WHY PAKISTAN SHOULD EXIT THE IMF PROGRAMME?

Ishrat Husain [1]

Pakistan has formally conveyed its decision that the country does not wish to enter into a successor agreement with the IMF on completion of the current PRGF Programme at the end of 2004. This decision has evoked two kinds of responses – one that of relief that we will no longer be subjected to the harsh conditionalities of the Fund and second that of disbelief that the country is not yet ready to shed off this yoke and even if this is done it will only be for a temporary duration – in other words, it will not be sustainable.

As I had earlier written a paper in January 2001 on "Why Pakistan had to adopt the IMF Programme?" providing the rationale behind Pakistan's decision to go through that route, this paper, written three years later, attempts to outline the reasons which have now prompted us to terminate financial arrangements with the IMF. In order to understand these reasons in the proper context, we should begin by asking the following questions:

a) When does a Country approach the IMF?
b) Why did Pakistan approach the IMF?
c) What did Pakistan get out of the Agreements with the Fund?
d) What are the factors that call for exit and are they sustainable?
e) What is it that we will be able to do differently?

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

This Article appeared in the Daily Dawn on February 29, and March 1, 2004

which become reluctant to provide financing to such IMF dependent economies. The sooner a country is able to sever its financial programmes 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 programme 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, we needed quick infusion of funds to sustain and support our balance of payments situation, (ii) to find a permanent and durable solution to our external debt problem. Instead of approaching the IMF every three years or so and obtain a rescheduling of our flows, we were determined to seek a stock reprofiling that will align our 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. We used to enter into agreements and draw down the first tranche and seldom fulfilled all the obligations and conditionalities contained in the agreement.

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. We 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.

(c) **What did we get out of the Agreements with the IMF?**

Pakistan has been 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 interruption over a period of three years. This is an unprecedented record in the history of economic management of Pakistan and has led to the upgradation 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 has opened the way to accessing credit from the international markets at affordable price.

As the IMF agreements 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 will no longer by obligated to have future agreements with the IMF to seek debt rescheduling. In one go we have been able to find a permanent and durable resolution of our bilateral external debt by cutting back our stock of bilateral debt. Those who argue that debt reprofiling has simply postponed the D-day are sadly mistaken. The payments due after next 15 years in relation to the country's earning capacity will be miniscule.

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 our balance of payments obligations. The substitution of concessional loans for hard-term loans from these institutions was part of our 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 a $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 that 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 we have witnessed in 2002/03. September 11 did help accelerate the process of economic recovery and external sector viability.

(d) <u>What are the factors that call for exit and are they sustainable?</u>

At least six compelling reasons can be advanced in support of the exit strategy. In the following paragraphs these factors are elaborated and also the elements of their sustainability are pointed out.

1) A positive structural shift in external account of the Country has been achieved. Pakistan's payment capacity has become stronger and sound.

(a) Debt re-profiling, early payments of expensive debt, substitution of concessional for non-concessional loans from International Financial Institutions (IFIs), have 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 FY 05 and thereafter. New debt contracted is at concessional rates, highly selective and the rate of debt growth is quite low. Thus, there is very little danger of the country getting back into a debt trap.

(b) Workers' remittances are being routed through official banking channels and adding to the supply in the foreign exchange market. As the number of workers emigrating overseas is expanding every year and net migration back to Pakistan is expected to remain low - this source of foreign exchange earnings is expected to remain stable at $3.5 billion annually if not higher. It may be recalled that throughout the 1990s Pakistan received $3 to $3.5 billion annually from non-resident Pakistanis through different channels – foreign currency deposits, kerb markets and official banking - at different times. But the amount of annual flows remained unchanged although the delivery channels varied throughout the last 12 years.

(c) Trade gap is gradually declining and the exports' coverage ratio of imports is rising. Four years ago, the trade imbalance was $2 billion or 3.4 percent of GDP. In the last fiscal year this imbalance had come down to only $400 million or 0.6 percent of GDP. Export growth will receive a further boost from the demise of Multi-Fibre Agreement (MFA) in 2005. Policies in favour of export promotion are endorsed by all political parties in Pakistan and these are likely to remain in place.

(d) Foreign exchange reserves have been built up by the State Bank of Pakistan largely through non debt creating flows and will help the country meet any unanticipated exogenous shocks such as rise in oil prices, poor harvests, depressed world demand, etc. The risk that these will be depleted because of the payments of borrowed resources and foreign currency deposits which accounted for the reserve build-up in the past has been eliminated. Foreign reserves have been acquired by mopping up current account surpluses over last three years and are free from any encumbrances.

(e) A substantial amount of liquid reserves provides a strong backing for low cost market borrowing without conditionalities. If and when financing is needed to meet some short-term mismatches or requirements then we will be in a position to access international markets at favourable terms. This has been demonstrated by the recent successful entry of Pakistan in the international bond market where blue chip investment houses and fund managers subscribed to the Pakistani bond at fine pricing.

(f) Telecommunications, oil & gas, hydroelectric power generation, provide attractive avenues for increased foreign direct investment in the country. The very positive response to the award of two cellular licences attests to this trend.

