The glass remains half empty

Mushtaq Khan, May 14, 2019

The good news is that GoP and the IMF have reached an agreement for a 39-month Extended Fund Facility (EFF); the bad news is the IMF has committed only $ 6 bln for the entire program, while the ADB and the World Bank could chip in $ 2 to 3 bln during this period. To put this into context, SBP data shows that debt servicing alone during the period April 2019 to March 2020 is $ 14.7 bln. This does not even account for an increase in SBP's FX reserves or the current account deficit that will have to be financed.

In a nutshell, this program contains stiff targets to narrow the twin deficits, but provides little financial assistance to Pakistan.

The IMF's approval process is such that even if the program starts in June 2019, the first set of targets will be in end-September 2019. However, before the IMF's board approves this bailout package, GoP will have to deliver on certain prior actions, which are policy changes required to convince the IMF that Pakistan is serious about implementing structural reforms. From our past experience, these are hard changes that will carry a heavy political price – from the IMF's perspective, these changes are required if the program is to have any chance of succeeding.

Prior Actions

From media reports, the immediate policy focus may be on further tightening interest rates (reports claim another 200 bps increase), and eliminating subsidies on utilities. On the basis of SBP's monetary policy schedule, we expect a change in interest rates on 25 May (the last Saturday of May), and an increase in utility rates by early June. To ease the burden on low-and-middle income families, the increase in tariffs will focus on affluent households and commercial/industrial users.

In effect, by early June, the economic picture will change and market sentiments could further deteriorate. This will set the stage for the stabilization program, which unlike the previous two programs will be painful, and will surely trigger a harsh response from opposition political parties and the public.

Managing the external sector

While Pakistan's fiscal side will require significant adjustments (i.e. additional revenues during a sharp slowdown in economic activities), it is the management of the external sector that will be most challenging. As shown above, the financial assistance from the IFIs is woefully inadequate for the country to achieve a soft landing.

Details of the IMF program will be made public after the IMF board approves the bailout. But some implications are obvious: all FX swaps with commercial banks will have to be rolled over; the current account deficit for the next three years may have to be brought down to a range of $ 2-4 bln (against a deficit of $ 20 bln in FY18); and Pakistan's debt payments to our "international partners" in the next three years will have to be rescheduled. The latter is a not-so-subtle hint by the IMF that China, Saudi Arabia and the UAE, would carry the burden of rescheduled debts.

For a staff level agreement, Pakistan may have already committed to a reduced repayment burden, which means an understanding has been reached with Pakistan's abovementioned friends. While this is a source of comfort for the country, it still leaves a tough balancing act for SBP: the central bank will have to manage the current account gap, increase its unencumbered FX reserves, and manage the demands of foreign companies that need to repatriate their profits. During the course of the EFF, Pakistan's external sector will remain stressed.

Fiscal challenges

Media reports claim that additional revenue measures of Rs 600-700 bln are needed to ensure no gaps in the country's macro framework. The IMF has allegedly set a ceiling on the *primary* fiscal deficit at 0.6% of GDP for FY20 (the fiscal deficit less debt service payments). Targeting the primary deficit makes sense, as the IMF expects debt servicing to increase as it pushes SBP to hike interest rates and allow the currency to weaken. This means that even if the authorities are able to meet the ambitious primary deficit target, the country's financing needs could still be significant as debt servicing is likely to be quite high (we refer to this as the *fiscal blowout*).

Focusing on the primary balance means looking at revenues and non-debt expenditures. Both are challenging: generating additional revenues during a recession is not easy, and cutting expenditures will have to focus on non-interest *current* expenditures as the IMF will not want to be criticized for squeezing developing spending. This means cutting back on administration costs, subsidies and defence spending. The magnitude of these cuts will be revealed in the program details.

