APPENDIX-B

FINANCIAL SECTOR AND FISCAL POLICY

B. FINANCIAL SECTOR AND FISCAL POLICY

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B. FINANCIAL SECTOR AND FISCAL POLICY

1. FINANCIAL SECTOR

1.1 Financial Structure

1) Financial System

Sri Lanka's financial system is mainly composed of institutions as tabulated below. Total assets of the banking sector and other financial institutions were Rs.1,266 billion as of the end of 1998, only 1.25 times the GDP.

Total Assets of Banking Sector and Other Financial Institutions

(Rs. Billion)

	1996	%	1997	%	1998*	%
Banking Sector	761.5	76.7%	864.7	75.4%	952.4	75.2%
1. Central Bank	181.6	18.3%	183.9	16.0%	188.7	14.9%
2. Commercial Banks	470.9	47.4%	544.7	47.5%	605.1	47.8%
2.1 Domestic Banking Units	389.8	39.2%	442.8	38.6%	501.7	39.6%
2.1.1 Two State Banks	230.3	23.2%	252.5	22.0%	277.4	21.9%
2.1.2 Domestic Private Banks	111.1	11.2%	135.5	11.8%	167.0	13.2%
2.1.3 Foreign Banks	48.4	4.9%	54.7	4.8%	57.3	4.5%
2.2 Foreign Currency Banking Units	81.1	8.2%	101.9	8.9%	103.5	8.2%
3. Licensed Specialized Banks	109.0	11.0%	136.0	11.9%	158.6	12.5%
3.1 DFCC	16.5	1.7%	18.2	1.6%	23.6	1.9%
3.2 NDB	19.6	2.0%	26.3	2.3%	31.4	2.5%
3.3 National Savings Bank	67.7	6.8%	83.8	7.3%	90.9	7.2%
3.4 SMIIB	5.2	0.5%	6.4	0.6%	6.6	0.5%
3.5 RDBs	-	-	-	-	2.8	0.2%
3.6 Private Savings and Development Banks	-	-	1.4	0.1%	3.2	0.3%
Other Deposit Taking Institutions	37.7	3.8%	44.5	3.9%	46.9	3.7%
1. Finance Companies	18.0	1.8%	22.3	1.9%	26.1	2.1%
2. RRDBs	4.0	0.4%	5.2	0.5%	2.3	0.2%
3. Others	15.8	1.6%	16.9	1.5%	18.5	1.5%
Other Housing Finance Institutions	10.8	1.1%	11.8	1.0%	12.3	1.0%
Contractual Saving Institutions	159.1	16.0%	193.0	16.8%	219.6	17.3%
1. Insurance Institutions	19.6	2.0%	23.1	2.0%	24.2	1.9%
2. Employees Provident Fund	116.1	11.7%	144.7	12.6%	168.3	13.3%
3. Employees Trust Fund	17.1	1.7%	19.9	1.7%	22.8	1.8%
4. Private Provident Funds	6.3	0.6%	5.3	0.5%	4.3	0.3%
Specialized Financial Institutions	24.0	2.4%	33.3	2.9%	35.0	2.8%
1. Leasing Companies	6.1	0.6%	7.5	0.7%	10.0	0.8%
2. Merchant Banks	13.0	1.3%	19.8	1.7%	19.4	1.5%
3. Venture Capital Companies	2.3	0.2%	2.8	0.2%	2.9	0.2%
4. Unit Trusts	2.7	0.3%	3.1	0.3%	2.7	0.2%
Total	993.2	100.0%	1,147.2	100.0%	1,266.1	100.0%

Source: Central Bank of Sri Lanka
*Provisional

As of the end of 1998, the banking system consists of two large stated-owned commercial banks (Bank of Ceylon and People's Bank), six domestic private banks, 18 foreign commercial banks, National Savings Bank (NSB), nine Rural Regional Development Banks (RDBs), three Regional Development Banks (RDBs) and a state mortgage bank (SMIB). Two development finance institutions (DFIs), i.e., National Development Bank (NDB) and DFCC Bank (DFCC), provide long-term development finance. 25 finance companies provide lease financing and installment credits. There are five leasing companies, ten merchant banks, seven venture capital companies, two government provident funds (i.e., Employee's Provident Fund (EPF) and Employees' Trust Fund (ETF)). The state is dominant in life insurance (45% share), general insurance (60%), and pension funds (over 80%).

- The Central Bank

The Central Bank of Sri Lanka is responsible for formulation and execution of the monetary policy with the present main goal set at the maintenance of monetary stability. Apart from the traditional central banks' activities, the Central Bank carries out other activities such as managing the provident plans and supervising development banks and savings banks.

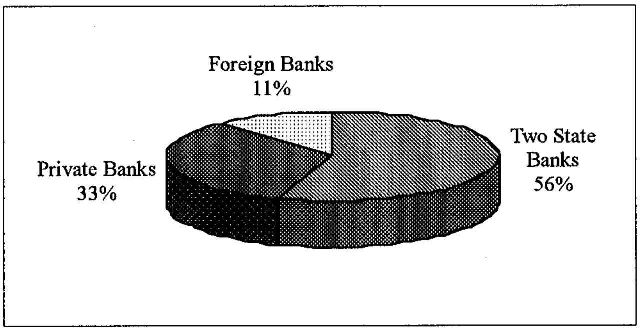
- State-owned Commercial Banks

Two state-owned banks, Bank of Ceylon (BOC) and People's Bank (PB), account for over 50% of assets of the domestic commercial banking sector though their share has been declining steadily as part of the government policy. These two state banks have a large branch network in the rural areas. Financial performance of these state commercial banks is inferior to that of private commercial banks (for reference, non-performing loan ratio to total advances in the first quarter of 1999 was 19.3% for state-owned commercial banks, 14.7% for private commercial banks and 11.3% for foreign banks). The Government signed a performance agreement with BOC and PB in July 1998 stipulating specific targets to improve performance such as profitability, management costs, non-performing loans, rationalizing unprofitable branches and freezing the number of employees. However, the banks continue to fail these targets set by the government. Although the government sees the privatization of these banks as the eventual solution, it might be difficult to privatize them in the short term because of the strong opposition by the Labor Union.

- Domestic Private Commercial Banks

This is the fastest growing group largely due to aggressive deposit mobilization via branch expansions and now provide more than a third of the entire bank lending amount. The private domestic commercial banks provide various products and services to the public but in general short-term financing is predominant. Industrial credits granted by commercial banks during the first three quarters of 1999 were Rs. 27 billion, up by 12% compared to the same period of 1998. Commercial banks are free to set their deposit and loan rates.

Domestic Commercial Banking Sector



Source: Central Bank (As of end 1998)

- Development Finance Institutions (DFIs)

NDB and DFCC are the two development finance institutions engaged in development financing. They performed well over the past decade even compared to their counterparts in other countries. They are fundamentally private sector institutions, although 22% of NDB shares are still owned by the public sector. They play an important role in supplying long-term funding sources to the private sector, including the manufacturing sector, as such long-term loans are limited in Sri Lanka. NDB and DFCC together supply about two thirds of the total investment financing, though their share to the total financial sector in terms of assets is only 3.2%. The 9% manufacturing production increase in 1997 was partly attributable to a 44% increase in financing from these DFIs. To the industrial sector, 69% of NDB loans and 55% of DFCC loans were disbursed in 1998. Although they still depend heavily on credits of international financing institutions (e.g., IDA and ADB), they started lately to issue debentures to raise their own funds and have been diversifying the operations.

- National Savings Bank (NSB)

NSB is the price leader in the market for time and savings deposits. Claims on the government and government-related institutions account for 80% of NSB's assets. NSB has recently allowed to undertake wider banking activities including investment in the equity market.

- Regional Development Banks (RDBs)

Restructuring of Regional Rural Development Banks (RRDBs) was completed in June 1999 by setting up one Regional Development Bank (RDBs) in each province. RDBs are to provide credit to rural individuals and enterprises, which often do not have access to the formal credit system.

- Government Provident Funds

Employee's Provident Fund (EPF) is the largest investment fund in the country with approximately Rs.200 billion. EPF has a fund worth of approximately Rs. 20 billion. These institutions mobilize large amount of long-term funds but invest them mainly in short-term government securities. Almost two-thirds of government debt is sold directly to captive investors such as these pension funds, NSB and government-owned specialized banks. Both have recently been allowed to invest in the equity market.

- Venture Capital Companies

Total assets of the VCCs increased by 1% in 1998. Venture capital companies invested in 135 projects in 1998, compared to 161 projects in 1997. The services sector was the largest recipient of funds (60%) absorbing Rs. 1,390 million. Meanwhile, 34% of the funds were invested in the manufacturing sector.

- Capital Market

The Colombo Stock Exchange (CSE), the only stock exchange in Sri Lanka, currently has 239 companies listed on its exchange. CSE operates an equity market as well as a debt market. The market capitalization of the equity market is Rs. 117 billion, which accounts for only 11.5% of GDP as of the end of 1998. The average daily turnover is approximately Rs.60 million. It is open for foreign investors. CSE expects to more than triple the market capitalization within three years. The debt market has been recently set up and has a market capitalization of Rs. 4.5 billion as of the end of 1998. So far 11 companies have issued debt instruments. The debt market is not open for foreign investment and secondary trading in debt is negligible. But, the corporate debt market is expected to be one of the fastest growing markets in the next decade.

2) Interest Rate Structure

The interest rates are generally free of direct controls by the governments, but some influence remains on the interest rate structure by transacting government securities in the primary and secondary markets, and through its dominance in the banking sector. Interest rates in Sri Lanka have come down over the past years, but still remain high compared to neighboring countries (refer to the next table). The real interest rate has been positive in the past few years.

Lending Interest Rate Comparison

(%)

	1995	1996	1997	1998	1999
India	-	14.5-15.0	14.00	12.0-13.0	12.0-12.5
Nepal [a]	15.0-17.0	15.0-17.5	14.5-17.0	12.5-17.0	12.5-17.0
Pakistan	13.39	13.70	13.72	15.00	N/A
Malaysia	8.03	9.18	10.33	8.04	8.04
Philippines [b]	11.63	12.46	20.00	14.20	12.93
Indonesia [c]	19.30	19.00	25.40	34.80	33.10
Singapore	6.26	6.26	6.96	5.90	5.80
Thailand	13.80	13.0-13.3	15.30	11.5-12.0	9.5-10.0
Taiwan	7.80	7.53	7.65	7.87	7.84
Sri Lanka [d]	20.10	18.70	14.20	15.10	14.90

(a) Lending Rate-Commercial
(b) Overall Weighted Average Interest Rate
(c) Lending Rate-Working Capital
(d) Average Weighted Lending Rate
Source: Central Bank

The yield curve is also yet to be developed in Sri Lanka; the difference between the yields on shorter and longer maturity Treasury bills was small, resulting in a flat yield curve throughout 1998. Treasury bill yield rates are higher than the commercial bank deposit rates. The other problems include high volatility of overnight money interest rates and undeveloped medium to long-term bank deposit rates.

1.2 Situation and Characteristics of Financial Sector

1) Inefficient Financial Market

A competitive, efficient and dynamic financial system plays a crucial role in mobilizing and efficiently allocating savings towards development of the industrial and other sectors. However, the financial market in Sri Lanka is not necessarily based on the principle of market competitiveness principle and it is inefficient, indicating disadvantage to the industrial sector or to the whole economy, for that matter.

Although regulatory, supervisory and institutional reforms have been implemented in the financial sector during the last decade (e.g., improved disclosure requirements, loan recovery mechanisms, recapitalization of state-owned banks), the development process of the financial sector has been slow and the financial sector deepened only slightly. As summarized in the following table, during the period from 1989 to 1998, broad money of Sri Lanka grew annually at 17.5%, reaching 37.3% of GDP, while nominal GDP grew at 16.8% in 1998. The financial sector grew annually at 5.3% in real terms, reaching only 125% of GDP, while inflation averaged 11.9%. National savings, as a percentage of GDP, increased from 14.6% to 23.2% during the same period.

