



## “Impact of Currency devaluation on Pakistan’s Economy”

Syed Abdul Sattar Shah,

Asst. Prof. IBA University of Sindh, Jamshoro,

Zahid Hussain Kazi

Assistant Professor-IBA-University of Sindh-Jamshoro

Dr.Ambreen Khaskheley

Assistant Professor-Deptt:of Economics

University of Sindh-Jamshoro

Faiz Muhammad Shaikh

Assistant Professor-IBA-University of Sindh-Jamshoro

Muhammad Shaoiab

Operation Manager-UBL-Jacobabad

### Abstract

This Paper investigates the impact of currency devaluation on Pakistan’s Economy. The Devaluation occurs in terms of all other currencies, but it is best illustrated in the case of only one other currency. Any rising of the prices of such inputs through devaluation, would raise industrial costs and reduce the intensity of capacity utilization. It examines that currency devaluation has positioned Pakistan lose heavily both as seller and as a buyer and has made no good substitute for remedial changes in economic policies and developmental planning. In Pakistan, industries are heavily dependent on imported raw materials for industrial goods and capital goods and components, and their access to advanced countries is 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. So, by examining devaluation in Pakistan it is concluded that it has always led us to the cost push inflation and never ending cruel economic circle. There are so many solutions to resolve the currency devaluation as appreciate the currency through Foreign Direct Investment, increase the export of goods in this situation will lead to high cash inflows because there would be high demand push by the countries.

## Council for Innovative Research

Peer Review Research Publishing System

**Journal:** International Journal Of Management & Information Technology

Vol . 10, No 5

[editorsijmit@gmail.com](mailto:editorsijmit@gmail.com)

[www.ijmit.com](http://www.ijmit.com)



## Introduction

When we talk about devaluation it means decreasing the value of nation's currency relative to gold or the currencies of other nations. Devaluation of Pakistan rupee will mean devaluation of Pakistan labor and talent in the international market evaluation will serve as a drug rather as a stimulant and cause an unprecedented inflation. 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 rupees 59-60 per dollar till 2006-07, but after that the currency has started devaluing since 2007 to date, in April 2008 it stands to rupees 63.40 against a dollar and it rose to rupees 94.52 till the end of last Government i.e. May 2013. It is a fact that Pakistani rupee was not stable even before PML-N's era but as soon as PML-N came into power, the depreciation kept going on and even accelerated at moments and Pakistani Rupee reached Rs 107 against USD till December 2013. Normally when this happens, if state bank of Pakistan intervene and put out some US Dollars in the Market against Pakistani currency things settle down. But in this case first no move was come from State Bank of Pakistan (SBP). Later on they did come in with a move to control the value of depreciating Pakistani Currency but that long due move came on very late and it was just temporary measure.

So, by examining devaluation in Pakistan it is concluded that it has always led us to the cost push inflation and never ending cruel economic circle. Long term plan is required which will supply us structure for having branded high valued products, ample enhancement in quality and image of current exports and searching better fresh markets with sublime marketing strategies. This would surely enhance our capability to reap the possible benefits from the currency devaluation.

## Reasons:

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 too 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 15<sup>th</sup>, 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 expenditures. Borrowing from the central bank increased the inflation. High inflation is proved lethal for export, because it distorts prices.

## Objectives:

1. How currency devaluation affects the Economy
2. Impact of currency devaluation on country's exports
3. To find the benefits of currency appreciation and FDI in the economic growth of the country.
4. To find the impact of currency devaluation on developing countries
5. Conclusion

## 1. How currency devaluation affects the Economy

Firstly there is expected to be an increase in Aggregate Demand. As Aggregate demand is equal to Consumption investment, government expenditures, imports, and exports if exports are cheaper, there will be more exports sold and the quantity of imports will fall. If the economy is close to full employment level, then higher Aggregate Demand will cause inflation.

Secondly, if there is devaluation, then there will be an increase in the price of imported goods. Imports are quite a significant part of the RPI (Retail Price Index), therefore there will be cost push inflation. However, it is possible that retailers may not pass the price increases onto consumers but have lower profit margins.

Thirdly, if there is devaluation, exports become less competitive without firms having to make much effort, therefore there is less incentive for them to cut costs and therefore in the long run costs will increase and therefore inflation will increase. However this may not occur if firms are well run and they keep incentives to cut costs.

A significant danger is that by increasing the price of imports and stimulating greater demand for domestic products, devaluation can exaggerate inflation. If this happens, the government may have to raise interest rates to control inflation, but at the cost of slower economic growth. Another risk of devaluation is psychological. To the extent that devaluation is viewed as a sign of economic weakness, the creditworthiness of the nation may be jeopardized. Thus, devaluation may dampen investor confidence in the country's economy and hurt the country's ability to secure foreign investment.

