Pakistan Economy

Tramping along a slippery path

1. Current Account Balance

Rampant domestic activity, higher global commodity prices along with machinery and food imports are likely to put pressure on the external account. Therefore, we expect current account to post a deficit of USD 9.7bn (2.9% of GDP) in FY22E.

2. Imports vs. Exports

With economic activity picking up we expect trade deficit to widen. We expect imports to expand 23% YoY while exports to post an increase of 16% YoY in FY22E. This will bring the total trade deficit to USD 39.3bn in FY22E, a 31% YoY jump from last year.

3. Remittances

Remittances have been the most reliable source of foreign exchange flows for Pakistan, registering a double-digit advance (27% YoY) in FY21, a level that was key to cover the trade imbalance in FY21. In FY22, we expect the inflows to stabilize and reach USD 30bn, marking a 3% growth only.

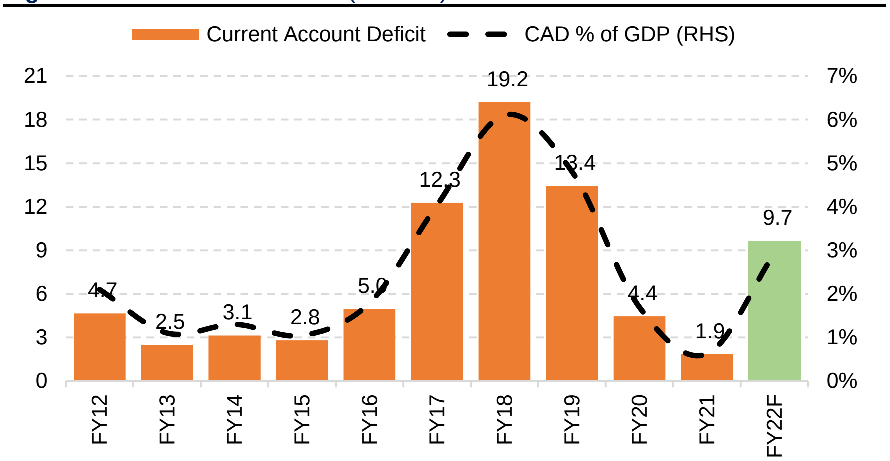
4. Debt Sustainability

The external financing needs of ~USD 20bn for FY22 are likely to be comfortably met which should help fuel reserves further. With RDA flows, Eurobond tap issues, SDR allocation and other inflows, FX reserves are expected to close FY22 at a level higher than FY21.

5. Currency Outlook

The flexible exchange rate has helped alleviate the risk to the current account, proving to be an excellent shock absorber so far. Over the next few quarters, our base case FX outlook is less pessimistic than was initially feared. We expect PKR to be 166.2/ USD by Dec'21 and 169.5/USD by Jun'22.

Fig 01: Current Account Deficit (USD bn)



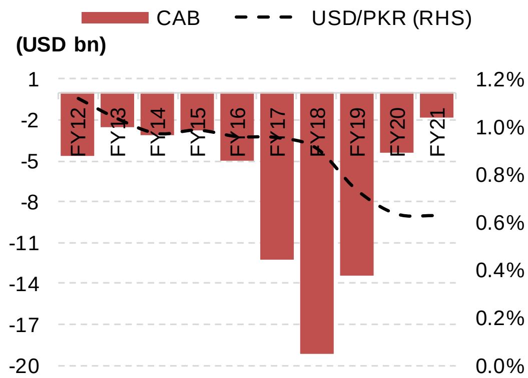
Source (s): SBP, AHL Research

Current Account Balance

USD bn	FY22F	FY21A	YoY
Exports of Goods	29.5	25.6	15%
Imports of Goods	66.8	53.8	24%
Goods Balance	(37.3)	(28.2)	33%
Services Balance	(1.9)	(1.9)	3%
Balance on Trade	(39.3)	(30.0)	31%
Primary Income Balance	(4.7)	(4.7)	1%
Secondary Income Balance	34.3	32.8	4%
Remittances	30.2	29.4	3%
CAB	**(9.7)**	**(1.9)**	422%
CAB % of GDP	***-2.9%***	***-0.6%***	

Source (s): SBP, AHL Research

Current Account Balance



Source (s): SBP, AHL Research

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Current Account Deficit set to print higher

