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# *Quid Pro Quo*

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## The Dutch Disease

**In order to deal with strong domestic demand and rising inflationary pressures, most Asian central banks have been pursuing a tight monetary policy whereby high interest rates prevail in their economies. However now the Asian central banks are finding raising interest rates is not enough to soak up the cash that fuels inflation. Subsequently an increasing number of these banks are turning to the foreign exchange markets for help in fighting inflation. Henceforth the Asian currencies from the Indian rupee to the Chinese Yuan are rising at a record pace.**

**This report will begin by listing the factors which have prompted local currency appreciation vis-à-vis dollar in the regional economies before analyzing the impact that gains in domestic currency will have on the economy. Taking India's economy as a case in point, the report shall then draw a case for appreciation of the Pak rupee.**

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**The Time to Rise**

While the Federal Reserve of the United States is faced with the prospect of trying to support a slowing economy, Asian central banks are by contrast trying to deal with very strong domestic demand and rising inflationary pressures.

It is thus no surprise that most Asian central banks have been pursuing a tight monetary policy whereby high interest rates and high cash reserve requirements prevail in their economies. However now the Asian central banks are finding raising interest rates and selling debt are not enough to soak up the cash that generates higher wages and fuels inflation. Subsequently an increasing number of these banks are turning to the foreign exchange markets for help in fighting inflation. Henceforth the Asian currencies from the Indian rupee to the Chinese Yuan are rising at a record pace. The Indian rupee's 12.6% gain this year is its biggest since at least 1974 while the Yuan has climbed 3.8%, its fastest appreciation since China ended a peg to the dollar in 2005. The Singapore dollar reached a 10-year high after its biggest monthly gain since 2001.

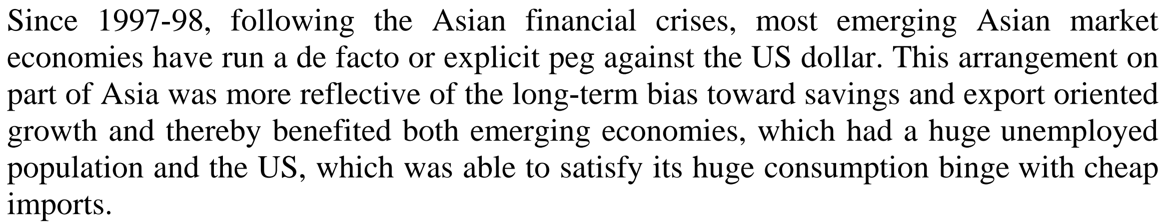
This is in sharp contrast to what has persisted in these economies for the past few years. Most Asian economies have been tightly managing their currencies while trying to run an independent monetary policy. Though these emerging economies have regularly curbed their respective currency strength in order to underpin exports and thus economic growth, in the wake of rising prices and downward pressure on the dollar they now find it increasingly difficult and costly to keep the currency at a stable rate. Hence quite recently we have seen rising forbearance for currency appreciation in the region.

By allowing their currencies to strengthen, Asian countries are particularly attempting to reduce the cost of importing coal, oil, iron ore and wheat, ingredients essential to their booming economies. However the risk is that the goods they produce may become too expensive, adversely impacting the performance of their export oriented sectors.

**The Dollar Decline: What's the Theory Behind?**

For the past few months the dollar has been heading south at an alarming rate, losing its value vis-à-vis other major currencies. The economists have given a lot of arguments and counter arguments, most of them complex and some a little dodgy, in an attempt to explain the dollar decline. However the answer is simple: America is living beyond its means.

The Americans have been living way beyond their means, consuming much more than what they could possibly afford and, in the process, borrowing far beyond their capacity for too long. The spendthrift nature of the American consumers has been supported for long by a policy of maintaining weak currencies across the world, notably in Asia.



Since 1997-98, following the Asian financial crises, most emerging Asian market economies have run a de facto or explicit peg against the US dollar. This arrangement on part of Asia was more reflective of the long-term bias toward savings and export oriented growth and thereby benefited both emerging economies, which had a huge unemployed population and the US, which was able to satisfy its huge consumption binge with cheap imports.

