<u>Why does Pakistan have to accumulate foreign reserves</u>?

By Dr. Ishrat Husain

The critics of the present policy on reserve accumulation fall into three distinct categories. The first group consists of 'I don't accept' type who do not wish to be bothered with any facts and for them this is simply juggling of statistics. They do not have any credibility in these numbers and don't believe that the country has so much reserves. For them, I can only pray that Allah opens their minds and allows them to see some light. They can, if they choose to do so, verify the credibility of these statistics by looking at our weekly statements over the past 32 months particularly when we didn't hesitate to announce publicly in October2000 that SBP reserves were down to $ 995 million only. It is also a widely known fact that it was the Annual Report of SBP for 1999-2000 which disclosed, for the first time, a complete and comprehensive picture of the country's external debt and liabilities including the Military Debt and has been publishing the updated data every year since then. We also regularly publish all the inflows and outflows of foreign exchange received or paid by the country. For greater transparency we have for the first time since April 2001, begun to segregate the SBP deposits from those of our banking system. As the banks were allowed to retain these deposits and to manage them on their own in the best interest of their customers, it was essential that these should be disclosed separately. This has assured resident and non-resident Pakistanis that the risk of freezing their deposits due to mandatory surrender requirement to SBP has been eliminated and they can safely deposit their foreign currency in Pakistani banks. But even despite such transparency and disclosure if this group dismisses the numbers we can't do very much to reassure them.

The second group consists of those who consider foreign reserves to be 'irrelevant' as this hasn't helped the conditions of common man. They confuse the domestic budgetary resources with external resources and are not perhaps fully aware of distinction between the fiscal and external accounts. Foreign reserves belong to the whole nation – the government and private sector while budgetary resources belong to the Government alone. In theory these reserves can be transferred to the Government by SBP in form of loans. This group would like the SBP to draw down these reserves and provide the equivalent rupees to the Government. The Government can then use these resources in a variety of ways (a) increase its development expenditure and thus boost the declining investment level, (b) insulate the general public from hikes in petroleum prices, electricity and gas prices by providing subsidies, (c) devise special schemes such as Housing, Yellow Cab, Yellow tractor, (d) set up programs for direct employment creation, (e) extend concessional loans at low rates of interest for agriculture, exports, SME and IT sectors. What will be the consequences of this policy? The reserves will be exhausted in less than two years, the Government's domestic debt will increase by Rs 420 billion and debt servicing component of the budget will create additional annual budgetary outlays of Rs 40 billion every year and inflation will most likely be in double digits. But none of these schemes or subsidies can be sustained after two years i.e. after the reserves are exhausted. This Government can become very popular among this group of critics by following this course of action and appeasing the general public. But the legacy to the succeeding governments will be an empty coffer, a serious risk of default, higher burden of debt and severe inflationary pressures. Incidentally, these were the same individuals who were using the stick of level of reserves in 1999 and 2000 as an indicator of economic performance of this Government and alerting everyone to the imminent default on external debt. Now that these reserves have reached a respectable level they are pooh-paahing these as being irrelevant. It is therefore hard to convince this group. However, an attempt is made in the final section of this paper to identify the links between reserve accumulation and real economy.

The third group of critics recognizes that the reserve accumulation is indeed a remarkable achievement but they attribute it mainly to non-economic factors such as the September 11 events and are skeptical about its future sustainability. In their view this is a one-off change which is unlikely to recur in the future. Some of them are also concerned about the non-traditional ways in which the reserves were accumulated in the past. This group is indeed raising the right questions and deserves a detailed response.

The more valid theoretical argument that under a free floating exchange rate regime the supply and demand will equilibrate and thus there is no need to accumulate reserves has not been raised by any one. In practical terms developing countries have become more cautious since the 1997 Asian crisis and believe that the sudden change in market sentiment can leave them highly vulnerable. Therefore they fall back upon reserve accumulation as a precautionary step and a first line of defence against such possible eventualities. China and India's large reserves today cover more than 12 months' imports. So do a large number of Asian countries including Japan. The following excerpt from a recent Reuters' story on growth in Asian forex reserves summarizes this trend more succinctly.

