ECONOMIC IMPACT OF THE IMF PROGRAM

By

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A staff level agreement has finally been reached with the IMF. A press note was issued from the IMF headquarters on May 12, 2019 confirming the willingness for a three year Extended Fund Facility (EFF) to Pakistan. The size of the EFF is $6 billion. However, the agreement is 'subject to IMF management approval and by the Executive Board. This requires timely implementation of prior actions and confirmation of international partners' financial commitments.'

Although the details of the policy measures and the sequencing and timing of their implementation are not fully known fairly decent professional educated 'guesses' can be made on the prior actions and other structural reforms that we will be expected to undertake during the tenure of the Program? And based on this identification of the proposed reform actions and fulfillment of performance criteria on a quarterly basis an attempt can be made to assess the likely macroeconomic impact of their implementation.

To this end this article first describes the key objectives of the Program. This is followed by identification of the prior actions in Section 2. The key targets are then derived as implied by the text of the press statement in Section 3. Section 4 then presents the likely macroeconomic impact of the IMF Program.

The 46 equation Macro Econometric Model of Pakistan developed by the authors is used to simulate the consequences of attainment of the key deficit reduction targets on important macroeconomic variables like GDP growth, investment, inflation, employment and incidence of poverty in the country, over the duration of the Program from 2019-20 to 2021-22. This will highlight the extent of the tradeoff between growth and stabilization and the price that the people of Pakistan will have to pay to eventually get the economy back on the path of sustained and, relatively, high growth.

1. PROGRAM OBJECTIVES

The Program aims to support the Government's strategy for achieving stabilization of the economy by **reducing domestic and external imbalances.** A process of structural adjustment has already started. These efforts will need to be strengthened. The EFF will support the attainment of stabilization of the economy by implementation of an ambitious macroeconomic and structural reform agenda.

The budgetary imbalance will be removed by implementation of tax policy and administrative reforms and by the achievement of greater resource mobilization. A plan of cost recovery and greater efficiency will be put in place in the energy sectors and state-owned public enterprises so as to reduce the stress on scarce public resources.

The adverse external balance of payments position and the low and declining level of foreign exchange reserves will be improved by access to significant external financing. Further, a market-determined exchange rate system is expected to enhance competitiveness, restrain imports, improve functioning of the financial sector and contribute to better resource allocation. Simultaneously, trade will be facilitated.

The Program aims to insulate the poor, to the extent possible, from any adverse consequences of the process of structural adjustment. As such, there will be emphasis on prudent spending growth aimed at preserving essential development spending, scaling up the Benazir Income Support Program and improving targeted subsidies.

2. PRIOR ACTIONS

The forthcoming Federal and Provincial budgets for 2019-20 are likely to be one of the primary means for the implementation of many of the prior actions. These are likely to include the following:

- **(i) Taxation proposals which can raise an extra Rs 700 billion of revenues in 2019-20.**
- **(ii) Attainment of a primary deficit reduction to 0.6 percent of the GDP from the likely level of a deficit of close to 2 percent of the GDP in 2018-29.**
- (iii) Containment of the growth in non-debt servicing related current expenditure.
- (iv) Likely restoration of the level of development spending to near the level proposed prior to the cut imposed in the Supplementary Budget of 2018-19.
- (v) Significant increase in the outlay of programs like the Benazir Income Support Program.

In addition, over the next few days and weeks, there is a likely **to be a 20 to 25 percent increase in electricity and even higher in gas tariffs, with the targeting of the subsidy only to lifeline domestic consumers**.

Furthermore, there will be a process of rupee devaluation to a level agreed with the IMF as the starting point for the adoption of a market determined exchange rate policy. And, already, on the 16^{th} of May a downward adjustment of almost 5 percent has taken place.

