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Expanding Horizons – Integration with the World Economy

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By virtue of location, Sri Lanka being in the middle of an extensive network of interconnected trade routes, the country has inherited a long history of international linkages. As such, Sri Lanka's integration with the world economy is hardly a new phenomenon. Yet, the recent decades have experienced some remarkable changes in economic integration across the globe. According to a prominent economist, "[t]he pace of global economic change in recent decades has been breathtaking indeed, and the full implication of these developments for all aspects of our lives will not be known for many years" (Ben Bernanke, 2006).[1] Undoubtedly, the world economy has moved towards closer integration during the recent decades. International trade flows have increased substantially, financial markets in developed and emerging economies have become increasingly integrated, significant parts of the world economy that were relatively insulated until recently, opened up to free trade and capital flows, and continental European countries adopted a single currency. In light of these global economic changes, a worthwhile question to raise would be how Sri Lanka's integration with the global economy has evolved over time. This article reviews the last sixty years of integration of the Sri Lankan economy with the world, in light of obvious expansions of international trade, labour, and financial flows. For example,

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1 Bernanke, B.S. (2006):"Global Economic Integration: What's New and What's Not New?" Annual Economic Symposium, Federal Reserve Bank of Kansas.

Sri Lanka's merchandise imports have more than doubled during the recent decades relative to the gross domestic product (GDP), i.e., from 17.1 per cent in 1970 to 36.1 per cent by 2008[2] ; while merchandise exports have risen from 14.8 per cent of GDP in 1970 to 20.8 per cent by 2008, less impressive though. Overall, merchandise trade, including both exports and imports, has increased dramatically over the same period, i.e., from 31.9 per cent of GDP in 1970 to 56.9 per cent by 2008. Further, trade in services as a percentage of GDP has also doubled, and stood at 10 per cent in 2007, compared to 4.2 per cent in 1970. Meanwhile, Sri Lanka has experienced a dramatic increase in remittances over the years, which has brought about significant macroeconomic consequences for the economy. For example, during 2009, private inflows amounted to US dollars 2.9 billion (which is about 6.9 per cent of GDP), while during 1970, total remittances were just about US dollars 107 million. Moreover, Sri Lankan economy has seen increased participation of international business establishments over time. As of 2010, eleven foreign banks are in operation in Sri Lanka, while several leading multinational companies continue to expand their businesses, and this trend is expected to continue to a larger extent, owing to greater liberalisation of economic policy being introduced on a regular basis. Moreover, Sri Lanka's bond portfolios have become more international, attracting more foreign investor confidence on the post-war economy. Sri Lanka's ability to benefit from the remarkable developments in information and communication technology and the payments and settlements system facilitated enhancing the economic integration.

In general, economic integration refers to a process of removing cross-border discriminations which may affect the flow of goods and services, and the movement of factors of production. Thus, arguably, a country can benefit a lot through increased participation in the world economy. Such benefits may include efficient allocation of resources due to changing production patterns, gaining international standards of efficiency through domestic competition, access to larger markets, and the ability to participate in international capital markets in the event of country-specific shocks, and more importantly, the exposure to new ideas, technologies and products.[3] However, one should not lose focus on some negative aspects attached to greater economic integration, which may mainly include the possibility that the infant or less effective industries may find it hard to withstand open market competition and be forced to exit the market, consequently. Nonetheless, in a rapidly changing economic environment in which national borders and regional differences are becoming less and less relevant, increased economic integration may seem to be inevitable, the challenge remaining for any country, especially, a small open economy like ours, would be to making use of economic integration as a means of achieving accelerated economic growth.

2 Of course, the last couple of years mark a decline in imports due to the impact of adverse macroeconomic consequences (see, for example, the IMF's World Economic Outlook, Oct 2010).

3 See the report by Nepal Rastra Bank (2005):"The Process of Economic Integration is South Asia", International Finance Division, Research Department.

