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Changing Lanes - Pursuing a Liberalised Economic Policy

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Economic liberalisation is largely accompanied by reduced government intervention and ensuring greater private sector participation in the overall economic activity. The liberalisation attempts pursued by the country have brought about a mixed performance in economic transition. When other Asian economies, which were on par with Sri Lanka at the time of independence, secured very rapid growth, Sri Lanka was able to achieve middle income status only after about 60 years since independence. The prevalence of factors such as variations in balance of payments, government's commitment to social welfare programmes, democratic political system, political strengths of successive governments and some structural deviations in the international market prevented Sri Lanka from establishing its standing among the emerging economies. In the context of the theme, this article reviews circumstances under which the country changed its liberalisation policy from time to time since independence.

At the time of independence, Sri Lanka was largely an agricultural economy with full currency convertibility in all transactions with a fixed exchange rate system and also with relatively more favourable socio-economic conditions compared to most other Asian countries. The country was quite liberal and the private sector could engage in economic activity quite freely. However, certain factors that were to make macroeconomic management subsequently more difficult were already built into the socio-economic system, leading to a change in the path of economic policies. Among such factors were expansionary fiscal policies including the provision of free health and education, subsidised food, the presence of vast income disparities, democratic political system and neglected domestic agriculture.

At this time, a greater part of the population lived in rural areas and depended on agriculture. The agricultural sector was segmented into two: widely as an advanced modern plantation sector producing three major export crops; tea, rubber and coconut, and a backward traditional sector producing mainly subsistence crops, which provided livelihood for a larger part of the population. A relatively high per capita income compared to most other Asian countries with a large subsistence rural population itself shows the income disparity that persisted at the time.

In the early period of independence, foreign trade played a dominant role in the economy making the country one of the most open economies in Asia. Foreign trade accounted for about 70 per cent of the GDP with a share of nearly half a per cent of the total trade in the world market. The country relied predominantly on primary plantation products for its export earnings while increasingly depending on imports for its basic food requirements. The postwar developments in the international sphere also called for a more liberal economic environment with free trade marked by full currency convertibility. International trade was greatly hampered by unfair economic competition led by high tariff, trade barriers and competitive devaluation. Therefore, developed nations accepted the necessity of maintaining a stable international monetary environment backed by fixed exchange rates. As a result, the Bretton Woods Conference led to the establishment of a monetary arrangement based on a system of fixed exchange rates anchored by the convertibility of the US dollar into all other currencies. Accordingly, the value of the Sri Lankan rupee stood at around Rs. 4.77 per US dollar under the fixed exchange rate introduced under the Bretton Woods System. Subsequently, the economic agenda of the successive governments was determined by the need for maintaining the fixed exchange rate regime while dealing with the developments in the balance of payments (BOP).

The economic structure driven by the three commercial crops did not provide a satisfactory framework for the sustainable development of the economy. The rural masses, who had limited access to basic needs of nutrition, education, shelter, medical care, sanitation, etc., were unable to enjoy the economic benefits generated by plantation crops exports. The highly organised plantation sector was complemented by the economic mechanism orchestrated by the colonial administration dominating the activities in the services sector such as trade, commerce, banking, insurance and transport.

The thrust of the government's economic development initiatives was aimed at ensuring an equitable welfare distribution among all segments of the economy and attaining sustainable economic growth. Therefore, the government was committed to strengthening social welfare measures through direct intervention in the economy. In the meantime, to reach out to the masses, domestic agriculture sector, particularly paddy, was given the first priority by the government. In the midst of high expenditure on food imports, particularly rice, the overriding objective of the government's development policy was centred on achieving self-sufficiency in rice.

