

PROFESSOR H.A. DE S. GUNASEKERA
MEMORIAL ORATION 2012



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And the
Professor. H. A. de S. Gunasekera Memorial Trust Fund

**Exchange Rate as a
Policy Instrument –
A Critical Evaluation of
Sri Lankan Experience**

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***Deshamanya* Professor W. D. Lakshman**

I am immensely pleased and greatly honoured by the invitation extended to me by the Department of Economics and Statistics, the H.A. de S. Gunasekera Memorial Trust Fund and by all the institutions in the University of Peradeniya which are associated with the activities of this Trust Fund to deliver the HAdES memorial oration for 2012. It is always a privilege, a great honour and a pleasurable nostalgic experience to be invited to address an academic gathering at my *alma mater* to which I owe so much. My pleasure and the feeling of being honoured are enhanced greatly by the fact that the oration is to remember my guru and mentor at university to whom I owe personally a lot for what I have been able to achieve in life.

Professor H.A. de S. Gunasekera, intimately but respectfully referred to as HAdES by friends, contemporaries, colleagues as well as his students was a giant in the university community from the 1950s onwards until Jan. 5, 1981, when he passed away while still holding the positions of Professor of Economics and the Head of the Department of Economics at the University of Colombo. His time in the University of Ceylon in Peradeniya until 1978 was the heyday of social sciences and humanities in our university system with a galaxy of scholars illuminating the Faculty of Arts with HAdES occupying an undoubtedly leadership position among the social science scholars. HAdES returned to Peradeniya after a period of study leave spent in London in the 1950s and having completed a brilliant piece of research in monetary economics and history of money and banking in Ceylon through the British colonial period including a few years in the post-colonial period until the establishment of the Central Bank in 1951. The published

version of his research work *From Dependent Currency to Central Banking in Ceylon*, London: G. Bell & Sons (1962) with the London School of Economics and Political Science associating as joint publisher was indeed a masterpiece combining history of ideas in monetary economics and the history of currency and banking institutions in colonial Sri Lanka – a book that has been used as a reference work by generations of scholars in monetary economics.

I can still remember, during my early undergraduate days, my seniors and certain younger teachers talking of the unfair delay in filling the vacant chair of economics – the intention being to debar HAdES from being selected for that position. Political rivalries, both internal and external to university administration, were factors in university decision making then as well as they are today – the difference being perhaps only a matter of degree. It was indeed good for the healthy development of economics teaching at university level in this country that the university administration was eventually compelled to appoint HAdES to the Chair of Economics. I can also remember the brief unsuccessful attempt at the time to arouse students' feelings against his assuming duties as Professor of Economics. Students are often better judges about what is best for their university than many other stakeholders. The most productive period of his professional life as a university teacher, and from a number of different perspectives the period in which he accomplished the most was, I believe, the few years from 1962, when he was appointed to the Chair of Economics in the then University of Ceylon in Peradeniya, until he left the university on secondment in 1970 to take up the post of Secretary in the Ministry of Planning. The contribution he made during this period, 1962-70 to develop the Department of Economics in Peradeniya was unparalleled. The quality of courses offered changed dramatically both in content and quality. Human resources in the Department improved to unprecedentedly high levels. HAdES showed an immense capacity to select young graduates in economics who were not only of the bright scholar type but were also committed to work in Sri Lanka even after completing doctoral studies in a developed country university. By the mid-1970s, the Peradeniya Department of Economics was undoubtedly

the strongest at the time among all seats of higher learning in which there were economics departments. The demand for the products of the Peradeniya Department of Economics from all sectors in the economy requiring trained economists was very high.

Honouring one of the leading academic monetary economists Sri Lanka has produced let me discuss a monetary policy topic of current interest in this memorial oration – “the exchange rate as policy instrument” – a topic which had attracted the attention of HAdES at both academic and practical policy making levels. I recall that one of the innovative foreign exchange management systems Sri Lanka had developed – the Convertible Rupee Accounts (CRA) system – came into being in the 1970s when HAdES was holding a key position in the country's economic administration and management. Since I am addressing a mixed audience which includes only a fraction of professional economists, I will not go too far into the academic domain of the subject under discussion but will take up matters of broader interest to the informed general public.

Exchange Rate as Policy Instrument

Stated in simple terms, the exchange rate is the price of a unit of domestic (foreign) currency stated in foreign (domestic) currency terms – as when we say US\$1 = SLRs. 126 or its reciprocal SLRe. 1 = US\$ 0.008. The exchange rate however, is a price with a difference, a huge difference at that. We are familiar with innumerable kinds of prices – those of different kinds of food, clothing and garments, personal services like hairdressing, laundry services, transport services and so on. In a complex market economy today we will be paying a price for almost everything we use in our daily lives – except when we deal with Nature or when we are in a “*dansa*” environment. Although the exchange rate too is, in a sense, such a price, it is nevertheless significantly different from almost all other prices we are familiar with, in the sense that a change in the exchange rate of a currency would directly affect almost all other prices and many macro level variables in the country using that currency. The effects of a change in this particular price are thus felt,

unlike in the case of most other prices, over a large and extensive sphere.

