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Globalization - Liberalizing the Capital Account in Sri Lanka



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Introduction

International capital flows occupy a central place in the contemporary world economy. Over the years, more particularly during the last half century, cross border capital flows have played a significant role in promoting world economic development and contributing to world prosperity. These flows which occurred first amongst advanced industrial countries later percolated to developing countries as well, to the mutual benefit of both capital exporting and importing countries. The process was facilitated by progressive liberalization of exchange controls, first with respect to current transactions and later extended to capital transactions as well. Recent developments in the international scene such as the emergence of extensive derivative markets, the formation of currency unions, the collapse of the centralized political systems in Eastern Europe and in the former Soviet Union, and the opening of the Chinese economy to foreign investment have provided additional boost to cross border capital flows. Meanwhile, recently the International Monetary Fund (IMF) has adopted capital account convertibility as one of its specific objects, meaning that the Fund would encourage its member countries to progressively liberalize their capital accounts. Perhaps, the time is not far away when a major part of the world economy gets integrated into a globalized setting with unrestrained cross border flows of goods and services and of capital for the betterment of the world community. It is unlikely that the developing countries like Sri Lanka can be apart from this general trend of happenings, lest they remain marginalized for ever in the world economy.

International capital flows however, are not an unmixed blessing. Experience has shown that at times such flows can become highly volatile exposing countries to economic crises and painful adjustment programs, raising doubts as to the wisdom of having an open capital account. The Mexican crisis in 1995 and the recent crisis in East Asia are cases in point. But analysts believe that these crisis situations were largely the outcome of economic misdemeanours on the part of the affected countries and could have been avoided or minimized with judicious application of policies, reforms and regulatory mechanisms, whilst enjoying the benefits of capital flows which they indeed did for many years with great enthusiasm.

In Sri Lanka, control over external trade and payments or foreign exchange control has been a major irritant in the economic milieu for a major part of the post-Independence period. First applied to capital transactions in the late 1950's (the Act itself was promulgated in 1953), the exchange control restrictions were progressively extended to current transactions as well and by the mid-1960's the entire gamut of external payments came under the purview of the Exchange Controller inflicting heavy economic costs. While some developing countries, particularly those in East Asia, were making rapid progress in economic advancement, Sri Lanka, dictated by severe foreign exchange shortages, was condemned to a path of slow growth accumulating in its wake considerable economic and social stress. It was only in March 1994, after over three decades since their invoking, that the country was able to liberate itself fully from control over current account transactions when it accepted the obligations under Article VIII of the IMF Articles of Agreement. However, the restrictions on capital transactions continued to remain in force although facilities were made available for private capital to move in and out of the country on a restricted basis. Progress in further liberalizing the capital account have been slow and the country appears to be undecided as to whether or when it should start on the

path of full liberalization. Meanwhile, some countries in the region have already announced time-frames for capital account convertibility.

The purpose of this paper is to discuss the rationale and prospects for liberalizing Sri Lanka's capital account in the context of the emerging domestic and international economic environment. Section I of the paper is devoted to a discussion of the rationale for liberalizing the capital account, while Section II deals with the recent developments in the international scene with respect to capital account liberalization. Section III examines the current state of the exchange controls in Sri Lanka. Section IV considers the preconditions required for fully liberalizing the capital account. In the penultimate section an assessment be made of the improvements in economic management/reform effort required in Sri Lanka to be compatible with an open capital account position. In Section VI the main issues are summarized with some concluding remarks.

Section I :Rationale for Liberalizing the Capital Account

Capital account liberalization focuses on freedom from restrictions or taxes imposed directly on foreign exchange transactions on both inward and outward capital transfers. Accordingly, the following could be considered as exchange restrictions that apply to capital movements and which would give rise to exchange controls on capital account.

(i) Restrictions or approval requirements to purchase foreign exchange for the purpose of acquiring assets abroad;

(ii) Limits on the amount of foreign exchange that can be transferred for the purpose of investment abroad;

(iii) Restrictions on the repatriation of capital or foreign exchange holdings;

(iv) Multiple currency practices that apply to the purchase or surrender of foreign exchange related to capital transfers; and

(v) Restrictions on the placement/borrowings of funds by financial institutions in the international market.

Countries continue to apply restrictions on capital transactions because they believe

(i) that capital controls will help raising domestic investment and rate of economic growth;

(ii) that liberalization of the capital account should come relatively late in the reform process and should be preceded by the elimination of distortions in the goods market and the existence of necessary financial infrastructure including the operation of market based instruments of monetary control;

(iii) that such controls provide additional freedom to domestic interest rate and exchange rate policies; and

(iv) that controls on capital movements can help protect a country's exchange reserves and improve its balance of payments.

Experience has shown that while some of these assertions may appear relevant in particular situations, in the long run attempts to restrict capital movements cause heavy economic costs for the country concerned and the world economy in general.

The fundamental purpose of opening the capital account is to promote greater efficiency in the allocation of resources so that both savers and investors are better off. The welfare improvement of opening the capital account, accordingly, arises from the better allocation of resources that it gives rise to. An open and liberal system of capital movements is perceived to foster global economic growth and prosperity by contributing to an efficient allocation of world saving and investment. Further, a country's own financial system can gain efficiency with exposure to foreign financial markets and the introduction of advanced financial technologies.

