Reality Bites

Mushtaq Khan, June 6, 2018

Last month, the government repeatedly stated that Pakistan did not need an IMF program. Media reports since the caretaker government has taken charge (June 1), reveal a very different story. The Ministry of Finance now claims that unless Pakistan starts talks with the IMF, the external deficit could escalate into an economic crisis.

In two articles published on June 3 and 5[1], Shahbaz Rana of the *Express Tribune* reported on briefings made to the new caretaker Prime Minister (PM), by senior officials of the Ministry of Finance (MoF). Using unnamed sources at the meeting, Rana has described how:

- 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, the country has no option but to look to the IMF for help, and sought permission to begin talks immediately;
- The Ministry has 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 budget, MoF informed the caretaker PM that the fiscal deficit would exceed the revised target of 5.5% of GDP, and most likely post a gap of 6.5%.

Many may not be surprised by this change of heart – after all, the political masters have left, and the "system" must now pick up the pieces. As stated in our earlier paper (*The vicious twin deficits, Part 2*, May 30, 2018), the sense of déjà vu with mid-2013 is much too strong, and the bureaucracy knows the next steps that have to be taken. While some may take comfort from this – we do not.

The previous government has been in denial about the external deficit problem, even when the market started taking steps to protect itself. We have also been flagging this issue for over a year with a growing sense of unease (see **Appendix 1**).

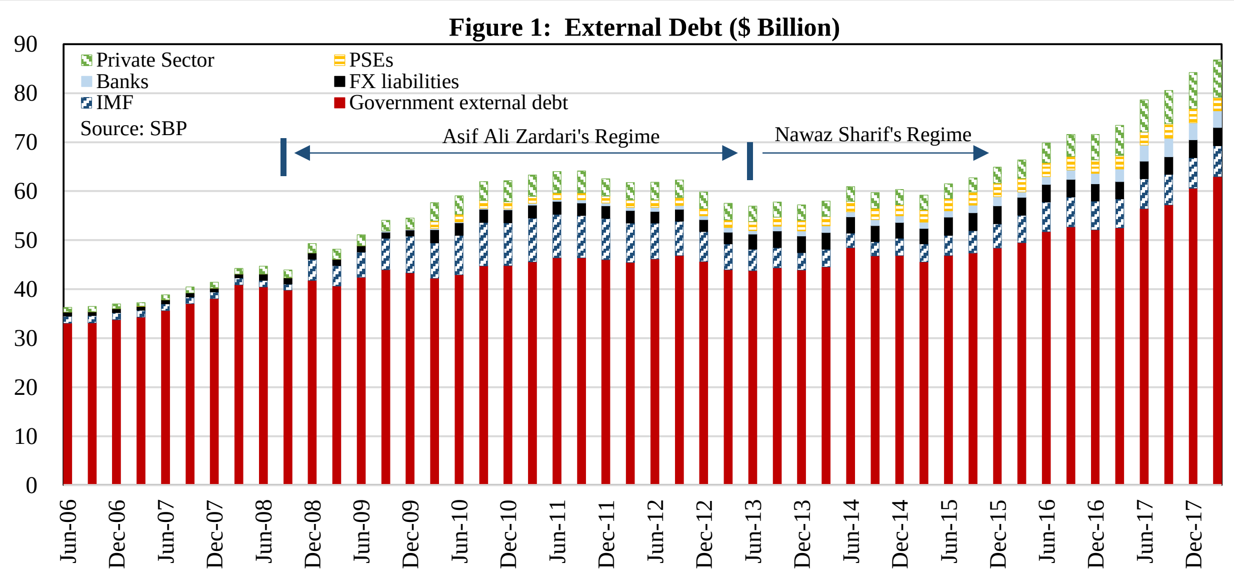
The point to make is not that the underlying problem is a matter of debate, or what lies ahead is uncertain. The point is that institutions that are tasked with ensuring that Pakistan's economy remains on a stable path, have failed.

