The IMF Strikes Back

Mushtaq Khan & Danish Hyder, March 23, 2018

We take an odd sense of comfort from the latest IMF Staff Report on Pakistan.[1] While the overall outlook is a bit foreboding, it's the return to a more responsible and realistic narrative about the economy, which signals a policy shift towards stabilization in FY19.

To analyze what the IMF is saying (explicitly and implicitly), we will structure this paper on the basis of our history with the Fund, and what is new in their current analysis. In doing so, we will move back and forth within the report, citing specific paragraphs.

What's old?

The Staff Report contains the usual issues in familiar language. To close observers of IMF programs dating back to the mid-1990s, this is old ground. What is disappointing in the report, is that the issues discussed are almost exactly the same as they were in reports dating back 20-years.[2] Then there is the IMF's ideological fixation 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.*

While we agree that demand pressures have been pushing imports (especially high-end consumer imports), increasing interest rates will do little to address the problem. This is because domestic demand is not driven by consumer credit availed from commercial banks, but rather the undocumented wealth-effect from real estate holdings. In Pakistan, a factor the government has no control over (undervalued real estate) has far more impact on consumer demand than do interest rates.

One should also realize the above quote contains something that we have not seen in an IMF report – an admission that a PKR adjustment (depreciation) will have inflationary implications.[3] So the IMF's argument is that since a PKR adjustment is required to narrow the external gap – and this will stoke inflation – interest rates should be increased for policy consistency.

But then the IMF goes into automatic pilot: it states that an increase in interest rates will strengthen the PKR by increasing foreign demand for Rupee-denominated government securities. Of all the players involved in Pakistan's economy, the IMF should have realized by now that foreign demand for Pakistani government securities is almost non-existent, not just because of taxation anomalies, but also because of political risk.

We are also a little annoyed by the IMF's assertion (para 8) that the 25 bps increase in interest rates in January 2018 was required to address "domestic demand pressures". This flies in the face of market sentiments (at the time) that an interest rate change after 20 months could not be justified by prevailing

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[1] This represents the culmination of the post-programme monitoring (PPM) Staff Report that was issued on March 14th 2018.
[2] Also, SBP's net international reserves (NIR) will become one of the more important program parameters, which will dominate media attention in the next stabilization program.
[3] This was not a one-off lapse. In para 10, the IMF states: *Absent major changes in the exchange rate, headline inflation is expected to remain in mid-single digits both in 2017/18 and in the medium term.*

market conditions (*The Unexpected Interest Rate Hike*, January 30, 2018). Having said this, orthodoxy is to be expected from the IMF; it confirms market suspicions that this increase was motivated by the need to show the IMF that our policymakers were doing the right thing.

In terms of unaddressed problems, the restructuring of loss-making state-owned enterprises (SOEs) has been mentioned repeatedly, while the power-sector circular debt (the IMF claims this has reached Rs 514 bln as of end-December 2017) will again need a one-off payment, as was the case when the Nawaz Sharif government entered an IMF program in 2H-2013. The next government will likely blame past mismanagement for this problem. Although this takes Pakistan back to square one, the report states that the persistent drain on the federal government on account of PIA and Pakistan Steel Mills will require immediate attention.

In terms of what to expect when the stabilization program begins (perhaps in the guise of *early actions* required to enter an IMF program), para 24 states the need to increase power tariffs and consider additional electricity surcharges, to halt the build-up of circular debt. As repeated by the Fund, steps will be required to stop the financial hemorrhaging in both PIA and PSM.

What's new?

There are several new dimensions to this IMF Report, which should be flagged:

- CPEC;
- The rapid increase in Pakistan's external debt;
- The reform agenda of the previous Extended Fund Facility (EFF) remains incomplete;
- An admission that a weaker Rupee has inflationary implications (already discussed);
- How the government has creatively skirted parliamentary limits on the country's total debt;
- The GoP airs its differences with the IMF's assessment;
- From the federal government's perspective, the 18th Amendment could be hampering the government's ability to undertake politically sensitive economic reforms; and
- A fleeting mention of the need for a "centralized electronic fiscal cadaster."[4]

CPEC

CPEC's inclusion is not surprising as it has started to impact Pakistan's economy in the past two years, with the pace picking up after the last IMF program. The Fund briefly mentions the scope of this project, and how it is driving domestic investment in ancillary industries, and Pakistan's overall import growth. The Fund also mentions how the scale of this project has created growth momentum in the economy, which is now beginning to stress the external sector. While the report flags the external debt/liability created by this project, it does not link this up with the export growth required to make this project sustainable.

