PAKISTAN’S ECONOMY- Trends and Indicators: June 2019

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All Charts and trends from Trading Economics, unless otherwise specified.

Overview

The macroeconomic challenges continue to dominate Pakistan's woes as the country prepares to enter into the fiscal year 2019-20. Despite tight fiscal and monetary policies to curb the twin deficits leading to deceleration of the GDP to a nine-year low of 3.3% in the ongoing fiscal year, lower revenue collection and higher current expenditure pushed the budget deficit to 5.5% of the GDP mainly due to heavy domestic and foreign borrowing to meet growing expenditures. Adding to the supply-side slowdown, the agriculture sector registered a growth rate of 0.85% against the target of 3.8%; industrial sector 1.4% against 7.6% and the services sector 4.7% against 6.5%.

On the demand side, the exports declined by 1.9% despite the exchange rate depreciation, while imports declined by 4.9%. It helped in reducing the trade deficit by 7.3% during July-April 2019 while it had shown an expansion of 24.3% during the corresponding period of last year[1].

The workers' remittances played a major role in containing current account deficit to 4.03% of GDP. The current account deficit showed a contraction of 29% to USD 12.6 billion during the current year while it had stood at USD 17.92 billion during the corresponding period of last year[2].

The overall output of Large Scale Manufacturing Industries (LSMI) decreased by 2.93% as domestic demand contracted and rising world prices crimped demand for raw materials[3]. Furthermore, a slowdown in agriculture and industry, as domestic demand shrinks, kept services growth suppressed as well. Stabilization measures, rising inflation and declining exchange rates are containing growth in private consumption and investment, while public sector development spending has already reduced.

On July 03, 2019, the Executive Board of the International Monetary fund (IMF) approved a three-year, USD 6 billion bailout plan. The fund will review Pakistan's performance quarterly over 39 months, phasing release of the additional aid over time. This is Pakistan's 13th IMF program and as part of the IMF package, Pakistan has committed a comprehensive reform program to stabilize the economy and lay the foundation for a robust and balanced growth. That would mean the economic growth rate going down to 2.4% during the current fiscal year, compared to 3.3% of GDP last year ending June 30, 2019.

Likewise, the rate of inflation has been projected at 13% under the IMF program. The authorities have promised the keep the State Bank of Pakistan's policy rate at least 1.5% higher than the projected inflation. This means the policy rate will further go up to 14.5% from 12.25% at present.

Pakistan is set to receive a total of USD 6 billion in about three years ending 2021-22 from the IMF, while it has to repay about USD 4.355 billion in four years ending 2022-23, showing net receipts of USD 1.65 billion[4].

[1] Staff Report| Economic Survey 2018-19: Economy hits nine-year low at 3.3pc, June 10, 2019 (www.pakistantoday.com.pk)
[2] Salman Siddiqui| Current account deficit shrinks 29% to $12.68b, June 20, 2019 (www.tribune.com.pk)
[3] Staff Report | Large Scale Manufacturing decreases by 2.93% during July-March of FY19, May 15, 2019 (www.mettisglobal.news)
[4] Khaleeq Kiani| Pakistan to get $1.65bn net receipts out of $6bn IMF package, July 08, 2019 (www.dawn.com)

Recent Trends

Global Oil Prices

Oil futures rose on July 05, 2019 as tensions over Iran and an extension to output cuts by OPEC and its allies boosted prices, but mixed economic data limited the rally.

Brent crude futures settled at USD 64.23 a barrel, up 93 cents, or 1.47%. U.S. West Texas Intermediate (WTI) settled at USD 57.51 a barrel, up 17 cents. Both benchmarks were down for the week as concerns about a slowing global economy outweighed risks to supply. Brent recorded a 3.3% weekly loss and WTI shed roughly 1.8%.

The U.S.-China trade war has dampened prospects of global economic growth and oil demand, but talks resume next week in a bid to resolve the deadlock. The Organization of the Petroleum Exporting Countries and allied producers such as Russia, known as OPEC+, supported prices by extending their deal on supply cuts. Tension in the Middle East also offered support, particularly to Brent. "Brent is pricing in more of the geopolitical risk than WTI," said Phil Flynn, an analyst at Price Futures Group in Chicago.

