The IMF Programme and the Domestic SME Sector

Due to the current economic challenges faced by Pakistan, the Government of Pakistan (GoP), after extensive negotiations, has entered into yet another financial assistance programme from the International Monetary Fund (IMF); the new Extended Fund Facility (EFF) amounting to USD 6 Billion shall be based over a 39 month period. This research brief evaluates the likely impact of this new IMF programme and its implications on Pakistan's Small and Medium Enterprise (SME) segment.

IMF & Pakistan – A Longstanding Relationship

The very first interaction between the IMF and Pakistan dates back to the year 1958[1]. Pakistan has availed 21 IMF bailout programmes since then, 12 of which were obtained in the last three decades alone[2]. The IMF provides loans to countries as a stop gap measure to implement fiscal and monetary policies needed to restore conditions for a stable economy and sustainable growth as compared to any abrupt shift in policies.

The Extended Fund Facility (EFF) and the Extended Credit Facility (ECF) for low-income countries are the Funds' main tools for medium-term support to countries facing protracted balance of payments challenges[3]. These arrangements last for 3-5 years, with funds disbursed in a number of tranches. Pakistan's reliance on the IMF Financial Assistance Programmes vis-à-vis other countries in the region has been the most frequent, with a total of 21 assistance packages having been availed. Turkey is a close second with 19 programmes availed, however, it is worth noting the last assistance programme that turkey availed got expired in 2008. The newly negotiated IMF package would be the 22nd facility to be availed by Pakistan.

Exhibit 1: Country Comparison of Financial Assistance Programme Availed

Country	Total Programmes Availed	Expiry of Last Availed Programme	Total Assistance (SDR** Bn)	Public Debt as % of GDP***	Current Account (Deficit)/ Surplus as % of GDP[4]
Pakistan*	21	Sep 2016	19.4	66.3%	(5.7%)
Turkey	19	May 2008	37.7	32.3%	(3.5%)
Indonesia	11	Dec 2003	17.8	29.8%	(3%)
Bangladesh	10	July 2015	2.8	33.4%	(3.6%)
Afghanistan	9	July 2019	0.25	6.8%	(28%)
India	7	June 1993	7.7	69.5%	(2.3%)
Iraq	4	July 2019	7.2	51.7%	2.3%
Iran	2	N/A	N/A	44.2%	1.3%
China	2	N/A	N/A	50.1%	0.4%

Source: IMF, Pakistan Economic Survey, Global Finance, Trading Economics.

**Pakistan is currently in talks with the IMF delegation for finalization of a new bailout plan. This would be country's 22nd arrangement since 1958.*

***SDR (Special Drawing Right) is a basket of currencies and serves as a unit of account of the IMF and some other international organizations.1 SDR is Equivalent to 1.38 USD.*

**** As of June 2018*

Author

Hashim Sohail is a Senior Analyst in the Knowledge Management team. Hashim has over 5 years of work experience in the financial and research sector.

Hashim has done his ACCA and holds a Fist Class Honors in Applied Accounting from Oxford Brookes as well. In addition, he has also successfully completed the CFA program in June 2017.

[1] International Monetary Fund. Pakistan: History of Lending Arrangements as of April 30, 2018. https://www.imf.org/external/np/fin/tad/extarr2.aspx?memberKey1=760&date1key=2018-04-30; Yousuf Nazar, Daily Times. https://dailytimes.com.pk/284400/pakistans-economic-crisis-and-the-imf/
[2] Khurram Hussain, Dawn https://www.dawn.com/news/1155958
[3] International Monetary Fund. Fact Sheet. https://www.imf.org/en/About/Factsheets/IMF-Lending
[4] Latest available figures – Trading Economics

22nd Bailout Plan: Negotiations and Assessments

In a statement dated Oct 4, 2018, the IMF concluded that there are significant economic pressures being faced by the country on the back of an overvalued Pak Rupee coupled with the expansionary nature of fiscal and monetary policies which have deteriorated the current account position of the country[5]. Pakistan's currency averaged PKR 104 per USD over a 4-year period from 2013 to 2017 (average devaluation of 1% each year against a historic average of 4%-5%). The Real Effective Exchange Rate (REER) i.e., the exchange rate adjusted for inflation, during this period escalated to 125 in 2017[6](104 in 2013), indicating overvaluation. Since Dec, 2017 PKR/USD parity has witnessed significant correction, with the Pak Rupee devaluing 27% against the USD[7]. Further the current account deficit of the country clocked in at 5.7% of GDP (USD 18Bn in FY18) against a 3-year average of 2.3% – mainly on the back of an expanding trade deficit and stagnant growth in foreign remittances [8].