Because of the strong effects it generates, exchange rate variation – whether through market forces (depreciation/ appreciation) or through deliberate official manipulation (devaluation /revaluation) – is considered a potent economic policy instrument in the armoury of a country's authorities. As its effects are widespread and extensive, as well as unpredictable, the authorities are usually very careful, particularly in a democratic polity, in the use of this policy instrument. Keenly conducted, critical public discourse and debate about its socio-economic effects, often combined with public protest movements, are known to have accompanied significant changes in the currency exchange rates in different countries in the world. In the history of exchange rate systems in the world so far, therefore, the periods when free fluctuations in the exchange rate were permitted were relatively of short duration when compared with the very long period of dominance of "stable" exchange rate systems (the Gold Standard and the IMF system of 1946-1971).

As a policy instrument, an exchange rate change is considered effective in the achievement of two broad sets of policy goals or objectives, one short term and the other long term. In the first set of policy objectives, the exchange rate movement is treated as an instrument that is available to bring back "external economic stability" that is being eroded and to keep maintaining such stability. The external stability of a country's economy is gauged through analyses of various aspects of the country's balance of payments statement. On exact quantitative measures to be used in such exercises, however, there is hardly any perfect agreement. The following components of a country's balance of payments, often measured against a relevant macroeconomic variable like the Gross Domestic Product, are used to analyse the degree of a country's external stability. No uniformity of opinion exists, nor can such uniformity be expected, about "benchmark levels of stability" in the analytical use of ratios so computed:

- Trade (merchandise) account or the trade gap
- Current account or the current account balance

- Basic balance
- Overall balance or the official settlements balance.

Following the recent global payments crises, particularly the on-going European debt crisis, the movements in a country's foreign debt levels, relatively to relevant macro variables, are also used widely to gauge the degree of "external stability". The level of foreign reserves held by the monetary authorities, stated against annual imports of the country, is another indicator used to gauge the degree of external stability. The exchange rate movements are used as both indicator¹ and corrective measure in an environment of "external instability" of a country's economy.

When the flexible exchange rate is used as a corrective policy instrument (usually in combination with other measures) it is expected to bring about its effects through changes in incentives affecting production and trading via price changes. The exchange rate corrective of a fundamental deficit in the balance of payments is devaluation or depreciation of domestic currency. Such depreciation/ devaluation on the one hand, reduces "foreign currency prices" of domestically produced goods and services thus promoting foreign buyers to buy local goods and services in larger volumes than before. On the other hand, it leads to an increase in "domestic currency prices" of imported goods and services thus creating incentives to reduce importation of goods and services. The above is the simplest possible explanation of the possible effects of currency depreciation on a country's balance of payments,

¹ The rupee depreciates (appreciates) when the rupee supply to the foreign exchange market exceeds (falls short of) the rupee demand. In the simplest case one can imagine (i.e. ignoring the many complicated and complex transactions that take place in foreign exchange markets), rupees are offered (supplied) to purchase foreign exchange by those who want the latter for various transactions like importation of goods and services from abroad. Rupees are demanded in foreign exchange markets by those who normally use a foreign currency and want to purchase goods and services from us for rupees. A change in the foreign exchange value of a rupee would in the first instance be an indicator of the degree of a country's balance of payments stability. An actual currency depreciation or pressure for depreciation, for example, would be an indicator of growing weakness of the country's balance of payments in which foreign payments (read imports) systematically exceed foreign exchange receipts (read exports). No government in the world would permit the exchange value of its domestic currency to be determined totally by conditions of the demand for and the supply of foreign exchange. Monetary authorities intervene as supplier of foreign exchange when the pressure is for the domestic (foreign) currency to depreciate (appreciate). Pressure for domestic currency to depreciate operates when its normal supply, arising from the country's foreign exchange earning activities, falls short of demand for foreign exchange for imports and other transactions made in foreign currency.

abstracting away from many complicated operations, including the very significant speculative activity, within the foreign exchange market.

I described the second set of policy objectives as long term. These indeed refer to how what I earlier called the short term effects continue to operate in the long run. The exchange rate movements are seen as an important policy instrument that can help bring about structural change in an economy and to stimulate economic growth therein. In the interpretation of this growth and structural change objective of exchange rate variations, the focus is mainly on impacts of an exchange rate change on domestic production incentives. The impact of a change in exchange rate on domestic production incentives can be summarized here in simple terms. An exchange depreciation (or keeping the exchange rate "under-valued"), other things being equal, makes domestic products more competitive in international markets against those produced in other countries. It is a widely heard argument that many fast growing export-oriented economies (e.g. the East Asian and Southeast Asian countries in their fast growth phases) have managed to grow rapidly by keeping their exchange rates "under-valued" for a considerable length of time. In addition, currency depreciation has the potential of helping import substitution activities as well and it has indeed been used in the past effectively by countries which succeeded in effectively setting up efficient import substitution industries.

