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GLOBALISATION AND SRI LANKA: THE ECONOMIC IMPACT*

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Abstract: Globalisation is the global integration of product and factor markets. International experience shows that countries that yielded to the process of globalisation well in advance have reaped large benefits, mainly by allowing access to the global consumer base. It benefits smaller countries more, as those countries can gain from economies of scale in production facilitated by access to large markets. It allows countries to identify inefficient economic activities, and replace them with productive activities. However, to reap full benefits of globalisation and to avoid harmful effects, a country should implement a wide range of regulatory and supervisory measures. Those are, financial sector regulation and supervision, anti-trust legislation and other internationally recognised measures such as action against money laundering. At the same time, excessive resistance to the process of globalisation may marginalise countries, yielding more serious repercussions. Countries should be mindful of the fact that there are other more important factors affecting economic growth such as technological development, human capital accumulation, enhancing law and order, enhancing democracy and mechanisms to counter negative externalities arising from individual selfish actions.

"As it is the power of exchanging that gives occasion to the division of labour, so the extent of this division must always be limited by the extent of that power, or, in other words, by the extent of the market. When the market is very small, no person can have any encouragement to dedicate himself entirely to one employment, for want of the power to exchange all that surplus part of the produce of his own labour, which is over and above his own consumption, for such parts of the produce of other men's labour as he has occasion for".

(Adam Smith, 1776)

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** Although the author is attached to the Economic Research Department of the Central Bank of Sri Lanka (see inside back cover), the views expressed in this paper are his own and do not necessarily represent those of the Central Bank of Sri Lanka.

Introduction

Globalisation is the international integration of product and factor markets. The process of globalisation began a long time ago, since the international movement of goods and persons became feasible. The process was facilitated by the philosophical inputs of various economists, thrust by international institutions and revolutionary developments in information technology. The seminal work of classical economists such as Adam Smith and David Ricardo on the absolute and comparative advantage of nations, fuelled the process of globalisation. The General Agreement on Tariff and Trade (GATT) and the World Trade Organization (WTO) helped the process grow faster through efforts on bringing down border tariff and other barriers on the movement of goods and services and establishing the rule based system on trade.

The success generated by many economies as a result of allowing foreign investment, encouraged the rest of the world to relax their restrictions on international capital mobility. To attract international capital, financial markets were developed in many countries with greater flexibility. The intense competition and the high profits of innovation encouraged firms in developed countries to hire skilled workers from any country in the world. Global financial investors have made use of liberal policies on capital mobility and have begun shifting funds from country to country, seeking the highest return. The advances in information technology have helped disseminate information through the electronic media without national boundaries, thus further enhancing the trade, capital and labour flows.

Process of Globalisation

Curiosity of human beings is at the centre of the process of globalisation. The inherent curiosity to inquire into new ways of doing things and the urge to learn about other countries and nations have led to inventing ways of communication and transportation. Thus, the process of globalisation began with the dawn of civilization.

The new inventions have had a remarkable impact on transportation and communication as shown in Figures 1-3. The information technology applications have become cheaper, paving the way for different countries to be integrated at very low costs. The development of low cost technology has been endogenous, thus the process of globalisation is autonomous.

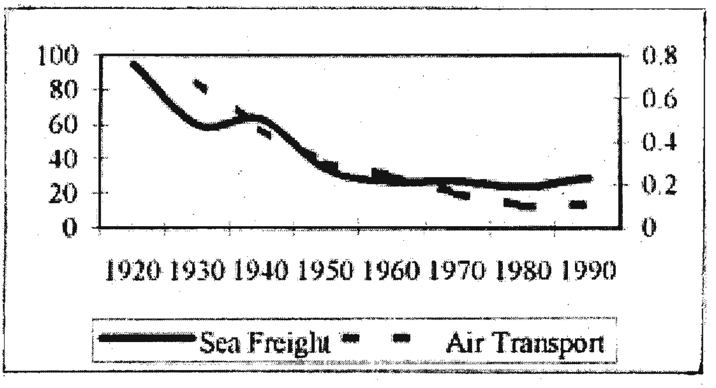

Figure 1: Transportation Cost

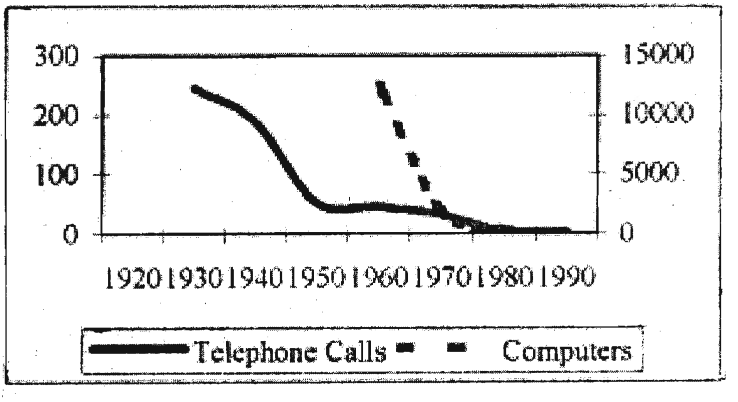

Figure 2: Cost of Telecommunication and Computers (US $)

