1 Global and Domestic Macrofinancial Environment

The global economy has experienced a synchronized real growth. Besides the U.S, upside growth momentum has been witnessed in Europe and Asia—driven by rebound in trade and investment against the backdrop of supportive financial conditions. Short-term risks to financial stability—after receding in CY17—have slightly risen recently. Medium-term vulnerabilities—arising from tightening financial conditions, rising leverage, policy uncertainly, geopolitical tensions, cybersecurity breaches and extreme weather conditions—remain a concern. Domestically, the economic growth prospects remain challenging due to twin deficits. Moreover, rebound in global energy prices and strengthening of domestic demand conditions may give rise to price pressures. In the medium term, however, prospects are upbeat, due to opportunities arising from CPEC and positive developments on some structural issues like energy shortages, law and order conditions, etc. Encouragingly, the banking sector remains robust, profitable and resilient and continues to support the real growth with an uptick in advances to private sector.

1.1 Global Developments

Synchronized firming up of economic activity…

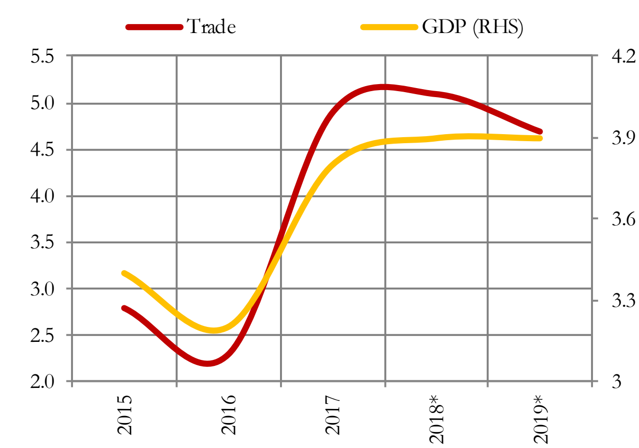
Global economic growth reversed its course to recovery mid-way through 2016 and gained further momentum in the year 2017—aided by rebound in investment and trade against the backdrop of conducive financial conditions[36] (**Figure 1.1**). For the first time since global financial crisis (GFC), the upturn remains synchronized as approximately three-quarters of the global economy is sharing upswings in economic cycle.[37]

The world output has upsized by 3.8 percent in 2017 against the growth of 3.2 percent in 2016 (**Table 1.1**). The economic activity in advanced economies (AEs) surged by 2.3 percent in 2017 compared with a 1.7 percent growth a year earlier. The AEs are expected to gain further momentum in 2018.

Among AEs, euro area and the U.S. have delivered strongest growth of 2.3 percent followed by 1.8 percent in U.K and 1.7 percent in Japan. The elevated momentum in AEs reflects improving private investment, firmer consumer spending and rising external demand as a result of policy induced monetary and fiscal stimuli.

Figure 1.1
Rebounding International Trade and GDP

Global Trade and World Real GDP Growth



*Projections
Source: World Economic Outlook, IMF, April 2018

In line with AEs upbeat economic performance and prospects, the emerging markets and developing economies (EMDEs) have grown by 4.8 percent during 2017 and could register a slightly better performance in 2018 (4.9 percent). Robust growth

[36] Financial conditions generally refer to the ease of obtaining financing. Conducive financial conditions imply narrower credit spreads, higher asset prices, lower volatility, increasing risk appetite, exchange rate appreciation and favorable commodity price movements.

[37] IMF (2018). World Economic Outlook Update. *Washington, January.*

in Asia - notably, China, India, Pakistan – and others e.g., Turkey, contributed towards overall upbeat activity in EMDEs. Improved external environment such as recovery in AEs and benign global financial conditions has reinforced economic momentum in EMDEs, supported also by sustained robust domestic demand.

Table 1.1
Global Economy: Real GDP Growth

	2016	2017	2018*	2019*
	Percent			
World	3.2	3.8	3.9	3.9
Advanced Economies	1.7	2.3	2.5	2.2
EMDEs	4.4	4.8	4.9	5.1
EMDEs - Asia	6.5	6.5	6.5	6.6
MENAP	4.9	2.6	3.4	3.7
USA	1.5	2.3	2.9	2.7
Euro Area	1.8	2.3	2.4	2.0
U.K	1.9	1.8	1.6	1.5
Japan	0.9	1.7	1.2	0.9
China	6.7	6.9	6.6	6.4
Turkey	3.2	7.0	4.4	4.0
Russia	-0.2	1.5	1.7	1.5
Saudi Arabia	1.7	-0.7	1.7	1.9
Pakistan	4.5	5.3	5.6	4.7

Source: World Economic Outlook, IMF, April 2018

* projections

Despite strong growth revival, a key global policy challenge is to boost potential output in the medium-term, as growth in several countries remain weak while inflationary pressures in most of the AEs have remained subdued.

Amid favorable tax policy changes – US economic outlook further improves…

The US economy has accelerated by 2.3 percent in 2017–up from 1.5 percent in 2016.[38] The notable pick-up in economic activity is attributed to strengthening private investment, robust consumption growth, rising corporate profits, weakening dollar and robust external demand.[39,40]

More recently, the favorable changes in the US tax policy have, inter alia, led IMF to revise growth projection upward by 60 basis points to 2.9 percent for 2018 and the benefits resulting from corporate income tax cuts are likely to continue till 2020.[41]

Besides improved real sector performance, U.S. financial system is becoming more resilient. The stock market achieved historic highs during CY17. The solvency and leverage in the U.S. banking system are at lowest level since 1990, while banks' profitability is gradually improving, backed by rising interest rates. The capital and liquidity requirements in the eight U.S. Global Systemically Important Banks (G-SIBs) are above minimum regulatory requirement, indicating reduced solvency risks. Moreover, largest banks have remained resilient in the stress tests recently conducted by the Federal Reserve.[42]

Global financial conditions remain benign despite Fed's tightening…

Despite gradual tightening of monetary policy by Federal Reserve (Fed), global financial conditions (ease of getting financing) have been supportive.[43] Since December-2016, federal fund rate have increased by 75 basis points but Chicago Fed's National Financial Conditions Index (NFCI) has further trended down[44] (**Figure 1.2).**

[38] IMF.(2018). World Economic Outlook Update. *Washington, April.*
[39] World Bank. (2018). Global Economic Prospects. *Washington, January.*
[40] U.S. Exports has risen by 5.6 percent in CY17 (Source: Federal Reserve Board)

