THE CURRENCY CRISIS OF 2008/2009

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The main elements in macro-economic equilibrium are the components of Aggregate demand and Aggregate Supply. The condition for equilibrium is the equality of Aggregate Demand and Aggregate Supply. The balance between the two depends on the Saving-Investment gap. In equilibrium the two are equal. But in an open economy there are imports and exports of goods & services as well as unilateral transfers where residents may give gifts or provide other monetary benefits to foreigners without receiving money in return. Our migrant employees who remit money to the country are an example of unilateral transfers.

When the trade in goods & services and unilateral transfers are included there is the Current Account of the balance of payments. The government may also receive grants which enter the current account. The last year we had a current account surplus was in 1977. (US$144.1 million) Since then we have run deficits which have ballooned over the years and last year it was US$ 3775 million. These deficits are after taking into account the migrant employees transfers. Such deficits can be funded by depleting Foreign Exchange Reserves or by attracting foreign captial either in the form of borrowings or as an equity by either the government or by the private sector or both.

The balance of payments has two major components: the current account (which is basically imports and exports) and the capital account (which is basically investments in this country and foreign countries). The two components generally offset each other (for the most part). Freely fluctuating exchange rates will impact both of these components because the price of the currencies will fluctuate. But a freely fluctuating exchange rate affects the two components in opposite directions. Assume dollars and Rupees. If the dollar costs less Rupees imports will be cheaper but exports will be expensive for foreigners. If dollar costs more in terms of Rupees the cost of imports will rise and exports will be cheaper for foreigners. This condition will reduce imports and increase exports, thereby improving the current component of the balance of payments. However, if dollars are cheaper, investments in the country will be less expensive for locals but if the dollar means more Rupees then it's cheaper for foreigners to invest here. Whether they will actually invest here or not depends on other factors. But if they decide to invest then the capital account balance will move in the opposite direction from the current account balance. The Central Bank has largely ignored the current account deficit in the balance of payments because there has been a surplus in the over-balance of payments. When the oil prices rose sharply in 2007 the country's current account deficit deteriorated sharply more than doubling from the level of 2007 which as $1401 million. Even the over-all balance worsened into a deficit of $ 1225 million in 2008. Foreign aid from multilateral institutions like the World Bank and the ADB had declined and in any case those funds were earmarked for projects and could not be used for general purposes. Such funds are also received after the Rupee expenditure has been incurred by the government. The government implementation of projects and the consequent utilization of project aid are notoriously slow and inefficient.

The global Financial Crisis affects Sri Lanka

The global financial crisis affected the country by August 2008 onwards. Foreigners had invested previously in our stock market which had been opened up in a limited way several years ago. In December 2007 the Central Bank decided to allow foreigners to invest in Treasury bills and Bonds also and raised the ceiling imposed earlier on such investments. This contributed to the lowering of yields on Treasury securities of short term maturity. This is the advantage of allowing foreign capital inflows to the country. The corporate sector too will be able to borrow cheaper. Of course there are risks in liberalizing the capital account. But with prudent macro-economic management these risks can be minimized. The contry received inflow of US$ 300 million approximately during this period. But when the global financial crisis worsened, foreigners started selling their bills and bonds in the secondary market and repatriated their money in foreign exchange. They expected a depreciation of the Rupee but the Central Bank preferred to hold the Rupee and lose the Foreign Reserves instead . Foreigners also started selling their stocks in the stock market and repatriating the foreign currency proceeds. The figures of such withdrawals from the bond market are not available but likely to have been about $200 million. The drain from the stock market was less but also significant. Their decision was moved by both pull and push factors. The bankers in their home countries were calling in loans and stepping up margin calls and the crisis in the balance of payments which had now spilled over to a deficit in the over-all balance of payments was undermining their confidence in the Rupee and the country's ability to repay foreign loans. The Sovereign Bond issued earlier, traded in Singapore at a significant discount. There was fear that the Rupee would have to be sharply depreciated and cause foreign investors capital losses on their investments in stocks and bonds in the local market. The Central bank Governor did his best to reassure them that there would be no depreciation and he held the Rupee stable. But the foreign investors had no confidence and took out their money as the Rating agencies also downgraded the sovereign rating.

