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Determining the Exchange Rate – Exchange Rate Regimes in Sri Lanka

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The Monetary Law Act (MLA), under which the Central Bank of Ceylon was established in 1950, placed with the Bank the responsibility of the preservation of the par value of the Ceylon rupee and the free use of the rupee for current international transactions. Following the collapse of the fixed exchange rate arrangements under the Bretton Woods system globally, an amendment to the MLA placed with the Bank the responsibility of maintaining the par value or when no determination of such par value has been made, maintaining such exchange arrangements as consistent with the underlying trends in the country and relate its exchange with other currencies, as to assure its free use for current international transactions. The MLA also requires the Bank to maintain international reserves adequately to meet any foreseeable deficit in the BOP to maintain the international stability of the rupee and to assure the greatest possible freedom of its use in the current international transactions.

Accordingly, it is a responsibility of the Central Bank to maintain a suitable exchange rate arrangement for the country in line with the underlying macroeconomic conditions and maintain international stability of the currency. This paper outlines the way in which the Bank discharged this responsibility by maintaining an appropriate exchange system and effecting changes to the system promptly to deal with emerging challenges and thereby endeavoured to maintain the international stability of the currency over the last 60 years.

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Fixed Exchange Rate Regime

At the time of independence, Sri Lanka had a fixed exchange rate system pegged to the pound sterling under the Bretton Woods System. The linking of the rupee with the pound sterling was influenced mainly by Sri Lanka's trade links with the Sterling Area, which had been established during the pre-independence colonial era. According to the Ceylon Currency Ordinance No.2 of 1949, there had been an automatic link of the Sri Lankan rupee with pound sterling via Indian rupee. Hence, even though the Pound Sterling was devalued in 1949, according to this law it was not possible to change the rupee exchange rate against the pound sterling as long as the sterling-Indian rupee exchange rate remained unchanged. The Currency Law was amended by the Currency Amendment Act No.4 of September 1949 to abandon this automatic sterling-Indian rupee link with the Sri Lankan rupee. Accordingly, the exchange rate of the Sri Lankan rupee was linked directly to gold instead of the Indian rupee or the pound sterling. This amendment of the Law gave the flexibility to Sri Lanka to determine its own exchange rate in relation to any currency. The parity was fixed at one Sri Lankan rupee to 2.88 grams of gold, preserving the then existing parity of the Sri Lankan rupee with the pound sterling at 1 shilling and six pence. Thus, the value of the pound sterling in terms of the rupee was Rs. 13.3336.

The US dollar-rupee rate was determined by the US dollar-sterling rate in the London market. As mentioned above, even though the Sri Lankan rupee was not devalued when the pound sterling was devalued in 1949, the Sri Lankan rupee was devalued against the US dollar by 30 per cent to Rs. 4.77. The devaluation coupled with the Korean War boom, brought about a massive surplus in the balance of payments. When Sri Lanka accepted membership of the IMF in 1950, this parity was used as the par value of the rupee. During the 1948-1966 period, the parity between the rupee and the pound sterling remained unchanged at Rs. 13.3336, while the rupee-dollar exchange rate remained unchanged at Rs. 4.77 during 1949 – 1966.

The continued pressure on external assets in Sri Lanka due to imports growing at a faster rate than exports, made it imperative that the Sri Lankan rupee be devalued. Accordingly, it was devalued by 20 per cent on 22 November 1967. Though this was intended to improve export competitiveness in Sri Lanka while discouraging imports, it proved to be an unsuccessful attempt as it was effected with a considerable time lag in relation to the developments in external trade.

Multiple Exchange Rate Regime (1968-1977)

The fixed exchange rate system came under tremendous pressure towards late 1950s but was continued despite balance of payments problems and a rapid depletion of international reserves with the support of progressively stringent controls imposed on external trade and payments. In 1968, an attempt was made at partial liberalisation by introducing a system of Foreign Exchange Entitlement Certificates (FEECs). The FEECs was a system of dual exchange rates with one "official" exchange rate applicable to essential imports and traditional exports, and the other much depreciated rate applicable to all other exports and imports. This had the twin objectives of export diversification with an additional incentive for non-traditional exports and import compression by allowing the market mechanism to regulate "non-essential" imports, and thereby addressing the balance of payments problem in the country. Initially, the FEECs rate for the pound sterling was fixed at Rs. 20.5714, which was 44 per cent above the official rate of Rs. 14.2857 per pound sterling. This rate was increased to 55 per cent in 1969 and to 65 per cent in 1972. However, the BOP deficit was continued, requiring further tightening of controls particularly with the oil price crisis in 1973. The FEECs system was continued with such stringent controls till 1977.

