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The Art of Investment

Economic Outlook

Holding Ground

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Pakistan's macroeconomic profile is expected to improve following the resumption of the stabilization program under the IMF's Extended Fund Facility (combined reviews followed disbursement of US$499mn and further monetary support of US$1bn expected in Jun'21). Macroeconomic stability is being assisted by well-anchored inflationary expectations which should encourage the SBP to continue its accommodative policy stance and improved outlook on the external account aided by a nascent recovery in exports and strong inward remittances. The GoP has committed to a set of fiscal benchmarks for the next five years in order to bring down the fiscal deficit to 2.9% of the GDP by FY26. In addition, reforms to broaden the tax base are expected to be introduced in the upcoming Federal Budget FY22 while the government will also be committing to an action plan to arrest circular debt accumulation. Given a relatively manageable CA outlook coupled with a well-funded financial account, we do not see significant pressure on the PkR in the near term. Our estimates suggest a net average funding surplus of ~US$3.2bn over the next three years (FY21E-FY23F). In this backdrop, we see the PkR/USD parity trading around 154-155 up to Jun'21 and gradually reach 162 by Jun'22.

Improved macroeconomic profile: Despite the initial uncertainty and panic, economic growth has recovered from crisis trough levels. This has been enabled by relatively early relaxation in lockdown restrictions and through a strong coherent policy response by the government (construction and agriculture packages, fiscal relief package of 2.5% of GDP) and the State Bank of Pakistan (lowered key policy rate by 625bps along with additional liquidity measures and incentives to the industry) cumulatively worth 4.8% of GDP (PkR1.99tn). Improvement in economic activity has been reflected through high frequency data points - local cement/HSD/MOGAS were up 18/18/10%YoY respectively in 9MFY21. Industrial activity has also picked up owing to supportive GoP policies with LSM depicting ~8%YoY growth in 8MFY21 (Feb'20: -0.2%YoY). In this backdrop, real GDP growth for FY21/22 is expected to clock in at ~2.9%/4.2%YoY (vs. -0.4% in FY20), supported by activity in the construction sector and recovery in the services sector next year assuming the government is able to inoculate a relatively larger portion of the population and its virus containment efforts are successful.

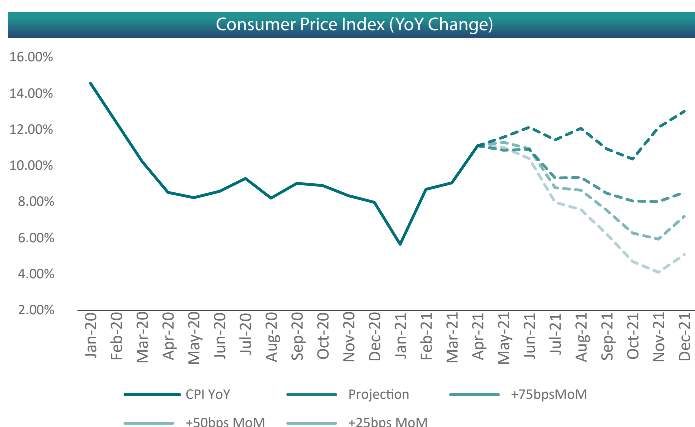
Policy focus: After the recent change in the economic team (new Finance Minister and members of the Economic Advisory Council), the government has hinted towards growth-oriented policies which can be a challenge under the fiscal consolidation efforts of the IMF program. While economic indicators are showing signs of improvement, the country is currently facing a third wave of infections which is a key downside risk to economic growth. From a policy perspective, the government is expected to remain focused on its Covid-19 inoculation program (started in Feb'21 but rollout has been slow due to limited supply of vaccines) and containing the spread of infections in 2021 primarily through smart lockdowns. That said, with new cases averaging over 5k (positivity ratio over 10%) coupled with relatively higher mortalities, a short-term circuit breaker or repeat of the large-scale lockdown similar to 2QCY20 cannot be ruled out.

Accommodative monetary policy: Inflation is expected to average around 9% in FY21 (upper end of SBP's target range) on the back of weaker domestic demand environment. However, CPI continues to face upside risks from higher commodity prices (particularly food). The external outlook remains healthy as current account (CA) is expected to post a marginal deficit -0.1% of GDP in FY21 (vs. -1.1% in FY20) on the back of nascent recovery in exports and strong inward remittances. With a stable external account outlook (upcoming IMF review in Jun'21 to release ~US$1bn tranche), SBP is expected to continue its accommodative stance and is unlikely to materially reverse course on its monetary policy until meaningful economic recovery, in our view.

