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The rupee value

The decision of the State Bank of Pakistan (SBP) not to provide an indicative level to banks' treasuries to delineate the range for the rupee-dollar parity led to the rupee depreciating from 141.40 rupees to 146.52 rupees per dollar in the inter-bank market by close of business Thursday. The rate rose to as high as 148 rupees before coming down to 146.40 rupees to one dollar in the inter-bank, reflecting SBP's intervention. The Chief Spokesman for SBP contended that "this movement reflects supply and demand conditions in the foreign exchange market and it will help in correcting imbalances." The question is whether the SBP violated the terms of the staff-level agreement with the International Monetary Fund (IMF) by intervening in the market. The answer is in the negative because the agreement specifies market-determined exchange rate and not a free float.

A market-determined exchange rate is defined as an instruction by the SBP to banks to discover the rate of the rupee vis-a-vis dollar based on their demand and supply situation; in the event that demand is greater than supply for an individual bank it must go to the market to bridge the shortfall. However, the SBP is watching closely at the rate and will act to preempt any element of trying to squeeze the market by any or a group of players in the money market. And that is what happened on Thursday and that is precisely what is likely to happen in days, weeks and months to come or at least till the 39-month $6 billion Extended Fund Facility (EFF) programme is completed. Therefore, the SBP fully complied with the staff-level agreement. Free float is markedly different from a market-determined rate as the price of the currency is set in the open foreign exchange market based on supply and demand relative to other currencies.

The IMF condition for a market-determined exchange rate was necessitated to a large extent by to its own failure in the previous EFF (September 2013-2016) to restrain the then Finance Minister Ishaq Dar from propping up the rupee value through market intervention by the SBP, made possible by shoring up foreign exchange reserves through borrowing. The mandatory quarterly reviews during that time did mention an overvalued rupee, (the tenth review dated March 2016 in a footnote gave a very wide margin for overvaluation of the rupee – between 5 and 20 percent claiming that "model estimates are imprecise and show significant variation, this being only indicative), that eventually led to a decline in exports, as our products became uncompetitive internationally, and a rise in imports, as imports became more attractive, culminating in a record high current account deficit of 19 billion dollars by end of last fiscal year. However, the reversal of this disastrous policy, in spite of bringing the possible negative fallout of an overvalued rupee by Business Recorder as well as independent economists during the ongoing EFF, it was never made into a Fund time-bound structural benchmark or condition for a tranche release.

Additionally, Dar's policy to borrow from abroad to shore up reserves, by rationalizing that the rate of interest is lower abroad than domestically, and issuing Sukuk/Eurobonds at rates well above the market rate (with the then mission leader acknowledging that reserves reflect debt equity) the Fund must also accept responsibility for its part in putting the country into a debt trap.

Thus the IMF has gone from one extreme, looking the other way when the government of a country on an IMF programme engages in artificially propping up the rupee, to the other extreme, by insisting on a market-determined exchange rate when the country's foreign debt as well as the budget deficit have become unsustainable, and that too as a prior condition.

The obvious fallout of the rupee erosion would be a much larger allocation for debt and interest payments in the budget, in the current year the budgeted amount for debt and interest constituted around 45 percent of total current expenditure. Next year the allocation would have to be at least 525 billion rupees more for this item as of today as each rupee loss of value vis-a-vis dollar adds 105 billion rupees to our debt. The staff-level agreement bars the government from reducing development or social security programmes funding, therefore, this implies lower allocation on the next two major current expenditure items – defence allocated 1.1 trillion rupees and running of civilian government allocated 463 billion rupees in the April 2018-19 budget. To accommodate the rise in debt these two expenditure items would have to be reduced to a level that maybe untenable not only politically but perhaps also from a security perspective.

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