1 Economic Review

1.1 Overview

The FY18 ended with a mixed performance of the economy. The real economic activity gained further momentum and inflation remained below the target for the fourth consecutive year. In the same vein, growth in private sector credit was strong and investment edged up in terms of GDP. At the same time, however, sharp deceleration in revenue growth compared to expenditure and increased dependence on imports to meet growing domestic demand led to widening in the twin deficits to unsustainable levels. In fact, persistent increase in imports overshadowed a recovery in exports. The resulting record current account deficit led to increased pressures on foreign exchange reserves and exchange rate. Similarly, the fiscal deficit was highest during the last five years. Together these led to a faster accumulation in public debt, especially the external debt (**Table 1.1**).

Table 1.1: Selected Macroeconomic Indicators

	FY15	FY16	FY17[R]	FY18	
				Target	Actual[P]
percent growth					
Real GDP[1]	4.1	4.6	5.4	6.0	5.8
Agriculture	2.1	0.2	2.1	3.5	3.8
Industry	5.2	5.7	5.4	7.3	5.8
Services	4.4	5.7	6.5	6.4	6.4
Private sector credit[2]	5.9	11.2	16.8	-	14.9
CPI inflation[1]	4.5	2.9	4.2	6.0	3.9
percent of GDP					
Current account balance [2]	-1.0	-1.7	-4.1	-2.6	-5.8
Fiscal balance[3]	-5.3	-4.6	-5.8	-4.1	-6.6
Gross public debt[3]	63.3	67.6	67.0	61.4	72.5

P: Provisional; R: Revised
Data sources: [1] Pakistan Bureau of Statistics; [2] State Bank of Pakistan; [3] Ministry of Finance.

The real GDP growth was broad-based, as all the three sectors – agriculture, industry and services – contributed to acceleration in growth. The agriculture sector, in particular, performed quite well on the back of record contribution from crops and livestock sub-sectors. Besides higher agriculture production, buoyant manufacturing and construction activities – sustained by improved energy supply, CPEC projects, and strong domestic demand – played a key role in pushing up industrial sector growth.

However, looking from the demand side, like previous expansionary cycles, the growth was led by a surge in consumption.[1] A number of factors, including low interest rate environment, increased fiscal spending, and improved real incomes, provided a boost to domestic demand. More specifically, lower borrowing cost continued to encourage businesses to borrow for both working capital and fixed investment purposes during the last couple of years. On the supply side, the banks had sufficient liquidity due to net retirement of long-term debt by the government. Moreover, increased government reliance on SBP borrowing to finance higher fiscal deficit also added to liquidity with the banks.

A persistent increase in the fiscal deficit during the last two years has been an important factor adding to demand pressures in the economy. During FY18, there was also an unwelcome deviation from past trends. Against a sustained increase in development spending and containment of current expenditures observed in previous years, FY18 saw a reversal: development expenditures declined, while growth in current expenditures accelerated. Thus, the composition of expenditure shifted from investment to more consumption.

In this backdrop of higher economic activity and domestic demand, the growth in imports remained strong. Though all the major commodity groups except for food recorded strong growth, the major contribution to higher imports came from petroleum, machinery, metals, and chemicals. Moreover,

[1] The share of consumption in the real GDP increased to 93.2 percent during FY18 from 91.7 percent in FY17. This is significantly higher when compared to the average share of 88.7 percent during the previous five years.

increase in commodity prices, especially of oil and steel, was the major factor that pushed up the import bill. In fact, the price impact was almost twice the quantum impact in increase in imports during FY18.

Encouragingly, exports recorded a broad-based recovery, supported by improved energy supplies at the time of gradually picking up global demand. Moreover, export of surplus wheat and sugar and higher commodity prices in international market also contributed to a double-digit growth in exports. Despite this, imports were still 2.3 times of exports in absolute terms. In addition, interest payments on external debt and repatriation of profits also increased considerably during FY18, whereas absence of CSF weighed on the services account. The deficit in these accounts could not be offset by remittances, which grew moderately. Thus, the current account deficit reached a record US$ 18.1 billion in FY18.