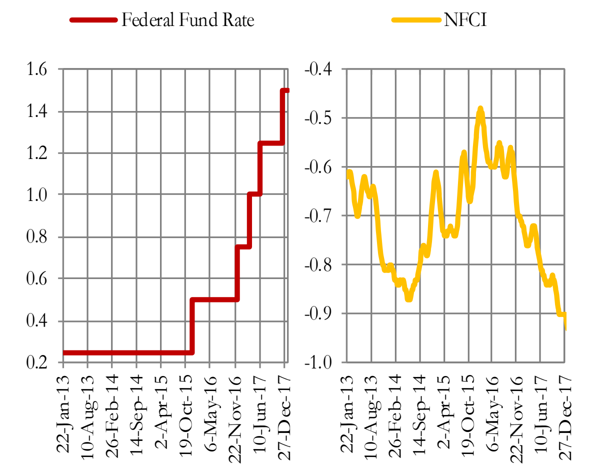
[41] IMF.(2018). World Economic Outlook Update. *Washington, January.*
[42] Office of Financial Research. (2017). Financial Stability Report.
[43] Bank for International Settlement. (2017). BIS Quarterly Review. *December.*
[44] The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and

Figure 1.2

Despite Fed's tightening, Financial Conditions have further eased

Federal Funds Rate and National Financial Conditions Index

(Percent) (Index)



Source: Federal Reserve Bank of St. Louis

There appear to be two reasons behind such phenomenon. First, relatively accommodative stance of other major central banks has further helped ease financial conditions in USA and globally. Second, it might be due to monetary policy communication strategy of the Fed, which provided clear market guidance.[45]

With substantial growth momentum, euro area demonstrates notable progress in the banking sector…

Besides Asia, upside growth surprises have been particularly pronounced in the euro area –- with output growth of 2.3 percent in 2017. Policy stimulus (monetary) and improved global demand is driving the ongoing impressive broad based economic performance across member countries.[46] The fiscal stance was suggested to be neutral by the European Fiscal Board with re-composition of the government expenditures to investment spending.[47] Moreover, unemployment rate has dropped to its lowest level since 2009 while some member countries have increasingly been facing labor shortages.[48]

Despite such positive developments, European banking system remains vulnerable to adverse shocks such as reversal in global risk sentiment. Banks' profitability in several member countries remains under pressure due to prolonged economic weakness and slow progress on addressing structural challenges. Moreover, stock of NPLs, in response to improved economic growth and policy measures by the European authorities, is falling but still remains elevated at some banks.[49]

China continues on a steady economic course…

China's economy is treading on a faster than expected growth trajectory, although growth remains lower than historic standards. The economy expanded by 6.9 percent in 2017 owing to recovery in global trade, robust infrastructure spending, previous policy easing, and resilience in the real estate sector. Moreover, expectations of further slowing down of growth rates in 2018 and 2019, perhaps, reflects both natural economic transition and policy induced tighter financial conditions. The Chinese economy is rebalancing towards consumption and services; credit growth has been restrained while the fiscal stimulus has subsided.

Despite stable growth prospects, risks to China's financial stability remain high.[50] Driven by corporate

"shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

45 Bank for International Settlement. (2017). BIS Quarterly Review. *December.*

46 World Bank. (2018). Global Economic Prospects. *Washington, January.*

47 Eurpoean Fiscal Board. (2017). Assessment of the Prospective Fiscal Stance Appropriate for Euro Area. *June.*

48 Ayia et al.(IMF-2016) point out that the impact of refugees on Europe's growth in the medium and long-term depends on how well migrants are integrated in the labor market. In short-run, however, a modest increase in GDP is expected due to some fiscal expansion.

49 (i) IMF.(2018). Global Financial Stability Review. *April.*
(ii) ECB. (2017). Financial Stability Review. *November.*

50 Reserve Bank of Australia.(2017). Financial Stability Review. *October.*

borrowings, debt levels have increased notably over the past decade: debt to GDP ratio has shot-up to 253.0 percent in 2016 from 141.0 percent in 2006. Furthermore, China's corporate debt is more than three times higher than in economies with comparable per capita income. Vulnerabilities arise from the fact that many state-owned firms – with large holdings of banks' loans – have excess capacity (lower sales), which undermines firms' ability to service their debt. Moreover, increasingly complex wealth management products offered by banks and enhanced interconnectedness have made China's financial system more complex. These developments point towards credit, liquidity and contagion risks – making financial system vulnerable to adverse shocks.[51]

…however, the outlook for GCC economies is not encouraging …

The footprints of sustained increase in global economic activity are hard to trace in Gulf Cooperation Council (GCC) countries. The GCC economies have experienced 0.2 percent contraction in GDP during 2017—down from 2.1 percent expansion in 2016. It mainly reflects lower oil output resulting from production cuts, which outweighs the benefits of oil price recovery observed during 2017.

As a result of lower oil prices, GCC economies have experienced large fiscal and current account deficits leading to bleak growth prospects (**Table 1.2**). Modest recovery in oil prices during 2017 and fiscal consolidation efforts[52], however, are expected to ease fiscal burden. Medium-term growth prospects remain muted, emphasizing the need for diversified sources for economic growth and private sector development.

Table 1.2
GCC Macroeconomic Performance

	2016	2017	2018*	2019*
	Percent of GDP otherwise mentioned			
GDP (annual change, percent)	2.1	-0.2	1.9	2.6
Current Account Balance	-3.4	2.1	4.3	3.1
Fiscal Balance	-10.8	-5.5	-3.4	-1.9
Average Oil Price (US$ per barrel)	41.2	53.1	62.3	58.2
CPI (year avg - percent)	2.1	0.2	3.6	2.5

Source: Regional Economic Outlook, Middle East and Central Asia, IMF (May-2018); Bloomberg; World Economic Outlook, IMF, April 2018
*Projections
Note: Oil price for 2018 reflect IMF projection.

It is pertinent to highlight that the diplomatic rift between Qatar and other states (Saudi Arabia, UAE, Bahrain, and Egypt) is expected to have some impact on Qatar's economic growth during 2017.[53] The impact on the neighboring countries, however, remains limited.

