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Rational Resolution

Since FY 2000 the Pakistani rupee has depreciated by only 2% against the dollar as compared to the 54% depreciation of the rupee that occurred in the last five years (FY95-FY99) of the previous decade.

Admiring the ability of the State Bank of Pakistan to sustain a stable exchange rate while preventing the economy from the undesirable implications of wildly fluctuating rates, this paper argues for a gradual devaluation of the rupee to counter one of biggest challenges facing the growing economy—a burgeoning current account deficit.

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The Developing Contradictions

The Textile Sector in Pakistan occupies a significant position in the growing economy, as it contributes a substantial portion to the national income while constituting 58% of merchandise export earnings and employing 40% of the industrial labor force. However quite recently the sector has come under severe crisis as textile exports fell by 7.8% in Jul-06 as compared to the corresponding period of the previous year. This consequently caused the total exports to decrease by almost 10% for Jul-06 enhancing the pressure on the current account. The current account deficit burgeoned to a significant crest of US\$ 4.99 billion for the current year as compared to the deficit of US\$ 1.53 billion for the preceding year. This signals a noteworthy macroeconomic risk facing the Pakistani economy that has continued to exceed the 7% growth rate for the third successive year, while expected to grow above 7% for the coming year.

Though rising energy and financial costs are blamed to be the main culprits for the current crises facing the textile sector, in our view one of the biggest challenges to our products comes from the stable rupee dollar parity. This is primarily due to the State Bank maintaining a stable rupee dollar exchange rate for the past five years that does not reflect the inflation differentials that exist between Pakistan and the rest of the world.

As a consequence of this stable exchange rate two contradicting issues have developed for the growing Pakistani economy - a burgeoning current account deficit and firm expectations of a continuation of stable exchange rate. Moreover, the fact that this stable exchange rate fails to mirror the inflation differentials, the regime has significantly violated the relative purchasing power parity.

Relating the inflation rates of the two countries with the market exchange rate of their respective currencies, relative PPP assumes that the change in exchange rate is determined by price level changes in both countries:

The % change in the RS/US\$ between two periods \approx Inflation Rate Pk – Inflation Rate US

As the price level increased by an average rate of 3.38% in the US for 2005 since the previous year while that in Pakistan increased by 9.28% for the corresponding period, the relative PPP required the rupee to depreciate by almost 5.9%. However on the other hand the rupee depreciated by only 0.88% and hence was overvalued by almost 5%.

On account of the preceding arguments the State Bank has often been criticized by international and local organizations for its strong intervention to sustain an approximately constant exchange rate. Nevertheless, the State Bank has opted to continue a stable exchange rate regime to arrest the excessive volatility in rates. The rupee depreciated by only 0.88% against the US dollar to Rs 60.22/US\$ for FY 06. With this move the State Bank aims to evade the undesirable risks associated with widely fluctuating exchange rates.



The more things change, the more they remain insane!

Wide fluctuations in the exchange rates have adverse implications on the economy in terms of shifting production resources, curbing trade and investment decisions and decreasing confidence in the local currency.

Large and unpredictable changes in the exchange rates result in increasing the exchange rate risk causing the rates to be an unreliable information signal. As calculating prices in terms of domestic currency becomes a difficult task, international trade decisions are hampered especially where the transactions are expected to be settled at some future date. Simultaneously the speculation about currency appreciation or depreciation will discourage international investment:

Consider a US resident investor who invests US\$ 10 million in a capital project desiring an annual 20% rate of return in dollars. Hence he expects to receive US\$ 12 million by the end of the year. Firstly, the investor converts his dollars at the current market exchange rate of Rs 60/US\$, investing Rs 600 million. If the exchange rates fluctuate considerably and the rate depreciates by 10% to Rs 66/US\$, the investor's rate of return shall fall below the expected rate of return. Hence not certain about the rate of exchange, the investor will demand a higher return to adjust for any adverse changes that might result from currency fluctuations. Though the return for the foreign investor can move in both directions depending on whether the local currency depreciates or appreciates, the uncertainty in expected profits tends to decrease the foreign investment.

Additionally due to uncertain price signals production resources are often shifted from exportable goods to consumption goods. This re-allocation of resources may contribute to the rise of unemployment.

As in a volatile exchange rate system there is unlimited scope for speculative positions to be built in both directions, the exchange rates tend to deviate from its fundamental equilibrium position even further. For e.g. if the rupee continues to depreciate against the dollar local residents shall lose confidence in the local currency and desperately rush to hold dollars. This will result in additional depreciation in the value of the rupee causing the inland remittances to dry up, while local residents will shift funds outside the country. Hence the capital flights will assume extraordinary proportions and there could be grave social and political consequences.