Key Institutions

In our view, the Finance Secretary's confession about the true state of the country's economic health, reveals a dysfunction that is as serious as the underlying economic problems. 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. Shallow economic reforms

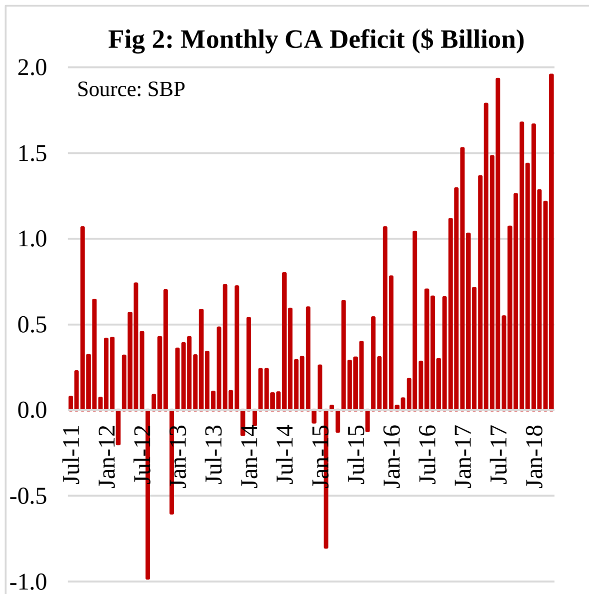
[1] Financial wizards to brief caretaker PM on economy, June 3, 2018; https://tribune.com.pk/story/1726405/1-financial-wizards-brief-caretaker-pm-economy/. Pakistan needs IMF support, Mulk warned, June 5, 2018; Link: https://tribune.com.pk/story/1727908/1-pakistan-needs-imf-support-mulk-warned/

and short-term policy measures, have characterized the operations of each of these institutions for a while. The following responsibilities provide a sense of their importance to the economy.



<u>FBR</u>: Tax rules and enforcement, *ad hoc* concessions & exemptions, imposition of advance tax, release of export rebates, and the need to widen the alarmingly small direct tax base. The heavy collection machinery and the avenues for corruption, are also legendary. These are some of the issues that businessmen and individuals have to grapple with.

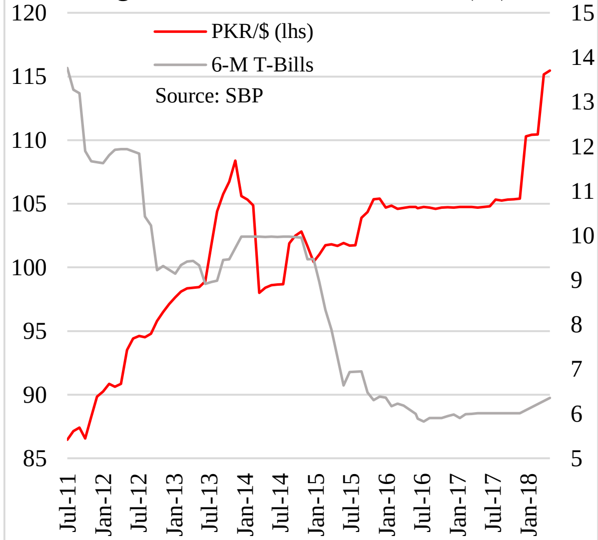
<u>EAD</u>: This institution is the guardian of Pakistan's future FX debt payments. The sharp increase in external borrowing by the previous government (**Figure 1**), begs the question: did the seniors at EAD warn MoF or SBP about the stream of FX repayments being created? With a monthly current deficit that has been trending up since early 2016 (**Figure 2**), and the stream of future FX repayments in FY19 and FY20, perhaps 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 undertaken by SBP. This will not be easy without drastic efforts to reduce the monthly current account deficit (see **Figure 2**). This brings us back to the fundamental point: did EAD communicate this reality to policymakers, especially nearing the end of the political cycle?

