Could the next IMF program be decisive?

Mushtaq Khan, December 12, 2017

The big news is the change in exchange rate management that started on December 8th. On December 11th, a PSO Dollar-swap transaction with a commercial bank (which the market expected would be rolled-over) was settled in the interbank market. It now appears that all PSO Dollar-swaps will be settled in this manner. This is a strong indicator that SBP and MoF both want a weaker PKR, which is a total reversal in policy.

It should be noted that this long-awaited adjustment could have negative consequences for Pakistan's macro stability and may not jump-start exports – the point was to halt the rapid growth in imports. With growing expectations that a PKR adjustment was imminent, importers naturally front-loaded their orders, which continued to feed the trade deficit and deplete SBP's FX reserves. With this adjustment, it is hoped that the behavior of importers will change.

All this has happened against the backdrop of the ongoing talks between the IMF and GoP. The question is: where does this lead to?

Post-Program Monitoring

For countries that have borrowed beyond their allotted quota, the IMF must ensure that the client country is in a position to repay its debt – it does this through a rigorous post-program assessment. These discussions are underway in Islamabad, and are likely to end this week. As per past practice, both the IMF and the GoP are likely to issue a press statement covering the main takeaways from the PPM. In our view, this will suggest the direction of future policy discussions, and the nature of the next IMF program.

This note seeks to pre-empt what is likely to be announced, and the media coverage it could generate. While many analysts still feel the government will delay approaching the IMF (for a program) till after the 2018 elections, the fact that the PKR was devalued – and that too during the PPM – is a strong indication the incumbent government cannot keep the IMF on the sidelines till the elections. This means that despite the recent success of the Eurobond/Sukuk, Pakistan's external sector needs tough policy steps to reign in its external deficit well before the scheduled elections.

Timing for the PKR adjustment

The timing to let the PKR adjust according to "market forces" is strange indeed. The nudge is likely to have come from the on-going PPM, but following so soon after the successful mobilization of $ 2½ billion, is still a little odd. Look at the numbers, however, and the timing begins to make sense.

After many months of not updating numbers on its future FX liabilities, SBP finally did:

- As of end-September 2017, SBP had conducted $ 6,070 million worth of $-swaps with commercial banks operating in Pakistan;
- As of end-September 2017, SBP had mobilized $ 3,779 million from overseas banks via the FE-3 scheme, which is distinct from the FE 25 swaps mentioned above; and
- From October 2017 to September 2018, committed sovereign debt payments of $ 5,811 million will have to come out of SBP's FX reserves.

As of end-September 2017, SBP's liquid FX reserves were $ 13,857 million, against FX debts and liabilities worth $ 15,660 million. This means that even back in September, SBP's unencumbered FX reserves were negative $ 1.8 billion.[1] The policy hubris of the ex-FM (Ishaq Dar) in maintaining a fixed Dollar-PKR parity – despite a growing external deficit – forced SBP to deplete its FX reserves by $ 1.2 billion during October and November 2017. So while the market may have celebrated the $ 2½ billion that was recently mobilized, this buys us about 3-4 months of breathing room at most. As things currently stand, we still think SBP's *unencumbered* FX reserves are negative.

This means SBP's ability to intervene in the interbank market is severely constrained, which could explain why it decided to let the PKR go. It also reveals that SBP has now decided that it has little choice but to depreciate the PKR to narrow the external deficit. This has clearly been done against the wishes of the ruling political party, as it will undermine the coveted macro stability that the ruling government has been bragging about. In our view, this shows that while political compulsions are often driving economic policies, policymakers cannot stand indefinitely against the market.

Going forward, despite the political wishes of the incumbent government, it is the compulsions of the country's economic realities that will now determine policymaking.

What to expect

With the PPM press release likely to be announced soon, we will touch on a few issues that have been hinted at in the local media. Other than noncompetitive Pakistani exports and the size of the current account deficit (and the customary praise for macro stability and resilient growth), four other issues are likely to be flagged in the press release: (1) the use of regulatory duties to curb imports and the declining number of income tax filers; (2) the persistence of the circular debt issue in the energy sector; (3) the expected FX outflows from CPEC-related projects; and (4) the government is not availing the full tax potential in real estate transactions. Each of these could become thematic components of the next IMF program.

