ECONOMIC CONSEQUENCES OF THE TOTAL REMOVAL OF EXCHANGE CONTROLS

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1. Introduction

The alm of the paper is to analyse the impact of a policy of liberalising exchange controls on the Sri Lankan economy with a view to making recommendations regarding the implementation of such a policy. With this objective in mind the paper begins with a selective analysis of the recent macro performance of the Sri Lankan economy highlighting those features of it which are considered salient for a discussion of the impact of exchange liberalisation. It then presents the current position regarding exchange controls, and then goes on to consider the impact on the economy of a policy of liberalising exchange controls. A final concluding section draws together the findings of the previous sections in respect of the implementation of such a policy.

Given the time constraints placed on the study, particularly in the context of the absence of a readily available macro economic model for the country, it is not possible in this draft to consider a number of scenarios under different sets of assumptions. What is attempted is a discussion of prospects and possibilities on the basis of what the authors consider, from as impassionate and unbiased a viewpoint as possible, to be the most likely ground situation for, and consequences of, a policy exchange liberalisation.

The basic conclusion of the study is that if exchange control liberalisation is to be embarked upon at this stage of Sri Lanka's economic development, it must be phased and supported by a sizeable foreign exchange reserve and/or a guaranteed reserve pipeline.

2. A Selective Review of the Recent Macroeconomic Performance of the Sri Lankan Economy

Output

Aggregate trends

The average annual rate of growth in output of the Sri Lankan economy between 1978 and 1990 was 4.8%, which is considerably higher than the average for the preceding 1971–77 period (at 3.1% per annum). Over the 1978–90 period a distinction is often drawn between the relatively strife-free pre-1983 sub-period, when the rate of growth was an average 6.0% per annum, and the ensuing strife torn 1984–89 period when the average annual growth rate dropped to 3.4%. With the return to normalcy in the Southern part of the country in 1990, output growth, at 6.2%, returned to its pre-strife levels.

The major determinant of growth in the Sri Lankan economy, which the general political and security environment has undoubtedly had a bearing on, is investment. This is evidenced by the close correspondence between the average rate of growth in output and investment as a proportion of GDP. Thus, during the low growth 1971–77 period investment amounted to an annual average 16.1% of GDP, while during the higher growth 1978–90 period it climbed to an annual average 25.5% of GDP. Further, during the 1978–83, sub-period investment was in the order of 28% of GDP while in the ensuing lower growth 1984–89 sub-period it was only 23% of GDP.

A corollary of the above is that periods of high growth appear to have been financed by correspondingly high levels of foreign financed investment. 40% of total investment in the 1978–90 period was financed by foreign savings while only 17% of investment in the 1971–77 period was financed from foreign savings. Also, during the high growth high investment 1978–83 sub-period foreign savings accounted for 45% of investment financing while in the lower growth 1984–90 sub-period it accounted for a mere 30%.

The basic conclusion which emerges from the preceding is that high growth rates appear to be explained by high levels of foreign financed investment. The exception to this growth/investment/savings pattern appears to be 1990. In that year the rate of growth was 6.2% while investment was only 21.7% of GDP, and foreign savings financed a mere 22.5% of investment. One explanation for this anomaly is that growth in 1990 was based on excess capacity.

Sectoral Trends

At a sectoral level services and manufacturing grew most rapidly over the 1978–90 period. Services grew at an average annual rate of 5.4% and manufacturing at an averge annual rate 5.3%. Agriculture grew by a more modest 3.8%. The averge growth rates for both services and agriculture were considerably higher in the 1978–83 sub-period than in the

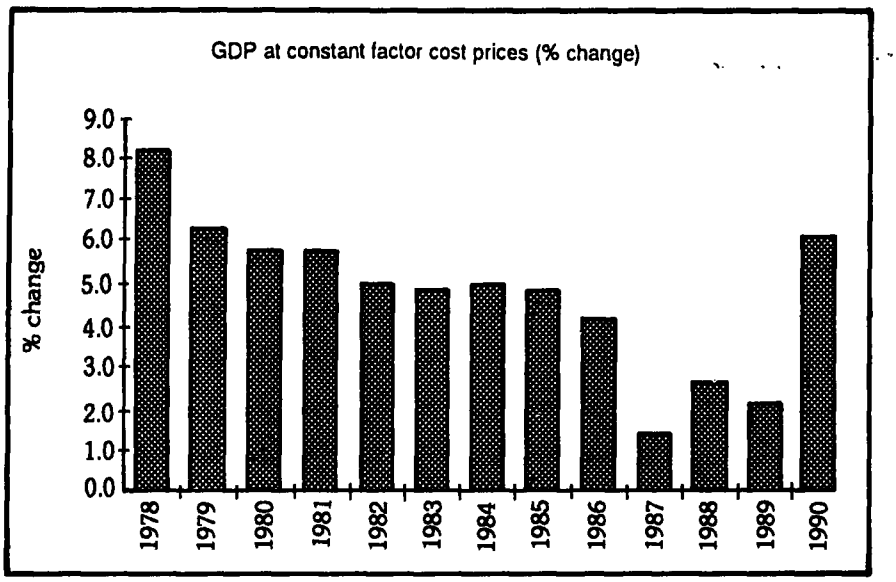

Figure 1: GDP growth rate 1978–90

Table 1: Investment and Savings

	1978–83	*1984–89*	*1988*	*1989*	*1990*
As % of GDP					
Investment	27.9	23.4	22.8	21.6	22.6
Private and public corporations	21.8	18.4	16.9	17.2	18.4
Government and public enterprises	6.2	5.2	5.9	4.4	4.2
Savings	27.9	23.4	22.8	21.6	22.6
National	13.0	13.6	12.0	12.1	17.5
Foreign	14.9	10.0	10.8	9.6	5.1

Source: Central Bank.

later 1984–90 sub-period, while for industry it was the reverse. Agriculture grew at an average annual rate of 4.2% in the earlier period and then fell back to 1.2% in the later 1984–90 period. The corresponding figures for services were 7.3% and 3.9%. In contrast the manufacturing sector grew at a respectable 4.4% in the 1978–83 sub-period and then at a remarkable 7.3% in the later sub-period, during which civil strife was at its worst.

Within agriculture paddy, and more generally the non-plantation sector, has performed well, and the plantation sector, especially tea, has performed badly. Paddy performed particularly well in the 1978–83 period, in the first flush of liberalisation. The average annual growth rate of paddy production during this period was a creditable 6.9%. As a result of the deteriorating security situation and climatic factors this rate slumped in the ensuing 1984–90 period to a meagre 1.4%. In contrast tea production actually declined in the early period and then registered a respectable 4.2% average annual rate of growth in the later 1984–90 period.