The feasibility of and full transition to the formal signing of the EFF will hinge on the success in obtaining confirmation of international partner's financial commitments. This is a very unusual perquisite. However, the financing gap is unlikely to be closed unless there is formal agreement on, for example, the rollover/rescheduling into long-term commitments (based on original maturity dates) of the deposits and 'swap' funds placed with the SBP by countries like Saudi Arabia, UAE and China, and perhaps even the commercial debt provided by 'private' institutions. These liabilities total more than US$18 billion over the next two years.

The bottom line is that most of these prior actions will be rather difficult to meet. The IMF has made it absolutely clear that unless these actions are faithfully and fully implemented there will be no EFF with Pakistan. The country has been left with no, if any, options.

3. PROGRAM TARGETS

As already mentioned above, the magnitudes of key macroeconomic variables over the Program period have, so far, not been explicitly indicated. The Government has also preferred to not make publicly available the three-year Macroeconomic Framework agreed with the IMF staff mission.

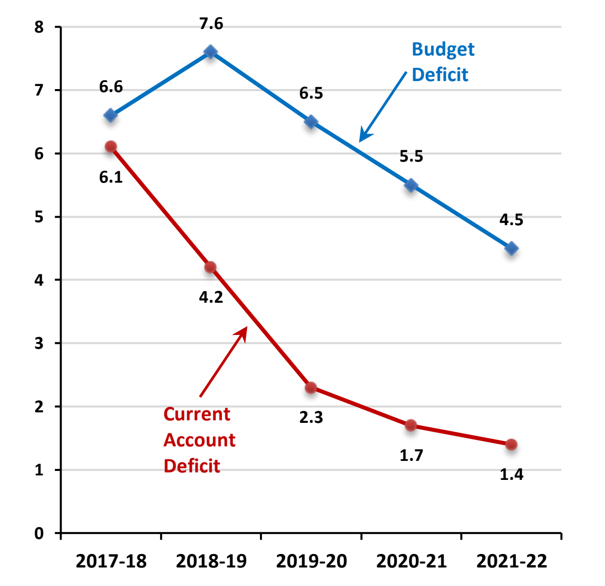
However, there are essentially only two critical targets relating to the reduction in the domestic and external imbalances, as follows:

(i) The budget deficit has to be reduced sharply so as to reduce the level of aggregate demand in the economy and thereby contain imports. Further, the level of public debt as a percentage of the GDP must start falling. The focus in the proposed EFF has shifted towards containment in the primary deficit, as opposed to its past practice of demanding a reduction in the overall fiscal deficit. This is a key element of the strategy to reduce the growth in public debt. As highlighted above, the primary deficit is expected to be brought down to 0.6 percent of the GDP in the first year of the Program from a deficit of close to 2 percent in 2018-19. A primary surplus will need to be generated in 2020-21 and reach almost 1 percent of the GDP in 2021-22.

The expectation is that the cost of debt servicing will be 5.5 percent of the GDP in 2018-19, representing a big jump in relation to the level of 4.4 percent of the GDP, due to the hike in interest rates. The budget deficit is the sum of the primary deficit/surplus and the cost of debt servicing. As such, it is expected that the budget deficit will be close to 7.5 percent of the GDP in 2018-19**. The implied targets will be to reduce the budget deficit to 6.5 percent of the GDP in 2019-20, with debt servicing at 5.9 percent of the GDP. It is assumed that the terminal year target will be 4.5 percent of the GDP in 2021-22**, as shown in Figure 1.

(ii) The most critical target relates to the reduction in the current account deficit so as to restore the sustainability of the external balance of payments. The current account deficit had reached a peak level of $19 billion in 2017-18, equivalent to 6.1 percent of the GDP. There is likely to be a significant reduction to $12 billion or 4.2 percent of the GDP in 2018-19. **Clearly, there is a need to bring the current account deficit down to a safe level of below 2 percent of the GDP during the tenure of the Program**. The assumed annual targets during the three years of the Program are also presented in Figure 1.

