

The Economy

The Rupee Depreciates

A significant development in recent months has been the continuous depreciation of the external value of the Sri Lanka Rupee. It is now quite clear that gradual depreciation is being deliberately used as a corrective to the deteriorating trade and payments situation of the country. A part of the burden of adjustment is to be borne by the exchange rate. It is also quite clear that gradual depreciation in small daily doses is being preferred to an once-and-for-all official act of devaluation.*

During the period January-October this year, the Rupee has depreciated by 12 per cent against the US Dollar, 19 per cent against the British Pound, 22 per cent against the Japanese Yen, and 16 per cent against the Indian Rupee. (See Table I below). All indications are that this trend of depreciation would continue for the next few months. It is widely speculated that the depreciation would continue in stages until the Rupee value of the US Dollar reaches at least Rs. 20, at which rate the Rupee value of a British Pound would probably be in the range Rs. 46-48 (the exact rate depending on the dollar-pound parity prevailing in world money markets).

The new exchange rate system established on November 16, 1977 started out with a Rupee value of the US Dollar at Rs. 16 and a Rupee value of the British Pound at Rs. 29. In the ensuing period up to the middle of this year, while the Rupee value of the dollar remained fairly stable within a narrow range of Rs. 15.50 to Rs. 16, (that is a fluctuation of no more than about 3 per cent), the Rupee values of all other major currencies recorded substantial increases (in varying degrees). Thus, by June 1980, the Pound had risen to over Rs. 37 and the German Mark to over Rs. 9, indicating a Rupee depreciation of 22-23 per cent rela-

tive to the original levels of November 1977. Given the fact that the Rupee maintained a relatively stable value with the dollar, these changes essentially reflected the appreciation of the Pound and the Mark (relative to the dollar) in world money markets. Beginning from about July this year, a distinct change in this picture began when the Rupee value of the dollar crossed the hitherto existing upper limit of Rs. 16 and began to move upwards. By mid-September the value had exceeded Rs. 17 and by end October it was fast approaching Rs. 18. Corresponding changes took place in the Rupee values of other major currencies. The position in late October when compared with the exchange rates set on 16 November 1977 shows that the Rupee had depreciated by 33 per cent against the Pound, 25 per cent against the German Mark, 22 per

cent against the Japanese Yen, 20 per cent against the Indian Rupee, and 9.3 per cent against the US Dollar.

Behind the Rupee depreciation are factors such as the unprecedentedly high domestic inflation, soaring import bill and the widening foreign trade gap. It is a well known theory in international economics that a devaluation can be expected to achieve the desired results (that is promoting exports and curbing imports) only if the domestic inflation can be kept under control. Inflation by raising the cost of exports and making imports attractive to relative domestic production, will offset the effects of a devaluation. In Sri Lanka, the available evidence indicates that inflation which was running over 20 per cent in 1978, rose to around 30 per cent in 1979. There are no prospects for a lower rate of inflation in 1980. Inflation rates of such magnitudes are far higher than those commonly found in countries with which Sri Lanka trades. When a country inflates faster than its trading partners, imports will be encouraged and the

TABLE I External Value of the Sri Lanka Rupee Value of Rs. 100 in Foreign Currencies

	US Dollar	British Pound	German Mark	Japanese Yen	Indian Rupee
1977 November 16	6.25	3.44	14.08	1536	54.05
1978 January*	6.51	3.34	13.79	1574	52.63
1979 January	6.44	3.23	12.03	1299	53.19
1980 January	6.44	2.85	11.16	1538	51.55
February	6.35	2.78	11.21	1582	50.51
March	6.15	2.83	11.83	1536	50.51
April	6.24	2.75	11.24	1488	49.75
May	6.27	2.65	11.09	1397	48.54
June	6.22	2.66	11.00	1359	49.02
July	6.14	2.62	10.92	1395	48.31
August	5.95	2.49	10.67	1303	46.08
September	5.81	2.43	10.54	1231	45.45
October 24	5.67	2.31	10.57	1202	43.10
Rupee Depreciation during January — October 1980 (%)	12.0	19.0	5.3	22.0	16.4
Rupee Depreciation during November 1977 — October 1980 (%)	9.3	32.8	24.9	21.7	20.3