The convertibility of the US dollar into gold was suspended in August 1971 by the United States. With this, the rupee was linked to the US dollar at the prevailing parity of Rs. 5.9524 per US dollar, allowing the parities against other currencies to be determined on the basis of their cross rates to the US dollar in international foreign exchange markets. As the Bretton Woods fixed exchange rate system began to collapse globally, in June 1972, the pound sterling was floated. With this, the rupee, which had been linked to the US dollar from November 1971 was re-linked to the pound sterling in July 1972 at the existing parity of Rs. 14.94. The parities with other currencies were fixed from time to time on the basis of their cross rates with the pound sterling in the international foreign exchange markets. Though this practice of fixing the exchange rate from time to time could have created arbitrage opportunities, it may have not been possible to make use of such opportunities due to exchange control regulations.

Sri Lanka moved from a hard peg to a single currency, to a basket peg in May 1976 in determining the exchange rate by relating it to an appropriately weighted basket of currencies. This step was necessitated by the need to insulate the rupee from random events abroad, which under the previous regime, tended to be transmitted to Sri Lanka, via the link between the rupee and the pound sterling. With the use of a basket of currencies in the determination of the exchange rate, there was a greater scope for underlying trends in the Sri Lankan economy to be represented in Sri Lanka's exchange rates vis-a-vis other currencies. The exchange rate was gradually re-adjusted under a crawling peg system between August and mid November 1977 with the intention of finding a more realistic rate of exchange for the rupee.

Managed Floating Exchange Rate Regime (1977 – 2001)

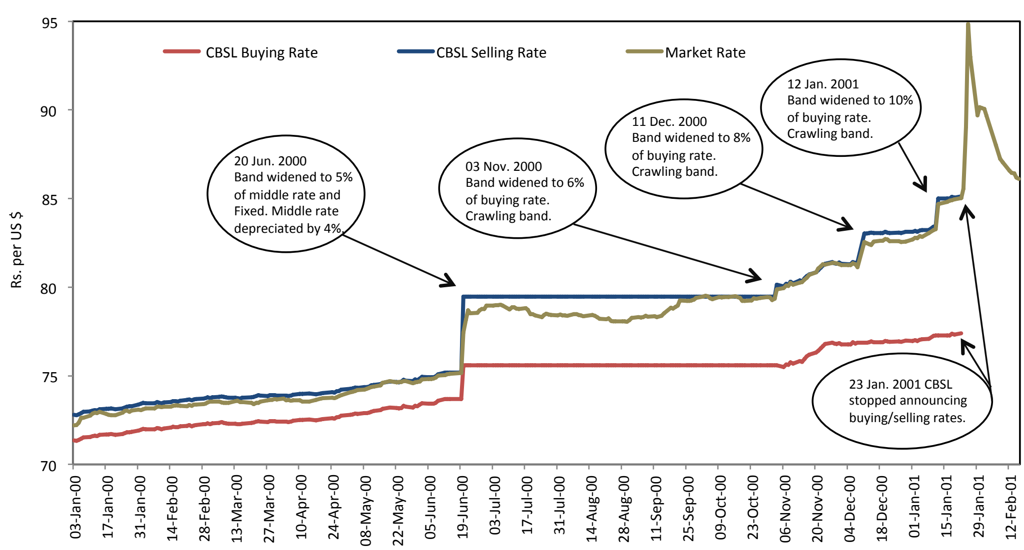
In November 1977, Sri Lanka made a major shift from restrictive policies towards a liberal policy regime by removing most of the restrictions on transactions on external trade and payments. The dual exchange rate system was abolished by introducing a unified exchange rate, while the rupee was initially depreciated by 46 per cent. With the unification, the exchange rate was allowed to float, providing scope for the exchange rate to be determined largely on the basis of demand and supply conditions in the market. The new system marked a radical shift in Sri Lanka's exchange rate policy by moving from a fixed exchange rate regime to a managed floating exchange rate system based on a basket of currencies. The more market oriented system of managed float was expected to insulate the domestic currency from unwarranted random events and to maintain a realistic exchange rate closer to the true price to ensure the external competitiveness of domestic goods and services.

