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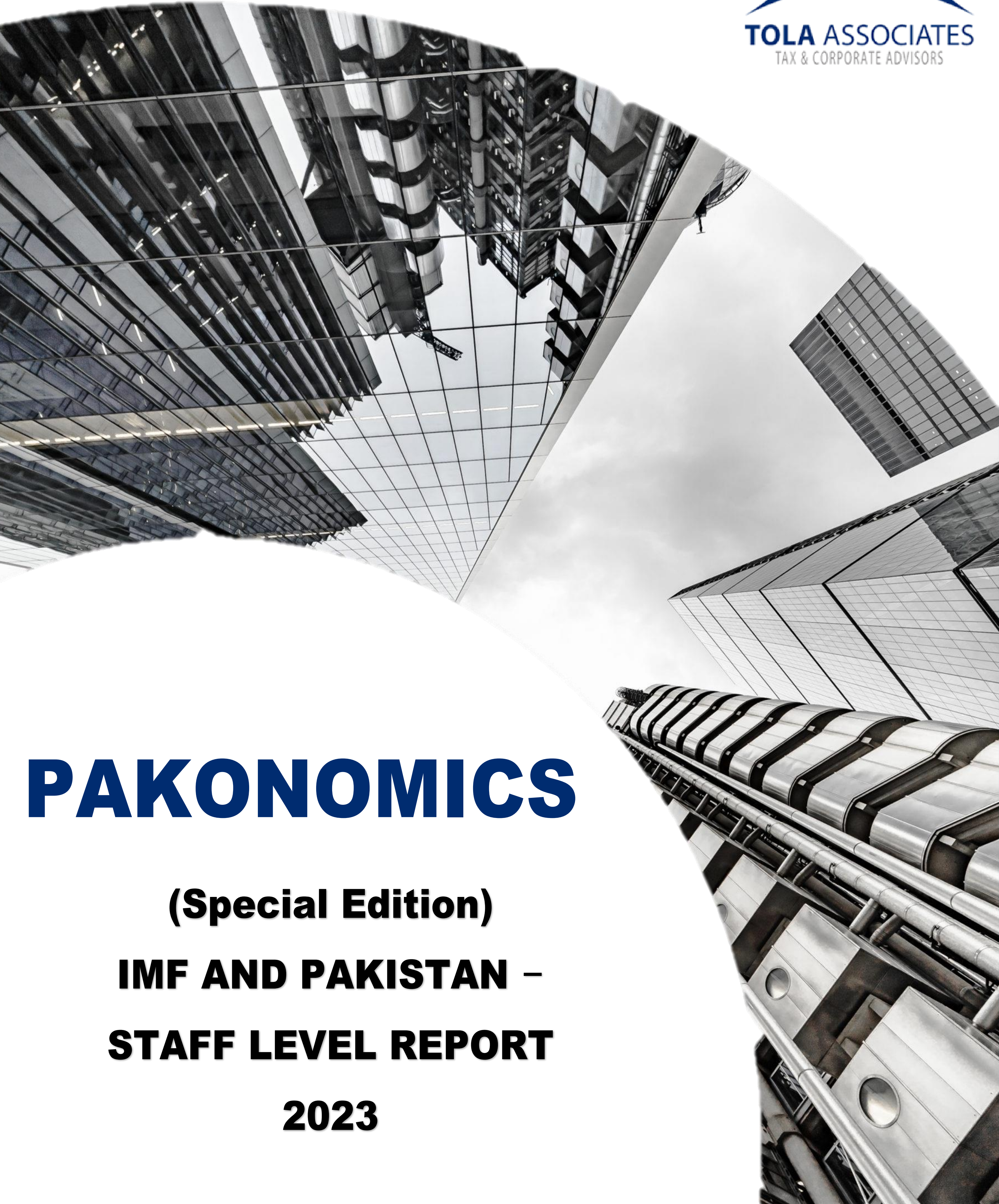

PAKONOMICS

(Special Edition)

IMF AND PAKISTAN – STAFF LEVEL REPORT 2023

PREAMBLE:

Asalam-o-alaikum everyone! Hope this publication finds you in good health. It is no secret that the economy of Pakistan is trying to climb out of an extremely precarious situation, amidst a global recession, and the supply chain disruptions that have occurred due to; (a) The disastrous floods; and (b) Political turmoil. Among these uncertainties and supply chain disturbances, we are pleased to report that Pakistan and the International Monetary Fund ("IMF") have reached a staff-level agreement ("SLA"), marking a significant milestone in their ongoing collaboration to address the country's economic challenges and foster sustainable growth. This agreement reflects the joint commitment of both parties to implement prudent economic policies and reforms that will steer Pakistan towards a path of macroeconomic stability and fiscal resilience.

