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IMF Executive Board Concludes 2009 Article IV Consultation with Pakistan

On March 30, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Pakistan.[1]

Background

Since the last Article IV Consultation in December 2007, Pakistan has been facing significant economic difficulties. With sharp increases in oil and food prices, and adverse security developments, Pakistan has experienced a significant widening of the fiscal deficit, owing in large part to increasing energy subsidies, and major pressures on its balance of payments. As a result, inflation rose considerably and international reserves declined sharply.

To address these challenges, in October 2008, the authorities embarked on a stabilization program for 2008/09–09/10 (July-June) aimed at restoring financial stability while protecting the poor. This program, supported by a Stand-By Arrangement (SBA), envisages a significant tightening of fiscal and monetary policies to bring inflation down and strengthen the external position, and includes several structural measures in the fiscal and financial sectors.

Initial developments since the approval of the program have been generally positive. The exchange rate has been broadly stable, enabling the State Bank of Pakistan (SBP) to buy foreign exchange on a net basis. As a result, gross international reserves have increased from US$3.5 billion at end-October to US$6.7 billion as of February 20. Despite the somewhat improved confidence, credit and broad money demand growth have been slower than envisaged under the program.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Policy implementation has been good and the program remains on track. All quantitative performance criteria and the structural benchmarks for the first program review were met. The end-December fiscal deficit target, which proved challenging, was achieved through a combination of revenue and expenditure measures.

Social protection is a key element of the program. In this context, the authorities pressed ahead with the strengthening of the Benazir Income Support Program (BISP), which provides cash grants to the poorest families. The expansion of BISP will increase the spending on social transfers from 0.4 percent of GDP in 2008/09 to 0.6 percent of GDP in 2009/10.

Banks have weathered the crisis well thus far, but should be monitored carefully. Based on the recently conducted Financial Sector Assessment Program (FSAP) update, the banking system appears to be generally well-capitalized and liquid. Aggregate financial soundness indicators improved since the 2004 FSAP, although the worsening macroeconomic environment affected adversely bank profitability and asset quality in 2008. Gross nonperforming loans rose from 7.7 percent of total loans in June 2008 to 9.1 percent in December 2008 but capital adequacy ratios stayed around 12 percent of risk-weighted assets over the same period.

The global economic and financial environment has deteriorated significantly since the start of the program. In light of these developments, the authorities agreed with the mission on a revised macroeconomic framework (with lower growth and inflation) and supporting policies for 2008/09 and beyond. The authorities have chosen to adhere to the program's fiscal target for 2008/09 and continue with further fiscal adjustment in 2009/10. There should be scope for the State Bank of Pakistan to lower its discount rate if inflation abates, the external reserve position continues to improve, and the government can sell T-bills to banks and nonbank private investors.

Pakistan needs additional external assistance to reduce risks, and greater development and social spending. The upcoming donor meeting planned for April provides an important opportunity for mobilizing additional assistance.

Executive Board Assessment

Executive Directors commended the authorities for the progress achieved under the stabilization program. Directors observed that fiscal consolidation and improved coherence between fiscal and monetary policies have helped to tackle the roots of large imbalances, while structural reforms have progressed broadly as envisaged. As a result, the exchange rate has broadly stabilized, inflation has come down, and foreign reserves have strengthened.

Directors noted the increased risks stemming from the subdued global outlook and slower domestic activity. Weaker demand for exports and uncertainty about workers' remittances entail important risks for the external position, while tight domestic credit and dim external private financing prospects could constrain growth. Directors also observed that political risk had risen recently.

Directors commended the authorities for adhering to the program’s fiscal deficit target for 2008/09 under difficult circumstances and supported the envisaged fiscal adjustment for 2009/10. Referring to the ambitious revenue target, they encouraged the authorities to identify additional contingency fiscal measures to avoid last-minute expenditure compression.

Directors stressed that, over the medium term, higher revenues will be critical to create fiscal space for development and social spending. They welcomed the action plan to reform tax policy and administration. Directors emphasized in particular the need to replace the general sales tax with a broad-based value added tax. They also commended the planned establishment of a medium-term budget framework.

Directors welcomed the focus on social protection in the authorities’ program. They were encouraged by the progress under the BISP, which envisages a considerable increase in social transfers in the coming years. Directors underscored the importance of reviewing other components of the social safety net, with a view to possibly merging existing cash transfer plans with the BISP, and eliminating gaps and overlaps between the federal and provincial programs.

Directors indicated that the monetary policy stance was appropriate. They agreed that interest rates should be kept on hold for the time being in order to avoid financial pressures and to further consolidate disinflation. Directors saw some scope for lowering interest rates in the future, provided that inflation further declines and international reserves continue to strengthen. They stressed the need to continue to avoid central bank financing of the government.

Directors welcomed the envisaged strengthening of the SBP’s policy framework. They emphasized that the operational independence of the SBP needs to be enhanced, and its quasi-fiscal operations transparently accounted for and eventually eliminated.

Noting the staff’s assessment that the rupee may be slightly overvalued, Directors observed that the exchange rate had remained broadly stable in recent months. Looking ahead, they saw the need to maintain exchange rate flexibility in order to strengthen external competitiveness and respond to a volatile external environment.

