CAPITAL MARKET IN SRI LANKA - PROBLEMS AND PROSPECTS

W. A. Wijewardena

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THE CAPITAL MARKET IN SRI LANKA: PROBLEMS & PROSPECTS

W. A. Wijewardena

Sri Lanka Economic Association
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This paper is one of the 18 papers, published under a special series of publications by the Sri Lanka Economic Association (SLEA) with financial assistance from the United States Agency for International Development (USAID). The objective of these publications is to provide economic literature on current and topical themes on the economy of Sri Lanka to a broad audience that is interested in economic issues, but has little or no background in theoretical economics, while maintaining high analytical standards. Hence, the papers have been written in simple language avoiding the use of sophisticated technical terms, mathematical equations and models etc. which are normally found in economic literature.

ABBREVIATIONS

A I C C	- Agricultural and Industrial Credit Corporation
C B A	- Colombo Brokers' Association
C B S L	- Central Bank of Sri Lanka
C D S	- Central Depository System
C S B	- Ceylon Savings Bank
C S E	- Colombo Securities Exchange
C S M B	- Ceylon State Mortgage Bank
D F C C	- Development Finance Corporation of Ceylon
E T F	- Employees' Trust Fund
M I G A	- Multilateral Investment Guarantee Agreement
M L C F	- Medium and Long-term Credit Fund
N D B	- National Development Bank
P O S B	- Post Office Savings Bank
S B A	- Share Brokers' Association
S C F	- Savings Certificates Fund
S E C	- Securities and Exchange Commission
S M I B	- State Mortgage and Investment Bank
U T	- Unit Trust
V C F	- Venture Capital Financing

THE CAPITAL MARKET IN SRI LANKA: PROBLEMS AND PROSPECTS.

SECTION 1: CAPITAL MARKET: THE ROLE, NATURE AND ORGANISATION

The financial markets are generally divided into two sub-categories: the money market and the capital market. The money market covers all financial transactions with a maturity of one year or less. Hence, the capital market, by convention, covers financial transactions with a maturity of more than one year. In the capital market, transactions with maturities between I and 5 years are normally regarded as medium term, while those with maturities of more than 5 years fall into the long-term. In the long-term market, there are very long term transactions with maturities extending beyond 20 years and perhaps going upto a maximum of 40 years. In this study, all these maturities, medium, long-term and very long-term, are generally referred to as the capital market even though the different maturities may exert different qualitative impacts upon the economy.

A person who wants to start-up a business needs money to buy land, buildings, machines etc. which help him to produce a good or a service for sale in the market. These supportive equipments are known as the capital. In addition, he needs money to meet his day to day expenses, such as telephone bills, electricity bills etc. These are known as his working capital. Of the two markets, the working capital requirements are provided by the money market, while the capital requirements are met by the capital market with its transactions with different maturities. Both these capital requirements are equally important to a business, However, in the present study, attention will be paid only to issues relating to the capital requirements provided by the capital market.

Acquisition of capital equipments by various businessmen is called "capital formation" and once such capital formation occurs, it serves the businessmen and hence the economy, for a long-period of time. Every year, a part of the capital will be used up for production and therefore worn-out. The amount so worn-out is called depreciation requiring the addition of new capital to take its place. In addition, new capital items are to be acquired either because production has to be expanded or because old items have to be replaced on account of becoming obsolete due to improvements in technology. All these processes known as the investment capital will progressively expand the capital stock of a country. The expansion in the capital stock helps an economy to increase output, employment and the level of natural resource utilisation thus leading to an expansion in the production capacity and through it, economic growth. Thus, capital formation arising from a high level of investment capital, not only lays foundation for economic growth, but also, acts as the engine of growth.

The money to meet investment capital requirements is raised through savings which is the part of income set apart after using for current consumption. Some businessmen meet their capital requirements entirely out of their past savings, but due to the complexities and the high scale of production, such savings may not be sufficient to meet their all aspirations. In these circumstances, they have to rely on savings made by other people. The role of the capital market is to mobilise these savings from the savers concerned, make available such savings to needy businessmen and develop mechanisms to take care of the safety, ready availability and the continuity of such savings at the lowest cost. For this purpose, the market develops various institutions which are called financial intermediaries. These institutions take the form of commercial banks, savings and development banks, finance companies, merchant banks and other supportive service institutions and also separate markets like the share market and the bond market. In the case of the first category of institutions, the link between the saver and the final user of funds is built-up by the lending institution assuming a liability to the saver and acquiring a claim on the user. In the latter category, the market produces a convenient market floor with a host of supportive institutions for savers and users to meet each other and complete their transactions.

The capital market can, therefore, be broadly broken into two sub-markets as follows:

(a) Loan market or the non-securities market where the moneys are made available to users in the form of loans through financial intermediaries without creating a tradeable security in the process.

(b) Securities Market where the moneys are acquired by users by selling a debt acknowledgement called a 'security' to savers which may be tradeable or non-tradeable in the market by the saver before its maturity.

In a developed capital market, there is a proper balance between these two sub-markets. However, in the capital markets of developing countries, the two sub-markets display a lop-sided development with a well developed loan market and an under-developed or sometimes an infantile, securities market. Sri Lanka is not an exception to this general observation.

A. Loan Market or Non-Securities Market

The principal institutions involved in this market are the development banks and to a lesser extent, commercial banks and finance companies. The reason why commercial banks cannot play a vital role in this market is the inability to use their money raised through short-term deposits for lendings that mature in a long-period. Such a situation, known as a 'mismatch between sources and uses of deposits' will create difficulties for a bank to pay maturing deposits due to shortage of cash. Yet, commercial banks have been historically using an increasing share of funds for medium and long-term loans, though a bulk is still used for short-term purposes. Finance companies, on the other hand, have gained expertise in a particular type of financing such as facilitating businessmen to acquire capital items while using (hire-purchase or lease purchase) and simply renting capital items (leasing). Thus, the main burden of providing long-term funds to needy businessmen normally devolves on specialised agencies called development banks.

The main method of providing long-term financing is project financing in which the loans could be used only for a pre-approved project. The borrower repays the loan in monthly instalments over a given period of time and hence, these loans are also called instalment loans. While the loan is being repaid, the project is continuously being monitored by the lending bank.

The main steps involved in a project loan can be summarized as follows:

(1) A businessman conceives a project idea which he develops to a certain extent by examining all its aspects.

(2) The businessman may hire a project consultant to prepare a report on the project called a 'Feasibility Study Report'. This report puts the project into a formal form and covers aspects such as the nature of the project, the product to be produced, sources of raw materials, availability of technology, cost structure, financial status and the profitability of the project etc.

(3) The businessman approaches a bank with his feasibility study report for a loan. The bank, while checking on the credentials of the businessman, makes an independent evaluation of the project proposal to ascertain its feasibility, viability and profitability.

(4) If the project is acceptable to the bank, a long-drawn negotiation takes place between this would-be borrower and the bank. The matters to be settled in these negotiations are as follows:

(a) a minimum equity participation by the borrower so that he also has a responsibility for the proper use of the money in the project.

(b) the type of security to be given by the borrower so that the bank can recover its money in the event of the failure of the project.

(c) the grace period within which the borrower is not required to repay the money so that he is given sufficient time to develop the project and earn repayment capacity.

(d) the period of maturity of the loan so that the borrower as well as the bank does not run into undue money problems.

(e) the method and stages of the disbursement of the loan so that the borrower is allowed to use the money depending on the progress he makes.

(f) the bank's control over the management of the project so that, while the borrower can benefit from the bank's rich experience, the bank can hold some control on its affairs to lead it in the proper direction.

(g) the method of subsequent supervision of the project by the bank such as submission of periodical reports and visits by bank officers etc., so that the bank can monitor its progress properly.

(5) Once a concensus is reached between the borrower and the bank, a loan agreement is drawn by incorporating the above terms and conditions of the loan. After this loan contract is signed, the bank releases the loan as agreed.

(6) The borrower starts repayment, after the elapse of the grace period, while the bank continues to monitor the project very closely to ensure its success and thereby repayment of the loan.

The above steps are normally followed by different banks in different forms. In this context, one of the foremost concerns of any bank is the need for ensuring the safety of the money it lends while helping economic growth. Banks have an obligation towards the savers who supply them with funds; therefore, they should ensure that the moneys they lend are properly used. In this endeavour, banks have to take adequate precautions against three types of mishaps:

(1) Safeguarding themselves from habitual and deliberate loan defaulters;

(2) Avoidance of loan defaults due to bad management or reasons beyond the control of the borrowers;

(3) Minimising losses due to the recklessness of the borrowers known as moral hazard practices.

In order to tackle the above problems, lending banks adopt a range of measures such as checking on borrowers' credentials from Central Data Banks maintained by Credit Information Bureaux, close monitoring and follow-up of projects and incorporating terms and conditions in loan contracts as explained above.

B. Securities Market

In the Securities Market, the borrowers issue a debt acknowledgement certificate known as a security to savers when obtaining funds. These securities take the form of permanent lending in the form of shares in a company or a fixed period lending in the form of bonds or debentures. In the latter case, the bond/ debenture which carries a given annual interest rate is repayable on a pre-determined maturity date and could sometimes be sold to another investor before its maturity. The transactions could be carried out on a formal trading floor operated by a stock exchange.

In an organised securities market, the focal point is the stock exchange which provides the following services:

(1) facilities for companies, and sometimes governments and local bodies, to raise long term funds by issuing shares and bonds.

(2) facilities for savers to invest their moneys in the most profitable investment outlets.

(3) facilities for holders of shares and bonds to re-sell the same to others so as to:

  (a) meet their urgent money problems (obtaining liquidity);

  (p) earn a good capital profit by selling at a higher price than the purchase price;

  (c) avoid losses by changing money from a loss making investment to a profitable investment (portfolio re-adjustment).

(4) facilities for the dissemination of vital information on companies and securities at a negligible cost among savers and borrowers.

(5) facilities for maintaining an orderly and well-behaving securities market so as to cultivate the confidence of savers and borrowers in the market.

(6) facilities for easy and quick settlement of transactions so as to minimise the inconvenience (transaction costs) caused to participants;

(7) continuous supervision of the companies and other borrowers in the market so as to prevent them from taking undue advantage of investors;

(8) provision of guidance and directions to companies, brokers, dealers, consultants and collective investors (unit trusts, mutual funds, country funds and regional funds etc) so as to maintain the highest professional, moral and ethical standards in the market.

To provide the above services, a stock exchange conducts a primary market for share/bond issues as and when such issues are made and a regular secondary market for second hand sale of securities. From an economic point of view, this facility allows the people who have the best profit opportunities and are willing to take risks to obtain the necessary funds. In addition, the stock exchange provides, a continuous surveillance of the market and the companies concerned, enacts and enforces rules and regulations to maintain law and order in the stock market, publishes price information both in individual and average forms and uses the services of a host of other supportive agents such as dealers. brokers, consultants etc.

When an investor purchases a share certificate, it entitles him to a piece of ownership of the company concerned. He may choose either to keep the certificate with him or sell it to another investor in the secondary market. If he keeps the certificate with him, the following benefits will accrue to him.

(1) He will receive a part of the annual profits of the company called dividends, if the company decides to pay dividends.

(2) He will get other privileges such as right to buy shares issued only to existing shareholders (Right Issues) and free shares issued out of accumulated past profits of the company (Bonus Issues).

(3) If the share prices increase in the market, he will enjoy an increase in the value of his assets known as the market capitalisation.

If on the other hand, if he chooses to sell his shares in the secondary market, he will receive the following benefits:

(1) He will receive ready cash (liquidity) to be used for some other purpose.

(2) He will make a capital profit (capital gain) if the shares are sold at a price higher than the purchase price.

(3) He will be able to make a re-adjustment of the different investments held by him (investment portfolio) so that he can change from a loss making investment to a profit making one.

A common observation in all developing countries is that share-holders normally choose to hold their shares for a considerable period of time instead of selling in the secondary market. Therefore, the secondary market activities in these countries remain somewhat at a very low ebb.

Companies choose between share issues and bond issues for the purpose of raising long-term capital. If share issue alternative is chosen, several types of shares can be issued by them for that purpose.

(1) Ordinary shares that give voting rights to share holders.

(2) Ordinary shares that do not give voting rights to share holders.

(3) Convertible preference shares where the share holder is given the option to exchange his shares for ordinary shares after a period of time.

(4) Redeemable preference shares where the value of shares is paid back by the company after a period of time.

Of the above, the first two represent permanent capital, while the last two constitute capital given for a sufficiently long period, with repayment commitments. Obtaining permanent capital by way of issuing ordinary shares will bring the following benefits to a company.

(1) There is no fixed charge to the income of the company, while the capital is of a permanent nature. The payment of dividends is dependent on making profits and if profits are made subject to the discretion of the Board of Directors.

(2) The level of owner's contribution to the company known as the equity capital is raised in a company. This will increase the owner's risk taking compared with that of the outside creditors. Such a situation is referred to as a favourable debt-equity ratio or leverage ratio.

(3) A favourable debt-equity ratio will allow the company to raise more funds by way of loans and bond issues.