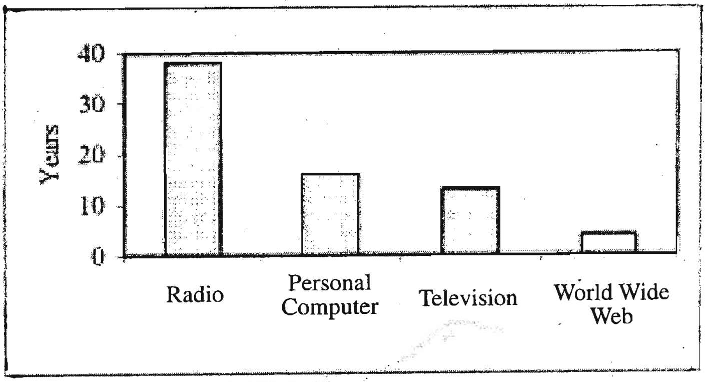

Figure 3: Technology Acquisition

Source: World Bank

Globalisation of Sri Lanka

Sri Lanka has made significant progress in integration into the goods market, but has not shown sufficient progress in factor market integration.

Goods Market Integration

Sri Lanka too has been a trading post since era of ancient kings. Many foreign traders have visited Sri Lanka in search of new goods and to exchange their goods for Sri Lankan goods. Greed and superior war power had made Sri Lanka a colony of the Europeans. During the colonial era, the country was integrated with the rest of the world.

After independence, Sri Lanka was from time to time governed by political leaders who believed in 'self sufficiency', a notion that contrasts with the notion of comparative and absolute advantage explained in the theory of international trade. If a nation produces all the goods and services needed, it is undoubtedly producing some goods which are not efficiently produced. Such production imposes a large opportunity cost on a country's resources, and it affects both domestic and global welfare.

The economic policy change of 1977 brought in several fundamental changes to the economy. The policies supporting 'self sufficiency' were affected due to the liberalisation of the economy. The consumer and producer choice was for imported consumer goods and production inputs, thereby causing a heavy damage to domestic industries that were surviving under import barriers. The two decades since 1977 have sharpened Sri Lanka's export competitiveness. Trade liberalisation was culminated in Sri Lanka accepting Article VIII of the IMF in March 1994. Sri Lanka has evidenced sharp increases in export earnings as well as import expenditure during the past two decades as seen in Table 1. The weighted average tariff rate has been falling as shown in Table 1.

Table 1: Sri Lanka's Exports, Imports and Average Tariff

Year	Exports US $mn	Imports US $mn	Weighted Average Tariff Rates
1975	563	767	-
1977	767	726	-
1980	1065	2051	-
1985	1315	2044	-
1990	1984	2686	-
1995	3807	5311	9.7
1996	4095	5439	8.5
1997	4639	5864	7.7
1998	4798	5890	7.4
1999	4610	5980	7.0
2000	5522	7320	4.5

Source: Central Bank of Sri Lanka

Although the policy shift in 1977 favoured integration into the goods market, it did not address the integration of factor markets: capital and labour.

Table 2: Capital Account Restrictions and Per Capita Income

Restrictions and Per Capita Income	India	Sri Lanka	South Korea	Singapore	USA	Switzerland
Restrictions on						
Capital market securities	yes	yes	yes	yes	yes	-
Money market securities	yes	yes	yes	-	yes	-
Collective investment securities	yes	yes	yes	-	yes	-
Derivatives and other instruments	yes	yes	yes	yes	-	-
Commercial credit	yes	yes	yes	-	-	-
Financial credit	yes	yes	yes	-	-	-
Guarantees, sureties, and financial backup facilities	yes	yes	yes	-	-	-
Direct investment	yes	yes	yes	-	yes	-
Liquidation of direct investment	yes	yes	yes	-	-	-
Real estate transactions	yes	yes	yes	yes	-	yes
Personal capital movements	yes	yes	yes	-	-	-
Per Capita Income $ (1999)	450	820	8,490	29,610	30,600	38,350

Source: IMF (1999) and World Bank (2000/2001)

Capital Market Integration

Capital market integration in Sri Lanka has been limited by the concerns on foreign exchange availability. The capital account remains significantly closed even after the liberalisation of the economy in 1977. According to the IMF (2000) Sri Lanka maintains restrictions on a broad spectrum of capital transactions as illustrated in Table 2.

