# MACRO-ECONOMIC CHALLENGE IN MAKING SRI LANKA A FINANCIAL HUB

## By R.M.B Senanayake

### What is a financial hub or a financial center?

There are several financial centers in the world in London, in New York, Tokyo, Hong Kong and Singapore. They must be distinguished from tax havens such as the Bermudas where financial transactions take place because there is no tax and transactions can be done in secrecy. But the International Community is increasingly demanding transparency, of tax havens. So the international financial centers provide low tax regimes but not tax free status for financial concerns which set up office in such centers.

To understand what policy considerations are involved in making a city or country an international financial center let us consider the growth of Singapore as a financial center and compare the situation in Sri Lanka regarding the important factors that helped Singapore to become a financial center. The facts are drawn from the book ***Singapore***: ***A Country Study*** published by the Federal Research Division of the Library of Congress under the Country Studies/ Area Handbook Program sponsored by the Department of the Army.

### Growth of Singapore as a Financial Center

As a result of its strategic location and well-developed infrastructure, Singapore traditionally had been the trade and financial services center for the region with Indonesia on one side and Malaysia on the other. In the 1970s, the Singapore Government identified financial services as a key source of growth and provided incentives for its development. By the 1980s, the focus was on further diversification, upgrading, and automation of financial services. Emphasis was placed on the development of investment portfolio management, securities trading, capital market activities, foreign exchange and futures trading, and promotion of more sophisticated and specialized fee-based activities. The economy was well managed and instead of a Central Bank with the power to create money, a Monetary Authority was set up. The domestic finances were well managed. The external situation was also managed without too much fluctuation in the value of the Singapore dollar. The Singapore dollar was fully convertible although there were some restrictions which were gradually removed. I have drawn upon international journals to trace the progress of Singapore as an international financial center.

Sri Lanka too has certain natural advantages in its situation in relation to South Asia. India and Pakistan are, if not exactly hostile, are not the friendliest nations. There are visa restrictions and exchange control restrictions placed on financial transactions between the subjects of the two countries relative to each other. So if we are a free market center for foreign financial transactions, we could attract international financial transactions between the two countries subjects. But there are Exchange Control regulations in Sri Lanka which do not permit capital account convertibility. The Exchange Control Act still operates, seventy years after the end of World War II. Originally Exchange Controls were introduced under the Defense Regulations but instead of allowing them to lapse the newly established Central Bank passed a law called the Exchange Control Act which is still operative. The Indian, Pakistani and Sri Lankan Rupee all had the same par value at the time in the early 1950s at Rs 5.95 or so. Today the Rupee/US dollar rate is Rs 112-114 while the Indian Rupee is around 40 to the dollar and the Pakistani Rupee Rs 60 to the dollar. This shows the failure on the part of our authorities to manage the external finances. It is essential to have a stable exchange rate tied, perhaps, to one or more of the Reserve currencies of the world. There is a sort of stability in the Rupee now. But it is not the product of market forces but the result of Central Bank operations in the foreign exchange market. What is needed is a free market determined exchange rate. But today, unlike in the past, capital transactions play an important role in the determination of exchange rates. Therefore despite deficits in the trade account with exports falling short of imports and inward remittances from migrant workers being unable to fully offset such balance of trade deficits and the running up of high current account deficits the Rupee tends to appreciate due to short term capital inflows to the stock and bond markets and government borrowings in foreign currency. So the Rupee is strong and stable despite the underlying weakness of the external sector of the country. Singapore however maintains a stable exchange rate as does Hong Kong.

By the mid-1980s, Singapore was the third most important financial center in Asia after Tokyo and Hong Kong. Its financial services sector enjoyed double digit growth over a long period. It soon accounted for some 23 percent of GDP and employed approximately 9 percent of the labor force. In 1985, however, growth in the sector slowed to just 2.6 percent, and in December of that year, the Stock Exchange of Singapore suffered a major crisis, which forced it to close for three days. The domestic economy was also in difficulties and foreigners began to express doubts over the future of Singapore as a financial center. Sri Lanka had a rudimentary form of share trading conducted by the Colombo Brokers Association. It could hardly be called a market for the brokers met across a table and exchanged shares for money with no auction process. In the mid 1980s Sri Lanka established the Colombo Stock Exchange and commenced the open outcry system of share trading. In 1987/88 the JVP insurrection led to a steep fall in the market.

