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FINANCIAL MARKET

Emerging Trends

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A Glossary of Selected Financial Terms

A number of terms, some old and some relatively new or used in a different sense, crop up in any discussion of the financial markets today. Here are some terms used in the preceding articles:

Arbitrage:
The simultaneous or near simultaneous purchase of assets in one market and their sale in another market to take advantage of price differences in the two markets. Such operations take place with respect to currencies or securities.

Banker's acceptance:
A time draft not exceeding six months, across the face of which the bank has written the word "accepted" to indicate that the bank will honor the draft upon presentation at maturity.

Bonds:
* **Eurobond:** *A long-term bond marketed internationally in countries other than the country of the currency in which it is denominated. The issue is not subject to national restrictions.*
* **Zero coupon bonds:** *These bonds pay no periodic interest (hence their name), so that the total yield is obtained entirely as capital gain on the final maturity date.*
* **Dual currency bonds:** *Dual currency bonds are denominated in one currency, but pay interest in another currency at a fixed rate of exchange. Dual currency bonds can also pay redemption proceeds in a different currency from the currency of denomination.*
* **Floating rate bonds:** *The most commonly issued instrument, the interest coupons on which are adjusted regularly according to the level of some base interest rate plus a fixed spread.*

Corporate receivables:
The amounts owned to a firm by its clients

Currency swap:
A transaction in which two parties exchange specific amounts of two different currencies at the outset and repay, over time, according to a predetermined rule which reflects interest payments and amortization of principal.

Eurocommercial paper:
A short-term unsecured note issued by a nonbank in the Euromarkets.

Eurocurrency:
A currency held in the form of time deposits in financial institutions outside the home country of the currency.

Eurodollars:
Dollars held in the form of time deposits in banks outside the United States. These banks can be foreign-owned or overseas branches of US banks.

European Currency Unit (ECU)
A currency basket composed of specific quantities of the currencies of European Monetary System members. The ECU is used as part of the system's divergence indicator (for measuring relative movements of member currencies) and provides a unit of account used to value members' exchange reserve assets.

Exit bond:
A bond issued by a debtor country to a creditor bank in place of a bank credit that allows the creditor bank to be exempted from future requests for new money and restructuring.

Forward contract:
An agreement to exchange at a specified future date different currencies at a specified contractual exchange rate (the forward rate).

Forward cover:
The agreement to purchase or sell at a future date at an agreed price a fixed amount of a particular foreign currency in order to insure against the possibility of exchange rate movements having an impact on the domestic currency value of the foreign currency.

Forward exchange market:
This market involves contracts for the purchase or sale of currency at some date in the future.

Futures contract:
A highly standardized foreign exchange contract written for a fixed number of foreign currency units and for delivery on a fixed date.

Gilt-edged market:
Mainly used in the United Kingdom, to mean all marketable government securities except Treasury bills.

Hedge or hedging:
A method of buying and selling commodities, securities, or currencies to reduce the risk of negative price movements that might reduce a trader's profits. (See "forward cover," above)

Interest rate swap:
A transaction in which two parties exchange interest payment streams of differing character based on an underlying principal amount. The three main types are coupon swaps (fixed rate to floating rate in the same currency), basis swaps (one floating rate index to another floating rate index in the same currency), and cross-currency interest rate swaps (fixed rate in one currency and floating rate in another).

London interbank offered rate (LIBOR):
The interest rate at which prime banks offer deposits to other prime banks in London. This rate is often used as the basis for pricing Eurocurrency loans.

Market maker:
An institution that stands willing to buy or sell an asset at some price, or an institution that deals so frequently and in such volume in an asset that it makes it possible for others to buy or sell that asset at almost any time.

Menu approach:
The initiation of a broader range-the "menu" of financing modalities into the debt-restructuring process.

New money/concerted money:
Equiproportional increase in exposure of a group of banks arranged through a bank advisory committee responsible for negotiating a new loan package for countries that have lost spontaneous access to external financial resources.

Note issuance facility:
A medium-term arrangement enabling borrowers to issue short-term paper, typically of three or six months' maturity, in their own names. A group of underwriting banks may guarantee the availability of funds to the borrower by purchasing any unsold notes at each rollover date, or by providing a stand by credit.

Prioritization of debt:
Preferred treatment of one or more categories of claims to other claims.

Securitization:
The term is most often used narrowly to mean the process by which traditional bank assets, mainly loans or mortgages, are converted into negotiable securities. More broadly, the term refers to the development of markets for a variety of new negotiable instruments.

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Structural Development in Financial Market

The world has been witnessing major changes in the structure of the global financial market during the last two or three decades. Analysis of the nature of these structural changes in the financial market is a sine qua non for understanding the complex issues confronting macro-economic policy makers in the context of new technology, liberalization and market innovation which are taking place simultaneously world wide.

Technology

The widespread application of computer and telecommunications technology in financial market operations has enabled markets to process a significantly larger volume of real time transactions and to link markets instantly in different zones.

The expansion and rapid growth of the international capital markets is the major result of the fast developing technology. The transfer of capital in the international market can be effected almost instantly by merely pressing a button of the computer. The development in information technology has accelerated the global integration of financial markets by making possible round-the-clock trading. These changes in financial markets have led to price volatility in the currency, bond and equity markets.

Liberalization

The structural changes which are taking place world wide following the application of the concept of liberalisation have helped tremendously in the greater integration in the international financial markets. Liberalisation has been promoted by official policies to enhance efficiency in domestic financial markets and to facilitate the linking of the domestic institutions to international sources of finance.

Liberalisation has been proceeded along two basic paths: relaxation of price and quantity restrictions and easing of limitations on certain types of financial activities. Easing of flexible exchange rates as part of the structural changes has been the most significant step with regard to some developed economies ie. France, Japan and United Kingdom. Through this freedom the residents of these countries have been able to gain access for foreign currency investment, thereby increasing the substitutability of domestic and foreign assets. This also paved the way to foreign borrowers to gain access to national markets and their ability to borrow in international currencies, further integrating domestic and foreign financial markets. Further foreign financial institutions have been afforded the opportunity to enter into national markets and enjoy similar treatment as national financial institutions.

New Instruments

Innovative instruments are the third major force transforming financial markets. They fall into two broad categories, credit or liquidity creating and risk transferring. Greater use of tradable assets issued directly by the borrower (ie. securitization) is the most important element in the first category. In addition to this shift from bank credit to securities, securitization has involved the packaging of assets that were not previously traded (eg. bank credits, mortgages, corporate receivables) into tradeable assets. Banks have been deeply involved in this process. They have also been involved in the expansion of bond markets by issuing, selling and buying securities. Syndicated loans have been displaced to a large degree by issues of international bonds.

As a result of securitization process the distinction between bond market and bank credit market has tended to become blurred, while the relative importance of traditional bank credit flows has been weakened.

The financial system has changed dramatically over the last 20 years with those new trends and securitization, probably being the most dominant trend in the international financial markets during this period. This made an impact on the credit market by shifting credit flows from bank lending to marketable instruments. This is called off balance sheet activities (OBSAs). Banks could shift their securitized safest asset off-balance sheet and retain the risky assets only on balance sheet.

Financial Market and Money Supply

The income, expenditure and borrowing of the government create cash flows which affect the total volume of bank deposits. In other words the government's spending, taxation and borrowing policies have implications for credit and the money supply. Therefore, the size of the government (public) sector borrowing requirement or what the government needs to borrow each year is crucial for the growth of the money supply.

If government's spending is greater than its income government has a budget deficit. The budget deficit must be financed by borrowing. Borrowing from domestic market affects the money market. When the government finances its budget deficit through bank borrowings (expansionary sources) the money supply rises. Financial innovations are mostly visible in developed countries in the West as well as in the East. Another important debt instrument operating in the modern financial market is the Debenture. The Debenture can be defined as an interest bearing debt with a maturity date issued by a firm in need of long term funds (see the article on Debentures which appears in this issue). The other traditional debt instruments that are being traded with marketable values in the financial market are zero coupon bonds, promissory notes, corporate bonds and Central Bank Bonds (Treasury bills).

Capital Account

According to the IMF, liberalization of capital account of the balance of payments could bring about major benefits to an economy, because the country's residents and the government will be to borrow and lend at more favourable terms and in more sophisticated markets. Despite the lessons of the current Asian currency turmoil which is partly an outcome of the opening up of the capital account, the IMF still encourages the Third World countries to open up the capital account to achieve high level of economic growth. This account can be understood as a part of Balance of Payments Account (BOP). The BOP is a statistical 'accounting' record of a country's international trade transactions and capital transactions with other countries during a period of time. The BOP has two parts, namely, current account which accommodates all international transactions except those with regard to investment and the capital account includes the international transaction made by the government as well as the private sector in the form of capital or investment eg. foreign direct investments. All capital transactions like lending, borrowing, investing and disinvesting, with the rest of the world are included in the capital account.

The capacity to conduct operations in the capital account partly depends on the foreign exchange controls as well as on fiscal and monetary policies. If the government follows a closed economic policy the international transactions of the capital account will be largely restricted to the government. If the government follows a liberalized policy under the conditions the capital account is usually kept open at various levels based on the government's decisions to do so.

Today Soviet Russia and Communist China who were the two pioneers in the centrally planned economies in the world have opened their BOP capital account considerably, with the introduction of the programme of 'reforms and opening up' while embarking on a policy of open market economy.

The opening of capital account allow inflow of foreign direct investments (FDI) into the country and investment outflows from the country.

FDI is an important source of capital for economic growth according to the accepted economic theory. Equity investment can be either indirect (portfolio) or direct investments (FDI). The large capital inflows in to five major ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore and Thailand) would not have occurred unless they keep their capital account opened. Therefore, by keeping the capital account open the country's financial market could grow efficiently. However, there prevails a view that the present financial crisis affecting some countries of ASEAN has a link with the opening of their capital account as part of their reforms, introduced by the IMF. Some economists argue that this currency turmoil is a result of mis-management of capital.

Financial Intermediation

Intermediary means a go-between. Financial intermediary is an institution which links lenders and borrowers by obtaining deposits from lenders and then re-lending them to borrowers. Lenders are persons or organizations in the economy with excess money and are therefore sometimes referred to as surplus units. Borrowers are persons or organizations in the economy who are short of money, and are sometimes referred to as deficit units.

Financial intermediation facilitate the process of moving funds from surplus units to deficit units. However, there are instances where lending and borrowing take place without financial intermediaries. The debenture issue is an example. The following intermediaries are the usual operators in the financial market.

(a) the commercial banks
(b) merchant banks and development banks
(c) financial houses
(d) insurance companies, pension funds, unit trust companies and investment trust companies
(e) savings banks
(f) trust savings banks

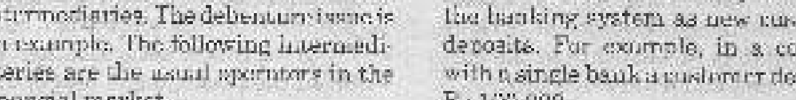
Cheques, commercial bank or National Savings Bank savings books, Deposit Certificate or Debenture Certificate, Treasury Bill, etc. are the instruments involved in these transactions.

In Sri Lanka the most important financial institutions are the Central Bank, Commercial Banks and other banks and institutions engaged in partial banking activities. Saving and development banks and financial institutions, also operate in money market. Maintenance of risk and capital adequacy is very important for banks which engage in financial intermediation.

Bank deposits and creation of money

Notes and coins in circulation are only a small part of the total money supply or total money stock. The overall money supply (M2) consists of notes and coins in circulation plus demand and time deposits held by the public with commercial banks. Therefore, the monetary authorities adopt measures to control the total volume of bank deposits, when it needs to control money stocks. A feature which distinguishes banks from other financial institutions is that bank deposits are regarded as money (liquidity). By approving a loan a bank gives the borrower money to finance transactions. This means that the loan creates money. In contrast, a non-bank financial institution also lends money to a customer, but the loan is accomplished by transferring funds from a bank account of the lender to the bank account of the borrower. Thus, the total amount of money remains unchanged and no creation of money takes place through that loan. eg. when a bank lends money, most of the money will find its way back into the banking system as new customer deposits. For example, in a country with a single bank a customer deposits Rs 100,000.

The bank re-lends this deposit to other customers. The customers will use the money they have borrowed to buy goods and services, and they will pay various firms and individuals for these purchases. If the firms and individuals receiving payment deposit the money in their own bank accounts, the bank deposits will have doubled.



e.g.

Original deposit	-	Rs. 100,000
New deposits	-	Rs. 100,000
Total deposits	-	Rs 200,000

This will enable the bank to lend more money (another Rs 100,000/-) and raise its assets portfolio up to Rs. 200,000/- and this in turn will create more and more deposits and bank assets, enabling the bank to lend more and more money.

Behaviour of Interest Rates

Interest rate is the price of money, which is the tangible form of finance. The financial market is the central cover of market economy in the classical economic system. Therefore interest rates can be identified as a major determinant factor of the market economy system.

Interest rates are referred to as real and nominal. Nominal interest is indeed considered in any financial activity. The real rate of interest is the return that an investor gets when the nominal rate is adjusted by the rate of inflation. If the nominal rate of interest ie. the interest actually paid after one year on a loan or a deposit is 15%, and if there is 12% price inflation over the year then the "real" rate of interest is 3%.

Banks as well as other financial institutions which deal in the market operate different interest rates. The government treasury bill rates and government bond rates are the most determinant factor in this market. However, commercial banks maintain a prime lending rate which is the indicative rate that a bank offers to its important corporate customer. But in practice the prime lending rate cannot be considered as a general indicator of interest rates as the proportion of loans given at the prime lending interest rate is negligible compared to the amount given at rates higher than the prime rates.

However if banks are allowed to create money in this way the financial market will not be subject to any control. Therefore, the regulatory system of most countries have provision for supervision and regulation over banks and other financial institutions. The Central Bank in any country is vested with these powers. In this task Central Banks use direct or indirect controls over the financial institutions as are suitable.

These controls focus on the following three different and conflicting aims which banks must judiciously pursue. Those are :

* Profitability
* Liquidity
* Security and Capital Adequacy

Profitability ensures the provision of benefits for its share holders and liquidity enables the bank to settle its debts. The need for security arises because people deposit their money with banks as they are regarded as stable and safe institutions. Therefore, banks should securely and wisely utilise the depositors funds. Capital adequacy refers to the need for a bank to have sizeable base of capital funds to protect against risks of insolvency, bad debts and losses.

Inter-Bank Market

This is a market in unsecured loans transacted between banks (including discount houses). A large proportion of inter-bank dealing covers the need for short term funds (overnight money) although some loans are for longer periods. Interest rates are quoted for overnight money through spot decisions. The role of Inter-bank market (also known as inter-bank Call Money Market) is to help to smooth out fluctuations in receipt and payments by the banks. A well-established bank can use the market to borrow funds in its own name and lend the funds at a higher rate of interest. It also helps to forecast the likely future trends in the interest rates of the financial market.

Liberalizing Capital Transactions

In addition to liberalizing trade, more countries are also gradually removing restrictions on cross-border movements of capital, either unilaterally or as part of regional initiatives.

The number of countries with liberal or mostly liberal capital regimes has grown from nine to thirty in the past two decades, while the number of countries with relatively restrictive rules has dropped sharply, from seventy-three to fifty-three

Just as countries differ markedly with respect to growth in trade, so there is considerable disparity in countries' ability to attract foreign capital. Although worldwide private and official capital flows have expanded by about a factor of ten in the past two decades, developing regions have fared unequally in attracting these flows. Much of the expansion has been in private flows, and among developing regions most of these go to East Asia and Latin America. One estimate suggests that more than half the population of the developing world has been little touched by this aspect of globalization.

Of particular concern to developing countries is the composition of these growing private capital flows. Whereas many developing countries actively seek foreign direct investment, they regard portfolio investment with ambivalence. Foreign portfolio investors can help develop local financial markets by providing liquidity and by influencing the regulatory framework and corporate governance. But they also bring the risk of sudden capital flight, whose destabilizing effects were dramatically illustrated by Mexico's crisis of 1994-95.

Managing the risk of capital flight, and of large capital flows generally, has been a challenge for most developing countries. Increasingly the risk is regarded as a welcome source of government discipline, which discourages capricious and irresponsible policies, and many countries have relaxed capital controls. Still, large flows in either direction can accentuate a country's vulnerabilities through large external imbalances, rising inflation or interest rates, or exuberant credit expansion that could compromise the soundness of banks.

The means at governments' disposal to keep themselves out of trouble are almost all a matter of domestic policy; in particular, prudent fiscal policies, credible monetary and exchange rate regimes, a sound and prudent banking system, and, possibly, measures that reduce the publics' expectation that the government will bail them out if investments turn sour.

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Financial Structure in Sri Lanka and Economic Development

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The financial structure in any country has a very close relationship with its economic structure. This is because the financial institutions, through financial intermediation, are able to transfer funds from surplus units to deficit units. An efficient and effective financial system is very useful for accelerating and maintaining economic growth. In other words, the existence of an organised financial institutional framework is essential for the capital investment process, which comprises the three separate but inter-related savings, financing and investment functions to be effective.

