Beyond forex reserves

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By Shahid Kardar

NO matter what amount of spin government spokesmen put on the burgeoning of Pakistan's foreign exchange reserves as an outcome of good economic and financial management, the fact is that, notwithstanding the better macro-economic management that this country has witnessed in the last three years or so (which has certainly made its contribution), our change in fortunes has more to do with the events of September 11 than with any other factor.

Government spokesmen claim that the increase in reserves is one of the signs that the economy is on the mend, if not about to take off. The expected growth rate of 4.5 per cent for this year, when the rest of the world is experiencing a slump (less than one per cent in the eurozone and less than 0.5 per cent in Japan), is a notable achievement, which reflects the growing strength and resilience of, and confidence in, the economy, especially because two of the sources of the growth in reserves are the increase in exports and private remittances, — that is, non-debt creating flows, that are not reversible.

However, a closer look at the composition of these reserves will reveal that a significant part of their accretion is attributable to the grants from our western allies for services that we rendered post-September 11 and the State Bank's purchases of foreign exchange from the banks and from the open market — this activity accounting for close to 60 per cent of the stock of reserves. These are abnormal, one-time flows, not based on historical trends.

Moreover, there were other factors contributing to this build-up of reserves which were debt creating, being money lent by the IMF, World Bank and the ADB and the deposits parked with domestic banks by non-resident Pakistanis. The inflow of external remittances through formal banking channels instead of being channelled, as in the past, through the hundi system, has saved the State Bank, and thereby the government, the premium of rupees three to four that had to be paid by the State Bank to buy dollars from the informal/kerb market.

In view of the above factors, some argue that this growth in reserves is not truly reflective of a strong economy that is poised for a take-off. They argue that there is disjunction between the performance in the external and internal fronts as increased foreign exchange inflows are not translating into real physical investments but finding their way into speculative investments in real estate, into the secondary capital market represented by the stock exchanges and advance bookings for cars. Financial sector activities by themselves contain limited forward and backward linkages, unless they are strategically linked to real sector activities and to the overall performance of the economy.

Why should we be maintaining large reserves of dollars, for which Americans should be grateful to us, for holding their currency essentially as a non- or low-income generating asset? The benefits to us of maintaining large reserves include the improved exchange stability of the rupee, greater confidence in Pakistan's ability to carry out external transactions, honour its obligations and withstand shocks, and hence serve as a security blanket for external investors, while sending positive signals to rating agencies, although all gains are quite difficult to quantify.

While the opportunity cost of maintaining high reserves includes the cost of not pre-paying foreign debt, foregoing trading and investment opportunities (the latter in high interest earning securities), the investment by the State Bank in lower yielding instruments is likely to reduce its profits by Rs. 15 to Rs. 18 billion on a full year basis. As a result, it will be interesting to see a big shortfall in the State Bank's actual profits, compared with the Rs. 26 billion estimated as a potential receipt in the federal budget for this year. Moreover, despite the brave face it is putting up, the State Bank is clearly at a loss on what to do with these reserves essentially lying idle or in extremely low-yielding instruments.

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To prevent the increase in reserves inducing inflationary pressures, the State Bank has chosen to contain monetary expansion through the sterilization of these reserves (mopping up the additional rupees in the banking system from those who surrendered their foreign exchange to the State Bank) through open market operations involving sales of government securities. In 2002 the open market operations of the State Bank were almost five times those in 2001, and roughly equal to the increase in foreign exchange reserves, reflecting the extent to which the State Bank through open market operations absorbed the foreign exchange reserves.

In the face of the unrelenting accumulation of reserves, the State Bank has been selling government securities to absorb the additional liquidity injected into the system in the process of buying up dollars. This abundance of liquidity in financial markets has facilitated large government borrowing at continually declining interest rates. All these activities and outcomes have become much more pronounced during the current financial year.

The commercial banks and other financial institutions have also opted for the easier path of pumping this liquidity into government paper. Apart from being risk averse and fighting shy of financing all but the very creditworthy in the private sector, banks have also been lazy and continuously making large investments in government securities well beyond the statutory requirements, even after the sharp decline in the yields of such instruments. The increase in market borrowings by the government has resulted in the pre-emption of the lendable funds of banks. The asset portfolio of scheduled commercial banks shows that their investments in government securities have grown appreciably. As a result, the investments of banks in government securities as a percentage of total deposits were, at 30 per cent, double the statutory requirement of 15 per cent.

Resultantly, the link between liquidity, credit, money and economic activity appears to have been severed as a result of the continued over-investment in government securities as a substitute for bank financing to the commercial sector. Banks are reluctant to bring down their lending rates commensurate with the decline in the rate of return being offered to depositors, with the burden falling more on small and medium enterprises, which have limited access to funds.

Throughout the 1990s monetary expansion was the result of an increase in net domestic assets of the State Bank which induced an expansion in bank credit. In the last one year and a half the monetary growth has been accounted for by the increase in the foreign exchange assets of the State Bank, with some of the sterilization by the Bank taking place through a reduction in the credit lines to domestic borrowers, with the shrinking in the role of banks as sources of money. The high share of net foreign assets is the outcome of a conscious policy of the State Bank to intervene in the market for foreign exchange to keep the exchange rate lower than it would have otherwise been the case.

There is no doubt that the experiences of the last 18 months or so are a sharp break from the past. However, is the improvement in the external account in the face of slowing international demand a sign of greater competitiveness of the economy? Or is it that since domestic demand is weak industry is offloading its surplus inventories and production in international markets? If this indeed is the case then imports and widening trade deficits could quickly mop up the reserves as domestic demand picks up.

Also, the attack on money laundering networks which resulted in more stringent rules being applied, could have caused huge sums of illegal, unaccounted for, money in international capital markets to look for safer heavens. It is, therefore, quite possible that some of this money through over-invoiced exports and remittances, — hot money trying to dodge legal barriers — could flow back with the same ease.

The writer is a former finance minsiter of Punjab.