EXCHANGE RATE

elephant in the room

Pakistan's exchange rate has seen considerable upwards revision since last year, as the economy recovered from a meek external liquidity position, strengthening by 5% against the US$ in CY14.

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In Pakistan's case, a strong PkR holds multiple implications because while the economy benefits from relatively cheaper imports (positive impact on CPI), corporations with sizable exports (such as textiles which account for >50% of Pakistan's exports) lose ground in terms of competitiveness. That being said, the PkR/US$ is projected to undergo measured depreciation (avg. 2.3% p.a. in the next three years vs. 2.5% in the previous three years) as global dynamics continue to weigh.

TIn FY16, PkR/US$ parity is expected to average PkR105/US$ (interbank) implying 3.2%YoY depreciation. Episodes of volatility can remerge from uncertainties over:

1) regional currency outlook,
2) US fed rate decision and
3) domestic lobbying to enhance export competitiveness. Equity market performance is likely to remain immune (weak historic correlation of negative 30% between index performance and PkR/US$ movements) while tailwinds from a relatively weaker PkR should benefit sectors such as Textiles, Power and Oil & Gas.

CURRENCY RECAP:

After peaking at PkR108/US$ in Dec'13, the PkR's parity vis-à-vis the US$ has seen considerable revision, with the exchange rate now hovering around PkR104/US$ (app: +3.7%). PkR's strength over the US$ has sustained despite sharp gains recorded by the greenback against most global currencies (Dollar Index posted gains close to 8% over FY15). A key driver for currency strength has been swift fx reserve accretion to historic high of US$18.7bn (import cover: 5m). This coupled with tapering of the external financing gap through a deceleration in imports growth to 2.0%YoY in FY15 (primarily due to a US$3bn savings in oil imports) and surge in remittances growth (+16%YoY in FY15) has largely limited relative volatility of the PkR.However, despite the PkR/US$ parity remaining largely stable in the interbank market since the start of CY15, recent turn in global currency markets post Yuan's devaluation and consequent risks of competitive devaluation across the region have also had a profound impact on the PkR (interbank) which depreciated by 2.5% (intraday) against the US$ taking CYTD decline to 3.9%. A soft inflation environment has also allowed the Real Effective Exchange Rate (REER) index to gain 7.7%YoY in FY15.

MEASURED DEPRECIATION AHEAD

The PkR/US$ parity is forecasted to average ~105/US$ in FY16E (3.2YoY% depreciation) with annual depreciation to average 2.3% during FY1E-FY18F, escalating to 5%YoY thereafter. Estimates are derived from time-series econometric regression analysis accounting for key drivers, primarily:

1) fx reserves,
2) inflation differentials and
3) interest rates. Downward pressures can emanate from:

1) expectations of stronger US$ performance, 2) regional currency volatility and risks of competitive devaluation across the region, 3) higher debt servicing over the medium term, and 4) inflationary pressures re-emerging next year. While pressures for state enforced depreciation to aid trade competitiveness remain, interference from the GoPshould remain limited where a weaker PkR will be detrimental for imports and the external debt position.

FOREIGN RESERVES key support to stability:

Fx reserves remain a key determinant of PkR's direction, whichare anticipated to steadily rise over the medium-term on the back of: 1) remainder IMF tranches worth US$2bn, 2) stability in the current account, 3) increased loan disbursements from multilateral donors, 4) planned foreign debt issuances (US$500bn Eurobond and possibly a US$500mn Sukuk in FY16) and 5) expectations for FDI to pick up as projects under CPEC gather pace. Materialization of the latter will be a key driving force for Pakistan's external account with potential of over US$8bn foreign investment (assuming planned power projects to come on line with avg. 60% foreign holding) spread over a period of 3-5yrs. However, reserves are likelyto taper FY18 onwards due to relatively higher debt servicing, emanating from: 1) IMF EFF agreement, 2) Paris Club debt and 3) maturity of US$1.25bn Eurobonds. Moreover, with the end of the IMF program and privatization program, pace of foreign inflows will likely slowdown.

CURRENT ACCOUNT TO REMAIN IN CHECK:

With international oil prices expected to remain soft,outlook for the current account remains positive with possibility of a minor surplus (0.4% of GDP) in FY16. Though exports recovery remains improbable (exports projected at US$23.5bn to decline 2.6%YoY in FY16) owing to the country's low cost competitiveness, benefits from lower imports are in place. A further slowdown in oil imports could result in savings of ~US$3.75bn or 1.0% of GDP (assuming crude oil prices average US$50/bbl) which takes import forecast for FY16 to US$38.6bn (-6.6%YoY). Healthy remittances growth projected at 14%YoY to touch US$21bn next year and possible CSF payments (~US$700mn in remainder FY16) should provide stability to the BoP position.

REAL INTEREST RATES COUNTER INFLATIONARY PRESSURES:

The recent slide in Pakistan's price level (CYTD avg. CPI at 2.8%YoY) has also supported PkR's stability with inflation differential with most trading partners tapering off.