Currency depreciation and its impacts

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Devaluation means decreasing the value of nation's currency relative to gold or the currencies of other nations. Devaluation occurs in terms of all other currencies, but it is best illustrated in the case of only one other currency. Devaluation and Depreciation are sometimes used interchangeably, but they always refer to values in terms of other currencies and the value of currency is determined by the interplay of money supply and money demand.

In common modern usage, it specifically implies an official lowering of the value of a country's currency within a fixed exchange rate system, by which the monetary authority formally sets a new fixed rate with respect to a foreign currency. In contrast, (currency) depreciation is most often used for the unofficial decrease in the exchange rate in a floating exchange rate system. Historically, early currencies were typically coins stamped from gold or silver by an issuing authority which certified the weight and purity of the precious metal.

A government in need of money and short on precious metal might abruptly lower the weight or purity of the coins without announcing this, or else decree that the new coins had equal value to the old, thus devaluing the currency. Present day currencies are usually fiat currencies with insignificant inherent value. As some countries hold floating exchange rates, others maintain fixed exchange rate policy against the United States dollar or other major currencies.

These fixed rates are usually maintained by a combination of legally enforced capital controls or through government trading of foreign currency reserves to manipulate the money supply. Under fixed exchange rates,

persistent capital outflows or trade deficits may lead countries to lower or abandon their fixed rate policy, resulting in devaluation (as persistent surpluses and capital inflows may lead them towards revaluation). Devaluation is usually undertaken as a means of correcting a deficit in the balance of payments.

Some analyst are of the view that weakening the value of currency could actually be good for the economy—since a weaker currency will boost manufacturing production, which in turn will lift employment and all this will set in motion economic growth and keep the economy going. But the dangers of a falling rupee too quickly, would be that the foreigners will stop investing in the country, which would make it impossible to finance the current account (trade) deficit.

It will then be forced to push interest rates up to defend the rupee (crashing rupee stock and bond markets is supposed to make the rupee more valuable), and that could create recession. In an open market, the perception that a devaluation is imminent, may lead speculators to sell the currency in exchange for the country’s foreign reserves, increasing pressure on the issuing country to make an actual devaluation. When speculators buy out all of the foreign reserves, a balance of payments crisis occurs.

Economists Paul Krugman and Maurice Obstfeld state that the balance of payments crisis occurs when the real exchange rate (exchange rate adjusted for relative price differences between countries) is equal to the nominal exchange rate (the stated rate). In practice, the onset of crisis has typically occurred after the real exchange rate has depreciated below the nominal

rate. The reason for this is that speculators do not have perfect information; they sometimes find out that a country foreign reserve are at lower level after the real exchange rate has fallen. In these circumstances, the currency value will fall rapidly.

This is what occurred during the 1994 economic crisis in Mexico. Devaluation of a currency was a matter of prestige in the past. However with the lapse of time it has been learnt that such an operation is sometime necessary to save the country from economic hardships. Devaluation is not an enduring way to improve the economy, unless the Government revises its method of economic planning and execution of plans, no amount of devaluation will stabilise the external value of our currency. We must give highest priority to the consolidation of our economy vis-a- vis expansion.

A strong discipline should be exercised over all the unproductive expenditure whether it is in public or private sector. Possible impact of the devaluation on the economy Possible impacts of the devaluation on the economy could be the stimulation of merchandise exports, discouraging merchandise imports and thus improving terms of trade, increase revenue collection and savings in repatriation of profits and royalties by existing foreign investors, bringing illegal foreign exchange leakages into official channels and putting an end to gold smuggling. Inflow of foreign capital can be improved by devaluation only if prices do not rise.

It is supposed to provide an escape from vexation import controls that prevent utilisation of full industrial capacity, stifle export drive, bestow monopoly profits on a few, inefficient market regulation and pressure on

budget and domestic prices will sky rocket. The obvious consequence of devaluation in the short run would be to worsen the balance of payment position and raise the burden of Pakistan's foreign debt and debt service liability and foreign loans repayment would break the back of the budget, which would in turn increases the trade gap.

It will upset all the cost-price relationships in the economy, lead to galloping inflation, and will stall many ongoing projects due to rising costs. Persistent adverse trade balance and disequilibrium in balance of payment are the main causes, which compels a country to devalue its currency. Major components of trade balance are exports and imports of a country. Adverse trade balance is generally the result of slackness in exports in comparison to imports. It might affect exports prices and thus wipe out all the edge that might be hoping to gain in the export markets through devaluation.

The markets for Pakistan's traditional export are inelastic, therefore devaluation may thus in fact give no big boost to their exports, because there is a small quantum of value added exports and major requirement is based on export of raw material. Further the quality of export not competitive in the foreign market. If an export -boom in agro-based industries does come about, the consequential diversion of land from food crops will raise food prices and cause a rise in wages unaccompanied by any gains in productivity.

Moreover, most of the bigger enterprises will face increasing difficulties in loan repayments and the cost of new industrial investments will shoot up sharply. In Pakistan, industries are heavily dependent on imported raw

materials for industrial goods and capital goods and components, and their access too many advanced countries are blocked by quotas and tariffs. , any rising of the prices of such inputs through devaluation, would raise industrial costs and reduce the intensity of capacity utilisation.

Therefore, it should be avoided as a resort to deficit financing. Devaluation with its implications will cause a contraction in economic activity and consequential slide down in income tax receipts will raise the burden of Pakistan's defence equipment, and foreign debt overnight. It cannot stop smuggling as long as black- market transactions in foreign exchange continue. Devaluing the Pak. Rupee means devaluing the price of Pak labour and talent in the international market who send foreign exchange through home remittance.

Devaluation will make Pakistan lose heavily both as seller and as a buyer and will make no good substitute for remedial changes in economic policies and developmental planning. Devaluation of Pakistan Rupee will mean devaluation of Pakistan labour and talent in the international market evaluation will serve as a drug rather as a stimulant and cause an unprecedented inflation. Bold steps must be taken to enliven capital market and more foreign aid procured.

Strong disciplined should exercised over all unproductive expenditure, whether it be public sector or private sector. Lavish spending of aid was bad enough, but it would be even worse to raise the cost of debt repayment through devaluation, whose benefits in terms of larger foreign investment are quite illusory. Central exercise as well as sales tax receipts and custom

duties should go down due to lower volume and high prices of imported inputs resulting in cut-backs in industrial production.