Broad Money to GDP in 1996

(%)

	Sri Lanka	Bangladesh	India	Nepal	Pakistan
Broad Money to GDP	33	37	49	38	44

Source: World Bank

Government borrowing still dominates the financial markets, while savers invest mainly in bank deposits. About 38% of the asset side is concentrated on the immobilized government securities, while 33% of the liabilities side is on the bank deposits.

High budget deficit (9.2% of GDP in 1998) leads to expansion in money supply, weak currency, high inflation and high interest rate. The government, in order to compensate for the budget deficit, has placed non-marketable low fixed rated government securities called "Rupee Loans" to captive investors such as NSB, two state pension funds, and insurance companies. About two thirds of total government debt is sold directly to such captive investors. The government also has a high statutory reserve requirement of 11% to the banks. The effect is to raise funding costs, put upward pressure on lending rates, and reduce earnings. The financial sector should be liberalized to increase competition among banks and thus reduce costs and improve the quality of their services to customers such as the industrial sector.

2) Weak Banking Sector

The financial condition of the banking sector is poor. The level of non-performing assets is high, especially in the state-owned sector. The non-performing ratio to total advances in the first quarter of 1999 was 19.3% for state-owned commercial banks and 14.7% for private commercial banks and 11.3% for foreign banks.

The net non-performing loans continue to exceed capital for the state banks and now equal capital for the private domestic banks suggesting a risk to solvency. Moreover, domestic banks are provisioning at about half the rate of foreign banks and are seriously under provisioned.

Non-performing Ratio to Total Advances (1st Quarter in 1999)

(%)

	State-owned Commercial Banks	Private Commercial Banks	Foreign Banks
Non-performing ratio	19.3	14.7	11.3

Source: Central Bank

The two large state commercial banks, which together have more than a half of the banking system, charge high lending rates to the customers to cover their high costs, and the private commercial banks follow the suit charging high interest rates rather than going into competition. This situation is one of the major constraints for development of the manufacturing sector.

3) Long-term Investment Instruments Still in the Process of Establishment

The government started to issue the market-oriented Treasury bonds in March 1997 with aims to develop local medium to long-term bond markets and to improve budget deficit by reducing its reliance on short-term debt with captive investors.[1] Now most of the new deficit financing requirements of the government are met by these Treasury bonds.[2] The yield curve of government bonds is starting to ascend.

Treasury bonds have become popular in the market and provide the private sector with medium "benchmark"[3] interest rates and a risk free yield curve beyond one year. Primary issues of corporate debentures increased since, providing the market with new instruments for capital mobilization, though issuers have been mainly large corporations and commercial banks. Commercial banks were permitted to hold Treasury bonds as a part of their liquid assets and use those for secondary market transactions with the Central Bank in their liquidity management, which is expected to release the pressure on interest rate. However, these government bonds have not been held by the retail sector as much as planned, and the captive investors remain to be the largest holders of the government bonds. Fund management skills of institutional investors (e.g., insurance companies and pension funds) should improve while more marketing is needed to make the retail sector aware of the option of purchasing these government securities.

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1 The longest maturity is seven years.

2 The share of Treasury bonds in the total net domestic borrowing rose from 22% in 1997 to 72% in 1998.

3 The decision to allow treasury bonds to be freely usable to meet the liquid asset requirement, has a possibility of preventing the determination of a market-determined yield curve, which would provide a benchmark for the issuance of private debt securities.

As for the banking sector, banks have lengthened the maturity of the liability side by issuing debentures, and introducing a three-year deposit rate in case of the Bank of Ceylon.

4) Small Capital Market

Throughout the 1990s, the government focused on development of the local equity market infrastructure, resulting in the establishment of a modern stock exchange. The infrastructure for trading, clearance, settlement and safekeeping of securities already meets international standards. Several tax reforms have also been carried out, including grant of tax bonus (5% of the prevailing tax rate) to companies looking for listing in the Colombo Stock Exchange. Nonetheless, liquidity of the equity market is small and market capitalization to GDP is also small (11% as of the end of 1998), lower than the neighboring countries. And its development process has also been slower than those countries as shown in the table below.[4]

Market Capitalization to GDP

(%)

	1990	1996
Sri Lanka	11.4	15.1
India	12.7	36.1
Indonesia	7.6	12.8
Philippines	12.9	37.4
Pakistan	7.0	16.9
Thailand	29.7	1.7

Source: World Bank

The government is trying to reduce the dependence on foreign investors by broad basing the domestic investor base, both retail and institutional. For example, the two state pension funds (ETF and EPF), NSB and insurance companies have been permitted to invest in the equity market. Currently, there is an idea to use post offices as stock trading windows all over the country in order to solve the problem of little accessibility to the retail market. Efforts are also being made to develop the investment fund industry. CSE expects to more than triple the current market capitalization within three years.

In order for the equity market to develop further, it should attract listing of large companies (for example, through well-designed privatization programs of state companies) as well as active participation of large institutional investors like ETF, EPF, NSB and insurance

[4] Number of listed companies in Sri Lanka increased slightly from 175 in 1990 to 239 in 1997 underperforming most of the neighboring countries (Thailand 214 to 431, Pakistan 487 to 781, Malaysia 282 to 708, Indonesia-JSE 125 to 282, India 2,556 (1991) to 5,843, Taiwan 199 to 404 and the Philippines 153 to 221).

companies, who could make long term strategic investments in the stock market. These measures would not only help to stabilize the equity market but also increase the market size and liquidity.

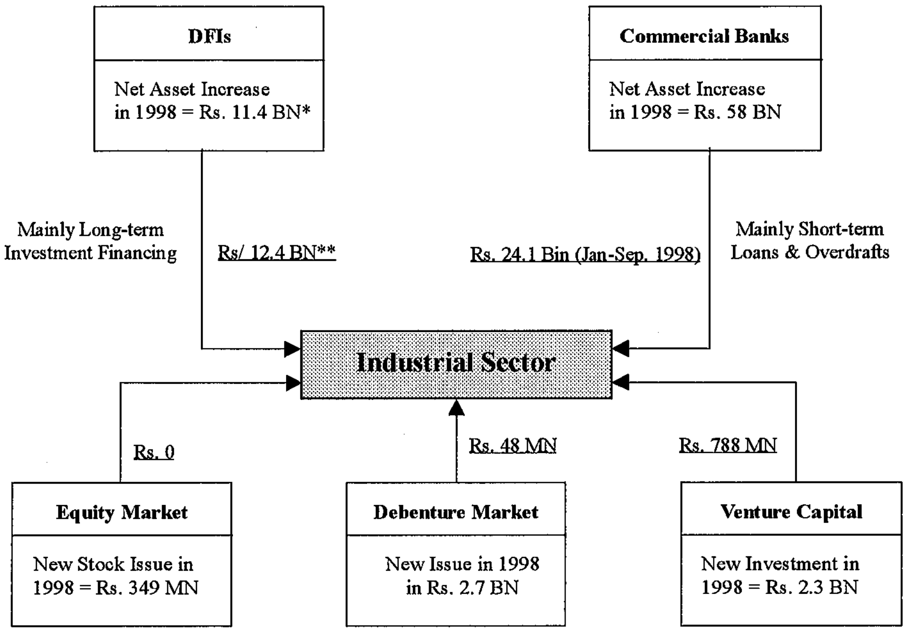
As for the debenture market, the 1999 Budget proposed further measure to provide an equal tax treatment for debt and equity instruments including removal of the stamp duties, and 10% withholding tax on interest earned on debt securities. The rules of the Stock Exchange were amended to permit companies to issue debenture independent of equity listing. Moreover, the Credit Rating Agency has been recently set up.

Further development of a debenture market requires sound macroeconomics such as low inflation and interest rate, currency stability, and a market oriented institutional investor base, including permission of foreign investors and non-bank financial institutions to participate in the market. Development of market-determined yield curve by further issuance of long-term government bonds is also required. The debt market is expected to be one of the fastest growing markets in Sri Lanka in the next decade.

1.3 Funding for Industrial Sector

1) Recent Funding for Industrial Sector

The following table shows the flow of funds to the industrial sector by source in 1998. Commercial banks are by far the largest source supplying a gross amount of Rs.24.1 billion in the first three quarters of 1998, of which about 70% were short-term loans. In 1998, commercial banks increased the assets by Rs.58.9 billion, of which Rs.17.9 billion was raised through foreign liabilities (non-resident foreign currency accounts, resident non-national foreign currency accounts and resident foreign currency accounts) and Rs.17.3 billion by time and savings deposits. DFIs supplied a gross amount of Rs.12.4 billion long-term loans to the industrial sector in 1998. Net investment by venture capitalists into the industrial sector was Rs.788 million and financing through issuing debentures was only Rs.48 million. There was no new listing of any industrial company in the equity market in 1998.



* Rs.5.1 BN for NDB in 1998 and Rs. 6.3 BN for DFCC in 12 months to March 1999
** Rs.10BN for NDB and Rs.2.4BN for DFCC

Inflow of Funds into the Industrial Sector in 1998

2) Banking System

Indirect financing is the main fund sourcing for the industrial sector in Sri Lanka. Bank borrowings are mainly used for working capital requirement, capital expenditure and export/import financing. There is not so much demand for funding an R&D expenditure yet, as R&D is not so active. Generally speaking, DFIs provide long-term capital expenditure loans and working capital loans at concessional terms, while commercial banks provide short-term loans to the private sector. (Commercial banks do provide concessional loans to the private sector such as SMILE and SMAP loans, which are provided to them by DFIs).

Banks are conservative, security-conscious and tend to take a long time in processing loan applications. Banks are expected to become more collateral-based in the near future in an effort to improve the non-performing ratio. Meanwhile, the presentation of project proposals by industrialists is generally poor which makes the banks even more security conscious. The Credit Guarantee System of Central Bank, set up in the mid 1970's, has not been operating effectively.

(i) Development Finance Institutions

DFIs provide investment loans or long-term capital expenditure to the private sector. Loans are generally given against the project assets. DFIs depend on the multinational and foreign funds for long-term funding to the industrial sector. Such loans accounted for 36% of NDB's borrowing as of the end of 1998 and 41% of DFCC's borrowing as of March 1999. The demand for these concessional loans is high as they carry lower rates than the market interest rates. The weighted average interest rate of NDB was 16.07% between December 1998 and November 1999.

The main institutional financing schemes for development of the industrial sector are introduced in the Box below.

Main Institutional Financing Schemes for Industrial Sector

- SMILE (Small and Micro Industries Leader and Entrepreneur Promotion Project)

SMILE is a loan scheme totaling 5,430 million yen provided by JBIC (Japan Bank for International Cooperation) for promotion of small and micro scale industries. Eligible enterprises are those with less than Rs. 10 million of fixed assets on completion of the project. The loan can be obtained mainly for the purchase of machinery and equipment, commercial vehicles, construction of factory, and the financing of permanent working capital requirements. Loan amount is up to 75% of the project cost subject to a maximum of Rs. 5 million. Repayment period is 3 to 10 years with grace period up to a maximum of 2 years with the annual interest rate not exceeding 14%.

- SMAP (Small and Medium Enterprise Assistance Project)

SMAP is the continuation of the four SMI loan schemes initiated by the World Bank. ADB loan of US$5.0 million and ADB guaranteed loan of US$50 million are also used for this loan. An eligible SMI has the fixed assets worth less than Rs. 40 million on completion of the project. The loan can be provided for purchase of machinery, equipment and commercial vehicles, construction of factory/office buildings and the financing of permanent working capital requirements. Loan amount is up to 75% of the project cost subject to a maximum of Rs. 20 million. Repayment period is 3 to 10 years with grace period up to a maximum of 2 years with the annual interest rate of 15 to 18%.