The economy of Pakistan has witnessed several of these undesirable consequences of widely fluctuating exchange rates in the previous decade that was marked by wide exchange rate volatility in contrast to the currently prevalent stable rupee dollar exchange rate.

In Sharp Contrast

Prices were highly volatile in the 1990s, ranging between 5.7% and 13% as a consequence of declining economic growth, expansionary monetary policies, output setbacks and a depreciating Pak rupee. The continuous readjustments in the administered prices of gas, electricity and POL products further added to the pressure on prices and consequently exchange rate volatility as depicted in the following figures:

Figure 1

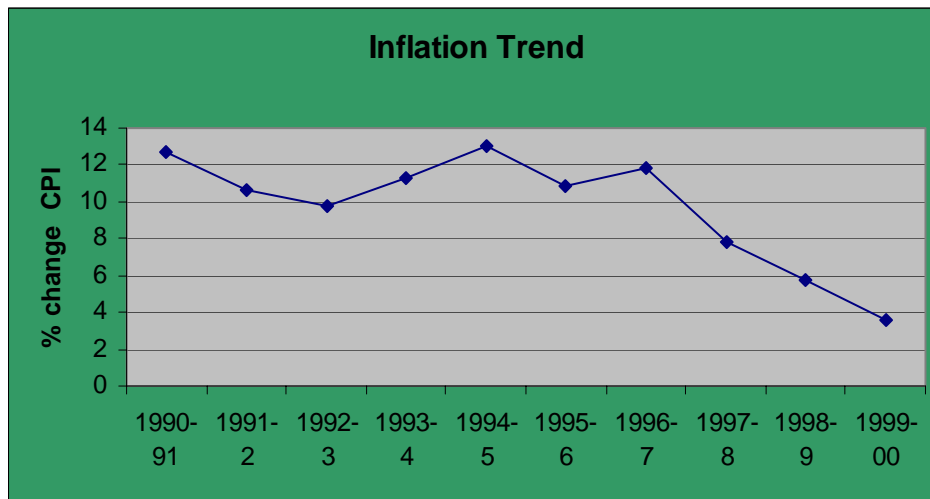
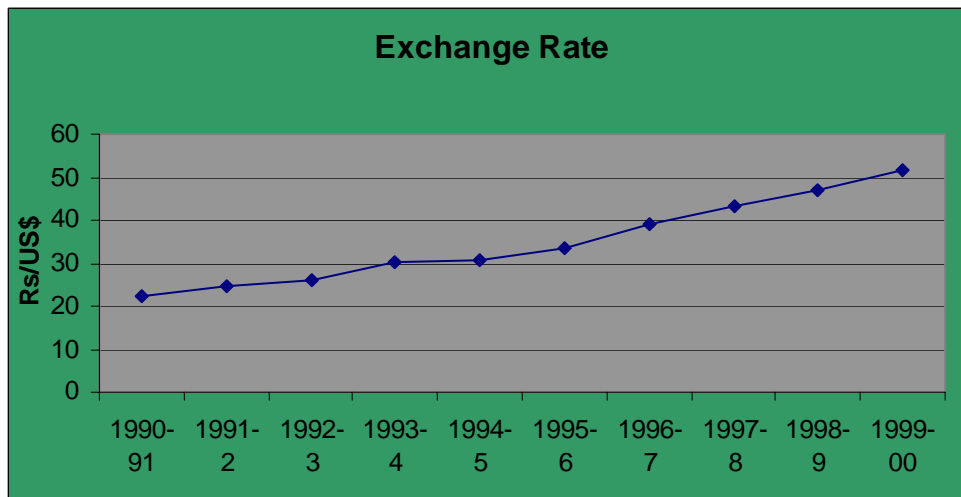



Figure 2



The rupee depreciated remarkably by almost 54% against the dollar in the last five years of the previous decade from Rs 33.57/US\$ in 1995 to Rs 51.77/US\$ in 1999. As



explained in the previous section, this resulted in widespread uncertainty and speculation in the 1990s. Consequently, the economic agents from all sectors locked significant sums of capital in dollars both as a hedge, and as a speculative bet to optimize on dollar appreciation. This is often defined as *unofficial dollarization*.

The Green Fetish

In economic literature unofficial dollarization refers to the unofficial currency distribution where the local currency comes in direct competition with the U.S dollar as a medium of exchange. Unofficial dollarization occurs when the value of the local currency becomes too volatile and so the relatively more reliable dollar is used for personal savings, investments and borrowings. The few who are still anxious to hold local currency demand higher rates as a premium to prevent themselves from the attrition of its value. Where the central bank consequently confirms higher rates in order to defend a sharp devaluation of the local currency, most businesses begin to borrow in dollars to evade high borrowing costs. As people lose faith in the local currency and buy dollars, the local currency comes under greater pressure against the dollar and hence devalues further. As a result, a virtuous cycle of uncertainty and devaluation gains momentum and despite higher interest rates, most households refuse to save in the local currency and businesses prefer to export their capital out of the country. Though it maybe argued that the high rates attract foreign investment, the fact that the returns need to be paid in dollars cause considerable uncertainty to the investor due to wild fluctuations in the exchange rate, hampering investment decisions.