Financing of this large current account deficit necessitated increased reliance on external borrowings, leading to a considerably higher accumulation in external debt during FY18. Another worrisome development was heavy reliance on commercial loans, which entail both higher interest rates and lower maturity relative to borrowing from multilateral and bilateral sources. As a result, the average time to maturity of external loans fell to nearly 10 years in FY18 from over 20 years in FY14. The overall official and private inflows fell short of financing the current account deficit, resulting in more than US$ 6 billion decline in the SBP reserves during FY18. These pressures prompted multiple episodes of exchange rate depreciation during the year.

The pass-through of exchange rate depreciation and higher international commodity prices, in addition to strong underlying demand pressures, started to reflect in higher year-on-year inflation from May 2018. The core inflation – excluding volatile food and energy prices – after remaining sticky around 5.5 percent, picked up pace from March 2018 onwards. Yet, the average inflation was slightly lower during the year, primarily due to low food inflation on the back of more than sufficient food stocks available in the country. Closely watching these developments and the likely impact of an expansionary fiscal policy and worsening external accounts on the macroeconomic stability, especially the future inflation path, the MPC raised the policy rate in January 2018, reversing the multi-year easy monetary policy.

In sum, Pakistan’s economy is again at a familiar juncture, with imbalances emerging as the growth picked up, making it challenging to maintain the virtuous equilibrium of low inflation and higher growth. The only difference this time is heavy investment is underway in energy and infrastructure. Nonetheless, the main reason for repeat of such cycles now and often has been low investment and the economy’s limited capacity to produce. On the other hand, most of the growth spurts have been consumption-driven. Therefore, as domestic demand grows above the economy’s capacity, it leads to build-up of imbalances and ultimately overheating of the economy. This, in turn, warrants immediate action, and most often in the past, introduced short-term stopgap measures. These provided relief for the time being, but made it less expedient to take more painstaking structural reforms to address the underlying issues.

This time too, several measures have been taken to reduce the pressures on external account and manage inflation expectations. Increase in interest rate, adjustments in exchange rate, restriction on advance payments and imports on open account, increase in regulatory and custom duty, and imposition of cash margins on selected non-essential goods are aimed at containing imports and narrowing current account deficit. However, expansionary fiscal policy in an election year and increase in oil prices have partially offset the expected impact of these measures.

To address the structural constraints, however, broad-based and deep structural reforms are needed in key areas of the economy. Pakistan has already implemented several reforms related to financial sector and monetary and exchange rate policies. In particular, the reforms related to improving monetary policy framework, gradually moving to a more competitive exchange rate policy, and enhancing financial inclusion and access to finance of otherwise underserved sectors including SMEs, women and young entrepreneurs, and small farmers, are already in progress.

However, these have to be complemented by reforms aimed at addressing longstanding structural issues impeding investment, industrialization, trade, and resource mobilization. More specifically, Pakistan needs to increase investment through enhanced savings by promoting a saving culture, introducing new financial products and increasing public savings. The resulting decrease in overall consumption would help lower import demand in the short to medium term. In the long-run, Pakistan can reduce its dependence on imports by shifting power generation to renewable sources, switching to more cost-efficient ways of transportation, and promoting the domestic production of oilseeds. Concurrently, the export base as well as value addition needs to be enhanced in order to keep the current account deficit at sustainable levels over the medium term. Exports can particularly be facilitated through reduction in the cost of production, especially by lowering energy and transportation costs; enhancing productivity by improving the quality of labor through vocational training; and exploiting the untapped export potential of non-traditional items and markets.

In the case of revenue generation, Pakistan can enhance its tax base by exploiting the potential of direct taxes.[2] Currently, the share of direct taxes in total taxes is significantly lower compared to its peer countries. This can be enhanced by removing exemptions, bringing the untaxed segments under tax through amendment in the Income Tax Act, and rationalizing the minimum taxable income vis-à-vis per capita income. Furthermore, the digitization of the revenue collection system can both facilitate taxpayers and control leakages by reducing human interface. It is also important to note that reforms in any particular area of the economy may not be effective unless coordinated with reforms in other sectors. Finally, it can hardly be overemphasized that the success of reforms would crucially depend on an improvement in governance.

