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BASKET PEG OR FLEX: A TEMPLATE FOR ASSESSING THE COMPETITIVENESS OF PAKISTAN'S TRADE SECTOR

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ABSTRACT

This paper has been divided into two parts. The first part explores the appropriate exchange rate system for improved competitiveness of Pakistan's trade sector. The second part finds out the solution of question that how to determine the optimal baskets and how heavily the euro and US$ ought to be weighed in any such currency baskets. It has been argued that at least two important targets, viz. Appropriate exchange rate regime and trade competitiveness need to be taken into account when determining an optimal basket. Drawing on a simple game, regression models are developed based on empirical evidences provided by Abed, Erbas and Guerami (2003). This paper has developed a simple framework within which the optimal exchange rate response to a change in weights of two currencies in the dollar-euro basket pegs. The results propose that Pakistan's external sector competitiveness ought to be insensitive to euro & dollar exchange rate changes. In other words, Pakistan should continue its prevailing floating exchange rate regime. Using the consumer price-based indices, the appreciation, or depreciation of Real Effective Exchange Rates (REER) applies to euro and dollar has been analyzed for Pakistan from 1982 to 2005.

KEYWORDS

Basket peg, competitiveness, depreciation, exchange rate, floating.

INTRODUCTION

Exchange rate economics was revitalized in the early 1970s. The catalyzing event was the crumbling of the postwar monetary system, under which countries had for the previous quarter century kept their exchange rates fixed within narrow ranges, with only occasional adjustments. Subsequently, except within Europe, the major industrial countries have maintained flexible exchange rate arrangements, and market pressures have been allowed to generate large fluctuations in currency values. Since the collapse of the Bretton Woods exchange rate system, a vast literature has developed on the virtues and pitfalls of fixed versus flexible arrangements. While a variety of theoretical criteria for choosing the right regime have been proposed, there is still no consensus on how precisely these should be quantified and, to the extent they bear conflicting implications, how they should be prioritized. Following the disorderly exits from pegged regimes by a number of emerging market economies over the past decade, regime choice has drawn increased attention and a more systematic approach to assessing the implications of the various criteria appears warranted.

This paper proposes a broad set of quantitative indicators based on analytical factors that have been identified in the literature as having important effects on the competitiveness—and hence the choice—of exchange rate regimes. The selection of the key factors—external sector components (exports & imports); real effective exchange rates; consumer price indices; gross domestic product—is guided by quantifiability and cross-country comparability, and techniques to measure each factor empirically are specified in the form of a template for the time period 1982-2005. Comparisons with other countries are used to assess whether Pakistan's competitiveness for its trade nominates it as a "natural" candidate for a basket peg regime based on a particular criterion or not? For example, countries that have a high degree of trade orientation will benefit from a regime that pegs the currency to that of its major trading partner. Since it is unclear a priori what constitutes "high" trade orientation, the analysis envisage trade component's competitiveness because of two-currency basket peg rule. The sample comprises 11 economies[2] of various sizes and levels of development, spanning major regions as European Union Asia and US. This study highlights the two-currency basket peg and its implication on the external sector competitiveness of Pakistan. In economy like Pakistan, the consideration of choosing the right exchange rate regime include credibility of financial markets and financial wealth, the transactions costs arising from exchange rate volatility and trade components. If no substantial gain is to be achieved by switching from flexible exchange rate to basket-peg, such considerations might well dominate to ensure the competitiveness of non-oil exports & heavy imports and favor the decision to continue with flexible exchange rate regime. In dollar-euro basket peg, one peg dominates the other depends critically on the elasticities of exports and imports to and from the major trading partners. Depending upon the components of the trade account (imports & exports, and non-oil exports), the stability gains from switching to the basket peg is measured. More flexible exchange rate may serve as an optimal arrangement as compare to a pegging rupee to a dollar-euro basket policy, in the future in case of Pakistan's economy see in annexure.

Since 1982, a managed float has characterized the Pak rupee; the rupee was pegged to a basket of currencies with the US dollar being the main anchor currency. Pakistan has also maintained a de facto peg for much of the time since the early 1990s. In 17 July 2000, a free float replaced this system. However, current scenario witnesses that in practice regular state bank of Pakistan (SBP) intervention continues, and therefore the issues of real depreciation to correct the trade balance still remain relevant. Changes in exchange rates have pervasive effects, with consequences for prices, wages, interest rates, productions levels, and employment opportunities, trade and thus with direct or indirect implications of virtually all economics participants. Accordingly, large and unpredictable changes in exchange rates present a major concern for macroeconomic stabilization policy (Kemal, 2005).

