1 Economic Review

1.1 Overview

Pakistan's economy maintained its momentum towards a higher growth trajectory in FY16. An enabling policy environment was one of the key factors that contributed to this impetus. Higher infrastructure spending by the government and decades' low interest rates provided a boost to domestic demand; and easing in the energy supply situation addressed a key bottleneck holding back industrial performance. An improvement in the security situation supplemented these policy measures. While some indicators were short of the targets, they still posted better position as compared to FY15 (**Table 1.1**).

The current account deficit during FY16 was higher than the last year, though it was comfortably financed by financial inflows. In fact, in net terms, the FX inflows during FY16 were higher than outflows, which led to accumulation of foreign exchange reserves to an all time high level. FY16 also saw the successful conclusion of the IMF program, which not only provided direct FX support but also helped the country secure financing from other IFIs and the international capital market. This, in turn, led to stability in the FX market.

Table 1.1: Macroeconomic Indicators

				FY16	
	FY13	**FY14**	**FY15**	**Target**	**Actual**
growth in percent					
Real GDP[1]	3.7	4.1	4.0	5.5	4.7
Agriculture	2.7	2.5	2.5	3.9	-0.2
Industry	0.7	4.5	4.8	6.4	6.8
Services	5.1	4.5	4.3	5.7	5.7
CPI inflation[1]	7.4	8.6	4.5	6.0	2.9
as percent of GDP					
Current account balance[2]	-1.1	-1.3	-1.0	-1.0	-1.2
Fiscal balance[3]	-8.2	-5.5	-5.3	-4.3	-4.6
Public debt[3]	61.3	62.4	64.8	*	66.5

* Public debt target in amended FRDL Act has been set at 60 percent of GDP for 2017-18, and 50 percent of GDP for 2032-33
Source: [1]Pakistan Bureau of Statistics; [2]State Bank of Pakistan; [3]Ministry of Finance.

The stable exchange rate, along with the decline in oil prices, helped push CPI inflation down to only 2.9 percent in FY16. The impact on the wholesale price index (WPI) was more pronounced as it showed a deflation of 1.1 percent. Recognizing the space for pro-growth policies created by these developments, SBP slashed the policy rate to 5.75 percent (lowest level since early 1970s); retail lending rates of commercial banks and refinance rates on SBP's concessional schemes followed suit. The availability of low-cost funding provided much needed support to private businesses, which was reflected in their increased borrowings from commercial banks. Similarly, the government also scaled up its development spending further during the year; importantly, it created room for this stimulus via restricting its current spending as well as mobilizing higher revenues. Therefore, fiscal consolidation remained on track, and the budget deficit reduced further to 4.6 percent of GDP for the first time since FY07.

That said, there are certain challenges that deserve the undivided attention of all stakeholders:

- First, Pakistan needs to increase its savings and investment levels. Although public investment is increasing despite resource constraints, investment by the private sector has not increased sufficiently. This has inhibited the country's potential growth. On the other hand, savings are not commensurate with required investible resources. The situation cannot be fully remedied unless the private sector, in particular, comes up with attractive savings schemes in the areas of pensions, provident fund, gratuity, old age benefit schemes; targeted marketing of such schemes (including in the rural areas) is also imperative.
- Second, exports continue to pose a major challenge for a sustainable external account. Some recent policy fixes (like zero rating of exporting sectors and release of refunds), are welcome steps and will have positive impact, but structural issues in the export industry should also be resolved. In fact, these shortcomings magnify the impact of falling global commodity prices (for example, the decline in unit prices suppressed export values of certain commodities; and

quantum export of some products declined due to competitiveness related issues). Therefore, a more coherent and integrated industrial and trade policy, supplemented by a regulatory regime that rewards innovation, is the need of the hour. A more agile policy framework will help address the export decline, and also induce other foreign investors to take a long-term view of Pakistan.

- Third, while ongoing fiscal consolidation measures are welcome and have been widely appreciated by both local and foreign stakeholders, the reliance of the tax structure on stop-gap measures (like imposition of regulatory duties in November 2015) is creating distortions in the economy. As sectors like telecommunication and energy yield hefty revenues, others, like agriculture, are hardly contributing their worth in total taxes.
- Finally, the country has been unable to spend nearly as much on social sector development as it needs to. Be it health or education, Pakistan spends much less as percentage of GDP than many developing countries. Despite some improvements in areas like poverty alleviation, maternal and child mortality, and primary school enrolment, the country was unable to meet a majority of the targets set under the Millennium Development Goals (MDG) framework. With the Sustainable Development Goals having replaced MDGs last year, a deep rethink is required across all levels of the government – federal, provincial, and local – to have any meaningful chance of meeting the SDGs.