1.2 Review of Developments during FY18

Real Sector

The real GDP growth accelerated from 5.4 percent in FY17 to 5.8 percent in FY18, the highest during the past 13 years. The growth was also broad-based, with all the three sectors showing robust performance. A number of factors contributed to this improved performance, including capacity expansion in some industries, low interest rate environment, higher public spending (particularly on CPEC related projects) and increase in energy supply.

Specifically, the agriculture sector recorded strong growth of 3.8 percent in FY18, considerably higher than the 3.5 percent target and 2.1 percent growth achieved in FY17. A rebound in the production of crops and higher growth in livestock played a key role in improved performance of the sector. Record production of rice and sugarcane, besides improvement in cotton crop, resulted in 3.8 percent growth in crop subsector during FY18 compared to 0.9 percent in FY17. Moreover, there was a turnaround in the performance of other crops (pulses, oilseeds etc.), showing 3.3 percent increase in production during FY18 against a decline of 2.7 percent in FY17. Crop pricing (in case of sugarcane and wheat), continuing subsidies on inputs, increased access to credit, and favorable weather conditions, contributed to this healthy performance. The livestock sub-sector, which accounts for nearly 60 percent of the value addition by agriculture, grew by 3.8 percent during FY18 compared to

[2] See Box 4.2 in Chapter 4 for more detail.

3.0 percent increase in FY17, with the major push coming from various projects initiated by the provincial governments and increasing trend of dairy farming on modern lines.

The industrial sector grew by 5.8 percent during FY18, slightly higher than the 5.4 percent growth achieved in FY17. This modest acceleration was mainly brought about by continued robust construction activities and improved performance of the manufacturing sector, while growth in value addition by electricity generation and distribution and gas distribution saw a considerable deceleration. The construction sector continued to benefit from CPEC-related infrastructure projects, while large-scale manufacturing (LSM) growth was supported by strong demand consumer durables and construction-allied industries. However, fertilizer and sugar industries could not maintain last year's performance. In the case of fertilizer, the suspension of domestic gas to smaller manufacturing units affected their performance as the use of imported RLNG was more costly. The decline in sugar production, despite a record sugarcane crop, was due to the delayed start of crushing by mills due to a pricing dispute, which diverted sugarcane to alternative usage.

Notwithstanding the improved performance of the commodity producing sectors, the value addition by the services sector grew by 6.4 percent in FY18, slightly lower than the 6.5 percent growth in FY17. This was due to the slower growth of finance and insurance, transport, storage and communication, and other private services. The major boost, nevertheless, came from wholesale and retail trade, largely in line with the performance of agriculture and industry, and general government services.

Monetary Policy and Inflation

Mounting pressures on foreign exchange reserves, along with the projected trajectory of external account and medium-term inflation, led the MPC to increase the policy rate by a cumulative 75 basis points (bps) during the year, after keeping it unchanged for the last two years. The main factors that led to this reversal in the policy rate included: (i) growing macroeconomic imbalances; (ii) likely impact of exchange rate deprecation on inflation; (iii) insufficient financial inflows; (iv) sharp increase in global oil prices in H2-FY18; and, (v) higher-than-expected fiscal expansion.

Despite the hike in policy rate by 75 bps, weighted average lending rates (WALRs) inched up by only 39 bps during FY18. Apart from typical lags involved in the transmission, this low pass-through mainly represented two broad developments. First, banks had sufficient liquidity at their disposal to cater to the demand of the private sector. Although occasional liquidity pressures emerged in the interbank market during the course of the year, these were subsided by SBP's proactive management in the interbank market via open market operations, which are conducted to keep the overnight rates close to the policy rate (**Chapter 3**). The overall ease in the liquidity during FY18 was evident from lower volume of commercial banks' borrowing from SBP's reverse repo facility in FY18, as compared to FY17. Second, ongoing competition across banks to extend funds to credit worthy borrowers, as reflected in improved asset quality, led the banks to place their funds in higher-yielding private loans rather than in government securities.

Thus, while WALR remained stable throughout, the demand for bank credit continued to grow at a rapid pace. The momentum in working capital loans was particularly strong, and was visible across a large number of sectors, including textiles, cement, electrical machinery, iron and steel, edible oil and ghee, basic chemicals and rice processors. This growth was attributed to increased industrial capacities; buoyant activity; as well as increased prices of raw materials.

