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EXCHANGE RATE REGIMES AND CURRENCY BEHAVIOURS IN PAKISTAN: AN EXPLORATORY ACCOUNT

The objective of this study is to explore the exchange rate regimes and PKR (Pak rupee) behaviours prevailed under such regimes in the economy of Pakistan since its inception. It is concluded that PKR was influenced unnecessarily by GBP and USD during the fixed exchange rate regime. Moreover, Pakistan used its currency as a tool to boost up its exports, and too much focus was given on this tool instead of paying more attention to other core issues related to exports. This study provides an opportunity for policy makers and researchers to understand PKR behaviour under various exchange rate regimes.

Keywords: *exchange rate regimes; Pak rupee; Pakistan; exports.*

Мухаммад Акрам

РЕЖИМИ ОБМІННОГО КУРСУ ТА ВАЛЮТНІ ЗМІНИ В ПАКИСТАНІ: ДОСЛІДНИЦЬКИЙ ЗВІТ

У статті досліджено режими обмінного курсу та зміни у курсі пакистанської рупії, які переважали під час цих режимів в економіці Пакистану від її початку. Згідно з висновками, вплив курсів фунту та долару на рупію під час фіксованого режиму обмінного курсу виявився необов'язковим. Більш того, валюта була використана як засіб підвищення експорту і цьому методу приділялося забагато уваги у порівнянні з іншими важливими питаннями експорту. Дослідження надає можливість управлінцям та дослідникам зрозуміти коливання пакистанської рупії за різних режимів обмінного курсу.

Ключові слова: *режими обмінного курсу; пакистанська рупія; Пакистан; експорт.*

Літ. 20.

Мухаммад Акрам

РЕЖИМЫ ОБМЕННОГО КУРСА И ВАЛЮТНЫЕ ИЗМЕНЕНИЯ В ПАКИСТАНЕ: ИССЛЕДОВАТЕЛЬСКИЙ ОТЧЕТ

В статье исследованы режимы обменного курса и изменения в курсе пакистанской рупии, которые преобладали во время этих режимов в экономике Пакистана от ее начала. Согласно выводам, влияние курсов фунта и доллара на рупию во время фиксированного режима обменного курса оказалось необязательным. Более того, валюта была использована в качестве средства повышения экспорта и этому методу уделялось слишком много внимания в сравнении с другими важными вопросами экспорта. Исследование предоставляет возможность управленцам и исследователям понять колебания пакистанской рупии при разных режимах обменного курса.

Ключевые слова: *режимы обменного курса; пакистанская рупия; Пакистан; экспорт.*

1. Introduction. During the period of financial liberation and globalization, the role of exchange rate is crucial in finance and international trade related matters for small open economy such as Pakistan. Stable exchange rate may provide assistance to financial institutions and enterprise in reducing and hedging their operational risks, and evaluating performance of investments (Rahman & Hossain, 2003; Nieh, 2005).

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On the other hand, exchange rate movements increase exchange exposure to financial institutions and enterprises, affect profitability of multinationals, and significantly affect macroeconomic fundamentals like level of output, unemployment, wages, prices and interest rates which may results in real exchange rate devaluation (Parikh & Williams, 1998).

The selection of suitable exchange rate system is an important matter in finance and international economics. Traditionally, it seems that an economy depends upon exchange rate while responding to foreign shocks which actually characterizes an economy. After the collapse of Bretton Woods system, there are two broad systems of exchange rate: fixed exchange rate system and floating exchange rate system. In fixed exchange rate system, economy responds independently to each foreign shock, whereas in floating exchange rate system economy automatically adjusts aftershocks. Some economists prefer fixed exchange rate system due to greater stability while many economists prefer floating exchange rate system because it allows administrating their own stabilized policies. Modern literature on selection between fixed exchange rate system and flexible exchange rate system traces back to the work of Friedman (1953). Mundell (1963, 1961b, 1961a, 1960) refined and supplemented the early work of Friedman (1953) who discovered role of capital mobility while selecting exchange rate regime.

