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## *Quid Pro Quo*

### ECONOMIC REPORT

#### PLAN C!

October 29th, 2008

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On September 3<sup>rd</sup> we took out a report highlighting Pakistan's past relations with the International Monetary Fund. In that report we discussed the possibility of Pakistan going back into the Fund's program and the likely reforms that it will have to endure.

56 days later, Pakistan's FOREX reserves have come down to a level where it can only sustain a few weeks worth of imports, whereas the trade and current account deficits (courtesy negative interest rates and an overvalued currency) remain stubbornly high. GOP funding from the SBP, which was supposed to be retired by PKR 21 bn on a quarterly basis, has actually increased by PKR 271 bn over the current fiscal year and Pakistan's rendezvous with the IMF now seems imminent.

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## PLANS A, B & C

These three scenarios were rather eloquently explained by the de facto Finance Minister Mr. Shaukat Tarin in his inaugural press conference after taking over at the helm of the Finance Ministry.

Plan A sought loans from international agencies such as the World Bank and Asian Development bank. However, these loans have now been officially declined as the IMF barred the World Bank's plans to lend Pakistan USD 300 mn in an emergency package, citing that only the IMF has mandate to lend for balance of payments support whereas the WB's financing is restricted for development projects.

Plan B sought to turn to the so-called friends of Pakistan for aid. However, this too seems increasingly unlikely due to the international financial crisis. Countries are increasingly wary of the ripple effects of an integrated global economy in which mortgages going sour in Chicago result in the Hungarian forint collapsing months later. It should therefore come as no surprise that countries including our friends are holding onto what is left of their dollar reserves.

How rich are our friends?

China holds the lion's share with 27.5% of the world's dollar reserves, followed by Japan with USD 1 trillion.

Realistically speaking, had any one of these countries actually intended to lend to Pakistan they would have done so by now. Saudi Arabia recently declined selling Pakistan USD 400 mn worth of urea on deferred payments and the Chinese sent our President home with mere good wishes and a quarterly visit invitation. Iran has also been approached for an oil facility but they too aren't comfortable extending this facility for the requested 2 years. There is however a real possibility that if Pakistan were to follow a broadly acceptable reformist agenda, which could be independently monitored - like the one provided by IMF - then these countries may change their mind.

**\$ Reserves of Friends of Pakistan**

| Friends of Pakistan | \$ Reserves in bn |
|---------------------|-------------------|
| US                  | \$38.94           |
| China               | \$1,906.00        |
| Saudi Arabia        | \$33.25           |
| UK                  | \$41.70           |
| Germany             | \$41.57           |
| UAE                 | \$60.54           |
| Pakistan            | \$4.03            |