Figure 1: Projected Budget Deficit and Current Account Deficit



We proceed now to highlight the likely implications on key macroeconomic variables on the basis of simulations of the Macro Econometric Model to achieve the above two key targets.

4. MACROECONOMIC IMPACT

Revenues: the expectation is that an additional Rs 700 billion (in our view Rs.600 billion now that Rs.100 billion will come from the vacation of the stay of the earlier SC decision on taxation of telecom related services) will be generated in the budget of 2019-20 through implementation of a large number of taxation proposals relating particularly to withdrawal of exemptions and special treatment by both the Federal and Provincial Governments. Although more than Rs.250 billion of tax exemptions relate to international commitments (FTAs, PTAs, CPEC, etc.) and on basic consumer goods at the Federal level greater scope lies in the eliminations or adjustments in the case of special treatments-like the existing lower rate of GST on LNG and motor spirit (plus import duty on the latter), the reversal of the generous exemption limit on the income tax liability of salaried and non-salaried individuals, etc.. At the level of the provinces there is a long overdue need to develop the potential of the Agriculture Income Tax and Property Tax and continued efforts to expand the base of the GST on Services.

If achieved, this will raise the tax-to-GDP ratio by 1.7 percent to 14.2 percent in 2019-20. Thereafter, a feasible target over the next two years will be to raise the tax-to-GDP ratio to 16 percent of the GDP in 2021-22. This will require implementation of taxation proposals in 2020-21 and 2021-22 of Rs 350 billion and Rs 250 billion respectively. Overall, **over the three years of the Program this target is ambitious and involves an increase in the tax-to-GDP ratio of 3.5 percent**. This is perhaps one of the most challenging targets in the Program and the success or failure of the Program will probably hinge on the performance of tax revenues. It is, of course, possible that the Government may have agreed to a somewhat less ambitious target for 2021-22. Non-tax revenues are expected to remain at 2.2 percent of the GDP.

Total Expenditure: **The budget deficit is assumed to be brought down in the Program by over 3 percent** of **the GDP**. Therefore, there will be some fiscal space to increase the level of public expenditure by almost

0.5 percent of the GDP during the Program. The assumption is that this will primarily be in development spending, including the BISP and other interventions for social protection.

The key projected magnitudes of public finances are presented in Table 1.

Table 1: Budgetary Projections – *(% of GDP)*					
	2017-18	**2018-19**	**2019-20**	**2020-21**	**2021-22**
A. TOTAL REVENUES	**15.2**	**14.5**	**16.2**	**17.2**	**18.0**
Tax Revenues	***13.0***	***12.5***	***14.2***	***15.2***	***16.0***
Federal	11.8	11.4	12.9	13.8	14.4
Provincial	1.2	1.1	1.3	1.5	1.6
Non-Tax Revenues	**2.2**	**2.0**	**2.0**	**2.0**	**2.0**
Federal	1.8	1.6	1.6	1.6	1.6
Provincial	0.4	0.4	0.4	0.4	0.4
B. TOTAL EXPENDITURES	**21.8**	**22.1**	**22.7**	**22.7**	**22.5**
Current Expenditure	***17.8***	***18.7***	***18.8***	***18.6***	***18.4***
Federal	***11.8***	***12.7***	***12.7***	***12.5***	***12.3***
Debt Servicing	4.4	5.5	5.9	5.6	5.4
Others	7.4	7.2	6.8	6.9	6.9
Provincial	***6.0***	***6.0***	***6.1***	***6.1***	***6.1***
Development Expenditure	**4.0**	**3.4**	**3.9**	**4.1**	**4.1**
Federal	2.1	1.8	2.0	2.1	2.1
Provincial	1.9	1.6	1.9	2.0	2.0
C. BUDGET DEFICIT	**-6.6**	**-7.6**	**-6.5**	**-5.5**	**-4.5**
Primary Deficit/Surplus	-2.2	-2.1	-0.6	0.1	0.9

