1 Economic Review

1.1 Overview

The pace of expansion in the economy continued to accelerate in FY17 as well. The real GDP growth in FY17 was the highest during the last ten years. It was led by a rebound in agriculture and a broad-based increase in value addition by services sector (**Table 1.1**). Within industry, major support came from improvement in manufacturing and construction activity. From the demand side, the major contribution came from a surge in domestic consumption followed by a moderate increase in investment.

Favorable macroeconomic policies continued to support expansion in the economy. The impetus to economic activity particularly came from an accommodative monetary policy and the consequent increase in private sector credit, especially for fixed investment; recovery in farm incomes; a steady increase in development spending; and, continuing work on infrastructure and energy projects under CPEC.

The real economic activity also benefitted from tax incentives provided by the government during the last two years to support exporting industries, agriculture and private investment.[1] These fiscal measures, nevertheless, have led to an increase in budget deficit in FY17.

Table 1.1: Selected Macroeconomic Indicators

	FY14	FY15	FY16	FY17	
				Target	Actual[P]
	percent growth				
Real GDP[1]	4.1	4.1	4.5	5.7	5.3
Agriculture	2.5	2.1	0.3	3.5	3.5
Industry	4.5	5.2	5.8	7.7	5.0
Services	4.5	4.4	5.5	5.7	6.0
CPI inflation[1]	8.6	4.5	2.9	6.0	4.2
	percent of GDP				
Current account balance[2]	-1.3	-1.0	-1.7	-1.0	-4.0
Fiscal balance[3]	-5.5	-5.3	-4.6	-3.8	-5.8
Gross public debt[3]	63.5	63.3	67.6	61.4	67.2

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

One of the outcomes of an expanding economy was the surge in imports, which together with a decline in exports and remittances resulted in a widening of the current account deficit. While an increase in capital and raw material imports bodes well for the future productive capacity of the economy, the persistent increase in imports for consumption purposes remains a source of concern. These trends have led to increased reliance on external borrowings and pressure on foreign exchange reserves.

The impact of the increase in domestic demand (as reflected by widening of the twin deficits) on inflation was somewhat balanced by a limited pass-through of the increase in international commodity prices, sufficient stocks of key food items (wheat, sugar, and rice), and a stable exchange rate. Therefore, though inflation trended upward, it continued to be well anchored and remained lower than the target for the third consecutive year in FY17. The increase in inflation during FY17 was largely due to higher food inflation, especially increase in prices of perishable food items on account of disruptions in supply chain in the initial months of the year.

With this background, the report highlights four major challenges that need to be addressed to sustain expansion in the economy with low and stable inflation: switching away from consumption-led to investment-cum-export oriented growth; reducing current account deficit to manageable levels;

[1] For instance, reduction in duties on import of machinery, lower sale tax on fertilizer, tax credit for investment and employment generation, and zero-rating facility for export-oriented industries. See Box 4.1 for more details.

alleviating credit constraints for SMEs; and, enlarging the resource envelope and creating the fiscal space required to fund infrastructure and social development projects.

The share of consumption in Pakistan's GDP has increased to nearly 94 percent in FY17, up from around 90 percent during the last 10 years.[2] On the other hand, despite a substantial increase in import of machinery and credit for fixed investment during the last couple of years, the investment-to-GDP ratio has edged up only slightly. Given the favorable policy environment as well as improved security situation and reduced energy constraint, further improvement in ease of doing business can help stimulate strong recovery in private investment.

Though Pakistan has made some progress in ease of doing business in 2017, yet it ranks low amongst the regional peers that underscores the need to introduce reforms in this regard.[3] This is crucial for enhancing productivity and efficiency in the economy to enable domestic producers to compete both on domestic and international fronts. At the same time, there is also a need to review the industrial policies which are currently characterized by semi-liberalized, non-uniform, and escalating tariff structure.[4] This has not only diverted export orientation of the industrial sector but also made it import dependent by hindering the formation of strong backward linkages in the economy.