Exchange rate regimes in Pakistan can be broadly categorized as: fixed exchange rate regime, managed floating rate regime, two-tier exchange rate regime, market based unified exchange rate regime and floating exchange rate regime. Before the independence of State Bank of Pakistan (SBP), adoption of exchange rate regime started in Pakistan from fixed exchange rate regime up to early 1980s and evolved to the managed float regime till 2000. Afterwards, floating interbank exchange rate system was selected in 2001 as a preferred option and SBP worked and regularly intervene in order to maintain real effective exchange rate; increase the intact of competitiveness of Pakistani exports; smooth excessive fluctuations and keep stability in market. Exchange rate regimes and exchange rate behaviour in low income developing country like Pakistan leave some important questions to be answered. This study attempts to answer such questions.

Research Questions

RQ.1. What type of exchange rate regimes prevailed in Pakistan since its inception and how these regimes responded to changes in PKR?

RQ.2. What are the determinants of switching to different exchange rate regimes in Pakistan?

RQ.3. How PKR responded to changes in world's leading currencies (USD, GBP, and EUR) in various exchange rate regimes?

RQ.4. How fixed exchange rate regime influenced exports competitiveness of Pakistan?

2. Fixed Exchange Rate Regime: (1947-7th January, 1982). During initial few years, the PKR (Pak rupee) was tied to GBP (British pound), and a fixed exchange rate system prevailed in the country in the period starting from 1947 to 7th January, 1982 (Janjua, 2007).

Britain had more than 3,000 million in its outstanding debts to creditors in GBP area at the end of World War II, from those who provided funds to Britain during the

war. Faced with heavy payment deficit balance of 1,250 million during 1954-1950, many countries anticipated the devaluation of GBP and converted their pounds into USD. After the WWII, Britain was not ready to supply consumer goods to its trading partners in GBP area who then switched to USA for fulfillment of their needs of consumer goods. It resulted in devaluation of GBP by 30% on September 18, 1949 and GBP lost its attractiveness as a reserve currency to be held in major quantities by foreign governments. Now national banks wanted USD instead of GBP (Newton, 1984; Kit, 2001).

Dorosh and Valdes (1990) argued that due to deteriorating value of GBP, many countries in the GBP area devalued their currencies but Pakistan until 1952 held liberal import policy and decided not to devalue its currency because its exports surged due to increased demand of Pakistani cotton and jute during Korean War, country was earning large amount of foreign exchange. But as soon as Korean War ended, demand for Pakistan's exports declined and amount of foreign exchange also shrined. To control the situation government implemented import control to handle the situation but the devaluation was still delayed until 1956.

Subroto (1993) explained that at the time of partition, Pakistani rupee traded at par with Indian rupee, but India devalued its currency in 1949 following the devaluation of GBP. Pakistan did not respond to devaluation of GBP and Indian rupee, this brought the existing common market between India and Pakistan to an end. On July 31, 1955, Pakistan devalued the PKR to Rs.4.76 to USD and again Pakistani rupee and Indian rupee began to trade at par.

To encourage exports in the country, export taxes were lowered and finally reduced to zero. Many restrictions were imposed on import of goods and import licenses were issued to only a few importers. Many schemes were introduced to encourage exports; the most effective of them "Export Bonus Scheme (EBS)" was introduced in 1959. Under EBS, export bonus vouchers were awarded to manufacturers of the products each time they exported the products manufactured by them. The number of export bonus vouchers being awarded was certain percentage of freight on board (F.O.B). Some items were allowed to be imported by using export bonus voucher, these items were restricted for imports otherwise, and were added in "bonus list". In early years of 1960s, for partly finished goods bonus rates were 20% and for finished goods rates 30% of F.O.B values which were later on increased to 30% and 40% respectively. As a result of this export bonus scheme, exchange rate was devalued a great degree because imports were purchased by bonus vouchers awarded on exports (Dorosh & Valdes, 1990).

In 1965, the war between Pakistan & India left both countries in severe economic shocks. In response to these shocks, India devalued its rupee in 1966 by 57.5% but Pakistan showed no response to Indian rupee's devaluation. In 1971, with the collapse of Bretton Woods System, GBP started to depreciate and since Pakistan rupee was pegged to GBP it started to appreciate. (Subroto, 1993).

When GBP became less popular as a reserve currency and economic influence of USD became more strong and apparent, Pakistan decided to peg its currency to USD, and PKR was linked to USD in 1971.

