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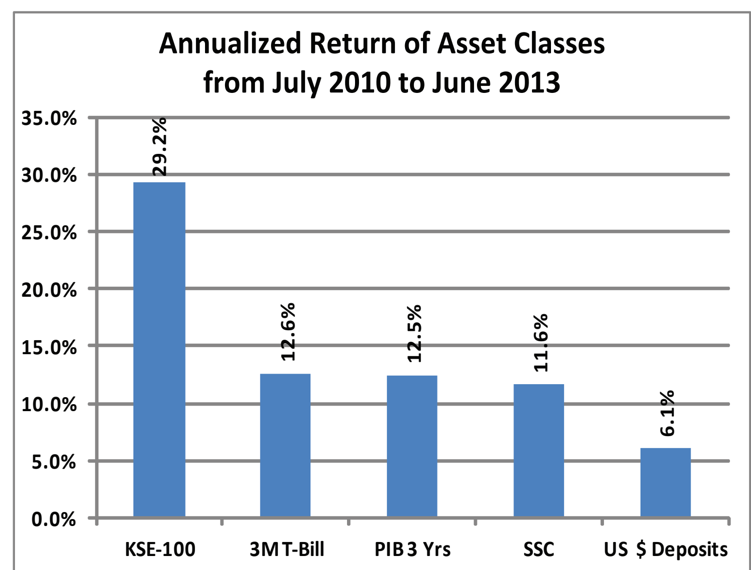
Impact of the IMF Program on Capital Markets

Pakistan has signed a fresh USD6.7bn loan agreement with IMF in September 2013. Key medium-term objectives of the program include gradually raising GDP growth rate to 5% per annum, bringing annual inflation down to 6% - 7%, increasing SBP reserves to over 3.5 months of imports, and reducing fiscal deficit to 3.5% of GDP by 2015/16. Other targets include restructuring and privatization of public sector enterprises, improving business climate, liberalizing trade regime and strengthening and simplifying the tax system.

The current program is different from earlier IMF facilities wherein funds were released upfront while reforms were back loaded. Due to Pakistan's failure to undertake key structural reforms after release of money under previous arrangements, this program entails periodic disbursement of funds subject to satisfactory completion of quarterly reviews/compliance with structural benchmarks and targets. IMF has initially disbursed just USD544mn, while the remaining amount will be paid out in equal quarterly installments over the next three years.

So far, the government has shown adequate resolve to meet with tough IMF conditions. For instance, in a very difficult decision, the government has raised power tariffs substantially for industrial and commercial users to eliminate unbearable subsidy burden. Domestic electricity rates have also been increased by 30% on average despite strong political and public opposition. However, we feel that the complimentary steps, such as controlling theft and corruption, and posting of competent and honest professionals in the power sector, are slow in taking off. SBP has reduced intervention in the forex/money markets, and monetary policy is being gradually tightened. Except for SBP reserves/NFA target, the government has met other key benchmarks for the September quarter. In our opinion, due to a precarious external account position and dependence of other multilateral aid on IMF approval, the government will be forced to continue with tough structural reforms in the future as well.

The tough actions required under the IMF program would result in significant immediate pain with ramifications in the form of slowdown in GDP growth rate, further currency depreciation, higher interest rates, and tighter money market conditions in the short-term. This will impact asset class returns in FY14 compared to their historical performance during the last few years. Over the FY10-13 period (see chart), T-bills have provided a return of 12.6% p.a., PIBs 12.5% p.a., Special Saving Certificates (SSCs) 11.6%p.a., and foreign currency (USD denominated) bank deposits 6.1% p.a. Equities have yielded the highest return of 29.2% p.a. during the same period.



PKR is already down 8.0% during the first 4 months of FY14 and is expected to decline by another 4% - 5% against USD by June 2014. Rising inflation is expected to force SBP into increasing discount rate, resulting in rise in T-bills and PIB rates. On the other hand, equity market may not be able to match its historical performance in the short-term due to tough macroeconomic conditions and rising interest rates. However, we are bullish on the stock market over the medium-term (1-5 years) when structural reforms start bearing fruit in the form of subsiding macroeconomic stresses, accelerating GDP growth and rising investor confidence. We expect the stock market to post strong performance after a temporary hiatus, and deliver solid double-digit returns to the investors over the medium-term.

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