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ECONOMIC CONSEQUENCES OF THE TOTAL REMOVAL OF EXCHANGE CONTROLS

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The Budget

The liberalisation of foreign exchange controls and accompanying depreciation of the currency and probable rise in interest rates will have consequences for government expenditure, revenue and deficit financing. To begin with the depreciation of the currency and probable increase in interest rates are likely to add to the expenditure burden of the government. The depreciation of the currency will increase government expenditures, especially capital expenditures, as a result of increases in import prices. Increases in interest rates will add to the government's debt repayment costs and, to this extent, reduce budgetary savings. The greater choice which would be available to domestic savers may put a further upward pressure on interest rates payable on government securities. Offsetting these are the reduction in prices of importables and the increase in revenues from trade based taxes. On balance there is likely to be some pressure on the budget at least over the short run. More precisely, the net impact is likely to be an addition of 2% of GDP onto the overall budget deficit, moving the deficit from 9.9% of GDP 11.9% of GDP.

With the possibility of a rise in interest rates there may also be an inclination towards so called inflationary financing of the budget deficit in the short-run. Even if there were not, and the increase in budget deficit were 'funded' (by borrowing from the public), "crowding out" should not longer be a problem. Liberalisation of exchange controls gives the private sector access to a potentially unlimited pool of foreign funds, albeit at a premium.

Inflation

Currency liberalisation and its attendant consequences for the exchange rate, interest rates and budget are likely to aggravate underlying inflationary pressures, at least in the short-run. First, the depreciation of the Rupee to its expected post-liberalisation equilibrium level will add around 5% to 10% to the underlying rate of inflation. Since the expected inflation outturn for 1991 in the absence of a liberalisation of exchange controls (and a corresponding depreciation of the currency) is around 10%, this would suggest a post-liberalisation rate of inflation of around 15%-20%. If speculative activity causes the nomianal exchange rate to overshoot the impact on inflation will be correspondingly greater. Second, and relatedly, the greater propensity for the exchange rate to fall in the context of a liberalised foreign exchange environment carries with it the possibility of an inflation-currency depreciation spiral. Third, this greater propensity for the exchange rate to fall also means that there would be less protection for the domestic economy from price shocks emanating from the world economy. The monetary authorities have less discretionary powers in, for example, lagging the exchange rate to dampen and stagger the impact of exogenous price shocks on the domestic economy. Fourth, relatively higher domestic rates of interest will tend to feed into production costs fuelling inflation and/for squeezing profits, investment and output. Lastly, liberalisation will further limit the ability of the monetary authorities to control credit through control of the reserve base. Banks and other financial institutions will be increasingly at liberty to supplement their reserves through external borrowings. The limited development of the secondary bond market may make mopping up of excess liquidity through the sale of government securities difficult.

Savings, Investment and Aggregate Output

Liberalisation of exchange controls will undoubtedly expand the availability of foreign savings although it may initially diminish domestic savings and cause interest rates to rise. The foreign component of aggregate savings will rise because of an increase in access to foreign funds by Sri Lankans and a greater confidence by foreign investors in their ability to repatriate principal and dividends upon demand. Interest rates, especially short-term rates, will rise because of a relatively greater uncertainty (including exchange rate uncertainty) in the Sri Lankan economy. Domestic savings may contract because of an increase in domestic consumption expenditures on imports and an increase in the purchase of foreign financial assets by Sri Lankan nationals and companies. A mitigating factor here may be the additional finanacial savings generated by the increase in interest rates.[8]

Liberalisation of exchange controls should boost investor confidence, especially foreign investor confidence, since profits and principal can henceforth be repatriated at any time. The accompanying currency depreciation will most likely give a further boost to the export sector, particularly the manuacturing export sector. Against this the pressure on the budget, higher interest rates and a more volatile currency resulting from a liberalisation of exchange controls, could have offsetting negative consequences. Budgetary pressures could result in cutbacks in public investment programmes with negative consequences for growth. High interest rates will add to producer costs while volatile exchange rates will add to investor uncertainty, particularly in the export sector. Also, the fall in prices of importables resulting from the liberalisation of exchange controls would undoubtedly adversely affect already weakened domestically oriented producers, although this may serve to release resources from less productive (domestically oriented) sectors to more productive (export oriented) ones.

On balance it waould appear that aggregate output need not be seriously disrupted by a liberalisation of exchange controls *per se,* provided that there are no unforseen shocks to the system which cause a sudden exodus of capital, an unsustainable depletion of reserves, and a sharp fall in the exchange rate. On the contrary, it is possible that if controls are lifted in phased manner and in a climate of growing investor confidence and a relatively stable domestic and international economic environment, the liberalisation itself could serve to propel the economy to considerably higher levels of growth. The worry is that at present these ideal conditions are absent and in this context a liberalisation of controls, even a phased liberalisation of controls, could be positively damaging.

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Sectoral Output

Agriculture, particularly domestically oriented agriculture, is likely to benefit least from the liberalisation of exchange controls. Compared to industry and services, it is likely to attract relatively less foreign direct investment. Most producers, particularly those producing for the local market, lack the wherewithal to make use of the greater availability of foreign financing. The fall in importables prices will have a negative impact on domestically oriented agriculture, which accounts for around 50% of total agricultural production. Export-oriented agriculture will certainly benefit from the accompanying currency depreciation in the short-term, because of increased revenues, but it is not clear what the longer term consequences for either output or revenues is likely to be because of the lag in response of the sector to price changes.

