INDUSTRIALISATION AND THE PROBLEMS OF ACCESS TO FINANCE OF SMALL AND MEDIUM SIZED FIRMS IN CEYLON

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The method of approach employed to investigate the problem was predominantly influenced by two persons who have contributed to expand the field of knowledge about small firms and their particular problems, namely, Professor J. Bates (The Financing of Small Firms) and Professor R.W. Davenport (Financing the Small Manufacturer in Developing Countries). It could be said that the work of the former, influenced the foundation, and that of the latter, the framework for this study. I thank them accordingly.

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C. Anton Balasuriya
ABSTRACT OF THESIS

This study is an investigation of an area in the economic structure of Ceylon, where scant attention has been paid to date, namely, the adequacy and access to finance of small and medium sized manufacturing firms. Therefore, the study involved venturing into areas where little was known and filling in gaps where there were only partial answers, answers of doubtful validity or none at all.

In order to investigate the problems fully, the study was conducted at three levels, namely,
(a) The macro level: The interlinkage of the small and medium sized firms and their importance in the development strategy of the country, the steps in the emergence of the industrialization process, and the inter-dependence of the economic, industrial, and financial structure, in relation to small and medium sized firms. (Chapters I to 4)
(b) The financial intermediary level: The directions of lending, attitudes and the problems the financial institutions face. (Chapter 6)
(c) The firm level: The problems as envisaged by the borrower, and their viewpoints. (Chapter 7)

At all three levels, four specific questions were examined.

(Chapter 5).

(i) Where do they get the finance?
(ii) Is it adequate or inadequate?
(iii) If inadequate, the reasons for this inadequacy?
(iv) What are the likely solutions?

The mode of investigation was:

(i) Examination of the available literature
(ii) An interview survey of financial intermediaries

(iii) An interview survey of one hundred small and medium sized firms

(iv) A general interview survey of persons from financial institutions, Government ministries and departments, the Central Bank, other controlling bodies, Business chambers and some firms.

The data collected from the three surveys are analysed; cause and effect of financial inadequacy are identified; and lastly, suggestions for further study and future action are made. (Chapters 8 and 9)

The results of the study underlined the existence of a credit gap in the case of small and medium sized firms. It confirmed that this deficiency of credit experienced by this sector, was/is a result of,

(i) The absence of any institutions dealing with long term finance to this sector, and the shortcomings of services ancillary to finance.

(ii) The meagreness of available short and long term credit flowing into this sector

(iii) The shortage of funds in the financial market

(iv) The structural inadequacy of institutions and the stock market.

(v) The newness of industrialization and the under-developed nature of the country.

(vi) A three way communication and attitude gap, i.e., the Government, financial intermediaries and the firms.

(vii) The structural weaknesses of small firms

(viii) The repercussions of Government policy indirectly impinging on this sector, the absence of continuity and ambiguity of policy towards this sector.
I. CODING INDEX

Every paragraph begins with three numbers. For example: 1.2.3

1 - denotes number of chapter
2 - denotes sub-section of the chapter
3 - denotes paragraph under the sub-section

2. FOOTNOTES

Footnotes in the text contain only explanatory notes to clarify further, any point in the text.

3. REFERENCES AND BIBLIOGRAPHY

The Bibliography contains all the relevant works to which reference has been made in the course of this research.

(i) It is arranged in alphabetical order of the authors followed by chronological order of publication or availability.

(ii) Each reference is given a number according to the order in which it appears in the bibliography.

The References to particular authors and books and other publications in the text are given by their bibliography number and the page of the relevant work. For example, if the book by R.W. Davenport, 'Financing the small manufacturer in developing countries' is given the bibliography number, (say) 6I, if and when a reference is made or quoted from this book, after the quotation, the reference would appear as follows, (See Bib.6I, Page 14) which means the quotation is from the work mentioned at No.6I of the bibliography and on page 14 of this work.
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I. 9  GENERAL ASSUMPTIONS AND CHARACTERISTICS OF SMALL FIRMS
I.I. INTRODUCTION

I.I.1. This is a study levelled at examining the place of small and medium sized firms in the structure of industry in a developing country with special reference to the problem of finance, namely, the present financial facilities available to these firms and their access to available finance, both external and internal. In a general sense all firms have financial problems at one time or the other and at various levels of their development and growth. However, this is a study not of small and medium sized firms which are content to remain small and static and wishing to make decent levels of incomes out of the business, but the problems of the dynamic firm and those entrepreneurs who are anxious to grow.

I.I.2. Small firms are an important facet of a country's industrial structure. This is true and likely to remain so, whether the country is a so called 'developed' country or a 'developing' country notwithstanding whether the country is small or large. Many economists and planners tend to believe that the days of the small firms are numbered in a world of oligopolistic competition, international trading blocks, state controlled large enterprises and state sponsored planned and central economies. However, this is far from the truth; small business organisations continue to contribute their share to economic development although their characteristics, priorities, and form change according to the changing socio-economic patterns of a country.

I.I.3. The problem is examined with a historical perspective of the overall development of the country, tracing it to the present date and
projecting it to the future development of the country. This has been necessary due to the general characteristics of economic growth of developing countries, namely, the existence of a considerable degree of interlinkage between different sectors of the economy, each impinging on one another, and the checks and balances of each sector of the economy having repercussions on every other sector. An attempt is made to examine the problem in four ways; namely, from the viewpoint of the economist cum planner, the industrialist cum entrepreneur, the financier cum financial adviser and finally that of the practical man.

1.2. METHODOLOGY

1.2.1. As stated above the problems of access to finance could not be examined in isolation from the general economic development of the country, as this would not bring out the dimensions of the problem nor the directions and solutions for the future. The study is divided into three parts consisting of four chapters in the first and second parts, and six chapters in the third part. Part one is an introduction to the study, while part two is an examination of the process of industrialisation and economic development, the structure of industry, the development of financial institutions and their present structure. The material for this part consists of both primary data and secondary data. The former was obtained by way of personal interviews, discussions and brain storming sessions with economists, planners, administrators and others connected with the industrial sector, both in Government and various other institutions. The secondary data is both from published and unpublished material. In part two the intention has been, to give on the one hand, a background knowledge of the problems and on the other
hand, to examine the 'why' and 'how' of the problems. In doing so a number of hypotheses are built up.

I.2.2. Part three consists principally of primary data from two field surveys, the interviews mentioned above, and their examination and analysis. Hypotheses that were built and questions that arose in part one are examined, as well as the availability and access to finance both short term and long term for different needs of the firms. A three pronged plan was chosen for the field research, namely a questionnaire-interview survey of the financial institutions in Ceylon, a questionnaire-interview survey of a hundred selected firms and thirdly a series of interviews with those connected with industry mentioned in part two above and entrepreneurs who began as small time businessmen.

I.3. PLAN OF CHAPTERS

I.3.1. In keeping to this basic plan outlined above, Chapter One deals with the place of small firms in general in a country's industrial structure, some of the reasons for their survival, their importance to the economy especially in a developing country, a summary of the sources of finance available to the small firm in general and those particular to Ceylon, and finally in conclusion an outline of general assumptions made with regard to the problems of small firm finance.

I.3.2. Chapter Two examines the broad aspects of industrial and economic policy and their development both past and present, in a context applicable to the present study. The purpose has been to understand the present position and attitude towards industry which is a result of past aims and policies and the expected future outcome. In the course of this chapter many external factors that have direct and indirect effect on the
present problems of industrial finance are brought to light. The chapter, critically examines industrial policy of different Governments at different periods of time, attitudes created, strengths, weaknesses and lapses in policy and their successes, failures, and repurcussions on the economy.

1.3.3. **Chapter Three** outlines the present industrial structure of the country with an introductory analysis of the economic situation, emphasising the features of public finance, terms of trade and balance of payments. Industrialisation is only one aspect of development and it is pertinent therefore to examine the state of the whole economy with regard to the availability of finance. For, the constraints imposed in the latter would automatically have resultant effects on industry and particularly on the problems dealt with in this study. With this background an attempt is made to outline the dimensions of the present structure and the place of the small scale sector in relation to the large scale public and private sector.

1.3.4. **Chapter Four** examines another aspect of the country's development, which has a direct bearing on this study; namely, the development of her financial institutions and other forms in the credit market.

1.3.5. **Chapter Five**: This chapter deals with the composition of the three surveys. Questions are formed to fill in the gaps in existing knowledge about various aspects of accessibility to finance of this sector, which were identified in the preceding chapters and the hypotheses that were formed as a result.
I.3.6. **Chapters Six and Seven:** These chapters and those that follow form the core of this study, as the questions that arose and the hypotheses that were made, are examined and tested by field research, i.e.; questionnaire and interviews. It is presumed that at the end of part two of this study, the reader would have a general idea of the economy of Ceylon, its history, both economic and industrial, development and form of her financial institutions, their limitations and peculiarities British influence in this development, and the problems of finance of a developing country. With a background knowledge of all these factors an attempt is made to analyse the problem of finance that small and medium sized firms face in Ceylon. The subject matter for these chapters and those that follow consist of the two field surveys and a series of interviews with those connected with industry mentioned earlier. Survey one was questionnaire-interview investigation of all the financial institutions in Ceylon. The direction, form, limits and conditions of their lending are examined with reference to the constraints and other limitations discussed in parts one and two of this study. Survey two, was a questionnaire-interview investigation of a hundred selected (by stratified sample survey) small and medium sized firms in Ceylon, their present access to finance, the difficulties they face with regard to all aspects of finance. Survey three was a series of interviews that connected the two specific surveys, filling in necessary gaps, comparing the results and bringing the whole investigation of the problem into a balanced whole. Thus an attempt is made to investigate all factors that affect the central problem of availability of finance, such as form, structure, adequacy, direction, attitudes and constraints, internal as
well as external. A detailed outline of the profile of the investigation is given in chapter five.

1.3.7. **Chapters Eight and Nine** are mainly analytical. The survey findings are examined and analysed in the light of what has been discussed in the early chapters. The cause and effect of the problems identified, are analysed. Finally in the light of this investigation possible solutions to some of the problems and steps taken already to alleviate some of these are examined.

**1.4. LIMITATIONS OF THE STUDY**

1.4.1. This study has been limited due to three main factors. The first is a capacity limitation. This study outlines at a macro level a micro problem. Thus at a micro level the study is detailed, while at a macro level it could be considered only as one facet of the problem in the overall development of Ceylon. Time in terms of physical capacity in relation to work load and output, limits a single researcher in going into greater detail than attempted.

1.4.2. The other two limiting factors are interlinked. Firstly, comprehensive industrial statistics are markedly lacking especially for the small and medium firm sector. This has been partly due to the absence of size classification, even for administrative purposes and partly due to the short history of industrialisation in Ceylon. The available financial statistics on industrial lending are hardly coherent for proper analysis. The financial institutions and the banks do not keep lending statistics by firm size, but by loan size and distinction is made only between loans to the Government and private sector. Secondly, the industrial sector is inundated with form filling due to
different and varying controls of duties, import, export, and exchange controls, registration and quota systems. As a result all the statistical returns of the sector are directed to particular purposes.

1.4.3. Despite the partial failure to get all the financial and accounting information the survey intended to collect, it is necessary to state at this early stage, that it has not in any way invalidated the results obtained in this study about the problems of access to finance of small and medium sized firms. The availability of better statistics would have further strengthened the results.¹

1.5. MEASUREMENT OF SIZE

1.5.1 It is important at the outset to establish a scale of measurement of what are meant by 'small' and 'medium' sized firms or business, for purposes of establishing a frame of reference for this study. Table I shows a definition of small, medium and large business in Ceylon. The process of establishing this scale and its likely weaknesses has been outlined in Chapter Five.² Obviously, any definition of size relating to a country is a static one and could only be applied to that particular country, as the terms small, medium and large are relative terms and differ according to the industrial maturity, gross national product, physical size, economic activity, variables used in classification and various other local factors. However, if a general definition is sought for the developing countries, 'smallness' could be taken as those establishments which, (i) carry out manufacturing, processing and

¹. See Chapter Five and Appendix B

². See Chapter 5.4
servicing activities and are differentiated from other firms by a lack of specialisation in management, i.e. they are managed by the people who own them. If, to this is added the qualification that 'those firms which do not have access to the capital market for funds', then this term by and large could be applied generally to developed countries too.

I.5.2. As outlined in Chapter Five no precise meaning has been given to size factor of firms in Ceylon, to date.¹ The general understanding one obtained after a series of interviews with those who had connections with industry, i.e. planners, economists, statisticians, businessmen, financiers and lay people was, that everyone's idea of size differed according to diffused objectives of analysis and the overall outcome was one of confusion. However, recently in a paper compiled by an United Nation industrial economist on industry in Ceylon, an attempt has been made to define size of small firms for the purposes of this United Nation survey.² He observes that,

"Statistics of industries in Ceylon are not adequate for much accurate analysis of industrial structure or change. Inadequacy is specially great in respect of the small scale sector ....In Ceylon small scale industrial sector could be said to comprise the following sub-sectors or segments.

(a) Manufacturing and handicraft activities carried out in homes or backyards (excluding hand-loom weaving)
(b) Hand-loom weaving in homes, co-operative, Government or private establishments.
(c) Power-loom weaving in public, co-operative or private establishments
(d) Manufacturing activities (including industrial servicing) carried out in factory type establishments with or without the use of power
(e) Small-scale mining and mineral processing activities

1. See Chapter 5,4
2. See Bib. 62 pages 1 - 2
In developing countries it has always been difficult to stipulate limit of output, employment or investment where the small scale sector, particularly the factory sector ends, and the medium and large scale sector begins. It is thus difficult to separate 'small' from 'medium' and 'large' scale industries. However, for administrative purposes the upper limit for small scale industrial units (in Ceylon) may be thought of as Rs.100,000 worth of investment in fixed capital or Rs.5,000 of fixed capital per person employed."

I.5.3. The adequacy or the inadequacy of this definition will not be discussed here, in this paper, as this definition has been construed in order to use for the purposes of collecting data for the paper mentioned above, and Divatia himself has admitted the limitations of this study as follows, "presentation of the structure attempted here is based on scattered and fragmentary data sources and possible estimates of variables involved. It is therefore necessarily tentative and imperfect, and at best gives some idea only of the dimensions and proportions." Prominence is given to this definition here, with two purposes in mind, namely, (i) in order to establish the fact that up to now classification as to size of industry or statistics relating to industry, were markedly lacking and (ii) to make use of some of the statistics given in his paper, however tentative they are, for this study.

**TABLE I**

<table>
<thead>
<tr>
<th>Size</th>
<th>Employment (Persons)</th>
<th>Net Assets/Capital Employed</th>
<th>Value of output/Turnover/Value of Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>Under 100</td>
<td>Under 150</td>
<td>Under 300</td>
</tr>
<tr>
<td>Medium</td>
<td>100 to 250</td>
<td>150 to 500</td>
<td>300 to 1,000</td>
</tr>
<tr>
<td>Large</td>
<td>Over 250</td>
<td>Over 500</td>
<td>Over 1,000</td>
</tr>
</tbody>
</table>
I.6. IMPORTANCE OF SMALL BUSINESS

1.6.1. Many attempts have been made in developed countries to pinpoint the problems of small firms and foster their growth. Undoubtedly, bringing the problems of small firms out into the open and constructive efforts made to help them in these countries, run counter to the belief in many quarters, that small firms have outlived their usefulness, on the other hand it strengthens the belief that small firms form an important facet of any industrial structure.

1.6.2. In the United Kingdom, for example, both the Macmillan Committee Report and the Radcliffe Committee Report gave considerable emphasis to the lot of the small firm in British industry. The latter Report emphasized the importance of small business by concluding that,

It is some measure of the importance of private firms in British industry that of the total gross profit earned in manufacturing, building, and distribution, less than two-third are taken by quoted public companies, while the remaining third is earned by private and unquoted public companies.

The Bolton Committee, whose Report has been recently published (Nov. 1971) endorsed this view further.

We had no doubt from the first that the future prosperity of the small firm sector was an important matter; its sheer size and ubiquity are sufficient to ensure that. There are at least one and a quarter million small firms in the United Kingdom; they give employment to some six million people or 25 per cent of the employed population, and are responsible for nearly 20 per cent of the gross national product. Still more important, than its quantitative contribution is the fact that small firms play a vital role in the preservation of a competitive private enterprise system. We believe that the small firm is in fact an essential medium through which dynamic change in the form of new entrants to business, new industries and new challenges to established market leaders, can permeate the economy. We therefore believe that in the absence of an active and vital small firm sector, the economy would slowly ossify and decay.

1. Bib. 141, Section 233

2. Bib. 22, Pages XVIII - XIX
I.6.3 Britains' recognition of the need to help small and medium sized private industry is seen in the establishment of the Industrial Commercial Financial Corporation (ICFC) in 1945. This organization was set up especially to cater to the financial needs of the small firm sector, i.e. to satisfy the needs for long term capital of small and medium sized companies in amounts too small for a public issue.

Initially the share capital of this Institution was contributed by the Bank of England and the Commercial Banks. Its business consists both in making loans on fixed terms for long periods and subscribing to share capital of business, especially at the early stages of a firm's life. Its activities are meant to supplement and not to supersede the activities of other lenders and financial institutions.

I.6.4 In the United States of America too, due recognition has been given to the need for fostering the growth of small business. In 1953 an institution called the Small Business Administration was set up to help small firms. It was empowered to render financial assistance to small firms, to obtain for them a fair share of Government finance and to help in solving management and technical problems. The small Business Act of 1953, which created this institution underlines the significant fact that even in a developed country like the United States of America, where big business has pride of place, considerable Government attention is given to the problems of small firms. Since this Act, many high powered committees have investigated the financial problems of small firms, among which are the U.S.Congress sittings of 1957 and the Committee on banking and currency of 1958.

I.6.5 In Canada, the Industrial Development Bank was set up by an Act of Parliament in 1944 to provide a regular source of medium and long term financing for small and medium sized business, which were unable to raise funds in the securities market. It was particularly concerned with the
financing problems of smaller business enterprises. The preamble to the Industrial Development Bank Act effectively emphasized the importance of small business as follows:

"Whereas it is desirable to establish an Industrial Development Bank to promote the economic welfare of Canada by increasing the effectiveness of monetary action through ensuring the availability of credit to industrial enterprises which may reasonably be expected to prove successful if a high level of national income and employment is maintained, by supplementing the activities of other lenders and providing capital assistance to industry with particular consideration to the financing problems of small enterprise."

I.6.6 In the Asian Region, Japan recognized the importance of fostering the growth of small industry, long before she reached the stage of rapid economic growth and industrial maturity she has today. She has a vast array of institutions helping and assisting the small scale business sector, and the modernization of small enterprises is being regarded as one of the aims in the political schedule, whereby financing is made available to small enterprises to be modernized in the forms, such as, subsidies, bounties, supporting money etc. The array of financial institutions established to aid small firms show the formidable role the Government plays, and the importance the Government places, in the upliftment of this sector to bolster further, her expanding economy. The Government sponsored financial institutions are, (i) Smaller Enterprise Credit Corporations, (ii) Smaller Enterprises Finance Corporations, (iii) Smaller Enterprises Central Finance Associations, (iv) Smaller Enterprises Loan Corporation (v) Peoples' Finance Corporation, (vi) Smaller Enterprises Credit Guarantee Corporation (vii) The Sho-ko Chukin Bank, (viii) The Small Business Credit Insurance Corporation, (ix) The Central Bank for Commercial and Industrial Corporation. Despite all these institutions, the need for finance of small firms in Japan is so great due to rapid industrial expansion that banks were still providing 48.2 per cent of outside finance of small industry in 1969.

1. Industrial Development Bank Act 1944, Ottawa, Canada.
1.6.7 These are examples of four developed countries which have recognized the need to assist the small scale industrial sector in their respective countries. Space and time limits this study from emphasizing the importance given to the problems of small firms both in developed and developing countries. It is apparent that more countries are realizing that there is a case for providing special services to small firms, no matter what level of sophistication or development the country's economy has reached.

1.6.8 The point emphasized here is that small firms play and will play in the future an important part in the process of industrialisation even in developed countries, and this is especially applicable to developing countries, even more so than in the case of the former. A question uppermost in one's mind, when discussing the role of small and medium sized firms in any economy is how they survive despite the limits imposed on them on the financial and competitive fields. The answer cannot be found in one good reason, but it is a juxtaposition of many reasons. A few of these which are prominent by their bearing on this question are given below:

(i) There are many economic activities, which are not suited to large scale enterprise, because there are not many technical economies of scale in certain trades, while others do not depend on high rates of output to justify its costs.

(ii) Big firms frequently tolerate small competitors who may take only an insignificant part of the market, while many small firms usually follow the leadership of the big firms and avoid making trouble.

(iii) External economies which accrue to an economy or to a particular area as a result of large scale operation. These may take the form of specialised ancillary trades which the big firms may not find worthwhile to undertake themselves as the demand would not justify the large scale production.

(iv) A growing economy also provides opportunities for small firms, as
population grows, income is generated, which in turn increases demand for goods and services.

(v) Unemployment is also an important cause, as people who are unemployed or become unemployed may set up their own firms in an attempt to survive.

(vi) The desire of independence is also a major factor and this explains why so many small firms set up and continue in business despite the fact that their earnings would sometimes fall below that amount they would earn if employed under someone else.

(vii) Finally many firms which are large corporate organizations today did start small and there are ample evidence of this in every country.

Bates, discussing the reasons for the existence of small firms observed that:

"A substantial part of the explanation of the continued existence of small firms is therefore, that they do a different job from the big firms. They are different not only quantitatively in the numbers of employees, capital employed, volume of sales etc., but also qualitatively in the composition of output, the things they make, the markets in which they sell and so on. And to the extent to which this is so, they will continue to exist, to set up and make a living alongside the big firms. And in doing so they will continue to play a vital role in the functioning of trade and commerce." I

The foregoing arguments for the existence of small industry can be applicable to any country.

1.6.9 In the next section of this chapter, an attempt is made to emphasize why the encouragement of small industry is particularly applicable to developing countries, especially those where the economy is moving from an agricultural base to that of a dual base, i.e. both agriculture and industry forming the economic base. This in no way belittles the role of large industries, some of which are necessary to take advantage of the technical economies of scale and for a balanced economic growth, but to emphasize that small industries have a dynamic role to play in infant industrialization, as a vehicle of growth of the economy. From henceforth our terms

I. See Bib.15, Page 9
of reference will be confined to Ceylon in particular.

1.7. CASE FOR SMALL AND MEDIUM SIZED FIRMS

1.7.1 In Ceylon today small and medium sized firms are the predominant form of industrial organization. This predominance is more a result of combination of historical, social and geographical factors than any 'spin-off' from the economic policy of successive Governments or as a result of a direct policy of encouragement of this sector. There are strong reasons why a positive policy of fostering small and medium sized industry is an urgent necessity in Ceylon. The case for such a policy is made on the grounds of limitations imposed by major factors which inhibit enterprises in the form seen in industrialised countries being successful under these structural limitations found in these new nations.

1.7.2 It has been a common characteristic of many newly formed independent countries, that great many of them attempted to solve the problems of infant industrialisation by the creation of new and large organizations equipped and staffed from scratch as 'the' solution to underdevelopment. This has partly being the policy of successive Governments in Ceylon too. This policy, has been, and, is followed despite the realisation that a type of organisation which has evolved in one society cannot be transplanted without major alterations in another, with different socio-economic standards, skills, attitudes and motivations, to run efficiently and smoothly. Results from newly independent countries in the process of industrialisation show this to be a bitter truth. However, despite the evidence of failure of a country trying to adopt this method, many countries follow the same path in setting up large scale industries. The reasons one could assign for this recurrent feature are as follows:—

(a) 'We are all right Jack' attitude .. the idea that the failure of modern

1. See Chapter 3
large scale industrial unit in one country is due to certain localized characteristics and conditions pertaining to that country in particular, which is supposedly assumed not to prevail in the other.

(b) 'Cure for all ills' attitude ... political and social considerations feature largely here, such as, (i) political promises made on the campaigning field without much forethought, as regards the solution of unemployment, guaranteeing everyone a living wage etc. (ii) to nurture the idea of self-sufficiency (iii) to 'jump the queue' in the process of development, such as 'overnight' transfer of a feudal agricultural economy to a modern industrial nation state.

