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MONTHLY REPORT

Economic Resilience in Turbulent Times: Pakistan's 2024 Outlook

JAN 2024

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THE ERA OF FALLING INTEREST RATES

As the world economy braces itself for 2024, the stance of global central banks on interest rates emerges as a cornerstone for financial stability and economic growth. The central banks' interest rate views serve as a window into the future monetary policies that are expected to shape the global economy in the coming year.

THE FED SETS THE GLOBAL TONE

As the curtains rise on 2024, the Federal Reserve's (Fed) anticipated policy shift is casting a long shadow across the global economic stage. With a potential rate cut beginning in March, amounting to a total easing of 125 basis points in CY24, the Fed's policy maneuvering sets a precedent for central banks worldwide, heralding an era of monetary easing to combat economic slowdown and subdued inflation.

EUROPE FOLLOWS SUIT: ECB AND BOE ON THE PATH TO LOWER RATES

In tandem with the Fed's trajectory, the European Central Bank (ECB) and the Bank of England (BOE) are charting their course toward reduced interest rates. The ECB's timeline points to a June 2024 cut, carefully orchestrated in response to the continent's economic stabilization and inflationary pulse. Similarly, the BOE's forward guidance signals a reduction in rates by mid-2024, with the dual aims of catalyzing economic recovery and anchoring inflation expectations within the UK.

EMERGING ECONOMIES' BOLD MOVES: PAKISTAN'S NOTABLE EASING CYCLE

In South Asia, Pakistan's monetary policy stands out with its particularly assertive approach. The State Bank of Pakistan (SBP) is preparing for a bold easing cycle, with a substantial 300 basis point reduction on the cards by June 2024. This move is a testament to the nation's resolve to stabilize its economy and manage inflation amid a backdrop of fiscal challenges and external economic pressures.

Interest Rate Outlook 2024		
Central Bank	**Expected Stance on Rate Cuts**	**Mentioned Reasons for Cut**
Federal Reserve (Fed)	Begin rate cuts in March 2024, total 125 bps easing	Economic slowdown, lower inflation
European Central Bank (ECB)	First cut expected in June 2024; may act earlier	Economic stabilization, inflation control
Bank of England (BOE)	First cut expected in June 2024; rates to 4.5% by year-end, 3% in 2025	Economic recovery, lower inflation expectations
Bank of Japan (BOJ)	Maintain current policy until around July 2024	Economic growth stabilization, inflation targets
People's Bank of China (PBOC)	Likely to resume rate reductions in Q1 2024	Economic growth support, financial stability
State Bank of Pakistan	Start easing from March 2024; cut rates by 300 bps to 19% by end-June 2024	Economic stabilization, inflation management
Reserve Bank of India (RBI)	Shift to easing in April 2024; repo rate to 5.5% by Q4 2024	Economic recovery, managing inflation
Central Bank of Turkey	First rate cuts expected in Q4 2024	Economic recovery, inflation management
Saudi Arabian Monetary Agency	Rates likely to fall in 2024 in line with Fed cuts	Alignment with Fed policy, economic conditions

Source: Bloomberg, HBFC Research

INDIA'S CALCULATED APPROACH TO EASING

India, a regional economic heavyweight, is adopting a more measured easing policy. The Reserve Bank of India (RBI) eyes April 2024 to initiate a reduction in rates, intending to support the country's economic trajectory while keeping inflation in check. This approach is emblematic of the RBI's strategy to foster sustainable growth and maintain economic stability in a complex inflationary environment.

THE GLOBAL PIVOT TOWARDS ACCOMODATION

This alignment across nations signifies a global pivot towards monetary accommodation in 2024. The strategic easing by central banks around the world reflects a collective commitment to fortify economies against the specter of slowing growth and to establish a conducive environment for recovery. The uniformity in policy adjustments also indicates a concerted effort to preclude the onset of recession, marking a significant shift from the tighter monetary policies of the past.

SBP'S APPROACH IN THE EASING CYCLE: STRIKING A DELICATE ECONOMIC BALANCE

The global easing cycle is a high-wire act for central banks as they seek to invigorate growth without fanning the flames of inflation. In particular, the SBP's strategy illuminates the challenging balancing act of providing economic stimulus while avoiding the pitfalls of inflationary spirals, a concern that is central to Pakistan's economic policy framework.