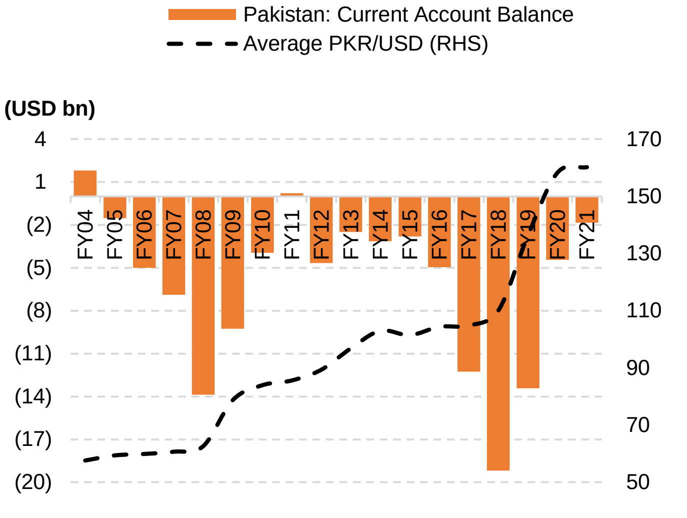
As much as a deficit sounds innately problematic and a surplus virtuous, fact of the matter is, growth phase of the economy in Pakistan is usually seen to be complemented with deficit on the external front, however, a manageable one. Dwelling more on what played out in the 1HCY21, we highlight that the bulk of the pressure emanated from the deterioration in the balance of trade position with imports surging by 50% YoY during the period. Despite the economic headwinds engendered by the recurring 'waves' of the pandemic, FY21 closed with external sector being the strongest in years, with CAD clocking in at 0.6% of GDP (10-Yr low). SBP reserves rose by USD 5.2bn during the year and crossed USD 17bn (3 months import cover), a 4.5-Yr high.

Going forward, rampant domestic activity, higher global commodity prices along with machinery and food imports are likely to put pressure on the external account. Therefore, we expect current account to post a deficit of USD 9.7bn (2.9% of GDP) in FY22E, as trade deficit widens with economic activity picking up hence, leading to import growth (23% YoY). This is in-line with the SBP's expectation of CAD to remain in the "sustainable" range of 2-3%, supported by robust remittances and improved exports' outlook. On the trade front, the uptick in import will be augmented by the capital assets' import against TERF facility. In addition to this, with oil prices staying downwards sticky along with a high domestic demand, we expect the import bill will be pushed up. On the other hand, exports are likely to show improvement as global commodity prices remain high while volumetric growth remains intact. We expect the exports to post an increase of 16% YoY in FY22E to reach USD 36.5bn. This will bring the total trade deficit to USD 39.3bn in FY22E, a 31% YoY jump from last year. However, in order to address the trade deficit, Pakistan needs to not only focus on improving export competitiveness, but also on managing excessive internal demand for discretionary imports. Moreover, with the normalization of economic activities in advanced and developing economies, we expect improved inflows from the Pakistani diaspora (remittances). Considering the substantial contribution of remittances to the secondary income balance (c.88%), we look for a 3% YoY increase in secondary income balance to USD 30bn.

When CAD is a concern (Checklist)	**FY18**	**FY22E**
Persistently large	✓	✗
Fuels consumption rather than investment	✓	✗
Occurs alongside excessive domestic credit growth	O	✗
Follows an overvalued exchange rate	✓	✗
Accompanies unrestrained fiscal deficits	✗	✗