Several sub-sectors contributed to the overall positive performance of the services sector. These include: banking, insurance and real estate (9.9%); wholesale and retail trade (5%); electricity, gas, water and sanitary services (8.9%); and transport, storage and communications (5.0%). Banking, insurance and real estate generally outperformed all other service sectors over the 1978–90 period as a whole and the 1978–83 and 1984–90 sub-periods—the exception being public administration and defence in the latter sub-period (for obvious reasons). Domestic trade in goods performed well in both sub-periods, growing at 6.9% and 5.3%, respectively. Trade in imports did well in the early period, notching up an average annual growth rate of 13.3%, and poorly in the later period, when its rate of growth slumped to less than 1%. In contrast trade in exports performed relatively poorly in the early period, when it grew at 2.7%, and considerably better in the later period during which it grew at a creditable 6.6%. Earnings from tourism grew precipitously between 1978 and 1982, exceeding the 400,000 tourist arrivals mark by 1982. Civil disturbances and a general deterioration in the security situation in the country led to a collapse of the industry thereafter. By 1989 tourist arrivals were less than half the 1982 figure. With the restoration of some degree of normalcy in the country in 1990 the industry made a dramatic recovery. Tourist arrivals rose by more than 50%. As a result the "Services n.e.s" component of the services sector, of which tourist earnings is the major part, rose by a massive 9.1%.

The Evolving Structure of Production

Although the data is far from conclusive, it can be argued that certain structural shifts appear to have taken place in the post-1977 period between and within sectors. The most apparent shift between sectors is the decline of agriculture, from 26.5% of GDP in 1978 to 22.4% of GDP in 1990, and the growth of services, from 44.8% of GDP to 49% of GDP between the same two end points. The proportion of GDP accounted for by industry has remained the same although some significant intra industry compositional changes appear to have taken place (see Table 4 below).

Within agriculture the most notable development is the marked fall in share of plantation agriculture, primarily because of contractions in rubber and coconut products. In spite of the problems besetting the sector tea has maintained and even increased its share. Within industry construction has expanded massively, largely due to the massive public sector infrastructure development projects which have taken place, while manufacturing has declined. Within manufacturing, however, there have also been significant compositional changes. Perhaps none more so than the increase in share accounted for by factory production. In fact it is evident that most of the contraction in manufacturing share is attributable to the slump in export processing. Lastly, the expansion in the proportion of GDP accounted for by services is mostly accounted for by the

Table 2: Sectoral Growth Rates

	1978-90	*1978-83*	*1984-90*	*1990*
Agriculture, Forestry & Fishing	3.6	4.2	2.1	8.8
Agriculture	3.8	3.9	2.6	10.8
Tea	1.5	-2.3	4.2	12.6
Rubber	-2.0	-0.3	-2.5	3.0
Coconut	3.3	4.2	4.1	1.6
Plantation Agriculture	1.3	0.6	2.3	6.2
Paddy	6.3	6.9	1.4	23.0
Other	4.6	4.4	4.1	7.8
Non-plantation Agriculture	5.2	5.6	2.8	12.5
Foresty	3.2	6.4	1.8	2.3
Fishing	3.4	8.2	-1.1	-5.0
Industry	5.1	6.1	5.5	7.6
Mining & Quarrying	6.2	7.8	7.2	9.1
Manufacturing	5.3	4.0	7.3	9.5
Export Processing	1.2	-0.9	3.9	8.4
Factory Industry	7.4	5.8	9.7	14.9
Small Industry	4.5	7.1	2.7	3.5
Other	2.4	9.2	-3.8	-40.7
Construction	3.9	9.4	1.1	2.0
Services	5.4	7.3	3.9	4.3
Electricity, Gas, Water & Sanitary Services	8.9	13.2	5.5	10.2
Commodity Production	4.3	5.1	3.8	8.1
Transport, Storage & Communication	5.0	6.6	3.6	3.8
Wholesale and Retail Trade	5.0	7.0	3.6	3.6
Imports	8.1	13.3	0.7	-2.0
Exports	3.9	2.7	6.6	11.2
Domestic	5.6	6.9	5.3	6.0
Banking, Insurance & Real Estate	9.9	11.8	6.8	6.3
Ownership of Dwellings	2.9	4.6	1.6	1.5
Public Administration & Defence	8.9	10.8	7.8	3.5
Services n.e.s.	3.6	6.0	1.1	9.1
GDP at constant prices	4.8	6.0	3.8	6.2

Source: Central Bank.

sizeable expansion in banking, insurance and real estate and public administration and defense. In fact, if the latter is excluded, the shift towards services would not be nearly so pronounced.

Government Fiscal Operations
Trends in the Budget Deficit

Between 1978 and 1990 the average annual budget deficit before grants was 14% of GDP (11% including grants). A plot of the trend in the deficit over the period is given in figure 3. This figure shows the deficit moving from an initial 14% of GDP in 1978 to a colossal 22.2% of GDP in 1980 consequent upon a massive public invesment programme by the incoming UNP government and a worsening international economic climate—the second oil shock and resulting world market recession. From 1980 to 1984 there was a marked improvement in the budgetary outturn which was brought about by a combination of contractionary policies and an improvement in the external environment. The dramatic improvement in tea prices, and therefore export tax revenues, in 1984 saw the deficit fall to 9% of GDP. With the deterioration in the security situation and commensurate increases in government expenditures on law and order, the deficit again started to climb. By 1988 it had reached an unsustainable 15.7% of GDP (before grants). The situation led the Sri Lankan authorities to enter into a structural adjustment programme with the International Monetary Fund and World Bank one of the objectives of which was to reduce the size of the deficit. The result was a fall in the deficit to 11.2% of GDP in 1989 and 9.9% of GDP (7.8% of GDP after grants). Again the process was aided, at least in 1989, by an improvement in the international environment as manifested in an improvement in the terms of trade.

