AccFIN²
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Accounting and Finance Industry Forum 2019

INSIGHT REPORT

on

Sri Lankan Economy and Financial Markets: Issues and Challenges

Organized by

Department of Business Finance
Faculty of Management
University of Peradeniya

In Collaboration with

National Economic Council of Sri Lanka

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Insight Report of the Accounting & Finance Industry Forum 2019

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MESSAGE FROM THE VICE CHANCELLOR
University of Peradeniya

1^{st} AccFIN^2 Industry Forum - 2019

It is with great pleasure that I pen this message for the first ever AccFIN^2 Industry Forum organized by the Department of Business Finance, Faculty of Management of the University of Peradeniya, in collaboration with the National Economic Council of Sri Lanka, Colombo Stock Exchange, Sri Lanka Finance Association, and the Association of Kandy Chartered Accountants. This year's forum will be held under the theme “Sri Lankan Economy and Financial Markets: Issues and Challenges”, where the urgent need for recovery of the economy from the after effects of the April 21st brutal attacks, and the necessity for the development of the financial markets in the economic development will be discussed and examined in the eyes of the academia and the industry.

I believe that the AccFIN^2 Industry Forum – 2019 will not only become a platform for the presenters and the participants to share their ideas on the theme of the forum, but more importantly this will also develop strategies and provide solutions for the benefit of the policy makers of the country. In addition, this will be a great opportunity for the participants from the academia and the industry to examine the possibilities of academic-industry partnerships and collaborative research.

Thus, it is my honour to congratulate the organizers and the collaborative partners of the AccFIN^2 Industry Forum for their time and effort spent in making this great endeavor a success.

Professor Upul B. Dissanayake
Vice - Chancellor
University of Peradeniya
Sri Lanka

MESSAGE FROM THE DEAN
Faculty of Management
University of Peradeniya

1st AccFIN² Industry Forum - 2019

I am glad to write this message for the maiden AccFIN² Industry Forum organized by the Department of Business Finance of the Faculty of Management. This is also the first time that this type of an event takes place in our young Faculty of four years, which I believe is important in several aspects.

From the institutional perspective, this event adds value and provides opportunities to develop links with the industry which is very much important for a Management Faculty to produce employable graduates. The tasks performed by the collaborative partners of this forum (viz. National Economic Council of Sri Lanka, Colombo Stock Exchange, Sri Lanka Finance Association, and Association of Kandy Chartered Accountants) are mostly relevant to the discipline of Accounting and Finance, and I have no doubt that the students specializing in Accounting & Finance will be benefited immensely by their presence at the forum.

From the societal perspective, an event like this could contribute significantly for the economic development of the country through the outcomes and the implications generated by the forum. This Insight Report itself provides strong evidence on the degree of contribution of the forum. I am sure that the insights that the forum produce will be mostly relevant for the decision making of the policy makers in the country.

While congratulating the Department of Business Finance, I wish the AccFIN² Industry Forum a great success. May the guest speakers and the participants from both academia and industry engage in fruitful discussions that will generate new insights to address the current issues and challenges faced by the Sri Lankan economy and its financial markets.

Dr. M. Alfred
Dean
Faculty of Management
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Sri Lanka

MESSAGE FROM THE HEAD OF THE DEPARTMENT

Department of Business Finance

Faculty of Management

University of Peradeniya

1st AccFIN² Industry Forum - 2019

It gives me an immense pleasure in writing this note to mark the very first AccFIN² Industry Forum organized by the Department of Business Finance, Faculty of Management of the University of Peradeniya.

The AccFIN² Industry Forum generally aims to strengthen the link between academia and industry, which currently lacks in Sri Lanka, specially related to Accounting and Finance discipline. Specifically, this forum will be organized as an annual event to discuss an important issue in the economy/business with the participation of the academia and the industry experts. Through this academic-industry collaboration, it is expected to develop a platform to find solutions/ provide recommendations for the issue identified in a particular year.

In this year, the Department of Business Finance will collaborate with the National Economic Council of Sri Lanka to organize the forum under the theme, "Sri Lankan Economy and Financial Markets: Issues and Challenges". Colombo Stock Exchange, Sri Lanka Finance Association and the Association of Kandy Chartered Accountants have also joined their hands with the Department as the other collaborative partners.

We, at the Department of Business Finance, sincerely hope that this forum will initiate a discussion on the current year's theme, so that it will be an eye opening event for the policy makers, academia, industry and other stakeholders. This 'Insight Report', which is prepared based on the sub themes discussed at the forum, will be disseminated among those interested parties to use them in various decision making.

On behalf of the Department of Business Finance, I thank all the resource persons, the moderator, the participants from both academia and industry, and all the collaborative partners, who contributed immensely to make this Industry Forum truly a success.

Dr. E.M.A.S.B. Ekanayake
Head, Department of Business Finance
Faculty of Management
University of Peradeniya
Sri Lanka

Table of Contents

SRI LANKAN ECONOMY AND FINANCIAL MARKETS: ISSUES AND CHALLENGES

1st AccFIN^2 Industry Forum - 2019

PREFACE

The Department of Business Finance, Faculty of Management, University of Peradeniya, in collaboration with the National Economic Council of Sri Lanka, the Colombo Stock Exchange, the Sri Lanka Finance Association and the Association of Kandy Chartered Accountants, presents this Accounting & Finance Industry Forum (AccFIN^2) – 2019 under the theme, "Sri Lankan Economy and Financial Markets: Issues and Challenges".

Low economic growth, high level of government debt, down-graded credit ratings, low market capitalization, low investor participation rates, inactive investors – these are some of the common issues and challenges that come to the forefront when looking at the Sri Lankan economy and financial markets. How does an economy generate growth within the context of such a lackadaisical financial climate? How can financial markets make themselves more performance oriented to investors who are willing to take the plunge and attract investors who prefer to stay away? What are the constraints to achieving both economic growth and financial market development and to what extent are these inter-twined? In an economy that has been wanting to be the next Singapore for quite a while, asking these questions and finding credible and evidence-backed answers becomes crucial. This is what this forum is about. Our hope is that the mix of academic and industry participants will help to strengthen the theoretical base and practical implications of the conversations that take place.

After the Inauguration Session in the morning, the proceedings will move to the heart of the Forum – which is the five technical sessions. In the **first** technical session, Prof. Lalith P. Samarakoon, Secretary-General and Chief Economist, National Economic Council will present on the "Status of the Sri Lankan Economy: Challenges and Opportunities". This will present an overview of the Sri Lankan economy and financial markets, including reviewing some of the key sectors such as the real, fiscal and external sectors, whilst identifying some of the challenges and opportunities for growth. In the **second** technical session, Mr. C.J.P. Siriwardana, Deputy Secretary General – Economic Affairs, National Economic Council, will present on "Financing the Development of Sri Lanka and Debt". This presentation will discuss the role that the government has played in the development process in the past and highlight current issues relating to the financing of public investment and public debt management. In the **third** technical session, Senior Professor D.B.P.H. Dissa Bandara, Deputy Secretary General – Financial Affairs, National Economic Council will present on "Financial Sector Development of Sri Lanka: Issues and Strategies". This will present an overview of the status of the financial sector in the country, whilst highlighting current issues and discussing strategies and solutions to overcome them. After the lunch break, in the **fourth** technical session, Mr. Rajeeva Bandaranaike, Chief Executive Officer, Colombo Stock Exchange, will present on "Current Status and Future Plans of the Colombo Stock Exchange". This presentation will present issues related to market performance, long term strategy, size and liquidity, product diversification, technology, market regulation, governance and regional cooperation. In the final **fifth** presentation, Mr. Angelo Ranasinghe, Executive Director, Bartleet Religare Securities (Pvt.) Ltd. will discuss the expectations of the Colombo Stock Exchange from the perspective of a listed company including the gaps and shortcomings. The day's proceedings will end with a Panel Discussion which will incorporate all five technical session presenters.

Wishing you a fruitful and invigorating Forum!

Dr. Suresh J.S. de Mel
Moderator/Panel Discussion

The Status of the Sri Lankan Economy: Challenges and Opportunities

Prof. Lalith P. Samarakoon

Secretary-General and Chief Economist, National Economic Council of Sri Lanka

1. Introduction

The purpose of this paper is to provide a brief overview of the status of the Sri Lankan economy. Sri Lanka has faced challenging domestic and global economic and political conditions in recent times. Despite difficult conditions, the country managed to avoid serious economic and financial repercussions for the most part and continue economic growth, albeit slowly. But there are concerns about important structural imbalances and vulnerabilities in key areas of the economy. This paper will review key sectors of the economy, particularly the real, fiscal and external sectors, and briefly outline main challenges and opportunities.

2. Overview of Recent Economic Performance

2.1 Real Sector

Economic growth and employment are two important areas of the real economy. In terms of the overall economic growth, over the past 10 years (2009-2018), the Sri Lankan economy recorded an average annual growth of 5.4% in real terms (Table 1). This period consisted of two different growth episodes. In the five-year period from 2009-2013, which was the period immediately after the end of the 26-year civil war in May 2009, the economy grew at an annual average rate of 6.5%. The higher growth was particularly impressive in the three years after the end of the war where the growth was 8.0% in 2010, 8.4% in 2011, and 9.1% in 2012 thus showing continued high growth momentum. However, this momentum broke with growth declining substantially to 3.4% in 2013, and in the last five-year period of 2014-2018 the average annual growth declined to 4.2% which is more than 2 percentage point drop relative to the previous five-year period. Moreover, growth has shown continuous declines since 2015, and the growth in 2018 of 3.2% was the lowest in 16 years.

Table 1: Economic Growth

Year	Real GDP Growth (%)
2009	3.5
2010	8.0
2011	8.4
2012	9.1
2013	3.4
2014	5.0
2015	5.0
2016	4.5
2017	3.4
2018	3.2

Sources: Department of Census and Statistics, Central Bank of Sri Lanka

In terms of the sectoral composition of the economy (Table 2), the services sector is the largest sector of the economy contributing to 57% of the real gross domestic product (GDP) in 2018, followed by the industry sector (27%) and agriculture (8%). It is clear that during the past five years, the sectoral structure of the economy has barely changed and been very stable.

In terms of sectoral growth, the agriculture sector has grown at an average rate of 2.1% over the past five years. With the exclusion of the negative growth in 2016 and 2017, this sector has shown a growth of about 5% at most. Industry sector recorded an average growth of 3.3% with large variability from 0.9% in 2018 to 5.8% in 2016. Service sector has shown steady growth averaging about 5%. Reflecting the volatility in agriculture and industry growth, the overall GDP growth has been deteriorating since 2015. Clearly, the sectoral growth rates have been low and have not been able to develop into a sustainable upward trend.

Table 2: Sectoral Composition and Growth of Sri Lankan Economy

Year	% of Nominal GDP				Real Growth Rate %				Real GDP Growth %
	Agriculture	Industry	Services	Taxes & Subsidies	Agriculture	Industry	Services	Taxes & Subsidies	
2014	8.0	28.3	56.9	9.2	4.9	3.5	5.2	6.9	5.0
2015	8.2	27.2	57.4	9.4	4.8	2.1	5.7	7.5	5.0
2016	7.4	27.8	56.4	9.6	-3.8	5.8	4.7	6.3	4.5
2017	7.8	27.3	55.7	9.6	-0.4	4.1	3.6	3.3	3.4
2018	7.9	27.0	56.8	9.2	4.8	0.9	4.7	-0.4	3.2
Average	7.9	27.5	56.6	9.4	2.1	3.3	4.8	4.7	4.2

Sources: Department of Census and Statistics, Central Bank of Sri Lanka

The composition of the economy in terms of the expenditure on GDP (Table 3) indicates that private consumption expenditure (C) constituted 70% of the Sri Lankan economy in 2018 and is the largest share of the economy. The second largest expenditure component is investment expenditure with a share of 29% in 2018. Government expenditure is 9% of the economy. Net exports, which is exports minus imports, have been a negative contributor due to imports exceeding exports. Their share in the economy was about -7% in 2018. It is quite evident that the structure of the economy in terms of the expenditures has not changed much in the past five years either.

As for nominal growth in expenditure components, consumption and government expenditures have grown at an average rate of 8% and 11.9% respectively during 2014-2018 (Table 3). They have been somewhat volatile, particularly due to very lower growth in 2016. Investment has been the most volatile over time ranging from -7% in 2015 to 22% in 2017. Except in 2015, the growth in net exports has been negative, and the magnitude of negative growth has continued to increase reflecting weak trade performance. On average, net exports have recorded a growth of -5.2%.

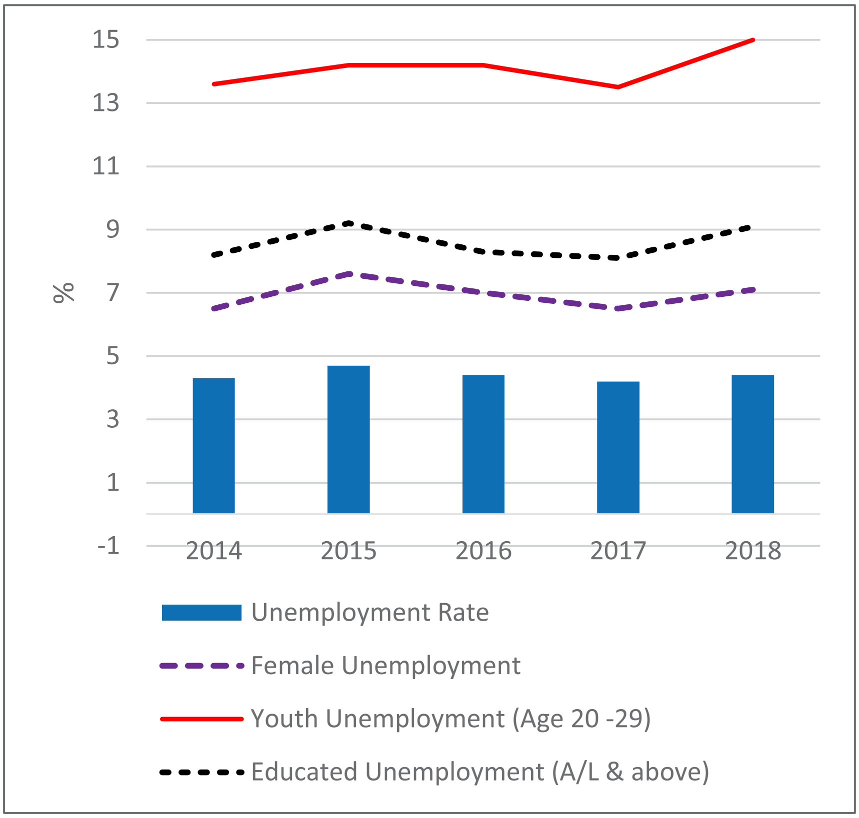
Table 3: Expenditure Composition and Growth in the Economy

	% of Nominal GDP				Growth Rate %			
Year	C	G	IN	X	C	G	I	NX
2014	67.7	8.3	32.0	-8.0	9.1	16.6	4.8	-1.2
2015	70.1	9.0	28.4	-7.5	10.0	13.4	-7.0	1.4
2016	63.8	8.5	35.0	-7.3	3.1	3.0	22.0	-6.0
2017	69.9	8.4	28.8	-7.2	10.2	11.4	15.8	-10.1
2018	69.8	9.0	28.6	-7.3	7.4	15.0	6.8	-10.3
Average	68.3	8.6	30.6	-7.5	8.0	11.9	8.5	-5.2

C = Private consumption, G = Government consumption, I = Investment, NX = Net Exports
Sources: Department of Census and Statistics, Central Bank of Sri Lanka

Sri Lanka's economically active population of 15 years of age and over or labor force in 2018 was 8.387 million consisting of 65% male and 35% female. The employed population was 8.015 million people consisting of 66% of men and 34% of women. The employed population is 95.6% of the labor force resulting in an unemployment rate of 4.4%. However, the economically inactive population was 7.8 million people consisting of 26% male and 76% female, resulting in a low labor force participation rate was 51.8%. In terms of gender, the labor force participation was 73% for male and 34% for female. In terms of sectors of the economy, 46.6% was employed in the services sector, 27.9% in the industry sector and 25.5% in the agriculture sector. When considering the employment status, 57.3% of the employed people were employees of public (14.5%) and private institutions (42.8%) while 42.7% was self-employed.

Figure 1: Unemployment



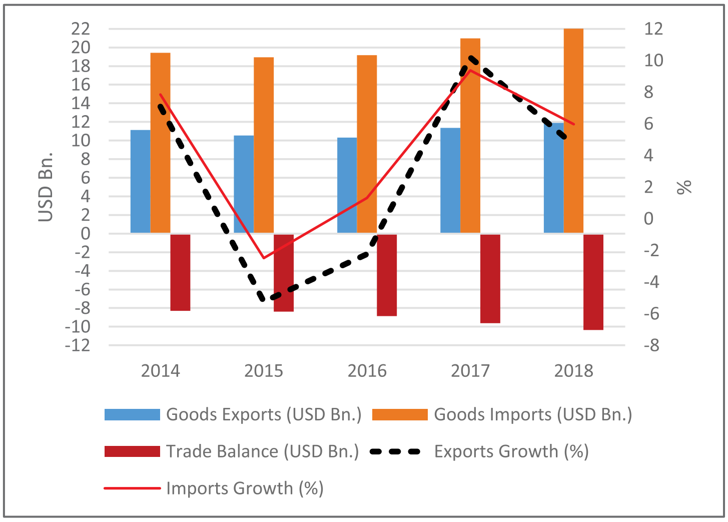
Sources: Department of Census and Statistics, Central Bank of Sri Lanka

The unemployed population was reported as 372,593 people in 2018. While the overall unemployment rate is 4.4%, female unemployment is much higher at 7.1% compared with male unemployment of 3% (Figure 1). When considering age categories, unemployment is 21.4% in the 15 -24 age group, 20.1% in the 20-24 age group, and 10.4% in the 25-29 age group. In terms of education level, the highest unemployment rate of 9.1% is associated with the G. C. E. (A/L) and above group. Thus, unemployment is the highest in female, youth and the educated categories.

2.2 External Sector

In the external sector, current account, foreign direct investments and currency play important roles in the economy. As for Sri Lankan's trade, in 2018, earnings from export of goods grew by 4.7% to USD 11.9 billion. This was after a very strong growth of 10.2% in 2017 (Figure 2). However, export earnings declined in both in 2015 and 2016. Imports of goods increased by 6% in 2018 to USD 22.2 billion. The trade deficit which stood at USD 9.6 billion in 2017 widened to USD 10.3 billion in 2018. During the five-year period from 2014-2018, exports grew at an average rate of 2.9% while imports grew at 4.4%. Negative growth in exports in 2015 and 2016 and slow exports growth in 2018 have contributed to the volatile export performance in recent years. Reflecting these trends, Sri Lanka's trade deficit has increased at an average rate of 6.4% over the same time period.

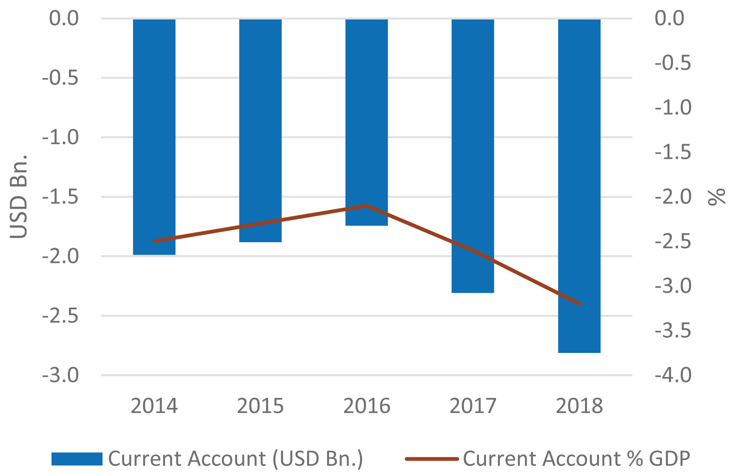
Figure 2: Goods Exports, Imports and Trade Balance



Source: Central Bank of Sri Lanka

The improving trend in the current account deficit observed during the 2014-2016 period reversed in 2017 (Figure 3). In 2018, the current account deficit worsened from USD 2.3 billion (2.6% of GDP) to USD 2.8 billion (3.2% of GDP). The widening of the trade deficit due to slower growth in merchandise exports, higher growth in merchandise imports and decline in the income account, among other factors, have contributed to the deterioration of the current account.

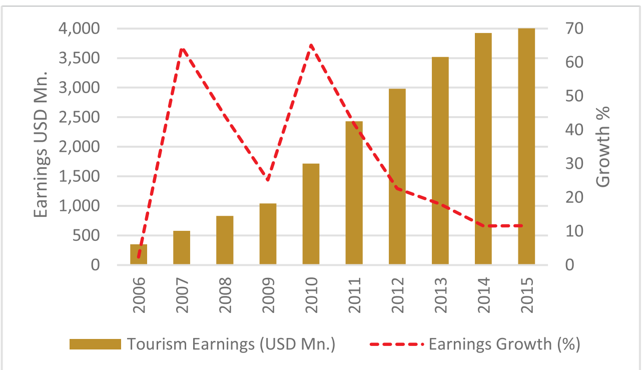
Figure 3: Current Account



Source: Central Bank of Sri Lanka

The largest contributor to the services account of the balance of payments is the tourism industry. In 2018, 2.3 million tourists arrived in Sri Lanka. According to official statistics, the industry provides direct and indirect employment to 388,487 people. The number of people who earn income from activities related to the tourism industry is quite possibly much more. In 2018, Sri Lanka's gross earnings from tourism amounted to Rs. 712 billion or USD 4,381 million which is an increase of 12% over the previous year (Figure 4). Gross tourism earnings are about 5% of the GDP of the country. On net basis, the contribution of tourism earnings to the services account was USD 2,721 million in 2018. One clear pattern is that the tourism earnings growth has shown a secular decline to about 12% after peaking at 65% in 2013.

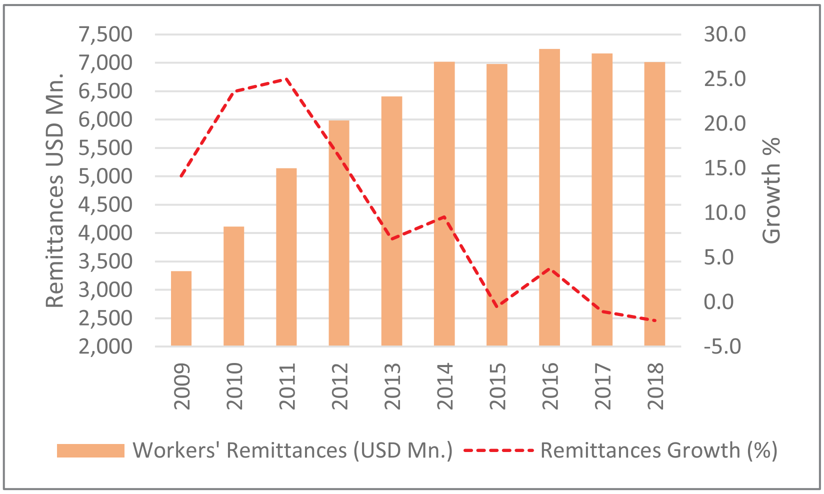
Figure 4: Tourism Earnings



Source: Central Bank of Sri Lanka

The most important positive and the largest contributor to the income account of the balance of payments is workers' remittances from abroad (Figure 5). In 2018, remittances amounted to USD 7,015 million which was a decline of 2.1% relative to the previous year. Remittances have now declined for two consecutive years and seemed to have plateaued at about USD 7 billion. The growth in remittances also has continued to exhibit a secular downward trend since 2011.