If a company chooses to issue bonds so as to raise long-term capital, it enables the company to raise the required money just for a particular period. This is specially advantageous when moneys are needed for a specific project. The bond-holders as against share holders, do not have a piece of ownership in the company, but enjoy the benefit of creditor status. This status allows them to receive a fixed compulsory interest income while the company is going, and priority over share holders to receive their money back when the company is closed down. In order to pay interest to the bond-holder, interest coupons are normally attached to the bond and therefore, the fixed interest rate is called the coupon interest rate. The bond holder may detach the interest coupon on the due date and forward to the company to receive his interest income. These bonds, like shares, have a ready secondary market and therefore, the bond holders can sell them to others before maturity so as to meet his cash requirements (liquidity), earn capital profits and change the structure of his investments (portfolio readjustments) to avoid losses and increase profits.

The redemption value of a bond is known as its par value. As distinct from the par value, there is a market price of the bond determined in the secondary market depending on its popularity as revealed by the demand for and the supply of the bond. The actual earning ratio known as the interest yield of the bond is therefore the percentage ratio of the fixed interest income and the market price. Consequently, when the market price goes up, the interest yield will fall and when the market price falls, the interest yield will rise showing a negative relationship between the two variables.

Companies normally choose to issue bonds to derive the following benefits.

(1) It enables the companies to raise long-term capital without having to take in new share-holders. Therefore, the right of the existing share-holders is not diluted by way of having to share the benefits with a larger number of share - holders.

(2) Interest payable on bonds is an expenditure of the company. Therefore, the company is entitled to deduct such expenditure from the taxable income so that it can reduce its tax payments.

(3) The company can maintain a proper balance between equity and capital. If shares have already been issued upto the maximum level possible, additional long-term capital can be obtained by issuing bonds.

The proper functioning of a capital market in any economy will be essential not only to raise production but also to continue with economic growth. All developed countries have achieved their present development status by ensuring that the capital markets function efficiently so as to promote capital formation by channelling the required amount of long-term capital on the scale and at the speed required. One of the weaknesses in developing countries is the absence of such a capital market to play this catalytic role, despite many measures taken by authorities to develop such an efficient market in their respective countries.

SECTION 2: THE LONG TERM LOAN MARKET IN SRI LANKA

In the previous section, the importance of the long-term loan market in the capital market in modern economies was highlighted. It was observed that in developing countries, the capital market was characterised by a lop-sided development with a well developed loan market and an infantile securities market. Sri Lanka's capital market too conforms to this general trend.

Historically, Sri Lanka has been concentrating on the development of a proper, institutional infrastructure to cater to the long-term capital needs of the country. Since commercial banks were aversive to go for long-term lending on a significant scale, attention was paid to the creation of special institutions to fill the vacuum. The first institution so created was the Ceylon State Mortgage Bank (CSMB) in 1931 for the purpose of providing long-term loans to agriculturists against the mortgage of agricultural property. Due to shortages in funds and defective land titles, this Bank could not play an important role in long-term lending and its performance in the first two decades was far from expectations. Accordingly, even by 1952, its total lending was well below Rs 2 million. A similar fate of insignificant performance was recorded by the Agricultural and Industrial Credit Corporation (AICC) established in 1943 for providing long-term loans to both agriculturists and industrialists. Therefore, in order to gain capability to implement an effective loan program, by 1970s, it was felt, that these two institutions should be merged and allowed to pool their resources. Accordingly, the State Mortgage and Investment Bank was set-up in 1979 by merging the two institutions with powers to borrow by issuing a wide range of bonds and securities to finance its lending program.

In early 1950s, very little attention had been paid to investment financing even though the country had accumulated a sizeable foreign exchange reserve following the boom in the rubber sector which benefitted immensely from the Korean War of early 1950s. To meet the demand, in 1955, the Development Finance Corporation of Ceylon (DFCC) was established as a joint stock limited liability company to assist in the establishment, expansion and modernisation of private industrial, agricultural and commercial enterprises in the country. The DFCC was empowered to borrow money from both domestic and foreign sources to finance its activities. In addition to direct long-term lending to customers, it was empowered to offer financial assistance to the private sector businessmen in the form of capital contribution, debenture purchases, guarantees and many other novel methods of investment financing.

The institutional infrastructure in the capital market was further strengthened in 1970s by two important measures taken by authorities. The first of such measure was the establishment of the National Savings Bank (NSB) in 1972 by amalgamating the Ceylon Savings Bank (CSB), Post-Office Savings

Bank (POSB) and the Savings Certificates Fund (SCF). The main objective of this new institution was to launch an integrated campaign to mobilise savings scattered throughout the country and thereby promote savings habits among the public. However, all the resources mobilised by this Bank were lent to the Government to meet the unfinanced gap of the budget, mostly its capital expenditure. The other important measure taken in this decade was the establishment of the National Development Bank (NDB) in 1979 to promote industrial, agricultural, commercial and other enterprises in the economy. This Bank was expected, especially, to take appropriate measures to develop the rural sector by promoting self-employment projects to alleviate rural unemployment and poverty. As in the case of the DFCC, the NDB too was empowered to borrow money both from the domestic and foreign sources. However, in keeping with the changing business trends, the NDB has been empowered to provide a wide range of services other than lending, such as training of businessmen, technical and consultancy services to prospective project promoters.

A noteworthy feature in the institutional build-up in the long-term lending institutions in the country has been the key role played by the Central Bank in bringing them into existence and measures taken for their subsequent promotion. The need for such an institutional build-up had been felt for sometime. But, the underdeveloped nature of the economy and a lack of initiative by the private sector made it imperative on the part of the Central Bank to play this catalytic role in not only laying the foundation for these institutions, but also shouldering the other activities involved such as training of staff, meeting initial capital requirements etc. Once these institutions were set-up and the initially raised resources were utilised for term-lending, it became important to ensure a continued lending program uninterrupted by a shortage of resources. For this purpose, new and additional resources had to be made available to lending institutions to replenish the Funds that had already been lent. With this objective in mind, the Central Bank inaugurated its Medium and Long-term Credit Fund (MLCF) in 1964 to provide refinance facilities for medium and long term loans granted by approved credit institutions which included development banks and selected commercial banks.

The objectives of the MLCF could be enumerated as follows:

(1) To ensure a continued flow of medium and long-term credit to vital sectors such as industry, agriculture and exports by providing liquidity to lending institutions.

(2) To lower the cost of credit to borrowers in the above vital sectors especially when interest rates are higher on account of restrictive monetary policies.

(3) To encourage investment in projects that would raise output, employment and the levels of domestic resource utilisation, one of the development objectives of the Central Bank.

(4) To encourage the formation of public companies by making it a condition for recepients of assistance under the scheme to convert their businesses into public limited liability companies within a given time-frame.

The resources necessary for the operation of the scheme were transferred from time to time out of the reserves of the Central Bank. Since these reserves constituted the profits earned by the Bank in the past, the re-finance loans just amounted to a re-cycling of resources thus minimising the adverse impact on the money supply. Furthermore, it was also expected that the increase in the output by the new projects would raise the total supply of goods and services in the market neutralising and pressures which the Central Bank's money would have inflicted on the general price level.

In the initial years of its operations, the MLCF scheme played only a very insignificant role. However, with the build-up of new institutions in the long-term lending market and the advent of the open economy policies in late 1970s, the utilisation of funds began to increase progressively. Accordingly, the outstanding re-finance under the MLCF which stood at Rs 55 million at end-1977 rose to nearly Rs 3 billion as at the end of 1991. The ever increasing significance of this scheme in the over-all re-finance schemes for the Central Bank can be gauged from its rising share in the last 15 years: in 1977, its share stood at 6 per cent of totat re-finance: this rose to nearly 40 per cent by the end of 1991.

A salient feature in the long-term lending by the development banks in 1980s except the SMIB, has been a diversification of their operations to cope with the requirements of a newly emerging market economy. In 1970s when Sri Lanka was following closed economy policies, these institutions mainly concentrated themselves on project loans or mortgage loans. They were operating under severe constraints of funds, both equity and borrowered. Consequently, these lending institutions had to plan their lending operations so as to be within the resources available. The expansion of the resource base in 1980s by raising equity, borrowing from external sources and issuing debentures in the local market enabled these institutions to move away from their limited traditional lending to a much wider area of business covering practically every need of the private businessmen. Most of the new lines of business offered by these institutions (except the SMIB) were provided through the floatation of subsidiary companies to undertake these specialised services.

The diversified areas of business by the NDB and the DFCC have almost made them parallel with the British investment banks or German universal banks. These new lines of business, in order of their significance, could be outlined as follows:

(1) **Project Loans:** The two Development Banks still utilise a bulk of their resources for financing project loans. These projects range from the small and medium scale industry to very large agricultural, industrial and export projects. In the case of the Small and Medium Scale Industry, the Sri Lanka

Table 1

Medium and Long Term Loans Granted by Financial Institutions 1980 - 91

Rs Million

Year	Commercial Banks	NDB	DFCC	SMIB	Finance Companies*	Total
1980	5106	160	278	127	311	5982
1981	6529	417	370	162	519	7997
1982	7864	615	498	218	893	10088
1983	9112	829	592	291	1010	11834
1984	9696	1096	656	509	1733	13690
1985	11205	1429	853	857	2216	16560
1986	12452	1947	1114	1323	2392	19228
1987	14789	2640	1506	1764	2603	23302
1988	18818	3205	1773	2173	2939	28908
1989	23450	3615	2253	2502	2925	34746
1990	27183	4984	3000	3657	3342	42166
1991	30033	5632	3364	2697	3441	45168

* Hire Purchase Business only.

Source : Central Bank of Sri Lanka

Government has received a line of credit from the Asian Development Bank (ADB) and funds are channelled to the project promoters by way of re-finance loans provided by the NDB through a host of participating lending institutions. By the end of 1991. three of such loan schemes had been completed and in 1992, the fourth loan scheme was commenced.

(2) **Leasing:** Leasing facilities enable businessmen to obtain capital items such as plant and machinery, computers, vehicles etc. on a lease basis. Leasing has become very popular in the recent past, since it is advantageous to both the lending bank and the customer. In the case of the customer, the deductibility of the entire lease rental for tax purposes, ability to move into advanced equipment at the end of the lease period, and the flexibility of the lease arrangement to suit all customers have been the main advantages. The lending bank benefits from the diversified business as well as the depreciation allowance for tax purposes.

(3) **Venture Capital Financing:** Venture Capital Financing (VCF) is a novel method of meeting capital requirements of small scale self-employment oriented persons. In this case, self-employment seeking people are afforded to realise their dreams by a joint venture set-up by the equity participation of the lending bank and the technical know-how and the management supplied by the business promoter. The lending bank provides further assistance to the business promoter by undertaking to train him in business management

wherever necessary, finding markets for the product and sometimes actually participating in running the business. Further, the owner is also provided an opportunity to buy back his business from the lending bank after a certain period of time when he gains capability of standing on his own. Until such time, profits are shared by the lending bank and the owner according to a pre-determined ratio.

(4) **Share Issue Underwriting:** New share issues in the stock exchange should by underwritten by underwriters with adequate financial standing so as to ensure that the issuer is able to raise the planned amount of capital irrespective of the prevailing market conditions. For this insurance service, the share issuer pays a previously agreed commission to the underwriting company. In the case of development banks, the underwriting is done as a syndicate activity thus pooling the resources of and sharing the risks among many other financial institutions.

(5) **Share-broking:** Share-broking has been another diversified business for the development banks. In this connection, they have teamed up with overseas reputed share-broking firms so as to benefit from their rich experience and gain capability for introducing innovative measures so as to make the country's share market in line with the developments elesewhere in the world. Apart from functioning in the secondary share market as a broker between buyers and sellers, these share-broking firms participate in the primary market as share issue managers as well.

The entry of development banks into this business has led to increased competition among broking firms in the market.

(6) **Corporate Advisory Services:** Corporate Advisory Services encompass vital areas in business such as formation of companies, raising both equity and loan capital in the market, training and recruitment, re-structuring, merging, and acquiring of existing businesses, market research and surveys, etc. With the growth of the private sector economy, especially in a background of privatising the state sector, these services provided by these banks are of paramount importance to the economy. An advantage enjoyed by the development banks, in this context, is the possibility of using their already built-up human capital consisting of trained professional personnel to provide these marginl services. With the corporate advisory services, lending becomes just a part of a full package delivered to businessmen, allowing them to receive all business services under one roof.

The above is a brief list of the diversified business activity of more dynamic development banks, viz, the DFCC and the NDB, in Sri Lanka. However, the SMIB seems to be lagging behind in this respect, though there are no any legal impediments for that Bank to venture into these new areas. Apart from some trivial changes in mobilising funds, this Bank has not brought about any significant changes in its lending pattern in the last decade. In early 1980s, the Bank was concentrating itself granting mortgage loans for housing property; even in 1990, it is undertaking the same with only an expansion in coverage to include commercial property developers, a business which is profitable in an economic boom, but highly risky in an economic recession.

The problems faced by the long-term lending banks in their operations can be outlined as follows:

(1) **Information Gathering:** A wide range of information is needed by a lending bank in order to process a loan application effectively. This information can be categorised into several types:

(a) Information on prediction of major macro-economic variables such as the growth rate, inflation rate, balance of payments situation and the exchange rate.

