BUSINESS RECORDER
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17th May, 2019

Currency depreciation was already on the cards

The writing was on the wall. Market was expecting dip in exchange rate as it is one of the supposed pre-conditions of the upcoming IMF programme. The dollar closed at 146.52 while the intraday high of was at 148. The surprising element is that it happened the very next day of PM meeting with exchange companies in the presence of SBP Governor, where control on currency rate was discussed.

Timings of the meeting were not right, as it sent a wrong signal in the market and gives an impression that macroeconomic decisions are not in control of PM. Otherwise, the currency depreciation was on the cards. "A market-determined exchange rate will help the functioning of the financial sector and contribute to a better resource allocation in the economy. The authorities are committed to strengthening the State Bank of Pakistan's operational independence and mandate," stated IMF in its recent press release.

The currency depreciation implicitly shows SBP's operational independence, as it disregarded PM's statement. The question is what does market based exchange mean. Is it the same as a flexible or free float exchange rate where demand and supply of currency determine the rate? If that is the case, it is dangerous in a thinly traded market where only a few bank treasures trade. The currency would be highly volatile and could be detrimental for a fragile economy trying to recover.

It will be highly surprising if this is what the IMF meant by market based exchange rate. The reading of the market players is that it would be some form of managed exchange rate regime. The SBP might have an emergency fund to manage volatility during the Fund programme, and let the currency adjust based on quarterly flows. This is to keep market stable in the short term.

The other way could be to peg it to other economic fundamentals. One popular indicator is real effective exchange rate (REER) computed, based on nominal exchange rate and inflation relative to trading partners. There are different methods to compute REER and based on that currency value could be different.

There is one computed by the SBP every month. The latest published number for March is 104.4. The equilibrium is at 100, and to reach that, nominal exchange rate should fall by similar percentage. In November 2017, REER was 124.2 and was implying 24.2 percent currency depreciation to reach 100, assuming inflation remains constant. The currency depreciated by 29 percent since then - from PKR/USD of 104 to 146.5.

Since inflation moved up due to depreciation, the need of nominal currency movement was higher than REER in past 18 months. A 3.5 percent depreciation yesterday should have brought the REER almost at 100. If this is the peg, every month, the currency will adjust slightly to keep REER around 100..

Higher the inflation, higher would be the nominal currency depreciation to bring REER back to 100. In coming months, with high energy prices and new taxes - removal of tax exemptions, inflation may touch double digits. Market is expecting inflation to peak in September. Expect some currency depreciation after that - in November and December.

There is another way to look at things. According to monetary economists, IMF and SBP use a common methodology - CGER (Consultative Group for ER Misalignment). It is based on three sub-models (macro fundamentals based model, external balance based model and a REER based model). This methodology is implying 15 percent more currency depreciation. It was 18 percent prior to yesterday's adjustment.

The market expects parity at 160-165 by December. A lot however would depend on foreign flows - if the inflows are higher, currency may settle below the targeted rates and vice versa.

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