9 April 2021

IMF Program

Conditions are manageable; reforms to continue

Following the resumption of the IMF EFF Program and disbursement of a third tranche of US$500mn in late March 2021 (total disbursement: US$2.0bn since July 2019), major performance targets have been updated in the recently released IMF Staff report.

Broadly, the set of performance targets are largely the same as at the start of the program in July 2019. Since most of these are in advanced stages of being completed, we believe that the targets are achievable for the government. Therefore, barring any political distraction or escalation of the third wave of Covid-19 in Pakistan, we think the reform process can continue smoothly. Aside from the outlook for higher sales tax in case of some sectors, there are few other negatives for corporate profitability, in our view.

It is also worth noting that the IMF has kept the original tenure of the program the same as before the Covid-19 pandemic, despite a year-long suspension. That is, it is slated to complete by June 2022. Hence, the remaining disbursements will be larger than in the original schedule (please refer the table on Page 2 for the revised schedule). This is an additional positive from the perspective of balance of payment stability, in our view.

Fiscal measures

- The IMF has set a target for FBR tax collection of PKR6.0tn for FY22f, c.23% higher compared with the revised target of PKR4.7tn for FY21. For this, the following two measures are recommended:
  - Equalizing of **General Sales Tax** (GST) at 17% for sectors which enjoy lower or zero rates. This could be inflationary in the medium term, as many affected products are in the Food or Agriculture sectors; but it is possible that this move is introduced gradually.
  - Rationalizing of **Personal Income tax** - entailing lesser slabs than presently (12) and at potentially higher rates.
- The IMF has recommended the **withdrawal of Covid-19 related relief packages**, with the exception of an increase in the fund size of Benazir Income Support Program (BISP), which entails handouts for the impoverished and vulnerable segments).
- The IMF has not recommended any cuts in **infrastructure expenditure**; instead, it has suggested to utilize the fiscal space created by the above revenue measures. In our view, the expenditure will continue to be depressed in FY21/22f (PSDP: average c.2.6% of GDP during FY19/20 vs. c.4.4% in the prior three years), given the ambitious Revenue targets.

The above measures will be reflected in the upcoming Budget for FY22. It is worth mentioning here that based on our recent interactions with the IMF, it seemed to be open to adjusting the negotiated terms – should the third wave of Covid-19 escalate into another health and economic crisis in Pakistan. We think this could mean deferring the withdrawal of the relief measures in place since the first wave of Covid-19, should the need arise.

Monetary and Financial

- The IMF has reiterated that the present **Monetary Policy** is appropriate, given the present output gap and an uncertain outlook. Recall that the SBP has kept the policy rate unchanged at 7.0% since July 2020.
- **Housing package:** The IMF recommends the removal of the condition on commercial banks to lend up to 5% of their loan portfolio to the Housing and Construction sectors – as it may distort credit allocation in the economy. While this may be positive for the Banking sector's asset quality, it can potentially make the financing of the Naya Pakistan Housing scheme difficult for the government, in our view, as the scheme entails limited public funds (hence, negative for Construction sectors).
- The amended SBP Act retains the central bank's ability to continue **Refinancing facilities**, but it should not compromise the Bank's primary goal of price stability. As per the SBP, these facilities (LTFF and TERF) will be unchanged after the passage of the Act.
- The market-determined regime of **exchange rate** should continue, but the SBP may intervene to (i) shore up its Forex reserves, or (ii) contain excessive market volatility.
- IMF requires the establishment of **Single Treasury Accounts** by May 2021 (a structural benchmark).

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There is now clarity that the restriction on quasi-fiscal activities of the SBP (as per the proposed amended Act) does not cover the SBP's ability to continue refinancing facilities (concessionary loans for certain priority sectors). This is positive as it has been a very effective tool for incentivizing exports and fixed asset investment by industries.