(b) Information on policy variables such as the Government policies, Central Bank's monetary policies etc.

(c) Information on the performance of individual sectors in the economy such as industry, agriculture, exports etc.

(d) Information on individual loan applicants, their track records, past borrowings, loan defaults, future plans etc.

Of the above information requirements, the first 3 have to be acquired by the banks from the market trends, government and central bank reports and studies conducted by foreign organisations. However, a research and economic monitoring unit is a must in every development bank in order to acquire, process and supply such information to the management on a regular basis. Though some banks have taken initial steps in this direction, the indications are that the progress so far shown is much to be desired.

With regard to the 4th type of information, the long prevailed gap was filled by the Central bank in 1990 with the active co-operation of the Government and all lending institutions, by establishing a Credit Information Bureau to gather information on borrowers and supply such information to lending banks to facilitate processing of loan applications. This was an effective method of checking the incidence of wilful and shifting defaulters and compelling borrowers to make a full-disclosure of information to banks at the time of applying for loans. The Credit Information Bureau got back to business within a very short period of time and developed a data base covering about ?6,000 borrowers of both regular and irregular type in all lending institutions by mid '992. The reports produced by the Bureau on individual borrowers were comprehensive and included information not only on the borrower, but also on companies of which he functioned as a director as well. In the case of companies, information on directors as well as subsidiary companies was also supplied. The popularity of Bureau's reports could be gauged by the ever increasing number of requests per month currently running at about ?000 - 4000, despite the fact that a fee is charged on these reports.

The Bureau's services can now be expanded to two other areas of information dissemination which are equally important to lending banks. One such area is the rating of borrowers with regard to their credit-worthiness as is done in other developed countries. This information will be extremely useful when deciding on renewing existing facilities or granting marginal extension of credit. The other area in which the Bureau should engage itself is the preparation of custom-tailored reports on specific jobs such as a full investigation of a particular borrower or any of his individual business activities. These reports will enlighten lending banks on why a particular borrower fails to repay his loans or becomes slower in his business activities and the Bank will get an early opportunity of taking the necessary precautionary measures.

(2) **The problem of Collateral:** Bankers normally insist that the borrowers should furnish them with suitable collateral to cover their lendings. This is because the banks have a liability and an obligation towards those who supplied them with funds by way of deposits, purchase of bonds or direct loans etc, for safe return of such funds. The problem of collateral becomes more crucial in the case of project loans due to two reasons. First, project loans are repaid over a period of time by way of instalments. Hence, the lending bank may lose its grip on the borrower and become unable to monitor the loan very closely. Second, over this long period, many unforeseen adversities may plague the economy converting a once profitable project into a completely loss-making one. In either case, the bank's risks and the possibility of losing its money become greater.

Lending normally brings about four types of risks to a bank.

(a) Credit risk where the borrower may default the loan causing losses to the bank.

(b) Price risk where the lending bank is forced to experience losses due to unanticipated changes in price — inflation rate, interest rates and the exchange rate etc.

(c) Liquidity risk where the lending bank cannot recall its loan in a hurry to meet urgent financial obligations and is forced to sell its investments at a huge loss.

(d) Systemic risk where the entire banking system faces the threat of collapse due to unnecessary regulations, chain effects caused by the default of loans by large borrowers etc.

One of the remedies used by banks to overcome the problem of risks is to lend against suitable collateral. However, in developing countries, many creditworthy borrowers are unable to provide suitable collateral and therefore unable to borrow even though the projects they promote are viable. From a point of view of the economy, such a situation is disastrous to the continued growth in the economy.

However, some critics have suggested that the banks should not be too much concerned about the collateral factor, if the project under consideration appears to be viable and profitable. There is a merit in this argument, since the repayment capacity of a project is generated by its viability and not by the quality of the collateral supplied. Even if collateral is not supplied, if the project is viable, the risk to the banker is minimal. If, on the other hand, even if first class collateral has been supplied, the bank may have to incur losses when converting the collateral into cash. Therefore, a bank, from the point of view of prudence and contribution to economic growth, should give a higher priority to the viability factor than the collateral factor.

In this section, we have discussed the evolution of the long-term loan market in Sri Lanka to its present status. The institutional build-up in the long-term market has come about mainly due to the initiative taken by the Central Bank to promote such institutions. It was observed that the more dynamic development banks in Sri Lanka have now diversified their activities into many novel areas thereby providing investment banking services to customers. The problems that have stood in the way to effective lending by these banks have been gradually solved, but there are still many problems that deserve the attention of the authorities.

SECTION 3: THE SECURITIES MARKET IN SRI LANKA: THE HISTORICAL EVOLUTION

It was noted in the previous section that the long-term loan market in Sri Lanka grew to the status what it is today by the active patronage extended by authorities. But the securities market did not enjoy such a fortunate position, even though its beginning dates back to more than one and a half centuries. During the long history of the corporate form of business in Sri Lanka, the securities market, and more specifically the share market, grew at a woefully slow pace. One explanation for this slow growth is that, while the long-term loan market was nurtured at every stage by official patronage, the share market was left to develop on its own in response to changing market conditions. The intervention of the state in this respect was limited to the enactment of the necessary legislation governing the operation of limited liability companies. Even such legislation was a simple duplication of what was introduced in the United Kingdom from time to time. In some cases, the state policies were truly inimical to the growth of a healthy share market in the country.

A share market was first set-up in Sri Lanka on a very limited scale through the Share Brokers' Association (SBA) formed in 1894. The limited liability companies formed about half a century ago in Sri Lanka were governed by the U. K. Company legislation and the Joint-Stock Company Ordinance enacted locally in 1861. All capital requirements of these companies were met through issues in the London Market, while local commercial banks met a part of the working capital. With the expansion of tea and rubber companies which needed additional investment capital for modernisation and expansion purposes, it was felt that the London Market could not supply all the capital requirements. At the same time, there was a growing business class which was also interested in owning companies. Hence, in order to cater to this class, several successful new issues of shares were made in the market to raise capital for tea and rubber companies. In 1904, the Colombo Share Market was brought under the control of the Colombo Brokers' Association (CBA) which was more interested in commodity broking than share broking. In 1910, a set of rules was enacted by the CBA to facilitate the share transactions in the Colombo Market. However, there were still no rules governing the requirements for quotations and dealings in shares of rupee companies. The inevitable result of this lapse was the closure of the door of the share market to the public at large. This led to the concentration of the controlling power within quoted companies in the hands of a few individuals. This trend continued till about early 1950s where the share market was largely participated by foreign nationals and a handful of middle class local businessmen. Consequently, the market was limited only to the city of Colombo and the Sri Lankans never got-accustomed to investing in shares on an appreciable scale.

The legislation relating to the formation of limited liability companies was updated by the Government by enacting a new Companies Ordinance in 1938. This Ordinance, though not the most upto date legislation incorporating many recent developments in the business environment, represented a significant improvement over the prevailing legislation. The CBA on its part responded much belatedly by updating and strengthening its rules in a new set of bye-laws in 1955. These bye-laws set out requirements for quotation of shares on the CBA's Official List and the regulations concerning dealings in those shares. However, by the time the CBA attempted to regularise the share market, its activities were dwindling on account of widespread speculations about a possible nationalisation of plantation companies and the imposition of exchange control on outward remittances as from 1958. These factors discouraged the inflow of new foreign capital to the country which in turn reduced the activities in the share market. Finally, by the nationalisation of plantation companies by the Government in early 1970s, a large number of quoted companies was removed from the actively traded share list.

During early 1970s, apart from the nationalisation of plantation companies, several other measures introduced by the Government inhibited the growth of the share market. First, the bias in favour of the state sector in the declared policies of the Government discouraged even the formation of companies outside the plantation sector. Second, the enactment of such draconian legislations as the Business Acquisition Act frightened away both local and foreign investors.

Third, incomes policies such as Ceiling on Income and Compulsory Savings Law took away the investible surplus from income earners thus drying out the funds flow that would have enriched the share market. Fourth, the strict exchange controls and import controls imposed by the Government did not create a suitable environment for investment in productive activities by the private sector. Thus, this period saw the most inactive era of the country's share market. The inevitable corollary of the inactivity and the disinterest on the part of the authorities was that Sri Lanka's share market lagged behind, while those of other countries in the region such as South Korea, Singapore and Malaysia advanced much faster on modern lines making a significant contri ution to rapid economic growth in their respective countries. Thus, by the end of 1970s, a rigorous attempt had to be made by Sri Lanka to revive the share market and derive the benefits it would have brought about to a private sector based economy.

The new Government which had come to power in 1977 attempted to address this issue from a much broader front. While recognising the importance of an efficient share market for the development of the private sector economy on a corporate basis, measures were taken step by step to remove the obstacles for the creation of an active share market These measures included the following:

(1) Enactment of a new Companies Act incorporating most modern developments in the corporate sector thus providing the necessary legal background for the establishment and operation of joint stock companies.

(2) Appointment of several committees to investigate into the problems involved in the creation of a healthy share market.

(3) Enlisting the services of foreign institutions such as the United States Agency for International Development and the Asian Development Bank to study and report on the measures to develop the share-market in Sri Lanka.

(4) Encouragement of the CBA to set up a Securities Exchange in Colombo so as to provide a formal market floor for easy and quick share trading.

(5) Tax concessions and other incentives granted to local companies to issue shares in the market.

(6) Gradual removal of exchange and import controls so as to create a conducive environment for both local and foreign businessmen to undertake productive investment.

(7) Initiation of action to introduce the necessary legislation to set-up control and regulatory bodies to develop a healthy share market and maintain law and order in the market.

(8) Abolition of legislations such as the Ceiling on Income and Compulsory Savings and the Business Acquisition Act to encourage private sector to undertake investment.

(9) Encouragement of foreign investments by setting up free-trade zones, foreign and local investment advisory boards and signing of the Multilateral Investment Guarantee Agreement (MIGA sponsored by the World Bank.

(10) Establishment of an Employees' Trust Fund (ETF) contributed by employers for the purpose of creating a share-owning employee class in the country and increasing the flow of funds to the share market.

The response of the private sector to the above measures was dramatic. In early 1980s, it was recognised that the absence of a formal trading floor was the main obstacle to the development of an active share market in the country. Upto this time, share-trading was a private affair arranged through the share-brokers. This was considered somewhat an 'under the table deal' and the availability of market information on share prices etc. was restricted. This arrangement prevented the buyers from getting the competitively lowest price and the sellers from getting the competitively highest price. Furthermore, the absence of free information dissemination and competition enabled some investors to corner the market and most often get enriched at the expense of other investors. By and large, this method of private share trading restricted the share market to a handful of businessmen living in Colombo and effectively closed the door for ordinary citizens to participate in the share market. Hence, the establishment of a formal stock exchange in Sri Lanka was considered as the number one priority of the development of a share market in the country.

In 1982, a private company by the name of Colombo Stock Exchange Limited (CSEL) was incorporated with the objective of setting up a formal Stock Exchange in Colombo. However, on account of certain differences which arose between the CSEL and the CBA, the CSEL never got an opportunity to set up a Stock Exchange. Meanwhile, the CBA, which hitherto continued its share business within closed doors opened a trading floor towards mid-1984 which was subsequently taken over by the Colombo Securities Exchange (Guarantee) Limited (later re-named Colombo Stock Exchange Limited (CSE). The new company was entirely owned by brokers, though there were provisions for dealers to join. The initial membership of the CSE consisted of 07 members and 02 associate members.

The infantile CSE did not have much activity in the initial period. It was open only for two hours a day from 10.00 a.m. to 12.00 noon for trading. Since it did not have its own bye-laws, rules and regulations concerning listing procedures, disclosure requirements, and matters relating to insider-trading, it followed the rules of the CBA in the initial period. But these rules needed considerable revision and updating compared to those of other modern stock exchanges. For the purpose of listing in the official share list of the CSE, a public company was required to offer 20 per cent of its shares in the market for a period of at least one week. However, of this, the entire 20 per cent need not be offered to the public. There were also not effective provisions to compel companies to publish their final accounts in sufficiently detailed form.

Even though there were more than 17,000 limited liability companies in Sri Lanka, only a negligible number amounting to 169 had been listed in the CSE in December, 1985. However, this small number would have been a blessing to the CSE, since it did not have any facilities to cater to more companies. Even in these companies, transactions took place rather infrequently. Furthermore, the number of shares offered in the market was even below 1 per cent of the total issued share capital of these companies. This situation reflected an unhealthy feature which hindered the growth of an active share market in the country: the desire of the promoters of companies to retain controlling interest among themselves. As a result, only the minimum number of shares that had to be offered in the market to get a quotation was placed in the market for trading. On account of these supply constraints, the demand for shares continued to play a dominant role in determining their prices. A corollary of this feature was market prices becoming a misleading indicator of the true financial state of the companies concerned.