History of Exchange Rate Management in Sri Lanka

From the time of political independence in 1948 up to the setting up of the Central Bank in 1950 Sri Lanka (then Ceylon) did not have any autonomous monetary system. Under the Currency Board System in force the SL Rupee was linked to the Sterling Pound and together with the latter currency, the rupee was in a stable exchange rate system. The exchange rate stability under the Bretton Woods system continued until 1977 with a few episodes of devaluation in years like 1949, 1967 and 1977 and two innovative methods introduced into the management of the SL rupee. The first of these two innovations was the introduction of a dual exchange rate system in 1968 under the name of Foreign Exchange Entitlement Certificate (FEEC) system. The purpose was to

improve economic management of the country through selective currency devaluation thus also avoiding the extensive and disruptive socio economic repercussions of such general devaluation. Under the FEEC system, the official rate of exchange of the rupee was applicable for conversion of foreign exchange earned from "traditional" exports of tea, rubber and coconuts but foreign exchange earned from "non-traditional" exports were converted to rupees at a devalued rupee rate enabling the latter group of exporters to earn more rupees per dollar earned. The idea behind this treatment of two arbitrarily defined groups of exports was to encourage "non-traditional" exports relatively to "traditional" exports. Imports also were arbitrarily divided into two groups, those entitled to be transacted at the official exchange rate and those that could be transacted at the FEEC rate. The former group included imports of essential consumer items like rice, sugar, dhal etc. so that their domestic prices could be maintained at relatively low levels whereas most other imports could be paid with foreign exchange acquired at a higher rupee rate. The difference between official and FEEC rates varied from time to time according to government decision. At the time the system was abolished in 1977, the value of a unit of foreign exchange under the FEEC system was 45 percent higher than the official rate.

The second innovation under the stable exchange rate system prior to 1977 was called the Convertible Rupee Account (CRA) scheme which was introduced in 1972. There was a strong need at the time to enhance officially declared foreign exchange earnings of the country in the strictly regulated and controlled foreign exchange regime that then operated. The purpose of the CRA scheme was to encourage new and "non-traditional" exports and also to encourage exporters of gems to formally declare their foreign exchange earnings. In the conversion of foreign exchange earnings from these two groups of exports into rupees the FEEC rate applied and the exporters concerned were permitted to retain 25 percent of their foreign exchange earnings in "convertible" rupee accounts which they could use to make any desired imports freely, by-passing the strict foreign exchange control regulations in force at the time.

The Bretton Woods system of stable foreign exchange rates was becoming increasingly difficult to operate for various reasons during the 1970s. Because of the FEEC and CRA schemes, the stable exchange rate system in Sri Lanka too had become an utterly complicated system subject to administrative discretion, drawing criticisms from many quarters. It was under such an environment that a newly elected right wing government introduced, in November 1977 in its first major policy statement, an integrated system of foreign exchange rates, abandoning both the FEEC and the CRA schemes and devaluing the rupee by 42 percent (or increasing the rupee value of a US dollar by 73 percent²). Sometime after this November 1977 change, the rupee was placed on a flexible (floating) exchange rate system. The SL rupee remained stable till end of the 1970s, and since 1980, depreciated continuously. Looking at only the US dollar rate, the exchange rate varied from Rs. 15.45 to a dollar at the end of 1979 to Rs. 114.38 to a dollar at the end of 2009 – an 86 percent depreciation of the rupee over a thirty year period³.

Flexible Exchange Rate Experience (1977-2009) Critically Examined

As noted earlier, the economic policy changes of November 1977 were radical and far reaching. The highly interventionist “control regime” which operated from around 1960 to 1977 was reformed into a system of liberal markets, which were popularly described then as an “open economy”. These policy changes were accompanied by certain exchange rate reforms. These exchange rate reforms included three important components: (a) unification of the rupee exchange rate abandoning the FEEC and CRA schemes, (b) devaluation of the rupee by 43 percent and (c) significant reduction of the scope of the exchange control regime. In the continuation and expansion of this policy reform process, the rupee

² The two exchange rates compared here are as follows. Before the November 1977 change, the rate was US\$ 1 = Rs. 8.99. The rate after the November change was \$1 = Rs. 15.56. These two rates give the 73 percent increase in the value of the dollar. The same rates can be stated as Re 1 = US\$ 0.111 (pre-November 1977) and Re. 1 = US\$ 0.064 (post November 1977). These two rates give the 42 percent devaluation of the rupee.

³ This is a 640 percent increase in the rupee value of the US dollar – sometimes also loosely described as a rupee depreciation of 640 percent.

was later “floated”, leading to a gradual process of rupee depreciation after 1979 (Table 1). During the entire period after 1979, the rupee exchange rate continued to depreciate except in the two isolated years of 2005 and 2010. The important policy issue of maintaining exchange rate stability has got back into contemporary policy dialogue during the post 2005 period.

During 1977-2005 there was within Sri Lanka, extensive official level glorification of the processes of liberalisation, globalisation and privatisation as means for economic growth and development. As part of this policy thinking, flexible exchange rate management came to receive extensive emphasis as a mechanism for balance of payments stabilization, progressive structural adjustment, and export-oriented industrialisation (EOI). The role of the IMF and the World Bank in promoting exchange rate flexibility was quite dominant.

