The Parable of Pakistan & the IMF (Part 2)

Mushtaq Khan[1], June 3, 2019

In late 2016, my colleague (Danish Hyder) and I wrote a paper about Pakistan's relationship with the IMF (*The Parable of Pakistan and the IMF*, 27 December 2016). A shortened version of this paper was subsequently printed in the Herald magazine (https://herald.dawn.com/news/1153641).

As we gear up for the next IMF program, I revisited this paper and have extended the analysis to gauge how the forthcoming 39-month Extended Fund Facility (EFF) is likely to fare, given Pakistan's checkered relationship with the Fund.

Pakistan's 30 year relationship

To put things into context, let's summarize our relationship with the IMF. The point is not to include details of past programs, amounts availed and the actual reforms implemented, but to highlight certain trends in the past 30 years:

- Our on-going relationship started in late 1988 after the death of General Zia-ul-Haq. This paved the way for democratic elections that were famously won by Benazir Bhutto and the PPP. This also coincided with the end of the Soviet invasion of Afghanistan, which ended the era of close military cooperation between Pakistan and the US;
- The 1990s were characterized by regular changes in government between the PPP and Nawaz Sharif's PML-N, with both parties having two stints in power. During this decade, Pakistan remained engaged with the IMF, but the relationship was interrupted by the political musical chairs as new governments re-engaged with the IMF on their terms. In our view, except for partially successful financial sector reforms in the early 1990s, the underlying structure of Pakistan's economy changed little during this period;
- Nearing the end of the 1990s, Pakistan experienced two negative shocks: Pakistan's nuclear tests in May 1998; and General Musharraf's coup in October 1999. The severing of relations with the US and the imposition of international sanctions, stalled the IMF and IFI-sponsored reforms. Given the low level of SBP's FX reserves, Musharraf's government realized that unless Pakistan re-engaged with the IMF, it would face sovereign default in early 2001. After prolonged negotiations, Pakistan secured a 10-month Standby Arrangement (SBA) in November 2000, which was one of the few programs to be successfully completed;
- 9/11 took place just after Pakistan had qualified for a 3-year Poverty Reduction & Growth Facility (PRGF). With US debt relief & Paris Club rescheduling as rewards for supporting the US war of terror, and the channeling of worker remittances through the banking system, the performance targets in the PRGF became meaningless, and Pakistan cruised through the program without any tangible economic reforms. One may recall, that this was the period of a consumer-led economic boom, which coupled with record FDI in telecom and the banking system, kept Pakistan's economy humming until the import-dependent growth (and rising oil prices) created a BoP crisis in late 2007;
- The new PPP government (Zardari) entered the next IMF program in late 2008, which was a period when many countries were facing acute economic challenges because of record high oil prices and the financial crisis of 2008;
- By the last year of the PPP's term in power, the need to return to the IMF was increasingly obvious, but this was postponed till after the general elections in mid-2013;

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- The first thing the PML-N government had to do was to secure another IMF program, which ended rather unceremoniously in September 2016. Again, little came of this program as the collapse of oil prices in mid-2014 had effectively made the IMF's key targets irrelevant. For other performance benchmarks, the IMF provided waivers so that the program continued; &
- As we enter the next IMF program, the inordinate (and wasteful) delay in securing this deal must be noted. We first flagged the current BoP problem back in May 2017 (*Pakistan's BoP: The Calm before the Storm*, 31 May 2017).

The Doctor and the Aunt

In our 2016 paper, we created a parable to illustrate Pakistan's relationship with the IMF. In it, we described how Pakistan is a *Patient* who is tended to by his *Aunt* (or Pakistan's political leadership & bureaucracy), who lives in the patient's house. We represented the IMF as the *Doctor*, who is engaged by the Aunt to help the patient. We closed the system by stating that the *Doctor* reports into the *Board*.[2]

Box 1: How the players interact

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 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.

After being bed-ridden for decades, 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 as the guardian of the Patient, the Aunt has the final say.

