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## The Parable of Pakistan and the IMF

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The IMF program that concluded in September 2016, was deemed a success after flying under the market's radar for almost three years. Pakistan's economy is doing reasonably well, but this may not have much to do with the program. Having said this, given decades of dependency on the IMF, there is a strong expectation that Pakistan will once again ask this institution for help if its economy gets into a tough spot.

This relationship (i.e. dependency) can be better understood by looking at our history with this IFI.

### Past Programs

As with any other country, Pakistan only approaches the IMF when it faces a BoP problem. Although this still remains the trigger to approach the IMF, programs since the 1990s (in collaboration with the World Bank) have focused more on comprehensive structural adjustments than just hard currency support.

Since December 1988, Pakistan has had 9 separate engagements with the IMF (three of these were double *programs* – i.e., more comprehensive engagements). The last 4 programs, which were in the 2000s, were completed successfully, but the previous 8 in the 1990s were abandoned.

The turning point came in early 2000, when Pakistan was facing sovereign default by year end. General Musharraf had taken charge in October 1999 and had little choice but to seek IMF assistance. One should recall that Pakistan fell out of favor with the West in May 1998 (nuclear tests) and again with Musharraf's coup. The discipline with which the November 2000 Standby Arrangement was implemented, ensured completion of the program in September 2001. With this rare success, in December 2001 the GoP and IMF embarked on a 3-year growth program to consolidate these gains.

However, a closer look at the 4 successful programs, reveals that two are clearly linked with positive external developments (positive shocks). The 3-year December 2001 program was supported by debt rescheduling/write-offs and generous US grants after 9/11, while the 3-year November 2013 Extended Fund Facility became irrelevant after the collapse of oil prices in mid-2014.

We would therefore argue that the only truly successful IMF program was the 10-month November 2000 program, and this was because the GoP had little choice but to deliver if it wanted to avoid sovereign default. Clearly it is the political will to change, as well as external developments, which determine whether reform programs are successfully completed.

This raises the question: what exactly does the *IMF* do to ensure program success?

### Doctor-Patient Parable

A parable may better illustrate Pakistan's complicated relationship with the IMF.<sup>1</sup>

The incentive for a Doctor (IMF) to maintain a relationship with a Patient (country) is pretty straightforward. If the Patient makes a full-recovery, the Doctor may feel professionally satisfied, but

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<sup>1</sup> By the IMF's own admission in 2002, Pakistan was third in a list of 51 countries described as "prolonged users" of IMF support. Our peers are the Philippines (#1); Panama (#2); Kenya (#7); and Argentina (#16).

will also lose a customer. A ‘well-intentioned’ Doctor would prescribe bitter medicine and demand behavioral change – he would not allow the Patient an easy way out. A ‘self-serving’ Doctor, on the other hand, will yield to the Patient’s reluctance to change bad habits, and prescribe milder medication; the Doctor will also schedule regular visits to keep administering the palliative.

But after being bed-ridden for almost a decade, why doesn’t the Patient insist on a course of treatment that would actually cure him? In our view, this is because the Patient is under the charge of his Aunt, who lives with the Patient. As with the Doctor, we also assume the Aunt is either well-intentioned (wants the Patient to recover) or self-serving (wants to keep the Patient weak so she can continue living it up in the Patient’s house).

Any Doctor should be able to see through the motivation of the Aunt. But it’s not that simple – the Doctor reports into a Board, which insists that the Aunt has final say (as the guardian of the Patient). The issue is, after 8 failed treatments that have focused on the same illness, why does the Doctor continue to treat the Patient? Why doesn’t the Doctor adopt a tough-love approach? Why doesn’t the Aunt demand a more effective treatment that will show results?

This boils down to a simple question: why is Pakistan such a prolonged user of IMF programs?

### Game Theory

Another way to look at this question, is using a simplified game theory approach (if readers are uncomfortable with game theory, please move to the next section).

In this game, the Doctor (IMF) represents the Board, while the Aunt (Government) represents the Patient (the people of Pakistan). For a prolonged user, this game is repeated, and the ‘payoffs’ shown are what the two players (Aunt and Doctor) receive.

		Aunt (Government)	
		Well Meaning	Self Serving
Doctor (IMF)	Well Meaning	Q1: 4, 4	Q2: -2, -5
	Self Serving	Q3: 5, -2	Q4: 8, 8

Quadrant 1 shows both the Doctor and the Aunt working for the betterment of the Patient. In doing so, the Doctor works himself out of a job. Although he is professionally satisfied, he does not gain as much without a stable job.

In Quadrant 2, the Doctor is well-intentioned but the Aunt refuses the treatment. The Patient suffers terribly (sovereign default), and the Doctor is punished by his Board. Both players are individually hurt in this worst-case scenario.

Quadrant 3 shows a well-intentioned Aunt and a self-serving Doctor. The treatment fails but the Doctor is assured of more work (hence, he prefers this to Quadrant 1). The Aunt is

disappointed and hurt, and the Patient continues to suffer.

In Quadrant 4, both the Doctor and the Aunt are self-serving. The treatment obviously doesn’t work, but this serves the interests of the Doctor and the Aunt as both know another treatment will soon begin. Since these payoffs are for the agents (not the Patient or the Board – the principals), this case shows the conflict of interest that often arises in a Principal-Agent relationship.