Under the managed floating system, the Central Bank initially quoted its fixed daily buying and selling rates for six major currencies. However, after 1982, the Bank limited its quotations only to the intervention currency, the US dollar, allowing the commercial banks to determine the cross rates for other currencies based on market conditions. At the beginning, the band width was set at Rs. 1.50 per US dollars 100. This was revised to Rs. 3.00 per US dollars 100 in March 1987. The margin was gradually raised to 1 per cent by March 1992 and to 2 per cent in 1995.Therefore, this system was better known as a managed floating with a crawling band. With the liberalisation of the exchange rate under the managed float system, the country also liberalised its payments system by removing exchange control regulations. By March 1994, it had completed the removal of all restrictions on current external transactions and accepted Article VIII of the Articles of Agreements of the IMF. Capital account transactions were also largely liberalised, except for restrictions on investment abroad and borrowing abroad by residents, and investment in domestic debt instruments by non-residents.

In 2000, the Sri Lankan economy faced a major challenge of a critical decline in its external reserves due to two main reasons, i.e., a sharp increase in the prices of petroleum products and expenditure on defence related imports with the escalation of war with terrorists. Accordingly, a massive deficit of US dollars 516 million in the balance of payments was recorded in 2000, placing a tremendous pressure on the external reserves and the exchange rate.

Chart 7.1

Buying and Selling Rates of the Central Bank and Market Rates



In this background, the Central Bank faced a major challenge in managing the exchange rate with the crawling band. There was a continued pressure on the exchange rate to depreciate and the market exchange rate tended to operate around the Central Bank's selling rate most of the time, requiring the Bank to sell foreign exchange to defend the exchange rate. The Central Bank responded to this by widening the spread between its buying rate and the selling rate. As shown in Table 7.1 & Chart 7.1, it was raised progressively to 5 per cent in June 2000, to 6 per cent in November, to 8 per cent in December and to 10 per cent in January 2001, allowing market forces a greater scope to determine the exchange rate.

However, the market exchange rate reached the selling rate of the Bank immediately after the widening of the band, and this proved the fact that maintaining an exchange rate band was no longer sustainable given the market conditions prevailing at the time with rapidly dwindling external reserves. The country's official external reserves fell sharply from US dollars 1,619 million at end 1999 to US dollars 1,386 million by June 2000 and further to US dollar 1,043 million by end December 2000. This level of reserves was not sufficient to finance even two months of imports. The Bank also lost the control over monetary policy as monetary policy had to be used to defend the exchange rate, rather than to achieve its primary objective of price stability. The Bank raised its Repurchase and Reverse Repurchase rates eight times to reach 20 per cent and 23 per cent, respectively, by January 2001, from 9.25 per cent and 13.48 per cent that prevailed in December 1999 (Table 7.2). These increases in interest rates and reserve losses were the cost of maintaining a fixed exchange rate band. This showed that this system of exchange rate determination was not sustainable over the long run and hence it was imperative that the country move to a system of free floating unless it was prepared to give up the achievements in liberalisation so far and move back to introducing restrictions on current account transactions, violating the obligations under the Article VIII of the IMF.

Independent Floating Exchange Rate Regime

Sri Lanka took a major step forward in the liberalisation of foreign exchange transactions on 23 January 2001, by allowing commercial banks to determine the exchange rate freely while abstaining from daily announcement of the buying and selling rates of foreign exchange in advance. It indicated that the Bank would participate actively in buying and selling at or near market prices. The new system permitted freer transactions in the market while stabilising the value of the rupee and helping authorities to build up official foreign reserves. This in fact was a culmination of the process of allowing greater flexibility in the determination of the exchange rate by widening the band with its complete removal. In order to support the system by restraining speculative activities in the market, which were likely in the early stage of floating and to encourage exporters to bring back export proceeds, the Bank also implemented the following precautionary prudential measures.

- Limits were placed on daily working balances maintained by commercial banks in foreign exchange, on the basis of past export-import transactions. This was to prevent banks building up foreign exchange for excessive trading.

