MCB Bank Limited

Issue # 61

Treasury & Investment Banking Group

Quid Pro Quo

ECONOMIC REPORT

BRAKING THE RUN

The draw down in reserves, slow growth in SCRA figures, FDI and inward remittances due to political and economic uncertainties, has caused the local currency to stumble in recent months. Coming under immense pressure the exchange rate has climbed above the PKR 70/$ parity for the first time in history.

This paper will attempt to propagate that though depreciation of the rupee according to market fundamentals is unavoidable a rapid decline must be avoided as it leads to panic and lack of trust in the local market, eventually leading to unofficial dollarization. The paper will close by outlining plausible strategies that can be used to rescue the Pak rupee and improve investor sentiment.

FALLING RUPEE, HURTING SENTIMENT

In the current fiscal year, FY08, the local economy is challenged by multiple economic challenges, which include growing macroeconomic imbalances - the widening fiscal and current account deficit- and rising inflation.

The fiscal deficit has been recorded at 8.5% of GDP while trade deficit for the first ten months stands around $16.08 bn compared to last year's trade deficit of approximately $13 bn. Though the new government has announced that it will undertake rigorous efforts to bring down the fiscal deficit to as low as 5% of GDP, the trade deficit is likely to worsen in the wake of rising food and energy prices in the international markets.

Oil prices have reached new highs settling close to $129 per barrel with an outlook of further price hikes. As a result, the oil import bill rose past $8 bn in the July-April period, the highest in Pakistan's history. Coupled with declining exports many economists are predicting a breach of the $20 bn level for trade deficit. Textile exports have gone down by almost 3% during the same period of FY08, this sector accounts for nearly 65% of exports out of the country.

Meanwhile inflationary pressures have been strong. Most distressing has been food inflation which has surged on the back of sustained increases in food and energy prices in the international markets, and subsequent supply disruptions and market inefficiencies in the domestic markets. Furthermore weak agricultural output this fiscal year has further worsened the situation. This has necessitated the need to import huge quantities of essential food items, particularly wheat, increasing the trade deficit further.

This exposes the frailty of the economy, since imports of important commodities like oil and wheat cannot be stopped. At the same time with the looming power crisis and a global economic slowdown exports are unlikely to increase enough to bridge the gap.

One clear impact of the ballooning trade deficit has been depleting FOREX reserves which stood at $12.26 bn in the week ended May 3, with reserves held by SBP dropping to $9.93 bn. Adding further to the woes is the slow growth in FDI flows and remittances since the imposition of emergency in November 2007 and ensuing political turmoil in the country. International investors have waited on the sidelines to let the political situation stabilize while the SCRA accounts witnessed significant capital outflows as reservations about Pakistan's economy grew.

All these changes have naturally been putting a downward pressure on the PKR/$ peg and the rupee slipped past the 64/$ mark for the first time since 2001. It is no surprise since the decrease in rupee value is in line with market fundamentals. This instability has now transcended into the inter-bank market. Where speculation and hedging has led to volatility with the dollar crossing PKR 70/$ parity for the first time in history.

In line with the disappointing performance of parameters and the ensuing instability in the rupee S&P reduced its long-term currency debt rating for Pakistan to B from B+ and its long-term local currency rating to BB- from BB hitting investor sentiment further, the KSE fell by 0.8% after the announcement. This has further spurred widespread uncertainty and speculation prompting economic agents from all sectors to lock significant sums of capital in dollars both as a hedge and as a speculative bet to benefit from dollar appreciation. This phenomenon is often defined as unofficial dollarization.

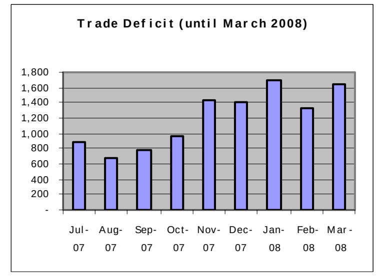

Figure 1 - Trade Deficit

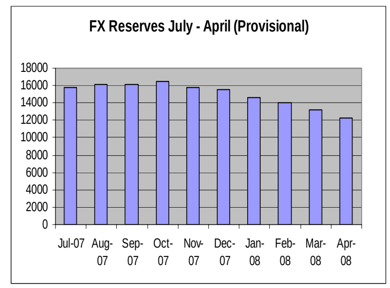

Figure 2 - FOREX Reserves

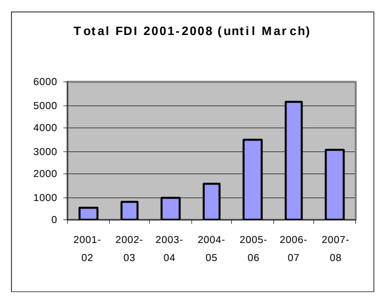

Figure 3 - FDI

RE-VISITTING 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 or any other stable currency for that matter 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.