(g) Privatization of large public sector enterprises will generate net positive earning in foreign exchange over the next few years. These earnings can be invested productively to generate a stream of annual income in foreign exchange.

(2) Fiscal deficit has been reduced to 4.4 percent and will be further reduced to 3-3.5 percent thus obviating the need for large scale borrowing from either domestic or foreign sources. Fiscal deficit reduction has been built on the basis of solid and durable footings such as:

(a) Debt servicing as proportion of government revenues is on a declining course and will free up space for development spending on infrastructure and social services. Four years ago, debt servicing claimed 66 percent of government revenues. This year, this ratio has significantly declined to 31 percent and the future projections show it will attain 25 percent. Unlike the past where cut on development expenditures led to lowering of growth rate this boost to development spending will stimulate 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 in the country will benefit. In the past, fiscal deficit target was achieved by cutting development expenditure. This risk is much lower for the future years as the burden of debt servicing has been reduced structurally.

(b) Tax collection has 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 should lead to higher tax collection with lowering of tax rates, minimizing contact between taxpayer and tax collection, improving the quality of tax administration and providing immediate relief against discretionary excesses of tax collectors. 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 have been restructured and turned into profitable ventures such as Pakistan Steel and PIA and several others are in the process of privatization such as KESC and WAPDA distribution companies. The elimination of public sector enterprise losses will result in budgetary savings and lowering fiscal deficit.

(3) Fiscal discipline will not be abandoned after the expiry of the IMF Agreement but will instead be enforced in the future 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 will monitor the progress and thus national sovereignty of economic decision-making will be restored and rest in the hands of the elected representatives of the population. There will be a shift of target setting and monitoring from the control of IMF to the national authorities. As these targets will reflect the consensus among the Local Governments, Provinces and Federal Government it is more likely that they will be adhered to and the change in governments will not affect this commitment. For the first time a long-term credible instrument of economic discipline has been put in place in the country.

(4) Another important tool to keep the economy on the right path will be the reaction of financial markets. Once Pakistan, as a sovereign borrower or Pakistani corporate sector establishes links with the global markets we will be under constant scrutiny by the Fund Managers, Credit Rating Agencies, Research Analysts, etc. Any tendency of laxity on our part will be instantaneously penalized by the markets in form of increased spreads on Pakistani paper. These spreads will act as a powerful signal 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 present 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 will be made instantaneously by thousands of players in a herd like fashion and the economic

managers will be simply helpless by-standers to the inflicting of this punishment. The need to remain on course under such circumstances will be quite obvious to everyone.

(5) A number of financial crises 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 will further bring about cost efficiencies, improved customer service, increased coverage and outreach, target underserved sectors and areas and extend 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 will 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 will remain flexible and continue to entrench low inflationary expectations with base money growth driven mainly by accumulation of international reserves. Export competitiveness will remain the 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. Post-2005 textile goods market offers an excellent opportunity for our exporters to capture as much share as possible in absence of quotas.

(e) **What is it that we will be able to do differently?**

The second generation of reforms which Pakistan proposes to undertake will be driven domestically and do not require any assistance from the IMF. As the emphasis of economic policy has now shifted from macroeconomic stabilization to accelerated pro-poor growth with employment generation and poverty reduction as the objectives, there are many ways whereby the exit from the IMF will allow us to do things differently and also achieve these objectives in a manner that does not cause severe hardships to the population at large. Social well-being of the population will move from secondary position to occupy the primary position as the country has already achieved macroeconomic stability (and will continue to hold on to it). The targets will 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 will 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 we are not going to relax in terms of maintaining the control of the country's fiscal balance but we can 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 in the past the balancing act will be done by readjusting non-development expenditure and raising tax revenues. The scope and time horizon for adjustment will be more realistic as we free ourselves from short-term performance criteria and quarterly targets monitored under an IMF programme.

Second, it has become quite abundant from the experience of the Social Action programme 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 and private-public-community partnerships would 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 will 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 programme is not relevant.

Fourth, monetary and credit policy will 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 in the next five years they will 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 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 shortages and congestion for the benefit of the majority of the population. 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. These 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 upgrading of higher skills will be the 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 towards 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 programme is fully justifiable as the country is no longer in a crisis mode and does not require any financial infusion and the road ahead can be traversed without their assistance.

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 programme? Will we revert to 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 programme 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 programme and then suffer the humiliation and lose the credibility. If the intention is to go back to old ways of doing things then we should not consider extending the programme in any case.

But I am an optimist and a firm believer in social democracy. My hunch, based on last one and a half year of experience, is that the Jamali Government is fully committed to these second generation reforms and will successfully tide over this period of five years by continuing economic reforms, practicing good governance and strengthening our financial, judicial and educational institutions. We should then be on our way to achieving a competitive economy and social democracy for Pakistan – the goals which have eluded us so far. Under those circumstances, the risk to the exit strategy will be minimal.

To reiterate the success of this exit strategy 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. I am quite sanguine that we, the Pakistanis, are ready to say good-bye to the IMF and still achieve better standards of life for the majority of our population.