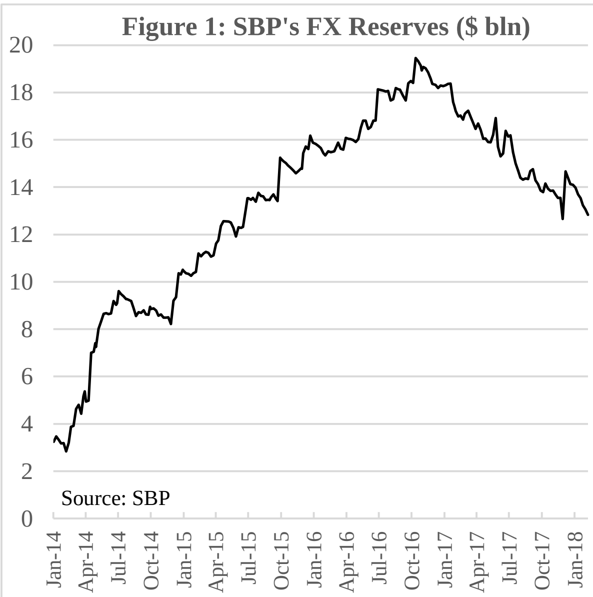
FATF and Pakistan's economic outlook

Mushtaq Khan & Danish Hyder, February 19, 2018

The timing couldn't have been worse. As Pakistan resorts to short-term borrowing to shore up SBP's dwindling FX reserves (**Figure 1**), being placed on the G-7's Financial Action Task Force on Money Laundering (FATF) watch-list, will surely muddy the country's outlook. The US is spearheading this effort to isolate Pakistan, and has gained the support of the UK, France and Germany.



This issue will not go away. President Trump doubles down when his policies are criticized, and the growing strategic alliance between the US and India should ensure that harder actions against Pakistan are on the table. Unlike previous US governments, Trump's White House may not be willing to play a cautious role with Pakistan. Sensing that Pakistan is now vulnerable, and keen to show some results in America's longest war, President Trump may be willing to play hardball, threatening Pakistan with international isolation.

One could easily imagine India using its newfound influence with President Trump (emboldened by the fact that India is the Trump Organization's largest foreign venture), to push the US to squeeze Pakistan into submission.

Analysts (both in Pakistan and abroad) have flagged how this development could complicate Pakistan's relationship with the IMF, and other international financial institutions (IFIs). In the past several decades, IFIs have been the primary source of assistance and guidance, whenever Pakistan's external sector has been stressed – this tends to happen quite regularly in a 3-4 year cycle. Given this path dependency, key players in the Pakistan economy are understandably unnerved; if they see our policymakers remain passive, a sense of panic will set in.

What could Pakistan do?

Answering this question requires some background. Let's assume the US is able to get European support to place Pakistan on FATF's watch-list. One must realize that Pakistan has been on FATF's watch-list from 2008 to 2015, which implies that in itself, this does not mean that external assistance (IFI programs) will be suspended. While being on the watch-list leaves open the possibility that Pakistan could still approach the IMF, it does create a pretext whereby the White House could impose economic sanctions against Pakistan, or use its IMF veto (the only country that has such a say) to stall serious negotiations that are required to enter a stabilization program.

Given the IMF's *modus operandi*, if its management knows that it will not be able to secure the green-light from its Board, then it will not make a case for a program with Pakistan. Given the process that must be followed, a delay in formal negotiations implies that the program start date will also be postponed. This could be unnerving for the Pakistani market, as SBP's FX reserves continue on their downward trajectory, and most of what it has is already encumbered (we have been flagging this point since May 2017).

If the US does place Pakistan on the FATF watch-list, and threatens further actions, this would put tremendous pressure on Pakistan's policymakers to keep the FX market calm. In our view, calming statements alone would not be enough.

We have listed what could happen, if neither side is conciliatory:

- If the US follows up Pakistan's placement on the watch-list with threats of further action, this will provoke anger from both the civilian government and the military establishment in the country. China and Russia are likely to speak up in favor of Pakistan, but this will only be diplomatic support.
- Sensing the worst, the market may panic over stories that Pakistan has been isolated and could face a BoP crisis in the immediate future. This will create pressure on the kerb market and disrupt the interbank market.
- Pakistan's policymakers are likely to lay the blame for the market's anxiety firmly with the US (and by association with the IMF). The government could then announce a series of steps to reduce the outflow of FX (non-tariff barriers on specific imports, temporarily halting some imports, requiring importers to get SBP approval for lumpy imports, delaying the repatriation of profits, etc.), and cite the adverse external situation that has been created by the Trump administration. SBP could further depreciate the PKR, again citing the hostile external environment.
- The Pakistan Army could retaliate by suspending the US/NATO supply routes, as it had done after the Salala incident in November 2011. It could justify this move as retaliation for America's disrespect for the burden that Pakistan has had to bear in the US war on terror.
- If measures to narrow the external deficit do not bear fruit fast enough, GoP may decide to *tap* the excess demand from the previous Eurobond issue, knowing there is sufficient appetite from ex-pat Pakistanis who know that at worse, the sovereign bond's maturity could be extended (technical default). Even outright default (paying bond holders with the equivalent in Rupees) is a possibility that Pakistani investors could accept.
- A further measure would be to seek voluntary debt rescheduling from friendly creditors, or to hint that hostile creditors could face a temporary suspension of debt servicing.
- If the standoff becomes more acrimonious (with a clear divide between the western world and countries that are closer to China and Russia), Pakistan's case could become a rallying point for developing countries that have not fared well with the IMF. This would challenge the institutional credibility of the IMF and create a vacuum wherein alternative "Asian" options could gain traction. With the US appearing to be keen for an economic standoff with China, this may become the tipping point for the global financial infrastructure that has existed since the end of WW2.

