Great Expectations

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Political Scene The presentation of the draft constitution to the MPs of the Peoples Alliance by the President marked the most significant event in the month of July.

Market observers felt that this showed the government’s commitment towards peace which was a key component for the upliftment of the market.

President Chandrika Bandaranaike Kumaratunga was the chief guest at a two-day workshop, especially held to apprise members of parliament and organizers of PA constituencies of the proposed constitution. It is reported that a resolution moved at the end of the workshop by Vocational Training and Rural Industries Minister Amarasiri Dodangoda was endorsed by the house.

The President in her speech at this forum said that achieving a peaceful solution to the ethnic problem is the biggest challenge the country has faced since independence.

Economic Front

On the economic front, Deputy Minister of Finance, Prof GL Peiris speaking at a meeting organized by the Central Bank in the month of July said that the Central Bank had introduced two major changes in policy to encourage the recovery of the economy.

The first of these was the introduction of a scheme to enable non-BOI exporters to obtain foreign currency loans. Although some people had been initially skeptical of this scheme and said that it would have only a negligible impact, US$103 million had been granted under this facility, by the middle of June. This has enabled exporters to obtain credit at relatively low rates and increased their competitive ness. The second was the reduction in the statutory reserve requirement (SRR) on the deposits of commercial banks. The reduction in the SRR had released about Rs 8,000 million of high powered money, which has a multiplier effect on credit creation, into the system and had also enabled commercial banks to reduce their lending rates,’ the minister said.

He mentioned that initially, the banks had invested the additional liquidity in Treasury Bills, as expected, but that subsequently, banks have started reducing their Treasury Bill holdings and extending credit. Interest rates have declined significantly. The prime lending rate has come down by about 5 percentage points, from around 18% at the end of 1996 to 13% in July. The average lending rate has come down by about 1-2 percentage points. However, this reduction may not be sufficient. The full benefit of the policy changes would not be felt immediately as it would take about one year for the cycle to be completed.

Prof. Peiris explained that new credit to the pri vate sector had increased by Rs 7,541 million in the first five months of 1997. Private sector credit had grown by 11% at end May. This was expected to increase to about 15% by the end of the year, which would be a desirable feature, given the current inflation trends.

Macro-economic Indicators

Referring to favorable trends in current macro- economic indicators, the minister mentioned the low debt service ratio, improved budgetary management despite challenges, the recent surge in stock market activity and improved prospects for a higher economic growth rate of about 5.76%. He also stated that in the recent mission to raise US$50 million through a Floating Rate Note (FRN), he was impressed by the confidence placed in the Sri Lankan economy by foreign investors.

Meanwhile, market analyst and researcher, Econsult in their latest update said ‘at the end of June, consumer price inflation had dropped to 14.7% and the year-on-year rate to 3.9%. The last time the year- on-year rate was at these levels was at the beginning of the second quarter of 1995.

A sharp fall in wholesale prices preceded the fall in consumer price inflation, suggesting that one of the major causes of the current abatement of inflationary pressures was a decline in cost of production.

Recent minimum wage data shows wage pressures continuing to build even as inflationary pressures begin to subside. By the end of April the rate of nominal wage increases in the private sector (as proxied by increases in nominal minimum wages), went into double digits for the first time in over 3 years.

Some government and private sector economists have seen fit to attribute this recent reversal in consumer price inflation to the government’s success at

controlling money stock expansion, particularly, narrow money stock expansion. From the chart it may be seen that narrow money stock growth has indeed plummeted since the first quarter of 1996 and, therefore, it could have conceivably induced a subsequent fall in consumer price inflation. If this is the case, what sense is to be made of the remainder of the data? For example, what sense is to be made Econsult analysts ask, 'of the 1994-96 period when the fall in inflation appears to precede the fall in narrow money supply growth and the subsequent rise in inflation appears to be prior to the rise in narrow money supply growth?"

