The Pathfinder Economic Alert

Depreciation of Rupee: Is it a Powerful Tool to Drive Growth and Employment?

The Pathfinder Foundation strongly supports the depreciation of the Rupee by three percent announced in the Budget Speech. The Economic Alert – 15 called for early remedial action to address the deteriorating trade balance; the buildup of foreign commercial debt/increased debt servicing; and the decline in non-borrowed reserves and running down of extremely large amounts of the country's foreign reserves defending the Rupee.

Increased foreign borrowing by banks and corporates can address the immediate problem of declining reserves, particularly as the headroom for Government foreign commercial borrowing has been reduced (as reflected in the significantly lower figure provided for this purpose in last week's Budget). However, increased foreign borrowing by the private sector is a top-gap solution to the problem of declining reserves. It is also important to recall that the Asian crisis was caused by excessive private sector short-term debt rather than unsustainable sovereign borrowing. Hence, any such borrowing should be based on strict prudential norms. **The ultimate solution has to be an increase in exports of goods and services and a containing of imports by enhancing the competitiveness of the economy. Depreciating the currency is a powerful growth and productive employment oriented means of achieving this.**

The Economic Alert – 15 pointed out that there is no pain-free option for the remedial action to address the emerging imbalance in Sri Lanka's external account. Early action is needed to address this problem. As a lower-middle-income country, Sri Lanka can no longer be bailed out with concessional aid money. It is exposed to the unforgiving bond markets which respond brutally to deteriorating macro-economic fundamentals.

Currency depreciation has an impact on the cost of living through increases in the prices of essential imports, such as oil, fertilizer, wheat, milk foods, sugar and pharmaceuticals. It also pushes up the budgetary cost of financing external debt.

However, other macro-economic measures, such as increasing interest rates and/or further tightening fiscal policy (raising taxes or cutting expenditure) will have a negative impact on investment, growth, employment and the provision of basic services. This would be counter-productive for the Government's efforts to place the economy on a higher trajectory of inclusive growth and productive employment. On the other hand, depreciating the currency assists in achieving these objectives by increasing the competitiveness of exports and all import competing economic activities.

It is still too early to determine whether the adjustment of the exchange rate constitutes a shift to a more flexible policy or whether it was a one-off measure to boost revenues to meet the Government's budget deficit target. Currency depreciation increases the Rupee value of imports and results in higher revenues from import duties and taxes. It also increases the profit margins of exporters and producers of import substitutes thereby raising their tax liability (except where there are tax holidays).

It is extremely encouraging, however, that the Government has exercised tight fiscal discipline by broadly adhering to its path of fiscal consolidation. This has opened up the option of adopting a flexible exchange rate policy without the danger of triggering an inflationary spiral. It has also created the conditions for a balanced use of all macro-economic instruments for demand management.

As pointed out in the Economic Alert – 15, for much of the last three decades, an unsustainable fiscal deficit has resulted in lopsided macroeconomic management that has been over-reliant on monetary policies for demand management. This has resulted in high interest rates that have stifled growth and the creation of productive employment by pushing up the cost of funds in the economy. Better fiscal outcomes now provide an opportunity to pursue the type of balanced macro-economic policies that have yielded notable successes in East and South East Asia.

The adjustment of the exchange rate in the Budget Speech is an important step in the right direction. Competitive (even undervalued) exchange rates have been a major part of the Asian success story, which has also included robust fiscal performance and low interest rates. ***Exchange rate policy should be based on a pragmatic view of market developments and the need to protect the economy's competitiveness. Fiscal consolidation, lower core inflation and self-sufficiency in rice have created the conditions for a paradigm shift in exchange rate management in Sri Lanka.***

This is the Nineteenth in the series of Economic Alerts issued by the Pathfinder Foundation.

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