Besides further reducing the cost of doing business, Pakistan also needs to expand the export base. In addition to changes in textile production mix in line with changing world demand pattern[5], another avenue could be by exploiting the export potential of the services sector – the largest sector of the economy. Drawing from the experiences of leaders in global services exports, like Philippines and India, Pakistan has the potential in exports of ICT related and Business Process Outsourcing services. This is also worth noting that Pakistan has comparative advantage over regional peers in terms of lower labor costs and large young, English-speaking talent pool. But this will require policy support for the development of business skills and linkages with the global market.[6]

Moreover, the private sector also needs to venture in export of agriculture and dairy products by generating exportable surplus through enhanced crop yields and reduced cost of production by encouraging corporate farming. In this regard, the importance of managing water resources and their efficient utilization in agriculture using latest technologies (like drip irrigation system) can hardly be overemphasized. In fact, this has become extremely important as the gap between slowly falling water supply and growing demand especially due to rising population and urbanization has been increasing steadily.

In addition to increasing the foreign exchange receipts by stimulating exports, there is a need to contain import of unnecessary and luxury items, meant for consumption, in order to reduce trade deficit and narrow the current account deficit. As government aims to achieve higher GDP growth in FY18 and given increased dependence on imported machinery and raw material, the import growth may continue to

---

[2] The share of household consumption increased to 81.8 percent of GDP in FY17, from the average of 80.4 percent during the last 10 years.

[3] The World Bank's Ease of Doing Business Report (2017) shows that Pakistan's rank improved to 144 in 2017 from 148 in 2016. In regional comparison, Pakistan fares better in terms of resolving solvency (ranks 2nd among the 8 south Asian countries), and access to credit (ranked 3rd). However, there is a need for improvement under the heads of *starting business*, *getting electricity*, *dealing with construction*, *paying taxes*, and *trading across borders*.

[4] See Box 2.1 for details.

[5] See Special Section 3, State Bank of Pakistan Annual Report 2014-15.

[6] See Box 2.4 for details.

remain high. In this context, Pakistan should discourage unnecessary imports to finance those of capital goods and essential raw materials to strengthen recovery in investment.

Moreover, easing constraints in access to finance in underserved sectors like SMEs and agriculture may also help in boosting exports and reducing dependence on imports. In particular, the share of SMEs in total private sector credit has fallen to 5.9 percent during FY17 from around 15.0 percent in FY08. Such a low exposure of banks to SMEs is despite the fact that these enterprises contribute 30 percent to GDP, 25 percent to exports of manufactured goods, and 35 percent to manufacturing value added. On its part, SBP has been actively involved in the promotion of SME finance by providing commercial banks strong regulatory support as well as incentives like refinancing and risk-sharing against SME loans. Currently, SBP is looking to significantly enhance the share of SMEs in overall bank credit. In this regard, SBP is working on a roadmap to explore issues and identify the constraints, from both the SME and banks' sides.

Regarding revenue generation, the reforms already initiated at the federal level need to be deepened further, particularly aimed at improving tax administration and broadening the tax net. In addition, the provinces also need to step up efforts to enhance their own revenue collection.[7] This is particularly important in the context of fiscal decentralization and devolution plan. As provinces get a major share from tax collection under the 7th NFC Award, this does not leave enough resources with the federal government to meet debt servicing and defense needs. Therefore, the provinces were expected to generate surplus by enhancing their own tax collection – especially from sales tax on services and income from real estate and agriculture – and thus help keep fiscal deficit at manageable level.

1.2 Assessment of FY17

Real sector

The real GDP growth maintained its upward trajectory, expanding by 5.3 percent during FY17 as compared to 4.5 percent in FY16. Though the target of 5.7 percent for FY17 was missed, the growth was the highest recorded during the last decade. All the favorable factors including record low interest rate, increase in development spending, work on various projects under CPEC gaining further traction, improving security situation and easing energy supply continued to support expansion in real economic activity.

The growth was not only the highest during the last decade but also broad-based. The major thrust, nevertheless, came from the agriculture sector which recorded 3.5 percent growth during FY17 against a marginal increase of 0.3 percent in FY16. This rebound was enabled by an impressive recovery in the production of important crops, which grew by 4.1 percent after recording a sharp decline of 5.5 percent in FY16. The turnaround in crop production was supported by increased access to finance and favorable government policies, especially the incentives announced under the Kissan Package and continued support prices for sugarcane and wheat. Livestock, the largest sub-sector that accounts for half of the value addition by agriculture sector, remained consistent in its contribution with 3.4 percent growth during FY17, the same as in FY16.