If this game (with the same payoffs) is repeated, the Doctors ‘dominant strategy’ is to be self-serving – irrespective of how the Aunt behaves, the Doctor is better off playing selfish. For the Aunt, it is not clear. However, if the Aunt knows that the Doctor will always be self-serving, she too will gain more from being self-serving. Hence, Quadrant 4 is a stable equilibrium.

This assessment may appear too abstract to be relevant, but it can be made more intuitive by thinking about the behavior of the IMF, the GoP and the role of the IMF's Executive Board.

### **The IMF mandate**

The IMF was created to assist countries facing balance of payment problems, and is considered the lender of last resort. Since Pakistan often has insufficient Dollar reserves, its ongoing relationship with the IMF is not surprising.

Broadly speaking, the reason for failed IMF programs may be 'exogenous shocks' (e.g. unanticipated floods; a sharp increase in oil prices; civil war; etc.), or a lack of 'political will' to make changes (i.e. the unwillingness of the government to implement certain policies) – or a combination of the two. As self-serving governments are more common than negative external shocks, prolonged IMF users are more likely to suffer from a lack of political will to change their economic systems.

The IMF's willingness to accept half-hearted implementation of economic reforms, creates an incentive for governments to show Bad Faith (i.e. to promise reforms that it has no intention, or ability, to implement). Since Bad Faith ( $\approx$  bad behavior) makes it more likely that the country will face a BoP problem in the future (which the IMF is mandated to help out with), the IMF has to state that previous programs failed because of Bad Luck, which is to say it was beyond the control of both the IMF and the client government.

Failure cannot be ascribed to poor program design/monitoring (IMF) or Bad Faith (the government).

### **Bureaucratic compulsions**

The IMF's inability to learn from the past is driven by its bureaucracy, which operates with its own internal incentives. If the IMF makes future engagement contingent on past performance, it risks losing its regular clients (prolonged users). This would reduce the IMF's workload, which goes against the mindset of any seasoned bureaucracy.

The IMF is therefore willing to return to countries even if they engineer their own problems. It cannot cite the lack of political will (of the government), as Bad Faith would reveal poor operational practices within the IMF. Hence, the IMF remains 'apolitical', even though the hindrance to real economic reforms is always political.

### **Realpolitik**

Keen observers of the IMF, are of the view that the institution is also a source of foreign policy leverage for the US (as the only member of its Executive Board with a veto). Having the final say on whether a country defaults on its external payments, is a powerful position to be in. Many would argue that Pakistan's status as a prolonged user, makes it particularly vulnerable to geopolitics.

Having said this, US leverage is not always used as a stick to influence a country's policy decisions. The IMF was all praise for Pakistan after 9/11, and the local media sometimes characterized the December 2001 PRGF as a reward for joining the US war on terrorism. Although this program became irrelevant after the positive developments post-9/11, the IMF was still enthusiastic about its 'successful' completion in late 2004, when Pakistan was in the midst of a credit-led consumer boom.

## **Pakistan's Outlook**

Despite misgivings about falling exports and a slowdown in remittances, the outlook for Pakistan's economy is upbeat. The comfort from low oil prices is likely to continue till 2020, which should keep annual inflation in the range of 4-6 percent; this would also contain subsidies to Pakistan's inefficient power sector. Even while direct tax collection perpetually misses its annual target, low interest rates have eased domestic debt servicing, which has kept the fiscal accounts manageable.

The next positive is the China-Pakistan Economic Corridor (CPEC). Although we think CPEC raises many unanswered questions, it factors prominently into the bullish sentiments that businessmen express. The booming stock market should help attract portfolio inflows in FY17, and FDI for CPEC-related projects should also help the external sector.

Pakistanis also take comfort from closer ties with China, while India and the US are developing strong common interests. This is especially relevant as president-elect Trump prepares to enter the White House. Trump Tweets will challenge the global economic order, but will not be as destructive as suggested by the global media.

As we have discussed in a previous note, CPEC cannot be allowed to fail, as it would undermine China's economic strategy for the 21<sup>st</sup> century. Just partnering up with China, appears to be sufficient to promise a sustainable growth trajectory for Pakistan.

## **Conclusion**

Pakistan's status as a prolonged user of IMF support, suggests that 'reform fatigue' has set in. Both the IMF and the GoP appear to have settled for a strategy to accommodate the status-quo and then firefight through issues.

Against the backdrop of a dysfunctional relationship between Pakistan and the IMF, CPEC may be a new character in the Pakistan-IMF parable – a no-nonsense 'Doctor' who must ensure that Pakistan is healthy enough to partner up with China. If this is indeed the case, the IMF program that just ended in late 2016, may be the last Pakistan will have.

Reforming a country's economy is not just about changing policies or issuing circulars – it's not even about securing parliamentary approval for sensitive policy change. Structural reforms are about changing people's behavior, especially for those who feel political power gives them license to extract resources for personal gain.

Changing such behavior is not easy, which explains why structural reforms are notoriously difficult to implement.

As we have argued, prolonged interaction between representatives (the government as an agent of the people of Pakistan, or the IMF acting on behalf of its Board), can lead to second-best outcomes. Since Pakistan has been a prolonged user of IMF support, it must now approach economic reforms with a completely different mind-set, and attitude.