

# THE PROBLEMS OF DOMESTIC RESOURCE MOBILISATION IN SRI LANKA

W. A. Wijewardena

Deputy Director of Economic  
Research, Central Bank of Sri  
Lanka.

## Part III

### Capital Market and Resource Mobilisation

The main function of a capital market consisting of one or more securities exchanges is to allocate new funds to those industries and firms that can most effectively use them and provide liquidity to those who desire to make portfolio re-adjustments. In this context, the first function relates itself to the task of resource mobilisation for the expansion of the production capacity of the economy, while the second function helps to build-up confidence among investors about the safety of the funds and the solvency of the system in which they have invested by providing secondary market facilities. The efficient functioning of the securities market is dependent on the free and timely availability of information and the competition among the market participants.

Though Sri Lanka has a long history of corporate form of business organisation, its capital market, by any comparison is still in a state of rudiments. Supply of loan capital to private firms through the issue of bonds or debentures takes place very rarely; the share market, both primary and second-

ary is yet to develop and expand in order to meet the equity capital requirements of a growing private sector.

Sri Lanka's stock exchange is still in its infancy with only four years of operational experience. With the limited volume of daily transactions, the trading floor cannot operate longer than two hours a day. Only 174 public companies

	Percent
1981	0.0225
1982	0.0275
1983	0.0208
1984	0.0483
1985	0.7417
1986	0.8176
1987	2.1327
1988	1.4291

Source: Colombo Securities Exchange

are registered in the stock exchange, though more than 15,000 companies have been granted limited liability status in Sri Lanka.

An active share market, both at the primary and the secondary level, is a necessary condition for the growth and the functioning of the private sector economy on a corporate basis. Primary market enables the private companies to raise the needed capital in the market and maintain a safe debt equity ratio; secondary market, through its subsequent share

transaction activities, provides an investment opportunity for the prospective investors on the one hand and gives an indicator of the likely cost of capital to the private companies concerned by reflecting the true market value of their shares, on the other. Consequently, a company with rising share prices in the market will find itself in a more advantageous position of being, able to raise fund at a relatively lower cost, while the declining share prices below the par value would indicate the opposite.

In order to reap maximum benefits by all the parties involved in the market, it is necessary that the market should function purely on the basis of the demand and supply forces generated by free dissemination of information. However, the actual operation of the share markets world throughout has been far from this ideal characterised by many features that are essentially unhealthy for the efficient functioning. As Baumol pointed out, (Baumol: 1965: p.83) 'the oligopolistic position of those who operate in the markets, the brokers, floor traders and specialists; the random patterns which characterises the behaviour of stock prices; the apparent unresponsiveness of supply to price changes and management's efforts to avoid the market as a source of funds' have raised some questions about the allocative function of the world's most active stock exchange, viz. the New York Stock Exchange (NYSE). The present state of Sri Lanka's share market is no exception to this comment.

The development of the share market in Sri Lanka is hindered by two problems: limitations on the supply of shares to the market and the imperfections in the information dissemination processes. Public companies in Sri Lanka are very conscious about retaining the 'controlling interest' for the original promoters and, therefore, the supply of shares to the market is limited to the bare minimum neces-

ary to obtain a market quotation. As a result, the proportion of the non-tradeable share of a company is much higher than the tradeables which in many cases stand less than 10 per cent of the total shares issued. For instance, during the period from 1981 through 1988, the total number of shares traded in each month was less than 2 per cent of the total number of shares issued by these companies. (Table 9) This proportion is, by any standard, too low, since there is a possibility of double or multiple counting of the same share traded in the market more than one time during a month. These supply limitations have caused a low turnover in the market, on the one hand, and the demand for shares to play a very important role in determining share prices, on the other.

Though the availability of free and timely information is necessary for the efficient functioning of a share market, Sri Lanka's information generating machinery in the share market does not seem to operate satisfactorily. The information required by the market participants in this respect ranges from the general economic conditions of the country to specific information on the operation of the individual companies. With regard to the general economic conditions of the country, the information on the past economic conditions is mainly disseminated by the Central Bank in its various monthly and annual reports and, to a lesser extent, by foreign agencies which publish country reports.

However, the market lacks any information with regard to the future economic conditions of the country, since there is no practice of revealing the forecasts of at least the major macro variables such as the inflation rate, money supply targets, growth rate etc. Though the authorities prepare tentative forecasts of these macro variables for internal guidance, the general public has no access to them since it is usually kept as a classified set of information. In developed western countries, the lacuna so created is filled by private research organisations which produce and supply the needed economic forecasts to the market at a very low or zero cost. However, in Sri Lanka, private organisations do not have the necessary facilities nor competent staff to undertake such services.