Another possible consequence is a round of successive devaluations. For instance, trading partners may become concerned that devaluation might negatively affect their own export industries. Neighboring countries might devalue their own currencies to offset the effects of their trading partner's devaluation. Such policies tend to worsen economic difficulties by creating instability in broader financial markets.

Since the 1930s, various international organizations such as the International Monetary Fund (IMF) have been established to help nations coordinate their trade and foreign exchange policies and thereby avoid successive rounds of devaluation and retaliation. The 1976 revision of Article IV of the IMF charter encourages policymakers to avoid "manipulating



exchange rates to gain an unfair competitive advantage over other members." With this revision, the IMF also set forth each member nation's right to freely choose an exchange rate system.

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 utilization 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 to advanced countries is 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 labor and talent in the international market that 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 labor 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 exercise 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.

So, by examining devaluation in Pakistan it is concluded that it has always led us to the cost push inflation and never ending cruel economic circle. Long term plan is required which will supply us structure for having branded high valued products, ample enhancement in quality and image of current exports and searching better fresh markets with sublime marketing strategies. This would surely enhance our capability to reap the possible benefits from the currency devaluation.

## **1. Impact of currency devaluation on country's exports**

Devaluation is a natural process in the history of financial markets. All currencies witness their currency rates falling and rising and if 10 British pounds were able to buy, say, 20 U.S. dollars a year ago, today the pound could be devalued and its purchasing power would only be enough to buy only 15 dollars. In contrast to market devaluation, governments around the world sometimes resort to devaluation as a tool to protect their trade balances. Thus, the local currency is forcedly devalued and its currency rates against other major currencies are reduced while restrictions are often imposed preventing the home currency from being exchanged at higher rates.

These types of government intervention in the foreign exchange market are a perfect example of official devaluation while the natural market devaluation is often referred to as depreciation, a process when the currency rates fluctuate downwards. In both cases, the country whose currency is devaluated could benefit from the lower cost of its export of goods, which now are cheaper to buy by customers in countries whose currencies are stronger. The history of trade recalls many examples of intentional devaluation with the purpose of conquering new markets through the lower currency rates of the devalued currency.

One of the biggest devaluation waves in history was in the 1930s when at least nine of the leading world economies devalued their national currencies, including Australia, France, Italy, Japan and the United States. During the Great Depression, all these nations decided to abandon the gold standard and to devalue their currencies by up to 40%, which helped revive their economies and stabilized currency rates.



Meanwhile, Germany, which lost the Great War a decade earlier, was burdened to pay vigorous war damages and intentionally provoked a process of hyperinflation in the country. Thus, the Germans witnessed the biggest ever devaluation of their national currency and the currency rates hit rock bottom. At that time, the currency rate of the German mark to the U.S. dollar stood at several million or billion marks per dollar. On the other hand, this devaluation helped the German government in covering its debts to the war winners although the average Germans paid a disastrous price for this government policy.

The governments around the world are often tempted to lower unnaturally the currency rates in order to benefit from the lower value of the national currency. The lower currency value encourages exports and discourages imports improving the country's trade deficit and imbalances. However, the average citizen of a country with a recently devalued currency could suffer from higher prices of imported goods and overseas holiday costs.

## Role of Exports to minimize devaluation

The effect of devaluation on the trade balance of the devaluing country runs in terms of the supply and demand conditions in the devaluing country and in the rest of the world. It is presumed that the devaluation initially tends to reduce the foreign prices of the country's exports in proportion to the devaluation. At these reduced prices, foreign demand for the country's exports will be increased, thus tending to bid up the foreign prices of these exports part-way back toward their pre-devaluation levels.

Shinzo Abe became Japan's prime minister in December 2012, he remarked "*Central banks around the world are printing money, supporting their economies and increasing exports. America is the prime example. If it goes on like this, the yen will inevitably strengthen. It's vital to resist this.*"

Shinzo Abe's remarks summarized a prevalent theme in central banks' attempts to jumpstart their domestic economies today - money printing. I prefer to call it currency printing since it is fiat currencies that are being created out of thin air.

By: Vincent Tie

So how does currency printing support economies and increase exports? The Central banks at the command of their governments are able to devalue their currencies by inflating their money supply. This is predominantly done by central banks buying government bonds and other financial assets in the open market. Digital currency is credited into the respective banks as payment for the purchases. These transactions inject currency into the banking system which then flow out to the rest of the economy through banking activities.

