10

Foreign Exchange Transactions: From Controls to Relaxation

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Introduction

Exchange controls, i.e., controls on specific foreign exchange transactions or case-by-case basis approvals for certain international financial transactions have generally been imposed to restrict the use of foreign exchange for international financial transactions. Many countries have resorted to exchange controls with the outbreak of the World War II as an attempt to preserve the foreign exchange resources in the face of the devastation caused by the war. Hence, in the late 1930s, widespread trade restrictions and capital controls were introduced as emergency measures to arrest the depletion of international reserves and allow for the import of much needed goods. As economies recovered after ending the war, a number of advanced countries removed exchange controls although exchange controls survived in many developing countries. The general belief in the 1960s and 1970s was that controls were needed to ensure necessary protection against adverse external shocks and preserve the independence of national policies.

In Sri Lanka too, the initial exchange controls were introduced under the Defence (Finance) Regulations that were passed in 1939. However, there has been a gradual and focused relaxation of exchange controls since 1977, which was an integral component of overall liberalised economic

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policy pursued, to achieve a greater efficiency in the conduct of international financial transactions and to enhance overall competitiveness of the economy to sustain a high rate of economic growth. At present, all international transactions of current nature are free of exchange controls while many of the capital transactions too are largely free of exchange controls. The authorities have, however, taken a gradual approach in relaxing exchange controls on capital transactions given the macroeconomic risks that could arise from the adverse effects of abrupt movement of large capital inflows and outflows and the necessity of safeguarding monetary and financial stability.

A series of further relaxations are to be introduced, having in place the prudential regulations and a market surveillance mechanism on foreign exchange transactions to promote investor confidence, market discipline and stability.

Early Measures of Exchange Control

After the establishment of the CBSL, the administration of Exchange Control function was entrusted to the Monetary Board with effect from 01 September 1950. The Exchange Control Act was enacted on 16 August 1953 empowering the CBSL to administer exchange controls. At present, the provisions of the Exchange Control Act and the Monetary Law Act together provide the CBSL with a wide spectrum of discretionary powers to regulate the country's foreign exchange operations in the country.

The high commodity prices associated with the Korean boom in 1950 made possible Sri Lanka to raise the external assets recording a favourable balance of payment situation in the country. However, this situation had changed subsequently and with the continuing decline in external assets along with rising imports, exchange controls had been tightened in 1952. The regulations that permitted remittances without prior approval of the Exchange Control authorities on account of maintenance, travel, charity and other current purposes were withdrawn in September 1952, and lower exemption limits were fixed. Subsequently the limits were progressively revised downward and by the end of that year exchange controls were considerably restricted.

The balance of payments situation had aggravated further from late 1950. The net outflow of capital on account of sale of British investments had grown steadily in the decade after independence adding further complication to the BOP situation. While official capital flows became significant after the 50's, this was not sufficient to offset the large outflow of private long term capital. In 1961, number of items, which were previously under Open General Licence were brought under import control. Further, several items were banned, by using the simple expedient of not issuing any licences for them. Further, import restrictions were imposed in February, July and September 1962. By this time all items of import, other than foodstuffs, fuel, fertiliser, petroleum products and drugs were under import control. Import controls underwent a radical change in October 1962 when a scheme of individual licensing applicable to nearly the whole range of imports was introduced. In 1964 and 1965, in the face of a deteriorating foreign exchange situation, import controls were tightened further.

A significant departure from the control regime followed thus far was the introduction of the Foreign Exchange Entitlement Certificate (FEECs) scheme in May 1968. This scheme had two main objectives – one was to promote and diversify exports, the other was to liberalise imports and to move away from the system of quotas and stringent controls. All foreign transactions (exports, imports and invisible transactions) were classified under two categories. The FEECs scheme was designed to provide a cash incentive to selected exports and invisible transactions, and to impose an additional rupee cost on selected imports and invisible payments. All other foreign receipts and payments were to be transacted at the official exchange rate. Under this scheme FEECs were issued to exporters who surrendered foreign exchange to commercial banks against non traditional exports. Exports of tea, rubber, coconut and coconut products were, therefore, not eligible, under this scheme.