Fiscal consolidation expected to continue: Despite the pandemic, fiscal performance (fiscal deficit est. to clock in at ~7.1% of GDP in FY21) has been satisfactory with 9MFY21 fiscal deficit limited to 3.6% of GDP (primary surplus at 1.0% of GDP). Despite the momentum in revenues, realized tax collection in FY21 is expected to undershoot the revised FBR tax collection target of ~PkR4.7tn and as a result, reliance on indirect taxation measures and non-tax revenues is expected to rise going forward. Upcoming budget is expected to focus on revenue generation likely through GST (0.7% of GDP) reforms (commitment under the IMF program) and decline in circular debt accumulation involving electricity tariff hikes to bring it closer to cost recovery.

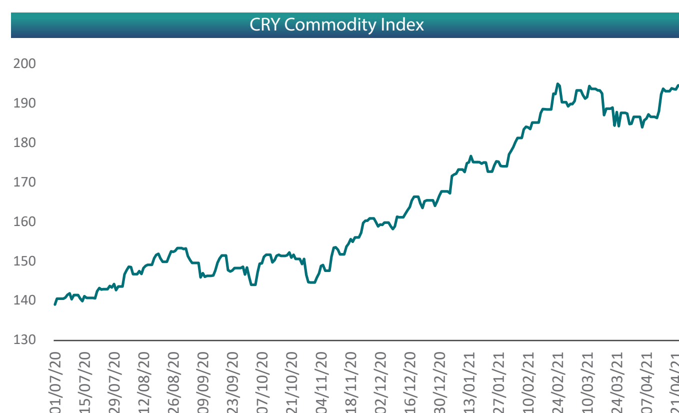
Inflation within range but upside risks present: Inflationary expectations are expected to remain elevated and controlling these price pressures will be a challenge in 2021, owing to administered price increases (utility tariffs), base effects, fiscal adjustment under the IMF program and possibly higher fuel prices (which have a second-round effects on the economy) resulting from an uptick in global oil prices. That being said, increase in inflationary pressures are expected to be offset by a relatively weaker domestic demand environment (negative output gap) as economic activities have yet to recover to pre-covid levels (spare capacity). In this backdrop, core inflation has remained relatively subdued with the latest reading implying a moderate rise (both urban and rural). Additionally, underlying price pressures are expected to be contained through stability in the PkR/US$ parity on positive external funding outlook coupled with easing debt-repayment concerns under the extended G20 debt-service suspension and deceleration in food inflation as supplies improve.

Consumer Price Index (YoY Change)



Source: PBS, FAML Research

CRY Commodity Index



Source: Bloomberg, FAML Research

Apr'21 inflation has clocked in at 11.1%YoY vs. 9.1%YoY in Mar'21, primarily driven by higher food prices (Ramadan and base effect) and quarterly revision in the house rent index. However, relative decline in petroleum prices and downward adjustment in electricity prices (fuel price adjustment) has helped to contain the inflationary impact. On a sequential basis, inflation rose by 1.0%MoM. In the near term, the low base effect last year (declining international commodity prices during 2HFY20) together with upcoming electricity tariff adjustments may temporarily push YoY inflation higher in the next few months. In this regard, inflation for the next two months (May-Jun) is likely to average ~11%YoY, following strong commodity prices (CRB index up 41%FYTD), pending electricity tariff adjustments (PkR1.39/unit base tariff adjustment as part of annual rebasing) in Jun'21 and ongoing Ramadan season despite government measures (Ramzan Package and strategic imports) to improve the supply chain of food products. Positive vaccine related developments (availability and roll-out) coupled with significant global monetary and fiscal stimuli and consequent demand recovery outlook have together acted as a catalyst for the price performance of nearly all global commodities pushing their respective prices beyond pre-pandemic levels. This can be a key risk going forward if it results in one-off supply shocks or second-round effects. Downside risk emanates from reportedly record surplus production of wheat (30MMT vs. 24MMT consumption) and sugar (5.7MMT vs. 5.3MMT) which can anchor inflationary expectations going forward. Additionally, renewed waves of Covid-19 can also negatively impact global demand for commodities (particularly oil).