Iran threatened to capture a British ship after British forces seized an Iranian tanker in Gibraltar over accusations the ship was violating EU sanctions on Syria. [5]

Monetary Policy

Since January last year, State Bank of Pakistan has hiked rates by 550 basis points. The last monetary policy on May 21, 2019 witnessed increase in interest rates by 150 basis points by SBP, to 12.25%, citing rising inflationary pressures. Average headline CPI inflation reached 7.0% in Jul-Apr FY19 compared to 3.8% in the same period last year. Moreover, the annualized headline month-on-month inflation has risen considerably in the last three months due to the recent hike in domestic fuel prices and rising food prices and input costs. As such, inflationary pressures are likely to continue for some time. These pressures on headline inflation are explained by adjustments in the administered prices of electricity and gas, significant increase in perishable food prices, and the continued unfolding impact of exchange rate depreciation. Core inflation maintained its 13-month upward trajectory accelerating to 7.2% in June 2019 from 7.0% percent a year earlier.

Despite the improvement in the current account and a noticeable increase in official bilateral inflows, the financing of the current account deficit remained challenging. Consequently, reserves declined to USD 8.8 billion as of 10th May 2019 from USD 10.5 billion at end-March 2019. The exchange rate also came under pressure in the last few days. In SBP's view, the recent movement in the exchange rate reflects the continuing resolution of accumulated imbalances of the past and some role of supply and demand factors. SBP will continue to closely monitor the situation and stands ready to take measures, as needed, to address any unwarranted volatility in the foreign exchange market. Furthermore, the current level of reserves is below standard adequacy levels (equal to three months of imports cover). The MPC committee further noted that deep structural reforms are required to improve productivity and competitiveness of export-oriented sectors and improve the trade balance.[6]

[5] Laila Kearney| Oil prices rise on Iran tensions, OPEC output cuts, July 05, 2019 (www.reuters.com)
[6] SBP Monetary Policy Statement, May 20, 2019

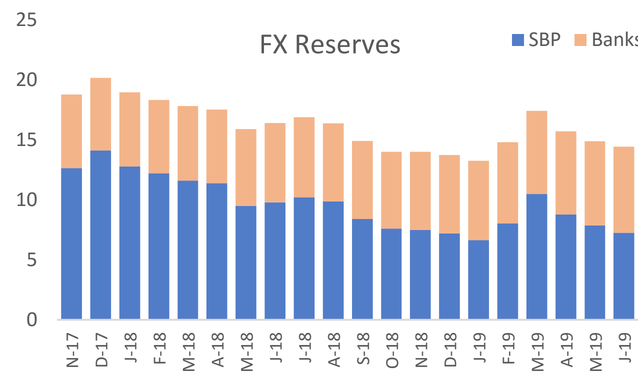
Global Commodity Markets

Gold[i] prices rebounded from recent lows, as US yields stabilized, and the dollar started to give back some of its latest gains. Analysts predict prices to remain around USD 1,395 per ounce on the back of recent Dollar gains against a basket of major currencies. A stronger dollar makes gold costlier for holders of other currencies. Fading US rate cuts expectations have imposed considerable headwinds on bullion's appeal as traders pivot towards a strong recovery in the US dollar. Expectations for a 50 basis point rate cut this month have evaporated, but investors still expect a 25 basis point cut due to weak inflation and trade war worries. This is a clear indication that markets are still bearish over the expected growth implications on the currencies as compared to yellow metal.[7].

[i]Gold price trends are of particular importance as investors buy gold as protection from either an economic crisis or inflation. In June 2016, gold prices surged $100 an ounce in six hours. Investors panicked when Great Britain voted to leave the European Union. Prices rose from $1,254.96 at 4 pm on June 23, the evening of the Brexit vote, to $1,347.12 at midnight. That's because investors bought gold as a hedge against a declining euro and British pound. (Source: "Gold Surges Following Brexit Decision," The Wall Street Journal, June 2, 2016.)

Key Indicators

Forex Reserves[8]



As of June 28, the forex reserves of Pakistan stood at USD 14.4 billion. The country's foreign exchange reserves are on decline due to continued external debt servicing and higher current account deficit. Pakistan made a total repayments of USD 9.5 billion during FY 19 and repayments during FY 20 are projected at USD 11.8 billion.

