ECONOMIC REVIEW
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Small and Medium Enterprises

A People's Bank Publication

DIARY OF EVENTS

December, 2012

05th In the annual Global Corruption Perception Index released by Transparency International (TI), Sri Lanka scored 40 points and was placed in the 79th position among 176 countries. Among the South Asian Countries Sri Lanka ranks second above India, Nepal, Pakistan and Bangladesh.

04th Typhoon 'Bopha' slammed into the southern island of Mindanao, Philippines, toppling trees and blowing away homes with 210-kilometre per hour gusts. A total of about 900 people died and hundreds were missing in the mountainous Mindanao.

07th A visiting high level delegation of permanent representatives to the United Nations on mission to observe the progress on the implementation of the Lessons Learnt and Reconciliation Commission (LLRC) recommendations and other post-war developments in Sri Lanka, held discussions with President Mahinda Rajapaksa at Temple Trees.

08th The Wall Street Journal reported that the United States granted 180-day waivers on Iran sanctions which imposed for reducing imports of Iranian oil, to Sri Lanka, China, India and a number of other countries, in exchange for their cutting purchases of oil from Iran.

The high level delegation of permanent representatives to the United Nations visited the former Tamil Tiger terrorist stronghold of Kilinochchi. They observed the progress made on reconciliation in the North, three years after the conflict ended and received an update on the Army's role and its contribution to the development in the region.

17th Visiting Australian Foreign Minister Bob Carr called on Sri Lankan President Mahinda Rajapaksa at Temple Trees. The discussion between the President and visiting minister touched on a range of issues, including illegal immigration, the Commonwealth Heads of Government Meeting - 2013 and economic relations between the two countries.

30th Achieving another remarkable milestone in the country's booming tourism industry, Sri Lanka Tourism welcomed the arrival of the recorded 1,000,000th tourist in 2012 at the Bandaranaike International Airport.

January, 2013

08th The Divineguma Bill was passed in Parliament wit more than a two thirds majority. The Bill has been legislate to absorb 27,000 Samurdhi Development Officers into th Public Service and this Act was designed to empower 1. million poor families in all parts of the country to overcom economic difficulties in the government's attempt to realiz the aim of making 'Sri Lanka the Miracle of Asia'.

11th Chinese government media said that a landslide kille at least 36 people, when it smashed into a remote village i southwestern China.

13th Sri Lanka Disaster Management Centre said during th period of one month from mid December, the death toll fro floods, earthslips, lightning activity and other mishaps i the wake of torrential rains countrywide rose to 52. It furthe said the number of families affected by inclement weathe during this period rose to 137,776.

Russian President Vladimir Putin met the prime minister o Bangladesh for talks that included the signature of a $1 billio arms contract. Bangladesh has recently been expanding it defence capabilities, building a new airbase close t neighbouring Myanmar and adding frigates to its navy.

18th Indonesian disaster agency said the floods i Indonesia's capital Jakarta left at least 11 people dead, a murky brown waters submerged parts of the city's busines district, causing chaos. This massive flood, the capital's wors floods in five years, have also forced 18,000 people to fle from their homes.

27th An Australian parliamentary delegation led by Deput Leader of the Opposition Julie Bishop arrived in Sri Lanka t discuss the issue of 'people smuggling' from Sri Lanka t Australia. The group will meet with senior government official and others for discussions on curbing 'people smugglin activities.

31st Visiting UK Minister Alistair Burt went to the North o the country on the first day of his visit to Sri Lanka, holdin a range of meetings and opening a youth project designed t facilitate countrywide reconciliation.

General Facts/Profile - SME Sector

Sri Lanka*

- Sri Lanka has a diverse group of enterprises. It is estimated that around 16,000 manufacturing enterprises operate in urban areas and over 600,000 in rural areas.
- It is noteworthy to see that 41% of these enterprises are engaged in production.
- SMEs constitute 80-90% of total establishments and 20% of industrial value addition.
- It accounts for 70% of employment generated in the business sector.
- However the large scale Industries contribute 80% of total value addition in the Industrial sector.
- SMEs in Sri Lanka operate either as individual enterprises or in groups / clusters. Some of them operate in industrial estates set up mostly by the Government.
- Altogether, there are around 60 industrial estates run by Board of Investment, Ministry of Industries, Industrial Development Board, Urban Development Authority and private sector.
- Large number of naturally formed SME clusters of different sectors exists in Sri Lanka, connected with the natural resource base of the region. Few of the clusters are listed below:
  - Brass industries in Kandy area, Beliatte, and Jaffna
  - Blacksmith, silversmith villages in Webada, Kothmale and Puwakdandawa
  - Coir clusters in different parts of Sri Lanka
  - Wood working in Moratuwa
  - Cane products clusters
  - Handicraft and related metal finishing clusters in Kandy area.
  - Rice milling clusters in Ampara, Polonnaruwa, Anuradhapura and Tissamaharama
  - Clay based product clusters (Tile, Pottery, Ornamental items and Brick)

* According to the recent (2006/07) Banking Survey done by IFC of the SME Market in Sri Lanka

Source: www.treasury.gov.lk, June 2010

Europe

- 23 million enterprises
- 75 million employees (55% private sector)
- 99% of European companie
- More than 80% employees in specific industrial sectors (textile, building and furniture) 2/3 European GDP

Source: Fonte: Eurostat, Commission Communication on "Modern PMI policy for Growth and Employment" (2009)

India

- 45% of manufacturing output
- 40% total exports
- 26 million units
- 59 million people employed
- 6,000+ products and services

Source: Development and SMEs: Synergize to Sustain, Dr. Ipshita Basu Guha , Nov 2011

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SOME HIGHLIGHTS ON SMALL AND MEDIUM ENTERPRISES

Definitions/Classifications on 'SME'

European Commission

Enterprise category	Headcount	Annual Turnover (Euro)	Annual Balance sheet total(Euro)
Medium	<250	50 million	43 million
Small	<50	10 million	10 million
Micro	<10	2 million	2 million

Source: European Commission, 2012

World Bank

Firm size	Employees	Assets (USD)	Annual Sales (USD)
Micro	<10	< 100,000	< 100,000
Small	< 50	< 3 million	< 3 million
Medium	< 300	< 15 million	< 15 million

Source: World Bank, 2003

Central Bank of Sri Lanka

SME : Enterprises with annual turnover less than Rs.600 mn

Source: Central Bank of Sri Lanka, Bank Supervision Department Guidelines of the Operations of the Investment Fund Account

The International Finance Corporation definition on Sri Lanka's SME

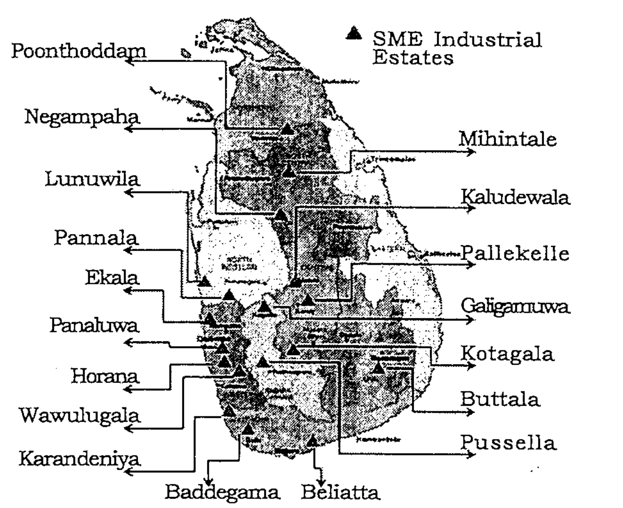
For the purpose of implementing the recent (2006/07) Banking Survey on SME market in Sri Lanka. The International Finance Corporation used following classification:

(i) Small Enterprise: LKR 10 million to 100 million asset value

(ii) Medium Enterprise: LKR 100 million to 400 million asset value

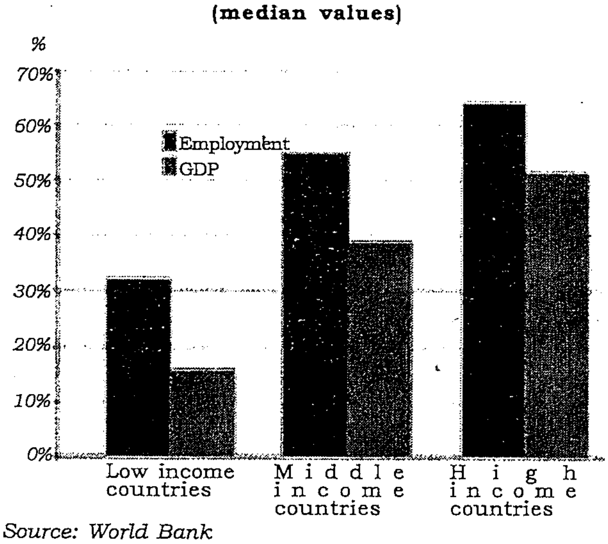
Source: www.treasury.gov.lk, June 2010

SME Industrial Estates in Sri Lanka



Source: Ministry of traditional Industries and Small Enterprises Development

SME Contribution to Employment and GDP (median values)



Source: World Bank

Size, Share and Finance Source of Enterprise - A Case Study in India

Size of Enterprises	Share of Total Enterprises	Finance Source and Size
Multinational Corporation	0 - 1%	>US$2mn Banks, International Commercial Finance
Large Enterprises	0 - 9%	
Medium Enterprises	5-10%	>US$ 500,000 Local Banks , subsidized domestic/ International funds
Small Enterprise	20%	> US$ 5,000 Local Banks, Informal financial Institutions, Personal Connections
Micro Enterprises	65-75%	> US$ 0 Microfinance Institutions, Loan Sharks, Personal Connections

Source: http://beyondprofit.com/data-sme-financing-gap-%E2%80%93-a-lucrative-one-to-fill/, 2010

Reasons for Starting Businesses, Perceived Success Factors and Barriers for Sri Lankan Entrepreneurs in the SME Sector

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Abstract

This paper examines the motivations for business ownership, perceived success factors and problems faced by Sri Lankan entrepreneurs engaged in the in SME sector. Forty seven entrepreneurs in Colombo district were surveyed for this purpose. The primary reasons for starting a business are to increase income, to obtain job security, and to secure personal freedom. The most important business success variables are good product at a competitive price and hard work. Friendliness and reputation for honesty were also cited as critical success factors. The most serious problem faced by small entrepreneurs in Colombo district is the unreliable employees. Other important problems include the weak economy and high interest rate.

Introduction

Small and medium-sized enterprises (SMEs) are playing a crucial role in Sri Lankan economy in terms of employment generation, poverty reduction and regional development. Entrepreneurship is strongly linked to small and medium sized enterprises, which are one of the main developing forces of developing economies. SMEs encompass establishments operating in agriculture, manufacturing, mining, constructions, and service sectors. "The industry sector, of which nearly 90% consists of SMEs represents approximately 26% of GDP (Wikermasinghe, 2011)."

In the aftermath of the three – decade civil war, the government has given priority to achieve higher economic growth. Within this context, more specifically, the government targets balanced development in all parts of the country including Northern and eastern Provinces. The government is currently implementing an impressive infrastructure development programs along with the resettlement of Internally Displaced People (IDPs). Within this the opportunities available for the private sector,will range from the opening of vast areas of fertile land, accessibility to two thirds of Sri Lanka's coastal line, and ocean resources, including some of the best natural beaches (eg. Nilaveli, Pasikuda). Hence, SMEs can offer prospects for putting people back to work, generating incomes and contributing to the rebuilding of the society.

According to the Central Bank of Sri Lanka (1998), cottage and small scale industries sector, which comprises of the SME sector, plays an important role in economic development through creation of employment opportunities, mobilization of domestic savings, poverty alleviation, income distribution, regional development, and training of workers and entrepreneurs.On the other hand, SMEs do not exist in isolation from the rest of the economy, since they are integral part of the supply chains, with large enterprises, as suppliers, customers, or complementary producers.

After independence in 1948, almost all successive governments have taken various measures to uplift this sector, but still the level of development of this sector is very low. In terms of growth, most of the SMEs have stagnated or have achieved only a slow growth. In this situation, it is important to know which factors are motivating individuals to enter the entrepreneurial career, what are the perceived success factors and what are the prevailing barriers for their growth? This article is based on an empirical study conducted by the author through interviewing 47 entrepreneurs who are running small enterprises in the Colombo district. Initially, 50 entrepreneurs were randomly selected for this study from the list of entrepreneurs who registered at Open University to follow the Certificate in Entrepreneurship and Small Business Management course. Three entrepreneurs declined to answer the survey or ended the survey prematurely. Out of the 50 entrepreneurs in the sample 47 entrepreneurs answered the survey questions. There is no generally accepted one definition for SMEs in Sri Lanka and the white paper prepared by the task force for SME development (2002) has agreed upon the concept of (a) small scale enterprises – as those with asset values not exceeding Rs.20 million and (b) medium scale enterprises – as those with assets values not exceeding Rs. 50 million, excluding land and buildings. This definition is adopted for our study since it is felt to be more adequately comprehensive.

Motivators/ Reasons for Entering in to an Entrepreneurial Career

Impact of entrepreneurs' motivation, on entering into an entrepreneurial career is a widely known topic in developed countries and number of studies was conducted in developed countries but such studies are very rare in developing countries such as Sri Lanka. Substantial number of researchers in developed countries have taken various approaches to explain important motivators of entrepreneurs that have influenced them to start their own businesses (Stefanovic et al. 2010). According to some researchers, motivation for an entrepreneurial career is determined by inner personality traits such as the need for achievement, a desire to innovate, propensity for risk taking, and a preference for locus of control.(Benzing and Chu 2009). Simultaneously, some researchers believe that external/situational factors are more important than personality factors. Situational factors are classified in to two sub factors namely, "push factors" and "pull factors". Pull factors such as desire to be one's own boss, personal satisfaction, change life style, increasing wealth and getting the advantages of prior work experience are attracting individuals to enter to an entrepreneurial career. "Pull motivation" seems to be associated with the individual having a reasonably strong positive internal desire to start a business venture. External negative conditions such as unemployment, losing job and a low paying job with little upward mobility also attract individuals to enter in to an entrepreneurial career and those situations are considered as push factors.

Table1 Motivational Factors for Entering in to an Entrepreneurial Career

Motivational Factors	Mean	Standard Deviation
1. To be my own boss	3.40	1.45
2. To be able to use my past experience and training	3.75	1.58
3. To prove I can do it	3.87	1.26
4. To increase my income	4.26	0.99
5. To provide jobs for family members	2.11	1.26
6. For my own satisfaction and growth	3.81	1.24
7. So I always have job security	4.06	1.09
8. To build a business to pass on	3.29	1.52
9. To maintain my personal freedom	4.21	0.98
10. To have fun	2.43	1.59

The author used the five point likert scale (1= not very important, 5= extremely important) to understand entrepreneurial motivations and entrepreneurs were asked to mention to what extent the given 10 factors were important to them to select an entrepreneurial career. Table 1 shows the given motivational factors, mean values and standard deviations. Majority of entrepreneurs have started their own businesses to increase their income and that factor was the highest motivation factor to enter into an entrepreneurial career. Around 53 percent of respondents in our sample perceived it as an "extremely important factor" for their career decision. Obviously, working in an organization as a salaried worker, people are receiving a stable income while the income levels of successful entrepreneurs are increasing. Some previous studies have found that entrepreneurs in developed countries are motivated by independence and self-fulfillment more than income (Cromie 1987)."Countries that have higher GDP per capita tend to produce entrepreneurs who are motivated by higher order needs that "pull" the individuals into an entrepreneurial career. The second highest motivational factor is ability maintain personal freedom. As Sri Lanka was a western colony for many years, organizations in the government sector are still following bureaucratic characteristics which have been introduced by British for day-to-day administration. If an individual select salaried employment option, he or she needs to work in a highly formalized environment and those who do not prefer such formalized working conditions are enter into an entrepreneurial career. "To have job security" is the third most important motivator, because people start their own businesses to create their own employment opportunity. In our sample, 45 percent of the entrepreneurs cited "to have job security" as an extremely important motivating factor. Entrepreneurs in our sample cited 'providing jobs for family members and 'starting business as a fun' as the least important motivation to enter into an entrepreneurial career.

Perceived Success Factors

There is no single agreed-upon definition of business success, but researchers generally use continued viability or longevity as a surrogate for business success. Entrepreneurs have understanding on which factors would improve their prospects for business success and many small entrepreneurs would argue there is no one concrete recipe for success, but many successful small entrepreneurs have in common certain characteristics that have contributed to the rise of their companies. Prior research on entrepreneurs in different countries has concentrated on three types of success factors: (1) the psychological and behavioural traits of entrepreneurs; (2) the managerial skills of entrepreneurs and (3) the external environment (Benzing et al. 2005). The goal was the current study to determine the extent to which entrepreneurs perceive management skills and the external environment as instrumental to business success.

The author used the five point likert scale (1= unimportant, 5= extremely important) to understand the perceived success factors and entrepreneurs were asked to what extent the given 19 factors were important to them. Table 2 shows the perceived success factors of small entrepreneurs in our sample, their mean values and standard deviations. Entrepreneurs rated "good product at competitive price" as the most important success factor. Around 79 percent of the respondents in our sample perceived it as an 'extremely important factor' for business success. As shown in Table 2, "hard work" was ranked second among the elements necessary for building a flourishing enterprise and 81 percent of entrepreneurs perceived hard work is an extremely important factor for business success. As the owner of the business is a core-worker in this type of businesses, he or she has to work hard and this phenomenon implies the labour intensive-ness of this sector. Charisma or friendliness, reputation for honesty, customer service, position in society, and social skills were also cited by entrepre-neurs as important factors for business success. These factors commonly can be categorized as social capital and small entrepreneurs should commit to build and maintain social capital to succeed in their entrepreneurial life. It is interesting to note that small entrepreneurs in our sample gave least importance to "political involvement" and "satisfactory government support" and among the respondents, only 6 percent perceived political involvement as an extremely important factor for business success.

Table 2 Mean Score for Variables Contributing to Business Success

Success Factors	Mean	Std. Deviation
Good Management Skills	4.40	1.06
Charisma: Friendliness	4.74	0.53
Satisfactory Government Support	2.74	1.44
Appropriate Training	4.43	0.74
Access to Capital	4.04	1.08
Previous Business Experience	3.81	1.36
Support from Family and Friends	4.08	1.08
Marketing/Sales promotion	4.38	0.94
Good Product at Competitive Price	4.77	0.48
Customer Service	4.68	0.86
Hard Work	4.75	0.57
Position in Society	4.64	0.70
Maintenance of Accurate Records	4.51	0.75
Ability to Manage Personnel	4.51	0.80
Social Skills	4.64	0.82
Political Involvement	2.06	1.32
Reputation for Honesty	4.72	0.77

Prevailing Barriers for Growth

Barriers or problems can be defined as the individuals' perceived difference between a current and a desired state of reality. Organizational problems can be classified into different categories namely, human relations and technical issues, organizational inputs and outputs or as strategic and operational issues. At the macro level, the problems facing entrepreneurs in Sri Lankan SME sector are similar to those facing entrepreneurs in other emerging economies. First, entrepreneurs in emerging countries face an unstable, highly bureaucratic business environment. The laws governing private enterprise, especially business registration and taxation systems, are overly complex and difficult to understand. As highlighted in the white paper on SMEs development in Sri Lanka (2002), Sri Lankan SMEs are facing number of problems or constraints in areas such as access to credit, information technology and markets. The author used the five point likert scale (1= Not a problem, 5= Very serious problem) to understand the perceived problems and entrepreneurs were asked to what extent the given 14 factors were relevant to them. As shown by the mean scores in Table 3, the most critical problems faced by the small entrepreneurs are (1) inability to attract and retain good employees; (2) weak economy; (3) high interest rates; (4) unable to obtain long term finance and (5) too much competition. Substantial number of entrepreneurs (40 percent in our sample) agree that attracting and retaining good employees is a "very serious problem" and another 34 percent chose it as a 'serious' problem. In terms of unable to obtain long term finance, 40 percent of our respondents chose it as a 'serious' problem and 19 percent of respondents chose it as a 'very serious' problem . Besides the current study, many of the previous studies also have found that inability to obtain long term finance is one of the crucial problems faced by Sri Lankan small entrepreneurs. Substantial number of entrepreneurs (34 percent) cited high interest rate as a 'very serious problem' for SME development. Due to the inherent high risk of this type of enterprises, they have to pay higher interest rates.

Table 3 Problems Faced by SMEs

Barriers	Mean	Std. Deviation
Unreliable employees	4.11	0.89
Too much competition	3.49	1.16
Unable to obtain short term finance	3.38	0.97
Unable to obtain long term finance	3.66	0.98
Too much government regulations	3.36	1.24
I have to look after everything	3.27	1.36
Weak economy	3.89	1.00
Lack of management training	3.44	1.31
Lack of marketing training	3.44	1.16
Lack of accounting records	3.59	1.39
Complex tax structure	3.38	1.39
High interest	3.81	1.07
Poor transport	3.25	1.45
Difficult at finding raw material	3.36	1.37

Responding entrepreneurs did not consider 'poor transport' as a serious problem.

Conclusion

This paper investigated the motivations for entering in to an entrepreneurial career, perceived success factors and problems faced by small and medium enterprises through analyzing the data collected from 47 practising entrepreneurs in SME sector.

Through our empirical study, it was found that the most important reason for deciding to own a business in the SME sector in Sri Lanka is "to increase income", which is probably a common situation in developing countries. Individuals are "pushed" in to an entrepreneurial career by the need to increase income and create job stability for themselves. Policy makers need to find possible ways, such as simplifying registration, providing tax holidays for new start-up business for a reasonable time period to increase business income and encourage further SME development. 'Personal freedom' and 'job security' were the second and third important motivators. It confirms the importance of financial and non-financial factors for entering individuals into small business ownership. It was also found that the most important factor contributing to perceived business success of small entre-preneurs is "good product at competitive price" and second ranked factor is "hard work". SME supportive organizations have to take measures to strengthen their services to support SMEs for value addition of their products so that they could compete with large enterprises. With respect to the problems, Sri Lankan small entrepreneurs rank "inability to attract and retain reliable employees" as their most serious problem. As a solution for this problem, the government needs to strengthen tertiary education institutions to supply trained labour so that match with labour demand. In addition to the labour related problems, weak economy, high interest rate and unable to obtain long term and short term finance also are considered as serious problems. "Financial policies have an important impact on capital mobilization and development of enterprises (Harvie 2004)." The government and other supportive organizations need to take measures to expand financial markets so that entrepreneurs could access right amount of finance at right time at minimum cost.

The empirical part of this article identified two major limitations. The first is the geographical limitations associated with focusing only on the Colombo district. Sri Lanka consists with 25 districts organized with 9 provinces and drawing broad generalizations from this study is difficult. Second, with a sample size of 47 entrepreneurs, these findings should be considered preliminary.

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Small and Medium Enterprises: Innovation System Approach towards Their Development and Sustainability

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1. Introduction

The Small and Medium Enterprise (SME) sector is well recognized for its contribution to employment, innovation and economic dynamism and is also considered as an engine of growth providing an essential part of a healthy economy. This sector provides industrial leaders of the future, improves the competitive edge of the economy by maximising the range of choices available through market provision, and also challenges the dominance of existing large industrial units thereby forcing them to innovate. SMEs have been the chief source of creating new jobs in many countries and are found in all sectors of the economy, primary, secondary and tertiary and provide employment for persons of different skills viz., skilled, semi-skilled and unskilled. It would not be an exaggeration to mention that the overall health of the economy depends, to a large extent, on the SME sector of the developing countries. Various studies conducted on the importance of small firms demonstrate that the bulk of new jobs are emanated from small enterprises. For example, in the United Kingdom, during the period of 1995-99, new businesses had created 2.3 million jobs, 85 per cent of which were provided by micro, small and medium sized enterprises (Kirby & Watson, 2003).

