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A Subsidiary of National Bank of Pakistan

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Federal Budget FY2017-18-Implications for Economy and Capital Markets

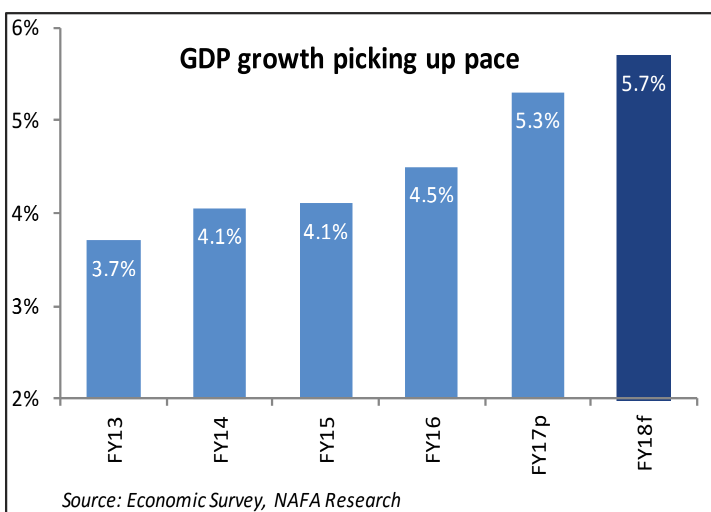
In the backdrop of rising noise in domestic politics and stalled economic reforms program, PML-N government announced its last budget of its tenure, with attention focused towards growth. Although the government has achieved broad macroeconomic stability in the last two years, FY18 being the election year, the federal budget envisages a delicate balance between populist measures and prudence on the fiscal side.

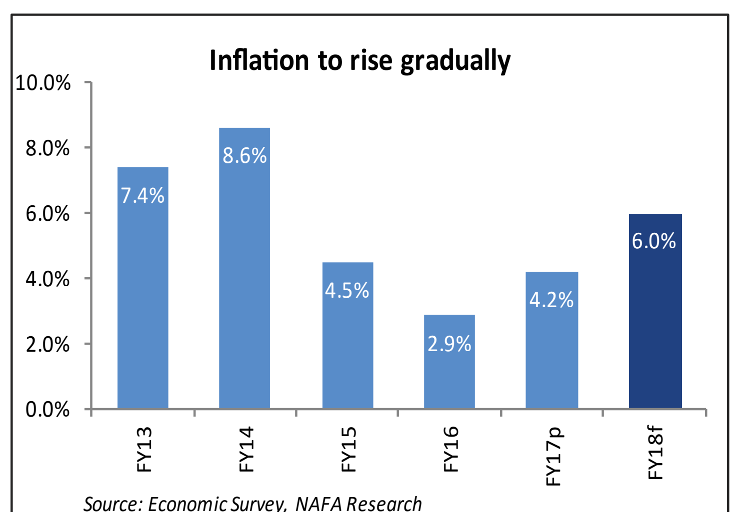
Pakistan's economy continues to grow strongly with GDP growth clocking in at 5.3% for FY2017 (the highest in the past decade) underpinned by the rebound in the agriculture sector, continued growth in the manufacturing sector, and healthy contribution by the service sector. Helped by the favorable external environment due to stable oil prices, Inflation remained under control as captured in average CPI of 4.2% and benign policy rates of 5.75%. Healthy FX reserves accumulation equivalent to 18 weeks of imports driven by inflows under the financial and capital accounts. For the first time, the size of the economy has surpassed USD300 billion, with per capita income rising to USD1,629 in FY17 compared to USD1,531 in the preceding year. However, beneath the surface, a number of warning signs are emerging. Revenue growth is slowing, exerting pressure on the fiscal account due to rigidity of the expenditure side; stagnant exports, rise in imports and tapering off remittances growth are leading to widening of the current account deficit.