Dollarization may lead to reduced risk and protection against inflation and devaluation, however there are substantial drawbacks as well. Foremost, the central bank loses its ability to manipulate the economy and administer monetary policy effectively. This exposes the economy and money markets to high risk and volatility, compelling economic agents to follow a cautious investment plan. Secondly, foreign reserves are put under enormous pressure as dollar demand rises rapidly. If FOREX reserves are insufficient current account deficit is likely to widen as the government will need to borrow to fulfill dollar demand.

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 vicious 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.

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. We are witnessing a similar turn of events after the imposition of emergency rule where investors are shying away from investment and a cloud of uncertainty has veiled the economy.

TRYING TO CURB THE KERB

Till recent past, foreign exchange transactions took place in the private sector using the kerb rate, which was the rate of choice in the 1990's. However, due to policies implemented during previous government's tenure, FOREX flows now go through more transparent channels. This was favorable for the Pak rupee, since it shielded the rupee from speculative advances and allowed the SBP to maintain a managed float.

However, taking advantage of recent instability, speculation has once again taken its toll on the kerb market, which went through a panic phase displaying erratic rate movements and an increasing difference between the inter-bank and kerb markets. To reign in this difference and in part to restore some normalcy to the market, the SBP disbursed about $6 mn to category 'A' exchange companies to halt the rupees slide against the dollar.

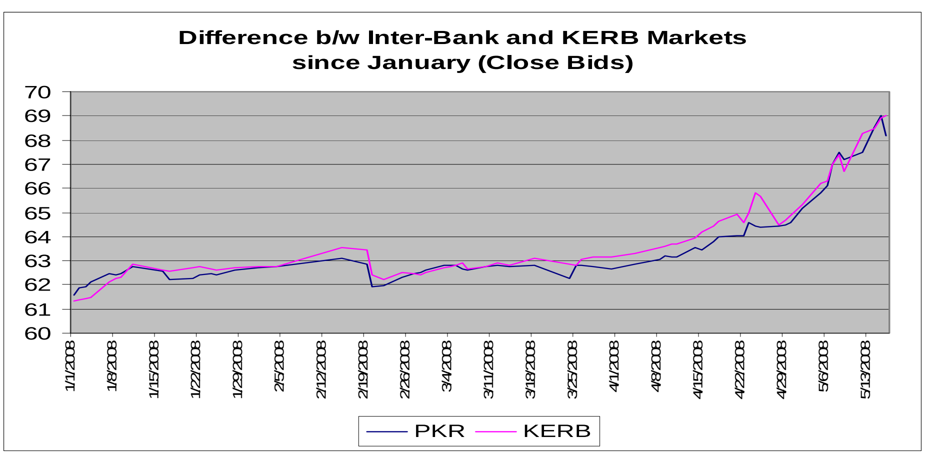

Figure 4 - Difference b/w Inter-Bank & KERB Markets from January

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Furthermore to protect foreign currency reserves and curb kerb rates the SBP has implemented second phase reforms for exchange companies relating to corporate governance. These reforms look set to define clearly the objective and scope of exchange companies as well as bring more discipline through enhanced transparency, disclosure and strong monitoring. In a nutshell, the SBP has decided to change its approach from 'bringing financial discipline and corporate culture' to 'ensuring discipline and maximum compliance'.

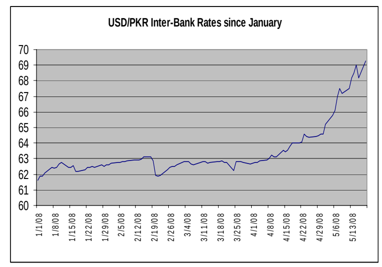

Figure 5 - USD/PKR Exchange Rate

Even after taking these measures the kerb market continued to display volatility, prompting the central bank to stop exchange companies from sending cash pound sterling, Euros and UAE Dirhams abroad. At the same they were also being directed to close all Nostro accounts by May 31st and bring back their balance to foreign currency accounts in Pakistan. These policies aim to improve the supply of dollars and also stop the rupee from depreciating further.

