December 10, 2006

SBP Governor's Press Statement

Exchange rate has broad based implications for resource allocation, trade openness, balance of payments and growth of the economy and therefore it needs to be left to market fundamentals so that it aligns itself closer to the long run equilibrium rate. Given the significance and sensitivities surrounding exchange rate policy regime, it is critical for the central bank to ensure that market players understand well the exchange dynamics in Pakistan and the central bank policy stance in this area.

I have convened this press conference following reports of misperceptions and misunderstandings regarding central bank's positioning on the exchange rate. Although I have clarified on several occasions that the central bank is not in the business of devaluing or artificially backing the currency but there continue to be speculations or improper interpretation and pressures on the Government to manipulate and maneuver the exchange rate.

To set the record right, the central bank abandoned fixed exchange rate regime a long time ago and moved to a floating exchange rate regime since early 2000. While the initial years of reforms did see sharp depreciation of the rupee, with the emergence of macroeconomic stability, Pakistan has enjoyed a degree of exchange rate stability, which has augured well for restoring investor confidence.

The Debate on exchange rate adjustments has lately been re-triggered by a set of events which have included recent weaknesses in the export performance and the recent IMF Article IV Report. There are some clarifications that are in order to set the debate right in this context right. The IMF has not advocated, in its consultations with Pakistan, any depreciation and rather has provided its perspective and analysis of the movements in the real effective exchange rate. The exchange rate assessment offered by analysts is often highly eclectic and subjective in nature as different approaches and methodologies offer different inferences. Abstracting from theoretical debates, the reality is that Pakistan exchange rate regime is determined in the interbank market and trends are influenced by supply and demand pressures for foreign exchange at a point in time and by macroeconomic fundamentals at large.

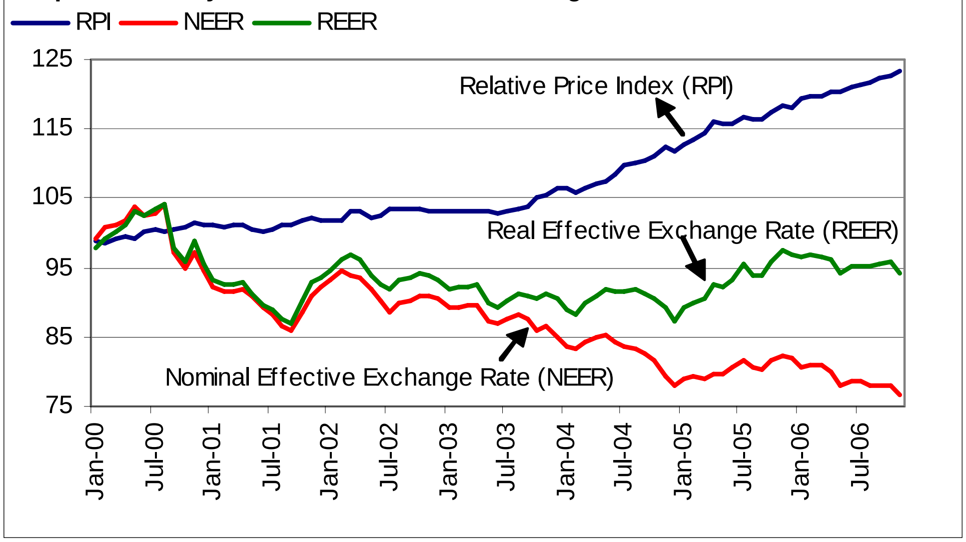
As customary for central banks, the State Bank of Pakistan intervenes in the interbank market from time to time, but these interventions are only to reduce excessive volatility in the market. Pakistan, like all oil importing countries, has to pay a high price for oil imports and the pressures created from the oil import procurements do generate lumpy payments which induce high volatility that is disruptive and generates confusing market signals. It is in this context, foreign exchange interventions for oil support involve SBP providing liquidity to the interbank market for petroleum imports to dampen the excessive market volatility. This action is temporary as the injections are subsequently re-purchased but they help in avoiding unhealthy disruptions and preventing attendant risks of speculative opportunities.

Inappropriate exchange rate adjustments can actually hurt exporters, if these raise costs and if exporters are unable to increase prices due to increased competition. Graph 1 shows that the real effective exchange rate for the rupee has remained relatively stable in recent years, with a nominal depreciation being offset by an increase in relative inflation.

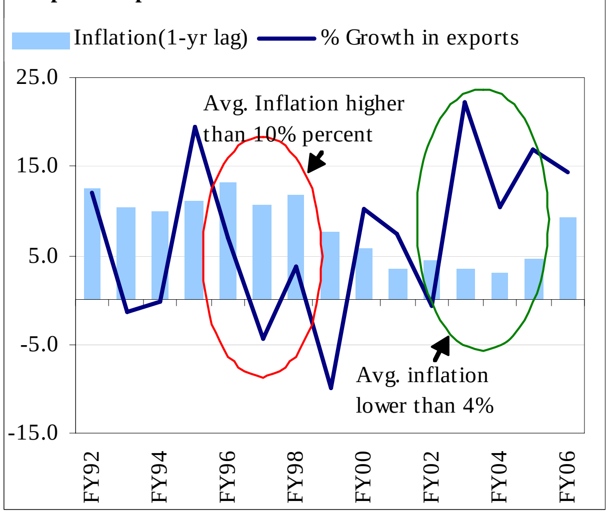
In this context a better policy to support export growth would be to reduce the cost of business in Pakistan. Thus, the SBP aims to help exporters by trying to reduce inflation in the economy. This complements the government's efforts to improve economic efficiency by simplifying processes, bettering the country's infrastructure and negotiating to improve market access. Indeed, Graph 2 clearly shows that the strongest export growth has been seen in years when inflation was low, and when the rupee remained relatively stable (see Graph 3).

The State Bank would also like to stress that current account deficits, by themselves, neither automatically lead to exchange rate adjustments nor are such adjustments always desirable. Specifically, in light of the country's growing financial accounts surpluses and declining debt-to-GDP ratios, Pakistan is in a position to sustain higher debt levels, if necessary, to sustain the development of its economy.

Graph 1: Stability in the Real Effective Exchange



Graph 2: Export Growth and Inflation



Graph 3: Exports Growth and Rupee Stability