

# Exchange Rate Management, Structural Change and Economic Growth

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# Why is the Exchange Rate Important?

- The answer to this question is best provided by *Roberto Frenkel and Lance Taylor* as follows:

The exchange rate affects any economy through many channels - it influences key macro-price ratios, such as those between **Tradable and non-tradable goods**, **Capital goods and labor**, and **Exports and imports** (via the costs of intermediate inputs and capital goods).

- ➔ The exchange rate can significantly influence resource allocation, **especially if it stays stable in real terms for an extended period of time.**
- ➔ A competitive and stable RER, by encouraging the production of tradeables (export and import competing goods) and greater labor intensity in both tradable and non-tradable sectors, can make a substantial contribution to economic growth and employment creation
- Dani Rodrik goes further and argues that “just as overvaluation hurts growth, undervaluation facilitates it”.

# How can You Tell if an Exchange Rate is Overvalued or Undervalued?

- Different methods are used to estimate whether a currency is overvalued or undervalued. For example, the IMF uses the “external balance assessment (EBA)” methodology; Rodrik uses PPP conversion factors to calculate the real exchange rate (RER) for a country and adjusts it for the Balassa-Samuelson effect
- Alternatively, one can argue that as the exchange rate is the price that equates the supply and demand of foreign currency in a country, a competitive exchange rate would be one where the balance on the current account of BOP of a country is close to zero
  - ➔ If a country is having large current account surpluses and accumulating reserves the exchange rate is undervalued and if it is having large deficits and losing reserves, or borrowing to finance the deficit, the exchange rate is overvalued
  - ➔ That is why, on various occasions, USA has accused Korea, Taiwan, Japan, China and Germany of manipulating their currencies and having undervalued exchange rates

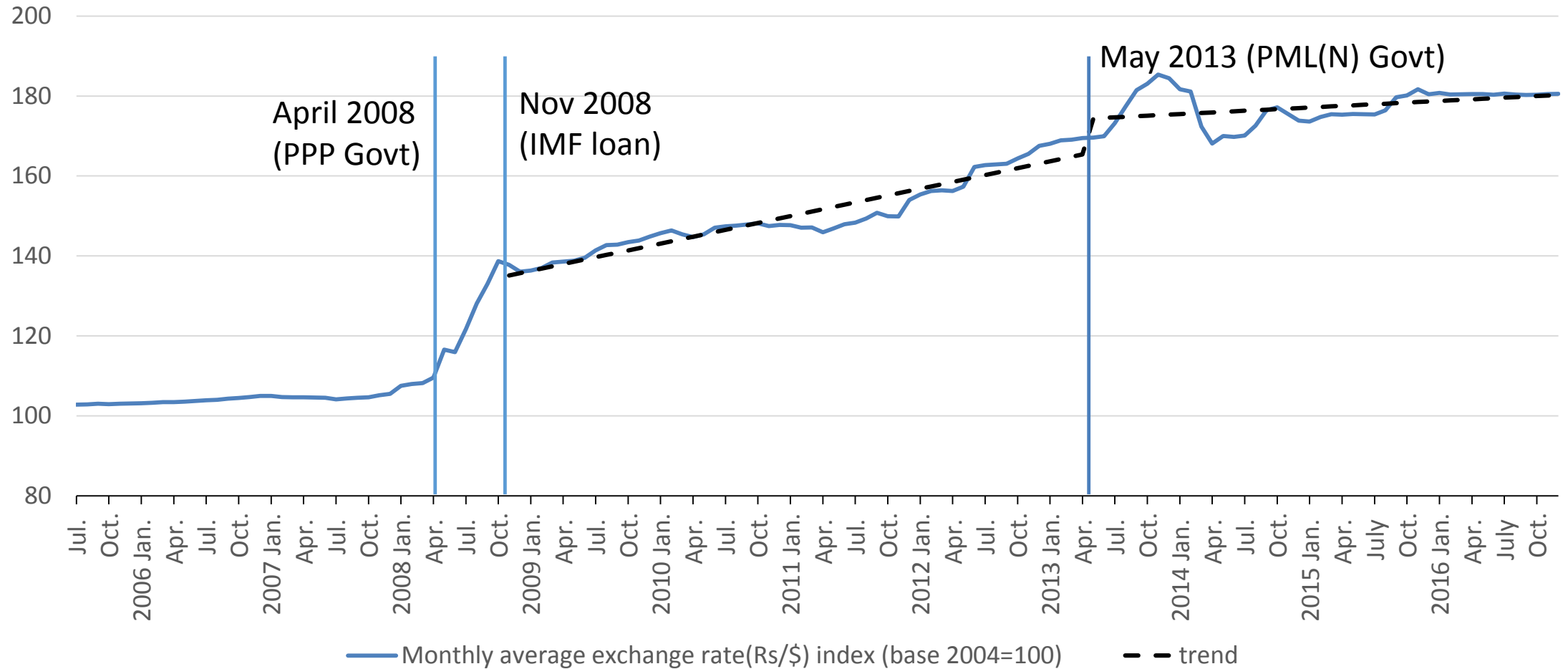
# Is Pakistan's Exchange Rate Overvalued?