Directors noted that Pakistan’s financial system has weathered the crisis well. They welcomed the recent formulation of contingency plans for dealing with problem banks. Directors encouraged the authorities to monitor developments closely and to assess potential problems on a timely basis.

Directors welcomed the intention to address the circular debt in the energy sector, which should help ease constraints on economic growth originating in the energy sector, though noting that further steps are needed to arrest new accrual. They also welcomed the intention to eliminate electricity subsidies.

Directors encouraged the authorities to further strengthen the regime for addressing money laundering and the financing of terrorism. In addition, they noted the need for effective implementation and consolidation of the institutional framework.

Directors emphasized the need for additional external assistance to strengthen the economy and to provide scope for greater development and social spending. The upcoming donor meeting should provide an important opportunity for mobilizing additional external assistance.

Pakistan: Selected Economic Indicators, 2007/08–2009/10 1/
(Population: 160.9 million (2007/08))
(Per capita GDP: US$1,042 (2007/08))
(Poverty rate: 23.9 percent (2004/05))

	2007/08	2008/09		2009/10	
		Prog.	Proj.	Prog.	Proj.
	(Annual percentage change)				
Output and prices					
Real GDP at factor cost	5.8	3.4	2.5	5.0	4.0
Partner country demand (WEO definition)	4.5	…	…	…	…
Consumer prices (period average)	12.0	23.0	20.0	13.0	6.0
Consumer prices (end of period)	21.5	20.0	10.0	6.0	6.5
Pakistani rupees per U.S. dollar (period average)	…	…	…	…	…
	(In percent of GDP)				
Saving and investment					
Gross saving	13.2	13.5	14.2	15.6	15.6
Government	-2.8	-1.1	-0.9	0.8	0.8
Nongovernment (including public sector enterprises)	16.0	14.5	15.1	14.9	14.8
Gross capital formation 2/	21.6	20.0	20.1	21.3	19.9
Government	4.3	3.0	3.2	3.8	4.0
Nongovernment (including public sector enterprises)	17.2	17.0	16.9	17.5	15.9
Public finances					
Revenue and grants	14.6	15.1	15.4	16.1	16.0
Expenditure (including statistical discrepancy) 3/	21.7	19.1	19.6	19.2	19.2
Budget balance (including grants)	-7.1	-4.0	-4.2	-3.1	-3.2
Budget balance (excluding grants)	-7.4	-4.2	-4.3	-3.3	-3.4
Primary balance	-2.5	0.6	0.6	1.6	1.5
Total government debt	57.4	54.6	56.9	52.4	55.4
External government debt	26.2	26.9	27.9	27.1	26.2
Domestic government debt	31.2	27.7	29.1	25.4	29.1
	(Annual changes in percent of initial stock of broad money, unless otherwise indicated)				
Monetary sector					
Net foreign assets	-7.8	-4.9	-3.4	1.8	-1.4
Net domestic assets	23.2	15.7	11.8	14.1	12.1
Broad money	15.3	10.8	8.4	15.9	10.6
Private credit (percentage change)	16.4	25.2	8.3	19.6	14.1
Six-month treasury bill rate (period average, in percent) 4/	9.6	12.7	…	…	…
External sector					
Merchandise exports, U.S. dollars (percentage change)	16.5	12.0	-5.5	11.0	1.6
Merchandise imports, U.S. dollars (percentage change)	31.2	1.1	-14.5	5.7	-5.5
Current account including official current transfers (in percent of GDP)	-8.4	-6.5	-5.9	-5.7	-4.3
	(In percent of exports of goods and services, unless otherwise indicated)				
External public and publicly guaranteed debt	169.7	160.0	186.3	154.2	189.0
Debt service	15.2	16.9	23.1	15.4	20.2
Implicit interest rate (in percent) 5/	5.0	2.4	2.4	3.2	2.4
Gross reserves (in millions of U.S. dollars) 6/	8,591	8,591	9,091	11,291	10,591
In months of next year's imports of goods and services	2.7	2.1	3.0	2.6	3.3
Memorandum items:					
Real effective exchange rate (annual average, percentage change)	-0.8	…	…	…	…
Terms of trade (percentage change)	-10.2	…	…	…	…
Real per capita GDP (percentage change)	4.1	1.6	0.9	3.3	2.4
GDP at market prices (in billions of Pakistani rupees)	10,478	13,384	12,970	15,880	14,298
GDP at market prices (in billions of U.S. dollars)	167.6	...	...	...	...

Sources: Pakistani authorities; and IMF staff estimates and projections.

1/ Fiscal year ends June 30.

2/ Including changes in inventories. Investment data recorded by the Pakistan Federal Bureau of Statistics are said to underreport true activity.

3/ Expenditure on social assistance in 2008/09 is budgeted at 0.5 percent of GDP. The program will target an additional 0.3–0.5 percent of GDP.

4/ 2008/09: average for June–December 2008.

5/ Calculated as interest payments in percent of the end-of-period debt stock of the previous year.

6/ Excluding gold and foreign deposits of commercial banks held with the State Bank of Pakistan.