As shown in **Box 1**, we sought to explain the Pakistan-IMF relationship in a game-theoretic setting, whereby both the *Doctor* and the *Aunt* (agents) can behave in one of two ways: they could be *well-meaning* (towards the principal) or *self-serving*. Given the prolonged relationship between Pakistan and the IMF, we characterize this game as being played repeatedly, and the pay-offs shown in **Chart 1** are the accumulated gains/losses of the two players over this period of interaction.[3]

Quadrant 1 shows that the Doctor and the Aunt work towards the betterment of the Patient (**Chart 1**). Doing so means the Doctor will eventually lose a customer, and the Aunt has to return her own house (which she may or may not want). Both the Doctor and the Aunt are lauded for their help by a grateful nation and the global powers (Pakistan and the IMF board, respectively, who are the principals in the game). Hence, both players enjoy positive returns as shown in the payoff of 4.

Quadrant 2 shows what happens when the Doctor is well-intentioned, but the Aunt becomes self-serving. Acting on her self-interest, the Aunt does not give the patient the right care (and medication), so as to continue living at the patient's home at his expense. The real world analogy is simple enough: Pakistan's political leadership and bureaucrats prioritize their individual interests over the interest of the country – this doesn't require much imagination! Hence, from the GoP's perspective, even though the country continues to suffer and they are criticized for being ineffective policymakers, the bureaucrats and

[2] We assign two groups to each player to characterize the principal-agent relationship. The real stakeholder is the principal, who hires an agent to look out for his interest. For example, in a client-broker relationship, the client is the principal (as the owner of the money) and the stock broker is the agent. The client should trust the broker, but yet retain a level of oversight over the broker's activities, to ensure that the agent's behavior is in the interest of the principal.
[3] It is important to realize that Q2, Q3 and Q4 represent a failed program, while Q1 is a successful economic reform program.

politicians retain their privileges and protect their financial interests. These personal gains *overshadow* what the nation stands to gain from fixing the country's structural problems.[4]

On the flipside, for the IMF staff that was well-intentioned, a failed program would be a professional disappointment, especially after assuring the IMF's board that the program would be successful. These IMF staffers could be downgraded to a lesser job, which would destroy their career progression. The negative payoff (-5) is what staff members will experience, as they grumble about being taken for a ride by the Pakistani team.

Chart 1

		Aunt (GoP)	
		Well-Meaning	**Self-Serving**
Doctor (IMF)	Well-Meaning	Q1: 4 / 4	Q2: 5 / -5
	Self-Serving	Q3: -5 / 5	Q4: 8 / 8

Quadrant 3 depicts a scenario where Pakistan's policymakers are well-intentioned, but the IMF is not. This may strain credulity, but one could argue that the IMF is a self-perpetuating bureaucracy and its board would like to keep some countries weak so as to retain political leverage over them. In this scenario, Pakistan's policymakers make an all-out effort to succeed, but the IMF finds a way to stall the program. In this case, the IMF gains a payoff of 5 (IMF staff retains their jobs, and the board retains its leverage), and Pakistan gets a payoff of negative 5 (its bureaucracy and political leadership resign in disgrace).

Quadrant 4 shows the scenario where both the IMF and Pakistan's policymakers are self-serving. The bureaucracy gains in an under-handed manner, while the political/economic elite protect their interests by not reforming (i.e. they do not change their self-serving behavior). Promises to reform are made, with the awareness that there is no real intention to change, while the financial assistance is used to keep a dysfunctional economy going (the debt buildup is simply passed to the future government). For the IMF, the staff retains a regular customer and the board retains policy leverage over this client. In terms of the payoffs, the outcome is better for the individual players compared to the gain from setting the country on the right path. In simple terms, the personal returns to bureaucrats, politicians, insiders and the IMF staff, overshadows the country's welfare and the professional pride for doing a good job.

