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IMF programme targets for 2019-20

The Extended Fund Facility [EFF] to Pakistan of $6 billion, over a period of 39 months, has finally been blessed by the Executive Board of the IMF. Prior to this, a number of measures had to be taken to qualify for the programme. This included a 12 percent depreciation of the Rupee following the Staff level agreement on the 12th of May. A tough Federal Budget was presented on the 11th of June which included additional taxation of almost 1.2 percent of the GDP and some economy in expenditure associated with our security needs. An understanding was also reached that henceforth there would be no resort to borrowing from the SBP to finance the budget deficit. Earlier, the Monetary Policy Committee of the SBP had announced a big jump of 150 basis points in the Policy Rate on the 20th of May. More recently, there has been big escalation in gas and power tariffs.

These prior actions have been justified on the grounds, first, that the economy is in a highly vulnerable position with negative net international reserves. Also, Pakistan's credibility to undertake major structural reforms has been questioned by the inability to do so during the last Programme and the poor historical record of financial management since 2015-16 but also generally in previous programmes.

The IMF has issued a statement after the Executive Board meeting. The Acting Managing Director has highlighted that 'Pakistan is facing significant economic challenges' and employing the usual platitudes emphasized on the need for undertaking wide-ranging and deep reforms to restore sustainability and take the economy eventually on to a trajectory of higher and more inclusive growth.

The annexure to this statement highlights the Programme reform agenda. This includes strong fiscal consolidation for reducing public debt, especially by increasing the revenue to GDP ratio by 4 to 5 percent of the GDP by the end of the Programme. Other steps as already mentioned above include a transition to a flexible, market-determined exchange rate, energy sector reforms to eliminate quasi-fiscal losses and improving governance and transparency while facilitating the ease of doing business.

It also contains the projections of the magnitude of the key variables, based on the likely impact of reforms, for 2019-20, the first year of the EFF. The estimates of these variables for 2018-19, the base year, of the Programme are also presented so as to highlight the extent of stabilization that is likely to be achieved in the first year. The three year Macroeconomic Framework of the Programme is likely to be released shortly and will present the projections for the last two years, 2020-21 and 2021-22.

The objective of this article is to access the likelihood of the targets being attained in 2019-20. This, of course, also requires an examination of the validity of the base year estimates for 2018-19. Part I focuses on the GDP growth, investment and rate of inflation. Part II examines the validity of the balance of payments projections and Part III of the public finances for 2019-20.

The IMF projections are compared with the projections which emerge from over 46 equation Macro Econometric Model of Pakistan, with simulations run with the likely magnitudes of the policy variables in 2019-20.

Macroeconomic projections

The Fund Programme projects the GDP growth rate to fall to as low as 2.4 percent next year. This is barely above the rate of population growth. However, as highlighted in subsequent sections, real public expenditure, excluding debt servicing, will expand rapidly by almost 5 percent, as envisaged in the budgets of the Federal and Provincial Governments in 2019-20.The volume of exports is expected to grow by over 8 percent next year while imports are projected to fall by almost 5 percent. In our opinion, these three developments will serve to raise the aggregate level of demand in the economy, even in the presence of falling private investment, owing to the high and rising interest rates. Therefore, the economy may perform somewhat better and achieve a GDP growth rate of close to 3 percent.

The rate of inflation in 2019-20 is projected at the average rate of 13 percent, with a rate below 12 percent at the end of the year. This implies that given the relatively low inflation of below 9 percent in June 2019, the monthly inflation rate will peak mid-year and then start falling. The peak rate attained in December 2019 could be as high as 18 percent, especially in the face of a rapidly falling Rupee. Also, as highlighted later, if the depreciation of the exchange rate has to be large so as to achieve the targeted reduction in the trade deficit then the average inflation rate in 2019-20 may approach 15 percent.

Balance of payments

The first year, 2019-20, of the Program targets for a big reduction in the current account deficit, from 4.6 percent of the GDP in 2018-19 to 2.6 percent of the GDP in 2019-20. In absolute terms, this will require a fall from $13 to $14 billion in 2018-19 to between $6 and $6.5 billion in 2019-20. This will represent a big downward adjustment of more than 50 percent in one year in the current account deficit. In effect, this will be the litmus test of success or failure of the Programme in its first year.

As indicated above, the proposed strategy for achieving a reduction in the deficit is to boost exports by over 8 percent while containing imports by almost 5 percent. Exports have, in fact, been hit negatively by the Budget of 2019-20. The zero-rating scheme has been partially rescinded, input invoicing of energy inputs has been withdrawn, a 10 percent sales tax has been imposed on ginned cotton and pending refunds have crossed Rs 200 billion. Given these fiscal moves and justifiable doubts about the ability of the FBR putting in place a mechanism for the efficient and timely processing of exporters' tax refunds (which would aggravate their liquidity and working capital difficulties) the prospect for 8 percent growth in exports is low.

The likely unavoidable result of these developments will be greater reliance on the depreciation of the currency to reduce imports sharply so as to achieve the targeted reduction in the current account deficit of $7 to $8 billion in 2019-20. The probability is that the fall in the value of the rupee will be even more than the decline observed in 2018-19. It will not be surprising if this leads to a fall in the real effective exchange rate of over 12 percent in 2019-20.

Turning to the external financing requirement, the IMF statement says that $38 billion will be mobilized by the Programme from multilateral and bilateral creditors for Pakistan during the tenure of the Programme. This raises the question of what will be the cumulative external financing requirements of the country over the next three years.