Encouragingly, Pakistan seems to be well positioned to address these challenges and make progress to a higher growth trajectory and social development. The most important support would come from a stable macroeconomic environment and growing investments in CPEC-related projects that would help improve the existing infrastructure and power supplies to businesses. Moreover, a prolonged spell of low oil prices has made it easier to expedite and deepen structural reforms.

While expediting the reform process remains essential in the public sector, the private sector must also step forward and proactively adjust organizational strategies in line with changing business dynamics. Without private sector participation, it will be hard to achieve a high and sustainable growth that is built on the pillars of entrepreneurship, innovation and competitiveness.

1.2 Assessment of FY16

Pakistan's economy grew at 4.7 percent in FY16, well above the 4.0 percent growth realized last year, but less than 5.5 percent growth target for the year. In fact, the positive impact of an improvement in growth-enabling factors like better energy supplies, availability of low-cost funding, receding security concerns, strong domestic demand, etc., was partially offset by dismal performance of the agriculture sector during the year.

Like FY15, the agriculture sector remained under stress in FY16 due to depressed commodity prices and unfavourable weather conditions. An additional factor in FY16 was pest attacks following the erratic and heavy rains during the *kharif* season. This inflicted heavy losses on the cotton crop, which was 29.0 percent less than last year.[1] The performance of other crops was not encouraging either. As a result, crop sector posted a negative growth of 6.3 percent in FY16, which led to a decline of 0.2 percent in overall agriculture sector for the first time since FY01.

The livestock sector, accounting for more than half the agriculture sector, grew by 3.6 percent in FY16, compared with 4.0 percent last year. Despite lower growth, this sector has been witnessing a number of encouraging developments lately. For example, the corporate sector is stepping up the development of meat processing facilities, and positioning itself as an exporter and retailer. The government is also actively promoting this sector, and has established the Pakistan Halal Authority to

[1] The crop sector experienced a decline during FY16 despite a better growth performance of wheat and sugarcane crops compared to the previous year (these two crops contribute over 55 percent of the value addition by major crops).

promote trade and commerce in halal food products. In addition, the government has also reduced customs duty on the import of meat processing machinery.

The industrial sector posted a healthy growth of 6.8 percent in FY16, which was not only higher than 4.8 percent growth realized in FY15, but also surpassed the annual target of 6.4 percent. As noted earlier, this was primarily driven by: (i) stable macroeconomic environment; (ii) strong policy support in the form of low interest rates and a rise in infrastructure spending; (iii) better energy supplies; and (iv) an improvement in security conditions. Additional support came from ongoing CPEC-related projects, which created demand for construction and allied industries. Construction activity grew by 13.1 percent in FY16 – more than double the level of growth seen in FY15. This also played a key role in supporting large-scale manufacturing (LSM) due to its strong forward and backward linkages.

Although growth in LSM was recorded 3.2 percent in FY16 – lower than 3.4 percent last year, it was primarily due to a complete halt of operations in Pakistan Steel Mills (PSM). The issue with PSM operations led to 9.3 percent contraction in steel production during the year. Not only did this contraction eclipse vibrancy in private steel manufacturing, it also pulled down the overall LSM growth. Excluding PSM, the LSM showed a growth of 3.7 percent in FY16, compared to 3.0 percent last year.

Encouragingly, a number of other industries posted a healthy growth during FY16. For instance, (i) fertilizer sector grew by 13.8 percent in FY16 due to uninterrupted gas supplies, and provision of LNG as a feedstock; (ii) cement sector posted a 10.1 percent growth in FY16, which was almost 4 times that of the last year, benefiting from strong domestic demand and low coal prices; (iii) auto sector recorded a strong growth for yet another year primarily on the back of Apna Rozgar Scheme of Punjab government, and availability of low cost auto financing; and (iv) edible oil industry witnessed notable improvement, which could be attributed to fall in international prices of palm and soybean oils, stable exchange rate, and a steady demand in the country. Moreover, pharmaceuticals, leather, and chemicals, also saw a reasonable growth during the year. Meanwhile, the performance of textile sector, which is the biggest sub-sector of LSM, remained subdued; the sector grew by only 0.4 percent in FY16 – less than half the last year's growth.[2]