Further liberalisation was seen in 1972, when a certain percentage of the gross earnings of the exporters of certain minor and non-traditional exports was allowed to be retained as an incentive in the form of Convertible Rupee Accounts (CRA) to be used towards the importation of specified goods and payments for specified services. The oil crisis in 1973 and the resulting balance of payments difficulties compelled a significant tightening of exchange controls and controls for both current and capital transactions were introduced and prevailed until 1977. 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.

Although the BOP difficulties and resulting pressure on external reserve position required governments to impose controls, severe control clearly had several disadvantages. The exchange control involves extra costs of administration and may delay or interfere unduly with trade and other productive activities in the economy. These inevitably give rise to attempted evasion, which may, if unchecked, lead to concealed losses of exchange, black market exchange rates and other undesirable features. Further, because some could always seek to exploit legal as well as illegal loopholes, there could be a tendency for controls to breed further controls. The removal of restrictions on current international transactions and certain capital account transactions beginning 1977 reflected the recognition of the merits of international trade and benefits of capital flows on the domestic economy and the need to create a conducive environment to facilitate private sector led economic activity.

Gradual Liberalisation since End 1977

A significant relaxation of exchange controls had been implemented in late 1977 as a part of the substantial policy initiative to free the economy from administrative controls. At the same time, the exchange entitlements for travel, business, medical treatment, education and emigration, were increased and the authority to grant exchange for selected current account transactions was delegated to commercial banks. Accordingly, foreign exchange for passage and exchange in respect of travel on holiday, business, official duty, payment for subscriptions, remittances on account of export commissions, payment of profits and dividends were delegated to commercial banks. Meanwhile, the determination of exchange rate has gradually been based on the market forces by moving to a managed floating exchange rate system since November 1977.

A series of further measures had been taken to improve the institutional mechanism to facilitate trade financing, promote foreign private investment and encourage inward remittances. Accordingly, commercial banks were allowed to operate Foreign Currency Banking Units (FCBUs) from 1979 with the objective of developing the off-shore market in Sri Lanka and to provide financing facilities in foreign currency to industries in the Export Processing Zones. Commercial banks were also permitted to open accounts for non-resident Sri Lankans, who had foreign exchange earnings from a period of residency abroad, and for foreign nationals. Exporters were permitted to borrow from Foreign Currency Banking Units (FCBUs) for financing inputs to execute export orders. The Resident Non-national Foreign Currency (RNNFC) Account Scheme, which permitted non-nationals resident in Sri Lanka to maintain foreign currency accounts, was introduced.

Exchange controls were further liberalised beginning 1990 simplifying the procedures and delegating more exchange control functions to commercial banks. The outflows associated with these inflows, such as interest, profits, sale proceeds and dividends were made completely free of any restriction. All current earnings of NRIs in the form of dividends, rent, etc have been made fully repatriable. Permission was granted in 1990 to approved country funds, regional funds and non-resident individuals to invest in shares in listed companies up to 40 per cent of the issued share capital. The 100 per cent Transfer Tax on such purchases was abolished at the same time. With this, a scheme of Share Investment External Rupee Accounts (SIERA) was introduced through Authorised Dealers, to facilitate and monitor such investments enabling Sri Lankan residents who received foreign currency, to maintain foreign currency accounts, and commercial banks were permitted to open Resident Foreign Currency (RFC) accounts, in 1991.

In 1992, approved country funds, regional funds, non-resident individuals, and corporate bodies incorporated outside Sri Lanka were permitted to increase their investment in shares in listed companies from 40 per cent of the issued share capital up to 100 per cent, subject to exclusions, limitations and conditions set out by the Controller of Exchange. The repatriation and surrender requirements in respect of export proceeds were abolished in 1993. Export proceeds were permitted to be retained in foreign currency accounts either in Sri Lanka or abroad. The remaining restrictions on payments in respect of travel, education expenses overseas and remittances for miscellaneous purposes were removed.