The country was able to maintain the liberal policy regime in the early period supported by two commodity booms. External trade, the main driver of the economy, raised the country's foreign reserves. It also increased government revenue through taxes on both exports and imports and facilitated the continuation of the welfare programme. However, fluctuations in the prices of agricultural commodities in the world market, while causing a sharp decline in external reserves, induced a change of lanes of economic policies towards the end of the decade. Highly vulnerable exports and steady demand for imports tended to impact the BOP resulting in a rapid drying up of foreign reserves while excessive expenditures on welfare measures brought about a heavy burden on the government budget.

In addition to large scale public expenditure on welfare, initiatives were taken for industrial sector development through government intervention. Controls on foreign exchange transactions and foreign trade as well as the nationalisation efforts were also given the highest priority in government intervention in the economy. Growing BOP difficulties led to the introduction of further restrictions such as tightening foreign exchange controls by establishing the Foreign Exchange Budget Committee, import licensing, imposition of cash margins on the opening of letters of credit, trade controls with higher import duties and ceilings on advances for importing certain types of goods and restrictions on hire purchase finance. Greater emphasis was placed on import substitution industries by providing incentives and protections. In the context of international experience too, particularly in East Asian countries, import substitution has emerged as one of the development strategies available in a fixed exchange rate regime. Subsequently, although Sri Lanka could not reap the due results, East Asian countries were able to transform their economies into export led industrialisation once they got into export promotion. Some major services were nationalised in order to service a large segment of the population. During this period of time, nationalisation and an expansionary public sector were not new to the region. India also followed a heavily centralised economic model with the nationalisation of heavy industries such as steel, shipping, aviation, mining, etc., while receiving a large inflow of foreign aid, mainly in the form of official development assistance.

By mid 1960s, the economy was highly regulated with protectionist measures in response to a deteriorating BOP position, largely an outcome of expansionary policies with fixed exchange rates. In order to arrest the continued decline in foreign reserves, export promotion strategies were implemented in mid sixties within a framework of import substitution. Export promotion strategies were aimed at the diversification of exports while import substitution was aimed at reducing expenditure on imports. Also, there was an attempt towards partial liberalisation. To promote minor export crops, a Bonus Voucher Scheme was introduced in 1966. The rupee was devalued by 14 per cent in 1967. To diversify exports by promoting non-traditional exports and to discourage non essential imports, a dual exchange rate system was introduced in 1968 under the Foreign Exchange Entitlement Certificate (FEEC) mechanism. In order to boost minor exports sector, such exporters were granted a share of their export earnings in foreign currency by introducing a convertible rupee account. However, as a whole, the external position weakened considerably during 1960s despite external assistance from institutions such as the International Monetary Fund (IMF) in the form of stand-by arrangements and compensatory financing for export commodity price fluctuations.

The deterioration in external reserves continued. The food crisis began in 1971 and an unprecedented oil price hike in 1973 worsened the situation, creating severe problems for the government in its economic management. Exchange control measures were further tightened to preserve foreign exchange. New state enterprises were established and the existing ones were strengthened, ensuring greater state involvement in market activities. The Co-operative movement including Co-operative Wholesale Establishment (CWE), Salu Sala, Building Materials Corporation, State Trading Corporation, Paddy Marketing Board, Ceylon Fisheries Corporation, etc., were assigned a greater role in the management of internal trade. Amidst severe shortages during the economic crisis, price controls and drastic rationing were introduced to ensure fair distribution.

In the international front too, certain economic developments began to surface despite regulated capital movements under the fixed exchange rate regime. Structural deficiencies in the US economy, stemming from the oil crisis, the Vietnam War, accelerated inflation, huge trade deficit and draw down of reserves threatened international monetary management, which was primarily held by the fixed exchange rate system. With growing difficulties, the continuation of the US commitment to the fixed exchange rate system and its obligation to convert dollars into gold on demand, became extremely difficult despite the devaluation of the dollar on several occasions. Eventually the convertibility was withdrawn in 1971 and the Bretton Woods system of exchange rates collapsed in 1973. Changing value of the rupee in relation to the US dollar with the collapse of the Bretton Woods system and growing BOP difficulties compelled the Sri Lankan government to further tighten exchange controls. During this period, transactions relating to both exports and imports as well as other foreign exchange payments required the permission of the Controller of Exchange. These highly restrictive exchange controls for both current and capital transactions prevailed until 1977.