The critical magnitudes in the balance of payments are described below:

Exports: The performance of exports is also an extremely crucial factor in determining the success or failure of the prospective EFF. During the last two years intensive efforts have been underway to revive exports after their fall since 2013-14 with some recovery in 2017-18. Not only has a big devaluation of the rupee been resorted to but also an export incentive has been offered. Zero rating has been given to overall sales. In addition, subsidized electricity and credit is being offered to exporters and imported inputs into production of exports have been exempted from import duties. However, exports have remained stagnant in the first ten months of 2018-19. This is perhaps the kernel of the structural problem that Pakistan faces.

The likelihood is that the IMF may have insisted only on the use of instrument of depreciation of the rupee as the mechanism for boosting exports, along with withdrawal of other measures representing special treatment of exports. Consequently, the pressure on the rupee is going to be even greater during the tenure of the Program.

The projection is that a minimum growth rate of 6 percent annually will be required in exports of goods and services during the tenure of the Program.

Imports: Imports have contracted by 8 percent in the first ten months of2018-19. This has been achieved by a combination of the rupee depreciation, use of ITPs, levy of regulatory duties and imposition of cash margin requirement on selected imports. The IMF may also insist on the withdrawal of the last two measures as contrary to the goal of 'facilitating trade'. They will probably be withdrawn soon and reliance placed here also on containment of imports entirely by the instrument of rupee depreciation. **In order to achieve a significant reduction in the current deficit of the magnitude described earlier there will be need to reduce imports of goods and services by at least 6 percent in 2019-20.**

Table 2: Balance of Payments Projections – *($ billion)*					
	2017-18	**2018-19**	**2019-20**	**2020-21**	**2021-22**
Trade Deficit in Goods & Services	**-36.9**	**-32.0**	**-29.1**	**-26.7**	**-28.3**
Exports	30.1	20.6	32.8	35.1	36.2
Imports	67.0	62.6	61.9	61.8	64.5
Primary & Secondary Income (Net)	**17.9**	**19.9**	**21.1**	**22.4**	**23.7**
CURRENT ACCOUNT DEFICIT	**-19.0**	**-12.1**	**-8.0**	**-4.3**	**-4.6**
FINANCIAL ACCOUNT SURPLUS	**13.7**	**12.0**	**8.5**	**7.4**	**7.5**
Others*	-1.0	-0.7	1.2	0.8	0.8
BALANCE OF PAYMENTS	**-6.3**	**-0.8**	**1.7**	**3.9**	**3.7**
RESERVES WITH SBP	**9.8**	**9.0**	**10.7**	**14.6**	**18.3**

Import Cover in Months	1.7	1.7	2.0	2.9	3.4

** Equal amount of IMF financing of $2 billion annually for three years from 2019-20 onwards.*

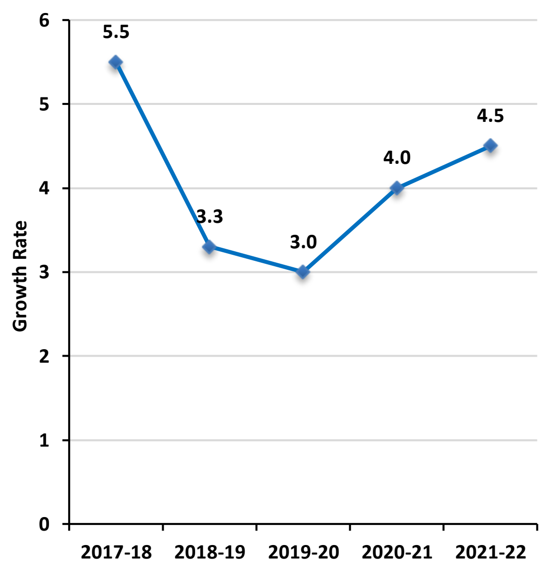
The projected likely magnitudes of the key components of the balance of payments are presented in Table 2. They are, of course, based on the rollover of deposits, swap funds with the SBP and of other repayments due. Without this, it is clear that there will be no Program with the IMF.

