Currency and its effect on the economy economics essay

At times countries depreciate their economies to balance the deficit amount as analysts consider it as good for economy and country. Since a weaker currency will boost exports, which in turn will lift employment and all this will boost up the economic growth.

In case of our country Pakistan the performance is not good as different major sectors of our country are not showing good results and are below the line of profit. even though exports from different countries were increased at times but at the same time imports were also improved as well. According to the Federal Bureau of Statistics (FBS) the overall imports during FY11 were $40. 414 billion as compared to $34. 710 billion during FY10, which is an increase of 16. 43 per cent. Recently Pakistani rupee depreciated to an all-time low Rs 86. 56/58 against per dollar due to high demand for import payments.

Depreciation of the rupee will further inflate import bill as well as will raise domestic price level of goods and commodities, by reducing the purchasing power of people of the country is just like causing a boosting inflation in the country.

PAK Rupee's Depreciation Halts Growth Economic

Almost over 30 percent depreciation of Pakistan rupee against US dollar since the beginning of 2008 has nearly halted economic growth in the country, hitting all the key areas of economy from agriculture to industry; manufacturing to import of goods; IT sector to students studying abroad and government should take instantaneous measures to detain further devaluation of rupee to avoid more harmful consequences for the economy.

In our country as all main sectors are showing negative performance and has given future reports that it will fall more thus casing government to less taxes and huge foreign debt. The decline in the exchange rate goes on in spite of the fact that foreign exchange reserves have almost doubled, which should be a cause of great concern for policy makers.

Depreciation of the rupee at its current pace won't push up exports, rather will certainly inflate import bill and inflation that, over the years, became directly linked to the exchange rate because of Pakistan's ever higher dependence on imports, particularly of energy inputs.

Faster the depreciation of the rupee, higher will be inflation and lower the competitiveness of Pakistan's business and industry. Therefore, government should get quickly into action to capture this dangerous trend to bring stabilization in exchange rate to guard national economy from further damages.

Benefits of exchange rate depreciation

The value of Pakistani rupee against the US $ has been continuously decline over the last three decade. The official exchange rate of PKR is declined from 10/$ in 1980 to 95/$ in 2012 which is about 85%. floating exchange rate system is adopted by Pakistan depending on the market conditions and it is adjusted in the hope of improving trade balances. The following arguments are presented to justify the benefits of the currency depreciation.

Currency devaluation switches the consumption of goods from the foreign goods to the domestic goods. By the devaluation of home currency the domestic inhabitants finds the foreign products more expensive and the foreigners find the domestic products cheaper as a result of which the exports will raise. This process will improve the trade balances and will promote the local production of goods.

The devaluation of currency will reduce the value of cash balances and helps to improve the real prices of both the trade and non traded goods i. e. services

According to the J curve phenomenon that when value of local currency goes down as compared to foreign currency, the export level raises and import become expensive. this process causes trade deficit in the short run due to the increase in import bills by expensiveness of foreign currency . however eventually the domestic goods become more competitive in the international market due to which foreign demand for domestic goods increases bringing an improvement in the trade balances. In Pakistan there is a negative relation between exchange rate and the trade balances which means that the currency depreciation will further destroy the trade balances instead of improving it. The possible reason for this negative relation is the inelasticity of imports and exports.

Major imports of Pakistan include Petroleum, Machinery, Chemicals, Drugs and Fertilizers. Petroleum constitutes about 29% of the total imports of Pakistan, and the demand of petroleum products is highly inelastic. Due the inelastic nature of these imports, the currency depreciation will only increase the import bill in terms of local currency

SHORT-RUN AND LONG-RUN EFFECTS OF CURRENCY DEPRECIATION.

The number of studies that have included Pakistan in their analysis of the J-curve is small. Many studies investigate only the long run relationship between exchange rate and trade balance while ignoring the J-curve altogether. Furthermore, almost all of the studies that include Pakistan in their analysis either use the OLS, IV or the 2SLS techniques, all of which are prone to the problem of unauthentic relationship unless the time series under consideration are still, thus casting significant doubt on their findings. Because of the stationary problem, at thievery least the empirical results in those studies cannot be directly compared with thrones that employ recently developed econometric methods such as the VAR and error-correction modeling technique. Gylfason and Schmid (1983) used aggregate data on five developed and five less developed countries and incorporated both demand and supply side effects of real exchange rate depreciation into their model. Relationship between exchange rate and trade balance with an expected increase in trade balance due to a 10% devaluation of Pakistan’s rupee to be equal to 1. 3% of PakistaniGNP. However, since the data used were not tested for stationary, their empirical results are somewhat biased.

