Interest and Exchange Rates: Impact on the Economy

Economists Point of View
Saman Kelegama
Institute of Policy Studies of Sri Lanka (IPS)

Increase in Credit Supply

- Government borrowing strategy was supported by a low interest rate regime because the captive sources can be tapped easily.
- Private sector made use of the low interest rate to borrow excessively. Demand for credit grew at 21.8 % in 2004, 13.2% in 2005 and 22 %in 2006.

Background to the Current Macroeconomic Situation

- Since 2004 Sri Lanka has been pursuing a fairly relaxed monetary policy to accommodate fiscal expansion.
- Fiscal expansion, i.e., increase in expenditure was required to rectify certain backlogs in the economy (e.g.,low public sector wages, low pension allocation, etc.) and fulfill political imperatives (e.g.,fertilizer subsidy), and Tsunami rehabilitation in 2005.

Inflation

- Consequent to such borrowing there was more money in the economy than the supply of good which inevitably led to increase of inflation.
- The government was reluctant to increase interest rates dramatically not only because of the need to borrow but also due to two other concerns.

Increased Bank Borrowing

- Increased expenditure could not be matched by the low revenue levels of 15 % of GDP in 2003. All additional expenditure items had to be met by borrowing. Bank borrowing amounted to Rs. 43.3 bn in 2004, Rs. 26.2 bn. in 2005 and Rs. 80 bn. in 2006.

Interest Rate (IR) Policy

- Government did not want to compromise growth by giving excessive importance to stabilize the economy by a higher interest rate.
- There was a view point that high interest rates will increase the interest payment on debt which amounted to 28 % of government expenditure or about 6 % of GDP and consequently it may not achieve the desired target of reducing domestic borrowing.

Adjustments came in mid-2006

- By mid-2006 the government took measures to increase the interest rate in doses and continued till March 2007. By August 2007 interest rates has increased to reach close to 18 %
- Interest rates work on the economic system with a lagged effect, i.e., what is done today will produce results in 4 to 6 months.

Not a Smooth Decline in Inflation

- Increases in oil prices, domestic revisions will always create one off inflationary impacts as was seen in the month of July 2007 when the Kerosene price was revised. These are the aberrations from the figure that we will witness over the coming months.

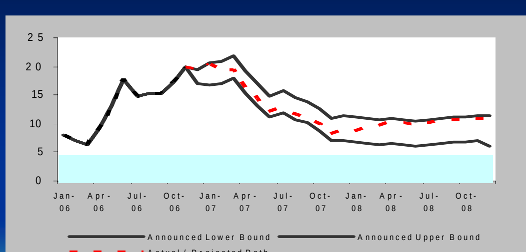
Gradual Decline in Inflation

- High interest rates will bring down inflation, the exact reduction of inflation depends on how biting the interest rate is for various sectors.
- Inflation coming down also depends on people’s expectations on prices coming down.
- Sri Lanka’s inflation is both demand pull and cost push determined. Interest rates work more on controlling the demand-pull inflation. Thus when the inflation is coming down there will be aberrations from the envisaged path.

Impact of IRs -- 1

- High interest rates can temporary attract foreign funds (discourage outflows) to help finance the BOP current account deficit. In Sri Lanka, given that the capital account of the BOP is not liberalized, political uncertainty, etc., such effects are fairly weak.
- High interest rate has started to adversely impact on sectors where there had been some speculative behaviour such as real estate market, share market, etc.

CBSL is expecting the Inflation to come down as indicated



Impact of IRs -- 2

- Major export firms have been less affected because the majority of them have BOI status and enjoys off-shore borrowing facilities.
- SMEs have been adversely affected but not all of them because some SMEs depend on the informal finance market also for credit and they are used to high interest rates.
- Banks will make profits, as has been the case world-wide when IRs are high. NPLs will gradually increase but since our early 2007 level was good, there is no major danger.