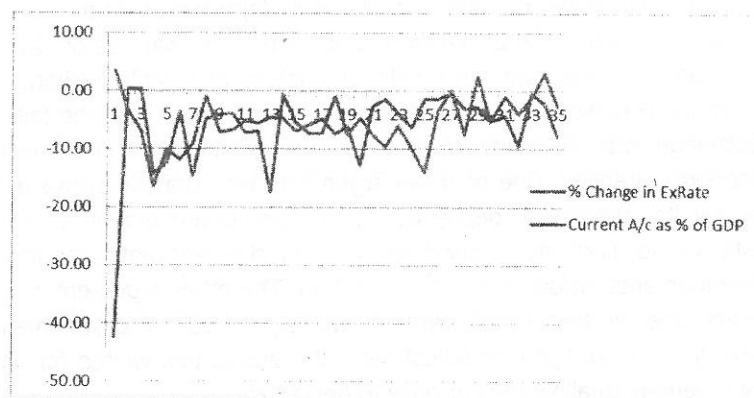
The continuous depreciation in a flexible exchange rate system reflects the systematic failure of foreign exchange outflows from the country to remain within limits which foreign exchange inflows could afford. Policy makers in the flexible exchange rate system would have expected currency depreciation to help ease the continuing conditions of external imbalance. In spite of continuous depreciation of the rupee for decades, however, Sri Lanka did not achieve stable balance of payments conditions. It was common for the champions of flexible exchange rate systems to present two arguments when confronted with the failure of exchange rate flexibility to lead to the promised land of external economic stability. One of these arguments was that Sri Lanka did not permit its currency to depreciate to an appropriate extent so that the rate would find the realistic level given the relevant contemporary developments including domestic inflation. The other argument was that every time the balance of payments was seen weakening systematically calling for exchange rate adjustment, the authorities waited for unduly long periods to allow the currency to depreciate.

Such counter factual argumentation notwithstanding, the danger of depending too heavily on foreign exchange markets to achieve the desired conditions of external economic stability must be highlighted.

Movements in a country's balance of payments are clearly caused by extensively complicated combinations of a multiple of factors. It is not easy to identify which ones among these multiple causal factors were the more significant.

A careful interpretation of Table 1 and Chart 1, in the light of background macroeconomic data, indicates that there was some association between (a) the ratio of the current account balance (CAB) to GDP and (b) overall economic strategies adopted by different political regimes. Excluding 1977 from calculations as it was the solitary year of a current account surplus, the average of the CAB to GDP ratio for 1978-2011 was (-) 5.55 percent. Periods when priority in the overall economic strategy was on economic growth acceleration had witnessed relatively high CAB to GDP. The ratio during 1978-83 was (-) 9.6 percent. In some years during this period, CAB to GDP ratio reached the highest levels it ever reached in Sri Lanka. The advantage which the regime enjoyed during 1978-83 was that there were large inflows of foreign aid at the time and defence expenditures were negligible.

Chart 1 - Exchange Rate Movements and Current Account Balance 1977-2012



Note: Numbers along horizontal axis refer to years starting from 1977.

Source: Table 1

The change of political regime in 1994 also brought forth a few years (1994-96) when the government attempted to accelerate growth without being overly concerned about the CA deficit. This regime however, had neither of the advantages noted above for the regime of 1978-83. Foreign exchange inflows were limited, foreign reserves were declining and security expenditures mounting. The CA deficit soon became a significant growth constraint dominating policy dialogue. During 1997-2005 the average CAB to GDP ratio, at (-) 2.58 percent, was at its lowest for the period under consideration. While the influence of the IMF in Sri Lankan policy making was perhaps the strongest during this period, the official domestic economic establishment too was strongly in favour of maintaining stability in the economy as opposed to growth. This also included a short period of government in political cohabitation in which the two components of the Executive, the President and the Cabinet, were occupied by two opposing political camps. This period of cohabitation witnessed a shift in policy priority from growth to stability as the global economic conditions were also getting increasingly difficult. This period also included the only year in which post-independence Sri Lanka recorded negative growth. The very low CAB to GDP ratio during 1997-2005 is thus not very difficult to understand.