The industrial sector, particularly the manufacturing sector, is likely to benefit the most from exchange liberalisation. Most inflows of foreign direct investment, equity finance and credit will accrue to this sector. The industrial sector as a whole will be more affected than agriculture by a rise in interest rates in formal money markets since it acquires more of its finance from these sources than is the case in agriculture. However, the nature, structure and functioning of the industrial sector is such that these cost increases are more readily passed on through commensurate increases in final selling prices. Domestically oriented industry will be hurt by the expected fall in the price of importables, while export-oriented industries should benefit from the implied release of resources and accompanying currency depreciation. Export sectors producing higher value added products are likely to benefit more from depreciation than other industrial exporters because of the latter's heavy dependence on imported inputs. Some of the benefits accruing to the export oriented industrial sector could be offset by a greater post-liberalisation uncertainty surrounding exchange rate movements.

The services sector will be least affected by a rise in the price of importables and a more volatile exchange rate consequent on liberalisation because of the high proportion of non-tradables in the sector. For much the same reason the services sector as a whole will be more affected by an accompanying depreciation of the currency than either of the other two sectors. The exception in this case is the tourist sub-sector, which should benefit considerably from currency depreciation because of its relatively higher proportion of non-traded inputs. Both tourism and the wholesale and retail trade sub-sectors will also benefit directly from the elimination of exchange controls given the considerable nuisance cost of the latter. Sections of the organised part of the services sector should benefit from expanded inflows of foreign direct investment, equity finance and credit. As noted earlier, banks will be able to expand their asset bases by supplementing their reserves from foreign sources without recourse to central bank borrowing. However, banks and other financial institutions may suffer somewhat from the greater availability of loanable funds which liberalisation will give rise to.

5. Conclusions, Prospects and Possibilities

In keeping with the economic strategy of liberalisation, it seems only logical that exchange controls be eased and eventually removed. What the preceding has pointed to is the importance in this process of timing, sequencing and context. The current political uncertainty and economic backwardness of the country suggests the present is not an opportune moment for such a policy initiative. Assuming a resolution to the current political and security problems besetting the country, and assuming further that the authorities are able to secure the necessary guarantees of foreign exchange support, the best that could be hoped for in the event of a total liberalisation of exchange controls at this stage is:

(a) A deterioration in the current account of the balance of payments by at least 3%-4% of GDP;

(b) A depreciation of the Rupee to around Rs. 50: US$ 1;

(c) An increase in the base rate of interest by 3%-4%;

(d) A deterioration in the budget deficit from 9.9% of GDP to 11.9% of GDP;

(e) An increase in the domestic rate of inflation by 10%, i.e., a doubling of current levels;

(f) A contraction in investment and output, especially in agriculture and certain sections of manufacturing.

This outcome it must be stressed is not the most likely but the best one could hope for in the circumstances. In fact the most likely outcome of a complete elimination of foreign exchange controls at the present juncture is an intolerable depreciation of the currency and increase in interest coupled with an unsustainable depletion of reserves.

Accordingly, it is our opinion that Sri Lanka is as yet not in a position to justify a policy thrust towards the total elimination of exchange controls. The process of exchange liberalisation should ideally begin at a time when the country has attained a greater degree of economic strength and political stability, and there is relative calm in international commodity markets. This would enable a maximisation of export earnings while minimising the inflationary impact of the unavoidable currency depreciation that would follow from exchange liberalisation. The burden of compensating adjustments in the short-erm should fall on foreign exchange reserves and (possibly) the exchange rate, but not the interest rate.

If and when liberalisation of exchange controls takes place the preceding also suggests that it should do so gradually, beginning with an easing of controls pertaining to transactions in goods and services. Once stability in the external account is achieved, and with a further strengthening of the economy, liberalisation of private transfers could be considered. Only at an advanced stage of development of the economy and its fuller integration into the world market should liberalisation of capital flows be considered. Capital flows, particularly short-term capital flows can be seriously disruptive, especially for small, relatively weak economies, with underdeveloped financial systems and limited foreign exchange earnings capacities.

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Notes

1. The starting date for the period is taken to be 1980 for pragmatic reasons; the new more reliable central bank external price series only begins in 1979.
2. The level of gross reserves can be supported temporarily through foreign borrowing and drawing from a country's account with the IMF, but this cannot continue indefinitely.
3. Other long-term private capital flows includes investments and disinvestments of capital in firms other than those that are foreign or non-resident controlled, but where they hold shares.
4. It bears repeating that foreign capital inflows not only facilitate but also encourages increases in import expenditures.
5. The real exchange rate index shown in figure 1 is that for the Sri Lankan Rupee against the US Dollar using Sri Lankan and US prices.
6. The real rate of exchange is a hypothesised construct which adjusts the nominal exchange rate for inflationary differentials. Movements in the real rate indicate either short-run disequilibrium (e.g., the nominal rate has not been adjusted for inflationary differentials) or that there have been underlying structural changes.
7. See Nicholas, H. and Yatawara, R. (1991).
8. By the same token, however, aggragate national savings may contract because higher interest rates will lend to deplete retained profits.

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