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IMF STAND-BY ARRANGEMENT FOR PAKISTAN AND ITS INCONCLUSIVE END - WHAT WENT WRONG?

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Abstract

Economy, after having witnessed an impressive rate of growth with relatively greater price stability, low incidence of foreign debt and many other favorable social and economic indicators, especially since 2003-04 up till the end of 2007, started facing serious macroeconomic imbalances. These brought about a sharp decline in the foreign currency reserves, bringing the country to the brink of default in its commitment of external payments and worsening economic situation as a whole. The failure of friendly countries of Pakistan to rescue it from economic collapse compelled the Government of Pakistan to seek financial assistance under IMF Stand-By Arrangement (SBA) so as to be able to correct serious macroeconomic distortions in the economy. The IMF entertained the request of the government and originally approved in November 2008 a 23-month programme, worth SDRs 5.17 billion (500% of the country's quota) equivalent to about US \$ 7.6 billion under the Fund's 'Emergency Financing Mechanism', which was later enhanced to 7.236 billion SDRs (700% of the country's quota), worth nearly US \$ 11.3 billion .

To ensure the success of the loaning programme, the IMF, in consultation with the government, designed performance criteria and structural benchmark conditionalities to attach these to SBA as a component of the loan package. These conditionalities sought reduction in fiscal deficit, tightening of monetary policy, amendment in banking legislation to enhance effectiveness of the State Bank of Pakistan's enforcement powers in the area of banking supervision, and harmonizing General Sales Tax (GST) and income tax regimes. Furthermore, the IMF called for achieving SBP's Net Foreign Asset (NFA) targets, finalization of electricity tariff adjustments in consultation with the World Bank and Asian Development Bank with a view to eliminating tariff subsidies, removal of inter-corporal debt in energy sector and adoption of an action plan to strengthen social safety net for the marginalized population.

The government, however, failed to implement some of the very significant conditions attached with the loan such as limiting fiscal deficit targets, implementation of VAT regime, finalization of amendments in legislative framework for the State Bank of Pakistan and the energy sector reforms. This became an irritant in the relationship between the Fund and the government. As a consequence, the programme remained suspended after the fourth review held in April 2010. The remaining two tranches amounting to about US \$ 4.06 billion worth SDR 2.296 billion were, therefore, withheld. However, at a later stage the IMF, on the request of the government, extended the programme in December 2010 for a period of seven months till end September, 2011 in the hope that the macroeconomic managers may succeed in implementing the remaining key conditionalities.

However, because of the government's inability to implement all these largely on account of some political reasons and the rigid stance of the IMF for their strict implementation, the government abandoned its efforts for total compliance with the

laid down criteria. The programme, therefore, ended up inconclusively in September 2011 with which a lot of hopes were pinned at the time of its proposition.

The paper mainly aims to evaluate the extent of success and failure in achieving the structural benchmark targets and performance criteria attached to IMF's Stand-By Arrangement which came to a premature end. It also examines whether the economy could move forward as a result of the financial assistance received to the extent of about 63.85 per cent of the total amount of loan committed despite meeting many of the most important conditionalities of the Programmeme. The analysis has been made on the basis of the available facts and an in-depth assessment of the macroeconomic trends, which forced the government to approach the IMF for financial assistance on an emergency basis to stabilize the economy showing serious downward economic trends in the country.

Keywords: Stand-By Arrangement (SBA), multilateralism, conditionality, circular debt, structural benchmark, performance criteria, foreign reserves, net foreign assets, Special Drawing Rights (SDRs), Value Added Tax (VAT), interbank rate.

Acknowledgements: The study is basically based on the data, provided by the authorities to the IMF Missions for their various reviews to examine the progress made under their Stand-By-Arrangement Programme and of the State Bank of Pakistan. The author is grateful to Dr Zafar Mahmood, Higher Education Commission's Foreign Professor at Pakistan Institute of Development Economics and Shafqat Munir, SDPI Adviser on Policy, Media and Outreach, for their detailed comments on the previous and initial draft of the paper respectively. He is also thankful to Dr Abid Qaiyum Suleri, SDPI Executive Director, for his valuable suggestions to draft and refine this document. The author also acknowledges with thanks the appreciable assistance provided by Muhammad Adnan, SDPI Project Assistant.

1. Contextual Background and Objectives of the Study

- 1.1. The International Monetary Fund (IMF) was formally established in December 1945 after the Second World War. This was the time when the world witnessed the spawning of multilateral¹ organizations and their regimes for dealing with some crucial economic and social issues. The objectives for the establishment of

¹ "At its most basic level, multilateralism refers to the cooperation of three or more states in a given area of international activity. To act multilateralism is to act in consultation and agreement with two or more states, rather than independently or through a narrower bilateral arrangement. As a recurrent institutional form of international life, however, multilateralism also has a qualitative dimension. In context to a power-base dorder, a multilateral... (continued on next page) ... (continued from the earlier page) order is based on rules that are separate from the identity of the actors. Collective action is routine, enduring and principled, rather than purely episodic or expedient" [Patrick, S 2000].

the IMF were: to promote international monetary cooperation and to oversee whether such cooperation among the countries is expanding along with balanced growth; to assist in achieving exchange stability through multilateral system of payments and to grant short-term financial assistance for making adjustments to achieve balance of payment equilibrium among the member countries.

- 1.2. Its role is to provide financial assistance to its member countries facing balance of payment disequilibria, under its various loaning programs with adequate safeguards that their financial and economic health is made sound enough to be able to repay the loans. It also provides a forum for the exchange of information and views about international monetary concerns especially with a view to giving technical and financial assistance to its members to enable them to maintain exchange stability and equilibrium in balance of payments, and in some cases to minimize the duration or to mitigate the severity of disequilibrium [IMF undated]. For achieving these objectives, the IMF, over the years, has devised a range of lending instruments to address the specific circumstances, which may be faced by individual member states [IMF 2010^e].
- 1.3. The loan packages, as claimed by the IMF, are being provided by it to its member countries in need of financial assistance for the last two decades or so. They are made to suit each client and are accompanied by certain terms and conditions that govern each loan contract. These are called 'conditionality' [IMF 2010d] or conditionalities which in their broad sense, have been defined as a policy framework comprising both the design of IMF-supported programme i.e., the underlying macroeconomic and structural policies and specific performance standards. These are meant to ensure that progress is made in the execution of the loan programme in line with its objectives.
- 1.4. The conditionalities are attached to a loaning programme as an integral part of the financial package to carry out a close monitoring of the performance of economy. The objective is to ensure reduction in fiscal deficit, decrease in non-development spending of the government, reform in tax collection machinery and regimes, upward revision of discount rate etc. It is argued that these are meant to accelerate the growth rate of an economy to bring changes in the regulatory framework and forge closer linkages with the global economic system. The objective is to safeguard IMF resources by ensuring that the country's economy becomes strong enough to repay the loan [IMF 2010^d].
- 1.5. Some analysts believe that the loans provided by the IMF have served as a vital input in managing the financial problems of the borrowing member countries since the early years of its establishment. They hold the view that loans did help overcome the balance of payment deficits, stabilize the currency, rebuild foreign currency reserves, and manage liquidity problems by providing various types of

loans to meet their short and medium-term needs. However, some other analysts are of the view that IMF programs have always exerted pressure on the government of a borrowing country owing to tough conditionalities resulting in some bitter decisions that have led to slow economic development, rise in inflation, increase in the level of poverty, fall in the quality of social services and rise in the incidence of unemployment.

- 1.6. A section of economic analysts has expressed concern over the broadening and deepening of conditionalities, which have led to IMF's growing involvement in the policy framework of the borrowing countries. Similarly, they plead that the proliferation of such loan packages has failed to improve the economic health of such countries through restructuring and stabilization policies. In fact, these are believed to hinder appropriate responses by the borrowing governments to cater to social and economic needs of their citizens. Thus that there are diverse opinions regarding the social and economic consequences of the IMF a package under its various lending programmes.
- 1.7. Prior to the recently ended Stand-By Arrangement², the country had availed the IMF loan facility 18 times since 1958 [Appendix]. The country approached the IMF in 1958 for the first time to seek a loan worth 25 million Special Drawing Rights (SDR³) equivalent to nearly US \$ 24.80 million under the Stand-By Arrangement. It was, however, cancelled even before its date of expiry due to its non-utilization. An in-depth review of the performance of successive governments in availing of various IMF loan packages sanctioned for Pakistan unfolds a chronicle of both successes and failures in implementation of these loan facilities [Hyder, SN 2011^b].