- Applying the principle that “a competitive exchange is one where the balance on the current account of BOP is close to zero” we identify the most recent year when this was case in Pakistan
- In FY2004 Pakistan had a small surplus on the current account of BOP and in FY2005 it had a small deficit – so we can say that in 2004 Pakistan had a competitive exchange rate
- SBP publishes a monthly series of Real Effective Exchange Rates (base 2010) which shows if the Rupee is appreciating or depreciating in real terms
- We rebase this series to 2004 and from the revised series we can see the extent of overvaluation of the Rupee for any year
- It shows that, during the previous 10 years the Rupee has generally been overvalued and this overvaluation has increased dramatically since December, 2013

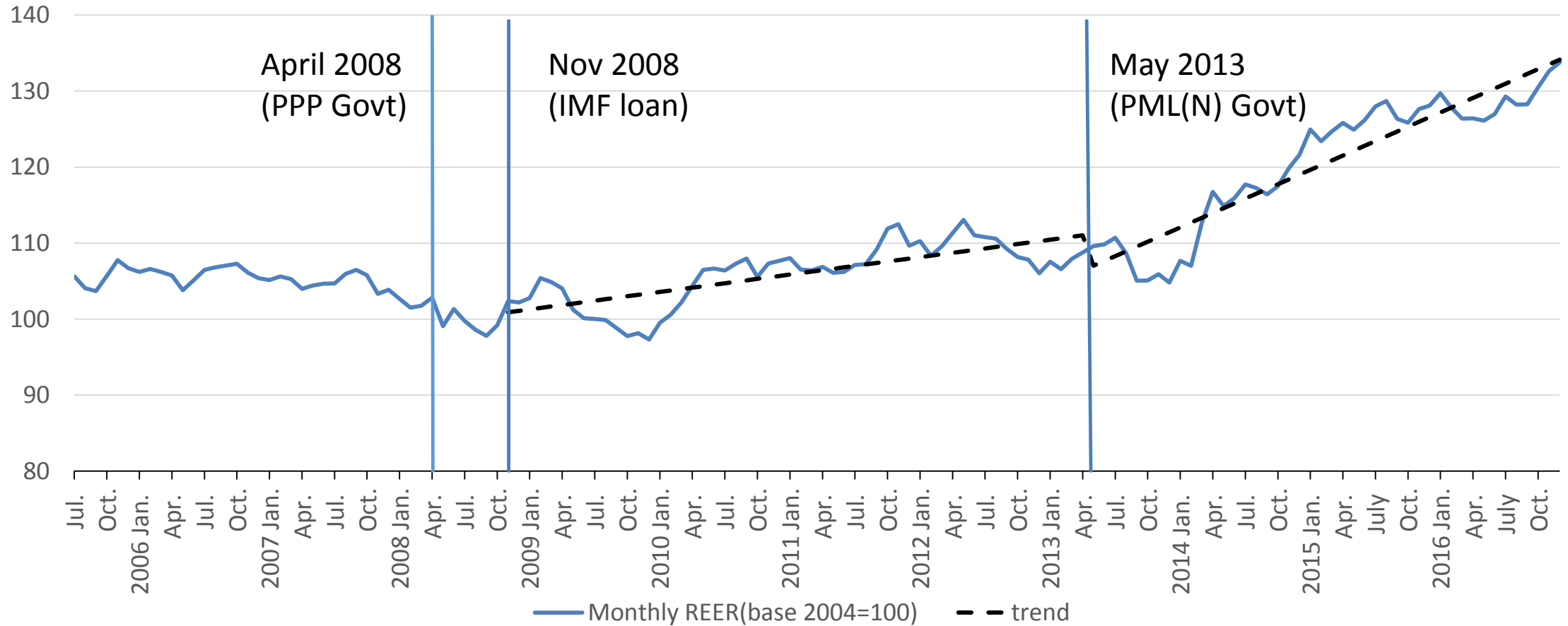
# What is Pakistan's Exchange Rate Management Policy?

