IMPACT OF CURRENCY DEVALUATION IN PAKISTAN

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ABSTRACT

Pakistan's currency value has decreased dramatically over the past 2-3 decaded which has happened due to a variety of significant economic issues, but continuing inflation is the main source of worry for the average citizen. The devaluation of the rupee has come to be widely believed to be Pakistan's primary cause of inflation. On the other hand, the official position is that the need for a devaluation is due to the increase in domestic prices. Plus if we talk about exchange rates since the collapse of the Bretton Woods system, discussions of policy have focused on the connections between exchange rates, domestic prices, and international prices. A key point to note is that stable exchange rates guarantee macroeconomic stability, which has a positive effect on economic growth and thus a country prospers. Inefficient use of resources and capital can result from misaligned exchange rates, which can also reduce economic efficiency. One of the earliest hypotheses establishing the connection between exchange rates, domestic price levels, and foreign price levels is the purchasing power parity (PPP) hypothesis. Purchasing Power Parity (PPP) is an economic theory that compares different countries' currencies through a "basket of goods" approach. It allows for economists to compare economic productivity and standards of living between countries. Some countries adjust their gross domestic product (GDP) figures to reflect PPP. In policy terms, exchange rate management is at the center of many financial stabilization plans and PPP provides a theoretical basis for external adjustment policy - At the theoretical, empirical, and policy levels, PPP theory has broad ramifications. For instance, the monetary approach to determining exchange rates uses PPP as a fundamental building block. Therefore evaluating the PPP theory is crucial since its results are applied in numerous current studies on international finance as well as crucial policy choices.

KEYWORDS

Currency, economic issues, inflation, devaluation, purchasing power parity

1.1 – PROBLEM STATEMENT

Currency devaluation is one of the most important issue nowadays from past many years. It was in the start a strategic idea to gain exports but afterwards due to this strategic idea a number of issues were created as the devaluation was going the limit and it is now affecting the Pakistan's economy. The major factors that were affects are Inflation, Purchasing power and the last which is most important among all is Foreign investments. All of these were highly affect because of devaluation of in currency.

There are so many reasons behind currency devaluation, in Pakistan; industries are heavily dependent on imported raw materials for industrial goods and capital goods and components, and their access to many advanced countries are blocked by quotas and tariffs. There are so many factors that cause currency crises to occur, i.e. economic, political, corruption, etc. One of the major and most discussed causes of current crises is the ever rising price of imported crude oil, which hit close to a record $127 a barrel on May 15th,2013. Another may be the gap between aggregate demand and domestic supply is filled by imports. The result is that imports grow more quickly than exports. Current account deficit goes up, which has to be financed through either falling foreign exchange reserves or capital inflows. Capital inflows, however, may not be forthcoming because of lack of trust in the country's financial situation. The Previous Government resorts to borrowing from the central bank or from foreigners to meet huge expenditure. Borrowing from the central bank increased the inflation. High inflation is proved lethal for export, because it distorts prices.

1.3 – OBJECTIVE

The main purpose of conducting this research is to investigate the impact currency devaluation in Pakistan. By collecting data on each variable different factors like inflation, purchasing power & foreign, we need to expose how those variables affecting every other.

Our objective here is to provide theoretical underpinnings in order to develop a model for the simultaneous dedication of price level and exchange rate below managed float. Before moving to this task, however, we keep in mind a naïve econometric technique, specifically Granger causality test, to observe the cause and effect relationship between exchange rate and price level

1.4 – SPECIFIC AIM

The specific aim of this research was to investigate the effect of exchange rate on foreign direct investment.

2.1 – LITERATURE REVIEW

This research is about the effect of Currency devaluation on Inflation, Purchasing Power and foreign investment. In this research a proper discuss on these topics is set. In Pakistan, recently transitioned from a managed float exchange rate regime to a market-based exchange rate regime, the behavior of the exchange rate during the adjustment process assumes significance. Many distortions have been reduced in Pakistan over the past one and a half decades as a result of changes in the exchange rate regime, trade and financial liberalization, and the loosening of restrictions on capital flows. The parity condition may be forced to converge toward the long-term equilibrium path as a result of these structural changes. (Bhatti, 1996).

