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ECONOMIC REPORT

RESURGENCE OF THE PKR

There are numerous theories pertaining as to how exchange rates should be determined and what exactly should they reflect. Many economists argue that the exchange rate is simply a proxy for the strength of the central bank standing behind it, where as proponents of more traditional schools of thought describe it as the "numerical manifestation" of a country's trade flows - whereby countries with trade surpluses should have stronger currencies versus their trading partners, since increased demand for a currency abroad strengthens it.

But this equation in today's world is far too simplistic as it does not account for financial flows, both capital (typically portfolio investment and FDI) and current (such as workers remittances), which favorably impact a country's balance of payments (BOP). This paper will seek to identify some of the major factors that affect the value of a currency; and on these individual counts, ascertain why has the PKR depreciated (versus the USD) so dramatically over the last few months.

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OVERVIEW

Exchange rate movements affect the nation's trading relationships with its partners. According to conventional economics a strong currency acts like a deterrent to exports by making them expensive for foreign consumers, whereas imports become cheaper in the domestic market, thus encouraging consumerism. Therefore a weak domestic currency, in theory at least, should typically improve the country's balance of trade by encouraging exports. However, empirical evidence of our economy has shown that the benefits of currency depreciation in terms of export competitiveness have been short lived; reasons for which may warrant a separate debate

DETERMINANTS OF EXCHANGE RATE

Having established the importance of exchange rate in determining the terms of trade of a country, we now shift focus to some of the factors that help determine it.

INFLATION DIFFERENTIAL

As per conventional Economic Theory, a country with consistently low inflation should exhibit a rising currency value, as its real purchasing power increases relative to other currencies. In other words, high rates of inflation in the long-run are usually caused by excessive growth of money supply (which actually diminishes its underlying value as there is more currency in circulation chasing fewer goods).

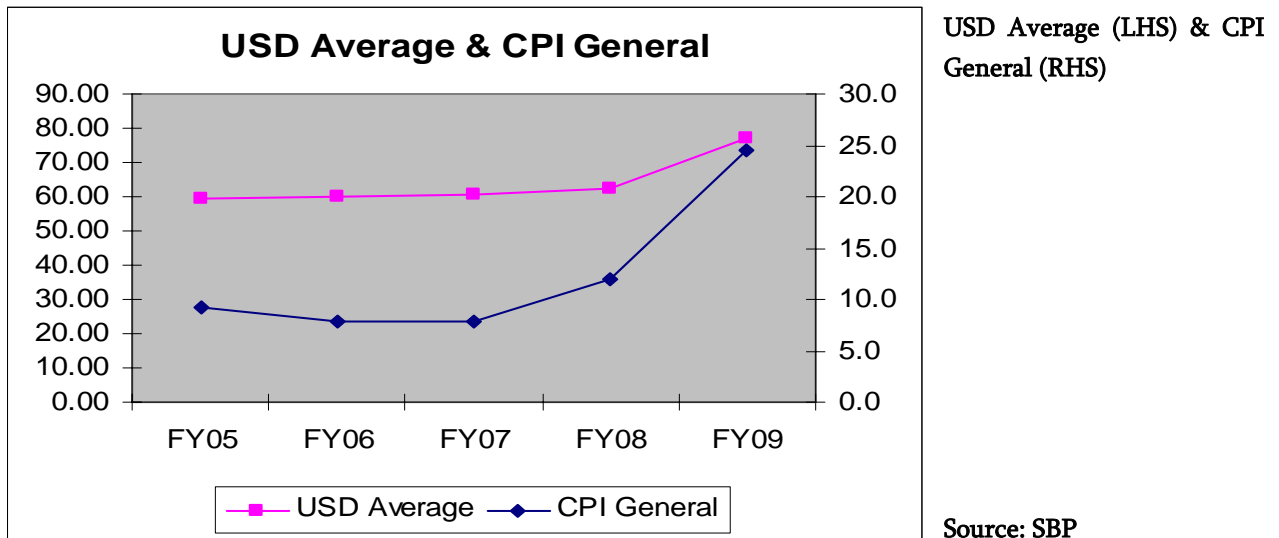
The biggest peril of inflation as we have stated in our previous reports, is that it causes people to lose faith in the underlying currency as a store of value. Hence there is an increased propensity to hedge by holding more stable currencies. This has been witnessed in the recent USD/PKR parity, which depreciated significantly due to high bouts of inflation, leading to the re-emergence of what we like to call the *green fetish* (Dollarization). The theory of Purchasing Power Parity (PPP) is built pretty much around the same principal. It equates the value of two currencies as per their ability to purchase a basket of similar goods, after adjusting for transportation and taxes.





