

Pakistan and the IMF: Debts, Deficits and Dependency

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Summary

For decades, Pakistan has depended on the International Monetary Fund (IMF) to fill economic gaps as crises erupt. What binds both entities? Will this persistent dependency continue post COVID-19 or will a self-reliant growth model emerge? This paper focuses on the last three packages (in 2008, 2013 and 2019) provided by the Fund to identify the continuities that compel the recent Pakistani governments to seek IMF assistance.

Introduction¹

Pakistan's relationship with the International Monetary Fund (IMF) dates back to the 1950s. The IMF manages the international monetary system by assisting member countries address their balance of payment issues. This assistance comes mainly through either short-term loans under its Standby Agreement (SBA) or medium-to-long-term loans under its Extended Fund Facility (EFF). Both packages come with conditionalities. Pakistan, over the years, has relied on IMF assistance to paper over economic dips that have followed cyclical growth spurts. Two factors are largely responsible for Islamabad's requests to the IMF for financial assistance – current account deficits and fiscal mismanagement.

Pakistan-IMF Packages, 2008-2020

The 2008 Bailout

In 2008, Islamabad approached the IMF for assistance. Spillover effects from the global financial crisis, energy sector subsidies and a current account deficit dented the government's financial position. In 2007-08, global oil prices rose, but the government, fearing economic instability, continued heavily subsidising the energy sector, transferring the burden to local consumers which increased the budget deficit to 7.4 per cent of gross domestic product (GDP). Nevertheless, rising oil imports increased the total imports, burdening foreign exchange reserves which plummeted. Remittances decreased due to the global financial crisis. Rising imports with falling remittances widened the current account deficit by 492 per cent from June to September 2007. To offset this deficit, the incoming Pakistan Peoples Party government struck a deal with the IMF for an SBA package of US\$7.6 billion (S\$10.44 billion according to present rate) for 23 months. The IMF demanded a consolidation of fiscal space by increasing tax revenues and phasing out energy subsidies. To

¹ All data used in this paper is available on the CEIC database. Where other sources have been used, a citation has been provided in the footnote.

² Press Release, "IMF Executive Board Approves US\$7.6 Billion Stand-By Agreement for Pakistan", 24

manage inflation and attract investments, the IMF recommended the Pakistani central bank to tighten monetary policy and stop financing the budget deficit.²

The IMF's assistance, coupled with a recovering global economy, built a façade of stability despite enduring economic problems. By 2011, foreign reserves stabilised. Global oil prices decreased drastically, reducing Pakistan's import commitments. The current account deficit stabilised in January 2009 but did not improve due to stagnant exports. Due to IMF conditionalities, Pakistan rationalised energy subsidies and allowed domestic fuel prices to increase.³ As a result, the fiscal deficit narrowed to 5.15 per cent in 2008-09 but soon the defence budget ballooned to replace the energy subsidies; tax revenues did not keep pace with rising defense spending which boosted the fiscal deficit to nine per cent in 2011.

The 2013 Bailout

In 2013, the Pakistan Muslim League (Nawaz) [PML-N] government signed a US\$6.68 billion (S\$9.18 billion) EFF package with the IMF released over three years subject to Pakistan's adherence to conditionalities.⁴ This time, large fiscal deficits and structural issues in the energy sector drove Pakistan's request for assistance.⁵ Pakistan's fiscal deficit in 2012-13 was approximately 8.5 per cent of GDP, almost double its 4.7 per cent target. This large and growing deficit was attributed to poor fiscal consolidation driven by low tax collection and weak tax administration. Tax revenue hikes were offset by rising development expenditures from 2.8 per cent to 5.1 per cent from 2011-2013. Additionally, inefficiencies in the energy sector increased costs due to price distortions, poor regulation, improperly targeted subsidies and lax energy distribution. Nearly two per cent of the 2011-12 GDP was lost to power shortfalls.⁶

This IMF programme was designed to prevent another balance of payments crisis, reduce fiscal deficits and rebuild reserves. IMF conditionalities also sought to raise Pakistan's tax-to-GDP ratio by broadening the tax base and extending the tax net; reform the energy sector through comprehensive energy policies, price adjustments, enhanced governance and regulations, and public sector enterprise reforms; and rebuild foreign reserves by reforming monetary and exchange rate policies by enhancing central bank independence, strengthening public debt management and phasing out electricity subsidies.