It also postulates that adjustments to parity are made via nominal exchange rate movements. This theory basically relies on the law of one price (LOP) in an integrated and competitive product market with an implicit assumption of a risk neutral world. The idea is based on the flow theory of exchange rates, which states that imports and exports are paid for by the demand for currency.PPP remains controversial even though the theory has been around for centuries. (Bhatti, 1996).

Since January 1982, Pakistan has used a managed floating exchange rate system.The managed float exchange rate policy was replaced by the free flexible exchange rate policy in July 2000.As a result of these regime shifts in exchange rates, it is possible to eliminate deviations from parity in a variety of ways. IN a fixed exchange rate, changes in domestic price levels cause parity to be adjusted, whereas in a managed floating exchange rate regime, changes in exchange rates cause parity reversion (Froot and Rogoff, 1995).

Although its intellectual roots can be traced back to the early works of British economist David Ricardo from the 19th century, PPP is typically credited to Cassell's writings from the 1920s. According to Pilbeam (1998), the central idea of the PPP theory is that when the prices of goods are measured in the same currency, goods market arbitrage equalizes prices worldwide.PPP is frequently used to determine the connection between the exchange rate and relative prices and serves as an equilibrium condition in both the theory of determining exchange rates and exchange rate policy. The law of one price (LOP), which simply states that trade and effective arbitrage in goods markets should guarantee identical prices across nations in the absence of transport costs, quotas, tariffs, and other trade obstacles, is the foundational principle of PPP.The concept of perfect goods arbitrage is the foundation of the LOP. Economic agents use price differences to make a risk-free profit in arbitrage. According to Pilbeam (1998), proponents of PPP argue that the exchange rate needs to change in order to guarantee that the LOP holds internationally for the same bundle of goods.

PPP lacks conclusive evidence, despite its theoretical appeal and simplicity. Concerning

the process of convergence toward long-run equilibrium, PPP theory is silent. According to Coakley and Fuertes (2000), researchers have recently shifted their focus from testing long-run PPP or real exchange rate stationery to measuring the speed of adjustment back to equilibrium. The PPP puzzle is centered on the slow rate of adjustment and the high short-term volatility of real exchange rates (Rogoff, 1996).According to Boyd and Smith (1999), the general consensus predicts a reversion rate of 15% annually, which equates to half-lives of approximately 3 to 5 years.2001, Engle and Morley).According to the research that has been conducted, the varying rates of convergence of nominal exchange rates and prices may be the underlying cause of the PPP conundrum (Cheung et al.,2004).According to Engle and Morley (2001), nominal exchange rates do converge at a much slower rate than prices do, and their half-lives range from three to six years, whereas prices' half-lives range from one to two years. Nevertheless, Cheung et al.2004) demonstrates that nominal exchange rate adjustment rather than price adjustment accounts for 60-90% of PPP disequilibrium adjustments. Consequently, the rate of nominal exchange rate convergence determines the observed rate of PPP reversion. The structural vector autoregressive (VAR) method developed by Clarida and Gali (1994) is utilized in a lot of the current research on short-run PPP dynamics.Orthogonalized impulse response functions are used in this method to measure how shocks affect individual variables. However, the non-unique identification of the impulse response functions is one major drawback of this strategy (Coakley and Fuertes, 2000).The persistent profile method, as proposed by Pesaran and Shin (1996), can be used to gauge how quickly the real exchange rate changes. Instead of measuring variable specific shocks, the persistent profile approach measures the rate of mean reversion of the exchange rate on system-wide shocks. It provides information on the overall shape of the adjustment path and, in contrast to the standard method, does not require any strong erogeneity property of the variables involved in PPP (Helga and Serati, 2000).

Secondly, Savings and growth are seriously threatened by high and rising inflation.The real return on financial assets decreases at a high inflation rate, which, on the one hand, discourages saving and, on the other, encourages the accumulation of non-financial assets.Lower savings would result in lower investment and slower growth given Pakistan's limited access to international capital markets.

