Day Break

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Economy

PKR: Approaching IMF a Necessity Now; Else More Price Pain to Come

- As per news reports, the Exchange Companies Association of Pakistan (ECAP) from 25th January will remove self-imposed 'artificial cap', keeping the open-market rates premium close to interbank rate.
- The emergence of this black market can be attributed to the country's significant depletion of its foreign exchange reserves. The immediate consequence we anticipate will be an increase in prices. Essential imports like food and oil will now be sold at higher rates, which, without government intervention, would quickly lead to higher inflation.
- Given the limited foreign exchange (FX) reserve position, the State Bank of Pakistan's (SBP) ability to intervene and take corrective measures is limited. Reaching out to IMF and other donor agencies is eminent, delays in which will only keep the PKR official rates at the helm of the black market.

PKR at interbank crossed 255 mark against the US$, 9.6% devaluation in a single day. This is one of the highest daily depreciation since 1998.

The Background Story

As per news reports (link), the Exchange Companies Association of Pakistan (ECAP) from 25th January will remove self-imposed 'artificial cap', keeping the open-market rates premium close to interbank rate, which previously was at ~4.0%. However, this created a third unofficial 'Black' currency market, whereby rates were trading at even higher premium 10-15% to interbank rates.

… History Suggests Emergence and Outcomes Black Market Have Been Rather Painful

The emergence of black currency markets is not new and has occurred in various countries throughout history, such as in the 1970-80's in East European countries and Ghana. They still exist in countries such as Iran, Argentina, Nigeria, and the Philippines. More recently, Egypt had to deal with a similar parallel currency market. Though black currency markets have emerged in different countries at different time periods, the economic outcome has been similar in nature. Official rates eventually

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converge to or close to black market rates, resulting in a rampant rise in inflation.

Pakistan Struggles with Black Currency Market amid Depleted FX Reserves

Pakistan too now to have to deal with black currency market. Black market premiums for US$ have hovered over and above 10-15% of the official exchange rate or the interbank rate.

The emergence of this black market can be attributed to the country's significant depletion of its foreign exchange reserves. As of January 26, 2023, the State Bank of Pakistan's (SBP) held reserves fell to a multi-year low of US$3.7bn, down from US$16.1bn last year. To address this shortage, authorities have either been reluctant or delayed seeking a rescue from the International Monetary Fund (IMF). Despite this, with minimal foreign exchange reserves on hand, the SBP and government have restricted access to exchange reserves for non-priority companies by not issuing letters of credit (LC) to importing companies (Link) and earlier in Sept-22 by increasing cash margins requirements (Link). As a result, local companies that rely on imports for their raw materials have had to either shut down production or resort to the black market to obtain the necessary US dollars.

More Price Pain

The immediate consequence we anticipate will be an increase in prices. Essential imports like food and oil will now be sold at higher rates, which, without government intervention, would quickly lead to higher inflation. Assuming all other factors remain constant, the domestic prices of MS and HSD will rise by ~10% due to the depreciation of the exchange rate. Prices of non-essential items have, to some extent, already been factored in with black market rates. In the medium term, the indirect impact of higher energy and other non-essential item prices will be substantial.

Addressing the Imbalance: The Immediate Approach

Although there is no single solution, but foremost will be for the SBP will need to intervene and ensure the correction of US$ demand/supply imbalance. This intervention may not completely eliminate the black currency market, but it can lead to a reduction in premiums. This will not only guide exporters and remittances to official channels but also decrease the cost of providing essential raw materials for the local market and export industry, and help keep inflation in check to some extent.

The CBE's Effort to tackle Black Currency Market

Additionally, the Central Bank of Egypt (CBE) recently adopted a similar approach when dealing with Black currency market, by canceling the letter of credit (L/C) system and returning to a cash-against-documents system for importing goods by the end of 2022. This primarily eliminates the involvement of banks, thereby reducing the pressure on foreign exchange reserves held by banks, and secondly, reduces the delays caused by the L/C process. It is hoped that this simplification of import procedures will eventually lead to the provision of essential raw materials for the local market and export industry at official rates rather than black market rates, allowing production to resume.

