FURTHER DEPRECIATION OF THE RUPEE: IS IT NECESSARY?

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The Sri Lankan government is now negotiating with the officials of the World Bank for a loan of 100 million dollars under the Bank's Structural Adjustment Lending Facility (SALF). The government also expects to get, by the end of the year, the third tranche of the 300- 400 million dollar IMF loan approved in September 1991. Sri Lanka has already received the first and second tranches of this loan which were negotiated under the IMF Enhanced Structural Adjustment Facility (ESAF). Both loans are considered to be soft loans as the terms of payment are relatively easier than those operative for non-official loans. The World Bank loan will be released in one instalment and is repayable in 30 years with a 10 year grace period. The IMF loan is offered in three tranches and the repayment period is six years. Since the IMF is constituted to offer short-term financial assistance to member countries, its loan repayment terms are usually more stringent than the terms of the World Bank which specializes in development-oriented lending.

There is no doubt that the Sri Lankan government badly needs the World Bank SALF loan and the release of the third tranche of the IMF ESAF. But, the government has to demonstrate, in practice, its willingness to accept and to be bound by the conditionalities attached to this type of financial assistance.

Although the concrete IMF- World Bank package is being negotiated in secrecy and therefore will not be revealed to the public, the general line of the conditionalities is quite clear; they involve very tough policy decisions the effects and implications of which will transcend the boundaries of the narrow field of economics. The privatization of two state banks will again be on the agenda. Pressure will be put for the privatization of other public corporations and services such as railways which are still in state hands. A further simplification of the tariff structure will be suggested and the government will be asked to allow the exchange rate to rise up to Rs. 50 a US dollar which is considered the reasonable exchange rate for a Sri Lankan rupee. According to the *Sunday Times* "the [B]ank has also suggested that the subsidy on diesel should be removed and petrol and diesel sold at the same price." As a senior government official is reported to have said:

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> The World Bank wants speedier reforms which could be hard to implement and politically difficult for the government. The [B]ank wants these done very quickly. These matters are in the process of implementation but it has been slow and only cosmetic improvements have been made (*Sunday Times*, July 19, p.7).

We have to consider seriously the effectiveness of these measures in achieving a sustainable higher rate of economic growth and level of employment, easing our balance of payments problem and diffusing the fruits of economic growth to the masses. On all three counts, our past record has not been satisfactory. We have failed to sustain what we had achieved in certain years in the past. This was also true of the policy package which was introduced in 1977 and implemented during the last one and a half decades.

However, there has been no serious discussion on these important issues. We have official and semi-official publications which always talk about past achievements and adopt an optimistic approach to the future. In contrast, the populist approach is that the diagnosis of the official international organizations is wrong and that their remedies are doomed to fail. Sometimes these populists are against foreign capital because it may have destructive effects on archaic relations; at other times they criticize foreign capital because it is not modern enough. I hold a different point of view. I do not oppose conditionalities just because they have been proposed by the international organizations. We are living in a period in which international intervention in national affairs is unavoidable and necessary.

Exchange Rate Movements

In IMF- World Bank thinking and in their formulation of the stabilization package, the exchange rate adjustment always plays a major role. The aim of this article is to analyse the impact of the further adjustment of the exchange rate on the Sri Lankan economy, more specifically on its growth rate, the rate of inflation and the balance of trade.

Let us first investigate the movement of exchange rates during the last 15 years. In 1977, the UNP government unified the multiple exchange rate regime which prevailed in the pre-1977 period and substantially devalued the rupee which was considered as being overvalued. The main thrust behind these measures was to improve the competitiveness of our exports and to reduce the trade balance in the context of an increasing demand for imports as an outcome of trade liberalization. Since then the Sri Lankan rupee has been allowed to float in response to the market demand for and supply of foreign exchange.

Table 1 shows the movements of the bilateral nominal exchange rate between the US dollar and Sri Lankan rupee between 1977 and 1992. The Sri Lankan rupee has been depreciated against the US dollar by more than 70 per cent during the period 1977-1992. The more appropriate measure of the external value of the Sri Lankan rupee is the Nominal Effective Exchange Rate (NEER) which can be defined as the trade weighted nominal exchange rate with respect to Sri Lanka's major trading partners. The rupee has been depreciated against almost all the currencies of the countries with which we have strong trade links. The annual report of the Central Bank of Sri Lanka states:

> The cumulative changes since 16th November 1977 [when the Rupee was placed on a float] show that the Sri Lankan Rupee has depreciated by 51.6 per cent against the US dollar, 50.8 per cent against the Pound Sterling, 61.6 per cent against the Deutsche Mark, 39.3 per cent against the French Franc, 75.2 per cent against the Japanese Yen and 15.3 per cent against the Indian Rupee (1988: 198).