- Banks were instructed to ensure settlement of export proceeds within 90 days. Penalty interest rates were to be charged when overdue.
- Forward sales and purchase of foreign exchange were to be backed by a rupee deposit of 50 per cent, to discourage excessive forward contracting.
- Banks were advised not to permit early or prepayment of import bills, in anticipation of depreciation.
- Banks were also instructed to limit their forward market operations only to trade based transactions.

Table 7.1
Exchange Rate Changes

Date	**Band width**	**Exchange Rate of CBSL (Rs./US$)**			**Depreciation (%) at CBSL**		
		Buying	**Middle**	**Selling**	**Buying**	**Middle**	**Selling**
10-Nov-1982	Rs.1.50/= per 100 US$	21.0225	21.03	21.0375	-		-
6-Mar-1987	Rs.1.50/= per 100 US$	28.7325	28.74	28.7475			
9-Mar-1987	Rs.3/= per 100 US$	28.735	28.75	28.765	0.01	0.03	0.06
28-Feb-1992	Rs.3/= per 100 US$	42.9650	42.9800	42.9950			
23-Mar-1992	1.0 per cent	42.9840	43.2000	43.4160	0.04	0.51	0.97
17-Mar-1995	1.0 per cent	49.6804	49.9300	50.1797			
20-Mar-1995	2.0 per cent	49.4109	49.9100	50.4091	-0.55	-0.04	0.46
19-Jun-2000	2.0 per cent	73.6907	74.4350	75.1794			
20-Jun-2000	5.0 per cent	75.6000	77.5400	79.4700	2.53	4.00	5.40
2-Nov-2000	5.0 per cent	75.6000	77.5400	79.4700			
3-Nov-2000	6.0 per cent	75.6000	77.8700	80.1400	0.00	0.42	0.84
8-Dec-2000	6.0 per cent	76.8700	79.1400	81.4100			
11-Dec-2000	8.0 per cent	76.8700	79.9448	83.0196	0.00	1.01	1.94
11-Jan-2001	8.0 per cent	77.2750	80.3498	83.4246			
12-Jan-2001	10.0 per cent	77.2750	81.1388	85.0025	0.00	0.97	1.86
22-Jan-2001	10.0 per cent	77.4050	81.2688	85.1325			
22-Jan-2001	CBSL stopped announcing its buying and selling rates in advance.						

Note: During 10 November 1982 to 2 November 2000, the band was computed symmetrically about the middle rate. Since 3 November 2000, it is computed from the buying rate.

Table 7.2

Changes in Central Bank Interest Rates

Date	Repo Rate	Reverse Repo Rate	Bank Rate
31-Dec-99	9.25	13.48	16.00
05-Jan-00	9.00		
21-Jan-00		13.30	
04-Apr-00		13.00	
09-May-00	9.25		
12-May-00		13.25	
19-May-00		14.00	
08-Jun-00	9.50		
26-Jul-00	11.00		
31-Aug-00	11.75		
19-Sep-00		15.50	
29-Sep-00	13.00	16.00	
02-Oct-00			18.00
08-Nov-00	15.00	18.00	20.00
21-Nov-00	17.00	20.00	25.00
18-Jan-01	20.00	23.00	

Source: Central Bank of Sri Lanka

Immediately with the change in the exchange rate regime, an overshooting of the rate was expected and did occur, as experienced in a number of other countries. The rupee depreciated from Rs. 85 to around Rs. 98 per US dollar within the first three days, but stabilised around Rs. 88-90 per US dollar within a week's time. The weighted average exchange rate in the spot market recorded a depreciation of 9.1 per cent by 25 January 2001 compared with the pre-float level, but the rate of depreciation declined to 1 per cent by 7 March 2001. This was a relatively quick stabilisation of the exchange rate compared with the experience of other countries that floated their exchange rates. For example, Brazil's currency depreciated by 21 per cent on the first month of floating in January 1999, while the Indian rupee depreciated by 16 per cent in the first month of floating in March 1993.