A developed financial sector will include an extensive institutional network, varied financial instruments and developed markets. Such financial sectors function in the western industrialised countries. However, in many developing countries, the financial sector is characterised by a narrow institutional base and a limited range of instruments and tools. The role of 'money' in economic development should also be considered. In the 1950s and 1960s especially, attempts were made to show the intrinsic relationship between money and savings behaviour and habits, and financial intermediation. While financial savings is a primary factor in capital accumulation, money also plays a crucial role in this process. These relationships have been analysed, among others, by Arthur Lewis, Goldsmith, Gurly and Shaw. Savings habits and the development of financial intermediation provide an impetus to the economic development process, strengthening the relationship between them. Thus in the 1970s attention was given to the importance of such a financial institutional framework and the function of money and savings when the economy develops within such an efficient relationship.

Banks or any other financial institution is the medium which brings together savers and investors. All savers are not potential investors. That is, savers and investors are not the same. In a developed financial system they should not be so. These two categories have different objectives and the objectives of both these groups are achieved under financial intermediation. This is especially so for deficit units, which are provided the opportunity to make investment decisions. For the savers, it becomes possible to exchange their savings for savings instruments offered by the financial institutions as well as to select instruments to suit their needs and risks they are willing to take.

The advantages of financial intermediation can be summarised as follows:

1. Provides facilities to borrowers and lenders by supplying a range of financial instruments.
2. Increases the profits of transactions by reducing the costs of economic units.
3. Increases the liquidity of savings units.
4. Minimises adverse effects by spreading risks.
5. Increases the motivation for commercial enterprises to join together to enhance profits.

The financial sector can be divided into two broad sectors as the formal sector and the informal sector. The formal financial sector comprises financial institutions and institutionalised financial markets. The main characteristic of the informal financial sector is that financial transactions take place without recourse to an institutional framework. The informal sector is the main source of short term funds, especially in rural areas. Money lenders, pawn brokers, those who save through seettu, relatives and friends of borrowers are the major financial sources in the informal sector. It has been revealed that in Sri Lanka as much as 80 % of the loans that are disbursed for consumption purposes are obtained from the informal financial market. The limited facilities provided to the small and medium scale entrepreneur and the private consumer by the developed financial sector is the main reason that is attributed to the predominance of informal sector credit transactions. In Sri Lanka, as in many other underdeveloped countries, the informal financial sector plays a more important role than the organised sector in supplying credit. (Ghate 1988).

There are two separate types of financial institutions within the organised financial sector. They are banks and non-banking financial institutions. The central bank and the commercial banks comprise the banking sector. In the latter category of non-banking financial institutions are savings banks, development banks, pension funds, leasing companies, merchant banks, insurance companies, finance companies and other formal finanical institutions. (See note on the structure of the organsied financial sector). The special feature that distinguishes these two types of financial institutions is that in the banking sector, liabilities, which include demand deposits and cash, are available to them to be used as a medium of exchange. These liabilities are utilised for lending and economic transactions. While the institutions in the non-banking sector primarily engage in financial intermediation, some institutions maintain special financial services for their clients. These are leasing services, insurance, merchant banking etc. Neither do these institutions accept demand deposits nor do they provide credit.

The organised financial market in Sri Lanka can be classified into two main sections according to the maturity of the financial instruments that are offered in the market. These two sections are: the financial market and the capital market. Transactions in the financial market are limited to financial instruments, which have a maturity period of one year or less. In the capital market, the financial instruments have a maturity period exceeding one year.

Marcia Stigum defines the financial market as a low risk, high liquidity, wholesale market, which exists for the purpose of obtaining short term loans. Among the short term financial instruments and transactions in the Sri Lankan financial market are commercial paper, bills of exchange, inter- bank call money loans and foreign exchange dealings. The Central Bank of Sri Lanka has classified the financial market into four main sections as follows:

1. Inter-bank call money market
2. Internal foreign exchange market
3. Treasury bill market, and the
4. Off-shore bank market.

Among the capital market transactions are the primary and secondary markets for government securities, bonds and shares. Thus, the capital market is a place which provides long term funds. The capital market, which comprises share capital and loan capital has the primary function of investing savings productively. As the issue of shares can lead to the establishment of large companies with the ability to enhance technical efficiency, managerial know-how and ability, and research capability, the opportunity thus arises for low risk, large scale investments. The most developed sector of the capital market in Sri Lanka is the credit or the non-security market. But it has several drawbacks such as capital inadequacy, the lack of a suitable financial service mix, and the lack of trained personnel. (See note on the Structure of the Capital Market in Sri Lanka).

Recent Developments in the Financial System of Sri Lanka

Prior to the extensive and far reaching economic reforms introduced in the period after-mid- 1977, the financial sector in Sri Lanka was characterised by a limited institutional framework, markets and financial instruments. Its transactions were limited. The economic activities of the country were also at a low level, especially during the 1970 - 76 period. The Central Bank of Sri Lanka is the controlling authority of all financial institutions. The Currency Board System was in operation until the Central Bank was established in 1950 after Sri Lanka gained independence from British rule in 1948. While the deficiencies of the currency board system were evident to the authorities, they also realised the necessity of an independent financial system. During this period, the foreign owned commercial banks, which were almost exclusively financing the plantation sector and the import-export trade, were at the helm of banking business. Of the 12 commercial banks that were operating in Sri Lanka in 1950 as many as 10 were branches of foreign banks. At the same time, the commercial banks were confined to the city of Colombo with a few branches functioning in provincial towns. The number of financial institutions was very low. Also, they were not developed. Thus when Sri Lanka ceased to be a crown colony, the financial institutional framework had the characteristics of a developing country and was very weak. The main local bank that was operating at that time was the Bank of Ceylon, which was established in 1939.

The year 1961 marks a significant landmark in the history of banking in Sri Lanka. The Bank of Ceylon, which was nationalised in that year became a state owned bank. The People's Bank, another state bank, was also established in the same year by an Act of Parliament. Thereafter, following British banking practice, of branch banking, a rapid expansion of bank branches was witnessed throughout Sri Lanka. Due to the state ownership of the two local banks, and their rapid growth, their market share of commercial banking business in the 1960s was approximately 75%. By the end of the 1960s, these two banks held 71% of the total bank deposits and 72 % of the total advances.

However, it is evident that the strong growth of the branch network of these two banks was not a result of an institutional expansion due to market forces in the economy, but was, to a great extent, due to the intervention of the government to democratise the banking system. Consequently, though this goes against economic principles, such an intervention seems reasonable as the foreign banks were not interested in operating a wide geographical branch network.

With the implementation of new economic policies in 1977, far reaching reforms were introduced in the financial sector as well. Under these new economic policies, free trade zones were established and as greater reliance was placed on foreign direct investment, recognised foreign banks were permitted to open branches in Sri Lanka. One result of these policies was the establishment of off shore banking in 1979. The primary objectives of these policies were to develop Colombo as an international financial centre, and to attract and transfer surplus resources for the development of the country. By 1994, the number of foreign bank branches operating in Sri Lanka had increased

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Fiscal and Financial Reforms in Sri Lanka

Dr V Kanesalingam

Fiscal and financial reforms are part of the comprehensive package of economic liberalization programme. As Deepak Lal explains:

"A major motivation for liberalisation from the viewpoint of many states in the developing world lies in an attempt to regain control over an economy which seems to be less and less amenable to the usual means of government control. Usually the most important symptom of this malaise is a creeping but chronic fiscal crisis (also reflected sometimes, but not always in a balance of payments crisis), which has in different forms beset most economies in the last decade. Its origins lie in the creation of politically determined entitlements to current and future income streams for various groups in the economy (the deserving poor; industrial labour; regional interests; old age pensioners; infant declining, or sick, industries to name a few). As these entitlements are implicit or explicit subsidies to particular groups, they have to be paid for by implicit or explicit taxation of other groups in the economy. However, justifiable on grounds of social welfare, the gradual expansion of this transfer state leads to some surprising dynamic consequences".

A consequence, as Lal observes is the accompanying tax burden to finance the gradual expansion of politically determined entitlements. This increasing tax burden leads at some stage to generalised tax resistance, avoidance and evasion and to the gradual but inevitable growth of parallel or underground economy. With taxes being evaded, with domestic and foreign credit virtually at an end, with private agents having adjusted to inflation to evade the inflation tax, the government finds its fiscal control of the economy vanishing. The usual response to this situation is for the government to regain a degree of fiscal control through some liberalisation of controls in the economy. Typically, however, these liberalisation attempts are half-hearted and include some tax-reform, monetary contraction and some measures of export promotion. As Lal points out: "The major lesson to be drawn is that liberalisation is often undertaken to regain fiscal control but if nothing is done to rescind unsustainable public expenditure entitlements a stabilisation cum balance of payments crisis eventually emerges which undermines the attempt to liberalise the economy. It would thus be seen that a *sine qua non* of a sustainable liberalisation attempt must be the prior establishment of fiscal control through a reduction of unsustainable public expenditure commitments".

Turning to the Asian countries, one notes that beginning from the late seventies, fiscal and financial sector reforms have been an integral part of the overall structural reform of the economies of these countries. They have recognised that in both the short-term stabilisation and long-term structural reform programmes, reforms in the fiscal and financial sectors play a crucial role. Fiscal adjustment as well as consequential monetary policy changes is required for stabilization. In the longer term context a revenue-buoyant fiscal system that will sustain incentives and will promote the efficient use of resources has to be established. As for the financial sector, its structure, scope of freedom of operations and regulation must be changed to enable the effective use of monetary policy to promote saving and its financialization and to ensure the most efficient deployment of financial resources.

Starting in some cases in the late seventies and in others during the eighties, fiscal and financial sector reforms have been carried out in most of the Asian countries. In the reform effort, however, South Asian countries, except Sri Lanka, seem to have lagged behind. Among the larger countries, India seems to be the later comer. In all these countries, however, the inefficiencies arising from the suppression of competition and from centralised allocation of resources have become more and more evident.

Fiscal Reforms

The economic reform programme launched in 1977 was followed by changes in the fiscal policy of Sri Lanka. These changes had as their main aim the creation of an environment conducive for accelerated economic growth and development. Accordingly, the government budget was assigned a multiplicity of functions, such as resource mobilisation for development of infrastructure, allocation of resource for education, health and other services to improve standards of welfare and the creation of a favourble climate for private sector enterprise while ensuring economic stability. Fiscal pressure in Sri Lanka are severe with government revenue around 21 per cent of GDP and expenditure around 31 per cent. The fiscal challenge is to make substantial inroads into this deficit. The fiscal change required will be unlikely to be realised solely through expenditure reduction. The focus of fiscal reform, particularly in the context of the economic liberalisation programme is on tax policy, the aim of which is to raise substantial extra revenue whilst restructuring the system to provide greater simplicity, efficiency and consistency with a more market oriented economy.

While economic reforms introduced in 1977 had improved economic efficiency, they were not altogether successful in reducing the size of the public sector, in improving the performance of public enterprises and in re-orienting the industrial sector towards export markets. These structural constraints to growth have been aggravated by a level of public spending far beyond the country's available resources. Inspite of a relatively high revenue/GDP ratio of around 20 percent, fiscal deficit rose to 18 percent of GDP in 1980-82, gradually declining to 11-13 percent during 1983-88. The resulting expansion in aggregate demand fuelled inflation and because of inadequate flexibility in the exchange rate, it led to a gradual depreciation of the exchange rate in the 1980s. This has impeded faster development of the export sector and its diversification. This has, together with the deterioration in the external, terms of trade, contributed to current account deficits which averaged 16 per cent of GDP in 1980-82, though gradually declining thereafter to around 10 per cent of the GDP.

At this point it is pertinent to refer to some broad features of public finance in Sri

Lanka over the past 15 years. Although the private sector began to play an increasingly important key role since the launching of economic liberalisation in 1977, there was still large government involvement in major lead projects and the role of the public sector continued to be significant in the economy even a decade or more thereafter. To illustrate, the total government expenditure had still been around a third of the GDP by the end of the decade of the eighties. The substantial excess of government expenditure over its income resulted in higher annual deficits which as explained above were around 10 per cent of the GDP in that decade.

Deficit financing has been a feature of Sri Lanka's fiscal management. As shown above, during the 1980s, exceptionally high fiscal deficits of over 10 percent of the GDP were the norm. These fuelled inflation, crowded out private investment in favour of relatively unproductive public investment and increased the public debt. The most destabilizing fiscal outrun in recent years was in 1988, whose overall deficit reached 15.7 per cent. This required inflationary borrowing from the monetary system of 4.6 per cent of the GDP which partly contributed to the 21.5 per cent inflation rate recorded in 1990.

In this background,fiscal policy was oriented to the need to reduce the deficit and was a turnaround in fiscal management, Fiscal operations in the period commencing 1989 resulted in an overall deficit of 10.4 per cent of the GDP which was considerably lower than the deficits experienced since 1978. Since 1989 government revenue has averaged around 20.7 per cent. However, during this period current expenditure also remained high at around 22.2 per cent of the GDP. But a lower capital expenditure during this period contributed towards sustaining lower budget deficits.In financing these deficits, the government relied on both foreign and domestic sources. The use of foreign loans since 1989 averaged at around 4 per cent of GDP while foreign grants remained at around 2.1 per cent of GDP. The most noteworthy feature of the post-1989 period is the elimination of borrowings from the banking system for financing fiscal deficits.

Fiscal operations have also had an impact on the size of the public debt. The continuing high budget deficits in the period since 1977 contributed to great increase in total public debt from Rs 24,434 million in 1978 to Rs 404,863 million at the end of 1992. In relation to GNP it rose from 57 per cent in 1977 to 97 per cent in 1992.

The magnitude of the budget deficits and the consequent increase in the public debt indicated the need for reforms not only to reduce public expenditure as a fraction of GDP but also for increasing tax revenues. In the context of the on going process of economic reform the need for fiscal reform became increasingly imperative. Accordingly the government appointed the Taxation Commission in July 1989. The Commission was required,among other matters, to inquire and report on the then existing system of taxation including the overall incidence of tax, the mix of taxes, the revenue potential and the actual revenue performance of the various taxes, the tax structure including the base and rates, as well as the methods of assessment and collection of taxes. In its report presented in November 1990, the Commission observed, inter alia, that:

"Within the broad framework of national development policies and strategies, it is to the private sector that the country would look, in the future, to undertake the necessary investment for the expansion of production and the rapid generation of employment opportunities which are a *sine qua non* for future economic growth and social stability. As the government's policy pronouncements clearly state, the era when it was sought to achieve these objectives through taxing the private sector and using such tax revenues for investment by the public sector is over".

The Taxation Commission had observed (in 1990) that fiscal policy in Sri Lanka "has recently been moving in the direction of a low rate system with the gradual limitation of tax incentives". The Commission was of the view that the trend towards the elimination of the incentives should continue and that the tax system should move further in the direction of a broad based, neutral and low rate system. It recommended a system with lower rates applied to a broader base in order to establish a better foundation for adjustments necessary on fiscal policy grounds.

In the context of liberalisation of trade, the Commission had recommended that (i) export duties should be scaled down and should be used only sparingly and when required in the national interest; also, the export duty tariff should be simplified; and (ii) export cesses should be phased out, and the institution for which these cesses are earmarked, should set up their own funding mechanisms and institutional arrangements for research and development.

Financial Reforms

Prior to 1977, the financial system was repressed with negative real interest rates and relatively slow expansion of financial assets, as reflected in their low ratio to the GDP. The nominal rates were in the range of 7 to 7.5 per cent on one year time deposits mostly held by two of the state owned banks. Bank lending rates were higher than deposit rates, ranging between 9.5 to 14 per cent and in the context of the prevailing inflation rate then, they were negative in real terms. Most credit to private sectors was subsidized through selective credit policies.The subsidy was financed by the Central Bank through the liberal and unrestricted accommodation the banks enjoyed with the former at concessionary refinance rate.

The financial liberalisation policy started with the removal of restrictions placed on the foreign banks and also on the domestic private banks as regards the opening of new branches. Many new foreign banks entered the country under the licensing system to open new banks. The main accent on Sri Lanka's financial reform was the removal of restrictions on interest rates.With the economic liberalisation, it became necessary to allow market forces to determine interest rates so as to mobilise domestic savings to meet the growing investment needs of the economy. This necessitated the adoption of measures to eliminate administrative controls on interest rates. The bank rate was raised from 8.5 to 10 per cent per annum.

This gave the signal to other market rates of interest and there was a sharp rise in the interest rates on deposits of the National Savings Bank (NSB), the most dominant mobiliser of financial savings.

Simultaneously, the basic exchange rate and the premium value (FEEC) were first unified at an initial rate of SL Rs 16 to the US dollar and then the exchange rate was allowed to float. The depreciated exchange rate and increased domestic interest rates helped to reduce the illicit outflow of financial assets and to strengthen the domestic financial intermediary process. At the same time the Central Bank adopted measures to contain monetary expansion in order to ensure that positive real interest rates were realized. It restricted access of banks to its credit to 4 per cent of selected items of assets as of 30 September 1977.

