Yet another circular debt
By
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The International Financial Institutions (IFIs), including the IMF and the World Bank, and the finance team led by Dr Abdul Hafeez Shaikh are all worried about the financial indiscipline exhibited by the political leadership over the last two years. In particular, they are worried because the political leadership in the centre and in the provinces is totally oblivious to the developments taking place on Pakistan's financial scene. For them, it is business as usual. In order to give them a shock treatment, the finance team made a candid presentation to the prime minister on the state of the economy in general and finances in particular. The political leadership was told point-blank that if we did not bring our house in order, if we continued to follow the path of fiscal profligacy, and continued to play politics with tax reform agenda, Pakistan would be in dire straits by end-December 2010.

The IMF and the World Bank have also shared their concerns with the political leadership about the ongoing financial indiscipline. In particular, the political leadership was told that if Pakistan failed to implement the VAT or reformed GST by October 1, 2010, the IMF Programme would be suspended and as such the remaining tranche would not be released. If the IMF Programme is off the track, flow of funds from the World Bank and the ADB will also dry up. Money from the Kerry-Lugar Act may also not be available to Pakistan. In short, the political leadership was told bluntly that Pakistan must bring its house in order, maintain financial discipline at all levels of governments, bring economy at the centre stage and support the efforts of its economic team if it expects financial assistance from the IFIs and the Friends of Pakistan.

In addition to the strong message given to the political leadership, the IMF has also raised its serious concern on the financial indiscipline of the provincial governments; budget deficit, instead of shrinking, has widened in the midst of the IMF Programme, thus becoming a source of embarrassment for them; rising circular debt owing to the mismanagement of the power sector; the perpetual bleeding of PSEs draining Pakistan's finances; and the senseless increase in support price of wheat, giving birth to yet another kind of circular debt. The last concern raised by the IMF is the subject matter of this article.

The present government has raised the support price of wheat from Rs425 to Rs625 and then to Rs950/40 kg during the last three years. The cumulative increase is estimated at Rs525 or 123.5 per cent since 2006-07. In plain language, the government itself has increased the price of wheat from Rs10.6/kg to Rs23.8/kg in just three years. Such a senseless increase in the price of wheat was nothing but to benefit the big farmers at the cost of voiceless millions. Such a massive increase in the price of the basic diet of the people in general and poor and fixed-income groups in particular was cruel.

This act of cruelty has had multidimensional adverse impact on the economy of Pakistan. Firstly, the empirical evidence suggests that a 10 per cent increase in the support price of wheat increases overall prices (CPI-based) by three per cent. In other words, support price of wheat is highly inflationary in nature and has been one of the root causes of the persistence of double-digit inflation in Pakistan. Over the last three years, the cumulative overall inflation and food inflation have increased by 44.5 per cent and 54 per cent, respectively. The incomes of the poor have not increased proportionately and as such they have been devastated by inflationary pressures.

Secondly, the persistence of double-digits inflation has forced the State Bank of Pakistan (SBP) to keep the discount rate at the elevated level, resulting in a substantial increase in cost of borrowing, discouraging investment (investment has declined from 22.5 per cent of GDP in 2006-07 to 16.6 per cent in 2009-10 – a decline of six percentage points), slowing economic growth (averaging three per cent per annum as against seven per cent in the previous five years) with attendant rise in unemployment and poverty. It has also increased the cost of financing fiscal deficit from domestic sources, thus increasing the share of interest payments in total expenditure. These have been the macroeconomic consequences of the senseless increase in the price of wheat.

Thirdly, the massive increase in the price of wheat has given rise to yet another kind of circular debt. The government not only increased the price of wheat to Rs950/40 kg but also procured 9.2 million tons from the farmer – the highest ever purchases thus increasing the financing requirements from banks to Rs219 billion in 2008-09. In the current wheat season (started May 2010), the government has targeted to procure 7.5 million tons, thus raising the additional financing of Rs178 billion. The outstanding stock of commodity financing at end-June 2010 has been Rs413 billion, of which the wheat financing accounts for overwhelming share. How such a large amount is going to be retired to commercial banks?

On the start of current wheat procurement season, commercial banks were reluctant to provide financing for the wheat procurement but were forced by the SBP and the Ministry of Finance to provide financing. The total stock of wheat as on June 14, 2010, has been 10.7 million tons as against 9.5 million tons on the same date last year. Even if all the 10.7 million tons of wheat are released to the flour mills at the rate of Rs1050/40 kg, the government will receive Rs280 billion – much less than the outstanding stock o Rs413 billion. Who will retire the remaining stock of commodity financing? How commercial banks will finance next year's wheat procurement? Is this a new circular debt in the offing?

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Dr. Ashfaque H Khan, “Yet another circular debt,” *The News*. 20-07-2010.
Keywords: Economics, Economic policy, Economic crisis, Economy, Leadership, Budget, Budget policy, Kerry Lugar Bill, International relation, Poverty, Tax, Taxes, Foreign policy, World Bank, Aid, Pakistan, IMF, SBP, GST, VAT