Exchange Rates (ERs)

- Exchange rate is determined by the inflow and outflow of capital/finance.
- If there is large government expenditure which involves importation of costly goods then such expenditures make in-roads to the external current account (forex reserves depletes).
- High debt payment settlement in a particular year has the same effect
- Oil price increase significantly increased the import bill

Depreciation of ER

- Exchange rate depreciates also to accommodate the increase in the cost of production (fuel, electricity, wages, etc.) which the exporters in particular cannot pass on to the buyers.
- Depreciation favourable for domestic resource based exporters and moderately favourable for import dependent exporters.

ER Market

- Currency then depreciates to cut imports and maintain a balance.
- However, when there are capital inflows currency appreciates to permit more imports as the system could accommodate with the new foreign exchange available.
- This is how, in very simple terms, the foreign exchange market works and can be shown by the exchange rate behaviour during mid-2004 to mid-2005.

Forex Market

- 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 reflects changes in underlying macroeconomic 'fundamentals' such as inflation, fiscal deficit, etc.

Exchange Rate (ER) trends from August 2004 – August 2005: Rupee/Dollar (monthly average)

Month	Aug 04	Sep	Oct	Nov	Dec 04
ER	103.40	103.24	103.82	104.66	104.82

Month	Jan 05	Feb	Mar	Apr	May	June	July	Aug 05
ER	99.64	99.39	99.44	99.72	99.86	99.99	100.30	100.85

Note: ER is the monthly average; **Source**: www.centralbanklanka.org

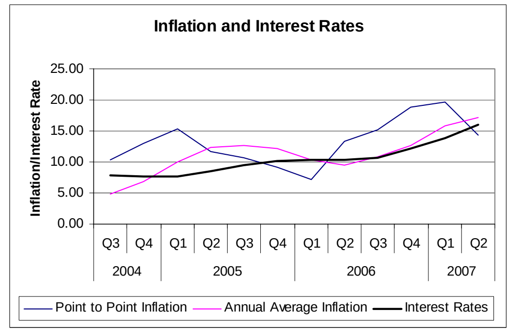
Stability of ER

- 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 CB has to pump in dollars to the market to restore stability. This can be a costly exercise for the entire economy.

Stability curbs Speculation

- 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 behavior by exporters holding back foreign exchange and importers advancing their operations, also contributes to the depreciation of the currency.

Interest Rate behaviour



Impact

- Speculative behaviour of the ER is visible in the SL market, where there is macroeconomic instability. 5 % depreciation in 2007 so far and 1.4 % depreciation during mid-June to mid-August 2007. Part of it due to speculation, part due to debt payment, oil import outflows, forex outflows due to uncertainty, and rest due to macroeconomic imbalance.
- In a highly import dependent economy like Sri Lanka (Imports = 35 % of GDP) exchange rate depreciation has some impact on cost of living.

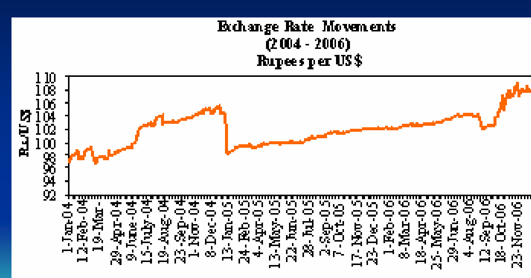
CB Interventions

- Exchange rate when depreciating like this gives room for powerful speculators to have a go at the currency. Speculative attacks have already taken place in Sri Lanka and the CB had to come in to defend the currency.
- Has the CB intervention led to overvaluation of currency ?

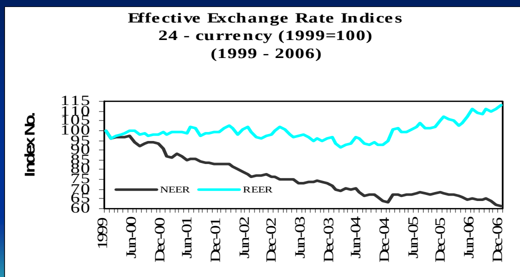
IR–ER Link

- Interest rates should be able to bring adequate cuts in expenditures to bring about stability in the macroeconomy without putting pressure on the ER to bring that stability.
- When the interest rates are inadequate to do so (due to not biting adequately) some part of the adjustment in the economy to bring stability falls on the exchange rate. It depreciates to cut imports and discourage spending (or expenditure).
- In fact ER is doing that in the Sri Lankan economy, e.g. when rev.repo window was opened recently, rupee weakened.