The importance of international capital movements has long been recognized by many. First, international capital movements provide vital support to the multilateral trading system by the transfer of financial resources from countries with current account surpluses to those with current account deficits. Second, capital movements play a critical role in raising investments by allowing a country to mobilize a larger volume of financial resources as entrepreneurs have access to a wider range of financial instruments and markets. Most developing countries do not have sufficient domestic savings to finance the investment needed to attain the desired rate of economic growth. The impact in augmenting domestic investment is most obvious when capital is transferred in the form of foreign direct investment. Third, by enabling a greater international division of labour and more efficient allocation of resources, international capital flows raise productivity and living standards the world over. Fourth, a country's own financial system could grow in efficiency with the introduction of advanced financial technologies. Fifth, restrictions on foreign capital flows affect the mobility of capital and will limit the efficiencies already gained from decontrolling foreign exchange markets.

This is not to dismiss the reality that with capital account liberalization the economy is made vulnerable to external forces. Once the capital account is liberalized, countries necessarily throw open its savings and investments to the rest of the world, be it direct investment or investment in financial instruments. This, in turn, follows that it is of paramount importance for the economy to be well guided in a consistent macroeconomic framework, in order to avoid undue fluctuations in the flow of funds across the frontiers. For instance, low interest rates in major financial centres with relatively high domestic interest rates can lead to a surge in foreign capital flows if the domestic capital market is open, particularly with limited exchange rate flexibility. This would, therefore, dictate the need for a greater degree of convergence in macro-economic conditions between the domestic economy and the rest of the world in an open capital account regime. Then, there is also a paramount need to avoid policies and practices that can cause rapid flow reversals such as those facing Mexico and Asia in the recent past.

There are those favour partial liberalization of the capital account, i.e. opening only with respect to direct foreign investment, while having it closed for portfolio investment, on the contention that the latter involves a large speculative element and is therefore highly volatile. It is unlikely that a country can fully realize the benefits of international capital flows with a capital account which is only half open, because a significant proportion of international capital movements now take place in the form of portfolio flows. Furthermore, a half open capital account is unlikely to generate the required degree of confidence for foreign capital to flow in required magnitude, for fear of policy reversals.

Foreign capital inflows resulting from an open capital account should be welcomed for the potential benefits that they bring -- investment, technology, growth and employment. But the authorities should accept the challenges to improve the efficiency of money and capital markets so as to better absorb such inflows for productive uses and minimize the adverse impact on macroeconomic stability. In general, the country's financial infrastructure should be so fashioned and developed as to facilitate smooth transfer of funds and efficient allocation of resources with minimum of friction in the monetary scene. At the same time, domestic financial markets should be strengthened and the operation of market based instruments of monetary

and exchange policies should be able to maintain external and internal balance in the economy.

In the case of Sri Lanka, the case for capital account liberalization lies in the relative size of the economy and the need for attracting foreign investment to support the country's development effort. Sri Lanka is a small island economy. She has achieved a high level of human development in the areas of life expectancy, literacy, reduction of infant mortality etc., through heavy public spending on social sectors such as health, education and nutrition. But her rate of economic growth, which has averaged about 4 per cent over the last 50 years, has left much to be desired in fulfilling the development aspirations of the populace, particularly in creating productive employment. Human development with high unemployment can cause serious social discontent bursting into periodic youth unrest as was experienced in the country on two occasions in the recent past.

Currently, Sri Lanka's investment ratio is about 25 per cent of GDP with a national savings ratio of about 20 per cent of GDP, the balance coming from foreign savings, mostly foreign aid. The prospects for raising domestic savings are indeed very limited. Fiscal consolidation or reduction of the budget deficit has been often advanced as a means of raising domestic savings. While this may be so, the scope of further reducing the budget deficit is admittedly very narrow in the short run. With revenue being inflexible upward and capital expenditure inflexible downward, the burden of fiscal adjustment must necessarily fall on current expenditure. In the area of current expenditure, although the public service and pension reforms have been talked about as areas available for expenditure pruning, it is doubtful whether much could be achieved in the short-run. The peace dividend from cessation of hostilities in the North and East is also unlikely to generate much savings either in the short-run, as it is likely to take a considerable length of time and effort for an effective demobilization process to take effect.

With valiant efforts on the part of the Government, the budget deficit has been pruned to 6.5 per cent of GDP in 1998. Given the structure of the budget -- defence, public administration, pensions, interest payments on public debt and welfare expenditure accounting for over 80 per cent of current expenditure - the scope for further pruning of the deficit is admittedly very narrow. The deficit target for 1999 is 4.5 per cent of GDP. This seems to suggest that the prospects for raising domestic savings through fiscal consolidation is rather limited, particularly in the short-run, and at best not more than 3-4 per cent of GDP can be expected.