Trade Balance

By the end of April, official reserves had fallen by some US$64 million, taking the official reserve cover to under 4 months of imports from 4.5 months at the end of 1996, the report added. Significantly, the growth rate of official reserves has now followed the growth rate of gross reserves into negative territory for the first time since 1990. While the present level of reserve cover for imports is nowhere near critical, the protracted downward trend requires some attention from policy makers at the present juncture, if one is to avoid the necessity of having to take more drastic measures at a later stage.

The trade balance continued to hold up in spite of an increase in imports because of a corresponding growth in export earnings, particularly from garments and textile products and planation agriculture exports. This means, as in the recent past, the weakness in private remittances and capital inflows was mostly to blame for the slippage in reserves, Econsult says.

Economic growth rates in the region

Meanwhile, in another report by this research agency analyzing the economies in South Asia and Sri Lanka, analysts say notwithstanding major changes in the economies of the South Asian region over the last two decades or so, the trend economic growth rate for the region has remained remarkably stable. Taking the economies of India, Pakistan, Bangladesh and Sri Lanka to be representative of regional trends, it may be seen that the unweighted average growth rate of these economies, as a group, has been in the 4.7% to 5.1% range over this period. The weighted average for the group fluctuates from under 4% to over 6%. "

Trend growth rates (whether weighted or unweighted) for the South Asian region compare unfavorably with East Asian economies but favorably with Latin American

economies. Current indications are that trend economic growth in the South Asian region is rising and is presently above the 5.5% mark, or very close to historic hights. The question is whether this upward trend is sustainable in the context of the political instability afflicting the region.

A look at individual country trends within the South Asian region reveals marked differences between them. In the second half of the 1970s, India's performance was below that of the other three South Asian economies. In the 1980s, India and Pakistan easily outperformed Sri Lanka and Bangladesh and, in the first half of the 1990s Sri Lanka played catch- up. In terms of long-term trends, India and Pakistan appear to have experienced something of a slump in the early 1990s following strong growth in the 1980s. In Pakistan's case, the 1990s weakness was, in fact, a continuation of a declining trend which began in the early 1980s, whereas in India, the slump resulted from a fundamental restructuring (liberalization) of the economy, which was expected to usher in an era of prosperity.

Recent indications suggest that over the 1995- 2000 period, trend economic growth may pick-up significantly in Bangladesh and marginally in India, while declining in Pakistan and Sri Lanka. With all countries in the region undergoing major liberalizations, the difference between them in terms of growth prospects appears to revolve around relative political stability and, to a lesser extent, economic commitment.

The escalating war in Sri Lanka and the growing level of violence in Pakistan will undoubtedly prevent any significant upward shift in trend economic growth rates in these two countries, while growing political uncertainty in India is acting as a drag on what had recently been a strong economic growth momentum. Curiously, both India and Sri Lanka appear to have been also afflicted by problems of economic Puritanism the need to do things according to economic orthodoxy rather than the dictates of economic reality. One consequence of the latter has been the slow-down in export growth as a result of currency overvaluation', Econsult says.

Industrial growth rates in the region

Their report also says that there has been a steady increase in the trend growth rate of industrial production for the region, underlying the shift towards industry. At the end of 1995, the average growth rate of industrial production for South Asia stood at 9%. This compares with an average industrial production growth rate of 3.4% at the end of 1975. India, Bangladesh and Sri Lanka have all experienced

rising trends over the 1975-1995 period as a whole, while Pakistan, in contrast, has experienced a declining trend. Indeed, it is this decline in industrial production that is the heart of the protracted decline of the Pakistan economy.

Recent trends suggest that industrial production growth for the region may slow down in the coming years, unless there is a strong export drive such as that taking place in Bangladesh. Industrial production growth in India is estimated to have fallen sharply in 1996 (to around 7%) compared with the heights it reached in the previous year (12.7%). In Sri Lanka, 1996 saw industrial production growth fall for the third consecutive year with continuing weak export production. In Pakistan,

industrial production growth is estimated to have actually been flat last year, making it the worst performance in the last 20 years. Only Bangladesh appears to be experiencing continued strong industrial production growth, and this in spite of considerable domestic political turmoil. In fact, Bangladesh has managed to register double digit industrial production growth in four out of the last five years, with an average of a massive 11.3% for these years.

