IMF's EFF: Different or more of the same?

Mushtaq Khan, July 30, 2019

After much delay, the IMF's Board agreed to Pakistan's request for a stabilization program on 3 July. The 39-month Extended Fund Facility (EEF) is more than a Standby Arrangement (SBA), which is generally used to address a temporary balance of payment (BoP) problem. The EFF is designed to rehabilitate the country's macro-economy to keep it a healthy participant in the global trade order.

While most economic agents felt a sense of relief, for those who still doubt the importance of the IMF program, the counterfactual is important to consider. If Pakistan had not approached the IMF last year, by now donor-fatigue would have set in with Pakistan's friends (China, Saudi Arabia and the UAE). Furthermore, if Pakistan's request for IMF assistance had been rejected by the board[1], the slow drip-drip desperation would have turned into a torrent, and Pakistan's economy would have gone into a tailspin.

How the IMF helps

It's certainly not the IMF's SDR 716 mln ($ 991 mln) that was released after the program was approved. In our view, the importance of the IMF program is the way it addresses the following questions by providing a structured outlook: (1) How much more will the PKR/$ parity adjust in the coming year? (2) How much higher will interest rates increase? (3) How much can Pakistan secure to repay its mounting $ debts? (4) Will SBP continue to restrict FX outflows? (5) How sharply will the twin deficits narrow by? And (6) how long will it take for Pakistan's growth prospects to improve?

Most people will agree that economic uncertainty is far more debilitating than tough economic conditions. Certainty gives people the opportunity to prepare themselves and their businesses. No one doubts the need for urgent steps to stem the growing sense of gloom that had overwhelmed the economy. The economic slowdown was clear enough before the program started: manufacturing posted negative growth, auto sales had slumped, cement dispatches were down, and people were losing jobs.

This paper seeks to address the questions listed above. **Part 1** will look at the entire program period, and focus on the macro projections that show how the twin deficits are to be managed. **Part 2** will look specifically at program details in FY20, to understand the quantitative and qualitative targets that are part of the EFF.

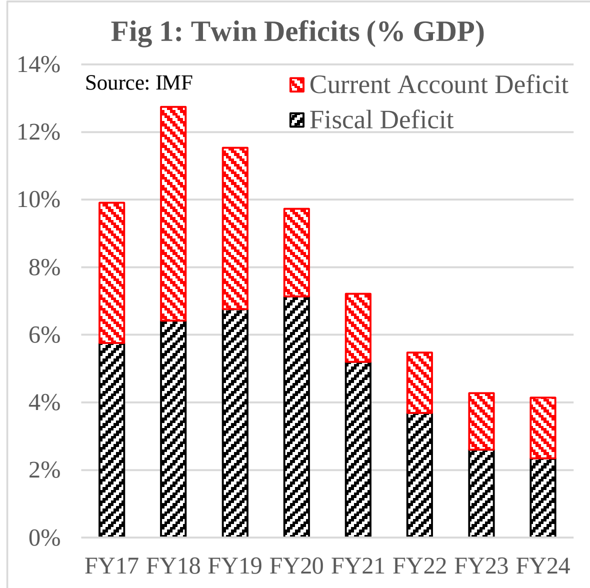
Part 1: Pakistan's macro-economic outlook FY20-FY24

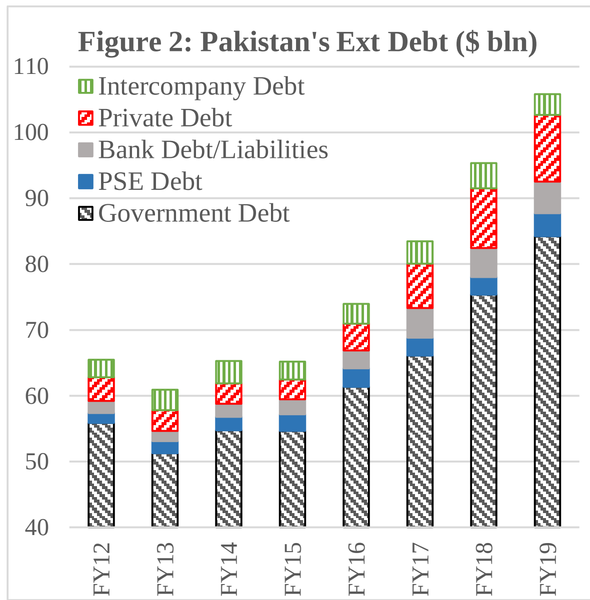
While some claim that the Federal Budget presented a comprehensive picture of what to expect in the year ahead – we disagree. Without details on the external sector (which the Budget barely covers), the outlook on the real sector, monetary developments and the fiscal side, are not credible. For an import-dependent country in an economic crisis, commercial entities cannot plan for the future without a credible assessment of Pakistan's BoP position (i.e. the questions posed earlier).

For the past three years, Pakistan's twin deficits have been in the danger zone. As shown in **Figure 1**, Pakistan's twin deficits were at, or above, 10% of GDP, but this did not deter the previous government

[1] This would have been unlikely, but after US Senators warned the US Treasury not to support Pakistan's case in the IMF, being rejected at the board stage would not have been impossible.

from its short-sighted policy to push economic growth before the elections in mid-2018. This drove the twin deficits to record highs, with an unprecedented current account deficit of $ 20 bln in FY18. This necessitated desperate borrowings, which increased Pakistan's external debt to unsustainable levels (see **Figure 2**).





While this growth strategy failed to secure another term for PML-N, the incoming PTI government also failed to stabilize the economic situation in FY19. As shown in both **Figures 1** & **2**, the PTI government persisted with a loose fiscal policy and was unable to reduce the external deficit with the urgency it deserved. As a result, Pakistan's external debt continued to rise despite indications that this debt had become unsustainable. Piecemeal currency adjustments did little to narrow the trade deficit in FY19: in our view, the one-off increase in remittances and the reduction in CPEC-related machinery imports, did most of the job of narrowing the external deficit last year.