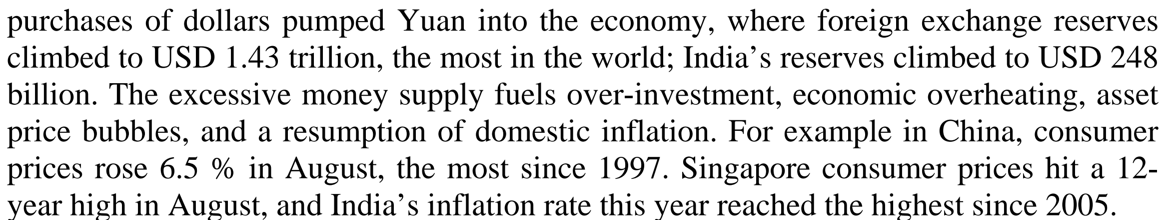
While the going was good, everyone profited and expected the arrangement to continue indefinitely. Unfortunately, the limitations of the arrangement became apparent with time and since late 2006 what we have witnessed is a relaxation of this strategy as more and more policymakers are stepping back from the markets, setting the stage for a faster rise in regional currencies.

This has raised some critical policy concerns in the region as exporters rally against currency appreciation. On the other hand the central banks of these economies are justifying the rise in the value of their currency while some are advocating for even further appreciation.

Before analyzing that whether it is a prudent choice for central banks to step back from foreign exchange intervention and allow currency appreciation or whether the value of all regional currencies will rise any further, it is more critical to determine why we are witnessing a shift in the paradigm in the Asian economies in the first place.

The emerging economies strong economic growth and high domestic interest rates offer promising opportunities for foreign companies. Subsequently we have seen a flood of foreign exchange inflows in the region. The surge of capital and other inflows into Asia has taken a variety of forms, ranging from FDI to remittances sent home by the expatriates. Such huge foreign currency inflows under a flexible exchange rate regime where exchange rate is determined by market forces, essentially results in appreciation of the local currency. However most emerging economies actively manage their exchange rate whereby the central bank is responsible for maintaining the exchange rate within the target band. This essentially means that it has to absorb the additional supply of dollars resulting from foreign inflows which otherwise will result in appreciation of the currency. The central banks therefore move to buy these dollars, in turn increasing the level of their foreign exchange reserves. Though these reserves present a constructive balance of payments outlook in the short to medium term, making it a more than welcome development, it presents a challenge to the monetary management. This is because central bank's purchase of dollars inevitably results in an increase in money supply as it buys dollar in exchange for the local currency which it basically has to create.

Hence Asian economies which have tightly managed their exchange rates hitherto have seen their foreign exchange reserves multiply manifold. The reserves however have translated into increasing base money and broad money supply. For example China's



purchases of dollars pumped Yuan into the economy, where foreign exchange reserves climbed to USD 1.43 trillion, the most in the world; India's reserves climbed to USD 248 billion. The excessive money supply fuels over-investment, economic overheating, asset price bubbles, and a resumption of domestic inflation. For example in China, consumer prices rose 6.5 % in August, the most since 1997. Singapore consumer prices hit a 12-year high in August, and India's inflation rate this year reached the highest since 2005.