Chart 14.1
Some Indicators on the Integration with Global Economy

Chart 14.1.a
Merchandise Trade (as % of GDP)

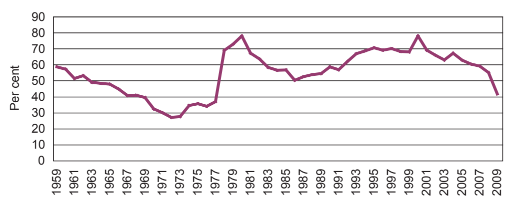


Chart 14.1.b
Trade in Services (as % of GDP)

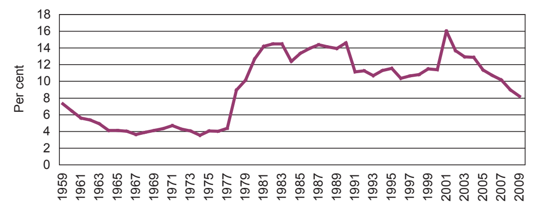


Chart 14.1.c
Foreign Direct Investment (as % of GDP)

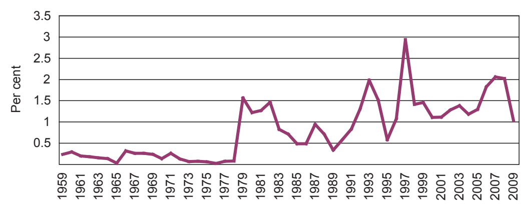


Chart 14.1.d
Private Long-term Investment (as % of GDP)

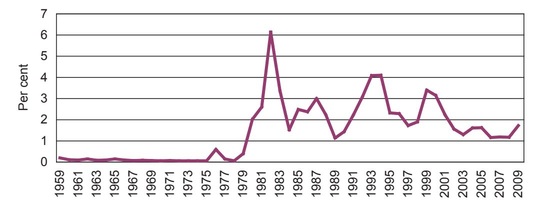


Chart 14.1.e
Government Long-term Investment (as % of GDP)

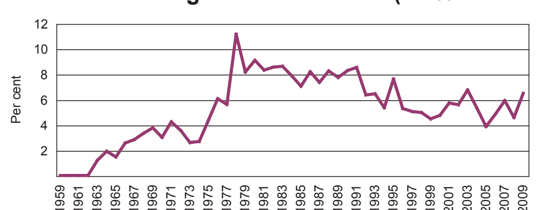
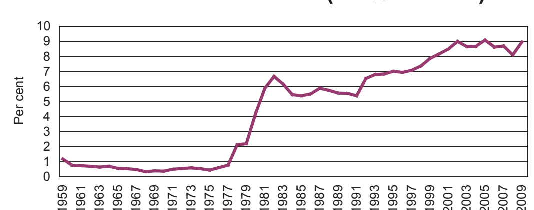


Chart 14.1.f
Total Private Transfers (as % of GDP)



Notes:

1. Merchandise trade is the sum of merchandise exports and imports divided by the value of GDP, all in U.S. dollars.
2. Trade in services is the sum of services exports and imports divided by the value of GDP, all in U.S. dollars.
3. Foreign direct investment is the sum of equity capital, reinvestment of earnings, and other short- and long-term capital, as shown in the balance of payments. This series shows the sum of net inflows and outflows and is divided by the value of GDP.
4. Gross private capital flows are the sum of the absolute values of direct investment inflows and outflows recorded in the balance of payments financial account, excluding portfolio investment, and other changes in the assets and liabilities of monetary authorities and general government. The indicator is calculated as a ratio to GDP in U.S. dollars.
5. Private Transfers are the sum of the absolute values of direct inflows and outflows recorded in the balance of payments financial account.

Sri Lanka's economic integration with global economy has met with some drastic changes over time, mainly because of changes in the development policy framework adopted by successive governments from time to time. These policies range from inward-looking import substitution industrialisation to outward-looking export oriented industrialisation, although they are not mutually exclusive. Accordingly, the extent to which Sri Lankan economy has been involved in the world economy has changed significantly. For example, Chart 14.1 shows some indicators on Sri Lanka's integration with global economy over the period from 1959 to 2009.[4] A noticeable feature is that most of the indicators show a significant upward shift around 1977, during which economic liberalisation policies were introduced in Sri Lanka by relaxing strict exchange and import control measures and moving away from inward-looking policies with a greater emphasis on import substitution industries. As shown in Chart 14.1.a merchandise trade jumped to over 77 per cent (as a share of GDP) by 1980, from just over 30 per cent in 1976. Similarly, Chart 14.1.b shows that trade in services increased to about 16 per cent (as a share of GDP) by 1980 from about 4 per cent in 1976. However, mobilising of foreign resources, in terms of foreign direct investments has not been subject to dramatic changes (see Chart 14.1.c). This may be due to various reasons, such as, existence of some stringent capital controls during that time, the time taken to build up the market sentiment etc. However, private and government long term investments showed some substantial improvement (see Charts 14.1.d and e). Also, total private transfers have increased markedly since 1977 (see Chart 14.1.f). Given this significant policy change that occurred in 1977, it would be useful to look at Sri Lanka's economic integration with the world economy in two sub-periods, i.e., pre-1977 and post-1977 periods, as described below.