Energy prices are rising for some time…

The IMF maintains that oil prices declined by 8.1 percent between Feb.-Aug. 2017 despite announcement of extension in production cuts by OPEC and some non-OPEC oil exporters in May-2017.[54] According to the World Bank, sustained lower oil prices primarily reflects stronger than expected production of shale oil, role of OPEC polices, and softening of oil demand due to technological improvements such as electric and energy efficient vehicles.[55]

[51] Ibid.
[52] Fiscal consolidation efforts are targeting both revenue and expenditures. Saudia Arabia and UAE have recently (Jan-2018) introduced value added tax (VAT) while other GCC economies are expected to introduce it in the year 2018.
[53] Qatar's real GDP growth has slightly reduced to 2.1 percent in 2017 from 2.2 percent in 2016.
[54] IMF. (2017). World Economic Outlook. *Washington, October.*
[55] World Bank. (2018). Global Economic Prospects. *Washington, January.*

However, between Aug.-Dec. 2017, oil prices rebounded by USD 11.0 to USD 61/barrel, reflecting improved global growth, adverse weather conditions in US, extension of agreement between OPEC and the Russia to limit oil production, and geopolitical tensions in the Middle East. Moreover, in 2018, oil prices are expected to rise further with the average future contract trading at USD 77.09/barrel.[56] The medium-term prices for oil futures contracts in May 2018 average around USD 71.10/barrel.

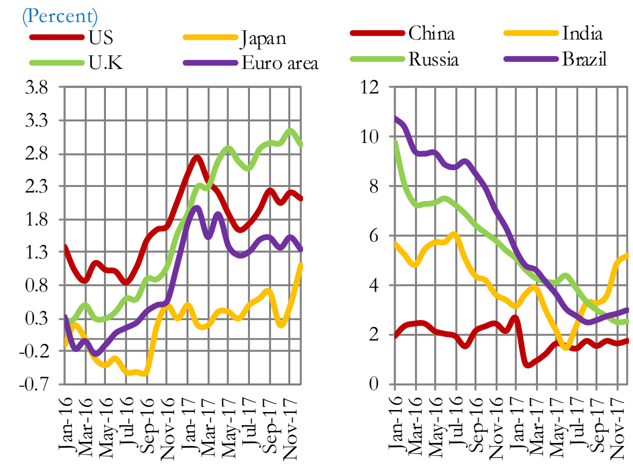
Inflationary pressures remained muted…

In AEs, inflation has remained at 1.7 percent during 2017 – up from 0.8 percent in 2016. In EMDEs, however, inflationary pressures have receded to 4.0 percent in 2017 from 4.3 percent in 2016 (**Figure 1.3**).

Figure 1.3

Inflationary Pressures have Remained Weak

Monthly-CPI Inflation (YoY) in Major Advanced and Emerging Economies



Source: Bank for International Settlement

Recently, rising oil prices have stimulated headline inflation in AEs but wage and core price inflation still remain weak. In EMDEs, headline and core inflation have risen slightly in later months of 2017 after experiencing a decline early in the year.

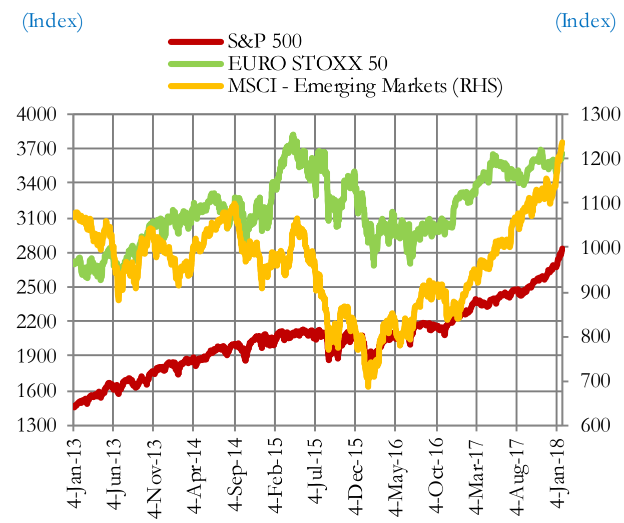
After receding in CY17, short-term risks to global financial stability have slightly risen recently…

Short-term risks to financial stability receded in CY17 in response to improved resilience of the global financial system, tighter regulatory oversight, and economic recovery. Recently, however, risks have increased, somewhat, reflecting volatility in equity prices in early February-2018 and decline in risky asset prices in March-2018 in the wake of escalating trade dispute between the U.S. and China.[57]

Figure 1.4

Rising Equity Variations across the Globe

Equity Prices in USA, Euro, and Emerging Markets



Source: Bloomberg, Federal Reserve Bank of St. Louis

…and medium-term risks remain alive …

The low for long interest rates and QE has intensified search for yield[58] in markets leading to

[56] Bloomberg, May 29, 2018.

[57] IMF. (2018). Global Financial Stability Report. *Washington, April.*

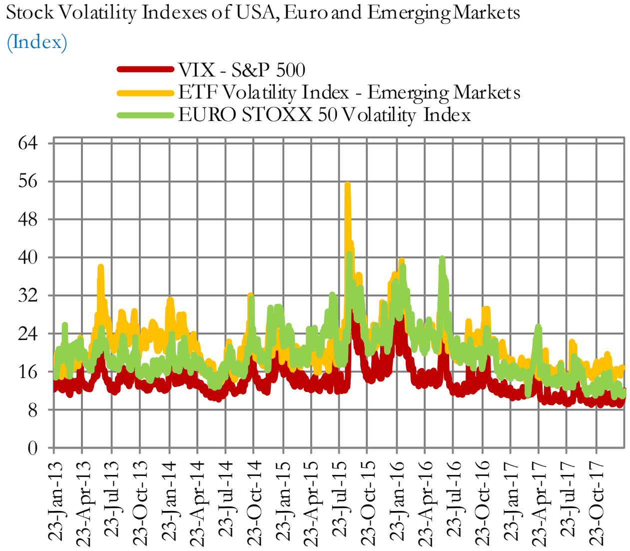
[58] About 80 percent of the fixed income index (US$ 15.8 trillion) offered yield over 4 percent in 2007 against less than 5 percent (US$

overstretched asset valuations, low volatility (**Figure 1.4 & 1.5**), and compressed spreads (**Figure 1.6**). While such financial conditions have helped firm up economic growth, they have also driven up sensitivity of the financial system to market and liquidity risks. The yield seeking investors have increased their exposure in companies with low investment grade rating in the US.[59]

It needs to be emphasized that vulnerabilities are migrating from the banking sector to the nonbank and market sectors of the financial system as the search for yield intensifies. An abrupt adjustment in monetary policy can lead to repricing of risks causing financial market turbulence and international spillovers. In contrast, gradual monetary policy normalization, as expected, is likely to aid further build-up of financial excesses and medium-term risks.