Despite improved performance of Large-scale Manufacturing (LSM) and steady construction activity, the pace of increase in industrial value addition slowed down slightly compared to last year. It grew by 5.0 percent during FY17 compared to 5.8 percent in FY16 and slower than the 7.7 percent target set for the year. This was mainly because *mining and quarrying* and *electricity generation and distribution and gas*

[7] See Box 4.4 for details.

distribution could not maintain their last year performance. LSM grew by 5.7 percent during FY17, up from 3.1 percent last year.[8] Significant contribution came from a record increase in sugar production, accounting for almost half of the LSM growth during FY17. The construction-allied and consumer durable industries, such as automobile, steel, cement, chemical, etc. – particularly benefiting from low interest rate, increase in development spending, and work on CPEC projects – also continued to lend support to LSM growth.

The services sector maintained its growth momentum, growing by 6.0 percent as compared to 5.5 percent in last year. With this, the share of services sector steadily increased to almost 60 percent in real GDP. In line with the recovery in agriculture as well as improved manufacturing activity and rise in trade, the major contribution to services came from *wholesale and retail trade.* The other sub-sectors also pushed their contribution by 0.1 percentage points each to overall services growth. In case of *finance and insurance*, a significant increase in banking sector credit as well as deposits contributed to the higher growth; whereas an increase in teledensity, broadband and 3G/4G mobile internet subscriptions supported the higher contribution from the *transport, storage, and communication* sub-sector.

From the expenditures side, the major impetus to growth came from domestic consumption, which grew by 8.9 percent (and accounted for 94 percent of nominal GDP). Despite a significant increase in import of machinery and private sector credit (especially for fixed investment) in FY17, the investment as percent of GDP (in nominal terms) increased only marginally to 15.8 percent from 15.6 percent in FY16. This uptick was primarily due to an increase in public investment as private investment (as percent of GDP) declined in FY17. The contribution from net exports also remained negative. These developments may add to the challenges in sustaining higher growth in future.

Monetary policy and inflation

With a view to consolidate gains from reduction in the policy rate, and striking a balance between inflation (remaining below the target) and emerging pressures on external accounts, the Monetary Policy Committee decided to keep the policy rate unchanged at 5.75 percent during FY17. The lagged transmission and easing liquidity conditions led to a decline in the weighted average lending rate (incremental) by 57 basis points on average during FY17 to 7.2 percent.

The low interest rate environment, easing energy constraints, improving business confidence, and steady progress on power and infrastructure projects under CPEC, resulted in an unprecedented expansion of Rs747.9 billion in private sector credit during FY17. More importantly, a little more than one third of this credit expansion was meant for fixed investment purposes. A large portion of fixed loans was availed by textiles under the redefined Long-term Financing Facility (LTFF) for Balancing Modernization and Replacement (BMR). Sugar and fertilizer industries also borrowed long-term for setting up captive power plants, while the cement industry borrowed for capacity expansion in view of growing domestic demand.

Notwithstanding the switch from scheduled banks to SBP, the government's budgetary borrowing from the banking system was considerably higher during FY17 at Rs 1,045.8 billion (on cash basis) compared with Rs 791.3 billion in FY16. Moreover, Public Sector Enterprise (PSEs) also borrowed aggressively: Rs 254.9 billion during FY17against the average borrowing of Rs 72 billion recorded during the last four

[8] In provisional National Income Accounts, PBS used estimate of 4.9 percent for LSM growth for arriving at provisional GDP estimates for FY17.

years. The bulk of this borrowing was meant for financing of energy-related projects including LNG pipelines, Dasu dam and the Neelum-Jhelum power project.

All these factors – i.e. private sector credit, government borrowing for budgetary support and PSE borrowing – led to a considerable expansion of Rs 2161.5 billion in Net Domestic Assets (NDA) of the banking system during FY17 compared to Rs 1347.9 billion observed in FY16. SBP's NDA, in particular, expanded by 37.4 percent during FY17 due to government's increased recourse to SBP borrowings. Most of the expansion in NDA, however, was offset by a sharp contraction (Rs 405.2 billion) in Net Foreign Assets (NFA) of the banking system. As a result, reserve money expanded at a slightly lower rate of 22.5 percent during FY17, compared to 26.5 percent last year.

This deterioration from the asset side notwithstanding, the growth in broad money (M2) during FY17 was same as in FY16 (13.7 percent). The composition of money supply from the liability side, however, improved considerably. The growth in currency in circulation decelerated to 17.3 percent during FY17 from 30.5 percent increase in FY16. On the other hand, total banking system deposits expanded by 12.4 percent during FY17 against, an 8.7 percent increase recorded in FY16.

