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THE IMF AND PAKISTAN
(A Road to Nowhere)

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PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS
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The IMF and Pakistan
(A Road to Nowhere)

MEEKAL AZIZ AHMED

A great deal is written and said about the IMF's interaction with Pakistan, none of it good, most of it couched in sweeping negative terms and some of it quite hostile. As a somewhat secretive and faceless institution with its own jargon (often referred to as "Fund-speak"), mystifying lending facilities and complex "access" mechanisms, our disquiet is understandable. While much has changed in recent years with the Fund becoming more transparent and open—thanks especially to its new, hard-hitting Independent Evaluation Office (IEO)—misgivings and suspicions still run deep.

No country turns to the Fund when the sun is shining. When the economy is performing well, the Fund only conducts "surveillance" over member-country policies in the context of an annual consultation under Article IV of the Articles of Agreement. An IMF staff mission visits a member country, discusses the evolving economic and financial situation and makes policy recommendations. However,

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these recommendations are not binding on the authorities and nor are the views of Executive Directors in the IMF who discuss the staff's report in a Board meeting and present their point of view. This is because the Fund has no "leverage" over the country's economic and financial policies unless it has a financial arrangement with it. In a non-programme context, the Fund can only give advice and use moral suasion.

The 2008 Crisis and the "IMF Programme"

Countries only turn to the IMF in times of grave crisis; thus the starting point is invariably one of extreme volatility and disequilibrium. The decision of the present government to ask for IMF help in 2008 is a case in point. The economy was in dire straits, rushing headlong towards bankruptcy and debt-default. Economic growth had slowed, inflation had reached levels unheard of in Pakistan, the domestic and external deficits had widened appreciably. Millions of households which the previous government claimed had been lifted out of poverty fell back. As confidence waned, there was massive capital flight. The rupee was in virtual free-fall, asset price bubbles in the stock market and the real estate sector, fostered by ample liquidity and speculative risk-taking, popped. Most ominously, gross foreign exchange reserves were being depleted at an alarming rate, at one time dropping by almost a billion dollars in a week. This was the most compelling evidence of an economy in great distress.

A confluence of domestic and external factors served to push the country into crisis in 2008. Domestically, the overly expansionary policies of the previous government were being reflected in sharply rising internal and external imbalances and accelerating inflation. Externally, a global commodity price surge (especially for food and oil) placed immense strain on Pakistan's balance of payments position. There followed the global financial crisis of 2008-09, dubbed "The Great Recession in the US", whose knock-on adverse effects on trade and financial flows were felt through contagion by all countries. But

these adverse external shocks accentuated, but did not cause, Pakistan's 2008 economic crisis. The Pakistan economy was already in serious trouble [Cheema (2004)]. The fiscal stance had become dangerously pro-cyclical during a period of strong growth, when it should have been playing an anti-cyclical role and dampening demand pressures, and monetary policy remained far too loose and accommodative. Overheating pressures and the risk of accelerating inflation had been talked about as far back as 2005 [SPDC (2005)]. Those warnings were ignored as well as further warnings calling into question the sustainability of Pakistan's much-heralded economic boom [Iqbal (2007)].

Rather than take prompt corrective measures to stem the alarming slide of the economy, the new government pinned its hope on securing external resources from bilateral donors and friendly countries (Saudi Arabia, China) including commitments from a new concoction called "Friends of Democratic Pakistan (FODP). In other words, the authorities were looking around for a "free lunch"—but there was none forthcoming. The government said they had a "Plan A", a "Plan B" and a "Plan C" when it should have been self-evident that the only plan that would work was "Plan F", the IMF because no one else would give us any money. Indeed, all of Pakistan's bilateral donors (as well as the World Bank and Asian Development Bank) urged the government to enter into a Fund arrangement as a precondition of financial support. Even our "friends" balked.

To be fair, such prevarication and clutching at straws in the wind is not unique to Pakistan. Countries will typically wait in the hope that the economic situation will somehow turn around and some may even take corrective measures. No country wants to end up at the IMF doorstep in Washington DC and ask to be bailed out because it means they have accepted failure and have lost control over the economy. But in waiting so long, the task of halting the downward spiral and the return to a semblance of macroeconomic stability becomes all the

more onerous and difficult with the pain of adjustment falling disproportionately on the poor and vulnerable who have little or no social protection.