Thirdly, By increasing the real exchange rate, a high inflation rate reduces a nation's external competitiveness, restricts exports, and undermines the government's efforts to improve the trade balance. As a result, a sharper depreciation of the currency may be required, which may further accelerate inflation.

Finally, Due to the higher proportion of their incomes that they spend on food items, the poor and groups with fixed incomes suffer the most from high and rising inflation.WPI accounts for almost 53% of food prices. The government dealt with the problem of rising inflation primarily by focusing on the demand management policy, which included cutting the budget deficit and borrowing from the banking system. This kept the growth of the money supply close to that of the nominal GDP and slowed the rate at which the currency depreciated. The government's efforts to reduce inflation have not been successful, as

evidenced by the persistence of high and rising inflation.

The Pakistan Institute of Development Economics (PIDE) was directed in September 1994 by the Prime Minister to investigate the causes and solutions of Pakistan's high inflation rate. In response to the directive, the PIDE identified key factors that contributed to the high inflation rate [see Naqvi, et al.]1994)].These are the factors: i) an increase in the prices of manufactured goods, food, raw materials, and fuel;(ii) expectations regarding inflation; and (iii) the money supply's rate of growth in relation to GDP.Naqvi and others1994), followed by inflationary expectations as the most significant contributing factor. Due in part to the one-year delay in its effect, the expansion of the money supply was comparatively less significant. Increases in indirect taxes (sales and excise), excess money supply, currency depreciation, supply shocks like the virus-induced reduction in cotton output and the weather-induced lower wheat crop, higher agricultural support prices, increases in the prices of utilities, production losses due to power and infrastructure bottlenecks, increases in wages and salaries, and inflationary expectations are among the many other factors that contribute to the recent rise in inflation. A recent study by ABN AMRO Bank (hereafter the Bank) cites the food supply shocks and price adjustments as important factors, but they still attribute the recent rise in inflation to inadequately tight financial policies. Particularly, the significant deviation from the budget's fiscal targets for 1994-1995 appears to be the primary cause of the current high inflation rate.

This study applies these analyses to the smallest of details and tries to not only identify but also quantify the factors that contribute to Pakistan's current high inflation rate. As a result, the WPI was chosen as a measure of inflation in this study due to the fact that changes in utility administration prices and crop procurement prices have a direct impact on this index. In addition, it examines how various factors affect the WPI's individual components—the WPI for food, manufacturing, and raw materials—which, through an estimated equation, feed into the overall WPI.90% of the overall WPI is made up of these three parts. An attempt has been made to identify and quantify the effects of key policy variables by estimating the separate equations for each WPI component. The key policy variables which are included in the equations can be grouped into five categories - demand management policies, supply-side shock, price policy, imported inflation (due to exchange rate depreciation), and the role of inflationary expectations. As will be seen in the ensuing pages, the present study provides explanations for the recent surge in inflation and suggests how to control inflation in Pakistan. A consistent time series data covering the time-period from 1972-73 to 1993- 94 has been used for the analysis.

In spite of the significance of exchange rate policies for the economy, Pakistan's transition to a flexible rate system has resulted in relatively few studies of this topic over the past ten years. Although Ahmed's 1992 article attempted to address the issue of Pakistan's exchange rate policy by testing the long-term stable relationship between the exchange rate and domestic and foreign relative prices, also known as Purchasing Power Parity (PPP) theory, the study's methodology was rather limited. The objective of this paper is to empirically

estimate the vector auto regression (VAR) model of a set of relevant key real and monetary variables that influence the real exchange rate because it is possible that a straightforward version of PPP will not be sufficient to explain Pakistan's complex real exchange rate behavior. We will be able to more precisely analyze and identify the intricate interrelationships among potential policy instruments (such as tariffs, deficit financing, domestic credit creation, devaluation, etc.) with this method. The exchange rate policy's intermediate and ultimate goals. The estimation results can be used to evaluate the Central Bank's ability to avoid exchange rate misalignment and to identify the factors on which the Bank should concentrate its attention if it is to achieve the objective of exchange rate policy.The following is the order of the paper: In Section 2, we provide a succinct overview of the methods used to empirically determine the real exchange rate's behavior and the variables that will be included.We examine the significant estimation results in Section 3.The concluding remark in Section 4.

