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Pakistan and the IMF

Press Release:
IMF Executive Board Approves US$451 Million Disbursement in Emergency Natural Disaster Assistance for Pakistan
September 15, 2010

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Pakistan: Letter of Intent

September 10, 2010

LETTER OF INTENT

Islamabad, Pakistan
September 10, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Strauss-Kahn:

The floods that hit Pakistan in late July and August are a natural disaster of massive proportions. Some 1,540 people have died, a further 2,320 have been injured, and more than 2 million families have been displaced. Over 15 million people (almost 10 percent of the population) have been affected and large parts of the country, from the Chinese border to the mouth of the Indus River, have been flooded. Although fewer casualties have been sustained than after the 2005 earthquake, the damage to economic infrastructure and private property is much more severe.

It is too soon for a precise estimate of the economic fallout and reconstruction cost, but undoubtedly we will need substantial support. The World Bank and the Asian Development Bank (ADB) will provide a Damages and Needs Assessment by mid-October. But, it is already clear that our needs will far exceed our means.

We are, therefore, seeking rapid assistance from the IMF to help us cope with the immediate economic impact of this disaster, and request a purchase under the policy on Emergency Assistance for Natural Disasters (ENDA) in the amount of SDR 296.98201 million (28.73 percent of quota). The assistance will be used to meet the immediate financing needs of the government for providing urgent food, shelter, and health services without over-burdening domestic financial markets or depleting foreign exchange reserves. Financial assistance from the IMF will also help sustain confidence in our external position during these difficult times, and encourage financing from other sources. We remain very much committed to the reforms we are undertaking under the Stand-By Arrangement (SBA), as discussed in our letter of May 3, 2010 to the Fund, and hope to be able to complete the fifth review under the program in the coming months.

Economic and Budgetary Developments before the Floods

Even before the floods, our economic circumstances were far from easy, but we were making progress with our stabilization and reform program. Manufacturing activity had rebounded in recent months and real GDP growth in 2009/10 reached 4.1 percent according to provisional estimates. We had been on track to reach at least 4½ percent GDP growth this year. Inflation had come down from 25 percent in October 2008 to 12–13 percent in recent months. To contain inflation, in July the State Bank increased its policy interest rate by 50 basis points to 13 percent. Gross reserves reached US$13 billion in June 2010, and the exchange rate has been stable around 85–86 rupees per dollar. The pickup in reserves resulted from a steady narrowing of the current account deficit, to US$3.5 billion (2 percent of GDP) in 2009/10.

Fiscal policy faced a number of challenges in 2009/10. The reorganization of the tax administration had a temporary adverse impact on tax collection and, despite our efforts, tax collection fell short of target. At the same time, there were overruns in security spending due to the difficult security situation, and provincial spending was higher than expected. Consequently, the 2009/10 fiscal deficit reached 6.3 percent of GDP, compared with an unadjusted program target of 5.1 percent and an adjusted target of 4.6 percent of GDP. Although we were able to draw on domestic bank and non-bank financing, we also had to rely on central bank financing, which exceeded the target by Rs. 42 billion. We have met all other end-June performance criteria under the Fund-supported program.

Our budget for fiscal year 2010/11, set before the floods, targets a deficit of 4 percent of GDP—a federal fiscal deficit of 5 percent of GDP combined with a provincial surplus of 1 percent of GDP. To achieve this target, we have raised the general sales tax (GST) rate by 1 percent and increased some excise and direct taxes. We have also resumed tax audits, using risk-based selection criteria to increase their efficacy.

We have also worked closely with the provinces to ensure they run the desired surpluses. The share of tax revenues distributed to them increased significantly under the 7th National Finance Commission award. As spending responsibilities have not yet been transferred to the provinces as envisaged following the 18th constitutional amendment, the provinces were expected to save the additional funds and run surpluses. They have agreed to revise initial budgets and scale back spending plans.

