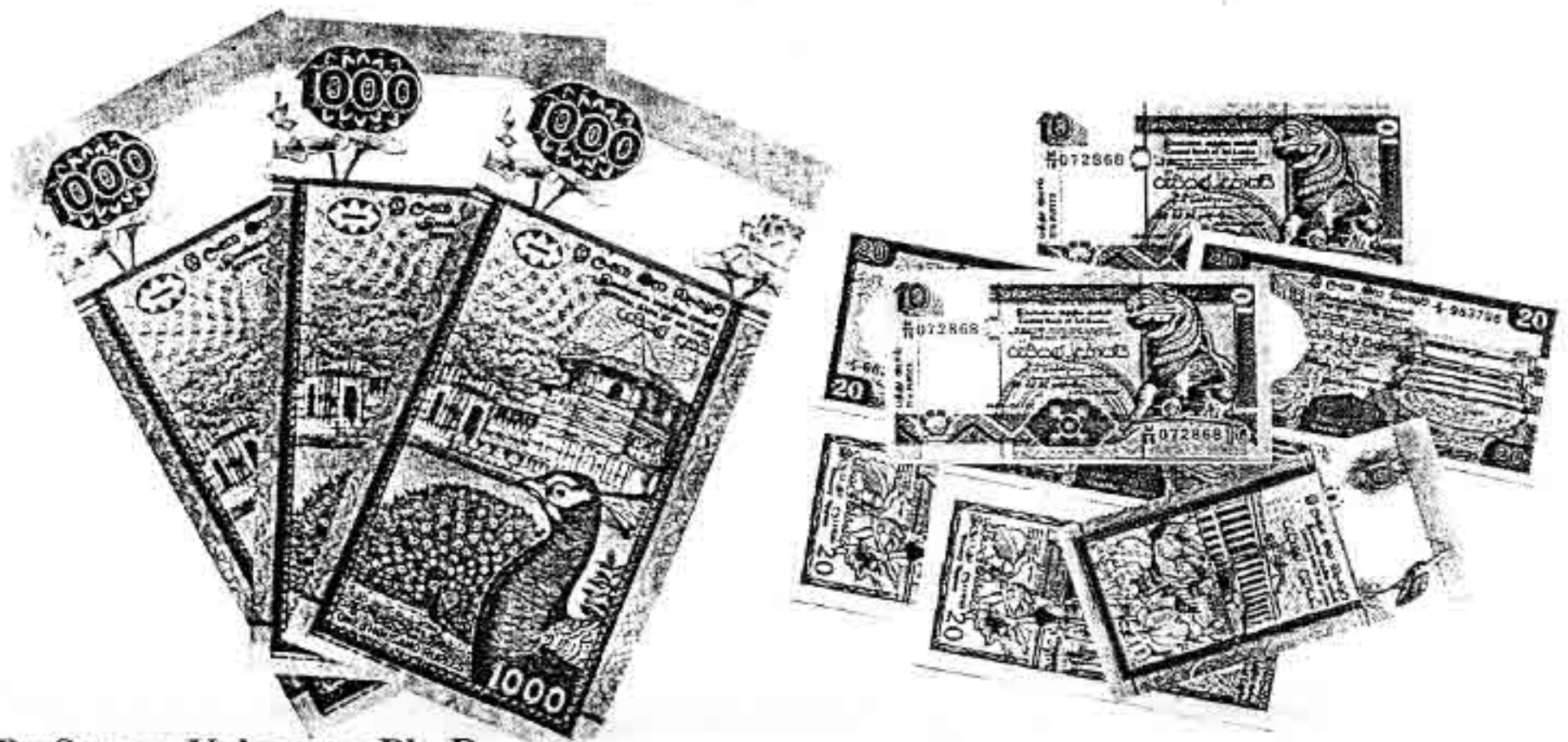


# WHY IS THE RUPEE DEPRECIATING so RAPIDLY?



By Saman Kelegama Ph. D

**S**ince early August 2007, the rupee has depreciated quite steeply. This can be seen from a comparative exercise of depreciation rates.