Targeted measures to increase the country's revenue base is one of the focus areas of the IMF's assessment. Evaluating the fiscal scenario reveals that total revenue collection stood at 17.2% of GDP in FY18 expanding 2.3 percentage points over the last three years. The increment in revenue was accounted for mainly by the expanding base of tax revenues, however, rising expenditures kept the fiscal deficit intact. Tax expenditures remained at 21.3% of GDP, the levels witnessed during FY08 & FY13. This shows that not much had been done to control expenditures, however, better tax collection resulted in fiscal deficit to clock in at 4.1% of GDP, showing improvement against the levels witnessed in FY12-13 (~8.5% of GDP)[9].

The last availed IMF programme amounting to SDR 4.3 Bn, expired on Sep 2016 (details available in **Annexure-I).** In the two years post expiry, Pakistan's foreign reserves witnessed a downward trajectory reaching USD 14.9 Bn in Feb 2019[10], equivalent to the country's import bill of around four months. In Sep 2016, foreign reserves were significantly higher, amounting to USD 23.6 Bn. On 7th Oct, 2018, the GoP officially approached the IMF with a request for a new bailout plan. After extensive rounds of negotiations since then, the government and IMF representatives officially announced on 12th May 2019 that Pakistan has successfully secured its 22nd bailout program of USD 6 Bn, spread over the next three years[11].

The SME Landscape of Pakistan

Almost 9 out of every 10 enterprises in Pakistan are classified as Micro, Small and Medium Enterprises (MSMEs). SME contribute ~40% to the country's GDP and absorb 80% of the non-agriculture labor force[12] Even with such significant contribution to the economy, the SME sector faces substantial challenges in securing credit lines from local financial institutions mainly due to lack of collateral, poor governance and documentation practices, and the reluctance of financial institutions to extend credit to SMEs. Following a significant decline in lending to SMEs post the financial crisis of 2007-08, the State Bank of Pakistan and the GoP devised the National Financial Inclusion Strategy (NFIS) in 2015. The NFIS is based on eight pillars, of which one target is to enhance SME sector credit to 17% (currently 8.7%) and increase the number of SME borrowers to 700,000 clients by 2023[13].

Financing to SMEs by local banks and Development Financial Institutes (DFIs) stood at PKR 513 Bn as of Dec 2018, with total number of SME borrowers clocking in at 180,704 borrowers out of the estimated total operational 4.5 million SMEs[14] . As per the SBP, SME credit constitutes only 8.46%[15] of total private sector credit which is significantly low compared to a regional average of 18.7% (avg. of Bangladesh, India and Sri Lanka)[16].

Potential Impact of the IMF Programme

The IMF team in its initial assessment welcomed some of the recent measures taken by the GoP, i.e. devaluation of the local currency and increase in the policy rate (increasing by 500 bps since July 16, including the latest increase of 50bps in Apr). However, the IMF has stated that additional policy measures are needed, including an expanded revenue base, further depreciation of the local currency,

[5] International Monetary Fund. Press Release Dated 4th Oct, 2018, IMF Staff Concludes Visit to Pakistan.
[6] SBP, Economic Data
[7] SBP, Economic Data
[8] SBP, PBS
[9] Government of Pakistan. Ministry of Finance. Economic Survey 2018
[10] SBP, Economic Data
[11] IMF Reaches Staff-Level Agrement on Economic Policies with Pakistan for a Three-Year Extended Fund Facility
[12] SMEDA, State of SMEs in Pakistan
[13] State Bank of Pakistan. Policy for Promotion of SME Finance and NFIS 100 Day Agenda.
[14] Bridge Factor. Feasibility Study for a SME Financing Platform. December 2018
[15] State Bank of Pakistan. Quarterly SME Finance Review, Dec 2017.
[16] Bridge Factor. Feasibility Study for a SME Financing Platform. December 2018

(based on market sentiments), tightening the monetary policy, lower development expenditure and increase in gas and electricity tariffs (lower subsidies) along with increased autonomy of the regulators i.e. SBP and FBR, in order to manage the expanding budget deficit[17].