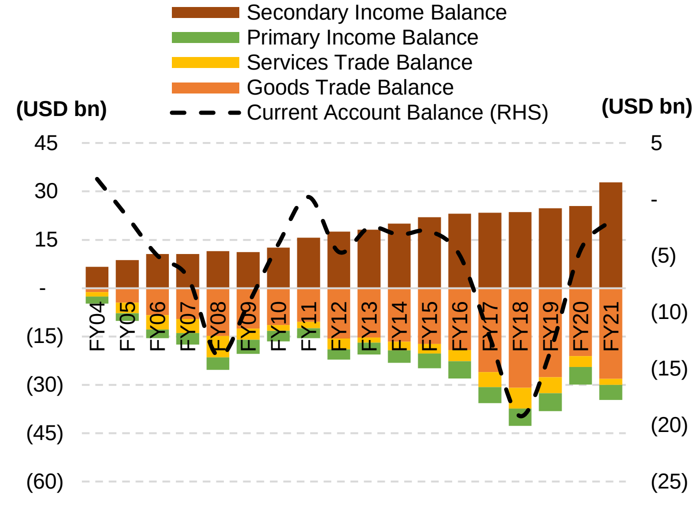
* O *= Indifferent*

Fig 02: Current Account Deficit of USD 1.8bn during FY21



Source (s): SBP, AHL Research

Fig 03: Component wise Current Account Balances



Source (s): SBP, AHL Research

Table 01: Current Account Balance

USD mn	FY17A	FY18A	FY19A	FY20A	FY21A	FY22E
Current Account Balance	(12,270)	(19,195)	(13,434)	(4,449)	(1,852)	(9,667)
% of GDP	*-4.0%*	*-6.1%*	*-4.8%*	*-1.7%*	*-0.6%*	*-2.9%*
Exports of Goods	22,003	24,768	24,257	22,536	25,630	29,471
Imports of Goods	48,001	55,671	51,869	43,645	53,785	66,813
Balance on Trade in Goods	(25,998)	(30,903)	(27,612)	(21,109)	(28,155)	(37,343)
Exports of Services	5,915	5,851	5,966	5,437	5,937	7,091
Imports of Services	10,576	12,277	10,936	8,753	7,812	9,016
Balance on Trade in Services	(4,661)	(6,426)	(4,970)	(3,316)	(1,875)	(1,925)
Balance on Trade in Goods and Services	(30,659)	(37,329)	(32,582)	(24,425)	(30,030)	(39,268)
Balance on Primary Income	(5,014)	(5,437)	(5,610)	(5,459)	(4,670)	(4,700)
Balance on Secondary Income	23,403	23,571	24,758	25,435	32,848	34,300
Workers' Remittances	19,351	19,914	21,740	23,131	29,370	30,215

Source (s): SBP, AHL Research

Demand could catapult import bill higher

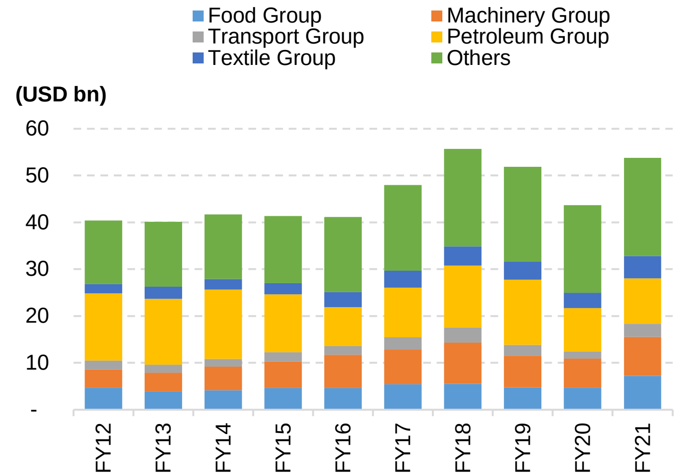
As the government/SBP is considering a variety of measures to propel demand through expansionary policies, our balance of payments (BOP) model suggests that imports could rise faster in FY22E as consumer demand surges with improved domestic macroeconomic conditions leading to a growth in the external sector. To recall, last year imports of some categories exceeded historical averages including mobile phones, machinery (mainly due to TERF), cotton, food and COVID vaccines. This had a cumulative impact of USD 6bn. We expect imports in this fiscal year to expand 23% YoY to settle at USD 75.8bn (FY21: USD 61.6bn). The Central Bank also expects imports to be up, mainly dominated more by machinery (investments) rather than consumption, as opposed to in FY17, while also being concentrated amongst various sectors compared to FY18 when power and telecommunications were major sectors that attracted imports. Therefore, the machinery group, we expect, may display an increase of 32% as major expansionary cycles of the cement, textile and related sectors have already resumed with the economy showing signs of growth. In addition, machinery purchased against TERF will also add to the overall import numbers which is expected to be ~USD 1.6bn per annum for next two years. To recall, SBP has so far approved PKR 436bn as at Apr-01-21. The food group import, moreover, is likely to witness a jump in FY22E (11% YoY) as international prices of edible oil remain high. In addition, the overall imports will be significantly impacted by higher petroleum imports due to price effect, on account of noticeably higher crude oil prices underpinned by the better-than-expected global vaccination rate, output cuts and faster economic recovery. Petroleum imports are likely to be 4.5% of the GDP in FY22E. For oil-related imports, our FY22 Brent crude average price estimate is USD 65/bbl.