(c) 'Let's get the facts from the experts' attitude ... this arises due to the urgency with which the new administrators seek to solve all the problems. As a result a surfeit of planners and advisers are invited to a country. The experts and consultants themselves cannot be blamed, the point at issue is whether it is advisable to rush to obtain expert help for every conceived aspect of development, without first concentrating on basic planning such as the direction of development, the present limitations by way of resources, manpower, and education in achieving these goals. Once this is done, it would not be difficult to examine the pool of expertise available in one's own country first, and secondly obtain the services of outside advice, in those fields where local knowledge is insufficient or unavailable.

1.7.3 Most experts or planners come from developed countries, who have experienced in their lifetime, only that facet of industry (or any other discipline) where the 'incubation' and 'hatching' period is past history and industry is in the process of maturity or 'matured' in static terms. They do not see (possibly it is impossible to see) various interactions that are prevalent in a new country, firstly due to the period of survey or
study being short and secondly, due to most 'facts' and figures that they
do not obtain themselves, are obtained as second-hand information from their
local counterparts. Added to this, statistics and data are scarce for proper
analysis. Thus the 'IF's' of any expert report are so many that these 'if's'
cannot be fitted neatly into a preconceived idea of how to develop the country's
industry (or the economy) under these varying interactions. Thus many
conditions are assumed and the much maligned 'ceteris paribus' condition is
used in the final deductions and recommendations.

1.7.4 The ultimate result of expert advise has been in many
instances more chaos than before. For, as the 'ceteris paribus' conditions do
not remain true, the local planners with perhaps all good intentions alter
the plan to suit the real existing conditions. The overall effort is a
shattering of the preconceived development model of the experts; and there is
more confusion added to programmes already begun on the lines of the experts'
recommendations, a hasty 'paper work' alternative plan is adopted and the
result is chaotic to say the least.

1.7.5 The application of the above line of argument, is general
to many developing countries. The point to be emphasized is, that in Ceylon
a long term continuing policy for development and overall encouragement to
expand the existing industrial nucleus had been markedly lacking at the early
stages of industrial development. Even today, proper emphasis is not given
to this factor. Thus a case is made in this section for infant industriali-
sation to be tackled by an intensive programme of small scale viable industries,
taking into consideration the limitations of the economy. This policy should
be a continuous one, disregarding which political party forms the Government.

1.7.6 The limitations referred to in section 1.7.1, can be
broadly categorized under four major economic limitations, namely, 'land',
'l Labour', 'capital' and 'knowhow'. Under the economic limitation 'land', one
could include both raw material and market limitations. The country is mainly agricultural, although its industrial raw materials are unmapped rough estimates have shown that major industrial raw materials, such as, iron-ore, coal, oil, copper, zinc etc., are not available in large quantities, for economic exploitation. Further those deposits that are found, are scattered over a large area which excludes large scale exploitation. It is true that this argument alone is not sufficient to dismiss large scale industrialization, as Japan despite the lack of major industrial raw materials have shown that it could still circumvent this limitation. But, this limitation in combination with others discussed below, strengthens the belief that at the initial stage of the country's industrialisation a vast complex of viable small firms will be better suited to the country.

1.7.7 The raw material limitation mentioned above does not preclude small firms exploiting the industrial potential of the country. At the beginning there is wide scope for small units to further process and in some cases undertake final manufacture of many agricultural exports and products of other extractive industries, which are exported today in a raw or semi-processed state.¹ There is evidence that already this process is underway. Further the scattered location of some of the raw materials makes the exploitation of some of these by small units more feasible. The location² of these industrial units at raw material source would indirectly result in solving three other problems, namely (i) under-employment and unemployment in the rural areas, (ii) bringing a more economic balance to the depressed and less developed areas in the country and (iii) a greater awareness of industrialisation, and the "learning process" of industrial life and knowhow would be

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¹ Some of the exports which could be further processed, manufactured into final products, and made into by-products are, Rubber, Coconut, cocoa, spices, mineral sand, graphite, vegetable fibres and oils.

² See Table 19 in Chapter 3. At present most units are predominantly in the western province.
increased in the predominantly agricultural areas.

I.7.8 Large scale industries necessarily demand large markets. Ceylon is a small island with a land area of about 25,000 square miles with a population of about 12.5 million. The country is still predominantly agricultural and the living patterns and human demands are conditioned by the preoccupation of the greater part of the population in the daily struggle to eke out a level of life above subsistence. Further the living habits and the demands of the people are not conditioned by mass advertising of the type found in developed countries, seasonal demands are few, fashion change slowly, and there is less stereotyped habits and demands as found in developed countries. Hence the low purchasing power of the people, lack of uniformity of demands, limits the market with perhaps a few exceptions such as a few basic necessities like building materials, basic clothing and a few partly processed food-stuffs. Due to limitations such as these, large scale factories which necessarily turn out products in large quantities cannot run at capacity to realise economies of scale in most goods. On the other hand, markets may be perceived in foreign countries, but, here a differentiation has to be made between the perceived market and the real market. For, the availability of a market overseas does not necessarily guarantee that one’s products could find a ready market, without taking into consideration other factors such as tariff policies applying to that market, international quota agreements, bilateral and multilateral trade agreements, international politics, changing fashions and tastes, variable economic conditions and lastly competition from similar or alternative products from other competitors.

I.7.9 Small industries on the other hand are not necessarily curtailed by the small market at home, as their produce have a better chance of cornering small markets to suit the demand patterns at less expense. Small factories while at first meeting local demands, could at the same time make
inroads into foreign markets. It is an acceptable fact that markets are
developed over a period of years, and if this is the case, the initial probe
into the outside market, if successful and shows future promise; the small
manufacturer with perhaps continuous Government encouragement could gradually
enlarge the production capacity to meet this demand, based on continuing sales
and projected future sales. This strategy of development of the industrial
sector has many advantages, compared to the alternative of, founding industries
on perceived markets which in many instances lead to unnecessary economic
waste which Ceylon cannot afford, due to her capital limitation. Therefore
it is the basic realities of the perceived market and the available real
market situations that have to be taken into account in gearing industry for
export.

1.7.10 Labour is an important factor of production and in
comparison to developed countries, cheap labour is available in the country.
However the availability of cheap labour alone does not guarantee efficient
production nor a case for large industries. Most labour available in Ceylon
falls into the category of unskilled or semi-skilled labour. Rough estimates
show that given a constant machine/labor mix, productivity of labour is low,
in comparison to the same machine/labor mix, in developed countries. In the
case of most industrial labour, it is a case of adjustment from the more
relaxed atmosphere of peasant agriculture and living patterns of individual-
istic life where the rhythm of activity is conditioned by seasons of climate,
to that of industrial life. The pressures enforced by large factory conditions,
where there is alienation of management from the general work force, the
rigidity of the administrative structures, and spans of authority, the
pressures imposed from different directions, the slow moving vertical and
horizontal communication patterns, the meaninglessness of repetitive work
they scarcely understand, the need for interaction between different productive
units, the necessity to keep time schedules in production, the need for machine minding, upkeep and service, are all alien to them. The general standard of education of the workforce, the shortage of training programmes contribute to their ignorance about the relationships between productivity and wage scales, cost-income relationships, and the important aspect, that efficient production would benefit the whole community. All these factors cannot be imposed on the labour force 'over night', it could come only through a process of learning and correct policies, sector wise and nation wise over a period of time.

1.7.11 In this sense, considering the limitations mentioned above, small establishments could contribute a great deal to this process of learning, where interpersonal relationships and hierarchies of authority are more informal and flexible, personal contact, team spirit and the sense of belonging are closer. Further, management which in most instances are the owners of the establishment are in close contact with the process of production, while the employees in most cases are individually known to them. Thus the transition of the rural worker to urban and modern industrial life would take place in an atmosphere they would be able to understand and appreciate better, especially as the rural worker coming from his village environment is used to a great deal of comraderie and simple human relationships, which he is more likely to find in the small factory. Further it would also be easier to train on the job a small workforce which could be better supervised and nurtured with closer attention paid to the learning process of industrial life both in learning new skills and adjusting themselves in the human and the social field.

1.7.12 Capital, both external and internal is a scarce commodity in Ceylon. The need for capital resources in all sectors of the economy are enormous. The country cannot afford to waste away resources by forms of
political window-dressing and status symbols such as by experimenting on industrial ventures more on whims and fancies of pressure groups, than on basic economic and social factors, nor can it embark on industrial policies which are ill thought, and has been hastily construed. Thus overall capital limitation introduces certain limitations on the choice of industry. In this sense there are good grounds to revise industrial policy in terms of size. It is a correct premise to assume that large scale industry in most instances is synonymous with more intricate and sophisticated and more expensive machine units and techniques combined with administrative and management commensurate with them, as compared to the small unit. Perhaps it is true that they contribute to efficient production and economies of scale, but these likely advantages have to be gauged in the light of other relative factors such as markets, capital, the obvious unsophistication and the low level of skills of the workforce and the shortages at different levels, of management cadre.

I.7.13 On the other hand it has been estimated that in many developing countries under existing conditions, small firms tend to make better use of capital. I Paucity of capital at the correct time is one of the major inhibitions to industrial growth, as well as overall industrial growth. Therefore if capital has to be rationed to the industrial sector, it will perhaps be better utilized in financing a number of small ventures, than concentrating on a few large ventures, where the overall benefit to the economy as well as the success of these ventures and the economic feed back to the country is in doubt. This has many advantages, for the risk is spread over a wide number of establishments, there is more flexibility for adjustment and change with less capital waste, and more opportunity is given to management and labour to learn their skills at the 'grass root' level. Finally there

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I. See in this context Bib. I22, and also Section 3.3.13 to 3.3.16.
is: case for the limited capital to be distributed in an equitable basis to a large sector of industry with perhaps the prospects of being more remunerative in viable small firms than in perhaps a few large ventures.

I.7.14 There has also been a tendency for the large firms to be capital intensive in a country where labour is plentiful though untrained. Here again small units with more labour intensive and simple methods of manufacture could solve one of the pressing problems that face the country today, namely, unemployment. Finally, the overall cost of maintaining small machine units may be small in comparison to larger machine units due to (i) relative ease of servicing and upkeep
(ii) fewer break-downs due to the easier understanding of the machine process thereby eliminating manhandling of a simple machine in comparison to an intricate one,
(iii) the greater interest and caution shown in the case of small factories where they are owner managed, as the manager has a stake in keeping the machines and tools in good order.

I.7.15 The country intends to embark on a process of rapid industrialization with the future emphasis on export oriented industries. The large state factories are destined to play a major role in this expansion. In some spheres of activity there is a case for large scale industries especially in the case of some extractive and processing industries (see section I.7.19). It is perhaps doubtful whether the same reasoning is applicable in case of all large state factories that are in existant and those that are planned. If external markets are to be found in the future, the finished goods have to be at a level acceptable to the market. It is an accepted fact that in developed countries the productive process as well as the finished product is constantly being streamlined to meet the demand

I. See Bib.63
created by rising income levels, better living conditions, differing tastes and the inter-action of advertising to create new demands. Thus the demand pattern is constantly changing due to different patterns created in a dynamic world. The process of establishing large industries based on the available demand patterns leads to the danger of machinery and technology acquired at considerable cost being outdated long before their economic and machine life expires, thus tying down the factory to outdated technology and finished product in terms of the foreign market. Although technically new machinery could replace the old, the initial costs involved plus the foreign exchange limitations exclude this possibility. The overall result would be that this particular industry would lag behind those of its competitors in other countries and in many instances the very same country that sold the techniques and machinery would be outspcing Ceylon in the market. There are a number of instances where advanced industrialized countries have got rid of their obsolete machines, spares and knowhow in this manner, necessarily binding the recipient country to an outdated production process and technology. This danger could be minimised by foreign participation as well as by starting small and gaining experience, knowhow, and techniques as one goes alone, whereby the risk element of being tied down incurring wasteful expenditures will be minimised.

1.7.16 The country is deficient in terms of knowhow and management techniques at different levels, while rationalization and research and development techniques, especially in the case of large state ventures are prominent by their absence. However, the potential for the development of these techniques are present, this is especially seen in the entrepreneur class of the small and medium sized sectors. Despite the prominence given to agriculture and large state run industries there have existed side by side indigenous cottage crafts and skills. Added to this class there has also
developed over the past two decades a class of entrepreneur characterized by a combination of resolution, tenacity, enterprise and resource to exist despite the 'foster-child' treatment they have received at the hands of the successive Governments, during the last two decades. They have gained an insight into business, establishing relationships with customers and their tastes, especially in those fields which can be called the basic necessities, namely, food, clothing, household goods and building equipment. The majority of them have had no access to business schools, management courses and in some cases adequate schooling. Most of them up to 1948 had no opportunity at all to set up in business, as Ceylon was a colony and part of the British Empire and her economy was an appendage to the mother country, nor were they financially viable at the beginning of their careers as entrepreneurs, as a result of heritage. Most of them would have had in varying degrees a mixture of initiative, imagination and drive, decision making in face of uncertainty, incentiviveness and more than a fair share of risk acceptance. To summarize, the majority of those interviewed during the field survey seemed to belong to that tenacious breed of men with a flair for adventure and challenge forming the backbone of any developed country's industrial history.

1.7.17 Finally taking into consideration all what have been said in the preceding pages, it could be said that entrepreneurs of small units, in most cases managing their own businesses have more interest, and a stake to look after machines, labour and capital. For, they depend on their business for their livelihood and success in life, apart from the sacrifices they have made initially in starting the firm and investing their own savings and capital in the business. On the other hand, management (in a number of instances) in state owned large corporations, were, and are appointed due to political and other considerations, than for their business acumen or
efficiency, whose period of tenure varies with the time the political party or sponsors whom they owe allegiance to, stays in office, thus responsibility and commitment are at a minimum. This is even more so when appointed management do not have a stake in the venture, in terms of capital and effort and their policies and mis-management are not accountable in the same way as appointed management do to the shareholders in private corporate bodies. Following from these observations it could be stated that smaller units can be managed more efficiently, in terms of shortage of trained and experienced management and labour, while the absence of cumbersome administrative and financial regulations in small establishments as compared to large state corporations, would facilitate the introduction of better administrative, financial and accounting techniques and controlling mechanisms to make the best use of the scarce capital available.

1.7.18 The case for encouragement of small firms in a developing country in no way belittles the role of some large nationalized state industries in planned economic development. The emphasis to be made here is that small firms have a vital role to play in the forward and backward linkage within this industrial structure.

1.7.19 Large scale industries under state control have been advocated for a number of reasons. Some of the underlying economic reasons are,

(a) inadequate scale of private enterprise
(b) the need to reconstruct the basic industries in a manner which private enterprise would not or could not undertake
(c) doubt whether private enterprise could raise the vast capital sums needed to purchase and instal the modern equipment the basic industries required.

There were also social, administrative and ideological reasons
behind the creation of these large state corporations. One of the social reasons is the desire to control in the interests of public welfare, the arbitrary economic power of the monopolists and near monopolists, and the belief that the advantages of a beneficial mechanism created by the State should accrue to the whole community. Administratively it was thought that it would be easier for a Government to harness the development potential of the country by setting up large industries which could act as growth points for development for specific industries. Ideologically the framers did not see the new organizations merely as correcting particular weaknesses, supplementing particular deficiencies or improving particular economic relationships within an accepted and fundamentally unchanged economic system, they saw it as a means to the transformation of the system, a step, on the road to a new social order. Finally the idea that embodied most or all of these reasons was that state ownership and control were essential to national planning, which in turn was the only way to ensure the best use of the country's resources from the view point of either of maximum welfare or of full employment.

1.7.20 All these reasons have partial validity, but when one or more of these are given prominence at the expense of the others, the job is likely to be ill done. The advantages of large scale organizations though genuine enough, can be exaggerated and too little attention paid to factors such as the size of the working unit, productive unit, commercial unit, viability, need for vertical and horizontal expansion, human and physiological factors influencing management and workforce, all of which sets limits to the size of the fully efficient and effective economic unit.

1.7.21 To summarize, while it is necessary to think in terms of Government intervention in setting up large corporations as infra-structure essential to the economic well being and development of the country at the
infant stage of industrialization, it is of vital importance to see that this motive alone would not supersede or eliminate the role the small and medium sized firms can play in the context of overall economic development and planning. In concluding this section one cannot do better than quote from a paper presented to the United Nation Conference on the application of Science and Technology for the benefit of less Developed Countries, as far back as 1962. In this paper Hoselitz argued as follows:

"It is quite customary when we think of industrial development in the new nations, to evoke a picture of a large scale industrial plant, e.g. in steel or cement production. But the existing markets, demand patterns and conditions of comparative advantage in developing countries are such as to make the establishment of small plants, mainly producing light consumer goods, most attractive. Hence industrialisation must be thought of in the next two or three decades, not in terms of new Pittsbur^hss or Birmingham's in the developing nations of Asia and Africa, but rather as a process in which small capital is allocated in various industrial or commercial fields. The reason for this stems from the very different relative supply of labour and capital, and particularly from the fact that capital to be invested, on a long term basis is in very short supply and often available through the ordinary channels. In other words, banks will ration credit to small entrepreneurs who wish to grow rapidly. Many enterprises may have to begin with meagre capital funds and grow only to the extent to which they can reinvest their profits. In the industrial field, the certainty that small and medium scale enterprise in the developing countries will persist must be taken into account. In the light of Western Europe's historical experience entrepreneurs on the small and medium scale will have important roles for several decades."

In the light of this above observation and what have been described in the preceding pages, the nucleus for basic industrialization is present in Ceylon, what is wanting is a primary decision of the direction of development of this sector. There are a number of alternatives available, namely, emphasis on large scale industry, emphasis on small scale industry or a combination of both. The experience so far in Ceylon is that Government emphasis has been placed on alternative one (I). This study favours the third alternative, as a more sensible approach, keeping in mind the overall problem of development found in developing countries.

Further it is more relevant and feasible to guide the available resources

I. B. Hoselitz - In paper presented to the U.N. Conference on the application of science and technology to the benefit of the less developed areas.
and talents in a gradual process whereby time is given for the 'learning process' to take root and continuity of the process of industrial sophistication is established, rather than an attempt being made to supplant a system borrowed directly from another country to an unprepared business and industrial structure.

I.8. SOURCES OF FINANCE

I.8.1 It has been established beyond doubt, from the experience of developed as well as developing countries, that small and medium sized firms face many problems as opposed to large firms. Many of these problems are similar whatever the stage of development of the country, while others are localised problems depending on the socio-economic set up, history of industrialisation, and various other factors. No attempt will be made to analyse all the problems, they are too numerous to include in a study of this nature. Among the foremost problems firms face, one of the most important is the problem of access to finance. In other words finding funds (a) for the establishment of the firm, (b) for expansion at the opportune time, (c) in the right quantities, (d) of the right type and conditions (e) and at various stages of development. Most other problems which firms face such as inability to employ top management and train those in management, lack of skills, shortage of raw materials, lack of sales, inferior technology and products, are in a way interlinked with the central problem of finance. An attempt will be made to point these out, whenever this has a relevance to the central problem of finance. Many other factors which are not directly linked to finance but have in course of time contributed to the shortage of finance, firms experience in the present context as well as their relevance in a future context will be dealt with at relevant times. In this sense one could

I. See Bib.15, Page II
assume that money is an entity around which all business activity revolves.

1.8.2 Assuming that finance is the core of the business, in the following pages, an outline of all sources of finance available to small and medium sized firms will be made. Firms need finance for various purposes, of which the most important are for equity capital, working capital to finance the day to day working of the firm, long term capital for investment and expansion and short term finance to meet the unexpected exigencies of a normal business. Due to economic, social and other factors, a small firm could not depend upon the personal savings of the proprietor, partners or shareholders alone to meet these needs. Thus one could conclude that in general the fact of unavailability of finance apart from other factors at the crucial time has been one of the main causes of failure of a great number of small firms every year and the stagnation of many others.

**Long Term Finance - Equity Capital**

1.8.3 In general there is no readily accessible channel corresponding to the new issue market through which the small industrialist could raise long term funds. This of course is an inherent factor of smallness.

1.8.4 **Personal Savings**: Most small and medium sized firms get their initial capital from their own personal savings, immediate family, friends and relatives, but the capital employed this way cannot possibly be great. Thus in many an instance they look for outside capital in combination with their personal capital to start the business.

1.8.5 **Private backers**: Another source of equity capital is to make an outside investor interested in buying into a business. However, for an outside investor to come in, the investment in the business should promise a greater return than other alternatives such as marketable
securities or real estate. In general investors prefer equity investment in going concerns of long standing, of medium and large size business. An equity investor in a small business loses liquidity compared with an investor in listed securities. It is also true that in many instances the time horizon of profits of the promoter of the business and the potential investor are not compatible. External investors normally are not willing to put too distant time horizons on profits while the promoters of many small business aspire to create for themselves a good long run source of income in not pressing for short run profits. On the other hand promoters of small business are rather reluctant to involve unknown persons in their ventures due to factors such as unwanted interference. This is specially true in countries where unemployment is great, as shareholders or partners attempt to create jobs and employ relatives and family members even if the persons concerned do not come up to the standard of the job in question.

1.8.6 Long term Financial Institutions : Besides the above alternatives the only other avenue for equity capital is to turn to financial institutions. In this category commercial banks developed on British banking traditions do not on principle lend directly for equity or venture capital purposes. In most countries both developed and developing, long term credit institutions have been set up to meet the demand for long term credit from industry. In Ceylon at present two institutions exist to help industry with their financial requirements, namely, The Agricultural and Industrial Credit Corporation (AICC) and the Development Finance Corporation of Ceylon (DFCC). Both these institutions have been vested with powers in their Ordinances to help nurse viable new industries by contributing to their equity. It would suffice here to say that not much has emerged in this
sphere from these two organisations since their inception.1

Long Term Finance - other than for equity

I.8.7 (a) Personal savings: This again is an unquantifiable source of funds of small firms. In many instances if funds were available from this source, they are more often than not dried up, as funds from this source is usually employed at the commencement of the business. Another source is loans from directors and relatives, but taking into account the long term employment of such funds, this source is not always dependable.

I.8.8 (b) Company Reserves: This consists of the retained earnings of the past profits of the firm. However, retaining profits of the firm for reinvestment depend also on the initial problem of availability of other sources of finance. Besides, real profits in small firms are small. Although many tend to argue that small firms can retain greater part of their profits, in real life this is not always true. Research studies2 have shown, that in many small firms the average profits are not very large in comparison to a salary earned by a person employed in a large business. Profits are also used for the expenses of the businessmen and their families. While in other circumstances profits are used to raise their standard of living to the original level, where considerable sacrifices were made initially to start the business or to raise their standard of living to a higher bracket altogether. Finally given that firms are able to retain a certain amount of profit, this reserve is further depleted by income tax, import duties and high rates of company taxation.

I.8.9 (c) Private Backers: The reasons discussed earlier about private backers are relevant here, i.e. social factors such as the reluctance of most family and private firms to take in outside partners or term  

1. See Chapter 6, Sections 6.12 and 6.13  
2. See Bib. 144
loans from them, due to the probable levels of interference they envisage such as interference regarding the overall policy and administration of the firm, day to day running of the firm, and interference as regards the intake of new employees.

1.8.10 (d) Debentures: Debentures are of two main types, i.e. mortgage debentures and debentures with a floating charge. However, a mortgage debenture is secured by the mortgage of a particular fixed property (land or buildings) owned by the company. Small firms in many instances do not wish to commit their property in this way, because if the company is unable to meet its financial obligations and is forced into liquidation, the proceeds of the sale of these have to be utilised first to repay the debenture secured on them. Debentures with a floating charge on the other hand are not attached to any particular asset of the company. However, for a company to be eligible to issue debentures it should expect to earn a fairly stable rate of profit so that its internal rate of return at its lowest level covers debenture interest. It must also possess assets of such a nature that would retain much of their value even if the company failed.

1.8.11 Thus in the case of the former, i.e. mortgage debentures, whilst it is a safe form of investment for the lender, the small businessmen in some instances would be reluctant to tie up all their possessions into one venture, a form of 'putting all your eggs in one basket' exercise. Furthermore, many small businesses would not have fixed assets such as land and buildings to offer as security. While many businesses would not be able to afford the latter, i.e. debentures with a floating charge, as the cost of capital to them would be more or less the same as their rate of return. In general the firms that can raise finance through debentures (both types) are those well established firms having, for example, property,
marketable securities and those having a good record of good management and steady profits over a number of years. These two qualifications would naturally leave out a great number of small firms, especially those where the risk factor is great. Other avenues of long term finance both for equity and other purposes which are available in developed countries, such as mortgage finance, sale and lease back finance, finance from investment trusts, insurance companies, pension and provident funds, are not yet developed in Ceylon.

