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Pakistan's Dilemmas between the US and China
—Resolution of Foreign Currency Shortage Postponed—

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Many economic Indicators of Pakistan have become available for FY 2017/18. Real GDP grew by 5.8%, keeping a high growth rate mainly helped by capital investment related to China Pakistan Economic Corridor (CPEC). However, the current account deficit and the fiscal deficit have increasingly deteriorated, causing a drain in the foreign exchange reserves. Thus Pakistan is now in a situation where it is inevitable to seek for emergency loans from the IMF and related countries. In this article, I would like to explain the situation of Pakistan's twin deficits and external debts.

1. Worsening twin deficits

The current account deficits widened in FY 2017/18 (July 2017 -June 2018) to $18.1 billion (5.8% of GDP) from $12.4 billion (4.1% of GDP) in the previous fiscal year and worsened from the IMF projection (deficit of 4.8% of GDP) as of July 2017.

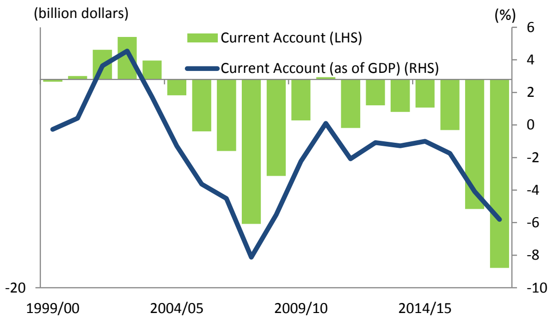
Based on the IMF assumption of the average oil price of $68.76[1] a barrel in 2019, and the components of the current account other than energy and the real GDP growth rate remaining at the same level as in the previous fiscal year, the author had a trial calculation in which the current account deficit for FY2018/19 is estimated to stay high at 5.8% of GDP. In the first

[1] The IMF projected in its October 2018 issue of the World Economic Outlook the simple average oil prices of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil until 2019. The author used this forecast even though the IMF forecast is for a period of January to December 2019 and there is a time gap of a half year from the Pakistan's fiscal year which covers from July 2018 to June 2019.

quarter of FY2018/19 (July-September 2018) , however, the current account deficit narrowed by 3.0% from the corresponding quarter a year ago to $3.7 billion reflecting an increase of receipt of remittances by 13% from a year ago.

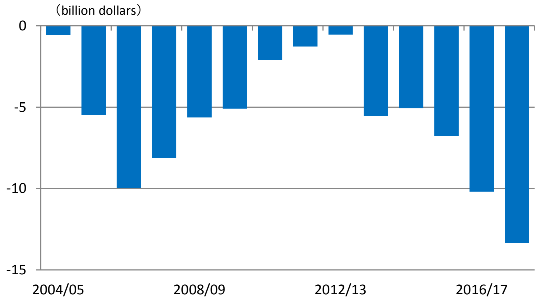
The fiscal deficit increased to $13.3 billion (6.6% of GDP) in FY2017/18 from a deficit of $10.2 billion (5.8% of GDP) in the previous fiscal year and exceeded also the IMF forecast (5.5% of GDP) estimated as of July 2017. With the scheduled increase of expenditures related to CPEC, the fiscal deficit is expected to worsen again in FY 2018/19.

(Figure1) Pakistan's Current Account Balance



(Source) IMF

(Figure 2) Pakistan's Fiscal Balance



(source) Datastream

(Table 1) Main Economic Indicators

	2015/16	2016/17	2017/18
Economy			
Real GDP Growth (%)	4.7	5.3	5.8
CPI (%)	2.9	4.1	4.4
External Account			
Current Account Deficit (% of GDP)	0.9	4.1	5.8
Current Account Deficit (billion dollars)	5	12	18
Trade Deficit (% of GDP)	4.5	13.2	9.9
Trade Deficit (billion dollars)	24	34	38
o/w China	6	9	10
Remittances (% of GDP)	3.7	9.4	6.3
FDI (% of GDP)	0.4	0.9	0.9
Fiscal Account			
Tax (% of GDP)	12.4	12.5	12.9
Fiscal Deficit (% of GDP)	4.6	5.8	6.6

(Source) Thomson Reuters

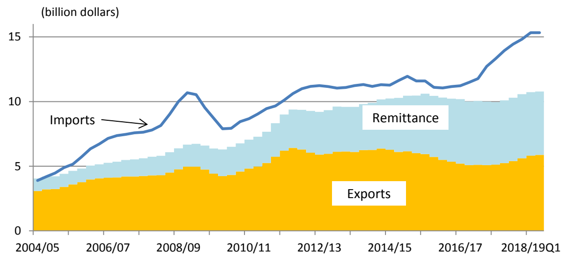
The increase of the current account deficits is mainly attributed to an increase of trade deficits associated with brisk consumption, increase of capital goods imports relating to CPEC and increased imports of crude oil reflecting expanding energy demand.