Figure 5: Workers' Remittances

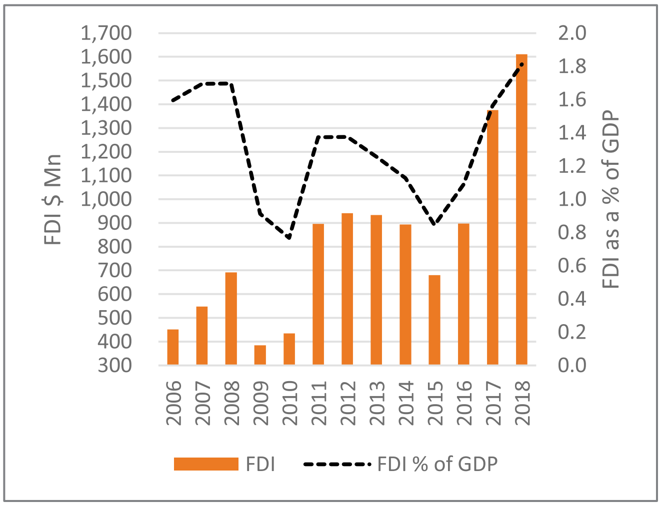


Source: Central Bank of Sri Lanka

In financing the current account, one of the sources of financing included in the financial account is foreign direct investments (FDI). FDI, excluding foreign loans obtained by Board of Investment (BOI) companies, was USD 1,611 million in 2018 and has shown an increasing trend over the past three years (Figure 6). As a percent of GDP, FDI was 1.8% in 2018 and has shown an uptrend since 2015 low of 0.8%. Both in absolute and relative terms, Sri Lanka will need to have substantially more FDI in order to fuel growth.

Sri Lanka rupee came under tremendous pressure in 2018, and as a result the rupee depreciated against the U.S. dollar by 16.4% to Rs. 182.75 per USD (Figure 7). This was by far the worst year for the rupee in the past 10 years. Over the 2009-2018 period, except for 2012 and 2015, the rupee has been relatively stable, and over this 10-year period it depreciated by an average of 4.5% against the USD.

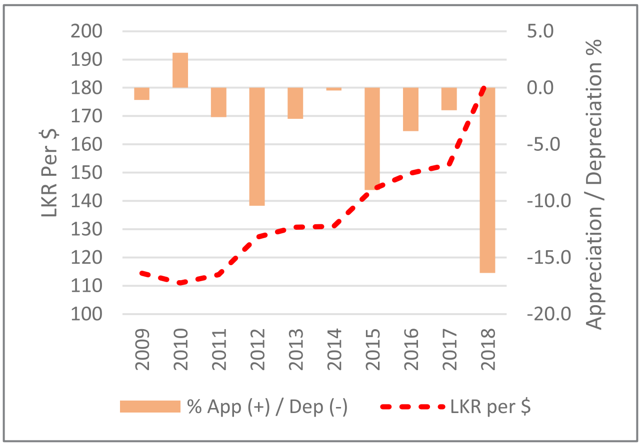
Figure 6: Foreign Direct Investments



Source: Central Bank of Sri Lanka

The depreciation of the rupee in 2018 was largely driven by the monetary policy tightening by the U.S. Federal Reserve Bank and the rise in U.S. interest rates. While the Fed has put on hold any further rate increases, any sign of increased growth expectations could once again generate expectations for further tightening. In such a scenario, the rupee will likely come under more pressure.

Figure 7: Currency (Sri Lanka Rupee vs USD)

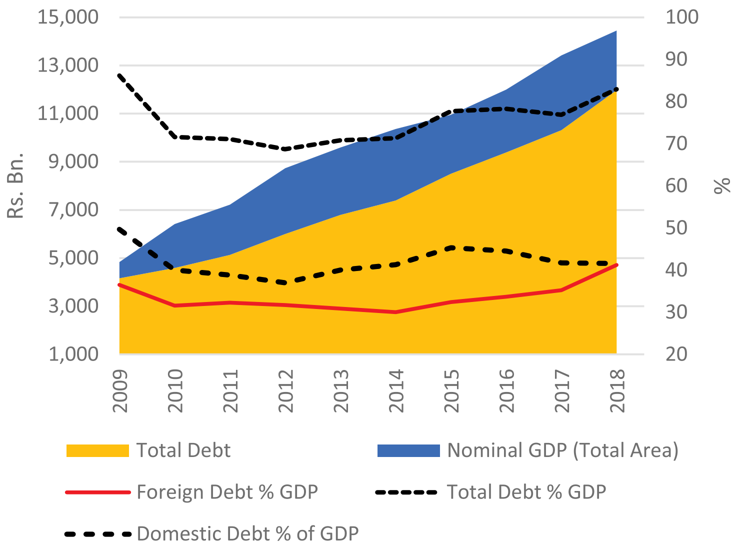


Source: Central Bank of Sri Lanka

2.3 Fiscal Sector

Sri Lanka's public debt amounted to Rs. 12 trillion in 2018 (Figure 8). Relative to the nominal GDP of Rs. 14.5 trillion, debt stands at 83% of GDP. Public debt has almost tripled over the 10 year period from about Rs. 4 trillion in 2009 and increased by 62% since 2014. This amount of public debt is quite high and unsustainable in the current and expected growth environment.

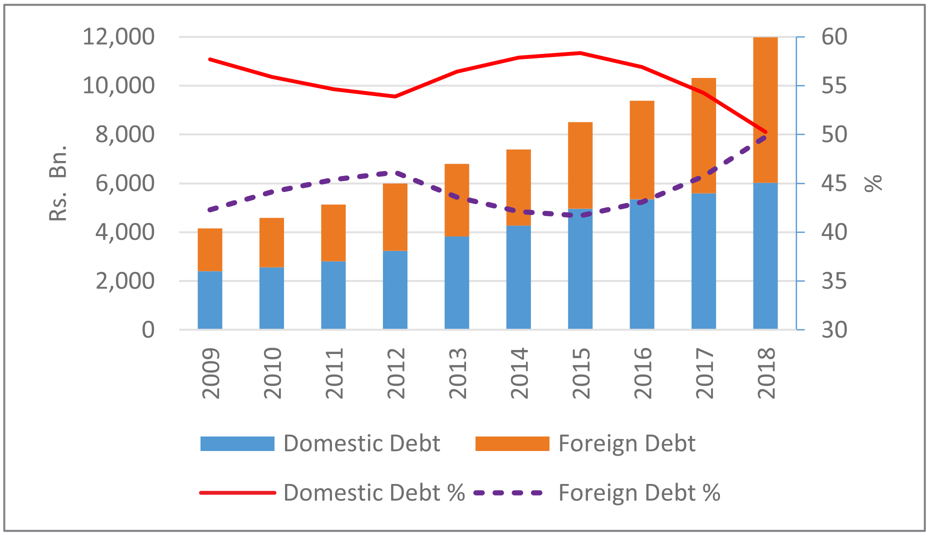
Figure 8: Public Debt



Source: Central Bank of Sri Lanka

Debt composition in terms of domestic and foreign debt has also changed in the rent years. As a percent of the GDP, foreign debt has continually increased from 30% of GDP in 2014 to 41% in 2018 while domestic debt has remained at 41% of the GDP. Since 2014, as a percent of total debt, foreign debt has increased from 42% to 50% whereas domestic debt has decreased from 58% to 50%. These statistics clearly show the increasingly more reliance on foreign debt as a source of financing (Figure 9). Thus, not only that total public debt has reached alarmingly high levels but also more and more of debt is now foreign-denominated debt which requires Sri Lanka to earn foreign currency or to borrow more from abroad in order to service such debt.

Figure 9: Domestic and Foreign Debt

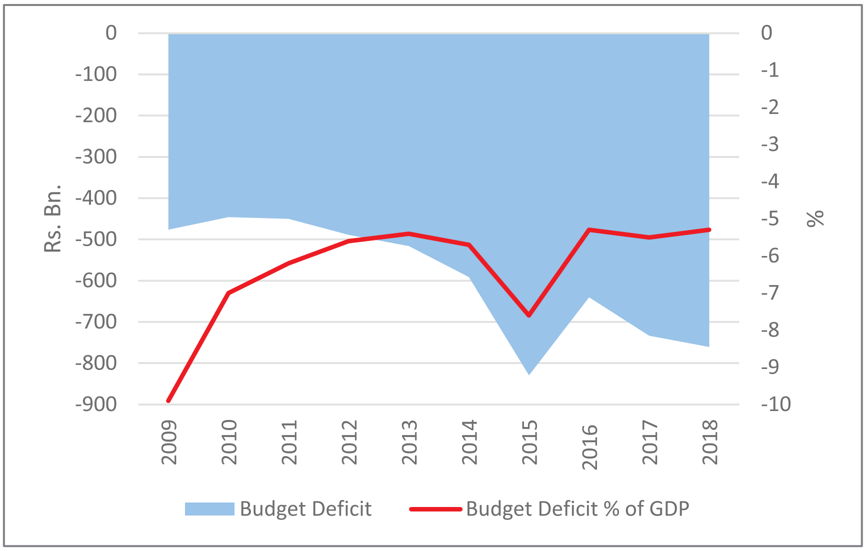


Source: Central Bank of Sri Lanka

Sri Lanka's budget deficit as a percent of the GDP has improved from 9.9% in 2009 to 5.3% in 2018 which is almost a 5% percentage point improvement (Figure 10). However, the budget deficit was already in the 5.4% to 5.7% range during the 2012-2014 period before worsening to 7.6% in 2015. In this context, the improvement in the overall fiscal balance in the recent years has been very small.

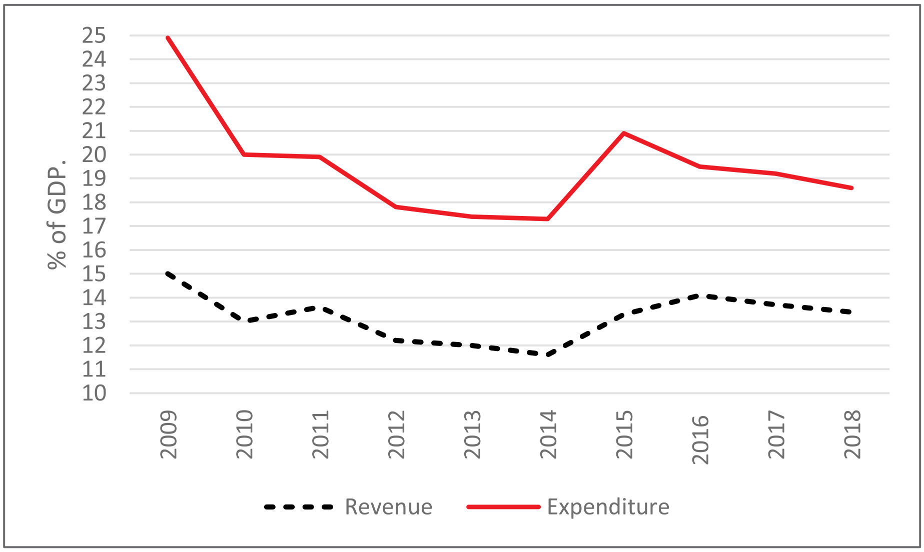
The government budget for fiscal year 2019 projects the deficit to be 4.4% in 2019. Government revenue was 13.4 of the GDP in 2018 and has ranged from 12% to 15% in the past 10 years suggesting that there has not been much change in the revenue (Figure 11). Government expenditure was 18.6% of the GDP in 2019, and this is substantial decline from almost 25% in 2009. The government expects the revenue to improve to 16.8% and expenditure to decrease to 20.3% of GDP by 2020 resulting in a target budget deficit of 3.5%.

Figure 10: Fiscal Balance



Source: Central Bank of Sri Lanka

Figure 11: Government Revenue and Expenditure



Source: Central Bank of Sri Lanka

3. Key Challenges and Opportunities

Sri Lankan economy faces numerous challenges. While global economic and financial conditions have a material impact on an export-oriented small economy such as Sri Lanka, many of the impediments to economic development have been created by lack of commitment to effect the necessary policy changes and their implementation on the part of Sri Lanka. Some of main policy areas to address challenges and opportunities are briefly discussed below.

3.1 Policy Uncertainty

First and foremost, the high degree of policy uncertainty is one of the main issues. In regard to most economic matters, Sri Lanka does not have robust and clear policies. This is further exacerbated by frequent, ad-hoc changes in any existing policies. To ensure policy certainly, Sri Lanka must establish a robust policy making system, drafting long-term economic policies, and establishing an institutional mechanism for their implementation.

3.2 Political Uncertainty

Policy uncertainly is also closely correlated with political uncertainty. In the recent years, there has been multiple political events that have led to increased policy uncertainty. Frequent changes in the size and the composition of the cabinet of ministers and oversized Cabinet of Ministers have been noteworthy and has been a real constraint to developing, sustaining and implementing economic, financial and social policies in order to address significant economic problems faced by the country.

In this regard, Sri Lanka must take measures to define and limit the size of the cabinet, perhaps constitutionally, to a reasonably low number that is appropriate for the discharge of government responsibilities and commensurate with the size and the resources of the country. While the changes of the cabinet are triggered by political composition of the government, Sri Lanka faces an enormous challenge to ensure stability of the cabinet for the tenure of a government. Recognizing the possibility of frequent cabinet changes, decoupling policy formulation and implementation mechanism from the political process as far as feasible can help ensure policy stability to a greater extent.

3.3 Global Economic Conditions

According to the World Economic Outlook, global economic growth decelerated from 3.8% in 2007 to 3.6% in 2018 and is projected to moderate to 3.3% in 2019 (Table 4). Growth in advanced economies are important for Sri Lanka because of its export markets, and growth in advanced economics is also projected to decline from 2.2% in 2018 to 1.8% in 2019 and continue to maintain low growth in the medium term. Sri Lanka's largest export destinations are the European Union countries and the United States and their growth in 2018 is projected d to decline to 1.6% and 1.8% respectively. This expected slowdown in global growth coupled with trade tensions between the U.S., China, European Union and Mexico will likely cause global trade to moderate as well. These global conditions have the potential to affect Sri Lanka's external sector, particularly exports growth.

Table 4: Global Economic Growth & Projections (Real GDP Growth %)

			Projections			
Year	2018	2019	2020	2021	2022	2023
World	3.6	3.3	3.6	3.6	3.6	3.6
Advanced Economies	2.2	1.8	1.7	1.7	1.6	1.6
U.S.	2.9	2.3	1.9	1.8	1.6	1.6
Euro Area	1.8	1.3	1.5	1.5	1.4	1.4
European Union	2.1	1.6	1.7	1.7	1.6	1.6
Emerging Market and Developing Economies	4.5	4.4	4.8	4.9	4.8	4.9
Emerging and Developing Asia	6.4	6.3	6.3	6.3	6.2	6.1
China	6.6	6.3	6.1	6.0	5.8	5.6
India	7.1	7.3	7.5	7.7	7.7	7.7
ASEAN-5	5.2	5.1	5.2	5.2	5.2	5.3
Sri Lanka	3.0	3.5	4.0	4.3	4.5	4.6

Source: World Economic Outlook (2019 April)

3.4 Sustained High Economic Growth

The greatest challenge for Sri Lanka is to stem the deteriorating growth that has been evident in the recent years and to reignite the economy with a concerted effort to reach higher single growth in the next decade. This requires a closer analysis of growth dynamics of the Sri Lankan economy taking into account experiences in other lower-middle income (LMI) and upper-middle income (UMI) economies (Table 5).

Clearly, when Sri Lanka averaged a growth of 4.2% in the 2013-2017 five-year period, South Asia grew at 5.7% and every country in the South Asian region recorded higher average growth than Sri Lanka. The notable stars were India with an average growth of 7.4%, Bangladesh with 6.6% and Maldives with 6.3%. The average growth in East Asia was 6.5% with growth exceeding 7% in China, Cambodia, Laos and Myanmar. While it may not be possible to exactly replicate the growth paths of these high growth Asian economies, their growth experiences clearly suggest opportunities for growth. Economic reforms are absolutely essential for Sri Lanka to unleash its growth potential.

Table 5: Economic Growth Rates of Lower and Upper Middle Income Countries (Real GDP Growth %)

Country / Income Category	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	5-yr Average	10-yr Average
Sri Lanka	6.0	3.5	8.0	8.4	9.1	3.4	5.0	5.0	4.5	3.4	4.2	5.6
LMI Average	5.2	2.3	5.4	5.4	4.9	4.6	3.8	4.3	3.9	3.8	4.1	4.4
LMI - South Asia												
Bangladesh	6.0	5.0	5.6	6.5	6.5	6.0	6.1	6.6	7.1	7.3	6.6	6.3
Bhutan	4.8	6.7	11.7	7.9	5.1	2.1	5.7	6.6	8.0	4.6	5.4	6.3
India	3.1	7.9	8.5	5.2	5.5	6.4	7.4	8.0	8.2	7.2	7.4	6.7
Pakistan	1.7	2.8	1.6	2.7	3.5	4.4	4.7	4.7	5.5	5.7	5.0	3.7
Sri Lanka	6.0	3.5	8.0	8.4	9.1	3.4	5.0	5.0	4.5	3.4	4.2	5.6
Average	4.3	5.2	7.1	6.1	5.9	4.5	5.8	6.2	6.7	5.6	5.7	5.7
LMI-East Asia												
Cambodia	6.7	0.1	6.0	7.1	7.3	7.4	7.1	7.0	6.9	7.1	7.1	6.3
Indonesia	6.0	4.6	6.2	6.2	6.0	5.6	5.0	4.9	5.0	5.1	5.1	5.5
Laos	7.8	7.5	8.5	8.0	8.0	8.0	7.6	7.3	7.0	6.9	7.4	7.7
Mongolia	8.9	-1.3	6.4	17.3	12.3	11.6	7.9	2.4	1.2	5.3	5.7	7.2
Myanmar	10.3	10.6	9.6	5.6	7.3	8.4	8.0	7.0	5.9	6.8	7.2	7.9
Philippines	4.2	1.1	7.6	3.7	6.7	7.1	6.1	6.1	6.9	6.7	6.6	5.6
Vietnam	5.7	5.4	6.4	6.2	5.2	5.4	6.0	6.7	6.2	6.8	6.2	6.0
Average	7.1	4.0	7.3	7.7	7.6	7.6	6.8	5.9	5.6	6.4	6.5	6.6
UMI-South Asia												
Maldives	9.5	-7.2	7.3	8.6	2.5	7.3	7.3	2.9	7.3	6.9	6.3	5.2
UMI-East Asia												
Malaysia	4.8	-1.5	7.4	5.3	5.5	4.7	6.0	5.1	4.2	5.9	5.2	4.7
China	9.7	9.4	10.6	9.5	7.9	7.8	7.3	6.9	6.7	6.9	7.1	8.3
Thailand	1.7	-0.7	7.5	0.8	7.2	2.7	1.0	3.0	3.3	3.9	2.8	3.1
Average	5.4	2.4	8.5	5.2	6.9	5.0	4.8	5.0	4.7	5.6	5.0	5.4

Source: Word Development Indicators, World Bank

3.5 Agricultural Sector Modernization and Productivity Improvement

The share of the agriculture in the Sri Lankan economy (8%) is smaller compared to LMI countries (11%) and less than half of the agriculture share in LMI countries in Asia (17%) (Table 6). In fact, Sri Lanka's agriculture share is the same as that in UMI countries and UMI countries in Asia. This suggests that the share of the agriculture sector in Sri Lanka has already reached that of UMI countries and there is likely to be little gain in reducing it relative size further. What is needed is modernization of agriculture modernization, diversification and promotion of export-oriented agriculture in order increase productivity, and achieve stable and high growth in the agriculture sector.

Table 6: Sectoral Composition of GDP of Countries by Income Level (% of Nominal GDP) in 2017

Sector	Sri Lanka	Lower Middle Income (LMI)	LMI- Asia	Upper Middle Income (UMI)	UMI- Asia	High Income*	HI- Asia*
Agriculture	8	11	17	8	8	2	2
Industry	27	27	30	26	38	24	29
Services	56	53	48	57	53	64	63

*Excluding Hong Kong and Singapore
Source: Word Development Indicators, World Bank

3.6 Export-oriented Industrial Development

The share of the industry sector of Sri Lanka (27%) is fairly at par with LMI and UMI countries (Table 6). However, a comparison with UMI countries in Asia, where the industry share is about 38% of the economy, suggests that Sri Lanka needs to expand industry sector as a growth driver. This requires targeted expansion of existing industries and development of new industries with a special focus on export markets.

3.7 Development of New and Competitive Services Sector

The services sector of the Sri Lankan economy exceeds that in LMI economies (53%) and is comparable to the share in UMI economies (57%). However, given Sri Lanka's geographical location and the availability of highly educated workforce, Sri Lanka has great potential to increase the services sector in line with high income economy (HI) average of 64%.

3.8 Increasing Share of Trade in GDP

Sri Lanka's exports are only 22% of the economy whereas it is 35% of LMI countries and 37% in UMI countries (Table 7). Sri Lanka's exports as a proportion of the economy is less than half that in UMI economies in Asia (53%) suggesting the need to expand exports significantly in order to achieve high growth. Imports as a percent of the economy are 29% and much lower than that of LMI economies (45%) and UMI economies (46%). Reflecting higher imports than exports, net exports contributed -7% to the economy of Sri Lanka in 2017. Although the contribution of net exports is much more negative (-10%) in LMI economies in general, it accounts for only -5% in LMI economies in Asia and -3% in UMI economies. Further, UMI and HI economies in Asia show a positive 7% contribution of net exports suggesting the important role of played by net exports in their economies.

Overall, trade, which is the sum of exports and imports, as a percent of the economy was 51% in Sri Lanka whereas trade has played a much bigger role in LMI economies (80%) and UMI economies (78%). Trade is 99% in UMI economies of Asia which comprise of China, Malaysia and Thailand.

Table 7: Expenditure Composition of GDP and Trade of Countries by Income Level (% of Nominal GDP) in 2017

Sector	Sri Lanka	Lower Middle Income (LMI)	LMI - Asia	Upper Middle Income (UMI)	UMI - Asia*	High Income	HI - Asia
C	70	69	65	63	48	52	48
G	8	14	10	16	14	19	18
C+G	78	83	75	79	66	71	66
I	29	27	31	23	31	24	26
Ex	22	35	36	37	53	62	72
IM	29	45	42	41	46	56	65
NE	-7	-10	-5	-3	7	5	7
Trade	51	80	78	78	99	118	137

*China, Malaysia, Thailand

C = Private consumption, G = Government consumption, I = Investment, NX = Net Exports

Source: Word Development Indicators, World Bank

3.9 Sustained High Exports Growth

Many of the export-oriented Asian economies saw their exports grow at much higher rates during the same period (Figure 12). Some countries with which Sri Lanka has to compete for inward investments and markets have recorded much higher export growth. For example, export growth rate was 17.9% in Laos, 14.7% in Cambodia, 13.4% in Vietnam, and 7.3% in Bangladesh. This highlights the overall weak export performance of Sri Lanka and the need to a robust policy framework to increase exports.

