



MCB Bank Limited

Issue # 68

Treasury & Investment Banking Group

Quid Pro Quo

ECONOMIC REPORT

THEY'RE BACK

September 3rd, 2008

The International Monetary Fund (IMF) is an international organization that oversees the global financial system. Traditionally it has been viewed with suspicion around the world and accused of promoting a fixed and rigid set of economic guidelines for developing nations. However, the IMF does play a vital role in the global economy as a lender of last resort, in addition it also provides technical assistance where required.

Pakistan and the IMF have had a checkered relationship. From 1988 onwards, Pakistan has signed up for the IMF program nine times, and if recent reports are to be believed Pakistan is on the verge of re-entering a fresh IMF program, modalities for which could be discussed as early as this month. This rumour has gained further momentum after PM Gilani stated that his government had taken the unpopular decision to raise electricity tariffs due to pressure from the World Bank and IMF. This paper seeks to assess the possibility of Pakistan re-joining the IMF program and it will bode for its future.

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BRIEF HISTORY

The international Monetary Fund (IMF) was created after WWII in 1944 with a view to stabilize the global exchange rate system and rebuild the world's economy. In its early days, members contributed to a pool maintained by the Fund, which could be borrowed from by countries facing imbalances. From the 44 member countries that started the organization the number of members has now increased substantially as has its objectives.

Today the IMF describes itself as 'an organization of 185 countries working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty'.

RELATIONSHIP WITH PAKISTAN

Pakistan has had a long and rather checkered relationship with the IMF. Since 1988 alone we have entered into nine different agreements with the organization, out of which only the last one (under Gen. Musharraf's regime) was implemented successfully. A question that naturally comes to mind is: Why was there a need to sign so many agreements?

The rationale and objectives stated by various governments may have differed, but the common denominator is always to obtain foreign exchange for balancing the burgeoning fiscal deficit. Pakistan has traditionally relied on foreign capital inflows to offset its trade imbalances but in times of crisis or global economic slowdown (which reduces the risk appetite for foreign investors) the country has had to resort to the IMF and other donor agencies, which often tend to step in as lender of the last resort.

Newly formed governments have also turned to the IMF to help resuscitate the economy – until such time it finds a foothold and is able to manage on its own. Subsequent to enrolling in IMF programs governments are also able to shift the blame of unpopular policies to external pressures and obligations. More than six





RELATIONSHIP WITH PAKISTAN ... Continued

governments have changed between 1988 and 1999, this denotes a climate of political uncertainty and weak support for the Federal government. Therefore the weak governments in order to implement reformist policies and block the pursuit of populist policies by political leaders, agreed to join the Fund's programs. Another added benefit of doing so, was debt relief and debt rescheduling, which would otherwise be very hard to accomplish by a government lacking credibility in international debt markets.

An equally intriguing question stemming from the above scenario is: Why did so many agreements fail until the last successful one?

The first reason that comes to mind is disruption caused by the continuously changing power centre. New governments led to new agreements being signed, this adversely affected the effectiveness of past programs and hence the GOP's ability to implement them successfully. Due to the short tenure of governments, policies were not implemented thoroughly enough, leading to economic fall outs. Another reason, possibly an extension of the first, is the lack of commitment to long term goals, as the newly formed political governments were more inclined towards short-term fixes, instead of a more permanent transformation of economic infrastructure. Governments simply did not want lose out to harsh reforms, only to see the benefits accrue to their political opponents.

In such a climate of political uncertainty and short life of governments it was no wonder so many IMF programs went to waste. Only the last IMF program under Gen. Musharraf was a success.





WHAT WAS DIFFERENT THIS TIME ROUND?

The Musharraf government displayed considerable political will to restore Pakistan's lost credibility. As a result of this, GOP agreed to a 10 month SBA program to demonstrate good faith to the international financial community, before moving onto a medium-term IMF program. There was good reason to yield to the Fund's demands, first and foremost Pakistan was on the verge of default on external debt and had a financial crisis that was quickly spiraling out of hand. Pakistan's foreign reserves in FY1999 were in the vicinity of a meager \$600 mn. Gen. Musharraf came to power with a promise to avert the looming crisis and set Pakistan on a long-term economic revival plan based on strong fundamentals and poverty alleviation. Due to these reasons his government gave full support to the IMF, but shared decision making powers in the Poverty Reduction Strategy Paper (PRSP).

