Deceptive choices

Mushtaq Khan, September 4, 2018

With the likely election of a PTI candidate as the President of Pakistan tomorrow, the country's political landscape appears to have settled down with a degree of stability that few could have predicted. Prime Minister Imran Khan has grown into his job, and his cabinet has started to manage the country. Positive signals have been sent on the foreign front (e.g. Pakistan's strong commitment to China and CPEC; friendly overtures to Iran; a balanced approach to the US; and the well-wishes of Indians who have been avid fans of Imran Khan – the cricketer).

On the economic front, however, there is not much clarity. The stock market remains unsettled, and there is an eerie calm in the foreign exchange (FX) market. As we have regularly reminded our clients, the monthly balance of payment (BoP) and inflation data, will keep the country's economic problems front-and-center. These need to be addressed.

Having said this, some promising steps have been announced by Asad Umar (the Finance Minister). He has: promised to debate whether the country should approach the IMF in parliament; constituted an Economic Advisory Committee (EAC) with prominent economists – a group which had advised the two previous governments; and appointed an adviser to reform public sector enterprises (PSEs) and impose a strict austerity drive in all government agencies.

However, talking to market people and corporate/business executives, there is a perceptible sense of uncertainty about what the new government really intends to do. While most have applauded PTI's social welfare agenda and the need for austerity, they are unsure about the outlook for interest rates and the Rupee – they also worry about the last-minute borrowings to shore-up SBP's FX reserves. More specifically, while they broadly agree that China is a dependable friend and partner, they wonder whether China's efforts to stabilize Pakistan's economy will succeed.

In our view, the *IMF or China* debate is one of several vaguely defined trade-offs that business leaders are trying to figure out. From our discussions, we would suggest additional deceptive choices: *manage the external deficit or provide relief for the people*; and *disruptive reforms or accommodative change*. Media coverage of these issues has not helped. In our view, most commercial entities remain ill-informed about the implications of choosing a side, even if they have firm opinions to justify their viewpoint.

Broadly speaking, most businessmen and corporate executives side with China (over the IMF), and feel that economic reforms need to be consensus-driven. On the external deficit, many sympathized with the government's need to reward its supporters, but were increasingly concerned about the size of the current account deficit – however, all took comfort from China's engagement with Pakistan.

Given the private sector's ambivalence about these issues, we will attempt to shed some light on these matters.

The IMF or China

The narrative is simple. In the past, Pakistan has been dependent on the IMF (and by association – the US) for regular help to stabilize its economy. The political-economy argument was that this gave the US leverage on Pakistan's foreign policy, specifically in Afghanistan. Now that China has stepped up as a counterweight to the US, Pakistan should shift its dependency and move away from the IMF.

Many claim that China has already stepped into the void with much needed loans to shore up SBP's FX reserves. They also point to CPEC, and how this has added to Pakistan's growth momentum. The private sector is looking for clarity on how exactly China will help Pakistan's economy, and specific steps it will take to resolve the current uncertainty. Some have even predicted that after the federal government rejects the proposal to approach the IMF, China will disclose its economic plan for Pakistan and the shift away from the US would be complete.

This is an ill-informed viewpoint. Pakistan does not face a binary choice: the IMF *or* China. The first thing to realize is that China is the third largest contributor to the IMF, and unlike the Trump administration, Premier Xi has shown his commitment to multilateral organizations. Since Trump has unleashed his trade war against China (and others), Xi is increasingly viewed as the champion of free trade and a supporter of multilateral organizations.

The next point to note, is that there is no alternative to the IMF. While the creation of the Asian Infrastructure Investment Bank (AIIB) has been spearheaded by China and headquartered in Beijing, it is not a substitute for the IMF. AIIB is mandated to provide infrastructure loans to developing countries, but these are project-specific and often purchased from originating financial institutions (i.e. these assets are bought from global financiers who initiated the projects). AIIB does not have the expertise (or mandate) to assist countries that are facing an external sector problem.

One must also realize that the IMF's mandate is to help member countries overcome temporary BoP problems – the operative word being "temporary". IMF conditions require the member country to take policy steps to narrow the external deficit to more *sustainable* levels, which means demand pressures must be reduced by fiscal contraction. Being a frequent user of IMF assistance (Pakistan has been a top 5 user for decades) is stark evidence of macro mismanagement: in other words, the country's economy is overly dependent on imports but is unable to export enough to pay for these imports. In simple terms, it means Pakistan's economic system is not sustainable.