² Press Release, "IMF Executive Board Approves US\$7.6 Billion Stand-By Agreement for Pakistan", 24 November 2008. <https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr08303>. Accessed on 10 July 2020.

³ Farhan Bohari, 'Pakistan to phase out fuel subsidies', *Financial Times*, 1 July 2008. <https://www.ft.com/content/5706e02c-46ca-11dd-876a-0000779fd2ac>. Accessed on 23 July 2020.

⁴ Press Release. "IMF Executive Board Approves 3-Year, US\$6.64 Billion Extended Arrangement For Pakistan", 2013. <https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr13322>. Accessed on 3 August 2020.

⁵ Reuters, "IMF Concerned Over Pakistan's Falling Reserves", *Dawn.com*, 2013. <https://www.dawn.com/news/779681/imf-concerned-over-pakistans-falling-reserves>. Accessed on 3 August 2020.

⁶ Press Release, "IMF Executive Board Approves 3-Year, US\$6.64 Billion Extended Arrangement For Pakistan", 2013. <https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr13322>. Accessed on 3 August 2020.

Pakistan's economic performance after the package shows an equivocal outcome. GDP grew from 3.5 per cent in 2012 to 5.6 per cent in 2017. Inflation declined from 9.6 per cent in 2012 to 4.1 per cent in 2017. While IMF conditionalities and assistance improved macroeconomic outcomes, the current account balance thereafter suggests that the IMF's impact narrowing fiscal deficits may have been transient.⁷ Moreover, given that Pakistan reaped the benefits of lower oil prices, the IMF's targets did not go far enough.⁸

The 2019 Bailout

Imran Khan's Pakistan Tehreek-e-Insaf government turned to the IMF to stabilise a weakening economy soon after entering office. In September 2016, the IMF's EFF programme came to a halt and repayments to the IMF were set to begin. Debt repayments to the Paris club, a group of creditor countries, were due to begin by 2016-17. From 2016 to 2019, debt servicing increased by 64 per cent which constricted the fiscal space and worsened the fiscal deficit from 4.64 per cent to 9.07 per cent. The current account deficit worsened because of the PML-N government's overvaluation of the exchange rate; this move favoured imports, especially from China, and disadvantaged exports. The burden of servicing a huge external debt and ballooning imports fell on foreign reserves which depleted by 65 per cent in January 2019. Pakistan's attempts to resolve these issues via assistance from China and Saudi Arabia proved to be insufficient.

To manage these issues, a US\$6 billion (S\$8.24 billion) EFF package was approved in July 2019. The IMF demanded the incoming government to increase tax revenues to pay back debt, adopt a free-floating exchange rate to reduce pressure on reserves, and tighten monetary policy to attract investments and reduce inflationary pressures caused by expensive imports.⁹ COVID-19 arrived just as the IMF's assistance stabilised the economy. The ensuing crisis shifted the discussion away from stabilising the economy and toward mitigating the economic effects of the pandemic. The IMF has also postponed discussions of a second review and has not approved the release of additional funding. Instead, the IMF has assisted Pakistan through a US\$1.386 billion (S\$1.904 billion) package to bolster the government's fiscal capacity to fight COVID-19.

Factors driving Pakistan's IMF Dependence

Persistent Current Account Deficits

Pakistan's balance of payment problems are caused by a persistent current account deficit. In 2008, the oil crisis widened the deficit; in 2018, debt servicing and increased imports due to an overvalued rupee widened the deficit. Each time, a yawning deficit was followed by dwindling reserves and Pakistan seeking IMF assistance to replenish reserves. Whether

⁷ B Memon, "Significant Progress Achievable: IMF", *The Express Tribune*, 2015, <https://tribune.com.pk/story/943397/significant-progress-achievable-imf>. Accessed on 3 August 2020.