Table 02: Goods Imports Breakup

USD mn	FY17	FY18	FY19	FY20	FY21	FY22E
Petroleum Group	10,607	13,263	13,929	9,280	9,747	15,101
Agri. & Other Chemicals	7,123	8,315	8,394	7,032	8,409	8,661
Machinery Group	7,410	8,785	6,768	6,193	8,322	10,995
Food Group	5,417	5,502	4,751	4,713	7,244	8,028
Textile Group	3,589	4,091	3,854	3,301	4,756	6,183
Metal Group	3,674	4,762	3,907	3,228	4,583	4,812
Transport Group	2,643	3,207	2,315	1,512	2,745	3,431
Miscellaneous Group	1,196	1,256	1,030	789	1,163	1,221
Others	6,342	6,491	6,919	7,597	6,815	8,381
Total	**48,001**	**55,671**	**51,869**	**43,645**	**53,785**	**66,813**

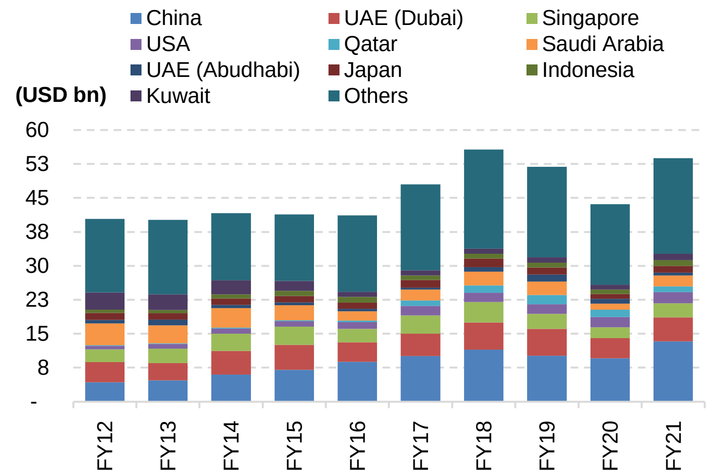
Source (s): SBP, AHL Research

Fig 04: Commodity wise Imports Break-up



Source (s): SBP, AHL Research

Fig 05: Country wise Imports Break-up



Source (s): SBP, AHL Research

Exports- Revving up

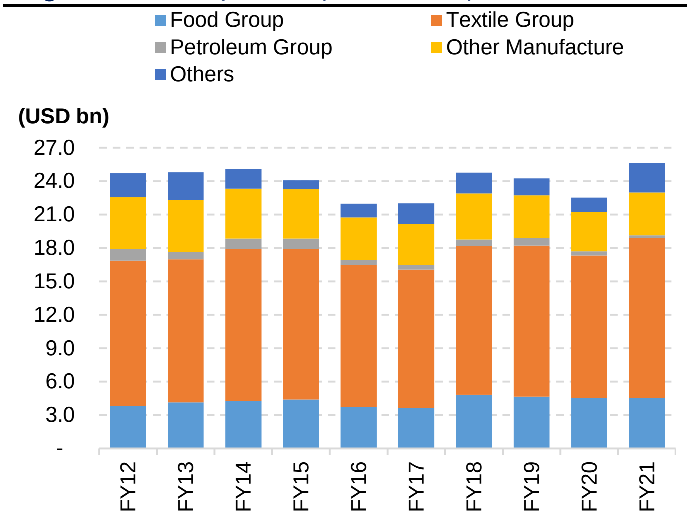
Export earnings are set to improve in FY22 relative to FY21 levels as global economy rebounds. Moreover, improvement will be further augmented by the steps taken by the relevant official authorities such as reduction of duty on import of raw materials and availability of LTFF and TERF for capacity addition, to bolster exports. Meanwhile COVID situation is a lot better than other economies, we project total export earnings in FY22 to print at USD 36.5bn, 16% higher than FY21 levels. Our forecast is premised on our expectations of improved textile exports posting a growth of 20% YoY primarily on the back of textile policy that is being drafted in a way to support expansions and concessionary prices for the textile players. However, downside risks associated with this sector remain: cotton crop shortage owing to supply constraints and any uptick in cost of production especially if interest rates go up in the latter half of FY22. In addition, the reduction in the output gap in advanced economies favors higher commodity prices on increased international supply chain activities. Given the composition of Pakistan's exports, we believe the higher commodity prices will translate to higher input prices for the textile sector, a matter of concern for the overall sector. Moreover, we think the global recovery as economies open up, bodes well for the service sector. Thus, we expect higher receipts from travel and transport services. Accordingly, we believe the services account (net) will increase by 20% YoY to USD 7bn (FY21: USD 5.9bn). Another sector that is likely to contribute towards the services account is the technology particularly due to the shift towards digitization. Last year alone, technology contributed 36% to the overall services' export, marking a 47% YoY jump. With the recent measures taken and incentives given by the government to move towards digitization, we have modelled a growth of 35% YoY for FY22E.