Another way to view this, is to think of a country that lives beyond its means, and instead of taking hard steps to discipline itself (namely, reducing consumption of foreign goods), it opts to use a credit card and racks up significant debt. Once the debt gets too heavy, it starts looking around for help to repay. Since the IMF is the creditor of last resort (i.e. the only one willing to help), the Fund demands hard steps from the debtor to rein in its behavior. The *straight and narrow* path is adopted for a while, but, once the crisis has been averted, the country returns to its old habits. The external deficit again begins to rise, and it's just a matter of time before the country starts heading down the road to the IMF.

Pakistan's history with the IMF also creates another dependency – market participants who have lived through past BoP problems, are by now conditioned to IMF policies and the sense of calm that they create in the market. The 3-year macro outlook that underpins an IMF bailout package, gives businesses operating in Pakistan a hard handle to anchor their expectations. Without this assurance, businesses will remain confused and passive.

The question then, is as follows: what could China propose (as an alternative to an IMF program) that would have the same calming effect on Pakistan's market?

This brings us to another fundamental point. Policies to narrow the twin deficits are not easy because they require a drastic change in economic behavior, which will not suit the status quo. Barring a

Box 1: Pakistani assets held abroad

Since the Amnesty scheme was launched by the previous government, local media has often reported on the massive wealth holdings of Pakistanis in Switzerland, the UK and the UAE. The most recent coverage claims that Pakistanis own $ 150 bln worth of property in the UAE, specifically Dubai.

This is noteworthy for two reasons: one, it shows the magnitude of wealth that Pakistanis have generated and kept outside the ambit of local tax authorities; and two, that most of these assets have been purchased by skirting SBP rules which disallow Pakistanis from taking hard currency from Pakistan to invest in real estate overseas.

Of greater concern from our perspective, is not how much of this money will be repatriated to Pakistan (after owners are forced to declare them to FBR), but how these media reports could create a false sense of comfort that the current BoP problem pales in comparison with these vast sums of "illegal" wealth (we realize the general public may view this as looted money, even if a fair share of these assets has been purchased legally). These media reports are being used by PTI to highlight the need for expats to invest in Pakistan, or to bring back their illegal wealth.

There are several things to keep in mind when reading such reports:

- The headline numbers are likely exaggerated as they are current valuations and not the initial investment amounts;
- Some of these assets may have been purchased with money generated outside Pakistan;
- These assets could belong to Pakistanis who have residency or foreign passports, which shows no wrong-doing;
- Unless there is evidence that these assets were purchased using money that was sent illegally from Pakistan, the GoP cannot claim ownership of these assets;
- FBR requires all filers to list all assets in their wealth statement, but there is no tax liability on these assets as there is no wealth tax in Pakistan; &
- Even in the case where these assets have been purchased with illegally secured funds, possible repatriation could take years as the process will require sovereign bilateral agreements, exhaustive legal procedures and a comprehensive policy from GoP.

In our view, overseas Pakistani assets should not be viewed as wealth that the GoP can tap into – nor would these investors voluntarily invest this money in Pakistan. If owners are compelled to file their taxes in Pakistan and declare these assets, and a wealth tax is imposed, this will at best create a stream of tax revenues that is 1 or 2 % of the purchase value. This will not amount to much.

However, the specific case of Dubai is insightful in proving the extent of over and under invoicing of Pakistan's trade flows. For an economy that is based primarily on real estate, tourism, and hospitality, by FY18, the UAE (more specifically Dubai) has become the second largest importer to Pakistan, and the third largest market for Pakistani exports. In our view, this is only possible if the UAE is used as a temporary stop for Pakistan's imports and exports, and this is only lucrative if such transactions are misreported. The wealth (and Dollars) that is extracted from Pakistan by grossly over-invoicing imports, is then invested in Dubai's real estate.

revolution that seeks to overthrow the entire system of government, taking on the economic interests of the status quo will be resisted, albeit in a roundabout manner. Past reform programs were initiated (and half-heartedly implemented) only because Pakistan was facing an acute FX problem, and normal economic activity would not have been possible without IMF assistance.

If the IMF was to be replaced by China, the question to ask would be why China would finance Pakistan's external deficit indefinitely. As we have argued in an earlier paper (*Pakistan's Balance of Payments, the IMF & China, 14 September 2017)*, China is more likely to choose a combination of soft loans, trying to work with Pakistan to narrow its bilateral trade deficit, and most importantly, urging Pakistan's policymakers to implement hard reforms so that Pakistan's economy is robust enough to partner up on CPEC. More simply: why would China give Pakistan a blank cheque?

