The vicious twin deficit, Part 2

Mushtaq Khan, May 30, 2018

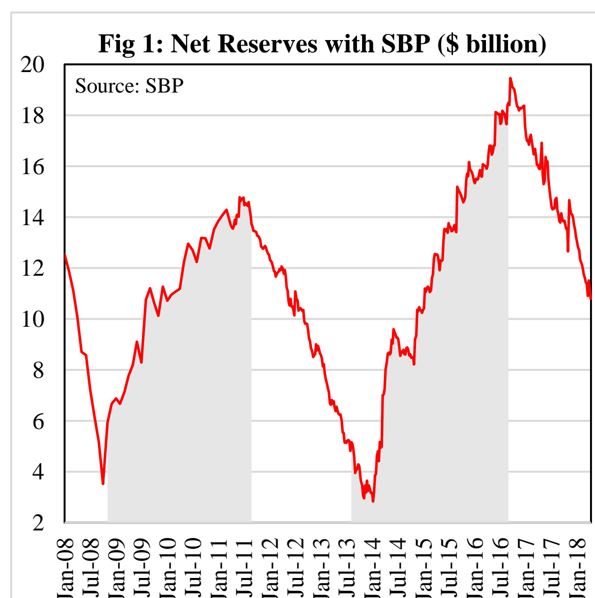
In the earlier paper (April 26), we concluded by saying that belated policies to narrow the external deficit (and contain the spillover on the fiscal side), are necessary, but not sufficient, to right the ship. Most stakeholders are anticipating that the next government will return to the IMF (as did Nawaz Sharif's government back in mid-2013) – there is a strong sense of *déjà vu*.

Table 1: Pakistan's Fiscal Accounts

Rs billion	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Revenue	**2,078**	**2,253**	**2,567**	**2,982**	**3,637**	**3,931**	**4,447**	**4,937**
- Tax	1,473	1,699	2,053	2,199	2,565	3,018	3,660	3,969
- Non-tax	605	554	514	783	1,073	913	787	968
Expenditure	**3,007**	**3,447**	**3,936**	**4,816**	**5,026**	**5,388**	**5,796**	**6,801**
- Debt Servicing	1,990	2,299	2,540	3,285	3,255	3,386	3,775	4,564
- Defence	642	698	889	991	1,148	1,304	1,263	1,348
- Other Expenditure	375	451	507	541	623	698	758	888
Deficit	**(929)**	**(1,194)**	**(1,370)**	**(1,834)**	**(1,389)**	**(1,457)**	**(1,349)**	**(1,864)**
% of GDP	**-6.3**	**-6.5**	**-6.8**	**-8.2**	**-5.5**	**-5.3**	**-4.6**	**-5.8**
Financing	**929**	**1,194**	**1,370**	**1,834**	**1,389**	**1,457**	**1,349**	**1,864**
- External	189	108	129	(2)	512	181	371	541
- Domestic	740	1,087	1,241	1,836	877	1,276	979	1,322
- Bank	305	615	712	1,458	324	892	787	1,046
- Non-bank	436	472	529	378	553	366	192	277
- Pvt Proceeds	-	-	-	-	-	18	-	-

Source: SBP

The previous Zardari /Gillani/Ashraf government also witnessed an FX crisis nearing the end of their 5-year term, and refused to take corrective steps. It was left to the previous caretaker government to begin talks with the IMF, which were formalized as a three-year program in September 2013. Other than the need to depreciate the PKR and build SBP's FX reserves, the Nawaz Sharif government had to bite the bullet and pay-off the Rs 503 billion circular debt, which the Zardari government had built up. This spiked the fiscal deficit in FY13 to 8.2% of GDP (see **Table 1**).



Despite this nagging familiarity, there are some differences compared to five years ago. The PKR has been adjusted twice (in December 2017 and March 2018) but this has not reined in the external deficit. Having said this, SBP's reserves are not as low as they were in mid-2013, which means the sense of urgency is lower (see **Figure 1**[1]). However, unlike 2014 when Pakistan's inflation began falling after global oil prices collapsed, we are now facing

[1] The shaded portions of **Figure 1** show the duration of the last two IMF programs.