Exports increased in FY2017/18 by $2.7 billion over the previous year. They were spurred by the exports to the UK, Germany and Spain under the EU's "Generalized Scheme of Preferences (GSP) +" which was applied to the products of Pakistan.

However, imports also increased to push the amounts by $6.8 billion higher than the previous year. The increase reflected higher bills for crude oil (by 53% or $3.9 billion) and LNG (by 67.5% or $1.9 billion) than in the previous year due to increased demand for oils coupled with higher oil prices.

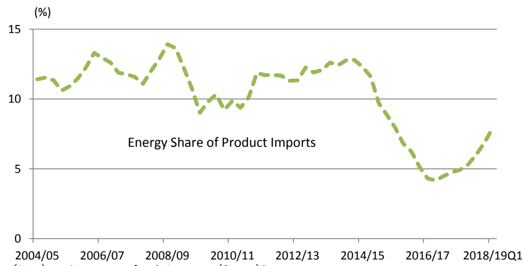
The trade deficit for the year widened to $38.0 billion ($23.3 billion for exports against $61.3 billion for imports) from a deficit of $33.9 billion for the previous year, accounting for about 70% of the expansion ($5.7 billion) of the current account deficit.

(Figure 3) Trades and Workers Remittances



(Note) moving average of each 4 quaters (Source) Datastream

(Figure 4) Share of Energy in Imports



(Note) moving average of each 4 quaters (Source) Datastream

(Table 2) Imports of Oils

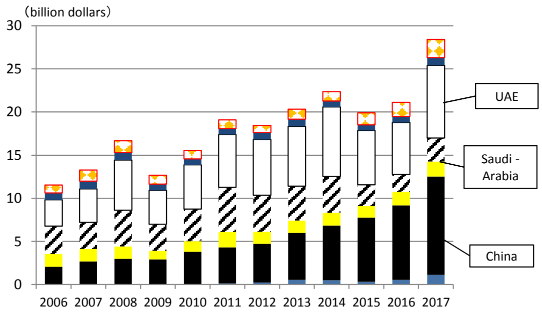
(million ton)

	2015/16	2016/17	2017/18	2018/19F
Crude Oil	8.7	8.7	10.3	*10.6*
High Speed Diesel	3.0	3.8	3.6	4.1
MoGas	4.3	4.6	5.1	5.6
Total	16.0	17.1	19.0	20.3

(Source) Thomson Reuters (Note) Figure in Italic: Net by Export

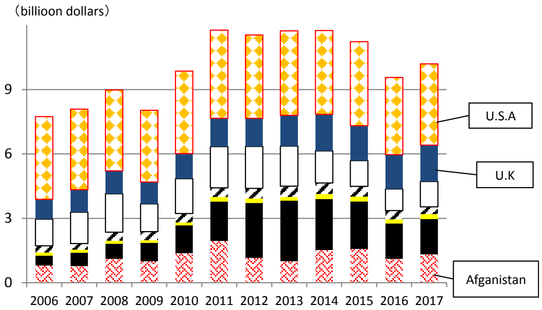
Imports by country show that the UAE, Saudi Arabia and China were the major trading partners. Pakistan imported oils from the UAE and Saudi Arabia while it imported from China cellular phones and coals used for Sahiwar and Quasim coal power plants constructed under the CPEC projects. On the other hand, the US, UK and Afghanistan were the major partners of Pakistan's main exports of clothes.

(Figure 5) Major Exporters to Pakistan



(Source) Datastream

(Figure 6) Major Destinations of Pakistan Exports

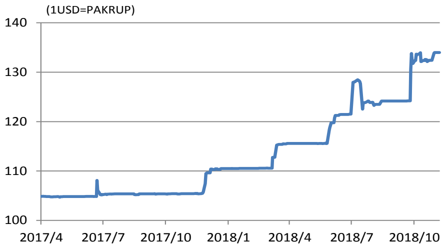


(Source) Datastream

Consumer prices rose by 4.4% in FY 2017/18, accelerating a bit from a rise of 4.1% in the previous year. Excluding food and energy, it rose by 5.7%, putting an upward pressure on the prices of core items. In addition, the depreciation of the rupee accelerated in 2018, and the State Bank of Pakistan (SBP) raised its policy rates by an aggregate of 2.75% to the current level 8.5%.