Short and Medium Term Finance

1.8.12 Short term credit needs of small firms are better met than are their needs for long term credit or for equity capital. Two important sources of short term credit for small business, are trade credit and bank credit.

(a) Trade credit or interbusiness credit: This can take many forms such as, open book credit, trade acceptances, trust receipts, direct loans or advances between two firms. The popularity of trade credit especially among small firms is due to many reasons, such as (i) unavailability of credit from any other source (ii) the ease of obtaining trade credit as compared to bank credit or other institutional finance, (iii) the reluctance and inability to observe all or some of the stringent qualifications banks require, (iv) firms which are creditworthy but cannot adequately demonstrate this to institutional sources, due to them being new firms without an established credit record or not having kept conventional credit standards, (v) lack of adequate and proper contacts with financial institutions (vi) easier access, due to greater risk the supplier is ready to assume (vii) lesser degree of tying up the security a firm possesses, (viii) easier accessibility during tight money periods.
1.8.13 However, this form of credit would in the majority of cases be more expensive than bank and institutional credit. For example, a trade creditor may offer terms of a discount of 5 per cent for a period for which the account could run before it is finally paid up; assuming that this is three months, if the discount is allowed to lapse, the effective annual rate of interest is approximately 20 per cent. This effective rate of interest may even be higher, i.e. if the period of discount is shorter, say, 2 per cent discount on a thirty day credit, if paid within the first ten days, and the discount allowed to lapse, there is a 2 per cent penalty assessed for the use of the funds for a maximum of twenty days. This is equivalent to an annual rate of interest of approximately 36 per cent (360/20 x 2% = 36%).

1.8.14 Apart from the high cost of credit, there is also the added danger of trade credit for the small firm, in partly losing its independence as the firm becomes dependent more and more on the creditor. There have also been instances where credit has been extended to smaller firms with the ulterior motive of taking over or crushing the firm at a later stage. There is also the practice of tying up the products of the debtor firm to the creditor firm at a price decided upon by the creditor firm. If the purpose is to sell their raw material and machinery credit is limited only to these items, thus excluding finance for other purposes. The direction of credit too depends upon the policy of the creditor firm. Normally they would grant credit to those debtor firms, that give the highest return in a present or future context to the creditor firm. Lastly, there is also the factor of the unreliability of trade credit, especially in times of credit restraint policies of the Central Bank. There is ample proof that during these times many large firms demand immediate payment for goods and services sold to small firms, while those
Large firms that buy goods and services from small firms tend to postpone the payment of bills. Government Departments and State Corporations have been the biggest offenders in this sphere in Ceylon. The observation by Davenport is very apt here, namely that,

"Credit in less developed countries tend to be characterized to a lesser degree by some of the major merits inter-business credit commonly posses in industrialised countries and to a greater degree by some of the major drawbacks associated with interbusiness finance" I

1.8.15 (b) Bank credit: Bank credit for working capital purposes is one of the most popular forms of short term financing by small firms. Banks normally extend credit on an overdraft basis for periods up to six months. If the credit worthiness of the small borrower according to banking standards is sound, the bank overdraft is an extremely convenient and economical form of finance. Once an overdraft is granted and the banker is satisfied that the firm is a good customer it is rarely withdrawn. Although overdrafts are reviewed periodically, it is not uncommon that they run for a long time. The borrower pays what he owes, i.e. the amount by which the account is overdrawn at the end of each day's business. The banks raise no objections to the firm reinvesting its profits and acquiring new assets. Thus in effect an overdraft indirectly facilitates the acquisition of assets which would normally require long term capital. However, commercial bank lending to small industry is limited, due mainly to three bank characteristics, i.e. (i) sources of funds of banks (ii) traditional and conservative lending patterns, and (iii) basic orientation to lending.

1.8.16 As most bank funds come from depositors, there are certain constraints within which they lend, the most important among them being the protection of the liquidity and security of the depositors. Although the possibility exists for commercial banks to undertake term

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I. See Bib.61, Page 119
and short term financing of businesses which according to their normal patterns of lending appear risky, obligations to depositors tend to rule it out under present conditions in many developed countries. The basic orientation to financing of most commercial banks in Ceylon is towards commercial business and most financial accommodation is of short term nature, such as advances for import/export business. Conventions and practices have developed over centuries of experience in these fields.

1.8.17 Even in the case of short term accommodation their preference lies in the provision of finance to large and well established firms. This is a natural outcome, for, many large businesses are the major sources of depositors, of the banks. Thus attracting depositors, particularly large depositors, is a direct function of accommodating them and giving them priority in loan and overdraft considerations. The same mode of reasoning applies to normal commerce as the average client of the bank is a merchant, providing deposits, giving remittances and foreign export/import draft business; it is natural therefore that the banks accommodate him first. Small entrepreneurs on the other hand are usually of minor importance as depositors, as leaders of the society and as persons of influence. Further the unit cost of a small loan is greater than that of a large one, risk factor in general is greater and there has been a greater tendency for small firms to fail, especially in the early years of a business venture.

1.8.18 The overall result is that banks tend to extend finance to small firms only to the extent that funds are not required by primary customers and even this meagre accommodation is made on standard procedures of lending. Given that some banks do lend to small firms, more than others, they are further restricted by Government monetary policy, such as ceilings, on lending, credit creation (overdrafts), reserve ratios, and special deposits which in normal circumstances are first applied to the commercial banks. See Chapter 7.
Other channels of short term capital

1.8.19 Apart from the traditional channels of finance enumerated above, there are institutions which specialise in leasing and hire purchase facilities. Hire purchase is frequently used and it is an important source of funds for small firms. It is particularly useful because it is one of the ways by which a new business may acquire initial credit, allowing it a breathing space to become established and survive the 'take off' period of a new venture or business, as payment for items such as machinery can be staggered over a period of time. Therefore, it is particularly convenient in cases where machines and plants have to be bought at the inception of a business, especially when a big slice of capital will have to be tied up in expensive plant and machinery. Thus it allows the firm to economise its liquid reserves and to use other credit facilities for the purchase of materials etc. However, hire purchase in general is not a cheap source of finance and there is the danger of small firms over-financing by way of hire purchase due to its ease and convenience.

1.8.20 Hire purchase financing is not yet fully developed in Ceylon. In recent times finance companies have been mushrooming in Ceylon at a rapid pace. Today there are altogether about seventy five finance and hire purchase companies registered as limited liability companies. The majority of them are very small units, and of the seventy five only about four companies could be termed 'fairly stable and well established' and these four share the bulk of the deposits, hire purchase and loan business. However, the percentage of industrial financing of these companies is minimal. A recent Central Bank of Ceylon survey concluded,

"Almost the entirety of hire-purchase business transacted was in respect of motor vehicles and agricultural machinery; financing of industrial machinery, household durables etc., account for less than one per cent of the outstanding volume of hire purchase business"(I)

1.8.21 Another off-shoot of hire-purchase financing is equipment leasing. Leasing has many benefits in common with hire-purchase. For example budgeting is made easy because commitments are known in advance and it is also convenient in many firms to accommodate a leasing rental to a departmental budget, than it is to buy a new machine. As in hire-purchase scarce capital can be economised and used for normal operating needs. Further problems of obsolescence are minimised while indirectly the business could avoid, continuing to work its old machinery or purchase old re-conditioned machinery thereby incurring heavy maintenance costs. Cost of leasing is also tax deductible expense which is another advantage to small firms. However, in Ceylon equipment leasing is only at an experimental stage, a service carried out by the finance division of the Industrial Development Board of Ceylon.

1.9 GENERAL ASSUMPTIONS AND CHARACTERISTICS OF SMALL FIRMS

1.9.1 Enquiry into small firms in many parts of the world have established a number of general characteristics of the small scale entrepreneur and the small firm. In the case of the small entrepreneur a United States University study aptly describes these as; (a) having more than a normal endowment of energy and independence, (b) self confidence being usually high, (c) having a combination of aggressiveness and personal sensitiveness. They further went on to analyse the bearing these characteristics have on the financial policies of small firms, i.e. (i) that ethical standards tend to vary more than that of big business, (ii) that creditors may be forced to protect themselves more fully, (iii) that unconventional financial standards are more likely to prevail, and (iv) that their greater willingness to assume risk, requires those who deal with them to use different discounting factors in evaluating any deals being considered.

1.9.2 What is described above could be accepted more or less as basic characteristics of small firms. Others that can be added to this list is their desire for independence and secretiveness. These situational problems are responsible for those assumptions made about small firms such as greater risks in lending, disorderly financial management, ignorance about proper administrative control, greater possibility of failure, less viable and a host of other assumptions arising from these. All of these contribute to that elusive term called 'creditworthiness' which is considered the 'sine qua non' of credit qualification.

1.9.3 On the side of lenders these above assumptions influence to a great deal the general attitudes towards small firm lending. The general attitude of borrowers is that financial institutions give greater value to convention and conformity, while little weight is given to aggressive entrepreneurship. Thus institutions have a natural bias against lending to small firms. Other assumptions made are that most lenders are too conservative and over-cautious with their motto being to 'play safe', which in normal circumstances affect smaller firms more than large and established firms. There is also the belief that new small firms suffer the most, where institutional lending is concerned due to the 'play safe' policy coupled with the natural tendency to back or have a stake in the 'winning horse'. Therefore the more tried and accepted a firm is the more chances it has of its loan application being successful. Following from this the small firm sector has come to the conclusion that there is a general tendency for banks and other financial institutions to favour the large borrower, and a likelihood of discrimination against the small borrower especially in times of credit restriction policies of the Government.
I.9.4 The tasks of the chapters that follow are to examine these general characteristics and those that arise from them in relation to industrial finance, as well as to examine, identify, categorise, analyse, and propose solutions to the special problems of access to finance of medium and small scale firms in Ceylon.
## CHAPTER 2

**INDUSTRIAL DEVELOPMENT – THE PAST AND THE PRESENT**

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2.1 INTRODUCTION

2.1.1 Ceylon is a small island isolated to a considerable extent from the industrial influence of the modern world, by her geographical position as well as by design. From the beginning of the sixteenth century with the coming of the Portuguese it remained a colony of the European powers up to 1948; changing hands during this period from the Portuguese to the Dutch and finally to the British. Her land area is approximately twenty five thousand square miles with a population of about twelve million. The economy is dependent on three major plantation crops which bring in nearly 90 per cent of her export earnings. The export price of these products have been declining for a decade, while imports have been steadily rising. The import of her essential food-stuffs to sustain her population alone has absorbed roughly 50 per cent of the export income. The heavy dependence of the economy on three major crops, the prices of which have constantly fluctuated in the world markets have made her vulnerable to changes elsewhere, over which she has no control. Her terms of trade have been declining for the past decade at an alarming rate. As a result, the foreign exchange resources available for expansion and growth have been extremely meagre.

2.2 ECONOMIC AND INDUSTRIAL HISTORY UP TO 1948

2.2.1 Prior to 1850 Ceylon's economy was purely agricultural and extractive, consisting of small peasant agriculture concentrated largely on rice and other food-stuffs, while her chief exports were of an extractive nature, i.e. cinnamon, other spices, precious stones and natural pearls. The foundation of her present economy was laid with the introduction of

1. In 1948 Ceylon become an independent Nation State.
commercial plantations by the British. In the 1850's there was a considerable inflow of British capital to open up coffee plantations and the 'coffee economy' was born. This was the first impact of large scale western commercialism on a slow moving feudal economic structure.

2.2.2 This commercial sector was principally financed and controlled by British interests, i.e. subsidiaries of British Banks, Commercial Plantation and Agency Houses. Thus a viable commercial sector developed where capitalist business methods prevailed, while leaving the greater part of the country feudal and agricultural. Within the next twenty five years coffee plantations expanded rapidly with a resulting boom in coffee exports, which became the chief source of national income. However, the coffee economy collapsed in the 1880's due to a leaf blight and by 1882 this leaf blight had spread all over the plantations. In the resulting crisis many banks and Agency houses collapsed and went into liquidation, while many of the investors were rendered penniless. Looking back through history, this has been a blessing in disguise for the country as a whole, and a warning for the future. It was a blessing in the sense that the Government ventured to encourage the growing of tea in place of coffee, which to date is the mainstay of the economy. It was a warning perhaps, although not heeded for a considerable period of time, that it was dangerous to depend on one major crop as the sole provider of the economy. Tea was closely followed by rubber and coconut plantations. In comparison to tea and rubber plantations, coconut was mainly a Ceylonese undertaking consisting mostly of small holdings. This dual-economy pattern became the main characteristic of the country's economy, with the commercial sector and the resulting commerce in the hands of the foreigners, while the agricultural sector dealing mainly in rice and other cereal cultivation
remained in Ceylonese hands. Ceylonese enterprise in the commercial, plantation, and industrial sectors were not encouraged under colonial policy, as the objective was to keep the colonies as a source of raw material and markets for finished goods of the metropolitan country.

2.2.3 The disruption of shipping and trade and the general economic chaos as a result of the first World War, led to a strong demand in the country for the diversification of the economy to produce both agricultural and industrial goods. The outcome was the appointment of an Industrial Commission whose report was published in 1922. It was a valuable and comprehensive report outlining the economic prospects for the future, and proposed twenty-one possible industrial ventures that could be set up in the country. However, with the end of hostilities and the determined effort made by the western countries to regain lost markets, no full-hearted attempt was made to incorporate any of the recommendations of this Commission. The only valuable result was the recognition by the colonial Government of two important principles, i.e. (i) the Government to play an active part in the industrial development of the country, making her self-sufficient in men and materials, and (ii) to achieve objective one above, the need for adequate administrative machinery, scientific and technical advice. These objectives however remained in name only, and the administration lapsed into a period of inactivity as far as industrialisation was concerned. This state of administrative lethargy regarding industry continued up to the great depression of the 1930's, when the Government was once again shaken out of its complacency. The depression

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1. See Bib. 24

2. The proposed industries were, (1) Forestry and Timber, (2) Tea chests (3) Bricks and Tiles, (4) Soap, (5) Coir fibre, (6) Tapioca, (7) Coir industries, (8) Fisheries, (9) Mining, (10) Coconut, (11) Vegetable (Cont'd. next page)
underscored once more, the danger of depending on a few plantation crops for the country's export revenue and the heavy dependence on imports for most of her consumption goods.

2.2.4 Up to 1931 with the exception of the agricultural processing industries there was hardly any other manufacturing industry worthy of the name. In 1931, under the Donomoore Constitution Ceylon was given a voice in her own affairs. The new legislature realised the lopsidedness of the economy and the economic 'straight jacket' the country was in. At the same time there was pressure from many quarters for an industrial base and for diversification of the economy. The pressures exerted culminated in the appointment of a technical adviser from India, to examine and report on steps the country should take in future development. His report published in 1935 recommended strongly the establishment of a proper industrial base.

2.2.5 The salient features of the recommendations were,

(i) The establishment of a Department of Industries. This was advocated on the grounds that in the absence of a central coordinating organisation, the proposal to investigate and exploit Ceylon's resources would hardly likely to come to fruition. The functions of the proposed Department were to assist industries by placing at their disposal technical advice, to undertake pioneer and demonstration work in relation to industries in general and to guide the industrial policy of the Government.

(ii) The encouragement of cottage industries, mainly as a subsidiary

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(1) See Bib 28.
occupation for the farmers. In the words of the Report, 'the socio-economic conditions of Ceylon, which is more or less a purely agricultural country render it best suited to the improvement of cottage industries as a subsidiary occupation of the people, especially the cultivators.' The Department was also given the responsibility to familiarise and encourage the habit of cottage industries, to stave off competition from factory industries, to provide technical knowhow, and to facilitate the access to necessary funds, machines and tools.

(iii) Third and most important recommendation was an industrial survey and feasibility study. The Report emphasized the importance of this survey as an essential factor in a scheme of economic development of the resources of the country which must precede the scientific investigation of the various raw materials. Preliminary investigation was to be with special regard to, (a) the availability of various raw materials of industrial importance, both tapped and untapped, (b) the uses industrial or otherwise to which these raw materials were put, (c) existing system of industrial production both in cottage and factory works, (d) social and economic conditions of the people in relation to further exploitation of potential resources by appropriate industrial methods.

2.2.6 The concluding paragraph of the Report summarised the urgent need for a properly based national policy of development. It emphasized as follows,

"Planning has become the main spring of national activity in the economic production and distribution of the world today. On both sides of the hemisphere most of the countries are mobilising all their national resources for planned programmes of economic production. Ceylon cannot be isolated, she is inevitably caught up in the nexus of the world trade. She has always been vulnerable changes elsewhere over which she has no control. In a changing world Ceylon can no longer afford to drift without a plan. Bitter economic necessity calls for comprehensive planning of both agricultural and industrial production without delay. It is true that
agriculture has been, and perhaps will be for many years yet, the mainstay of Ceylon, but a wholesome economic balance of agricultural and industrial production is the greatest need of the moment. Agriculture and industry like the two wings of a bird are indeed essential for Ceylon in her flight to prosperity and progress" (Bib. 28, page.7)

2.2.7 The policies that were followed thereafter did not give this excellent statement of fact the weight it deserved, especially where industries were concerned. The results of this report were the setting up of a Bureau of Industries, greater awareness in the organisation of cottage industries, and the making of preliminary investigations for the establishment of factories to manufacture a series of products. However before any of these industrial units were properly established on an economic and commercial basis the second world war intervened.

2.2.8. Parallel to this industrial investigation, a Commission was appointed to investigate the existing financial institutions in Ceylon. This too was a direct result of the depression and the pressures brought on by the public for the establishment of a state bank to provide adequate facilities for the Ceylonese, to develop, agriculture, commerce and industry. At this time all the banks operating in the country were either Indian or British owned, established to meet the needs of export and import trade and that of tea and rubber plantations. They had little or no dealings with the Ceylonese and their business was mainly of short term character. One of the main avenues of credit available to the indigenous people were the 'Chettiyar' money lenders who had accommodation to banks through the medium of the 'shroff'. They lent at exorbitant rates, and more often than not, held the Ceylonese to ransom.2

1. The Ceylon Banking Commission of 1934 under Sir Sorabji Pochkanawala.
2. See Chapter 4, Section 4.2.1 and 4.2.10 to 4.2.14.
2.2.9 In 1934 the Ceylon Banking Commission recommended a state aided Ceylonese bank. The foreign commercial banks and the Chamber of Commerce who predominantly represented the foreign plantation and commercial sector opposed this proposal as they did not approve of the Government giving assistance for the encouragement and development of indigenous banking and industry in Ceylon. However, the State Council of Ceylon approved the proposal and the recommendation of the Commission was referred to a committee of London Bankers by the Secretary of State for their expert opinion. The London Committee rejected the proposal of a state aided deposit bank undertaking long term credit to agriculture and industry. The Board of Ministers in the State Council continued their fight for the Bank and on their second submission of the proposal with amendments, the London Committee though not convinced that there were sufficient grounds for a new deposit bank recognised the need for Government financial assistance for new industrial ventures and refinancing of agricultural debt. They, therefore recommended a special institution to perform these functions, a proposal which was accepted and procedures were set in motion to establish an agricultural and industrial credit institution. Subsequently, the pressures for a deposit bank bore fruit, and the Bank of Ceylon ordinance was enacted in 1938, although the terms and conditions of the charter severely restricted the proposed bank's activities.

2.2.10 Thus around 1935 for the first time a definite industrial policy pattern was emerging in the minds of the planners. Despite this new mode of thinking the indigenous entrepreneurs were at first shy of coming forward. This perhaps is not surprising as up to that date, they had been restricted from entering the field of industry and commerce, apart from the failure of the banking system to accommodate them. Thus initial
industrialisation naturally fell to the lot of the Government, while commerce fell into the hands of foreign merchants, the majority of whom were from India.

2.2.11 During the war many factories were set up through necessity rather than as a result of the culmination of proper planning. Most of these factories were geared to the war effort to substitute and supplant the existing scarcities. Plans had been drawn, though not finalised for most of these industries when war intervened. War-time conditions prevented the Department of Industries from obtaining the machinery required, resulting in shoddy factories with secondhand or makeshift machinery in dilapidated buildings. Economic location factors were not taken into account, availability of buildings determined the location of factories. Local participation was hardly forthcoming despite a statement of intent by the Minister of Industry (at the time) in the budget debate, to the effect that the aim of the Government was to create a suitable environment, and to convince the general public of the vast possibilities that lay in industry. The Government's intention was to act as a 'path blazer' and a pioneer, to create the infra-structure for industrialisation. War-time conditions, uncertainties and fears coupled with the two reasons given earlier, resulted in a very poor public response. Retrospectively, it was an ill timed invitation for public participation although the motives were good.

The end of the war, was the death knell for these industries, due firstly, to the founding limitations mentioned above, and secondly, though it was profitable to produce during war time and sell to a closed market, this

1. For example, steel rolling, leather, drugs, ceramics, glass, acetic acid, paper and cardboard, coir goods, wood work and carpentry.

2. In 1938 the Bureau of Industries was reorganised to form the Department of Industries.
condition no longer remained true. But, they continued to run these industries at heavy financial loss.

2.2.12 In 1946 the policy of the British Government with respect to her colonies was published as a white paper. Two systems of development for the colonies were envisaged, namely, (A) 'all in' planning system, i.e. a single plan for the whole community and (B) 'outline' planning system, i.e. under which the Government was to provide a certain general framework which left ample scope for private planning or individual initiative, both as regards production and consumption. The latter plan implied the existence in partnership of private initiative and state planning and control, and the preparations in which these two to be mixed being capable of variation from time to time to facilitate change and adjustment to suit changing conditions. This was a very practical proposal, but as far as Ceylon was concerned there was no desire to put this plan into action immediately. Ceylon was to concentrate on development in the immediate future in the direction of agriculture, and to build the resources for future industrial development. In the meantime an attempt was to be made to develop technical skill, gain experience of business management, factory organisation, to build up the necessary accumulation of savings. There seemed to be here, a tussle between the local interests to industrialise as quickly as possible and the foreign interests to move slowly towards this goal. Whatever the case may be, the principle was accepted that Ceylon should diversify her economy.

2.2.13 In 1946 on the eve of the dissolution of the State Council, the Executive Committee presented a review of industrial policy, the past,

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present and the future\textsuperscript{1}. This report laid down some practical lines of policy for the future. The observation was made that the war time industrial ventures were designed to play an experimental role and were intended to create an industrial environment providing a stimulus to private enterprise in the industrial field. It outlined the framework for an industrial policy to deal with the post-war situation. Industries were demarcated into a 'Basic industrial sector' under state ownership and a 'non-basic industrial sector under private ownership, with the state assisting them with technical advice, information and protection. The basic industries were to be those of strategic importance for development requiring a large capital outlay, such as iron and steel, cement, power, heavy chemicals, textiles and pharmaceuticals. Their final proposal was that the factories already established by the Government should be formed into Corporations with both Government and private capital. Thus on the eve of Ceylon's independence it would appear that a firm policy for the future was envisaged, the period of hesitation and planning wilderness was at an end, and the future of industrialisation and diversification of the economy were assured, with a place for both private and state industry. However, this was not to be; with the first flush of independence, all the safeguards, controls, and plans for the future were thrown overboard and for the next few years, policy regards industry took second place.

2.2.14 In concluding this section, it is worthwhile to underline a number of important features in the economic and industrial history of Ceylon which influenced the future of industry and economic thinking. The failure to incorporate some lessons learned, in subsequent planning, and

\textsuperscript{1} See Bib. 32.
the misapplication of others, have contributed to many of today's problems.

(a) The crisis in the 'coffee' economy showed for the first time the danger of depending on one major crop for the sustenance of the economy. This factor was ignored as proven by the crisis that followed during the first world war. It was ignored for the second time when the recommendations of the Commission of 1922, were laid aside, this was followed by the crisis during the great depression. Finally at the beginning of the second world war the economy was still unprepared. This 'Damocletian sword' has been hanging over Ceylon's economy to present times.

(b) The seeds of unbalanced growth were sown by the development of one sector, i.e. the plantation sector, at the expense of and detriment to, all other sectors.

(c) The apparent 'lapse of memory' of the administration and planners then and partly now in failing to implement a valuable recommendation made as far back as 1935, i.e. the absence to date of a full and comprehensive survey of available industrial resources both tapped and untapped.

(d) The idea so fervently put forward by the Banking Commission of 1934, i.e. the necessity of a state aided institution to undertake both short and long term credit for agriculture and industry.