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an increase in the cost of living, which is likely to continue in FY19.

The *déjà vu* also makes sense because of the circular debt, which has again built up and is estimated at Rs 573 billion as of April 2018 (*Business Recorder*). There is also the recent increase in both Pakistan's domestic and external debt.

While the next IMF program should feel familiar enough, Pakistan's debt overhang will complicate how its economy is stabilized. To put all this into context – and to keep it simple – we would characterize Pakistan's economy by the challenges it faces; the policy tools it can use; and the macro repercussions of using these policies. This is shown in **Chart 1**.

Challenges, Tools & Repercussions

While most analysts would list Pakistan's external and fiscal deficits as the main challenges, we would also include the existing stock of Pakistan's sovereign debt. The latter creates a stream of future repayments (in Rupees and Dollars) that will strongly influence the next stabilization program (especially on the FX side – see **Figure 2**).

Chart 1 shows that Pakistan's policymakers are likely to use three main policy tools (the PKR/$ parity, retail fuel prices and interest rates) and shape fiscal policies to ensure that the budget deficit is kept below *negotiated* targets. As shown in **Chart 1**, the use of these policy instruments will impact inflation and the stock of Pakistan's sovereign debt.[2]

Table 2 A (Chart 1 Explained)

Linkage	Explanation
a	The current account deficit is gradually depleting SBP's FX reserves (hence the negative sign, see **Figure 1**)
b	To shore up SBP's reserves, the GoP has been borrowing hard currency (positive sign)
c	Pakistan's external deficit is not being managed, but simply financed. These inflows have increased SBP's FX reserves, but only temporarily – the most glaring example can be seen in **Figure 1**, where the $ 2.5 billion borrowed in December 2017 (via Eurobonds/Sukuk) had spiked SBP's FX reserves, but were quickly depleted. While this hard currency was used to pay off the external deficit in FY18, Dollar repayments will remain on the government's fiscal books for years to come. This is the same for the *ad hoc* financing that Chinese banks have been willing to provide to shore up SBP's FX reserves. This stopgap financing does not really solve Pakistan's fundamental economic imbalance. The downside is that these commercial loans (& swaps) will have to repaid – and most likely in FY19 and FY20
d	To address the problem, the GoP has depreciated the PKR to narrow the external deficit, which should shore up SBP's FX reserves (positive sign)
e	Similarly, retail fuel prices have also been increase, which should help narrow the external deficit. This is justified as global oil prices are at 3-year highs
f	The PKR depreciations directly impact the government's external debt servicing, which explains why the previous Finance Minister was so fixated on keeping the PKR parity fixed (positive impact on debt servicing)[3]

To build our argument, we simply explain the various linkages in **Chart 1** in the following Tables.

[2] In our view, these consequences could explain the current government's lack of policy action to narrow the twin deficits. To apportion blame evenly, the Zardari/Gillani/Ashraf government also refused to take hard steps just before the general elections.
[3] Unfortunately, Ishaq Dar didn't give sufficient importance to the strong import (and anti-export) bias that this exchange rate policy created. In our view, this is the root cause of the unsustainable external deficit that the country must now manage.