Foreign Investment are one of a key variable, according to the International Monetary Fund (IMF): "an investment undertaken to acquire a long-term interest in businesses operating outside the investor's economy." The FDI is a significant source of external funding, allowing countries with low capital levels to access external financing. Due to a lack of investment in emerging nations and resource limitations, the private sector and market forces have increasingly served as the primary drivers of economic growth. The neoclassical growth model states that FDI stimulates economic growth by boosting investment efficiency and volume. Because of the advantages that come with attracting foreign direct investment, all nations, especially the least developed ones, try to do. (Hassan and Mahmood, 2013).

A few different asset categories are gathered as investments with the hope of receiving a return in the future. In a broader sense, the investment makes the mechanism that calls for finance for the expansion and improvement of the economy possible. Foreign direct investment and portfolio investment are two types of foreign investment. (Khan and Khattak, 2009). Real investment, or foreign direct investment (FDI), is a medium- to long term commitment with the aim of obtaining the ability to exercise managerial control through the use of capital (Aqeel and Nishat, 2005). Direct investment is the long-term commitment of capital to the economic activity of the host nation (Kolstad and Villanger, 2004). FDI is frequently produced by large multinational corporations through mergers and acquisitions or the building of new facilities (IMF, 2003).

The following is the main theme of this essay. FI would be significantly impacted if agents believed that there was a chance of mean reversion following a big shock to the currency. For instance, if agents think that a significant devaluation of a foreign currency will be followed by a gradual mean reversion of that exchange rate throughout the course of the FDI project, this suggests that the currency will initially be "cheap" for a short period of time. Due to the fact that the foreign asset today looks to be affordable in comparison to its anticipated future income stream, we hypothesis that FI would move to that country in these conditions. This is due to the fact that if there is anticipated mean reversion (i.e., anticipated future growth)

(Rehman et al. 2012) demonstrated that, in comparison to other currencies, the benefits of Currency devaluation depreciation in the Pakistani rupee are decreasing up to 30 years. There are two approaches to explain currency value. The first is that when a currency is devalued, domestic goods become less expensive and imported goods become more expensive. As a result, local items are in greater demand, and the trade balance between the foreign and domestic economies is subsequently improved. The second is a decrease in the real value of money as a result of money devaluation. When local currency and goods lose value, foreign currency exports are less expensive and imports are more expensive.

Inflow of Global Investments is a significant factor affecting the nation's economy. In Pakistan, the sharp decline in FI inflow seen over the past three years has contributed to joblessness, a drop in tax receipts, and economic instability. The deteriorating state of law and order, violence, political unrest, currency devaluation, bad national governance, and subpar performance of the stock exchange were among the contributing factors. FI intake into Pakistan was 5409.8 million US dollars in 2008; it dropped to 2150.8 million US dollars only in 2011, a 71% fall from 2008. Since 2008, Pakistan has developed into a hub for terrorist activity. Many foreign employees from China, the US, and France are kidnapped for ransom and killed as a result of the weak law and order situation, which ultimately limits the inflow of foreign direct investment and also causes disinvestment by international investors. Another significant issue hurting Pakistan's economy is currency devaluation. Since 2008, Pakistan's Rupee has been devalued by up to Electronic copy available at: https://ssrn.com/abstract=2183074 NICE Research Journal Vol. 5 : (2012); pp 93-110 3 over 50%. As they exit their host country, foreign investors convert their withdrawal into the host country's currency, which is reduced to 50%.