While inflation remained lower than the target for the third consecutive year, it trended upward. The average CPI inflation rose to 4.2 percent during FY17 compared to 2.9 percent in FY16. The increase in inflation during FY17 was fairly broad-based as the number of items recording: (i) an increase in prices of more than 5 percent rose to 147 in FY17 from 135 in FY16; (ii) a moderate increase between 0 and 5 percent was 272 in FY17 against 248 in FY16; and (iii) a decline in prices was only 68 in FY17 against 104 in FY16.

Higher inflation in FY17 was an outcome of both an increase in domestic demand and temporary issues in the supply chain which led to higher food inflation. The pick-up in domestic demand was particularly reflected in gradually rising core inflation: the NFNE rose by 5.2 percent in FY17 compared to 4.2 percent in FY16. The increase in food inflation was largely due to higher prices of perishable food items in the beginning of FY17. Some disruptions in border trade with Afghanistan and India affected domestic prices of fruits and vegetables. Yet, stable exchange rate and a decline in energy prices (despite an increase in international oil prices) helped to contain inflation well below the target of 6.0 percent.

Fiscal policy

The fiscal deficit rose to 5.8 percent of GDP during FY17 against the target of 3.8 percent, and 4.6 percent in FY16. A large primary deficit, 1.6 percent of GDP – the highest during the last four years – indicates that expenditures other than interest payments have increased. As the revenue deficit, 0.8 percent of GDP during FY17, was same as in FY16, this indicates that current expenditures were managed in line with revenue generation. Together, these reflect a considerable increase in development expenditure, which has been spearheading improvement in real economic activity for the last couple of years.

The higher deficit in FY17 was, nevertheless, due to slower growth in revenue collection as well as a sharp increase in total expenditure. The revenue collection grew by 11.0 percent during FY17, down from 13.1 percent in FY16. This was despite a sharp recovery in non-tax revenue. Bolstered by a considerable increase in mark-up income (on lending to PSEs), proceeds from sale of stakes in the Pakistan Security Printing Corporation and two LNG power plants (acquired under the Pakistan

Development Fund), non-tax revenue grew by 23.0 percent in FY17 against a 13.9 percent decline recorded in FY16.

On the other hand, the pace of tax collection slowed down considerably to 8.4 percent, from 21.3 percent growth recorded in FY16. Also, this slowdown was broad-based as the growth of FBR and provincial taxes decelerated. Within FBR taxes, the growth in direct and indirect tax collection decelerated to 10.3 percent and 6.5 percent during FY17 from their respective growth rates of 17.8 percent and 21.8 percent in FY16. The slower growth in tax collection was partly a consequence of tax incentives provided to support exporting industries, agriculture and investment in the economy. It is also worth highlighting that growth in tax collection fell below 9.5 percent growth in the nominal GDP. As a result, the tax to GDP ratio declined to 12.5 percent after rising consistently to 12.6 percent by FY16 from the low of 9.3 percent in FY10. The tax to GDP ratio in FY17 was also significantly lower compared to 12.9 percent target for the year.

In contrast to the slowdown in revenue collection, expenditures grew sharply. The total federal and provincial expenditures jumped by 17.3 percent during FY17 compared with 7.6 percent increase in FY16. While growth in expenditures was broad-based, development expenditures grew much sharply by 30.1 percent during FY17, on top of the 16.9 percent growth recorded in FY16. Most of the expansion in development spending was concentrated in Q4-FY17 when provinces accelerated their spending in a bid to complete the work on the social and development projects. The total provincial expenditures increased by almost Rs1.0 trillion in Q4-FY17, about 40 percent of the total provincial expenditure during the year.

The resulting higher financing requirement was largely met through bank borrowing, with increased recourse to SBP borrowing. Besides, financing from external sources also remained sizeable, most of which was mobilized towards the end of the fiscal year.

Domestic and external debt

During FY17, the increase in the fiscal and current account deficit created pressure on public debt accumulation. Yet the pace of debt accumulation was moderate during FY17 due to revaluation gains of US$ 822.4 million (due to appreciation of US Dollar against major currencies – Chapter 6). In particular, the pace of increase in public debt was lower as compared to the growth in nominal GDP. As a result, the gross public-debt-to-GDP ratio improved to 67.2 percent by end-June 2017 from 67.6 percent as of end-June 2016. Within the gross public debt, government debt-to-GDP ratio increased slightly to 61.6 by end-June 2017 from 61.2 percent as of end-June 2016.[9] Nonetheless, it was still higher than the 60 percent ceiling set for FY18 under the Fiscal Responsibility and Debt Limitation Act, 2005.

