
Position Paper

# Rupee Crisis?

By late April 2012 the rupee crashed to a considerably low level of Rs. 133 to the US dollar, far beyond the expectations of the authorities, instantaneously creating extensive debates and much unrest amongst economists, politicians, the business community and the general public. However, therein lies the question - can one actually call this a 'rupee crisis? To come to a substantiated comprehension of the issue it is essential to analyze, both the root causes of the 'rupee crisis' and its resulting consequences.

## A bit of history

From 23rd July 1983 up to 18th May 2009, Sri Lanka was in the depths of a civil war. As the military defeated the Liberation Tigers of Tamil Ealam (LTTE) after 26 years, the Rajapaksa Government cannot be blamed for wanting to ensure that the people felt the dividends of peace. Consumption was, therefore, encouraged through various economic tools, such as artificially holding down interest rates, reducing duties on vehicles, increasing subsidies (e.g. fertilizer) and so on. However, "as the government encouraged this high consumption, in order to buy goods, people had to borrow, which meant consumption was credit-based and lacked sustainability."[1]

1. Dr. Harsha de Silva TISL Sambhashana Discussion Forum, 25.04.12.

TRANSPARENCY INTERNATIONAL SRI LANKA
a nation that upholds integrity

The result: The public was increasingly in debt as there was a significant expansion in their consumption. There were also mounting problems created by credit taken to keep fuel prices down and finance state enterprise losses. This was one of the most important triggers for the 'shortage of dollars', because as oil users got subsidized energy they spent the money they would have spent on oil, on other imports. Credit therefore started to spike in June 2011, as there was a rise in international oil prices which was also not passed on, allowing people to spend merrily. Simultaneously, the government increased capital expenditure, through infrastructure development projects. It is important to bear in mind that a sustainable and strong economy cannot be built through infrastructure developments, unless the extra income received is not spent and instead saved.[2] However, with the government encouraging spending, long term economic benefits could not be reaped. As the government increased its own spending - through borrowed funding - when they launched infrastructure investment spending programs to build highways, ports, airports and power plants, it left the government heavily indebted to foreign funders as loans have to be repaid with interest.

Though at the time, the Sri Lankan government may have wished to build a strong national economy with a dynamic export and industrial sector, as appropriate policies were not developed what ensued was a credit-based and import-driven consumption boom. As cuts in taxes and increases in subsidies were made, people started spending more. With increased consumption comes increased prices (i.e. as the demand for goods and services increase the price of goods increase). There are two economic tools at the discretion of the authorities to be used in order to control the rising demand and corresponding inflation. The tools are a) the interest rate and b) the exchange rate. However, the post-war 'feel good' aura that the government felt compelled to maintain led to a clear abandonment of accepted economic theories and tools. As interest rates were kept low, the exchange rate wasn't adjusted to reflect the true value, and coupled with this the government's expectations of higher foreign inflow didn't occur. As a result, by mid-2011, there were clear indications of increased credit expansion coupled with an increase in government expenditure and an increase in the money supply. Let's take a little detour to elaborate on what increasing money supply means, and why the government resorted to such measures.

## Increasing money supply

The money supply can simply be understood as the money the Central Bank prints. In order to sustain the increased consumption of both the public and the government, the Central Bank has been charged by critics of mismanaging the reserve money supply, especially from the last quarter of 2010. To understand the corresponding issues, a simple economic theory known as the Mundell-Fleming Model can be utilized.

The Mundell – Fleming Model plainly says that if a country prints more money than what its people need, the excess money will be used on both domestic and imported goods and services. When people are inclined to use more imported goods, like in Sri Lanka, it widens the gap between imports and exports leading to a trade deficit, which when prolonged, leads to a current account deficit and thereby ultimately contributing to an overall Balance of Payments deficit.

This current account deficit has to be financed by using the existing foreign reserves or borrowing from other countries. When the exchange rate is not allowed to depreciate appropriately, it will worsen the balance of payments crisis because, it encourages more imports and the use of foreign services, and discourages exports and the sale of local services to foreigners. Thereby, it causes the foreign reserves to fall further.[3] Hence what the Mundell-Fleming model simply prescribes is to cut down the money supply.

