Inspiration

Inaugural Speech

Globalisation and Financialisation: Implications for Developing Countries

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The concept of concentration and centralization of production in Marx's *Capital* was further developed by Baran and Sweezy in their *Monopoly Capital*, in which they described advanced capitalism as an economic and social order dominated by giant, monopolistic (or oligopolistic) corporations. Surplus (value) could be expected to rise in this system as genuine price competition is avoided, together with continually rising productivity. But chronic lack of effective demand became the main economic constraint at this monopoly stage of capitalist development. Expected profits on new investments, under conditions of low effective demand turned out to be weak, and corporations tended to refrain from carrying out new investments. With the presence of idle plant and equipment business would be deterred from investing in still more capacity. As real wages were rising less than productivity wage-based consumption too would be chronically weak relative to society's capacity to produce. Under monopoly capital the long-term growth trend would therefore, be sluggish, characterized by a wide, and even widening, underemployment gap. The normal state of the economy at monopoly capital stage, Baran and Sweezy argued, was stagnation or an underlying trend of slow growth. Economic stagnation, in this sense, was not meant technological or consumer-product stagnation. Continuing development of production technology only increased the productive potential of the system, intensifying its over-accumulation tendency.

In the first half of the 1970s capitalism fell into a crisis of inflation combined with stagnation. This situation was called one of stagflation – a term newly coined and added to the language during this period. As inflation was interpreted as the real culprit, there were attempts at economic restructuring aimed basically at keeping inflation under control. This is what systems of thinking called monetarism, supply-side economics, neo-liberalism and so on focussed on. The Age of Hayek replaced the Age of Keynes. Using debt as leverage, a period of neoliberal globalization was ushered in over the third world as well. As Sweezy argued in 1997 there were important underlying trends in the history of capitalism since the mid-1970s: (1) the slowing down of the overall rate of growth; (2) the worldwide proliferation of monopolistic (or oligopolistic) multinational corporations; (3) the financialisation of the capital accumulation process and (4) globalization as a phenomenon, reflecting the new transformation of imperialism.

Financialisation.as a term came up in political economy discourse, as mentioned, in the mid-1990s but became more widely used since the onset of the global financial crisis in 2007. It has its roots primarily in heterodox economics and Marxist political economy, but is being adopted also by the orthodoxy. The idea of dominance of finance capital in mature stages of capitalist development is found in earlier writings. In its broadest sense financialisation refers to the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the global economy and domestic and international activities of individual economies.

There are several ways in which financialisation can be understood. First, it refers to the astonishing expansion and proliferation of financial markets over the past thirty years, during which the ratio of global financial assets to global GDP has been estimated to have risen three times, from 1.5 to 4.5. Second, financialisation has been associated with the expansion of speculative assets at the expense of mobilising and allocating resources for investment in real activity. Third, financialisation has been understood as both the expansion and the proliferation of a bewildering range of seemingly infinite supply of exotic and opaque financial instruments and services – futures, options, derivatives and so on. Fourth, at a systemic level, financialisation involves the dominance of finance over industry – the shift in the centre of gravity of the capitalist economy from production to finance. Profits of financial companies in the US are estimated to have jumped from below 5 per cent of total corporate profits after tax in 1982 to 41 per cent in 2007.

Corporations and wealthy investors have surpluses at their disposal. In order to preserve and expand this money capital in the face of declining investment opportunities in the real economy, it is poured into speculation using a variety of assets. Financial institutions facilitated this through creation of needed financial instruments. This “casino economy” continued over decades, interrupted by credit crunches, and central banks intervening at these times of crisis as lenders of last resort. The more the central banks were effective at preventing the financial system from collapsing, the more they set things up for bigger crises down the line.

Even non-financial corporations have been caught up in the process of financialisation. They have come to be increasingly valued on the basis of the performance of their shares on financial markets rather than on productive criteria. These companies have started deriving greater profitability from their financial, as opposed to their productive, activities. This is reflective of a shift in corporate governance and restructuring in the US, UK and parts of Europe in the 1980s and 1990s to what has become known as the ‘shareholder value movement'. The idea is that, left to the manager, resources may be inefficiently allocated or guided by motives of personal advancement. Companies should therefore ‘maximise shareholder value’ since a higher return to shareholders represents a manifestation of greater efficiency in allocation of resources. In addition,

managers' interests should be aligned with those of shareholders by the latter being remunerated through share and stock options. A shift in firms' decisions on capital allocation from a principle of 'retain and invest' to 'downsize and distribute' has also been noted. These developments have come with lower rates of investment by firms and, at the same time, with higher debt ratios of firms. In other words, firms often have taken out loans to buy back shares to increase shareholder value. All this produced an increased short-termism in the management of even non-financial corporations.