However, it has not succeeded in putting a brake on the currency depreciation, and on December 7 the currency fell to 138.8 rupee a dollar, the lowest as ever, with the cheaper rupee becoming a future factor for inflation. Some news media have reported that the consumer inflation is expected to reach around 7% in FY2018/19.

(Figure 7) Exchange Rates of the Rupee against the Dollar

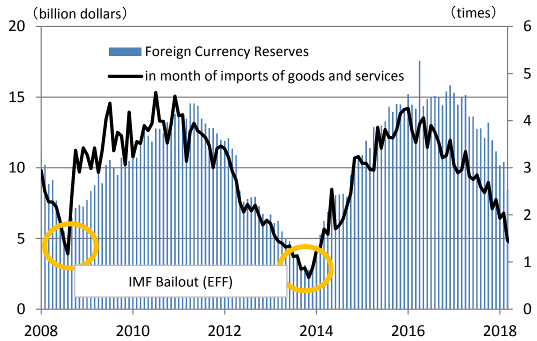


(Source) Datastream

2. Falling International Reserves and Increasing External Debts

The decline of foreign exchange reserves shows no sign of touching bottom due to widening current account deficit and central bank's market interventions to defend the depreciation of the rupee. The reserves decreased to $8.5 billion (1.5 times of import bills) in May 2018. Excluding the borrowings of $6.1 billion from the IMF that was implemented in 2013, its own holding of reserves amounts to only $2.4 billion. In 2008 and 2013 when the reserves declined drastically, the IMF implemented loans to bail out Pakistan. It seems that Pakistan again faces the same situation in which it is forced to seek for an external support.

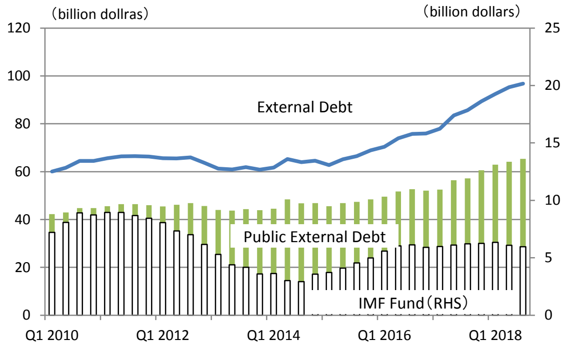
(Figure 8) Foreign Exchange Reserves



(Source) Datastream

Meanwhile, Pakistan's borrowings denominated in foreign currency increased to $95.1 billion at the end of FY 2017/18. Of which external public debts stood at $64.1 billion and it seems that in this is included a substantial amount of loans from China related to CPEC budgeted at $62 billion.

（Figure 9）External Debts



(Source) Datastream

Based on the statistics of the central bank, external financing needs for FY 2018/19 are estimated to reach $8.8 billion after deducting inflow of foreign currencies from the foreign currency needs.

(Table 3) Foreign Currency Needs

	2017/18	2018/19F	2019/20F
External Financing (billon dollars)	-204.2	-222.9	-180.1
Current Account	-181.3	-178.4	-134.4
o/w Interest Payments	-22.9	-26.9	-30.2
Debt Payments	-51.9	-74.5	-86.2
FDI (net)	25.3	27.0	37.0
Debt Inflows (billion dollars)	143.5	134.5	133.0
China	18.1	10.4	20.0
Private	34.4	25.0	20.0
IMF Fund	-	-	-
External Financing Needs	-60.7	-88.4	-47.1

（Source）Thomson Reuters

Prime Minister Imran Kahn who took office in August succeeded in agreeing with Saudi Arabia on a loan of $6 billion[2], and he also asked the United Arab Emirates for a financial support. Furthermore, he sought an additional loan from China when he met with President Xi Jinping at the summit meeting held on November 2-5. On November 7, it also sought for an

2 Half of $6 billion will be used to fill the supply-demand gap in foreign currencies, and the rest will be used to pay the oil bills equivalent to $3 billion imported from Saudi Arabia over the next three years.

emergency bailout from the IMF.