As stated in an earlier paper (*Pakistan's Balance of Payments, the IMF and China*, September 14, 2017), it would be in China's interest for Pakistan to resolve its chronic external sector weakness, in order to ensure that CPEC is a commercial and strategic success. Despite some rumors that the IMF (acting as an agent of the US) is against CPEC, or seeks to contain Pakistan's participation in this undertaking, we see no anti-CPEC bias in the IMF Staff Report. This is somewhat surprising as the market perception of the December PPM was quite alarming, as media reports stated that there was a fundamental disconnect

[4] Both authors had to look at a dictionary to understand what a "cadaster" is. The answer gives us reason to be optimistic, which will be discussed a bit later.

between the IMF and Pakistan, about various issues like the burden imposed by CPEC and the lack of serious power-sector and fiscal reforms.[5]

Our qualitative assessment of the March PPM is within the context of the media reports.

External debt

The Staff Report brings up Pakistan's external debt in para 14 (out of 40), and 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 urgency, that the debt build-up will continue for the next several years.[6] 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.[7]

What may be lost on some readers, 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 there is an unspoken rule in the global order, whereby member countries cannot default (or roll-over) their repayments to the IMF. Hence, for a country that is having difficulties repaying its debts, the Fund gauges the country's external obligations, and provides sufficient funding to repay its sovereign debts, while working to narrow the trade deficit.

While the government may continue saying it has no intention to approach the IMF, this is only political posturing. Since Pakistan's scheduled debt payments are not going away, flagging Pakistan's ability to repay the IMF, is tantamount to an invitation to Pakistan's next government to visit them in Washington DC. We hope that the program details that are agreed upon will formalize not just the heavy debt servicing in the next two years, but also the burden that CPEC-related projects will impose on the country.

The incomplete EFF

We started flagging Pakistan's BoP problem in May 2017 (*The Calm before the Storm*, May 31, 2017). This was just eight months after the end of the EFF, which means there was not enough time for our policymakers to make a total hash of the economy: this suggests that the IMF program lacked traction, which implies issues with program design. The circular debt is back to alarming levels; the current account deficit continues to grow while FX reserves have been falling since October 2016; and most of the fiscal revenue growth witnessed in FY18 has been driven by incidental factors, without any semblance of policy effort.[8]

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

[5] Media reports about the December PPM, specifically the coverage by the Express Tribune (Shahbaz Rana) talked about how the IMF mission was *appalled* by the size/scope of CPEC, and the disconnected outlook of the IMF versus the GoP. His coverage in the Express Tribune was quite detailed: *Pakistan, IMF begins post-programme monitoring talks* (Dec 6th); *Sheer size of CPEC portfolio appalls IMF* (Dec 7th); and *IMF questions levy of duties, weak tax regime* (Dec 8th). The PKR/$ parity was suddenly depreciated on December 8th 2017.

[6] Even if the IMF is generous and commits a lot of money upfront, it is still a debt that will have to be paid off in the future.

[7] 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. Hence, the challenging economic outlook.

[8] Para 12 (The fiscal deficit will likely remain elevated), has the following line: "Stronger tax revenues (12.9 percent of GDP, up from 12.5 percent last year) – owing to robust import growth, higher oil prices, the recent exchange rate depreciation, and imposition of regulatory duties – and lower interest expenditures are expected to provide a moderating effect on the deficit."

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

The ineffective FRDL

Para 29 talks about the Fiscal Responsibility and Debt Limitation Act (FRDL Act), which was passed in 2005 as a partial 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, as an effort to cap the country's indebtedness. 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%. As the Staff Report states in footnote 6:

> *The FY2017/18 Budget Act changed the definition of debt subject to the mandated limits from gross debt to net debt*.[9]

In the decades-old relationship with the IMF, Pakistani policymakers have gotten to know their IMF counterparts, in terms of what they need to accomplish, and how much leeway we have to deliver on committed reforms. In an earlier paper (*The Parable of Pakistan and the IMF*, December 27, 2016), we talked about how a prolonged relationship between a self-serving doctor (the IMF) and a chronically ill patient (Pakistan), could evolve into a mutually dependent relationship, whereby the health of the patient is no longer the end goal of both parties.

