The Challenges Facing Pakistan's Economy

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Introduction

On 14 July, the State Bank of Pakistan surprised the market with a larger than expected increase in interest rates. Two days later, SBP let the PKR adjust, with the currency moving from 121.5/$ to 128/$ in the trading day. Then on 30 July, the PKR appreciated to 124.5/$. In just two weeks, the most closely watched price in Pakistan has unhinged people's expectations about what is likely to happen next.

While these events do not materially alter our assessment of the challenges facing Pakistan, they create a sense of foreboding about the future. The developments of these two weeks have changed our inflation outlook, and the market now expects SBP will increase interest rates by another 100 bps in September. As discussed in our previous papers (*The vicious twin deficits, Parts 1 and 2*, April and May 2018), policy measures like the ones mentioned above, should be carefully weighed against their future repercussions. The steps are significant, but the issue is whether these moves will narrow the external deficit and not feed the fiscal deficit.

One thing is clear; the rising growth momentum posted in the past several years, will end in FY19.

In structuring our assessment of how the country got to this stage, we will split the paper into two parts.

The Problem:

1. To better appreciate the macro challenges that lie ahead, we start with our macro projections for FY19, specifically the PKR/$ parity, retail fuel prices and inflation. These price adjustments are necessary to narrow Pakistan's external deficit, and set the policy mood for the future;[2]
2. We trace the slow buildup to this problem, showing that it emanated (as did all past economic challenges) from short-term policies that first manifested in the country's balance of payments (BoP);
3. We then analyze the spillover on Pakistan's external debt, and how this impacts the fiscal accounts. Since we argue that an IMF program is now necessary, the likely increase in domestic interest rates will add pressure on Pakistan's fiscal deficit in FY19;
4. This policy direction was only halted when the caretaker government took charge in June 2018. We argue that short-term policies *and* institutional weakness are to blame.

The Solution:

5. We look at two players who will determine the path forward: the IMF and the new PTI government;
6. Using the IMF's March 2018 Staff Report, we suggest the broad parameters of the next program, but conclude that for the program to succeed, additional "unorthodox" steps are now required;
7. We then focus on the newly elected PTI government. Given the state of the economy it has inherited, we list several things the new government will need to focus on to create calm in the economy. We argue that while PTI's campaign to eradicate corruption is heartening, implementation may be diluted somewhat as the likely disruption from this course of action, may be too heavy for the new government; &
8. We end with a brief summary of the paper, and our conclusion.

[2] The PKR and PoL prices have a significant impact on headline inflation, and subsequently on domestic interest rates.

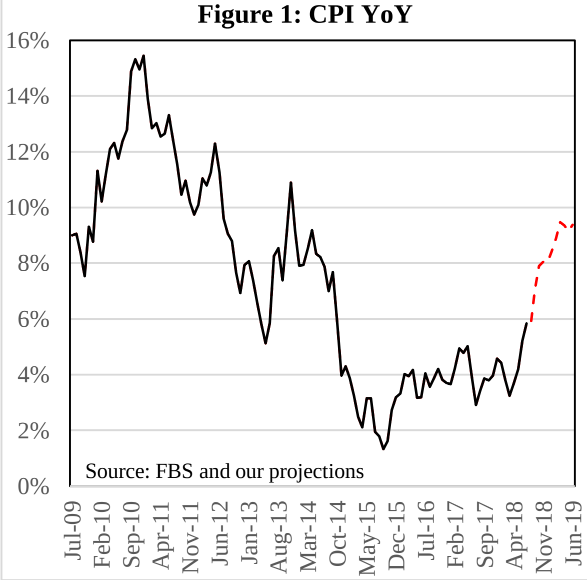
Macro Projections Q1-FY19

We have little hard information to get a handle on what FY19 could look like. Given what has happened since the announcement of the Federal Budget (in April 2018), we can safely disregard this economic roadmap. Furthermore, as the caretaker government has stated that it will not begin talks with the IMF, there is no alternate master-plan to build upon.

In this section, we focus on Pakistan's balance of payments (BoP) to suggest the likely use of three key prices to stabilize the economic outlook – the PKR/$ parity, retail fuel prices, and interest rates, respectively. In our view, the policy goal should be to narrow the current account deficit as *sharply* as possible, without disrupting the economy.

Table 1: Price Shocks		
	Month end PKR/$	Fuel/ltr (Rs) Super
Jul-17	105.3210	71.30
Aug-17	105.2641	69.50
Sep-17	105.3328	71.50
Oct-17	105.3441	73.50
Nov-17	105.3955	75.99
Dec-17	110.3007	77.47
Jan-18	110.4207	77.47
Feb-18	110.4510	84.51
Mar-18	115.5052	88.07
Apr-18	115.7006	86.00
May-18	115.7074	87.70
Jun-18	121.6337	91.96
Jul-18	124.3320	95.24
Aug-18	125.5920	95.24
Sep-18	131.8520	103.99
Oct-18	131.9020	108.85
Nov-18	132.0820	109.72
Dec-18	134.3320	112.78
Jan-19	134.4120	113.72
Feb-19	134.6720	114.57
Mar-19	137.3620	116.26
Apr-19	137.5420	116.42
May-19	137.7720	116.96
Jun-19	140.3520	118.61

Figure 1: CPI YoY



As shown in **Table 1**, the price increases we have proposed are significant, and will not be easy on the country (especially retail fuel prices). This is a valid concern as such increases just after winning a public mandate, are not politically feasible. If the price adjustments are more tempered, this will be reflected in a larger external deficit than we expect. This means that the new government will focus more on financing the gap than narrowing the gap. This distinction is critical: financing helps ease the short-term pain, but it adds to the debt burden on Pakistan's external sector. In this analysis, we err on the side of hard steps to narrow the external deficit *this year*.

Since fiscal data for FY18 has still not been published, and the FY19 budget is a non-starter, our projections will remain a partial equilibrium analysis.[3]

The PKR adjustments since December 2017, show that policymakers are willing to use this very important price to start the stabilization process – this in turn will be reflected in retail PoL prices. However, given the urgency to narrow the external deficit, we assume that retail fuel prices will be increased using surcharges to reduce the demand for fuel. So even if global oil prices remain in the range of $ 70-80/barrel (Brent Crude), policymakers may have to increase retail fuel prices throughout FY19 (see **Table 1**).

[3] This means our analysis does not fully capture the impact of the price changes (in **Table 1**) on the real sector. More specifically, our analysis will not examine aggregate growth based on how specific sectors are impacted by the price changes shown in **Table 1**.

Research presented by SBP in its FY12 *Annual Report*, shows that the PKR and PoL are the most influential factors in determining how Pakistanis set retail prices. This allows us to use the projections shown in **Table 1**, to predict inflation this year (**Figure 1**).

The near doubling of inflation in FY19 will not be easy to bear. Our model shows a sharp increase in YoY inflation till March 2019, with the average inflation for the year at 8.1%. The point to note in **Figure 1**, is that our projections (shown as a dotted line) build on the sharp increase in YoY inflation that has *already* been realized in the past several months. A key assumption in our model is that retail fuel prices are the most powerful determinant of inflation, as they directly impact the food sub-index (34.83% weight), rent, utilities & fuel (29.41%) and transportation (7.20%).

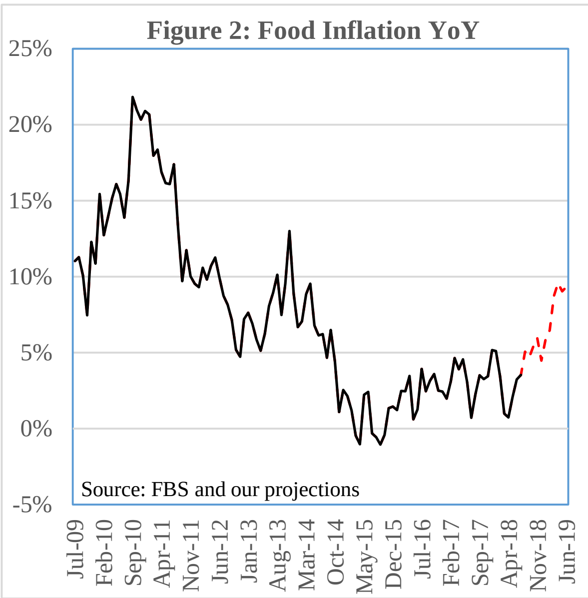


Figure 2: Food Inflation YoY

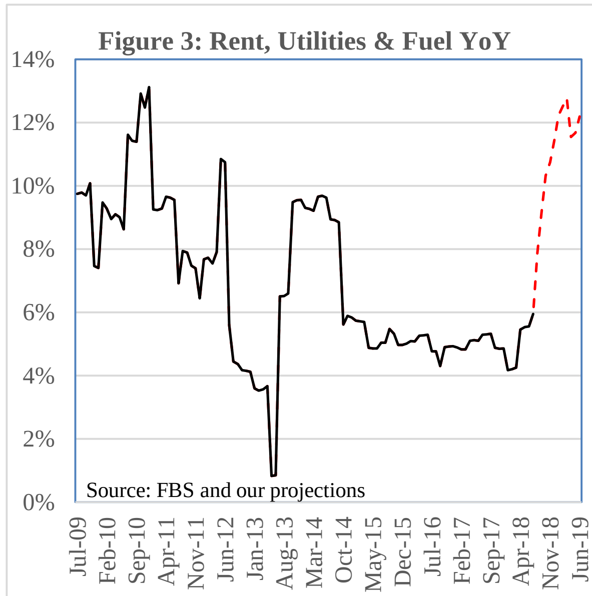


Figure 3: Rent, Utilities & Fuel YoY

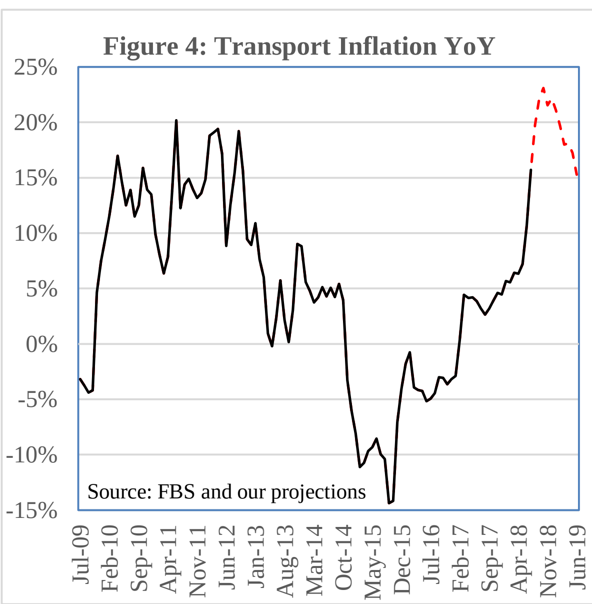


Figure 4: Transport Inflation YoY

In the case of food inflation (**Figure 2**), the role of diesel prices (in terms of trucking) is critical in determining wholesale prices, which are passed on to the retail level. As shown, the increase in food prices is significant, but far from the peak experienced in the past. We believe that the new government will be very careful in monitoring food prices, in order to maintain social and political calm.

Figure 3 shows the impact on the *rent, utilities and fuel* sub-index. This increase is much sharper, but not unprecedented (see mid-2013). We also factor in the likely hike in power tariffs that will be required to halt the further ballooning of the circular debt. Again, the projected trend we have shown, builds on an upswing that started in March 2018.

Figure 4 is the most dramatic. The need to reduce domestic demand for fuel (to clamp down on the country's oil import bill) is the only reason to increase retail fuel prices, despite the spillover on inflation.

As shown, we predict YoY inflation in this sub-index will hit 23% in October 2018. While this may seem excessive, one must note that as of July 2018, YoY inflation has already touched 15.7%. More specifically, **Figure 4** shows that transportation costs have increased sharply in the past 2½ years, and the predicted increase in PoL prices will maintain this momentum. However, because of the base effect, YoY transportation will peak and start falling during the fiscal year.

While our prediction that inflation will more than double (from 3.9% in FY18 to 8.5% in FY19) may also seem overly pessimistic, one must realize that the three sub-indices shown in **Figures 2-4** account for almost 72% of the CPI basket.

It is critical to put the numbers in **Table 1**, and their implications (**Figures 1-4**) into context. Our partial equilibrium analysis is suggestive of direction, causality and the link between PoL and the heavyweights in the CPI basket. The fallout of these price increases (**Table 1**) on imports (oil and non-essential items), the adverse impact on the real sector (consumer spending, autos, electronics, finance/trade, services), and the fiscal pressure from higher debt servicing, will be discussed below.

Barring an exceptional positive shock, FY19 will not be a pleasant year. More specifically:

- GDP growth is likely to fall from 5.8% last year, to a range of 3½-4½ % in FY19;
- With the expected settlement of the circular debt, this means the fiscal deficit could increase from about 6.8 % in FY18, to as much as 8-9 % of GDP in FY19;
- We expect the current account deficit to narrow sharply from $ 18 bln in FY18, to a more sustainable $ 11-12 bln this year. This will not be easy;
- Even though inflation is expected to double in FY19, we do not think interest rates will match this increase, as this would create fiscal pressure. We would predict a further 250 bps increase in the remaining part of FY19, which means the discount rate would be 10% at the end of FY19; and
- It is difficult to predict SBP's import coverage, as the size of the IMF bailout package is unknown.