The European Union (EU) is an intergovernmental and supranational union of 25 democratic countries known as member states[3]. The European Union was established under that name in 1992 by the Treaty on European Union (the Maastricht Treaty), and having an area of 3,892,685 km and approximately 460 million EU citizens as of December 2004. The Union has today a common single market, consisting of a customs union; a single currency (the euro) managed by the ECB (adopted by 12 of the 25 member states), a Common Agricultural Policy (CAP), a Common Trade policy (CTP), a Common Fisheries Policy (CFP), and a Common Foreign and Security Policy. In Europe, under the European Exchange Rate Mechanism (ERM), a group of countries did give up some domestic policy options for the sake of maintaining exchange rate relationships, but their example does not apply to the major industrial countries as a group.

This study look at the matter of alternative exchange rate regimes and trade competitiveness in the perspective of both the advanced countries, who generally have a choice and the emerges who have less of one and who often emulate what the advanced countries have done. Following the introductory part, paper is intended as follows. Section 1 surveys some of the concise literature involved theoretical aspects of exchange rate arrangements, empirical evidences with analytical considerations related to regime choices from developing, developed, emerging & transition countries as well as Pakistan, and for and against views on exchange rate systems. Third section highlights the methodology part, statistical estimation, and results interpretation. Section 4 presents conclusion with some policy issues. Finally, bibliographical framework is listed.

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[2] core members of international monetary system and are major trading partners of Pakistan

[3] 25 countries: Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, UK;

note - Canary Islands (Spain), Azores and Madeira (Portugal), and French Guyana, Guadeloupe, Martinique, and Reunion (France) are sometimes listed separately even though they are legally a part of Spain, Portugal, and France; candidate countries: Bulgaria, Croatia, Romania, Turkey; note - the EC has recommended that Macedonia become a candidate country.

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MOTIVATION

The East Asian crisis of 1980s and 1990s has raised a number of theoretical issues and puzzles, many of which have important implications for macroeconomic policy. Among the most important, is the question of what the appropriate exchange rate regime for small and open emerging economies like Pakistan is?

OBJECTIVES

The paper is conducted for the following purposes
- To assess the trade regime gains can be achieved by switching from floating exchange rate regime to basket peg regime.
- To hit upon the dominant currency peg from dollar-euro basket peg in order to improve competitiveness of external sector of Pakistan.
- To guesstimate the exchange rate regime that endow with liberal transitional strategy for the transitional economy like Pakistan.

LITERATURE REVIEW

This is a substantial theoretical and empirical literature on the alternative exchange regimes and external sector competitiveness of Pakistan's economy. In Pakistan, considerations in choosing a currency peg include credibility of exchange rate regimes and monetary policy stance, the effects of exchange rate volatility on financial markets and financial wealth, the transactions costs arising from exchange rate volatility. If no substantial gain is to be achieved by switching from flexible exchange rate to basket-peg, such considerations might well dominate to ensure the competitiveness of external sector and favor the decision to continue with flexible exchange rate regime. Following this introduction, the theoretical framework is explained in section 2 of this part. Empirical evidences related to paper are discussed in section 3.

THEORETICAL FRAMEWORK

Economic theory provides a relatively little guidance on the relationship between exchange rate and trade policies. Trade and exchange rate policies have a common denominator in that they provide a certain degree of protection or support to domestic industries. There will always be a change in the level of the exchange rate that will, increase the return to certain exporting or import-competing activities. At first glance, one is tempted to argue that stable exchange rates are a precondition for stable trade policies. However, this need not be the case. One can view the impact of exchange rate regimes on the stability of trade policy in four ways. The first link concerns the taxonomy of exchange rate regimes following with sub sections like, currency basket peg, OCA, and target zone framework. The second link, competitiveness of exchange rate regimes, has its origin in the direct impact of exchange rate policy on the external sector, BOP, national price level, and monetary policies more generally. The third link comes from the relationship of real effective exchange rates and external sector. The study shall turn to each of these aspects in turn. The fourth link examines the different sides of exchange rate regimes i.e., determination of exchange rate regimes and new orthodoxy. From the view point of theoretical aspects of exchange rate regime, First of all theoretical framework takes up a set of other issues briefly in subsequent sub-sections: the fear of floating argument, Keynesian analysis of flex, and on the argument the no" size fits for all" exchange rate regime.