Financialisation however, could not alter the underlying problem of stagnation within production. Growth of finance relative to the real economy led to financial bubbles that threatened to burst. If these became too big, they could overwhelm central banks and the treasury departments producing serious debt deflation – a concept developed by Irvin Fisher as long ago as 1933 to develop an explanation of depressions.

Financialisation is about the appropriation of surplus, accelerating the concentration of wealth in the hands of what is now popularly known as 'the one percent'. As Ben Fine argued on the basis of a review of critical literature, financialisation widens its influence, both directly and indirectly, to cover both economic and social policy. It places more aspects of economic and social life at the risk of volatility from financial instability.

The processes involved in financialisation have their corresponding impacts on developing countries, thus adversely influencing their prospects for real sustainable development. The main purpose of this talk is to raise some of the more important elements in the influence of financialisation on developing countries.

Stagnation and financialisation at the centre of the capitalist world economy are structurally related to new openings for export-driven industrialization in the low-wage periphery. This allowed some degree of industrialization in the periphery – export oriented industry at lower levels in the global value chain of certain products (e.g. clothing). But the long term impacts of these export-oriented industrialisation episodes in developing countries after the 1970s have not been very promising in terms of sustainability. The available empirical research on this is limited. But some analysts use this limited evidence to argue that, contrary to what globalisation protagonists predicted, financialisation tendencies appear not to be permitting those developing countries which commenced export oriented industry at lower levels in the value chain to gradually engage in up-stream (higher value added) activities of the value chain. These countries are therefore not moving on to a level of sustainable industrial and economic development (as NICs in East Asia did in the 1960s and 1970s). Such upgrading prospects have all but disappeared in the process of financialisation of global capitalism. This happened through structural changes that have taken place in the strategies of lead

firms in the capitalist centres of the world which coordinate and control supply chains and suppliers in developing countries.

Increased concentration of lead firms in value chains (e.g. coffee and clothing) that are open to developing countries has led to a growing asymmetry in power between buyers in the centre and sellers in the periphery. This has allowed for the shift in the distribution of income/value-added from developing country producers towards lead firms. Women working in the clothing industry have been disproportionately affected as a result of more stringent demands of buyers (both in terms of price and flexibility). This has spurred the reconfiguration of subcontracting into more tenuous and arms-length relations and more precarious labour contracts. In the case of coffee, financialisation has meant more volatile prices for coffee and weakened bargaining power for coffee producers and marketing firms in producing countries. This was exacerbated by the dismantling of the national coffee marketing boards as part of structural adjustment policies (in Uganda). Faced with more volatile prices, local middlemen have little alternative but to buy as low as possible from the farmer in order to buffer against sudden falls in the world price. This means that farmers receive a low farm-gate price regardless of whether world markets are going up or not.

In the wake of the global financial crisis, it has become evident that countries and regions that have avoided the worst effects have been those which have shielded themselves from the processes of financialisation, and where a strong manufacturing base has been developed and maintained (China and Germany being prime examples). But in the period after the 1980s the bulk of the developing countries did not succeed in achieving such levels of sustainable industrialisation except for a few large countries like Brazil, China and India. But monopolistic organisations in the spheres of finance, technology, communications, strategic natural resources and military power continue to hold onto the reins of power in the global economy keeping the developing world under their economic control.

There are certain international dimensions of financialisation showing its impacts on developing economies. International financial liberalization was promoted on the promise of generating (foreign) investment-based growth. Financial globalization, it was argued, would allow capital to be allocated to its most efficient use. In particular it would benefit developing countries. These ideas were behind IMF programmes of neo-liberalism imposed on developing countries. However, financial globalization has failed to live up to expectations as on average, capital has been flowing ‘uphill’, i.e. from poor to rich countries.

The liberalization of international capital flows has led also to increased volatility of exchange rates, often culminating in violent exchange rate crises. Financial globalization and liberalization seems to have led, also to long-lasting international

imbalances. As a consequence of financial globalisation, exchange rate movements are increasingly determined by capital flows rather than by economic fundamentals such as current account positions. Indeed episodes of massive capital inflows followed by sudden and sharp capital flow reversals – swings of capital inflows ('capital flow bonanza') followed by capital flow reversals – resulting in exchange rate crises have been a common feature particularly in emerging and developing countries.

