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Island

The New Exchange Rate Regime

by Analyst

The Central bank has widened the limits within which it will permit the exchange rate to fluctuate to 5% on either side of the middle rate. Hitherto the Bank would intervene by buying or selling US dollars to the commercial banks within 2% of the middle rate. We follow what economists call a ``crawling peg", with the peg being adjusted from time to time to allow a stepwise devaluation in small doses.

The Bank pretended that the exchange rate was market determined as a political ploy to avoid the criticism that it was devaluing the rupee. In fact each year there was an accumulated devaluation of 8-10%. And the depreciation of the real rate in 1999 was 7%. (Last year it was 6% since inflation had come down)

This devaluation or depreciation was to neutralize the inflation differential between the country and our trading partners/competitors. It was necessary to keep our exports competitive. But the very depreciation itself contributed to inflation and was destabilizing the economy. The accumulated small doses of depreciation raised the cost of living and the organized workers both in the private and public sectors agitated for and invariably succeeded in pushing up their money wages, nullifying the benefits of depreciation to the economy and setting the stage for another round of depreciation, like the cat trying to catch its own tail.

So we had this continuous vicious circle. Domestic inflation is affected by imported inflation, directly through the price of traded goods and indirectly through the price of non-traded goods. The latter effect is what bewilders the public and makes newspaper editors breathe fire. It operates because as traded prices increase, supply tends to shift from non-traded to traded goods while demand shifts from traded to non-traded goods; the consequent excess demand for non-traded goods then causing their prices to increase.

Of course the domestic inflation is also affected by the domestic monetary situation as well. This type of passive crawling of the rupee was suitable when the financial markets were repressed. But financial markets have been liberalized somewhat in recent years and the Central Bank has lost some control over monetary instruments, particularly the interest rate.

When the exporters (and the banks) expect depreciation they keep their foreign exchange earnings abroad without bringing them to the country. This puts pressure on the exchange rate unless the Central Bank increases the interest rates to a level sufficient to offset the profit that will accrue to those who keep funds abroad in the hope of a depreciation and borrow locally at the prevailing interest rates which will not eat into their anticipated exchange gain through the expected depreciation.

The exporters who keep funds abroad have to borrow locally to finance heir trade while they hold their money abroad in the hope of profiting from an anticipated depreciation. When the interest rate goes up it is worth less for them to hold money abroad since the anticipated exchange gain from the depreciation will be neutralized by the interest rate going up. So, interest rates have to go up when money is held abroad by exporters in dollars rather than converting them to rupees to finance their credit requirements for trade.

But increases in interest rates reduces credit draw off by the domestic business sector not involved in export-import trade and they suffer unnecessarily. This increase in local interest rates to conserve foreign exchange affects domestic private sector investment adversely. In short it affects economic growth negatively. Why should the domestic sector, both business as well as consumers who borrow, suffer when they are already burdened by high interest rates?

These higher interest rates also raise costs and prices of the locally produced vegetables, rice etc. Economists call this, sacrificing domestic for external stability. It would not be so bad if at least the policy could preserve external stability by bringing about a balance in the current account of the balance of payments. But this policy has failed to achieve this as the following figures show.

Balance of Payments Crisis

US $ Million	90-94Avg	1995	1996	1997	1998 1	999
Exports	2511	3807	4095	4639	4735	4600
Imports	3601	5311	5439	5864	5891	5899
Trade Bal.	(1090)	(1504)	(1344)	(1225)	(1156)	(1299)
Service Bal.	179	152	105	159	143	147
Factor Income Bal.	(162)	(170)	(197)	(159)	(178)	(263)
Private						
Transfers (net)	622	675	710	787	848	887
Current A/c Balance	(861)	(786)	(677)	(394)	(288)	(4[illegible]5)
Overall Balance	240	52	(68) 1	63	37	(263)

Source: Trends in Public Finance (General Treasury) & Central Bank Annual Report 1999.