Sri Lanka, like many other developing countries, aimed at replicating the industrial development success achieved by the so-called newly industrialised economies in Asia during the early 1980s. In addition, the contribution of SMEs to the generation of high economic growth and reducing unemployment, inequality and poverty has been recognized by the successive governments since the country gained Independence in 1948. According to the Banking Survey (2006/07) done by IFC of the SME Market, in Sri Lanka, SMEs constitute 80-90% of total establishments and 20% of industrial value addition. It accounts for 70% of employment generated in the business sector (Ministry of Finance and Planning, 2010).

2. SME Contribution towards Employment Generation and Value added Products in Sri Lanka

It is important to recognize the role, played by the SMEs towards economic growth and development, especially when there are capacity restrictions with regard to management risked and uncertainties, in areas such as public acceptance of bio technological products, markets and policies about future development. Also, SMEs have fewer financial resources to invest in new technologies when compared to multinational companies. According to the Annual Industry Survey 2003 of the Department of Census and Statistics, 50 per cent of the one million jobs created in the business sector were by SMEs (Table 1).

3. Development of SMEs in Sri Lanka — Policy Initiatives:

Sri Lanka is the first country in South Asia to open its economy in the late1970s when it adopted a market-oriented economy as against an import substitution trade policy. As a part of this strategy, investment and trade liberalisation was given high priority in the policy reforms that took place in the 1980s and 1990s. The successive governments have articulated their policies and strategies to accelerate economic growth and development and to reduce regional imbalances and poverty on a sustainable basis in a number of policy documents: National Employment Policy for Sri Lanka (2002); Business Incubation Programme (2002); White paper on SME Sector (2002); Poverty Reduction Strategy Paper (2002); *Mahinda Chintana—Rata Perata* (GOSL, 2004) and the Country's Annual Budget Speeches. These documents have discussed the importance of SMEs.

The 'White Paper' produced by a Task Force appointed to study the local SME sector is a comprehensive document reviewing the SME sector in Sri Lanka (GOSL, 2002). This document highlighted many recommendations based on the principle of *'maximum support but minimum intervention'* in order to develop a policy framework for SME development in the country. However, there is no evidence to indicate whether such recommendations were actually implemented, except for a few cases. The present government that came in to power in November 2005 also gave high priority to the SME sector. To implement its

Table 1 Share of SMIs in total number of Establishments, Employment and Value added in Sri Lanka 2006

Type of Industry (2-Digit Level)	Establishment (%)			Employment (%)			Value-added (%)		
	Small	Medium	Large	Small	Medium	Large	Small	Medium	Large
Mining	91.1	6.3	2.6	46.9	14.3	38.9	59.8	11	29.2
Food, beverage and tobacco products	63.6	30.35	5.96	17.2	38.55	44.25	6.75	29.6	63.7
Textile, apparel and leather products	53.1	35.2	11.7	12.5	33.2	54.3	3.3	18.3	78.3
Wood and wood products	85.5	14.5	-	41.9	58.1	-	45.7	54.3	-
Paper and paper products	36.4	46.8	16.9	8.9	45	46.2	2.2	25.15	72.7
Chemical, petroleum, rubber & plastics	62.9	21.7	15.4	9.8	23.7	66.5	3.7	28.3	68
Non-metallic mineral products	80.8	15.5	3.7	31.2	31.8	37	18.4	37.6	44
Basic metal products	42	34.4	23.6	7.1	31.8	61	0.7	30	69.2
Fabricated metal products, etc.	73.8	19.6	6.6	25.3	38.9	35.8	23.9	37.5	38.6
Manufactures n. e. c.	41.7	27.8	30.5	22.16	26.3	51.5	19.7	29.6	50.7
Average %	63.09	25.22	12.99	22.29	34.16	48.38	18.41	30.13	56.12

Source: Adapted from Industry Survey 2006, Department of Census and Statistics

policies, a special SME Bank was established in 2005, followed by a National Enterprise Development Agency (NEDA), both of which were under the then Ministry of Enterprise Development and Investment Promotion. As quoted in the Annual Report of the Central Bank of Sri Lanka (2012): " the government continued its efforts to promote the Small and Medium Enterprise (SME) sector creating employment and income generating opportunities. The National Enterprise Development Authority (NEDA) continued its efforts in formulating policies for the development of this sector. The World Bank continued to support in strengthening the SME sector under the 'Pilot Crisis Response Facility' (PCRF) during 2010. The PCRF scheme facilitates licensed commercial banks in offering SME sector financing through refinancing, partial credit guarantee of loans and technical assistance. Budget 2011 has also proposed to provide relief to SMEs that were adversely affected during the global financial crisis by exempting SMEs operating on sub-contract basis from Economic Service Charge (ESC) and by providing a concessionary income tax rate of 10 per cent)".

Despite many initiatives, policy inertia is one of the most important reasons that has constrained the growth and development of SMEs. For example, the economic policy reforms, introduced during the post 1977 period, repeatedly emphasised on the significance of export-oriented foreign direct investment with attractive incentive packages. As a part of this strategy, investment and trade liberalisation was given high priority in policy reform agenda in the 1980s and 1990s. The establishment of the Board of Investment (BOI) as a 'one stop shop' to help large firms in obtaining administrative clearance and infrastructure support was yet another policy initiative during the post-liberalisation period. In this policy reform process the SMEs, however, were left with ad-hoc policy prescriptions and weak institutional support. Needless to say that such policies and enterprise development have been usually biased towards large-scale enterprises.

As highlighted in the most recent document of National Human Resource and Employment Policy (NHREP,2012), there are SMEs in the agri-business sector engaged in growing spices, fruits and vegetables and in the manufacturing sector engaged in numerous industrial activities accounting for about 20 percent of industrial establishments. In the service sector SMEs accounts for more than 90 percent of business establishments. SMEs are an essential source of employment opportunities and are estimated to contribute to about 35 percent of employment. Several important points of policy relevance regarding employment in SMEs have also been identified in the NHREP which are given below:

- There is a gender bias in SME employment. Workers employed in SMEs are predominantly men. Good equal employment practices are needed to correct the above bias and to attract, recruit, retain and promote women in SME employment.

- SME entrepreneurs do not have sufficient knowledge and experience of personnel management practices. Most entrepreneurs do not like to provide training, health and welfare facilities for employees due to the resulting increase of cost of production.

- A common feature found in SMEs is the high degree of absenteeism among SME workers. This causes losses in productivity and in staff morale. Attendance improvement policies and programs require to be implemented.

- SMEs suffer from a lack of information exchange, leading to conflict, dissonance and other industrial relation issues.

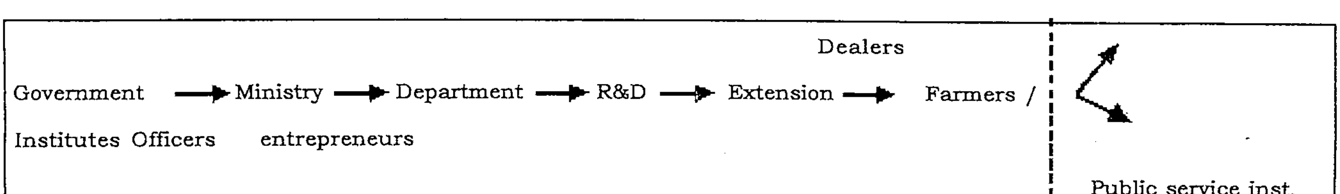
4. Concept of National Innovation System (NIS)

The concept of a NIS has been used globally for more than fifteen years now to understand the dynamics underlying innovation at the national context from the perspective of historical and comparative analyses. Besides, the development and transformation of the national innovation systems within the new perspectives of science policy, is an important landmark for the governments to promote competitiveness of industries and services.

NIS has been useful to explore the networks of institutions in the public and private sectors whose activities and interactions initiate, support, modify and diffuse new technologies. Based on the NIS perspectives, various studies have drawn attention to the differences between the nations in the way they create and adopt innovations, and also in the skills and capabilities that exist in bringing about technological change, when a network is identified and established. It must be emphasized that not only the working protocol of the public sector research and extension services, which is a linear model, is essential for economic growth, but also many other actors are involved in this process. As highlighted by Raina (2004), it challenges many of the accepted norms and assumptions of public sector Research and Development (R&D) planning where the view is that research by laboratory scientists delivers technologies which though extension officers transfers further down the line to farmers or entrepreneurs to adopt. The process stops at that level (Figure 1) and from there onwards farmers /entrepreneurs need to look after all issues relevant to sustainability of SMEs.

The NIS concept is still novel to many countries including Sri Lanka, even though it is a process that has been happening throughout without our realization. Its contribution towards a country's socio-economic development first gained attention when Freeman (1987) and Lundwall (1992) brought forward their discussions on the idea of innovation and how it operates as a complex system of a phenomenon. According to them, this system operates through networks of research, entrepreneurship and other actors interacting to produce and use new knowledge. In contrast to the earlier conceptions of science and technology policies, which in a large measure were equated with the R&D, as a whole, the perspective of NIS draws attention to various other important actors and agencies in the national set-up, which have a crucial role to play in the dynamics of innovation. In other words, while R&D is quite crucial to any form of success, it is now seen as *one important actor among other actors* in the NIS.It relates to the role of science and technology policies and the commitment of political actors, the strength of universities and other knowledge institutions, the role and status of business enterprises and their technological capabilities etc. What is also important from the NIS perspective is the *'system based' interdependency and interaction of actors* in the process of technical change and innovation or in taking the idea from the bench and laboratory level to the field or farmers or to the level of its commercial success in the market or industry or use by a client (Wickremasinghe & Krishna, 2007).This view also agrees with Nelson (1993), who observed that NIS is a set of actors and institutions whose interactions determine the innovative performance of national firms such as SMEs. Edquist (1997) stressed that NIS can evolve through knowledge, capabilities, linkages, networks, and changes in the institutional arrangements that may change from time to time with new technology based results and supportive policy regimes that are of equal importance. Application of the innovation systems approach has been further explored by the Organization for Economic Cooperation and Development (OECD, 1997), the United National Commission on Trade and Development, the European Commission, and more recently, by the World Bank along with many other policy researchers in various parts of the world.

One of the positive features of adopting an innovation system perspective in the Sri Lankan context has been to explore how



Public sector responsibility SMEs responsibility

Figure 1 Linear Model of the Public Sector Operation

micro, small and medium enterprises operate as a system towards sustainability and contribute to socio-economic development of the country and how science and technology could contribute in this context. According to Wickremasinghe (2006), the NIS concept that deals with important elements such as innovation and learning, is still not

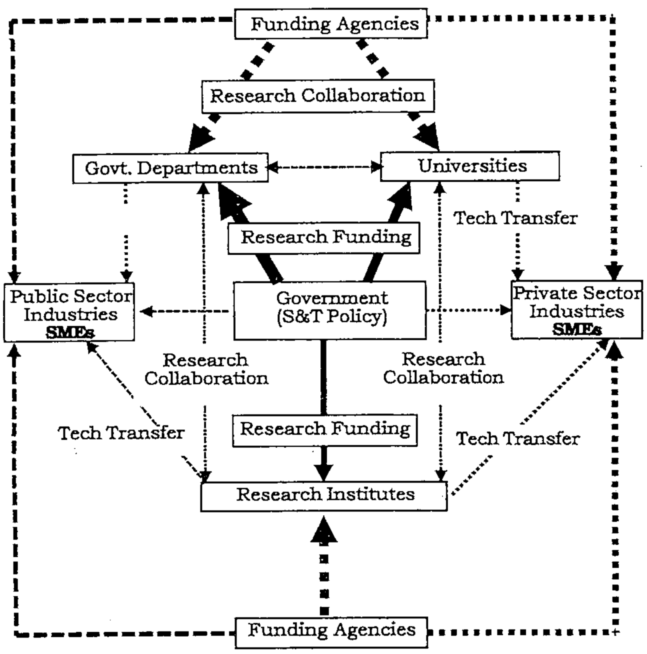


Figure 2 Conceptual Framework showing different actors involved in the NIS concept up to technology transfer

familiar to Sri Lanka, where the interaction among various actors and institutions involved in technological innovation is vital. She highlights how the entities such as government policy framework, R&D activities, education system, culture, history, traditions etc.,can also play their roles in this system of network towards socio-economic development of Sri Lanka. In general, small and medium enterprises in most countries still suffer from several inadequacies including technological backwardness, low production efficiency and poor quality of products. In order to make them technologically competent and enable them to manufacture products based on the new edge technologies, a consistent effort must be made for facilitating transfer and diffusion of technologies from the academic and research institutions. Innovations for new product development and improvement of productivity and quality of existing products are essential for the future of SMEs to keep pace with changing market conditions and preferences.

Given the multiplicity of definitions and perspectives, as briefly referred to above, the relevance and use of NIS is also limited: (a) to trace the growth and significance of S&T policies and political actors; (b) to understand the institutional set-up, status and structure of science and technology institutions, universities, business enterprises etc.; and (c) to explore the extent to which various actors in the system interact and draw out policy implications for fostering a systemic based innovation in the Sri Lankan context. Figure 2 illustrates this conceptual framework of the NIS common to SMEs in any country.

5. Suggested Innovation System Model for SMEs in Sri Lanka

According to most recent work of policy researchers on innovation systems, the above framework can be adapted and applied to any type of small and medium enterprise expanding it to market and sales. Such studies suggest that community driven developments are most successful and sustainable when the rural community (farmers/ entrepreneurs) is encouraged to contribute directly to the initiatives where they are made full partners in managing their jobs. Hence, new strategic initiatives taken in this directive are crucial to achieve growth in livelihoods, increased incomes and to ensure provision of essential services to the poor. It is important to maintain mutual dependencies among actors and networks as well as breaking the usual linear model that has been in existence in the past.

The conventional public sector R&D linear model has not explored the involvement or the role played by input dealers / processors and the public service agencies. The linear model of the government had not worked successfully in most developing countries and as a result, farmers and village entrepreneurs are moving away from agriculture and SMEsrespectively, due to poor incomes they receive.

The proposed innovation model indicated below for SME entrepreneurs has been worked out based on the above framework involving the following actors:

Rural community/ SME entrepreneurs: Rural community or small and medium entrepreneurs is the most important actor in the proposed model as they needto be involved in the learning and innovation process and create their own vision for development of the enterprise.

The government: Policy, strategies and implementation

Knowledge providers: Universities and R&D institutions.

Service providers: Industrial Development Board (EDB), Export Development Board (EDB), Sri Lanka Standard Institution (SLSI) etc.

Vocational Training Centers: To provide training at vocational capacity.

Market: Value added products of SMEs need to be sold at a good price.

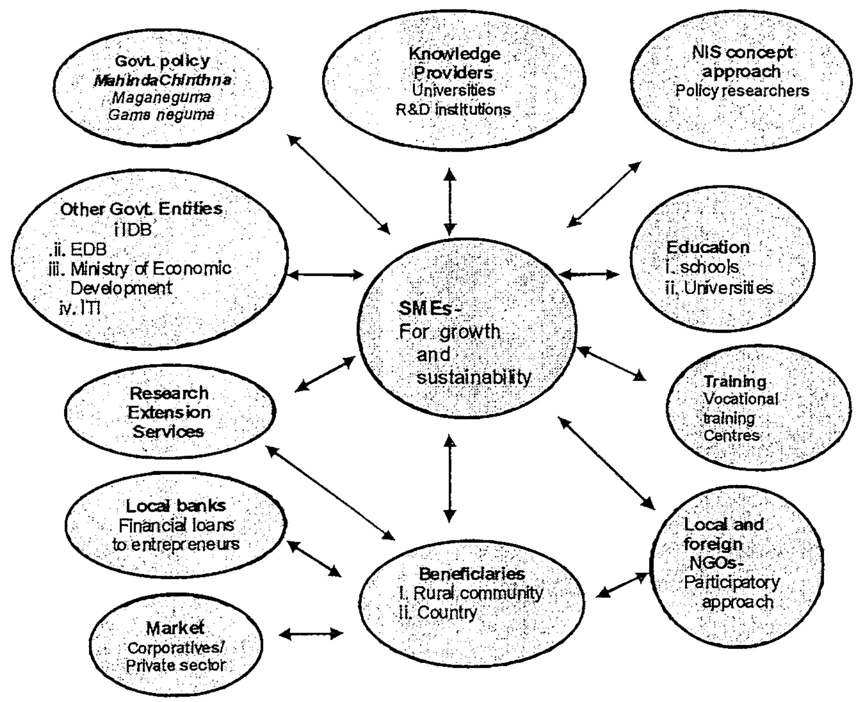


Figure 3 Innovation System model developed for small and medium enterprisesin Sri Lanka towards economic growth

Banks: The State/private banks need to provide loans at low interest rates to rural entrepreneurs.

Non Governmental Organizations (NGOs): To disseminate knowledge, and extend other services.

The model further shows the importance of actor-oriented approach and the institutional arrangements that are useful to support a viable innovation system in a small and medium scale enterprise. Most of the entrepreneurs are not involved in making value added products of SMEs due to inadequate knowledge in such product preparations, lack of funds for initiation and lack of knowledge in finding market for their products. The policy interventions promoting public private partnership is a must. For example, the government institutions that are involved in the above tasks must publicize their functions and improve links with the small and medium entrepreneurs and other actors who play significant roles in the network.

6. Conclusion and Recommendations

As discussed in this paper, all actors and institutions identified in the above model should work as a system to uplift the status, development and sustainability of the small and medium enterprises in Sri Lanka. The above model can be applied to any SME, but it is emphasized that all actors, institutions and the extent of their involvement will vary from one SME to another. This is because each system evolves independently based on the government policy framework, R&D activities, Market demand, education system, geography, history demography, culture, traditions etc., as mentioned previously. Finally, it is recommended that the government may consider working out a policy framework for SMEs as suitable to the above model and appoint a coordinating body that has the authority to facilitate, assist and link all actors and institutions relevant to any SMEs towards their development and sustainability.

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Access to Finance for SMEs in Sri Lanka: Challenges and Policy Options

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Introduction

Small and Medium Enterprises (SMEs), though known to be an integral component of Sri Lanka's economic and social fabric, is still faced with a myriad of constraints which impede their ability to grow. Even though the sector has received much attention from successive governments as well as international donor agencies, the sector is still faced with these challenges that need to be addressed in a comprehensive manner. Among them is the critical issue of the difficulty in accessing finance. This article aims to dissect this issue to better understand the drivers of access to finance, provide the latest insights from a new SME survey in Sri Lanka, and put forward some potential solutions to address the problem, including highlighting mechanisms in other countries which may serve as models for Sri Lanka's own efforts.

Context

Historically, SMEs around the world have frequently had difficulties in accessing finance. The recent global financial crisis, however, intensified this challenge. According to the Economist Intelligence Unit (EIU) survey report on access to finance among SMEs- *Surviving the Drought*[1], 45 per cent of respondents from the Asia-Pacific region say that the availability of finance has deteriorated in the aftermath of the crisis. According to the IMF, lending to the sector has fallen much more sharply than it has to larger companies[2]. The stresses and pains of SMEs owing to the lack of finance seem to have augmented with the tightening of financial regulations in the aftermath of the global financial crisis.

A recent IFC study revealed the severity of the financing issue faced by SMEs, particularly in emerging markets. Approximately 45-55 per cent of formal SMEs in emerging markets were found to be *unserved* (i.e., they need credit but do not have access to it) while 21-24 per cent were found to be *underserved* (i.e., they have access to some credit but still identify financing as a constraint)[3]. The survey also concludes that only 17 per cent and 32 per cent of small firms in low and middle income countries, respectively, had access to a loan/ line of credit from financial institutions, while the corresponding figure for high income countries was 50 per cent[4]. Further the results of the World Bank Enterprise Surveys indicate that SMEs in developing countries are more likely than SMEs in developed countries to report access to finance as a major obstacle for their development[5].

Findings from IPS-NCCSL SME Survey

Adding to this body of knowledge is a recent survey of SMEs in Sri Lanka conducted by the Institute of Policy Studies with the National Chamber of Commerce of Sri Lanka[*]. The survey was conducted in late 2012 via a semi-structured questionnaire. The sample was randomly selected using NCCSL database of SME members[**]. The common feature of the sample was that they were all members of the chamber and formally registered businesses. Although all respondents come from this same enterprise cohort, any selection bias is unlikely owing the strongly heterogeneous nature of the enterprises surveyed. The authors looked closely at the nature of the business that each respondent was engaged in to ensure that the results aren't skewed towards any one business type (i.e., wood work, food processing, etc). This was deemed not to be the case.

Table 1. Distribution of Respondents by Province

Eastern	9
Central	24
North Western	24
Uva	11
Southern	10
North Central Province	12
Sabaragamuwa	4
Western	4
Northern	3

The survey received 101 responses, covering all provinces in Sri Lanka (see Table 1). At the outset, the focus in the sampling was on enterprises outside the Western Province, taking the argument that SME development in other regions is particularly difficult. As such, 96 per cent of respondents were from regions outside the Western Province.

The aim of the survey was to identify the key issues faced by SMEs in Sri Lanka. According to the findings of this survey, 91 per cent of respondents considered access to finance as one of the 'top five constraints' on their businesses, while half of all respondents considered it as their 'most significant constraint' (see Figure 1).

The most significant reason for inadequate access to finance experienced by most of the survey respondents was attributed to the inability of financing development/ expansion plans. Of the respondents who reported they had inadequate access to finance, 69 per cent said they had more difficulty in accessing finance for development/expansion, while

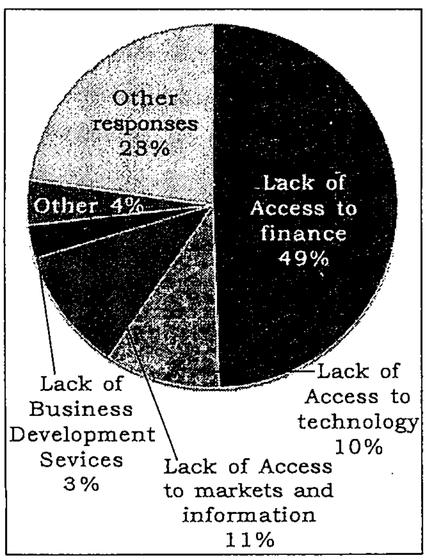

Figure 1 Most significant constraint on businesses as perceived by SMEs

Source: Wijesinha *et al. (forthcoming)*, 'Revitalizing Sri Lanka's SME Sector'

those who stated it was more difficult to access working capital were relatively fewer (around 31 per cent).

According to the survey results, financial restrictions also contributed to the tightening of other constraints on the working of the business. Of the individuals that participated in the survey, more than one-third of those whose employees had not received any training credited insufficient finances as the main reason for it.

The majority of respondents (60 per cent) noted that formal channels were their main source of financing (37 per cent) of which government banks were the preferred option.

development banks. The unwillingness of formal banking institutions to serve SME clients, for a number of reasons, was another significant motive for using alternatives. However, the survey further revealed that 75 per cent of those currently using informal sources declared that they would prefer using formal financing sources instead.

The survey also explored the respondents' thoughts on what the state can do to address this access to finance challenge. As the results in Figure 3 show, 60 per cent of respondents sought the provision of concessionary loans and other forms of government aid/support, while 11 per cent observed the

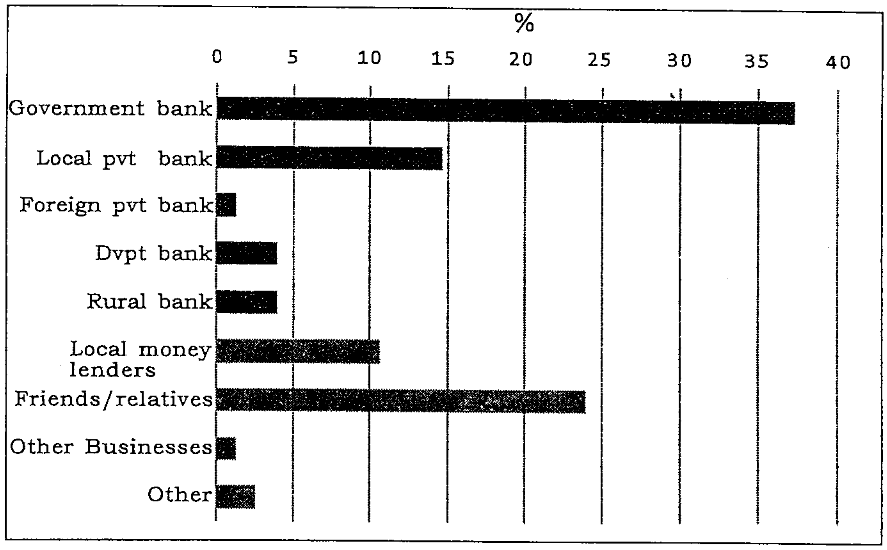

Figure 2 Current Sources of Finance for SMEs Reporting Access to Finance as Most Significant Constraint

Source: Wijesinha *et al. (forthcoming)*, 'Revitalizing Sri Lanka's SME Sector'

Informal sources were acknowledged by nearly 40 per cent of all respondents as part of their financing options, with the majority coming from friends/relatives and local money lenders (Figure 2).