As more currency circulating in the economy, price inflation in goods and services will inevitably rise since more units of currency compete for the relatively same pool of goods. In other words, each unit of the currency now buys less. This devaluation of the currency makes the exports of the country cheaper compared to other countries.

In Jan 2013, Abe announced a massive 10 trillion yen stimulus for the economy. The government would fund the majority of this stimulus through the issuance of bonds. Now we know that these bonds will eventually be bought up by the Japan central bank in their bid to devalue the yen.

In May 2013, the yen hit 100 yen to a dollar – an exchange rate last seen 4 years ago. The Japanese currency had declined 20% in 6 months. For the Japanese consumer buying goods in the US dollar, they would now require 100 yen to exchange for 1 USD instead of about 80 yen in Dec 2012. The Japanese consumer did not vote for the reduction of their purchasing power. It was not their choice. It was an intentional act by their government hell-bent to devalue the currency believing that it was the answer to spur the economy quickly. This route was the easiest for the Japanese politicians to achieve quick results which can be broadcasted in the media when economic indicators show growth.

## Its negative effects on other countries

Japan's monetary easing actions have also caused problems for other countries. The South Korean won appreciated 21% since Abe took office. Their exports declined as a result. Thailand also cut interest rates to curb the baht's appreciation as a result of Japan's monetary policy. They too want to their exports to do well on the international markets. Instead of competing based on innovation to bring better products and services to the market, currency devaluation is now a means to get ahead of your competitors.

Today, competitive devaluation of currencies to spur economies is a beggar-thy-neighbor policy that is commonly adopted by governments and their central banks. It is not sustainable and it also requires governments to go deeper into debt. Japan is not the sole culprit every country that has a central bank today is involved in competitive currency devaluation. They may call it by different nice-sounding names such as 'quantitative easing', 'loose monetary policy' or 'monetary stimulus' but they all point to the same thing – inflating and devaluing the currency.

So if you devalue your currency to favor exports, you must assume that your trading partner's economy is booming. If you are assuming that devaluation will help your exports, you must realize that exports are dependent upon demand and cost competitiveness. Both assumptions may fall short. Some feel that instead of opting for devaluation, is it a good time to check current account deficit, Tax to GDP ratio, budget deficit, government expenditure, encourage Public Private Partnership models and so on.

Devaluation of a currency has become very common in the present age. Countries facing financial strains due to unfavorable economic conditions have no alternative but to devalue its currency so as to push up its exports earnings and



simultaneously to decrease imports. Such countries usually officially decrease the value of their currency in relation to gold as well as other foreign currencies

Developing countries who in general export primary goods encounter adverse balance of trade frequently. The reasons for lagging behind their exports are that they export primary goods, which faces severe competition in the international market. It is interesting to note that competition in the world market takes place among developing countries only as they all produce primary goods and export them. Simply it can be easily deduced from the standing facts that when a country's exports remain stagnant and does not rise even after taking necessary steps for its promotion and whose imports continue to rise dislocating the balance of payment position and widening the current account deficit are left with only one alternative viz. devaluation of its currency to ease the situation. Such developing countries are in acute shortage of foreign exchange reserves, which are needed for capital formation in the country.

### 3. Benefits of currency appreciation and FDI in the economic growth of the country

An appreciation means an increase in the value of a currency. It means a currency is worth more in terms of foreign currency.

Jan 2009 If £1 = €1.1

June 2012 £1 = €1.27

In this case we can say there was a 15% appreciation in the value of the Pound against the Euro – between Jan 2009 and June 2012.



#### Effects of an appreciation on the UK economy

**Exports more expensive:** The foreign price of UK Exports will increase Europeans will find British exports more expensive. Therefore with a higher price, we would expect to see a fall in the quantity of UK exports.

**Imports are cheaper:** UK consumers will find that £1 now buys a greater quantity of European goods. Therefore, with cheaper imports we would expect to see an increase in the quantity of imports.

**Lower (X-M):** with lower export demand and greater spending on imports, we would expect fall in domestic Aggregate Demand (AD), causing lower economic growth.

**Lower inflation:** An appreciation tends to cause lower inflation because:

Import prices are cheaper. The cost of imported goods and raw materials will fall after an appreciation, e.g. imported oil will decrease, leading to cheaper petrol prices. Lower AD leads to lower demand pull inflation. With export prices more expensive, manufacturers have greater incentives to cut costs to try and remain competitive.



Assuming demand is relatively elastic; we would expect an appreciation to worsen the current account position. Exports are more expensive, so we get a fall in exports. Imports are cheaper and so we see an increase in imports. This will cause a bigger deficit on the current account.