Two features of the financial reform in Sri Lanka merit recognition: one, the financial reform was much milder than might have been expected; two, government intervention did not evaporate though the form and direction it had assumed until recently and was market determined. It was not the dimension of the financial reform that was important but the break it marked from the dirigistic traditions of the country's policy makers.

The reform enabled the financial system to operate in a more competitive environment, since more banks, especially foreign banks, entered the field. This was evident from the subsequent establishment of the foreign currency banking units (FCBUs) which could transact in foreign currency with non-resident enterprises in the free trade zone.

In brief, the financial reforms adopted in Sri Lanka in the post-1977 period pursued several policy objectives, viz: (a) to improve the efficiency of the financial sector by restructuring state-owned banks, reducing intermediation costs of lending and removing interest rate ceilings; (b) to promote a secondary market for government securities; (c) to promote the use of equity financing for investment projects through the public issues of shares in the Colombo Security Exchange and to improve the regulatory capacity of the Securities Council and (d) to expand and accelerate the privatisation (peoplisation) programme to include a number of state-owned enterprises and selected financial institutions and ensuring a broad-based share ownership.

Along with measures to depreciate the exchange rate and to reduce the illicit outflow of financial assets, there has also been substantial liberalisation of foreign exchange controls. These tended to aggravate underlying inflationary pressures. The greater propensity for exchange rate to fall in the context of a liberalised foreign exchange environment carries with it the possibility of an inflation-currency depreciation spiral. This greater propensity for the exchange rate to fall also means that there would be less protection for the domestic economy from price shocks emanating from the world economy.

Liberalisation of exchange controls helps [illegible] since profits and capital can be remitted [illegible] any time. The accompanying currency depreciation will give further boost to the export sector particularly the manufacturing export sector.

The progress in the liberalisation of foreign exchange restrictions is indicated below:

1977 Delegation of authority to commercial banks to release foreign exchange for selected current transactions. Relaxation of restrictions on remittances of profits and dividends.
1979 Exchange controls were further relaxed, [illegible] commercial banks.
1980 Increased release of Non-Resident Blocked Funds and introduction of the Resident Non-National Foreign Currency (RNNFC) Account Scheme.
1982 Exchange entitlements of living expenses of Sri Lankan persons studying abroad were increased.
1985 Exchange entitlements of Sri Lankans abroad further liberalised.
1989 Release of foreign exchange for travel abroad further liberalised.
1990 Commercial banks were permitted to open Non-Resident Foreign Currency (NRFC) accounts for Sri Lankans and [illegible] released.
1991 Exchange allowances for business and [illegible] travel increased.
1991 Residents in Sri Lanka were permitted to bring in unlimited amounts of currency. No foreign [illegible] in Sri Lanka.

1993 The annual basic exchange allowance for travel abroad was raised significantly.
1993 The repatriation and surrender requirements in respect of export proceeds were abolished. Export proceeds were permitted to be retained in foreign currency accounts [illegible] in Sri Lanka or abroad. The remaining restrictions on payments in respect of travel. All [illegible] were removed.
Commercial banks were permitted to issue international credit cards.
Foreign exchange allowances of emigrants at the time of departure was raised.
The remittance of pensions in full to persons retired and permanently living abroad was permitted.
1994 All remaining restrictions on current account transactions were removed and the country reached Article VIII status of the IMF accepting obligations under Sections 2,3 and 4 of Article VIII of the IMF Charter with effect from 15 March.

Cont'd from page 5

But the international community has important interests at stake in addressing the risks associated with capital flows. A better understanding of these risks and greater confidence in managing them would encourage countries to participate more actively in world markets. More-open and better functioning capital markets in developing countries would improve the use of global resources and increase portfolio diversification.

What kind of collective actions could help achieve these benefits? Closer consultation among central banks and financial regulators could help upgrade national regulatory frameworks and financial practices. And greater cooperation among national authorities could help establish procedures for mutual assistance in crises, such as the IMF's new facility to help member countries absorb external shocks.

Another concern is growing regionalism. The past two decades have witnessed a sharp increase in the number of regional market-opening agreements, including NAFTA, Mercosur, and APEC. Regionalism is not simply about trade. In the case of the European Union, for example, it also reflects the desires of neighbouring nations for greater political integration in response to common security concerns, for cost sharing for infrastructure and institutions, and for increased bargaining power in international negotiations.

Opinion is divided on the merits of regional arrangements, and the evidence remains inconclusive. Some argue that regionalism will divert attention and resources away from the more important multilateral processes and undermine progress toward global nondiscriminatory trade rules. Others contend that regionalism enables states to undertake innovative market-opening measures that will eventually serve as building blocks for multilateral initiatives. Regional partners have indeed pioneered arrangements later adopted in multilateral agreements; and example is the European Union's treatment of trade in services.

Some of the concerns about regionalism may be legitimate. But regional arrangements can be made more consistent with more-open and integrated world markets. One way is to open membership in such arrangements to any trading partners what wish to join, rather than restrict it to countries within the region. Another option is to establish, through a multilateral mechanism, a time-bound convergence process for ending differences between internal and external trade barriers to a stipulated minimum. (Extracted from World Development Report 1997)

Financial Markets The Need for Reform

by

R M B Senanayake

Inspite of lofty statements by persons in authority about making Colombo a financial centre for South Asia, there is little market development. The stock market is highly automated with screen based trading and a central depositary for shares. The brokers offices are computerised with an electronic order entry system where orders can be entered from the brokers office itself and confirmation of trades can be obtained instantly. Until a few months ago, the brokers had to meet on the floor of the Stock Exchange and bid against each other under the open outcry system of auctioning of shares. Confirmation of trades to the clients was available only after close of business at the end of the day. Now there is on-line trading and also an on-line market information system which clients can access while trading is going on. Customers can also access their portfolio on-line and can place orders and have them executed instantly if they match a buy or sell quotation for the required quantity. The customer can also access his financial account to find out how much he owes the broker or the latter owes him. Brokers can now issue monthly account statements showing all their transactions for the month.

The mechanics of trading are now easy. But the Stock Exchange doesn't allow the standard market practices followed in other stock markets. In most markets payment for the shares purchased is **on delivery** - with the money changing hands at the same time as the shares. In our bourse, the shares purchased or sold are transferred at the end of the day by electronic book transfers in the Central Depositary, although the financial settlement is on T + 5 (trade date plus 5 days) for purchases and T + 7 (trade date plus 7 days) for sales. The settlement date is therefore for financial settlement and not for delivery of the shares purchased. In other markets the settlement date is the same for purchases and sales. The present practice has arisen to help the broker firms to obtain money on purchases before they pay out on sales of the same day. The system of delivery versus payment is more conducive to market development since it makes short sales possible, giving time for the short seller to borrow the shares.

Margin Trading

The purchase of shares in developed markets involves either an outright purchase where the full sum is paid on settlement day or a purchase **on margin**, where for example a Finance Company may guarantee the payment by a letter. A more formal instrument such as a promissory note would be more legally binding. It would cover say up to 50% of the value of shares purchased by the client. The present practice is for the broker and the lending institution to sign an agreement under which the sales proceeds are sent to the lending institution instead of the client and the lending institution undertakes to pay for the purchase. The broker firms should be allowed to engage in such margin trading. They are in a much better position to do this business with less hassle for the clients - It also gives an additional source of income to the broker firms. At present the rules of the Stock Exchange require compulsory sales of shares not paid for by T + 15. This should be left to the discretion of the broker firms provided sufficient margin by way of cash or securities is available in his account and it is the margin that perhaps could be specified by the Rules.

In other stock markets short selling of shares is permitted. This is generally done by brokers lending the shares to clients who wish to sell short (sell shares which they do not have because they think their share prices will come down and they could repay loan by purchase at a lower price, giving them a profit). The broker firms make a charge for such lending. Financial institutions like the Unit Trusts, Merchant Banks etc. could lend shares to the brokers for on-lending to their clients. Short selling allows clients who wish to speculate to do so. A client who takes a view of the market should be able to sell even without having the share if he feels a particular share is overvalued and its price is too high and should come down.

It is noticed that stock markets in the world recover fast after a steep fall. We saw how the New York market bounced back the very next day after a steep fall of 7%. This is because short selling is permitted. Our stock market however, exhibits long periods of slow declines in prices although it can and has fallen steeply at times. Prices are not adjusted fast enough to new information, particularly for individual shares apart from general market movements. If a company puts out adverse results or results below expectations, then its stock price will be downgraded. It is better for it to be adjusted speedily. Speculators and other active market players sell on being aware of adverse results or when they suspect advice results. The market price should settle down soon in line with the new realities. In our market the decline is slow and protracted.

Another weakness in the market is that broker firms are not allowed to trade on the firms account. This practice is allowed freely in other countries and is responsible partly for the lower volatility of share prices in such markets. Brokers realise early when there are bargain prices and if they are free to buy, they will do so without waiting for clients to come along who will realise these prices are too cheap. Of course there is a risk that broker firms will put their interest first, before the interests of their clients. But this can be regulated as elsewhere. This facility should be allowed at least for the most liquid shares. According to our company law a company is not allowed to buy its own shares. This is an outmoded restriction repealed in most countries. Our proposed new company law is in cold storage for the last 3 years owing to lobbying by interested parties. In other countries a company will buy back its shares if it feels it has fallen too low or if it feels there should be less equity and retire some of it.

Corporate Governance

The governance of quoted companies requires to be improved. Some companies have only Executive Directors while others have wholly or mainly Non-executive Directors from outside the companies. The weakness of the former is that the Managing Director who is often the Chairman as well, is all-powerful. There should be checks and balances on the power of any holder of power, for the good of the organization. Lord Acton's saying, that : power corrupts and absolute power corrupts absolutely – is as applicable in the private sector as in the public sector.

Companies which have outside directors, seem to select them to adorn their Boards rather than for any contribution they can make. Very old men are appointed and they go on and on, term after term. The selection of outside directors seem to be a matter of kissing going by favour. A Chairman of a particular company may appoint to his Board, men from another company board and the latter will return the compliment by appointing him to their boards. Such outside directors are beholden to the Chief Executive and are reluctant to exercise their independent judgement in deference to the traditional value of loyalty to the person who appointed them. The latter too expects such loyalty. The Directors in the process lose sight of their fiduciary obligation to the shareholders.

There is also siphoning of money from the quoted company into private companies owned and managed by the managing director or the controlling shareholder. High management fees based on turnover are paid to such private or unquoted companies by the directors of the quoted company depriving minority shareholders of their legitimate return. Quoted companies resort to such transactions only where the other party is a fully owned subsidiary or at least subsidiary of the

[illegible]	[illegible]	[illegible]	[illegible]

Source: Central Bank

company. The authorities have not realised the extent of the problem and the need for 'arms length' transactions. The Accounting Standards although applicable under the S.E.C. regulations are not enforced strictly. Investors in the primary market have dried up because primary issues were sold at large premia above the par values, not justified by the earning capacity or the net asset values.

Foreign investors in the stock market are much less than in the heady days of 1992-94. In 1995 there was a net outflow. In 1996 the net outflow was around Rs 200 million. In 1997 too there will be a net outflow. Since the currency and stock market crisis in South East Asia there is a regular net outflow every week. Foreign investors have to cope with the risk of an exchange rate depreciation in addition to the market risk of a fall in prices. Foreign institutional funds would like to hedge such currency risk. But there are no hedging instruments available in our financial market for either market risk or foreign exchange risk. Market risks are normally hedged by investing in the derivative market, trading in futures and options. We do not have such markets. We haven't even thought of such a market although the Central Bank has recently referred to the need for a Commodity Futures Exchange. The Colombo Brokers Association recently celebrated their centenary. Commodity Traders in other countries have progressed from Auctions to a Commodities Exchange over much shorter periods.

The currency risk can be hedged by a forward exchange contract. But our forward exchange market is stultified by restrictions. Forward contracts are available only to importers and exporters of goods, not to all those having an exposure to currency risk. It is desirable and even necessary to allow foreign investors to access the forward exchange market. In the case of direct foreign investments, the investors can keep their cash in foreign currency and convert only what is necessary to pay out locally. But in the case of portfolio investors, they have to convert their money into Rupees into a SIERA (Share Investment External Rupee Account) Account, before they can buy shares in the stock market. They don't earn interest on idle balances in such accounts which are treated as current accounts although no cheque books are issued. So, if foreign portfolio investors are allowed to buy and sell forward exchange contracts they may be more willing to continue to hold their shares in an uncertain situation such as the present, when stock markets have crashed all around us.

Long Term Debt Market

The long term debt market consists primarily of government bonds. A few companies have issued corporate debentures though not quite successfully, and have listed them on the Stock Exchange. But the volume of trading in such debt securities is negligible. There are also a number of government debt securities maturing in the medium term which used to be traded insignificantly in the stock market prior to the Stock Exchange introducing screen based trading. They were also traded in insignificant quantities and only once in a way. New issues of long term debt, the primary market, are taken up mostly by the captive government institutions like the Employees Provident Fund, the Employees Trust Fund, the Insurance Corporation and the National Savings Bank. These institutions hold such securities to maturity even though the interest rates may change giving them sometimes the opportunity for capital gains. These institutions as well as the banks do not mark down the value of such securities in their Balance Sheets when interest rates rise above the original coupon rates. The Banks and Insurance Companies also hold such securities to maturity since they do not write down the value of the investments on the basis of the current yield of 13-14% for long and medium term securities. The loss on the holding of securities is no longer hidden then and the profits would be reduced. Thereafter these institutions no longer have an incentive to hold such securities to maturity. Such a measure would activate the secondary market in debt securities and provide a bench-mark for pricing of corporate debentures. A Corporate debentures market cannot develop in the absence of a developed secondary market in government bonds.

The Reserve Bank of India insists that the government long and medium term securities in the portfolio of the banks should be valued on the basis of a yield of 14% for a 10 year loan and 13.5% for a 2 year loan. The government should also issue medium and long term debt through auctions and the captive government institutions should have the freedom to invest in such securities or not and make competitive offers. A free competitive primary market for debt securities is ess essential for a corporate debt market to emerge. Corporate bonds being unsecured are not risk free like government bonds. There is the risk of default when the maturity date comes along. So there will be a risk premium on such corporate debt. It is also necessary to establish a credit rating agency. This is a financial infrastructure requirement where the government must take the initiative. Objective credit ratings can be made only if the agency is independent and not controlled directly or indirectly by corporates.

Some companies have issued convertible debentures, convertible into shares on maturity on the assumption that the share market would have improved from the time the issue is made. Sometimes warrants are attached to make the debentures more attractive.

The lack of an effective clearing system and a depositary centre for government debt securities also hinders the development of a secondary market in debt. Listed corporate debt securities have such a system. But the major players in government bonds, the banks and financial institutions are not participants in the clearing mechanism of the Stock Exchange. In the case of shares such a clearing is operated by ANZ Grindlays Bank on behalf of the Stock Exchange. Perhaps a similar clearing is necessary for trading in debt securities. It could include Treasury Bills as well and should include the primary dealers and any other large players like EPF, ETF and the Insurance Companies. The present system of paper transfers is clumsy and extremely slow.

The government seems to have at last realised that financial instruments should not be taxed although financial institutions should be taxed. Secondary markets can't develop if the financial instruments are taxed. Withholding tax on debt securities has been withdrawn in the recent budget. Capital gains on the sale of debt securities will also be tax free from next year. But this tax exemption is confined only to primary dealers. It should be extended to the public investors as well, to encourage them to sell in the secondary market instead of holding such debt securities to maturity. It is necessary for the Inland Revenue Department to define interest, discount and capital gains so that the public understood how the tax system operates. It is only then that the public can decide rationally when to hold a security to redemption and when to sell in the secondary market.

There is also no reason to debar foreign investors from the debt securities market when they are allowed into the stock market. There will be no rush to enter because of the exchange risk, risk of inflation and the country risk. It might also attract non-resident Sri Lankans to invest. As the economy grows faster, foreign funds will be attracted which will relieve the pressure on local funds which are required by the corporate sector. The corporate debt market will emerge only when a bench-mark interest rate for medium and long term government debt is established. Long term interest rates are affected by the public's expectations of future inflation. A more informed further opinion will arise if foreigners also have access to such a market. Once a bench mark interest rate is established the companies can decide whether they can borrow through the issue of debentures at a more favourable rate than currently obtainable from the banking system and development banks.

A debt market should develop with the Finance Companies, Insurance Companies, Unit Trusts and foreign investors as major players. The government debt market presently consists mainly of the primary dealers who are expected to be market makers. But they cannot quote two way prices owing to the smallness of the secondary market. They do not quote a daily asking/bidding price for any debt security. The prices of government bonds in the secondary market are now reported in the newspapers. But the prices are not widely disseminated and the pricing structure is fragmented. The Central Bank operates a re-purchase market for Treasury Bills to provide liquidity. It should be extended to all government debt securities. The Repo market participants are linked to the banks. Other recognised financial institutions may also be brought in. Repos should perhaps lower a longer term to maturity, say up to one month - No details are published which show the distribution of Repo transactions according to their maturities. The Central Bank should do so.