Figure 1.5
Ebbing Stocks Volatility across the Globe

Stock Volatility Indexes of USA, Euro and Emerging Markets



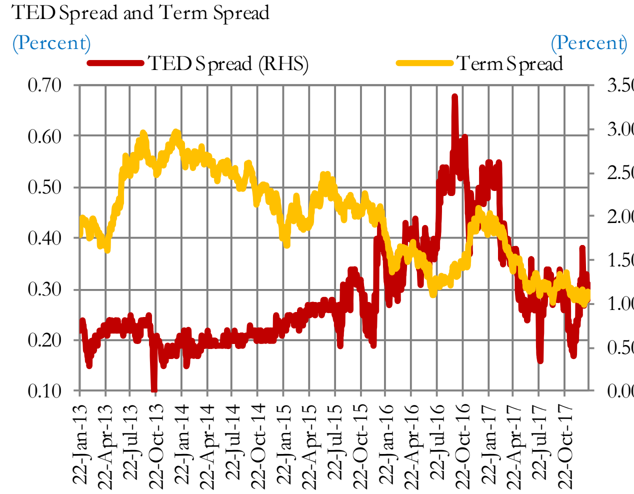
Source: Bloomberg, Federal Reserve Bank of St. Louis

With improving global recovery, the key stability challenge is to gradually rebalance central bank and private sector portfolios.

In this backdrop, the IMF estimates suggest that since 2010, around US$ 260 billion portfolio inflows to emerging economies can be attributed to unconventional Federal Reserve policy. The inflows, however, are likely to reduce by US$ 35 billion a year over next two years on account of monetary policy normalization in the US.[60]

Figure 1.6
Spreads have Remain Compressed in 2017

TED Spread and Term Spread



Source: Federal Reserve Bank of St. Louis
Term spread is the spread between 10 year US treasury constant maturity and 3 months treasury constant maturity; TED spread is the spread between 3 month LIBOR and 3 month US treasury bill

Also, rising leverage is a particular concern…

Debt burdens have increased to considerable extent among G20: nonfinancial sector debt (borrowing by governments, households, and nonfinancial firms) has risen to more than US$ 135 trillion.[61] Among G20, rising leverage in AEs remains a particular concern as debt-to-GDP ratio in these economies has notably increased to 256 percent in 2016 from

1.8 trillion) in 2017. This indicates that too much money is chasing too few yielding assets.

[59] Reserve Bank of Australia. (2017). Financial Stability Report. *October.*

[60] IMF. (2017). Global Financial Stability Report. *Washington, October.*

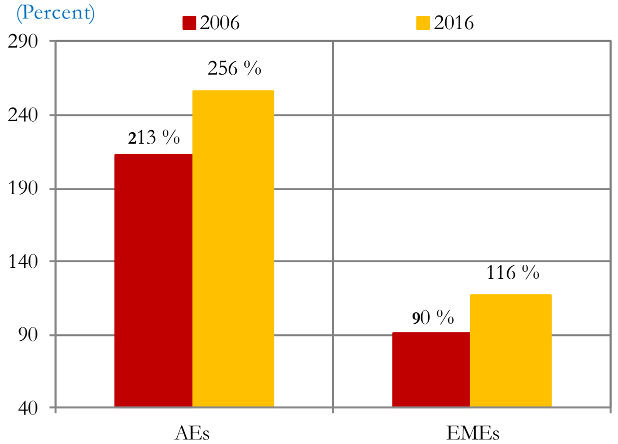
[61] Since 2006, most of the increase in debt-to-GDP ratio in AEs has been in government sector (30.2 percent) followed by nonfinancial firms (6.6 percent), and households (6.0 percent). On the contrary, in

213 percent in 2006. In EMEs, however, leverage ratio expanded by 26 percentage points to 116 percent in 2016 (**Figure 1.7**).[62]

Easy financial conditions have encouraged increased borrowing, which in turn helped stimulate aggregate demand. On the other hand, the downside risks emerge from the fact that with elevated debt burden, nonfinancial sector has increasingly become sensitive to changes in the interest rates. Debt servicing pressures are rising despite lower interest rates due to the increased stock of debt. While monetary policy is gradually normalizing in the USA, a build-up of further leverage could increase credit risk in the financial system.

Figure 1.7
Rising Non-Financial Sector Debt across G20

Non-Financial Sector Debt as Percent of GDP in G20
(Percent)



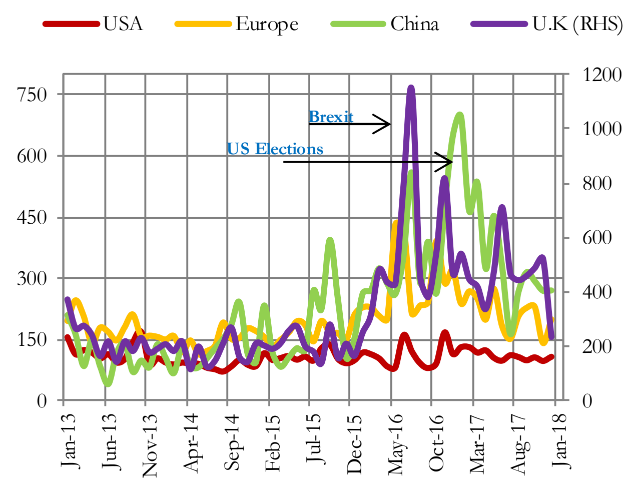
Source: IMF
AEs represent Japan, Canada, USA, UK, Italy, Australia, South Korea, France, and Germany.
EMEs represent China, Brazil, India, Turkey, Mexico, Russia, South Africa, Saudi Arabia, and Indonesia

Besides rising financial vulnerabilities, there are other critical risks in sight as well…

Policy uncertainty remains one of the potential medium-term risks to the global growth. For instance, uncertainty over anticipated US regulatory measures, the possibility of inward looking policies (trade restrictions), post-Brexit proceedings, cyber security breaches, and rising geopolitical tensions together appear to make medium-term growth prospects cloudy. Moreover, adverse climate changes taking place in certain regions of the world—such as rising temperature, more frequent natural disasters, rising sea levels, loss of biodiversity, and adverse spillovers from affected countries — could have serious implications for growth and stability.[63]

Figure 1.8
Policy Uncertainty has Receded in 2017

Economic Policy Uncertainty Index (EPU)
(Index)



Source: Federal Reserve Bank of St. Louis

Figure 1.8 shows that economic policy uncertainty in major economies has relatively receded in 2017 compared to the year 2016. Economic Policy Uncertainty Index (EPU), however, has remained well above the average (considering EPU data since 2013) in 2017 for Europe, U.K. and China. IMF (Oct-2017) observes that the near-term prospects of inward looking policies though have diminished in