Moreover, we may also have to borrow an additional US$15-20 billion over the next two years to achieve the projected level of reserves.

Given the greater pressure on the rupee, the Model indicates that **the Real Effective Exchange Rate (REER), with the base year of 2010, will have to be substantially reduced during the next three years. It is close to 100 currently and will have to be brought down to almost 75 by end-June 2022.**

GDP growth: The GDP growth rate has already come down sharply in 2018-19 due to the initial steps towards stabilization. PBS estimates that the growth rate will be 3.3 percent as compared to 5.5 percent in 2017-18.

Figure 2: Projected GDP Growth Rate – *(%)*

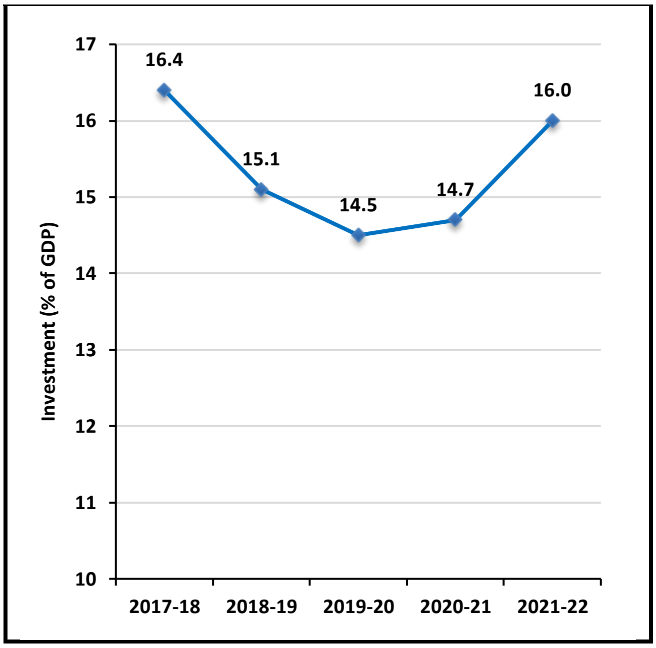


There is a high level of risk that the economy's growth rate could plunge further to 3 percent or below in 2019-20. First, private consumption expenditure in real terms will be limited by the lack of significant increase in disposable income due to higher direct taxation and by the increased tax burden on goods and services.

Second, private investment is likely to fall in real terms due to the hike in interest rates. In fact, the SBP policy rate may reach a peak rate of 14 percent in 2019-20. Also, the price of capital goods will rise relative to the domestic price level due to the continuing devaluation of the rupee. Third, the growth in public consumption expenditure will be restricted by the effort to reduce the fiscal deficit. Beyond 2019-20 there may be some upsurge in the GDP growth rate to 4.5 percent by 2021-22.

Rate of Investment: The overall rate of investment, public plus private, is also expected to fall significantly to near 15 percent of the GDP in 2018-19 as compared to 16.4 percent of the GDP in 2017-18. This will be due, in particular, to the big reduction in the size of the national PSDP.

Figure 3: Projected Investment – *(% of GDP)*



The year, 2019-20, is likely to witness a further decline in the overall level of investment to 14.5 percent of the GDP, as shown in Figure 3, due primarily to the fall in private investment for reasons already given above. This will represent the lowest level of investment since 2010-11. Beyond 2019-20, there is the expectation of a rise due to the recovery in public development spending.