Global economic recession

The global financial crisis was followed by an economic recession in the developed countries. Commodity prices fell in the latter half of 2008 just as oil prices fell during this period. The national tea sale average price fell from Rs 335 per kilo in June to Rs 263 by October 2008. There was a similar collapse of rubber prices. So export earnings fell along with the draining of foreign exchange from the bond and stock markets. The Central bank held on to the value of the Rupee and sold a huge amount of dollars to keep its value unchanged. The Official Foreign Exchange Reserves fell drastically to less than $ 1500 million.

The government therefore decided to borrow externally and from commercial sources. Development Bonds were issued to Sri Lankan citizens and local banks that had foreign currency accounts with local banks. Discussion was held with the bankers about issuing another Sovereign Bond. But the responses were not favorable and the government did not proceed with the idea. Earlier a Sovereign Bond was issued to raise $500 million in 2007. In 2008 the government raised $ 600 million through Development Bonds instead. But in 2008 there were foreign debt repayments falling due. $807 million had to be repaid and thus there was a reverse flow of dollars outwards.

The foreign currency holdings of the banks have also been tapped to increase the official Foreign Exchange Reserves. But these measures were not enough. So the government applied to the IMF for a standby credit of $1900 million based on our quota entitlement. While the negotiations were on with the US Government being critical of the Government and its record of human rights, the oil prices started falling and the crisis eased slightly in 2009.

The IMF Stand-by Credit

An IMF Standby Credit is given for balance of payments support and not for development. The country has to establish a need for such credit and the amount of credit is related to the quota of the country member. As such the country applied for US$1900 million although our need was much more. The IMF has granted the credit. Incorrect information in different ways is being propagated regarding this credit. It cannot be used for development expenditure. It is in a separate account in the Central bank and the IMF would monitor how this credit is being used. The Central bank has not explained why the IMF gave more than what we asked for. There are rumors that it was to settle the payments overdue on the hedging transactions. The IMF credit is tied to an economic reform program and the objective is to raise the depleted Foreign Reserves to an agreed level considered as prudent by both parties. So the over-all reserve target to be achieved by the end of the 21 month period is specified. There are also quarterly targets agreed to. As long as the quarterly targets are met the Central bank has freedom to use the credit even to support the value of the Rupee in the foreign exchange market. The IMF does not restrict foreign borrowing even foreign commercial borrowing because it realizes the need for cheaper funds to service the private sector. A limit of US$1750 million has been imposed on such borrowings. But they have to take place while complying with the Quarterly Reserve targets.

The IMF and the Government have agreed on what policies should be employed to restore the Official Foreign Exchange Reserves to an adequate level required for carrying on day to day foreign trades in a current account of the balance of payments which is freed as per Articles of the IMF agreed to.

Reform Policies

There are several ways to correct the current account deficit in the balance of payments. They belong to two broad categories, namely Expenditure Reducing and Expenditure Switching policies. They broadly include commercial policy such as higher tariffs, import controls and quantitative restrictions on the one hand and Devaluation or Depreciation of the Exchange Rate on the other. The IMF does not favor direct controls and quantitative restrictions because they affect the market prices artificially and distort the allocation of resources in the economy which is bad for economic efficiency and sustainable economic growth.

The Central Bank has been maintaining a more or less fixed exchange rate regime and intervening in the market to prevent depreciation of the Rupee since it would push up the cost of living and worsen the government fiscal deficit since it has to fork out more Rupees by way of

interest and foreign debt repayments fixed in foreign currencies like the U.S dollar and the Japanese yen. This would mean the Government has to either tax more or borrow more and since it is unwilling to pay higher interest rates on Treasury securities it has only one option, namely to print money. But that too would be inflationary and push up the cost of living. So the government decided to maintain stability in the Rupee. But the IMF wants a free float for the Rupee so that it is market determined and reflects its true economic value. This is necessary for the country to increase its exports and strengthen the import substitution industry and agriculture. But politically depreciation of the Rupee would make the government unpopular. So the government is in no position to implement a floating Rupee if it expects to go for an election. It's future course of action remains to be seen.