Janjua (2007) stated that the new exchange rate in 1971, when PKR was being linked to USD, was fixed at level of Rs.4.76 against one unit of USD. Pakistan export-

ed major products to its east wing (now Bangladesh), but after Indo-Pak war of 1971, East Pakistan separated to form Bangladesh and all the products that were previously exported to East Pakistan now had to be absorbed in remaining Pakistan. As a result of goods surplus, cotton was accumulated in large amounts during 1971-1972.

Dorosh & Valdes (1990) reported that from the time of introduction of EBS, bonus vouchers accounted for 35% of total export proceeds and goods imported on bonus vouchers were 40% of total imports of the country up till 1971. Moreover since the introduction of EBS, it combined with all unfavorable outcomes of multiple exchange rates including the discrimination of prices between exporters and importers, and resulted in misallocation of resources and negative impacts on output and growth of the country (Janjua, 2007; Rafiq, 1999). Under such circumstances, to avoid further damage to balance of trade, bonus voucher scheme was eliminated and PKR was devalued by 131% in May 1972.

This period was characterized by high rate of inflation. All the subsequent events drew the attention of policy makers to make adjustments in exchange rate of Pakistan. Consequently, the PKR was depreciated and the new exchange rate was set at Rs.11.00 per USD in May 1972. This new exchange rate was considered overvaluation of PKR by some experts but in February 1973 USD was devalued by 10%, and Pakistan rupee being linked to USD automatically appreciated by 10% to a new value of Rs. 9.90 against 1USD. This exchange rate system remained functional until January, 8th, 1982, after that multiple exchange rate regime came to an end, and managed floating exchange system came into practice (Janjua, 2007).

Khan (2008) elaborated that during the period of end-1980 to end-1981, USD appreciated and Pak-rupee being linked to USD also appreciated significantly against other currencies of the world. This appreciation of Pak-rupee adversely affected the competitiveness of Pakistani exports to non-USD countries. Under such circumstances Pakistan delinked its PKR from USD and pegged its currency to a group of selected currencies which were involved in trade with Pakistan.

3. Managed Floating Exchange Rate Regime: (8th, January, 1982 – 21st, July, 1998). Appreciation of USD in early 1980s leading to appreciation of Pak rupee had adverse impact on attractiveness and affordability of Pakistan's exports at international markets. In order to maintain a healthy and favorable balance of payment and to achieve export competiveness, managed floating exchange rate was adopted on 8th, January, 1982. Under managed floating rate mechanism, the value of PKR relative to value of weighted basket of currencies was reviewed on daily basis by the monetary authorities and adjustments were made when needed in accordance with exchange rate and prices prevailing in major trading partners and economic indicators of home country (Janjua, 2007).

Depreciation of 20% and 11% was recorded in PKR in 1982-1983 and 1983-84 respectively, overseas Pakistan remittances improved significantly and increased to the level of 30% in 1981-1982. This improved the current account and real exchange rate appreciated slightly. Nominal exchange rate depreciated more rapidly between 1985-1986 (Subroto, 1993).

The devaluation in PKR reached 78.5% since introduction of managed floating in 8th, January, 1982 till its elimination in July, 21, 1998 (Rafiq, 1999).

4. Dual Exchange Rate Regime: (22nd July 1998 to 18th May 1999). Pakistan successfully conducted nuclear tests and became the 7th atomic power of the world on

May, 28, 1998. As the consequence of these nuclear tests, many economic sanctions were imposed on Pakistan by its major donors. Pakistan faced crisis-like situation and had to deal with this situation. The level of foreign exchange reserves fell sharply from USD 1,315 mln. to USD 930 mln. between May 27, 1998 and June, 1998. On November, 12, 1998, the declination in foreign exchange reserve reached the level of USD 415 million. The inflow of finances from bilateral and multilateral donors was also interrupted, giving rise to uncertainty that country will fail to meet its international financial obligations. Due to this uncertainty, speculative demand of USD in the market surged and boosted pressure on PKR. On July 11, 1998, premium reached the record level of 28.24%. On 22nd July 1998 State Bank of Pakistan made a move by substituting the managed floating exchange rate system with "new exchange rate mechanism" (Janjua, 2007).