Figure 12: Growth in Merchandise Exports in Selected Economies (2013-2017)

Source: Word Development Indicators, World Bank

3.10 Increased Foreign Direct Investments

FDI flows in some of the main LMI and UMI economies in Asia are much larger (Table 8). FDI in 2017 was USD 9.5 billion in Malaysia, USD 8 billion in Thailand, USD 10 billion in Philippines, and USD 14 billion in Vietnam. India attracted USD 40 billion while China's FDI was USD 168 billion. In relative terms, FDI was about 3% in Malaysia and Thailand, 6% in Vietnam and 13% in Cambodia. Sri Lanka will need to attract substantially more FDIs in the 3% to 6% of GDP in the medium-term in order to increase export-oriented manufacturing industries.

Table 8: Foreign Direct Investments in Some Key Asian Economies in 2017

Country	FDI (USD Mn.)	% of GDP
Bangladesh	2,151	0.9
China	168,224	1.4
India	39,966	1.5
Sri Lanka	1,375	1.6
Thailand	8,046	1.8
Malaysia	9,512	3.0
Philippines	10,057	3.2
Vietnam	14,100	6.3
Myanmar	4,685	7.0
Laos	1,599	9.5
Cambodia	2,788	12.6

Source: Word Development Indicators, World Bank

3.11 Increasing Labor Force Participation

Sri Lankan's labor force participation of 54% is one of the lowest in the lower-middle and upper-middle income economies in Asia (65%) (Table 9). South Asia in general has lower labor force participation with an average of 58%. Involving more of the economically inactive population, particular women, in the labor force is a challenge that Sri Lanka to consider in its development strategy. As pointed out earlier, addressing the higher unemployment among female, youth and the educated must be considered key policy priorities. A sizable share of the youth unemployment is graduates and individuals with other post-secondary education and generating employment opportunities for them and absorbing them into the workforce must be a top priority.

Table 9: Labor Force Participation in Selected Asian Economies

Country	Labor Force Participation Rate (%)
India	52
Pakistan	53
Sri Lanka	54
Bangladesh	59
Philippines	60
Mongolia	60
Myanmar	62
Malaysia	64
Maldives	65
Bhutan	67
Indonesia	67
Thailand	68
China	69
Vietnam	77
Laos	78
Cambodia	81
Overall Average	65
South Asia Average	58

Source: Word Development Indicators, World Bank

3.12 Fiscal Consolidation

In order to achieve a sustained fiscal balance, Sri Lanka needs to increase government revenue and rationalize government expenditure. Increase in government revenue will critically depend on improved economic growth. However, measures are needed to improve tax administration and collection as a top a priority. As for expenditures, a complete rationalization of government expenditure is required and must involve significance reduction in wasteful and unnecessary government expenditure and allocation of resources to more productive and job-creating initiatives which will contribute to increased economic growth. Beyond the medium-term, the deficit needs to be contained at about 3% of GDP.

A large part of the inefficiencies of the economy and budgetary pressures can be attributed to unnecessarily large and in some cases duplicative government ministries, departments, institution, and commercially and financially unviable and poorly-managed state-owned enterprises (SOE). The government must implement a concrete program of SOE reforms which will include sale, divestiture, and restructuring as appropriate. Further, Sri Lanka has built up an inefficient and disproportionality large government bureaucracy and governance system which for the most part is incapable of supporting economic development. Reforms are essential to reduce the size of the government.

3.13 Debt Sustainability

The high level of public debt amounting to 83% of the GDP is not sustainable in the long-run. Given the continued fiscal deficit, the government will be forced to continue to rollover existing debt as they mature and, as a result, reduction of existing debt will be a significant challenge. The government projects that debt will decline to 70% of the GDP by 2023 and this will require substantial economic growth.

3.14 Leveraging Private Sector Investments

Sri Lanka needs to re-orient its growth model to leverage private capital for long-term investment projects including infrastructure investments. The fiscal and public debt constrains facing the economy only allow very limited fiscal space for large investments and borrowings by the government. Domestic private sector should be encouraged to partner with foreign investors for large capital investment projects.

3.15 Developing Domestic Capital Markets

Although various capital market development plans and policies have been proposed, the government has not recognized the importance of developing local capital markets and the investor base. Sri Lanka's equity and corporate debt markets have to be developed in size and liquidity in order to attract more domestic savings to stock and bond market investments, provide more dynamic and efficient markets to raise funds domestically and increase private sector capital formation for investment projects.

3.16 Exploiting Geographical Location Advantages

Sri Lanka as an island centered between the East and the West and located in the East-West maritime route has enormous opportunity to develop into one of the best aviation, port, commercial and services hubs in the region. The Colombo Port City can be developed as a vibrant and dynamic financial center in the region and Hambantota Harbor, which is a pivotal link in the Chinese Belt and Road Initiative, as an active trans-shipment hub and a port.

4. Conclusions

Sri Lanka's recent economic performance has been mixed. The country is trapped in a growth conundrum. While the economy has continued to expand, growth has been low and decelerating in recent years. The country lags in making policy, structural and other reforms that are necessary and critical to unlock impediments to growth. Low growth risks continued efforts to contain budget deficit and may lead to worsening of the current account deficit. Policy measures to address the twin deficits are vital since countries with persistent twin deficits tend to have weak growth and their currencies tend to depreciate more. Sri Lanka's public debt is high and unsustainable under the prevailing economic policy and growth prospects. Further deterioration of fiscal balance could lead to more borrowings by the government and build-up of more debt. Sri Lanka is highly vulnerable to tightening of global financial conditions when accessing international financial markets to borrow funds to service and refinance its foreign debt which has continued to rise over time.

Export-oriented industrial development financed by private capital, particularly foreign direct investments, is key to higher economic growth. In this context, Sri Lanka needs to have a robust exports growth strategy and a regionally competitive incentive framework for attracting foreign direct investments on a larger scale. Significant reforms are needed to modernize and diversify the agricultural sector in order to increase productivity and its contribution to growth. Private capital needs to be leveraged for infrastructure development as growth driver. Country's high-level of human development and highly educated workforce should be harnessed to expand existing and new service industries which have greater potential for contribution to the overall growth. Overall, achieving sustained high single digit economic growth is necessary to overcome fundamental economic imbalances. Besides economic policy and structural reforms, ensuring policy certainty and political stability are vital to spur investments and growth.

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Financing the Development in Sri Lanka and Debt

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1. Introduction

This paper intends to discuss the role the government played in development process and issues related to financing of the public investment and public debt management in the economy. Since the independence, the successive governments have followed various strategies to address socio-economic issues inherited from the colonial era. The public investment program has allocated more resources to uplift the socio-economic services in order to create conducive environment to accelerate the development in the economy. As a result, the successive governments had to adopt deficit budget policy that led the government to borrow to finance the resource gap in the budget.

The government was able to finance the deficit from concessionary external funding and institutional resources available at the domestic market until early 2000s. The elevation of the Sri Lankan economy to a middle-income country status made the country not eligible for concessionary funding from external donors. As a result, the entire net funding requirement of the government budget had to be financed from market-based borrowings from domestic and external sources. The continuation of high borrowings from market sources have raised the concerns on the sustainability of fiscal management and vulnerability of public debt. This has been the priority of the government compelled to bring the corrective measures in order to maintain the stability in the economy while accelerating the development in the long run.

This paper is structured as follows: Section 2 explains the role the government has been played in development and its new strategy to accelerate the development in the country. Section 3 describes major funding sources mobilized for the financing of budgetary operations in the past. Further, it explains the development in the recent past shifting towards the market-based borrowings from local and international sources. Section 4 illustrates the evolution of public debt in the post-independence economy and the role the government has to play to maintain the sustainability in debt management in the economy. Section 5 briefly gives the conclusion with several recommendations in order to allocate more funding for the developments of the economy.

2. Development Role of the Government

At the time Sri Lanka gained independence from the British in 1948, the GDP per capita was USD 120, only second to Japan in Asia. Although, the country recorded a high income, Sri Lanka economy had suffered from a series of structural weaknesses. The economy was characterized structurally as a "dualistic export economy" broadly dividing the economy into two prominent sectors namely the modern well organized sector that was catering to the external demand and the highly unorganized traditional sector producing for the existence of the masses living in the rural sector in the country. The modern sector represented the plantation sector and export sector both of which were facilitated by well organized financial and commercial sectors under the guidance and blessings from the government. The colonial government had conducted a "Laissez - Faire Economic Policy" or minimum intervention policy during the pre-independence period. As a result, socio-economic conditions of the traditional sector which represented mainly the rural population was at very low and sub-standard living conditions. After gaining the independence, the narrowing the gap between the two sectors while driving the economy forward were the challenging tasks faced by the successive governments.

In view of the economic policy environment, the post independence period in Sri Lanka could be clearly distinguished into two periods with the implementation of liberal economic policies in 1977. The first period is pre-liberalized era from 1948 to 1977 and the second is post-liberalized period from 1978 to date. During the pre-liberalized period, all successive governments made their best efforts to uplift the socio-economic conditions in backward areas and to take the economy forward through dedicated medium term national development plans with defined targets to be achieved at the end of the planned period. Accordingly, five National Development Plans were launched with targeted public investment programs with well defined targets including the increase of output, promote import substitution, optimize resource utilization, generate employment, diversify exports, strengthen the balance of payment and uplift the standard of living of people (Table 01). However, the government was the sole investor contributing to uplift the socio-economic conditions of the economy during this period. There was no parallel involvement from the private sector to improve the socio-economic sectors of the economy because, during that period, Sri Lanka was not considered as an attractive investment destination among foreign direct investors due to limited space available in key businesses, lack of commercial-type resources and policies adopted by successive governments. In addition, low purchasing power of people with relatively small market size was also seen as reasons for Sri Lanka to become an unattractive place for foreign direct investors.

Table 1: National Development Plans in Sri Lanka[1]

Plan	Period	Objective	Total Investment
6 year Plan	1947/48 – 1952/53	To increase output of essential goods and reduce dependence on imports.	Total government investment of Rs. 1,739 Mn. during the plan period.
6 year Plan	1951/52- 1956/57	Revised form of first 6 year plan incorporating Colombo Plan for co-operative economic development in South East Asia.	Total government investment of Rs. 1,359 Mn. during plan period.
6 year Plan for investment	1954/55- 1959/60	First comprehensive development plan to optimize the utilization of limited resources.	Total government investment of Rs. 2,529 Mn. during the plan period.
10 year Plan	1959-68	Comprehensive national investment plan for rapid import in Agriculture and Industrial sectors to generate employment, improve BOP, enhance the standard of living and to diversify the export sector.	Total national investment of Rs. 13,600 Mn. Government share was 62%.
5 year Plan	1972-76	To achieve 6% annual average growth and generate 810,000 jobs during the plan period.	Total investment of Rs. 15,000 Mn. during the plan period.

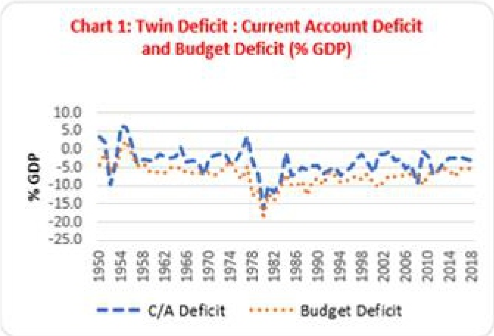
After 30 years of operations, the country's score card showed that the impact of the National Development Plans were good in improving social services in the country lifting the country's social status par with the global standards. However, these Development Plans were not success in delivering expected economic targets envisaged in these National Plans. As a result, after 30 years of post independence economic management, the country's economic conditions were far behind the peer countries in the region. For example, Sri Lanka's GDP per capita increased only to

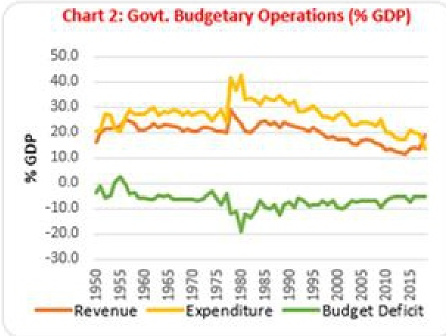
[1]Since the liberalization of economy in 1977, the successive government abandoned the national planning process in Sri Lanka

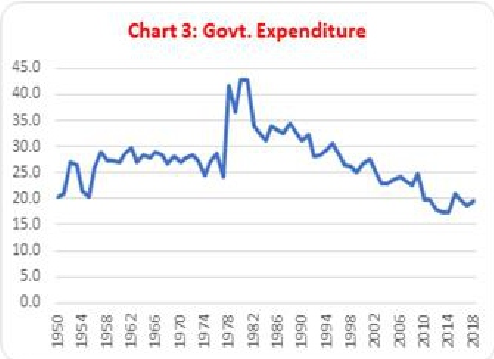
USD 289 in 1977 from USD 120 in 1948. During the same period Malaysia, Thailand, the Philippines, and Indonesia, countries which were behind to Sri Lanka in 1948, recorded GDP per capita of USD 1,027, USD 445, USD 450 and USD 334 respectively in 1977. Further, the Sri Lankan economy was highly vulnerable to the volatile external sector and the tight external reserves position became a critical issue in managing the stability in the macro economy. These poor economic achievements compelled the political authorities and policy makers to look for new policy framework for the country in order to accelerate the growth and exploit the true potential of the country.

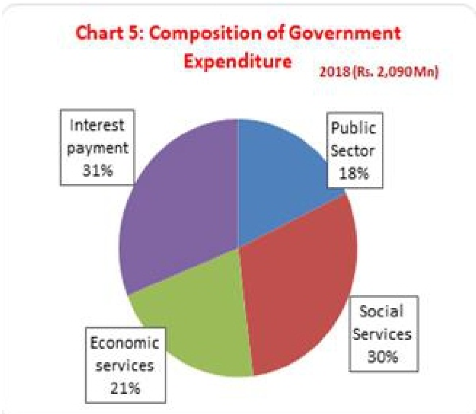
Accordingly, Sri Lankan authorities decided to liberalize the economy in 1977, as a pioneer country in South East Asia, and designed it for the optimal utilization of country's resources. With the liberalization of the economy main objective of the government was to increase the level of investment and accelerate the economic growth by improving the efficiency of allocation of resources in the economy. While promoting the private sector to play a dynamic role in the economy, the government has dedicated to play a facilitator role by providing necessary infrastructure for the smooth operation of the private sector in the economy. In this process, more attention was given to the public investment program specially to improve the economic services. During the early part of the post-liberalization period, the government has allocated historically highest amount of resources in terms of GDP for the public investment program reporting over 20 percent of GDP in early 1980s. Several mega type projects such as Mahaweli Development Program were initiated in order to optimally use the untapped resources in the economy.

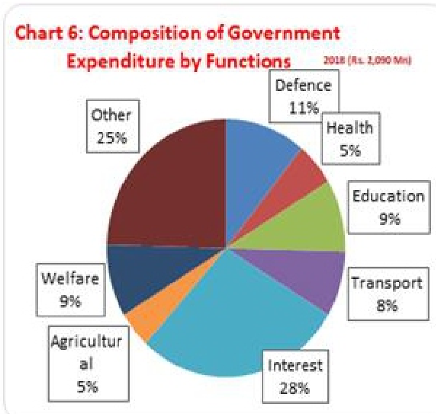
The economy responded very positively for the liberal economic policies and annual average growth recorded over 6 per cent during the first five years of post liberalization period, 1978-1982, in comparison to the annual average growth rate of 3.4 per cent reported during the five years immediately before the introduction of liberal policies, 1973-1977. However, the Sri Lankan economy was not fortunate to reap the full benefit of open economic policies due to the internal conflict which prevailed over three decades period. During this period, an escalation of defense expenditure and sharp reduction of tax revenue (Chart 04) resulted in an increase of the overall budget deficit significantly and servicing of public debt became a challenging task during this 30-year period. Finding required resources for budgetary operations became a difficult task and this resource constraint was largely reflected in the public investment program, by curtailing funding of the development programs of the budget. This has had a serious negative impact on the development and overall macroeconomic performances during this period. This period is known as "Three lost Decades" to the economy.











After ending the internal conflict in 2009, the post-war economy has again shown the true potential under the new policies adopted to expand the aggregate demand in the economy. The peaceful country environment has brought back the investors' confidence and allowed them more space in the expansionary policy environment. The gradual reduction of defense expenditure and cost of borrowings both from the domestic and international markets helped create more space in the government budget to allocate more funds for public investments. The public investment program has also been reoriented with the objective of facilitating high economic growth while encouraging parallel investment through private investors including foreign direct investments (FDI). Further, this development helped the fiscal authority to come up with the revenue based fiscal consolidation program in a more effective manner. Under new fiscal policy, government envisages to lower the budget deficit by enhancing revenue collection and streamlining the expenditure without curtailing the financing for planned investment program of the budget. During last ten years of the post-war period, public investment program accounted for about 25 per cent of the total government expenditure amounting to 5-6 per cent of GDP.

In the public investment program, around 65 per cent of financial resources have been allocated for the improvement of economic services in the country. In this process, high priority was given to the transport sector followed by agriculture, irrigation, energy and water supply sectors. With regard to the public investment in social services, more resources were allocated to enhance the education and health infrastructure in the country. In addition, housing and community services sectors were also given due attention considering the important role this sector plays to improve the social well-being of people.

According to the international classifications, the Sri Lankan economy has now come closer to the upper middle-income category status country. In order to take the economy through the upper middle-income path, the country has to address it structural weaknesses to avoid the country falling into the "middle income trap" that keeps the economy in stagnated. Therefore, the country needs a "paradigm shift" in its policy front that would help sustain the economic growth and the development in the long run.

In the fiscal front, limited space available in the fiscal sector for promotion of the development in the economy is the major drawback restricting any enhancement of resource allocation for the public investment in the government budget. A sharp reduction of tax revenue since 1990s was the main reason for limited resource availability in the budget. The government revenue in term of GDP has dropped from over 20 per cent in early 1990s to about 12.5 per cent in 2017, recording the lowest in comparison to peer countries (Table 02). Therefore, the on-going revenue-based fiscal consolidation program needs to be given high priority to enhance the tax revenue and thereby allocate more non-debt resources for the investment programs in needy sectors in the economy. Also, it will be the only sustainable solution to improve the stability in the fiscal sector and to enhance the socio-economic infrastructure through private sector participation and that will ensure the long-term sustainable development in the country.

Table 02: Tax Revenue / GDP (%) - 2017

Country	%
Sri Lanka	12.5
Maldives	19.5
Nepal	21.0
Malaysia	13.8
Thailand	14.8
Vietnam	19.1
Bhutan	13.1

3. Financing the Development

A fiscal operation of borrowings in order to finance the government development activities goes back to the colonial era. The first formal debt instrument was introduced by the British rulers in 1923 by issuing Treasury bills , a short-term debt instrument issued under the Treasury Bills Ordinance. Consequently, the colonial government felt the necessity of mobilizing medium to long term funds to finance the investment activities of the government. Accordingly, a new debt instrument called "Rupee Loans" was introduced under the Registered Stock and Securities Ordinance in 1937.

These two debt instruments had been actively used for raising funds from the domestic investors to finance the budgetary operations at the time of independence in 1948. However, there were no formal funding arrangements to raise funds to finance the budget from external sources.

In the post-independence period, the deficit budget policy that has been adopted during last seven decades compelled the successive governments to borrow funds to meet the resource gap in the budget. Since the domestic resources were not adequate to meet the total funding requirement of the budget, government had to rely on external funding sources to meet the resource gap.

In the domestic front, Sri Lankan government continued to use Treasury bills and Rupee Loans to mobilize resources from the domestic market with marginal modifications until mid-1997. Major investors contributed to invest in these two instruments were pension funds, insurance companies, saving institutions and banks. Since the Rupee Loan is not a market-based instrument, the government as well as investor felt the necessity of having a market-based debt instrument to develop the long-term activities in the debt market. This has led the government to introduce Treasury bonds in 1997, which is a market-based tradable instrument issued with medium to long term tenure. Since then, issuance of Rupee loans were gradually phased out and replaced by Treasury bonds which became the key debt instrument to raise funds for government from the domestic market. Meanwhile, issue of new Treasury bills was limited and issued mainly to meet urgent cash flow requirements in the budget. This policy has considerably helped to lower the roll over risk in the debt portfolio. In addition, government rupee securities market i.e. Treasury bonds and Treasury bills, was opened for foreign investors from 2007. This policy has increased the investor base and competitive borrowings of the budget. At the same time, risk mitigation policies were also introduced in order to face any shocks due to volatile external sources.

In view of external funding, the financing of the development programs of the government was largely done through the external concessionary funding sources during the first five decades of post-independence economy. The formal external funding has been brought into the development plans from the early 1950s with the

World Bank programs. This process was further expanded with the funding arrangements with other multinational agencies such as Colombo Plan, Asian Development Bank and other multilateral agencies. At the same time, various bilateral arrangement also channeled their funding for the development of the country through the government investment programs. However, with the elevation of Sri Lanka into a lower middle income country status, availability of concessional funding started to decline from early 2000s. In this background, the government faced the difficulty of continuing its development plans which were expected to finance largely through the external concessionary sources. This has led the government to search for alternate funding sources. In the domestic front, one alternate was to tap the limited resources available in the domestic forex market. Accordingly, a US dollar denominated new debt instrument called "Sri Lanka Development Bonds (SLDBs)" were introduced to raise excess foreign exchange available in the local market. Since the resources available in the local forex market is limited, this fund raising source was not adequate to meet the shortfall created by the declining external concessionary funding sources. Therefore, the government had no other option except accessing the international commercial sources. In this process, government had two options; one was to penetrate the international capital market by issuing international sovereign bonds and the second was to tap the international commercial loan market.

In accessing the international market, the Sri Lankan government had its first experience in 1997 by issuing "Floating Rate Notes (FRN)" amounting to USD 50 million. Although it had good responses from the international investors, for nearly a decade, the country could not raise funds through a similar issue in the international capital market at a reasonable rates due to the aggravation of the internal conflict and weak macroeconomic conditions that prevailed in the country. In this background, the government made several attempts to mobilize funds from the international market through loan arrangements. Accordingly, there were three "Syndicate Loans" and one "Club Loan" raised during the period from 2000 to 2008. Relatively short-term nature, investors preference for small size of issuance and non-marketable features were the main concerns raised for these international loans that would make some negative impact on the prudent debt management of the country. Therefore, this types of loan arrangements were not recognized as a permanent source of funding for a country such as Sri Lanka which needs long-term funding to match with its development programs. This has encouraged the government to issue marketable debt instruments which can reach a broader investor base to mobilize long-term funds from the international capital market. Due to the high liquid nature and tradability in the secondary market, investors appetite for these instruments is higher in the international market.