The recent fall in interest rates have exposed the banks to the risk of interest rate mismatch on their assets and liabilities. They pay interest on Savings and Fixed Deposits at a fixed rate to maturity. They receive interest on their overdrafts and loans. The interest rates can be changed only when they come

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Treasury Bond Programme

Trends During the 1st few Months of Implementation

by
K. G. D. D Dheerasinghe
Central Bank of Sri Lanka

Issue of Treasury Bonds by the Central Bank of Sri Lanka (CBSL) which began in March, 1997 continued since then at regular auctions held on fortnightly basis. Total Treasury Bonds issued during the first 7 months at 14 primary auctions amounted to Rs. 8,000 million. This total includes Rs. 6,500 million, made up by Rs. 500 million each issued at 13 of the 14 primary auctions and Rs. 1,500 million issued in one auction. The maturity was 2 years in respect of bonds amounting to Rs. 7,500 million whilst the balance Rs. 500 million was issued with a maturity of 4 years.

The Treasury Bond programme was launched by the CBSL as part of the Financial Sector Reforms Programme undertaken by the Government of Sri Lanka. The focus of the introduction of this new debt instrument inter-alia, was on effective debt management, better monetary policy operations and development of the government debt securities market.

Treasury Bonds differ from hitherto available Government Debt Securities in respect of many attributes. The exclusive characteristics of Treasury Bonds are associated with medium to long-term maturity, market determined yield and issue in the form of coupon bonds. Treasury bills which are zero coupon securities have also been issued at market determined yields, but the maturity of these securities is restricted to less than 12 months. The Government Rupee Loans which are long term debt securities are issued at administratively pre-determined rates of interest. Therefore, medium/long term coupon bonds issued at market determined yields have been a unique features of Treasury Bonds.

2. Primary Issue of Treasury Bonds

Method of Issue

Treasury Bonds have been sold by auction which were held fortnightly. The value dates have been the first and 15th of the month and auctions have been held two days prior to this date. The Primary Dealers had exclusive access to primary auctions of Treasury Bonds with the exception of the Employees' Provident Fund (EPF) which was allowed to bid on a non-competitive basis. The purpose of permitting the EPF was to ensure that the auction is fully subscribed. This arrangement was deemed justifiable since there is no provision for purchase of Treasury Bonds by the CBSL at primary auctions as in the case of Treasury Bills. As stipulated in the Statement of responsibilities for Primary Dealers (SRPD) one responsibility of the Primary Dealers is to fully subscribe the primary auctions. However, this provision has not been strictly enforced by the CBSL.

Bearing in mind the concern of the issuer, i.e. the CBSL of likely undersubscription of the issue, the options available were either placement or issue on tap basis. The auction alternative, which is a much more market based method was preferred to the other two alternatives. All past auctions have been fully subscribed by Primary Dealers. It appears that this modus operandi is now well established.

Amount Issued

The Treasury Bond Programme announced by the CBSL envisaged a total issue of Rs. 10 billion for the period March to December, 1997. The cumulative value of Treasury Bonds issued at 14 auctions during the past 7 months is totalling Rs. 8 billion. Except in one auction where the amount issued was Rs. 1,500 million, rest of the 13 auctions confined to Rs. 500 million which was the amount originally announced. It was deemed desirable to maintain uniformity in the amount offered in order to maintain regularity of the programme. This would also have ensured stability in the market.

Coupon Rate

Treasury Bonds are coupon bonds. They were the first debt securities issued in form of a coupon bonds in Sri Lanka. Treasury Bonds carry a coupon rate and this was 14 per cent in respect of issues in the first 2 auctions. The coupon rate which is administratively pre-determined by the CBSL continued to be adjusted in alignment with the interest rate trends in the market. A sharp drop in interest rates was observed in the market since March, this year and the coupon rate was gradually lowered in successive issues and was fixed at 12 per cent per annum at the last two auctions of two year Treasury Bonds.

Interest on Treasury Bonds is payable half yearly at the coupon rate and for this purpose interest coupons are attached to the bond certificate. The amount of half-yearly interest payment is indicated in these detachable coupons. Investors are expected to present their Treasury Bond certificates to Primary Dealers who will detach the coupon and return to the Public Debt

Table 1

Primary Auctions of Treasury Bonds
From March 1997 to September 1997

[illegible]

Source: Central Bank of Sri Lanka

Department of the CBSL for collection of interest proceeds. The interest payment of the first issue of Treasury Bonds fell due on 1st of September, 1997. Up to now first half-yearly interest payments of two Treasury Bond issues have been made. The regular flow of income to the investor in the form of coupon interest has been an attraction built into Treasury Bonds.

Maturity

The maturity period of Treasury Bonds issued up to now has been 2 years in respect of 13 issues with the exception of one issue where 4 year bonds were issued. With the issue of Treasury Bonds, a tradeable instrument with a maturity over 12 months became available in the market. Although there was a general reluctance on the part of Primary Dealers to purchase a longer term instrument, Treasury Bonds fast became popular and with this new development, an environment conducive for a long term yield curve to be established was created.

Treasury Bond Yields

At the primary issues, yields of Treasury Bonds depended on the prices at which they were bought by the Primary Dealers. The coupon rate has only been an indicative yield. This observation is made on the basis of actual (weighted average) yields to maturity and coupon rates of Treasury Bonds issued at primary auctions in the past seven months. Figure 1 shows that actual yield to maturity has differed from the coupon rate in most of the recent issues and this may be attributed to downward pressure on the interest rates.

The Primary Dealers had the freedom to bid at discount or at par or at a premium at primary auctions. If the bids are accepted from dealers at discount, the yield to maturity will be higher than the coupon rate. In the case of bids accepted at par the yield to maturity will be equal to the coupon rate. If the dealers have bid at premium, the yield to maturity will be lower than the coupon rate. The experience during the past seven months indicates that Treasury Bonds have been sold at different auctions either at discount or par or at premium. At the first two auctions where the coupon rate was 14 per cent, the entirety of the issues have been sold at par and hence the yield to maturity of these bonds has been 14 per cent. However, 12 auctions that have been held since then have shown different bidding patterns where at 11 of these auctions more bids than the offer have been received at premium and hence, the issues have been sold to primary dealers at yields

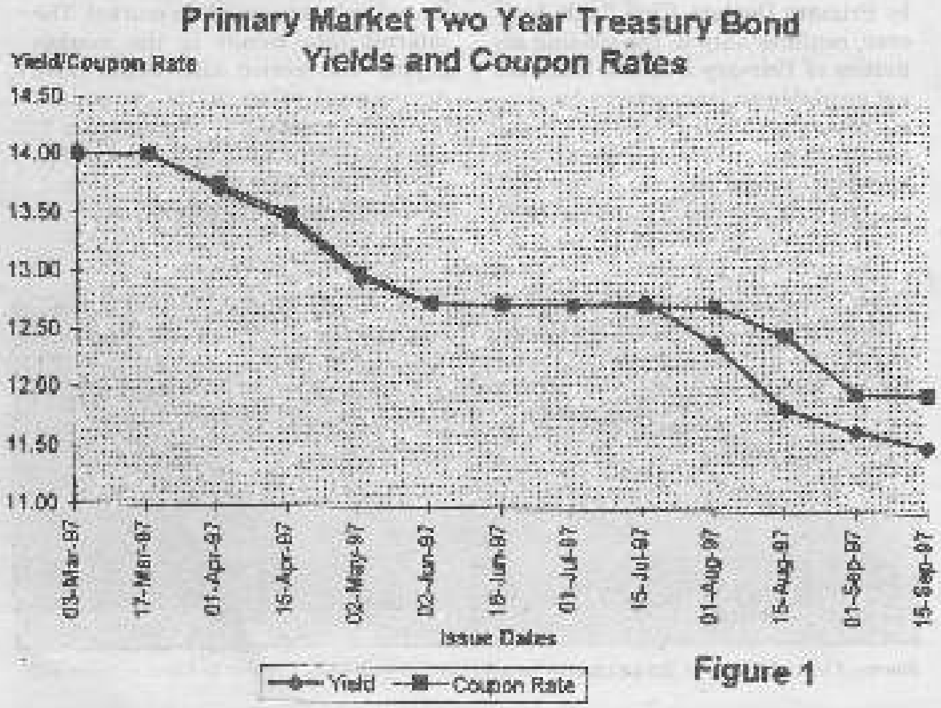


Figure 1

to maturity less than the respective coupon rates. In one auction bids have been accepted at discount and this has resulted in higher yield to maturity than the coupon rate, although marginally. In more recent auctions bids have been made at premium and as a result the yield to maturity has fallen considerably below the coupon rate. Detailed statistics on the auctions held during the first seven months of the Treasury Bond Programme are given in Table 1.

Level of Subscription at Auctions

Bids received at each auction in the past have been much higher than the amount offered. The lowest value of bids received at an auction was Rs. 755 million where Rs. 500 million of 4 year Treasury Bonds were offered. The largest subscription received so far at one single auction has been Rs. 3,365 million where Rs. 500 million of 2 year Treasury Bonds were offered. The cumulative total value of bids received at all 14 auctions in the past seven months amounted to Rs. 23,174 million which is nearly four times the total amount offered at Rs. 6,000 million. The growing oversubscription at successive auctions has been due to increased popularity of Treasury Bonds which has provided an adequate return to the investors and liquid and easily tradable instrument to the dealers.

3 Secondary Market of Treasury Bonds

A secondary market for Treasury Bonds emerged although in a small way after the first few primary issues. The Primary Dealers who began bidding for the purchase of Treasury Bonds cautiously in a small scale at discount in the first two auctions soon began to bid confidently at par and at premium, thereby showing more effective participation.

The main characteristics of Treasury Bonds such as transferability, low risk and availability in flexible denominations have been the main factors that contributed to the emergence of the secondary market. Treasury Bonds are a liquid instrument and therefore, longer maturity periods than Treasury Bills do not appear to have been a constraint to their acceptability for trading in the secondary market.

The Treasury Bond yields matter more to the investors who keep securities until maturity than to dealers who use them for trading. The initial two issues of Treasury Bonds has yield to maturity of 14 per cent (since they were sold at primary auctions at par) and due to high return compared to the current interest levels in the market which are substantially lower than 14 per cent, holders of these Treasury Bonds were reluctant to offer them in the secondary market inspite of potentially high capital gains. The gradual and sharp fall in market interest rates would have discouraged secondary trading in Treasury Bonds. The buying and selling of Treasury Bonds in particular would have been more, had the market interest rates been stable if not falling.

Secondary Market Activities

The secondary market activities constitute buying and selling and repurchases and reverse repurchases. The former are genuine secondary market transactions while the latter arise from liquidity needs. The lending and borrowing of securities may also be taking place in our secondary market, but their magnitudes are unknown. The question also remains whether or not the transactions of this nature be permitted.

Table 2 provides some statistics relating to secondary market transaction by Primary Dealers. This Table however, confines only to the trading activities of Primary Dealers. Data are not available on transactions by players other than Primary Dealers. Since our market is not well developed, it may be assumed that the volumes of trading by non Primary Dealer players are small. Further, Table 2 contains only sales of Treasury Bonds by Primary Dealers and if their purchases are included this will lead to double counting.

A major non Primary Dealer player operating in the market has been the Employees' Provident Fund (EPF) who also has access to the primary auction at the CBSL. Hence, other than that of EPF, holdings of any non Primary Dealer player can result only from sales by Primary Dealers. The information in Table 2 therefore, is an under statement to the extent of sales by non Primary Dealer players are excluded.

The information in Table 2 is for the period 03rd March, to 30th September, 1997. During this period 14 primary issues of Treasury Bonds have been made for sale of Treasury Bonds for Rs. 6,000 million. Of this total Rs. 4,290 million (57.2%) has been purchased by Primary Dealers and the balance Rs. 3,210 million has been purchased by the EPF. Total sales in the secondary market by Primary Dealers amounted to Rs. 3,234 million and as at 30th September, 1997 their holdings amounted to Rs. 1,910 million.

The total volume of secondary market trading at Rs. 3,234 million for a period of 8 months is very small by any standard. However, this may be viewed more positively and in relation to the total purchases and holdings of Primary Dealers in an infant market. The interest rate trends in the market during this period also would have discouraged sales in the secondary market. Therefore, it is premature to comment and draw conclusions on the basis of information given in Table 2. However, some comments on the trends

Table 2

Secondary Market Sales of Treasury Bonds by Primary Dealers (Rs. Million)

[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]

Source: Central Bank of Sri Lanka

indicated by this data may be warranted.

Volume of Activities

The data on secondary trading activities by Primary Dealers indicate that the market has progressively increased its volumes of trading. For example total secondary market sales for the period up to 31st July, 1997 amounted only to Rs. 1,084 million. This volume of transaction was for a period of 5 months. The total volume of transactions for the two month period from 01st August to 30th September, 1997 amounted to Rs. 2,150 million. This amount is almost twice the volume for the former period. With the increase in primary issues of Treasury Bonds, market will have larger volumes for more trading in the future. In a situation where availability of Treasury Bills is becoming less due to retirement and non issue of new Treasury Bills, Treasury Bonds will be the main instrument available to the market for trading purposes.

Market Making

The Statement of Responsibilities and Privileges for Primary Dealers (SRPPD) requires the Primary Dealers to be market makers in Government debt securities. In fact, market making is the main function of Primary Dealers. As an initial step taken by the CBSL in this regard, guidelines have been issued requiring the Primary Dealers to quote two way prices for Treasury Bonds.

Table 3 provides statistics released by the CBSL on two way prices quoted by Primary Dealers. This Table contains averages of daily prices quoted by selected Primary Dealers and to that extent they are only indicative prices. It is evident from these quotes that the spreads between buying and selling prices have been too broad. In more developed markets buying and selling spreads are very narrow.

Volume of trading is a determinant of the profit level. High buying prices and low selling prices discourage trading. Hence, it is in their own interest that the dealers quote competitive prices.

Bottle-necks in the market

Although the market has shown encouraging trends, there remain some major bottle-necks. The physical issue of paper based certificates has been a bottle-neck for trading activities. At the primary auction the issue of scrip has not been a constraint since the bonds are made available to the Primary Dealers immediately after the settlement has been made. The problems occur in the secondary market where physical delivery of scrips is required as and when transactions take place. This problem may be totally addressed by a system of scripless securities. The CBSL is now examining this proposition. The issue relating to physical delivery may be partially addressed by a custodial system where the custodian maintains the scrips of all dealers. However, such a system is not in place at present.

Primary Dealers normally consider Treasury Bonds as a relatively less liquid instrument in relation to Treasury Bills. The reasons for this are as follows :

(a) As in the case of Treasury Bills, Treasury Bonds are not used by the CBSL for Open Market Operations. The CBSL cannot purchase Treasury Bonds at primary auctions due to legal restrictions. Hence, for the CBSL to acquire a stock it must buy Treasury Bonds in the secondary market. Upto now CBSL has not used Treasury Bonds for its Open Market Operations and therefore, at present CBSL does not have a stock of Treasury Bonds. The position of the CBSL is clear in this regard as it has indicated to the market that Treasury Bonds will be used for its monetary policy operations once the proposed system of Open Market Operations is implemented in the near future.

(b) Treasury Bonds have longer maturities than Treasury Bills. Conventionally, the length of maturity has an inverse relationship with the liquidity of the instrument. However, in developed markets, maturity period has no bearing on the liquidity of the instrument. This situation will ease gradually as the market develops.

(c) Treasury Bonds are not taken into account in computing the liquid asset ratio of commercial banks. Therefore, there is a general reluctance on the part of commercial banks to acquire and maintain stocks of Treasury Bonds. According to the Banking Act, securities with maturity less than 12 months are accepted as liquid assets and as maturities gradually get reduced overtime to less than 12 months Treasury Bonds will become eligible for the purpose liquid asset ratio.

Cont'd on page 30

Table 3

Buying and Selling Prices of Treasury Bonds
(On 08/10/1997)
Quoted by Primary Dealers

Bond Series	Maturity DD/MM/YY	Average Buying Price	Yield	Average Selling Price	Yield	Buying and Selling Spread
11.00% 1999 A	01.03.1999	103.64	11.09	104.29	10.59	0.65
14.00% 1999 B	15.03.1999	103.46	11.31	104.09	10.83	0.63
13.75% 1999 A	01.04.1999	103.14	11.38	104.00	10.75	0.86
13.50% 1999 A	15.04.1999	102.99	11.30	103.80	10.72	0.81
13.00% 1999 A	01.05.1999	102.13	11.46	103.20	10.71	1.07
12.25% 2001 A	15.05.2001	99.73	12.33	101.14	11.94	1.41
12.75% 1999 A	01.06.1999	101.80	11.50	102.21	11.20	0.44
12.75% 1999 B	15.06.1999	101.80	11.52	102.44	11.10	0.64
12.75% 1999 C	01.07.1999	101.61	11.56	102.70	10.97	1.09
12.75% 1999 D	15.07.1999	101.77	11.59	102.85	10.91	1.08
12.75% 1999 E	01.08.1999	102.36	11.25	103.19	10.74	0.83
12.50% 1999 A	15.08.1999	101.88	11.32	102.71	10.83	0.83
12.00% 1999 A	01.09.1999	100.80	11.50	101.66	10.99	0.86
12.00% 1999 B	15.09.1999	100.82	11.51	101.85	10.90	1.03
12.00% 2000 A	01.10.2000	100.61	11.75	[illegible]	11.25	1.21

* Per Rs. 100
** Yield to Maturity % per annum
This report is based on two-way quotes submitted by five Primary Dealers.

