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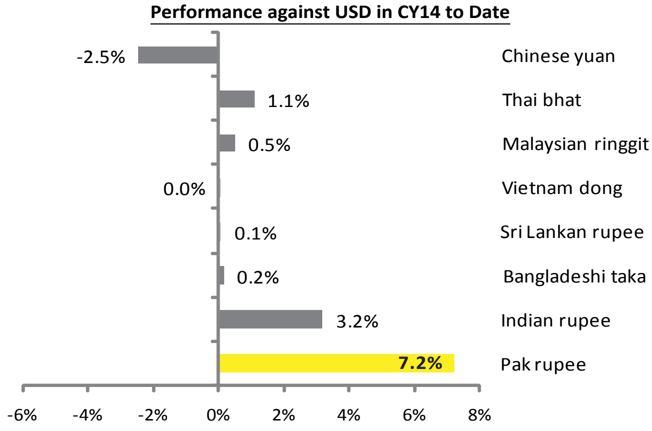
Is The Present Exchange Rate Sustainable?

In this interwoven world, exchange rate provides a link between domestic and international markets for trade of goods, services and other types of financial transactions. Misalignment of exchange rate can create severe macroeconomic disequilibria. International Purchasing Power Parity (IPPP) theory has been used by the policymakers to determine the relative value of different currencies. IPPP theory states that exchange rates between countries are in equilibrium when their purchasing power is same. When a country experiences higher inflation than another country then that country's exchange rate must depreciate by the inflation differential between the two countries in order to maintain its trade competitiveness. If a country is facing higher inflation relative to another country and does not depreciate its currency, then generally its exports will become uncompetitive and suffer, its imports will become cheaper and increase, and it will face a higher trade and current account deficit in the future.



During March, the Pak rupee has strongly appreciated by 6.2% against the US dollar, making the local currency one of the best performing in CY14 so far. It all started with a healthy build up of foreign exchange reserves (albeit from an abysmally low level) mainly driven by unexpected receipt of USD1.5bn in aid from Saudi Arabia buffeting speculators, exporters and general public, who were holding dollars in anticipation of further rupee depreciation.

Notwithstanding some positives of the aforesaid currency movement, such as lower imported inflation and decline in rupee value of foreign debt, we believe that the prevailing exchange rate, if sustained, would render the domestic economy uncompetitive, and will result in a significant increase in the trade and current account deficits in the future. With foreign exchange reserves of only around US$ 9.7 billion, Pakistan cannot afford this. Inflation has risen over the last 12 months, and with further tariff hikes on the cards, we expect the aforesaid trend to continue going forward. Thus, if nominal exchange rate remains stable, rupee's real effective exchange rate will continue to appreciate over time.

As depicted in the following table, cumulative inflation in Pakistan since July 2008 has been 68.2%. During the same period, inflation in the US amounted to 6.7%. Thus, Pakistan's inflation differential with the US since July 2008 is 61.5%. While, over the same time, Pak rupee has depreciated by 38.0% against US dollar. Hence, post its strong performance in the current month, Pak rupee is already overvalued by 23.5% against US dollar in inflation-adjusted terms, taking July 2008 as base period.

Cumulative inflation since July 2008 -Pakistan	Cumulative inflation since July 2008 -USA	Inflation differential with the US	Cumulative PKR depreciation against USD since July 2008
68.2%	6.7%	61.5%	38.0%

Source: SBP, BLS

Pakistan went through a similar episode during FY04-09 (see table below), when the then government did not adequately devalue the rupee, despite high inflation differential with the US. Due to an overvalued exchange rate, country's trade deficit started ballooning, rising from 1.2% of GDP in FY04 to an unsustainable level of 8.8% in FY08. This forced the government to massively devalue the Pakistani rupee in FY08 by about 11% and FY09 by 21% against the US dollar before the trade balance started improving.

	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Pak CPI inflation	4.6%	9.3%	7.9%	7.8%	12.0%	17.0%	10.1%
US CPI inflation	2.2%	3.0%	3.8%	2.6%	3.7%	1.4%	1.0%
Inflation differential with the US	2.4%	6.3%	4.1%	5.2%	8.3%	15.6%	9.1%
PKR depreciation vs. USD	**0.3%**	**3.0%**	**0.8%**	**0.8%**	**10.9%**	**20.4%**	**5.3%**
Pak trade balance (% GDP)	**-1.2%**	**-4.0%**	**-6.5%**	**-6.2%**	**-8.8%**	**-7.5%**	**-6.5%**

Source: Pakistan Economic Survey, BLS

A prerequisite for exchange rate stability is price stability alongside a healthy FX reserve position. Thus, in order to maintain a stable exchange rate, the government will have to first control inflation. Otherwise, this massive appreciation of the real effective exchange rate will take a heavy toll on our economy over the medium term.