The most common reasons for using such sources were listed as high interest rates and the inability to provide collateral requested by formal banking institutions, with seemingly little relief from

need for better institutional mechanisms in providing access to finance. 12 per cent noted that measures to address the difficulty of collateral are important while 7 per cent sought tax concessions and other relief in the absence of better access to finance.

This issue isn't new, and has been rightly identified in earlier policy documents as well. For instance, the National Strategy for Small and

Medium Enterprise Sector Development in Sri Lanka, White paper (2002) identifies problems related to finance as the foremost impediment to SME growth in the country[6]. The report further states that the lack of SME access to

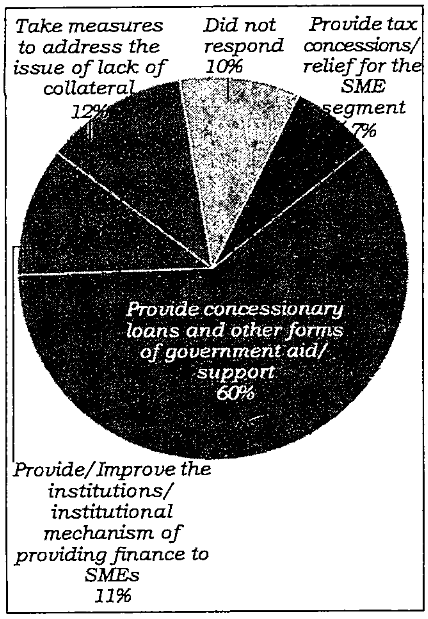

Figure 3 Respondents' Suggestions for Government Support in Addressing Access to Finance

Source: Wijesinha *et al.* *(forthcoming)*, 'Revitalizing Sri Lanka's SME Sector'

finance results in a vicious circle linking financing problems with the performance and progress of SMEs, as the lack of finance in turn results in undesirable outcomes such as the use of outdated technology, absence of quality control, and weakening profitability[7].

Unpacking the Problem

The problem of low access to finance broadly includes four sub sets of problems, namely, availability of funds and other credit instruments, access to equity and loan capital, cost of borrowing and management of finances. The problem of availability of funds is said to owe partly to inherent characteristics within SMEs and partly to the under developed nature of Sri Lanka's financial markets. The lack of venture capital and equity financing options for Sri Lanka are said to compel SMEs to depend mostly on bank loans. The problem of poor SME access to funds is said to attribute to factors such as the inability of SMEs to produce collateral with proper titles, the lack of development orientation on the part of both commercial and development banks, and the lack of proper skills among SMEs to make bankable project proposals. The third problem of cost of funds is said to attribute mainly to the high risk credit profile of SMEs which inevitably lead to high interest rates being offered to the segment, while the problem of management of finances is said to attribute to several factors including insufficient equity base, high cost of finance, over ambitious business acceleration, lack of financial management experience, non-separation of business and private expenditure, over-expenditure on status symbols such as cars, and unexpected policy changes[8].

Sri Lanka currently has a wide spread network of banks covering most of the rural corners of the country. In 2011 alone 194 new branches were opened across Sri Lanka[9]. Hence the problem of low SME access to credit is due to reasons that go beyond merely not having access to the country's existing banking network. It has become clear that the weak SME access to credit situation in Sri Lanka stems from both demand and supply side factors. The authors conducted in-depth key informant interviews (KIIs), especially with senior officials of banking and financial institutions in the country, to uncover more insights on this issue. The following sections take a closer look at the findings of this:

Demand-side Factors: SMEs' Inherent Limitations

When considering the demand side factors, the lack of collateral seems to be the most significant constraint on SME access to credit. Financial sector institutions surveyed observed that the high non-performing loans (NPL) ratio of SME customers have prompted them to demand higher collateral when giving out SME loans, in order to cover potential default losses. Banks assert that although they have tried alternatives to collateral-based lending, like cash flow-based and risk-based lending, the NPL ratio was higher for such lending and felt that collateral is necessary in order to exert pressure on SME customers to repay their loans. The banks also expressed a concern that effective credit guarantee schemes, which would ease high default risks of the SME segment, were not available in Sri Lanka, but if introduced would improve the SME credit climate by allowing banks to lend collateral-free.

The lack of transparency and financial discipline among SMEs was considered as the second most significant demand-side factor. Tax implications appear to be causing reluctance among SMEs to disclose proper financial accounts to banks. The lack of proper financial data makes it virtually impossible for banks to evaluate the creditworthiness of SMEs and has thus constrained the amount of credit given to the sector.

The lack of access to markets, market information, and effective supply chains has been considered as an inherent characteristic constraining SME growth. This in turn has an impact on SMEs access to finance. The interviews revealed that this lack of access to markets, market information and supply chains have prevented SMEs from making better evaluations of critical business criteria such as their respective market size and market trends. This in turn has made SME business plans less feasible prompting banks to refrain from lending to SMEs due to inadequate and/or poorly-prepared business plans. The lack of sufficient knowledge of business practices such as the effective financial management, business planning, book-keeping, etc., prevent SMEs from making bankable business proposals. Banks have begun making efforts to address this issue by conducting training programs and establishing special SME centers to assist SMEs in preparing proposals. However, certain banks expressed concern that SME entrepreneurs were reluctant and unmotivated to gain such skills despite of their clear importance. Moreover, the banks also believe that there is a strong need for government attention on this matter, remarking that the banking sector alone cannot help address the challenge sufficiently. The findings of the interviews also reveal that inherent characteristics within SMEs such as the lack of proper technology, poor quality products and labour issues not only impose major challenges on SME growth but also make SMEs riskier than other segments for banks to serve. This in turn makes banks hesitant to lend to SMEs. Necessary measures need to be taken to overcome such weaknesses in order to minimize the risk profile of SMEs and thus make banks keener on serving the sector.

The interviews also highlighted the fact that administrative delays and difficulties in obtaining permits and licences from government institutions enforces problems for SMEs in obtaining credit because the banks are unable to provide credit without proper documentation. Most banks believe that bureaucratic procedures need to be reformed so that a speedier service can be provided for the SME sector when obtaining permits/licences.

Our findings suggest that the lack of proper insurance coverage for the SME segment is yet another critical factor limiting SME credit. Banks feel that the insurance providers of Sri Lanka seem to have given very little emphasis to the SME segment as most SMEs have been unable to obtain proper insurance coverage. The high risk profile of SMEs make banks hesitant to lend to SMEs that do not have proper insurance coverage.

The lack of proper management and leadership plans was found to be yet another demand side shortcoming constraining SME access to credit. Most SMEs are family run businesses and there seems to be no second line of management for these businesses (especially when the children of the SME owner are reluctant to take up the business). The banks are not in a position to lend to SMEs without a proper line of management as any mishap to the entrepreneur would mark an end to the business, leaving banks at a loss.

Supply-side Factors: Limitations within the Banking Sector

The KIIs revealed several constraints within the financial sector itself that hinder SME access to credit. Majority of the banks interviewed stated the lack of effective government support and/or incentives given to the banking sector for promoting SME lending as a key factor limiting SME credit. The banks stated that the extremely risky nature of the SME market makes it difficult for banks to serve the segment and that, incentives were needed to make it worthwhile for them to serve such a risky market. This was a surprising observation given the number of concessionary and SME-specific loan schemes available in the market, particularly those refinanced by the Central Bank of Sri Lanka or international development agencies. Banks expressed their disappointment in the current refinance facilities provided by the government as they were found to be ineffective and unprofitable for banks. They also felt that the government needs to take a more proactive role in providing necessary credit lines for SME lending.

The lack of staff who are skilled in SME lending emerged as a critical supply-side constraint. SME lending is a service that calls for a different kind of banking approach. A more analytical, patient, and small business-oriented banking attitude is required for SME lending. It was highlighted that staff in branches rarely have time to attend to SME customers as they are preoccupied with achieving strict monthly targets. Hence, there seems to be a lack of staff in banks that can and are willing to attend specifically to SME customers and provide a specialized service to them.

The findings also underscored that financing facilities provided for the SME segment in Sri Lanka seemed to be limited predominantly to loans, leasing and pawning. The lack of diverse and innovative banking products and services aimed at start-ups and small businesses are limited, often non-existent, in Sri Lanka's financial markets. The limited range of SME-focused or SME-friendly financial products offered seems to be a factor constraining SME credit.

The banks also expressed concerns about the policies adopted by the government with regard to financial markets such as imposing credit ceilings and high interest rates as a constraint on SME lending. The banks believe that a favourable financial environment with less interruption is needed so that they will be at a position to follow strategic plans to promote the SME sector. The cost and time taken to deal with policy changes are said to take away time and effort from serving the SME market, as most often than not, banks are found to be preoccupied responding to ad-hoc policy changes rather than following systematic plans:

Hence the findings of our interviews suggest that shortcomings within both SMEs and financial markets need to be addressed in order to overcome the problem of low SME access to credit.

Given the severity of the issue of low SME access to credit in Sri Lanka, it is crucial that is it addressed if Sri Lanka is to revitalize the SME sector. Bearing these issues in mind, let us look at some of the following options available for Sri Lanka to overcome this challenge – SME-oriented banking, SME credit scoring, and credit guarantee systems.

SME-oriented Banking

Even though there has been a recent shift in the focus of banks (especially in Sri Lanka), from large corporates to a newer, smaller, but yet lucrative, segment of SMEs, the banking procedures and practices carried out by Sri Lankan banks seemed to have not changed accordingly to best suit the new SME focus. Nanayakkara (2011) reckons that the traditional banking functions practised in Sri Lanka involving SME financing do not help in promoting SME lending[10].

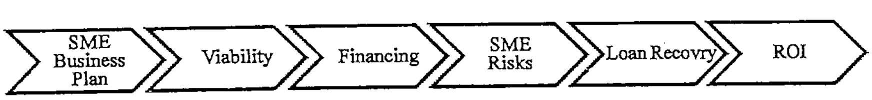

Figure 4 Banker's Traditional Interest in SME Lending
Source: Nanayakkara (2011)

Nanayakkara (2011) goes on to state that SMEs, who are most often than not, unskilled in preparing business plans find themselves unable to complete even the first step of the traditional banking process and often do not succeed beyond the first step of the process (see Figure 4). The high rate of failure of SME applications at the project viability stage is said to owe mainly to the inability of bank staff in accurately assessing the business proposals as they lack entrepreneurial skills to assess the projects.[11]. Most loan applicants are start-ups with no prior financial statements, thus SMEs lack the necessary records to prove their financial strength. It remains questionable if SMEs should be evaluated based on the same criteria imposed by traditional banking procedures.

Given the inability of the traditional banking procedure to meet the demands of the SME clientele, the need to streamline Sri Lanka's banking procedure to best suit SME customers is essential. It is with this in mind that Budget 2012 proposed a special SME bank branch (known more commonly now as 'SME centers') to be set up by each state bank in all districts. Even though these measures were taken in the right direction, the effectiveness of it is uncertain. Interviews conducted by IPS with leading banks unveiled the difficulties faced by such banks in establishing SME centers. The banks (including state banks) revealed that they are constrained by the lack of financial and human resources to run these SME centers.

International success stories of banks that have succeeded in effectively targeting the SME sector brings to light not only the absence of innovative banking practices but also the lack of tools such as credit scoring/rating models, credit registries/bureaus, credit guarantee schemes, etc., which contribute toward building an enabling credit environment in the country. Let's explore a couple of these in detail.

SME Credit Scoring

IFC (2010) defines credit scoring as a mathematical technique that uses historic credit data to predict a future outcome, typically the probability of default[12]. Wells Fargo, a leading bank in the United States, pioneered the use of credit scoring systems for SMEs in 1992[13]. The automated credit reports and scoring enabled the bank to provide a cost-effective service to its SME clientele. Credit scoring involves the process of granting a score to an individual/ individual business based on parameters such as length of time in business, nature of business, length of time with bank etc. The traditional banking process as depicted in Figure 4, typically involves banks evaluating the creditworthiness of SMEs based on financial data. As discussed in the previous sections of the chapter, asymmetric information due to the lack of proper financial data with regard to SMEs make it impossible to evaluate their creditworthiness based on traditional appraisal methods. Hence the credit scoring method can be used to evaluate the creditworthiness of SMEs and can help in overcoming information asymmetry. Even though it is unlikely that Sri Lankan banks would rely solely on a credit score to make a lending decision, these models can be deployed as a pre-screening tool to determine which applications to investigate more thoroughly and which applications to reject completely. They could reduce the average time spent on processing applications and the cost of acquisition - two key factors that limit banks from lending to the SME segment.

These models are already prevalent in the East and South East Asian region. A study showed that more than 70 per cent of financial institutions surveyed in ASEAN economies have implemented some form of rating or scoring for SME loans. Banks in some ASEAN economies were able to increase loans to the SME sector by 61 per cent by 1995 since the introduction of credit scoring in 1992[14].

The KIIs conducted with banking sector officials in Sri Lanka underlined the fact that the top management of banks was aware of such innovative tools. Yet, what seemed to be lacking was the confidence to courageously embark on such schemes due to the typical risk-averse nature of Sri Lankan banks.

However, it should be kept in mind that several challenges which are unique to developing countries make the execution of credit scoring challenging. The 'Access Finance' Newsletter (World Bank, 2006) identifies four challenges in adopting Small Business Credit Scoring (SBCS) in Developing Countries[15]:

1. Limited availability of timely, accurate and reliable data in credit bureaus and similar data registries

2. Poor record management and MIS systems in financial institutions

3. Significant investment cost to develop SBCS tools

4. Bank's reluctance to share information on SME customers among peers

A possible jump start developing countries can employ is the 'pooled-data' model, by obtaining detailed SME portfolio data from a number of lenders. This method is a low cost alternative to custom built models. Recent research by the World Bank and the Fair Isaac & Company in several Latin American countries such as Colombia and Mexico, demonstrates the feasibility of such pooled data SBCS solutions. In terms of structuring a credit rating scheme, Sri Lanka can learn from neighbouring India. India's Performance and Credit Rating Scheme, a program that rates small scale industries was formulated in consultation with the Small Industries Associations, the Indian Banks' Association and various credit rating agencies including Credit Rating and Information Services of India (CRISIL), Investment Information and Credit Rating Agency of India Limited (IICRA India), and Dun and Bradstreet. The rating agencies combine an evaluation of the performance and credit worthiness of the enterprise and include parameters that measure operational, financial, and business and management risks. Eventhough each enterprise is responsible for paying the special "small-scale industries fee" set by each credit rating agency, the Ministry of Micro Small and Medium Enterprises subsidizes 75 per cent of the fee charged. Further, the Ministry funds an initiative to create awareness amongst MSMEs about the strength and weaknesses of their existing operations and provides them an opportunity to enhance their organizational strengths. The ratings have improved access to banking finance by at least 20 per cent of rated clients, and collateral requirements have decreased by 10 per cent of rated cases[16].

Credit Guarantee Systems

Credit guarantee schemes have been regarded as a mechanism that enables SMEs to bypass the limitations imposed due to the lack of adequate collateral. The IFAC/ Banker survey found that lenders do not value information industry trends and clients' business plans nearly as much as they do cash flow statements, collateral and transaction histories[17]. In Sri Lanka, inadequate collateral is a serious issue for the SME sector, because banks are traditional and risk averse in their lending, and are strongly collateral conscious. Credit Guarantee Schemes (CGS) have the objective of absorbing part of the loss resulting from the default of a bank loan. It reduces the risk of a lender, serves to improve the supply of credit and facilitates the smooth operation of the loan market.

The interviews conducted by IPS with the banking sector of Sri Lanka underpinned the idea that the banking sector is very much dissatisfied by the credit guarantee schemes (CGSs) which have been introduced so far. But they remain hopeful that a profitable CGS would soon be introduced in the context of Sri Lanka as CGSs as a concept promises optimism for bolstering SME access to credit. It is useful to look at some examples from the Asian region.

In Malaysia, the Credit Guarantee System offered by the Credit Guarantee Corporation (CGC) enables viable SMEs without or with minimal collateral and no track record, to gain access to financing from financial institutions. Further, the SME Credit Bureau established in 2008 by the CGC enables SMEs to be aware of their own credit standing and identify critical areas for improvement that will enhance their credit worthiness provides trade information and probability of default of a company. In Thailand, the Small Business Credit Guarantee Corporation (SBCG) is responsible for the Small Industry Credit Guarantee Fund that provides credit guarantees to unsecured parts of a loan. Three guarantee schemes are functional - a normal scheme which guarantees unsecured loans between 10-40 million baht, a risk diversification scheme where financial institutions and SBCG share the risk of loans provided, and a loan guarantee scheme which guarantees up to 10 million baht and payment of up to 10 million *baht* for a term of 7 years. In India, the Small Industries Development Bank (SIDB) has a credit guarantee scheme that provides financial and deferred payment guarantees to its MSME customers. SIDBI, together with India's Ministry of MSMEs has created the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE). This fund encourages lending institutions to emphasize the firm's project viability and extend credit based on primary assets rather than secondary collateral. Thus, CGTMSE covers collateral free loans up to 1 crore (approx. US$ 200,000) to new and existing SMEs and also provides rehabilitation assistance to the lender, should factors beyond management's control.

Oehring (1995) suggests that credit guarantee schemes will only function successfully if they are part of the national private sector (including banks), if there are no restrictions regarding the origin of funds used for the scheme, income from fees and investments cover the cost of running the scheme, guarantees are granted only to financially sound projects and companies and the schemes consist of backup programs that provide training, professional advice, and other services[18]. Bearing all this in mind policy makers should focus on introducing effective CGSs to Sri Lanka as it will undoubtedly help in bridging the SME financing gap.

Conclusion

The issue of weak access to finance for SMEs in Sri Lanka is an ongoing challenge - is one that calls for urgent policy responses if the sector is to survive, grow, and contribute fully to national output. Eventhough the steps taken in recent times by both the Government and SME lenders themselves are steps in the right direction it appears that much more needs to be done. As this article has discussed, the dynamics driving the problem are many and arise from both supply and demand side factors. Both must be addressed simultaneously. The Government, together with the financial sector, should create an enabling environment for SME lending in the country through the establishment of Credit Guarantee Schemes and Credit Scoring initiatives, while the banking sector needs to boldly adopt SME-friendly banking. Meanwhile, SMEs need to be supported to ease their inherent limitations which lead to their weakened position in accessing formal finance.

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Footnotes

* The sample was randomly selected using NCCSL database of members classified by NCCSL as SMEs. Any selection bias is unlikely owing the strongly heterogeneous nature of the enterprises surveyed. All are formally registered businesses.

** The size of the database was 400 members. However the authors acknowledge that this does not capture the entire SME population in these Provinces. Such information is not available from government census and statistics data owing to SME definition and classification issues.

Financing SMEs - Key Challenges and Issues for Bankers

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The definition of Small & Medium scale Enterprises (SMEs) varies from country to country. The classification can be based on the firm's assets, number of employees, or annual turnover along with the loan amount. Central Bank of Sri Lanka defines SMEs as enterprises with less than Rs. 600 million turnover per annum and with a maximum exposure of Rs. 200 million mainly to be classified as a SME for Basel II Capital adequacy calculation and utilization of funds accumulated in the Investment Fund Account in Banks.

Whatever the definition, and regardless of the size of the economy, the growth of SMEs throughout the region is crucial to growth of respective economies. Because, SMEs play a critical and important role in providing job opportunities, enhancing the quality of human resources, maximizing the use of local resources, saving foreign exchange, nurturing a culture of entrepreneurship, fostering creativity and opening up new business opportunities etc. Most corporate organizations in Sri Lanka or elsewhere are the establishments started as SMEs in its early stages. Classic examples from our own country may be Nawaloka Group, Access International, Softlogic Group of companies.

In most literature, it is mentioned that access to financing has been recognized as a major impediment for many SMEs and its growth, whereas corporate business entities have the advantage over the SMEs in doing so primarily as a result of their formalization.

However, according to Juliet Mckee and Kimball Dietrich (2003), most common problems for SMEs are the lack of access to market information and technology, the low quality of human resources and the lack of access to capital. Despite efforts by financial institutions and public-sector bodies to close funding gaps, SMEs continue to experience difficulty in obtaining risk capital. These funding gaps relate to firm size, risk, knowledge, and flexibility.

The development literature focus a good deal of attention on issues faced by SMEs in accessing finance. Traditionally, the focus is on obstacles created by financial institutions, mainly by commercial banks or on imperfections in the broader institutional environment. However, SMEs also make decisions about financing and display attitudes that have an important bearing on financing decisions. Therefore, constraints may also appear on the "demand side" of the financing market.

Objective of this article is to discuss the key challenges and issues for bankers pertaining to SME lending, of which, part of them are inherent in SMEs and for others bankers are responsible.

1. Issues of SMEs

1.1 Lack of financial literacy or weak financial literacy

In the literature, lack of financial literacy is designated as informational asymmetries where SMEs typically possess privileged information on their business that cannot be easily accessed or cannot be accessed at all by lenders or outsiders.

Reasons for this may vary and also have different perspectives.

SMEs are mainly driven by entrepreneurs who have nurtured in their own ways to prospective SMEs. As a result of hard ways of development, they either had no time to devote further education or do not believe in learning. This is evident from the credit applications that are submitted to banks for financing. This eventually leads to low levels of financial literacy among entrepreneurs.

Financial literacy is the ability to understand how money works in the world: how someone manages to earn or make it, how that person manages it, how he/she invests it (turn it into more) and how that person donates it to help others. More specifically, it refers to the set of skills and knowledge that allows an individual to make informed and effective decisions with all of their financial resource.

Though many SME owners are sound in developing business models and working out the profitability of products and services, understanding about the macro picture of the SME's overall financial standing in terms of profit and loss account, balance sheet and cash flows is weak. As a result, they sometimes opt to resort to outsiders or merely depend on themselves in preparation of financial information which may or may not reflect the actual picture of the SMEs. Because of this impediment, banks have no choice, but to depend on collateral for SME financing. At the backdrop cash flow lending is encouraged, financial institutions are struggling to project the SMEs' sustainable bankability. This is recognized as the main obstacle for banks and financial institutions in financing SMEs.

One of the options to counter this impediment is the concept of **"Para accountant"**. A Para accountant is an external consultant who uses finance, economics, risk management and technology skills to help organizations prepare and report financial and tax statements according to accounting principles and regulatory requirements. A Para accountant also may review a firm's internal controls, processes and procedures to ensure that such controls are adequate. A Para accountant may work on a client's site or remotely. They are not necessarily qualified accountants, however, might be an option.

Bankers' prime objective in this endeavour is to develop reliable sources of information so that they could project the sustainable cash flows of the business. With this objective banks could train their credit appraisal officers as Para Accountants, who will interacts with prospective SMEs and develop a set of financial information while strengthening the banking relationship over a period of time.

1.2 Entrepreneurs' knowledge about building a prospective banking relationship

A banking relationship is about much more than just selecting a bank to handle a company's bank accounts. If the relationship is managed well, it can help a company to thrive.

SMEs that use more than one bank will need to manage multiple banking relationships. A company will first have a business account (or several) at a retail bank (or banks) for all day-to-day financial transactions. Whether it is retail, SME or corporate, the banks should have a team of business banking advisers on hand, to advise and guide a company. It's important to ensure continuity— banks usually offer a contact with a designated person and in turn expect to deal with the same person or persons from the company. A good banking relationship depends not only on personal rapport, but also by having a solid understanding of the company and its financial needs. Over time, a banking adviser should build up a good understanding of the company's preferred ways of doing business and incorporate that into how their banking requirements are handled.