Meanwhile, if Sri Lanka is to grow by 8 to 10 per cent of GDP on a sustained basis, which only will provide a basis for clearing the backlog of unemployment and eliminating poverty, a rate of investment of about 32 - 35 per cent of GDP would be necessary. With the national savings being low at about 20 - 22 per cent of GDP and the potential for getting foreign aid at no better than 5 per cent of GDP, it is vitally essential to encourage private foreign capital to come into the country to raise the domestic investment rate to the desired level. Attracting such magnitudes of private foreign capital will not be possible under a controlled capital account regime as evident from experiences in the recent past. Hence, the rationale for promoting capital account liberalization speedily in Sri Lanka. Otherwise, the alternative would be to continue with moderate investment and slow growth with nagging high unemployment and social discontent.

Section II : Recent Developments in the International Scene

Recent years have witnessed a fundamental shift in the global economy such as increased current account convertibility, rapid growth of private capital markets, increased regional and monetary integration and the adoption of market oriented reforms. It has also witnessed a rapid progress in achieving capital convertibility in industrial countries. A turning point in this connection was the suspension of all exchange controls in 1979 by the United Kingdom and the dismantling of the restrictions on capital movements in Japan beginning 1980. Australia dismantled most controls in 1983 and New Zealand in 1985. In 1986, the Netherlands removed its remaining restrictions while France and Denmark virtually fully liberalized their capital accounts by 1989. The others who joined the club in 1989 were Italy, Austria, Ireland, Sweden and Norway. In 1990, Belgium and Luxembourg abolished the two tier trading system that had been operated jointly since 1959. During 1991-1994 those industrial countries that continued to maintain exchange controls on capital movements too eliminated them. Thus, by 1994 virtually all industrial countries had abolished restrictions on capital movements (IMF - Issues in International Exchange and Payments Systems, 1995).

As a result of the liberalization by the industrial countries, the issue of capital account convertibility is now being focused almost exclusively on the developing countries. A large number of developing countries had eliminated all exchange restrictions on current transactions as a major thrust in their basic economic strategies. This was due to a growing recognition on the part of these countries that exchange restrictions are an inefficient and largely ineffective way to achieve their intended objectives - conserve foreign exchange, protect domestic industry and raise tax revenue. However, in most developing countries outward capital movements remained tightly controlled until recently. Progress towards capital convertibility may have been slower in developing countries because of the acute shortage of domestic savings and greater perceived risk of capital flight, particularly in countries with below-market interest rates and generally unsound macro policies. However, in the more recent past it has been observed that developing countries are also becoming increasingly intertwined with the global financial system. A number of developing countries with structurally strong balance of payments positions had for some time eliminated exchange controls on capital movements, while a few with weak balance of payments also joined them lately in the context of comprehensive stabilization and liberalization programs. Following this, net private capital flows to developing countries have assumed significant proportions in recent years. For instance, according to IMF estimates, private capital flows to emerging markets exceeded US$ 255 billion in 1996, a more than four fold increase over 1990. This reflects the potential for increased capital flows to developing countries in a more open global financial system.

Meanwhile, in April 1997 the Interim Committee (of the Board of Governors of the IMF) approved a plan to amend the IMF's Articles of Agreement to extend it's jurisdiction to cover capital account transactions as well. This was confirmed at the 1997 IMF/World Bank Annual Meetings held in Hong Kong and was termed as adding a new chapter to the Bretton Woods agreement. The rationale behind this policy decision is that an open and liberal system of capital movements was considered to be immensely beneficial to the world economy and "the only path to world-wide prosperity". However, it has been recognized

that "the capital account liberalization should be an orderly and sustainable process and part of a well-sequenced reform effort involving sound macroeconomic policies and strong financial systems". Accordingly, it is very likely that the IMF would put in place transitional provisions analogous to those in place for current account liberalization and, hence the adoption of capital account convertibility can be progressive rather than abrupt.

The original Articles of Agreement of the IMF and its amendments gave the IMF a long term mandate to bring the world exchange controls to current convertibility, with particular focus being given for convertibility in goods and services. This was probably prompted by the fact that one of the IMF's most important challenges at the time of its establishment in 1944 was to re-establish an international system of payments to promote international trade in goods and services that had been decimated by the Great Depression of the 1930s and the World War II that followed. Accordingly, over one half of the IMF's membership has now accepted the obligations of Article VIII of the Articles of Agreement. Virtually all the industrial countries have for some time been free from exchange restrictions relating to trade in goods and services. As stated before, industrial countries also have virtually abandoned exchange controls on capital transactions.

Meanwhile, the European Economic and Monetary Union (EMU) and the adoption of a single currency (euro) scheduled to commence in January 1999 is likely to involve significant implications for international capital flows. In the European market, a drop in transaction costs and elimination of currency risk will result in a sharp increase in cross border capital flows within Europe with implications on capital flows to other markets. The euro is expected to accelerate the development of corporate bond markets and Eu-wide equity markets for blue chip stocks. A single currency should also induce greater uniformity in market practices, more transparent pricing and increased market integration. It is also anticipated that international investors would want to hold large volumes of euro-denominated assets. At the same time, foreign investors might want to borrow in euro in integrated financial markets with efficiency gains and, hence, lower borrowing costs. Thus, with the EMU and euro, the size and pattern of capital flows to and from the euro zone will change, as will the allocation of international portfolios.