Table 03: Goods Exports Breakup

USD mn	FY17	FY18	FY19	FY20	FY21	FY22E
Textile Group	12,457	13,377	13,581	12,799	14,409	17,262
Food Group	3,618	4,818	4,648	4,539	4,503	5,063
Other Manufacture	3,659	4,134	3,822	3,522	3,834	4,218
Petroleum Group	411	575	676	369	235	258
Others	1,859	1,865	1,531	1,307	2,649	2,670
Total	**22,003**	**24,768**	**24,257**	**22,536**	**25,630**	**29,471**

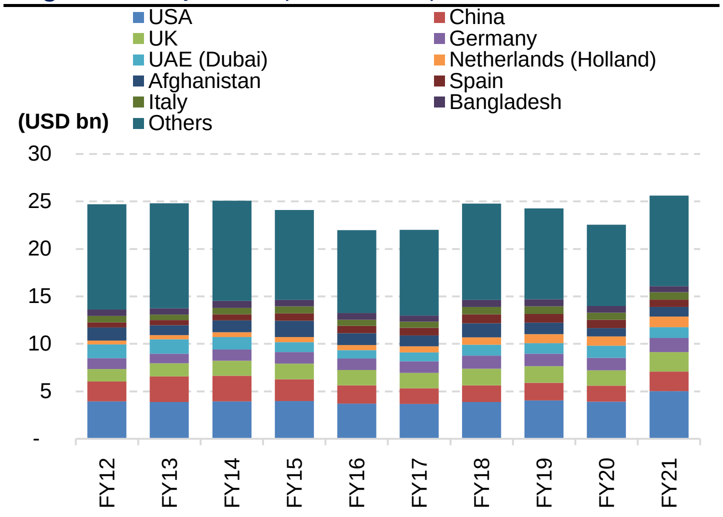
Source (s): SBP, AHL Research

Fig 06: Commodity wise Exports Break-up



Source (s): SBP, AHL Research

Fig 07: Country wise Exports Break-up



Source (s): SBP, AHL Research

Remittances - Vaccinating against deficit

Remittances have been the most reliable source of foreign exchange flows for Pakistan. During the past 10 years, inward flow of remittances increased at a CAGR of 10.1%, driven by persistent export of man power from Pakistan along with encouragement by the government to use legal channels to remit money into Pakistan. Remittances registered a solid double-digit growth (27% YoY) and its level was key to cover the trade imbalance in FY21. This gives a picture of the importance it plays in the nation's balance of payments position. The country wise data reveals that inflow from KSA, UAE, UK and USA, during FY21 amounted to USD 7.7bn (+16% YoY), USD 6.1bn (+9% YoY), USD 4.1bn (+58% YoY) and USD 2.8bn (+58% YoY), respectively. Remittances are likely to grow this year (although at a slower pace against last year). Some of the factors that will support the inflows are: crackdown on illegal channels of remitting and workers sending money to their families and the incentives for migrants as well as remittance payment executors by the SBP. All said, in FY22, we expect the inflows to stabilize and reach USD 30bn, marking a 3% growth.