At the same time, the whole era of neoliberal financialisation has been tied to the third world debt crisis, leading to new financial dependencies. Even China and India, despite their huge economic advances, have not been able to break out of the imperial systems of foreign exchange and financial control, which leave them often passively responding to initiatives determined primarily within "the triad" of the United States, Europe, and Japan. Emerging economies are now massive dollar creditors, yet the U.S. economy lies outside their control and continues to dictate the terms, reinforcing their reliance on exports and external outlets as safe havens for their surplus from exports. Financialisation, with its attendant problems, is growing apace in Asia as well.

Financialisation also has had profound effects on income distribution through the following channels: (a) rise in 'rentier income', i.e. interest and dividend income as well as capital gains; (b) rise of incomes in the financial sector, most notably in the form of bonuses; (c) shifting of the power balance between capital and labour leading to a decline in wage shares. The adverse impacts growing relative inequalities create on social and political stability and peace do not augur well for sustainable development of these countries.

Keynote Address

The Global Economic Outlook and Challenges to Developing Countries

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Introduction

Thank you, Professor Sirimal Abeyratne, for inviting me to address this Sri Lanka Economic Research Conference 2012, the first of a series of this kind. When Professor Abeyratne and Dr. Gunaruwan met me in this regard, I explained to both of them that I am not the best person to deliver this inaugural lecture as I am no longer in the field of economic research. Nevertheless, they thought I should come and their power of persuasion made me to accept the invitation.

This is a timely event on a timely subject as the global economy reminds us of the depression of 1930, a scale of despair we have only seen in textbooks. This gathering is a result of a commendable initiative by the Sri Lanka Forum of University Economists as it mobilises professionals in economics in our State universities to engage in a greater dialogue and research at a time the Government has offered a range of incentives to research activities in the whole economy, and special allowances for those in the public service and particularly the academic staff of State universities to deepen their engagement in research. As you know, although there was some resistance at the beginning to tie up the research allowance with tangible outcomes, it is a great encouragement that the incentive structure has now been accepted by all in our university system. We have seen both, a significant enthusiasm on research and also the desire to undertake scientific research in many fields of timely relevance such as productivity improvement, resource management, prevention of communicable and non-communicable health risks, clinical trials, energy and water management, intelligence etc., that will improve the competitive edge of our economy. Analytical work with critical examination of data, revisiting theories, analysing development models and cross-sectional experiences and coming up with alternative models, are unavoidable avenues of research in economics and social sciences that are essential elements for the upliftment of social and economic development particularly when conventional wisdom of globalisation provides no light in the present context having threatened sustainability and confronted risks for employment creation, income growth and price stability. You have chosen therefore a timely subject as concerned economists to broaden knowledge and make your professional contribution to the society. This Conference will enable all of you to publish your work, deliberate research findings and share them with the public and policy makers. Therefore, I must place on record my

sincere appreciation for all efforts made by Professor Abeyratne as Chairman of the SLFUE and Dr. Gunaruwan as its Coordinator, by giving leadership to make this 2012 - Research Conference, a success.

As you all know, I am not anymore a researcher. I am performing my responsibilities in the Government subject to many pressures stemming from politics, Trade Unions, vested interests, the governance framework, competing claims for limited resources, institutional rigidities, family concerns and my own values in life.

In that sense, I am of course a good text book economist, as economics is all about maximising "utility" subject to constraints, driving at optimum outcomes. Economists describe such outcomes as efficient. Sometimes they speak of "*pareto optimal"*- resources being allocated in the most efficient manner. They refer to "*ceteris paribus*" – everything remains constant other than the variable at hand. Believe me, if that is the case, economics is wrong because I have not found such a world as yet and the reality generally ends up with sub-optimal outcomes. Nevertheless, the subject is interesting, since everyone speaks of something called economics. In a sense, it seems that all of us are economists.

This is why I simply did not want to be your Chief Guest, since I was not sure where my hat would fit in. Yet, I accepted. Anyway, since the sub-optimum outcome has now become the reality, let me share my perspective from what I have read about the global economic outlook and consequent challenges to developing countries - particularly to our own country.

Background of Current Global Economic Performance

The world experienced an unprecedented rise in food and energy prices towards mid 2008 in the backdrop of developing economies in Asia, Middle East, Africa and Latin America having sustained three decades of high economic growth. Countries like China exceeded its annual growth in excess of 10 percent. India proved that South Asia no longer register the "Hindu growth rate" of 3 percent and, instead, could perform three times in excess. In the wake of rising commodity and asset prices and the surge in investment banking in support of deregulation, privatisation and associated financial and business restructuring, the three decades of global development has produced diverse financial instruments such as hedging, derivatives, illiquid asset backed mortgages, diversifying and deepening the global financial and capital market transactions probably even crossing the boarders of regulatory radars.