- The implicit policy with regards to management of the exchange rate in Pakistan has undergone a significant change in recent years.
- Prior to March 2013, the 'policy target' of exchange management was **stability of the real effective exchange rate (REER)** – i.e. a de facto **soft peg with a trade weighted basket of currencies**
- PML(N) government's 'policy target' for exchange rate management seems to be **stability of the nominal exchange rate against the US dollar** – i.e. a de facto **soft peg with the US dollar**
- Since currencies of Pakistan's major trading partners (UK, Europe and China) have depreciated against the dollar, the REER appreciated by over 20% between May 2013, when the PML(N) government took office, and December 2016
- The overvaluation of the Rupee had increased to over 30% in December 2016

# Monthly Average Exchange Rates (Rs./\$) index (Base 2004=100)



# Monthly Real Effective Exchange Rates (Base 2004=100)

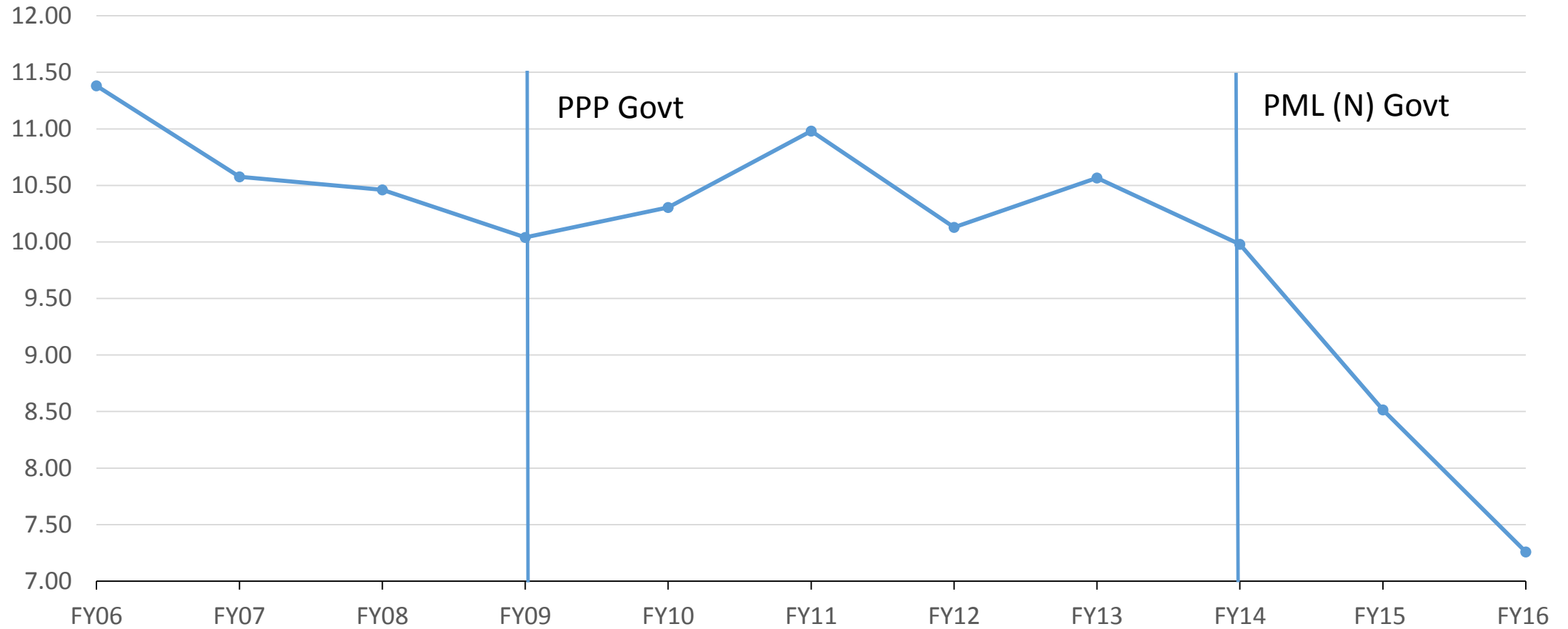


# What has been the Effect of Overvaluation on the Economy?

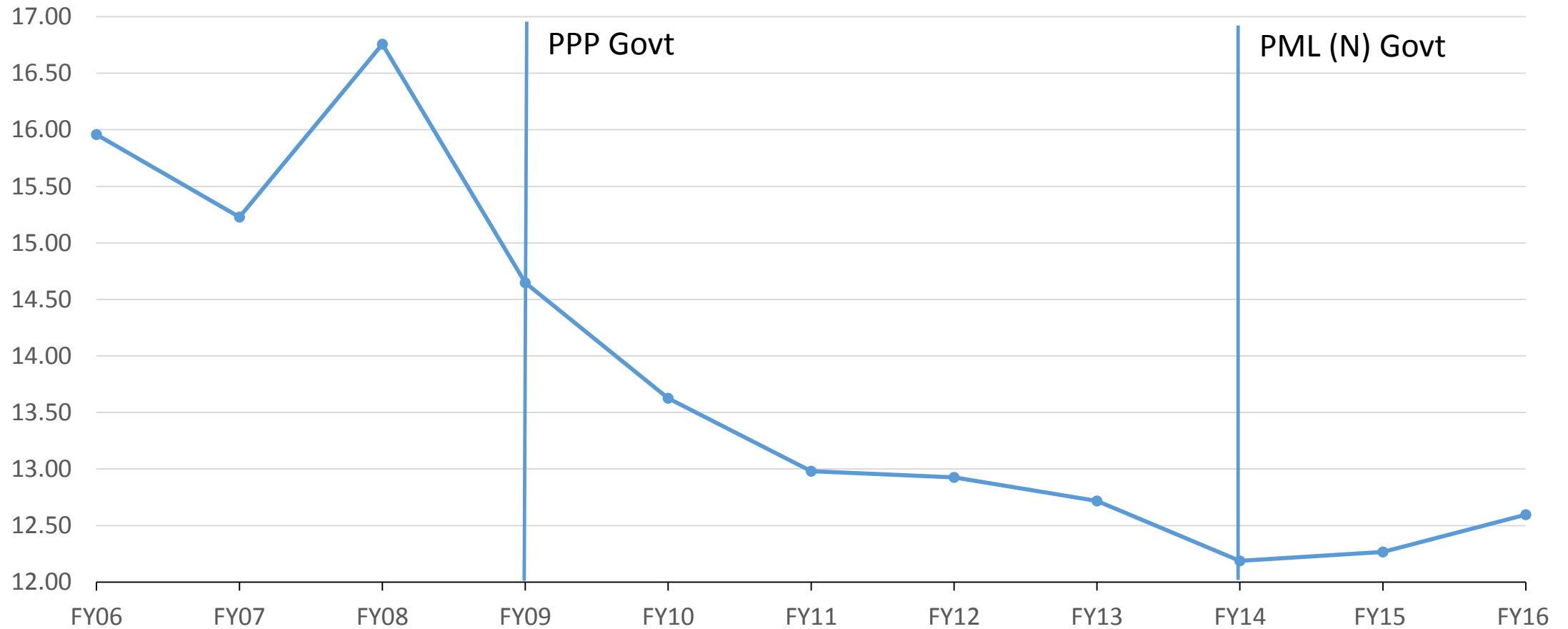
- As argued in the beginning, we would expect overvaluation to:
  - Negatively impact exports
  - Positively impact imports
  - Negatively impact large scale manufacturing (LSM)
- In the next few slides we present exports, imports and value added in LSM as a percentage of GDP for past 10 years