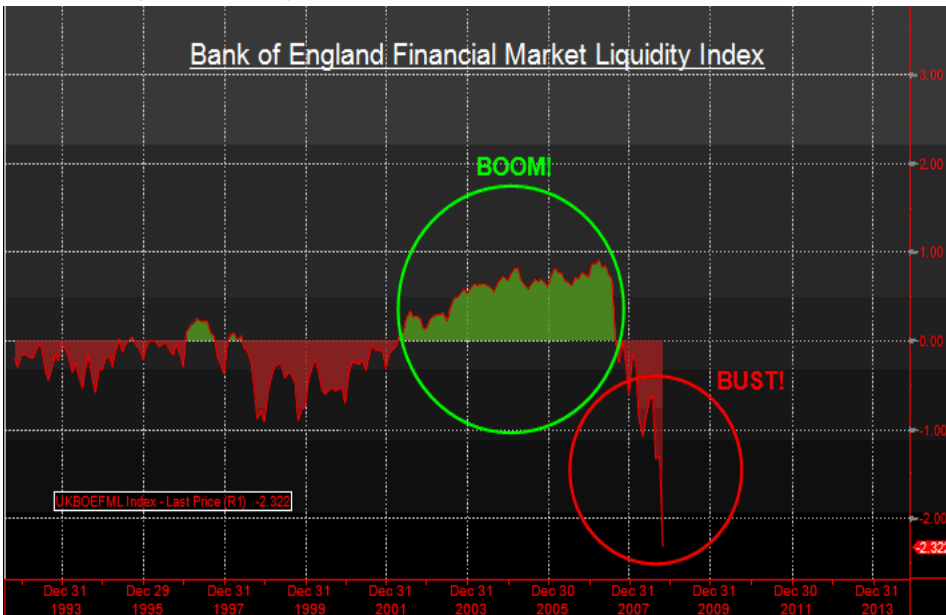
Source: Bloomberg



### PLANS A, B & C ... Continued

Enter IMF Plan C. This is the least desirable of options for the current government but due to a lack of options, a deal with the IMF is a near certainty. Pakistan's financing needs are estimated at USD 15 bn over the next two years and the estimated USD 6 bn provided by the fund is expected to pave way for other flows. In return, the fund is likely to insist on bringing down the fiscal deficit, withdrawing subsidies, increasing tax base, further tightening monetary policy and a implementing more flexible exchange rate.

#### Bank of England Banking Sector Liquidity Index



Source: Bloomberg



### PLANS A, B & C ... Continued

The U.K. central bank's Financial Market Liquidity Index gauges how much liquidity is present in the banking system. The Bank of England calculates this index twice a year, with the current level updated on Oct 17. In April 2007, liquidity was at its highest level in at least 17 years, and had doubled in the previous four years. The shaded green areas highlight periods of increasing liquidity (boom), while the red areas illustrate contraction (Bust).

The graph clearly shows that liquidity is becoming harder to find and the situation is going to continue for a number of years. Inter-bank liquidity is drying up, while banks will need to adjust their balance sheets and funding models, weaning themselves off current high levels of official sector support.

Add to this the toxic cocktail of Pakistan's domestic political turmoil, problem of insurgency in NWFP and failing infrastructure, it is understandable why countries are reluctant to help Pakistan unilaterally and would rather see it join an IMF program that would also ensure sound economic policies.

Therefore, in our opinion all possible avenues for emergency aid have now been exhausted. Indeed the German Foreign Minister summed up accurately that Pakistan needs an IMF loan not in the next month or six months, but in the next one week.





## **DEFAULT!**

The mere mention of the word sends a cold chill down the spines of the government and media alike. Pakistan has to pay approximately USD 4.5 bn in debt servicing and loan repayments during the current fiscal year. However, given that the average trade deficit is approximately USD 500 mn per month and with only USD 4.03 bn left in reserves in real terms, the likelihood of default is looming large. This is mirrored in Pakistan Credit Default Swap (CDS), trading as high as 50%.

What will happen if Pakistan defaults on its obligations? Countries and credit agencies around the world will declare Pakistan insolvent and assign a credit rating of zero. The huge volume of imports will come to a grinding halt because foreign exporters will not accept Pakistan's Letters of Credit to send goods. All transactions will become cash based and will depend on the availability of State Bank's reserves. Needless to say trade will be severely disrupted and local manufacturers will be hit hard by rising costs and interruption in supply lines. Not to mention the damage it would do to the reputation of Pakistan, especially being a nuclear powered state, not only in the eyes of investors but governments around the world. Hawks will have a field day and conspiracy theories will spring from every corner on how to tackle a dangerously instable Muslim country.

Hence the less we flirt with this possibility (as a nation) the better.



## A LIFE SAVER - BITTER PILL OR NOT

The IMF was set up for just this kind of crisis. It is primarily a reformist agency aiming for long-term reforms over short term solutions. Hence, their policies are often viewed as being too harsh and blunt. Domestic proponents argue that the diagnosis of economic problems carried out by IMF staff is partial and incomplete, since they are not sensitive to political realities and institutional capacities of the country. As a result of this, any valuation by their staff does not take into account practicality of the implementation process. More so, there is a belief the paradigm used by IMF is primarily based on the Washington Consensus of liberalization, privatization and deregulation, something that will open the domestic economy to international competition and devalue the local currency by following a flexible exchange rate regime, something we are not ready for.

Whether these policies are right or wrong is always open to discussion. However one thing is certain, that success of the last IMF reforms was based on mutual understanding and trust between the government and the fund. Gen. Musharraf's government extended support to the program, while the fund was flexible in its approach when setting growth targets encouraged by strong economic performance and competent execution of policies. The last IMF program lasted four years, at the end of which inflation was low, market fundamentals were in order and the financial sector was strong. This set the economy on a strong growth path with average GDP growth of 7.42% between 2003 and 2007.