As shown in **Figure 1**, the EFF does not intend to narrow the twin deficit as sharply as we thought. In fact, the fiscal deficit is projected to increase in the first year of the EFF, which can be traced to the increase in interest rates, the growth of Pakistan's external debt, and the sharp currency adjustments. The actual stabilization will take place in FY21 and FY22, when the twin deficits are to be brought down to more sustainable levels.

Balance of payments

As shown in **Table 1**, the priority this year is to narrow the external deficit. Since this is a hard target in the EFF (via the quarterly floor on the increase in net international reserves – NIR), the IMF thinks a hard adjustment in the external sector (in FY20) will be sustainable. Prioritizing the external sector makes sense, so as to give comfort to Pakistan's trade partners that the country will meet its dollar payments in the period ahead. As stated in the program summary, the IMF claims that the EFF should be able to "coalesce broader support from multilateral and bilateral creditors in excess of $ 38 billion, which is crucial for Pakistan to meet its large financing needs in the coming years."

Other than keeping the trade deficit around $ 25 bln in the next three years, it is insightful to look closer at the *Services* and *Primary Income* balances in **Table 1**. In a growing economy, the services deficit is likely to increase because of freight payments and other imported services. The projected economic slowdown and the likelihood that Pakistanis will buy less FX (for travel, health and education) because of the weaker Rupee, could explain the sharp curtailment in net service payments. This contrasts with the growing imbalance in *Primary Income*, which is dominated by external debt servicing and returns on DFI.

The growing dependency on DFI inflows, can also be seen in the *Financial Account*, where DFI gradually becomes the main source of financing Pakistan's current account deficit (see **Table 1**).

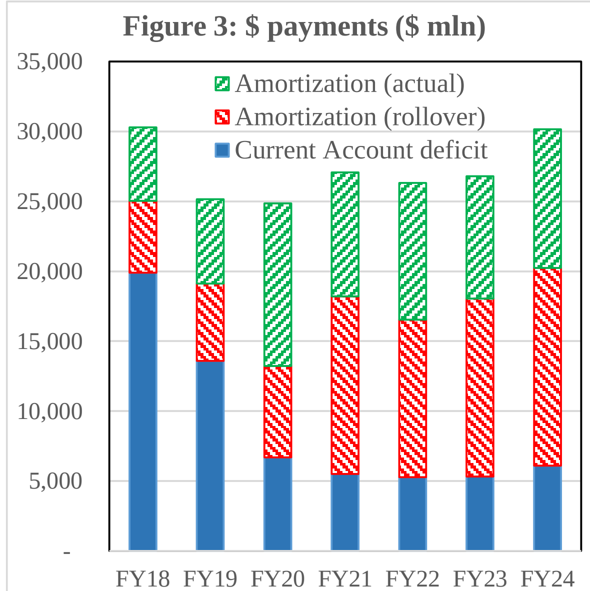
Table 1: Pakistan's Balance of Payments

US$ mln	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24
Current Account	**(12,621)**	**(19,897)**	**(13,587)**	**(6,695)**	**(5,490)**	**(5,274)**	**(5,310)**	**(6,082)**
- CA as a % of GDP	4.14%	6.32%	4.78%	2.59%	2.01%	1.79%	1.68%	1.79%
Trade Balance (net)	*(26,680)*	*(31,824)*	*(28,219)*	*(24,891)*	*(24,464)*	*(25,059)*	*(25,660)*	*(26,846)*
- Merchandise Exports	22,003	24,768	24,217	26,834	29,460	31,705	34,109	36,698
- Merchandise Imports	48,683	56,592	52,436	51,725	53,924	56,764	59,769	63,544
Services Balance (net)	***(4,339)***	***(6,068)***	***(4,265)***	***(2,022)***	***(1,866)***	***(1,826)***	***(1,777)***	***(1,641)***
Primary Income (net)	***(5,048)***	***(5,484)***	***(5,744)***	***(5,456)***	***(5,935)***	***(6,351)***	***(7,060)***	***(8,052)***
**** Interest payments***	***(3,056)***	***(3,056)***	***(2,978)***	***(3,570)***	***(3,928)***	***(4,285)***	***(4,654)***	***(5,051)***
**** Return on DFI***	***(3,217)***	***(3,217)***	***(2,560)***	***(2,643)***	***(2,945)***	***(3,120)***	***(3,486)***	***(4,242)***
Secondary Income (net)	***23,446***	***23,479***	***24,641***	***25,674***	***26,775***	***27,962***	***29,187***	***30,458***
- Remittances	19,351	19,914	21,842	22,538	23,619	24,730	25,867	27,031
Capital Account	**375**	**376**	**266**	**690**	**613**	**572**	**576**	**488**
Financial Account	**10,198**	**14,300**	**12,223**	**8,744**	**7,930**	**8,576**	**11,003**	**9,827**
- Direct Investment (net)	2,663	3,461	1,729	2,094	2,854	3,614	4,380	5,036
- Portfolio Investment (net)	(250)	2,257	(1,262)	333	1,856	2,040	2,328	2,328
- Other Investmens (net)	7,785	8,582	11,756	6,317	3,219	2,921	4,294	2,463
* SBP	4	1,548	5,495	(4,000)	(1,000)	-	-	-
* GoP	4,971	4,894	3,904	8,133	2,750	846	1,405	(425)
* Banks	(1,631)	109	(217)	1,259	1,484	1,784	2,084	2,034
* Others	2,298	2,522	2,432	1,567	1,719	1,713	1,392	1,611
Errors & Omissions	**102**	**(920)**	**(454)**	**-**	**-**	**-**	**-**	**-**
Overall Balance	**1,946**	**6,141**	**1,552**	**(2,739)**	**(3,052)**	**(3,873)**	**(6,269)**	**(4,233)**
- Change in SBP reserves	1,844	6,227	1,928	(4,364)	(3,280)	(4,423)	(5,978)	(3,184)