Earned versus Borrowed Foreign Exchange Reserves

There is a world of difference between earned and borrowed Foreign exchange reserves. The Government was under the belief that foreign debt could always be rolled over in the same manner as local Rupee debt. But it should learnt from the experience of 2008. To increase Earned foreign exchange we have to take remedial measures. The depreciation of the Rupee and a general monetary contraction policy is called for to correct the current account deficit.

The basis for fiscal consolidation was laid down in the Financial Management (Responsibility) Act of 2003. It fixed 5% for budget deficits and 85% for the aggregate public debt in terms of the Gross Domestic Product as the maximum limits in the transitional phase which was to run up to 2013. It is useful to compare them with the Maastricht criteria for the European Union member countries. The Maastricht criteria are to maintain a budget deficit up to 3 percent of GDP and to keeping public debt under 60 percent of GDP to reach the fiscal stability.

Fiscal stability and macro-economic stability

The fiscal stability (balanced public finance) is a useful indicator of the macroeconomic health. The last year in which we ran a surplus in the budget was way back in 1955 (Rs 91 million). In 1956 the budget was in over-all deficit to the extent of Rs 65 million. Thus began the age of fiscal profligacy with the politicians thinking that money was wealth. The budget deficits have ballooned over the period since 1956 and in 2008 it was Rs 341 billion (not millions but in billions now). The high budgetary deficits are considered as the cause of macroeconomic problems. Among those

Problems in many cases are:

- High level of inflation,
- Current account deficits,
- Highly indebted economy,
- Slow economic growth.

The Macroeconomic Connections of Budget Deficits

First of all it's necessary to say, that there can be several notions of budget deficit. They are the

- Structural budget deficit
- The inflation adjusted budget deficit
- The primary account deficit
- The current account deficit.

We have been running increasing deficits in the current account of the budget which indicates a structural deficit. The taxes on both individuals as well as businesses is high. More than 80% of the tax revenue comes from indirect taxes which increases the prices of goods & services. Since the deficit is funded partly at least by printing money there is no doubt that the people would be better off if they pay for the free health and free education instead of paying for them from high taxes and inflation.

The quantifying of the budget deficit also takes different forms:

- Balance of government sector including state corporations- the Public Sector budget deficit
- Balance of government sector alone
- Balance of government sector plus privatization receipts and grants received from foreign governments
- Balance of government sector less privatization and grants received

Each of these concepts have their usefulness for different types of analysis. The present regime has increased the ***inflation adjusted budget deficit*** unlike all previous governments. This has had its effects on inflation.

The emergence of any macroeconomic instability depends also on how budget deficits are financed. There are several options for funding the budget deficit:

- Selling Government bonds to locals
- Borrowing from abroad,
- Monetization,
- Selling off state assets.

The bond selling at the home financial market leads to increase in demand for private funds in the Economy. The more funds the government deficit demands the less money will remain for the private Investments. The excess demand for money will invoke a rise in interest rates. Higher interest rates, according to theory, stimulate private sector and households to increase savings and shift some investments towards the future. In this case we say that public expenditures (deficits) crowd out private investments.

On the contrary, external borrowing usually causes appreciation of real exchange rate, deepening the Current account deficit, increasing foreign debt and thus causing the loss of foreign reserves. An extreme and very serious result of foreign borrowing can be currency crises, for which this scenario is very common .

Monetization causes hyperinflation, and that's why this method of budget deficit financing is forbidden in many industrial and some developing countries.

The impact of budget deficit on macroeconomic stability is also influenced by the absorption ability of a particular economy. In general it can be said, that long-term budget deficits are much more easily absorbed by countries with high level of private savings and fully developed financial markets.

Since less developed countries like ours, possess less private savings, and lack fully developed financial markets, and also have regulated prices, they should try to reduce budget deficits, and thus avoid possible macroeconomic problems.