On the back of a modest growth in commodity producing sector (agriculture and industry), higher trade volumes, and healthy performance of financial institutions, services sector grew at a decades' high level of 5.7 percent in FY16. Within services, the biggest contribution came from *wholesale and retail trade* as the drag from domestic crop sector was outweighed by higher import volumes and strong growth in industrial sector. At the same time, the impetus to *general government services* came from an increase in salaries of government employees. The contribution of *finance and insurance* sub-sector also improved as the profits of commercial banks continued to increase. The impact of lower interest rates on banks' profitability was largely offset by a pickup in credit to private sector and growing non-interest income of the banking sector.

Monetary policy and inflation

SBP policy rate witnessed two separate cuts of 50 and 25 bps during FY16, on top of a cumulative reduction of 300 bps in FY15. These cuts, calibrated with the adequate provision of liquidity, led to a visible reduction in banks' retail rates.[3] The weighted average lending rate (WALR) on fresh loans

[2] Both external and domestic factors were in play: weak external demand, fall in unit value of exports, long-standing competitiveness issues that undermined the ability of textile sector to capitalize on robust domestic demand and a significant improvement in overall business environment.

[3] The outstanding level of OMOs remained on average Rs 1.3 trillion during FY16, compared with Rs 0.4 trillion in the previous year; acceptance-to-bid ratio in OMOs increased, as SBP maintained the cut-off rate very close to the policy rate; and number of OMOs also increased. SBP conducted 92 OMOs for liquidity injections in FY16, compared to 76 in the previous year.

saw a reduction of 237 bps in FY16 on average, to reach 7.8 percent for the year. This sharp reduction in the cost of borrowing and favourable business environment created demand for bank credit in FY16. In absolute terms, credit to private sector expanded by Rs 460.6 billion during the year – more than double the level of expansion seen in FY15. Encouragingly, the expansion was fairly broad-based, as all the major sectors (including textiles, power, fertilizer, construction, and transport) resorted to bank borrowing. In addition to businesses, consumer financing also gained traction, with strong demand for auto loans.

Some support to credit expansion also came from a decline in government borrowing from the banking system. Specifically, net budgetary borrowing from the banking system stood at Rs 787 billion in FY16, which was Rs 101 billion lower than the last year; this was a result of contained fiscal deficit and availability of external funding. Within the banking system, the government continued to retire its borrowing from SBP for yet another year. These retirements not only helped the government contain its borrowing from SBP in line with the IMF targets for three of four quarters of the year, but also facilitated SBP in meeting IMF limits on its net domestic assets in these quarters.

Despite the contractionary impact of net retirement to SBP, reserve money witnessed an expansion of 26.5 percent in FY16 – more than double the increase seen in FY15. However, this had only a muted impact on the broad money supply (M2) in the economy, which showed around the last year's growth rate. Liability side provides interesting insight on this issue: currency in circulation grew at an unprecedented rate of 30.5 percent, while the deposit growth declined to a 7-year low.[4] As a result, currency to deposit ratio has reached the highest level since FY03, reducing the money multiplier from 3.6 to 3.2 in just one year.

Benefiting from the contained monetary expansion, the fall in global commodity (especially oil) prices, adequate supply of perishables, and stable exchange rate, headline CPI inflation hit a 47-year low of 2.9 percent in FY16. The decline in CPI inflation was fairly broad-based, as it was visible across various groups including food, housing, furnishing, health, etc. Both measures of core inflation (non-food-non-energy and trimmed mean) also recorded a decline in FY16. Transport group contributed the most in pulling the core inflation down, as prices within this group *fell* by 6.9 percent in FY16. Similarly, the impact of decline in global commodity prices was more pronounced on WPI, which has shown on average a deflation of 1.1 percent during FY16.