Then came the deregulation and further liberalization of financial markets the world over and the costs of doing business came to matter. There was too much regulation in Singapore relative to other financial centers like Hong Kong or Seoul. This threatened business for Singapore. But the Singapore Government which is well staffed with professionals and run without any sort of political interference, did succeed to remain competitive. The government took steps to correct some of the problems, and by 1989 Singapore's financial service sector could again be described as "booming." Sri Lanka next had a boom in the stock market which ended with a crash in 1991/92.

The financial sector in Singapore included three types of commercial banks (full license, restricted, and offshore), representative offices, merchant banks, discount houses, and finance companies. In 1988 there were 13 local, 64 merchant, and 134 commercial banks. All banks in Singapore were administered by the Monetary Authority of Singapore and were required to hold a statutory minimum cash balance against their deposits and other specified liabilities with the Authority. Sri Lanka too has established banks which were both foreign banks and local banks. There was little competition because of the dominant market positions of the two state owned banks the Bank of Ceylon and the Peoples Bank.

The Development Bank of Singapore was established in 1968 to provide financial services supporting industrialization and general economic development. Owned jointly by the government (49 percent) and private sector shareholders, it had evolved from a long-term financing institution to a multiservice bank. The largest Singaporean commercial bank in terms of assets in 1989, the Development Bank was listed on the stock exchanges of both Singapore and Malaysia. Through its subsidiaries, it also provided specialized financial and insurance services, factoring, stock broking, merchant banking, and venture capital investment management services. The Development Bank was the city-state's largest source of long-term finance, including equity and venture capital financing, medium- and long-term loans, and guarantees. Sri Lanka had Development banks which obtained funds from International Financial institutions like the World Bank and the Asian Development Bank and re-lent to the large corporates as long term finance. Sri Lanka does not have any home grown long term funding institutions. The Sri Lankan banking tradition is short term finance by way of funding foreign trade. Even domestic trade doesn't have financial instruments except the post dated cheque.

The Singapore Foreign Exchange Market had grown remarkably since the 1985 recession. Major currencies—the United States dollar, the Japanese yen, the West German deutsche mark, and the British pound sterling—were actively traded. Volumes in such other currencies as the Australian dollar had risen as well. Average daily turnover was US$45 billion in 1988 compared with US$12.5 billion in 1985. The Sri Lankan foreign exchange market is heavily regulated. The banks are not allowed to hold open foreign exchange positions and are allowed to hold only limited foreign exchange. Trading in foreign exchange is largely confined to proprietary trading by the banks.

Singapore established the Asian dollar market as the Asian equivalent of the Eurodollar market in 1968, when the local branch of the United States-based Bank of America secured government approval to borrow deposits of nonresidents, mainly in foreign currencies, and use them to finance corporate activities in Asia. At the time, expanding economic development in Southeast Asia was rapidly increasing the demand for foreign investment funds, and the desirability of a regional center, able to carry out the necessary middleman function was apparent. Singapore offered the ideal location. The Asian dollar market was essentially an international money and capital market for foreign currencies, and its assets grew from US$30 million in 1968 to US$273 billion in November 1988. To operate in the market, financial institutions were required to obtain approval from the Monetary Authority of Singapore and to set up separate bookkeeping entities called Asian Currency Units for transactions in the market. Funds were obtained mainly from external or nonresident sources—central banks, foreigners seeking a stable location such as Singapore to deposit cash, multinational corporations, and commercial banks outside Singapore.

In 1973, to stimulate the expansion of the Asian dollar market, the Monetary Authority of Singapore established the so-called offshore banking system, designed to concentrate on that market and its foreign exchange operations. Beginning in 1983, funds managed in Singapore on behalf of nonresidents and invested offshore or in the local stock market were exempt from tax. The fees earned for managing such offshore funds were taxed at a concessionary rate of 10 percent.

