**[FALL OF THE RUPEE](http://dawn.com/news/1045193/fall-of-the-rupee)**

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WHY is the Pakistani currency depreciating so rapidly vis-à-vis foreign currencies? How can this trend be arrested? What is the future outlook for Pakistan’s currency? These questions must be addressed in a dispassionate manner.

Economic theory has many explanations for relative currency movements. The simplest one is that if country X records the inflation rate at 10pc per annum while country Y’s is only 2pc, the bilateral exchange rate of country X should result in depreciation of 8pc vis-à-vis country Y.

Hardly any country has economic ties with only one country. Therefore, a trade-weighted exchange rate is used where weights correspond to the relative share in trade with each country in a given basket. The US dollar dominates the multilateral basket as oil payments and other trades and services are settled in US dollars. Given that the latter is the dominant currency, the relative inflation differential between the US and Pakistan becomes a significant determinant of exchange rate movements.

Trade is not the only component of foreign exchange transactions. Workers’ remittances now equal more than 50pc of merchandise exports. Current account balances should be examined for explaining currency movement. A surplus current account implies Pakistan has become a net exporter of capital to the rest of the world.

It can either use this surplus to invest in foreign portfolios or allow its companies to invest directly in other countries. For a poor country the best bet is to add this surplus to the country’s foreign exchange reserves. The current account is, however, only one part of balance of payments, the other is the capital and financial account.

When foreigners bring in their net investment — foreign direct investment or portfolio — or the country borrows in foreign exchange these accounts become positive. The current account surplus along with this positive balance in the capital account means that the country has more foreign exchange than required.

The exchange rate then starts appreciating and we get fewer rupees for each dollar. An appreciating exchange rate makes our exports non-competitive and imports cheaper.

Thus in the next round our current account balance will turn into a deficit to be financed by capital inflows. The exchange rate will start moving towards its previous level. But if the current account remains in deficit and capital balances are negative (FDI and portfolio inflows in Pakistan have fallen from 3pc of GDP to negative during the last five years) then the demand for foreign exchange exceeds the supply.

This excess demand can only be met by drawing down foreign reserves. In 2012/13 the reserves declined by 44pc largely due to repayment to creditors. The rupee has depreciated 17pc since then despite the State Bank losing about $3.5 billion of reserves defending the currency. We faced a similar situation in 2008.

Foreign exchange reserves are a barometer of the country’s external payment capacity. Adequate reserves give a sense of confidence to those engaged in the business of import and export.

Once the reserves start moving downwards, the exporters (suppliers of foreign exchange to the inter-bank market) withhold their earnings (they are obliged to surrender the foreign exchange within 90 days) from the market expecting they will get a higher rate in the next few months thus causing a shortage of dollars in the market. The importers (those who demand foreign exchange from the same market) rush to book their orders to hedge against future depreciation.

The speculators also jump in. This increases the overall demand for dollars in the inter-bank market. As the exchange rate on any particular date is determined by the supply and demand of foreign currency available in the market the excess demand, relative to the short supply, results in depreciation.

This creeping depreciation alerts others and even housewives begin to convert their savings from rupees into dollars. The self-fulfilling prophecy is realised, and reinforces negative market sentiment, and the rupee-dollar parity keeps going down. Additional rupee liquidity in the banking system pumped by the State Bank to finance fiscal borrowing helps the holders of foreign currency as they can now retain their positions in the inter-bank market. In case the State Bank chooses to intervene in the market either by making outright payments for some lumpy imports or purchasing dollars in the forward market it has to run down its reserves. Unless these reserves are recouped their declining level will lead to the same consequences as in the case of the inter-bank transactions.

How can this trend be arrested? In the short run, the market sentiment needs to be reversed by a substantial infusion of foreign exchange or the expectation of such infusion. The present government that enjoys favourable market sentiment has tried to break this vicious cycle by negotiating an Extended Fund Facility with the IMF to essentially pay off future installments of the IMF loan.

It’s also negotiating some quick loans worth $6bn with the World Bank, Asian Development Bank and the Islamic Development Bank. If the government fulfils its obligations for tranche releases and the programme is kept on track, it is possible that the reserves may be replenished to safe limits. Market players will thus be assured that they can sell or buy foreign exchange at a stable rate. Precautionary excess demand and speculative activity will thus gradually be reduced and the inter-bank market would be at or near the equilibrium point and the pace of depreciation will assume normalcy.

So the future outlook for Pakistani currency will squarely depend on the policy performance of the economic managers — how well and swiftly they can restore market confidence through timely measures. If the fiscal deficit is not reduced and continues to be monetised by high-powered money, the reserves remain precarious, supply shortages continue and inflationary pressures persist. This will put pressure on the exchange rate which will move along a downward adjustment path.

Should the government seriously implement the reforms it has committed itself to, the outlook may improve. Any semblance of drift, indecision, backtracking or political expediency during the implementation stage may once again derail the economy from the prescribed path.

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