The SLA between Pakistan and the IMF represents a significant step towards addressing the economic challenges and fostering sustainable growth. The projections by the IMF underscore the importance of maintaining policy discipline and implementing reforms to achieve macroeconomic stability and fiscal consolidation. As such, we recognize the significance of these indicators and policy implications.

Moreover, the policy measures agreed between Pakistan and the IMF have been endorsed by the Executive Board of Directors of the IMF, pursuant to which a Stand by Arrangement ("SBA") has been approved and signed between Pakistan and the IMF. The duration of this SBA will be 9 months, with a review scheduled after every 3 months.

We hope this publication will assist our readers in a better understanding of the macroeconomic indicators that influence the economy of Pakistan.

Towards the end, we would like to reiterate that tough times never last, and that our prayers are with Pakistan to recover from the economic downturn it has unfortunately been marred with due to, *inter-alia*, political instability and the floods.

Kind Regards,

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Designed by Salman Ahmed

Contents

IMF AND PAKISTAN – STAFF LEVEL REPORT:

(July 2023)

The International Monetary Fund ("IMF") has issued a country report following the approval of the Executive Board for a nine-month SBA for Pakistan, amounting to SDR 2.25 billion (USD 3 billion). The report includes a thorough assessment of Pakistan's current economic conditions and outlines the economic and financial policies that the Pakistani authorities intend to pursue to address the ongoing challenges.

The comprehensive report of the IMF contains; a Press Release featuring a statement from the Chair of the Executive Board, a Staff Report prepared by a dedicated team for the Executive Board's consideration, a Staff Statement providing updates on recent developments, and a Statement by the Executive Director for Pakistan.

The IMF acknowledges the commendable efforts made by the Pakistani authorities during the second half of Fiscal Year 2023 ("FY23"). However, it is essential to highlight that challenging economic, social, and political conditions, alongside insufficient external financial support hindered significant progress in successfully concluding the Extended Fund Facility ("EFF") that officially expired on June 30th, 2023.

To address these obstacles and maintain macroeconomic stability, the Pakistani authorities have taken proactive measures and renewed their commitment to implementing necessary policy actions. Consequently, they have sought assistance from the IMF under a new SBA. This demonstrates their determination to tackle economic challenges and foster sustainable growth.

Program objectives. The discussions focused on four policy pillars: (i) An appropriate FY24 budget to support needed fiscal adjustment; (ii) A return to a market-determined exchange rate and proper functioning of the Forex (FX) market to absorb Balance of Payment shocks and eliminate FX shortages; (iii) An adequately tight monetary policy to support disinflation and anchored expectations; and (iv) Continuation of structural efforts to strengthen the energy sector viability, SOE governance, and the banking sector, while supporting efforts to build Pakistan's climate resilience.

Projections of Economic Indicators:

The IMF projects a moderate upturn in Pakistan's real GDP, with a projected GDP growth of at 2.5% in FY24, compared to a growth of 0.29% in FY23. The recovery is expected to be influenced positively by base effects from flood recovery, particularly benefiting sectors like agriculture and textile. However, the full impact on the economy might be delayed due to the time required for normalization regarding import management. External challenges and the need for stringent macroeconomic policies may pose additional obstacles to the recovery process.

Furthermore, the IMF forecast indicates that the average Consumer Price Index ("CPI") for FY24 is expected to be 25.9%, compared to 29.6% in the previous year. The end-of-period inflation is projected to fall below 20% only in the fourth quarter of FY24.

Over the past two years, inflation has been on a steady rise, but it is anticipated to decrease starting from June 2023 due to base effects and reduced contributions from food items. However, price pressures are likely to remain high, partly because of delayed monetary tightening and elevated inflation expectations. The core inflation is expected to gradually decline in FY24, due to necessary policy tightening, which typically operates with a lag.

The deceleration in inflation is expected to continue in FY25, with the possibility of achieving single-digit end-of-period inflation only by mid-FY26. This indicates that while there is a positive trend in inflation reduction, it may take some time for inflation to return to more manageable levels.

Moreover, the fiscal deficit is expected to be around 7.5% of GDP in FY24, higher than the 6.5% projected by the Ministry of Finance for FY24. However, the fiscal space has been negatively impacted, and persistent vulnerabilities in the fiscal and debt position call for maintaining small primary surpluses in the coming years.

