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Devaluation: Impact and Measures

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INTRODUCTION

When a devaluation occurs, relative price changes are induced domestically whereby prices of traded goods rise relative to non-traded goods increasing the relative profitability of exports and import substitutes. Under these circumstances, resources move into the traded goods sectors. Exports increases while imports are cut down. However, in the short run, the current account balance may worsen following a devaluation as the import volume will increase immediately, while export augmentation will take place only after a substantial lag.

Devaluation has also been often associated with reduced economic growth and increased unemployment. The rise in the cost of living and the redistribution of income that it gives rise to have been frequently criticized for transferring the burden of adjustment to the lower income groups who are least able to afforded it. This strategy has been ineffective since it can increase inflation without sufficiently improving the balance of payments position, ultimately inducing another devaluation and plunging the country into an inflation-cum-devaluation spiral.

Against this background, the Nepalese devaluation of November 1985 and July 1991 will be scrutinized. Some recommendations are also made.

DEVALUATION OF 1985

In November 1985, the Nepalese currency was devalued by 14.7 per cent against both the US dollar and the Indian rupee. Consequently, the exchange rate of Rs. 1 IC soared from Rs. 1.45 NC to Rs. 1.70.

The related authorities were reluctant to devalue earlier because of the feared inflationary consequences. They should have conceived that where a future devaluation seems inevitable, however, postponing it for fear of inflation while maintaining the same monetary and fiscal regime simply intensifies inflationary pressures by raising both the probability and the magnitude of devaluation.

The prime objective of devaluation was to prevent the Indian reserves from falling to a level critical to the country's financial stability as well as to stimulate exports and curb down imports with an attempt to reduce the increasing trade gap. The possibility of higher export earnings after devaluation were governed by the following propositions: (a) some of the exports forming relatively small proportion of the total

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export earnings face elastic demand and as a consequence of permanent stimulus provided by devaluation, their sales would expand in the international market; and (b) the government would take necessary steps to check the inflationary pressures in the economy that otherwise may nullify the advantages offered to the exports by the new exchange rate.

The government did formulate some devices in order to curb the difficulties arising from devaluation. These included, among others, (a) development of a practical system for pre-shipment financing, (b) simplification of the procedures and documentation for export licensing, (c) development of an evaluation and monitoring system for receipts of foreign currencies on the basis of set export prices, and (d) provision of bonded warehousing facilities to supply essential inputs for export industries at a lower price. In spite of these measures, hardly any notable results were attained. The trade scenario was not satisfactory as the trade deficit soared from Rs. 5001.5 million in 1984/85 (the year prior to devaluation) to Rs. 6263.2 million in 1985/86 (the year of devaluation), to Rs. 7931.8 million in 1986/87 (the year after devaluation), and to Rs 13166.0 million in 1989/90 (four years after devaluation). Moreover, the remedial measures to cope with the problems of inflation were also not so effective. The inflation rates were 4.1 per cent and 15.9 per cent for 1984/85 and 1985/86, respectively. The double digit figures prevailed till 1987/88. Although the inflation rate dropped to 8.1 per cent in 1988/89, it catapulted to 11.5 per cent in 1989/90.

DEVALUATION OF 1991

Since the devaluation of July, 1991 was an upshot of the Indian devaluation it is noteworthy to make some remarks in this respect. In India devaluation was inevitable since the rupee was over-valued. India did not have the external reserves or the borrowing capacity to anticipate a cyclical upturn nor the financial resources to bring about sufficient export augmentation within a reasonable period of time. The foreign exchange reserves were depleted, the total reserves able to meet less than a month's imports. The Indian authorities were of the view that a devaluation would restore profitability without reducing foreign exchange reserves or public savings.

The above state of affairs did not apply to the Nepalese economy. In July 1991, the country had sufficient foreign exchange reserves to satisfy about eight months imports. Hence, the primary cause for undertaking this measure is that the Nepalese official exchange rate is basically determined by India and the country's economy is very sensitive and dependent on the changes in the Indian economy. The Nepalese devaluation can, thus, be ascribed to the devaluation of the Indian rupee by 23.1 per cent that was effected twice by the Indian Government since July 1. As a result, the Nepalese currency was devalued against the US dollar by 20.9 per cent but was kept unchanged against the Indian rupee after the second bout of the latter's steep devaluation on July 3. The Nepal Rastra Bank stuck to the 1.79 per cent revaluation on July 1 of the Indian rupee keeping the value at Rs. 1.65 while the US dollar was devalued at Rs. 42.70. The revaluation of the Nepalese currency by 1.79 per cent against the Indian currency will hardly make any difference to the Nepalese consumer.

After the announcement of devaluation a package of measures to tackle the adverse repercussions should have followed suit. The Minister of State for Finance, while presenting the budget for the fiscal year 1991/92, was well aware that he was responsible for not merely drafting an annual financial programme for the government, but initiating a process of fundamental economic reform. To minimize the serious consequences of devaluation, there was a need to reduce the size of the government budget, slash wasteful spending, put an end to the fiscal drain through the public sector and re-orient the tax system. Fundamentally, however, the State Minister should have targeted on expenditure cuts rather than revenue-raising, because the problem is not that too little money is flowing into the government treasury, but that too much of the money goes unproductive. However, no concrete measures have been explicitly spelled out in the budget except that unnecessary and waste expenditures would be eliminated. The State Minister has himself acknowledged that any change in the Indian economy will have its impact on the Nepalese economy indicating that the government would take steps from time to time depending on the reform measures exercised by India.

The impact of devaluation on the trade deficit may be disappointing. According to my estimate, the total deficit in 1991/92, based on past economic behavior, is estimated to be Rs. 22197.3 million without any change in the exchange rate. With changes in the exchange rate, the figure is estimated to be about Rs. 24570.6 million. Thus, the added burden on the trade deficit due to exchange rate changes is about Rs. 2373.3 million. Apart from the normal rate of inflation, there would be a further 12.2 per cent increase in the inflation rate with changes in the exchange rate.