Without the IMF's structured conditionalities, could we expect China to replicate similar economic targets for Pakistan? And even if it did, wouldn't this provoke the GoP (or the country's legislature) to complain that this is not how a friend treats another friend? In our view, Pakistan's status quo would prefer that China simply fund the external deficits, without interfering too much in Pakistan's economy (the way the IMF does). In *realpolitik*, our status quo would argue that Pakistan's needs are small in the larger context of what China seeks to achieve globally, and so China should view this economic lifeline as a small price for Pakistan's loyalty to China.

In our view, this story is unlikely to fly for a very simple reason: after the anti-corruption campaign that Premier Xi has forcefully implemented at home, it is absolutely impossible that China would pander to Pakistan's economic elites.

A final complication with shifting towards China, is the IMF's seal of approval. This seal basically means the IMF is satisfied that the country's macro economy is on the mend, which means the country remains a viable destination for foreign investment. At this point in time, if the IMF steps out of the picture (say Pakistan's parliament decides that the country should not approach the IMF), foreign fund managers could become jittery. Their portfolio management systems rely on global rating agencies, but more importantly, on the IMF's seal of approval. A poorly managed break from the IMF could accelerate net portfolio outflows, which have been trickling out since mid-2017. With foreign investment estimated to be $ 6 – 7 billion in the PSX, heavier outflows will almost surely trigger an FX crisis.

In summation, the IMF is too integral to Pakistan's business sentiments especially during this period of uncertainty, while the "China option" is too untested and politically fraught to provide a viable, realistic alternative.

Narrow the external deficit or provide relief for the people

For a newly elected government, this is a tough call. The decision to cut retail fuel prices on 1 September (especially diesel – the fuel of the people), is good for the average Pakistani and will help defuse inflationary expectations. However, after a record high external deficit in July 2018, this casts doubt on whether the PTI government is serious about tackling the growing BoP problem. We could argue that the fall in global oil prices in the first half of August, and the pricing formula OGRA uses to make its monthly recommendation, justified the government's decision to cut prices. But reducing PoL prices when the country's oil bill has increased from $ 10.6 bln to $ 13.3 bln in FY18, will not go down well with foreign fund managers. With Argentina and Turkey experiencing currency crises, and fears expressed about Indonesia, Malaysia, India, Brazil and South Africa, foreign investors are already edgy.

In our view, the PTI government should be very careful about the sentiments of foreign investors (especially those invested in the PSX). As stated earlier, if outflows gain momentum and this begins to show in SBP's FX reserves, it could destabilize the economy. More simply, even though relief for the poor is a defensible policy, at this point in time, it is not the right signal. As mentioned earlier, the drip-drip nature of FX is such that unless the August 2018 BoP deficit is significantly lower than what was posted in July, the market will be difficult to manage in the remaining part of 2018.

Disruptive reforms or accommodative changes

The caution with which the PTI government is moving forward is understandable. Most people will agree that campaign promises are formulated to get elected – but once elected, a more responsible mindset must prevail. Observers will also agree that the new government has inherited an economy that was on the brink, and should therefore be extra cautious after the mismanagement by the PML-N government.

As mentioned earlier, implementing economic reforms is not easy. Such reforms can be driven from the top with limited consultation (disruptive reforms), or be formulated after detailed discussions with all stakeholders (accommodative change). For example, it makes sense to have a parliamentary debate about whether Pakistan should approach the IMF, as this is an important decision that has consequences for the entire country. However, if the level of discussion is not deep, or textured enough to understand the alternative (i.e. total dependency on China), the resulting decision will be ill-informed and wrong.[1]

One must realize that a shift to China will be a unique undertaking for both countries, and it is critically important to know how Pakistan's economic players will respond to this shift.

Furthermore, one can easily predict the parliamentary decision, as the elected representative of the country would clearly choose to retain sovereignty in policymaking. More simply, would an elected representative of the people accept an economic roadmap from a foreign institution, especially one that is popularly known for doing the bidding of a foreign (and possibly hostile) power? Or, more selfishly, would an elected representative agree on tough fiscal conditionalities, which would restrict his/her power to reward his political constituency?

In addition to these politicians (some of whom are *seasoned* politicians), there are the engrained interests of, and the power wielded by, the bureaucracy. As enablers of the political leadership, Pakistan's bureaucracy has been tainted by venal politicians who view their election victory as a mandate to enrich themselves. As discussed in our last paper (*The Challenges Facing Pakistan's Economy, 15 August 2018*), short-term policies cannot be implemented without a complicit bureaucracy. With a rigid hierarchy that takes decades to reach a position of power, if the bureaucracy facilitates (and partakes in) corruption, it will protect its interests with the same zeal with which politicians protect their wealth and proclaim their innocence. As the anchor of the status quo, the government machinery is equally resistant to change.