However, the impact on the current account is not certain: An appreciation will tend to reduce inflation. This can make UK goods more competitive, leading to stronger exports in the long-term; therefore, this could help improve the current account.

The impact on the current account depends on the elasticity of demand. If demand for imports and exports is inelastic, then the current account could even improve. Exports are more expensive, but if demand is inelastic, then there will only be a small fall in demand. The value of exports will increase. If demand for exports is price elastic, there will be a proportionately greater fall in export demand, and there will be a fall in the value of exports. Often in the short term, demand is inelastic, but over time people become price sensitive and demand more elastic. It also depends what goods you export. Some goods with little competition will be inelastic. China's manufacturing exports are more likely to be price sensitive because there is more competition.

## **Economics situation and currency appreciation**

The impact of an appreciation depends on the situation of the economy. If the economy is in a recession, then an appreciation will cause a significant fall in aggregate demand, and will probably contribute to higher unemployment. However, if the economy is in a boom, then an appreciation will help reduce inflationary pressures and limit the growth rate.

It also depends on economic growth in other countries. If Europe was experiencing strong growth, they would be more likely to keep buying UK exports, even though they are more expensive. However, in 2012, the EU economy was in a recession, and therefore was sensitive to the increased price of UK exports. It also depends why the exchange rate is increasing in value. If there is an appreciation because the economy is becoming more competitive, then the appreciation will not be causing a loss of competitiveness. But, if there is an appreciation because of speculation or weakness in other countries, then the appreciation could cause a bigger loss of competitiveness. An appreciation can help improve living standards – it enables consumers to buy cheaper imports. If the appreciation is a result of improved competitiveness, then the appreciation is sustainable, and it shouldn't cause lower growth. An appreciation could be a problem, if the currency appreciates rapidly during difficult economic circumstances.

## **Benefits of Foreign Direct Investment (FDI)**

Foreign Direct Investment (FDI) acquired an important role in the international economy after the Second World War. Theoretical studies on FDI have led to a better understanding of the economic mechanism and the behavior of economic agents, both at micro and macro level allowing the opening of new areas of study in economic theory.

Various studies on the subject of inflation, Foreign Direct Investment and growth have been presented. The majority of this research work has been done internationally. Some of these important empirical studies have been critically reviewed to develop objectives in the context of Pakistan and, further, to analyze it to draw some important conclusions and policy recommendations.

## **Research on Foreign Direct Investment (FDI)**

Falki (2009) conducted a study on the impact that FDI had on the economic development of Pakistan. The study included data on FDI gathered from the Handbook of Pakistan economy of 2005. Data ranged from 1980 and 2006 and held variables such as domestic variables, labor force and foreign invested capital. Falki used the endogenous theory of growth and a regression analysis, Falki was able to conclude that FDI had a statistically negative effect on the gross domestic product and foreign direct investment in the country. Similarly, Agarwal (2000) in his study found that the increase of FDI in South Asian countries was in association with the exponential investment by local investors, providing evidence to believe that the relationship between FDI and GDP and the influence of FDI on GDP was negative till the year 1980. In the following years, early 80s, the link was mildly positive and strengthened over the years in the late eighties into the nineties.

In contrast, Adam & Tweneboah (2009), economists from Ghana, conducted an independent study on the FDI and stock market development in the country concludes that FDI in Ghana had a positive impact on the development of the economy and the stock market. The examination included data of market capitalization as a proportion of the Local GDP and Ghana cedi and Dollar exchange and the net FDI influx of the quarters between the years 1991 to 2006. With the use of multivariate co-integration analysis and the Vector Error Correction Model, the study revealed that the relationship between FDI and the Ghanaian stock market will be beneficial in the long run for the country.

An important study by Abbas *et al.* (2011) conducted an examination on the influence of FDI and CPI on the GDP's of SAARC member nations. The study concluded that the general model in these countries developed a positive relationship between Foreign Direct Investment and GDP while negative relationship between Consumer Price Index and GDP. This conclusion was tested using the multiple regression models. The data of the SAARC countries ranged from the year 2001 to 2010. Wu & Chiang (2008) endeavored to find if FDI can facilitate economic development. The study applied the threshold regression analysis. The empirical analysis concluded that FDI does play a defining role in the economic development. This was found out after an analysis of data of 62 countries from the year 1975 to 2000. The study found that FDI depends significantly on the initial GDP and human capital. This means that countries that have a significant GDP and human prior to FDI showed a positive relationship. The study also showed that countries with a strong financial



system are more capable of exploiting the potential of FDI. Through empirical analysis of the data between 1975 and 1995, it was found that FDI had a greater impact in countries with a stable financial system.