A GLOBAL ODYSSEY OF UNREST AND CHANGE

The year 2023 has been marked by a series of dramatic global events ranging from devastating conflicts and political upheavals to significant economic shifts and groundbreaking technological advancements.

GEOPOLITICAL CONFLICTS AND CRISES

Geopolitical conflicts in the region intensified following a series of military operations by Israel in Gaza, which led to significant casualties and captives. The operations, which Israel states were a response to aggression, have been met with international concern. The resulting increase in anti-Semitic incidents globally has become a pressing issue, where global powers failed to deescalate the situations. In Europe, the war in Ukraine persisted with limited strategic gains, affecting global grain shipments and intensifying the standoff between Russia and NATO.

POLITICAL DYNAMICS

The United States grappled with political instability, seeing the historic ousting of a House speaker and the unprecedented criminal charges against former President Donald Trump, impacting his eligibility for future office.

ECONOMIC AND FINANCIAL DEVELOPMENTS

Central banks signaled a pivot in monetary policy after a period of aggressive tightening, with the Federal Reserve indicating a reduction in interest rates for 2024, marking a pause in the inflation combat strategy. The banking sector experienced tremors reminiscent of the 2007-09 financial crisis, with the collapse of major banks and a consequential emergency takeover, shaping a precarious financial landscape.

TECHNOLOGICAL ADVANCEMENTS

Generative AI became a focal point of corporate strategy following the success of OpenAI's ChatGPT, though it also raised serious ethical and practical concerns within the tech industry.

MARKET MOVEMENTS

The stock market rebounded significantly in 2023, driven by AI enthusiasm and gains in various sectors, from pharmaceuticals to travel, underscoring a post-pandemic economic recovery and expected monetary easing in coming years.

NATURAL DISASTERS AND HUMANITARIAN CRISES

Turkey and Syria were devastated by a severe earthquake, highlighting issues of disaster preparedness and response. Other regions also suffered from natural calamities, including wildfires and earthquakes, prompting international concern and aid efforts.

CONCLUSION

The year 2023 was laden with incidents that have profound and lasting implications for international relations, national politics, economic stability, technological progress, and societal welfare.

CROSSROADS AT THE RED SEA: HISTORICAL ECHOES & MODERN TRADE DYNAMICS

The Red Sea has seen a notable rise in attacks by Houthi rebels since mid-November 2023, escalating regional tensions with implications for global trade. Historically, this region has experienced piracy and conflicts, such as the Somali piracy in the late 2000s and the Houthi's previous attacks on Saudi vessels, reflecting the larger conflict between the Houthi rebels and the Saudi-led coalition.

The Red Sea is a crucial maritime route, with the Bab el-Mandeb Strait alone channeling about 12% of global trade (approx. USD 1trillion), including vital energy supplies. The recent Houthi strategy, including hijacking the Galaxy Leader tanker, has forced major shipping companies to adjust their routes, impacting shipping times and costs. The US-led Operation Prosperity Guardian coalition aims to secure this strategic corridor. These developments emphasize the importance of maintaining navigational safety in the Red Sea, a linchpin for international trade and energy supply, highlighting the role of global cooperation in regional stability.

RED SEA CLOSURE: IMPACT AND ALTERNATE ROUTES

The potential closure of the Red Sea, a vital maritime corridor, could profoundly disrupt global trade. Rerouting via the Cape of Good Hope would extend travel by 7 to 10 days, impacting shipping timelines and costs. The Arctic Route, shorter by 30% for certain trips, is limited by seasonality and environmental risks. The Panama Canal, though useful for Americas-Asia trade, doesn't compensate for Europe-Asia routes. Consequences would include a spike in shipping costs by up to 30% and delayed deliveries, affecting just-in-time production and Egypt's economy would lose over USD5 bn in Suez Canal revenue, with surrounding regions also suffering economic setbacks. The closure's ramifications highlight the Red Sea's indispensable role in maritime commerce and the intricate considerations for alternative pathways.

