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Pakistan goes to the IMF!

In a dramatic development, the government has decided to go to the IMF for help. Even a day earlier, this was not on the agenda. The Prime Minister, in his press conference in Lahore on 7 October, spent a great deal of time stressing his desire to seek friends' help to place a sizeable deposit in the SBP to tide over the foreign exchange needs of the country. Alternatively, he pointed out, he was counting on recovering the looted wealth of Pakistan stashed away in foreign accounts. This would be helpful in meeting the foreign exchange needs. Only reluctantly, he conceded that if those efforts were not successful, the Government would seek a programme from the IMF.

The Finance Minister was maintaining an ambiguous stance on the desirability of Fund programme from the very outset. Even on the eve of an assessment Mission, the minister never gave an impression that it was becoming inevitable to approach the Fund. He consistently maintained that it was not a negotiating mission; he said its report could serve as a good basis to start negotiations, should the Government decides to go for a programme.

With such sustained ambivalence, the dramatic announcement is both a sigh of relief and cause for wariness. Before we discuss the possible reasons for the decision, let us express an unqualified appreciation for the correct decision no matter how much late in the day it was decided. There was no other way to move forward in seeking to stabilize the economy.

What was the trigger for the decision? Analysts agreed that what happened in the stock market on Monday shook the most hardened opponents of this course of action. In a single day, the market was down 1328 points or 3.4 percent with a value loss of Rs 110 billion. It has fallen below the 38,000 barrier as it registered a two-year low. Exchange rate also lost considerable value with rupee closed at Rs 130 in the open market. This was clearly a sign of evolving melt-down. There was no room left to procrastinate.

But a new set of challenges await the managers in negotiating a programme that can be delivered with minimum pain. Unfortunately, the IMF would view it from a different set of glasses. Having seen what Pakistan did with our last successful programme, their focus would be to build such mechanisms that would put some barriers on the levers applied by the Government to neutralize the gains as soon as the programme was over.

What are the likely features of a programme under the current circumstances? The first major question policymakers should decide is whether they would request a stand-by or an extended fund facility (EFF). The last programme was EFF and we feel that given the pattern of economic management, the Government would be well advised to seek a three-year EFF to ensure a medium term engagement that would lead to sustained revival of the economy. A message the minister had given, in his video statement, was his keen desire to break the recurring cycle of seeking Fund's support once and for all. Such a goal would also be achieved under an EFF rather than a Stand-by.

The primary objective of the programme would be to stem the depletion in country's reserves. It surely would provide its own resources to meet the financing gap, but it would first work to minimize the gap through demand management. The foremost consideration in this regard would be the run-away fiscal deficit that feeds into an equally unbounded balance of payments deficit. A significant cut in fiscal deficit would be a policy variable (performance criteria), and in all likelihood, the IMF would demand it to be of no more than 5% during the year. The fiscal adjustment made at the time of mini-budget was inadequate – despite its own assessment of previous Government's deficit of 7.2% – even when one grants Government's own claim for the effort to be 1%, though a more conservative estimate was merely 0.3%. Thus a significant adjustment still remains to be accomplished through a combination of tax effort and expenditure cuts.

In a statement at the conclusion of the Mission, IMF had pointed out that significant adjustments in interest and exchange rates were also warranted besides adjusting the electricity prices. Accordingly, a number of actions affecting aggregate demand will be taken leading to significant increase in inflation. Accommodative monetary policy will have to end, leading to interest rate increase and pressure on the Government to reduce its borrowings from the central bank in a very big way. Activation of other sources of financing, notable foreign (sukuk and euro bonds) will have to be resorted to rationalize the borrowings from the central bank.

The most important component of the programme would be the structural benchmarks in a number of sectors such as privatization, energy, financial and banking, central bank and corporate governance. Specific policy measures would have to be committed with a designated timelines for giving effect to these measures.

Two areas that would occupy Fund's special attention, and for which we should be well prepared, are ways to ensure that the fiscal deficit is reined in credibly, even beyond the programme period, and there is a durable plan to settle the circular debt and to ensure that it is firmly stopped from recurring. Over-hauling tax machinery would also be a part of this arrangement. While the first concern would be addressed by strengthening FBR efficacy and fiscal responsibility and debt management framework, the latter is inextricably linked to the revival of divestment plan for Discos and Gencos, which the previous government abandoned mid-way.

In yet another remarkable development, the SBP has made an unprecedented exchange rate adjustment of almost Rs 10, which is surprising unless a series of prior actions had been agreed with the Fund during their last visit. In that eventuality, there would be other actions that would be unfolded in the coming days. If it is not a prior action, then we recommend that the Government should hold further adjustment actions until the programme is negotiated so that markets adjust to the parameters agreed upon under the programme.

(The writer is former finance secretary)

waqarmkn@gmail.com

Waqar Masood Khan