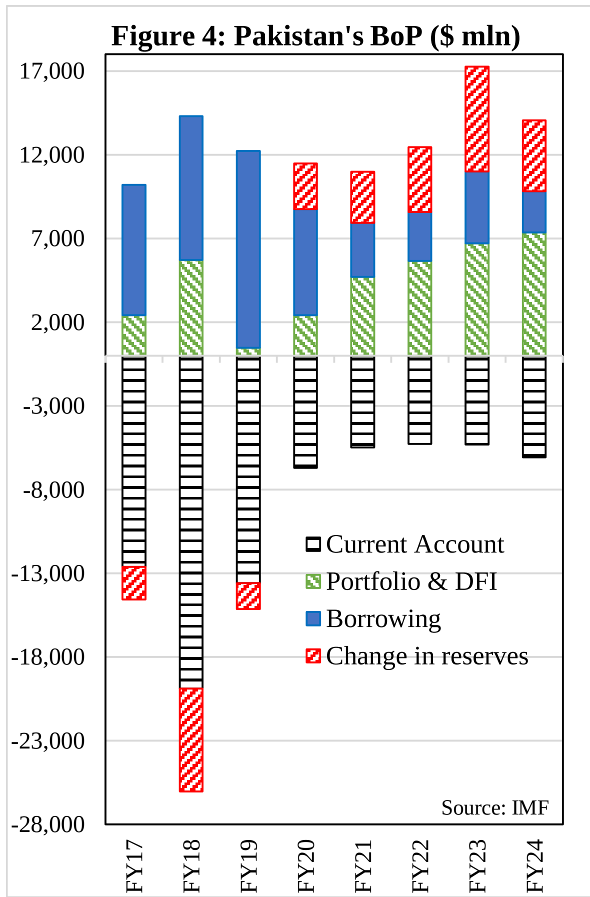
Source: IMF and SBP

Before going below the line, a few observations about remittances are in order. The authorities and the IMF think worker remittances will continue to post healthy dollar-terms growth for the period FY20-FY24. We feel this is optimistic as remittances were stagnant during FY15-FY18, and only increased last year because of the slowdown in the GCC (specifically Dubai) and Pakistanis availing the Amnesty scheme. The 4-5% growth shown in **Table 1** also contradicts the efforts by GCC countries to reduce imported manpower to increase jobs for local nationals.

While the reduction in the current account (CA) deficit is necessary to stabilize the economy, the massive debt build-up has created a heavy repayment stream that neutralizes the smaller external deficit (see **Figure 3**). This means Pakistan will need $ 25-30 bln each year to finance the CA deficit and to meet its debt obligation. However, since Pakistan is unable to mobilize this quantum of hard currency, the GoP has secured a commitment from its friends that most of the money they provided in the past several years (in cash or in kind) will be rolled-over. As shown in **Figure 3**, during the period FY21-FY24, Pakistan will have to rollover more of its debt payments that it actually repays.[2]



To move towards sustainability, the EFF reveals an abrupt shift in financing the external deficit from FY21 onwards. This becomes clear in **Figure 4**, which shows how non-debt creating inflows (i.e. portfolio and DFI) become the main avenues to finance the external deficit in FY21-FY24, and also to build reserves. Compare this with the period FY17-FY19, where large external deficits required heavy (almost desperate) borrowing while simultaneously losing FX reserves. The solid blue bar shows the quantum of borrowing that is to be replaced by portfolio inflows (net stock market inflows and Eurobond issues) and DFI (which is primarily from China). Even within *borrowings*, there is a shift away from government borrowing to private sources (see *GoP* and *Banks* in *Other Investment net* in **Table 1**).



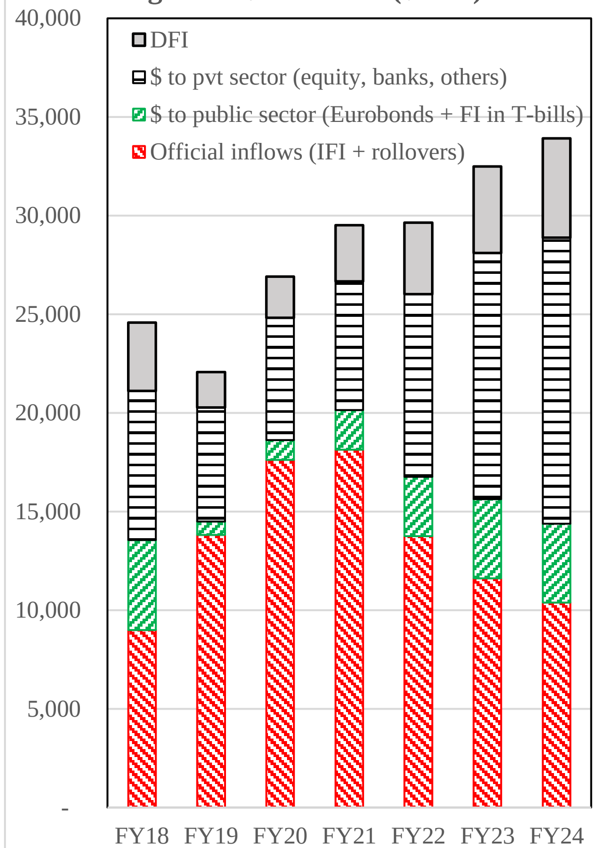
This raises an interesting question: unlike government borrowing which is predictable and lumpy, will portfolio inflows and DFI be as stable? The gut-feel answer is no, as people think of portfolio inflows as *hot money*, while DFI is contingent on domestic investment conditions, which (at this point) are not too attractive. Nevertheless, the IMF report categorizes dollar availability as shown in **Figure 5**.