If the IMF's disclosure of how the Pakistani authorities were able to meet the FRDL requirement is an indication of a change in heart (for the doctor), perhaps the relationship will change for the better. Does this mean that the next stabilization program will be more rigorously pursued to achieve real results?

The Authorities' views

Despite this being an IMF Staff Report, Pakistan's policymakers felt strongly enough to insist that this report also include their side of the story. This is a not-so-subtle effort by the Authorities to rebut the IMF's assessment. This was done *four* times in a 14-page document: (1) after the IMF's Macroeconomic Outlook; (2) after the Fund's view of Pakistan's capacity to repay the IMF; (3) after the IMF's list of required policies for the external sector adjustment; and (4) after the Fund's appraisal of what is required to strengthen Pakistan's macro stability in the medium term.

The points raised by the Authorities can be summarized as …*while we agree with the IMF's proposed measures, the Authorities are confident they have done enough and things will be fine*. The most glaring (and somewhat amusing) assessment is the Authorities' view on exchange rate management – more specifically, in response to the IMF's call for greater exchange rate flexibility, para 25 states:

> *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.

[9] 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 the country did not breach the FRDL.

Provincial governments are not reformist

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

> *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 consultation with the provinces, which may limit the range of politically feasible reforms.*

From our perspective, this might be the first time an IMF document has explicitly stated that economic reforms are politically difficult. In our view, this is progress for an institution that prides itself on being an apolitical participant, even when it's internal operations and all its clients, are deeply immersed in politics. So while the Staff Report has repeatedly talked about the need to restructure loss-making SOEs like PIA and PSM, there is little mention of the reasons that Pakistan has been unable to restructure these enterprises (or move more forcefully against power distribution companies that create the circular debt). Mentioning the difficulty in taking on politically active unions, or installing professionals in management, or protecting SOEs and Discos from self-serving political interests, would have been refreshing.

With the on-going media discussion about reversing the 18th Amendment (the decentralization of policy making to provincial governments), we hope the forthcoming program details will find a balance between the political desire for provincial autonomy against the urgent need for these provincial governments to upgrade their operations and commit to institutional reforms that meet global best practices.

Fiscal cadaster

"Fiscal cadaster" refers to a comprehensive register of real estate holdings in a country. Since November 2016, we have been highlighting the fact that real estate is perhaps the greatest repository of Pakistani wealth (*Addressing the real economic challenges facing Pakistan*, November 21, 2016). The IMF Staff Report touches on the need to create a centralized electronic register of real estate holdings/properties, which we wholeheartedly agree with. In fact, our more recent paper (*Could the next IMF program be decisive*, December 12, 2017), suggested that since demand pressures are driving imports, a more effective policy to reduce aggregate demand, would be to rectify the gross undervaluation of real estate holdings in Pakistan. This would give policymakers a much better handle on the purchasing power in the economy, as they would have a better sense of the actual wealth of Pakistanis.

Targeting real estate would more accurately document the main source of Pakistani wealth (which drives consumption/investment behavior and imports), and also boost tax revenues from the real estate sector. It would be a critical first step in documenting Pakistan's economy, and forcing all Pakistanis into the tax net. Although the political opposition to this would be substantial (especially as this is the main avenue for hiding corruption-generated wealth), one thing should be very clear: the more political opposition there is to a specific policy reform, the more profound and spectacular the results if that specific reform is carried through.

Again, this issue will be settled when details of the next stabilization program are made public.

Assessment

The IMF Staff Report acknowledges that the incumbent government may not be in a position to implement its recommendations, effectively saying that the required steps are not tenable given the forthcoming general elections. While this reveals that initial discussions with the IMF may begin with the interim government, Pakistan's macro situation is such that the economic challenges it is facing will surely eclipse political bickering, and set the policy agenda of the next government.

The IMF has expressed limited reservations regarding the scale/scope of CPEC, which is surprising given the media reports of the December 2017 PPM. This is even more surprising since the Fund has flagged the external debt build-up and the heavy servicing requirements in FY19 and FY20. In an earlier paper (*Could the next IMF program be decisive*, December 12, 2017) we stated that simply incorporating CPEC-related FX debts/liabilities in Pakistan's BoP outlook, would address the growing concerns that observers have about this project. We expected this issue to carry more policy prominence.