One could argue that a consensus driven approach to economic reforms, is likely to be bogged down to the point that the end goal of economic reforms is almost forgotten. In Pakistan's case, since the IMF has always been viewed as an external agent of change, the government machinery has undermined its efforts at real reforms to protect the interests of the status quo. To bring about real economic change, it is important to overcome institutional inertia and build momentum – in this scenario, there is something to be said for disruptive reforms from the top.

Dr Mahathir's election as the world's oldest Prime Minister this year, provides a good example to Pakistan. Campaigning on an anti-corruption campaign against the decade old, scandal-ridden government of Najib Razak, Dr Mahathir was recently quoted as saying:

> *We found that the government machinery was wholly ruined, and all the ministries ruined, because the policy was not to govern the country but to get opportunities.*[2]

Dr Mahathir is known for his exceptional political acumen and his defiance of global financial institutions during the Asian Crisis, but it is his fight against corruption that will be his legacy. His willingness to

[1] This is especially problematic as Pakistan's elected legislature is unlikely to have a handle on what shapes market sentiments.
[2] FMT Reporters, 3 September 2018.

speak so openly about how members of the government (bureaucrats and politicians) are often the lynchpins in financial scandals and corruption, should not be taken lightly.

Concluding thoughts

When confronted by a government machinery steeped in nepotism and corruption, democratic principles may not be first-best. It may not be possible to carry everyone, especially when a large fraction of those who yield political power are allegedly corrupt, or condone corruption. Misleading options (from this faction) that divert public attention away from the real issues, could easily engulf even the best-intentioned government. Imran Khan's anti-corruption campaign secured PTI a comprehensive election victory, but hesitant first steps on the economic side, and a *business as usual* approach to governing, could extinguish the public goodwill.

As discussed in this paper, Pakistan should approach the IMF for a bailout – and do it quickly. Pakistan's top leadership should also visit Beijing, not just to share its vision for economic and social reforms, but to shore up China's support on CPEC and the China-Pakistan FTA.

In effect, it's not China *or* the IMF, but a bit of both.

In terms of relief for the people, this will not generate political goodwill if things are soon reversed. In our view, it would be wiser to communicate the true state of Pakistan's economy and ask the people to bear with the hardship, in exchange for a more prosperous future. If a non-debt creating solution to Pakistan's BoP problem has been formulated, it should be shared with the public immediately. If not, then the government should focus its attention on negotiating one. While the general public may not be well-versed in the details of Pakistan's BoP outlook (and what it means), sending out the right signals to a more select group that is able to calm economic sentiments, will go a long way in setting the government on the right path.

As stated in earlier papers, hard policy steps in Pakistan will be positively greeted, as they signal that things are on the mend. If the government takes the right steps and justifies them, that *itself* will create a virtuous cycle whereby investors (and people at large) will start planning for the future. Furthermore, the short-term economic pain will be easier to bear if people see that past corruption is being prosecuted, and the guilty (however untouchable) are being taken to task. In our view, political opposition will weaken if the accountability drive is bipartisan, and not just limited to the political class. Also, as discussed in our last paper (*15 August 2018*), the short-term economic cost of prosecuting corruption is acceptable, when viewed in the context of the medium-to-long term prosperity it could engender.

The real battle will be with the beneficiaries of the status quo, many of whom feel they are free of any hint of corruption. It is important to recall that crony capitalism has many levels, and any businessman or corporate executive who has used his/her connections in the government (or with regulators) to promote the company's financial interests, is also guilty.[3] For most of them, the use of personal influence is justified as necessary because everyone else is doing it, or because it helps their bottom-line. These practices are a stylized fact in Pakistan.

People who champion the need for real economic reforms, but still use their connections to advance their business interests, make up the bulk of Pakistan's status quo. The rest comprise the political class, the

[3] The weakness in state institutions, and/or the involvement of government officials in crony capitalism (or corruption), require a proactive and complicit private sector. Examples range from the widespread practice of over/under-invoicing trade flows (see **Box 1**); corporate/business influence on government policies; averting government regulations; expediting rebates; evading withholding tax in banking transactions; and/or skirting SBP's foreign exchange regulations.

bureaucracy, high profile businessmen and their facilitators, and political insiders. Since the status quo has engineered or facilitated the weakening of state institutions, trying to reform the economic structure of the country will be resisted. If this is the case, an inclusive process to formulate economic reforms, will become little more than a drawn-out talking shop. In our view, despite the ensuing chaos, disruptive reforms would be more effective in Pakistan.