A major departure in the exchange control regime had been the acceptance of the Article VIII of the IMF Articles of Agreement under which all remaining restrictions on current international transactions were removed in March 1994 and a series of capital account liberalisation measures were introduced thereafter. In 1995, commercial banks were permitted to obtain foreign loans up to 5 per cent of their capital and reserves, introducing some relaxation on the capital account. This was raised to 15 per cent with the introduction of foreign currency loans to non-BOI exporters in 1997. Permission was also granted more freely to private sector firms on a case by case basis to undertake investments in foreign countries in 1996. In 1997, commercial banks were permitted to provide foreign currency loans to non-BOI exporters, from either their domestic units or from their FCBUs, subject to some safeguards. In 2000, limitations for investment by non residents in the banking (up to 60 per cent), insurance (up to 90 per cent) and stock brokering (up to 100 per cent) were further relaxed.

A series of further relaxations have been undertaken during the last decade to grant greater flexibility for residents and non-resident Sri Lankans to maintain their earnings abroad in foreign currency and to promote investments including investments in government securities. Some measures to grant greater flexibility for Sri Lankan resident individuals, corporate and unincorporated bodies to maintain their earnings abroad in foreign currency, invest in equity of overseas companies include:

- RANSI Accounts for non-resident Sri Lankans introduced in 2001 to promote investment in real and financial assets.
- Permission granted in 2003 for Sri Lankans employed abroad to obtain foreign currency loans, against the security of their NRFC Accounts balances and repayment to be made in foreign currency.
- Permission for Shipping/Airline agents to maintain foreign currency accounts on behalf of their principals.
- Promotion for exporters to pay sea/air freight in foreign currency from funds in their foreign currency accounts.
- Introduction of a Indirect Exporters Foreign Currency Accounts (IEFCA) scheme to allow indirect exporters to receive payments in foreign currency from direct exporters in 2005.
- Introduction of a Foreign Currency Account for Gem and Jewellery Exporters to facilitate foreign exchange requirements of the Gem and Jewellery Export sector.
- Introduction of a Special Foreign Investment Deposit Account to facilitate permitted non resident parties to open and maintain Time/Savings deposits (in DBU) in designated foreign currency and Sri Lanka rupees.
- Permission was granted to amalgamate funds in NRFC, RFC, SFIDA, Investments in T/Bonds and Foreign Currency Fixed Deposit for Dual Citizenship applicants.

- Granting permission for authorised dealers to release total balance to the credit of existing non-resident block accounts as at 01 July 2008 and outward remittance of US dollars 20,000 per annum from block accounts operative after 01 July 2008.
- Permission to Sri Lankan resident individuals, corporate and unincorporated bodies to invest in equity of overseas companies.
- Permission to insurance companies to invest a part of their assets abroad; and
- Permission for Sri Lankan companies to open and maintain overseas offices.

Steps taken to promote investments including investments in government securities include:

- Issue of Sri Lanka Development Bonds (SLDB) denominated in US dollars by government.
- Introduction of Treasury Bond Investment External Rupee Account (TIERA) in 2006, to facilitate approved non resident parties to invest in rupee denominated Treasury Bonds up to 5 per cent of outstanding Treasury Bonds at any given time and this Permitted limit for non-resident investment in Treasury Bonds was increased up to 10 per cent of outstanding Treasury Bonds at any given time.
- Permission for Authorised dealers to accept third party foreign currency deposits subject to a limit of US dollars 1,000 (or its equivalent) per transaction in 2007.
- Introduction of Treasury bill Investment External Rupee Account - Deshabhimani (TIERA – 2), in 2008, to facilitate permitted foreign parties to invest in rupee denominated Treasury bills up to 10 per cent of outstanding Treasury bills at any given time.
- Permission for migrants up to a maximum of US dollars 150,000 (including personal effects) at the time of their departure from Sri Lanka; and
- Introduction of "Treasury bill/bond Investment External Rupee Account - Deshabhimani (TIERA – D)", to facilitate Sri Lankans living abroad to invest in rupee denominated Treasury Bonds up to 10 per cent of outstanding Treasury bills and Treasury bonds at any given time.