"The reserves of Asian and Japanese Central banks jumped more than 10 percent in the first half of this year as they bought dollars to slow the rise of their currencies, giving a valuable hand to their exporters and helping to fend off deflation. The developing economies of Asia were natural importers of capital until 1997 financial crisis brought home with a vengeance the vulnerability of running current account deficits in an era of footloose global capital. Their reserves melted away like a snowman in the sun, forcing Thailand, South Korea and Indonesia to ask the International Monetary Fund (IMF) to bail them out. Since that traumatic episode, Asia has saved more than it has invested resulting in big current account surpluses that have been partly recycled in the form of an accumulation of official reserves."

To those Pakistanis who would like the country to be free from the influence of the IMF there is no other better option to assert our economic sovereignty than to accumulate these reserves.

Of course, there are many well-informed observers and commentators who are aware of the positive benefits to the country from pursuing such a policy and who feel good about it. The arguments presented in this paper will reinforce their conviction and inform the rest of the community which would like to be enlightened on this issue.

I would therefore like to divide my presentation today by addressing the following three questions:-

(a) Why does a developing country have to accumulate reserves? What is an optimal level of reserves for Pakistan?

(b) How did we accumulate reserves during the last 32 months?

(c) How does the level of reserves affect the real economy?

(a) Why does a country accumulate reserves?

There are several reasons for a poor developing country to accumulate reserves.

First, Reserves are used as a tool of exchange rate and monetary policy management. The Inter bank market is used to affect monetary policy by either supplying domestic currency to the market or buying it in the market against foreign currencies. This affects the domestic money market balance and so domestic interest rates. In Pakistan where the foreign exchange market has been liberalized the State Bank of Pakistan intervenes to affect the rate at which rupee trades. The objective of a stable, realistic exchange rate which does not erode the competitiveness of Pakistani exports can only be realized if the SBP has adequate reserves and can intervene at times to achieve this objective. In the long term we have to maintain or enhance Pakistan's share in the world markets and this market share cannot be allowed to slip away due to volatility or violent swings in the exchange rate. A pro-active policy of Reserve management helps Pakistan in maintaining the competitiveness of its goods and services in the world economy.

Second, reserves provide funds in foreign currencies for servicing external debt and liabilities. Adequate foreign currency is needed at the time when debt servicing payments fall due to avoid a default. Unlike in the past when the State

Bank and the Government had to raise expensive commercial loans to make these payments, gradual accumulation of reserves through non-debt creating means to a sufficiently comfortable level avoids the panic in the market and obviates the need for contracting additional debt for the country. This approach of raising resources at the time of making payments reduces credit rating agencies' confidence in the country and also entails large open currency risks on the liability portfolio. The costs become invariably quite high when the lenders know that the country has to make payments and has very little choice. A high level of reserves provides implicit guarantee to the creditors that the country will be able to meet its obligations on time.

Third, in case of Pakistan, reserves are held as a defence against unforeseen emergencies or as a cushion against unanticipated exogenous shocks. In May 1998, the open market exchange rate took a deep dive because the level of reserves was inadequate to meet even partial withdrawal of foreign currency deposits. Again in 2000-2001 when the SBP reserves were hardly around $ 1 billion enough for 3 weeks imports the free float of currency led to a steep depreciation of 18-20 percent shaking the confidence of the markets. There was no economic rationale for such a free fall of rupee. In contrast, the country had accumulated reserves upto $ 3.2 billion by September 10, 2001 and there was no speculative attack on rupee either after September 11 or December 13 or May 8, 2002 or May 13, 2003.

The market participants were in no hurry to either hoard the dollars for their future requirements or to withhold supplies in anticipation of further depreciation of currency. This confidence building measure along with favorable external developments such as stringent conditions imposed on Hundiwalas in the U.S. and UAE helped a great deal by accelerating inflows of workers' remittances to Pakistan through the banking channels. The experience of the unforeseen shocks recorded during the last one year does substantiate the belief that large reserves do act as a cushion against possible exchange rate instability and consequential flight of capital.

