GoP's mixed signals, the IFI's clarity & the task ahead

Mushtaq Khan[1], April 11, 2019

This paper will start with an overview of the discussions I had with businessmen in recent days. It will then summarize the views of the three international financial institutions (IFIs), which contradict the Finance Minister's optimism about the state of the economy. In our view, this BoP crisis is different from past troubles because of the rapid debt build-up in FY18 and FY19, which means the forthcoming stabilization program will be as challenging as the November 2000 Standby Arrangement with the IMF. The paper will then flush out what this means and what policymakers should prioritize. While the proposed amnesty scheme is expected by mid-April, we conclude that since this will be a tough transition, the government should use the economic lull to clean-up the system and put this economy on the right path. Despite the pervasive cynicism, we feel that certain political & geopolitical factors could help this government push through the much-needed reform process.

Idle chatter

In discussing the state of the economy with commercial entities, two points attract a clear consensus: one, the PTI government was too slow to take charge of the economy it inherited, and it now owns the problem; and two, there are too many mixed signals about what this government seeks to achieve.

People will talk about the *Riyasat-e-Medina* vision of the PM, and contrast this with the messaging from the Finance Minister. Then there is the government claim that it had the upper-hand in its negotiations with the IMF, which suggests that the program should be relatively easy. Some have mentioned that the government's concession to non-filers contradicts its desire to bring them into the tax net. And finally, there is clear message that hard steps have been taken in the past six months, which means economic growth will soon recover. All this while, the stock market under-performs as investors are still not certain about where the country is heading.

Dysfunctional kerb market

In any discussion, the focus inevitably becomes the currency. The FM's statements that further devaluations are not needed, are viewed in light of current conditions in the kerb market, where the supply of Dollars has dried up. As has become customary, SBP called in the large money-changers several times last week to discuss the pressure in the kerb market, as this complicates the management of the interbank rate. Predictably, SBP insisted – and money-changers agreed – that the kerb rate would not exceed 1% of the interbank rate. Whether people are able to secure Dollars at this rate, is another issue.

As this is a topic of much interest within the media, prominent money-changers have become regular "experts" who explain what is likely to happen. In a recent interview, the president of the Forex Association talked about the distinction between legitimate demand for hard currency, and speculative purchases. He claimed that members of the association (money-changers and Foreign Exchange Companies) make a distinction between the two, and only cater to legitimate demand.

[1] The author would like to thank Danish Hyder for his editorial assistance.

This is a disturbing development: it appears that the managers of the parallel FX market have taken it on themselves to self-regulate, and determine whether purchases are legitimate or speculative. Nothing is said of the fact that if speculators were willing to pay more for cash Dollars, moneychangers would earn higher profits. This begs the question: should a regulator have a financial stake in the market it regulates? If this is not checked immediately, SBP will lose all moral authority with – and control of – the kerb market. In our view, money-changers must be strictly regulated by SBP.

Media reports claim that the FM has categorically stated that both the GoP and the IMF are not targeting a specific PKR/$ parity. This is true. One must understand that once the magical rate is reached, the market will be in equilibrium, which means Dollar inflows would be equal to outflows, and market sentiments would automatically reflect this sense of calm.[2] This is pure fantasy.

The truth of the matter is – and the FM did mention this – that the IMF does not want a specific PKR/$ parity, but is seeking a change in the entire currency regime. Media reports have already covered the policy intent to shift towards a more market-driven exchange rate regime. Unfortunately, when contemplating such a policy shift, the internal decision must be implemented *immediately*. If the point is to change sentiments in the FX market, it cannot be announced and debated beforehand, as the market will preempt the decision and adjust its behavior accordingly.[3]

The IFIs clear up the picture, and sneak in a warning

While Pakistan's policymakers fumble towards stabilization, the IFIs have become increasingly vocal about what lies ahead. In the recent past, the three key IFIs have released their assessment of how Pakistan's economy will fare. The Asian Development Bank was the first, and although it did not project the country's economic performance in the years ahead, it caused a stir by asserting that growth this year would only be 3.9%. This punctured the government's narrative, and paved the way for harsher commentary.