The Pakistani media always makes reference to the “IMF programme”. It is not an IMF programme. It is Pakistan’s programme and one that we are, or should be, fully committed to. “Programme ownership” is a critical ingredient in successful programme implementation. Without “owning” the programme, it will fail. Pakistan has typically lacked ownership, especially at the political level. This then translates into faltering implementation, a sleigh of hand to meet targets, and more grievously a roll-back of reforms once the programme has either come to an end or, more typically, has been terminated by the authorities themselves. An example of a roll-back is the removal of exemptions and concessions as part of programme conditionality. However, once the programme has been abandoned, these concessions and exemptions are quietly restored and, no doubt, new ones added, fragmenting the tax base again and leading to a loss of revenue.

Rigid, Unbending and Inflexible

The Fund’s image as a cold, unbending negotiator with pre-conceived ideas and fixed views is a myth. To begin with, Pakistan has had many gifted and talented negotiators in the Ministry of Finance and the central bank. Their grasp of technical matters is widely acknowledged and they negotiate hard and well. To suggest that the Fund “dictates” to the authorities who just sit there awe-struck and dumb-founded has no basis in fact. The reality is that, contrary to popular perception, what emerges as a programme is not what the Fund wants but what the member-country thinks is doable and politically and socially acceptable.

The starting point of negotiations typically finds the two sides far apart. But after several iterations, views converge with both sides

giving ground. On balance, the Fund will generally defer to the authorities' views if they are convincing and well-argued because of the presumption that the authorities know the "ground realities" and political constraints better.

But the IMF's magnanimity has not always worked to our advantage. In one striking case, the Fund's acquiescence to the authorities' "reforms" came back to haunt them. This was in the case of the highly controversial and infamous, "no-questions-asked and no-tax" foreign currency accounts, 64 percent of which belonged to residents (the balance to non-residents and institutional investors). The Fund knew that this was, in essence, a brazen money-laundering scheme that was being presented as a bold act of "far-reaching" external sector capital account liberalisation (even if the authorities got it backwards because they continued to retain restrictions on the current account). The Fund also knew fully well (even if we did not) that the scheme was a ticking time-bomb. As the size of these foreign currency deposits swelled, they knew that it would make the economy increasingly vulnerable with potentially catastrophic consequences in the event of a shock since there was virtually no reserve cover. By relenting and allowing the scheme to become an easy, if increasingly costly, source of financing growing external deficits instead of focusing on achieving durable external adjustment through boosting net exports, the Fund left itself open to charges of naivety, incompetence and complicity.

As another—more recent—example of the Fund's munificence, during the Musharaff regime and after Pakistan had successfully completed the first multi-year programme in history [or so it was alleged by the authorities but see Sherani (2011)], the Fund produced annual Article IV reports which were unusually effusive (by Fund standards) in respect of the authorities' handling of the economy. Either IMF staff was unaware, or insufficiently cognizant, of the risks and vulnerabilities that were building up; or they succumbed to a bit of

friendly arm-twisting by the authorities who did not want the Fund to take away the punch bowl and spoil the party by raising concerns. In retrospect, after the 2008 crisis hit Pakistan, the Fund must have wished their consultation reports had been sharper, more objective and better balanced because they had failed in their primary task: to alert the country authorities to the stresses emerging in the economy and which foreshadowed grave trouble ahead.

The Fund's Imprint, Resilience and Reforms

There are many in Pakistan who think that the Fund has had a "key influence" [Naqvi (2012)], on the conduct of our macroeconomic and structural policies. Since Pakistan has a long history of non-implementation and eventual abandonment of Fund-financed programmes (save the one noted above), this cannot be true. At best, given Pakistan's distressingly sub-par implementation record, one can only surmise that the Fund's influence on policy-making in Pakistan has been ephemeral and/or fleeting at best. Those in Pakistan who have a deep and abiding commitment to economic reform feel frustrated that so little reform has been undertaken and deplore the fact that the Fund has been insufficiently tough on Pakistan—letting us off the hook time and again rather than taking the opportunity of a crisis situation to push through much-needed reforms. To some this suggests that the IMF is in cahoots with Pakistan's elite and is not willing to stare down powerful vested interests in agriculture, the stock market, the real estate sector and services, which remain either untaxed or under-taxed.