FINANCIAL M A R K E T

The Performance of the Colombo Stock Exchange

Rajiv Cassichetty

Established in 1896, the Colombo Stock Exchange (CSE) is the oldest securities market in the region. The market was used extensively to finance the expanding plantation sector and developed rapidly during the years of colonial rule until the late 1940s. However, the introduction of exchange controls and nationalisation of the plantations in the post-independence period crippled the market.

The market remained extremely inactive until the late 1970s when liberal economic policies introduced in 1978 placed the onus of development on the private sector. The shift in focus resulted in an increase in demand for capital from the private sector. The Government established a second development bank (National Development Bank) to fund capital requirements and actively promoted venture capital companies. The Government also took steps to revitalise the stock market by offering incentives to investors. However, development of the market in the 1980s was slow. Hurt by increasing intensity of the ethnic conflict and the economic slowdown in the latter part of the decade, development of the market slowed.

The Revival in the 90s

The market however gained a new lease of life in the 1990s with the government's initiative of opening the market to foreign investors. The market has since attracted increasing volumes of portfolio capital and made rapid strides in the development of its infrastructure.

As is common in emerging markets, performance has been characterised by extreme volatility. During the last 7 years the market has experienced two strong bull runs and two sharp declines. In statistical terms the market performance, recorded a 6% growth p.a. with a standard deviation of 220% over the past 7 years - 1990 to 1996 (Table 1)

Table 1

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

What drives markets – theoretical underpinning

In simple terms, the value of an asset is the present value of cash flows generated. Thus the value of an asset is directly dependent on the stream of future cash flows it is capable of generating and the discounting factor.

The equation 1 identifies the theoretical relationship between these factors.

Equation 1

$P = d(1+g)/(k-g)$

Where

P - price

d - dividend in the first year

g - sustainable growth in dividend

k - is the discounting factor

Future cash flows

Future cash flows in the case of stocks are dividends. The ability to pay dividends is dependent on the ability to make profits in the future. It follows naturally that the value of a stock is higher when its ability to make profits is greater. The ability to record growth in profits is dependent on its equity capital base, the return on equity and the retention rate (the profits retained for the year).

The relationship is given by equation 2.

Equation 2

$g = ROE*E(1-r)$

Where

g - sustainable growth in dividend

ROE - return on equity

E - earnings per share (EPS)

r - retention ratio (how much of profits is retained i.e. not paid as dividends)

The discounting Factor (k):

The discounting factor is the rate used to discount the future stream of cash flows to estimate the present value of the same cash flows. According to the Capital Asset Pricing Model (CAPM), the discounting factor is the sum of risk free return and a risk premium. The discounting factor takes into consideration inflation (incorporated in the risk free rate) and risks unique to a stock or an industry (incorporated in a risk premium). Due to the restricted capital movements (a closed capital account) valuation parameters of international and domestic investors differ. The international players will determine their valuations based on the investment opportunities in the rest of the world, prevailing interest rates and the currency outlook. Domestic investors will determine discounting rates based solely on local investment alternatives.

PE ratios and earnings growth - a direct relationship

Forecasting cash flows for listed companies based on publicly available information is both difficult and prone to error as the number of variables to be considered are numerous and vary substantially. At the same time, determination of an appropriate discounting factor and consideration of risks unique to the market, the industry and the particular stock - real return, inflation and risk of the industry - is laborious and extremely subjective. Most investors thus avoid using this tedious theoretical method of determining asset prices based on cash flows.

The most commonly used alternative for determining a fair value of an asset is the Price Earnings multiple (PE ratio). Here the EPS of an asset is multiplied by the appropriate PE multiple to compute the intrinsic value of the asset. A relationship between the PE and discounting factor and the earnings growth can be derived from the equation 1 above. The relationship is given by Equation 3.

Equation 3

$P/E=(1-r)(1+g)/(k-g)$

Where:

P - price

g - sustainable growth in dividend

k - discounting factor

g - sustainable growth in dividend

E - Earnings Per Share (EPS)

r - Retention ratio (how much of profits is retained i.e. not paid as dividends)

It is evident from the above relationship that the PE of a stock will increase as its growth potential increases and vice versa. The inverse is true of the discounting factor, i.e. the PE is low if discounting factor is high. Thus if risks associated with the stock are high or that a higher rate of return is required by the market (investment alternatives yield higher returns), then the PE will be lower. In order to dispense with the need to determine the discounting factor and the growth rates of earnings, the PE ratio is determined through relative references. The references are usually relative to the market PE or a PE of a stock in the similar trade with similar growth prospects and similar risks. The rest of the paper is a discussion of market performance in relation to earnings growth and PE ratios.

1990 – driven by foreign Interest in a illiquid Market

Plagued by political instability - a leftist insurrection and escalation of conflict in the North and East - and a sluggish economy - suffering from a severe drought, economic and corporate performance was poor. GDP growth was only 4.2% in 1989 and corporate earnings grew by 8%. The market traded at a PE of 11 x 1990 (historic basis i.e. on 1990 earnings). Against the back drop of political and economic instability the market seemed fairly valued or even marginally over valued.

In 1990 the behest of the World Bank, the Government took the first steps toward liberalising the stock market. The Government approved country and regional funds, and individuals outside Sri Lanka could invest up to 40% of the issued capital of listed Companies through Share Investment External Rupee Accounts (SIERA). It also abolished the 100% transfer tax on share transfers between non nationals. The ensuing period saw a moderate inflow of foreign portfolio capital. The total portfolio capital amounted to a modest Rs 380 m.

However domestic activity at the time was marginal and liquidity was extremely poor. The market was dominated by a few institutions, high net worth individuals and retailers: the market was capitalised at Rs. 18b. The free float was estimated at 20%. As such the market was unable to absorb the sudden inflow of foreign capital. As a result the turnover levels surged and annual turnover increased from Rs. 226 m in 1989 to over Rs 1.5b in 1990. Unable to take sizeable positions, investors were forced to pay heavy premiums to get decent lines. Investors who take up positions in illiquid markets when they are at the initial stages are essentially long term aggressive players. They are willing to wait long periods to realise their gains and are not too concerned about liquidity or paying premiums to enter the market. The market PE almost doubled to 20x and market indices shot up. The ASI increased from 179 to 384.

1991 – Gains against a poor Base

In 1991 the political and economic scene was changing. The crushing of the left insurrection had dramatically changed views on economic prospects. Helped by a bumper harvest GDP grew by 1 by 6.2%. Against extremely poor earnings in 1989 and 1990, corporate earnings surged. Driven mainly by the banking sector and the reviving tourism sector corporate earnings grew 40% in 1991.

Aggressive reforms and investment initiatives by the government resulted in an increasing improvement in investor sentiment. Reforms included aggressive privatisation. Ceylon Oxygen and Pugoda Textiles were offered on the stock market. The extremely attractive valuations resulted in significant interest. Returns on the investment was well over 100%.

Attracted by the changing scenario, the market attracted an increasing level of foreign portfolio investment. Portfolio capital increased to over Rs. 1.7b. in 1991. While the market continued to trade at a high PE of 20x, share prices in 1991 were driven mainly by earnings growth of 40%. The market recorded a growth of 117%. Together with the newly privatised entities and new capital issues, capitulisation increased to over Rs 80b. (Table 2).

Year	1989	1990	1991
All share Index	176	384	837
Sensitive Index	841	883	1194
Market Cap (Rs b)	17.08	38.85	81.05
Turnover (Rs b)	1.26	1.56	4.3
Portfolio cap (Rs b)		380	1328
PE x		20x	20x
Earnings Growth (%)		8	40

1992 - an over heated Market

The corporate performance was not sustainable: the earnings growth of 40% - in 1991 and in 1992, moderated. High interest rates and high inflation eroded profits. Against a high base in 1991, earnings growth was a low 7%. Thus valuations suddenly appeared grossly overvalued and the PE crashed from 20x to 12.5x. High market prices in late 1992 resulted in many corporate bodies approaching the market to raise capital. The surge in capital calls were a drag on liquidity in an already over heated economy. (This resulted in money moving out of the secondary market). The combination of these factors led to a sharp correction and the ASI declined by 25% to 603 by end 1992.

The second run – a Revival

Continued aggressive economic reforms and increasing levels of investment led to strong medium to long term economic prospects and bullish investor sentiment. Direct investment had almost doubled in 1993 and there was surge in banking and finance sector activity. The financial sector corporate earnings grew 40%. Extremely bullish forecasts resulted in valuations being re-rated. This led to a surge in share prices.

Buoyed by an aggressive privatisation programme, liquidity improved considerably. The market capitalisation increased. As a result, the number of companies in which foreigners could invest also increased. Among them were high quality liquid stocks such as NDB, Dockyards and Kelani Tyres (Table 3) Attractively priced privatisation's resulted in the offers attracting foreign interest.

The market also benefitted significantly from the changing allocation of portfolio capital to Asia. The reallocation was driven by the availability of cheap global funds. Most developed economies were undergoing recessions and equity markets were performing poorly. Monetary policy was benign and interest rates were low. Under these conditions most global fund managers were reallocating their funds in the fast developing economies in South and South East Asia. A comparative analysis of PE multiples in the Asian markets in 1993/94 is given below. With the exception of Thailand and Korea, all other countries had PE's of well above 20x earnings. Earnings growth was also extremely high. With the exception of Malaysia, earnings growth was well above 20% in most countries. Sri Lanka also attracted a strong inflow of portfolio capital. Portfolio capital peaked at Rs 3.2b in 1993. (Table 4)

Strong performance in the market, and strong gains on initial offerings of privatisation, also saw a large number of retailers rush into the market. Most inexperienced players followed the market trying to make overnight gains. The dream ride continued virtually unabated. Valuations were driven to dizzy heights. In 1993/94 the market PE exceeded 23x. Public offerings were priced at extremely high levels. Despite the high prices, the offerings were oversubscribed 20x to 30x times. The heavy demand resulted in prices being driven to over 100% the offer/issue price on the first day of trading. Overnight gains brought speculators into the market. Manipulation of the inadequate trading system resulted in artificial pricing. (Peaking in March 1994 to hit 1400).

The Crash

In 1995 the market experienced a significant decline. The poor performance is attributed to a combination of factors. Firstly continuous upward movement in the market kept pushing valuations to unrealistic levels. Stocks traded at 25x to 30x earnings. In order to support such valuations sustainable earnings growth of 25% is a tall order. The market was over valued and over heated. It was heading for a sharp correction again. However, the correction was heightened by the significant changes in the economic and political scene that were about to take place. This coupled with the global reallocation of funds led to an extremely sharp decline in the market.

Political uncertainty arose when the ruling party lost a by-election in 1994. Uncertain of the policies of a new government led to foreign investors holding back. Subsequent presidential and general elections in the same year saw the advent of a new government – a coalition with a leftist past. Sympathetic towards labour, the government reaction to labour unrest was slow.

A number of listed companies were directly affected - Lanka Ceramics and Korea Ceylon suffered from prolonged industrial strikes. The resulting bad publicity led investors to hold back on investment plans. The collapse of the peace talks and the deteriorating security situation in the capital - subsequent to the collapse of peace talks, and an escalation in terrorist attacks by the LTTE, had a negative impact. Earnings prospects of the tourism sector collapsed.

On the global front, the US interest rates were raised by the US Federal Reserve in October 1994, indicating a recovering US economy. The rate hikes also gave rise to attractive bond yields. Funds started to flow back out of Asian markets into the US bond market. The strong recovery in the US economy and equity markets saw a sharp decline in valuations in Asian markets.

Table 4

	[illegible]	Indonesia	Thailand	Philippines	Malaysia	Korea
Earnings Growth						
1993	[illegible]	[illegible]	15.8	18.3	[illegible]	[illegible]
1994	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	37.8
PE Multiples						
1993	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1994	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	16.1

Table 3

	NDB	Distilleries	[illegible]	Kelani Tyres
Offer Price (Rs)	50/-	10/-	18/-	16/-
Price Earnings Multiple	9 x 12/1992A	10 x 3/1992A	13 x 3/1992A	9 x 3/1992A

The table shows a considerable moderation in PEs in the Asian markets. Only two markets had PEs of above 20x in 1995: Philippines of 21.8x and Malaysia of 21.8x. Earnings growth had also slowed considerably. Only Korea and Philippines had a growth over 20% in 1995. Coinciding with political instability in the country then, Sri Lanka was hit harder than most other markets. The ASI collapsed and declined to close at 663 at end 1995 from 983 at end 1994. (See Table 5)

Table 5

Earnings growth (%)	India	Indonesia	Thailand	Philippines	Malaysia	Korea
1994	31	30.8	26.8	30.4	18.9	57
1995	31	20.0	11.6	32.1	11.7	27
P.E multiples (x)						
1994	16.1	17.1	23.3	28.7	17.4	18.1
1995	10.8	18.5	19.9	21.7	21.8	12.6

1996 – One of the worst Years

1996 has been one of the worst years for the economy and the market. Hit by one of the worst droughts, and the resultant energy crisis the economy grew by 3.8% which was the lowest growth rate in the period. The energy crisis caused severe hardships to the industrial and consumer oriented Companies. The bombing of the Central Bank and the commuter train in Dehiwala, killed all chances of a recovery in tourism. As a result earnings grew by only 6%. The market PE declined to 10x. ASI followed suit dropping to 603 at end 1996.

1997 and forward

It is evident from the above discussion that PEs are directly related to earnings growth. i.e. if earnings growth prospects were promising then PE ratios were high and vice versa. It follows that the future direction of the market, will be determined by the ability, and the level of the country to post sustainable levels of earnings growth. Earnings will be dependant largely on interest rates, inflation, taxation and economic performance.

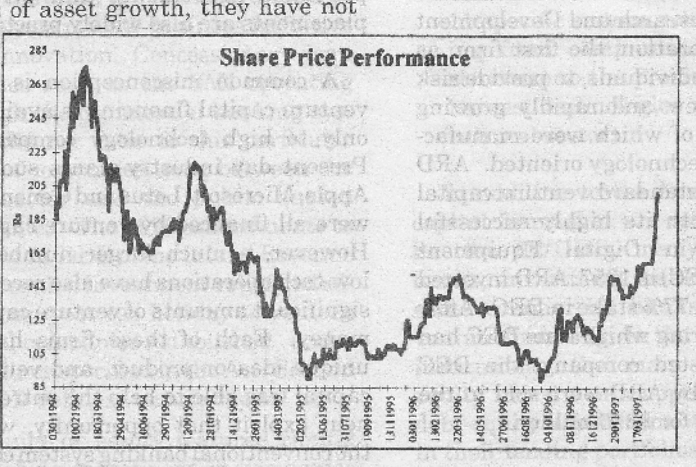
Economic Growth

The agriculture, manufacturing and services sectors account for around 20%, 20% and 50% of the economy. The medium term growth of these sectors is expected to be 2% to 3% in agriculture, 10% to 15% in manufacturing and 6% to 7% in the services sector. Savings are unlikely to see a significant increase and the investment ratio is expected to be in the range of 25% to 27%. (around 5% of investment will be financed through Direct Foreign Investment). Under these conditions the trend line GDP is estimated at between 5% to 6%.

Interest Rates

The interest rates are currently at low levels. Most corporate bodies have experienced a sharp reduction in the short term lending costs. The decline in short term borrowing will result in cheaper working capital and lower interest burden. However, uncertainty prevails as to how long the rates can be maintained at current levels. As a result lenders have been reluctant to reduce long term rates. Given the continuation of the low interest rate environment, long term rates will also drop. The declining interest burden will see improved profitability.

The banking sector is experiencing squeezing margins. Experiencing high levels of asset growth, they have not been able to drop interest rates on deposits. However, the lending rates have declined, putting pressure on margins. However, they will look to compensate through higher growth in assets. Thus the banks with stronger networks and exposure to international trade will record the best performance. Overall, the borrower will benefit the most from the low interest rates. The financial sector will record stronger performance once the economy recovers to a higher level, at which point it is expected that banks will loosen their over cautious lending enabling them to record strong growth in volumes.



Inflation

Inflation has moderated in 1997. However, cost push inflationary pressures are still high. The production costs are thus rising. Cost of fuel, energy and transport has increased. Thus wages will increase. Corresponding increases in rents will also be seen. Thus production and operating costs are expected to rise. Higher inflation will also mean less consumption. Thus growth in domestic demand will also be sluggish and companies catering to the domestic market are unlikely to see sharp growth in volumes. While 1997 will show a recovery in demand, the picture for 1998 is still not clear.

Taxation

The Government has announced its intention to reduce tax rates by 1998/99. The reduction will result in lower tax bills. It is estimated that the reduction in tax bills alone could contribute around 1% to 3% growth in earnings.