The table shows the continuing adverse situation in the last two years when the trade balance, the factor income balance and the current account balance have worsened. Then the overall balance has turned adverse and it is a large deficit amounting to US $ 263 million. All this is does not take into account the full effects of the oil price hike, which has taken place in the last six months.

The magnitude of the crisis is shown by the fact that official reserves have fallen further to US $ 1,371 mn. as at end of April 2000.The terms of trade as at end of April 2000 is 82.6 which shows a further deterioration continuing the downward trend from September 1999.Although wheat and sugar prices have fallen in world markets the price of rice has gone up to US $ 250 per metric ton from $ 194 last April.

What will be the projected balance of payments deficit for year 2000 on the current account and the deficit in the overall balance? It will be much larger than in 1999 unless corrective action is taken. The Central Bank is right to take some action although it is far from what really has to be done in the same direction. The 5% band will give more flexibility than the 2% band.

How wide should the band be? A forecastable downward crawl as before will still cause a capital outflow. The local interest rate and the foreign interest rate differential must be considered when the rate of crawling is decided on. The foreign exchange market will reflect supply and demand on trade account more accurately, excluding the speculative factor if the exchange is allowed to operate more freely.

The depreciation will have to be carried out in an erratic way to preclude any possibility of drawing conclusions of general validity, so that the speculators do not have only a one-way bet.

Risk of exhaustion of foreign reserves

The Annual Report of the Central Bank shows that although inflation has come down significantly (thus eliminating the need for depreciation to maintain the real exchange rate, the rationale for the small doses of depreciation) the current account of the balance of payments has worsened to 3.1% of the GDP. Worse, the overall balance of payments position has turned negative by a large figure, as much as US $ 263 million whereas previously we had a surplus generally.

The commercial banks had also been building up foreign exchange abroad. The government could not go ahead with the planned foreign market borrowings. Foreign aid had also declined. So there is a risk of running out of foreign exchange reserves to meet our commitments. The outstanding foreign debt increased to US $ 9,049 mn. in 1999. What is more significant, the annual amount of foreign exchange to repay the foreign debt is increasing somewhat steeply in recent years.

The total debt service payments, which consist of long term and medium term debt and interest payments on all foreign debt increased by 12% to US $ 846 million. The amortization of foreign loans increased by 17% to US $ 550 million. The foreign debt repayment and interest payment falling due this year are not available but they are likely to be even higher than last year.

The debt service burden was 12.5% in 1999.The total external debt including the foreign currency liabilities of the banks is US$ 9,707 million while the official foreign assets are US$ 1,639 million. Columbia suffered reserve exhaustion in 1966, Chile suffered a crisis in the Allende years, Brazil, Peru, and Mexico all suffered foreign exchange crises and in the late 1980s had to default on their foreign debt.

It should not lead to much depreciation as exporters convert their dollars to rupees. But it will not be sufficient since the Bank will still largely determine the rate and the market will still speculate on what is the underlying policy of the Bank. There will be no real change except for a little more fluctuation in the rate. The Bank should give much more freedom to the market and this should be considered only a first step.

Causes of the crisis: oil price hike and war purchases

But there are fundamental questions, which have to be addressed, like how effective is exchange rate adjustment to bring about a correction in the Balance of Payments. It is clear that a nominal rate crawl of 2% at a time with discreet adjustments at periodic intervals, (say one month) will not suffice to deal with an external shock like the oil price hike. There was a similar oil shock in the 1970s when we were under a strict exchange control regime and there was much hardship caused to the people.We didn't have sufficient foreign exchange reserves to spread the pain over a longer period.

When the UNP came to power they devalued drastically and the World Bank gave adequate foreign exchange to act as a buffer to finance any pent-up demand for imported goods and services. So, what now is the attitude of the UNP? A UNP MP who is also an economist blames the government and accuses it of mismanagement.

