11. Balance of Payments and Exchange Rate Regime

Despite a strong recovery in exports and capital inflows after a slowdown in 1999, the external sector reflected some deterioration in 2000. The current account deficit widened and the overall balance of the balance of payments recorded a large deficit

Private remittances

Private remittances, which consist mainly of remittances by Sri Lankan workers in the Gulf, increased by 9 per cent to US dollars 1,147 million during 2000.

- ▲ Compensation payments received by Sri Lankan workers who were displaced during the Gulf war amounted to US dollars 45 million during 2000.
- ▲ Net private remittances are expected to exceed US dollars one billion in 2001.

Worker Remittances

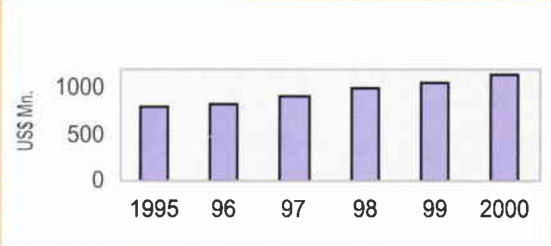

Chart 11.1

Foreign Direct Investments

Foreign direct investment (FDI) inflows amounted to US dollars 203 million during the year.

Foreign direct investments abroad by Sri Lankan residents amounted to US dollars 2 million.

Foreign Direct Investments US$ Mns

	1995	96	97	98	99	2000
Inflows	27	100	133	150	201	203
Outflows	12	13	5	13	24	2

Source: Central Bank

Table 11.1

Services Income

Net foreign exchange earnings from services declined from US dollars 147 million in 1999 to US dollars 38 million during 2000 due to:

- ▲ 8 per cent drop in tourist earnings as a result of a drop in tourist arrivals
- ▲ 2 per cent drop in transshipment cargo handling due to competition from neighbouring countries and
- ▲ higher payments on freight services

Foreign exchange earnings from services are projected to increase in 2001 with a recovery in the tourism sector.

Net Service Income

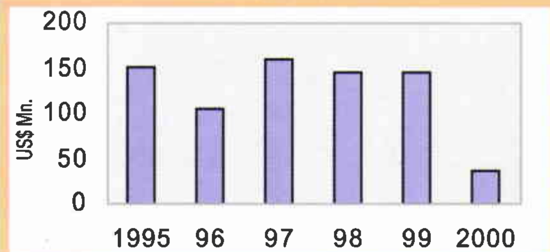

Chart 11.2

Portfolio Investment

Foreigners continued to be net sellers in the stock market with a net outflow of US dollars 45 million in comparison to an outflow of US dollars 13 million in 1999.

With the restoration of macroeconomic stability, a net inflow of US dollars 25 million is expected in 2001.

Foreign loans to the government

Foreign loan disbursements to the government increased from US dollars 379 million in 1999 to US dollars 495 million in 2000.

Long-term loan capital to the government is expected to increase to US dollars 541million in 2001.

Balance of payments

Balance of payments deteriorated due to a larger deficit in the current account. The overall balance of the balance of payments reflected a large deficit of US dollars 516 million in 2000. This was mainly due to:

- Additional expenditure of US dollars 400 million on oil imports due to high oil prices.
- Surge in defence imports by US dollars 285 million.
- A turnaround is expected in the balance of payments with a surplus of US dollars 140 million in the overall balance in 2001.