² *Stand –By Arrangements (SBA) has been designed to provide short-term balance of payments assistance to middle income countries for meeting deficits of a temporary or cyclical nature. These arrangements are typically for 12 to 16 months. Drawings and disbursing are phased on quarterly basis, with their release made conditional on meeting performance (conditionalities) criteria after the completion of periodic program reviews. Repurchases are made 3-1/4 to 5 years. It is the costliest loan in terms of rate of interest which is equivalent to market rate. For details regarding this kind of facility along with others may be referred to web link <http://www.imf.org/external/np/exr/facts/howlend.htm> and the details regarding the features of the recent SBA programme have been provided in the proceeding sections.*

³ *Special Drawing Right (SDR) is an international monetary unit of account used by IMF for the purpose of maintaining international foreign exchange reserve assets for allocation to its member countries. It represents a claim to foreign currencies for which it may be exchanged in times of need. The normal value of an SDR is derived from the basket of currencies, initially made by weighted average of five currencies of the economic globe. However, after the emergence of Euro Zone and Euro currency, it is calculated by using four currencies comprising of US \$(44%), Yen (11%), Euro (34%) and GB Pound (11%) valued in US \$. The US dollar value of SDR is posted daily on the basis of exchange rates quoted at noon. Pakistan has its quota of SDR 1,033.7 million [IMF 2010^b].*

- 1.8. During the early years, the government generally succeeded in achieving the objectives of various loan packages, which hinged upon a successful implementation of terms and conditions of the programmes. It may be observed that loaning by the IMF till that time was not characterized by any significant dissimilarity from the viewpoint of conditionalities attached to the loan packages. It provided freedom to the economic managers to formulate the economic policies independently to go well with the priorities of the economy which made possible, to a great extent, the fruitful utilization of various loans disbursed to Pakistan [Hyder, SN 2011^a].
- 1.9. However, a major shift has been noted in the trend of the conditionalities attached to its loan packages approved by the IMF since 1980s. This period witnessed the conditionalities becoming increasingly stringent on the plea of restructuring reforms for stabilizing the economy and thus placing it on a healthy footing. The rigorous demands introduced by the IMF adversely affected the implementation of its programmes during the last two and a half decades or so except in case of two loans: one under SBA (SDR 465 million) and another under Poverty Reduction and Growth Facility (PRGF-SDR 1033.7 million), executed during the years 2001-2004.
- 1.10. The IMF lending strategy during the last two and a half decade has provoked an intense debate among analysts and scholars. Both the proponents and opponents of IMF role have arguments to support their respective points of view. The governments and the analysts of the low income countries including some from developed world are critical of the harsh conditions being attached by IMF with its loan packages. They believe that these terms allow IMF's growing involvement in the policy-making process of borrowing countries and has thus eroded these governments' independence in drawing up their economic roadmap [Hyder, ST 2001].
- 1.11. On the other hand, the IMF supporters strongly believe that its various loan programmes such as Stabilization and Structural Adjustment Programmes have successfully overcome macroeconomic imbalances besides meeting short and medium term objectives of solving the problem of balance of payment disequilibrium in member countries. The implications of IMF loaning to Pakistan have also evoked opposing responses from relevant experts [Yousaf, S 2009].
- 1.12. In recent years, the IMF has claimed to have become flexible in the way it has interacted with the countries for extending financial assistance for their structural economic reforms. It now follows a process that also involves consultations with stakeholders in the country, aimed at enhancing the effectiveness of its

programmes by resting these on strong country ownership. It has, therefore, revised its conditionality framework to ensure that structural reforms linked to disbursement of its financing are suitably tailored to member countries' specific policies and their economic benchmarks. To ensure adherence to the revised strategy, a set of performance criteria and provision of monitoring of structural reforms have been introduced for the periodic program reviews. Positive findings emerging from these reviews become the basis of disbursement of the next installments. [IMF 2010^d].

- 1.13. In view of the above, the study attempts to examine the extent of success and failure in accomplishing the fundamental structural reform targets to rehabilitate the economy within the framework of conditionalities attached to the recent SBA Programme. It also aims at analyzing the factors, which constrained the implementation of some key conditionalities causing inconclusive winding up of the programme at more than half way on account of which the last two tranches (according to the revised disbursement schedule) worth SDR 2.3 billion equivalent to about \$ 4.06 billion were not disbursed. It has also been examined whether the utilization of loan amounting to \$ 7.24 billion (63.85 per cent of the total loan) released before the conclusion of the Programme could leave any tangible impact on the economy during the implementation stage of the programme as well in its immediate post implementation period.
- 1.14. This analytical exercise has been carried out in the backdrop of the specifics of macroeconomic drifts in the country showing serious downward economic trends forcing the government to approach the IMF for financial assistance to rehabilitate the fast declining economy, almost on the brink of collapse.

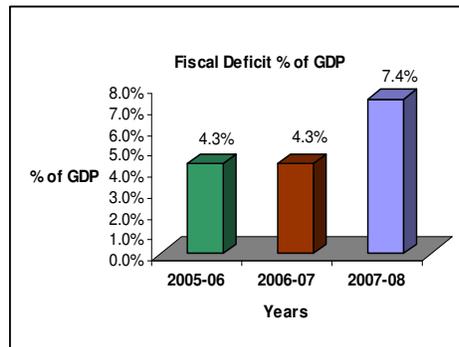
2. Macroeconomic Condition Gripping the Government to Approach IMF for Financial Assistance under Its Stand-By Arrangement (SBA).

- 2.1. Towards the closing years of the last century and the beginning of the present one, Pakistan's economy was in bad shape because of conflict with India, stoppage of financial assistance from many quarters, on account of nuclear test in May 1998, pushing it to further economic isolation, high defense expenditures and massive interest payments. Because of its inability to pay back the external debt and meet other international monetary obligations, there were several rounds of debt rescheduling between Government of Pakistan, donor clubs and international financial organizations during 1998-2001. The economy faced a severe balance of payments crisis due to weak capital inflows, declining FDIs, falling exports owing to low demand at global level, food insecurity etc.
- 2.2. The country, however, received a breathing space in 2001 and onwards in terms of foreign exchange receipts on account of a substantial increase in remittances

from Overseas Pakistanis, reimbursement for the cost of services provided under Coalition Support Program, increase in the volume of direct investment and portfolio investments, which helped strengthen the foreign exchange reserves despite a widening current account deficit. All these coupled with prudent economic policy measures, such as privatization of public sector enterprises, expansion in the role of markets, establishment of market-based regulatory bodies and reduction in the cost of doing business along with substantial decrease in the foreign debt and debt servicing with relatively greater price stability, boosted the national economy.

2.3. The positive trends in the economy made it possible for the country to make its entry into the international capital market in mid-2000s. Moreover, the external debt came down to 27.8 per cent of GDP in 2007-08 in comparison to 2000-2001 and gross official foreign exchange reserves rose to \$ 15.65 billion at end-2006-07 and to \$ 16.45 billion in October 2007. On account of meaningful policy incentives and foreign investments, GDP was found growing on average by more than 7 per cent per annum, while inflation was contained to only around 7 per cent during 2005-06 to 2006-07. The period witnessed almost all social and economic indicators improving appreciably until the downbeat warning sign started emerging during the last quarter of 2007 and early 2008 [SBP 2009].

2.4. The situation deteriorated sharply from mid-2008 onwards. An adverse internal security situation, exorbitant rise in international prices of fuel and food and global financial turmoil caused a severe damage to the economy of Pakistan. Another contributing factor was delay in passing over the higher energy prices to consumers leading to an unbearably heavy subsidy to the power sector and consequently to a heavy increase in the fiscal deficit.



The fiscal deficit, which was only 4.3 per cent of GDP during 2005-06, remained at the same level in 2006-07 but rose sharply to 7.4 per cent of GDP in 2007-08 [GOP 2009].

2.5. The new coalition government in 2008 inherited a set of handicaps to the economy which coupled with policy inaction led to higher inflation, slow growth and a sharp decline in the external reserves position. The widening fiscal deficit, largely on account of heavy rise in subsidies, was financed by credit from the central bank. Headline inflation reached as high as 25 per cent in mid 2008 compared to 6.5 in August 2007, causing serious harm to vulnerable groups. The

core inflation (excluding energy and food) increased to 18.3 per cent in October 2008 as compared to 7.6 per cent in 2006-07 and 12.0 per cent in 2007-08 [Finance Division, Economic Survey, 2008-09]. The rupee depreciated its value in terms of US \$ by 29.81 per cent during December 2006 to December 2008, adversely affecting the economy as a whole and carrying serious social and economic repercussions.

- 2.6. Real GDP growth slowed down to 3.7 per cent in 2007-08 as compared to 6.8 per cent in 2006-07 reflecting weaker performance of agriculture, commodity producing and manufacturing sectors. The external current account deficit widened to nearly US \$ 13.73 billion or 8.5 per cent of GDP in 2007/08 from US \$ 6.88 billion (4.8 per cent of GDP) in 2006/07. Though the growth of exports and workers' remittances went up but imports rose by more than 30 per cent owing to an increase of \$ 4 billion (2.5 per cent of GDP) in the value of oil imports and strong aggregate demand growth. This combined with a sharp decline in capital inflows, particularly in portfolio investment, led to a drop in gross international reserves from \$ 14.3 billion at end-June 2007 to a critically low level of \$ 6.4 billion on 25th. November, 2008 [GOP 2009].
- 2.7. Besides the widening gap in the current account, factors such as loss of investors' confidence following the deterioration in Pakistan's fiscal position, domestic political instability, internal law and order situation and rise in prices of commodities and fuels resulted in a significant decline in capital inflows (the decline in capital inflows in 2007-08 in comparison with their size in 2006-07 amounted to \$ 2.5 billion or 163 per cent of national quota of SDRs with IMF). Since Pakistan has been highly dependent on foreign capital inflows to finance its relatively large current account deficit, a substantial decline in these inflows resulted in a large depletion in international reserves. This became the basis for the authorities to seek Fund financing to build up the reserve position beyond the normal access level to stabilize the sharply declining economy.
- 2.8. As regards the impact of international financial crisis on the financial sector of the economy of Pakistan, the analysts were of the view that its direct impact has not been felt due to less developed linkages with international market. This is because it has been in its developing stage with limited, albeit growing, linkages with global market and thus relatively immune against the contagion in global financial market. However, its effects are said to have been felt by other sectors, though to a limited extent, as a result of global slowdown which passed on through the trade balance. This occurred due to a downward drift in global demand resulting in a substantial decline in commodity prices which worsened the trade balance. This manifested in negative effect on capital account and a significant reduction in private capital inflows [Ali, MM 2009].

