

Managing Sri Lanka's Foreign Reserves

H.A. Karunaratne,
Director, International Operations Department

Introduction

During the last 60 years, the size of foreign reserves of the country, reserves management techniques adopted as well as the knowledge base have expanded significantly. Foreign reserves of the country have surged to an unprecedented level during the past one and a half years with the improved investor confidence after the end of the 30-year long conflict and stable economic and political conditions of the country. These reserves should be properly managed in order to facilitate the country to meet its foreign obligations and be invested prudently to generate income. The maintenance of adequate reserves is also crucial to preserve the external value and the stability of the Sri Lankan currency.

What are Foreign Exchange Reserves?

Foreign reserves are assets or claims that a country holds in a foreign soil. These assets fall into a wide variety of instruments ranging from short-term claims in money markets to long-term investments. Foreign assets are mainly held and managed by the monetary authority or a central bank. In certain countries such as Singapore, the responsibility of managing foreign reserves lies with institutions specially designed for that purpose. Accordingly, foreign reserves are jointly managed by the Monetary Authority of Singapore and the Government Investment Corporation in Singapore. In Sri Lanka, the Central Bank of Sri Lanka (CBSL) is the sole authority empowered by law to manage the international reserves of the country.

Legal Framework of Reserves Management

The Monetary Law Act (MLA), the Act under which the bank was established, provides the framework for deployment of the foreign currency assets and gold, defining the broad parameters in respect of currencies, instruments, issuers and counter parties in its Section 67. In brief, MLA permits the following assets categories to be maintained in its foreign assets.

- (i) Gold;
- (ii) Assets in foreign currencies in the form of –
 - a. Documents and instruments of types customarily employed for the international transfer of funds; or
 - b. Demand and time deposits in central banks, treasuries, and commercial banks abroad; or
 - c. Securities of foreign Governments; or
 - d. Foreign notes and coins; and
- (iii) Special Drawing Rights in the International Monetary Fund.

The Monetary Board, the governing body responsible for making all policy decisions related to the management, operation and administration of the CBSL, may direct to hold international reserves in gold or currencies freely convertible into gold particularly considering the prospects of stability and convertibility of the currencies as well as the anticipated demand for such currencies. It may also direct to further widen the scope of reserves management activities to enhance the safety, liquidity and return objectives of reserves management. Accordingly, with a view to further streamline the portfolio management activities, the CBSL has framed appropriate guidelines stipulating stringent criteria for issuers, counterparty investments, maturity profile and risk monitoring, which have been approved by the Monetary Board.

Objectives of Foreign Reserves Management

Since independence, primary goals of reserves management continue to be safety and liquidity while a significant focus has been placed on return objectives.

Safety, Liquidity and Return

Safety of the investments and the capital preservation are the most important aspects of any investment that cannot be compromised. This is simply to say whether the funds invested are available as and when required without depleting its value. Central banks in general invest funds in highly credible instruments and countries, even though they generate a low return with

a view to ensure the safety of its investments. Liquidity is also a major concern as it is important to avoid any default or reputational risk, which is the essence of banking. This is the ability to obtain funds as and when they required at short notice without incurring an undue cost. Return is required to service the reserves and to earn an income in order to maintain the value of the investments.

Why Reserves should be Managed

Managing reserves is paramount as to:

- Support and maintain confidence in the policies for monetary and exchange rate management including the capacity to intervene in support of the national currency, i.e., demonstrate the backing of domestic currency by external assets,
- Limit external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis,
- Support for the country's external transactions i.e. exports and imports of goods, services and financial capital as well as financial transfers,
- Provide a level of confidence to markets that the country can meet its external obligations,
- Assist the government in meeting its foreign exchange needs and external debt obligations and maintain a reserve for national disasters or emergencies,
- The accumulation of reserves may involve a financial cost, hence the effective utilisation of the reserves is crucial and it has heightened the need of managing reserves prudently.