The Budget Deficits and Economic Performance

According to empirical findings about the impacts of budget deficits to the developing economies, we can make following conclusions:

1. The budged deficits are unambiguously bad for economic growth,

2. High budget deficits are mostly explained as consequences of planned political decisions, and not as a consequence of external shocks or reactions on current internal economic situation,

3. Although short term budget deficit financing by monetization doesn't necessarily leads to inflation, in long term horizon monetization causes inflation growth,

4. There is some evidence that public investments are not always positive for private investments, The public investments have negative effects on private investments. Public investments replace rather than complement private investments,

5. Budget deficits cause current account deficits in the balance of payments and overvaluation of the exchange rate. This makes another negative impact on economic growth, namely a decrease in exports as stated earlier,

6. Reducing budget deficits is an effective policy measure in rising national savings. The conclusions made above can differ, and the actual situation in a particular country will be the most decisive. In one country budget deficits can lead to high inflation causing debt crises or low inflation with crowding out effect, and slow economic growth.

Budget Constraint

A rising budget deficit has to be covered either from monetary resources, or from others non-monetary resources. A thoroughly undesirable practice is that of running payment arrears. The government purchases goods and services but doesn't pay for them promptly. The Armed Forces have been delaying the payment of bills as much as six to eight months. The other public sector institutions also resort to this practice. The fact is that in the past no public official could make a monetary commitment unless there was provision in the budget and funds were allocated by the Treasury. But today fiscal discipline has broken down and the Treasury is no longer able to control public finances. It is like any other department and individual ministers are said to be openly flouting the regulations regarding the incurring of payment obligations. So control of public finance seems to have ceased. Payment arrears is a dangerous phenomenon which breaks the credit cycle in the economy which links the government and the public sector with the private sector. Corporations like the CEB and the Railway seem to be defaulting on bills for the supply of oil to the Ceylon Petroleum Corporation which disrupts the finances of the CPC which then has to obtain loans from the two state owned banks. This is a thoroughly undesirable practice disrupting the credit cycle in the economy. There are also payment obligations incurred for arms purchases under foreign credits which are not reported in the published accounts and which seem to be outside the control of Parliament. The total outstanding payment obligation with repeat to arm purchases under foreign credit is unknown at any given pointing time. Such information is not in the published accounts . A predent practice would be to include such information in published accounts which would ensure proper disclosure and enhance accountability. The budget constraint is no longer being applied by government institutions.

Impact of the budget deficit on the money supply

There's a connection between budget deficit and alternative methods of deficit financing. Depending on which method is used to fund the budget deficit has an important bearing on the money supply and interest rates. The budget deficit can be measured in terms of the change in net aggregate debt for the year. This is a better indicator of the budget deficit than any direct computation from the figures of government expenditure.

The change in net public debt equals the sum of budget deficit plus debt service charge. Debt service represents the interest payments of governmental debt from the state budget. It is better to use this figure for the budget deficit.

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The impact of budget deficit on macroeconomic stability is also influenced by absorption ability of a particular economy. In general it can be said, that long-term budget deficits are much more easily absorbed by countries with high level of private savings and fully developed financial markets.

Since less developed countries possess less private savings, and lack fully developed financial markets, they should try to reduce budget deficits, and thus avoid possible macroeconomic problems.

The Budget Deficits and Economic Performance

According to empirical findings about the impacts of budget deficits in the developing economies, we can make the following conclusions:

1. The budget deficits are unambiguously bad for economic growth,
2. High budget deficits are mostly explained as consequences of planned political decisions, and not as a consequence of external shocks or reactions on current internal economic situation,
3. Although short term budget deficit financing by monetization doesn't necessarily lead to inflation, in the long term horizon monetization causes inflation growth,
4. There is some evidence that public investments are not always positive for private investments, which denies general opinion to this question. The public investments have negative effects on private investments. Public investments replace rather than complement private investments,
5. Budget deficits cause current account deficits and overvaluation of the exchange rate. This makes another negative impact on economic growth, decrease in exports as stated earlier,
6. Reducing budget deficits is an effective policy measure in rising national savings. Those conclusions made above can differ, and the actual situation in a particular country will be the most decisive.

