BMA CAPITAL

Pakistan Economy

IMF IV Consultation: Steps in the right direction but little to solve long term structural problems

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Once again Pakistan has entered a ~ 3 Year EFF with the IMF worth USD 7.1 BN that aims to resolve Pakistan's long-standing structural problems. The IMF has taken steps in the right direction with benchmarks that address long-standing tax inefficiencies in real estate and agriculture, efforts to address governance and corruption problems, and steps towards further macro-stabilization. However, on a closer look, the exports and external imbalance problem that stems from it remains largely unaddressed and projections appear rosy.

The IMF appropriately identifies Pakistan's structural problems: The IMF highlights that weak governance, a difficult business environment, and economic volatility have hindered investments. At the same time " a large part of the economy is propped up by the extensive use of protection, subsidies and tax concessions" and these measures have led to inefficiency and low productivity.

It goes on to detail that insufficient investment in social sectors; health and education has hindered Pakistan's ability to make use of its growing population.

Through various measures, the state's support of businesses has "undermined the development of a dynamic and outward-orientated economy."

The IMF highlights the non-observance of previous Program criteria as a key determinant of future macroeconomic instability, especially during the 2019 – 2023 EFF, and suggests the current EFF will build on the lessons of past programs.

Structure of the new EFF: The new EFF program sees Pakistan building on the macroeconomic stability achieved during the previous SBA program. Real GDP growth is expected to rise to 4.5% by FY28, the Current Account Deficit is expected to be under 1.0%, and External Debt / GDP is expected to contract from 31.3% in FY24 to 27.3% by FY29. This deleveraging is conditional on benign Current Account Deficits and a consistent Primary Surplus on the fiscal side.

But yet again, It's Mostly Fiscal: While there are steps in the right direction - we particularly like the structural benchmark related to the normalization of the tax regime within the Agriculture sector - the Fund misses the mark in several areas. While the role of preferential tax treatments and subsidies in hindering competitiveness is addressed, the Fund does not dwell on the significant role high energy prices and political and economic volatility have played in this area. During most programs, the focus has been reducing the stock of circular debt to fixing the cash flow problems within the energy chain but the competitiveness of energy tariffs as a means to promote exports is never explicitly addressed as Performance Criteria or Indicative Targets. Moreover, while the Fund highlights that targets on …

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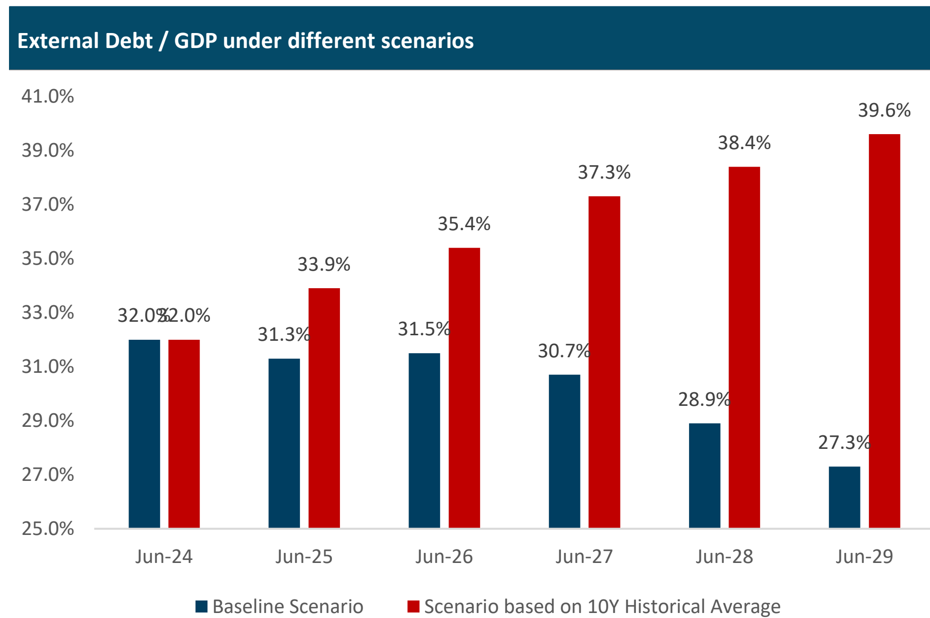
Health and Education spending are rarely met and that lack of education, poverty (and associated developmental stunting due to child poverty) are major long term obstacles to structural reform, the Fund does not envision any changes to program design which would limit the disbursement of funds should such longer term PC or IT targets be not met (historically funds have been disbursed as long as Quantitative targets are met even as actual structural changes are waived off and kicked down the road).