In the game shown in **Chart 1**, both players adopt a self-serving strategy as this is each player's *dominant strategy*.[5] It also means that once both players are in Q4, no player has an incentive to become well-meaning as this would reduce his individual payoff. This means the equilibrium outcome (Q4) is stable and is known as a Nash equilibrium (see **Box 2**).

Box 2: Nash equilibrium

With prolonged interaction, the IMF will realize that if it is well-intentioned, Pakistan's policymakers will become self-serving. They also know that this could jeopardize their career in the IMF. Similarly, if Pakistan's policymakers realize that the IMF will be self-serving, then it makes more sense to also be self-serving (policymakers get a payoff of 8 for being self-serving, and a payoff of *negative* 5 for being well-meaning). Hence, the equilibrium for both the IMF and GoP is to be self-serving, which means the reform programs will fail repeatedly.

[4] As shown in **Chart 1**, if the players are in Q1, the Aunt has the incentive to become self-serving as she gains a higher return, even if the country continues to suffer.
[5] This means each player gains more from being self-serving, irrespective of his opponent's strategy. This is clear from the payoffs shown.

With the exception of positive/negative external shocks that change the payoff matrix, this game-theoretic framework could explain the string of failed reform programs in Pakistan.

Have things changed?

Since the last program was negotiated in 2013, several developments have occurred that could alter the traditional interaction between the IMF and Pakistan:

1. Since 2013, Pakistan has developed much closer ties with China, while it has become relatively estranged from the US;
2. CPEC has taken hold in Pakistan, which formalizes the increasingly close economic ties between the two countries;
3. President Trump has upset the global order. His trade war against China will keep both countries engaged in a battle that could shape the remaining part of the 21st century and polarize the world;
4. Pakistan has been put on the watch list by FATF, with India leading the charge to have Pakistan blacklisted. It is important to realize that India's ties with the US have deepened since Modi became prime minister;
5. Pakistan has stated that it will remain neutral in the standoff between the US/Saudi and Iran; &
6. The ascent of right-wing political parties (and governments) the world over is a significant marker in the ideological battle that will shape the world.

At the risk of making too fine a point, we would argue that the real principals in the two groups (the US working through the IMF, and the Pakistan Army via the government) have developed increasingly divergent views in the recent past. The US Treasury Secretary has stated that the US would not approve IMF money being used to repay China's One-Belt; One Road project, while Pakistan has become increasingly dependent on China for BoP support.[6]

This creates an intriguing possibility: will the change in geopolitics influence how the IMF handles Pakistan? More specifically, will the IMF be willing to condone missed targets by offering waivers, as it did during the 2013-16 program? Will the IMF immediately re-engage with Pakistan if the current program stalls? And, has the mood in the IMF's board soured on Pakistan in the past few years?

Let's take this further. Let's say Pakistan enters the IMF program and is able to get through the end-September targets, but cannot meet the primary deficit ceiling for end-December 2019. Let's also assume the IMF program stalls as a waiver is not provided. This compels US rating agencies to downgrade Pakistan, which creates an immediate foreign exchange problem in the country. Let's then assume that Pakistan turns to China for help.

The one-off game

As a long term player, let's assume that China offers a *grand bargain* that promises to be mutually beneficial. To overcome Pakistan's perennial problem in the external sector, China commits to the following measurers:

1. Open its domestic market to Pakistan's exports;
2. Propose joint-venture partnerships to help identify new goods that Pakistan could export to China;
3. Change the nature of CPEC to include import-substitution (within Pakistan) to reduce the large bilateral trade deficits that Pakistan runs with China;

[6] This has created a popular topic of discussion, which predicts that since Pakistan is now in China's camp, its relationship with the IMF will soon end. We disagree with this view, since the IMF is a global institution and the lender of last resort for all member countries. This explains why Pakistan returned to the IMF, as there is simply no other alternative.