The government has set an ambitious GDP growth target of 6.0% for FY18 that envisages 3.5% growth in agriculture sector, 6.4% growth in manufacturing sector, and 6.4% growth in services sector. Encouraged by rebound in agriculture growth in FY17, the government has again laid greater emphasis on agri sector with special incentives package along with hefty rise in development expenditure (total PSDP of PKR2.1trn, up 37% YoY) as projects under CPEC gather pace. The government budgeted to bring down FY18 fiscal deficit to 4.1% of GDP from 4.2% revised target in FY17 through 13% rise in total federal revenue with outsized emphasis on indirect taxes, and tight control over current expenditures (a mere 2% rise) especially subsidies. The budget assumes inflation at 6% for FY18. The government hopes to counter the mounting risks to the Balance of Payment (BoP) position from widening current deficit by healthy surplus on financial account driven by bilateral/multilateral disbursements and significant jump in Foreign Direct Investment (FDI) in infrastructure and energy sectors under the CPEC. We believe that the budget deficit and current account deficit will be significantly higher than projected by the government.

Against the government target of 6%, we expect GDP growth at 5.7% for FY18 underpinned by capacity expansions by the private sector as reflected by the healthy growth in private sector credit off-take, benefiting from benign inflation and interest rates. We also see healthy contribution to growth from the public sector investment activity under the CPEC related projects in infrastructure and energy sectors. Owing to expected decline in energy shortages and investment under CPEC and improving business confidence, investment to GDP ratio is expected to rise to 17% and would be the key catalyst for ascent in GDP growth.

We feel the actual numbers of fiscal deficit for both FY17 & FY18 may well reach around 4.5% of the GDP against the government's unrealistic target of 4.2% and 4.1% respectively, due to slower than projected growth in tax collection and fiscal slippages especially on the subsidy front. In line with the government estimates, Inflation is expected to rise to 6% in the next fiscal year due to gradual rise in food and commodity prices (notably oil), higher money supply growth, and measured currency devaluation. External account position is projected to remain under pressure with current deficit at 3.0% of GDP as a result of rise in trade deficit, lower CSF inflows and limited growth in remittances.