INFLATION DIFFERENTIAL ... Continued

The graph below shows clearly that single digit CPI was accompanied by a stable exchange rate, while surging CPI has been mirrored in USD/PKR parity movement, albeit with a lag. Hence the deteriorating PKR value has not been the cause but a collateral damage of inflation.



We expect inflationary pressures to subside by Q1FY09, mainly because of declining international commodity prices and various demand management measures implemented by the SBP (such as the 200 bps discount rate hike announced by the central bank on 12th November). This should result in the PKR strengthening and smart money would again be diverted towards rupee denominated investments.



INTEREST RATE DIFFERENTIAL

This theory simply holds that global capital moves freely, hence it is directed towards the highest risk adjusted return, in other words the elasticity of interest rates comes into play (where more is invested at a higher rate and vice versa).

Traditionally interest rates are the quickest and generally the most sure shot mechanism of altering the value of the underlying currency. The whole concept of carry trades was built around this principal, whereby investors borrowed in lower yielding currencies (typically the Yen) and invested in higher yielding ones, assuming of course the inherent currency risk.

Therefore, if the Euro zone were to increase its policy rate - everything else being constant - then the value of Euro would rise since investors would sell currency X to buy Euro (in order to invest in Euro zone markets).

Currently this option is not viable for Pakistan, evident from its 5Y Credit Default Swaps currently trading at 25.21%, down from a high of 51.05% on 27th October 2008. As a result, it is not financially viable for foreign investors to invest in fixed income instruments due to the high risk surcharge. Hence, we do not expect nominal interest rate differentials to play a pivotal role in attracting foreign currency flows in the near term.

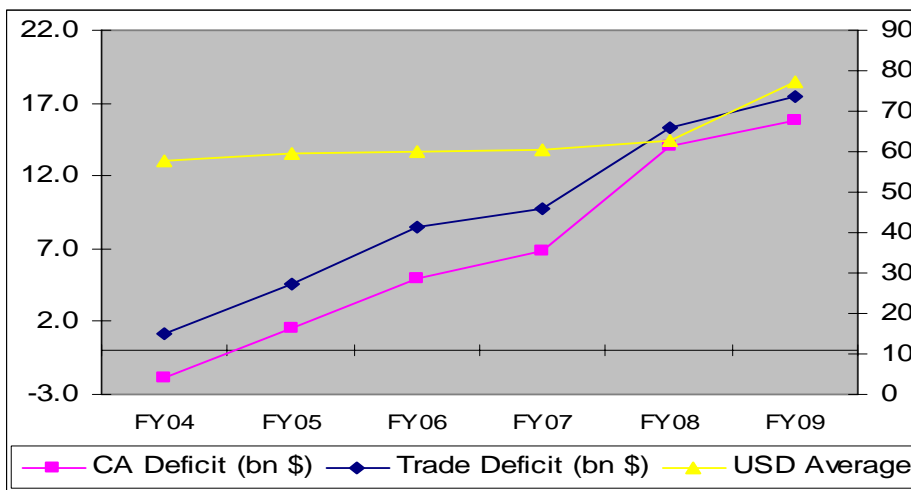


Source: Bloomberg - Pakistan 5Y CDS

CURRENT ACCOUNT POSITION

Current account is the balance of trade plus payments for; goods, services, interest and dividends (basically recurring flows). A deficit in the current account simply shows that the country is spending more than it is earning, hence it is borrowing capital or drawing down on reserves to make up the deficit. This diminishes demand for the underlying currency in international markets, thereby weakening its value.

In Pakistan's case the burgeoning current account deficit has been one of the major sources of concern and has taken its toll on the PKR. Pakistan did register a CA surplus of USD 1.811 bn in FY04, but since then the CA has been going ever deeper



CA Deficit, Trade Deficit (LHS) & USD Average (RHS) - FY09 figures are annualized for Jul-Sep period

Source: SBP

In theory it is entirely possible to have a stable currency and simultaneously run a sizeable current account deficit, as long as the economy can attract adequate capital inflows (primarily FDI and Portfolio Investment) to plug the gap. Pakistan was particularly successful in achieving this over the last couple of years (up to 2007), till which point there was no real pressure on the PKR, in fact we were adding to our FX reserves each year. Once these capital flows dried up and we had to resort to drawing down on our reserves to finance the current account deficit the value of PKR plummeted (exacerbated by the monetization of fiscal deficit). This is why a lot of economists view large current account deficits as unsustainable in the long run; it simply increases the economy's vulnerability to exogenous shocks.