Compared to **Figure 3**, the gross inflows shown in **Figure 5** are well above committed outflows as the EFF projects a sustained increase in SBP's FX reserves. Two issues should be noted: one, the bulk of *official inflows* are rolled-over debts, and two, *$ to private sector* and *public sector* entail inflows from foreign investors (more specifically, equity investors, Eurobond holders, foreign investors in Pakistani T-bills/bonds, and global bank lending to private Pakistani banks – see **Figure 5**). As shown, the bulk of $ financing into the country will come from private foreign investors and not official creditors.

[2] The generosity is shown in **Table 1**, where the outflows of $ 5 bln from SBP in FY20 and FY21 represent the repayments to Saudi Arabia and the UAE for the BoP support provided to the central bank. Instead of simply rolling over this money, Saudi and the UAE have agreed to convert these into loans to the government, which shows up in the GoP head in *other investments net*. This will provide the bulk of the external financing for the fiscal deficit this year.

Given Pakistan's poor global image, this is ambitious but also necessary. The IMF is very particular about debt sustainability, and the EFF envisages a drastic change in external financing from debt to non-debt inflows. This is needed to ensure that Pakistan's amortization payments continue as scheduled, but *fresh* inflows do not add to the debt burden. Hence, as shown in **Figure 5**, from FY21 on, there is a shift towards DFI and equity inflows to rehabilitate Pakistan's external sector. It also means that future CPEC-related projects will be equity financed.

Figure 5: $ Available ($ mln)



While we concede the logic of this argument, we remain cautious about the growing dependency on non-debt inflows. Even accounting for possible foreign investment in GoP paper (shown in green), these retail inflows will impose a great deal of discipline on domestic policymaking. As other EM countries have experienced (e.g. Egypt), dependency on short-term investment in government securities forces the central bank to ensure that domestic interest rates are high enough to compensate for future weakening of the local currency. If foreign investors feel they are not being rewarded for the risk they face, this money will exit, which would create immediate pressure on the central bank's FX reserves.

In our view, Pakistan is perhaps being compelled to grow up. If it wants to run an external deficit, it must *attract* dollar financing from non-official sources. Once this happens, policymakers must manage this stock of debt/equity very carefully, and remain diligent to the concerns of foreign investors. Given Pakistan's global image, this will be challenging.

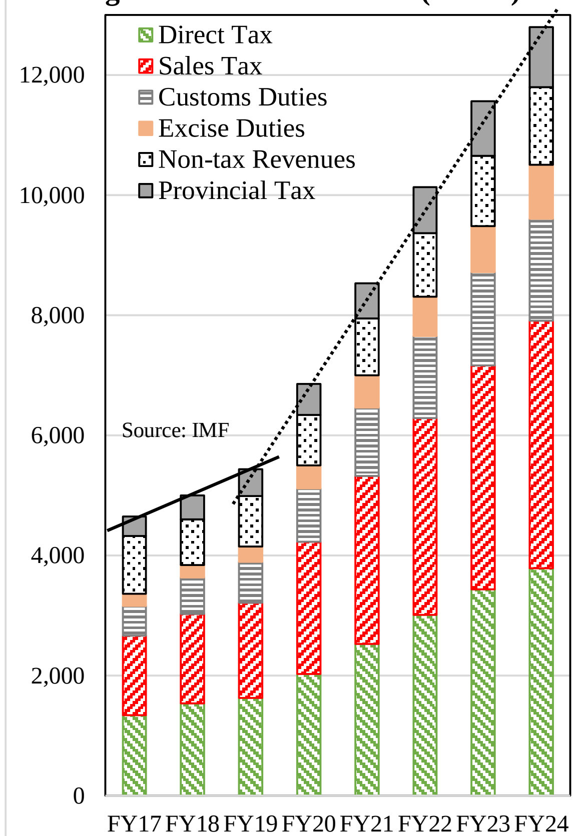
If we had a say in the matter, we would urge more caution. While there is foreign appetite for investment in the PSX and government securities, we are concerned that once these inflows start (and this gains a certain momentum), the dollar inflows could change the behavior of Pakistani investors/consumers, and also policymakers. Pakistan has a history of squandering positive external shocks, which eventually lands us in a BoP crisis: (1) 9/11 sharply increased our FX reserves and triggered a consumer boom that ended badly in 2008; and (2) the collapse in oil prices in mid-2014 allowed the government to go on an import binge (encouraged by Ishaq Dar's infamous currency management) that has brought us to this point.

In our view, with the massive dollar debt that the country has accumulated, Pakistan should narrow the current account deficit even more than shown in **Table 1**. Since manpower is Pakistan's biggest export, imports and net service payments should be limited to (and financed by) our export revenues and remittances *alone*. This means that for FY20, Pakistan should have targeted a *zero* current account deficit, and then gradually increased the external surplus (in the next several years) to cover a growing portion of Pakistan's *Primary Income* balance. This policy discipline – though hard – would dig the country out of the debt trap it is in.

Fiscal Accounts

We have less to say about the EFF's fiscal projections, except to note that they are ambitious (see **Figure 6**). The sharp increase in the trajectory of revenues during the EFF is clearly shown in **Figure 6**, whereby all tax heads are expected to post strong growth. While the emphasis is on progressive taxes (direct tax), the program also relies on custom duties (trade taxes). The IMF is generally against trade taxes, but the shortage of revenues in this country leaves it little choice but to rely on such taxes.

Fig 6: Pakistan's Revenues (Rs bln)



As discussed in an earlier paper (*No Pain, No Gain*, 12 June 2019), the Budget for FY20 sets the right tone by focusing on measures to increase income tax and the GST base. EFF program details stress the *revenue-based* fiscal consolidation as the heart of the stabilization program. Nevertheless, compared to the Budget documents from early June, the IMF program details are surprisingly light on specific fiscal measures to achieve the Rs 5.55 trn FBR target for FY20.