During 2001-2004, the rupee depreciated by 5.9 per cent, in 2005 it appreciated by 2.4 per cent (due to the tsunami funds inflow), and in 2006, the rupee depreciated by 5.2 per cent. In 2007, by mid-September, the rupee has depreciated by more than 5 per cent and the depreciation from August to mid-September alone was 1.8 per cent. How can one explain this?

In this context, it is important to understand how the market economy works. First, the market works to bring about equilibrium or a balance among various variables in the economy and this is done through pressurising key variables/instruments operating in the commodity market, money market and the foreign exchange market.

One can examine this from three examples:

(1) If the demand in the economy exceeds the supply, the prices of the commodities will go up to restrict demand to match the supply and bring about some balance;

(2) If the demand for credit exceeds the supply of credit, the interest

rate will go up to cut the additional demand for credit and restore some balance in the money market; and

(3) If the demand for foreign exchange exceeds the supply of foreign exchange, the exchange rate will depreciate to make foreign exchange more expensive in rupee terms and bring about some balance in the foreign exchange market.

Secondly, it is important to note that activities in these three markets are inter-related. For example, if the inflation is high the interest rate will go up to cut money supply and reduce inflation, or if expenditure (i.e., consumption and investment) is high the interest rate will go up to cut demand for credit and cut expenditure.

However, if interest rates are artificially held below the market rate, then the ability of the interest rate to cut expenditure in the economy will be less, and the exchange rate would consequently depreciate to cut imports

(because with depreciation, imports become costly) and thereby discourage some expenditures.

Once one comprehends these basic issues, it is not difficult to understand the current behaviour of the exchange rate in Sri Lanka. It is well known that Sri Lanka pursued a fairly relaxed monetary policy supported by a low interest rate policy since mid-2004 to increase government expenditure to meet various requirements.

First, the public sector (which employs 1.2 million people) wages and pensions had not been increased for many years and remained an outstanding backlog and had to be addressed.

Second, graduate youth unemployment remained a hot political issue and employment had to be immediately found for around 40,000-50,000. Third, election promises such as the fertiliser subsidy had to be increased and more money had to be allocated for infrastructure development.

All this required large expenditures at a time when expenditures were increasing on the military front, maintenance of a large cabinet to sustain the political coalition, tsunami rehabilitation work after 2004, etc.

As state revenue could not support these expenditures, the government had to resort to large-scale borrowing and in this case, bank-borrowing played a key role during 2004-2006. Bank borrowing, sometimes referred to as 'printing of money,' is inflationary and this is precisely what manifested in the Sri Lankan economy by mid-2006.

The Central Bank of Sri Lanka, which pursued a monetary policy that accommodated the fiscal imperatives during mid-2004 to mid-2006, got activated and took measures to bring down inflation after mid-2006 by tightening the monetary policy, engaging in open market operations, introducing indirect monetary controls, and exerting 'moral suasion' on commercial banks to restrict lending.

However, the tightening of the mon-

**The options are very limited for the Sri Lankan economy, with very little tolerance margin for any policy errors. The best way out of the dilemma is to sacrifice some growth by raising the interest rate further till inflation is brought down to a single digit level. After all, it is high inflation and not low growth that makes governments more unpopular among the general public 77**

etary policy was done very gradually with increasing interest rates in mild doses from September 2006 to March 2007. If one looks at the behaviour of the interest rate with inflation (see Figure 1), one can see that the real interest rate (interest rate minus inflation) has been negative during most of the post to mid-2006 period.

When this is the case, the interest rate does not bite adequately and bring down the demand for credit in the economy as desired to reduce inflation. Moreover, indirect monetary controls and moral suasion have not proved very effective in restricting credit. At present, credit to the private sector is growing at 24 per cent and this clearly indicates that the interest rates have not been very effective in restricting credit in the economy.

