DAWN

24th December, 2018

As IMF talks sputter, govt seeks another route

ISLAMABAD: The scale of the adjustment being demanded by the International Monetary Fund (IMF) "is too large" and accession to the programme is likely to be delayed, a senior official involved in the negotiations tells Dawn.

"Our talks with the IMF are not going well," he says, adding: "The only option we have now is to do something on our own."

Take a look: Differences remain over tough conditions of IMF bailout

Conversations with senior officials from the finance ministry, with direct knowledge of the Fund talks, paint a dismal picture of where the talks currently stand. "There is no chance that the adjustments as proposed by the Fund can be made," one of them says. "The demands in their current shape are too steep to be implemented."

Fund asking for steep cuts in current expenditure

This has put the government in a quandary, since an IMF programme is essential to unlock access to resources from other multilateral lenders like the World Bank and the Asian Development Bank, as well as from global financial markets.

In the meantime, the government has procured some breathing space through bilateral support from Saudi Arabia, and now a commitment from the Abu Dhabi Fund for Development of another $3 billion deposit "in the coming days". In addition, the same sources tell Dawn, talks with China are near conclusion on another $2.2bn deposit with the State Bank, with the last meeting held on Dec 20, though these funds will be subject to certain conditions.

Also read: Why Pakistan will go to the IMF again, and again and again

But with the current account deficit running at more than $1bn per month, these inflows will buy little more than time. Officials at the finance ministry tell Dawn that these bilateral inflows can tide the country over for one year, at the very best. Eventually, an IMF programme becomes necessary no matter what, and the government is hoping that something can be done in the intervening period to bring about some flexibility in the Fund's position.

Explore: Approaching the IMF

"It is possible that the IMF may come around, considering our position and will not let us collapse," says one of the sources. "After some tough talk, I think they may come to a point to sign a basic agreement."

The sticking points

But at the moment such a point seems like a distant prospect. One central issue in the talks is the size of the adjustment between revenues and expenditures that the Fund is asking the government to implement. Another issue is a continuing hike in interest rates, which will raise the cost of borrowing for both the government and business. The discount rate has already been raised by 4.75 per cent since January, a near doubling in one year since it has gone from 5.75pc to 10.5pc in the time period, with the latest jump of 1.5pc being the sharpest one yet.

In addition, there is a demand for complete free float of the exchange rate, as has been widely reported already, to allow the market to fully determine the value of the rupee. This demand is also an important sticking point. Government officials believe that Pakistan's foreign exchange markets are too thinly traded to be left to the market, and are insisting that they retain some space to intervene, even if only to smooth out sharp swings induced by speculative activity. The Fund says that in the past such discretionary power to intervene in the currency markets has been used to manage the rate.

“Ours is a small market in the range of $200 million to $300m trading on a daily basis,” a senior official tells Dawn. Agreeing to the IMF demand would “allow few players to manipulate the tiny market easily,” he says. “This is again politically and economically impossible for Pakistan to agree to this demand.”

One of the officials chuckled when his attention was drawn to recent media reports which say that Pakistan has committed to bringing the exchange rate to Rs150 per dollar by June 2019. “No such thing has been committed,” he says, adding that discussions are only on the mechanism for determining the exchange rate, and not its actual value.

In a separate comment to Dawn, IMF’s Resident Representative in Islamabad Teresa Daban Sanchez also says the same thing. “The IMF’s advice on exchange rate issues is not for Pakistan to reach or target a particular rate,” she says in a message sent from Washington DC where she is currently visiting. The “advice” instead focuses on the policy through which the exchange rate will be determined, “in particular for Pakistan to transition towards a market-based exchange rate regime”.

She says the Fund officials are strongly prohibited from talking about ongoing talks with any country. But in more general terms, she says, “Fund policy advice is for fiscal consolidation, monetary tightening, flexible exchange rate regime, reduction of losses at the state-owned enterprises (including circular debt), and strengthening social safety net to protect most vulnerable from adjustment”.

Weight of failures past

The IMF cites its disappointments in previous dealings with Pakistan as justification for demanding upfront action this time round, finance officials tell Dawn. “They are telling us that commitments made in past programmes were not fulfilled,” one of the sources says, adding that as a result they now want the adjustments to come before the funds are disbursed.

In the last IMF programme, Pakistan obtained a record number of waivers for failing to comply with its commitments from privatisation to reduction in circular debt. These waivers or non-implementation of commitments did not sit well with the Fund, and blistering commentary in the local press pointing this out has also left some scars. Government officials are also convinced that another reason the Fund is taking a tough line with Pakistan is the changes in the Trump administration’s attitude towards Pakistan.

