

Intl Wheat Prices up 61% since Jun10: Another Shock in the Making?

- Downward revision in wheat production forecast by FAO together with export ban placed by Russia (world's 3rd largest exporter of wheat) caused sharp increase (61% since Jun10) in wheat prices globally
- In sight of a possible fall in crop yields (especially wheat), international fertilizer prices have started to improve during the last 6 to 8 months. The increase can potentially be seen as a preamble to a hike in fertilizer prices going forward
- Differential between domestic (PKR950/maund) and int'l wheat prices has already turned into negative 8% in Aug10 from 38% premium recorded in Jun10, by virtue of which adverse impact on domestic supply and prices can not be ruled out
- Although support prices for wheat procurement are expected to remain stable, retail prices normally move in tandem with supply side factors. Continued surge in int'l prices may point towards possibility of wheat being smuggled out, resulting in higher retail prices in domestic market and eventually fuelling inflation going forward
- Higher demand for fertilizer post flood scenario is likely to surpass fertilizer supply by 150-200ktons due to recent damage to soil nutrient content. In this case, consideration of diverting budgeted subsidies from wheat to fertilizer import (~PKR3-3.5bn) seems prudent
- Although reported production data portrays adequate grain availability when compared to demand, govt's storage capacity remains at less than 40% of the domestic consumption. Therefore, govt.'s capacity to handle shortfall in supply seem inadequate. We believe it seems prudent to reassess the stock availability post flood scenario and revisit the decision for export quantity (earlier projection of 2mn tons). At current price levels, exports of 500,000-700,000 tons of wheat can yield USD150-175mn

FAO not very positive on wheat... Russia Agrees

For the second time in a row Food and Agriculture division of the United Nations (FAO) has revised downward their estimates regarding global wheat production. Revision has been primarily driven by potential downturn in outputs of Canada, Ukraine and Russia due to adverse climate conditions.

Wheat Production Forecast by AOP

mn tons	Actual	Initial	Revised 1 (Jun10)	Revised 2 (Aug10)
Period	2008-2009	2009-2010		
Production	684	682	676	651
Supply	827	860	873	845
Utilization	649	663	675	659
Trade	139	121	122	122
Ending stock	178	196	194	188

Source: FAO

Following the first impulse to protection of domestic economic stability, Russian president Vladimir Putin has officially announced a ban on grain exports from Russia. Similarly weather conditions in Canada, Ukraine and Kazakhstan have led to mass speculation of possible significant curtailment in wheat at availability, during the current fiscal year.

Grains on restricted list

As a result of potential shortfall in international wheat availability (after Russia - 3rd largest wheat exporter globally slapped a ban on grain exports), wheat prices have rallied significantly.

Russia's plan of grain export ban comes after a severe drought that impacted the country's potential agriculture and food security. Aggravated further by wildfires, the culmination is likely to put Russia in the shadows of food export markets at least for the current fiscal year. It is estimated that persistence of water shortage is likely to impact the crop not only for the current period but could potentially impede Russia's return to the global trade market for the next year too. Current estimates of Russia's wheat output stand at 45mn tons roughly 25% lower than its 2009 production.

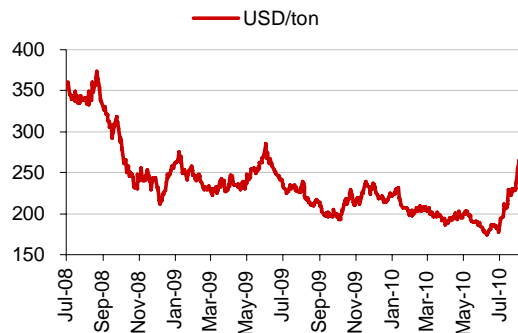
Ukraine, Russia's neighbors has experienced nothing less. Drought has driven across the boarder and is likely to impact wheat output for Ukraine too. Shortage of wheat at the European doorstep is likely to cause massive stir internationally as wheat demand is likely to remain unabated.