- 2.9. All these factors resulted in a heavy depreciation of foreign currency reserves, which declined to \$ 6.4 billion in November 2008, raising concern that the country may not be able to honour its international financial commitments, due in the next fortnight, in the absence of any substantial financial assistance. The rating agency, namely the Standards and Poor's downgraded the country's sovereign debt in mid-2008 to the level of CCC+ from B, with a negative outlook, close to defaulting on its commitment of external loan repayment [Qayum K 2008]. It was, therefore, obvious that the country's foreign reserves were not enough even to afford one month's import payments in the quarter ending 2008. In October, 2008, the then Advisor to Prime Minister on Finance was quoted to have stated that the country needed at least an amount of \$ 5 billion within 30 days for stabilizing its economy.
- 2.10. These factors together with the lack of a positive response from the friendly countries in extending financial assistance to salvage Pakistan's economy from rapid deterioration left no option to the government except to approach the Fund for its economic bail out. It, therefore, formally requested the IMF for urgent help in November 2008 through its Letter of Intent along with the memorandum of economic and financial policies for economic reforms framed by the government in consultation with IMF that Pakistan intended to implement. The strategy already set out by the macroeconomic managers along with some economic reform measures put in place in advance and successful implementation of two Fund-supported programs in the recent past under the Poverty Reduction and Growth Facility granted during 2001-04, provided a sound basis for IMF to consider the request on emergency basis [IMF 2008] which it approved within four days of the submission of request.

3. Program Financing, its Aims and Modalities of Implementation

- 3.1. While evaluating the request for financial assistance, the IMF staff supported the proposal backed by their analysis that "even with the envisaged narrowing of external current account deficit, the overall gross external financing needs would remain large, particularly during the first year of the program" [IMF 2008]. It realized that financial account would remain under constant strain in spite of large pledges from polygonal sources and privatization proceeds likely to be received in future. They identified that a sizeable financing gap would remain taking into account the inadequate private financial inflows and thus the financing by the Fund will be essentially required to help build reserves from the current low levels. Since the IMF appraisal concluded that Pakistan met all the 'Exceptional Access Criteria' it sanctioned a loan on exceptional access under 'upper credit tranche' terms [IMF 2008].

- 3.2. According to IMF since Pakistan had a relatively moderate external debt burden, it may be able to meet its obligations towards the Fund in a timely manner in case the government's owned Structural Performance Criteria and Benchmarks targets are fully and effectively implemented as per schedule. As stated earlier, the conclusion drawn by the Fund was based on its scientific analysis as well as on the ground of a good record of the country in servicing the fund's obligations, especially in the recent past. These considerations became the basis for approval of SBA program with exceptional access⁴ under "upper credit tranche. In case of Pakistan, although the crisis was basically of current account, the Fund approved this facility in spite of realising that the balance of payment needs in Pakistan are unlikely to be short-lived and the country will be facing a prolonged need for current account adjustment [IMF 2008].
- 3.3. The IMF fully realized that overcoming the current economic and financial crisis of Pakistan will require hard choices and sustained actions. The government and IMF both, therefore, strongly felt that the success of the financial assistance programme hinged on its unrelenting and vigorous implementation of economic reforms to restore the economy and stabilize it for sustainable growth [Ahmed, M 2008]. A package of financial assistance, as stated earlier, amounting to US \$ 7.6 billion worth SDR 5.17 billion (500% of the country's quota), albeit with some conditionalities was, therefore, approved by IMF in a record time of four days following the request. However, prior to the acceptance of the request a thorough interaction of the Fund's technical mission had taken place with the authorities to delineate the future policies of structural economic reforms attached to loan financing which were to be pursued by the government.
- 3.4. Keeping in view the urgency of financial assistance, the loan was approved in November 2008 under the Fund's 'Emergency Financing Mechanism' procedure. The access was, therefore, made front-loaded, given the needs at the beginning of the programme. The first release amounting to 3.1 billion worth SDR 2.067 billion (200 per cent of SDR quota) was, therefore, paid on emergency basis, while the remaining tranches were originally planned for disbursement through seven installments. Later, in August 2009, it was augmented to US \$ 11.33 billion worth SDRs 7.24 billion (700 per cent of the quota), covering a period of 25 months ending in December, 2010. It was enhanced on the ground that a hefty dose of financial help was necessary on account of the country's sizeable external

⁴ *The principle of "exceptional excess" is provided to any member state, only in case it faces crisis in its capital account through resources of the Supplementary Reserve Facility (SRF), where SRF conditions apply. It is meant for colossal short-term financing requirements reflected by stress on capital account and the country's foreign reserves [IMF 2008].*

imbalance and also due to the risk of large capital outflows, which had already started gaining momentum. It may, however, be noted that the amount of loan approved under the SBA was more than double of the entire amount of the 19 loans sanctioned so far to Pakistan by the IMF since 1958.

- 3.5. At the time of granting the financial support, the Fund also held the view that while macroeconomic tightening will definitely hurt, it was necessary to achieve long-term sustainable growth. It was also hoped that the consequential burden of adjustment would fall least on the most vulnerable members of Pakistani society. That is why the IMF was in full agreement with the social safety network program proposed by the government and considered it mandatory for the SBA program to be simultaneously oriented towards ensuring key protection measures for the have-nots for which the expenditure on social safety warranted a substantial increase. This was meant to ensure by incorporating social security for the poor as an element of the conditionalities attached to the programme. The disbursement under the program was, therefore, subjected to satisfactory quarterly review of observance of conditionalities i.e., performance criteria (PCs) and benchmarks (BMs) targets attached to the program by IMF, said to have been set out in consultation with the government⁵.
- 3.6. The SBA programme approved by the IMF had three overarching objectives which were said to be designed by IMF and the government authorities with mutual consultations. The financing program aimed to “(i) restore financial stability through tightening of fiscal and monetary policies to bring down inflation, strengthen foreign currency reserves and develop the confidence of local and foreign investors; (ii) protect the poor to preserve social stability through a well-targeted and adequately funded social safety net; and (iii) raise

⁵*There are contradictory versions regarding imposition of the conditionalities attached to the Program. The press quoted the statement of an official of the government that despite all the tough conditions, objections and differences, the government was compelled to seek the IMF assistance package since no country came forward even to extend loan to Pakistan in its extreme economic distress to meet emergent international obligations of the country. Whereas an official of IMF stated in his article published in ‘Khaleej Times’, also posted by IMF on its official website, that “the program and its conditionalities were largely based on the targets and measures that the government authorities themselves set out which was appreciated by IMF. He added “the Fund was inclined towards the program since it was home-grown”. He further stated that since it was fully owned by the country, it had the potential for best implementation [Ahmed, M 2008]. It is generally believed that the government had demonstrated a great degree of program ownership. Any way, since that time, a lot of apprehensions are expressed on the government’s decision from the view point of its implications for the social and economic consequences of the Program on the economy and the people of Pakistan.*

budgetary revenues through comprehensive tax reforms to enable significant increase in public investment and social spending required for achieving sustainable growth.” [IMF 2008].

4. Key Elements of IMF Conditionalities- Objectives and their State of Implementation

(i) The fiscal programme seeks to reduce the deficit from 7.4 per cent of GDP in 2007-08 to 4.2 per cent in 2008-09 and to 3.3 per cent in 2009-10, while allowing for increased spending on the social safety net”.

1. As stated earlier, the broad objectives of the package of financial assistance were to rehabilitate the economy and to create confidence among the international and domestic investors by redressing the then ongoing macroeconomic distortions along with achieving social stability by protecting the poor. To pursue these objectives, the Program envisaged a significant tightening of fiscal and monetary policies. The measures considered essential to accomplish this task were provided in a framework of conditionalities in the forms of Performance Criteria (PC) and Structural Benchmarks (SB).

4.1. Fundamental Structural Reform Targets and their Development Trends

- 4.1.1. It was observed that one of the most fundamental structural reforms under the Programme was to lower the fiscal deficit to the desired level. This reduction was proposed to be achieved through target oriented measures, primarily by phasing out energy subsidies, curtailment of the non-development expenditure, better prioritizing of development outlay and implementing reforms in tax policy and tax administration including public financial management. As for fiscal discipline, the facts placed before the IMF mission for the Second Review revealed that despite continuing revenue limitations, budget execution through the end of the third quarter, 2008-09, was cautious but the fiscal target of end-June, 2009 was missed as it exceeded by about 0.9 per cent of GDP.
- 4.1.2. The situation further worsened by the end of the third quarter ending March, 2010. The educated guess submitted to the IMF mission indicated that fiscal deficit target was again missed by 0.4 per cent of GDP. It ultimately swelled to 6.3 per cent of GDP by end June, 2010 mainly due to lower revenue collection

and a heavy expenditure on security measures. However, the fiscal deficit later declined considerably and was reported to be 5.3% of GDP in June, 2011. This was despite the fact that the release of the next tranche of the loan disbursement was stopped after the fourth release in April, 2010. The trend continued even till end September, 2011 (i.e. the extended period of the programme) though the reduction was marginal, that is, 1.2 per cent of GDP as compared to 1.5 per cent during the same period in the previous year.

- 4.1.3. As regards the trends in Consumer Price Index (CPI) and Sensitive Price Indicator (SPI), these jumped to over 20 per cent while the Wholesale Price Index (WPI) was marginally below 20 per cent during the financial year 2008-09. Inflation was considerably brought down during the financial year 2009-2010 but still all the price indices recorded a double digit increase. During the financial year 2010-11, the SPI and WPI surged by 37.51 per cent and 84.87 per cent respectively over the preceding year. However, some positive development was recorded during the first quarter of financial year 2011-12 as these indices were found to be following a downward curve. According to the statistics released by Pakistan Bureau of Statistics (PBS), the CPI came down to 11.47 while SPI and WPI slumped to 10.68 and 18.62 respectively but could not be brought down to less than two digit level. .