In this context, the government of Sri Lanka decided to enter into the international capital market by issuing international sovereign bonds (ISBs). Accordingly, the preparation of the system for the issuance for ISBs started from early 2000s and as a main pre-requisite, government appointed international rating agencies namely Fitch Ratings and Standered and Poor's in 2005 to obtain sovereign rating for the country. In addition, sovereign rating advisers were also appointed to advise the government on sovereign rating upgrades and to develop a strategy to enter into the international capital market. In line with these arrangements, necessary steps were taken to improve the macroeconomic fundamentals in the economy. With the completion of these preparatory work, the government issued its first ISB in 2007. Since then, except in 2008, Sri Lanka has been a regular issuer of ISBs over the last ten year period. These funds helped the government fill the resource gap and continue its public investment as envisaged in the annual budgets. In addition, project-based commercial borrowings were also promoted through bilateral sources.

Table 03: Issuances of International Sovereign Bonds (ISBs)

	Year	Amount (USD Mn.)	Coupon Rate (%)	Tenure (Years)	Maturity (Year)
1	2007	500	8.25	5	2012
2	2009	500	7.4	5Y 3M	2015
3	2010	1,000	6.25	10	2020
4	2011	1,000	6.25	10	2021
5	2012	1,000	5.875	10	2022
6	2014	1,000	6.0	5	2019
7	2014	500	5.125	5	2019
8	2015	650	6.125	10	2025
9	2015	1,500	6.85	10	2025
10	2016	1,000	6.825	10	2026
11	2016	500	5.75	5Y 6M	2022
12	2017	1,500	6.2	10	2027
13	2018	1,250	5.75	5	2023
14	2018	1,250	6.75	10	2028
15	2019	1,000	6.85	5	2024
16	2019	1,400	7.85	10	2029

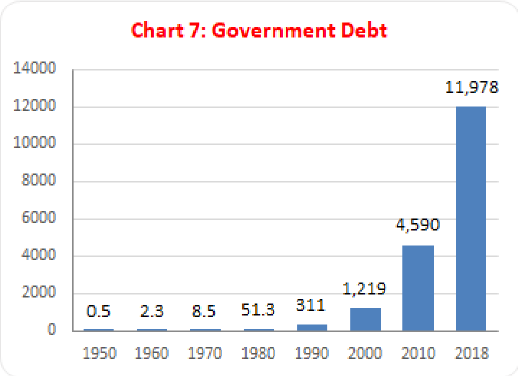
Source: Central Bank of Sri Lanka

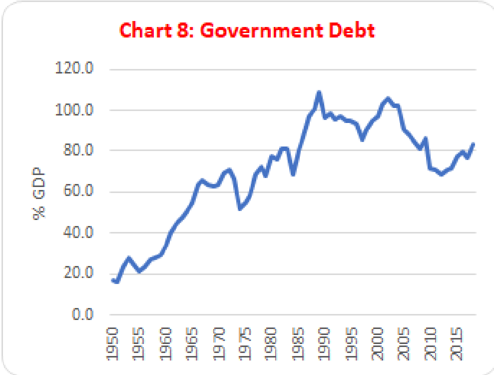
Going forward, financing the public investment program will rely heavily on the Treasury bonds and ISBs raising funds from local and international markets. At the same time, the government encourages to attract non-debt creating financial resources to finance its development programs. This alternate funding arrangement includes a public-private partnerships (PPP) for investment on public-owned commercial entities and they are structured according to the agreement of respective parties. Further, the promotion of FDIs on selected economic services helps the government to lower its borrowings while maintaining the envisaged national investment plan. At the same time, effective implementation of the revenue-based fiscal consolidation program would generate additional space in the fiscal program that can be used to accommodate more funding for the public investment program. At the same time, the government has to streamline the investment plan giving due attention to the projects which would generate adequate rate of return that would be sufficient to pay back long-term liabilities raised at market rates by the government.

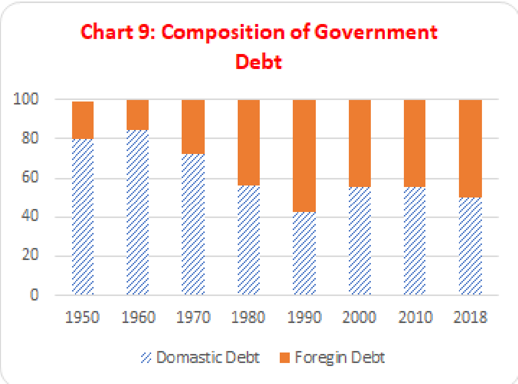
4. Public Debt Management

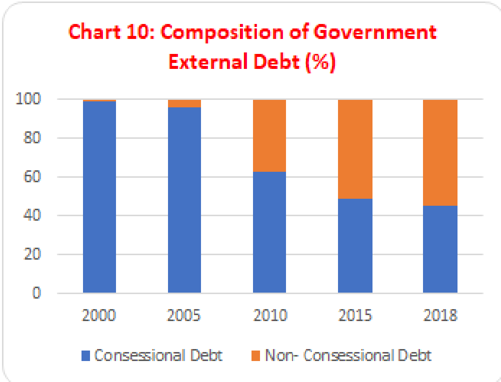
In Sri Lanka, public debt is not a new issue as it was a legacy of British colonial government. During the early years of post-independence period, the entire funding requirement of the government was mobilized from the domestic sources. However, with the introduction of Nation Development Plans and engagement of international agencies such as the World Bank and Colombo Plan in formulating the national planning process, external concessional funding became an important source to finance the development plans of the government from early 1950s. Until early 2000, external debt was mobilized mostly in concessional terms which include long grace and pay back periods and lower interest rates in comparison to the interest rates prevailed in the market. As a result, servicing of external debt was not an issue in the budget and its impact to the macroeconomic management was at acceptable levels.

Accordingly, the successive governments borrowed funds from both domestic and external sources resulting in an outstanding public debt stock comprising external and domestic debt. The increase of outstanding debt stock in rupee terms was mainly due to net borrowings of the government budget. In addition, the depreciation of rupee against foreign currencies contributes to increase the nominal value of debt stock. During the period from 2015 to 2018, a sharp depreciation of rupee had a significant impact on the debt sock and increased nominal value by over Rs. 1.3 trillion. The stock of outstanding debt in nominal terms increased from Rs. 654 million in 1950 to Rs. 11,978 million in 2018 (Chart 07). In the recent past, outstanding debt stock in terms of GDP also shows an upward move (Chart 08). Since the net deficit of the budget is now in the region of 4.5 per cent of GDP, annual net borrowing requirement which adds to the debt stock is in the region of Rs. 600 billion. Therefore, reduction of deficit and maintaining the stability in exchange rate are the key debt dynamics needed to decelerate nominal growth of debt.









The domestic debt stock accounted for higher share in the total public debt except in early 1980s during which the government borrowed heavily to finance mega development programs. However, limited resources available in the domestic sources, continuously high deficit remained in the recent past and sharp depreciation of rupee have combinely affected to increase the share of foreign debt in the total debt stock gradually in the recent past (Chart 09). Further, lack of concessional funding and high reliance on commercial funding from external sources have increased the share of non-concessional debt in the total external debt portfolio (Chart 10).

Since the government is not in a position to generate "a balanced budget" situation in the foreseeable future, the outstanding debt stock in nominal terms will continuously increase in the future. This would make fiscal management an extremely difficult task and increase the vulnerability of debt management in the economy. In 2018, total annual debt service payment was more than the annual revenue collection of the budget (Table 05). Further, due to lack of sufficient external reserves and limited availability of rupee funds in the domestic market to meet the resource gap in the budget, government is compelled to access the international capital market to service external debt. The continuation of this model is highly unsustainable and needs a serious policy adjustments to bring strict discipline to fiscal management and prudent debt management policies to avoid any possible default of debt service payment in the future. Further, such improvement would help government to allocate more funding for the development of needy sectors of the economy.

The rising public debt stock and its vulnerability of servicing payment obligations became a key concern among political authorities and policy makers in the recent past. In addition, this concern has been highlighted by various external parties including International Monetary Fund and International Rating Agencies as Sri Lanka debt level is considerably higher than peer countries (Table 04). Currently, the government is heavily relying on market based external and local funding to finance the resource gap in the budget and still continues its borrowing requirement at a sizeable level. This has raised a major concern with regards to the sustainability of debt in the economy as all key debt indicators have deteriorated in the recent past (Table 05).

Table 04: Debt/GDP Ratio : Country Comparison (2015 data)

Country	Ratio
India	68.7
Pakistan	67.2
Vietnam	61.5
Malaysia	50.9
Thailand	41.8
Nepal	26.8
Sri Lanka	77.6

Since the public debt management is becoming a complex task, the Central Bank as a debt manager has come up with a series of new measures to improve the prudent debt management in the economy. They include limited issues of short term debt, lowering of the fragmentation in Treasury bonds program, issuing long term debt to increase the average time to maturity of debt stock, improve the yield curve, introduction of new auction system for Treasury bonds, and releasing advance debt issuance calendar. In addition, introduction of the new Active Liability Management Act is an another positive development as it gives the flexibility to the debt manager to operate the debt management. At the same time, the government should adhere to the revenue-based fiscal consolidation program to achieve expected medium term targets. Further, strong adjustments are needed to the macroeconomic management in order to bring the stability into the economy, a prerequisite to achieve stability to the public debt management in the economy.

Table 05: Central Government Debt Indicators

Indicator	2013	2014	2015	2016	2017	2018
Central Government Debt/ GDP %	70.8	71.3	77.7	78.3	76.9	82.9
Domestic Debt/ GDP %	40.0	41.3	45.3	44.5	41.7	41.6
Foreign Debt %	30.9	30.0	32.4	33.7	35.2	41.2
Total Foreign Debt/ Export %	151.9	142.5	154.0	159.3	162.2	181.0
Total Debt Service/ GDP %	12.1	10.4	12.0	11.3	11.9	14.5
Total debt Service/ Government Revenue %	102.2	90.0	90.6	80.2	87.5	108.8
o/w Domestic Debt Service/ Government Revenue %	74.8	65.1	63.1	62.7	66.3	81.3
Total Debt Service/ Government Expenditure %	49.1	44.3	42.5	44.0	46.6	53.1
o/w Domestic Debt Service/ Government Expenditure %	35.9	32.0	29.6	34.4	35.3	39.7
Foreign Debt Service/Export %	16.0	13.7	17.4	11.6	13.4	16.0
Total Interest/ GDP %	4.8	4.2	4.7	5.1	5.5	5.9
Domestic Interest/ GDP %	3.7	3.2	3.6	4.0	4.3	4.4
Domestic Interest/ Government Recurrent Expenditure %	29.4	24.8	23.2	27.5	29.6	30.6
Foreign Interest/ Exports %	5.5	5.0	5.0	5.0	5.7	6.5

Source: Central Bank of Sri Lanka

5. Conclusion

Historically, the Sri Lankan government has played an important role to enhance investment and growth in the economy. The financing of public investment was largely arranged through borrowings which have now become a market-based arrangements from both local and the international sources. The continuation of the deficit budget policy and corresponding borrowings to finance the resource gap has increased the outstanding public debt to a unsustainable level. Further, reliance of external commercial borrowings is an increasing trend. As a result, the servicing of public debt is becoming a critical issue given the limited space in the budget and external resources in the economy.

In this context, the government should give high priority for the on-going revenue-based fiscal consolidation program. At the same time, strengthening of public investment program also needs high attention with a priority-based funding for investment which could generate adequate return to pay back debt servicing liabilities in the long run. The public debt management has to introduce prudent debt management practices with the ultimate objective of maintaining the countries unblemished debt servicing record maintained over 70 years period. Overall, the macroeconomic management has to be elevated to a new height in order to avoid the middle income trap and take the country through the upper middle income path by exploiting the true potential of the economy with productivity enhancements.

Annex 01: Socio- Economic conditions of Sri Lanka

	Item	1953	1963	1978/79	2003/04	2016
1	Population (Mn.)	8.1	10.6	14.4	19.2	21.2
2	Life Expectancy (Years)	42.2 (1946)	61.7	69.9 (1971)	74.3	75.5
3	Infant mortality (per 1000 live births)	71	56	38	9.4	8.5
4	Literacy (%)	NA	79.4	86.2	92.5	NA
5	No schooling (%)	41.8	26.8	14.9	7.9	3.3
6	Pipe -Born water (%)	11.3	15.0	21.8	38.9	47.7
7	Availability of Electricity (%)	4.1	7.0	13.1	74.9	99.3
8	Housing: Thatched roof (%)	56.7	49.3	31.7	5.6	NA
9	Employment in Agriculture (%)	NA	53.0	48.3	32.8	27.1
10	Unemployment (%)	16.6	13.8	14.7	8.9	4.4
11	Gini Coefficient	0.46	0.45	0.43	0.46	0.45

Sources : Department of Census and Statistics : Household Income and Expenditure survey
Central Bank of Sri Lanka

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Financial Sector Development of Sri Lanka: Issues and Strategies

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1. Introduction

The purpose of this paper is to provide an overview of the current development of the Sri Lankan finance sector issues and to discuss strategies and solutions. Sri Lanka is a USD 89 billion economy with a per capita GDP of USD 4,102 and has recorded an average economic growth of 5.33% over the past 10 years. Its capital market primarily consists of government securities, stock, and corporate bond markets which have a combined value of USD 43.4 billion. The government securities market is the dominant sector with a value of USD 27 billion whereas the stock market capitalization is USD 16 billion. The capital market is about 55% of the economy with government securities and stock markets representing 34% and 20% of the economy respectively.

There is a fairly long history of capital markets in Sri Lanka with the modern stock market dating back 34 years. The regulatory, institutional, trading, clearing and settlement infrastructures are fairly well-established. Although many components of the capital market are in place, Sri Lanka needs to undertake substantial and challenging structural and policy reforms in order to establish a well-functioning financial system with more broad-based, efficient and stable capital markets and to fully leverage its potential to achieve long-term economic objectives.

2. The Finance Sector and Capital Markets of Sri Lanka

2.1 Finance Sector

The Sri Lankan finance sector consists of the Central Bank, deposit taking financial institutions (commercial banks, specialized banks, finance companies, co-operative rural banks, and thrift and credit societies), specialized financial institutions (leasing firms, primary dealers, stock brokers, unit trusts, underwriters, investment managers, margin providers and venture capital companies), insurance companies, and superannuation funds.

At the end of 2018, total size of Sri Lanka's finance sector amounted to Rs. 18.9 trillion (USD 103.4 billion). The finance sector assets are 131% of the GDP of Rs. 14.5 trillion (USD 89 billion). Table 1 and Figure 1 show data relating to the finance sector composition. The largest segment of the finance sector is deposit taking financial institutions accounting for 71% of the finance sector assets. The second largest sector is superannuation funds, which include the two largest provident funds - EPF and ETF - among others, amounting to 15% of the finance sector assets.

2.2 Capital Markets

The key components of the capital markets of Sri Lanka include government securities, stocks and corporate bonds. As at the end of 2018, total size of the capital market was Rs. 8 trillion (USD 44 billion). Government securities markets dominate with a share of 61%. The second largest asset class is the stock market which has a 35.4% share of the capital market. The listed corporate debt market is very small accounting for just 3.6% (Table 2 & Figure 2). In terms of the importance in the economy, total size of the capital market is about 56% of the Sri Lankan economy. The size of the government securities and stock markets are 34% and 20% of the economy respectively.

Table 1: The Size and Composition of the Finance Sector of Sri Lanka in 2015 & 2018

FINANCE SECTOR	FinanceSector Assets - 2015				Finance Sector Assets- 2018			
	Rs. Bn.	USD Bn.	% of Total Sector	% of GDP	Rs. Bn.	USD Bn.	% of Total Sector	% of GDP
1. Central Bank	**1,426.0**	**9.9**	**10.4**	**12.8**	**1,914.3**	**10.5**	**10.1**	**13.2**
2. Deposit Taking Financial Institutions	**9,119.0**	**63.3**	**66.7**	**81.5**	**13,336.7**	**73.0**	**70.5**	**92.3**
Licensed Commercial Banks	6,974.0	48.4	51.0	62.4	10,372.4	**56.7**	54.9	**71.8**
Licensed Specialized Banks	1,103.0	7.7	8.1	9.9	1,421.6	**7.8**	7.5	**9.8**
Licensed Finance Companies	915.0	6.4	6.7	8.2	1,383.7	**7.6**	7.3	**9.6**
Co-operative Rural Banks	116.0	0.8	0.8	1.0	147.7	**0.8**	0.8	**1.0**
Thrift and Credit Co-operative Societies	11.0	0.1	0.1	0.1	11.3	**0.1**	0.1	**0.1**
3. Specialized Financial Institutions	**544.0**	**3.8**	**4.0**	**4.9**	**240.1**	**1.3**	**1.3**	**1.7**
Specialized Leasing Companies	81.0	0.6	0.6	0.7	47.6	**0.3**	0.3	**0.3**
Primary Dealers	283.0	2.0	2.1	2.5	83.6	**0.5**	0.4	**0.6**
Stock Brokers	10.0	0.1	0.1	0.1	8.7	**0.0**	0.0	**0.1**
Unit Trusts	130.0	0.9	1.0	1.2	67.0	**0.4**	0.4	**0.5**
Market Intermediaries	32.0	0.2	0.2	0.3	16.4	**0.1**	0.1	**0.1**
Venture Capital Companies	8.0	0.1	0.1	0.1	16.8	**0.1**	0.1	**0.1**
4. Insurance Companies	**454.0**	**3.2**	**3.3**	**4.1**	**606.6**	3.3	**3.2**	4.2
5. Superannuation Funds	**2,119.0**	**14.7**	**15.5**	**18.9**	**2,807.8**	**15.4**	**14.9**	**19.4**
Employees' Provident Fund	1,665.0	11.6	12.2	14.9	2,289.4	**12.5**	12.1	**15.8**
Employees' Trust Fund	223.0	1.5	1.6	2.0	312.1	**1.7**	1.7	**2.2**
Approved Pension and Provident Funds	185.0	1.3	1.4	1.7	149.1	**0.8**	0.8	**1.0**
Public Service Provident Fund	46.0	0.3	0.3	0.4	57.2	**0.3**	0.3	**0.4**
Total Finance Sector	**13,662.0**	**94.8**	**100.0**	**122.2**	**18,905.5**	**103.4**	**100.0**	**130.8**
Memorandum Items								
GDP (at current market prices)	11,183.0	82.3			14,450.0	88.9		
Exchange Rate (Rs. per USD Annual	135.94				162.5			
Exchange Rate (Rs. per USD Year	144.06				182.8			

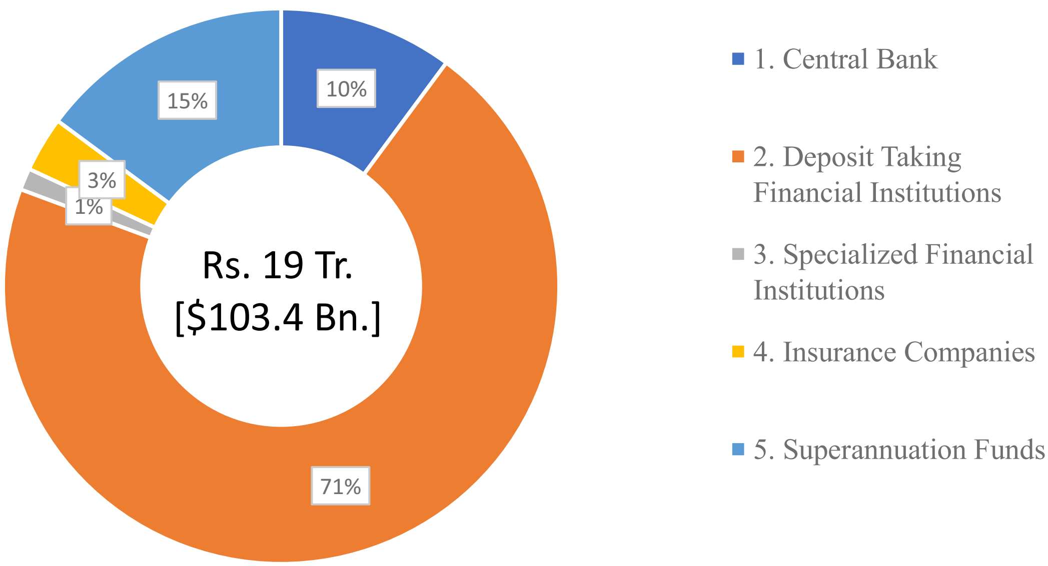
Source: Central Bank of Sri Lanka Annual Report 2018

Table 2: The Size and Composition of Capital Markets of Sri Lanka in 2018

	Value of Capital Market Asset Classes			
Capital Markets	Rs. Bn.	USD Bn.	% of Total Capital Market	% of GDP
Government Securities (1)	**4,888**	**26.7**	**61.0**	**33.8**
Treasury Bills	747	4.1	9.3	5.2
Treasury Bonds	4,141	22.7	51.7	28.7
Stock Market Capitalization	**2,839.50**	**15.5**	**35.4**	**19.7**
Corporate Debt Market Capitalization	**288.5**	**1.6**	**3.6**	**2.0**
Total	**8,016**	**43.9**	**100.0**	**55.5**

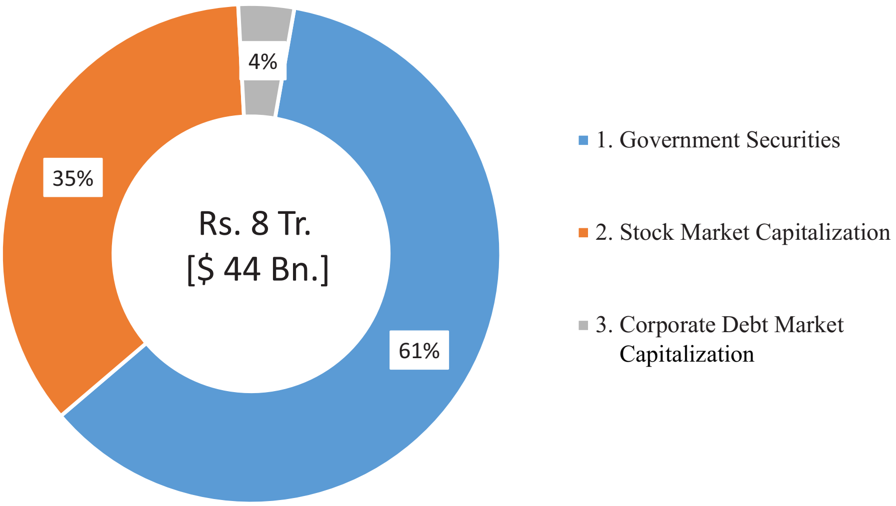
(1) Face value of outstanding government securities.
Source: Central Bank of Sri Lanka Annual Report 2018, Colombo Stock Exchange

Figure 1: The Size and Composition of the Sri Lankan Finance Sector in 2018



Source: Central Bank of Sri Lanka Annual Report 2018

Figure 2: The Size and Composition of the Sri Lankan Capital Markets in 2018



Sources: Central Bank of Sri Lanka Annual Report 2018, Colombo Stock Exchange

3. The Equity Market

3.1 Overview of the Sri Lankan Stock Market

Share trading in Sri Lanka dates back 123 years when the Share Brokers' Association was established in 1896 as a secondary market for share transactions. The market went through numerous transformations and periods of growth and decline due to economic and political changes over its long history. The modern stock market, however, dates back 34 years to 1985 when the Colombo Securities Exchange was established which was later renamed as the Colombo Stock Exchange (CSE) in 1990. The Securities and Exchange Commission was established in 1987 under the Securities Council Act No. 36 of 1987.