- Micro Credit Scheme

Micro Credit Scheme is tailored for micro enterprises and self-employment projects. The credit line is obtained from the Government of Germany, through kfW. The value of fixed assets of an eligible customer is less than Rs. 2 million. Loan amount is up to 75% of the project cost subject to a maximum of Rs. 250,000. Repayment period is 5 years with grace period up to a maximum of 1 year with the annual interest rate of 11% to 12%.

- PCAF (Pollution Control and Abatement Fund)

This credit line is provided by the Government of Germany through kfW to promote the pollution control projects in industrial enterprises, which initiated prior to 1995. Assistance is mainly for procurement of equipment for end-of-pipe treatment and equipment that contributes toward substantially improving the safety of the workplace, and the relocation of highly polluting industries to industrial estates equipped with waste treatment plants. Loan amount is up to 100% of the project cost subject to a maximum of Rs.10 million. Repayment period is 7 years with grace period up to a maximum of 1 year with zero real rate of interest.

- e-friend (Environmentally Friendly Solutions Fund)

JBIC provides this credit line for the promotion of energy saving and pollution control projects for industrial enterprises. Loan amount is up to 100% of the project cost subject to a maximum of Rs.20 million. Repayment period is 10 years with grace period up to a maximum of 2 years with the annual interest rate of 8.5%.

(ii) Commercial Banks

The loans to the industrial sector by commercial banks accounts for only 10.8% of total commercial loans, as of June 1999, which is smaller than the representation of the manufacturing sector in GDP (17% in 1998). As the table below shows, by far the majority of the commercial loan made to the industrial sector is the short-term loan (68.8%), 21.5% are medium-term and only 9.7% are the long-term loans.

Commercial Banks Advances to Industrial Sector by Maturity

(%)

	Short Term	Medium Term	Long Term	Total
Sep 1998	72.0	20.2	7.8	100
Dec 1998	70.8	20.2	9.0	100
March 1999	67.6	22.3	10.0	100
June 1999	68.8	21.5	9.7	100

Source: Central Bank

Short-term working capital financing by commercial banks has never been automatic and banks do not consider financing purely on the basis of confirmed orders, especially for SMIs (Banks provide quick loans only for known customers). It is lent against security such as stocks and receivables of customers.

As for export/import financing for industrial enterprises, the lending period is usually four to six months. There is keener competition among banks for export financing than import financing because banks are able to receive the repayment in foreign currency. Thus, the interest rate for export financing is 1 to 2% lower than import financing. Although the Sri Lanka Export Credit Insurance Corporation was established to provide guarantees to banks, it has not proven to be effective. The reasons for this were partly in debt recovery laws, which were heavily in favor of the borrower than the lender.

As of December 1999, the interest rate offered by commercial banks for long-term investment ranges between 16% and 23% and is not benchmarked to AWPR (Average Weighted Prime Lending Rate). The short-term interest rate ranges from 13.5% to 16% in the case of the Commercial Bank of Ceylon. Such a high interest rate has been dampening private enterprises in Sri Lanka, and has led to lower productivity and profitability in the industrial sector.

The banks may become more willing to lend long-term if they are able to raise long term funds. Commercial banks recently started to issue medium to long-term debentures. They also need to introduce long time deposit rate in order to be able to provide long-term funding to the private sector.[5] As of October 1999, 44% of liabilities of commercial banks remain in time and savings deposits for a maximum of 18 months.

3) Equity Market

The equity market has not yet become an effective funding source for SMIs in Sri Lanka. Value of new shares offered was Rs.2.178 million in 1996, Rs.583 million in 1997 and Rs.349 million in 1998. None of the manufacturing companies listed their shares between 1996 and 1998. The equity market has two major problems: the size is too small and the liquidity is quite limited. In addition, the market is almost entirely foreign driven, resulting in high market volatility. Also, there is reluctance on the part of enterprises about listing their shares on the Exchange. A listing would entail many obligations by way of meeting stringent continuing listing requirements of the CSE[6]. Companies have to be more transparent and accountable and there appears to be a fear of loss of control as well. The cost of equity is still high compared to the cost of bank borrowing cost and even compared to the debenture cost. All these factors combined with depressed market conditions make the equity market unattractive for industrial enterprises.

One positive sign for the SMI sector, however, is that the second board with lesser listing requirements has been established with the purpose of encouraging the medium sized companies to come for the listing. Industries with a capital of only Rs. 5 million and above are qualified for a listing on the second board and the continuing listing requirements are not so stringent as for the main board enterprises. CSE expects to more than triple the current market capitalization within three years.

4) Debenture Market

As discussed under the Section 1.2, the primary market for corporate debt is quite small and the secondary market trading of corporate debt listed on the CSE is relatively inactive. In 1998, seven companies listed debentures amounting to Rs.2,668 million, of which most was raised by banks and only 1.9% was raised by a manufacturing company (Ceylon Glass

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5 Commercial Bank of Ceylon lately introduced three-year deposit rate, which was welcomed by the market.

6 The listing requirements for the Main Board are as follows: The company should have an issued capital or a market capitalization of at least Rs. 75 million. At least 25% of the issued capital should be in the hands of the public. At least three years of satisfactory operating record. The listing requirements for the Second Board are as follows: The company should have a issued capital or a market capitalization of at least Rs. 5 million. At least 10% of the issued capital should be in the hands of the public. No operating record is required for the second board.

Company Ltd.) The corporate debt market has not yet become an effective funding source for SMIs. However, the debt market is expected to be one of the fastest growing markets in the next decade.

1.4 Financial Constraints for Industrial Development

Major bottlenecks found in the financial system for sustained development of the industrial sector are summarized below.

(i) High Interest Rate
The bank-lending rate has come down over the past years but still remains high even for concessional loans. The high interest rate dampens the private capital investment. The interest cost accounts for 3.7% of the total cost in the manufacturing sector on an average. There are many companies that refrain from making bank borrowings and use the same production machinery for decades, leading to low productivity, low efficiency and weak competitiveness of the industry as a whole. High and volatile interest rates also increase the risk for both lenders and borrowers especially for long-term investments and complicates the pricing of financial instruments. Interest rate should come down for development of long-term investments including both banking and capital market instruments.

(ii) Lack of Long-term Funding at Reasonable Cost
Concessional long-term loans provided by development refinancing schemes, particularly through DFI, are scarce while commercial banks are rather short-term oriented with most of their liabilities shorter than 18 months. The limited amount of long-term loans that commercial banks do provide to the industrial sector bear a higher interest rate, require more security and more cumbersome application procedures. Consequently, those enterprises which need to borrow at all from a commercial bank prefer (or obliged) to borrow short-term loans and roll them over even in case of financing a long-term project, resulting in bearing the maturity risk. Capital market, both equity and debenture, is still small to be an effective funding source for the SMI sector.

(iii) Security Driven Bank Loan
Basically, bank loans are provided against securities including concessional loans.[7] This

[7] In case of commercial bank loans in 1998, with regard to collateral, 88% of the loans were secured, while 26% of the total loans were issued against immovable property, plant and machinery. About 16% of the loans were covered by personal guarantees and promissory notes.

implies that small companies and start-up companies have difficulty in borrowing loans from banks. They are also unwilling to lend to SMIs for the small loans that require high transaction costs. The banks are conservative and rely on securities, rather than taking on the task of analyzing the proposed project cash flow and financial accounts of enterprises, which leads to high non-performing loans.

(iv) Lack of Effective Credit Guarantee System

There is no properly operated credit guarantee system. The Credit Guarantee System of the Central Bank, set up in mid 1970's for SMI loans, has remained ineffective.

(v) Poor Credit Analysis and Management on the Part of Banks

Bankers are not well trained in the area of credit analysis and management, which leads to high non-performing loans and poor financial status of banks. Lack of these skills also makes banks dependent on securities. Meanwhile, enterprises, especially small enterprises do not employ qualified accountants and this proves to be an obstacle when obtaining financial assistance or being monitored for progress by banks. There are cases when small enterprises lack financial discipline. In addition, some companies are not well versed in the loan scheme options available to them.

(vi) Lack of Policies

Institutional financial policy is not well incorporated into the industrial policy. It is the Central Bank and DFIs that take initiatives in implementing institutional financing for the industrial sector, and MID is not properly involved in this important financial operation in the industrial sector.

2. FISCAL POLICY

The budget is considered as the main policy document of the government and the main fiscal policy tools determining the levels and directions of the functions of the government. In developing countries like Sri Lanka, fiscal policy plays a dominant role in determining overall industrial development.

2.1 Current Fiscal Policy (Tackling with Budget Deficit)

Though improving slightly over the past decade, the government budget continues to be in the deficit, amounting to about 10% of GDP. Although the government expenditure to GDP has decreased over the past decade, the revenue to GDP has also decreased at a similar rate and thus the budget deficit to GDP remains at around 10%. The deficit budgetary policy has caused excessive growth in money supply, high inflation, high interest rate and pressure on exchange rate, as well as high public debt.

Since 1995, the fiscal policy has been directed to lower budget deficit through the correction of structural deficiencies in the budgetary operations. This deficit reducing strategy has been designed to be completed over the medium term. The short-term measures have also been introduced within the medium-term policy framework for the systematic consolidation of overall policy strategy. The short and medium-term strategies are expected to generate at least current account surplus in the budget and to help enhance the national savings and increase the public investments. The gradual reduction in overall deficit is designed to help solve most of the long lasting problems in the economy.

In the revenue side, short-term revenue measures have been taken for the revision of the National Security Levy (NSL), re-rating of excise taxes on an ad-valorem basis, introduction of new taxes (e.g., diesel tax, luxury tax and Save the Nation Contributions (SNC)), and revision of administration charges on public services and social security contribution on a cost recovery basis. Similarly, in the expenditure front, short-term measures have been implemented for elimination of wasteful expenditure, improvement of cadre management, use of privatization proceeds for settling high cost debt, reduction of operational losses of public enterprises, rationalization of welfare programs through better targeting, enforcement of borrowing limit on public enterprises and improvement of cash management and budgetary exemption procedures.

The medium-term policy structure consists in the elimination of distortionary taxes and movement towards a value added base taxation, widening the tax base by restricting tax evasions, improving tax administration, rationalization of public sector activities, continuation of public enterprise reforms, gradual reduction of security related expenditure, improving fiscal management and finally restructuring of public debt.