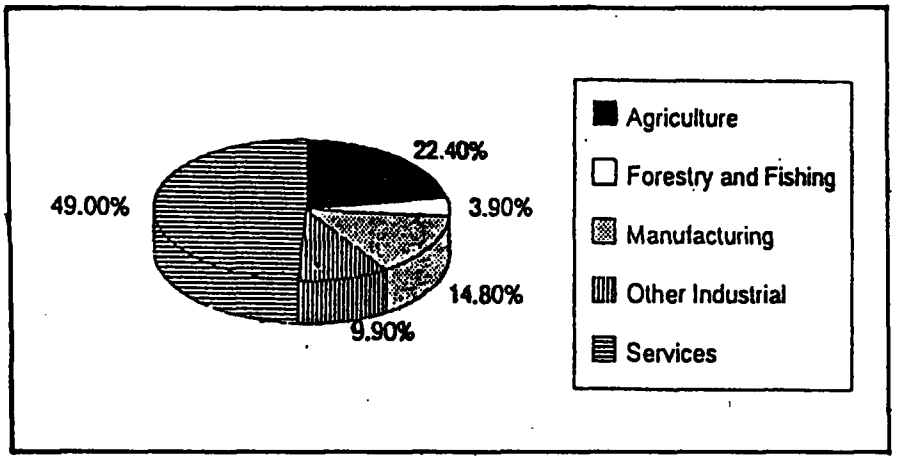

Figure 2: The Composition of Value Added in the Sri Lankan Economy 1990

Expenditure and Revenue Composition

Underlying these budgetary developments have been compositional changes in both expenditure and revenue. On the expenditure side current expenditures as a proportion of total expenditures rose from 59.2% of total expenditures in 1978 to 78.9% of total expenditures in 1990, having initially declined. The major source of this increase has been interest payments on government debt. In 1978 interest payments accounted for 8.2% of total government expenditure. By 1990 this figure had risen to a massive 22.7% of total expenditures. Expenditures on goods and services also rose; from 20.5% of total expenditures in 1978 to 33.2% in 1990. Expenditures on transfer payments and subsidies, a sub-component of expenditures on goods and services, fell in keeping with the adjustment policy

Table 3: Production Structure as a % of GDP (current factor prices)

	1978	*1983*	*1990*
Agriculture, Forestry & Fishing	**29.3**	**28.3**	**26.3**
Agriculture	**26.5**	**23.8**	**22.4**
Tea	2.8	3.4	3.1
Rubber	1.3	0.9	0.5
Coconut	4.2	3.2	1.7
Plantation agric.	8.4	7.5	5.3
Paddy	5.2	6.0	5.2
Other	12.8	10.3	12.0
Non-plantation agric.	18.1	16.3	17.2
Forestry	1.3	1.7	1.9
Fishing	1.7	2.8	2.0
Industrial	**26.1**	**26.3**	**26.0**
Mining & Quarrying	2.3	2.5	2.4
Manufacturing	18.6	14.0	14.8
Export Processing	7.4	3.4	3.0
Factory Industry	8.5	8.5	10.7
Small Industry	1.1	0.8	0.7
Other	1.0	1.3	0.5
Construction	4.7	8.6	7.4
Services	**44.8**	**45.4**	**49.0**
Electricity, Gas, Water & Sanitary Services	0.5	1.3	1.3
Commodity production	55.3	54.6	52.3
Transport, Storage & Communication	8.9	11.0	9.9
Wholesale and Retail Trade	22.1	19.1	21.3
Imports	6.5	8.2	7.6
Exports	4.7	1.6	1.7
Domestic	8.2	9.4	12.0
Banking, Insurance & Real Estate	2.4	3.7	4.6
Ownership of Dwellings	3.7	3.2	2.5
Public Administration & Defence	3.7	3.6	5.5
Services n.e.s.	4.1	4.8	4.1
G.D.P.	**100.0**	**100.00**	**100.0**

Source: Central Bank

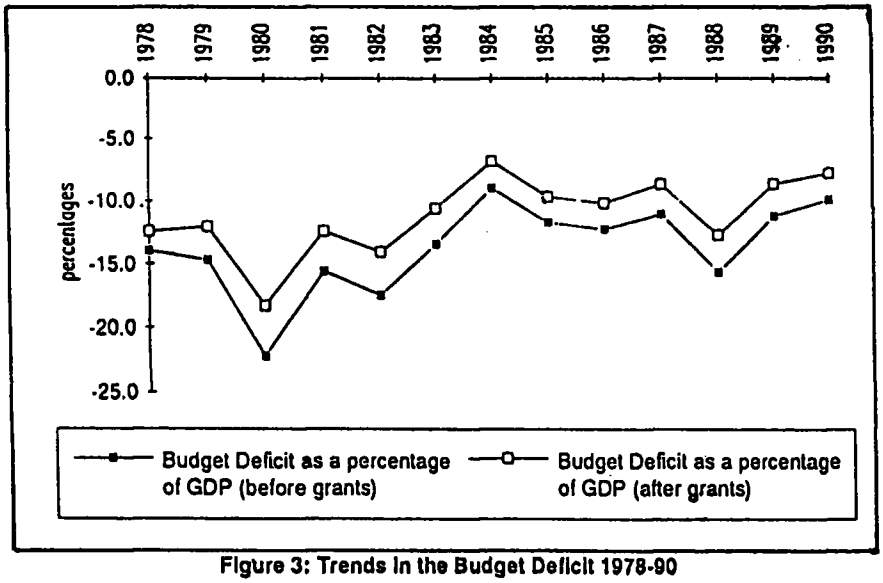

Figure 3: Trends in the Budget Deficit 1978-90

stance of eliminating all subsidies and production oriented transfers as well as targeting welfare transfers.

The fall in the proportion of total expenditures accounted for by capital expenditures is entirely attributable to the massive reduction in capital transfers to public enterprises. Capital transfers fell from a height of nearly 31.5% of total government expenditures in 1982 to only 6.4% in 1990. More recently this fall has been accompanied by an increase in lending to public enterprises.