(e) The creation of an indigenous bank with a 'straight jacket' charter, with restrictions on its activities some of which are still prevalent today.

(f) The crossroads of future commercial banking structure, i.e. options open to the London Committee of 1935, whether to support the further development of commercial banking in Ceylon on the British model or one that was more aligned to the continental banking system where the relationship of banks and industry were quite closely linked.
The idea that was born after the first world war, i.e. that the country should diversify the economy and that economic development should proceed on a dual base consisting of agriculture and industry for economic growth and survival.

The types of industries that were recommended in 1922 and 1938.

Finally looking back to these times a definite pattern of planning behaviour patterns has emerged. They are (a) apparent forgetfulness or short memory, (b) not learning from ones own mistakes or those of other countries, and (c) the slow moving and general lethargic attitude of problem identification, and the equally long gap between identification and the application of corrective measures.

The results of this behaviour patterns have been disastrous to planning and administration, because, a slight fault or malfunction in a conceived plan or policy or corporate body, with time, breeds around it many defence mechanisms which jeopardise the whole system. The delay, firstly in identifying and pinpointing the fault, secondly, in taking action to remedy it, may result in permanent malfunction or the death of the plan or the policy. For, this delay or in-action structurally alters the whole system, in many instances multiplying the fault to permeate the whole.

In terms of an analogy, the elimination of a fault or bias in the malfunctioning of a plan could be taken as an administration of a curative medicine to restore the body balance in a patient. If the ailment had been ignored and allowed to linger on, resulting in a major surgical operation which had become necessary to save the life of the patient, the removal of the deceased organ is not by itself necessarily sufficient to restore the sick patient to health. More often than not, it results in continuous ill health or sometimes in the death of the patient.
2.3 ECONOMIC AND INDUSTRIAL HISTORY FROM 1946 - 1956

2.3.1 The initial disequilibrium in the economy with Ceylon becoming a fully independent sovereign state is understandable. The tasks the administration faced, in the social, economic and administrative spheres were many. They were taking their first hesitant steps in full self-government for the first time. Thus they were hesitant and unsure of the future policies and programmes, and most programmes and policies followed were of an experimental nature.

2.3.2 The first step in the programme of economic development was the launching of the first 'six year plan' (1948 - 1953/54). This was designed to foster economic development through planned outlays in the public sector. The Plan was in line with the economic thinking of the times where it was felt, that only the State could afford to undertake large capital outlays in every sphere of activity. The Plan mapped out a scheme of development with the main objective of agricultural self-sufficiency with a secondary programme of industrial development in the public sector. The proposed industries were to be the exclusive preserve of the State, and no plans were made for outlays in the private sector.

2.3.3 In following the main objective of agricultural self-sufficiency, the administration took a step in the right direction. The population of Ceylon was increasing at a fast rate, this created an increased demand for food production and also resulted in rising unemployment. Ceylon imported most of her food to feed her population, thereby using a large proportion of her meagre foreign exchange earnings. Further the people had an agricultural tradition and the population was concentrated mostly in the rural areas. The plan was for the expansion of the land available for agriculture by clearing up jungles, constructing irrigation
schemes and resettlement of the peasantry in large colonization schemes. As the system of peasant agriculture was primitive in techniques, modern methods were to introduced. The colonization schemes were to have their own infra-structure as regards training centres, technical aid and construction centres, tractor stations and repair workshops, cooperative credit schemes, schools and health centres.

2.3.4 The programme for industrial development was not spelt out so specifically and in such intricate detail as that of agriculture. The main weaknesses were the absence of infra-structure planning and the lack of coordination between the Ministries under which the industries were to run as separate departments. The plans of the individual Ministries were not commensurate with one another. The individual plans themselves lacked cohesive planning, such as feasibility and viability of the proposed industries, and practical cost estimates. Added to these planning mistakes, there were factors such as the usual shortage of technical and management staff found in developing countries, the novelty of large scale planning, and the lack of appreciation of linkage effects between programmes. Finally the lack of forward planning resulted in considerable delays in delivery of plant and machinery from foreign suppliers. The outcome was a considerable waste of resources, with constant revision of scope, costs, and direction of the industries. The cement factory which commenced production in 1950 was the only large scale scheme completed during the period of the Plan. During this time local private enterprise received scant attention and no Government encouragement was given, nor was any thought given to the development of industry by way of foreign participation, know-how or capital, as one report observed, 'the very idea seemed repugnant to the policy at the time and the atmosphere hostile'.
2.3.5 Parallel to this programme of large scale factories, cottage industries were vigorously promoted but without much thought for their future capacities, limitations, marketability, quality and need of the products. Cottage industries as far as the Administration was concerned, meant handicraft goods and there was considerable political value in the encouragement of this sector as cottage industries were conceived as an arm of rural development. As one report observed, the outcome was, 'Ceylon become studded with hundreds of training centres for cottage industries. These training centres did not produce either workers or valuable products but turned out more and more teachers.'

2.3.6 In 1952 a Commission was appointed by the Government to examine the usefulness of a number of commercial undertakings run exclusively with state funds. This report recommended that state undertakings especially in the field of industry, if they were to prove commercially successful, should be transferred to corporate bodies, joint stock companies, or to cooperative organisations.

2.3.7 In the same year the Government invited a team from the International Bank for Reconstruction and Development (IBRD), to study, review and report on the economic conditions of the country. Before the observations and recommendations of the IBRD mission are outlined, it is pertinent here to summarize the main causes of the failure of the industrial policy up to that date. They could be categorized under seven broad headings.

(a) Lack of coherent and a consistent policy: As outlined in the chapter so far, there were a number of crisis points in the industrial history of the country from which the administration could have drawn valuable conclusions for the future. The first was the crisis during the first

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1. See Bib.37.
2. Sessional Paper XIX of 1953 - (Gunesekera - De Zoysa Report)
world war resulting in the appointment of the Commission of 1922, the second was the crisis during the depression of the thirties culminating in the Banking Commission of 1934 and the appointment of a technical adviser, and the third was the crisis during the second world war and the resolutions of the State Council and the Six-Year Plan. The recommendations and the resolutions after each crisis were admirable, but these plans were never really put into action. Though the plans looked good on paper, a detailed study on an objective basis was never undertaken, thereby making the plans weak and incoherent. During this period, the inactivity on adequate plan formulation and application, as far as industrialisation was concerned, leads one to conclude, that the attitude towards industry was secondary and there was an underlying lack of consistency among the planners to make this truly a viable sector. It was also felt that there was no spirit of involvement by the colonial Government to see a policy through nor the ability to whip up the enthusiasm of the general public.

(b) The policy of running all State Industries as sub-divisions of different Government Ministries and Departments: This was bound, more often than not, to lead to inefficiency, as a business could not be run in the same way as a bureaucratic Government Department. Further, civil servants even if they be good administrators need not necessarily be at the same time equally proficient in business management. In the light of this observation the recommendation of the Commission was very sensible. This recommendation, i.e. to make the present industries run as Government departments, into corporate bodies, had greater validity. For, such a conversion would ensure that, (i) its board and staff would be impelled by motives of public service and not private gain, (ii) it would be an independent body fettered neither to the

1. See above (2.3.6)
Government of the day, nor, since its capital carried no voting rights in the undertaking, to a particular group of shareholders, (iii) it could be a functionally constituted body having a clearly defined and specific objective laid down in the statute of its origin, comprising a Board and staff chosen for specific competence and not because of political alignments or civil service qualifications, (iv) finally, it could be constituted as an independent body devoid of politics, yet standing in a generally recognised relationship of mutual responsibility to Parliament through a particular Minister.

(c) Scarcity of skills: There was an acute scarcity of technical, management, corporate business, administrative, financial, and accounting skills in the country, during this period. Added to this shortage of management skills, there was on the other hand a lack of experienced and qualified workforce. This shortage of skills was specially true in the case of large scale industries, where their absence was acutely felt.

(d) Excessive mechanization: All state industries suffered from excessive mechanisation and over capitalisation. Most industries which were state ventures were highly capital intensive with very high capital to labour ratios. This perhaps is a little surprising in a country where capital was a scarce resource while labour was plentiful. The skills required to run these machines were very high, while the largely peasant labour available in the country, whose level of industrial productivity was very low were quite unused to working under even simple factory conditions.

(e) Inadequate preparation: Basic infra-structure planning and adequate feasibility studies were markedly lacking, the type of goods selected for manufacture were not according to any assessment of comparative advantage such as availability of raw materials or other factors of production, but
were often adhoc decisions. The basic requirements of resource mapping which had been recommended in 1935 was still to come.

(f) Insufficient incentive for private enterprise: There was insufficient encouragement of private enterprise, though frequent 'lip-service' was paid that the Government was making a start in setting up industries in order to create the necessary climate for private enterprise, not much incentive was forthcoming for private entrepreneurs to set up business. The Administration failed to rouse the enthusiasm of the people, i.e. worker, entrepreneur and investor alike, in the type of industries they began. It was difficult to be enthusiastic about products such as hydrogenated oils, plywood, cement, and caustic soda. Further, there was no policy to encourage foreign participation in capital and knowhow, nor any attempt to learn from the experience of other countries.

(g) Absence of other facilities: Finally, there was no parallel development of financial institutions and facilities to take the burden of industrial financing, institutions to harness and direct capital, to disseminate financial and management techniques, to distribute capital according to modern methods of financial assessment and control of projects. The Government bore the whole burden of financing these ventures and the inexperienced administration attempted at the same time to function as 'Captains' of industry. The overall result seem to have been an industrial mis-adventure. Although statistics are not available, on rough estimation there seem to have occurred a considerable wastage of public funds on these industrial ventures.

2.3.8 The Report compiled by the IBRD mission was published in 1952. It was not surprising that the first observation they made in

1. See Bib. 89.
the Report was the heavy dependence of the economy on the three major agricultural crops. It is important to remember that this very same observation was made as far back as 1922, which helps to underline the fact that thirty years after, nothing very constructive had been achieved in the diversification programmes. The IBRD Report was quite comprehensive and was constructive in its analysis of the existing situation, its weakness and the probable and the possible future. As this Report forms a landmark in the economic development of Ceylon and the observations made were relevant at the time, (while some still persist), it is important to examine in some detail its analysis of the industrial sector in Ceylon in relation to avenues of finance available to this sector.

(a) Banks and other institutions: They observed, (i) that banks had failed where industrial financing was concerned, (ii) that the Bank of Ceylon, the only Ceylonese bank at this time, which was set up primarily to help Ceylonese businessmen was still restricted in its activities due to the constraints imposed on it, at its birth, (iii) that almost all banks financed only trade and commerce, and had not provided facilities for the kind of medium term borrowing helpful to new ventures, such as advances secured on plant to be paid off over five to ten years, (iv) that development of private industry, had been retarded by inadequate facilities for medium and long term credit. The Agricultural and Industrial Credit Corporation (AICC), founded in 1943 with the dual purpose of promoting agricultural and industrial ventures, by way of loans, underwriting, share capital, etc., had failed in its nine years of existence to discharge these functions adequately. They also observed that there were no other agencies whatsoever from which a local operator could get the long term credit he needed.
(b) Private Capital: They observed that, (i) private capital alone had not done its share, while the State coming to its rescue had not helped private industry to help itself, but had tried to do the job unaided. One result of this policy had been that private capital had felt actually excluded and afraid. (ii) that Ceylonese themselves lacked the technical background for other types of production than tea, rubber and coconut, while non-Ceylonese funds found full employment in these three major plantation crops. (iii) where investment trends were concerned, preference for investment in land exceeded all other, as there was a sentimental attachment to land which made land values very high often out of proportion to their yielding capacity, (iv) the Ceylonese investor or the local capitalist if they did not buy land preferred to import merchandize or participate in speculative ventures which offered quick returns, such as speculation in rice, which they understood well and considered reasonably secure. On the other hand the Ceylonese investor felt that in modern industries, the return by way of annual dividends was somewhat meagre. They also believed that if the owners of an industry were desirous of quick returns, they could do so only by such measures as adulteration, progressive lowering of quality, inadequate plant upkeep, all of which impaired the security of the investment. The Ceylonese more often than not suspected their own countrymen of resorting to these things. As a result they seldom ventured to buy shares in a Ceylonese industrial undertaking, and if they bought any shares at all, it would be preferably those of foreign companies with established technical standards.

(c) Foreign Capital: They observed that (i) while Ceylon had been an excellent place in which to invest in the past, after independence the Government had failed to adopt a clear cut policy towards external capital, resulting in uncertainty and fear of expropriation in the minds of the outside investor.
2.3.9 Apart from these observations, the Mission recommended a number of new institutions and suggested ways and means of organising the industrial policy of the country. They were,

(a) The non-proliferation of any further large scale industry, and the desirability of giving emphasis in the future to small and medium scale industry, widely scattered and diversified to take advantage of labour and raw materials in different parts of the country.

(b) Less Governmental intervention in the sphere of industry and the encouragement and harnessing of local entrepreneurship.

(c) The establishment of a Development Corporation, with funds from the banks, the Government, and the investing public, to permit joint financing of industrial projects under competent and profitable commercial management.

(d) The encouragement of foreign capital participation by a firm statement of policy regarding investment, repatriation of profits, and the security of the investment against expropriation.

2.3.10 The IBRD Report seemed to have shaken the complacency of the Administration. This Report, coupled with the 'Gunesekera - De Zoysa' Report made a great impact on industrial policy of the Government then in office. Thus in 1954, for the first time since independence, the Government set down a firm policy for industrialisation. The main features of this new policy for industrialisation were as follows,

(a) Encouragement of foreign capital and enterprise in large scale undertakings.

(b) Promotion of Small scale enterprise.

(c) Assistance to be given to local industry both large and small.

(d) Directional control of capital movements in the country.

(e) Government participation in private enterprise.
(f) Redrafting of existing industrial legislation.

(g) Accelerated industrial research.

(h) Coordinated and systematised training facilities.

(i) Industrial standardisation.

2.3.11 The new thinking on the future of industry was embodied in the Report of the Minister of Industries. On small industries, the report stated as follows,

"After carefully studying the matter over the past year, I have come to the conclusion, that the hope of industrialisation in Ceylon lies in the promotion of small scale enterprise, by which term I mean, really decentralised factory industries, rather than enlarged cottage industries."

The extent of assistance the Government was to provide was embodied in the same report as follows,

"I want the Government to have an increasing share in guiding, controlling, and directing industries, in the best possible channels, to use our limited resources in the best possible way.... and in the initial stages of this policy of encouraging private enterprises, the Government would necessarily have to give a helping hand by way of finance, personnel, research, protection, marketing, and in many other directions."

2.3.12 This Report is also important for the fact, that this was the first time and also the last to date in which the Government defined what Small Industry were, and the difference between cottage and small industries. This differentiation was based on the international definition decided on by the International Labour Organisation (ILO), at its regional meeting in Ceylon in January 1953. This definition embodied the following observations.

(i) The characteristics of home or cottage industries were to be (a) the use of simple hand tools, (b) working generally at home, (c) occupation entirely subordinate to some other principal occupation, and (d) the product not needing any high degree of skill but mainly dexterity.

(ii) On the other hand, genuine small industries were to be, (a) those with a fair degree of mechanisation and needing some mechanical skill, (b) the

1. See Bib 37, Page 13.
proprietor generally being full time worker himself engaging labourers for wages, or on a share basis or on piece work terms, (c) the industry was to be generally the sole occupation of both the proprietor as well as the worker for at least a substantial period of the year.

2.3.13 The Government of the day accepted most of the recommendations of the IBRD mission and these were embodied in the second Six Year Plan of the country, i.e. 1954/55 to 1959/60. This was the first attempt at proper planning for development, as well as the first time that a policy statement was made, regarding the place of industry in national planning. However, even in this plan the greater emphasis was placed on agriculture. This was in accordance with the recommendations of the IBRD mission who felt that although the role of industry in the development of the economy was most important in the existing state of economic development; industrial development was to be assigned a second place in the order of priorities for allocation of resources. Therefore out of the total investment in the Plan estimated at Rs. 2,529 million, only Rs. 112 million or 4.4 percent was reserved for investment in industry. Government's share of investment in the overall total was to be Rs. 1600 million, of which, Rs. 460 million or 29 percent was allotted to agriculture while only Rs. 75 million or 4.7 percent was reserved for industry.¹

2.3.14 Despite the secondary role given to industry, the recognition of the fact that industry has a role to play in the economic development of the country was an important landmark as far as future industry was concerned. The emphasis in the future was to be on small scale industries in which the public were to be encouraged to play a more significant and

¹. See Bib. 38.
active part. In the large scale sector, foreign participation and investment were to be welcomed to collaborate with Ceylonese interests especially in fields such as fertilizer, sugar and textiles which were suitable for large scale enterprise, but for which neither the Government nor the Ceylonese investor alone had the adequate capital and technical knowhow.

2.5.15 In order to encourage private initiative both local and foreign, a number of incentives were proposed. They were as follows,

(a) Tax concessions such as exemption from income tax for the first five years, in industries which were Government sponsored and where the Government was a shareholder.

(b) Exemption of income tax of new industries for the first five years, as long as not more than five per cent dividend was declared.

(c) Adjustment of import duties by the reduction of, and in some cases total removal of, duties on goods required for the establishment, promotion and development of new industries.

(d) Protection of nascent industries by quantitative controls of imports of competitive goods, and an assurance of a market for goods by the application of the provision of the Industrial Products Act.

Apart from these specific incentives to private enterprise, the overall attitude of the Government towards private industry was explained in the Plan as follows,

"Industrialisation in the programme is based on a new policy designed to 'help the private sector to help itself'. As a first step towards the implementation of this policy the Government sponsored Corporations Act, No. 19 of 1955, has been placed in the Statute Book. This Act enables the transfer of Government enterprises to the private sector in three stages."

Thus the role of the Government as regards industry was to be that of a guardian, helper, and collaborator and not as a monopoly entrepreneur.

1. See Bib. 38, Page 238.
The Government, as guardian, was to provide protective tariffs, guarantee the market, and allow tax exemptions; as helper, it was to provide the infrastructure such as power, transport, establish financial institutions, and provide a pool of technical and scientific knowledge; and finally as collaborator, the Government intended to participate in private large scale industry, transfer some of the state industries to the private sector, and to autonomous corporations.

2.3.16 In spite of all this new motivation and the polarisation of Government thinking towards industry, the industrial sector did not see the fruition of this new policy. If reasons can be advanced for the collapse of this policy, it may be ascribed to the 'Korean boom' of 1954, the 'tea boom' of 1956, and last but the most important, i.e. the defeat of the Government which formulated this policy at the General Elections of 1956. Factors one and two gave Ceylon a period of booming prosperity, and prosperity and plenty made the country temporarily forget hardships, controls, and resolutions. Import spending rose despite the assurance of the Government of protection of nascent industries, and consumer spending on imported goods increased. Investors found it more lucrative to invest in plantation crops especially rubber, coconut and tea, which had buoyant markets. Thus during these years the rapid advancement of industry which was expected, never got off the ground, and the final curtain on the industrial policy was drawn when the change in Government resulted in a change in industrial policy as well.

2.4 ECONOMIC AND INDUSTRIAL POLICY FROM 1956 - 1965.

2.4.1 As described in the preceding pages, the planners up to 1956 laid greatest stress on agriculture, and industry was necessarily a 'step-child'. In the policy of the new Government that came to office
in 1956, equal status was laid on development of agriculture and industry. Further, as this Government professed to follow socialist ideals, public ownership of basic industries was considered to be an essential aspect of any new policy. In contrast to earlier policy, they assigned the task of providing employment to the expanding work force to the industrial sector. The industrial sector was divided into three main parts, namely,

(a) State owned and controlled basic industries: These consisted of large scale heavy industries and those considered vital to preserve the sovereignty of the country, e.g. iron and steel, cement, fertilizer, chemicals, petroleum, salt and sugar.

(b) Joint State-private enterprises: These were of equal importance, though not in the same grade as (a) above, e.g., textiles, rubber goods, ceramics, glass, leather, etc.

(c) Private enterprises: These were not considered vital to the country, but were deemed necessary to achieve a balance, e.g., processed foods, soft-drinks, confectionary, pharmaceuticals, etc.

2.4.2 The policy measures that were followed did not always keep to these classifications and they were subjected to frequent change, but the underlying policy was that the State was to be responsible for the major role in industrialisation. This was entirely a new direction to industrial policy compared to the earlier period. It was somewhat akin to the policy followed by the last State Council before independence, where the State was to play the major role in industrialisation, although the objectives for this policy then and now were different. The frame of reference for the earlier policy was for the Government to play an active role on industrialisation in the beginning as a temporary measure with the intention to encourage and bolster industrialisation. In the case of the latter policy, it was on the
premise that the Government should have control of all factors of production on socialist and welfare ideals, and this Government predominance was to be a continuous policy.

2.4.3 In 1957, in accordance with the new policy, the State Industrial Corporations Act was enacted with specific provisions for the nationalisation of any existing industry with immediate transference of ownership from private to the State, and the setting up of new industries under State ownership. Under this Act, a number of new State Corporations were established, i.e., Salt, Sugar, and Mineral Sands in 1957, Textiles in 1958, Hardboard in 1959, and Steel in 1961.

2.4.4 In 1959, the Government launched its first long term perspective Plan covering a period of ten years, i.e. 1959 - 1969. This Plan gave coverage both to the public and private sector. In drawing up the Plan, the Government sought the advice and guidance of a number of internationally known economists.¹

2.4.5 This plan emphasized the importance of industrialisation far more than any policy followed up to this date. This was in a way the culmination of the idea that had eluded the country since 1920, in terms of diversification of the economy to attain a reasonable balance. Industrialisation was considered as the cog in the machinery of development to accelerate economic growth, to release the dependence of the economy on a few plantation crops, and to solve the problems of increasing unemployment of the educated, the skilled and the unskilled workers. Kaldor and Lange in their reports, came out strongly in favour of industrialisation.²

¹ Professor Nicholas Kaldor, Professor Oscar Lange and Dr. Gunnar Myrdhal.
² See Bib. 42.
unemployment and the encouragement of industrialisation associated with large scale construction projects, rather than solving unemployment through agricultural colonisation schemes. However, he emphasized that industrialisation should be properly planned in particular fields, taking into account capacities such as raw material availability, domestic and foreign markets, capital, industrial skills, learning capacities, and prospects of comparative advantage. Lange in his report specifically sounded a warning against haphazard industrialisation. Despite this reservation, he stressed the importance of industrialisation in his report as follows:

"Industrialisation is the factor which alone has the force of carrying forward the Islands’ economy by increasing natural output, providing the necessary outlet for employment, making full use of the country’s human and natural resources and producing a rise in the standard of living of the population."

2.4.6 Thus both reports stressed industrialisation to be the 'sine qua non' of the new development policy to solve most problems in the economy. The Administration, taking all advice into consideration, made adequate financial provision in the Plan for industry. It provided for a total investment of Rs. 13,600 million, of which the industrial sector was allocated Rs. 2,714 million or about 20 per cent, while the agricultural sector was allocated Rs. 3,110 million or about 23 per cent. This increase in the share allocated to industry from a mere 4.7 per cent in the last development plan to 20 per cent in this Plan stresses the importance attached to industry for the future development of the country.

2.4.7 The initial phase of industrialisation was to be directed at two sectors, namely, the planned and the unplanned sectors. The former was to consist of all industries undertaken by the Government. This sector more or less included all industries that came under the original classifi-

1. See Bib. 42, Page 75.
fication of the basic sector and the joint State-private enterprise sector. All projects in the planned sector were to be set up within the framework of the Plan. The unplanned sector was to consist of industries which, though not essential, were considered necessary. These were to be in the hands of the private sector. However, the plans for this sector were not properly spelled out and there were no adequate estimates or any specific proposals for this sector. Whatever estimates that were available on this sector were in the nature of targets and goals. This was a general weakness of the Plan, which was later to result in a series of ad-hoc policies and mis-adventure, that did not do the cause of future industrialisation any good. The only specific aim proposed in the Plan for this sector was the creation of a favourable environment by way of fiscal policies.¹

2.4.8 As was the case of most plans in the country, especially in the case of industrialisation, this plan too was fated not to come to fruition. A number of factors intervened to prevent the implementation of the Plan, the foremost among them being the death of Prime Minister of the country by assassination and the resulting political upheaval.² Added to this, there were foreign exchange problems facing the country due to adverse balance of payments, and there were administrative and organizational changes in the machinery of planning as a consequence of the period of disorder that followed the death of the Prime Minister. Thus there was an impasse in direct plan implementation until 1961 when the first short term implementation programme covering three fiscal years, i.e. 1961/62 to 1963/64, was launched. This was a hastily constructed Plan, more as a salvage measure of the Ten Year Plan. The total investment in this Plan was to be Rs.2,296 million of which the industrial sector was allotted Rs. 561.8 or

¹. See Bib. 43.