Across the Atlantic, Canada's farm output has also turned into a hotspot of discussion. Adverse climate conditions for Canada have led to speculations that wheat production shortfall contributors are likely to find a new companion. Canada has long been one of the major contributors to global trade in grains and currently rates as one of the largest exporter of wheat.

Wheat prices sprinting ahead: Up by 61% since Jun10

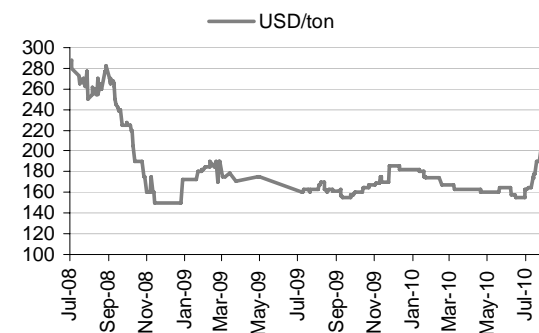
As a result of rising concerns on wheat availability, both spot and future contracts have started to rally significantly. CBOT traded Dec10 future contracts have already rallied over 61% since Jun10. Similarly the second most important staple food (rice) has also begun to take up after wheat.

Wheat Prices - Chicago



Source: BMA Research

Wheat Prices - Ukraine



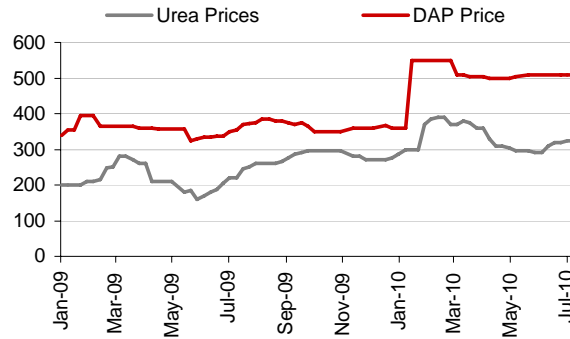
Source: BMA Research

Recent trend in Fertilizer prices

In sight of a possible fall in crop yields (especially wheat), international fertilizer prices have started to improve during the last 6 to 8 months. Fertilizer prices after experiencing a significant crash during FY08 have started to rebound only recently. The increase can potentially be seen as a preamble to a hike in fertilizer prices going forward.

We expect that overall output shortfall is likely to drive additional fertilizer demand globally which is likely to have trickle down effect on Pakistan's inflation going forward.

International Fertilizer Prices (USD/ton)