Prevalent in most emerging economies, unofficial dollarization hence arises from a lack of confidence in the domestic currency as a consequence of wide exchange rate fluctuations. As mentioned in the previous section, in the 1990s the economy of Pakistan was marked by high price volatility and devaluation of the rupee. This posed a significant threat to the country's economic health and as the rupee depreciated, local investors desperately rushed to buy dollars.

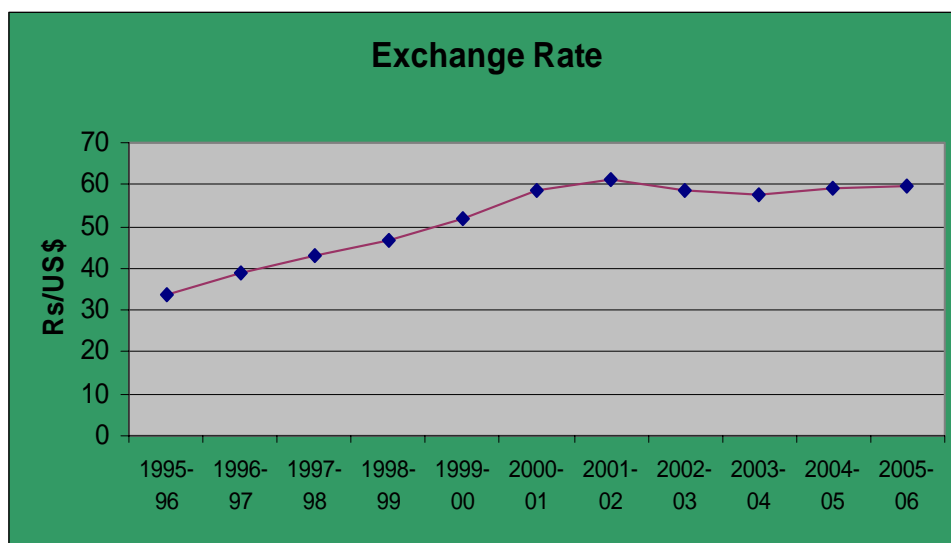
Reviving Confidence

The unofficial dollarization that marked the 1990s presented no panacea for the declining economic growth. In fact the lost confidence posed a significant threat to the economy in terms of declining local investments. The endemic uncertainty thus asked for an immediate policy action to rebuild the lost confidence in the domestic currency.

Comprehending the consequent risks in terms of dollarization of the widespread uncertainty resulting from wild fluctuations in exchange rate, the Shaukat Aziz regime took the remarkable initiative of shifting towards maintaining a fairly constant rupee dollar exchange rate. In the past five years the rupee has depreciated by only 2% against the dollar as compared to the 54% depreciation of the rupee for the last five years of the

previous decade. Hence examining the exchange rate stability that has persisted since FY00 it can be said that the State Bank has pursued strict constancy in the rupee dollar exchange rate, reviving the lost confidence of the local investors.


Figure 3



Moving forward...

Admiring the indisputable achievement of the State Bank in sustaining constancy in the exchange rate for almost five years now, we would like to point towards certain emerging problems associated with this policy that cannot be ignored.

As mentioned in the first section, the current account deficit has grown to US\$ 4.99 billion for the current year against a deficit of US\$ 1.53 for the last year. Though it is heartening to know that the rupee has remained more or less stationary against the dollar in the wake of this external imbalance, the consequent decline in the competitiveness of exports and its effects on our economy needs to be stressed. As the rupee dollar rate stays fairly constant depreciating by only 0.88% for the FY 06, the minimal change in exchange rate over the year fails to reflect the significant inflation differential existing between Pakistan and the US. It has been already concluded in the first section; that the rupee needed to be depreciated by almost 5% alone in FY 06 to maintain the purchasing power parity. This has caused the economy's exports to continue to loose their competitiveness resulting in a decline in exports putting greater pressure on the current account. The following example depicts how the international competitiveness of exports decline as exchange rate stability violates relative PPP:




Consider a local business that exports 1000 units of textile at \$1 at a market rate of Rs60/US\$. If each unit costs Rs 54 to the exporter he is expected to make a profit of Rs 6/unit or Rs 6000 on the deal. Moving forward, if the exchange rate remains stable at Rs 60/US\$ while the inflation for the period is 10% in Pakistan as compared to 5% in US the cost of each unit rises to Rs 59.4 for the exporter. The price of the final product in US dollar would have only increased to US\$ 1.05. This would imply that the Pakistani exporter gets Rs 63/unit as the final price. This decreases the profit from Rs 6/unit (60-54) to Rs 3.6/unit (63-59.4). On the other hand if the exporter aims to maintain a profit of Rs6/unit he will have to increase the unit price to Rs 65.4 or US\$ 1.09. This increase in price will cause the demand for the exports to decrease. Thus the exchange rate stability in wake of wide price differentials will cause the competitiveness of exports to decline in the international markets.