When interest rates do not cut expenditures adequately, as explained above, the exchange rate takes over the task of cutting expenditures in the system by curbing imports, and this happens by the exchange rate depreciating. What is happening in the Sri Lankan economy today is precisely this. If the interest rates are further increased to generate a positive real interest rate, the pressure on the exchange rate to depreciate would be much less.

The question now arises as to why the interest rates are not increased more. Here the political economy becomes relevant. First, the government does not want to compromise growth by retarding private sector activities too much by higher interest rates. In

other words, the government does not want to give too much importance to stabilise the economy fearing economic retardation.

Second, since public debt is already high (93 per cent of GDP) and interest payment on debt is about 5.4 per cent of GDP, there is a fear that a further interest rate hike will increase interest payments and will be counter-productive in bringing down expenditure. It is this thinking that prevents a larger increase in interest rates.

The crucial issue here is that as a result of the current interest rate policy, inflation decrease is gradually making deviations from the path as articulated by the Monetary Policy Road Map of the Central Bank in January 2007 (Figure 2).

Inflation expectations have not been fully curbed by the current interest rates and this too contributes to the existing inflation. Inflation also increases the cost of production and puts pressure on the exchange rate to depreciate in order to make exports more competitive.

It should be noted that market based exchange rates behave according to economic fundamentals and speculation. Market sentiments can often overshoot, exaggerating the degree of economic uncertainty at any particular time, and leading to dramatic consequences as a result of 'herd behaviour.'

Market perceptions of the exchange rate risk may not always reflect changes in underlying macroeconomic 'fundamentals' such as inflation, high expenditures, etc. With illiquid or non-existence futures markets, exporters and importers do not have the tools to act as a hedge against exchange risks. Often, speculative behaviour by exporters holding back foreign exchange and importers advancing their operations, also contributes to the depreciation of the currency.

There is a speculative component in the depreciation in the Sri Lankan Rupee since of late. Speculative at-

tacks and cautious behaviour of traders are visible in the market. The Central Bank is aware of this and keeps restoring stability in the exchange rates by pumping in more dollars into the foreign exchange market.

This is done to prevent speculation and to offset the foreign exchange outflows (due to the uncertain situation in the country and other reasons) driven by depreciation but this cannot go on indefinitely as it is a costly exercise. The Central Bank pumped in US\$ 29.9 million in June, US\$ 50 million in July and US\$ 105.6 million in August.

The good performance of the external trade sector in the first half of 2007 and the gross official foreign reserves at US\$ 2.7 billion may appear comforting, but given that huge oil bills have to be settled from time to time, the exchange rate defence has to be minimised. This can be done by using three policy options.

First, increasing interest rates further so that it becomes biting and makes in-roads to the growth process. Growth will have to be compromised for some time to restore stability. Second, cutting down government expenditure to restore some stability in the macro-economy.

It appears that the latter option has been pursued by cutting down capital expenditure by 2 per cent of GDP this year. Capital expenditure reduction always carries medium term growth reduction implications.

Thus, it would have been much more effective if current expenditures were curtailed by cutting down conspicuous consumption and reducing the government subsidies for loss-making state-owned enterprises such as the Ceylon Electricity Board, Ceylon Railways Department, Ceylon Petroleum Corporation and Ceylon Transport Board.

The government subsidy of 2-3 per cent GDP could have been reduced if effective private-public partnership is introduced to these ventures. But for this to happen, the political will has to

be in place.

The third option is to obtain a foreign commercial loan for infrastructure development activities in the next 10 years and provide a temporary boost to the reserve level so that the exchange rate will have less pressure to depreciate.

To the extent that this money is sterilised, there will not be inflationary implications but when converted to local currency after some time, it will have an impact on money supply and then on inflation, thus once again putting pressure on the exchange rate

to depreciate. The envisaged US\$ 500 million loan, which is subject to debate at present, has to be prudently handled if it is to be effectively made use of to the benefit of the economy.

