
Chapter 6

The Central Bank's Role in the International Economy and Foreign Aid

The role of the Central Bank in the international economy and foreign aid is related, among other things, to two of its basic objectives, viz., the maintenance of a viable balance of payments position and the maintenance of the stability of the external value of the rupee and its free use and convertibility in current international transactions. The principles laid down in the Monetary Law Act (MLA) for the determination of international monetary policy deals with three fundamental areas of national interest, namely the balance of payments, management of international reserves and determination of the exchange rate of the Sri Lanka rupee.

The first section of this chapter reviews the principles and guidelines provided in the Monetary Law Act for the determination and the conduct of international monetary policy. The second section examines how the Central Bank has fulfilled its obligations in the area of balance of payments and international reserves over the past forty years in the context of changing domestic and external conditions. The third section discusses the Bank's experience with respect to exchange rates, exchange

and payments arrangements and reforms. The final section reviews the evolution of international relations of the Central Bank, paying special attention to its relationship with the International Monetary Fund and the facilitation of the government's aid mobilization efforts.

Guidelines on the Determination and Conduct of International Monetary Policy

The principles and guidelines laid down in the Monetary Law Act on Balance of Payments and Reserve Management are aimed at facilitating the Central Bank's role in international monetary matters, especially in the maintenance of a sustainable balance of payments position and the preservation of external confidence in the economy, which is key to the achievement of many other objectives.

In order to have effective control on the utilization of the foreign exchange resources of the country, the Central Bank has been made the custodian of its international reserves. Therefore, it is one of the prime responsibilities of the Central Bank to maintain an international reserve adequate to meet any foreseeable deficit in the balance of payments¹. While the commercial banks are permitted to keep required working balances in foreign exchange, the Central Bank could from time to time prescribe or fix maximum limits on those working balances.²

The Central Bank has to monitor the behaviour of international reserves taking into account the current level of reserves and all foreseeable inflows and outflows of foreign exchange. The key areas that the Central Bank has to be cautious about are developments in the balance of payments, the volume and the maturity of the Bank's own external liabilities, the volume and the maturity pattern of foreign exchange assets and liabilities of the government and the commercial banks, and the composition of external assets.

The Monetary Law Act provides specific guidelines on how the Monetary Board should proceed whenever the Monetary Board anticipates a crisis situation in the balance of payments which could cause

1 Monetary Law Act, Section 66(1).

2 Monetary Law Act, Section 77(1).

a serious decline in international reserves, or whenever the level of international reserves has declined to a position that causes a threat to the free convertibility of the rupee in the settlement of Sri Lanka's international payments. In such a situation, it is the responsibility of the Central Bank to adopt corrective policies immediately and thereafter submit a detailed report to the Minister of Finance giving the nature, causes and the magnitude of the likely threat, along with measures which the Monetary Board has already taken and other measures that are proposed to be taken.

The maintenance of balance of payments viability, exchange rate policy and reserve management are all inter-connected and directly related to the international monetary stabilization efforts of the Central Bank. However, as the behaviour of the external sector of the economy is not independent of developments in the domestic sector, the Central Bank, when implementing policies or advising the government on policies aimed at external stability, cannot ignore the implications of those policies on the other areas of the economy.

Exchange Rate Policy

The Monetary Law Act, prior to the amendments made in 1978, provided for an exchange rate system which was in line with the adjustable peg system (i.e. stable but adjustable par value system) of exchange rates introduced in the original Articles of Agreement of the International Monetary Fund (IMF)³. Accordingly, the par value of the Sri Lanka rupee had to be expressed in terms of gold, as a common denominator, or in terms of the United States dollar. The initial par value of the Ceylon rupee was established at Rs. 4.76190 per US dollar. As the value of the US dollar had been expressed in terms of gold (US Dollar 1 = 0.0285714 ounces) the original par value of the rupee in terms of gold was 0.006 ounces.

Under the adjustable peg system which prevailed until the major policy shift towards a liberalised economy in mid-November 1977, the objective of the Central Bank with respect to the exchange rate was "---the

3 Monetary Law Act, Chapter II, Section 5.b and Articles of Agreement of the International Monetary Fund, Article IV as adopted on July 22, 1944.

preservation of the par value of the rupee and the free use of the rupee for current international transactions." Although strict surveillance on exchange rate policies of member countries was exercised by the IMF, member countries were free to change their exchange rates for spot transactions within a margin of one percent. Larger changes were permitted to correct fundamental disequilibria in the balance of payments only after consultation with the IMF. Following the same principles governing the conduct of exchange rate policy as had been specified by the Bretton Woods System, Section 69(1) of the Monetary Law Act prior to the 1978 Amendment, empowered the Monetary Board to recommend to the Minister of Finance any alteration of the par value of the rupee if the continuation of the existing par value was an obstacle to the achievement of growth in real income, employment and balance of payments objectives.

The Monetary Law Act (as amended in 1978) provides for any type of exchange rate arrangement - fixed, completely flexible, managed float or any other system. Section 3(1) of the Monetary Law Act, which states that, "The Monetary Board shall,... recommend to the Minister in charge of Finance and Planning that the par value of the Sri Lanka rupee be determined in terms of Special Drawing Rights or in terms of such other common denominator as may be prescribed by the International Monetary Fund," allows for a stable but adjustable exchange rate system. Section 65 provides adequate powers to the Central Bank to introduce alternative exchange rate arrangements by stating that "in determining its international monetary policy the Monetary Board shall endeavour to maintain the par value of the Sri Lanka rupee, or where no determination of such par value has been made under Section 3, maintain such exchange arrangements as are consistent with the underlying trends in the country and so relate its exchange with other currencies as to assure its free use for current international transactions." Section 5 which deals with the powers and objectives of the Central Bank, has also been amended to specify the objectives under alternative types of exchange rate systems. According to the new sub section 5(bb) of the Monetary Law Act, the objective of the Central Bank under any other exchange rate arrangements should be the preservation of the stability of the exchange rate of the Sri Lanka rupee in relation to foreign currencies. Thus, according to the amended Monetary Law Act, the

Central Bank has greater flexibility in the determination of a suitable exchange rate system and the conduct of exchange rate policy.