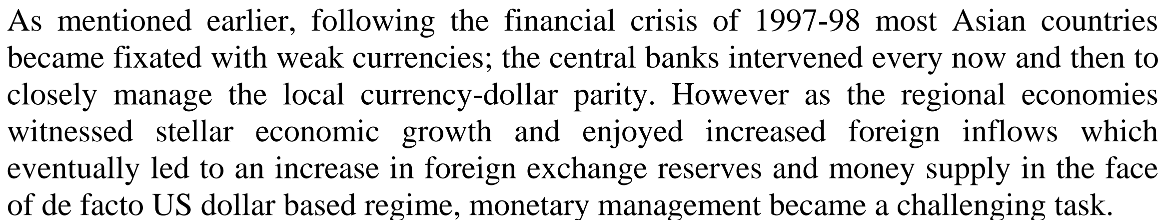
It was under these circumstances that most of these economies had initially tightened their monetary stance by raising interest rates. However one must pay heed that the central banks cannot effectively tighten monetary conditions to reign in credit growth as long as the local currency is de facto stabilized against the US dollar. This is because a high domestic interest rate under tightly managed exchange rates would encourage inflows of hot money through various channels and thereby frustrate monetary tightening even further. For example the People's Bank of China increased rates five times this year, while the Reserve Bank of India has boosted its target seven times in two years. Despite this, China's money supply has expanded more than 18 % in the last three months while salaries in India are expected to climb to an average of 14.5 % in 2007, the most in Asia for the second year in a row.

Thus the resulting reserve money growth calls for an increased need to sterilize foreign inflows and thereby limit the expansion of central bank base money. However it must be recognized that sterilization carries a fiscal cost for the central bank. This is because central banks tend to sterilize foreign inflows via sale of government securities which mop up the excess liquidity. The central bank is then required to pay periodic interest on these securities which appears as a drain on the central bank's balance sheet. In reality, therefore, reserve increases in regional economies have been only partially sterilized, indicating that they have been translated into increasing money supply.

It is thus no surprise that as the regional economies are becoming aware of the costs and limitations of maintaining the de facto US dollar based regime, we are witnessing increasing tolerance over currency appreciation. The central banks of more economies than ever before have allowed greater exchange rate flexibility by intervening much less in the currency market in order to better manage their domestic macroeconomic and financial conditions and achieve; that is to reduce overheating pressures and avoid a build-up of financial vulnerabilities and inflationary pressures.

**Asia gets the Dutch Disease – India takes the Lead**

Dutch disease is a term referring to episodes where large inflows of foreign exchange lead to appreciation of the currency, undermining a country's traditional export industries.



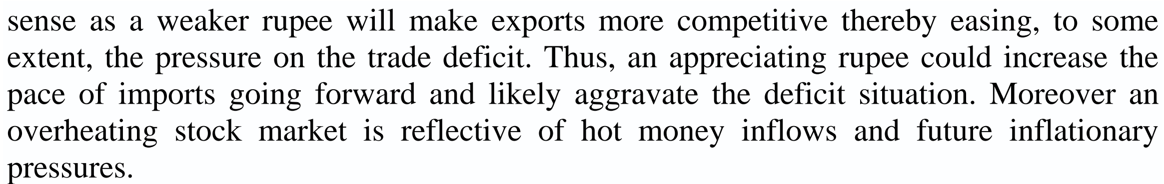
As mentioned earlier, following the financial crisis of 1997-98 most Asian countries became fixated with weak currencies; the central banks intervened every now and then to closely manage the local currency-dollar parity. However as the regional economies witnessed stellar economic growth and enjoyed increased foreign inflows which eventually led to an increase in foreign exchange reserves and money supply in the face of de facto US dollar based regime, monetary management became a challenging task.

Hence the recent inflationary pressures witnessed in the regional economies have been caused by the rapid economic growth and increased liquidity. Subsequently in recent months the central banks of Asian economies have expressed increased tolerance towards currency appreciation. For example the Monetary Authority of Singapore recently said it shall increase the pace of appreciation for its dollar against a basket of currencies to curb inflation. The Singapore dollar rose 2.4 % in September, and is currently trading at a ten year high. Similarly central banks in Taiwan, Korea and China have also scaled back intervention in recent months in what may signal a move toward stronger currencies in the region in an attempt to control rising prices.

So far the best performer in the region has been the Indian rupee. This year rather saw some major developments for the Indian economy. Inflation reached a two year peak of 6.7% in Jan-07. In a bid to check inflation, the Reserve Bank of India raised cash reserve ratio for the banking sector by 50 basis points to 6.5% in April and the Repo rate from 7.5% to 7.75% to curb the excess liquidity in the banking system. However high domestic interest rates and thereby a wide interest rate differential which has widened all the more after the fed funds rate has been cut to 4.75% on 19th Sept-07 has stimulated foreign investment in the local stock market. Subsequently the local stock market hit a record high last week. In the first three weeks of this month foreigners bought about USD 1.5 billion of local stocks, which is about 1/10th of their net purchases in 2007.