The collapse of the former Soviet Union in 1990/1991 and the break-down of the centralized political systems in Eastern Europe inaugurated a major transition of communist societies to modern capitalist democracies. An important feature of this development was the emergence of a large number countries which came to be known as transition economies committed to the adoption of market friendly policies, thereby reintegrating them to the world economic and financial system. Some of these countries have already launched major economic reform programs and have begun to attract large doses of foreign capital, particularly foreign direct investment. Ultimately, the ability of these countries to satisfy the needs and aspirations of their populations would depend on sustaining economic growth at high levels which would, in turn, require attracting foreign capital and raising investment. Once the process of transformation to market based economies is complete, which of course is likely to take considerable time, these countries will become a formidable force in competing for international capital with significant implications on global capital flows.

With the rapid integration of the world economy with vastly expanding capital flows, and with the extension of the IMF's jurisdiction to cover capital account transactions in the near future, the world economy is steadily moving to a stage where external transactions, both current and capital, will be free of any restrictions. This will lead to a new world situation where free play of market forces and external capital flows will determine the economic destinies of nations. It is in this context that any move towards capital account convertibility in Sri Lanka will have to be viewed. Failure to address this issue at the appropriate time and under appropriate safeguards exposes the country to the risk of remaining marginalized in the world economy for an extended period.

The recent Asian currency crisis which has profoundly affected many of the fast growing Asian economies, has acted as a poser to the wisdom of having an open capital account. Admittedly, these countries had been vast beneficiaries of foreign capital inflows which enabled them to achieve rapid economic growth but at the same time making them highly vulnerable to change of investor sentiment. On the other hand, it has been argued that countries with less open capital accounts such as China and India have withstood the Asian currency crisis with minimum of disruption. Thus, the question has been raised that in a world of rapidly growing but volatile capital flows, will not capital account liberalization create added potential for economic destabilization and serious loss of welfare. This has no doubt sharpened the misgivings of the developing countries about the wisdom of liberalizing the capital account as an urgent policy initiative.

The Asian currency crisis has to be viewed from a wider perspective than being carried away by emotion and sentiment. The crisis is the outcome of a wide array of economic misdemeanours on the part of high performing Asian economies rather than an open capital account problem *per se.* Analysts have identified several major contributory factors for the crisis. First, most of these countries had formally or informally pegged their currencies to the U.S. Dollar, an arrangement that became unsustainable once the Dollar started gathering strength. Second, inadequate policy responses in the face of macroeconomic destabilization such as excessively high current account deficits and rising asset prices riding on the crest of sharply growing private sector credit. Third, in the context of pegged exchange rates, these countries attracted large capital inflows, mostly short-term debt capital, which were beyond their capacity to use productively and at the same time exposing them to potential foreign exchange risks. Fourth, inadequately regulated and poorly supervised financial institutions in most countries led to imprudent and excessive lending exposing them to solvency and liquidity crises. Fifth, excessive government involvement in the allocation of resources in some countries contributed to an inefficient use of resources which lacked the capacity to withstand pressures when circumstances changed adversely. Sixth, widespread nepotism and crony capitalism in some countries prevented timely implementation of corrective action when danger signals appeared on the horizon. Seventh, the crisis also is very much the outcome of a moral hazard problem which affected both domestic borrowers as well as foreign lenders who entertained the belief that there would always be a rescue operation, as was indeed the case when Mexico was affected.

It is a combination of factors enumerated above that eventually proved combustible which however, was further exacerbated by political uncertainties and the failure to take timely and convincing corrective action to address the emerging problems. There are those

who believe that the currency crisis is not attributed purely to weak economic fundamentals but, mostly to speculative action on the part of international investors. Whether the speculative element played a role or not as the crisis gathered momentum, it is the underlying economic misdemeanours that ignited the crisis in the first place. One must not lose sight of the fact that all these countries benefited immensely from the vast resource flows that occurred in the international capital market which enabled them to achieve admirable growth rates for two to three decades raising their per capita income levels many fold. They should also have been mindful of the need to abstain from economic misdemeanours that would undermine investor confidence leading to large scale capital outflows and the resulting economic dislocation.

This is not to suggest that the entire blame for crises should go to the capital importing countries and the capital exporting countries had no role in them. They indeed do by encouraging their banking institutions and other investors to undertake high risk lending in the absence of appropriate regulatory controls over their own financial systems, probably themselves having been affected by the moral hazard problem. So, there is a strong case for strengthening international financial systems to reduce the probability of such crises occurring. Perhaps the IMF will have a greater role to play than had been the case in the past in exercising more effective surveillance over the international financial system. Unfortunately, the IMF surveillance had been largely asymmetrical, in that its surveillance activities are more focused on program countries, i.e. those countries which have had recourse to the Fund's resources, to the relative neglect of others. For instance, none of the countries affected by the recent East Asian crises had programs with the Fund in the immediately preceding period and therefore the policy dialogue with them would have been confined to annual Article XIV Consultations, the revelations or policy prescriptions arising from which are not binding on member countries. The recent crisis situations in the context of large cross-border capital flows seem to suggest the need for more effective surveillance on the part of the IMF not only by extending the surveillance arm to non-program countries but also by initiating appropriate action for strengthening the international financial system.