Balance of Payments Developments and International Reserves

Pre-1977 Period

The problems of balance of payments management have been the most formidable of all economic problems faced by Sri Lanka over the last 40 years. The Central Bank has been paying continuous attention to these problems. This is mainly due to the fact that balance of payments related problems, as well as the policies that are readily available to deal with such problems, as mentioned previously, have far reaching implications for the national economy.

During periods when the country is facing severe balance of payments difficulties, the ability of the Central Bank to fulfil its responsibilities in the international economy depends to a very large extent on the volume of international reserves held by the country and in particular, the Central Bank. The ability of the Bank to maintain an adequate level of international reserves was impaired on several occasions by serious balance of payments difficulties, some of which were not directly related to domestic economic policies, but to exogenous factors such as adverse movements in the terms of trade (Table 6.1). However, this should not veil the fact that the balance of payments difficulties experienced by Sri Lanka over the past 40 years are attributable in some measure to lax macro-economic policies, especially the problems relating to public sector finance. The Central Bank not only paid constant attention to these problems and expressed its concern in periodical reviews of the economy and policy advice to the government, but also attempted to minimise the adverse effects of these policies through corrective measures.

Table 6.1
Change in Terms of Trade and Import Capacity of Reserves

Period	T/T	R/M
1950-1957	-1.9	9.1
1950-1960	-0.2	7.6
1961-1970	-5.4	2.5
1971-1977	1.1	4.0
1961-1977	-2.7	3.2
1978-1989	-4.2	3.4
1950-1989	-2.5	4.7

Note :

T/T = Annual average percentage change in the terms of trade.

R/M = Import capacity of gross foreign reserves, in months

(a) 1950 - 1960

Sri Lanka's external payments position, having experienced mixed fortunes during the first few years after the establishment of the Central Bank, came under continuous pressure thereafter⁴. This was due to two major reasons, viz., adverse movements in the terms of trade and excessive domestic monetary expansion stemming from expansionary budgetary policies.

Sri Lanka experienced considerable prosperity in her balance of payments during 1950-51 due to a surge in the export prices of her major export commodities, resulting from the Korean-war boom. While rubber prices rose by 267 per cent between 1948 and 1951, the terms of trade improved by 51 per cent.

This externally induced prosperity, however, was short-lived and by mid-1951, the major export prices were on a declining trend. While the terms of trade deteriorated by 24 per cent in 1952, the balance of payments position weakened sharply, causing a sharp decline in external

⁴ Central Bank of Ceylon, 1950-75 Commemorative Volume, p.19.

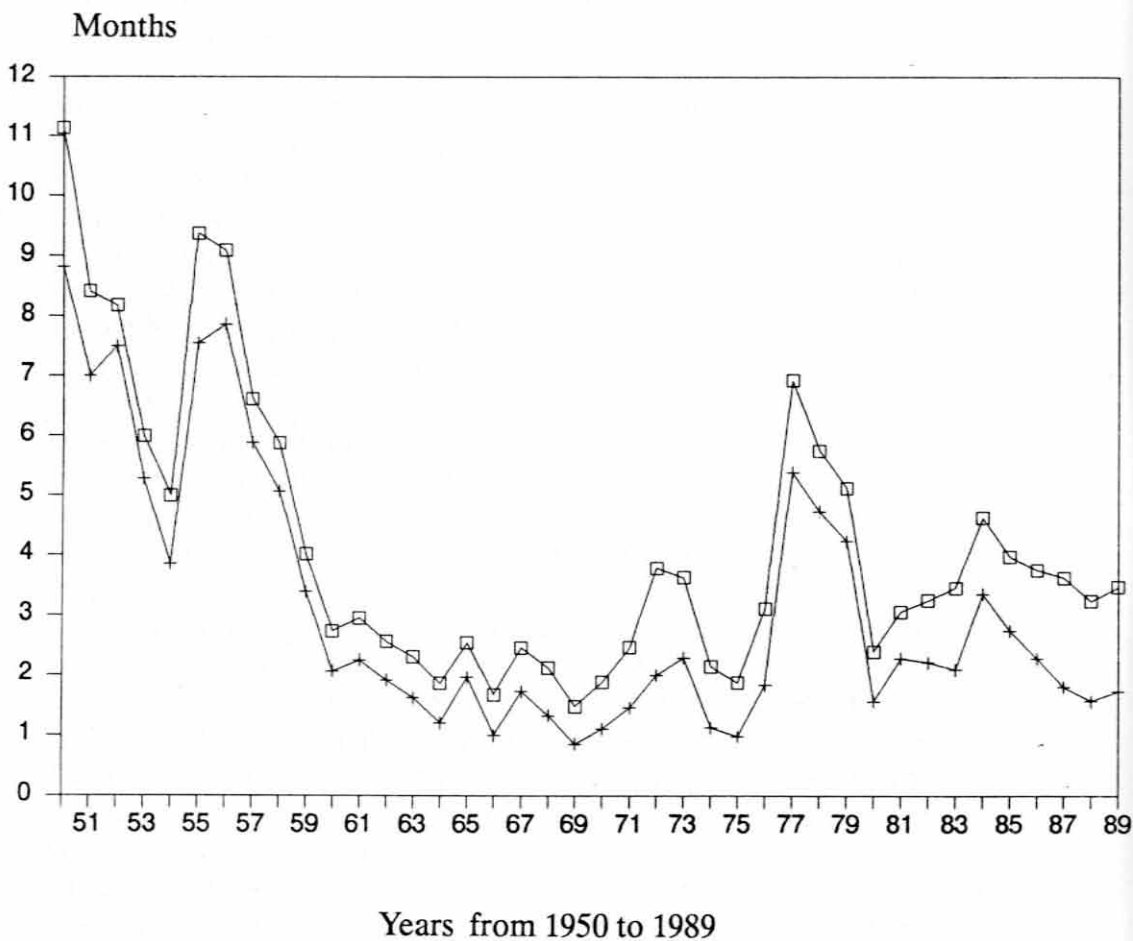
assets. As shown in Chart 6.1, the import capacity of gross external assets declined from about 12 months in 1950 to 4.7 months by the end of 1953. This decline in external assets was not solely due to the deterioration of the terms of trade but also related to the excessive increase in nominal purchasing power due to expansionary monetary and fiscal policies.