While price levels in Pakistan continue to face surging pressure from higher international commodity prices, the trend of core inflation has remained relatively tapered due to policy response (tax relief measures and tariff concessions), appreciation of the Rupee against the US Dollar and relatively stable transportation costs. In this backdrop, we estimate headline inflation to average around 9% in FY21 (close to the upper end target of SBP's range of 7-9%) and average around the same level during CY21. Our estimates are subject to various upside risks primarily emanating from utility price adjustments (every 5% increase in oil price raises our monthly inflation estimate by 19bps whereas every 5% increase in utility tariffs translates into +24bps impact on monthly inflation), international commodity prices and possible fiscal adjustments under the IMF program in the upcoming Federal Budget FY22. However, it will be challenging for the government to completely implement these measures given their inflationary nature. Historically, IMF fund programs have focused on revenue mobilization largely thorough indirect taxes (e.g. GST rates) which is inflationary in nature.

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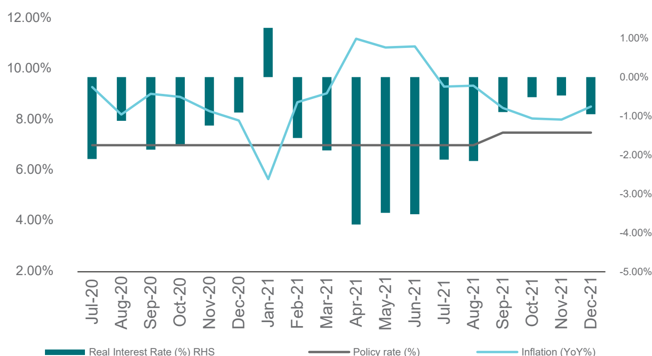
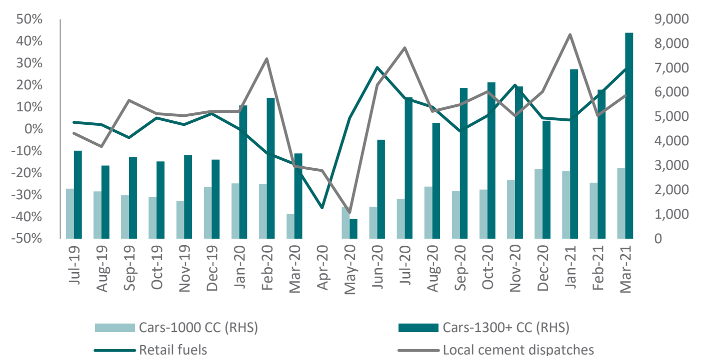
Monetary Policy Outlook - Accommodative: As a policy response during the pandemic to stimulate the economy, the State Bank of Pakistan (SBP) aggressively cut the benchmark policy rate in 2020 by 625bps to 7% and has kept it unchanged in subsequent monetary policy reviews. That said, even though controlling inflationary pressures will be a challenge in 2021, CPI is expected to remain within the central bank's target range. With a stable external account outlook (upcoming IMF review in Jun'21 to release ~US$1bn tranche), SBP is expected to continue its accommodative stance which should also encourage private-sector lending as the government's significant borrowing requirement (finance sizable fiscal deficit) has been crowding out the private-sector credit. Additionally, with the country going through a third wave of the virus and the economy yet to recover to pre-covid levels, the SBP is unlikely to materially reverse course on its monetary policy until meaningful economic recovery, in our view. In line with SBP's forward guidance, we expect the SBP to keep the policy rate unchanged in the upcoming meeting in May'21. However, upside risks to inflation emanating from higher international commodity prices and fiscal adjustments in the upcoming Federal Budget FY22 (IMF expects FBR to increase tax revenues by 27%YoY to PkR5.9tn in FY22 vs. revised PkR4.7tn target in FY21) can encourage the SBP to gradually raise the benchmark rate by 50bps in 1HFY22. Fiscal measures in the upcoming budget and deferral of power tariff hikes can influence monetary policy outlook in 1HFY22.