The stock market has its own Central Depository System (CDS). Trading has been fully automated under the Automated Trading System since 1997. The main securities traded on the CSE include ordinary and preference shares, corporate debentures and government securities. [1]In 2017, the CSE had 296 listed companies with a total market capitalization of about Rs. 3 trillion and an annual turnover of Rs. 221 billion (Table 3).

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[1]Government securities have not been traded on the CSE since July 2012

Table 3: Turnover, Listed Firms and Market Capitalization of the CSE (2008-2018)

Year	Annual Equity Turnover (Rs. Mn.)	Number of Companies Listed	Market Capitalization (Rs. Bn.)	Market Cap as a % of GDP	Turnover as a % of Market Cap	Turnover as a % of GDP
2008	110,454	235	489	11	22.6	2.5
2009	142,463	231	1,092	23	13.0	2.9
2010	570,327	241	2,210	34	25.8	8.9
2011	546,256	272	2,214	31	24.7	7.6
2012	213,827	287	2,168	25	9.9	2.4
2013	200,468	289	2,460	26	8.1	2.1
2014	340,917	294	3,105	30	11.0	3.3
2015	253,251	294	2,938	26	8.6	2.3
2016	176,935.4	295	2,745.4	23.2	6.2	1.5
2017	220,591.2	296	2,899.3	22.7	7.8	1.6

Source: Colombo Stock Exchange

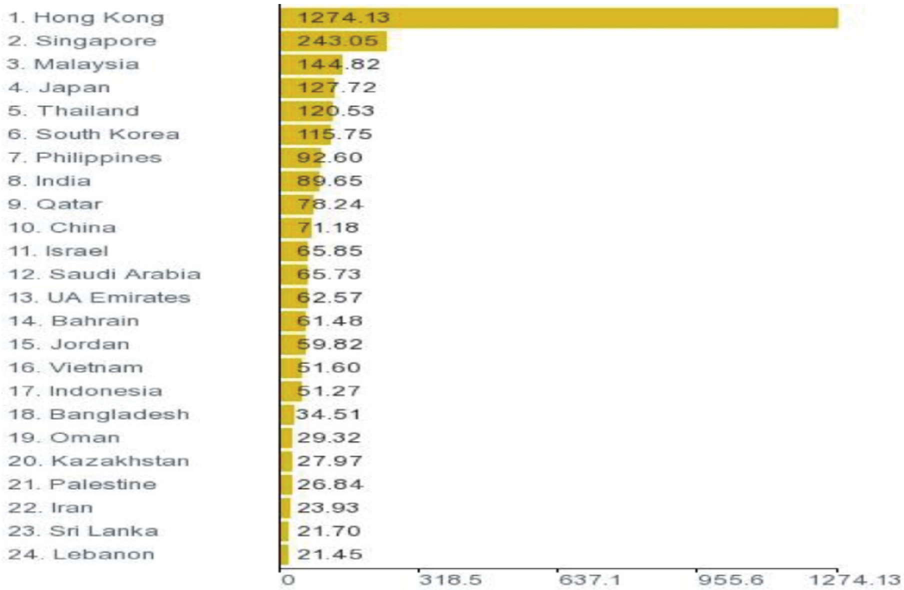
3.2 Concerns and Impediments

3.2.1 Market Size

One of the most important characteristics of an equity market is its size in terms of the market capitalization. A larger market provides more investable stocks and better opportunities for diversification. Market size has an important influence on the ability to attract institutional investors, particularly foreign investors, and their asset allocations across markets. Table 4 shows important measures of market size.

The relatively smaller size makes the Sri Lankan equity market less attractive in the region. The market capitalization of the CSE was USD 15.5 billion as of the end of 2018 (Table 2). It is the smallest of the four main stock markets in South Asia that include Bangladesh, India, Pakistan and Sri Lanka. The Bangladesh stock market is about twice, Pakistan is about three times, and India is about 143 times the Sri Lankan market. Overall, the Sri Lankan market represents just about 1% of the South Asian regional capitalization whereas Bangladesh constitutes just over 1%, Pakistan 2% and India 96%. Market size relative to the GDP indicates the significance of the stock market in the economy (Figure 3).

Figure 3: Market Capitalization as a Percent of the GDP, 2017



Source: TheGlobalEconomy.com, The World Bank

3.2.2 Liquidity

Liquidity is also a very important aspect of a vibrant stock market. Turnover (value of shares traded), turnover ratio (turnover as a percent of market capitalization), and turnover to GDP ratio are three key indicators of liquidity and depth of a market overall. Table 4 provides data relating to liquidity of South Asian stock markets.

In terms of 2015 data, Sri Lanka has the lowest turnover with just over USD 2 billion, and turnover is much larger in other South Asian markets. A more important measure of liquidity, however, is the turnover ratio. The average turnover ratio for South Asia is 27%. With a 9% turnover ratio, the Sri Lankan stock market is the least liquid in the South Asian region. All the South Asian markets are less liquid compared with the average turnover ratio of 80% for the emerging markets. The CSE's turnover ratio has to triple to reach the regional average and increase almost nine-fold to be at par with the emerging markets.

These statistics quite clearly demonstrate that the CSE significantly lags behind its regional competitors and emerging markets in terms of market liquidity. As discussed later, smaller pubic float of listed firms, lack of market making, lack of a large number of active individual investors, and lack of an active fund management industry are some of the key reasons for relative illiquidity of the Sri Lankan stock market. This has been a significant weakness in the Sri Lankan stock market inhibiting participation of large institutional investors and foreign investors. Regional and emerging market comparisons point to the need for material increases in liquidity of securities to be competitive in the regional and emerging markets space.

Many listed firms have a smaller free-float impeding active trading. Before the new listing rules were enacted in 2014, the CSE required, as a condition for initial listing, that a company should have a minimum public float of 25% to be listed on the Main Board and a 10% minimum public holding for companies to be listed on the Diri Savi Board (the Second Board) irrespective of the sector or the market capitalization. This requirement, however, was not imposed as a continuous listing requirement. As a result, many companies have lower public float than what was required at the time of listing.

Table 4: Measure of Liquidity of South Asian Stock Markets in 2015

Market	Turnover (USD Mn.)	Turnover Ratio (%)	Turnover as a % of GDP
India	797,400	27	37
Pakistan	26,978	41	9
Bangladesh	13,139	33	9
Sri Lanka	1,758	9	2
South Asia Average		27	14
MSCI Emerging Markets' Average		80	53

Sources: World Federation of Stock Exchanges, National Stock Exchanges, World Bank, IMF

The lack of market making severely limits liquidity. The brokers and trading members play a brokering role only. Market makers are specialized institutions that quote bid and ask prices and stand ready to become a counterparty to buy and sell transaction. As a result, when there is no ready counterparty to a buy or sell trade, market makers step into complete the trade providing continuous liquidity to the market. The lack of market making inhibits trading activity and liquidity in the Colombo stock market. The regional markets such as India, Bangladesh and Pakistan have all introduced market makers in order to improve stock market liquidity.

3.2.3 Other Concerns and Impediments

Transaction costs on stock trades in Sri Lanka are the highest in South Asia. Transaction costs in the CSE are 0.82% for transactions up to Rs. 50 million whereas it is 0.02% in the National Stock Exchange of India. Although it is negotiable for transactions above Rs. 50 million, the minimum cost of 0.20% is still higher than the regional counterparts except for the Bombay Stock Exchange (Table 5). Higher transactions costs make the CSE less competitive regionally. It is alleged that although the minimum transaction cost for trades above Rs. 50 million is 0.20%, some stock brokers compete for clients, particularly high net worth investors, by giving rebates thus undermining the level playing field. It seems that there is no mechanism to detect such practices either.

Table 5: Transactions Costs of South Asian Stock Markets (March 2016)

Market	Transaction Costs of Equity
India - NSE	0.02%
India - BSE	0.275%
Pakistan	Negotiable
Bangladesh	0.03%
Sri Lanka	Transactions up to Rs. 100 Million - 1.12% (with 0.30% Share Transaction Levy) Transactions above Rs. 100 Mn: Negotiable with a minimum brokerage (floor) being 0.20% (Equity - with effect from 27th June 2017)

Sources: Respective stock exchanges

There are no minimum capital requirements for the brokerage industry. This leaves the industry exposed to possible undercapitalization relative to the capital at risk, and any financial distress or failures in the brokerage industry will undermine the investor confidence and require the regulators and the Government to potentially rescue them. The fact some brokers maintain their own portfolios and some investors engage in margin trading make it even more important that a prudential capital requirement regime is introduced.

3.3 Recommendations

3.3.1 Increasing Market Size

The key to increasing the market size is to have more companies listed on the CSE. The main sources for new listings include privately-owned enterprises and state-owned enterprises (SOEs). Recent deliberations in this regard at the level of the CSE and the Government have also included encouraging small and medium scale enterprises (SMEs), companies operating under the Board of Investment (BOI) regulations, and foreign firms to list on the CSE. Leveraging the stock and bond markets as an avenue for funding infrastructure development through appropriately formed corporate structures is another potential source for market growth.

a) Listing privately-owned enterprises:
   A mechanism to encourage and bring large private companies to list is very important for market growth. Any impediments for privately-owned companies to list on the exchange such as reluctance to dilute ownership and inability to comply with listing rules and disclosure requirements need be examined. In addition to any regulatory and economic incentives such as tax incentives, enhancing the capacity and attractiveness of the stock exchange as the most desired avenue for capital raising for corporate growth is fundamental to a strategy to bring more private companies to the stock market.

b) Listing state-owned enterprises:
   The 2006 SEC Capital Market Master Plan anticipated listing large state-owned enterprises as a key strategy to increase the market size. The Government owns or has significant ownership interests in some of the most important economic entities in the country including banking, insurance, savings, home mortgages, energy, aviation, pharmaceuticals, and plantations, among others. However, 10 years later, not a single new SOE has been listed on the CSE. This underscores the importance of developing capital market development plans within a broader national policy framework in order to get the high-level political and policy commitment to such initiatives.

c) Public enterprise reforms:

The 2015 Prime Minister's Economic Policy Statement as well as the 2016 Budget spelled out the Government's broader policy framework on SOE reforms. The proposals relating to SOEs include the following:

i. Rather than privatizing SOEs simply as a means to increase revenue, a more strategic approach will be followed where the SOEs will be strengthened and made independent.

ii. All SOEs will be brought under a government-owned State Holding Corporation and shares of these enterprises will be passed onto a Public Wealth Trust, where the Secretary to the Treasury and the Governor of the Central Bank will be the custodians. This Trust will be managed by a Board comprising of members from civil societies, trade chambers, and trade unions, who will be nominated by the Constitutional Council. The Public Wealth Trust is answerable to the Parliament. A new Public Enterprise Act will be enacted to provide the necessary legal framework to this effort.

iii. The boards of SOEs will be strengthened with the appointment of professionals. Key SOEs will be allowed to operate and be evaluated based on key performance indicators. Key SOEs will also be encouraged to adopt a rating mechanism which will also facilitate the entities to access the domestic and foreign capital markets through various instruments for their capital requirements.

iv. The Government will exit partially or fully from non-strategic investments in Lanka Hospitals, Hotel Developers PLC (Colombo Hilton), Hyatt Residencies, Waters Edge, Grand Oriental Hotel, Ceylinco Hospital, and Mobitel by listing such investments in the Colombo Stock Exchange during 2016. The monies generated through such listings will be used to retire high cost debt.

v. Restructure regional plantation companies into small manageable units so that they could seek listing in the Colombo Stock Exchange.

More recently in April 2016, the Minister of Finance indicated that the Government will privatize non-strategic SOEs as a means to cut public debt and list them on the CSE[2].

Listing of minority stakes of key commercial public-enterprises will help increase the market capitalization and promote a market-based framework for the management of these enterprises. The large commercial enterprises owned by the Government that have the potential to increase market size significantly include the Bank of Ceylon, People's Bank, National Savings Bank, State Mortgage and Investment Bank, Sri Lanka Insurance Corporation, Sri Lankan Airlines, and Ceylon Petroleum Corporation, among others.

While listing of large SEOs is one of the best methods for market growth, this needs to be carried out in a gradual process within a framework for public enterprise reforms. Some of the SOEs are making losses and some have large amounts of debt on their books. Therefore, public enterprises will need to be restructured and reformed to make them financially strong before they can become viable candidates for listing on the stock market. Therefore, public enterprise reforms are an essential first step to lay the foundation for possible listing of viable enterprises on the stock exchange. It is also important to establish a national policy framework on public enterprises that is linked to the capital market development policy. This requires identification of SOEs that can be potentially rehabilitated, restructured and listed, an economically sound and politically feasible public enterprise reforms strategy, and a realistic timeline to make them professionally managed and financially sound.

d) Infrastructure Development Corporations:

Another strategy to be considered is the establishment of a market-based infrastructure development model. Equity and bond markets can be effectively leveraged to raise much needed capital expenditures for infrastructure development projects such as toll roads, railways, ports, and regional airports. Some of the policy proposals outlined in the 2015 Economic Policy Statement stated that the Government will create a special purpose vehicle for the

[2] Govt looking at privatizing non-strategic investments to cut debt, Daily Mirror, 03/15/2016. http://www.dailymirror.lk/106881/Govt-looking-at-privatising-non-strategic-investments-to-cut-debt

purposes of attending to infrastructure development initiatives and take meaningful steps to incorporate private sector style efficiency measures that will ensure that the state entrepreneurial ventures are run efficiently and to encourage local and global investors to participate. Some of the key proposals in the 2016 Budget in regard to infrastructure development include the following:

i. Establishing a Special Purpose Vehicle (SPV) for the Southern Expressway and the Katunayake Expressway where private investors will be invited to invest into the SPV for which the Government will guarantee a minimum return. The funds generated from the investments in the SPV will be utilized to pay debt.
ii. Establishing a SPV for the Norochcholai coal-fired power plant to be securitized. The ownership structure of power plant will not change but the Ceylon Electricity Board's liquidity position will improve and thus enable its expansion activities.
iii. The Ceylon Petroleum Corporation will collaborate with investors to form a company that will manage the oil tank farm in Trincomalee which is presently under-utilized. This facility will be operated as a bonding warehouse.
iv. Improving the domestic air transportation by establishing three new domestic airports at Digana, Badulla, and Puttlam through a PPP arrangement.

e) BOI Board:

Another strategic goal of the CSE for 2016 is to set up of a BOI Board for listing companies established under the Board of Investment (BOI) of Sri Lanka Act. The BOI is charged with facilitating the setting up of companies with foreign investments in various industries in export processing zones and industrial parks or outside of such zones. The concerns stated in respect of the proposed SME Board are equally applicable to a potential BOI Board as well. It is important to carry out a detailed feasibility study on setting up of a BOI Board.

While the addition of SMEs and BOI companies will increase the market size, it is important to assess the economic and practical feasibility of such initiatives. The size, profitability, financial stability, growth prospects, and free-float available for trading are some of the key features that will decide their attractiveness to investors at the IPO stage and in secondary market trading.

f) Dollar Board:

Under its strategic goals for 2016, the CSE is also considering a proposal to establish a dollar board for listing of foreign and domestic companies which would be permitted to issue dollar-denominated securities. The 2016 Budget also stated the need to encourage foreign companies to list in the CSE. There has been some progress on this initiative. The CSE is exploring the feasibility for Maldivian companies to raise U.S. dollar-denominated equity which will be initially open for subscription to foreign investors only. The CBSL has approved this proposal and the CSE planned to conduct a road show in March 2016. The economic rationale, practical feasibility, willingness on the part of borrowing firms to raise capital on the CSE by issuing foreign-currency denominated bonds, readiness of CSE in terms of regulatory, trading, clearing and settlement infrastructure, and the issues relating to secondary market trading and liquidity need to be carefully evaluated.

3.3.2 Increasing Market Liquidity

a) Higher free-float:

The CSE has taken several initiatives to increase market liquidity. In 2014, rules on minimum public float as a continuous listing requirement were implemented in order to increase market liquidity.[3] These new rules require any entity listed on the Main Board to have a minimum public holding of 20% of its ordinary voting shares in the hands of a minimum of 750 public shareholders or a market capitalization of Rs. 5 billion in the hands of a minimum 500 public shareholders while maintaining a minimum public holding of 10% of its ordinary voting shares. Further, any entity listed on the Diri Savi Board is

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[3] The Rule 7.13 of the Continuing Listing Requirements of CSE Listing Rules.

required to maintain a minimum public holding of 10% of its ordinary voting shares in the hands of a minimum of 200 public shareholders. The rules also suggest the methods to be followed by companies that fall below the threshold. They include issuance of new shares to the public through a prospectus, offer for sale of shares held by the non-public shareholders to public through a prospectus or any other lawful modality determined by the listed entity. The rules provide for transitional provisions, appeal to the SEC and requesting waivers from the SEC as well as the possibility for companies to obtain two extensions for a total period excessing 12 months to fully comply with the rules. However, when a company fails to comply after all the extensions, then the company will be transferred to the Default Board of the CSE and then may be liable to one or more of the sanctions that include publication of a notice of malfeasance, suspension of trading and mandatory delisting. All listed companies are expected to be fully compliant with these public float rules by 31st December 2016.

However, the CSE has faced obstacles to the enforcement of these free-float rules. Minority shareholders of certain listed companies have reportedly challenged the rules and apparently threatened to delist their companies from the CSE. An option for companies not meeting the 20% free-float rule is to be transferred to the second board called the "Diri Savi Board." However, companies do not like this option because of the fear that it will damage their reputation as a listed company from being delegated to a less reputable second board. As such, the implementation of the free-float rule has been slow and will continue to be a challenging issue.

Increasing public float is an important step to enhance liquidity of listed shares. It helps more trading and in turn better price discovery which is one of the important functions of stock market. The assurance that prices are efficient in reflecting publicly available information is critically important to attract more investors to participate in the market. Therefore, implementation of minimum public float rules must be considered a necessary step for creating a liquid and more transparent stock market. Moreover, the public float requirements will need to be increased beyond 20% over time.

b) Market making Mechanism:

The Sri Lankan stock market needs to establish a market making mechanism to ensure a continuously liquid market for listed stocks. This is one of the necessary conditions to create a liquid market since market makers will mandatorily act as liquidity providers by being ready to be a counterparty to trades. Having an acceptable level of public float will be an important pre-condition to establish a feasible market making system. At the start, it might not be possible to require market making in all listed stocks due to persistent illiquidity. But a market making system needs be set up at least for a segment of the market that satisfies a minimum public float and trading activity thresholds. Market making can be expanded to cover more stocks as the market develops in size and liquidity over time. Sri Lanka needs to study the best practices and experiences in establishing market making mechanisms in other developed as well as similar emerging markets and develop a plan for introducing market making without delay.[4]

c) Lower Transaction Costs:

The CSE needs consider reforming the transaction cost structure with the objective of lowering them to an appropriate level. [5]Transaction cost reforms should also consider merits of moving to a more market-based, negotiable brokerage with appropriate conditions for balancing the objectives of ensuring industry competitiveness, profitability and revenue to the SEC and the CSE. Negotiable brokerage will make the industry more competitive and also eliminate the current alleged practice of brokers giving illegal commission rebates to selected clients creating an unfair playing field. The improved operating efficiencies from demutualization coupled with brokerage industry reforms will help Sri Lanka to lower transactions costs and become a more competitive securities market.

[4]Other options to enhance liquidity include reducing the bid-ask spread through changes in the tick size and introduction of individual stock and equity index derivatives that will have the effect of increasing trading of underlying securities.
[5]The 2016 Budget removed 0.3% share transaction levy to encourage trading activity in the share market effective January 01, 2016. Further, the Budget also removed the stamp duty on share certificates.

3.3.3 Brokerage Industry Reforms

a) Brokerage Industry consolidation:
Sri Lanka should design and implement a brokerage industry consolidation plan. The 2016 Budget has recognized the importance of brokerage industry consolidation. It states that the volatility of the stock market has resulted in many stock brokers facing significant issues and that sustainability of stock brokers is important to long term capital market development. The Budget encourages stock brokers to merge in order to strengthen their capacities and capabilities. The planned introduction of minimum capital requirements for brokers and the stock exchange demutualization will provide an opportunity to provide the necessary regulatory framework for industry consolidation. The goal should be to have an optimal number of brokers to create a financially strong and competitive intermediation industry.

b) Universal Brokerage:
Sri Lanka will benefit greatly from adopting a universal brokerage model where market intermediaries deal in all capital market products such as equity, corporate and government debt securities, unit trusts, derivatives etc. For a smaller market such as Sri Lanka, having specialized brokers for different capital market products might not be economically viable. The expected consolidation might pave way for universal brokerage. In addition to increasing investor access and penetration, universal brokerage will help diversify revenue sources of the industry making it more resilient to different market conditions. Currently, there is no plan to introduce such a model.

The main barrier to a universal brokerage model is that the regulatory powers for different capital market segments are segregated. The SEC has the regulatory authority on listed equity, corporate debt and unit trusts whereas the CBSL has the regulatory authority on government securities markets. A single regulator model or rationalization of securities regulation are important to provide a robust regulatory framework for universal brokerage. However, within the existing framework, the SEC should be able to establish a universal brokerage model for equity, listed debt securities and unit trusts.

c) Minimum capital requirements:
Sri Lanka needs to introduce minimum capital requirements for market intermediaries in the CSE. The CSE and the SEC are working on a risk-based capital adequacy model.

d) Enhancing technical capacity of brokers:
The SEC needs to revise, upgrade and expand the existing financial industry qualification framework to include multiple capital market instruments. In order for brokers to deal in multiple products such as stocks, bonds, unit trusts and derivatives, they need be technically competent. Presently, many brokering firms are equipped to deal with stock trading only and lack adequate technical skills necessary to trade and provide investor advice on other instruments. Enhancing technical knowledge and skills calls for a robust financial industry training and licensing system. Ultimately, a better trained and educated industry professionals will prepare them for universal brokerage.

4. The Government Securities Markets

4.1 Overview of the Government Securities Markets

As per the Monetary Law Act No. 58 of 1949, the Public Debt Department (PDD) of the CBSL is in charge of the issuance of government securities and public debt management on behalf of the Government Treasury. Government securities in Sri Lanka include Rupee-denominated securities and foreign currency denominated securities. The main types of rupee-denominated securities include Treasury bills and Treasury bonds whereas foreign currency denominated securities include Sri Lanka Development Bonds, which are Treasury bonds denominated in foreign currency, and Sri Lanka sovereign bonds.