## The onset of the 'rupee crisis'

Many economists argue that early in 2011 the Central Bank could have seen that the rate of inflation was rising and money supply was increasing, and therefore, should have increased interest rates and stopped overvaluing the rupee in order to slow down demand. However, as the

2. www.ft.lk/2010.05/03/are-we-facing-a-rupee-crisis/

3. http://www.sundaytimes.lk/100502/BusinessTimes/bt08.html

government and relevant authorities failed to do this, as the Mundell-Fleming model predicts, imports rose exponentially leading to a trade deficit and a deficit in Sri Lanka's current account. In order to maintain the artificially high value of the rupee, the Central Bank is known to have released $2.5 billion dollars, within a very short period of time, from its foreign reserves to maintain rupee stability. This was done starting from around August 2011. At this point if the government allowed for a gradual depreciation of the rupee rather than trying to finance the rupee through the foreign reserves, which is a highly expensive venture, economists argue that the situation would have corrected itself rather than creating the crisis the country is faced with today. As the Central Bank spent billions to defend the rupee, its FOREX reserves fell from a peak of $8.1 billion in July 2011 to $6 billion by year's end.[4]

Despite the government saying it had $8 billion in foreign reserves, little did Sri Lankans realize then that over 80% of these reserves was borrowed money. For example, the country received $1billion in sovereign bonds, $500 million as development bonds, $1.8 billion from the IMF, and so on. This leaves the public pondering as to where that really leaves Sri Lanka in terms of the so called $8 billion reserves.

With the government trying to finance the rupee through borrowed money, the pressure on its foreign reserves began to mount. To top this off as the demand for imported goods is inelastic (i.e. demand is not sensitive to changes in the price of imported goods), nearing the end of 2011 Sri Lanka's trade deficit reached $9,710 million from $4,825 million in 2010, and was rapidly growing.[5] As this heightened the pressure on the country's foreign reserves, President Rajapaksa was finally forced to announce a 3% devaluation in the rupee-US dollar exchange rate during the Budget Speech on 21 November 2011, bringing the rupee down to 113.89/90. Though a depreciation of that nature was unanticipated at the time, the rupee was still highly overvalued. The International Monetary Fund (IMF) at the time believed that "the rupee is not less than 20% over-valued, however, the Central Bank has resisted calls by the Treasury and IMF to freely float it."[6]

## Problem Statement

What finally triggered the devaluation of the rupee to Rs.130 in April 2012 was a combination of factors.

- The primary trigger was the government's attempts to encourage consumption, and its undertaking of credit to keep fuel prices down and finance state enterprise losses, which led to increased consumption and increased foreign debt. The problems, therefore, arose due to such credit financed subsidies, or lost taxes, which were financed by more state borrowing.

- The Central Bank's and the government's endeavors to artificially control the rupee value (by financing it through sovereign bonds, IMF money, and other such forms of borrowed money) which was creating an erosion of the official foreign exchange reserves.

- The trade deficit and current account deficit which was heightening the pressure on foreign reserves and leading to an overall deficit in the Balance of Payments. Even after the 3% devaluation, "imports had increased by 50% over the 2010 value whilst exports had increased by only 22%, leaving a trade deficit over $4,000million"[7]

- The Balance of Payments deficit that could not be bridged through export earnings nor remittances; "last year's deficit was so large that the remittances plus increase earnings of tourism dollars was sufficient to cover only 60% of the divide."[8] The government tightly controlling interest rates, i.e. not letting it increase in order to maintain the feel-good factor. Thereby as consumption kept increasing at a rapid rate, the inflation rate was becoming harder and harder for the Central Bank to control.

As a result of the ongoing activities, the rupee could not be further sustained at a rate of Rs. 113 and had to be allowed to fight its own value. Accordingly, the Central Bank decided to float the rupee in February 2012. This is why by the end of April 2012 (over a very short period of time) the country saw the exchange rate depreciate from Rs. 113 to Rs. 133.

4. http://www.globalpeacesupport.com/2012/01/Sri-Lanka-Heading-Towards-Inevitable-20-Percent-Depreciation-of-the-Rupee/
5. www.ft.lk/2012.05/03/are-we-facing-a-rupee-crisis/
6. http://www.globalpeacesupport.com/2012/01/Sri-Lanka-Heading-Towards-Inevitable-20-Percent-Depreciation-of-the-Rupee/
7. http://www.nation.lk/edition/opinion/item/5703-rupee-depreciation-will-stop-as-overvaluation-ends.html
8. www.ft.lk/2012.05/03/are-we-facing-a-rupee-crisis/.