Going forward the CA deficit is expected to narrow from its current level of USD 3.952 bn in Jul-Sep FY09 vs USD 2.271 bn in same period FY08, owing primarily to falling commodity prices (oil is currently trading at USD 55.04 per barrel compared to a high of USD 145 in Jul08) and rising exports (helped by the cheaper PKR); Once these pressures ease, so too will the pressure on PKR.

EXTERNAL DEBT

Due to Pakistan's current BOP (Balance of Payments) position, foreign investors seem reluctant to invest in Pakistani debt. Furthermore, dwindling FOREX reserves and huge debt burden has, in the eyes of these investors, increased the risk of a potential sovereign default.

Total external debt of Pakistan stands at USD 44 bn (table next page), while debt service obligations due early next year are approximately USD 3-4 bn (table given below).

	Total	Maturity breakdown (residual maturity)		
		Up to 1 month	More than 1 month and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits	-3,232.24	-314.06	-894.93	-2,023.25
—outflows (-)				
Principal	-2,254.12	-282.81	-589.75	-1,381.56
Interest	-978.12	-31.25	-305.18	-641.69
—inflows (+)				
Principal				
Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	-1,945.00	-680.00	-1,265.00	0.00
(a) Short positions (-)	-1,995.00	-725.00	-1,270.00	0.00
(b) Long positions (+)	50.00	45.00	5.00	0.00

Pakistan's Debt Repayment Schedule

Source: SBP

Pakistan had foreign reserves of USD 7.32 bn as of Oct 17 2008, out of which, SBP reserves were USD 3.28 bn. However, we estimate the real figure of SBP's own liquid reserves closer to USD 2 bn, taking into account swaps done by the central bank. This has greatly decreased international confidence due to concern over a potential sovereign default (there is ample evidence of this in Pakistan's Credit Default Swaps currently trading at 25.21%).

Pakistan's ability to service its debt was also questioned by Standard & Poor's rating agency, that released a report on 10th November stating it was most concerned about Pakistan defaulting, followed by Sri Lanka and Vietnam. Pakistan's credit rating was cut by S&P on Oct 6 to CCC+, which is seven levels below investment grade, on concern it won't be able to pay its debt servicing costs.

Therefore, to instill investor confidence and effectively meet its immediate obligations, Pakistan is looking to secure an IMF loan reportedly in the region of USD 7.5-9 bn, for a two year term. With the expected announcement of IMF program around the corner, we should see a marked reduction in default expectations and the ensuing strengthening of Pak Rupee.

Below is the debt profile of Pakistan followed by the debt servicing schedule for next year.

Pakistan's Debt Profile

(Million US Dollars)

ITEM	30-06-03	30-06-04	30-06-05	30-06-06	30-06-07 ^a	30-06-08 ^a
1. Public and Publically Guaranteed Debt						
a) Public Debt	29,197	29,936	31,084	32,898	35,349	40,243
(i) Medium and long term (>1 year)	28,279	29,504	30,879	32,603	35,110	40,047
<i>Paris Club</i>	28,092	29,482	30,608	32,434	35,085	39,334
<i>Multilateral¹</i>	12,154	13,598	13,014	12,785	12,694	13,928
<i>Other bilateral</i>	14,635	14,097	15,279	16,631	18,532	21,451
<i>Military Debt</i>	344	575	706	835	931	1,129
<i>Commercial Loans/Credits</i>	263	204	188	130	83	41
<i>Euro / Sukuk/Global Bonds</i>	231	198	166	153	137	120
<i>Local Currency Bonds(TBs & PIBs)</i>	465	810	1,255	1,900	2,650	2,650
(ii) Short Term (<1 year)	-	-	-	-	58	15
<i>IDB</i>	187	22	271	169	25	713
b) Publicly Guaranteed Debt	918	432	205	295	239	196
i) Paris Club	436	31	-	-	-	-
ii) Multilateral	315	251	80	190	155	132
iii) Other bilateral	128	116	99	85	71	60
iv) Commercial Loans	22	20	16	12	8	4
v) Sandak Metal Bonds	17	14	10	8	5	-
2. Private Non-guaranteed Debts² (Medium and long term , >1 year)	2,028	1,670	1,342	1,585	2,002	2,612
3. Private Non-guaranteed Bonds	-	-	-	-	250	275
4. IMF	2,092	1,762	1,611	1,491	1,407	1,337
Total External Debt (1 through 4)	33,317	33,368	34,037	35,974	39,008	44,467
5. Foreign Exchange Liabilities³	2,122	1,951	1,797	1,586	1,473	1,817
Special US \$ Bonds	696	552	421	247	156	121
Foreign Currency Bonds (NHA / NC)	175	153	131	109	88	66
National Debt Retirement Program	6	1	-	-	-	-
Central Bank Deposits	700	700	700	700	700	1,200
NBP / BOC Deposits	500	500	500	500	500	400
Other Liabilities (SWAP)	45	45	45	30	30	30
<i>FEBCs/FCBCs/DBC</i> s	42	22	10	7	5	4
Total External Liabilities (1 through 5)¹	35,439	35,319	35,834	37,560	40,481	46,284
Official Liquid Reserves⁴	9,529	10,564	9,805	10,765	13,345	8,577