Table 1: IFI projections	FY18	FY19	FY20	FY21	FY24
Real growth % (IMF)	5.2	2.9	2.8	na	2.5
Real growth % (WB)	5.4	3.4	2.7	4.0	na
Real growth % (doctored papers)	5.8	3.0	na	na	na
Fiscal Deficit % GDP (IMF)	6.5	7.2	8.7	8.0	7.7
Fiscal Deficit % GDP (WB)	6.5	6.9	6.3	5.3	na
Fiscal Deficit % GDP (doctored papers)	6.6	na	na	na	na
CA Deficit % GDP (IMF)	6.1	5.2	4.3	na	5.4
CA Deficit % GDP (WB)	6.1	5.6	2.9	2.4	na
CA Deficit % GDP (doctored papers)	6.1	4.5	na	na	na
Avg Inflation % (IMF)	3.9	7.6	7.0	na	5.0
Avg Inflation % (WB)	3.9	7.1	13.5	11.0	na
Avg Inflation % (doctored papers)	3.9	7.9	10.7	na	na

Source: WEO & FM April 2019, IMF. South Asia Country Briefs, Apr 2019, WB

The projections from the Washington-based IFIs were more detailed (see **Table 1**). In looking at these numbers, one must realize that Pakistan is one country in a regional assessment (WB), and an even smaller player in the global economy (IMF). The point to make, is that these assessments are stale (i.e. not current), and as we will argue later, the IMF's macro projections are almost absurd.

[2] Policymakers who talk about an equilibrium exchange rate should refrain from opining on an issue that simply doesn't exist. An equilibrium exchange rate only exists in theory, but is casually discussed in policy circles as some sort of fact. In our view, an equilibrium exchange rate is as real as a unicorn – a mythical horse with a prominent horn on its forehead. In fact, even the level of over/undervaluation of a currency can be disputed, as it hinges on the date at which the analyst assumes that the exchange rate was "in equilibrium".

[3] If there is credible reason to believe that the currency regime will change (to narrow the trade imbalance), this will actually increase the trade deficit in the short term. Importers will rationally front-load their purchases, while exporters will delay the surrender of hard currency till they can get a higher pay-off via a flexible exchange rate regime. As a rule of thumb, currency management should never be discussed in public.

The World Bank believes economic growth would be 3.4% this year, while the IMF thinks growth will be below 3% – both claim that growth in FY20 will be lower. But this is where the similarities end, which is strange given the close coordination between the two IFIs.

In **Table 1**, the World Bank shows that the slowdown in growth is based on a sharp contraction in the external deficit (from 5.6% of GDP to 2.9% in FY20), but not because of the fiscal side, as the fiscal deficit only narrows to 6.3% in FY20. The report explains how stubborn defence spending, the likely spike in debt servicing and slow revenue generation in FY20, will not make it possible to narrow the fiscal gap.

The IMF paints a very different picture. It shows that while growth will fall sharply this year, it assumes almost similar growth in FY20. Furthermore, unlike the World Bank, the IMF doesn't factor in a stabilization program in FY20, which is shown by the fact that there is only a moderate fall in the external deficit while it predicts a sequence of unsustainably large fiscal deficits till FY24 (see **Table 1**). Easing inflation next year is also a sign that the PKR has not been devalued much.

While the IMF appears to assume there will be no stabilization program next year, it does predict that without serious policy changes, Pakistan's economy will continue to underperform, and will slow further to 2.5% growth in FY24. However, these projections are inherently flawed: (1) without a stabilization program and the good house-keeping seal of approval, how could Pakistan *finance* a 5.4% external deficit in FY24? And (2) with a significant increase in the fiscal deficit in FY20, how does inflation fall in that year?

What the IFIs say about the size of Pakistan's twin deficit is insightful. We have long argued that Pakistan's twin deficit, which hit 12.6% of GDP in FY18, was a clear sign that the country's macro imbalances are unsustainable. Both the IFIs show that Pakistan's twin deficit in FY19 will be 12.4% and 12.5%, respectively, which basically means little has been done during the year to narrow the imbalances. But while the WB sees a course correction in FY20 (the twin deficit narrows to 9.2% of GDP), the IMF actually thinks the imbalance will get worse at 13%.[4]

Since we are convinced Pakistan needs an IMF bailout, this means the real economic pain will be experienced in FY20.