There are many advantages having a sound banking relationship for SMEs.The bank is more likely to offer loans and other lines of credit, potentially at preferential rates of interest, if the bank advisers feel there is a good relationship with the company. The bank's advice can be tailored for the company's needs and personal style, rather than given generically.

In times of crisis, a company having its bank's support will be crucial. Even if a company is a text-book case of insolvency, strong personal rapport with a company representative means that the bank is more likely to offer leeway if it knows that directors are doing their utmost to keep the company going.

Failure to develop a strong relationship, however, means that the SME is likely to miss out on good advice and, crucially, support in times of difficulty. However, unfortunately, many SMEs are not on the right track to understand the importance of having a good banking relationship. Given that no sound financial information are available, at least, SMEs should try to maintain a healthy customer relationship with the financial institution to entice financial needs, especially in difficult periods.

It is both Bankers' and SMEs' responsibility of developing a prospective banking relationship over a period of time without compromising risk capital. More than the credit facilities, credit plus would be reasonably appropriate to start such a relationship and then move into advanced levels of relationships along with credit facilities.

1.3 Financial discipline of entrepreneurs

As Henry Ford correctly cited, **"Wealth does not come accidently. You have to plan for it."** One's discipline explains the right behaviour and ability to take decisions without emotions. Hence, financial discipline is all about right financial decisions. In order to be financially discipline one should understand concepts of accounting and financial management in SME business.

Accounting in general is all about record keeping and developing summary financial reports. Most commonly available financial reports or information are the profit and loss account, balance sheet and the cash flow statement. Unless SMEs keep records of their daily activities, it is difficult to develop financial statements with regard to their businesses. With no financial statements, SMEs will always struggle in making financial decisions. More often, there is no clear distinction between the business finance and the finances of the proprietor. Therefore, it is critical that the lender examines carefully borrower's all commitments, i.e., those related directly to the business and those associated with the proprietor's private life and assets.

Lack of Business Planning is a result of weak financial indiscipline in SMEs where investment decisions, working capital decisions, even pricing decisions are based on the entrepreneurs' values than on facts. The lack of proper financial discipline results in incorrect business decisions, which hampers the sustainability of the SMEs.

MacRobert (2002), in his SME manual explains why SME borrowers are different to commercial and corporate borrowers. One of the common reasons is unskilled/ untrained principals. Many SME principals in the Asia-Pacific region are self-starters, often with limited formal education, and minimal training in business management skills. That is not to say that they are incompetent, but that they often lack the capacity to research information on ways to strengthen their businesses, and, indeed, to be aware that such resources even exists. Role of the bankers in this regard is to educate the importance of financial discipline through strong banking relationships. Bankers are one of the key sources, to get SMEs to believe in financial discipline. Bank officers should take the initiatives in this endeavour to educate the SME owners.

Role of the Government is also a key imperative in developing required conducive environment through institutional and policy frameworks. Some universities in Sri Lanka have already started dedicated departments to teach courses related entrepreneurship. (Example: University of Sri Jayewardenepura and University of Colombo) and it is important to note that Business studies is part of the GCE A/L curriculum. Recent budget proposals in 2011, 2012 and 2013 have given enough support to encourage SMEs and SME financing and one of the very useful proposals was to direct government banks to set up dedicated SME Branches not only to facilitate SMEs with easy access to finance, but also to educate SME owners and to guide and direct them to right places and people. However, strengthening the institutional framework to develop business development support services is also an imperative.

2. Issues with Banks

SMEs are not only critical to the economy, but also to the banks' profitability. Most diversified banks maintain a substantial percentage of exposure to the SMEs as a strategic investment given the diversity within the SME portfolio itself. It is always profitable, but need to properly evaluate and closely monitor the delinquencies to avoid any credit risks.

It is a perception as well as a fact sometimes, that SMEs are always highly risky as explained by many banks. It may be due to several factors including, non availability of financial information, no tax returns, no collateral, one man show, highly sensitive to economic conditions, no proper organizational structure, and many more. These are reasons given to avoid or very conservative underwriting of SME credit proposals. As a result of these reasons, credit policies of financial institutions are based on stringent credit guidelines.

2.1 Institutional framework with hindering process issues

In the case of many developing countries, the above mentioned obstacles to SME financing are exacerbated by institutional and process factors. Most developing countries are still highly concentrated and have uncompetitive banking sectors. This reinforces the tendency to adopt conservative lending policies. Credit policies which mainly cover the credit risk and market risk, endorse a processes which covers many elements to secure exposure, while satisfying the regulator's requirements. This eventually results in a value driven credit culture in financial institutions.

According to MacDonald and Timothy (2006), management's credit policy determines how much risk the bank will take and in what form. A bank's credit culture refers to the fundamental principles that drive lending activity and how management analyzes risk. There can be large differences in their lending philosophy. The three potentially different credit cultures are: values driven, current profit driven, and market share driven. The institutional framework is reflected through the credit policy in this part of the world, the tendency is to inculcate a value driven credit culture, which has the following attributes:

- Focus is on credit quality with strong risk management systems and controls,
- Primary emphasis is on bank's soundness and stability and a consistent market presence,
- Underwriting is conservative and significant loan concentrations are not allowed,
- Typical outcome is lower current profits from loans with fewer loan losses.

It is evident with lower non-performing ratios prevailing in banks justifies that credit risk is covered with loan risk mitigation factors and discourage granting venture capital to SMEs. Eventually, SMEs need to resort to acceptable securities which hinders them from easy access to finance from financial institutions.

2.2 Collateral syndrome (Risk avert)

Strong value driven credit cultures in financial institutions always tighten the belts in covering credit risk. Unless the financial institutions develop competencies in cash flow based lending, credit officers have no choice but to cover themselves with collateral in risky SME lending. Competencies itself will not drive the business unless the risky lending is rewarded with challenging business targets. Security based lending propositions are gradually becoming unhealthy for economies as it discourages strategically

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SME Access to International Markets: Issues and Remedies

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Introduction

International trade is a process of increasing connectivity, where ideas, capital, goods, services and people are transferred across country borders . Trading globally enhances the domestic competitiveness and extends the sales potential of existing products. Olejarova (2002) states that it gives more opportunities for developing countries to access to global markets, accelerates technology transfer from developed countries, improves productivity and increases efficiency.

In Sri Lanka, large firms, with sufficient capital, market base information, access to modern technology and infrastructure facilities, are more successful in participating in international trade. However, it is yet a challenge for many Small and Medium scale Enterprises (SME) to engage in international trade due to 'inadequate access to capital and finance, inadequate industrial infrastructure, lack of market base information, obsolete technology and lack of modern management skills' (Gamage, 2009). Further, supplier networking is also a critical challenge for SMEs.

Trading globally requires extensive planning, budgeting and prioritization which are immense challenges for many SMEs in Sri Lanka. This research intends to explore the challenges faced by Sri Lanka SMEs on export operations.

The majority of SMEs in Sri Lanka are located in rural areas. Some of the SME entrepreneurs prefer to locate their enterprises within Industrial Parks owned and maintained by the Government. At present there is a large number of SMEs located in these industrial parks spread throughout the country. There are very strict conditions attached to these leaseholds properties and lessees find it almost impossible to mortgage these properties to banks for loans. Although, most of the SMEs own movable assets such as plant and machinery, banks are reluctant to take them as collateral because, Sri Lanka still does not have a Movable Assets Registry to register the mortgages of movable mortgages preventing borrowers transferring the ownership of same after the mortgage. However, these industrial clusters and networks are not well designed .

1. Structural Weaknesses Problems Faced by SMEs

1.1 Inadequate risk capital

When banks provide funds to any SME, they expect a reasonable equity stake or a risk capital from the owner. This is common to lending by banks to any business. If the owner of the business does not have an equity stake in the business, he is not taking any risk. Risk taking is one of the primary characteristic of an entrepreneur. Today, banks expect around 30-40% as risk capital from the owners of enterprises in order to secure their full commitment to the business; reduce the burden of debt servicing and also to share the risk in a business failure. Most of the SME entrepreneurs find it difficult to raise this minimum risk capital and the limitation in equity capital restricts the access to finance by SMEs from the banking sector.

1.2 Use of outdated or substandard technology

Most SMEs in Sri Lanka use locally developed technologies in producing and delivering goods and services. One of the main factors that influences the success or failure of an enterprise is the technology it uses. The quality of most of the products and services produced by SMEs are of moderate quality or not up to international standards due to this substandard technology. They find it difficult to compete with relatively high quality cheaper imported products. Also with increasing globalization and phasing out of tariff and non-tariff barriers to widen international trade, prospects for SMEs in Sri Lanka may be affected adversely, unless the above aspect is considered. This situation may adversely affect the SMEs in Sri

Lanka thereby reducing their viability. Due to the substandard quality of products produced by some SMEs, they have only a very limited market regionally or nationally. Due to quality issues entering the international market is difficult for them.

1.3 Lack of managerial skills

Due to the smallness of the business, many SMEs find it difficult to employ skilled managers to look after specific areas of their businesses. Like in larger firms there is no segregation of owners from the managers. Owners and/or managers of SMEs often need to perform a wider range of tasks than those do in larger firms since there is less room for specialization. This requires the few managers or employees employed by SMEs to possess diverse skills not limited to one or two specific skills. Managers in developing countries do not have this multiple skills. Lack of specialization makes management capabilities of SMEs very weak. In addition, poor financial position of SMEs prevents them acquiring skills from outside.

2. Remedies to Overcome Structural Weaknesses in SMEs

Above are the main structural weaknesses of SMEs that prevent them from accessing finance from the formal banking sector. This situation compels SMEs to borrow from the informal sector at exorbitant rates of interest. Sometimes the rates are as high as 10 to 15% per month. This cost of finance renders most SMEs unviable. What are the remedies available to SMEs to overcome this situation?

2.1 Financial records

In order to encourage and motivate SMEs to maintain proper books of accounts and prepare proper periodic financial statements reflecting actual level of performance, the Government needs to provide some attractive fiscal incentives. Until 2011, there was hardly any difference between the tax rates for SMEs and large corporates. This compelled SMEs to understate their incomes and avoid taxes. Although, the tax rate applicable to SMEs (where the total investment is less than RS 25.0 mn) was reduce to 10% in 2011Budget proposals, an improvement in the financial record keeping cannot be seen so far. In addition to tax incentives it is essential to introduce some non-fiscal measures to motivate SMEs to maintain proper books of records.

2.2 Risk capital

A few years back, the Government of Sri Lanka encouraged through fiscal incentives the establishment of venture capital companies to provide venture capital mainly to SMEs. Although, initially there were about 5-6 venture capital companies, they could not perform according to the expectations. These venture capital companies were investing in large corporates rather than investing in SMEs. Only very few companies out of those are surviving today and they are also not helping SMEs. Many countries in the World have sought to address the issue of risk capital for SMEs by establishing dedicated stock exchanges, junior market segments or separate market platforms to enable SMEs to raise equity from general public and institutional investors. At present in Sri Lanka, there is no formal institution set up to help SMEs to raise equity capital. It is time for policymakers to seriously consider the possibility of establishing a Government sponsored and/or funded venture capital institution exclusively for SMEs. This will encourage the entrepreneurs to set up new SME ventures and also banks to lend to them.

2.3 Sub-standard technology and managerial skills

The performance of SMEs in Sri Lanka is affected adversely due to the use of sub-standard technology and due to lack of proper managerial skills. The poor financial standing and the smallness in the size of SMEs prevent them acquiring these skills for themselves. Therefore SMEs all over the world resort to outside support in areas such as technology upgrading, improvement of product quality, improving managerial skills and expansion in market access. Therefore, it is essential for any country with a substantial SME sector to have a vibrant network of Business Development Services (BDS) Providers. When a SME entrepreneur needs professional advice on a specific problem relating to the operation of his enterprise, he should be able to access quality and reliable professional advice to resolve the problem. Although, institutions such as Industrial Development Board and Export Development Board were set up for this purpose, whether they could provide this service effectively is questionable. In Sri Lanka there are many such supporting institutions for SME devlopment. Most of them are doing the same things. There is no coordination mechanism. In countries like Philippines, Indonesia and Malaysia there are very efficient and effective networks of Business Development Services Providers and SMEs in these countries heavily depend on them for professional advice to solve their in-house problems. During the 1980s and 1990s, there were several concessionary finance schemes to help SMEs to upgrade technology and managerial skills of their enterprises. These schemes were designed and implemented in project base and ad-hoc nature. Sri Lanka does not have a national plan for SME development.

Why Banks are Reluctant to Lend to SMEs and How to Motivate Them

In Sri Lanka, some banks are reluctant to lend to SMEs and as such banks are frequently subjected to criticism by policymakers, politicians and SME Entrepreneurs. The criticism is reasonable to some extent as the reluctance on the part of banks hampers the growth of SMEs. There are three main reasons for some banks to be reluctant to lend to SMEs.

1. Perception of banks that SMEs are with high risk

Most banks have a perception that SMEs are high risk due to the following reasons:

- Insufficient assets and low capitalization, vulnerability to market fluctuations and high mortality rates,
- Information asymmetry arising from SMEs' lack of accounting records, inadequate financial records and reliable business plans,
- High administrative and transaction cost and low returns,
- High probability of default,
- Inability of banks to properly assess whether the SME borrowers possess managerial skills to generate adequate cash flows to service the debt.

This perception is not correct and SMEs are an attractive line of business in developed countries. The international researches have shown that Return on Assets (ROA) on corporate lending is around 1.0-1.5% whereas the ROA on SME lending as high as 1.5-3.0% provided SME lending is carried out properly. The managerial deficiencies in SMEs can be minimized by promoting vibrant network Business Development Services (BDS) providers. As in the past, banks should work closely with Authorities and international development agencies for this purpose like in countries like Philippines and Indonesia.

One way of minimizing the risk of SME lending is to obtain the services of rating agencies. The credit rating system helps overcome the reluctance of banks to lend to SMEs. The rating agency assigns a rating to an enterprise indicating its risk profile based on the assessment of its past performance and also measuring its operational, financial, business and managerial risks. Although, a few international rating agencies are operating in Sri Lanka all of them concentrate on rating of listed corporates and listed instruments. No rating of SMEs in Sri Lanka has been done so far. In India, rating of SMEs is done in large scale by rating agencies such as CRISIL, Dun & Bradstreet and SMERA. SMERA was specifically set up by the Government of India to rate the risk profile and credit worthiness of micro, small and medium scale enterprises (MSMEs) to enable them to obtain funds from the formal banking sector at attractive rates of interest. Banks will be comfortable to lend to these MSMEs which have been rated by independent professional rating agencies. In India, 75% of the fees charged by rating agencies from MSMEs are subsidized by the Indian Government. It is time for authorities in Sri Lanka to introduce a system of credit rating similar to that of in India.

Transaction and Administrative cost will depend on the methodology and technology used in SME credit delivery. At present, most banks in Sri Lanka use "Judgmental Method" or "Manual Underwriting Method" for approval or rejection of SME loan applications which involved in manual collection and review of operational data and personal information on borrowers. This system of processing of loan applications is time consuming and costly and also sometimes result in wrong judgment or adverse selection. Usage of credit scoring models by banks for lending to SMEs can overcome information asymmetry and high transaction cost. Credit scoring models can easily discriminate between high and low risk borrowers.

2. Lack of commitment of top management of banks

Top management of many banks in Sri Lanka is not fully committed to promote lending to SMEs. They are more comfortable with lending to few corporates, even if that segment of the market is highly competitive. They perceive this sector to be risk free, hassle free and with high profitability. This negative attitude of top management of some banks trickles down to all level of management making SME lending in these banks negligible. SME activity becomes less attractive career-wise to lending officers as corporate lending is *more* recognized by the top management. The top management of these banks very often considers SME lending as a corporate social responsibility for political reasons and not as a profitable business line. This criticism is not common to all banks in Sri Lanka as there are some banks truly committed to promotion of SME lending.

To change this negative attitude of some banks, it is necessary to use the "Carrot and Stick" approach to motivate the reluctant banks to lend to SMEs. The "Carrot" may be some fiscal incentives. At present there are certain fiscal incentives for banks to lend to SMEs. The Budget proposal for 2012 encourage banks to set up dedicated branches for SME lending and profits from these branches will be taxed at a reduced rate of 24% and not at the normal rate of 28%. Further reduction of the tax rate on profits from SME lending will compel and motivated banks to increase their SME lending activities. The "stick "may be the directives from the Regulator making it mandatory to channel certain percentage of their loan portfolio to the SME sector. If this is not complied with, banks will be penalized. This is known as priority sector lending. In India, all banks are compelled to allocate 35% of their lending portfolio to priority sectors, one of which is the SME sector. It appears that Sri Lanka has accepted the principle of directed lending to priority sectors by making it mandatory (under Budget Proposals 2012) that all banks should lend a minimum of 10% of the funds available in their "Investment Fund Accounts" with the Central Bank to the SME sector. The amount available for this will be not significant as banks are required to invest only around 8% of their annual profits in this account. Therefore, there is a need to enhance the amount available for SME sector linking the amount that should be lent to SMEs to the total lending by banks and also fixing a higher percentage like in India.

3. Lack of skills for lending to SMEs

Bankers use two different approaches in lending; one based on collateral and the other based on cash flows. Some banks wrongly perceive that if lending is secured by realizable assets with adequate cover, such loans are risk free and that banks could realize the full value of the assets to recover the total outstanding in default related situation. This is a misnomer in a country like Sri Lanka. Realization of mortgaged assets is a long drawn process and it might take on an average 3-5 years or sometimes even more. By the time the asset is sold, its realizable value may be much less than the original value if the asset is a movable one. Banks will have to spend huge amounts on litigation and at the end of litigation, both parties might lose and only the lawyers; auctioneers and security firms will be the winners. On the other hand, if the lending is done only on the basis of cash flows, it makes room for willful defaults. In a situation where no collateral is taken, the borrower will not lose anything in willful default situations or genuine business failure. Collateral should only be a means of "hand twisting" and not a means of debt recovery. As such proper lending should be a combination of collateral based and cash flow based lending approaches placing more emphasis on cash flows. The problem with most banks is that they have no skills in cash flow based landing. Estimating cash flows based on the appraisal of past performance and the future prospects of the enterprise is a difficult task and it requires specific skills. If the lending is for a corporate, preparing cash flows is not a difficult task as almost all corporates maintain proper financial records. As most of SMEs do not maintain proper financial records, computing cash flows from unreliable and incomplete financial records is a very difficult task. The situation becomes more difficult for banks as most SMEs also do not have assets that are acceptable to banks as collateral. Therefore, it is essential for banks involved in SME lending to vigorously train their lending officers in cash flow based lending.

In conclusion it can be said that if the structural weaknesses of SMEs are corrected and the reluctance of bankers to lend to SMEs are remedied, a smooth flow of funds from the banking sector to the SME sector could become a reality.

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Global Value Chains & Export-Oriented SMEs – Sri Lankan Perspective

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Abstract

Export performance has been critical for the economic development of many developing countries in recent years. It has contributed to faster growth and poverty reduction. Exports have produced economic benefits deriving from efficiency gains associated with exploiting comparative advantages and improved allocation of scarce resources. There are also dynamic gains in the export sector driven by greater competition, greater economies of scale, better use of capacity, dissemination of knowledge and know-how, and technological progress. Competiveness of enterprises is fundamental for SMEs to to get integrated to Global Value Chains and to succeed. In Sri Lankan perspective, to increase export share of SMEs one has to adapt to the changes required in integrating to Global Value Chains (GVCs) following lessons from other developing countries.

Introduction

Export competitiveness is a forerunner of a country's economy for sustainable development. Most analyses of export competitiveness uncover a series of issues that a country would need to address to achieve success in export markets. As factors that constrain exports are generally complex and numerous, governments often find that all these issues cannot be addressed concurrently due to cost concerns, implementation barriers and political impediments.

Despite international trade experiencing a contraction of 12.2% in 2009[1] in the wake of the financial crisis, trade is again on the upswing. This is evidenced by a record-breaking 14.5% surge in the volume of exports in 2010[2]. The question is what are the trade policies and regulations needed to achieve export success? Answering this question is the challenge many countries are faced with to achieve export success.

It is now widely recognized, to tackle the multitude constraints faced by exporters, trade policy can no longer be limited to only so-called 'border measures'[3]. Policymakers must address a wide range of national issues, which are more inward oriented. Because of the success of forerunners of export-led economic growth[4], especially in the east Asian economies, since the mid-1980s, many other developing and least developed countries (LDCs) have tried to emulate this model. There has been a fundamental shift in development policy. From an import-substitution model to become more outward oriented. Today, the focus is on improving international competitiveness, and allowing the dynamic export markets to become members of Global Value Chain, which presents opportunities and challenges to Small and Medium-sized enterprises (SMEs) to prosper in the export trade.

As in many developing countries, contribution of SMEs to the export economy of Sri Lanka remained at 4% to 5% in value terms over the period from 2010 -2012 [5]. Graduating SMEs to contribute more from the opportunities available globally is the challenge the countries have by integrating them to the Global Value Chains (GVCs), and becoming more efficient considering the investments made and resources allocated for the SME sector.

Sri Lankan Perspective

The rapidly changing international trading environment, highlights the importance of adopting a strategic approach to sustain the growth momentum of exports in existing markets and diversifying into new markets. The diverse range of issues that emerge in facing these challenges require a competitive response, by the countries if the desired goals of export development efforts are to be realized.

Exports contribute nearly 17% to the GDP of Sri Lanka (Performance Review –2012/Sri Lanka Export Development Board)and as the premier export promotion organization, mandated to develop and promote exports from Sri Lanka, the Sri Lanka Export Development Board (EDB) plays a leading role in achieving the national objectives, as set out in the "Mahinda Chintana". Policy document (GOSL) reference).

The export sector of Sri Lanka, after facing a setback in 2009 due to the global economic crisis, rebounded strongly in 2010. The momentum gathered by the sector improved further in 2011 registering a highly commendable growth of 22.22%. However, during the period January–December 2012, the export earnings have registered a drop of 6.0% due mainly to the prevailing adverse external environment. It should be noted that, even though the export sector (Adverse effects of global financial crisis -2009 led countries to confront with economic recession which resulted contraction of purchasing power) suffered a setback in 2012, the earnings of the sector in that year is still higher

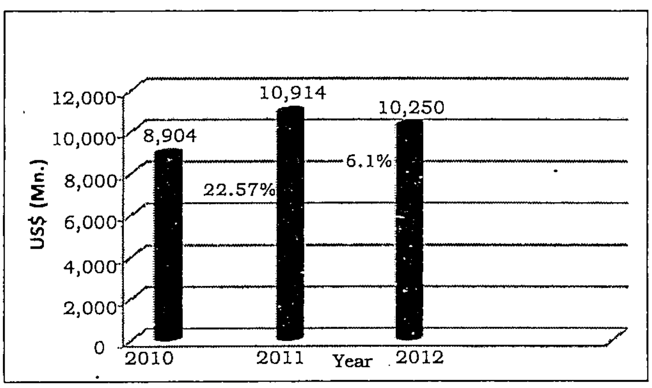

Figure 1 Overall Export Performance [Merchandised Exports and Exports of Computer a Information Technology]

Jan. -Dec. 2010, 2011, 2012

Source: Sri Lanka Export Development Board

than the earnings recorded by the sector in 2010.

The graph below indicates the performance of the export sector during the period January – Dec ember in 2010, 2011 and 2012.

The Table 1, above presents the export performance of the four major sectors i.e. Agriculture, fisheries, Industrial and Computer & Information Services in the years 2010, 2011 & 2012.

As shown in the Table 1, export earnings of the country have diminished by 6.09% during the period under review. Earnings from Fisheries exports which accounted for 2.09% of total exports, increased by 4.80% while earnings from Agricultural exports and Industrial exports which accounted for 22.94% and 74.3% to the total export earnings, dropped by 8.59% and 5.43% respectively. Export earnings of the Computer & Information Technology sector which accounted only for 4.6% of the total export earnings in 2012 grew by 34.08%. However, the salient feature in export earnings was that contribution from SMEs from all sectors to export earnings remained at 5% over the last three years.