All in all, the options are very limited for the Sri Lankan economy, with very little tolerance margin for any policy errors. The best way out of the dilemma is to sacrifice some growth by raising the interest rate further till inflation is brought down to a single digit level. After all, it is high inflation and not low growth that makes governments more unpopular among the general public. ■

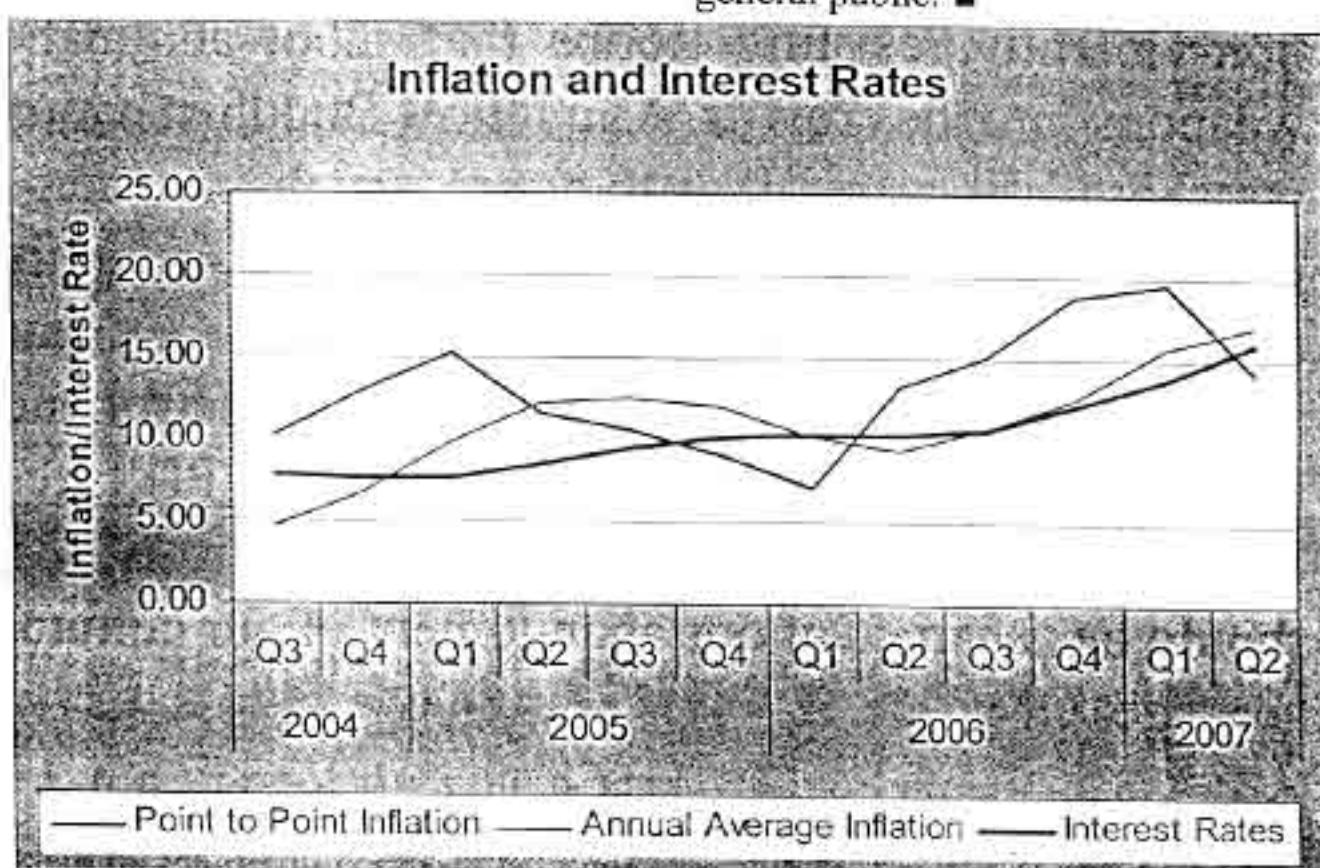


Figure 1

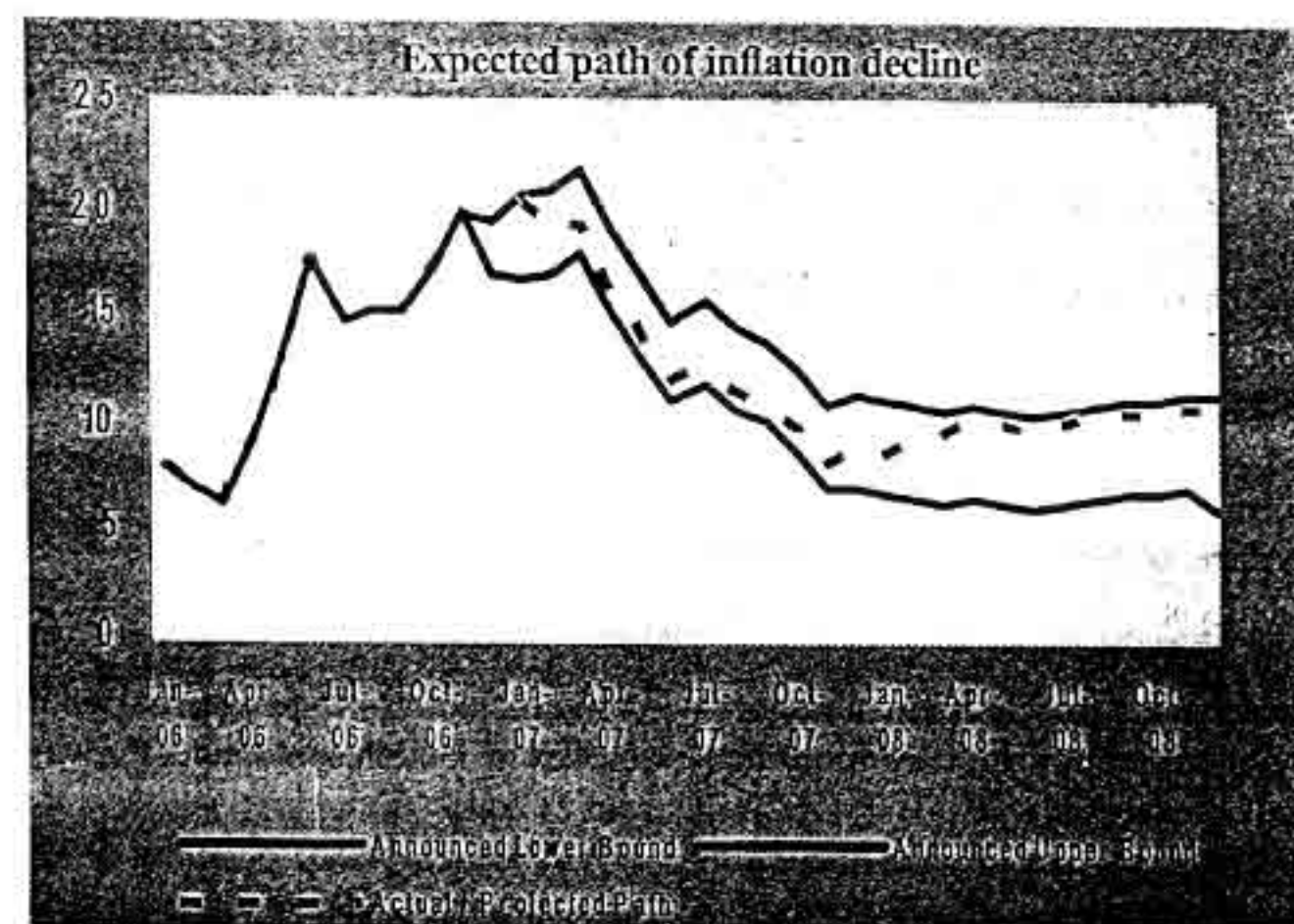


Figure 2