CPI (June) & Monetary Outlook For FY ended 2017

Growing public debt

The government of Pakistan is borrowing heavily from domestic sources i.e. commercial banks. In FY 2000, almost half of the total public debt was from domestic sources. Now this has increased to 70%. Debt from domestic sources is more expensive than from external sources like International Financial Institutions (the fact that borrowing from such institutions involve stern conditions is a different debate altogether).

Gross domestic debt was PKR 14,748 billion while net domestic debt was PKR 12,768 billion as at end March 2017. Gross domestic debt registered an increase of PKR 1,121 billion during the year while government borrowing from domestic sources for financing of fiscal defici was PKR 1,018 billion. This differential is mainly attributed to increase in government credit balances with the banking system.

Most of the incremental mobilization was recorded in floating debt while net retirement was witnessed in permanent debt. Despite significant PIBs maturities of PKR 1,427 billion, marginal net retirement was witnessed owing to proactive debt management that brought down the interest rates on long term domestic debt portfolio significantly, thus bringing down the overall cost of domestic debt portfolio.

Domestic Debt (PKR Bn)

	2011	2012	2013	2014	2015(P)	2016(P)	2017(P) *
Permanent Debt	**1,125.6**	**1,696.9**	**2,179.2**	**4,005.3**	**5,016.0**	**5,944.2**	**5,378.8**
Market Loans	2.9	2.9	2.9	2.9	2.8	2.8	2.8
Government Bonds	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Prize Bonds	277.1	333.4	389.6	446.6	522.5	646.4	729.5
Foreign Exchange Bearer Certificates	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Bearer National Fund Bonds	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Federal Investment Bonds	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Special National Fund Bonds	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign Currency Bearer Certificates	0.0	0.0	0.0	0.0	0.0	0.0	0.0
U.S. Dollar Bearer Certificates	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Special U.S. Dollar Bonds	1.0	0.9	4.2	4.4	4.4	4.5	4.5
Government Bonds Issued to SLIC	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Pakistan Investment Bonds (PIBs)	618.5	974.7	1,321.8	3,223.5	4,158.3	4,925.0	4,276.5
GOP Ijara Sukuk	224.6	383.5	459.2	326.4	326.4	363.9	363.9
Floating Debt	**3,235.4**	**4,143.1**	**5,196.2**	**4,610.9**	**4,612.6**	**5,001.8**	**6,603.7**
Treasury Bills through Auction	1,817.6	2,383.4	2,921.0	1,758.6	2,331.3	2,771.6	3,851.4
Rollover of Treasury Bills discounted SBP	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Market Related Treasury Bills (MRTBs)	1,417.3	1,759.2	2,274.7	2,851.8	2,280.9	2,017.1	2,751.7
Bai Muajjal	-	-	-	-	-	212.6	-
Unfunded Debt	**1,655.8**	**1,798.0**	**2,146.5**	**2,303.8**	**2,570.3**	**2,680.9**	**2,765.7**
Defence Savings Certificates	234.5	241.8	271.7	284.6	300.8	308.9	326.0
Khas Deposit Certificates and Accounts	0.6	0.6	0.6	0.6	0.6	0.6	0.6
National Deposit Certificates	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings Accounts	17.2	21.2	22.3	22.6	26.4	29.2	31.8
Mahana Amdani Account	2.1	2.0	2.0	1.9	1.8	1.8	1.7
Postal Life Insurance	67.1	67.1	67.1	67.1	67.1	67.1	67.1
Special Savings Certificates and Accounts	529.1	537.4	734.6	738.8	867.5	896.5	922.2
Regular Income Scheme	182.6	226.6	262.6	325.4	376.0	359.8	339.1
Pensioners' Benefit Account	146.0	162.3	179.9	198.4	214.1	234.7	250.9
Bahbood Savings Certificates	428.5	480.8	528.4	582.4	628.3	692.1	737.4
National Savings Bonds	3.6	3.6	0.2	0.2	0.1	0.1	0.1
G.P. Fund	44.3	54.6	73.1	80.5	85.8	88.3	85.8
Short Term Savings Certificates	-	-	4.0	1.3	1.7	1.9	2.8
Total Domestic Debt	**6,016.7**	**7,638.1**	**9,521.9**	**10,920.0**	**12,198.9**	**13,626.9**	**14,748.1**