Patterns of Sri Lankan Exports

An analysis of the export sector reveals that its structure is quite concentrated, both in terms of product composition and export destinations over the last three decades. Therefore, a more vertically diversified export structure is needed; given that our exports are composed basically of primary goods with technologically stagnant production practices relative to the industrialized economies.

Considering the performance of the top 10 export products of Sri Lanka in 2012, Apparel industry still remains as the largest exporting sector, accounting for 40% of the overall merchandise exports of Sri Lanka and recording 1% of the world's total exports of the sector (Performance Review -2012/Sri Lanka Export Development Board). The second largest export sector is tea products, accounting for 22% of the world exports having a strong comparative advantage in the world market, as its revealed comparative advantage index is 75.7%. The other major exports are rubber based products and gem/jewellery products. These five product categories together account for 75.2% of the total export earnings of Sri Lanka in 2012 and Sri Lanka's export product basket continued to be concentrated on a very limited number of products.

Another important phenomenon is that the structure of export destination differs for major export products and highly dependable on few countries. In the case of apparel industries, their destinations are quite concentrated on a few countries, mostly destined to USA and EU markets, for example: articles of apparel, accessories, knit or crochet go to top three export markets, ie: US, UK and Italy. The situation is similar in diamonds, gems & jewellery product sector of which over a half of the exports is destined to Belgium alone. On the other hand, export destinations of rubber based products and tea are relatively evenly distributed.

In general, Western countries continue to be the major destinations for Sri Lanka's exports. EU and US together absorbed 60% of the country's exports in 2012. Therefore, the adverse economic conditions prevailing in these countries negatively impact the export earnings of Sri Lanka.

Composition of Exports

The Figure 3 below illustrates the contribution made by each product sector to the total merchandise export earnings of the country during the period of January to December 2012. It reveals that 80% of export earnings were derived from eight product sectors, which were identified as thrust export sectors which are earmarked to surpass US$1Bn.target (except Apparel & Tea exports which have already surpassed the US$ 1Bn. target) by 2020.

SME Contribution of Exports

Sri Lanka is presently a small player on the global scale recording

Table 1 Export Performance by Major Sectors (Value US$ Mn.)

	Jan-Dec 2010	Jan-Dec 2011	Growth %	Jan-Dec 2012	Growth %
Agriculture Exports	2,216.18	2,453.00	10.69	2,242.31	-8.59
Fisheries Exports	202.24	195.31	-3.43	204.68	4.80
Industrial Exports	5,781.64	7,678.56	32.81	7,261.93	-5.43
Total Merchandise exports	8,638.85	10,558.82	22.22	9,773.60	-7.44
Computer & Information Technology Services	265.00	355.00	33.96	476.00*	34.08
Total Exports	8,903.85	10,913.82	22.57	10,249.60	-6.09

Source: Sri Lanka Customs * Provisional

only US$ 10.2 Bn. export revenue from merchandised exports, where SME contribution to total exports was only around 5% contributed by 82% of registered exporters of the country. Lack of a national definition for SMEs paved the way to have varied definitions in defining SMEs by the institutions which deals with SME development. SLEDB is no exception and definition of SMEs by the Sri Lanka Export Development Board is "Enterprises having an annual export turnover less than Rs.150Mn.in a given year".

According to the definition Table 2 below analyses the composition of exporters for the 3-year period from 2010 to 2012.

From the data above it is obvious that percentage share of composition of Sri Lankan exporter community remains to be as same with a slight decline of number involved in both Non SME and SME sectors and the same behaviour also recorded when comparing the export revenues generated by the both sectors over the three-year period from 2010 to 2012. The data on same is given in Table 3 below.

Although the country's export sector registered a considerable growth rate of 22% in 2011 after the global crisis in 2009, it is noteworthy that the SME export sector has not recovered in terms of total export revenue generated by the sector in 2012, which recorded around 4% drop compared to the revenues generated in 2011.

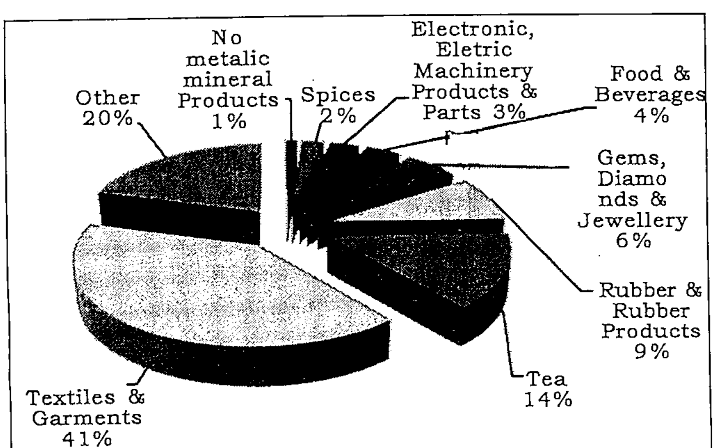

Figure 3 **Composition of exports - 2012**

Source: Sri Lanka Export Development Board

In terms of number of exporters and export revenue generated, the country's export structure heavily dependent on large scale exporters. Over concentration on limited number of product sectors is phenomenal in Sri Lanka's export structure and SME export contribution also revolved around same product sectors over the years. In year 2012 contribution of SMEs to exports is depicted in Figure 2 below.

SMEs contribution to exports in 2012 mainly concentrated in Manufacture, Agriculture, Plantation, other export agriculture crops, fish & fisheries, industrial, manufactures and other sectors. Manufacturing accounted for 33% of the total export contribution having processed food export products & Confectionary & bakery products as the highest export earners from the sector. Agriculture sector accounted for 21% share, and highest export revenue earners of the sector were mixed coir fibre and tea packets. Industry sector accounted for 19% share with the highest contribution from export of gems and garments. Other export crops, Fish & Fishery products, Plantation, other sectors contributed 11%, 7%, 7% and 2% respectively.

The prominent feature in the main sectors of SME export contribution is that most of the sectors too are heavily concentrated on the same major export product sectors, majority of which are dominated by the non SME (large scale) exporters. The exception is Manufacturing, which consist of widely diversified export products ranging from processed foods to ships & boats and parts of aircrafts etc., which are categorized as Non Traditional Exports. Over concentration on limited products has to be analyzed with the present status of global demand for such Sri Lankan products.

With the latest global trade statistics by the International Trade Centre (ITC), global demand for Sri Lankan products is depicted in Figure 4 below.

Table 2 Composition of Exporters - Exporter category wise

Sector	2010		2011		2012	
	No. of Exporters	% Share of total exporters	No. of Exporters	% Share of total exporters	No. of Exporters	% Share of total exporters
Non SME	611	18	647	18	591	18
SME	2,697	82	2,881	82	2,685	82
Total	3,307	100	3,528	100	3,276	100

Source: Sri Lanka Export Development Board

The Figure 4 below presents the performance of 20 leading export products of Sri Lanka in the international market. The bubble denotes a particular product and the size of the bubble represents the amount of that product (in US terms) we export to the world market[6] .

As derived from the above chart where Sri Lanka is a net exporter for major product categories of Tea and Apparel which falls into Non SME category are placed in the "Losers in the growing sectors" and "Losers in the declining sectors" respectively. Product sectors such as printed books, vegetables, Milling Products, Miscellaneous edible preparations, Ships & Boats are placed in the "Winners in declining sectors" and "Winners in growing sectors" respectively in the global scenario. If the bubbles fall into the "Winners in growing sectors", it means that the world demand for the product denoted by the bubble is increasing and also Sri Lanka's share of that product in world exports is also increasing. Our export products such as Rubber and articles thereof; Miscellaneous edible preparations; Edible fruits, nuts, peal of citrus fruit, melons; Ships, boats and other floating structures; Milling products, mould, starches, inulin, wheat gluten; Miscellaneous chemical products; Residues, waste of food industry, animal fodder, fall into this category. Trade promotion efforts for these products should aim to broadening the supply capacity to cater to the markets with increasing demand.

The Sri Lankan status in global scenario in "Winners in growing sectors" need to be harnessed fully to strengthen the exports of the country.

SME involvement in economic activities is greater in the above stated sectors. These sectors are directly or indirectly have linkages with Global Value Chains though their potentials are not fully harnessed yet. Further, these sectors are some of the main employers of the labour force (75 % of the labour force/Report of Census & Statistics) of the country and have a greater potential for development domestically targeting global markets. With these potentials open to the SME sector for development domestically and globally the country has to pave the way for SMEs to strive for competitiveness required by the global value chains. Let's look at what is needed as threshold for Global Value Chains for SMEs to excel in exports.

Global Value Chains (GVCS) & Lessons for SMEs

The acceleration of globalization, aided by the rapid development in information and communication technologies, improved transport facilities and tariff reductions by countries, presents opportunities and challenges to Small and Medium-sized Enterprises (SMEs). Participation in GVCs can give SMEs the opportunity to attain financial stability, increase productivity and expand their markets. Cooperation within a network of upstream and downstream partners can enhance a firm's status, information flows and learning possibilities; introduce new business practices and more advanced technology. On the other hand, SMEs' involvement in value chains demands greater managerial and financial resources, the ability to meet international standards and the protection of in-house intellectual property. To meet these challenges, even in developed countries SME s need the support of their governments (OECD, 2007).

A value chain describes the full range of activities through which a good or a service passes from its conception to its distribution and beyond. This includes several activities such as design, production, marketing, distribution and support to the final consumer. All these activities can be contained within a single firm or divided among different enterprises; they can be contained within a single geographical location or spread over wider areas. A Global Value Chain (GVC) is a

Table 3 Composition of Exports - Exporter category wise

Sector	2010		2011		2012	
	Export Turnover	% Share	Export Turnover	% Share	Export Turnover	% Share
Non SME	899,100	95	1,054,092	95	1,026,245	95
SME	50,804	5	53,508	5	48,870	5
Total	949,904	100	1,107,600	100	1,075,115	100

Source: Sri Lanka Export Development Board chain of activities which are divided among multiple firms in different geographical locations. GVCs cover a full range of interrelated production activities performed by firms in different geographic locations to bring out a product or a service from conception to complete production and delivery to final consumers (UNCTAD, 2006).

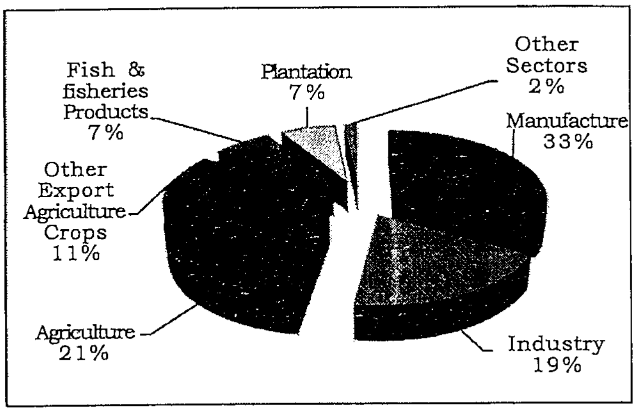

Figure 3 Contribution of SMEs to exports–2012

Source: Sri Lanka Export Development Board

Industries need value chains for efficient production, based on industry requirements. Global Value Chains determine competitiveness of enterprises along the activities which involve concept, design, production, marketing, distribution, retailing and R&D, and they might even include waste management and recycling. All these activities are linked to a one another and each link of the chain performs an activity, and different firms add value at each stage of the production or service process.

Rapid reduction of costs involved in transportation, accessing information due to technological advancements and ICT has facilitated production, trading products and services through spatial division of value chains.

Accordingly availability of natural resources, low cost labour for labour intensive industries etc. have integrated into GVCs due to competitive advantages of the locations. . Because of the possession of certain specialized skills and trained human resources, some of the best examples in Asia are IT firms in India, and electronics firms in China, Taiwan Province of China, Malaysia and Singapore have successfully integrated into GVCs.

In Sri Lanka, some of the SME Apparel & Garment accessory manufacturers, processed fruit & vegetable manufacturers, wooden toys & handicraft manufacturers, rubber based component parts for automotives are integrated to GVCs successfully.

According to Humphrey (2003), "[...] large retail and branded companies such as Nike and Gap in clothing and footwear, and supermarkets within the food industry can exercise a decisive influence over GVCs without taking direct control of large parts of the production process and its associated logistics".

SMEs from selected developing countries such as Vietnam, Bangladesh, Kenya have managed to build up competitive advantages, particularly through their market intelligence programmes and R&D initiatives which enable them to compete successfully in global markets due to the distribution of functions (R&D, production and marketing) or roles among different tiers of suppliers and distributors.

The SLEDB as the apex organization for export development of the country carry out its functions as a Promoter, Advisor, Facilitator, Knowledge-provider and for the exporter community. The programmes for development of SME export sector are embedded in these functions where market, product, supply development programmes are implemented with the consultation of "ADVIORY Committees" which represent members of exporter community as well.

The challenge for SMEs is to determine how and where (in which niche markets) to position themselves so as to best reap the benefits of globalization. Market researches and market development programmes by the Divisions of the SLEDB facilitate export-oriented SMEs to establish market linkages with niche markets. What they need in order to create competitive capabilities is the capacity to continuously upgrade their skills so as to increase their returns. Continuous upgrading includes, **Process upgrading** {aims at increasing the efficiency of internal processes (e.g. increased inventory turnover, lower scrap and successful adoption of standards)}. For example, Nestle has helped local suppliers in developing countries to meet better standards in agricultural produce, offering training and technical assistance in field care, post-harvest practices, storage and transportation.

Product upgrading includes the ability to produce components or retail new or more competitive products developed by leading firms (e.g. automobile dealers, gas stations, restaurant chains, travel agencies, drug stores, and courier services).

Functional upgrading seeks to increase the value added by changing the mix of activities conducted within the firm (e.g. taking responsibility for outsourcing accounting, logistics and quality functions). For instance, General Motors, HP- Compaq, Nortel, and Sony have outsourced IT services to Wipro in India; Eli

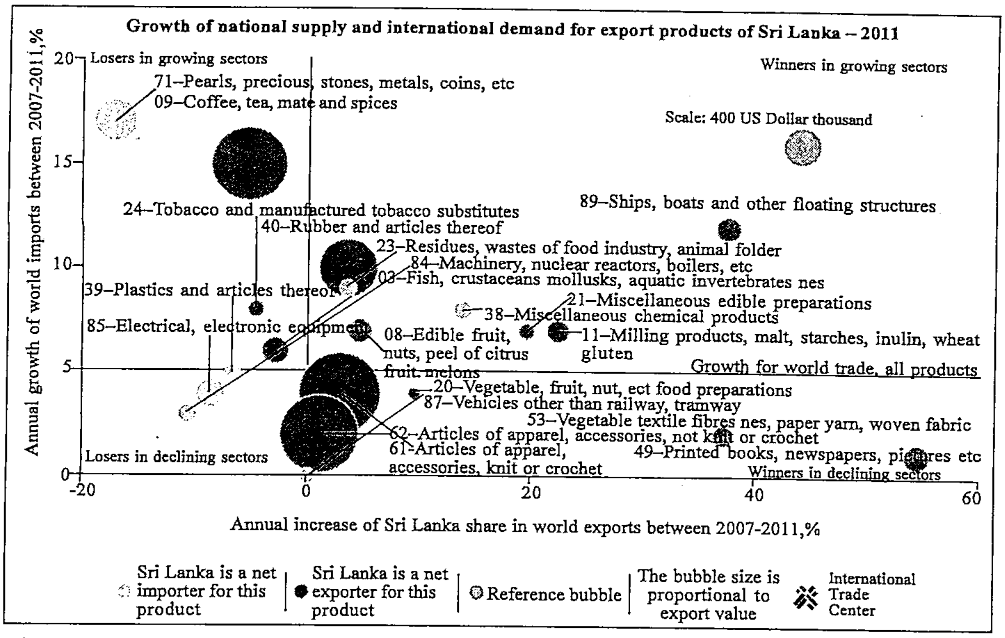

Figure 4 Global Demand for Sri Lankan Products

Source: International Trade Centre

Lily and GSK Pharma outsourced pharmaceutical functions to Shashun Chemicals, India; and Bharat Forge, India has been performing engineering for Caterpillar, FA W (China), Ford, Meritor, and Toyota (IBEF , 2007). Some SME s became global suppliers or even TNCs in their own right through functional upgrading in a GVC.

These are some of the GVCs which look for outsourcing IT enabled services at present from Asian countries for which Sri Lankan SME IT/BPO companies also have the potential get integrated. As the SLEDB has identified the IT/BPO/ KPO sector as one of countries strategic export sector for development and has developed a strategic plan for the sector to boost development of SMEs involved in the sector targeting an export revenue of US$1Bn. in 2015.

Chain upgrading creates opportunities for suppliers that have developed competencies and skills to move to a new value chain. For example, firms in Taiwan Province of China gradually moved from the manufacture of transistor radios to calculators, to TVs, to computer monitors, to laptops and now to WAP phones.

Conclusion

There are now many examples of developing countries that have been able to develop competitive export industries and have been rewarded with remarkable economic growth: the Republic of Korea and Chinese Taipei in the 1960s; Southeast Asian countries such as Thailand, Malaysia and Singapore in the 1970s; China in the 1980s; and Central and South American countries in 1990s, such as Chile. These countries were also able to tap into the phenomenal growth in international trade. Behind all these success stories, SMEs of the countries have played a vital role in integrating to Global Value Chains. Fundamental is that continuous improvement of SMEs to gain "Competiveness" to integrate into GVCs within respective enabling environment in an economy. Sri Lankan SMEs too have to be robust enough to be integrated to GVCs to increase their export share to the economy by continuous upgrading in enhancing competiveness to excel in exports. To enable the SMEs to enhance their competitiveness to get integrated into GVCs the government assistance in R&D, product adaptation, use of new technology and lowering cost of production to be facilitated by relevant stakeholder institutions.

The SLEDB has particularly implemented assistance programmes for export oriented SMEs in obtaining international product / system certifications for Tea sector, Spices and allied products sector, development of production facilities in line with international Good Manufacturing Practices/ Good Workplace Practices for coir sector, finding niche markets for processed food sector, gem & jewellery sector etc. are some of the initiative by which most of the export oriented SMEs in the regions have benefited in enhancing their competitiveness to get integrated with GVCs.

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[5] Export Statistics – Sri Lanka Export Development Board – 2012

[6] The Y Axis of the Chart denotes the Annual growth of world imports between 2007 -2011,% and the X Axis denotes the annual increase of Sri Lanka share in world exports between 2007 -2011, %. Accordingly Winning sectors are the sectors which falls into the quadrants having a high annual growth of world imports and high annual increase of Sri Lanka share in world exports.

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important investment decisions. Government of Sri Lanka recently enacted legislations to ease the pressure on SMEs through amendment of Parate execution where normal civil procedure of debt recovery should be applied for loans below Rs. five million with security of property mortgages.

2.3 Weak competency in building cash flow based lending propositions

Strong value based credit policies encourage security-oriented lending and creates knowledge gaps in credit officers. Security-oriented lending does not require strict cash flow projections and credit evaluations. Developing cash flow projections is an art and requires overall knowledge about the industry, technology, external factors (external climate) and specific firms (internal climate) along with econometrics modeling to analyze the cash flows. When it comes to large projects, knowledge in project appraisals and risk analysis will help the credit officers to get exposed to project financing. At the backdrop of investor confidence and developing businesses in emerging economies, venturing into risky business propositions is in the agenda of the banking and financial intuitions. Financing SMEs are risky but at the same time profitable, so indeed banks need to develop how best they could mitigate the risk of these ventures. One of the options is to gradually develop a culture of SME financing with confidence through development of competencies in their credit officers. Competency development not only addresses econometric techniques of analyzing and evaluating the credit proposals, but also industry knowledge and exposure, experiences of sick industries and business units, world politics and world economics, knowledge in emerging markets and technologies, behaviours and issues of labour, understanding the entrepreneurship etc.

Conclusion

Many of the literature examine the issues of financing SMEs world over. However, there are key issues not only from the SMEs point of view, but also from the financial institutions and, government's point of views. No one can expect the SMEs to nurture in best practices all by themselves. In this regard, the role of financial intuitions is greater, when it comes to inculcate and nurture SMEs in the right directions. The issues for SME financing discussed above are the keys, but there are many others which needs further discussions.

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Emerging Challenges for SMEs in Sri Lanka

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Small & Medium Enterprises (SMEs) form a high impact- making component of the socio-economic structure in any developing country. Development or decline of the SME sector spreads its impact on the national and area-bound economy, employment, poverty alleviation, quality of life, educational level and many more. In addition, it serves as the breeding field for national and global level entrepreneurs. In terms of economic volume, the Banking Survey (2006/ 2007) done by the International Finance Corporation (IFC) of the SME Market in Sri Lanka, reveals that the SMEs constitute 80 – 90% of the total establishments and 20% of the industrial value addition together with 70% employment opportunities generated in the business sector. The whole scenario is a representation of the significance of the SME sector in the national economy and the social development map in Sri Lanka.

Despite its inherent importance and practical potential to be the vibrant contributor to the overall development of the country, especially in a post-war era where over 30 year old destructive pressure of different restrictive factors has been released, the power of the SME sector is yet to be unleashed via a cluster of effective methodologies. The prevailing constraints include multiple factors ranging from intrinsic attitudinal and habitual barriers to less capacities and capabilities to be winning enterprises to escalating operational costs. It is evident that, most of the SMEs regularly encounter a series of problems, and are under-performing without a planned and steady march. In fact, our practical experience with the SMEs reveals the fact that the "survival" is the biggest challenge in their day-to-day business. "Operation for survival" and "Crisis Management" are being taken precedence in terms of management approach, especially for a majority of SMEs. Many development-focused support models are demanded by the wake up calls emerging even under the current atmosphere if the country requires to get the optimum harvest of the SME sector.

Apart from that, we are living in a fast changing world impacted by the global village effect where our SMEs are exposed to an environment of rapidly shifting consumer habits, exponentially developing technologies, increased global competitiveness even on our rural lands and many more emerging situations. The battle field for SMEs is ever changing and becoming more complicated. This evolving dynamic environment is posing a series of new challenges to the SMEs in Sri Lanka and the other developing countries, compelling the entrepreneurs, governments, SME-related chambers and associations, business consultants and mentors, academics and the other organizations and personnel supporting SME development to view in a visionary manner and act in a non- traditional way providing their individual and collective contribution in order to unlock the real economic value of the SME sector, allowing it to yield the enhanced social value addition. The purpose of this article is to reveal about some emerging challenges for SMEs in Sri Lanka enabling the interested and responsible stakeholders to explore more about such challenges and design and implement precise solution models that can enable the SMEs to face these challenges.

Information and Communication Technology (ICT) Development & Social Networking

Information and communication technology (ICT) has taken an exponential growth pattern. The adaptability of its applications for business development is multi-faceted and its degree is ever increasing. It can be successfully manipulated for product improvement, productivity improvement, operational accuracy enhancement, cost reduction, local and global marketing, and many more aspects intertwined with SME development. In almost all SME segments of product or service based industries and trading firms, ICT applications and e- commerce will automatically be placed on the high priority list of requirement for them to be competitive. However, current situation reveals that the Sri Lankan SMEs are backward in using ICT and e- commerce in their businesses.

As an example, Social networks are increasingly and profitably used by many companies in developed countries. When used in effective way, it is a powerful process to engage consumers and suppliers, together with the other public in product development. This is called co-creation. It provides insights and extremely valuable ideas of outsiders, basically customers in product designing, marketing, after sales activities and a host of business development processes. This practice speeds up the development cycle and establishes customer loyalty. Eventhough distributing co-creation, or distributing innovation through the value chain was initiated by large companies, the advancing business environment has motivated the SMEs to use similar formats, sometimes with certain variations for their business development.

In this context, SMEs of tomorrow will have to be equipped with ICT enabling mind-sets, awareness, knowledge and tools in order to capture the full benefit package of the serving markets. Increased applications of ICT will no longer be an option for SMEs, but a must for the survival and development. E-readiness of SMEs will be a prime concern within the atmosphere of emerging challenges.

