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THE RUPEE SLIDE

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November 4, 2021

(Views expressed in the brief are those of the author, and do not represent those of ISSI)

Pakistan's exchange rate has deteriorated by around 12% since early May 2021 in response to the escalating current account deficit as the government went for expansionary monetary and fiscal policies fueling domestic demand and imports to achieve brisk economic growth. This resulted in high demand for the US dollar to pay for imports resulting in massive depreciation of Pakistan's rupee.[1]

However, the State Bank of Pakistan (SBP) on October 6, 2021, announced that it would take measures to curb the undesirable outflow of foreign currency, in the wake of constant depreciation of the local currency against the US dollar. Through the implementation of the recently announced measures, the central bank aims to enhance transparency in foreign currency transactions by exchange companies. According to the central bank, travellers to Afghanistan will be allowed to carry only $1,000 per person per visit, with a maximum annual limit of $6,000. Moreover, exchange companies will be required to conduct biometric verification for all foreign currency sale transactions equivalent to $500 and above and outward remittances. This requirement will be applicable with effect from October 20.[2]

1 "Rupee hits one-year low against dollar," Dawn, September 3, 2021, https://www.dawn.com/news/1644208/rupee-hits-one-year-low-against-dollar

2 "SBP takes measures to curb 'undesirable' dollar flight from Pakistan to Afghanistan," Geo.Tv, October 6, 2021, https://www.geo.tv/latest/374375-sbp-takes-measures-to-curb-undesirable-dollar-flight-from-pakistan-to-afghanistan

It is important to note that Dr Reza Baqir, Governor, SBP, during the presentation of monetary policy in August had made it clear that the current account deficit would be higher in FY21 ranging between 2-3% and the exchange rate would respond to this deficit in the form of appreciation of the US dollar. However, the limit of devaluation of local currency was not identified. Also, in the budget 2021, Public Sector Development Programme (PSDP) was increased from PKR 630 billion to PKR 900 billion to counter the adverse impact of the COVID-19 pandemic. This was a massive increase of around 40%. This was done to get the wheel of the economy going, while also spurring growth in the dozens of industries linked to proposed development projects and construction.[3]

Fitch Ratings has revised down its forecasts for Pakistani rupee for this year and for 2022 based on Pakistan's worsening terms of trade, tighter US monetary policy, alongside the flow of US dollars out of Pakistan and into Afghanistan.[4]The depreciation of rupee in response to the burgeoning trade deficit has doubled during the July-September period from a year ago, spiking the price inflation in the country. Pakistan's current account deficit, the gap between the country's higher foreign expenditures and sluggish income widened to $1.5 billion in August 2021. The trade deficit widened by 133% to $4.05bn in August reflecting mounting pressure on exchange rate due to higher demand for dollars from the importers. The central bank does not have much space to reduce imports because 70-80% of the total imports are of essential goods.[5]

One of the major problems with Pakistan's trade environment is the country's heavy reliance on energy imports. This reliance not only leaves the country extremely vulnerable to macroeconomic shocks resulting from change in international energy market dynamics, but also results in a distorted baseline for growth. A growth spurt almost necessarily results in escalating inflationary pressures, without financing capital imports. In the first two months of FY22, import of petroleum products rose by more than 86% whereas import of machinery grew by less than 20%.[6]

Furthermore, the devaluation of currency increases the external debt and liabilities of the economy. For every further 1% devaluation the national debt will climb up by approximately Rs.125 billion. It discourages investment and negatively affects the export industry of the country by making the exports cheaper for foreigners. It makes imported goods expensive for domestic consumers which

3 "Rupee becomes worst performer in Asia," Express Tribune, September 3, 2021, https://tribune.com.pk/story/2318312/rupee-becomes-worst-performer-in-asia

4 "Fitch expects Pakistani rupee to weaken further in 2022," Reuters, September 30, 2021, https://www.reuters.com/article/pakistan-currency-devaluation-idUSL8N2QW1JS

5 "Rupee hits fresh low of 170.48 against US dollar," Geo.Tv, September 29, 2021, https://www.geo.tv/latest/373019-rupee-drops-to-historic-low-of-170-against-us-dollar-in-intra-day-trading

6 "Curbs on dollar purchase," Dawn, October 8, 2021, https://www.dawn.com/news/1650783

discourages imports. It also has negative effects on social welfare which depends upon real GDP and rate of unemployment.[7]

The dollar is also a commodity and hence gains value when its demand increases. Over the last 2-3 years, Pakistan has received many external loans and borrowed a significant amount from the bond market, which has increased the supply of dollars. Additionally, because of the Covid-19 situation, business activity has been temporarily shut down, and as a result, the dollar exchange rate dropped to Rs.153. The economy is going through a period of volatility because the demand for the dollar has risen, but so has the supply issue.[8]

There is a need to harmonise the monetary and fiscal policy, if both these policies will move in separate directions, the economy will suffer badly. The government needs to realise that external account imbalances cannot be sustainably financed through foreign remittances, aid, and debt. Pakistan needs to move towards a tenable balancing of trade paradigm. And while export oriented policies are perhaps necessary to improve the equation, structural disparities on the import side must not be neglected. The policymakers need to realise that while exports can be enhanced through conducive regulatory interventions, the country's economic growth potential should not be left unnecessarily exposed to external shocks.[9]

The post-pandemic global economy has changed, and the scope of the new normal is expanding. There is little room for applying quick-fix solutions to structural problems. The government not only miscalculated the potential growth rate of remittances but also failed in right-forecasting the growth rate of imports. Therefore, the government and SBP should regulate their policies to bring stability in Pakistani currency and stop it from devaluation. They should devise a stringent plan and effective monetary policy to curb inflation and devaluation of currency from Pakistan. It is good to see the fiscal and monetary authorities finally take some action to control the re-emergence of vulnerabilities in the economy. But such ad hoc steps cannot be a substitute for sound economic policies and deep structural reforms.

7 "The devaluation of economy," The Frontier Post, 2018, https://thefrontierpost.com/the-devaluation-of-economy/

8 "Devaluation drags Pak rupee to bottom of currencies," Daily Times, September 5, 2021, https://dailytimes.com.pk/812251/devaluation-drags-pak-rupee-to-bottom-of-currencies/

9 "PTI's economic deja vu," The Tribune, October 04, 2021, https://tribune.com.pk/article/97490/ptis-economic-deja-vu