Energy & SOE Governance

- The IMF has added the completion of **payments to the IPPs** as per recent negotiation as a new Structural Benchmark targeted for end-May 2021 (first tranche: PKR180bn). Recall that so far the payments have not been disbursed due to bureaucratic delays.
- **Power tariffs** will be increased cumulatively by more than c.PKR5.0/KWh (c.30% of present weighted average) through quarterly adjustments in March, June and September 2021 – including a PKR3.34/KWh increase in the base tariff and the remainder being pending fuel cost adjustments.
- As per the proposed amended **NEPRA Act**, which is a structural benchmark and targeted to be instated by the government by June 2021, further power tariff hikes will have to occur automatically. NEPRA is the Power sector regulator.
- **Power tariff subsidies** – which are estimated to cover nearly 93% of residential customers – will have to be restricted to the most vulnerable only.

Note that the IMF has no longer pushed for deliverables related to privatization of Power sector related SOEs (the distribution companies or Discos in particular), which is widely considered to be a long-term solution of the circular debt problem. In our recent discussions with the IMF, it was reasoned that privatization in the Power sector will inevitably take more years than the tenure of an IMF program, and it is not practically possible to require quantifiable targets in such a program. The power tariff hikes will increase the CPI by 1.0ppt, all else the same; to counter which, the government will have to achieve significantly lower food prices (through administrative measures in some cases), in our view.

To reiterate, we think that the set of performance targets laid out in the report are not difficult for the government to achieve as most of them are already close to completion. Hence, the reform process should continue with little hurdles from here, and our overall thesis on the Pakistan market – a sharp rebound in corporate profitability and rerating of the market to long-term mean valuations (from a FY22f P/E of c.5.7x to 9.0x) – remains well intact.

IMF forecasts for major economic indicators of Pakistan

	2020A	2021f	2022f	2023f
Real GDP growth (%)	(0.4)	1.5	4.0	4.5
CPI – (yoy %)	10.8	8.7	8.0	7.3
C/A Deficit as % of GDP	(1.1)	(1.5)	(1.8)	(2.0)
Fiscal Deficit as % of GDP	(8.1)	(6.7)	(5.1)	(4.0)
Primary balance as % of GDP	(1.8)	(1.1)	0.3	1.5
FBR Revenue (PKR tn)	4.0	4.7	6.0	6.9
Govt. Debt to GDP (%)	92.8	92.9	88.2	82.1
External Debt to GDP (%)	41.3	42.1	41.7	40.3

Source: IMF

Selected Structural Benchmarks

Target	Completion
Establishment of TSA-1	end-May 2021
PKR180bn payment to the IPPs	end-May 2021
Rationalization of Power tariff cross-subsidy	end-June 2021
Annual rebasing of power tariff	end-June 2021
Track and trace system for Tobacco	end-June 2021
Amendments of OGRA Act	end-June 2021
Notification of 4QFY20 power tariff	end-Sep 2021

Source: IMF

Timeline of the EFF program with larger disbursements than originally

	Amount of Purchase		
Availability Date	**SDR mn**	**USD mn***	**Conditions**
July 3, 2019	716	1000	Approval of arrangement
December 6, 2019	328	450	1st review and end-Sep, 2019 performance criteria
March 5, 2021	350	500	2nd, 3rd, 4th and 5th reviews performance criteria
June 4, 2021	750	1000	6th review and end-Mar, 2021 performance criteria
September 3, 2021	491	700	7th review and end-Jun, 2021 performance criteria
December 3, 2021	491	700	8th review and end-Sep, 2021 performance criteria
March 4, 2022	491	700	9th review and end-Dec, 2022 performance criteria
September 2, 2022	651	1000	10th review and end-Jun, 2022 performance criteria
Total	**4,268**	**6,000**	

Source: IMF
**based on current exchange rate*

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Neutral	Total return expectation of > -5% or expected to match the return of KSE-100 index
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*Based on 12 month horizon unless stated otherwise in the report.

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Risks: Delay in achievement of SBs, (ii) populist decision making by the government, and (iii) opposition regaining momentum

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