The Central Bank's stand in such situations was very clear right from the early 1950s. Having identified the root cause of the problem in Sri Lanka's international payments situation, the Central Bank stated in its 1952 Annual Report that "... the Bank judged that the dominant economic problem was the rapid fall in external assets, and that all necessary steps must be undertaken to make the country live within its means The Bank recognized that falling export income and higher import prices would have caused some loss of external assets even in the absence of credit expansion. The core of the problem was that monetary as well as fiscal policies were creating so much domestic purchasing power that the Ceylon economy could not return to equilibrium with the outside world The situation required a contraction of domestic purchasing power that could cut consumption and reduce imports even of essential goods"⁵. The Bank, in principle, did not favour the tightening of quantitative restrictions on imports to correct continuing deficits in Sri Lanka's international payments position. The Bank cautioned the government about the actual and possible future ill effects of welfare oriented policies, comprising mainly the consumer-oriented massive subsidy programmes, on Sri Lanka's balance of payments. Although an Eight-Point Austerity Programme which included, among other measures, the intensification of indirect import controls, was launched, it was evident by the end of 1952 that the programme had not reduced the budget deficit sufficiently to arrest the serious drain on external assets.

However, during 1954-55 Sri Lanka's international payments situation improved significantly and the balance of payments recorded a remarkable surplus of about US dollars 120 million during those two years. This was largely due to a short-supply of tea in the world market, a very fortuitous development for Sri Lanka as a tea exporting country.

5 Central Bank of Ceylon, Annual Report, 1952, P.6.

Chart 6.1
Import Capacity of Reserves



□ Total Reserves + Official Reserves

While tea prices rose by 43 per cent between 1952 and 1955, the terms of trade improved by almost 47 per cent, recording their highest level since 1939. Despite some subsequent deterioration in the terms of trade, the overall balance recorded a small surplus in 1956, benefiting from the earlier tea price boom.

The two brief boom periods in the fifties helped Sri Lanka maintain a relatively strong external assets position and defend the exchange rate without imposing quantitative restrictions on imports. From 1957 onwards, Sri Lanka's balance of payments took a completely different turn. The terms of trade turned adverse, contributing to a continuing unfavourable external payments position from 1957 to 1964. The net external assets of the country declined by US dollars 129 million between 1957 and 1960 and by a further US dollars 40 million during the next four years due to continuing overall deficits in the balance of payments. The terms of trade deteriorated by about 9 per cent between 1957 and 1964. Following these developments, there was a drastic decline in the level as well as the import capacity of gross external assets. The level of gross external assets declined from US dollars 251 million (Rs. 1,194 million) in 1957 to US dollars 64 million (Rs. 305 million) in 1964 while the import capacity of gross international reserves dropped from 13 months in 1957 to 2.1 months by the end of 1964.

As indicated previously, the problems in the balance of payments were only partially related to adverse movements in the terms of trade. These problems were made much worse by expansionary fiscal policies. The financing of successive budget deficits through credit creation by the Central Bank swelled total money income in the economy, which eventually increased aggregate demand. Consequently, the outlays on imports grew much faster than current receipts from exports of goods and services, exerting increased pressure on external assets. Successive Central Bank Reports had drawn attention to the scale of fiscal and monetary expansion and their adverse implications on the country's balance of payments. During this period, the Central Bank repeatedly emphasised the need for total imports to bear a closer relationship to Sri Lanka's import capacity. The Central Bank contended that the deficits

in the balance of payments and the drain on external assets were essentially budget-induced and stressed that basic corrective action would be to achieve a substantial reduction in the budget deficit.⁶

(b) 1960 - 1970

The continued worsening of the external payments position from 1957 called for urgent corrective action. As the international payments situation was at a critical stage and the maintenance of the convertibility of the rupee was under serious threat, the high and growing demand for imports had to be suppressed by vigorous controls and rationing of foreign exchange. In 1960, the government enforced a series of measures to reduce the demand for imports. The Central Bank supplemented those measures by monetary policy action which included raising Bank Rate and reserve requirements, imposition of cash margins on Letters of Credit, ceilings on advances for importing certain types of goods and restrictions on hire purchase finance.

The imposition of widespread and stringent import and exchange restrictions during the early 1960s failed to stabilize Sri Lanka's weakening external payments position. In order to ease the pressure on international reserves, the Central Bank in 1961 utilized the reserve tranche of Special Drawing Rights (SDR) 11.3 million with the International Monetary Fund (IMF), which was equivalent to 25 per cent of the country's quota. Sri Lanka made a further drawing of an equivalent amount in 1962 under the first credit tranche from the IMF as a balance of payments support loan. Despite these drawings, the overall payments position continued to remain weak. The Annual Report of the Central Bank for 1964 carried a detailed analysis of the problems faced by the country due to the widening imbalances in her international payments position and the difficult challenges the country was facing in the wake of the widening foreign exchange gap. While the Central Bank highlighted the importance of "project aid" to achieve medium-term and long-term growth objectives, the Bank stressed the need for immediate additional external assistance in the form of concessional aid to support and strengthen the country's external payments position⁷.

6 Central Bank of Ceylon, 1950-75 Commemorative Volume, p.19.

7 Central Bank of Ceylon, Annual Report, 1964, pp 3-12.

Despite some improvement in the terms of trade and the severe curtailment of imports, pressure on external assets continued through 1965 although the year ended with an overall surplus of US dollars 18 million (Rs. 86 million). Once again it became necessary to resort to drawings from the International Monetary Fund to support the balance of payments. By then, it was becoming increasingly apparent that the stringent controls on imports were not capable of solving the basic problems in the balance of payments. The rupee was devalued by 14 per cent in 1967. Several new policy measures were introduced soon afterwards including the Foreign Exchange Entitlement Certificate Scheme (FEECS) with the hope of reducing chronic imbalances in the balance of payments. At the same time, the country started accumulating medium and long-term external liabilities. The Central Bank proceeded to make further drawings from the IMF as balance of payments support. Drawings were made under the Compensatory Financing Facility (CFF) for export shortfalls in 1967 and 1968 and under the credit tranches in 1967, 1968, 1969 and 1970 (Table 6.2). During the four year period 1967-70, a total of SDR 84 million was made available to Sri Lanka under these facilities.