Investment trends in the region

Sri Lanka has had the highest levels of investment amongst the four largest South Asian economies over the two decades ending 1995. Regrettably for Sri Lanka, this has not translated into relatively higher GDP growth rates. One reason is undoubtedly the costly war. Another is the apparent misuse of resources in augmenting the competitive strength of the economy.

Current trends in Sri Lanka, as well as other South Asian economies, suggest that the levels of investment required to match the growth rates achieved by their faster growing Asian neighbors have still a long way to go. Moreover, foreign resources are necessary to achieve these rates. In the absence of a greater degree of political stability in the region; the required expansion of resource flow is, however, unlikely to be forth- coming.

However, according to projections made by the Industrial Association of Sri Lanka (IASL), Sri Lanka is expected to achieve a growth rate of 6.5% over the next few years in the event the government maintains the present favorable economic trend. The Association’s chairman Cubby Wijetunge speaking at the 6th annual general meeting of IASL, at which Minister GL Peiris was Chief Guest said that the present economic situation was definitely sounder than it has been in the last couple of

year.

It is reported that IASL also expects a 10% industrial growth during this year also based on the current economic trend.

Financial news update

Meanwhile, the government's decision to divest its controlling holdings in the National Development Bank (NDB) made big news in financial circles. This sale of shares is expected to bring in approximately Rs 4 bil- lion into the government coffers. At present the gov ernment holding in NDB is around 275 million worth of convertible debentures. These debentures were originally created during the privatisation of this bank in 1993 and are scheduled to be converted into ordi- nary shares during the period 1991 and 2001. Though the original agreement specifies that the debentures will be converted into 27.5 million ordinary shares, the current conversion is expected to be on the basis of 2 ordinary shares for 3 debentures. This would result in the issuing of 18.33 million ordinary shares and will make a total share capital of Rs 358.30 million com- prising 35.83 million shares of Rs 10 each.

Jardine Flemming in an analysis says "NDB fulfills a real, vital role in the Sri Lankan economy by making medium and long term development loans to strategic industries. With a loan portfolio that has broad exposure to agriculture, manufacturing, tourism and services, the bank is perfectly positioned to benefit from the recovery of the economy this year. We are forecasting Sri Lanka's real GDP to grow 5.1% in 1997 versus 3.8% in 1996. Interest rates, meanwhile, have fallen by 3% year-on-year. The bank also has a substantial portfolio of shares in a market that has risen 37% so far this year."

According to Jardine Fleming the bank's earnings were hurt in 1996 by the weak economy and the fall off in tourism, which resulted in a drop in core prof- its and an increase in non-performing loans to 10.9% of its gross total loans. However, with the economy recovering and interest rates coming down, its borrowers' financial position is expected to improve. This offers investors considerable upside potential, as our analysis of bank shares across Asia shows that there is a direct relationship between declines in non- performing loans and increases in the market value of banks. Also the bank is fairly conservative with regard to provisioning; it makes a general provision of 3%, which is higher than that made by its peers both within the country and elsewhere in the sub-continent,' Jardine Fleming reports.

The growth in economy, the creation of capital markets and the deregulation of the banking industry present both a challenge and an opportunity to NDB, as for other development banks across Asia. The artificially erected business boundaries of the past are coming down. In response, the NDB is repositioning itself as a universal bank. It is diversifying into retail commercial banking, merchant banking, investment fund management and venture capital. NDB's various diversifications which are presently in a state of gestation, are expected to pay off handsomely over the next 2-3 years.

The bank's management is proactive and independent. The management has a clear strategic vision and a concrete plan of action. Unlike some of its peers and competitors, NDB is actively engaged in building up a second tier of management so that there is a clear line of succession. One of the major uncertainties surrounding the share price since its listing in 1993 has been the Rs 275 million in convertible bonds issued to the Sri Lankan Government. Now finally, the issue might be settled, possibly to the advantage of share- holders, reports Jardine Fleming.