Net Inflows to the Share Market

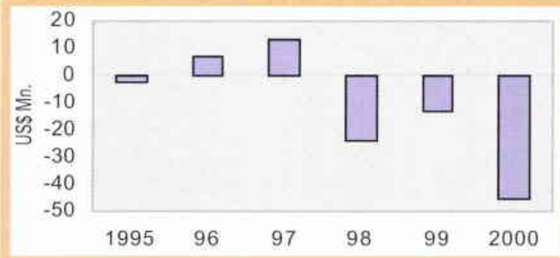

Chart 11.3

Government Foreign Loan Disbursements

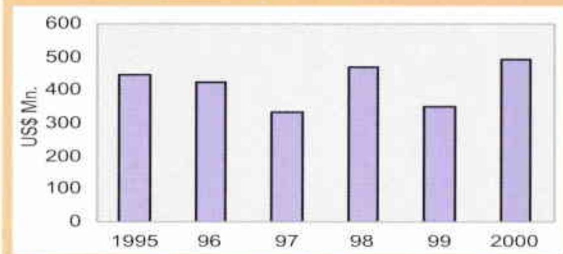

Chart 11.4

Overall Balance

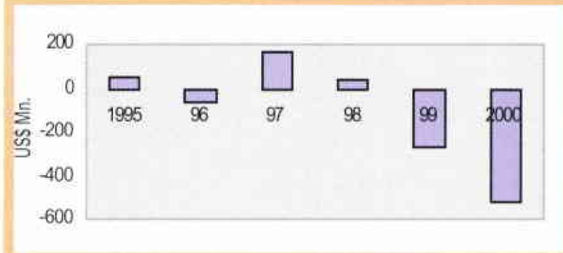

Chart 11.5

Foreign Reserves

Gross official reserves declined by 36 per cent or US dollars 596 million to US dollars 1043 million.

Gross official reserves are projected to increase to about US dollars 1,500 million in 2001.

Changes in Exchange Rate Regime

As a natural evolution of the flexible exchange rate system adopted since 1977, Sri Lanka moved to a freely floating exchange rate system from 23 January 2001 in order to permit the market to determine the exchange rate and, through that mechanism, reflect the true value of Sri Lanka rupee, vis-à-vis other currencies and build up the country's foreign reserves effectively.

Introduction of the Managed Floating System in 1977

- With the introduction of liberal economic policies in 1977, the exchange rate regime too was changed from a fixed exchange rate system to a managed floating system allowing market forces to determine the exchange rate changes.

- At the initial stage of floating, the Central Bank's management of the exchange rate was considered essential, as the foreign exchange market was thin and the financial system was not mature enough to operate on its own. Accordingly, the Central Bank announced daily the rates at which it would buy and sell foreign exchange from and to the market with a narrow band.

- The Central Bank adjusted the exchange rate announced daily on a regular basis by taking into account, developments in the domestic and international financial markets, in order to ensure compatibility of the exchange rate with the macroeconomic fundamentals in the country and maintain the country's competitiveness in the external trade.

- Meanwhile, the Central Bank also progressively enhanced the scope for market determination of the exchange rate by widening the margin of its buying and selling rates from time to time with the domestic foreign exchange market gaining a greater degree of maturity.

Gross Official Reserves

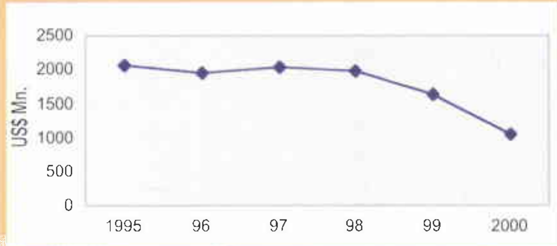

Chart 11.6

Interbank Exchange Rates

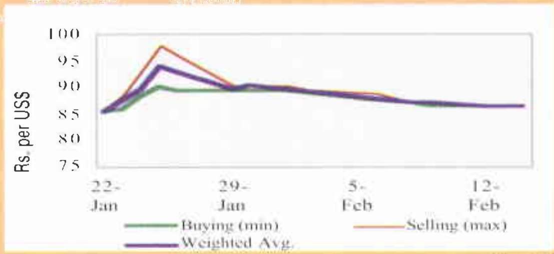

Chart 11.7

Changes in 2000

- An increased balance of payments deficit largely due to high oil import prices and security related additional imports resulted in a reduction in official foreign reserves in 2000 exerting pressure on *the exchange rate.*

- With a view to supporting the policies for ensuring macroeconomic stability, the Central Bank widened its exchange rate band several times in 2000 allowing a greater freedom to the market to determine the rate.

- Accordingly, the Central Bank widened the margin between its buying and selling rates of foreign exchange from 2 per cent to 5 per cent in June 2000 and further to 6 per cent in November and 8 per cent in December before widening it to 10 per cent in January 2001.