SME financing is categorized in three buckets—Manufacturing, Trading and Services—by SBP. As per the latest SBP quarterly review 41% of total SME financing is in the manufacturing segment and ~31% is diverted towards the trading segment. Since the SME portfolio is tilted towards the manufacturing side, any contraction in profitability on the back of increased utility overheads and higher financial expense will be perceived negatively by financial institutions, giving rise to the need for additional collaterals for new credit lines to cover the risk, thereby restricting credit availability to the SMEs. A similar contraction in the availability of credit was observed in 2008-09 (period of economic contraction and higher interest rates). In addition, NPLs for the SME segment were around PKR 20-40Bn during FY04-08, but jumped to PKR 77 billion in FY09, further reinforcing the contraction in credit to SMEs. The SME NPL ratio ranged between 32-35% during Mar-11 and Sep-14. Prior to 2008, it hovered between 8-13% (FY04-08)[18].

Majority of SME lending is short term[19] in nature, as of Dec 2018[20] 66% of total SME credit portfolio is reported to be working capital. The risk restricting measures prompted by an economic slowdown, will reinforce the tendency to restrict long-term lending to the SME sector (restricting capital for expansions).

In addition to the banks, it is reasonable to assume that a general economic slowdown will also impact the lending scenario of Non-Banking Financial Institutions (NBFIs). Analyzing the portfolio of Orix Leasing Pakistan Limited (OLP), the leading leasing entity of Pakistan, highlights that the company's infection ratio (NPL to Gross Advances) stood at ~1% in 2008 which expanded to 4% in the following four years. Another insightful statistic is that the company's gross advances portfolio has not been able to reach the levels witnessed in 2008 and currently stands at PKR 18.8Bn (PKR 23.5Bn in 2008)[21].

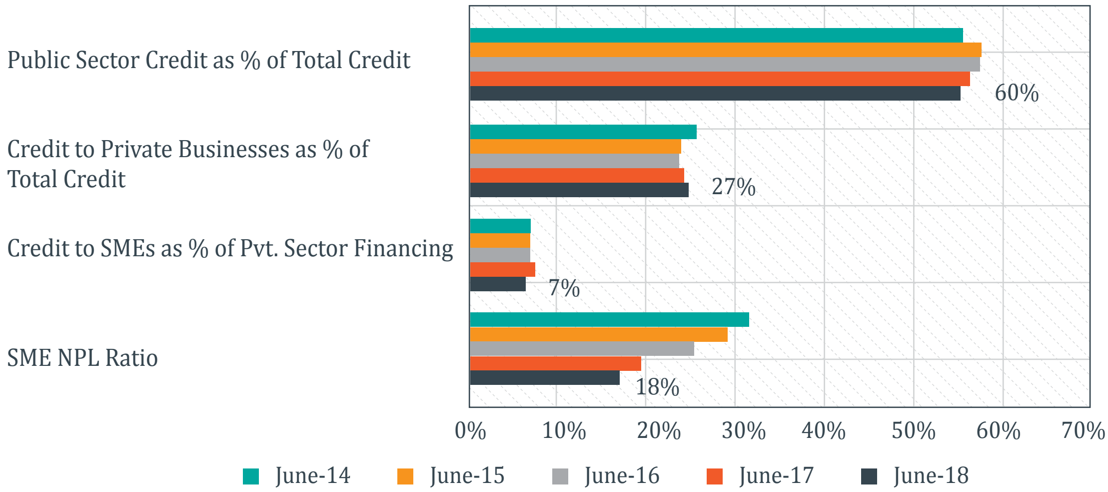
Further, due to the recent increase in the policy rate, 6-month KIBOR is currently hovering at 11.25% to 11.5%[22]. This means that the effective cost to the private sector would be around 13 – 15.5% (assuming a spread of 2% - 4%). Such high rates will eventually dampen demand for credit due to expensive pricing.