The revenue side raises an interesting issue. We would argue that economic growth of 2 – 3 % effectively means Pakistan is in recession, as this growth comes primarily from the country's already high population growth, and the significant share of livestock in the real economy. This is what you could call *organic* growth, which takes place irrespective of economic policies. The challenge is as follows: generating additional revenues from organic growth is not possible without targeting the untaxed sector. But this issue links up with the amnesty scheme, which is expected to be announced on 22 May. As discussed in a previous paper (*Amnesty vs. Accountability*, 29 April 2019), the amnesty would have to be carefully calibrated, not just to document the economy but also to generate revenues – it would also need to have enough *bite* to satisfy both the IMF and FATF.

The exchange rate

Despite the unending list of economic challenges facing the country, the PKR is the first thing on most people's minds. Media reports claim that the IMF is looking at a further 20% adjustment, which puts the PKR/$ parity at 170/$.[1] We have been arguing that because the trade deficit has not narrowed (despite currency adjustments), it is no longer the *level* of the currency, but the currency *regime*. This focus on the regime will be part of the next IMF program.

In our view, it would be better to hold off on interest rates till SBP floats the currency, and then use monetary tools (both interest rates and cash reserve requirements) to support/defend the currency. Media reports are now hinting that interest rates could be a *prior action*, in which case the regime change is more likely in early Q1-FY20, when GoP will face a strict external deficit ceiling imposed by a tough *net international reserve* (NIR) target. Despite the likelihood that prior actions will precede the currency float, it is the latter that will change the economic narrative, and drive home the concept – and pain – of stabilization.

[1] This focus on the level of the currency is misplaced. If the currency is to be floated (which has been hinted at for months), then targets for the parity make little sense. As we have argued in the past, to reduce imports (and discourage importers) a degree of currency volatility is required.

Outlook for the program

Box 1 and **2** summarize the reasons to be optimistic or pessimistic about the successful completion of the 39-month EFF. The performance of the stock market is a reminder that sentiments remain firmly bearish, even after the staff agreement with the IMF. Media coverage has listed the policy changes the IMF program will require, and people are worried about how this will impact their livelihoods. The better analysts are looking at past IMF programs – many of which remained incomplete – to gauge whether this government has the commitment to see thorough what is expected to be a tough program.

We acknowledge the reasons to be pessimistic, and would argue that the majority of business sentiments fall into this camp. People rightly claim that the economic mess inherited by the PTI government (which could have been better managed by the incumbents) is so heavy that a soft landing is simply not possible. Others think it is Pakistan's isolation from the US (and close ties with China) that has shaped the bailout package. We agree that this may have played a role, which further suggests that the IMF will be less forgiving (than in the past) if GoP is unable to meet the targets that it has committed to. Without waivers, this increases the risk that the program could stall.

Having said this, hard conditions and partial support could be a signal that short-sighted policymaking comes with a cost. The IMF will argue (correctly) that the behavior of the PML-N government in FY18, which unfortunately the PTI government continued, created an unsustainable external debt problem, which both Pakistan and its "friends" must pay for. This argument gains further credence when one considers the reservations expressed by US Senators, namely that IMF funds cannot be used to repay China for its ambitious One-Belt; One-Road initiative. The same argument would be used against repaying Saudi Arabia and the UAE.

Come what may, the fact remains that Pakistan had little choice but to accept the IMF program on *this* IFI's terms. The challenge now is to take this program seriously, and ensure that a future hiccup does not set

Box 1: Reasons to be pessimistic

- The package offered by the IFIs is much smaller than Pakistan's needs;
- The required policy changes will be painful given the sheer magnitude of the macro imbalances that must be narrowed;
- PTI's track record in government raises doubts about its ability to manage the political and public anger that this program could unleash;
- This pain could disillusion PTI's support base, which will be seized upon by PPP & PML-N;
- The recent change in the finance team and other cabinet positions reveals a degree of internal discord within PTI;
- Despite facing a looming economic crisis, the PTI government has not formulated a coherent narrative about what will happen and why hard measures are necessary;
- Weak institutions (regulators, planners, ministries, PSEs) are unable to guide policymakers and smoothly implement policy decisions; &
- PTI has done little to arrest the elite capture of policymaking.

