

**Progress and Problems
of Development Financing**

The primary focus of the government's medium term (1980-1990) strategy has been on issues connected with the structural transformation of the country's productive capacity. Government funds, through its public investment programmes, have been channelled into public sector projects whose objective has been to assist in this transformation; while the development banks and other financial institutions were expected to assist the private sector to achieve this same objective. The private sector has been assigned an important role in the strategy of structural transformation in the medium term and in recent years with this objective in view the government has provided a variety of incentives for private sector development. However, the results so far have not been upto expectations. While there had been a favourable response to incentives in sectors such as paddy, construction and tourism, industry has moved relatively slowly (except in garments and petroleum products). This slow progress in the latter sector has been accounted for partly due to external factors, such as recession in the developed world in the 1980's and partly to biases in the structure of incentives in the economy.

The government has recognised in its investment programme for 1985-89 that much potential exists in non-traditional industries, particularly, factory industries, small scale and cottage industries. Its declared policy in this regard is to rely more on private entrepreneurship and initiative, while government action is directed towards the provision of basic infrastructure and maintaining an appropriate system of incentives. "It is anticipated that all remaining avenues of efficient import substitution will be exhausted soon and export-oriented

manufacturing closely related to the country's resource endowments will have to be built up. A crucial element in the medium term strategy of the Government will be the restructuring of the investment pattern of the country. Public investment is projected to decline from current levels (i.e. 14.9 percent in 1985) to about 12 percent of GDP by 1989. Over the same period, the relative share of private investment is expected to increase from about 10.3 percent to 13.3 percent of GDP".

In this context it is of interest to look back on the performance of one of the government sponsored financing institutions whose intention is to help in achieving these very objectives. * The NDB recently celebrated its fifth year of existence. It is an appropriate time to review its progress, to examine its own objectives and to consider how far it has been able to achieve these.

This Bank was established in January 1979 and was envisaged to be a significant plank in the government's new economic and development strategy. Its broad aim was the financing of private enterprise through loans and equity. Specifically it set out:

- (1) to become a significant source of term financing and equity
- (2) to stimulate development of the capital market
- (3) to assist the rural sector through a comprehensive refinancing programme for small and medium scale industries,
- (4) to engage in project promotion
- (5) to be willing to accept a higher level of risk than commercial banks by having a more flexible and innovative approach.

There is no doubt that the Bank has achieved its broad aims of acquiring a considerable presence in the field of Development Finance. In these initial years of its existence it has approved financing of 179 projects totalling Rs 1,784 million, in

Of the NDB's Rs 600 million subscribed capital the Government holds 67%, Central Bank of Ceylon 17%, People's Bank 8% and Bank of Ceylon 8%.

nearly all varieties of businesses from partnerships and individuals to large private and public sector companies. This level of activity has enabled a total investment of Rs. 6,823 million to be mobilised, creating employment opportunities for more than 10,000 people. Its business turnover has increased steadily in these 5 years and from 17 projects in 1980 it approved 73 projects in 1984. (The table below sums up the NDB's performance over this 5 year period and generally indicates the type of investment taking place in recent years.

type of financing has attracted competition through leasing schemes started by other financing institutions.

In attempting to stimulate investment in productive and viable projects, however, the NDB has had to face many direct problems in financing and also problems arising from inherent deficiencies in the economic and incentive system. There is for instance the problem why agricultural and industrial output, exports and investment failed to achieve steady growth in the 1980's; the reasons

exports and a deceleration of valuable foreign exchange earnings for the country.

In addition real wage costs have risen progressively for the export sector as a whole from 1979 to 1982 with the tea boom resulting in a decline in 1983-84, albeit to levels still above that of 1978. Real wage cost increases have been more moderate for domestic goods, (that is, goods not traded in world markets) suggesting a weighting of profitability away from exports towards domestic goods.

GROSS APPROVALS OF NDB FINANCING FACILITIES BY SECTOR 1980-1984

Amounts in Rs. Mn.