Regulatory duties & dwindling number of tax filers:

In addition to steps taken in the Budget for FY18, the government has twice imposed regulatory duties on certain imports, ostensibly to contain the external deficit. This has not dented the pace of imports so far, and the IMF has shown concern that this measure was being used to shore up tax revenues. In an earlier paper (*Too Little, Too Late*, Oct 18th 2017) we had mentioned the "clever" use of regulatory duties as it could reduce import demand and also generate revenues for the government. It appears that the IMF has caught on, hinting that this goes against the spirit of fiscal reforms, where the point was to shift away from trade taxes towards direct taxes.

This ties in with the falling number of income tax filers. Despite extending the deadline several times, media reports claim that the number of filers is just 65% of the filers in FY16.[2] This is particularly embarrassing as the new census states that Pakistan's population is estimated to be 208 million, against the previous working estimate of 180 million. From the many IMF documents on Pakistan's economy, it appears that the effort to expand the tax base and create a more equitable tax burden, has gone nowhere.

[1] "Unencumbered" refers to free reserves – i.e. SBP FX reserves that are not due or already earmarked. The point is that SBP has historically borrowed short-term money to beef up its reserves to create calm in the FX market. However, SBP should not be using these Dollars as they have to be paid back soon. So SBP's unencumbered reserves are zero when the entire stock of its reserves have to be repaid within a year.

[2] Business Recorder (15th November 2017), states that against 1.2 million direct tax filers in FY16, till 14th November 2017, only 775,000 tax returns were filed.

In our view, not only will tax collection be a top priority in the next IMF program, but to compensate for the failure of the current government to implement fiscal reforms, this may be imposed quite strictly. More specifically, fiscal reforms may be formalized as legally binding limits that require parliamentary oversight (and waivers), to ensure that Pakistan's elected representatives cannot skirt responsibility.

Circular debt:[3]

That this issue has resurfaced, after the one-off financial settlement in the early days of the Nawaz Sharif government in 2013[4], must be disappointing to the IMF. In an article in the Dawn (dated August 8th 2017), the circular debt was estimated to be above Rs 800 billion. What is especially disappointing is that the PML-N's 2013 election campaign, specifically targeted the energy sector, and promised to stop load-shedding and eliminate the circular debt.[5]

The new program will have to focus on *real* energy reforms. Unlike the current government's focus on creating new generation capacity, we agree with SBP's 2014 assessment:

> *In our view, it is the old and poorly managed power distribution network – not inadequate generation capacity – which is keeping load management at such high levels… This means the existing T&D network is a more binding constraint than generation capacity*.[6]
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> *In effect, the more binding bottleneck at this time is distribution, not generation. Therefore, even if existing generating units are geared up to operate three-fourth of their capacity, the country simply does not have the infrastructure to distribute this power to end-users. Hence, greater policy focus is needed on distribution, which suggests early restructuring (and privatization) of distribution companies and public investment in distribution.*[7]

This means that restructuring state-owned distribution companies (Discos) should be the first line of action. Overstaffing and political interference in the distribution of power, creates the operating losses that lie at the heart of the circular debt problem. Restructuring the Discos will require significant political will. The easy option is to inaugurate new generation capacity and promise the general public that load-shedding will eventually stop. As we have seen, it won't.

Outflows from CPEC-related projects:

News reports have flagged the IMF's grave concerns about the FX liability created by the stream of CPEC projects, which have been guaranteed by the government. In an article in the Express Tribune, the reporter used a very strong term to describe the IMF's response – *Sheer size of CPEC portfolio appalls IMF*, December 7th. Although the article did acknowledge that the GoP's projections differed from the IMF's, it does raise a contentious issue. For several years now, local analysts have been questioning the sustainability of CPEC projects, in terms of the repayment burden they have created.[8] For the IMF, this

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[3] This simply means that the revenue generated from the sale of power to end-users, is insufficient to pay for the cost of generation, transmission and distribution. For example, the distribution company (Disco) is unable to pay the generating company (Genco) in full, which in turn is unable to pay the oil importer (PSO). Hence, each upstream company is left with receivables on its balance sheet, which when added together is the circular debt in the power sector.