However, it is calculated that even after borrowing from Saudi Arabia, Pakistan will have foreign currency shortage of $5.8 billion in FY2018/19. It is not expected for the country to be able to earn much of foreign currencies from CPEC projects. Neither domestic tax revenues are expected to increase strongly. The Pakistan government forecasts that tax revenues will start to increase from around 2021 but remain at a low level until 2025.

China did not meet the emergency loan request from Pakistan. It is considered that China has already provided a substantial amount of loans to Pakistan. It was reported that, together with loans from Chinese commercial banks, Pakistan's debt outstanding to China accounts for 53% of Pakistan's external debt. Although it was believed that China was in a position to be compelled to bail out Pakistan from its fiscal difficulty, this topic was not incorporated in the Joint statement.

The US, the biggest contributor to the IMF, has shown its concern over the IMF's extending a new loan to Pakistan. Since 2001 the US has annually provided Pakistan with a support of $1.2 billion through the Coalition Support Fund（CSF）for counter-terrorism operations. In addition, in recent years it has feared that the loans from the IMF might have been used as payment to China, and thus strengthened a sense of caution over additional funds flowing into Pakistan through the IMF. However, the US is now facing a dilemma that if it does not agree to provide emergency loans to Pakistan, which is a geopolitically important[3] county to the US, China will strengthen its own position.

Now that Pakistan failed to get an emergency loan from China, it would have been the only alternative for Pakistan to accept such conditions as the debt reduction measures, an increase of its debt transparency, and liberalization of the economy that were believed the IMF had proposed at the November consultation and aim at steady fiscal consolidation while at the same time wipe out the fears of the US. After two weeks' discussions, however, Pakistan could not come to get the emergency loan approved, and a series of the IMF visit to Pakistan ended. According to some media reports, consultations between the two are expected to continue until the middle of January 2019.

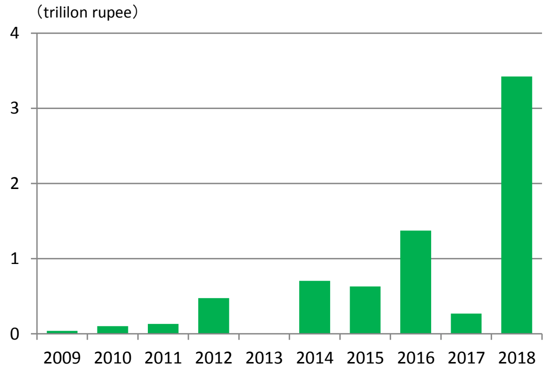
3. Attention on a smooth refunding of domestic debts

On the bond market, domestic debts denominated in rupee dominate with increasing bond issuance by 12.9 trillion rupees in 2017 and by 13.2 trillion rupees in 2018 (both about 11 trillion yen in Japanese yen). Most of them are short-term bills with maturity of less than a year, which means they will be redeemed in 2019. For the time being, whether or not they will be

[3] As is explained later, Pakistan is recognized so because (1) it is in dispute with India over the sovereignty of Kashmir region, and (2) Taliban soldiers are hiding in its border region along Afghanistan.

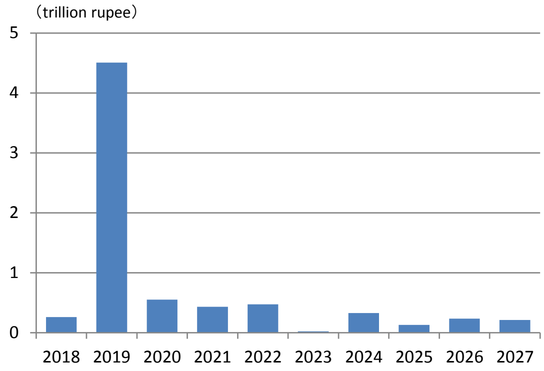
redeemed smoothly is a focus of attention.