What is important to bear in mind is that, in the current environment, the countries which are heavily dependent on foreign capital are also vulnerable to reversals in market sentiment. Thus, the lesson to be learnt from the Asian currency crises is not to keep the capital account closed thereby denying the benefits of international capital flows altogether but to ensure that appropriate policy thrust is in place which would ensure the beneficial utilization of such capital. Attempts to keep the capital account closed for fear of negative investor sentiment and/or speculative attacks is to throw the baby of development with the bath water of caution. Of course, one needs to be sagacious in attracting foreign capital. As a rule equity capital is less risky than debt capital. Even in the case of equity capital, direct investment is preferable to portfolio investment as the latter contains a high volatile element which runs for the exit door at the slightest sign of fragility. The worst type of foreign capital is the short-term debt capital which are by nature highly sensitive to change of investor sentiment and, therefore, are highly volatile. So, what is required is a judicious application of policies, incentives, regulations and supervisory functions which will promote a more stable and balanced capital structure while remaining in a liberalized setting. A foreign exchange rate regime which is not sensitive to changes

in domestic and international conditions should be religiously avoided. Monetary policy should be effectively used to prevent excessive accumulation of foreign liabilities. A well designed regulatory structure should be in place to prevent imprudent borrowing and lending by financial institutions.

Section III : Current State of the Exchange Controls in Sri Lanka

As mentioned in the introductory section, the Post-Independence period witnessed an era of growing exchange control regimentation in Sri Lanka. This started changing in 1977 when a series of major economic reforms was introduced which constituted a fundamental policy change designed to facilitate the transformation of the economy from an inward looking to an outward oriented one. A major plank in this reform program was the relaxation of restrictions on external trade and payments. The Government followed up its program of economic reforms introduced in 1977 with further policy initiatives in the immediately succeeding period. However, these initial efforts at reforms faltered after 1982 as large macroeconomic imbalances emerged in the context of a heavy public investment program. The situation was further worsened by an outbreak of civil unrest, first in the North and subsequently in the South as well. In the period that followed, many economic problems emerged -- reduced GDP growth, growing unemployment, weakened balance of payments and rising debt service payments.

The program of economic liberalization received resurgence once again with the easing of civil unrest in the South since 1989 and the process of dismantling remaining distortions was greatly accelerated. The liberalization measures were heavily centered on further relaxation of the remaining restrictions on trade and payments in order to create an environment for the private sector to operate efficiently. The liberalization process was culminated in March 1994 when all the remaining restrictions on current international transactions were removed. Following this, the country accepted the obligations of Article VIII of the IMF Articles of Agreement. Thus, by March, 1994 Sri Lanka has pushed through a full liberalization program with respect to current account transactions. However, a few commodities continued to be subject to import licensing. In July 1996 import licensing requirement on the remaining commodities was removed except those on wheat, meslin, maize and a few strategic commodities.

With respect to private foreign capital, a number of reforms was put through making Sri Lanka a more hospitable place for investment. Among these were the rationalization and simplification of investment procedures, abolishing of 100 per cent transfer tax on share transactions with non-nationals, relaxation of exchange controls on inward remittances for share purchases and outward remittances of profits, setting up of Share Investment External Rupee Accounts (SIERA), granting approval for Country and Regional Funds, permission for 100 per cent foreign equity participation in certain economic sectors, abolition of capital gains tax on the sale of shares of quoted companies and the Stamp Duty on the sale and transfer of shares, and the elimination of the withholding tax on dividends. The process of liberalization and inflow of foreign capital received a further boost following the launching of a program to privatize Government owned business enterprises.

Thus, while Sri Lanka has taken the initiative to liberalize the current account and parts of the capital account, particularly those relating to private capital flows, a wide range of restrictions on capital

transactions still remain in force. First, private foreign capital, both portfolio and direct, have only limited access to certain areas of investment such as banking, finance and plantations, while certain other areas such as money lending, pawn broking and coastal fishing are completely excluded for foreign investments. Second, Sri Lankan debt markets, both private and public, is not open to foreign investors. Third, Sri Lankan enterprises, except those in free trade zones, do not have unrestrained recourse to international capital markets for funds. Fourth, Sri Lankans cannot undertake foreign investments for the purchase of either physical assets or financial assets, without the prior approval from the authorities. Lastly, commercial banks in Sri Lanka do not have unlimited access to the international capital and money markets to fund their domestic banking operations.

All these restrictions meant that there is no free flow of funds between the domestic economy and the rest of the world. For instance, a Sri Lankan saver cannot have his funds invested in a foreign financial centre even though he stands to receive a higher rate of return in a foreign market than in the local market. Although Sri Lankans have access to foreign currency account facilities with domestic banks, local currency is not freely credited to such accounts. A Sri Lankan investor cannot operate in a foreign share market using domestic funds. Similarly, Sri Lankan stocks and shares are not quoted in overseas stock exchanges, while foreign stocks are not quoted at the Colombo Stock Exchange. At the same time, commercial banks in Sri Lanka cannot place funds in the international market even in situations of excess domestic liquidity.

All in all, Sri Lankans do not have the freedom of investing money either locally or abroad depending on their perceptions of the rate of return. Similarly, foreigners do not have unrestrained access to the domestic market to undertake investments. This situation arises because the Sri Lankan Rupee is not fully convertible or the capital account is not fully liberalized. In turn, it is due to the fact that the conditions for fully liberalizing the capital account just do not exist.