Given the number of past IMF programs, Pakistan's bureaucracy has become accustomed to meeting program targets. However, there are no binding targets on revenue generation in the EFF, nor any *Structural Benchmarks* to create the platform for collecting revenues. As we will discuss in **Part 2**, we argue that the IMF program doesn't emphasize the need for fiscal reforms as it ideally should have (see **Box 1**). Whether this is part of an understanding with the Pakistani authorities that revenue generation needs a *heuristic* approach (a step-by-step, learning-by-doing approach) remains to be seen, but we are disappointed with the lack of details about how the authorities will sharply increase tax revenues in FY20.

On the other hand, high revenue projections create space for generous government expenditures during the EFF. As shown in **Figure 7**, the linear increase in expenditures is higher than in the preceding years, even if the gradient (of the increase) is lower than the increase in revenues (see **Figure 6**). The sharp increase in debt servicing (domestic and foreign) in FY20 was anticipated, on account of the increase in interest rates and the sharp depreciation of the Rupee. While the increase in defence spending was also anticipated, we are surprised that *other federal expenditures* post strong growth in later years.

As shown in **Figure 7**, the bulk of the increase in government spending is on account of development spending and provincial expenditures. Excluding these heads, there is no perceptible increase in the growth of expenditures in the coming years. In fact, IMF conditions in FY20 include two *Indicative Targets* on health/education (which is very generous) and BISP transfers (see **Table 2**). However, given our experience with revenue slippages, the authorities often compensate by cutting back on development spending and allocations for provincial governments. So one way to view the expenditure projections, is to realize there is enough space to cut back on expenditures if revenues are not forthcoming.

Figure 8 shows the size of the fiscal deficit and how it will be financed. As shown, the fiscal deficit will increase in nominal terms as well as a percentage of GDP in the first year of the EFF, (see **Figure 1**). This is driven by higher provincial spending and debt servicing. Given the orthodoxy to increase interest rates, the IMF has not placed any restriction on the size of the fiscal deficit but does have hard ceilings on the primary deficit for the four quarters of FY20 (this is discussed in **Part 2**). On the basis of **Figure 8**, one could argue that FY20 is the year to fix the external deficit, and FY21 will be the year when the fiscal side will be brought under control.

One last point: the EFF has a very strict condition that GoP cannot borrow from SBP *at any time* during the entire year. This continuous target implies that in all primary auctions in FY20, SBP will have to ensure that all maturities (on T-bills and PIBs) are totally covered by the bids made by commercial banks.[3] In view of this limit on central bank financing, the bulk of deficit financing in FY20 will come from external sources (see **Figure 8**). It is interesting to note that once the external financing dries up (after the EFF), banks step in to become the main source of government financing.

Part 2: What to expect this year

The EFF program details have a lot to say about what will happen this fiscal year. Prior actions (PAs) have already been taken, and to stay on track with the program, there are two *continuous* performance criteria that are binding through the year (zero borrowing from SBP, and zero accumulation of GoP's dollar arrears). The latter means that SBP cannot delay any dollar payment that the GoP is scheduled to make in FY20.

Fig 7: Total Expenditures (Rs bln)

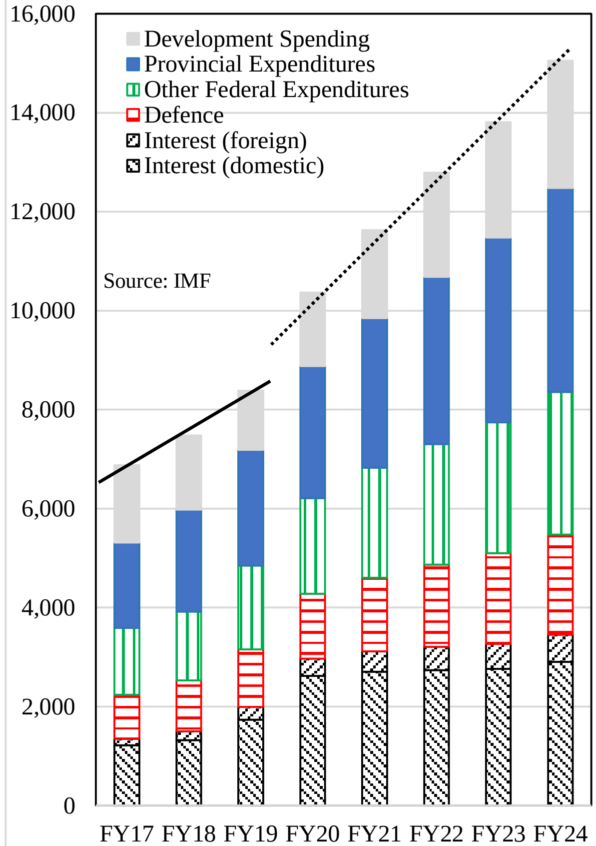
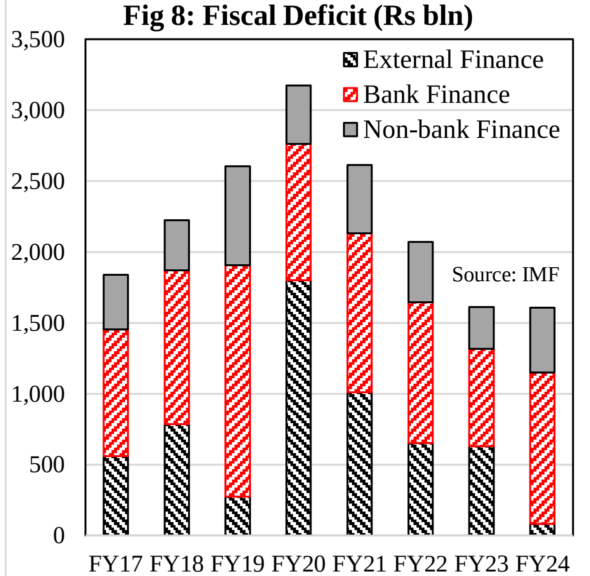


Fig 8: Fiscal Deficit (Rs bln)



[3] This could force SBP to increase cut-off rates in the primary auctions, which in turn would force it to subsequently raise its policy rate.