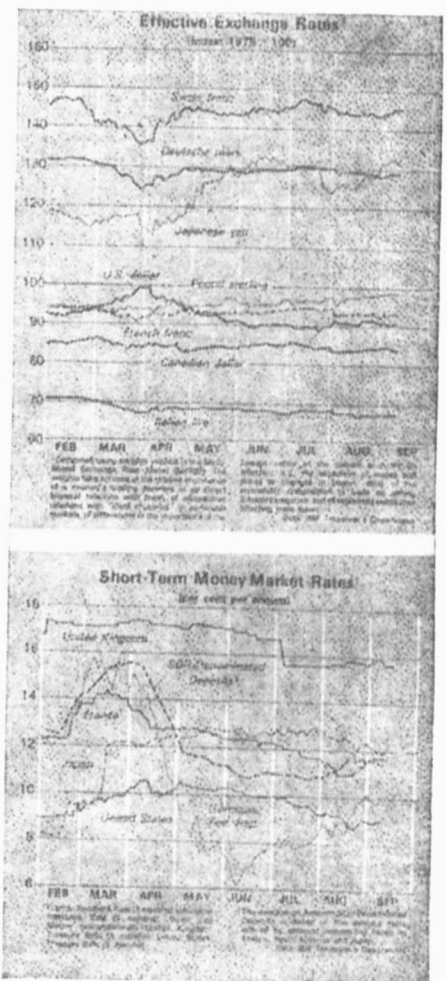
* End of month

competitiveness of exports will fall. In such a context, further rounds of devaluation/depreciation are required to recover the lost ground. If inflation continues unabated, a vicious circle of devaluations can follow — exchange rate depreciations leading to further inflation and further depreciation of the rate in an endless succession.

* The term 'devaluation' refers to a decrease in the external value of a currency by government decree, and usually done by a considerable fraction at a time. Any consideration of such a change is usually shrouded in secrecy and even denied publicly in order to prevent speculative activity. When an exchange rate is not fixed but is allowed to fluctuate, a drop in the external value is referred to as a 'depreciation'. Such changes are usually continuous and involve small movements practically each day. It is a process spread over a period in contrast to a discrete adjustment involved in a devaluation.

In an open economy such as that prevalent in Sri Lanka, where the propensity to import is high, a substantial portion of the domestic inflationary pressures is likely to leak out by way of higher imports. The import content in consumption is likely to be particularly high in the case of those social groups who have experienced substantial income expansion from trade, commerce, transport and construction in recent years. Demand induced domestic inflationary pressures will necessarily inflate the import bill. Moreover, the accelerated development programmes in the public sector (the lead projects) carry a substantial import content. The rise in petroleum prices have further inflated the import bill. The total import bill of the first seven months of 1980 (January-July) at Rs. 19.4 billion shows an increase of 55 per cent over the level recorded in the corresponding period of last year. The trade gap of these seven months has approached a level of nearly Rs. 10 billion which was 130 per cent, more than the trade gap of the corresponding period of 1979. In fact, the trade gap of these seven months was even more than that of the whole of 1979 by as much as 36 per cent.

Compared with the escalating import bill, export earnings (in particular the major exports) have remained sluggish. A major breakthrough in the export field remains as yet a distant goal. As seen in Table 2, the extent to which exports have financed the import bill has successively declined over the years. During January-July 1980, export earnings were adequate only to finance about one-half of the import bill as against 87 per cent in 1978 and 68 per cent in 1979. Earnings from tourism and the inflow of foreign transfers (in particular the remittances from migrants in Middle eastern countries) have shown a distinct improvement, but these have made only a marginal contribution to the financing of the yawning trade gap. Foreign loans and aid have continued to be the principal source of financing the trade gap. However, all indications are that mobilisa-



The depreciation in the value of the rupee has to be viewed closely within the context of the changing rates in the major international currencies. The above chart from the IMF's fortnightly bulletin, "IMF Survey", of September 15, 1980 clearly indicates the trends. Most apparent is the steady rise in the strength of the pound sterling, which over the past 1½ years has appreciated by 20 per cent. By contrast we observe the weakening position of the US Dollar; its weakening position vis-a-vis the other currencies and the SDR are evident in the above illustration. The broad picture that emerges, however, is the basic indiscipline within the international monetary structure, which some analysts forecast could cause further destabilisation and excessive movements in exchange rates in the future. Various attempts are being made to deal with these problems though not much has yet been effected.

tion of foreign aid has reached the maximum possible levels, particularly in the context of the global recession that the world economy is passing through today. In this context, the import bill cannot obviously continue to soar in the future in the way that it has behaved in the past few months. The

country may have to be more selective in future as to what to import and to what extent. Coupled with the exchange rate depreciation (which attempts to regulate the overall import volume, the success of which depends on the ability to control the inflation), an element of rationalisation may have to be introduced into the import structure to give better incentives to local production. At present the structure of incentives appears to be heavily weighted in favour of more imports and not less and as a result import competing domestic production has remained sluggish, if not declined.

TABLE 2 Summary of Foreign Trade (Rs. Million)

	Exports	Imports	Trade Deficit	Exports as % of Imports
1978	13,193	15,100	1,907	87
1979	15,282	22,570	7,288	68
1979 (Jan-July)	(8,191)	(12,499)	(4,308)	(66)
1980 Jan-July	9,474	19,378	9,904	49