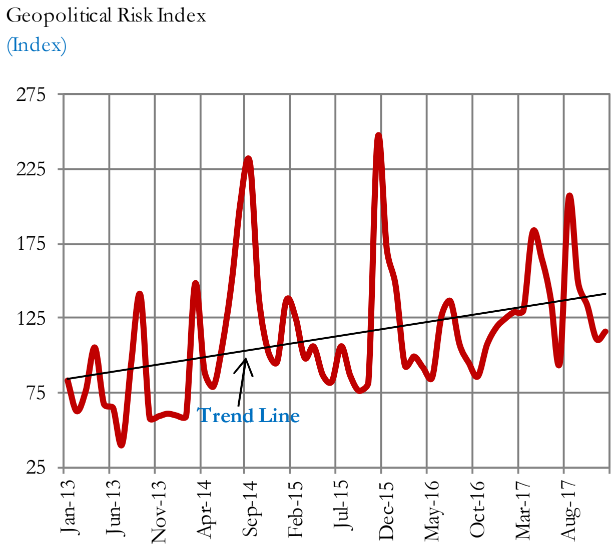
EMEs nonfinancial firms have witnessed most of the increase in debt-to-GDP ratio (17.3 percent) followed by households (7.1 percent) and government (1.7 percent). Source:

[62] IMF. (2017). Global Financial Stability Report. *Washington, October*
[63] IMF. (2017). World Economic Outlook. *Washington, October.*

AEs but increased pressures for protectionism still persist.

Geopolitical risks have risen notably in East Asia and the Middle East during 2017. The uptrend in Geopolitical Risk Index (GPR) reveals rising downside risks to global growth from geopolitical tensions (**Figure 1.9**). Caldara and Iacoveillo (2018) point out that increasing GPR is associated with adverse effects on a broad set of economic indicators.[64]

Figure 1.9
Geopolitical Risks have risen in 2017



Source: Caldara and Iacoveillo (2018)

1.2 Domestic Developments

Domestic economy maintains growth momentum…

The domestic economy has expanded by 5.37 percent during FY17, recording highest growth in a decade (**Table 1.3**). The momentum in economic expansion continued in FY18 with estimated growth of 5.79 percent. Besides services, industry and agriculture have also contributed to the economic activity during FY18.[65]

Table 1.3
Pakistan: Key Economic Indicators

	FY15	FY16	FY17	FY18	FY18 Target
	Percent				
Real Sector					
Real GDP Growth	4.04	4.71	5.37	5.79	6.00
LSM Growth (YoY)	3.43	3.12	5.63	6.24	
Inflation (Average)	4.53	2.86	4.15	4.03	6.00
	USD billion				
External Sector					
SBP Reserves (End-of-Period)	14.8	19.4	16.1	11.6	
Current Account Balance	(2.8)	(4.9)	(12.60)	(12.0)	
Exports (Goods)	24.1	22.0	20.4	17.1	23.10
Imports (Goods)	41.4	41.3	52.9	44.5	48.80
Trade Balance	(17.3)	(19.3)	(32.50)	(27.4)	
Remittances	18.7	19.9	19.4	14.6	20.70
PKR/USD Rate (Year Average)	101.3	104.2	104.7	107.7	
	Percent				
Fiscal Sector					
Fiscal Deficit (as % of GDP)	(5.32)	(4.56)	(5.85)	(4.30)	(4.10)
Revenue Growth (YoY)	8.08	13.12	19.80	16.00	
	Percent				
Monetary Sector					
M2 (YoY)	11.89	13.25	13.69	4.82	
Currency to Deposit Ratio	29.32	35.20	36.66	36.64	

Source: Ministry of Finance, Pakistan Bureau of Statistics and State Bank of Pakistan

Note: For Real Sector, LSM growth and inflation data is up to February and April 2018, respectively. The External Sector data is up to March-2018. In Fiscal Sector, revenue growth and fiscal deficit represent Jul-Mar FY18 period. Monetary Sectory data is up to March-2018. Moreover, GDP growth for FY18 is a provisional number.

In FY18 (Jul-Feb), LSM has expanded by 6.24 percent—higher than the recorded growth of 4.4

[64] Caldara, D., & Iacoveillo, M. (2018). Measuring Geopolitical Risk. *International Finance Discussion Papers 1222.*

[65] Services, industry and Agriculture sectors have contributed 3.85 percent, 1.21 percent, and 0.73 percent, respectively, in GDP growth during FY18 (Pakistan Economic Survey 2017-18).

percent in the comparable period of last year. A broad based growth in LSM activity mirrors continued expansion across various sectors of the economy.

…amid a mixture of downside risks and upside potential …

A number of macroeconomic challenges pose risks to the recent upsurge in economic activity, the foremost being the pressures developing in the external sector. Rising machinery imports and higher crude oil prices have led to a larger current account deficit both in FY17 and FY18 (Jul-Mar), which—absent matching inflows—has resulted in decline in reserves. Consequently, PKR depreciated by over 5 percent against the USD during CY17 with further depreciation of 4.59 percent occurring in March 2018.

The rising international oil prices and the related upward pressures on the import bill may further strain the external balances, going forward. However, the recent positive turnaround in the growth of exports and remittances in FY18 (Jul-Mar) is a positive development and if the trend continues it may alleviate some of the concerns of the external sector.

Fiscal deficit has also worsened during FY17; reaching a four-year high of 5.85 percent of GDP, mainly due to lower revenues and higher development expenditures.[66] In FY18 till March, the fiscal deficit has surged to 4.3 percent against budgetary estimate of 4.1 percent for the full fiscal year. The revised SBP estimates suggest that fiscal deficit could expand to 5.5 percent of GDP.[67]

Regardless of the size of the fiscal deficit, the critical aspect for the banking sector is its financing. Government's heavy reliance on borrowing for budgetary support from commercial banks could impact financial intermediation and lead to tightening of financial conditions for the private sector.

Inflationary pressures, so far, have remained benign despite higher oil prices, as inflation has remained below the official target of 6 percent. Additionally, equity market, after remaining bearish in H2CY17, have picked up some momentum recently.[68]

Besides CPEC, the lagged impact of easy monetary stance resulting in a robust uptake of private sector credit; corporate tax rationalization[69]; incentive package for exports; government's focus on infrastructure development; and ameliorating law and order situation suggest stable medium-term outlook.

Nonetheless, in the short term, the balance of risks remains tilted towards the downside. Therefore, the policy challenge is to sustain the current growth momentum given the rising macroeconomic vulnerabilities.