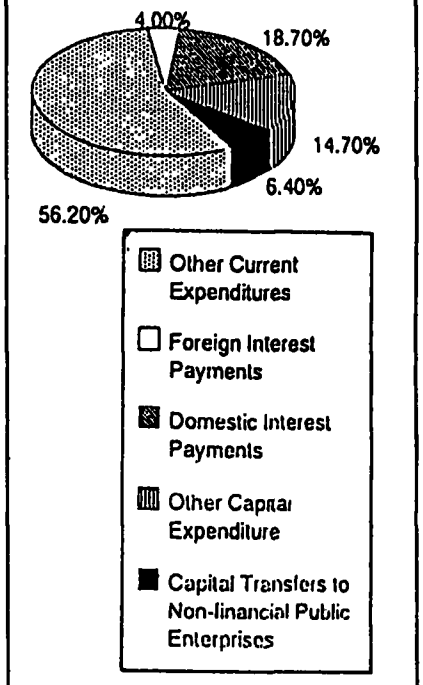

Figure 4: The Composition of Government Expenditure 1990

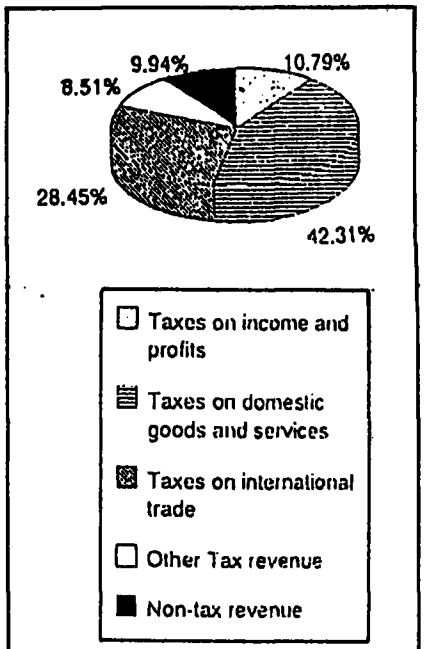

Figure 5: Composition of Government Revenue 1990

Compositional changes on the revenue side have not been nearly so marked. Revenues from taxation have increased marginally over the post 1977 period as a whole having declined systematically up to 1988 - the beginning of the structural adjustment programme. In 1990 tax revenue accounted for 90% of total revenue. One of the most significant compositional changes on the revenue side has been the decline in proportion of revenue from taxes on internationally traded commodities. As a proportion of the total revenue from this source fell by some 25% over the 1978-90 period. Nevertheless, trade-based tax revenue still accounted for around 30% of total revenue in 1990. A breakdown of the various components of government revenue is given in Figure 5.

Deficit Financing

Over the post 1977 period 45% of the budget deficit has been funded from foreign sources. Of this some 60% has been in the form of foreign borrowings and the remainder in the form of grants. Domestic bank financing (so-called inflationary financing) over the period has amounted to 40% of total domestic financing. Since embarking on the IMF/-World Bank sponsored structural adjustment programme in 1988 this source of financing has contracted significantly. In 1989 bank borrowing represented a mere 4% of total deficit financing and in 1990 the figure was 11%.

Inflation

The average annual rate of inflation between 1978 and 1990 and measured by the Colombo Consumers Price Index (CCPI), the Wholesale Price Index (WPI) and the Gross Domestic Product Deflator (GDPD) was 13.3%, 13.6% and 12.5%, respectively. Plotting annual percentage changes in the three indicators over the post 1977 period shows three distinct periods when inflationary pressures increased; 1978-80, 1982-84 and 1985-90 (see figure 6). Studies conducted by the Institute of Policy Studies, the University of Colombo and the International Monetary Fund concur that most of the inflationary pressure over the period has come from the world market and (to a lesser extent) domestic administrative price increases. Using the CCPI as a proxy of inflation and plotting the rate of change of the CCPI against the rate of change of the general import price index suggest the existence of a close relation between the two indices, especially in recent years (see Figure 7). The years in which the relation appears to breakdown are the middle years, 1983-86. These can be explained in terms of: first, the inordinately large movement in export prices (which are a component of the CCPI) during these years, secondly, changes in certain administratively determined prices, and thirdly, in 1986, domestic food supply problems arising from drought and not compensated for by corresponding increases in imports.

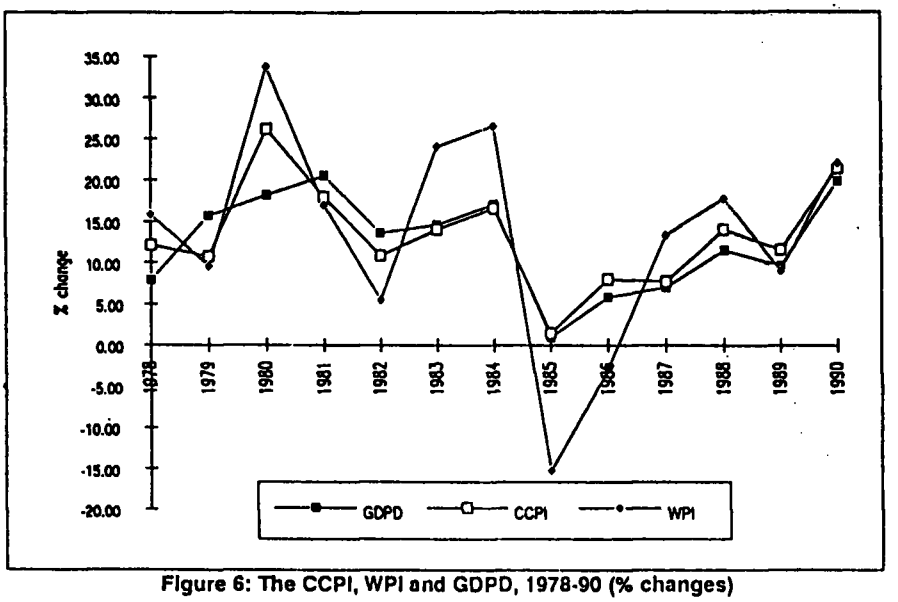

Figure 6: The CCPI, WPI and GDPD, 1978-90 (% changes)

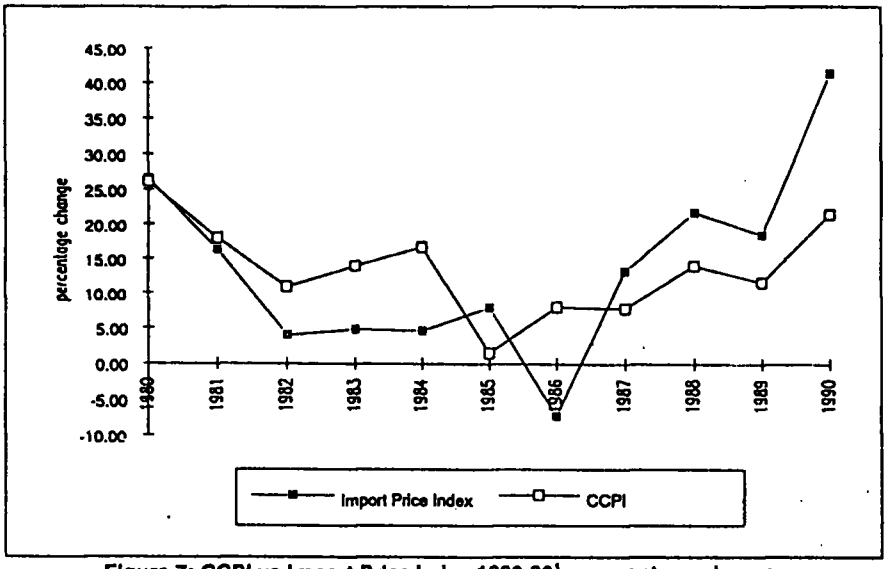

Figure 7: CCPI vs Import Price Index 1980-90[1] - percentage changes

Demand factors, the budget deficit and credit expansion, have undoubtedly also exerted a pressure on the aggregate price level, particularly in certain years (e.g. 1981), but generally their role has been one of propagating cost-push pressures (see Nicholas 1990).