Rate of Unemployment: With low GDP growth and a decline in the level of investment it is not surprising that **the number of unemployed workers will increase sharply by 51percent from 3.7 million in 2017-18 to 5.6million by 2021-22.** The cumulative number of jobs created over the four year period, 2018-19 to 2021-22, is 5 million, as compared to the increase in labor force of 6.9 million. The PTI commitment of creating 2 million jobs annually will appear to be a distant pipedream. In fact, **the unemployment rate is expected to rise from 5.8 percent in 2017-18 to almost 8 percent by 2020-21**, as shown in Figure 4. It may fall somewhat in 2021-22 if the economy attains a growth rate of 4.5 percent or more.

Figure 4: Projected Unemployment Rate – *(%)*

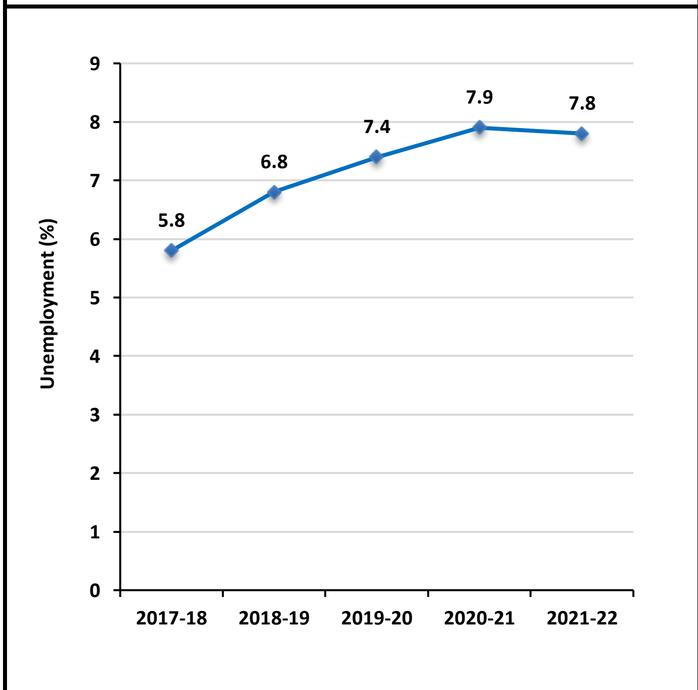
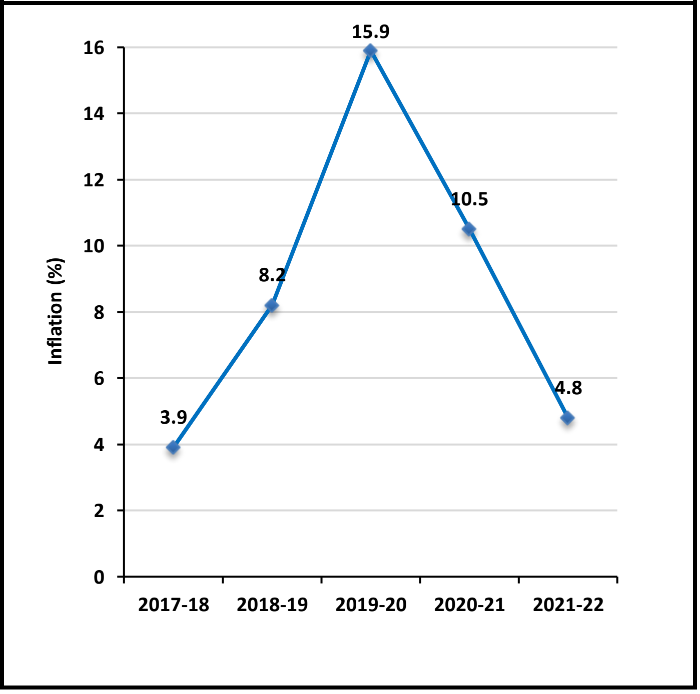


