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Recipe for an undervalued rupee?

As expected, the rupee is now frequently allowed to adjust to widely unacceptable parity with the dollar on the basis of demand and supply. The exchange rate is operating in a rigged, thin currency market, steered by the ‘invisible hands’ of the central bank and prompted by the International Monetary Fund (IMF).

However, the move towards ‘market determined exchange rate’, whatever it means, is creating problems. The mid-May bout of devaluation was too much for the broad segments of the market to digest as indicated by the stock exchange’s shrill response. Between January 1, 2018 and May 17, 2019, the rupee had depreciated by 34 per cent against the dollar.

Before his resignation, former State Bank governor Tariq Bajwa had reiterated more than once that the rupee’s exchange rate had achieved price equilibrium. And going by his statement, the latest exchange rate adjustment seems to be uncalled for and excessive.

With the real effective exchange rate and intrinsic value of the rupee ignored, devaluation has lost all prudent limits as currency markets lack discipline

To address the issues thrown up by a steep devaluation, the cash-strapped, debt-ridden government is considering setting up a fund to support the beleaguered national bourse. The fund is to be channelled through the National Investment Trust.

A dollar fund may also be created as advised by the IMF to beat back speculative attacks on the rupee with the condition that the State Bank will square off all its interventions at the end of each quarter. The question arises: what kind of markets are we creating?

The government is saddled with a record $105 billion foreign debt which keeps soaring in rupee terms with every bout of devaluation. Debt servicing is becoming more problematic.

By one estimate, the debt surged by Rs661bn because of the rupee depreciation in two days of this month. Within 48 hours, the rupee touched Rs150 to a dollar in the inter-bank market, a level that was maintained in the next trading session the following Monday.

A State Bank statement explained: “this movement reflects the demand and supply conditions in the foreign exchange market. It will help correct market imbalances.”

Analysts say every devaluation in the past few years has followed the same pattern. Also, by a strange coincidence, some of the devaluation moves have been preceded by hoarding that creates an artificial shortage of dollars in the currency market. Thus the currency dealers make windfall profits.

On May 15, a meeting of a delegation of Exchange Companies Association of Pakistan (ECAP) with Prime Minister Imran Khan, attended by the finance advisor and the new State Bank governor, was reported to have reached a consensus that there was no shortage of dollars in the country.

However, the most worrying aspect is that the intrinsic worth of the rupee and its real effective exchange rate (REER) are rapidly losing their weight in the market determined exchange rate. With the two benchmarks ignored, devaluation has lost all prudent limits as currency markets lack discipline.

After three prior devaluations, the REER in March was provisionally at Rs104.41 per dollar. The REER is used to determine the individual country’s currency value relative to other major currencies.

Similarly the disconnect between the market determined exchange rate and purchasing power parity (PPP) of the rupee is widening. PPP is considered the fair value in arriving at the real exchange rate.

For example in 2014, the exchange rate of the rupee measured by PPP was estimated at Rs30.82 against the official exchange rate of Rs103.86 per dollar. Currency analysts say PPP exchange rate remains stable over a long time.

Devaluation plus subsidies have incentivised exports at the cost of productivity in export-oriented industries, worsening Pakistan's terms of trade (TOR) and resulting in transfer of resources abroad.

Cumulatively over the 10 months of the current fiscal year, export earnings rose marginally to $19.16bn from $19.09bn a year ago though a higher quantity of goods were sold for each dollar earned. Therefore, rupee earnings went up 23pc.

A depreciating rupee encourages an increasing number of affluent people to invest in the greenback to protect the value of their money. That explains the phenomenon of flight of capital to a much more hospitable environment abroad while the stashed funds are often used for under-invoiced imports.

Large scale manufacturing (LSM), which contributes 80pc of the manufacturing output and bulk of exports, shrank 10.6pc in March and by 2.93pc over the first nine months of the current fiscal year against the targeted growth of 8.1pc. This happened despite devaluation plus subsidies to boost exports.

The increase in the State Bank policy rate by 150bps to 12.25pc— an 8-year high – effective from May 21, coupled with exchange rate instability, will adversely affect balance-sheet of leveraged companies similar to the time when sharp devaluation took place in the early 1970s. It will also discourage long-term fixed investment.

In their meeting, the ECAP delegation had urged the primes minister to ban imports of goods produced locally that, according to ECAP, could reduce the import bill by $5-10bn. Trade imbalance is the core issue that is triggering growing protectionism worldwide.

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