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With or without IMF

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Pakistan Economy

The level of economic uncertainty is at a peak these days. This is due primarily to delay in the finalization of the sixth review by the IMF of the Extended Fund Facility of $6 billion to Pakistan. Discussions between the Government team and the IMF team started in Washington on the 4th of October. This process is still on-going after almost six weeks. Usually, a quarterly review of the IMF program is concluded within one week.

The finance minister, now Advisor to the Prime Minister, had indicated that the letter of intent issued by the Government on the 9th of March contained commitments on a very tough set of actions and reforms, which include the following:

(i) Phasing out of temporary COVID-19 refinancing schemes.

(ii) Finalization of audited accounts of COVID-19 spending.

(iii) Establishment of a Single Treasury Account.

(iv) Implementation of a tax track and trace system.

(v) Harmonization of the Federal and the Provincial sales taxes.

(vi) Withdrawal of exemptions and reduced rates in the Federal sales tax.

(vii) Reduction of the number of slabs in the personal income tax with greater progressivity.

(viii) Increase in the power tariff by Rs 3 per kwh.

(ix) Settlement of arrears to the IPPs.

(x) Recalibration of the Circular Debt Management Plan.

(xi) Improvement in the targeting of electricity subsidies.

(xii) Full implementation of the AML/CTF plan.

(xiii) Implementation of the Privatization Program.

Perhaps never before had such a wide-ranging commitment been made to implement reforms in one quarter by the end of June, when the sixth review was to be undertaken by the IMF. There was a change of the finance minister on the 16th of April 2021. The actual process of carrying out the above-mentioned steps was very slow. The new Finance Minister indicated his lack of willingness to implement some of the reforms like the big escalation in power tariffs. Overall, in view of the lack of implementation of the reforms, the Fund had to postpone the sixth review to the end of September.

Current status

The Finance Advisor revealed on the 16th of November 2021 that the IMF has insisted on, more or less, full implementation of the reforms mentioned above. He has indicated that before completion of the review and submission of the review of the Executive Board of the IMF in mid-December a number of prior actions will have to be undertaken, including the following:

(i) Presentation of a Finance Bill to increase taxes to the National Assembly. On an annualized basis, roughly Rs 400 billion worth of new tax measures need to be undertaken in the sales tax domain.

(ii) Approval of the SBP amendment bill by the Parliament. This bill is to grant substantially greater autonomy to the Central Bank.

(iii) Two other prior actions which were not revealed by the Advisor.

Beyond the completion of the sixth review, the following actions have also to be undertaken:

(i) Enhancement of the petrol levy every fortnight or every month.

(ii) Reduction in the size of the Federal PSDP from Rs 900bn to Rs 700bn in the on-going financial year.

(iii) Enhancement in the power tariff early next year.

Pakistan Economy

Key Data	
KSE100 Index	46,489
KSE-All Share Value (PKRmn)	11,997
KSE-All Share Value (USDmn)	68.5
KSE-All Share Volume (Shmn)	304.2
Market Capitalization (PKRtn)	7.9
Market Capitalization (USDbn)	45.3
1Year High	48,726
1 Year Low	39,633

Source: PSX, Next Research

The tough stance adopted by the IMF has raised the fundamental question as to whether the Government will be able to implement the extremely difficult prior actions. The implications of the prior actions are highlighted below.

Autonomy of the SBP: IMF has insisted that the SBP will not be subject to the normal accountability process, it will set its own inflation target and the Government will not be able to borrow directly from the SBP. Also, the Monetary and Fiscal Policies Coordination Board will probably cease to exist. Earlier when the draft was circulated there was a strong negative reaction in the media and civil society, including economists, against the extreme autonomy proposed for the SBP. This resistance is also likely to be seen in the Parliament.

Sales Tax Reforms: The withdrawal of exemptions and reduced rates in the different schedules of the Sales Tax Act, 1990, to raise annually Rs 400 billion, will significantly raise the price level and retard the process of production in the economy. Major items on which exemptions may be withdrawn or the sales tax rate enhanced are listed in Table 1 below.

Table 1: Major Candidate items* for withdrawal of exemption or enhancement in rate

IMPORTS
Machinery; Mobile Phones; Drugs; Ingredients for Medicines; Pesticides; Medical equipment; LNG; LPG; etc.
DOMESTICALLY PRODUCED
Machinery; Ingredients for medicines; Fertilizer; Natural Gas; Tractors; Ginned Cotton; Stationery, etc.

Source: Sales tax Act, 1990
*Excluding food items

Will the Government be able to raise tax rates on machinery, agricultural inputs, natural gas, LNG, etc.? This is at a time when the political temperature is rising and there is large-scale public dissent on the high and continuing rise in the price level of essential food and other items.

Given the severe constraints, political and economic, to implementation of the major prior actions highlighted above, there is need to admit the likelihood of a decision by the Government not to implement the prior actions and effectively withdraw from the IMF Program. Therefore, two scenarios are presented for 2021-22 'with' and 'without' the IMF Program.