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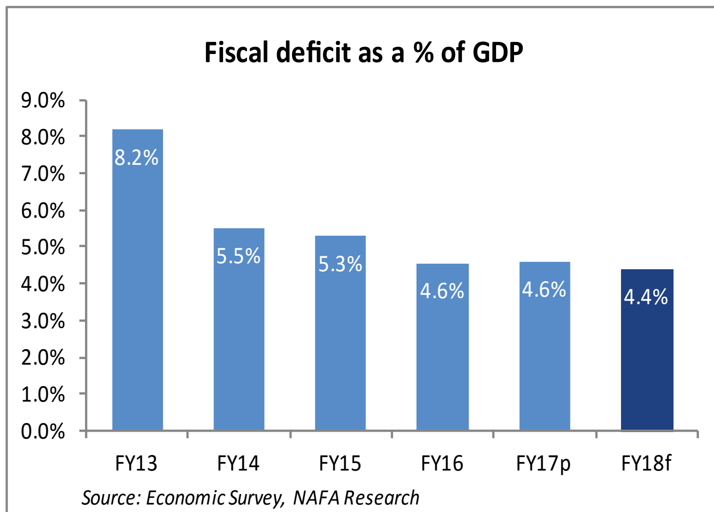
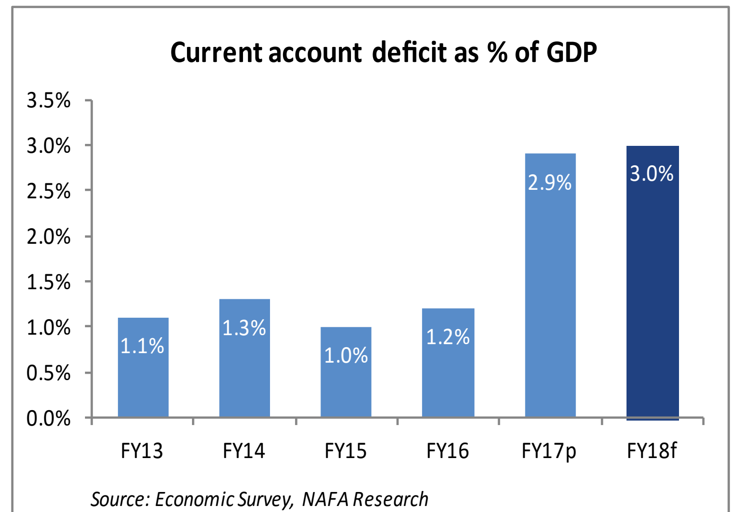
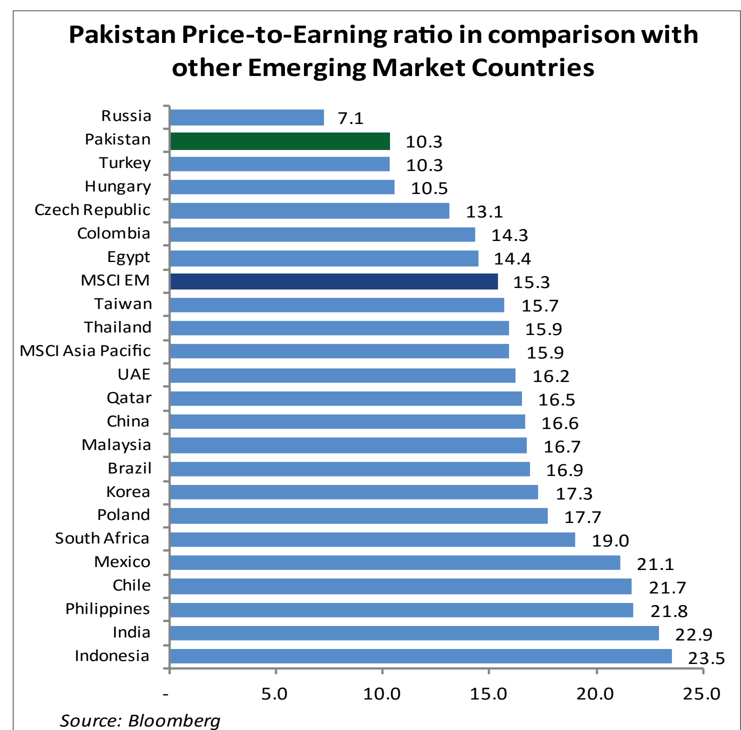




In our base case scenario, we expect a gradual hike in policy rate by 75-100 basis points during FY18 as inflation picks up. Concomitantly, the sovereign yields curve will shift upward and steepen as the premium on the long-term bonds increase due to inflationary pressures emanating from widening current account deficits and mounting risks of currency devaluation. In this investment backdrop, we advise investors to invest in floating fixed income securities and keep the maturity of their fixed income portfolio short.



The budget had a few negative surprises for the stock market and listed companies such as (i) increase in Capital Gains Tax (CGT) for non-filer increased to 20% and removal of cascading CGT structure over longer term holding for both filer and non-filer; (ii) 2.5% increase in tax on dividends for companies to 15%, and Mutual Funds dividends to 12.5%; (iii) continuation of one-off super tax at 3% for non-banking companies and 4% for banks; and (iv) Non-Government companies excluding Banks to pay 10% extra tax if their payout is less than 40%. The market was also expecting abolishment of tax on Bonus shares which did not materialize.

Due to taxation heavy budget for the stock market, absence of net inflow from foreigner's side during MSCI Emerging Markets inclusion date, and headlines linked to Panama Leaks Case investigations the market remained under considerable pressure in the post budget week. While volatility is likely to remain elevated in the coming months due to political noise, we hold a positive outlook on the stock market for the long term investors on the back of improving economic growth, benign near-term inflation & interest rate outlook, abundant local liquidity, compelling stock market valuations relative to other EM countries and healthy corporate earnings growth. In view of the above, we expect the stock market to deliver healthy double-digit returns in FY18.

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