The Balance of Payments, Exchange Rate and Foreign Exchange Reserves

The Balance of Payments

A country's balance of payments is a record of its transactions with other nations. It comprises a current account and a capital account. The current account covers financial flows relating to trade in goods and services, factor incomes, and grants. The capital account covers financial flows relating to the movement of money as capital, whether as investments, or credit flows. The sum of the balances on the two accounts,

after allowing for errors and omissions, is equal to the overall balance. Financing of a payments imbalance is, for the most part, through a depletion of reserves.[2] Since reserves are limited, and since their availability determines a country's ability to maintain a steady flow of essential imports, a systematic depletion of reserves is cause for concern. In fact, a country is said to have a balance of payments problem when payments imbalances lead to an unsustainable depletion of reserves. At some point in time corrective action has to be taken. The nature of this action will depend on the general economic strategy pursued by a country, as well as the flexibility afforded it by actual holdings of, and access to, reserves.

Looking at movements in Sri Lanka's balance of payments of the post 1977 period it is evident that the current account balance, and more especially the trade account balance, exerted the major influence (see Figure 8). Between 1978 and 1989 the current account was continuously in deficit, the average annual deficit for the period to 7.3% of GDP (or 10.4% of GDP if grants are excluded). The figure for the sub-period, indicating a substantial improvement in the current account balance between the two sub-periods. 1990 saw a continuation of this improvement in the current account balance, to -3.0% in 1990 from -4.4% of GDP in 1989 (or from -7.1% of GDP in 1989 to -5.1% of GDP in 1990 if grants are excluded). Between 1978 and 1989 the average annual trade deficit amounted to 13.5% of GDP. The average annual deficit for the 1978-83 sub-period was 16.6 per cent of GDP while for the sub-period 1984-89 it was 10.4 per cent. Underlying the improvement in the current account in 1990 was a significant improvement in the trade balance; to -8.8% of GDP in 1990 from -9.5% of GDP in 1989.

A comparison of Sri Lanka's current account performance with that of other developing countries is instructive (see Table 4). Table 4 shows that Sri Lanka's performance over the 1978-89 period as a whole was considerably worse than the average for other developing countries, including other non-fuel primary (agricultural) product exporters. Clearly, it was the exceptionally large volume of grants (and ready access to international reserves, that enabled Sri Lanka to sustain such a large current account balance. For the 1978-89 period as a whole net official transfers amounted to over 10 per cent of total exports of goods and services. The proportionately better performance of Sri Lanka in the 1984-89 period may be at least in part attributable to the increasing diversification of its export base towards manufactured exports. Certainly the 1984-89 period seems to have been one in which developing countries oriented towards manufactured exports fared relatively better.

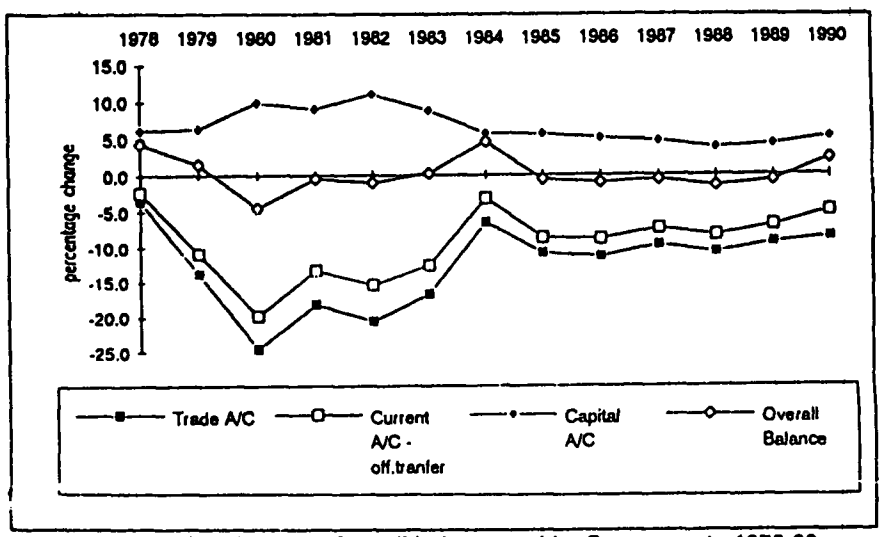

Figure 8: Trends in the Overall balance and its Components 1978-90

Table 4: An International Comparison of Sri Lanka's Current Account Deficit as a Proportion of Export of Goods and Services *

	1978-89	*1978-83*	*1984-89*
Sri Lanka (before grants)	-35.4	-41.3	-29.5
Sri Lanka (after grants)	-24.7	-30.5	-18.9
Asia	-3.3	-7.2	0.7
Developing countries	-3.7	-4.8	-2.5
Non-fuel exporting	-8.2	-14.5	-1.9
Non-fuel primary product exporting	-25.4	-28.3	-22.5
Non-fuel agricultural product exporting	-28.6	-32.4	-24.8
Non-fuel manufacture exporting	-2.9	-8.4	2.5

* The 1989 figures for countries other than Sri Lanka are estimates

Sources: "World Economic Outlook" International Monetary Fund
"Annual Report 1989", Central Bank.

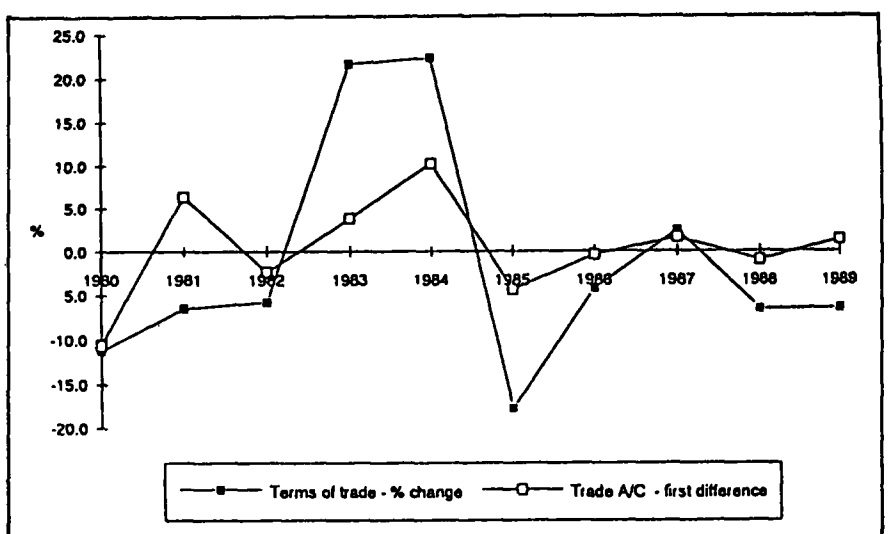

Figure 9: Changes in Sri Lanka's Merchandise Trade Balance and Terms of Trade

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Studies conducted by the Institute of Policy Studies and the University of Colombo show that the most important determinant of changes in the trade balance, and therefore the current account balance, are the terms of trade. Figure 9 is a plot of changes in the trade deficit (as a percentage of GDP) against percentage changes in the terms of trade index. It confirms the existence of a strong positive relation between the two variables. In those years where the relation appears weak relative volume changes were particularly strong. Thus, the excessive deterioration and subsequent improvement in the trade balance in 1982 and 1984 respectively were due to strong reinforcing movements in relative volumes. The considerable improvement in the trade balance in 1989 was, by contrast, attributable to strong compensating changes in relative volumes in that year.