The Study conducted in Pakistan by Shabir and Mahmood (1992) analyzed the relationship between foreign private investment FPI and economic growth in Pakistan. The study used the data for 1959-60 to 1987-88; the study concluded that net foreign private investment (FPI) and disbursements of grants and external loans had a positive impact on the rate of growth of real GNP. However they did not treat FDI as a separate variable. Similarly (Ahmed, et.al, 2003) examined the causal relationship between FDI, exports and output by employing Granger non-causality procedure over the period 1972 to 2001 in Pakistan. They found significant effect from FDI to domestic output.

The purpose of this study is to identify the main trends in FDI theory and highlight how these theories were developed, the motivations that led to the need for new approaches to enrich economic theory of FDI. Although several researchers have tried to explain the phenomenon of FDI, we cannot say there is a generally accepted theory, but new evidence adding some new elements and criticism to the previous ones.

Foreign direct investment (FDI) is an integral part of an open and effective international economic system and a major catalyst to development. Yet, the benefits of FDI do not accrue automatically and evenly across countries, sectors and local communities. National policies and the international investment architecture matter for attracting FDI to a larger number of developing countries and for reaping the full benefits of FDI for development. The challenges primarily address host countries, which need to establish a transparent, broad and effective enabling policy environment for investment and to build the human and institutional capacities to implement them.

Developing countries, emerging economies and countries in transition have come increasingly to see FDI as a source of economic development and modernization, income growth and employment. Countries have liberalized their FDI regimes and pursued other policies to attract investment.

## Benefits

The overall benefits of FDI for developing country economies are well documented. Given the appropriate host-country policies and a basic level of development, a preponderance of studies shows that FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development. All of these contribute to higher economic growth, which is the most potent tool for alleviating poverty in developing countries. Moreover, beyond the strictly economic benefits, FDI may help improve environmental and social conditions in the host country by, for example, transferring “cleaner” technologies and leading to more socially responsible corporate policies.

FDI has the potential to bring social and environmental benefits to host economies through the dissemination of good practices and technologies within MNEs, and through their subsequent spillovers to domestic enterprises. There is a risk, however, that foreign-owned enterprises could use FDI to “export” production no longer approved in their home countries. In this case, and especially where host-country authorities are keen to attract FDI, there would be a risk of a lowering or a freezing of regulatory standards. In fact, there is little empirical evidence to support the risk scenario.

FDI like “official development aid” cannot be the main source for solving poor countries’ development problems. With average inward FDI stocks representing around 15 % of gross domestic capital formation in developing countries, foreign investment acts as a valuable supplement to domestically provided fixed capital rather than a primary source of finance. Countries incapable of raising funds for investment locally are unlikely beneficiaries of FDI.

## 4. The Impact of currency devaluation on developing countries

The effects of devaluation on output growth in Less Developed Countries (LDCs) has played an important role in the economic and political agendas of developing countries for several decades during which devaluation has been one of the most frequently used policy tools under both

IMF-regulated and independent stabilization programs in these countries. Whether devaluation of the currency affects national income positively or negatively has also received considerable attention among academic researchers. In order to analyze empirically whether or not devaluation results in output contraction in LDCs, data from 18 sample countries are used in a fixed-effect procedure. LDCs are divided into two categories and two different regression analyses are conducted.

## Investigation

First, data from a group of 10 countries, including both manufacturing product exporters as well as agricultural and primary product exporters, are used to estimate a model of real output behavior for a period of 25 years. Then, to investigate if there exists a qualitative difference between different countries in terms of the effect of devaluation on economic growth, data from two different groups of countries (8 manufacturing exporters, 8 agricultural and primary exporters) are analyzed for a 20-year period. In addition to the change in real exchange rates, the role of monetary and fiscal policies, as well as terms of trade changes, are incorporated into the model as the possible determinants of real output growth. The results indicate that devaluation creates a contractionary effect on output in the first year, whereas it has an expansionary effect in the following year. Also, the results suggest that there is no qualitative difference between manufacturing exporters and agricultural exporters in terms of the effect of devaluation on output growth. Fiscal expansion (increasing relative size of government expenditure) has a significant positive effect on output growth for all countries, regardless of their export



composition. The effect of terms of trade changes on output is generally negative for agricultural and primary exporters, but fluctuating for manufacturing exporters. Manufacturing product exporters have a higher output growth trend than agricultural and primary exporters.