Exhibit: Market Survey of Monetary Policy decision

With recent adjustment in official PKR rate, open market premium has shrunk to 0.6%, compared to prevalent ~4.0%. (source: SBP, Forex.PK, IGI Research)

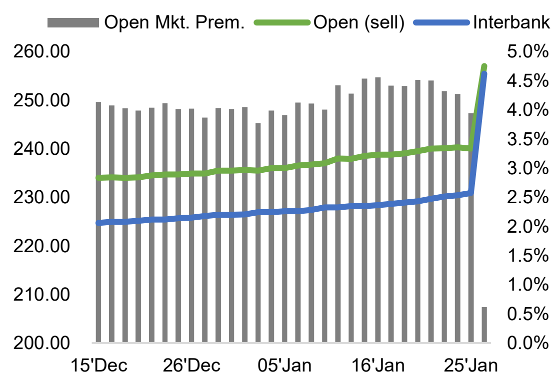


Exhibit: Pakistan Depreciation over the course of history

Over the past 50 years, the PKR has depreciated by an average of 8% in 37 years, compared to an average of 4.2% appreciation in 5 years, and remained unchanged for 8 years. (source: SBP)

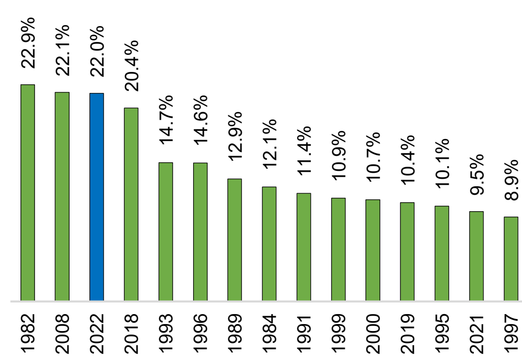


Exhibit: Pakistan CPI and PKR/USD parity

Periods of high PKR depreciation was followed by high inflation rate. (Source: SBP)

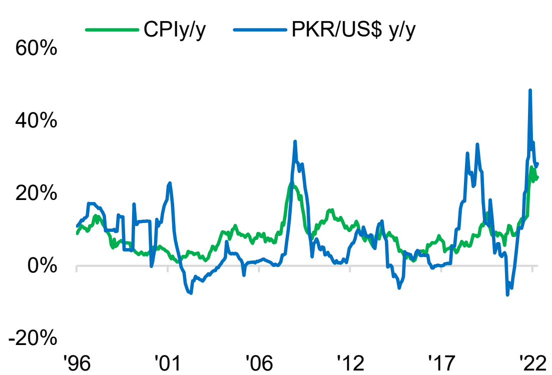
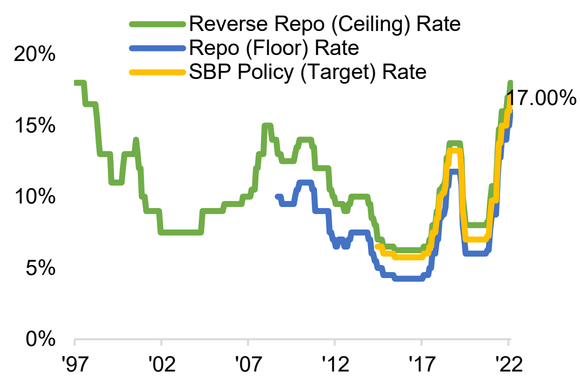


Exhibit: Pakistan Policy Rate (historical)

Last time Pakistan had 18% of Discount rate was back in Jun-98.



Approaching IMF: A Necessity to Stabilize Currency

But even before taking such steps, the Central Bank of Egypt (CBE) had to intervene in the currency market to correct the imbalance, which was only possible once they approached the International Monetary Fund (IMF). Pakistan stands in a similar situation. Given the limited foreign exchange (FX) reserve position, the State Bank of Pakistan's (SBP) ability to intervene and take corrective measures is limited. Reaching out to IMF and other donor agencies is eminent, delays in which will only keep the Pakistani Rupee's official rates at the helm of the black market.

Higher Inflation = More Rate Tightening

SBP in recent monetary policy statement increased the policy rate by 100bps citing, inflationary pressures are persisting and broad-based, which could feed into higher inflation expectations over a longer period and emphasized the importance of anchoring inflation expectations and achieving price stability to support sustainable growth.

Post official exchange rate the price pain will be inevitable and hence inflation expectation will be high. Our initial expectation of rate hike in 1HCY23 was of 200bps, of which 100bps has been delivered. We think, SBP will now need to come more aggressive on rate hike, as to further suppress demand and anchor down inflation.

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