Preferential tax treatments and state subsidies are highlighted as obstacles to export competitiveness. Under one SB, the Fund envisions a Plan to end Special Economic Zone incentives.

Yet the Fund does not acknowledge the positive role government support can play in an intelligently devised Industrial Policy. Even as the US, through the Inflation Reduction Act, and the EU through similar measures are creating incentives for investment in clean energy and on-shoring of manufacturing, and even as new technologies such as Electric Vehicles, Battery Storage and Solar PV continue to be subsidized globally, no room is felt for Pakistan to implement similar targeted measures to promote export competitiveness.

Projections are Optimistic even by the Fund's own scenarios: Tucked away in its Annexures, the IMF highlights its External Debt / GDP projections for Pakistan in its baseline scenario. The Fund notes that 1) in past programs implementation has been sporadic and the "Authorities" have tended to revert to unsound policies post Program end 2) It then goes on to mention that at 10Y historical averages for variables such as GDP Growth, Fiscal Deficit and the Current Account Balance, Pakistan's External Debt/GDP would be expected to significantly worsen, in sharp contrast to the baseline scenario.

External Debt / GDP under different scenarios

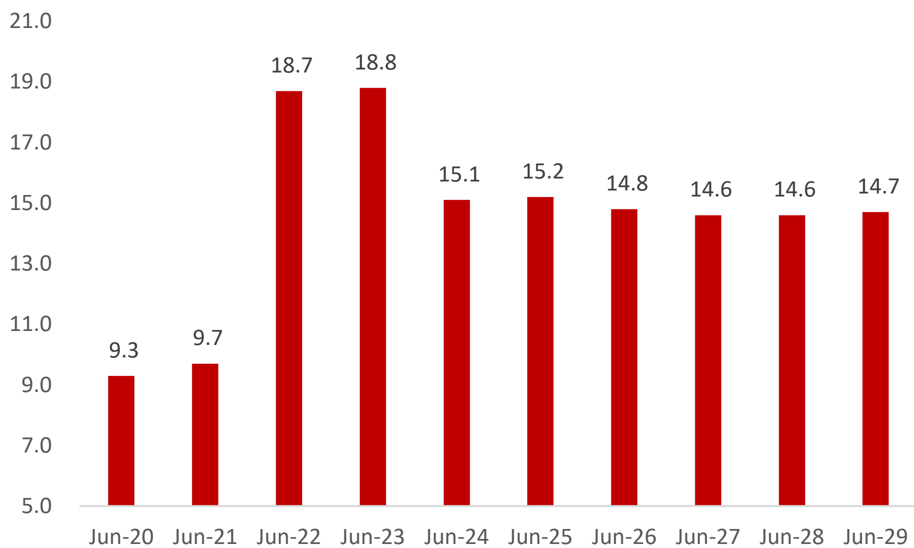


Source: IMF

This leads us to question certain forecast assumptions: Firstly, the Fund's Oil Import Projections appear highly optimistic. Despite Pakistan importing roughly 80% of its oil (in both raw and refined form), the considerable geopolitical risk of further conflict in the Middle East and a world economy that is gradually recovering, the IMF projects Pakistan's Import Bill to decline from USD 15.1 BN in FY24 to USD 14.7 BN by FY 29. While Brent averaged ~$ 83/bbl in FY24, it currently stands at $73/bbl.

Considering demand for oil products averages in the double digits and tends to grow as the economy enters an upward cycle (as projected by the IMF), a reduction in the absolute dollar value of the oil import bill implies a significant reduction in Brent oil prices in the IMF estimates!

Oil Import Bill Projections (USD Billion)



Source: IMF, BMA Research

Concerns on the spill-over effects of GDP growth: For an economy which has proved impossible to grow at 4 – 6% real GDP growth without inviting unintended consequences in the shape of higher imports and a worsening trade balance, the IMF projects GDP to grow at 4.5% while the Current Account Deficit is expected to remain steady at -1% of GDP.

Between FY25 and FY29, Exports / GDP is expected to grow 0.5% while Imports / GDP is expected to grow only 0.2%. This implies that the projections assume exports will perform better than imports, a highly unlikely scenario for Pakistan.

Implications for Equity Strategy and Our View: Investors are well versed with the anatomy of an IMF program and what that entails for Pakistan. We do not expect this program to be any different from previous EFFs; macro-economic stabilization in the short term will take precedence over longer term reforms, the subjectivity of which does not lend itself to appropriate supervision during the short terms of the EFF programs relative to the long-term nature of these reforms.