Quantitative Performance Criteria (QPC):

The following conditions must be met or else the program stalls:

1. A quarterly floor on SBP's unencumbered FX reserves (NIR targets);
2. A quarterly ceiling on SBP's net domestic assets (NDA), which means that in addition to zero borrowing from the central bank, SBP must carefully watch what it lends to non-government parties;
3. A quarterly ceiling on SBP's FX swaps/forwards, which basically means that SBP can no longer "borrow" FX from commercial banks to shore up its reserves;
4. A quarterly ceiling on the primary deficit, which seeks to ensure that non-debt government spending is covered by total revenues;
5. A quarterly ceiling on government borrowing from SBP. While the continuous condition will ensure that GoP cannot borrow during FY20, this condition demands that the federal government *retires* Rs 569 bln to SBP in Q4-FY20; and
6. A quarterly ceiling on GoP guarantees, which means the government cannot issue any more guarantees during the course of the year.

Indicative Targets (ITs):

The following targets should be met, but missing them will not stall the program:

1. A quarterly floor on BISP transfers, to ensure that the government disburses a minimum volume every quarter;
2. A quarterly floor on health and education spending, to ensure that the government disburses a minimum volume every quarter;
3. A quarterly floor on FBR revenues, to ensure that FBR collects a minimum amount every quarter;
4. A quarterly ceiling on FBR tax refund *arrears*, which means that FBR cannot hold back tax rebates to show higher tax collections (as it often does); and
5. A quarterly ceiling on power sector *arrears*, which means that the circular debt cannot increase beyond the agreed limits.

Structural Benchmarks (SBs):

These are non-quantifiable reforms that are "critical to achieve program goals and are intended as markers to assess program implementation during a review."[4]

1. No further tax amnesty schemes;
2. Issue licenses to monitor the movement of cigarettes in the country;
3. Take all steps necessary to exit FATF's gray list by October 2019;
4. Make all necessary amendments in the SBP Act to make the central bank autonomous;
5. Power tariffs to be determined by the regulator (not the government);
6. Implement circular debt reduction plan (immediately halt hemorrhaging);
7. NEPRA will notify tariffs quarterly (no role for the government);
8. Conduct reputable audits of PIA and PSM (by Dec 2019);
9. All SOEs are to be classified into the following categories by September 2020: (1) maintain under state control; (2) privatize; and (3) liquidate;
10. Submit to parliament a new law for SOE governance & transparency;
11. Finalize BISP banking contracts & implement financial inclusion for women;

[4] IMF Factsheet on IMF Conditionality, March 2016.

12. Narrow the education gender gap; &
13. Update BISP database for beneficiaries.

Given the details that are covered in the SBs, we are very surprised that revenue generation – clearly the most ambitious part of the IMF program – attracts very little attention (see **Box 1**).

Box 1: Why are there so few IMF conditions on fiscal revenues?

IMF's conditionalities (PAs, QPC, ITs and SBs) reveal a clear ranking: Without doing the PAs the program cannot begin, while not meeting a QPC would end the program; on the other hand, missing ITs and SBs will not stall the program but will need to be renegotiated. If one goes by this ranking and looks at the conditionalities in the EFF, one can deduce that the primary focus of the EFF is as follows:

1. The external sector;
2. The monetary sector;
3. The fiscal accounts; &
4. Rehabilitating the SOEs and protecting social spending.

The Budget for FY20 introduced new revenue measures worth Rs 516 bln, with Rs 200 bln each to be mobilized from income and sales tax. The Budget reduced the minimum threshold on income tax and introduced many more tax brackets with a clear focus on being progressive. However, the fact that the EFF only has one *Indicative Target* on FBR revenues is surprisingly lax.

In our view, given the ambitious revenue targets and the PTI's narrative to target the untaxed (using the Amnesty scheme), the IMF program should have done more to create the platform to identify and induct new tax payers into the net. We expected a slew of SBs that would create the ground work to increase documentation of all assets, identify institutions that would interface with non-filers, and dovetail the Amnesty scheme into the expanded tax base. This omission is especially disappointing since a previous IMF report stated the need to create a *fiscal cadaster* (a comprehensive digital record of all Pakistanis who own assets and have bank deposits in the country) as part of fiscal reforms. The EFF report does not even mention the fiscal cadaster.

Table 2 summarizes the specific performance targets for this fiscal year. The negative/positive signs must be clearly understood: e.g. for SBP's NIR, **Table 2** states that in Q1-FY20, SBP's NIR can *at most* fall by $ 735 mln, while for subsequent quarters, SBP's NIR must *at least* increase by $ 2.17 bln, $ 3.47 bln and $ 2.05 bln, respectively. Similarly, SBP must *at least* reduce its stock of FX swaps/forwards by $ 500 mln in Q4, while the government must *at least* reduce its stock of central bank borrowing by Rs 569 bln in Q4.