Pre-1977 Period

The first decade following independence (1948-1959), in which the Central Bank of Sri Lanka was established[5], marked some significant steps towards promoting economic activities, other than merely focusing on the plantation crops sector, which had been given prominence under the colonial administration. These activities included several development programmes aimed at developing transportation, power, health, education etc., as well as irrigation and land development programmes. However, during 1960s, Sri Lanka had to confront with several economic problems, particularly, on the external front. For example, the balance of payments deteriorated, mainly due to faster growth of imports over exports (Charts 14.1.a and b depict a declining trend of both merchandise trade and trade in services, during late-1950s and 1960s). Consequently, the promotion of export trade was considered essential, and more importantly, perhaps, import restrictions were viewed as the most appropriate measure at the time. However, by late 1960s, adverse impact of the quantitative restrictions became more apparent, import substitution policy deemed to be less effective, and orientation towards economic liberalisation and the greater

4 The data sample begins from 1959 due to data availability.

5 The Central Bank was established by the Monetary Law Act No.58 of 1949 and commenced operations in August 1950, thus ending the Currency Board System which was set up under the Paper Currency Ordinance No.32 of 1884. The Bank was called the Central Bank of Ceylon until it was renamed as the Central Bank of Sri Lanka in December 1985.

reliance of private sector development were viewed as appropriate. In order to overcome the economic hardships, a significant inflow of capital and intermediate goods was necessary. Since export earnings were not adequate to meet this demand, mobilisation of foreign aid was considered to be inevitable. By late 1960s, on the recommendation of the Central Bank, several policy measures were introduced to promote exports, including devaluation of exchange rate by 20 per cent in 1967, introduction of dual exchange rate under Foreign Exchange Entitlement Certificate (FEEC) scheme, which provided a depreciated exchange rate system for non-traditional exports and non-essential imports. Further, in 1972, the Convertible Rupee Account (CRA) Scheme was introduced to boost the minor export sector by granting exporters a share of export earnings in foreign currency.[6]

Post-1977 Period

According to the Central Bank Annual Report (1995), "Sri Lanka had a highly distorted trade policy regime prior to 1977, consistent with the inward-oriented development strategy followed at that time. Both tariff and non-tariff barriers were extensively used to control imports, for balance of payment reasons, as well as to protect domestic activities and industrial enterprises, which were mostly state run, against import competition" (p.108). It was realised by 1977 that restrictive policies adopted during the earlier period constrained economic activity, resulting in a shortfall in both import substitution and export oriented production sectors. Economic activity was further hampered due to limited imports of intermediate and investment goods, and overall, the level of saving and investment has remained low prior to 1977. Subsequently, a policy package was prepared to liberalise and simplify exchange and trade system, with the view to allowing price mechanisms to determine economic activities and to eliminate the adverse effects of import and exchange controls (see Table 14.1 for a summary of the key financial reforms and capital account liberalisation measures implemented since 1977). To this end, the involvement of the Central Bank has been significant. For example, the introduction of managed floating exchange rate system in 1977 by abandoning the dual exchange rate system, helped to maintain export competiveness. Further, rationalisation of the tariff structure by establishing the Tariff Review Committee and a Presidential Tariff Commission helped improving the efficiency of the price mechanism and reducing distortions. Also, the Central Bank played a key role in mobilising financial resources from both domestic and foreign sources, in order to match the investment requirements that the country was in great need at the time. Implementation of several monetary and fiscal policy measures helped promoting private investments. These included interest rate reforms, extending credit facilities to the private sector, development of the share market, and in particular, allowing internationally reputed foreign banks to open branches, and introducing off-shore banking since 1979 with a view to attracting foreign investors and promote the export sector. Among the measures adopted by Sri Lanka in recent years in relation to expanding economic integration, the participation in regional economic co-operation is one of the most significant.