P: Provisional *end-March, 2017

To beat rising gap between income and expenditure, government borrowing from banks rose 69.43% in less than 11 months of the current fiscal year. The government borrowed PKR 850 billion from commercial banks for budgetary support between July 1, 2016 and May 19, 2017, compared with PKR 502 billion in the corresponding period of the last fiscal year.

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Government continued borrowing from the banks to fund its spending following shortfalls in tax and non-tax revenues and below-than-expected foreign inflows. It borrowed an amount of PKR 869 billion from the State Bank of Pakistan (SBP) during the period under review.

Non-tax revenues have declined due to fall in inflows from the coalition support fund. However, the federal government had repaid PKR 188 billion in debts to the central bank a year earlier.

The pace of public sector borrowing from the central bank remained higher since the first quarter of FY17 right after the conclusion of the International Monitory Fund-backed Extended Fund Facility programme.

In FY17, the government was to borrow PKR 741.3 billion from banks to meet budget-related expenditures, which was higher than the actual target of PKR 452.9 billion set for the current fiscal.

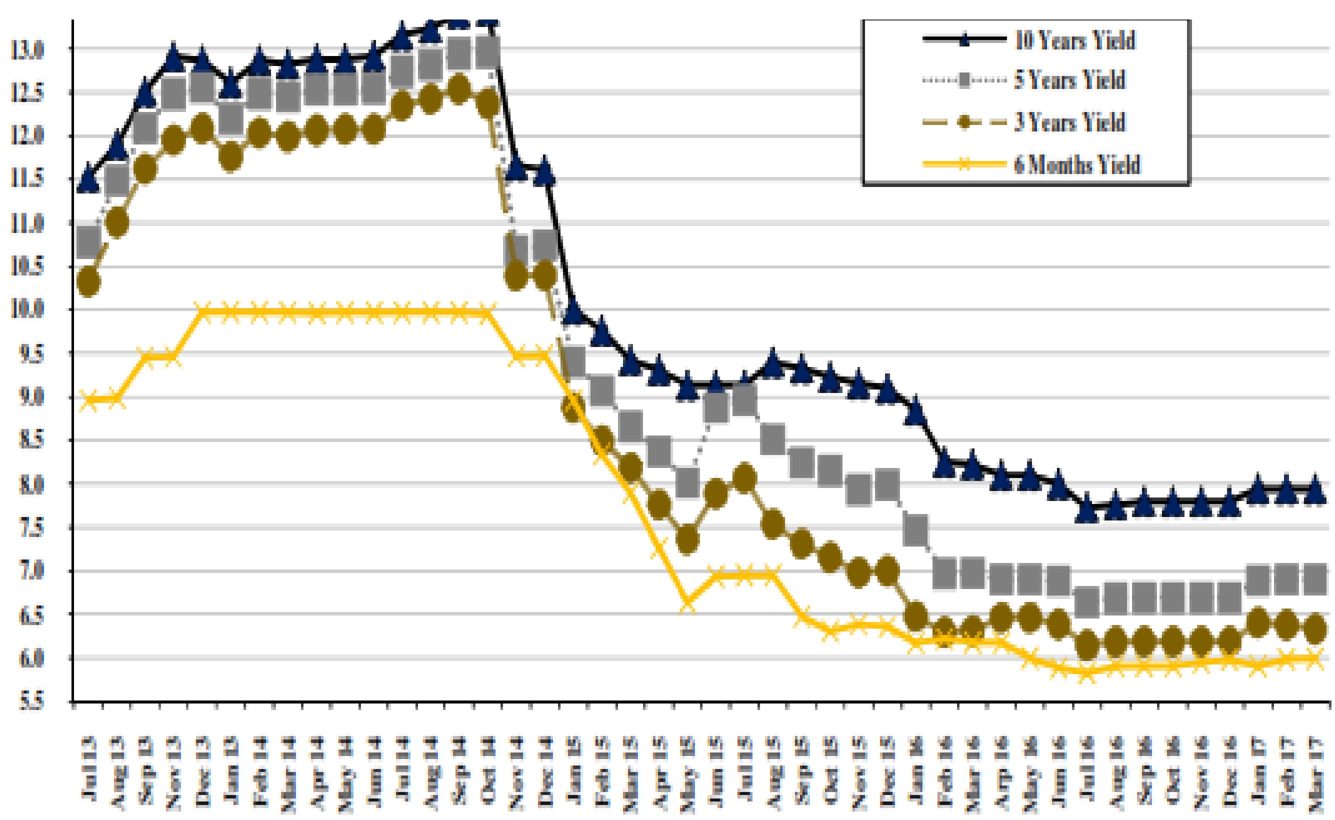
The government has already missed the annual target of PKR 741.3 billion bank borrowing, indicating that its requirement to borrow from banking sources is higher than what was estimated in FY17 budget.