In view of the poor state of affairs explained above, the major challenge faced by the CSE was the expansion of its activities on modern lines so as to be an effective contributor to the development of the capital market, and through the capital market, the entire economy. It was again felt that the CSE alone could not meet this challenge successfully. A great deal of co-operation of the authorities as well as expertise from external sources was needed for a complete overhaul of the CSE and thereby uplift it from the plight to which it had fallen. On top of this, a regulatory mechanism for the stock market was needed not only to maintain law and order in the stock market, but also to guide the CSE and inculcate confidence of investors in the share market. All these were attended to in the last few years of 1980s and the first two years of 1990s. We will be discussing these developments in more detail in the forthcoming sections.

SECTION 4: THE COLOMBO STOCK EXCHANGE: THE MOVE TOWARDS MATURITY

The Colombo Stock Exchange (CSE) is still a very young institution with only 8 years of operational experience behind it. Therefore, it is too much to expect such an infant institution to come up with miraculous results within such a short period of time. Till about 1989, the CSE was fighting for its own survival having been set-up in an inappropriate time: a hostile environment for business and investment brought about by two civil wars of the worst kind. With these odds against it, the CSE somehow managed to move forward gradually and finally ended up as one of the emerging share markets in the region, though there is a long way ahead to reach full maturity. In this Section, we assess the performance of the market during the 8 year period from 1985 to 1992 and examine the operational and institutional changes that were introduced to the market during this period.

A. Assessment of the Performance (1985-1992)

It will be appropriate to assess the performance of the CSE during 1985-92 by breaking it into two sub periods; the period from 1985-89 in which the CSE was trying to pick itself up and the period from 1990-92 in which it was moving fast ahead towards maturity. The performance of the market is given in Tables 2 and 3.

During 1985-89, all market indicators available to assess the performance of the CSE reveal a very low level of operations characterised by a sudden down-turn in 1989. In the first few years, the market grew steadily but slowly creating hopes for the future. However, this trend was reversed in 1988 and 1989. The annual turn-over grew steadily from Rs 79 million in 1985 to Rs 380 million in 1988. This suddenly fell to Rs 255 million in 1989. Accordingly, the average daily turn-over which was just a few lakhs in 1985 improved marginally to a little over Rs 1 million in 1988. This again fell below Rs 1 million in 1989. The average share prices were another casualty of these trends. The CSE all Share Price Index rose from 100 in 1985 to 218 in 1987. Responding to the inactivity in the market, this index fell to 172 in 1988 and improved marginally to 179 in 1989. Showing a similar trend, the CSE Sensitive Price Index, covering the share price changes of 24 very good companies - rose much faster from 100 in 1985 to 384 in 1987. Reversing the trend, it fell to 310 in 1988 and improved to 342 in 1989. These changes in the price indices were also reflected in the market capitalisation - the appreciation in the value of shares in the hands of share holders. Accordingly, the market capitalisation which stood at Rs 10 billion in 1985 rose to Rs 19 billion in 1987, Reversing the trend, it fell to Rs 16 billion in 1988 but marginally improved to Rs 17 billion in 1989. This slow growth associated with sudden down-turn in 1989 may have disheartend many an investor who would have had high hopes about a very quick upswing in the country's share market.

The discouraging performance of the CSE during 1985-89 could be attributed to reasons both internal and external to the Exchange. Of the internal reasons stand prominently its own disorganisation and the poor state. The CSE lacked experience, expertise and equipment to run a formal trading floor for stocks. In many respects, there were no differences in the new 'open-outcry' market and the 'private arrangement market' run by the CBA. The delays in introducing its own rules and regulations, in establishment of information dissemination systems, and lack of effective surveillance of companies to maintain corporate discipline contributed to keep many a new investor away from the market. Hence, for all practical purposes, the market was just a duplication of the earlier privately arranged market run by the CBA. Though the CSE's necessity had been long felt by the corporate sector, its sudden appearance in the market was totally unexpected by the market participants who were unprepared for it. Hence, as a pre-strategy of promoting its own operations, it would have put its own house in order before doing any other thing.

The external reasons that contributed to the slow pace of the CSE fell into two categories. First, there seems to be a kind of apathy or disinterest by authorities by not creating the necessary environment contributory to its healthy development in time. The delays in setting up regulatory authorities, the non-delivery of the promised fiscal package in time or sometimes the adoption of contradictory policies are cases in point. The liberalisation of the exchange control did not progress as planned and even by 1990, no attempt had been made to liberalise the capital account to permit easy private foreign investments. On the other hand, some of the policies adopted by authorities were truly inimical to the

Table 2

Sri Lanka's New Share Issues In The Primary Market

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Total No. of Share Issues	05	13	19	37	13	03	05	05	10	02	01	05	13
No. of Shares Offered (Mn)	1.39	28.43	37.11	94	63.25	8.71	101.75	20.59	20.1	11	7.0	12.1	83.1
Value of Shares Offered (Rs. Mn.)	15.9	281.7	311.1	1001.2	632.5	87.1	130.5	205.9	201.1	110	70.0	121.5	1296.2
Share Investment as a percent of Total financial Savings	0.2	4.3	2.8	8	5	0.8	1.6	1.1	1.1	0.9	0.8	0.5	2.0

Source: Central Bank of Sri Lanka

Table 3

Sri Lanka's Secondary Share Market Indicators (1985 - 1992)

	1985	1986	1987	1988	1989	1990	1991	1992*
Market Capitalisation as at 31st December (Rs. Mn)	10,029.9	12,026.2	18,728.1	15,571.6	17,087.0	36,850.0	82,700.0	65,281
Total Number of Shares Issued as at December	733,128,266	779,098,888	819,696,175	919,077,671	1,043,011,010	1,099,509,952	1209,500,788	1292,300,788
Value of Shares Issued as at December (Rs. Mn)	7,331.3	7,791.0	8,197.0	9,191.0	10,401.0	10,908.1	11,610.0	11,659
Number of Shares traded	5,410,819	6,330,551	17,182,100	13,135,240	12,000,000	11,709,000	95,136,266	87,669,675
Value of Shares Traded (Rs Mn)	79.2	113.0	331.9	379.9	255.0	1,562.3	4,911.0	1,969.1
Average Turn-Over per day (Rs. Mn)	0.28	0.50	1.18	1.33	0.89	6.6	16.6	20.5
Percentage of the Traded Share/total Issued	0.74	0.82	2.10	1.43	1.17	3.8	7.9	6.8
Percentage of the Value of Shares Issued to GDP	1.52	1.51	1.17	1.12	1.12	3.7	3.1	3.1
Percentage of the Value of Shares Traded to GDP	0.05	0.08	0.17	0.17	0.10	0.5	1.3	1.1
Rate of Market Capitalisation (percent)	36	51	129	69	64	238	710	415
Price Indices (End of the Year)								
– CSE All Share (1985 - 100)	122	111	218	172	179	384	838	597
— CSE Sensitive (1985 - 100)	159	218	381	310	312	650	1199	822

• Provisional

Source: Central Bank of Sri Lanka

growth of a healthy share market in the country. In order to encourage share investments, capital gains arising from the sale of shares had been exempted from income tax in 1980. However, acting on a false allegation of speculative activities in the share market, this was reversed in 1987 to the much discontent of the share-holders. It was abolished only in 1990 after several representations were made by the private sector chambers. The lack of consistency in government policies in this manner too contributed to the frequent ups and downs in the activities of the CSE during this period. It was, however, the JVP insurrection of 1987-89 that hit the fledgling CSE in the worst manner. It contributed immensely, to the loss of investor confidence in a private sector economy and accordingly brought the operations of the CSE to a very low level especially in 1989.

However, this decline in the share market in 1989 is not without any beneficial effects. It opened the eyes of both the authorities and the CSE to speed up measures which would have been taken long time ago to set-up and maintain a strong share market in the country. Thus the period from 1989 records the era of reforms and changes that were responsible for moving the CSE towards a more matured state making it one of the emerging share markets in region.

The second period from 1990 to 1992 is characterised by mixed results: a sudden upsurge in the market followed by a down-turn. Reversing the earlier inactivity and the lull in the market, 1990 recorded a take-off, while 1991 was a phenomenal boom year. In these two years, the CSE became a hive of investment passing a significantly high volume of funds through it to the development of the country's capital market. However, the experience in 1992 records that the 1990-91 Boom was just an over-heated position wreaked by a quick profit seeking 'speculative bubble', a phenomenon much dangerous for an emerging share market. Hence, in the absence of steadiness in the market, the over-heated bubble would have exploded at any time thus ruining the entire market.

The share market indicators in 1990 and 1991 are a reversal of the experience in the previous period from 1985 to 1989. The annual turnover in the market rose sharply from Rs 255 million in 1989 to Rs 1562 million in 1990 and further to a record Rs 4,944 million in 1991. Consequently, the average daily turnover which remained at around Rs 1 million during 1985-89, rose to Rs 7 million in 1990 and Rs 17 million in 1991. A more remarkable growth was shown in the two share price indices: the CSE all share price index rose from 179 in 1989 to 384 in 1991 and further to 838 in 1991. The Sensitive Price Index recorded an equally sharp growth from 342 in 1989 to 680 in 1990. This rose further to 1199 in 1991. The growth in prices were reflected in the market capitalisation too. In 1989 it stood at Rs 17 billion or 7 per cent of GDP. This rose to Rs 37 billion in 1990 accounting for 12 per cent of GDP for that year. The market capitalisation in 1991 was much appreciable with a value of Rs 83 billion or 22 per cent of GDP. Though this level of market capitalisation as a percent of GDP is still below other emerging markets in the region such as Thailand and Indonesia, it showed some promising signs of future growth in the market.

Though there was a slight reversal in the activities of the CSE in 1992, it did not fall below the pre-1990 levels. While the market recorded somewhat a slower pace, the share prices continued to decline with occasional improvements from time to time. This was reflected in both price indices. The CSE All Share Index fell from 838 in 1991 to 597 in 1992 recording a 28 per cent decline. Similarly, the Sensitive Index fell from 1199 to 822 between the same years recording a sharper decline of 32 per cent. Reflecting these price deteriorations, the market capitalisation fell sharply from Rs 83 billion in 1991 to Rs 65 billion in 1992. This recorded an erosion of the value of the wealth owned by investors by 22 per cent.

Many a reason has been adduced to the growth in the share market in 1990-91 and its subsequent deterioration in 1992. The growth was mainly caused by the sudden profit expectations by investors from anticipated entry of foreign investors to the local market following the liberalisation of exchange control and private foreign investments. The demand for shares of many companies in which the foreign investors were speculated to buy shares increased dramatically pushing their prices upwards. However, when the entry of foreign investors became slower, the market reacted by an over-supply of shares which led to subsequent price deterioration.

B. Operational Changes in the CSE

(1) Rules and Regulations

It was mentioned earlier in this section that the CSE, for lack of its own rules and regulations, followed those of the CBA which needed a substantial revision and updating. This matter was attended to by the CSE with the assistance from external sources and framed its own rules and regulations by 1989. These rules and regulations were sufficiently comprehensive and in line with those of the other more developed stock exchanges elsewhere in the world. The rules and regulations are normally expected to cover the following areas.

(a) The requirements which apply to companies that submit their applications for registration in the CSE known as listing;

(b) The manner in which any sale or purchase of shares and securities should be conducted on the floor of the CSE;

(c) Once a company is registered with the CSE, the requirements which it should continue to follow in order to keep that registration;

(d) Setting out guidelines known as the corporate disclosure policy, for the listed companies to make the maximum disclosure of information for the benefit of the investing public and how people within companies should not use exclusive information for their own benefits, a process known as 'insider trading'.

The main objective of framing rules and regulations to be complied by listed companies and other participants is the need for maintaining an orderly trading system on the floor of the exchange. This is necessary to protect investors from being deceived by other participants in the market, viz. other investors, brokers, and listed companies. If there is room for such cheating, it would seriously undermine the confidence of investors in the market. Therefore, the rules imposed by the CSE aim at inculcating the confidence of investors in the share market. These rules endeavour to ensure three main factors:

(a) That investors get sufficient and reliable information on a company to make a prudential evaluation of a particular investment in shares;

(b) That all trading activities are conducted on a fair and open basis leaving no room for any person to manipulate the same;

(c) That boards of directors of companies extend proper treatment to investors even in situations where they may represent only a minority of share-holders.

It is noteworthy that companies that seek admission to the Official List of the CSE should comply with the requirements of the CSE as well as those contained in the Companies Act and the Securities and Exchange Commission Act.

In order to ensure that all listed companies have a minimum size, the CSE rules require a company to have a minimum paid up capital of Rs 5 million. In addition, depending on the size of the company, the CSE rules require companies to issue a minimun percentage of shares to the public as follows:

(a) Companies with a share capital between Rs 5 million and Rs 10 million - 40 per cent.

(b) Companies with a share capital of Rs 10 million and Rs 25 million - 30 per cent.

(c) Companies with a share capital above Rs 25 million - 25 per cent.

The above minimum percentages stipulated by CSE rules are expected to ensure that at least a minimum of share will be supplied to the market. This rule has become necessary, since it has been observed that company promoters seek to keep controlling interest among themselves by supplying only a bare minimum to the market.