4. Reschedule Chinese loans to Pakistan and delay profit repatriation from Pakistan, to help SBP build its FX reserves;
5. Help design an industrial policy for Pakistan (as part of CPEC), with a specific focus on labor training, industrial cities that create jobs and provide social services, and to open up export markets for Pakistan's industrial production; &
6. Work with the government to improve Pakistan's agricultural sector, both in terms of product focus and yields.

In return, China wants to ensure that Pakistan becomes a stable economy that does not survive on hand-outs. In our view, China needs a prosperous Pakistan for several reasons: (1) to ensure CPEC is a success; (2) to retain access to Gwadar port (for military and commercial reasons); (3) to develop China's relatively neglected western provinces; (4) to secure its oil & gas imports from the Middle East via a secure land corridor through Pakistan; and (5) to make Pakistan stable enough to keep India engaged.

For this to materialize, Pakistan's policymakers must prioritize structural reforms over the myriad interests of the economic/political elite. If Pakistan doesn't show the political will to overcome these vested interests, China could threaten to wind down CPEC and downgrade its relationship with Pakistan. In effect, Pakistan would be forced out of the China camp and could find itself isolated in the global community.

Chart 2

		Aunt (GoP)	
		Well-Meaning	**Self-Serving**
Doctor (China)	Well-Meaning	Q1: 4 (Aunt) / 4 (Doctor)	Q2: 5 (Aunt) / -5 (Doctor)
	Self-Serving	Q3: -5 (Aunt) / 5 (Doctor)	Q4: -3 (Aunt) / -3 (Doctor)

In terms of the parable, China replaces the IMF as the *Doctor* (see **Chart 2**), but this would be a one-off game.[7]

Unlike the game in **Chart 1**, if this game results in the worst outcome (Q4), this will hurt both countries and will not allow for a reset (this is not a repeated game). If we assume that China is well-intentioned, **Chart 2** shows that Pakistan has two choices: it could also be well-intentioned and save the relationship (Quadrant 1), or its vested interests could become greedy and self-serving (see payoff in Quadrant 2). This means that Q1 will not be a stable outcome (i.e. not a Nash equilibrium).

However, this is a one-off game. When China realizes that its generosity is being exploited, it will decide that Pakistan is beyond redemption – China will therefore change its strategy and become self-serving. That would push the game into Quadrant 4, which is where the two countries will remain (Q4 is a stable equilibrium, as neither country has the incentive to become well-intentioned). The negative 3 payoffs reveal the implosion of Pakistan's economy, and the strategic and material loss to China.

Let's look at this from the other angle: assume Pakistan starts this game well-intentioned, but China becomes self-serving. In other words, China insists that Pakistan must honor all its sovereign obligations, and if it doesn't have the hard currency to meet these repayments, it must hand over real assets to China (e.g. highways, shares in PSEs, Gwadar port, other chunks of land, etc., as discussed in a previous paper

[7] We have only changed the payoffs in Quadrant 4 to reflect the high cost (to both China and Pakistan) if the two countries try to take advantage of each other. While many would argue that the cost to Pakistan would be far greater than to China, one must realize that the payoffs in the chart are of *ordinal* significance only, which means that the numbers are only important in terms of ranking. So 5 is better than negative 3, but not X percent better.

Pakistan's Balance of Payments, the IMF & China, 14 September 2017). In this scenario, China and its companies may gain more from this extortion, but they will quickly lose all goodwill in Pakistan – especially amongst its people. This may compel the well-intentioned GoP to opt out of CPEC, and perhaps even nationalize all CPEC-related projects. This will anger China, and the game will end in Quadrant 4.

Like the game in **Chart 1**, the dominant strategy is to be self-serving.[8] However, unlike **Chart 1**, the stable equilibrium (Q4) will give each players a negative 3 payoff. From **Chart 2**, the preferred outcome is for both players to be well-intentioned (a mutual payoff of 4). But Q1 is not a stable equilibrium: if China plays well-meaning, then Pakistan gains by becoming self-serving (and vice versa).