Accessing up-to-date Technology

Technological improvements are continuously offering new machinery, tools, and processes that can be used by the businesses for profit optimization and business sustainability. In fact, companies create real wealth when they combine up-to-date technology with new ways of doing business. SMEs who are away from this practice will face the danger of being phased out from the competition. The prevailing reality of very weak usage of up-to-date technology by the SMEs will pose a threat to their survival unless they make a shift towards accessing the new technology. The shift will undoubtedly be possible if the SMEs are enabled to access up-to-date technology. Traditional mind-sets, short-term focus on business operation, lack of awareness on technological improvements, costs of technology acquisition, less preparedness of supporting national mechanisms etc. would be obstacles in this regard.

Greening Enterprises

"Greening a business" is a fast popularizing strategic business approach irrespective of the size of the business. A green business formulates and adopts strategies and policies that ensure a sustainable future with positive environmental concerns and increased quality of life of its customers, employees and community. It reduces energy consumption, carbon footprint, environmental damage and supports environmental and human sustainability. Global surveys reveal that "greening" provides a competitive advantage for the businesses, improves customer acceptance, increases community engagement which strengthens the enterprise image, and a host of other business advantages in addition to its unique contribution to environmental conservation (Ref: www.earthshare.org). In its real sense, economic development should be achieved without harming the planet and communities. Greening business was initially limited to corporate businesses, but it is speedily encroaching the boundaries of SMEs owing to its high relevance. More powerful waves on "green employment" are taking shapes to be released from the generation points and the SMEs should be ready to encounter the situation when they reach the shores. Inclusion of "Environmental Entrepreneurship" in all relevant areas will be an absolute need. Green business members of the SME community will have a significant advantage over the others in terms of sales, profits, goodwill and sustainability. Greening will be a compulsory factor soon when engaging in international business.

Mega Competition by Large Companies

It is evident that the competition by big scale businesses is systematically protruding into the SME market. Gradually expanding super markets in strategic locations is a clear indicator in this regard. The trend will continue in many fold and more big companies will open up mega super markets, departmental stores and super markets in strategic cities and mini super markets in suburbs and remote locations flashing an increased challenge for the SMEs in all locations. The policy of strengthening the shoulders is more sensible when you are receiving more and more weight on your shoulders, than requesting for lightening the weight. Similarly, the strategies, practices, tools, systems, mechanisms should be explored and implemented to overcome this challenge which has already commenced raising its head.

Market Mind-set Shifts and Knowledge Gaps

Consumer mind-sets and the resultant habits are continuously being shaped by the accruing knowledge, forceful media, internet and many other factors. These dramatic shifts are widening the gap between what the SMEs think about the consumers and their wants and needs and the real consumer thinking, wants and needs. Situation will worsen with the fact that the consumers are becoming more knowledgeable than the SMEs in most of the occasions, especially in respect of product/ service related and relevant business related areas. The knowledge gap weakens the customer loyalty and solidifying customer relations. Less entrepreneurial capability and the static attitudinal nature of SMEs generates a barrier to visualize the relevant shifts in the first place and then to act accordingly, resulting in the reduced competitiveness. SME related consumer research, mentoring organizations, business development training, state sponsored SME development initiatives will have a vital role to play in addressing this situation.

Intensive Entrepreneurship Demand

Entrepreneurship in full scale reflects consumer- centered marketing approaches against product or service centered ones, creative initiatives for business maintenance and development, business planning, cash-flow linked financial discipline, product/ service quality improvements, environmental entrepreneurship and more. The future will demand a grown entrepreneurship from SMEs. Survival and development-focused requirements will include business operations supported by many entrepreneurially attracted tools and strategies such as "energy strategy" which is a working paper setting out how energy will be managed in the business. Current observations and analyses on SMEs do agree with the fact that the level of entrepreneurship of SMEs should be strengthened significantly. All emerging challenges are wake up calls for the SMEs to compel them to think that they should acquire intensive entrepreneurial capabilities. The external facilitation of an enabling business environment and provision of tools and processes would not be a fully qualified solution to face the business future. Emerging conditions demand intensive entrepreneurship from the SMEs if they want to reap the full benefit. It is so in respect of reaping the best harvest in terms of economic and social development too.

Proliferation of Imports of Products from Emerging Global Markets

Consumer attraction towards the products in-bound from the emerging global markets is becoming greater. More and more products are imported from India and China (out of BRIC countries) and countries such as Japan and Thailand. The trend is aggravating pushing the local manufacturing segment of SMEs in to a difficult corner. The impact of this challenge, not only squeezes the manufacturing segment, it replaces the losing layers of manufacturing with trading, altering the SME composition adversely. Handling this situation definitely requires more specific planning and implementations while state policies and SME support schemes, entrepreneur education and empowerment, initiatives of business chambers and associations will have positive engagements in framing solution strategies in addition to the focused efforts to be exercised by the SMEs themselves.

Access to Business Financing

Costs are already escalating; markets and profits for SMEs are shrinking compelling the SMEs to look for more borrowing for survival, not for business expansion. In contrast, Banking institutions are taking extreme precautions in lending as they are worried about recovery despite the fact that Banks operate SME support units with SME lending schemes. The outcome is that the SMEs become too large for micro financing and too small for commercial financing, narrowing down the business financing options practically available for SMEs. The resultant environment of highly structured lending processes with no option for flexibility will serve no purpose in terms of SME development unless corrective actions are taken in devising a pro-development mechanism for the SMEs to have access to finance when required. Understanding the total picture of the challenge is extremely important for the solution providers to design and implement the integrated solution consisting with horizontal and vertical solution models.

Increasing Demand for SME-related Research

SME- related research has not yet been a priority item in the agenda in Sri Lanka. Even to assess the current situation of SMEs in Sri Lanka, the facts and data available are extremely insufficient and understanding of trends and patterns is difficult. However, designing and formulating policies, development-led solutions, and sourcing for appropriate tools in order to face the emerging challenges require vital information on the SME sector, its behaviour and its potential. Enabling and Strengthening of initiatives for conducting SME Research is absolutely essential for this purpose. Since the challenges are emerging in continuously, Sri Lanka should have a dynamic process of performing SME- related research. Logical and scientific analysis of research findings, making them available for policy and strategy formulation and decision making, and full scale usage of them instead of treating them only as academic support material are associated important factors.

SME Development Enabling Policies

Availability of a comprehensive SME policy which is a sector development- focused synergic formulation with a 360 degree coverage is extremely vital in order to enable the SMEs to overcome the emerging challenges and competitively move forward. The well designed policy is the basis for fully functional enabling environment. This vital need should not be overshadowed by incongruent, losely-bound, policy-like pieces of material. Compatibility with the global and regional SME policies should be a qualitative feature of the SME policy.

Promotion of Woman-led Enterprises

Women entrepreneurship is apparently in a backward stage in Sri Lanka. Although the actual research-based hard facts are not available, our experiences in working with SME community provide a clue that the woman-led enterprises do not exceed 15%. Advancing global and regional SME development support systems are more focusing on supporting woman-led enterprises. If the current situation continues, SME sector will not be able to accrue the benefits from the emerging, well designed support systems dedicated for women entrepreneurship development. Attracting more women to start up SMEs, establishing their commitment, and creating enabling environment for them to continue the business are vital components of the relevant challenge.

Internationalization of SME Marketing

"Internationalization" refers to the increasing of geographical spread of economic activities across the national boundaries. Evolutionary environments will enable the SMEs to be internationalized if they are ready to climb up the ladders to get into the next level of business. Although the potential for internationalization is created, the foreseeable concerns will include the readiness of SMEs for internationalization together with the product/ quality adherence, creation of enabling environment, prevalence of market research strength and many more associated factors. State policy will be a strong enabler in preparing and motivating the SMEs for internationalization. A multi-stakeholder approach will be necessary to overcome this challenge. Focused efforts, if exercised precisely, will accrue significant results in SME development.

Uprising Media Effect

Propagation of media effect, both of electronic and print is setting an impactful trend on enterprise operation and consumer behaviour. Comparatively, electronic media is more powerful and the media pressure generally directs on challenging the enterprises to strictly observe the accountability to the state, the people and the planet and flashing positive or negative effects on business, short term and long term. While accountability-related media effects are justifiable and healthy in terms of social norms, SMEs will have to be ready to face this situation since managing the accountability aspect in full swing needs more resources and management talents. From the other component of flashing positive and negative effects on business by media, the negative effects will have to be eradicated using counteracting strategies by SMEs. The process of counteracting will be very costly or, sometimes, nearly impossible. The continuing and aggravating trend may pose a hard- bodied challenge for SMEs.

Conclusion

There are two major implications associated with these emerging challenges. If they are not foreseen and appropriate steps are not taken, SME sector will face a setback flashing a negative impact on economic and social development territories while weakened breeding grounds will retard the probability of generating high calibre entrepreneurs. In a scenario where the emerging challenges are foreseen and appropriate steps are taken, the power of the SME sector can be unleashed to a significant level if the other SME development mechanisms are set in motion. Based on the undisputed fact that the SME sector is the backbone of the national economy and social development, all interested parties should make a serious note on the emerging challenges highlighted and yet to be uncovered and initiate appropriate actions to turn the tide to the advantage of the land.

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Flourishing Entrepreneurial Culture in the Country

Strategy: Competitive Business Opportunity Identification, Matchmaking with entrepreneurs and Business Sector Development – *"Gamata Obina Vyapara"*

Method: A mixed approach of Local Competitive Advantage (LOCA) and Value Chain Development (VCD) for promoting Entrepreneurs at Regions.

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Director
National Enterprise Development Authority (NEDA)

Introduction

For a business to succeed there should be a successful entrepreneur who possess or inculcate entrepreneurship characteristics. At the same time the entrepreneur should select a viable business opportunity that fits into one's culture, background etc. If a patient is sick, a doctor can prescribe medicines to acquire. But when an enterprise is getting weak, it is not as straight forward as prescribing a medication to a particular illness. This writing concentrates on an approach to identify viable business opportunities as a pro-active measure for businesses to succeed.

Business opportunities exist in the environment. They originate to satisfy human needs. Needs of humans are identified in a form of a hierarchy by Maslow (1954) in his book on *Motivation and Personality* . Business opportunity exists, if only it can satisfy an existing human need or an anticipated human need. Entrepreneurs seize business opportunities in seeking profits and take risks. Risk minimization through risk management is an essential factor. More higher risk ventures will give more profits. Therefore, business opportunity plays a major role in entrepreneurship development. Hence, it is important to discuss an approach that brings about business opportunities for entrepreneurs. In other words, failure rate of start-up businesses is high, as much as 40%, as per findings of *Gesellschaft für Internationale Zusammenarbeit* (*GIZ*) sponsored Competency Based Economies through Formation of Enterprises (CEFE) Project. Hence, it is important to investigate the present approaches of, especially Micro, Small and Medium Entrepreneurs, in selecting a business opportunity for them. The approaches could be confined to the following:

1. Inherited from the family,
2. Follow the neighbour,
3. Experienced at a workplace,
4. Trained / Learned a subject,
5. Acquiring Technical knowhow,
6. Just seen or accidently happened.

A business selected in this manner will face issues such as marketing, high cost of production and will operate within a limited profit margin.

The right business for a village (*"Gamata Obina Vyapara"*) based on Local Competitive Advantage and Value Chain Development (LOCA and VCD) methodology is offering a solution to identify a competitive business sectors and business opportunities.

Justification Gamata Obina Vyapara Program

Small and Medium Enterprises (SMEs) have been identified to play a crucial role in the economic development process in Sri Lanka, as well as to alleviate poverty and create employment opportunities. In Sri Lanka, majority of the population are living in rural areas which is estimated to be around 84 percent of the total population (World Bank, Annual Report-2012). The Small and Medium Enterprises in the rural areas, are the major sources of employment next to agriculture. It is clear that the sector has not achieved desired level of contribution when compared to other countries. As per estimates made by Kohatha Year 2010 and in his presentations to Ministry of Enterprise development and investment promotion, there are about 650,000 SMEs in the country.

Hence the National Enterprise Development Authority (NEDA) of the Ministry of Industry and Commerce has undertaken various steps to promote this vital sector since its inception. NEDA promotes SME sector especially in rural areas in the country under the "Gamata Obina Vyapara" programme to promote business at village level, under the "Mahinda Chinthana Way Forward" policy.

The Objectives of the programme are to introduce a risk minimizing business undertaking strategy, by introducing a competitive business opportunity to the right entrepreneur.

This program consists of two major components:

1. Identifies Competitive Business Opportunities, issues and make suggestions for development of competitive business sectors in a given geographical area (District Level) through LOCA methodology,

2. Identify impediments for development of competitive business sectors and propose sector development proposals.

Through the above components of the program, NEDA promote SME sector at regional level and encourage rural host communities to engage in businesses by developing regional entrepreneurial culture through the "Gamata Obina Vyapara" program.

Component 1:

NEDA identifies competitive business opportunities, issues and make suggestions for development of competitive business sectors at District level through Local Competitive Advantage (LOCA) methodology. NEDA has completed this program in Kurunegala, Kandy, Mannar and Batticaloa districts, so far 120 entrepreneurs were developed. NEDA completed this program during 2011 – 2012. NEDA found that Entrepreneurship development and technology transfer could play a vital role in enterprise development other than providing financial assistance. The progress evaluation of the programme was just began and therefore, clear outcomes will be published later. NEDA provide further assistance for ensuring their sustenance. During the implementation process NEDA found that External disturbance in selecting right entrepreneur has hindered the real outcome of the programme and NEDA envisages strategies to overcome them in the future. Instead of grant component, NEDA promotes accessibility to finance and convincing the banks about risk minimizing approach in this program.

What is LOCA?

Local Competitive Advantage (LOCA) is a methodology that identifies competitive business opportunities, problems/ constraints and suggestions for development of business sectors in the region (District) and, it consists of following steps:

Objectives —

- Identify competitive business sectors in the region,
- Identify major business issues in the above competitive business sectors and develop proposals for resolving the issues,
- Identify potential areas to be improved,
- Identify competitive business opportunities.

Different phases under LOCA

1. Research & Analysis Phase

1.1 Build-up phase

A Core team and a support team will be set-up during this period. The core team consists of implementing organizations' members and project management staff. There will be 3-6 members in the core team. The support team consists of stakeholders of a main business sector in the region.

Overall action plan with the time lines and responsibilities of stakeholders will be prepared. Available secondary information and data will be collected.

Stakeholders will be invited for a start-up work shop, which is one of the most important steps of the LOCA program.

1.2 Hypothesis workshop

Results of initial research will be taken into consideration. Teams' expectations towards the LOCA project will be aligned. Expected opportunities and constraints will be taken into consideration. Expected proposals and outcomes also are taken into consideration during hypothesis workshop. The team will prepare for the next event that is start-up workshop.

1.3 Start-up workshop

Participants will be the private sector stakeholders, Business Development Service Providers (BDSP), authorities etc. related to business development. Media also will be invited. Participants will be convinced that there would useful outcomes through the program and their support is mobilized for the program.

Identified business sectors will be verified during this program. Initial assessment will be on opportunities and constraints and rules and regulations. Possible solutions also will be identified from the group as initial proposals. According to participants' information, interviews and mini-workshops will be arranged.

1.4 Focus group discussions and interviews

These will be used to collect information and data that are important for the LOCA program. Market requirements, opportunities and constraints in supporting functions, rules & regulations will be identified in different business sectors. Possible interventions will also be taken into consideration.

1.5 Results (Analysis) workshop

Data and information collected during previous phases will be analyzed collectively by the team.

Proposals will be developed in order to develop identified competitive business sectors.

In addition to the LOCA Methodology, value chain development analysis will be conducted for competitive business sectors in order to identify gaps in the value chain and business opportunities (existing opportunities and future potentials)

Finally a list of competitive businesses will be prepared.

1.6 Results presentation workshop

All relevant governmental and non-governmental organizations, representatives from each business sectors, political decision makers, authorities, BDS providers and media will be invited for a Results Presentation Workshop.

During this phase awareness and publicity will be given for the LOCA project and stakeholders commitment would be solicited for the proposals. The team will present and discuss findings of the LOCA research & analysis and action plan.

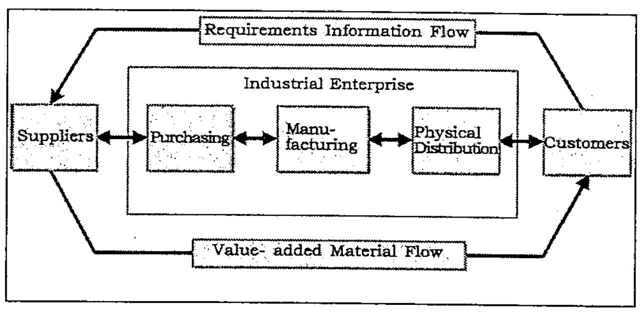
1.7 Follow-up and implementation phase

A follow-up program will be conducted based on proposals through the District Enterprise Forum. Requirements and demand conditions will be identified. The findings of SWOT analysis carried earlier will be discussed and implemented. Finally the competitive business opportunities will be published.

1.8 Value chain development (VCD)

Interlinked value-adding activities that convert inputs into outputs which, in turn, add value helps create a competitive advantage. A value chain typically consists of (1) inbound distribution or logistics, (2) manufacturing operations, (3) outbound distribution or logistics, (4) marketing and selling, and (5) after-sales service. These activities are supported by (6) purchasing or procurement, (7) research and development, (8) human resource development, and (9)corporate infrastructure.

Identifying the process that takes place in between production and the products are delivered to the end consumer are taken into account in the process of doing a VCD. The business opportunities are identified in this process and amount of value addition are calculated. For this purpose, an in depth analysis is not done as the requirement is only to identify that business opportunities exist, along the value chain for an identified competitive business sectors of the LOCA exercise.



Source: Bowersox and Closs (1996)

Component 2:

2. Services under component

Through the above component of the program, NEDA expects to promote the SME sector at regional level and to encourage other rural host communities by developing regional business models through the "Gamata Obina Vyapara" program. Steps are given below.

2.1 Entrepreneurship development training program:

This training plays more attention on the development of entrepreneurship skills of the selected beneficiaries while giving them an opportunity to uncover their potentials and future goals.

The selected beneficiaries will be given an entrepreneurship development training which concentrates on:

- The self-confidence development as an entrepreneur,
- Match Business with the entrepreneur,
- Improvement of financial literacy,
- Impart business planning skills and management capabilities.

At the end of the entrepreneurship development training, the beneficiary will have his/her own business plan for a chosen business from LOCA findings. At the same time a need analysis will be carried out during the training with references to further training (competency development, technology etc.) and type of marketing assistance needed.

2.2 Financing of business plans

When it is required the financial assistance for the proposed business plans, NEDA provides financial support by way of a grant while facilitating to obtain a bank loan.

2.3 Technological improvements of businesses

Under this phase technology transfer programs are designed and conducted. Further, field visits are arranged to research and development organizations:

In this regard, following technological categories are more prominent when designing the programs:

- Human related capacity development (mainly technical skills),

- Introduction of new production processes,
- Introduction of new machineries and equipment,
- Product development & promotion,
- Productivity & quality improvements.

Divisional Secretariat office with the support of NEDA officer arrange technical training programs as per beneficiary requirements and financial support are provided by NEDA.

2.4 Marketing Development

Training programs & field visits are arranged by the NEDA with supporting of Divisional Secretariat Office in regard to the following:

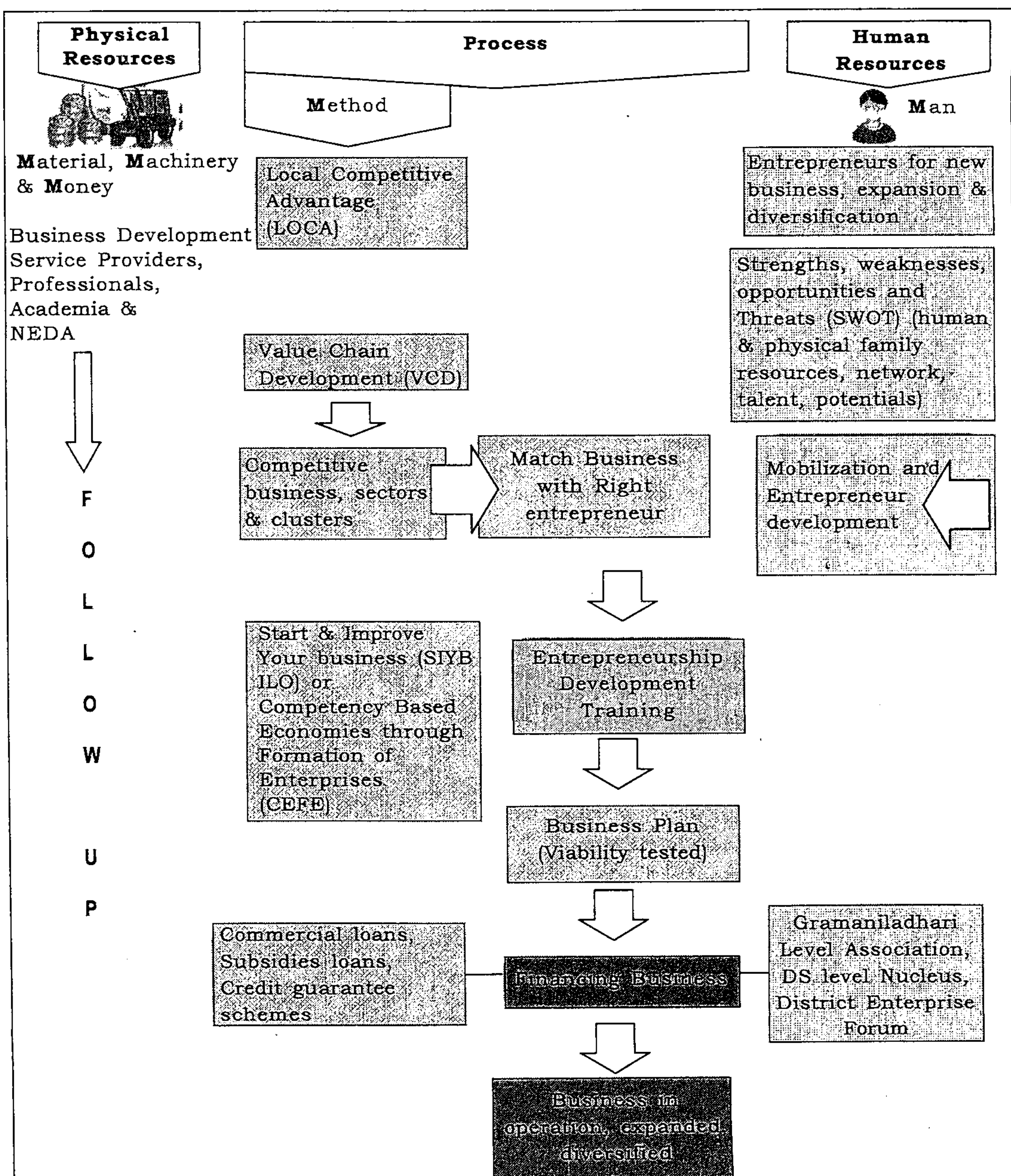
- Package designing,
- Marketing skills development,
- Promotional material designing,
- Promotional program designing.

2.5 Business Counselling & follow up Activities

Business counselling and follow up activities will be done by NEDA with supporting of the Divisional Secretariat office/BDS providers.

The approach is figured in the following manner:

"Gamata Obina Vyapara" - Enterprise Development Approach (EDA) of NEDA



Prepared by Lakshman Wijeyewardena, Director, National Enterprise Development Authority (NEDA) – January 2010

Conclusion

In conclusion, GOV is a strategy (a support business development service of the government) to minimize the risk involve in engaging into a business. The risk of a business is managed; financial organizations are encouraged to extend their fullest support as the recovery is ensured. The business is sustained. Usually, if a business is successfully running, entrepreneurs tend to honour the repayment of loans. The new business opportunities derived from VCD will pave the way for high return businesses. The success rate of businesses are improved and returns from business are escalated, public will attract towards engaging in to business and leads to entrepreneurial culture in the country and establish forward and backward linkages of businesses servicing an entire value chain.

