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Together we Rise

Amid the appreciation witnessed in the currencies of most regional economies against the dollar, the Pak rupee seems to be following the stride, even if marginally. Since the beginning of 2007, the rupee has gained over 50 paisa against the dollar.

This report will analyze the factors prompting the Asian policy makers of India, China, Thailand and Malaysia to step back from foreign exchange intervention, allowing their currencies to rise. It will then examine the presence of these factors in Pakistan and thereby evaluate the future of the dollar against the Pak rupee.

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Wake up and smell the Coffee!

Most Asian economies for the past few years 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, they now find it increasingly difficult and costly to keep the currency at a stable rate as the upward pressure on the local currencies rises on account of increased foreign inflows. No surprise, quite recently we have seen rising forbearance for currency appreciation in the region.

Asian policy makers have slackened their control over the markets, allowing the regional currencies to strengthen. While they are not going to end intervention completely by any means, significant currency appreciation has taken place which cannot be ignored.


The Indian Rupee which is so far the best performer in Asia for this year has appreciated by 9.58% against the dollar since the beginning of this year. The Thai Baht has hit a fresh ten year high at 33.3/USD, appreciating by over 8%. The Malaysian Ringgit has strengthened by 2.17% since the beginning of this year while the Chinese Yuan has appreciated by over 3.2% for the same period.¹

Amid this current scenario where regional currencies are rising in value, a critical question facing our economy is whether is it now the Pak rupee's turn to follow the same stride? In fact it is interesting to note that likewise other regional currencies, the Pak rupee has started to gain strength against the dollar, even if marginally. Since the onset of 2007, the rupee has gained over 50 paisa; it started the year at 60.9430/USD and is currently being traded at 60.4055/USD. However, many analysts are likely to disregard this recent gain in strength of the rupee as insignificant. True that this is a rather small number when compared to the significant appreciation that took place with most regional currencies, particularly the Indian rupee, but what we would like to emphasize is that, that this over 50 paisa gain witnessed since Jan'07, cannot be overlooked and is reflective of the bigger picture where upon realizing the costs of foreign exchange intervention, most regional economies are relaxing their control over their respective currencies against the dollar.

Where do coffee beans grow?

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. Back then, this arrangement was more reflective of the long-term bias toward savings and export-oriented growth and thereby benefited both emerging economies, which had a huge

¹ Reuters



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 Asia in the first place.

The emerging economies stellar 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 foreign direct investment (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 in most emerging economies, as mentioned earlier, the exchange rate is rather actively managed by the central banks which manage the local currency-dollar parity very closely. What we will address here is the monetary impact of the huge foreign inflows in emerging economies, given that they follow a Managed Regime.

Since under the Managed Regime 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 essentially has to create.



Hence tightly managed exchange rates have resulted in foreign exchange reserve increases which have translated into increasing base money and broad money supply. The excessive money supply can fuel over-investment, economic overheating, asset price bubbles, and a resumption of domestic inflation. Essentially, we cannot expect the central banks to 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 further inflows of hot money through various channels and thereby frustrate monetary tightening even further. 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; that is to reduce overheating pressures and avoid a build-up of financial vulnerabilities.

Case-in-Point: India

Labeled as the best performer in the region, the Indian Rupee has appreciated by more than 10% over the past six months. The main reason for the INR appreciation since late 2006 has been a flood of foreign exchange inflows that took the form of foreign direct and portfolio investment, external commercial borrowings and home remittances:

- FDI: At the back of strong performance of the economy and sound economic growth prospects, the FDI in fiscal year 2006-07 (Apr 06-Mar 07) recorded a three fold increase over the previous year, amounting to around USD16 billion. More than half of these inflows arrived in the final four months of the year (Dec 06-Mar 07).
- External commercial borrowings: According to balance-of-payments data as of Dec 06 inflows through external commercial borrowings, which are primarily aimed at financing investments and acquisitions, showed a year on year increase of 33%, amounting to USD12.1billion.