Sources and Uses of Reserves

Accumulation of reserves in the recent past occurred mainly on account of purchases of Dollars in the local foreign exchange market. Continuous inflow of funds to the government securities due to increased investor confidence also made a significant contribution. Furthermore, remittances from Sri Lankan Diaspora, migrant worker remittances, Stand-By Arrangement Facility received from the International Monetary Fund (IMF) and proceeds from the sovereign bond issues and foreign loans and grants were the other significant contributors to the enhanced reserves. Income generated from the investments of the enhanced foreign reserves has also increased remarkably in the recent past due to active reserves management policies employed by the CBSL.

The major outflows that decreased the reserves were debt service payments and repayment of foreign borrowings and foreign exchange sales to the domestic market to meet demand for import of goods and services.

Evolution of Reserve Management

(a) Reserve Adequacy

Sri Lanka's approach to reserves management in the early days was essentially based on the traditional approach, i.e., to maintain an appropriate level of import cover defined in terms of reserves equivalent to a number of months of imports. Thus, the emphasis on import cover constituted the primary concern, until the economy was liberalised in 1977.

Subsequently, there were several changes to the external sector policy with a large number of international transactions and payment liabilities arising in areas other than import of commodities. The liabilities included discharging short-term debt obligations and servicing of medium-term debt. In addition exchange rate management was also encompassed within the purview of reserves management. These changes necessitated a major shift in the approach to reserves management.

The focus in deciding on the level of reserves was in fact shifted to ensuring a reasonable level of confidence in the international financial and trading communities about the capacity of the country to honour its obligations and maintain trade and financial flows; the amount of foreign currency reserves required to counter speculative tendencies or anticipatory actions amongst players in the foreign exchange market, and the capacity to maintain the reserves so that the cost of carrying liquidity is minimal.

In 1977, with the introduction of the managed floating exchange rate regime, a further change in the approach to reserves management was warranted and the emphasis on import cover was supplemented by the objective of smoothing out the volatility in the exchange rate through market intervention.

In this context, the traditional approach of assessing adequacy of reserves in terms of import cover has been broadened to include a number of parameters that take into account the size, composition, and risk profiles of various types of capital flows, as well as external shocks to which the economy is vulnerable. In the meantime the prevalent bullish economic environment in Sri Lanka with strong investor interests and prospects for an acceleration in economic activity further underscores the need for strong reserves.

(b) Reserve Management

The Sterling Area began in early 1930's when a group of countries of the British empire (except Canada, Hong Kong and Newfoundland which joined Canada in 1949 to become Canada's tenth province) and few others decided in favour of a stable exchange rate in Sterling since it was the most widely used currency in international trade. Ceylon was a member of the Sterling Area and

as a result it was bound to follow some of the Sterling Area's common practices in maintaining reserves such as maintaining a greater portion of reserves in Sterling and pooling earnings in Gold and US Dollars to a central pool.

During the early years of 1950, Sri Lanka had a large amount of foreign reserves accumulated due to the rubber and tea price boom with the Korean War. This caused an enormous liquidity in the system and the government had to discourage inflows to the country. In 1954, after a series of discussions between Ceylon and Britain, Ceylon was allowed to maintain its reserves independently in Dollars and gold in addition to Sterling, subject to an upper limit. The excess Dollar earnings above the upper limit were subjected to transfer into the central Dollar pool, which was a significant feature of the Sterling Area. Under the Sterling Dollar pool arrangement, member countries were required to contribute to the pool using their excess Dollar earnings and allowed to draw from the pool for their requirements. Due to the subsequent negotiations, Britain agreed to increase the upper limit of Dollar holdings at frequent intervals.