In addition, higher discount rate also makes government bonds more lucrative for the banks where they earn a decent return on a risk-free profile. This eventually results in a 'crowding out' effect with a higher Investment to Deposit Ratio (IDR) vis-à-vis Advances to Deposit Ratio (ADR)[23], indicating restricted provision of credit and subdued appetite of banks to take on additional risk by lending to SMEs.

Thus, the supply of credit and the demand for credit are both likely to decline. This argument is further validated from analyzing the trends witnessed post the economic contraction of 2008. Lending to private businesses as a percentage of total credit stood at 46% as of Dec-08 and contracted to 28% over the next five years[24]. Due to the reasons listed above, the SME sector suffered from a larger proportionate contraction of credit, compared to the private sector as a whole.

17 IMF - Press Release Dated 4th Oct, 2018, IMF Staff Concludes Visit to Pakistan
18 Karandaaz Pakistan. Characteristics of SME Financing & NPLs in Pakistan. Nov 2017
19 Short term credit mainly represents working capital lines having a maximum tenor of 12 months with an option to roll over,
20 State Bank of Pakistan. Quarterly SME Finance Review, Dec 2017.
21 Orix Leasing Pakistan Limited. Annual Financial Reports.
22 As off April 26th, 2018.
23 IDR refers to the proportion of Banks deposits base routed towards investment instruments, which include T-Bills, PIBs, Off-shore Bonds, TFCs and other equity investment. ADR on the other hand is a ratio of advances rolled out by the banks to their respective deposit base.
24 SBP Economic Data

Exhibit 2: Trend of Credit and SME NPL over the last 5 Years



Rising PKR/USD parity has far-reaching implications - and may have an adverse impact on profitability, owing to limited capability to potentially pass-on adverse movements in the parity to final consumers. While manufacturing firms may be exposed to increased cost of production (e.g. companies operating in Steel, Cement, Auto industries) this will also have an impact on the performance of trading firms. Looking at the 8-month (July-Feb) stats, the two industries which have been affected adversely, are those providing construction inputs. Cement has contracted by 4% YoY in the eight months of current fiscal year (~12% YoY growth during same period of last year) while the steel industry registered a dismal growth of 3% YoY growth vis-à-vis 26% July-Feb period last year. The argument is further validated by evaluating the impact of increase in the PKR/USD parity on the change in Quantum Index of Manufacturing Industries (QIM) index over the last 10 years, which shows a negative correlation of 0.6x between both the variables, demonstrating slowdown in industrial manufacturing against adverse currency movements[25].

Further, the trading portfolio constitutes more than 30% of the total SME credit and SMEs operating as trading firms that import a value-added product and sell it in local market (e.g. firms involved in the trading of pesticides, gems and metals, electrical appliances, food items - dry milk powder, tea, chemicals etc.) shall be forced to raise the retails prices in light of rising PKR/USD parity. This will eventually result in higher prices across the board and would limit the purchasing power of final consumers leading to depressed demand for such products. Decreasing sales volumes will eventually slow down the business for these firms and would result in financial institutions being more skeptical of the cash flows available to these firms for repayments.

One can argue that devaluation can provide necessary stimulus to the country's export which became uncompetitive over the last few years due to overvaluation of Pak Rupee. Pakistan however, is classified as an import-oriented country with overdependence on imports to meet expanding domestic demand[26]. This places a cap on the necessary benefits envisaged on the back of devaluation. As per recent stats published by the SBP, exports over the 8-month period have remained stagnant at USD 16 Bn and import payments have contracted by 3% YoY during the same period. This shows that in addition to an overvalued currency, there exist structural impediments that need to be addressed to enhance the country's exports. Textile Articles, being the significant export commodity of Pakistan registered a growth of 4% since Dec 17 against the currency devaluation of 27%. This implies that currency adjustment alone is not sufficient to boost exports. An important factor to consider is that growth in industrial exports does not come into effect in the short term, it is a gradual process and is based on the strategic decisions of the buyers and commitments from exporters as well[27].