The Problem:

Pakistan's Achilles' heel – Balance of Payments

The BoP crisis and the lack of structural reforms (in the power sector, in loss-making state-owned enterprises, in tax collection, in weak state institutions and the all-pervasive corruption) are likely to dampen both consumer and business sentiments. This begs the question: how did the country come to such a position, and that too so quickly?

The short answer is that the crisis has been creeping up for years, but most people simply chose to ignore it. **Figure 5** & **6** need to be stared at for a bit. The following are our key takeaways:

- Exports have effectively been stagnant for a decade;
- Imports have exploded in the past two years;
- The trade deficit has been increasing quite sharply since FY12, but has gone off the charts in the last two years;
- The sharp increase in industrial imports (a good thing) has been matched by the increase in the country's oil bill (a bad thing);
- Pakistan's mainstay exports (textiles) have been stagnant in the range of $ 12.7 to $ 13.7 bln since FY11;

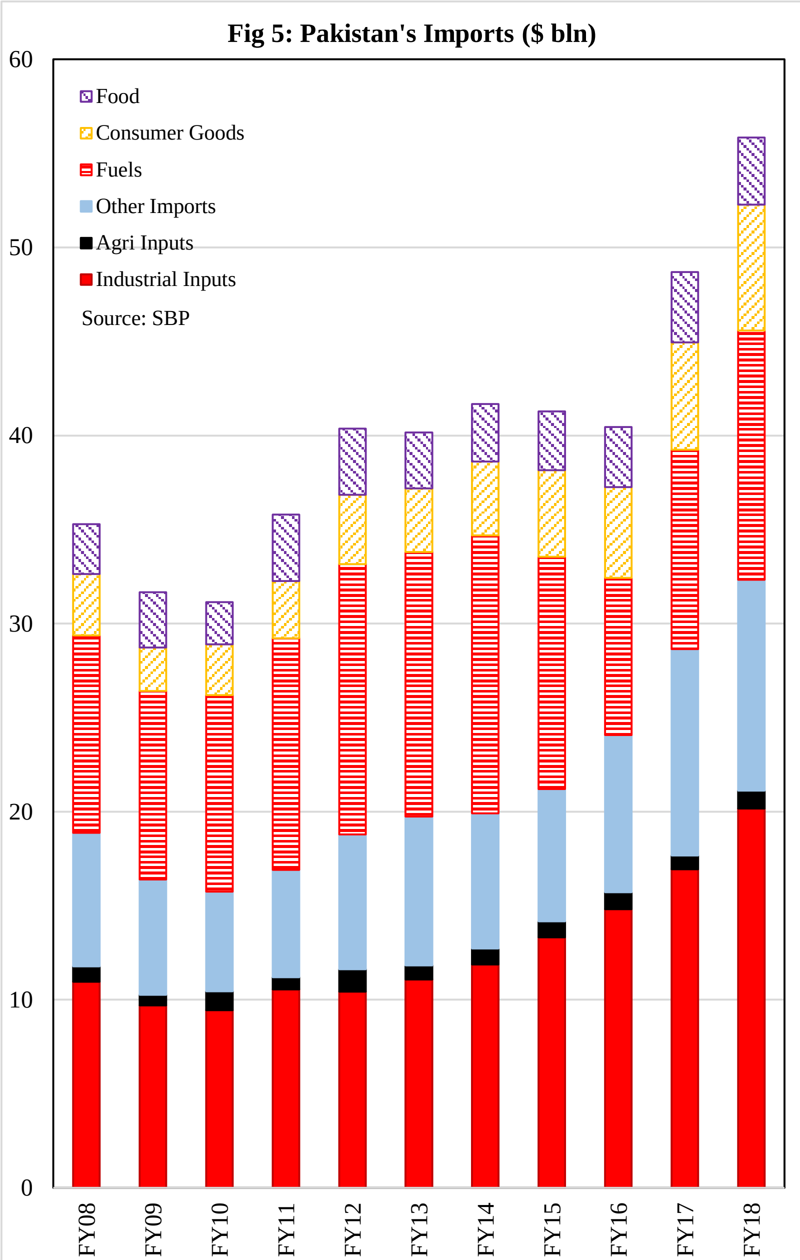


Fig 5: Pakistan's Imports ($ bln)
60
50
40
30
20
10
0
Food
Consumer Goods
Fuels
Other Imports
Agri Inputs
Industrial Inputs
Source: SBP
FY08
FY09
FY10
FY11
FY12
FY13
FY14
FY15
FY16
FY17
FY18

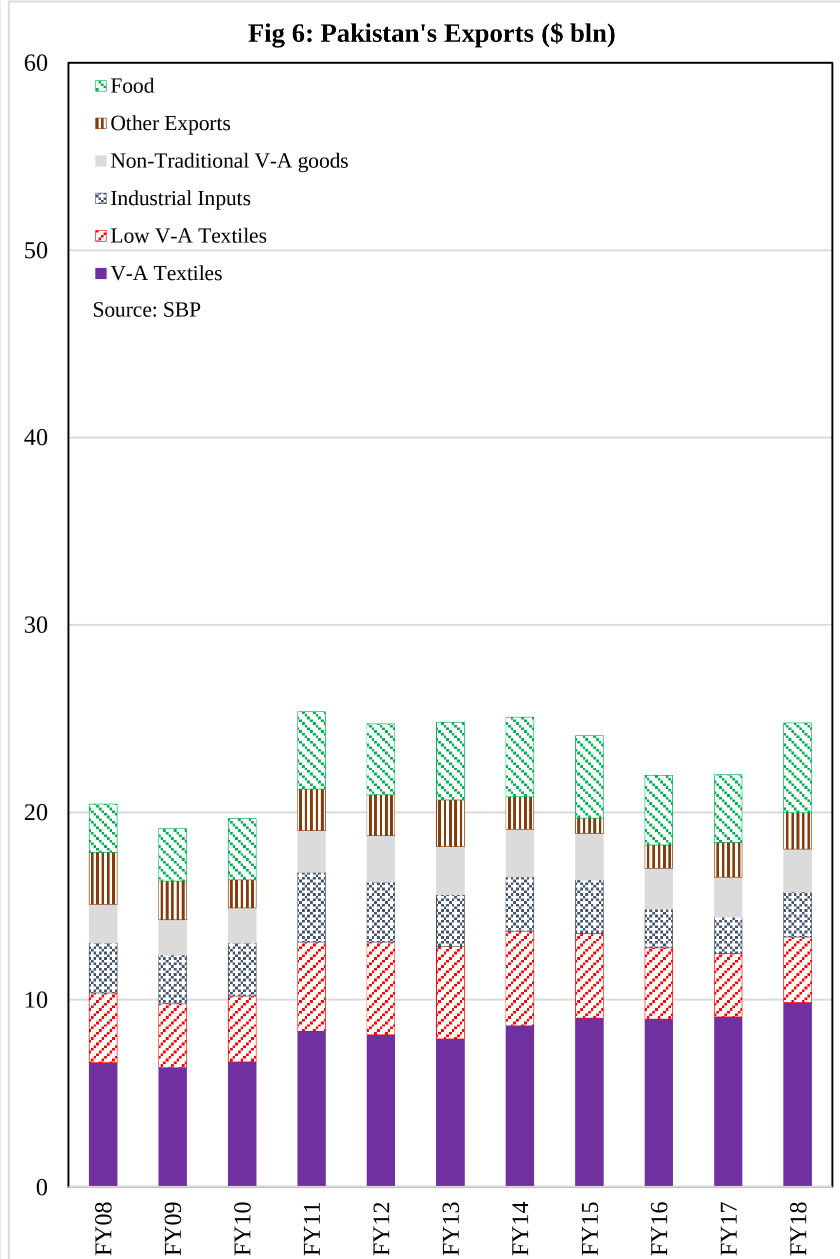


Fig 6: Pakistan's Exports ($ bln)
60
50
40
30
20
10
0
Food
Other Exports
Non-Traditional V-A goods
Industrial Inputs
Low V-A Textiles
V-A Textiles
Source: SBP
FY08
FY09
FY10
FY11
FY12
FY13
FY14
FY15
FY16
FY17
FY18

Table 2: Pakistan's BoP ($ mln)

							Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
BoP BPM6	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**	**FY17**	**FY17**	**FY17**	**FY18**	**FY18**	**FY18**	**FY18**	**FY 17**	**FY 18**
Current Account	**214**	**(4,658)**	**(2,496)**	**(3,130)**	**(2,795)**	**(4,867)**	**(1,660)**	**(3,063)**	**(3,267)**	**(4,631)**	**(3,546)**	**(4,374)**	**(4,276)**	**(5,798)**	**(12,621)**	**(17,994)**
1. Good & Services	(12,456)	(18,957)	(16,919)	(19,240)	(20,237)	(22,689)	(6,438)	(7,208)	(7,712)	(9,661)	(8,539)	(8,776)	(8,878)	(10,052)	(31,019)	(36,245)
- Trade Balance	(10,427)	(15,652)	(15,355)	(16,590)	(17,267)	(19,283)	(5,276)	(6,107)	(7,096)	(8,201)	(7,272)	(7,371)	(7,687)	(8,744)	(26,680)	(31,074)
- Merchandise Exports	25,369	24,718	24,802	25,078	24,090	21,972	5,054	5,577	5,683	5,689	5,664	6,131	6,473	6,504	22,003	24,772
* Textile Exports	13,076	13,068	12,832	13,659	13,540	12,756	3,064	3,037	3,244	3,106	3,264	3,312	3,422	3,346	12,451	13,344
- Merchandise Imports	(35,796)	(40,370)	(40,157)	(41,668)	(41,357)	(41,255)	(10,330)	(11,684)	(12,779)	(13,890)	(12,936)	(13,502)	(14,160)	(15,248)	(48,683)	(55,846)
* Oil Imports	(12,317)	(14,368)	(14,066)	(14,774)	(12,344)	(8,360)	(2,349)	(2,649)	(2,771)	(2,838)	(2,945)	(3,385)	(3,517)	(3,416)	(10,607)	(13,262)
- Services Balance	(2,029)	(3,305)	(1,564)	(2,650)	(2,970)	(3,406)	(1,162)	(1,101)	(616)	(1,460)	(1,267)	(1,405)	(1,191)	(1,308)	(4,339)	(5,171)
2. Primary Income (net)	(3,017)	(3,245)	(3,669)	(3,955)	(4,599)	(5,347)	(993)	(1,426)	(1,005)	(1,624)	(1,022)	(1,489)	(1,043)	(1,728)	(5,048)	(5,282)
3. Secondary Income (net)	15,687	17,544	18,092	20,065	22,041	23,169	5,771	5,571	5,450	6,654	6,015	5,891	5,645	5,982	23,446	23,533
- Remittances	11,201	13,186	13,922	15,837	18,721	19,917	4,740	4,765	4,599	5,247	4,791	4,955	4,862	5,017	19,351	19,625
Capital Account	**161**	**183**	**264**	**1,857**	**375**	**273**	**95**	**30**	**159**	**91**	**104**	**54**	**109**	**109**	**375**	**376**
Financial Account	**2,101**	**1,280**	**549**	**5,553**	**5,074**	**6,790**	**1,941**	**2,817**	**1,556**	**3,884**	**1,634**	**4,730**	**1,636**	**4,022**	**10,198**	**12,022**
- Direct Investment	1,591	744	1,258	1,572	915	2,286	422	967	538	736	699	790	600	671	2,663	2,760
- Portfolio Investment	338	(144)	26	2,762	1,886	(429)	175	615	(134)	(906)	(98)	2,338	18	1	(250)	2,259
- Others	172	680	(735)	1,221	2,271	4,933	1,344	1,235	1,152	4,054	1,033	1,602	1,018	3,350	7,785	7,003
-Inflows	1,092	671	(421)	1,010	2,200	5,029	1,217	1,681	961	5,106	613	1,962	832	4,062	8,965	7,469
-Outflows	(920)	9	(314)	211	71	(96)	127	(446)	191	(1,052)	420	(360)	186	(712)	(1,180)	(466)
Errors & Omissions	**16**	**(80)**	**(309)**	**(422)**	**(8)**	**456**	**(99)**	**166**	**(289)**	**324**	**(339)**	**(123)**	**26**	**(86)**	**102**	**(522)**
Change in Reserves and IMF Funds	**2,492**	**(3,275)**	**(1,992)**	**3,858**	**2,646**	**2,652**	**277**	**(50)**	**(1,841)**	**(332)**	**(2,147)**	**287**	**(2,505)**	**(1,753)**	**(1,946)**	**(6,118)**
- Change in SBP reserves	2,225	(4,430)	(4,530)	3,285	4,595	4,661	379	(50)	(1,841)	(332)	(2,147)	287	(2,549)	(1,795)	(1,844)	(6,204)
- IMF Account	(267)	(1,155)	(2,538)	(573)	1,949	2,009	102	0	0	0	0	0	(44)	(42)	102	(86)
- Exceptional Financing	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
SBP Reserves (gross)	**16,614**	**11,905**	**7,198**	**10,509**	**14,836**	**19,446**	**19,823**	**19,653**	**17,844**	**17,550**	**15,442**	**15,764**	**13,300**	**11,364**	**17,550**	**11,364**
SBP Reserves (net)	14,022	10,803	6,008	9,033	13,088	16,819	18,491	18,272	16,466	16,144	13,857	14,107	11,602	9,789	16,144	9,789
Import Cover in months	**4.96**	**3.21**	**1.80**	**2.62**	**3.92**	**5.28**	**5.37**	**4.69**	**3.87**	**3.49**	**3.21**	**3.13**	**2.46**	**1.93**	**3.98**	**2.10**

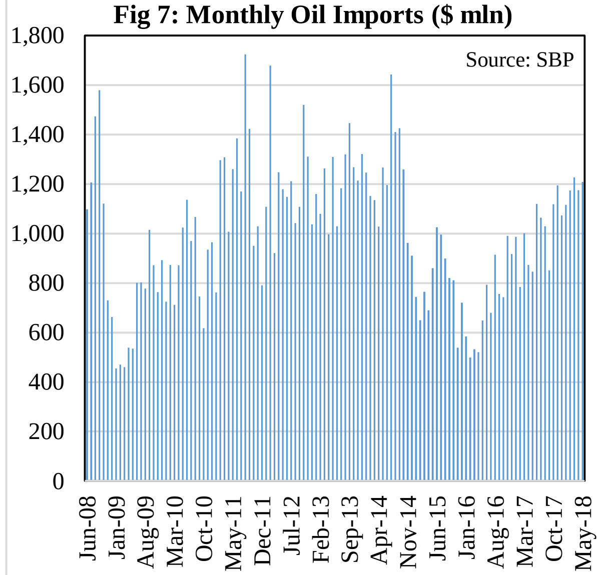
Source: SBP

- From July 2012 till his departure in December 2017, the ex-Finance Minister Ishaq Dar insisted on maintaining an almost fixed PKR/$ parity, which effectively decimated exports and incentivized exporters to look at more lucrative investment opportunities within Pakistan; &
- The trade deficit for FY18 was $ 31 bln, while Pakistan's total exports were only $ 24.8 bln.

