Too Little, Too Late?

Mushtaq Khan, October 18, 2017

The front-page announcement of the wide-ranging increase in import duties, was expected. The external deficit in FY17 was large enough to worry the market, but the accelerated import growth in FY18, is enough to demand policy action.

Analysts have not been sympathetic. Many have stated that this policy will not be enough to reverse the trend in the country's balance of payments. Some say this policy step is *too little, too late*. We disagree somewhat, and have a more pessimistic assessment. In our view, it's not about being too little, too late: it is about being *too little, too late, and too clever*.

To analyze the potential impact of this policy, we will address it at several levels: (1) how this policy is being promoted or portrayed; (2) how effective these measures could be; and most importantly (3) what it reveals about policymaking, and where it is headed.

The official notification by FBR is a consolidated list of all 8-digit HS-coded imports that have been impacted. 276 items (of a total of 731 items that now carry import duties[1]) have either had the import duty rate increased since the FY18 Budget, or are newly targeted. However, a closer look at the details, reveals a disconnect between the official document and how the media has presented this policy. We feel the policy is being portrayed as being more comprehensive than it really is.[2] This suggests that the authorities are trying to signal concern, but not really taking steps that could meaningfully help reduce BoP concerns (pressure).

In terms of effectiveness, the import duty on a high profile consumer item like reconditioned vehicles (imported cars and jeeps of any engine size), has not changed. For more relevant consumer imports (e.g. new vehicles, A/Cs, LCD/LED TVs, tomato ketchup and processed cheese), the policy impact (in terms of an increase in retail price) will be borne by higher income groups, and will not have much impact on inflationary pressures that impact the average Pakistani household.

In our view, it is the stated intention of this policy announcement that is more unsettling. The government claims that these enhanced duties, will be used to disburse export refunds that have been held back for years, thereby incentivizing exports. In effect, this policy will supposedly quell Pakistan's external sector crisis by reducing imports and increasing exports *simultaneously*.

In our view, such clever policymaking is ultimately self-defeating. It is more representative of short-term fixes than sound policymaking.

Market response

Market players will view this policy as a short-term measure, which will be reversed once Pakistan's government returns to the IMF. Knowing this, importers will realize that the release of FX from SBP will be more strictly managed; foreign investors will know that repatriating profits will be harder; exporters

[1] Dawn, October 18th.

[2] Media reports have talked about a sharp increase in import duties on wheat, apples and chandeliers. A closer look reveals that the items that have been targeted are inconsequential subsets of wheat (Durum wheat), apples (dried apples), and chandeliers (a specific household item that is one of the smallest HS-coded imports with an annual cost of only $ 2-3 million).

will know that banks will be more vigilant about ensuring that export revenues are surrendered on time; and domestic investors will rethink their investment plans.

For those who watch the FX market closely, the next IMF program is inevitable – the issue is whether the incumbent economic team will take the first step, or whether this will be done by an interim government that is supposed to pave the way for the next election. What is clear, however, is what the next IMF program will entail.

With a brewing BoP problem and a growing fiscal deficit, demand management will be necessary. This means narrowing the trade deficit by devaluing the PKR; it also means curbing import demand by reducing aggregate demand, which means an increase in interest rates.

From past experience, there will be tough quarterly targets to reverse GoP borrowing from SBP, which will not only push interest rates up, but also crowd out the private sector (as banks shift their lending to the Federal government). With the likely increase in retail fuel prices, food inflation will increase, which will adversely impact headline inflation.

Other measures to contain aggregate demand could entail binding limits on the government's *primary* fiscal deficit, which means clamping down on discretionary government spending. Furthermore, the government will have to scrap its recently enhanced import duties, which the IMF will "rationalize" to remove price distortions.

Politics

The World Bank appears to have heeded the government's call to change its view that Pakistan needs US$ 31 billion in FY18. One must realize this figure is computed by projecting the current account deficit in FY18, adding known external debt and liability payments during the year, and accounting for the needed increase in SBP's FX reserves to match the growth in import payments. However, without the IMF's seal of approval, even the government's more acceptable $ 17 billion figure (required in FY18) is not attainable.