Treasury bills are zero-coupon short-term securities with three, six and twelve-month maturities. Treasury bonds have been issued with 2, 3, 4, 5, 6, 8, 10, 15, 20, and 30-year maturities and carry a fixed rate of interest. Sri Lanka Development Bonds have been issued with short-term maturities such as three, five, and twelve months and with longer term maturities of two years with both fixed and floating interest rates. Treasury

Bills are issued weekly while Treasury bond auctions are held depending on the Government's cash flow needs.

4.1.1 Primary market:

Government securities are sold by the PDD through multiple-price competitive auctions. The participants to the primary auction are approved primary dealers, and currently there are 15 primary dealers consisting of 8 bank primary dealers and 7 non-bank primary dealers. Each primary dealer is required to bid for at least 10% of the value of securities offered at the primary auction. Sri Lanka has relied primarily on short-term funds for financing the Government's cash flow requirements (Table 6). Over the past 10 years, except for 2015, the percentage of funds obtained through the issuance of Treasury bills has ranged from 81% to 95% with an average of 91% of the total amount of bills and bonds. This trend changed significantly in 2015 when the Government obtained Rs. 710 billion through Treasury bonds representing 41% of total issuances. The issuances in 2015, both bills and bonds, were the largest in the past 10 years totaling Rs. 1.7 trillion.

Table 6: Primary Market Issues of Government Securities (2006-2015)

Year	Treasury Bills (Rs. Mn.)	Treasury Bonds (Rs. Mn.)	Total (Rs. Mn.)	% Bills	% Bonds
2006	398,233	42,848	441,081	90	10
2007	388,458	18,513	406,971	95	5
2008	252,596	32,808	285,404	89	11
2009	416,157	52,231	468,388	89	11
2010	520,146	46,098	566,244	92	8
2011	489,073	26,107	515,180	95	5
2012	728,341	59,326	787,667	92	8
2013	842,527	201,199	1,043,726	81	19
2014	759,240	27,750	786,990	96	4
2015	1,027,979	709,832	1,737,811	59	41

Source: Central Bank of Sri Lanka

4.1.2 Sovereign bonds:

Since 2007, Sri Lanka has made eight international sovereign bond issues with maturity periods of 5 and 10 years for a total of USD 7,650 million (Table 7). Six of these issues amounting to USD 6,550 million are still outstanding. The Sri Lankan Government also has announced its intention to make another sovereign bond issue for USD 3 billion in 2016 denominated in U.S. dollars and Chinese Renminbi. Sri Lanka's credit is rated B+ by both S&P and Fitch. [6] Fitch downgraded Sri Lanka's credit rating from BB- (speculative) to B+ (highly speculative) in February 2016.

Table 7: Sovereign Bond Issues by Sri Lanka

Issue No.	Issue Date	Amount (USD Mn.)	Maturity (yrs)	Maturity Date	Issue Yield %
1	10/18/2007	500	5	2012	8.250
2	10/1/2009	500	5.25	2015	7.400
3	9/27/2010	1,000	10	10/4/2020	6.250
4	7/27/2011	1,000	10	7/27/2021	6.250
5	7/25/2012	1,000	10	7/25/2022	5.875
6	1/6/2014	1,000	5	1/14/2019	6.000
7	4/11/2014	500	5	4/11/2019	5.125
8	5/28/2015	650	10	6/3/2025	6.125
9	10/27/2015	1,500	10	11/3/2025	6.850
Total		7,650			

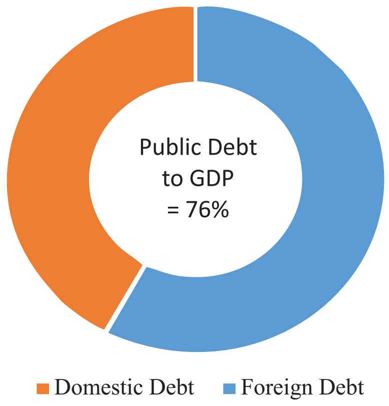
Source: Central Bank of Sri Lanka

4.1.3 Debt profile:

As at the end of 2015, the total public debt outstanding stood at Rs. 8.5 trillion with 58% domestic debt and 42% foreign debt (Table 8). The largest component of domestic debt is Treasury bonds constituting 39% of the total debt. Commercial foreign borrowings are 15% of the total debt, and the largest component of that is sovereign bonds. The total public debt represents 76% of the GDP with domestic and foreign debt amounting to 44% and 32% of the GDP respectively (Figure 4).

[6] India is rated BBB-/BBB-, Bangladesh BB-/BB-, Pakistan B-/B by S&P and Fitch respectively.

Figure 4: Public Debt as a Percentage of GDP in 2015



Source: Central Bank of Sri Lanka Annual Reports

Table 8: Debt Profile of Sri Lanka in 2015

Type of Debt	Amount (Rs. Bn.)	% of Total Debt
Domestic Debt	**4,959**	**58.3**
Treasury Bills	658	7.7
Treasury Bonds	3,305	38.9
Rupee Loans	24	0.3
Sri Lanka Development Bonds	668	7.9
Central Bank Advances	151	1.8
Other	152	1.8
Foreign Debt	**3,544**	**41.7**
Concessional	1,730	20.3
Non -concessional	507	6.0
Commercial Borrowings	1,307	15.4
International Sovereign Bonds	958	11.3
Non -resident Investments in Treasury Bills	5	0.1
Non -resident Investments in Treasury Bonds	299	3.5
Other	45	0.5
Total Outstanding Debt	**8,503**	**100.0**

Source: Central Bank of Sri Lanka Annual Report 2015

4.1.4 Ownership of government securities

Treasury bills are predominantly held by the banking sector (Table 9). The banking sector owns 67% of bills with the largest owner being commercial banks. The ownership of the non-bank sector is 32% with savings institutions and insurance companies holding 10% and 7% respectively. The private ownership is 14% of the total. Foreign investors own about 1% of bills. In contrast, a majority of Treasury bonds (77%) is held by the non-bank sector with the EPF being the largest holder with 45% of bonds. Foreign investor ownership of bonds is about 8%. [7]According to LankaSecure, there were 86,944 investors in government securities during 2014.

Table 9: Ownership of Government Securities in 2015

Owner	Treasury Bills		Treasury Bonds	
	Rs. Mn.	%	Rs. Mn.	%
1. Bank Sector	**445,418**	**67.2**	**517,613**	**14.4**
1.1 Central Bank	104,754	15.8		
1.2 Commercial Banks	340,664	51.4	517,613	14.4
2. Non -Bank Sector	**212,822**	**32.1**	**2,787,635**	**77.3**
2.1 Employees' Provident Funds	-	-	1,612,461	44.7
2.2 Other Provident Funds	162	0.0	42,713	1.2
2.3 Savings Institutions	67,766	10.2	358,470	9.9
2.4 Insurance and Finance Companies	47,375	7.1	58,808	1.6
2.5 Departmental and Other Official Funds	7,570	1.1	245,045	6.8
2.6 Private and Other	89,949	13.6	470,138	13.0
3. Foreign Investors	**5,045**	**0.8**	**298,734**	**8.3**
Total	663,285	**100.0**	3,603,982	**100.0**

Source: Central Bank of Sri Lanka Annual Report 2015

4.1.5 OTC secondary market:

The secondary market for government securities is an over-the-counter market operated through primary dealers who provide bid and ask quotes over the trading system. The trading system used for secondary market trading is the Bloomberg trading platform. Sovereign bonds are listed on the Singapore and Berlin Stock Exchanges. In 2014, the total value of secondary market transactions in government securities recorded in the Lanka Secure amounted to Rs. 38.4 trillion with Treasury

[7] The foreign ownership limit for government securities is 12.5% of the outstanding amount. The 2016 Budget proposed to reduce the limit to 10%.

bills and bonds accounting for Rs. 15.1 trillion and 23.4 trillion respectively. Repo and reverse repo transactions accounted for 85% (Rs. 32.7 trillion) of secondary market transactions while outright transaction represented only 15% (Rs. 5.7 trillion) of the total.

4.1.6 Listed secondary market:

From 2004, the CSE began trading government securities. As the data in Table 10 shows, trading of government securities on the exchange has been low and continued to decline. There has not been any trading of government securities since July 2012. Investors in government securities dominated by institutions have been long accustomed to trading of government securities in the OTC dealer market which is much more active than the CSE in terms of volume of transactions and provides better price discovery. Therefore, there is no fundamental reason for investors to trade in a small and thinly traded CSE.

Table 10: Listed Government Bond Trading Statistics

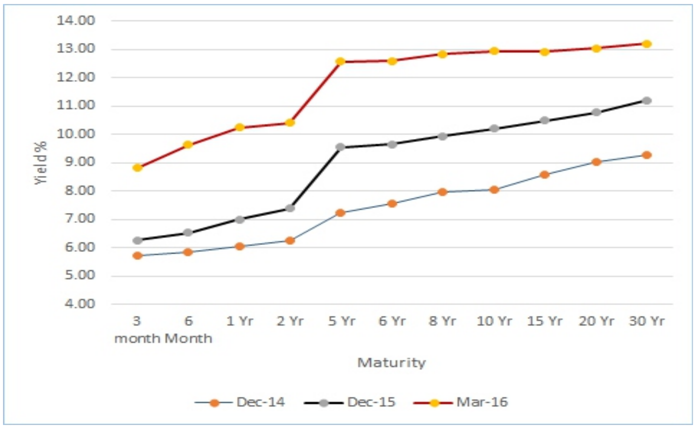
Year	Turnover (Rs. Mn.)	No of Trades	No of Bonds Traded (No. Mn.)
2004	1.987.9	1 ,343	553.5
2005	326.4	522	307.0
2006	207.1	379	213.2
2007	709.3	208	742.7
2008	195.2	69	208.2
2009	99.0	42	102.8
2010	45.7	18	46.8
2011	28.4	7	28.9
2012	6.1	2	6.7

Source: Colombo Stock Exchange

4.1.7 Treasury yield curve:

Outstanding government securities have maturities ranging from 3 months to 30 years. The secondary market average buying and selling yields on government securities reported by the primary dealers provide an indication of the behavior of market yields. It should be noted that the two-way quotes of primary dealers do not necessarily represent transaction yields since trades may not have occurred for some maturities. Figure 5 shows the government securities yield curve based on the average of the two-way quotes at the end of 2014, 2015 and March 2016. Yields have increased across all maturities and more so for medium to long-term bonds with 5 to 30 year maturities. The first three months of 2016 have seen about 300 basis-point rise in yields across the board reflecting monetary policy tightening by the CBSL to control the excessive growth in money supply and upward trend in underlying inflation.[8]

Figure 5: Sri Lanka Treasury Yield Curve



Source: Department of Public Debt, Central Bank of Sri Lanka

4.2 Concerns and Impediments

a) *Bond maturities are mostly concentrated in short to medium term bonds.* About 56% of the outstanding Treasury bonds have maturities of 8 years or less (Figure 6) and 40% of the issues are from just 5, 8- and 10-years maturities. The average time to maturity of the government bonds portfolio was 6.98 years the end of 2014. The rest of the bonds mature from 9 to 30 years and are fairly unevenly distributed across maturities. From all the bond series issued since 1997, 94% of them had maturities up to 10 years. Clearly, the number of long-term bond issues with maturities of more than 10 years has been few. This makes the amount of bonds available for secondary market trading at long-term maturities low, reducing liquidity and price discovery for such maturities.

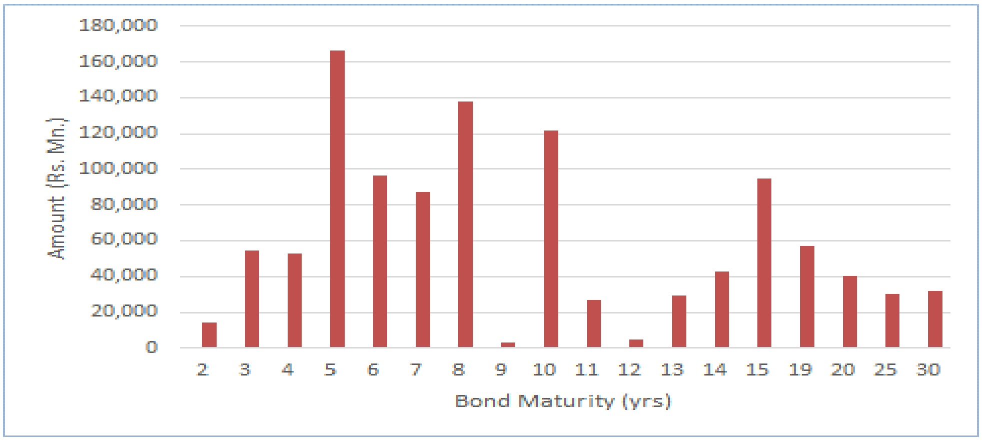
[8]The CBSL increased the statutory reserve ratio from 6.0% to 7.5% on January 16, 2016, and the standing deposit rate from 6% to 6.5% and standing lending rate from 7.5% to 8% on February 19, 2016.

b) *A larger portion of outstanding redemptions are concentrated within the next 8 years*. This bunching of debt is a direct result of issuing a majority of bonds in short to medium-maturities, mostly maturing in the next 8 years. About 58% of the outstanding bonds will need to be paid off by 2023, and there is a large concentration of redemptions in the 2018 to 2023 time period (Figure 7). This creates a large need for refinancing during this period of 6 years which potentially leads to refinancing risk when large amounts will have to be refinanced and a larger impact on interest rates at the time of refinancing.

c) *The secondary market trading in government bonds in the primary dealer market is fairly illiquid, particularly in longer maturity government bonds*. The major reason for lack of secondary market trading is that a vast majority of bonds are held by institutional investors such as provident funds, insurance funds and unit trust funds that tend to hold them to maturity. Most secondary market yields are just bid and ask quotes from primary dealers and do not represent actual transaction yields due to very infrequent secondary market transactions. As a result, the secondary market yields are not very reliable and do not provide a reliable risk-free yield curve across all maturities. This lack of a reliable Treasury yield curve hampers efficient and transparent pricing of both government and corporate bonds as well.

d) *There has been a lot of recent public discussion in Sri Lanka of private placement of government securities outside of the auction process, particularly prior to 2015.* For example, only 71% and 68% of the funding through bills was conducted through the primary auction in 2005 and 2006 respectively. As for bonds, however, only 23% and 15% was sold through the auction in 2005 and 2006. There is no publicly available data to verify the occurrence and severity of private placements in the past 10 years. If in fact it occurs, the concern is that private placements undermine the validity and efficiency of the price discovery process which is a prerequisite for developing benchmark interest rates. Some have expressed the view that privately placed bonds receive a better rate causing a divergence of yields between the primary and the secondary markets.

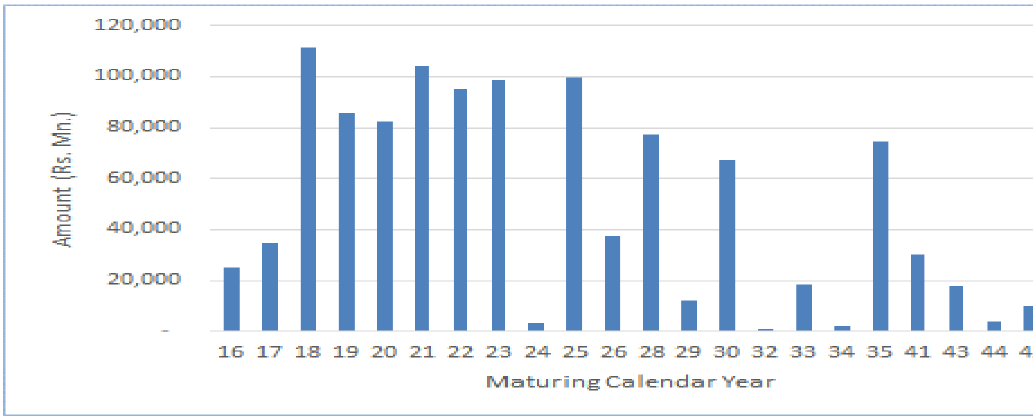
Figure 6: Outstanding Government Bonds by Original Maturity (a)



(a) Bonds outstanding for redemption from 2016 and beyond from issues up to Feb, 2016.

Source: Central Bank of Sri Lanka

Figure 7: Outstanding Government Bonds by Redemptions Year (a)



(a) Bonds outstanding for redemption from 2016 and beyond from issues up to Feb, 2016.

Source: Central Bank of Sri Lanka

e) *The lack of an auction calendar makes auctions and interest rates less predictable and undermines the credibility of auctions.* The Central Bank does not publish an auction schedule in advance. This makes it difficult for the market participants to predict the timing and amounts of the future Treasury auctions and increases the uncertainty of the level and direction of future interest rates.

f) *The practice of outright rejection of auction bids undermines the credibility of the primary market*. Since January 2015 to April 01, 2016, there have been 4 Treasury bill auctions and 30 Treasury bonds auctions in which none of the offers were accepted. In many cases, this resulted in significant jumps in the subsequent auction yields resulting in drastic changes in market interest rates and bond prices. In addition to creating higher interest rate and price volatility, outright rejection of offers leads to inefficient price discovery and undermines investor confidence in the auction mechanism.

g) *The lack of a competitive primary dealer system reduces liquidity, increases transaction costs, and seriously undermines the efficiency of the price discovery process.* Existing primary dealers, which include eight banks and seven dedicated dealer institutions, represent a much less diversified investor base. The requirement that all government institutions and agencies must invest their funds through the state banks has also reduced competition and created an uneven playing field among primary dealers. The bank-based primary dealers dominate the primary market, and the contribution of dedicated primary dealers to the primary auction is low.

4.3 Recommendations

a) *Developing a reliable benchmark yield curve across the entire term structure must be considered a top debt management strategy.* A viable benchmark yield curve is not only important for well-functioning government securities markets, but also forms the foundation for accurate market pricing of a range of financial instruments such as corporate bonds, debentures, repos, interest rate futures and swaps. Pension funds and insurance companies have a need for longer term instruments for asset and liability management. Issuance of more long-term securities will help improve liquidity at the long-end of the yield curve leading to more trading and reliable price discovery.

b) *Issuance of fairly evenly distributed maturity structure that spans both medium-term and long-term segments will benefit both the Government and the investors in the long-run.* For the Government, such a strategy will help reduce refinancing risk of the debt portfolio. The Treasury securities market is dominated by government-run superannuation funds, commercial banks, savings institutions and insurance and finance companies. Many of these institutions have a fundamental need for long-term bonds to manage their investments in long-term portfolios and reduce asset-liability maturity mismatches. Long-term government securities play a very important role in this regard. It is critically important that the debt issuance strategies aim at establishing a market for all key maturity segments. Maturing short to medium term government securities should be converted into long-term securities in order to increase the quantity of bonds at long maturities and to increase the average time to maturity of the government bonds portfolio beyond 6.98 years observed at the end of 2014.

c) *Emphasis must be placed on creating an even maturity profile by issuing relatively more of benchmark securities at key points along the yield curve.* In order to create a proper yield curve, the Government needs to identify the maturities that are considered key by the market and viable in the long-run. For example, benchmark bonds may be issued in 2, 5, 10, 15, 20, and 30-year maturities rather than spreading out at too many maturities as it is the case now. The Government could establish a maturity target for the entire debt stock as a guide for structuring instruments across the yield curve.

d) *The Central Bank needs to publish a Treasury auction calendar in advance in order to provide credibility and predictability to auctions.* This will also make government borrowing more predictable. It is important to publish an annual auction calendar indicating, at the minimum, aggregate monthly data on the types of securities and the volume of funding that the Government plans to obtain through Treasury auctions, and a more detailed quarterly schedule of forthcoming auctions containing security type, term to maturity, coupon rate, volume, announcement date, auction date and settlement date. If the absence of the auction calendar is due to lack of predictability of the details of the Government's future funding needs, then it is critically important that the Treasury prepare a detailed annual funding plan to facilitate the development of an auction calendar.

e) *A market-based government funding strategy is critical to the development of the debt securities market.* Practices such as private placements, partial filling of offered amounts, outright cancellation or rejection of announced auctions etc. must be limited to exceptional circumstances. In order to preserve the credibility of the auction process, it is necessary to fill the entire amount offered to the auction except in the event of an under-subscription and unusual market conditions. If carried out consistently over time, except under unusual market conditions, such practices have perverse effects on the development of an efficient and transparent market for government securities. Determination of primary market yields on a competitive and market basis is important to create yields that fairly and accurately reflect fundamental market and economic conditions.

f) *Enhancing the competition in the primary market by creating a more diversified pool of investors in government securities is important.* One possible option for enhancing the competition in the primary market is to allow large investors such as provident funds, insurance companies, savings institutions, and mutual funds (unit trusts) directly participate in the primary auction rather than through primary dealers. Higher demand from sources outside of the banks will also provide stability to the auction market. The Government needs to study the effectiveness of the existing primary dealer structure with the aim of increasing the competition, creating stable demand, and deepening the market for government securities through a diversified investor base. Policies are also required to remove restrictions for government agencies to invest only through state banks to create a level playing field for primary dealers.

g) *A more transparent and efficient trading platform for government securities must be established*. Whether this involves enhancing the infrastructure of the existing broker-dealer OTC market for government securities with new technologies or setting up of an electronic exchange-based trading system, such as the ATS of the stock exchange, needs to be carefully evaluated. Given the small size of the debt market in Sri Lanka and the need for improving liquidity, consideration must be also given to the importance of developing a single, transparent secondary market trading system for both government and corporate debt securities.

h) *Reforming the exiting market making mechanism for government securities is important to enhance transparency, efficiency, price discovery, and investor confidence in the market.* The process of market making is highly opaque and potentially leads to collusion and other anti-competitive practices as well. The present system of market making by primary dealers is not a mandatory market maker system. Rather, they are required to provide two-way quotes. Lack of a robust market making system undermines the reliability of yield and prices as reflecting true economic conditions and competition and diminishes investor confidence as to transaction prices and yields. Therefore, along with a new trading platform, serious consideration should be given to revamping the market making mechanism and making market making mandatory.

i) *The government securities market needs a central counter party mechanism with a bond clearing house.* Although the original plan was to develop one CCP for Sri Lanka in conjunction with the CSE and the SEC, the CBSL has recently announced its intention to establish a CCP system separate from the one that is being currently developed for the CSE. However, it is important consider significant cost and other advantages associated with having one single CCP for Sri Lanka.

5. The Corporate Bond Market

5.1 Overview of the Corporate Bond Market

The primary market for listed corporate debt has been very active since 2013. In order to encourage corporate debt listing, the CSE enacted new listing rules for corporate debt in 2013. The Government provided tax incentives for investing in listed debt securities in the 2013 budget by exempting interest income received from listed debt from income and withholding taxes with effect from January 01, 2013 which had led to a resurgence of primary market for corporate debt. [9] In 2013, 28 debt issues raised

[9] The 2016 Budget Speech recognized that the corporate debt securities market in Sri Lanka has been active in raising almost Rs. 50 billion in 2014 which is a fourfold increase over 2012. In order to facilitate the expansion of the corporate debt securities market, the Budget proposed to waive the income tax and withholding tax applicable to those activities into 2016.