[4] In an article in the Express Tribune (dated July 23rd 2013), it was stated that the government paid Rs 480 billion of Rs 503 billion to settle the circular debt problem.

[5] This issue was given a great deal of prominence in the PML-N's Manifesto 2013, specifically as "Energy Security: Continuous Availability & Affordability".

[6] Annual Report 2013-14, SBP, page 39.

[7] ibid, page 37.

[8] For the past several years, local experts have been flagging the FX burden created by CPEC. Based on specific project details (especially the Dollar returns guaranteed on energy projects) and falling FX reserves, most analysts have become increasingly skeptical of CPEC, while some are calling this project the equivalent of a modern East India Company. Some of the analysis

issue is particularly discomforting, as the last 3-year program was "successfully" concluded in September 2016.

Since the last IMF program was required because of a BoP problem, and tell-tale signs of the current BoP issue had become obvious by mid-2017, this time around, there is likely to be a fair bit of soul-searching within the IMF. There is sufficient evidence that Pakistan was able to complete the last program because it was granted frequent waivers from the IMF for targets that were not met. Why the IMF was willing to look the other way when the GoP was unable/unwilling to take tough steps on restructuring the Discos (to tackle the circular debt), or move on the independence of the central bank, or push through the restructuring of loss-making PSEs, or cast the tax net more widely; will certainly factor into the internal discussions at the IMF.

This, coupled with the strained relations between Pakistan and the US, will surely make the program design and implementation that much stricter. It also means the negotiations with the IMF are likely to be drawn-out. In our view, the likely summary of the PPM and the volatility in the FX market, suggest that the policy dialogue for the next several months will be shaped by the design and focus of the next IMF program.

Nevertheless, we do see a silver-lining in the IMF's discomfort.

- To satisfy growing public doubts about sustainability, the real thinking behind CPEC will have to be revealed. As we have discussed in an earlier paper (*Pakistan's Balance of Payments, the IMF & China*, September 14th 2017), if CPEC does not focus on enhancing Pakistan's exports, our policymakers will have no choice but to offer debt-to-equity swaps to Chinese creditors (i.e. China starts buying choice Pakistani assets). This potentially strains the relationship between the two countries, which does not bode well for CPEC.
- If both Pakistan and China have not focused on Pakistan's ability to generate additional FX (to sustain CPEC), this should force a re-think of this undertaking. Perhaps an export-oriented CPEC could focus on cotton and food production, which are then exported to China. Another possibility is that Chinese textile companies relocate their low value-added units to Pakistan, which allows this country to enter the Chinese global supply chain.
- If Pakistan is unable to convince the IMF that CPEC (in its current form) is sustainable, at the very least, it should shame our policymakers into enforcing better institutional coordination, and also upgrading the effectiveness of institutions like SBP, MoF, SECP, FBR, etc. These institutions, with their Chinese partners, would have to approach CPEC at a macro level – i.e. to formulate a medium-term macro framework of policy measures (and reforms) that allows the country to absorb and sustain the various components of CPEC. This is necessary to make the entire project commercially and economically sound.

<u>The tax potential in the real estate sector:</u>

In another article in the Express Tribune covering the PPM (*IMF questions levy of duties, weak tax regime*, December 8th), it was stated that the IMF had concerns about low revenue generation from the real estate sector, with a specific focus on increasing *official* property valuation rates. In our view, this is a critical issue, which we discussed a year ago (*Addressing the real economic challenges facing Pakistan*, Nov 21st 2016). We estimated that real estate, gold/jewelry and livestock could account for as much as 80-85% of Pakistani household wealth, with the bulk of this invested in real estate. We argue that grossly

may be sensationalist, but most will agree that there appears to be no master-plan (on the Pakistani side) that balances future FX outflows (linked to CPEC) with the country's deteriorating BoP outlook.

undervalued real estate, especially when market prices are rising, creates an impetus for consumer spending that the government is simply unable to control. This, in turn, leads to the import of luxury items.