## The Comparable Conditions in Sri Lanka

Sri Lanka too has an off shore market which lends mainly to BOI companies. Local corporates are not allowed to borrow in foreign currency because the Central Bank thinks it is too risky.

Inaugurated in 1973, the Stock Exchange of Singapore was governed by a committee comprising four elected stockbroker members and five appointed non-broker members. In late 1988, the 327 companies listed on the main board of the exchange were classified into six groups: industrial and commercial, finance, hotel, property, plantation (farming), and mining. The market underwent a major, prolonged reorganization following the December 1985 collapse of a Singaporean company, Pan Electric, which revealed a massive web of forward share dealings based on borrowed money. The collapse resulted in a tighter regulation of the financial futures market and the securities industry. In 1986, the Securities Industry Council was established to advise the minister for finance on all matters relating to the securities industry. The Colombo Stock Exchange is owned by the founder members and it has allowed new members with only the right to trade. The new members are called trading members. So there are two classes of members and the first class only has rights to manage the Exchange. Recently, the Government has approved the demutualization of the Colombo Stock Exchange a step in the right direction.

In 1987, the government of Singapore introduced tax incentives to encourage the trading of international securities in Singapore. The National Association of Securities Dealers (NASDAQ) in the United States and the Stock Exchange of Singapore established a link to facilitate the trading of NASDAQ stocks in Singapore by providing for the exchange of price and trading information on a selected list of NASDAQ stocks between the two exchanges. A move by the Singapore exchange to a new, spacious location in 1988 brought a transformation in trading methodology, including partial automation of the trading system, which, until then had adhered to the traditional outcry auction system.

The Colombo Stock Exchange also switched over to automated trading and gave up the open outcry system of trading shares on the trading floor. Previously, there was a tax incentive for companies to list on the Stock Exchange since listed companies paid a lower tax rate. But this concession was withdrawn by the government. There is a paucity of companies which are listed on the Colombo Stock Exchange, a mere 250 or so. Despite the boom in the stock market and despite evidence of large amounts of money with stock market investors few companies have taken advantage of listing on the Colombo bourse which would enable them at least to raise capital to pay off high cost bank borrowings.

Trading in gold futures originally was undertaken in the Gold Exchange of Singapore, which was established in 1978 and reorganized in 1983. The scope of its activities was widened to include financial futures trading, and it was renamed the Singapore International Monetary Exchange (SIMEX). Starting in 1984, the financial futures market featured a mutual offset arrangement between SIMEX and the Chicago Mercantile Exchange, which allowed contracts executed on one exchange to be offset on the other, without additional transactional cost for market participants. The linkage was the first of its kind in the world and greatly facilitated round-the-clock trading in futures contracts. In 1988, six forms of futures contracts were traded: international gold futures; the Eurodollar time deposit interest rate; the Nikkei Average Stock Index; and three currency exchange rates—US dollar/West German deutsche mark, US dollar/Japanese yen, and US dollar/British pound sterling. Trading volume on the SIMEX had grown steadily.

Sri Lanka earlier liberalized the import of gold realizing the difficulties of monitoring smuggling. Then it imposed taxes on gold imports which dried up the official gold imports. Recently, the taxes on gold imports have been withdrawn and official gold imports through official channels may revive. There seems to be scope for gold refining and cutting gold bars into smaller pieces to sell to the Indians who are large buyers of gold.

The Government Securities Market in Singapore was launched in May 1987, auctioning at market rates taxable Singapore government securities ranging in maturity from three months to five years. Previously, long-term government stock was sold to a captive market of banks, insurance companies, and a few individuals and nonprofit organizations. We have an auction for Treasury Bills and Bonds but the Central Bank does not accept offers to fill the demand but rejects higher offers. The Treasury seems to direct the price at which the Employee's rovident Fund, the National Savings Bank and the Employees Trust Fund quote for the Treasury securities and hence the Central Bank allocates securities to these captive institutions at prices which do not represent market determined interest rates for Treasury bills or Bonds.

