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Exchange rate volatility declines to 2.7% in first half of FY10

Exchange rate volatility during first half (July-December 2009) of the current 2009-10 fiscal year (FY10) has declined to 2.7% as compared to 10.5% in the corresponding period of the previous year.

During the first half of FY10 the Rupee has witnessed a marginal depreciation of 3.4% against the US dollar as compared with a sharp depreciation of 15.7% in the corresponding period of FY09 thus broadly exhibiting stability of the exchange rate with improvement in macroeconomic fundamentals.

It may be pointed out that relative stability in the Rupee has emanated from the improved flows in the interbank foreign exchange market. In fact, during December 2009, market conditions helped the State Bank in completing the transfer of oil payments to the market earlier than planned. Though, this transfer may have caused some volatility in the interim period, the interbank market continued to operate smoothly.

It may be emphasized that it is very normal for the exchange rate to exhibit healthy volatility in both directions as in the case with other liquid international currencies. Flexibility in the exchange rate is important to insulate real effective exchange rate from any unwarranted misalignment, which in turn, protects the external competiveness. Current exchange rate does not reflect any misalignment in the real effective exchange rate and does not suggest any unidirectional pressures.

It may be pointed out that transfer of all oil payments to the interbank does not adversely impact the overall dollar liquidity in the market. Previously when SBP was supplying dollars to banks for effecting oil payments, SBP subsequently bought back the same dollars from the market to replenish its reserves. Hence, in the current situation when 100% oil payments are done from the market, it does not in any way create additional burden on the market flows.

Nevertheless, shifting of the oil payments to the market could result in higher volatility of the exchange rate in the interim period in accordance with the timing of the flows, but the overall dollar liquidity in the market will remain balanced.

Additionally, the external current account deficit reflects improvement in H1-FY10 to $1.8 billion as compared to $7.8 billion in the same period last year. Apart from the improvement in the trade balance, there has been an unprecedented increase in home remittances which is likely to be sustainable on account of the joint Pakistan Remittance Initiative of the Federal Government & the State Bank. Gross foreign exchange reserves are at a comfortable level of $15.2billion with import coverage ratio of seven months.

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