Summary of Government Fiscal Operations

(As % to GDP)

	1980	1985	1990	1995	1998 (a)
1. Revenue	19.6	22.3	21.1	20.4	17.3
2. Expenditure and Net Lending	41.8	34.1	31.0	30.5	26.4
2.1 Current Expenditure	18.5	20.1	22.3	23.1	19.7
2.1.1 Security	1.3	4.5	4.1	6.5	5.0
2.1.2 Interest	3.4	4.6	6.4	5.7	5.4
2.1.3 Wages (b)	4.5	3.6	3.9	3.4	3.0
2.1.4 Subsidies and Transfers	8.4	5.5	6.5	6.1	4.6
2.1.5 Others	0.9	1.9	1.4	1.4	1.6
2.2 Capital and Net Lending	23.3	13.9	8.7	7.4	6.8
2.2.1 Public Investments	18.5	13.8	8.3	7.9	6.7
Acquisition of Real Assets	7.9	4.5	3.7	3.4	3.2
Capital transfers	9.4	8.6	2.3	2.9	2.2
On Lending	1.2	0.6	2.2	1.7	1.4
2.2.2 Other	4.7	0.2	0.4	-0.5	0.0
Restructuring Cost	0.0	0.0	0.0	0.5	0.4
Others	4.7	0.2	0.4	-1.0	-0.3
3. Current Account Balance	1.1	2.2	-1.2	-2.7	-2.4
4. Overall Deficit Before Grants and Excluding Privatization Proceeds	-22.2	-11.7	-9.9	-10.1	-9.2
5. Financing	22.2	11.7	9.9	10.1	9.2
5.1 Foreign Financing	9.2	6.4	5.7	4.5	1.7
5.1.1 Loans	5.3	4.4	3.6	3.2	1.0
5.1.2 Grants	3.9	2.0	2.1	1.4	0.7
5.2 Domestic Financing	13.0	5.3	4.2	5.1	7.0
5.2.1 Banks	9.8	2.9	0.1	1.1	1.9
5.3 Privatization	0.0	0.0	0.0	0.4	0.4

(a) Provisional

(b) Excluding those paid to defense staff

Source: Central Bank

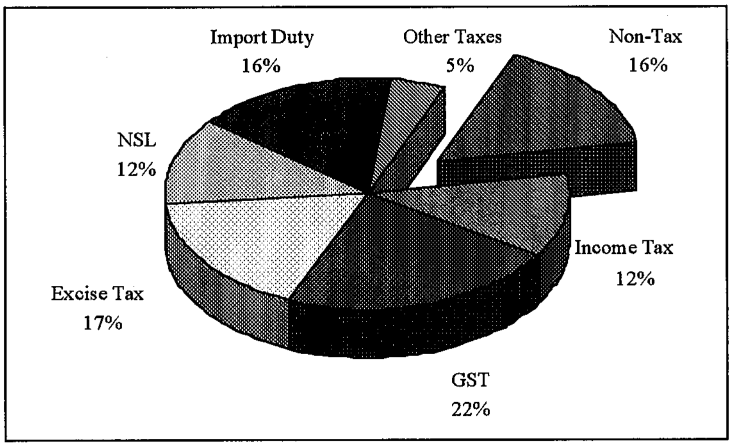
As for financing the budget deficit, the government is now heavily dependent on domestic sources in financing the deficit as the resources available from foreign concessional loans and grants have been limited over the period. As shown in the table, the amount of domestic financing surpassed foreign financing in the first half of the 1990's. The government raises funds from domestic markets through three major debt instruments; i.e., Treasury bonds, Treasury bills and Rupee securities. The domestic borrowing policy currently emphasizes the need of shifting from short-term instruments to medium and long-term instruments, and from non-marketable to market orientation with the intention of developing medium to long-term markets for the government securities.

2.2 Fiscal Mechanism

1) Tax Revenue

Government revenue consists of tax and non-tax revenues, and the tax revenue accounts for about 85% of total revenues. Tax revenue to GDP has declined and thus offers little scope for significant enhancement in the short term.

In Sri Lanka, tax policies have been often changed and re-estimated in line with the changes in overall policy strategies. With the liberalization of the economy together with the export-led growth strategy, taxation of export sector was gradually phased out over the period. In the meantime, government resource mobilization has gradually shifted from direct taxes to indirect taxes with the view of enhancing saving and investments through higher private sector participation. Tax revenue composition for 1998 is illustrated below. At present, the government raises more than 90% of the tax revenue through five major taxes, GST (22% of revenue in 1998), excise taxes (17%), and import duties (16%), income tax (12%) and NSL (12%).



Government Revenue Composition – 1998

Progressive reforms in the tax system were implemented in the 1990's aiming at a decrease in budget deficit through the correction of structural deficiencies in the budgetary operations.

Removal of export duties and introduction of a number of new taxes such as NSL, Excise tax, Save the Nation Contributions (SNC) and GST (Goods and Services Tax) could be listed as major reforms.

The burden of direct taxation was gradually lowered by reducing the marginal tax rate, with the intention of encouraging the private sector to enhance savings and investments. In addition, the role of direct taxation shifted from the function of resource mobilization more towards resource allocation during the recent period. In this context, the government had to rely heavily on indirect taxes in raising revenue. Import duty structure was designed to play a dual role: revenue generation and protection of import substitution industries in the economy. However, the tariff structure was continuously simplified by lowering the tariff rate and no tariff band that reduces the level of protection. The current strategy in the tax front aims at simplification of the tax structure by lowering the number of taxes and tax rates and the broad base of tax system through tax administration.

Goods and Services Tax (GST)

Introduction of GST in April 1998 in place of TT (Turnover Tax) was the most important reform introduced to improve the efficiency in tax system. GST, a derivative of a value added tax, is generally considered as clear, efficient and self-policing consumption based indirect tax. GST applies a single rate of 12.5% to all imports, manufacturing and service sectors with a registration threshold of 1.8 million per year to exempt any small businesses. Exemptions are also given to a wide range of activities such as health care, education, financial services, the primary produce of agriculture, some foodstuffs and commodities. The government intends to rely on the GST as the main revenue raising instrument in the future and the tax base of GST will likely expand in the future.

Full input tax credit mechanism to refund GST paid on inputs is implemented in order to eliminate cascading cost on production and distribution (this refunding procedures, however, should be simplified). In comparison with TT, GST would thus help to improve horizontal integration of industries that helps for the specialization in manufacturing activities while discouraging vertical integration. In addition, domestic industries and exports have been placed on an advantageous position over import of finished products through an input credit system providing an investment incentive for local production. The taxation of GST is under the destination principle and all exports are zero rated. Direct exporters are given deferred payment facility for imported inputs.[8] Although GST is much simpler than TT, some SMIs without a proper accountant still have trouble adjusting to the change. Some supplies are exempt from GST, which means that no tax is payable but the GST paid on inputs cannot be claimed either. Hence, when an exemption occurs at the beginning or in the middle of the supply chain, non-recoverable tax tends to occur. As a consequence, such non GST payers are put on disadvantageous position compared to its GST paying competitors and opt to register themselves as GST payer voluntarily. Such voluntary registration has reached approximately 6,000.

[8] Imports for processing of exports, which were exempted under TT, were brought under the GST system.

2) Expenditures

High current expenditure is largely due to the high cost on interest payments, salaries of public servants, security related expenditure and direct welfare payments, leaving little room for the flexibility in budgetary. The government has not been so successful in restraining the current expenditure. Instead, the government has been restraining capital expenditure in order to control overall expenditure. The share of current expenditure to GDP has increased from 18.5% in 1980 to 19.7% in 1998 while that of public investments has declined drastically from 18.5% to 6.7% during the same period. Capital expenditure in the infrastructure sectors such as energy, transport and telecommunications has declined as a share of GDP. The long term development potential of the country may be put at increasing risk if the government fails to allocate sufficient expenditure on infrastructure investment.

3) Constraints in Budget and Possible Solution

Deficit in the current account, as well as large overall budget deficit, creates severe difficulty in overall economic management. Large government borrowings from domestic sources will pre-empt resources in the market that crowded out private investment while banking sector financing in budget deficit fuels for high inflation in the economy. The reduction of the budget deficit through the fiscal consolidation process is the only way to emancipate the country from an in-built macroeconomic bias. In this process, curtail of expenditures should be aimed at current expenditure side by rationalizing welfare payments, reducing security related expenses, carrying out public sector reforms, pension reforms and savings of domestic interest cost through low interest rate regime (according to the World Bank's estimate, Sri Lanka's debt service is expected to increase from US$401 million in 1998 to US$457 million in 2003 and US$470 million in 2007). At the same time, buoyancy in the tax system needs to be improved to some extent mainly through broad base of tax structure and tax administration. This process may take some time to accomplish and short-term significant recovery in the budget is unlikely.

2.3 Budget Procedure

Budget approval process for each Ministry takes steps as summarized as follows. The process is different for the Recurrent Expenditure, Capital Expenditure and Foreign-aided Project.

(i) Recurrent Expenditure

Each Ministry with the assistance from its Planning Division and Accounts Division prepares a budget estimate for the Recurrent Expenditure for the subsequent fiscal year and submits it to the Department of National Budget of the Ministry of Finance and Planning (MOFP). The Department of National Budget holds a meeting to consult with each Ministry and decides on the amounts to be allocated under each expenditure item for the Recurrent Expenditure budget.

(ii) Capital Expenditure

Each Ministry prepares its capital expenditure estimate for the subsequent year with assistance from its Planning Division and submits the budget proposal to the Department of National Budget for approval. The Department of National Budget prioritizes proposed projects often through discussions with the Ministries and then determines the capital allocation for each Ministry. If a new capital project is introduced, approval of the Cabinet has to be obtained in advance.

(iii) Foreign-aided Projects

In case of the projects using a foreign aid, the Department of External Resources of the MOFP decides on the priorities based on the recommendations made by the Department of National Planning, as well as on the policies/objectives agreed with the donor agencies. The Department of External Resources recommends proposals for inclusion by the Department of National Budget. The Department of National Planning does not review the proposal made by the Department of External Resources as extensively as the estimates for Recurrent Expenditures or Capital Expenditures.

As for new projects, each Ministry consults the relevant Departments of the MOFP and also obtains approval of the Cabinet well in advance of submitting the estimates to the MOFP. After these processes, the MOFP makes a budget draft including the Recurrent Expenditure, Capital Expenditure and foreign aided projects, and then submits it to the Cabinet. Draft estimates of the central government revenue and expenditure include central government transfers to sub-national governments (Provincial Councils and local governments) as well. After review and approval by the Cabinet, the Appropriation Bill will be submitted to the Parliament for final approval, about four weeks prior to the budget date. On the Budget day, the Minister of Finance announces the measures on revenue and expenditure and the amount of borrowings to fill the gap between receipts and payments of the budget.

At present, the budget for each Ministry is considered on identified programs and projects basis. However, from the year 2000 the government will adopt a new output-based Modified Program Budgeting System in order to better allocate the budget by category. Each Ministry will have up to 10 programs.[9]

2.4 Fiscal System for Industrial Sector Development

1) Budget of Ministry of Industrial Development (MID)

Budget Making Process

Every February, MID's three programs (General Administration, Development of Industries and Promotion and Development of Handlooms and Textile Industries and related Activities) prepare budget requirements for the subsequent fiscal year in line with the guideline to be defined on the basis of the 'Public Investment Program 1998-2002' prepared by MOFP. MID's opinion is reflected in this five year investment program. By March 31, a draft budget of these three programs will be finalized including the foreign-aided projects, which is presented to the Treasury for negotiation. The negotiation between MID and MOFP generally lasts until June. For the foreign-aided projects, MID, representatives of the foreign governments and Director General of External Resources will discuss the draft together. The approval by the Cabinet for large projects is required even during this process.

Expenditure of MID

MID's expenditure between 1995 and 1999 including the Department of Textile, which is under the supervision of MID, is summarized in the next table. Capital expenditure of MID accounts for the largest share of the total expenditures, of which the Industrial Estates Projects take the largest portion. Capital expenditures for Industrial Estates Projects have been increasing sharply from Rs. 228 million in 1996, to Rs. 522 million in 1997, Rs. 1,547 million in 1998 and Rs. 854 million in 1999, most of which consists of the budget for the Seethawaka Industrial Estate. This is because the government initiated a new industrial strategy in 1995 with special emphasis given to establishing industrial estates. The budget for Industrial Estate Projects is expected to be Rs.357 million in 2000 and come down after 2002. Budget for Industrial Development Board (IDB) is generally small at approximately Rs. 20 million. Big jumps in 1997 and 1998 are due to implementation of the Foundry Development and Training Center.