Ironically, the valuation of real estate provides the IMF with a powerful policy lever to control Pakistan's consumer demand. It is a stylized fact that residential and commercial real estate in Pakistan is often only 15-20% of the actual market value – the value at which transactions are conducted. The IMF is correct in its assessment that transfer fees and other taxes, which are based on the "official" value, short-change the exchequer. But more importantly, when market values are rising but official valuations remain stagnant, asset holders realize a significant capital gain, which easily changes their spending behavior (via a wealth effect).

In effect, if the IMF wants to reduce demand pressures (which is needed to reduce imports), instead of increasing interest rates or devaluing the PKR further (which would trigger inflation), it could simply insist that real estate valuations be more accurate. This could be advocated as a fiscal measure, but it would be a powerful tool to rationalize real estate valuations, which in turn would control consumer spending and reduce speculative investment. It would also more accurately document commercial transactions, which will increase the tax base. While the vested interests in Pakistan would adamantly oppose such documentation (as it would expose ill-gotten wealth, and how it is hidden), the government could push this through as an IMF requirement that cannot be refused.

Conclusion

While many have resigned themselves to another IMF program in the near future, this one could be different and more difficult. It is likely to be different in terms of forcing the government to be more transparent about CPEC (which is much needed), and also by focusing on the reservoir of undocumented wealth in Pakistan. The IMF, in collaboration with the GoP, would not only be able to quantify the quantum of wealth in this country, but also compel asset holders to document their wealth and enter the tax net. This theme is well supported by global initiatives to clamp down on tax evasion, which means Pakistani wealth will be increasingly uncomfortable overseas, while the option of capital flight is now almost impossible.

In terms of a tougher program, this can be justified by the state of Pakistan's economy. Given the external debt overhang that has been created in recent years, the market expects a large bailout package to tide over future FX payments. This may not materialize for several reasons: (1) the IMF may want to eliminate the moral hazard problem, whereby a client country makes payment commitments knowing that the IMF will always bail it out; (2) Pakistan's strained relationship with the US could make negotiations difficult; (3) the IMF may argue that the scope of CPEC is too ambitious, especially when Pakistan's fundamentals cannot sustain such an undertaking; and (4) the IMF could simply argue that Pakistan's external debt is not sustainable, which means it should not borrow more (even from the IMF).

As the saying goes: Pakistan will have to do more.

We are optimistic on this count. If Pakistan's policymakers are sincere in their goal to enhance documentation, they should embrace the IMF program. By all accounts, Pakistan will be facing a shortage of hard currency for the next several years, and cannot simply continue to weaken the PKR as this has adverse macro consequences. The challenges ahead are serious: (1) export stagnation will take time to overcome; (2) remittances are likely to fall, especially from the GCC; (3) external debt payments will remain heavy for the next several years; and (4) a more sustainable CPEC is yet to be unveiled.

The upside is that the true nature of CPEC will have to be revealed, or tweaked to ensure it has a direct impact in terms of boosting exports. The other potential upside, is that a credible government that seeks to clean up the country (think documentation) would be well-positioned to attract Pakistani wealth held abroad. With Pakistan and the UAE joining a coalition of 102 countries in the OECD's Common Reporting Standard in 2018[9], alongside the targeting of known tax havens globally, Pakistanis who have kept their wealth abroad, could be enticed to pay a fine and bring their money back home. This could be a significant step, and a timely stopgap measure, as Pakistan adopts more reasonable policies to create a sustainable external regime.

To summarize, Pakistan's return to the IMF should not be viewed as more of the same. Circumstances are changing within the country (e.g. CPEC, undocumented wealth, accountability of office-holders) and globally (the Iran-Saudi standoff in the Middle East, the slash-and-burn US foreign policy, China rising). The stakes for the country are much higher now, which means that Pakistan cannot afford to play a short-term game with the IMF as it has in the past (*The Parable of Pakistan and the IMF*, December 27th 2016). If Pakistan is to play a role in the emerging bi-polar world order, it must anchor its economy to sounder fundamentals. From past experience, Pakistan only takes hard policy measures when its back is against the wall – this is where we find ourselves again.

[9] This entails the bulk sharing of tax and financial data amongst central banks.