Pakistan is struggling with the debt overhang

The sharp increase in Pakistan's debt-to-GDP ratio is more damaging. In this area, the messaging from the two IFIs is similar. The World Bank report shows that Pakistan's indebtedness experienced a massive increase in FY19, increasing from 73.5% of GDP in FY18, to a projected 82.3% this year. This 8.8% increase is a harsh reminder of the short-term borrowing carried out to finance the external deficit, followed by devaluing the Rupee as a rear-guard action. SBP has identified this problem: for the period March 2019 to February 2020, Pakistan must repay $ 22.4 bln, of which, at best, $ 7.8 bln of FX swaps could be rolled over. That still leaves $ 14.7 bln that must be repaid (in 12 months) to bilateral/multilateral lenders, commercial creditors and holders of Eurobonds.[5]

The IMF goes one step further. Within the cohort of Emerging Market & Middle-Income Economies, Pakistan is consistently the worst performing in the group of 40: (1) the largest fraction of Pakistan's debt matures in any given year (roll-over risk); (2) Pakistan's revenue stream is the second lowest as a

[4] How Pakistan will be able to fund these deficits undermines the credibility of the IMF's projections.
[5] This debt repayment stream will shape the targets that the IMF sets for SBP's net international reserves (NIR), which will force the authorities to sharply curtail the country's monthly current account (CA) deficit.

percentage of GDP; (3) Pakistan posts the steepest rise in gross debt to GDP (which will continue to rise from 72.1% of GDP in FY18 to 85.6% in FY24); and (4) the average maturity of Pakistan's government debt is only 1.1 year, which is the lowest in the cohort of 40 countries (India comes in at 9.3 years, Egypt is at 3 years, and South Africa is at 13.1 years).

Preparing the economy for stabilization

As we have discussed in past papers, it should be possible to narrow Pakistan's current account deficit this year to $ 12 bln. As shown in **Figure 1**, the trajectory of the CA deficit since January 2019 has been heartening, and with a lagged pass-through of lower oil prices (**Figure 2**), narrowing the external deficit this year should not be a stretch. The real issue is the size of the external gap in FY20. In our view, with stagnant remittances and exports, imports would have to be brought down to the point that the CA deficit next year does not exceed $ 7 bln (this is extrapolated in **Figure 1**). While the adjustment is significant (after an external deficit of $ 19 bln in FY18), one must realize that the CA gap must be small enough to accommodate the large *capital account* outflows that will materialize in the coming year (i.e. debt servicing).

Fig 1: Monthly CA Deficit ($ bln)

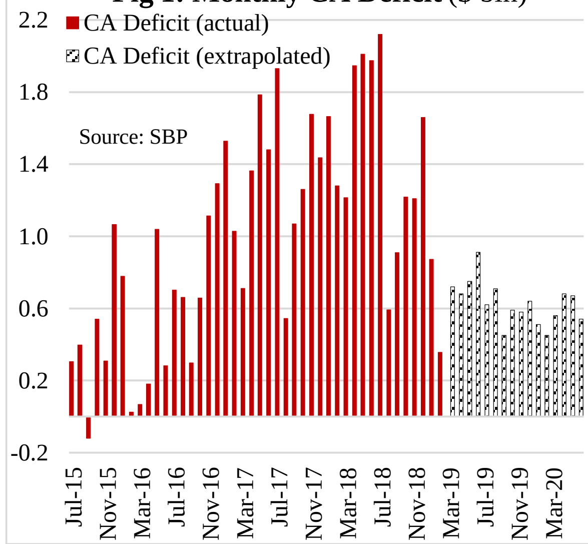
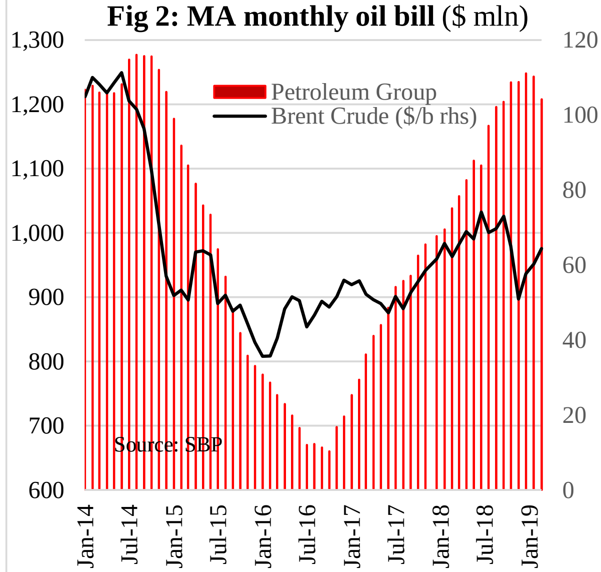