Section IV : Preconditions Required for Fully Liberalizing the Capital Account

It does not need to be emphasized that fully opening of the capital account will have far-reaching implications on the domestic economy. With an open capital account, there will be greater freedom for foreign funds to move in and out of the country fairly rapidly in a context of increased linkages among global financial markets. Therefore, adequate safeguards are necessary to prevent speculative capital flows which can be very damaging, leaving the economy with a painful adjustment when it reverses. The 1995 financial crisis in Mexico and the recent financial crisis in East Asia are cases in point. Here the preservation of macroeconomic stability which underpins public confidence in domestic currency is of paramount importance. One important ingredient of such a policy strategy would be the direction and content of fiscal policy. Fiscal deficits will need to be maintained at levels which will not result in additional money creation or exert excessive pressure on domestic interest rates. At the same time, such deficits should not undermine the domestic savings effort driving a country to depend excessively on foreign savings.

It also needs to be borne in mind that the opening of the capital account takes away the freedom of authorities to pursue a real effective exchange rate policy in balance of payments management,

underscoring the need for maintaining price stability. Here the monetary policy will have to play a crucial role in demand management, to prevent overvaluation of domestic currency. Significant interest rate differentials between the domestic economy and the rest of the world that would give rise to speculative opportunities need to be avoided, lest the country would be engulfed in an inflationary spiral due to the monetization of capital inflows. The exchange rate policy should take a flexible stance without excessive pegging to a particular currency or a basket of currencies. The recent experience of both Mexico and East Asia underscores the dangers of excessive pegging with consequent over-valuation of currency.

An important aspect to be emphasized in opening the capital account is the need for improving the regulatory framework. A significant portion of the increased capital flow resulting from an open capital account position will enter the domestic economy through the commercial banking system. Therefore, the banking system should be well regulated to prevent excessive exposure and improve prudential standards. The need for and availability of adequately trained regulators in the context of constantly advancing financial markets and financial instruments cannot be over-emphasized. If commercial banks in the domestic economy are not stable, well managed and well supervised, opening the capital account suddenly could lead to a domestic banking crisis through over lending and imprudent banking. The current financial crisis in East Asia is largely attributed to weaknesses in the banking systems which necessitated extensive bailing out operations by Central Banks, which in turn undermined the stability of currency. Conversely, a sound and efficient banking system will eliminate the creation of additional risks to the financial system due to increased capital flows. Its structure and operations should be such that a sudden reversal of the capital flow should not destabilize the economy.

A possible surge in capital inflows resulting from an open capital account makes the need for financial sector reforms more urgent. First, increased inflows tend to increase the flow of funds to the financial system encouraging risky lending. Therefore, the financial system should be sound and efficient. When extending credit, financial institutions should be able to anticipate the effect of a reversal of capital flows on the financial viability of the enterprises that they are financing and reduce the concentration of credit to sectors that may be affected by such reversals. If, on the other hand, financial institutions operate in an environment which allows them to misallocate credit, a capital inflow induced expansion of credit can expose financial systems to large risks. Second, to the extent that capital inflows increase open foreign exchange positions of financial institutions, such inflows increase their exposure to exchange risks. Third, if inflows reduce domestic intermediation, the impact of an abrupt reversal of the inflows on the economy becomes severe. On the other hand, a sound and more efficient financial system would allow more accurate assessment and pricing of credit risks and would prevent domestic savings from declining in the face of surges in capital inflows. It is therefore, important not only that the financial sector must have a robust market infrastructure but also financial resilience and be ready to cope with sudden reversals of inflows and volatility of asset prices.

Experience has shown that structural weaknesses in the financial sector can constrain the capacity of a country to absorb foreign capital inflows efficiently. More particularly, in a thin money market with a limited number of instruments and segmented financial markets, open market operations relying

heavily on government paper and Central Bank issues can stifle efficient use of foreign inflows. A healthy banking and financial system is essential as a weak financial system is an open invitation to financial crisis. Meanwhile, increased access to international capital markets may make it easier for more credit-worthy firms to tap international capital markets directly by issuing stocks or bonds. Such capital inflows will have to be efficiently absorbed into the domestic economy in order to realize maximum benefits and minimize destabilization effects. Regulatory mechanisms should be in place which would prevent domestic enterprises accumulating disproportionately heavy foreign liabilities, particularly short-term liabilities.

The sustainability of the current account is an important ingredient in a successful open capital account position. Current account deficits financed by long-term capital, in particular by foreign direct investment, are more sustainable than those financed by short-term capital flows. Deficits which make heavy recourse to short-term borrowings unavoidable are totally intolerable. In the case of equity capital, there should be a healthy balance between direct investment and portfolio investment, the former assuming the more dominant position, thereby minimizing the contagion effects of unsavoury developments elsewhere.

The timely availability of economic data both to domestic policy makers as well as to the international investor community is considered to be a vital necessity in an open capital account setting. In fact, the paucity of basic economic information had been attributed as a major contributory factor for the crisis in Mexico as well as in some of the Asian countries. Bearing this deficiency in mind, the IMF in 1996 developed a mechanism to disseminate economic information -- Special Data Dissemination Standards (SDDS) -- to which a number of developed and developing countries have already subscribed. The objective of SDDS is to encourage the timely publication of economic data by countries which wish to have access to international capital markets and which are used by market participants in evaluating a country's policies and prospects. The very act of publication of such data acts as a built-in stabilizer against macroeconomic excess and constitutes an invaluable protection for countries with good policies against contagion effects.