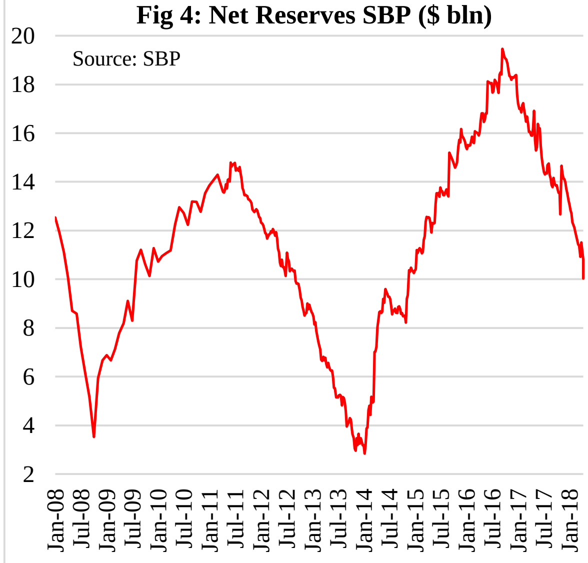
SBP: The PKR/$ management is the most glaring failure (**Figure 3**).[2] As discussed in an earlier paper (May 2017), this created a strong disincentive for exporters that lies at the heart of Pakistan's poor export performance, and the record high current account deficit in FY18. Despite the sharp increase in the monthly current account deficit in 2016, SBP kept the PKR parity fixed. It was only during the IMF's PPM discussions with the authorities in December 2017, that the first PKR adjustment was made, and more recently in March 2018.

Fig 3: PKR/$ & 6-M T-Bill Rate (%)



The inaction to narrow the trade deficit is even more surprising as SBP's FX reserves have been falling since Q3-FY16 (**Figure 4**). Looking ahead, not only would the external deficit have to be brought down with some urgency, but the stabilization and eventual increase in SBP's FX reserves would require more time than in the past (**Figure 4** shows that SBP's reserves increase with the onset of the IMF program).

Fig 4: Net Reserves SBP ($ bln)



What is particularly troubling is the sharp fall in recent months (see **Figure 4**): in our view, with the unexpected PKR adjustments in December 2017, importers have responded to the uncertainty this created, by front-loading their requirements. This implies that to calm market expectations going forward, a comprehensive and credible economic plan has to be announced quite soon. As stated in an earlier paper (*The Unexpected Interest Rate Hike*, January 30, 2018) the only way to keep the market calm would be to signal the onset of the next IMF program.

Institutional responsibility

The relationship between elected politicians and the bureaucracy, has changed a great deal in Pakistan during the past two decades. In my view, the abovementioned institutions were once respected for the professional commitment – and caliber – of the senior bureaucrats that managed these institutions, more so than the presiding ministers. In some ways, an analogy with the British comedy show *Yes Minister* is useful to put this into context.

While the British comedy show paired a naïve, but well-meaning minister (Jim Hacker) against a smooth-talking, manipulative permanent secretary (Humphrey Appleby), the situation in Pakistan is almost the opposite. Nevertheless, what is interesting is how the British bureaucracy is shown as having its own agenda, and is able to control the impulses of politicians. From the perspective of Pakistan, the unity of

[2] 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.

the civil service *brotherhood* (and its ability to defy political pressures), is something that needs to be appreciated.[3]

This translates into a strong check and balance on policies that may be expedient (for politicians), but will ultimately harm the country. In our view, Pakistan's bureaucracy has lost the ability to keep political whims in check, which in turn, has changed the goals of senior bureaucrats. The goal is no longer to protect the institution (or public welfare), but to have an excuse to justify decisions. This implies that the bureaucracy has effectively given up responsibility for the institutions they manage. No degree of formal autonomy given to these institutions will change this, unless the incentives of the bureaucrats are changed.

This politicization of Pakistan's civil service (which dates back to the early 1970s) now appears to be complete. In our view, unless key economic institutions are able to stand up to short-sighted, politically driven policies, Pakistan's economy will remain structurally weak. Whether the power imbalance between politicians and institutions can be rectified, and how exactly this is to be done, is a very complex issue that is not just limited to Pakistan.[4]

Path forward

As the caretaker government settles in, there are several inter-related issues that need to be closely watched. Specifically, how the caretaker Finance Minister (an ex-World Bank and ADB employee) manages the market's expectations about what lies ahead. An objective assessment of the state of the economy would be the best start, and would gain credibility if this is done in a gathering of senior officials of the international financial institutions (IFIs).

In the final analysis, it is the composition and professional competence of the next economic team that will be decisive. The caretaker government does not have the mandate to chart a policy path on behalf of the next government; the best it can do is to be honest about where we stand and the steps that are required in the next several months. There should be a specific focus on institutional strengthening, as Pakistan's economy will continue to drain SBP's FX reserves, and unless this hemorrhaging is addressed, it could trigger volatility in the interbank FX market.