As a whole, the external payments position weakened considerably during the 1960s. The depletion of external assets was so rapid that despite the imposition of stringent controls on imports, the import capacity of reserves declined to about 2.5 months during the 1960s as compared with an average import capacity of 7.6 months in the 1950s. With the continuous adverse developments in the balance of payments and the steady accumulation of external liabilities, the external value of the rupee came under heavy pressure. Consequently, the Central Bank's ability to maintain the convertibility of the rupee for international current transactions was seriously impaired.

By the end of the 1960s, Sri Lanka had accumulated a substantial amount of short-term debt, which was a matter of serious concern for the Central Bank. As the share of resources available by way of foreign exchange receipts from current transactions continued to decline, financial prudence required that an increased absorption of resources should be continued with an increase in long-term capital inflows. However, the amount of capital available in the form of long-term capital stagnated after 1967. Consequently, there was increased recourse to short-term

trade financing. Since the balance of payments difficulties faced by Sri Lanka were essentially due to structural weaknesses, further use of short-term credit for balance of payments purposes, without concerted efforts to correct these weaknesses, did not seem appropriate. The Annual Report of the Central Bank for 1969 observed that "given a persistent resource gap, it is preferable to finance it through long-term aid rather than placing reliance on short-term foreign credit because the latter tends to aggravate the balance of payments situation by imposing a heavy debt servicing burden in the short-run." These prognostications of the Bank became real before long when there was a sharp increase in debt service payments on account of short-term debt in the early 1970s.

Table 6.2
Balance of Payments Support Loans from the IMF 1950-1989
(SDR Million)

Fund Facilities	1960-70	1971-77	1978-89
CFF for export shortfalls	38.8	59.8	212.8
BSFF Rubber	-	-	5.8
Oil Facility	-	77.7	-
Reserve Tranche	11.2	-	24.8
Credit Tranches,SBA,EFF	109.9	37.6	414.5
SAF	-	-	111.8
Total	159.9	175.1	769.9
Less Repurchases	72.2	129.3	524.1
Net Use of Fund Credit	87.7	45.8	245.8

Source: Central Bank of Sri Lanka

Note:

- CFF - Compensatory Financing Facility
- BSFF - Buffer Stock Financing Facility
- SBA - Stand By Arrangement
- EFF - Extended Fund Facility
- SAF - Structural Adjustment Facility

(c) 1970 - 1977

The developments in the external payments position during the period 1970-77 were similar to those in the 1960s, except that the accumulation of external liabilities proceeded at a speedier rate. As happened during the 1950s, the terms of trade experienced mixed fortunes during these seven years. The 1973-74 oil price increase exerted additional pressure on the balance of payments. This was temporarily cushioned by IMF assistance which amounted to SDR 78 million under the Oil Facility, between 1975 and 1977. It was gradually realized that there were serious underlying weaknesses in the external sector, comprising the exchange rate system and trade and payments system, and in the overall approach to economic management which had to be corrected without further delay. Although a five year development programme for 1972-77 had been launched, the plan could not be implemented owing partly to weaknesses in the plan itself and partly to severe resource constraints.

The Central Bank during this period was seriously concerned about the rising external debt and debt service payments. While total external debt rose from SDR 446 million (Rs. 3,249 million) in 1972 to SDR 705 million (Rs. 13,321 million) by 1977, the debt service ratio remained above 20 per cent except in 1977 when it declined to 16 per cent as a result of an increase in export earnings due to favourable export prices. During these difficult periods in which the country had to meet high debt service obligations, the Central Bank had to make short-term borrowings in international financial markets to maintain an adequate level of reserves and buttress import capacity. The outstanding level of the Central Bank's annual short-term debt amounted to about SDR 30 million during the 1972-1974 period. To overcome external payments difficulties, IMF resources amounting to SDR 153 million were made available under the Compensatory Financing Facility (CFF) for export shortfalls, the Oil Facility and the credit tranches during the period 1971 to 1977. When these drawings are netted out for repayments in respect of earlier drawings, the net use of IMF credit by Sri Lanka amounted to SDR 23 million.⁸

8 The drawing of SDR55 million made under the Stand By Arrangement in late 1977 is not included in this total.

Post 1977 Period

Sri Lanka introduced a series of economic reforms in August, 1977, which culminated in the presentation of the Budget for 1978, in mid-November, 1977. The new measures represented a substantial policy initiative to free the economy from excessive administrative controls and to promote the allocation of resources in accordance with the market mechanism in which relative prices adjust to reflect underlying market relationships.

It was realised that although various incentives had been offered to encourage and diversify exports, strengthening the balance of payments depended heavily on more fundamental changes in the structure of prices and incentives. Therefore, the shifts towards market orientation of economic activities was not merely aimed at accelerating economic growth, but also aimed at solving Sri Lanka's external sector problems. The policy reforms also included measures to reduce the expansionary impact of government budget deficits by reducing welfare oriented expenditures and rationalising subsidy programmes, with the objective of easing the budget related pressures on money, prices and the balance of payments.

The Central Bank supported the policy initiatives by amending the Monetary Law Act to accommodate a managed floating exchange rate system to replace the previous fixed exchange rate system. In addition, the Central Bank supported external sector policies through appropriate monetary policy measures as well as by improving the institutional set-up to facilitate trade financing, for promoting foreign private investment and encouraging inward remittances. Noteworthy developments were the introduction of offshore banking facilities as an incentive scheme to attract foreign private investors to the newly established export-processing zone, the Non-Resident Foreign Currency Accounts Scheme to facilitate inward remittances by Sri Lankans working abroad and the introduction of concessional lending facilities to export-oriented activities.

The shift in economic policies from an inward looking development strategy to an outward looking or more liberalized development strategy could not fully resolve the country's external sector problems. Although

the policy package introduced in the late 1970s was expected to improve the balance of payments situation in the medium and long-term with reasonable stability in the exchange rate, achievement of this objective was hampered by several policy and non-policy related impediments.

The policy-related developments which hindered the anticipated achievements in Sri Lanka's international payments position were again related to large fiscal imbalances, initially due to ambitious, long-gestation investment programmes undertaken by the government without due regard to domestic resource constraints, followed by the continuous postponement of required adjustments in the wake of deteriorating domestic economic conditions.