Labour Market Integration

Countries around the world have shown resistance to labour market integration, purely for non-economic reasons. However, high quality human capital is being tapped by countries for economic gains. Under the liberalisation efforts of the WTO, professional services are earmarked for further liberalisation.

Impact of Globalisation

Globalisation could bring in benefits to a country primarily in three major ways. Firstly, it can offer access to a large market. Secondly, it can intensify competition. Thirdly, it facilitates technology and knowledge spillovers to countries. A large market could enhance the degree of product specialisation by a country as explained by Adam Smith (1776). Even a small country like Singapore could reach high per capita income as globalisation has enabled it to overcome the constraint of a small domestic market. Globalisation eliminates domestic protection and intensifies competition. Governments will not be able to grant protection through tariff or subsidies in the face of falling production, transportation and telecommunication costs. Thus, countries will have to enhance macroeconomic as well as firm level competitiveness.

Competition also helps countries through the process of "creative destruction" where old firms are replaced by new firms as the economy discards old goods and services in favour of new goods and services. In the history of technological innovations, for example, the "slide-rule" industry was replaced by the "calculator" industry in the seventies, and the 'vacuum tube' industry was replaced by the 'transistor' industry.

If the old industry were given any protection, it would have hindered the new industry as well as all the other industries which are interdependent.

The final outcome of globalisation is increased per capita income and lower inflation in countries. Econometric studies show a positive relationship between the openness of a country and its per capita income, and a negative correlation between a country's openness and inflation rate as explained in Appendix 1 and Figures A1 and A2.[1]

Globalisation also provides a series of indirect benefits to a country. The need to be competitive enhances efficiency in many facets as explained by the Central Bank (2000). It also forces a country to enhance the quality of education and build up human capital. Furthermore, the increased integration with the rest of the world forces a country to be transparent in its policies as well as maintain credibility and accountability.[2]

International Reaction

Some view globalisation as an unfriendly and unhealthy development both in developing and developed countries. In many international fora, developing country groupings such as G-15, G-24 and G-77 have expressed their concern over the negative impact of globalisation and marginalization of developing countries.

Since the exposition made by Adam Smith in the eighteenth century, the world has benefited from international trade. The mercantilist ideas of saving precious gold by restricting imports have caused a reduction in welfare in individual countries as well as the world as a whole.[3] However, even in the most democratic and free market oriented countries, protection occurs and disturbs the global economic growth. Examples are the heavy protection in rice farming in Japan and agriculture in the USA and the European Community.

Many countries have resorted to imposing selective tariff and non-tariff barriers, as well as imposing WTO permitted indirect controls to discourage international trade. Such controls come in the form of safeguard measures, technical specifications and anti-dumping measures.

Alan Greenspan (2001) explains that 'the campaign to expand free trade is never won.[4] It is a continuing battle. Though tariffs in industrial countries have come down sharply over the past half-century, other barriers have become more prevalent. Administrative protection in the form of antidumping suits and countervailing duties is a case in point. These forms of protection have often been imposed under the label of promoting "fair trade," but oftentimes they are just simple guises for inhibiting competition. Typically, antidumping duties are levied when foreign average prices are below the average cost of production. But that also describes a practice that often emerges as a wholly appropriate response to a softening in demand. It is the rare case that prices fall below marginal cost, which would be a more relevant standard. In the view of many economists, antidumping initiatives should be reserved for those cases in which anticompetitive behaviour is involved. Contrary to popular notions about antidumping suits, under U.S. law, there is no requirement to show evidence of predatory behaviour, or of intention to monopolize, or of any other intentional efforts to drive competitors out of business.'

Greenspan (2001) further states that 'in the end, economic progress clearly rests on competition. It would be a great tragedy were we to stop the wheels of progress because of an incapacity to assist the victims of progress. Protectionism will also slow the inevitable transition of the workforce to more productive endeavours. To be sure, an added few years may enable some workers to reach retirement with dignity, but it will also keep frozen in place younger workers whose opportunities to secure jobs with better long-run prospects diminish with time.'

Strategies

In developing strategies we should be mindful of several facts. The fundamental fact is that globalisation is an unstoppable process, as it is a natural development of human efforts in finding ways and means of overcoming the barriers imposed by 'distance'. Countries that oppose globalisation, or countries that do not have the conducive environment will be ousted from the process and will be marginalised. As Greenspan (2001) noted, the globalisation process may generate 'victims of the progress'.

A country should develop competitiveness along the lines discussed by authors such as Porter (1994) and outlined by the Central Bank (2000). A country should develop its macroeconomic and microeconomic competitiveness to be able to integrate seamlessly into the process of globalisation.

Sri Lanka could use the negotiating opportunities available at international fora such as the WTO. The liberalisation of the services sector (GATS - General Agreement on Trade in Services) under the WTO requests countries to liberalise professional services. As Sri Lanka is endowed with skilled labour a mechanism to utilise this comparative advantage may be pursued.