Economic scenarios for 2021-22

The trade-off for the Government in opting out of the IMF Program is that while it will have to take stronger measures to contain the current account deficit and face greater difficulty and higher cost of external borrowing, it will be able to contain the rate of inflation by not resorting to larger additional taxation and enhancement in the petrol levy. Also, a big increase in the electricity and gas tariffs can then largely be avoided in 2021-22. There is need to use the Macroeconomic Model built by me and my students to identify the economic scenarios with and without the IMF. The likely magnitude of the policy variables in the two scenarios are presented below in Table 2.

Measures to control imports are stronger in the 'without IMF' scenario. There will be need for a larger increase in the policy rate and bigger depreciation of the Rupee. Further, measures will be imposed of big increases in the level of import tariffs on non-essential items like automobiles and parts, exotic food items, mobile phones, other consumer durables, plastic materials, some chemicals, etc. Also, higher import margin requirements will be spread to more items.

Table 2: Projected Magnitude of the Policy Variables in the two Scenarios – 2021-22

	With IMF	Without IMF
• Rise in Policy Rate *(percentage points)*	2.0	2.5
• Extent of Depreciation of the Rupee *(%)*	12.5	20.2
• Extent of Increase in the Effective Import Tariff* on Imports *(percentage points)*	0.5	3.0
• Increase in the Tax-to-GDP ratio *(percentage points)*	2.0	1.0
• Decrease in Federal PSDP from budgeted level *(Billion Rs)*	-200	-200
• Revenue from the Petroleum Levy *(Billion Rs)*	250	100
• Increase in Electricity Tariff *(Rs per kwh)*	3.00	0.00

* The current average import tariff is just above 10%

On the domestic front, the 'without IMF' scenario will mean less increase in the tax-to-GDP ratio and no new taxation proposals implemented during the remainder of the year. Also, petroleum levy will not be subject to upward adjustment to minimize the increase in POL prices, unlike the 'with IMF' scenario when it may be increased every month. Further, the increase in electricity tariff will likely be postponed in the 'without IMF' scenario to the next year. The projected magnitude of the key macroeconomic variables is given in Table 3 in the two scenarios.

Table 3: Projected Magnitude of Macroeconomic Variables* in the 'with IMF' and 'without IMF' Scenarios, 2021-22

	With IMF	Without IMF
GDP Growth rate *(%)* *	4.5	3.5
Rate of Investment *(% of GDP)* *	14.0	13.0
Rate of Inflation *(%)* *	12.0	9.5
Public Finances *(% of GDP)* *		
• Revenues	15.5	14.5
• Expenditure	22.0	22.0
• Budget Deficit	**-6.5**	**-7.5**
• Primary Deficit	-0.5	-1.5
Trade and Balance of Payments *($ billion)* **		
• Exports of G&S	38.0	38.5
• Imports of G&S	79.5	75.5
• Trade Deficit of G&S	**-41.5**	**-37.0**
Current Account Deficit	**-11.0**	**-7.5**
Balance of Payments	**1.0**	**-5.0**
Foreign Exchange Reserves	**18.5**	**12.5**

**To the nearest 0.5% of GDP*
***To the nearest $0.5 billion*

The GDP growth rate is likely to be lower at close to 3.5 percent in the 'without IMF' scenario due to lower real consumption spending by upper income households, fall in private investment in the presence of higher interest rates and a reduced level of foreign direct investment. The rate of inflation is significantly higher in the 'with IMF' scenario despite less depreciation in the exchange rate. This is due to a higher level of sales taxation on basic intermediate inputs and consumer goods and a big increase in the electricity tariff. Also, petroleum prices will be higher because of the continuing escalation in the petroleum levy. The public finances will be in a better position in the 'with IMF' scenario due to the higher revenues from sales tax and petroleum levy. However, there may still be a primary deficit of about 0.5 percent of the GDP. As opposed to this, the primary deficit could rise to 1.5 percent of the GDP in the 'without IMF' scenario. The most important indicators in 2021-22 will be those related to international trade and the balance of payments. Exports are expected to show buoyancy in both scenarios because of the strong on-going recovery in the volume of world trade. Due to stronger measures to compress imports in the 'without IMF' scenario the level of imports could be lower by almost $4 billion than in the 'with IMF' scenario. Consequently, the current account deficit can be lower by $4.5 billion in the former scenario.

The surplus in the financial account will be substantially smaller in the 'without IMF' scenario due to the withdrawal of assistance by multilateral institutions in the absence of the IMF program. Also, Pakistan may need to seek more debt rollover, especially on project loans from China. Overall, while there will be a small BOP surplus in the 'with IMF' scenario, there will be a deficit of up to $5 billion in the 'without IMF' scenario. Consequently, foreign exchange reserves could fall to $12.5 billion in the latter scenario and the SBP will have to play a more active role in exchange rate management. The next few weeks will be witness to a lot of news on the reform and legislative fronts. The Government could meet a lot of resistance in the implementation of prior actions agreed with the IMF. Therefore, there is the need also to anticipate an economic scenario without the IMF program as done above.

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