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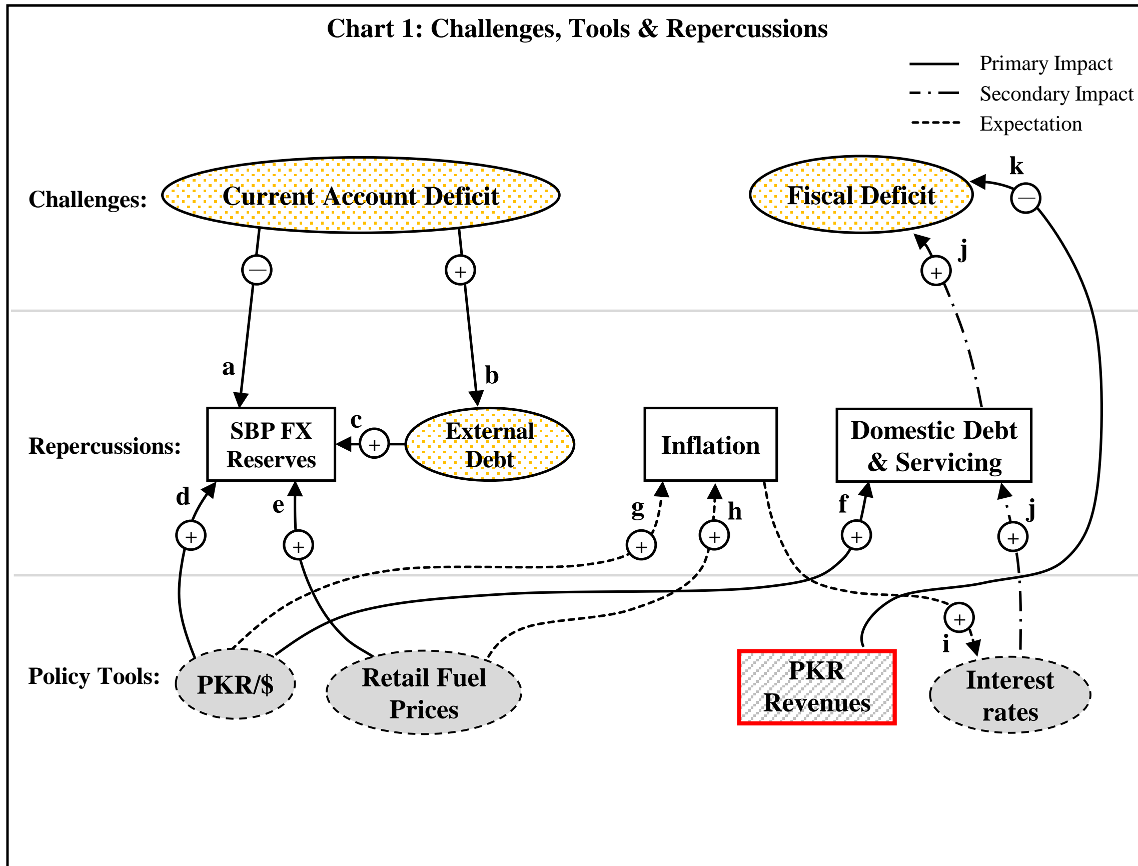