While public investment which averaged less than 8 per cent of GDP per year during 1970-77 rose to over 15 per cent of GDP during 1978-83, responding favourably to the liberalized economic reforms introduced in 1977, private investment also showed similar growth. The combined effect was an increase in total investment to about 28 per cent of GDP from about 16 per cent during the earlier period. With these developments, domestic demand continued to grow, exerting heavy pressure on prices, the balance of payments and the exchange rate. On the external side, the cyclically high export prices and increased aid inflows permitted Sri Lanka to maintain gross international reserves at levels exceeding 5 months of imports in the 1977-78 period. However, from about mid-1979 onward, the international economic scene became less favourable to Sri Lanka. The terms of trade declined by 16 per cent between 1979 and 1982. While the deficit in the current account excluding foreign grants rose from 5.5 per cent of GDP to a level averaging 16.5 per cent during 1980-1981, net aid inflows could finance only a portion of the enlarged deficit. Despite the public sector resorting to large commercial borrowings from abroad, the balance of payments recorded an overall deficit of SDR 166 million in 1980 and a further deficit of SDR 26 million in 1981.

The crux of the external adjustment problem faced by Sri Lanka was that the increased reliance on foreign savings had not been matched by comparable gains in exports to service the associated increase in external debt. In order to reduce the growing pressure on external assets, the Central Bank adopted a very restrictive monetary policy during this

period. In addition, outstanding commercial borrowings by the Central Bank increased from about SDR 3.4 million at the end of 1979 to SDR 18 million in 1980. The restrictive monetary policy measures introduced in 1980 were aimed at both domestic price stabilization and reducing pressure on the balance of payments. These measures were targeted at reducing excess domestic demand by raising the cost of funds. However, the balance of payments position continued to be under heavy pressure and the Central Bank had to intensify the restrictive monetary policy measures in 1981. The Bank, in May 1981, had to resort to very direct measures to curtail expansion of credit and reduce leakages though the balance of payments.

Despite the introduction of a liberalized policy package in 1977, weaknesses in the external sector became a major constraint which reduced the flexibility in the management of foreign reserves. The Central Bank in its Annual Report for 1981 commented that "to be effective tools of economic stabilization, monetary and fiscal policies should have a common goal. Restrictive monetary policy can have little impact in the context of an expansionary fiscal policy. In any event, the leakage of excessive credit expansion through loss of external reserves has obvious limits, given the need to maintain a satisfactory level of reserves⁹." The same Report proceeded to state that "Sri Lanka's balance of payments problem is fundamental in character and major adjustments are required to bring about reasonable stability in external payments. This cannot be achieved in the short-run. In the short-run the emphasis of stabilization policies is directed more on demand management However, medium and long- term policies should necessarily be formed on long-term stability through the expansion and diversification of exports¹⁰."

Restrictive monetary policy measures together with some depreciation of the exchange rate and fiscal restraint on capital expenditures helped to contain the flow of imports to some extent by 1982. The volume of imports in fact dropped by 8.4 per cent between 1980 and 1982. Despite this contraction of imports, the overall balance remained in deficit due to the sluggishness of exports and worsening of the services account due

9 Central Bank of Sri Lanka, Annual Report, 1981, p.8.

10 Central Bank of Sri Lanka, Annual Report, 1981, p.10.

to increased debt service payments. The pressures on international reserves were particularly strong after September 1982. The Central Bank, in order to forestall the drain on its foreign exchange reserves, increased its outstanding short-term foreign debt from SDR 16 million in September, 1982 to SDR 125 million by June 1983. In addition to the Central Bank's short-term borrowings, the rest of the public sector was also accumulating a large amount of short-term debt.

It was obvious, at the time, that more fundamental corrective measures were urgently needed in all major areas of the economy to avoid a crisis in the balance of payments. Therefore, as a significant step, a Stand-By Arrangement was negotiated with the IMF in support of the adjustments needed, among other things, to reduce the current account deficit of the balance of payments from 15 per cent of GDP in 1982 to 12 per cent in 1983 and to 10 per cent in 1984.

While a stabilization program with a commitment of SDR 100 million from the IMF was launched in mid-1983, the country was again blessed with a boom in international tea prices and the terms of trade improved by 23 per cent in 1983 and by a further 24 per cent in 1984. During this period, the prices of rubber and coconut, on average, were also favourable. The Stand-By Arrangement was suspended after utilizing only 50 per cent of the committed Fund support under the program. The current account deficit, excluding official grants, declined from 19.8 per cent of GDP in 1980 to 3.6 per cent of GDP in 1984 and the overall balance recorded a surplus of SDR 297 million in 1984. The reserve management task could have been extremely difficult for the Central Bank in the absence of those favourable terms of trade gains, especially because of the emerging constraints on development due to civil disturbances which had led, inter alia, to heavy defence related expenditures, a fall in tourist income and the deterioration of the investment climate. Benefits from the terms of trade gain coupled with the undisrupted inflow of official capital on concessional terms, enabled the country to rebuild its stock of foreign exchange reserves during this period.

The Central Bank responded to these externally induced favourable developments by taking appropriate measures to moderate their inflationary impact and reduce its accumulated short-term external

liabilities. The level of outstanding short-term debt of the Central Bank declined from SDR 71 million at the end of 1983 to virtually zero by the end of 1984. The level of gross external assets of the country reached a peak of SDR 735 million in 1984 from SDR 296 million in 1980 and the international reserves held by the Central Bank also rose from SDR 192 million to SDR 494 million during this period (Table 6.3). The import capacity of the reserves held by the Central Bank rose from 1.5 months in 1980 to 3.2 months in 1984.

However, favourable developments in the external payments position were short-lived. Although the country was able to manage with a comfortable level of foreign reserves accumulated during the boom period 1983-84, the required adjustments in key areas of the economy were constantly delayed. On the one hand, continued civil disturbances prevented the full potential of exports being realized and, on the other, the terms of trade took a reverse-turn when prices of Sri Lanka's basic imported commodities increased considerably in the international markets. The balance of payments position showed large overall deficits after 1985. In the three years after 1985, the cumulative effect of the overall deficits was a decline in the country's net external assets by SDR 238 million. Again in 1987 the Central Bank resorted to short-term borrowings to supplement reserves. The level of the Central Bank's borrowings stood at SDR 41 million by the end of 1987. Despite these borrowings, the international reserves held by the Central Bank dropped by 58 per cent between end 1984 and end 1987. The import capacity of Central Bank's reserves once again declined to 1.5 months.