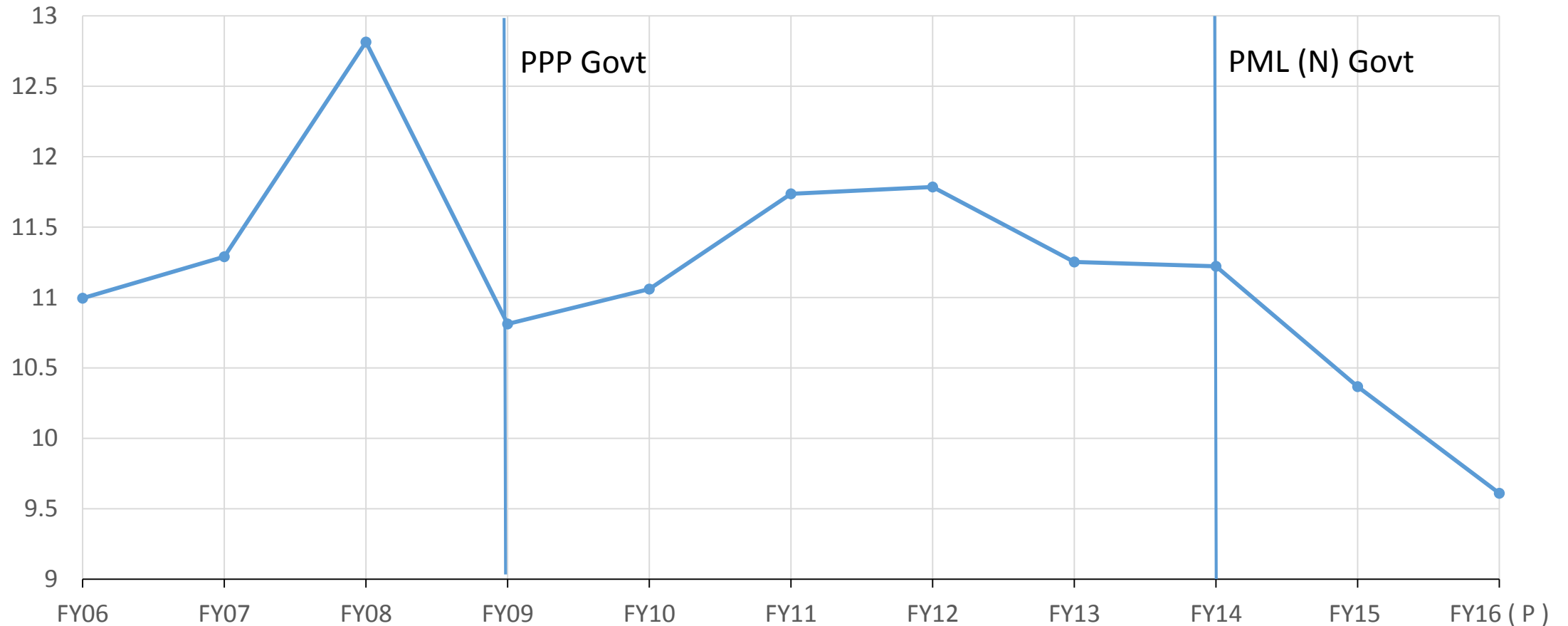
# Non-fuel exports as percentage of GDP



# Non-fuel imports as percentage of