Short USDPKR

Thesis: Despite the government change, economic and political instability in Pakistan is far from over. FX reserves will continue to deplete, leaving the SBP with a smaller toolkit to defend rupee strength - regardless of whether an IMF deal is reached. Positive short-term political news gives an opportunity to enter at a more attractive price level.

Background

<u>Pakistan facing financing crisis</u>: The State Bank of Pakistan (SBP)'s FX reserves are $10.8 bn, only two months of imports, and almost $0.5 bn down from last week due to debt payments. Pakistan faces an estimated $20 bn CAD for the current fiscal year, and $30bn next year. At least $3 bn are needed to fund international debt for the remainder of the fiscal year. However, a significant proportion of existing FX reserves are needed for its food and energy imports as elevated prices and supply disruptions hit Pakistan's terms of trade. The previous Khan government's relief packages, including a cap on energy and food prices, rapidly drained FX reserves and is expected to expand the fiscal deficit to 10% of GDP. CDS spiked to 2011 levels amid market worries about a Sri-Lanka-like BOP crisis.

<u>Political instability and leadership change</u>: The former PM Imran Khan was ousted after the Pakistani Supreme Court allowed a no-confidence vote he blocked by dissolving parliament to go ahead. The new PM is Shehbaz Sharif, a brother of a former PM Nawaz Sharif, who was ousted by corruption charges. That ouster paved the way for Khan to take office. Khan's populist party broke with the existing two-party system and, under its leadership, policy diverged further from America, aligning closer to Russia and China instead. Khan is still immensely popular among the electorate; he has successfully encouraged supporters to take to the street in protest and demand new elections - which he is likely to win. He blamed America for being behind his deposition. Notably, the military, which plays an outsized influence in Pakistani politics, tacitly withdrew its support for Khan and hinted at support for greater cooperation with America, given the Ukraine conflict - India's deepening ties with Russia.

<u>IMF deal, WB, ADB:</u> In 2019, Pakistan locked in a $6 bn EEF deal with the IMF, $3 bn of which remains to be paid out. Imran Khan's populist policies and diverging foreign policy stance meant that many of the requirements for this infusion weren't being met. The IMF, WB, and ADB refused to continue talks until a new party governed. Now that

this has materialised, there have been positive messages from the IMF and the new government, though no time-frame has been provided.

Analysis

The change in leadership strengthened the Pakistani rupee due to expectations of greater cooperation between the IMF and the Sharif government. However, given mass rallies in support of Khan and high political tensions in parliament, any further positive news is unlikely. Moving forward, the current government won't have the political capital to pass through the reforms needed to get the country back on track for the $3 bn from the IMF.

Following through with Khan's call for new elections would be one way to solidify the new government's authority to the electorate and members of parliament. And, if Khan was still defeated, then positive legislation and an IMF deal would follow. A Khan defeat in elections is unlikely, though - his popularity is still high despite economic issues, and will only grow, especially if the new government dishes out unpopular policies in hopes of attracting IMF support. An alternative, given military backing, is for the government to ride out the unrest. Still, parliamentary elections are in two months, and it is unlikely that the new government would push through unpopular austerity measures that hurt the electorate in the run-up to such a pivotal election. I see talks resuming and continuing at least until July without much legislative progress. Further backslides should be expected before any significant reforms.

Without an IMF deal, FX reserves will continue to drain due to weak terms of trade and eurobond payments. The SBP will be increasingly unable to continue current interventions aimed at protecting the rupee's value, a tool it has used more and more in recent weeks. The PKR's negative exposure to elevated commodity prices and a historic CAD place pressure on the currency to weaken further. We have seen other CBs like Egypt devaluing their currencies in face of this, despite the impact on inflation, in order to absorb some of the external account pressures. I view that as a possibility in the short/medium term.

Even if a deal is reached, the SBP will still likely have to stop or tone down FX interventions aimed at strengthening the rupee, allowing it to weaken. These were the terms under a previous IMF deal in 2017, since the CB continued to push policies to resist downside pressures from the market. The situation is similar today and I expect this to be one of the main IMF requirements, alongside removing energy and food subsidies.

Risks

The main risks involved in this trade are unexpected increases in domestic political capital, faster-than-expected negotiations with the IMF, or sudden inflows of additional FX reserves. Because of the internal political situation I described above, the first two seem minimal. Efforts have been ramped up to deal with deteriorating reserves, including encouraging more remittance flows. Here, cooperation with the US, Saudi Arabia, and China to bolster SBP FX accounts would be key. However, even assuming success, I don't see this as sufficient. An execution of the IMF bailout and accompanying structural monetary and fiscal reforms will be necessary to deal with the fundamental problem.

Trade expression

The issue with expressing this trade via an outright short on USDPKR is carry. Since the Pakistani key rate is 12.25%, we would be paying much more in carry than would justify the trade. Rather than a USDPKR spot position, we could express a bearish view through the NDFs. An alternative expression would be to short the sovereign bonds.