The year 1977 marked a turning point in economic policies of Sri Lanka with the introduction of far reaching liberalisation measures. Sri Lanka was the first country in the South Asian region to liberalise substantially like this. The inward looking restrictive policies, which constrained economic activities, were reversed by implementing policies geared towards liberalising the economy with greater private sector participation in production and investment. The remarkable success of some Asian economies, which transformed themselves into emerging markets and reached developed country status through export-oriented economic policies, provided the basis for this change. The market oriented economic structure was adopted in two main fronts: the external sector was strengthened by promoting trade and investment through a series of liberalisation measures, while direct state involvement in economic activities was phased out to improve quality, productivity and competitiveness.

The dual exchange rate system was replaced by a managed float allowing the exchange rate to be determined largely on the basis of market conditions and a series of exchange control relaxation measures was implemented, displaying a major shift from the restrictive policies. The removal of restrictions on current international transactions, the elimination of quantitative restrictions on imports, the provision of wider authority to commercial banks to deal with foreign exchange, the enhancement of exchange entitlements for travel, business and medical treatment, the promotion share market investment, the removal of price controls and licensing requirements, and the facilitation of foreign employment and worker remittances were among the relaxation measures.

Similarly, among the measures introduced to reduce the fiscal burden arisen from an expanded public sector included restructuring food subsidies, rationalising and simplifiying of the tariff structure to reduce state intervention, privatising government enterprises, and promoting private sector led growth in place of import substitution. The degree of tariff protection offered to import substitution industries were gradually scaled down. Export industries were encouraged through the adoption of incentives to encourage foreign direct investments (FDI) and the establishment of export processing zones with attractive tax incentives, unlimited access to foreign currency credit, better infrastructure, minimum government intervention, etc. By 1994, all restrictions on current account transactions were removed and Sri Lanka accepted obligations under Article VIII of the IMF's Articles of Agreement.

Foreign capital inflows, which were almost non-existent during the pre-1977 period except for some foreign loans to the government, increased gradually. Capital account transactions increased initially with the implementation of the privatisation programmes, backed by early liberalisation efforts and thereafter, in line with economic development, inducing a significant volume of private foreign capital flows in addition to official flows. Except for a few strategic areas, foreign exchange restrictions were removed, thereby permitting greater inflow of foreign capital. Accordingly, free movement of inward foreign investment in shares and inward FDI except for a few restricted areas, were allowed and the repatriation and the surrender requirement for export proceeds were abolished, enabling exporters to retain these proceeds abroad, if they wished to do so. Meanwhile, commercial banks were permitted to borrow up to 15 per cent of their capital reserves from abroad and the private sector was allowed to make overseas investments with permission being on a case by case basis.

External trade liberalisation was further strengthened with the expansion of bilateral, regional and multilateral trade agreements. Sri Lanka remained firmly committed to the multilateral trading system, being a founder member of the World Trade

Organisation (WTO). Sri Lanka has also made commitments under General Agreement on Trade in Services (GATS) on telecommunication, tourism, and financial services. Initiatives have already been taken to broaden the services and investment sector liberalisation through existing trade agreements.

International experience shows that a liberalisation process complemented with right policies would result in rapid economic growth. However, the liberalisation attempts pursued in Sri Lanka have not yielded the expected results due to a number of factors. During the period since independence up to 1977, the democratic political process changed the governments a few times, imposing different political ideological approaches in terms of liberalisation. However, the development approach during this period mainly centred on promoting domestic agriculture with rising public expenditure on maintaining social welfare measures. At a time, one administration pursued a relatively liberal approach favourable to the private sector, but following a political change the other pursued an inward looking approach with nationalisation and an expanded government creating uncertainty in the minds of investors. As a result, when the East Asian countries attracted a large quantum of FDI and moved away from import substitution industry to an export led industrialisation, Sri Lanka continued to struggle with import substitution framework without much needed FDIs.

