

**International**

In 1974 the international banking community suffered several shocks, and it is only now that bankers are gradually recovering from them. The most serious were the bank failures in U. S. A. and Germany, and of these, the failure of Herstatt Bank—a privately-owned bank in West Germany—was the most spectacular. These failures, and particularly the inability of Herstatt to meet its commitments even on some "spot" foreign exchange transactions, came as a great surprise to international bankers. Until then they had been used to the idea that only banks in countries having balance-of-payments deficits or unsettled political conditions were potential defaulters in their commitments. Established banks in economically and financially strong countries were considered safe risks, even in transactions involving very large sums and fairly long periods. The Herstatt experience calls for a revision of this view.

It is now generally agreed that the root cause of these failures was the unprecedented 'floating' of exchange rates of almost all the internationally traded currencies. Fixed exchange rates had for long been considered to be an essential pre-requisite for stability in international transactions, but one after another, leading currencies were forced to abandon fixed parities and adopt floating rates. The U. S. dollar held out for some time longer than others, and its capitulation in March 1973 signalled the end of an era in the international monetary field.

This general adoption of floating exchange rates created an extremely fluid situation in international currency markets. It also provided great opportunities to speculators and presented equally great risks to banks and other legitimate operators in these markets. Buying and selling foreign currencies under high pressure has always been a specialised and risky business, and in the banks this was the preserve of exchange dealers who were acknowledged experts in their field. With 'floating' exchange rates, the risks attendant on 'dealing' vastly increased, calling

for even sharper skills than before. At the same time the prospect of large speculative profits also increased, and 1974 saw several banks, including two large international banks, come to grief as a result of their dealers being unable to resist the temptation to speculate in a big way. While the smaller banks found the shock fatal, the two international banks were strong enough to withstand it by absorbing the losses.

Even so, these spectacular events shook the international banking system, and for a time bankers nervously looked around to see who will fall next. Fortunately, as always in banking, the lesson was quickly learnt, and the banking community with the assistance of Governments was able to put together various devices to successfully tackle the new problems.

The basic cause of these upheavals lay in the freedom which international bankers traditionally had in their operations. This freedom was guaranteed by the laissez-faire doctrine that equilibrium in international transactions can best be achieved by allowing market forces to have free play. The disastrous events of 1973/74 have caused a recognition of the dangers of this doctrine, and without openly repudiating it, Central Banks and Governments have proceeded to systematically curtail this freedom.

Fortunately for us, in the developing world, we have always been too poor, particularly in foreign exchange resources, to be able to afford the luxury of the freedom of action so cherished by bankers and businessmen in the West. Exchange control is a permanent fact of life with us, and this meant that the scope for speculative deals in foreign exchange has been totally absent. This has spared us here in Sri Lanka from the risks to which the Western countries have been exposed in recent years. Thus, the defaulting potential of banks in developing countries may have been somewhat exaggerated, after all.

**Sri Lanka Finance Companies**

For some time now there have been suggestions that some action

must be taken by Government to regulate the activities of our Finance Companies. The point has been well made that they are an aberration in a planned economy tending to disturb, and to some extent neutralise, the Government's efforts at directing the development of the economy towards pre-determined objectives. The discussion on this subject increased in the period of the run-up to the last Budget, and it was expected that the Budget proposals would contain some measures to bring the Finance Companies within the ambit of the Government's regulatory powers. In the event, the Budget proposals were disappointing in that they contained only a withholding tax on interest paid by Finance Companies.

The implications of this measure were quite naturally exaggerated as part of the build-up against the so-called expropriatory character of the Budget proposals. In fact, however, it was no more than an advance collection of Income Tax very similar to the long-standing deduction at source of tax on dividend income.

Some meaningful and effective regulation of the activities of Finance Companies is urgently needed in the interests of an effective control over national economic activity. In the first place, the uncontrolled operations of Finance Companies have a distinctly inflationary impact on the economy. While the Central Bank imposes credit restrictions on the commercial banks with a view to containing inflationary pressures and directing resources to priority areas, the Finance Companies carry on their lending unabated, most of the time financing precisely those areas which the Central Bank wants to be starved of credit.

Another consequence of these activities is the disturbance of interest rate structures. Being unable to attract deposits as easily as the banks, they have to offer very high interest rates in order to get deposits. By this means they attract money that might otherwise have gone into the banking system, and also compel the less liquid banks to offer high

interest rates (by bank standards) in order to retain at least some of their deposits.