Table 2 gives a more holistic picture of Pakistan's balance of payments (BoP):

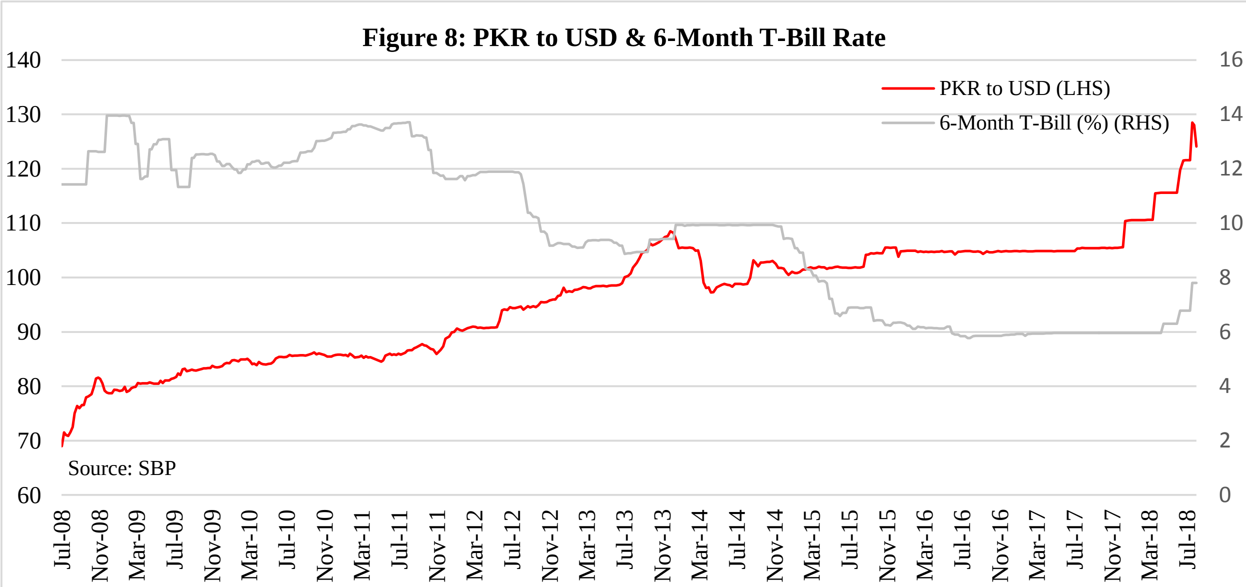
- Pakistan's current account deficit (which is a better indicator of the external deficit than the trade deficit) increased from $ 2.8 bln in FY15 to $ 18 bln in FY18;
- SBP's net FX reserves have been falling consistently every quarter since Q1-FY17, and currently cover just above 2 months of imports; despite fundamentals deteriorating for quite some time, FY17 was relatively easy for SBP to manage. Against an external gap of $ 12.6 bln, Pakistan was able to borrow or get FDI worth about $ 10.2 bln. In FY18, the wheels came off the bus: the external gap was $ 18 bln and despite all efforts, Pakistan only managed to solicit $ 12 bln. Of this $ 12 bln, the standout items were the Eurobond in Q2 ($ 2.3 bln shown in portfolio investments), and the desperate borrowing in Q4 ($3.4 bln shown as *others*). Unfortunately, the latter will have to be paid off soon, which means the outflows from the financial account in FY19 will be stressful;
- Annual remittances have managed to show nominal growth in recent years, but have been effectively stagnant since FY15. The policy comfort from a rising level of worker remittances (in play since FY02) ended in FY15; &
- Another source of external comfort that has disappeared, is the country's oil bill. As shown in **Table 2** (and in **Figure 7**), Pakistan's oil bill fell from $ 14.8 bln in FY14 to $ 8.4 bln in FY16, when oil prices collapsed. As global prices began to recover (so did Pakistan's quantum of imports), the country's oil import bill has once again increased and reached $ 13.3 bln in FY18. **Figure 7** shows that the monthly oil bill had been increasing consistently since mid-2016.

Fig 7: Monthly Oil Imports ($ mln)

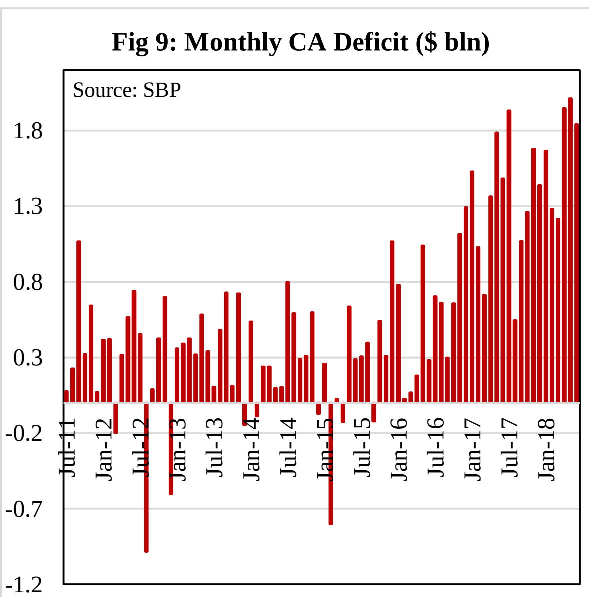


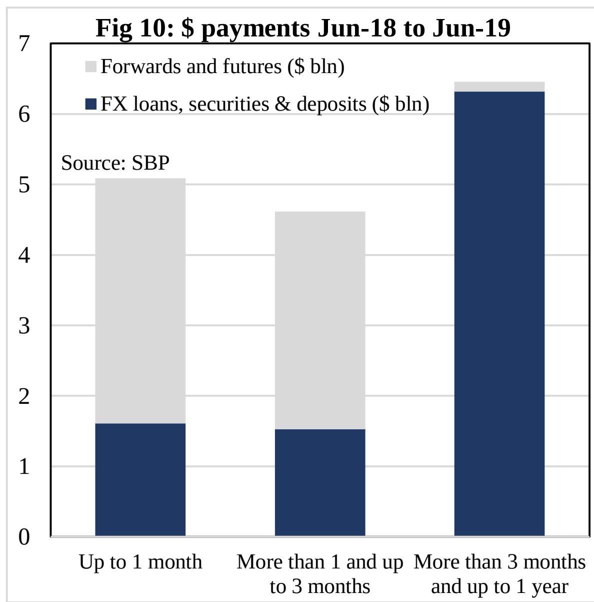
We started writing about Pakistan's BoP problem in May 2017, alarmed by what we saw. Since then, we have written 12 papers that focused on the growing external deficit and the urgent need to address this problem. Fleeting efforts to narrow the external deficit were ineffective, as the political narrative remained convinced that the country could finance its way out of the BoP problem (*Too Little, Too Late?* 18 October 2017).

The heavily managed PKR/$ parity till December 2017 was driven by one person – the Finance Minister Ishaq Dar **(Figure 8)**. During his term as FM, Dar insisted on a "stable" currency irrespective of underlying market forces. As shown in **Figure 9**, even as Pakistan's monthly current account deficit started trending up in early 2016, SBP maintained a fixed exchange rate till he resigned his post on 18 November 2017. In several media interviews, the famously combative FM would challenge reporters to prove to him the advantage of devaluing the Rupee, and would be happy to counter the calls for a more flexible currency by citing the sharp increase in the country's indebtedness if he allowed for a devaluation. This accounting approach to economic management will remain his enduring legacy, and will continue to have dire consequences for the country.[4]



External debt accumulation





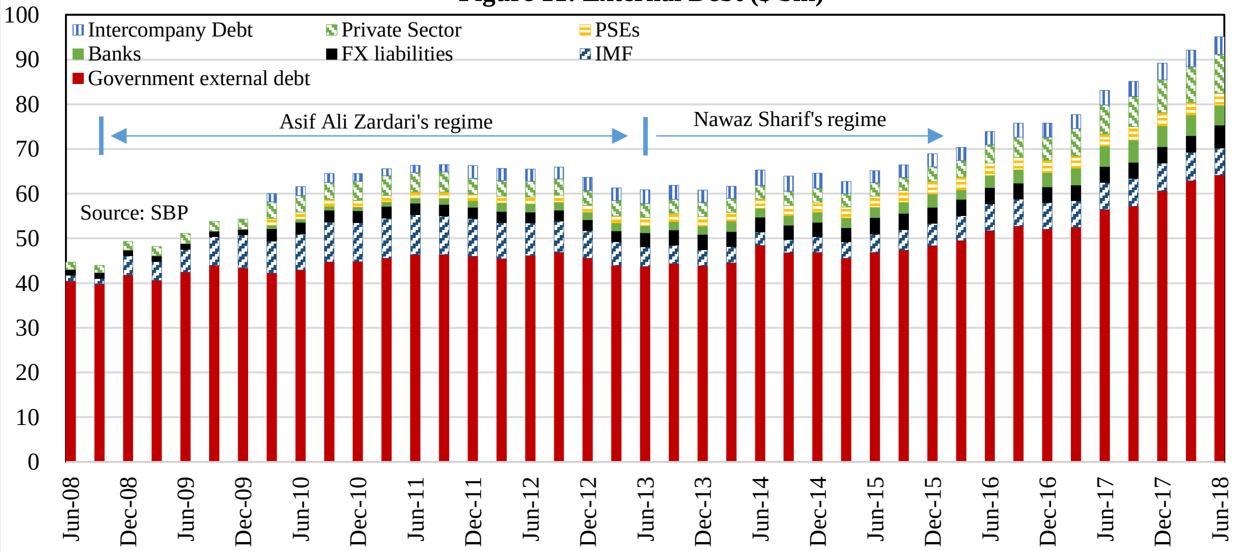
The failure to check short term policy decisions, is best reflected by the spate of commercial borrowings in FY18. As shown in **Figure 10**, the stream of external debt and FX liabilities that must be paid in the next 12 months, is a daunting ask.

From SBP's website, as of end-May 2018, SBP FX reserves were $ 9.5 bln while its debt (and FX liability) repayments for the next 12 months were $ 16.1 bln. In effect, SBP's unencumbered FX reserves at the beginning of June 2018 were *negative* $ 6.6 billion. This means the central bank's current FX

[4] Soon after leaving his post, the PKR was first devalued on 8 December 2017 (moved from 105.6/$ and settled at 110.7/$), then again on 20 March (settled at 115.5/$), again on 11 June (the PKR settled at 121.5/$), and most recently on 16 July (it settled at 128.5/$). From Dar's accounting point of view, just the exchange rate weakness has increased Pakistan's debt by just over Rs 2 trillion since end 2017.

buffer is already earmarked for known repayments, and it needs an additional $ 6.6 bln to meet committed repayments before end-June 2019. To put this into context, even if the external deficit (current account) is zero during FY19, SBP/GoP would have to borrow $ 6.6 bln to repay its debts/liabilities and *still* would have zero FX reserves at the end of June 2019.

Figure 11: External Debt ($ bln)



Despite the sharp fall in SBP's FX reserves, the previous economic team continued to borrow to the point where financial account repayments in FY19 will be just as challenging as narrowing the current account deficit this year.

Figure 11 puts Pakistan's external debt into perspective. During the term of the Nawaz Sharif government, the country's external debt (& liabilities) increased from $ 60.9 bln (at end-FY13), to $ 95.1 bln as of end-June 2018, with an accelerating pace nearing the end. In FY18 alone, Pakistan's external indebtedness increased by $ 11.7 bln.