Fiscal policy

Fiscal consolidation remained on track as the budget deficit for FY16 (as percent of GDP) continued to fall for the fourth consecutive year. Helped by high growth in tax revenues and a stringent control over current expenditures, the budget deficit for FY16 declined to 4.6 percent of GDP, from 5.3 percent in the previous year.[5] The FBR tax collection recorded a strong growth of over 20 percent in FY16, and surpassed the annual target for the first time since FY10. This improvement was largely attributed to: (i) new tax measures, especially aimed at enhancing the scope of differential taxation structure for return filers and non-filers; (ii) additional measures implemented in November 2015 to make up for the revenue shortfall (including regulatory duties on a number of items); and (iii) various other tax measures implemented from time to time, including changes in duty structure on petroleum products (**Chapter 4**).

Within tax revenues, direct taxes posted a YoY growth of 17.8 percent in FY16, which was lower than the last year, and almost half the growth target in the budget. Composition of direct taxes remained skewed towards withholding tax, which is deducted at source and is generally passed on to

[4] Sharp rise in currency in circulation, as highlighted in previous reports, could be attributed to the imposition of withholding tax on financial transactions exceeding Rs 50,000 for non-filers. Strong demand for prize bonds also lends credence to this view; mobilization through prize bonds reached Rs 123.9 billion in FY16, compared to Rs 75.9 billion during last year.
[5] Both the primary and revenue deficits also improved during the year.

customers by the businesses. Voluntary collections, which accounted for over a quarter of direct tax collections, saw a rise of 18.5 percent in FY16. Collections under this head were largely concentrated in 'pay as you earn' mode; the share of 'collections with returns' remained subdued.

Sales tax, which has 69 percent share in indirect taxes and constitutes 42 percent of FBR tax revenues, saw a 19.8 percent rise in FY16 – more than double the growth realized last year. This is largely explained by higher collection on POL products, electrical energy, cement, machinery and vehicles. These five groups accounted for nearly half of the overall sales tax collection in FY16.

Moving to expenditure side, the overall spending saw an increase of 7.6 percent in FY16. Current expenditures remained nearly at the last year's level, as a reduction in interest payment (driven by historic low interest rates) almost entirely neutralized the rise in other expenditures. In fact, the control over current spending created much needed room to prioritize public sector development program (PSDP) spending, which grew by 20 percent YoY during the year, on top of 14 percent growth recorded last year.

While the consistent adherence to fiscal discipline is very much appreciable, some restructuring of fiscal operations is still required for sustaining the improvements: firstly, tax policy needs to be forward looking, instead of relying on stop-gap measures. Especially, overtaxing the sectors like telecommunication and energy, which act as catalyst for the economy, can hurt long-term growth objectives. Similarly, tax on financial transactions does not bode well for the objectives of financial inclusion and documentation. It is worth reiterating that the currency in circulation has soared and prize bonds of big denominations are high in demand. This reflects the public's inclination towards bearer instruments – a move away from documentation (**Chapter 3** and **4**). Secondly, on the expenditure side, more resource allocation is needed for social sector development to enhance the living standards of the people.

Public debt

Public debt, which essentially represents accumulated budget deficits, witnessed a rise of Rs 2.3 trillion in FY16, and reached Rs 19.7 trillion (66.5 percent of GDP) by end-June 2016. This sharp increase in public debt as compared to the level of deficit for the year, could be largely explained by: (i) revaluation losses caused by unfavourable currency movements; (ii) an increase of Rs 459.4 billion in government deposits held with the banking sector; and (iii) the increase in loans from the IMF, which are generally for balance of payment support. The first two factors accounted for around 33.5 percent of the rise in public debt in FY16. While the revaluation losses (or gains) are entirely driven by movements in global currencies, the sizeable rise in government deposits represents the need to carefully monitor public debt and cash management.

That said, there was a favourable shift in the composition of public debt in FY16: the share of external debt slightly increased, which eased pressure on domestic sources of funding. Moreover, concessionary borrowing from multilateral institutions accounted for a large part of the increase in external debt. Borrowings from domestic sources, which constituted 62 percent of the rise in public debt, also entailed lower cost due to historic low level of interest rates prevailing in the economy.

In absolute terms, domestic debt increased by Rs 1.4 trillion during FY16, and amounted to Rs 13.6 trillion (or 46.0 percent of GDP). Most of this increase came from longer tenor government bonds like PIBs and Ijara Sukuk, which accounted for 56.2 percent of the rise in domestic debt in FY16, and pushed the share of permanent debt to 43.6 percent by end-June 2016. These changes helped improve the maturity profile of domestic debt.

