

Featured Charts 1.7 Exchange Rate Dynamics Under the Flexible Exchange Rate

The appreciation of the Sri Lanka rupee recorded over the past two years was mainly due to the improved fundamentals as measured by the external current account surplus given limited forex outflows. This appreciation would have been more prominent if the Central Bank did not intervene in the domestic foreign exchange market to purchase record levels of foreign exchange. The general perception that an appreciation of currency is a reflection of better economic performance is a myth. Like currency depreciation, appreciation also has its own merits and demerits, and persistent appreciation could harm external competitiveness of the country. Thus, under the flexible exchange rate arrangement, as stipulated under the Central Bank Act (CBA), the exchange rate movements would be determined largely by demand and supply conditions in the foreign exchange market. Persistent depreciation or appreciation of the exchange rate is less likely under this arrangement, unless the economic fundamentals drive such trends.