Fiscal spillover

The country's fiscal accounts for FY18 have still not been consolidated and released to the public. As shown in **Table 3**, the fiscal deficit in FY13 can be traced to the one-off settlement of the circular debt, which perhaps was required to enter the 3-year IMF program in mid-2013. While the improvement in FY14 was easy, the trend in the last two years is disappointing. Expenditures have grown rapidly in recent years, and this pace is likely to pick up in FY19 (see **Table 3**).

As shown in **Figure 12**, the stock and servicing of Pakistan's domestic debt has increased consistently in recent years. While this is the norm in most countries, two trends in the dynamics shown in Pakistan are worrying: (1) the stock of debt has increased quite sharply in FY18; and (2) while debt servicing tapered during FY16 and FY17, this can be traced to the cut in interest rates in FY15 and FY16, and the fact that Pakistan's domestic debt is increasingly short-term. With the country's market debt (T-bills and PIBs) shifted totally into the shortest maturity (3-months), GoP now faces almost Rs 49 bln debt repayments every quarter. This means the recent increase in interest rates (from 6% in mid-April 2018 to 8%, see **Figure 8**), coupled with the short maturity of this debt, will create a sharp increase in debt servicing within the fiscal year.

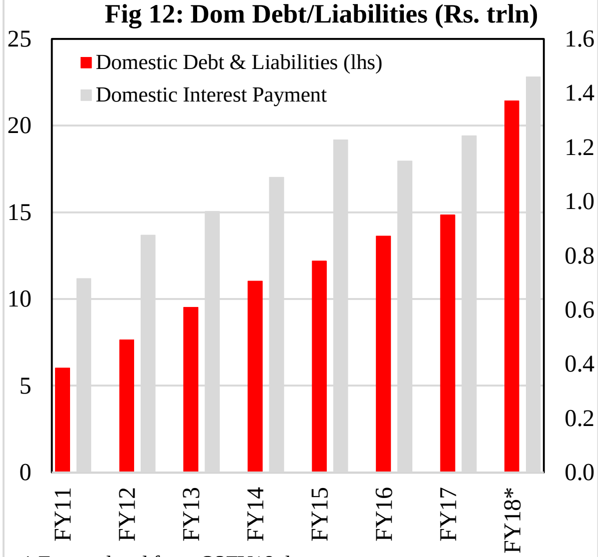
Table 3: Pakistan's Fiscal Deficit (Rs. bln)											
Fiscal Accounts	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**	**FY18***
A. Total Revenue	**1,499**	**1,851**	**2,078**	**2,253**	**2,567**	**2,982**	**3,637**	**3,931**	**4,447**	**4,937**	**4,867**
i. Tax Revenue (a+b)	1,051	1,205	1,473	1,699	2,053	2,199	2,565	3,018	3,660	3,969	4,102
a. Federal Tax Revenue	1,009	1,252	1,483	1,679	1,946	2,049	2,375	2,812	3,377	3,648	3,728
Direct taxes	388	496	540	627	732	736	884	1,029	1,218	1,343	1,345
Indirect taxes	622	755	943	1,053	1,150	1,200	1,382	1,559	1,895	2,018	2,158
Sales	386	472	540	655	809	841	1,002	1,089	1,302	1,323	1,400
Excise	84	112	134	133	122	120	139	164	188	199	186
Customs	151	170	165	173	218	240	241	306	405	496	573
Other taxes	2	1	103	92	64	112	108	224	265	286	225
b. Provinces	39	(48)	(113)	(72)	107	151	190	206	283	322	373
ii. Non-tax revenue	449	646	605	554	514	783	1,073	913	787	968	765
B. Total Expenditure	**2,277**	**2,531**	**3,007**	**3,447**	**3,936**	**4,816**	**5,026**	**5,388**	**5,796**	**6,801**	**6,841**
i. Current Expenditure	1,853	2,042	2,386	2,901	3,123	3,660	4,005	4,425	4,694	5,198	5,434
of which Interest Payments	510	656	661	717	902	1,006	1,162	1,304	1,263	1,348	1,564
ii. Developmental Expenditure	452	480	613	506	732	777	1,136	1,141	1,314	1,681	1,402
iii. PSE	(28)	7	39	8	12	363	101	-	-	-	-
C. Discrepancy	-	3	(32)	32	70	16	(215)	(178)	(212)	(78)	5
D. Fiscal Deficit (A-B-C)	**777**	**680**	**929**	**1,194**	**1,370**	**1,834**	**1,389**	**1,457**	**1,349**	**1,864**	**1,975**
Financing	777	680	929	1,194	1,370	1,834	1,389	1,457	1,349	1,864	1,975
External	151	150	189	108	129	(2)	512	181	371	541	699
Domestic	626	531	740	1,087	1,241	1,836	877	1,276	979	1,322	1,275
Bank	106	224	305	615	712	1,458	324	892	787	1,046	1,085
Non-Bank	520	306	436	472	529	378	553	366	192	277	191
Fiscal Deficit as a % of GDP	**(7.3)**	**(5.2)**	**(6.2)**	**(6.5)**	**(6.8)**	**(8.2)**	**(5.5)**	**(5.3)**	**(4.6)**	**(5.8)**	

Source: SBP. * Extrapolated for the full year FY18.

Unfortunately, with the market driven primary auction system, commercial banks will not invest in longer-term government paper unless they are convinced that the increasing trend in interest rates has ended. However, with YoY inflation spiking, and expectations that the forthcoming IMF program will require more monetary tightening, the authorities have no choice but to wait-and-see where the country's debt servicing burden will settle.

This mechanical relationship from the need to narrow the external deficit via a weaker currency, to an increase in inflation, to an increase in interest rates, to a heavier debt burden, was explained in a previous paper, and will be further explored when the new PTI government lays out its economic plan.

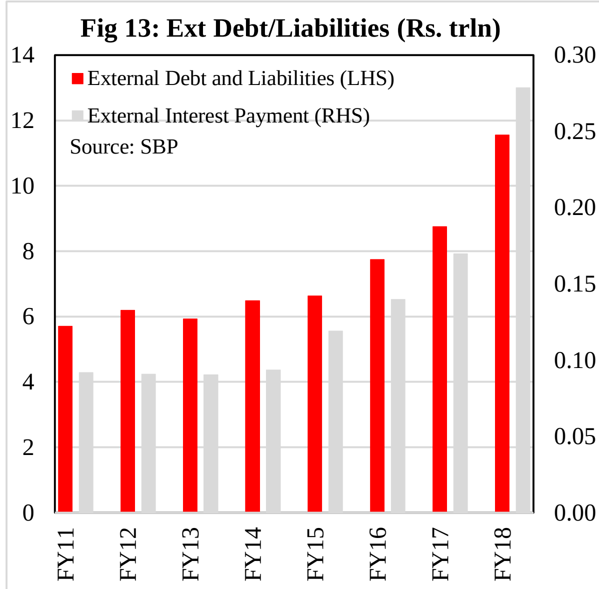
Fig 12: Dom Debt/Liabilities (Rs. trln)



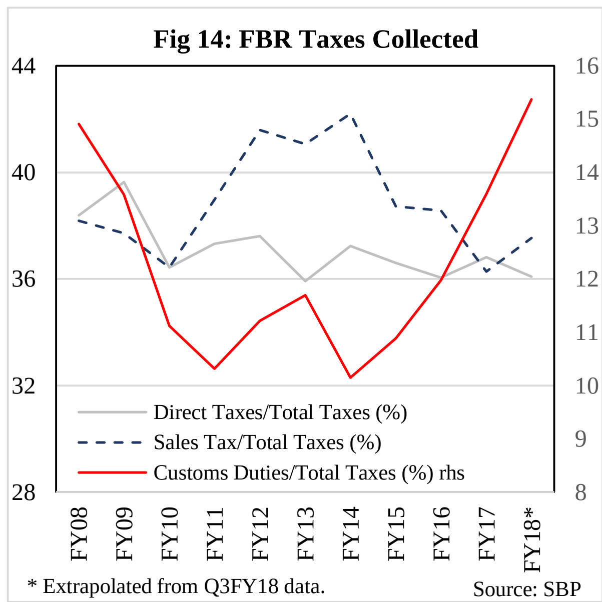
* Extrapolated from Q3FY18 data. Source: SBP

Add to this Pakistan's external debt servicing. As shown in **Figure 13**, things appeared quite stable during the years FY11-FY14, as the external deficit was small; the stock of the country's external debt was falling (see **Figure 11**); and the PKR/$ was stable. The upward trend witnessed in FY16 and FY17 can be traced to the growing external deficit, and the increase in external borrowing while the PKR was strictly managed. FY18 shows the blowout: the external deficit hits $ 18 bln and the GoP responded by simply borrowing to finance the gap, and then by weakening the PKR sharply to narrow the gap.[5]

As shown in **Figure 13**, the data for FY18 shows that Pakistan's external debt (denominated in Rupees) has increased from Rs 8.8 trln to Rs 11.6 trln, while external debt servicing increased from 170 bln to 279 bln in one year.



Turning our attention to revenues, while **Table 3** shows that revenues posted strong nominal growth, and the extrapolated data for FY18 is likely to be an underestimate because of the revenues realized via the Amnesty Scheme, it is the composition of FBR taxes collected that is disturbing. As shown in **Figure 14**, direct taxes as a percentage of FBR collections appear to have settled at 36%, which reinforces the need to bring *more* people into the income tax net. The fall in sales taxes (as a % of total) is also disappointing, as this has been the focus of fiscal reforms for decades. The glaring problem in **Figure 14**, is the sharp increase in trade taxes, which the IMF is dead-set against.



Part of this shift towards trade taxes can be seen from the sharp increase in Pakistan's import bill in the past two years (see **Figure 5**). So while it does not appear that the fiscal authorities intentionally shifted towards trade taxes, it does warn us that trade taxes will fall as policymakers try to bring down imports.

Finally, there is the circular debt that will have to be paid off at the initial stages of the next IMF program. Media reports claim that commercial banks are now reluctant to lend further to the Power Holding Pvt Ltd (PHPL) where about Rs 550 bln worth of receivables from distribution companies have already been parked. PHPL's effort to absorb more of the circular debt from the system indicates that the financial hemorrhaging may again be threatening PSO's ability to import petroleum for the power sector.

It is important to understand that forcing GoP to write off the circular debt (or take on PHPL's receivables, which boils down to writing off these receivables), is just a book keeping entry that will not impact the market or the banks. But such a settlement will add an additional 1.7% (of GDP) burden on the fiscal deficit for FY19. Even though we assume that the next stabilization program will be strict about bringing down the primary fiscal deficit in FY19, with the expected increase in debt servicing (both

[5] In some ways, the previous economic team got the worse of both worlds. At first it tried to finance the external deficit instead of trying to narrow the BoP gap. When it couldn't narrow the BoP and had accumulated a significant volume of external debt in the process, it *then* adjusted the currency on the enhanced stock of external debts/liabilities.

domestic and external) and the settlement of the circular debt, the fiscal deficit in FY19 is likely to be in the range of 8-9% of GDP.

Reality check

The good news is that things have changed. The Government of Pakistan finally acknowledged the dire BoP situation after the caretakers took charge on 1 June (*Reality Bites*, 6 June 2018). After months of denying the need for an IMF program, Shahbaz Rana of the *Express Tribune* reported on briefings made to the caretaker Prime Minister (PM) by senior officials of the Ministry of Finance (MoF).[6] Using unnamed sources at the meeting, Rana revealed the following:

- A source was quoted as saying that without immediate corrective actions: "the economic bubble may burst within the next fiscal year [i.e., FY19]."
- The Finance Secretary is reported to have told the caretaker PM that the country has no option but to look to the IMF for help, and sought permission to begin talks immediately;
- The Ministry also said that Pakistan needs an IMF program in place by August, to manage scheduled external payments;
- In terms of the PKR/$ parity, the PM was informed that the delayed devaluation of the Rupee was responsible for the rapid depletion of SBP's FX reserves; and
- In terms of the federal budget, MoF informed the caretaker PM that the fiscal deficit would exceed the 5.5% of GDP target, and most likely post a gap of 6.5%. In the most recent Monetary Policy Statement (14 July 2018), the fiscal gap is estimated at 6.8% of GDP.

Many may not be surprised by the MoF's change of heart – after all, the political masters had left, and the bureaucracy would have to pick up the pieces for the next government. While some may take comfort from this, we do not. The previous government had denied the existence of a BoP problem, even when the market started taking steps to protect itself. The point to make is not that the underlying problem is a matter of debate, or that what lies ahead is uncertain. The point is that institutions that are tasked with ensuring that Pakistan's economy remains on a stable path, have failed.

Institutional weakness

In our view, the Finance Secretary's confession about the true state of Pakistan's economy, reveals a dysfunction that is as serious as the underlying economic problems themselves (see **Box 1**). And it doesn't end with the Ministry of Finance (MoF): there is the Federal Board of Revenue (FBR), the Economic Affairs Division (EAD) and the State Bank of Pakistan (SBP), to name the most important institutions. Shallow economic reforms and short-term policies have characterized the operations of each of these institutions.[7]

[6] *Financial wizards to brief caretaker PM on economy*, June 3, 2018; *Pakistan needs IMF support, Mulk warned*, June 5, 2018.
[7] One could argue, that since the bureaucracy has a permanent presence in the government (and a well-defined framework for who has executive power, and how he/she can wield this power), it would be more wary of taking steps that will come back to hurt the country. As discussed in **Box 1**, the politicization of the bureaucracy started in the 1970s under the regime of Zulfiqar Ali Bhutto. Before this, the Pakistan Constitution had safeguards for civil servants in the federal constitutions of 1956 and 1962. This was reversed in the 1973 Constitution.