Meanwhile, with a notable increase of US$ 6.8 billion during the year, the stock of external public debt reached US$ 57.8 billion by end-June 2016. A fifth of this rise was attributed to revaluation losses, with the remaining reflecting higher government borrowing. Specifically, the increase in external debt mainly represents loan disbursements by the IMF (US$ 2.0 billion); other IFIs (US$ 2.1 billion); and commercial borrowing (US$ 583 million). It should be noted that multilateral loans (especially from the World Bank and ADB), which constitute 45.7 percent of the public external debt, are primarily to support reforms in the areas of taxation, doing business, trade facilitation and education. Apart from being concessional, these loans are also likely to enhance the repayment capacity of the country by promoting efficiency and productivity.

Above changes in the public debt profile are less likely to change the debt sustainability perspective: the external debt does not pose any imminent risk on solvency or liquidity fronts in the foreseeable future, and the favourable shift in the composition of domestic debt has lowered the re-pricing and roll-over risks for the government. However, the need for quick recovery in Pakistan's export earnings can hardly be over emphasized for sustaining the prevailing comfort in debt servicing.

External sector

The strengthening of the external account, underway for the past two years, continued in FY16. While the current account deficit deteriorated during the year, it was comfortably financed by higher FX inflows in the form of IMF disbursements, official debt flows (including short-term commercial borrowings), and a surge in FDI.[6] Massive surplus in the financial account contributed to a sizable US$ 4.6 billion increase in SBP's FX reserves, which reached an all-time high of US$ 18.1 billion by end-FY16. The year also saw the conclusion of the IMF program, which provided much FX comfort to the country.

In fact, strong official inflows have become more crucial from the BoP standpoint, as they have been offsetting FX pressure stemming from the trade account. While low oil prices made it easier for the country to finance the import of industrial goods (particularly machinery and steel) to supplement higher economic activity, exports continued to cast a shadow on the external front; export receipts declined 8.8 percent in FY16, after falling 3.9 percent in FY15. With overall import payments declining by a marginal 2.3 percent, the trade deficit widened 6.9 percent in the year (after growing 3.6 percent in FY15). Although the fall in international commodity prices weighed on export values, the role of structural constraints and lack of product innovation cannot be ignored.

Meanwhile, additional pressure on the current account came from a widening primary income deficit; this was mainly a result of higher repatriations of profits and dividends, as well as a noticeable rise in reinvested earnings of foreign firms.

The slackening in exports had been, up till now, compensated by the stellar growth in remittances: the percentage of the trade deficit (both goods and services) covered by worker remittances has grown from 70 percent to 93.9 percent over the past five years. But this FX comfort has lately started to weaken, as this segment is not completely immune from adverse global developments: the remittances increased albeit with a reduced growth of 6.4 percent in FY16. The country's high dependence on the oil-rich GCC for remittances emerged as a challenge in an era of low oil prices: inflows from the region grew by 6.0 percent in FY16, against 24.1 percent in FY15. Another issue was the tightening of AML/CFT and consumer protection regulations in the US, which has increased business costs for US-based global money transfer operators. The UK, however, was an outlier, with remittances from the country rising by a solid 8.5 percent in the year.

In this backdrop, it has become critical for the country to generate FX from non-debt sources – i.e. exports and FDI – to finance essential imports for industrial activities. Simultaneously, non-essential imports need to be curbed, and import substitution be given policy support, where applicable. And

[6] The country had also issued a US$ 500 million Eurobond in September 2015; this was netted out by the maturing of another Eurobond of the same size in March 2016.

with the end of the IMF program, sustaining the FX comfort of the past three years is important. It is, therefore, imperative for the country to maintain engagement with other IFIs for the continuation of reform process and having access to long-term and concessional funding.

Encouragingly, multilateral agencies like the ADB have recently renewed their commitments to Pakistan, with most FX assistance reserved for either large-scale infrastructure projects or for governance reform programs.[7] In this backdrop, Pakistan's status as one of the founding members of the Asian Infrastructure Investment Bank (AIIB) will also be critical going forward.[8]

At the same time, the focus should be on reforming the business climate, so that not only existing manufacturing units perform at their full export potential, but foreign investors also take a long-term view of the country. Some recent developments have been encouraging – like the announcing of zero-rating for five key exporting sectors, improved power supply to industry, and Pakistan's reclassification as an emerging market by MSCI. Yet, sustaining the macro stability achieved over the past three years will require more deep-rooted structural reforms.[9] Granted that short term policy measures may appear more appealing, it is only by removing structural bottlenecks holding back exports and FDI that the country can sustain external sector stability.

