THE EXCHANGE RATE POLICY OF SRI LANKA AND ITS IMPLICATIONS ON THE EXPORT SECTOR 1981 – 1988

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(The views expressed in this article are those of the author and in no way represent the views of the EDB.)

Introduction

With the collapse of the Brettonwood system in the early 1970's exchange rate policy has been considered an active instrument in the management of the economy by many a Government. For instance Professor Lakshman points out in his study that prevailing systems vary from independent or managed floating to single currency pegging or basket of currency pegging. The Sri Lankan Rupee since 1982 has been linked to a major currency and adjusted according to the developments in the foreign exchange market. (Lakshman 86:2)

The exchange rate has been considered a vital policy instrument in the development of the export sector. From a theoretical perspective, a depreciation of the Rupee will result in an increase in the price received by exporters in local currency. In a "small country" case, it is assumed that the changes in the exchange rate will not affect the international prices of the exports or the imports. This is due to the fact that the market share of a small country is marginal and cannot have an impact on the aggregate supply or demand.

Therefore, a depreciation is a market signal for exporters to increase their volume of exports. Invariably, with a depreciation, foreign exchange in terms of Dollars will decline unless and otherwise the supply is responsive to the changes in rupee returns of the exporters. The favourable effects of the depreciation will have to trickle down to the producers or the manufacturers if this process is to take place. A "realistic exchange rate", that is, a depreciating exchange rate, is considered a pre-requisite for the creation of a conducive investment climate for the export sector, specially in the developing countries.

More than the Nominal Exchange Rate (NER), which is the officially declared rate, it is the Real Effective Exchange Rate (REER) that indicates the impact of an exchange rate policy on exports. The rate of inflation vis-a-vis the trading partners and the net subsidy (Subsidies minus Taxes) will have to be taken into account.

The depreciation of the Rupee indicates that for one unit of foreign currency more units of rupees should be paid. In other words the exporter who earns foreign exchange will receive more in terms of Rupees when the rupee is depreciating and conversely importers have to pay more in terms of Rupees for one unit of Dollar. Therefore, a depreciation would result in an increase in the profitability of the exporters while discouraging the import sector.

The effects of a depreciation can be viewed in terms of elasticities. The traditional approach is contained in the Marshall–Lerner condition which states that "the sum of elasticities of demand for a country's exports and of demand for its imports has to be greater than unity" for a depreciation to have a positive effect on a country's trade balance. (Sodersten:279) Nevertheless in a developing country like Sri Lanka, it is assumed that the demand for our export products is elastic. In other words, the international market can absorb whatever amount we supply as our supply levels are insignificant.

However, the favourable effects of the depreciation will be eroded by inflationary trends. If domestic inflation is comparatively higher than the inflationary trends of the trading partners, the desired results will not be achieved.

Scope, Methodology and Limitations

The scope of this paper is confined to the movements of the real exchange rates and the behaviour of price and volume indices of exports and imports. Therefore, in order to evaluate empirical evidence of exchange rate policy in Sri Lanka, the real exchange rate indices and the trade indices have been analysed.

Due to the inability to obtain information pertaining to subsidies and taxes, the effective rates have not been computed. The reasons being that some of the subsides granted by Government agencies are product specific and the taxes are often applied on an individual basis. Therefore, a generalisation will conceal the actual situation.

The period under review is 1981-1988 and the base year for the computation of all indices is 1981.

Real Exchange Rate Movements

According to the real exchange rate indices (Table 1A) for the trading partners, the Sri Lankan Rupee had appreciated drastically from 1981 – 1984 against all major currencies; that is the US Dollar, the Sterling Pound, the Deutsche Mark, the Yen and the French Franc. However, since 1984, they had shown a positive depreciation and after 1986 they have exceeded even the 1981 level. The rate of depreciation with regard to the French Franc, the Deutsche Mark and the Yen are notably higher than for the two major currencies, the Dollar and the Pound.