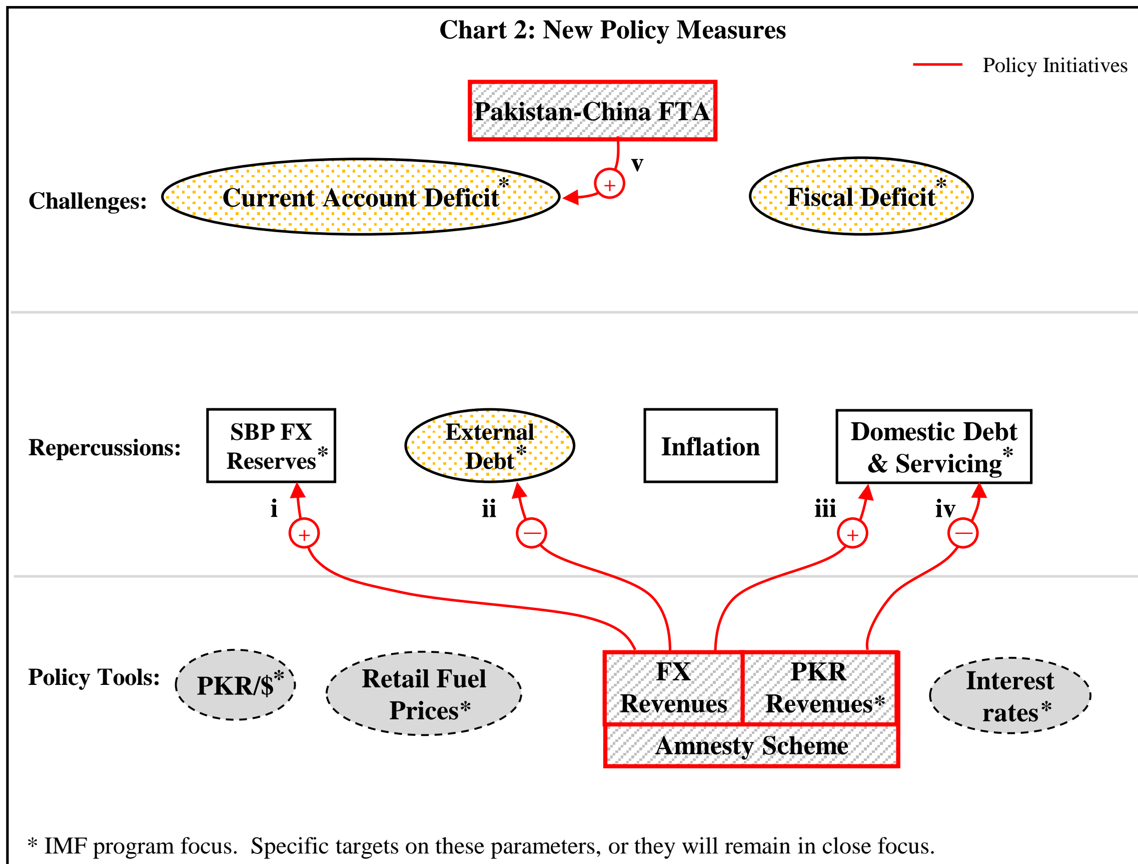

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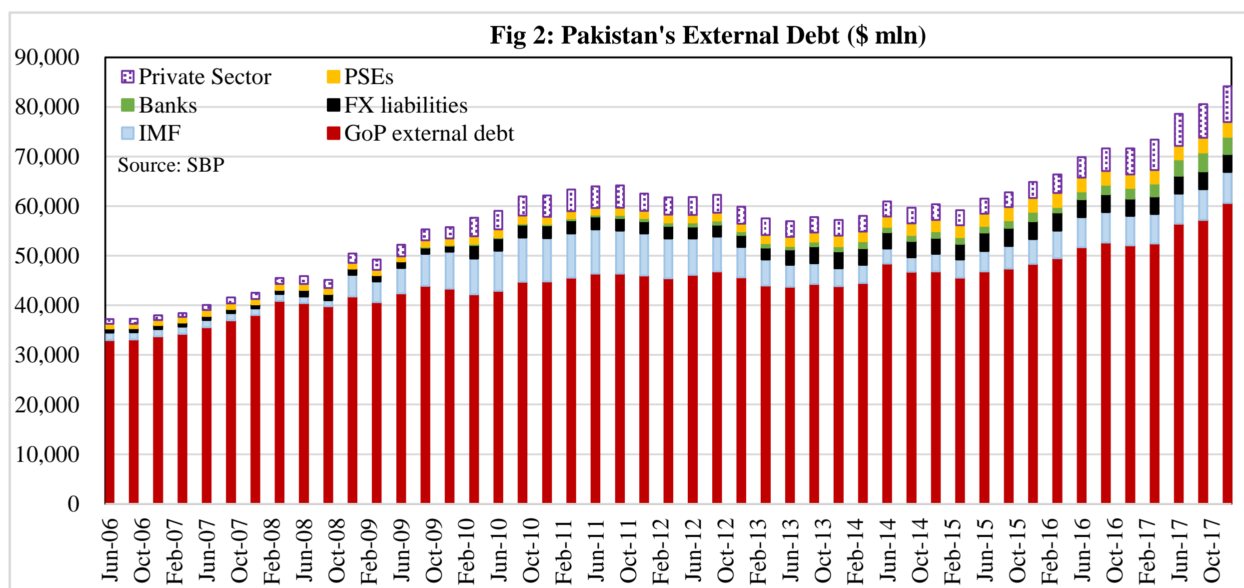
Inflationary expectations impact interest rates