Short-lived Stable Exchange Rate Experiment

Perhaps because of the disillusionment of policy makers about continuous rupee depreciation from 1979 to 2009 failing to produce concrete positive impacts on the country's payments imbalances or on the country's growth and structural change patterns, the years 2010 and 2011 saw an attempt to revert back to a "stable rupee" policy. A "low interest rate structure and stable exchange rate regime" achieved through coordinated fiscal monetary cooperation was declared part of the government's macroeconomic policy, as such a policy would "be conducive for a rapid expansion in investment and growth"⁴. This

⁴ Department of National Planning – Ministry of Finance and Planning, *Sri Lanka – The Emerging Wonder of Asia*, Mahinda Chinthana Vision for the Future, The Development Framework Government of Sri Lanka, Colombo: Department of National Planning, 2010, p. 6

attempt at policy reversal in respect of exchange rate management was strengthened by the availability of large foreign exchange inflows – both autonomous and accommodating – following the end of the 30-year civil war in May 2009. This attempt to maintain stability in the rupee exchange rate through Central Bank intervention, however, was short lived. The Bank could continue with this policy of market intervention to keep the rupee stable only for about two years. By early 2012, having found this policy unsustainable in the context of continuing pressures for rupee depreciation, the Bank had announced its decision not to intervene in the foreign exchange market to prop up the rupee as from 10th February 2012. This led to the US dollar going up from Rs.114 to a dollar to over Rs. 120 in the matter of a few days. The US dollar continued to go up in value, briefly rising to a level slightly above Rs. 130. The rate now remains hovering around Rs. 128 - 129.

In terms of net benefits to the economy and society, there is a lot to be said in favour of a stable, as opposed to a flexible, exchange rate system. A brief account of the reasons which appear to have made the attempt to stabilise the rupee exchange rate short-lived will be useful therefore, from a policy point of view. The economic, monetary and financial authorities in Sri Lanka failed to maintain unity of purpose and action in the exchange rate domain during the last stages of the two year period of Central Bank intervention for exchange rate stability. Differences of opinion about exchange rate management between, for example, the Treasury and the Central Bank had become part of public knowledge already at the time the Budget statement was presented to Parliament in November 2011. While the Central Bank was still promoting exchange rate stability, the 2011 Budget Speech announced a 3 percent devaluation of the rupee. The two parts of the economic – financial establishment failed to speak the same language in the context of widespread expectations of impending currency depreciation. The exchange rate movements are highly susceptible to speculative activity and to anything that influences the related public expectations. Differences of opinion between parts of the economic establishment of the country emerged at a time when the opinion of many influential quarters – the financial press, parliamentary speeches and published

analytical pieces – was that the policy of intervention in the foreign exchange market was unsustainable. The apparent conflict of opinion among authorities themselves strengthened the expectation that the Central Bank would soon abandon the policy of foreign exchange market intervention. These expectations themselves expedited the abandonment of the policy of intervening in foreign exchange markets to support the rupee.

Making things more difficult for the Central Bank at the time were the developments pertaining to the negotiations with the IMF for the release of the penultimate (i.e. seventh) instalment in the US\$ 2.6 billion standby facility extended to Sri Lanka in July 2009. An IMF team was in the country during the late January and early February of 2012 and there were reports of this team insisting on a return to the flexible exchange rate system. The IMF's role in introducing and managing a flexible exchange rate system in Sri Lanka since the late 1970s is well known among knowledgeable circles. The public expectations of the rupee to depreciate and the Central Bank to give up its market intervention policy were thus strengthened by media reports covering IMF news conferences of the time.

The Central Bank's Road Map announcement of 3 January 2012 placed emphasis on migrant remittances, tourist earnings, and foreign capital inflows as factors that could effectively support the rupee's exchange value. This was realistic thinking in keeping with historical trends. Every year after 1977, the trade balance was in deficit and to cushion the trade balance impact on the current account, Sri Lanka depended throughout this period on services account surpluses, net migrant earnings (defined as private transfers for balance of payments accounting) and during the pre-2009 period, also on official transfers (foreign aid). The peculiarity of the post-2009 (post civil war) period was that the trade deficit rose to heights not experienced before because of the unprecedented rate of increase in imports. The stable exchange rate experiment of 2010-11 collapsed because the authorities failed (for whatever reason) to take effective action to rein in imports. A strategy of restraining imports, using measures that fall even outside the strict

trade liberalization framework, could have been justified but adequate restraint on imports could have been exercised through measures that do not go against the trade liberalisation framework. That such import restraining measures are available and can be used is shown by measures adopted after the currency depreciation process commenced in February 2012. But no such action was taken to support the stable exchange rate experiment of 2010-11.

The macroeconomic stability that needs to be projected to both local and overseas investors has been sacrificed by inconsistent pronouncements of the Treasury on the one hand, and the Central Bank on the other and by frequent reversals of their economic assessments. The Treasury argued in late 2011 that the rupee was so strong that it will appreciate to a level of US\$ 1 = Rs. 100, the rate that prevailed in 2004. Subsequently in early 2012, with economic fundamentals not having changed drastically, it began arguing that the rupee must depreciate. The 3 percent devaluation announcement in the Budget Speech of November 2011 would have been Treasury work. After this announcement, the Central Bank attempted to convince the public that the announced 3 percent devaluation was to be a "one off" change. Shortly thereafter, the Bank was seen moving away from that position announcing the abandonment of its intervention in the foreign exchange markets.