Fiscal affairs are a strong point of the Fund. Yet, despite all the programmes we have had with the IMF and the legions of technical assistance missions and fiscal experts, the tax system remains dysfunctional, discriminatory, regressive, inflationary, and highly corrupt with too many exemptions, concessions, tax arrears, non-filers and under-filers, not to mention the death-knell of any fair system of tax administration, too many amnesty schemes, all of which have

failed to broaden the tax base. Pakistan's tax to GDP ratio after 64 years at below 10 percent of GDP is still amongst the lowest in the world and risks falling further.

Having said that, it would be unfair to say that no reforms have been undertaken in Pakistan even if they have been implemented only as a prelude to, or under the shadow of, an IMF-financed arrangement. While reforms on the fiscal front remain conspicuous by their non-implementation, progress has been made with reforms in the banking sector, including the bold de-nationalisation of banks, stronger prudential regulations and supervision over the financial sector, central bank autonomy, external tariff simplification and liberalisation, greater interest rate and exchange rate flexibility, and institutional capacity-building.

As a consequence, the Pakistan economy today is more open and flexible than it was 30 years ago. It is, however, by the same token, also more vulnerable to domestic and external shocks which underscores the need for sound macro-policy management. The economy has also demonstrated, time and again, that it does respond to forceful and well-calibrated adjustment measures and bounces back fairly quickly; this suggests that the economy is also very resilient. Thus, there is no doubt that adjustment worked—as happened in 2008 but also in the case of all prior crisis episodes and there was never a risk of a relapse.

But alas, it is to Pakistan's everlasting misfortune, that adjustment has never been sustained to the point where the economy has been put firmly back on a self-sustaining growth path. Adjustment fatigue and complacency soon sets in and macroeconomic populism takes over, especially once foreign exchange reserves have been built back to more comfortable levels and the specter of an ignominious external debt-default has receded. The willingness to stay the course and press on with adjustment and reforms wanes and there is much

brash talk about the need to regain our "economic sovereignty" and getting rid of the "begging bowl"—until, of course, the next crisis. Given this recurrent tendency to relax the policy stance prematurely, take risks, lose focus and allow the programme to drift off-track, Pakistan has earned the unflattering sobriquet in the IMF of a country characterised by "start-stop adjustment".

Conditionality Much Berated

Conditionality in IMF programmes arouses great passion and angst, is much-talked-about and much berated. It is true that in the past conditionality has tended to be overbearing and complex and there has often been cross-conditionality between the IMF and the World Bank. However, in recent years conditionality has been considerably streamlined. Programme reports to the Executive Board must highlight and justify why conditionality is being imposed in regards to a specific measure or policy action. This is an area where extensive work has been done by the IMF's IEO which critically looks back at IMF programmes and makes recommendations on how they could have worked better, including by streamlining conditionality.

Whatever the level and depth of conditionality, and contrary to popular perception, in reality programmes tend to be quite flexible. At quarterly reviews of the programme, if targets are missed, they are simply re-set, pushing the envelope of adjustment out into the future and essentially making the programme easier to implement. If there is a "design flaw" in the programme as is often claimed, it can be modified and/or changed, or the time-frame for implementation of a specific measure "back-loaded". There is nothing in the strictures of a programme to preclude such a modification. If there is a "performance criterion" that has been breached, Pakistan will ask for and the IMF staff will support a recommendation to the IMF Executive Board for a "waiver" of the non-observance of that target/policy measure. While the ability to waive non-observance of a target is good in principle since targets can be missed for "genuine" reasons which are beyond

the control of the authorities (such as an unanticipated exogenous domestic or external shock), waivers are also prone to abuse and can set up perverse incentives to implement policies in a timely manner. Pakistan has the dubious distinction in the IMF of being a programme country that has made frequent and excessive use of requests for waivers for non-compliance of programme targets. While there was no case where a request for a waiver was rejected by the IMF's Executive Board (that would have drastic implications since it would have meant the programme would end and no further drawing of IMF resources would be allowed), the displeasure and grudging acquiescence of members of the Executive Board to granting repeated waivers in the case of Pakistan has been palpable.