². The Prime Minister was the chief force behind this Plan, being the Chairman of the National Planning Council.
25 per cent. However, the greater percentage of this total was allotted to State sector industries and private sector investment was largely excluded from the Plan. In the meantime ad hoc decisions and 'stop-gap' policy measures, towards industry, especially the private sector, become a familiar pattern during the next few years.

2.4.9 Private industry was by and large tied to the fluctuating fortunes of the balance of payments crises. The adverse balance of payments situation made it necessary for the Government to introduce import control measures such as licensing and quota systems on imports of consumer goods, raw materials, machinery, spare parts and other intermediate goods. Those goods that were deemed 'essential' were allowed to be imported on licenses on a quota basis, while those termed 'non-essential' were completely banned. Despite the non adoption of the long term plan, i.e. the Ten Year Plan, the Government was committed to a policy of progressive industrialisation. A scheme of assistance to Government approved 'essential' industries was introduced, and to these, fiscal and other forms of encouragement such as tax exemptions, concessionary duties on imported machinery and equipment were made available. These concessions, coupled with the part restriction and complete ban of some earlier imports created a feasible climate for local entrepreneurs to venture into Government approved import substituting industries. The new industrialists were assured of a protected market, and a certain amount of Government development loans were also made available to small industrialists. This brought in a period of confidence to would-be entrepreneurs as well as to new investors. However, the absence of forward planning, mismanagement and the lack of proper direction of policies resulted in a considerable degree of waste and mis-direction of industry in the country, although this could have been the beginning of
2.4.10 The plans for the future direction of private industry, if any, were kept very vague. Although as mentioned earlier, there was at this time a system of industrial approval by the Government, the necessity and feasibility of new ventures were not given adequate weight. Approval was granted to any industrial venture that cared to make an application to the Department of Industries, irrespective of the necessity or value in economic terms as an intermediate or final good. Industrial appraisal on meaningful economic and development criteria were markedly absent. This ambivalent policy of industrial approval was an apparent contradiction to the economic necessity of the times. Import restrictions were imposed on most previously imported goods which were considered 'non-essential', with a view to conserving scarce foreign exchange earned from the fluctuating and falling prices of the major agricultural exports. Therefore it was a time where the most stringent feasibility criteria should have been applied to new industries, both in the private sector and the State sector, especially those having large foreign exchange component in inputs. However in a number of instances approvals were given for the manufacture of the very same products, the import of which were banned due to them being considered non-essential or luxuries at the existing level of the country's development.

2.4.11 Foreign exchange has always been a scarce commodity in Ceylon, but scant thought was given to this factor, and the need for restraint was flouted with impunity in allowing import permits under the guise of helping nascent industries, for the import of new and reconditioned (and in many cases obsolete in the countries manufacturing them) machinery.

1. See below, Section 2.4.11.
Some of the machinery imported were different makes and models with different capacities and from different countries. The overall result was, unnecessary creation of excess capacities, need for wide inventories in spare parts, and need for varying skills resulting in import of technical expertise the country could ill afford. Apart from the scarcity of foreign exchange, Ceylon has always had a shortage in local investment funds both private and Government.¹ Despite this limitation, The Department of Small Industries in 1962, under a scheme of financial assistance disbursed loans without keeping to the provisions and safeguards of normal loan procedure. Direct loans as well as plant and machinery on hire purchase were made available to would-be industrialists, individual workshops, partnerships and companies without proper security or collateral. There was no adequate scrutiny of the applicants, nor their guarantors creditworthiness, nor was there a mechanism for the proper supervision of loans once they were granted. Through this scheme a total of roughly eleven and a half million rupees were disbursed; to date roughly eight million rupees are still outstanding, and the prospects of collecting at least half of this balance is bleak, due to the inadequacy of proper records of the recipients and the absence of a legal hold on them.²

2.4.12. Tax exemptions were another incentive that was offered. The basic underlying policy here was for the industrialists to feed back profits to sustain growth. There were obvious instances where some industries were set up merely to reap the benefits of these incentives which applied for the first five years of a firm’s life. Thus some firms after this exemption period was over, closed up their ventures and after the elapsing of a certain

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¹ See Chapter 3, Section 3.2.1.
² See Chapter 6, Section 6.3.
period of time floated another venture to qualify for this incentive once again. On the other hand there were those who squeezed maximum profits by paying out high dividends and let the firm stagnate thereafter. This was made easy as the 'no tax' clause applied to a firm's dividends as well. Further, profits were very high in some industries due to the closed nature of the market to foreign goods, the lack of quality and price control, the absence of, any trade description law, adequate weight and measures control, and the non application of the Food and Drugs Act. The absence of these measures tempted the industrialists to market sub-standard, adulterated, improperly weighted and falsely described goods with impunity at whatever price the market would bear.

2.4.15. The avowed objectives of policy and the direction of development were, the production of essential goods to sustain the economy, as well as with a foreign market in view, and to accelerate overall economic development. But, due to absence of controls and the apparent ease with which approval was obtained for production, entrepreneurs were attracted to those spheres of production which yielded quick and maximum profits. These were naturally the very same products, the import of which were banned as being 'non-essential' or 'luxury' items, for which products there was a ready market especially among the middle and higher income earners. Thus most goods produced, considering the economic level of the country, were not those that could be considered essential requirements at that stage of development. Most goods had high foreign exchange-input components, while in others all components were imported and merely assembled in Ceylon. There was hardly any birth of invention, attempts at adaptation of local raw materials, nor were there any considerable exports of finished goods. Inefficient industries

1. See Chapter Six, Section 6.11
flourished under an umbrella of full protection and minimum control. The linkage effects of industry envisaged by the creation of growth points by the large State owned industries were markedly absent, nor were there any forward or backward linkage among private sector industries. This was a result of all the ills of this type of industrialisation, namely, the high costs of the input producing industries, lack of precision and uniformity and general quality, failure to keep delivery dates, as well as contracted quantities. The result was that complementarity was sacrificed among industries for individual self-sufficiency at great costs and excess capacities, while others preferred to get their inputs from foreign countries who in general supplied a better product, at promised dates and at a cheaper rate.

2.4.14. This policy or the general lack of a continuous policy has retarded sound industrial growth in Ceylon, and the after effects will be felt for a long time to come, if not leaving a permanent scar in the industrial structure of the country. It has resulted in proliferation of waste in foreign exchange and local capital, lopsided growth in industry, excess capacities, unsuitable machine mixtures, fostering of non-essential wants, and a warped sense of business strategy. It has also resulted in the growth of an entrepreneur class or type of entrepreneur who could be termed 'pseudo-industrialist' compared to the genuine entrepreneur. If a comparison is made of the two types, the former is one who attempts to accumulate wealth by whatever means possible for his own selfish needs and personal consumption. His behaviour is speculative, irrational and illogical and devoid of any scruples. He is 'old' in the industrial history of every developed country. In the case of the latter, he will be one who strives to accumulate capital for use in production and expansion, is scrupulous in his business behaviour
and is representative of the spirit of capitalism peculiar to the modern world. Unfortunately the former type of industrialist flourished during these early times artfully cultivating positions of influence, tax and other business dodges such as over invoicing of imports, and under invoicing of exports, and 'black-marketing' of industrial raw materials. Although this type of entrepreneur is in the minority, their activities have overshadowed those of the genuine entrepreneur. As a result the term 'industrialist' in general, has been tainted in the eyes of the general public, the financial institutions and individual investors, and has come to be associated generally with the characteristics of the 'pseudo-industrialists'.

2.5 Economic and Industrial History 1965 and After

2.5.1. It took some time for the results of this industrial misadventure to permeate the minds of the planners. It was perhaps a little late in altering the direction and effects of this period altogether. The Government in the Budget speech of 1964/65, drew up a programme of national priorities in relation to the availability of foreign exchange and other factors of production. The aims of this policy were to be:

(a) to identify what particular industries were a necessity in the context of immediate and future development of the country.
(b) to assess the raw material availability for the above industries and the possibility of local substitution against imported raw materials.
(c) to encourage those producing 'essential goods' and to discourage those producing goods which were considered 'non-essential'.
(d) to introduce price and quality control to all locally produced goods
(e) to tie the import quota system operating for import of essential raw materials, to a qualification basis, on the 'approved' industries, achieving production targets set.
(f) to allocate foreign exchange for import of only those goods on the basis of a shortfall of essential goods, which local production could not meet.

2.5.2 These were the priorities that were to be given to industry; however, as was the case earlier, before the policies came to fruition, the Government that introduced these policies went out of office in March 1965. The new Government did not significantly change the above industrial policy, but more positive steps for industrial planning were introduced in the same year. A planning committee was set up in the Ministry of Industries with the objective of preparing a comprehensive report for industrial development in both the public and the private sector. This was followed by the reorganisation of the private sector wing of the Development Division of the Ministry of Industries. The reorganisation was envisaged as follows:

i. There was to be an Industries Planning Unit with an Advisory Council

ii. The above unit was to have three separate divisions dealing with Policy, Administration and Development.

(a) The policy unit was to be responsible for major decisions, evaluation and overall policy.

(b) The Administrative unit was to regulate, control and supervise the industrial sector

(c) The Development Division was to be responsible for provision of necessary facilities for industry and had nine sub-divisions responsible for various industrial sectors, with the functions to collect and record statistical information on production, employment, raw materials, and foreign exchange requirements.

iii. In order to complement the activities of these Divisions, an Industrial Development Board was to be set up with specific functions relating to particular needs of industry, such as technical services and training
facilities, provision of raw material and equipment on hire-purchase, an investment bureau for capital and credit, an export bureau for export market promotion, and an industrial research bureau.

2.5.3 In May 1966, the Industrial Development Board was set up incorporating the functions set out above and the existing Small Industries Service Institute (SISI) was also absorbed into this institution. When this reorganisation of the Department of Industries on the proposals set out above was complete, the Department wielded complete control over the whole industrial sector. Besides these reorganisation measures the Government made public its policy measures regarding private industry. A firm statement of policy was made regarding the role of foreign investment, and guarantees were given to approved foreign investments as regards remittance of profits and dividends, royalty payments, technical service fees, non-nationalisation or expropriation of private undertakings and non-discrimination of foreign enterprise against local enterprise. In July of the same year the Ministry of Industries defined the criteria for investment approval of industries. In the case of new industries preference was to be given to small scale industry located in rural areas, for the manufacture of light engineering products, building and construction materials and textiles, those with an export potential, and finally those that would have a linkage effect with agricultural development. All the above measures were a step in the right direction and were long overdue especially after the disruptive influences of the early years of the sixties, coupled with the crises in the shortfall of foreign exchange resulting in a ban on new industries as well as expansion of existing industries from around November 1963 to March 1968.

2.5.4 In the public sector, expansion and rationalisation policies continued despite the stricture of foreign exchange, as they were considered

1. The SISI was set up under a United Nations Technical Aid Scheme
basic and essential to the economy. In 1966 a team of World Bank experts were invited to study the status and economic usefulness of the existing industrial corporations, their present weaknesses and potential future capacities. Parallel to this study another committee was empowered to study the pricing policies, accounting, costing and profit systems of the public corporations. The greater portion of the investment in this sector took the form of expansion of capacity and continuation policies to projects already planned and underway. By 1968, there were altogether twenty three State corporations and the total investment in the State corporation sector was estimated to have increased by 109 per cent by 1969 from a figure of rupees 487 million in 1965.

2.5.5 The curtailment of private sector expansion and investment continued up to the beginning of 1968. In March of the same year the Ministry of Industries approved the setting up of one hundred and sixteen new industries of which ninety one were to be by local enterprise, while the other twenty five included foreign capital and technical collaboration.

2.5.6 In May 1968 a new scheme was introduced which carried a premium on the payments and receipts of foreign exchange, which was called the Foreign Exchange Entitlement Certificate (FEEC) scheme. The scheme was launched with the tacit approval of the International Monetary Fund which provided a standby credit of U.S.Dollars 19.5 million to back the scheme. It was in effect a selective devaluation of the Rupee and the introduction of a partial floating exchange rate. The official exchange rate applied to exports and imports of certain items and official money transfers, while a floating rate of exchange determined by the demand and supply of FEEC's applied to all other transactions. The premium rate was established on weekly tender for these certificates.¹

¹ The original floating rate established by tender was found to be impracticable and the FEEC's were made available at a rate determined by the Central Bank. This stands today at a premium of Rupees 55 for every Rupees 100 worth in foreign exchange.
2.5.7 This scheme was introduced chiefly for the encouragement of non-traditional exports, for selective liberalisation of import controls, and as a hedge against the flourishing 'black-market' in foreign currency. The importance of this scheme to industry, is seen in the context of the prevailing system prior to the introduction of this scheme. As stated earlier most industries in Ceylon were dependent on imported raw materials and other inputs for their production. This has always been a deciding factor in industrial expansion and growth, for, this dependence on imported inputs made all production runs, by and large, dependent on the availability of foreign exchange. This was especially true from 1963 onwards, as there were severe restrictions on imports of raw materials by private sector industry due to recurring balance of payments crises. The Ministry of Industries in order to regulate industrial imports and conserve foreign exchange allocated quotas and licenses depending on the importance of the industry in the national development grid. As a result no new enterprises or expansion of private industry was encouraged due to meagre quotas allowed for raw material import. Most industries were barely capable of continuous production and there were frequent stoppages while most factory and machine units were underutilized.

2.5.8 Under this scheme all exports, other than those deemed traditional, received FEEC certificates equal in face value to the FOB value of foreign/actually earned by such exports. The importers of all goods other than those specified as exempted had to surrender FEEC’s of equal value to the c.i.f price of the goods. This in effect meant that all imports coming under this category had a premium charge on them of rupees fifty five to each

1. These FEEC Certificates were freely transferable.
rupees 100 worth of the foreign exchange cost of the import. The imports were divided into two categories, i.e. Category 'A' and 'B'. The Category 'A' goods were exempted from the requirement of the surrender of these certificates, as they were considered essential to the country. This consisted of items such as foodstuffs, drugs, fertilizer, petroleum products and agricultural implements. All imports not specified in Category 'A' came under Category 'B', which required the surrender of certificates of equal face value. Category 'B' was further sub-divided into imports under 'special license' and under 'open general license'. The former consisted of goods other than industrial raw materials, while the latter were mainly industrial raw material, machinery and other production requisites and finished products. Imports of all these items were allowed only to importers and industrialists registered by the Ministry of Industries.

2.5.9 The quotas and the licensing system that applied before the introduction of the scheme were removed. In other words the industrialists were given a free hand to import all their requirements, though at a higher local duty. This scheme also made special concessions to small industrialists with a turnover of less than rupees 100,000 per annum to import their raw material at the official rate of exchange.2 The scheme had a two pronged effect on industry, as now those who were earlier satisfied in merely producing for a home market began to look for foreign markets, while on the other hand the uncertainty of the availability of raw materials, machinery and other

1. The scheme worked as follows: For example if an industry exported goods to the value of Rs.100,000, they would receive apart from the Rs.100,000 paid by the buyer, FEEC certificates to the face value of Rs.100,000 (which in real terms meant certificate with a value of Rs.55,000, as Rs.100 = Rs.55) as a bonus. They could utilize this either for import of goods or sell it as it was transferable.

2. e.g. During the time of the introduction of the scheme the official rate of exchange stood at around £1 = Rs.13.33. Thus the FEEC rate with a 55% premium would be £1 = Rs.20.97.
inputs, due to the licenses and quotas given on the availability of foreign exchange was removed.

2.5.10 In spite of the apparent interest shown by the Government in industrial expansion, greater effort was made in the field of agriculture to expand production, as this Government was committed to a promise of agricultural self-sufficiency in non-export products, in order to reduce the foreign exchange outlay on import of foodstuffs. This was a necessary measure in more than one way. Reduction of import of food-stuffs would necessarily release foreign exchange for industrial expansion, while the increase in production and employment in the rural sector, would in turn increase rural spending power as well as the increase in the propensity to save, both of which could be harnessed for industrial expansion.

2.5.11 The year 1968 should have been the final year of the Ten Year Plan if it had been implemented. Although it was never implemented in the way the planners envisaged, it provided a framework within which the planners sought to operate. The new Government that came to power in 1965 did not produce a long term development plan, but introduced yearly targets set on the budget year.

2.5.12 All these policies helped to create the necessary base for industry. The EEC scheme built up the necessary climate for expansion according to decided priorities; foreign exchange for expansion was guaranteed through a dollar loan by the World Bank to the Development Finance Corporation of Ceylon; and the 'statement of policy', on foreign investment by the Government attempted to build the necessary confidence for foreign investment and participation. The spin-off of this build up resulted in the industrial sector gearing itself for a period of activity and expansion. However, this

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1. Rice, the staple diet of 99 per cent of the population and other subsidiary foods such as milk, eggs, fish, meat, poultry, corn, wheat, potatoes, chillies and onions.
was not to last, as the Government responsible for this build up, went out of office at the General Elections of 1970. The socialist Government that came to office was more oriented towards state ownership of industry, while assigning a secondary role to the private sector. The change in policy coupled with another balance of payments crisis, pushed the private sector, in the order of priorities for development, further back. The proposed legislation of the new Government as regards ownership of private wealth and property, expropriation and nationalisation of industry, ceiling on land ownership and earnings have further depressed the investment climate in Ceylon.

2.5.13 Looking back on the history of industrialisation in Ceylon, a prominent feature has been the influence that the political philosophies of the two parties which have formed the alternative Governments since independence (1948), have had on industrial policy measures. Ceylon has been alternatively governed by two major political parties, namely, The United National Party (UNP) which can be described as right of centre, and the Sri Lanka Freedom Party (SLFP) which is left of centre, (in terms of political ideology). The former, formed the Government for the first two terms, i.e. 1948/53 and 1953/56, followed by two terms by the latter, i.e. 1956/60 and 1960/65. Once again from 1965 to 1970, the UNP formed the Government and since 1970, the SLFP in alliance with other leftist parties, calling themselves the United Left Front (ULF) are in Government. A decade ago the development policies of the two major parties were different as regards the order of priorities of development. The UNP laid greater stress on agriculture while industry played a secondary role (see section 2.3). The SLFP on the other hand, in its development strategy attempted to give similar roles, both to agriculture and industry, with agriculture having a slight edge. Since

1. According to the constitution of Ceylon a 'term of Government' is for a maximum period of five years. (Since writing this, Ceylon became a Republic in March 1972 and the term of Government has been fixed for a period of six years.)
1965 the UNP in its development strategy has elevated the role, that industry would play commensurate with agriculture, though still agriculture continues to have a slight edge over industry. Thus, basically the aims of both parties, where the aims of development are concerned in these two spheres are not very much different. The difference today is in the methodology used in attaining these goals. The main difference in the sphere of industry is that the UNP, while stressing that it is necessary for State participation and control in certain areas, believes at the same time, that private sector industry, both large and small has an important role to play, thus necessitating active co-existence of state and private enterprise. The SLFP on the other hand, is more attuned to a policy of state control and direction of industries, and adopts a 'let live' policy towards the private sector, while at the same time belittling the role this sector could play in national development.

2.5.14 Thus, while the policies followed in the development of agriculture by both parties have been very similar, and there is continuity of policy since independence the same cannot be said of industry. The main underlying theme has been a struggle to 'get off', on the process of industrialisation. In this sense it has taken nearly fifty years (twenty six years before and twenty four years after independence) to achieve a semblance of balance in policy objectives and strategy. The process of achieving this, as described in the preceding pages is dotted with waste, misdirection and miscalculation. This has been due partly to teething troubles such as inexperience resulting in a process of experimentation, indirect problems arising from the development of other sectors, limitations imposed by series of balance of payments crises, and political ideology and expedience over-riding economic rationale. Thus the overall effects have been the frequent changes and direction in policy, lack of continuity and uniformity, resulting in lop-sided development and waste in 'money', 'factor' and 'human' terms. The first two are closely linked, as
experimentation and frequent changes in direction, have resulted in unnecessary wastage of capital funds both local and foreign, by way of administrative costs, unfulfilled plans, uneconomic ventures and capital leakages. While unsuitable machine mixtures, excess capacities, high foreign exchange content of factor inputs, production of non-essential products at present level of development of the country, inferior products, have added to the waste. In 'human' terms the man-hours spent on project planning, development plans which were never implemented, the learning of inferior technology and business methods, the growth of a 'pseudo-capitalist' class, and the attitudes created in the various groups in the industrial mix (labor, entrepreneur, financial institutions, administrative bodies and the consumer) have contributed to the overall loss.

2.5.15. In recent times, despite the ideological differences in development strategy, an important development has been the similar principles shown by both factions on the strategy of future development of the small scale industrial sector. Upto now, the efforts made towards the development of this sector were half-hearted or the plans made were never put into full operation, while many plans remained in the manuscript stage and were not made operational. The broad fields of agreement in the sphere of encouragement of the small scale sector are: -

(a) Location of small scale industry in the rural areas, with a view to expanding the industrial base into all regions, to mop up unemployed labour in the different provinces, accelerate development of the depressed areas and to facilitate the use of raw materials at source.

(b) To encourage those industries that have a linkage effect with agriculture and other agro-based industries.

(c) To encourage the setting up of small industry that have a future export potential and those using greater percentage of local raw material in the product.
2.5.16 So far the methodology to be used in the encouragement of this sector to achieve these goals have been rather vague. The previous Government in office, set up the Industrial Development Board\(^1\) to facilitate this expansion, but as pointed out in Chapter Six, Section 6.7., it failed to live up to the planned expectations. As a result the present Government while limiting the role the Board was to play in this sphere, plans to pursue its policy through District Development Councils,\(^2\) centrally controlled by the State. Both schemes have not sorted out adequately one of the most important prerequisites for small industry, namely the access to finance.\(^3\)

2.6 CONCLUSION

2.6.1 In the course of this chapter, detailed analysis of the early development of industry in relation to economic development, the policies followed, the repercussions of these policies on industry, and the problems created for the future were made. It will suffice in concluding this chapter to give a brief resume of the whole period. The course of industrialisation in Ceylon is remarkable for the number of study groups, expert reports, recommendations and plans, as against the slow implementation of the findings and recommendations of these groups. The seeds of unbalanced growth were sown at an early stage in the economic history of Ceylon, due to the development of a viable commercial and plantation sector as against a slow moving illiterate rural sector. Upto 1948, the Ceylonese themselves could not take decisive measures in the future strategy of development as they had to work within the constraints of colonial policy. When independence came in 1948, it came more as a surprise and a little too suddenly so that the Ceylonese were somewhat unprepared to shoulder the burden of development by themselves. Thus nearly one and a half decades were spent on a process of experimentation and the early

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1. See Chapter 2, Section 2.5.3  
2. Ceylon is divided into sixteen districts  
3. See Chapters 4, 7 and 8
period was prominent for political expediency overriding economic rationale. The pressures of development needs in other sectors had necessarily repurcussions on the industrial sector, foremost among them being the limitations of available foreign exchange. The foreign exchange available to industry after meeting the necessary expenditures on imports of foodstuffs and other urgent necessities of the country were extremely meagre. The fact that the economy was already conditioned to a pattern of sectoral growth, resulted in the parallel growth of the financial institutions and administrative machinery in relation to the needs of this sector. Therefore the process of reorientation was necessarily slow.

2.6.2 The ineptness of successive policies resulted in unrestricted lopsided growth and the proliferation of destructive industrial practices. All plans that were fostered were dogged with constant change and the changes in Government did not give a fair opportunity for good policies to mature. This was accentuated by the lethargic attitude and the inordinate delays in plan formulation, putting them into action, the gap of problem identification and the delay in taking corrective action.