Section V : Current State of the Economy in the Context of Capital Account Convertibility

As already mentioned elsewhere, the Sri Lankan economy has to reach a certain level of prudence and resilience in economic management and financial sector reforms before it could consider opening her capital account. In the area of economic management, significant improvements are required in macro management. First, Sri Lanka's inflation record in the recent past, with an average of about 12% during the period 1980 - 1996 is not conducive to an open capital account state. This has to be brought down to a more sustainable level of about 2-4% - a rate more in line with the inflation rates of the trading partners. Second, the fiscal deficit which directly and indirectly has been a primary cause for high inflation has to be constrained at a more tolerable level of about 3-4% of GDP, reducing from the current level of 7-8% of GDP. Much of the adjustment will need to come from the current budget without further pruning the capital budget, which has been a feature of fiscal management in the recent past. Third, the large public debt which now stands in excess of 90% of GDP has to be pruned down to a more moderate level and in the current

context this could only be achieved by utilizing the privatization proceeds to liquidate a significant portion of the domestic debt. Fourth, the external current deficit will have to be contained at a level which is bridgeable from long-term capital flows, both official and private, without having to resort to short-term external borrowings. Thus, the size of the current account deficit which can be sustained would depend on the prospects for long-term capital inflows. Fifth, a flexible exchange rate policy which would eliminate the risk of the currency getting into an over-valued position in real effective terms is a vital necessity.

In the area of financial sector reforms, the unfinished agenda is formidable. The fact that Sri Lanka's financial sector is highly skewed in terms of institutional dominance and the paucity of specialized institutions need not be over emphasized. In terms of total assets of the financial system, the commercial banking system occupies a predominant position. Of the total assets of the financial system outstanding as at the end of 1996, commercial banks accounted for approximately 60 per cent. This predominant position of the commercial banking system underscores the need for a strong regulatory framework for the functioning of the commercial banking system, in order to avoid any untoward fluctuations that may endanger the stability of the country's financial system. Sri Lanka has a well structured and up-dated regulatory framework for the supervision of commercial banks. However, it may still be important to examine the existing supervisory and regulatory framework and make necessary legislative changes for strengthening prudential supervision in keeping with an open capital account environment.

With respect to the structure of commercial banking, a highly imbalanced and segmented character is evident. For instance, the two state banks still account for over 60 per cent of the assets of the banking system, the domestic private banks and the foreign banks sharing the balance. This highly skewed banking structure in favour of state-owned banking is a severe limiting factor in maintaining the efficiency of the banking system. In particular, the predominance of the state sector in the country's banking operations prevents the market signals being transmitted speedily through the banking system. It is generally the case that state-owned institutions have less of an incentive to manage risks properly because there is presumption that the authorities will intervene to bail them out when in difficulty. Then, there is the problem of directed lending and the resulting poor quality of loan portfolios and concessional credit. Such a banking structure is likely to show lesser strength in meeting sudden financial stresses if and when the economy slows down. There is also the problem of high inter-mediation costs due to the inefficiency of the state banking sector which has contributed to keep the domestic lending rates high in relation to financial costs of funds and far in excess of those prevailing in the world outside and which, in turn, create pressure for foreign funds to flow in. Therefore, there is an overriding need for the country's banking structure to be changed in favour of a more balanced and less state dominated structure capable of promoting efficiency in resource allocation and meeting financial stresses.

Among the other institutions in the financial system which are likely to be affected by an open capital account position will be the development banks. It is very likely that with high domestic interest rates, these banks will be tempted to have recourse to the international financial markets to augment their resource base. These institutions are likely to get exposed to unduly heavy foreign exchange risks, if appropriate regulatory provisions are not in place. It is also likely that specialized institutions such as venture

capital companies, merchant banks and leasing companies will go to the international market for raising funds in an open capital account position. Accordingly, it is necessary for the Central Bank's supervisory control to be extended to these institutions as well.

Another major market to be affected by an open capital account position will be the domestic public debt market. At the end of 1996 the total domestic debt stood at Rs. 349 billion consisting of Rs. 206 billion of Rupee securities, Rs. 125 billion of Treasury bills (TBs) and Rs. 18 billion of provisional advances. Currently, this entire market is shut off to foreign investors. However, with the opening of the capital account, a very large part of this debt is likely to be thrown open to the international investor. This is particularly so with the proposed changes relating to the marketing of TBs and Rupee securities on a scripless basis. Allowing for the sovereign risk associated with the flow of funds across borders and the foreign exchange risk, there can be a flood of funds into this market if the differential between the interest rates on government debt instruments in Sri Lanka and those obtained in international capital markets is not eliminated. In view of the relatively large public debt in Sri Lanka, such capital flows are likely to cause heavy fluctuations in the domestic financial system. Accordingly, action is required on the macroeconomic front to ensure that the interest rate differential between the domestic economy and the rest of the world remains at a minimum.