The bulk of the government borrowing is fetched through treasury bills and Pakistan Investment Bonds. The government has planned to borrow PKR 390.1 billion from the banks in the next fiscal year, staring July 1.

Analysts seeS public sector borrowing from the banks those of the SBP to remain high as the government wants to continue taking advantage of low interest rate environment. It’s more likely to give preference to the banks over non-bank sources for raising funds in the next fiscal year.

The government is also likely to fund spending from taxation as huge bank borrowing would push the state of domestic debt and budget deficit up. As elections are due next year, the government will as usual add more to public spending and hence witness further deficit overshoots.

T-Bills PIBs Yields (6 Months, 3, 5 & 10 Years) - In Percent



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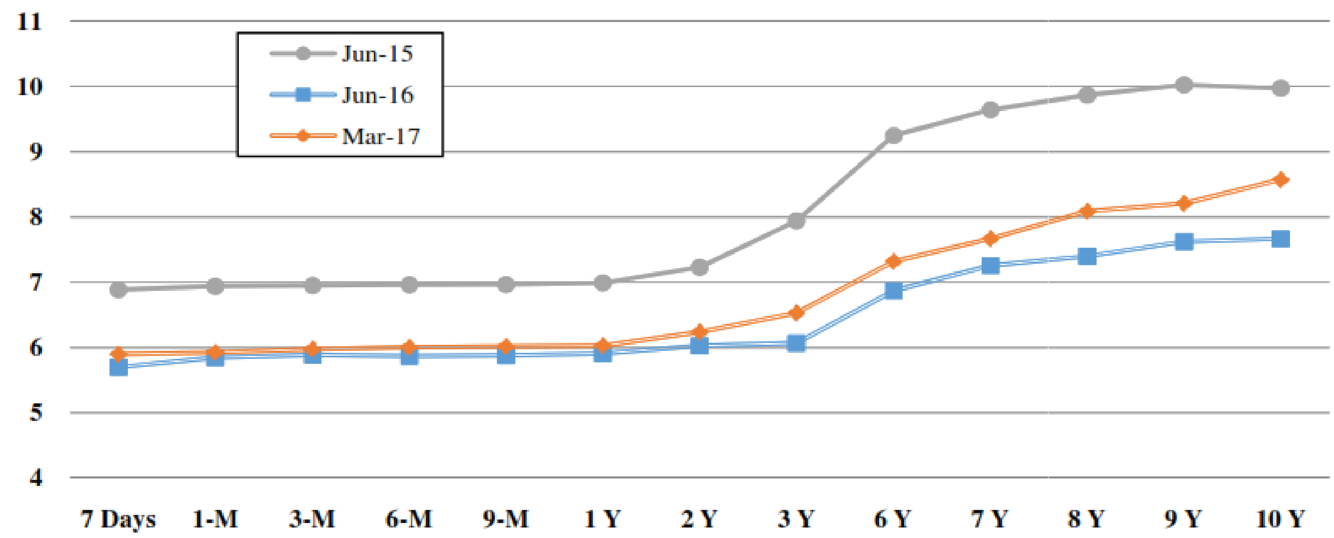
Secondary market yields