The strong external reserves position gradually evaporated due to expansive fiscal policies of successive governments that led to a continuous expansion in imports. It declined from US Dollars 233 million in 1956 to US Dollars 90 million by 1960. Reserves declined further to US Dollars 42 million in 1970, which were sufficient to finance 2.1 months of imports. Payments for imports of goods and services were controlled by a variety of exchange control measures during this period to protect the depleting reserves. A system of dual exchange rate was introduced in 1968 and continued with an 'official' rate for traditional exports and 'essential' imports and a much depreciated rate for other exports and imports to encourage export diversification and discourage non essential imports. In 1974, the Asian Clearing Union (ACU) was formed to further economise the use of foreign exchange by a group of six countries including Sri Lanka. In 1975 reserves stood at US Dollars 57 million, which were sufficient to finance imports by 1.7 months. Reserves position of the country improved by 1976 to a level sufficient to cover 3 months of imports with the receipt of IMF assistance and a reduction in imports through further restrictions. These reserves were mainly invested in US T-Bills, fixed deposits, call accounts and Sterling securities.

In 1977, Sri Lanka unified its exchange rate with a currency depreciation and moved to a system of managed floating with a partial liberalisation of external trade and payments. In this environment during the post 1977 era, there has been a substantial expansion and diversification in the country's external transactions. Sri Lanka diversified the currency basket of the reserves to include French Franc, Japanese Yen and Deutsche Mark. Further, it managed to increase its foreign reserves from US Dollars 278 million in 1977 to US Dollars 2,029 million by end 1997, which was sufficient to finance 6.4 months of imports. Reserves management activities and techniques were expanded during this period deviating from traditional money market products into more meaningful portfolio management and trading strategies.

However, external reserves declined continuously from 1997 to reach US Dollars 1,049 million by end 2000 largely owing to the escalation of war requiring higher expenditure on imports, higher petroleum prices and slowing down in export earnings. In this environment the country completed the liberalisation of exchange rate arrangements by introducing a system of independently floating exchange rate on 23rd January 2001, allowing commercial banks to freely determine the exchange rate. Reserves position gradually began to improve since then along with the recovery from negative GDP growth in 2001. Reserves reached US Dollars 3,500 million in 2007 and the Bank commenced assessing alternative investment opportunities such as repurchase and bond lending programmes to enhance return while maintaining liquidity and safety of reserves. With the emergence of sub-prime concern, the Bank moved its reserves as a prudential measure to more safe institutions such as reputed central banks. However, reserves declined sharply to US Dollars 1,300 million by early 2009 as foreign investors in sovereign securities withdrew their investments due to their own liquidity concerns at the peak of global financial crisis and the Bank sought alternative measures to augment reserves including SWAP arrangements with friendly nations. However with the ending of war and Stand-By Arrangement (SBA) facility with IMF, reserves improved sharply and by October 2010 it stood at an unprecedented level of US Dollars 7 billion. At present reserves are managed by a team of experts in multi currency and multi product environment targeting to achieve a higher rate of return.

Current Reserves Management Framework

Reserves management functions had been initially vested with the former Banking Department, which was one of the key departments of the Bank since its inception. After reallocating the functions of the Banking Department into four separate new departments in 2002, reserves management function was assigned to the International Operations Department (IOD). The required internal arrangements such as segregation of duties by creating a Front Office and Middle Office and enhancing technical and academic skills of the employees have been met over the time to match with the international standards required in reserves management. Front Office is the place where the transactions in foreign currencies take place and is often called as the ‘Dealing Room’. Middle Office performs the key function of risk monitoring and acts as an independent unit, which evaluates and analyses the risk faced by the Front office. Back Office functions are required to effect and settle the transactions originated by the Front Office. This involves the maintenance of foreign currency accounts and sending payment instructions among others. At present, Back Office functions are carried out by the Payments and Settlement Department, which was also a section of the former Banking Department. In addition, policy recommendations relating to reserves management are made by the Foreign Reserves Management Committee (FRMC) at its monthly meetings and implemented with the approval of the Monetary Board. The FRMC is chaired by the Assistant Governor in-charge of the price stability cluster, and is comprised of Director of Economic Research, Director of International Operations, Chief Accountant as members and Director of Management Audit as an observer. It provides guidance for reserves management activities while reviewing the progress at its regular meetings.