ECONOMIC CHALLENGES AND STRATEGIC MANAGEMENT FOR PAKISTAN'S NEW GOVERNMENT

As Pakistan approaches a vital general election on February 8, crucial for its economic stability, the incoming government faces numerous complex domestic and international challenges. Key issues include managing fiscal policies, reaching revenue targets, handling large external debts, and maintaining foreign reserves. These factors pose a significant test for economic policy execution and governance.

DOMESTIC ECONOMIC CHALLENGES AND SOLUTIONS

Pakistan's economy confronts multiple challenges, notably managing a fiscal deficit projected at 7.5% of GDP, surpassing the 6.5% target. This stems from a high budget deficit, increased borrowing costs, and lower revenue collection. The Federal Board of Revenue (FBR) aims to collect PKR 9.4 trillion but is likely to fall short. Essential reforms include enhancing tax collection efficiency, broadening the tax base, and implementing tax reforms. Additionally, balancing the budget with a focus on development spending and addressing losses from State-Owned Enterprises (SOEs) is critical for fiscal sustainability and economic stability.

EXTERNAL ECONOMIC CHALLENGES AND MANAGEMENT

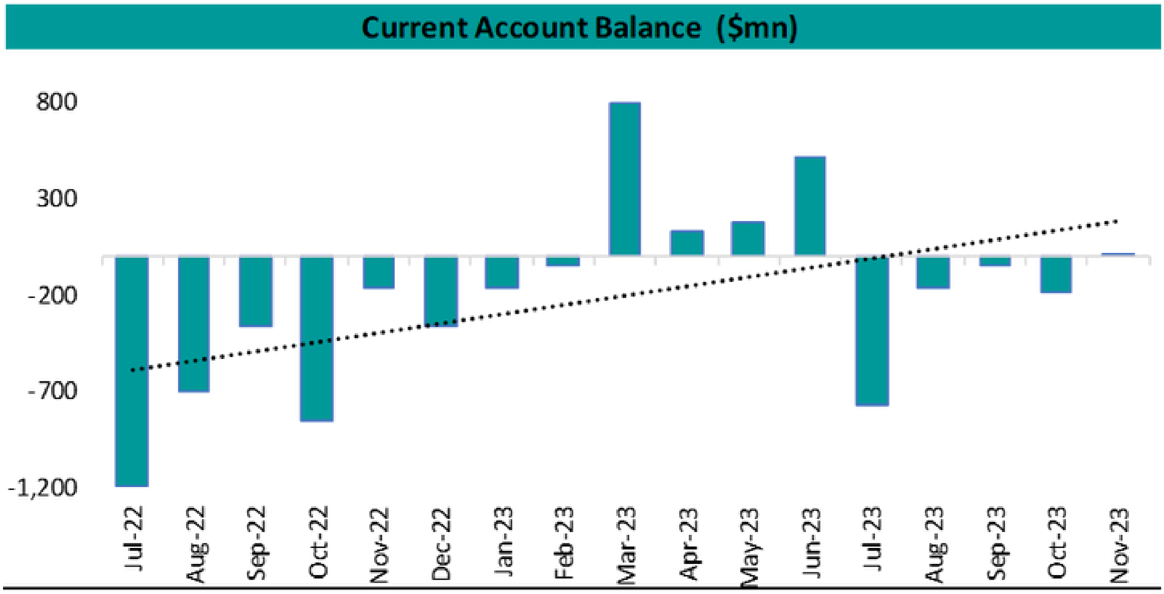
Externally, Pakistan faces the daunting task of servicing a substantial external debt of USD 24.5 billion in FY24E, including interest and principal repayments. Effective management and negotiation of these repayments are crucial, as is managing the significantly depleted foreign exchange reserves. Improving export performance and attracting foreign investment are key to rebuilding reserves. Compliance with the IMF's Stand-By Arrangement is also essential for international financial support.

CONCLUSION

Pakistan's incoming government must undertake immediate fiscal consolidation, strategic debt management, and structural reforms to balance domestic responsibilities and external obligations. Effective management of these economic challenges is crucial for Pakistan's future economic path.

CURRENT ACCOUNT BALANCE: PATHWAYS TO ECONOMIC STABILITY

The journey of Pakistan's current account balance from July to November 2023 paints a compelling picture of an economy striving towards equilibrium. With the deficit shrinking substantially by 52.45%, from USD3.2bn in the previous fiscal year to USD1.16bn in FY23, this period marks a significant stride in Pakistan's fiscal management. This improvement in the current account balance is not just a standalone achievement but a reflection of a confluence of various economic factors and policy decisions that have influenced the broader economic landscape.