[9] 1. Civil Administration, 2. Public Order, 3. National Security and Defense, 4. Social Security and Welfare, 5. Human Resource Development, 6. Infrastructure Development 7. Economic Services, 8. Research and Development, 9. Culture, Art and Religion and 10. Restructuring and Reforms

It is also noted that there is no clear distinction of the projects carried out by MID and other related governmental organizations and there is no sufficient coordination among them either in the area of budget or in projects.

MID Expenditure

(Rs. Thousand)

	1995	1996	1997	1998 Est.	1999 Est.
Recurrent Expenditure					
MID	124,053	176,043	193,178	460,531	222,374
Dept of Textile Industries	29,511	37,552	34,783	41,104	42,322
Total	153,563	213,595	227,961	501,635	264,696
Capital Expenditure					
MID	189,552	343,634	750,226	1,844,385	1,067,180
(Industrial Estates)	(-)	(228,127)	(521,894)	(1,547,200)	(854,200)
(Contribution to IDB)*	(-)	(20,000)	(17,000)	(113,700)	(20,000)
(NIBM)*	(7,000)	(20,000)	(6,000)	(15,000)	(0)
Dept of Textile Industries	3,128	6,146	5,667	3,600	10,100
Total	192,681	349,780	755,894	1,847,985	1,077,280
Grand Total	346,244	563,375	983,855	2,349,620	1,341,976

*Expenditures of IDB and NIBM are estimate figures.

Source: MID

Monitoring Process by MOF.

MID needs to submit quarterly progress reports both on capital and recurrent budgets to the Ministry of Plan Implementation, which in turn reports to the President. MID also submits monthly expenditure reports to the Treasury. The President calls MID and the Treasury for the quarterly meeting to discuss mainly on the progress of capital expenditure spending. The Auditor General appointed by the Parliament audits on a continuous basis by stationing five of his staff at MID.

2) Expenditures of Other Industry-related Organizations

Expenditures of other governmental organizations related to industrial development are also summarized in the following table:

Expenditure of Industry-related Organizations

	1997	1998 Est.	1999 Est.
Recurrent Expenditure			
MOST	403,225	452,463	469,744
MVTRI	-	434,030	610,285
MIICF	100,585	123,275	142,246
MPAHAPI	371,810	669,121	726,075
Capital Expenditure			
MOST	136,590	353,325	860,050
(ITI)	n.a	n.a	(30,000)
(SLSI)	n.a	n.a	(30,000)
MVTRI	-	409,300	480,520
MIICF	1,194,247	345,115	330,630
(EDB)	n.a	n.a	(300,000)
MPAHAPI	1,305,182	1,014,740	2,635,500
(SLIDA)	(20,300)	(24,500)	(26,000)

Source: MOST, MVTRI, MIICF, and MPAHAPI

3) Fiscal Policy for Industrial Development

Promotion of private investments on industrial activities became one key objective in the fiscal policy agenda since liberalization in 1977. The government has realized that fiscal incentives and public investment play a positive role in removing disincentives and stimulate investment especially in high risk taking activities. Fiscal policy had been designed to promote industrial development in two ways; one was to provide a wide range of incentives to attract private sector participation in investing on the industrial sector and the other was to directly allocate fiscal resources to broaden the production capacity in the economy. Taxation policies as well as expenditure policies, therefore, were redesigned to remove the supply bottleneck in the industrial sector and to achieve desired targets. Direct taxes have played a major role in promoting resource allocation in the industrial sector by providing tax holidays and various other tax reliefs for industrial investments. In addition, other taxes (e.g., import duty, NSL, Stamp Duty, GST) have also been used to direct the private investors towards the industrialization strategy.

The factors identified as detrimental to the fast industrialization process are lack of attention or less interest on R&D. Establishment of the National Research Council[10] and Presidential Fund for Innovators are some of the steps taken during the recent past to overcome R&D

[10] The National Research Council was established in 1998 for the coordination of all research institutions of the government. This Council is functioning directly under the President and helping to formulate research policy in all sectors and is responsible for the allocation of resources.

problem. Meanwhile, human resource development was also brought under the purview of fiscal policy specially to improve computer and management skills of educated youths. In order to overcome the problem of lack of skilled labor, the Skills Development Fund was set up in 1999 to encourage the employers to conduct job entry training, upgrading and retraining of their employees as well as to improve enterprise based training. It is the first of its kind in the country and should be marketed more aggressively. In addition, government has extended financial assistance to IDB, National Institute of Business Management (NIBM) and other private parties to train the unemployed with the intention of reducing the mismatch in the labor market, as well as to improve the quality of labor available at the market.

4) Fiscal Incentives for Industrial Development

Tax incentives provided to the industrial sector can be categorized into two types; i.e., incentives offered under Section 17 of the BOI Law, and general incentives under the normal laws of the country. The incentives offered under Section 17 of the BOI Law are discussed separately in "Investment and Trade". The Secretary of MID sits at the Board of BOI but BOI takes initiatives in offering the incentives to the industrial sector under Section 17 of the BOI Law. The incentives under the normal laws are discussed below.

(i) Fiscal Incentives for Introduction of New Technology

- 'Fiscal Incentives for New Investments Utilizing Advanced Technology' or so called Advanced Technology Incentives is the only tax incentive offered by MID. It was first introduced through the 1996 budget and was extended three times to 2001. It is to encourage both existing and new enterprises to acquire advanced technology and to modernize their production. However, its main interest seems to lie in creation of employment rather than introduction of advanced technology. For instance, it requires minimum additional employment of 50 persons for existing companies, which contradicts with the basic concept of introducing advanced technology. The requirement of minimum 50 employment for start-up companies also seems too high. Moreover, this incentive is readily offered to not-so-advanced machinery and equipment as long as they are new.

  The Advanced Technology Incentive scheme offers duty free import of approved machinery and equipment and five year tax holiday for new enterprises. It also offers import duty waiver on approved machinery and equipment and a five-year tax exemption on profits attributable to new capital expenditure for existing enterprises. A five-year tax exemption on incremental profits for existing companies is not so attractive compared to the benefits gained through the Investment Tax Allowance while a five-year tax holiday is not so significant to new companies as they do not usually make enough profits to pay corporate tax in the initial stage.

Despite its lenient selection (approximately 90% approved rate), this incentive scheme does not seem to appeal so much to the investors. Total approved investment has been decreasing from Rs.24.5 billion in 1996 to Rs.4.4 billion in 1997, Rs.5.4 billion in 1998 and Rs.2.8 billion as of November 25, 1999. Many companies which have their projects approved under this incentive program have declined the approval and switched over to the 'Investment Tax Allowance'[11], which has proved more beneficial to investors. As of November 25, 1998, Rs.37.2 billion has been approved under the present incentive but only Rs.9.5 billion worth projects, or 25.5% of the approved amount, has been implemented under the present incentive.

Projects Approved for Advanced Technology Incentives
(Nov. 1995-Nov. 1999)

	Sector	No. of Projects Approved			Investment Involved (Million Rs.)		
		New	Existing	Total	New	Existing	Total
1.	Food Beverage & Tobacco	25	72	97	2,464	6,578	9,042
2.	Textile Wearing Apparel & Leather Products	14	43	57	759	1,849	2,608
3.	Wood & Wood Products	7	10	17	268	210	478
4.	Paper & Paper Products, Printing ' Publishing	11	38	49	665	1,636	2,301
5.	Chemical, Petroleum & Rubber Products	45	126	171	2,178	5,503	7,681
6.	Non-Metallic Mineral Products	10	11	21	1,684	669	2,353
7.	Basic Metal product	6	17	23	1,037	1,070	2,107
8.	Fabricated Metal Products	18	51	69	726	2,700	3,426
9.	Constructions	13	16	29	687	588	1,275
10.	Other Industries*	9	6	15	1,106	216	1,322
	Total Industrial	158	390	548	11,574	21,019	32,593
	Total Services	14	23	37	549	4,054	4,603
	GRAND TOTAL	172	413	585	12,123	25,073	37,196

Note: *Including the machinery and electric/electronic industries.
Source: MID

Therefore, this incentive is now used mainly to receive the import duty waiver both by new and existing companies. It would be better to introduce two separate incentives; zero-rated import duty on capital investment and continuation of Investment Allowance Tax. (Further discussion is made in Section 4.1 Resources Allocation.)

[11] 'Investment Tax Allowance' is to set off 75% of capital investment against 50% of the assessable income. When investment exceeds Rs. 250 million or is undertaken in backward areas, 100% on investment can be set off against 75% of assessable income. This incentive is scheduled to be terminated in 2000.

- "President's Fund for Inventors", set up in 1998, is also to promote innovative projects designed to adopt new technology with emphasis on the development of products utilizing local material and creating employment for educated youth.

(ii) Incentives for Direct and Indirect Exporters

The exporters, who do not receive concessions under Section 17 of the BOI Law, may get tax concession under the normal law of the country. Under this scheme, the profits of a company earned through exporting non-traditional goods both directly and indirectly are liable for payment of income tax at a lower rate (15%) until April 2014. Other general benefits include accelerated depreciation allowances.

There are also several other schemes to help exporters obtain duty-free access to imports and local purchases, if they are required for export production, which are serviced by the EDB.

(iii) Other Incentives

- The lower National Security Levy of 0.5 % for the importation of machinery and equipment.

- The duties on textile and other related raw materials were abolished in the 1998 budget to overcome the customs related problems faced by the export oriented garment manufactures who relies heavily on imported raw materials. Accordingly, import of yarn, fabrics and all related intermediate and capital goods were made duty free from November 1997. This measure is expected to eliminate customs delays, smuggling and under invoicing, as well as to reduce lead-time of exports. Meanwhile, a 10% customs duty was imposed on import of ready-made garments to encourage non-export or domestic market oriented garment industry.

2.5 Major Constraints for Industrial Sector

Although some fiscal incentives are extended to the industrial sector, industrial development still has various difficulties as pointed out hereunder. Major constraints and proposals are cited to facilitate formation of the financial and fiscal framework in Chapter 3 in more detail.

(i) Revenue constraints in the public sector that directly relate to lower public investment such as infrastructure investment are one major problem in the expansion in production capacity in the economy. Inadequate infrastructure causes higher costs in marketing, transportation and communication, as well as instability of energy supply. Empirical studies have identified that public investment has a positive relation with private investment. In fact, there is a strong dissatisfaction and need in the industrial sector for the infrastructure including traffic, road, electricity and energy.[12] The private sector has not participated in infrastructure development as much as desired by the government.

(ii) Concentration of industries more on garment and apparel industries would have a risk with the abolishing of MFA. Although the diversification of industrial production has taken place over the years, still 44% of industrial production and 67% of industrial exports derive from apparel and textile production. Fiscal policy should be aimed at diversifying the industrialization process.

(iii) There is a favoritism for BOI companies against non-BOI companies and exporting companies against non-exporting companies, which should be gradually remedied.

(iv) There is a need to move from a subsidy-based investment culture to an efficiency-based investment in order to efficiently use the limited amount of resources.

(v) Inadequate development of infrastructure led to unequal regional distribution of industries. Although, the government in the recent past has given several incentives to disperse industries to the regions, further encouragement should be given to the regionalization of industries.

(vi) The commercialization of new research findings and new innovations is essential to continuous enhancement of productivity and competitiveness of the industrial sector. However, institutional arrangements for commercialization of research and development in Sri Lanka have not improved to the required level[13].

(vii) There is little coordination between MID and other industry-related institutions (e.g., MOST, MVTRD, BOI, EDB and CINTEC) though some of their missions and incentives given to the industry overlap one another (this issue is discussed separately in "Administrative/Legislation/Institution").

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[12] In the questionnaire survey conducted to 24 enterprises in 4 sub-sectors, 27% replied infrastructure when asked critical problem for business. Also when asked about critical infrastructure problem, 63% pointed out high cost of electricity, 52% traffic congestion, 41.7% poor road conditions (pavement, etc.), 42% poor electricity/power failure and 25% poor road network.