It is in this background that the global financial services firm Lehman Brothers, collapsed in September 2008 and several other investment banks and mutual funds

faced problems with illiquid assets. Several acquisitions including shareholdings of Merrill Lynch was undertaken by the Bank of America with the support of US authorities. No support was extended to rescue Lehman Brothers. Parallel to this, the US government sponsored enterprises Fannie Mae and Freddie Mac were placed into conservatorship by the U.S. Treasury, due to defaults of mortgage backed securities and money market fund guarantees. Banking failures were also reported in UK, Belgium, France, Germany Ireland, Luxembourg and the Netherlands. The Federal Reserve Bank and the US Treasury bailed out AIG, a large American insurance corporation. The capital infusion to overcome this subprime mortgage crisis through what is known as *Troubled Assets Relief Program* (TARP) was US$ 700 billion. An Economic Recovery Plan with a further commitment of US$ 787 billion was adopted to support a stimulus plan. The fallout in the financial system is estimated to have lost US $19.2 trillion in household wealth and 8.8 million jobs. In the United Kingdom, the Treasury acquired the shareholdings of Northern Rock and Bradford Bingley. Discontents of globalisation, which was seen in mass scale unemployment, closure of factories, loss in household wealth and rise in poverty, became concerns of a magnitude that are far beyond the great depression in 1930.

However, contrary to the predictions, the world economy bounced backed in 2010 following a sharp fall in oil prices, with a huge financial instability still prevailing due to inadequate capital to manage underlying risks, loss of faith in certain new instruments once believed to be the best fool-proof models. Nevertheless, China introduced a huge stimulus package to boost its exports and investments overseas. Some experts described this as a V- shape recovery, through underlying adjustments in the US economy, prompting a debate among multilateral agencies like the IMF, as well as economists and political leaders in the US, leading some others to predict a W-shape recovery process.

Interestingly, after 30 years of Regan-Thatcher reforms in the US and UK in the 1980s, the world seems to have recognised the role of Governments, particularly in the regulatory side and the need for intervention to complement the role of the private sector and a market economy. Success stories like South Korea, Singapore, China, Brazil etc., that promoted reliance on a blend of “State and market” for rapid growth in global trade and investment, received a renewed interest on those growth strategies.

The recovery did not prove the V-shape theory right. I am not sure whether a W- shape recovery theory will prove to be right either. It could be even an L-shape for a while, as the world is now confronted with the looming Euro Zone crisis and wide-spread political instability in the Middle East. Since of late 2011, the commodity prices increased, and oil prices in particular moved up from about US$ 70 per barrel towards US$ 125 per barrel. The US sanctions on Iran is another dimension affecting the global economy, particularly since major countries like India, China, rely on Iran for their

crude oil imports and smaller countries export labour and agricultural commodities to the Middle East. The US economy was not showing signs of steady improvements with quarterly growth rates falling below 2 percent and financial imbalances widening. The Euro Zone faced a financial crisis with Italy, Greece and Spain loosing fiscal control with deficits in excess of 10 percent of GDP and failing to honour their debt servicing and contractual obligations affecting sovereign ratings. Germany, the largest European economy slowed down to 1 percent growth in GDP. The 17 countries in the Euro Zone have slipped into a double decline position, with the whole region showing a decline of 0.1 percent in GDP growth in the third quarter 2012. The US policy makers are debating to address what is called a "fiscal-cliff", through a policy consensus for raising taxes and curbing spending to stabilise the US economy and resume employment and income growth.

The downturn in Europe and the uncertainty in the ultimate outcome of the US fiscal crisis are major concerns for emerging economies such as India, China, Brazil, South Africa and other smaller, yet high-performing, economies which have relied for three decades on the US and Europe, due to their export and FDI led strategies. Unlike in 2009 when the slowdown in the global economy reduced oil and commodity prices, the current scenario appears to take a different turn as oil prices show no signs of falling in the near term. An explanation given for high oil prices is that refineries around the world, built to refine Iranian Crude are underperforming due to embargos on Iran, and the uncertainties prevailing in the Middle Eastern oil producing countries.

