**Tough Times Ahead!**

In the past few months we have seen a substantial increase in the prices of raw materials imported from China. According to one estimate the API prices increased ranging between 30% to 50% impacting the margin on domestic sales by 1.5 to 3 per cent.

With the increased globalization accompanying complexity of the pharmaceutical supply chain, managing the role of materials sourcing has become extremely challenging. Reducing time and costs are important goals of sourcing, but increased regulations and more rigorous enforcement make these goals difficult to achieve. Current trends have forced life science industry companies to more rigorously optimize sourcing activities for raw materials, intermediates, active pharmaceutical ingredients (APIs) and other material components for both clinical supplies and commercial manufacturing. If managed improperly, sourcing can result in supply chain interruptions, significant unexpected expenses and quality control issues.

**Some of the prominent issues under consideration**

- Pakistan’s economy doesn’t look to be in a very promising situation going forward looking at the major economic indicators.

- Depreciation of PKR against USD seems imminent and this could have a huge impact on the pharmaceutical industry of Pakistan as it is majorly dependent on imports of basic raw materials and excipients.

- Yuan is getting stronger every day against USD coupled with the improving economy of China, going forward imports from China are not going to be as cheap as they used to be historically.

- Despite the fact that Pakistan has very good relations with China as compared to most of the countries in the world, the EPA Crackdown is constantly posing a huge supply risk which is reflected through the international price hike in the API prices. We have already seen gaps in the supply from China and may see them winding further in the future.

- As mentioned in our previous reports Chinese government is targeting to improve their standards and targeting “high value” markets such as US, UK, Japan and others. Hence improving standards means higher price.

As per an Executive Director, Pharma Bureau “The biggest challenge faced by the industry is the complete freezing of prices of pharmaceutical products. The price mechanism set by the government since 2001 has not allowed the pharma industry to increase prices of even those drugs whose costs have gone up by more than a 100 percent, whereas the price of inputs such as fuel, electricity, labor wages and raw materials have increased drastically making the survival of the industry very difficult. There were 36 MNCs working in Pakistan in the early 2000s in the sector, that number is now down to about 22. That is an eye-opening number of exits.

On the other hand, the growing menace of counterfeit products has become a serious problem for the established pharmaceutical companies. The proliferation of fake and modified goods is not only hurting the industry but the consumers as well. The menace is adversely affecting the government revenues and thereby the public sector socio-economic programs. Counterfeit medicines are estimated to cost the government over Rs 12 billion a year.

Pakistan’s pharmaceutical sector is simply unable to meet local demand and increase exports under the current regulatory regime, which is extremely oppressive. Pricing undoubtedly is the most burning issue with the Drug Regulatory Authority of Pakistan (DRAP). Contrary to DRAP, majority of developing countries regulate drug prices to safeguard the interest of the consumers, but their regulations are transparent. Neighboring India and China liberalized their drug pricing, which has benefitted domestic consumers and accelerated their exports. India’s exports are in excess of US$15 billion per annum while Pakistan’s exports have declined and are now approximately US$160 million a year. If Pakistan aims to double its exports to Sri Lanka within a year as stated recently it will need to review its drug pricing mechanism.
What is required is a transparent and set formula for increase in prices. It should not be left to the discretion of any official as this will only open the door to graft.

The DRAP should be strengthened and its regulatory capacity be brought at par with global standards. Though this will take some time, the regulator, initially, should bring a dug price equal to its average price in regional economies, like India, Bangladesh, Sri Lanka and others with the same socio-economic indicators.”

**Export and import of medical and pharmaceutical products of Pakistan**

![Graph showing export and import of medical and pharmaceutical products of Pakistan from 2002 to 2011.](chart)

Having said that we are of the view that the reasons discussed in the report such as increase in prices of pharmaceutical raw material in the international market, deteriorating economy of Pakistan, devaluation of PKR and strict measures taken by DRAP to implementing proper framework would have a negative impact on the Pakistani pharmaceutical market. Despite the fact that actions taken by DRAP to improve the quality of medicines in Pakistan is extremely positive, we think it should be coupled with a lenient pricing mechanism. Constant increase in prices of raw material while static end product price could be disastrous for this industry if not addressed timely.

