

PAKISTAN'S EXPERIENCE WITH THE IMF 2000 – 2004

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Pakistan's relationship with the IMF during the 2000 – 2004 period was quite unique and distinctive. Unlike the earlier eight agreements that were concluded with the IMF during 1988-99 and were never implemented beyond the first tranche release it was only in this period that two successive agreements – a nine month Stand-by Arrangement (SBA) in the year 2000 followed by a three year Poverty Reduction and Growth Facility (PRGF) were successfully completed. All the sixteen reviews by IMF staff were completed and eleven successive tranches were drawn on time without any extension or interruption. The last two tranches were not drawn down although the conditionalities were met because the country had acquired financial strength and did not require the IMF money.

The IMF in its own report 'Pakistan – Ex Post assessment of Longer-Term Program Engagement' pointed out that "conditionality in Pakistan's Fund-supported programs become increasingly extensive after 1999. Structural conditionality peaked in the 2000 SBA. To overcome shortcomings in performance in the previous incomplete programs quantitative conditionality was augmented in the 2000 SBA and 2001 PRGF. Despite such tough conditionalities Pakistan delivered on its commitment and established a track record of performance. The total of 56 Performance Criteria, benchmarks and prior actions in this arrangement was nearly three times the Fund-wide arrangement of 19 conditions."

The other distinctive feature was that Pakistan was one of the few countries which graduated from an IMF program country directly to international financial markets in 2004. All the sovereign bonds issued during 2004 to 2007 were oversubscribed and the pricing was tight.

In order to understand as to why the experience in this period was different from the past episodes of relationship with the IMF it would help if the following questions are addressed :

- a) When does a country approach the IMF?
- b) Why did Pakistan approach IMF?
- c) What did Pakistan get out of the two agreements with the Fund?
- d) What were the factors that led to an early exit?
- e) Why did Pakistan have to go back to the IMF in 2008?

The agenda of second generation reforms that can put back the economy on a sustained path after the completion of IMF agreements was initiated but not followed through and got interrupted due to political considerations and the regime change. These reforms are necessary to build upon the stabilization phase and are therefore recapitulated in this paper for the consideration of the policy makers.

The IMF is a cooperative institution of developing and developed countries which was established at Bretton-Woods in 1945 to provide stability to international financial system. Unlike its twin, the World Bank, which is a long term development partner of developing countries, the IMF comes into action only when a country faces dire financial difficulties. Thus, its assistance is for temporary and limited duration and not for longer term. A prolonged association with the IMF shows that the economy is suffering from chronic ailment and has not been able to come out of the woods. This carries a stigma in the international financial markets which become reluctant to provide financing to such IMF dependent economies. The sooner a country is able to sever its financial programs with the IMF, the better off it is in signaling that the economy has become normal and healthy.

(a) When does a country approach the IMF?

A normal healthy and well functioning economy does not approach the IMF for financial assistance. It is only when an economy is in a crisis situation or likely to hit a crisis in near term, the authorities invite the IMF to engage in negotiations for a possible financial package that can be quickly disbursed over a given period of time to overcome or avert the crisis. The occasions for such a recourse arise (a) when the country is having serious current account imbalances and is unable to meet its external payment obligations out of its own generated resources including the normal flows from external sources such as Foreign Direct Investment (FDI), disbursements of loans, etc. or (b) when the external debt obligations falling due immediately are in excess of the country's capacity to pay. This occurs mainly when commercial creditors refuse to roll over maturing debt or demand high roll-over premiums, or (c) when a country has been hit by speculative attack on its currency (particularly under a fixed exchange rate) and is depleting its foreign exchange reserves rapidly to avert that attack or (d) when the banking sector or financial sector suffers from a systemic failure and the depositors' money is at risk or a combination of these and other factors.

The examples of Mexico, Russia, East Asian countries, Turkey and Argentina in the late 1990s can be used to illustrate one or the other of the above described motivating factors for their approaching the IMF.

Most of African countries have been prolonged users of IMF resources – reflecting the unhealthy state of their economies. In Asia, Pakistan, Philippines and Indonesia have been resorting to the Fund for assistance more frequently and for longer periods than other countries. India entered into an agreement in 1991 but exited the program a few years later as it recovered from the crisis situation. China hasn't approached the IMF as it has a strong and healthy economy.