Euro Zone Crisis

Underpinning the Euro Zone crisis is the near bankruptcy of sovereign governments in the Euro zone itself. Many countries such as Spain, Romania, Hungary and Greece have faced difficulties in repaying or refinancing their government debt without the assistance of third parties. The sovereign debt crisis and associated banking and financial system vulnerabilities continue to threaten the stability of the global financial system and the recovery of global growth. According to available information, the largest bailout package for Greece with a total commitment of Euro 491 billion, which has been financed by European member States, the IMF, and the European Financial Stability Fund, has already injected Euro 246 billion with no sign of stability shown by Greece. The IMF itself has diverted its main focus onto the European sovereign debt crisis since mid 2010, though there is a major disagreement within the Euro Zone leaders and the IMF, following the admission by the IMF that austerity measures – by lowering expenditure on social spending and public service benefits to curb deficit – are more damaging than expected, and the inability of France and Germany to agree on a pure European solution to Greece's short term debt requirements. As the crisis in Greece has deepened and there are indications that it would spread to Spain and

Portugal, the IMF itself has committed for a Euro 120 billion rescue package over 3 years to Greece. However, the Managing Director of the IMF, Christine Lagarde has criticised the European debt crisis and the over emphasis placed on austerity measures. The Managing Director has warned, emphasising that the European Union bailout funds seem inadequate to stop the spread of the crisis to countries such as Spain and Italy. The Managing Director herself has made the most forceful intervention in the European crisis by calling the Euro Zone to move swiftly towards a Fiscal Union. The Fund has also taken a turn to lend directly to struggling banks in the Euro Zone area rather than through the respective national Governments, while appealing to the European Central Bank to take more aggressive measures in terms of monetary policy actions.

Despite these, there appears to be a visible disagreement between the European Union, European Central Bank and the IMF over the Greece debt crisis and the mechanism to prevent the crisis stricken Greece from collapsing due to its public debt. The Greek debt to GDP is expected to hit 190 percent in 2013, whereas the Euro Zone has set a target of 120 percent by 2020, which the Euro Zone Finance Ministers want to extend by a further 2 years. However, the IMF has insisted that an extension should not be granted and instead European governments should consider to write-off some Greek debt. This has caused a significant impact on Germany. Despite financial aid amounting to billions and sweeping cuts in public spending, Greece has been unable to escape the downward spiral impact of sovereign debt of a shrinking economy.

Adjustment Constraints

It is also important to understand the structural challenges that the global economy is confronted with, in the midst of a looming bankruptcy in the banking and financial system. The US economy is confronted with an ageing infrastructure challenge and severe competitions to its exports and import from competing industries of emerging economies and the looming fiscal-cliff. The fiscal and monetary policy space to intervene has also been constrained due to high deficits and inflation which generally require tightening of monetary policy. The tax breaks introduced in response to the 2008 crisis is expected to be over by 01st January 2013. Inability to expand such concessions further and the likely pressure for higher taxation as well as the difficulties to provide a fiscal stimulus through public spending, has put US policy makers to focus on reforms towards balancing the responsibilities of the Government and the private sector. The ultimate adjustments in the US – is an area that would be interesting for extensive policy research. Euro Zone which is now formally on a severe recession with large bailout packages linked to adjustments in public policy may create more uncertainties as the 17 nations may react differently to such adjustments.

Turning to the emerging economies, countries such as Indonesia, Russia and other energy rich nations in Africa and Latin America may enjoy the benefit of high oil prices as long as oil producing Middle East remains unstable consequent to conditions prevailing in major Middle East countries such as Iran, Israel, Egypt and Syria. However, more stable oil producing countries seem to have faced a dilemma with high oil prices. Although there is a short-term gain, such high prices have also encouraged other nations to look at energy intensive technology development, exploration of renewable energy, and even to take on expensive oil explorations, globally. Major oil producing countries such as Saudi Arabia itself have ventured into solar based energy sources to diversify their energy driven economies. One should not overlook the prospects of such strategies, considering initial and timely adjustments made by Japan in the aftermath of the first oil shock in 1971 by adopting the energy efficient electrical and motor vehicle industry revolution. Unlike in early 70's the world is more resourceful now, both in terms of capital and technology, with several countries such as South Korea and China having moved rapidly with technology as a source of economic growth.