Venture Capital - Concept, Practice and Future Directions

by

Nissanka Weerasekera,

General Manager - People's Venture Investment Co. (Pvt) Ltd. and President - Venture Capital Association of Sri Lanka

The word venture means, according to most dictionaries, 'the [act of] undertaking a risk, or a risky undertaking". This meaning captures an important aspect of venture capital - it is capital invested in highly risky ventures. But there is more to venture capital than making high-risk investments. Venture capital also involves a proactive relationship between the venture capitalist and the investee firms. Venture capitalists actively monitor the investments and sometimes assume important managerial roles within the investee firms. In return, venture capitalists expect to achieve high rates of return on invested funds.

Although the roots of venture capital can be traced from investments made by wealthy families in the United States in the 1920s and 1930s, Ralph E. Flanders, then president of the Federal Reserve Bank of Boston, is credited with the concept as it exists today. In 1946, Flanders founded the American Research and Development (ARD) Corporation, the first firm, as opposed to individuals, to provide risk capital to new and rapidly growing firms, most of which were manufacturing and technology oriented. ARD created the standard venture capital paradigm with its highly successful investment in Digital Equipment Company (DEC) in 1957. ARD invested $70,000 for a 77% stake in DEC. After 14 years, during which time DEC had become a listed company, the DEC shares held by ARD were sold in the open market for $355 million.

Entrepreneurs often develop products and ideas that require substantial capital during the formative stages. Many of them do not have sufficient funds to finance projects themselves, nor do they possess adequate tangible assets to pledge as collateral to obtain conventional debt financing. Venture capital firms in countries such as the U.S. will finance these projects by taking an equity stake of the company, as opposed to collateral-backed debt financing, provided that the projects show potential for high growth and substantial earnings. Such investments are very risky, not only because they are unsecured, but also because of the long time it takes the investments to mature. However, if and when successful projects such as DEC are selected, the returns can be very high. These returns are realized at the point when the venture capital firm "exits" from the investee company. There are a number of ways in which venture capital firms can exit from their investments. The most desired method is by an Initial Public Offering (IPO). Other exit mechanisms such share repurchase agreements and private placements are also widely practiced.

A common misconception is that venture capital financing is available only to high technology companies. Present day industry giants such as Apple, Microsoft, Lotus and Genentech were all financed by venture capital. However, a much larger number of low-tech operations have also received significant amounts of venture capital money. Each of these firms had a unique idea or product, and venture capital was able to help the entrepreneur exploit that opportunity, when the conventional banking system could not collateralize the value contained in an idea or product.

2. The Venture Capital Practice in Developed Markets

The concept of venture capital is relatively new to Sri Lanka. As such, hardly any research or academic work has been done in the area of venture capital financing in this country. Even in the United States, where venture capital originated in the early part of this century, relatively little has been published on this subject in the most influential finance journals. Barry (1994) suggests two reasons for this. First, the theoretical problems are complex, multi-faceted, and difficult to solve. Second, the very nature of venture capital creates difficulties for the empiricist because data on private investment by private firms are not easily obtained. Nevertheless, significant progress has been made recently towards understanding the problems of venture capital finance. The findings of some of the work cited below are not altogether irrelevant to the Sri Lanka situation.

Recent work in venture capital finance cover a wide range of issues. Gorman and Sahlman (1989) found that venture capitalists spend roughly half of their time monitoring portfolio companies and the other half evaluating new opportunities. Typical respondents said that they had replaced three Chief Executive Officers in portfolio companies during their careers as venture capitalists. This finding is consistent with the broad view that key activities of venture capitalists are identifying and recruiting members to the team of portfolio companies.

A number of papers described the specialization of venture capitalists [see, for example, Gupta and Sapienza (1992), Norton and Tenenbaum (1993) and Ruhnka and Young (1991)]. They suggest that the specialization of venture capitalists makes it prudent for the venture capital investor to diversify across venture capitalists to eliminate the risk inherent in specialization.

Other papers have examined the activities of venture capitalists in evaluating new opportunities. Most notable has been the work of Tyebjee and Bruno (TB) (1984), who examined 90 deals made by 41 venture capitalists. They point out five principal activities carried out by the venture capitalists; 1. Deal organization; 2. Deal screening; 3. Deal evaluation; 4. Deal structuring; and 5. Post-investment. Recent research on venture capital in the finance literature as focused on steps four and five. A body of literature also exists that focuses on steps two and three [for example, see Roberts (1991) and MacMillan, Zemann and Subbanarasimha(1987)].

Venture capitalists manage other people's money to achieve high returns. In order to do so, they invest in risky investment opportunities. An important indicator of the success of venture capital, therefore, is the realized rate of return in relation to riskiness of investments in venture capital funds; have venture capitalists provided returns adequate to compensate of the risk incurred? Huntsmand and Hoban (1980) examined 110 investments by three venture capital firms over the period 1960-1975. They showed that venture capital returns depend on outliers. While the average return over the period was 18.9%, eliminating the top 10% of investments resulted in an average return of 0.28%. In other words, venture capital success is highly dependent on finding a few outstanding investments, and diversification is vital. Huntsman and Hoban provide no formal tests of the superiority or inferiority of their returns with respect to a formal model of returns.

One way to find data on venture capital activities is to identify IPOs in which venture capitalists have been investors in the offering firm. For example, using IPO listings from Venture Economics, the major provider of data on the venture capital industry, Barry, Muscarella, Peavy, and Vetsuypens (1990) developed an exhaustive set of initial public offerings (IPOs) by venture-backed companies over the period 1978-1987. They examined whether the presence of experienced venture capitalists on the board of a firm going public affects the result of the offering. Evidence indicated that the market recognized the quality of the venture capitalists because IPO underbracing was lower when the firm had more experienced venture capitalists who had been investors.

Sahlman (1990) describes a myriad of agency conflicts in venture capital. Sahlman explains why conflicts exist, and he explains the mechanisms to deal with such conflicts. There are conflicts between the investors and the venture capitalists as well as conflicts between managers of portfolio firms and venture capitalists. Sahlman demonstrates that there is a similarity in the mechanisms for addressing such conflicts, and he relates agency costs in a venture capital context to agency issues in other settings.

3. The Venture Capital Industry in Sri Lanka

The venture capital industry in Sri Lanka is relatively young. Currently there are about 8 venture capital firms in the country. Most of them were established after the government provided certain fiscal incentives for the formation of venture capital firms. There was widespread belief amongst the financial community that the prevalent high interest rate regime, the absence of ready sources of equity capital for unquoted companies, and a conservative banking culture, combined to retard industrial growth and discourage private business initiative and innovation. Concessionary loan schemes such as the SMI operating through the commercial banking system did not cater to this particular scale of companies lying between the SMI sector and the public quoted companies. The 1990 amendments to Section 22/DDD of the Inland Revenue Act provided investment relief including a ten-year tax holiday to venture capital companies established under guidelines specified in the Act. Section 22/DDD defines venture capital as:

(a) equity or equity featured capital seeking investment in companies which promote new products, new processes or new markets;

(b) typically including an equity feature which means a chance for total loss of capital invested as well as a chance to participate fully in the business's growth; and

(c) capital invested with an eye to future divestment, i.e. when a risky venture has matured.

To be eligible for the fiscal incentives, venture capital companies should have a minimum issued capital of Rs.50 million and offer proof of professional management by way of :

(a) a technical service agreement with a management company with necessary expertise; and/or

(b) professional staff trained by a foreign venture capital company; and/or

(c) local professional personnel with venture capital management experience.

Furthermore, the Act restricts venture investments to the following areas

(a) manufacturing activities involving new products, new processes, and new markets;

(b) manufacture of non-traditional products for export;

(c) export trading houses dealing in non-traditional products; and

(d) specified service activities per 'annexure' (the annexure contains 11 specific service activities ranging from communication infrastructure to the provision of post-harvest technologies to the agricultural sector).

In addition to the formal venture capital firms that are covered under Section 22/DDD, many merchant banks, investment banks and even some commercial banks engage in venture financing. In the case of these institutions, the main purpose of equity investments appear to be the debt-equity adjustment of client firms in their lending portfolios.

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Debentures, new horizons to long-term investors

by

Bandula Ranaweera

Executive Director CSFSL

A developed capital market is essential to the steady progress of investments and economic growth of a country. In terms of the technology, international investor participation, the level of regulation to achieve fair-play and sensitivity to macro considerations, the equity market of Sri Lanka has developed to a level that could be matched with many developed markets in the region. However, the debt market has not even made a mark in the minds of the people.

A debt instrument, in principal gives a definite return, and also a money back guarantee of the capital. Thus, compared to equity instruments, a debenture offers a guaranteed return on the invested capital could be expected. In contrast, the equity investments offer only a probable return, which could be higher or lower than the debt instrument or depending on the Company's performance. Debt security holders have the advantage of receiving the prior claim on the assets of the firm over equity holders in case of a bankruptcy. Thus the noteworthy feature of debt securities is the fixed period interest income and fixed maturity date.

Thus Debentures can be defined as an interest bearing debt that has a maturity date, issued by a firm in need of long-term funds. According to the portfolio theory, higher the risk, the return also would be higher. The debenture is an instrument offering an attractive rate of return at a considerably low level of risk and is an ideal security to achieve a proper risk return profile for the entire portfolio.

The types of debt instruments which are of marketable are debentures, zero coupon bonds, promissory notes, corporate bonds, government bonds, central bank bonds etc. Recently, the debentures are making an appearance in the market showing a positive trend towards developing the debt market of Sri Lanka.

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Ceylinco Securities and Financial Services Ltd (CSFSL) is the latest establishment entered to this vibrant debt market in the Sri Lanka. By making an application to the Securities & Exchange Commission of Sri Lanka they got permission to issue quoted, unsecured, four-year debentures worth Rs.150 Mn. with an option to the holders to redeem it after three years. The rate of interest of the proposed debenture is 17.5% and is the third debenture issued to the public.

Why invest in debentures

Investments in debentures provide several advantages to the investor over other securities. In general, the debentures carry fixed interest income for a specified period and if held to maturity there will not be a capital loss. Debentures offer attractive rates compared to the alternatives available in the market such as treasury bills, fixed deposits or other deposits issued by finance companies and commercial banks etc.

Traditional method of raising funds for a company is through a loan. Thus a commercial bank comes to the picture by collecting public deposits and distributing them to the companies. When a commercial bank is involved, their profit margin and the Central Bank reserve requirement add to the cost the funds. Therefore, the debenture issuer by-passes the commercial banks and reaches the investors directly and collects the funds at a better rate than what is offered by commercial banks and intern reducing the effective cost of borrowing too.

When the other popular 3-year fixed income instruments were compared, the rate of interest rates offered to the investors varies from 9% to 21%. However even at 21%, when further analysed, the effective yield is only 17.6%. This is because the rates are quoted on simple interest basis in contrast to compounded basis (interest on interest). Therefore, though the coupon rate of a debenture may sound mediocre, the effective yield is higher. As an example, the proposed four year debenture with 17.5% coupon paid bi-annually, offers an effective yield of 18.27% which is a superior rate compared to the most of other interest bearing instruments in the market.

A quoted debenture offers a great flexibility to the investors of debentures as a ready market exist to buy or to sell as and when the requirement arises. If the sale was made at the right time (ie. when the market interest rates are lower than the rate of the debenture), the debenture holders could earn a capital gain. Though the debenture holders are having this opportunity, the issuing company would not be able to call the debentures until it is matured after a specified period, unless the debentures are with a Call option attached to it. Debentures give an added avantage to their investors though the Put Option so they can realise the invested capital without a capital loss at the end of three years if the market interest rates are higher.

Shortcomings and criticisms against a straight debenture

As in any other financial instrument, there are shortcomings and criticisms of debentures. There could be capital losses arising from the changes in the general level of market interest rates, if an investor wants to sell the instrument at a wrong time. Market interest rate is the interest rate expected by investors for similar maturity and risk profile investment. The price of a debenture is determined by calculating the present value of the future cash flows of a debenture.

Therefore, as market interest rates rise the price of a debenture will fall and as market interest rates fall the price of a debenture will rise. If an investor sells a debenture prior to maturity when the market interest rate is higher than the debenture interest rate then the investor may incur a capital loss.

If a debenture is attached with a Call Option, the issuer will have the right to replace the debenture with a lower interest security. Therefore, the investor would be in an uncertainty of getting the money back early than the specified period. In the case of a convertible debenture the holder of the debenture will have an opportunity to convert the debentures to ordinary shares. In the event that the firm is liquidated, dissolved, or reorganised, debt security holders have a prior claim on the assets of the firm over equity capital holders.

What harm when the debentures are issued on an unsecured basis

The corporate debt market is showing signs of development as Sri Lanka's third public issue of quoted debentures are approved.

Secured debt instruments has an asset that is assigned through a mortgage, which would be liquidated in case of a default by the borrower. Other than the lower liquidation risk, of debentures, the other risks affiliated with it are similar to those of a secured debenture. As a matter of fact, the other risks involved with any fixed income security are similar to those of any unsecured debenture and even term deposits with Commercial banks or finance companies are having the similar risk profile.

In Sri Lanka Rs. 261,907 million is invested with Commercial Banks and another Rs 10,202 million with Finance companies on fixed deposits as at 31st December 1996. These public funds have no specific security other than the credibility of the financial institution. But the close supervision on the activities of these financial institutions by the Central Bank, gives a higher confidence to the investing public.

Nevertheless the crashes of Finance companies which we experienced in May 1980's and the still unsettled credit is an example of the unsecured status of these instruments.

Thus, the investing public should not fear the unsecured debentures. However, the investor be rational enough to investigate the credit worthiness of the issuer prior to making the investment. As quoted debentures are allowed to be issued only by public quoted companies, their financial performance, the market conditions in which they operate, and the potential to grow in the future can be gauged, by investors. Once the above are properly evaluated the investors can establish the level of risk and the return of the investment.

The CSFSL has received the approval from the Colombo Stock Exchange and the Securities and Exchange Commission for the proposed quoted debenture issue. The Company is planning to raise Rs. 100 million through a public issue of debentures with an option to retain a further Rs.50 million if the issue is oversubscribed.

The funds are to be utilised for financing its existing and future lease portfolio, where a funding mismatch exists.

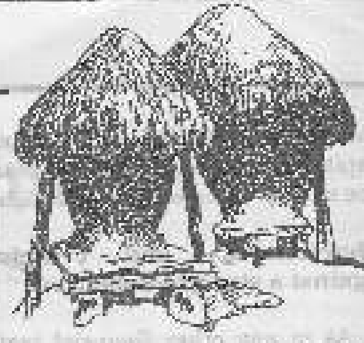
The debenture will carry an interest around 17.5% payable every six months yeilding an effective rate of 18.27% per annum. Deutsche Bank A. G. will act as trustees to the issue while the Bank of Ceylon is the bankers to the issue. The issue is expected to be opened for public subscription in mid March 1997.

The issue is uniquely characterised with a Put Option to the investor during the tenure. The Put Option is a right but not an obligation given to the investor to surrender the debenture to the issuer and redeem at the par value. The option is available at the end of the 3rd year of the 4 year debenture.

This is only the third public issue of debentures and CSFSL is the second company following VANIK's successful two issues. Corporate debenture market can be another alternative to fixed deposits, although the investors are not very familiar with this instrument. Theoretically both instruments carry a mid or a long term tenure, though in actual sense quoted debentures have a flexibility, as it can be traded in the stock exchange like a quoted share, therefore the investor has an opportunity of divesting and reclaiming of the capital and interest component before maturity. Practically the investor is benefited by the high interest offered by the issuer to accommodate the full term of the debenture, although he can divest via the Stock Exchange in the short term still earning the same interest rate while any capital gains made are tax free. This advantage is not available with investments in fixed deposits, because in the event an investor decides to recover principal sum early, he/she will be penalised and will receive interest only at a much lower rate.

A further advantage to the investor is the current very high interest rates attached to these debentures. This is done as a means of inducement to invest in a somewhat unfamiliar product in the early stage of its life cycle. This should be viewed as an opportunity that should be capitalised on by the investors as the premium interest rates offered on quoted debentures can be expected to move down in the future when the local issuers and investors become more familiar with the instrument.

Recent Trends in the Agricultural Sector



The agricultural sector, which is an important sector in the Sri Lankan economy, is currently confronted with a variety of problems. The gross domestic product, which was 20.8 per cent in 1987 had declined to 15.8 per cent by 1996. Similarly, the gross national production in the agricultural sector growth declined by 5.1 per cent in 1989, 2 percent each in 1992 and 1996. The main reason attributed to the decline in production is the drought conditions which prevailed over a long period of time.[1]

Paddy

The highest contribution to the agricultural sector is derived from paddy production. In 1996, the contribution to gross domestic production was 3 per cent. In 1989 this percentage was 5.4. The highest paddy production during the ten year period was recorded in the year 1995 and amounted to 2,810 metric tons. The highest acreage that was sowed- dumised was in the year 1994 and stood at 880,000 hectares. However, by the end of 1996, paddy production had declined by 26 per cent, while the area cultivated had decreased by 18 per cent. Productivity, which was 3564 kg per hectare in 1987 had dropped to 4,513 kg per hectare in 1996. Severe drought conditions that prevailed during this period is the main reason for the productivity decline. Cultivation in Kurunegala, Anuradhapura, and Polonnaruwa districts was severely affected by the drought.