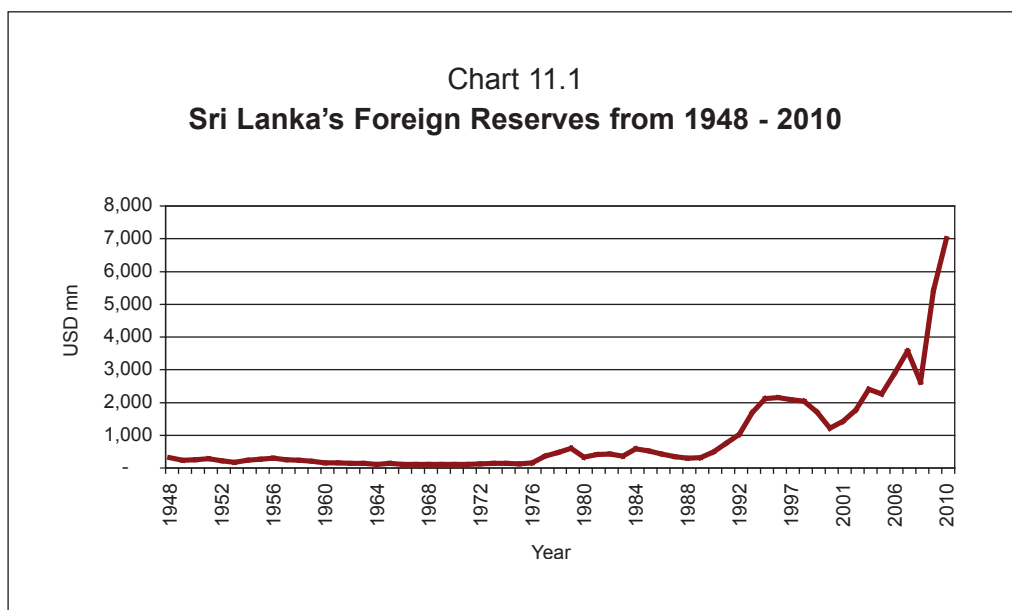
Reserves management activity is a commercial activity whether it is carried out by a central bank or any other entity. Sri Lanka similar to many other countries in the region did not pursue active reserves management policies until mid 1980's. Reserves management activities were limited mainly to placing money market deposits as it was considered adequate since our reserve requirements were limited and the markets were not complex at that time. Service providers were limited and the knowledge pool was scant and communication was confined to cable messages. The CBSL used to send cable messages to the Bank of England and the Federal Reserve Bank of New York in its early days requesting to make payments in other currencies or to place money market deposits since there were no market quotes available. Until the acknowledgment is received, there was no confirmation on the exchange rate or the deposit rate applied. In 1977, in addition to Sterling Pound, US Dollars, Indian Rupee, Japanese Yen, Deutsch Mark and French Franc were used for market transactions in Sri Lanka. Activities in the foreign exchange markets gradually picked up along with the technical developments such as Reuters market information screens and development of Asian financial centres such as Tokyo, Hong Kong and Singapore. With these developments, CBSL commenced investing a part of its reserves in fixed income securities more methodically in early 1980s to enhance the return of the portfolio. These activities have now been further expanded to a number of government and non-government investments including US, UK, Japan, Europe, Australia and New Zealand governments with active diversified portfolio strategies.