FEAR OF FLOATING

The modern "fear of floating" problem[4] was due to pervasive problems of currency mismatch. Many countries that claim to have floating exchange rates, do not allow the exchange rate to float freely. Countries, not yet open to international capital flows, are likely to be concerned about the behavior of the exchange rate; it also makes room for the fear of floating argument. UnCalvo and Reinhart (2000) expressed fear that large fluctuation in exchange rates, perhaps exaggerated by speculative capital movements, would involve damaging uncertainties for international trade. The fear-of-floating literature points to a number of additional factors that may explain why some countries are reluctant to allow exchange rate flexibility. Rogoff and others (2004) come across with the same findings that countries with limited access to external private capital have tended to experience lower inflation under rigid exchange rate regimes than under more flexible regimes.

KEYNESIAN ANALYSIS OF FLEX

Work on flexible rate in macroeconomic perspective goes back to Polka and Leursen and Metzler, as well as James Meade. Keynes model identifies the terms of trade with the exchange rate; it essentially assumes that prices and costs are fixed in terms of supplies currency and that fore exchange rate raises import prices relative to export prices.

The analysis drew flexible rates into a macro economic framework by identify the exchange rate with the terms of trade. Which in turn effect the composition of domestic appending and are a determinant of exports? In the absence of capital flows, the exchange rate will adjust to maintain the trade balance in equilibrium. An expansionary domestic policy, e.g., would raise income and import spending. The resulting trade would cause depreciation and switch demand toward domestic goods until the deficit was eliminated (Drnbusch and Krugnan, 1976).

NO "ONE-SIZE-FITS-ALL" SOLUTION

An important decision for the Central and Eastern European countries seeking membership in the European Union is choosing the most appropriate exchange rate regime. Experience has shown that many considerations are involved in this decision and that there is no "one-size-fits-all" solution. Because accession countries maintain a wide diversity of exchange rate regimes, from a currency board arrangement (Estonia) to floating regimes (Poland since April 2000 and the Czech Republic). A common goal of the countries is to move toward meeting the Maastricht criteria as they complete their transitions, but there seems to be no direct link between the exchange rate regime they have in place and their progress in meeting that goal.

TAXONOMY OF EXCHANGE RATE ARRANGEMENTS

Every country that has its own currency must decide what type of exchange rate arrangement to maintain. In reality, however, there are different varieties of exchange rate regimes (see in table), providing a range of alternatives. An exchange rate is simply a price: the price in domestic currency of a unit of foreign currency. Unlike most prices, the exchange rate has normally been fixed in some manner. To put the point graphically, if exchange rate arrangements lie along a line connecting free floating on the left with currency boards, dollarization, or currency union on the right, the intent was not to remove everything but the corners, but rather to pronounce as unsustainable a segment of that line representing a variety of soft pegging exchange rate arrangements. For the same reason, countries rarely allow their exchange rates to float freely. In most countries with floating currencies, the national authorities follow exchange market developments closely throughout every trading day, sometimes intervening to purchase or sell currencies, on their own account for limiting the extent to which the excess demands of supplies of market participants cause exchange rate to fluctuate. Hybrid exchange rate system combines some of the attributes and characteristics of both pegged and flexible exchange rate system.

PEGGING: A SINGLE CURRENCY OR BASKET?

If a country traded heavily with countries that were already on gold, then it could have an incentive to adopt the same monetary regime as its main trading partners. For those that do adopt an exchange rate anchor, a further choice is whether to peg to a single currency or to a basket of currencies. The choice hinges on both the degree of concentration of a country's trade with particular trading partners and the currencies in which its external debt is denominated. When the peg is to a single currency, fluctuations in the anchor currency against other currencies imply fluctuations in the exchange rate of the economy in question against those currencies. By pegging to a currency basket instead, a country can reduce the vulnerability of its economy to fluctuations in the values of the individual currencies in the basket.

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[4] Whereby countries that say they float do not, seem to have been prevalent pre 1914. If fixing was quite painful under the gold standard for many of the peripheral countries, floating could be just as problematic for them as is the case today

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OPTIMUM CURRENCY AREAS

The theory of optimal currency areas suggests that countries benefit from adopting the same anchor as trade partners, since this reduces their bilateral exchange rate variability. They find that, after controlling for other factors, the probability of choosing a particular anchor currency increases with the amount of trade with other countries that use this same anchor. During recent years, the theory of optimum currency areas has been resuscitated, greatly benefiting from, and contributing to, the consideration of various practical issues.