In addition to ordinary shares, the CSE rules permit companies to issue other types of shares, such as preference, non-voting and debentures, but such shares cannot exceed 50 per cent of the issued ordinary share capital. The issue of non-voting shares is important to a company, because it enables the company to raise more capital without diluting the existing ownership. When foreign ownership in companies is considered undesirable, it is a method of attracting more foreign investments. In view of this, the CSE rules have stipulated the terms and conditions of issuing non-voting shares. These conditions include that ordinary shares should be pre-issued so that investors get an idea of the value of the company, non-voting shares cannot exceed 50% of the ordinary share capital, non-voting shares should have a limited life upto a maximum of 5 years, and the failure to pay dividends on non-voting shares for 3 consecutive years will convert them automatically into ordinary shares.

In addition to the initial listing requirements, there are continuing and additional listing requirements imposed by CSE rules. The objective of these requirements is to compel a company to conform to certain norms, while continuing to be listed in the CSE. The continuing listing requirements compel companies to make announcements to the CSE about various aspects of a company. These aspects cover, inter alia, important changes about companies, whether or not dividends are paid, if paid, the rates and dates of board meetings that decide on dividends etc. The Listed Companies should also submit half-yearly and annual financial statements to the CSE as prescribed by it. Along with the audited annual accounts, the distribution of the shares should also be forwarded. The additional listing requirements describe the manner in which applications should be made by the listed companies to the CSE for approval to issue bonus shares and right shares. All these requirements aim at preventing listed companies from pursuing a behind the curtain secret policy.

An important update in the rules of the CSE is the new Corporate Disclosure Policy. Since information on companies is a vital input for investing public to make prudential investment decisions, the new disclosure policy compels companies to disclose all material information to the public. Under this, all listed companies should make an immediate public disclosure of all material information about its affairs in a manner designed to make the maximum public dissemination of such information. In this connection, whenever there are rumours and reports circulating about a company in the market, the company concerned should immediately confirm or clarify them. Similarly, whenever there are unusual market developments, the company in question should appropriately respond to them. Another important disclosure policy is that the listed companies should not engage themselves in unwarranted promotional activities.

One of the black marks for any share market is the occurrence of insider trading where people who have access to exclusive information on a company use that information to gain a profit at the expense of other share holders. From the point of view of economics, there is nothing wrong in using information profitably by some body. However, from a moral and ethical point of view, use of such information for his own benefit is not conisdered as an appropriate activity. Since such trading undermines the credibility of any share market in the eyes of investors, all countries have made insider trading a punishable offence. While Sri Lanka's Companies Act as well as the Securities and Exchange Commission Act contain provisions relating to insider trading, the CSE too, by its rules, has required insiders not to undertake trading on the basis of material information not available to other investing public. If they wish to undertake trading, they should do so after permitting sufficient time for such information to disseminate among the public and in any case not earlier than 5 days from the release of such information to the press or other media.

Updating and expanding the rules and regulations of the CSE have been an important step taken to maintain an orderly market for securities in Sri Lanka. In the brief history of the CSE, there have been several instances where these rules had to be imposed by the CSE on errant companies. On several occasions, the CSE took prompt action to suspend the trading of shares of certain companies, and effectively regulated the new share issues by compelling some companies to strictly conform to its rules and penalised some companies by delaying admission when they did not make their initial share issues in accordance with the guidelines issued by the CSE. By and large, companies presently listed with the CSE could be said to be behaving properly. However, the credibility of the CSE could be maintained only if the CSE has the will and the commitment to impose these rules impartially and without discrimination.

(2) Electronic Clearing and Settlement:

The Central Depository System (CDS)

One of the problems faced by modern stock exchanges is how to maintain efficiency of their operations against a background of a very rapidly expanding trade volume. The efficiency requires that delivery, clearing and settlement involved in a share trading should be completed within the shortest time possible and at the lowest cost to all the parties concerned. Historically, the authenticity for share-ownership has been the share-certificate issued by the company concerned under its seal. Hence, to effect a transfer of a share, the share certificate had to be physically moved from the seller through his broker to the company concerned for concellation and issue of a new share certificate in the name of the buyer. In the meantime, money has to move from the buyer to the seller through the broker in settlement of the purchase. A sizeable volume of documentation was necessary to complete this transaction adding paper work at every stage. Hence, share trading created an enormous volume of paper work, took a long period to deliver the shares to the new buyers and denied upto date information to companies on the share-holders to enable them to issue dividend warrants, communications regarding bonus and right issues and annual general meetings. Furthermore, the loss of certificates by share holders was a frequent occurrence and a very tedious and time consuming procedure had to be followed for issuing a duplicate. Hence, any measure to eliminate paper work, and expedite delivery, clearing and settlement was most welcome by any stock exchange.

In advanced countries, this challenge was met by developing a paperless share market by using electronic methods to complete a share-trading. Under this system, a centralised computer will maintain accounts for share-holders, brokers/dealers and listed companies and effected share transfers simply by making book entries. The operation of this system was similar to that of a computerised current account department in a commercial bank. The system will provide periodical statements to share-holders and brokers/dealers giving details of the transactions during the period and the period-end balance. It also supplied the companies with an updated list of share-holders so that they could address all their communications to share-holders without missing any one of them. Since paper share certificates were not issued, the question of loss certificates did not arise. Thus, the electronic transfer methods successfully tackled the problems involved in paper based share trading and was responsible for creating a paperless share-market in advanced countries.

The CSE too had faced the above problem of paper work and delay in completing share transactions. To tackle this problem, action was taken to create a Central Depository to hold shares in trust for share-holders and effect electronic transfers. A trust could not be set-up under Sri Lankan Laws as a legal personality and the Central Depository should necessarily be a legal personality holding these shares in trust. Therefore, to facilitate the establishment of the Central Depository System as a limited liability company holding shares in trust, the Companies Act was amended to permit the establishment of a Central Depository as a limited liability company. Accordingly, the Central Depository System (CDS) Ltd. was set up in 1991 as a subsidiary of the CSE. The CDS started to cover listed companies on a step by step basis and completed the coverage of all listed companies by mid 1992. Hence, the CSE became one of the few paper-less share markets in this region.

A salient feature of the CDS is the introduction of a Central Depository and an electronic record keeping system for individual share-holders. It also provides lists of beneficial share-holders to each listed company as at the posted record date to allow companies to mail dividend warrants, right and bonus issue communications, annual reports, proxy statements etc to share holders. While transactions are paperless, all transactions are fully settled by the CDS within 6 market days. With the addition of the CDS, the CSE acquired the capability for handling an ever rising volume of share transactions.

C. Entry of New Institutions to the Market.

(1) Unit Trusts

A Unit Trust is a collective fund set up for the purpose of mobilising funds from the public by selling its units and using those funds to buy shares of listed companies. Hence, a unit trust serves to gather scattered savings from small savers and enrich the resource flows to the share market.

Three parties should get together to set up a unit trust: unit holders, trust managers and the trustees. The arrangement among them is set out in a document called the Trust Deed executed by them. The operational procedure of a unit trust in a brief form is as follows: The public will buy units from a unit trust. The money so received will be used by the trust managers to buy shares in the stock exchange. The trust managers will maintain an investment portfolio so as to earn the maximum profits for the trust. With the increase in the value of the investments, the trust managers will re-value the units every week and offer to buy back the units already issued from unit holders at a buying price and sell new units to new unit holders at their selling price. The spread between the buying price and the selling price will be a source of profits to the unit trust. Because of this property of the right to buy back its own units, a unit trust is called an open ended institution. To encourage unit holders to keep their money in the unit trust, periodical dividends are also declared by the trust managers.

The national economy will derive the following benefits from unit trust schemes:

(a) Since unit trusts mobilise scattered small savings, the rate of domestic savings mobilisation is increased.

(b) Since unit holders are mostly small savers belonging to the lower income groups, by facilitating them to buy shares of companies, the inequility in the income distribution can be somewhat narrowed.

(c) Since a unit trust is a group investment scheme, it helps to alleviate any congestion on the floor of the stock exchange.

The unit trusts are beneficial to investors in a number of ways.

(a) Small savers who are willing to buy shares but cannot do so because of the smallness of their savings will get an opportunity to own shares through unit trusts.

(b) Investors who have no knowledge of the operations of the share market can contribute to a professionally managed share portfolio.

(c) Free information and education programs carried out by unit trusts will enrich the knowledge of investors.

(d) Small investors can spread the risk by owning a part of a well diversified portfolio of shares owned by a unit trust.

In Sri Lanka, the unit trusts are being set up under the provisions of the Securities and Exchange Commission Act (earlier Securities Council Act) which empowers the Securities and Exchange Commission (SEC) to license, control and regulate unit trusts. Though trusts of any nature are normally set up under the Trust Ordinance, the consideration that the provisions of the Trust Ordinance were not sufficient to govern these novel institutions prompted the authorities to introduce the enabling legislation as a part of the SEC Act by an amendment to the Securities Council Act in 1991. In terms of the Act, the SEC is given wide powers relating to all regulatory aspects of unit trusts. In terms of this Act, no unit trust can commence operations without a licence granted by the SEC to that effect. Under certain circumstances involving the violation of the provisions of the Act, the SEC can cancel or suspend the licence already granted to a unit trust. All prospectuses and advertisements to be issued by the licensed unit trusts should have received the prior approval of the SEC. While the Act lays down the minimum contents of the Trust Deed which governs the activities of a unit trust, any amendment to the Trust Deed should not be done without the prior written approval of the SEC.

Four unit trusts have been granted licences to carry out unit trust business in Sri Lanka by the SEC under the Act. All these unit trusts have been sponsored by leading financial institutions in the country with foreign collaboration to draw foreign expertise. All unit trusts set to business in competition with each other with an unparalleled propaganda campaign to lure the public to buy their units. One of the criticisms levelled against the unit trusts was that, while highlighting only the beneficial sides of the unit trusts, they failed to give a balanced opinion to the public on both the risks and dangers side by side with the benefits of the scheme. Since the SEC is the approving authority of all propaganda advertisements, the criticism should be wholly directed to the SEC. As a result of this one-sided advertising campaign, the public who bought units with the objective of earning quick profits was grossly disappointed, since even after 01 year, the buying price of units remained well below their par value.

The table 4 below gives the provisional data on the operations of the four unit trusts as at end-September, 1992.

Table 4
Operations of the Unit Trusts

Rs Million

Name of the Trust	Fund Value	Equity Investment	Equity Investment as % of the Fund
1. National Equity Fund	825	242	29
2. Pyramid Unit Trust	284	140	49
3. Ceybank Unit Trust	539	140	26
4. Comtrust Equity Fund	161	59	37
Total	1809	581	32

Source: Collected by the Author

It is apparent from the Table 4 that the equity investment by the unit trusts out of the funds raised has been below the mark. The bulk of the investments made by them has been in Treasury Bills and bank deposits, since, in 1992, they did not get a suitable environment in the bearish share market to invest in shares. Since the scheme has been in operation only for a short period of time, it is too early to make a general comment on the investment strategy of these unit trusts.

(2) Country/Regional Funds:

In order to attract foreign investments to Sri Lanka's fledgling share market, the Government gave approval to a number of Regional/Country Funds to make investments in the share market. By the end of 1991, 58 Regional Funds and 1 Country Fund had been approved by the Government.

A Country Fund is a pooling of resources in a foreign country to invest in equity in a specific country. Once the funds are invested, a country fund cannot move the funds away from that country. A Regional Fund, on the other hand, is a pooling of resources in a foreign country with the objective of investing in equities in a number of countries in a particular region. Hence, when any investment in a country becomes undesirable, a regional fund can freely move funds from that country to another country in the region. Hence, for a regional fund to operate, there should be laxed foreign exchange controls to enable a regional fund to move funds freely out of the country.

The operations of these regional funds became a booster to Sri Lanka's share market in 1991. In that year, about 40 per cent of the share purchases had been effected by non-nationals. Of these foreign inflows, a large amount in the region of US$ 40 million (Rs 1700 million) had been channelled by the regional and country funds.

In this section, we analysed how the CSE began its onward move towards maturity after 5 years of inactivity since its establishment in mid-1984. During 1990-92 period, the CSE introduced a number of novelties including an updated system of rules and regulations and an electronic clearing and settlement mechanism. Vital market information is now released by the CSE on a daily basis, so that investors will get adequate information to make prudential investment decisions. A greater degree of surveillance and supervision is exercised by the CSE on listed companies to maintain market discipline. When compared with other stock exchanges in the region, it is definitely a credit to the CSE that no any other exchange in the region has achieved that level of maturity within such a short period of time.

SECTION 5: THE REGULATORY ASPECTS OF THE STOCK EXCHANGE: THE SECURITIES AND EXCHANGE COMMISSION

Financial markets are very rarely allowed to self-regulate, even though there is a sizeable number of proponents who propound the virtues of such a system. The line of arguments put forward by them goes as follows: the market system is the most efficient method of bringing about market discipline in any industry, since it is non-discriminatory, automatic and costless. The discipline is brought about by forcing firms to go out of business if they fail to produce their output to satisfy the consumers. Hence, an essential ingredient of market discipline is allowing ill-doing firms to collapse. Since an ordinary industry is allowed to self-regulate without the explicit intervention by authorities and it performs well, there is no reason for authorities to intervene in the financial industry. Such unnecessary intervention is fatal to the financial industry on many counts: it very often is discriminatory, imposes additional constraints on firms in the financial industry, raises transaction costs and finally, causes managers in financial firms to deviate from market based decision making. Thus, the intervention of authorities in the financial system in the guise of bringing discipline to the market should be avoided as far as possible.