An adjustment program was immediately launched with IMF assistance of SDR 109 million under the Compensatory Facility for Export Shortfalls and another SDR 45 million under the Structural Adjustment Facility (SAF). Although the adjustment program under the SAF aimed at, among other things, a marginal surplus of about SDR 4 million in the balance of payments in 1988, the achievements fell considerably short of expectations. The implementation of macroeconomic adjustment policies including a restrictive monetary policy stance, which sought to improve the balance of payments performance, was interrupted by the

worsening fiscal situation largely due to the unsettled domestic security conditions. Furthermore, these uncertainties prevented anticipated capital inflows, both private and official, from being realized.¹¹ The overall balance, instead of the anticipated surplus, recorded a deficit of SDR 64 million in 1988. The level of international reserves held by the Central Bank fell drastically and reached a critical level by mid 1989.

Table 6.3
Balance of Payments, External Assets and Bank Borrowings
 (SDR Million)

	Overall Balance	Gross External Assets Total	Central Bank	Bank Borrowings	Debt service payments
1978	65	371	305	8	120
1979	35	475	392	3	118
1980	-166	296	192	18	137
1981	-26	387	284	11	150
1982	-18	466	302	78	228
1983	1	496	295	71	287
1984	297	735	494	-	308
1985	-111	611	386	-	341
1986	-65	492	274	-	357
1987	-62	423	203	41	383
1988	-64	428	193	5	403
1989	-67	447	191	50	371

Source : Central Bank of Sri Lanka

The sporadic civil disturbances in 1989, the deterioration of the terms of trade, the lack of adjustments of the fiscal deficit together with some real appreciation of the exchange rate brought the external payments situation to a near-crisis by mid-1989. It was well known that large scale capital flight was taking place due to both political and speculative reasons, exerting further pressure on external assets. While negotiations were underway to move on to the much needed second year arrangement under the Structural Adjustment Facility with the IMF, the Central Bank adopted very restrictive monetary policy measures as in the early 1980s,

11 Central Bank of Sri Lanka, Annual Report, 1988, p.18.

to minimize the leakage of credit through the balance of payments. The Central Bank's reserves were under severe pressure and the Bank had to finance the enlarged deficit in the balance of payments by raising the level of short-term foreign borrowings. By mid-1989, the outstanding level of short-term borrowings by the Central Bank was almost equal to the level of gross official reserves which stood at SDR 125 million at the end of June 1989. This was sufficient to finance only about three weeks of imports. Total gross reserves, including those of the commercial banks, were sufficient to finance only about three months of imports.

The second-year arrangement under the Structural Adjustment Facility was approved by the IMF in October 1989 enabling Sri Lanka to draw SDR 67 million which was equivalent to 30 per cent of Sri Lanka's quota in the Fund. The external target of the second SAF arrangement is to reduce the current account deficit gradually to about 6 per cent of GDP by 1992, allowing for a modest recovery in the level of gross official reserves. The Central Bank's role in the structural adjustment program was to implement appropriate monetary policy measures while maintaining flexible management of the exchange rate and monitoring the implementation of the program.

There has been a sharp turn-around of the balance of payments situation since September, 1989 following the restoration of confidence in the economy as a result of the implementation of the economic stabilization measures and improvement in the security situation. While the total gross external assets of the country amounted to SDR 501 million, gross reserves held by the Central Bank stood at SDR 243 million as at the end of May 1990. This has been a significant and noteworthy achievement on the balance of payments front in the midst of very difficult circumstances.

The Exchange Rate, Exchange Arrangements and Reforms

Pre -1977 period

Sri Lanka became a member of the International Monetary Fund (IMF) on August 29, 1950, the day after the opening of the Central Bank, and according to the Articles of Agreement of the IMF the par value of the Sri Lanka rupee was fixed at Rs. 4.76190 = US dollar 1. As Sri Lanka

was a member of the Sterling Area the exchange rates were based on the fixed Sterling/Sri Lanka rupee rate of Rs. 13.33 and the rates for other currencies in London. The par value of the US dollar was expressed in terms of gold as 0.888671 grams of fine gold per dollar. Therefore the par value of the Sri Lanka rupee in terms of gold was 0.186621 grams of fine gold.

The Central Bank issued regulations prescribing that currencies for settlement with countries in the non-Sterling Area were to be similar to the regulations governing payments with other Sterling Area Countries¹². Accordingly, payments to the Sterling Area could be made in any Sterling Area Currency, and receipts from the Sterling Area could be accepted in any Sterling Area currency. Settlements with countries with which Sri Lanka had entered into bilateral payments agreements had to be made through the relevant clearing accounts. Payments to all other countries had to be made by crediting sterling or Sri Lanka rupees to a Sterling External Account or an External Rupee Account, or in the currency of the creditor country. Receipts from all other countries had to be accepted in sterling or Sri Lanka rupees from a Sterling External Account or an External Rupee Account, in any specified currency, or any other marketable or freely exchangeable currency in the United Kingdom. International transactions involving deviations from the general regulations required permission from the Controller of Exchange.

Sri Lanka adopted the fixed exchange rate system introduced by the Bretton Woods system. While Sri Lanka was experiencing significant prosperity in her foreign exchange reserve position in 1951, public opinion in the country was moving for an upward revision of the exchange rate as a measure to combat inflation¹³. The Central Bank, however, decided against such an upward revision because the Bank felt that long-term considerations outweighed the immediate benefits of a lowering of the cost of living and more equitable distribution of income.

Sri Lanka maintained the par value of the Sri Lanka rupee without much difficulty in a relatively open economic environment in the 1950s as it

12 The IMF, Annual Report on Exchange Restrictions.

13 Central Bank of Ceylon, 1950-75 Commemorative Volume, p.20.

had a fairly comfortable level of foreign reserves up until 1957. However, the par value and the free convertibility of the rupee were sustained from 1957 to 1960 at the cost of a continuous depletion of external assets. As the flexibility of exchange rate adjustments was limited, stringent control of imports and other foreign payments were imposed to defend the par value of the Sri Lanka rupee in the early 1960s, with severe adverse implications on the balance of payments and on overall economic growth.