⁸ Mark Sobel, "Pakistan, The United States, And The IMF" Center for Strategic and International Studies, 2020. <https://www.csis.org/analysis/pakistan-united-states-and-imf>. Accessed on 29 August 2020.

⁹ IMF Press Release No.19/264, "IMF Executive Board Approves US\$6billion 39-Month EFF Arrangement for Pakistan", 3 July 2019. <https://www.imf.org/en/News/Articles/2019/07/03/pr19264-pakistan-imf-executive-board-approves-39-month-eff-arrangement>. Accessed on 15 July 2020.

Pakistan relies on imports for growth or finances its development through debt or prevents local consumers from shocks in international markets, these measures can be backed by sustained export promotion and foreign direct investment. If growth is financed by imports and debt, the bubble would likely burst every few years.

From 2000 to 2018, export growth has not matched burgeoning imports. During this period, while imports increased approximately four-and-a-half times, exports did not double. Rising imports is largely due to increasing consumption needs of the domestic market, an overvalued rupee, and the China-Pakistan Economic Corridor (CPEC).¹⁰ Exports remained sluggish due to a failure to diversify, reliance on low value-added commodities like textiles or agriculture products, low labour productivity, and overvaluing the Rupee. Sustained trade deficits have consumed foreign reserves.

Fiscal Mismanagement

The second factor driving Pakistan's IMF reliance is poor fiscal management. Pakistan has grappled with fiscal problems given limited revenue-generation capacity, ailing energy sector and recurrent spending-side issues.

Public revenue generation in most countries hinges on taxation. Pakistan's tax-GDP ratio in 2017-18, however, was 13.7 per cent, below the 20 per cent needed to maintain an adequate level of investment and public services.¹¹ Moreover, the tax base cannot be widened, given a large informal sector, predominance of cash-based transactions and tax evasion. Another driver of large fiscal deficits is Pakistan's bloated state-owned enterprises (SOEs) and an ailing energy sector. SOEs, such as Pakistan International Airlines, Pakistan Steel Mills and Pakistan Railways, operating at major losses, have undermined fiscal strength. In fact, net losses of SOEs were so large that they surpassed the annual defense budget.¹² The energy sector, despite countless reforms, has deepened fiscal deficits given high subsidies and increasing debt.¹³

Government expenditure has also been inefficient and mismanaged. The 2020 fiscal budget saw an increase in defense spending, 41 per cent of expenditure already diverted to service debt repayments.¹⁴ Inefficient allocation of resources, which accommodates the interests of the military and political elites, has also widened fiscal deficits, asphyxiating growth. Unless these problems surrounding fiscal mismanagement are addressed, Pakistan's economy will

¹⁰ Hafiz Pasha, "What has caused Pakistan's alarming trade deficit?", *Herald*, 24 July 2017. <http://herald.dawn.com/news/1153812>. Accessed on 18 July 2020.

¹¹ H Qayyum, "Pakistan Tax Reform | The Asia Foundation", The Asia Foundation, 2019. <https://asiafoundation.org/2019/01/30/pakistan-tax-reform/>. Accessed on 3 August 2020.

¹² I Mukhtar, "Losses Of State Owned Enterprises Surpassed Annual Defence Budget", *The Nation*, 2020. <https://nation.com.pk/06-Jun-2020/losses-of-state-owned-enterprises-surpassed-annual-defence-budget>. Accessed on 3 August 2020.

¹³ M S Khan, "Powering The Powerless In Pakistan", *The Diplomat*, 2020. <https://thediplomat.com/2018/11/powering-the-powerless-in-pakistan/>. Accessed on 3 August 2020.

¹⁴ A Siddiq, "Why Is Pakistan Spending So Much Money On Defence Amid COVID-19?", *Al Jazeera*, 2020. <https://www.aljazeera.com/indepth/opinion/pakistan-spending-money-defence-covid-19-200625115702999.html>. Accessed on 3 August 2020.

cycle between booms and busts with dependence on the IMF that arrive with thorny conditions.