China, KSA and UAE have placed more than USD 9.2 billion in the form of loans and placements during FY 19 to support balance of payment and build the depleting foreign exchange reserves of Pakistan, Qatar also has announced direct investments and deposits worth USD 3 billion in Pakistan out of which USD 500 million were received by Pakistan on June 30, 2019[9].

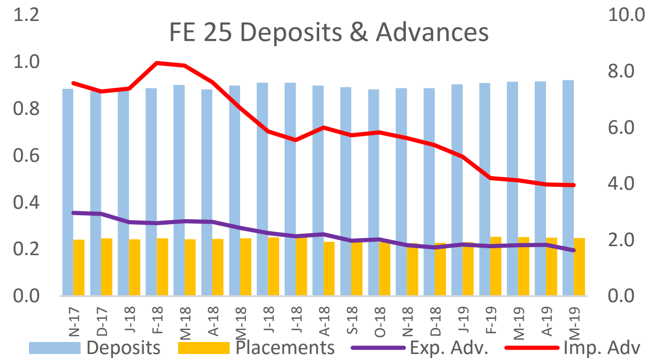
The International Monetary Fund (IMF) on July 03, 2019 announced the approval of a USD 6 billion bailout package to Pakistan for a period of four years. The approval comes at a time when Pakistan is facing increased challenges in managing the forex reserves amidst increasing PKR devaluation.

The PM’s Advisor on Finance and Revenue Dr Abdul Hafeez Shaikh said the approval of 39-month reform program by the IMF executive board without opposition from any member would provide stability to Pakistan. He said this had improved the country’s standing and other institutions had also started extending their financial support. He said the Asian Development Bank would disburse about USD 2.1 billion out of USD 3.4 billion agreed funds to Pakistan this year and the World Bank had also agreed to additional assistance purely for budgetary support.

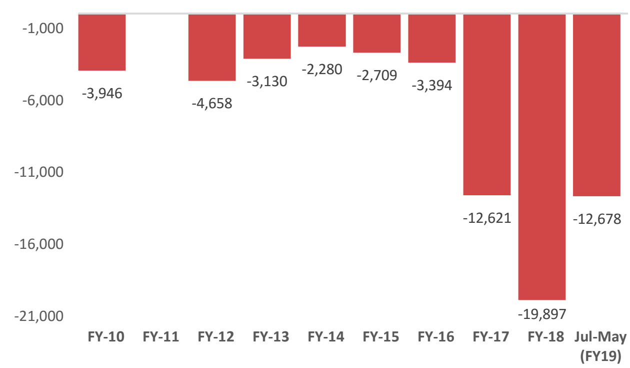
[7] Reuters| Gold slips as dollar strengthens ahead of Powell testimony, FOMC minutes, July 10, 2019 (www. economictimes.indiatimes.com)
[8] State Bank Of Pakistan
[9] Staff report| $500m received from Qatar, June 30, 2019 (www.dawn.com)

Giving a breakdown of USD 38 billion expected financial support from lenders other than IMF, Dr Shaikh said about USD 8.7 billion funds had been lined up against project loans, USD 4.2 billion for program loans, about USD 14 billion of rollover loans and up to USD 8bn in commercial loans. He did not go into details and sources of these loans.[10]

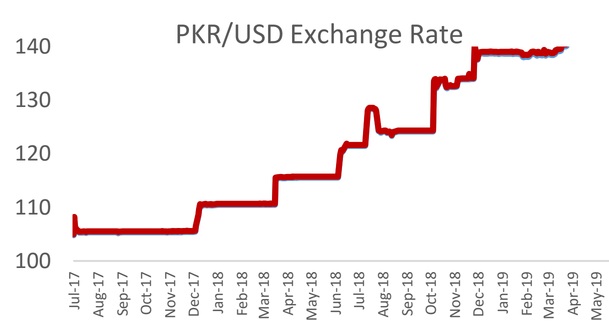
The FE-25 deposits profile has been stable throughout the last twelve months except for import advances which were higher during the start of the last calendar year and have now eased off to remain below USD 0.4 B from USD 1 B. Export advances on the other hand have not shown any sizeable growth despite the appreciation of USD exchange rate of more than 28% during last year. During the recent past, the exchange rates had been maintained stable by SBP through open market operations, therefore, the corrections are taking longer time to translate into a positive impact on exports.