However, expansion in loans for fixed investment remained lower in FY18 compared to FY17. The slowdown came primarily from the fertilizer sector, as scheduled retirements of earlier loans were made, and also from the power sector where fresh capacity installations remained subdued. SBP's subsidized financing schemes for export-oriented sectors also played an important role in encouraging capacity expansion activities in some sectors, such as textiles. As for the power sector, although fixed investment activity remained dull in H1-FY18, it picked up pace during the second half of the year as firms expedited ongoing projects in the wake of imposition of ban on new power projects. In overall terms, the economy witnessed a healthy increase in private credit of Rs 775.5 billion in FY18 compared to Rs 747.9 billion in the previous year.

This took the private sector credit to GDP ratio to an 8-year high of 17.4 percent. It is important to note that despite the increase in recent years, private sector credit to GDP ratio in Pakistan at end FY18 is much lower than the peak of 27.2 percent just a decade ago. Importantly, it also stands lower compared to regional economies, such as India (49.5 percent), Bangladesh (47.6 percent), and Sri Lanka (45.7 percent).

Meanwhile, budgetary borrowings from the banking system remained elevated during FY18. Not only did the government rely on SBP financing and borrowed around Rs 2.2 trillion in Q3-FY18 alone, it also breached the 'zero quarterly borrowing' limit as prescribed under the SBP Act. Public sector entities also borrowed heavily, especially energy-related entities as well as those involved in commodity operations. As a result, the overall net domestic assets grew by 15.9 percent in FY18. However, its impact on overall monetary expansion was partially diluted by a sharp contraction in net foreign assets (NFA) on the back of growing external account deficit. The overall money supply grew by 9.7 percent, lower than the 13.7 percent growth recorded last year. Similarly, reserve money rose 12.7 percent during FY18 due to sharp fall in SBP's NFA, offsetting the impact of huge budgetary borrowings from the central bank in the year.

One of the reasons for increased government borrowing from SBP was scheduled banks' lack of interest in longer tenor bonds, as the market expected an increase in interest rates in view of stronger inflation expectations. In most auctions, scheduled banks had a clear preference for 3-month T-bills and took less interest in PIBs, which led to scrapping of eight successive PIB auctions between Aug-Mar FY18. However, the PIB auctions during Q4-FY18 were more successful, as the government managed to raise Rs 46.1 billion from fixed-rate coupon bonds. Another highlight of FY18 was the launch of 10-year floating rate coupon PIBs, which attracted a considerable degree of interest; market participants offered Rs 296.1 billion in two such auctions against the combined target of Rs 100 billion. However, only Rs 43.1 billion was accepted in these auctions.

Meanwhile, an increase in global commodity prices and demand-driven pressures drove up non-food inflation. However, their combined impact was more than offset by a sharp fall in food inflation. The impact of improved supplies of key food staples and a change in the duty regime for cigarettes persisted throughout the year. CPI inflation stayed below the annual target for the fourth consecutive year during FY18, and clocked in at its second lowest level since FY03. The overall inflation was 3.9 percent in FY18, compared to 4.2 percent last year.

After falling for three consecutive years, domestic prices of petroleum, diesel and LPG recorded double digit growth as international prices soared and exchange rate depreciated during FY18. Similarly, the non-food non-energy (NFNE) core inflation reached the peak of 7.1 percent in June 2018 – highest level since October 2014. On the other hand, house rent, education, clothing, health and readymade food inflation rose at almost their usual pace. Nevertheless, education inflation continued to grow by double digits – mainly due to upward revisions in fees of both government and private institutions. Likewise, health inflation rose by 8.1 percent in FY18 due to increase in drug prices and doctors' fee, both of which have traditionally maintained consistent uptrend in their price level.

Fiscal Policy

Fiscal accounts continued to deteriorate for the second consecutive year, with the deficit rising to its highest in the last five years. Though the pace of increase in both revenue collection and expenditure slowed, the growth in expenditure outpaced revenue mobilization. As a result, the fiscal deficit rose to 6.6 percent of GDP during FY18, surpassing both the 4.1 percent target for the year and 5.8 percent deficit in the previous year. The primary deficit increased to 2.2 percent of GDP from 1.6 percent realized last year, indicating a much faster increase in non-interest expenditure. Similarly, the revenue deficit increased to 1.8 percent in FY18 from 0.8 percent in FY17, which suggests the increase in the fiscal deficit was more due to a sharp increase in current expenditure.

