BUSINESS RECORDER
Founded by M.A. Zuberi

28th November, 2019

Analyses & Comments by BR Research

Exchange rate – cautiously optimistic

The US-PKR parity moved down from its peak of 164 in July to 155.3 in Nov. The question is how would the currency to move in months to come. One crucial variable is the Real Effective Exchange Rate (REER), other important indicator is current account balance and the third factor is overall balance of payment situation. There are different models central banks use to evaluate the equilibrium value, and market evaluates these factors along with demand supply situation to determine the price.

The SBP publishes monthly REER value on 2013 base of 100, and any movement is pegged to it. The REER peaked to 120 in Nov-17 and exports were highly uncompetitive while imports were becoming cheaper and resultantly the current account deficit was growing. There are two factors that determine REER – one is nominal exchange rate relative to trading partners and other is relative inflation to those countries.

Since Dec-17, nominal currency started depreciating while the inflation in Pakistan remained relatively low in FY18 and FY19, and both factors helped REER move down – touched its low at 89.8 in Jul-19. Thereafter, due to improvement in current account deficit and overall supply of foreign currency, the nominal currency started appreciating. However, the inflation started creeping up, and REER started moving up again – as per latest SBP data, it is at 94.4 in Sep19.

In the last two months, inflation moved up further to let the REER go higher – it is standing at 98.9, as per Bloomberg data. Now the question rises again, whether there is some need of currency correction. Current account recorded a surplus in October, and the capital/financial flows in balance of payment have increased too – ADB/WB related flows are coming in, foreign portfolio investment is pouring in, SBP forward liabilities are decreasing and there are signs of domestic foreign currency conversion too. Seeing all these, there are no apparent pressures on currency depreciation from demand and supply.

One of the reasons for higher rupee demand is the relative competitiveness of Pakistan to its trading partners. According to an SBP graph, the relative competitiveness of Pakistan, based on REER, to India, China, Malaysia, Thailand, Sri Lanka, Philippines, Indonesia and Mexico, was marginal (2014-16) and the country was completely out of competitive range in 2017, before reverting to competitive band in 2018; and today, it is in the middle of the range.

That is encouraging and making exports competitive, and the theoretical assertion is validated by exporters who are finding it hard to cope with the demand in existing capacity, and many textile and other sectors are in the process of expansion. However, REER upward movement due to higher inflation is a point of concern.

This could lead to nominal currency depreciation. But on the basis of current account and overall foreign currency market supply and demand position, REER pressure can be subsided. The key question is the inflation expectations relative to peers, and that could give some clue on the nominal exchange rate movement. If inflation comes down, REER can come down from current levels of 98.9.

The good news is that inflation is expected to recede in the second half of this fiscal and that could ease the pressure of higher relative price index. On current account, the central bank and market expect the deficit reduction to continue. There is EBA CA model that tells about required currency adjustment based on current account deficit.

In simple words, if current account deficit is higher than manageable levels, nominal currency depreciation is required. Seeing the reduction in deficit, the currency is comfortable from this point of view and that can absorb the recent increase in REER. On overall balance of payment, reserves are building, and more importantly Net International Reserves (NIR) position is improving – the forward liabilities of SBP are reducing fast.

The external borrowing is moving away from high cost commercial borrowing to concessional long term flows from ADB and WB, which is lowering the risk of future external repayment pressure. Now if the economic growth picks up, there will be higher pressure on imports and that could result in current account deficit out of the permissible limits – and that may require nominal currency depreciation.

For growth to pick up without having pressure on currency; demand-supply situation has to be improved. For that reserves, have to be built, and foreign portfolio investment is needed till the time FDI is attracted. The portfolio investment has crossed billion dollars – with over $600 million in one month. However, virtually all the flows are in 3M papers, and that is a point of concern. There is a need to have more flows in long term bonds, and taxation issues in PIBs must be resolved. The buzz is that taxation problems will be fixed in December, and this coupled with upcoming positive IMF report on first review, the flows will accelerate. Plus, the concessional multinational flows can also pick with better IMF report card.

The SBP could then think of running pro-growth policies. But for that interest rates have to come down, and some fear that portfolio investment may fizzle once the rates are down. That could be the case when economic fundamentals are weak, but if macro picture is better, the story can be sold at lower rates to carry trade investors.

The bottom line is that in early phase of stabilization, running a pro-growth strategy can put a pressure on currency and can erode confidence.

The reserve building needs to continue, fiscal consolidation needs to go deeper and current account deficit reduction needs to be certain, before opening up the avenue of much needed growth.