	1980		1981		1982		1983		1984		TOTAL	
	No	Amount Loan Equity	No	Amount Loan Equity	No	Amount Loan Equity	No	Amount Loan Equity	No	Amount Loan Equity	No	Amount Loan Equity
1. Food Beverage and Tobacco					03	20.30	04	88.50 1.35	04	48.66	11	157.46 1.35
2. Agriculture, Agro Business and Fishery			01	5.80	02	39.40	03	27.28 25.00	07	33.72	13	106.20 25.00
3. Textile and Weaving Apparel	01	14.00	04	66.85 6.20	04	29.80 3.00	02	5.48	11	44.42 0.55	22	160.55 9.75
4. Wood/Paper Products	01	8.00					01	5.20	03	18.95	05	32.15
5. Rubber and Leather Products	02	8.00	02	30.30 3.00	05	53.70 5.89	04	11.99 0.45	12	68.35 0.5	25	172.34 9.84
6. Metals and Chemicals (incl. Petroleum & Engineering)	06	107.70	04	41.80	08	124.80 3.89	11	54.45 7.31	20	111.68 1.23	49	440.43 12.43
7. Hotels	03	79.00 2.50	06	81.20 5.05	07	66.50 0.83	09	61.17 2.00	04	23.59	29	311.46 10.38
8. Service Industries	04	63.50 3.75			03	31.40			07	126.66 26.00	17	268.66 29.75
9. Miscellaneous			02	9.00			02	5.00 3.00	05	19.9	09	33.90 3.00
TOTAL	17	280.20 6.25	19	234.95 14.25	32	365.90 13.61	39	306.17 39.11	73	495.93 28.28	180	1683.15 101.50

In terms of innovativeness and greater risk-taking the NDB was keeping to its objectives. It has made a conscious effort to pioneer certain types of projects and to finance projects which would not have been implemented due to difficulty in obtaining finance from any existing financial institution. These projects include successful ventures in shrimp farming, agro industries, polishing and treating of gem stones, computer software, and foliage plant production for export. The specific innovative financing schemes have been loan syndications and co-financing of projects and equipment financing schemes. In equipment financing a sum of Rs 31.65 million was advanced within a short period and the success of this

according to the review may be found in the behaviour of relative prices and real costs facing these sectors as determined by the exchange rate and tariff structure of the economy. The movement of various cost indices for exports gives some indication of the changing competitiveness of Sri Lankan exports in world markets. The evolution of these indices, relative to corresponding indices for non export activities, show the attractiveness of export oriented activity relative to non-export activity within the national economy. When rates of profit are higher for domestically oriented activities, resources are likely to flow away from actual and potential export ventures to competing uses in non-export sectors, resulting in poor growth of

Also the real capital costs have been higher for the export sector. Real interest rates (that is, nominal rates deflated by own selling price) have risen dramatically since 1979, reaching average rates of 19.1% and 29.3% in 1981 and 1982. Until the export price boom in 1983-84, interest rates had been more moderate, although sometimes still quite high, for the non-traded sector. Comparing real wage and real interest costs between domestic goods and non traditional exports, it appears that apart from the initial devaluation in 1977, the post liberalization period has not witnessed any special attempt to structure production costs in favour of non traditional exports.

The conclusion is that in con-

trast to production as a whole, import activities faced extremely low, mostly negative rates. Between 1979 and 1983, it was significantly more profitable to borrow for import trading than for domestic or export production.

The trade-oriented activity of the Commercial Banks reflects the strong demand for credit due to low (often highly negative) real interest rates faced by the commercial sector. Lowering economy-wide interest rates is not the solution to this problem, states the NDB. Real interest rates in Sri Lanka, so that lowering them further would seriously jeopardize the development of the financial sector which is crucial for growth, while not eliminating the problem of bias against exports. The NDB Chairman, Mr. C.A. Coorey suggests that the solution is to raise the relative price of exports through exchange rate adjustment and tariff reform so that the viability of exports will not be destroyed.

The Chairman's overview of the economy in the 5 year period of 1984 makes reference to the Sri Lanka's balance of payments and debt service position, indicating that post-1977 investment has been largely foreign financed, which reflects the constraints in raising domestic savings, despite increases in real income.

One result has been the increase in recent years of the total external debt service ratio of goods and services. The review states "depending on how one wants to look at it, Sri Lanka's high debt service ratios are as much a reflection of poor export performance as "too much" borrowing. It is not sufficient to be satisfied that external debt build up has gone into higher investment rather than to higher consumption or widening budget deficits. Future balance of payments viability depends crucially on the quality of investment undertaken; efficient foreign exchange earning projects yielding relatively quick returns lend a great deal of flexibility

to external finance management, allowing the country continued and steady access to foreign savings to keep it on a high investment-high growth path. The urgent need for infrastructure projects to provide adequate electricity, irrigation, transport and communications which lay the basis for future expansion of tradable goods production imposes severe constraints on external debt management. For technological reasons, such projects tend to require long gestation periods while the direct services they provide are non-tradable (in world markets) and hence generate foreign exchange only indirectly through the tradable production they facilitate. Thus the ability of Sri Lanka's traditional tree crop exports to earn foreign exchange in the meantime becomes all the more significant. The sharply improved macroeconomic picture in 1984, largely on account of temporarily high tea prices, vividly illustrates the importance of a strong export sector to the country's economic well being.

