IMF negotiations with a Twist

Mushtaq Khan, November 9, 2018

For the second time in five years, Pakistan is negotiating a bailout package with the International Monetary Fund (IMF). Media reports claim the IMF mission will complete its negotiations by 20 November, which means the news stream for the next two weeks will cover these proceedings. The point of this paper is to give clients a sense about what is likely to make headlines (which could impact the markets – PSX), but more importantly, to gauge whether the next IMF program will incorporate the unorthodox policy measures we have been advocating.

If these negotiations result in a new IMF program, it would be the 13th since 1988. However, this one should be different for a simple reason: financial assistance from friendly countries is expected to be part of the IMF bailout package, which is a first for Pakistan. It remains to be seen whether this bilateral aid comes with conditions, which need to be incorporated into the next package. While the $ 6 bln committed by Saudi Arabia will certainly help Pakistan (and is not likely to have policy conditionalities), the fact that China has not committed a figure so far – but has proposed the creation of a taskforce to evaluate Pakistan's needs – is new and interesting.

In our view, the measured response from the Chinese government is not an effort to stall or deflect Pakistan's call for help. Local media reported that the Pakistani delegation has already reached Beijing on 8 November.[1] As the delegation includes the SBP Governor, and federal secretaries from Finance, Commerce, Planning & Development and Foreign Affairs, the discussions should be serious and consequential.

While the market perceived the lack of a number (i.e. the quantum of Chinese aid) negatively, we take it as a positive step forward. From our perspective, this reveals that China's desire to help Pakistan goes beyond short-term financing, and entails a more substantial effort to solve Pakistan's structural problems. This makes sense as a structurally weak Pakistani economy cannot sustain CPEC. While this may appear to be driven by China's self-interest, it also helps Pakistan.

What is foreign investment?

For decades, Pakistan's policymakers have been trying to solicit foreign investment, with little success. In our view, these promotional pitches were really motivated by the need to secure hard currency to finance the external deficit. One must understand that foreign investment (especially foreign direct investment – FDI) *is not a grant, and is certainly not cheap*. FDI may not be a debt, but if one believes in the risk-reward trade-off, and knows that sovereign debt is the least risky investment, this means the dollar returns on the latter should be much lower than if the foreign investor has invested in a project that carries greater risk and has a delayed repayment schedule.[2]

[1] Unlike some views expressed in local media, this is not a snub to the visiting IMF mission. Most of the discussions between Pakistan and the IMF mission are technical discussions that do not involve senior management. Once the two sides decide on their stance on the program design, senior management negotiates the final program. This happens nearing the end of the visit, and takes a day or two at most.

[2] For example, let us consider three types of foreign investment in Pakistan: (A) a foreign bank makes a dollar loan to the Government of Pakistan; (B) a global fund invests in the PSX; and (C) a foreign company invests in a power generation project that will take 4 years to come online. In terms of risk taken by the foreign investor, clearly C is riskier than B, which in turn is riskier than A. Taking into account the liquidity of these investments and the time-lag before repayments begin, we would argue

CPEC is Chinese investment characterized as class C (see footnote 2). For CPEC to be successful, the returns on these investments must be sufficient to compensate for their illiquid nature, and the delay before repayments begin. Furthermore, given the scale of CPEC, success hinges on a strong macro economy, whereby Pakistan is able to sustain its external repayment stream. Instead of thinking of the Chinese request to discuss financial assistance as a negative, this should be viewed as the legitimate concern of a large foreign investor who is looking out for its interests.

There is an upside for Pakistan: by looking out for its self-interest, China will want to ensure that Pakistan's economy is on a sound footing. This necessarily means the unaddressed structural problems that have hampered Pakistan's economy for decades, need to be tackled despite the heavy political price. Since Pakistan's policymakers have consistently lacked the political will to implement hard reforms, this puts the country into a dilemma: appease Pakistan's moneyed interests that resist reform, and alienate Pakistan's only global ally, or vice versa.

What could come of CPEC?