Market analysts say that the Vanik-Asia Capital Agreement (see box) and the sale of NDB shares would push the stock market to greater heights in the month of August.

The Asia Capital Vanik dispute over Forbes Ceylon Ltd., appears to be finally settled. Vanik in a letter informed the Colombo Stock Exchange that 'On 29th July 1997, Vanik Incorporation Limited (VANIK) and Asia Capital Limited (ASIA) signed an Agreement whereby ASIA has agreed to dispose of its shareholding in Forbes Ceylon Limited (FCL) amounting to approximately Eleven percent (11%) in the event of a general offer being made by VANIK to the Shareholders of FCL under the Take Overs & Mergers Code, 1995. VANIK is presently negotiating with Global Equity Corporation the beneficial shareholder of 50% shares of FCL to purchase these shares on a General Offer at the undermentioned consideration (which consideration however is subject to variation after verification by VANIK of the current net asset position of FCL to the satisfaction of VANIK and subject to obtaining necessary approvals from the Controller of Exchange.

For every One Hundred (100) shares of FCL :-

a. A sum of Sri Lanka Rupees Three Hundred and Fifty (SL Rs. 350/-) plus

b. The issue and allotment of four

(04) fully paid ordinary shares of Sri Lanka Rupees Ten (SL Rs 10/-) each of VANIK carrying voting rights; plus

c. The issue and allotment of five

(05) fully paid ordinary shares of Sri Lanka Rupees Ten (SL Rs 10/-) each of VANIK not carrying voting rights; plus

d. The issue of Four (04) transferable redeemable debentures of Sri Lanka Rupees One Hundred (SL Rs 100/-) each carrying interest at fifteen percentum per annum and redeemable in five equal annual instalments commencing at the expiry of the sixth year from the date of issue with a Call Option by VANIK to redeem all the issued Debentures at a premium of 5% at anytime after the completion of five years from the date of issue.

e. The issue of one(01) Warrant per Debenture entitling the holder after three years but before the expiry of three (3) months from the said three (3) years, to the purchase of one (01) fully paid ordinary share of VANIK carrying voting rights at the rate of Sri Lanka Rupees Twenty Five (SL Rs. 25/-) per share.

Further if such a General Offer is made the Offer will be conditional upon:

(i) The passing at an Extraordinary General Meeting (or at any adjournment thereof) of VANIK of such resolution or resolutions as are necessary.

(a) To increase the Authorized Share Capital of VANIK to accommodate the issue of ordinary shares and Non Voting Class X shares to be issued to the FCL shareholders pursuant to the Offer.

(b) To issue Ordinary Shares of Rs 10/- each to FCL shareholders without them in the first instance being offered to the existing shareholders in terms of the Articles of Association of VANIK.

(c) To issue Non-Voting (Class “X”) shares of Rs 10/- each to FCL shareholders without them in the first instance being offered to the existing shareholders in terms of the Articles of Association of VANIK.

(d) To issue Warrants to FCL shareholders along with Redeemable Debentures, which would entitle the Warrant holder as at the completion of three years from the date of the issue of the Warrants, to exchanging his Warrant with an Ordinary Share

of VANIK of a par value of Rs 10/- at Rs 25/- per share at the completion of three years from the date of issue of the Warrant.

(ii) VANIK obtaining a listing for the aforementioned Voting Shares, Non-Voting (Class “X”) Shares, Redeemable Debentures and the War- rants, from the Colombo Stock Exchange.

(iii) On valid acceptances being re- ceived by not later than 4.30 p.m. on the final closing date of the Offer in respect of such number of FCL shares which together with shares acquired or agreed to be acquired either pursuant to the Offer or otherwise will result in VANIK holding shares carrying not less than fifty one per centum (51%) of the voting shares of FCL.