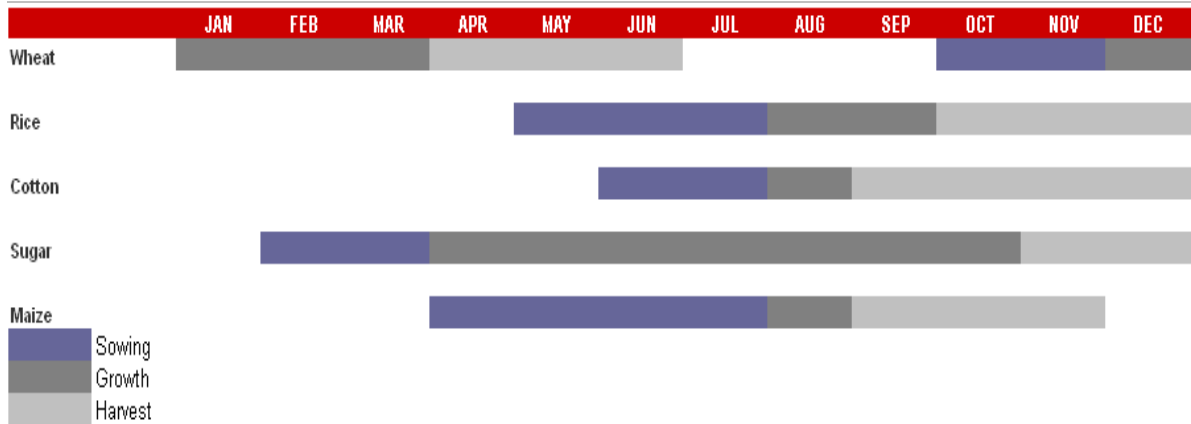


Source: Bloomberg

Domestic concerns despite healthier production

Taking into account the catastrophe of the recent flood, damage occurred to the agriculture sector is seemingly massive. The crop sowing and harvesting patterns (as mentioned below) help assess damage to different crops due to the recent flood. As the harvesting season for wheat normally ends before monsoon, it is imperative that wheat crop remained immune to the recent destruction. However, concerns for cotton and rice are significant as their growing period of these crops collide with monsoon season.

Crop Calendar



Source: Pakistan Meteorological Department

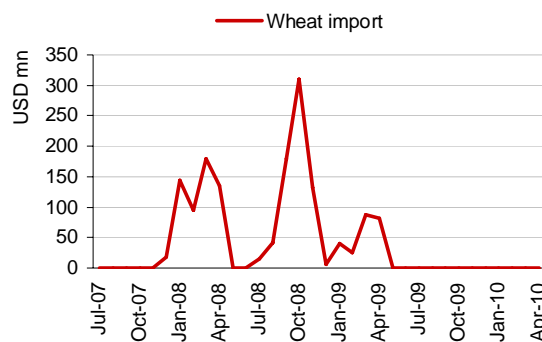
Pakistan's major crops including wheat, cotton, rice and maize contribute 33% and 7% to agriculture sector and GDP respectively. Wheat alone consumes 53% of the total area under cultivation and contributes ~59% to major crops. According to the relevant authorities, Pakistan has appropriate stock levels for the current year with expected production of 23.8mn tons and 4.2mn tons of inventory (total available wheat stock at 28mn tons) against ~20mn tons of domestic consumption. However, we believe the recent flood and surge in international prices are likely to impact the supply and prices of wheat in domestic market.

To give a prospect of the recent supply side issues pertinent to wheat, we have analyzed the data for the period FY07-10. Pakistan's wheat crop production was recorded at 23 and 20mn tons respectively in FY07 and FY08. However, due to the weak boundary controls and higher international prices wheat supply remained the key concern for these periods amid smuggling to neighboring countries. These

Administrative weaknesses caused wheat import of USD570mn and USD1,010mn in FY08 and FY09, which have further aggravated the external account worries. To control leakages government though increased wheat support price to PKR625/maund to PKR950/maund since then. Desired results were achieved; which however may not have been possible had the wheat prices continued to rally in international markets.

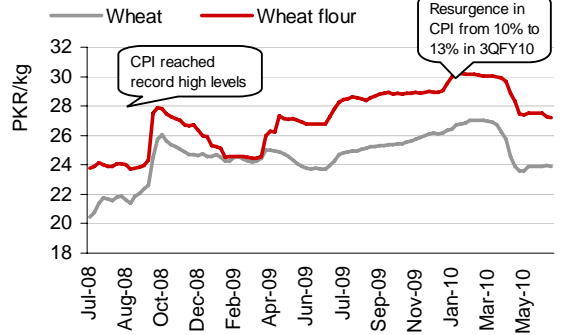
Therefore, considering the recent rally in wheat prices amid supply concerns globally, effective administrative controls on domestic front are of prime importance. In addition damage to wheat storage can not be ruled out considering heavy flood in the country (initial estimates of stock damage recorded at ~3000-4000tons of wheat).

Pakistan Wheat Import



Source: SBP, BMA Research

Domestic Wheat and Flour Prices at Retail



Source: FBS, BMA Research

Timely measures regarding supply and price controls would help avoid economic imbalances and can potentially add value to external account.

