



# WHEN FOREIGN EXCHANGE RESERVES AREN'T IN RESERVE

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Struggles of traders and ordinary folks to buy U.S. dollars for importing and foreign travel needs respectively are a familiar, sorry reading in the national press all too often.

**Margaret Thatcher,**

**“There is no way in which one can buck the market”**

**[you can't buck the market].**

## ‘Dollar shortage’

The so-called dollar shortage has remained an endemic malaise in the Maldives economy for much of the last fifty years or longer. Successive administrations have ‘tried and failed’ to resolve the problem.

Why is this such a big problem? Some may say, because people make it a problem. Economists

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would say, because the market is not clearing at the fixed price as demand for dollars exceeds the supply. A naïve answer may be, because the “Mafia dollar earners” are hoarding a large chunk of the supply to sell in the black market. A pragmatist might say, because of all of the above.

In 1988 the UK Chancellor of the Exchequer, Nigel Lawson, tried and failed to keep the Sterling pound down despite repeated interest rate cuts. He then resorted to intervention in the foreign exchange markets, selling pounds to try to drive the price down.

This, according to an article published in the British paper, Independent on 5 April 1998, prompted the

Prime Minister, Margaret Thatcher, to tell the House of Commons, „There is no way in which one can buck the market“ [you can't buck the market]. The debate went on therefore that the exchange rate should find its own level, and that the government cannot and should not have a policy for the value of the pound.

Indeed, in a competitive, free market such as the UK, prices (including the price of foreign exchange) are not to be fixed, so that they are allowed to remain flexible to move up and down depending on the demand and supply.

In Maldives the issue is the reverse of the situation that Lawson experienced: he sought to push the value of Sterling downwards in a flexible exchange rate system; in Maldives the central bank is buying the rufiyaa (i.e., selling dollars) as the authorities continue efforts to avoid a devaluation of the rufiyaa to defend a fixed exchange rate regime. Policy and regulatory attempts are made to maintain the value of the rufiyaa at a rate that is higher than what appears to be the market clearing rate: buyers and sellers of dollars do not agree that the official, fixed rate (currently at the ceiling, MVR 15.42 to the dollar) is the market value of the rufiyaa. At this rate, dollar suppliers are not willing to sell their entire quantities of supply, and are quoting rates above the officially pegged rate. At these rates the market clears, buyers buy at the rates that the suppliers quote. In an economist's conviction, this is the market mechanism working as

market forces (buyers and sellers) bargain and settle at a price at which the transaction takes place.

### **One former central bank governor concluded that the presence of high levels of dollarisation in the economy lends support to maintaining a fixed exchange rate regime**

Therefore, the problem is of a legal nature rather than economic: selling and buying dollars at these rates are illegal because they are above the officially fixed exchange rate; if a rate was not fixed, they would be deemed legal transactions working according to market determinations.

There are those in Maldives who appear to advocate that the foreign exchange regime should be changed to a flexible system. The two basic arguments raised in support of their advocacy are (1) the high level of bank deposit dollarisation, and (2) the quotation of some local prices in dollars. As a solution, they also argue that regulation of foreign exchange should be strengthened such that deposit dollarisation can be reversed and all pricing can be enforced to be quoted in MVR. This author knows of one former finance minister and one former central bank governor who maintain this advocacy, and one former central bank governor who, on the contrary, concluded in a research that the presence of high levels of dollarisation in the economy lends support to maintaining a fixed exchange rate regime in the Maldives.

## Central bank intervention 'imminent'?

Maldives Economic Review reported in its September 2019 issue that MMA's Strategic Plan 2018-2022 planned to review the current exchange rate regime.

The plan said, "We [MMA] will work to enhance our monetary policy transmission mechanism through de-dollarisation and by pursuing the most appropriate exchange rate regime for the Maldives to maintain price stability."

The analysis concluded that MMA's plan to "review" the regime was an indication of the central bank's belief that the appropriateness of maintaining a pegged system was in question. Since the plan also says that the central bank would be "pursuing the most appropriate exchange rate regime", this implies that in the central bank's belief, some regime other than the current fixed system is the most appropriate regime.