- Foreign portfolio inflows: These constitute net annual inflow of funds by foreign institutional investors particularly into the booming stock market and overseas equity issues of Indian companies via Global depositary receipts (GDRs) and American depositary receipts (ADRs). Inflows from the foreign institutional investors amounted to USD 4.6 billion for the first five months of 2007 while inflows from GDRs and ADRs amounted to USD 3.8 billion for the current fiscal year, a 48% year-on-year increase.
- Investments and remittances: In 2006-07 NRI deposits in special bank accounts amounted to USD 3.8 billion, a 35% increase over the previous year. The increase was primarily due to the attractive interest rates offered on such deposits. Another source of foreign-exchange inflows has been remittances coming from the huge number of Indian expatriates. Such remittances amounted to a colossal USD 19.6 billion in April-December 2006, a 15% year-on-year increase.

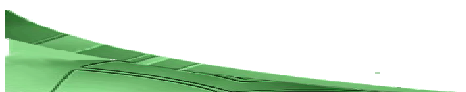
As the Indian economy witnessed such huge foreign inflows in the recent months, the upward pressure on the rupee mounted. It became thus extremely difficult for the RBI (Reserve Bank of India) to tightly manage the rupee dollar parity while running an independent monetary policy and therefore the RBI allowed the rupee to appreciate. In the Annual Policy Statement for the Year 2007-08, the RBI governor admitted that ‘...dealing with the impossible trinity of fixed exchange rates, open capital accounts and discretion in monetary policy has become more complex than before.’²

Is the Pak rupee next in row?

Like the central banks of most emerging economies, 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. Total foreign investment for the first 10 months of the fiscal year 2006-07 amounts to USD 5.9 billion, 48% more than the amount (USD 4.05 billion) during the same period last year.

As explained earlier under tightly managed exchange rate regime, growing foreign inflows essentially translate into increasing base and broad money supply: In order to prevent rupee appreciation, the SBP seeks to purchase the foreign exchange, spurring undesirable growth in reserve money in the process. The money supply as of Jun-23rd increased by PKR 570 billion as compared to an increase of PKR 362 billion for the previous year. This increase is reflected in the increase in NFA of the banking system;

² Annual Policy Statement, RBI, 2007-08. Part 1, 86.



NFA increased by PKR 206 billion as compared to an increase PKR 41 billion witnessed in the previous year (Figure1).


This surge in M2 expansion is a more challenging development given that this has the potential to cause resurgence in excess demand pressures in the economy. During the current fiscal 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 an increase in liquidity within the banking sector. The increased liquidity in the banking sector exerts a downward pressure on the interest rates as visible in the recent declining trend of the 6M KIBOR. The 6 M KIBOR fell from average monthly rate of 10.55% in Jan to an average of 10.03% in June. This has resulted in narrowing the gap between KIBOR and the yield on T Bills, fuelling participation of commercial banks in T Bill auctions. Before interest rates fall enough to stimulate private sector credit expansion once again, increasing the demand and subsequently inflationary pressures, the SBP will have to take some crucial steps to curb monetary expansion.