Broadly there are four schools of thoughts related to determine the relationship between Currency exchange rate and Trade balance which are: the Marshal-Lerner, the J-curve, the S-curve and the direct method for devaluation prediction. The Marshal-learner model is the extension of Marshal's model which stated that devaluation or depreciation of currency makes export relatively cheaper and Import relatively expensive. Abba Lerner extended the work of Alfred Marshal and added the concept of elasticity of demand for export and import of the goods. Lerner explained that if the demand for export and import of the goods in a country is relatively price elastic then devaluation would positively affect the terms of trade (Lerner, 1944). The J-Curve emphasize that effect of devaluation would emerge in long run because the volume of export and import is unlikely to be affected in short run due to trade agreements and switching costs etc. therefore, in short run devaluation may affect negatively.

## Trade Deficit faced by developing Countries

The South Asian countries such as Bangladesh, Bhutan, India, Nepal, Pakistan and Sri Lanka have been experiencing annual Trade Deficit since 1970s to date. Interestingly such Trade Deficit has been observed in combination with continuous depreciation of their Currency with parity to US Dollar. Apparently this phenomenon appears to be in contradiction with Marshal's theoretical frame work. Alfred Marshal stated that devaluation or depreciation of currency makes export relatively cheaper and import relatively expensive, therefore devaluation may be an effective tool for earning surplus balance of trade (Marshall, 1923). In this study we have applied the contribution of Abba Lerner. Abba Lerner extended the work of Alfred Marshal with objective to apply the concept more practically under various scenarios. Abba Lerner developed a condition that if the demand for import and export of a country is elastic then the objective of surplus terms of trade may be achieved. If the demand for import and export is inelastic then devaluation would further increase the deficit (Lerner, 1944).

Over the past three decades many Less Developed Countries (LDCs) have implemented economic stabilization and structural adjustment programs under the initiative and supervision of the International Monetary Fund (IMF). As stated by Khan and Knight (1981) and Doroodian (1994), a typical IMF stabilization program contains the following policy measures:

Real devaluation

01. Reduction in government expenditures and increase in taxes
02. Decrease in growth of domestic credit
03. Increase in domestic real interest rates.

The effect of real devaluation on output growth is therefore important for a country implementing this policy. Obviously, devaluation does not have to be part of an IMF-guided stabilization program. Regardless of their level of economic development, many countries have "resorted either voluntarily or by some coercion to devaluation as a key policy choice for propelling economic growth. These countries embrace devaluation as a strategy that will result in increased output growth and further development." (Nwanna, 1994, p.70)

In other words, the issue of devaluation has long been a major item on the economic and political agendas of LDCs. These countries needed to devalue their currency for a variety of reasons, including correcting the price distortions and getting the right prices for the market forces to function properly, and changing relative prices of traded to nontrade goods, hence increasing competitiveness in the foreign markets. As a result, it would be possible to decrease foreign trade deficit and improve the balance of payments (BOP); and, above all, to achieve a viable economic growth.

Increasing the rate of growth of output is crucial foreconomic development. Output growth is essential for LDCs in order toraise national income per capita, achieve higher standards of living for theirpopulation, and close the development gap between themselves and the industrialized countries.

The Devaluation as a policy instrument is relevant especially in the context of misalignment. A variety of reasons could lead to price misalignments in LDCs: government policies of high tariffs on imports; taxes on exports in some cases; overvaluation of the currency associated with import substitution for industrialization as opposed to export promotion policies; and restrictions on commodity as well as capital flows. As a result of some combination of these policies, domestic prices deviate from world prices. Devaluation might play a key role in eliminating the market distortions and correcting the price misalignment. However, since economic growth is indispensable, the question of whether or not there is a trade-off between output growth and devaluation becomes a critical issue.

Within this framework, the objective of this study is to analyze the role of devaluation on output growth, which has been part of the stabilization programs<sup>2</sup> that many LDCs had to implement voluntarily or involuntarily in recent decades, and to investigate empirically whether devaluation is expansionary or contractionary.

Given the fact that the agricultural sector has a significant share in the overall national income as well as being a major source of employment for many LDCs, the link between devaluation, economic growth and agricultural policy is not a puzzle. Growth in the agricultural sector contributes considerably to overall economic growth. Devaluation policy changes the relative price of tradable goods to no tradable goods. As a result of devaluation, therefore, agricultural exports, hence agricultural production, and total export earnings as well as overall output growth will be affected.