Bahmani-Oskooee (1998) employed the Johansen and Juselius maximum likelihood co-integration technique to estimate the well-known Marshall-Lerner condition for six countries using quarterly data over the period 1973I-1990IV. In the results for Pakistan, the Marshall-Lerner condition which implies that the sum of import and export demand elasticities must add up to more than one was not met. This finding using aggregate data to test the Marshall-Lerner condition is in line with that of Bahmani-Oskooee and Alse (1994) who could not establish co integration between Pakistani trade balance and the real exchange findings were, however, contradicted by Aftab and Aurangzeb (2002) who used Johansen and rate. These Juselius method and quarterly data over the period1980-2000 to show that the long-run Marshall-Lerner condition for Pakistan is satisfied. Although their method is an improvement over Bahmani-Oskooee (1998), it may still suffer from aggregation bias as bilateral data for individual trading partners were no employed . Due to inconsistent findings by previous research, as reviewed above, we would like to reconsider the short-run (i. e., the J-curve) and the long-run effects of real depreciation22

These 13 partners account for almost 70% of overall trade activity of Pakistan in 2003. In order to get some insight about the relative importance of each partner, we provide these trade shares in Table 1. 2Table 1. Bilateral Trade Flow between Pakistan and Her Major Trading Partners in 2003.

Trading Partners

Value of Exports

(Millions of U. S. dollars)

Value of Imports

(Millions of U. S. dollars)

China 447 1, 858

France 310 318

Germany 598 672

Hong Kong 472 117

Italy 394 352

Japan 145 838

Korea 259 371

Kuwait 70 918

Malaysia 74 59

Saudi Arabia 448 1, 492

U. A. E. 1, 013 1, 632

U. K. 795 525

U. S. A. 2, 528 924

World total 11, 283 14, 825

Source: Direction of Trade Statistics 2004, International Monetary Fund.

The value of Pak Rupee against US dollar has depreciated cumulatively by 28% since March, 2008 up till 10 November, 2011, Minister for Finance, Revenue and Planning and Development, Dr. Abdul Hafeez Sheikh told the National Assembly on Friday, during the question -hour session.

In a written reply to a question asked by Molvi Agha Muhammad, the minister said that the reason for depreciation of exchange rate was widening of the current account deficit during the period, because of large trade deficit due to higher demand for imports and rising international commodity prices, particularly that of oil.

In addition, he said foreign capital and financial inflows also started to decline due to both global financial crisis and deteriorating law and order situation in the country.

The minister said that the State Bank of Pakistan had taken various steps to stabilize Pak Rupee, including raising policy rate of 500bpc cumulatively in 2008, gradual withdrawal of market support for oil payments since FY 2009 and imposition of 100% Letter Credit margin on import of non-essential and luxury items to discourage imports. These measures helped in narrowing down the trade deficit and stabilize the exchange rate, he added.

Devaluation of Currency

Devaluation of currency is an active economic strategy. It is sometimes used when countries are poorly in debt. This occurs when a country lowers the official value of its currency in relation to foreign currencies. This is intended to raise the price of imported goods and increase the value of the country's exported goods. This can be a risky economic move because it can flicker hyperinflation.

Devaluation and Depreciation

Both of these concepts involve international economics and foreign exchange trading. Devaluation is a result of natural changes within the world economy. Devaluation can occur because of several different circumstances. These circumstances also might not necessarily be the fault of the country whose currency was devalued. Other countries' currencies can get stronger which results in a devaluing domestic currency. Currency depreciation is an active economic move with the desired result being devaluation of currency on the foreign exchange market.

Effect of depreciation on economy

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 unauthorized 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 about to happen, 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 stabilize 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.

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 utilization. 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 defense 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.

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.