How the Government is solving the balance of payments crisis

The government is trying to resolve the balance of payments crisis by curtailing imports rather than increasing exports. In the short run perhaps there is no alternative since export production cannot be increased in the short term. Fortunately the tea prices have gone up although industry spokesmen point out that their profits will not increase because their fixed costs have increased and with the decline in production they are unable to generate a sufficient return on their investments. This is a problem facing many companies today. Their return on equity is not sufficient to build up reserves. Fortunately the interest rates on Treasury bills have come down. A CEO from a leading financial institution has pointed out that even the banks are not earning a sufficient return on their equity. Financial management theory says a company must obtain a return above the risk free rate of return and that it must cover the risk premium. The risk free rate of return is the return on 12 months Treasury Bills. In the case of the banks there are excessively high tax burdens which reduce the profit after tax. But they are in an oligopoly and can at least price their products to provide a sufficient return. Other businesses are in a competitive environment and unable to determine the prices of their products. The return on equity is low in several quoted companies and according to theory they should be deploying their capital elsewhere.

The Government is depending on the imposition of high cesses and taxes on imports to reduce the volume of imports. The Central bank in the recent release of external trade figures says "The cumulative export earnings and import expenditure during the first half of 2009 amounted to US dollars 3,189 million and US dollars 4,437 million respectively, resulting in a trade deficit to US dollars 1,249 million, reflecting a 59.9 per cent contraction as compared to the corresponding period of 2008. Earnings from exports decreased by 13.7 per cent in June 2009, year on year basis. However, the rate of decline in exports, slowed down in June compared to the notably high declines in April and May. The largest contribution to this decline was from the industrial sector (73 per cent) followed by the agriculture sector. Industrial exports declined by 13.5 per cent to US dollars 420 million in June 2009, led by lower exports of rubber based products, textiles and garments and petroleum, owing to the impact of the global economic slowdown" As for imports the Bank comments as follows "

Expenditure on imports declined by 30.3 per cent to US dollars 832 million in June 2009. Except for the expenditure on sugar imports, which increased by 42.7 per cent due to the upward trend in international sugar prices owing to global supply constraints, expenditures incurred on all other subsectors of imports, declined. The largest contribution (64 per cent) to the overall decline was from the intermediate goods, followed by the investment goods (20 per cent). Expenditure on imports of intermediate goods continued to weaken in June reflecting the lower expenditure incurred on petroleum imports. The total expenditure on petroleum imports declined by 52.6 per cent during the first half of 2009 to US dollars 866 million compared to US dollars 1,825 million expended in the corresponding period of 2008. The average crude oil import price, which was US dollars 108 per barrel in the first half of 2008 had halved to US dollars 53 per barrel in the corresponding period in 2009. The reduced expenditure incurred on fertilizer imports was also led by the prices, which declined by 46.2 per cent in June 2009. Imports of investment goods also declined in June reflecting a slowdown in all major sub sectors. Cumulative expenditure on imports decreased by 36.7 per cent to US dollars 4,437 million during first half of 2009" So the reduction in imports is due largely to the fall in world prices of commodities, particularly oil prices. But with the recovery of the world economy commodity prices including oil are likely to rise and then there could be a reversal of this downward trend since most of the imports are essential goods including food commodities and intermediate goods such as fertilizer required for essential agricultural production. Oil prices have already risen to over $70 and if this trend continues then we cannot expect this reduction in imports to continue. There has also been a reduction in imports of investment goods showing the decline in private sector investment.

The Bank points out however that. "Private remittances increased by 5.4 per cent from US dollars 1,505 million recorded during the first half of 2008, to US dollars 1,586 million in the corresponding period of 2009. As a result, remittances during the first half of 2009 were US dollars 337 million (about 27 per cent) in excess of the trade deficit. This probably will give a current account surplus after many years but the figures of the balance of payments have not yet been released for the first half year.