Inflationary expectations in Pakistan are largely determined by administered price – the PKR/$ parity and retail fuel prices. This is a departure from orthodox economic theory, which depicts money supply – and demand pressures – as the primary determinant of inflation. Research done by SBP shows that when asked, the majority of retailers/wholesalers who were surveyed, identified the PKR/$ parity and fuel prices as the main justification to increase their prices.[4] This is based on a simple common-sense argument: retailers are able to justify increasing prices, when they appeal to the consumer's awareness of key price increases, which they claim *forced* them to increase their own prices.



In effect, the two simplest ways to reduce imports (by making them more expensive for domestic consumers and discouraging the use of motor fuels) also directly impact headline inflation. As stated earlier, this is the main reason the Nawaz government shied away from taking steps to narrow the external deficit, unless it was compelled to do so (*The IMF Strikes Back*, March 23, 2018). For Pakistan's leadership, the political cost of higher inflation was simply not acceptable.

There is another complication: rising inflation creates expectations that interest rates will be increased. Since Pakistan's domestic debt has increased sharply in the past five years (between June 2013 and March 2018, total domestic debt increased by over 78%), an increase in interest rates would burden the fiscal side quite heavily.

The problem with interest rates

The magnitude of the increase in interest rates, will depend on the IMF's program design. As shown in **Figure 3**, the mix of government borrowing from the banking system has changed abruptly in 2018. With banks unwilling to lend at previous interest rates, SBP had no choice but to step in to finance the government's debt servicing. **Figure 3** also shows that past IMF programs were very clear in their intent – central bank financing is deemed inflationary, and therefore is to be discouraged (the shaded portions of **Figure 3** are the past two IMF programs).

[4] Chapter 5, Annual Report FY12, State Bank of Pakistan, and in http://www.sbp.org.pk/publications/staffNotes.htm

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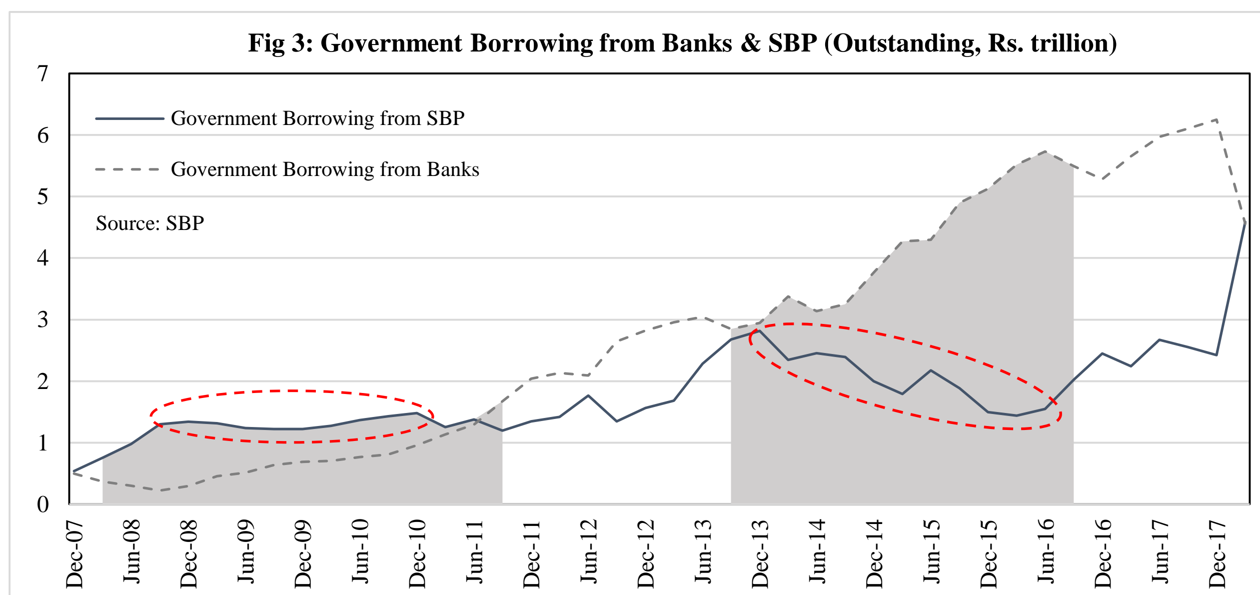