Alternatively, in the post-1977 era, although the successive governments demonstrated their commitment to liberalisation policies, Sri Lanka could not achieve the expected rapid growth experienced in the emerging market economies owing to certain other factors. In particular, there had not been strong investor confidence in the economy due to the three decade long ethnic conflict, intermittent civil insurrections, persistent macroeconomic imbalances and reluctance of the governments to pursue some necessary adjustments on account of political pressures.

However, under the present administrative regime, which came into power in 2005, there have been vast developments which are conducive for prosperity. The end of the war changed the underlying economic preferences of the country in numerous fronts. It effectively altered the socio-economic structure of the country and continued to follow the liberalisation path, further strengthening the other complimentary factors to achieve a more meaningful liberalisation. It does not follow a privatisation programme, but restructured loss making state entities with Public-Private Partnership arrangements while facilitating the participation of the private sector across all economic sectors. The government revitalised some state institutions such as CWE, Paddy Marketing Board, Transport Board, etc. to operate parallel to the private sector, establishing relevant benchmarks to shield consumers from unfair competition. Unlike the pre 1977 regime, the government took over the management of SriLankan Air, Sri Lanka Telecom and Shell Gas, which were under the private sector, in a transparent manner without creating negative perceptions within the investor community. The ethnic conflict which hovered in the investors' mind for nearly three decades was completely eradicated. The macroeconomic environment was strengthened with a stable exchange rate, higher growth rates, lower and predictable inflation, lower interest rates, higher level of foreign reserves, etc. Some effective policy decisions such as implementation of Norochcholai Coal Power Plant, the Upper Kotmale Hydro Power Project, removal of the fuel subsidy and tax reforms, continuation of fertiliser subsidy which were not characterised earlier due to political risk, were implemented reflecting political boldness and confidence. Implementation of mega infrastructure projects such as power projects (Uma Oya, Moragahakanda), road development (Southern Highway, Colombo Outer Circular, Colombo-Katunayake Airport Expressway), port development (Colombo South Harbour, Hambantota Port Development), aviation (Mattala International Airport, Katunayake Expansion), sports complexes (International Sports Stadium in Diyagama, International Cricket Stadiums in Suriyawewa, Pallekele) and many other projects fulfilled the long-felt needs of the country and also laid the foundation for subsequent investments.

Capitalising the excellence in macroeconomic, political and social spheres, Sri Lanka penetrated the international capital market for required funds to finance various infrastructure projects. Successful completion of sovereign bond issues became truly a hallmark achievement in establishing Sri Lanka's presence in international capital market. It effectively established the benchmark for the corporate sector to raise debt capital from foreign sources.

In addition, the comparatively controversial segment of the liberalisation process, the capital account liberalisation was also further strengthened during this period exploiting the sound macroeconomic stability, efficient financial system and political stability. Accordingly, among other things, investments by foreigners in Rupee denominated debentures and unit trusts, foreign borrowings by companies and students, opening of places of business in Sri Lanka by foreign companies, opening of foreign currency accounts by foreigners on tour or business, payments to non-residents in respect of purchase of real estate properties in Sri Lanka and engage in money changing business by selected super markets were permitted. With the further liberalisation of the capital account, which is considered the logical conclusion to the liberalisation process, is expected to attract a steady and continuous flow of FDIs which were remote in the past.

A retrospective review into the liberalisation attempts in the past and the host of strengths rooted in the current socio-economic structure show the true resurgence of the decade-long liberalisation attempts. Against this background, the country is now in a better position to take a decisive leap while making up for opportunities missed in the last few decades.

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