<i>Period</i>	<i>CPI</i>	<i>SPI</i>	<i>WPI</i>
Jun-09	20.77	23.41	18.19
Jun-10	11.73	13.22	12.63
Jun-11	13.92	18.18	23.35
Sep-11	11.47	10.68	18.62

*Note: Base Year 2007-08. The data before the period under reference worked out on the basis of base year 2007-08 is not available.

Source: Pakistan Bureau of Statistics

(ii) ‘The programme envisaged a tightening of monetary policy and to address financial sector vulnerabilities and to improve liquidity management and monetary policy implementation’.

- 4.1.4. If we look at the monetary management by The State Bank of Pakistan (SBP), we find that even before the start of the IMF Program, it was managing the discount

rate according to the requirements of the economy. It showed its resolve to make further adjustments in keeping with the national economic realities. Adopting a flexible approach, the SBP lowered its discount rate to 14 per cent in April, 2009 on 100 basis points and subsequently to 13 per cent in August 2009 and to 12.5 per cent in November 2009. However, to contain inflation, the State Bank increased the discount rate by 50 basis points to 13 per cent in July 2010 and to 13.5 on 50 basis points in end-September, 2010

4.1.5. Subsequently, it decided to further raise the discount rate to 14 per cent w.e.f November 30 2010. It was the third consecutive increase within a short span of six months and was enforced with the purpose of controlling inflation. However, these moves did not prove fruitful because of their adverse impact on the level of investment in the country on account of negative implications for the cost of doing business. However, on failing to achieve the desired objective, the State Bank decided to bring down the discount rate to 13.5 per cent on 50 basis points in July, 2011 so as to promote investment and it remained unchanged till end September, 2011. In general, the monetary Policy continued to adopt a cautious approach by adjusting the bank rate according to national economic compulsions.

4.1.6. It may be noted that contrary to the conventional economic principle that a high discount rate will depress inflationary trends in any economy, it came out that inflationary pressure remained low during the period the State Bank lowered its discount rate. The author in his research paper published in July, 2011 had advocated the need to examine whether the economic policy based on the principle of high interest rates could help control inflation in our context where many economic variables were not normal. Keeping this position in mind, a cheap monetary policy, to an extent, may be helpful in reviving the economy as it may reduce the cost of business and hence promote investment and consequently increase production and employment. [Hyder, SN 2011^b].

4.1.7. Besides scientifically managing the monetary policy, the State Bank sought to gradually eliminate lending to the government for budgetary support, follow a flexible foreign exchange rate, prepare a contingency plan to safeguard the problem banks and to take measures to improve monetary management. These aspects are discussed in later sections.

4.2. Structural Performance Criteria and Benchmarks

4.2.1. Both these elements of IMF conditionalities, said to be set out as an integral part of the SBA, focused on areas of macroeconomic reforms. These were considered vital for realizing the program intents along with the time bound programme of strengthening the social safety net for the poor. These included provisions such

as monetary and fiscal policies for lowering inflation and augmenting the external finance position, reforms in tax regimes and administration, strengthening the State Bank of Pakistan's supervisory and enforcement capacity including preparation of contingency planning to protect the small banks susceptible to distress on account of upward movement of discount rate. In addition, these covered power sector reforms, implementing an action plan to provide social safety cover to protect the marginalized population and transforming the existing treasury account system into single accounting system.

- 4.2.2. The success and failure in achieving the targets set out for the structural benchmark and performance criteria have been analysed in-depth along with their implications for the national economy and the masses at large in the sections that follow.

4.3. Structural Performance Criteria

- 4.3.1. The performance criteria under the SBA stipulated the following which have been analysed to examine the extent of success or failure of the government in implementing these elements of conditionalities along with their possible implications for the economy:

(i) "Amendments to the banking legislations will be submitted to Parliament to enhance the effectiveness of State Bank of Pakistan (SBP) enforcement powers in the area of banking supervision, by end-June, 2009." [IM, 2008]

- 4.3.2. The condition to this effect was laid down to make the State Bank of Pakistan more effective as an independent administering agency in its sphere of monetary management. It was included as one of the conditionalities with mutual agreement of IMF and the government. In fact, the government had itself suggested to carry out required legislative amendments to imbue SBP with greater enforcement authority and to make it a more effective instrument for monetary management. It was, however, observed by the Second Review covering the period ending-June, 2009 that the target period for submission of the proposed amendments to the Parliament could not be met. The date for submission was, therefore, revised to end-August, 2009. Despite the extension in the target date, the submission of the draft legislation to the Parliament was further delayed and was eventually submitted to the National Assembly in October, 2009 and was approved in February, 2010. The bill was placed before the Senate in early May, 2010 but its approval remained in suspense and was finally cleared in May, 2011, which meant a delay of about a year.

- 4.3.3. As stated earlier, the basic objective of laying down this provision as performance criteria among the conditionalities was to enhance its effectiveness in the areas of banking supervision, ostensibly to improve and maintain the health of the economy. Had this been implemented according to the prescribed time schedule, it may have had an early positive imprint on the national monetary management and a healthy stride towards the recovery of the economy. It merits a mention that along with fiscal discipline, the monetary regulation on scientific lines is also of vital significance for efficient economic management of any economy.
- 4.3.4. To perform its assigned role effectively, the national monetary authority should have complete autonomy in its areas of operation without government's unwarranted intervention. This was in fact the most striking objective of the proposed legislation. The purpose was also to eliminate SBP Financing to the government to ensure planned reduction in the deficit financing and to make financial resources available to the private sector for productive purposes. However, it is yet to be seen whether the empowerment of the State Bank of Pakistan has enabled it to exercise an effective authority in managing and administering monetary affairs of the country.

(ii) "The government will submit, by end June 2009 the draft legislation to the Parliament to harmonize the GST and income tax laws, including for tax administration and to reduce exemptions for both taxes"[IMF, 2008]

- 4.3.5. The purpose of keeping this conditionality as a key objective of the program was to enlarge the tax base in the country so as to substantially enhance its financial resources for productive investment and for boosting economic development. It was also aimed at enlarging the social safety net to bring the vulnerable population in its ambit. It was felt by IMF and the government authorities that strapping of revenue collection was vital for raising the tax-to-GDP ratio in the country (the lowest even compared with the low ranking developing economies) and that this will also bring down the fiscal deficit to the desired level. Unfortunately the government failed to comply with this requirement by end-June, 2009. However, as a corrective measure it was agreed by the second review to extend the deadline to end-September, 2009.
- 4.3.6. Regarding reduction in tax exemptions, it was decided that with a view to achieving a meaningful progress in this area, it would be implemented in

tandem with the VAT⁶ which was then decided to be made effective from 1st. July 2010.

- 4.3.7. Subsequently, there has been a substantial progress in carrying out tax administration reforms, albeit with some delays. In October, 2009 Finance (Amendment) Ordinance, 2009 was issued to harmonize sales tax, income tax and federal excise duty through which about ninety per cent of total tax revenue is collected by Federal Board of Revenue (FBR). Under the new arrangement, the responsibility of mobilizing domestic taxes consisting of sales, income and federal excise duties was consolidated in line with the new administrative structure and assigned to a newly created Inland Revenue Wing of the FBR. It was a big leap towards reforming the tax administration with the purpose of achieving efficiency and effectiveness in tax collection. Since these taxes are not only identical in nature but are also mutually dependent in practice, the unification of the entire sources of inland revenues for tax management is expected to result in a definite improvement in revenue collection mechanism.
- 4.3.8. In order to ensure efficient performance of the Inland Revenue Wing and to eliminate the risk of legal challenges relating to the service matters of the concerned officials, a new occupational group was established in October, 2009 and its staff was in position by November, 2010 after the completion of all legal formalities and the Inland Revenue Service (IRS) thus came into being in the FBR. All the officers of defunct Income Tax Group and a number of officers belonging to Custom & Excise Group on their own option were allocated to Inland Revenue Service. At the same time, the former Custom & Excise Group was re-classified as Pakistan Custom Service and defunct Income Tax Group ceased to exist, as per programme.
- 4.3.9. As observed by the third review of the Program undertaken in November, 2009 significant progress was found to have been made in the direction of tax administration reforms since a number of these were successfully implemented by the government according to the given time schedule. The FBR by that time had already introduced the system of tax audits by external auditors and set up the Expeditious Refund System (ERS) in all Regional Tax Payers Offices (RTOs) and Large Tax Payers Units (LTUs). ERS system, which was introduced on time, is expected to facilitate timely and accurate verification of sales tax refund claims submitted by exporters and minimize the risk of fraudulent refund claims.

⁶ Value Added Tax (VAT) is a fee that is assessed against business by government at various points in the production of goods and services-usually at the time a particular product or service is resold or value is added to it. For tax purposes value is added whenever the value of a product or service increases as a result of application of factors of production.