However, this reasoning breaks down if: (1) this is a one-off game; (2) each player knows the payoff matrix; and (3) each player can react to the other's change in heart. So if China is well-meaning, but Pakistan decides to become self-serving, then China will surely punish Pakistan by becoming self-serving. Once the two countries are in Q4, the relationship breaks down and both countries suffer – although Pakistan will be in far worse shape than China.

This means the best outcome (Q1) is unstable, which implies that both players must do as they promised. Any breach in trust would push both countries into the worst outcome (Q4). This game effectively increases the cost of being self-serving, to the point where both players have the incentive to be well-intentioned. In this scenario, Pakistan finally reforms itself by taking on its vested interests, strengthens its economic foundations, and become an equal partner on CPEC. But this means the elite capture of policymaking in Pakistan, must come to an end.

Who are the vested interests?

In the World Bank's March 2019 document (*Pakistan@100*), the Bank listed four groups that constitute the elite capture of policymaking in the country: (1) civil servants; (2) landowners; (3) industrialists; and (4) the military. To this we would add the *market opportunists* who create market volatility for self-interest. The power these groups have and their goal to protect their interests, is the primary reason that Pakistan adopts a self-serving strategy when it interacts with the IMF.

<u>Civil servants</u>: This group guides policymakers, and is known for intimidating new incumbents in terms of what is possible and what will create trouble. Bureaucrats are also responsible for implementing policy decisions, and are known for having close ties with Pakistan's moneyed interests. As this group *is* the government machinery, it can deflect/undermine policy reforms to suit its (or others') interests. It is also known that the bureaucracy jealously protects its *fraternity*, which means outsiders cannot be inserted in the system. The bureaucracy also ensures that potential change agents do not become disruptive. In this self-serving environment, well-intentioned bureaucrats are sidelined.

<u>Landowners</u>: Large landowners have loyal vote-banks, which automatically gives them political power. In Pakistan, this group has resisted documentation and still refuses to pay taxes. With seats in the national and provincial parliaments, they are able to block any policy that hurts their interests. This group is also opposed to social development (education, health, skill development) as this could undermine the control landowners exercise over their constituents.[9]

[8] Irrespective of what the other player does, each player has an incentive to be self-serving. Note, a payoff of negative 3 is better than a payoff of negative 5.

[9] As lawmakers, they are also able to influence agri support prices, which influences sowing patterns and wealth generation. This group has also resisted investing in new technology to increase yields, as feudals fear that professional management could change the social order and threaten their power.

Industrialists: This group has amassed huge wealth in Pakistan, which is often used to buy political power. Industrialists have close ties with civil servants, to ensure that policies benefit their businesses, and to block anything that harms their interests. Many in this group have also entered politics and are sitting members of parliament. As lawmakers, they can protect their businesses from foreign competition, secure tax breaks and demand subsidies on energy.

The military: The *Establishment* has a track record of shaping politics and politicians. This group is actively engaged in real estate development, which is one of the most lucrative businesses in Pakistan. The military also manages large conglomerates that compete with private sector companies. With a hostile India on the border, the military has first priority on the government's budget, even at the expense of development spending. This group can influence politicians, landowners, industrialists and the bureaucracy.

Market opportunists: This group includes the large stock market players and moneychangers who manage dollar flows and manipulate the open market. As most people are aware, the PSX does not play a direct role in Pakistan's economy, as most of its activity is secondary market trading (i.e. for corporates operating in Pakistan, the PSX is not often used to generate equity financing). Moneychangers can strongly influence sentiments in the FX market, while the stock market bandits use their deep government ties to shut down the entire market (as they did in 2008) or to push for self-serving bailout packages (as is currently happening).

Many would argue that groups like these are influential in other countries, and there is nothing unique about Pakistan. While we agree, we would argue that in Pakistan, these groups are *too* extractive. For example, growing the economy at 6-7% and controlling 25-30% of this growth is one thing; growing the economy by 3-4 percent but extracting 7-8% of GDP in the same year, is something quite different. For an extractive government, there is nothing left to build upon, as the vested interests are too busy pilfering resources to think about building the country.

