Pathfinder Economic Flash

No More Backtracking: Stay on Course on Interest and Exchange Rate Policies.

Last week saw both the exchange and interest rates come under some pressure, despite the courageous reforms introduced by the Authorities in early February 2012. It is important, however, to learn from the policy mistakes of the recent past and to resist imminent pressure to manipulate these two key economic prices.

The Rupee closed at USD/LKR 130.20 at the end of last week. The pressure on the currency was expected to ease after the New Year. However, there was no sign of this as yet. In addition, the Central Bank has announced that it will stop supplying dollars for oil imports from May 2012 as part of its efforts to build up its depleted foreign reserves. This will inevitably exert further pressure on the value of the Rupee.

Last week also saw a continuation of the rise of market-determined interest rates. The Central Bank has raised the Repurchase and Reverse Repurchase Rates by 50 and 125 basis points (bps) respectively. However, these actions are trailing well behind the markets. Treasury Bill rates have increased by over 400 bps, since August 2011. Last week's Treasury Bill Auction (18/4/2012) saw yields rise across all maturities.

The simultaneous pressure on the exchange and interest rates indicates that the adjustment necessary to stabilise the economy (i.e. address the sharp deterioration in the external position) is not complete as yet.

The Pathfinder Foundation has argued that the challenge for the Authorities is to use all the available macroeconomic instruments to achieve the most growth/employment oriented stabilisation trajectory while containing the adverse effects on the poor and vulnerable.

The policy stance adopted during August 2011 – February 2012 clearly demonstrated that attempts to resist market pressures are extremely costly. The attempt to defend the misaligned policies resulted in $3.6 billion being spent on propping up the Rupee and a hemorrhaging of a quarter of the country's foreign reserves, much of it borrowed from abroad on commercial terms.

The following lessons should be drawn from the recent policy mistakes.

- A very high price has to be paid in terms of the deterioration in the external finances; the foregoing of growth and employment; and the increase in the burden on the people, if economic policies seek to defy market forces.
- No one can hold down interest rates and support the value of the Rupee at the same time when there are imbalances in the economy. The less the exchange

rate is allowed to adjust towards its market-determined value, the higher the interest rates will have to be allowed to move and vice versa.

- The failure to respond to global trends in a timely manner (e.g. an increase in the oil price) inevitably results in more painful action further down the line.

In conclusion, it is important that stabilization policies are allowed to run their course. Failure to do so will increase the depth and duration of the economic downturn. It is important that the Authorities abide by the policy commitments that they have made in the recent past. These policy measures should be supplemented by a new package of reforms that increases the competitiveness of the economy and strengthens its growth framework.

Your views and comments on this subject are welcome at www.pathfinderfoundation.org