Under general permission to further facilitate investments by non-residents, the steps have been taken to grant:

- Permission for foreigners to invest in Rupee Denominated Debentures issued by local companies with effect from November 2010.
- Permission for foreign companies to open places of business in Sri Lanka.
- Permission to foreigners on tour or business in Sri Lanka to open accounts in foreign currency.

Benefits and Risks of Capital Account Convertibility

Sri Lanka has been following a gradual approach in relaxing the capital account transactions. In view of the decline in external financing the particularly from official sources, i.e., bilateral and multilateral agencies, the need to finance gap in savings-investment, and increasing sophistication of investors making it much easier to move capital around under different guises, capital-account liberalisation was considered as an important and inevitable step to benefit from increasing globalisation and increased movement of capital flows. But, the premature full convertibility of the capital account is considered to be dangerous without adequate safeguards. Accordingly, a series of sequential measures were taken to promote different forms of capital flows across the country's borders, i.e., foreign direct investment (FDI), portfolio flows (including investment in equities), and bank borrowing.

In fact, there are numerous benefits as well as risks in liberalising the capital account. In a developing country like Sri Lanka, the savings-investment gap is usually a common phenomenon and is generally reflected in the continued current account deficits. The flow of capital would then reduce the cost of capital, increase investment, and also facilitate domestic liquidity management, which will bolster domestic economic activity by reducing the cost of raising capital for investment and raising the output.

An increasing number of countries have encouraged foreign direct investments (FDIs), which could facilitate the transfer of foreign technological and managerial know-how and encourage competition and financial development, thereby promoting growth. Countries also favour FDI, as they are relatively long term and not subject to rapid reversals associated with changes in investor sentiment. Moreover, business cycles, in general, are not synchronised across countries, and the capital flows can offset volatility, which could otherwise have arisen in countries' own national incomes. Hence, inflows stemming from liberal capital flows should contribute to contain output volatility.

The fluctuations in international capital flows, particularly reversal of short-term capital inflows can have adverse macroeconomic shocks. International investors may tend to pull back in bad times, thereby amplifying the swings in the domestic macroeconomy. It has been found that the premature opening of the capital account also poses serious risks on the smooth functioning of the financial intermediation. The high levels of short-term liabilities intermediated by the financial system also create risks of bank runs and systemic financial crises when the financial sector is weakly regulated.

Conclusion

Having liberalised all the current international transactions in March 1994, Sri Lanka has been following a gradual liberalisation of capital account transactions, considering the risks associated with full convertibility without adequate safeguards. Sri Lanka has already benefitted in a number of different ways following the measures taken to increase capital flows by way of partially liberalising the capital account. Increased inflows have contributed to expand and strengthen the efficiency and reduce volatility in the foreign exchange and money markets. At the same time, the careful mix of external sector and financial sector reforms have contributed to the sustained rise in foreign exchange reserves and improved the confidence of investors in the Sri Lankan economy.

The country's improved economic fundamentals, strong and resilient domestic financial sector as well as the effective and comprehensive surveillance framework, have provided necessary space for further liberalisation of the capital account. Moreover, the country's strong trade and financial inter-linkages with the regional and global economies and the need to accelerate growth taking into account the new regional and global challenges, makes it necessary to review the remaining controls in order to continue to attract capital flows.

At the same time, necessary checks and balances that facilitate legitimate business should be in place while making effective due diligence possible. For instance, with a view to addressing macroeconomic consequences of large capital flows, some countries have recently used selective capital controls. An implicit tax on capital inflows, which are reversed within less than a year has been imposed to induce a shift from shorter- to longer-term inflows. Therefore, Sri Lanka will also continue to pursue a strategy of further liberalising the capital account to harness the full potential of the Sri Lankan economy while promoting a sound and stable financial system as well as a resilient and competitive economy. This comprehensive approach will be the key towards achieving a balanced and sustainable growth with greater stability.