Fourth, in addition to improving liquidity in foreign currencies high level of reserves also contribute to the creditworthiness of the country. By repaying most of its expensive commercial and short term liabilities during the last two years, Pakistan has improved its debt indicators. The standard practice of Bank of International Settlements is to show net external debt and obligations of each country. This figure is derived by deducting the country's reserves lodged as deposits overseas from the gross claims of the external creditors. The reserves of the country reflect both the SBP and banking system's holdings. But for the purpose of net external debt calculations we use only the SBP's own reserves. In

1999 when Pakistan's gross external debt and liabilities amounted to $ 38 billion and the liquid reserves held by SBP were slightly above $ 1 billion the net external debt and liabilities of Pakistan was approximately $ 37 billion and the net debt/GDP ratio was 62 percent. As the SBP has accumulated reserves of about $ 5 billion and the gross debt stock has been reduced to $ 36 billion the net external debt and liabilities at end-June 2002 amounted to $ 31 billion. The net debt/GDP ratio has lowered to below 50 percent. This improvement in credit worthiness and debt indicators has helped in the upgrading of the rating of the country by Moody's and S&P and also has a direct influence on the decisions of foreign direct investors and portfolio investors. It is another story that the perceived security and political risk of Pakistan is still quite high and thus act as an inhibiting factor in the flow of foreign investment.

What is optimal level of reserves of Pakistan? There is no precise measure which can provide a guidance to this question but a number of partial indicators can be taken into account. One is the traditional indicator i.e. coverage of months of imports. On this indicator we have progressed from a low of 3 weeks of coverage to 7 months coverage i.e. a jump of almost 9 fold. The second is the ratio of short term external debt to foreign reserves. This ratio has come down significantly from 207 percent in 1999 to 42 percent at end June 2002. Third, we have to relate the level of reserves to servicing of external debt and liabilities. In 2001-02 the country actually paid about $ 6 billion in servicing its external debt which is almost 40 percent of foreign exchange earnings. This was despite the rescheduling of our Paris Club debt on which we saved $ 1.5 billion debt servicing. Had the reserves been low it won't have been possible to make such large payments. Finally, comparison with other countries in the region can also provide some insights. In 1999, the ratio of foreign reserves held by India was 40 times that of Pakistan. By June 2002 this ratio has declined to 8 times while the size of Indian economy is about 6 to 7 times that of Pakistan.

It can be seen from an examination of our debt indicators and comparison with other countries that the country hasn't yet reached the optimal reserve level as the debt burden is still quite heavy, and while the risks and vulnerabilities have been mitigated to some extent the country has still a long way to go before it can declare victory.

(b) How did we accumulate these reserves?

There are two popular viewpoints expressed in the media about the sources of reserve accumulation. Prior to September 11, 2001 the concern was that the SBP was purchasing dollars from the open market and this was not the right way to build up reserves. As I have explained on numerous occasions in the past the country did purchase almost $ 4 billion from open market during 1999-00 and 2000-01. Pakistan had no other choice as medium and long term external capital flows to the country had turned negative in both these years (minus 380 million in 1999-00 and minus 738 million in 2000-01), i.e. a poor country such as ours was paying that much more out of its own resources than it was receiving from abroad. Payments of $ 3,756 million and $ 5,101 million had to be made for debt servicing in 1999-00 and 2000-01. We had two options available – either to resort to the usual commercial borrowing and thus add to an already unsustainable level of debt causing additional debt servicing obligations for the future or purchase the remittances of Pakistani workers channeled through open market at the prevailing rate which was Rs 2 – 3 higher than the inter bank rate. We chose the second option, made all the payments due on time, built up our reserves, avoided commercial borrowing and saved the country from future debt servicing of approximately $ 400 million annually. In the process we paid Rs 11.6 billion over and above the inter bank rate to acquire this amount of $ 5.2 billion. In terms of cost benefit analysis the country was definitely a net gainer by choosing this option.

After September 11 it is being argued that all this build up has taken place due to political and non-economic factors as Pakistan had aligned itself with the U.S. in the fight against terrorism and this largesse is a direct result of this reward. In other words, this is a one-off phenomenon which is unlikely to recur in future and thus the Government should not self congratulate itself on this achievement.