## Liberalization of Financing Transactions

The new rules introduced in Singapore allow foreign investors to borrow Singapore dollars to invest in local assets such as bonds, equities and commercial real estate. However, analysts say the policies will have greatest impact on the bond and derivatives markets, where fund managers stand to see the greatest returns. Specific measures include:

- Banks can lend Singapore dollars to non-residents in Singapore and extend Singapore dollar credit to non-residents to fund offshore activities.
- Banks can transact Singapore dollar currency options with other banks and financial institutions in Singapore. However, the MAS is still cautious about not internationalizing the Singapore dollar, as a safeguard against speculative attacks. Specifically:
- Foreigners or non-residents borrowing Singapore dollars to fund offshore activity will still have to swap Singapore dollar proceeds into foreign currency.

## What Constitutes Business in a Financial Center?

By the term financial hub, what is meant is the setting up of an international financial center in Colombo. The advantages of such a financial center are that the country can develop another source of income by providing financial services to foreigners particularly to those in the South Asian region. There are a large number of Indians and Pakistanis abroad who can be attracted to buy financial products in Colombo. But it is unlikely that they would be attracted by the financial products presently offered in the country. They would be interested primarily in financial products of their home countries, India and Pakistan. But this means these financial products should be made available for trading here. There are some essential requirements for setting up an international financial center. The most important need is to have full capital account convertibility. Unless there is free movements of capital permitted both inwards and outwards, for local residents and for foreigners there is no possibility whatsoever for making the country a financial center.

But to make the Rupee fully convertible and to permit full capital account convertibility seems but a distant dream. It requires a stable macro-economic environment which means budget deficits are out. But can a country ever carry on without running up budget deficits? There are structural imbalances in our budget. Government Revenue falls much short of government expenditure. The private business sector is heavily taxed and it will be difficult to attract foreign companies to set up business here if the tax incentives are withdrawn. A financial center does not go along with any form of Exchange Control. Nor does it go along with chronic budget deficits. Not only must the Rupee exchange rate be free to move with market forces but the interest rates too should be free to move according to market forces. Presently both the Rupee exchange rate as well as the short term interest rates are determined and managed by the Central Bank. Accordingly the macro-economic environment is not conducive to making the country a financial center.

A well developed stock market is an essential requirement. Such a stock market will have large companies both local and foreign listed on the local stock exchange. For example, if Indian stocks are listed on the local stock market then expatriate Indians may be attracted to buying shares of Indian companies in Colombo instead of Bombay. In addition to the stock there is the government bond market and the corporate bond markets. Here too it should be possible for foreigners to buy into say Indian government bonds and Indian corporate bonds in Colombo. Consider the financial sophistication required for setting up a financial center. There are a number of financial products that figure in a financial center such as portfolio management, Private Equity

Funds, Hedge Funds and other Investment Funds specializing in equity, foreign exchange and equity products. The business opportunities have to be created. They will not arise spontaneously. An efficient banking system and an equally efficient, well capitalized stock brokering system should be in place before foreigners will come in to park their money here. Private Banks are non-existent here. The target group of investors will have to be the expatriate Indians, Pakistanis and other South Asians. Foreign capital market players will open offices here if there are no controls over their doing business here. Do we allow foreign business firms to do business freely in Colombo? Won't they have to obtain half a dozen approvals? Can they even open banks account freely here? Only savings accounts can be opened freely by foreigners and foreign firms.

The Singapore government also realized the value of making Singapore a financial center for marine insurance. China is a large player in international trade. But those who make marine insurance claims under Chinese policies are in for a rude shock. Their interpretations of the Institute Cargo Clauses is often different. In these circumstances, Singapore realized the advantage of making it a center for marine insurance. The Monetary Authority of Singapore has awarded three insurance companies with the Approved Marine Insurer (AMI) status, which entitles them to generous tax breaks and other benefits. Gerling Global Re, HSBC Insurance (Asia) and Swiss Re are the first batch of companies to be granted the new AMI status. The MAS introduced the new scheme as part of its plans to develop Singapore as a marine insurance centre for Asian business. MAS' Executive Director of Insurance, said: "The AMI scheme provides experienced marine insurers with the relevant expertise, an added incentive to grow their business focus here, and contribute to developing the level of marine hull and liability underwriting capabilities in Singapore."