At the same time RBI has chosen to stay on sidelines and allowed the rupee to appreciate in the wake of heavy dollar inflow. As a result the rupee has been driven 12.5% up against the dollar this year. Such significant appreciation is however complicating monetary policy and currency management. The reason for RBI’s tolerance for currency appreciation was the same as explained above: While the RBI in the past has been active in intervening in the foreign exchange markets, had they bought the dollars this time, more rupees would have been released into the financial system, thereby negating its aim to cap the liquidity. The rupee’s surge has helped cut India’s inflation rate to an annual rate of 3.4 % in September.

Though the RBI has shown increasing tolerance towards rupee appreciation, it cannot completely disassociate itself from foreign exchange market. This is because the surge in the rupee has its downside as it hurts the sentiments of export oriented sectors notably that of software, pharmaceutical and textile sectors. This is likely to worsen the trade deficit scenario. Typically, in a trade deficit scenario, depreciation of the rupee makes



sense as a weaker rupee will make exports more competitive thereby easing, to some extent, the pressure on the trade deficit. Thus, an appreciating rupee could increase the pace of imports going forward and likely aggravate the deficit situation. Moreover an overheating stock market is reflective of hot money inflows and future inflationary pressures.

Hence the rupee appreciation has to be capped. It is under these circumstances that the India's stock market watchdog proposed on 16th Oct-07 urgent curbs on the flow of foreign funds into shares through instruments known as participatory notes. This will not only cool the overheating market but also calm the rising rupee.

At the same time exporters who have rallied against the gains in rupee must realize that though the rupee appreciation vis-à-vis the US dollar has resulted in loss of revenue it has not eroded their competitiveness as other currencies too have appreciated against the US dollar. Another way of looking at it is to be conscious of the fact that the recent appreciation of the rupee has more or less negated the recent spurt in crude prices which otherwise would have resulted in a hike in petrol and diesel prices. This would have naturally triggered another bout of inflation, leading to interest rate hikes, and the similar series of events would have followed. Hence exporters too have benefited from rupee appreciation even if indirectly. Moreover rupee appreciation will reduce the burden of servicing and repaying of foreign debt of companies that have raised dollar denominated debt.

**Must we get inspired?**

Amid the regional currencies' appreciation, the Pak rupee has also witnessed some appreciation since the beginning of the year. However the rupee appreciation has been very small when compared to that of other currencies. Nevertheless the economy faces similar growth challenges.

The State Bank of Pakistan has been actively managing the economy's exchange rate, particularly the rupee dollar parity for the past few years. The stable rupee and the economic progress under the current leadership have strengthened the confidence of foreign investors in Pakistan's economic growth prospects, as reflected by the increased foreign investment and home remittances in the previous months. In the wake of maintaining rupee-dollar parity, this resulted in expanding the base and broad money supply significantly in FY 2006-07. The money supply for the year was recorded at PKR 658 billion as compared to supply of PKR 446 billion for the previous year. This increase was reflected in the increase in NFA of the banking system; the NFA for FY 2006-07 stood at PKR 274 billion as compared to NFA of PKR 73 billion for FY 2005-06. During the year the money supply growth despite a decrease in private sector credit off take (due

to high interest rates and increased budgetary borrowings), lead to increased liquidity and strong inflationary pressures.

Hence it is no surprise that the SBP further tightened its monetary stance for the current year by raising the discount rate to 10%. However with the Fed funds rate down to 4.75%, the interest rate differential between the two economies has widened even further and is likely to stimulate even more dollar inflows, particularly in the equity market. For example the KSE-100 index hit the highest ever level of 14,366.99 points on 8th Oct-07 primarily on the back of strong foreign investors' interest. In the wake of heavy dollar inflows if the rupee-dollar parity continues stronger inflationary pressures in the coming months are likely to be built. Therefore the only choice left with the SBP like the regional economies is to either accept inflation and high interest rates or to step back from the foreign exchange market and allow the rupee to increase in value. Since the beginning of the CY 2007, the rupee has appreciated by approximately 1%. This however is rather insignificant compared to the rise in the value of the Indian rupee or the Chinese Yuan.