Fig 2: MA monthly oil bill ($ mln)



Let's put this into perspective: if SBP were simply to maintain its current level of FX reserves (at $ 10.5 bln), post a current account deficit of $ 12 and $ 7 bln for FY19 and FY20, respectively, and also roll-over all FX swaps, net outflows from March 2019 to February 2020 would be a whopping $ 23 bln. This means borrowing about $ 2 bln each month from bilateral/multilateral sources and others, just to keep SBP's FX reserves at their current level.[6]

That is why this program will be different from the last two. This time around, low FX reserves need to be built-up not just to a 3-month minimum coverage (for imports), but also to create a repayment capacity for the external debts. In some ways, the challenges ahead are similar to what Pakistan experienced in May 1998, when after we responded with our own nuclear tests, the IFIs totally disengaged and the US imposed binding sanctions on the country, which was already reeling from the freezing of foreign currency accounts.

[6] One must realize that $ 10.5 bln is just 2⅓ months of import cover, which means at the very least, the IMF will insist on 3-months coverage. Some would argue that even the $ 7 bln external deficit in FY20 is too large, which means efforts to compress imports further would leave economic growth at levels that are driven by the population, and growth in agriculture (primarily livestock).

The shortage of FX was so acute, that SBP effectively stated that by end-2000, Pakistan would not be able to service its external debts. This paved the way for the November 2000 Standby Agreement with the IMF, which was tough but successful. At that point, there was only one policy priority in the country – complete the IMF program, and enter into a longer 3-year growth program.

As things stand, while the slowdown in growth will continue for at least 18-24 months and imports will become more expensive, the authorities should consider a national campaign to discourage imported consumer products (durables and foodstuffs). This is necessary to influence import demand, signal policy urgency and could sway consumers to adopt a nationalist viewpoint where imports are concerned.[7] This may not have a material impact on Pakistan's import bill, but if cash imports of high-end consumer items do fall, this should increase the inflows of hard currency from the GCC, which eventually will enter the interbank market. At this point in time, policymakers must take all necessary steps to convey the urgent need to change consumption patterns, as this will help SBP manage the Rupee when it is up against strict NIR targets. In our view, the market does not fully appreciate how hard things could get.

PTI's Amnesty Scheme

The government is expected to announce a new Amnesty Scheme in mid-April till, which will end in June 2019 – this will replace the previous scheme announced by the PML-N government. The new scheme will increase the coverage of assets, require more details of banking transactions; and ask people to file tax returns for FY18. Furthermore, tax rates to regularize benami accounts & liquid foreign assets will be increased; credit entries in bank accounts (actual and benami) will carry a higher tax rate; and there is a requirement that all foreign assets be repatriated back to the country.

This scheme will supersede the PML-N version, and is clearly stricter. This should address concerns that the previous scheme was too lenient towards those who hid their wealth, while punishing those who pay their taxes and declare their assets. While a vocal subset of the elite will push-back against this scheme and demand easier terms, it is up to the government to stand firm and show its commitment to see it through.