Table 2 B (Chart 1 Explained)	
Linkage	Explanation
g	As discussed above and shown in **Chart 1**, the PKR adjustment influences retail price setting, which increases inflation
h	Similarly, the increase in retail fuel prices also spikes inflation, specifically working through food and transportation
i	Now that inflation is projected to increase (see **Figure 4**), the market expects an increasing interest rate environment, which is often part of an IMF stabilization program. The 50 bps increase in interest rates on May 25 creates more clarity (especially after the previous two decisions that confused the market in January and March 2018), and should help lure investors back into Pakistan Investment Bonds and 6 and 12-month T-bills. The aversion to long tenor bonds has become quite serious – as of end-March 2018, 3-month T-bills accounted for over 91% of total bank holdings of T-bills, which was only 12% in September 2016.[5]
j	The direct impact of an increase in interest rates on debt servicing is clear enough, but as discussed below, the IMF's aversion to the use of central bank financing will have to square off against the sharp increase in interest rates that will be required if SBP financing is brought down too rapidly

With the sharp increase in SBP financing in Q1-2018 (see **Figure 3**), the issue becomes how abruptly the government will be required to reduce its reliance on the central bank. The IMF is well aware that an abrupt reversal will push interest rates sharply upwards, which – given the shortened maturity of outstanding T-bills – will create tremendous pressure on debt servicing in FY19. This would hurt the economy, and the IMF program itself.

This bring us to how debt servicing impacts the country's fiscal deficit. As the largest single federal expenditure (see **Table 1**), if the increase in interest rates (and the mix of government financing from the

[5] In an effort to increase the maturity of outstanding market debt (PIBs and T-bills), SBP has announced the launch of a floating rate 10-year PIB. As stated in our May 8, 2018 blog, this undermines capital market reforms that were initiated in 2000.

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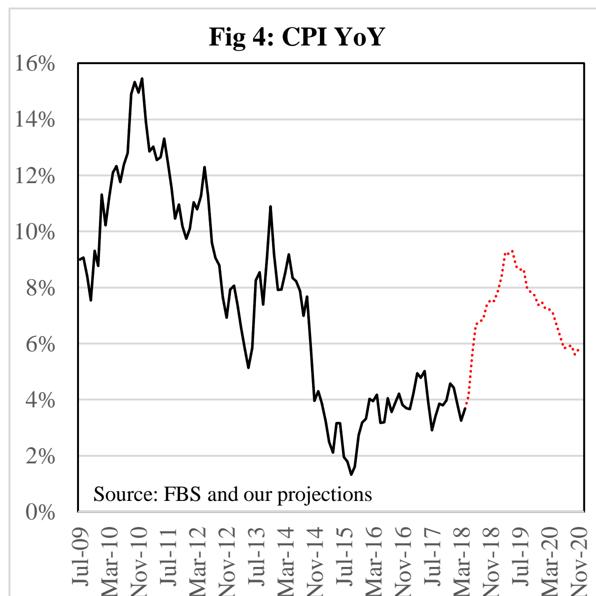
banking system) is not carefully managed, the first year of the program could witness a sharp increase in debt servicing, which would make the program more austere for Pakistan, and surely undermine the political will to continue the reforms. Hence, to ease the country into the stabilization program, both Pakistan's policymakers and the IMF, are likely to seek common ground to ensure that the economic pain is not frontloaded.



For Pakistan analysts, **Table 2 C** is familiar territory, especially as the country moves into the next IMF program. But this familiarity is also tinged by regret over the failed reforms in the past several decades.