While there is an element of validity in the above line of arguments, one should not disregard a basic distinction between a firm in an ordinary industry and a firm in the financial industry. A firm in an ordinary industry, if allowed to fail because of the ill-behaviour in the market, is an isolated incident with short-lived social costs: the output lost to the society could be recouped easily by stepping up production in other firms and the employees who lost their jobs could be absorbed by other industries within a very short period of time. However, a firm in the financial industry, if allowed to collapse, will have chain effects on other firms in the industry leading to a general financial crisis. This would entail an enormous social cost on the society, since it leads to a chaotic situation in the economy. Therefore, the market mechanism, instead of driving it back to stability, may lead it to a general collapse. Hence, the government is supposed to regulate, control and supervise the financial system in order to supply it with the necessary prudence as a 'public good'. Though governmental regulations and supervision cannot totally rule out financial crises, they nevertheless help the system to receive advanced warnings and take the necessary remedial measures promptly.

Sri Lanka's share market and institutions in the share market are controlled, regulated and supervised by the Securities and Exchange Commission (SEC) (earlier Securities Council) under the Securities and Exchange Commission Act (earlier Securities Council Act.) The institutions coming within its purview are the stock exchanges, stock brokers, stock dealers and unit trusts. With regard to these institutions, the SEC has wide powers.

The broad objectives of the SEC under the Act are as follows:

(a) Creation and maintenance of a fair and orderly securities market.

(b) Protection of the financial interests of the investors.

(c) Operation of a compensation fund to compensate investors against the losses arising from the failure of brokers / dealers to fulfil their contractual obligations.

(d) Regulation of the securities market and the maintenance of professional standards in the market.

The above objectives make it obligatory on the SEC to take full responsibility for the orderly development of the securities market in the country and the maintenance of its financial discipline. The establishment of the SEC in this respect creates dual supervisory authorities over the financial system: the banking and the financial institutions by the Central Bank and the securities market by the SEC. While these two institutions are independent institutions functioning under the Ministry of Finance, the linkage between the two has been made by making a Deputy Governor of the Central Bank an appointed member of the Council of the SEC. Coincidentally, the first Chairman of the SEC too functions as the Appointed Member of the Monetary Board, making that linkage too strong for the moment. Therefore, under the present arrangement, any policies adopted by each institution affecting adversely the other could be sorted out, at least in theory, before implementation, but this need not be the case at all times. Hence, one of the short-comings of the dual supervisory system is the possibility of adopting conflicting and contradictory policies by one body thereby inflicting adverse impacts on the other.

The following powers, duties and functions have been assigned to the SEC to achieve the above mentioned objectives.

(a) **The licensing powers:** The SEC is empowered to issue licences to stock exchanges, stock brokers, stock dealers and unit trusts. The objective of this power is to make a public control of the institutions and persons concerned, since without a licence, they cannot operate their respective businesses.

(b) **Regulatory Powers:** The SEC is empowered to issue directions to stock exchanges and unit trusts so as to ensure proper conduct of business by them. This power vested in the SEC is useful, when these institutions follow policies contrary to the objective of maintaining a stable and solvent financial system.

(c) **Controlling Powers:** The SEC can suspend or cancel the listing of any securities or the trading of any securities for the protection of investors, if there is evidence that some irregularity or malpractice has been done in that particular transaction. This power granted to the SEC is very vital in the sense that the ultimate protection to the investor has to be provided by it. In a securities market, participated by numerous market agents, it is inevitable that some market agents may seek to derive undue profits at the expense of others. Unless there is some check on these occurrences, the credibility of the securities market will be lost seriously damaging the future development of the market.

(d) **Advisory Powers:** One of the duties assigned to the SEC is to advise the Government on the development of the securities market. This role assigned to the SEC is understandable since it is in over-all charge of the securities market. However, the Central Bank remains the economic advisor to the Government including the matters relating to the securities market. While one cannot argue that the Government should seek advice only from one institution, there will definitely be a problem if these two institutions give two contradictory pieces of advice to the Government.

(e) **Examining powers:** The SEC could inquire into the business affairs and examine books of licensed stock exchanges, stock brokers, stock dealers, unit trusts and listed public companies, whenever there is reason to believe that an irregularity or a malpractice has been done by any of these institutions. This power will enable the SEC to maintain a proper securities market and professional standards in the market. When these inquiries produce findings of malfeasance, such findings could be published by the SEC for the information of the general public. Such publications will make the operations of securities markets transparent to the public thereby helping to inculcate the confidence of the investors in the market.

In addition to the above powers and functions, two more functions assigned to the SEC deserve comment. One is the question of insider trading and the other is on the procedure to be adopted in operating the compensation fund.

We have already dealt with the guidelines set by the CSE in its Corporate Disclosure Policy on the question of 'insider trading' in the previous section. The SEC Act too provides for a wide range of provisions on this matter. The devotion of an entire Part (Part IV) for 'insider dealings' in the SEC Act testifies to the importance it has given to this subject.

In terms of the SEC Act, the dealing in securities in the following circumstances by individuals concerned is construed as 'insider dealing' which is an offence punishable with a jail term upto 5 years and/or a fine upto Rs 10 million.

(a) When a person has access to exclusive information on a company, because he is a director or an employee of or a consultant to that company or a related company.

(b) When a person obtains exclusive information on any company because he is a director or an employee of or a consultant to another company.

(c) When a person has obtained exclusive information on any company through any other individual who has access to exclusive information relating to that company.

(d) When a person has obtained unpublished price sensitive information on a company about which he is going to submit a take-over offer.

(e) Advising other people to buy shares when a person has obtained information in the manner set out in (a) to (d) above.

Thus, insider dealing has a very wide meaning in the SEC Act. However, it is difficult to eliminate it altogether by legal means, because of the difficulties in proving them in courts of law or commissions of inquiries. Therefore, the Act sets out as a moral guideline that it would be reasonable to expect that a person connected to a company will not use any exclusive information for his private gain except in the discharge of his normal duties and functions. Further, the Act stipulates that a person should not deal in securities when he knows that he has access to unpublished price sensitive information relating to these securities.

Certain types of transactions have been exempted from the meaning of 'inside' dealing' mentioned above, even if a person has obtained exclusive information on a security. These exemptions have been made in order to facilitate normal transactions in a securities market.

(a) A transaction done in good faith as a liquidator, receiver or trustee in a bankruptcy.

(b) If the information was obtained by him in the ordinary course of his business.

(c) If the information in question was obtained by him in the course of his business as a stock broker or a stock dealer in which he was engaged or employed.

One of the objectives of the SEC is to maintain a Compensation Fund for the purpose of compensating investors who had to undergo losses due to the failure of stock dealers/brokers to fulfil their contractual obligations. The provisions relating to this Fund have been set out in Part V of the Act. The salient features of these provisions are as follows:

(a) The Fund should consist of moneys allocated by the Government. The use of public funds for this purpose appears to lead to a moral hazard practice, since the stock dealers and brokers whose action leads to the payment of compensation do not have incentives to exercise care and caution when fulfilling their contractual obligations. Hence it would have been much more prudential, had the Fund consisted of moneys recovered from stock dealers/brokers on a regular basis.

(b) The affairs of the Fund will be managed by a three member committee appointed by the Minister from among the members of the Council. The appointment of a sub-committee to handle compensation questions is a practical measure, since the entire council cannot meet regularly to dispose of such complaints.

(c) The Sub-Committee will assess the requests for compensation and award such compensations out of the moneys in the Fund. The decision of the sub-committee for all purposes will be final and conclusive.

(d) The affected investors should submit their applications to the sub-committee within 3 months of suffering financial losses. The Committee may examine all the relevant documents, examine other evidence relating to the case and decide to allow or disallow the claim for compensation.

Within the first 5 years of operation of the SEC, no case has come up before it for compensation of investors due to failure of the stock brokers operating in the CSE. While this is a testimony for the responsible hehaviour of stock brokers observing the ethics of their trade and maintaining the professional standards, the SEC should not be complacent in this regard. It would be more important to prevent such occurrences as far as possible rather than waiting for payment of compensation at the end.

In this section, we discussed the regulatory aspects of the securities market. While it is beneficial to have financial markets self-regulated as far as possible, the high social costs of any failure of these markets compel authorities to exercise at least a certain degree of supervision on them. The regulation and supervision do not guarantee solvency and the stability of the financial markets. Yet the existence of a prudential regulatory system will at least help build up investor's confidence which is essential for the smooth operation of such markets.

SECTION 6: MACRO - ECONOMIC POLICIES AND THEIR IMPACT ON THE STOCK EXCHANGE*

Macro-economic policies, as distinct from their micro counterparts, consists of of measures adopted by authorities to influence the aggregate economic behaviour of a country. The main target variables to be influenced by such policies comprise the levels of real national output, prices, employment and resource utilisation. Since the economy is made up of an infinite number of distinctive economic units acting independently but reacting to each other, macro-economic policies assume that their behaviour could be influenced by changing the general conditions under which they are operating. The authorities usually attempt to achieve two interrelated objectives by adopting macro-economic policies. First, as a short term stabilisation policy, macro-economic policies attempt to lead the economy along its long term growth path whenever it deviates from the trend line due to economic fluctuations. Second, as a long term growth strategy, macro-economic policies endeavour to create a conducive environment for the economy to achieve a continued economic growth and maintain overall efficiency in resource allocation, production and consumption. To achieve these objectives, it is often emphasised that authorities should adopt prudential macro-economic policies, a set of policies which are consistent with each other and do not lead the econ-

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* This section is based on a paper presented by the Author at the Seminar on "The Share Market - Its Application and Economies" by the Chartered Institute of Management Accountants of Sri Lanka on 17 th August 1991 in Colombo.

omy to bankruptcy in the long run. The basic policy instruments available to authorities in this respect consist of three main policies, viz. fiscal policy, monetary policy and exchange rate policy. This section will identify the impact of these policy instruments on the efficient operation of the Stock Exchange.

A. Theoretical Considerations of Macro-economic Policy:

An Overview

There are three main macro-economic policy instruments available to authorities in order to influence a country's aggregate economic behaviour. These policy instruments consist of fiscal policy, monetary policy and the exchange rate or the balance of payments policy. Of these policy instruments, the first policy is mainly implemented by the Government, while the last two are implemented by the Central Bank.

(1) Fiscal Policy

Fiscal policy consists of measures adopted by the Government to influence the level and the composition of Government revenue and expenditure. The supposed impact of fiscal policy on the economy is based on a utilitarian analysis which assumes that individual economic agents change their behaviour in response to the changes in the relative cost-benefit composition faced by them. Accordingly, any imposition of a cost or the removal of a benefit is assumed to curtail the activities of individuals, while the extension of a benefit or the removal of a cost induces them to expand their activities. The basic policy instruments used by the Government in this connection are the tax policy and the expenditure policy. Whenever a new tax is introduced, the economic agents are expected to reduce their activities in response to the new cost inflicted on them. Similarly, when benefits are granted to individuals, they are expected to enhance their activities in order to reap the full benefits. Following this line, the Government has, at various stages, introduced different tax measures and expenditure policies so as to achieve specific objectives by influencing the behaviour of economic agents.

(2) Monetary Policy

The Monetary Policy which is a monopoly of the Central Bank consists of any policy measure adopted by the Bank to influence the cost and the availability of money. The cost of money is simply the opportunity cost of money or the rate of interest. The availability of money is the availability of money as a stock to economic agents through the credit creating processes of the banking system. Consequently, the monetary policy has been divided into two sub policies, viz., interest rate policy and the credit policy of the Central Bank. However, it is very important that the monetary policies are implemented in co-ordination with the fiscal policy, so as to ensure the maximum efficacy. This is because if the Government resorts to borrow from the banking system so as to finance the budget deficit, the resultant monetary expansion will force the Central Bank to adopt restrictive monetary policies. These restrictive monetary policies in turn impose an undue constraint on the operations of the private sector and therefore, should be regarded as a tax imposed on the private sector. Thus, it is important that the cost of monetary policy should be equally distributed between the Government sector and the private sector.

In any economy, the existence of an active capital market constitutes one of the pre-requisites for attaining continued economic growth. The capital market provides long term financial facilities to enterprises so as to raise the rate of investment capital and thereby the production capacity of the economy. The efficient operations of the capital market will depend, to a large extent, on the variety of savings instruments available to investors and the underlying liquidity and safety considerations. The monetary policy can play an important role in promoting these conditions that are necessary for a successful operation of the capital market.