Emerging Economy Outlook

The outlook in emerging Asia will be shaped by several factors. The outgoing leadership in China has set a target of doubling its current GDP in 10 years. However, its economy is under pressure from a strong exchange rate and shrinking export markets in European and US economies. The Chinese economy is also loosing comparative advantage in labour intensive production technologies as poverty levels and unemployment have declined resulting in an upward pressure on wages. Despite these challenges, the Chinese economy is rich in international reserves and capacity to invest overseas. Chinese investors have already made significant inroads to Africa, Latin America, Asia, Europe and North America during the last two decades. China has also acquired a significant ownership in the international bond market. Its domestic economy is also richer than it was in 1980, when the Chinese economy was placed on a path of economic reforms. It is an interesting research area for emerging economies like ours to study how the Chinese economy will modify its competitive policies to regain the lost export momentum while managing the pressure on the exchange rate to appreciate. A dynamic econometric model could be adopted to predict the exchange rate in China, when it doubles its present GDP in 10 years. One should not overlook how Asian economies like Japan and Korea attained their advanced economy status while experiencing a significant appreciation of their currency. In fact, over the past 30 years the Japanese currency has appreciated from Yen 280 per US Dollar in 1980s, to Yen 78 per US Dollar as of now, while the Korean Won has appreciated from Won 1,131 per US Dollar in 2000 to Won 1,082 per US Dollar in 2012.

India, the South Asian power house, has broken the premise of the Hindu Growth rate of 3 percent by realising a near 10 percent growth after the 1980 economic reforms, and has once again committed to create another wave of reforms to regain the lost momentum in the economy in recent years. The debate there is interesting. The popular view is that India has delayed its reform process, particularly in areas of adjustments to rising oil prices and reforming the fiscal structure at both national and state government levels, to create more space for a private sector driven economy. There is a view that regulatory reforms are also insufficient to attract sustainable Foreign Direct Investments. The political limitations to adjust petroleum prices to arrest ballooning subsidies and the resistance to implement a coherent private sector led expansion as well as the limited manoeuvrability in public finance with a fiscal deficit of 10 percent of GDP, the ability to catch-up with delayed adjustments is bound to be a challenge which would have to be closely watched. Nevertheless, India, like China, has a huge internal market which is capable of supporting investments in import competing and export industries, for high growth.

Japan, the only Asian member country in G-8 is heading for a national election, which has given some hope towards refocusing its own strategy in the emerging global economic environment. Its currency is on a path of appreciation as I referred to earlier. The appreciation of the Yen has made its import - export mix unfavourable to sustain growth in Japan and retain its current economic standing in the global economy. The Japanese economy is also confronted with an ageing population that has made social security and pension reforms a major subject in policy discussions. Japan also runs a large fiscal deficit of around 10 percent of GDP and a public debt to the tune of 23O percent of GDP. Countries which have been relying heavily on Japanese Official Development Assistant (ODA) are confronted with a rising debt service burden due to the sustained Yen appreciation in the global financial market.

Indonesia is a yet another large Asian economy which has stabilised well after the 1997 East-Asian Financial Crisis with its large growing domestic market and energy and natural resource base which provides a unique advantage in the current context. Its economy has maintained an annual growth rate of around 7 percent in recent years, supported by both domestic and external demand. The exchange rate does not seem to be under pressure for appreciation. Considering the large labour force, the country also seems to be enjoying the advantages of pursuing labour intensive exports further. Asian flagship economies such as Singapore and Hong Kong have remained strong, attracting their economies as global financial hubs. They have proved to be prompt in their policy reactions to global shocks. The transition of the Vietnamese economy, reforms in Cambodia and recent political reforms in Burma have also given a promising outlook to Asia. All in all, the Asian region as a whole is in a better position to cope up with current global uncertainties. Its large and relatively strong middle income population provides a buffer to maintain a higher economic growth than before. They have also

developed strong technology, research and investment capabilities. The banks in Asia have strong international reserve positions. The official reserve position itself supports export import financing as well as global trade and investment. Conservation of energy, moving on to energy saving industrial production and exploration of energy resources from both renewable and non-renewable energy may open new areas for development in research, technology and investment opportunities in Asia.

Several nations in Africa such as Uganda, Angola, Kenya, South Africa, have emerged as steady middle income economies, while exploration of mineral resources as well as oil has attracted foreign investments in to these countries. The entrance of investors from emerging economies in Asia as well as Latin America to Africa, has reduced their vulnerability to the downturn in the US and European economies. Latin America is dominated by large economies such as Argentina, Brazil and Mexico. These economies may have a contagious effect from their colonial relationship with European economies, but would remain strong due to the stability in their financial systems and the relatively diversified trade and investment relationships with other emerging economies.