Figure 1: Profile of Monetary Assets

	Credit Plan 2006-07	Stocks		Monetary Impact During	
		30-Jun-06	30-Jun-05	1st July 06 to 23-Jun-07 ^P	1st July 05 to 24-Jun-06
1. Net Government Sector Borrowing (a+b+c)	<u>130,100</u>	<u>843,281</u>	<u>752,515</u>	<u>129,019</u>	<u>74,327</u>
a. Barrowing for Budgetary Support	120,100	717,632	646,682	138,158	57,240
(i) From SBP		403,566	268,474	-35,819	119,956
(ii) From Scheduled banks		314,066	378,208	173,976	-62,717
b. Commodity operations	10,000	107,762	87,836	-9,273	17,071
c. Others	0	17,887	17,997	134	17
2. Credit to Non-Government Sector (d+e+f)	<u>395,000</u>	<u>2,190,769</u>	<u>1,782,368</u>	<u>301,660</u>	<u>354,988</u>
d. Credit to Private Sector (i+ii)	<u>390,000</u>	<u>2,113,890</u>	<u>1,712,093</u>	<u>291,289</u>	<u>352,348</u>
i. Commercial Banks		2,018,961	1,601,550	289,494	369,183
ii. Specialised Banks		94,928	110,543	1,795	-16,835
e. Credit to Public Sectors Enterprises (PSEs) (iii+iv+v)	<u>5,000</u>	<u>60,991</u>	<u>53,348</u>	<u>10,017</u>	<u>3,678</u>
iii. WAPDA, KESC, OGDC, PTC, PIA & Pak.Steel		36,979	32,224	11,841	1,159
iv. Others		47,237	44,838	-1,571	2,030
v. PSEs Special Account-Debt Repayment with SBP		-23,225	-23,714	-253	489
f. Other Financial Institutions (SBP credit to NBFIs)	<u>0</u>	<u>15,889</u>	<u>16,927</u>	<u>353</u>	<u>-1,038</u>
3. Other Items (net)	<u>-75,000</u>	<u>-305,979</u>	<u>-205,470</u>	<u>-66,767</u>	<u>-107,945</u>
4. Net domestic assets of the banking system	<u>450,100</u>	<u>2,728,071</u>	<u>2,329,414</u>	<u>363,912</u>	<u>321,370</u>
5. Net Foreign assets of the banking system	<u>9,800</u>	<u>688,429</u>	<u>636,939</u>	<u>206,482</u>	<u>41,387</u>
6. Monetary Assets (M2)	<u>459,900</u>	<u>3,416,500</u>	<u>2,966,352</u>	<u>570,394</u>	<u>362,757</u>
(Growth)	(13.46%)			(16.70%)	(12.23%)

p= Provisional

Source: Monetary Policy Department



Sterilization of foreign inflows is way to control the excess liquidity in the system. We have already witnessed SBP's attempts at sterilization as reflected by the increased number of OMOs conducted in the interbank market. Being one of the principle tools for sterilization of excess liquidity, OMOs are highly effective in the short run. However as mentioned earlier they carry a huge fiscal cost in the long run as it involves the SBP effectively swapping high yielding local debt for low yielding foreign debt.

Another point that needs to be noted is that in order to mop up the excess liquidity via OMOs, the SBP may tend to keep interest rates high which are likely to attract even more foreign inflows in the economy. In this way OMOs contradict with the motive for which they were conducted in the first place. Moreover money supply has been increasing at such a fast pace at the back of foreign inflows, that sterilization of inflows alone cannot curb the monetary expansion without incurring extensive costs.

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. What is interesting to note is that the rupee, even if marginally, is already rising in value. Though the over 50 paisa gain since Jan '07 witnessed in the rupee is not so significant relative to the 9.58% appreciation of the Indian rupee or the 3.2% appreciation of Yuan over the past six months, it cannot be disregarded especially under the current circumstances where all regional currencies are strengthening. With foreign inflows likely to reach record high levels in the coming months with some transactions like HBL and NBP GDRs and PSO privatization in the pipeline, we expect rupee appreciation to continue in the future and see the rupee reaching below 60 levels against the dollar by the end of Dec'07.

However we do not expect the SBP to 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 regional economies. The SBP is therefore likely to take account of such risks and allow only marginal appreciation of the rupee. As they say what's good for the goose is not good for the gander.



Economic Snapshot

Fiscal year 06-07														
	Units	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May
<u>Inflation</u>														
Headline Inflation	%	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4
Core inflation	%	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7
Food inflation	%	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3
Non-food inflation	%	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.10	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69
6 month	%	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9
12 month	%	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10
<u>External Sector</u>														
Export	Mln US\$	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	1421	1536	1446	1534
Import	Mln US\$	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	2103	2070	2159	2275
Trade balance	Mln US\$	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(741)
<u>Remittances</u>	Mln US\$	507	464	376	435	422	410	448	475	391	457	520	513	537
<u>Forex Reserves</u>	Mln US\$	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778



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