The government has announced it would allocate PKR 1 trillion for the federal Public Sector Development Programme. This would be 40% higher than revised estimates of PKR 715 billion for the current financial year.

Initial calculations from renowned economists suggest the budget deficit could reach almost 6% of the gross domestic product (GDP) against the official target of 4.1% in FY18. The budget deficit stood at 4.2% in FY17.

Apart from being expensive, payments will be due on almost half of the domestic debt within a year. While only 11% of the external debt will be due within a year. So Pakistan has to pay off the costly debt within short intervals of time. This fact has major implications for the Pakistani economy. In order to make room for high debt servicing, the government has to compromise spending on social sectors like education and health. Pakistan's performance in health and education is already unpromising.

But these are not the only issues associated with high domestic borrowing. Over-reliance on domestic debt reduces the amount of credit available to private sector and renders the leftover credit expensive. Private sector which generates employment and is the lifeline of any economy is deprived of an essential opportunity to expand itself.

External Front Challenges

Issues are also present in external borrowing by the government. Since coming into power, the PML-N government has borrowed $655 million from Dubai-based Noor Bank at interest rate ranging from 4.1% to 4.71%. These are non-traditional sources of borrowing where terms of engagement are not transparent. Unavailability of this information can compromise parliamentary oversight on matters of public debt.

Most of the borrowed money in Pakistan is used to build up foreign exchange reserves or used as a budgetary cushion by the government. Quite recently, the State Bank of Pakistan has borrowed $3.93 billion to bolster foreign reserves.

Pakistan is forced to undertake this practice since it earns less foreign exchange through exports than it has to spend on its imports. In addition to this, in order to maintain the value of rupee, Pakistan needs dollars to effectively intervene in the foreign exchange market. Dollar stability is mostly viewed in Pakistan as a symbol of political achievement. So any incumbent government tries to keep it under control for political gains.

Such policy choices are diverting borrowed money from development sectors such as health and education. Spending on these areas can improve Pakistan's debt carrying capacity in the long-run. But the

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current regime of spending most of the debt money on non-development sectors would induce even more borrowing in the future to pay off previously contracted debt.

Pakistan's borrowing strategy which is dominated by excessive domestic borrowing and obsession with building foreign exchange reserves may render its public debt stocks unsustainable. It will hurt both private and development sectors. On top of that, a defective debt strategy has the potential to impair the policy space available to the policy makers because in some cases the creditor may steer the helms of the economy in order to ensure smooth repayments. The $6.6 billion Extended Fund Facility of International Monetary Fund (IMF) that Pakistan undertook in 2013 included various restrictions on the Government of Pakistan in terms of domestic policy choices.

There is both good debt and bad debt. Unfortunately, policy choices in Pakistan are relying more on bad debt. Such policy choices are a product of political ambitions which are most of the times oblivious of the tenets of sound economics.

Pakistan's internal economy is rupee denominated and our external economy is dollar denominated. Pakistan's external economy comprises the entire stream of dollar inflows and dollar outflows. Here's the record on imports or dollar outflows: Our imports have gone up from $35 billion a year five years ago to nearly $45 billion a year. That's an increase of 28 percent in five years.