…The external account exhibits weaknesses necessitating corrective actions…

International reserves remained under pressures during FY17 and FY18 (Jul-Mar) due to persistent rise in current account deficit (**Figure 1.10**). In FY18, imports (mainly petroleum and machinery) surged by 15.98 percent while exports posted 13.27 percent growth leading to current account deficit of USD 12.60 billion. In the absence of matching inflows, international reserves have fallen by USD 3.6 billion in FY18 to reach USD 17.8 billion. The

[66] State Bank of Pakistan. (2017).The State of Pakistan's Economy, Annual Report, FY17, Chapter 4.
[67] SBP. (2018). Monetary Policy Statement. *May.*

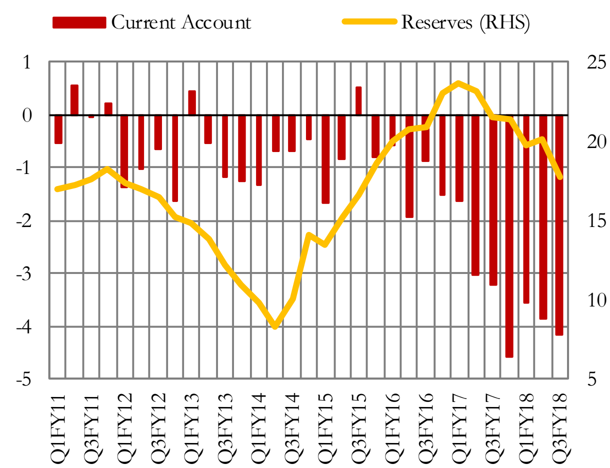
[68] KSE-100 index has improved to 45,488.86 as of April 30, 2018 from a low of 40,471.48 as of December 29, 2017.
[69] Ministry of Finance, Income Tax Ordinance, amended as of 30-06-2017.

stress in the external account has created pressures on the exchange rate as well (**Figure 1.11**).

Figure 1.10

Reserve have remained under pressure amid rising Current Account Deficit

Quarterly Current Account Deficit and Quarter-end Total Reserves
(USD billion)

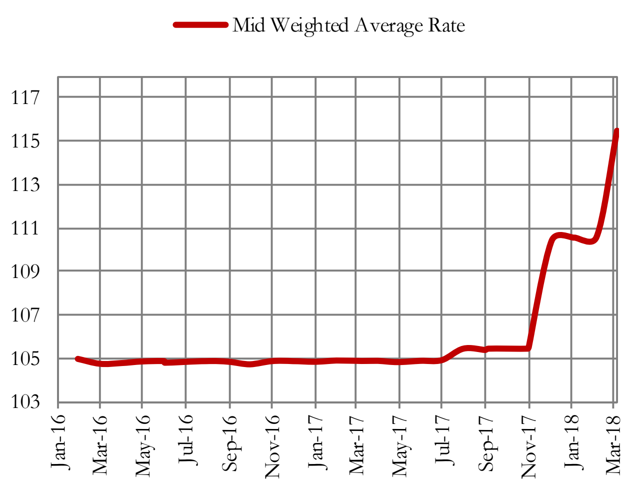


Source: SBP

Figure 1.11

PKR has Depreciated against the USD in December-17 and Mar-18

Monthly Trajectory of the Pakistani Rupee
(PKR/USD)



Source: SBP

In order to help stem deteriorating current account deficit, the government has imposed regulatory duties on certain import items in October-2017.[70] Moreover, on financing front, the government has introduced financial and regulatory measures to exporting industries to help lift-up exports growth.[71]

…yet if trade-offs are managed well, higher dividends are expected…

The imports of machinery continue to play an important role in widening the current account deficit. This reflects ongoing infrastructure development and economic expansion, which would help converge domestic economy to higher income level in the medium to long-term. Therefore, there is a need to manage the short-term challenges at the external front in order to realize higher growth in the future.

…the future direction of external account hinges on several factors…

Going forward, the scale of vulnerabilities in the external sector, among others, depends upon global demand, pace of remittances, policy response and commodity prices. Improving global demand, especially in AEs, may boost exports. Remittances inflows might increase from AEs that are showing faster economic growth (especially, U.S. and U.K.).

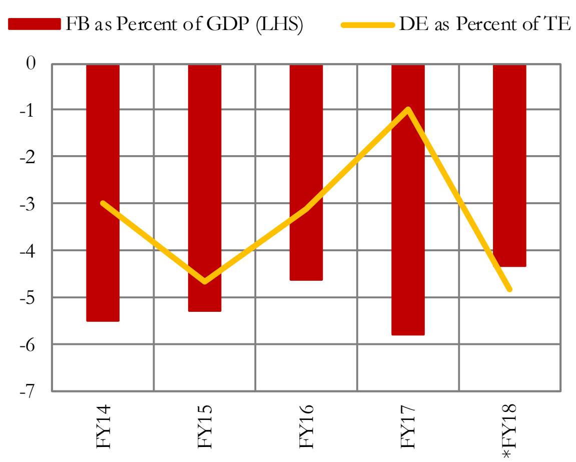
[70] http://download1.fbr.gov.pk/SROs/2017101712101357551SRO.(1035)-2017dated16.10.2017.pdf

[71] These include drawback of local tax and levies, tax rebates, export finance schemes and export incentive package worth PKR 180 million (State of Pakistan's Economy –Third Quarterly, FY17).

Also, the recent policy initiatives undertaken by Pakistan are likely to boost remittances inflows.[72]

Moreover, expected uptick in exports in response to incentive package announced by the GoP and the lagged impact of regulatory duties on imports may help contain the current account gap. A weaker currency (PKR) is also expected to increase exports. The recent uptrend in international oil prices, however, may impede recovery in external account.

Figure 1.12
Rising Developmental Expenditures have Widened Fiscal Deficit
Fiscal Balance and percent share of Developmental Expenditures in Total Expenditures



Source: SBP; Ministry of Finance
*Data for FY18 is up to Jul-Mar.