(b) Why did Pakistan approach the IMF?

There were three main motivations behind Pakistan's decision to approach the IMF in 2000 (i) as the country was almost on the brink of a default on external payments, quick infusion of funds was needed to sustain and support the balance of payments situation, (ii) to find a permanent and durable solution to the external debt problem. Instead of approaching the IMF every three years or so and obtain a rescheduling of the flows, it was determined that a stock re-profiling should instead be sought that will align the debt payment capacity with the new profile of payments, and (iii) to restore the lost credibility of Pakistan in the international financial community as Pakistan was called a one-tranche country. Pakistan used to enter into agreements and draw down the first tranche but seldom fulfilled all the obligations and conditionalities contained in the agreements.

It was quite clear from the beginning that this will not be an easy ride and the people of Pakistan will have to suffer pain in the short term. But the idea was that after going through this tough period of tribulations and avoiding the crisis situation, the country will be able to stand on its own two feet and regain its national sovereignty in economic decision making. The authorities won't have to run to the IMF or the US Government every now and then with a begging bowl to bail us out of one crisis or the other. This was the objective with which the stand-by agreement of 2000 and the Poverty Reduction and Growth Facility (PRGF) agreement of 2001 were negotiated with the IMF. The objective was achieved upto October 2007 but then the neglect in making necessary economic adjustments and steering the course of the economy firmly led to a reversal.

(c) What did Pakistan get out of the two agreements with IMF?

Pakistan was able to establish its credibility as a serious player in the international financial community by drawing down eleven successive tranches from the IMF without any delay or extension or interruption over a period of three years. This was an unprecedented record in the history of economic

management of Pakistan and led to the up-gradation of Pakistan's credit rating from selective default in 1999 to B2 in 2003, almost a universal appreciation of our track record by bilateral and multilateral creditors and opened the way to accessing credit from the international markets at affordable price.

As the agreements with the IMF remained on track and the performance was impressive, the Paris Club – a group of officials of bilateral creditors – agreed to re-profile the entire stock of external bilateral debt of \$12 billion on a long-term basis. The grace period for the re-profiled debt was fixed at 15 years and the repayment period was extended to 38 years. Thus, in net present value terms, the stock of the debt was reduced by one-third. This treatment was exceptional and only four other countries had received such a generous package. Pakistan was no longer obligated to have further agreements with the IMF to seek debt rescheduling. In one go the country was able to find a permanent and durable resolution of the bilateral external debt by cutting back of bilateral debt. Those who argue that debt reprofiling has simply postponed the D-day were sadly mistaken. The payments due after next 15 years will be miniscule in relation to the country's expanded earning capacity.

The IMF's financial assistance combined with that from the World Bank and Asian Development Bank in form of quick disbursing concessional loans provided the cash flow in the initial years to meet the balance of payments obligations. The substitution of concessional loans for hard-term loans from these institutions was part of the debt reduction strategy. This infusion also helped restore the confidence of other private commercial creditors and slowed down flight of capital by resident Pakistanis. The slow build-up of foreign exchange reserves from less than \$1 billion in 2000 to \$3.2 billion by June 2001 also stemmed the speculative attack on rupee and calmed the foreign currency markets.

It is fair to surmise that Pakistan was able to achieve all the three objectives it had set out for itself in approaching the IMF in the year 2000. There is no denying the fact the post September 2001 developments have immensely helped strengthen Pakistan's external sector but the sacrifices made by the ordinary Pakistanis in meeting the harsh conditionalities of the IMF should not be ignored or overlooked. Had there been no September 11 it would have taken another two more years to achieve the results that were witnessed in 2002/03. September 11 did help accelerate the process of economic recovery and external sector viability.

(d) What were the factors that let to an early exit?

At least six compelling reasons can be advanced in support of the exit strategy.

- 1) A positive structural shift in external account of the country was achieved. Pakistan's payment capacity had become stronger and sound due to the following developments.
 - (a) Debt re-profiling, early payments of expensive debt, substitution of concessional for non-concessional loans from International Financial Institutions (IFIs), radically reduced the burden of debt servicing from 66 percent of foreign exchange earnings in FY00 to 25 percent in FY04 and even lower in FY05 and thereafter. New debt contracted was at concessional rates, highly selective and the rate of debt growth was quite low. External Debt to GDP ratio fell significantly from 45 percent in 1999/00 to 28 percent in 2004/05.
 - (b) As confidence in the economy built up, workers' remittances started being routed through official banking channels adding to the supply in the foreign exchange market. As the number of workers emigrating overseas was expanding every year and net migration back to Pakistan remained low – this source of foreign exchange earnings financed the growing trade imbalances.