Economic and Budgetary Impact of the Floods

The floods have destroyed infrastructure and seriously undermined the economic outlook. Agriculture, which accounts for 21 percent of GDP and 45 percent of employment, has been hit particularly hard. There is significant damage to cotton, rice, and sugarcane crops as well as livestock. This will hurt our export performance, especially in the textile sector, and will lower domestic demand in other sectors. We expect GDP growth to be 2½–3 percent this year, about 1¾ percentage points lower than would have been possible without the floods. Furthermore, the damage to crops and the disruption of supply chains in rural areas will inevitably lead to higher inflation for food and other items. Additional demand for building material, medicine, and social services will also contribute to price pressures. We expect the average annual inflation rate to increase from 11.7 percent to 13½ percent this year. The financial sector is also suffering, with dozens of bank branches closed in flood-hit areas.

While it is presently difficult to estimate with any accuracy, the floods will have considerable budgetary impact. The rescue and relief operations and the costs of repairing and rebuilding public infrastructure will place a heavy burden on public finances at both the provincial and the federal level. At the same time, tax revenues are likely to fall as economic activity weakens. The floods will likely hurt the balance of payments. Imports will rise in the short run as food and other basic goods will need to be sourced from abroad, while capital equipment imports will increase when reconstruction begins.

Our Response to the Floods

The Government of Pakistan has moved swiftly to provide relief and mobilize resources. The National Disaster Management Authority, its provincial counterparts, and other agencies have made great efforts to provide rescue and relief operations in the areas affected by the floods. Thousands of people have been evacuated, food and medicine have been distributed to displaced persons, and some emergency repairs have been made to roads and other infrastructure.

Donors have responded with emergency assistance, aid pledges, and reallocation of resources. The United Nations has led the effort for early recovery and assistance operations for which it needs US$460 million, of which so far it has secured US$275 million from public and private international donors. Also, the World Bank and the ADB have committed to reallocate US$1 and US$2 billion, respectively, to help us finance reconstruction.

The cost of emergency operations and the reconstruction that lies ahead will compel us to adapt our fiscal framework to boost budgetary resources and enable the government to address the emergency, improve service delivery to the population, and increase public investment to raise growth. We will, therefore, shift resources from non-priority current and development spending to relief and reconstruction spending. We will also introduce a temporary 10 percent income tax surcharge. Despite these efforts, there is no doubt that the massive spending needs and the revenue shortfall that are being caused by the floods will push the deficit above 4 percent of GDP. Given the limitations on domestic resources, additional external financing is urgently needed, preferably in the form of budgetary grants.

The SBP is taking steps to limit the damage to the economy and the financial sector. It is working closely with banks to facilitate the flow of credit and also with international development agencies to expand and redirect the existing financing facilities to small and medium-size enterprises and microfinance projects in the areas hit by the floods. And, to make sure Pakistan's international trade and financial relations continue to function normally, we will not impose any restrictions on the making of payments and transfers for current international transactions nor introduce any trade restrictions or enter into any bilateral payment agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement.

We will continue to co-operate closely with the Fund in the context of our SBA, both to provide support for our reform efforts and help provide a consistent economic and financial framework in the challenging period ahead. Specifically, the existing GST will be transformed through the introduction of a reformed GST capturing the features of a VAT, enabling us to start raising the tax revenues required for sustainable growth. We also remain committed to reform the electricity sector in order to eliminate tariff differential subsidies and resolve circular debt, and to address the quasi-fiscal implications of commodity credit. We will adopt measures to cap the fiscal deficit at 4 percent of GDP before the impact of the flood. The macroeconomic framework will be re-evaluated once the damage needs assessment has been completed, and a revised budget will be submitted for approval to the cabinet and presented to the standing committees on finance and revenue of the National Assembly and the Senate of Pakistan. We are working actively to deliver these reforms and thus remain confident that the fifth review under the SBA can be completed later this year.

Sincerely,

/s/	/s/
Abdul Hafeez Shaikh	Shahid H. Kardar
Minister of Finance	Governor of the State Bank of Pakistan