BUSINESS RECORDER

PKR: The upsides and downsides of devaluation

- DR ISHRAT HUSAIN
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- ARTICLE

The country these days is in grip of serious uncertainty in regard to the fate of the Pakistani currency. Genuine businessmen are in a "wait and see" mode, the social media is full of arguments for and against devaluation while the speculators are busy spreading self-serving rumours. Pakistan rupee has devalued by 2100 percent over the last 70 years but the debate on the effects of devaluation remains unsettled and fiercely contentious.

The purpose of this article is to provide a dispassionate analysis of the issue. Instead of taking a firm or doctrinaire position, we raise several questions and argue that the answers to these questions should guide the policymakers in arriving at a decision.

Economic theory tells us that the efficacy of devaluation depends on the competing effects of demand and supply side impact of the exchange rate. On the demand side, exchange rate has favourable effect as depreciation increases competitiveness and helps increase net exports. On the other hand, it may cause an increase in real interest rate and have a negative impact on investment and growth. On the supply side, depreciation has negative effects as domestic firms adjust prices in the event of both the changes in the exchange rate and prices of foreign goods. Most studies arrive at ambiguous results as the net effect depends upon these competing effects along with the form of exchange rate expectations. In some cases, devaluation has positive effect in the short run while in others it is not fruitful. However, in the long run, the effect of devaluation is neutral.

Empirical evidence suggests that there is no unique or correct way to measure equilibrium exchange rate. Trading partners 'weighted exchange rate' is different from competing countries 'weighted exchange rate'. Most of the discussion of rupee overvaluation is based on Real Effective Exchange Rate (REER) published by the IMF. It is pertinent to mention here that in its November 2006 Article IV consultation Report, the IMF had estimated that the rupee was overvalued by 10 percent according to the equilibrium real exchange rate and external sustainability methods. But their estimates based on macroeconomic balance approach did not point to any overvaluation.

The next question is whether you use current account deficit only or look at the combined current account and capital and financial accounts together. The outcome may turn out to be quite different in two cases. In 2005/06, the current account deficit was nearly 4 percent of GDP similar to the current situation. But it was covered by foreign investment, borrowing from international markets and from multilateral institutions and the overall balance of payment ended up with a surplus of $ 1 billion that was added to the foreign exchange reserves.

Let us suppose that the Central Bank depreciates the currency by 10 percent. What would be the consequences? Some products that are unable to compete in the international markets at the current exchange rate of Rs 106 would be able to benefit as each dollar would now yield Rs 117 and they can cover their costs and make profit. This would bring additional export revenues to the country. Some of the local industries would be able to profitably produce import substitutes as the prices of competing imported goods go up. Both of these responses would help in reduction of trade imbalance. Some of the workers' remittances that are at present diverted to informal money changers may be channelled through the banks. Thus the current account deficit would be lowered compared to the present level. How long will this benign and positive impact last would depend upon the future expectations. In Pakistan, it has been observed that Exchange rate expectations are not formed rationally but follow the Bandwagon effect in the event of discrete devaluation expecting further depreciation in the future. In case the net effect of devaluation on the balance of payments is either neutral or negative or the reserves are not maintained at a reasonable level "Bandwagon expectations" kick in. Exporters withhold their supply of dollars in the interbank market hoping to get a better rate after 90 days-the maximum time allowed to surrender foreign exchange. Importers would rush in with their requirements for next few months to take advantage of the prevailing lower rate which they expect is likely to depreciate further. The market would thus be short of supply and high in demand for dollars and the rate has to move downwards to clear the market.. The expectations are fulfilled.