The contribution of the services account to the current account balance has been negative for a large part of the 1978–90 period because of the slump in tourism after 1982 and the rise in world market interest rates. In fact 1990 saw a dramatic improvement in the services account because of both a fall in world market interest rates and a massive 60% rise in tourist arrivals (with a commensurate increase in tourist income).

The growth of net transfers has been far and away the outstanding positive current account development in the post-1978 period. In 1977 net transfers amounted to less than 2 per cent of GDP at current market prices. By 1982 the figure was up to 9 percent of GDP. For the 1978–89 period as a whole the average annual rate is around 7 per cent of GDP, with the biggest contribution coming from private transfers. The major source of private transfers has been income repatriated by migrant workers in the Middle East. The relative contribution of these transfers was particularly pronounced over the 1985–89 sub-period, when Middle East migration grew most rapidly. From 1987, along with a fall in world oil prices, there has been a decline in these transfers, which can only be made worse by the present crisis in the region. Net official transfers comprising mainly official grants received by central government, although proportionately smaller than net private transfers, was also significant. These transfers amounted to a average annual 3 per cent of GDP for the 1978–89 period as a whole. After an initial spurt, net official transfers (as proportion of GDP) declined. Possibly the single most important reason for this decline is problems of disbursement of these funds resulting from domestic political and security problems.

Net non-monetary capital inflows rose considerably between 1978 and 1982, then fell continuously between 1983 and 1988, picking up again in 1989. The largest component of non-monetary capital flows is government long and short-term borrowing (commodity, project and other loans received directly by the government). Over the 1978–89 period as a whole this component amounted to around 70 per cent of total net non-monetary capital flows. Net government inflows rose rapidly between 1980 and 1984 and then declined equally rapidly between 1985 and 1987, levelling out thereafter. In spite of the decline in net government inflows after 1984 this component accounted for relatively more (84 per cent) of total non-monetary capital inflows during the 1984–89 sub-period than over the earlier 1978–83 sub-period. Net private sector non-monetary capital flows comprise direct investment and long-and short-term non-monetary capital flows.[3] Net foreign investment flows to the private sector accounted for 11.5 per cent, and net other non-monetary foreign capital inflows to the private sector 19 per cent, of the average annual growth in total non-monetary capital flows over the 1978–89 period.

In 1990 there was a marked improvement in the capital account as compared with 1989; from a surplus of SDR 251 m. (or 4.2% of GDP) to a surplus of SDR 297 (or 5.1% of GDP). This improvement was mostly due to an increase in foreign lending to government and partly to a decline in repayments of interest and principal.

Financing the Deficit

The overall deficit has been mainly funded through running down foreign reserves and drawings from the IMF. The average annual net drawings by Sri Lanka from the IMF over the 1978–89 period amounted to 50 percent of the annual balance to be financed. More importantly the IMF has provided relief in years when it was much needed (1981, 1988 and 1989), permitting the Sri Lankan authorities to avoid what would have otherwise been even more painful corrective measures. Hence, there is little doubt that without IMF support Sri Lanka's reserve position would not have been tenable. In fact there would have been little hope of sustaining such a large current account imbalance, especially since IMF endorsement also opens the doors to a considerable volume of foreign grants and loans.[4]

Reserves

In 1978 reserves were equivalent to 5.4 months of imports. They had expanded considerably over the preceding two years because of buoyant export prices, especially tea prices. The liberalisation of the economy, a massive expansion in investment, and a (second) major hike in world oil prices (1979/80) left gross reserves at a mere 2.4 months of imports by 1980. The year was a turning point. A massive expansion in official foreign capital inflows, coupled with a dramatic rise in tea prices, saw gross reserves climb to an equivalent of 4.6 months of imports by 1984. The ensuing collapse in world market tea prices, the fall in direct foreign investment and the slump in tourism brought about some erosion of this position (particularly the official reserve position), in spite of a accompanying decline in the import price of oil. By 1988 gross external assets had fallen back to 3.1 months of imports. There was a slight improvement in the final 1989 figure after reserves had fallen to a precariously low level during the first half. A reversal of short-term capital flight through a depreciation of the rupee, a revival in tourism, and the first traunch of a SAF facility from the IMF, all contributed to the turn around. The improvement in the overall balance of payments position in 1990 bolstered the general reserve position pushing it to a level equivalent to 3.1 months of imports from 2.8 months in 1989.

The Exchange Rate

In 1977 the Sri Lankan exchange rate was unified and substantially depreciated in an attempt to improve the competitiveness of the export sector. Since this time the currency has been depreciated inter-

mittently to maintain competitiveness. The last major depreciation of the currency took place in September 1989 in accordance with targets set by the International Monetary Fund as a condition for securing much needed adjustment loans. The exchange rates for the Sri Lankan Rupee against currencies of selected countries for end—December 1989, 1990 and end—April 1991 are given in Table 5. This Table shows that while there has been some depreciation in 1990 of the Rupee against the Japanese Yen (4.3%), the Geman Mark (9.4%) and the British Pound Sterling (14.0%), there was almost no depreciation against the US Dollar (0.6%). It also shows that by the end of April 1991 the Rupee had further depreciated marginally against the US Dollar (1.6%) and the Japanese Yen (1.3%) while appreciating against the German Mark (10.6%) and the British Pound (8.2%). In the context of a somewhat rapid rise in the domestic rate of inflation, this has resulted in a significant appreciation of the real effective exchange rate-the nominal exchange rate adjusted for inflation differentials between Sri Lanka and its major trading partners. By the end of April of 1991 the real exchange rate index had fallen by 16.4% in relation to its December 1989 level (see Figure 10[5]). In fact, the current level of the index is the second lowest over the entire post 1978 period. If the end-of-year 1989 real exchange rate represents something of an equilibrium level, then the present level is evidently seriously out of alignment.

3. Exchange Control: The Current Situation

The trade and payments system today may be described as relatively free of controls. Inward and outward remittances and payments settlements are handled by the commercial banks under the procedures prescribed by the Central Bank of Sri Lanka.

