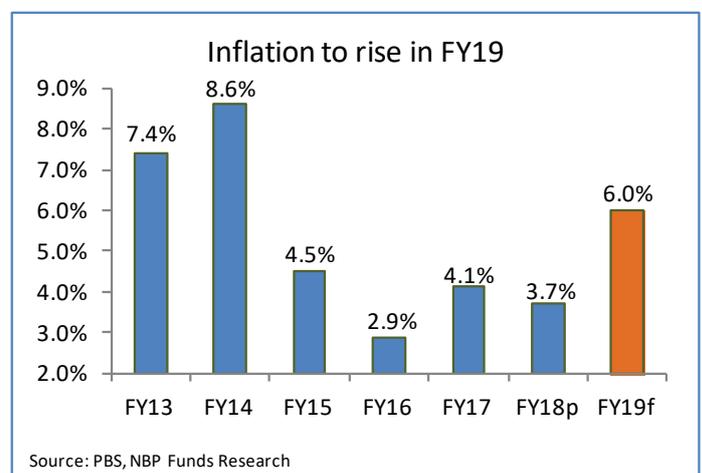
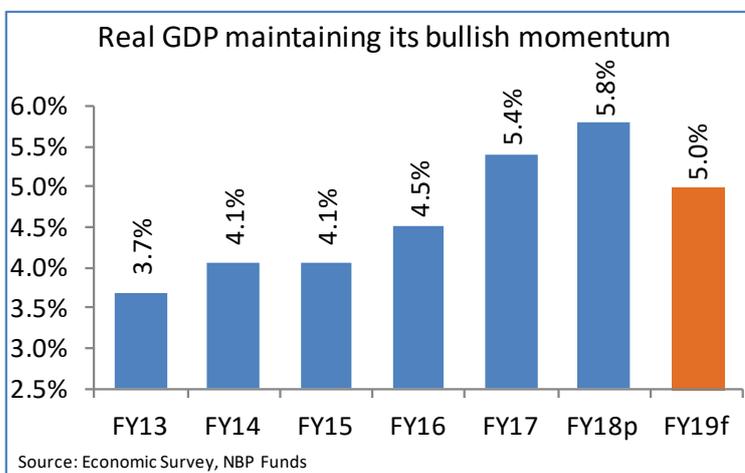


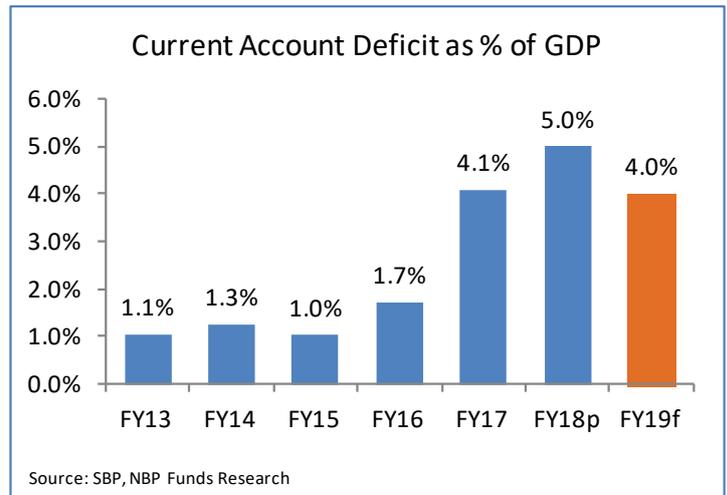
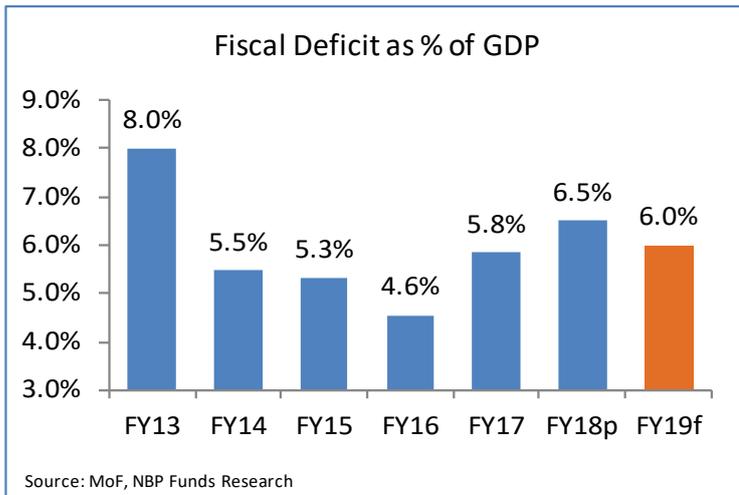
Federal Budget FY2018-19 - Implications for the Economy and Capital Markets