- (c) Trade gap gradually declined and exports' coverage ratio of imports rose until 2006/07. Trade deficit that was \$2 billion or 3.4 percent of GDP in 1999/2000 came down to only \$ 400 million or 0.6 percent of GDP in 2004/05.
- (d) Foreign exchange reserves built up by the State Bank of Pakistan largely through non debt creating flows helped the country meet un-anticipated exogenous shocks such as rise in oil prices, poor harvest, depressed world demand, etc. The risk that these reserves will be depleted because of the payments of borrowed resources and foreign currency deposits withdrawals was minimized. Foreign reserves were acquired by mopping up current account surpluses over three years and were free from any encumbrances unlike in the past where the foreign reserves were only \$1 or 2 billion compared to foreign currency deposits liabilities of \$ 11 billion.
- (e) A substantial amount of liquid reserves provided a strong backing for low cost market borrowing without harsh conditionalities. If and when financing was needed to meet some short-term mismatches or requirements the country was in a position to access international markets at favourable terms. This was demonstrated by the successful entry of Pakistan in the international bond markets for four successive years where blue chip investment houses and fund managers over subscribed to the Pakistani bonds and provided fine pricing.
- (f) Telecommunications, oil & gas, and financial services proved attractive avenues for increased foreign direct investment in the country. The very positive response to the award of cellular licences attested to this trend. The inflow of foreign direct investment obviated the need for contracting external debt and led to a reduction in the country's indebtedness.

- (g) Privatization of large public sector enterprises also generated positive earning in foreign exchange over the next few years as a number of foreign strategic investors were attracted by the country's favourable macro economic environment.
- 2) Fiscal deficit was reduced to 3 – 3.5 percent. The need for large scale borrowing from either domestic or foreign sources was lowered. Fiscal deficit reduction was built on the basis of solid and durable footings such as:
- (a) Debt servicing as proportion of government revenues was on a declining course freeing up space for development spending on infrastructure and social services. In 1999/2000 debt servicing claimed 66 percent of government revenues. By 2004/05 this ratio significantly declined to 31 percent and 25 percent by 2006/07. Unlike the past where cut on development expenditures led to lowering of growth rate this boost to development spending stimulated the economy. Every rupee spent on external debt servicing leaves the country. If that rupee is instead spent on schools, water, medicines, a poor person or pensioner, the country benefits. In the past, fiscal deficit target was achieved by cutting development expenditure but during this period the current expenditure was curtailed from 16.5 percent of GDP in 1999/2000 to 14.4 percent in 2004/05. In the same period Development expenditure went up from 2.2 percent to 3.9 percent of GDP.
- (b) Tax collection increased by almost two thirds during the last four years on the back of structural reforms and widening of tax base. The on-going reforms in restructuring of CBR and tax administration should lead to higher tax collection in future with lowering of tax rates, minimizing contact between tax payer and tax collection, improving the quality of tax administration and providing immediate relief against discretionary excesses of tax

collectors. Pakistan has one of the lowest tax-GDP ratios in South Asia. Higher tax-GDP ratio will guarantee an increasing level of development budget within a lower fiscal deficit target and with declining debt ratios.

(c) Public sector organizations that were incurring huge losses such as nationalized commercial banks have been privatized, others were restructured and turned into profitable ventures such as Pakistan Steel and PNSC and several others are yet to be privatized such as WAPDA distribution companies. The elimination of public sector enterprise losses will result in budgetary savings and lowering fiscal deficit.

3) It was ensured that Fiscal discipline would not be abandoned after the expiry of the IMF Agreement but enforced by the Parliament of the country. A legal framework in form of Fiscal Responsibility Law has been enacted with clear timeline for reducing the level of fiscal deficit and the extent of indebtedness (60 percent of GDP). Parliament is expected under this Law to monitor the progress and thus the target setting, monitoring and economic decision making are shifted from external agencies to the elected representatives of the people. As these targets reflect the consensus among the Local Governments, Provinces and Federal Government it is more likely that these will be adhered to and the change in governments will not affect this commitment. However, this expectation was not met in 2007-08 when the fiscal targets under the law were not met although a long term credible instrument of economic discipline has been put in place in the country. The lesson to be drawn from this episode is that it is more a matter of political will rather than the letter of law that is more critical.