(3) Exchange Rate or the Balance of Payments Policy

The responsibility for the formulation of exchange rate policies lies mainly with the Central Bank and to a lesser extent with the Government, but the Central Bank functions as the main implementation agency. Under exchange rate policies, the objective of the authorities is to maintain the internal and external balance in the economy by allowing the value of the domestic currency to reflect its true cost in transactions in the domestic economy as well as with the rest of world. In fact, the preservation of the value of the currency in this manner is one of the two objectives of the Central Bank. This requires the Bank to pursue a realistic exchange rate policy based on the operation of the demand and supply forces in the market. Accordingly, when there is an excessive demand for foreign exchange (an increased supply of the Sri Lanka rupee) the value of the rupee should be allowed to depreciate in the market; conversely a greater supply of foreign exchange (greater demand for Sri Lanka rupee) should lead to an appreciation of the currency. The authorities should attempt to achieve these objectives by adopting a flexible exchange rate system and a liberal trade and payments policy so as to maintain efficiency in the foreign exchange market

An appropriate combination of the three policies under reference will help the authorities to create the required economic conditions for a self-sustained growth in the economy in the long-run. All policies should be consistent with each other and clearly spelt out so as to dissipate any doubt in the mind of economic agents. Any contradiction in the policy will neutralise their effect in the short run and will act counter to the growth objectives in the long run.

B. A Review of the Macro-Economic Policy Stance in 1980s

A salient feature of the macro-economic policy stance that was in force in Sri Lanka in 1980s has been the major emphasis placed on the need for checking inflation and, through it, maintaining stable exchange rates. These two objectives normally form the crux of the short term stabilisation policies pursued by governments. However, the two objectives are so inter-related that the achievement of the first is a pre-requisite for achieving the second. Since inflation leads to build pressures on the exchange rate, a deteriorating exchange rate is usually regarded as a symptom, but not the cause, of inflation. This is why the current policy stance has placed a considerable emphasis on inflation. An inflation-free era is a key factor determining the investor confidence, a condition necessary for ensuring a continued high capital investment in the economy. In this connection inflation taxes investors by forcing them to take unnecessary risks in the form of having to use their resources for insurance against rising prices. Hence, all macro-economic policies are presently geared to the achievement of this short run stabilisation objective so as to minimise the underlying adverse effects.

In the area of fiscal policies, the main objective of the Government in the 1980s has been the maintenance of a high public sector capital formation rate by raising the quantum of capital expenditure of the Government to a considerably high level. The Government's participation in capital formation was necessitated by the inadequacy of basic infrastructural facilities in the economy for sustaining a continued economic growth. Accordingly, a huge sum of money was invested by the Government in power generation, road network, irrigation activities, buildings and ports and airports etc. This high capital expenditure coupled with an ever-expanding recurrent expenditure pushed up the total expenditure of the Government to a significantly high level of about 33 per cent of GDP in late 1980s. The component of capital expenditure accounted for about 10 per cent of GDP. With a total revenue of around 21 per cent of the GDP, Government fiscal operations resulted in a deficit of about 11 per cent of GDP on average. The corollary of such a huge budget deficit was the need for financing the budget through a variety of sources.

There are three conventional sources which the Government normally chooses to tap in order to finance the budget deficit. All these sources were used in varying degrees during 1980-92. First, a significant portion of resources was utilised from the country's banking sector, mainly the Central Bank, by issuing a substantial volume of Treasury Bills to raise short term funds. However, since the Treasury Bills were continuously re-issued, this source of financing ultimately turned out to be a long term source of financing for the Government. The underlying monetary expansion through the bank borrowings for budgetary purposes led to instability in the price levels: this was tantamount to the imposition of an inflation tax on the private sector to effect a transfer of resources from that sector to the Government sector. The second source used by the Government for budgetary purposes was the utilisation of domestic compulsory savings grenerated through the Employees' Provident Fund and voluntary savings generated through the National Savings Bank. These two sources do not lead to monetary expansion and are therefore regarded as non-inflationary. However, when the Government utilises resources of this magnitude for its own purposes, a reduction in the resources available to the private sector may result in a possible crowding out of the economic activities to be undertaken by that sector. Thirdly a significant amount of foreign resources was utilised by the Government to finance the budget deficit specially to meet the foreign exchange cost of the capital projects undertaken by the Government. On an average, the foreign financing of the budget amounted to about 6 per cent of GDP during 1980s. Most of the loans were contracted as project loans extended by major donor countries under concessionary terms.

During 1980s, the deficit in the Government sector emerged as the principal source of inflation in the economy. Hence, the expansionary fiscal operations of the Government led to the imposition of restrictive monetary policy measures by the Central Bank so as to check inflation. However, such restrictive policies normally resulted in a curtailment of the private sector economic activities and therefore, should be regarded as an implicit tax on the private sector. Since 1980, the authorities have introduced a rather stringent monetary policy package consisting of both quantitative monetary policy measures and market oriented monetary policy measures. Of the quantitative measures, the Bank rate has been raised to 15 per cent, statutory reserve ratio to 13 per cent, while bank lending for non essential purposes has been restricted. At the same time, authorities have used market type monetary policy measures such as the open market operations policy. Under this policy, a rigorous secondary market for Treasury Bills has been developed so as to reduce the ever increasing excess liquidity in the economy. Interest rates on Government Treasury Bills have been allowed to increase from a level of about 13 per cent to 17 per cent, so that funds would flow from the non bank public to the Government sector. However, the overall impact on the restrictive monetary policy measures has been the additional constraints imposed on the private sector to undertake new economic activities.

In the field of the exchange rate policy, Sri Lanka had been adopting a relatively greater open economy policy since 1977. The degree of openness should be compared with the policy package in force in the previous period and not with the other countries in the region which have increasingly opened up themselves to international trade. Of the three main accounts of the balance of payments, viz., the merchandise account, service account and the capital account, only selected items in the import category of merchandise account had been opened under the new policy even till 1989. In the case of imports, major items such as crude oil, sugar, rice and subsidiary food items had remained a virtually government monopoly upto very recently. Therefore, of the total import bill, only about 40 per cent of imports had been opened up for free trade. With regard to the other two accounts, the capital account had been completely restricted and controlled by authorities upto 1989, while the service account had been slightly liberalised by allowing citizens to undertake restricted travel and pay for other services.

It is only in 1990 that authorities started to pay attention to the question of liberalising the capital account of the balance of payments. Even by 1992, all foreign borrowings were subject to the control of authorities With regard to private foreign investments, initially a limited relaxation was extended in the form of allowing foreign investors to acquire equity in local companies upto 40 per cent of the total issued share capital. This was completely liberalised in 1992. Foreign investment with the Greater Colombo Economic Commission (now Board of Investments) has been fully liberalised but subject to the approval of the GCEC. With regard to the transfer of capital and profits arising from private foreign investment, it is still necessary to obtain exchange control approval for investments outside the GCEC. It is, therefore, considered that Sri Lanka has a long way to go in order to achieve a relatively higher degree of openness in its foreign exchange transactions.

C. Impact of Macro-Economic Policies on the Stock Exchange

The stock exchange, like an individual banking institution, is merely a micro entity in the capital market. Its main function is to provide a formal market floor for the listed companies to raise loan and equity capital at the primary market level and provide liquidity and opportunities for portfolio re-adjustments to investors at the secondary market level. For the successful operation of a stock exchange there are certain pre-requisites to be satisfied: a legal environment to conduct transactions in a fair and orderly manner, free dissemination of information among investors, investors' confidence in the financial system, availability of a variety of savings instruments in the market, low transaction costs and an improvement in the demand and supply conditions in the market. The stock exchange should achieve these qualities on its own and the general macro-economic policies can play only a marginal role in helping it to achieve them. In this connection, selective micro type policies could be more appropriate to promote the activities of the stock exchange and maintain the required degree of efficiency.

There are basically three characteristics of macro-economic policies that serve to build up investor confidence: prudence predictability and reliability. Macro-economic policies should be prudential in the sense that the adoption of such policies will allow the economy to move along the long term growth path avoiding any possibility of wild deviations. To perform this task, policies should be compatible with each other so that all policy measures should reinforce one another in bringing about the desired changes in the economy. If one policy measure is negated by another policy measure, the overall impact of the policy on the economy becomes neutral. It so happens that when certain macro policy measures are adopted by authorities in one area with a view to bringing about efficiency in the overall system, the effect of these policy measures are countered by other measures that are injurious to the healthy operation of the market system. For instance, authorities may adopt restrictive monetary policies in the form of high interest rates and a curtailment in credit expansion so that the market system will receive a price incentive to allocate credit for the most desired needs of the economy. In such a background, the extension of cheap refinance loans by authorities will prevent the market system from determining the economically desired level of credit thereby leading to a misallocation of resources towards the sectors for which concessionary bank credit is available. Probably this may lead to a mis-use of credit through the refinance schemes. The presence of such contradictions in the policy reduces the prudence in the macro-economic policies.

When a certain policy package is announced by authorities, any departure from the declared policy will reduce its reliability as well as predictability. Such a policy will force investors to form adverse opinions on its credibility and prevent them from making predictions about its future course. It is only in a background of credible and reliable policy that investors are able to change their behaviour in the long run in response to the conditions created by the policy. For instance, if the authorities have declared policy measures to stabilise prices and the exchange rate, the continued adoption of that policy will lead investors to respond to it appropriately. If there are policies that are counter to this objective, then, the reliability of the policy package is greatly diminished. Furthermore, the investors' inability to predict the future policies will leave them in an uncertain and risky situation weakening their initiatives to engage in economic activities. Hence it is of utmost importance that the macro-economic policies adopted by authorities should be prudential, credible and predictable.

One of the basic policy measures adopted by authorities to promote the stock exchange is the fiscal policy. Under fiscal policy measures, authorities attempt to promote the operations of the stock exchange by providing various tax incentives to direct the activities towards the desired end and imposing taxes on other areas where a curtailment is necessary. Such a system of policy is popularly known as 'supply-side economics', since it intends to remove bottle-necks in the supply of goods and services. In Sri Lanka, the following tax policies have been adopted in order to promote the activities of the stock exchange.

(1) Policies to promote investment -

(a) **Investment relief** - Investment expenditure in specified investments such as venture capital companies, unit trusts or mutual funds has been exempted from income tax upto Rs 50,000 or one third of the assessable income whichever is lower.

(b) **Tax treatment of dividends (withholding tax)** - The withholding tax on dividends has been gradually reduced from one third of the dividends to 15 per cent over the time.

(c) **Tax Concessions to Group Investors** - A five year tax holiday has been granted to unit trusts while a 10 year tax holiday has been granted to approved venture capital companies.

(d) **Capital Gains Tax on Share Transactions** - Capital gains tax in respect of quoted company shares has been abolished.

(e) **Abolition of Wealth Tax on Quoted Shares** - No wealth tax is payable on the holding of shares in quoted public companies.

(2) Measures to promote the Stock Exchange

(a) **Stamp Duty** - Stamp duty payable on the issue and transfer of shares in quoted public companies has been abolished.

(b) The 100 per cent tax on the transfer of shares involving foreign nationals has been removed.

(c) No exchange control permit is required by foreigners to acquire shares in quoted public companies even upto 100 per cent of the ownership.

(3) Measures to promote quoted public companies

In order to promote quoted public companies with a broad based ownership, the profit tax has been reduced from 50 per cent in the case of private companies to 40 per cent in the case of quoted public companies. However, to become eligible for the reduced tax rate, the following two stipulations have been made:

(1) the company should have more than 200 shareholders, and

(2) not more than 5 persons should own more than 60 per cent of the total equity.

(4) Tax Holidays for approved investments

The following categories will be entitled to tax holidays/tax exemptions for a period of 5 years provided that the initial investments are made during the period from 01. 01. 1990 to 30. 06. 1992.

(1) Companies providing industrial infrastructure facilities for labour intensive and/or export oriented projects;

(2) Offshore services such as insurance, shipping and aviation, underwriting, syndication of loans and international consultancy;

(3) The profit component resulting from the expansion of capacity in respect of existing industries by installing additional plant and machinery as approved by the Ministry of Industries.

All these tax concessions are intended to promote investments in limited liability companies listed with the Stock Exchange and facilitate transactions by reducing the transaction costs involved. However, the policies are to be applied selectively and the objective of authorities has been to promote selective areas such as export oriented projects and industrial projects. At the same time, certain policies have been adopted to promote the institutional infrastructure of the capital market. So far capital market of the country had been highly biased in favour of the long term development banks. The new measures have attempted to rectify this imbalance by promoting new institutions such as unit trusts, venture capital companies, mutual funds etc. The tax holidays granted to these institutions will allow them to earn sufficient profits in the initial period of operations, so that they can stand on their own after getting established firmly in the market.

Establishment of unit trusts in the capital market should be regarded as an important step taken to promote the activities in the Stock Exchange in many respects. Traditionally, Sri Lankan savers had been used to place their money in interest bearing bank deposits and remain inactive in equity investments. Consequently, the activities in the stock market has been completely left to a few individuals who had virtually monopolised the market. In order to broad-base the stock market, it is necessary to mobilise small scattered savings from every corner of the country and make such savings available to companies which desire to raise equity capital. To achieve this end, unit trusts could help small savers to obtain a stake in the capital market by providing a variety of savings instruments to them under professionally managed investment schemes. Furthermore, when many people participate in the stock exchange, the transaction cost in the exchange would increase due to congestion and increased volume of activities. Unit trusts provide a group investment facility which would in turn help reduce the congestion on the market floor. In this respect, the concessions given to unit trusts by tax exemptions should be viewed as a salutary measure. However, the discrimination between unit trusts and venture capital companies does not seem to be justified. Unit trusts are given only a 5 year tax holiday, while venture capital companies have been granted a 10 year tax holiday. The different tax concessions therefore affords an undue preference to venture capital companies over unit trusts, thereby causing a greater allocation of resources to the former than the latter. As far as the business risk and the need for innovations are concerned. both type of institutions face the same market environment. Therefore, it is necessary to rectify this imbalance by equalising the tax concessions granted to them.