[13] It has been observed that although 125 patents have been issued for new innovations during 1990-1995 period only one company has started commercial production of the patented items.

3. FINANCIAL AND FISCAL FRAMEWORK FOR INDUSTRIAL DEVELOPMENT

3.1 Financial Improvement

1) Needs for Public Financial Support

(i) Strong Need for Concessional Loans

From the questionnaire survey conducted by JICA to 204 manufacturing enterprises in four sub-sectors (51 electrical/electronics enterprises, 50 machinery enterprises, 50 rubber enterprises and 53 plastic enterprises), as well as survey conducted by UNIDO in two subsectors (apparel and leather), it was revealed that there is a strong need for both public and commercial loans. According to the questionnaire survey, a total sum of the future borrowing plan reaches Rs. 6,500 million, as tabulated below.

Future Borrowing Plan by Sub-sector

(Rs. million)

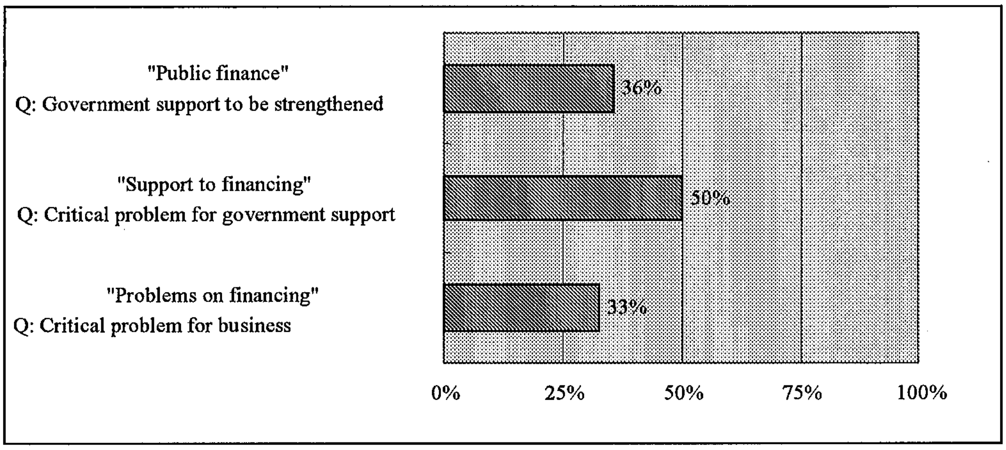
	Leather	Rubber	Plastic	Machinery	Electrical/ Electronic	Total
Public Loan	240	2,060	440	100	430	3,270
Commercial Loan	170	2,160	330	110	470	3,240
Total Borrowing Plan	410	4,220	770	210	900	6,510

Note: Data on the apparel sector have been incomplete.
Source: Questionnaire Survey

Nearly 50% of the surveyed enterprises have plans to increase both commercial and public loans in the near future. As for the amount of the borrowings, about 25% says "Rs. 1 to 5 million", followed by 14% of "Rs. 0 to 1 million", and 13% of "Rs. 6 to 10 million". Companies tend to rely on commercial loans more than on public loans for both investment and working capital. About 34% of the surveyed enterprises replied that they are dependent (including heavily dependent and rather dependent) on commercial loan for investment and working capital respectively, while dependence on public loans for investment and working capital ranges from 21 to 24%. This implies that there is a shortage of public loans, and that companies borrow short-term commercial loans and roll them over even for long-term investment purposes as commercial banks offer mainly short-term loans to the industry.

From the questionnaire survey and interviews with some of these enterprises, it has been found that there is a strong need for public support on finance and loans at concessionaire rates both for working capital and capital investment purposes. For instance, when asked about critical problems in government support, more than 50% replied that the problem is support in financing. When asked about critical problems in business, more than 33% replied "problems on financing". And to the question asking the government support to be strengthened, 36% replied "public finance" (see Table below).

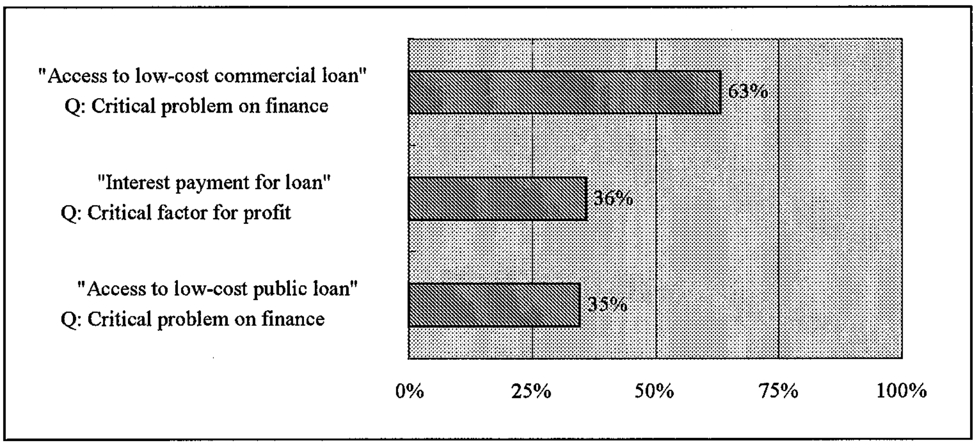
Strong Need for Public Financial Support



Source: Questionnaire Survey

More specifically, there is a strong demand for concessional loans. When asked about critical problem on finance, 63% replied that it is an access to commercial loans at low interest rates, and 35% replied "access to public loans at low interest rates". 36% of the surveyed enterprises replied "interest payment for loan" when asked about the critical factor for profit. It would be appreciated if the concessional loans to the industrial sector would be increased and the interest rate is further lowered.

Critical Need for Low-cost Loan



Source: Questionnaire Survey

(ii) Establishment of Effective Credit Guarantee System

Establishment of an effective credit guarantee scheme would greatly facilitate and enhance a flow of the loans to the SMI sector as the banking sector is expected to rely more heavily on collateral. In fact, the majority of companies interviewed say that a lack of collateral is one of the major problems on finance and many neighboring countries either have established or are in the process of establishing the credit guarantee system.

(iii) Support to Venture Companies

In addition to provision of financial support to the existing SMI sector, the need for the public venture capitalists' role would also be substantial for promotion of the SMI sector by bringing in new high-quality companies into the market. There is a need to create the environment in which new entrepreneurs will be motivated to establish own companies. Even in countries where the market is relatively efficient and competitive, the government offers support to the venture companies. 24% of the enterprises replied "entrepreneurship development" when asked about government support to be strengthened. (Public venture capitalist's role is proposed more in detail in Chapter 4.)

(iv) Support for Financial Management of Companies

Many SMIs lack proper accounting and financial practices, which has become a hindrance to the banks in analyzing the proposed projects of potential customers. For instance, there are many companies that have not yet fully adapted to the change from the turnover tax to GST even after two years. Improvement of financial management on the part of enterprises would facilitate the credit analysis by banks and decrease default rate and eventually lead to lowering interest rates. Public support and advice should be offered to SMIs in the area of financial management. (Public support on financial management to SMIs is proposed in detail in Chapter 4.)

2) Improvement in Financial Sector

(i) Development of Financial Infrastructure

In order for the industrial sector to achieve sustainable expansion, development of stable and efficient financial infrastructure including currency and interest rate would be indispensable. For example, when asked about the critical problem in finance in the questionnaire survey, 47% of enterprises pointed out a depreciation of Sri Lankan Rupee. Since the import ratio of raw materials is high for the four sub-sectors (over 50% of the four sub-sectors import over 50% of raw materials on an average), depreciation of Rupee is a serious concern.

Meanwhile, high and volatile inflation and interest rates should be stabilized for development of long-term investment including both banking and capital market instruments, as it only increases the risk for both lenders and borrowers and complicates the pricing of financial instruments, especially that of the longer-term. There should be an incentive for investors to invest for longer terms by offering them medium to long-term deposit rates with reasonable spread.

(ii) Development of Capital Market

Sri Lankan enterprises mainly depend on the banking sector for fund raising, and the capital market is not large enough yet to be an effective funding source for the industrial sector. Development of both equity and debenture markets would greatly enhance the industrialization process of the country[14]. The equity market capitalization is expected to increase at least by three times within three years. Recently established Credit Rating Scheme should be expanded successfully for the development of the debenture market. The debt market is expected to be one of the fastest growing financial sectors for the next decade.

(iii) Reinforcement of Banking System

The banking sector also has some room for improvement in order to better service the industrial sector.

- Improvement of Financial Performance of Banks

Commercial banks should reduce the costs and improve their unfavorable financial condition. They need to improve loan recovery rates through reinforced credit analysis and credit management skills. It should eventually lead to a lower interest rate.

- Restructuring and Ultimate Privatization of State-owned Commercial Banks:

Privatization of the two state-owned commercial banks, which account for the majority of the domestic commercial banking sector, has long been discussed in vain, though the government realizes that it is necessary to privatize them eventually. Further progress in the restructuring, and eventual privatization, of these state commercial banks is necessary for strengthening the banking sector as a whole.

[14] Empirical studies show that there is a correlation between the development of the banking sector and liquidity of the stock market and the economic growth rate. (The Economist October 23, 1999).

3.2 Improvement in Fiscal Support

1) Needs for Tax Incentives

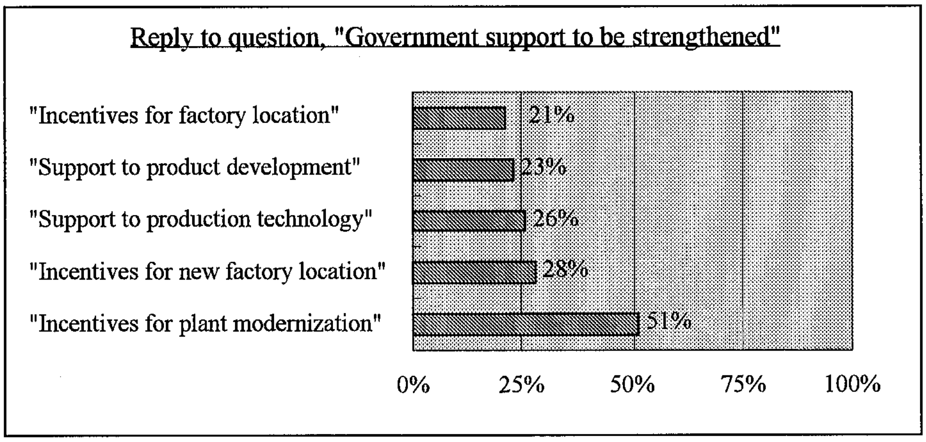
There is a strong need in the industrial sector for tax incentives. When asked about the critical problems in government support, 37% pointed out "weak investment promotion/incentives". Based on the questionnaire survey, a strong need was found in the industrial sector for government support in technology, marketing, training and R&D, as well. Government support including tax incentives could be used wisely to meet the needs for such support.

From the questionnaire and interview survey, a strong need for government supports is found in the following areas of the business.

Support for Technology Enhancement

When asked about the government support to be strengthened, 51% replied "incentives for modernization of plant", 28% "incentives for new factory location", 26% "support to production technology", 23% "support to product development" and 21% "incentives for factory location".