But what the public need to understand is that the crisis does not lie in the devaluation of the rupee, i.e. it is not a 'rupee crisis'. This was inevitable. "There is no crisis but rather economic problems"[9] The rupee had to be depreciated as it was clearly too expensive to artificially maintain an overvalued rupee. Some economists further argue that the rupee is still overvalued and still managed by the Central Bank; "as the demand for the rupee decreases due to suffering exports and an increase in the supply of rupees due to the increase in imports, left to market forces, this low demand and high supply would mean the rupee has no choice but to decrease further in value."[10] **Though inevitable that the rupee had to fall, the 'crisis' and blame therefore lies in the serious mismanagement and clear oversight of fundamental macroeconomic theories and tools by the appropriate authorities, and the lack of transparency in their actions and decisions made.** As opined by Economist Dr. Harsha de Silva MP, as the government was trying to artificially control both the exchange rate and the interest rate instead of allowing periodic or market-driven adjustments, the delay resulted in triggering a major crisis.[11] Accordingly, it is evidenced that if the rupee was left to market forces from the onset, the country could have significantly curtailed the dire consequences it is faced with today.

## The consequences of the rupee crisis

To put it into perspective "the rupee has depreciated 13.3% since the Central Bank stopped intervening to defend a specific price on 9th February 2012 and 16.3% from 21st November, when the government allowed a 3% devaluation."[12] A heavy devaluation, as which occurred over the past few month left the unsuspecting general public facing some very harsh consequences. With the rupee value falling from Rs. 110 to over Rs. 133 within months and interest rates rising, it has sent higher costs to people whilst also lowering growth. The public is now increasingly finding it difficult to afford basic commodities as the cost of living has become unbearable.

As foreign reserves fell to $5.9 billion in November 2011 the worry, at present, is if the country can survive with the $5.9 billion in reserves over the course of 2012 - especially, taking into account higher oil prices, rising cost of fertilizer, increasing consumer goods, and debt repayments. The IMF Sri Lanka Alternate Executive Director, Nandalal Weerasinghe, in April 2012, made a statement which suggests that the authorities would not be able to improve net international reserves by June 2012 as they had promised. Added to this, owing to the government's insistent borrowing over 2010 and 2011, the country now has a debt of $800 million on development bonds to repay by the end of the year. A calculation made by academician Dr. Prasanna Perera shows that foreign reserves have declined to an average of $500 million per month (by May 2012). Some economists argue that in actuality the value is even lower as the government has visibly failed to manage the budget. Dr Harsha de Silva further argues that "the problem will only worsen. We were told not to panic; that $574 million was coming in June 2012. But $500 million is Bank of Ceylon borrowings and we understand that they are talking about interest rates in the 7.5% region. Borrowing at this rate will put everyone else in Sri Lanka in trouble."[13] Such temporary solutions, i.e. knocking at the doors of the IMF and such global lenders, will only exacerbate the problem.

Though the authorities predicted that the currency will appreciate to Rs. 125 by the end of the first quarter 2012, it did not materialize. It has disillusioned public trust in the government. Furthermore, as a result of Sri Lanka's reputation for lacking transparency, poor governance systems, a highly unionized labour force, and the recently passed expropriation law, the country saw Foreign Direct Investment (FDI) undershooting the forecasted $750 million benchmark in 2011. Now with the sudden and drastic devaluation of the rupee, the level of confidence in both local and foreign investors has further declined. It is no secret that local and foreign investment began to flee the country in 2011 and 2012. And even though foreigners have been net buyers in the stock market this year, there is a clear decline and a significant strain on foreign reserves, thereby signaling a decline in Sri Lanka's economic activity.

The impact on the balance of payments has not been a satisfactory one either. Technically, as a currency devalues, the demand for exports should increase

9. Dr. Prasanna de Silva,TISL Sambhashana Discussion Forum 25.04.12,
10. Interview with Geetha Peiris
11. Dr. Harsha de Silva, TISL Sambhashana Discussion Forum 25.04.12,
12. www.ft.lk/2012.05/03/are-we-facing-a-rupee-crisis/.
13. Dr. Harsha de Silva, TISL Sambhashana Discussion Forum 25.04.12,

(as monetarily exports are more competitive) while demand for imports decrease (as the price of imports rise). This is why export dependent countries, with a dynamic and efficient export industry, are able to reap copious benefits following a devaluation of its currency. Sri Lanka, on the other hand, is an import dependent country, with an inelastic demand for imports. Sri Lanka imports all its essential goods from food, such as flour, infant milk, wheat, sugar, dhal, to its energy needs, e.g. coal, oil. Therefore, with the depreciation of the rupee, the demand for imports did not decrease. With the rupee at 133 to the dollar and the price of imports substantially higher, the general public are now forced to battle with both economic and social problems, such as a higher rate of inflation, an erosion of purchasing power and real incomes, a rising interest rate and tightening of credit, a decline in the standard of living and more.

