

# Is the rupee floating in a sea of speculation?

by Channa Kasturisinghe

The controversy surrounding the rapid depreciation of the Sri Lanka rupee has taken a new turn with the Central Bank and some economists hinting at speculation for causing the unwarranted dip.

The issue was widely discussed at a seminar organized by the Society of Certified Management Accountants of Sri Lanka in Colombo yesterday.

Dr. Saman Kelegama, Executive Director of the Institute of Policy Studies Sri Lanka said that market perceptions of the exchange rate risk may not always reflect changes in underlying macroeconomic fundamentals such as inflation, fiscal deficit etc.



Some degree of stability in the exchange rate is important to reduce speculative attacks and cautious behaviour of traders. When speculators attack the exchange rate, it could artificially depreciate. Then the Central Bank has to pump in dollars to the market to restore stability. This can be a costly exercise for

the entire economy.

"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 contribute to the depreciation of the currency," Dr. Kelegama said.

He said speculative behaviour of the exchange rate is visible in the Sri Lankan market, where there is macroeconomic instability.

"There has been 4.7 percent depreciation in 2007 so far and 1.4 percent depreciation during mid-June to mid-August 2007. Part of it was due to speculation and a part was due to debt payment, oil import outflows, forex outflows due to uncertainty. The rest was due to macroeconomic imbalance," he said.

Dr. Kelegama said that when exchange rate depreciates, it gives room for powerful speculators to have a go at the currency.

"Speculative attacks have already taken place in Sri Lanka and the Central Bank had to come into defend the currency," he said.

The Central Bank Governor Ajith Nivard Cabraal in his message said that it was a bit curious that in recent weeks, the Sri Lankan Rupee depreciated at a faster pace against the US Dollar, although the external sector perform-



ance clearly showed that such depreciation is not based upon any fundamental macroeconomic factors.

"Looking at the movements in rupee in the recent past, the rupee depreciated against major currencies during the first seven months of 2007. The rupee-dollar exchange rate, which remained at Rs. 107.71 per dollar by end 2006, has depreciated to Rs. 111.80 per dollar by end July 2007. The prevalence of above average domestic inflation resulted in for depreciation of the rupee," Cabraal said.

However, Dr. Harsha de Silva, Senior Lead Economist LIRNE Asia said that he would not blame it on speculation. "I think that those in the foreign exchange market are acting rationally," he said.

Dr. Nihal Jinasena, Chairman of Jinasena Group of Companies, highlighted the need for a reasonably stable or predictably devaluing currency.

"We are in the business of manufacturing and exporting. We are not in the business of currency speculation. But that is precisely what we end up doing because we are forced into it. Hedging, forward booking, forward sales of currency, derivatives and all other financial instruments become our daily parlance, not productivity, quality, output etc.

Sometimes, there is more money to be made by picking the correct derivative rather than by merely manufacturing and export-

ing the product. Secondly, foreign exchange fluctuations result in either huge financial losses or gains depending upon your borrowing in a foreign currency," Jinasena said.

R.M.B Senanayake, another expert on the subject also spoke.

He said: "The Central Bank used to regulate the purchase of dollars by the commercial banks insisting on documentary proof of genuine trade transactions for such purchases, to discourage speculative purchases of dollars.

But is there much speculation except for the fact that the foreign investors finance their operations by borrowing from local banks rather than convert their dollars into rupees, betting on rupee depreciation? Or, is it that the flow into dollars is due to the higher value of imports particularly oil imports?"