4) Another important tool to keep the economy on the right path after it enters the financial markets is the reaction of financial markets. Once

Pakistan, as a sovereign borrower or Pakistani corporate sector establishes links with the global markets the country will be under constant scrutiny by the Fund Managers, Credit Rating Agencies, Research Analysts, etc. Any tendency of laxity on our part is instantaneously penalized by the markets in form of increased spreads on Pakistani paper as happened in 2008. These spreads act as a powerful signal and feedback effect that we should either mend our ways or be ready for a likely financial crisis as lack of confidence by the markets in Pakistan's economy can eventually push us to that dungeon. Unlike the situation where we can enter into negotiations with the IMF and persuade their Board to waive off some of the performance criteria the verdict by the market is made instantaneously by thousands of players in a herd like fashion and the economic managers are simply helpless by-standers to the inflicting of this punishment. The need to remain on course under such circumstances should be quite obvious to everyone.

- 5) A number of financial crisis in the emerging economies had arisen due to weak financial sector institutions particularly the commercial banks. Fortunately, since 1997 the banking sector in Pakistan has undergone major transformation and has emerged today quite strong in terms of capital adequacy, asset quality, management soundness, liquidity, profitability and systems. Electronic banking, product diversification, cost reduction, strong risk management and corporate governance and a healthy competitive environment have introduced cost efficiencies, improved customer service, increased coverage and outreach, and extended the benefits of financial intermediation to middle and low income groups of the population. The supervisory and regulatory framework has been strengthened to international standards and the Central Bank and SECP act as vigilant watchdogs over the affairs of these institutions to ensure that they work to maximize the returns to

the economy at low acceptable risk. A healthy and sound financial sector will be less vulnerable to shocks and will have the resilience to withstand those shocks without recourse to exceptional assistance from the IMF.

- 6) Monetary and credit policies and exchange rate policies had become flexible and entrenched low inflationary expectations with base money growth driven mainly by accumulation of international reserves. The developments in 2007-08 and early half of 2008-09 whereby the Government borrowed heavily from the Central Bank reversed these expectations and both headline inflation and core inflation reached record high levels. Export competitiveness was the main focus of the exchange rate policy so that Pakistan is able to enhance its share in global markets, diversify into new products and new markets and develop new areas of comparative advantage. There have been slippages in meeting export targets in the last two years but it is primarily due to domestic energy shortages rather than the exchange rate misalignment. IMF's calculations show that the Pakistani rupee was not overvalued in terms of Real Effective Exchange Rate (REER).

(e) Why did Pakistan have to get back to the IMF in 2008?

A natural question that has perplexed the minds of most Pakistanis is: If the 2000-2004 program was so successful and had laid the foundations of sustained growth why did the economic conditions deteriorate so rapidly that the country had to once again enter into another stand by program in 2008 – just four years later.

A cursory glance at macro economic indicators in October 2007 – a year prior to the new SBA clearly demonstrate that the economy was in a good shape. Exchange rate was stable at around Rs.60 per US \$; foreign exchange reserves were at their peak around \$ 16.5 billion; current account deficit was running at an

annualized rate of 5.3 percent of GDP. Export growth rate was 14.2 percent and import growth rate was 4.5 percent. Monetary growth was 18.2 percent slightly above nominal GDP growth rate and private sector credit expanded by 15.2%. Headline CPI inflation was 9.3% on Year to Year (YoY) basis in October 2007. Government borrowing from SBP seemed to be within safe limits.

From November 2007 onwards, however, all these indicators worsened and the speed of their deterioration was quite rapid. Foreign exchange reserves were depleting fast, rupee depreciated by almost 25 percent. Headline inflation hit YoY rate of 25 percent. Current account deficit widened to annualized 11.7 percent of GDP.