**Economy**

Rupee witnessed a second round of currency devaluation by 4.5% and closed at PKR 115.5 per USD by March end. Recent recovery in international food prices, coupled with the fall in domestic food prices, has significantly narrowed the gap between international and domestic food prices. With local and international food prices converging, any further PKR devaluation may lead to a substantial rise in CPI inflation. It is expected that CPI inflation will reach 6.0% in FY19.

The State Bank of Pakistan (SBP) maintained the policy rate at 6.0% in its Mar-18 review, contrary to street consensus. The central bank’s decision seems to have been driven by low headline inflation readings. However, with two rounds of currency devaluation already in place, rising fiscal expenditure ahead of the elections, and a likely increase in CPI inflation to 6.0% in FY19, monetary tightening is imminent in the near future. As low food prices have somewhat delayed the translation of PKR devaluation into higher headline inflation. It is expected that SBP may have to raise the policy rate to 7.5% by Dec-18.

Pressures on Pakistan’s external account has continued during 3QFY18. Current Account Deficit (CAD) during Jan-18 amounted to USD 1.6bn (6.0% of GDP) and decreased slightly to USD 1.2bn (4.6% of GDP) in Feb-18, taking 8MFY18 CAD to USD 10.8bn (4.8% of GDP). For 8MFY18, trade deficit is up by 23% YoY to USD 23.2bn (10.4% of GDP) driven primarily by faster increase in imports at 17% compared to 13% YoY growth for exports. Among exported items, textiles contributed the largest chunk of increase in exports (up 8.1% YoY), followed by the Food Group (up 25.2% YoY) and Other Manufacture (up 17.3% YoY). On the imports side, large increase was witnessed in the petroleum group due to higher oil prices (up 27% YoY), followed by the Metal Group (up 33% YoY) and Chemicals (up 15.8% YoY). Worker’s remittances for 3QFY18 increased by 5.7% YoY, driven primarily by upticks from USA, UK and UAE. However, what remains concerning is a decline in remittances from Saudi Arabia and other GCC countries, which cumulatively fell by 11.4% during the quarter, amounting to 35% of total remittances.
Jul-17 to Mar-18 broad money supply (M2) reported an increase of 4.4% compared to an increase of 4.5% during Jul-16 to Mar-17 indicating a marginal slowdown in M2 growth over the same period. Government’s borrowings for budgetary support increased considerably by 10.4% while private sector credit offtake recorded growth of 7.8% from Jul-17 to Mar-18.

**Yield Curve**

Some Key Factors

- Pakistan’s External Account woes continue to worry investors as outlook on Foreign Exchange (FX) reserves and Current Account Deficit (CAD) seems alarming at a time when Pak-US relations are not good.
- FX reserves held by Pakistan’s Central Bank have come down from US$16.1bn in beginning Jul 2017 to 3-year low of US$11.8bn as of Mar 22, 2018. This equates to around 2.6 months of import cover as compared to last 5-year average import cover of 3.5 months.
- With this situation, there are three possible scenarios that can unfold: 1) strict measures including further PKR devaluation and interest rate hike, 2) entry into IMF’s program and 3) bailout from friendly countries.
- Pakistan can avoid knocking IMF’s door, though probability of it happening is low if the Govt. manages to arrange decent external financing from friendly countries (China & Saudi Arabia) by 3Q2018 along with taking corrective measures.
- If Pakistan seeks IMF funding, according to a few analyst it is anticipated that we might see a further devaluation of 10% in FY19 and 7% in FY20 which is likely to take PKR/USD parity from current Rs115 to Rs136 by FY20.
- It is also anticipated that SBP policy rate may be increased from current 6.00% to 8.75% by FY20 under IMF program.
- With reform measures, CAD will likely clock in below 3% of GDP by FY20 vs. 5.1% expected in FY18 & foreign exchange reserves will improve to US$15bn by FY20 vs. US$11.8bn as of Mar 22, 2018.