Play the politics & geopolitics

From a political-economy perspective, the government faces a tough choice: it could become defensive and muddle through the political criticism that will build on growing public anger, or it could go on the offensive and generate public support along the way. The latter entails a total change in the government's narrative, where accountability for past misdeeds is taken as the primary objective for the next two years. This means a disruptive cleaning-up process that will dampen economic activity; it also means compelling people into the tax net and ensuring that they pay their fair share of taxes. It basically boils down to rewriting the *social contract* with the people – not with the elite, but with the people who voted PTI into power.

But to go on the offensive, the government needs a game plan. It needs to gain the moral high ground to hold others to account, which means its own political machinery must be clean. If the government gears up to investigate people for their past misdeeds, it must ensure that the judicial system is fair; the investigating agency is professional; and the policymakers driving this cannot have fingers pointed at

[7] There is a valid argument that even a significant increase in retail prices may not deter demand for high-end consumer items. This is especially relevant in Pakistan, where a sizeable part of high-end demand is driven by people who have substantial undocumented wealth, or large cash balances. To keep this spending in check, the forthcoming amnesty scheme should be launched with a media campaign to put these people on notice, making clear that their spending habits could be monitored as part of the documentation exercise.

them. This level of transparency and cleansing will not be easy in a country where systems, institutions and procedures are already compromised.

But there are some upsides: (1) Pakistan now finds itself in such a dire situation that it has no choice but to target the untouchables; (2) the election of the PTI government is the most significant change in the country's political landscape since the late 1980s (the end of the Zia-ul-Haq era); and (3) with the change in the global order, Pakistan has a trusted ally in China. These are important ingredients that could forge a bold path forward. Despite the likely hardship in store for the country, the public's frustration with the status quo may be sufficient to bring about real change. The real issue, in our view, is whether the status quo has any regret for its role in the poor state of affairs, and wants to change things.

Conclusion

There is a sense of disillusionment regarding the government's economic strategy. Policy measures have not narrowed the twin deficit, and the market is expecting hard times ahead. Furthermore, the slow start to proper management of the economy has killed the goodwill the government had when it first came to power. Pakistan's economic problems may have been engineered by Ishaq Dar, but Asad Umar now owns them. Uncertainty about the currency is understandable, as Pakistan's economy is addicted to imports, but the country's external deficit is now too large and must be narrowed sharply (Blog: *The need to overcome Pakistan's addiction to imports,* 3 April 2019).

The key IFIs have painted a more realistic picture of how this economy will fare. Growth this year will be in the range of 2.9 to 3.9%, while the fiscal deficit is projected at 6.6 to 7.2%. In effect, Pakistan's twin deficit this year will remain at an alarming 12.5% for the second consecutive year. While the World Bank has correctly assumed the start of a stabilization program in FY20, the IMF has not! The Fund appears to be sending a warning to the country, that if our policymakers continue to drag their feet on corrective policies, economic growth will not only slump below 3% this year, but will keep falling for the next five years. This will likely end PTI's political prospects.

Both the previous and current governments are responsible for the debt trap that Pakistan is in. Global experience shows that getting out of a debt trap is very painful, and we think the market does not fully appreciate how hard things could get. To overcome this challenge, polices alone may not suffice – we feel the government must start a nationwide media campaign to discourage all imports, even if this curtails economic activity.

While this may seem to be an insurmountable challenge, the dire situation also creates an opportunity. If Pakistan enters a recession in FY19 and remains within one in FY20, it opens up the possibility of rewriting the social contract in the country. This means the government promises to clean up corruption and put an end to the *elite capture* of policymaking, and in exchange, the people have to bear the economic hardship for the next 18-24 months. By pushing hard on accountability, and showing the country that no-one is too powerful to defy the laws of the land, PTI could bring about a tipping point for the country.

A final thought: Pakistan is too large a country, and one with too many unique characteristics, to adopt an imported development paradigm. Policymakers need to think outside the box and think for themselves. A heuristic approach to economic development (the Chinese model), dovetails well with CPEC, and this relationship must be leveraged to solve as many economic problems as possible. If globalization is going out of fashion and bilateral agreements take hold, Pakistan has a head-start with China.