Current expenditure grew by 12.6 percent during FY18 compared to a 10.7 percent increase in the previous year, with the major impetus coming from higher provincial current expenditure. However, growth in federal current expenditure decelerated slightly to 9.1 percent in FY18 from 10.4 percent in the previous year. Development spending, on the other hand, declined by 6.5 percent. This was mainly due to a sharp contraction in federal development spending by 20.6 percent, while growth in provincial development expenditure also slowed down to 3.3 percent during FY18 from 43.8 percent in FY17.

Meanwhile, revenue growth decelerated to 5.9 percent in FY18 from 11.0 percent in FY17. This deceleration was mainly led by a sharp contraction in non-tax revenue. Against this, the growth in the tax revenue was broad based with both the FBR and provincial taxes picking up pace significantly during FY18.

The FBR tax collection grew by 14.3 percent in FY18 compared to an 8.0 percent increase in the previous year. This also reflects one-off receipts from the tax amnesty scheme announced for the registration of undeclared domestic and foreign assets. Besides the improvement in direct taxes, the indirect tax collection remained robust on the back of buoyant economic activity, strong domestic demand, and the pass-through of increases in international commodity prices to domestic prices. In the case of provinces’ own tax revenue, the major contribution came from persistently rising collection from General Sales Tax on Services (GSTS), followed by stamp duty and excise duty. As a result, the total tax to GDP ratio increased to 13.0 percent in FY18 from 12.4 percent in FY17.

The higher fiscal deficit was financed through increased borrowing from both the external and domestic sources. In case of external finance, the government heavily relied on bilateral and commercial loans and Eurobonds/Sukuk. On the domestic front, the government increased its recourse to SBP borrowing, not only to meet its fresh borrowing requirements but also to retire the maturing long-term debt owed to banks.

Domestic and External Debt

The widening of both fiscal and current account deficits along with depreciation of exchange rate, led to increase in public debt accumulation during FY18. Compared to an 8.8 percent increase in FY17, public debt grew by 16.5 percent during FY18. Out of the Rs 3.5 trillion accumulation during FY18, Rs 1.1 trillion was due to revaluation losses on account of the depreciation of US dollar against major currencies and the depreciation of PKR against US dollar. As a result, the gross public debt rose to 72.5 percent of GDP as of end-June 2018 from 67.0 percent at end-June 2017, remaining significantly higher than the 60 percent limit envisaged in the Fiscal Responsibility & Debt Limitation Act, 2005.

Unlike in FY17 when around 70 percent of the increase in public debt was driven by domestic debt, more than half of the increase in public debt during FY18 was contributed by external debt. The major contribution to increase in external debt came from bilateral and commercial sources (borrowing from foreign banks and proceeds from Eurobonds and Sukuk). Importantly, most of the fresh loans were on floating rates and of relatively short maturity. This shortened the overall maturity profile of the public debt, and therefore, increased rollover and interest rates risks.

Within the domestic debt, the entire increase was due to short-term debt as the government retired most of the maturing long-term debt during FY18. Moreover, the hefty retirement in PIBs were met through SBP borrowings. These developments worsened the maturity profile of domestic debt during the year. In addition to the increase in public debt, PSE debt and external and domestic liabilities also increased considerably. As a result, Pakistan's total debt and liabilities (TDL) increased to 86.8 percent of GDP at end-Jun 2018 from 78.6 percent as of end-Jun 2017.

External Sector

A double-digit growth in exports and a modest recovery in remittances notwithstanding, the strong growth in imports pushed the current account deficit (CAD) to a historic high of US$ 18.1 billion during FY18. Though financial inflows were higher during FY18, these remained insufficient to finance the elevated CAD. Resultantly, SBP's foreign exchange reserves declined by US$ 6.4 billion in the year, reaching US$ 9.8 billion by end-June 2018. This led to increased pressure on the PKR, which depreciated by 13.7 percent against the US dollar during the year.