Clearly thriving from this political stability the economy during the entire nine years tenure from 1999-2008 grew by an average 5.4% per annum, significantly better than the 4.5% average in the preceding decade. Manufacturing benefited the most during his time growing by nearly 9% on average every year more than double the average compared to 1989-1999 period's 4.7% growth, the highest growth came in FY2003-04 when LSM grew by 14.01%. The services sector has arguably been one of the most consistent performers, averaging 6.07%, with the highest growth rate in FY2006-07 of more than 8.5%. Pakistan also enjoyed considerable investment, at an average of 15.7%, highest growth was by more than 32% in FY2005-06. This is in addition to the Karachi Stock Exchange (KSE) reaching a record level of 15,676 in April 08 from 994 in June 1999, which is an unprecedented growth of around 1500%. Looking at these impressive figures international rating agencies like the S&P and Moody's improved Pakistan's ratings, increasing the economy's appeal for foreign investors by reducing cost of risk. Also Pakistan was put on the 'Next 11' list after the BRIC (Brazil, Russia, India and China) nations.

These economic milestones were possible because the government and IMF worked in unison. There was a healthy mix of autonomy and conditionality, allowing the appropriate policies to be made in accordance with IMF backing. The Fund's board was relatively flexible with its approach and examined the evidence presented by relevant authorities before setting targets. However, the Musharraf era is behind us now and the current government faces significant political and economic crises. Like its predecessors if it opts to look for assistance from the IMF, then what should we expect?



WHAT SHOULD WE EXPECT IF THE IMF DOES COME BACK?

IMF's basic objective is to; increase savings and investment, stimulate the domestic economy, bring about sustainable GDP growth and reduce poverty. To this effect, it follows a multi-pronged strategy, some of which are discussed below.

Strengthening domestic financial markets has always been a priority. Although the overall banking system has improved considerably, it is at risk of slowing down. Thereby it will be keen to bring reforms into the services sector. The Fund may also modernize the Central Directorate of Savings (CDNS) in order to better incorporate the National Saving Schemes (NSS) with domestic financial markets.

Increasing government revenue is pivotal to fiscal independence. Pakistan's tax-to-GDP ratio is relatively low at 18.22%, this limits the resources available to the government for fiscal expenditure, thus putting strain on borrowing from the SBP. Even though the FBR has drastically improved tax administration in recent years, the IMF would probably like to see the agriculture and services sectors taxed in order to increase the tax base and tax-to-GDP ratio. The Fund is also supportive of indirect taxation such as GST.

The IMF has traditionally discouraged SBP's financing of the GOP as it risks monetizing the fiscal deficit, due to spiraling growth in M2. The fund in its previous programs has set stringent NDA (Net Domestic Asset) targets. These were aimed at encouraging the GOP to borrow more from market based sources and thereby deepening its financial markets.

Trade liberalization; the IMF is one of the biggest proponents of free trade and encourages member countries to follow this policy.

These are some of the main structural reforms the Fund is likely to implement. Its strategy is aimed towards balancing the country's books by reducing current account deficit, limiting fiscal expenditure and allowing market forces to determine the exchange rate.



IMF RULE ON THE HORIZON?

IMF highlighted in a paper published in January 2008, that the government's interest rate stance, if not strengthened, may fall short of achieving the desired reduction in external current account deficit and inflation. In addition to this, they also pointed out that fiscal policy needs to be tightened to bring down the deficit. Borrowing from the central bank should be limited and money should be borrowed from private saving schemes to help halt the momentum in price levels.

However, none of these policy adjustments were adequately drafted. Hence in FY08 the economy witnessed record current account deficit of 8.4%, trade deficit of 12% and skyrocketing inflation which reached CPI 12% on average, food inflation for the same period was 17.6%.