On a positive note, the country did manage to see exports rise. However, Sri Lankan exports have very little value addition. The import content of raw materials used in exports is very high. For example, "inputs into its largest export, textiles, are imported – it does not manufacture the yarn or the capital goods necessary to produce the finished good."[14] Thus it is argued that up to 90% of the product value is imported. Even goods which are technically known to have high value addition (rubber, for instance) in the end use a high percentage of imported intermediary goods, such as fuel and machinery, which increases cost of production, increasing price and thereby reducing competitiveness in the international marketplace. Furthermore, Sri Lanka's largest export markets (the US and the EU) are currently facing weak economic growth, export competitors have been able to increase cost efficiency, and export competitors have also been able to make use of devalued currencies, thus leaving Sri Lanka far behind in terms of a competitive export sector. Recent figures have shown that, both exports as a percentage of GDP, and Sri Lanka's share of global exports, have been declining. This is a clear indication of the lack of competitiveness of Sri Lankan exports, and a reaffirmation that this limited advantage in the countries' export sector (due to the change in the exchange rate) has not been able to offset the huge disadvantage set off by the import sector on the balance of payments, the current account, the exchange rate, on the foreign reserve, and the standard of living of the ordinary masses.

The repercussions of the devaluation of the rupee have also left the country facing a lower economic growth and an increase in income inequality. It has been evidenced that "despite a projected economic growth rate of 7.5% for 2012, its South is expanding at a slower rate while the Northern and Eastern provinces are growing at double digits, albeit from a low base."[15] Economists also argue that the veracity of growth data is subject to much doubt.

The citizenry, as mentioned before, are facing innumerable difficulties. Hence it is indisputable that today Sri Lanka is by and large undergoing an economic crisis. What is important to understand is that the crisis is not that the rupee depreciated; rather the crisis lies in the authorities' mismanagement of the economy which led to the rapid devaluation and the detrimental consequences that followed. It is also undeniable that, if like other export efficient countries Sri Lanka is able to maximize the benefits of a lower currency the citizenry and authorities wouldn't be calling this a crisis at all.

## Statement of Position

In consideration of all the above factors the Position taken is that -

- The government must invest in ensuring that Sri Lanka's export industry becomes a competitive player in the global market. To do this, issues of inefficiency and corruption should be addressed. The government should also invest in mechanizing the agricultural sector and improve logistics, which would help increase production. The manufacturing and agricultural sector, therefore, should be revamped in order to improve Sri Lanka's export returns.

- The trade deficit, current account deficit, and balance of payments deficit need to be reduced. This cannot be achieved through the short term approaches the government has been following up to date, such as borrowing more money. As borrowing money does not reduce the current

14. http://www.globalpeacesupport.com/2012/01/Sri-Lanka-Heading-Towards-Inevitable-20-Percent-Depreciation-of-the-Rupee/

15. http://www.globalpeacesupport.com/2012/01/Sri-Lanka-Heading-Towards-Inevitable-20-Percent-Depreciation-of-the-Rupee/

account gap, it expands it, because when the proceeds are spent it causes items in the current account to be imported. Unless long term approaches are taken into consideration, such as allowing the rupee and interest rates to freely float and letting market adjustments take place at its own pace, Sri Lanka is going to face further economic crises.

- The government also needs to start paying off the debts and make hard choices in terms of conserving foreign exchange reserves. To do this the government and Central Bank have to avoid making populist decision.

- There is a consensus amongst economists that Sri Lanka is in need of a change in its economic policies, if it is to ever overcome the crises faced today and develop wholeheartedly as a nation.[16] Therefore, an important policy prescription, in order to overcome the present situation and rebuild the Sri Lankan economy, is one that entails a complete overhaul or at least an adjustment of the economic tools presently used by the Central Bank and government.

- If the country is to ever achieve sustainable economic growth, it is vital that the treasury (Ministry of Finance) and the Central Bank begin to function as transparent and accountable bodies; so that the voting public of Sri Lanka is not kept in the dark when important economic decisions are made, or in the case of the rupee crisis, when timely economic decisions are failed to be made.

- July 2012 -

16. TISL Sambhashana Discussion Forum 25.04.12

TISL under its Sambhashana outreach programme held a discussion on the Rupee Crisis on 25 April 2012. The panelists were Dr. Harsha De Silva MP, University Lecturer Dr. Prasanna Perera and Economist R.M.B.Senanayake with Nisthar Cassim, Editor Daily FT as moderator.

Transparency International Sri Lanka
6, 37th Lane, Queen's Road, Colombo 3

Phone: 011 4369781 - 3
Fax: 011 2506419
Email: tisl@tisrilanka.org
www.tisrilanka.org