The country's current account deficit improved by 29% during the eleven months of this fiscal year, mainly due to decline in goods imports. According to the SBP, the country's current account posted a deficit of USD 12.7 billion in July-May FY19 compared to USD 17.9 billion in the same period of last fiscal year (FY18), depicting an improvement of 29% or USD 5.2 billion. Followed by lower import bill, month on-month (MoM) basis current account deficit in May 2019 improved by 47% to USD 1,089 million compared to USD 2,062 million in May 2018. During the eleven months of FY19, goods imports dropped by 6% to USD 48.5 billion against USD 51.47 billion in same period last year. According to SBP, If hike in oil prices had not taken place, then imports would have dropped further by an additional USD 2 billion and exports would have risen by an extra USD 1 billion[11].



The PKR/USD exchange rate continued to remain under pressure as the exchange rate touched the highs of PKR 163/USD during June 2019. The massive depreciation in exchange rates is mainly attributable to repayments of more than USD 9.5 billion during the year, which despite placements of USD 9.2 million by China, KSA and UAE, kept exchange rates and forex reserves under pressure throughout the year.

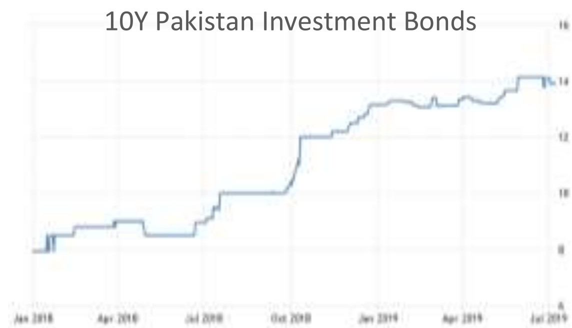


[10] Khaleeq Kiani| IMF package to bring $38bn from other creditors, July 05, 2019 (www.dawn.com)
[11] Salman Siddiqui| Current account deficit shrinks 29% to $12.68b, June 20, 2019 (www.tribune.com.pk)

With tighter fiscal measures in place to control the economic spending and import bill, backed up by the receipt of support packages from friendly countries, the exchange rate should remain stable in the short term. However, with the approval of USD 6 billion bailout package from IMF amidst stringent conditions expected to be in force , it will be interesting to see how exchange rate is managed ahead, as the market expects further depreciation to PKR 180/USD by the end of 2019[12].

Pakistan Interest Rates

Pakistan 10Y traded at 13.90% on Monday July 08, 2019, however, the SBP's rate is 12.255%. The higher spread is indicative of the rising inflation expectations with S&P assigning B- rating February 2019. It is pertinent to mention here that the rising spread is indicative of the longer term inflation expectation that the investors foresee in the current market.



Tenders for Sale of 3 - Month, 6 - Month & 12 - Month GoP Market T- Bills were invited by SBP through Primary Dealers on July 03, 2019 with settlement date on July 04, 2019. Auction Target was PKR 600 billion. The cut off yield was set at 12.7495% whereas weighted average yield was 12.7421%. With the monetary policy announcement a month ahead, the auction results indicate a further increase in the recently announced policy rate.

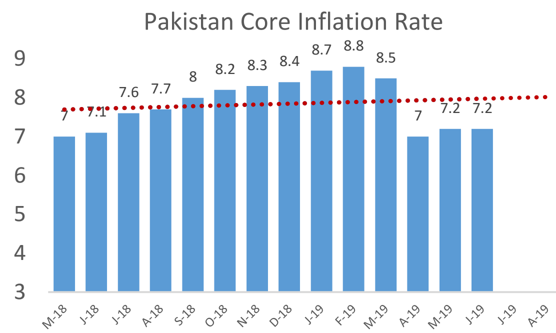
The SBP raised key interest rates by 150 basis points on May 21, 2019, citing the impact of evolving macroeconomic situation, the MPC noted that further policy measures are required to address underlying inflationary pressures from higher recent month-on-month headline and core inflation outturns, recent exchange rate depreciation, an elevated fiscal deficit and its increased monetization, and potential adjustments in utility tariffs. A marked shift in the pattern of government borrowing from scheduled banks to SBP entails inflationary concerns; and even as stabilization measures gradually work through the economy, underlying inflationary pressures persist[13].