Rs. 68 billion representing 72% of all the capital raised through the CSE through equity, rights and debt issues (Table 11 & Figure 8). Companies raised Rs. 54 billion in 2014 and Rs. 83 billion in 2015 through debt issues. The 2015 debt issues represented 85% of the total capital raised through the CSE. 2016 Budget has extended these tax incentives through 2016. The CSE also changed the maximum tick size to Rs. 10,000 in 2013 to improve liquidity.

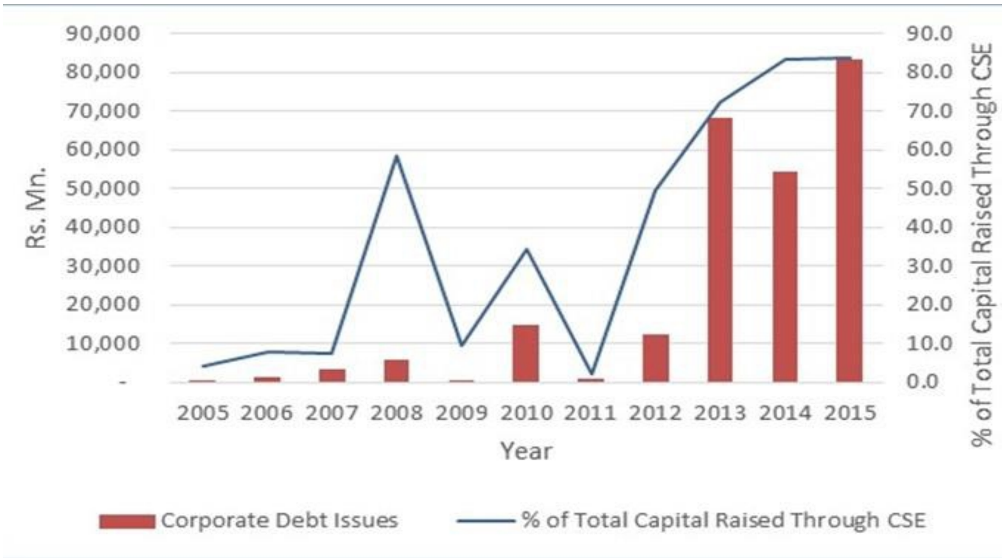
The listed corporate debt market in Sri Lanka commenced in 1997. Since then, the turnover in the corporate debt market has increased from Rs. 57 million to Rs. 4,714 million in 2015 (Table 14). However, the corporate debt market turnover is only about 19% of the stock market turnover of Rs. 253 billion in 2015. The market capitalization of the listed corporate debt market was Rs. 239 billion in 2015. Relative to the stock market size of Rs. 2,938 billion in the same year, the corporate debt market was about 8% of the size of the stock market indicating that the corporate bond market in Sri Lanka is significantly smaller compared with the stock market. This is primarily due to the preference for bank-based financing by companies for their borrowing needs.

Table 11: Primary Market Activity of the Corporate Debt

Year	No. of Corporate Debt IPOs	Amount of Corporate Debt IPOs (Rs. Mn.)	Corporate Debt IPOs as a% of Total Capital Raised via CSE
2005	2	350	4.4
2006	1	1,257	8.1
2007	3	3,571	7.3
2008	4	5,866	58.3
2009	1	631	9.7
2010	1	15,000	34.3
2011	1	1,000	2.1
2012	3	12,500	49.3
2013	28	68,262	72.4
2014	20	54,235	83.4
2015	25	83,414	83.5

Source: Colombo Stock Exchange

Figure 8: Corporate Debt Issues at the CSE



Source: Colombo Stock Exchange

The secondary market trading activity has shown significant growth since 2013 (Table 12). The market cap of listed debt stood at Rs. 239 billion in 2015.[10]

Stock brokering firms are expected to deal in both equity and listed debt securities. There are 28 members and trading members of the CSE who act as brokers to both equity and listed debt. Additionally, in order to attract specialist intermediaries to deal in corporate debt securities, the CSE began admitting primary dealers as debt trading members since 2013. So far, 8 of the 15 primary dealers have become debt trading members who deal in debt securities only.

[10] Calculated based on year-end closing prices.

Table 12: Corporate Debt Trading Statistics

Year	Turnover (Rs. Mn.)	No. of Trades	No of Debentures Traded (No. Mn.)	Market Cap (Rs. Mn.)
1997	57	203	0.6	329
2000	425	1,701	25.1	5,803
2005	207	625	2.2	24,600
2010	72	92	0.7	30,100
2011	2,691	62	25.9	37,859
2012	76	39	0.7	46,311
2013	2,229	173	20.0	165,700
2014	7,140	401	56.9	230,300
2015	4,714	220	42.2	238,735

Source: Colombo Stock Exchange

5.2 Concerns and Impediments

a) *The supply of corporate debt securities is primarily concentrated in the bank, finance and insurance sector.* Banks issue corporate bonds primarily because they help meet tier II capital. There are only a few debenture issues in beverage, food and tobacco, construction and engineering, diversified holdings, health care, investment trusts, plantations, and trading sectors. The concentration of corporate debt limits diversification opportunities for investors across different industries with different sensitivities to the overall business cycle.

b) *The secondary market for listed corporate debt is highly inactive and illiquid*. The ability to sell an asset quickly without affecting its price is an important characteristic of a good market. The number of trades as well as number of debentures traded have been very low (Table 12). Trading activity reached the lowest level in 2012 when the turnover was just Rs. 76 million and the number of trades was 39. Although trading activity picked up since 2013 relative to the period preceding, the absolute level of trading is very low. According to debt market specialists, this low level of trading in corporate debt reflects the preference for Sri Lankan investors in corporate bonds to buy and hold them to maturity rather than selling them prior to maturity. A vast majority of investors in corporate bonds are institutional investors such as unit trusts, banks, pension funds and insurance funds, and given the smaller size of the listed corporate debt market and the large sizes of the these institutional investors, their holding of corporate debt is very small in absolute values as well as relative to their portfolios. Therefore, there is no fundamental portfolio rebalancing or cash flow need for institutional investors to trade their corporate debt holdings. On the other hand, potential investors become hesitant to invest due to lack of liquidity which in turn could reduce the primary market demand for corporate debt limiting the ability for companies to raise funds through debt issuances. Lack of liquidity does not allow investors to engage in dynamic portfolio strategies either.

c) *There is no market making mechanism for corporate bonds*. This is the case for equities as well. The role of a market maker is to stand ready to buy or sell an asset at any time irrespective of whether there is a counterparty to a transaction. Market makers essentially act as liquidity provides. Stock brokers and debt trading members in Sri Lanka are only obligated to act as intermediaries to transactions between buyers and sellers. They are allowed to trade on their own portfolios. However, the CSE does not have a formal market maker mechanism to ensure a continuous and liquid secondary market.

d) *Participation of stock brokers and debt trading members in secondary market trading is low.* As a strategy to expand secondary market trading in corporate bonds on the CSE, primary dealers were allowed to trade in listed debt securities from 2013. Although the turnover has increased since then, trading activity remains low suggesting low level of participation of debt securities dealers in the listed corporate bond market.

e) *Transactions costs on large trades are high*. The transaction costs for corporate debt consist of the brokerage commission and fees (SEC, CSE and CDS fees). Currently, the brokerage commission is negotiable and fees are 2 basis points. Although the brokerage is negotiable, even a smaller brokerage commission can result in a large amount of brokerage fees for large trades.

f) *Secondary market pricing of corporate debt is hampered by the lack of an efficient Treasury yield curve.* One of the biggest challenges to the development of a vibrant corporate bond market is the lack of an efficient secondary market for government bonds. The listed government bond market is completely inactive and secondary market trading in government bonds in the primary dealer market is low, particularly in longer maturity government bonds. Most secondary market yields are just bid and ask quotes from primary dealers and do not represent actual transaction yields due to very infrequent secondary market transactions. As a result, the secondary market yields are not very reliable and do not provide a reliable risk-free yield curve across all maturities. This lack of a reliable Treasury yield curve hampers efficient and transparent pricing of corporate bonds and significantly diminishes the value of the listed corporate debt market as an efficient price discovery mechanism.

g) *Unlisted corporate debt including bonds, debentures, commercial paper and promissory notes is unregulated.* Given the growing importance of these unlisted instruments in the market, if left unregulated, this segment of the market could lead to unscrupulous financing and investment practices leaving the investors unprotected. Lack of regulations could also result in building up of systemic risk in the financial system.

5.3 Recommendations

a) *Increasing the size of the listed corporate bond market is important in order to deepen the market and expand diversification opportunities for investors.* This requires continuation of a more active primary market for capital raising through debt IPOs. It is important to encourage companies, particularly from sectors outside the banking and finance industry, to use the corporate debt market as opposed to bank-based borrowings to raise their debt capital.

b) *In the long-run, conditions must be established such that debt financing through the capital market becomes more beneficial to companies than bank-based financing*. The upsurge in primary market activity in the recent years has been primarily induced by favorable tax treatment of corporate bonds. Although tax advantages have been extended through 2016, they may end at some point in time. In the long-run, the market growth will critically depend on the ability of companies to raise funds at more competitive terms through the capital market compared with bank-based borrowings. In this context, it is important to review existing listing rules and economic and other advantages and disadvantages for companies to raise funds through debt issues through the CSE to assess and create conditions necessary to make raising debt through the CSE more beneficial to companies.

c) *Policies and reforms to increase the institutional investor participation in the listed corporate debt market are important in order to create a strong investor base for corporate debt.* Typical investors in corporate bonds are institutional portfolios such as pension funds, savings institutions, insurance companies, and mutual funds due to their large size and long-term investment horizon. However, the institutional investor sector in Sri Lanka such as the Employees' Provident Fund (EPF), the Employees' Trust Fund (ETF), and unit trusts have invested only modest portions of their funds in corporate bonds reflecting the constraints such as small size, illiquidity, and inefficient price discovery, among others.

d) *Introducing a formal market making mechanism will greatly help increase trading and market liquidity*. Since lack of market makers is a weakness in the entire exchange-traded market, introducing market making must be considered a critical systemic change in the current brokerage system that spans all listed instruments and implemented in a holistic regulatory framework rather than through piecemeal changes affecting only some sectors of the listed capital market.

e) *A central counterparty clearing and settlement system is an essential component to mitigate settlement risks and promote investor confidence in the capital market.* The initiatives underway in this regard include the establishment of a Central Clearing Corporation with a central counter party and moving to the DVP settlement system for all debt securities. Therefore, the expeditious completion of the CCP project should be considered a priority.

f) *Introducing repurchase agreements (repos) on corporate debt securities will lead to more trading of corporate bonds and enhance market liquidity*. Currently, unlike government securities, there is no repo market for corporate debt. Repos on corporate bonds will help generate demand for underlying corporate bonds since the intermediaries such as primary dealers as well as investors will need underlying bonds to execute repo agreements. Brokers and dealers point out this being very important to creating a more active market for listed corporate debt. In fact, the CSE has already identified the importance of introducing repos on corporate debt. Exchange traded repos will require the central counterparty system for managing credit risk. Therefore, the introduction of the CCP will enable the CSE to introduce trading of repos on the stock exchange where bid and ask prices and volumes of repos will be observable on the automated trading system.

g) *Lowering transactions costs for debt securities is also important*. The CSE is considering specifying a brokerage fee cap of Rs. 10,000 per trade in order to lower high transaction costs associated with large volume traded.

h) *Unlisted corporate debt market needs to be regulated.* This is important to provide adequate information and protection to investors and to mitigate against any systemic risk emanating from build-up of unlisted debt.

i) *Introducing bond derivatives will also contribute to the development of the market.* The lack of a formal and developed derivatives market in bonds further constraints active trading of corporate bonds. Bond derivatives provide important instruments for hedging interest-rate risk and are an important part of risk management tools. Therefore, in addition to strategies for creating a sizable and active corporate bond market, Sri Lanka also needs a comprehensive road map and a framework for developing an organized corporate bond derivatives market.

j) *Technical capacity of stock brokers on debt instruments and trading needs to be enhanced.* The SEC needs to revise, upgrade and expand the existing financial industry qualification framework to include a fully-fledged training and certification requirement for dealing in debt securities.

6. The Unit Trust Industry

6.1 Overview of the Unit Trust Industry

The unit trust industry in Sri Lanka dates back 25 years. It began with the formation of the National Asset Management Limited (NAMAL) in 1991. Unit trusts are regulated under the Unit Trust Code of 2011 which was enacted under the SEC Act of 1987. [11] As of the end of 2015, there were 14-unit trust management companies (UTMCs) operating 72 unit trusts. The total size of the unit trust industry, as measured by the value of net assets under management, was Rs. 129 billion in 2015. Over the 10-year period from 2005 to 2015, the industry's net assets have recorded an average annual growth of about 46%. However, the growth has been highly variable over the years, and largely influenced by a few years of very high growth, particularly in 2009, 2010, 2013 and 2014. The number of total unit holders was 37,526 at the end of 2015. Although there has been encouraging growth in the past two years, on average, unitholders grew only at about 5% per year over the past 10 years (Table 13).

There are two closed-end funds (CEFs) in Sri Lanka. In 2009, the National Asset Management Limited launched Namal Acuity Value Fund, which is a closed-end term trust with a defined maturity of 10-years. The investment objective of the fund is to achieve long-term capital appreciation by adopting a dynamic asset allocation strategy for investment in listed equities as well as listed and unlisted fixed income securities. The second CEF, the Candor Opportunities Fund, was launched in 2015 by Candor Asset Management (Pvt) Ltd. It is also a term trust with a 5-year maturity. The

[11] The Unit Trust Code of 2011, The Gazette of the Democratic Socialist Republic of Sri Lanka, No. 1723/4, September 12, 2011.

target asset allocation of the fund is 97% equity and 3% fixed income, cash and cash equivalents. The Namal Acuity Fund is listed on the CSE.

The unit trusts operating in Sri Lanka can be classified into five broader categories in terms of their asset allocation and investment objectives. They are money market, gilt-edged, income, growth, and balanced funds (Table 14). The largest fund type by far is represented by money market funds which invest in short-term fixed income securities such as Treasury bills, bank deposits, commercial paper, asset backed securities and repurchase agreements. They represent 56% of the industry net assets and 28% of the number of unit trusts. The second largest category constituting 19% of the industry is income funds whose primary objective is to maximize interest and dividend income by investing in fixed income securities, bank deposits, repurchase agreements and equities. Gilt-edged funds which invest only in government securities such as Treasury bills, Treasury bonds and repurchase agreements on government securities, have an asset allocation of 12%. Gilt-edged, money market, and income funds combined, all of which are on the lower end of the risk spectrum, has an 87% share of the industry in terms of net assets. The balanced funds which have both the income and growth orientation and invest in both fixed income securities and equities constitute only a 7% share of the industry. Growth funds whose primary objective is capital appreciation with a larger asset allocation to equities account for only 6% of the net assets although there are 24 such funds, representing the second most number of funds behind the 28 money market funds.

The distribution of the unit holders across fund types, however, gives a different picture of investor preferences (Table 14). Although balanced funds rank the fourth in terms of net assets, they have attracted the largest number of investors accounting for 63% of the unit holders. This suggests that a vast majority of unit holders have small investments in unit trusts and prefer a more balanced investment approach. Interestingly, the second largest group of subscribers represents investors in growth-oriented funds. Similar to balanced funds, however, the total net assets in growth funds rank the lowest in the industry indicating that a large number of investors have made smaller investments in funds that primarily invest in the stock market. Although money market funds have the largest net assets under management, only 11% of the unit holders own units of such funds. The number of unit holders is relatively smaller in gilt-edged and income funds as well. It appears that a relatively smaller number of investors dominates investments in money market, gilt-edged and income funds in Sri Lanka.

Table 13: Key Data on Unit Trusts in Sri Lanka as at December 31, 2015

Year	Net Asset Value (NAV) (Rs. Mn.)	Growth in NAV (%)	No. of Unit Holders	Growth in Unit Holders (%)	No. of Unit Trusts	No. of UTMCs
2005	4,495		23,654		13	6
2006	5,352	19.1	23,417	-1.0	13	5
2007	6,296	17.6	23,191	-1.0	14	5
2008	6,780	7.7	22,685	-2.2	17	5
2009	9,952	46.8	23,117	1.9	18	5
2010	22,228	123.4	24,649	6.6	21	5
2011	24,059	8.2	26,636	8.1	33	6
2012	31,062	29.1	27,952	4.9	48	11
2013	54,304	74.8	29,648	6.1	62	11
2014	127,356	134.5	32,619	10.0	74	14
2015	128,850	1.2	37,526	15.0	72	14
Average Annual Growth Rate (%)		46.2		4.9		

Source: SEC Annual Reports, Unit Trust Association of Sri Lanka, CBSL Annual Reports

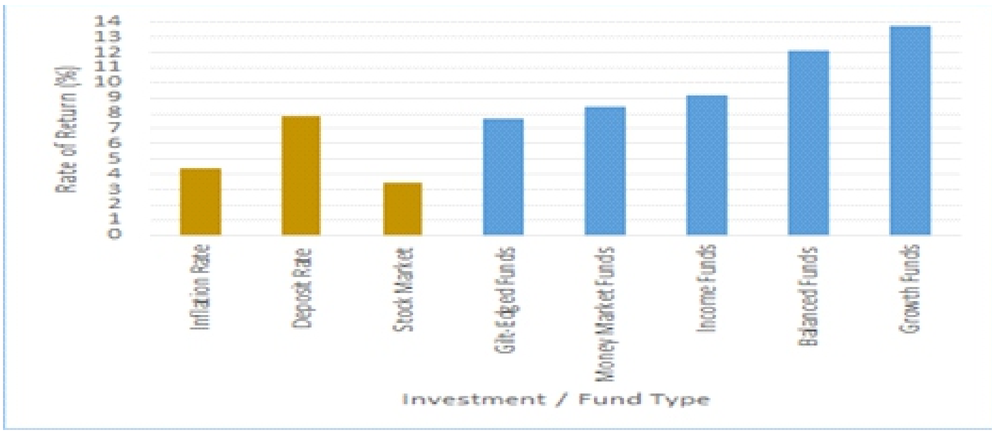
Table 14: Distribution of Unit Trusts by Fund Type as at December 31, 2015

Fund Type	Net Asset Value (NAV) (Rs. Mn.)	NAV %	No. of Unit Holders	% Unit Holders	No. of Unit Trusts	% Unit Trusts
Gilt-Edged	15,197	12	1,270	3	13	18
Money Market	72,510	56	4,287	11	20	28
Income	24,487	19	2,104	6	14	19
Balanced	8,634	7	23,721	63	8	11
Growth	8,022	6	6,144	16	17	24
Total	128,850	100	37,526	100	72	100

Source: The Unit Trust Association of Sri Lanka

All the unit trust funds have outperformed the inflation, bank deposit rate and the stock market over past five-year period from 2011 to 2015 (Table 15 and Figure 9). The average inflation was about 4.4%, deposit rate was about 7.8%, and the total return on stocks was just 3.5% during the five-year period. In contrast, unit trusts recorded average returns ranging from about 7.7% (gilt-edged funds) to 13.7% (growth funds) in a pattern that perfectly correlates with the risk associated with fund types. Growth and balanced funds outperformed the stock market in each of the past five years. Money market, gilt-edged, and income funds recorded very impressive absolute returns from 2011 through 2013, underperformed the risky assets in 2014, and did well in 2015.

Figure 9: Average Performance of Unit Trusts and Benchmarks (2011-2015)



Sources: The Unit Trust Association of Sri Lanka, Central Bank of Sri Lanka, Colombo Stock Exchange

Table 15: Performance of Unit Trusts (2011-2015)

	Annual Rate or Returns (%)					
Year	**2011**	**2012**	**2013**	**2014**	**2015**	**Average**
Inflation Rate (1)	4.9	9.2	4.7	2.1	0.9	4.4
Average Deposit Rate (2)	7.2	10.1	9.4	6.2	6.0	7.8
Stock Market (3)	-6.8	-4.4	7.8	36.3	-5.2	3.5
Gilt-Edged Funds	6.3	9.4	11.6	5.0	6.1	7.7
Money Market Funds	7.5	9.8	12.0	6.3	6.3	8.4
Income Funds	8.8	9.9	10.8	8.9	7.3	9.2
Balanced Funds	14.3	5.2	8.6	26.8	5.7	12.1
Growth Funds	18.3	5.2	10.5	28.7	5.9	13.7

(1) Year-on-year change in the Colombo Consumer Price Index, 2006/07=100,
(2) Average Weighted Deposit Rate of Commercial Banks (AWDR),
(3) Change in the All Share Total Return Index.

Sources: CBSL Annual Report 2014, CBSL Monthly Economic Indicators for 2015, Unit Trust Association of Sri Lanka.

6.2 Concerns and Impediments

a) Unit trusts and mutual funds are essential to developing a vibrant capital market. They perform the vital task of mobilizing savings for investing in unit trust funds which in turn create demand for capital market securities. This role of unit trusts in generating a constant demand for securities is one of the most critical backbones of a strong capital market. As a result, a robust unit trust industry is key to the demand side of securities markets. However, several structural and other factors have constrained the industry's ability to develop into a more widespread avenue for savings for Sri Lankans and play a stronger role on the demand side of the capital markets.

b) *Penetration of unit trusts into the savings base in Sri Lanka remains extremely low*. Savings in Sri Lanka are predominantly absorbed by the baking and non-banking financial institutions rather than unit trust or securities market products. In 2015, the total savings and fixed deposits held in deposit-taking institutions in Sri Lanka was Rs. 5,151 billion whereas total net assets of unit trusts were only Rs. 129 billion amounting to about 2.5% of the entire deposits. This highlights both the lack of penetration of unit trusts among savers as well as the potential for growth with appropriate structural and strategic changes.

c) *Participation in unit trusts by the Sri Lankan population remains low*. The number of unit trust holders in 2015 was only 37,526, and the growth in the number of unit holders has averaged about 5% over the past 10 years. This contrasts with the 581,775 accounts held in the CDS of the CSE by local individual investors suggesting there are almost 16 times more accounts with stock brokers than with unit trusts. [12] The total economically active population excluding self-employed and contributing family workers in 2015 was about 5.2 million. [13] Thus, only about 0.7% of the economically active population has invested in unit trusts highlighting the extremely low participation in unit trust funds.

d) *The lack of awareness about saving and investing through unit trusts makes it difficult to attract more investors*. Both the unit trust industry and the stock exchange have held many investment awareness seminars. However, the growth in the subscriber base has been low.

e) *Saving and investing public's preference for a fixed rate of return is a big impediment to attract more subscribers.* Traditionally, people are used to depositing money in savings and fixed deposit accounts with banking and non-banking financial institutions because of higher fixed interest rates they were able to earn. This also seems to suggest a fairly high level of risk tolerance on the part of the savers and the investing public.

f) *The industry has very limited distribution channels making it difficult to reach out to potential investors.* Unit trusts are primarily sold through unit trust companies themselves. Given the smaller asset base and lack of wide

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[12] The number of active CDS accounts, however, is much lower.