Contd. from last issue

Economic Drivers of Post-war Cities in Eastern Sri Lanka

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The Economic Base Sectors and their Growth Potentials

The economic base analysis is an exercise in mapping the structure of the local economy in terms of the (i) basic sector (aka export sector), and (ii) non-basic sector. The basic (or export) sector refers to all goods and services sold outside the boundaries of the city (or the district). The non-basic sector refers to goods and services sold within the local economy such as output from grocery retailing, hairdressing, restaurants, and other local services. Economic base analysis is based on the economic base theory according to which money earned from the basic/ export sectors is the main source of growth in the economy that determines the rate of employment and growth of employment in the non-basic sectors that caters to local consumption. Economic base analysis is an analytical tool used to forecast income and employment generation in the local economy.[24]

An important catalyst is the economic linkage between the city and its hinterland – in this case the linkages between the three cities and their respective districts. The provincial 'market towns' and the district capitals like Ampara city, Batticaloa city, and Trincomalee city exist largely to serve the outlying areas (mainly the respective districts). Even if the base economic sub-sectors such as agriculture and fishing are not carried-out within the city proper the city benefits. It provides necessary services to farmers and fisherpersons, and associated middle-women, traders and agents, such as banks, communications, and transport service providers. It is the city and its regional offices which manage the roads, water, electricity, transport, telecommunications, financial services, etc, upon which the region's economic base relies. The city's traders also supply inputs to agriculture and fishing and also facilitate downstream sorting, packing, wholesaling and in general adding value to the product. It is the city where main government administration and public services are situated. Finally, it is the city where the hinterland population goes for many of its needs such as health, educational, and entertainment/leisure services.

In this section the main economic base sectors and sub-sectors present in the districts of the Eastern Province are briefly reviewed; since it is their dynamics that are most important factors that drive the sub-regional/provincial economies and consequently the economies of the cities located within it. In general, any economic base activities in a particular sub-region will need the services provided by the major town/city in the area, even if most of the inputs and outputs physically by-pass the city.

The government services (public administration, other government services, and defence), construction, and factory industry are the largest three contributing economic sub-sectors in the Eastern Province (EP) accounting for almost 50% of the PGDP. The government services and construction sub-sectors each contributed little less than 20% to the provincial GDP and factory industry sub-sector contributed little more than 10% in recent years. (See Table 6)

Table 6 Highest Contribution to the Eastern Economy by Economic Sub-sector (%) 2003 – 2010

Highest sub-sector contribution	2003	2005	2007	2009	2010 (provisional)
Government Services	11.5	19.0	19.4	19.4	17.9
Construction	1.9	5.1	21.5	18.0	15.9
Factory Industry	17.7	17.3	11.8	10.4	9.6
Paddy	16.9	14.7	5.0	9.0	8.2
Transport	8.8	6.9	5.5	7.9	10.5
Wholesale and Retail Trade	8.9	13.5	11.0	7.5	11.0
Fishing	11.9	3.8	3.8	5.5	6.5

Source: Central Bank of Sri Lanka, *Economic and Social Statistics of Sri Lanka*, various years.

Government Services

As we noted above, Sri Lanka is saddled with a bloated bureaucracy and an overgrown defence force which are drain on the national economy; for every 16 citizens there is 1 public sector employee (including the armed forces – national, provincial and local) (see endnote number 20) and for every 46 citizens there is 1 armed forces personnel.[25] Sri Lanka has one of the highest public sector personnel per capita and armed forces personnel per capita in Asia and the World. With the total public debt of Sri Lanka equivalent to around 75% of its GDP, it is necessary that Sri Lanka right-sizes its bureaucracy and the armed forces and release scarce financial resources to produce higher productivity goods and services.[26]

Excessive (or dispro-portionate) public expenditure crowds out private investment. Besides, the salaries of bulk of the public servants are comparatively small and hence the purchasing power of public sector emoluments is very limited. Therefore, having a large public sector is not going to create sufficient demand for goods and services produced by the private sector, which in turn stifles private investment on production of goods and services. If the growth of private investment (and thereby private sector employment) is stifled, the population will depend on the public sector to create more employment opportunities. This will result in further expansion of the public sector in terms of personnel and expenditure. This process results in a vicious circle of multiplying public sector (employment and share of the economy) resulting in diminishing productivity of government services and diminishing value-for-money to the citizens, which in turn fuels the expansion of the public sector.[27]

Construction

The contribution of the construction sub-sector to the eastern provincial economy will not last long as the time series data shows. (See Table 6) Due to the resumption of the (hitherto suspended) post-tsunami reconstruction works after the end of the civil war in the East in July 2007 and the post-war reconstruction works, the share of the construction sub-sector in the provincial economy got a boost. However, post-disaster and post-war reconstruction works will not carry on forever. The decline in the share of the construction sub-sector in 2009 and 2010 (after the peak in 2007) in the EP is an indication of the temporary spurt in growth of this sub-sector. However, construction of economic and social infrastructure is an on-going process that needs to last not only in the short and medium terms, but in the longer term as well.

Therefore, the current top two largest contributing sub-sectors to the eastern economy, viz. government services and construction, are undesirable and unsustainable respectively. However, the construction of economic and social infrastructure in the EP such as the Trincomalee harbour development and other infras-tructures proposed or in the pipeline have potential to contribute consi-derably to the provincial economy as it attempts to catch-up with the rest of the economy and get connected to the global economy. That leaves only the factory industry and paddy crop sub-sectors to be the major consistent and positive contributors to the provincial economy for a considerable period of time. (See Table 6)

Factory Industry

The contribution of the factory industries to the provincial GDP has dropped sharply from between 17% and 18% in the early to mid-2000s to between 10% and 12% in the late-2000s. However, it is the third largest shareholder in the provincial economy; being concentrated in the Trincomalee city area. Therefore, it qualifies as an economic driver in Trincomalee only.

The factory industries are almost entirely in the Trincomalee district within the limits of the Trincomalee Urban Council. With the Trincomalee harbour in the city limits and the railway line to Colombo and Batticaloa it makes logistical sense for the factory industries to be concentrated in Trincomalee city. Therefore, factory industries are the economic drivers of the Trincomalee city which is the largest urban centre in the Trincomalee district.

Table 7 Share of the National Paddy Output (%) 1980 2011

	1980	1990	2000	2004	2010	2011
Sri Lanka	100.0	100.0	100.0	100.0	100.0	100.0
Eastern Province	**20.6**	**19.0**	**21.0**	**29.9**	**24.8**	**16.8**
Ampara	11.7	11.9	15.2	19.1	14.7	10.6
Batticaloa	4.4	5.3	2.0	6.2	6.2	2.8
Trincomalee	4.5	1.8	3.7	4.5	3.9	3.4

Source: Sarvananthan, Muttukrishna, (2008), *The Economy of the Conflict Region: from economic embargo to economic repression*, Point Pedro (Sri Lanka): Point Pedro Institute of Development, pp102 (for 1980-2004); CBSL, *Economic and Social Statistics of Sri Lanka 2012*, pp43 (for 2010 & 2011); CBSL, *Annual Report 2011*, Statistical Appendix Table 16 (for 2010 & 2011 district breakdown)

Note: Paddy output dropped significantly in the EP in 2011 because of severe floods in early-2011. Therefore, 2011 was not a representative year.

Paddy

Historically, the Eastern Province in general and Ampara District in particular had been a major contributor to the total production of paddy in the country. Rice, the derivative of paddy, is the staple food of the people of Sri Lanka. The EP accounted for over 20% of the national paddy production in 1980 (pre-war time), 19% in 1990 (war time), 21% in 2000 (war time), almost 30% in 2004 (ceasefire time), and almost 25% in 2010 (post-war time). Within the EP, Ampara district alone accounted for more than half of the total production of paddy in the province during the past thirty years. (See Table 7) Thus, Ampara district has demonstrated a consistent competitive advantage in paddy production over a long period of time.

Further, the productivity of paddy cultivation (i.e. quantity of paddy produced per hectare of land) in Ampara district is the fifth-highest among the twenty-five districts plus two special agriculture zones in the country. The Table 8 catalogues the top five districts/ special agriculture zones in terms of productivity of paddy cultivation in a descending order. Moreover, the productivity of paddy cultivation in Batticaloa and Trincomalee districts are among the lowest in the country. Hence, Ampara district has re-affirmed its competitive advantage in paddy production in terms of productivity too (not only within the province but in the country as well).

Therefore, we would argue that paddy crop is an economic driver in the Ampara district only in the EP. Although Ampara city urban area is not a major paddy producing area, it functions as one of the major centres of trade in agricultural inputs and one of the major wholesale market areas for the sale of paddy to other districts in the country.

Fisheries

The Eastern Province is a coastal province and has the longest coastline among all the provinces in the country. Therefore, fishing has been a major economic activity in the province. Ampara (Kalmunai) (2nd), Batticaloa (1st), and Trincomalee (4th) top the districts with the largest fisher population in the country in 2009 (and before); 82,120; 89,910; and 76,970 fisherpersons respectively.[28]

The EP accounted for almost 15% of the total fish-catch in the country in 1980 (pre-conflict year), which dropped to less than 10% in 2000 (conflict year) and then shot-up to over 21% in 2004 (ceasefire year) and 23% in 2009 (post-war year). Trincomalee and Ampara districts have been the highest contributors to the provincial fish-catch in all the years under consideration, except 2009. (See Table 9) While Kalmunai is the fishing hub in the Ampara district, Trincomalee city (and the surrounding areas) is the fishing hub in the Trincomalee district.

Although the fishing sub-sector accounted for only 6.5% of the provincial GDP in 2010 (latest year for which data is available), fishing sub-sector would qualify as an economic base sub-sector (or economic driver) because of the fact that more than one-fifth of the total fish catch in the country is from the East (2004 & 2009) (a large part of which is sold outside the province) and the number of fisher populations in all three districts in the East were among the top four in the country.[29]

Within the agriculture sector in the EP, paddy cultivation (Ampara district), dairy farming (Batticaloa district), and fisheries (perhaps all three districts) sub-sectors could be regarded as economic base sub-sectors (or economic drivers) in selected districts only.

Agricultural production in Sri Lanka should be specialised (concentrated) in districts/areas where each crop or sub-sector has the highest yield/productivity within the province as well as in the country as a whole and its share in the national output. Historically, paddy cultivation, for example, had been undertaken in all the districts in the country without spatial specialisation resulting in diseconomies of scale and abject poverty among most paddy farmers in the country. Although Batticaloa district accounted for over 6% of the national paddy production in 2004 and 2010 (see Table 7), Batticaloa recorded the highest incidence of poverty in the country (>20%, which was just 9% in the country as a whole) according to the latest Household Income and Expenditure Survey (HIES) 2009/ 2010 because of one of the lowest yield per hectare in the country (see Table 8). Similarly, cultivation of several crops and the production in sub-sectors are dispersed throughout the country, disregarding respective competitive advantage (or disadvantage) in terms of productivity and spatial specialisation.

Agglomeration in the agrarian economy of Sri Lanka is the critical need to transform the low-productivity and low-value agriculture production into higher-productivity and higher-value agriculture in the country.

Manufacturing

Over twenty-five years of war has destroyed (either partially or fully) almost all the industrial infrastructure of the province and uprooted associated skilled human resources. But the large-scale industries situated in secured zones mainly surrounding the Trincomalee port (Prima Flour Mill, Prima Logistics, Mitsubishi/Tokyo Cement, Fuji Cement, Bio Mass Power plant and the Indian Oil Company) were able to function. (Also see the section on "Factory Industry" above).

In addition to the factory industries, there are thousands of small and medium industries in the country which are referred to as "cottage industry" and "processing" (tea, rubber and coconut) in the national income accounts. Of course there are no tea or rubber processing industries in the east.

Table 8 Paddy Yield by District 2002 – 2011

Special agriculture zone / District	Maha (kg per hectare)			Yala (kg per hectare)		
	2001-2	2006-7	2010-11	2002	2007	2011
Udawalawe zone	5,238	5,636	6,337	4,902	5,641	6,545
Mahaweli 'H' zone	5,192	5,563	5,004	4,606	5,136	5,508
Hambantota Dist	4,820	5,215	5,147	4,343	4,940	5,140
Polonnaruwa Dist	4,627	5,119	3,831	4,528	5,057	5,055
Ampara Dist	4,607	4,934	3,333	4,512	4,993	4,913
Anuradhapura Dist	4,323	4,726	4,313	4,190	4,804	4,700
Trincomalee Dist	3,607	4,261	2,388	4,238	4,376	4,737
Batticaloa Dist	3,126	2,891	2,399	3,282	3,680	4,114

Source: Central Bank of Sri Lanka, *Annual Report*, Statistical Appendix Table 16 (2011), various years.

Note: The first two rows pertaining to special agriculture zones along the longest river in Sri Lanka, the Mahaweli. There are two agriculture seasons in Sri Lanka: Maha – Sept/Oct to Mar/Apr & Yala – Apr/May to Aug/Sept

According to the Census of Industry of 2003, there were 7,399 manufacturing industries (including factory, processing (coconut only) and cottage industries) in the EP.[36] Out of this total, 7,067 (95.5%) had less than ten employees and just 332 had ten or more employees. The total number of manufacturing industries in the EP (7,399) accounted for just 5.6% of the total manufacturing industries in the country in 2003 (131,387).[37] The total employment in all the manufacturing industries in the EP in 2003 was 27,692; accounting for just 2.7% of the total employment in all the manufacturing industries in the country in the same year.[38]

Local Endowments

Mineral resources

There appears to be little in the way of mineral resources in the Eastern Province that could be easily exploited for export out of the area and that could generate much employment or that could be used as inputs into manufactures. However, building materials for local production have created a demand for a number of mineral deposits, especially clay for roofing tiles and brick.

Trade and services

Each city in the EP has numerous banks, telecommunication services (including broadband internet), educational and health centres, wholesale trading centres, markets, and a wide array of retail establishments and distributors. These are important factors in a city's competitiveness but they are almost all derived or "non-basic" activities oriented to serving only local markets. The universities in the cities, however, perform a certain basic function to the extent that students come from outside the immediate region. Hotels and restaurants also can be considered "basic" to the extent that they cater to international tourists and domestic tourists coming from outside the region.

Higher-order transport services

Transport services that serve more than the local population and enterprises can be considered base economic activities. Trincomalee harbour and the rail services connecting Colombo, Batticaloa, and Trincomalee could be considered base economic activities. The Trincomalee harbour serves the entire eastern seaboard and could serve the whole country; second only to the Colombo Port. The Trincomalee harbour has the potential to become the springboard to the emerging Asian economies such as China, India, Korea, Malaysia, Singapore, Viet Nam, and others.

Tourism

Although tourism in the EP is still a very small part of the provincial economy concentrated almost entirely in the Trincomalee district, it has the greatest potential in all three districts. Out of the total of 5 million foreign guest nights in 2011 in the entire country, only 79,000 (or 1.6%) foreign guest nights were spent in the East Coast. However, it has increased from 10,000 foreign guest nights in 2007 to 79,000 foreign guest nights in 2011.[33] In other words, out of all the tourism areas in the country (Ancient Cities, Colombo City, East Coast, Greater Colombo, Hill Country, and South Coast), the East Coast is experiencing the highest growth rate in the tourist traffic (foreign guest nights) in the post-war (post-2007) period.

Not only does the eastern coast have some of the best natural beaches in the country, their exploitation has been largely on hold for decades due to the protracted armed conflict. Thus, there is tremendous potential especially along the practically virgin coastal areas from Mullaitivu in the north-east all the way to Arugam Bay in the south-east (total length of over 240 kilometres).

Table 9 Share of the National Fish Catch (%) 1980-2009

	1980	1990	2000	2004	2009
Sri Lanka	100.0	100.0	100.0	100.0	100.0
Eastern Province	**14.9**	**16.7**	**9.6**	**21.1**	**23.3**
Ampara	6.0	6.9	4.4	7.8	5.5
Batticaloa	2.1	2.4	2.0	6.4	8.4
Trincomalee	6.8	7.3	3.2	6.9	9.4

Source: Sarvananthan, Muttukrishna, (2008), *The Economy of the Conflict Region: from economic embargo to economic repression*, Point Pedro (Sri Lanka): Point Pedro Institute of Development, pp109 (for 1980, 1990 & 2000); Department of Census and Statistics, *Statistical Abstract 2010* (for 2004 & 2009) http://www.statistics.gov.lk/abstract2010/chapters/Chap5/AB5-34.pdf

It should be added that there are a number of eco-tourism destinations (mainly national reserves and parks) and also heritage sites in or within close distance to the main resort areas in the Eastern Province. Trincomalee has the highest potential because Habarana with its stupas and rock shrines, ancient water/irrigation tanks, Minneriya National Park, and the spectacular rock fortress of Sigiriya are within a short drive. There are also the Maduru Oya, Lahugala, and Gal Oya National Parks near Ampara and Batticaloa, as well as the religious centre of Buddhangala just outside the Ampara City.

Human resources

According to the latest Household Income and Expenditure Survey[34] (HIES) 2009/10, the demographic characteristics of the Eastern Province (EP) was somewhat different from that of the country as a whole. The salient features of the demographic characteristics of the EP are as follows:

While 33.4% of the national population had "never married", 40.0% of the eastern population had "never married" (the highest share after the Northern Province among all the provinces) (Ampara 41.4%, Batticaloa 38.9%, and Trincomalee 38.9%).[35] Besides, among the female-headed households in the country, while nationally 17.8% were in the age group of 25-39 years old, it was 30.4% in the EP (highest share among all the provinces) (Ampara 35.8%, Batticaloa 25.9%, and Trincomalee 29.1%).[36] While 32.3% female-headed households were married in the country as a whole, 35.5% of the female-headed households in the EP were married (Ampara 39.6%, Batticaloa 36.3%, and Trincomalee 25.4%).[37]

Further, while only 26.0% of the national population was 14 or under by age, it was 32.5% in the EP (Ampara 31.2%, Batticaloa 32.8%, and Trincomalee 34.3%). Moreover, while 12.3% of the national population was 60 and above by age, only 6.9% of the eastern population was in that age group (Ampara 8.1%, Batticaloa 6.3%, and Trincomalee 5.8%).[38]

While 14.7% of the population in the country had passed the General Certificate of Education Ordinary Level (G.C.E. O/L) (Grade 10) public examination, only 11.9% of the eastern population had passed the same (Ampara 11.7%, Batticaloa 10.5%, and Trincomalee 14.4%). Similarly, whereas 11.2% of the country's population had passed the G.C.E. A/L (Advanced Level) (Grade 12) public examination and above, only 7.4% had passed the same in the EP (Ampara 8.8%, Batticaloa 7.7%, and Trincomalee 4.3%).[39]

The forgoing data indicate that there is higher share of unmarried population in the East vis-à-vis the country as a whole, the female-headed households in the East were much younger compared to the total female-headed households in the country as a whole, higher share of female-headed households in the EP was married in comparison to the entire female-headed household population in the country, significantly younger population in the EP compared to the rest of the country, and that the educational level of the population of EP was lower than that of the country as a whole.

Poverty

The incidence of poverty (head-count index) in the country has drastically declined during the past twenty years. While the percentage of population living below the poverty line in the country was 26% in 1990/91, it had dropped to just 9% in 2009/10. Rural and urban poverty has declined more than in the estate areas. (See Table 10)

However, according to the latest available data, the Eastern Province had the highest incidence of poverty (among all the provinces) where almost 15% of the population was deemed poor.[40] Moreover, among all the districts in the country, Batticaloa district had the highest incidence of poverty at over 20%. (See Table 10) District-wise data reveal that all the districts in the country barring the districts in the North and East had experienced reduction in the population living below the poverty line over the years.

There are no data available on poverty in the urban areas of the three districts in the Eastern Province. The above relates to total district populations. Considering that urban poverty is much lower than rural poverty at the national level, it can be assumed that poverty levels in the cities of these districts are lower than the district-wise figures.

Table 10 Headcount percentage of population under the poverty line

	1990/91	2009/10
National	26.1	8.9
Urban areas	16.1	5.3
Rural areas	29.4	9.4
Estate areas (plantations)	20.5	11.4
Eastern Province	not available	14.8
Ampara District	not available	11.8
Batticaloa District	not available	20.3
Trincomalee District	not available	11.7

Source: Department of Census and Statistics, *Household Income and Expenditure Survey* 1990/91 and 2009/10 (pp35).

Institutions: Business Environment

The business environment is getting better in all three towns, but it could be improved further in many ways. In Trincomalee basic economic infrastructures such as electricity, telecommunications and internet services are now reasonable. Water, however, is only available for limited number of hours each day. The city still suffers from poor connectivity, especially in terms of the poor road network to the rest of the island and the lack of any scheduled commercial air services to Trincomalee airport. The reconstructed A15 road to Batticaloa (recently completed with bridges) is an example of how connectivity can be quickly improved through investment in and upgrading of roads. It now takes only two hours to reach Batticaloa from Trincomalee. The same could be said for Batticaloa and Ampara as well. Basic infrastructure and utilities that businesses rely on are available, although they could be improved.

According to a qualitative survey undertaken by The Asia Foundation[41], roads are "poor" in Ampara, Batticaloa, Kalmunai, Kattankudy, Kinniya, and Trincomalee towns; telecommunication services are "good" in all the foregoing towns; electricity supply was "good" in Kinniya, "poor" in Ampara, and "average" in Batticaloa, Kalmunai, Kattankudy, and Trincomalee towns; water supply was "good" in Ampara, "poor" in Kattankudy, and "average" in Batticaloa, Kalmunai, Kinniya, and Trincomalee towns. (This survey was undertaken about two years after the end of the civil war in the EP in 2009. There is no recent data to discern any changes that may have taken place since then.)

An enterprise survey undertaken in Sri Lanka by the World Bank in 2011 reveals the challenges facing businesses in Sri Lanka with indicators by Province.[42] Nationally, the main obstacles to doing business for manufacturing firms were ranked as follows: (a) access to finance, (b) competition with the informal sector, (c) electricity supplies, and (d) tax rates. In the Eastern Province, the first ranked obstacle faced by manufacturing enterprises was access to finance at 36% of respondents, followed by customs and trade regulations at 26%, then licensing and permits and inadequately educated workforce at 13% each. For service enterprises in the Eastern Province, the greatest obstacle was access to finance at 60% of respondents followed by access to land at 20%.

Current and Potential Economic Drivers of the Secondary Cities in the East

This concluding section recapitulates the current economic drivers in the three secondary cities of the Eastern Province and also identifies the potential economic drivers of the same secondary cities. (See the following Table)

Currently, fishing is the only sub-sector that would qualify as an economic driver in all three districts/cities under scrutiny (note that Kalmunai and not Ampara City is the fishing hub in the Ampara district). Further, infrastructure construction and factory industrial manufacturing are also economic drivers in the City of Trincomalee. Moreover, paddy crop cultivation in Ampara district is an economic driver of the City of Ampara. Fishing is the only economic driver in the City of Batticaloa. Therefore, while the City of Trincomalee is driven by three economic sub-sectors, two economic sub-sectors drive the City of Ampara (including Kalmunai), and only one economic sub-sector drives the City of Batticaloa.

However, construction of infrastructure (physical and virtual), development of economic institutions (such as law and order, political and fiscal decentralisation, property rights for land, and financial integration), fishing, human capital development (such as education and training services), and tourism sub-sectors could be potential economic drivers of all three secondary cities in the EP. Thus, the foregoing five are cross-cutting potential economic drivers in the three cities under consideration. Further, factory industrial manufacturing (including processing) has the potential to continue as an economic driver of the City of Trincomalee and paddy crop cultivation in the Ampara district has the potential to continue as an economic driver of the City of Ampara.