## The economic Policies

Another point that should be emphasized is perhaps the changing character of devaluation policies. Until the 1980s the vast majority of LDCs followed fixed exchange rate policies. Starting from the late 1970s and early 1980s, however, many LDCs switched from a fixed to a flexible system as a result of a series of internal and external factors.<sup>3</sup> For this reason, we have to deal with not only devaluation, but also depreciation so long as the analysis covers the more recent years. But in essence, devaluation and depreciation function in the same way, in the sense that they both change relative prices in favor of tradable commodities. Therefore, the fact that some LDCs have switched to a floating exchange-rate system does not create a major problem in terms of the focus of our analysis.

There was no serious controversy over the possible effects of devaluation on economic growth until the late 1970s. The dominant view up to that period was that devaluation would improve trade balance, alleviate balance of payments difficulties and accordingly expand output and employment. The mechanism behind these positive effects is that devaluation switches demand from imports to domestically produced goods by increasing the relative prices of imports, and makes export industries more competitive in international markets by stimulating domestic production of tradable goods and inducing domestic industries to use more domestic inputs.

The economic policies directed towards affecting external balance and output by changing the composition of expenditures are called expenditure-switching policies. One of the most frequently used policy instruments for expenditure-switching policies has been exchange rate devaluation.

However, the consensus on this issue (i.e. the devaluation leads to output expansion) was broken at the end of the 1970s. An alternative line of approach has emerged since, which has raised the possibility that devaluation could be contractionary, especially in developing countries.

This approach is sometimes referred to as *structuralize* because it usually tends to consider the economic problems of LDCs as "structural."<sup>6</sup> Contrary to the traditional approach, this view argues that devaluation is highly likely to have a contractionary effect on output and employment, especially for LDCs. The channels through which devaluation might cause a reduction in national output can be divided into two categories: demand side channels and supply side channels. As these names suggest, channels in the first category are considered to be effective primarily on aggregate demand, while those included in the second category are effective rather on aggregate supply.

## Conclusion

The study gave me two results that how economy discourages with currency devaluation and way to appreciate the currency. There are so many reasons behind currency devaluation; 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. The most discussed causes of current economic crises are the ever-rising price of imported crude oil, which hit close to a record \$127 a barrel on May 15<sup>th</sup>, 2013. Borrowing from the central bank increased the inflation. High inflation is proved deadly for export, because it misleads prices.

If we examine devaluation in Pakistan it is concluded that it has always led us to the cost drive inflation and never ending cruel economic circumstances. Currency devaluation has positioned Pakistan lose heavily both as seller and as a buyer. Devaluation of Pakistan Rupee will mean devaluation of Pakistan labor and talent in the international market evaluation will serve as a drug rather as a stimulant and cause an unprecedented inflation.

The Exports and Foreign Direct Investment do play a significant role to appreciate the currency. The impact of an appreciation depends on the situation of the economy. If the economy is in a recession, then an appreciation will cause a significant fall in aggregate demand, and will probably contribute to higher unemployment. However, if the economy is in a boom, then an appreciation will help reduce inflationary pressures and limit the growth rate. FDI have led to a better understanding of the economic mechanism and the behavior of economic agents, both at micro and macro level allowing the opening of new areas of study in economic theory.

## Recommendations

Pakistan is facing various economic challenges. It shows that our country is in the list of under developed countries. The major problem in Pakistan is increase in population which is directly effecting our economic growth. Today not only the country is burdened with heavy debt, it has also reached a stage where it cannot simply move forward. Exports are not satisfactory and revenue from taxation is not sufficient. Unemployment is rapidly increasing. The overall scenario presents a dismal situation. This could be seen from the fact that many times a default situation emerged and it had to be faced by making great sacrifices of national sovereignty. *Of course, due to higher rate of population.* Conceived in this way a critical look at Pakistan's economy, presents a gloomy picture.

We should increase our investments but due to less financial reserves this investment is not possible. If we want to increase our investments for getting higher growth we should increase our savings for GDP to at least 20 percent, especially when foreign investments are not involved. For accelerating the rate of economic development, there should be political stability in the country. Export Promotion Bureau and Embassies/ High commissions abroad should explore markets for Pakistan's products through trade shows, business delegations and international advertising. Moreover the export base should be broadened by exporting software handicrafts, fresh fruits, vegetables, fish, livestock and flowers etc. Suitable arrangements for processing or packaging of fish, fruits and vegetables should be made. The above mentioned measures are hoped to stabilize the ship.



Now the time has come that if we want Pakistan to rise up to that extent where the prosperity, integrity, solidarity and economic stability will be all around, (then) every Pakistani will have to work as far as dedication in him lies. By working with whole concentration and conviction we may achieve that much a strong Pakistan.