A country needs a well developed and healthy corporate sector to benefit effectively from an open capital account situation, because it is the corporate sector which exposes itself to international capital markets either directly or indirectly through domestic financial intermediaries . Unfortunately, in Sri Lanka the corporate sector is not only very thin but is also rigidly controlled through interlocking devices with little evidence of transparency. Although standards for corporate governance and accounting and auditing have been developed lately, there is little evidence of these having being adopted or widely practised. Meanwhile, the rate of growth of the corporate sector in the recent past has also left much to be desired with the business community continuing to pursue a wait-and-see policy. The number of companies listed at the Colombo Stock Exchange at around 240 represents a very minute fraction of the corporate enterprises in the country and seems to be growing at snail's pace. A vigorous and fast developing corporate sector is a vital necessity in realizing the maximum benefits from an open capital account position.

Section VI : Concluding Remarks

Recent years have witnessed a fundamental shift in the world economy such as increased current account convertibility, adoption of market oriented reforms in many countries, increased regional and monetary integration, breakdown of the centralized systems in the former Soviet Union and Eastern Europe, a rapid growth in private capital markets and a sharp drop in official capital flows, particularly from bilateral sources. All industrial countries and a number of developing countries have also liberalized capital account transactions. Meanwhile, the IMF has initiated action to extend its jurisdiction to promote capital account convertibility among its member countries. All these developments seem to suggest that the world economy is poised to get increasingly globalized in which market forces are going to play a major role in determining the economic fortunes of countries. There is a growing possibility that those developing countries which fail to get assimilated into the

globalized system will get marginalized and will lose out in the battle for economic advancement.

For countries which are already not in a liberalized setting, this would mean having to push through a program of structural and economic reforms speedily. It needs to be recognized that a highly globalized economic system also poses risks. The harsh consequences of openness to global economic currents should not be under-estimated. In particular, the large capital flows ingrained in a highly globalized system can have potentially harmful effects on countries prone to macroeconomic destabilization. Strong inflows can weaken internal resolve and put pressure on domestic monetary policy. They can also create the illusion that macroeconomic discipline can be relaxed and, in some cases, weaken political support for reforms. At the same time, large-scale capital flows are typically associated with widening external imbalances which eventually risk provoking sudden reversals with changes in investor sentiment, as the recent turbulence in some Asian countries proved. This would mean that globalization increases the cost of inappropriate policies. Thus, while an open liberalized system will confer considerable economic benefits to a country, the risk of having to go through painful adjustment periods is equally high if the "game is not played according to the rules". In other words, countries adopting more open systems cannot afford to compromise on economic prudency. Instead, the authorities should spur the economy to be more sensitive and readily adaptable to market forces and competition.

Then, there is the problem of spillover or contagion effects. There have been many instances in the recent past in which capital outflows from a country that was following unwise policies had an impact on neighboring countries or on countries perceived to be in similar conditions. The most recent example is obviously the spillover from Thailand to other countries in East Asia. Some argue that countries should regulate capital inflows in order to protect themselves from the consequences of another country's problems. This, however, goes against the very philosophy of capital account liberalization. If those affected by spillover are following sound policies, the outflow will be temporary and soon normalcy will return. If, on the other hand, those countries also suffer from some symptoms of economic mis-management, then a program of economic reforms is urgently called for before matters get too serious. In such an event the outflow due to the spillover effect can prove to be beneficial.

In Sri Lanka, there are different shades of opinion with respect to economic reforms and liberalization. There are those who are pathologically against any form of liberalization and argue that the 1977 liberalization brought more misery than good. This is in spite of the dismal experience of the 1960-77 controlled regime in terms of economic performance. Then, there are those who still believe that the commanding heights of the economy should be under public ownership. This even after the break-down of the socialist systems world-over. There is also some degree of antipathy towards foreign capital even among those who believe in a free enterprise system. They believe that foreign capital should not be allowed into certain strategic sectors of the economy. Then, there are those who oppose privatization in the mistaken belief that only those enterprises in the public sector are national assets, despite being run inefficiently with high economic costs. Even among those who believe in capital account liberalization, there are those who advocate a cautious, step by step, approach rather than an abrupt opening of the door. This appears to be a caution dictated by the difficulties

in achieving macroeconomic stability, particularly in the context of the ongoing civil unrest, and slow progress in financial sector reforms..

A major missing link in the thinking of those who eschew liberalization is a lack of a vision for the country as to how it could move forward economically in order to address growing economic and social problems such as high unemployment and wide spread poverty. The country has made little progress economically during the last 50 years since Independence, while some countries in Asia which were similarly placed in the 1950s have made some path-breaking progress. Sri Lanka is a small island economy with limited resources. Its economic fortune therefore lies on how best and how speedily it could get integrated into the world economy to enable it to draw resources from the rest of the world. Sri Lanka cannot generate sufficient investment out of its own resources, particularly in the short run. Therefore, it has necessarily to look outside . Official capital flows are on the wane and will not continue to be a guaranteed source of resources. This makes Sri Lanka to depend heavily on private capital flows in the future years if she is to attain the status of an emerging market economy and this needs a liberal approach to the capital account. The alternative is to remain marginalized, condemned to a low growth path and accumulate growing social discontent.

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