Growth of Reserves

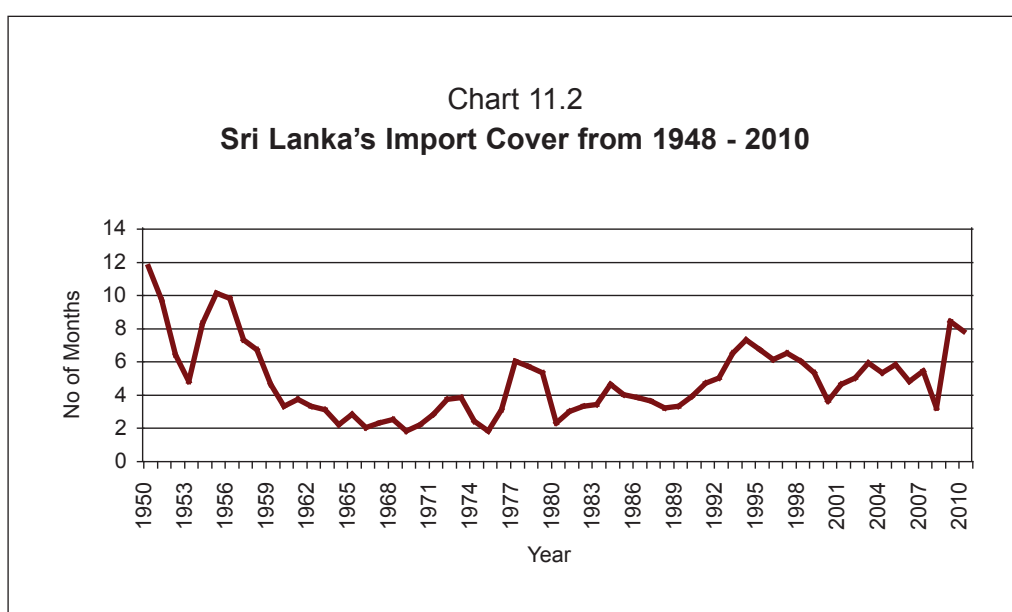
In Sri Lanka, the pace of increasing reserves was not quite prominent until 2009. From there onwards, the reserves picked up at an accelerated rate with the end of the conflict leading to an enhanced investor confidence, resulting in a favourable outlook on the country. Prior to 1977, particularly since early 1960s, the country managed with a limited value of reserves supported by a set of stringent controls and regulations. With the liberalisation of the economy, coupled with the introduction of a managed floating exchange rate regime in 1977, the need to maintain a comfortable level of reserves was widely felt especially to minimise the excessive fluctuations of the exchange rate. Thereafter, the level of reserves gradually increased, until it dropped to a bare minimum due to economic and political uncertainties experienced in the 1988-89 period. Since mid 2009, with the enhanced political and economic stability of Sri Lanka, foreign exchange reserves have grown significantly.

Chart 11.1 shows the movements of foreign exchange reserves of the country beginning from 1948.

The reserves, which stood at US Dollars 1.4 billion in May 2009, increased gradually to US Dollars 5.3 billion at end November 2009. This momentum in the reserves continued in the second half of 2010, reaching a healthy position of US Dollars 7 billion in early October 2010. The current level of reserves indicates the ability of the country to maintain an import cover of 6.2 months.