The real exchange rate vis-a-vis some of our competitors, (Table IB) that is, India, Pakistan, Philippines, Singapore, Korea and Thai-

land, too had taken a dip since 1981 and reached the lowest in 1984 indicating an appreciaiton of the Sri Lankan Rupee against the major competitors. As a result, the profitability of the Sri Lankan exporters vis-a-vis the competitors would have eroded. However, since 1984 they too had recorded a depreciaiton. Yet except for the Philippines peso, others had not reached the 1981 level.

As discussed earlier, the depreciation is indicative of the fact that the Sri Lankan exporters get more Rupees for their foreign exchange earnings, provided the Dollar price or the price in terms of foreign currency remains the same.

In the short term, the profitability will be increased. It will undoubtedly be a signal for the exporters to increase their supply levels.

Export Price Indices

If the international prices remain the same, theoretically when there is an appreciation, the export price index should show a decline. With a depreciation, the export price index should reflect an upward trend.

However, according to the empirical evidence, at the height of the appreciaiton, the export price index had reached a peak in 1984;specially in respect of tea, rubber and coconut. (Table 2). This is an indication that the international prices were very favourable during that period.

In spite of a depreciation, the price indices had declined for precious stones, coconut products, and tea in 1985 and 1986. The price indices of minor agricultural products, and the industrial products had shown an upward trend throughout the period under review, indicating that the exchange rate had not shown much of an impact on the price even when the Rupee was appreciating. It is evident that Sri Lanka is a price taker.

However, some of the exporters claim that when there is a depreciation they reduce the prices to be more competitive. If this measure is not coupled with an expansion in the supply level the depreciaiton will result in a decline in foreign exchange earnings. This is not desirable considering the chronic Balance of Payment problems the country is confronted with at present.

Export Volume Indices

With the depreciation of the Rupee the desired result should be an expansion in the export supply levels. This trend has not been reflected in product sectors such as rubber, and minor agricultural products during the period as they had depicted a continuous decline. Even in tea, the increase had been marginal. The supply of agricultural products are more dependent on the weather patterns of the country.

The supply position had reflected positively an upward trend in the product sectors, such as precious and semi precious stones and in industrial sector products. However, precious stones being high value items, it is the price index more than the volume index that should be considered an indicative factor. (Table 3)

Analysing the real exchange rate, export price and volume indices, we could deduce that a depreciation

Table 1A

INDEX OF REAL EXCHANGE RATE
(1981 = 100)

	US$	*UK£*	*DM*	*J.YEN*	*FRENCH FRANC*
1981	100.0	100.0	100.0	100.0	100.0
1982	100.3	90.3	99.3	100.0	93.5
1983	95.4	78.9	81.9	87.5	77.6
1984	81.3	56.6	61.3	62.5	64.3
1985	99.4	83.4	84.3	88.3	90.3
1986	102.9	103.1	118.8	118.7	122.3
1987	117.7	112.5	133.5	125.1	135.8

Source: *IFS, Central Bank*

Table 1B

INDEX OF REAL EXCHANGE RATE
(1981 = 100)

	Indian Rupee	*Korea Won*	*Pakistan Rupee*	*Phillippines Peso*	*Singapore Dollar*	*Thai Baht*
1980	108.0	90.0	94.3	97.9	94.5	105.5
1981	100.0	100.0	100.0	100.0	100.0	100.0
1982	94.8	96.7	79.4	97.4	89.7	99.2
1983	89.6	86.7	76.2	69.4	80.5	95.1
1984	69.8	70.0	61.7	69.7	65.1	65.1
1985	90.1	81.0	73.7	98.3	77.7	84.5
1986	98.1	83.3	80.0	103.3	68.4	84.8
1987	94.8	84.0	77.1	103.5	73.3	93.2

Source: *IFS, Central Bank*

Table 2

EXPORT PRICE INDICES
1981 = 100)

