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Drought, Flooding, Wheat Crisis and Inflation

Despite a bumper wheat crop in 2007, the economy of Pakistan has been plagued with a severe shortage of wheat and thus high wheat prices since the beginning of the current fiscal year, 2007-08. Soaring international wheat prices emanating from a global decline in wheat harvests on the back of droughts hitting the globe, and the hoarding and smuggling activities of our community explain to a large extent the anomalies in the local market for wheat.

This report will examine the current wheat crisis facing the economy, assessing in detail the combination of factors responsible. The report will then conclude possible short term as well as long term solutions available to the government to resolve the current situation.

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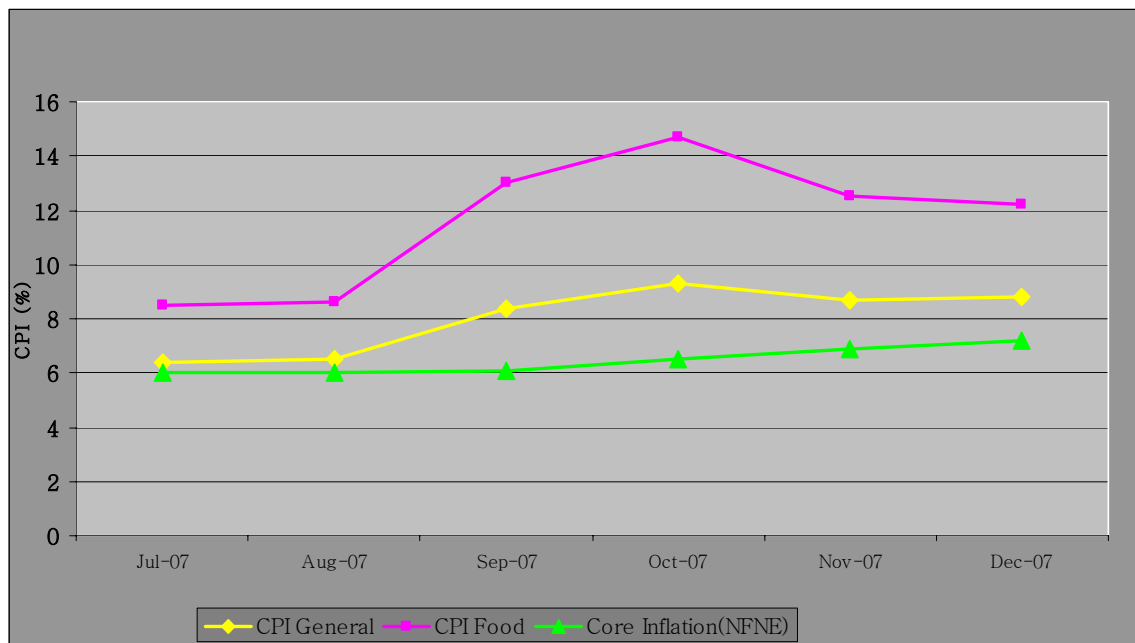
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Wheat Prices and Rising Inflation

Since the beginning of the current fiscal year abnormally high food inflation has been a cause of distress to all economic agents, particularly the low income group consumers. CPI food inflation reached double digits in September and to a twenty nine month high in October at 14.7%. Though food inflation has come down since then, it is still high at 12.2%. The food inflation witnessed in the recent months is not broad based. Though prices of many food items have registered volatility over the months it is the persistent rise in wheat/wheat flour prices which has contributed most significantly to food inflation.

Wheat is assigned the highest weight in the CPI food basket as it is the cheapest source of energy and protein for the low-income groups and therefore is a part of everyday meal for a larger proportion of our population. At the same time it is not only a constituent of fodder for livestock but a vital ingredient for most processed food items. It is thus no surprise to witness high wheat prices translate into a rude price shock for the entire economy. It is therefore critical to assess the factors contributing to high wheat prices.

Figure 1: CPI (General, Food and Core) Jul-Dec FY08



In pure economic sense an increase in price of a commodity results either from an increase in demand for the commodity or a decrease in supply or a combination of both. High wheat prices are said to be a result of severe shortage of wheat in the market. This appears to be rather confusing as in 2007 the economy produced wheat grain of 23.3

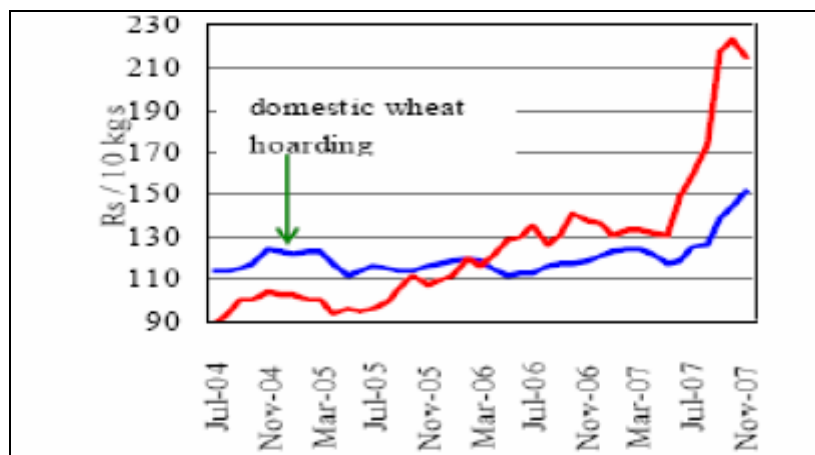
million tones – more than enough to satisfy the demand of its population at a price people could easily afford. One thing is therefore clear that the surge in wheat prices cannot be explained by the simple demand supply models; it extends much beyond this.