This has prompted international financial institutions like the World Bank and IMF, to pressurize the government to cut subsidies and curtail borrowing from the central bank. The Prime Minister recently approved a hike in electricity tariffs and announced the government will phase out oil subsidies by the end of this year. A move that can be interpreted as the government having ongoing negotiations with these aid agencies.



CONCLUSION

IMF is primarily a reformist agency aiming for long-term reforms over short term solutions. Hence, their policies are often viewed as being too harsh and blunt. Domestic proponents argue that the diagnosis of economic problems carried out by IMF staff is partial and incomplete, since they are not sensitive to political realities and institutional capacities of the country. Due to this, any valuation by their staff does not take into account practicality of the implementation process. More so, there is a belief the paradigm used by IMF is based primarily on the Washington Consensus of liberalization, privatization and deregulation, something that will open the domestic economy to international competition, which it is not ready for.

Whether these arguments are right or wrong is always open to discussion . However one thing is certain, that success of the last IMF reforms was based on mutual understanding and trust between the government and IMF board. Gen. Musharraf's government extended support to the program, while the Fund was flexible in its approach when setting growth targets, encouraged by strong economic performance and competent execution of policies. The IMF program lasted four years, at the end of which inflation was low, market fundamentals were in order and the financial sector was strong, this set the economy on a strong growth path with average GDP growth of 7.42% between 2003 and 2007.

The IMF's board is due to meet the government this month and if/when a new program is drafted is anybody's guess. Having said so, the smart money is definitely on the re-emergence of a Pak IMF partnership, as the government is visibly taking tough economic decisions in order to appease the Fund, having already announced energy tariff hike, removal of subsidy on oil and a tight monetary stance.

For all the opponents of IMF reforms; empirical evidence (of over 9 agreements and counting) has shown that left to our own devices we overburden the economy, through a mixture of lax monetary policy, fiscal indiscipline and rampant subsidies – all of which are unsustainable in the long run. Hence we go back knocking.



ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	July
<u>Inflation</u>														
Headline Inflation	%	6.4	6.5	8.4	9.3	8.7	8.8	11.9	11.3	14.1	17.2	19.3	21.5	24.3
Core inflation	%	6.0	6.0	6.1	6.5	6.9	7.2	7.8	8.1	9.3	10.8	12.3	13.0	14.7
Food inflation	%	8.5	8.6	13	14.7	12.5	12.2	18.2	16	20.6	25.5	28.5	32.0	33.8
Non-food inflation	%	4.9	4.9	5	5.4	5.9	6.3	7.3	7.8	9.4	11.2	12.5	13.8	17.3
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.69	9.05	9.05	9.05	9.05	9.09	9.09	9.38	9.59	9.59	9.95	11.3	12.2205
6 month	%	8.9	9.12	9.12	9.12	9.21	9.29	9.29	9.61	9.86	9.86	9.86	11.5	n/a
12 month	%	9.16	9.39	9.39	9.39	9.4	9.49	9.44	9.87	10.13	10.13	10.32	11.7	n/a
<u>External Sector</u>														
Export	Mln US\$	1,434	1,475	1,463	1,593	1,524	1,500	1,634	1,591	1,833	1,862	1,954	1,089	1,921
Import	Mln US\$	2,423	2,206	2,150	2,555	2,864	2,910	3,316	2,909	3,549	3,406	3,241	7,869	3,117
Trade balance	Mln US\$	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1196)
<u>Remittances</u>	Mln US\$	495	489	516	580	505	479	557	502	602	590	584	547	627
<u>Forex Reserves</u>	Mln US\$	15,723	16,106	16,145	16,354	15,807	15,589	14,657	14,031	13,232	12,362	11,258	11,285	9,920

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Research Team

Treasury and Investment Banking Group
MCB BANK LIMITED
20th Floor, MCB Tower, I.I Chundrigar Road.
Karachi

Contact

Shan Husain

Telephone: 92-111-000-111 Ext: 4420

Cell: 92-321-2345300

Email: shan.husain@mcb.com.pk

Haider Ali Jafri

Telephone: 92-111-000-111 Ext: 3220

Cell: 92-3008269281

Email: haider.jafri@mcb.com.pk

Fax: 92-21-2270094

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