Nominal vs. Real Interest Rates



Source: PBS, SBP, FAML Research

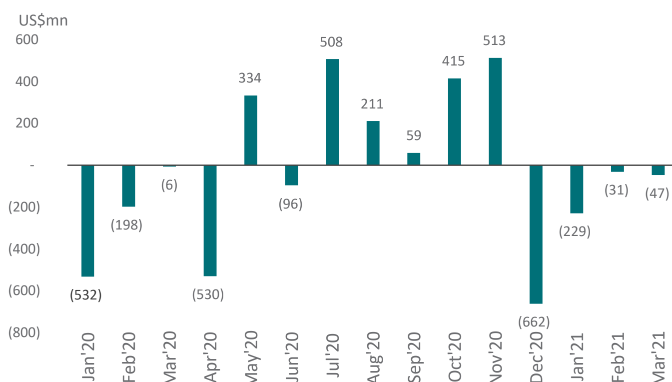
High-frequency indicators reflecting sharp recovery



Source: APCMA, PAMA, OCAC, FAML Research

External Account – Higher Remittances Ensuring Stability: Pakistan has registered a Current Account (CA) surplus of US$959mn (0.5% of GDP) in 9MFY21 (vs. a CA deficit – CAD of -US$4.15bn (-2.1% of GDP) last year). Subdued domestic demand restricting overall import payments (relatively lower avg. international oil prices containing energy related imports) along with higher workers' remittances (up 26%YoY to ~US$21.5bn in 9MFY21 - remittances have continued to exceed US$2bn for the tenth consecutive month) are major drivers behind external account improvement. Restrictions on air travel have also contributed to the strength in inward remittances as expats switched to formal channels (PRI incentives). Atypically higher other current transfers (up 96%YoY to reach ~US$3.1bn in 9MFY21) have also contributed to the strength in CA, reflecting potentially higher foreign social contributions during the pandemic. Additionally, impetus from relatively higher withdrawals in FCY deposits by non-resident Pakistanis and converted into PkR (citizens repatriating back and PkR appreciation) is also driving the strength in other current transfers. As the domestic economy improves, the trade deficit has widened (up 18%YoY to US$18.6bn in 9MFY21) on the back of imports of capital goods and industrial materials as well as food, together with rising international commodity prices.

Monthly Current Account Balance

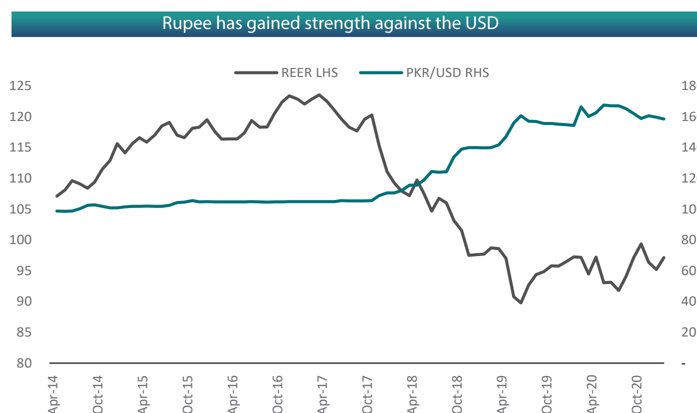


Source: SBP, FAML Research

Current Account Projections

(US$bn)	FY19	FY20	FY21F	FY22F
Current Account Deficit (CAD)	-13.59	-2.97	-0.18	-1.09
CAD (% of GDP)	-4.79	-1.13	-0.06	-0.36
Exports of Goods	24.22	22.51	23.39	25.04
Imports of Goods	52.44	42.42	47.21	50.13
Balance on Trade in Goods	-28.22	-19.91	-23.82	-25.09
Balance on Trade in Services	-4.27	-2.83	-1.87	-1.88
Workers' Remittances	21.84	23.12	28.09	28.93

Going forward, higher imports as the global economy opens up is a key downside risk which can still push the CA balance to a deficit. However, CA surplus run-rate to date (9MFY21) together with an on-going recovery in exports and strength in remittances (estimated to reach US$28.0bn in FY21, up 22%YoY) is expected to keep CAD at ~-US$0.2bn (-0.1% of GDP) in FY21 vs CAD of US$2.9bn (-1.1% of GDP) in FY20. Exports have witnessed a nascent recovery (up 2%YoY in 9MFY21) on global spillovers of virus outbreaks and also due to exporters (utilizing the SBP's temporary Covid-related regulatory relaxations) holding back export receipts for up to 270 days (up from the previous time limit of 180 days). That said, a positive export outlook (order book of textile players extending to 4-6 months particularly for the value-added segment as vaccine availability in trading partners consolidates demand) along with structural shifts (expats are remitting through formal channels - Roshan Digital Account (RDA) has already exceeded US$1bn) should together counter pressure from higher imports (commodity upcycle). The resumption of the IMF program provides further comfort on meeting external financing needs as the program is expected to unlock additional multilateral funding (only 53% of budgeted multilateral disbursements received during 8MFY21). Our positive outlook depends significantly on the direction of the pandemic as a successful vaccine rollout and strong growth in developed economies provides upside risks to exports. On the flipside, renewed virus outbreaks are a downside risk which can derail the global economic recovery process.