Suppose the rate of growth of imports falls slightly in 1991/92 because of devaluation of the Nepalese currency vis-a-vis the foreign currency. In this case the contribution of devaluation to trade deficit would be Rs. 1394.5 million and there would be a further addition of 9 per cent to the normal rate of inflation.

If the Nepalese vis-a-vis the Indian currency had been appreciated to Rs. 1.50 and the US dollar depreciated to Rs. 38.90, the burden on the trade deficit would have amounted to Rs. 179.9 million. There would have been a further increment of the rate of inflation by only 2.2 per cent in this case.

Hence, a significant decline in the rate of inflation is very unlikely in the next couple of years, unless there is some extraordinary development, like a super bumper crop. Crucial costs like higher transport cost will have widespread repercussions. Since fertiliser subsidy is reduced, this is bound to affect foodgrain prices.

The heavy dose of devaluation of the Nepalese rupee vis-a-vis the foreign currencies has put the proposed growth target for the Eighth Plan in jeopardy. Issues such as its proposed size and sectorial allocations will have to reformulated. The planners will have to reexamine the balance of payments situation under the totally different foreign trade scenario.

Some economists argue that there are crucial conditions for the devaluation theory to function in a Nepali-type economy. For instance, the price elasticities of export supplies and import demand must exceed zero. According to the famous

Marshall-Lerner conditions, a devaluation would bring a positive impact on the current account only when the sum of both elasticities exceeds unity. Moreover, in Nepal, the supply of primary and agricultural commodities is quite rigid in the short run while the elasticity of import demand is likely to be low especially when they comprise of raw materials, semi-processed commodities and capital goods. Hence a devaluation may lead to a further deterioration rather than improvement of the trade balance, measured in domestic currency. Further, this strategy also brings about grave redistributive consequences since it demands a downward movement either in the share of wages in the industrial sector, or in the terms of trade which agriculture gets vis-a-vis industry. And the latter again is likely to demonstrate itself in terms of a decline in the share of agricultural wages.

Further, the price-cost relationship in the primary sector is not important from the point of view of the country's exports, and hence would not justify a general devaluation. This is firstly due to the domestic elasticity of supply of such products which is small and unresponsive to changes in export prices; and, secondly, the export price in terms of foreign currency will be the same, irrespective of the exchange rate, so that devaluation will not stimulate world demand for the product. However, these propositions are likely to hold only within certain limits.

SUGGESTIONS

The success of a devaluation will be governed by its ability to stimulate the growth of exports. More exports may be forthcoming if there is a higher inflow of imported raw materials as well as capital equipment and spare parts to rehabilitate previously neglected plant and equipment.

If the government controls the fiscal deficit, and hence the monetary expansion immediately after devaluation, there will be a counteracting force which will help to contain inflation. When monetary expansion is kept in check, the ability of producers and traders to pass the cost increases through higher prices is greatly reduced. The crucial point, thus, is to maintain a firm check on demand and on monetary expansion. At the same time, measures to reduce fiscal deficit should, as far as possible, avoid heavy indirect taxation of commodities of mass consumption.

To counter the cost-increasing impact of devaluation, production and new investments should be stimulated, freedom of entry and exit in industry should prevail, and the resource base of the financial institution should be strengthened, so that they can finance new investments.

The favorable outcome of devaluation also depends to a large extent on the supporting steps taken by the government. These can be classified into three types: price policies, demand management measures and policies that transform an initial increase in supply into an actual increase in exports. Price policies must ensure that the change in the exchange rate is fully reflected in the price structure of the economy. Price adjustments should take place. Restrictions on imported inputs for tradables should be relaxed, and cost and incentive distortions hindering the production of tradables will have to be removed.

In Nepal, it can be said that devaluation taxes the poor in at least there ways: by reducing the real wage, increasing unemployment, and reducing government services. A curtailment in the real incomes of the poor may not be acceptable and government expenditures on health and education, among others, may have to be sustained in real terms. Moreover, due to devaluation other government expenditures will take an upward trend, as the cost of their import content and that of debt service rise, demanding larger increases in revenues to reduce the budgetary deficit. While devaluation will also raise government revenues - through higher tax revenues on trade and incomes and higher profits from public enterprises - the impact on expenditures is more immediate and will other tend to be larger. If higher profits in tradables do not generate higher private investment due to lack of confidence or uncertainty, the government will need to encourage it; this, in itself, may limit the government's options in reducing private sector consumption. The government's options in reducing private sector consumption. The alternative to reducing consumption is to cut back investment that would reduce future growth. Whichever option is resorted to, these would be unpopular decisions for the government.

Because of these narrow options, the government has to tread a thin line between a credible adjustment effort required for devaluation to be effective and the priority it places on the social fabric. This priority can be facilitated, for instance, by curtailing government expenditures where they least affect the basic needs of the poor, or by tightening credit for consumer durable. In order to contain expenditure, massive cuts will have to be effected in subsidies and well-conceived schemes will have to be devised to ensure that the weaker sections of the population are not adversely affected.

The government will also need to frame a collaborative policy in various fields so that foreign exchange earnings and savings increase. Development expenditures could be redirected to mitigate the existing obstacles. The capital stock and export-servicing facilities may also have to be rehabilitated for facilitating the channelisation of more exports to foreign markets.

Because devaluation entails sudden price changes and a fall in purchasing power, it does capture more public visibility and understably generates more political opposition. Thus, the government should develop and overall macro-economic stabilization programme which it should discuss with major opposition parties so as to enable the evolution of national consensus of economic policy reform.

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