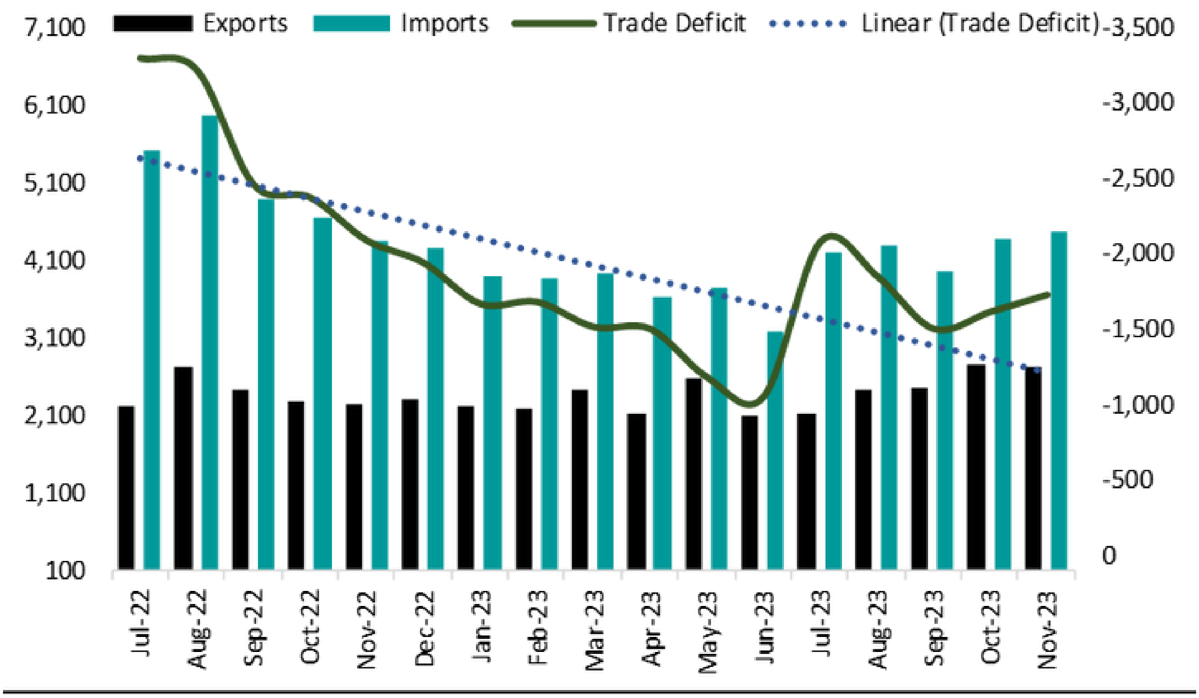
Source: SBP, HBFC Research

INTERPLAY WITH TRADE DYNAMICS

A critical aspect of this improvement is rooted in Pakistan's trade dynamics. The increase in exports to USD12.5bn, up 5.00% from FY22, illustrates the economy's resilience and adaptability in enhancing its global trade footprint.

This growth in exports, despite global market uncertainties and local challenges, signifies a strategic advancement in either diversifying export goods or tapping into new markets. On the other side, the import strategy appears to have been tactically managed. The 16.07% reduction in imports indicates a deliberate approach to curb non-essential imports, thus preserving valuable foreign exchange and mitigating the trade deficit's pressure on the current account.

Trade Statistics ($mn)