Lastly, the current account deficit ("CAD") is projected to widen to 1.8% of GDP (USD 6.5 billion) in FY24, compared to 1.7% of GDP (USD 6.00 billion) as per the annual planning projection of Pakistan. The increase in CAD is anticipated due to the recovery in both exports and imports. To ensure stability and build reserves, it is crucial to maintain a moderate CAD of around maximum 2% of the GDP over the medium term, aligning it with projected official and capital flows. This approach will effectively manage external imbalances and strengthen Pakistan's financial position in the future.

The chart *infra* illustrates the projections made by the IMF and the Ministry of Finance and Ministry of Planning of Pakistan for FY24:

Key Economic Indicators		
	IMF Projection	**Pakistan's Govt. Target**
GDP (%)	2.5	3.5
Inflation (%)	25.9	21.0
Budget Balance (% of GDP)	(7.5)	(6.5)
Primary Balance (% of GDP)	0.4	0.4
Current Account Balance (% of GDP)	(1.8)	(1.7)
		(Source: IMF and Ministry of Planning and Finance)

A. Fiscal Policy:

The FY24 budget sets forth a strategy for gradual fiscal improvement, with one of its key objectives being to achieve a primary surplus 0.4% of GDP. To boost tax revenues, several measures have been put into effect, amounting to over PKR 254bn, including:

- Increasing the maximum Petroleum Development Levy ("PDL") to PKR 60/liter, with a target of reaching an average rate of PKR 55/liter during FY24, that is expected to generate PKR 79 billion.

- Implementing an increment in the Personal Income Tax (“PIT”), that is likely to generate PKR 30 billion.
- Rationalizing tax exemptions for fertilizer, anticipated to result in PKR 34 billion in revenue.
- Doubling the tax on sugary drinks, adding PKR 8 billion in additional revenue.
- Raising the advance tax on the purchase and sale of immovable property, yielding PKR 46 billion.
- Expanding the tax base for non-filers owning second homes and high-wealth items, leading to PKR 19 billion in revenue.
- Increasing the advance tax for builders and developers based on the land size of the project under development, generating PKR 15 billion.
- Raising the additional General Sales Tax (“GST”) on deliveries to businesses not registered for VAT, expected to generate PKR 23 billion.

Broad-based reforms will have to continue to improve the fiscal framework.

- **Strengthening revenue administration**: The authorities will seek to expand the PIT base by another 300,000 persons through the use of data on the withholding tax of businesses, third-party data, and physical surveys to book new individuals.
- The service sector, especially retailers, will also be targeted for tax inclusion by better utilizing data, such as tax collected through electricity bills on commercial connections.
- The authorities in Pakistan are implementing policy measures to enhance Public Financial Management (“PFM”) and improve oversight of State-Owned Enterprises (“SOEs”). This includes:
    - The operationalization of a central monitoring unit (“CMU”) within the Ministry of Finance to analyze performance of the SOEs, full implementation of the treasury single account (“TSA-2’) for efficient cash management, and the issuance of periodic reports on SOEs' performance.
    - Additionally, commitment control systems are being strengthened to enhance budget execution and expenditure controls.
- **Improving Debt Management.**
    (i) Provide adequate resources for Debt Management Office (“DMO”) staffing and expeditiously fill vacant positions, including at the director-level;
    (ii) Effectively empower the DMO to implement the agreed medium-term debt management strategy (“MTDS”), which will be updated annually.
    (iii) The government plans to lengthen the maturity profile of public debt and manage the cost-risk trade-off of fixed-rate versus floating-rate long-dated debt.

Beneath tables illustrates the projections of General Government Budget made by the IMF.

Pakistan: General Government Budget						
PKR billion	**FY23E**	**FY24F**	**FY25F**	**FY26F**	**FY27F**	**FY28F**
Revenue and grants	9,637	13,426	15,399	17,322	19,311	21,579
Revenue	9,602	13,377	15,296	17,215	19,206	21,477
Tax revenue	8,456	11,261	13,093	14,738	16,442	18,385
Federal	7,789	10,393	12,086	13,606	15,178	16,971
FBR Revenue	7,200	9,415	10,952	12,330	13,754	15,379
Direct taxes	3,271	3,884	4,420	4,961	5,536	6,232
Federal excise duty	414	600	711	800	897	1,004
Sales tax/VAT	2,566	3,607	4,297	4,853	5,404	6,019
Customs duties	949	1,324	1,524	1,716	1,916	2,124
Petroleum surcharge	542	869	1,008	1,134	1,265	1,415
Gas surcharge	38	69	80	90	100	112
GIDC	9	40	47	52	58	65
Provincial	667	868	1,007	1,133	1,264	1,414
Nontax revenue	1,146	2,116	2,202	2,477	2,764	3,092
Federal	7,789	10,393	12,086	13,606	15,178	16,971
Provincial	667	868	1,007	1,133	1,264	1,414
Grants	35	49	103	107	105	102
						(Source: IMF)

