FUTURE OF THE IMF PROGRAM

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Pakistan Economy

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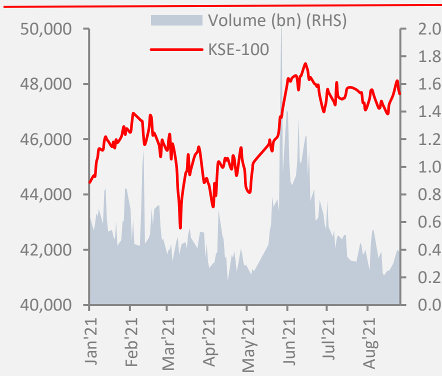
Key Data	
KSE100 Index	47,363
KSE-All Share Value (PKRmn)	11,513
KSE-All Share Value (USDmn)	69.2
KSE-All Share Volume (Shmn)	384.6
Market Capitalization (PKRtn)	6.3
Market Capitalization (USDbn)	37.9
1Year High	48,726
1 Year Low	39,072

Source: PSX, Next Research

KSE100 Index & Volume



Source: PSX, Next Research

The good news at the beginning of this report is that Pakistan received SDRs worth almost $2.8 billion from the IMF on the 23rd of August. This is part of the global injection of SDRs equivalent to $650 billion to improve liquidity position of developing countries following COVID-19. Earlier Pakistan had received a loan of $1.4 billion in June 2020 as part of the IMF Rapid Financing Instrument, following the first COVID-19 attack. $500 million were also released in March 21 following the completion of the second to the fifth review under the on-going Extended Fund Facility to Pakistan of $6 billion. The total outstanding debt of Pakistan with the IMF stands at $7634 million, as of end-March 2021. Under the Extended Fund Facility, Pakistan is to receive another $3.1 billion following successful completion of the sixth to eight reviews by September 2022. The next review, which is the sixth review, is due shortly in the first week of September. If this review is completed successfully then Pakistan will receive a loan installment of almost $1 billion.

Reforms and the implementation

Pakistan agreed to a set of reforms following negotiations in February and March 2021. Not only are the reforms wide-ranging in character but they are also tough to implement. Perhaps the best example is the big increase agreed to in power tariffs of Rs4.95 per Kwh, from February to September 2021, which is equivalent to over 30 percent of the tariff prevailing in January 2021. An increase of Rs1.95 per Kwh was implemented in February 2021. The remainder, Rs 3 per kwh, has not been implemented. The new Finance Minister has stated that it will add to inflation and other ways will be found to reduce the circular debt of the power sector. More recently, he has also asserted that it will not be possible to generate Rs 610 billion from the Petroleum Levy in 2021-22. The conditionalities to be implemented prior to the Sixth Review in September 2021 are in the form of prior actions, performance criteria, indicative targets and structural benchmarks. These are described below along with the status of their implementation.

Prior Actions: There are two key prior actions. The first is the passage of amendments to the SBP, NEPRA and OGRA Acts by the Parliament. The second is notification of the annual and quarterly price adjustments respectively to the power tariff adding up to Rs 3 per kwh. Within the set of prior actions on amendments to the SBP, NEPRA and OGRA Acts the following Act has been passed by the National Assembly:

'The Regulation of Generation, Transmission and Distribution of Electric Power (Amendment) Bill, 2021.'

It was passed on the 10th of June 2021 and relates to NEPRA. The second bill passed also on the same day is the

'SBP Banking Services Corporation (Amendment) Bill, 2021'

This provides a measure of greater autonomy in the discharge of regulatory functions by the SBP. In particular, no suit or legal proceedings can be initiated against the SBP or any director or officer of the State Bank for anything which is in good faith done or intended to be done. The required power tariff increases have not been notified as highlighted above.

Performance Criteria: There are eight performance criteria, of which two are critical. The first is the generation of a primary fiscal surplus of Rs130 billion, equivalent to 0.8 percent of the GDP, in the General Government budget in the first quarter of 2021-22. The second difficult performance criterion is a limitation on the increase in Government guaranteed debt for the State-owned Enterprises (SOEs) to only Rs 20 billion in the first quarter of 2021-22. This debt increased by Rs 80 billion in the first nine months of 2020-21. Restricting the increase during the on-going quarter to only Rs 20 billion will require a substantial improvement in the performance of SOEs and increased ability to service their debt repayment obligations. The budget deficit target has been set at 6.3 percent of the GDP for 2021-22 as agreed with the IMF. However, the IMF has apparently expressed some serious doubts about the feasibility of attaining this target. In particular, instead of a large increase in the petroleum levy required to achieve the target of Rs 610 billion in 2021-22, it has been brought down in the face of big increase in the international price of oil. This will imply lower non-tax revenues of at least Rs 100 billion in the first quarter of 2021-22. However, FBR revenues have exceeded the target for July 21 on the back of a big upsurge in imports. Generation of a primary surplus in the first quarter of 2021-22 will hinge on tight controls on expenditure. The second performance criterion of limiting the increase in the level of Government guaranteed debt will be difficult to achieve in the first quarter of 2020-21 given the on-going performance of SOEs.

