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Does Pulwama jeopardise Pakistan's potential IMF deal?[1]

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Summary

Is it possible that Pakistan has scored an own-goal by allegedly sponsoring the 14 February 2019 terrorist attack on Indian security forces in Pulwama, Kashmir, which took 40 lives? Since the Pakistan-based terrorist group Jaish-e-Muhammed has claimed responsibility for the attack, India has vowed to work on isolating Pakistan economically and diplomatically as a state sponsor of terrorism. This comes at a time when Pakistan is facing an external payments crisis, with only US$7 billion (S$9.5 billion) in reserves – less than two months of import cover – and is in desperate need of a bailout by the International Monetary Fund (IMF). Yet, if India succeeds in convincing major shareholders of the IMF – the United States, the European countries, Japan and China – and international organisations like the terror financing watchdog, the Financial Action Task Force, of Pakistan state's involvement in these attacks, an IMF bailout of Pakistan, which looked like a distinct possibility just a couple of weeks ago after the meeting between Pakistani Prime Minister Imran Khan and IMF Managing Director Christine Lagarde, could be in jeopardy. Unless Pakistan takes significant steps to convince the G7 and other countries that it is serious about combatting home-grown terrorism, it risks going over the precipice.

Pakistan's Fragile Financial Situation

Outwardly, Pakistan is putting up a brave face and appears to have gotten a reprieve with the Saudi Crown Prince Mohammed bin Salman promising investments of up to US$20 billion (S$27 billion) during his recent visit there in what has widely been interpreted as help for the country's crumbling economy. These promises include investments such as a US$10 billion (S$13.5 billion) oil refinery at Gwadar Port – a port in Pakistan which has been leased to China for 43 years – and longer-term investments in agriculture and energy. However, these are just pledges of potential future investment, and even if they materialise, funds will flow slowly as projects get grounded. Despite the fanfare of Pakistan's Prime Minister Imran Khan and the crown prince cheerily driving through the streets of Islamabad in a horse-drawn carriage, this promised Saudi assistance will do little to rescue Pakistan from its rapidly deepening balance of payments crisis.

Pakistan has been cash-strapped for months, with the Khan government having inherited a broke economy from its predecessor in July 2018, but the financial situation has worsened. This led the government to seek bilateral loans from its allies in late 2018 in order to address its immediate external balance financing needs, as well as trying to avoid approaching the International Monetary Fund (IMF) for loans. Saudi Arabia already came to Pakistan's rescue with a US$6 billion (S$8.1 billion) loan package in October 2018, which included US$3 billion (S$4.1 billion) in balance of payments support and US$3 billion (S$4.1 billion) in deferred

[1] An abbreviated version of this article was published in the Indian Express at https://indianexpress.com/article/opinion/columns/pulwama-terror-attack-india-pakistan-relations-5593546/.

payments on its oil imports – though so far only US$1 billion (S$1.35 billion) has reportedly been deposited with Pakistan. The United Arab Emirates (UAE) also pledged a US$3 billion (S$4.1 billion) financial support package to Pakistan and transferred its first instalment of US$1 billion (S$1.35 billion) in January 2019. China reportedly also gave Pakistan a US$2 billion (S$2.7 billion) loan at the beginning of 2019. However, these bilateral loans, which reportedly total US$6-8 billion (S$8-11 billion), are only a stop-gap measure. In a sign that these bilateral loans have done little to address the issue of a huge current account deficit and the increasing risk associated with investing in Pakistan, two out of the world's three biggest credit rating agencies, Standard & Poor's (S&P) and Fitch, downgraded Pakistan's long-term credit rating at the end of 2018 and early 2019 to B-, which, for the S&P, is six steps below an investment grade rating.

IMF Rescue Package for Pakistan

The inability of bilateral lending to assuage investor confidence led the Pakistani government at the end of 2018 to approach the IMF for a bailout, with talks still ongoing on the size and conditions attached to the bailout package. While an IMF bailout of Pakistan has still not been finalised, the need to access IMF assistance is a sharp brush with reality for Prime Minister Khan who, as is typical across South Asia, won office on the promise of huge handouts. Early in his tenure, Khan exuded confidence that friendly countries such as Saudi Arabia, the UAE and China would come to his aid, thereby helping him avoid going to the IMF and escape the harsh conditionalities that will accompany an IMF package, including stringent expenditure cuts. Evidently, those hopes have not materialised to the extent expected, forcing the Prime Minister, who once said he would rather commit suicide than approach the IMF, with little choice but to negotiate with the Fund for Pakistan's 12th bailout package since the 1980s.

Even before the Pulwama attacks, there were difficult issues that Pakistan needed to settle with the Fund. One of the main issues is to secure a rollover of the short-term debt owed to China to assure the United States (US) and other big members of the Fund that IMF assistance will not be used to repay Chinese loans. The reassurances that the Fund will seek, however, will likely go beyond repayments due to China. Pakistan has short-term debt and medium- and long-term debt maturing in the next one year totalling over US$12 billion (S$16.2 billion). The IMF will insist on assured refinancing of these obligations in order to minimise the funding gap that it will need to fill.

While managing short-term debt obligations is imperative, that by itself will not ensure Pakistan's medium-term balance of payments viability. Towards this larger goal, the IMF will demand a complete and meaningful float of the exchange rate and Pakistan will find it difficult to yield on this, in part out of fear that it might be setting itself up for volatile exchange rate movements and the consequent financial instability.

