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What the programme demands

The news of IMF staff mission reaching an agreement with Pakistan for $6 billion over the next three years should bring an end to the uncertainties facing our economy for the last nine months.

Entering an IMF programme has its cons in terms of monetary tightening and resultant inflationary pressure, but at the same time it was inevitable as all alternative plans B, C, D etc, would only work once we follow fiscal discipline – and under the given circumstances this discipline could be best followed in an IMF programme.

First thing first, why were the current negotiations between Pakistan and the IMF tough? The IMF was asking for reducing energy (electricity and gas) losses through upward revision of tariffs and withdrawal of subsidies. It was asking for withdrawal of tax concessions and exemptions to improve the fiscal deficit positions. It was also emphasising on addressing the balance of payments crisis through observing quarterly targets for net international reserves (foreign currency reserves). Meeting these demands may hit the political capital of the government. However, ignoring them is not an option; and let me explain why.

Curbing the energy circular debt – not only the amount of debt but also aligning the whole energy supply chain and bringing all concerned (refineries, oil and gas distribution companies, NTDCs, power generation companies – GENCOs, power distribution companies – DISCOs, K-Electric etc) – on same wavelength is crucial for Pakistan's energy and fiscal sustainability.

A quick glance at the numbers reveals that in 2013 the accumulated losses of 10 DISCOs were Rs20 billion. In 2018 these losses shored up to Rs296 billion. In 2013, the three DISCOs; FESCO (Faislabad), LESCO (Lahore), and IESCO (Islamabad) reported Rs24 billion, Rs14 billion and Rs10 billion profit respectively, whereas in 2018 they reported losses of Rs40 billion, Rs42 billion and Rs27 billion respectively. Despite receiving significant tariff subsidies from government, those profit-making DISCOs turned into loss-making entities during the last five years .

Credit goes to the PML-N government for improving the power supply situation during the last five years (2013 to 2018). However, this supply improved at a hefty cost in the form of accumulated losses of DISCOs, tariff subsidies, and the capacity charges (minimum payment to be made to generation companies). The combined effect of tariff subsidies and losses of DISCOs in FY2018 was Rs492 billion and the numbers are piling up mainly due to the capacity charges. For fiscal order, the IMF wants these losses to be passed on to consumers, and rationalizing of the tariffs in a manner that in the future such losses don't accrue.

This would mean an increase in electricity tariff for all except consumers consuming less than 300 units per month. But here's a catch. To distribute the effect of 'capacity charges payment', the government would have to increase on-grid electricity consumption. However, an increase in electricity tariffs, above a certain threshold, would encourage consumers to go off-grid (solar panels or captive power generation) and this in turn would mean that on-grid electricity would turn more expensive. Part of the solution can be to reduce transmission and distribution losses of the power sector through better governance, but electricity tariffs will have to be increased to curb the energy circular debt.

The IMF is also asking for withdrawal of tax concessions and exemptions for overcoming fiscal imbalance. After paying the share of the provinces from federal divisible pool, the federal government can barely manage the two non-discretionary expenses – debt payment (mark-up and principle amount) and defence budget. To meet all other expenses (running the civil government, pensions, salaries, subsidies, public sector development etc) it must borrow. The fiscal year starts with a few trillion rupees deficit and this fiscal imbalance needs to be managed either through an increase in revenue or decrease in expenditures. One way of doing it would be to bring taxable tax-evaders into the tax net (this remained elusive so far; let's see how aptly the new chairman FBR handles it). Until we broaden our tax base, the government will not be able to give tax waivers and exemptions.

The IMF’s prescription to manage this situation is to increase total tax revenue by 1.7 percent of GDP; increase in FED and GST; and reduction in the losses of state-owned enterprises (PIA, PSM etc). It is also asking for an increase in the interest rates by another 1.5-2 percent. Increased interest rate helps address demand-led inflation which is not the case in Pakistan so the government should have resisted it. The government would have negotiated the pace and sequence of how to implement the IMF’s demands.

Averting a balance of payments crisis requires building foreign currency reserves. Ishaq Dar was mindful of supply-side constraints for exports; to contain the import bill, he relied on an overvalued rupee. However, that had negative implications on foreign currency reserves. The IMF does not want the incumbent government to spend another 'hard borrowed' $24 billion on rupee stabilization. That is why it is asking the government to give policy independence to the State Bank of Pakistan. It has also set quarterly targets to maintain net international reserves. If the government wants to avoid further depreciation of the rupee then it would have to boost foreign currency reserves through issuance of Eurobonds, Sukuks and/or renewal of 4G licences. The other alternative would be for the SBP to buy dollars from the open market which would put pressure on the value of the rupee against the dollar.

The IMF programme may help address the chronic issues of our economy. However, for that to happen we need to implement what we agree with the Fund. Pakistan has a history of unsuccessful IMF programmes. The one that it completed, albeit with sixteen waivers, was the last programme under former finance minister Dar. Implementation of the agreement would not only have inflationary pressure but a political fallout too.

The government is trying to expand the scope and magnitude of poverty alleviation programmes to absorb some of the inflationary pressures. However, in the absence of a fiscal cushion, the government would have to try innovative measures to boost the economy, to create new jobs and secure livelihoods of the people. The private sector can be an important ally of the government for this purpose, provided the government can restore its confidence through announcing budgetary measures that improve the ease and cost of doing business.

This whole scenario presents a challenge and an opportunity for the newly appointed finance adviser, the new governor of the State Bank, and the new chairman FBR. The fine print of the IMF programme and the next federal budget would help prove whether or not the critics of the new economic team had any weight in their criticism.

The writer heads the Sustainable Development Policy Institute. Twitter: @abidsuleri

Dr Abid Qaiyum Suleri