- Higher prices and resurgence in CPI:** Considering heavy weight (43%) of food items in the CPI basket, wherein wheat is the major contributor, upside move in wheat and wheat related prices at domestic level may arrest the expected fall in inflation going forward. Although support prices for wheat procurement are expected to remain stable, retail prices which hurt the masses normally move in tandem with supply side factors. Differential between domestic (PKR950/maund) and int'l prices has already turned into negative 8% in Aug10 from 38% premium recorded in Jun10, by virtue of which adverse impact on domestic supply and prices can not be ruled out.
- Fiscal account imbalance amid subsidies:** Budget allocation for FY11 reflects allocation of PKR12bn (PKR25.5bn in FY10) for wheat imports which is less likely to be used amid better production. Therefore it is imperative that fiscal outlays are reduced by better administrative controls while export receipts should be boosted through a nominal quantity of wheat exports. At the same time, higher demand for fertilizer post flood scenario is likely to surpass fertilizer supply by 150-200ktons due to damage to soil nutrient content to refurbish soil quality. In this case, consideration of diverting budgeted subsidies from wheat to fertilizer import (~PKR3-3.5bn) seems prudent.
- Potential revenue generation through exports:** Wheat imports during FY08-09 caused damage to the exchequer as imports were made at higher prices despite appropriate production and stocks. In current fiscal year, govt. has planned to export some of the wheat surplus (~2mn tons). Although reported production data portrays adequate grain availability when compared to demand, government's storage capacity remains at less than 40% of the domestic consumption. Therefore, govt.'s capacity to handle short fall in supply seem inadequate. Minimal govt. control on supply, poor administrative controls and mass destruction due to flood provide lucrative opportunities for hoarders/traders to capitalize on higher prices through smuggling. Therefore, it seems prudent to reassess the stock availability post flood scenario and revisit the decision for export quantity. At current price levels, exports of 500,000-700,000 tons of wheat can yield USD150-175mn.

Economic Statistics

					FY08A	FY09A	FY10A	FY11E
Economic indicators								
GDP growth	%				3.7	1.2	4.1	4.5
Agriculture	%				1.0	4.0	2.0	3.8
Manufacturing (LSM)	%				4.8	(3.7)	5.2	5.6
Services	%				6.0	1.6	4.6	4.7
External Account								
		Jun-10	May-10	MoM				
Trade balance	USD mn	-1241	-930	33%	(14,970)	(12,627)	(11,377)	(11,894)
Exports	USD mn	1782	1716	4%	20,427	19,121	19,636	21,600
Imports	USD mn	3023	2646	14%	35,397	31,747	31,013	33,494
Remittances	USD mn	841	758	11%	6,451	7,811	8,906	9,975
Current account	USD mn	-453	63	-819%	(13,874)	(9,261)	(3,507)	(3,285)
FDI	USD mn	174	256	-32%	5,410	3,720	2,205	2,426
Overall balances	USD mn	485	51	851%	(5,290)	(3,002)	1,253	3,645
Trade balance as % of GDP		(7.0)	(5.3)		(9.0)	(7.6)	(6.4)	(6.1)
Current account as % of GDP		(2.6)	0.4		(8.3)	(5.6)	(2.0)	(1.7)
Fiscal Account *								
		3QFY10	2QFY10	QoQ				
Total Revenue	PKR bn	491	483	2%	1,499	1,851	2,027	2,411
Tax Collection	PKR bn	355	360	-1%	1,051	1,312	1,513	1,779
Current account expenditures	PKR bn	601	538	12%	1,853	2,042	2,231	2,433
Development expenditures	PKR bn	125	124	1%	452	480	646	663
Fiscal deficit	PKR bn	223	180	24%	777	680	723	685
Tax Collection as % of GDP		2.4	2.4		10.0	10.0	10.2	10.4
Budget deficit as % of GDP		1.5	1.2		7.4	5.2	4.9	4.0
USD Reserves								
		Jun-10	May-10	MoM				
SBP reserves	USD mn	12,951	12,250	6%	8,577	9,177	12,951	14,951
Banks' reserves	USD mn	3,816	3,693	3%	2,822	3,307	3,816	4,316
Total foreign reserves		16,767	15,943	5%	11,399	12,484	16,767	19,267
Reserves in months of imports		5.5	6.0		3.9	4.7	6.5	6.9
Interest Rates ~								
		Jun-10	May-10	MoM bps				
Weighted avg. lending rates		13.39	13.4	(0.01)	11.96	14.02	13.44	13.20
Weighted avg. Deposit rates		5.79	6.05	(0.26)	5.18	6.50	6.05	5.95
Banking spreads		7.6	7.35	0.25	6.78	7.52	7.39	7.25
		Jul-10	Jun-10	MoM bps				
6M KIBOR		12.38	12.35	0.03	14.19	12.76	12.37	11.85
12M T-bills		12.41	12.33	0.08	11.79	12.15	12.38	11.90
10yr. PIB		12.97	12.70	0.27	13.42	11.99	12.84	12.30
Banking Sector ^								
		2-Jul-10	1-Aug-09	YoY				
Currency in circulation	PKR bn	1,316	1,172	12%	982	1,152	1,295	1,399
Money supply	PKR bn	5,659	5,057	12%	4,689	5,138	5,777	6,355
Deposits	PKR bn	4,656	4,153	12%	3,839	4,120	4,775	5,253
Advances	PKR bn	3,009	2,998	0%	2,669	2,917	3,009	3,219
Investments	PKR bn	1,823	1,863	-2%	996	1,349	1,823	1,877
Pvt. Sector credit	PKR bn	2,978	2,862	4%	2,888	2,907	3,019	3,170
Price Indices								
		Jul-10	Jun-10					
CPI	%	12.3	12.7		12.0	20.8	11.7	11.4
SPI	%	14.9	16.5		14.2	22.7	13.2	
WPI	%	18.7	17.6		16.4	18.2	12.6	