- The widening of margins in this manner and regular adjustment of the exchange rate, by taking into account the market developments, permitted a reduction of the pressure in the foreign exchange market, thus avoiding a financial crisis as experienced in a number of developing countries, particularly in East Asia and Latin America.

- However, the Central Bank observed that in the current economic environment, regular widening of the intervention band leads to a formation of market expectation of continuous depreciation of the rupee, thus exerting an unnecessary pressure on the official external reserves of the country.

- At the same time, the increases in the interest rate that were effected to provide stability in the exchange market could not be maintained for a longer period, as high interest rates would be detrimental to economic activity in the long run.

New Exchange Rate Regime

- Hence, from 23rd January 2001, the Central Bank refrained from announcing the buying and selling rates in advance. Instead, it decided to participate actively in buying and selling of foreign exchange 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 the official foreign assets.

Precautionary Measures

- As a precautionary move to help and stabilise the market and promote prudential conduct by commercial banks by restraining speculative activity and encouraging exporters to bring back export proceeds, the Central Bank implemented the following temporary measures in consultation with commercial banks and foreign exchange dealers.

- Limits on daily working balances maintained by commercial banks in foreign exchange, on the basis of past export-import credit facilities, to prevent banks from building up foreign exchange for unwarranted speculative activities.

- Requesting banks to ensure settlement of export credit by exporters by using export proceeds within 90 days. This period was extended to 120 days in respect of exports, where it is customary to grant 120 days' deferred payment terms to buyers. Additional interest rates were to be charged, when settlement became overdue.

- Requesting banks to limit their forward market operations only to trade related transactions.

- Requiring forward sales and purchase of foreign exchange to be backed by a rupee deposit of 50 per cent, to discourage speculative forward contracting.

- Advising banks not to permit early or prepayment of import bills, in anticipation of a depreciation.

- As expected, these measures helped to create a greater stability in the foreign exchange market during the transition period and strengthen the financial system under the new exchange rate regime. Experiences in other countries have shown that strengthening of the financial system is crucial in improving the resilience of the economy to external shocks.

- These measures are expected to be relaxed gradually and removed once the foreign exchange market has reached its stability levels.

Experience under the New System

- Following the change in the exchange rate system, the rates in the foreign exchange market increased gradually during the first two days but an overshooting occurred only on the third day which recorded a depreciation of 9.8 per cent compared with the pre-floating level. Such an overshooting was not unanticipated and not excessive compared with the experience of many other countries that moved from a fixed or managed system to a floating system.

- For example, the Brazilian *real* depreciated by 40 per cent on the first day of floating and 21 per cent in the first month of floating in January 1999. The Indian rupee depreciated by 16 per cent in the first month of floating in March 1993, the Korean *won* by 31 per cent in the first month of floating in December 1997 and the Swedish *kroner* by 28 per cent in the first five months of floating in 1992.

- The foreign exchange market in Sri Lanka has shown signs of stability within a short period of time. The exchange rate has stabilised at around Rs. 86 per US dollar at the end of February 2001, indicating only a 1.1 per cent depreciation from the pre floating level.

- Similarly, the spread between buying and selling rates of foreign currencies has narrowed drastically in the interbank foreign exchange market as well as in banks' transactions with customers.

- The following main factors have contributed to achieving a faster stability in the market.

- Release of pressure in the foreign exchange market gradually through regular adjustments of the exchange rate according to changes in the macroeconomic fundamentals of the country and widening of the band over a longer period to allow more flexibility in the market.

- Timely and effective implementation of precautionary measures with the introduction of the new regime.

- Safeguards provided by high interest rate policy and continuation of capital controls.

- Cordial and close relationship between market participants and the authorities.

- The new system has already halted the drain on official foreign reserves and will help to build up the same.

- In addition, with the restoration of stability in the exchange market and the decline in the expectations about continued depreciation, the Central Bank would be in a position to gradually reduce its interest rate, too. As a first step, the Central Bank reduced its repo and reverse repo rates by 1 percentage point on 26 February 2001.

- The new system will also improve market confidence and the country's external competitiveness, encouraging investors, both domestic and foreign, and expanding the capacity of the economy to achieve higher growth and create more employment opportunities in the future.