Following rebuttal published by Business Recorder on February 10, 2021 entitled "SBP responds to BR editorial"

BUSINESS RECORDER
Karachi, Wednesday 10 February 2021, 27 Jamadi-us-Sani 1442

<u>Clarification: SBP responds to BR editorial</u>
<u>Business Recorder</u>

KARACHI: Apropos an editorial titled 'An expensive correction' published on 8th February, 2021 in Business Recorder, State Bank of Pakistan (SBP) says it would like to draw newspaper's attention to the following point:

"And while the SBP insists that one cannot measure the degree of over or under-valuation by using 100 as the key determinant in the REER (a view not shared by previous governors of the SBP) yet the SBP has to date not come up with any estimate or projection of the real rupee value other than to insist that it is a long-term concept.

SBP says: "Your [newspaper's] statement refers to data on Real Effective Exchange Rate (REER) and argues that a movement away from 100 reflects under or over valuation of the currency. We would like to clarify once again that your [newspaper's] understanding of the concept is wrong and that any change in REER with reference to its base year value of 100 does not suggest in any way an under or over valuation of the exchange rate. Therefore, the statement made in the editorial is incorrect and misleading.

"The concept of appreciation or depreciation of REER must not be confused with the concept of currency overvaluation or undervaluation which are entirely different concepts. Neither can overvaluation nor undervaluation be deduced from comparing the index numbers to 100. The REER index number merely shows a comparison relative to the 'chosen' base year.

"The extent of exchange rate under/over valuation is computed through a medium-term analysis using sustainable norms for the current account balance, fiscal balance, demographic condition, debt, etc. For example, the IMF uses an approach called External Balance Assessment to assess under/over valuation (see https://www.imf.org/en/Publications/WP/Issues/2019/03/19/The-External-Balance-

Assessment-Methodology-2018-Update-46643). Nowhere does this paper state that a REER value of 100 is synonymous with the exchange rate being correctly valued.

"Finally, and as we hope it would be readily apparent, if the SBP were to change the base year used for the REER calculation, the numerical value of the REER for any given month would automatically change and it would be incredulous to argue that the extent of over/undervaluation in that month has changed simply due to changing the base year.

"Here we would also like to share that our records do not confirm that any of our previous Governors has shared any such view. However, we shall be happy to review any such statement available in public domain that you may share with us.

"You will agree that the exchange rate is a very delicate topic to comment on due to its sensitivities for the economy and particularly the financial sector. Therefore, any remark based on misconceptions could have deep negative repercussions for the financial markets."

Following clarification/rebuttal was issued to Business Recorder in response to an editorial published on February 8, 2021 entitled ''An expensive correction".

Rebuttal to Business Recorder

Apropos the editorial titled 'An expensive correction' published on 8th February, 2021 in your newspaper, we would like to draw your attention to the following point:

"And while the SBP insists that one cannot measure the degree of over or under-valuation by using 100 as the key determinant in the REER (a view not shared by previous governors of the SBP) yet the SBP has to date not come up with any estimate or projection of the real rupee value other than to insist that it is a long-term concept."

Your statement refers to data on Real Effective Exchange Rate (REER) and argues that a movement away from 100 reflects under or over valuation of the currency. We would like to clarify once again that your understanding of the concept is wrong and that any change in REER with reference to its base year value of 100 does not suggest in any way an under or over valuation of the exchange rate. Therefore, the statement made in your editorial is incorrect and misleading.

The concept of appreciation or depreciation of REER must not be confused with the concept of currency overvaluation or undervaluation which are entirely different concepts. Neither can overvaluation nor undervaluation be deduced from comparing the index numbers to 100. The REER index number merely shows a comparison relative to the 'chosen' base year.

The extent of exchange rate under/over valuation is computed through a medium-term analysis using sustainable norms for the current account balance, fiscal balance, demographic condition, debt, etc. For example, the IMF uses an approach called External Balance Assessment to assess under / over valuation (see https://www.imf.org/en/Publications/WP/Issues/2019/03/19/The-External-Balance-Assessment-Methodology-2018-Update-46643). Nowhere does this paper state that a REER value of 100 is synonymous with the exchange rate being correctly valued.

Finally, and as we hope it would be readily apparent, if the SBP were to change the base year used for the REER calculation, the numerical value of the REER for any given month would automatically change and it would be incredulous to argue that the extent of over/undervaluation in that month has changed simply due to changing the base year.

Here we would also like to share that our records do not confirm that any of our previous Governors has shared any such view. However, we shall be happy to review any such statement available in public domain that you may share with us.

You will agree that the exchange rate is a very delicate topic to comment on due to its sensitivities for the economy and particularly the financial sector. Therefore, any remark based on misconceptions could have deep negative repercussions for the financial markets. It would be pertinent to mention here that SBP issued a similar clarification in response to your editorial a year earlier on 6th February 2020. It is unfortunate that the same mistake is being repeated.