Table 04: Country Wise Remittances

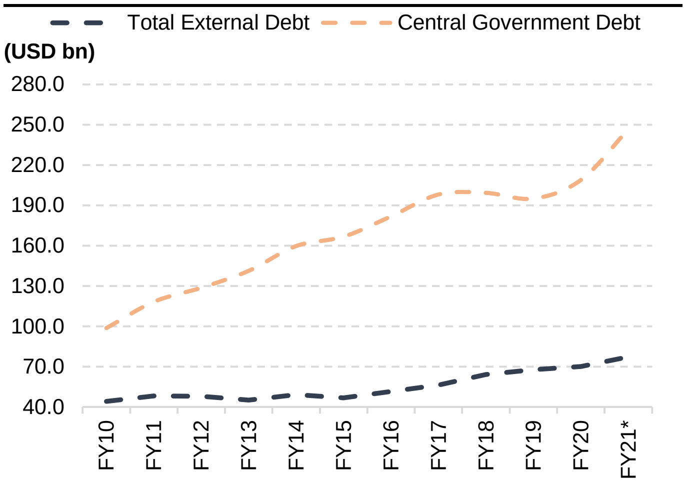
USD mn	FY17	FY18	FY19	FY20	FY21A	FY22E
Saudi Arabia	5,470	4,859	5,003	6,613	7,667	7,868
UAE	4,328	4,333	4,617	5,612	6,114	6,298
Other GCC Country	2,325	2,158	2,119	2,910	3,310	3,408
UK	2,342	2,763	3,412	2,569	4,067	4,181
USA	2,453	2,714	3,309	1,743	2,754	2,834
EU Countries	483	656	609	1,778	2,709	2,794
Australia	205	228	246	340	593	611
Canada	187	211	213	313	586	605
Norway	41	48	43	70	111	114
Japan	14	23	23	66	85	87
Switzerland	26	27	31	31	41	42
Others Countries	1,477	1,602	2,113	1,086	1,333	1,372
Total	**19,351**	**19,622**	**21,739**	**23,132**	**29,371**	**30,215**

Source (s): SBP, AHL Research

Stress testing debt sustainability

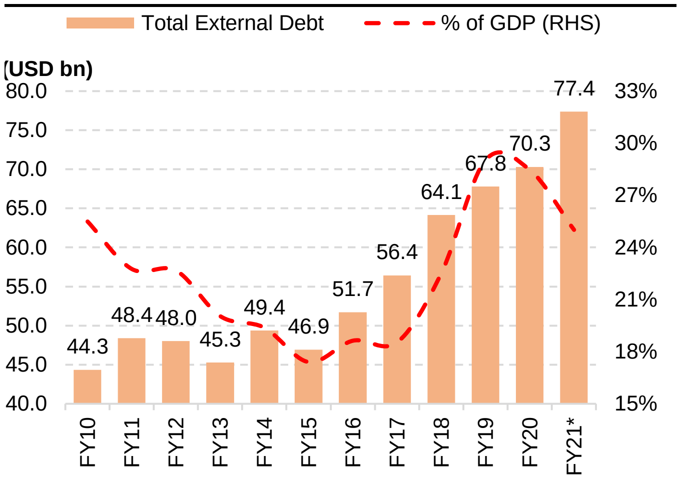
The external financing needs of ~USD 20bn for FY22 are likely to be comfortably met which should help fuel reserves further. RDA inflows since Sep'20 have clocked-in at USD 2bn. July saw a further USD 1bn being raised through a tap issue of the Eurobond, that was issued in March and raised USD 2.5bn. In August, reserves are likely to be further supported by USD 2.8bn from IMF's SDR allocation. Unless an unexpected shock occurs such as higher oil prices or capital flight from emerging markets, the BoP position should remain sustainable supported by the market-based flexible exchange rate and domestic investment climate. Moreover, FX reserves are expected to close the upcoming year at a higher level than FY21. In a way FY21 was an incredible year for the economy (better than several past years); decade low CAD was recorded and foreign reserves were at a 4 year high. On the debt front, the State Bank does not think there will be a repeat of the boom and bust cycle. The government has been cautious of the debt position. Debt to GDP has come down despite COVID outbreak and economic growth, going from negative territory to +4%, due to prudence on the fiscal side. While other economies observed higher debt to GDP levels. Going forward, net debt inflows will be even lower than this year, as mentioned by the SBP in their post-MPC analyst meeting, while external inflows (IMF, Global SDR expectation of nearly USD 2.8bn in Aug'21, inflows from non-IMF and private creditors) will aid FX reserves. So with the leverage position being contained, an asset bubble burst can be ruled out. Moreover, net reserves have improved as forward liabilities of the government have come down from USD 8bn to USD 4.7bn. Also supporting the stance of improvement in reserves.