Social sector

The ultimate objective of economic policies and development is to enhance the welfare of the people. Healthy growths in economic activity, low inflation, provision of infrastructure and financial facilities, etc., are the means to achieve that end. It is therefore imperative to analyze how the recovery in economic activity and other positives have impacted the social sector over the past few years. Coincidently, FY16 also marked the end of timeframe for the Millennium Development Goals, which had required countries to improve their socioeconomic indicators over a period of 15 years. A visible improvement has been observed on this front at the international level. For instance, the MDG goal of reducing extreme global poverty by half (from the level in the year 1990), was met five years ahead of schedule. Similarly, improvements were noted in primary school enrolment and literacy rates, infant and maternal mortality rates, and HIV prevalence, at the global level.

Despite that, like many other countries, Pakistan also could not achieve a majority of the MDG targets. Furthermore, the pace at which the country improved its social indicators lagged behind that of its regional peers, and was not enough to improve the quality of lives of the least prosperous segments of the population. As a result, Pakistan's absolute ranking in the UN's Human Development Index remained low during the MDG timeframe.[10] Moreover, as absolute poverty has gone down, income inequality has gone up in the country (**Chapter 7**).

There are numerous reasons for this weak performance: subdued economic growth (partly a result of the war on terror), and macroeconomic shocks and the subsequent episodes of consolidation and stabilization, basically meant that the country had insufficient resources available for social development. Furthermore, the provinces, which became responsible for social sectors like health and

[7] For instance, in August 2016, the ADB approved a US$ 810 million financing package for Pakistan's energy sector; the duration of the program is from 2016 to 2026.

[8] Pakistan is one of the first countries that will receive AIIB project financing. In May 2016, the AIIB announced that it will partner with the ADB and the UK's Department for International Development in co-financing a 64-kilometer stretch of the M4 motorway, which will connect Shorkot with Khanewal. The project's cost has been estimated at US$ 273 million (source: http://www.aiib.org/html/2016/PROJECTS_0426/101.html).

[9] For a detail discussion on reforms needed to address structural issues in exports, see SBP Annual Report FY15, Special Section 3: What has Caused Stagnation in Pakistan's Exports.

[10] In 2000, Pakistan was ranked 138th out of 173 countries on the HDI. By 2014, it had slipped to 147 (out of 188 countries). In the same period, regional countries like Sri Lanka and Bangladesh were able to improve their HDI ranks.

education after the 18th amendment and the 7th NFC Award, are still in transitionary phase. There is a need to strengthen their technical and monitoring capacity to ensure efficient resource allocation.

An additional problem is the country's rapidly growing population, which is putting further strain on the already inadequate social infrastructure. Pakistan still has a large number of children out of school. Besides, the near exclusion of half the population (females) from education and the labour force means that the country has yet to fully exploit its human potential.

In essence, the state's inability to provide essential social services to a majority of its constituents has led the private sector to try and fill this gap; this is particularly true for the health and education sectors. However, this has come at a cost: not everyone can afford these services. Moreover, rural areas are still being largely left out.

In this backdrop, the government should assume a more proactive role in expanding the social security net in a targeted fashion. The progress made in areas like financial inclusion and women empowerment (through BISP) needs to be sustained and improved upon.[11] And with the world already moving forward on meeting the SDGs, it has become imperative for stakeholders in the country – both in the public and private sectors – to exert their concerted efforts to improve social service delivery for those segments of the population that need it the most.

1.3 Outlook for FY17

With an improved macroeconomic environment, better energy supplies, and subsiding security concerns, business sentiments are upbeat. In addition, smooth progress on CPEC-related projects will ease infrastructure and energy constraints, and also create demand for industrial output. Economic activity would also benefit from pro-growth policies: the policy rate currently stands at a historic low of 5.75 percent, which has made funding easier for businesses and consumers. Similarly, growing development spending, despite a planned reduction in budget deficit, would continue to support infrastructure-related industries. Therefore, domestic demand is likely to remain strong, as reflected by leading indicators like credit expansion to businesses, consumer financing, and trade. In this backdrop, the government envisages a GDP growth of 5.7 percent for FY17 – a sizeable 100 bps rise from the 4.7 percent growth realized in FY16. The major contributions to this increase are expected to come from a recovery in agriculture sector and further increase in industrial activity; the services sector is envisaged to maintain the growth of the previous year.