## References

1. Gudaro, Amna Muhammad et al: Impact of Foreign Direct Investment on Economic Growth: A Case Study of Pakistan, Journal of Management and Social Sciences.Vol. 6, No. 2, (Fall 2010) p.p.86. PDF
2. Udomkerdmongkol, Manop et al: Foreign Direct Investment and Exchange Rates: A Case Study of U.S. FDI in Emerging Market Countries, Discussion Paper in Economics No. 06/05. University of Nottingham 2006. PDF
3. Wyk, Jay van and Lal, Anil.K: Risk and FDI Flows to Developing Countries, SAJEMS NS 11 (2008) No 4. PDF
4. Denisia, Vintila. Foreign Direct Investment Theories: An Overview of the Main FDI Theories, Volume 2, Issue 2, December 2010. PDF
5. OECD: Organization for Economic Cooperation and Development: Foreign Direct Investment for Development, Maximizing Benefits, Minimizing Costs: Overview. OECD Publications Service 2002, 2, rue André-Pascal, France. PDF
6. Alexander, Sidney.S: Effects of a Devaluation on a Trade Balance: Staff Papers - International Monetary Fund, Vol. 2, No. 2 (Apr., 1952), Published by Palgrave Macmillan Journals on behalf of the International Monetary Fund Stable. PDF
7. Borensztein, E. et al: How does foreign direct investment affect economic growth, Journal of International Economics 45 (1998). PDF
8. ACAR, Mustafa. Devaluation in Developing Countries: Expansionary or Contractionary, Journal of Economic and Social Research 2 (1) 2000. PDF
9. Laura Alfaro. et al: Does Foreign Direct Investment Promote Growth? Exploring the Role of Financial Markets on Linkages, NBER Working Paper No. 12522, Issued in September 2006. PDF
10. Frankel, Jeffrey. A. Contractionary Currency Crashes In Developing Countries, NBER Working Paper No. 11508 Issued in August 2005. PDF
11. Raza, Dr Alam. Effects of Currency Depreciation on Trade Balances of Developing Economies: A Comprehensive Study on South Asian Countries, IOSR Journal of Humanities And Social Science (IOSR-JHSS) Volume 14, Issue 6, Sep. - Oct. 2013. PDF
12. Why Do Governments Devalue Their Currency Rates: URL accessed on May 3, 2014, Web <<http://www.currencyolutions.co.uk/currency/why-do-governments-devalue-their-currency-rates>>
13. Currency Devaluation and Revaluation: URL accessed on September 2011 web <<http://www.newyorkfed.org/aboutthefed/fedpoint/fed38.html>>
14. Zaiby, Parveen. Currency devaluation and its impact on the economy: web <<http://jang.com.pk/thenews/apr2008-weekly/busrev-21-04-2008/p3.htm>>
15. Tie, Vincent. Currency devaluation becomes the solution to all economic problems: URL accessed on 25-10-2013 00:00 web <[https://www.bullionstar.com/article/currency\\_devaluation\\_the\\_solution\\_to\\_all\\_economic\\_problems](https://www.bullionstar.com/article/currency_devaluation_the_solution_to_all_economic_problems)>
16. Shah, Hassan Youssef. Rupee devaluation: URL accessed on October 15, 2013. Web <<http://www.pakistantoday.com.pk/2013/10/15/comment/rupee-devaluation/>>
17. Batada, Abdul Rahman. Devaluation and its impact: URL accessed on Mar 05 - 11, 2001. Web <<http://www.pakistaneconomist.com/issue2001/issue10/f&m2.htm>>
18. Global Economic Analysis - Currency Appreciation and Depreciation: web <<http://www.investopedia.com/exam-guide/cfa-level-1/global-economic-analysis/foreign-exchange-parity-influences.asp>>
19. **Harding, Torfinn and Javorcik, Beata.** Can FDI help developing countries upgrade export quality: **URL accessed on 30 September 2011.** Web <<http://www.voxeu.org/article/can-fdi-help-developing-countries-upgrade-export-quality>>
20. Pettinger, Tejvan. The effects of an appreciation: URL accessed on February 21, 2014. Web <<http://www.economicshelp.org/blog/10050/economics/effects-appreciation/>>
21. Bized. The Economic Effects of Devaluation: URL accessed on Mon, 01/01/2001 - 13:00. Web <<http://www.bized.co.uk/virtual/dc/trade/theory/th13.htm>>
22. Devaluation (Money). Web <<http://www.referenceforbusiness.com/encyclopedia/Dev-Eco/Devaluation-Money.html#ixzz32SIRvjpB>>