The Pathfinder Economic Alert

Exchange Rate Policy in Sri Lanka

The Government of Sri Lanka has set the target of doubling per capita GDP to US$ 4000 by 2015. This requires accelerating growth to 10% and increasing the investment ratio to 40% of GDP. In 2005 – 09, they averaged 6% and 27% respectively.

The government's growth target, therefore, requires an increase in investment of 13% of GDP. This can only be generated from private investment, domestic and foreign, as public investment cannot increase above its current 6 – 7% of GDP without exacerbating the twin problems of excessive budget deficits and high levels of public debt.

A realistic exchange rate is a crucial element of the policy framework necessary for increasing private investment. Depreciation of the rupee was an important element of the liberalization package of 1977. The intention was to boost growth and development by increasing the competitiveness of Sri Lanka's export and import competing sectors. However, this objective has been undermined for much of the subsequent 33 years by inflationary pressures stemming from an endemic structural budget deficit which has fuelled excessive aggregate demand in the system. This has resulted in the exchange rate being used as an anchor against inflation rather than as an instrument to maintain/enhance the competitiveness of the economy. Consequently, the exchange rate has not been adjusted to reflect the inflation differentials (i.e. differences in cost structures) between Sri Lanka and its major competitors and trading partners. An over-valued exchange rate is not only a disincentive for exporters but also provides an implicit subsidy to foreign producers at the expense of local producers of import competing goods and services.

In the new millennium, inflation averaged 9% per annum during 2000 – 2003 and the exchange rate (LKR/USD) was depreciated by an average of about 7% per year in this period. In 2004 - 2009, the corresponding figures were 12% and 2.3% respectively. During this period many of Sri Lanka's competitors and trading partners enjoyed lower levels of inflation. The loss of competitiveness stemming from the resulting over-valuation of the rupee has reduced the capacity to accelerate growth, investment and employment on a sustainable basis. Instead, growth, investment and employment have been driven by public expenditure leading to an unsustainable budget deficit and a worrisome debt level. The lack of fiscal space has now placed an even higher premium on creating a conducive enabling environment for private investment-led growth and employment creation.

However, it is difficult to maintain a competitive exchange rate when the budget deficit is fuelling excess demand. Depreciating the currency in such a context merely raises the spectra of

triggering an inflationary spiral. This stems from the high import component of the basic consumption bundle and the high import coefficient of exports. More recently, there have also been concerns regarding the impact of currency depreciation on the budget through the increase in the rupee equivalent of external debt service payments.

A key lesson from Sri Lanka's exchange rate experience is that it is difficult to maintain a stable and competitive exchange rate without addressing the underlying problem of persistent budget deficits. Realignment of the nominal exchange rate cannot determine the course of the real exchange rate, if budget deficits are a systematic source of macroeconomic instability.

In recent months, the upward pressure on the value of the rupee, through increased capital flows and healthy official external reserves, has raised concerns regarding the "Dutch disease." The comfortable reserves are largely a function of import compression in a low growth year (2009); increased remittances; and most significantly higher levels of external borrowing. This means that, to a large extent, they are not "earned." When exchange rate movements are based on capital flows and do not reflect cost differentials between a country and its major competitors and trading partners, the economy loses competitiveness (both exports and import competing goods and services) and becomes hollowed out. This happened to the Netherlands in the 1980s following an increase in capital flows, as a result of the discovery of oil and gas- hence the reference to the "Dutch disease."

In summary, a competitive exchange rate is an essential element of the package of policies that are now required to promote the private investment, domestic and foreign, needed to meet the government's growth and development targets. A stable and competitive exchange rate cannot be achieved without the fiscal consolidation essential for achieving an economic environment with lower inflation and inflationary expectations.

In the past, it has been difficult to summon the political will to address the budget deficit in the context of sustaining a 30 year war effort and the pressure for populist policies in a polity which has been highly competitive and adversarial. The end of the war and the emergence a strong government provides a timely opportunity to tackle the challenge of fiscal consolidation effectively and create a more stable framework for maintaining a competitive exchange rate. A key element of East and Southeast Asia's success has been the ability of these countries to maintain fiscal discipline and a competitive (often under-valued) exchange rate. It is noteworthy that the Philippines, which has experienced greater fiscal instability, has been one of the less successful countries in the region.

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