2.6.3 Since 1964, there has been a more concerted effort at planning, standardization and rationalization of policy objectives and strategy. As regards small industry an attempt was made to encourage this sector on a pre-conceived plan in 1954, but it never got off the ground. There have been intermittent policy directives towards this sector, but on the whole these seem to have caused more harm than good. Two important gaps in plan formulation during the whole of this period are, (i) the absence of a concerted effort to survey the overall industrial potential, i.e. raw material resources and manpower, and (ii) the absence to date of any comprehensive survey of financial institutions embodying both the organised and the unorganised sector, in order to examine the form, availability and limitations of this sector in relation to the overall development needs of the country, especially in the field of industry.
CHAPTER 3

THE PRESENT ECONOMY AND THE INDUSTRIAL STRUCTURE

3.1 INTRODUCTION
3.2 THE PRESENT ECONOMY
3.3 THE INDUSTRIAL COMPLEX
3.4 PROJECTIONS FOR THE FUTURE
3.1. INTRODUCTION

3.1.1 Ceylon in the 1970's as it was fifty years ago is still dependent on the earnings of three major plantation crops to bolster her economy. In chapter two the reasons for this dependence were outlined in detail. It was also seen, the 'idea' that the present 'modus operandi' of the economy should be changed as quickly as possible dawned on those governing the country as far back as the 1920's. Further, the previous chapter outlined the reasons for the failure of this 'idea', namely, diversification, to take root rapidly and the failure of the policies followed to make a deep impact on the industrial structure to the present date.

3.1.2 This chapter first outlines the present economy, the constraints imposed on it, and the dilemma the country faces as a result of this historical development and the relationship this has on the finance of industry. Secondly, the present structure of industry is outlined in the light of the present structure of the economy.

3.2. THE PRESENT ECONOMY

3.2.1 In Ceylon today, the three plantation crops bring in nearly ninety per cent of her exchange earnings. The contribution of this sector is vital to the economy in the absence of adequate quantities of major industrial raw materials such as coal and oil, minerals such as high grade iron-ore, zinc, nickel, aluminium and copper. Thus in order to build the necessary infrastructure for industry most basic raw materials as well as machinery and tools for industry, agriculture, building and construction have to be imported. Further the low level of skills and knowhow have made it necessary, the import of skills and technical knowhow. In addition, the inability of the agricultural sector to meet the requirements of Ceylon's basic necessities have resulted
### Table 2

**EXTERNAL ASSETS OF CEYLON**

<table>
<thead>
<tr>
<th>End of Period</th>
<th>Total External Assets</th>
<th>PURCHASES from I.M.F</th>
<th>Total</th>
<th>CHANGE in Total External Assets between periods</th>
</tr>
</thead>
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<td>-</td>
<td>1,132.9</td>
<td>+ 169.2</td>
</tr>
<tr>
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<td>1,216.8</td>
<td>-</td>
<td>1,216.8</td>
<td>+ 83.9</td>
</tr>
<tr>
<td>1952</td>
<td>873.8</td>
<td>-</td>
<td>873.8</td>
<td>- 343.0</td>
</tr>
<tr>
<td>1953</td>
<td>640.4</td>
<td>-</td>
<td>640.4</td>
<td>- 233.4</td>
</tr>
<tr>
<td>1954</td>
<td>944.3</td>
<td>-</td>
<td>944.3</td>
<td>+ 303.9</td>
</tr>
<tr>
<td>1955</td>
<td>1,228.8</td>
<td>-</td>
<td>1,228.8</td>
<td>+ 2284.5</td>
</tr>
<tr>
<td>1956</td>
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<td>-</td>
<td>1,275.7</td>
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</tr>
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<td>-</td>
<td>1,061.9</td>
<td>- 213.8</td>
</tr>
<tr>
<td>1958</td>
<td>933.2</td>
<td>-</td>
<td>933.2</td>
<td>- 1128.7</td>
</tr>
<tr>
<td>1959</td>
<td>734.0</td>
<td>-</td>
<td>734.0</td>
<td>- 199.2</td>
</tr>
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<td>1960</td>
<td>541.3</td>
<td>-</td>
<td>541.3</td>
<td>- 9.6</td>
</tr>
<tr>
<td>1961</td>
<td>477.9</td>
<td>53.8</td>
<td>531.7</td>
<td>- 27.8</td>
</tr>
<tr>
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<td>450.1</td>
<td>53.8</td>
<td>503.9</td>
<td>- 41.6</td>
</tr>
<tr>
<td>1963</td>
<td>462.3</td>
<td>-</td>
<td>462.3</td>
<td>- 111.3</td>
</tr>
<tr>
<td>1964</td>
<td>351.0</td>
<td>-</td>
<td>351.0</td>
<td>+ 88.9</td>
</tr>
<tr>
<td>1965</td>
<td>330.4</td>
<td>109.5</td>
<td>439.9</td>
<td>- 122.3</td>
</tr>
<tr>
<td>1966</td>
<td>173.6</td>
<td>144.0</td>
<td>317.6</td>
<td>+ 131.3</td>
</tr>
<tr>
<td>1967 (*)</td>
<td>326.7</td>
<td>122.6</td>
<td>448.9</td>
<td>+ 14.1</td>
</tr>
<tr>
<td>1968</td>
<td>249.8</td>
<td>213.2</td>
<td>463.0</td>
<td>- 85.9</td>
</tr>
<tr>
<td>1969</td>
<td>299.6</td>
<td>77.5</td>
<td>377.1</td>
<td>+ 25.5</td>
</tr>
<tr>
<td>1970</td>
<td>346.0</td>
<td>56.6</td>
<td>402.6</td>
<td>- 14.2</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon

(*) The Ceylon Rupee was devalued by 20 per cent on November, 22nd 1967. Beginning November 1967, external assets are calculated at the new rate of exchange.
in the import of foodstuffs which on an average take nearly 50 per cent of the earnings of export. Thus, the 'nemesis' of growth has been the fluctuating fortunes in the earnings of foreign exchange. At present the chief earners of foreign exchange as stated, being three major crops, this dependence has introduced to the economy a 'vicious circle' of growth. The desire for diversification is there, for which foreign exchange is necessary; to earn foreign exchange, more efforts and resources have to be diverted to increase the exports of these three crops at the expense of the other sectors by better methods of, cultivation, production, processing and marketing. However, as the sales of these goods are world market determined, whatever effort is made to increase production, export and market them, Ceylon by herself is helpless to influence the market for them nor could Ceylon be assured of safe and steady markets. Thus growth in other sectors of the economy rises or falls with the rise and fall of foreign exchange earnings from these crops, this is especially applicable to the industrial sector.

3.2.2 Since proper diversification measures were introduced in the last decade, the balance of payments difficulties have been acute. For the last twenty years, Ceylon has had only two short lived periods of prosperity, i.e. the 'rubber boom' between the years 1950 to 1951 and the 'tea boom' of 1954 to 1956. External assets apart from these two periods, have shown a declining trend. Since 1957, with the exception of 1965 Ceylon has had a deficit in her balance of payments current account. This was a result of deficit financing by successive Governments in order to acquire the necessary tools in building up the infra-structure of the country, such as transport and communication, power, health, education, agriculture and industry. Added to this the Government has had to meet

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1. See Table 2 - External Assets of Ceylon
an enormous import bill for food, every year.

3.2.3 One of the major factors behind the adverse balance of payments has been the unfavourable price trends of Ceylon's major exports. Table 3 shows this trend from 1947. For example, in 1947 Ceylon exported a volume of 287 mil. lbs. of tea, earning in return U.S.$ 170 mil., while in 1970 by exporting a volume of 459 mil. lbs., nearly 60 per cent more than the 1947 volume, the export earnings were U.S.$ 188 mil. or only about 10 per cent more than that received for 60 per cent less volume in 1947. This figure would even look more bleak if the present value of the dollar is compared to that of 1947. In the case of rubber, although it showed a better performance than tea, the trend is quite similar. For example, in 1947, a volume of 182 mil. lbs. of rubber were exported earning U.S.$ 39 mil. while in 1970, a volume of 354 mil. lbs. realised U.S.$ 73 million. Thus by increasing 95 per cent of the volume of exports the increase in export earnings were only 85 per cent more than the 1947 receipts. The case of coconuts and related products have been different due to export quantity fluctuations as a result of climatic conditions, although the export prices have been steadily rising.

3.2.4 The overall result where export earnings are concerned is that export earnings in 1970 of U.S.$ 341 mil. were lower than that of any year between 1954 and 1968. The increase in export earnings from 1947 to date (1970) has been only U.S.$ 74 mil. or 27 per cent, if the calculations are made for the last two decades (1950-1970), the increase shows even greater adversity, i.e. increase of only U.S.$ 13 mil. or 4 per cent. In concluding this section it is worthwhile to summarize the major factors that have contributed to the deteriorating balance of trade, in Ceylon.

(a) The rise in import prices for the goods Ceylon imports, combined with
### TABLE 3

**CEYLON'S MAJOR EXPORTS - VOLUMES AND EARNINGS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Volume</th>
<th>Value</th>
<th>Volume</th>
<th>Value</th>
<th>Volume</th>
<th>Value</th>
<th>Volume</th>
<th>Value</th>
<th>Total</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mn lbs</td>
<td>Rs Mn</td>
<td>$ Mn</td>
<td></td>
<td>Mn lbs</td>
<td>Rs Mn</td>
<td>$ Mn</td>
<td>Mn lbs</td>
<td>Rs Mn</td>
<td>$ Mn</td>
</tr>
<tr>
<td>1947</td>
<td>287.3</td>
<td>567</td>
<td>170.8</td>
<td></td>
<td>182.2</td>
<td>137</td>
<td>39.2</td>
<td></td>
<td>572</td>
<td>93</td>
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<tr>
<td>1948</td>
<td>296.0</td>
<td>590</td>
<td>177.7</td>
<td></td>
<td>207.3</td>
<td>143</td>
<td>43.1</td>
<td></td>
<td>970</td>
<td>153</td>
</tr>
<tr>
<td>1949</td>
<td>297.6</td>
<td>650</td>
<td>195.8</td>
<td></td>
<td>197.0</td>
<td>125</td>
<td>37.7</td>
<td></td>
<td>940</td>
<td>168</td>
</tr>
<tr>
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<td>298.1</td>
<td>752</td>
<td>158.0</td>
<td></td>
<td>265.1</td>
<td>405</td>
<td>85.1</td>
<td></td>
<td>1030</td>
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</tr>
<tr>
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<td></td>
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<td>122.3</td>
<td></td>
<td>1263</td>
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<td>78.4</td>
<td></td>
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<td>217.3</td>
<td>338</td>
<td>71.0</td>
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<td>235.9</td>
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<td></td>
<td>1171</td>
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<td>250.8</td>
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<td>350</td>
<td>73.3</td>
<td></td>
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<td>60.9</td>
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<td>1017</td>
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<td>222.9</td>
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<td>59.2</td>
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<td>1969</td>
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<td>352.2</td>
<td>440</td>
<td>73.9</td>
<td></td>
<td>874</td>
<td>237</td>
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</tbody>
</table>

Source: Central Bank of Ceylon (derived from Custom's Returns)

(1) Three major products, (2) includes re-exports.

**Notes:** Exchange Rates - 1947-49: 1 US $ = Rs. 3.32 (Rs. devalued in September 1949)
1950-67: 1 US $ = Rs. 1.76 (Rs. devalued in November 1967)
the rise in volume of imports due to the growth of the population, development demands, increase in freight rates of world shipping, the higher prices of imports obtained under 'tied' credit and aid agreements.

(b) Poor prices fetched by tea and rubber. Tea prices have remained very low since 1965, while rubber has faced increased competition from synthetic rubber, and other substitutes such as plastics. There were also uncertainties created by the stock-piling policies of major powers.

3.2.5 The Central Bank of Ceylon in its Annual Report for 1970 advocates fundamental changes in Ceylon's development strategy. The emphasis is placed on:

(a) the utilization of foreign aid for investment in those fields which will tend to increase the capacity to export especially in the industrial sector;

(b) the utilization of commodity aid to be geared as far as possible to projects which will have early beneficial effects on the balance of payments;

(c) the need to give much greater emphasis to the production of foodstuffs, particularly subsidiary food crops;

(d) the urgent necessity for an organised survey of natural and mineral resources to identify their availability for new products as well as to provide inputs for domestic industry dependent largely on imported raw materials.

As already described in chapter two¹ these very same ideas have been emphasized time and again, but the pathos of the situation is that these measures have to be constantly emphasized due perhaps, to politics playing a more important part than economic rationale² in influencing policy and planning. Other important issues pinpointed in the same report

1. See section 2.3, 2.4, and 2.5.

2. See section 2.5.13
are, firstly, the adverse results of the availability of credit from abroad, which has insulated the economy from the drastic economies of expenditure she should otherwise have been compelled to adopt in accordance with the constraints imposed by the balance of payments. Secondly, the continued availability of imports which has tended to conceal the gravity of the country's balance of payments and the need for exercising restraint in both private and public expenditure.

3.2.6 The conclusion to be drawn from these observations are, (i) the need for reduction in the overall level of consumption. This may seem paradoxical, as basic economic theories tend to encourage consumption to activate a flagging economy, via the generation of new investment to meet this demand. However, in Ceylon where the consumption demand is directed to imported goods, and the country is deficient in basic raw materials as well as capital goods this mechanism does not work, on the other hand it generates further strain on the already critical balance of payments situation by an increase demand for imports. (ii) the urgent necessity to curtail the budgetary gap to manageable proportions as a measure for tackling the balance of payments problem.

3.2.7 The present level of the economy could be understood by studying the country's gross national product (GNP) tables. The GNP at constant (1959) factor prices in 1970 was Rs.9,695 mil., while at current factor cost prices it was Rs.11,618 mil. compared to Rs.9,316 and Rs.10,748 mil. respectively in 1969. Thus while the real GNP increased by 4.1 per cent over the year, the GNP at current factor cost price (money GNP) increased by 8.1 per cent. However, in terms of economic growth this is a slow rate of growth, especially when the population growth is taken into account. It was estimated in 1959, that the economy would have to grow at least by

1. Tables 4 and 5 GNP at factor prices and GNP at current prices.
### TABLE 4
GROSS NATIONAL PRODUCT AT CURRENT FACTOR COST PRICES

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
<th>% change over previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount Rs. Mn.</td>
<td></td>
<td></td>
<td></td>
<td>1969</td>
</tr>
<tr>
<td>1. Agriculture, Forestry, Hunting and Fishing</td>
<td>3,656</td>
<td>3,732</td>
<td>3,949</td>
<td>+2.1</td>
</tr>
<tr>
<td>2. Manufacturing, Mining, Quarrying, Electricity, Gas, etc.</td>
<td>1,224</td>
<td>1,399</td>
<td>1,545</td>
<td>+14.3</td>
</tr>
<tr>
<td>3. Construction</td>
<td>509</td>
<td>646</td>
<td>771</td>
<td>+26.9</td>
</tr>
<tr>
<td>4. Trade, Transport and other Services</td>
<td>4,481</td>
<td>5,080</td>
<td>5,496</td>
<td>+13.4</td>
</tr>
<tr>
<td>5. Gross Domestic Product</td>
<td>9,869</td>
<td>10,857</td>
<td>11,760</td>
<td>+10.0</td>
</tr>
<tr>
<td>6. Net Factor Income from Abroad</td>
<td>-61</td>
<td>-109</td>
<td>-142</td>
<td></td>
</tr>
<tr>
<td>7. Gross National Product</td>
<td>9,809</td>
<td>10,748</td>
<td>11,618</td>
<td>+9.6</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.

### TABLE 5
GROSS NATIONAL PRODUCT AT CONSTANT (1959) FACTOR COST PRICES

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
<th>% change over previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount Rs. Mn.</td>
<td></td>
<td></td>
<td></td>
<td>1969</td>
</tr>
<tr>
<td>1. Agriculture, Forestry, Hunting and Fishing</td>
<td>3,248</td>
<td>3,276</td>
<td>3,395</td>
<td>+0.9</td>
</tr>
<tr>
<td>2. Manufacturing, Mining, Quarrying, Electricity, Gas, etc.</td>
<td>1,206</td>
<td>1,333</td>
<td>1,421</td>
<td>+10.5</td>
</tr>
<tr>
<td>3. Construction</td>
<td>446</td>
<td>520</td>
<td>598</td>
<td>+16.5</td>
</tr>
<tr>
<td>4. Trade, Transport and other Services</td>
<td>4,000</td>
<td>4,255</td>
<td>4,366</td>
<td>+6.4</td>
</tr>
<tr>
<td>5. Gross Domestic Product</td>
<td>8,900</td>
<td>9,384</td>
<td>9,781</td>
<td>+5.4</td>
</tr>
<tr>
<td>7. Gross National Product</td>
<td>8,862</td>
<td>9,316</td>
<td>9,695</td>
<td>+5.1</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.
5 per cent per year, for the country to maintain her present (1959 level) of the economy, plus a minimum increase of growth of at least 2 per cent per year. This was calculated with the rapid increase in population in mind. In the last twenty years the population has doubled although the rate of increase has lessened over the last two years keeping to an average of about 2.4 per cent per year. Even this increase in population is too high in terms of the resource growth of the country. The 1963 population census estimated the population to be about 10.5 million. In this total population, 60 per cent were under twenty five years of age, of which 19 per cent were in the age group 14-25 years of age. These statistics show an obvious trend for the future as the greater part of the population falls into the fertile range. The estimated mid-year population in 1970 was 12.5 million, a rise of 19 per cent since 1963 or a 2.4 per cent yearly increase. In per capita terms the growth rate of 4.1 per cent after allowing for a population growth of 2.1 per cent was 2.0 per cent, which is on the low side as compared to per capita ratio of growth of 3.5 per cent and 5.8 per cent in 1969 and 1968 respectively. This is even lower when the change in the terms of trade is taken into account, for in a country like Ceylon, because of the importance of the value of exports and imports in relation to the level of national income, estimates of GNP at constant prices have to be estimated against the movement of prices of exports and imports. In 1970 the import price index increased by 4.2 per cent while the export price index increased only by 0.4 per cent resulting in the deterioration of the terms of trade index by 3.6 per cent, which means, that while real output increased by 4.1 per cent, real national income increased only by 3.4 per cent. Thus in 1970

1. The average rate in 1959 was 3 per cent population growth for year
2. 1968 figures of the economy cannot be taken as a norm as this was a 'freak' year, where the maturity of a number of measures resulted in a high rate of growth in all sectors.
3. Real national income is obtained by adjusting estimates of real products for the loss of income due to the adverse movements of the terms of trade.
### Table 6

**Sectoral Composition of Gross National Product at Constant (1959) Factor Cost Prices**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rs.Mn</td>
<td>%</td>
<td>Rs.Mn</td>
<td>%</td>
</tr>
<tr>
<td>1. Agriculture, Forestry, Hunting and Fishing</td>
<td>2,302</td>
<td>39.1</td>
<td>3,248</td>
<td>36.7</td>
</tr>
<tr>
<td></td>
<td>3,276</td>
<td>35.2</td>
<td>3,5395</td>
<td>35.0</td>
</tr>
<tr>
<td>2. Mining and Quarrying</td>
<td>31</td>
<td>0.5</td>
<td>37</td>
<td>0.4</td>
</tr>
<tr>
<td></td>
<td>55</td>
<td>0.6</td>
<td>65</td>
<td>0.7</td>
</tr>
<tr>
<td>3. Manufacturing</td>
<td>682</td>
<td>11.6</td>
<td>1,154</td>
<td>13.0</td>
</tr>
<tr>
<td></td>
<td>1,261</td>
<td>13.5</td>
<td>1,335</td>
<td>13.8</td>
</tr>
<tr>
<td>4. Construction</td>
<td>283</td>
<td>4.8</td>
<td>446</td>
<td>5.0</td>
</tr>
<tr>
<td></td>
<td>520</td>
<td>5.6</td>
<td>598</td>
<td>6.2</td>
</tr>
<tr>
<td>5. Electricity, Gas, Water, Sanitary services</td>
<td>10</td>
<td>0.2</td>
<td>15</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td>18</td>
<td>0.2</td>
<td>21</td>
<td>0.2</td>
</tr>
<tr>
<td>6. Transport, Storage, and Communications</td>
<td>541</td>
<td>9.2</td>
<td>824</td>
<td>9.3</td>
</tr>
<tr>
<td></td>
<td>899</td>
<td>9.7</td>
<td>913</td>
<td>9.4</td>
</tr>
<tr>
<td>7. Wholesale and Retail Trade</td>
<td>801</td>
<td>13.6</td>
<td>1,253</td>
<td>14.1</td>
</tr>
<tr>
<td></td>
<td>1,367</td>
<td>14.7</td>
<td>1,391</td>
<td>14.3</td>
</tr>
<tr>
<td>8. Banking Insurance and Real Estate</td>
<td>51</td>
<td>0.9</td>
<td>110</td>
<td>1.2</td>
</tr>
<tr>
<td></td>
<td>114</td>
<td>1.2</td>
<td>118</td>
<td>1.2</td>
</tr>
<tr>
<td>9. Ownership of Dwellings</td>
<td>201</td>
<td>3.4</td>
<td>275</td>
<td>3.1</td>
</tr>
<tr>
<td></td>
<td>291</td>
<td>3.1</td>
<td>302</td>
<td>3.1</td>
</tr>
<tr>
<td>10. Public Administration and Defence</td>
<td>301</td>
<td>5.1</td>
<td>432</td>
<td>4.9</td>
</tr>
<tr>
<td></td>
<td>445</td>
<td>4.8</td>
<td>459</td>
<td>4.7</td>
</tr>
<tr>
<td>11. Services</td>
<td>728</td>
<td>12.3</td>
<td>1,105</td>
<td>12.5</td>
</tr>
<tr>
<td></td>
<td>1,139</td>
<td>12.2</td>
<td>1,184</td>
<td>12.2</td>
</tr>
<tr>
<td>12. Gross Domestic Product</td>
<td>5,930</td>
<td>-</td>
<td>8,900</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>9,384</td>
<td>-</td>
<td>9,695</td>
<td>-</td>
</tr>
<tr>
<td>13. Net Factor Income from Abroad</td>
<td>-37</td>
<td>-0.6</td>
<td>-39</td>
<td>-0.4</td>
</tr>
<tr>
<td></td>
<td>-66</td>
<td>-0.7</td>
<td>-85</td>
<td>-0.8</td>
</tr>
<tr>
<td>14. Gross National Product</td>
<td>5,893</td>
<td>100.0</td>
<td>8,862</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>9,516</td>
<td>100.0</td>
<td>9,695</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.

### Table 7

**Total Resources and Their Uses 1968–1970**

<table>
<thead>
<tr>
<th></th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
<th>% change over previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rs.Mn</td>
<td>Rs.Mn</td>
<td>Rs.Mn</td>
<td></td>
</tr>
<tr>
<td>A. Resources</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Domestic Product</td>
<td>10,318</td>
<td>11,409</td>
<td>12,775</td>
<td>+ 10.6</td>
</tr>
<tr>
<td>Imports of goods and non-factor services</td>
<td>2,474</td>
<td>2,879</td>
<td>2,549</td>
<td>+ 16.4</td>
</tr>
<tr>
<td>Total...</td>
<td>12,791</td>
<td>14,288</td>
<td>15,324</td>
<td>+ 11.7</td>
</tr>
<tr>
<td>B. Utilisation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumption</td>
<td>8,958</td>
<td>9,884</td>
<td>10,595</td>
<td>+ 10.3</td>
</tr>
<tr>
<td>Gross Domestic Capital formation</td>
<td>1,668</td>
<td>2,253</td>
<td>2,492</td>
<td>+ 35.1</td>
</tr>
<tr>
<td>Exports of goods and non-factor services</td>
<td>2,165</td>
<td>2,152</td>
<td>2,237</td>
<td>0.6</td>
</tr>
<tr>
<td>Total...</td>
<td>12,791</td>
<td>14,288</td>
<td>15,324</td>
<td>+ 11.7</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon
the deterioration of the terms of trade index by 3.6 per cent deflated real national income by 0.7 per cent to 3.4 per cent, allowing for a population growth of 2.1 per cent, the per capita real income figure reduces to 1.3 per cent.

3.2.8 An analysis of the sectoral composition of the real GNP shows that sector one accounted for Rupees 3,395 million or 35 per cent of the total GNP. The output of this sector increased by 3.6 per cent in 1970 as compared to 2.2 per cent in 1969. The increase was mainly due to the increase in the production of agriculture for home consumption. The growth of real output in the agricultural sector (sector one), play an important part in the overall economic growth due to its importance as a feeder of raw material and services to the other sectors of the economy, especially the manufacturing sector. The increases in production of sectors, two, three, four, five, six and eleven of 18.2, 5.9, 15.0, 16.6, 1.6, and 2.6 per cent respectively, were at a decreasing rate compared to the years 1968 and 1969.