Economic and social infrastructures have to be restored and new ones developed in all three secondary cities of the EP in order to get connected physically and virtually to the economic hub of the City of Colombo and the

Economic Drivers of the Secondary Cities in the Eastern Province

ECONOMIC DRIVERS Economic sub-sector	**Ampara**	**Batticaloa**	**Trincomalee**
Current			
Construction – Infrastructure			✓
Fishing	✓ (Kalmunai)	✓	✓
Manufacturing – Factory Industry			✓
Paddy Crop	✓		
Potential			
Construction – Infrastructure (physical and virtual)	✓	✓	✓
Economic Institutions (law & order, property rights for land, political & fiscal decentralisation, financial integration)	✓	✓	✓
Fishing	✓	✓	✓
Human Capital	✓	✓	✓
Manufacturing – Factory Industry			✓
Paddy Crop	✓		
Tourism	✓	✓	✓

Greater Colombo area and thereon to the rest of the world. In the modern world, lack of fast highways, airports, and harbours connecting different cities within and outside the country could be partially compensated by the development of Information and Communication Technologies (ICTs) in interior parts of the country which are much more cost-effective. Modern virtual connectivity (ICTs) is less costly and less time-consuming than the traditional modes of physical connectivity (roads, railways, and sea and air ports). Thus, physical distance could be bridged considerably through virtual connectivity. However, an economy (such as that of the Eastern Sri Lanka) overwhelmingly dominated by primary produces (agriculture) and limited secondary produces (such as manufacturing and construction) need to depend heavily on physical connectivity such as roads, railways, and sea and air ports. Therefore, construction of physical and virtual infrastructures could be potential economic drivers of the secondary cities in the East.

Secondly, as noted above, human capital development in all three secondary cities in the East is lower than the average of the country in terms of lower and higher secondary public examination results. Therefore, development of human capital is *sine qua non* to enhance the competitiveness of the secondary cities in the EP. The Eastern University of Sri Lanka (EUSL) is mainly situated in Chenkalady (16 kilometres from the Batticaloa town) and partly within the Batticaloa town itself. The EUSL also has another campus in Trincomalee district, which is out of the Trincomalee town (closer to Nilaveli). The Ampara District has its own university; the South Eastern University of Sri Lanka (SEUSL) in Oluvil along the coast (Oluvil also has a small harbour). There are few vocational and further educational institutions in all three districts of the East. The quality of school education and tertiary education needs to be improved in addition to increasing the number of admissions and output of students. Educational level of a city population is strongly correlated to the economic growth of the same city. Education is a critical ingredient in the local agglomeration economies and cities boost the accumulation of human capital.[43] Therefore, human capital development should be a thrust activity in the eastern secondary cities.

Thirdly, economic institutions such as law and order, property rights for land, political and fiscal decentralisation[44], financial integration, etc, needs to be restored and strengthened in the three secondary cities of the East. As a result of the prolonged armed conflict, such economic institutions have deteriorated in the past three decades.[45] As argued before, while physical infrastructure connects places, virtual infrastructure and economic institutions connects people.[46] Therefore, development of economic institutions is a *sine qua non* for enhancing the competitiveness of primary and secondary cities. The development of economic institutions is a cross-cutting potential economic driver of the secondary cities under scrutiny.

Fishing will continue to be a cross-cutting economic driver in all three cities and outlying areas keeping with its natural advantage. Tourism is an emerging cross-cutting economic driver in all three cities/districts as noted above. Factory industrial manufacturing will continue to be an economic driver in the City of Trincomalee because of its logistical advantage with the one of the world's best natural harbours, airports, and railroads. The cultivation of paddy crop will continue be an economic driver of the City of Ampara and outlying areas.

Another critical competitive advantage all three districts/cities in the EP have is its relatively younger population compared to all other districts in the country. A "demographic dividend" is realised when the number of working-age population increases more rapidly than the number of dependent/elderly population in a geographic area or country.[47] South Asian countries (except Sri Lanka) are currently reaping a demographic dividend which will continue until 2040 (and beyond in Afghanistan). In Sri Lanka the demographic dividend ended in 2005.[48]

However, in contrast to all the districts in the country, the three districts in the Eastern Province are endowed with a much younger population; a uniquely eastern demographic peace dividend. According to the Household Income and Expenditure Survey 2009-10, while only 26.0% of the total population of the country is under the age of 14 years, 34.3% of the population of the Trincomalee district, 32.8% of the population of the Batticaloa district, and 31.2% of the population of the Ampara district are under the age of 14 years.[49] As a corollary, while the share of the population that is 60 years and older in the country as a whole was 12.3%, it was just 5.8% in Trincomalee district, 6.3% in Batticaloa district, and 8.1% in Ampara district.[50] A considerably higher share of unmarried women in the population of the former conflicted-affected region (in Ampara, Batticaloa, Jaffna, Trincomalee, and Vavuniya districts) is another comparative advantage vis-à-vis other districts in the country.[51]

Therefore, the secondary cities in the East should take full advantage of this uniquely eastern demographic peace dividend and convert it into economic peace dividend by focussing their economic revival strategies on youths. This has the potential to result in a youth spring in Eastern Sri Lanka.

Footnotes

[24] Cities Alliance, The, (2007), *Understanding your Local Economy: A Resource Guide for Cities*, Washington D.C, pp87-88.

[25] Sarvananthan, Muttukrishna, (2011), "Sri Lanka: Putting Entrepreneurship at the Heart of Economic Revival in the North, East, and Beyond", *Contemporary South Asia*, 19 (2), June, pp209.

[26] Sarvananthan, Muttukrishna, (2011), "Sri Lanka: Putting Entrepreneurship at the Heart of Economic Revival in the North, East, and Beyond", *Contemporary South Asia*, 19 (2), June, pp206.

[27] Sarvananthan, Muttukrishna, (2011), "Sri Lanka: Putting Entrepreneurship at the Heart of Economic Revival in the North, East, and Beyond", *Contemporary South Asia*, 19 (2), June, passim.

[28] http://www.statistics.gov.lk/abstract2010/chapters/Chap5/AB5-32.pdf

[29] http://www.statistics.gov.lk/abstract2010/chapters/Chap5/AB5-32.pdf

[30] According to the Census of Industry of 1983, there were 5,720 manufacturing industries in the Eastern Province. (Sarvananthan, Muttukrishna, (2008), *The Economy of the Conflict Region: from economic embargo to economic repression*, Point Pedro (Sri Lanka): Point Pedro Institute of Development, pp110)

[31] Sarvananthan, Muttukrishna, (2008), *The Economy of the Conflict Region: from economic embargo to economic repression*, Point Pedro (Sri Lanka): Point Pedro Institute of Development, pp110.

[32] Sarvananthan, Muttukrishna, (2008), *The Economy of the Conflict Region: from economic embargo to economic repression*, Point Pedro (Sri Lanka): Point Pedro Institute of Development, pp112.

[33] Central Bank of Sri Lanka, *Annual Report 2011*, Statistical Appendix Table 79.

[34] The latest HIES was undertaken between July 2009 and June 2010 (first one after the end of the civil war) throughout the country. However, three northern districts, namely Kilinochchi, Mannar and Mullaitivu were not covered by this survey. In addition Vavuniya North DS division of the Vavuniya district was also not covered. Therefore, the data pertaining to the Northern Province and Vavuniya district are not entirely representative. http://www.statistics.gov.lk/HIES/HIES2009_10FinalReport.pdf

[35] Household Income and Expenditure Survey 2009/10, Table 7.

[36] Household Income and Expenditure Survey 2009/10, Table 9.

[37] Household Income and Expenditure Survey 2009/10, Table 10.

[38] Household Income and Expenditure Survey 2009/10, Table 3.

[39] Household Income and Expenditure Survey 2009/10, Table 5.

[40] If the entire Northern Province is surveyed then North could become the poorest province in the country.

[41] Asia Foundation, The, (2009), *Qualitative Assessment of the Local Enabling Environment for Private Enterprise in the Eastern Province of Sri Lanka*, June, Colombo, pp34.

[42] World Bank, The, (2012), Sri Lanka: Findings of the World Bank Enterprise Survey, Finance and Private Sector Development Department, March 2012. These findings need to be treated with caution since the sample size of the survey was small.

[43] For empirical evidence see Nallari, Raj, Breda Griffith, and Shahid Yusuf, (2012), *Geography of Growth: Spatial Economics and Competitiveness*, Washington D.C: The World Bank, pp54&58.

[44] See Sarvananthan, Muttukrishna, (2011), "Fiscal Devolution: A stepping stone towards conflict resolution in Sri Lanka", *Economic Review*, 37 (1&2), April/May, pp44-48.

[45] See Sarvananthan, Muttukrishna, (2009), "The Path to Economic and Political Emancipation in Sri Lanka", *Conflict Trends*, Issue 4, pp13-22 for a comprehensive policy brief on the role of economic institutions in the emancipation of the conflict-affected regions in Sri Lanka.

[46] Nallari, Raj, Breda Griffith, and Shahid Yusuf, (2012), *Geography of Growth: Spatial Economics and Competitiveness*, Washington D.C: The World Bank, pp8.

[47] Nayar, Reema, et al, (2012), *More and Better Jobs in South Asia*, Washington D.C: The World Bank, pp1.

[48] Nayar, Reema, et al, (2012), *More and Better Jobs in South Asia*, Washington D.C: The World Bank, pp2.

[49] In Colombo district only 23.2% of the population is under the age of 14 years.

[50] Household Income and Expenditure Survey 2009/10, Table A3. (Colombo district has one of the highest shares of '60 years and above' population in the country with almost 15%) http://www.statistics.gov.lk/HIES/HIES2009_10FinalReport.pdf

[51] Household Income and Expenditure Survey 2009/10, Table A7. http://www.statistics.gov.lk/HIES/HIES2009_10FinalReport.pdf

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Macroeconomic Policies: Monetary Policy

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Introduction

Policy economics is an important area coming under the scope of economics. Economic policy can be defined as a course of action based on economic theories and intended to resolve a specific economic problem or to achieve a set of policy goals which are related to the five key macro variables such as employment, output, the price level, the exchange rate and the balance of payments. Until the twentieth century, the main responsibility of the government towards the economy was to provide a stable background of law and order, and security of contracts that would help citizens to get on with the private economic activity on which the material wealth of the nation depended. Early in the history of economics, it was realized that the amount of money and credit that was available to 'grease the wheels of commerce' was at least partially under the control of the government. It was also realized that mismanagement of the monetary system could cause inflation. The government's responsibility was therefore understood to include management of the monetary system in such a way that there was enough money to satisfy the needs of trade, but not so much as to cause inflation. The macro variables other than the price level were not, however, considered to be the responsibility of government policy.

In response to the so-called Great Depression of the 1930s, and the decade of heavy unemployment that was a part of it, modern macroeconomic theory was born. Since that time, economists have understood that government policy can have a significant influence on the nation's overall level of economic activity, while governments have, for better or for worse, accepted a responsibility for influencing the behaviour of major macro variables. Today, in nearly every country, governments are held responsible for the good health of the economy. At election times incumbent governments are judged, first among many other issues, on their economic performance.

Economic Goals

If economic policies are designed to achieve certain economic goals, then we need to recognize a number of major macroeconomic policy objectives which most governments strive to achieve. They include:

- Economic growth: Produce more and better goods and services, or more simply, develop a higher standard of living.
- Full employment: Provide suitable jobs for all citizens who are willing and able to work.
- Economic efficiency: Achieve the maximum fulfilment of wants using the available productive resources.
- Price stability: Avoid large upswings and downswings in the general price level; that is avoid inflation and deflation.
- Economic freedom: Guarantee that business, workers and consumers have high degree of freedom in their economic activities.
- Equitable distribution of income: Ensure that no group of citizens faces poverty while most others enjoy abundance.
- Economic security: Provide for those who are chronically ill, disabled, laid off, aged, or otherwise unable to earn a minimal levels of income.
- External balance: Seek a reasonable overall balance with the rest of the world in international trade and financial transactions.

The above list of basic economic goals inevitably entails problems of interpretation. We might disagree substantially on their specific meanings and, hence, the types of policies needed to attain these goals. What are 'sizeable' changes in the price level? What is a 'high degree' of economic freedom? What is an 'equitable distribution' of income? These objectives are often the subject of spirited public debate.

Also, some of these goals are complementary; when one goal is achieved, some other goal or goals will also tend to be achieved. For example, achieving full employment means eliminating unemployment, which is a basic cause of inequitable income distribution. But other goals may conflict or even be mutually exclusive. The involve **trade-offs**, implying that to achieve one goal we must sacrifice another. For example, efforts to equalize the distribution of income may weaken incentives to work, invest, innovate, and take business risks, all of which promote economic growth. Taxing high-income people heavily and transferring the tax revenues to low-income people is one way to equalize the distribution of income. But then the incentives to high-income individuals may diminish because higher taxes reduce their rewards for working. Similarly, low-income individuals may be less motivated to work when government stands ready to subsidize them.

When basic goals do conflict, society is forced to develop a system of priorities for the objectives it seeks. If more economic freedom is accompanied by less economic security and more economic security allows less economic freedom, society must assess the trade-offs and decide on the optimal balance between them.

Instruments of Economic Policy

There are two sets of macroeconomic policy tools available to the government. One set, called demand-side policies, works on the demand side of the economy's markets. These are called the policies of **demand management**. The other set, called supply-side policies, work on the supply side of these markets. The demand side relates to spending decisions by economic agents – households, firms, and government agencies – both at home and abroad. The principle of aggregate demand management policies is that the government can take actions to offset or smooth out those of private agents – firms and households – in order to dampen or eliminate fluctuations in total spending. The idea is to take the edge off recessions as well as booms. Two traditional demand management instruments are fiscal and monetary policy. **Fiscal policy** manipulates government expenditures or taxes in an attempt to affect the volume of national spending. **Monetary policy** is directed at influencing interest and exchange rates, and more generally conditions in financial markets. This in turn affects spending on goods and services. The **supply side** relates to the productive potential of the economy. The choice of hours worked by households, the productivity of their labour, and in general the efficiency with which resources are allocated in generating a nation's output, all affect an economy's aggregate supply. Accordingly, supply-side policies represent government's effort to increase an economy's long-run capacity as well as its overall efficiency. Frequently, this effort is about reducing or eliminating government-induced inefficiencies, which were introduced before the importance of the supply side was understood, or as the result of successful lobbying by interest groups. It is also about bringing idle or underutilized resources into productive uses. The main purpose of this article is to present a detailed discussion on the nature and operation of monetary policy.

Monetary Policy

Monetary policy is the manipulation of the amount of money and credit available, and the cost of that credit to borrowers (i.e. interest rates) in an attempt to influence total demand. Since businesses and households borrow to finance much of their expenditure, changing the availability, and the terms, of credit can influence total demand. By making more funds available to be borrowed, and by exerting a downward pressure on interest rates which lowers the cost of borrowing, the government seeks to increase total demand. By making fewer funds available to be borrowed, and by exerting an upward pressure on interest rates, the government seeks to lower total demand. Monetary policy is administered by a country's central bank – in Sri Lanka this is the Central bank of Sri Lanka. How the Central Bank of Sri Lanka can accomplish these changes in the conditions of credit will be discussed in detail in the subsequent sections of this article.

Objectives of the Central Bank of Sri Lanka

The Central Bank of Sri Lanka was established by the Monetary Law act of 1949 and is responsible for safeguarding both the value of the Sri Lanka Rupee and the country's banking, financial and payments system. In keeping with global trends in central banking, the objectives of the Central Bank were streamlined by amending the Monetary Law Act in 2002, to enable it to pursue its core objectives and to free it of the multiple objectives that were originally assigned to it. With this amendment, the Central Bank has two objectives:

- Maintaining economic and price stability, and
- Maintaining financial system stability.

With a view to encouraging and promoting the development of the productive resources of Sri Lanka. Prior to amendment of the Act, the Central Bank had multiple objectives such as the stabilization of domestic monetary value, the preservation of the stability of the exchange rate, the promotion of a high level of production, employment and real income and the encouragement and promotion of the full development of productive resources. The problem was that these multiple objectives could sometimes be in conflict or be inconsistent with each other. Meanwhile, a consensus had developed internationally that a central bank's primary goal should be the maintenance of price stability. As price stability is crucially dependent on stable macroeconomic conditions, one of the core objectives of the Central Bank was specified as 'economic and price stability'.

Further, as the stability of the financial system is crucial in improving the resilience of the economy, 'financial system stability' was also identified as a core objective of the Central Bank. The two objectives are correlated and complement each other. Ensuring financial system stability is of prime importance, as monetary policy is transmitted through financial institutions to achieve price stability. Hence, the two objectives are in harmony and this enables the Central Bank to perform its main functions more effectively.

Monetary Policy Instruments

A primary function of the Central Bank, as stated in the Monetary Law Act, is the determination and implementation of monetary policy for the country. The Central Bank of Sri Lanka possesses a wide array of tools to be used as instruments of monetary policy. The main instruments of monetary policy are the following:

- Open market operations: These operations involved the purchase or sale in the open market of government securities (Treasury Bills or Bonds) or sale or retiring of Central Bank securities to affect the liquidity in the banking system. The Central Bank sets the policy interest rates, i.e. the Repo rate (selling/borrowing rate) and the Reverse Repo rate (buying/ lending rate), for standing facilities and expects the open market operations to take place within this interest rate corridor,
- Statutory reserve requirements on commercial bank deposits: This is the proportion of deposits that commercial banks are required to keep as a cash deposit with the Central Bank,
- Bank Rate: This is the interest rate at which the Central Bank lends money to commercial banks that have liquidity difficulties. The Bank Rate is much higher than the Reverse Repo rate and is a penal interest rate,
- Foreign exchange operations,
- Quantitative restrictions on credit,
- Ceilings on interest rate,
- Refinance facilities,
- Moral suasion: A persuasion tactic used by the Central Bank to influence and pressure, but not force, banks into adhering to policy.

At present, monetary policy places greater reliance on market based policy instruments. The main monetary policy instruments currently used are (a) policy interest rates and open market operations (OMO) and (b) statutory reserve requirement (SRR) on commercial bank deposit liabilities.

Policy Interest Rates and Open Market Operations

The Central Bank conducts open market operations with counter-parties such as commercial banks and primary dealers, to control market liquidity. Open market operations involve the purchase or sale in the open market of government securities or the issue of central bank securities. The sale of securities by the Central Bank in open market operations has the effect of withdrawing liquidity from the banking system, while the purchase of securities by the Central Bank injects liquidity into the banking system. At present, the Central Bank conducts its monetary policy under a system of active open market operations which was introduced in March 2003. The key elements of the new system are:

- An interest rate corridor formed by the Central Bank's over-night policy rates, i.e. the repurchase rate (Repo rate) and the reverse repurchase (Reverse Repo) rate,
- A daily auction either to inject or withdraw liquidity in the market,
- Standing facilities to counter-parties at these rates,
- Outright transactions.

A Repo/Reverse Repo is an agreement to buy/sell securities with an undertaking to sell/buy them back at an agreed date and at an agreed price. The Central Bank's Repo rate is its over-night borrowing rate, while the Reverse repo rate is the over-night lending rate. The change in Central Bank's Repo and Reverse Repo rates is the signalling mechanism of its monetary policy stance. These rates are reviewed on a regular basis, usually once a month, and revised if necessary.

Under the current open market operations system, the Central Bank makes a daily assessment of liquidity in the banking system and conducts either Repo or Reverse Repo auctions for an amount determined by the Central Bank, to reduce large fluctuations in the inter-bank interest rate. If there is excess liquidity in the market, the Central Bank will conduct a Repo auction to mop-up the surplus money. If there is a shortage of liquidity in the market, the Central Bank will conduct a Reverse Repo auction to put money into the market. The magnitude of the Central Bank intervention depends on the overall liquidity excess or shortfall. The auction interest rates are determined by the counter-parties (commercial banks and primary dealers) through their bids. Participants could make up to three bids at each auction and the successful bidders will receive their requests at the rates quoted in the relevant bid.

Standing facilities are available to those participating institutions which were unable to obtain their liquidity requirements at the daily auction. That is, even after the daily auction, if a participant needs liquidity to cover a shortage, he could borrow funds on reverse repurchase basis under the standing facility. Similarly, if a participant has excess money, he could enter into a repurchase transaction under the standing facility. Accordingly, these facilities help containing wide fluctuations in interest rates.

Outright transactions are conducted at the discretion of the Central Bank to address long term liquidity issues. If a relatively large liquidity surplus exists and is likely to persist for a long period, it is absorbed by selling treasury bills outright out of the holdings of the Central Bank, and if a sufficient stock of treasury bills is not available, by issuing the Central Bank's own securities.

There also exist another policy rate known as the Bank Rate. It is the rate at which the Central Bank provides credit to commercial banks as a lender of last resort. These are collateralised loans and government securities are accepted as collaterals. The Bank rate is usually a penalty rate and it is higher than other market rates. Therefore, at present this rate is just an indicative rate as commercial banks can borrow from the Central Bank at the Reverse Repurchase rate which is less than the Bank rate.

Statutory Reserve Requirement (SRR)

The statutory reserve ratio (SRR), i.e. the proportion of the deposit liabilities that commercial banks are required to keep as a cash deposit with the Central Bank, also has been widely used to influence money supply in the past. However, the reliance on SRR as a day-to-day monetary management measure has been gradually reduced with a view to enhancing market orientation of monetary policy and also reducing the implicit cost of funds which the SRR would entail on commercial banks.

Under the Monetary Law Act, commercial banks are required to maintain reserves with the Central Bank at rates determined by the Bank. At present, demand, time and saving deposits of commercial banks denominated in rupee terms are subject to the SRR and the applicable ratio is 10 percent on all deposit liabilities. By changing the SRR, the Central Bank can influence the credit creating ability of commercial banks and hence, broad money supply and market interest rates.

Monetary Policy Targets

Excessive growth in money supply generates inflation. This happens when the growth in money supply is greater than the growth in output. The changes in money supply are a primary causal factor affecting price stability. To maintain price stability, the Central Bank influences the growth in money supply by determining the level of reserve money. This is done by targeting the level of reserve money needed to achieve the desired path for the growth of the money supply.

At present, monetary management in Sri Lanka is based on a monetary targeting framework. In this framework, the final target, price stability, is to be achieved by influencing changes in broad money supply which is linked to reserve money through a multiplier. Reserve money is the operating target of monetary policy. The monetary targeting framework is operated through a monetary programme. The monetary programme is prepared by the Central Bank taking into account economic factors such as the expected fiscal and balance of payments developments, economic growth, desired levels of growth in credit and inflation. Based on these factors, the monetary programme sets out the desired path for monetary growth and determines the path of quarterly reserve money targets necessary to achieve this monetary growth. The Central Bank would then conduct its open market operations within a corridor of interest rates formed by its policy rates to achieve the reserve money target. Policy rates are periodically reviewed and adjusted appropriately, if necessary, to bring the reserve money to the targeted path.

The Transmission of the Monetary Policy to the Economy

Changing monetary policy has important effects on aggregate demand, and thus on both output and prices. The process by which the changes in monetary policy instituted by a central bank affects the general price level and output in the economy is referred to as the monetary policy transmission mechanism. There are several channels through which monetary policy changes are transmitted through the economy. These are usually identified as (a) the interest rate channel (whereby the economy is impacted through changes in interest rates), (b) the credit channel (where the economy is affected through changes in the availability of credit), (c) the exchange rate channel (whereby the economy is affected through changes in the exchange rate) and (d) the wealth channel (whereby the economy is affected through changes in asset prices and their impact on wealth). Of these channels, greater emphasis has been placed on the interest rate and credit channels, particularly in developing countries. If the Central Bank tightens, for example, borrowing costs rise, consumers are less likely to buy things they would normally finance – such as houses or cars – and businesses are less likely to invest in new equipment, software, or buildings. This reduced level of economic activity would be consistent with lower inflation, because lower demand usually means lower prices. Also it is important to note here that there are different and long lags, sometimes extending up to two years, in the process of transmitting the monetary policy impact from the policy instruments (i.e. SRR or OMO) to intermediary targets (such as broad money supply) and subsequently to the final targets (i.e. prices and output).

Conclusion

Through monetary policy, the Central Bank seeks to provide the economy with the 'right' rate of money growth – enough to encourage high employment, steady prices, and rising real GNP. These are the basic macroeconomic goals of efficiency, stability, and growth. The more recent evolution of the global economy has accentuated the challenges that face monetary authorities. Increasingly, monetary policy decisions have to be made in an environment of heightened uncertainty. Structural changes associated with globalization have increased the uncertainty in interpreting macroeconomic indicators regarding the state of the economy. Financial markets, driven by massive cross-border capital flows, and the information technology revolution, immediately transfer the valuation of risks associated with uncertainty across the globe and this can lead to contagion. More than ever before, the choice of monetary arrangements depends on the choices that other countries make. Despite these constraints, monetary policy plays a continuingly important role in the economy.

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