Rafiq (1999) claimed that to cope up with the challenge of deteriorating economy, the managed floating exchange rate mechanism was replaced with the dual exchange rate system in July, 22, 1998. This dual exchange rate system was a composition of 3 different rates: official exchange rate, floating interbank rate, and composite rate. The monetary authorities (State Bank of Pakistan) determined the official exchange rate, while the forces of demand and supply ruled the interbank floating rate in interbank market. The third component called composite rate was determined by combining the official and interbank rate in a specific percentage. Initially this percentage was 50% floating rate and 50% interbank rate. Later on, in December 21, 1998 the previous percentage rate was modified to 20% official and 80% interbank rate. Further modification was made in March, 11, 1999 when percentage was set to 5% official and 95% interbank floating rate. The reasons behind the introduction of two-tier exchange rate mechanism were to give benefits of devaluation to the exporters to maintain export competitiveness, to facilitate the remittance of money to Pakistan by overseas Pakistanis, to discourage the non-essential imports and to limit the impact of inflation.

A number of measures was taken to foster stability in value of Pak rupee at both interbank and open market. Measures taken by SBP included timely intervention in Forex market, controlling of speculation forces by encouraging the money changers and taking them into confidence over their actions. SBP also issued notices to unregistered money changers asking them to obtain licenses in order to pursue their exchange activities as "authorized money changers". SBP cautiously monitored the outflows of foreign exchange and fluctuations in composite rate. As a result, Pakistani rupee appreciated from Rs 63.75 per USD to Rs 52.35 per USD between September, 4, 1998 and May, 18, 1999 in the free market, and also the level of foreign exchange reserves was raised from USD 415 mln. to USD 1,738 mln. on November, 12, 1998 and May, 18, 1999 (Rafiq, 1999).

The dual exchange rate mechanism is basically a multiple currency exchange rate system. Pakistan being a member of IMF accepted the Article VIII according to which a member country is not allowed to adopt a multiple exchange rate system. However with the approval of IMF, a member country may adopt multiple exchange rate system temporarily. Now Pakistan government was inclined to adopt a unified exchange rate policy to avoid the violation of Article VIII (Rafiq, 1999).

5. Market-based Unified Exchange Rate Regime: 19th May 1999 – 20th July 2000. Dual exchange rate system came to an end and market-based unified exchange rate system became functional in 1999, in which PKR was allowed to float within a narrow band. SBP started making purchases in unofficial markets (Kerb market) to divert the flow of foreign exchange from unofficial market to interbank market (Zulfiqar & Adil, 2005).

Adoption of unitary exchange rate mechanism took place on May, 19, 1999 as the dual exchange rate mechanism was the temporary arrangement and solution. Under unitary exchange rate system the supply and demand of PKR in the interbank market determined its value, the official exchange rate was eliminated and interbank floating rate was enforced as a functional rate that governed the exchange of foreign receipts and payments. In this regime an authorized dealer from interbank market was responsible for carrying out foreign exchange transactions for all the purposes that were allowed by the authorities under law. These things included loan repayments, imports of products etc. Authorized dealers had discretion to set rates for foreign exchange transactions undertaken, but the difference between bid and ask prices was not allowed to exceed Re 0.5 per USD. Under this policy of exchange rate, the State Bank of Pakistan was given authority to engage in buying and selling of foreign exchange. Later, the scope of state bank's intervention increased further and it was authorized to buy and sell even from the sources that were outside the country. In case of any fluctuations State Bank was not bound to provide any forward cover, however an authorized dealer was free to provide forward cover for foreign exchange transactions. During the market-based unified exchange rate regime value of PKR remained between Rs 50.70 – Rs 52.16 and Rs 52.40 to Rs 54.40 per USD respectively (Rafiq, 1999).

6. Free Floating Exchange Rate Regime: 20th July 2000 – to present. Pakistan adopted free floating exchange rate system on the 20th July 2000. Under this system, exchange rate is decided by interaction of free market forces of demand and supply in open market. In stabilizing and monitoring exchange rate, monetary policy is playing a vital role and monetary policy's instruments such as open market operations are used from time to time to effectively handle Forex fluctuations. Proactive monetary policy measures are used to minimize the speculation activities. The State Bank also controls the discount rate by raising or lowering the cash reserve requirement (CRR) and CRR is also used to control the pressure on PKR. State Bank makes purchase of bonds in open market which increases the supply of money at the market (Janjua, 2007).