The Central bank also says that there have been capital inflows this year, reversing the net outflows of the last year. Total net foreign inflows to the government T-bills and T-bonds since mid May 2009 to 10th August 2009 amounted to US dollar 270 million says the Bank But these are borrowings and not earned reserves. The stock market has not shown any net inflows of foreign capital so far. But we should not depend on short term capital inflows which are notoriously volatile. It is different if we can attract foreign direct investment funds for they are more permanent and less volatile. But there are no indications yet of any real interest in direct foreign investment despite the end of the war.

The Central Bank reports an increase in Gross Foreign Reserves by the end of June. It says the Gross Foreign Reserves excluding the Asian Clearing Union (ACU) balances are "US dollars 1,618 million. If we exclude $62 million placed with two domestic banks it is $1556 million. (Normally Foreign Reserves are held with banks and institutions abroad). Would this be sufficient for our imports? The Bank says "Based on the previous 12 month average imports (US dollars 953 million per month), these reserve values are equivalent to 1.8 and 1.7 months of imports, respectively although it adds "However, in view of the current and expected low imports, resulting from the sharp reduction in the oil and petroleum product import bills, the actual equivalent number of months of imports would be much higher". What should be noted is that the present circumstances are unlikely to last and if oil prices go up then hard decisions will have to be taken. The government is depending on high taxes and fiscal levies to reduce imports. But there is a limit to such levies because most of the imports are food articles required for consumption by the ordinary people who can't afford to pay too much for them.

The Budget Deficit and Macro-economic stability

The deficit must be covered either from monetary or non-monetary resources. We can consider how the deficit can be funded and what affects each alternative way of doing so has on the economy. The chief method to fund a budget deficit is to increase taxes so that the deficit is eliminated ***ab initio***. But when there is a deficit then it can be covered only by grants or by borrowing. The government can borrow locally or from foreign sources. It is usual to consider the budget deficit ***after grants***. The average received as grants from foreign sources has been about Rs 30 billion in recent years. Earlier many projects in the budget were funded from foreign aid but the importance of this source of financing has declined. So in 2007 the Government went for commercial borrowings to fund the budget deficit. It obtained Rs 100 billion by way of foreign loans. The previous year 2006 the amount was only Rs 40 billion. But in 2008 the government could not raise money from foreign loans and in fact had to repay foreign loans of Rs 4 billion. External borrowing have their benefits by reducing the interest charge but it usually causes appreciation of real exchange rate, deepening the current account deficit, increasing foreign debt and loss of foreign reserves. Extreme and very serious result of this foreign borrowing can be currency crises, for which this scenario is very common.

If the government were to borrow locally it does so by issuing Treasury Bills and Bonds .If these are subscribed to by the public instead of the banks then it comes out of the savings of the

people and is not inflationary. There would then be an increase in aggregate demand by the amount of such borrowings spent by the government. The more funds the government deficit demands the less money will remain for the private investments. The excess demand for money will also invoke a rise in interest rates. Higher interest rates, according to theory, stimulate private sector and households to increase savings and shift some investments towards the future. In this case we say that public expenditures (deficits) crowd out private investments.

But if the Treasury Bills and Bonds are subscribed to by the Central Bank and/or the banks then it is called printing new money by the economists. This course of action is not resorted to by developed countries because it leads to runaway inflation ending in hyper-inflation. So most countries do not allow it. But Sri Lanka has a history of money creation to fund budget deficits particularly in the 1990s. The country has been pushing for a higher rate of economic growth than the potential growth capacity of the economy. So when the government spends money in the hope of raising the growth rate what it achieves is not higher growth rates but higher inflation.

The Budget Deficits and Economic Performance

There is some evidence that public investments are not always positive for private investments. The public investments can have negative effects on private investments, particularly where they are funded from savings of the public. Public investments replace rather than complement private investments, Budget deficits cause current account deficit and overvaluation of the exchange rate. This makes another negative impact on economic growth, causing a decrease in exports. Although the decline in export earnings last year was due to the global economic crisis yet our competitors like India and Kenya depreciated their currencies offsetting to a large extent the devaluation of the ruble in Russia an important market for our tea exports.