Despite the controversial policies, several countries are lining up for IMF's assistance, some of the ones inducted are; Hungary which secured USD 12.5 bn, Iceland USD 2 bn and Ukraine which received USD 16.5 bn. The common denominator between these countries and Pakistan is; High current account deficit, rampant inflation and substantial external financing needs.



## HONEYMOON PERIOD

As per current reports the IMF conditionalities (built on our own terms) are definitely expected to be harsh. One of the first steps it will take is to propose an increase in the discount rate by approximately 2.5% to 3%, however, negotiations are ongoing on this quantum and if Pakistani authorities are successful this rate hike maybe around 1.5%. Iceland after joining the IMF program has had to increase its policy rate by a whopping 6% to the level of 18%, and Hungary raised its policy rate by 3% to 11.5% subsequent to signing up with the IMF.

### Current Policy Rates, CPI and Real Interest Rates

| Country     | Current Rate | CPI    | Real Interest Rate |
|-------------|--------------|--------|--------------------|
| US          | 1.50%        | 4.90%  | -3.40%             |
| Japan       | 0.50%        | 2.10%  | -1.60%             |
| UK          | 4.50%        | 5.50%  | -1.00%             |
| Canada      | 2.25%        | 3.50%  | -1.15%             |
| Euro Region | 3.75%        | 3.60%  | 0.15%              |
| Hungary     | 11.50%       | 5.70%  | 5.80%              |
| Iceland     | 18.00%       | 14.00% | 4.00%              |
| Ukraine     | 12.00%       | 24.60% | -12.60%            |
| Brazil      | 13.75%       | 6.30%  | 7.50%              |
| Turkey      | 16.75%       | 11.10% | 5.65%              |
| Pakistan    | 13.00%       | 23.90% | -10.90%            |

Source: Bloomberg

Government subsidies will almost certainly be slashed drastically, including those on fertilizer and electricity. This may prove politically suicidal for the newly elected government which recently had to withdraw its decision to increase electricity tariffs owing to widespread public protests.



## HONEYMOON PERIOD ... Continued

The tax base will be broadened to include taxation on agriculture, real estate and the stock exchange. This shall again prove highly unpopular at a time when markets are tumbling. But by far the most difficult pre-requisite will be to cut the military's budget (by an estimated 30%), something both the Defense Minister and President have strongly denied - atleast publicly. In a (un)related story the COAS Gen. Ashfaq Kayani has decided to suspend building of new USD 750 mn GHQ in Islamabad, stating that the army shared the nation's quest for economic stability.

Borrowings from the central bank are expected to be "brought down to net zero" as per newspaper reports, which will require a Herculean effort considering incremental borrowings from SBP in this fiscal year alone have reached PKR 271 billion. This alone should put considerable pressure on interest rates especially on quarter and year ends. But on the bright side the GOP will finally realize that the PKR is a finite resource - and we can then hopefully rid our selves from *Mugabe-nomics*.

The IMF has reportedly also asked for a more flexible exchange rate, whereby the SBP will not intervene to dictate the exchange rate or as they say smooth the volatility cycle. However, the PKR has already depreciated by more than 30% from Jan08 and it is unlikely such a dramatic weakening will occur again.



## CONCLUSION

The IMF other than providing the much needed cash fulfills an even greater role – that of an identifiable villain. Every government and central bank knows the necessary reforms but shy away owing to domestic pressures. They simply pass on the gaps so that nothing unpopular happens on their watch. Hence we gave out food and energy subsidies which even the USA (owing to their resolve to remain a going concern) could not give to its citizens. Our exchange rate for the better part of last decade pretty much remained overvalued and real interest rates negative – in a nutshell we encouraged people to keep consuming under the pretext that all's well – and now we find ourselves broke.

The biggest peril of our current economic state is that people have simply lost faith in PKR as a store of value. This has led people to hoard goods and invest in alternate currencies putting further pressure on both parity and inflation. The quickest way to reverse this trend is to hike PKR interest rates so that more money is diverted towards savings and stop the SBP from printing money so that inflationary expectations can be lowered. This shall lead to increased investments in PKR denominated investments and the PKR 170 odd that has left the banking system since July08 will start to find its way back into the system.

During 2000-2007 the PKR actually appreciated versus the USD and subsequently investors were lining up to buy Pakistani assets, the stock exchange and property prices both soared to record levels and interest rates were subsequently lowered owing to huge NFA flows. Each year we were actually adding to our Foreign Exchange reserves. To bring back this trend, especially with our current account deficit, restoring faith in the PKR has to be of paramount importance as it is essential in attracting capital flows.