Anti-Growth and Anti-Poor

The Fund is accused of being anti-growth and anti-poor. Its anti-growth reputation stems from its perceived obsession with fiscal austerity. This approach, it is alleged, is recommended always and everywhere, irrespective of specific country circumstances—the familiar "cookie-cutter" criticism of the Fund's approach to adjustment. However, a crisis situation in any country has several common characteristics: excessive internal and external deficits, slowing growth, accelerating inflation and rapidly diminishing foreign exchange reserves. In such a situation of extreme disequilibrium, the country has no choice but to stabilise the economy first via measures to reduce aggregate demand and bring it into better alignment with the economy's aggregate supply potential, even at the cost of some short-term sacrifice to growth.

During the 2008-09 global financial crisis, many countries (including India, China, and for the first time Low-Income Countries under IMF-financed arrangements [IMF Survey (2012)], had built up "fiscal buffers", and its counterpart, a cushion of foreign exchange reserves. This allowed them the room to manoeuvre and implement a counter-cyclical fiscal policy stance so as to mitigate the effects of the

down-burst of recessionary forces emanating from a global economy in turmoil and protect their domestic growth objectives. Pakistan was not as fortunate or similarly well-placed and had virtually no room for manoeuvre. It's "twin-deficits" had reached record levels (both in excess of 8 percent of GDP) and had to be reduced. It would be disingenuous to suggest that Pakistan should have adopted the same expansionary fiscal policy stance.

Again, the adjustment in 2008 under the Fund-financed programme worked well. The economy stabilised quickly, inflation came down, there was evidence of return capital flight, the exchange rate stabilised and reserves were built up. Most importantly, the economy was poised to grow. Unfortunately there followed the Mother of all Floods which left a wide swath of human and physical destruction in its wake. The Fund not only "accommodated" the higher spending that was needed to re-build the capital stock that had been destroyed by easing the permissible level of the fiscal deficit, it also granted Pakistan about $500 million under its facility of natural disasters. But the floods proved to be the first of a series of fatal distractions and policy missteps, including frequent changes in top positions in finance and the central bank, which meant a loss of policy continuity. But what doomed the arrangement was the failure to implement the VAT/RGST (the lynchpin of the arrangement), despite augmentation of access and an extension of the programme.

More generally, to the extent that a "tight" fiscal policy stance reduces government (or more broadly public-sector) borrowing and debt, and eases inflationary pressures, it provides room for the central bank to cut its policy interest rate. Money and credit policies can focus on expanding lending to the private sector, the main engine of growth in the economy, while remaining within the "safe limits" of monetary expansion consistent with low inflation and balance of payments viability. Tight fiscal policies, combined with efficiency-enhancing

structural reforms that are well-sequenced can be, and often are, growth-augmenting.

Contrarily, there is no example of any economy that has achieved sustained high growth rates with “loose” policies. To be sure, loosening the policy stance will produce some growth especially where there is slack in the economy and a negative output-gap as reflected in unused resources of labour and capital; but it will be short-lived with the price-output split of nominal growth tilting towards faster inflation and slower real growth as economic slack is taken up and the output-gap closes. If the output-gap turns positive so that the economy is operating above “trend potential”, the excess demand (relative to supply potential) will spill over into the external side and lead to a faster rise in imports relative to exports and, unless fully financed by public and private capital inflows, will create balance of payments difficulties.

The Fund is also accused of being anti-poor by allegedly imposing draconian cuts in development spending but more specifically on the “soft” social sectors, or so-called “pro-poor expenditures”, because the quality of fiscal adjustment to them is less important than the cold calculus of its magnitude. This is untrue. The prerogative of where to cut spending, generally considered a better and longer lasting route to fiscal adjustment than raising taxes, belongs to the country authorities, not the Fund. The Fund will certainly give advice and they will typically focus on non-interest current spending which they may see as being wasteful and/or excessive (such as 80-member cabinets of Ministers and Advisors, and their perks). In Pakistan’s present security environment, the Fund has probably refrained from suggesting cuts in defense spending or has accommodated the authorities’ proposals. In the past, Fund programmes would typically insist on a ratio of defense spending to GDP that falls over time while striving to ensure that development spending exceeds defense spending—which was not always or often

the case and which would attract critical comment from several Executive Directors who would wonder what kind of programme, with such skewed priorities, they were being asked to approve.

