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Approaching the IMF

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PAKISTAN'S dire need to approach the IMF for financing has been widely discussed particularly since US Secretary of State Mike Pompeo's statement that any IMF programme should not bail out Chinese lending to Pakistan. The US has the largest quota (16.5 per cent) in the IMF, so its concerns obviously carry weight. However, the popular perception that an IMF programme will be tough only due to US pressure is misplaced. The real story might be the recently reformed IMF lending rules in 2016, which prevent the Fund from bailing out a distressed sovereign's existing creditors.

A primer on IMF lending rules: It is important to understand upfront that the Fund's lending rules vary depending on whether a country requests 'normal', or 'exceptional' (ie very large) access to Fund resources, with the bar of IMF conditions being higher for the latter. Pakistan's quota for normal access financing at the IMF is $2.85 billion. A request for Fund resources up to 435pc of its quota would be classified as normal access. For Pakistan, this amounts to $12.5bn.

It would seem at first glance that Pakistan's financing request to the IMF could be calibrated to just under this amount in order to avoid the tougher conditions associated with exceptional access. For instance, Pakistan might be able to borrow China, Saudi Arabia, Islamic Development Bank, and other non-IMF sources to bring its external financing gap below $12.5bn. However, there is a snag. Pakistan already owes $6bn in outstanding loans to the Fund from previous programmes and this counts towards the $12.5bn.

A debt re-profiling could kill four birds with one stone.

So, even with a new programme of size $6.5bn Pakistan will be considered an exceptional access case. Separately, if Fund disbursements over the first 12 months of the programme exceed 145pc of quota (around $4bn for Pakistan), this too would result in exceptional access, regardless of the total size of the new programme.

The upshot is that there are a range of plausible scenarios in which Pakistan ends up being subject to the Fund's exceptional access criteria. The toughest of these is that the IMF requires adequate safeguards on debt sustainability.

The Fund will make two assessments in this regard.

First, the Fund will decide what zone of debt sustainability Pakistan falls in. If the debt is unsustainable, it is classified in the Red Zone; if the debt is sustainable, but not with a high probability, it is classified in the Grey Zone; sustainable with a high probability falls in the Green Zone.

The Fund pays attention to two main variables when assessing the zone of debt sustainability: debt to GDP ratio, and gross public financing need/ GDP. For Pakistan, the former is close to the IMF's high-risk threshold for emerging markets (70pc of GDP), while the latter is well above the corresponding high-risk threshold for emerging markets (15pc of GDP); these thresholds are discussed in the recent Argentina exceptional access programme request in 2018. Given this, it seems unlikely that the Fund will classify Pakistan in either the Green Zone or the Red Zone, and it is likely to end up in the Grey Zone.

Second, the Fund must decide if the conditions mandated by its exceptional access lending rules are satisfied for the zone of debt sustainability the country is assessed to be in.

On this, the Fund's exceptional access lending rules generally require that countries falling in the Grey Zone undertake some kind of re-profiling operation on its existing loans. This is to ensure

IMF money is not used to pay off other junior creditors — something the Fund regretted doing during the 2010 Greek bailout.

A re-profiling is a lighter form of restructuring which usually involves a lengthening of the debt's maturity, with no change in the nominal principal or interest payments. In Pakistan's case, the re-profiling could cover the sovereign's external commercial debt, as well as bilateral loans from China as well as Paris Club creditors.

Should Pakistan re-profile its debt?: Governments generally balk at the idea of undertaking any restructuring of their debts (even of the light re-profiling variety mentioned here), because they are afraid of being shut out of markets for extended periods of time. However, this calculation may be misplaced given recent evidence that 'light restructurings have a smaller, if any, impact on market access loss compared to deeper restructurings'. Moreover, the evidence on re-profiling of debt by Pakistan (1999), Uruguay (2003) Cyprus (2013) and Jamaica (2013), indicate that re-profiling of debt "did not have destabilising effects on the banking system".

Moreover, a re-profiling will mean that IMF money will not disappear abroad as payments to external creditors but can be used to give breathing space to the new government to smooth out its fiscal adjustment efforts.

Pakistan already has some experience with such operations. It restructured a Eurobond in 1999 and received rescheduling treatments from the Paris Club in 1999 and 2001. These treatments helped restore Pakistan's debt sustainability.

In sum, if Pakistan does engage the IMF, the engagement is likely to be via the exceptional access window which has tighter conditions attached to it. With regard to debt sustainability, the Fund's lending rules may require Pakistan to re-profile its existing debt. While this may seem like painful medicine, it may not be so bad, especially for an incoming government that can blame the current woes on the previous governments' reckless borrowing.

Critically, a debt re-profiling could kill four birds with one stone: it would address US concerns that China should not be bailed out. It would be even-handed because all external creditors (including China and the Paris Club creditors) would be approached for a rescheduling. It would meet IMF requirements. And it would keep critical foreign exchange within the country, thus mitigating the pain that has to otherwise be inflicted on citizens. Still, Pakistan's long-term debt problems require long-term solutions: more efficiency in SOEs, a stronger workforce, better tax/GDP ratios, and so on.

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