Fiscal deficit continues to be a key concern…

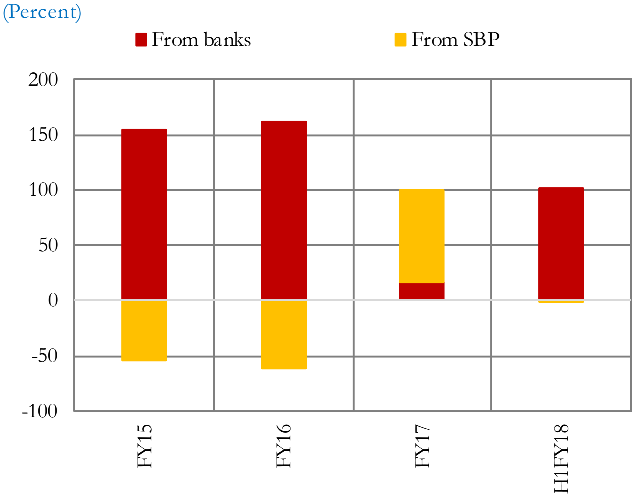
The fiscal deficit widened to 5.85 percent (of GDP) in FY17 from 4.56 percent in FY16, reaching a four year high. Rising deficit primarily reflected substantial increase in developmental expenditures (DE) which rose to 24.9 percent of total expenditures (TE) in FY17 from 22.45 percent in FY16 (**Figure 1.12**). Relatively contained interest payments in previous years provided fiscal space for elevated developmental expenditures.[73]

In Jul-Mar FY18, fiscal deficit has expanded to 4.3 percent—higher than 3.9 percent deficit recorded in the comparable period of previous year. Despite impressive growth in revenues during this period, widening fiscal deficit is due to higher expenditures especially developmental spending (29.70 percent growth).

…Budgetary borrowing pattern defines financial conditions for the private sector…

In line with the widening fiscal deficit during FY17, total budgetary borrowing from the banking system surged by 37.41 percent (PKR 1,087.2 billion) in FY17. Borrowing from SBP explains around 84.0 percent of the total banking system borrowing during FY17 (**Figure 1.13**).

Figure 1.13
Shifting Pattern of Government Budgetary Borrowing
Budgetary Borrowing from Banks and SBP as percent of Total Budgetary Borrowing
(Percent)



Source: SBP

[72] Two schemes have been launched in December-2017: Asaan Remittance Account and m-wallets. Asaan Remittance Account is meant to facilitate beneficiary in opening bank account while through m-wallets, beneficiaries would be able to withdraw cash from ATMs, bank branches, and branchless banking agents.

[73] State Bank of Pakistan. (2017).The State of Pakistan's Economy, Annual Report, FY17, Chapter 4.

In H1FY18, however, government budgetary borrowing entirely shifted from SBP to scheduled banks. Total budgetary borrowing from the banking system reached at PKR 313.2 billion of which banks provided PKR 315.9 billion while PKR 2.7 billion were retired to SBP. Such shifting pattern towards banks could lead to tightening of financial conditions for the private sector.

Nonetheless, post H1FY18 (Jan-Mar), the pattern of budgetary borrowing has reversed again whereby the government has relied on SBP borrowing (PKR 2.2 trillion) while retiring to the scheduled banks (PKR 1.7 trillion).

In CY17, the private sector lending maintains its pace amid strengthening demand …

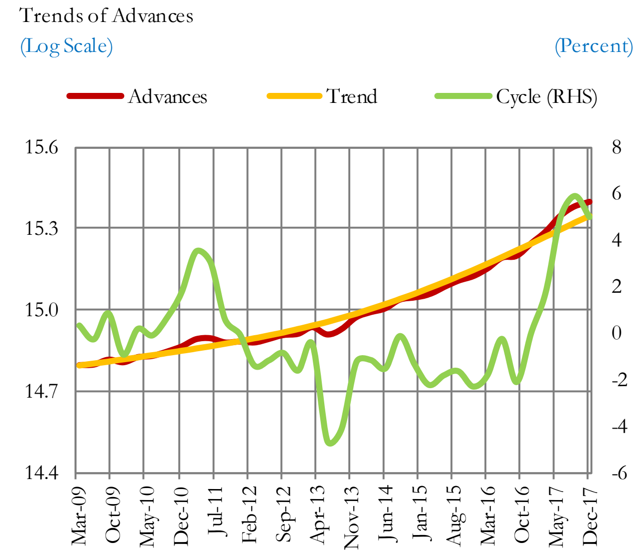
The advances to private sector have increased by 16.4 percent in CY17, with the largest rise in consumer financing (20.82 percent) followed by corporate advances (17.60 percent), SMEs (12.10 percent) and agriculture (4.70 percent). Moreover, corporate advances for fixed investment purpose have shown impressive growth of 15.24 percent (YoY) in CY17.

Sector-wise analysis reveals that cement sector observed highest growth (58.14 percent), followed by sugar (31.16 percent), textile (16.27 percent), and automobiles (13.0 percent). Broad based disbursement of advances reflects strengthening of demand conditions in domestic economy and increasing utilization of funds for capacity oriented projects. (**See Chapter 3.1 for detailed analysis**).

…and hovers above long-term trend …

The outstanding advances are hovering well above its long-run trend, with cyclical upturn starting in CY16 (**Figure 1.14**).[74]

Figure 1.14
Advances have grown



Source: SBP

Nonetheless, given low credit incidence in the economy,[75] such an acceleration is a welcome sign for growth rather than a concern pertaining to financial excesses. Also, the trend is already reverting back to its long-run path.

…banking sector's performance remains encouraging…

In CY17, banking sector's assets expanded by 15.86 percent (PKR 2.5 trillion) – up from 11.93 percent (PKR 1.7 trillion) in CY16. Notable acceleration in total assets has been sourced by robust growth in advances (18.43 percent – YoY) and investments (16.24 percent – YoY). It is pertinent to outline that investments continue to dominate banks' assets (**Figure 1.15**). In CY17, investments and advances

[74] The long-run trend has been calculated via Hodrick-Prescott filter. The cyclical component is the deviations from the this trend.

[75] Credit-to-GDP ratio is at 16.5 percent in 2016 compared with 49.8 percent in India, 44.4 percent in Bangladesh and 46.0 percent in Sri Lanka during the same period. (Source: World Bank)

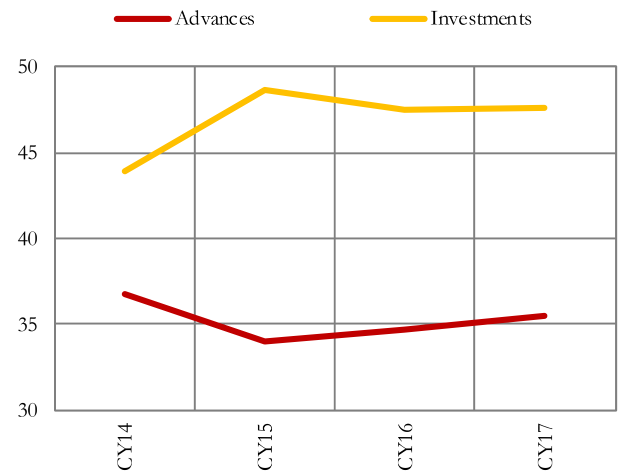
explain expansion in total assets by 47.6 percent and 35.5 percent, respectively.