3.2.9 There was a considerable slowing down of the rate of growth of the manufacturing sector. The real output in manufacturing, excluding tea, rubber and coconut products was only 5.9 per cent in 1970 as compared to 14.9 per cent and 10.6 per cent in 1968 and 1969. By value terms, the total value of industrial production (inclusive of tea, rubber and coconut) in 1970 was 8.4 per cent as compared to 16.2 per cent in 1969. The slow growth was more marked in the private sector. The reasons given for the slow growth in the private sector was the lesser availability of raw materials. In comparison to the private sector, there was a substantial increase in production in the manufacturing Corporations of the

---

1. Table 6 - Sectoral composition of the GNP at constant factor prices
2. A substantial portion of the manufacturing activity of sector three constitutes the manufacture of tea, rubber and coconut products.
State sector. One reason for this increase was deemed to be the increase in productive capacity, as well as the increased utilization of capacity. Another reason is that Government import controls were more stringently applied to the private sector industries, while the State sector industries were given special concessions for their import needs due to them being categorized as essential to the economy. Further the state industries have better facilities to obtain finance both local and foreign. The manufacturing sector as a whole, over the last few years have shown the results of Governmental policies to curtail the manufacture of non-essential consumer goods. This is shown by the reduction of the share of consumer goods in the overall total as compared to an increase in the share of the intermediate and investment goods categories in 1969 and 1970.

3.2.10 Taking the sector as a whole in 1970, the total share taken by each sector in the gross total has altered slightly as compared in 1959. The percentage of the total contribution in sector one, has dropped from 39.1 per cent, while the share in manufacturing (sector three) has increased from 11.6 to 13.8 per cent. The other sectors which have increased their contribution to the total are, sectors two, four, six and seven. Future trends seem to show that there will be increasing contributions by these sectors to the total GNP.¹

3.2.11 Table 7 shows the total resources that were available to the economy for the last three years. This consists of total domestic production plus imports. The increase in total resources of 7.2 per cent in money terms for 1970 was solely due to an increase in domestic production

¹. All production figures used in the preceding pages are taken from the Central Bank Annual Reports for the respective years.
by 12 per cent as well as a decrease in imports in value terms by 11.5 per cent. Although at first sight, this looks a favourable trend, this is not so when one examines the break down of imports. For, in value terms, the import of investment goods and intermediate goods dropped by 32.5 and 17.0 per cent respectively, while the volume of consumer goods, particularly in the food and drink category increased by 15.2 per cent. The analysis of utilisation of resources in money terms as shown in the table points to an increase in 1970 as compared to 1969, of 4 per cent for resources utilised for exports, 10.6 per cent for capital formation and 7.2 per cent for consumption. However, these percentages alter value when analysed in real terms to give, 1.7, 1.3 and 1.2 per cent respectively. In 1970 as in previous years the aggregate demand (consumption and capital formation) exceeded supply (resources available from domestic production) and the resulting gap was bridged by foreign borrowing and drawing down of available foreign exchange reserves.

3.2.12 Tables 8 and 9 show the imports and exports of Ceylon for the last five years. The table on exports outlines what was previously stated, i.e. the role that the plantation crops play in the economy of Ceylon. The total export earnings in 1970 was Rupees 2,035 million, of which 89 per cent was contributed by tea, rubber and coconut in the percentage proportions of 55, 22 and 12 per cent respectively, while rest of the exports brought in only 10 per cent of the total. The percentage share in the export total for 1970 as compared to earlier years has dropped in case of tea, rubber has picked up slightly, and coconut has remained more or less the same. Other exports though small show signs of picking up greater percentage of total. Table 10 shows the volume and value of other exports that took 10 per cent share of the grand export total, even here the major share is taken by agricultural crops such as
### TABLE 8

**EXPORT EARNINGS FOR THE YEARS 1966 - 1970.**

<table>
<thead>
<tr>
<th></th>
<th>Value in Rupees Million</th>
<th>Percentage of Total Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tea</td>
<td>1,027</td>
<td>1,061</td>
</tr>
<tr>
<td>Rubber</td>
<td>337</td>
<td>282</td>
</tr>
<tr>
<td>Three Major Coconut Products</td>
<td>216</td>
<td>167</td>
</tr>
<tr>
<td>(a) Copra</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td>(b) Coconut Oil</td>
<td>108</td>
<td>88</td>
</tr>
<tr>
<td>(c) Desiccated Coconut</td>
<td>63</td>
<td>61</td>
</tr>
<tr>
<td>Other Domestic Exports</td>
<td>116</td>
<td>121</td>
</tr>
<tr>
<td>Total Domestic Exports*</td>
<td>1,676</td>
<td>1,631</td>
</tr>
<tr>
<td>Re-Exports</td>
<td>24</td>
<td>59</td>
</tr>
<tr>
<td>TOTAL....</td>
<td>1,700</td>
<td>1,690</td>
</tr>
</tbody>
</table>

Sources: Central Bank of Ceylon & Ceylon Customs Returns.

**Note:** Value given at current prices

(+): Export earnings have been rounded off to the nearest million rupees.
TABLE 9
IMPORTS BY MAJOR CATEGORIES AND GROUPS OF COMMODITIES: 1966 - 1970

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rs. Mn</td>
<td>Rs. Mn</td>
<td>Rs. Mn</td>
<td>Rs. Mn</td>
<td>Rs. Mn</td>
</tr>
<tr>
<td>1. Consumer Goods</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of which</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) FOOD &amp; DRINK</td>
<td>956</td>
<td>783</td>
<td>989</td>
<td>976</td>
<td>1,069</td>
</tr>
<tr>
<td>(i) Rice</td>
<td>367</td>
<td>211</td>
<td>341</td>
<td>257</td>
<td>318</td>
</tr>
<tr>
<td>(ii) Flour</td>
<td>113</td>
<td>229</td>
<td>250</td>
<td>255</td>
<td>260</td>
</tr>
<tr>
<td>(iii) Sugar</td>
<td>105</td>
<td>74</td>
<td>97</td>
<td>115</td>
<td>171</td>
</tr>
<tr>
<td>(iv) Milk and Milk products</td>
<td>77</td>
<td>66</td>
<td>74</td>
<td>52</td>
<td>55</td>
</tr>
<tr>
<td>(v) Meat, Fish and Eggs</td>
<td>101</td>
<td>56</td>
<td>70</td>
<td>87</td>
<td>68</td>
</tr>
<tr>
<td>(vi) Food other</td>
<td>100</td>
<td>126</td>
<td>125</td>
<td>145</td>
<td>139</td>
</tr>
<tr>
<td>(vii) Drink and Manufactured Tobacco</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>(b) Textiles (incl. clothing)</td>
<td>119</td>
<td>73</td>
<td>77</td>
<td>122</td>
<td>124</td>
</tr>
<tr>
<td>(c) Other Consumer Goods</td>
<td>86</td>
<td>75</td>
<td>81</td>
<td>120</td>
<td>101</td>
</tr>
<tr>
<td>2. Intermediate Goods</td>
<td>470</td>
<td>441</td>
<td>629</td>
<td>592</td>
<td>451</td>
</tr>
<tr>
<td>of which</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Fertilizers</td>
<td>91</td>
<td>80</td>
<td>110</td>
<td>66</td>
<td>81</td>
</tr>
<tr>
<td>(ii) Petroleum Products</td>
<td>130</td>
<td>112</td>
<td>196</td>
<td>156</td>
<td>58</td>
</tr>
<tr>
<td>(iii) Chemical elements &amp; compounds</td>
<td>36</td>
<td>38</td>
<td>45</td>
<td>66</td>
<td>56</td>
</tr>
<tr>
<td>(iv) Paper and Paper Board</td>
<td>50</td>
<td>41</td>
<td>37</td>
<td>55</td>
<td>45</td>
</tr>
<tr>
<td>(v) Yarn and Thread</td>
<td>42</td>
<td>45</td>
<td>71</td>
<td>80</td>
<td>41</td>
</tr>
<tr>
<td>(vi) Other</td>
<td>42</td>
<td>34</td>
<td>39</td>
<td>37</td>
<td>26</td>
</tr>
<tr>
<td>3. Investment Goods</td>
<td>361</td>
<td>330</td>
<td>383</td>
<td>700</td>
<td>546</td>
</tr>
<tr>
<td>of which</td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>(i) Building Materials</td>
<td>70</td>
<td>48</td>
<td>95</td>
<td>99</td>
<td>119</td>
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<tr>
<td>(ii) Transport Equipment</td>
<td>116</td>
<td>89</td>
<td>80</td>
<td>213</td>
<td>126</td>
</tr>
<tr>
<td>(iii) Machinery and Equipment</td>
<td>162</td>
<td>175</td>
<td>195</td>
<td>368</td>
<td>276</td>
</tr>
<tr>
<td>4. Unclassified Imports</td>
<td>36</td>
<td>36</td>
<td>14</td>
<td>33</td>
<td>22</td>
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<tr>
<td>5. Total Imports ...</td>
<td>2,028</td>
<td>1,738</td>
<td>2,173</td>
<td>2,543</td>
<td>2,313</td>
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</table>

Source: Central Bank of Ceylon.
<table>
<thead>
<tr>
<th>Table 10</th>
<th>Export Volumes, Export Values and Average f. o. b. Prices of Selected Minor Export Products.</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
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<tr>
<td><strong>Coconut Products Group</strong></td>
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<tr>
<td>Coir fibre - bristle</td>
<td>Th. cwt.</td>
<td>563-0</td>
<td>506-7</td>
<td>474-0</td>
<td>-</td>
<td>25-6</td>
<td>24-6</td>
<td>22-3</td>
<td>-</td>
<td>43-35</td>
<td>48-63</td>
<td>47-13</td>
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<td>Coir fibre - mattress</td>
<td></td>
<td>1055-0</td>
<td>1180-3</td>
<td>1172-6</td>
<td>-</td>
<td>25-5</td>
<td>25-4</td>
<td>24-8</td>
<td>-</td>
<td>25-23</td>
<td>21-67</td>
<td>21-16</td>
<td>-</td>
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<tr>
<td>Coconut shell charcoal</td>
<td></td>
<td>319-1</td>
<td>385-2</td>
<td>583-4</td>
<td>+</td>
<td>5-2</td>
<td>3-4</td>
<td>6-7</td>
<td>+</td>
<td>16-54</td>
<td>8-90</td>
<td>11-53</td>
<td>+</td>
</tr>
<tr>
<td>Fresh Coconuts</td>
<td>Mn. nuts</td>
<td>7-6</td>
<td>10-3</td>
<td>6-3</td>
<td>-</td>
<td>3-3</td>
<td>4-2</td>
<td>2-9</td>
<td>-</td>
<td>2-44</td>
<td>0-41</td>
<td>0-46</td>
<td>+</td>
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<tr>
<td><strong>Spices Group</strong></td>
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<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Cinnamon quills</td>
<td>Th. cwt.</td>
<td>61-8</td>
<td>65-9</td>
<td>70-0</td>
<td>+</td>
<td>6-2</td>
<td>32-9</td>
<td>33-8</td>
<td>28-4</td>
<td>-16</td>
<td>531-79</td>
<td>513-33</td>
<td>405-79</td>
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<tr>
<td>Cinnamon chips</td>
<td></td>
<td>16-6</td>
<td>21-6</td>
<td>12-7</td>
<td>-</td>
<td>41-2</td>
<td>2-3</td>
<td>4-1</td>
<td>1-7</td>
<td>-58</td>
<td>141-30</td>
<td>191-11</td>
<td>134-02</td>
</tr>
<tr>
<td>Pepper</td>
<td></td>
<td>16-2</td>
<td>17-9</td>
<td>16-9</td>
<td>-</td>
<td>5-6</td>
<td>2-4</td>
<td>3-1</td>
<td>4-7</td>
<td>+51</td>
<td>146-53</td>
<td>173-12</td>
<td>279-42</td>
</tr>
<tr>
<td>Cardamoms</td>
<td></td>
<td>2-5</td>
<td>3-2</td>
<td>4-0</td>
<td>+</td>
<td>25-0</td>
<td>4-1</td>
<td>7-3</td>
<td>11-3</td>
<td>+54</td>
<td>1639-22</td>
<td>2297-00</td>
<td>2838-62</td>
</tr>
<tr>
<td>Cloves</td>
<td></td>
<td>1-0</td>
<td>4-6</td>
<td>5-5</td>
<td>+</td>
<td>19-6</td>
<td>0-1</td>
<td>2-8</td>
<td>4-1</td>
<td>+46</td>
<td>130-22</td>
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<td>756-41</td>
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<td><strong>Minerals Group</strong></td>
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<td></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Natural Graphite</td>
<td></td>
<td>212-6</td>
<td>224-6</td>
<td>192-6</td>
<td>-</td>
<td>14-3</td>
<td>7-6</td>
<td>8-3</td>
<td>+</td>
<td>9-9</td>
<td>36-91</td>
<td>36-78</td>
<td>46-39</td>
</tr>
<tr>
<td>Imanite</td>
<td></td>
<td>1455-0</td>
<td>1667-2</td>
<td>1556-2</td>
<td>-</td>
<td>6-7</td>
<td>2-6</td>
<td>4-1</td>
<td>+</td>
<td>2-4</td>
<td>1-78</td>
<td>2-45</td>
<td>2-63</td>
</tr>
<tr>
<td><strong>Other Agricultural Products</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cocoa beans</td>
<td></td>
<td>34-8</td>
<td>25-4</td>
<td>29-9</td>
<td>+</td>
<td>17-7</td>
<td>7-3</td>
<td>7-0</td>
<td>+</td>
<td>7-2</td>
<td>211-16</td>
<td>273-43</td>
<td>240-62</td>
</tr>
<tr>
<td>Unmanufactured tobacco</td>
<td>Mn. lbs</td>
<td>1-3</td>
<td>0-7</td>
<td>0-5</td>
<td>-</td>
<td>28-6</td>
<td>5-1</td>
<td>2-9</td>
<td>2-2</td>
<td>-24</td>
<td>3-81</td>
<td>4-04</td>
<td>4-21</td>
</tr>
<tr>
<td>Citronella oil</td>
<td>Th. lbs</td>
<td>297-8</td>
<td>402-6</td>
<td>426-5</td>
<td>+</td>
<td>5-9</td>
<td>1-2</td>
<td>1-8</td>
<td>1-9</td>
<td>+5-1</td>
<td>3-99</td>
<td>3-47</td>
<td>4-48</td>
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<tr>
<td>Cinnamon Leaf Oil</td>
<td></td>
<td>79-2</td>
<td>93-9</td>
<td>111-4</td>
<td>+</td>
<td>13-6</td>
<td>0-8</td>
<td>1-0</td>
<td>1-1</td>
<td>+10</td>
<td>10-51</td>
<td>10-29</td>
<td>10-12</td>
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<tr>
<td><strong>Fatty Acids Group</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Glycerol</td>
<td>Th. cwt.</td>
<td>24-8</td>
<td>23-1</td>
<td>21-4</td>
<td>-</td>
<td>14-4</td>
<td>2-0</td>
<td>1-2</td>
<td>1-5</td>
<td>+25</td>
<td>93-16</td>
<td>57-20</td>
<td>59-20</td>
</tr>
<tr>
<td>Glycerine</td>
<td>Th. cwt.</td>
<td>21-0</td>
<td>21-5</td>
<td>24-6</td>
<td>+</td>
<td>14-4</td>
<td>2-0</td>
<td>1-2</td>
<td>1-5</td>
<td>+25</td>
<td>93-16</td>
<td>57-20</td>
<td>59-20</td>
</tr>
<tr>
<td><strong>Manufactured Products Group</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leather tanned</td>
<td></td>
<td>10-1</td>
<td>11-6</td>
<td>13-3</td>
<td>+</td>
<td>14-7</td>
<td>1-8</td>
<td>3-2</td>
<td>3-6</td>
<td>+12</td>
<td>180-02</td>
<td>275-76</td>
<td>269-78</td>
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<tr>
<td>Leather of goat</td>
<td></td>
<td>3-3</td>
<td>0-4</td>
<td>0-5</td>
<td>-</td>
<td>...</td>
<td>1-1</td>
<td>0-2</td>
<td>0-3</td>
<td>...</td>
<td>338-23</td>
<td>397-97</td>
<td>252-76</td>
</tr>
<tr>
<td>Precious &amp; semi-precious stones</td>
<td>Th. carats</td>
<td>196-0</td>
<td>136-6</td>
<td>184-9</td>
<td>+</td>
<td>35-4</td>
<td>2-0</td>
<td>0-5</td>
<td>4-3</td>
<td>+760</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Jewellery and goldsmiths' ware</td>
<td></td>
<td>1-2</td>
<td>1-0</td>
<td>1-0</td>
<td>-</td>
<td>...</td>
<td>1-2</td>
<td>1-0</td>
<td>1-0</td>
<td>...</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Clothing of textiles</td>
<td></td>
<td>32-3</td>
<td>110-3</td>
<td>180-4</td>
<td>+</td>
<td>63-6</td>
<td>4-2</td>
<td>3-3</td>
<td>7-3</td>
<td>+136</td>
<td>28-78</td>
<td>53-38</td>
<td>30-62</td>
</tr>
<tr>
<td>Footwear of Rubber, Leather</td>
<td></td>
<td>10-4</td>
<td>29-0</td>
<td>31-8</td>
<td>+</td>
<td>9-7</td>
<td>0-3</td>
<td>1-5</td>
<td>1-0</td>
<td>-33</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td><strong>Total value of above items</strong></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total value of all minor export products</strong></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td><strong>Percentage of coverage</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

Source: Ceylon Customs Returns
coconut by-products, spices and secondary plantation crops. On the side of imports (table 8) the import of food take the greater share of the total import bill. Out of the total of imports amounting to Rupees 2,313 million in 1970, Rs.1,294 mil. or 55.3 per cent was taken by food-stuffs, textiles and other consumer goods, while around 43 per cent composed of intermediate goods and investment goods. If one derives the capacity to import out of the total export earnings, 63.6 per cent of export earnings is still utilised for the import of consumer goods.

3.2.13 The significance of the export and import imbalance to future policy has been obvious for a long time. As stated earlier, policies have not always given economic rationale top priority in development though this was taken to be the prime objective. However, in the pursuance of economic policy one cannot isolate economic motives alone without taking into account social considerations, and the ideal should be a balance between the two. During the last few years emphasis has been placed on import substitution to counter the continuing excess demand for imports.

3.2.14 In the field of industry due to the laxity of policies in the early years, most industries continue to depend to a large extent on imported raw materials. Table II shows this dependence on imported inputs which on the overall is as high as 75 per cent.\footnote{The table is for 1251 firms derived from a survey by the Central Bank of Ceylon - See section 3.3.18 for further details.} If payments for royalties and professional services are added to this total, this percentage would be even higher. The increase of exports of the industrial sector as well as the foreign exchange savings envisaged, has been negligible. The substitution effect could have been successful if the inputs that make the final product were also substituted by local raw materials as much as possible. Further if efforts were made, to increase the productivity of
**TABLE II**

PRODUCTION AND RAW MATERIAL USAGE - 1979.

<table>
<thead>
<tr>
<th>No.of Firms</th>
<th>Production Value (Rs.)</th>
<th>Raw Materials (Rupees Thousand)</th>
<th>Local Value</th>
<th>Local %</th>
<th>Foreign Value</th>
<th>Foreign %</th>
<th>Total Value</th>
<th>Total %</th>
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</thead>
<tbody>
<tr>
<td>1. Manufacture of food, Beverages and Tobacco</td>
<td>147</td>
<td>214.0</td>
<td>46,710</td>
<td>37.6</td>
<td>77,646</td>
<td>62.4</td>
<td>124,356</td>
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<tr>
<td>2. Textiles, Wearing Apparel and Leather industries</td>
<td>507</td>
<td>233.4</td>
<td>29,437</td>
<td>26.9</td>
<td>80,009</td>
<td>73.1</td>
<td>109,446</td>
<td>100.0</td>
</tr>
<tr>
<td>3. Manufacture of Wood and Wood Products, including Furniture</td>
<td>211</td>
<td>21.2</td>
<td>8,118</td>
<td>32.3</td>
<td>1,747</td>
<td>17.7</td>
<td>9,864</td>
<td>100.0</td>
</tr>
<tr>
<td>4. Manufacture of Paper and Paper Products</td>
<td>68</td>
<td>61.0</td>
<td>15,049</td>
<td>44.2</td>
<td>19,025</td>
<td>55.8</td>
<td>34,074</td>
<td>100.0</td>
</tr>
<tr>
<td>5. Manufacture of Chemicals, Petroleum, Coal, Rubber, and Plastic Products</td>
<td>211</td>
<td>231.7</td>
<td>35,109</td>
<td>15.2</td>
<td>195,236</td>
<td>84.8</td>
<td>230,395</td>
<td>100.0</td>
</tr>
<tr>
<td>6. Manufacture of Non-metallic Products except Petroleum and Coal</td>
<td>61</td>
<td>133.7</td>
<td>22,675</td>
<td>55.4</td>
<td>18,239</td>
<td>44.6</td>
<td>40,914</td>
<td>100.0</td>
</tr>
<tr>
<td>7. Basic Metal Products</td>
<td>1</td>
<td>23.9</td>
<td>24,022</td>
<td>100.0</td>
<td>24,022</td>
<td>100.0</td>
<td>24,022</td>
<td>100.0</td>
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<tr>
<td>8. Manufacture of Fabricated metal Products, Machinery and Equipment</td>
<td>211</td>
<td>239.8</td>
<td>25,964</td>
<td>17.2</td>
<td>124,651</td>
<td>82.8</td>
<td>150,615</td>
<td>100.0</td>
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<tr>
<td>9. Manufactured Products, n.e.s</td>
<td>31</td>
<td>13.9</td>
<td>1,525</td>
<td>21.8</td>
<td>5,486</td>
<td>78.2</td>
<td>7,011</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>1251</strong></td>
<td><strong>1371.6</strong></td>
<td><strong>184,637</strong></td>
<td><strong>25.3</strong></td>
<td><strong>546,110</strong></td>
<td><strong>74.7</strong></td>
<td><strong>730,747</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.
labour, cut down waste in raw materials, and to increase the overall industrial efficiency to derive economies of production on machines, labour and materials, perhaps the overall goals of industrialization could have been achieved. At present many industrial units producing previously imported goods, do not show any economies by way of the substitution effect, due mainly to mis-utilisation of the factors of production as compared to the imported article which is a product of an efficient industrial mix of another country. As a result, many of the items produced in Ceylon which were previously imported carry the same or sometimes more foreign exchange cost in the final product. The only effect that some of the industries have had, is the provision of employment, though this is laudable, inefficient industry cannot be excused on this ground alone.

3.2.15 On the side of agriculture, though food production has increased, the increase has been very gradual, for, still in 1970 the import of food and drink amounted to 46 per cent of total imports, and as table 8 shows this has increased over the past few years.

3.2.16 The future policy to minimise the economic ills of Ceylon has to be tackled in a number of ways:

(a) A concerted effort has to be made to decrease the import of consumption goods by way of accelerated expansion of food production and manufacturing industries geared for manufacture for the home market as well with an export market in view.

(b) In the case of exports, taking into account the future export potential of the major crops, there is not much hope for a substantial increase in the export earnings from this source. Thus the export sector will necessarily have to look for new exports both in agriculture and industry.

In the case of agriculture the future lies in the expansion of food crops, rice and other subsidiary staple crops, the maintenance of the
existing levels of exports of tea and rubber and in the increase in the
cocnut products base, in terms of total earnings and production. Industry
has to play a major part in the manufacture of essential inputs, then it
has done so far, and secondly, efforts have to be made, to increase the
degree of processing of, and in some cases the final manufacture of,
agricultural produce before export. Finally the present industry would
have to gear itself to utilise greater quantities of local raw material and
seek outside markets for their produce.

3.3. THE INDUSTRIAL COMPLEX

3.3.1 An attempt is made here, to outline the present industrial
sector in Ceylon, with the economic background of the present situation and
the likely direction of future development of the economy as described in
the preceding section. A note of caution has to be sounded here regards
the restrictions imposed, on the present analysis, due to the limitations
of the available statistical coverage of the whole sector. Industry in
Ceylon can be broadly divided into two major sectors, namely the State and
the private sector. In 1970 there were altogether twenty four State sector
industrial corporations, and two industries run under two Government
Departments. In the private sector the estimated number of large, medium
and small units, exclusive of cottage industry, hand-loom weaving units and
small scale mining units is roughly estimated to be about 3500 units.

