Brief Note on an Optimal Exchange Rate Regime for Pakistan

Dr. Syed Kumail Abbas Rizvi, CFA, FRM
Associate Professor of Finance
Lahore School of Economics
Email: skrizavi@yahoo.com kumail@lahoreschool.edu.pk

The choice of exchange rate regime is a complex one to make because of many reasons. It's not simply the matter of choosing fixed or floating regimes; there are lots of variations available with wide range of pros and cons. It is also equally important that whatever policy monetary authorities deem fit for the country, there shouldn't be any divergence between that stated policy and real time implementation else it would hamper the credibility of policy makers.

If we start from the easiest choice of being at the most rigid side of exchange rate flexibility spectrum i.e. pegging, we can't simply ignore its merits knowing our weaknesses including the one termed as Original Sin, the inability to borrow internationally in domestic currency [See: (Eichengreen, Hausmann, & Panizza, 2007); (Eichengree & Hausmann, 1999), (Eichengreen, Panizza, & Borensztein, 2008); (Hausmann & Panizza, 2003)], exchange rate pass through, inflation and huge trade deficit. The strongest point in favor of pegging is that it can bring stability of Inflation in that economy which pegs its currency with some other stable currency, in two ways. At first, by fixing that part of local inflation with the inflation of base country which is coming from traded goods and second by anchoring the expectation of local agents to the inflation of base country (Mishkin, 1998). Pegging also tends to equalize interest rates in both economies depending upon the degree of commitment to make the peg credible which in result could bring discipline in policymaking and helps policymakers in avoiding their pursuit of discretionary policies to achieve short-run objectives or the so called time-inconsistency problem described in detail by (Kydland & Prescott, 1977), (Calvo G. , 1978) and (Barro & Gordon, 1983).

There exist however, a lot of criticism on the policy of exchange rate pegging, including the arguments of loss of Independent Monetary Policy, Transmission of External Shocks, Speculative Attacks and Weakened Accountability. (Obstfeld & Rogoff, 1995). In addition to above, according to (Mishkin, 1998) ***pegging is inherently prone to full-fledged financial crisis triggered by exchange rate crisis when the peg breaks down***. These arguments and the Asian Financial crisis of 1997 first ruled out the choice of pegging in general and the intermediate regimes (soft pegs) in particular, by blaming them as a fundamental reason of crisis and provided a so called "Bipolar" prescription to the world which means either a country should go for hard peg or it should let it currency float freely. However, our analysis revealed (please see the detailed paper) that in case of Pakistan pure floating regime is not at all the solution of the problems we have (some of which we have mentioned above). And that is why exactly, even after officially adopting it in 2001, for the next seven years we did not really implement pure float on de facto basis and alas when we decided to fulfill our policy commitments in letter and spirit, the outcomes were disastrous.

Verdict

The only solution we can conceive at this point of time for a country like Pakistan, where you can't go against the international financial organizations and global community with severe pressure on policy makers to go for "Laissez-faire" sort of policies, ***is the "Managed Float****" (See Appendix 2 in the paper). Monetary authorities in Pakistan should declare that in principal they will not be intervening in the foreign exchange market and will allow market forces to determine freely the equilibrium exchange rate, however to curb any opportunistic drive by the market manipulators, or to stop any abrupt move in exchange rate that is neither synchronized with the current situations nor justified by the fundamentals, they will have a right to smooth exchange rate movement within the pre specified thresholds or bands by taking necessary actions including the direct intervention. There are still many countries like Singapore, Bangladesh, Russia, Malaysia and Switzerland which have exactly this type of "managed arrangements" termed by IMF, in its recent de facto classification of exchange rate regimes.* [1] *Such types of managed arrangements are not only able to accommodate market driven changes in exchange rate continuously but they also provide market participants this sense of security that no unjustified action will be allowed to hamper exchange rate to drive it away from its fundamental value.*

Detailed Paper:

1. **Rizvi, S. K.**, Naqvi, B. & Mirza, N. (2014). Being "Afraid of Float" to "Benign Neglect", A Jolting Ride of SBP on the Roller Coaster of Exchange Rate Regime. *Lahore Journal of Economics, 19(2),* 17-34.

Available at the following URl:

Download the Article

[1] http://www.imf.org/external/pubs/nft/2012/eaer/ar2012.pdf