The Fund is not averse to subsides as is often thought provided they are well-targeted and can be financed within a reasonably robust fiscal framework. They do feel uneasy, as any good fiscal economist would, with non-targeted subsidies that weight on the budget (most notably for oil) and whose benefits accrue mainly to the rich. This may still be acceptable provided there are offsetting and credible spending cuts elsewhere. Unfortunately, these conditions and qualifications are seldom fulfilled so that the subsidies become open-ended, burdensome and wasteful.

On the development spending side, the Fund will generally defer to the views of the World Bank (and Asian Development Bank, both of whom participate in programme negotiations) on the size and sectoral priorities embedded in the Annual Development Programmes. The highly disruptive and all-too-common practice of indiscriminate across-the-board cuts in development spending or slowing down releases of funds to projects to meet fiscal targets which seems to have become the norm in Pakistan is very much an indigenous innovation. If development spending has to be trimmed because of emerging "resource constraints", it should be done carefully and selectively, while fully protecting projects and programmes that are crucial to augmenting the public capital stock, raise the productive potential of the economy, and crowd-in investment by the private sector.

Rushing Headlong Towards another Cliff

The Fund is neither clairvoyant nor omnipotent and has made mistakes, most spectacularly in Asia [but see the spirited defense by Rogoff (2003)]. For our part, we need to reflect on why we are a "Prolonged User" of Fund resources (as Pakistan is categorised in the

IMF) and why we have been unable to get out of their clutches and stay out like other successful developing countries have done whether in Latin America, the Middle East, Asia and even Sub-Sahara Africa, once considered an economic backwater.

As of this writing (late 2012), the Pakistan economy is again under stress and headed for another balance of payments crisis. All the unmistakable signs are there: stagflation, rising macroeconomic imbalances that are being financed by unprecedented levels of domestic borrowing from the commercial banks and the central bank and, on the external side, given external financing shortfalls, by a reserve drawdown; rising debt levels, a collapse in domestic private investment which has touched a 50-year low combined with falling private foreign portfolio and direct investment inflows, a never-ending energy crisis that has crippled growth and employment prospects, especially in the SME sector which is the main-stay of the economy in terms of value-addition, employment, living standards and exports. If it had not been for the one silver lining in this darkening macroeconomic picture, namely, the unabated, if not-fully-understood surge in workers' remittances, the Pakistan economy would have already imploded.

However, the resumption of CSF reimbursements, prospects of the launch of the 3-G auction and the hope that we will eventually receive the balance due in regards to PTCL privation, offer some respite. But a strategy of "Begging and borrowing" [Yaqub (2012)], and what seems to be a strategy of "financing without adjustment" can only postpone the inevitable. Or as someone put it colourfully, it would only "prolong the agony of the death of the economy". The key issue therefore is not whether, but when the economy will face a full-blown crisis since, absent corrective measures, the financing for the growing imbalances, especially on the external side, will simply not be there and closing the financing gap (which includes the added burden of sharply rising debt-repayments to the Fund) will only lead to a

faster drawdown of our foreign exchange reserves. These worrying developments are already in evidence.

Quite clearly there are limits to which such a “strategy” can be considered to be a viable way to “adjust” to excess demand pressures. At some point, which is impossible to determine a priori even under various carefully-calibrated scenarios and assumptions, markets will take fright and panic will set in. As our many prior brushes with economic death attest, the economy can unravel with astonishing speed.