The NEER was further depreciated by 11.5 per cent in 1988 and by 13.4 per cent in 1990. The movement of the Real Exchange Rate (RER) for the Sri Lankan rupee against the US dollar is shown in Figure 1. The price differentials between Sri Lanka and its major trading partners have been taken into account in the calculation of the real effective exchange rate, which, therefore, measures the country's competitiveness in international trade. An increase in the competitiveness of our exports is reflected in a real depreciation of Sri Lankan rupee. Conversely, an appreciation means that Sri Lanka has lost its international competitiveness. The trend in the movement of the real exchange rate against the US dollar over the entire post 1977 period shows a slight increase, but a similar tendency cannot be seen in the behaviour of the REER. Until 1984 the REER had shown an appreciation, but it depreciated between 1985 to 1987 and started to appreciate again from 1988. The REER appreciated by 5.2 per cent in 1990 and 5.3 in 1991.

It is interesting to compare the movements of NEER and REER which have run in opposite directions in most of the years between 1977 and 1991. It is true that a real appreciation of the Sri Lankan rupee reduces the international competitiveness of our exports and encourages domestic consumption of imported items. The international lending agencies seem to have thought that the behaviour of the REER can be manipulated by further depreciating the Sri Lankan rupee. Let us examine the accuracy of this argument.

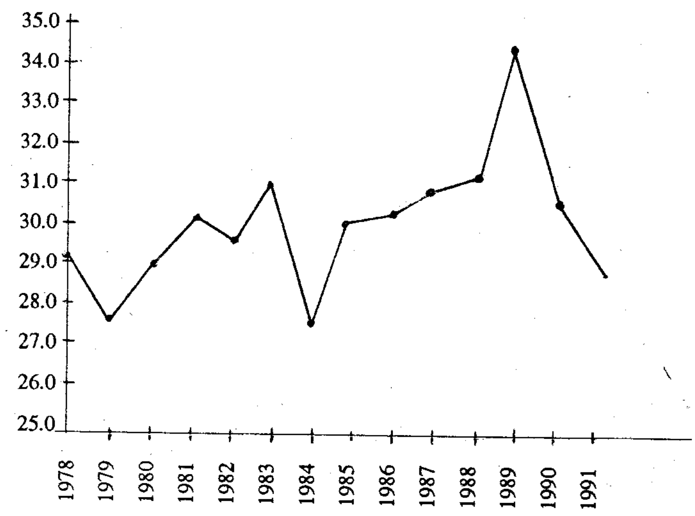

Figure 1

Table 1

Exchange Rate Movement 1977-1992

Year Dec.	Ex. Rate (US $) Buying Rate
1977	15.53
1978	15.49
1979	15.43
1980	17.98
1981	20.53
1982	21.31
1983	24.99
1984	26.27
1985	27.40
1986	28.51
1987	30.74
1988	33.01
1989	39.98
1990	40.22
1991	42.56
1992 (07)	

Source: Asian Development Bank (1991)

The Balance of Trade.

It is argued that the depreciation or devaluation of the domestic currency would result in transforming a country's comparative advantage into a competitive advantage. The argument in orthodox economic theory that countries enter into the international trade nexus because of comparative cost differentials conditioned by initial factor endowments thus appears to be unsubstantiated. For international trade to take place, there should be either an absolute advantage in producing a certain commodity/ commodities or the comparative advantage needs to be transformed into a competitive advantage by changing the price structure.

Introducing the new economic policy package in 1977, it was correctly shown that the Sri Lankan rupee was overvalued and did not correctly represent the country's actual international position, which is conditioned primarily by domestic factors such as labour productivity, cost of production and natural resource availability and, at least in the short run, by international factors such as protectionism and monopolistic tendencies. Any stabilization package therefore should include the fixing of an appropriate exchange rate taking into consideration the above mentioned factors, since an overvalued currency provides an artificial disincentive to exporters and an incentive to importers.

The fundamental flaw in the orthodox policy prescription, however, is that it assumes that price movements alone would bring about an equilibrium in the balance of trade. The exchange rate adjustment, it was argued, would cause exports to increase and imports to decrease. since the domestic incomes of exporters would rise while domestic price increases of imports will make them dearer.

However, the mechanism initiated by price changes which are necessary to bring about an equilibrium in the balance of trade is by no means automatic. Notwithstanding the fact that an increase in domestic incomes provides a stimulus for exporters to transfer more resources to the production of those exports in which the country has a comparative advantage, there may be certain inherent rigidities which hinder the expansion of the export sector. These may include the specialized nature of capital goods and equipment and the rigidity of prices and wages.