PML-N government recently announced its sixth and the last budget. As expected, the budget was somewhat populist and ambitious as it tried to offer relief to all the sectors of the economy and the broader society. The budget envisages boost to economic growth by placing emphasis on development projects, expanding agriculture sector output, stimulating industrial sector by lowering tax burden and sustaining robust consumption by offering tax relief to individuals. What remains laudable about the budget is that the government is making it difficult for the non-filers by placing restriction on acquisition of immovable assets and automobiles and thereby forcing them to come into the tax net. Similarly, provision has been made to reduce the steep gap between the real estate's market rates and the DC rates, which is an important and bold step in addressing the perennial issue of documenting the economy.

FY18 marked the continued improvement in economic growth as GDP growth is expected to clock in at 5.8%, the highest pace of growth in the last 13 years. The impressive growth is achieved on account of strong performance of agriculture, industry, and services sectors, which grew by 3.8%, 5.8% and 6.4%, respectively supported by low interest rates and benign inflation. The tailwind to the robust growth is provided by improved energy supplies, unprecedented ongoing investment activity under China-Pakistan Economic Corridor, strong credit growth, and buoyed investor & consumer confidence. However, due to the exchange rate adjustment during the year, the per capita income remained nearly flat at USD1,641.

The economic growth has picked up in the last couple of years, however the imbalances have re-emerged on both the internal front and especially, on the external side. As per the provisional budget estimates, the government is targeting fiscal deficit at 5.5% during FY18, which will likely be revised upwards in our view due to lower than projected provincial surplus and other fiscal slippages. The current account deficit stands at USD12 billion during 9MFY18 and the government is expecting it to reach USD15 billion for the full year 2018. In response to the declining SBP foreign exchange reserves, the government enacted various policy measures such as an exports rebate package, controlled PKR devaluation, and hike in import duties. The above policy actions have started yielding some initial results as March 2018 exports showed a healthy 12% growth on a YoY basis. Inflows from the recently promulgated amnesty scheme remain critical in providing much needed relief on the external front given lumpy external debt repayments and a still large current account deficit. Nonetheless, we feel that Pakistan will enter into a fresh IMF program in FY2019, which will be critical in reducing its external account concerns. Inflation is expected to rise to near 6% in the next fiscal year due to gradual rise in food and commodity prices (notably oil), incessant government's fiscal financing, and measured currency devaluation. Rise in inflation is also expected to result in increase in interest rates next year. Tightening of monetary, trade and fiscal policies in FY19 is expected to slow down the economic growth rate.





For the stock market and listed corporate sector, the budget is mainly positive. Though, contrary to expectations, two key proposals, removal of inter-corporate dividends taxation and rationalization of Capital Gain Tax were not enacted in the budget, other steps were favorable for the stock market and mutual fund industry such as: (i) abolition of 5% tax on issuance of bonus shares (for both corporates and mutual funds); (ii) gradual reduction in corporate tax rate (barring banking sector) from 30% to 25% by FY2023; (iii) phasing out of super tax from currently applicable rate of 3% on non-banks and 4% on banks in three years time; (iv) lowering of mandatory payout ratio from 40% to 20%, reduction of incremental tax on non-compliance from 7% to 5%; and (v) enhancement of investment limit for tax credit on shares and mutual funds from PKR1.5 million to PKR2 million.

For sectors, the budget is a mixed bag. It is positive for the Textile sector as the government has pledged to clear the refunds over the next 12-months, and reassured to clear new refunds on a monthly basis. The budget also mentions a new export package (for value added and non conventional markets) details of which will be given later. Fertilizer sector is also a beneficiary of the budgetary measures as the government rationalized sales tax rate on fertilizers to 2%, reduced sales tax from 10% to 5% on supply of feedstock gas, and raised the agri credit target to PKR1.1 trillion. The budget is marginally positive or a non-event for the Banking, Oil and Gas Marketing, Power Generation & Distribution, and Flat Rolled Steel sectors. It is negative for a few sectors such as Auto Assemblers as non-filers are now barred from buying new automobiles; Cement as FED has been raised from PKR62.5 per bag to PKR75 per bag; and Long Rolled Steel producers as sales tax on electricity has been raised by PKR2.5 per kWh to PKR15 per kWh.