Source: SBP, HBFC Research

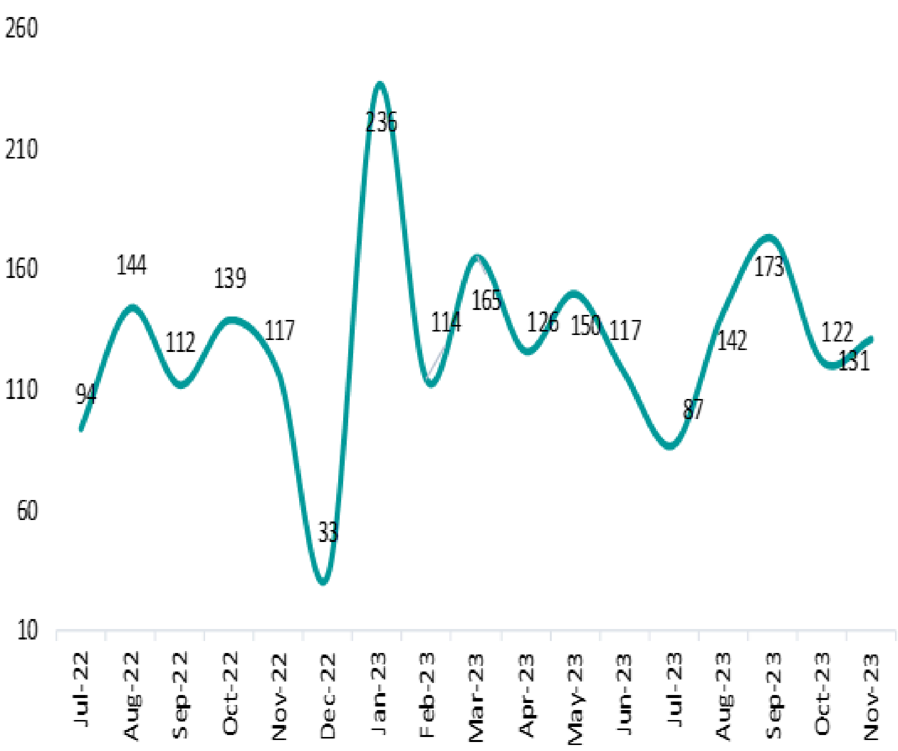
REMITTANCES: A PILLAR OF STABILITY

The role of remittances in shaping the current account's health cannot be overstated. While there has been a slight month-on-month dip, the year-on-year increase from USD2.17bn in Nov-22 to USD2.25bn in November 2023 is a testament to the unwavering support of the Pakistani diaspora. These remittances are not mere financial transactions; they are a lifeline that sustains families, fuels small businesses, and ultimately provides a stable inflow of foreign currency, cushioning the current account against external shocks.

INVESTMENT INFLOWS: SIGNALING CONFIDENCE

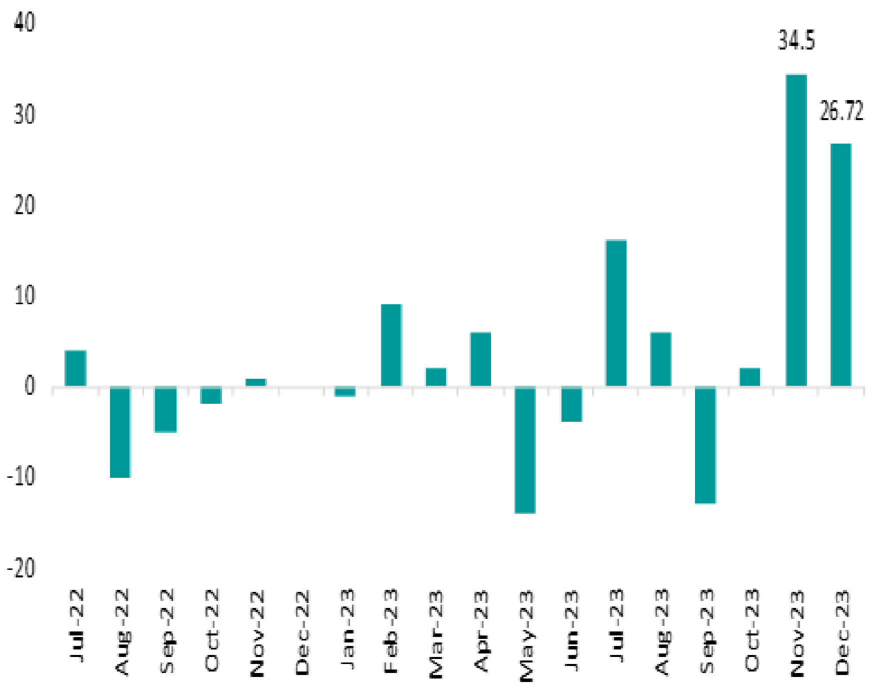
The landscape of investment inflows, encompassing both FDI and FPI, also plays a pivotal role. The increase in FDI points to a growing confidence among foreign investors in Pakistan's economic prospects, likely spurred by favorable policy reforms, infrastructural developments, or sector-specific incentives. Similarly, the remarkable surge in FPI from merely USD2mn in October to USD27mn in November 2023, and the substantial year-on-year increase, are indicative of a renewed interest in Pakistan's market. This surge not only brings in capital but also potentially stimulates the local stock market (+55% FY24 till date), enhances financial sector liquidity, and contributes positively to the overall economic sentiment.