## CONCLUSION ... Continued

Going back to the IMF is not necessarily a bad alternate (a.k.a. Plan C) if it instills a sense of discipline in our economy as a whole – but the fact that we keep going back warrants a whole new debate. The GOP has to decide in principle that it would once and for all stop borrowings from the SBP, have a flexible exchange rate and end subsidies. If the oil price goes up let us pay more for it – after all the only way to rationalize the demand for a scarce commodity is to increase its price.

Empirical evidence shows that upon completion of IMF programs the economies are generally better braced to embark on a path to sustainable growth as we did after 2004. But the fiscal discipline lessons we learn in upcoming months have to be remembered and adhered to in better days – we simply cannot expect to keep following the same policies and hope for a different result.



## ECONOMIC SNAPSHOT

| Fiscal Year 2008-09     |          |        |        |        |        |        |        |        |         |         |         |         |         |         |
|-------------------------|----------|--------|--------|--------|--------|--------|--------|--------|---------|---------|---------|---------|---------|---------|
| Units                   | Sep      | Oct    | Nov    | Dec    | Jan    | Feb    | Mar    | Apr    | May     | Jun     | Jul     | Aug     | Sep     |         |
| <u>Inflation</u>        |          |        |        |        |        |        |        |        |         |         |         |         |         |         |
| Headline Inflation      | %        | 8.4    | 9.3    | 8.7    | 8.8    | 11.9   | 11.3   | 14.1   | 17.2    | 19.3    | 21.5    | 24.3    | 25.3    | 23.9    |
| Core inflation          | %        | 6.1    | 6.5    | 6.9    | 7.2    | 7.8    | 8.1    | 9.3    | 10.8    | 12.3    | 13.0    | 14.7    | 16.4    | 17.3    |
| Food inflation          | %        | 13     | 14.7   | 12.5   | 12.2   | 18.2   | 16     | 20.6   | 25.5    | 28.5    | 32.0    | 33.8    | 34.1    | 29.9    |
| Non-food inflation      | %        | 5      | 5.4    | 5.9    | 6.3    | 7.3    | 7.8    | 9.4    | 11.2    | 12.5    | 13.8    | 17.3    | 18.7    | 19.2    |
| <u>T-bill (Wgt Avg)</u> |          |        |        |        |        |        |        |        |         |         |         |         |         |         |
| 3 month                 | %        | 9.05   | 9.05   | 9.05   | 9.09   | 9.09   | 9.38   | 9.59   | 9.59    | 9.95    | 11.3    | 12.2    | 12.4    | 12.6    |
| 6 month                 | %        | 9.12   | 9.12   | 9.21   | 9.29   | 9.29   | 9.61   | 9.86   | 9.86    | 9.86    | 11.5    | n/a     | n/a     | n/a     |
| 12 month                | %        | 9.39   | 9.39   | 9.4    | 9.49   | 9.44   | 9.87   | 10.13  | 10.13   | 10.32   | 11.7    | n/a     | n/a     | n/a     |
| <u>External Sector</u>  |          |        |        |        |        |        |        |        |         |         |         |         |         |         |
| Export                  | Mln US\$ | 1,463  | 1,593  | 1,524  | 1,500  | 1,634  | 1,591  | 1,833  | 1,862   | 1,954   | 1,089   | 1,921   | 1,726   | 1,779   |
| Import                  | Mln US\$ | 2,150  | 2,555  | 2,864  | 2,910  | 3,316  | 2,909  | 3,549  | 3,406   | 3,241   | 7,869   | 3,117   | 3,153   | 3,806   |
| Trade balance           | Mln US\$ | (687)  | (962)  | (1340) | (1410) | (1637) | (1637) | (1716) | (1,544) | (1,287) | (6,900) | (1,196) | (1,427) | (2,027) |
| <u>Remittances</u>      | Mln US\$ | 516    | 580    | 505    | 479    | 557    | 502    | 602    | 590     | 584     | 547     | 627     | 592     | 660     |
| <u>Forex Reserves</u>   | Mln US\$ | 16,145 | 16,354 | 15,807 | 15,589 | 14,657 | 14,031 | 13,232 | 12,362  | 11,258  | 11,285  | 9,920   | 9,130   | 8,322   |



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