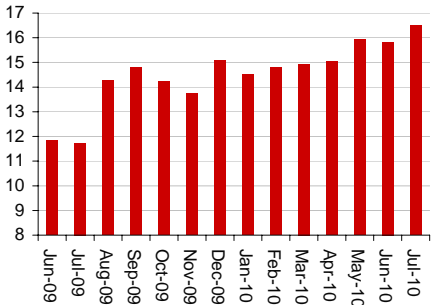
* Budgeted expected for FY09 & 10

~ Monthly average, Jun-end for annual numbers

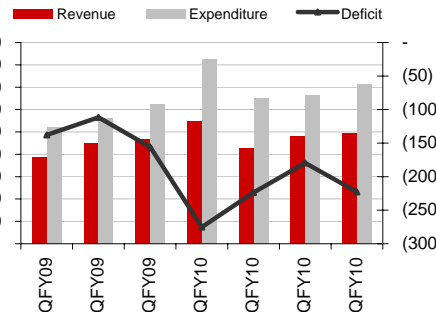
^ Stock at period end

Economic Snapshot

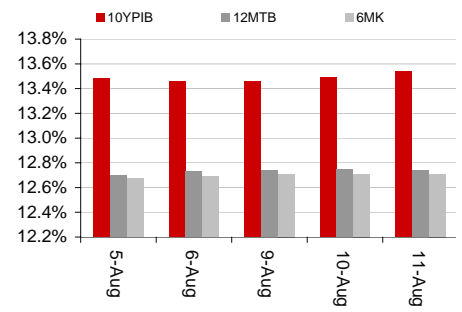
Reserves USDbn



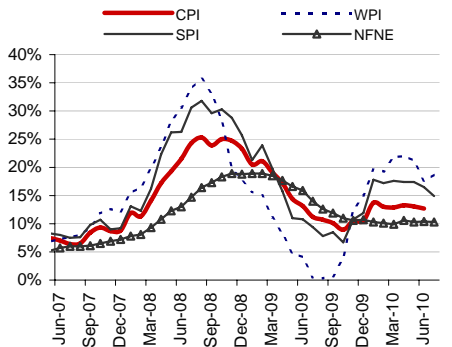
Fiscal account PKR bn



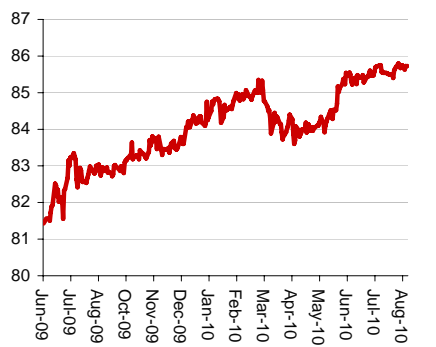