What caused this rapid deterioration that forced the country into a serious distress situation? Both international and domestic factors have contributed to this set back. The government's reluctance to make gradual adjustments in the prices of oil, electricity and gas, particularly in response to the changing international conditions, the postponement of new GDR and bond issues and privatization, the preoccupation with political issues and judicial crisis, the resort to excessive borrowing from the Central Bank for meeting the widening fiscal deficits, subordination of economic decision making to political expediency and the flawed transition to the newly democratic elected government were the major domestic factors. On the international front, the hike in oil prices from \$ 50 a barrel to \$ 150 during an 18 month period and doubling of most commodity prices, the front-line state status of Pakistan participating in the war against terrorism and the weakening security and law and order situation as a consequence caused major dislocations and amplified the imbalances in the economy. Until 2006-07 it was possible to finance the current account deficit through Foreign Direct Investment, GDR issues, international bond issues and other capital flows due to high investor confidence in Pakistan's economy. As the sentiments of both domestic and foreign investors turned negative due to political uncertainty, assassination of the former Prime Minister Mohatarma

Benazir Bhutto, the unstable coalition following the elections, the frequent changes in economic managers blaming the previous government of fudging the data and a general sense of drift and inaction these capital flows dried up. Domestic investors availed of the opportunities offered by the real estate boom in the UAE and transferred their capital there. Foreign investors withdrew their portfolio capital while the suspension of the privatization process, GDR issues and other new bond floatation's unnerved the foreign investors. In FY 07 the current account deficit of \$ 6.9 billion was not only fully financed by capital inflows of \$ 10.4 billion but an overall surplus on the balance of payments of \$ 3.7 billion added to the country's foreign exchange reserves. In contrast, the current account deficit in FY 08 rose to \$ 14.0 billion but the capital inflows shrank to only \$ 7.8 billion and the negative overall balance of \$ 5.8 billion was financed by depleting the country's foreign exchange reserves. This further weakened investor confidence, led to further capital flight, an attack on the rupee-dollar exchange rate almost created a panic situation.

Under the above set of circumstances the Government had no other option but to approach the IMF to tide over the crisis. The subsequent developments since November 2008 have shown that this decision was quite justified in terms of arresting the deterioration of macro-economic conditions.

Post – IMF Reforms

The second generation of reforms which Pakistan ought to undertake have to be driven domestically and do not require any assistance from the IMF. As the emphasis of economic policy shifts from macro-economic stabilization to accelerated pro-poor growth with employment generation and poverty reduction the exit from the IMF program allows the policy makers greater flexibility in achieving these objectives in a manner that does not cause severe hardships to the population at large. Social well being of the population moves from secondary position to occupy the primary position as the country achieves macro-economic stability (and will continue to hold on to it). The targets would

now be set in terms of social targets and targets for pro-poor growth leading the course and not the other way around, i.e. budgetary deficit objective driving the targets of poverty reduction, employment generation and social sector expenditures. Primary budgetary surplus for debt reduction should remain a target but its size and evolutionary path will be determined by the progress achieved in meeting the social targets – particularly education, health, nutrition, drinking water, population, pensions and social safety nets. As pointed out earlier the control of the country's fiscal balance should not be relaxed but it becomes possible to work with higher public expenditure, lower interest rates and a lighter monetary policy which are all consistent with high but pro-poor economic growth and stronger social targets. Instead of cutting the development expenditures in ad-hoc manner as was the case under the IMF programs the balancing act is done by readjusting non-development expenditure and raising tax revenues. The scope and time horizon for adjustment will be more realistic as the country frees itself from short-term performance criteria and quarterly targets monitored under an IMF program.

Second, it has become quite abundant from the experience of the Social Action program in the 1990s that budgetary outlays are not the only major constraint in delivery of social services and development of human capital. The fault equally lies in the pervasive weakness of the institutions responsible for the delivery. Devolution of powers to local governments offers an excellent opportunity for ensuring that the poor participate in the decision making and receive the services at their doorsteps with minimal waste and leakages. Capacity building private-public-community partnerships needs to be promoted to strengthen the local government institutions assigned the task for the delivery of social services. This is purely an internal matter in which the IMF cannot provide much help.

Third, the incidence of taxes and surcharges on the various classes of population should be examined and the structure altered to reduce the excessive

burden on the poor, i.e. ensure better distribution of tax burden. Surcharges on electricity, gas and petroleum products are regressive in nature and can be dispensed with by improving the governance of utility companies, bringing in more tax payers under the income-tax and corporate tax net, reducing widespread evasion, levying higher tax rates on luxury and conspicuous consumption and plugging in leakages and corruption. These measures require institutional strengthening and restructuring for which the IMF financial program is not relevant.