Indicative Targets: Here too, there are two key areas. The first is the revenue target of FBR of Rs 5829 billion for 2021-22, which was originally set at Rs 5963 billion. The collection is the first quarter is required to be Rs 1181 billion. The second target is the reduction in the power sector payment arrears by Rs 166 billion in the first quarter of 2021-22. With regard to power sector payment arrears, for the first time, the Federal Budget of 2021-22 includes under the head of subsidies, a provision for payment of Rs 136 billion to the IPPs. Bulk of this payment may have to be made in the first quarter of 2021-22, thereby increasing the deficit in the first quarter.

Structural Benchmarks: The first is the end to tax amnesties, including that given for investment in real estate. The second is no new tax preferential treatment or exemptions in the income tax. The third relates to implementation of more and stronger measures for exit from the FATF. The Government has ended the tax amnesty to the real estate sector as of the end of June 2021. With regard to the FATF, according to the FATF President:

"Pakistan has made significant progress and it has largely addressed 26 out of 27 items on the action plan it first committed to in June 2018"

However, he added that more needed to be done on investigation and prosecution of senior leaders and commanders of UN-designated terror groups. The tax exemption provision in the Second Schedule of the ITO has actually been extended to 19 more institutions including the Abdul Sattar Edhi Foundation, SECP, Fauji Foundation, the Citizen's Foundation and the Army Welfare Trust.

Macroeconomic projections for 2021-22

The projections agreed to in February and March 2021 and highlighted in the 2nd to 5th Staff Review report of April 21 are as follows:

Table 1: Macroeconomic projections for 2021-22

	2021-22 Projections
• GDP Growth Rate (%)	4.0
• Rate of Inflation (%)	8.0
• Level of Investment (% of GDP)	15.9
Public Finances (% of GDP)	
• Revenues	17.0
• Expenditure	22.5
• Deficit	-5.5
Balance of Payments ($ billion)	
• Current Account Deficit	-5.4
• Reserves	17.8

Source: IMF

The Government has set a more ambitious target for growth of GDP at 4.8 percent. the Annual Plan rate of inflation target for 2021-22 is 6 percent. Apparently, agreement was reached with the IMF later on a budget deficit target of 6.3 percent of the GDP, which is now the target in the Federal Budget of 2021-22. The big question mark relates to the projection of the current account deficit in 2021-22. It was set earlier at a relatively low level of $5.4 billion in February 21, when the current account had been in surplus. This position has changed substantially following the subsequent surge in imports and return of a deficit. The likelihood is that the IMF may insist on the setting of a target at the lower end of the projection by the SBP of 2 to 3 percent of the GDP of up to $7 billion. This will require significant depreciation of the rupee and some increase in interest rates. Already, the rupee was projected by the IMF in April 2021 to fall to Rs 173.25 per US $ by the end of 2021-22.

Likely outcome

The Sixth Review, which is due in early September, by the IMF is likely to be the most difficult review faced by the Government since the commencement of the Program two years ago.

The issues will primarily include the following:

(i) Absence of increased power tariff notifications adding up to Rs 3 per Kwh and in this absence lack of finalization of a realistic plan for management of the circular debt.

(ii) Lack of the earlier agreed increase in the petrol levy up to Rs 30 per liter.

There are now two other areas of concern, as follows:

(i) Actions to be taken possibly in the form of import duty enhancements, increase in import margin requirements, depreciation of the rupee and higher interest rates to significantly contain the level of imports and restrict the current account deficit.

(ii) Plans for launching of the Kamyab Pakistan Program of subsidized credit, with credit guarantee, of Rs1.6 trillion to 30 million borrowers over the next three years.

Fundamentally, the IMF may try and put a brake to the strong expansionary fiscal and monetary policies being adopted by the Government so as to prevent a hemorrhaging of the current account. There is some perception that these expansionary policies may be a prelude to early elections. The Government has meanwhile tried to improve its negotiating position by borrowing more and building up foreign exchange reserves. They have gone up to beyond $20 billion to the highest ever level after receipt of SDRs of $2.8 billion from the IMF.

The finance minister has said in a recent press conference that:

"There is no Plan B. Remaining in the IMF Program is in the interest of Pakistan."

He has also indicated that there is no plan to seek a suspension of the Sixth Review and its merger with the Seventh Review, especially in light of the fourth COVID-19 attack. The IMF also has a somewhat greater interest in continuation of the Program so that Pakistan can continue to honor the bigger debt repayment obligations to it. Overall, the Sixth Review will witness tough and extended negotiations. The probability is higher that an agreement will eventually be reached and the Program will continue till September 2022. There will then be a spate of actions by the Government.

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