Budget Deficit and the Money Supply

Depending on whether the budget is funded by borrowings from the public or from new money created, will affect the money supply. If it is the latter then there will be an expansion of the money supply. Money creation also helps the Central Bank to keep interest rates low. So budget deficits have led to a monetary expansion in our economy. The connection between an increase in money supply and an increase in inflation is well established. Fortunately for us world prices of oil and food have come down in 2009 and this has produced a dramatic decrease in imports while exports have also been reduced owing to the global economic recession. The first half 2009 figures were commented on in an earlier paragraph. What has happened is that despite the monetary expansion and not because of it, the inflation has come won. But the average level of inflation is still around 10% and is unlikely to come down much more. In fact the chances are that inflation will once again start rising if and when oil prices go up. Already they have risen from $54 to around $72. The upward trend is likely to continue.

It is an opportune time to examine the options available to bridge the budget deficit. If there is a negative budget balance (deficit), it's necessary to cover it. The government has several options how to finance this deficit, provided that the deficit will be covered by issuing bonds

there are also several subjects to whom these bonds can be sold:

1. Foreign subjects (private and public),
2. Households and firms,
3. Domestic banking system,
4. Central bank.

If the bonds are taken up by the Central bank or the banking system there is the phenomenon of new money creation or money printing. It the bonds are bought by foreigners then the adverse effects on the money supply will not be there. But there is the risk that if and when the foreigners decide to repatriate their money they will sell them in the secondary market converts the Rupees into dollars and repatriates the proceeds. The currency crisis was brought on by their actions in 2008.If the bonds are bought by local households and firms then it is their savings that would be utilized and there is no effect on money supply although when the money is spent by the government there could be a macro-economic imbalance if Aggregate Demand exceeds Aggregate Supply.

Exchange Rate Management

What should be the policy that the Central bank should follow to resolve the crisis in the balance of payments? Economists would recommend a rate that reflects the relative purchasing power of the Rupee and the dollar. This ratio should be such that 1 dollar will buy the same quantity of goods & services as its equivalent in Rupees. Thus if Rs 114 can buy the same basket of goods as I dollar then the relative purchasing powers are equal and the Rupee is at its appropriate value. Of course there are difficulties in applying the theory but a rate that reflects such parity is the equilibrium rate which is sustainable.

In 1956 Governor of the Bank of Israel was Stanley Fischer the economist who latter headed the IMF. Taking part in a Knesset Finance Committee session on monetary policy, Fischer told the committee, "***We, as a central bank, always stress the importance of exports to the economy. But the exporters must adapt their activity to the current reality, in which it is impossible to prevent market forces from having their effect on the exchange rate. Everyone, including the exporters, have to understand that the central bank cannot hold out forever against the market and win."*** He added that there was a close connection between inflation and the exchange rate. This is sound advice indeed. The Exchange rate of the Rupee with the U.S dollar has been stable within the spread of Rs 114/115. This stability has been the result of intervention by the Central Bank in the foreign exchange market. The Central Bank has intervened in both ways- to prevent an appreciation as well as a depreciation of the Rupee. No one will disagree with the former. It is the intervention to prevent a depreciation that is questionable.

The Central Bank has also resorted to sterilization to counter the effects of such intervention on the Reserves held by the commercial banks which then change, either increasing or decreasing. These changes then affect the Money Supply- increasing or decreasing it. The Central Bank does

not wish to expand the money supply too much for it undermines inflation control. Nor does it want to allow a decrease in money supply because growth of the economy would be adversely affected. But it has brought down interest rates although the decrease in policy rates of interest has still to be accompanied by any appreciable decline in interest rates for the private sector business firms. It prefers growth to inflation control despite the current account deficit in the balance of payments which means domestic savings is less than investment. Low interest rates don't promote savings. If inflation can be brought down to 5% then savers will get an adequate real interest rate.

Floating the Rupee-free or managed float?