Further decline in interest rates is almost a certainty as inflation is currently in single digits. Sectors that benefit from lower rates and stocks that have high dividend yields should continue to be in the limelight. Caution is warranted on any development of external imbalances if economic growth rebounds too sharply and/or interest rates decline too quickly.

We note that, given that this time around much of the macro-stabilization has already been achieved during the previous SBA and given that Pakistan has entered an EFF AFTER such stabilization has been achieved, this should ensure that prudent macro-economic policies continue to be employed, under the auspices of the IMF. This should bode well for policy certainty and short to medium term market outlook.

Medium Term Economic Framework

	Jun-20	Jun-21	Jun-22	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27	Jun-28	Jun-29
Economy										
GDP at Factor Cost	-0.9%	5.8%	6.2%	-0.2%	2.4%	3.2%	4.0%	4.1%	4.5%	4.5%
Inflation	10.7%	8.9%	12.2%	29.2%	23.4%	9.5%	7.8%	6.5%	6.5%	6.5%
External										
Current Account Balance	-1.5%	-0.8%	-4.7%	-1.0%	-0.2%	-0.9%	-0.9%	-0.8%	-1.0%	-0.9%
Exports	9.3%	9.1%	10.6%	10.5%	10.4%	10.0%	10.5%	10.6%	10.6%	10.5%
Imports	17.4%	18.0%	22.5%	18.2%	16.9%	17.1%	17.8%	17.8%	17.5%	17.3%
External Debt	37.6%	35.1%	32.2%	34.9%	32.0%	31.3%	31.5%	30.6%	28.8%	27.3%
Domestic Debt	35.3%	30.9%	36.6%	36.3%	31.5%	34.3%	33.1%	32.1%	31.0%	29.6%
Public Debt	72.9%	66.0%	68.8%	71.2%	63.5%	65.6%	64.6%	62.7%	59.8%	56.9%
Reserves USD BN	12.2	17.3	9.8	4.5	9.4	12.8	15.5	20.2	22.5	24.4
Fiscal										
Revenues	13.3%	12.4%	12.1%	11.5%	12.6%	15.4%	15.0%	15.5%	15.8%	15.8%
Expenditure	20.3%	18.5%	20.0%	19.2%	19.3%	21.4%	19.7%	19.0%	18.8%	18.6%
Fiscal Balance	-7.0%	-6.1%	-7.9%	-7.7%	-6.7%	-6.0%	-4.7%	-3.5%	-3.0%	-2.8%
Primary Balance	-1.5%	-1.1%	-3.0%	-0.9%	0.9%	2.1%	1.7%	2.0%	2.0%	2.0%
Debt Service	5.5%	5.0%	4.9%	6.8%	7.6%	8.1%	6.4%	5.5%	5.0%	4.8%

Source: IMF, BMA Research

Type of Benchmark	Structural Benchmarks	Date
Fiscal	Do not grant amnesties or issue new preferential tax treatments	Continous
	Seek prior parliamentary approval for non-budgeted expenditures	Continous
	Approve National Fiscal Pact to devolve spending to provinces	Sep-24
	Share report detailing actions to reduce the government footprint	Sep-24
	Amend Agriculture Income Tax legislation to align with PIT and Corporate Income Tax for Small Farmers and Commercial Farmers respectively	Oct-24
	Implement compliance risk management measures in Large Taxpayer Units in Large Cities	Dec-24
	Develop Project Selection Scorecard for PSDP projects	Jan-25
	Introduce 5% FED on Fertilizer and Pesticides	Feb-25
Governance	Amend Civil Servants Act to ensure asset declarations of high-level public officials and make these digitally filed and publicly accessible	Feburuary 2025
	Publish full Governance and Corruption Diagnostic Assessment Report	Jul-25
Monetary and Fiscal	Average premium between interbank and open market FX rate < than 1.25%	Continous
	Parliamentary approval of ammendments to Bank Resolution and Deposit Insurance Leglislation	Oct-24
	Place undercapitalized private banks under resolution	Nov-24
Energy Sector	Complete policy actions to prepare two DISCOs for privatization	Jan-25
	Eliminate captive power usage in the gas sector	Jan-25
	Public notification by the government of the Decemeber 2024 semi-annual gas tariff adjustment	Feb-25
SOEs	Prepare a plan based on the assessment conducted to fully phase out all current SEZ incentives by 2035	Jun-25

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Old rating system

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)