The Wheat Paradox: It All Began with Drought in Australia

With regards to the current wheat crisis facing the economy, over and above the issue of price is its availability in the market despite a bumper wheat crop in 2007.

In the most simplistic sense this paradox is often explained by the activities of hoarders. In wake of rising international wheat prices, the hawkish flour millers find it more lucrative to hoard wheat now and eventually sell it at a higher price later. This results in a shortage in the domestic markets putting an upward pressure on the wheat prices; thus the domestic wheat prices move in tandem with the international wheat prices.


Figure 2: Domestic Wheat Price vs. International Wheat Price



Source: SBP Quarterly Report

In the international markets the wheat prices have soared on the back of significant declines in the global wheat harvests. In this section we will review the shortage of wheat that plagued the international markets and how it translated into a domestic wheat crisis.

The wheat shortage in the international markets can be traced to the drought hitting Australia. Being one of the biggest wheat producers, Australia exports about 70% of its production, principally to Asian countries. In recent years, however, the Australian agricultural output as a whole has suffered severely at the hands of drought. The Murray-Darling basin in south-eastern Australia yields 40% of the country's agricultural produce, but the two rivers that feed the region were so pitifully low, until recently, that it was expected that soon there will be only enough water for drinking supplies. Thus Australia



was in the grip of its worst drought on record and it was therefore not surprising to see the Australian wheat harvests decline significantly. In 2007, Australia harvested approximately 12 million tones as against an estimate of 25 million tones. Nonetheless the drought was not just confined to Australia; it was rather global with Australia being worst-hit. Poor rainfalls resulted in lower than expected wheat harvests worldwide and thus led to soaring wheat prices on the global markets.


With the international price of wheat almost two fold of the domestic price of wheat in Pakistan, the hoarders who recognized this as a profit opportunity, hoarded huge stocks of wheat and wheat flour to be able to sell it at rising prices as mentioned earlier. For this reason, often the hoarders are accused to be the sole culprits behind the wheat crisis facing the local economy. However the wheat crisis facing the economy cannot be explained by just the activities of the hoarders; rather it involves more complex loops.

One must take note of the fact that hoarders are rather creatures of opportunity and cannot dictate prices. What they actually do is identify price discrepancies (in this case the difference between domestic and international wheat prices) in the market and accelerate the process of market moving towards an equilibrium price. But in order for there to be a price discrepancy in the first place there must be the provision of movement of goods, which is happening in this case through smuggling. For smugglers, who have been the biggest profiteers of the whole situation, price differential presents a perfect recipe to make abnormal profits. Not to forget that our historically porous borders provide the strongest support to these individuals.

Thus the smugglers in most cases connived with the hoarders and sold the wheat/wheat flour across the border making abnormal trading profits from the price differential that existed across the line. It is estimated that over a million tones of wheat has been smuggled across the border while over a million is still hoarded and hidden. Afghanistan has been the biggest recipient of the smuggled wheat. Naturally the economy is facing a shortage of wheat and by this means, high wheat prices.

Though the government has moved forward with the pure intention of addressing the current wheat crisis by importing wheat from Australia and America and providing substantial subsidies, it has further exacerbated the situation. This is because the government's policy to provide subsidized wheat from warehouses to flour mills is rather faulty in the sense that it is from the flour mills that tones of wheat is being smuggled out. This essentially means that the government is indirectly subsidizing the smugglers while the local farmers continue to receive the low prices – almost less than half of what the government is paying to the Australian and American farmers for the wheat imported from them.

Hence the true beneficiaries of this faulty wheat policy are neither the local farmers nor the local consumers; rather it is the middlemen and traders – both of who connived in



smuggling of wheat across the border, and the international consumers who procure the smuggled wheat. The local consumer is forced to pay high wheat prices which are close to the international prices while local farmers fail to get deserved prices for their wheat harvests. In this way the local farmers are actually subsidizing the consumers across the border, say those in Afghanistan, instead of those within it.

Every Cloud has a Silver Lining

As argued in the preceding section, the wheat crisis facing the economy is a result of price differential between the international and local wheat prices and the subsequent market inefficiencies underpinned by wheat pricing policy of the government. This wheat crisis, marked by severe wheat shortage and thereby soaring prices, has contributed significantly to economy wide inflation. However it has particularly affected the low income group consumers, as these individuals spend a higher percentage of their income on wheat than the higher income groups, and the poor farmers/producers, widening the income gap even further.