Source: Annual Report (2010), CBSL



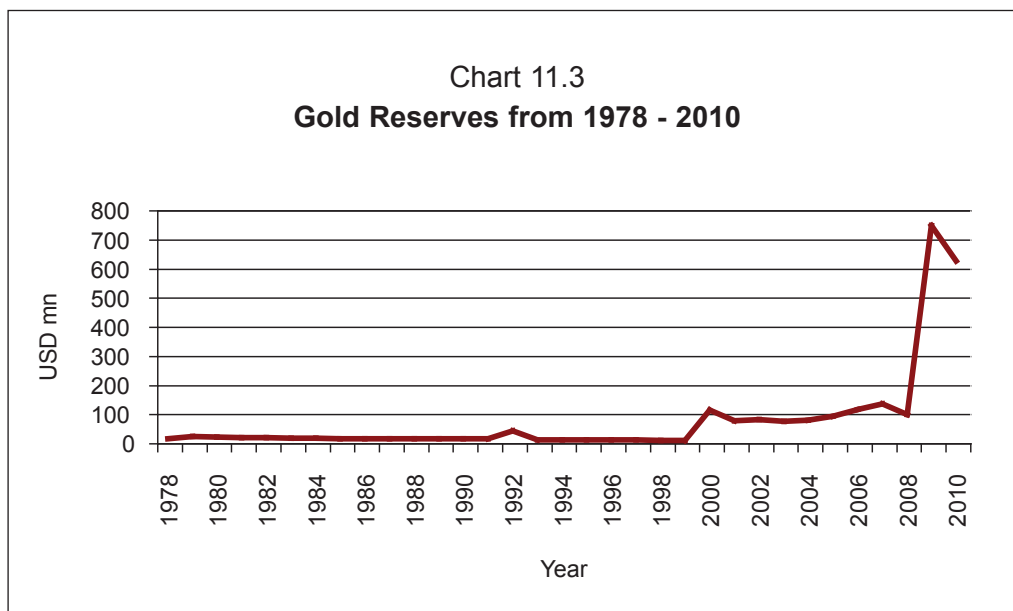
Source: Annual Report (2010), CBSL

Management of Gold Reserves

Investments in Gold reserves were not prominent until CBSL received a quantum of gold from IMF in 1977-78 at the rate of US Dollars 35 per troy ounce. During 1980s and 1990s gold reserves had been accumulated through trading and investments in the gold market. Gold reserves have been extremely useful as a safe haven asset for the country when it faced crisis situations especially in 1988-89 where CBSL had obtained much sought US Dollars by exchanging gold holdings with the agreement to take them back (on a SWAP arrangement) proving its multi facet usage. The CBSL has entered into a more diversified portfolio management with the increased emphasis on gold holdings by purchasing ten metric tons of gold from IMF in November 2009. The active management of gold holdings by CBSL and trading opportunities had created a renewed hope of a good income stream. In order to safeguard physical gold holdings, CBSL maintains its gold reserves at the custody of the Bank of England, London. Chart 11.3 exhibits the movements of gold reserves since 1978.

Reserves Management Strategy

In line with the enhanced reserves position, new investment opportunities will be looked into in search of higher returns. Accordingly, investments will be further expanded to high yielding securities, bond lending activities and repurchase market strategies in international bond markets.



Source: International Financial Statistics, IMF and Economic Research Department, CBSL

With the current boom in emerging market economies particularly in Asia, Latin America and the Eastern European region, the worldwide investors speculate a higher demand for emerging market sovereigns as well as corporate bonds. Therefore, Sri Lanka intends to move into these markets with the aim of diversifying its fixed income securities further.

Risk Management in Reserves Management

Sound risk management is an essential element in effective reserves management. Risk management functions aimed at ensuring sound governance based on best international practices that have been adopted by CBSL to promote the safety, liquidity and return objectives. Good governance framework of the Bank identifies and assesses the risks of reserves management operations and it allows the management of risks within the acceptable parameters and levels. Risk exposure of the bank is monitored continuously to determine whether exposures have been extended beyond acceptable limits. Over the past 60 years, these practices have evolved and at present, Middle Office, which is the risk management division of IOD, uses a number of indicators to measure and mitigate the risk involved. These indicators primarily include Duration, Convexity and Stress Testing to measure the interest rate sensitivity. The risks relating to deployment of reserves, namely, market risk, credit risk, operational risk and liquidity risk are detailed below:

Market Risk

Market risk comprises currency risk and interest rate risk

- (a) Interest rate risk: The key aspect of the management of interest rate risk for CBSL is to protect the value of the investments from the adverse impact of interest rate movements. The interest rate sensitivity of CBSL portfolio is measured and managed in terms of duration. The emphasis is to keep the duration or the interest rate sensitivity of the portfolio within a manageable level. Interest rate exposure is further managed by placing restrictions on the tenor of investments.
- (b) Currency risk: Currency risk arises due to the uncertainty in exchange rate fluctuations. The CBSL foreign currency reserves are invested in multi currency, multi market portfolios to minimise the risk arising from exchange rate movements. Currency movements are managed against the approved benchmark composition, which may be revised from time to time by the management.

Credit Risk

Credit risk refers to risk arising out of defaults or delays in payment obligations. This is mitigated by assigning trading limits for counterparties or the trading partners of CBSL, which includes central banks, large and sound commercial banks and investment houses. Counterparty Credit

Risk Management System (CCRMS), which is a unique system developed by CBSL facilitates a comprehensive evaluation of the counterparties using financial indicators, ratings and products. Total exposure to all the counterparties are maintained within the assigned levels with the aim of minimising risk exposure and to enhance product availability to suit the investment requirements of CBSL.