Under the independent floating exchange rate system, it is not necessary for the Bank to use monetary policy to defend the exchange rate, as the exchange rate is not considered a nominal anchor. Therefore, the Bank is able to target its monetary policy to achieve the prime objective of price stability. However, the Central Bank can intervene in the market to prevent excessive fluctuations in the exchange rate. The Market Operations Committee (MOC) of the Central Bank daily monitors the current and expected foreign exchange inflows and outflows, movements in the dollar in the international market against SDR basket of currencies (Euro, Yen, UK Pound, US dollar) and against the real effective exchange rate (REER) computed with a 5-currency basket (euro, yen, pound sterling, US dollar, Indian rupee), indicators such as interest rate differential and forward premium and net open position of the commercial banks etc. in order to identify any risk of large fluctuations in the exchange rate to examine whether there is a need for the Central Bank to intervene. One of the large items of foreign exchange outflows in Sri Lanka has been the settlement of oil bills by the Ceylon Petroleum Corporation (CPC), which destabilises the market when they attempt to purchase a large amount of foreign exchange from the market to settle oil bills. Therefore, the Central Bank allowed CPC to open and maintain foreign currency accounts with two state commercial banks to build up foreign exchange deposits gradually enabling them to settle oil bills.

Under the present system of independent floating where the exchange rate is determined through market forces, the Central Bank intervention in the foreign exchange market by purchasing or selling foreign exchange has been limited only to contain excessive volatility in the exchange rate, and to build up reserves. Table 7.3 shows movements of the rupee against the US dollar and the intervention by the Central Bank since the commencement of the new exchange rate regime. Except for a few exceptions, the general tendency in the exchange rate has been to depreciate though at a varying degree, which reflect largely the higher inflation in Sri Lanka relative to inflation in its trade partner countries. In 2005, the rupee appreciated with the expectation of large scale foreign exchange inflows to assist people and re-build areas affected by the Tsunami. In November 2006, the government Treasury bill market was opened for foreign investors up to a maximum of 5 per cent of the outstanding stock. This ceiling was raised to 10 per cent in December 2007. The government Treasury bond market too was opened up to 10 per cent of outstanding stock for foreign investment in May 2008. Since interest rates in Sri Lanka were quite high relative to international markets, there had been considerable foreign financial inflows to the government securities market, particularly since late 2007, exerting pressure on the rupee to appreciate. The Central Bank as a prudential measure built up its reserves by absorbing most of the inflows and thereby contained the rupee appreciation.

Sri Lanka faced a major challenge of a significant decline in its foreign exchange reserves from the last quarter of 2008 till about mid 2009 with pressure on the exchange rate to depreciate. This was mainly due to the adverse impact of the global financial crisis together with the intensification of the war. There was a heavy demand for foreign exchange during the first few months of 2009, due to repatriation of investments in government securities by foreign investors, in view of their own liquidity constraints due to financial crisis, the settlement of large petroleum and war related import bills, and acute drying up of sources of foreign financing. As there was a severe shortage of foreign exchange in the market, the Central Bank had to fill it by supplying a significant amount of US dollars out of its foreign exchange reserves, as otherwise there would have been a substantial depreciation of the rupee, which could have been rather destabilising and would have had a lasting impact on the confidence of foreign investors, making their return to the country even with the restoration of normalcy in the international financial market rather unlikely. Accordingly, gross official reserves reached a low level of US dollars 1,082 million by March 2009. The rupee depreciated to its lowest level of Rs. 120.25 against the US dollar by April 2009.

However, with the ending of the war in May 2009, and the approval of the Stand-by Arrangement Facility (SBA) by the IMF in July 2009, investor confidence improved and foreign investments in government securities increased substantially. The Central Bank commenced re-building its reserves by absorbing foreign exchange from the market and thereby containing the

Table 7.3
Movements of the Exchange Rate and the Intervention by the Central Bank