Table 1.2: Key Macroeconomic Targets and Projections

		FY17	
	FY16	**Target[4]**	**SBP Projection[2]**
		percent growth	
Real GDP	4.7[1]	5.7	5.0 – 6.0
CPI (average)	2.9[1]	6.0	4.5 – 5.5
		Billion US$	
Remittances	19.9[2]	20.2	20.5 – 21.5
Exports (fob)	22.0[2]	24.7	22.0 – 23.0
Imports (fob)	40.1[2]	45.2	42.0 – 43.0
		percent of GDP	
Fiscal deficit	4.6[3]	3.8	4.0 – 5.0
Current a/c deficit	1.2[2]	1.5	0.5 – 1.5

Sources: [1] Pakistan Bureau of Statistics; [2] State Bank of Pakistan; [3] Ministry of Finance; [4] Planning Commission

In line with soft commodity prices in the international market, inflation outlook for Pakistan remains subdued. Some increase from the previous year's level is on cards because domestic demand is gradually picking up; impact of taxation measures announced in the federal budget for FY17 may be passed on to consumers; and energy group is unlikely to record deflation this year. The risks to this benign outlook are exogenous in nature: for instance, surge in oil prices due to supply shock, and sudden rise in prices of perishables due to supply disruptions.

[11] It is encouraging to note that the government is expanding the social security net through BISP and recently, increased the annual stipend to beneficiaries from Rs 18,000 to Rs 19,338.

On the fiscal side, the government has envisaged a budget deficit of 3.8 percent of GDP for FY17 – 80 bps lower than the actual deficit of 4.6 percent in FY16. This would require strong fiscal discipline and concerted efforts to enhance revenues. The continuation of taxation reform for widening the tax base and bringing more people in the tax net would be key to achieving the target. An extremely important development in this context is the government's decision to effectively tax the real estate business. Though aggressive taxation measures, announced in the FY17 budget, were modified during negotiations with the realtors, the revised measures still retain the intent. These measures are expected to increase tax collection, and also help promote real economic activity by discouraging speculation in the real estate market.

Exports are expected to post a marginal recovery in FY17, supported by further improvement in energy supplies in the country, some pick up in global commodity prices, and recovery in global demand (particularly in the Euro area). Measures taken by the government to support exporters, like release of tax refunds and zero rating of exporting sectors, will also contribute to this recovery. Here, it is important to recall that the gradual transformation of the Chinese economy has created an opportunity for textile sector of Pakistan. Specifically, as China is moving away from low value added textiles due to rising labour cost, Pakistan's textile sector could step in to fill the gap, and get integrated in the global value chain. On the import side, the ongoing power and construction related projects under CPEC are likely to weigh in heavily. A moderate increase in domestic demand, and the expected recovery in global commodity prices, would also contribute towards import growth during FY17. The demand for machinery and steel would remain particularly strong.

In case of workers' remittances, the double-digit growth realized in the past many years, is less likely to be the case. Despite a gradual recovery in oil prices, the Gulf governments are unlikely to revert to volumes of infrastructure spending that were in place before the oil price crash; focus seems likely to remain on economic transformation that will help reduce their dependence on oil revenues. Therefore, we expect remittance growth to remain tepid in FY17.

In overall terms, the current account deficit is likely to stay in the range of 0.5 – 1.5 percent of GDP during FY17. Key risks to this forecast include: (i) the immediate impact of *Brexit* on international commodity prices (its impact on Pakistan's exports to the UK will become clear over the medium-term); (ii) slowdown in the Chinese economy; and (iii) an unexpected change in the pace of work on CPEC projects.

Finally, it should be recalled that the IMF program has been a key element of BoP comfort over the past three years. The program has helped the country's stabilization program, and shored up the confidence of international creditors. However, the need for expediting reform process related to energy sector PSEs, and other loss-making organizations (like PSM, PIA), can hardly be overemphasized. It is only by removing structural weaknesses that the country can continue to pace itself towards a high growth trajectory.