These factors explain why Pakistan has repeatedly turned to the IMF. Yet, why does the IMF countenance Pakistan's recurring appeals despite chronic economic problems? Pakistan's strategic and geopolitical value has also played a role.

Geopolitics of IMF Assistance to Pakistan

Pakistan's Strategic Relevance

Pakistan's strategic location has drawn the attention of the United States (US) and its North Atlantic Treaty Organization (NATO) allies. During the 1980s, Pakistan became the channel for the transport of US arms and breeding ground for training of jihadists for war against the Soviets. Hence, the US sustained Pakistan's military expenditure and covered domestic economic problems. In the 1990s, when Pakistan's nuclear programme became known and the war against the Soviets ceased, the majority of aid to Pakistan was cut off. However, the IMF channel was maintained as the situation in Afghanistan had not settled and Pakistan's support could be vital at some point.

Post-9/11, Pakistan regained its strategic relevance due to the US-led war in Afghanistan. During the signing of the 2008 package, the war in Afghanistan was at its peak, and leaving Pakistan alone to manage its fiscal issues would have resulted in military expenditure cuts that could have undermined the US interests in Afghanistan. Thus, the leader of US Central Command, General David H Petraeus, met IMF officials to guarantee a package to keep Pakistan's economy afloat.¹⁵ Moreover, during the signing of the 2013 package, the US was planning to withdraw its troops and transport military equipment through Pakistan. Stability, as a result, in Pakistan was essential. As long as the war continued in Afghanistan, the US and its NATO allies relied on Pakistan for its military support and in return leveraged their influence with the IMF to continually support Pakistan. Pakistan, on the other hand, developed a dependence on the IMF, ignoring the Fund's earlier exhortations when it came to deftly managing the economy.

China-Pakistan and China-US Relations

After the US drawdown in Afghanistan in 2014, Pakistan's geopolitical importance to the US would have waned if not for China's increasing presence in South Asia, a clear cause for concern. The US also feared a loss of control over Pakistan, which was becoming China's largest beneficiary. In fact, since 2010, Pakistan's ties with China have become stronger; investments towards CPEC substantially increased during the PML (N)'s rule from 2013 to 2018. Thus, the US, using the IMF as a front, attempted to ensure Pakistan's compliance to pursue geopolitical interests and challenge China's economic influence. The IMF pushed Pakistan for greater transparency regarding its dealings with China and the CPEC,

¹⁵ J Perlez, "Monetary Fund Approves \$7.6 Billion Loan to Pakistan", *The New York Times*, 2008. <https://www.nytimes.com/2008/11/26/world/asia/26pstan.html>. Accessed on 1 August 2020.

particularly to ensure IMF loans did not finance CPEC or propel Chinese business interests. If the IMF does not support Pakistan financially, China remains the only viable option.

Conclusion

Dependency on the IMF is an integral part of the Pakistani growth story. Despite assistance from China and Saudi Arabia vis-à-vis balance of payment issues, their support cannot substitute IMF assistance. In fact, the CPEC and increased Chinese presence in Pakistan augments Pakistan's burgeoning debt to China. The IMF and Pakistan will remain tied unless the latter refocuses on exports and generates sufficient tax revenue.

The question now is whether the COVID-19 crisis will spur change or deepen existing problems? For the former to happen, a change in mindset of the political and military elite is required. However, the latter is more likely to happen. COVID-19 has worsened Pakistan's economic state. The fiscal deficit has widened due to low tax revenues and trade balance has worsened as exports fell. Thus, Islamabad is likely to use the IMF's assistance to manage and overcome immediate economic struggles. What is needed, however, are comprehensive long-term structural reforms to weed out systemic weaknesses and reinstate robust institutional frameworks to facilitate industrialisation and export growth. Otherwise, debt and balance of payments crises will rear in the short-to-medium term.

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