Source: SBP, FAML Research

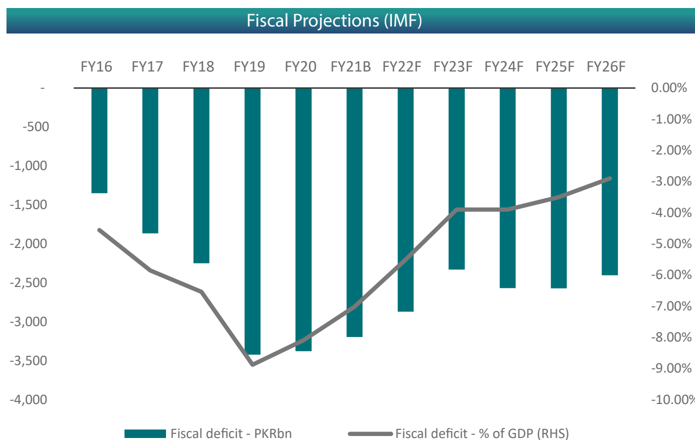
External Funding Flows - Projections

Amount in US$bn	FY19	FY20	FY21F	FY22F
CAD	-13.51	-2.97	-0.18	-1.09
Foreign investment (FDI+FPI)	1.02	2.12	1.34	2.46
Capital Account	0.25	0.29	0.31	0.31
Debt repayments	-8.64	-9.63	-12.3	-10.81
Debt inflows	19.42	15.47	16.54	11.22
Net funding surplus/deficit	-1.45	5.29	5.72	2.10
SBP Reserves	7.29	12.57	18.3	20.39

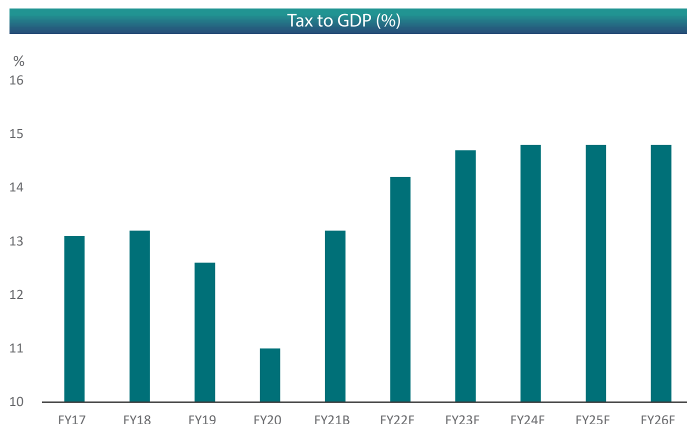
Rupee outlook remains stable: Under the ambit of the IMF program, Pakistan has switched to a more free-float based exchange-rate regime which better reflects market demand for the domestic currency. Given a relatively manageable CA outlook coupled with a well-funded financial account, we do not see significant pressure on the PkR in the near term. Our estimates suggest a net average funding surplus of ~US$3.2bn over the next three years (FY21E-FY23F) where upcoming IMF review in Jun'21 is expected to unlock an additional tranche size of ~US$1bn while timely materialization of funding flows from other multilaterals also provides confidence. PkR stability is also supported by the recent successful Eurobond proceeds of US$2.5bn, materialization of external funding flows from multiple sources (up ~15%YoY to reach US$7.2bn in 8MFY21), G20 debt deferment of ~US$2.7bn and roll over of the US$2bn UAE loan deposit with SBP reserves reaching US$16bn (~4 months import cover) – highest since Jun'17. Improvement in foreign exchange liquidity in the interbank market have also been aided by the build-up in trade nostros abroad with commercial banks and exporters expecting currency appreciation selling export proceeds in the forward market. These factors along with generally improving confidence in the recovering economy have facilitated appreciation of the Rupee with the PkR/US$ parity appreciating 9% since its peak in FY21TD. In this backdrop, we see the PkR/USD parity trading around 154-155 up to Jun'21 and gradually reach 162 by Jun'22. Our base case is premised on: i) continuation of IMF program over the forecast horizon and resultant timely materialization of funding flows from other multilaterals, ii) repayment of the bilateral loans from KSA this year partially financed through Chinese support and iii) full materialization of expected debt relief from G20 countries.