The picture put forward in this report, strongly suggests that Pakistan will require a stabilization program in FY19. In our view, it is now imperative that Pakistan's policymakers do not shy away from hard reforms as they have for the past decade.[10] The issue is whether the *political will* can be generated to make this happen.

We are a bit disappointed that the issue of real estate undervaluation has not been given the prominence it deserves. The overall tone of the document is also mechanical, as the old problems are listed with the same proposed solutions that have not delivered. We were hoping that a water-tight procedure to more accurately value real estate holdings, could have been launched as an out-of-the-box solution to tackle one of the most politically sensitive structural problems in Pakistan.

In overall terms, the IMF Staff Report creates some optimism that Pakistan's economic policies will become more proactive. The policy paralysis that started in mid-2017, is likely to continue till the next elections, but just having an on-going dialogue with the IMF, should keep the market calm. The country can also take some comfort that Pakistan's macro economy is still relatively stable, and we do not see a meltdown (as in 2008) before the next government enters a new program. This calm is reflected in the PSX, which has been rallying since the PKR was adjusted in March 20.

Conclusion

Both the market and **doctored papers** take some comfort from the IMF Staff Report. As stated earlier, the content and tone of the report reveals the caution Pakistan's policymakers need to exercise. Since the IMF has been a perennial partner in solving past BoP problems, this report addresses the uncertainty that Pakistan's economy has been grappling with over the past four or five months.

The report itself stands out for the issues raised, and admissions that are uncharacteristic for the IMF. As stated earlier, by allowing the Pakistani authorities to air their views, the IMF's viewpoint is sharper, and not as diplomatic as in the past. Talking about how the well-intentioned FRDL was nullified, or admitting that the EFF's reform agenda remains incomplete, is quite significant for the Fund. Furthermore, being able to talk about the political resistance to economic reforms or how the incumbent cannot be expected to do the right thing, are a departure from the past. Finally, the neutral-to-positive stance on CPEC (despite the FX debt/liability created) was surprising.

However, to seasoned analysts of past IMF programs, the sheer familiarity of this document creates a nagging sense that this is just more of the same. If the past is any guide, the issues that need to be addressed and the manner in which they are likely to be prosecuted, are too familiar. As discussed in an earlier paper (*The Parable of Pakistan and the IMF*, December 27, 2016), the long history we have with

[10] Past practices suggest that the government would opt for a borrow-and-spend strategy, as it is easier than taking hard steps. This means entering a debt-trap (if we are not already in one now), which would leave the country exposed and vulnerable to external influence. The question is: with changing geopolitical forces currently at play, can Pakistan's economy afford to remain as vulnerable as it has been?

the IMF, suggests that the next program will not deliver – yes, it will stabilize the economy, but is unlikely to address the structural problems.

Setting aside past luggage, if we focus on the more forthcoming PPM report and the fact that the next economic team will surely be more credible, competent and well-intentioned, compared to the past regime (Ishaq Dar), we can hope for the best. This will also depend on the program details that the IMF staff and our policymakers agree upon. Since the IMF alone cannot solve our problems, the responsibility to take a new direction, lies with Pakistan's policymakers, and more importantly, it depends on the *political will* to make hard changes.

Post-script: the PKR/$ change

The recent depreciation of the PKR has created some uncertainty about just how far the government will allow the PKR to adjust (as in all cases where expectations are not properly managed), the market is expecting the worst. In our last macro projections (*3Q-FY18 Macro Projections: Stepping into the Unknown*, January 22, 2018), we projected the PKR/$ parity at 114.4 for end-March, and 118.6 for end-June 2018.

Larger adjustments carry the risk of spiking inflation, which would require a sharper increase in interest rates. As we argued in this paper, Pakistan's domestic debt is already a heavy burden with a very short-term maturity, which means a significant increase in interest rates would blow-up Pakistan's fiscal side. Therefore, in our view, both the IMF and the GoP will be conservative in adjusting the PKR and interest rates.

We will be tweaking our macro projections for 4Q-FY18, which we will share with select clients in the last week of April.