In a past paper (*Pakistan's Balance of Payments, the IMF & China*, 14 September 2017) we said:

> *Some view China as the country's [Pakistan's] savior, which will use its ample resources to ensure that Pakistan's economy is not disrupted – others fear that Chinese commercial loans (imposed on Pakistan), will only add to the country's BoP worries.*

This debate is now getting more airtime as some market participants are convinced that China will not provide easy funding, while others are expecting a huge financial package that would make the IMF unnecessary. The FM's press conference statement that the balance of payment crisis is over (6 November) has been used to suggest that China is behind Pakistan all the way. In our view, this entire discussion is misguided.

In our September 2017 paper, we put forward three distinct (and somewhat extreme) answers to a simple question: *how will China deal with Pakistan when it runs into a BoP problem?*

1. <u>China bails Pakistan out with few conditions</u>. In this scenario, China effectively encourages Pakistan to leave the ambit of the IMF, and is willing to tolerate Pakistan's economic indiscipline as an acceptable price for having a loyal ally.
2. <u>China treats CPEC as a purely commercial venture</u>. This means that if Pakistan is unable to meet its contractual repayment obligations, it could pursue one of these two extreme options:
    a) Demand real assets in exchange for repayments that Pakistan is unable to make. In the paper, we talked about a possible debt-for-equity swap, whereby the Government of Pakistan could either sell land, a stake in state-owned companies, free transit rights, etc., in exchange for hard currency it owes China. This would fit into the Western media characterization that OBOR is all about debt diplomacy; or
    b) Help Pakistan develop repayment capacity to meet CPEC obligations. We argued that China and Pakistan could embark on bilateral negotiations to increase Pakistan's exports to China, and renegotiate the China-Pakistan FTA so that more advantages are given to Pakistan.
3. <u>China urges Pakistan to get serious with economic reforms</u>. In this scenario, we suggested that China would not help financially, but would nudge Pakistan's policymakers to enter into and implement a tough IMF program. We said that Pakistan's economic health is an important factor for China, as future BoP problems would undermine CPEC.

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that if the return on A is 7.5%, then B should be in the range of 9-10%, while the returns on C could be around 13-15%. And this return is in dollar terms, which means the higher return incorporates the currency risk foreign investors must also bear.

We concluded this discussion by stating that the preferred options for both China and a reform-minded Pakistan, would be options 2b and 3. This appears to be playing out.

To put this issue to rest, we would argue that if China had announced a package (say $ 6 or 10 bln) at the end of Imran Khan's visit to China, this would have been interpreted as option 1. Without hard steps to narrow the twin deficits, this offer would only delay the day of reckoning. By suggesting a taskforce to discuss Pakistan's economic needs, China is revealing itself to be a true friend.

The IMF and CPEC

Since a holistic view of CPEC has not been shared with the country, we think media coverage of the IMF negotiations will focus on CPEC. This fits well into the popular presumption that the IMF (acting on behalf of the US) would be critical of CPEC (the face of China's *One Belt, One Road* initiative). Media reports claim the IMF has noted with concern the high guaranteed returns on CPEC power generation projects, and has questioned whether the GoP should sign more sovereign agreements. Local media is likely to talk up China's *debt diplomacy*, using the examples of Sri Lanka, Malaysia and sub-Saharan Africa.

In our view, questions about CPEC details should not be viewed through a geo-political lens – the IMF is well within its rights to caution Pakistan about its future FX repayments. Since CPEC has materialized after the last IMF program was negotiated in mid-2013, this topic will figure prominently. We think the resulting clarity about this mega-project is necessary, and also feel China (and its investors) will welcome this transparency.

The heavy borrowing by GoP in the recent past, and the need to sharply reduce Pakistan's import bill in FY19, will impose hard limits on FX repayments that Pakistan can sustain. Transacting in RMB (via the currency swap arrangement) could provide some relief to Pakistan's BoP, but this is not a solution as the RMB is also a hard currency, and borrowing RMB will add to Pakistan's external debt.

We believe the IMF and China could enter into a cycle of negotiations, where the Pakistani team would effectively become an intermediary between the two. In effect, the IMF will calculate the quantum of external payments that Pakistan can afford in the next three years, and recommend that certain CPEC repayments be rescheduled and restructured. Team Pakistan would then take these proposals to China, which may agree to some delays or propose bridge financing instead; this would then have to be communicated to the IMF, and the cycle would start again.