They believe that the fundamentals haven't changed in any significant way and the underlying determinants are still weak.

What are the economic fundamentals which determine the path of reserve accumulation while moving towards a path of debt sustainability? These are (a) reduction in trade, fiscal and current account balances (b) net inflows of non-debt creating foreign private capital i.e. remittances, FDI and portfolio investment (c) reduction in debt servicing payments (d) net inflows of official assistance on concessional terms from international and bilateral donors.

During the last three years (1999-00 – 2001-02),

?? Trade gap has narrowed from $ 1.6 billion to $ 1.2 billion. Current account balance has turned surplus to $ 2.7 billion from a deficit of $ 1.9 billion.

?? Fiscal deficit has been reduced from 6.1 % to 4.9% of GDP.

?? Remittances have jumped 2.5 times from $ 1,060 million to about $ 2400 million.

?? FDI flows have averaged around $ 400 million annually.

?? Reprofiling of bilateral debt stock has resulted in a saving of debt servicing of $ 1 billion annually.

?? Repayment of $ 4.5 billion private, commercial and short term debt and liabilities has reduced the stock of debt and thus extinguished future debt servicing obligations.

?? IMF, World Bank, ADB and other donors are providing concessional assistance of about $ 2.5 – 3 billion annually while their hard term loans are being repaid.

It may thus be seen that reserve build up has in fact taken place mostly through a combination of those measures which are underpinned in economic fundamentals. The end result of the above measures is that Pakistan has generated a current account surplus for the first time in many decades and its vulnerability to external shocks has reduced to a large extent.

Will this process sustain itself over time? Conceptually, the positive reserve would result from the interaction of current account and capital account balances. Very few developing countries can show capital account surpluses until foreign direct investment exceeds all other capital outflows. Thus the only plausible way is to generate current account surpluses which are larger than capital account deficit. Again, developing countries cannot be expected to have exports higher than imports on a consistent basis for long periods of time. Thus current account surpluses are likely to originate from services and current transfers accounts and by reducing net exports to a manageable level.

Services include interest payments on external debt. As bilateral debt has been restructured only moratorium interest payment will be made. Multilateral debt is undergoing a shift in its composition as new loans are being contracted on concessional terms and old non-concessional loans are being repaid. Expensive commercial debt and short term debt have been repaid during the last two years thus reducing the interest payments due. Debt servicing payments will thus be lower than originally due.

The more critical factor in case of Pakistan is workers' remittances. In 1999-00 and 2000-01 these remittances were channelized by the State Bank of Pakistan by using both the open market as well as the inter bank market. These aggregate inflows into the current transfers averaged about $ 3 billion annually. Since September 2001 these remittances are coming mainly through the inter bank market but the overall amount has remained unchanged as the inflows from open market have consequently declined. As foreign exchange market is further liberalized and the two markets are unified this volume of $ 3 billion will continue to flow into the current transfers account. It is quite likely that it may in fact go up as our foreign exchange market becomes integrated and thus more efficient. So those who believe that the increase in remittances flowing through the inter bank market in post September 11 period is unsustainable are mistaken. It was simply a shift in the source of mobilization of these remittances – from the open market to inter bank market but the overall volume flowing into the country's current account has remained largely unchanged during the last three years.

Looking forward, the grant assistance received from the USA and other donors this year was of a temporary nature and should be discounted. Assistance from IMF (approximately $ 500 million annually) should also not be counted upon after 2004 when the present agreement is concluded. Beyond 2004, exceptional financing of the type received in the past two years should not be included in any calculations except that the reprofiling of Paris Club debt has been secured on a long term basis.

The volume of assistance from the World Bank and ADB will depend upon the implementation of various structural reforms agreed with them. To the extent we continue to remain on track their concessional loans will remain available. But as soon as we break these commitments these flows will disappear.