(Figure 10) Bond issuance



（Source）Thomson Reuters

(Figure 11) Scheduled Redemption of Bonds



（Source）Thomson Reuters

(Table 4) Bonds Scheduled for Redemption in 2019

Description	Maturity Date	Issued Amount(PKR)	Market of Issue	Currency	Issue Date	Government Bond Type
PAKIST / PKGV 2019-Jan-03	2019-Jan-03	2,666,784,835,000	Pakistan	Pakistani Rupee	2018-Oct-11	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 2019-Jan-17	2019-Jan-17	587,988,038,000	Pakistan	Pakistani Rupee	2018-Oct-25	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 2019-Jan-17	2019-Jan-17	1,034,566,000	Pakistan	Pakistani Rupee	2018-Jul-19	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 9.000 2019-Jan-20	2019-Jan-20	3,329,900,000	Pakistan	Pakistani Rupee	2004-Jan-20	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 6.100 2019-Feb-15	2019-Feb-15	116,256,700,000	Pakistan	Pakistani Rupee	2016-Feb-15	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 5.590 2019-Mar-29	2019-Mar-29	80,400,000,000	Pakistan	Pakistani Rupee	2016-Mar-29	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 2019-Apr-11	2019-Apr-11	3,112,742,000	Pakistan	Pakistani Rupee	2018-Oct-11	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 7.250 2019-Apr-15	2019-Apr-15	1,000,000,000	Eurobond	U.S. Dollar	2014-Apr-15	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 7.250 2019-Apr-15	2019-Apr-15	1,000,000,000	United States	U.S. Dollar	2014-Apr-15	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 7.000 2019-Apr-21	2019-Apr-21	396,988,100,000	Pakistan	Pakistani Rupee	2016-Apr-21	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 9.000 2019-Jun-10	2019-Jun-10	3,665,900,000	Pakistan	Pakistani Rupee	2004-Jun-10	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 11.500 2019-Jul-17	2019-Jul-17	236,487,400,000	Pakistan	Pakistani Rupee	2014-Jul-17	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 12.000 2019-Sep-03	2019-Sep-03	39,399,100,000	Pakistan	Pakistani Rupee	2009-Sep-03	PAKISTAN, ISLAMIC REPUBLIC OF
PAKIST / PKGV 7.000 2019-Dec-29	2019-Dec-29	240,879,900,000	Pakistan	Pakistani Rupee	2016-Dec-29	PAKISTAN, ISLAMIC REPUBLIC OF
	TOTAL	**4,508,877,181,000**				

（Source）Thomson Reuters （Note）Shaded Cells: dollar base

4. Relationship between the US and Pakistan

As noted above, the US has so far aided Pakistan with the provision of counter-terrorism money and others. It was because Pakistan is located in a region with geopolitical importance. Pakistan has a border with India and China, and especially with India it has had a long-running dispute over the sovereignty of Kashmir region since 1947, which prompted it to come to hold nuclear weapons. The US has exerted its influence over the region by making a balance through aids to Pakistan.

Pakistan has also a potential for an expanded domestic demand. Its population is projected to increase to 300 million by 2050 from the current 200 million, with a trial calculation that a million of employment will be created annually by increased foreign direct investment from around the world. The US has maintained a good relationship with Pakistan also because it is forecast to become a promising destination of the US exports, given the prospective economic growth associated with the population increase.

In the event of the September 11 terrorist attacks, Pakistan worked in collaboration with the US to wipe out al-Qaeda that was hidden along the borders of Pakistan and Afghanistan. However, the relations between the two countries are becoming sour recently. The US thinks Pakistan is practically supporting the Taliban, former ruling group in Afghanistan. Therefore, it cut $300 million out of the support fund through CSF, putting a pressure on Pakistan to end its support to the Taliban group. Furthermore, it is another cause of concern to the US that Pakistan has strengthened its connection with China through CPEC that was launched in 2013. If Pakistan becomes fully incorporated in the "Belt and Road" initiative, the influence of the US in the region will relatively decline.

Although the relationship between the two is not always favorable recent years as was seen above, Pakistan is still important to the US both in geopolitical and economic terms. If the Pakistan economy should eventually collapse, the risk of terrorism could be reignited. On the other hand, if CPEC continues to be promoted as it stands now, China will acquire the ability to advance to the Arabian Sea. Therefore, it will be difficult on strategic grounds for the US to turn away from Pakistan. The consultation between the IMF and the Pakistan government is reported to have been postponed to January 2019, but it is considered that the US will choose to eventually control the budget of Pakistan through the IMF lending programs.

5. Recent Development of CPEC

CPEC has now 64 projects, 21 of which are related to electricity business. According to a long-term plan of CPEC released in December 2017, its projects are classified into following four groups depending on the time of their completion. (i) The early harvest business category (2015-2019) focuses the development of electric power industry, (ii) in the short-term project (by 2022), development of roads and the Gwadar Port is planned, (iii) the medium-term plan (to 2025) foresees development of railways and industrial parks and (iv) development of agriculture and tourism is projected in the long term plan (to 2030).