COMPETITIVENESS OF EXCHANGE RATE REGIMES

A fixed nominal rate proved to be useful in the early stage of the stabilization program, but the insistence on a pegged exchange rate eventually became counterproductive. A system of FIX can only be reconciled with the insistence on national economic independence or economic growth by some kind of compromise with the principle of flexible rates: wider bands, gliding parties, or both. Similarly, many other exchange rate arrangements have been brought different levels of growth and being helper in smoothing out international adjustments. FLEX provides a simple, automates, and efficient mechanism of adjustment, and by eliminating balance of payments difficulties-a major source of protectionist devices. One of the great advantages of a system of floating rates is that it would render obsolete and irrelevant all the grandiose plans to shore up world liquidity through an increasingly cumbersome international payments apparatus. Movements in exchange rates can wipe out – or double - profit margin. Consistently, large and persistent changes in exchange rates often catalyze strong political pressures for import protection in countries that have had their international competitiveness eroded.

EXCHANGE RATE REGIMES AND EXTERNAL SECTOR

By its very failure in this respect, a fixed exchange rate system promotes the introduction of controls over international trade and investment, whereas, FLEX promotes freedom of trade and investment. In particular, empirical studies have failed to uncover statistical evidence that exchange rate variability has had much of a depressing effect on international trade volumes. Dellas & Zilberfarb (1993) also argue that higher volatility of exchange rate witnessed since the adoption of the floating regime in 1973 has led to a decline in international trade transactions. Looking at the volume of trade is not the place where one would expect to find the costs of fluctuating exchange rates.

EXCHANGE RATES VS BALANCE OF PAYMENTS

In addition to recognizing the close links b/w the behavior of exchange rates and the behavior of national price levels and interest rates, economist have long emphasized the interdependence b/w exchange rates adjust to international payments imbalances can be traced back at least as far as the fourteenth century. Since the middle of the twentieth century, major developments in both macroeconomic analysis and the evolution of the world economy – most notably, the Keynesian revolution and the rapid expansion of international capital transactions relative to the growth of international trade have altered perceptions of the behavioral linkages b/w exchange rates and the balance of payments. In its pure form, a system of fixed exchange rates must be rejected on the ground that the "balance of payments discipline." Under flexible rates, however, if market forces are allowed to work unimpeded, so that no actual or export payments deficit are surplus can appear. In sum, the highly competitive foreign exchange market is the most efficient means for bringing international payments and receipts into balance (Caves, 1963).

EXCHANGE RATES VS NATIONAL PRICES LEVEL

The perception of exchange rates are related to national price levels has been traced back to the sixteenth century. The general inflation that has taken place during the war has lowered this purchasing power in all countries, though in a very different degree, and the rates of exchanges should accordingly be expected to deviate from their old parity in proposition to the inflation of each country. Countries with inflation rates higher than their main trading partners often depreciated their currencies to prevent a severe loss of competitiveness. The actual rate of exchange cannot deviate very much from this purchasing power parity. A system of flexible exchange rates, on the other hand, achieves adjustment entirely through relative price changes (David, 1976).

Notwithstanding the exchange regime choice, five (Egypt, Jordan, Lebanon, and Morocco, Tunisia) of the six countries (Iran is the exception) registered low inflation rates, while real growth averaged about 3–5 percent during 1991–2001. Moreover, as many as 19 developing countries floated their exchange rates in 2002 and announced their inflation targets without a formal inflation-targeting framework. Lebanon also has a small open economy with a fixed peg to the dollar; its economy is highly dollarized.

EXCHANGE RATE REGIMES VS INTERNATIONAL MONETARY REGIMES

" . . .. The choice of appropriate exchange rate regime, which, for economies with access to international capital markets, increasingly means a move away from the middle ground of pegged but adjustable fixed exchange rates towards the two corner regimes of either flexible exchange rates or a fixed exchange rate supported, if necessary, by a commitment to give up altogether an independent monetary policy." Lawrence H. Summers (2000).

A short theory of the international monetary regimes that have transpired over the past century, elucidate that monetary policy in countries with floating exchange rate systems is likely to respond to movements of the exchange rate. In Canada, the use of a monetary conditions index to guide monetary policy, based on movements in both the exchange rate and the interest rate, formalized the impact of exchange rate movements on monetary policy (Flemine, 1962). In fixed regimes, monetary policy must be subordinated to the requirements of maintaining the peg. A system of FIX is inconsistent with the degree of monetary and fiscal independence required in today's world. FLEX allows old maximum independence with regard to monetary and fiscal policy (Emminger, 1976).