To counter this undesirable risk of a constant exchange rate, going forward we suggest a gradual devaluation of the rupee. We comprehend the significance of stable exchange rate regime for our economy, but we would like to stress the fact that stability in exchange rates does not necessarily mean a fixed peg. Hence in no way do we imply here a deviation from the persisting stability of the exchange rate but rather a steady slow devaluation that will prevent any excessive volatility. With this steady move, the State Bank shall still be able to secure the confidence of local and foreign investors on the domestic currency while at the same time protecting its exporters.

Besides controlling for declining competitiveness of the exports, we advocate gradual devaluation of the rupee to control for the rising demand of imports and hence further releasing pressure from the current account. Historically, many economists have criticized this reasoning for devaluation of the local currency, arguing that the demand for imports is fairly inelastic demand and hence devaluing the currency shall not bring about any significant decline in the imports and may actually increase the import bill. This assertion was usually supported by pointing the large portion of the import bill constituting the payments on oil that faces an inelastic demand. However it is important to closely examine the structure of the import bill that has significantly changed over time. The oil payments contribute only 23% to the rising import bill. The remaining bill consists of a large amount of consumer goods where for instance a significant explosion has been witnessed in imports of cell phones and cars that have an elastic demand.

The total import of cars was valued at US\$ 1.11 billion for the current year. Similarly, imports of cellular phones also experienced a considerable surge quite recently. The total imports of telecommunication sector stood at US\$ 430 million during Jul-Sep 2006 out of which the cell phones share stood at US\$ 200 million while the related apparatus and accessories imports amounted to US\$ 230 million. The imports of mobile phones depicted an increase of 57% to US\$ 200 million in first three months of the current financial year as against imports of US\$126 million in the corresponding period of the last financial year.



The fact that cell phones and cars have a fairly elastic demand, we expect the gradual devaluation of the rupee to decrease the imports of not only these goods but similar price elastic goods.

Additionally economists may criticize our suggestion of gradual devaluation on grounds that it will build up inflationary pressures for the local economy. However considering the fact that for the current year Pakistan is expecting a good harvest with a view of bumper wheat and rice crop and sufficient sugar production, it is important to stress that the biggest threat to inflation would come from rising fuel prices via devaluation. As a solution to this we would suggest a reduction in taxes on final fuel prices, so that the devaluation impact is not directly passed to the final consumer. By means of this policy the government will be able to control for the inflationary risks associated with the policy of local currency devaluation.

Drawing the curtains....

In the end, examining the endemic uncertainty that marked the 1990s as a result of wildly fluctuating exchange rates we find the State Banks move to maintain the exchange rate at a fairly constant rate, commendable. This has prevented the economy from replicating the dollarization culture of the previous decade while reducing the risks of low investments and trade. However, moving forward we find a gradual devaluation of the rupee an integral step for the growing economy. Indeed signs are already pointing at the State Bank adopting this view with the rupee depreciation witnessed over the past month. However before making any predictions, one must keep in mind the upcoming elections in 2007 that may introduce political considerations which are often insurmountable by any economic analysis or reasoning.



Economic Snapshot

Fiscal year 06															
Units	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	
<u>Inflation</u>															
Headline Inflation	%	8.53	8.27	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11
Core inflation	%	7.58	7.81	7.59	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70
Food inflation	%	7.52	6.41	5.84	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54
Non-food inflation	%	8.25	9.61	9.38	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41
<u>T-bill (Wgt Avg)</u>															
3 month	%	8.10	8.10	bid rej	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64
6 month	%	8.14	8.14	bid rej	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81
12 month	%	8.79	8.77	8.79	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00
<u>External Sector</u>															
Export	Mln US\$	1,318	1,317	1,205	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1350	1383	1420	n.a
Import	Mln US\$	2,037	2,021	2,024	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2370	2292	2450	n.a
Trade balance	Mln US\$	(719)	(704)	(819)	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)	(1030)	n.a
Remittances	Mln US\$	341	373	309	336	391	339	444	401	507	464	376	435	422	410
Forex reserves	Mln US\$	12,000	11,715	11,341	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503
n.a = Not Available															



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