**Key Economic Indicators**

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<tr>
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<th>FY17A</th>
<th>FY18E</th>
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<th>FY21F</th>
<th>FY22F</th>
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<tr>
<td>GDP Growth (%)</td>
<td>5.3%</td>
<td>5.7%</td>
<td>4.6%</td>
<td>4.7%</td>
<td>5.1%</td>
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<td>PKR/USD – June-end</td>
<td>105</td>
<td>115</td>
<td>127</td>
<td>136</td>
<td>140</td>
<td>144</td>
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<td>Inflation (%)</td>
<td>4.2%</td>
<td>4.0%</td>
<td>7.0%</td>
<td>7.5%</td>
<td>7.5%</td>
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<tr>
<td>Imports (US$bn) – as per SBP</td>
<td>48.5</td>
<td>53.1</td>
<td>52</td>
<td>49.8</td>
<td>50.7</td>
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<td>Exports (US$bn) – as per SBP</td>
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<td>23.7</td>
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<td>29.4</td>
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<tr>
<td>Current Account Deficit (% GDP)</td>
<td>4.1%</td>
<td>5.1%</td>
<td>3.8%</td>
<td>2.4%</td>
<td>2.1%</td>
<td>1.9%</td>
<td>1.8%</td>
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<tr>
<td>Foreign Direct Investment (US$bn)</td>
<td>2.3</td>
<td>3.3</td>
<td>3.9</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Fiscal Deficit as % GDP</td>
<td>5.8%</td>
<td>5.8%</td>
<td>5.0%</td>
<td>4.7%</td>
<td>4.7%</td>
<td>4.4%</td>
<td>4.4%</td>
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Source: State Bank of Pakistan; International Monetary Fund; Topline Research
Historic IMF Programs:
In Nov 2008, IMF approved US$7.6bn Standby loan for Pakistan. This was due to abysmally low FX reserves of US$3.5bn (1.6x imports) with high CAD in FY08 of 8.2% as % of GDP compared to 4.5% a year earlier. Post IMF program, five years later in 2013, Pakistan went into another IMF program (EFF) during Sep 2013 given extremely low foreign exchange reserves of US$3.0bn (0.8x imports) during that year acquiring US$6.6bn of loan.

Foreign Exchange Reserves Trend and IMF Program

The Economist Intelligence Unit expects the Pakistan rupee to continue facing significant downwards pressure in the months ahead. Still, we believe that the authorities will be broadly successful in keeping the exchange rate against the US dollar relatively stable ahead of the parliamentary polls, due by August 2018. However, following the elections, Pakistan's widening current-account deficit, weakening foreign-exchange reserves position and growing interest-rate differential with the US will lead to a much weaker currency. It is believed this depreciation will help to address growing macroeconomic imbalances and put the overall economic outlook on firmer footing.

A different global picture
External pressures are expected to increasingly weigh on the authorities' attempts to maintain exchange-rate stability. The US economy is expected to experience a technical recession in 2020 rather than 2019. This will have important ramifications for Pakistan. It is now forecast that monetary policy tightening by the US Federal Reserve will last into early 2020, with the main interest rate standing at around 3% by late 2019. This contrasts with monetary easing, taking the key interest rate to around 0.5% in 2019, as per the previous forecast.

The increase in the interest-rate differential with the US as the Fed continues to tighten monetary policy for much longer will result in further depreciation pressure on the Pakistan rupee. The politicization of exchange-rate management has contributed to the build-up of macroeconomic imbalances, but the Pakistan rupee is set to trade at a level more closely in line with economic fundamentals going forward.
The Currency

The renminbi is the official currency of the People’s Republic of China and it translates as “people’s currency”. The yuan is the basic unit of the renminbi, but it is also used to refer to China’s currency in general on an international level. It is the official currency in mainland China, but not in Hong Kong, Macau or Taiwan and is issued by the China’s central bank – the People’s Bank of China.