It is yet difficult to see whether Sri Lanka is firmly back within a flexible exchange rate regime. The Treasury and the Central Bank both are sending down messages to say that they do not wish to see, in respect of the exchange rate, a repeat of the 1979-2009 experience. The public hostility to such currency devaluation is evident from the experience of the last few months, although the intervention of other simultaneous developments (e.g. global fuel price increase) does not permit a sober and careful analysis of the impact of currency depreciation *per se*. The apparent predilection of authorities for a stable exchange rate regime is strengthened by such public antipathy to continuous currency depreciation. The Central Bank continues to express optimism about increasing foreign inflows through migrant worker

remittances, tourist earnings, export earnings, foreign direct investments, the proceeds from the IMF standby facility and other loans from international money markets. Reading these announcements and expressed optimism regarding foreign exchange inflows, one wonders whether the authorities will get back to their earlier policy of forex market intervention to maintain exchange rate stability. The recent Treasury statement to the effect that the realistic exchange rate under prevailing circumstances ought to be around US\$1 = Rs. 125 is worth noting. This statement was followed by a warning to speculators that they should not try to push the rupee further down. The Treasury warning hinted at the possibility of government intervention in the market in the eventuality of speculators trying to push down the rupee continuously. What impact this attempt to apply moral suasion in the forex market would have on market behavior is difficult to predict. The said announcement anyway indicates that the authorities have not fully moved away from the policy position of market intervention for exchange rate stability.

Stability versus Flexibility in Exchange Rate Management

The government since 2005, particularly after its re-election in 2010, has once again prioritised economic growth in setting its economic policy objectives. Economic growth was prioritised together with a commitment for distributive justice. As a growth promotion agent the state is brought back again to the centre stage, particularly in respect of infrastructure investments. The policy focus on distributive justice involved commitment to objectives of employment creation, poverty alleviation and subsidised assistance programmes to help weaker producer segments and underdeveloped regions. In pursuing these objectives, the end of civil war in May 2009 has provided the government a facility which the previous governments did not enjoy.

The prioritisation of growth under these changed socio-economic conditions continued to generate heavy demands for imports. The export growth failed to match the rapid growth of imports. As Table 2

shows total imports of the country today are heavily biased towards intermediate products (61 percent) with petroleum products alone taking a share of 24 percent of the total. Investment goods and consumer goods share the balance 39 percent of total imports more or less equally. Economic growth in Sri Lanka has always been very import-intensive. Adequately strong measures have not been taken to accelerate the expansion of commodity exports, particularly industrial exports. Merchandise trade deficit thus increased sharply in the course of a year from US\$ 4.8 billion in 2010 to US\$ 9.7 billion in 2011. This sharp deterioration of the trade balance was seen as a "serious challenge" to the management of stable external economic conditions. This was the main reason for going back to a flexible exchange rate regime – whether permanently or as a temporary measure. It is doubtful whether Sri Lanka has firm historical evidence to support the idea that exchange depreciation is the most effective measure to stabilise the balance of trade. Demand elasticity for imports in Sri Lanka is not very high as essential intermediate goods and also essential consumer items occupy a dominant place among imports. Imports intended for high income groups are also inelastic against the increase in rupee prices following exchange depreciation.

In addition to doubts about exchange depreciation as a strong balance of payments corrective, there are other reasons as well to make currency depreciation an unpopular decision among authorities. Depreciation creates many other difficult socio-political problems, mostly related to increased cost of living resulting from depreciation and consequent trade union demands for wage increases. Currency depreciation in liberalized markets usually leads to redistribution of income away from the poor. The drop in living conditions of the poor and vulnerable groups, worsened further by depreciation-induced inflation provides fertile ground political protest movements. I am tempted to remind you of the expression of "IMF riots", an expression that was familiar to us some time ago referring to the IMF's advice to developing countries to devalue leading to violent street protests in many parts of the Third World. Such protests would clearly be inimical to realising the full potential of a country for growth and development.

Subsidies to be offered to ameliorate such public protests would push up government expenditures. Additional revenues and loans raised to meet such expenditure needs have their associated problems. All this highlights the importance of alternative stabilisation policies that could be implemented without having to face all the adverse side effects of exchange depreciation.

Other Policy Options to Address the Balance of Payments Problem

A package of policies to correct a large and chronic balance of payments weakness would invariably have to incorporate several policy elements. The exchange rate would clearly be one of these elements. In addition there are other policy instruments that can be used to correct a balance of payments problem, particularly if the most pressing problem is, as in the context of contemporary Sri Lanka, to restrain the expansion of imports. Measures to promote exports are discussed separately. Export promotion measures normally take time to produce results in terms of significantly expanded exports and therefore, in the short term, more attention is likely to be paid to restraining imports.

- Selective trade controls would be able to achieve the objective of bringing down the selected imports most directly and the effectiveness of such controls are likely to be more effective than depreciation in reducing imports. Liberalised trading systems that are widely adopted globally do not endorse direct trade controls and the WTO would be acting like a watchdog to prevent member countries from adopting measures of direct trade controls. There is however room still available in a limited way to adopt quota restrictions on imports when recommended by national needs and requirements.

Selective imposition of high (perhaps prohibitive) import duties would be able to bring down targeted imports effectively. After the Central Bank's withdrawal from the foreign exchange market in February the government raised import duties on

selected items, particularly on vehicle imports, obtaining effective results in terms of reduction of the identified imports.