B. Poverty Reduction and Social Protection

- A higher BISP envelope
  - (i) To achieve a more meaningful UCT Kafalat generosity level;
  - (ii) Accelerate enrollment into the conditional cash transfer ("CCT") schemes for child education and health, which will also enhance school enrollment rates of girls;
  - (iii) Align CCT stipends with actual schooling and food costs; and
  - (iv) Ensure an adequate budgetary contingency to address exogenous shocks (including climate events).

C. Monetary and Exchange Rate Policies

- IMF emphasized that the SBP will need to continue its monetary tightening cycle to re-anchor expectations given that inflationary pressures are expected to persist over the coming year.
- Implementing a tighter monetary policy stance is crucial to address the ongoing inflationary pressures and bring inflation back within the target range of 5-7% by the end of FY25.

- To re-anchor inflation expectations and achieve the desired results, the SBP needs to maintain its monetary tightening cycle. This involves using higher interest rates and prudent liquidity injections based on incoming data.
- Reducing external imbalances and rebuilding reserves requires permanently ending administrative controls and actions to manage the current account and returning to a market-determined exchange rate
- The exchange rate will be market determined, allowed to act as a shock absorber, and free from formal or informal guidance or restrictions.
- Rates in the interbank and open market have converged, but a significant premium persists in the informal market. Pakistan must aim to ensure that the interbank-open market premium remains within a ±1.25 percent range on average.
- Moreover, Pakistan must remain committed to removing the remaining exchange restriction and multiple currency practice (MCP) when BOP conditions stabilize by the end of the program.
- According to the International Monetary Fund's latest projections, it is anticipated that the average exchange rate could reach approximately Rs305 per dollar by the conclusion of the current fiscal year. This projected rate surpasses the exchange rate quoted by the government while formulating the budget for the ongoing year (Rupee-dollar parity projected to remain volatile – Express Tribune).

D. Financial Sector:

- IMF emphasized close monitoring of the financial sector due to economic downturn and external financing challenges potentially impacting it.
- To ensure all commercial and microfinance banks meet minimum capital requirements, taking timely action to address capital shortfalls or regulatory non-compliance, including recapitalization plans or orderly market exit.
- Strict adherence to regulatory limits for banks' foreign currency exposure is crucial, alleviating the need for negative net open positions with a return to a market-determined exchange rate.
- Postpone extending deposit insurance to microfinance banks until sector vulnerabilities are addressed.
- Progress to be made in revising early intervention, resolution, and crisis management frameworks, including the deposit insurance scheme, with related draft amendments submitted to cabinet and planned submission to parliament by end-December 2023.
- Ensuring effective implementation of Anti-Money Laundering/Combating the Financing of Terrorism ("AML/CFT") measures.

E. Energy Sector Policies:

- Restoring energy sector viability requires urgent and tangible reform.
- Key measures include: (i) Notification in full (and, if needed, retrospectively with effect from July 1, 2023) of the FY24 annual rebasing (“AR”) as per the National Electric Power Regulatory Authority’s (“NEPRA”) imminent determination.
- Some modest relief from near-term measures aimed at improving distribution efficiency (primarily on the collection side).
- Steadfast acceleration of crucial medium-term cost-reducing reforms.
- Timely alignment of power tariffs with cost recovery levels and established tariff structure.
- Regular tariff adjustments, including one annual review, four quarterly tariff adjustments (“QTAs”), and twelve monthly fuel price adjustments (“FPAs”) per fiscal year, are crucial to implement the CDMP, limit fiscal pressures, and ensure the viability of power generators.
- Better targeting of power subsidies to protect vulnerable populations, introduce fairness, and reduce fiscal costs.
- Commitment to the third stage of the multi-year subsidy reform plan, supported by the World Bank, and submitting a subsidy rationalization reform plan for tube-wells for large agricultural users by end-2023.
- Sparing the lifeline and protected slabs during tariff adjustments to increase progressivity of the tariff structure for residential consumers and enhance fairness.
- Pursuit of other medium-term reforms to reduce costs and Circular debt (“CD”).