Operational Risk

Operational risk is addressed through segregation of duties and placing required internal controls and processes. Internally there is a total separation of the front and back office functions in CBSL reserves management activities, overseeing of activities, dual controls and business continuity plan. Treasury Dealing Room Management System (TDRMS), which facilitates the trading, processing of transactions and recording also ensures several checks at the stages of deal capture, deal processing and authorisation. The authorising powers are delegated to officers at various levels of hierarchy to ensure the integrity.

The middle office is responsible for risk measurement and monitoring, performance evaluation and concurrent audit. However, CBSL intends to move towards an advanced and a sophisticated internal control system in view of the expansion of reserves.

Liquidity Risk

Liquidity risk arises due to the inability to sell an instrument at short notice and without incurring a significant cost. This risk has been addressed by maintaining adequate reserves in liquid money market and capital market instruments. The CBSL has invested a significant component of its reserves in liquid and highly rated assets, which could be converted into cash at short notice.

Challenges Faced in Managing Reserves

The main challenge in managing the reserves in its early days of 1950s was the rapid accumulation of reserves and resulting liquidity surplus. However, this situation soon changed with foreign exchange outflows and the country moved into a more exchange controlled regime with limited foreign reserves. Investment instruments were limited to money market deposits and selected securities, which were kept until their respective maturities during 1950-1977. Currency diversification was confined to Sterling, Gold and US Dollars, which were considered as low risk assets.

The country faced a severe shortage of foreign exchange in 1989 in the midst of political uncertainty of the country. CBSL had to convert its gold holdings into US Dollars through a swap arrangement in order to meet its foreign currency commitments. During this period gold reserves were held at the Federal Reserve Bank New York, and for the purpose of this swap transaction gold was dispatched to Mase Wespac Australia. Later when CBSL received Gold with

the unwinding of the swap, the Bank of England was chosen as the custodian for gold in early 1990s'. Subsequently in late 1990s' and early 2000, the market value of the invested funds of the reserves was at much lower levels and funding for oil requirements was a severe burden. However, with prudent portfolio management activities and techniques, CBSL was able to meet the import demand while generating a reasonable income at that time.

The recent international financial crisis did not significantly affect the reserves portfolio of the country due to timely actions taken and the adoption of prudent risk management techniques. The exposure to Lehman Brothers, which was the first turn down in the 2008 recession, was mitigated due to the timely withdrawal of investments. Further when the sub prime crisis emerged, CBSL was not affected, as it had no exposure towards those markets or instruments.

The euro crisis, which started in the latter part of 2009 with the highest budget deficit of Greece, did not make a significant impact on CBSL exposure to the European region due to the timely risk mitigating actions effected on the investments in volatile markets. Since the sovereign debt crisis in the euro area is continuing CBSL is closely monitoring the investments in the region to further mitigate the risk.

Managing a high volume of reserves has become a challenge since it is required to maintain liquidity and safety of investments with a reasonable rate of return in a low interest rate environment globally.

Conclusion

Reserve management techniques and risk management have changed rapidly over the past 60 years along with the advancement of technology and knowledge. Primitive money market investment strategies have converted into more complex and advanced instruments in search of a higher return from reserves. The CBSL in its endeavour to meet the challenges of managing its reserves in complex financial markets has embarked on a modernisation programme where state of the art technology of electronic records, analysing, monitoring and reporting of reserve management activities will be introduced to enhance the return of the reserve portfolio. Further, it is intended to move into a broad array of asset classes, further expansion of geographical coverage of markets and extension of dealing hours to cover the global financial markets in different time zones. However, challenges still lie ahead since it is required to maintain the safety and liquidity of investments without hampering the country's reputation while attempting to earn a higher rate of return on the reserves in order to maintain and preserve the value of reserves.