The SBP has somewhat been able to rationalize the difference between inter-bank and kerb rates, albeit recent volatility has seriously undermined confidence in the inter-bank market, leading to active speculation in foreign currency.

Taking this into account the Governor of the State Bank Dr. Shamshad Akhtar emphatically asserted in an interview that the central bank will not devalue or revalue the exchange rate and the market alone will determine its real value. We will now look at the policy tools available to SBP for controlling exchange rate volatility and improving market sentiment.

MOOD SWING

According to market fundamentals the rupee should depreciate on account of high import costs, widening trade and fiscal deficits, drying foreign investment and weak agricultural output. Even so, contrary to sentiment in the market, the rupee should not show so much volatility and depreciate as rapidly as it has done recently. The State Bank is still in the driving seat and has a number of policy tools at its disposal to tame the burgeoning exchange rate.

Firstly, the State Bank can regulate import forward bookings to control FOREX outflow and stop the trade deficit from widening in the short run. Due to the depreciating rupee, importers have been lining up trying to book forward rates for imports in order to hedge themselves before the exchange rate climbs and becomes more unfavorable. This speculation has put additional pressure on the PKR/$ parity. Regulating import forwards will help smooth out market inconsistencies and curtail volatility in the inter-bank market. But such a move would undo much of the progress that has been made in the inter-bank market in the previous years. So the State Bank would probably do it only as a last resort.

On a medium to long term period the government can change the trade policy. The trade policy was liberalized by the previous government with a view to minimize smuggling. With the trade deficit increasing policy option the government may be contemplating putting into place for the upcoming budget is to revise the trade policy to discourage imports. There is certainly good reason to do so, because trade deficit has already reached a record $16 bn and is set to climb higher by the end of FY08. The only problem however with any such move is that it may encourage smuggling, as stopping imports all together may just cause a shift to unofficial channels.

This will put upward pressure on the rupee in the kerb market, which will open yet another can of worms for the government.

Turning to monetary policy the most potent step the State Bank can take is to increase the discount rate. Certainly a 50 basis point increase in discount rate has been rumored imminent. Higher interest rate besides having the immediate effect of contracting the money supply and bringing down inflation also cuts down consumer spending. Additionally higher interest rates may bring in foreign portfolio investors looking to invest at higher rates. The problem with this approach is that it is like using a bulldozer to squash an ant. The government may succeed in cutting down imports but it would be at a wider cost of slowing down the whole economy. Additionally majority of the imports are income inelastic, so a cut down in consumption may not be proportionately transferred to a cut in imports.

CONCLUSION

As mentioned earlier the exchange rate faced similar volatility during the late 1990's. However, with oil prices breaching the $130 per barrel mark today and the need to import substantial quantities of food at inflated global prices, the consequences of a rapid decline in PKR/$ parity will be grave. Therefore, we need an immediate and effective rescue package to protect the rupee and remove the shroud of sentiment over the economy.

ECONOMIC SNAPSHOT

Fiscal Year 2007-08														
	Units	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Inflation														
Headline Inflation	%	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8	11.9	11.3	14.1	17.2
Core inflation	%	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2	7.8	8.1	9.3	10.8
Food inflation	%	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2	18.2	16	20.6	25.5
Non-food inflation	%	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3	7.3	7.8	9.4	11.2
T-bill (Wgt Avg)														
3 month	%	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09	9.09	9.38	9.59	9.59
6 month	%	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29	9.29	9.61	9.86	9.86
12 month	%	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49	9.44	9.87	10.13	10.13
External Sector														
Export	Mln US$	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500	1,634	1,591	1,816	n.a
Import	Mln US$	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910	3,316	2,909	3,458	n.a
Trade balance	Mln US$	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1637)	n.a
Remittances	Mln US$	513	537	505	495	489	516	580	505	479	557	502	602	590
Forex Reserves	Mln US$	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,589	14,657	14,031	13,232	12,255

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