Although gross external borrowing also increased, around 70 percent of the increase in public debt was driven by domestic debt during FY17. Within the domestic debt, ownership structure shifted disproportionately towards SBP. This was because the government retired maturing PIBs of Rs 1.4 trillion in the year, rejected bids in four out of 12 PIB auctions and met the financing gap through SBP borrowings. As a result, the share of central bank in domestic debt increased to 20.2 percent during FY17, from 16.6 percent in FY16.

[9] As per Fiscal Responsibility and Debt Limitation Act, 2005 (FRDLA) amended in June 2017, "Total Debt of the Government is the public debt less accumulated deposits of the Federal and Provincial Governments with the banking system.

Moreover, the share of short-term debt increased as banks' increasingly shifted their investment to short-term debt instruments. From the government's perspective, it preferred to borrow in short-term, as banks were demanding higher rates on PIBs. In particular, the government rejected all bids in PIB auctions held during the second quarter. This combined with retirement of PIBs, led to a fall in the share of long-term debt, thereby shortening the maturity profile of domestic debt. Thus, the re-profiling of domestic debt increased the roll-over and interest rate risk.

External sector

The consistent strengthening of external sector buffers during the last few years, could not be sustained in FY17. As growth picked up pace, the imbalance re-emerged in the external sector. Specifically, the current account deficit widened to US$ 12.1 billion (4 percent of GDP) in FY17, from US$ 4.9 billion (1.7 percent of GDP) in FY16. This widening in the current account deficit was primarily driven by trade deficit, which increased by US$ 7.6 billion to a record high US$ 26.9 billion during FY17. A sharp 17.8 percent growth in imports was mainly responsible while exports also declined by 1.3 percent during FY17.[10] Moreover, for the first time since FY04, workers' remittances recorded a decline of 3.1 percent during FY17.

Within imports, machinery import has been rising for the last two years, which bodes well for the future productive capacity of the country. However, a 19.1 percent growth in imports (fob) excluding machinery indicates that a significant contribution to the overall growth in imports is coming from oil and consumer goods (including food). These trends are in line with the increase in income levels and rising share of consumption in overall GDP. Nevertheless, the situation is less encouraging when looked from the context of achieving and sustaining higher growth and maintaining external sector stability, especially from financing of current account deficit view point.

Exports showed some recovery in the third quarter of FY17, partially offsetting the decline observed in the first half of FY17. Therefore, the overall exports during the FY17 declined marginally by 1.3 percent against a much sharper decline of 8.8 percent in FY16. A marginal recovery in H2-FY17 mainly reflects increase in textile exports, as non-textile exports declined during FY17.

The trends in trade deficit were also mirrored in the services account. Higher growth in imports means increased requirement for the import of services like freight, finance, insurance, etc. Moreover, the receipts under Coalition Support Fund (CSF) of US$ 550 million in FY17 were also US$ 387 million lower compared to that in FY16.

Higher official and private financial inflows helped partially finance the current account deficit. In particular, net government external borrowing from various bilateral, multilateral and commercial sources stood at US$ 5.1 billion during FY17 compared to US$ 3.4 billion in FY16. In addition, private financial inflows also remained strong. FDI was higher by around US$ 100 million (driven mainly by CPEC inflows), whereas banks' offshore borrowings rose to US$ 1.6 billion during FY17, from US$ 406 million in FY16. Similarly, net incurrence of liabilities of the private sector (mainly power companies involved in CPEC projects), doubled to US$ 2.4 billion during FY17 from US$ 1.2 billion in FY16. On aggregate,

[10] According to PBS data, exports recovered by a modest 0.7 percent in the second half of FY17, partially offsetting the decline observed in the first half of FY17. Overall exports declined by 1.7 percent in FY17, against a higher drop of 12.2 percent recorded last year. The marginal recovery in H2-FY17 mainly reflects 1.9 percent increase in textile exports, as non-textile exports – especially non-basmati rice, leather, footwear and cement – continued to decline.

nevertheless, these inflows fell short of financing the current account deficit. As a result, SBP's liquid foreign exchange reserves declined by US$ 2.0 billion during FY17.