"The newly launched Tax Exemption Scheme for Offshore Marine Hull and Liability Insurance Business aims to reward companies making additional commitments in Singapore. It is available to all general and direct insurance and reinsurance companies making these commitments to writing offshore marine hull and liability insurance business from Singapore. Companies that qualify for the scheme are exempted from tax on underwriting profits, as well as certain income derived from investing premium income and shareholders' funds in relation to marine insurance business."

Russia has been planning to make Moscow an international financial center. Recently the Russian President Dmitry Medvedev said he considered it crucial to attract foreign experts and foreign companies with experience in such projects.

Medvedev also said it was necessary to establish normal and favorable conditions for capital and the relevant tax and customs facilities, to ensure effective judicial protection of property rights, to use modern models of risk insurance, and to create the necessary infrastructure.

Another macro-economic factor that has a bearing on the issue of setting up a financial center is the cost of doing business here. We are way down in the World Bank index regarding the convenience of setting up business and the prevalence of a friendly atmosphere for foreign business here. The JVP in particular and the Sinhala nationalist elements subscribe to a form of mercantilism. They do not like foreigners to buy land here and the government imposed a 100% tax on foreigners buying land in Sri Lanka. There are also the Labor Laws particularly the Termination of Employment law which prevents a firm from retrenching staff without seeking government approval. Such approval takes months to obtain and in any case involves the payment of compensation or severance pay which is too high. These labor laws will discourage the setting up of foreign financial firms here and without them there is no possibility of developing a financial center. There is also the high inflation which prevails here. Inflation has come down to single digit but will it be possible to maintain the current low inflation? The lower inflation is a byproduct of the global financial meltdown and the recession of 2008 and 2009. Sooner or later the world economy will recover and with it both oil prices and food prices will rise. The deficit financing policies of the Government, backed by the creation of excess liquidity through the Central Bank purchases of foreign exchange and the funding of budget deficits through commercial bank borrowing are all in the direction of higher inflation in the not too distant future. The costs of doing business will then rise here relative to other financial centers. Foreign firms will not be attracted to a new budding financial center if there are no cost advantages in setting up business here. Our land prices in the City are high already. If higher inflation returns and if the economy continues to be driven by government infrastructure investment and budget deficits, then asset price bubbles are likely in the property market. Foreigners who wish to set up here would have to pay high prices for their business offices here. As a new financial center we will have to be competitive to succeed. It is true that Colombo has modern facilities available and that foreigners taking up residence can maintain unchanged the living standards they are used to. So expatriate staff and families may feel comfortable here. Yet we cannot offer the same attractive standard of living as Singapore. We need to attract foreign expertise in the field of investment management. They should be free to reside here without hassle. Do we have such an environment? The traffic jams in the City make it difficult to reach destinations in time. Often roads are closed without any notice to provide security for VVIPs. But how can the fast moving financial business be carried out in such an environment. Our telecommunications services are vastly improved. Real time information services are critical for financial business. We need to improve our broad band Internet Services and generally make our telecommunications more efficient. Although our telecommunication sector is reasonably efficient yet there are power failures and these take too long to restore. Can we say that Colombo is an efficient place to do business? We have to ask this question from foreigners who do business here. My feeling is that we are very backward with regard to modern business operations. See how long it takes for outstation cheques to be cleared. There are several days in the year when we are closed. We probably have the highest number of holidays in the world. The midweek 'Poya' holiday disrupts the momentum of work and also causes absenteeism among the staff. Very soon we will also have excessive air pollution in the City of Colombo. Consider also the failure to keep the streets clean. Garbage accumulates by the roadsides and with the rains come the threat of dengue and other infectious diseases. These are not incentives for foreigners to live here.