6 See for more details, 40th Anniversary Commemorative Volume of the Central Bank of Sri Lanka 1950-1990.

Table 14.1
Financial Reforms and Capital Account Liberalisation

Date	Major Changes
1977	Delegation of authority to commercial banks with regard to selected current account transactions. Enhanced exchange entitlements for travel, business, medical treatment, education, and emigration.
1978	Inward FDI and portfolio investments were freely permitted, subject to existing regulations. Exchange allowance for business travel and education increased. Commercial banks permitted to open NRFC accounts for Sri Lankans and foreign nationals. Procedure simplified and more exchange control functions delegated to commercial banks.
1980	Introduction of Resident Non-National Foreign Currency Accounts (RNNFC) Scheme.
1981	Commercial Banks permitted to encash inward remittances and travellers' cheques and foreign currency notes up to US$ 500 without obtaining details on source or purpose of receipt.
1986	Exchange entitlements for education abroad further enhanced. Requirement to obtain exchange control approval for encashment of traveller's checques exceeding Rs.100,000 per day withdrawn.
1990	Permission granted to approved country funds, regional funds, and non-resident individuals to invest in shares in listed companies up to 40 per cent of issued share capital. With this, a scheme of Share Investment External Rupee Accounts (SIERA) introduced through authorised dealers to facilitate and monitor such investments.
1991	Exporters permitted to borrow from Foreign Currency Banking Units (FCBUs) for financing imports of inputs to execute export orders.
1992	Permission granted to approved country funds, regional funds, non-resident individuals, and corporate bodies incorporated outside Sri Lanka to invest in shares in listed companies up to 100 per cent of issued share capital, subject to exclusions, limitations and conditions set out by Controller of Exchange.
1993	Repatriation and surrender requirements in respect of export proceeds abolished. Export proceeds permitted to be retained in foreign currency accounts either in Sri Lanka or abroad.
1994	All remaining restrictions on current international transactions removed. Sri Lanka accepts obligations under the Article VIII of IMF Charter.
2006	Further opening up the capital account has been suggested, as being a means to facilitate economic growth further through promoting higher investment by minimising cost of equity capital and debt and improving the efficiency of the financial system. Thus, measures have been taken to liberalise the capital account further, including, the granting permission to foreign country funds, regional funds and the mutual funds, approved by the Securities and Exchange Commission in Sri Lanka, corporate bodies incorporated outside Sri Lanka and citizens of foreign countries to purchase and hold up to 5 per cent of the total outstanding value of Rupee Denominated Treasury bonds, at any given point of time.

2009	Permission was given to hold and sell rupee account named "Treasury bonds/bills Investment Extern al Rupee Account–Deshabhimani (TIERA-D)" provided that all such investments in aggregate do not exceed 10 per cent of the total value of T-bonds/ T-bills outstanding at any given point in time.
2010	Recently, the Central Bank of Sri Lanka announced some arrangements made in relaxing foreign exchange regulations relating to investment abroad by Sri Lankans, foreign borrowings by resident companies and investments by non-residents in the domestic market. Some of these key measures include permitting foreigners to invest in Rupee Denominated Debentures issued by local companies, permission to foreigners on tour or business in Sri Lanka to open accounts in foreign currency, permission to open Foreign Currency Accounts for Gem and Jewellery Industry etc.
2011	Further relaxations were announced such as permission to Sri Lankan resident individuals, corporate and unincorporated bodies to invest in equity of overseas companies (effective from 1 January, 2011,) and permission to Sri Lankan resident individuals, permission to insurance companies to invest a part of their assets abroad. In addition to the relaxations introduced in 2010, more relaxations were introduced with effect from January 1, 2011, which include granting permission to any person resident in Sri Lanka or any company or partnership registered in Sri Lanka to acquire, hold, and transfer shares of companies incorporated outside Sri Lanka and the sovereign bonds issued by foreign governments and governmental organisations subject to the directions specified by the Government. Particularly, the following limitations will operate of any permission granted to the above: (a) in respect of a company listed at the Colombo Stock Exchange, US dollars 500,000 or an equivalent amount in any designated foreign currency per annum; (b) in respect of a company which is not listed at the Colombo Stock Exchange, US dollars 100,000 or an equivalent amount in any designated foreign currency per annum; (c) in respect of a partnership registered in Sri Lanka, US dollars 100,000 or an equivalent amount in any designated foreign currency per annum; and (d) in respect of any individual resident in Sri Lanka, US dollars 100,000 or an equivalent amount in any designated foreign currency per annum.