The Central bank has now agreed with the IMF to float the Rupee. But it could still continue with the policy of managing the Rupee rather than allow it to float freely according to market forces. The Central Bank has a free hand to do so provided the Reserve target is met. Since the Reserve target seems to have been met the market has predicted a rise in the Rupee. This could be due to a surplus in the current account of the balance of payments or to capital inflows. The Central bank has initiated action to borrow $500 million from international capital markets. The Governor has said that the present level of the Rupee is satisfactory. But shouldn't the value of the Rupee reflect the relative purchasing power parities? Should it not be determined by market forces with the Bank intervening only to smoothen out any excessive volatility? ***Should capital inflows be allowed to determine the value of the Rupee?*** How would that affect our exports which must be increased if we are to over-come the balance of payments crisis in a permanent way? What is the appropriate value for the Rupee and can such a value be maintained when average inflation is still around 10%? The key to the appropriate value of the Rupee lies in the rate of inflation. Although the inflation rate has come down private sector economists in the foreign banks have said it is unlikely to come below 10% given the likely increase in oil and commodity prices with the revival of the growth in the developed economies likely to take place by the end of this year and the next. The importers and the government will have to accept the fact that unless inflation comes down to very low levels similar to that prevailing in the rest of the world economy which are markets for our exports as well as in countries competing with our exports, there will be no balance in the current account of the balance of payments. It will be impossible to prevent an over-valuation of the Rupee if inflation continues to prevail above the level in the world economy. So a 10% average inflation won't do .The Central Bank should concentrate on bringing down inflation below 5% since the prevailing inflation in the developed countries is closer to zero. But this means that the Central bank must make the control of inflation its ***prime and sole objective without seeking to promote economic growth as well.*** This used to be the thinking on central banking in the developed countries until the global financial crisis and recession set in. But our macro-economic imbalances are more due to home grown deficits, particularly the large fiscal deficit.

At what rate should Reserves be built up?

The Central Bank needs to build Foreign Reserves and the target level to be achieved in 21 months has been agreed with the IMF. The IMF has agreed to quarterly targets as well. The Central bank can intervene in the market to influence the exchange rate but should it do so at a rate of exchange that will remove the over-valuation of the Rupee? Should not the Central Bank announce an inflation target may be 3% by the end of the year? Unless such a target is announced the public cannot judge the claims of the bank that it has been successful in bringing down inflation **by its policy actions**. Some feel that since the bank has followed a low interest policy with expansion of the money supply it has not really contributed to the reduction of inflation which is due more too fortuitous circumstances. Expansionary monetary policies are generally considered by economists as pro inflation rather than against inflation.

Unless inflation is brought down to internationally comparable levels and the Central Bank does what it takes to do so we are not likely to get out of the woods. Already the monetary excess seems to have pushed up the stock market and created a bubble there for the companies have still to report positive results after the decline in earnings in the last two quarters. When the bank gives very low interest rates to savers they look elsewhere to increase their returns and the stock market is an obvious source. Some may even turn to unregistered financial institutions although the collapse of Golden Key is still fresh in the minds of the public. What is the aim of the Central Bank's low interest policy? ***Is it to promote more demand in a situation where demand outstrips aggregate supply***? The low interest rates in the developed world don't seem to be working to promote investment but rather to expand consumption. Of course these countries unlike ours have seen a fall in Consumption due to a decline in Aggregate Demand. But do we have the same situation here where the government has been expanding aggregate demand by its budget deficits which have ballooned over the years? Do we need to expand demand or curtail demand particularly government and public sector demand which is not fuelled by savings but by created money?

We need more private investment but this can come about only when the fundamentals of the economy are in better shape and the private sector has better expectations for the future. This is the task for the government and the Central Bank and the appropriate instruments of policy to do so have been agreed with the IMF. Let us stick to them to restore confidence of the world investing community in our economy. The stability of the exchange rate should be driven by the improvement of economic fundamentals, not by anticipations of Central Bank interventions in the foreign exchange market.

A persistent current account deficit is not sustainable. It is nothing but a manifestation of our living beyond our means. Both the government as well as individual citizens are guilty of doing so. But this situation is unsustainable. We have to correct the deficit in the current account of the balance of payments and build up our Foreign Exchange Reserves by earning them not by borrowing them since loans have to be repaid.