Red alert: Our exports – or dollar inflows – have gone down from $25 billion a year five years ago to $20 billion a year. That's a decrease of 20% in five years. And on top of all that, dollars coming back to Pakistan from Pakistanis working abroad are also trending downwards. No wonder our current account deficit – which is the sum of all dollar inflows and outflows – deteriorated by over 90% during the first seven months of the current fiscal year (compared to the same period last year).

Red alert: Our foreign exchange reserves – built up largely by high interest rate loans – are falling; and falling fast. Over the past few months, reserves have fallen from around $19 billion to a current level of under $17 billion. If the trend continues – especially when international oil prices have doubled over the past year – we would be forced to go back to the IMF by early-2018.

Foreign exchange reserves have continued to deplete by a monthly average of $500 million for the past seven months, raising fears among currency dealers that the dollar could spiral out of control in the inter-bank market.

Despite rising import bill, the exchange rate has been stable in the inter-bank market for more than a year thanks to intervention by the State Bank of Pakistan (SBP) to contain the dollar's rise. However, currency dealers believe the exchange rate could burst through the SBP-enforced ceiling if the reserves kept falling.

According to the latest SBP report, Pakistan's forex reserves fell by $3.51 billion since October to $20.52bn on June 2. State Bank's reserves dropped by $3.22bn to $15.7bn during the same period.

The current government brought down the dollar from PKR 108-9 to PKR 97 when it came to power four years ago. But it seems to have lost its grip now. For the last seven months, the government has failed to improve SBP reserves amid political turbulence.

Moreover, outflows have been swelling too, particularly the import bill which is likely to touch $50bn this fiscal year.

The outflow of profits and dividends by foreign companies operating in Pakistan could also touch $2bn by the end of the fiscal year; the amount repatriated by these firms already stood at $1.52bn during the 10 months through April.

Experts believe that the government will try its best to keep the exchange rate at the current level until the general election. Similarly, the government will also want to give forex reserves a boost.

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However, repayments on borrowed money have started and are set to pick up pace in a couple of years. During the current fiscal year, the government would have to pay about $6bn as debt servicing on foreign loans; the amount will only increase each year with rising Chinese investments in the country.

Despite fears about the future of the exchange rate, the open market is stable as supplies have increased during Ramazan.

State Bank of Pakistan (SBP) report released recently has said that Pakistan's external debt servicing will be 25% higher than a year ago The report also cited that the country's external debt servicing had risen to $5b by the end of April 2017 and in 2015-16 it had amounted to $5.3b.

SBP report further mentioned that the debt servicing in the third quarter amounted to $2.22b in comparison to $1.22b in the second quarter. The current deficit has also been growing reaching $7.2b in July-April 2016-17 which along with external debt servicing and falling remittances will pressurize the economy further.

Yes, the China-Pakistan Economic Corridor (CPEC) is now being presented as the panacea – a solution to all our difficulties including falling exports and declining foreign exchange reserves. Red alert: Assuming that some $35 billion of Chinese loans is utilised for energy projects, Pakistan's annual financing burden will go up to $5.3 billion a year plus an insurance premium of $2 billion upfront.

Pakistan's external, dollar-denominated economy is moving from bad to worse. Yes, the State Bank of Pakistan (SBP) has now moved in to bring some stability to the worsening external, dollar-denominated economy by imposing a 100% cash margin for imports of 404 non-essential, non-oil import items. What that means is that the Government of Pakistan has no policy remedy and the SBP has therefore jumped in with an administrative measure. History has it that administrative measures work – if they do – only over the short term.

Rewind back to early-2013 when foreign exchange reserves had started falling like nine pins-and within a few months we had to rush to the IMF for a 36-month, $6.4 billion Extended Fund Facility (EFF). Red alert: We are back to where we were in early-2013 with one big difference – our external debt servicing load is now twice as heavy. Imagine: over the next 14 months Pakistan must pay back $6.5 billion in principal plus interest.