Needs for Support to Technology Enhancement



Source: Questionnaire Survey

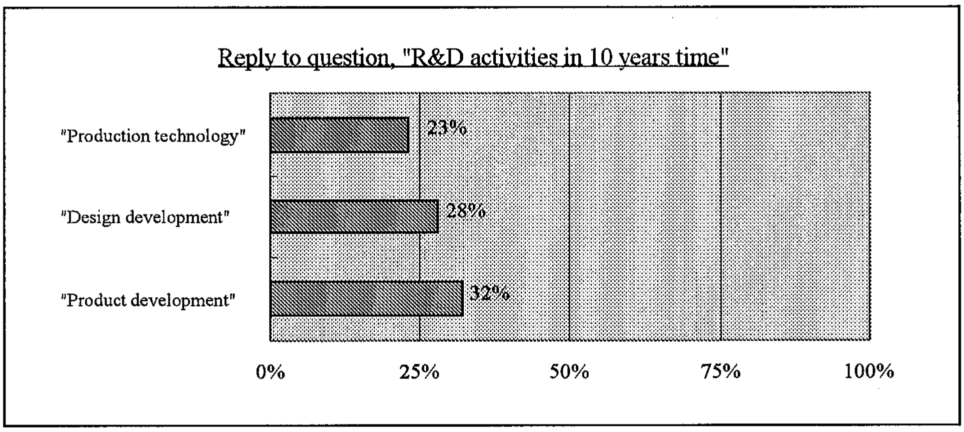
When asked about the basic strategy to be taken, 63% replied to "diversify product line", 53% to "modernize production process", and 36% to "produce high-value added products". It is also noted that in the questionnaire survey, 23% of enterprises pointed out "access to advanced technology information" when asked about critical infrastructure problems.

Support for R&D

When asked about R&D activities in next 10 years time, 32% pointed out “product development”, 28% “design development” and 23% “production technology”. Especially 29% of the electrical/electronic enterprises replied “strengthen own R&D activities” when asked about basic strategy to be taken. Financial and fiscal support to R&D investment in these areas should be effectively used.

In Sri Lanka, more than 90% of the research and development is carried out by the state sector but there has been lack of contact between the state industrial research institutes and industry. It is also essential that these institutes interact closely with industrial producers[15].

Need for Strengthening R&D



Source: Questionnaire Survey

Support for Training

When asked about manpower shortage in 10 years time, 46% pointed out “skilled-labor/technician”. When asked about basic strategy to be taken, 28% of the enterprises replied “strengthen manpower development”. When asked about the government support to be strengthened, 24% replied “public manpower/skills training” and 20% “support to on-the-job training”. Also according to the survey, 96% of training takes place on an on-the-job basis, but in 10 years time, only 58% of such training is expected to be carried out on an on-the-job basis, indicating a high expectation for outside institutions to take on this role.

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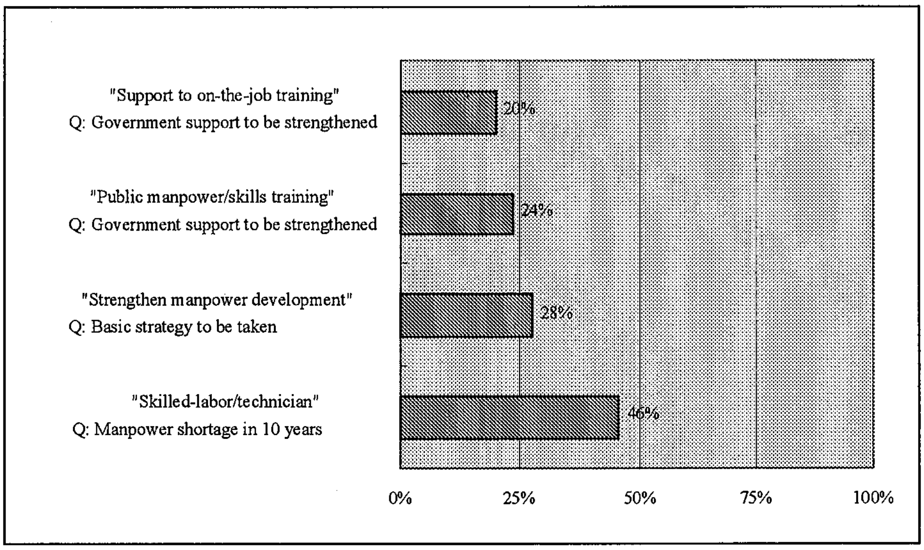
[15] Cited from ‘Development Strategy and Industrial Policy – Issues for Sri Lanka’ by Institute of Policy Studies.

Need for Strengthening Training

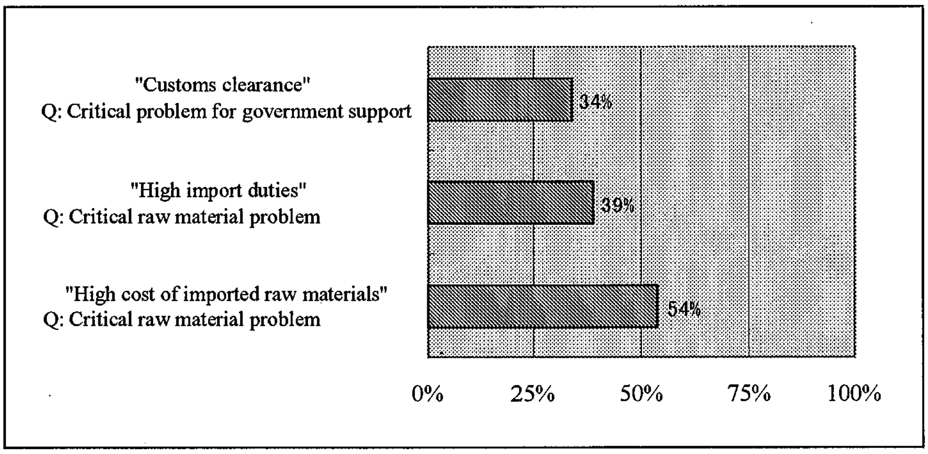


Source: Questionnaire Survey

Support for Import of Raw Materials

It is also noted that many enterprises reply on imported raw materials. For instance, 82% of companies pointed out "raw material costs" when asked about critical factors for profit. These enterprises expect to import more raw materials from abroad in the future. The ratio of imported raw materials is expected to remain high, particularly for plastic and electrical/electronic sectors, as 75% of electrical/electronic and 80% of plastic companies expect to import more than 50% of raw materials for next 10 years. When asked about critical raw material problem, 54% of the enterprises replied "high cost of imported raw materials" and 39% "high import duties".

Need for Incentives for Importing Raw Materials

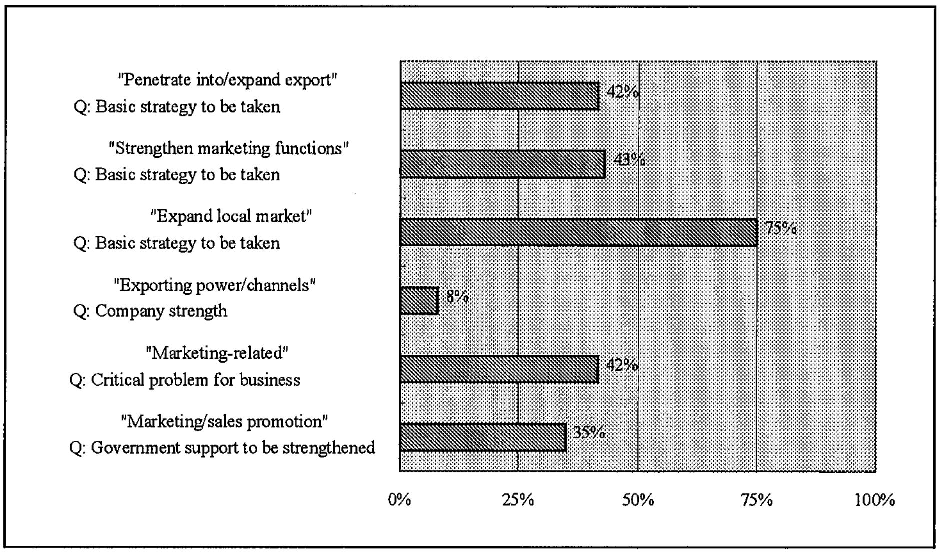


Source: Questionnaire Survey

Support for Marketing

Asked about the government support to be strengthened, 35% pointed out "marketing/sales promotion". For the question about critical problem for business, 42% pointed out "marketing-related". When asked about the basic strategy to be taken, 75% pointed out "expand local market", 43% pointed out "strengthen marketing functions" and 42% "penetrate into/expand export".

Need for Strengthening Marketing



Source: Questionnaire Survey

Both fiscal and technical support to the above areas should be provided for the development of the industrial sector.

In addition to the tax incentives discussed above, it would help if a public institution offered assistance on technology and management to the SMI sector. The institutional public support framework on each area is discussed further in Chapter 4.

2) Need to Incorporate Industrial Policy into Financial and Fiscal Policies

At the moment, financial policies and fiscal policies do not necessarily follow the industrialization strategy as the latter has not been clearly defined. MID should become a central institution to coordinate the various SMI policies including the financial and fiscal policies. MID should have initiatives in finding financial and fiscal needs as well as other kinds of needs in the industrial sector and in implementing them in order to pursue the industrial development of the country most efficiently by coordinating with and mobilizing, if necessary, relevant institutions such as MOFP, MOST, MORD, BOI and EDB.

4. PROPOSED FINANCIAL/FISCAL SUPPORT

4.1 Resources Allocation

1) Provision of Concessional Loans

In order to meet the strong demand for industrial credits as discussed in Chapter 3, the resources of concessional loans should be increased and the interest rate further decreased. The concessional loans should be offered for the purposes of investment in equipment and facilities, reinforcement of product design and R&D, factory relocation, import financing of parts and components, export financing, and promotion of technical colaboration with foreign enterprises, as well as for working capital. These concessional loans, with the establishment of the Credit Guarantee Organization (to be discussed in 4.2), should be provided particularly to the SMI sector. Such concessional loans are part of the industrialization strategy for the SMI sector and do not contradict with the idea of promoting the efficient financial sector. The coordination between MID and DFIs should be enhanced for efficient operation of the concessional loans to achieve this goal.

The concessional loans are extended for preference to the target industries selected by MID, including seven target industries identified and studied under this Master Plan. The concessional loans are particularly required for the "policy-driven industries"; i.e., electric/electronic industry, plastic industry, machinery industry, and IT service industry. In order to consolidate foundation for development of these policy-driven industries, the concessional loans are regarded as indispensable. Desirably, an adequate amount of loans is secured for support to the SMI sector for at least, a 5-year period of consolidation of the industrial foundation.

2) Introduction of Tax Incentives

It is desirable that some tax incentives be introduced to help promote the industrial sector. It is proposed that the following tax incentives be studied and implemented to attain specific goals within a limited time span or for a period of consolidating foundation for industrialization up to the year 2004.

<u>To Promote Advanced Technology</u>

- Resumption of "Investment Tax Allowance" from 2000 to 2004 for new capital asset with advanced technology for the SMI sector

- Zero-rated import duties of plant, machinery and equipment for the purpose of modernization for the SMI sector in case that they are not currently produced (and will not likely to be produced in the near future) in Sri Lanka

These two incentives are to replace the 'Fiscal Incentives for New Investments Utilizing Advanced Technology'.

- Maintain the custom tariff structure of finished products at the current level at least for the period of consolidating foundation of the target industries.

- Make 'plant relocation cost' eligible for the category of Accelerated Depreciation Allowance[16]

- Modification of the BOI critria to allow incentives for smaller IT emterprises

To Promote Training

- Double tax deduction of costs for training of R&D staff and design staff both for 'global-linked' and 'policy-driven' industries
- Double tax deduction for procurement of equipment at privte IT training institutes

To Promote Marketing

- Double tax deduction of costs for marketing of focal products both in 'global-linked' and 'policy-driven' industries

To Promote R&D

- Double deduction of computerization, R&D expenses of product development of the focal products as well as those of production technology, design development and licensing of foreign technology (both for in-house R&D and contract out R&D to outside organizations) for both 'global-linked' and 'policy-driven' industries

- Zero-rated duty for machinery/equipment, raw materials/component parts and samples used for R&D of the above nature both for 'global-linked' and 'policy-driven' industries

- Introduction of "Investment Tax Allowance" for R&D equipment of the above nature for the SMI sector

[16] Two-year (50% per annum) depreciation is adopted in Sri Lanka.