The question that really requires an answer is whether we will ever be able to follow the principles of prudent fiscal policy. This requires following the provisions of the Fiscal Management

(Responsibility) Act of 2003. It requires the budget deficit to be brought down to 5% of the Gross Domestic Product and the outstanding public debt to be bought down to 60% (in the transitional period up to 2015 the ceiling is 85%). The interest payments on foreign debt which was US$ 249 million in 2004 doubled to US$ 441 million in 2008 a mere four years. If we consider the total debt service payments including the amortization or repayment of debt then the figure for 2004 was US$ 484 million and in 2007 it was US$ 813 million (Central Bank of Sri Lanka Table on External Debt Service Payments.) The government will need to borrow more and more so that the inward flow of foreign exchange is sufficient to cover the debt servicing costs. If we do not get sufficient foreign funds by way of borrowing through government bonds, inflows to the stock market or by way of foreign direct investment there will be a reverse flow of foreign exchange on capital account. We would then have to depend on net exports and foreign inward remittances from the migrant workers to fund the debt servicing shortfall. These items would have to grow as fast as the debt servicing charge.

Let us consider the position of debt servicing in the government budget now. The total Interest payments on both domestic Rupee denominated debt and foreign currency debt was Rs 182 billion in 2007 and in 2009 the estimate was Rs 250 billion. About 40% of the Government Revenue is absorbed in debt servicing. Debt servicing charge is Growing at a Rate of growth which is higher than the rate of growth of Government Revenue. This is an unsustainable situation and government revenue growth will have to be increased to at least the rate of growth of the debt. Otherwise the ratio of Income to Debt will fall and make it more and more difficult for the government to service its debt. Prior to the 1980s the practice was to provide for Sinking Funds which were voted each year in the budget to provide for debt repayment. Now the government has to depend entirely on rolling over the debt. In the case of the domestic debt this is not a problem if the money is borrowed from the public's savings. But the interest rate will have to increase if the government were to borrow entirely from the public. What the government has been doing is to provide a significant amount of funds for the budget from the banking. The borrowings from the banking system are the equivalent of printing money. This includes not only the borrowings from the Central Bank but also borrowings from the commercial banks. As long as the Central Bank increases the Reserve Money the commercial banks have no problem subscribing to Treasury securities. Banks can create money for each time it lends money to a borrower it increases bank deposits either in its own bank or in other banks. So the banks together can create money up to the inverse of the Statutory Reserve Ratio. Of course they can go up to that maximum only if there are willing borrowers. But there is a perpetual willing borrower in the Treasury. So the banking system can create money. It is not only the Central Bank that can create money, for the commercial banks too can do so. But that would mean an excessive growth of money which will increase the rate of inflation after a time lag of about 9-12 months. The Central Bank likes to keep interest rates low ostensibly to help private business sector but really to help the Treasury to keep its interest bill low. So the Central bank recently upped the monetary target for broad money. There is the belief that the growth of the economy requires growth of the money supply. But there are periods of history where there was economic growth but with very little increase in money supply. Our economic growth rate in real terms is 67%. Do we need a 20% growth in money? What happens to the excess money created? It goes to increase the level of prices. Excessive growth of money supply produces inflation which after a point develops its own momentum. "How valid is the proposition that a growing economy requires a growing money supply."The real reason why central bankers increase the money supply apart from the need to support the Treasury is that bankers and businessmen in general fear deflation. Central Bankers regard deflation as the great devil they <u>must fight at any cost</u>, because deflation emphatically *is* a threat to those institutions responsible for inflationary increases in the money supply: fractional-reserve banks and their customers, which means "debt-ridden governments, entrepreneurs, and consumers." Deflation tends to liberate "the underlying physical resources for new employment. The destruction entailed by deflation is therefore often 'creative destruction' in the Schumpeterian sense." (William Greider noted that bankers championed "creative destruction" when it was affecting other people, but when it came knocking on their doors, the bankers were "not so accepting of their own fate.")

But this is another instance of putting the fox in charge of the chicken coop; the result has been a complete disaster. In the modern era, managed currencies everywhere have depreciated and fluctuated as never before in the history of monetary institutions. Unless the Central Bank is guaranteed its independence and the appointment of the Governor is removed from the sole discretion of the President and unless the holder of the post is of an independent frame of mind, it is difficult to ever visualize prudent monetary management of the economy. There is also the problem posed by the presence of the Treasury Secretary on the Monetary Board. This is prohibited in the U.S Federal Reserve System. So both the institutional conditions as well as the acceptance of fiscal prudence are problematic. In these circumstances to expect to make Sri Lanka a financial hub, I feel is more than a challenge.