GDP



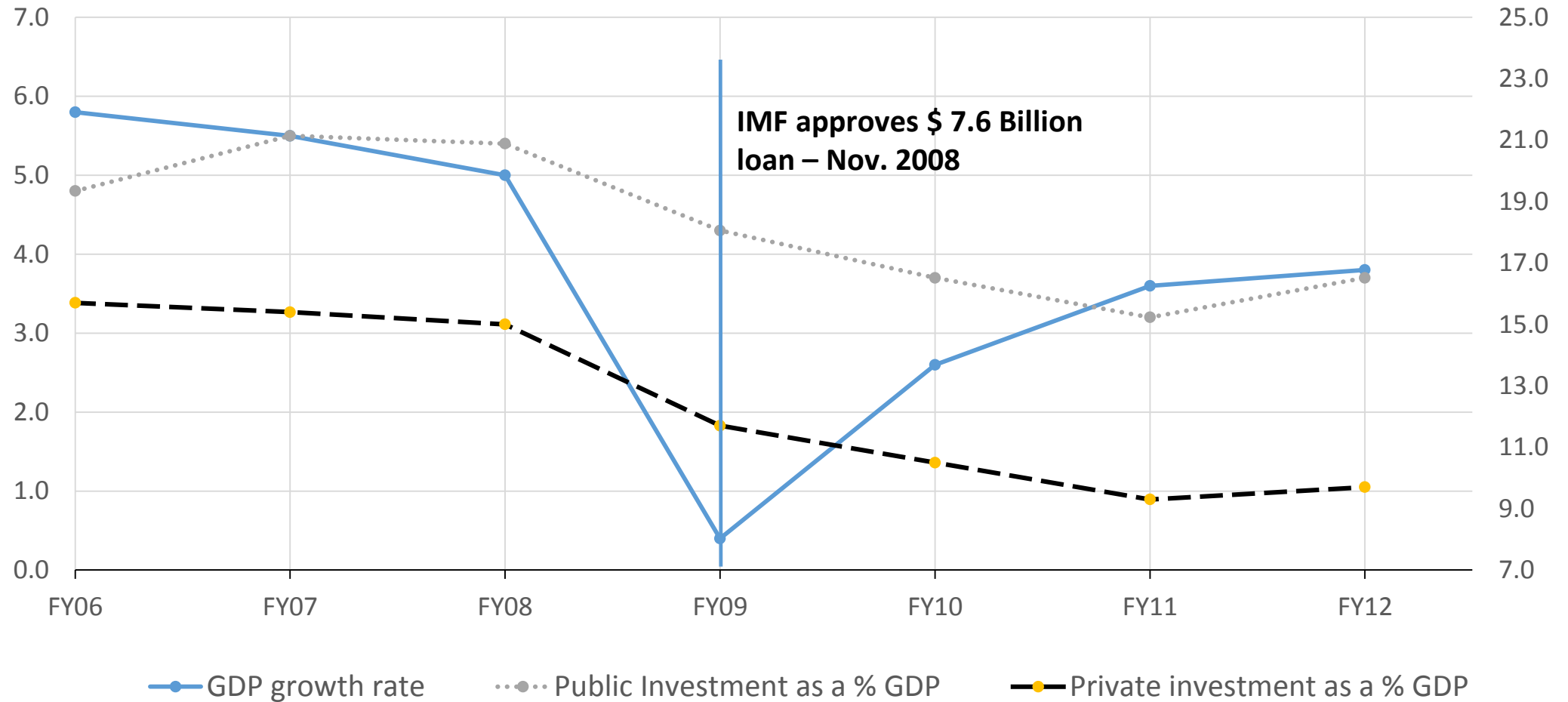
# Large scale manufacturing percentage share in GDP (current prices)