Table 2: IMF conditionalities in FY20 by quarter

Quantitative Performance Criteria (QPC):	**Q1-FY20**	**Q2-FY20**	**Q3-FY20**	**Q4-FY20**
SBP's Net International Reserves ($ mln) (+ min, - max)	-735	+2,167	+3,467	+2,054
SBP's Net Domestic Assets (Rs bln) (+max, - min)	59	-111	-355	+282
SBP's FX swaps/forwards ($ mln) (- min)	0	0	0	-500
Primary Deficit (Rs bln) (+max)	102	43	48	83
GoP borrowing from SBP (Rs bln) (- min)	0	0	0	-569
Indicative Targets (ITs):				
Transfers for BISP (Rs bln) (+ min)	45	41.4	46.8	46.8
Disbursements for health/education (Rs bln) (+ min)	349.2	349.2	522.6	523.0
FRB Revenues (Rs bln) (+ min)	1,071	1,296	1,390	1,746
FBR Tax refund arrears (Rs bln) (- min)	-15	-18	0	0
Power sector arrears (Rs bln) (+ max)	23	16	23	19

Within the QPC, the most binding will be the NIR target, which will determine the PKR/$ adjustments that are required to increase SBP's unencumbered reserves by the quantums shown in **Table 2**. As of end June 2019, SBP's NIR was *negative* $ 17,743 mln, which means if all the NIR targets are met in FY20, by the end of June 2020, SBP's NIR will still be *negative* $ 10,790 mln. This implies that SBP's FX reserves have to increase significantly before the external sector problem is resolved; it also means that SBP cannot use its *borrowed* reserves to support the currency.

The NIR targets are formulated after finalizing Pakistan's BoP, which in turn is based on committed loan disbursements (fresh), debt rollovers, bank borrowing from overseas creditors, anticipated DFI (which we assume has been committed to), net inflows from the IFIs, and any bond issuance that GoP is planning for the year. The catch is that NIR targets have "adjusters" for all these *known* inflows, which means that if these inflows are larger/smaller than expected, the NIR target would adjust accordingly. This basically compels the authorities to address the fundamental trade imbalance, and not look for extra financing from known sources.

The concern we have is that if the adjustment of the Rupee is insufficient to deter importers (or encourage exporters) during the course of the quarter, then SBP may be forced to adjust the currency more drastically just to meet the end-quarter NIR target.

Since we do not know the schedule for dollar inflows during the course of FY20, the fact that the NIR target allows for a depletion in Q1-FY20 seems to suggest that PKR management in the first quarter may be easier. What happens in Q2 and Q3 (where the NIR targets are quite steep – see **Table 2**) will depend on projected inflows and whether the trade deficit has narrowed sufficiently. Therefore, the smart thing to do would be to front-load the PKR adjustments so that trade flows have time to adjust.

Figure 9: PKR/$ projections (monthly average)

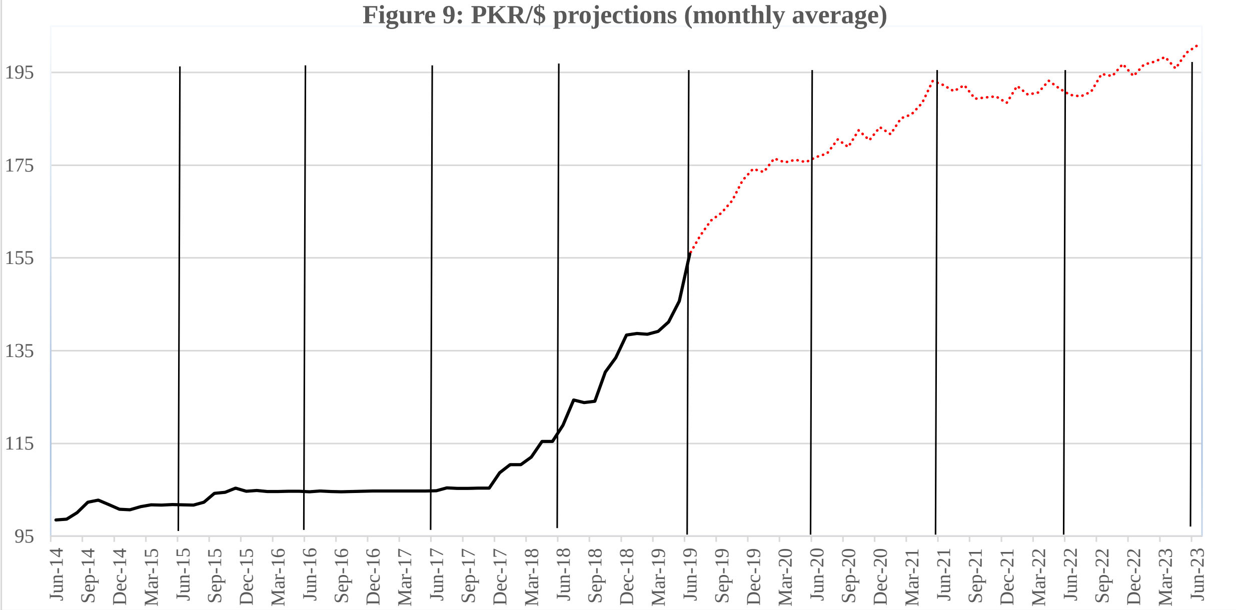


Figure 9 projects the average PKR/$ parity based on IMF data, with some creative back calculations. Against *actual* annual averages of Rs 109.84 and Rs 136.14/$ for the year FY18 & FY19, the back calculations give us Rs 110.05/$ for FY18 and Rs 135.54/$ for FY19, which are reasonably close. Computing forward gives us the following:

- FY20 = Rs 171.77/$;
- FY21 = Rs 184.27/$;
- FY22 = Rs 190.88/$; and
- FY23 = Rs 195.93/$.

These averages have been used to project the Rupee, with the currency moving in both directions. **Figure 9** shows that perhaps the worst of the currency adjustment is over.

Looking at the FBR revenue targets in **Table 2**, the program gives some leeway to start slow, but expects a strong ramp-up in the last quarter. While these floors on FBR's quarterly revenues are indicative, we assume that slippages would raise alarm bells in DC. If the IMF thinks revenue collection is not a policy priority, it could renegotiate the annual target but insist that FBR revenues become a quantitative performance criteria. Only then would revenue targets become make-or-break to stay in the program.