A related problem with macro policy is the perceived "lack of credibility" of the policy. This situation discourages both investors and companies. In the past, there has been a number of instances where authorities failed to give a clear indication as to their intention with regard to the development of the capital market. As an incentive to investors, capital gains on share transactions were exempted from income tax in early 1980. However, this facility was withdrawn in 1986 presumably to discourage speculators who were considered to be a hindrance to the development of the share market. This move on the part of the authorities left many unanswered questions in the minds of investors as to the predictability of the policy. To prove their doubts, capital gains on share transactions were exempted from income tax again in 1990, provided shares were held for a minimum period of 12 months. A similar instance of unreliability in the policy was the reduced tax rate on quoted public companies. In order to encourage the formation of broad-based companies, the applicable tax rate was reduced from 50 per cent in the case of private companies to 40 per cent in the case of quoted public companies. Many companies tried to gain this tax advantage by becoming public and getting listed in the stock exchange. However, in 1990, the tax concession was restricted to companies with more than 200 members and a dispersion of shareownership in such a way that five or less do not hold more than 60 per cent of the shares. Consequently, the companies which originally opted to become public so as to reap the benefit of reduced tax rate were required to make a further internal adjustment in order to continue to enjoy the tax benefit. That kind of sudden marked departure from the announced policy is not conducive to win the confidence of investors and companies.

One of the problems faced by the capital market in Sri Lanka is the smaller number of public companies quoted in the stock exchange. Of the 17,000 odd limited liability companies operating in the country only 190 are quoted as at end 1992 in the stock exchange. One advantage of becoming public by a company is the ease with which it could raise the needed long term capital for expansion purposes. However, the refinance policies of the Central Bank and the past over-emphasis on the development of the development banks provided easy concessionary long term credit to companies irrespective of their status. This obviated the necessity for raising capital in the market, a relatively more expensive method of raising funds. At the same time, authorities attempted to stabilise prices by adopting restrictive monetary policy measures in the form of high interest rates and low credit levels. In such a background, the concessionary long term credit granted by development banks and under Central Bank re-finance schemes served to remove the incentives for companies to convert themselves into public companies, let alone getting listed in the Stock Exchange. At the present stage of development of the Stock Exchange, a smaller number of listed companies may be a blessing since the facilities at the Exchange are not adequate to accommodate more companies. However, in the long run, when the expansion of the stock exchange is desired, it is necessary to eliminate distortions in the form of low cost long term credit at rates significantly lower than the prevailing market rates.

The share transactions in the stock exchange upto 1989 were confined only to local individuals. By means of restrictive exchange control measures, authorities had successfully removed foreign investors from the stock market over the time. However, private foreign investments at present form an integral part of the development of any stock exchange in the world. Many growing stock exchanges in the region had the benefit of foreigners' active participation in their early stages of development. In Sri Lanka, several measures adopted by authorities seem to be a dis-incentive for foreigners to actively participate in the country's stock exchange.

Up to mid-1990, a very prohibitive transfer tax of 100 per cent had been imposed on share transfers involving foreigners. This tax along with several other measures, was responsible for removing foreigners from the share market altogether. However, having realised the underlying cost of closing the door to foreign investors, action was taken to remove it in mid-1990. Consequently there had been a marked improvement in the share trading activities of the Stock Exchange mainly due to an increased participation by foreigners, on the one hand, and the perceived prospect of earning speculative profits by local investors, on the other. However, with the abolition of the transfer tax, the authorities still seemed to prefer to retain a certain amount of control over foreign investments by limiting the equity to be acquired to 40 per cent of the total capital. This restriction would have been imposed with the objective of preventing foreigners from becoming the owners of the local enterprises, by displacing Sri Lankan businessmen. However, this fear about a possible take-over of local business by foreigners does not seem to be well founded. Foreigners may acquire equity upto 100 per cent, only if they view the business in question as a viable and stable one and the economy shows signs of stability and strength. In the initial period, even if foreigners are allowed to acquire full equity, there is no potential danger to the local businessmen, since such a move may lead to effect a costless transfer of much needed technology to the local economy. Having realised the impediments placed on foreign investors, foreigners were allowed in 1992, to acquire even upto 100 per cent of shares of local companies.

The above analysis shows that macro-economic policies cannot perform miracles to promote the Stock Exchange. They can help investors by creating a stable macro-economic environment, mainly, stable prices and exchange rates, so that investors would not be forced to take unwarranted risks. Furthermore, when a policy package is announced, it is vital that the authorities refrain themselves from departing from that policy suddenly so as to gain credibility and predictability of the policy. Apart from this, the activities of the Stock Exchange are mainly affected by selective types of macro-economic policies such as the tax policy, interest rate and credit policy and the balance of payments policy.

In summary, macro-economic policies consist of measures adopted by authorities to influence the aggregate economic behaviour such as the real national output, general price level, employment and the rate of resource utilisation. The main macro-economic policy instruments available to authorities comprise the fiscal policy, monetary policy and the exchange rate policy. Fiscal policy which wholly falls within the domain of the government covers areas such as the tax policy, government expenditure policy and the public debt policy. Similarly, monetary policy which is a monopoly of the Central Bank includes its actions to influence the rate of interest and the level of credit in the economy. The exchange rate policy which is the responsibility of both the government and the Central Bank covers measures adopted to determine the exchange rate and the controls over foreign exchange payments. These policies could create a conducive environment for the efficient operation of the Stock Exchange, a sub-market in the capital market of the country.

The macro-economic policies in force since 1980 are all geared to stabilise prices and the exchange rate, so that an ideal ground situation would be created for the private sector to flourish and promote its economic activities. Apart from this general role of the macro-economic policy, the Stock Exchange is directly affected by the selective macro policies such as tax concessions, interest rate policies and the free transfer of capital to ensure private foreign investments. The current selective macro-economic policies in Sri Lanka attempt to provide the maximum incentives to boost the Stock Exchange activities. One vital requirement in this respect is the need for maintaining a consistent set of policies without causing sudden deviation from the announced policy so as to gain credibility for the policy package.

SECTION 7: SOME CONCLUDING REMARKS

The pivotal role which an efficient capital market plays in an economy in accelerating its economic growth was highlighted in the previous sections. The efficiency in this context is understood by reference to three major functions performed by the capital market. First, the capital market should be able to mobilise medium and long-term resources on a scale sufficient to meet the contemporary development needs. Second, the market should develop suitable mechanisms, instruments and institutions to channel these resources to those who can use them most productively. Third, in the process of mobilising and channelling resources, suitable methods and systems should be developed to pool and share risks by all parties involved in transactions. When these three functions are simultaneously performed, the capital market is said to be operating efficiently so as to enable it to maintain the required quantity and quality in its financial transactions. An environment conducive to such a development will be created allowing the capital market to develop on market principles, occasionally supported by regulation by authorities with the aim of strengthening market forces.

Sri Lanka's capital market is characterised by a lop-sided development with a well developed loan market and a fledgling securities market. This structure of the market itself is inimical to the attainment of efficiency. The corollary of this lop-sidedness in development is the transaction costs in the loan market becoming significantly lower than that in the securities market. This will encourage long-term fund users to seek more and more assistance from the long-term lending institutions and rely to a lesser extent on the securities market for that purpose. This will create a bias towards borrowing rather than equity financing as far as fund users are concerned. When borrowing becomes a relatively easier activity with a lower transaction cost, fund users tend to avoid the more costly and complex securities market. Hence, the future development of the capital market will call for the elimination of this imbalance in the market.

Historically many factors have been responsible for the observed imbalanced growth in the structure of the country's capital market. One such factor was the retardation in the evolution of the business enterprises in the country. Normally, the order of the evolution of business enterprises in a country is from sole-proprietorship to partnership, from partnership to private company, from private companies to public companies and from public companies to quoted public companies. In Sri Lanka, this evolution took place only upto the stage of private companies and no further. When corporate form of business was desired, private companies were formed. But, any further move from there onwards was not considered to be desirable on account of the higher costs involved on the one hand, and the absence of any practical difficulties for private companies to raise resources, on the other. Hence, as against 17,000 odd private companies, there were only a handful of quoted public companies numbering about 190.

The policies adopted by authorities too contributed to this retardation in the evolution of business enterprises into public companies. The authorities had helped to develop a fair structure of long-term lending institutions and these institutions provided an easy way of raising resources by way of medium and long term loans. The re-finance granted by the Central Bank under its Medium and Long Term Credit Fund Scheme, the Small and Medium Scale Industry Loan Scheme operated by the NDB backed by the resources from the ADB and the schemes like Central Bank's National Credit Plan and the Regional Rural Development Banking Schemes too contributed to the free and easy availability of resources to private companies in the form of loans. The re-finance schemes of which one of the objectives was to lower the cost of credit to borrowers carried comparatively lower interest rates than the prevailing market rates. This made loan financing cheaper and there was, therefore, no necessity to go for costly equity financing by the companies concerned.

The tax policies pursued by authorities in a way helped discourage the conversion of private companies into public companies. As for the corporation income tax, there was a slight reduction in the applicable tax rate in the case of public companies. The public companies were paying at the rate of 40 per cent, while private companies were subject to a higher rate of 50 per cent. When compared with the additional costs to be incurred by being public, the 10 percentage point reduction in the applicable tax rate was not a sufficient incentive for a company to convert itself into a public company. In this context, a tax differential of about 25 per cent would have been sufficient to serve the purpose. From the supply side of funds to the securities market, the authorities successfully kept the investors away from the market by continuously refusing to abolish capital gains tax on share transactions, wealth tax on share holdings and withholding tax on dividends. For a long period of time, these taxes had been in force and, therefore, there was a permanent dislike about the securities market created in the mind of the investors. Thus, when these taxes were abolished recently, it did not make that much of an impact on the share market.

Traditionally, the main mobilisers of long-term funds in the country, viz, the Employees' Provident Fund, the National Savings Bank and the state sector insurance companies, were all under the direct control of the government. Hence, the funds mobilised by them were not made available to the country's share market, but used by the government, for generations, as a source of borrowing long term funds by issuing government bonds. These captive investors thereby failed to strengthen the supply flows of funds to the country's share market. The monopolisation of the government bond market by these captive institutions resulted in the non-development of a free primary as well as a secondary market for these bonds. These institutions were not permitted to take risky portfolio management decisions and therefore, were condemned to hold onto the bonds acquired by them in the primary market until their maturity. Hence, subscriptions to government bonds was more or less like a privately arranged investment scheme rather than operated through the market.

The lack of incentives to form public companies as mentioned above contributed to a faster growth in the loan market as against the country's securities market. Consequently, the loan market was characterised by the existence of some sophisticated long-term lending banks rich with expertise and resources. This historically evolved outcome cannot and should not be reversed at this time. Hence, the most practicable method to rectify the imbalance in the market is the utilisation of both the expertise and resources belonging to development banks and commercial banks for developing the securities market.

The recent developments in the securities market in Sri Lanka amply display the use of rich resources of development banks and commercial banks for strengthening fund flows to the market on the one hand and building the institutional infrastructure in the market, on the other. The contributions of the banks for the development of the market should be treated as a welcome sign and encouraged by all means. The activities undertaken by banks in this respect encompass several areas. First, banks have used their own resources for equity investment in the share market thereby directly contributing to its fund flows. Second, banks have helped the primary share market by underwriting and managing share issues. Third, banks have pioneered to set up new institutions in the market so as to build up the institutional infrastructure in the market. The new institutions so created recently include broking companies, unit trusts and financial services companies. While the role which the banks have so far played in the securities market is laudable, they should be encouraged to engage in future activities in the share market.

A notable weakness in the CSE is the absence of market makers or share dealers. On account of this, any destabilising speculation in the market does not get self-corrected and the market is subject to long bouts of declines and upswings. If there are dealers who buy shares on their own account, any oversupply could be readily absorbed by them preventing substantial price falls. Similarly, if there are excess demands for shares, the dealers could unload shares out of their own portfolios so as to meet the excess demand and prevent further price increases. Hence, the market activities as well as prices are smoothened by the operation of the share dealers. The absence of this important market agent in the CSE has resulted in the lengthy bullish and bearish markets thereby adding an element of uncertainty to investors in the market. Hence, immediate action sould be taken to develop such institutions as dealing houses in the CSE. Perhaps the sophisticated banking sector could be pursuaded to set up such institutions by granting limited period tax concessions.

The small size of Sri Lanka's share market is perhaps a blessing at this stage, since it has been insulated from the adverse developments in the share-markets in the rest of the world. Consequently, the investors can expect to have a greater steadyness in the CSE than in other internationally linked share markets. This would perhaps be an attraction to foreign investors, since their moneys are safer in Sri Lanka's share market than in other developed markets in the region which normally fall victim to adverse developments elsewhere in the world. On this count, Sri Lanka's share market can easily become an emerging market thus moving faster than the other competitors in the region.

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