- 4.3.10. These reforms were introduced basically for the purpose of re-structuring the revenue collecting organization i.e. the FBR and its collection procedures to enhance its efficacy in revenue collection. The steps taken in pursuance of these reforms were aimed at improving the system with the ultimate objective of broadening the tax base and achieving its fiscal stability. It was anticipated that with the rise in the volume of revenue collection, more financial resources would be available to be injected into the economy for boosting economic development and addressing the problems of vulnerable groups. However, the success depended, to a great extent, on the capability and commitment of the concerned staff, political will to implement these reforms and the education of the taxpayers. The introduction of these reforms within the stipulated timeframe was an important achievement of the government.. It was believed that it would also pave the way for introducing the VAT regime.
- 4.3.11. The third review by the IMF staff mission, held in November, 2009 observed that considerable progress had been made towards introduction of the VAT by July, 1 2010. A series of exercises was undertaken for preparation of VAT Law and its submission to the Parliament by end-December, 2009. It was, however, submitted with some delay in end-February, 2010. The provincial governments also prepared their draft legislation and submitted to their respective assemblies in late March, 2010.
- 4.3.12. The delay in finalization of VAT regime at that time was mainly because some provincial governments did not respond positively to this tax regime and backed out, thus imperiling the overall consistency and timely implementation of the regime. However, during the fourth review of the Program held in April, 2010, the government reconfirmed the time schedule for the implementation of VAT but later extended it till October 2010. The Finance Minister, in his budget speech had categorically announced the imposition of VAT w.e.f. October 1, but even this commitment could not be honored.
- 4.3.13. The failure to enforce the VAT was mainly because of the opposition of two major political parties in coalition with the government and also on account of the vehement opposition of the business community who were determined to resist the imposition of the newly proposed sales tax regime. The business community seemed to oppose it mainly to evade full documentation of their businesses and thus avoid their tax obligations. The masses were also opposed to the introduction of the reformed sales tax since there was a general perception that it will fuel the inflationary pressure on account of increase in prices, implying thereby an additional burden on end consumers. The government, of course, strongly believed that the introduction of VAT regime will enhance their revenue generation capacity since it would be based on the documentation of the

economy and hence facilitate a realistic assessment of the tax obligations of the payers.

- 4.3.14. Despite its strong resolve, the government failed to implement the VAT which was considered one of the most important conditionalities under the IMF loan package. The IMF reacted by deferring its fifth review and withheld the next tranche of the loan which was due for disbursement in May, 2010. Although at a later stage, it agreed to extend the time limit for the implementation of the programme till September, 2010 but failure to implement the suggested reforms specially those relating to sales tax regime became the main factor responsible for the unceremonious termination of the programme. A detailed account of the events leading to the winding up of the programme is contained in a later section of the study.

4.4. Structural Benchmarks

(i) “Subordinating foreign exchange intervention policy to the achievement of SBP’s Net Foreign Assets (NFA) targets is a key program commitment ensuring sufficient exchange rate flexibility, which is critical for achieving the program’s reserve targets and promoting current account adjustment. To fulfill this commitment, the SBP’s provision of foreign exchange for oil imports will be phased out according to schedule, with the elimination of provision for furnace oil by February 1, 2009 as a first step. To achieve this, it will be shifted to interbank markets according to a given schedule” [IMF, 2008, P. 16].

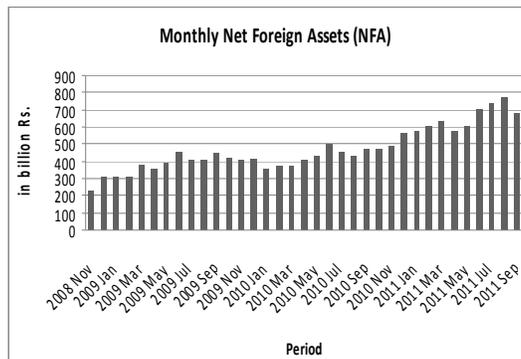
- 4.4.1. Another vital commitment of the government reflected among conditionalities was to allow adequate exchange rate flexibility with the aim of intervention in the foreign exchange market for gearing to attain the benchmark targets for the monthly NFA. The objectives were to ensure sufficient stock of foreign exchange reserves and provide a cushion to absorb the extreme exchange rate volatility. The government itself had indicated its intention to implement these measures in its proposed Programmes and had conveyed this to the Fund authorities while requesting for consideration of the grant of loan. It was basically meant to act as a hedge against economic instability.
- 4.4.2. During the period covered by the first review, the target of achieving NFA was met most successfully through February, 2009 as it rose to Rs 308.64 billion from Rs. 228.75 billion in November, 2008. The same rising trend was witnessed during the period covered by the second review through end May, 2009 when NFA had grown to Rs 393.22 billion. Similarly, the same positive trend continued with some upward and downward flows even during the next quarter

when the net foreign assets targets for September, 2009 were achieved most impressively as these rose to Rs. 448.92 billion. According to IMF these assets

(ii) To address any potential strains in the banking system the State Bank was entrusted with the task of finalizing a contingency plan for handling problem private banks, to be prepared by end-December, 2008 [IMF, 2008, P. 11].

exceeded by about \$ 1.3 billion over the target set for the period, showing a sturdy financial management by the economic managers.

4.4.3. In the subsequent period, the same positive trend continued again with marginal downward and upward fluctuations till the end of the original time frame laid down for the conclusion of the programme in December, 2010. From Rs503.48 in June, 2010 NFA rose to Rs. 564.23 billion in December, 2010 and to Rs. 705.56.25 billion in June, 2011 Subsequently, however, these started showing significantly negative trends and in September, 2011 these had declined by Rs.90.56 billion as compared to the assets of the previous month, reflecting a weak economic position in terms of net foreign possessions . It is however, worth noting that Pakistan not only succeeded in meeting this structural benchmark under the programme but also did well on the front of foreign assets buildup at least till August, 2011, despite the suspension of the IMF-SBA programme practically since May, 2010.



Source: International Financial Statistics (IFS)

4.4.4. As regards the conditionality of discontinuation of the proviso of foreign exchange by SBP for imports of the furnace oil, it was met as per benchmark target. The practice was stopped by the target date of February 1, 2009 and the transactions were moved back to the interbank market. The government had more or less fruitfully met the targets regarding the implementation of the structural benchmarks in respect of NFA and the discontinuation of provision of foreign exchange by SBP for the furnace oil by shifting it to interbank market.

- 4.4.5. The provision of this condition was basically motivated by the realization of the government that though the large banks appeared resilient to the potential shocks (i.e., higher interest rates and exchange rate depreciations); some small and mid-sized banks may be vulnerable to these tendencies. Having realized the potential threat, the government was already preparing a contingency plan for dealing with the private banks in trouble. The incorporation of this proviso as one of the structural benchmark conditionalities was, in fact, not a new one but a continuation of the existing policy / program of the government.
- 4.4.6. As a mandatory step, the Plan set out the criteria for preparation of the schedule for liquidity support, assessment of problem banks and intervention procedures. By the time the first review was held in February, 2009 the government had successfully implemented this structural benchmark conditionality as per the schedule set out under the programme. The government was right on target in preparing the plan and effectively persuading the proprietors of the ‘problem banks’ to go ahead with mergers or to proceed with fresh capital injection. The objective was to ensure the implementation of significant prescriptions by the government so as to guard against any latent damage which may be faced by the banking system. The ultimate aim was to achieve a higher degree of economic stability.
- 4.4.7. The above condition was provided to eliminate subsidy with the ultimate objective of stabilizing the economy by making available the financial resources for productive purposes and also to support the social safety-net program under implementation. The government had reached an understanding with the staff of the Fund that in order to comply with this structural benchmark directive the schedule for tariff adjustment would be prepared, as agreed, and the tariff differential subsidies will be eliminated by end-June 2009. The government finalized the schedule within the target time but it was approved in January 2009.

(iii) “In close collaboration with the World Bank, the government will finalize the schedule for further electricity tariff adjustments during 2008/09, by end-December, 2008 with a view to eliminating tariff subsidies by end-June 2009” [IMF, 2008, P11].

Practical steps were also taken to eliminate subsidy by raising the electricity rates with effect from February 2009 with a clear resolve to raise them further by a cumulative 4 per cent on average by end June 2009.

- 4.4.8. In the mean time, the government realized that a higher increase in tariff rates would be required to eliminate tariff differential subsidies on account of heavy increase in furnace oil prices as well as the cost of other input components of

power generation. The government, therefore, informed the IMF during the second review, held in July, 2009 that it had decided to postpone the elimination of electricity tariff differential subsidy by one year due to public and political pressure. The government, in fact, backed out of the agreement made with the IMF. This naturally became a matter of deep concern for the Fund and the lending financial institutions.

- 4.4.9. In view of seriousness of the issue, the government had to reconsider the program of eliminating the power sector subsidy and accordingly decided to increase the electric tariff rates so as to bring these in line with the terms of the Standby agreement. It was, therefore, decided with mutual consent that the government, in close cooperation with the World Bank and Asian Development Bank, would prepare the action plan to achieve this structural benchmark. A plan was, therefore, drawn up under which the government would reschedule the increase in the electricity tariffs during 2009/10, the target being to achieve cost recovery by August 2010, so that the government may not have to make any provision for tariff differential subsidy in the budget for 2010-11.
- 4.4.10. According to the revised agreement, electricity tariffs were to be raised in three stages with a view to limiting tariff differential subsidies to Rs. 66.7 billion (0.45 per cent of GDP) in 2009/10. Moreover, the government agreed to de-politicize tariff adjustments with a statutory provision by amending the National Electric Power Regulatory (NEPRA) Act in July, 2009 to ensure “(i) monthly tariff adjustments incorporating imported fuel cost adjustments; and (ii) quarterly adjustments reflecting changes in all other cost components of electricity generation.” Monthly adjustments started from August 2009 as per agreement and quarterly adjustments from August 2010
- 4.4.11. It was also provided under the agreement that the government will assume energy sector debt of about Rs. 277 billion (1.9 per cent of GDP). Out of this total, an amount of Rs. 216 billion was due to the borrowings from the commercial banks by power companies to which they had to turn because of inadequate tariff raises and default of tariff differential subsidies during 2004/05–2008/09, while an amount of Rs. 61 billion represented receivables from FATA and the outstanding dues payable to the power companies by the Karachi Electric Supply Company (KESC) [IMF 2009b].
- 4.4.12. The information notified by PEMRA reveals that as per agreement of the government with the IMF, monthly fuel cost adjustments, to be charged from the consumers on account of variation in its price, became effective from August, 2009. As a consequence, fuel cost adjustments were levied at the rate, on average, of Re.0.30 per unit for recovery from different categories of consumers for a period of five months ending December, 2009. By the end of the Fourth

Review by IMF mission in April, 2010 the fuel cost adjustments from August, 2009 were raised to an average rate of Re.0.54 per unit. However, it was observed that “the monthly adjustments on account of fuel cost changes were recovered with some lag”.