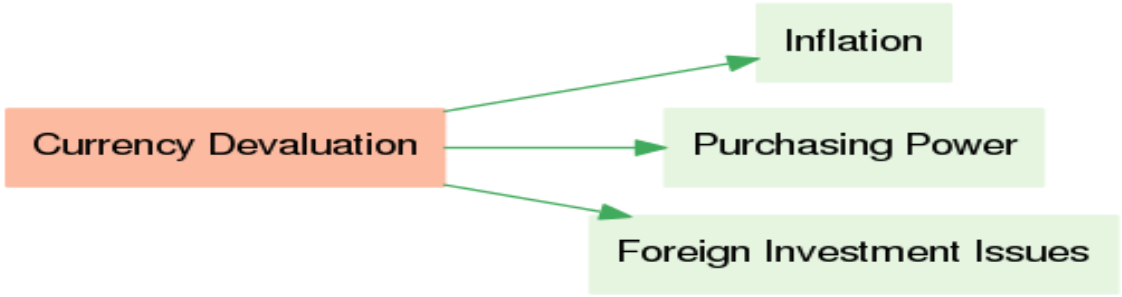
The coefficient of the currency is negative as per expectation (Khan and Nawaz, 2010). The depreciation of the currency of the country mostly influences the inflow of FI. This also confirmed through the hypothesis that foreign investors are definitely interested in high returns on the investment (Adam and Tweneboah, 2008).The negative impact of the exchange rate indicates that depreciation in host country currency negatively influences the inflow of FI to that country. That is why the monetary policy plays an important role in FI inflow (Nasir and Hassan, 2011). Hence, stable currency is necessary for investment inflow.

In Pakistan the price for energy resources and transportation is very much high that also impact the inflation rate and reduces the purchasing power of people living with in a country. This impacts heavily on the behavior of investors because they consider such situation not fissile for businesses because high price of energy and lack of purchasing power will bring them nothing against their investment. Similar is the case with foreign investment they also do not consider such situation favorable for investment. Moreover, other reasons also discourage FI in Pakistan such as LAW and order situation political situation in flexible tax rates and decreasing trend of stock exchange devaluation in currency. We are not a manufacturing oriented country therefore this situation also discharge foreign investors .besides other factors.

RESEARCH METHODOLOGY

3.1 – **Framework**

Independent Variable Dependent Variable



3.2 – Theoretical Framework

3.2.1 – Impact of Currency Devaluation on Purchasing power.

A currency devaluation means that imports will get more expensive and this might trickle down to domestic retail prices, reducing the purchasing power of households, especially the vulnerable.

3.2.2 – Impact of Currency Devaluation on Inflation

Inflation refers to the rise in the price of goods and services during a period. It's a common element in most economies, and if there is economic growth, there are almost no consequences. However, if inflation grows faster than the economy, it usually reduces purchasing power and living standards. The currency exchange rate has a direct impact on inflation because it affects the costs of imported goods and materials. The currency fluctuations can bring in investors or scare them away, and might affect the availability of money for governments to spend. Let's examine some specific consequences and ways to counteract them.

3.2.3 – Impact of Currency Devaluation on foreign investment issues

Currency devaluation reduces the return to foreign investment for the source country in terms of its own currency. This would reduce the supply of Second, an increase in the domestic prices in the host country in terms of its own currency increases the demand for capital and thus the rate of returns to capital.

3.3 – Methodology

We assume that Pakistan's economy uses a dual exchange rate system and has an active government because there is a large parallel foreign exchange market, or black market. Capital can't freely move around because of restrictions on exchange control. However, there is foreign currency in U.S. dollars that exists, is held by nationals, and is traded on the "black market. “To meet its demands for importable and non-traded commodity consumption, the government relies on deficit financing and taxes. Additionally, it is assumed that the government follows a tariff policy that does not distort the flow of money. We will be able to examine the spread of official and parallel "black market" rates (ERSBO) and the dynamic behavior of the real exchange rate (RER) using the complete model discussed above.

Based on theoretical studies and research that has been carried out by a number of previous researchers, this research is a complementary follow-up study on the impact of currency devaluation on inflation, purchasing power and Foreign direct investment according to Pakistan situation. The study discusses Pakistan’s recent transition from a managed floating exchange rate regime to a market based. The study is complementary because some of the variables used have been studied by previous researchers but in the composition of the relationship between variables that are different from each other and on different research objects. This study will enables us to determine very important determinants of foreign direct investment on short periods of time and enable us to closely monitor the relationship between independent and dependent variables. Moreover, the pattern of import and export varies drastically due to currency devaluation has been highlighted in this paper. Similarly the other variable discussed in this research is inflation that undermines the government’s intentions to improve balance of trade; this research also focuses on that.

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