Natural Gas:

- Persevere with regular biannual end-user gas price adjustments as per established formulae and timelines.
- Protect the most vulnerable consumers by sparing the protected slabs during price adjustments.
- Work with the World Bank on preparing guidelines for implementing the weighted-average cost of gas pricing (“WACOG”) law for the next regular OGRA determination.
- Develop reliable CD data, management, and projection capacity.
- Implement cost-reducing reforms, particularly to reduce UFG losses through infrastructure improvements, network rehabilitation, and theft control.

F. Structural Policies:

- Strengthening the governance, transparency, and efficiency of the SOEs to limit their fiscal risk.
- Commendation for enacting the new SOE law in early 2023.
- Urgency in progressing, with ADB support, on developing a new ownership policy and amending several SOE-dedicated Acts

- Gradually reduce the state's involvement in SOEs based on the March 2021 SOE Triage, including divestment of two LNG-based power plants, one development finance institution, and one small public bank.
- Continue regular and timely audits of key SOEs.
- Boost business environment, job creation, and investment for sustainable growth and development.
- Simplify procedures to start a business and remove unnecessary regulations.
- Streamline the FDI approval process.
- Improve trading across borders by reducing custom-related processing time and simplifying import/export document preparation.
- Simplify and harmonize the process of paying taxes.
- Enhance product market access and promote the adoption of information and communication technologies.
- Strengthen the effectiveness of anticorruption institutions.
- Encourage authorities to seek capacity development support for identifying crucial institutional governance reforms.
- Enhance timely provision of key macroeconomic data.
- Implementation of Quarterly National Accounts.

Conclusion:

The question of whether the IMF program alone can sufficiently lift Pakistan out of the current economic turmoil will only be answered in the months to come. Whilst, the IMF program can certainly play a crucial role in providing financial support and implementing structural reforms, it is imperative for Pakistan to undertake significant tax reforms, as emphasized and recommended by the Reform and Resource Mobilization Commission ("RRMC") through its interim report. The spotlight is now firmly on the RRMC and its proposed reforms / recommendations. It is intrinsic for the current Government and the future Government to accept the measures proposed by the RRMC and implement them in letter and spirit. These measures have the potential to yield substantial benefits to the country, as they could generate approximately PKR 1.5 trillion in tax revenue and, importantly, promote fairness and equity in the broken taxation system of Pakistan.
Furthermore, achieving the targeted GDP growth rate of 3.5% appears to be attainable, driven primarily by the projected surge in bumper agricultural production and the expected rebound of the Large Scale Manufacturing ("LSM") sector in ongoing FY24, which will be boosted by favorable base effects.
Additionally, in our humble view, inflation can be anticipated to potentially decrease to 21%. This potential decrease will be contingent on falling prices of petroleum products, palm oil and coal, which will ultimately reduce production costs and contribute to a more stable economic environment.

As such, this potential decrease in inflation can yield a positive impact by facilitating a reduction in interest rates by 3 to 4%, leading to significant interest expense savings worth approximately PKR 1.2 trillion rupees. This may provide fiscal space to Pakistan and contribute in reducing the fiscal deficit. This would place Pakistan in a more advantageous position compared to economies burdened with twin deficits and operating at negative interest rates.

Moreover, it is truly commendable to witness a significant upswing in Pakistan's economy, exemplified by the current account maintaining a surplus for the fourth consecutive month in June 2023. This noteworthy achievement has contributed to an impressive 85% reduction in the full-year current account deficit, resulting in a mere $2.56 billion deficit for the previous Fiscal Year 2023. These positive economic indicators not only reflect the nation's resilience but also pave the way for a more prosperous outlook in the upcoming Fiscal Year.

The sustained surplus in the current account signifies a favorable balance of trade, and it is a promising sign of economic stability and potential growth. The reduction in the deficit showcases improved fiscal management and prudent financial policies, instilling confidence in investors and stakeholders. As a result, Pakistan's economic prospects are expected to gain momentum, with increased investment, business expansion, and improved overall economic performance anticipated in the coming Fiscal Year.

However, it is crucial to recognize that the successful realization of these favorable outcomes hinges on the proper and effective implementation of the recommended reforms and policies by the RRMC. This entails prudent planning, efficient execution, and strong commitment from policymakers, as the path to economic stability and growth can be challenging but ultimately rewarding for Pakistan's future prospects.