- 4.4.13. During January to July, 2010, the fuel cost adjustments were enhanced by an average rate of Re.0.74 per unit whereas these were lowered to an average of Re 0.53 per unit during August to December, 2010. As a general rule, adjustments were made from time to time, in proportion to increases in the cost of fuel. The data provided by NEPRA indicated that the fuel cost adjustments were charged from the consumers, at an average rate of Re.0.59 per unit during January to May, 2011. Although no increases were made after May, 2011 under the head ‘tariff’ which was due for revision by the quarter commencing from July, 2011, the consumers of various categories were charged heavily in their electricity bills. This was owing to major increases on account of fuel cost adjustment which averaged Re.1.95 per unit during June-September, 2011.
- 4.4.14. The tariffs were, however, raised from October 2009, on average, by 41/2 per cent as against 6 per cent, in accordance with the agreement with the World Bank and the Asian Development Bank, because of application of cost differential adjustment. Further to this, it was decided that the left over 13/4 per cent will be realized along with the usual adjustment payable by December, 2009 by merging it with the regular quarterly adjustment. The full implementation of 6 per cent adjustment targeted for October, 2009 could materialize only in December. Moreover, additional cost accruing as a result of the delayed monthly adjustments effective from end-July, 2009, was also decided to be covered through the quarterly tariff adjustment.
- 4.4.15. The tariffs were, however, raised from October 2009, on average, by 41/2 per cent as against 6 per cent, in accordance with the agreement with the World Bank and the Asian Development Bank, because of application of cost differential adjustment. Further to this, it was decided that the left over 13/4 per cent will be realized along with the usual adjustment payable by December, 2009 by merging it with the regular quarterly adjustment. The full implementation of 6 per cent adjustment targeted for October, 2009 could materialize only in December. Moreover, additional cost accruing as a result of the delayed monthly adjustments effective from end-July, 2009, was also decided to be covered through the quarterly tariff adjustment.
- 4.4.16. However, the tariff was raised by 2 per cent on 1st October and yet again by 2 per cent on 1st. November, 2010 for the quarter ending December, 2010, reflecting again a shift in the policy of quarterly adjustments in the tariff rates. The same drift persisted in the next two quarters as the tariff cost adjustments in the guise

of surcharge became effective only from 15th March, 2011 and 6th May, 2011, instead of 1st January, 2011 and 1st April, 2011 respectively. The next quarterly adjustment programme was shelved and hence remained in suspense for the next quarter ending September, 2011. [Source: Government of Pakistan, 'Applicable Tariff GOP Notified']. Therefore, the electricity tariff adjustments still lagged behind the targets as agreed by the government with the WB and ADB.

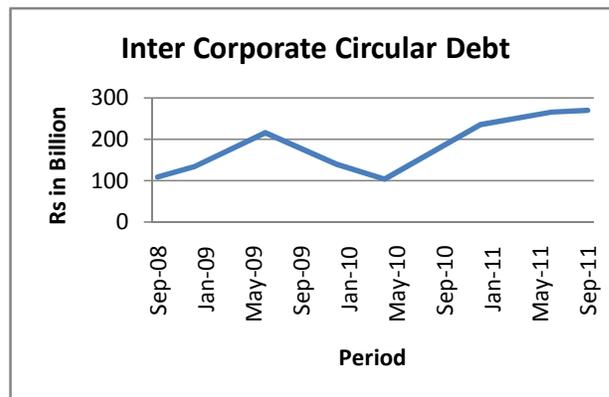
- 4.4.17. It may be observed that although the electricity tariffs, as a whole, that is, considering the average of all categories of consumers, went up by 31 per cent (excluding 4% surcharge) from the time introduction of IMF Program up to September, 2011, the government had to pay a heavy amount of subsidy despite its resolute wish to gradually eliminate the cost differential subsidy to the power sector. A total amount of Rs. 111.64 billion (0.88 per cent of GDP) was provided by the government as against the budgetary provision of Rs. 88.41 billion (0.69 per cent of GDP) to cover the power sector subsidy in the financial year 2008-09. Similarly the government had to pay Rs. 179.526 (1.21 per cent of GDP) against the budgetary provision of Rs. 66.70 billion (0.45 per cent of GDP) in 2009-10, an increase of about 60.8 per cent over the preceding year.
- 4.4.18. For the next financial year, the government contemplated to provide an amount of Rs. 87.32 billion (0.48 per cent of GDP) for subsidy, but the actual disbursement came to Rs. 343.14 billion (1.9 per cent of GDP) representing a whopping increase of 255.82 billion over the budgetary provision for the year. Similarly, an amount of Rs. 147.29 billion (0.71 per cent of GDP) was set aside for the subsidy to the power sector in the budget for 2011-12, an amount equivalent to Rs 20 billion over and above the budgetary allocation had already been spent under this head by end September, 2011, as revealed by sources in the Ministry of Finance.
- 4.4.19. It is obvious that notwithstanding the resolve of the government to gradually eliminate the subsidy to the power sector, it failed to achieve the targets of reduction in the level of subsidy for this sector; in fact, its volume continued to soar and soon recorded a manifold increase. Moreover, despite the heavy amount of subsidy provided to the people, the burden of electricity charges became unbearably oppressive for the masses, more so for the low-income groups. Besides, exorbitant increases in the cost of electricity caused heavy losses to almost all sectors of the economy especially the industrial sector. According to a conservative estimate the increase in the electricity charges as a result of manifold increase in the cost of power generation and the related problem of acute shortage of power and consequential emergence of the specter of load shedding has affected more than two per cent of the annual growth of the economy in the recent years [Pkeconomists 2012]. There is a consensus in the views expressed in the plenty of literature contributed by various authorities on

this issue that the rise in the tariff rates is not the solution of the problem; for a practical and lasting solution we have to go for cheap electricity generation through improving the production mix along with high-quality management of the power sector and good governance as a whole.

4.4.20. The problem of circular debt which has assumed menacing proportions in the country, surfaced for the first time in end 2007 in the form of a massive inter-corporate debt in the energy sector. It is said to be a single most significant factor responsible for causing a mess in the power sector affecting its supply and ultimately creating an economic crisis in the country. It was found occurring since one entity facing problems in its cash inflows started failing in paying its dues to suppliers and creditors. The electricity sector has, in fact, become hostage of circular debt [Ali, SS & Sadia, B 2010]

4.4.21. The emergence of this phenomenon can thus be traced to continuing heavy default by different departments of the federal and provincial governments including some major public sector enterprises and Karachi Electricity Supply Company (KESC). The power generation companies under the control of Pakistan Electric Power Company (PEPCO), KESC and Independent Power Producers (IPPs) then started failing to clear the dues payable to fuel suppliers who were consequently faced with severe liquidity crunch. The circular chain was completed when these suppliers also defaulted in payments to their creditors. There are various reasons for the inability of the power producers to pay to fuel suppliers such as inefficiency in collection of revenue from private sector, non-payment of dues by the public sector including the provincial governments and ineffective contractual agreements between PEPCO and KESC [NEPRA 2010].

4.4.22. According to the conditionality attached to the program, the circular debt which was greatly responsible for the poor performance of the economy, needed to be eliminated within the specified period. The IMF and many other agencies were firmly of the view that the resolution of the problem was necessary



to salvage the economy and improve its macroeconomic and social indicators. The conditionality to redress inter-corporal debt was made with the mutual agreement of the government and the IMF. By the time the First Review of the Program was held, the government had met the criterion by fast track preparation

of a plan to deal with the circular debt. However, it was found to have increased on a net basis from Rs. 51 billion (0.4 per cent of GDP) in mid-October, 2008 to close to Rs. 216 billion (1.7 per cent of GDP) by end June, 2009 [IMF 2009b]

- 4.4.23. Over a period of time the government had run short of the options available to handle the problem of burgeoning circular debt. To minimize this lingering burden, the government issued the Term Finance Certificates (TFCs) in March, 2009 to cover about Rs.98 billion out of the outstanding liabilities of Pakistan Electric Power Company (PEPCO). This was expected to bring about a significant increase in electricity production to help the recovery of the industrial sector which was badly suffering due to power shortages. However, even this measure could not bring about any significant improvement in the position of power supply [Ali, SS & Sadia B 2010].
- 4.4.24. The program to raise funds through the sale/lease of government property was also considered an effective expedient to meet the remainder of the obligations. The government guaranteed Rs. 85 billion (0.6 per cent of GDP) in TFCs to settle a portion of the energy sector's circular debt, albeit with great difficulty. As for the remaining circular debt, amounting to Rs. 216 billion as of June, 2009 it was decided to transfer it to a holding company of the Ministry of Water & Power at the earliest. Although the transfer did materialize but this structural benchmark was not accomplished according to original time frame.
- 4.4.25. The circular debt mostly fluctuated between Rs. 50 billion to Rs. 250 billion during the last three and half years but at one stage it had gone beyond Rs. 300

(vi) "In close collaboration with the World Bank, the government will adopt a strategy and a time bound action plan, by end March 2009, for adoption of specific measures to strengthen the social safety net for improved targeting of the poor"[IMF, 2008, P.11].

billion. According to official sources, the circular debt of the power sector, which was about Rs.109 billion in September, 2008 rose to Rs 216.0 billion in June, 2009 but shrunk to Rs 140.45 billion by end December, 2009 and further to Rs.103.94 billion at end April, 2010. It, however, spiraled to Rs. 235.44 billion by end December 2010 and further to Rs. 266.17 billion (1.5 per cent of GDP) and Rs.270 billion by end June, 2011 and September, 2011 respectively. The government has so far failed to overcome the problem which badly affected the economy despite the fact some significant measures have been taken to cure this festering sore.