This does not mean that a daunting outlook will undermine investor confidence. An objective assessment of the path ahead, and some indication of what could be different this time around, is a hopeful start. As stated in an earlier paper (*The vicious twin deficits*, Part 2, May 30, 2018), an impartial and just amnesty scheme, along with an understanding with China to address the lop-sided bilateral trade relationship, would go a long way in creating a sense of optimism about the future.

[3] One could argue, that since the bureaucracy has a permanent presence in the government (and a well-defined procedure of who has power, and how he/she can wield this power), it would be more wary of taking steps that will come back to haunt the government (and make their professional lives more difficult).

[4] The rise of populist politicians in the US and Europe, is beginning to rip apart the relationship between popular leaders and the institutions they now control. In Pakistan's case, discussions with Salim Raza reveal that efforts to protect civil servants from political pressures were part of the federal constitutions in 1956 and 1962, but were reversed in the 1973 Constitution. This issue will be discussed more interactively in a subsequent blog on our website.

Appendix 1: Past papers on Pakistan's Balance of Payments & the IMF

doctored papers has written ten papers about Pakistan's external sector imbalance (and the IMF) in the past year (this being the eleventh). What is interesting is how our narrative has evolved during this period. Although we called for the need for an IMF program a year back, we now think that this must be supplemented with *real* fiscal reforms in Pakistan.

1. *Pakistan's BoP Problem: The Calm before the Storm*, May 31, 2017. We flag weakened state institutions, the structural bias in favor of imports (and against exports), and how CPEC needs to be redesigned, to narrow the external deficit.
2. *Pakistan's Balance of Payments, the IMF and China,* September 14, 2017. We build on the role of China (via CPEC) to help Pakistan overcome its BoP problem. We claim that China would favor decisive reforms (via the next IMF program), with a specific focus on institutional strengthening. We also state that a fixed PKR/$ policy would push the country towards a much worse outcome.
3. *Too Little, Too Late?* October 18, 2017. We observe that the government's efforts to impose import controls indicate a sense of policy desperation. We describe an IMF stabilization program in 2018 as "inevitable."
4. *Could the next IMF Program be decisive?* December 12, 2017. Building on our narrative, we broadly define the parameters of the next IMF program. We talk about the need to focus on undervalued real estate and to document the informal economy.
5. *Q3-FY18 Macro Projections: Stepping into the Unknown*, January 22, 2018. While acknowledging important steps that have been taken (e.g. the PKR adjustment in December, and the fuel price increases in December and January 2018), we warn that these will push the country towards a higher inflation trajectory. We question whether the government would follow through with corrective policy steps.
6. *The Unexpected Interest Rate Hike*, January 30, 2018. The surprise 25 bps rise in interest rates is interpreted as paving the way into the next IMF program. It also signals that populist policies are highly unlikely despite the forthcoming general elections.
7. *FATF and Pakistan's economic outlook,* February 19, 2018. We state that an IMF stabilization program is now required as the Pakistani market is *conditioned* from past experience. More specifically, for the market to normalize its expectations, the familiarity of an IMF program is required. Again, we talk about real estate and the undocumented economy.
8. *The IMF Strikes Back,* March 23, 2018. Using the IMF's Post-Program Monitoring Assessment, we claim that the IMF is also hinting at what needs to be done in the next program.
9. *Q4-FY18 Macro Projections: The vicious twin deficits, Part 1,* April 26, 2018. We focus on the strong linkage between Pakistan's BoP problem (financing the gap instead of narrowing it) and the fiscal side. We also propose that the low inflation witnessed during the period FY15 to FY17, was abnormal for a country with structural fiscal and external deficits. This means Pakistan will return to the old days.
10. *The vicious twin deficits, Part 2,* May 30, 2018. We start by arguing that our current situation, has a sense of déjà vu with what happened in mid-2013. However, we argue that the debt burden is now so heavy that standard policy measures (e.g. a weaker PKR and higher interest rates) may not be enough to stabilize the economy. We again highlight the need to bring in real estate into the tax net, and to formulate a fair amnesty scheme for errant Pakistanis (both residents and non-residents).