- 1 Multilateral debt stock revised by EAD
2 Rescheduled Private Debt included by GOP so excluded from the stock of Private debt
3 Excluding FEBCs/FCBCs & DBCs from 30-06-1999
4 Excluding CRR/SLR

Source: SBP



POLITICAL STABILITY AND ECONOMIC PERFORMANCE

Foreign investors typically use the top down approach when formulating investment strategies for emerging economies. Therefore geopolitical risk factors play a pivotal role in their decision making. Pakistan is increasingly being perceived as a volatile state owing to the ongoing “war on terror” and hence the unstable political outlook, subsequently the foreign investors are demanding a higher risk premium as compensation (as reflected in the CDS).

The other important factor when analyzing a troubled emerging economy is the investor confidence in its ability to carry out the requisite economic reforms. This is where entering the IMF program, which validates its economic program and ensures independent monitoring, will help Pakistan considerably as a lot of concerns regarding fiscal discipline and default fears would be addressed. This shall bode well for the PKR as normalcy should ensue in financial flows.



CONCLUSION

The rupee hit a low of PKR 83.80 to the dollar in inter-bank on 10th October 2008, which translates into an annualized depreciation of approximately 35%. However, since then the rupee has recovered to the 80.35 level.

Even though there still is an inherent depreciatory bias in the PKR in long-run (owing primarily to trade imbalances), in the short-term we expect some semblance of stability to be restored. Factors which caused the dramatic slide in its value have now either subsided or have largely been priced in. This trend is evident from the recent resurgence of the Pak Rupee, illustrated below:



USD/PKR Parity since beginning FY07

Source: Bloomberg

Potential threats to the PKR value in the short-term could stem from sizeable foreign selling at the KSE and oil payments being fully brought back into the inter-bank market. The KSE 100 index currently frozen at 9,184 has borne the brunt of foreign divestment, with a massive 40% fall from its high of 15,435 points (on 27th April'08). The total outflow in SCRA for July'08 to date alone has been USD 256.4 million, a massive quantum considering the KSE has been frozen since 27th August'08. These numbers are expected to worsen, since the stock market is trading at an estimated 25% discount, as per off market transactions. Heavy selling by foreign investors who currently hold an estimated USD 2.1 bn worth of stock, subsequent to the unfreezing of the index, could lead to renewed pressures on the PKR. If oil payments (monthly estimate of USD 800 mn) are brought back fully to the inter-bank, could result in significant gyrations in the USD/PKR parity, something that does not bode well for any currency.

Though we expect the volatility to remain (these are uncertain times), we are of the view that the worst is now over and expect the USD/PKR parity to sustain this recovery and trade close to the PKR 80 mark for the time being.

ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
<u>Inflation</u>														
Headline Inflation	%	9.3	8.7	8.8	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3	23.9	25.0
Core inflation	%	6.5	6.9	7.2	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4	17.3	18.3
Food inflation	%	14.7	12.5	12.2	18.2	16.0	20.6	25.5	28.5	32.0	33.8	34.1	29.9	31.7
Non-food inflation	%	5.4	5.9	6.3	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7	19.2	19.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.1	9.1	9.1	9.1	9.4	9.6	9.6	10.0	11.3	12.2	12.4	12.6	12.6
6 month	%	9.1	9.2	9.3	9.3	9.6	9.9	9.9	9.9	11.5	n/a	n/a	n/a	12.7
12 month	%	9.4	9.4	9.5	9.4	9.9	10.1	10.1	10.3	11.7	n/a	n/a	n/a	12.8
<u>External Sector</u>														
Export	Mln US\$	1,593	1,524	1,500	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726	1,779	1,926
Import	Mln US\$	2,555	2,864	2,910	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153	3,806	3,647
Trade balance	Mln US\$	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1,427)	(2,027)	(1721)
<u>Remittances</u>	Mln US\$	580	505	479	557	502	602	590	584	547	627	592	660	466
<u>Forex Reserves</u>	Mln US\$	16,354	15,807	15,589	14,657	14,031	13,232	12,362	11,258	11,285	9,920	9,130	8,322	7,323



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