- Measures to reduce domestic aggregate demand – e.g. pushing up income and other taxes, reduction of government expenditures – would have the salutary effects of restraining the growth of imports. As the government itself imports extensively for its routine as well as developmental programmes of activity, it could easily take direct restraining action in respect of its own import budget.
- Every time there were sharp global increases in petroleum prices in the past, extensive were the discussions and action plans to reduce domestic demand for petroleum imports. These action plans were never systematically implemented, as they were gradually forgotten once the world market for petroleum products settled down. The search for alternative energy sources, together with the expediting of the search for domestic petroleum deposits, and measures to economise the domestic use of petroleum products are strategies that could be pursued as both short and long run measures to rein in imports.

On imports front, a combination of measures like the above would clearly be more effective and quicker to produce results than expecting a single measure like an exchange depreciation to bring about the needed restraint on imports, working through price effects. There is no suggestion here to maintain the exchange rate rigidly at a given level. It needs to change in line with changes in underlying fundamentals. I am reminded of the expression of "fundamental disequilibrium in the balance of payments" used under the Bretton Woods system prior to the 1970s. The argument here is that frequent changes in the exchange rate should be avoided as the net costs of such extreme exchange rate flexibility of are very high.

The Exchange Rate in an EOI Program

In Sri Lanka during the last three decades, every time agitations were mounted against rupee overvaluation, and raising demands for exchange depreciation, a section of the export community – not all exporters – became a strong protest group. An exporter's views on this subject would depend partly on the elasticity of demand for his/ her export product as a function of its foreign currency price and partly on his/ her production cost structure and the import content of production inputs. There is anyway the widespread argument that a policy of keeping the domestic currency undervalued in foreign exchange markets has been a strategy adopted by many countries which succeeded in export oriented industrialisation (EOI).

In these countries there was usually rapid growth of exports over a long period led by industrial exports. Industrial exports were indeed the bedrock of export-led growth. In order to succeed in EOI these countries have been driven by carefully devised policies of managing the value of their currency. Different countries had different experiences in this regard. The following are two widely seen historical patterns:

- The pattern seen in Japan and China: The exchange value of domestic currency would initially be maintained at a low (undervalued) but stable level. Continually rapid export growth from such exporting countries would gradually become a socio-political issue in their trade partner countries. The pressure from the latter country governments (usually led by the United States), under these circumstances would compel the former country governments to gradually let their currency value to gradually appreciate.
- The other pattern seen for example, in South Korea and Taiwan was one of gradual depreciation of domestic currency to low values during the rapid growth phase. With export successes, however, the currencies of such countries also gradually appreciated later.

Everywhere EOI was governed more by consistent and effective industrial policy leading to technological up-grading, productivity improvement and product diversification – currency under-valuation only as a single element within a broader and therefore more effective policy package

To Conclude

Currently in Sri Lanka there is no firm economic structural basis to believe that a flexible exchange rate regime now would not produce the same kind of currency depreciation process experienced during the last three decades. A strong EOI process needs to be promoted in which the country's industrial structure graduates to higher technological levels. The need for an active industrial policy for this purpose cannot be over-emphasised.

The expansion of tourism may provide jobs and incomes as well as Current Account balancing support over the short to medium runs. Migrant remittances are large now and will be so for some time to come. But Sri Lanka cannot make a great leap forward economically through these inflows. The inherent instability of these items also requires consideration. From a technological point of view this applies also to the apparel industry.

The next stage of industrialization (one may include IT based services also in this category) requires large new investments (high technology, new machinery, highly qualified technical personnel and other new inputs). One cannot see how the depreciating currency would help in the advancement of these activities. It may work against their growth by making machinery and equipment and inputs to be imported increasingly costly.

The country has begun since 2005 to build up the necessary infrastructure for the next stage of industrialization. A process of currency depreciation is the worst imaginable scenario for a country in the process of investing heavily in infrastructure using borrowed foreign

funds. Even private investors would not like to deal with a currency in free float leading to constant depreciation.

Cost of borrowing across the board will increase in the environment of a depreciating currency. Interest rate and exchange rate volatility enables banks to make large margins. Such process, good for bankers, is clearly not so to industry. This is particularly pertinent here as we do not have any development banks which can step in and take project finance risks.

The road ahead for the economy looks arduous, particularly as the global economy has not yet emerged fully from the financial and economic crisis which began several years ago. Intermittent fuel price increases and the consequent increases in prices of many mass consumption commodities are likely to be the pattern. Moving away decades of neoliberal policies, Sri Lanka appeared since the mid-2000s to be moving in the direction of accelerated growth and development in a guided market framework. There seem to be pressures and trends to re-establish the neo-liberal policy fundamentals but it is also possible, because of stronger socio-political and economic pressure, for a policy framework of "state guided markets" to be strongly re-established.