Size of the adjustment

In the proposed programme, the IMF is asking for an adjustment of around Rs1,600bn to Rs2,000bn over three to four years. What’s more, the Fund wants the burden of any expenditure cuts to fall on current expenditures that include debt service, defence and subsidies, according to a senior official who has been a part of the process. Previous governments cut development expenditures when undertaking an IMF-led adjustment and usually left current expenditures alone (other than subsidies).

A steep cut in current expenditures of the sort that the Fund is asking for can put the government in the awkward position of asking the generals to take a sharp pay cut. Additionally, the government will also be forced to seek at least a partial reversal of the provincial transfers under the 9th NFC award.

Officials from the government side say this demand — to cut current expenditures so sharply — is impossible to fulfil. “It is too difficult for Pakistan to agree to it,” one of them tells Dawn, adding that there is certain non-development spending which cannot be discontinued or reduced.

The emphasis on current expenditures in the talks comes as a result of a focus on what is known as a ‘primary balance’ in the parlance of public finance. The primary balance of a government’s budget is the difference between revenues and expenditures after removing interest payments. It tests whether the path of debt accumulation of any country is sustainable or not. If this balance is in deficit then it means that at least some of the interest payments due in the given year will have to be made through borrowing.

Last year, Pakistan ran a primary deficit of almost Rs760bn, meaning a substantial portion of interest payments that have to be made this year will have to be made with borrowed money. Cutting the primary deficit requires a cut in current expenditures, and usually becomes necessary when reducing the debt-to-GDP ratio is a priority.

When speaking on record, both the government and IMF staff lay emphasis on overall “fiscal consolidation”. Finance Minister Asad Umar did not respond to repeated requests for comment, but Dr Khaqan Najeeb, the ministry’s spokesperson, tells Dawn that the government will “continue on the path of fiscal consolidation to bring down both primary and fiscal deficits”.

Sanchez from the IMF also says that when the Fund assesses a fiscal consolidation, the staff will “usually look at primary balance, which is considered as the best indicator for these purposes, especially for debt sustainability. This is not new neither specific to Pakistan”. But in programmes past, the Fund has preferred to focus on the overall fiscal deficit rather than the primary deficit, and watched silently as development expenditures were slashed as part of a fiscal adjustment.

On the interest rates, the Fund is asking for the rate hikes of 2018 to continue well into the next year. “We have conveyed to the Fund that we have already increased the rate by more than 400 basis points”, but the Fund is asking for further increase, according to the official. Dr Najeeb says that ”the government conveyed to the IMF that Monetary Policy Committee is an independent committee and its meeting takes decisions considering the economic fundamentals at the time. It will continue to do so in future”. But the Fund is continuing to speak of “monetary tightening” as one of the elements of its “policy advice” for Pakistan.

There are other prior conditions too, which include further increases in gas and electricity tariffs and a huge increase in the revenue collection of the Federal Board of Revenue in the current fiscal year. “We really don’t have that much space to enhance revenue in the next six months as the IMF is asking,” the senior official says.

With these conditions, it is unlikely to get the IMF programme. But officials are optimistic to see some flexibility in the conditionalities in the next couple of months. “We have given them our plan about measures that we can easily do,” the source said, adding: “We are in contact with the Fund through video conferencing.”

Sanchez has already acknowledged receipt of the document containing the measures proposed by the government. “There is strong understanding between the authorities and Fund staff on the diagnostic of Pakistan’s macro challenges, the need for adjustment policies, and the goals to be achieved,” she tells Dawn from Washington DC. But agreement, it seems, is proving elusive.

“Discussions continue on the composition, sequencing, and prioritisation,” she says.
An alternative path

As talks with the Fund sputter on, the government has launched a massive effort to draw foreign exchange inflows through other means. Officials at the finance ministry tell Dawn that they hope recent measures may increase remittances by another $2-3bn and they are also looking for an increase in foreign investments. They say they hope an increase in remittances and FDI will reduce the pressure on the external side.

A steep drop in oil prices is another unexpected windfall. Given some of the new realities opening up, they expect the current account deficit to drop to around $13bn this year from last year’s $19bn. But this is only possible if there is continuing improvement in exports, remittances and FDI.

On the investment side, Saudi Crown Prince Mohammad Bin Salman is expected to announce a massive package of investments for setting up refineries near Gwadar in Balochistan. “They want to make an oil city near Gwadar,” the source said, adding that the establishment of one refinery involves an investment of $7bn to $8bn.

Pakistan is also making some efforts to make some arrangement with Qatar as Pakistan imports LNG from Qatar as well. “It is also under negotiations,” an official with direct knowledge of the talk says.

<u>Mubarak Zeb Khan</u>