Foreign Direct Investment ($mn)



Source: SBP, HBFC Research

Foreign Portfolio Investment ($mn)



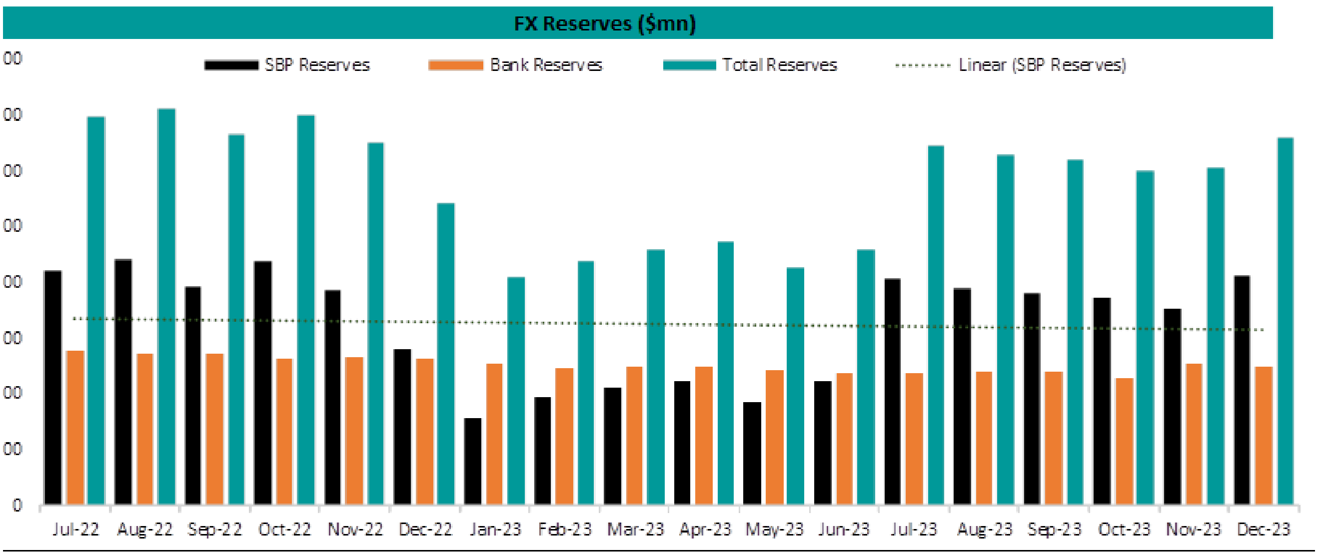
Source: SBP, HBFC Research

RUPEE DOLLAR EXCHANGE AND RESERVE INSIGHTS

By the end of 2023, the State Bank of Pakistan's (SBP) foreign exchange reserves climbed to USUSD8.2 bn, aided by recent inflows and support from Saudi Arabia and the UAE. The Pakistani Rupee's slight appreciation against the Dollar suggests effective monetary policy as SBP kept the policy rate unchanged. A significant part of this fiscal stability is due to a USD3bn IMF Stand-By Arrangement, with the initial tranche already impacting reserves. The SBP's measures have successfully reduced the import bill and trade deficit.

These reserves are key for Pakistan's upcoming debt obligations and have boosted confidence in financial markets. Continued IMF engagement, including a crucial USD700 million second tranche, is essential for stability. With total reserves at USD13.22 bn, Pakistan is better positioned to handle economic challenges.