Using the exchange rate issue, the message I would like to leave behind about policies in general, thus also respectfully remembering what HAdES would have tried to achieve in the 1970s, is as follows. A given problem has a number of possible policy measures. A given measure has effects on a wider range of variables than the immediately targeted variable involving "trade-offs", "second best solutions" etc. There is also no certainty of the direction and size of effects of a given policy measure on variables under consideration. The problems of *ceteris paribus* and *mutatis mutandis*, widely used in economic theory, are extremely difficult to handle in real world policy making. Correct decision making requires careful and holistic consideration of all options as well as good common sense political judgment.

Table 1 – Exchange Rate and Current Account Balance, 1977-2012

	Exchange Rate				Current A/c Balance as % of GDP
	US\$=SLRs	% change	SLRe1 = \$	% Change	
Nov. '77	8.99		0.11		
1977	15.56	73.08	0.06	-42.22	3.50
1978	15.51	-0.32	0.06	0.32	-3.40
1979	15.45	-0.39	0.06	0.39	-6.80
1980	18.00	16.50	0.06	-14.17	-16.40
1981	20.55	14.17	0.05	-12.41	-10.00
1982	21.32	3.75	0.05	-3.61	-11.90
1983	25.00	17.26	0.04	-14.72	-9.10
1984	26.28	5.12	0.04	-4.87	-0.90
1985	27.40	4.26	0.04	-4.09	-7.00
1986	28.52	4.09	0.04	-3.93	-6.70
1987	30.76	7.85	0.03	-7.28	-5.10
1988	33.03	7.38	0.03	-6.87	-5.60
1989	40.00	21.10	0.03	-17.43	-4.60
1990	40.24	0.60	0.02	-0.60	-4.70
1991	42.58	5.82	0.02	-5.50	-6.90
1992	46.00	8.03	0.02	-7.43	-5.70
1993	49.56	7.74	0.02	-7.18	-4.80
1994	49.98	0.85	0.02	-0.84	-7.30
1995	54.05	8.14	0.02	-7.53	-6.00
1996	56.71	4.92	0.02	-4.69	-12.90
1997	61.29	8.08	0.02	-7.47	-2.60
1998	67.78	10.59	0.01	-9.58	-1.40
1999	72.12	6.40	0.01	-6.02	-3.80
2000	80.07	11.02	0.01	-9.93	-6.40
2001	93.16	16.35	0.01	-14.05	-1.40
2002	96.73	3.83	0.01	-3.69	-1.40
2003	96.74	0.01	0.01	-0.01	-0.40
2004	104.61	8.14	0.01	-7.52	-3.10
2005	102.12	-2.38	0.01	2.44	-2.70
2006	107.71	5.47	0.01	-5.19	-5.30
2007	108.72	0.94	0.01	-0.93	-4.30
2008	113.14	4.07	0.01	-3.91	-9.50
2009	114.38	1.10	0.01	-1.08	-0.50
2010	111.00	-2.96	0.01	3.05	-2.20
2011	113.90	2.61	0.01	-2.55	-7.80

Source: Central Bank

Table 2 – Value of Imports, Composition and Rate of Increase, 2010-11

Category of Imports	2010 US\$ Million	2011	Imports Composition (%)		Rate of Increase (%)
			2010	2011	
1. Consumer goods	2,476	3,654	18.6	18.1	47.6
Food and beverages	1,322	1,567	9.9	7.8	18.5
Other consumer goods	1,155	2,087	8.7	10.3	80.7
Motor Cars, Cycles, Electrical Appliances.	455	881	3.4	4.4	93.6
Other	700	1,206	5.3	6.0	72.3
2. Intermediate goods	8,054	12,275	60.6	60.7	52.4
Petroleum	3,041	4,795	22.9	23.7	57.7
Textiles and clothing	1,812	2,321	13.6	11.5	28.1
Diamonds & precious metals	378	1076	2.8	5.3	184.7
Wheat and maize	265	429	2.0	2.1	61.9
Fertilizer	240	407	1.8	2.0	69.6
Other intermediate goods	2,318	3,247	17.4	16.1	40.1
3. Investment goods	2,758	4,286	20.8	21.2	55.4
Machinery and equipment	1,339	2,141	10.1	10.6	59.9
Transport equipment	593	1065	4.5	5.3	79.6
Building materials	822	1,076	6.2	5.3	30.9
Other investment goods	4	4	0.0	0.0	0.0
4. Total Imports	13,288	20,215	100.0	100.0	52.1

Source: Central Bank Annual Report 2011



Prof. H.A. de S. Gunasekera was Professor of Economics and Head of the Dept. of Economics of the then University of Ceylon. He succeeded Prof. Das Gupta to become the second occupant (and the first Sri Lankan occupant) of the Economics Chair in 1961. He also served as the Dean of the Faculty of Arts at Peradeniya (1963-1969) and later on as Secretary, Ministry of Planning (1970-

1977) under Prime Minister Sirimavo Bandaranaike. He was a much respected academic and public servant. A large number of his students have made outstanding contributions to both academic and public life in Sri Lanka and overseas.



Exchange Rate as a Policy Instrument - A Critical Evaluation of Sri Lankan Experience

By Deshamanya Prof. W.D. Lakshman