RELATION SHIP BETWEEN REER & TRADE COMPETITIVENESS

The link between changes in REER and trade competitiveness is very tight in some countries including the Czech Republic and Slovakia; in others, the relationship is more tenuous. Because the impact of exchange rate changes on trade flows is felt with a time lag, the imprecise nature of the relationship is not surprising. Moreover, the relationship was probably also influenced by the speed with which competitiveness was lost in individual countries, and this, in turn, was also a function of productivity improvements, which depended crucially on the success of industrial restructuring. This point is particularly evident in the competitiveness of Hungary. The relatively stable REER in Hungary has been associated with a constant level of trade balance and, most recently, with some improvement in the trade balance. The case of Poland is somewhat puzzling; the deterioration in the trade balance has been associated with a constant level of the REER measured by producer prices.

DETERMINANTS OF CHOICE OF EXCHANGE RATE REGIME

Exchange rate regime choice has evolved considerably in the past 100 years. At the beginning of the twentieth century, the choice is also becoming more obvious - - go to floating exchange rates, all the advanced countries have done it. There has been keen interest in empirical and theoretical studies on the choice of exchange rate regimes in developing countries in the aftermath of the currency crises in Mexico (1994), Southeast Asia (1997), Russia (1998), and Brazil (1999). The debate has focused mainly on the sustainability of conventional fixed pegs—so-called soft pegs—in the face of capital mobility and other shocks.

The theoretical literature provides broad guidance on exchange rate regime choice. The main criterion for regime choice is to reduce the output cost of an adjustment to exogenous shocks. The early literature on the choice of exchange rate regime took the view that the smaller and more "open" an economy (that is, the more dependent on exports and imports), the better it is served by a fixed exchange rate. In this framework, the best regime is the one that stabilizes macroeconomic competitiveness, that is, minimizes fluctuations in output, consumption, the domestic price level, or some other macroeconomic variable. The ranking of fixed and flexible exchange rate regimes depends on the nature and source of the shocks to the economy, policymakers' preferences, and the structural characteristics of the economy.

THE NEW ORTHODOXY

The claim of the new orthodoxy is that the choice of exchange rate regime has been hollowed out to one of two "corner solutions." One is a firmly fixed exchange rate, with an institutional guarantee that it will stay fixed, in the form of at least a currency board, or else "dollarization or monetary union. The other is a floating exchange rate that is almost "lightly managed."

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METHODOLOGY

In estimating trade Elasticities for Pakistan, most previous researchers have employed non-stationary data, Aftab, and Aurangzeb (2002) co integration, Marshall Lerner Kamal (2005) simultaneous equations model, Afzal (2005) techniques and specified models i.e., target zone model, elasticity approach, etc. has been used. In this study, OLS technique has used. Using annually data, the trade competitiveness with Pakistan's major trading partners is empirically tested. Moreover, two-currency basket rule has also been investigated for euro and dollar peg arrangements.

The period from the mid-1970s to the early 1980s has been characterized as "a heroic age" of exchange rate theory. During that time, international economists focused attention on three major structural approaches to modeling the empirical behavior of exchange rates and engaged in continuing efforts at theoretical extension in a spirited competition to explain the observed evidence. The three structural approaches have become known as flexible-price monetary models, sticky-price monetary models, and portfolio-balance models. For the most part, the various specification hypotheses that were entered in the empirical horse race were single-equation reduced-form models. The heroic ended when statistical tests revealed the sobering fact that none of the specification hypotheses could significantly outperform a naïve random walk model in predicting the out-of-sample behavior of the exchange rate.

DATA SOURCES

- International financial statistics (IFS) yearbooks (various years)
- Statistical supplement of Pakistan 2004-05
- Economic survey of Pakistan 2004-05

DATA DESCRIPTION

To derive optimal trade baskets (i.e. nominal effective exchange rate or NEER) appropriate consumer price indices are used to deflate the NEER (i.e. real effective exchange rate or REER), also to deflate the GDPs of all included countries. Aggregate of GDP of EU countries is calculated by summing up real GDPs of nine countries (Belgium, France, and Nether land, Luxemburg, Italy, Ireland, Denmark, UK and Greece). Aggregate CPI has also been calculated by taking total of CPIs of given nine countries. GDP deflators, CPIs and other given variables are converted into the base year 2000. Imports and exports are also made real by using GDP deflator and then completely was converted in to \$mln. Along with this, variables of Pakistan and US have also taken into account like US GDP, Pakistan's GDP, and bilateral exchange rate i.e., dollar-rupee & euro-rupee.

SAMPLING TECHNIQUE

Purposive sampling has been used to drawn a sample of 11 countries (trading partners of Pakistan, including Pakistan also). Secondary Data of all variables have been taken to perform assigned analysis of selecting the appropriate regime for external stability.