Meanwhile, the Pakistani Rupee (PKR) has so far been strong against USD standing at 281.9. However, the broader trend needs further attention. Since the start of the fiscal year, the PKR has depreciated by 1.42%, with a more pronounced fall of 24.51% throughout 2023. Over longer periods, the decline is even more stark – the PKR has depreciated by 24.54% over the past year, 20.69% over three years, 15.21% over five years, and an average of 10.33% per annum over the past decade. These figures collectively highlight the ongoing economic challenges Pakistan faces, particularly in maintaining the stability of its currency against the USD.



SBP, HBFC Research

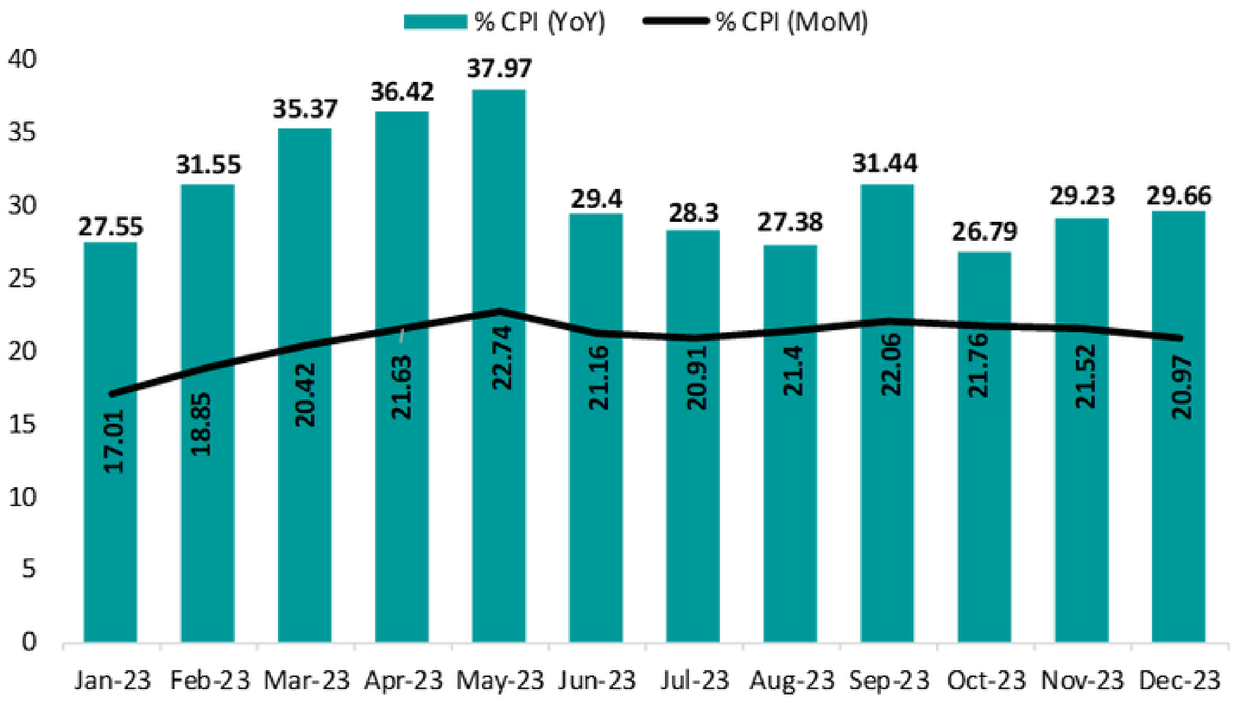
INFLATION TRENDS AND YIELD CURVE ANALYSIS

The CPI surge throughout 2023 can be largely attributed to multiple economic stressors. Notably, a historic peak in global petroleum prices significantly influenced transport and production costs, reflecting in the CPI's rise from 24.93% in July 2022 to 37.97% in May 2023. IMF-mandated hikes in power and gas tariffs further inflated household and industrial costs, intensifying from February 2023 onwards, with the CPI reaching over 31%.

Compounding these issues were the food supply disruptions due to 2022's flooding, which led to shortages and subsequent food price inflation. Concurrently, the Pakistani rupee faced depreciation amid external debt repayments, exacerbating the cost of imports and thereby contributing to a consistent CPI elevation above 29% towards the year's end.