You are therefore requested to clarify SBP's position by publishing the above mentioned views, in an equally prominent space as your original article. SBP respects Business Recorder for its dedicated reporting on the state of the economy and financial sector. SBP has always offered its support to the newspaper for the provision of information, verification of facts and SBP views. We wish to continue with this practice and would like to once again offer our support for fact checking and conceptual clarifications ahead of your article publications.

Following Editorial published in Business Recorder on February 8, 2021

BUSINESS RECORDER

Karachi, Wednesday 10 February 2021, 27 Jamadi-us-Sani 1442

An expensive correction

Business Recorder/Editorial

The federal finance minister, Dr Hafeez Sheikh, made disturbing revelations to the cabinet while seeking its approval to present the Fiscal Policy and Debt Policy Statement to parliament as required under the Fiscal Responsibility and Debt Limitation Act 2015.

The government spent 3 trillion rupees to correct the Pak rupee-US dollar exchange rate, Dr Sheikh noted. This claim raises questions on the need for such massive correction given that after the ignominious departure of Ishaq Dar from the country in August 2017, his successors - Miftah Ismail of the PML-N and Asad Umar of the PTI – appropriately abandoned Dar's flawed policy to keep the rupee overvalued to understate the country's debt repayments; and began correcting the rupee value through depreciation. From an overvalued rupee of around 105.12 rupees to one dollar in August 2017 (a rate that was reportedly between 5 to 20 percent overvalued as per a quarterly International Monetary Fund review), the rupee was valued at 117 to 118 to a dollar by April 2018 (at the end of the PML-N tenure), and around 150 rupees to the US greenback by the time Asad Umer was dislodged as the Minister of Finance.

As per the State Bank of Pakistan (SBP), the real effective exchange rate (REER) was 121 in June 2017, down to 107.4 in June 2018 and by the time Asad Umar left the Ministry of Finance, the REER was 98.5. In October 2020 the REER (provisional) was given at 97.1. And while the SBP insists that one cannot measure the degree of over or under-valuation by using 100 as the key determinant in the REER (a view not shared by previous governors of the SBP) yet the SBP has to date not come up with any estimate or projection of the real rupee value other than to insist that it is a long-term concept.

An undervalued currency, as per economic theory, raises exports and reduces imports and one reason for the rupee depreciation may have been to contain the historically high current account deficit inherited by the PTI government. However, a linear linkage between a cheap rupee and exports has not been established in Pakistan and one would have hoped for some research on this before us 3 trillion rupees was used to 'correct' the rupee-dollar parity.

Dr Hafeez Sheikh further noted that total debt today is 36.5 trillion rupees against 25 trillion rupees that the PTI government inherited with 11.5 trillion rupees borrowed during the past two years – 600 billion rupees for debt servicing, 3 trillion rupees for the rupee-dollar parity correction and 1.5 trillion rupees for subsidies to meet the tax shortfall due to Covid-19 outbreak. Four observations on this data are critical: First, the government broke all previous records by borrowing heavily from the domestic market - from 16.4 trillion rupees that it inherited to 23 trillion rupees – a rise of 40 percent, a highly inflationary approach to economy.

Second, as per the State Bank of Pakistan, the government borrowed 17 billion dollars in two years; however, the Ministry of Finance in its clarification uploaded on its website argues that: (a) foreign debt of 7.8 billion dollars (44 percent rise) was to finance its fiscal deficit (so much for claims that the government reduced its expenditures particularly outlay on the Presidency, the Prime Minister's office and of various ministries which we have consistently maintained constitutes a very small percentage of total outlay); in addition, the argument that borrowing was to fund Covid-19 related expenses requires clarification given that 695 billion rupees should have been taken out of the 1.2 trillion rupee package announced in April 2020 as 280 billion rupees wheat procurement is a usual annual activity that is later recovered by the government, 100 billion rupee refund to exporters was already budgeted, as was the advance payment under Benazir Income Support/Ehsaas programme of around 190 billion rupees was budgeted under this head for the year while the package noted 144 billion rupees; (b) 4.8 billion dollars (27 percent rise) on account of SBP's foreign exchange liabilities including swap arrangements with countries and commercial banks to sustain reserves required for three months of imports; (c) 2.2 billion dollars (13 percent rise) on account of public sector entities reflective of sustained government failure to improve performance; and (d) 2.099 billion dollars private sector borrowing.

And finally, responsibility for the revenue shortfall rests with the finance minister for agreeing to an arguably over-ambitious target with the IMF (the Federal Board of Revenue is under his administrative control) in spite of several warnings by his ministry and FBR officials as well as the independent economists and media that the 5.5 trillion rupee target was unrealistic as is the 4.9 trillion rupee target agreed for this year. In our view, the cabinet members need to question the Ministry of Finance's claims in order to hold those who are responsible and accountable. Their attention must not be diverted by a focus on the primary surplus, which excludes borrowing costs, especially as the rising budget deific (at present 2.5 percent of GDP – higher than the comparable period of the year before) is being met by heavy borrowing from the domestic and foreign markets.