The IMF has also been propagating the idea of increasing the revenue generation capability of the Government. Tax revenues have shown an increase of 3.7 percentage points over the last three years to reach 13.7% of the GDP in FY18 (highest in a decade)[28].

[25] SBP Economic Data, Economic Survey
[26] SBP Annual Report 2017-18.
[27] Ali Khizer, Business Recorder. https://www.brecorder.com/2018/12/14/459105/textile-ready-to-take-off/
[28] Ministry of Finance. Economic Survey 2018

However, more detailed analysis highlights that indirect taxation constitutes 60% of total tax revenues, averaging at the same level over the last five years. It can be expected that in order to stay eligible for the IMF programme the GoP will be taking steps to enhance its tax base in the coming years, which is evident from the recent budget where some restrictions have been imposed on non-filers[29].While the focus of the IMF is to increase the quantum of total tax revenue, the fact that the share of the informal economy is more than ~75% of GDP[30], the GoP needs to take sustained measures to expand the documented economy to decrease reliance on indirect taxes. While these structural changes will be positive in the long-run, from the perspective of the SME sector, an unintended impact could be an increasing number of small business getting undocumented to escape high levels of taxation. The challenge therefore, is to make the regulatory environment more conducive without hindering the financial inclusion of SMEs. Currently Pakistan is ranked at 136 out of 190 countries on the World Bank's Doing Business index[31]. The Government should incentivize SMEs to become documented without the fear of over regulation/penalties in future, as regulatory burden may drive out these businesses to the informal economy, limiting job creation and slowing down the growth of formal economy. For this, the GoP needs to assess the impact of the current taxation regime on SME businesses. Based on this assessment, the GoP may introduce structural changes to incentivize SMEs to become formalized and be included in the tax net, while ensuring the burden of tax for SMEs is rationalized.

Another argument is that going ahead with the IMF bailout may decrease the 'crowding out' factor due to high level of public borrowings. This will result in some space for the private sector (averaged at 32% during the tenor of last IMF arrangement). In fact, historical trends do not support a meaningful reduction in the portion of public debt as a result of an IMF arrangement. During the last IMF programme, public debt averaged 61% of total debt (62% when the programme started), while during the 2008-11 programme (amounting to SDR 7.2BN) the public debt expanded by 12 percentage points to reach 48% at the end of the IMF arrangement[32]. Another key factor will be the cost of borrowing, which were at record low levels[33] during the previous arrangement and that is not the case currently. Therefore, any increase in private sector lending is unlikely to be significant.

There are also social costs involved in going ahead with the IMF programme. A major concern is discontinuation of government subsidies. A key beneficiary of government subsidies has been the agriculture industry. The industry absorbs 42.3% of the country's labor force and is a major contributor to the GDP at ~20%[34]. The government has previously offered cash subsidies and GST concessions to the sector in order to support local farmers against rising prices of fertilizer products. Subsidy reduction on this front and any increase in gas prices (gas being a feed stock for fertilizer products) will increase the ex-factory prices of fertilizer products and adversely impact the buying power of small farmers, which in turn may hamper the growth of agri-SMEs and slow down GDP growth as well. The government is also contemplating an increase in sales tax rates on locally sold textile, leather, surgical, sports and carpets goods, which are currently charged at lower than standard rates[35]. A general economic slowdown is therefore a forgone conclusion.

In the last announced supplementary finance bill the incumbent government lowered the applicable tax rate to 20% (from 39% previously) on potential income generated from SME, agri and low-cost housing loan portfolio. However, it can be argued that this initiative is unlikely to be sufficient in incentivizing commercial banks to take on additional credit risk by shifting from investing in risk free GoP bonds[36]. At the industry level, the current outstanding SME portfolio captures only a fraction of Total Credit (i.e. aggregate of public and private sector lending), standing at 3%[37]. Lower share of SME based lending shall have a diluted impact on banks' net profitability, thereby limiting the scope of envisioned enhancement in SME credit.