Source: Central Bank of Sri Lanka- Annual Reports

Regional Integration

During recent decades, the world has seen global trends towards open regionalism which refers to a gradual movement towards continent-based integration. For example, North American Free Trade Agreement (NAFTA), the European Union (EU), Association of South East Asian Nations (ASEAN), Asia Pacific Economic Cooperation (APEC), are to name a few. Further, Sri Lanka has played a key role in moving towards regional integration in the South Asian region, for example, the formation of South Asian Association of Regional Cooperation (SAARC), participation in the South Asian Preferential Trading Arrangement (SAPTA), which came in to effect in 1995, and in the treaty regime on the South Asian Free Trade Area (SAFTA) in 2001 are some noteworthy developments. However, in order to make maximum use of the full potential in the region, an integrated development strategy for South Asia may need to be formulated, while overcoming some inherent contradictions and territorial disputes among the member countries. It is worthwhile to mention two key bilateral trade agreements that Sri Lanka has been involved with. First, the India-Sri Lanka Free Trade Agreement (ISFTA), which was signed in 1998 and implemented tariff concessions from 2000, resulted in removing tariffs on some goods immediately, while partial concessions are granted on selected goods. Second, the Pakistan-Sri Lanka Free Trade Agreement (PSLFTA) which was signed in 2002, and became operational from 2005, under which Sri Lanka has been able to enjoy duty free market access on 206 products in the Pakistani market, while Pakistan, in return, has gained duty free access on 102 products in the Sri Lankan market. Also, with a view to strengthening the trade links further in the region, Sri Lanka is in the process of negotiating Comprehensive Economic Partnership Agreements (CEPA) with India and Pakistan. While the increased economic integration may deliver its intended results, the conventional wisdom, however, suggests that increased trade linkages would lead to the effects of negative demand shocks to spillover intensely across international markets.

Economic Integration and Spillover Effects

During the recent global economic downturn, many advanced economies experienced some spillover effects due to the sharp slowdown of the housing sector of the United States and the subsequent turmoil that erupted in the international financial markets. For example, as reported in recent IMF World Economic Outlook (Oct 2010) the collapse of the world trade during the last year was sudden, severe, and synchronised, and accordingly referred to as "the great trade collapse". Further, the Report describes that "[f]or economies that rely heavily on external demand for their growth, [their] findings highlight the urgency of reorienting growth by strengthening domestic demand" (p.125), even if countries like ours may still need to look for ways and means to boost export earnings through appropriate measures. Subsequently, a different theme has emerged in international macroeconomics, namely "decoupling" which refers to "apparent divergences in economic performance among different regions of the world economy" (Kohn, 2008).[7] These divergences mainly relate to the perception that the business cycles of the United States and other advanced economies are becoming less synchronised (arguably though, given the way in which the recent financial crisis did spread across the globe); and also to the fact that economic growth in emerging market economies is fairly sustainable relative to the substantially slower growth in the advanced economies.