FDI flows will depend upon the macroeconomic environment, hassle-free and liberal regulatory regime, improved law and order and geopolitical situation. Exports are expected to increase at average 10 per cent annually but it needs to be recognized that no developing country is expected to build up reserves by simply increasing exports because its imports will always be higher than its exports. In other words, its exports will not be sufficient to finance its imports and its net exports will be negative. What the country can do is to minimize the gap between its exports and imports and this is exactly what has been accomplished during the last three years and should be pursued in the future too.

It may be relevant to point out that the biggest quantum jump in our reserves had taken place between July 2000 and June 2001 i.e. well before September 2001. During this one year period the reserves increased by 138 percent to $ 3.1 billion. The rate of increase during July 2001 and June 2002 was 105 percent. Thus it should be noted that the perception that the windfall gains of September 11 helped build up Pakistan's reserves, while partly true, is highly exaggerated and the real turn around had in fact begun to take place a year before that. The major reason for this improvement was rescheduling of debt by Paris Club and purchases of workers' remittances by the SBP.

To sum up, the question whether the reserves will continue to accumulate in future also will depend upon the record of the country in adhering to macro-economic objectives, pursuing good economic management and implementing structural policies. In case the progress is on track the reserve accumulation will be durable and sustainable.

(c) <u>How does the level of reserves affect the real economy</u>?

As we have explained in earlier sections foreign reserves management is an important tool for monetary policy and exchange rate determination. The situation can be contrasted for fiscal years 2001 and 2002. In FY 2001 when the reserves were low there was a steep depreciation of rupee due to speculative attack and flight of capital. The SBP used interest rate as a tool for stemming this onslaught. Although low inflation and a narrowing of the current account deficit did not justify an escalation in the interest rates the free fall in the foreign exchange market and the inability of the SBP to use sufficient reserves to avert this fall left it with no other choice but to raise interest rates. The discount rate had to move up from 11 to 14 percent in 2000-01 primarily to support exchange rate. The costs to the real economy in form of higher lending rate was thus quite substantial. In contrast, the reserves had reached a comfortable level of Rs 3.05 billion by June 2002. The exchange rate remained stable around Rs 64 for next three months and there was very little speculative activity as the markets were assured of the availability of foreign currency as and when they required. As a matter of fact and quite unusual for Pakistan the rupee appreciated by 6.6 percent after September 11 and again remained stable at the new level of Rs 60 for the next nine months or so. The differential in the rates between the inter bank and open market has almost disappeared leading to a virtual unification of exchange rate. Thus a major distortion in foreign exchange market which was fuelling speculation and also promoting flight of capital has been eliminated. The forex markets have been operating calmly without much turbulence. Consequently, the SBP was in a position to ease the monetary policy stance and by January 2002 the discount rate was cut by 5 percentage points and brought down to 9 percent. Government's debt servicing costs were also reduced as the T-bill rates declined from 12.9 to 6.4 percent. The weighted average lending rate of the commercial banks has also gone down to 12 percent from 14 percent without any serious effect on deposit rates. Export finance rate was also adjusted downwards from 14 percent to 8 percent thus providing a large boost to the profitability of exporters. Although the real interest rates are still high in the economy the beneficial effect of lower interest rates is quite significant.

Another way to examine the impact of reserves on every day life is to pose the counterfactual question: what would have happened in post September 11 or post May 8 or 13 or June 14 period in absence of such high level of reserves? Although this is a purely hypothetical question and the critics can always find faults with the scenario we are going to sketch but the past empirical evidence from previous episodes in Pakistan is quite strong to place a higher probability that such an outcome would have materialized.