Fig 08: External and Public Debt



Source (s): SBP, AHL Research, *May'21

Fig 09: Historical Trend of External Debt



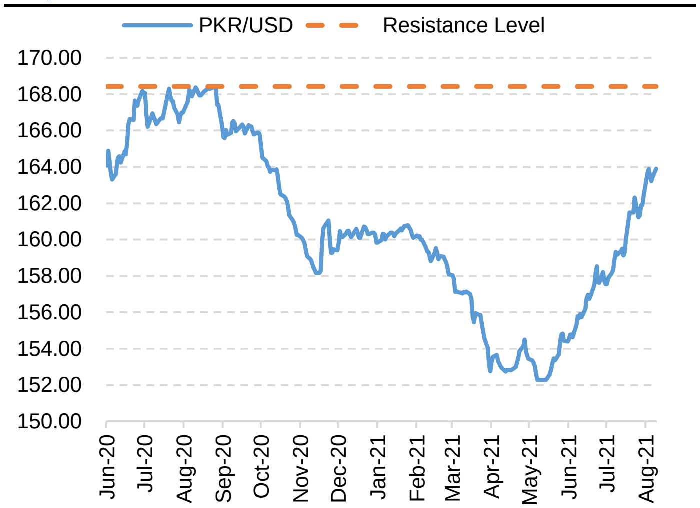
Source (s): SBP, AHL Research, * May'21

Currency Outlook - Our base case is less pessimistic

The flexible exchange rate regime followed by the SBP has helped alleviate the risk to the current account so far. To recall, the PKR-USD level was at 160 in Jul'19 and two years on, it is at a similar level (despite ups and downs in between). This shows that the market-based exchange rate is an excellent shock absorber. However, the Bank often partakes in the FX market to: (1) regulate liquidity in the market, (2) restrain shocks originating from external imbalance, (3) effect government payments and (4) bolster official FX reserves – all of which fall within the purview of the Bank. Over the next few quarters, our base case FX outlook is less pessimistic (4% annual depreciation) than was initially feared. We expect PKR to be 166.2/ USD by Dec'21 and 169.5/USD by Jun'22. This view is premised on our expectation of a manageable current account deficit position, alongside the country's comfortable reserve position, which could potentially improve the ability to defend the currency. All said, we note a few risks to our outlook:

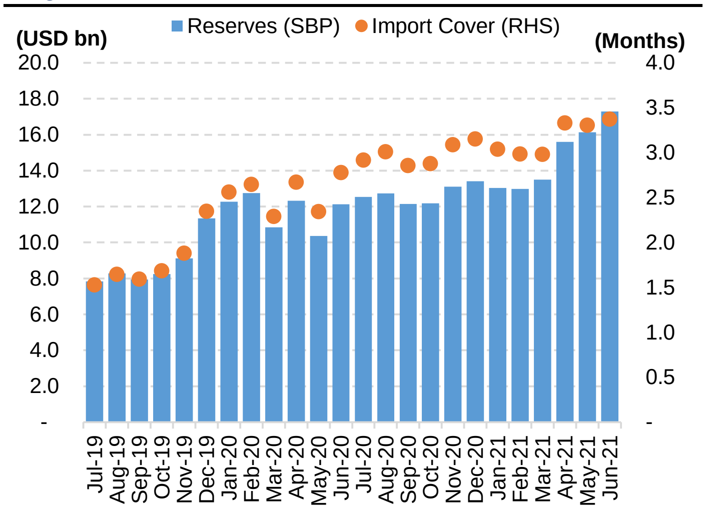
- A quicker and more-than-anticipated jump in imports as activity levels pick up
- A sharp uptick in the international oil prices
- Deferment, postponement and cancellation of some of all of the strategic external borrowing
- Improved trade in peer countries leading to competition putting pressure on our external account

Fig 10: PKR/USD Trend



Source (s): SBP, AHL Research

Fig 11: Reserves vs Import Cover



Source (s): SBP, AHL Research

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Rating	Description
BUY	Upside* of subject security(ies) is more than +10% from last closing of market price(s)
HOLD	Upside* of subject security(ies) is between -10% and +10% from last closing of market price(s)
SELL	Upside* of subject security(ies) is less than -10% from last closing of market price(s)

* Upside for Power Generation Companies is upside plus dividend yield.

Equity Valuation Methodology

AHL Research uses the following valuation technique(s) to arrive at the period end target prices;

- **Discounted Cash Flow (DCF)**
- **Dividend Discounted Model (DDM)**
- **Sum of the Parts (SoTP)**
- **Justified Price to Book (JPTB)**
- **Reserve Base Valuation (RBV)**

Risks

The following risks may potentially impact our valuations of subject security (ies);

- **Market risk**
- **Interest Rate Risk**
- **Exchange Rate (Currency) Risk**

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