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August 28, 1990

To: Members of the Executive Board
From: The Secretary
Subject: Sri Lanka - Modification of Exchange Arrangement

Attached for the information of the Executive Directors is a paper on a recent change in the exchange system of Sri Lanka.

Mr. M. W. Bell (ext. 8670) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Sri Lanka

Modification of Exchange Arrangement

Prepared by the Asian Department and
the Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by Hubert Neiss and Thomas Leddy

August 27, 1990

In the attached communication dated August 20, 1990, the Sri Lankan authorities informed the Fund of the adoption of a more market-oriented exchange arrangement, effective August 20, 1990.

In recent years, the Central Bank adjusted periodically its central exchange rate for spot transactions in terms of the U.S. dollar--taking into account developments in the external sector--and stood ready to buy and sell at that rate within an established margin. Rates for transactions among commercial banks in the interbank market and customer rates were freely determined by the banks. Following a gradual adjustment in the exchange rate that resulted in a 13.8 percent depreciation of the Sri Lanka rupee in terms of the U.S. dollar between July 1 and September 15, 1989, the rate was maintained at SL Rs 40 per U.S. dollar through August 20, 1990 when the new system was introduced.

Under the new arrangement, the Central Bank sets a daily reference exchange rate which is the weighted average of the previous day's rates on spot transactions in the local interbank market, including transactions with the Central Bank and which serves as the Central Bank's initial central rate for the day; when the amount of overall daily interbank transactions is less than US\$2 million, the reference rate is calculated on the basis of the previous two days' weighted average of the interbank spot transactions rate. During the course of the day, the central rate is adjusted--within a predetermined band around the initial central rate--through negotiations between the Central Bank and the commercial banks, depending on the Central Bank's external objectives and market conditions, with the Central Bank prepared to buy and sell at that rate. Transaction rates between commercial banks in the interbank market are negotiated freely between the banks and customer rates are freely determined by the banks.

In a forthcoming staff report for the 1990 Article IV consultation and request for use of Fund resources under the second annual arrangement under the SAF, a more detailed description and assessment of the new arrangement will be presented.

Attachment

Central Bank of Sri Lanka
Colombo 1, Sri Lanka

20th August 1990

Mr. P.R. Narvekar
Director
Asian Department
I.M.F.

Dear Mr. Narvekar:

I would like to inform the Fund of the change in Sri Lanka's exchange system which became effective today. The description of the new system, which is oriented toward market determination of the exchange rate, is as follows:

1. Under the new system, a reference rate for the rupee/US dollar rate will be established each day by taking the weighted average of the rates for rupee/foreign currency spot transactions in the interbank market, including dealings with Central Bank of Sri Lanka, during the previous day.

- In case that an overall daily interbank transaction amount falls below US\$2 million, the reference rate for the following day will be calculated on the basis of the two days' weighted average by adding it together with the transactions of the day immediately preceding.

- All commercial banks will report amounts and rates of all rupee/foreign exchange interbank spot transactions that have taken place during the day, including transactions affected through brokers and their dealings with the Central Bank.

- The reference rates for the next day will be calculated at the end of each business day by the Banking Department of the Central Bank. The reference rate will be communicated to all commercial banks by the commencement of the following business day, and will be published in major local newspapers as soon as practicable thereafter.

2. The reference rate will serve as the Central Bank's initial middle rate for the day. During the course of the day, the Central Bank's middle rate will be adjusted--within a predetermined band--through negotiations between the Central Bank and concerned commercial banks, and hence will be determined by the Central Bank's external objectives and market conditions. The Central Bank's buying and selling rates will be set, as before, by adding or subtracting a margin of SL.Rs. 0.015 per U.S. dollar.

3. Buying and selling rates between commercial banks in the interbank market will be negotiated freely between the banks, and customer rates will be determined by the banks.

4. The rupee exchange rate against other currencies will be determined by the arbitrage rate which takes into account U.S. dollar rates against other currencies in the international foreign exchange markets.

5. The reference rate for August 20, 1990 was set at SL.Rs. 40 per U.S. dollar.

Yours sincerely,

//signed//

Dr. H.N.S. Karunatilake