is now exposed;
- The Merkel era is likely to end on an anti-immigrant and xenophobic note. Rightwing parties have gained strength in Germany, and even within the Christian Democrats (Angela Merkel's party), there are misgivings about her defiant stance to accept a large number of Syrian refugees;
- The Yellow Vests have neutralized Macron's economic agenda, which is likely to undermine his pro-EU policy agenda. The growing resentment of non-Parisians could morph into a nationalist agenda that is anti-immigrant and anti-elite;
- The governments in Hungary and Poland are already rightwing and anti-immigrant; &
- Spain and Portugal are struggling to manage domestic discontent with stagnant economies.

One must realize that EU's parliamentary elections are scheduled for May 2019. With the rise of nationalist parties in many EU countries, the prediction is that rightwing parliamentarians could dominate the European parliament. As liberal politicians lose support in Germany and France, the EU elections will be closely watched. If rightwing nationalists are able to win a sufficient number of seats, and find common cause with other nationalists, this could have strong repercussions for immigration into the EU, and the plight of minorities who currently reside in Europe.

Saudi Arabia and the Middle East

As discussed in an earlier paper (*Khashoggi's murder is a point of no return*, November 1, 2018), the Khashoggi murder has created an unprecedented rift between US lawmakers and the House of Saud. With a democrat-controlled House in 2019, and a Senate vote to punish Saudi Arabia and censure the crown prince (MBS), relations between the kingdom and US will only get worse in 2019. As we have discussed, we do not see how MBS can remain in power. However, unlike previous successions in Saudi Arabia, a smooth transition is now more challenging because of the deep fissures within the House of Saud.

A change in Saudi leadership will have to be accompanied by a change in foreign policy. MBS's *Vision 2030* will be shelved as Aramco's IPO does not appear possible. We expect global pressure to end the Yemen war, and a less belligerent Saudi policy in Syria and Lebanon (this has been aided by President Trump's decision to withdraw US forces from Syria and Afghanistan). The likely change in Saudi leadership suggests that power in the Middle East will tip towards Turkey and Iran, and place both Abu Dhabi and Egypt on the defensive.

Given the nature of the kingdom, we are still unsure what will happen within Saudi Arabia itself. A disruptive transition of power will not help anyone, as there are legitimate fears that radical elements could gain traction and political power in the region, which could destabilize the neighboring monarchies. If the transition is to be smooth, it should afford a level of face-saving so it doesn't appear that the changes have been dictated from outside the kingdom.[7]

China

Compared to these global players, China may not witness as much disruption in 2019. However, the economic slowdown is likely to continue, and China will struggle to manage its debt overhang and housing market. Furthermore, the trade war with the US will remain in play and dampen investor confidence. However, as part of China's strategy to reduce its vulnerability to US policies, China will push to create a non-dollar clearing system for international trade. It will also launch the RMB as a hard currency, and create financial arrangements/institutions whereby China's trade flows are conducted in RMB, or in a non-dollar currency.

Outlook – Pakistan

Focusing on the undocumented economy is touching the untouchables – a difficult but necessary move. This will generate pushback, but with a pending IMF program, the government does not have the luxury to back off. If the economic slowdown does materialize and the government holds the course with accountability and documentation, the short-term pain will be worth it. In our view, the government should use this slowdown to: (1) take hard steps to improve the cost-recovery of Discos; (2) use NADRA to create a digital *fiscal cadaster*; (3) monitor the use of foreign currency accounts; and (4) work with tax non-filers to find a path to full disclosure and documentation.

Economic reforms only take hold when bad economic behavior is stopped. This means paying one's bills; paying one's taxes; not using influence with policymakers for self-interests; documenting all

[7] The least disruptive transition is to gradually strip MBS of key areas of power (economy, interior and defense), while he retains the title of crown prince. Over time, MBS will lose traction with global media, which could pave the way for Prince Nayef (who was the crown prince before MBS) to regain charge as crown prince, returning the succession line to previous norms. This scenario will allow the Saud family to retain absolute power. However, a more sustainable and acceptable solution is to move the kingdom towards a constitutional monarchy, with an elected parliament. This is a longer term transition that will have to be managed carefully, as neighboring monarchies will have to follow suit.

financial transactions; not hiding personal wealth/income; and stopping capital flight. Only a principled, across-the-board targeting of bad behavior will be acceptable and sustainable.

During periods of discomfort or stress, people take comfort from knowing that others are also suffering. This creates a window of opportunity: if the average middle class Pakistani must prepare for hard times, the government should simultaneously target powerful and affluent Pakistanis who have weakened the country. When the average Pakistani realizes that the untouchables are also facing hardship (and a degree of public shame), their pain may be a bit more bearable.

To summarize, 2018 has been an eventful year, but 2019 is likely to be more disruptive. While we remain apprehensive about the scale and scope of possible changes in the global arena, we are optimistic that after a tough start in 2019, Pakistan's economy will begin a journey towards structural strength and growth. But for this to materialize, the government must continue its accountability and documentation drive. What the government decides in terms of the penalties on non-filers (in the forthcoming mini-budget) will be the acid test. Staying the course will not be easy, but then again, structural reforms never are.