The optimists however expect the domestic wheat crisis to cave in, in the coming months. This is primarily on account of Australia now experiencing heavy floods which has helped the country move out of the grip of its worst drought ever and thereby is expected to increase its wheat harvests manifold. Increased Australian wheat harvests essentially mean increased world wheat supply and thereby falling international wheat prices. Thus the price differential for Pakistan will shrink, improvising the current situation.

What must be noted is that it is not prudent for us to depend upon flooding in Australia to improve our situation in terms of wheat crisis and the resulting inflation. Firstly flooding alone cannot guarantee a rebound from the wheat crisis because today the world food situation is being rapidly redefined by new driving forces; the most important being the increased production of bio fuels across the globe.

The debate concerning impact of bio fuel production on global food prices has come under strict scrutiny in the recent months. This is because current use of food crops like corn as the feedstock for bio fuels is driving up price for several agricultural commodities including wheat and dairy products. Thus with bio fuel production to reach new records in 2008, high global food prices are likely to prevail regardless of flooding in Australia. Floods in Australia therefore may not have the impact they are so hoped to have on wheat crisis and our economy may continue to face wheat shortages and high wheat prices in the coming months.

Thus with these recent developments whereby high global wheat prices will persist, the government must come up with a long term solution to correct the resulting market



inefficiencies. The government must reorganize its existing pricing policy while introducing new policies.

Reorganizing Actions: A must-do for the Government


It is clear from the arguments presented in this report, that the ultimate way to control the wheat crisis is to ensure perfect borders such that no smuggling of wheat can take place. However this is not as simple a measure as it may sound. Since the time of independence, our economy has been plagued with the evils of porous borders across which smuggling of food and non food commodities takes place frequently. Following the wheat crisis, though the government has taken cautious measures to curb any further trade in wheat across the border, they do not present a permanent solution.

What the government must note is that incentive to smuggle wheat will exist as long as there is a remarkable difference between international and local wheat price. Therefore in order to curb any illegal trading in wheat, the government will have to do enough to remove the incentive all together. And the first step to do so is to link local wheat price to international price. Thus the government must ensure that the wheat support price that the farmer gets is subsequently linked to the international wheat price. Correct wheat support prices will pass on the price signal to the farmer, resulting in more production. In this fashion local wheat prices will stimulate wheat production. In these circumstances even if wheat shortage does occur for any reason whatsoever, the wheat can be imported at the same price (since international wheat price will now be equivalent to local price) without requiring huge subsidies from the government.

The issue which arises with this is that the poor are the hardest hit by the resultant rise in wheat price. However the government can address this issue via targeted subsidies. This implies that the government will have to streamline its current broad based subsidies. One way of achieving this is via distribution of ration cards. Nonetheless any such approaches have always fell prey to corruption in our economy. Therefore it is critical that the government puts in place a transparent selection process before developing targeted subsidies. Alongside or in place of the distribution of ration cards, the government can place mobile distribution units whereby mobile units, say trucks, can distribute wheat to the inhabitants of a targeted area at a subsidized price.

Controversial – Yes; Irrational – Not So!

The suggestion we presented in the previous section of linking local wheat prices to the international prices, particularly at a time when international prices are ever increasing, may not be so warmly welcomed. However one cannot ignore the reality of the situation. If local wheat prices continue to deviate from the international wheat prices, smuggling



will continue incurring severe wheat shortages, and this will mean consumers paying a price close to the international price of wheat. Farmers will be the biggest losers as they will receive while the hoarders and the smugglers will continue to make abnormal profits. If the government does link the local price of wheat to the international price, smuggling will come to a halt. Consumers will be paying the same price while farmer will receive a better remuneration.

Hence the question the government needs to answer is who gets the chunk of the profits; the farmer or the middlemen.



Economic Snapshot

Fiscal year 07-08														
	Units	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec
<u>Inflation</u>														
Headline Inflation	%	8.88	6.64	7.39	7.67	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8
Core inflation	%	5.5	5.3	5.72	5.42	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2
Food inflation	%	12.71	8.7	9.99	10.74	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2
Non-food inflation	%	6.22	5.2	5.59	5.54	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.64	8.64	8.64	8.65	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09
6 month	%	8.81	8.81	8.81	8.82	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29
12 month	%	9.00	9.00	9.01	9.01	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49
<u>External Sector</u>														
Export	Mln US\$	1,536	1,227	1,421	1,536	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500
Import	Mln US\$	2,365	2,100	2,103	2,070	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910
Trade balance	Mln US\$	(829)	(873)	(682)	(534)	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)
<u>Remittances</u>	Mln US\$	475	391	457	520	513	537	505	495	489	516	580	505	479
<u>Forex Reserves</u>	Mln US\$	12,960	13,212	13,378	13,624	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,604



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