The higher CAD was primarily a result of a record-high merchandize trade deficit, which widened by 16.5 percent to US$ 31.1 billion in FY18. Even though export receipts rebounded strongly, rising 12.6 percent, these were not sufficient to offset the 14.7 percent uptick in import payments. With international oil prices staying 32.0 percent higher on average during FY18, the energy import bill increased sharply by 25.0 percent to US$ 13.3 billion, accounting for 37.1 percent of overall import payments. At the same time, rising industrial activity, an increase in power generation, infrastructure development, and capacity expansion in some industries boosted demand for imported raw materials and capital goods. In particular, import of machinery remained strong, increasing by 17.4 percent to US$ 8.7 billion in FY18.

Meanwhile, net capital and financial inflows stood at US$ 12.4 billion during FY18 compared to US$ 10.6 billion in FY17. This was largely contributed by official inflows on account of issuance of Eurobonds and Sukuk, commercial borrowings, and loans from multilateral and bilateral sources. On the other hand, private inflows were lower compared to last year.

Digitization of Services in Pakistan - Emerging Trends and Future Outlook

Advances in technology and its increased use in businesses in recent years has increasingly gained prominence globally. It is particularly reshaping the services business models, by making the service delivery more cost-efficient and improving the customer experience. The changing global trends in the services is creating new opportunities, and Pakistan is no exception.

In Pakistan, the services sector has contributed 67.6 percent to the country's GDP growth on average during last five years. The overall share of the sector reached 56.0 percent in nominal GDP by end-FY18, higher than the South Asian average. Digitization of services, in line with global trends, can further boost services' contribution to GDP. According to a study, Pakistan can push up its GDP growth by a cumulative 7.0 percentage points (roughly US$ 36.0 billion) and create around 4.0 million new jobs during 2016-2025, by increasing the use of digital financial services (DFS) alone.[3]

Though still at an early stage of development, e-commerce, fintech, and e-government have started to have a far-reaching impact on the macro-economy. Over the past couple of years, growing internet penetration and lower transaction costs have led to a rapid growth of e-commerce in Pakistan.

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[3] McKinsey Global Institute, 2016, 'Digital Finance for All: Powering Inclusive Growth in Emerging Economies' [mckinsey.com].

According to SBP data, sales of local and international e-commerce merchants reached Rs 40.1 billion in FY18, up from Rs 20.7 billion in FY17. Importantly, this does not include postpaid cash on delivery (COD) settlements that, according to market estimates, account for around 80 to 90 percent of the total volume, and about 60 percent of the total value of e-commerce in Pakistan.

Despite the consumer's strong preferences for cash and low financial and digital literacy, the digital payment infrastructure is gradually evolving in Pakistan. A rapid rise in the branchless banking accounts (mobile wallets), and a continuous increase in 3G/4G penetration, led to improved integration of the e-retailers and online marketplaces in the services sector business models.

Specifically, branchless and mobile banking, with the number of active accounts reaching 21.7 million by June 2018, have played a vital role in providing basic banking facilities to the people. In order to plug gaps in terms of coverage and affordability, nascent fintech firms are facilitating the large unbanked population of the country. If utilized appropriately, information and communication technology (ICT) and IT-enabled Services (ITeS) could substantially reduce the overall size of the informal economy and play a crucial role in increasing revenue generation. Given its potential and widespread outreach, ICT could also equip the governments to improve public service delivery through e-government. Punjab provides a good example, where the Punjab Information Technology Board (PITB) has delivered over 270 ICT-related projects (and has also facilitated the Agriculture E-credit Scheme of the Punjab government) over the past six years, which has improved the quality of public services delivery.

In addition, the government has been supportive of digitization over the past couple of years. In May 2018, the cabinet approved the first Digital Pakistan Policy, which provides a roadmap for the development of the sector to harness socio-economic growth in the country. More importantly, the digitization of financial services lies at the forefront of achieving the objective of providing access to formal financial services to 50 percent of the adult population, as laid out in the National Financial Inclusion Strategy. The strategy further aspires to having universal access to formal accounts, especially digital transactional accounts such as branchless banking accounts/M-wallets. Moreover, the strategy also envisages a shift from cash to digital platforms for large payment streams, including wages in the public and private sectors, government-to-business payments, and social cash transfers.