To be certain, our march back to yet another IMF rescue package has begun. The external sector of our economy is weakening by the day. Yes, the Economic Coordination Committee (ECC) of the cabinet has shown "concern over the widening of the current account deficit" but the government lacks either the capacity or the will-or both-to turn the tide via a policy response. Yes, the SBP held a meeting with the heads of all major banks in the country to "improve their capacity to control money laundering" in the amount of $10 billion a year but that's the farthest that the SBP is willing to go.

The currency market has fluctuated regularly in recent months with hefty rises and falls on some occasions. In the long run, however, the rupee has stood firm after experiencing extensive volatility, when it weakened from around PKR 98 to a dollar to above PKR 103 in the wake of political impasse over alleged election rigging. The rupee has been one of the best performing currencies in Asia for over three years despite the dollar's sharp appreciation against other currencies. However, the International Monetary Fund has repeatedly said that Pakistan's rupee is overvalued by 5-20%. According to analysts, the artificial support for the rupee has adversely affected Pakistan's exports.

For the first time in history, Pakistan's trade deficit has widened to $30 billion with one month still remaining before the close of ongoing fiscal year as the government could not find a solution to the burgeoning imports and a constant contraction in exports.

The gap between imports and exports stood at $29.99 billion from July to May in fiscal year 2016-17, which was 42.1% or $8.9 billion more than the comparative period of previous year, Pakistan Bureau of Statistics (PBS) announced on Monday.

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For the third straight month, the trade deficit breached the previous highest record and reached $30 billion.

Imports remained at high levels and were valued at $5 billion for the third consecutive month – the sole reason behind the uncontrollable trade deficit. The 11-month trade gap was $9.5-billion higher than the annual target of $20.5 billion, which was set by the Ministry of Finance at the beginning of FY17.

The fresh statistics have deepened concerns about long-term sustainability of the external sector, which the government is maintaining by borrowing from foreign countries and commercial banks.

Cheap imports have started hurting the import-substitution industries, according to experts. A strong rupee against the US dollar has made the imports cheaper.

Owing to the swelling trade deficit, the balance of payments of the country is now projected to worsen to levels never anticipated by the finance ministry. In its budget documents, the ministry has now revised the current account deficit projection to $8.4 billion for the outgoing fiscal year, which again appears to be at the lower end.

Exports fell 3.1% to only $18.5 billion in July-May FY17, which were $591 million less than the goods shipments reported in the comparative period of previous year.

Compared to this, the import bill fattened 20.6% to $48.53 billion in July-May FY17. In absolute terms, imports were $8.3 billion higher than the previous year.

Another worrying indication was that the 11-month import bill was 260% higher than exports of the country. The import bill was equal to 108% of the annual import projection made by the finance ministry. Contrary to this, exports in 11 months were only three-fourth of the annual target of $24.8 billion.

Independent economists say the ballooning trade deficit has finally exposed vulnerabilities of Pakistan's economy as financing such a huge gap in the midst of slowing foreign remittances and low foreign direct investment has become a challenge for the government.

It will be the fourth consecutive year when the PML-N government will miss its annual export target, though Pakistan enjoys duty-free status for its exports to the European Union. Exports were only 6% of the estimated size of Pakistan's economy called the gross domestic product (GDP).

Exports are not picking up despite offering two incentive packages to the exporters. However, these packages have remained partially funded, causing resentment among exporters.

There is a consensus among government and independent economists that exports must be at least 10% of GDP for sustainability of the country's external sector. Owing to lower exports, one-fourth of the export receipts went for external debt servicing in July-March FY17.

On an annual basis, the trade deficit in May was 60.8% more than the comparative period of previous year and the main reason was record imports worth $5.1 billion in the month, showed PBS data.