With the persistent inflationary pressures which are likely to aggravate with the oil prices crossing the USD 90/barrel mark, the SBP may have to pull up its strings and allow the rupee to appreciate at a faster pace. However one major hindrance facing the SBP is the trade deficit scenario. The SBP may not let the rupee rise as significantly as the other economies' currencies due to our rising current account deficit. The current account deficit for Jul-May period stands at USD 8.641 billion. Any appreciation is likely to slow down the exports and deteriorate the current account deficit even further. Moreover, the weak performance of the industrial sector over the last year of which textile is a big component may be more susceptible to dollar depreciation as compared to the region economies. The SBP is therefore likely to take account of such risks and allow only marginal/ gradual appreciation of the rupee.

# Economic Snapshot

| Fiscal year 06-07 | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Units | Sep | Oct | Nov | Dec | Jan | Feb | March | April | May | June | July | Aug | Sep |
| Inflation | | | | | | | | | | | | | | |
| Headline Inflation | % | 8.73 | 8.11 | 8.07 | 8.88 | 6.64 | 7.39 | 7.67 | 6.9 | 7.4 | 7.0 | 6.4 | 6.5 | 8.4 |
| Core inflation | % | 6.16 | 5.70 | 5.62 | 5.5 | 5.3 | 5.72 | 5.42 | 5.2 | 4.7 | 5.1 | 6.0 | 6.0 | 6.1 |
| Food inflation | % | 11.26 | 10.54 | 10.62 | 12.71 | 8.7 | 9.99 | 10.74 | 9.4 | 11.3 | 9.7 | 8.5 | 8.6 | 13 |
| Non-food inflation | % | 6.98 | 6.41 | 6.27 | 6.22 | 5.2 | 5.59 | 5.54 | 5.2 | 4.7 | 5.1 | 4.9 | 4.9 | 5 |
| T-bill (Wgt Avg) | | | | | | | | | | | | | | |
| 3 month | % | 8.64 | 8.64 | 8.65 | 8.64 | 8.64 | 8.64 | 8.65 | 8.69 | 8.69 | 8.69 | 8.69 | 9.05 | No bids |
| 6 month | % | 8.81 | 8.81 | 8.81 | 8.81 | 8.81 | 8.81 | 8.82 | 8.9 | 8.9 | 8.9 | 8.9 | 9.12 | No bids |
| 12 month | % | 9.00 | 9.00 | 9.00 | 9.00 | 9.00 | 9.01 | 9.01 | 9.08 | 9.10 | 9.16 | 9.16 | 9.39 | 9.39 |
| External Sector | | | | | | | | | | | | | | |
| Export | Mln US$ | 1,392 | 1,288 | 1,448 | 1,536 | 1,227 | 1,421 | 1,536 | 1,446 | 1,540 | 1,583 | 1434 | n.a | n.a |
| Import | Mln US$ | 2,172 | 2,162 | 2,139 | 2,365 | 2,100 | 2,103 | 2,070 | 2,159 | 2,190 | 2,373 | 2423 | n.a | n.a |
| Trade balance | Mln US$ | (780) | (874) | (691) | (829) | (873) | (682) | (534) | (713) | (650) | (790) | (989) | n.a | n.a |
| Remittances | Mln US$ | 422 | 410 | 448 | 475 | 391 | 457 | 520 | 513 | 537 | 505 | 495 | 489 | 516 |
| Forex Reserves | Mln US$ | 12,512 | 12,503 | 12,460 | 12,960 | 13,212 | 13,378 | 13,624 | 13,661 | 13,778 | 15,182 | 15,723 | 16,106 | n.a |

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