Figure 1.15

Investments continue to dominate Assets Expansion

Percent share of Advances and Investments in Total Assets

(Percent)



Source: SBP

On liability side, however, deposit growth remained less than encouraging. In CY17, deposits expanded by 10.29 percent – down from 13.56 percent in CY16. Deceleration in money supply (M2) – driven in part by contraction in Net Foreign Assets (NFA) of the banking system – seems to be one of the reasons behind slowdown in deposit. Other reasons include business strategy of some banks to limit the growth of domestic remunerative deposits and scaling back of operations by few banks in overseas market.

Encouragingly, asset quality continues to improve. In CY17, NPLR (non-performing loans to total loans ratio) has further moved down to 8.43 percent, which is lowest in a decade. Slowing profitability of the banking sector, however, remains a concern as Return on Assets (ROA – before tax) declined to 1.6 percent in CY17 from 2.1 percent in CY16. This reflects, apart from other factors, the impact of low interest rate environment.

On resilience front, banking sector is well positioned with Capital Adequacy Ratio (CAR) of 15.8 percent in CY17, which is well above the minimum regulatory requirement of 11.275 percent. (**see Chapter 3.1 for detailed analysis**).

…while the equity market has underperformed…

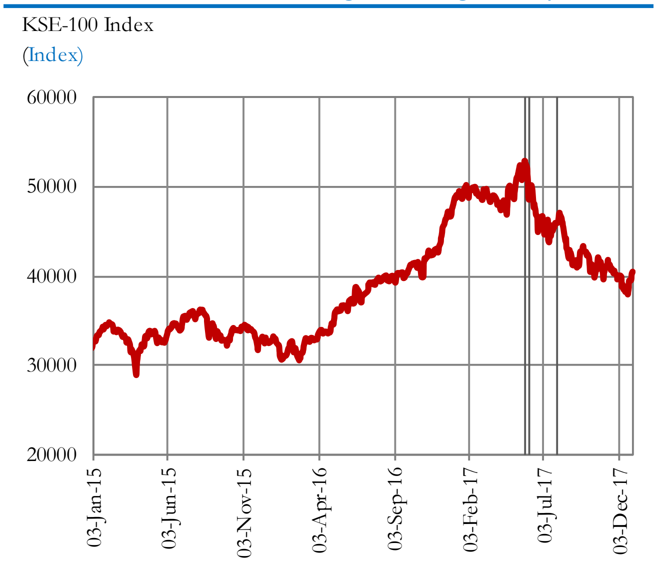
The KSE-100 index crossed 50,000 mark in CY17, touching its historical high on May 24, 2017 at 52,876 points. The growth in share prices was fueled by a bullish sentiment earlier in the year due to i) Pakistan's re-classification in the MSCI Emerging Market Index from the Frontier Market Index, ii) accommodative monetary policy stance throughout the year, iii) low inflation, iv) increased economic activity under CPEC and v) political stability.

However, the equity market began to decline towards end-May, dropping over 25 percent by the end of the year and closing 15.34 percent lower in CY17 on a YoY basis. The decline in equity prices began with the announcement of the budget 2017-18, which implemented new taxes on equity investments, and a smaller than expected take up of Pakistani bourses by international investors following the inclusion of Pakistan in the MSCI Emerging Market Index. The political uncertainty that followed in the second half of the CY17 and beyond may have dented the investor sentiments leading to an overall underperformance of the equity market during the year (**Figure 1.16**).

The index has, however, picked up some momentum recently and the volatility in the market is expected to taper further after the general elections as the political situation stabilizes. (**see Chapter 2 for detailed analysis**).

Figure 1.16

KSE-100 Index Slides after Reaching Record Highs in May 2017



Source: SBP

In short-term, domestic economic outlook is challenging while medium-term prospects look stable ….

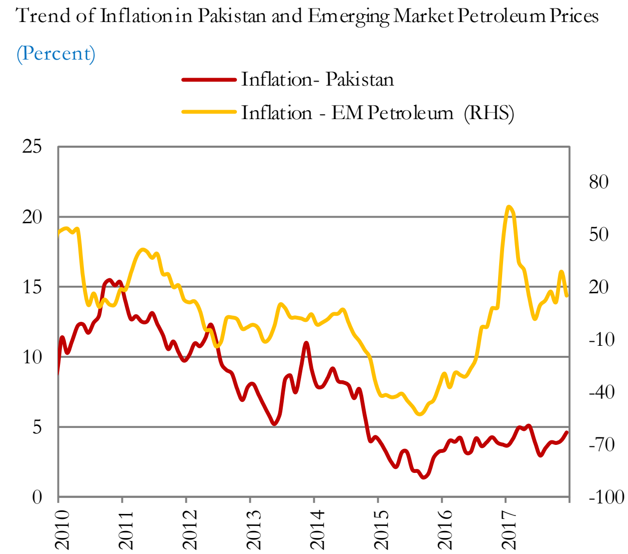
Global economy has followed robust economic course during CY17 aided by rebound in investment and trade. Financial conditions have remained largely supportive, however, with slight increase in short-term risks to financial stability.

At the domestic front, rising vulnerabilities in the external account—driven by increasing machinery imports and higher oil prices—have resulted in exchange rate depreciation and gradual build-up of inflationary pressures. Fiscal deficit remains a critical concern given its rising trend.

Further, the headline inflation has increased to 4.09 percent (on average) in CY17 compared to 3.76 percent last year, in the wake of increasing commodity and food prices. Energy prices have also added to the pressure as emerging market petroleum price index has increased by 13.79 percent in CY17 as the global oil price have rebounded **(Figure 1.17)**. Though inflation, despite pressures, is contained but if the stress in the external sector elevates, it could become a concern. These developments suggest that the domestic economy may experience tighter macro-financial conditions in the short-run.

Figure 1.17

Inflation in Pakistan is Rising with Petroleum Prices



Source The Wolrld Bank, Pakistan Bureau of Statistics

However, in the medium-term, economic outlook seems encouraging. CPEC, under the One Belt One Road (OBOR) initiative, is expected to yield positive dividends for economic growth via, inter alia, increasing Pakistan's connectivity to the rest of the world through a better highway network and development of the Gwadar port; establishment of industrial parks and technology transfers from China. Additionally, the ongoing construction of coal-based power plants and renewable energy farms are expected to alleviate the shortfall of power supply in the country.

Moreover, rising demand for fixed investment advances are likely to enhance the productive capacity of the firms, which in the wake of improving global demand may boost exports.

Effective management of macroeconomic vulnerabilities hovering at shorter horizon remains the key policy challenge, which in turn would determine medium-term economic prospects.