Categroy	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
1. Tea	89	95	100	99	147	218	167	123	146	155
2. Rubber	89	97	100	81	101	119	97	108	125	169
3. Coconut Products	90	104	100	80	101	171	127	89	116	163
4. Minor Agricultural Products	85	93	100	110	130	137	141	148	154	180
5. Precious and Semi--precious Stones	111	105	100	95	83	84	99	43	53	31
6. Industrial Products	80	89	100	111	122	123	140	203	222	263
7. Petroleum Products	55	76	100	96	120	131	143	69	92	71
All Exports	82	92	100	98	125	160	142	126	146	166

Source: *Central Bank of Sri Lanka*

does not necessarily mean an improvement in the export prices. If the depreciation is not reflected in the prices, the benefit of the depreciation would have been transferred to the buyers abroad. In the alternative there is a possibility of exporters under-valuing their invoices in order to retain foreign exchange in the importers country or transfer it into an account in another developed country. Either way, it will definitely be a strain on the foreign exchange earnings of Sri Lanka.

With a depreciation in the Rupee, if the supply of export goods remains inelastic, the desired results would not be achieved in the long run. In fact, the Balance of Payments problem will further deteriorate.

Import Indices

If the rupee is appreciating, imports will be comparatively cheaper while a depreciation will cause the prices of imports to escalate. This trend is not quite apparent when examining the exchange rate indices and import price indices. During the period when the Rupee was appreciating against major currencies in 1981-1984, the price indices for the intermediate and investment goods reflected upward trends. (Table 4)

The import price indices had increased at an accelerated rate for all import product sectors after 1984 due to the depreciation. There was an exception in the case of the intermediate goods which recorded a downward trend in 1986, inspite of the depreciation. This could have been caused by the declining international price trends of Petroleum Products, Which constitute a major portion of the intermediate goods.

The volume indices (Table 5) pertaining to consumer goods and intermediate goods, has recorded a continuous increase during the period under review. Even the depreciation since 1984, had not been able to arrest this upward trend. The decline in the volume index of investment goods may not necessarily have been due to the exchange rate depreciation. It can be attributed to the deceleration of the development activities in the Mahaweli and construction sectors.

These observed trends, the volume increase combined with the depreciation, would undoubtedly have brought about a leakage in foreign exchange from the country. Furthermore, the depreciation since 1984 is not reflected in the volume indices of imported products. The volume indices in respect of intermediate and consumer goods indicate a general upward trend. It is an indication that the increase in import prices is not a curtailing factor.

Import Intensity

According to the Government's

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(1981 = 100)

Category	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
1. Tea	85	100	100	99	88	112	111	117	113	123
2. Rubber	97	93	100	99	98	96	91	84	80	75
3. Coconut Products	131	83	100	130	132	86	165	171	123	61
4. Minor Agri-Cultural Products	76	70	100	92	81	71	61	68	72	98
5. Precious and Semi-precious Stones	147	144	100	240	376	280	292	1,385	1,424	3,954
6. Industrial Products	58	74	100	107	123	188	173	148	173	168
7. Petroleum Products	116	130	100	102	74	84	87	114	85	113
All Exports	89	95	100	105	99	116	120	128	130	130

Source: *Central Bank of Sri Lanka*

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1980	108.0	90.0	94.3	97.9	94.5	105.5
1981	100.0	100.0	100.0	100.0	100.0	100.0
1982	94.8	96.7	79.4	97.4	89.7	99.2
1983	89.6	86.7	76.2	69.4	80.5	95.1
1984	69.8	70.0	61.7	69.7	65.1	65.1
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Source: *Central Bank of Sri Lanka*

programme document "PUBLIC INVESTMENT 1988-1992" the dependence on imported raw materials in the manufacturing sector in 1985 was 89 percent, (page 62): The policy-makers or the economists who advocate the depreciation/ devaluation for the development of the export sector may have to bear in mind the import intensity of the non-traditional export product sector, which is approximately 65 per cent.

If we consider certain fiscal incentives, namely the Duty Rebate Scheme, the Manufacturing-in-Bond Scheme and the Machinery Exemption Scheme for exporters, it has been accepted that imported inputs are quite vital to the production of export goods. Therefore, a depreciation will make such inputs more expensive, thus increasing the cost of production.