The problem of information on the operations of specific companies seem to be more chronic than the previously discussed case. Even though the companies Act of 1982 has enacted a wide array of disclosure requirements with regard to the profitability, reserves, assets and liabilities of companies, the delay that occurs in publicising this vital information makes it less valuable for prospective investors. The CSE has continued to publish detailed information on the final accounts of quoted public companies in its **Hand Book of Rupee Companies**, but its usefulness has very largely been diminished by the belated publication. This situation has further been

aggravated by the lack of financial journals and newspapers exclusively reporting on the economic and business sector of the country.

An inevitable corollary of these imperfections in the information generating machinery has been the irrational acting by participants on gossip and private knowledge gathered here and there. This situation has given rise to a kind of speculation where a participant follows the market trend in the belief that the other market participants are better informed than himself. As a result, imitation of one participant by another in the market is a very common occurrence. This type of behaviour on the part of market participants has resulted the trading in the market to concentrate in a particular share or a class of shares.

Further, the extreme swings in the share prices resulting from these irrational changes in the demand have caused the share prices to raise or fall far beyond the levels justified by the internal conditions of some of the companies.

Given these imperfections, it is of vital importance to invest in the informational infrastructure of the share market for the market to bring about an efficient allocation of resources. The current situation not only hinders the growth in the market, but also keeps away many of the prospective investors. The lack of information also encourages profit seeking participants to pay for exclusive information on inside affairs of companies to make abnormal profits in the market, a practice considered to be injurious to the people who have already invested in these companies. Though such insider trading activities have been made an offence under the common law in almost all the countries, they nevertheless occur in view of the high premium attached to such trading and many loopholes in the enforcement of the law.

Table 10  
New Share Issues in Primary Share Market

Investment	1980	1981	1982	1983	1984	1985	1986	1987	1988
Engineering	1	7	6	12	5	3	1	2	1
Hotels & Travels	3	3	8	9	4	1	-	-	-
Finance & land	-	2	2	5	3	2	2	2	5
Beverages & Food	1	1	1	5	-	-	-	-	-
Miscellaneous	-	-	2	6	1	-	2	1	-
Total	5	13	19	37	13	3	5	5	10

Source: Central Bank of Sri Lanka

The only instrument traded in Sri Lanka's securities market is the ordinary shares of quoted public companies. Neither the corporate bonds nor the government securities are listed or traded in the market. Consequently, the capital market in Sri Lanka has not been able to play an important role in mobilising domestic resources for economic development. The absence of a variety of instruments to match the portfolio choice or prospective investors has scaled down its operations to a negligible level. The primary share market with a few share issues recording in each of the year from 1980 through 1988 has remained virtually inactive (Table 10). Though all the share issues were fully subscribed within the prescribed time period, with the exception of 1988 in which the proportion subscribed remained at 60 per cent due to unsettled conditions in the country, the total volume mobilised remained very low, while investment in shares was primarily limited to a handful of urban oriented investors.

Though the operations in the secondary share market recorded a gradual improvement since 1985, the over-all performance of the market can by no means be considered satisfactory. The value of shares issued as a per cent of GDP remained a constant of 4 per cent during 1985-1988, while the value of shares traded in the market as a per cent of GDP was well below 1 per cent during this period. The insignificant volume of share trading in the market brought its own harmful effects; first, share trading being a very low profit business did not encourage brokers to engage in that activity as their main line of business. Second, the low capital gains as revealed by the low level of market capitalisation reduced the profitability of company shares limiting the market to a few share investors. It is therefore necessary to take measures to increase both

the demand for and supply of shares in the market.

### Summary

Resources, both human and natural, that are mobilised in correct amounts at correct times for use by production entities have to play two roles: maintenance of the current production levels in the economy and expansion of the production boundary in order to ameliorate the standard of living of the people. However, the experience of many developing countries shows that the domestic savings are woefully inadequate to finance the high level of investment needed to be undertaken to raise employment and output on a continuous basis. Therefore, foreign savings have to play a very important role in these countries to fill the savings investment gap.

Since Sri Lanka's domestic savings remained at a very low level during the past few decades, a large volume of foreign savings was needed to finance the high volume of investment expenditure undertaken in the country. Country's financial savings which remained at around 5-10 per cent of GDP during the last decade was about 50 per cent of the domestic savings of the country. The low share of the financial savings in the total savings is mainly attributable to the prevailing relatively undeveloped condition of the financial market of the country.

Authorities in Sri Lanka have attempted to divert a bulk of the credit to be extended by banking institutions to priority areas by introducing re-finance facilities and preparing a national credit plan with a large volume of credit channelling to priority sectors. However, the actual credit utilisations do not reveal that these measures have been successful in bringing about an appreciable change in the sectoral distribution of credit by the banking system.

The rudimentary state of the capital market in Sri Lanka poses a serious problem for the successful domestic resource mobilisation in the country. The infantile securities exchange, informational asymmetries and the lack of a wide-spread investment oriented community in the country have greatly undermined the role of the capital market in achieving this objective.

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