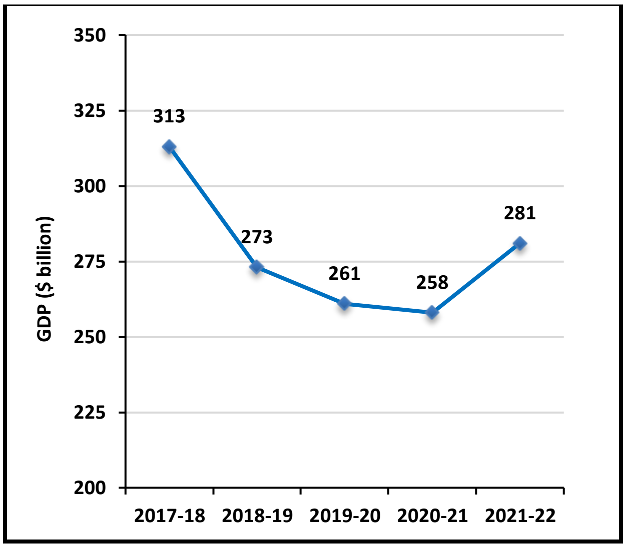
Figure 5: Projected Rate of Inflation – *(%)*



Rate of Inflation: The monthly average of the year-to-year rate of inflation in the consumer price index is estimated at 8.2 percent in 2018-19. The upsurge from 3.9 percent in 2017-18 is due primarily to the large depreciation in the value of the rupee. The Model indicates that **high double-digit inflation could be reached in 2019-20, with a peak rate of 16 percent**, as shown in Figure 5. This will be due to the spread and deepening of inflationary expectations as well as the rise in prices of imported products due to the continuation of the process of depreciation of the rupee and higher burden of indirect taxes. The rate of inflation is expected to fall in 2020-21 to 10 percent and to below 5 percent by 2021-22.

Figure 6: Projected GDP – *($ billion)*

Level of GDP: The sharp devaluation of the rupee at a rate generally faster than the rise in the implicit GDP deflator will lead to a hitherto unprecedented situation where the GDP starts falling in terms of US$, as shown in Figure 1, from 2018-19 onwards up to 2021-22. In fact, **the GDP in US$ is estimated in 2021-22 at $281 billion, which is even lower than the GDP in 2017-18 of $313 billion.** The per capita income could fall to $1300 by 2021-22. This is even lower than the per capita income of Bangladesh, which is currently at $ 1516, and rising at a fairly rapid rate.



Incidence of Poverty: The 'stagflation' from 2018-19 to 2020-21 will inevitably lead to a large number of people falling below the poverty line, as shown in Figure 6.The number of poor is likely to increase by over 4 million in 2018-19, by 5.2 million in 2019-20, by 3.6 million in 2020-21 and by 0.4 million in 2021-22. **Cumulatively the number of people falling below the poverty line during the IMF EFF to Pakistan is over 9 million**, equivalent to an increase in the incidence of poverty of almost 4.5 percentage points.

Overall, the process of stabilization under the umbrella of a three-year IMF Program could impose enormous strain on the economy and on the people of Pakistan, in the first two years, 2019-20 and 2020-21. The GDP growth rate is likely to be low, investment will plummet downwards, the rate of inflation will rise and the level of unemployment and number of poor people will increase perceptibly.

The heavy front loading in the IMF scheme of things is in contrast with the more gradual and less stressful pace of adjustment of the policy actions and choice of instruments proposed in our own Home-Grown Macroeconomic framework (printed earlier in these pages, with proposals on efforts on the economy of recurrent expenditures to dilute the burden of the measures related to additional taxation) aimed at achieving the same objectives. Unfortunately, this is the price the vast majority of people will be required to pay under the IMF program to minimize the risk of default, a daunting challenge for a PTI government with a wafer-thin majority in Parliament. It will, therefore, be vital for the PTI Government to seek and enlist the support of the opposition for pushing through the deep and comprehensive reform agenda, even under a less strenuous arrangement. Hopefully, the process of high and sustainable growth will become more feasible after 2020-21. **However, there will still be a need to repay all debts that are rolled over during the tenure of the Program.**

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