Conclusion

From the above stated arguments and evaluation, it can be expected that immediate policy decisions under the IMF programme is highly likely to hamper the overall business environment for domestic industries and due to structural impediments, this will result in a greater contraction in the overall SME space mainly backed by the increased cost of doing business and a decline in available credit, due to enhanced collateral requirements and more targeted provision of credit by financial institutions.

[29] Wajid Ali Shah, The Nation. https://nation.com.pk/21-Jul-2018/the-cost-of-being-non-filer
[30] State Bank of Pakistan. National Financial Inclusion Strategy (NFIS). 2015
[31] IMF Publication – Pakistan: Selected Issues
[32] Ibid
[33] SBP, Economic Data
[34] Ibid
[35] Shahbaz Rana, Tribune Express. https://tribune.com.pk/story/1870680/2-govt-offers-imf-rs190b-new-taxes-bailout/
[36] Current yield on a 10-year PIB is >13% p.a. (a spread of >2.5% over 6M KIBOR)
[37] SBP Financial Soundness Indicators, SBP Economic Data.

These factors will pose significant challenges in the short run, to the achievement of SBP's targets under the National Financial Inclusion Strategy (NFIS).

While recent measures by the GoP and SBP are positive including the development of an SME policy (underway), the restructuring of SMEDA, the easing of Prudential Regulations, advocating extensively with commercial banks to lend to SME sector while helping build capacities in cashflow based lending, providing indicative SME lending targets and mandating the creation of SME departments within all commercial banks, these measures are unlikely to be able to counter the expected contraction in the SME sector. To mitigate the impact of the IMF programme and improve the long-term trajectory of growth in SME economic activity and lending, the GoP may also consider the following:

- Improve information asymmetries in the SME sector with the promotion of key financial sector infrastructure (credit bureaus capturing SME credit portfolio, movable collateral registry).

- Create a more enabling business environment, with a specific focus on SMEs by conducting a systematic regulatory assessment, especially on the tax regime for SMEs e.g. offering rebates based on exports of certain products, as offered to the textile sector some other initiatives could be flexible tax slabs based on the revenue base of SMEs. The government did take capacity building initiative on the lenders side where they lowered income tax rate to 20% on income generated through SME portfolio; however, banks should be encouraged to pass this benefit on to the SMEs in terms of lower pricing. Furthermore, as mentioned above, cost of regulatory compliance should be lowered for SME's to promote documentation of such businesses. Reform efforts going beyond horizontal improvements in the business environment, and creating appropriate support measures targeted specifically at the development and competitiveness of SMEs will be very effective.

- Build the capacity of SMEs to take up and leverage technology and tap into export markets.

- Provide targeted incentives for R&D and innovation by SMEs, especially in key industries and focus sectors.

- Improve availability of data for informed policy making. The enterprise census, as recommended in the 100 Agenda on Financial Inclusion, should be completed at the earliest possible.