6 Months Kibor, 10 Year PIB & T-Bills



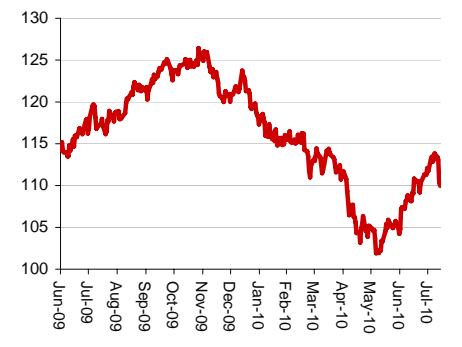
Inflation



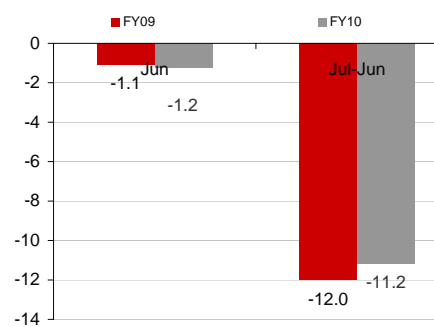
USD PKR Rates



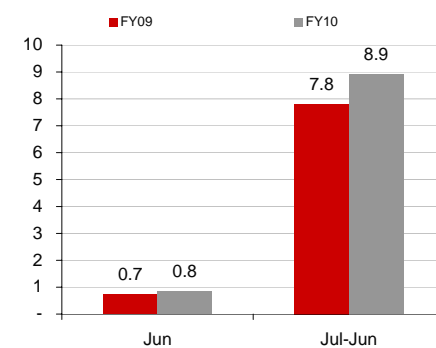
EURO PKR Rates



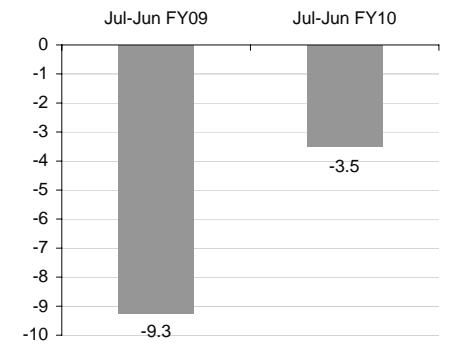
Trade Balance USDbn



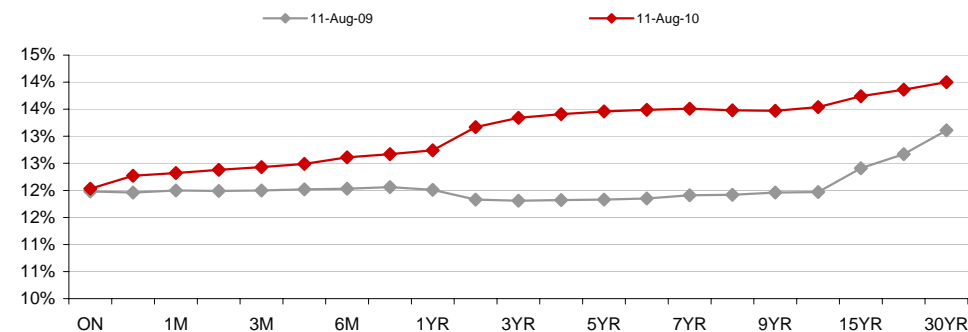
Remittances USDbn



Current Account Deficit USDbn



Yield Curve



* Reserves as of 30-Jul-10