This raises a simple question: why is the government categorically stating that an IMF program is not required (and why is the Finance Minister unwilling to even consider devaluing the PKR), when the economic situation will not allow for a political campaign that could get it re-elected? One could also question whether any political party could campaign for popular support, knowing that before the scheduled elections, the country could be facing much tougher economic conditions, which the new government will not be able to change (i.e. higher inflation and interest rates, little or no government spending, and a stagnant economy).

How did we get here?

Two exogenous factors have supported Pakistan's economy since 2014: one, the sharp fall in global oil prices; and two, CPEC. The resulting improvement in the external sector, helped SBP keep the PKR-Dollar parity stable (fixed) and build its FX reserves to record highs, while the fall in retail fuel prices pushed inflation well below even what policymakers had hoped for. The resulting improvement in business sentiments was seen in the roaring stock market and the sharp increase in real estate values. This increase in private wealth was spent on imported goods and services, which slowly overshadowed the oil-driven improvement in the external sector.

The failure to adapt to the changing fortunes of the economy is, in our view, the result of hubris on the part of policymakers. Instead of policy adjustments to narrow the growing external deficit (e.g.

depreciating the PKR), the authorities relied on external borrowings, which simply increased the country's external debt. This, in turn, has made policymakers even more averse to devaluing the PKR, as this would automatically increase the country's debt servicing burden (i.e. more Rupees for each Dollar that has to be repaid). Similarly, interest rates were not increased as the government was keen to maintain the feel-good factor, and also due to the fear of fiscal pressures.

With the feel-good factor no longer sustainable, it makes little sense for the incumbent government to continue doing what it is doing. Its decision-making has also raised doubts over whether the scheduled elections are likely to take place, as the lead-in (to elections) would be characterized by strict stabilization policies. It is understandable therefore, that the market and most observers, are confused about what is likely to happen in the months ahead.

Conclusion

Even if the increase in import duties is able to narrow the current account deficit, it will not reduce Pakistan's Dollar repayments (in FY18), nor will it allow SBP to increase its FX reserves from current levels. Furthermore, given the CPEC momentum (and vocal support from the Pakistan Army, the government and all other political parties, for this partnership with China), the pressure from this project on Pakistan's external sector, will remain. The IMF may indirectly impede CPEC by limiting the volume of GoP-guarantees that can be issued, or placing binding growth targets on SBP's FX, or by constraining government investment in the energy sector, but it will not be able to halt CPEC. In our view, CPEC could be the most contentious point of discussion between Pakistan and the IMF.

Unlike most observers, we do not see Pakistan being able to *go it alone* with just the support of China. Pakistan's short-sighted policymaking is likely to offend China much more than the IMF. While the latter would be happy to welcome back one of its most frequent customers, the partnership with China cannot be based on ad hoc hand-outs and emergency loans.

Short-term and self-serving economic policies, have defined Pakistan for decades. Policymaking is driven by political preference, as key institutions like SBP, FBR, SECP and MoF (to mention a few) are no longer able to influence (discipline) policymakers. This short-termism has created a similar mindset within the private sector, which is unwilling to invest in any long-term undertaking – a good example, is the country's inability to increase value-added exports, despite *decades* of ostensible policy focus.

As argued in previous papers[3], the forthcoming IMF program may stabilize the economy, but it will not rectify the structural problems. Similarly, CPEC will have to change its focus and prioritize exports (not power, or the road network) if it wants to succeed.[4] Policymakers must learn from their past mistakes, and not just kick the can further down the road – even if most Pakistanis are willing to take the easy route forward (and keep kicking), the Chinese may not.

The next reform program will have to deliver *real* results, not just in terms of managing the twin deficits and stabilizing the economy, but by rebuilding the institutional capacity – and strengthen – to safeguard against populist, short-term policymaking.

[3] ***Pakistan's BOP: The Calm before the Storm*** (May 2017), and ***The Parable of Pakistan and the IMF*** (December 2016).
[4] This will not be easy. The current China-Pakistan FTA is lop-sided as Pakistan runs massive trade deficits with China – this needs to be narrowed by increasing our exports. Hence, it makes sense for Pakistani firms to embed themselves in global supply chains with established Chinese exporters. This requires upgrading Pakistan's logistics, infrastructure and skill development. Some of these issues have been discussed in our May 2017 paper.