There were several noteworthy changes in the exchange rate system during the period 1960-1977. The first was the devaluation of the Sri Lanka rupee by 20 per cent on November 22, 1967. With the continuous deterioration of the external payments position and the depletion of foreign reserves of the country, it was apparent, from the early 1960s, that the Sri Lanka rupee was highly over-valued. When India devalued its currency in June 1966, the Sri Lanka government decided not to follow suit. But with the devaluation of the sterling in November 1967, the Central Bank recommended a 20 per cent devaluation of the Sri Lanka rupee in order to avoid a large misalignment of exchange rates between the Sri Lanka rupee and other currencies. The Central Bank was of the view that a devaluation of the rupee of this magnitude would be sufficient to provide incentives to enhance the export effort of the country. It was also felt that the devaluation would help to bring domestic prices in line with the scarcity value of foreign exchange and would help to do away with a substantial array of restrictions on foreign payments. Although the rupee was devalued by 20 per cent to Rs. 14.29 per pound sterling or 0.149297 grams of fine gold per rupee (Rs.5.95237 per US dollar), no relaxation of the exchange and payments system was made at that time as the economy was too liquid and such liberalization was considered to be inappropriate.

Another noteworthy change was the introduction of the Foreign Exchange Entitlement Certificate Scheme (FEECs) on May 6, 1968. Under this scheme, a substantially depreciated rate was applicable for transactions involving FEECs, which exporters of non-traditional products and most other earners or recipients of foreign exchange were entitled to receive. With the introduction of the FEECs to encourage non-traditional exports and discourage non-essential imports and excessive foreign payments, there emerged a dual exchange rate system

in Sri Lanka. From May 6, 1968 to July 17, 1969 the FEECs rate was 45 per cent above the official exchange rate. Between July 18, 1969 and November 10, 1972 the FEECs rate was 55 per cent over the official rate. From November 11, 1972 the FEECs rate was increased to 65 per cent over the official exchange rate and remained at that level until the FEECs system was abandoned with liberalized economic policy reforms in mid- November, 1977. The official rate was applicable to exports of tea, rubber and coconut products and the imports of food, fertilizer, drugs and small amounts of other imports, mainly of government corporations and departments and to some invisible (service) items. Nearly 25 per cent of exports and 60 per cent of imports were transacted through the FEECs market during the early 1970s.

The Sri Lanka rupee had been pegged to the US dollar from November 8, 1971 to July 9, 1972. After the devaluation of the US dollar in August 1971, the exchange rates for Sri Lanka's trading currencies, namely the US dollar, Indian rupee and pound sterling were maintained at the pre-August 16, 1971 levels. This resulted in broken cross rates when compared with other markets. Following the establishment of a new par value for the US dollar on March 8, 1972 after the second round devaluation of the US currency, the official exchange rate of the Sri Lanka rupee was set at Rs. 5.95 for the dollar. Following the decision to float the pound sterling on June 23, 1972, Sri Lanka decided to repeg the rupee to sterling from July 10, 1972 at a rate of Rs. 15.60 per pound sterling.

The early 1970s was a turbulent period in world exchange rate regimes and exchange arrangements, eventually resulting in the collapse of the Bretton Woods system of fixed exchange rates. Countries like Sri Lanka had to be watchful followers in the changing world currency markets. While some countries had already adopted flexible exchange rate regimes, the Sri Lanka rupee was pegged to sterling until May 24, 1976 when the official pegging to sterling was terminated and the exchange rate was thereafter determined in relation to a basket of currencies.

The rupee was revalued on March 12, 1977 to Rs. 12.51 per pound sterling and devalued to Rs. 12.77 per pound sterling on August 19 of the same year. This exchange rate change was followed by a series of changes on August 29, September 7, and 12 and on October 31, 1977. On

November 2, 1977 the Sri Lanka rupee was devalued to Rs. 15.70 per pound sterling and revalued again to Rs.15.53 on November 4, 1977. A complete departure from the fixed exchange rate system was made on November 16, 1977 when the dual exchange rate system was abolished and the exchange rate was unified at Rs. 16 per US dollar, thereby moving over to a managed float system.

Post-1977 Period

With the introduction of liberalized trade and payments policies in November 1977, Sri Lanka adopted a managed-float exchange rate system replacing the previous fixed exchange rate regime which, on account of its complexity, had proved highly ineffective in promoting exports, encouraging efficient import substitution and the maintenance of a viable balance of payments situation. Under the managed-float system, the exchange rate of the rupee is adjusted periodically by the Central Bank, taking into account domestic price developments relative to those of Sri Lanka's major trading partners. The Central Bank intervened in the foreign exchange market in order to correct erratic fluctuations in the exchange rate and to make the preferred directional changes.

The Central Bank also commenced using the US dollar as the intervention currency. The Bank established margins between buying and selling rates equivalent to Rs. 1.50 per US dollar and Rs. 3.00 per pound sterling. Similar margins were established, until March 1982, for the Deutsche mark, the French franc, the Indian rupee, and the Japanese yen. With the intention of improving the domestic interbank foreign exchange market after November 1982 the Central Bank stopped the quoting of rates for foreign currencies other than the intervention currency, the US dollar.

With the introduction of liberalized exchange and payments arrangements, Sri Lanka has by and large avoided entering into new bilateral payments agreements to replace old bilateral agreements which had lapsed. Currently, no bilateral agreement is in effect between Sri Lanka and any other country. However, Sri Lanka is a member of a regional payments arrangement, the Asian Clearing Union (ACU), which was established in 1975. According to the procedures governing

ACU transactions, payments to and receipts from other member countries, i.e. Bangladesh, Burma, India, the Islamic Republic of Iran, Nepal and Pakistan, in respect of current transactions are made in Asian Monetary Units¹⁴ or in the currency of the respective member of the ACU. Payments for imports from all other countries have to be made in any foreign currency or in Sri Lanka Rupees. However, export proceeds must be received in designated foreign currencies¹⁵.

During the 1977 - 1987 period, the Central Bank monitored developments in the foreign currency market taking into account the inflation differentials between Sri Lanka and her major trading partners, namely USA, UK, FRG, France, Japan and India and also paying attention to the underlying trends in the balance of payments and international reserves. From mid 1987, the Central Bank commenced monitoring exchange rate developments taking into account the movements of nominal and real effective exchange rates between Sri Lanka and her trading partner and competitor countries.

