3/9/2015

Pakistan—Program Note

Current IMF-Supported Program: A 36-month extended arrangement under the Extended Fund Facility (EFF) for SDR 4.393 billion (US$6.68 billion, 425 percent of quota), approved by the Executive Board of the IMF on September 4, 2013. The 6th program review was completed on March 27, 2015.

Background

Macroeconomic imbalances and longstanding structural impediments to growth have prevented full realization of Pakistan's potential. Problems in the energy sector, security concerns, and a difficult investment climate have combined with adverse shocks to undermine economic performance in the past decade. As a result, GDP growth has only averaged 3 percent over the past few years, well below what is needed to provide jobs for the rising labor force and to reduce poverty. With the population still increasing rapidly, per capita income growth has lagged behind many emerging economies.

Prior to the onset of the current IMF-supported program, the fiscal deficit widened, driven by weak tax collections, energy sector subsidies, and increased provincial government spending. Domestic deficit financing crowded out private sector borrowing and contributed to inflation. The external position weakened significantly, and, reinforced by an absence of access to external market financing, central bank reserves declined to critical levels.

Role of the IMF

The current government took office with a strong mandate to implement ambitious economic reforms to stabilize the economy and put Pakistan on the path to growth and prosperity. The government's plan focuses on strengthening macroeconomic and structural policies to shore up confidence, reduce economic imbalances, foster sustained inclusive growth, and provide employment opportunities.

Since September 2013, the IMF has been supporting the government's economic program by means of a 36-month extended arrangement under the Extended Fund Facility (EFF). The EFF arrangement, together with other multilateral and bilateral program support, provides needed external financing for Pakistan, and signals the authorities' determination to implement sound policies, thereby bolstering market confidence and catalyzing private investment and other inflows. That way, the EFF provides a framework in helping Pakistan to retain macroeconomic stability, and therefore to promote growth and protect the most vulnerable part of the population.

The Challenges Ahead

Much has been accomplished in the first half of the program. The fiscal deficit has been reduced, international reserves have increased substantially, and the threat of a crisis has greatly receded. Macroeconomic prospects are favorable. However, more remains to be done to consolidate and reinforce the gains in economic stability and strengthen reforms for higher growth and job creation. Pakistan's aspiration is to catch up over time with other emerging market countries in key macroeconomic and business climate indicators.

The key challenges facing the authorities are to:

Continue to build external buffers and maintain price stability. Central Bank reserves reached over 2.5 months of imports and inflation is under 4 percent. The central bank should continue to rebuild its foreign exchange reserves, making use of Fund disbursements, financial support from other donors, foreign exchange interventions, and exchange rate flexibility. A continued focus on price stability will also be important.

Continue with prudent fiscal policy to ensure medium-term fiscal sustainability. The reduction in the headline deficit from 8.8 percent of GDP in 2012/13 to 5.5 percent of GDP in 2013/14 (an improvement of about 1.5 percent of GDP after accounting for one-off factors), and further to 4.9 percent of GDP in 2014/15 are important achievements. Building on these, further efforts will be needed in the coming years to strengthen Pakistan's resilience to shocks.

Facilitating higher investment. Despite recent successes in reinforcing economic stability, investment as a share of GDP has remained too low to generate the desirable high rates of sustainable economic growth. Over time, public investment needs to increase significantly. To generate the necessary resources for this and other priority spending such as health, education, and social safety nets, the tax-to-GDP ratio must be raised considerably by broadening the tax base and improving significantly on taxpayer compliance.

Implement structural reforms to achieve inclusive growth. To facilitate higher private investment and remove obstacles to private sector-led growth, there is a need to address longstanding problems in the energy sector (especially dealing with the circular debt on a sustainable basis), continue reforms of the trade regime, restructure or privatize public sector enterprises, and strengthen the business climate.

Protect the most vulnerable. Since the outset of the arrangement, the number of beneficiaries of the targeted income support program increased by 10 percent, and stipends were raised by 50 percent. Throughout the program, it is a top priority of the government to protect the poor from direct and indirect impacts of fiscal consolidation and price adjustments by means of targeted income support.