However, we do not think this will sour relations between the IMF and China. In our view, China would willingly operate within the parameters set by the IMF, and not be dismissive of the Fund. China realizes the IMF is the global lender of last resort, and challenging its authority could destroy the effectiveness of the institution.[3] Furthermore, as China currently champions global free trade (a cause the US has abandoned), it would not want to undermine the IMF as this could impede global trade. For its part, the IMF would also be careful not to antagonize China. As discussed in earlier papers, the unfortunate politicization of the IMF by the US Secretary of State and some US senators earlier this year, sends a strong signal that the IMF is being closely watched by its largest shareholder – the US government. It is, therefore, in the IMF's self-interest to solicit China's support.

[3] As we discussed in a past paper (*Deceptive choices*, 4 September 2018), the Asian Infrastructure Investment Bank (AIIB) is not a substitute for the IMF.

The best outcome for all stakeholders is the following: cordial negotiations that result in a reform program, which instills confidence in Pakistan's economy. This would shore up the IMF's global relevance, while China could shatter the perceived negativity about CPEC (and by association, OBOR). To make all this possible, Pakistan would have to do the heavy lifting.

The next IMF program

As we have been arguing, given the current state of Pakistan's economy, orthodox demand management will have to be supplemented by unorthodox policy measures. With PKR devaluations and interest rate hikes, the government has signaled that hard days lie ahead.

As discussed in an earlier paper (*The Last IMF Program?* 18 October 2018), there are five interrelated areas that require focus, but in a slightly unorthodox manner:

1. External sector sustainability. This entails revisiting the China-Pakistan FTA to narrow the bilateral trade deficit. Policymakers should also make CPEC more transparent, and nudge this mega-project towards Pakistani exports and job creation. We also suggest that CPEC and the FTA should include import substitution, as a way to reduce Pakistan's trade deficit with China.
2. Resolve the circular debt problem. This entails politically difficult policies to: (1) increase power tariffs to eliminate the tariff differential subsidy; (2) eliminate political interference in the operations of the Discos; (3) compel provincial/federal government bodies to pay their electricity bills; (4) launch a street campaign to halt the theft of power; and (5) upgrade the transmission and distribution hardware to reduce technical losses.
3. Documentation and revenue generation. Continue the campaign to identify all overseas assets owned by Pakistanis; continue to penalize non-filers; make all real estate valuations more accurate; create a comprehensive fiscal cadaster; and amend the regulation of foreign currency accounts (FCAs) to satisfy FATF, and stop capital flight.
4. Formulate an Industrial Policy. Use CPEC as a blue print to create an Industrial Policy that focuses on promoting exports and creating jobs. We also suggest that the restructuring of loss-making PSEs be dovetailed into this Industrial Policy, so that politically active workers (in overstaffed PSEs) have alternative employment possibilities.
5. Institutional strengthening. We have been flagging the need to depoliticize the bureaucracy, and strengthen state institutions so they can operate in a professional and independent manner.

Conclusion

Media coverage of the IMF negotiations will focus on the expected increase in inflation, the PKR/$ parity, and disagreements on CPEC. This paper argues that the IMF's concerns about CPEC are legitimate, and this has little to do with the rivalry between the US and China. We believe greater transparency about the mega-project will be good for both Pakistan and China. We are optimistic the IMF and China will come to an understanding about how to stagger future CPEC projects, to make it more sustainable as Pakistan tries to narrow its twin deficits.

We also direct our client's attention to more unorthodox policy measures that could be taken as part of the new IMF program. Indications that the abovementioned five points could be incorporated into the reform agenda, would be a significant step forward. One thing is very obvious: China figures prominently in our reform agenda, and this gives us reason to be optimistic that this time around, the Government of Pakistan will do the hard stuff.

Changing poor economic behavior is not easy. Refusing to pay one's bills and demonstrating when denied services; viewing state employment as a *right* that requires no productive work; using government positions to extract rents; demanding subsidies from a bankrupt government; and hiding one's wealth and refusing to pay taxes, will not allow any country to prosper. If there is anything that would force Pakistanis to change their bad habits, it is the loss of China's support and friendship in this period of global turmoil.