Summary of the paper

While many people have been disappointed that the IMF program did not shore up the stock market, this hope was misplaced. What the EFF shows is a clear focus on stabilization, and forcing SBP to stop managing the Rupee. While we agree that the currency market had to be shaken-up to wean the economy off imported goods, we still think imports have not been sufficiently deterred. While import compression does take time, we feel the magnitude of compression (with the PKR adjustments) has not been enough.

If imports don't fall enough because importers feel that higher Rupee prices will not reduce demand, we fear this could force SBP into much larger currency adjustments, which could unhinge the macro-economy. As discussed in past papers, the huge income disparity in the country, the pervasive use of cash, and the elite's preference for imports, could undermine the EFF. This is especially worrisome as the authorities have committed not to impose *any* regulations to restrict imports, or to delay any legitimate dollar outflows (for services, profit repatriations, royalty payments, etc.). Binding NIR targets and limited avenues to deter imports (except to make them more expensive) is a risky strategy.

In terms of the 3-year outlook, we think the IMF program is credible in the first year (FY20), but less so afterwards. As we have been saying in past papers (*The vicious twin deficits Part 1*, 26 April 2018 and *The vicious twin deficits Part 2*, 30 May 2019), orthodox stabilization will not work because of the debt trap that Pakistan is already in. We had expected a more balanced (customized) strategy, but the EFF shows that this is not the case. The orthodoxy to increase interest rates (to support the Rupee, although SBP will not admit this) will not control inflation nor will it narrow the trade deficit, but it will worsen Pakistan's debt dynamics.

The IMF doesn't admit this (as it cannot), but the sudden shift in external financing to non-debt inflows (from private sources), and the growing dependency on these inflows to finance the external deficit and build FX reserves, are not credible solutions. As we have argued in this paper, it would have been wiser to target a near-zero external deficit earlier in the program (with selective import restrictions) not just to fix the BoP problem, but also to start chipping away at the debt overhang.

Before presenting our concluding thoughts, we would like to revisit the issue of whether the IMF was necessary, or could Pakistan have found an alternative solution. While the latter is a possibility, what the IMF program provides is a credible outlook for investors (and everyone else) to form their expectations about the future. In our view, Pakistan's Planning Commission or even MoF/SBP lack the credibility to issue an economic outlook that the market will accept. While we have some reservations about the IMF's outlook, these projections are internally consistent, capture the key sectors of the economy, and do not reflect a political agenda.

So what does the EFF have to say about the six questions we posed in paragraph three (page 1):

1. The PKR/$ parity will weaken further, but the bulk of this adjustment will be done in FY20. By *June 2023*, the Rupee will touch 200/$ for the first time;

2. Since the EFF wants Pakistan to maintain a *real* policy rate, SBP's discount rate could increase by a further 175 bps if the authorities target to maintain real rates at 200 bps;
3. The EFF claims the IMF program will open up sources of financing worth $ 38 bln for the next three years;
4. SBP has agreed that it will not restrict any dollar outflows that are permissible by its FE rules;
5. The EFF will focus on the external deficit in FY20, and start chipping away at the fiscal deficit from FY21. From a twin deficit of 11.5% of GDP in FY19, the program projects a twin deficit of 4.3% in FY23; and
6. If external financing sources materialize as anticipated, Pakistan should be able to enter a growth phase by mid-FY21.

Some of these answers may be disappointing, but in our view, this is better than having no answers – or having no *credible* answers. Until Pakistan's economic institutions regain the credibility they once had, the country will remain dependent on the IMF.

Conclusion

In an earlier paper (*The Last IMF Program?* 18 October 2018), we asked a simple question: given Pakistan's checkered history with the IMF and changing geopolitical dynamics, could the next IMF program be the country's last. This paper argues that the EFF is a pretty standard IMF program, and people could rightly ask whether anything is different this time around. We think there are some fundamental differences that could, indeed, imply that this may be the last program.

First, this IMF program is initially contingent on bilateral funding and then shifts the external financing need to private sources (DFI and portfolio inflows). This means that Pakistan is being told that if it intends to run an external deficit, then it needs to source out market – preferably non-debt – funding. This would expose the country to critical investor oversight, which would force our authorities to be more disciplined in their policymaking. In our view, this is a step in the right direction, but requires a degree of wisdom to ensure that the initial $ inflows are not squandered, and that Pakistan does not become dependent on hot money.

Second, the lack of concrete steps to increase tax revenues, implies that the IMF is leaving this responsibility to the authorities themselves. Instead of playing a tit-for-tat game (where the IMF sets interim targets to increase revenues, and the authorities find innovative reasons to explain why they couldn't deliver), it appears that the IMF is leaving it up to the tax authorities to figure out how this should be done. If the tax authorities cannot deliver, the program is off.

Some may argue that this is tantamount to giving the country a long enough rope to hang itself. This could be true, but it could also compel the authorities to use this slack to lasso a wild horse (this depends on the reader's disposition). So how long does Pakistan have to sort itself out? In our view, Pakistan has a one-year window during which the IMF would be a willing partner to ensure that we succeed. President Trump wants to end the longest war in US history (Afghanistan), and needs Pakistan's help to disengage American forces from the country – Trump needs this to happen before the 2020 elections to enhance his re-election chances. Hence, the easy-going body language between Donald Trump and Imran Khan, is politics in its purest essence – both the US and Pakistan need something from the other, and after the window closes, the mutual suspicions will surface again. So it boils down to whether Pakistan's policymakers can fix its economic dysfunction in the one year window of opportunity.

The immediate issue is whether the external sector can be managed using a flexible Rupee alone. Anecdotal evidence suggests that imports of luxury items and consumer durables have fallen in recent months, but the issue remains whether this adjustment is sufficient. If it is not, and the Rupee is adjusted more aggressively than shown in **Figure 9**, this could undermine the IMF program and unhinge the country's macro stability.