The developments in Nominal Effective Exchange Rates (NEER) and Real Effective Exchange Rates (REER) were constantly monitored by the Central Bank. As exchange rate policy actions have wide repercussions on the overall economy and particularly on domestic price stability, the Central Bank has to consider the implications of exchange rate adjustments on both domestic price stabilization and external payments stabilization objectives when measures are taken to influence the exchange rate. This task has become extremely difficult due to several reasons, mainly the expansionary impact of fiscal policy, frequent volatility in cross rates among key currencies such as the US dollar, Deutsche mark, UK pound and Japanese yen and the volatility in the terms of trade. Occasionally the maintenance of stability in the real effective exchange rate has become rather difficult owing to large changes in the value of the US dollar in international exchange markets.

The rupee depreciated both in nominal and real terms between the first quarter of 1978 and third quarter of 1979. The NEER depreciated by

14 This is the unit of account for ACU transactions.

15 Australian dollars, Belgian francs, Japanese yen, Netherlands guilders, Norwegian kroner, pounds sterling, Swedish kroner, Swiss francs, and the US dollars.

7.1 per cent during this period, while the REER depreciated by 11.6 per cent. The NEER continued to depreciate throughout the 1980s, except on a few occasions. However, according to REER indicators, the rupee remained at its appreciated level from the fourth quarter of 1979 to the second quarter of 1985. In order to avoid any large erosion of export competitiveness, the exchange rate was managed more flexibly after 1986. The NEER depreciated by 32 per cent between end-1986 and end-1989. During this period the REER depreciated by 5.5 per cent. The rupee has depreciated by about 63 per cent in nominal effective terms between early 1978 and end-1989. The real effective depreciation of the rupee during this period has been 13 per cent. It could be concluded therefore, that the management of exchange rate policy since 1977 has been consistent with the objective of export promotion and efficient import-substitution.

Representation in International Lending Institutions

Sri Lanka became a member of the International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD) the day after the opening of the Central Bank on August 28, 1950. In terms of the IMF and IBRD agreements, the Central Bank was designated as fiscal agent of the Government of Sri Lanka for transactions with the IMF and IBRD, respectively, as well as the depository for holdings of Sri Lankan currency of these two institutions.

Sri Lanka was given a quota of US dollars 15 million (SDR 15 million) at the time she joined the IMF. Five per cent of the quota was paid in gold and the balance 95 per cent was paid in Sri Lanka rupees. During the 1955 - 1957 period, Sri Lanka repurchased rupees to the value of US dollars 3 million, thus reducing the IMF's holding of Sri Lanka's rupees to 75 per cent of the quota. Since then, with the general increases in IMF quotas, Sri Lanka's quota has been increased a number of times. The quota was increased to SDR 45 million in 1959, SDR 62 million in 1964, SDR 78 million in 1966, SDR 98 million in 1970, SDR 119 million in 1979, SDR 178.5 million in 1980 and SDR 223.1 million in 1983. Sri Lanka withdrew its full convertible currency component in the reserve tranche in 1985. As a result, Sri Lanka's entire quota at the IMF is currently maintained in local currency.

While the Minister of Finance of Sri Lanka holds office (ex-officio) as the Governor representing Sri Lanka at the IMF, the Governor of the Central Bank of Sri Lanka is concurrently designated as the Alternate Governor of the IMF representing Sri Lanka.

Sri Lanka did not resort to drawings from the IMF until 1961. However, as the country's balance of payments position commenced weakening in the early sixties, the IMF became an important source of balance of payments support. In the current context, evolving a financial program that is acceptable to the IMF is a sine qua non for the mobilization of foreign resources from bilateral and multilateral lenders as well as from international financial markets. A summary of the drawings made by Sri Lanka under various IMF facilities was shown earlier in Table 6.2.

The outstanding position with regard to the use of IMF facilities by Sri Lanka is shown in Table 6.4. At the end of March 1990, the outstanding drawings from the IMF stood at SDR 273 million, which was equivalent to 122 per cent of Sri Lanka's quota in the IMF. Eighty per cent of the currently outstanding drawings consist of drawings made under the CFF 1988 and under the first and second year arrangements under the SAF. Sri Lanka has received its share in SDR allocations during 1970-72 and 1979-1981 amounting SDR 34 million and SDR 37 million, respectively. Drawings from the IMF under various facilities and SDRs received in each allocation have contributed to the gross official reserves of Sri Lanka.

In terms of the IMF's Articles of Agreement, member countries are required to hold consultations at regular intervals with the IMF. These regular consultations are basically to review developments with respect to exchange arrangements, trade and payments system and general economic conditions. The first such consultation between Sri Lanka and the IMF took place in Washington in 1952. During the next two years, the consultations were held in Washington. It was in 1955, that for the first time, the IMF consultations under Article IV of the IMF Charter were held in Sri Lanka. Since then Sri Lanka's consultations with the IMF have been held more or less on a regular basis and most of these consultations are held in Sri Lanka. The Central Bank of Sri Lanka has coordinated regular Article IV consultations along with negotiations with Special Fund Missions for the use of Fund resources.

Table 6.4
Outstanding Drawings from the IMF *
(SDR Million)

	1977 Dec.	1985 Dec.	1990 March
CFF	24	18	109
BSFF	-	5	-
Oil Facility	77	-	-
Credit Tranche	48	50	4
Extended Fund Facility	-	220	46
SAF	-	-	112
Trust Fund Loans	-	69	2
Total Debt to IMF	149	362	273

Source: IMF, International Financial Statistics, May, 1990

* Excluding reserves tranche drawings.

The Central Bank of Sri Lanka also helped the government's efforts to obtain resources from multilateral lending institutions such as the IBRD and Asian Development Bank (ADB) mainly by providing the background financial and economic information required for the discussions.

Sri Lanka became a member of the Multilateral Investment Guarantee Agency (MIGA) after ratifying the convention establishing the MIGA and completing the payment of subscription to 271 shares of its capital stock on May 26, 1989. As in the case of other multilateral lending institutions such as IMF, IBRD and ADB, the Central Bank is the official depository for the financial transaction between MIGA and Sri Lanka. In addition, under Section 38 of the MIGA convention, the government has designated the Central Bank of Sri Lanka as the official channel of communication between MIGA and the Government of Sri Lanka. Negotiations are underway for finalizing the procedures for issuing guarantees for foreign investment in Sri Lanka. The Central Bank is currently involved in these discussions.