Table 5

IMPORT VOLUME INDICES
(1981 = 100)

Category	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
1. Consumer Goods	150	149	100	94	142	125	147	156	144	163
1.2 Food and Drink	197	165	100	77	136	175	174	154	183	
1.2 Other Consumer Goods	84	116	100	124	151	113	115	136	133	136
2. Intermediate Goods	81	97	100	101	96	108	105	129	136	151
2.1 Petroleum	85	109	100	114	78	113	98	96	105	109
2.2 Fertilizer	83	129	100	43	35	53	73	80	73	134
2.3 Chemicals	96	94	100	98	113	142	130	194	166	177
2.4 Wheat	26	39	100	70	85	77	140	99	83	134
2.5 Textile and Clothing	81	83	100	84	88	95	107	199	220	340
3. Investment Goods	82	117	100	103	127	125	90	94	99	79
3.1 Machinery and Equipment	73	108	100	93	119	119	98	92	94	66
3.2 Transport Equipment	133	177	100	147	147	131	56	124	126	121
3.3 Building Materials	83	137	100	90	174	126	118	77	73	90
All Imports	94	111	100	100	110	114	109	124	127	130

Source: *Central Bank of Sri Lanka*

Even the Terms of Trade were very favourable in the year 1984, the best for the period under review. Therefore, it may require more concerted efforts of the Government agencies concerned with the development of exports to review the present policies to eliminate some of the conflicting aspects of the present policy package.

Table 4

IMPORT PRICE INDICES
(1981B = 100)

Category	1979	1980	1981	1982	1983	1984	1985	1986	1987	1998
1. Consumer Goods	65	85	100	96	91	93	101	107	126	149
1.1 Food and Drink	53	81	100	87	80	75	75	80	96	117
1.2 Other Consumer Goods	94	93	100	118	118	137	164	173	202	229
2. Intermediate Goods	62	83	100	105	112	119	128	98	111	126
2.1 Petroleum	43	77	100	103	105	108	113	63	78	71
2.2 Fertilizer	69	85	100	91	121	138	140	113	132	114
2.3 Chemicals	84	94	100	113	115	121	132	130	149	165
2.4 Wheat	61	76	100	101	102	114	110	108	91	117
2.5 Textile and Clothing	74	84	100	113	137	141	166	114	128124	
3. Investment Goods	90 98	100	11	117	120	133*	173	187	265	
3.1 Machinery and Equipment	93	101	100	111	117	117	129	168	191	293
3.2 Transport Equipment	84	96	109	116	113	123	145	159	202	
3.3 Building Materials	76	82	100	117	122	127	136	207	203	219
All Imports	68	96	100	104	109	114	123	114	129	157

Source: *Central Bank of Sri Lanka*

It should also be noted that the escalation in petroleum prices will cause an increase in the general price levels of the country. It would erode the profit margins of the exporters.

In analysing the Trade Balance, inspite of the movements in the real exchange rate with regard to the major currencies, the value of imports has reflected a persistent upward trend. Ironically the Trade Balance had recorded a vast improvement at the height of the appreciation. Since 1985, with a depreciating exchange rate, there does not seem to be an imporvement at all.

Conclusion

In this paper, I have examined the **hypothesis that a depreciating exchange rate will result in an improvement in the export performance** in terms of prices and volume.

However, the empirical evidence suggests that either an appreciation or a depreciation does not have a significant impact on the demand of imports or the supply of exports in the case of Sri Lanka.

Moreover, due to the high dependence on imported inputs, the cost of production of export goods escalates. Furthermore, more than 75 percent of the imports comprise intermediate and investment goods. Considering the limited resource endowments of our country, the curtailment of these goods would retard development efforts.

An exchange rate policy may not be the vital factor in the development of the export sector. A vigorous export marketing programme coupled with a concerted development effort of the supply base may improve export performance. A cohesive and a realistic export policy at the national level and a subsequent strengthening of the institutional structure may ensure better performance.

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