As China’s economy continues to expand, albeit at single-digit rates, it has already become the world’s second biggest economic power (third if you count the European Union’s output). This implies that demand for the renminbi will continue to rise alongside the jump in trade volumes. Moreover, the ongoing currency restrictions liberalization will play a major role in the growing interest towards the yuan.

Until less than a decade, the yuan was pegged to the US dollar at 2.46 yuan per USD. However, as China sought to switch to a market economy and gradually opened in the 1980s, the yuan was depreciated in order to give China a competitive edge on the international trade scene and boost exports. The renminbi’s value swung from 1.50 yuan per dollar in 1980 to 8.62 yuan in 1994, fueling a currency war between the two countries.

The peg was removed on July 21st, 2005 and revalued the USD/CNY cross at 8.11. The yuan saw a gradual appreciation during the next three years before it was re-pegged to the US dollar in the dawn of the 2008 financial crisis. On June 19th 2010, the People’s Bank of China announced it will undergo reforms of the renminbi’s exchange rate regime and increase its flexibility. Ever since the yuan has been steadily increasing in value against the US dollar, as the Chinese government seeks to rein in inflation, hitting a record high of 6.0395 yuan per U.S. dollar on January 14th 2014.

Next global reserve currency

Chinese leaders’ determination to put the country on a new course and achieve renminbi internationalization and status of reserve currency faces three goals: to encourage its use in cross-border investment; to develop offshore renminbi centers; and to expand its role in foreign trade settlement (it has already overtaken the euro to trail only to the US dollar). The reforms finalized at China’s Third Plenum in November 2013, which were seen as the boldest in decades, maintained that direction and, as a result, several foreign central banks now hold yuan reserves, indicating improving confidence in the yuan as a reserve currency.

Although it is not crucial, the size of an economy and its trade volumes play a major role in its currency gaining a reserve status. Another requirement is an open capital account, on which China learned from others’ mistakes. It opened its current account before its capital account, but kept some “soft” controls, allowing the currency to play an increasingly important role in global trade and finance, while maintaining some control over capital flows.

Other requirements are a flexible exchange rate, supporting macroeconomic policies and deep, broad and liquid financial markets ensuring a wide range of financial assets at the disposal of investors. China has already doubled the daily trading band for the USD/CNY pair to +2%, eased interest rates on foreign-currency deposits and allowed foreign investors an easier access to Chinese markets. The band was initially 0.3% around the PBOC’s central parity. It was raised to 0.5% in 2007, then upped to 1.0% on April 14th 2012, followed by an extension to 2.0% on March 17th 2014.

Upcoming reforms in that matter will be tested in the Shanghai free-trade zone before being implemented nationwide. They include allowing foreign companies to issue yuan bonds and access the domestic equity market, deregulation of services sector, simplifying customs clearance and interest rate liberalization, cross-border trade settlement and others.

As a result of the quickly accelerating financial reforms and rising international popularity, the renminbi is expected to become fully convertible earlier than until recently expected – most likely within the next three years. This would lift the limit on individual currency purchases, give bigger quotas for foreign investors and liberate foreign direct investment.

As per a report published by Deutsche Bank (DB), the internationalization of China’s Renminbi (RMB) has been described as the most significant global financial markets development since the formation of the euro. In recent years, China has demonstrated concentrated efforts to promote the use of RMB in cross-border trade, financing and foreign direct investment (FDI), especially in Hong Kong, Taiwan and Singapore.
The RMB internationalization accelerated in 2009 when China established the dim sum bond market and expanded the Cross-Border Trade RMB Settlement Pilot Project, facilitating pools of offshore RMB liquidity. The below chart shows increase in Cross-border RMB settlement in the period from Jan 2012 to Jan 2014.