Box 1: Institutional responsibility

The relationship between politicians and Pakistan's bureaucracy, has changed a great deal in the past three decades. The institutions mentioned in this paper, were once respected for the professional commitment (and caliber) of the senior bureaucrats. An analogy with the British comedy show *Yes Minister* is useful to put things into context.

While the British comedy paired a naïve, but well-meaning minister (Jim Hacker) with a smooth-talking, manipulative permanent secretary (Humphrey Appleby), the situation in Pakistan is different. The clash between the British bureaucracy and elected politicians, creates a fertile space to poke fun at bureaucrats and politicians alike, but it also shows that each group acts as a check on the other. From the perspective of Pakistan, the show reveals the sense of pride in being a member of the civil service (and in its ability to shape final policy decisions), which-is now lost amidst a degree of nostalgia for the good old days.

A fortified bureaucracy is a strong check against policies that are expedient (for politicians), but would ultimately harm the country. In our view, Pakistan's bureaucracy has lost the ability to counsel political leaders, because it has been politicized. The goal is no longer to protect public welfare (or the institution), but to have an excuse to justify past decisions. This means senior bureaucrats have effectively given up responsibility for the institutions they manage. No amount of formal autonomy given to these institutions, will change their operations, unless the incentives of the bureaucracy are changed.

The politicization of Pakistan's civil service (which dates back to the early 1970s) now appears to be complete. Unless key economic institutions are able to stand up to short-sighted policies, Pakistan's economy will remain structurally weak.

FBR formulates tax rules and is responsible for their enforcement. More importantly, it has the mandate to provide ad hoc concessions & exemptions, and can also impose advance taxes on corporations (to meet quarterly targets). FBR also controls the release of export rebates, which has been a bone of contention with most exporters. Finally, in terms of the tax collection machinery, the avenues for corruption are legendary.

EAD is the guardian of GoP's external debt payments. The sharp increase in external borrowing by the previous government (**Figure 11**), begs the question: did EAD warn MoF or SBP about the stream of FX repayments being created? With a monthly external deficit trending up since early 2016 (**Figure 9**), coupled with the accumulated FX repayments in FY19 and FY20, the existing debt burden is already too heavy for the country to sustain.

From SBP's website, for the period of 12 months starting June 2018, SBP has to repay $ 9 billion of sovereign debt, and an additional $ 6.4 billion on account of FX forwards and swaps (**Figure 10**). This is a tall order without drastic efforts to reduce the monthly current account deficit (**Figure 9**), which brings us back to the fundamental point: did EAD communicate this reality to policymakers, especially nearing the end of the political cycle?

In our view, SBP's PKR/$ management is the most glaring instance of institutional failure (**Figure 8**).[8] It created a strong disincentive for exporters, who –being rational economic agents – shifted their commercial attention to domestic real estate development and went on to make fortunes (*Pakistan's BoP: The Calm before the Storm*, 31 May 2017).[9] This lies at the heart of Pakistan's poor export performance, and the $ 18 bln current account deficit in FY18. Despite the sharp increase in the monthly current

[8] SBP's exchange rate policy reversal on July 6, 2017 (a day after being publically shamed by Finance Minister Ishaq Dar), was particularly embarrassing for the central bank.

[9] In our discussions with the large export houses in Lahore and Faisalabad in 2016, exporters said that since the PKR parity was being kept fixed, Dollar return from real estate development were phenomenally high. Since they realized that this bonanza would not last, they continued with their export activities to maintain commercial relationships, but put on hold any new ventures or product upgradations.

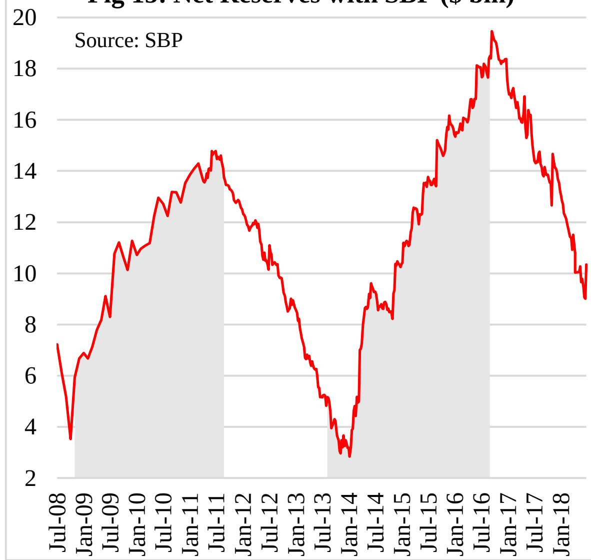
account deficit in 2016, SBP kept the PKR parity fixed until the IMF's PPM discussions in December 2017.

The inaction to reduce the trade deficit is even more surprising as SBP's FX reserves have been falling since Q3-FY16 (**Figure 15**).[10] What is particularly troubling is the sharp fall in recent months: in our view, importers have responded to the uncertainty created by the management of the Rupee by simply front-loading their requirements. This kept the monthly external deficit at elevated levels despite the devaluations of the PKR and SBP's efforts to discourage and delay hard currency payments.

The Solution:

There is an on-going debate over whether Pakistan actually needs to return to the IMF. In our view, the country has no choice but to return, and this was obvious to us in late 2017. The other issue is how the induction of the new PTI government could change the economic landscape. As we will discuss later, the induction doesn't change our view that a Fund program is required, but it does create some optimism.

Fig 15: Net Reserves with SBP ($ bln)



To structure this half of the paper, we will focus on the two key players who will shape the economy: the IMF and the new PTI government.[11] We will start by summarizing the broad parameters of the next IMF program, as hinted at in its March 2018 Staff Paper. As discussed in past papers, we are of the view that a strategy of demand management alone will not be enough. As we will discuss, traditional IMF prescriptions will have to be supplemented by more customized reforms.

Finally, we look at the electoral mandate achieved by the PTI, and its economic vision for the country. While we support PTI's focus on social welfare and human development, it is the anti-corruption campaign that is more promising. In our view, PTI's anti-corruption agenda could be used to push for: expanding the tax base; restructuring state-owned enterprises; documenting all economic transactions; and bringing real estate assets into the tax net. If the new government stays true to its campaign promises, this will certainly disrupt Pakistan's economy (see **Box 2**). In view of the anticipated hardship that is in store for the country (rising inflation and overall austerity), the anti-corruption agenda should complement the structural reforms that the IMF has been pushing for decades.

Back to the IMF

Most analysts felt the government would delay approaching the IMF till after the 2018 elections. While true, the fact that the PKR has been devalued four times since December 2017, indicates that the GoP

[10] The shaded portions of **Figure 15** show the term of the last two IMF programs. The rise and subsequent fall in SBP's reserves, around the programs, is glaringly obvious. As discussed later in this paper, we do not anticipate another peak with the next IMF program, but a more measured release of funding, which is contingent on steps to narrow the twin deficits.

[11] Many would argue that the geopolitics between the US and China are more important. As we discuss later in the paper, the US and China are posturing against each other, and this sets the tone for how Pakistan interacts with the IMF. However, it is the PTI government and the IMF that will need to weigh their respective goals, as they begin negotiating.

(past and caretaker) knew that it simply could not keep the IMF on the sidelines.[12] The first PKR adjustment was during the IMF's Post-Program Monitoring (PPM) discussions in December, and the second adjustment was undertaken when the IMF Staff Report was published in March 2018.[13] To get a flavor of what the next IMF program could look like, the March 2018, PPM Staff Report is a useful blue-print.

In our paper (*Could the next IMF Program be decisive*? 12 December, 2017), other than the PKR and the external deficit, we expected four major issues to be flagged by the IMF: (1) the use of regulatory duties to curb imports; (2) the persistence of the circular debt; (3) the hard currency outflows from CPEC-related projects; and (4) the need to tap into the tax potential in real estate transactions. We argued that each of these issues could become thematic components of the next IMF program.

The March 2018 Staff Report contained the abovementioned points and a few surprises (see below). While the IMF's overall outlook is a bit foreboding, it's the return to a more responsible and realistic narrative about Pakistan's economy – compared to the previous government's denial that Pakistan was facing a BoP crisis – that gives us a sense of comfort. To analyze what the IMF is suggesting (explicitly and implicitly), we will discuss what's familiar (old), what's new in the Report, and what needs to be considered.

What's old

Demand pressures, inflation and interest rates

The Staff Report summarizes the usual issues in its customary language. To analysts of past IMF programs, this is familiar territory. What is disappointing, is that the issues discussed are almost exactly the same as they were around 20 years ago, starting with the need to focus on demand pressures. In justifying the need for SBP to further tighten monetary policy in para 22, the IMF report states:

> *Staff recommends further tightening of monetary policy to slow domestic demand and import growth, strengthen demand for rupee financial assets, and mitigate the potential pass-through from the exchange rate adjustment to inflation.*

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[12] We remain skeptical of the IMF's effectiveness in *reforming* Pakistan's economy, but *stabilizing* the external sector without the IMF, is not possible. Since the late 1980s, Pakistan's economy has been hard-wired to expect an IMF program to resolve BoP problems, as 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. We think China's support will raise more questions and create uncertainty; if this uncertainty is not properly managed, it will create market turmoil.

[13] In response to the IMF's call for greater exchange rate flexibility, the Pakistani authorities had this to say (in para 25) about the PKR adjustment in December 2017:

> *The authorities agreed with the need for continued exchange rate flexibility but considered the recent depreciation as likely sufficient to restore equilibrium in the foreign exchange market.*

This report was made public on March 14, 2018, and on March 20, SBP depreciated the PKR/$ by a further 4 percent.

Box 2: The economics of investigating corruption

The initial public indication that something is being investigated will come from media coverage, and the response is likely to be positive – people will relish the fact that the corrupt are finally being taken to task. However, by the time this becomes a news item, those who are involved in the specific case (be it individuals or institutions) will know they could be implicated. While some individuals may try to leave the country (a clear admission of guilt), the more damaging impact is how the day-to-day operations of the institution will change.

We assume the initial corruption cases will focus on the misuse of public funds, the misallocation of public lands and embezzlement in PSEs, where extracted resources have been laundered (via banking and non-banking channels) and either invested within the country or sent abroad into shell companies. Hence, most of the likely corruption cases will focus on government agencies, public sector enterprises, regulators and commercial banks. We would also include long-term purchase agreements as transactions that could be investigated – these create committed repayments by public sector entities, whereby officiating government officials could agree on *out of market* prices in exchange for kickbacks.

Other cases of corruption, like awarding service contracts to favored entities or the personal use of company assets (e.g. automobiles, power generators, office equipment, etc.), are not worth the investigative effort.

In cases where public assets/funds are embezzled, or long-term purchase agreements are suspicious, the trail of financial flows is the easiest to secure, and use. Investigating senior bank executives, or those responsible for regulatory oversight, or the officiating public servants who fast-tracked such transactions, using a financial paper trail, opens up other links and draws in more people. As the scope of the investigation spreads, decision-making in banks and government agencies (e.g. PSEs, local governments, development agencies, regulators, etc.) could grind to a halt as senior management becomes too insecure to make executive decisions. This will hurt the rest of the economy.

Having said this, it is hard to quantify the impact of such investigations on the economy, except to say that even perfectly legitimate financial/economic transactions (that rely on these institutions) could either be delayed or scrapped all together. This will create economic pressure to halt such investigations, to allow such institutions resume their normal operations. This pressure must be resisted. In our view, the real impetus to stop corruption investigations, does not come from people who speak for the sake of the country's economic health, but from those who want to save themselves (or their friends) from their past misdeeds.

However, two points need to be made. One, the economic cost of corruption cannot simply be measured as lost opportunities, in monetary terms. The impact is more pernicious: corruption cripples institutions; distorts decision-making; misallocates scares resources (especially in the public domain), and undermines investor confidence about the safety of investment. Two, one should not underestimate the resistance to corruption investigations: it will be well-coordinated and come with full force, reflecting the rigor that can be bought with corruption money.

In effect, if the government seeks to prosecute (and eradicate) corruption in public agencies, it must have the strength and conviction to see it through. This is very challenging for a siting government unless it is willing to face the consequences. However, the short-term disruption could create a strong precedent, which means the decision to root-out corruption should be viewed as a trade-off between the short-term pain, for long-term gain. It also requires that the initial investigation must be so thorough (and air-tight) that the case can stand up to legal challenges. If done professionally using the right people, this signal, in itself, will do more to deter corruption than the penalties/indictments that are handled down to corrupt people.

While the economic rationale for proceeding is clear enough, it is the political dimension that will determine whether the new government will push hard on this agenda.

While we agree that demand pressures have been pushing imports, increasing interest rates will not necessarily address the problem. In Pakistan, domestic demand is not driven by consumer borrowing from commercial banks, but by the wealth-effect that resides in real estate holdings, which are largely undocumented. Given how real estate transactions are managed in the country, the government has little, if any control over the wealth effect.