Commodities

Prior licensing is required, however, in respect of a few commodity categories; those kept under licencing control for security and health reasons, certain durable consumer goods such as motor cars, and capital goods imports exceeding the value of Rs. 700,000. Import and export of gold also require licenses issued by the Controller of Imports Exports with the approval of the Central Bank. Gold requirements of the jewellery industry are met under Gold Replenishment Scheme. Gold sales have been further liberalised with the opening of gold sales outlets by the Central Bank at Katunayake and Colombo.

The GCEC handles the import procedures for GCEC enterprises. Imports other than those for export processing industry are normally effected against sight letters of credit valid for 180 days. Opening of letters of credit in respect of certain non-essential items require advance payment to the bank of the full value of the LC by the importers. There is an import duty of 3 per cent on LCs if they are not subject the 100 per cent margin requirement. This 3 per cent duty is however, waived for imports of inputs for export processing industries.

When it comes to exports, a number of specified items require prior licensing by the Controller of Imports and Exports. The Gem Corporation exercises control over gem exports and private sector gem exports on a consignment basis require prior approval of the exchange control department. The Gem Corporation handles gem exports in the name of miners who wish to export gems in their names.

According to current exchange control regulations all export proceeds must be collected within a period of 21 days to 6 months. All export proceeds exceeding Rs. 500,000 in value must be surrendered to a local commercial bank. Export proceeds GCEC enterprises too must initially be brought into the domestic banking system. Direct collection of export proceeds by Foreign Currency Banking Units or off-shore banking units is not permitted. Unless otherwise specified, foreign exchange proceeds from invisibles also must be surrendered to a local bank.

Services and Invisibles

As in the case of commodity imports, commercial banks are authorised to effect payments in respect of invisibles, including repatriation of profits and dividends by non-resident companies operating in Sri

Table 5: Rupee Exchange Rate Against Selected Currencies 1989, 1990

Sri Lankan Rupee -vs-	*1989*	*1990*	*1991**
US Dollar	40.00	40.24	40.90
Japanese Yen	0.2816	0.2943	0.2982
German Mark	23.70	26.16	23.38
British Pound	65.05	75.59	69.40

* Rates for end-April 1991

Source: Central Bank of Sri Lanka "Annual Report 1990"

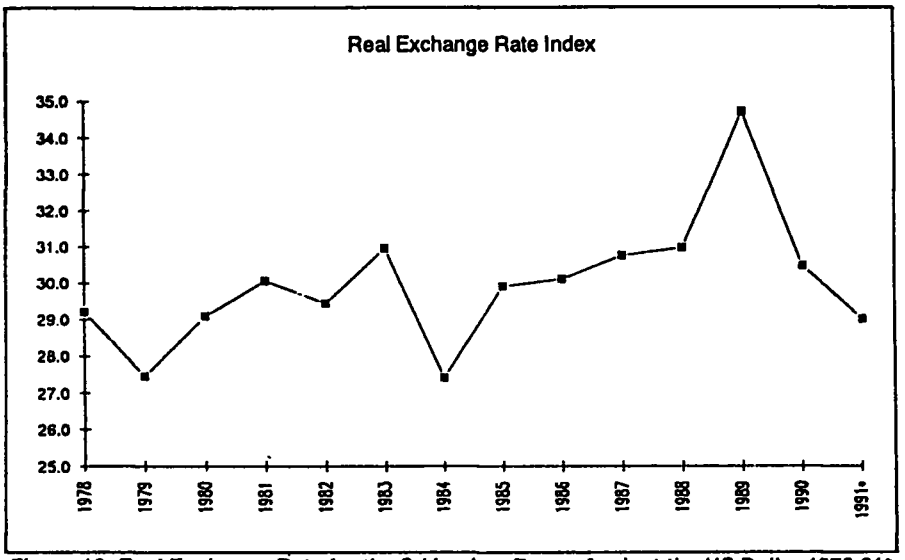

Figure 10: Real Exchange Rate for the Sri Lankan Rupee Against the US Dollar 1978-91*

Lanka, with no reference to the Central Bank. There are no payments restrictions respect of invisibles related to commodity imports. However, payments in respect of foreign travel, education, health etc. are subject to limits specified by the Central Bank. In respect of travel, the basic exchange allowances are now released once in every year irrespective of the country to which travel is sought. Expatriate workers employed by approved enterprises are allowed to remit upto two third of their monthly earnings if their contracts do not exceed three years and upto one third if the contracts are for a longer duration. However, foreign technical personnel in free trade zone enterprises are permitted to remit up to 90 per cent of their earnings.

All types of foreign investments are now handled by the Greater Colombo Economic Commission (GCEC). However, foreign investments which not entertained under the GCEC Law require approval of the Exchange Controller.

Investment in shares by non-residents up to 40 per cent of equity capital of existing companies is permitted without prior approval of the Exchnage Controller. A separate scheme of Share Investment External Rupee Accounts is available for this purpose. Sale/liquidation proceeds of investments and earnings from capital appreciation are permitted to be remitted abroad without any restriction.

Investments abroad by residents are not normally permitted unless there is sufficient evidence to show that such investments would promote exports from Sri Lanka and would guarantee a good return.

Foreign Currency Banking Facilities

There are several foreign currency banking facilities; Non-Resident Foreign Currency (NRFC) accounts, Resident Non-National Foreign Currency (RNFC) accounts, Resident Foreign Currency Accounts (RFCA) and accounts with Foreign Currency Banking Units (FCBU). The NRFC accounts were primarily aimed at mobilising foreign currency savings of Sri Lankan workers resident abroad and RNFC accounts were intended to service foreign nationals resident in the country. The RFCA facility, introduced in mid-August 1991 permits Sri Lankan residents who hold designated foreign currency amounting to a minimum of US $ 500 or its equivalent to maintain foreign currency accounts with banks. Foreign exchange savings from even one's basic travel allowance could now be credited to an RFCA. Non-residents and resident enterprises in investment Promotion Zones can maintain accounts with FCBUs in designated currencies. FCBUs can also lend in foreign currency to GCEC enterprises and other approved resident enterprises. Sri Lankan exporters too are permitted, since mid August 1991, to obtain foreign currency loans from FCBUs. In addition to above facilities, exporters are permitted to credit 5 per cent of incremental export earnings to foreign currency accounts.