Pakistan's experience with the IMF, dating back to the late 1980s, has been checkered (*The Parable of Pakistan and the IMF*, December 27, 2016). The reason is simple enough: politically difficult reforms are not implemented, and the IMF is unwilling (or unable) to manage one of its member clients – Pakistan – more firmly. As a result, restructuring loss-making SOEs (especially in the energy sector), increasing the net of direct tax payers, and disallowing regulatory exemptions that undermine the thrust (and discipline) of structural reforms, have not met with much success. These "incomplete" reforms are likely to be resurrected in the next program, with a greater sense of urgency to achieve real results.

Table 2 C (Chart 1 Explained)

Linkage	Explanation
k	The final linkage in **Chart 1**, reflects the fiscal policies that could be used to narrow the budget deficit. This entails fiscal contraction that translates into raising tax rates, increasing the number of tax payers, restructuring loss-making state-owned enterprises and reducing discretionary current and development expenditures[6]

New policy initiatives

As stated in the earlier paper (April 26), Pakistan's debt buildup and rising inflation will not allow the authorities (or the IMF) to rely solely on conventional avenues to reduce aggregate demand and stabilize the economy. In an earlier paper (*Could the next IMF Program be decisive?* December 12, 2017), we had argued that moving towards more accurate valuation of real estate holdings, would be an unorthodox but effective way to reduce demand pressures (and imports). Similarly, we talked about the need for Pakistan to have a clearer understanding whereby its trade relations with China are better balanced for the long-term sustainability of CPEC (*Pakistan's Balance of Payments, the IMF and China*, September 14, 2017).

In **Chart 2**, we have superimposed two policy initiatives on Pakistan's macro economy, which we feel are necessary to ensure that the next stabilization program has a fighting chance of being successful. To keep the analysis simple, we have indicated how these policy initiatives would impact the most closely

[6] The most obvious exception to expenditure cuts would be debt servicing, over which the government has no discretion. In the case of Pakistan, many would also argue that defence spending is another factor the government has no discretion over.

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watched parameters used to gauge the health of the economy. The role of the media in creating awareness and giving its assessment, will strongly influence investor sentiments.

The amnesty scheme

The amnesty scheme announced on April 8, 2018 (Foreign Assets (Declaration and Repatriation) Ordinance, 2018) had generated much interest, but is now largely forgotten. This is not surprising, as the scheme was decreed as a presidential ordinance, and would have to be enforced during the tenure of the caretaker government, which lacks the mandate and interest to prosecute this policy. We had argued in an earlier blog (April 6, 2018) that this scheme – though well-intentioned and founded on critical issues that need to be addressed – would not be seen as credible. Having said this, we strongly feel the next elected government will take this initiative forward, and are hopeful it will have the IMF's design support and endorsement.

By focusing on undervalued real estate in Pakistan, and seeking to give expat Pakistanis the opportunity to declare their wealth held abroad (which will become an OECD requirement in 2019), the incumbent government should be given credit for highlighting an issue that captures the bulk of Pakistani wealth, and is also the root-cause of poor documentation of economic/financial transactions in the country. If these two issues (real estate valuation and amnesty for errant Pakistanis) are credibly and intelligently tackled, it will go a long way in resolving this chronic problem in Pakistan's economy. **Table 3 A** lists the linkages shown in **Chart 2**.

Table 3 A (Chart 2 Explained)

Linkage	Explanation
i	Expat Pakistanis decide to declare their funds overseas, and bring them back to the country. This means that hard currency is converted into PKR denominated instruments, which, after they mature, are declared white. Whatever comes in will positively impact SBP's FX reserves
ii	Higher reserves mean Pakistan's policymakers will not have to borrow. That itself is good news for the country's external debt
iii	As stated in point **i**, the FX declared by expats and brought back to the country will add to Pakistan's domestic debt. In our view, this is far better than treating this as an FX liability, as we did with the resident foreign currency accounts (RFCAs) that were eventually frozen in May 1998
iv	The amnesty scheme for immovable wealth (real estate) will target both resident and non-resident Pakistanis. For non-residents, this inducts them into the tax base, which means a future stream of PKR tax revenues. For residents, more accurate valuation and the penalties against tax non-filers will also expand the tax base and create more accurate documentation of economic/financial transactions in Pakistan. This will go a long way to narrow the fiscal deficit and the government's future borrowing needs.