Pakistan adopted floating exchange rate system with the purpose to maintain the affordability of exports at international markets. The difference between floating and managed floating exchange rate system is that SBP does not intervene when it is necessary to stabilize the fluctuations at the foreign exchange market (Ishrat, 2005).

During 1999 and 2000, PKR was overvalued due to prevailing managed floating that did not allow PKR depreciate more than the narrow band. After the adoption of free floating exchange rate system, PKR depreciated sharply because of automatic adjustments of overvaluation by forces of demand and supply at free market. The PKR depreciated by 18.5% during 2001. The new exchange rate system used monetary instruments to check & control the expected high fluctuations of the exchange rate. After September, 11, 2001, restrictions were imposed on informal channels of

foreign remittances, as a result of which officially the exact amount of foreign remittances was recorded that showed significant increase, which in turn increased the Forex reserves of the country. Increased Forex reserves and increased inflow of remittance resulted in appreciation of PKR. So in order to maintain the competitiveness of exports, SBP purchased 8.2 bln. USD between the period starting from October 2001 till March 2004. The demand of foreign exchange from importers increased in the interbank exchange market, signalizing the SBP to cut down its purchases. To keep the liquidity maintained in the inter-bank market SBP also financed huge oil payments (Janjua, 2007).

When PKR was set to free float it depreciated 1,5% each month during initial few months. PKR was stable 3 months before September, 11 because of buildup of forex reserves of USD 2 bln., and PKR depreciated against other currencies while appreciated against USD after 9/11. After the adoption of floating exchange rate system, the tools of monetary policy (CRR and discount rate) were used to prevent the depreciation of PKR. After 9/11, to hold back the inflation and excess appreciation in PKR, open market operations and other measures were taken (Kemal & Haider, 2005).

Under the system of floating exchange rate, PKR gained strength against USD at the interbank market as well as at open market on account of increased foreign exchange reserves, current account surplus and increased worker's remittance through formal banking channels. During July 2002 and April 2003, PKR showed appreciation of 3.49% at interbank market, when it moved from level of Rs 59.7907 to the level of 57.7757 between July 2002 and April 2003 respectively, while PKR showed an appreciation of 3.25% at open market. But on other hand, Pakistani rupee faced depreciation against EUR, because during this period EUR gained popularity and emerged as a single preferred currency by investors at both local and global level. Between January and July 2002, PKR witnessed fall in its value from previous level of Rs. 57.7757 to new level of Rs. 59.7907 and further depreciation to the level of Rs. 62.7277 till April 2003 (Economic Survey, 2002-2003).

The economy in fiscal year 2004-2005 was characterized by high rate of economic activities, which gave rise to increased demand for imported machinery, raw materials and capital goods. The increased imports of non-oil and non-food products by 41% combined with high oil prices at international markets, increased the demand of USD to finance imports and oil payments. The increase in oil prices at international markets caused the imports of oil and petroleum to increase in value term by 30.9%. Also the prepayments of huge and expensive external loans combined with all the previously mentioned factors, exerted pressure on PKR. As a result, PKR witnessed a depreciation of 3.2% at interbank market and 3.5% at open market during fiscal year 2004-2005. Average rate at interbank market for the period ended in April, 2005 was Rs.59.4 per USD as compared to the rate of Rs.57.5 for the same period in the previous year. While the rate in open market for the end of April 2005 was Rs. 59.9, EUR kept gaining strength against PKR, and PKR was depreciated from level of Rs. 71.5 as on July 2004 to an average level of Rs. 76.8 in April 2005. On the whole exchange rate did not show large fluctuations against USD during the fiscal year 2004-2005. But, with the increased acceptability of EUR zone currency as a dominated and preferred currency at the international market against the USD, EUR

appreciated against major currencies. Thus, the Pak rupee depreciated by 6.9% against the EUR till April 2005 (Economic Survey 2004-2005).