VARIABLE DESCRIPTION

DEPENDENT VARIABLES

Exports (x) of Pakistan to US, Exports (x) of Pakistan to EU, Imports (m) of Pakistan form US & EU

EXPLANATORY VARIABLES

Real GDP (y) of Pakistan, Real GDP of US, Real GDP of EU, Real effective exchange rate applies to \$-R exchange rate (v)[5], REER applies to euro-R exchange rate (e)[6]

MODEL LAYOUT

TWO-CURRENCY BASKET PEG RULE

$\delta(r) = \Omega (\$) + 1- \Omega (€) \qquad 0 \le \Omega \le 1$

Where,

R = currency of Pakistan, rupee

\$ = Currency of US, dollar

€ = Currency of EU, euro

δ, Ω = constants to determine the nominal exchange rate b/w rupee and basket

REGRESSION SPECIFICATION

Following literature (Afzal (2005), Abed, Erbas and Guerami (2003),) export and import equations are:

$ln\ M\ t = \alpha 0 + \alpha 1\ ln\ et + \alpha 2\ ln\ v\ t + \alpha 3\ ln\ Y1\ t + \ t$

$ln\ X\ t = ß 0 + ß1\ ln\ et + ß 2\ ln\ v\ t + ß 3\ ln\ Y2\ t + V\ t$

$ln\ X\ t = \ 0 + \ 1\ ln\ et + \ 2\ ln\ v\ t + \ 3\ ln\ Y3\ t + \ t$

Where,

M t = Imports of Pakistan in t time period

X t = Exports of Pakistan in t time period

αs = Elasticities of imports[7] w.r.t e, v, & y1

ßs = Elasticities of exports w.r.t e, v, & y2

s = Elasticities of exports w.r.t e, v, & y3

et = REER apply to euro-R exchange rate

vt = REER apply to \$-R exchange rate

Y1 t = Real GDP of Pakistan in t time period

Y2 t = Real GDP of US in t time period

Y3 t = Real GDP of EU in t time period

t, V t,   t = stochastic error term

VALUE OF OMEGA

To get the suitable peg for the better competitiveness of external sector (imports from US & EU)

Ω = α 2 / α 2 + α 1

To get the suitable peg for the better competitiveness of external sector (exports to US)

Ω = ß 2 / ß 2 + ß 1

To get the suitable peg for the better competitiveness of external sector (exports to EU)

Ω = 2 / 2 + 1

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[5] v = V* [p/ps]   where, V= bilateral exchange rate b/w rupee & dollar, p= CPI of Pakistan, Ps= CPI of US

[6] e= E* [p/pe]   where, E= bilatetral exchange rate b/w rupee & Euro, Pe= CPI of EU

[7] α1= **[dM/M]/ [de/e]**

α2= **[dM/M]/ [dv/v]**

α3= **[dM/M]/ [dy1/y1]**

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ESTIMATION TECHNIQUE

1. Autocorrelation is checked by D.W test, in case of existent of serial correlation double log regressions equation will be transformed into first difference regression equations. Moreover, AR (1) technique is applied on the model to fix the problem of auto correlation.
2. Non-stationarity has been check in series by applying ADF test.
3. Ordinary-Least-Square method is used to estimate the regression equations.

SUMMARY STATISTICS

TABLE 1: ESTIMATES OF IMPORTS OF PAKISTAN FROM US & EU

Dependant Variable: Pak Imports		Obs = 20
Variable	Coefficient	t-Statistic
C	-6.958515☺	-1.171385
LOG(EEE)	0.083718☺	0.486751
LOG(VVV)	-0.559521☺	-1.009115
LOG(PAKGDP)	1.510538☺	2.712539
AR(1)	0.491323	1.933528
R^2= 0.990552		D.W = 1.979050
Adj R^2= 0.988452		
Basket peg rule		(R)=Ω($) + 1-Ω(€)
Ω = C3/(C3+C2)	1.083718	Peg to $ ☺
1-Ω	-0.08371	

☺ Significant at 1%
☹ Insignificant
☺ Inconclusive result

TABLE 2: ESTIMATES OF EXPORTS OF PAKISTAN TO EU

Dependant Variable: Pak Exports		Obs = 20
Variable	Coefficient	t-Statistic
C	8.280701☺	14.86264
LOG(EEE)	-0.364013☺☺	-1.878792
LOG(VVV)	1.062821☺	7.803024
LOG(EUGDP)	0.005393☹	1.034842
AR(1)	0.650626	4.311244
R^2= 0.992862		D.W= 2.433804
Adj R^2= 0.990823		
Basket peg rule		(R)=Ω($) + 1-Ω(€)
Ω = C3/C3+C2	0.635987	Peg to $
1-Ω	0.364013	