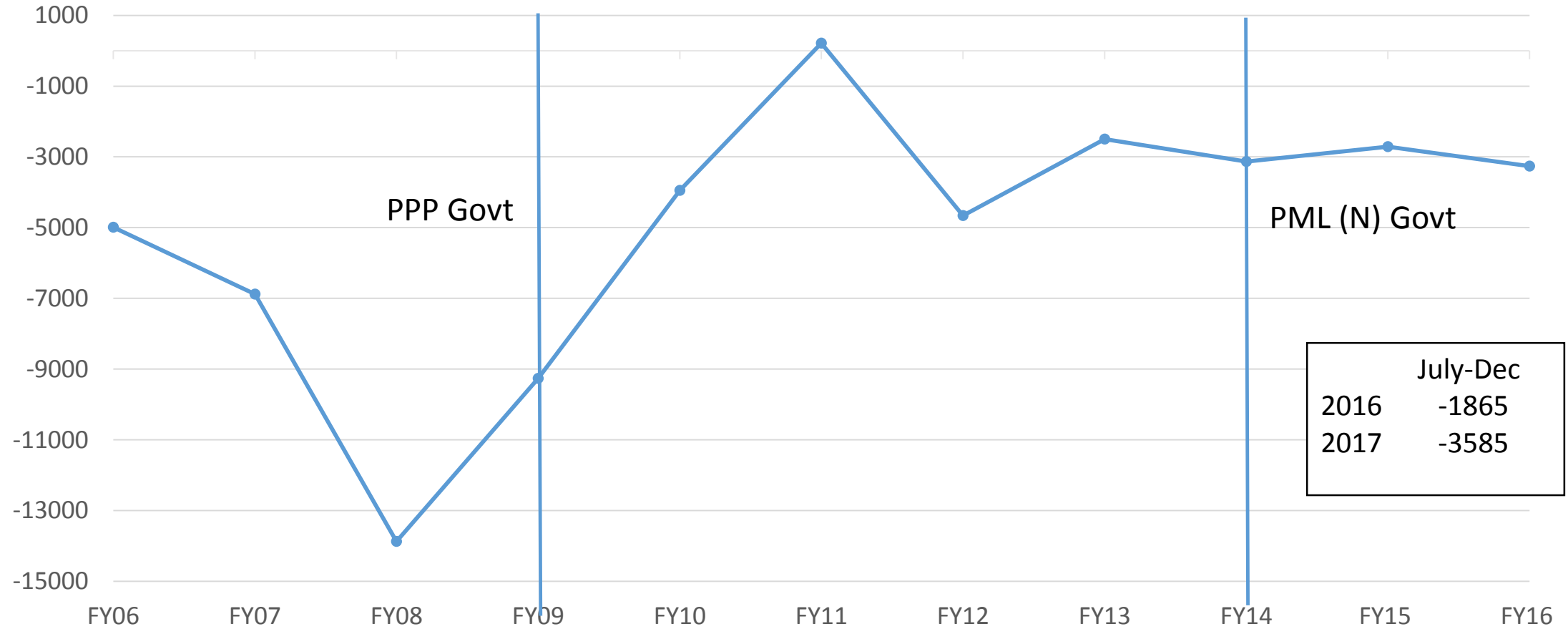
# What are the Potential Consequences of these Trends?

- Historically, in almost all countries at Pakistan's current stage of development the manufacturing sector has been the engine of growth:
  - Generates employment for the surplus labour in agriculture
  - Has the highest rate of productivity growth
  - Is the main source of export growth
- Decline in the manufacturing sector means that Pakistan will have to find an alternative engine of growth
  - Service sector?
  - Agriculture?
  - CPEC?
- Increasing import and declining export trends could result in an increasing current account deficit and risk of a BOP crisis
  - Back to the IMF!

# IMF loan FY2009



# Current account balance (Million US\$)



# What should be Pakistan's Exchange Rate Management (ERM) Policy?

- Pakistan should announce and commit to an exchange rate policy – in 2009, Pakistan was one of only 12 countries, out of 188, whose ERM system was classified by IMF as “Other managed arrangement”
  - Does not meet the criteria for any other category
  - Characterized by frequent shifts in policies
- The declared policy should be to:
  - First eliminate overvaluation
  - Then maintain a soft peg with a trade weighted basket of currencies – countries in the basket and their weights to be announced as part of the policy

# But Devaluation has Not Worked in the Past!

- For the policy to work there are some prerequisites:
  - First impact will be on the domestic price level and unless appropriate monetary and fiscal policies are put in place to prevent inflation the effect of the exchange rate adjustment will be quickly eroded
  - Exchange rate's impact is by influencing investment decisions, which obviously takes time to have an impact on production and employment, therefore it is necessary that:
    - Commitment to the Policy is credible
    - Implementation of the Policy is transparent
    - Policy is sustained for several years



Thank you