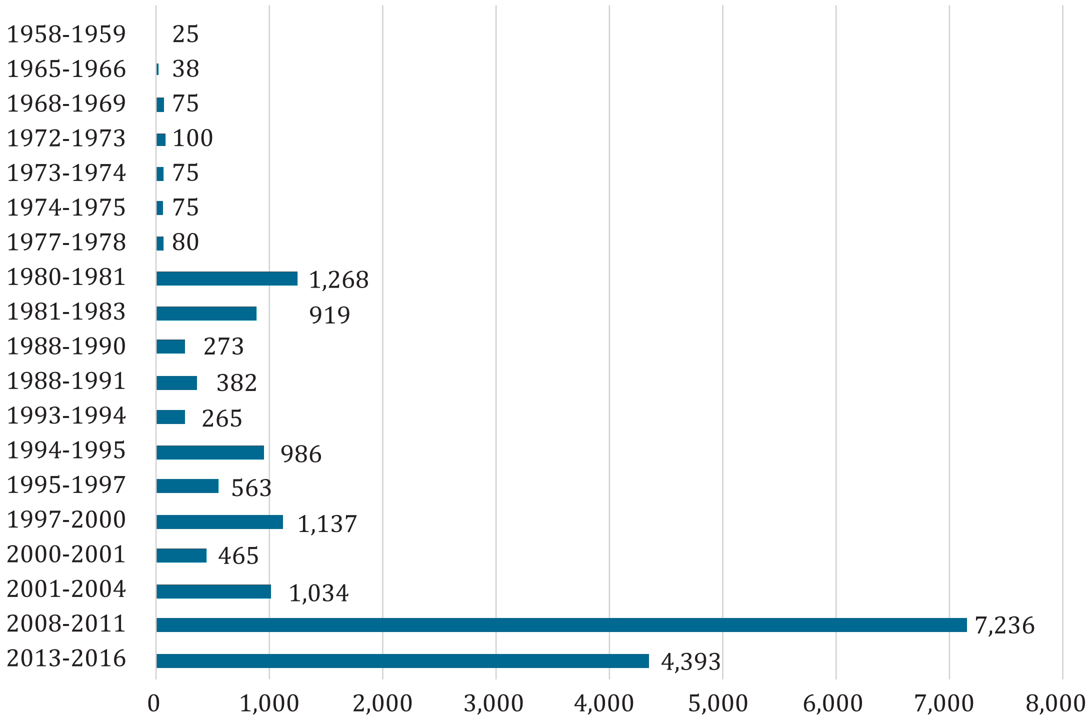
Growth in Pakistan's industrial activity depends upon the wellbeing of small and medium sized businesses. SMEs constitute 90% of the overall operating enterprises and are the major source for job creation. Slowdown in this segment will not only hinder the country's overall productivity but will also expand the unemployment ratio. As per World Bank's estimates Pakistan GDP growth in FY19 is projected at 3.4%. SME Loan portfolio equates 3% of country's overall GDP; our analysis reveals that given the economic slowdown there might be a contraction of PKR 50Bn in the total SME Loan portfolio in the outgoing year. Since, manufacturing segment constitutes 41% of the loan SME finance, proportionate reduction in portfolio shall result in a contraction of ~52,000 jobs, in the manufacturing segment[38].

It is relevant to state that structural reforms such as addressing information asymmetry through Credit Bureaus focused to cater the SMEs; setting up a movable collateral registry, building a conducive regulatory environment and taking focused measures to enhance ease of doing business for SMEs, can help address the prevalent shortcomings and enhance confidence among financial institutions in the medium to long term.

[38] Impact Tool Kit – Steward Redqueen

Annexure-I:

Pakistan - IMF Package Amount (SDR* Mn)



About Karandaaz

KARANDAAZ PAKISTAN is a Section 42 company established in August 2014 and focuses on fostering economic growth and creating jobs through financial inclusion of unbanked individuals and unserved enterprises, with a special focus on women and youth. The company has four verticals:

Karandaaz Digital

Focuses on expanding the poor's access to digital financial services in Pakistan by working across the ecosystem with all stakeholders.

Karandaaz Capital

Provides wholesale structured credit and equity-linked direct capital investments to micro, small and mid-size enterprises (MSMEs) that demonstrate compelling prospects for sustainable business growth and employment generation in Pakistan.

Karandaaz Innovation

Manages the Innovation Challenge Fund and Women Entrepreneurship Challenge, providing risk capital and grants to partners with the aim to generate innovative solutions in areas of financial inclusion and entrepreneurship.

Knowledge Management and Communications

Supports the company's core financial inclusion goal by developing and disseminating evidence based insights and solutions.

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1E, Mezzanine Floor, Ali Plaza,
Nazimuddin Road, F-6/4, 44000, Islamabad
Tel: (051) 8449761
Email: info@karandaaz.com.pk

karandaaz.com.pk
twitter.com/KarandaazPK
linkedin.com/company/karandaaz-pakistan
facebook.com/KarandaazPK