☺ Significant at 1%
☺☺ Significant at 10%
☹ Insignificant

TABLE 3: ESTIMATES OF EXPORTS OF PAKISTAN TO US

Dependant Variable: Pak Imports		Obs = 20
Variable	Coefficient	t-Statistic
C	9.113468☹	1.086643
LOG(EEE)	-0.558988☺	-2.891067
LOG(VVV)	1.317171☺	4.310857
LOG(USGDP)	-0.188957☹	-0.182278
AR(1)	0.506351	2.786763
R^2= 0.990043		D.W= 1.805068
Adj R^2 = 0.987831		
Basket peg rule		(R)=Ω($) + 1-Ω(€)
Ω = C3/ (C3+C2)	0.441012	Peg to basket
1-Ω	0.558988	

☺ Significant at 1%
☹ Insignificant at 1%

ELUCIDATION OF RESULTS

First, let interpret Pakistan's imports regression line. As expected there is a positive relationship between volume of imports and REER apply to €-R. which means 1% change in REER resulted in a significant +8% change in imports quantity. While REER apply to $-R shows negative impact on volume of imports depicting that, 1% change in REER brings 55% significant decline in imports quantity. So the influence of $-R REER is dominant on Pakistan's import strategy. With the exclusion of effects of all independent variables, the import volume of Pakistan is estimated which is screening again a negative impact but a significant effect. The GDP of Pakistan also affects the import level and according to theoretical background of import theory, the resulted insignificant estimated value of coefficient of PAKGDP shows positive relationship between GDP & imports. The R^2 value of about 0.99 means that 99% of the variation in imports quantities is explained by the explanatory variables i.e. both REERs and domestic GDP. Adjusted R^2 states that all regressors i.e., both types of REERs & GDP volume, are 98% relevant with the imports of Pakistan. As for as serial correlation is concerned, Durban-Watson statistics previously shows positive auto-correlation in time series data but to fix the problem AR(1) technique has been applied and now there exist ignorable autocorrelation. Goodness of fit is indicated by the value of F-statistics which is quite high i.e., 471.7665. Average annual imports of Pakistan for the time period 1982-2005 is $12.041mln. The purpose of conducting all these estimations is to solve the basket-peg rule for Pakistan's trade sector. For this reason, coefficient estimates are taken to find out the values of constant (**Ω**) for imports & exports

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volumes. Form the coefficients of REERs of import regression equation, it is concluded that Pakistan should peg rupee with $ and it is an appropriate exchange rate regime for economy like Pakistan in order to improve external sector competitiveness. However, this result is Inconclusive.

From the table 2, the results of exports of Pakistan to EU, the elasticities of exports w.r.t. REER apply to euro-R is -0.364, suggesting that if REER appreciates by 1%, on average, the exports go down by about 36%. In addition, the exports of Pakistan are very positively responsive to REER apply to $-R. Meaning, the strength of REER, to effecting the export quantity is 106%. The value of constant shows the quantity of exports will be $8.28 mln if value of all stimulus variables is zero. The effect of EU GDP is positive but insignificant. If the estimates for export from US are considered then the average value of exports will be $9.113mln by considering all predictors as zero. Nevertheless, the impact of EU GDP on exports is negative and again is insignificant. Autocorrelation in both export equations is removed by applying AR(1) technique. In both export cases, the variation explained by predictors is same i.e., 99%. Moreover, relevancies of all explanatory variables are almost 99% with the exports of Pakistan from both regions. Goodness of fit of both export cases is high, shown by the values of F-statistics. Solution of basket-peg rule for exports of Pakistan from US suggests that appropriate currency to peg from Pakistan's rupee is basket peg. Nevertheless, exports from EU suggesting opposite and favors dollar. Outcome of export from US equation are more acceptable because elasticity coefficients derived from this equation for REERs are highly significant as compare to the elasticity coefficients derived from second equation of exports from EU (table 2). But because of three different solution of basket peg rule, Pakistan' external sector is indifferent between such regimes. So the decisive way is to reject null hypopaper meaning, acception of alternative hypopaper i.e., Pakistan should continue prevailing floating regime.