We estimate that the repayments of external obligations (including private debt) over the IMF programme period will be close to US$55 billion. Adding an estimated gross Current Account deficit of US$20 billion over the same period (assuming an average annual Current Account Deficit of US$6-7 billion) the gross financing requirement will be roughly US$75 billion. Although the US$20 billion deficit of the Current Account could be an underestimate if interest rates on commercial borrowings through Euro Bonds, Sukuks and commercial bank loans continue to remain elevated (despite the country having entered into an IMF programme) in view of the likely lingering concerns of the market about a) the level of public debt; b) the precarious negative level of Net International Reserves; and c) the time it will take for key economic indicators to improve and convey a feeling of sustainability for market sentiment to become sanguine and more assured.

It will obviously not be possible for us to raise this volume of funding to meet liabilities of US$75 billion. Part of this gross financing requirement will require a rollover/rescheduling of debt of about US$20 billion (of which $14 billion has already been announced by the government as having been arranged). Of the $55 billion, inflows of Foreign Direct Investment could finance around $7 billion while $38 billion as already stated by both the IMF and the Government will be extended as funding support from "international partners" (IMF, World Bank, Asian Development Bank, DFiD/UK Aid, Islamic Development Bank. Since this figure includes the rollover of debts totaling US$14 billion the net inflow from other partners, excluding the IMF, will be in the range of $18-19 billion, none of which were represented in the negotiations of the programme but have seemingly still made commitments to provide this level of funding.

After accounting for this support there will a funding gap of $23 billion to be financed from other sources-more likely in the form of loans at commercial rate of interest. And if our Foreign Exchange Reserves are to be around US$15 billion (the equivalent of 3 months imports) at the end of the Programme then given the current reserves level of $7 billion we will need an additional $8 billion to build them up to cover three months imports, suggesting that we may need additional debt of $30 billion unless the $8 billion for the build-up of reserves will purchased by the SBP from the market (with all its implications for the exchange rate). On the assumption that we can raise an extra $3-4 billion as private debt and SBP picks up $8 billion from the domestic foreign currency markets, there may well be a potential financing gap of $18 billion. In other words, if we close 2019/19 with an external public debt of approximately us $107 billion our external debt on the culmination of the programme (2021/22) could be touching $125 billion. This will result in our external public debt to GDP ratio to rise to 42 percent or as a ratio of export earnings to almost415 percent, in stark contrast to the proclaimed primary objective of the programme, in the words of the IMF, "to reduce public debt", especially if, as is the likely outcome, real interest rates on debt (after factoring in further depreciation in the exchange rate of the rupee) end up being higher than the growth rate of the economy..

Public finances

The basic problem is that the IMF estimates for 2018-19 generally present a better set of the budget outcomes than is likely to be the case. This is probably largely a reflection of the optimistic revised estimates for 2018-19 presented in the Federal and Provincial Budget documents for 2019-20. These estimates tend to overstate the revenue-to-GDP ratio and understate the total expenditure-to-GDP ratio in 2018-19.

A prime example is that the of the revenue-to-GDP ratio. The IMF estimate is that it will be 15 percent of the GDP this year. This is based on FBR revenues of close to Rs 4150 billion. By now, it has become clear that there will be a bigger shortfall, even after the inclusion of the once-and-for all revenue from the Asset Declaration Scheme. As such, FBR revenues are unlikely to exceed Rs 3,900 billion.

Further, there has been little growth in Provincial revenues during 2018-19. In fact, in the first nine months there was zero growth in national tax plus non-tax revenues. However, the IMF estimate implies a growth rate of 10 percent for the year as a whole. This requires that the growth rate of revenues in the last quarter of the year was as high as 31 percent. This is definitely not the case.

A more credible estimate of the revenues-to-GDP ratio for 2018-19 is 14 percent of the GDP, indicating a fall of 1.3 percent of the GDP from last year's level. The fiscal effort required to achieve the Programme target of 16.3 percent of the GDP in 2019-20 is, therefore, much greater. The revenues-to-GDP ratio, will, in effect, be required to increase by 2.3 percent of the GDP in one year. This implies that a growth rate of 35 percent will be required in Federal and Provincial tax and non-tax revenues combined. This is well beyond the realm of possibilities, especially with very limited real growth or even fall in the various tax bases and a flattening out of non-tax revenues; for instance, if imports decline, the associated revenues from this source, which make up almost 45% of total tax revenues, will also be adversely affected.

The second major problem is that there is no real downward adjustment proposed in the fiscal deficit and in the size of the public debt in 2019-20. The Fund has indicated that the former will remain locked in at close to 7 percent of the GDP while the latter will increase by almost 2 percent of the GDP. The basic problem is that perhaps for first time in any IMF programme with Pakistan since the late 80s the focus has shifted towards the reduction in the primary deficit only and not in the overall budget deficit. This focus on the primary deficit has unwittingly provided an incentive. If not a free licence to even take on expensive debt, instead of emphasizing debt consolidation. We have, therefore, a situation in 2019-20 where the prime deficit could come down significantly while the budget deficit does not change or even increase as a percentage of the GDP. Therefore, the pressure on aggregate demand in the economy will continue and lead to less containment of the current account deficit. This must be considered as a serious flaw in the design of the new IMF Programme.

In conclusion, there is need to recognize the extraordinary efforts, perhaps belatedly, to get an EFF from the IMF. This should hopefully reduce uncertainty about economic sustainability and the risk of an incipient financial crisis. However, the Programme's targets for the first year look somewhat difficult to achieve even in the presence of a restrictive monetary policy, given the relatively expansionary nature of fiscal policy. The first IMF Quarterly Review on October 2019 will tell us how the Programme is beginning to perform. Any slippages in revenue, prospects for which look ominous with a slowing down of economic activities, reinforced by the short-term disruption caused by the budgetary measures, may just require a mini-budget not far down the road.

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