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IMF returns

Finally and belatedly an IMF staff mission has arrived in Pakistan. This is after a gap of five months. The last time a mission was here was in November 2018. During the intervening period, there has been considerable vacillation by the government as to whether it should go for a Fund Programme or not.

There has also been a very recent change in the leadership in the Federal Ministry of Finance. The previous Finance Minister had just returned to Pakistan after extensive meetings with the IMF in Washington. This had led to the decision that the IMF staff mission would be arriving in Pakistan shortly. However, there is a shroud of mystery as to why the Finance Minister was asked to resign just before final discussions with the IMF could take place on an Extended Fund Facility (EFF) for the next three years. The question is whether some commitments were made in Washington which the political leadership in Pakistan is not willing to honour.

Apparently, an initial Macro Economic Framework had been prepared by the IMF in early February 2019 based on Pakistani authorities and IMF staff estimates and projections. This Framework remains confidential. Even the Finance Committee of the National Assembly has not been given access to the Framework.

The basic issue is what are likely to be key areas of focus of reforms in the Programme? Some insights are presented below on the basis of developments in the national economy during the on-going financial year.

Turning first to the external balance of payments there are both some positive and negative developments. On the positive side there has been a visible decline in the current account deficit of $4 billion up to March 2019. The expectation is that it will be close to $12 billion this year as compared to $19 billion last year. This has been achieved on the back of a major slowdown in the economy, rupee depreciation of 16 percent during the year and a big cutback in CPEC related machinery imports. Nevertheless, the deficit is still too large.

The latest position of foreign exchange reserves with the SBP is that they stand at $9.0 billion, as of the 19th April. This level of reserves provides import cover of 1.8 months, somewhat lower than the minimum safe level of two months.

The IMF assesses the position of reserves of a country by computing the net international reserves. This is derived as the gross reserves with the Central Bank less foreign exchange liabilities of the Bank and the outstanding loan with the IMF. The result is that the net international reserves of the SBP are substantially negative at minus $7.9 billion as of the 19th April. Clearly, there is need to improve the somewhat precarious position of the balance of payments.

The IMF is likely to ask for a similar decline in the size of the current account deficit in 2019-20 to restore more stability in the external transactions. This will require the deficit to be reduced from about $12 billion in 2018-19 to almost $5 billion next year. Such a reduction will require some further depreciation of the rupee. If exports begin to take off then hopefully this will require less depreciation of the rupee than the fall that has already occurred in 2018-19 of 16 percent. Further, short-term deposits from China, Saudi Arabia and the UAE of a combined total of $9.4 billion have been placed with the SBP. One of the pre-conditions for agreement on the IMF programme is likely to be the rollover of these deposits.

The budgetary position of the federal and provincial governments has substantially worsened. Tax revenues have shown limited growth while the costs of debt servicing and defense expenditure have risen sharply. In the former case, this is due to the big hike in interest rates and rupee depreciation. The cut in development spending has not been adequate to contain the size of the fiscal deficit. There is the prospect of the annual budget deficit approaching 7 percent of the GDP in 2018-19.

The delay in finalization of the IMF Programme has exposed the vulnerabilities on the fiscal front. Consequently, stronger measures may be asked for by the IMF. The media has already carried the news that in the forthcoming budget of 2019-20, additional revenues of up to Rs 700 billion from taxation proposals will be asked for by the IMF to stabilise the public finances of the country.

This order of magnitude of fiscal effort poses the biggest risk to successful commencement of the Programme. For quick realization of additional revenues this will require the enhancement of tax rates of indirect taxes while income tax reforms will take time to yield results. Heavy indirect taxation will be regressive in nature and lead to higher inflation in prices of a wide range of consumer goods.

There is also the question of political feasibility of a budget with heavy indirect taxation. The PTI government has a razor-thin majority in the National Assembly and may not be able to get such a budget passed. A better option is to spread the incremental tax effort over the next two years and achieve greater economy in current expenditure next year while restricting the growth in development spending.

There are also other areas where reforms are likely to feature in the impending IMF Programme. The first relates to restricting the rapid growth in the circular debt in the power sector. The rise in fuel costs due to the rupee devaluation has increased further the circular debt. Therefore, the Programme may include a Structural Benchmark of a tariff increase to prevent further accumulation of circular debt. A similar step may also be required in the gas sector.

The other major area of concern is the quasi-fiscal deficit due to large losses of public sector enterprises. The last IMF Programme of Pakistan with the IMF included a commitment to privatize PIA and three DISCOs. This did not take place and this time a stringent requirement may be put in place to implement an expanded programme of privatisation.

Financing of the fiscal deficit also poses significant problems. As of the 12th April 2019, the government has borrowed an incredibly large amount of Rs 3503 billion from the SBP. This is almost as large as the cumulative borrowing from the SBP over the last 71 years. Simultaneously, an amount of Rs 2520 billion has been retired from the commercial banks.

This has enhanced inflationary pressures in the economy. The Fund may insist on large-scale retirement of government debt with the SBP and resort to market-based financing of the fiscal deficit. This will exert strong upward pressure on interest rates. Further, a shift towards PIBs rather than MTBs may be required to avoid future refinancing risks.

A serious and very contentious issue is the apparent insistence by the IMF that the exchange rate be market determined and not based on a managed float. The foreign exchange market is very thin and prone to speculation. In the event of shocks, there could be violent fluctuations in the value of the rupee. The SBP must have the residual right to intervene.

Another difficult issue will relate to the financing of repayment of Chinese debt. There is need for a Authorities and the IMF to have a clear understanding on the financing of the balance of payments of Pakistan over the next years. The Programme would be defective and inadequate if there remains a large amount of 'unidentified financing'. This has never been the case in previous Programmes or in IMF Programmes in other countries.

The size of the EFF is likely to range from $6 to $8 billion as indicated by the outgoing Finance Minister. The amount remaining in the SDR quota of Pakistan with the IMF is just above $6 billion after the financing under the last EFF is accounted for. The financing should be front loaded in 2019-20 so as to ensure that the reserve cover rises above two months of imports.

The next few weeks will be extremely important in influencing risk perceptions of Pakistan's economy. Successful negotiations will hopefully lead to a politically and economically viable Programme with the IMF for Pakistan. We wish success to our new de facto Finance Minister in the interaction with the IMF on the finalization of an EFF to Pakistan.

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