Restructuring loss-making SOEs

The restructuring of loss-making state-owned enterprises (SOEs) has been mentioned repeatedly in the IMF Report, with a specific focus on the power-sector because of the magnitude of the circular debt. When the Nawaz Sharif government entered an IMF program in 2H-2013, part of the circular debt had to be paid off, and this is likely to happen again. In the March Staff Report, the circular debt (as of end-December 2017) is estimated at Rs 514 bln. As happened five years ago, the new government will blame past mismanagement for this problem. The Report also flags the persistent fiscal burden on the federal government from PIA, Pakistan Railways and Pakistan Steel Mills.

In terms of what to expect when the stabilization program begins (perhaps as *early actions*), para 24 explains the need to increase power tariffs and consider additional surcharges, to halt the build-up of circular debt. This will be politically painful, but necessary.

What's new

There are several new dimensions to this IMF report: (1) CPEC; (2) the rapid increase in Pakistan's external debt; (3) the incomplete reform agenda of the previous program; (4) an admission that a weaker Rupee has inflationary implications; (5) how GoP creatively skirted parliamentary limits on the country's debt; (6) the political dimension of economic reforms; and (7) the need for a computerized record of all asset holdings in Pakistan (fiscal cadaster).

CPEC

CPEC's inclusion is not surprising as the project has geared up in the past several years. The IMF briefly mentions the scope of this project, and how it is driving investment in ancillary industries, and adding to Pakistan's import growth. The Fund mentions how this project is now beginning to stress the external sector. Despite rumors that the IMF is not inclined towards CPEC, or seeks to restrict Pakistan's participation in this undertaking, we found no anti-CPEC bias in the IMF Staff Report. This is surprising as the media's coverage of the December PPM was quite alarming: local media claimed there was a fundamental disconnect between the IMF and government officials, not just about the impact of CPEC on the external sector, but also that investment in power generation was fast-tracked without meaningful power-sector and fiscal reforms.

External debt

The Staff Report brings up Pakistan's external debt in para 14 (out of 40), and retains this focus in the next four paragraphs. Under the sub-heading *Capacity to Repay the Fund*, the IMF laments that after the end of the EFF in 2016, Pakistan's borrowing gained such pace that the debt build-up will continue for the next several years. Furthermore, the debt servicing burden will translate into fiscal pressure in the medium term, which will make it more difficult for Pakistan to secure affordable external financing.[14]

[14] The IMF's analysis shows that Pakistan's repayments to the Fund will increase consistently from SDR 75 million in FY17, to about SDR 820 million in FY21. It also reveals that while overall external debt servicing dipped slightly in FY18, it will post sharp increases in FY19 and FY20.

What may be lost in between the lines, is that by questioning Pakistan's ability to repay the IMF, the Fund is effectively saying that Pakistan will have little choice but to approach it for a bailout package. This is because of an unspoken rule in the global financial order, whereby member countries cannot default (or roll-over) their repayments to the IMF (or other IFIs). Hence, for a country that is having BoP difficulties, the Fund gauges the country's external obligations, and negotiates sufficient funding (in collaboration with other IFIs) to repay priority sovereign debts, while asking the client country to roll-over/reschedule other debts/liabilities *or* secure additional funding to make the BoP workable.

In our view, the issue of who gets paid and which loans need to be rolled over, will be the most contentious during the negotiations.[15] Given the accumulation of CPEC-related debts/liabilities (which is still not very clear) and the Chinese loans to give our BoP some "breathing space", Pakistan's repayments to China are likely to be hardest hit.

<u>Incomplete EFF</u>

To the IMF's credit, at the very start (para 1) the Staff Report states:

> *While the EFF had helped to support macroeconomic stability and address structural challenges, the policy agenda remained incomplete.*

This frank admission is new for the IMF, or perhaps there was so little to show for the last program, that the Fund simply admitted it upfront.

<u>Ineffective FRDL</u>

Para 29 talks about the Fiscal Responsibility and Debt Limitation Act (FRDL) that was passed in 2005, as a requirement for the *then* on-going IMF program. The FRDL sought to elevate the decision to increase the country's sovereign debt to the parliament, in an effort to restrain policymakers from adding to the country's debt. The FRDL was amended in 2016 to limit the federal budget deficit, and limit the debt-to-GDP ratio at 60% up to FY18, and then bring this ratio down in 15 years to 50%.

However, Pakistan's policymakers found a loophole. As the Staff Report states in footnote 6:

> *The FY 2017/18 Budget Act changed the definition of debt subject to the mandated limits from gross debt to net debt*.[16]

In the decades-old relationship with the IMF, Pakistani policymakers have gotten to know their IMF counterparts in terms of how much leeway they have to deliver on committed reforms. In an earlier paper (*The Parable of Pakistan and the IMF*, 27 December, 2016), we talked about how a prolonged relationship between a self-serving doctor (the IMF) and a chronically ill patient (Pakistan), could evolve into mutual dependency, whereby the health of the patient is no longer the end goal of both parties. One could argue that this mutual dependency lies at the heart of why Pakistan is such a prolonged user of IMF assistance.

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[15] In our paper (*Could the next IMF Program be decisive?* 12 December, 2017), we discussed how the IMF is likely to halt the borrowing spree, as Pakistan's external deficit was already unsustainable. This issue has been taken to a more sensational level, with Secretary Pompeo's comment and the letter sent by 16 angry US Senators about the IMF's view on accommodating Pakistan's request for a bailout package (see **Geopolitics and the IMF**).

[16] In effect, the IMF's efforts to cap the discretion of policymakers in terms of borrowing more, was cleverly skirted. Instead of taking hard decisions to reduce government borrowing, policymakers simply changed the definition of the debt to ensure that Pakistan did not breach the FRDL.

The disclosure that the FRDL was artificially satisfied in past IMF programs, could indicate a significant change in the IMF's attitude. Going forward, this bodes well for a more productive relationship.

Political dimension of economic reforms

In an unusual display of candor, in para 36 the IMF states:

> *They [the federal government] also agreed with the need for improving the fiscal federalism framework, while noting the constitutional constraints and the need for extensive consultations with the provinces, which may limit the range of politically feasible reforms.*

This might be the first time an IMF document (on Pakistan) has hinted that economic reforms have a political dimension. This is refreshing for an institution that prides itself on being an *apolitical* participant, even when its internal operations and all its clients, are deeply immersed in politics.

Having said this, the Staff Report doesn't go far enough to explain why Pakistan has been unable to implement hard reforms for the past three decades. As a specific example, to restructure loss-making SOEs, it would have been helpful to highlight the political will needed (by GoP) to stop the employment of political workers; to remove senior managers who only serve political interests; and to halt the practice of rewarding/punishing economic groups because of their political affiliations.

Fiscal cadaster

Fiscal cadaster refers to a comprehensive register of all asset holdings in a country. For quite some time, we have been highlighting the fact that real estate is perhaps the largest repository of Pakistani wealth (*Addressing the real economic challenges facing Pakistan*, November 21, 2016). The Staff Report touches on the need to create a centralized electronic register of all real estate holdings/properties, which we wholeheartedly agree with. As discussed earlier, a more effective policy to reduce aggregate demand in Pakistan would be to address the gross undervaluation of real estate holdings. This would also be a critical first step in documenting Pakistan's economy, and forcing all Pakistanis into the tax net.

Assessment

The March 2018 Staff Report acknowledges that the previous government was not in a position to implement its recommendations. The IMF expressed few reservations about CPEC, which is surprising but also heartening. However, the Fund does flag Pakistan's external debt and the heavy repayments from FY19 onwards, peaking in FY21.

We were a bit disappointed that the fiscal cadaster was not given the prominence it deserves.

What more is required in the next IMF program?

In our papers on Pakistan's deteriorating BoP, our assessment of what is required has evolved. While we called for an IMF program back in May 2017, in a subsequent paper (*Could the next IMF Program be decisive?* 12 December, 2017), we raised the need to address CPEC, and more broadly, Pakistan's trade/investment relationship with China – we also raised the need to enforce more accurate valuation of real estate assets in the country (proper documentation). We argued that since these issues are not part of a standard IMF program (but are now too fundamental to ignore), the next IMF program should address these structural issues, alongside chronic issues like loss-making SOEs, the circular debt, and the need to increase the number of direct tax payers.

Need to improve the documentation of economic transactions

There are two fundamental habits of most Pakistanis: one, the preference to deal with cash, which means there is no avenue to track financial transactions; and two, the preference to save in real estate, which is grossly undervalued. This means the average Pakistani does not believe in being documented, and therefore does not feel a fiscal responsibility to pay taxes.

Previous IMF programs have focused on the need to increase direct taxes, with a specific emphasis on income and sales tax. These efforts have made some inroads, but the overall picture remains disappointing. Since Pakistanis are reluctant to enter the tax net, they must be compelled to do so. In this regard, the need to focus on the fiscal cadaster, and to rectify the gross undervaluation of real estate holdings (as introduced in the Foreign Assets (Declaration & Repatriation) Ordinance [April 2018]), must be championed by the new government.

It is too early to make an assessment of the Amnesty Scheme. As stated in our previous papers, errant Pakistanis are justified in their concerns over whether this scheme would be adopted by the new government, whether the caretaker government had the mandate (or interest) to pursue this scheme, whether the 2 and 5% penalties could be legally challenged as being too lenient. There are also concerns that FBR could dredge up past financial transactions of the people who have come forward.

In this Amnesty Scheme, domestic assets have also been targeted. As discussed earlier, this will help the IMF program by reducing demand pressure and narrow the external deficit. We had argued in December 2017, that an effective way to reduce domestic demand in Pakistan, is to push for more accurate valuation of real estate holdings. As this is the dominant repository of household wealth in Pakistan, the capital gains that have been realized in the past several years (which are totally undocumented) have been driving local investment and the demand for luxury goods – this has also filtered down into the spending patterns of the middle and lower classes.

This wealth-driven economic prosperity has increased the trade deficit, and is beyond the control of the government. In our view, by documenting this repository of Pakistani wealth more accurately, and forcing these assets into the tax net, the government would have a better handle on demand pressures, which is exactly what the IMF seeks to achieve.

Need to rethink CPEC and the Pakistan-China FTA[17]

Back in May 2017, we stated that CPEC needs to be reoriented if it to succeed. As Pakistan's growing BoP problem was not being addressed, we argued that the Chinese authorities should be aware of this recurring problem, which has compelled Pakistan to keep returning to the IMF for BoP assistance. In planning CPEC, and its subsequent implementation, it is highly unlikely that our Chinese partners would be surprised by the BoP problem that has resurfaced in FY18. This begs the question: while Chinese banks have been helping with commercial loans to shore up SBP's dwindling FX reserves, they must know that this is not a solution. Something more robust is needed to overcome the structural imbalance in the external sector.

[17] It is important to make clear up-front that when we talk about the need to "rethink" our trade/investment relationship with China, we are talking about our interactions in the future. It does not mean renegotiating projects that have already been agreed upon, as this would be a breach of our sovereign promise to Chinese companies. However, if some CPEC-related projects fall into the ambit of future anti-corruption cases, they could be revisited from the perspective of identifying malfeasance on the part of Pakistani counterparts.

This is not to say that CPEC is responsible for our current economic troubles. In our September 2017 paper, we listed three possible strategies that China could be implementing with CPEC: (1) simply underwrite Pakistan's external obligations for the foreseeable future; (2) continue to provide commercial loans as it has been doing; and (3) nudge Pakistan's policymakers to implement hard economic reforms to put the country on a more sustainable footing (for more details, see **Box 3**).

To summarize, as Pakistan moves towards the next stabilization program, it should concurrently renegotiate the future direction of CPEC and the FTA with the Chinese authorities. In our view, the most immediate benefit of the IMF program, would be to create a three-year horizon on CPEC within the context of Pakistan's overall BoP. Off-hand statements by unnamed officials in the GoP that details of CPEC could not be shared with the public because of Chinese wishes, are not just incorrect, but totally irresponsible.

A project of this size and geo-political dimension, would only garner negative publicity if details were kept intentionally outside the public domain. As discussed in an earlier paper (*Pakistan's BoP: The Calm before the Storm*, 31 May 2017), the lack of a credible macro-picture of CPEC-related projects and the FX liabilities they carry, would inevitably create an impression that things are

Box 3: How could CPEC play out?

In an earlier paper (*Pakistan's Balance of Payments, the IMF and China*, 14 September 2017), we listed four possible outcomes that could be inter-related:

1. China realizes that Pakistan is incapable of repaying, but deems CPEC too important and continues with the project (*blank cheque*). This is simply Chinese largess;
2. Pakistan's inability to repay China results in the swapping of these debts into equity, which basically means Pakistan sells real assets in exchange for writing off Chinese loans (*debt for equity*);
3. China realizes that Pakistan's inability to repay means that China should be rethinking its free trade agreement (FTA), to sharply narrow the trade deficit that Pakistan currently runs with China (*enhance exports to China*); &
4. Pakistan implements hard reforms in the next IMF program, and is able to turn the country around to the point that CPEC becomes commercially viable. China plays no significant role in this outcome (*Pakistan reforms*).

In the paper, we argue that a *status quo* oriented GoP would prefer outcome 1 (do nothing), while a reformist Pakistan would prefer outcome 4 (help ourselves without favors from friends). We also stated that China would prefer outcome 3 even though based on China's own interest, outcome 2 would be better (get assets on the cheap).

In our view, the reason that China would prefer outcome 3 over outcome 2, is to maintain a strong long-term relationship between the two countries. If Pakistan is forced to sell choice assets to China, this would be perceived as exploitation by the people of Pakistan (the oft-cited East India Company example). If this sentiment begins to permeate in the country, it is hard to imagine that the government of Pakistan would be able to maintain the sort of close friendship that it currently has.