The poor output performance of the major export crops and the economy's uneven pattern of growth in the 1980's, apart from considerations of income and savings generation, are therefore causes for serious concern".

Also, the performance and experience of the Bank over its 5 years of existence has brought into focus the need for:

- Increasing investment particularly in the tea crop sector and export oriented undertakings.
- Diversification of industrial output, especially into high value added activities.
- Structuring of production costs such as wages, interest rates, tariffs etc. in favour of exports.
- Providing long term credit facilities at reasonable rates of interest for private sector development.
- Realistic and timely adjustments of the exchange rate.
- Increased domestic savings.
- An active securities market.
- Larger investment by both the public and private sectors in foreign exchange earning/saving projects yielding relatively quick returns.

Among the direct problems that the NDB has encountered, in attempting to stimulate investment in productive and viable projects have been a scarcity of well-researched and properly planned projects, due to lack of expertise in both private and public sector organizations in many of the basic business disciplines; and a shortage of new entrepreneurial talent willing to identify and exploit new opportunities made available under the Government's open economic policy.

Other areas which have caused concern are the inadequate management arrangements made by borrowers generally for the efficient and timely implementation of projects and specifically for obtaining the transfer of technology. Very often, the latter area has been left entirely in the hands of the supplier of machinery or the foreign investment partner. Legal covenants included in machinery supply arrangements, technical collaboration agreements and joint venture agreements have not been followed up on many an occasion resulting in considerable loss to the local company.

A surprisingly large number of companies also lacked adequate accounting and financial control systems. This has resulted in failure and undue delay in preparing proper accounts at regular intervals so that the management has no knowledge of the state of affairs of the business and therefore cannot and does not take timely action to deal with financing and/or operating problems.

Further more a considerable number of business establishments, although "public" companies in corporate form, are in fact "family concerns" with shares being closely held and management often unprofessionally organised. This situation has resulted in the business of these companies being severely restricted due to the inadequacy of equity capital. Capital expenditures, have often been

financed by short term borrowings resulting in an unbalanced capital structure with a severe strain on liquidity.

Another major constraint in stimulating investment has been the shortage of equity finance for manufacturing projects; but the scarcity of equity inhibits the growth of enterprises and has caused serious financial problems for existing businesses, which have placed too great a reliance on borrowed funds to finance their ventures.

The NDB's aim of assisting the development of the capital market and widening the base of share ownership in Sri Lanka was implemented relatively recently with the forming of the Capital Development and Investment Company Ltd. (CDIC) in January 1984. The CDIC, sponsored mainly by the NDB, was due to make equity investments in enterprises where the existing equivalent is considered insufficient for the viability of such projects.

This experience of development financing has brought into focus the constraints and contradictions that exist in Sri Lanka's economic environment itself. On the one hand are the government's policies towards enlarging and aiding the private sector; while on the other hand its financing aims are frequently obstructed by the fact that officially unambiguous signals are not being given for improving the environment for the private sector. The strongest of these signals to the private sector in any economy is the interest rate; which continues at a high level.

Yet another issue causing deep concern for all development financing institutions is the feeling that though the private sector was expected to play a crucial role in investment activity and the necessary funds are available it does not have the capacity and resources to absorb more productive investment funds.

Specific policy directions have also appeared to be an urgent need, particularly a statement defining precisely the path of industrial deve-

lopment, states the Chairman in his review.

He also raises the following broad issues which need to be examined and settled if the government's goals of economic development are to be realised:

- What is the impact of the open economic policy of the Government on the industrial development of the country?
- What specifically are the industrial sectors in which Sri Lanka has comparative advantage and how should these be supported and developed?
- The availability of cheap labour and industrial raw materials, such as rubber and other agricultural crops, have often been cited as factors which should attract investment to Sri Lanka in labour intensive and resource based industries. It is also said that Sri Lanka should benefit by the drift of industries from highly industrialized countries on account of their high costs of production. If so, why has this drift been confined only to sectors such as the garment industry?
- What else should be done to enhance Sri Lanka's comparative advantage in other industries?
- Are the promotional strategies presently adopted cost effective? Should they be changed from one of general seminar type publicity and ad hoc investment promotion missions in foreign capitals, to that of a specific and direct approach to potential investors whose profile in marketing and cost structure indicate they could benefit most, from those factors in which we have comparative advantage? How can such investors be identified?
- What is the most appropriate incentive structure for local industrial investment?
- Are the export incentives presently offered adequate and effective?
- Are our infrastructure and costs conducive to the establishment of competitive export oriented undertakings?