In absence of a strong reserve position the currency would have again suffered a free fall to Rs 70 per dollar or more and would have continued on a downward slide. The SBP would have intervened by raising interest rates and thus increasing the cost of borrowing for both the public and private sector. The prices of raw materials, inputs and other imported commodities would have jumped up and scarcities would have also surfaced. Petroleum and petroleum product prices which are linked to import parity prices would have been raised with consequential effect on domestic prices of fuel oil, diesel for transportation, Kerosene etc. As fuel oil is used for power generation, by cement industry and other industries the profitability of these sectors would have been hit hard. Electricity and gas prices which are already being resented by the middle class consumers would have jumped to unbearable proportions. Increase in prices of medicines would have caused an uproar in the society. Higher transport costs due to rise in diesel prices would have pushed the prices of essential commodities up and also resulted in higher tariff for low income traveling public which uses public transport. Even the vocal higher middle class which uses cars would have felt the pinch. As the Government's budget deficit would also have expanded due to higher rupee costs of external and domestic debt servicing the SBP would have been forced to expand money supply. The cumulative effect of these price adjustments and monetary expansion would have been double-digit inflation in the country, loss of profitability of many businesses and shut downs of firms and industries particularly those based on imported raw materials and inputs. The shedding of employment by private sector would have added to the ranks of unemployed in the country. The flight of capital by well-to-do Pakistanis who are able to transfer their domestic assets into foreign currency would have put more pressure on the money and foreign exchange markets. The chaos and disorder in the economy would have been highly disruptive hurting the common man most.

The above scenario or its variant has been avoided during the last one year in the face of exogenous shocks such as the September 11, Afghan hostilities, attack on Indian Parliament, the bomb blasts in Karachi etc. This can be attributed to the resiliency of the external sector achieved mainly through high level of reserves while the domestic economy is still under a low investment – low growth – low aggregate demand cycle.

There is, however, a legitimate argument of the critics of the present policy which cannot be ignored easily. They believe that if the SBP had adopted a neutral position and not intervened to defend the current exchange rate the cost of imported goods and services would have been lower due to appreciation of the rupee and the benefits would have passed on to the consumers in form of lower petroleum prices and transportation costs, lower costs of medicines etc. Electricity prices would have remained unchanged and prices of other goods in the economy which use imported raw materials and inputs such as vegetable ghee, tea, steel products, vehicles, motorcycles, refrigerators, TVs, etc. would have come down. While there is a lot of truth in this argument our history shows that while prices are raised more than proportionately and instantaneously in Pakistan by all and sundry the downward adjustment is always sticky. But even assuming that these prices of imported goods would have indeed been brought down the cost which the country had to pay was a sharp decline in the exports and an erosion of our share in world markets and diversion of home remittances from official to unofficial channels. Once a country loses its foothold in a foreign market other competitors step in and capture our share. It becomes extremely difficult then to regain this lost share even if the rupee had begun to depreciate once again. Thus it is a close judgment call to make – whether allow some immediate gratification to consumers of imported goods or tolerate this burden by helping our exporters to not only in maintaining existing but penetrating new markets and introducing new products. It is our judgment that in a globalized world where every developing country is trying to edge the other out of the markets the long run benefits of foreign exchange receipts to the country in the form of export revenues and higher remittances from overseas Pakistanis far exceed the short run pains suffered by the consumers of directly or indirectly imported goods and services in the economy.

Conclusion

There is an inherent trade-off in the short run between a debt reduction strategy and a public sector led growth acceleration strategy. As the country was under a heavy debt trap and faced with an acute liquidity shortage it was decided to reduce this vulnerability and secure the external sector of the economy. The stability in the exchange rate, the reversal of flight capital, the arrest in dollarisation of the economy, low inflation, the reduction in interest rate and lowering of debt ratios have been made possible by pursuing this strategy. Building up reserves through an active intervention in the market also ensured that the competitiveness of Pakistani exports is not eroded and the market share of Pakistan in world market is maintained.

The alternative strategy to draw down reserves and allow the Government to prime pump the domestic economy will prove short sighted, expose Pakistan once again to enhanced risk of default on its external debt and liabilities in the future and generate uncertainties and turbulence in the markets. The more viable way to accelerate growth is by inducing private sector to invest. This will require, in turn, political stability and consensus by all political parties on along term economic policy vision and direction for Pakistan, a more business friendly environment, a less contentious and adversarial relationship between bureaucracy and businessmen, improvement in internal and external security situation and the continuation of structural reforms and governance agenda. The tools of economic policy are geared to achieve the set objective. The same tool i.e. reserve accumulation cannot be used as a defence against external vulnerability and as a stimulus to domestic economy at the same time.