A New Economic Order

The 30 years of economic transformation that has led several nations to move away from the low income trap to an emerging economy status has reshaped the global economy. This transformation not only reduced poverty and unemployment in respective countries but also made them to rely on their own sovereign resources and private capital movements and to graduate from borrower status to lender status. This made multilateral financial institutions such as the World Bank, the African Development Bank, the Latin American Development Bank and the Asian Development Bank as well as the International Monetary Fund to redefine their role in international finance. In fact, the IMF itself was in a restructuring route by 2006, when it decided to dispose of its gold assets and adopt a retrenchment program to downside its scale of operations. Similar changes are taking place in the World Bank and other lending institutions, with the Export Import Banks of various nations in Asia, Europe, US having taken the place of multilateral lending institutions, with no conventional conditionality attached.

The G-8 countries consisting of Russia, US, UK, Japan, Germany, France, Italy and Canada together with the IMF and the World Bank, which shape global economic policies in the post war global economy, have recognised the pivotal role of newly advanced economies with the formation of G-20 which include Argentina, Australia, Brazil, Canada, China, India, Saudi Arabia, South Africa, South Korea and Turkey. These nations have raised their voice for increased quota allocations and capital contributions. The formation of BRICS consisting of Brazil, Russia, India, China and

South Africa is a new dimension to the global economic order. The United Nations itself has appointed a new panel of experts headed by Nobel Prize Winner Joseph Stiglitz, one time Chief Economist in the World Bank and Economic Advisor to President Clinton, to look into limitations of conventional economic policies, the underlying risks in the global economy and reforms to the international monetary and financial system in the wake of the global crisis. This panel has challenged the role played by international financial institutions, regulatory institutions, the multinational banking and financial network, as well as the conventional wisdom in the application of pro and counter cyclical policies - particularly in developing countries.

Poverty stricken developing economies are also faced with severe resource limitations. Their resource base remain poor while nations have only three years to go until the 2015 deadline to ensure 'Education for All' goal set collectively by 164 nations at its gathering in 2000 in Senegal. The economic downturn has shirked national budgets in many developing countries and the adjustment burden has fallen on social spending. Donor commitments to these sectors have also stagnated. In our own country, only less than 10 percent of education and health is financed from donor funding. The Government has requested them to share part of our budgets on education and health instead of project lending. Nevertheless, it is time we find our own solutions to consolidate exceptional gains realised in these areas in the past through free education and health for all, as the Government itself has committed to gradually raise funding to these sectors while encouraging the society to divert more resources for education and health. The Government and the private sector at present contribute 7 percent of GDP to education and health, which could be raised systematically through appropriate reforms in our policy strategies over the medium term. Economic research may have new opportunities to go in to all these aspects in the context of the looming global economic outlook that is ahead of us. Whether a new economic order will emerge with required changes to the global financial architecture that takes into account the considerations of developing economies and global trade and finance, is yet to be seen.

Impact on Sri Lankan Economy

Let me turn to make some reference to our own economic outlook in the context of the current global economic environment. As we all agree, the Sri Lankan economy is well integrated to global trade, travel, labour markets, financial institutions and capital markets. The country's import and export trade account for 40 percent of GDP. 80 percent of country's exports are with European, US and Middle East markets. Oil imports which account for nearly 30 percent of total imports at present originate from Middle East and Asian destinations. Import of machinery, intermediate goods and raw materials originate from Asian and European economies. 30 percent of imports are financed through export-import credit facilities offered by EXIM Banks in various countries and development financing agencies supporting Sri Lanka's development

initiatives. Tourism, which has reached a near billion dollar in turnover and with a million foreign travellers, is diversified in terms of source of traveller's origin, underscoring a gradual shift from the traditional west to newly emerging economies in Asia, Europe and the Middle East. Nevertheless, Germany and UK account for 20 percent of total tourist arrivals.

Overseas employment has become Sri Lanka's single largest source of foreign exchange earnings. Earnings from overseas employment have increased from US$ 400 million in 1990 to US$ 6 billion - almost two thirds of commodity export income in 2012. The composition of overseas employment has also been in transition with a shift from unskilled to skilled and professionals, female to male, and Middle East to emerging and advanced economies. These structural shifts have contributed not only to the rise in remittance income but also to change labour market dynamics in our own economy. The decline in unemployment rate and the non-availability of a skilled work force for emerging industries and services in the domestic economy have brought the Sri Lankan Economy to a juncture - to think of a global wage structure and evaluate its comparative advantage which is very much linked to rising overseas employment. It also demands us to adopt a productivity driven production process and to introduce reforms to our system of education. It is interesting to analyse how the economic paradigm has changed from the days when economists assumed capital as a mobile factor of production and land and labour as being immobile. However, at present all variables seem to have become mobile. Probably, it is only the degree of mobility that matters now. The land -labour ratio is rapidly becoming a redundant concept in the context of innovation by engineers of high-tech, high rise buildings and amazing creativity for space management, land usage planning, reclamation, and conservation.

