Faysal Asset Management

Research Note – IMF “Loan or No Loan”

January 21, 2013

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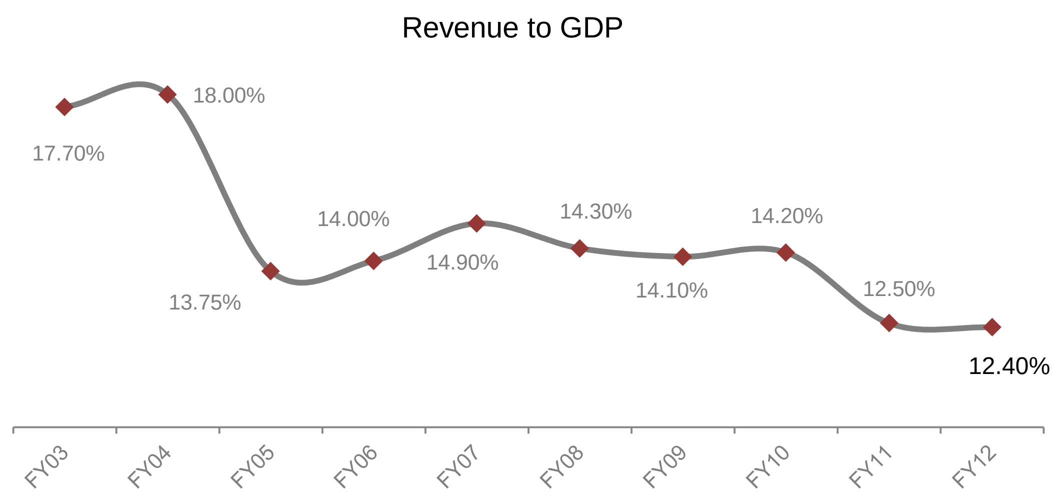
Bottom-line of the 2 weeks long negotiation between Policy makers and IMF Review Team:

- The topics that centered the discussion were i) stagnant revenue-to-GDP ratio ii) faltering public sector enterprises particularly the power sector.



- Since past few months IMF has vehemently claimed that it will not write-off or reschedule Pakistan's loan however "if Pakistan wanted any more out of the IMF then it would have to implement *certain prior actions*". There have been hopes of a prospective $5 billion bailout package after the IMF's visit to Islamabad.

- In that case IMF would insist President Asif Zardari to co-sign the loan agreement, which is expected to include conditionality such as greater revenue generation by the abolishment of income tax, sales tax, federal excise duty and customs duty exemptions besides the containment of losses incurred by public sector enterprises and the power sector.

- Insiders say that while the US seems to have persuaded the IMF to be 'lenient' regarding the conditionality to be attached to the fresh medium-term loan, the IMF team is unsure about how its board will react to the release of funds to an interim government.

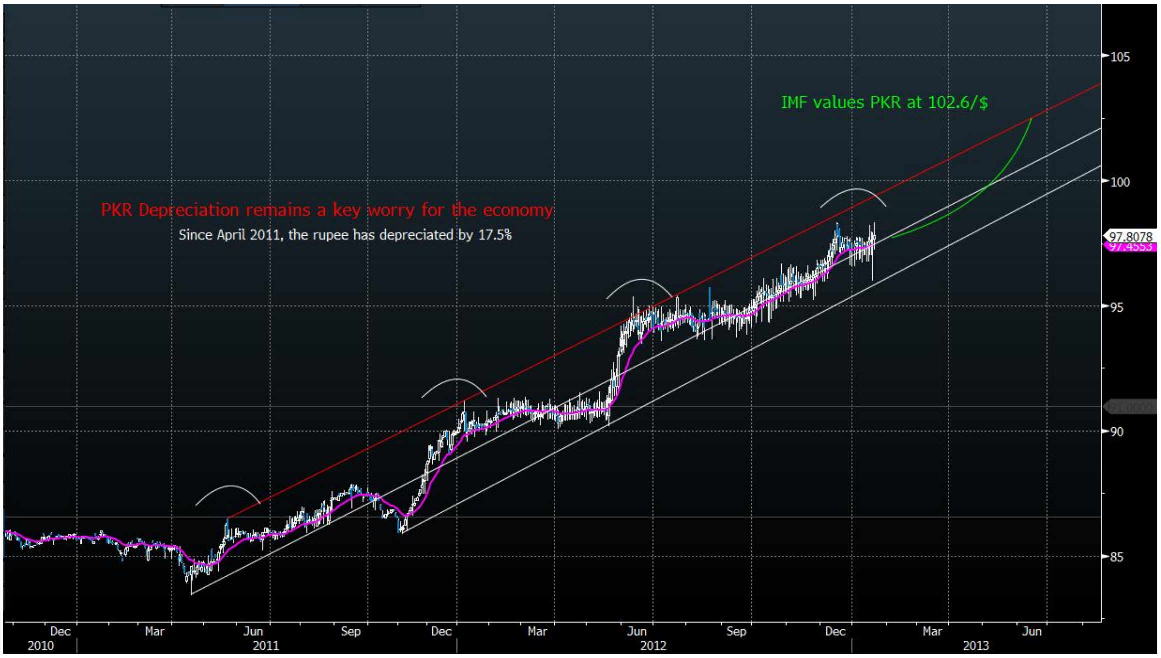
- IMF has serious doubts on the rosy macroeconomic picture portrayed by the policy makers. Since the overestimation of revenue and underestimation of expenses has been a norm for the economic managers. Half way through FY2013 the government also concedes that the revenue collection will miss the budget target of Rs2.38 trillion by at least Rs130 billion, while the IMF projects the shortfall at about Rs200 billion. Though the government has assured implementation of tax amnesty which would bolster revenue by an estimated two percent of GDP, the IMF is said to have refused to factor in the FBR's revenue projections

- The IMF predicts growth will touch 3.5 per cent in the fiscal year beginning in July against last year's figure of 3.7 per cent and slow to three per cent the following year – less than half the rate needed to absorb the population entering the workforce.

- The IMF is projecting a budget deficit of 7% to 7.5% of GDP for FY13. However the team is also said to have insisted on the reduction of the budget deficit by 1.5% of GDP over the medium term through policy measures.

- The Fund wants Pakistan to broaden its narrow tax base and slash subsidies it says mainly benefit the wealthy.

- The IMF is of the opinion that Pakistan's currency is overvalued by about five percent (which is admittedly better than the 10 percent undervalued it was a few months ago) and inflation, which has dropped of late, is set to rebound in the middle of this year. The IMF estimates that inflation for this fiscal year will reach around 9.5 per cent against 10.8 per cent last year.



- The IMF believes that Pakistan's macroeconomic stability in the short- to medium-term would largely depend on putting to an end to the power sector crises and increasing resource mobilization to at least 15 per cent of GDP.

Closing Note of Jeffrey Franks, the regional adviser to the Fund on Pakistan:

"It's not just the lack of energy; it's the unreliability, the unpredictability, that's what's holding your growth back more than any other thing."

Pakistan has to repay around $1 billion to the IMF in the remaining five and half months of FY13 and another $3.4 billion in the subsequent fiscal. Interestingly, despite the assertions of insiders that the current talks will determine the size of the bailout, the conditionality as well as its timing, officially, the Pakistani team continues to insist that it is not discussing a new bailout package with the Fund.