**China Cross-border trade settlement volume (RMB bn)**

![China Cross-border trade settlement volume chart](image)

**Source:** PBOC, Deutsche Bank

**U.S. Dollar Vs. Chinese Yuan**

The most popular China Yuan Renminbi exchange rate is the USD:CNY. During the period from 1997 to 2005, the China used conventional dollar peg system, and the Chinese yuan was valued at approximately 8.3 CNY per U.S. dollar. In 2005, the Chinese government transitioned to a managed floating rate system and revalued the CNY to 8.1 per USD. Under this system, the yuan's value is determined by using basket of currencies, and it is believed that the highest weightage is given to U.S. Dollar. The below chart shows the correlation between the dollar and the yuan.

As part China's efforts to internationalize the yuan, the Chinese government put forth a pilot program to regulate country's international trade with countries such as Hong Kong, Macao and ASEAN countries in 2009. The plan was initiated in only 5 provinces of China: Shanghai, Guangzhou, Zhuhai, Dongghuan and Shenzen. Since then, the program has been expanded to other provinces and allowed trade with rest of the world. The Chinese government has taken more measures to promote the RMB as a reserve currency by signing agreements with Australia, Japan, Thailand, Russia, and Vietnam to allow for direct currency trade, instead of the erstwhile conversion to the U.S. dollar.

![Chart showing correlation between USD and CNY](image)

**Strengthen:**

- The Chinese Yuan gained over 7% against the Dollar in 2017; it approached major resistance levels at the year end.
- High-quality of growth will be China’s major theme in 2018; prudent monetary policy will continue to apply.
- Curbing financial risks will be PBOC’ primary target in 2018; other risks are seen in trade and financial opening up.
The offshore Chinese Yuan (CNH) gained +7.3% against the U.S. Dollar in 2017 and the onshore Yuan rose +7.0%. Dollar weakness, Chinese regulator’s guidance, as well as China’s on-target growth have all contributed to Yuan’s advance.

![USD/CNH 1-Week](chart)

Chinese fundamentals set the foundation for a relatively stable Yuan. The country’s growth rate target was set to be around 6.5% in 2017. Despite of the 25+ year low level, the economy has avoided hard-landing and financial catastrophe and is expected to achieve the target or even beat it. Also, the PBOC has implemented a prudent monetary policy in 2017, which was tighter than in 2016.

Dollar’s weakness and PBOC’s guidance were the other top drivers. From January to May, the USD/CNH remained mostly in a range, despite that the Dollar weakened over the same span of time. This caused the Chinese regulator’s concern on a failing exchange rate regime. As a result, the PBOC introduced a counter-cycle factor in calculating Yuan’s daily reference rate. This is a major adjustment in Chinese exchange rate regime since the PBOC de-pegged the Chinese currency against the Dollar in August 2015.

Following this move, the Yuan restored momentum against the Dollar in the third quarter and hit the yearly-high level of 6.4433. In the last quarter, the Yuan pair entered a range, amid Dollar’s picking up and lack of domestic improvement. At the end of 2017, the USD/CNH fell to a long-term support zone (resistance for the Yuan).

As of Feb 2018, The central parity rate of the Chinese currency renminbi, or the yuan, advanced to new high against the U.S. dollar on persistent weakening of the U.S. dollar. The Chinese yuan strengthened 294 basis points to 6.3045 against the U.S. dollar, the strongest level since Aug. 11, 2015, according to the China Foreign Exchange Trade System. The first month of 2018 witnessed the yuan’s onshore exchange rate strengthen by 3.38 percent against the U.S. dollar, the biggest monthly gain since 1994. The reading was also over half of the 6.72 percent strengthened for the whole 2017, the sharpest annual appreciation in nine years. The dollar index, a gauge that measures the U.S. currency's strength against six other major currencies, has declined over 5 percent since December last year.

In China's spot foreign exchange market, the yuan is allowed to rise or fall by 2 percent from the central parity rate each trading day. The central parity rate of the yuan against the U.S. dollar is based on a weighted average of prices offered by market makers before the opening of the interbank market each business day.
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