Sri Lanka which enjoyed outright grants and concessional foreign aid from advanced countries, the Word Bank and the ADB since independence, is fast losing concessional funding due to its economic graduation towards a middle income country status since 2005. Further, the limitations of availability of funds from such agencies to meet growing demands for foreign capital towards public investments as well as conditionality and time consuming processes of lending agencies, on the one hand, and the availability of a much larger volume of resources from competitive and time efficient sources have diversified the use of foreign resources for development in our country, on the other hand, has increased country's global integration, financially. In addition, the Government itself has gone to the international capital market, floating long term Sri Lankan Sovereign Bonds for international investors to subscribe. The country has also exposed its sovereign debt instruments to international investors within exposure limits. The Country's external debt portfolio consists of debt denominated in several currencies, with 1/3 denominated in Yen, 60 percent in US dollars and the balance in Euro and other currencies. Considering these dimensions, one can visualise

the global economic integration within which our economy now performs. Hence, the current global economic scenario is a much more relevant subject to us than ever before.

Sri Lanka's biggest structural imbalance lies with external trade. The continued reliance on imports of products which can be replaced through sizable investments in capacity expansion in such activities and the slow transformation towards value creation exports in areas, in which Sri Lanka is resourceful, is the source of this problem. The ideology that "import replacement" is protectionism and incentives to shift from raw material exports to value added manufactured exports therefore need to be revisited in order to find an appropriate structural solution to the country's long standing economic problems in its external trade structure. In my view, import replacement can be made competitive and be consistent with global economic integration on several grounds. First, the "economies of scale" argument. Most of the heavy industries can replace nearly 6 billion dollar imports, which is almost a third of county's imports, and provide a solid domestic market scope justifying a sizable investment and efficient cost of production. Second, these are activities which are undertaken by the private sector and multinational investment companies already established in Sri Lanka, with capabilities in technological know-how and the required capital. Third, since the conflict has ended and the economy has entered a phase of higher economic growth driven both by private and public investments, these industries have prospects to cater to an expanding market. Fourth, agriculture itself is an area that has been a victim of a distorted comparative advantage by several countries, through subsidies in those producing countries that have denied exploration of domestic agricultural resources. Consequence has been the over dependency on imports for local requirement of sugar, dairy and milk powder, fish, and dry food. The aggregate value of such imports also account for 15 percent of total imports. Although the share of primary agriculture should decline with the development process, it should not lead to underestimate its potential to provide food security and generate required raw material for manufacturing and services sector growth through a value chain to transform the economy towards generating an exportable surplus. Last but not least, the country also relies heavily on the importation of petroleum products to meet its transportation and electricity requirements. Price distortions in favour of consuming imported fuel to meet transportation and electricity requirements has discouraged the exploration of the full potentials of renewable energy use, energy efficient production technologies, and the conservation of environment and water resources. Therefore, the current global dynamics provide us more opportunities in the midst of challenges, to position the Sri Lankan economy to adopt much more sustainable development strategies in the future.

In my view, such strategies should include the following. First and foremost, the flexibility in the exchange rate regime to provide a market environment in support of import replacement and export industries and foreign exchange earning sources to manage Sri Lanka's external finance, should not be compromised. Second, however

hard the adjustments will be, the country must continue its incentive structure that favours production of all viable import competing goods locally without labelling it as protectionism. Third, the country must move rapidly towards diversified value added exports by discouraging any form of raw material exports. Fourth, energy price distortions must be corrected to encourage the exploration of the full potential of renewable energy and energy efficient production practices. And last, but not least, to prepare the country's population, which still provides a demographic window of around ¼ of the population being young, to be the human capital that will drive the economic transformation in the decade ahead.

The imbalances in the internal demand needs equal corrections. Fiscal reforms to strengthen revenue efforts through broadening of taxation is vital to protect social spending and public investment, in order to ensure a gradual phasing out of fiscal deficits to a level that will make "crowding out" to "crowding in". The Government's commitment to maintain these trends is encouraging. State commercial enterprises must be made "profits centres" by making them key players in capital formation. This requires no privatisation but competent management structures.

Ladies and Gentlemen, I leave these thoughts with you to engage yourselves in deliberations over the next two days and enlighten us with appropriate policy advice to make our country move ahead with economic progress that my generation could not enjoy in our youthful days in life.

I wish the forum all success.

Thank You!