It was the eighth rate hike during the last twelve months, bringing borrowing costs to the highest in six years, amid intensifying speculation about an IMF bailout. Since January 2018, SBP has hiked rates by 550 basis points. Also, policymakers have devalued the currency numerous times since December 2017. In June 2019, core inflation rate in the country reduced to 7.2%. Policymakers forecast inflation rate for the

[12] *SCB Economics Unit*
[13] SBP Monetary Policy Statement, May 20, 2019

FY20 of 6.5%-7.5%, higher than the last year's target of 6% and GDP growth around 4%. The current inflation outlook, the market is expecting the interest rates to remain in double digits in six months' time. Insights from one of the leading banks in Pakistan expect interest rates to be at 13% by end 2019[14].

Pakistan Core Inflation Rate



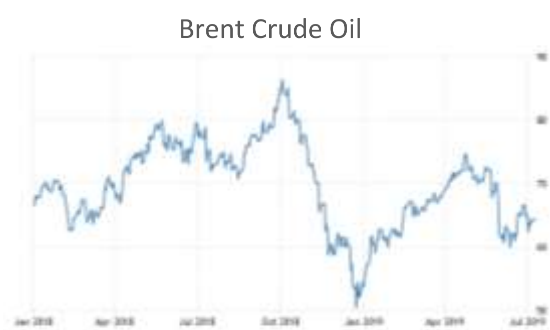
Core inflation is the change in costs of goods and services, but does not include those from the food and energy sectors. This measure of inflation excludes these items because their prices are much more volatile. It is most often calculated using the consumer price index (CPI).

Core consumer prices in Pakistan increased 7.2% in June 2019 over the same month in the previous year. The narrowing gap between the key interest rate and the core inflation was the main reason leading to interest rate hikes recently as the policy makers strive to control the headline inflation through monetary and fiscal measures.

PSM 100 Index

The stock market has had a bearish trend since July 2017 with uncertainty around Pakistan's future economic outlook and global realignment of investment portfolios in the light of rising US interest rates. Aside material developments on the FDI front during the recent months, the index continued to shed points due to perceived uncertainty on the political and economic front, thereby losing the initial 2019 momentum to close at 33,091 points. The index had started off the new year at a bull run on the first day of year 2019 and closed at 40,420 points on January 31, 2019. Foreign outflows and uncertainty over terms of USD 6 billion IMF bailout package played a catalytic role in the bearish close.

Crude Oil



Brent crude futures settled at USD 64.23 a barrel, up 93 cents, or 1.47%. The benchmarks were down for the week as concerns about a slowing global economy outweighed risks to supply. Brent recorded a 3.3% weekly loss and WTI shed roughly 1.8%.

Iran on Monday threatened to restart deactivated centrifuges and step up its enrichment of uranium to 20% in a move that further threatens the 2015 nuclear agreement that Washington abandoned last year.

[14] *SCB Economics Unit*

Washington has imposed sanctions that eliminate benefits Iran was meant to receive in return for agreeing to curbs on its nuclear program under the 2015 deal with world powers. The confrontation has brought the United States and Iran close to conflict, with U.S. President Donald Trump calling off air strikes last month minutes before impact.

Oil prices remain under pressure from lingering worries about demand as the U.S.-China trade war has dampened prospects for global economic growth. Goldman Sachs said growth in U.S. shale production is likely to outpace that of global demand at least through 2020 and limit gains in oil prices despite output curbs led by the Organization of the Petroleum Exporting Countries.

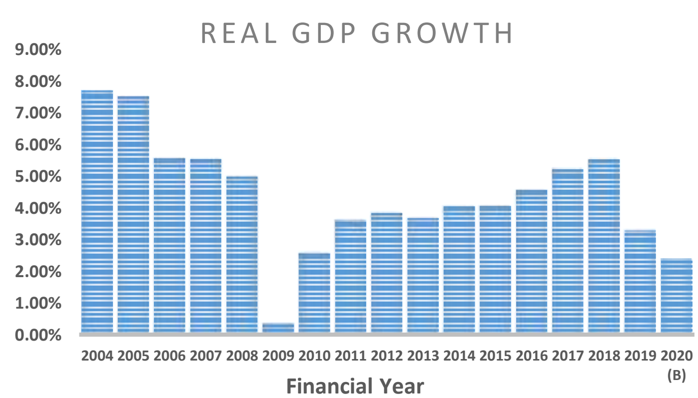
In a sign of growing concern over demand, investors cut their ICE Brent net long positions by 6,748 contracts to 248,006 in the week to July 2, 2019.[15]