A final thought: when thinking about the incentives of the government, one must realize that this is a combination of specific interests of the abovementioned groups. This then begs the question: who has a stronger say? In our view, this depends on how independently these individual groups are able to wield power: the ranking would be the military; industrialists; landowners; the bureaucracy; and finally the market opportunists. In simple terms, the military can project its power independently, while the bureaucracy and opportunists can only wield power if they are given the power.

Who could champion real change?

The groups operating in Pakistan are a formidable power bloc, and can stall any policy that undermines their hold on power and resources. Individually these groups may allow selective policy change, but in the past decade, the financial interests of all five have become so intertwined that issues like undocumented transaction, tax evasion, real estate undervaluation and assets abroad, suit the interests of all groups.

In view of this, trying to nudge the economy towards the right path is almost impossible, unless the consequences of defending the status quo create an existential threat to the country. But this is not considered a possibility, as many argue that the country has seen worse and will get by as it always has. We disagree – in our view, Pakistan has not witnessed a storm of this magnitude, but convincing the status quo of this is another matter.

In view of the growing disillusionment with the PTI government (and the misgivings about the PPP and the PML-N), we think the impetus for change would have to come from outside the country. From **Chart 2**, we propose that the agent of change may have to be China. But this begs the question: which of the five groups mentioned earlier would be China's local partner to champion real economic reforms?

From the discussion in the previous section, the most obvious choice would be the military. China has a long standing relationship with the Pakistan Army, and the latter has been chosen to provide security for all CPEC-related projects. Furthermore, it is a stylized fact that the military is the kingmaker in Pakistan, and is able to influence all other power centers that operate in the country. The real issue is whether the military has become too complicit with the moneyed-interests to be an effective check on their operations. Many have argued that the current government is the military's choice, yet the path forward is anything but certain.

Conclusion

In casual conversations about Pakistan's economy, people often talk about policymakers either kicking the can down the road or scraping the bottom of the barrel. This makes sense as the level of dysfunction in the economy is growing acute, and instead of facing the challenge and taking hard policy decisions, Islamabad is only looking for breathing space (keep kicking the can to postpone the final reckoning) or hoping for manna from heaven (to replenish Pakistan's empty barrel). The latest example of this folly, is the support fund that has been created to bailout the stock market bandits.

What if we are very close to the bottom of the barrel (and there is nothing more to extract) or we kick the can off the cliff? The issue is there is a finite end to this game.

As we have shown, the repeated games with the IMF have only delayed real economic reforms and denuded our resources. We also show that when the *endgame* (or one-off game) is played, *and* the country's existence is at stake, policymakers (whoever they may be) will have no choice but to take the hard decisions. In other words, when the payoff for the agent is similar to the payoff for the principal, the agent will behave in the principal's best interest.

Perhaps that is the nature of the beast (i.e. the self-serving behavior of an agent at the expense of a resource-starved principal): the beast can only be tamed by starving it. While the impetus for this change could come from outside the country, the military may be the only local partner that could team up with China to rebuild Pakistan's economy. If China is well-intentioned and works with the military (which we hope is also well-intentioned), this partnership must ensure that the government does not revert to self-serving behavior.[10]

With this start, one hopes that a new breed of leadership is created in Pakistan, which has been conditioned by decades of self-serving governments that have left behind a shattered economy. Perhaps they will be more empathetic towards the country. One can only hope.

[10] As discussed in a previous paper (*The Last IMF Program?* 18 October 2018), we had proposed the creation of an Oversight Council championed by task-specific Czars, to provide hands-on oversight of the government machinery, with executive powers to intervene if required. As discussed above, this oversight is required to ensure that the Government of Pakistan formulates policies that are in the country's best interests, and not just to enrich the vested interests.