

PAKISTAN—PROGRAM NOTE

Current IMF-Supported Program: 25-month, US\$11.3 billion Stand-By Arrangement (SBA), originally approved by the IMF's Executive Board on November 24, 2008 and augmented on August 7, 2009, in conjunction with the Board's second review of the program.

Background

Until the current economic crisis broke in 2008, Pakistan had enjoyed a relatively robust economic performance. Warning signs emerged in 2007 and early 2008, as inflation began to rise and external imbalances arose, even though growth remained strong. Conditions worsened significantly in mid-2008 with the sharp increase in international food and fuel prices and the deterioration in the security situation. Growing fiscal deficits, due in large part to energy subsidies, were financed by the central bank through the expansion of the money supply. As a result, inflation reached 25 percent in mid-2008, the rupee depreciated, and foreign currency reserves fell sharply. The high rate of inflation was particularly harmful to vulnerable social groups. Events urgently needed to be brought under control.

Role of the IMF

In Fall 2008, the Pakistani authorities embarked on a stabilization program to address the current crisis, supported by nearly US\$7.6 billion under a 23-month SBA. This exceptional financial support was necessary given the country's sizeable external imbalances and the risk of large capital outflows. In August 2009, during the Executive Board's second review of the program, IMF support was raised to US\$11.3 billion to address increased risks and financing needs, and the program was extended to 25 months. The program aims to:

- restore financial stability through a tightening of fiscal and monetary policies to bring down inflation and strengthen foreign currency reserves;
- protect the poor by strengthening the social safety net—this is a key element of the government's policy strategy; and
- raise budgetary revenues through comprehensive tax reforms to enable significant increases in public investment and social spending, needed to achieve sustainable growth.

Progress to Date

The program got off to a good start and Pakistan's economy has continued to stabilize. Macroeconomic imbalances have shrunk and inflation has fallen. The exchange rate has

stabilized and foreign currency reserves have increased from \$3.3 billion in November (before the SBA approval) to about \$8.3 billion in July 2009.

Demand for treasury bills has increased in response to an initial rise in interest rates by 200 basis points, allowing the government to retire some of its debt to the central bank. As the economic and financial situation improved, the authorities were able to lower the policy interest rate by 100 basis points in April 2009. Raising budget revenues, however, has been challenging and the authorities are striving to maintain fiscal discipline by eliminating non-priority spending. Nevertheless, preliminary data indicates that the budget deficit target (excluding grants) for 2009/10 has been missed by 0.9 percentage points of GDP. At the same time, the current account deficit has started to narrow, helped by the decline in oil prices, and inflation has dropped to 13.1 percent in June 2009. Important steps have been taken to strengthen bank supervision, reform the electricity sector, and strengthen the social safety net.

Challenges Ahead

The global economic environment has deteriorated markedly since the beginning of the current program and Pakistan has not been immune from this process—the impact of the global slowdown on the country's economy is now being felt. Manufacturing (mainly in the textile sector) has declined, with a related drop in exports. The overall economic situation remains difficult. The projection for economic growth for 2008/09 has been revised downward to 2 percent and for 2009/10 to 3 percent. Foreign investors remain skeptical about Pakistan's near-term prospects. As a result, Pakistan's ambitious privatization agenda is being delayed.

Looking forward, Pakistan's economic program is subject to an unusual degree of uncertainty associated with security problems and the depth and duration of the global slowdown. Despite the risk of further deterioration in the global economy, the initial success in stabilizing the economy augurs well for the program's success. The successful donor meeting in Tokyo in April 2009, where donors pledged financial assistance of US\$5 billion over three years, provides Pakistan with much-needed additional fiscal space in these difficult times. Under the augmented program the IMF provides bridge financing until this pledged donor support materializes. To sustain the additional spending in the medium term, however, it remains crucial that Pakistan raise tax revenue. In this regard, the introduction of a broad-based value-added tax is crucial. The mobilization of further external budget support is especially important for broadening the social safety net, supporting additional development expenditure, and rebuilding international reserves.