Moreover, comparing the first half of fiscal year 2023 to the same period in 2024, there's a noticeable rise in the average CPI from 25.04% to 28.8%. These figures not only represent the direct impact of the specified economic pressures but also underscore the broader inflationary environment within which Pakistan's economy operates, marking a period of challenge and adjustment.

Headline Vs Core Inflation

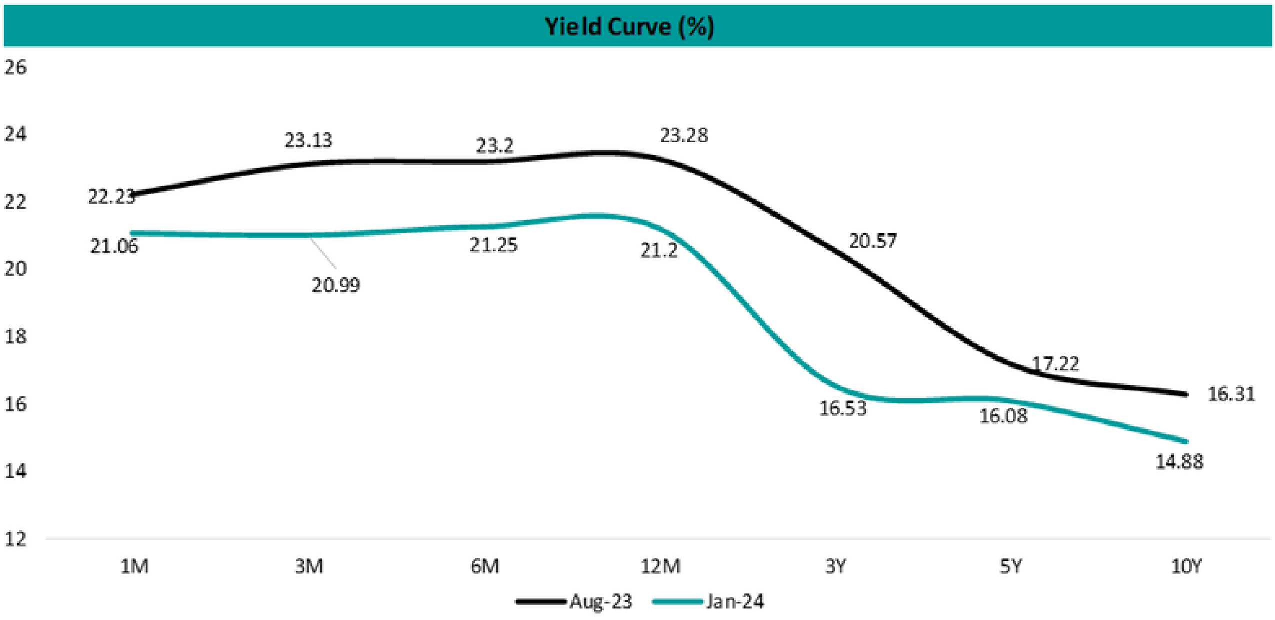


Source: PBS, HBFC Research

The yield curve analysis of Pakistan's various maturities suggests a significant interplay with current inflation expectations and future interest rate movements. The elevated short-term rates, particularly for 1M, 3M, 6M, 9M, and 1Y maturities, all exceeding 21.30%, with the 1M and 6M peaking at 21.37%, indicate that the market anticipates continued inflationary pressure in the near term. This is typically associated with a central bank's tightening monetary policy to curb high inflation, resulting in higher short-term interest rates to dissuade borrowing and cool the economy.

However, the declining trend observed in medium to long-term rates, with the 3Y rate at 16.55%, the 5Y at 15.92%, and a gradual decrease to 14.91% for the 10Y, followed by 14.68% for the 15Y and 14.67% for the 20Y, suggests a market consensus that inflationary pressures will ease in the future. This downward slope of the yield curve from one year onwards implies that the market believes the central bank's measures to fight inflation will be effective, and that interest rates may have reached their peak. Consequently, investors expect a lower risk of inflation over these longer periods, leading to lower yield requirements for long-term investments.

In essence, the current yield curve is indicative of an inflationary outlook that is expected to stabilize or decline in the long run. If the market's predictions hold true, we would see a normalization of monetary policy and interest rates in the future, aligning with the observed lower yields on longer-term maturities.



Source: HBFC Research

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