Between June 2006 and April 2007, PKR depreciated from Rs.60.2138 per USD to Rs.60.6684 showing a marginal depreciation of 0.7%. At open market,PKR traded at discount of 0.02% that is Rs. 60.655. However, like in the previous year, PKR somehow remained stable against USD, while EUR strengthened further and reached the level of Rs.77.02 in July 2006. PKR further depreciated against EUR in April 2007 to Rs 82.76. Overall depreciation of 0.7% took place during July-April 2007. In the same period the real effective exchange rate, which indicates the trade competitiveness, appreciated in real terms by 2.06%. This happened because the country was facing higher rates of inflation relative to its main partners in trade (Economic Survey, 2006-2007).

Beside the forces of demand and supply, the accumulation or reduction of foreign exchange reserves also affects the value of exchange rate. Pak rupee showed a depreciation of 16.3% between July 2008 – October 2009, the basic causes behind depreciation were a significant reduction in foreign exchange reserves, problematic situation of trade related outflows, surge of speculation activities, bad & uncertain political environment and huge foreign currency purchase by businessmen to avoid any anticipated losses on imports. Under huge pressure, PKR depreciated further till October 2008 and reached the record low level Rs. 83.46 per USD. Rather than waiting for market conditions to get worse, Pakistan signed Standby Arrangement (SBA) with IMF and adopted a more flexible exchange rate system. PKR started to regain its value after the signing of SBA with IMF, the external inflows and contraction of imports got back to normal. In April 2009 PKR swung back to the level of Rs.80.50 per USD. Furthermore, PKR not only appreciated and gained value against USD, but also EUR depreciated by 1.1 and GBP depreciated by 15.4% against Pak rupee during 2008-2009 (Economic Survey, 2008-2009).

Depreciation of PKR against USD was slowed down after the adoption of a more flexible exchange rate system, and PKR showed a depreciation of only 2.5 and 3.9% during December 2008 – June 2009 and during July 2009 – Mard 2010 respectively in contrast to the large slump of 16.2% in the previous year. This improved performance was a result of stable foreign exchange reserves and better position of payments balance. The period of July 2009 – Mard 2010 witnessed high fluctuations in exchange rate at the unofficial market because of high demand related to Hajj season in the starting few days and later on due to shifting of oil payments. In February 2010, high demand of USD at unofficial markets raised the premium and increased fluctuations. PKR recovered some of its value that was lost back in February against USD, and showed appreciation of 1.01%. This appreciation was due to increased inflows from portfolio investments and workers' remittances. PKR's better performance against EUR and GBP was primarily due to relative appreciation of USD against other currencies (Economic Survey, 2009-2010).

Pak rupee gained strength against USD at the open market as well as at the interbank market, underlying factors that caused PKR to strengthen were surplus in balance of payment, continued accumulation of forex reserves and foreign remittance through official banking channels. Average value of PKR moved from Rs. 83.7 in fiscal year 2009-10 to Rs. 85.3 in June 2010. During July 2010 – April 2011, the Pak

rupee showed depreciation of 2.2% against USD, while the depreciation was 6.6% for the same period in the previous year. This stability can be attributed to favorable balance of payments. Major contributors in 2.2% depreciation during July 2010 – April 2011 were irregular inflows and outflows resulting from oil payments made for import of crude oil by the oil marketing companies (Economic Survey, 2010-2011).

7. Conclusions. Behaviour of home currency varies in different exchange rate regimes according to specific dynamics of regimes. The economy of Pakistan passed through 5 different regimes and presently free floating exchange rate regime is prevailing. Destabilization in leading world currencies (USD, GBP) and uplifting exports remained the major determinants of switching over to regimes. Excessive reliance on exchange rate as a tool for boosting exports could not produce desired results as core related issues were not addressed. The changes in PKR as a result of linkage to USD and GBP could not let the Pakistan economy surface the internal consequences rather than external. Adjustment in PKR postponed and accumulated. When, after some intervals, these adjustments were incorporated, very high rate of inflation was observed. As a result, Pakistan had to face a number of economic issues including higher import bill.

For prospective studies, impact of exchange rate on economic growth, foreign direct investment and on various macroeconomic variables by considering exchange rate regimes can be considered.

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