Behaviour of Exchange Rate



REER Trend



Depreciation Trend

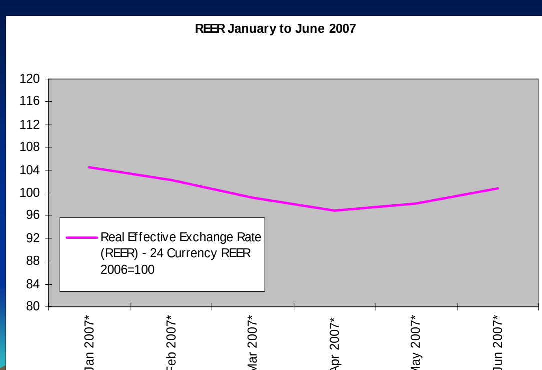
- On average rupee has depreciated by 5.9% during 2001-2004
- In 2005, rupee appreciated by 2.4 % due to tsunami inflows
- In 2006, depreciation was only 5.2%
- In 2007, rupee has depreciated by 4.6% by mid-Aug and REER has not been misaligned

REER Behaviour

- " REER which takes into account the inflation differentials amongst countries in addition to the variations in exchange rates, appreciated during 2006, indicating a deterioration in the competitiveness of Sri Lankan exports" (CBSLAR, 2006,p. 91)
- That is why we are witness a sharper depreciation of currency in 2007

Cut Govt. Expenditure

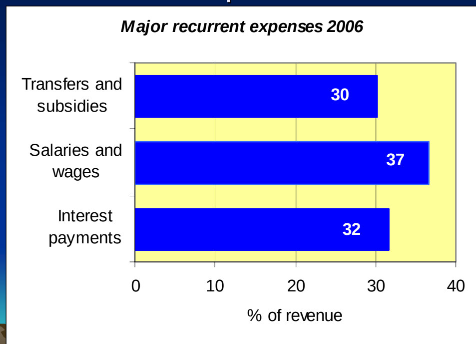
- If direct cuts on expenditure are made pressure on both interest rates and exchange rates will be less to increase and depreciate, respectively.
- The bottom line is that the government expenditure needs to be cut to reduce the pressure on ERs and IRs.



Cut Expenditure

- If the interest rates are increased further the pressure on the exchange rate to depreciate will be less
- This can be shown from the simple identity: Y – A = X – M
- Where Y- national output, A – overall expenditure, X- exports, and M- imports

Government Expenditure Structure



Difficulties in Cutting Expenditures

- Room for reducing recurrent cutting expenditures less due to this expenditure structure.
- Capital expenditures could be reduced however with long term adverse consequences on economic growth.
- This year, capital expenditure has been reduced from the budgeted 9.3 % GDP to 7.4 % GDP, not intentionally to reduce expenditures but due to a number of administrative limitations
- But given the fact that the government wants to go ahead with the infrastructure projects, Negenahira Navodhaya, etc., it is not always easy to cut capital expenditure to reduce expenditures.

Future

- SL will experience a budget deficit of 7.8 % GDP and not 9.2 % GDP as estimated earlier due to capital expenditure reduction and improvement of revenue.
- Due to reduced budget deficit pressure on the IR will gradually reduce. In my view, interest rates should not come down till the first/second quarter of 2008.
- Exchange rate will depreciate. The depreciation can be decelerated in the next 4 months because of reduced budget deficit and inflow of new external capital (US$ 500 mn).

Prospects

- US $ 500 mn borrowing should not be used to delay the macroeconomic adjustments required and to artificially bring down IRs.
- Expecting a minimum growth rate of 6.5 % this year.
- By early 2008, Sri Lanka will be able to reduce the pressure on both interest rate and exchange rate by bringing inflation under control.

End; Thank you