Fourth, monetary and credit policy must be geared to provide access to the poor and middle class segments of the population. Microfinance, Women's banking, consumer financing, mortgage loans, SME financing, agriculture credit, personal loans have just begun to take hold but they ought to be expanded as part of the banks' retail business. The boost in aggregate demand will have backward linkages in form of higher industrial production and buoyant service sector thus stimulating the level of economic activity in the country. A strong and independent Central Bank can pursue such policies without any external help but keeping a vigilant eye on the banking industry.

Fifth, infrastructure facilities such as energy, irrigation water canals and lining of water courses, farm to market roads, storages and silos for grains, urban transport, railway service, port handling, need to be upgraded so as to remove shortage and congestion for the benefit of the majority of the population. Energy shortages have created an irreparable loss to the manufacturing and export sectors and the sooner the capacity is expanded economic revival will pick up. Under a supply-constrained and non-price rationing environment it is the poor who suffer the most and the elites derive most of the benefits through connections and influence peddling. Those measures that provide equal access to public goods to the poor as well as non-poor require a change in the mindset of our political leaders across the party lines and an outside agency such as IMF can hardly be useful for this purpose.

Sixth, scientific education, research and technological development have been neglected far too long to the extent that Pakistan is losing its competitive edge in the dynamic products of the global market. Adequate budgetary allocations with strong incentives linking research and development with industrial productivity and continuous up-grading of higher skills should be part of this strategy. The resistance to reforms in higher education is quite fierce from the faculty organizations while priority to technological development is quite low both by the private and public sector. Reorientation of our policies and institutions in this area call for tough actions that can be best managed by a strong leadership.

Seventh, poverty is not only lack of economic opportunities but is also a state of powerlessness and helplessness on the part of the poor who are denied access to Police, Justice and Executive branches of the Government. Reforms of Civil Service, Police and Judiciary to make them more responsive to the needs of the poor have to be introduced. These reforms require a long term road map which is blessed by all stakeholders involved. Technical assistance from external donors can be helpful but the implementation has to be domestically driven. There is very little that the IMF can contribute toward the implementation of this agenda.

Conclusion

It can be seen from the outline of the above agenda that the second generation reforms are deeply rooted in the institutional restructuring, require political will and consensus among stakeholders, strong ownership and are not in any way contingent on the financial assistance of the IMF. This agenda will be driven mainly by the Parliament, political parties, Federal, Provincial and Local Governments, private sector, NGO's, academia and communities. Thus the exit from the IMF program upon completion of macro-economic stabilization phase is

fully justifiable as the country would not require any exceptional financial infusion and the road ahead can be traversed without the assistance of the IMF.

The biggest risk to this exit strategy is: When the economy bounces back, will the pressure for reform, fiscal discipline and good governance disappear in absence of an IMF program? Will we revert back to the bad old ways of doing things – e.g.

- Appointments and postings on sifarish, favouritism and nepotism.
- Award of contracts on kickbacks and plunder.
- Issuance of SROs to make a few selected individuals rich.
- Sanction of loans on the basis of political connections.
- Undertaking unproductive and wasteful mega projects of little economic value.
- Slow down of privatization process and financing of losses of public sector enterprise from within the budget.
- Paralyzing the functioning of local governments.
- Return of creeping protection of domestic industry to appease the lobbies of rent seekers.
- Incessant bureaucratic and political interference resulting in inconsistent, unpredictable and discontinuous policies.

If this scenario works out then even if an IMF program is in place, the IMF is bound to suspend the program and withdraw its assistance. Under those circumstances what is the point in going through the agony of negotiating another program and then suffer the humiliation and lose the credibility. If the intention is to go back to old ways of doing things then there is no point in extending the program in any case.

To reiterate, the success depends upon continuity and consistency of policies, good governance, institutional restructuring, national consensus

building and strong work ethic by all Pakistanis. Government can be an enabler and facilitator but the ultimate results will depend on the collective efforts and hard work of millions of farmers, firms, entrepreneurs, individual businesses and professionals. His mix will determine whether the majority of Pakistanis can achieve better standards of life.