To be clear, we do not propose that such a dire situation is likely to materialize. The most likely outcome, is that the abovementioned points are used as Pakistan bargains with the US to find a mutually acceptable outcome – we still see an IMF program as the solution for Pakistan's BoP problem. While we have been skeptical of the IMF's effectiveness in reforming Pakistan's economy (*The Parable of Pakistan and the IMF*, December 27, 2016), stabilizing the external sector without the IMF may not be possible, as the market has been hard-wired (since the late 1980s) to expect the IMF to resolve BoP problems.[1]

[1] Managing market expectations is complicated and path dependent. Many people think that China's stated support for Pakistan should suffice to keep the market calm; however, we feel this will raise more questions and create more uncertainty. If this uncertainty is not adequately addressed, this will create greater market turmoil.

For those who have been following Pakistan for some time, it should be clear that a BoP crisis is not characterized by a massive adjustment in the currency, or a multiple increase in inflation and interest rates – unlike other developing countries, our policymakers *directly* manage the economy. In our view, Pakistan's policymakers are very adept fire-fighters: their actions will not allow the macro economy to go into a tailspin, even if these steps sour and scar market sentiments. In effect, being on the watch-list and becoming estranged from the IMF, could isolate Pakistan from the global economy, but for *seasoned* players who are familiar with Pakistan's economy (including many foreign companies), this is business as usual.

So while the negative impact of being placed on the watch-list may be cushioned somewhat, it reveals that Pakistan as an investment destination, is not for the faint-hearted. Unless the government machinery in Pakistan (or the social contract) is completely overhauled, the country will not be able to escape the vicious cycle of the past three decades.

Conclusion

If our assessment feels all too familiar, it unfortunately is. If Pakistan's policymakers are unable (or unwilling) to change the poor economic behavior of its citizens, it is only possible to enhance the country's welfare by a limited amount. If Pakistan's economy continues to be structurally weak, the country will remain vulnerable to external influence. As discussed earlier, Pakistan appears to be on a boom-bust cycle that repeats every 3-4 years: the exception is when the country experiences a positive external shock.[2]

For many decades now, Pakistan's *Achilles Heel* has been its exports. The past three years have been particularly hard on exporters, which is reflected in the growing trade deficit. Unlike the past, the belated efforts to help exporters should not be ad hoc policies like generous fiscal incentives that cannot be sustained. What the country needs is a level playing field that allows exporters to plan for the medium-to-long term, and to be confident that policies are not changed mid-stream – in a nutshell, exporters need policy consistency, and efficient/pro-active institutions that oversee and regulate international trade. As we have been saying since January 2017 (*Does Pakistan need an Industrial Policy?* January 5, 2017), CPEC could be dovetailed into this need to increase Pakistan's exports.

But it's not just about exports. While policymakers have been dealing with regular BoP challenges, their inability to use policy levers to narrow the external deficit can increasingly be traced to the growth of the undocumented economy. Operating outside the direct control of policymakers, demand pressures that are based on the thriving informal economy, cannot be managed by increasing interest rates or by depreciating the currency. Since consumption and investment demand is reflected in our growing imports, we would argue that the persistent growth in undocumented wealth is a key driver of import demand. However, policymakers have been reluctant to act on this source of demand.

Having said this, it is only a matter of time before sacred cows like real estate, *Pakistani* business practices and hoarded cash balances, are forced into proper documentation. As we discussed in a previous paper (*Could the next IMF program be decisive?* December 12, 2017), more accurate documentation of real estate valuation *alone* (with an equitable capital gains tax) would be a powerful tool to reduce demand pressure. This is now required to narrow the external deficit.

[2] The last two positive shocks should be familiar enough: 9/11 forced the kerb FX market to cease activity, which allowed for a consumption-led economic boom during 2003-06, which ended with the macroeconomic meltdown in 2008. The more recent positive shock was the collapse in oil price in mid-2014, which allowed for strong economic growth and BoP comfort for the years FY14 to FY16.

So the real issue is whether the terror financing watch-list will simply force Pakistan to bargain the terms/conditions of its economic survival (as it has in the past), or whether this could jolt the country to seek real sovereignty in policymaking. If it wants the latter, there is no escaping tough economic decisions, even if they hurt our policymakers' personal interests. While our past has shown that personal interests prevails over what is in the country's interest, the point to consider is whether the changing global order, or the possible dynamics from the FATF watch-list, could force us to do the right thing.