Since CPEC has significant geostrategic advantages for China (see *One Belt, One Road: Building Asia on China's Strength*, 21 August 2016), it needs to ensure that its relationship with Pakistan remains strong for the long-term. Hence, China should be willing to sacrifice its own export interests (goods that enter Pakistan), by shifting some of these manufacturing units to Pakistan. Looking at the big picture, Pakistan's trade imbalance with China is a mere decimal point when looking at China's global trading volumes.

Outcome 3 entails a bilateral understanding wherein Pakistani exports are specifically produced for the Chinese market, and where Chinese companies relocate here as part of a policy of import substitution. Given the size of the external deficit in FY18, and the fact that the Pakistan-China trade imbalance is getting worse (see **Table 4**), we now feel the only sustainable outcome would be a combination of outcomes 3 and 4 (i.e. Pakistan reforms and exports more to China).

much worse than they appear. In fact, we talked about the growing perception that CPEC is the new East India Company, which exploited the Indian subcontinent in the 18 and 19th century.[18]

In effect, if the IMF program gives us a better handle on Pakistan's BoP outlook for the next three years, this could create the impetus for serious discussions not just about the long-term viability of CPEC, but also what needs to be done about the Pakistan-China FTA. If this materializes into a policy master plan, it could become the showcase of mutual economic gain for both China and Pakistan. This will help OBOR's progress in the 21st century.

Table 4: Pakistan - China Trade Deficit ($ bln)

	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18*
Exports	1.7	2.1	2.8	2.8	2.4	2.0	1.8	1.9
Imports	4.8	5.0	5.3	6.8	7.9	9.0	11.1	12.3
Deficit	**(3.1)**	**(2.8)**	**(2.5)**	**(4.0)**	**(5.5)**	**(7.0)**	**(9.3)**	**(10.4)**

Source: SBP. *Extrapolated for the year.

The rise of the PTI

In the lead up to the elections, we were concerned that a hung parliament in the center, and a PML-N government in Punjab, would undermine the government's ability to take corrective economic steps, as these measures would be politicized as score-settling.

The fact that the PTI has won a majority in the center, a clear majority in KP, and is likely to form a government in Punjab; signals a degree of political stability that few could have predicted (see **Table 5**). Furthermore, the main political parties have not banded together to challenge the results, which means that Pakistan has managed three consecutive general elections with a smooth transfer of power. The electoral defeat of seasoned politicians, and the global acceptance that the elections were free and fair, have created a sense that this is a new beginning for the country.

However, the opposition at the center and in Punjab, will be challenging for the new PTI government. This means ambitious steps by the new government would have to be tempered. Furthermore, holding politicians (and political insiders) accountable for corruption, may not be as forthcoming as the PTI election campaign had promised. While this may disappoint many voters, it is a stark reminder that it takes tremendous political capital to implement a strategy that threatens a corrupted status quo.

Aside from the political challenges ahead, Imran Khan's maiden address to the nation on 26 July, is heartening. The *PM-to-be* clearly linked the weakness of state institutions to pervasive corruption, which he has promised to prosecute. Even if the new government is unable to take on the big players, its determination to strengthen state institutions should not be sidetracked. After the mismanagement of Pakistan's economy during FY18, institutional strengthening is absolutely necessary.

There is a strong possibility that Asad Umar will become the next Finance Minister. With an impressive professional record in one of Pakistan's top blue-chip corporations, Mr. Umar should find acceptance from Pakistan's economic elite. While the message of change would be warmly received by the economy, opening up too many fronts may not be advisable. Nevertheless, the country's economic

[18] This negativity should have been countered by a coordinated GoP response, whereby the scope, project details, schedule and financing commitments/repayments of CPEC, were listed and presented in a holistic manner. This did not happen, and the growing number of public discussions/seminars regarding CPEC, only added to the sense of confusion with the local media assuming the worst. As part of the next IMF program, and in response to the recent concern shown by the US government (more on this later), the impact of CPEC should be made public knowledge. While we are convinced (and have been for over a year) that Pakistan's external sector problems are self-inflicted and not traced to CPEC, we are concerned about the FTA and how CPEC repayments will impact the country in the future.

Table 5: The 2018 Election Results (as of August 13, 2018)												
	PTI	**PML-N**	**PPP**	**MMA**	**MQM**	**BAP**	**GDA**	**BNP**	**PML-Q**	**ANP**	**Others***	**Total**
National Assembly												
Seats	116	64	42	12	6	4	2	3	4	-	10	**263**
Affiliated Independents	9	-	-	-	-	-	-	-	-	-	-	**9**
Women	28	16	9	2	1	1	1	1	1	-	-	**60**
Minorities	5	2	2	1	-	-	-	-	-	-	-	**10**
Total	158	82	53	15	7	5	3	4	5	-	10	**342**
To be Vacated	6	-	-	-	-	-	-	-	2	-	-	**8**
Total Seats	**152**	**82**	**53**	**15**	**7**	**5**	**3**	**4**	**3**	**-**	14	**338**
Punjab												
Seats	119	129	6	-	-	-	-	-	7	-	11	**272**
Affiliated Independents	23	1	-	-	-	-	-	-	1	-	-	**25**
Women	33	30	1	-	-	-	-	-	2	-	-	**66**
Minorities	4	4	-	-	-	-	-	-		-	-	**8**
Total Seats	**179**	**164**	**7**	**-**	**-**	**-**	**-**	**-**	**10**	**-**	11	**371**
Sindh												
Seats	23	-	75	1	16	-	10	-	-	-	5	**130**
Women	5	-	17	-	4	-	2	-	-	-	1	**29**
Minorities	2	-	5	-	1	-	1	-	-	-	-	**9**
Total Seats	**30**	**-**	**97**	**1**	**21**	**-**	**13**	**-**	**-**	**-**	6	**168**
K-P												
Seats	65	5	4	10	-	-	-	-	-	7	6	**97**
Affiliated Independents	2	-	-	-	-	-	-	-	-	-	-	**2**
Women	16	1	1	2	-	-	-	-	-	2	-	**22**
Minorities	2	-	-	1	-	-	-	-	-	-	-	**3**
Total Seats	**85**	**6**	**5**	**13**	**-**	**-**	**-**	**-**	**-**	**9**	6	**124**
Balochistan												
Seats	5	1	-	7	-	15	-	7	-	3	12	**50**
Affiliated Independents	1	-	-	-	-	-	-	-	-	-	-	**1**
Women	1	-	-	2	-	4	-	2	-	1	1	**11**
Minorities	-	-	-	1	-	1	-	1	-	-	-	**3**
Total Seats	**7**	**1**	**-**	**10**	**-**	**20**	**-**	**10**	**-**	**4**	13	**65**

Source: 1) Election Commission of Pakistan; 2) PTI gets lion's share of reserved seats in NA, Irfan Ghauri, Express Tribune, August 12, 2018.
* Including un-affiliated independents and seats pending decision.

vulnerability requires the PTI government to set the right tone for what it wants to achieve. We have listed several themes that should be addressed.

1. Managing expectations (vision vs. reality)

With depleting FX reserves and an unhinged PKR, there is a great deal of uncertainty about the day-to-day operations of the economy. Unless meaningful statements are made and measures are taken to give confidence to the domestic economy, the new government could face economic turmoil. With a serious BoP problem and mounting debt, the market expects an IMF stabilization program in the near future, and not just external loans as breathing space. On the back of widespread popular support and the promise of a '*Naya Pakistan'*, managing people's expectations (both political and economic) will be the biggest challenge for the PTI government.

If the new government remains committed to ending corruption and strengthening state institutions, and can explain the reasons for the tough economic outlook, even the inevitable pain could be an acceptable price for a more sustainable (and less corrupt) future. We therefore suggest that the new economic team focus on securing an IMF program, and ensuring that its anti-corruption campaign is dovetailed into the reform agenda.

2. How Pakistan got here (corruption & weak state institutions)
The second priority should be to push ahead with the anti-corruption drive. While this campaign will resonate with the general public, there is a need to cite specific cases to show that the government is not just targeting its adversaries. In our view, a public campaign to *name-and-shame* individuals is required, as the level of economic mismanagement last year, cannot be repeated. As discussed in **Box 1**, if the government machinery cannot restrain or influence policymaking, then there should be consequences for policymakers.

As we have argued, it is wrong to blame short-term policies alone; to be effective, these policies needed institutional enablers. Hence, the endemic institutional weakness needs to be corrected with a sense of urgency. Whether it is the mismanagement of the external sector (SBP & MoF), the circular debt problem (Ministry of Energy, Discos), loss-making SOEs (PIA, PSM, Pakistan Railways), and/or the inability to expand the direct tax base (FBR), these institutions have brought the country to its current predicament. This needs to be communicated to the general public, with a clear message that self-serving political agendas and institutional subservience, are to blame.

Having said this, some state institutions still have depth. Earlier in the year, following Pakistan's placement on the FATF watch-list, SBP suggested several changes in the rules/regulations concerning the use of foreign currency accounts (FCAs). If this is approved by the new parliament (which is likely), not only will SBP take a big step towards closing a key avenue that facilitates corruption, but it will also make exchange rate management less challenging (see **Box 4**).

3. Need to engage expat Pakistanis
It is widely known that affluent Pakistanis keep their wealth abroad, while expats are hesitant about bringing back their wealth to Pakistan – the Amnesty Scheme acknowledges this fact. In Imran Khan's inaugural address, he made a point about the need to encourage expat Pakistanis to invest in the country. He said this has not happened as expats are discouraged by the rampant corruption that exists in the country. In effect, his anti-corruption promise could also be justified by the need to solicit fresh investment from expat Pakistanis.

4. Talking to the IMF with a game plan
When the PTI government starts negotiating with the IMF, this would be the third consecutive time that a new government started negotiating with the IMF soon after taking charge. While the case of 2008 was different in that the world was grappling with record high oil prices, the problem in 2013 was largely self-inflicted as the PPP government refused to begin talks while in power – this is exactly what happened with the previous PML-N government. As we have seen in the past, the new government can simply blame the previous government and accept tough policies as the price to be paid for past mistakes.

The PTI government could do the same, but we think the new government should first formulate a comprehensive plan, and *then* talk to the IMF. As discussed earlier, unorthodox solutions are now required to stabilize Pakistan's economy. If the new government is able to push proper documentation and come to an understanding with China (before talking to the IMF), this would put the new economic team in the driver's seat. In our view, a more balanced commercial relationship between China and Pakistan should also help defuse the recent concerns aired by the US government and legislature (see **Geopolitics and the IMF**).

5. Pushing nationalism over provincial interests

In the March 2018 Staff Paper, we were surprised by the mention that political resistance was one reason for the incomplete reform agenda in the last program. Reading between the lines, the finger was pointed at provincial governments that have been empowered by the 18th Amendment. Looking ahead, two factors need to be considered: one, the 2018 election has created a less *party-centric* set-up in the provinces; and two, with real estate documentation /valuation on the policy agenda, it is critical that all provincial governments support this agenda.[19]

Since real estate transactions are governed by the provincial government, it is important to ensure that any such reform is done across all provinces with the same vigor and timeline. With PTI likely to form the two key governments (and KP), the chances of a federal government reform agenda, being implemented across all provinces, is that much higher.

Box 4: Financial Action Task Force (FATF) & PKR management

The G-7's FATF on Money Laundering placed Pakistan on the watch-list in February 2018. As expected, Pakistan was shifted to the grey list in June 2018. Analysts (both in Pakistan and abroad) have flagged how this development will undermine the country's ability to borrow from global markets, and could further complicate Pakistan's relationship with the IMF. While this is a valid concern, one must realize that Pakistan has been on FATF's grey-list from 2008 to 2015, which implies that, in itself, being on this list does not mean that assistance from the IFIs cannot be availed.

In our view, being on the FATF grey list is not much of an issue. The FX problem that Pakistan currently faces, and the policies required to overcome this challenge, should automatically placate FATF. More specifically, Pakistan's policymakers know that a period of currency weakness unhinges the parallel FX market, as people begin to dollarize their PKR balances. This creates pressure on the kerb market, which then begins to shape expectations about the interbank PKR/$ rate. As shown in previous exchange rate adjustments, the interbank PKR would only settle down if the kerb market is stable. In effect, to manage market sentiments about the interbank PKR/$ rate, SBP must also instill calm in the parallel FX market. If the kerb market moves on its own accord (as happened on 28 July), this feeds back into the interbank market. Only this could explain the surprise appreciation of the interbank PKR from 128.5/$ to 124.5/$, even as concerns of Pakistan's external deficit had reached fever pitch. Anecdotal evidence shows that the kerb rate appreciated from around 130-132/$ to 122-124/$ on Saturday (28 July), when the interbank market is closed.

From SBP's perspective, exchange rate management is complicated by the very liberal rules that govern how resident Pakistanis can use their foreign currency accounts (FCAs). One must realize that SBP has already recommended amendments in the rules/regulations on FCAs (the Protection of Economic Reforms Act [1992] – PERA, and Foreign Exchange Regulation Act [1947] – FERA), which needs parliamentary approval to become law. We are confident that this will be approved by the next government.

In our view, by limiting what Pakistanis can do with their FCAs, and monitoring all activities from such bank accounts, most of the FATF's concerns about money laundering will automatically be addressed. In effect, by making the regulation of FCAs more restrictive (i.e. how FCAs can be replenished, or how hard currency balances can be used), not only will exchange rate management become easier for the central bank, but it will also make FATF a non-issue.