Pakistan also has a large budget deficit problem, with the deficit recently hitting a six-year high, largely due to a double-digit growth in defence and debt spending in 2018-19, while improvements in revenue raising have been minimal. In an effort to address its budget problem, Pakistan has already raised gas and electricity prices. However, these measures have done little to address Pakistan's overall financial situation of huge external debt, rising inflation, reduced foreign investments, and decreased economic growth projections. The

Fund will, therefore, likely go beyond just utility prices and seek a comprehensive fiscal responsibility package from the government to ensure that its assistance will pave the way for restoring credibility to public finances.

Changing Perceptions about the IMF

The IMF never enjoyed a benign reputation. Across emerging and developing economies, the institution used to be seen as a necessary evil – to be approached as a last resort when all other avenues of resurrecting a sinking economy fail. A common feature across much of Latin America during the 1980s were 'IMF riots' – public anger against the hardships they had to endure because of IMF imposed conditions on their countries. These conditions, or a package of obligatory policy reforms, in exchange for financial support from the IMF in the form of loans, were linked to negative social and even political outcomes. The popular outrage against the IMF's insensitivity to the plight of ordinary people as it rescued Asian economies out of their crisis in the late 1990s is now stuff of folklore. And such protests continue with, for example, thousands protesting against IMF-back austerity measures in Argentina and in Jordan in 2018.

Yet, in fairness to the IMF, it must be said that the institution has made sincere efforts to live down that reputation by being more sympathetic to welfare concerns without, at the same time, diluting its loan standards. IMF loans today do not contain conditions of budgetary cuts to the social sectors. Yet, studies have also shown that the IMF's hype of promoting social sectors during structural adjustments under IMF loans, through mechanisms such as implementation of "priority spending targets" in the social sectors, are also not supported by the data.[2] Ultimately, however, the problem usually lies with recipient countries who, when faced with an IMF loan with strings attached calling for a general reigning in of a profligate budget, make cuts where they are easiest to make: in public education, health, housing or other social sectors that have the largest impact on the poorest and least vocal and organised sectors of society. These cuts are then blamed on the IMF, even when IMF loans have no conditions for budget cuts in the social sectors.

Notwithstanding this attempt by the Fund to reinvent itself, IMF aid still carries a stigma, especially in South Asia, and governments try to avoid it as much as possible. Despite the fear of domestic political backlash to IMF loan conditionalities, Pakistan's recent experience demonstrates the critical importance of an arrangement with the IMF for an economy in crisis. It is only an IMF package that sends the signals that can restore investor and market confidence in a flailing economy and enable a sustainable adjustment. But the reverse is also true: With institutions such as the Financial Action Task Force (FATF) continuing to keep Pakistan on the grey list at least until October 2019, Pakistan's credit rating will continue to stay low and the pressure on its economy will not abate. The IMF will, therefore, have to impose more stringent conditions or even significantly delay its loan agreement -- which is already evident in the long time it is taking Pakistan to secure an IMF loan. This will impact global investor confidence in Pakistan, prolonging and perhaps even deepening the economic crisis. For a country which has repeatedly been in economic crises over the past few decades,

[2] Kentikelenis, A., Stubbs, T., & King, L. (2016). IMF conditionality and development policy space, 1985-2014. *Review of International Political Economy, 23*(4), 543-582. http://www.tstubbs.net/uploads/4/0/5/3/40534697/kentikelenisstubbsking2016.pdf.

bilateral loans from friendly countries are no substitute for an IMF package as far as global investors are concerned.

Political and Security Implications

Arguably, Pakistan's economic position is better than it was six months ago. The fall in global crude prices has helped it reduce the import bill while a 30 per cent depreciation of the currency has made its exports more competitive.

On the political side, before the Pulwama attack, Pakistan's negotiating strength vis-à-vis the IMF seemed also to have been improving. The US is currently focused on securing a peace deal with the Taliban in order to leave Afghanistan and Pakistan's support is crucial for concluding the deal. In return for that support, the US, as the dominant shareholder of the IMF, would have put its formidable weight behind a Fund bailout package for Pakistan. And Pakistan will be sure to use this new found leverage in its negotiations with the IMF.

In the wake of the Pulwama attack, Pakistan may have forfeited that support. The US has endorsed India's right to self-defence, and in a clear signal that it is not willing to look the other way from Pakistan-based and possibly -supported terrorist group attacks, it has asserted that Pakistan must crack down on terrorists operating from its territory as per its obligations under United Nations resolutions.

Moreover, the FATF announcement on 22 February 2019 to keep Pakistan on the grey list for showing only limited progress in curbing money laundering and terrorism financing is bound to send a signal to FATF member countries of these political risks attached to bailing out Pakistan. The FATF decision was made despite a last minute effort by Pakistan to show action on curbing terrorism financing by reinstating bans on two Pakistan-based terrorist organisations and despite heavy lobbying by Pakistan of FATF member countries, especially the country that currently heads the FATF, the US.

Has Pakistan overplayed its hand? Will its worsening economic crisis and the deepening tensions with India in the wake of the Pulwama attack help it realise that the price to pay for sponsoring terrorism can be exceedingly high? How Pakistan responds to these questions will determine the chances for peace in the subcontinent.

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