[13] According to the 2015 4th quarter Labor Force Statistic Quarterly Bulletin of the Department of Census and Statistics, Sri Lanka had 8.6 economically active population which comprises of 4.9 million employees, 0.3 million employers, 2.7 million own account workers and 0.7 million contributing family members. Excluding own account workers and contributing family members, the economically active labor force was 5.2 million.

interest in unit trusts, it is not feasible for UTMCs to have their own branch networks in the country. Stock brokers and banks in Sri Lanka generally do not deal with unit trust products either. This is because brokers would prefer people investing in stocks while banks would prefer people depositing money in savings and fixed deposits. Although some UTMCs experimented with these avenues for distribution, the competing interests have made it infeasible to leverage the broker and bank branch networks as a way to expand distribution of unit trusts.

g) *Contractual savings system in Sri Lanka does not allow investment choice to subscribers.* It is mandatory for employers to contribute on behalf of employees to the Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF) both of which are state-managed, defined contribution retirement funds. These funds in turn decide where such contributions will be invested and, as such, Sri Lanka does not have a retirement system whereby employees have the discretion to direct their retirement contributions to investments of their choice as in the case of developed markets. The EPF and ETF primarily channel these funds to government securities with a small allocation to equities, corporate bonds and other investments. What this means is that unlike in countries where the pension sector has been liberalized and is market-driven, Sri Lankan economy does not provide a natural source of demand for unit trusts and mutual funds which in turn leads to a less vibrant professional fund management industry.

h) *The unit trust industry is proliferated with too many funds with a very small number of subscribers with smaller amounts of assets under management*. As the data show (Table 16), 10 funds have less than or equal to 50-unit holders, and 32 funds have between 51- and 100-unit holders. Thus, a total of 42 funds or 58% of the number of funds have less than or equal to 100 subscribers resulting in a vast majority of them having relatively smaller amounts of funds under management.

i) *The unit trust industry is proliferated with too many similar types of funds making it undistinguishable and uncompetitive* (Table 14). There are 13 gilt-edged funds, 20 money market funds, 14 income funds, 8 balanced funds, and 17 growth funds. Given the smaller size of the overall capital market and the unit trust industry, having too many funds with similar investment objectives makes them uncompetitive.

Table 16: Distribution of Unit Trust Subscribers as at December 31, 2015

No. of Subscribers	No. of Funds	Cumulative No. of Funds	Cumulative % of Funds
1 to 50	10	10	14
51 to 100	32	42	58
101 to 200	8	50	69
201 to 500	10	60	83
501 to 1,000	3	63	88
1,001 to 2,000	6	69	96
2,001 to 5,000	1	70	97
5,001 to 10,000	1	71	99
10,001 to 15,000	1	72	100

Source: The Unit Trust Association of Sri Lanka

j) *The unit trust industry is highly unconcentrated with too many smaller firms making it less strong (Table 17)*. NDB wealth management is the market leader accounting for 25% of the market share in terms of fund size, and the rest of the market is shared by 13 unit trust management companies (UTMCs). The top-4 concentration ratio is 61% while top-6 UTMCs have a market share of 78%. The balance 22% of the market is shared by eight UTMCs each having a smaller share ranging from 0.3% to 5%. The Herfindahl Index, which measures the extent of industry competitiveness, is 0.13 suggesting that the unit trust industry in Sri Lanka is unconcentrated. Having too many small firms with relatively smaller amounts of funds under management and with smaller number of subscribers makes the industry too scattered with many firms potentially struggling to expand its business to a viable scale and profitability.

Table 17: Market Structure of the Unit Trust Industry

Unit Trust Management Company	Total Fund Size Rs. Mn.	Market Share %	Cumulative Market Share %
NDB Wealth Management	32,256	25.0	25.0
Capital Alliance Investments	19,263	14.9	40.0
JB Financial	13,633	10.6	50.6
National Asset Management	13,368	10.4	60.9
Assetline Capital	11,292	8.8	69.7
Ceybank Asset Management	10,187	7.9	77.6
Ceylon Asset Management	6,423	5.0	82.6
Guardian Acuity Asset Management	5,779	4.5	87.1
First Capital Asset Management	5,505	4.3	91.4
Comtrust Asset Management	5,504	4.3	95.6
Asset Trust Management	2,158	1.7	97.3
Candor Asset Management	1,589	1.2	98.5
Investrust Wealth Management	1,454	1.1	99.7
Arpico Ataraxia Asset Management	440	0.3	100.0
Total	128,850	100	

Source: The Unit Trust Association of Sri Lanka

k) *Mutual funds in Sri Lanka are non-listed, open-end funds limiting investment choices.* Except for Namal Acuity Value Fund and the recently launched Candor Opportunity Fund which are both closed-end funds, all other funds are non-listed, open-end funds. Exchange-traded mutual funds provide the opportunity for investors to trade on the stock exchange and have the potential to broaden investor participation in mutual funds. The lack of an array of exchange-traded mutual funds limits investment choices, investor participation, and the growth of the unit trust industry as well as the overall capital market.

l) *The two available closed-end funds (CEFs) are term trusts having a defined maturity rather than perpetual trusts that are more common in developed markets potentially limiting investor interest.* The main structures for CEFs are perpetual trusts and term trusts. Most CEFs are structured as perpetual trusts without a defined maturity enabling the fund to exist and trade on an exchange indefinitely. Term trusts, however, have a defined maturity date at which time the fund is dissolved and net assets are distributed among the subscribers. The two CEFs that have been launched in Sri Lanka fall into the term trust category which are less common due to inherent limitations of such funds. Given these are equity funds, having a pre-defined exit date creates challenges for managing them particularly as the funds reach the maturity date due to the unpredictable nature of stock market conditions and directions. As a result, these funds have potentially added risk due to the importance of market timing strategies possibly limiting interest in subscribing to these funds as well as trading them on the exchange. [14]

6.3 Recommendations

a) The unit trust industry in Sri Lanka has excellent potential to develop to be a strong component of capital markets with appropriate changes in the industry structure, products, distribution methods, and investment education.

b) A comprehensive survey and study to assess the market for unit trusts and to identify various impediments for the public to invest in unit trust needs to be conducted.

c) The unit trust industry needs a comprehensive plan for educating the saving and investing public about benefits of unit trusts as a saving and investing vehicle. Education and awareness initiatives could take a two-pronged approach. First approach is to educate the general public through various investor seminars and media events and discussions. The second approach is to identify types of potential investors and to implement targeted education and awareness campaigns for each group.

d) The unit trust industry also needs to establish wider distribution channels for their products. Given bank branches do not seem to be viable due to competing interests, the entire capital market will benefit from having one

[14] Although, CEFs with fixed maturity, also called fixed-maturity plans (FMPs), are most common in India, they are fixed income funds rather than equity funds.

distribution mechanism for all capital market products including stocks, bonds and unit trusts. The most practical mechanism is the existing stock brokering firms and their branches. In this context, it is important that the SEC, the CSE, the stock brokerage industry and the unit trust industry work together to expand the scope of the stock brokering industry to include other capital market products and strengthen their institutional capacity and professional skills to handle a wider range of products that include unit trusts. This will require revisiting the existing fee structures of unit trusts to provide more incentives for stock broker firms to market and deal in unit trust products. This will also benefit brokers to develop a more diversified revenue structure rather than being completely dependent on commissions on stock transactions.

e) *Pension reforms needs to include external fund management of pension funds*. Currently, there is no pension reform plan. Pension funds, such as the EPF and ETF, should consider outsourcing a fraction of their funds to fund management companies for professional portfolio management. This will help pension funds to diversify their portfolios and optimize risk and returns. This will also contribute to growth in the unit trust industry and increase demand for securities market products which is important to increase the size and liquidity of the Sri Lankan capital market.

f) *The unit trust industry will need consolidation in order to make it more competitive and sustainable*. As discussed earlier, the industry is proliferated with 14 UTMCs and 72 funds resulting in too many UTMCs and too many funds with smaller amounts of assets under management and smaller number of subscribers. Industry competitive structure, profitability, financial stability and its contribution to capital markets could be strengthened through an appropriately designed consolidation strategy. Towards this, the regulators will need to undertake a number of tasks.

   i. Commission a comprehensive study of the competitive structure of the unit trust industry with a view to analyze the current competitive dynamics, optimal number of UTMCs and unit trust funds given the size of the industry and the economy, optimal strategies for industry consolidation, and a plan for consolidation.

ii. Design a consolidation strategy in consultation with the industry and other stakeholders.

iii. Provide for any necessary legal and regulatory guidelines for industry consolidation.

iv. Implement the consolidation plan in a properly phased manner.

g) *It is also important to introduce new listed mutual fund products.* New listed mutual fund products will further help the Sri Lankan capital market to solve the "small size and illiquidity puzzle" and propel the growth and trading with greater investor participation.

i. Perpetual closed-end funds: The unit trust industry needs to consider developing perpetual closed-end mutual funds, rather than defined maturity close-end funds, that are listed and traded on the stock exchange.

ii. Exchange traded funds (ETFs): Establishing exchange-traded funds is another growth option. A natural starting point will be ETFs on stock indices. The major obstacle to establish ETFs is the need for liquid investable indices, whether they represent the overall market or specific sectors within the market. It may be possible to create such a market index with the most liquid and large capitalization stocks with good free-float. However, this further points to the need for reforms to increase the liquidity of listed stocks. [15] No ETFs have been established in Sri Lanka. There are no ETFs based on the Colombo stock market either, i.e. a country ETF, listed on any foreign stock exchange. [16] It is important to draft a comprehensive policy paper on introduction of ETFs.

[15] The Unit Trust Code specially defines and allows for the creation of ETFs in Sri Lanka. The Unit Trust Code defines an ETF as "a unit trust which tracks an index or price of gold or any other commodity approved by the Commission, units of which are listed on a stock exchange and can be bought/ sold at prices, which shall reflect or approximately reflect the net asset value of such unit trust." Accordingly, the definition of an ETF is broad enough to encompass indices representing any underling financial asset such as stocks, bonds or commodities.

[16] MSCI Sri Lanka Index began in November 2007. Sri Lanka was removed from the MSCI Emerging Market Index in June 2001. Bangladesh, India and Pakistan have their country ETFs listed on foreign exchanges. In addition, India has a large number of ETFs on gold, index (S&P CNX Nifty, CNX 100, Sensex, BSE 100), banking sector, money market, and international indices (Nasdaq, Hang Seng) traded on the Bombay Stock Exchange and the National Stock Exchange. Gold and index ETFs dominate in India. No ETFs are traded in Bangladesh or Pakistan stock exchanges.

iii. Real Estate Investment Trusts (REITs): The 2016 Budget Speech also provides for the introduction of REITs. It proposed to introduce Listed Real Estate Trusts (REITs) in order to provide capital to real estate and infrastructure development and to enable small investors to directly benefit from the growth of the real estate sector. The Budget also stated that transfer of real estate assets to a REIT structure that distributes 90 percent or more of income to REIT unit holders will be exempted from stamp duty.[17]

h) *It is important to review the existing taxation framework for unit trusts and make appropriate changes to provide proper economic incentives for the operation of and investing in unit trusts*. The 2013 Budget slashed the corporate tax for income from unit trust investments to 10% from 28% in order to strengthen the management of unit trusts, attract more investors to the industry and strengthen the capital markets of the country. This incentive resulted in a number of corporates establishing unit trust companies in order to channel company funds to unit trusts to take advantage of the lower tax. [18]Any reversal of this tax incentive might lead those investors who invested primarily to take advantage of the tax incentive to withdraw funds leading to a significant shrinkage in the industry.

i) *The development of the unit trust industry also requires a SEC-mandated robust licensing framework for professionals in that industry*. The SEC needs to revise and expand the existing financial industry qualification framework in order to ensure that professionals in the unit trust industry have a high degree of knowledge and competencies.

[17] The CSE Strategic Plan 2016-2018 has also identified ETFs and REITs as areas for product development.

[18]Further, the 2015 budget provides for exemption of income arising or accruing to any unit trust from investments made on or after 1 January 2015 in US dollar deposits or US dollar denominated securities listed on any foreign stock exchange.

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Note on the Current Status and Future Plans of the Colombo Stock Exchange

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Market Performance

The Colombo Stock Exchange (CSE) navigated a year marked by volatility in common with stock exchanges around the world as a global economic slowdown, elevated geopolitical and trade tensions, the impacts of tightening monetary policy and the scrutiny of the technology sector contributed to depress global market capitalisation by 14.7% in 2018.

The CSE is also not immune to global trends of capital outflows from emerging markets. Market performance continued to be depressed with the benchmark All Share Price Index (ASPI) declining by 4.9% and the S&P Sri Lanka 20 Index (S&P SL 20) declining by 14.6%. It is noteworthy that the decline in market capitalisation was limited to 2% which compares favourably with declines experienced by other markets in the Asia Pacific region which recorded an average decline of 23.8% in 2018.

Foreigners continued to stay invested signalling interest and confidence in the country particularly vis a vis the capital outflows in the region. The year 2018 recorded a net foreign outflow of Rs. 15Bn. as against a net foreign inflow of Rs. 40.1 Bn. in 2017. Foreign investors accounted for 42% of daily trading volumes compared to 44% in 2017. Equity market turnover declined as the daily average market turnover dropped by 9 % from Rs. 833.6 Mn. in 2017 to Rs. 617.8 Mn. in 2018. Annual Debt market turnover increased by 23% to Rs. 4.4 Bn. reflecting a shift in asset allocations supported by high interest rates.

Capital raised through the market increased by 34% to Rs. 99.3 Bn. during the year, supported by 11 debt Initial Public Offerings (IPOs) which accounted for 55% of capital raised.

Strategy

The long term strategy of the CSE is to move from the current classification of a 'frontier market' to the 'emerging market' classification as per Morgan Stanley's Markets Index. The CSE would focus on the qualification criteria to achieve the benchmarks. However, there are factors which are beyond the control of the CSE and the strategy is focussed on achieving readiness for positive macroeconomic factors to support a re-entry in the Emerging Markets classification.

The qualification criteria includes the requirement for the market to have at least three companies meeting the quantitative criteria of a stipulated minimum full market capitalization, a float market capitalization and a liquidity criteria of a traded value ratio. In addition to these quantitative criteria there are five broad quantitative criteria such as openness to foreign ownership, ease of capital inflows/outflows, efficiency of operational framework, competitive landscape and the stability of the institutional framework that require some advancements from the current level.

However, it also must be borne in mind that it will be more advantageous to remain in the frontier market space currently, as there are gaps in the market to be filled before Sri Lanka can compete effectively in the emerging markets space where the dynamics will be very different.

Key development plans would be increasing the size and liquidity of the market, the introduction of a more balanced regulatory framework, focus on the post trade activities which include the introduction of a Delivery Versus Payment System and improving the customer experience through improved digitised solutions to market participants. These are the game changers, strengthening market processes and investor confidence, supporting the progress towards the medium term goals of the CSE.

Size and Liquidity

Size and liquidity remain as key constraints for market growth. The listing of large private sector companies and state owned enterprises remains a top priority for the exchange. Government policy will dictate the timing of the listing of State Owned

Enterprises (SOEs). Much more needs to be done in terms of creating awareness among the public that a listing does not constitute a privatisation but instead an opportunity for SOEs to obtain market based funding which they urgently require. There are examples of such SOEs that are majority Government Owned which have successfully listed and have become market leaders in their industry. On the contrary, the public at large and trade unions should be supportive as a listing results in greater transparency and a more productive institution. It is noteworthy to mention that in many countries markets have grown significantly both in size and liquidity following the listing of SOEs.

Encouraging higher investor participation remains another top priority item for the exchange. Much is being done to facilitate greater participation by local institutional and retail investors as well as foreign investors. The CSE continues to engage prospective local investors through a country wide awareness and an investor education program and the exchange continues to promote the market overseas among foreign institutional investors through the "Invest Sri Lanka" branded investor forums in collaboration with the Securities & Exchange Commission of Sri Lanka (SEC), Listed Companies and Stock Broking Firms.

Product Diversification

Two significant new initiatives have been launched during the year which will pave the way to enhance the opportunities for the corporate sector both locally and internationally to raise capital using the capital market.

The CSE launched a dedicated board for SME companies titled "Empower Board" and another dedicated board titled the "Multi Currency Board" (MCB) for companies incorporated overseas to list and raise capital in US dollars.

The Empower Board is already marketed and so far eight institutions have been registered as sponsors of listing applications for the Empower Board. Several workshops targeting prospective companies were conducted country wide. The marketing of the Multi Currency Board is scheduled to be commenced shortly once the all the regulatory matters are sorted out.

The Central Depository Systems (Pvt) Ltd (CDS) also launched a new corporate action service and corporate registrar service creating a fresh revenue stream. The CDS will enter this market space cautiously and mindful that the entry of the CDS into this space is to further complement, strengthen and support the good work done by the existing market intermediaries and not with the objective of replacing them.

Technology

The use of appropriate technology which is at the heart of stock exchanges will largely define the success or failure of exchanges. The CSE has identified this a very long time ago and hence have continued to invest in world class systems and continuous upgrades.

The CSE is again in the process of implementing further major upgrades to the trading and post trade technology which is due to be completed in 2020. The CSE works closely with the London Stock Exchange Group (LSEG) which has now become not only the technology partner but the business partner as well.

There are a number of investor centric technology developments that are happening which will significantly enhance the stakeholder experience. One of the key efforts is to provide uninterrupted access to the market and maintain a market wide robust Business Continuity Planning (BCP) mechanism with annual disaster recovery tests. Continuous stringent monitoring, investment and upgrades are carried out to the CSE IT systems which have helped the exchange to maintain 100% uptime in all main systems.

Market Regulation and Risk Management

The CSE continues its regulatory focus to ensure that all market intermediaries, which are within the purview of the exchange, are in compliance with the relevant rules and regulations. Where necessary, punitive and enforcement actions have been taken without fear of favour. There is a continuous effort to strengthen and upgrade the skills of staff members performing regulatory functions to ensure that an effective supervisory oversight is maintained.

The CSE also has established a robust system of monitoring the risk of stock broker firms. The risk based supervision and enforcement have resulted in three stock broker firms who were unable to comply with the minimum risk ratios ceasing operations during 2018.

The CSE also monitors the compliance of the continuous listing rules by listed companies. These also include the filing of timely financial statements, the corporate disclosure policy and the corporate governance rules. Companies which are in non-compliance are transferred to a watch list and the enforcement rules for companies under the watch list has proved to be an effective deterrent for non-compliance.

The CSE continues to monitor the market for any possible violations of market offences under the SEC Act. All suspected instances of any market offences relating to market manipulation, insider trading and front running, that have been identified through the market surveillance system during 2018, were referred to the SEC for further investigation.

The CSE commenced using a risk based approach to its review of financial statements of issuers which was previously more focused on compliance. This will facilitate improved risk management of the CSE as the review is expected to provide early warning signs enabling the exchange to consider appropriate actions, mitigating reputation risk.

Governance

The CSE significantly enhanced Board Governance with the CSE board adopting a Board Charter with enhanced fit and proper requirements. A Board nominations committee was also established to screen and recommend all elected Board appointments.

The CSE launched “Communicating Sustainability: Six Recommendations for Listed Companies” during 2018 to encourage more corporates to address environmental, social and governance factors in their capital market communications. The CSE worked closely with the Global Reporting Initiative (GRI) on Sustainability

Reporting and Corporate Social Responsibility to provide insights to listed issuers in adopting sustainable business practices and measuring, monitoring, managing and communicating sustainability performance. The exchange has also been actively encouraging women participation in listed company boards and partnered the IFC, UN Global Compact, UN Women and the WFE in a series of initiatives including a bell ringing ceremony and a publication of a directory of women on boards of listed companies to draw attention to the issue.

Regional Co-operation

The CSE has signed MOUs with the National Stock Exchange of India, the Korea Stock Exchange, the London Stock Exchange, the Dhaka Stock Exchange, the Sydney Stock Exchange and the Maldives Stock Exchange to explore opportunities of working together and co-operating with each other, strengthening strong relationships in knowledge transfer, technology transfer and product knowledge that has grown over the years.

The CDS has signed MOUs with the CSDC China, KSD Korea, NSDL India, CDCL India and the CDC Pakistan to co-operate and collaborate on mutual opportunities which will be beneficial to Sri Lanka as these are large regional depositories, assisting Sri Lanka to raise the bar on clearing and settlement platforms and protocols, strengthening the infrastructure.

The CDS hosted the 22nd Annual General Meeting of the Asia-Pacific Central Securities Depository Group (ACG) in Colombo with delegates from 25 depositories and clearing organizations in participation. The event marks the largest gathering of depositories and clearing organizations Sri Lanka has ever hosted and also upholds an unbroken tradition of 21 consecutive years of conferences for ACG.

Looking Ahead

The vision of the CSE is to become a demutualized, listed, diversified profitable exchange competing in the emerging market space in the next five to six years. Stakeholder support and innovation are key drivers for the growth of the CSE and the exchange is conscious of the need to facilitate wealth creation for its stakeholders within applicable legislative and regulatory frameworks and macroeconomic factors. However, policy reform, regulation and government agencies also have a key role to play in developing the capital markets pave the way to bringing in the partnerships to support the next stage of evolution. Monetary policy framework are also key as equity markets thrive in low interest regimes.

Capital markets in Sri Lanka are largely untapped and the government and the corporates must engage in the capital markets in a much more efficient manner. Moving forward, the exchange continues to strongly advocate a more balanced regulatory framework which will facilitate balancing risk versus over regulation and it hopes to work as a catalyst to achieve this balance with regulators and market participants.

Market intermediaries are key stakeholders and they must also drive the necessary changes to evolve, building investor capacity for financial inclusivity and investing in their own technology transformations to ensure that the stock market is future ready and able to compete effectively. Financial literacy is an area that all regulated financial service providers should focus on and the CSE looks forward to support and actively participate in the National Financial Inclusion Strategy of Sri Lanka.

The exchange is fortunate to have strong relationships with foreign investors. Further, MOUs signed with other exchanges during the year also provide platforms for exploring mutually beneficial opportunities, enabling the CSE to get product technology, market infrastructure and new product knowledge. The CSE is committed to innovating and technology. All broker back office systems have been upgraded with risk management capability and the CSE is in the process of digitising account openings to support the growth moving forward, leveraging technology.

It is necessary that the CSE takes note of the moderated forecasts for global, regional and country growth in 2019 as set out in the April issue of the World Economic Outlook. Encouragingly, it forecasts an uptick in economic growth in response to accommodative monetary policy stances, improved US-China trade relations and observes a resumption of portfolio flows to emerging markets and a strengthening of currencies. Downside risks make the recovery precarious, recommending policy makers to be objective and data dependent.

As with all risks, there is an opportunity, and this can be a time to forge ahead as investors look for compliant markets with strong governance frameworks backed by fin technology. The CSE is well positioned to leverage years of investment in strengthening the country's capital markets and it will drive the agenda to deliver opportunities for wealth creation to the stakeholders.

There is a need for all stakeholders of the capital market in Sri Lanka to continue to work together to regain the vibrancy of one of the more established stock exchanges in the South Asian region, ensuring that Sri Lanka is future fit to compete effectively.