We remain enthusiastic about the potential of the amnesty scheme, as it is effectively a form of *fiscal reform* Pakistani style. More specifically, it targets the real repository of Pakistani savings/wealth, and forces owners to document their assets more accurately. Now that this issue is part of a presidential ordinance, and there is domestic and overseas appetite to declare hidden wealth, we are confident the amnesty scheme will be carried forward.

While the next government will have to formulate the details of this scheme, some broader points can be made. The carrot of low penalties (for the declaration of hidden assets) needs to be balanced against the stick – punishment – for non-compliance. Furthermore, to ensure that this scheme is not mired in legal

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troubles in the future, it needs to be equitable. The latter means that the penalties for declaration cannot be so low that law-abiding Pakistanis feel they are being penalized for being good citizens, and paying their taxes in full. In our view, the amnesty scheme will only be successful if the issue of compliance is free of political (and financial) influence, and if people who have intentionally hidden their wealth are forced to pay a fair price for their past transgressions.

The Pakistan-China Free Trade Agreement (FTA)

As shown in **Table 4**, Pakistan's growing trade deficit with China must be reversed. As discussed in our September 2017 paper, the sustainability of CPEC hinges on a sound external sector, which means concerted efforts are needed to narrow the trade imbalance with China. Since Pakistan's trade deficit with China is now the largest bilateral imbalance for the country (while CPEC repayments are building up), if this economic relationship is to become mutually beneficial, the trade imbalance has to be narrowed quite sharply, and very soon. This cannot be left to market dynamics and slow evolution.

Table 4: Pakistan - China Trade Deficit

$ billion	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Exports	1.7	2.1	2.8	2.8	2.4	2.0	1.8
Imports	4.8	5.0	5.3	6.8	7.9	9.0	11.1
Deficit	**(3.1)**	**(2.8)**	**(2.5)**	**(4.0)**	**(5.5)**	**(7.0)**	**(9.3)**

Source: SBP

In our view, the Pakistani and Chinese authorities need to rethink the existing FTA, with the following end goals: to shift Chinese industries to Pakistan; to generate new Pakistani exports that are earmarked for China; and for Pakistan to embrace import substitution as a policy.

Only by credibly changing the trajectory of Pakistan's external sector will its relationship with China mature. As stated in an earlier paper (*The IMF Strikes Back*, March 23, 2018), we do not accept the view that the IMF will impede Pakistan's economic ties with China. The issue is whether the IMF will remain silent when bilateral trade negotiations effectively by-pass rule-based trading (and the role of multilateral institutions).

Conclusion

Pakistan is almost at the end of PML-N's 5-year term in power. This is a significant achievement for the country, as it is the second completed political term with a peaceful transfer of power. In the past month, political developments indicate that the incumbent political party (PML-N) may be losing ground to PTI, which is beginning to project itself as the next government. Since political unrest during the 2-month caretaker government appears highly unlikely, the transition to the next government should be smooth.

The policy steps required by the next elected government are also pretty straight forward. In our view, the caretaker government should take a sober view of the external sector, and signal its intention to begin talks with the IMF and other multilateral agencies. The bilateral discussions with China will have to be carried forward by the next elected government. Although the economic challenges Pakistan faces are significant, acknowledging the situation (which could explain the absence of populist economic policies), gives us some comfort.

Looking at the two policy initiatives we have discussed, we would characterize the amnesty scheme as an ambitious and customized fiscal reform, which requires significant political will to enforce. As for the FTA, we see this as a bilateral path that charts out a more customized trade relationship with China. As globalization is losing its ideological dominance (*The end of Globalization?* April 18, 2018), Pakistan's policymakers need to think out of the box. If these unorthodox initiatives are weaved into the next stabilization program, we remain optimistic that Pakistan's economy could finally be on the mend.

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