A more suitable indicator to benchmark against would be Platts-500 ppm which typically refers to any contract mechanism that derives its value by referencing the average of a set of Singapore-based oil price assessments published by Platts. Currently the value of trading stands at USD 76.817 and the benchmark futures are currently being traded USD 76.923 for August 2019. The outlook however eases off a bit to USD 76.555 for May 2020, which is evident of the effect of Venezuela's current crises and tightening of sanctions on Iran, and their translation into the oil market outlook[16].

This is of particular importance for a country like Pakistan, where country sales had dropped by more than 21% primarily due to higher oil prices. For an economy that is primarily dependent on energy driven through fossil fuel, a change in global oil prices directly impacts the inflation and in turn economic spending.

Areas of Focus

In the absence of further adjustment policies, growth is projected to remain subdued at about 2.4%, with continued external and fiscal imbalances weighing on confidence.



Aside some long awaited news of approval of a USD 6 billion bailout package from IMF for a period of four years, the possibility of further inflows from other lenders in the coming years still remains to be firmed up. While the exact modalities of the bailout package still remain to be confirmed, the government in its recent budget projected a lower real GDP growth amid rising interest and inflation rates in the country.

The reserves have maintained their levels despite massive repayments of USD 9.5 billion during FY 2019, thanks to the USD 9.2 billion support from the friendly countries, worker's remittances have shown

[15] Reuters| Oil rises 0.3% amid worries over Iran's nuclear program, July 08, 2019 (www.cnbc.com)
[16] Singapore Gasoil 500 ppm (Platts) Futures Quotes, July 09, 2019 (www.cmegroup.com)

improvement, import bills have eased down and there are promising intents by the friendly countries of exploring further investment opportunities in Pakistan. However, the stock market continues to remain at the 33,000 mark despite positive news from the investment front. The recent development of direct investment of USD 3 billion from Qatar comes as a positive news from the oil rich country to Pakistan's dwindling forex reserves. With the recent increase in global oil prices, it will be difficult for the government to continue with the improvement in Current Account Deficit, which to date appears to be on a positive trend as the government has so far been successful in keeping it in check. Going forward, the government is faced with an uphill task to control rising inflation and currency depreciation, hence interest rates for a steady money supply in the economy, the economic times ahead are challenging especially the first half of FY20.

Going forward, key areas which will impact economy and future prospects include:

- ✓ Impact of upcoming fiscal budget 2020-21
- ✓ Impact of upcoming monetary policy announcement on economic spending and exchange rates.
- ✓ Translation of impact of current trend in global oil prices and the impact on country demand.
- ✓ Impact of PKR depreciation on competitiveness of exports in Q1 of FY20.
- ✓ Impact of maturity of USD 6 Billion bailout package from IMF and the modalities of the package

Structural elements appear to be being put in place to positioning for growth in 2020, but impact of oil prices on balance of payments and economy overall, remains. This, along with general security environment and the modalities of the bailout package, are the key factors critical for the overall macro-economic environment of the country.

Recommendations

The shorter term focus continues to be on calibration of treasury and borrowing strategies on the following key modalities:

- ✓ Investment in short term financial instruments to leverage the impact of rising interest rates through SBP's monetary policy.
- ✓ Strategizing the investment through secondary market processes for greater flexibility towards upcoming monetary policy changes.
- ✓ A realignment of budgeting strategies in the light of future demand and revised growth prospects of the economy.
- ✓ Financing arrangements in USD denominations should be considered to position for better chances of lower total borrowing costs in lieu of increasing interest rates (Curr. 3M US LIBOR 2.69%)
- ✓ Import arrangements through deferred pricing strategies/clauses for increasing the likelihood of gaining advantage of unstable crude prices in the short term until effectiveness of OPEC production cuts becomes clear.
- ✓ A realignment of aspired returns through revisions in long term borrowing mix and strategies.
- ✓ A re-evaluation of CAPEX estimates (in equivalent PKR) in the light of changes to the USD-PKR parity.