In an interview with MMA Governor Ali Hashim in March, MER posed him a question asking what was being done to carry out what President Ibrahim Mohamed Solih announced earlier. The president said in February that the government was working on revising policies to ensure there was no shortage of U.S. dollars in the foreign exchange market.

In response the question the governor said that

"economic agents' support to new measures to solve this [dollar shortage] has been lacking." He continued:

*"... with every shock the first impact is on the foreign exchange. ... no one wants to really tackle this issue, until now. There is wide support from the public, ... the institutions that there has to be something done. And I think what the President has been trying to do with his statement is to lend his administration's support to any changes that we intend to take."*

**Here the governor was bold enough to make a remarkable admission, i.e., that the official exchange rate is not at the market level**

He refrained from being specific. MER rephrased the question and asked about what options were being considered.

The governor responded:

*"We are thinking on the supply side of it. ... if you look at how much we get into the country, we can manage with that, if all of it is in the financial system. ... With what MMA gets, ... it's manageable. But it has never brought the exchange rate to par. ... Always there has been a rate that is a bit more than the official exchange rate. ... So, ... if we can manage with this little amount ... until a shock, that means that if we can get twice or thrice that amount, we will manage in any situation. ... Yes, the time is right for it, and we will do something through regulations to ensure that the supply side is taken care of."*

Here the governor was bold enough to make a remarkable admission, i.e., that the official exchange rate is not at the market level ("it has never brought the exchange rate to par"). However, in terms of measures under consideration, the governor's response was again general, and MER pressed the governor to be more specific, asking if he was in a position to say more clearly how the 'shortage' was

going to be addressed. The governor said:

*"I think we will survive even if we have half of what the country earns. ... The pandemic brought the worst level of crisis. So, in the worst-case scenario I think half might not be enough. But then that is all because our data is not that accurate, because we are also speculating, we are playing this guessing game with numbers. So that's why I don't want to come up with a number. I want the actors and the players in the market to tell me, what they are comfortable with. That process is happening."*

**"... If you want a word in there, I think the word will be a surrender requirement. And then we will fine tune that requirement", he said.**

From this response, it appears that the first objective is to get the "players in the market" to agree to the idea of a surrender requirement, and then to determine a basis (e.g., a percentage of dollars earned) to be surrendered and where (e.g., banks or central bank).

MER then asked if a surrender requirement excluded any consideration of an adjustment [devaluation] of the exchange rate. The governor's response was:

*"Yes, because we are of the opinion that the exchange rate now is speculative, any parallel rate at the moment is speculative and the rate should be where it should be at the official rate."*

In his responses the governor made clear that a devaluation was not on the cards and that the central bank's key emphasis is on a regulatory measure, the surrender requirement. But it also goes against what the governor said earlier that "it has never brought the exchange rate to par".

So where does this leave MMA's plan to "... pursuing

the most appropriate exchange rate regime..." set out in its Strategic Plan 2018-2022? If this was on the table, it does not appear reasonable to think that the governor would resort to a surrender requirement.

As a final question on this issue, MER asked the governor's views on the maintenance by the IMF and the World Bank that the fixed exchange rate was appropriate for the country [despite describing that Maldives has dual exchange rates and the country goes through heightened foreign exchange pressures at every crisis].

The governor said:

*"IMF, I am not there with them 100%. I am there somewhat. But I do understand when they say that you should not have capital controls. So, no, we are not going to bring in capital controls. ... This is about ensuring that we are resilient for a shock and still near free market. But I don't think the IMF has done right in some of the cases, and this is one of the cases that they should really think hard of how this economy, of how the actors are operating here ..."*

The reader is left to reach his own conclusion on whether the governor is agreeing or disagreeing with the IMF/World Bank that a fixed exchange rate regime is appropriate for the country.