1.3 Economic Outlook

Recent policy measures and developments including monetary tightening, exchange rate depreciation and changes in import and custom duties are all likely to dampen domestic demand, especially imports. The additional revenue measures and a cut in federal development spending proposed in the Finance Supplementary (Amendment) Bill, 2018 might contain fiscal deficit as well. However, these developments will have implications for growth and inflation going forward.

In this context, the real GDP growth target of 6.2 percent for FY19 appears ambitious. The industrial sector, in particular, may witness a slowdown due to an expected reduction in consumer demand. More specifically, construction-allied and consumer durable industries may see slower growth in production. The former may be affected by a contraction in development spending, while the latter could be hit by rising domestic prices due to exchange rate depreciation and higher borrowing cost. Moreover, lower sugar production on account of expected decline in sugarcane crop may also dampen the food group's contribution to LSM growth.

Decline in the area under sugarcane crop, water shortages at the time of sowing of kharif crops – especially cotton – and weak trends in the off-take of fertilizer indicate that agriculture sector may not repeat last year's extraordinary performance. Recent rains and improved water availability as well as increased area under rice and cotton crops, however, may provide some support. Therefore, growth in agriculture may fall below the target as well as the last year's level of 3.8 percent. Slower growth in both industrial and agriculture sectors will also affect performance of the services sector. In this background, the real GDP growth is projected in the range of 4.7 to 5.2 percent during FY19 (**Table 1.2**).

In addition to slower economic activity, exchange rate depreciation and other administrative measures, especially the increase in import duties, would help moderate growth in imports barring any major shock to international oil prices. Meanwhile exports are expected to maintain the FY18 momentum into FY19 as well; though uncertainties due to growing global trade tensions could pose some downside risks to this momentum. Besides the lagged impact of depreciation, improved energy supply, better availability of raw materials (especially cotton, rice and hides), and continuation of the incentive package for export-oriented industries are the key factors supporting prospects of higher growth in exports. In addition, Pakistan can also benefit from a likely increase in food prices in international market. Persistence of drought-like conditions in major wheat producing countries could lead to higher wheat prices, increasing prospects for Pakistan to offload surplus wheat stock.

Moreover, workers' remittances are expected to increase moderately during FY19 on account of an uptick in international oil prices, steady economic activity in advanced economies, and various steps taken to facilitate remittances through official channels like m-wallet and asan remittance account. Incorporating these developments, the current account deficit is projected to be in the range of 5 to 6 percent of GDP for FY19.

Table 1.2: Key Macroeconomic Targets and Projections

	FY18	FY19	
		Target[1]	SBP Projections[2]
		percent growth	
Real GDP	5.8	6.2	4.7 - 5.2
CPI (average)	3.9	6.0	6.5 - 7.5
		billion US$	
Remittances	19.6	21.2	20.0 - 21.0
Exports (fob)	24.8	27.9	27.0 – 28.0
Imports (fob)	55.8	58.5	59.5 – 60.5
		percent of GDP	
Fiscal deficit	6.6	4.9	5.0 - 6.0
Current a/c deficit	5.8	4.0	5.0 - 6.0

Data sources: [1] Ministry of Finance and Planning Commission; [2] State Bank of Pakistan;

In addition to the earlier policy measures aimed to contain imports, recent changes in income tax – partial reversal of the tax relief announced in the FY19 budget, administrative revenue measures, and further increase in regulatory and federal excise duties would help maintain a higher growth in tax collection. Similarly, the announced reduction in development spending and austerity measures are likely to relatively slower the growth in overall fiscal spending. These measures are expected to contain the fiscal deficit in the range of 5 to 6 percent of GDP during FY19.

The overall assessment, therefore, suggests that underlying inflationary pressures may persist. Increase in gas tariffs, import duties and excise duty would further add to inflation both directly and indirectly. Moreover, pass-through of higher oil prices and exchange rate depreciation would keep inflation expectations high. Some of the impact of these factors, however, is likely to be offset by the increase in policy rate and lower food inflation, which is expected to remain subdued in FY19 as well in view of sufficient stocks of staple food items. With these developments in the background, average inflation is projected in the range of 6.5 to 7.5 percent during FY19, against 3.9 percent recorded in FY18 and 6.0 percent target for the year. However, there are risks to this assessment emanating particularly from volatile energy price. Moreover, global food prices may also increase in case drought-like conditions persist in major wheat producing countries.