4. Implications for the Sri Lankan Economy of the Removal of Exchange Controls

The Balance of Payments

A total removal of exchange controls would, from the point of view of the balance of payments, have both negative and positive effects. The negative effects would be felt in respect of imports and foreign asset holdings. Exchange controls, as is well known, tend to restrict the demand for both imports and foreign assets below their free market levels. As a consequence the prices of importables and foreign assets are higher than what they would be in the absence of exchange controls. Therefore, the liberalisation of exchange controls would *ceteris paribus* result in an increase in imports and domestic holdings of foreign assets. With regard to commodities and services there would be both income and substitution effects. On the one hand, there would be a fall in the price of importables leading to a rise in real incomes and an increase in demand for all commodities and services, including importables. On the other hand, the price of importables would fall relative to import substituting commodities and services, giving rise to a switch away from the latter towards the former. With regard to assets, Sri Lankan individuals and companies would with liberalisation be able to diversify their asset holdings across borders. There would be a relative increase in demand to hold foreign assets in relation to domestic assets and a resulting fall in the price of domestic assets in relation of foreign assets, i.e., there would be an upward pressure on domestic interest rates.

The positive effects which would mitigate the adverse consequences of liberalisation are likely to be:

a. An increase in demand for Sri Lankan assets by foreigners and Sri Lankans living abroad, including an increase in inward private remittances, foreign direct investment, and equity capital flows. The ability to remit interest and principal upon demand would be the incentive.
b. The increasing willingness of exporters to bring their foreign exchange earnings into what is recorded or, in the jargon applicable to a situation of exchange control, into "official" channels.
c. An increase in income receipts from tourism as the nuisance effects of exchange controls are eliminated.
d. Increased bilateral and multilateral aid flows in support of the broader liberalisation strategy of which the removal of exchange controls is an integral component.

If liberalisation were embarked upon in the current situation of political and economic uncertainty it would almost certainly give rise to entirely unsustainable short-term currency movements.

The net effect of a liberalisation of exchange controls on the balance of payments is likely to be negative in the short-run. A guestimate would be that the current account balance is likely to deteriorate by at least 3%-4% of GDP. The exact extent and duration of the negative impact on the external payments situation will clearly depend on a number of factors including the timing and sequencing of the exchange liberalisation, the domestic and foreign political and economic environments, and the compensating measures taken–the extent of prior currency depreciation, of increases in short-term interest rates etc. These issues will be returned to in the concluding sections, but it needs stressing that if liberalisation were embarked upon in the current situation of political and economic

uncertainty it would almost certainly give rise to entirely unsustainable short-term currency movements.

The Equilibrium Exchange Rate

The proximate determinants of the nominal exchange rate are the supply of, and demand for, the domestic currency in relation to the foreign currency. Therefore, short-run movements in the exchange rate will reflect changes in the country's balance of payments. Economists are divided over what determines the exchange rate over the long-run. Current orthodoxy (the so-called purchasing power parity approach) holds that the long-run equilibrium rate, the rate which is consistent with balance of payments equilibrium over the long-run, is determined by the relative price of tradeables with respect to non-tradeables and certain structural factors such as technological progress, changes in taxation and subsidies, changes in the external terms of trade, interest rates, exchange controls, import tariffs and export taxes, etc.[6]

If the exchange rate prevailing in December 1989, shortly after the last major devaluation of the currency, is taken as the equilibrium nominal rate, assuming structural factors to be constant, the current equilibrium exchange rate should be around Rs. 47: US$ 1.[7] If one assumes, however, that certain structural changes took place in the Sri Lankan economy since then, such as the return to relative normalcy in the Southern part of the country after a protracted period of turbulence, and that these developments have improved the country's relative competitiveness, then the current equilibrium rate may be significantly lower. Indeed, that there was a marked improvement in industrial export volumes and the overall current account balance in 1990 as compared with 1989 suggests that the unadjusted nominal exchange rate which prevailed during 1990 was a competitive one, inspite of the relatively higher Sri Lankan rate of inflation. Assuming that no further structural changes have taken place in the current year which have further improved the country's relative productivity, relative price changes alone would suggest that the present equilibrium exchange rate is in the order of Rs. 44: US$ 1.

A single step or phased elimination of exchange controls should see the nominal exchange rate move towards its equilibrium level in the long-run. Liberalisation of exchange controls itself represents a change in the structural parameters of exchange rate determination. Exchange controls tend to depress the demand for foreign currency in relation to the domestic currency. They do this by restricting the demand for imports and foreign assets below their free market levels, although, as noted above, there are a number of mitigating factors which need to be taken into account in the current Sri Lankan context. On balance, the equilibrium exchange rate should be much lower in the absence of exchange controls than with them, possibly in the range of Rs. 48 - Rs. 50: US$ 1.

One of the problems with eliminating exchange controls is that the ensuing fall in the value of the currency may be sharp, excessive, and economically damaging.

Reserve Support

One of the problems with eliminating exchange controls is that the ensuing fall in the value of the currency may be sharp, excessive, and economically damaging. To mitigate this the authorities could let the currency gradually depreciate to its estimated post-liberalisation equilibrium level, build up foreign exchange reserves and a credible reserve pipeline, and raise short-term interest rates. In a highly foreign trade dependent, underdeveloped, open economy like that of Sri Lanka, the level of adequacy of exchange reserves is likely to be rather high. Their appropriate level anyway would depend very much on the adequacy of the other measures taken to prevent short-term speculative capital outflows and the availability of a foreign exchange pipeline. Since official reserves are presently equivalent to just under 2 months of imports, a prudent cushion for liberalisation of exchange controls is arguably in the order of 5-6 months of imports if, additionally, (a) the exchange rate was brought down to something like its post liberalisation equilibrium level, (b) interest rates were raised to above their preliberalisation clearing levels, and (c) sufficient guarantees of interim foreign reserve support were elicited from the relevant international agencies—primarily the International Monetary Fund. After liberalisation and a stabilisation of the external payments position, interest rates and reserve support could gradually be reduced.

Liberalisation of exchange controls will also result in the exchange rate being entirely more volatile. This volatility would come primarily from short-term speculative capital movements. Excessive exchange rate volatility can be exceedingly damaging to productive investment and growth, especially in export oriented sectors (see later). Orthodox theory suggests that one device for dampening exchange rate volatility is the development of a forward market in the currency. The experience of many developed countries suggests that such markets do little to stabilise exchange rates and may even be destabilising. A further measure for dampening exchange rate fluctuations is flexible short-term interest rates. Appropriate movements in short-term rates could help stem short-term "hot money" flows and thereby contribute to a dampening of exchange rate gyrations. Fluctuating interest rates are, however, possibly even more damaging to productive investment and growth than fluctuating exchange rates because of their potentially wider deleterious impact—the negative impact not being confined to export-oriented industries. Accordingly, the extent to which the monetary authorities are able to prevent exchange rate fluctuation will depend in the final instance on the extent of reserve support at their disposal.

Will be Continued on Next Issue