Fiscal Outlook – Underpinned by tax reforms: Due to the pandemic, economic activity has been relatively subdued resulting into lower revenues while stimulating the economy (packages) and avoid compromising social and development spending at the same time are unique challenges (IMF projects fiscal deficit to clock in at ~7.1% of GDP in FY21). In this regard, fiscal relief packages of over 2.5% of GDP with focus on protecting the most vulnerable segments of the society has been encouraging. Despite the pandemic, fiscal performance has been satisfactory as 9MFY21 primary surplus has penciled in at 1.0% of GDP while fiscal deficit has been limited to -3.6% of GDP (vs.

-3.8% in 9MFY20) due to improved tax revenues (up 5%YoY to reach PkR3.76tn) and prudent expenditure management (up 4%YoY to reach PkR6.64tn). In this regard, FBR has encouragingly collected PkR3.39tn (up ~12%YoY) in 9MFY21. That said, realized tax collection in FY21 is expected to undershoot the revised FBR tax collection target of ~PkR4.7tn and as a result, reliance on non-tax revenues should increase including petroleum levy on gasoline and diesel (capped at PkR30/liter) and additional transfers of SBP profits.



Source: MoF, IMF, FAML Research



Source: MoF, IMF, FAML Research

For FY22, the IMF has estimated FBR revenue collection at PkR5.96trn (up 27.1%YoY vs revised FY21 target of ~PkR4.7trn) driven by reforms in the tax base (broadening, reducing informality, and simplifying and modernizing the tax system). Particularly, focus will be on revenue generation where the government has committed to introduce both a general sales tax (GST) reform (estimated 0.7% of GDP) and a personal income tax (PIT) reform in the upcoming Federal Budget FY22 which is together expected to yield an estimated 1.1% of GDP in additional revenues. In this regard, FBR estimates cumulative sales tax exemptions at ~PkR519bn in FY20. However, it will be challenging for the government to completely implement these measures given their inflationary nature. As a prior action, the government has already withdrawn income tax exemptions of ~PkR140bn (~0.3% of GDP). Additionally, the reform process also extends to the power sector where a detailed action plan with regards to decline in circular debt accumulation (total stock PkR2.3tn) is being committed. This includes raising the power tariff to gradually bring it closer to cost recovery (recently increased by PkR1.95/kWh on all slabs) with PkR1.39/kWh hike expected in Jun'21 and the 4QFY20 and 1QFY21 quarterly adjustments expected to be automatically notified in Sep'21 and Apr'21 through the amended NEPRA Act. In FY22, the IMF estimates fiscal deficit at 5.5% of GDP (primary surplus of 0.4% of GDP) on the back of higher revenues (17% of GDP vs. 15.8% in FY21E) and effective expenditure management (22.5% of GDP vs. 22.9% in FY21E).

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Umer is currently Director Research at Faysal Funds and has over twelve years of experience in the capital markets of Pakistan with nine years of experience in sell side equity research and over three years of experience in fund management and foreign sales (equity). Umer draws his leadership capabilities from previous roles including Fund Management and Head of Research roles. At his previous role at AKD Securities (AKDS), Umer was the Executive Director Business Development and headed the foreign institutional desk where he was the key point of contact (including independently replying research queries) for foreign clients and international partners. He was also responsible for successfully setting up and delivering some of the largest reverse roadshows and conferences for foreign asset managers in and outside of Pakistan along with non-deal roadshows (NDR) for domestic Companies. He was also instrumental in facilitating the Bank of China International (BOCI) to become part of the Joint Lead Managers consortium for Pakistan's medium-term note (MTN) program (Eurobonds) in 2021. He was also awarded "Best Strategist for Pakistan" by Asia Money Brokers Poll 2018. He has an extensive understanding of all major listed sectors at the Pakistan Stock Exchange and together with his fund management experience brings vast value to address client requirements. Prior to joining AKDS, Umer was the Head of Research at PICIC Asset Management Company (PICIC AMC) where he helped manage equities worth +US$ 150 million. Umer holds a Masters in Business Administration from The Pennsylvania State University, USA and a Bachelor of Science (Finance) from The Pennsylvania State University, USA.

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