- 4.4.26. The government and the Fund strongly felt the need to expand the social safety net to protect the poor and to provide them a cushion to minimize the adverse effects of the existing poverty, unemployment and inflation and further growth of these socio-economic ills. Even the existing level of unemployment and poverty at the start of the Plan was believed to have badly eroded the purchasing power of the marginalized population. The design and implementation of a comprehensive system of targeted social assistance was, therefore, made an integral part of the programme with mutual consultation of the government and the IMF.
- 4.4.27. It was, in fact, a continuation of the initiative already taken in September 2008 in the form of Benazir Income Support Program (BISP). The objective was to provide speedy relief to the underprivileged sections of the society with initial allocation of Rs. 34 billion (\$425 million) constituting about 0.3 per cent of GDP for the financial year 2008-09. The program envisaged covering 3.5 million deserving families. Under the BISP, each deserving enrolled family is to receive cash assistance of Rs 1000 (about \$ 11.5) per month at their doorsteps [IMF 2008].
- 4.4.28. Noticing some deficiencies in the program such as lack of objective targeting mechanism, the government and the IMF agreed to reform it by introducing a Score Card system as a device for identifying the marginalized population. The government, in collaboration with the World Bank, therefore, prepared a strategy and time bound plan by end-March 2009 as per schedule. By the time the first review was held, the roll out of the Score Card in 16 districts (pilot phase) had started and all the 130 districts were expected to be covered between December 2009 and June 2010 while actual disbursement was to be started soon thereafter. According to IMF sources, delays in BISP roll out and the government decision not to scale up Bai-tul-Mal (a cash transfer scheme in operation) were responsible for lower-than-projected spending on social transfers in 2008/09 [IMF 2009 a].
- 4.4.29. Owing to limited administrative capacity, the roll out of the reformed Program based on poverty Score Card system took longer time than envisaged. The performance on ground was dismal as only 1.76 million families were covered under the program by end-June 2009, which was much less than the original target of three million. The disbursements were also lower than the budgeted amount since only an amount of Rs.14 billion was disbursed which constituted only 41.2 per cent of the allocated fund. However, it was planned that the disbursements and the number of beneficiary families under the program would increase substantially to five million during 2009-10 and a budgetary allocation of Rs. 70 billion (approx. \$ 875 million) was, therefore, provided which constituted 0.47 per cent of GDP.

- 4.4.30. To make the programme more effective, it was laid down by the concerned authorities that the targeted families would receive financial assistance for the entire year irrespective of the date of their eligibility. However, it was observed during the fourth round of review in April, 2010 that owing to administrative constraints, the roll out of the score card-based targeting system of the Program had taken longer time than the given timeframe. As a result, the social spending remained below the budgeted amount and only a part of the budgetary allocation could be delivered. Owing to delay in strengthening the targeting system, only an amount of Rs. 19.4 billion was disbursed among 2.7 million families which was much below the target set for the period.
- 4.4.31. Due to slow progress under the program, the target was revised .by extending the support to additional four million families by the end of 2010-11. To meet the enhanced target, an allocation of Rs. 50 billion (0.27 per cent of GDP) was made for the program with an understanding that, if necessary, the amount may be raised further. However, by the end December 2010, only 3 million families were covered and only an amount of Rs. 16 billion was disbursed to the targeted families. Since BISP suffered from low implementation capacity, full achievement of the program was not possible even during 2010-11. The official sources revealed that the number of recipients of the programme fell by 48 per cent in July-September, 2011-12 as compared with the number of beneficiaries during the same period of the previous year. This decline occurred because the policy of preparing the list of beneficiaries on the recommendation of the members of Parliament to the score card system was abandoned on the advice of the World Bank except in case of Balochistan and tribal areas.
- 4.4.32. The factual position stated above indicates that the government has fallen short of achieving the program targets. The data reveals that there had been a substantial decline in spending on the social welfare front. It was mainly on account of lack of administrative capacity and the incompetence in managing the BISP which led

(vii) 'In the area of public financial management, reforms to improve control on cash disbursement and overall cash management will be undertaken by transforming the existing treasury system into single treasury account, to be completed by end-June, 2009' [IMF, 2008, P.11].

to a drastic decrease in disbursements under the two social safety programmes namely, Benazir Income Support and Pakistan Bait-ul-Mal. This failure has had serious implications for the marginalized population; especially in view of a sharp increase in poverty due to wide spread unemployment and ever-rising inflation.

- 4.4.33. In the area of public financial management, the government was conscious of the need for reform to improve control on cash disbursement and overall cash management, to be accomplished by transforming the existing treasury system into a single treasury account. The objective was to improve the public financial system for effective management of the financial resources of the government. This process was underway even before the introduction of SBA program. A considerable progress had, therefore been made by October, 2008, when the government introduced a system preventing the accumulation of unspent balances in accounts outside the Federal Consolidated Fund (FCF). Still a significant amount remained in accounts with commercial banks. It implied that the transition to the Treasury Single Account (TSA) system, benchmark conditionality, could not be accomplished as per the prescribed schedule.
- 4.4.34. In the First meeting of the IMF Mission held in February, 2009 to review the progress in the implementation of the conditionalities, it was informed by the government that a treasury single account had been created but the consolidation of the government funds may not be possible by end-June 2009. Considering the state of progress as well as the limitations being faced by the government to accomplish the task, it was decided in July, 2009 that technical assistance would be provided by the World Bank to conduct a survey for identifying the remaining balances with commercial banks. The purpose was to transfer these remaining amounts to the TSA by end-June 2010, subject to an assessment of the impact of transfers on the banking sector's liquidity. The re-adjusted benchmark conditionality was met but with some delay, that is, by October 2010.

5. Inconclusive End of the Programme

- 5.1. Despite taking some bold, though politically unpopular, reform measures, the government failed to accomplish some of the most important structural reform conditionalities. These related to the fiscal deficit which showed a continuous breach of fiscal deficit limits, non implementation of VAT regime, and non-finalization of amendments in the legislative framework for the financial sector, energy sector reforms and complete withdrawal of subsidies in the power sector. Failure of the government to implement some of the key conditionalities became a cause of irritation for the IMF that it suspended the program after the fourth disbursement and deferred the fifth review scheduled for July, 2010 first to August, then to September, 2010 and later on indefinitely. Consequently, it withheld the release of the remaining two tranches, amounting to \$ 4.06 billion worth SDRs 2.3 billion, constituting 64.07 per cent of the total amount of loan.
- 5.2. Realizing that continuation of financial assistance was of critical importance for the country, the government approached the IMF with the request to extend its SBA Program. The IMF with some reluctance gave a relaxation of nine month on

the ‘lapse-of-time basis and extended the programme till end September, 2011. This concession was meant to provide a chance to the authorities to meet the missing targets of benchmark conditionalities⁷ [for revised disbursement schedule refer to IMF 2010g]. The government soon realised that it may not be possible for it to accomplish the remaining tough conditionalities because of strong political blowback. The government also realized that it may not be able to set right the existing grave macro economic distortions in the economy, which these conditionalities were meant to address, in a short span of time. Finding that the IMF was adamant on compliance with the unaccomplished key structural reform conditionalities regardless of their political fall out, the government abandoned the idea of pursuing the matter any further. The program was, therefore, wrapped up on 30th. September, 2011 without achieving some of its significant structural reforms which were indeed most essential for economic recovery [Hyder, SN 2011b]

- 5.3. thorough examination of the facts reveals that the government faced serious handicaps in implementing some of the most essential conditionalities such as the introduction of reformed sales tax regime, because of lack of preparedness and absence of political support even by its coalition partners, strong resistance by the business community and non-acceptability by the masses. Likewise, manifold increases in the cost of electricity on account of faulty policies of the government regarding current generation mix and poor management of the power sector including bad governance as a whole, were responsible for the failure of the government in carrying out reforms in the power sector. It may be concluded that the supportive actions such as energy audit of the power plant to make targeted investment for improving efficiency, abolition of free electricity to Wapda/Pepco and performance based appointment especially of top management may have proved to be more effective in providing a significant financial stability to the power sector rather than a continuous tariffs increases for making adjustment in electricity cost. It has proved counter-productive as it had serious negative effects on the economy. Similarly, the burden of further increases in electricity tariffs would become more oppressive for the masses, more so for the marginalized segment of population.
- 5.4. An important factor responsible for failure in curtailing the fiscal deficit was the unprecedented flood disaster in July, 2010, unprecedented in the history of the region, followed by another spate of raging waters within less than a year. These calamities destroyed a sizable part of infrastructure, agriculture, communication and natural resources in addition to the loss of human lives which seriously

⁷ *The lapse of time procedure is adopted in case, the request for extension in time period is agreed by the Executive Board of IMF. It is approved without convening formal discussion.*

eroded the national economic assets. Though it is difficult to estimate precisely their adverse budgetary impact, the relief and rescue operations including rehabilitation of the homeless persons, the cost of repairing and rebuilding public infrastructure etc. must have placed a heavy burden on public finances at both the provincial and federal levels. Furthermore, rise in the prices of petroleum and its products, heavy spending on internal security, poor governance including corruption and un-checked non-productive expenditure badly hampered compliance with the conditionality concerning the fiscal deficit.