For the last fifty years we in this country have lived beyond our means. Our politicians think good times will last forever. In the 1950s the UNP taxed the plantation sector to death to finance free education, free health and later give free rice. When the Korean War boom collapsed, there was a need to adjust by removing the rice subsidy. But politicians dilly-dallied and exchange control had to be tightened and foreign trade had to be state controlled to prevent foreign exchange racketeering. (The abuses soon came to be carried out by state bureaucrats though)

After 1977, in spite of the introduction of the open economy, the government did not free all prices and allow them to be determined by market forces. Many subsidies, open and hidden, continued. These subsidies benefited the better off much more than the poor. So the middle and upper classes were able to spend lavishly and import all manner of luxury cars and other imported goodies. The housemaids labored in difficult conditions to remit foreign exchange to the country.

And what does the government do? It promoted the import of all manner of luxury goods which can be afforded by the rich only because they enjoy subsidies, don't pay taxes and practice all manner of cheating on customs duties and other indirect taxes. The politicians were given duty free vehicles, which they promptly sell in the market. An economically unjustifiable Duty Free Shopping Complex was introduced to enable some crony businessmen to make money while ruining the local manufactures and duty free concession given to all those returning from abroad after a long stay.

All these faulty policies have now come home to roost. Our foreign exchange reserves are fast being depleted. If they are exhausted the country will not be able to import even the basic foodstuffs required to feed the people. Nor will the country be able to repay foreign loans falling due for repayment. The crawling peg exchange rate policy did not prevent serious crises in several Latin American countries in the 1970s and 80s.

The problem is that why the policy can preserve the real exchange rate (this is the nominal rate adjusted for inflation) stable, it does not prevent the deterioration and emergence of a continuous deficit in the Balance of Trade or even in the Current Account of the Balance of Payment. Please see the table above and notice that our balance of trade and the balance on current account have been negative for the last several years.

We didn't have to worry because the remittances from the housemaids and the inflow of capital from abroad were sufficient o produce an overall surplus. But this situation has change with the large deficit of US $ 263 million last year. Our foreign exchange reserves are coming down fast. Now we have the oil price hike. Our living standards must be reduced to conserve the foreign exchange reserves.

The reserves are needed just for the purpose of what economists call an external shock. When misfortune strikes, no one wants to bear the loss in a single dose. The pain must be spread over a long period. We should continue to import the bare essentials from abroad. In the 1970s this was accomplished by severe exchange control restrictions. But nobody wants to go to that era of queues and blackmarkets which are the inevitable results of such restrictions.

The alternative is to raise prices of imported goods so that less will be imported and the reserves conserved for essential foods and oil. These items cannot be reduced too much. So, if the rupee depreciates it is necessary to curb imports and promote exports. The question is how much depreciation is required to restore balance in the current account of the Balance of Payments and stop the erosion of our foreign exchange reserves.

The other side of the coin is of course what will be the magnitude of the domestic inflation caused by this depreciation? Much more depreciation will take place with a more flexible exchange rate. How long can the pain be spread over by having only small doses of depreciation? Can we conserve foreign exchange reserves by reducing the purchase of weapons? Can we somehow attract more inflows of foreign capital? It is very unlikely unless the war is stopped.

Can we increase our earnings from tourism? Not likely unless the war is stopped. The truth of the matter is that the previous governments since 1983 did not prosecute the war vigorously because they did not want the people to bear the cost of the war. Now there is no question that unless the war is stopped, we may reach a situation of exhaustion of foreign exchange reserves and may have to default on the foreign debt . Nor are we likely to get much foreign aid since our lack of democracy and failure to settle the ethnic question are now taken notice of by the European Union.

A policy mix of flexible exchange rate and higher tariffs needed

The UNP blames the government saying that it has mismanaged the economy. There is much truth in this accusation since there is mismanagement of our resources like the foreign exchange; there is corruption and wastage, extravagance by politicians who get lavish perks at public expense. But this crisis in foreign exchange is more than that.

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