Devaluation in Pakistan in different periods

Pakistan had experienced an increased in wholesale price, after its first devaluation in 1955, due to inelastic production structure, which had generated uncontrollable inflationary pressure. Again on 11th May 1972, Pakistani Rupee was devalued by 56. 7% in terms of gold to a new, unified Official Rate of PRs11. 00 per U. S. Dollar and 4. 5% fluctuation range for the currency was also introduced. At the same time, the entire Export Bonus Voucher scheme with its complex accessory rates was abolished. On 8th

January 1982, the Rupee was devalued when the currency was unhitched from its link to the U. S. Dollar and the fixed Official Rate abolished. A controlled, floating Effective Rate for the Rupee, initially at the Rupee dollar exchange rate was Rs9. 9 per U. S. Dollar was established in relation to a trade-weighted basket of currencies, Pakistan has been on a system of managed float since January, 8, 1982, under this system the country has experienced massive downward slide in its exchange rate. In 1997, retail prices rose significantly to 20 to 24 rupees/kg (US 55. 4 to 66. 5 cents/kg), indicating short domestic supplies, the devaluation of the rupee against the dollar was highest in 1996, which contributed to the rise in price since sugar had been traded internationally in US dollars. As imports had increased in the 2 years period, the rising price of imported sugar (in rupees) was also reflected in the rising domestic price. An import tariff of 10 percent was removed in mid-1997, so as not to contribute to increasing sugar prices. It rose to very high amounting to Rs64. 1 in July 2001. The economic indicators showed some visible improvement since the year 2001-02 and it continued to be so, which helped the authorities to turn around the creeping devaluation and the rupee has stabilized in the range of (Rs) 59-60 per dollar till 2006 and May 2007 (Rs60), but after that the currency has started devaluing since 2007 to date i. e., April 2008 it stands to now Rs63. 40 against a dollar. It is concluded that devaluation may temporarily boost exports only if the demand of exported goods in the foreign country is price elastic, but this is not necessary for those goods for which the demand is not price elastic. We therefore, should first try to analyses the price elasticity of demand of goods exported from Pakistan, because experienced has taught that devaluation did not lead to increase in exports. Further to this, it has been observed that successive devaluation in the past have failed to evoke a favorable long term response in terms of improved exports. Apart from encouraging speculation it also shatters the confidence of the foreign investor in the domestic economy. It takes the economy on the path of devaluation aided cost push inflation and is a never ending vicious circle. A long term plan is required to put the economy on the right track. This should provide a framework for exporting value added branded products, improving the quality and image of existing products, finding new export markets and better marketing strategy.

We should try to effectively utilize the human resources, which is abundant in Pakistan and is under- utilized. Moreover, cut in government expenditure, improvement in budget and trade deficit, multiple and persistent exchange rate would also be of great help. But devaluation is not the solution of the current economic crisis and should not be resorted to in future.

7) How depreciation of a currency can be overcome

Depreciation is another way of saying that the price of the currency had fallen relative to the dollar. So, just like everything else in the economy, to raise the price back, you need to decrease the supply of the good in the market, in this case the rupee.

So, the central bank could theoretically buy back all the rupees circulating in the market right now. By buying back all the rupees in the market, the central bank is reducing the supply of the currency; less supply, price will increase, hence appreciation.

But, the limitation to this is that the central bank must have a lot of dollars or foreign exchange reserves. Because to buy back all the rupees, it must pay in dollars (take back rupees, give back dollars). At some point, the central bank may run out of dollars (just like in Asia in 1997) and it can't keep buying back rupees and at that point there will be a large correction and massive depreciation of the rupees.

In a time when everyone is hoarding up on dollars given the bleak European economic outlook, currency appreciation can be brought about in two ways:

Short term: the central bank can increase the supply of dollars in the market. But this is only a quick fix solution and is not sustainable

Long term: Attract dollars into the system by way of FDI/ Investments. This will require a conducive investment environment (which itself is subject to a lot of things) and a willingness on the part of the owners of the dollars to part with them, which may not be there given that the euro in under tremendous pressure and the dollar has become even more attractive

Of course, if every currency were to be backed with the present value of existing and future private sector marketable goods and services instead of government debt, this would be a moot question. If the currency were only to be issued when the central bank rediscounted private sector qualified paper originally discounted by its member banks, the currency would reflect the actual value of the marketable goods and services in the economy, and international exchange rates would reflect this, trading at actual value, with any arbitrage resulting from changes in the productive capacity of the country issuing the currency.

Conclusion

Depreciation of a currency helps to boost up the economic condition of a country by increasing its exports and decreasing unemployment. In our country as all main sectors are showing negative performance and has given future reports that it will fall more thus casing government to less taxes and huge foreign debt and all the main sectors are showing decline profit and both the imports and exports are increasing at the same time. Depreciation of the rupee will further inflate import bill as well as will increase domestic price level of goods and commodities, by reducing the purchasing power of people of the country is just like causing a boosting inflation in the country

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