The trade deficit stood at $3.5 billion in May, which in absolute terms was $1.3 billion higher than the deficit in May 2016. Exports in the month dropped almost 11% to only $1.63 billion. On a month-on-month basis, exports in May slumped almost 10% over exports recorded in April. In absolute terms, the exports were down $178 million. There was a marginal growth in imports on a month-on-month basis.

Encourgingly though, May 2017 saw an inflow of $1,867 million. It's the highest monthly inflow since June 2016, which was a Ramadan month and had then seen a month-on-month increase of 15%. And guess what the month-on-month jump in May 2017 was? A whopping 21%, as against 10-year May average of 3%. There is no way anyone could have expected this based on seasonality alone, especially in a fiscal year which has been consistently witnessing lower inflows month after month.

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It is usually those particular months in which Ramadan falls that witness a sharp spike in remittance inflows. For instance, a 20% jump in July 2013, a 10% increase in July 2014 and June 2015, and a 15% rise in June 2016 – all of these months coincided with the bulk of the annual Islamic fasting days. But never in the last ten years, the data for which is publicly available, has the month 'preceding' Ramadan witnessed as big a jump as seen in May 2017 (21%).

While the transaction management factors explain the rise in May, it may also be true that some of the Ramadan effect on remittance inflows has happened prematurely (in May) this year.

This is because there will be about seven days of Eid holiday in the region for Eid due on June 25/26. So effectively the remitter and the remittance machine have little more than half a month to work with. How much remittance will be channeled in June is anyone's guess at the moment. But whatever that number is, remittance needs a fresh boost as the country braces itself for the first annual fall in remittance in 13 years.

Inflationary targets – real or idealistic?

Monthly CPI was the key data points released last month, where inflation for May'17 was recorded at 5.02% YoY compared to 4.8% in Apr'17, above market consensus of 4.6% (FAML: 4.84%). This was largely due to low base effect as CPI was almost flat MoM.

We were not too surprised to see a reading above 5%, given expected upward movement in CPI from May onwards due to low base effect. Interestingly, May saw only 0.01% increase in CPI on MoM basis depicting soft prices during the month (food inflation, which has the highest weight in CPI of 34.8% is down -0.26% MoM in May).

Having said that, we believe maximum impact of increase in fruits/vegetable prices in Ramadan will likely be visible in June's CPI reading, though is expected to clock in at similar level close to 5% as the low base effect wards off and impact of recent POL price decline kicks in (albeit nominal).

Inflation Index	Index Weights	CPI Y/Y	CPI MoM	Index May'17	Index May'16
Perishable Food Items	4.99%	18.10%	-1.21%	248.26	210.21
Non-perishable Food Items	29.84%	2.40%	-0.08%	226.53	221.23
Food and Non Alcoholic Beverages	34.83%	4.55%	-0.26%	229.64	219.65
Alcoholic Beverages & Tobacco	1.41%	10.76%	0.14%	383.32	346.08
Clothing & Footwear	7.57%	3.68%	0.47%	236.71	228.31
Housing water & Gas	29.41%	5.12%	0.04%	196.70	187.12
Furnishing & household	4.21%	2.59%	0.65%	226.42	220.71
Health	2.19%	13.46%	0.10%	212.65	187.43
Transport	7.20%	4.21%	0.06%	176.43	169.31
Communication	3.22%	1.61%	0.00%	132.87	130.77
Recreation & culture	2.03%	0.17%	0.05%	196.12	195.79
Education	3.94%	11.17%	0.01%	249.23	224.19
Restaurant & hotels	1.23%	5.37%	0.51%	277.29	263.16
Miscellaneous	2.76%	5.34%	0.52%	245.99	233.52
Total	100%	5.02%	0.02%	216.33	205.99

Source: PBS

In 11MFY17, CPI inflation averaged 4.17%, which is within government's target of 6%, compared to 2.83% in the same period last year.