Where does the Sri Lankan economy stand in this context, given that it is a small open economy? So far, this article has described how Sri Lanka has been expanding its economic integration with the world economy, throughout the last sixty years or so. As such, one would reasonably expect a greater impact on the economy of the turmoil in the global financial markets

7 Khon D.L. (2008): "Global Economic Integration and Decoupling", International Research Forum on Monetary Policy, Frankfurt, Germany.

and subsequent decline in economic activity. However, Sri Lankan economy has been able to hold up its trend economic growth relatively successfully, despite the magnitude and severity of the recent economic meltdown. Simultaneously, the economy had to confront with another wave of negative shocks due to the escalation of counter-terrorism efforts, which brought about direct and indirect adverse effects, such as deterioration of tourism industry, risk premium on the financial market in the context of substantially downgraded sovereign ratings of the country, and overall deterioration of terms of trade etc. In explaining how Sri Lanka could be able to do so, the findings of a recent study by Artis et al. (2010) may be useful.[8] This study examines the behavior of the international business cycle across 25 advanced, emerging, and developing economies (including Sri Lanka) for a period of 125 years. The importance of international sources of fluctuations, either common shocks or spillovers, is measured relative to the share of the forecast error variance attributed to domestic shocks. Thus, a small domestic share corresponds to a relatively larger role for international rather than domestic disturbances. In this context, the finding relating to developing country block (to which Sri Lanka is a part of) is rather interesting, because it suggests that country-specific shocks still play a dominant role in business cycle dynamics, relative to international shocks.[9] For example, at longer horizons, international sources of fluctuations typically account for only about 40 per cent of business cycle variance, while country-specific shocks account for 60 per cent of business cycle variance during post-1973 period. Note, however, that this evidence may need to be evaluated carefully, because, it applies to the developing country-block in general, and not solely to Sri Lanka. As such, drawing firm conclusions on any signs of decoupling of individual countries may require further studies.

Concluding Remarks

Sri Lanka's economic integration with the world economy has met with some significant changes over time, i.e., from a lower degree of integration into a higher degree of integration. Over the last sixty years, Sri Lanka has made significant improvements in uplifting the living standards of its citizens, and in that, increased economic integration may have played a significant role. Note, however, that disagreements still exist on whether or not global integration benefits developing countries to alleviate poverty to a greater extent. Yet, as a rapidly emerging economy in the South Asian region, Sri Lanka has a lot to improve in order to catch up with the pace of development that some emerging market economies in the East and South East Asian region experienced over the recent decades. In this context, it seems worthwhile noting some observations made on the Sri Lankan economy in the very first annual report of the Central Bank in 1950, (p.13).

8 Artis, M., Chouliarakis, G., and Harischandra, PKG. (2011): "Business Cycle Synchronisation Since 1880", The Manchester School, Vol. 79(2) pp.173-207.

9 The key finding of Artis et al. (2011) is that there is compelling evidence in favour of a secular increase in international business cycle synchronisation within a group of European and a group of English-speaking economies that started off during 1950-1973 and accelerated since 1973. Further, since the 1960s, the gradual trade integration within a group of European countries diminished the relative significance of idiosyncratic (or country-specific) shocks, and resulting in the formation of the European Monetary Union. However, this observed secular rise in business cycle synchronisation in advanced economies does not extend to the emerging market and developing economies.

> "The achievement of a rapid increase in production in Ceylon is, of course, the core of the economic problem. It is most disconcerting, for example, to find that even on the crest of the present boom there is still some unemployment and a very considerable amount of underemployment. Such a situation should not be, for economic conditions could scarcely be more favourable for using labour to expand production than they are today. Purchasing power is more than adequate; demand is brisk. Money capital, labour, and land are available. The answer lies partly at least in adequacy of enterprise. Or, if the enterprise is present, the ways and means of linking it with money capital are absent. It is common knowledge that many of those with money are using their resources to increase their holdings of existing estates or what is worse, to speculate, rather than to replant, to open up new land, or to start new enterprises. Such activity contributes little to the country's development."

Of course, the macroeconomic structure of the Sri Lankan economy at present, may be distinctly different to what it was in 1950, yet it seems that some of the inherent characteristics are still apparent in the economy today. So, the Sri Lankan economy has to implement some structural changes, in the areas of mobilising and utilising of resources in a much more productive way that incentivises aggregate saving and investment in the economy. This may not be achieved through openness per se, but we may need to enhance our capacity to adapt to changes in the outside world. In this respect, Sri Lanka may need to re-examine the effectiveness of policy measures adopted in a range of important areas over the course of its post-independence history. One such more obvious area is the development of human capital, through an education policy based on research and development, which may deliver professionals and skilled manpower to be matched with the needs of the world economy in the 21st Century.