The high cost at which Finance Companies get their funds lead them to charge a high price for the funds they lend out, and it is not unusual for the effective rate to the borrower to be between 25 and 30 per cent. Naturally, this high cost of funds in turn increases the production costs of the borrowing entrepreneur, who in turn adds it to the market price of his product. By this means the inflationary pressures in the economy are further aggravated.

There is, of course, no doubt that by and large Finance Companies play a useful role so long as there is a place for private enterprise in the economy. Their borrowers are mostly sub-standard, and are willing to pay the high price because they have no alternative source of funds.

It is, therefore, not desirable to eliminate this source. What needs to be done is to regulate it.

This can be done by bringing them within the purview of the Central Bank's authority by a suitable amendment to the Monetary Law Act. They could then be required to maintain certain reserves with the Central Bank and would also be subject to the Central Bank's regulatory and supervisory authority including the scrutiny and direction of their lending portfolios. They can then be brought within the ambit of the credit restrictions and effectively prevented from introducing distortions into the economy.

The Central Bank's regulatory authority will also help to provide the much needed stability to the Finance Companies by ensuring that they take balanced risks. This in turn will help to protect depositors.

In U. K. and elsewhere in the West "secondary-banks" which are the counterparts of our Finance Companies, have been causing considerable concern. The central banks and commercial banks have realised that the failure of any of the "secondary-banks" may result in loss of confidence in banks proper, and have taken concerted action to help those in difficulty. From that they have moved on to a position of control to ensure that the "secondary-banks" adopt safe business practices which will prevent them from getting into difficulties.

Here in Sri Lanka, where the Government wants the economy to develop in a particular direction, there is a very strong case for regulating the activities of our own "secondary-banks", and amendment to the Monetary Law Act providing such regulations is therefore an urgent need.

## FOREIGN AID

In mid March at a panel discussion organised by the Sri Lanka Association for the Advancement of Science, a Professor of Engineering of the University of Sri Lanka made what must be one of the most patriotic and constructive solutions to the problems of the brain drain. His simplistic and naive suggestion was that the education system of Sri Lanka should be geared to the requirements of the Western countries so that those trained at considerable expense to the country would find steady jobs abroad.

On a more serious and reasoned level, a study published by UNCTAD the same week shows the full dimensions of the brain drain problem. According to this study which has quantified the inflow of trained personnel of the Third World into the U.S., the full extent of Third World aid flows into the U.S. is revealed in the clearest possible terms.

In 1970, according to this study, 11,236 skilled people left the developing countries and settled in the U.S. Asia accounted for over 75% of the emigrants, over 3,000 going from

India alone. Roughly half of the number were engineers, approximately one sixth doctors and natural scientists, respectively.

If one takes the income earned as an indicator for their value to society, doctors top the list. They are expected to earn an average of \$646,000 each during their professional life in the United States, as compared with \$44,000 in their respective home countries. Engineers, natural and social scientists are judged to earn sizeably less, between \$253,000 and \$230,000. For engineers and social scientists, this still amounts to about ten times the sum they can expect to earn at home. What represents a gain for the individual is a loss for the society.

In 1970 alone the total income transferred to the U. S. by this brain drain amounted to 3.7 billion dollars. In contrast the total official development assistance (largely consisting in reality of loans) by the U. S. to developing countries amounted to only 3.1 billion dollars. In this context India was one of

the biggest aid donors and U. S. one of the biggest recipient countries. Development aid of this form to the U. S. is seen in stronger light when compared with other relevant magnitudes. For example, it amounted to nearly 14% of total U. S. expenditure on research and development and about 38% of U. S. current expenditure on higher education. In 1970 alone it was roughly one eighth of the total U. S. assistance to post war Europe in the form of the Marshall Plan Aid. Lastly, the figure was equivalent to over 0.3% of the U. S. gross domestic product.

It is interesting to point out that this study indicating reverse aid flows to the West is in keeping with studies on the Latin American context on capital inflows. These have shown that instead of there being net capital inflows from the U. S. into Latin American countries as proponents of allowing 'free' capital movement would believe, there is on the contrary, a net outflow of capital from these countries to the U. S. for every quantum of capital received.

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