It would be required to register the companies (including subcontractors), specify the list of products and define expenses such as marketing and training expenses before introducing these new tax incentives.

4.2 Establishment of SMI Development Corporation (SMIDEC)

In addition to introducing fiscal incentives and concessional loans, it is proposed that a special organization be established to provide various required services to the SMI sector. The organization is named the SMI Development Corporation (SMIDEC), or alternatively SMI Development Fund.

1) Objective of SMIDEC

The main objective of SMIDEC is to promote the SMI sector by providing them with technological, management and financial services, as well as a credit guarantee system and venture capitalists' role, which are unavailable under the present conditions in Sri Lanka.

2) Organization of SMIDEC

SMIDEC will be established as a corporation by MID with the funds procured by the national budget[17], two Development Finance Institutions and, if appropriate by international financing agencies. Investment from local non-governmental organizations such as the Sri Lanka Chamber of Small Industries will also be invited. SMIDEC will also make borrowings from foreign donor agencies and raise their own money by issuing debentures. SMIDEC will replace some of the functions of IDB and will become a focal place to address issues and problems of the SMI sector. The services of SMIDEC will be made available island-wide through two development finance institutions' network[18]. It is expected that MID and DFIs will work closely through SMIDEC and by doing so, the financial policy will follow the overall industrial policy. In order to maximize the efforts and budget, as well as to achieve sustainability of SMIDEC, it is proposed to increase coordination with other existing institutions of similar functions from private, governmental and industrial, as well as academic sectors.

SMIDEC will have four functions, i.e., (i) Technical/Management Advice (TMA), (ii)

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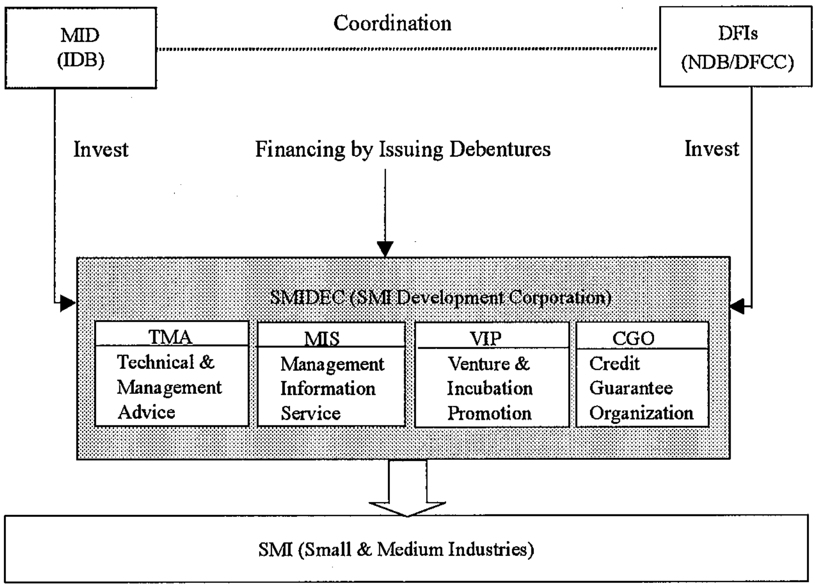
[17] It would be advisable that proceeds from the privatization of state-owned financial institutions or other state-owned companies be put into the SMIDEC as a part of the industrial restructuring program.

[18] NDB and DFCC Bank together have 20 branches islandwide.

Management Information Services (MIS), (iii) Venture & Incubation Promotion (VIP), and (iv) Credit Guarantee Organization (CGO). Each function will be financially independent though there is only one common fund from which separate accounts are made. The next diagram summarizes the concept of SMIDEC.

Schematic Diagram of SMIDEC



Operation of SMIDEC will be entrusted to a management consulting firm in Sri Lanka or its joint venture with an international management consulting firm to be selected through a public open bid. The selected firm may mobilize, if needed, some professional staff from the Central Bank (for CGO) and DFIs (for VIP and CGO).

The table below summarizes some operational aspects of the four functions of SMIDEC.

Operation of Four SMIDEC Functions (Provisional)

	TMA	MIS	VIP	CGO
Fund	-	-	Rs.350 MN	Rs.350 MN
Annual Budget	Rs.45mn	Rs.45 MN	Rs.5 MN (Covered by fund)	Rs. 29 MN (1st Year) Rs.5MN (after 2nd Yr.) (Covered by fund)
Employees	15	15	15	15
Priority Sectors	Policy-driven industries	Policy-driven industries and global-linked industries	Policy-driven industries	-
Cooperation	MID/IDB	EDB	MID, DFIs	DFIs, Commercial Banks, CRIB**

** CRIB stands for Credit Information Bureau of Sri Lanka.

(i) TMA (Technical Management Advice)

The objective of TMA is to contribute to SMIs by providing them with the required technological advice in order to consolidate foundation for development and enhance their competitiveness. The priority will be given to "policy-driven industries". Technical advisors/managers are the key people for TMA and they will be mobilized through MID to provide technology consulting in situ. For the first two years, foreign technical advisors will be mobilized through MID. From the third year onwards, MID and/or IDB will mobilize the technical advisors. Annual expense of the overseas technical advisors is estimated to be Rs. 20 to 40 million for 20 man months. The advisory service will be charged to beneficiaries, except for the initial consultation, in principle.

(ii) MIS (Management Information Services)

The objective of MIS is to contribute to SMIs by providing them with the required management advice services including corporate strategy, financial management and marketing information. Management advisors are the key people for MIS and they will be mobilized by the management consulting firm. In the field of export marketing, MIS should work closely with EDB. As for the financial management service, customer companies, even unlisted companies, should also learn to adopt accounting and auditing standards in order to increase the transparency as well as to prepare themselves for possible future listing of shares and/or bonds. MIS should also coordinate well with National Institute of Business Management (NIBM), which offers business management courses to industrialists.

(iii) VIP (Venture & Incubation Promotion)

The objective of VIP is to contribute to the new venture industry and related business by providing them with various kinds of support such as project planning know-how, legal issues, start-up procedures as well as funding opportunities. VIP reviews applications from potential new industrialists. It invests into successful venture companies and provides them with common service facilities at a low cost, in addition to the above-mentioned services. VIP will incorporate some of the functions of Industrial Incubator Program currently initiated by MID.

VIP will offer support to those entrepreneurs during the period of pre-startup to a few years after the start-up. After that, the venture companies will have developed sufficiently enough to move out of VIP to seek assistance from commercial banks or private venture capitalists for a more permanent setting. Unlike private venture capitalists with relatively short-term aims to gain high profits, VIP aims to nurture venture companies with a longer-term horizon. The priority will be given to entrepreneurs planning to set up their own companies in the near future or newly set-up venture companies in the "policy-driven industries". The first group of companies is expected to be on their own within three to four years, paving the way for a new entrant to VIP.[19] VIP will have its own fund and/or loans worth Rs.350 million. The fund is rotative and will be used to buy a stake in the targeted venture companies as well as to cover the expenses.

(iv) CGO (Credit Guarantee Organization)

The objective of CGO is to contribute to SMIs by providing them with credit guarantee scheme in order to facilitate the procurement of loans from the banks. It is a useful scheme to efficiently promote the financial flow into the SMI sector, which often lacks collateral. It is expected that the scheme be beneficial especially for those small companies who did not even have access even to SMILE or SMAP loans under the current marketing system. The scheme is also expected to contribute to lowering the interest rate by reducing the default rate and risk for the banks.

Foreign specialists in credit guarantee scheme will be sent to SMIDEC to consolidate the foundation of CGO and train local staff during the first 12 months. A professional staff will be seconded from the Central Bank and DFIs. It is reported that the Central Bank's SMI Credit Guarantee Scheme, started in the middle of 1970's, is not effectively operational and it could be incorporated into CGO of SMIDEC. CGO will have its own fund worth Rs.350 million. The fund is used to offer credit guarantee against and to cover the expenses. A small percentage of premium is charged to companies asking for credit guarantee scheme.

The cooperation and coordination with the DFIs and commercial banks will be indispensable for the sustainability of CGO. Participating Credit Institutions (PCIs) dealing guaranteed loans will be appointed as 'Financial Institutions Dealing with the Credit Guarantee'. These banks will keep to conditions of subloan set by CGO, cooperate during the credit analysis process with CGO, and manage the guaranteed credit strictly. In return, these PCIs will receive deposit from CGO, become more specialized in credit analysis and management fields and become a part of the establishment of the new CGO contributing to the economy of Sri Lanka. Meanwhile, DFIs will be entrusted to provide the PCIs with continuous supervision and advice and regular training to them in order to improve skills such as credit analysis and management.

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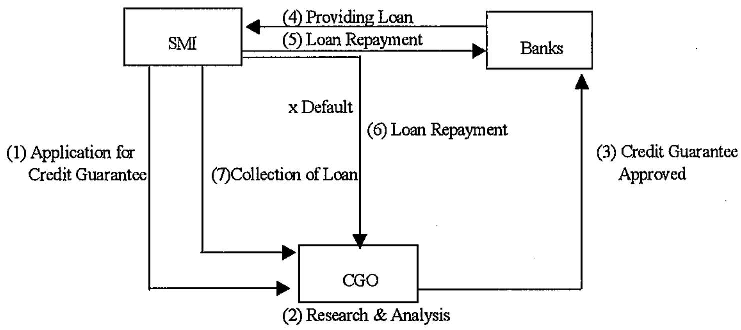
[19] It is important for private venture capitalists to have adequate means of exit, preferably selling shares at the Second Board of the equity market, which is expected to develop substantially by the year 2010.

Coordination with the Credit Information Bureau of Sri Lanka (CRIB) will also be sought in order to facilitate the credit analysis process of CGO. It was established in 1990 by the Credit Information Bureau of Sri Lanka Act No. 18 of 1990 and has been operating successfully. The Bureau collects and collates credit, trade and financial information on borrowers of lending institutions and provides such information to lending institutions that are shareholders of CRIB. (The present shareholders of CRIB are the Central Bank, commercial banks, licensed specialized banks and finance companies).

The diagram below illustrates the flow of credit guarantee provision. The credit guarantee scheme focuses mainly on the following three areas:

- ☐ Research and credit analysis before deciding to guarantee the loan,
- ☐ Credit management during the period that the credit is guaranteed, and
- ☐ Claims management after the collection right is transferred to the credit guarantee organization.

Flow of Credit Guarantee System



(1) A Company who wishes to make bank borrowing either for capital expenditure or working capital purposes using the credit guarantee goes to CGO or banks to apply for credit guarantee.
(2) CGO analyzes and investigate the credibility of the company.
(3) CGO accepts to guarantee the loan to the company if it sees the company is qualified.
(4) The bank will immediately finance to the company.
(5) The loan will be utilized by the company and will be repaid to the bank according to the contract.
(6) In case that the repayment by the company is delayed, terms will be changed or postponed. And upon the claim from the bank, CGO will repay the loan to the bank on behalf of the company. At this point, the liability of the company to the bank is cancelled and CGO will have the right to collect the loan from the company. However, in the case of partial credit guarantee, collecting right will be shared between the bank and CGO.
(7) CGO will collect the loan from the company in a long time period while advising the company how to restructure itself.
(8) After a certain lapse of the time, the unrecovered loan will be evaluated as final loss and depreciate it against the equity capital of CGO.