Similarly, as a result of the depreciation of the exchange rate, domestic prices and wages may increase thus raising significantly the cost of production. This tendency may, in turn, push up the cost of production in the economy. If the cost of production rises at a rate higher than the rate of increase in the domestic prices of exports, then the initial advantage may disappear. On the other hand, the reduction of imports depends not only on their prices but also on their price elasticities and their propensities.

The depreciation of the nominal exchange rate does not necessarily guarantee the movement of the real exchange rate in the same direction. In addition to the NEER, the level and movement of the REER depends on the country's rate of inflation which in turn depends on a complex set of factors. As a result, price movements may not transform a comparative advantage into a competitive advantage. So, the balance of trade position may not improve.

We may now turn to the Sri Lankan experience since 1977. Table 2 presents the value of exports and imports and the balance of trade. Although the rupee prices of imported items have increased significantly with the depreciation of the Sri Lankan rupee, no trend towards the reduction of import volume or value can be seen in the post 1977 period. On the contrary the total import outlay has increased by 285 per cent between 1977 and 1991.

The decline of import outlays from 1986 to 1988 is partly attributed to the decline of the level of economic activity due to civil disturbances throughout the island. The import outlay consists of two components, namely an independent component which comprises essential items with low price elasticities and the component which depends on the level of economic activity. As Table 3 shows, imports of investment goods have significantly reduced during the period 1984-88, which included the period of civil disturbances. These imports have started to rise again after 1989; the value of imported investment goods increased by 22 per cent from SDR 430 million to SDR 524 million. While the rate of increase of vehicles and transport equipment was 61 per cent, it was 16 per cent for the machinery and equipment. This shows that imports are price inelastic and depend more on the level of economic activity.

Table 2.

Exports, Imports and Balance of trade 1977-1991.
(Adjusted data in SDR millions)

Year	Exports	Imports	Balance of Trade
1977	630	581	+49
1978	674	771	-97
1979	759	1123	-364
1980	818	1577	-760
1981	928	1614	-686
1982	934	1826	-892
1983	998	1811	-813
1984	1432	1823	-391
1985	1311	1956	-646
1986	1036	1658	-623
1987	1080	1589	-509
1988	1098	1661	-564
1989	1216	1737	-521
1990	1461	1980	-519
1991	1491	2239	-747

Source: Central Bank of Sri Lanka, Annual Reports

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Table 3.

Imports of Investment Goods
(in SDR millions)

Year	Machinery and Equipments	Vehicles and Transport Equip.	Base Metals
1984	272	159	121
1985	222	141	114
1986	135	118	114
1987	121	117	107
1988	226	108	127

Source: Central Bank of Sri Lanka, Annual Reports

Total exports have increased by 136.6 per cent from 1977 to 1991 and it is interesting to note that the rate of increase in exports was significantly less than the rate of increase in imports (285 per cent). The increase in exports is mainly due to changes in the export structure which is now dominated by industrial products in value terms. Industrial exports have increased by more than 450 per cent from an insignificant SDR 94 million in 1978 to SDR 530 million in 1988; the dominant product category is textiles and garments which has increased from SDR 25 million in 1978 to SDR 333 million in 1988. However, the increase in industrial products cannot be solely attributed to exchange rate movements; it is also the result of the total policy package introduced in 1977 and may have taken place with or without the exchange rate adjustments. The issue of economic growth will be dealt with in the final section of the essay.

Rate of Inflation

As noted above, the NEER and the REER had moved in opposite directions for the greater part of the post-1977 period. The REER is the NEER adjusted to the differentials in the rate of inflation between the Sri Lankan economy and its major trading partners. Even when the NEER is depreciating, the REER may appreciate if the domestic rate of inflation is higher than the rate of inflation in its major trading partners. Let us now look at the price movements in Sri Lanka in the post-1977 period.

> The average annual rate of inflation between 1978 and 1990 and measured by the Colombo Consumers' Price Index (CCPI), the Wholesale Price Index (WPI) and the Gross Domestic Product Deflator (GDPD) was 13.3%, 13.6% and 12.5% respectively. Plotting annual percentage changes in the three indicators over the post 1977 period shows three distinct periods when inflationary pressures increased; 1978-80, 1982-84 and 1985-1990 (Lakshman and Nicholas, 1992: 20).