The breakdown of foreign direct investment (FDI) in FY 2017/18 showed that investment from China increased 37.4% over the previous year to $1.5 billion, contributing 61% to the total. 90% of its investment was concentrated in electricity ($700 million) and construction ($600 million). China continued to make an active investment in 2018 despite some countries refrained their investment in Pakistan due to uncertainties in the political outlook. In light of the long-term plan of CPEC, investment in electricity will continue until next year with investment in construction further increasing in the coming years.

Meanwhile, the challenges for CPEC include uncertainness of its debts. Some consider that China has provided loans focusing primarily on strengthening its influence in Pakistan by constructing facilities for military purposes in the regions that are covered by the "Belt and

Road" initiative. Interest revenue from loans China provided to the involved countries is also a big benefit to China. Against these backdrops the IMF thinks it is necessary to fully examine the contents of the CPEC borrowings from the point of how much unreasonable borrowings are included in them. It can be said quite natural that the IMF required the disclosure of debts as a conditionality for a new emergency loan to Pakistan in the November consultation between the two.

To mitigate the criticism about unreasonable borrowings since the debt problem of Sri Lanka, China had declared that it would implement CPEC so that Pakistan would not fall into fiscal crisis. However, in the latest summit meeting, China did not show its willingness to bail out Pakistan from its fiscal crisis. It will draw much attention what kind of policies China will take on Pakistan in the future.

(Table 5) Foreign Direct Investment in Pakistan

（billion dollars、%）

	2016/17	2017/18		
	Amount	Amount	Composition Ratio	Growth
China	1.2	1.5	61.0	37.4
Netherlands	0.5	0.1	2.5	-86.3
U.K	0.2	0.3	10.5	30.4
Swiss	0.1	0.1	3.2	-13.0
Total (including others)	2.7	2.5	100.0	-1.3

（Source）JETRO （Note）2017/18 covers first 11 months

（billion dollars、%）

	2016/17	2017/18		
	Amount	Amount	mposition Ra	Growth
Power	0.7	0.8	30.7	20.1
Foods	0.5	0.1	4.2	-79.9
Infrastructure	0.5	0.6	25.5	51.9
Finance	0.3	0.3	11.0	-0.6
Total (including others)	2.7	2.5	100.0	-1.3

（Source）JETRO （Note）2017/18 covers first 11 months

6. Future Agendas for the Khan Administration

The former Sharif administration achieved a high economic growth by actively promoting infrastructure investment utilizing the borrowings from the IMF and China as financial resources. The policy, however, widened the current account deficits, leading to a drastic increase of its external debts coupled with a sharp decline in the international reserves. The Khan administration is required, without being satisfied with the near-term acquisition of foreign currencies, to resolve the negative legacy even if it means a mild slowdown in the growth rate. In this regard, it is noteworthy that the central bank has implemented several rate hikes this year despite a possible dampening influence on the private investment.

The government decided at a cabinet meeting in September that it promote disclosures of CPEC initiative and review the projects[4]. In addition, Mr. Abdul Razzaq Dawood, the prime minister's commerce advisor, even said in that month, that "we should put everything on hold for a year so we can get our act together". The government's willingness to review the economic efficiency of the deals under CPEC is also to be welcomed.

[4] According to the Joint Cooperation Committee（JCC）which serves as a secretariat to CPEC, CPEC is scheduled to have the eighth meeting within the year to discuss the future cooperation policies between the two countries.

Prime Minister Khan continues to promote structural reforms that were launched by the previous administration. For instance, the government purchases the electricity for which the demand has been almost met by CPEC and ensures its stable supply to domestic makers. Also it improved the distribution of fertilizers to farmers while financing them by providing loans. These efforts resulted in a higher increase of exports than imports. In the newly established government, these efforts are expected to lead to improvement of both current account deficits and fiscal deficits.

Although Pakistan could not get the approval of an emergency loan in the November consultation with the IMF, it is reported that both parties agreed on the correction of the twin deficits, build-up of the buffer of foreign exchange reserves, increased transparency of debts which the IMF had requested. It was on the concrete measures like 20% taxation on electricity bills that the difference had remained. The time limit for negotiation is reported to have been set at January 2019, and it is highly expected that they will continue their negotiations toward reaching a final agreement on the emergency loan.

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