CONCLUSION AND RECOMMENDATIONS

Choice of exchange rate regime for the Pakistan's economy is perhaps the most fundamental component of trade policy. The scorecard based on outcomes derived from historical data (1982-2005), points to a strong case for an appropriate FLEX regime. Because, out of three equation's output, equation formulated for imports of Pakistan gives inconclusive result and from other two equations for exports, basket peg rule suggests dollar, to which Pakistani rupee should be pegged, but other supports euro-dollar basket for the Pakistan's exports. Taken together, the measures capturing the various regime choice considerations and outcomes of basket-peg rule do not indicate a strong case for pegging regimes for the rupee, meaning null hypopaper has been reject at standard level of significant. Under the stability criterion, estimates indicate that the prevailing floating exchange rate dominates the dollar-euro basket pegs. This conclusion reflects the fact that, for external sector of Pakistan, some of the elasticity estimates for the dollar-rupee REER & euro-rupee REER are significant and some are insignificant. Nevertheless, all three equations give different outputs.

However, it is noteworthy that the present Pakistan's situation is in contrast of basket peg or single currency peg. A basket peg with different weights may not establish a strong correlation between the Pakistan's currency and two basket currencies. While taken into account the flexible regime system, the following features stand out: Pakistan's relatively high degree of integration in global financial markets subjects it to the volatility of private capital flows and raises risks associated with operating a peg. Its relatively high dependence on cotton, which implies that Pakistan has a greater need for adjustment to commodity price shocks than more diversified economies. Moreover, real shocks have been far more important in Pakistan than nominal shocks, implying that a pegged regime would not be advantageous from a macroeconomic stabilization perspective.

Since Pakistan's external trade orientation remains relatively low by international standards, the trade gains that could be achieved via a peg are also low. Hence, economic integration factors also weigh against a peg. By contrast, evidence of concretionary effects of rupee depreciation may be a good reason to "fear floating" and adopt a peg. However, factors specific to Pakistan weaken, if not reverse, this argument. Since dollar, borrowing by the corporate sector in Pakistan remains very limited, balance-sheet effects normally associated with "Concretionary devaluation" is not likely to be present. Rather, causality more likely has been in the reverse direction—the de facto peg of the rupee was likely adjusted in response to the emergence of balance of payments pressures (reserves depletion), which often were the result of adverse supply shocks (e.g., weaker exports).

A "fear of floating" appears to have characterized Pakistan's exchange rate regime over the past 15 years. This fear was reflected in the maintenance of a de facto peg of the rupee against the dollar. The scorecard suggests, however, that this fear may have been misplaced and that a peg is not advantageous for an economy with Pakistan's features. Thus, increased exchange rate flexibility is likely to improve Pakistan's economic competitiveness.

POLICY RECOMMENDATIONS

A few qualifications to the analysis should be noted. First, the literature generally considers the relative advantages of fixed and flexible regimes without explicitly dealing with "nearly fixed" regimes. Some of the conclusions about fixed regimes may or may not be valid for nearly fixed regimes and should therefore be interpreted with caution. Second, the analysis for the most part takes as given that macroeconomic policies needed to support the chosen regime are in place, and methods to assess the sustainability of a particular regime are not covered. Regime choice would clearly be of limited importance in improving economic competitiveness if policies are not sustainable. Third, the assessment of the efficacy of a fixed or flexible regime under a particular criterion may well depend on the sample period over which the relevant indicator is measured. Fourth, different analytical considerations could well point in different directions in terms of whether or not a given country should peg. Weighing the importance of each consideration will depend on country-specific circumstances, which invariably introduces some subjectivity to the analysis.

In many respects, similar policies are needed to sustain any regime, especially if freely falling currencies are regarded as a non-regime. The fact that some factors may suggest that a fixed exchange rate regime is advantageous in a particular country, while other factors may suggest that a fixed regime is inappropriate, is in line with the empirical finding that no single factor consistently explains actual regime choice across a wide group of countries. With respect to the effectiveness of traditional exchange rate policies and intervention strategies, "the effectiveness of peg regime and suggestions to peg the rupee with dollar or euro depends crucially on the circumstances in which they are employed." Factors that are cited included the exchange rates, the role of REERs, and coordination and cooperation on GDPs. Furthermore, the effectiveness of exchange market intervention "under any type of exchange rate arrangement" depends on "whether market participants perceive that existing exchange rates are reasonably consistent with macroeconomic fundamentals external sector considerations, and whether the commitment of policy authorities to fix exchange rate is credible." Moreover, for a pegged exchange rate system involving strong commitments to avoiding realignments, "Convergent trade policies and competitiveness are necessary to avoid exchange rate adjustments on a more durable basis. . . . Timely adjustment [of parities] may involve lower economic costs and a smaller erosion of political credibility than attempting to resist adjustment for as long as possible. . . . The policy implication, accordingly, is that the degree of resistance to exchange rate adjustment should be kept consistent with the degree of convergence in external sector competitiveness."

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