[19] The provincial governments during 2013-18, were dominated by specific political parties and tended to focus on provincial interests, over the requirements of the federation. With different institutional capacities, Pakistan's main political parties focused on their specific province as a means of consolidating their vote bank. In effect, there was little inter-provincial harmony.

In addition to economic reforms, the need for provincial harmony to implement PTI's social welfare agenda, also needs to be noted. Furthermore, Pakistan's water scarcity needs a united policy response that cannot be allowed to regress into provincial squabbles.[20]

6. Executive power in policymaking

If a system of oversight is created in policy-making (at both a macro and institutional level), then the decisions should be full and final. Judicial intervention – however well-meaning – that challenges and reverses key decisions (e.g. the setting of power tariffs, development surcharges, retail fuel prices, etc.), undermines the ability to put the economy on a sound footing.[21]

In effect, if the new economic team decides that retail fuel prices must be increased, this decision should not be reversed by another institution. This is necessary to instill confidence that policies designed to stabilize the economy, will not be reversed by political or egalitarian concerns. If people realize that an outside agency can overrule the economic team's decision-making, it will be impossible to manage expectations and stabilize the economy.

Before trying to conclude this paper, we must address the growing concern about whether the IMF will be allowed to bail out Pakistan.

Geopolitics and the IMF

A recent statement by the US Secretary of State (Mike Pompeo) has sparked concern that Pakistan will not be able to secure a stabilization package from the IMF. In an interview given to CNBC on 30 July, Secretary Pompeo said that while the Trump administration is keen to meet the newly elected Prime Minister of Pakistan, the US would not allow the IMF to provide funding that could be used to repay Chinese loans.

More recently (on 3 August 2018), 16 US Senators have sent a letter to the US Secretaries of Treasury and State, urging an explanation on the following points:

- How the US representative to the IMF will respond to the debt burden that China's One Belt One Road (OBOR) – or the Belt Road Initiative – has created for participating countries;
- Whether the IMF will halt OBOR projects in those countries that are seeking an IMF bailout;
- Whether the IMF should flag the *predatory* nature of OBOR to countries that are considering signing up with China; and finally,
- How the US and its allies can help countries overcome the OBOR burden, and suggest an alternative way to help them get foreign investment for infrastructure development.

In the 2-page letter, Pakistan figured prominently, as did Sri Lanka and Djibouti. The senators did not shy away from talking about China's geostrategic goal to turn some of these countries into financial hostages, to secure naval bases in the Indian Ocean.

This letter is disturbing for several reasons: one, China has been the swing factor in providing loans to Pakistan, which means the US threat could complicate our negotiations with the IMF; two, the US has

[20] As we stated in our July 2018 monthly presentation, given the importance of these issues, perhaps the federal government could push for these changes, even if it requires suspending the 18th Amendment for a period of time.

[21] For example, in **Table 1**, we proposed a possible scenario for retail fuel prices for the forthcoming months of FY19. This is not based on some mechanical formula that tracks the increase in global oil prices (which we expect to remain range bound between $ 70-80/barrel for FY19), but the increase in the fuel surcharge required to reduce the demand for (and import of) petroleum in Pakistan to make our BoP more sustainable.

effective veto power in the IMF board and will carry many allies with it; and three, the explicit reference to China's geostrategic goal to control participating countries, is something the American establishment cannot ignore. This also plays into President Trump's strategy to challenge (and bully) multilateral organizations – first it was the World Trade Organization, then NATO, and now it's the IMF. In our view, the Trump administration's focus on the IMF will not go away.

However, both Pompeo's comment and the senators' letter, reveal a degree of ignorance about the IMF, and its charter.[22] While we acknowledge that frosty relations between Pakistan and the US would make the next IMF program less lenient, the ownership structure of this IFI means that it cannot reject a request for assistance, nor can it include conditions that favor or disfavor specific countries. As the global *lender of last resort*, the IMF is owned by all member countries (including Pakistan), which means it is obligated to help. This is especially relevant for Pakistan, as it is one of the most frequent users of IMF assistance.

Nevertheless, the signal that the US will be watching the IMF, is not an idle threat. This means the bailout package is likely to be smaller than requested, and the conditionalities would entail that some external loans are rescheduled or rolled-over.[23] However, it would be incorrect to conclude that a tough IMF program is driven by US pressure. As we have discussed, Pakistan's macro conditions are such that hard measures are required.

In our view, the US threat is most damaging to the IMF itself. For a multilateral institution to take sides in bilateral score settling, is not only unacceptable, but it *actually* poses an existential threat to the institution. By effectively disregarding the IMF's role in fostering rule-based global standards for foreign trade and investment, it creates an incentive for like-minded countries to band together and create their own trade/investment blocks.[24]

This would reverse the post-WW2 world order created by the US. While America could subtly push its sovereign interests via the IMF, the real value of this IFI is to keep all countries operating on the same legal/financial framework – especially when member countries experience difficulties meeting sovereign obligations to their trade partners. This allowed global trade to grow exponentially, and maintained confidence and order in the global medium of exchange – the US Dollar. For the US to threaten the IMF, is tantamount to reversing America's privileged position in the global order. Perhaps the angry US senators have not thought through this.[25]

In our view, the IMF will respond to the US senators as follows:

- No, it's not CPEC that has put Pakistan in a hole, but its own reckless policies;
- CPEC is financed by Chinese companies, and has not negatively impacted Pakistan's BoP in the past several years;

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[22] Insisting that a specific bilateral creditor (China) should not be repaid with IMF funds makes little sense, as a fair share of its lending is done via bonds that the IMF issues as an institution. For one member to insist that its wishes are obeyed by a multilateral institution (even by a dominant member), especially when these interests are evidently self-serving, is almost beyond comprehension. Pompeo and the angry senators are just a continuation of the angry rhetoric between the US and China.

[23] Media reports claim that Pakistan is asking for $ 12 bln. An argument could be made that recent borrowings to finance an unsustainable external deficit, could be specifically targeted as the underlying purpose for making such loans was unsound. If this is the case, the burden would fall largely on China.

[24] For example, if China steps into the void and promises to help OBOR partner countries, on the condition that they withdraw from the IMF, this would be the death-knell of the IMF. It would also take China and its OBOR partners outside the ambit of US executive power.

[25] The truly frightening possibility is that the senators know what they are doing, and this is indeed the new direction the US government wants to take. It is a known fact that President Trump has been bitter about the unfair deal the US gets for maintaining the global order. Hence, putting the IMF into a no-win situation, could signal that the US seeks to disengage from global affairs, and will only pursue relationships that are in its narrow interests.

- CPEC repayments do not start till 2022; and
- Yes, the IMF will strictly monitor Pakistan's FX payments during the course of the program.

Despite these complications, we expect the IMF to be receptive to Pakistan's request for a bailout. However, the program will be smaller (say $ 8-9 bln), and is unlikely to be front-loaded – this means SBP's FX reserves will not go shooting up as shown in **Figure 15**. With strict prior conditions and binding quarterly targets, waivers for failed performance targets will not be forthcoming.

Summary of the paper

The period since mid-July 2018 has been a roller-coaster ride for the country – the recent appreciation of the PKR is a case in point.[26] In our view, the caretaker set-up and state institutions have barely been able to manage the market, and its expectations. As discussed in our past papers, Pakistan's twin deficits in FY18 have reached levels that will immediately impact the fiscal and external gaps this year.

On the fiscal side, debt servicing pressure from rising interest rates (on a very short-term debt stock); the pace of external borrowings in FY18; and the cumulative depreciation of the PKR since December 2017, will add fiscal pressure in FY19. It doesn't end here: as happened in mid-2013, the IMF will want the government to acknowledge that the Rs 550 bln circular debt *parked* in the Power Holding Private Limited (PHPL), is part of GoP borrowing and government debt. If this goes through, it could increase the fiscal deficit by about 1½ - 2% of GDP, which means the fiscal gap this year will surely be larger than in FY18.

On the external side, with required financing in the range of $ 26 - 28 bln this fiscal year, the external sector outlook is not just daunting, it's depressing. Furthermore, efforts to narrow the external deficit have already sparked inflation (**Figure 1**), which will reinforce expectations that interest rates will follow suit. As the price of food, fuel and utilities increase, discretionary consumer spending will fall, which will hurt business sentiments, slow domestic investment and reduce aggregate growth. With the expected shift in government borrowing away from SBP, this will also crowd out the private sector.

The increase in debt servicing will squeeze government spending on development and social services, which means the new government's plan to focus on social welfare, will have to be delayed.

Unfortunately, events in recent weeks have created another complication. Doubts have been raised about the IMF's willingness to assist Pakistan, as the growing rivalry between the US and China is playing out at the country's expense, just when its economy needs clarity and calm (**Geopolitics and the IMF**). In our view, the US should refrain from using the IMF and CPEC in its war of words against China.

More specifically, there is a growing narrative that details about CPEC are intentionally shrouded in secrecy. The story goes that China does not want details disclosed to the world, while the IMF seeks to expose the vulnerability that CPEC is creating for Pakistan's economy. The narrative continues that the IMF (acting at the behest of the US) seeks to undermine CPEC, and Pakistan's relationship with China.

[26] The surprise appreciation of the PKR during the weekend (28 July) confused the market. It is noteworthy that this adjustment was engineered by the kerb market, which shows that SBP's ability to manage the currency (in the interbank market) is not as strong as it used to be. While we agree that this appreciation will be reversed as Pakistan's fundamentals have not changed, it reflects poorly on SBP's ability to manage market expectations during this period of uncertainty.

In our view, this story is flawed for two simple reasons: one, the secrecy about CPEC is a myth[27]; and two, Pakistan is not facing a binary choice of either siding with the IMF or going with China.[28]

If the PTI government can swiftly resolve the confusion about CPEC, within the context of the next IMF program, this should depoliticize CPEC. One must realize that Pakistan needs to implement hard economic reforms while retaining foreign investor confidence – this means it needs the IMF's seal of approval. But Pakistan also needs CPEC, and a steadfast partner in China.

Conclusion

The PTI government should urgently prepare for bilateral talks with China about possible changes in CPEC and the Pakistan-China FTA, to reduce pressure on Pakistan's external sector. Contrary to the popular view, Pakistan's weakness vis-a-vis China does not come from CPEC, but from the poorly negotiated FTA with China. The GoP then needs to share this understanding with the IMF, so the Fund can incorporate this bilateral understanding into the bailout package that will have to be coordinated with the other IFIs. Securing financing from friendly countries, will not resolve Pakistan's economic problem – financing just postpones and exacerbates the issue.

More broadly, structural economic reforms are not about changing policies or issuing directives, but about changing the behavior of people. Other than the glaring example of people not paying their taxes, loss-making SOEs remain problematic because their top management has no incentive to change its behavior – it is given a political agenda, and rewarded accordingly. If the PTI's anti-corruption campaign is able to root out rent-seeking in SOEs, and simultaneously strengthen state institutions, the goals Pakistan has been trying to achieve since the late 1980s, may finally be in reach.

There are reasons to be optimistic. With the on-going investigation of top politicians and their facilitators, and the growing public anger with pervasive corruption, PTI's campaign to target corruption could create the momentum to move decisively with structural reforms. However, the PTI government would have to prepare itself for economic and political disruption, as the vested interests will not give up without a fight (see **Box 2**).

The PTI government will have a very short honeymoon. If the government does not compromise on its campaign promises to eradicate corruption (without a political agenda), create new jobs (without a political agenda) and focus on social development (without a political agenda), the people of Pakistan may be willing to endure additional hardship for the promise of a better future.

The issue is whether this government has the conviction to take on such disruptive challenges upfront, or settle for a more gradualist approach. The downside with a gradual approach, is that the PTI government

[27] Most CPEC-related projects are commercially financed, which means there is transparency about project details. More specifically, we know details about the $ 32 bln worth of power projects that have been financially closed. We also know the terms/conditions for the $ 10 bln worth of infrastructure projects (road/rail and port). What is not known are how many of the power projects have been awarded (creating a repayment outflow), and details of one-off projects like the Orange Line in Lahore and the Karachi Circular Line. In our view, it is the lack of a comprehensive picture from the Government of Pakistan, and ill-advised statements from the Ministry of Finance, that have created the impression that CPEC details are being kept secret.

[28] The issue of the binary choice could become problematic. After Mike Pompeo's ill-advised statement, most analysts now see Pakistan's relationship with the IMF as being shaped by the rivalry between the US and China. As discussed, this is not how the IMF operates, and a bailout package (if requested by Pakistan) will manifest into a stabilization program. The problem with the binary narrative, is that the likely conditions attached to the stabilization program (which would have to be challenging), will be *viewed* as the heavy-hand of the US government, even if this is not the case. This will bias the media coverage of the IMF program, even if the specific reforms are desperately needed by the country. Furthermore, opposition political parties will seize this opportunity to criticize the PTI government for conceding to US pressure, without acknowledging that, as the global lender of last resort, the IMF is really the only avenue to stabilize Pakistan's economy.

may go down the same path as previous governments, even if it doesn't intend to do so. Pakistan's pervasive socio-economic dysfunction has its own inertia, and unless it is actively confronted, this state of being is likely to prevail. Although we wish this government well, we cannot call what direction the PTI government will take.