The IMF, as per its mandate, stands ready to assist Pakistan, a member-country in “good standing”, and with its resources help forestall another chaotic economic meltdown. But it has thus far refused to provide the government with a “Letter of Comfort” which is urgently needed to unlock quick-disbursing resources to support the budget and balance of payments. Many observers think that this hardening of the Fund’s attitude towards Pakistan reflects the deterioration of Pakistan’s relations with the United States and all that is needed is a US nod-and-a-wink and lobbying of other G-7 Executive Directors and the Letter of Comfort will be forthcoming. But, realistically speaking, any Pakistani economist of worth, or the Fund, would be hard pressed to declare that Pakistan’s macroeconomic situation is anywhere near “satisfactory and sustainable”. Such a declaration under the present highly-fraught economic circumstances would not only require a willing suspension of disbelief but would carry no credibility at all. And the Fund knows it.

Another Arrangement?

There is much speculation whether the IMF will engage Pakistan in a new programme but more specifically, given the election time-table, with an interim government. If there is an urgent balance of payments need and Pakistan has to move quickly, the point is moot even if the timing may be awkward. However, in this connection, it is

well to recall that there have been precedents (as in Bhutto's first government) provided certain conditions are met. It would require, at a minimum, for the major political parties to publicly endorse an IMF-financed arrangement. For its part, Pakistan needs to come up with a credible and well-articulated programme of adjustment and reform that is "home-grown" and commands broad "ownership".

What will the Fund "dictate" to Pakistan the next time around? Or should the question be what will Pakistan offer the Fund in terms of key policy reforms that would be worthy of an arrangement? At the minimum, any programme would have to offer the implementation up-front and as a "Prior Action" the RGST/VAT since that remains a promise betrayed despite drawing $7 billion of IMF monies in the last abandoned arrangement. IMF Management and Executive Directors have long memories and it is inconceivable that they would contemplate a new arrangement without this up-front measure no matter how much pressure the US can bring to bear on the IMF.

Despite the contrived and well-orchestrated opposition to the RGST/VAT, it is arguably a far better regime than the present chaotic, perennially under-performing GST with its multiple rates, "fake-and-flying-invoices" and overabundance of exemptions and concessions. By its own admission, the FBR calculates that the "tax-gap" under the present regime (the difference between what can be collected from the existing tax system as revenue versus what is actually collected), is a staggering 70 percent, compared to 50 percent only a few years ago. That was a damning indictment of how corrupt, ineffective and dysfunctional the tax regime has become.

But Pakistan could go further. To impart greater progressivity to the overall tax regime, Pakistan should also offer (and/or the IMF should insist) that all progressive taxes that were removed by previous governments (on wealth, capital gains, estates and inheritance) be reinstated.

Apart from the fiscal side, Pakistan's unfinished reform agenda remains large and many have written eloquently about it [Hasan (2011)]. However, by now, and given our economic history with IMF-financed arrangements, one point should be clear: a start-stop, one-tranche, multiple waivers, target re-set, abandon, rollback, cook-the-books approach to adjustment will not work. No economy can grow steadily under these unsettling and chaotic circumstances, provide jobs for its labour force, reduce poverty and bring some respite to its hard-pressed poor and vulnerable citizens. If this paradigm does not change, Pakistan will lurch from one crisis to the next as it has done for more than six decades and fall further behind its neighbours and other developing countries many of whom faced similar, if not more severe, balance of payments difficulties. They accessed IMF resources, took bold and sweeping measures to reform and restructure their economies, paid-off their IMF debt-obligations and have never looked back.

In conclusion, Pakistan's political leadership and policy-makers need to wake up. If the latter cannot convince the former about the looming risks ahead which will end in another wrenching crisis and what needs to be done to forestall it, they should admit they have failed in their duties as policy-makers and technocrats.

In any event, nothing is to be gained by placing all our economic ills at the IMF's doorstep, although countries are inclined to use the IMF as a political flack-jacket to deflect criticism and Pakistan is no exception. The IMF has not played a role in, nor contributed to, the many egregious examples of our incompetence, mismanagement, non-implementation, programme interruptions and programme failures. Nor is it responsible for the policy deviations, blunders and resort to fraudulent data to show compliance. The plight we find ourselves in today is part of a familiar repetitive cycle of perfidy by successive governments who have betrayed the people they purport to serve, and not because of IMF-recommended policies that, with the few exceptions noted above, we failed to implement.

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