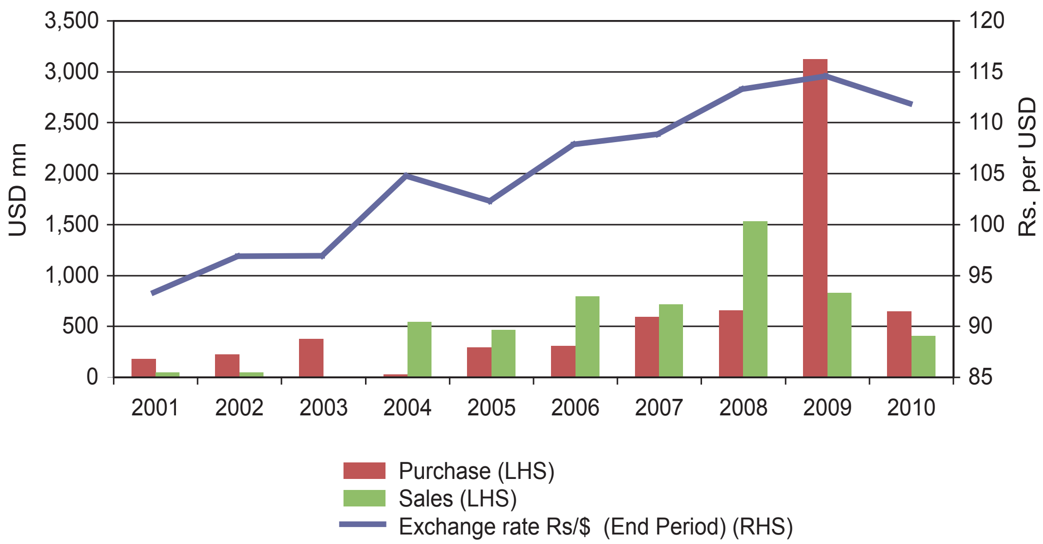
Year	Exchange rate Rs/$ (End period)	Appr./Depr. %	Purchases US$ mn	Sales US$ mn	Net US$ mn
2001	93.16	-14.06	180.25	45.68	134.58
2002	96.73	-3.69	223.65	46.58	177.08
2003	96.74	-0.01	377.40	2.50	374.90
2004	104.61	-7.52	27.0	541.68	-514.68
2005	102.12	2.44	289.95	463.70	-173.75
2006	107.71	-5.19	306.95	790.98	-484.03
2007	108.72	-0.93	592.63	715.85	-123.23
2008	113.14	-3.91	656.10	1,531.86	-875.76
2009	114.38	-1.08	3122.00	830.09	2,291.92
2010	110.95	3.09	753.20	819.80	-66.60

Source: Central Bank of Sri Lanka
Note: Negative sign denotes depreciation.

pressure on the rupee to appreciate. The receipt of two tranches of IMF facility amounting to US dollars 652 million, and a sovereign bond issue of US dollars 500 million in 2009 further supported to raise foreign reserves. Accordingly, the country's official reserves increased to US dollars 5 billion by end 2009. Other foreign inflows, such as private remittances, tourist earnings and trade related inflows also increased since the end of war. With this, foreign exchange supply in the market improved and accordingly the rupee appreciated during the second half of the year. It reached Rs. 114.38 per dollar by end of the year, resulting only a marginal depreciation of 1.08 per cent for the whole year. However, when compared to Rs. 120.25 per US dollar by April 2009, the exchange rate recorded an appreciation of 5.1 per cent by end of the year.

The inflow of foreign exchange continued into 2010, recording a further appreciation of the rupee by about 3.1 per cent from end December 2009 to December 2010 to reach Rs. 110.95 per dollar. Accordingly there has been a turnaround in the tendency in the rupee from depreciation

Chart 7.2
Central Bank Intervention and Rs/USD Exchange Rate



to appreciation, posing challenges in managing with continued foreign financial inflows. There is a pressing need to prevent a large appreciation of the rupee to support exporters to maintain competitiveness of their products in the international market. However, continued net purchases of foreign exchange by the Central Bank, though it augmented official foreign reserves and avoided large appreciation of the rupee, it has led to a substantial increase in excess rupee liquidity in the market making the monetary management a difficult task. The Bank has run out of its holdings of Treasury bills and commenced issuing its own securities in absorbing excess liquidity. A new instrument of dollar-rupee SWAP was also introduced for the same. Yet the excess liquidity remains quite high, which will eventually pose a risk of high monetary expansion unless measures were taken to address it. The sterilisation cost in 2010 was Rs. 12 billion. Therefore, in order to avoid any further build up of domestic rupee liquidity, a further liberalisation in capital account transactions with a careful monitoring system could be considered to ensure overall macro-economic stability of the country. In fact, initiatives in this regard have already been made.