How are these "Bandwagon expectations" formed? As soon as the currency is depreciated, the foreign buyer will demand from the existing exporters at least 5 percent price discount out of their 10 percent incremental earnings as if these were windfall gains and not a correction to price distortion. Then 40 percent of our exports are using imported raw material directly or indirectly (fuel, LNG, etc). So the cost of this 40 percent inputs will go up and the net gain to exporters will be limited to 2-3 percent as a result of 10 percent currency devaluation. But at the same time, the prices of imported goods will rise resulting in higher inflation. Inflation will adversely hit the poorer segments of the population as they have no assets except their labour and in an informal economy with high underemployment, the wages do not necessarily rise at the same rate as do prices. The central bank will have to raise interest rates to curb inflationary expectations and this would push up the cost of domestic capital. Imported capital goods will now cost more and some of the investment may have to be curtailed, postponed or abandoned lowering the investment ratio and growth rate. Fiscal deficit will also widen as the debt servicing burden in rupees would rise by10 percent partially offset by the higher import duty collection. Government borrowing from banks to tide over high fiscal deficits would crowd out the credit to the private sector further impeding investment and growth. Foreign investors would see their profits in dollar terms decline, discouraging them to bring in new investment. Market players therefore conclude that after the initial gains, the exchange rate would once again come under pressure because of these second and third order effects of devaluation.

What does the recent historical record inform us? During 2002-07, the US dollar traded around 60 rupees and the exports doubled while in the next five years the rupee depreciated by 51 percent but there was no corresponding increase in the value of exports. In the earlier period, inflation relative to trading partners was quite low and fiscal deficit was under control. In the latter period, inflation reached its peak of 23 percent and fiscal deficit had widened to 8 percent of GDP.

The lesson to be drawn from this historical evidence is that sound fiscal and monetary policies are critical to macroeconomic stability. The need for exchange rate depreciation in that event does not arise. To rely solely upon a blunt instrument such as exchange rate while other policies are moving in the opposite direction would prove harmful to the economy.

Markets are based on sentiments and it is essential to maintain the confidence of market players by avoiding the circumstances that form the Bandwagon expectations leading to pressure on exchange rate and depletion of reserves.

To conclude, unlike politics, the art of economic management involves tough policy choices and trade-offs. Each policy creates a set of winners and losers. To decide whether we should opt for depreciation, policymakers have to address the following questions: Are we prepared to curtail current account deficit and external borrowing and live with higher price inflation and lower growth rate? Are we in a position to accept higher unemployment and underemployment as a result of lower growth rate that would follow escalation in the prices of imported capital goods and raw materials for industry? Are we willing to slow down the present momentum of foreign investment and loans by the Chinese companies that would help us in tiding over energy shortages?

Shouldn't we consider alternate policy instruments that reduce the cost of production of our exporters making them competitive by giving them cash rebates expeditiously, resolve their liquidity problems by doing away with the present system of advance payments of taxes, duties and then granting refunds, minimize the interaction of exporters with many agencies of the Federal and provincial governments, give preference to them in allocation of gas, power, water, land etc? Can there be a more simple, transparent, electronically driven, unified method of assessing and collecting taxes, cesses, fees, and other government dues of the federal, provincial and local governments with least discretionary powers in the hands of tax collectors? Should additional incentives be given to the banks which are able to mobilize workers' remittances beyond the threshold levels? Should import duties be raised on non-essential luxury imports while strengthening surveillance on customs officials?

The answers to the above questions after calculating the net benefits of each of these policy decisions should guide the central bank authorities in determining whether we should go ahead with discrete devaluation or not. However, maintaining an unrealistic exchange rate is not sustainable in the medium term. By depoliticizing the exchange rate policy and allowing the central bank to pursue its policy of managed float with a two-way movement of the exchange rate in the inter-bank market, adjustments can be made to minimize misalignments, maintain a realistic rate and thus defuse the stimulus for the formation of "Bandwagon expectations". But it requires that no political statements about the level of exchange rate should be made and the Central Bank allowed to do the job without any outside interference. The Bank staff monitors continuously the inflows and outflows, examines the economic conditions in the trading partners, global commodity prices, policies of the competitors and many other variables and then make judgement call. Experts and outsiders even like former Governors do not have complete information and data. They should hesitate from making these calls as they can only speculate on the basis of their priors and thereby confuse the economic players. Other countries who have empowered their Central Banks have seen stability and calmness in the markets.

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