Efforts should also be directed at job skills enhancement and retraining – a process in which the private market is already engaged – and, if necessary, selected income maintenance programmes for those over a certain age, where retraining is a problem. Thwarting competition, by placing barriers on imports, will prevent markets in all nations from deploying capital to their most productive uses, that is, the most cost-effective production of those goods and services most highly valued by consumers.

Beyond Globalisation

As many growth economists such as Solow (1956), Lucas (1988) and Romer (1986), have illustrated, growth arises from technological improvements and development in human capital and knowledge. Globalisation could help raise the economic growth of a country to the extent that the country is receptive to change and is willing to adopt measures needed to raise its economic growth. According to illustrations by Barro (1997), many economies do not grow, due to factors other than globalisation (or the lack of it). Those factors are mainly, lack of law and order, low level of democracy, high inflation, excessive government consumption and low levels of human capital.

Countries also suffer from externalities arising from efforts of individual utility maximisation (as illustrated in the tragedy of the commons). External effects are prominent in the third world, where a sophisticated mechanism design is not available to internalise costs arising from such effects. The third world also suffers from the lack of a critical mass of human capital that is needed to generate a positive growth effect.

The Tragedy of the Commons

As Gibbons (1992) explains, since at least Hume (1739), political philosophers and economists have understood that if citizens respond only to private incentives, public goods will be under-provided and public resources over-utilized.[5] An illustration using Hardin (1968) shows that if common grazing lands are opened to farmers, cattle could have a healthy growth, and grazing land is not badly affected if only a few cattle are sent for grazing.

Similar to the tragedy of the commons, is the fact that each private decision or government decision (or failure to make such decisions) imposes large external impacts, both positive and negative, on economies. If a country does not have a mechanism to internalise those external costs, the country will face growth retardation.

Lack of a Critical Mass of Human Capital

A critical mass of human capital is needed to generate a catalytic effect. Poorer countries have witnessed brain drain, or physical movement of human capital to destinations where the critical mass exists (Thenuwara, 1997). In such an environment a rich country will continue to grow richer, whereas the third world will remain entrapped in the low growth cycle.

Notes

1 Econometric study was conducted using the data published in the IMF (2000).

2 This refers to the enhanced transparency, credibility and accountability in corporate governance.

3 Thenuwara (1997)

4 Alan Greenspan is the Chairman of the US Federal Reserve Board, the central bank responsible for US monetary policy.

5 Hume, D., 1739, Gibbons, Robert, 1992

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Appendix 1

Econometric Results of Openness, Per Capita Income and Inflation

In this study, capital restrictions on over 125 countries were examined in relation to the per capita income and inflation rate. The list of restrictions are as follows:

1 Capital market securities
2 Money market securities
3 Collective investment securities
4 Derivatives and other instruments
5 Commercial credit
6 Financial credit
7 Guarantees, sureties, and financial back-up facilities
8 Direct investment
9 Liquidation of direct investment
10 Real Estate transactions
11 Personal capital movements

Different countries impose different numbers of restrictions. The average inflation rate during 1988-1997 and per capita income during this period were regressed against the number of capital account restrictions. Results are summarised in Table A1 and Figures A1 and A2. Sources of data are IMF (1999) and World Bank (1999).

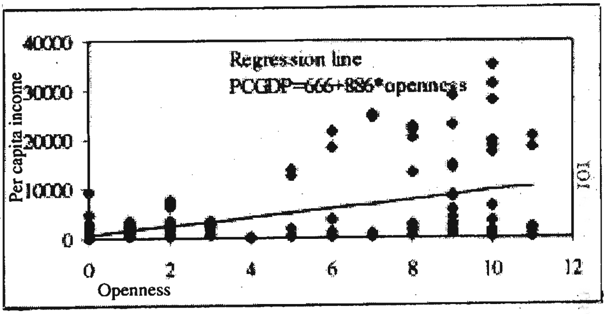

Figure A1: Behaviour of Capital Account Openness and Per Capita Income

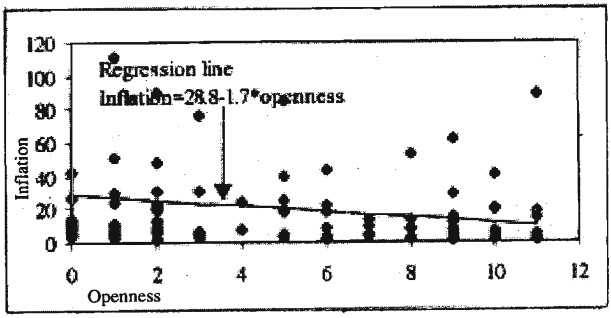

Figure A2: Behaviour of Capital Account Openness and Inflation