Paddy production during 1996/97 Maha amounted to 1.4 mn. metric tons. This 9 per cent increase in production over the comparative period of the previous year was mainly due to the increase in the area under cultivation and favourable weather conditions. The private sector had been active in purchasing paddy while purchases by the Paddy Marketing Board was at a low level. However, in the open market, the price of paddy was higher than the guaranteed price of Rs. 7.42 per kg.

Plantations

The plantations sector, which was the mainstay of the Sri Lankan economy for a long period of time had declined to the second position in recent years. Increase in production costs, decrease in the area under cultivation, new trends in the world market are some of the problems that confront the plantation sector. The government has taken several policy decisions to overcome these problems. The land reform programme is one important aspect of this policy package. However, it was seen that production costs increased and productivity decreased after the estates were nationalised. As a remedial measure, the government implemented a programme under which state plantations were handed over on contract to private sector management companies for a five- year period. As the expected results were not obtained even from this programme, in 1995 the government decided that the management of the plantations would be handed over for a period of 50 years, with the option of extending the contract period.

Tea

In 1992, the acreage under tea, which is a major plantation crop, stood at 221, 936 hectares. In 1996, it was 187,563 hectares. The extent of annual re-plantation is between 800 and 1,600 hectares. By 1996 the acreage that had been replanted was 6,086 hectares.

Tea production recorded a 5 per cent increase in 1996 to reach 258 million kilograms. Low country teas recorded the highest production increase mainly due to the rainfall that these areas experienced throughout the year. Low country tea production, which had been showing an upward trend annually reached 138.2 million. kg in 1996 and accounted for 53.4 per cent of total tea production. A significant feature was the substantial increase in small holder production. Higher yields is a factor that contributed to increased production. Productivity in Sri Lanka is 1,367 kg. per hectare. In Kenya it is 3,000 kg. Tea production had recorded a 5 per cent increase over the production in 1977. High and medium-grown tea production increased by 24 and 22 per cent respectively.

Earnings from tea exports after 1992 showed an upward trend. Export earnings increased from Rs. 24, 638 million in 1995 to Rs. 34,068 million in 1996 mainly due to the higher prices that prevailed in foreign markets.

In 1995 the F. O. B. price was Rs. 102.81 per kilogram. In 1996 it was Rs. 139.66.

The demand from the Commonwealth of Independent States has had a positive effect on the prices.

During the eight month period ending 31st August 1997, tea exports amounted to 163.7 kg. The average F. O. B. price per kilogram was Rs.150/-. This represents a 5.1 per cent increase in the volume of exports and a 13 per cent increase in the F. O. B. price over the comparative period of the previous year.[2]

The main export markets for tea were the Commonwealth of Independent States (CIS countries), Turkey, United Arab Emirates, Egypt, Syria. The amount imported by Egypt increased by 85 per cent over the previous year. The demand from CIS countries is for black tea.

One reason for the higher prices in the world market is the reduction in world tea supplies. Tea production, especially in Kenya dropped by 26 per cent by the end of July 1997 over the comparative period of the previous year.

The average price of tea recorded in

the domestic market for the period up to August 1997 was Rs. 112.36 per kilogram. This represents an increase of 12.3 percent over the comparative period in 1996. The average price of tea, which further increased by September 1997, was Rs. 129.44 per kilogram. The price of low country tea was Rs. 138.62 per kilogram.[3]

Rubber

The acreage under rubber cultivation has being decreasing gradually. While the area under rubber cultivation in 1988 was 200,248 hectares, in 1996, this extent had decreased to 162,000 hectares. The extent of land re-planted ranges between 1,600 and 6,200 hectares.

Rubber production, which continued to fall after 1989 recorded a production increase of 112.4 million kg in 1996 and represents a 6 per cent increase over the previous year. Improved productivity witnessed in recent years is mainly attributable to this higher production. Productivity for 1996 was 870 kg per hectare. A factor which contributed to the fall in rubber production was the use of rubber lands for the construction of houses and factories.

Rubber production rose by 4 per cent during the first five months of 1997. This was 50.7 million kg. Sheet rubber and latex crepe production rose by 3 per cent and 6 per cent respectivley.

Export earnings from rubber in 1996 amounted to Rs. 5.753 mn. The higher increase over the previous year is mainly due to the increase in the amount exported. The increase is 7 per cent. The export price of rubber in 1995 was Rs. 83.69 per kilogram. In 1996 the price fell to Rs. 79.78 per kilogram. During the first four months of 1997, export earnings from rubber amounted to Rs. 2087 mn., which represents a 10 per cent decline over the comparative period in the previous year. The main reason for lower export earnings is a fall in price. By April 1997 the F. O. B. export price of sheet rubber had declined further to Rs. 73.58 per kg. The increase in the supply of rubber in the world market and the reduced demand were the reasons for the decline in price.

In the domestic market, the price of R. S. S. which was Rs. 71.68 per kilogram in January 1996, declined to Rs. 61 in April 1997.

Coconut

Coconut production was at a high level in 1995 and amounted to 2,755 mn nuts. In 1996 production dropped by 8 per cent. The decline in production could be attributed to the lagged effect of the drought that prevailed during the end of 1995 and early 1996. Production costs also showed an upward trend during this period, increasing from Rs. 2.02 per nut in 1995 to Rs. 2.18 in 1996.

By May 1997, the prodution of nuts stood at 1,055 million, which is a 3 per cent increase over the comparative period for 1996. However, coconut oil production declined by 5 per cent.

Although the export of kernals declined in 1996, earnings increased by 24 per cent over the previous year. The main reason for higher earnings was the higher prices that prevailed in the world market, especially due to the increase in the prices of alternative sources of oil. The average export price per nut, which was Rs. 6.08 in 1995, increased to Rs. 9.42 in 1996.

The earnings from export of coconut products amounted to Rs. 4497.11 million up-to July 1997 recording a 12 per cent increase over the comparative period in 1996. The foreign exchange earnings from coconut kernels were Rs. 2815.12 million. This represents an increase of 24 per cent over the previous year. Production of kernels, however, increased by 5 per cent.

Earnings from non-kernel product coconut exports declined by 3 per cent due mainly to a fall in the amount exported. D.C. Copra prices were favourable during the year. When comparing the period up-to July 1996 with the period up-to July 1997, the price of one metric tone of D.C. increased to US$ 1198 from US4 1075. Copra prices increased from 699 to 805. However, the price of coconut oil fell from 943 to 886. The decline in the prices of soybean oil, and sunflower oil is the reason for the fall in coconut oil prices.

The major destinations for coconut products are as follows; D.C.-Germany, Poland, Egypt, Brazil, and Dubai. Coconut oil-Bangladesh; and Copra-Pakistan.

Minor Export Crops

Minor export crops comprise spices such as cinnamon, cardamom, cloves, and cocoa, coffee, and essential oils. Sri Lanka is especially famed for the export of spices. Sri Lanka's share of world production of minor export crops is 2 per cent. The decline in the prices of cloves in recent years has led cultivators to neglect clove cultivation. Pepper exports too have declined over the past few years. In 1996, citronella and cocoa production increased by 6 per cent. Coffee and nutmeg production declined marginally. Cinnamon and cinnamon-leaf oil production declined by 10 per cent and 46 per cent respectively.

In 1996, favourable prices prevailed for all minor export crops other than coffee and pepper. Black pepper prices in the world market fell by 8 per cent and coffee prices declined by as much as 27 per cent due to increased supply.

Earnings from the export of minor export crops amounted to Rs. 1597.7 million during the first quarter of 1997. This represents an increase of 12 per cent over the first quarter of 1996. The higher earnings from cinnamon, pepper, un-manufactured tobacco, is the main reason that can be attributed to the higher earnings.

Conclusion

The government has, through its budget for 1998, introduced several proposals and incentives to further develop the agricultural sector. The Tea Smallholdings Development Authority will set up a Rs. 200 million fund to provide loans to the tea small holdings sector, tea factory owners and tea small holders' coperatives for initial capital expenditure.

Capital investments in the non-plantation agricultural sector, and in agricultural research and seed production will be free of tax.

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to 36. A parallel development, after 1977, was the rapid growth of non-banking financial institutions. Savings banks, finance companies, development banks, leasing companies, pension funds, insurance companies, are among the more important non-banking financial institutions that were established. However, the finance companies have been the subject of much focus due to their rapid growth in the 1980s, and due to the collapse of some of them. The growth in finance companies witnessed in recent years can be attributed to the payment of higher interest rates on deposits, the ease with which loans could be obtained, and the provision of special services. (See Table 1).

Another development that was evident during the period after 1977 was the development of the financial and capital markets. Consequently, while considerable development is seen in the financial sector as a whole, it has also contributed to the economic development of the country. It is possible to state that this expansion of the financial structure has contributed to the establishment of an environment that would maintain at least a medium growth rate. (Budget Speech 1988).

The Relative Importance of the Financial Structure of Sri Lanka.

Due to the dynamic nature of the financial structure in any country its characteristics change with the growth and improvement of financial institutions and instruments. Therefore, it is opportune as well as important to analyse the manner in which the changing financial structure contributed to the economic growth process in Sri Lanka. To understand the developments, it is necessary to analyse the changes in the financial structure, the causal factors and their impact.

Several indicators are used to evaluate the relative importance of the financial structure in the economy. One such measure is to ascertain the relative contribution of the financial sector to the total employment generation in the economy. In 1963, the contribution of the financial sector to total employment was 0.5 per cent. In 1986/87 this percentage had risen to 1.6. By 1994 its contribution was 1.8 per cent. (See Table 2).

Employment in finance, insurance, immovable property and commercial service sectors have been taken as a percentage of the total contribution to employment.

In analysing the relative importance of the financial sector to the national economy, a useful indicator is to assess its contribution to the Gross Domestic Product. The contribution of the

Table 1

Total Liabilities of Financial Institutions (Rs. million).

1. Central Bank	3339	41.8	24.4	11529	40.4	31.7	80008	21.1	26.5
2. Commercial Banks	3122	39.2	22.5	10208	36.0	28.2	133,861	30.9	41.3
3. Regional rural banks	-			-		-	1435	0.4	0.4
4. Cooperative rural banks	-	-		-	-	-	3,246	0.8	3.5
5. Cooperative Credit Societies		-	-		-	-	571	0.2	0.2
6. National Savings Bank	-		-	2747	9.5	7.8	30061	7.8	9.3
7. Finance companies	139	1.7	1.7	245	0.9	0.7	9962	2.3	2.8
8. Development Finance Corporation of Ceylon	82	0.5	0.5	120	0.4	0.3	5013	1.3	1.2
9. National Development Bank	-	-		-	-	-	6887	1.9	1.9
10. State Mortgage and Investment Bank	-	-		-	-		3100	0.8	0.8
11. National Housing Development Authority	-						7734	2.0	2.3
12. Housing Development Finance Corporation	-	-	-	-		-	211	0.1	0.1
13. Employees Provident Fund	910	11.4	9.7	2614	9.2	7.2	48174	12.5	18.4
14. Employees Gratuity Fund	-	-		-	-	-	6861	1.8	1.8
15. Insurance Companies	404	5.1	2.9	967	3.5	2.7	8288	2.1	2.2
16. Merchant banks	-		-	-		-	1147	0.3	0.3
17. Leasing companies	-	-		-	-		1223	0.3	0.4
Total	7970	100	68.3	28509	100	78.8	385607	100	108.7

Source: Compiled from the publications of the relevant institutions

Table 2

Contribution of the Financial Sector to Employment Generation

Year	
1953	2.2
1963	0.5
1971	0.7
1973	0.7
1981	1.1
1985/86	1.5
1986/87	1.6
1994	1.8

Source: Annual Reports of the Central Bank of Sri Lanka, Census of Population reports and Labour force survey 1994.

financial sector to the GDP, which was 1.15% in 1970 had risen to 4.35% in 1980 and to 7.24% in 1995 (See Table 3). This ratio shows a steady as well as an increasing contribution over the years. The contribution of total financial assets of the financial sector to the GDP is another indicator that should be taken into account. Thus, in 1970 total financial assets, which was 58.3 per cent of the GDP, rose to 102.7 per cent in 1991 indicating the extent to which the economy had been monetised. (See Table 1).

The growth of the institutional sector accompanied by the introduction of financial instruments, has a positive impact on the utilisation of banks by the people. While the banking density shows the ability of the people to access banking services, the popularity of the institutions is indicated by the people's participation ratio. In 1970, each bank branch serviced 63,533 customers. By 1996, this number had decreased to 13,177 indicating a positive trend. In developed countries such as Belgium, Switzerland, Germany and France a branch bank services 1000 to 1500 customers. In UK this number is about 3000. The banking index shows that it had risen sharply from 0.157 in 1970 to 0.742 in 1996. (See Table 4). If the index exceeds 1.0 (there is more than one bank branch for every 10,000 persons) it shows a rapid growth of the banking sector. An average growth rate is indicated if the index is between 0.5 and 1.0, a low growth rate if the index is below 0.5, and a very low growth rate if

Table 3

The Contribution of the Financial Sector to the Gross Domestic Product

	(1)	(2)	(3)
1970	152	13,187	1.15
1971	166	13,674	1.21
1972	191	14,720	1.30
1973	220	17,920	1.23
1974	302	23,302	1.30
1975	336	25,691	1.31
1976	419	28,032	1.49
1977	542	34,684	1.56
1978	845	40,579	2.09
1979	1,243	40,782	2.50
1980	1,785	62,246	2.87
1981	2,463	78,508	3.14
1982	3,715	94,679	3.92
1983	4,183	113,878	3.67
1984	4,731	140,039	3.38
1985	5,693	148,321	3.84
1986	6,840	163,713	4.18
1987	7,455	177,731	4.19
1988	9,001	203,516	4.42
1989	10,496	228,138	4.60
1990	13,225	290,479	4.55
1991	16,399	335,356	4.89
1992	20,327	386,999	5.38
1993	27,804	453,092	6.14
1994 (a)	35,617	523,300	6.81
1995 (a)	43,346	598,327	7.84
1996 (a)	49,572	695,934	7.12

Financial Sector (1) Cumulative value (2) Gross Domestic Product (3) as a %
Bank, insurance and immovable property (a) provisional
Source: Central Bank of Sri Lanka

it is less than 0.1. A positive rate of increase in these indicators shows greater competitivness for customer deposits as well as a higher level of service to customers. One result of the development of banking services in Sri Lanka is that more than 30 per cent of the population hold bank accounts. Another factor which becomes apparent, according to banking indexes, is the growth of banks in proximity to cities and towns. In developing countries, including Sri Lanka, banking services are concentrated on and developed around urban areas. (Chandra-varkar 1985:24). Banking indices display considerable disparties in service between provinces and districts.

Another index that is of importance in evaluating the relative importance of the financial sector to the economy is the ratio of financial intermediation. If the final borrower obtains funds from, the informal sector, then there is no necessity for financial intermediation. If the final borrower obtains funds in an indirect way from a financial intermediatiary (such as a commercial bank), then there is financial intermediation. Consequently, in evaluating the financial structure, it becomes necessary to take into account financing processes which are measured by the intermediation index. The extent of indirect monetisation in the economy or the amount of funds the non-financial sector can obtain from the financial institutions is measured by this index. Changes in the index show the extent to which savings and investments become institutionalised. The financial intermediation index of Sri Lanka which was 51 per cent in 1950 was 78 per cent in 1984. It exceeded 95 per cent in 1990. However, since the securities market in Sri Lanka remains in an undeveloped state and functions under several constraints and limitations, it is difficult to consider this index as an accurate measure.

It is apparent therefore, that there was a marked expansion, both qualitatively and quantitively, in the financial sector especially after the financial sector reforms that were instituted with the implementation of the economic policies introduced in 1977. It is also clear that it contributed to the development process of the country. However, many hold the view that the branch expansion, institutional diversification and modern financial instruments introduced have not been paralleled by developments in the supply of credit. The main reason for this is attributed to the unchanged attitudes of both the financial institutions and the public. Bank lending should not be limited to commercial activities. Bank credit should flow into those areas which can enhance incomes and generate employment. Farming, cottage and small scale industries, and small enterprises comprise the majority of the enterprises in the Sri Lankan economy. Therefore, credit should flow, and be channelled into these sectors as well.

The Structure of the Organised Financial Sector in Sri Lanka

Institutions in the Financial Sector

Central Bank of Sri Lanka
Commercial banks
Other institutions which accept demand deposits

Institutions in the non-banking financial sector

Savings banks
Finance companies
Development banks
Merchant banks
Leasing companies
Pension funds
Insurance companies
Housing finance institutions
Rural banks
Others

Financial Market

Internal call money market
Treasury bill market
Internal foreign exchange market
Off shore banking market

Capital Market

Government and private sector primary securities market
Secondary market for private sector securities
Share brokers
Unit trusts
Investment fund management companies
Colombo share market

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The CBSL has issued guidelines on pricing of Treasury Bonds and these have been useful to Primary Dealers to understand conceptual issues relating to pricing. However, in their trading activities, Primary Dealers have encountered certain problems. One such problem is related to varying criteria used by different Primary Dealers in pricing, eg. number of days used (day count) for calculating interest. With regard to this issue, the general consensus of the CBSL and the Primary Dealers is to stipulate a uniform method of pricing on all players in the market. The initiative for this is expected from Primary Dealers as part of their self regulation on market practices.