6. Could the IMF Financing under SBA help to Overcome Declining Macro Economic Trends in the Country?

- 6.1. It would be a pertinent question to ask whether the IMF tranches comprising the initial release and four subsequent installments amounting to \$ 7.24 billion, forming 63.28 per cent of the total loan under the Programme could make any tangible contribution in arresting the rapidly declining macro economic trends. In other words, it needs to be examined whether the economy could move forward as a result of the financial assistance received before the inconclusive end of the programme despite meeting many of the most significant conditionalities of the Programme. It is also important to analyse the macro economic trends during the post suspension period covering the period up to September, 2011 to judge whether the continuation of the programme might have been helpful in stabilizing the economy.
- 6.2. One of the most fundamental structural reform targets was to reinforce financial discipline by lowering the fiscal deficit through strict control over budgetary expenditure. Though the fiscal deficit target appeared challenging, it was achieved at the very initial stage of implementation of the programme but the trend could not be maintained. Consequently, at the end of financial year 2008-2009, the fiscal deficit reached 5.2 per cent of GDP compared with adjusted program target of 5.1 per cent. The situation further worsened as it rose to 6.3 per cent of GDP by end June, 2010. Although, as mentioned above, the release of loan was stopped later on, the fiscal deficit declined noticeably and the downward trend continued even up to end September.
- 6.3. As for control over the inflationary trends in the country, the CPI and SPI shot up by over 20 per cent while the WPI was marginally below 20 per cent from the very early phase of the programme implementation. Though it was brought down to a comparatively lower per centage during the financial year 2009-2010, yet all the price indices rose by double digit and the next financial year witnessed a major increase in the SPI and WPI. However, some positive development was recorded during the first quarter of financial year 2011-12, as the inflationary trend was seen to be receding, as per the government statistics released by

Pakistan Bureau of Statistics (PBS). These trends, therefore, did not support any impact over the price level in consequence of the financing under the programme.

- 6.4. The weak performance of the economy in spite of the Program implementation under way, was also reflected in the deteriorating exchange rate which had remained almost stable for the last five to six years, but started depreciating heavily from the middle of the financial year 2007-08 as it came down from \$1 equal to Rs. 60.6 in June, 2007 to Rs 86 in June 2011 [GOP 2009, 2012] and to Rs. 87.48 in September, according to the [SBP 2011]. It is worth noting that the exchange rate depreciated by 41.09 per cent by June 2010 (the Program was in operation) taking the base year of 2006-07 while after its suspension, it declined by only 2.2 per cent during June 2010 to September 2011 which establishes that some other economic factors were more effective to maintain exchange rate stability rather the financing under the Program.
- 6.5. As regards the foreign exchange resources, these registered an increase at the very initial stage of the financial assistance provided by IMF. However, this increase was the result primarily of higher inflows of overseas remittances, higher decline in the value of imports as compared to lesser decline in value of exports, reimbursement under the coalition support fund (CSF) and, only to an extent, of the funding from the IMF. The foreign reserves which had come down to about \$ 6.4 billion by November 2008, rose to about \$ 12.43 billion in June 2009 and further to about \$ 16.75 billion by end June 2010. As noted above, this build up of foreign reserves came about mainly because of factors other than the IMF support.
- 6.6. As regards the foreign reserves position after the suspension of the programme, it generally showed a rising trend, albeit with some fluctuations, and touched the historic milestone of about \$ 18.24 billion by end June, 2011. Though, it declined to \$ 17.33 billion in September, 2011, the economy was still at a comfortable level in terms of foreign reserves. However, an apprehension is being generally expressed that the foreign exchange reserves will start dwindling from their currently high level after the commencement of repayment of IMF loan from the fiscal year 2011-12.

Table: 2 Foreign Exchange Reserves in million US \$

Period	NET RESERVES WITH SBP	NET RESERVES WITH BANKS	TOTAL LIQUID FX RESERVES

2007-08	8.58	2.82	11.40
2008-09	9.13	3.30	12.43
2009-10	12.96	3.79	16.75
2010-11	14.78	3.46	18.24
Sep- 2011	13.65	3.68	17.33

- 6.7. Unlike the healthy trend in the accumulation of foreign reserves, the country's debt followed a consistently negative drift. As regards the total debt in domestic currency during the active and post suspension period of the programme the data available indicates that the country was slipping into the quagmire of heavy indebtedness. The total debt (in domestic currency) which amounted to Rs. 4814.0 billion at the end of the financial year 2006-07, rose to Rs. 6055.0 billion by the close of financial year 2007-08. The same rising trend was observed in the coming years as it climbed to Rs. 7595.0 billion at end June 2009 and to Rs. 8938.0 billion by the end of June 2010 [GOP 2011]. It soared to Rs.10, 709.0 billion by end June, 2011 and stood at Rs. 11,263.0 billion (58.2 per cent of GDP) by the end of the first quarter of 2011-12, according to the information released by the State Bank of Pakistan. The period witnessed the foreign currency debt also moving along an upward curve, rising from \$ 36.5 billion (25.52 per cent of GDP) at the end of financial year 2006-07, to \$ 40.9 billion by end June 2008 and to \$ 46.3 billion at the end of 2008-09. It further grew to \$ 49.5 billion at the close of financial year 2009-10, to \$ 54.6 billion at end June 2011 [GOP 2012] and \$ 55.4 billion at end September, 2011 [SBP 2011]. As a result of the mounting debt liability, the huge amounts had to be paid every year by the beleaguered nation to retire the foreign debt whose volume will increase heavily in the years to come which will be hard for the economy to bear.
- 6.8. It is a matter of great concern that the total foreign debt and liabilities of the country have registered a steep increase during the period under review. Resultantly, Pakistan is the only country in South Asia to be classified as a highly indebted country. Indeed the financial assistance provided by IMF under SBA has helped in solving the immediate problem of correcting the extremely adverse balance of payment position and has also had marginal salutary impacts on the economy but escalating public debt may not bode well for macro economic growth in the medium and long runs.
- 6.9. It can be concluded from the descriptive review outlined in the preceding paragraphs that the economy witnessed a degree of stabilization during the initial stage of the Programme. However, at the later stage, it generally showed a negative trend, indicating the absence of any significant impact of the loaning on

the revival of the economy. On the other hand, many significant performance indicators showed positive trends; a few continuously and some intermittently even after the suspension of the programme. Although there were indications of positive trends at the early stage, the economic activity as a whole and the rate of economic growth remained highly subdued and inflation generally remained unabated. These facts lead to the conclusion that the SBA failed to deliver the desired results. It is not only the government that was responsible but the IMF should have ensured while designing its conditionalities the provision of measures required such as for limiting the non-productive expenditure by the government, removing inefficiency in the power sector which happened to be the cause of all economic ills in the country resulting the failure of the programme, and ensuring good governance in the country to achieve the objectives of the SBA.

APPENDIX

PAKISTAN'S HISTORY OF ARRANGMENTS WITH IMF (Amount in Million SDR)

TYPE OF ARRANGEMENTS	DATE OF ARRANGEMENTS	INITIAL DATE OF EXPIRATION	ACTUAL DATE OF EXPIRATION	AMOUNT AGREED	AMOUNT DRAWN	PER CENT UN-DRAWN
SBA*	8-Dec-58	7-Dec-59	22-Sep-59	25.0	0.0	100.0
SBA*	16-Mar-65	15-Mar-66		37.5	37.5	0.0
SBA*	18-May-72	17-May-73		100.0	84.0	16.0
SBA*	11-Aug-73	10-Aug-74		75.0	75.0	0.0
SBA*	11-Nov-74	10-Nov-75		75.0	75.0	0.0
SBA*	9-Mar-77	8-Mar-78		80.0	80.0	0.0
EFF**	24-Nov-80	23-Nov-83		1268.0	1079.0	14.9
SAF@	28-Dec-88	27-Dec-91	15-Dec-92	382.4	382.4	0.0
SBA*	28-Dec-88	7-Mar-90	30-Nov-90	273.2	194.5	28.8
SBA*	16-Sep-93	15-Sep-94	22-Feb-94	265.4	88.0	66.8
ESAFβ	22-Feb-94	21-Feb-97	13-Dec-95	606.6	172.2	71.6
EFF**	22-Feb-94	21-Feb-97	13-Dec-95	379.1	123.2	67.5
SBA*	13-Dec-95	31-Mar-97	30-Dec-97	562.6	294.7	47.6
PRGFΨ	20-Oct-97	19-Oct-00		682.4	265.4	61.1
EFF**	20-Oct-97	19-Oct-00		454.9	113.7	74.0
SBA*	29-Nov-00	30-Sep-01		465.0	465.0	0.0
PRGFΨ	6-Dec-01	5-Dec-04		1033.7	861.4	16.7
SBA*	24-Nov-08	30-Dec-10		7235.9	3402.6	53.0
TOTAL				11,934.30	7,027.00	41.1

SOURCE: State Bank of Pakistan.2009: *Annual Report- 2008-09*, (SBP, Karachi).

*SBA Stand by Arrangements
 **EFF Extended fund facility
 @SAF structural adjustment facility
 βESAF Enhanced structural adjustment facility
 ΨPRGF poverty reduction and growth facility

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