Water sustainability in Pakistan – key issues and challenges

The historical pattern shows that water supply in Pakistan has been limited and remained erratic. Climate changes and the on-going dispute with India on the Indus Water Treaty are further adding uncertainties over future water supplies. Moreover, the quality of water has deteriorated due to increasing pollution and contamination. On the other hand, demand for water is on the rise due to growing population and urbanization and higher agriculture needs.

The growing water stress is a serious challenge for food security and sustained long-term economic growth of the country. The stress is not only high (as water supplies are limited and the country relies heavily on the Indus basin to meet most of its needs), it is growing further due to rising population, rapid urbanization, and continued economic development. Addressing these concerns would require a national policy on water with a broader consensus among all the provinces and the federal government. This policy should focus on minimizing water losses, improving conservation, and strengthening capacity of regulatory institutions.

1.3 Outlook for FY18

The assessment based on the latest available information presents a mixed picture of macroeconomic conditions in FY18. The expansion in real economic activity is expected to maintain the momentum and inflation is likely to remain within the target. The external and fiscal accounts, however, may remain under pressure expected to emanate from likely elevated import demand and increase in public spending, by provincial governments in particular, in a bid to complete development projects before the upcoming general elections in the country (**Table 1.2**).

The real economic activity is expected to continue benefitting from accommodative macroeconomic policies, activity related to CPEC, and consistently improving domestic energy supply and security situation. The real GDP growth is projected to come close to the 6.0 percent target for FY18. The agriculture sector is expected to repeat its performance seen last year with major contribution expected from the crop sector, especially cotton and rice. Notwithstanding a fall in the area under cotton by 12 percent against the target, cotton output is expected to remain higher compared to last year.

Table 1.2: Key Macroeconomic Targets and Projections

	FY17	**FY18**	
		Target[4]	**SBP Projections[2]**
		percent growth	
Real GDP	5.3	6.0	5.0 – 6.0
CPI (average)	4.2	6.0	4.5 – 5.5
		billion US$	
Remittances	19.3	20.7	19.0 - 20.0
Exports (fob)	21.7	23.1	22.0 - 23.0
Imports (fob)	48.6	48.8	53.0 – 54.0
		percent of GDP	
Fiscal deficit	5.8	4.1	5.0 – 6.0
Current a/c deficit	4.0	2.6	4.0 – 5.0

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

The industry, largely LSM, construction and electricity generation and electricity and gas distribution, will continue to benefit from the ongoing work on infrastructure and energy related CPEC projects. Thus, the expected improved performance of the agriculture and industrial sectors will spillover to the services sector in FY18 as well.

With real economic activity gaining further traction, the import demand, both for machinery and raw materials as well as consumer goods, is expected to remain strong during FY18 as well. On the other

hand, growth in exports and workers' remittances is expected to recover. The exports are expected to benefit from a recovery in global commodity prices and ease in energy constraints. This is particularly indicated by a double-digit growth in exports recorded during the first two months of FY18.

In case of workers' remittances, the initiatives under PRI could help in attracting more receipts through official channel. The key initiatives includes new products for diaspora, extending the tie-up arrangements as practiced in case of GCC and UK to other sources of remittances like Malaysia, South Africa and New Zealand, and plans to further reduce the cost of fund transfers. Incorporating these developments, workers' remittances are projected to remain in the range of US$ 19-20 billion during FY17. Yet, the pace of increase in exports and remittances is likely to be slower compared to increase in imports. Therefore, the current account deficit is projected to remain around last year's level, that is, in the range of 4.0 to 5.0 percent of GDP.

The FY18 budget envisages fiscal deficit at 4.1 percent of GDP. Given the capital spending requirement of the government for completing various projects under CPEC and likely increase in provincial spending during the election year, achieving the target 4.1 in FY18 could be challenging. Moreover, any shortfall in revenue may keep the fiscal deficit close to FY17 level.

Notwithstanding expected increase in domestic demand, average CPI inflation is projected to remain in the range of 4.5 to 5.5 percent during FY18. Sufficient food stocks (wheat, rice, and sugar) in the country, weak domestic oil prices and stable exchange rate are expected to offset the impact of expected further rise in domestic demand. Moreover, as per IMF projections, the commodity prices, palm oil and sugar, are also likely to fall in international market over the next few months.

Thus, the assessment shows the economy is likely to continue to expand with low and stable inflation in FY18. Encouraging trends in private sector credit indicate underlying dynamics in real economic activity. However, maintaining this momentum going forward would largely depend on addressing emerging challenges in external and fiscal accounts.