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CPI (June) & Monetary Outlook For FY ended 2017

Date	Interest Rate			Inflation			Real Interest	M2 Growth
	Discount Rate	10-Y PIB	6-M Kibor	CPI	NFNE	Trimmed Core	Rate	
May-16	6.50%	8.26%	6.31%	2.82%	4.60%	3.60%	3.5%	-0.06%
Jun-16	6.25%	7.82%	6.11%	2.85%	4.60%	3.70%	3.3%	4.80%
Jul-16	6.25%	7.50%	6.02%	4.12%	4.50%	3.60%	1.9%	0.68%
Aug-16	6.25%	6.65%	6.02%	3.84%	4.60%	3.50%	2.2%	-1.35%
Sep-16	6.25%	7.76%	6.05%	3.86%	4.80%	3.70%	2.2%	2.83%
Oct-16	6.25%	7.82%	6.05%	3.95%	5.20%	3.80%	2.1%	0.30%
Nov-16	6.25%	7.94%	6.08%	3.92%	5.30%	3.80%	2.2%	0.45%
Dec-16	6.25%	8.34%	6.14%	3.88%	5.20%	3.70%	2.3%	4.29%
Jan-17	6.25%	8.19%	6.12%	3.85%	5.40%	3.80%	2.3%	-2.47%
Feb-17	6.25%	8.03%	6.13%	3.89%	5.30%	4.10%	2.2%	0.30%
Mar-17	6.25%	8.02%	6.13%	4.01%	5.30%	4.50%	2.1%	1.58%
Apr-17	6.25%	8.12%	5.90%	4.09%	5.50%	4.80%	1.8%	1.15%
May-17	6.25%	8.20%	6.15%	4.18%	5.50%	4.80%	2.0%	1.21%

Inflation & MPS Outlook

The advent of the holy month of Ramadan has transpired into a sharp uptick in prices of perishable food items ranging from pulses, to fresh vegetables, fruits and dairy products. The downtick in prices of petroleum products may help in cooling off the inflationary heat, however the impact may not be felt in FY17. The trend of steady increases in prices of housing utilities and house rents is expected to continue into the upcoming fiscal year which will add to the overall inflation expectations. Pickup in economic activity and a likely uptrend in aggregate demand driven by higher credit off-take may keep inflation on higher levels in the upcoming fiscal year. Pressure on the local currency in the wake of a dwindling current account will further aggravate the pace of price increases.

Two things to look out for at start of FY18 are (i) impact of budget on CPI in July (which we believe will be nominal) and (ii) likely introduction of re-based CPI (which could result in favorable impact on CPI).

We believe increase in cigarette prices and beverages, construction cost due to cement and steel price hike, as a result of FY18 budgetary measures, will translate into one-off increases in July and have nominal impact on our FY18 average inflation estimate of 6.1%. The impact of increase in regulatory duties on import of non-essential items and imported fruits and vegetables, though lacks clarity, is unlikely to have direct impact on CPI inflation given its likely absence in the CPI basket, though indirect impact may trickle down to some extent. Government is yet to come up with the list of items and changes in duty structure made in the budget.

The PBS is reportedly scheduled to implement the re-basing of CPI (to 2015-16 from current base year of 2007-08) by end of FY17. Potential surprises post rebasing could be in form of (i) changes in weights and/or items in the CPI baskets and (ii) CPI readings adjustments retrospectively. Change in the base (FY17 CPI readings) could potentially impact FY18 readings and in case of favorable change, it could have positive implications on monetary policy resulting in delay in DR hike to next year (we expect first DR hike of 25bp in late 1Q18 for now). Chances of downward adjustment in CPI readings and positive impact on CPI going forward would turn out to be positive for the incumbent government running for elections next year.

We expect overall CPI for the remainder of FY17 to hover around 4.25-4.75%. As headline inflation is picking up, expected to be close to policy rate by Sep'17. We reiterate our stance on policy rate and believe the central bank will make first rate hike in late 1Q18.

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