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Dollar diary: don't go the Dar way

The exchange and interest rate shocks sent jitters to the investors' community on Friday. First half was no different than the previous half a dozen currency depreciation episodes as long as communication between SBP and bank treasurer is concerned. The currency recovered in the second half to Rs136-136.50 per USD, as the SBP intervened after a stern notice by the PM.

Clarity is missing on whether the first half sharp decline in rupee was an independent move of central bank or it was with the advice/consent of finance ministry. With a decision of unexpectedly high (150bps) jump in policy rate, on the same day, it appears that both movements are IMF programme's pre-conditions. The focus should be on how to subside uncertainty in economic pricing, especially in exchange rate.

It is a politically sensitive economic indicator in Pakistan and because of that there was a strong affinity with sticky exchange rate in tenures of both Shaukat Aziz and Dar. Too frequent sharp movements in currency can erode investors' confidence which will not be easy for the incumbents to restore; but the currency should not be kept artificially high to come to a point of successive sharp depreciation.

The currency should be anchored in a transparent way for analysts to predict and investors to decide on future plans.

The IMF wants a free float; but that is a recipe of disaster in a thinly traded forex market. A few hours of no intervention on Friday, almost created a political crisis, compelling the highest authorities to intervene.

A better strategy could be to openly peg the exchange rate to real effective exchange rate (REER). It is a weighted average measure of trading partners' nominal exchange rate and relative price index. The SBP computes the monthly number based on an agreed methodology with the IMF. The equilibrium number of REER is 100, if it is over 100, the local currency is required to depreciate and vice versa.

The target should be to keep REER between 100-105 and adjust currency both ways to keep it in the band. The REER averaged 97.4 during Shuakat Aziz time, while in PPP tenure it averaged at 101.4 - the currency was not overvalued back then. The problem started in Dar's time, when REER shoot up from 104.3 in June13 to 124.9 in June17 - it averaged at 118.9 in the Dar(k) era.

It started receding after the currency depreciation started in Dec17 to stand at 108.1 in Oct18- rupee depreciated by 24 percent during Nov17-Oct18 while the REER appreciated by 13 percent in the same time. This means in current dynamics of Pakistan nominal currency and price movement relative to trading partners, REER adjustment is almost at half the pace of nominal depreciation- based on this ratio, the REER would come at 106.8 in Nov18.

To bring it close to 100, the rupee dollar parity could reach at 149.7. The fair value of dollar comes at 150, with 10 percent more room of depreciation to bring REER at 100 today. The need is to negotiate with the IMF or to come with an open policy to keep REER in a band of 100-105.

At Rs136.5/USD Friday closing, REER is valued at 105 and the SBP should not bring any change in parity till next month's actual numbers, and adjust accordingly to bring REER in the said band.

That is the story of exchange rate which is now fast approaching fair value. The SBP had the knowledge of REER adjustment prior to making the number public, and probably seeing it, Friday round of depreciation took place.

And seeing further room of depreciation, the central bank went too hawkish in its monetary policy stance.

Perhaps, 150 bps hike was a little too high. Anyways, both currency and interest rates are pricing indictors and they can move either way with changes in other fundamentals - inflation, current account deficit, and most importantly fiscal deficit.

Inflation is not likely to move in tandem with currency depreciation as food prices in Pakistan are already higher than international prices; and the blessings of low oil prices are with the government to lessen the woes. If the government is able to implement half of its intended reforms in taxation, money laundering, agriculture and exports; within a year or so, the prices (interest rates and exchange rate) may start swinging the other way.