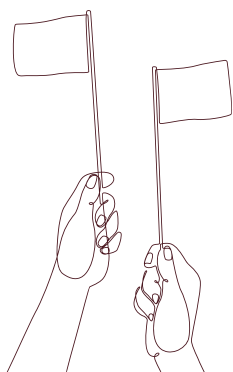
## Surrender requirement

Surrender requirements vary from country to country and within a country there may be different sub-requirements for different circumstances. A surrender requirement to the central bank may be defined as an obligation to sell foreign exchange proceeds within a specified time frame, usually from exports (Canales-Kriljenko, 2003), of goods and services. It is a foreign exchange control measure among others including capital controls, prohibitions on interbank foreign exchange trading, regulations hindering the taking of net open foreign exchange positions, etc.

**The administrative cost of enforcing regulations could be substantial, as resources must be expended on enforcement while the private sector also dedicates resources to circumvent them.**

According to Canales-Kriljenko (an IMF staff at the time of their study which was also published by the IMF), surrender requirements increase the central bank's relative size of foreign exchange intervention, bargaining position, and information advantage. They result in the concentration of foreign exchange supply

in the central bank thereby making it the main foreign exchange intermediary, and its influence greater on the path of the exchange rate as it gains control of the supply of foreign exchange.



While the Canales-Kriljenko study concludes that central banks in some developing and transition economies may be able to conduct foreign exchange intervention more effectively than those issuing the major international currencies, they recommend that research should assess empirically the effectiveness of such intervention in developing and transition economies and analyse its costs and benefits. They argue that it would be useful to test whether the benefits of reducing exchange rate volatility compensate for potential costs of such regulations, which may create distortions in resource allocation in the real sector and reduce opportunities for investment, consumption smoothing and risk sharing. According to them, the administrative cost of enforcing regulations could be substantial, as resources must be expended on enforcement while the private sector also dedicates resources to circumvent them. Finally, they point out that foreign exchange stability efforts may be counterproductive where the private sector can borrow abroad, as the sector may underestimate the risk of loss associated with an eventual currency depreciation, which may encourage international overborrowing.

## ‘Let it be’

Discussions with some private sector entrepreneurs suggest that there is no whole-hearted support for an introduction of a surrender requirement. They maintain that it is better to not take measures such as a surrender

requirement as it is unlikely to resolve the problem, than to impose such a measure, not be able to resolve the issue and consequently lose more credibility.

One argument against the measure is that even if it is introduced, those dollar earners that supposedly hoard the green back would still find creative ways to circumvent it, something Canales-Kriljenko also points out as mentioned above.

There are also those who view that thanks to the liberal foreign exchange regulations in the country, most dollar earners indeed retain their earnings in the country as regulations elsewhere are stricter.

## Concluding comments

If, as the governor admitted, the official exchange rate does not reflect the actual market rate, economists advocate that the best action is to adjust the exchange rate within a fixed regime. In the current situation, this would mean a devaluation, which would be reflective of what the IMF Executive Board advises (MER Vol. 1, Issue 1, September 2019). If this were to be the case, widening the exchange rate band by raising the current ceiling of MVR 15.42 would be a measure that would provide 'more flexibility'.

It has to be noted that the language of the IMF staff is different from that of the IMF Board's. The IMF staff welcomes MMA's plans to "review the current exchange rate regime with the aim to strengthen exchange rate

stability, accumulate foreign reserves and increase resilience to external shocks." The Board's language on the other hand was about providing "more flexibility in the pegged regime" to "better support the peg and build foreign reserves."

So, it appears that at the time of the introduction of MMA's Strategic Plan, MMA and the IMF staff were of the faith that the fixed exchange rate regime should be replaced. On the other hand, the Board's advice may be closer to the government's position, i.e., to defend the peg. But there is a variation between the government's position and the advice of the Board: providing "more flexibility". This would mean a devaluation, something that the government is known to wish to avoid at all costs.

The governor's ruling out of a devaluation now appears to be a departure from the intentions implied in the Strategic Plan to replace the fixed regime with another.

Short-term regulatory interventions are likely to only last short-term at best. They are likely to further damage what may be described as an already dented credibility. While domestic politicians pressure central bankers "to do something" as Governor Ali put it, a long-term plan to widen domestic production of both goods and services and to increase exports of both goods and services hold a better promise to lead to a sustainably defensible exchange rate policy framework.