There is a general consensus among economists about the main causes of inflationary tendencies in Sri Lanka. They agree that inflationary pressures are primarily exogenously determined and there has been a strong correlation between the rate of change in the CCPI and the rate of change in the general import price index. So the inflation is cost-push rather than demand pull. Lakshman and Nicholas write;

> Demand factors, the budget deficit and credit expansion, have undoubtedly also exerted a pressure on the aggregate price level, particularly in certain years (e.g. 1981), but generally their role has been one of propagating cost-push pressures (1992: 20).

Deepak Lal, one of the principal advocates of free-market economic policies, concludes:

> [T]his rise in non-traded good prices has been accentuated by the rise in the domestic price of traded goods, due both to a rise in foreign currency prices and the devaluation of the nominal exchange rate. Most of the inflation that Sri Lanka has experienced since 1977 can be accounted for by these two factors (Lal: 1985).

An observer who favoured and has argued for exchange rate depreciation as an effective policy prescription for the balance of payments problem writes;

> Simulation results suggested that exchange rate depreciation would not cause continuing inflationary pressure in Sri Lanka. Its impact on domestic prices would be completed within a short period and the rate of change in the level of prices would be substantially lower than the rate which exchange rates are depreciated (Wijesingha: 1990).

Since this conclusion is arrived at on the basis of a rigid set of assumptions, it has to be treated carefully. However, two things contradict the conclusion. First, when we take the period as a whole, the rate of change in the level of prices measured by all three indices was greater than the rate of depreciation of the Sri Lankan rupee against all the hard currencies. Second, what is important is not the annual rate of inflation, but the cumulative price changes. The continuous depreciation of the Sri Lankan rupee will aggravate the cumulative rise of domestic prices, both tradeables and non-tradeables. This in turn will change the cost structure and reduce the competitiveness of our exports. In the absence of a process which ensures the increase of labour productivity and a resultant lowering of the price of production, a currency which undergoes continuous depreciation will give rise to inflationary pressure.

Growth of Output

The policy prescriptions which are designed to support what is called the 'export-led growth mechanism' seem to →

have stemmed from a misreading of the development experience of Japan and the East Asian NICs. It was often argued that the higher rate of growth experienced by those economies was due mainly to the higher rate of growth of exports, particularly of exports of manufactured goods. In a serious study on Japanese economic development in the twentieth century, Ohkawa and Rosovsky (1973) have demonstrated an inversion of this relationship:

> We intend to argue a rather different set of propositions. Our position is that Japan's rate of growth of exports has been high and well above world averages because the rate of growth of its economy and especially of its industry has been high and well above world averages, and not vice versa (p.173).

Japan was able to increase its exports at an increasing rate not because of the manipulation of nominal prices but because of its ability to reduce the relative price of its products through constant gains in productivity in manufacturing.

> More rapid growth of exports simply means that Japanese goods were displacing goods of other countries in world markets. If we assume that world demand was relatively indifferent to the national origin of imported products, it is then clear the reason for highly successful export growth must lie on the supply side. Supply, in this sense, has broad meaning and includes export prices, quality, product differentiation, and financing. Since ours is a framework utilizing primarily the concept of national income, we will concentrate mainly on the relation between prices and export performance, and it will turn out to be largely a study in cost reduction because of relatively low labour costs and rapid technological and organizational advance (Ohkawa and Rosovsky, 1973: 174).

A few may argue against the view that higher exports contribute to higher economic growth and development. But the development process cannot be reduced to occasional spurts in output since it means a continuous process in which change begets further changes. Undoubtedly, the appropriate exchange rate which is consistent with the country's productivity level has to be set. But short term uncertainty regarding exchange rates will not help with the necessary long term steps which guarantee economic growth. Severe fluctuations in the real exchange rate may upset the entire strategy for the expansion of exports. Empirical results of the estimation of the model based on the experience of Chile, Colombia, Peru, the Philippines, Thailand and Turkey have unambiguously shown the clear and strong negative effect of real exchange rate uncertainty on exports (Caballero and Corbo, 1989). Attempts to manipulate the real rate by changing the nominal rate have failed in many countries, including Sri Lanka.

This analysis leads us to a rather familiar theme. The development process requires continuous transformation of the labour process and thereby a reduction of relative prices. The appropriate exchange rate may facilitate this process, but total dependence on price manipulations may not be able to create a competitive advantage for its products in the world market.

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Recognising the value of dissent means valuing the tolerance of dissent. In themselves individual expressions of dissent may often be of little worth; they will include the outpourings of the crank and the crackpot - or what seem to be such by the standards of the day. But the degree to which dissent is tolerated reflects the health of society and ensures that it has within it the potential for progress.

The Value of Dissent: A Publication of the Civil Rights Movement of Sri Lanka, 1992.