There are institutional limitations in the Government Debt Securities market. One issue is related to Primary Dealers engaging in too many activities. A solution for this has been proposed in the form of separate legal entities to undertake Primary Dealer activities. These entities will operate with dedicated capital and clearly defined disclosure requirements thereby eliminating conflicts of interests in their objectives and minimising the credit risk involved in settlement.

Treasury Bonds and Debt Management

The CBSL is responsible for managing the debt of the Government of Sri Lanka in terms of Section 113 of the Monetary Law Act No. 58 of 1949. This agency function which includes, issuance, servicing and repayment of domestic debt is carried out by the Public Debt Department of the CBSL.

Cost Minimization

One objective of this operation is to maintain the debt of the government in an economically rational manner viz. maintaining the debt at the minimum cost to the Government. The rates of interest of government debt are the main determinants of the cost of debt. Since the rates of interest are subject to fluctuations (particularly in less developed markets such as that of ours), maturity of debt also has a significant bearing on cost of debt in the long run. Therefore, cost minimization does not necessarily mean the issue of debt at the lowest rate of interest that is prevailing at a given point of time. If the interest rate is falling in the market, the debt management strategy should be to issue more short term debt so that the maturing debt can be issued at a lower rate of interest, thus minimising the cost of debt in the long run. Similarly in a situation where interest rates are expected to rise in the future more long term debt may be issued in order to achieve the objective of cost minimization.

Two main issues can be identified in relation to cost minimization objective and Treasury Bonds.

(a) Treasury Bonds are medium/long term instruments and does not provide sufficient flexibility in maturities. Therefore, in order to obtain optimum mix of maturities Treasury Bond programme may be supplemented by Treasury Bill programme.

(b) The behaviour of market interest rates may differ from interest rate expectations and therefore, it is difficult to forecast future interest rates for long term debt management purposes. Ever since, the introduction of Treasury Bonds in March, 1997, interest rates have fallen sharply. For example, weighted average interest rate of 12 month Treasury bills have fallen gradually from 14.7 in the first week of March to 10.6 in the last week of August, 1997. This was a sharp fall of 4 percentage points within a span of 6 months. The interest rates also have fallen gradually without experiencing any pressure for upward movement during this period.

In a situation of decreasing interest rates, due to the availability of Treasury Bonds, investors were able to lock-in their funds at higher rates for a longer time. However, the introduction of a long term instrument also would have assisted in bringing the high interest rates to more desirable and lower levels. On this basis it may be argued that Treasury Bonds have been instrumental in reducing the interest cost of debt to the government, although at the initial stage it has provided an opportunity for a longer term investment to the investors at a high rate of interest.

Distributional Effects

In as much as high cost of debt is a heavy burden on the government budget, interest payments on government debt have been a main source of income to investors irrespective of whether they are firms or individuals.

The total stock of government debt stood at 708.9 billion (including foreign debt) as at end of 1996 and the total payment of interest on debt for the year 1996 was Rs. 48.9 billion. The cost minimization objective will relieve the debt service burden of the budget to some extent and lower the interest income of investors resulting in income distributional implications. The impact on income distribution may be minimised by broad basing of debt ownership. The Treasury Bond programme which has contributed to lower and more stable interest rates while maintaining the originally planned borrowing programme has contributed to lower the distributional in-equalities which are usually associated with financing and servicing of the government debt.

Cash Flow and Borrowing

The government cash flow is an important determinant in debt management. The government borrowing generally serves the purpose of financing the budget deficit which occurs mainly due to capital expenditure in excess of any current account surplus. The cash flow management, therefore, is a function related to short term borrowing, mainly through Treasury Bills.

In most stable markets, larger proportion of debt is in long maturities. Short term maturities of debt in excess of desirable levels are an indication of weak debt management. With the introduction of Treasury Bonds, an initiative was taken to shift the debt from short maturities to long maturities. As at end of 1996 of the total domestic debt 35.5% was in short term domestic debt i.e. Treasury Bills and 56.7% was in long term debt i.e. Rupee Loans. The developments in 1997 have been favourable in shifting the debt from short maturities to longer maturities. With the excess privatisation proceeds it was possible to retire Rs. 10 billion of Treasury Bills in August, 1997 thus reducing the proportion of short term debt to 32.3% as at end of August, 1997. Further, the issue of Treasury Bonds has contributed to the increase in the proportion of long term debt to 67.4%.

Treasury Bonds and Monetary Policy Operations

Formulation and implementation of Monetary Policy is a prime responsibility of the CBSL. The open market operations of the CBSL constitute a significant component of activities relating to implementation of monetary policies. The CBSL is presently contemplating a new system of open market opertions which will provide repo and reverse repo facilities with the CBSL. Treasury Bonds will be eligible for open market operations with the CBSL once the new system is introduced.

During the recent months, interest have fallen due to the high level of liquidity prevailed in the market. This development may also have been due to better fiscal discipline that was maintained since the recent past. This situation has enabled the CBSL to successfully implement the Treasury Bond programme. The primary issues have been heavily over-subscribed at lower rates of interest.

Development of the Debt Securtities Market

In evaluating the development of the debt securities market, Treasury Bonds cannot be viewed in isolation. The debt management and monetary management which are prime concerns of CBSL would be better handled in a more developed debt securities market. The CBSL has eventually focussed its attention on developing the debt securities market.

Participation Levels

With the introduction of Treasury Bonds, the CBSL has stipulated minimum participation levels on Primary Dealers at primary auctions. This measure has enabled the CBSL to ensure effective participation of Primary Dealers in its effort to developing the market. Except in the first few auctions of Treasury Bonds in all recent auctions, the entire offer has been subscribed by Primary Dealers.

In developed debt markets liquidity and maturity have little or no bearing on each other. Although Treasury Bonds are securities with longer maturities they have gradually become liquid instruments as good as Treasury Bills. Thus, with the gradual reduction of Treasury Bills available in the market, Treasury Bonds will provide and instrument which is equally liquid, but longer in maturity.

Long Term Yield Curve

One important aspect of the Treasury Bond programme is the initiative taken for developing a long term yield curve for long term debt securities. The reduction in the frequency of primary auctions and increased maturities of future issues will enable the establishment of a long term yield curve. This will also provide a bench mark yield for corporate debt securities. At present hardly any corporate debt securities are available in the market. Development of corporate debt securities is imparative in the present context of the market where availability of liquid funds has increased due to low Government borrowing (crowding-in).

Anomaly in the Interest Rate Structure

The issue of new Treasury Bills in large volumes and roll over by way of re-issues in the past was associated with a lop sided interest rate structure in the market. This is evident from relatively higher interest rates of risk free (gilt-edged) government debt securities than that of other financial instruments such as bank deposits. This situation was contrary to the established relationship between risk and return structure. One favourable trend that may be observed in the market since recent few months has been the gradual rectification of this anomaly. The gilt-edged securities presently fetch lower interest rates than the rates at which high risk instruments are traded. The availability of long term government debt securities with market determined yields in the form of Treasury Bonds instead of short term instruments may have been a contributory factor to this improvement.

The gradual reduction of high interest rates to more desirable and low levels in recent months has been an achievement of conscious efforts made with the objective of developing the market. With reduced rates of inflation to anticipated levels, the investors will earn adequate real returns on their investment on Treasury Bonds whilst yield rates will remain stable. As an eventual outcome of this development the real rates of bond yields will be equal to or if not greater than real returns that were available to investors in high inflation and highly volatile interest rate regimes in the past. Thus, with the availability of Treasury Bonds, the investors are assured of a risk free, long term investment opportunity at market determined rates of interest with sufficient real returns.

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Low interest credit facilities have been provided to small and medium scale pepper, coffee, cocoa, enasal producers as a capital subsidy. Provision of credit facilities to farmers engaged in seed paddy production, the sale of state land or long-term lease to farmers engaged in fruit and vegetable cultivation, and tax-free import of machinery, and a ten-year tax holiday for fruit exporting companies have also been provided.

The following facilites also have been provided for marketing of agricultural produce:

A 100 per cent investment incentive and a five year tax holiday for investments in the devclopment of marketing and storage facilities.

Tax free imports of refrigerated tractors.

Provision of leasing facilities under easy terms for the purchase of refrigerated trucks.

Source:

1. Central Bank of Sri Lanka Annual Report 1996, Central Bank of Sri Lanka Monthly Buletin - July 1997
2. Forbes and Walker Limited - Weekly Tea Market Report, September 1997
3. Coconut Development Authority Monthly Bulletin, September 1997
4. Budget Speech 1998 - Minister of Justice Constitutional Affairs.

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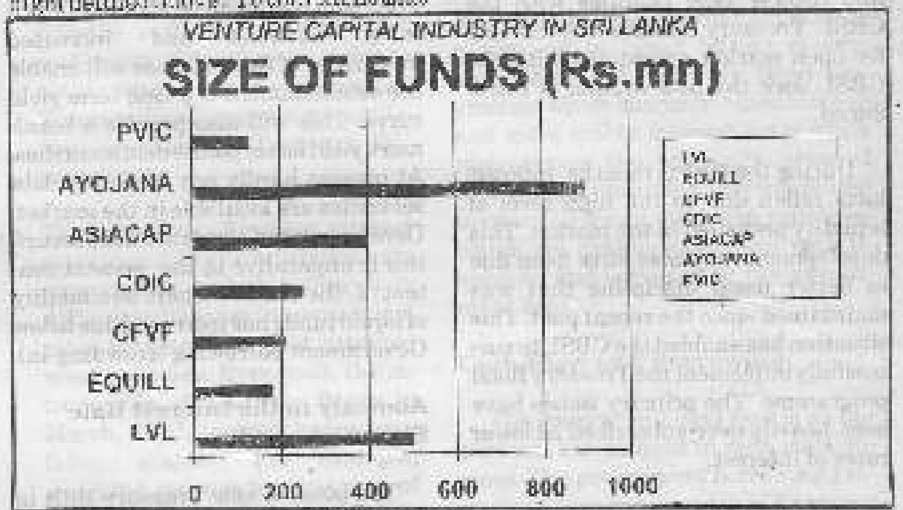
4. Future Directions

It has become necessary to examine and analyze the performance of the venture capital industry since 1990, as an alternative source of project financing in Sri Lanka, in relation to the venture capital paradigm. The venture capital paradigm can be defined as an investment model containing the following key elements:

- emphasis on innovative ideas or products
- non-bankable proposals (from a standpoint of collateral, as opposed to that of promoters' integrity), i.e., willingness to take risks
- medium to long-term time horizon for harvesting
- expectation and achievement of above-average returns (compared to debt financing)
- value addition i.e., proactive relationship with investee companies

As mentioned above, the demand for venture capital in Sri Lanka was the result of many factors, including but not limited to, the high cost of borrowing and collateral-oriented (as opposed to cashflow oriented) lending policies of the banking sector. This demand appeared to be latent one, though, as venture capital firms did not emerge in a significant way until the announcement of fiscal incentives under Section 22/DDD of the Inland Revenue Act in 1990. This shows that the emergence of the venture capital industry is more of a 'supply-push' phenomenon than demand-pull'. Next, notwithstanding the direction of causality between the supply of and the demand for venture capital, there is no evidence to suggest a significant contribution by the venture capital industry towards the creation of innovative enterprises. Therefore, there is a perception that the majority of investments made by venture capital firms during the past seven years does not correspond to the venture capital paradigm described above. Furthermore, it can be argued that the venture capital paradigm can be sustained only in a situation where venture capital responds to the demand from the productive (goods and services) sector rather than when the converse is true.

Growth and increased competitiveness of the private productive sector, particularly the export and manufacturing sectors, continue to be priority concerns in the economic development of the country and the improvement of the incomes and living standards of the people. New enterprise development is a key factor in this process and access to project finance is an essential requirement for that development. Venture capital is expected to fill a gap left by more conventional forms of project financing. Significant amounts of money have been invested in the form of venture capital in Sri Lanka during the past six to seven years. The whole rationale for funds to be invested in the form of venture capital is encapsulated in the venture capital paradigm defined above. To the extent that the actual experience does not correspond to the paradigm, the rationale for venture capital diminishes. Thus, it is necessary to examine the extent to which the desired results have been achieved or not, identify the causes for variations, if any, and provide a basis for appropriate policy interventions or course correction, if necessary. New businesses showing high growth potential are desirable not only due to the high rewards accruing to the investors, but also because high growth implies increased incomes of all the participants.



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[illegible]

Foreign Exchange Market

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mercial banks issued under new Act. Central Bank given wider powers in terms of Control of Finance

1990 Exchange Controls : *Permission granted to approved country funds, regional funds and non-resident individuals to invest in shares in listed companies up to 40 per cent of issued share capital. With this, a scheme of Share Investment External Rupee Accounts (SIERA) introduced through authorised dealers to facilitate and monitor such investments.*

Exchange Rate : *Central Bank stops fixed quotations for US dollar. Begins announcing buying and selling rates for US dollar at the beginning of each day. The rates could be varied during the day.*

Credit Information Bureau *established.*

Debt Recovery: *Debt Recovery (Special Provision) Act No. 2 of 1990, Mortgage (Amendment) Act No. 3 of 1990 and Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990 passed to facilitate debt recovery procedures of commercial banks.*

1991 Presidential Commission on Finance and Banking *commences work.*

Stock Market : *Securities Act amended to form Securities and Exchange Council (SEC) with wider powers, including regulation of unit trusts. Companies incorporated abroad permitted to invest in securities traded in the Colombo Stock Exchange, subject to certain terms and conditions.*

Institutional Changes : *Approval granted to issue licences for unit trusts.*

Exchange Controls : *Exporters permitted to borrow from Foreign Currency Banking Units (FCBUs) for financing imports of inputs to execute export orders.*

Money changers appointed and authorised to purchase and exchange foreign currency against Sri Lanka Rupees or against other foreign currencies.

Sri Lankan residents and non - residents allowed to open Resident Foreign Currency Accounts (RFCs).

1992 Credit Ceilings *on commercial bank lending to selected non-priority sectors removed.*

Exchange Controls : *Permission granted to approved country funds, regional funds, non-resident individuals, and corporate bodies incorporated outside Sri Lanka to invest in shares in listed companies up to 100 per cent of issued share capital, subject to exclusions, limitations and conditions set out by Controller of Exchange.*

Treasury Bill Market : *Appointment of Accredited Primary Dealers (APD) to participate in primary Treasury bill market; public required to bid through APDs.*

Foreign Investment : *Status of the Greater Colombo Economic Commission (GCEC) elevated to level of a Board of Investment (BOI) and its area of influence extended from limited zones to cover entire country.*

1993 New capital adequacy *standards for commercial banks introduced, based on Basle guidelines.*

Recapitalisation *of two state banks in order to restore financial viability and profitability and to raise capital to internationally accepted levels.*

Expansion in capital base *of National Development Bank (NDB), a leading development bank in Sri Lanka, through a public share issue.*

Exchange Controls : *Repatriation and surrender requirements in respect of export proceeds abolished. Export proceeds permitted to be retained in foreign currency accounts either in Sri Lanka or abroad.*

Remaining restrictions on payments in respect of travel, education overseas and remittances for miscellaneous purposes removed.

Treasury Bill Market : *Introduction of sale of Treasury bills under repurchase agreements (Repos) by Central Bank.*

1994 Exchange Controls : *All remaining restrictions on current international transactions removed. Sri Lanka accepts obligations under Article VIII of IMF Charter.*

Treasury Bill Market : *Accredited Primary Dealer System revamped and replaced by a system of Primary Dealers who have specific privileges and responsibilities.*

1995 Treasury Bill Market : *Central Bank introduces reverse repurchase agreements (reverse repos) for secondary market transactions.*

Foreign Borrowings : *Commercial banks permitted to obtain foreign loans upto 5 per cent of their capital and reserves.*

Exchange Rate : *Margin between Central Bank's buying and selling rates quoted daily for US dollar raised from 1 per cent to 2 per cent to permit greater flexibility to the market.*

Legislative Amendments : *Several important Acts amended to make provision for improvement in financial market activity.*

Credit Information Bureau Act - to permit more institutions to have access to the Bureaux.

National Savings Bank Act - to restructure capital base and make NSB operations more market oriented.

Banking Act - to bring NSB, DFCC, NDB and SMIB under Central Bank supervision and to enable closer Central Bank supervision of FCBUs.

Monetary Law Act, Registered Stock and Securities Ordinance and Local Treasury Bills Ordinance - to promote establishment of a scripless government securities system, to create market-oriented Treasury bonds and increase efficiency of secondary market in government securities.

Courtesy - Central Bank Annual Report, 1996.

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