Box 2: Reasons to be optimistic

- PTI is not as tainted as the opposition political parties (PPP and PML-N);
- Although the presence of "electables" in the party has been a source of concern (as Pakistan's political class is largely viewed as being venal), with the PTI in power, there is the possibility that more suitable people could be brought forward by Imran Khan;
- PTI has the support of the Pakistan Army, and a respectful relationship with the Judiciary;
- Imran Khan has shown his willingness to make abrupt leadership changes if required;
- Imran Khan's campaign slogans still have traction in the country, which means he will be able to regain political support if he returns to his promise to rid the country of corruption and the corrupt;
- This endows Imran Khan with the rare power to take on Pakistan's vested interests; &
- With his cricketing background, he could frame the painful transition as a match that has to be won if Pakistan is to be saved.

the country on a downward spiral. Staying true to the program boils down to some hard trade-offs:

1. Pakistan's economy must be weaned off imports, even if it disrupts the manufacturing and services sector. Similarly, exports must be increased and if dominant exporters are unable to deliver, the government should explore new export niches (in collaboration with China) and sideline the privileged few;
2. If the government wants to subsidize utilities, carry a bloated/inefficient government machinery, allow hemorrhaging PSEs to continue operating; or maintain a large army, it must generate revenues from those people who feel they are not obligated to pay their taxes; &
3. If some policymakers (and lobbyists) are more interested in their private interests than what is good for the country, they must be exposed and face public accountability (however untouchable they are perceived to be).

Decisive decisions and national-wide campaigns

To prepare people for the currency shock (which has immediate spillovers), the government must fortify itself with additional firepower, not just to manage the markets, but also to explain to people why these steps are required. Economic decisions are currently hamstrung by the need to secure provincial government support and parliamentary approval. While this is a fundamental requirement of a functioning democracy, it does slow policy responses and opens up avenues for score settling and political instability. As we discussed in an earlier paper, we cannot recall the last time an IMF program was debated in parliament; we ended with the observation that no elected representative would ever support an austerity program that is needed to stabilize the economy. So why bother?

There is more. Given the nature of the required economic changes, policies alone will not be able to secure the desired results. In our view, there has to be a clear messaging strategy, whereby people are informed about why these changes are required, which behaviors need to change, and the positives that lay ahead if we can buckle down and see through these hard measures. There must be an anti-import campaign; a "conserve energy" drive (discourage the use of air-conditioners, or keep thermostats at 26º C); a public appeal to discourage the consumption of retail fuels; and an anti-hoarding campaign with harsh punishments for those who are found to be guilty. With technocrats in the finance team, this messaging would have to be done by the Prime Minister himself.

Conclusion

The IMF program is much delayed, and this adds to the pain that will have to be borne. If it is not clear already, let us state again that this IMF program will be different from past programs, as our macro imbalances are much too large and the needed adjustment will be painful. How the government manages this transition is critically important: if it appears indecisive and responds reactively, the program is likely to stall. As we have discussed before, a premature end to this program puts Pakistan in a near-default situation, which implies a far more abrupt (and painful) adjustment process.

Instead of a false sense of bravado ("Pakistan has seen worse and will overcome!"), it is instructive to look at more developed countries that have experienced economic crises, to realize how easy it is to get trapped in one. Our policymakers may have realized that the country is now trapped, but the sense of urgency to manage the economic transition is not apparent, or tangible. The government must change its economic narrative to explain why the harsh steps are required, and what can be achieved if the policy changes are successful. Instead of political bickering and infighting (which will only make it worse), the country needs to come together to weather a storm that has been brewing for almost two years (*Pakistan's BoP: The Calm before the Storm*, 31 May 2017).