3.3.2 The State sector industries comprises largely of, what are
 termed 'basic sector' industries. Throughout the industrial history of
the country, Government initiative, effort and investment have been

1. These limitations were mentioned in Chapter One
concentrated in this sector, with the intention of making this sector the spearhead of industrial and economic development.\(^1\) The total capital invested in each corporation, puts them into the large sector category as far as this study is concerned, with capital investments ranging from Rupees one million to Rupees 243 million. The total capital invested in the corporations up to 1970/71 was around Rupees 1376 million. The levels of investment needed in these corporations were too large for private capital to undertake alone, though some of the activities of the corporations could be undertaken by private industry. The economic idea behind some of these corporations were, to reap the benefits of economies of scale and to minimise diseconomies of private enterprise such as wasteful competition in a resource limited economy.\(^2\) However, in some of the corporations installed capacity has been too large when seen in the light of raw material availability and future sales/externally and internally. One example of the former is the excess capacities of the factories of the sugar corporation and of the latter is the limited market envisaged for the products of the tyre corporation. Thus in some of the corporations the industrial mix is not correct to reap the advantages of large scale production. It may perhaps be argued by some, that excess capacities are necessary due to the prospects of future expansion and development. While agreeing to a certain extent, the equally cogent observation has to be made that excess capacity ties up much needed investment funds especially foreign exchange in idle factory capacity while over the years underutilized production runs depreciate the machinery as well as making them obsolete.

---

1. See Chapter 2
2. See Chapter I, Section I.8
3.3.3 On the side of finance, the financial soundness of some of the ventures cannot be assessed on a free economy criterion for a number of reasons. Firstly, most of these industries enjoy monopoly status in the country due to Governmental control of import of goods manufactured by the corporations and the restrictions on private industry in producing some of the products made by them. Thus local sales are to a captive market. Secondly, the profit criterion is also burdened by the fact, that some of the corporations have to put social considerations ahead of profit motive. Therefore they are not entirely free to fix their selling prices while at the same time they are required to perform relatively uneconomic services which are not undertaken by normal private business establishments. Thirdly, although most of the corporations are corporate bodies the Board of Directors are not entirely free to take business decisions of the type taken in privately owned industry and there is considerable amount of political interference in the overall administration of the corporations. Keeping these factors in mind, if one assesses the performance in terms of production and sales, several of the corporations have been consistently running at a loss, some of the losses of these corporations would have been greater if the opportunity costs of some of these funds blocked by way of idle capacity is taken into account. However, in recent times a number of them seem to be maturing in terms of administration, business strategy and financial management as shown by a recent survey of this sector.¹

3.3.4 As described in chapter two, these large corporations were intended primarily to be growth points for a number of small industries in the private and State sectors, with these corporations forming the core in forward and backward linkage, with input and output complementary and established chains of communication. The result so far has not proven this

¹. Central Bank of Ceylon.
point and complementarity has been sacrificed for individual self-sufficiency and vertical integration at considerable cost and waste of resources.

3.3.5. The private sector industry group comprise of a very large number of industrial units and the available estimates are rough calculations. The industrial units can be categorized into a number of sub-sectors, i.e.

(a) Cottage industries which consists of manufacturing and handicraft activities carried out in homes and backyards.
(b) Hand-loom units consisting of co-operative, private and individual weaver units.
(c) Power loom establishments both co-operative and private.
(d) Non-mechanized factory type units and mechanized factory units producing categories of goods falling into all nine sectors of table 17.
(e) Mining units

**TABLE I2**

**PRODUCTION UNITS IN THE INDUSTRIES SECTOR - 1970**

*(A Rough Estimate)*

<table>
<thead>
<tr>
<th>Sub-Sectors</th>
<th>Estimated No. of Units</th>
<th>Percentage of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Cottage Industry including handicrafts</td>
<td>11,200</td>
<td>43.1</td>
</tr>
<tr>
<td>B. Textiles Hand-loom</td>
<td>6,100</td>
<td>24.0</td>
</tr>
<tr>
<td>C. Textiles Power-loom</td>
<td>50</td>
<td>0.2</td>
</tr>
<tr>
<td>D. Manufacturing, i.e. All other products (mechanized and non-mechanized)</td>
<td>6,500</td>
<td>25.2</td>
</tr>
<tr>
<td>E. Mining Units</td>
<td>2,000</td>
<td>7.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>25,850</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Sources: Department of Census and Statistics, Department of small Industries, Ministry of Industries and Central Bank of Ceylon.
3.3.6 The largest group of units are in sub-sector 'A', followed by sub-sectors, 'B', 'E', 'E' and 'C'. This sector is characterised by a fairly small organised sector containing well established private firms, large, medium and small, of around 2500 units; and a very large number of loosely organised small units in the region of about 22,500 units.¹ On the whole manually operated industrial units predominate, while during the last few years there has been a process of increase of power using factory type industry. In the private sector the large and medium scale sector is estimated to be responsible for 53 per cent of the industrial output (gross value), 48 per cent of value added, 40 per cent of capital used and 24 per cent of the employment. The small scale sector is estimated to contribute 40 per cent output, providing employment for 71 per cent of the total employed, while using only 15 per cent of the total capital. As compared to these two sectors the state sector uses 45 per cent of the industrial capital, but provides only 10 per cent of the output employing only 10 per cent of the total.²

3.3.7 The majority of the large and medium scale private firms, fall into category 'D' above, consisting of mechanized factory type units. These comprise firms which were originally started by British interests or were subsidiaries of foreign firms, and secondly, those started by Ceylonese interests during the last two decades. Most of the former type of firms have over the years undergone a gradual process of ceylonization, with transfer of management to Ceylonese as well as Ceylonese being elected to the Board of Directors. Foreign Companies form the majority of those companies that handle the processing of tea, while their share in the manufacture of other products is insignificant. The type of management and

¹. See Table 12
². The sector classification is based on the classification compiled by N.V.Divatia, U.N.Industrial Economist in 1970/71
administration of these companies are representative of the business methods and practises of the western world. Large Ceylonese enterprises form the majority in the manufacture of rubber, and coconut products and the manufacture of consumer goods both perishes and durables and light engineering products. Though a number of them are quoted in the stock market, the great majority of them are more or less closed companies where the portfolio of shares are concerned, as the shares are held by family members, relatives and closed business associates and their transfer are strictly controlled. The financial and general administration of these firms are modelled on the former. In total number both groups constitute of roughly 1,000 firms.

3.3.8 As this study is more concerned about the small scale sector, an attempt is made in the following pages to describe this sector. The scantiness of literature and data, limits a detailed description of this sector. There has been no official surveys undertaken to study this sector nor has there been any attempt at demarcation of this sector.\(^1\) However, for the purposes of this study information on this sector has been gathered from widely scattered sources\(^2\) and the description is based on a recent study by a United Nation Industrial Economist in Ceylon.\(^3\)

3.3.9 According to these sources the small scale sector is taken to comprise five sub sectors.

(a) Manufacturing and handicraft activities carried out in homes and backyards. (excluding hand-loom weaving)

(b) Handloom weaving in homes or in co-operative, Government or private establishments.

---

1. See chapter 1, Section 1.5 and Chapter 5, Section 5.4
2. e.g. Central Bank, Department of Industries, Industrial Development Board and other published material.
3. See Bib.62
(c) Power-loom weaving in State or private establishments
(d) Manufacturing activities carried out in co-operative, private and
    Government establishments, with or without the use of power
(e) Small scale mining and mineral processing activities.

The upper limit in terms of capital investment for the above
demarcation is taken to be Rupees 100,000. The distribution of production
units based on figures from 1966-68 is given in table 13.

3.3.10 The major characteristics of this sector are the
    predominance of non-power using, non-factory type units combined with low
    intensity of capital for worker and low productivity of labour. Labour
    intensive methods of manufacture are predominant, while unorganised business
    methods and practices prevail.

3.3.11 Despite some of the present weaknesses of this sector,
    it is the biggest provider of employment at low capital cost, both of
    foreign and local capital. In the light of exchange scarcity and the need
    to provide employment at a rapid rate, this sector given the necessary
    incentives could play an important role in the industrial development of
    the country, due to the existing growth potential in the industries of this
    sector. Table 14 gives the estimated growth potential of some of the impor-
    tant sub-sectors in the small scale sector.

3.4.12 The importance of this sector in the overall industrial
    structure is seen in the table 15. This table shows estimated output,
    employment and fixed capital together with economic co-efficients in the
    mining and manufacturing sector for the year 1968. Though these estimates
    are based on weak data it tends to give a broad understanding of the
    structure as it is today, i.e. the place of the private sector as against
    the State sector, and the place of the sub-sectors in the private sector
    against each other as well as the public sector.
### TABLE 13

**DISTRIBUTION OF PRODUCTION UNITS IN SMALL SCALE INDUSTRY SECTOR:**

**BY ORGANISATION SUB-SECTORS: CEYLON 1968**

<table>
<thead>
<tr>
<th>Organizational Sub-Sectors of Small-Scale Sector</th>
<th>Estimated No. of Units</th>
<th>Sources of Data for Estimation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Cottage Industry (incl. Handicrafts)</strong></td>
<td>11,161</td>
<td>Non-mechanised Units employing 0 to 4 persons. (Census Dept. 1968 Survey) Excl. Handlooms</td>
</tr>
<tr>
<td>2. Handloom Industry</td>
<td></td>
<td><strong>46.5</strong></td>
</tr>
<tr>
<td>(a) Cooperatives</td>
<td>6,025</td>
<td>Based on Data from Dept. of Small Industries &amp; Handloom Survey 1964.</td>
</tr>
<tr>
<td>(b) Govt. Centres and Schools</td>
<td>(2,400)</td>
<td>Assumed Figure</td>
</tr>
<tr>
<td>(c) Private Units</td>
<td>(1,850)</td>
<td>Based on Handloom Survey 1964 &amp; Small Industry Dept. data (estimate for 1970)</td>
</tr>
<tr>
<td>(d) Individual Weaver's Units</td>
<td>(1,275)</td>
<td>Based on Handloom Survey 1964.</td>
</tr>
<tr>
<td>3. Powerloom Establishments</td>
<td>52</td>
<td><strong>20.8</strong></td>
</tr>
<tr>
<td>(a) Public (Small Ind. Dept.)</td>
<td>(32)</td>
<td>Non-Mechanised Units, excluding Handloom Units, and Mechanised having up to 10 employees (Dept. of Census 1968 Industry Survey)</td>
</tr>
<tr>
<td>(b) Cooperatives</td>
<td>(10)</td>
<td>Small Industry Dept. Loomage based on Textile Committee Report, at 50 looms per Centre</td>
</tr>
<tr>
<td>(c) Private</td>
<td>(10)</td>
<td>- - - - do - - - -</td>
</tr>
<tr>
<td>4. Small Factory Type Units</td>
<td>5,000</td>
<td><strong>7.4</strong></td>
</tr>
<tr>
<td>(a) Private</td>
<td>(4,966)</td>
<td>National Small Industry Corporation Factories and Fisheries Units</td>
</tr>
<tr>
<td>(b) Public</td>
<td>(14)</td>
<td>Estimated on basis of 17,600 employed (Sector Programme 1968) at average of 10 persons per Unit (weak estimate)</td>
</tr>
<tr>
<td>5. Small Scale Mining Units</td>
<td>1,760</td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

**TOTAL** 24,008

Source: Compiled by Mr. M.V. Divatia, ILO Expert (See Bib. 62)
### TABLE 14

**ESTIMATED GROWTH POTENTIAL OF SOME IMPORTANT SUB-SECTORS IN THE SMALL SCALE SECTOR.**

<table>
<thead>
<tr>
<th>Sub - Sector</th>
<th>Present Output (value added) (Percentage)</th>
<th>Present Employment (Percentage)</th>
<th>Growth Potential (Percentage per annum)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Textile</td>
<td>21.9</td>
<td>25.3</td>
<td>10 to 12</td>
</tr>
<tr>
<td>Light Engineering</td>
<td>13.2</td>
<td>8.0</td>
<td>10 to 20</td>
</tr>
<tr>
<td>Wood Products</td>
<td>11.0</td>
<td>26.0</td>
<td>10 to 12</td>
</tr>
<tr>
<td>Bakeries, Confectionary, etc.</td>
<td>10.0</td>
<td>4.7</td>
<td>6 to 8</td>
</tr>
<tr>
<td>Clay Products</td>
<td>7.7</td>
<td>10.0</td>
<td>8 to 10</td>
</tr>
<tr>
<td>Tobacco Products</td>
<td>7.4</td>
<td>8.4</td>
<td>8 to 10</td>
</tr>
<tr>
<td>Paper Products and Printing</td>
<td>6.7</td>
<td>3.8</td>
<td>10 to 12</td>
</tr>
<tr>
<td>Coconut Products</td>
<td>5.4</td>
<td>9.5</td>
<td>8 to 10</td>
</tr>
<tr>
<td>Grain Milling and Grinding</td>
<td>4.1</td>
<td>0.9</td>
<td>10 to 12</td>
</tr>
<tr>
<td>Mining</td>
<td>2.7</td>
<td>1.3</td>
<td>14 to 15</td>
</tr>
</tbody>
</table>

Source: Mr. M. V. Divatia, U.N. Economist, Ceylon.

Notes. Estimates are based on existing capacities, the present and future demand for these products, estimation of future needs in relation to other sectors of the economy.
TABLE 15

ESTIMATED OUTPUT EMPLOYMENT AND FIXED CAPITAL TOGETHER WITH ECONOMIC COEFFICIENTS IN THE MINING AND MANUFACTURING SECTOR - 1968.

<table>
<thead>
<tr>
<th>SECTORS</th>
<th>OUTPUT</th>
<th>EMPLOYMENT</th>
<th>CAPITAL</th>
<th>ECONOMIC COEFFICIENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Gross Value</td>
<td>Net Value Added</td>
<td>%</td>
<td>Number Employed</td>
</tr>
<tr>
<td>I. Public</td>
<td>310.0 (a)</td>
<td>124.0 (h)</td>
<td>4.4</td>
<td>18,700 (p)</td>
</tr>
<tr>
<td></td>
<td>3374.0 (c)</td>
<td>1093.0 (i)</td>
<td>95.6</td>
<td>795.0</td>
</tr>
<tr>
<td>2. Private</td>
<td>1952.0 (d)</td>
<td>586.0 (j)</td>
<td>48.2</td>
<td>103,300 (r)</td>
</tr>
<tr>
<td>(a) Large Scale</td>
<td>1422.0 (e)</td>
<td>507.0 (k)</td>
<td>41.6</td>
<td>301,000 (s)</td>
</tr>
<tr>
<td>(b) Small Scale</td>
<td>895.6 (f)</td>
<td>358.0 (l)</td>
<td>29.4</td>
<td>110,000 (t)</td>
</tr>
<tr>
<td>(i) Factory Type</td>
<td>525.0 (g)</td>
<td>149.0 (m)</td>
<td>12.2</td>
<td>190,000 (u)</td>
</tr>
<tr>
<td>(ii) Non-Factor Type</td>
<td>525.0 (g)</td>
<td>149.0 (m)</td>
<td>12.2</td>
<td>190,000 (u)</td>
</tr>
<tr>
<td>TOTAL</td>
<td>3684.0 (b)</td>
<td>1207.0 (n)</td>
<td>100.0</td>
<td>423,000 (o)</td>
</tr>
</tbody>
</table>

Source: Derived from tables given in a paper presented by Mr. M.V. Divatia, Uni Economist 'Small-Scale Industry - Dimensions and Directions of Development'.

Source Notes: - (a) Ministry of Industries. (b) Sector Programme estimates for 1968. (c) Derived as balance of 'a' and 'b' above.

(Continued next page)
Source notes continued:

(d) Estimate is for large private factories. This is derived by deducting from total, value of gross output of approved industries, published by Ministry of Industries in Statistics of Industrial Production 1963 & 1969, total for public sector enterprises, and using additional data from Industrial Survey of Central Bank of Ceylon for 1968.

(e) 'c' less 'd' is taken to give gross value of output for the small scale sector comprising, Small factories, Handlooms, Coir works, Wood works, Metal product units etc., and other non factory type manufacture. (f) Estimate is rather weak as little specific data are available. It is made by dividing up small scale industries output, i.e. Rs.1,422.6Ml., for each of the 25 sectors, between Factory type and non-factory type output on the basis of available scattered information and personal judgement.

(g) This is the residual in the small scale sector. (h) Value added to gross value ratio from Census & Statistics Dept. 1968 Survey (table for Public Sector). (i) Residual figure. (j) On basis of sector programme data. Value added to Gross value ratio would be 0.3 (k) Residual (l) Ratio from survey of approved small scale industries 1964 (SISI) Mr. M.V. Divatia. (m) Residual. (n) Estimate based on 1963 population census, i.e. gainfully occupied population tables. (p) Ministry of Industries data. (q) Residual. (r) Based on data published by Ministry of Industries, i.e. Statistics of Industrial production 1963 & 1969. (s) Residual. (t) Based on value added per worker in Small Scale Factory industry from Survey of approved Small Scale Industries 1964. (u) Residual. (v) Capital employed in State factories of Ministry of Industry Corporations, plus capital employed in the Milk Board plant (Rs 23.3 Mn.), Sugar Plants (Rs 81.1 Mn.) Petroleum Refinery (Rs. 107.6 Mn.) and Government Distillery (Rs. 2.6 Mn.).

(w) On the basis of Department of Census and Statistics survey of 1968, an average capital output ratio (value added) of 1:1 for large scale private industry seems reasonable.

(x) For Small Scale factory sector average average capital output ratio of 0.5, seems reasonable on basis of data in Survey of approved small scale industries - 1964, SISI.

(y) For non-factory type small scale industry which includes Handlooms, Woodwork, Potteries, Coir Works, etc., a ratio of 0.2 seems reasonable. Some support for this case could be found in Survey data for such industries from publications of Government of Bombay and Kerala State in India.

(+) Assumed to be reasonable for these sectors on the basis of available data.
3.3.13 Although the figures given in table 15 are estimates, it shows an important aspect of small firms as compared to state and large private industry. The table in terms of sector analysis shows, the predominant contribution of the small sector in terms of capital employed and output produced. The results are as follows:

TABLE 16
CAPITAL EMPLOYED AND OUTPUT RELATIONSHIP OF DIFFERENT SECTORS FOR 1968

<table>
<thead>
<tr>
<th>Industry</th>
<th>Fixed Capital used Rs. Mil.</th>
<th>Per Centage</th>
<th>Output Rs. Mil.</th>
<th>Per Centage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large - State</td>
<td>680</td>
<td>45.4</td>
<td>124.0</td>
<td>10.2</td>
</tr>
<tr>
<td>Large - Private</td>
<td>586</td>
<td>39.7</td>
<td>586.0</td>
<td>48.2</td>
</tr>
<tr>
<td>Small - Private</td>
<td>209</td>
<td>14.9</td>
<td>507.0</td>
<td>41.6</td>
</tr>
</tbody>
</table>

3.3.14 However, one cautionary note should be drawn here not to take these statistics at face value, for, as stated in section 3.3.3 all state industries have not been set up with only a pure profit motive in mind. But it does not escape from the fact that the state sector is very capital intensive, resulting in considerable excess capacities, that have not been utilised over a number of years. In this sense scarce foreign and local capital have remained unproductive and blocked in these units.

1. The classification of 'small firm' here is taken in terms of Divatia's classification, i.e. Rs.100,000 worth of investment in fixed capital. However, this size demarcation also falls within the small firm size demarcation made in this study.
3.3.15 Table 15 also shows that in terms of employment, with the same capital base the small sector provides employment for 71.2 per cent of the working population as compared to 24.4 and 4.4 per cent of the large private and the state sector respectively. This in turn shows another important aspect of small firms, namely, as a provider of employment, which underlines again the need to encourage this sector. The problem of providing employment to the growing workforce is one of the serious problems in the economy today. This, coupled with the capital shortage in the economy and the productivity of this sector in terms of capital employed, points this sector to be the real growth sector for the future. The future growth potential of the sector in terms of the overall foreign exchange shortage in the economy is seen in the following statement by Divatia:

"Based on available data and circumspect estimation it would appear that the foreign exchange per unit employment, i.e. imported input plus amortised value of machinery and equipment in the public (state) sector may be of the order of Rs.6,000 and in the large scale private sector Rs.100,000 or so and as low as Rs.11 to Rs.200 in the small scale sector." (See Bib.62)

3.3.16 Section II of table 15 shows the economic co-efficients of the sectors. This despite being based on weak data shows that the small sector has capital output ratio of 0.41 for a fixed capital per worker of Rs.695 as compared to capital output ratio and fixed capital per worker 5.48 and Rs.36,400 and 1.0 and Rs.5,674 for the state sector and the large scale private sector respectively. This vast disparity despite higher labor productivity in the state and large private sector due to higher levels of mechanization shows once again the small sector as the most favourable sector in terms of future expansion and development.

3.3.17 In concluding this section it may be worthwhile to summarize the salient features of the industrial structure as it exists today. (a) The existence of a capital intensive State sector, side by side with
the private sector, which is divided into an organised sector, and a large unorganised sector comprising of small scale non-factory type, manually worked units.

(b) The relatively low productivity of capital and labour and the low capital intensity of production.

(c) The high dependence of imported capital goods and raw materials by the sector as a whole.

(d) The heavy concentration, towards the manufacture of consumer goods for the home market.

(e) The poor inter-industry linkages and the excess capacities in many units.

(f) Finally the relatively small contribution of this sector to the Gross National Product, at present.

3.3.18 Having broadly outlined the characteristics of the industrial sector in the following pages an attempt is made to analyse the structure of industry according to capacities, production and employment. This section is based mainly on the data collected by the Central Bank over the years 1966-70 and the Ministry of Industries. The statistics used here apply only to a limited number of units, however, keeping in mind that the organised sector in private industry roughly comprises of 2,500 units (see section 3.4.7) and in the State sector comprises of 24 units (see section 3.4.1), the surveys cover nearly 80 per cent of the units in the organised sector. Therefore, although the data does not cover comprehensively the whole industrial sector it tends to show the principle trends which can be taken with fair accuracy to represent the whole manufacturing sector for this period. However, in the case of 1970 industrial data for the whole sector has been compiled by the Ministry of

1. See Table 17 - 'Value of Production and Employment of selected firms'
Industries. Though capital investment in the private sector would have given important insights into the dimensions of development of this sector, no such data is available for the year 1970 which covers the whole private sector. With these limitations in mind an analysis is made only of the statistics made available by the Central Bank on their coverage of 1394, 1830, 1804, 1962 and 1853 industrial units for the five years 1966 to 1970 respectively.

3.3.19 In table 17 industries are classified into nine major groups, on the basis of the United Nations classification of industry, giving the total number of units, employment and value of production. The table shows that in terms of production units, value and employment, group one dominates the industrial scene. In terms of production units, groups two, three and eight rank after group one, while in terms of production value, groups five, two and seven follow after one. In terms of employment groups one and two dominate the sector due to the large number of units in these groups and the labour intensive methods of production.

3.3.20 The value of industrial production in 1970 by 1853 units was Rs. 1,945 million. The marked increase in sector five was due to the commissioning of the petroleum refinery in late 1969. The increase in industrial production in 1970 over that of 1969 (exclusive of the output of the petroleum refinery) was 8.4 per cent. This increase as stated earlier (section 3.2.9) was due mainly to an increase in the production of state sector industries. In the total value of industrial production the share of the state sector and private sector industries were 69 and 31 per cent respectively. All groups have shown increases in the value of production in 1970, of which groups five, one and eight contributed most to the total, comprising of 60, 14 and 9 per cent respectively. The increases in group one, was mainly contributed to by the State corporations,
# TABLE 17

## VALUE OF PRODUCTION AND EMPLOYMENT OF SELECTED FIRMS 1966 - 1970

<table>
<thead>
<tr>
<th></th>
<th>Number of Firms</th>
<th>Number of Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Manufacture of Food Beverages &amp; Tobacco</td>
<td>711</td>
<td>822</td>
</tr>
<tr>
<td>2. Textiles, Wearing Apparel and Leather Industries</td>
<td>249</td>
<td>393</td>
</tr>
<tr>
<td>3. Manufacture of Wood and Wood Products including Furniture</td>
<td>1</td>
<td>14</td>
</tr>
<tr>
<td>4. Manufacture of Paper and Paper Products</td>
<td>54</td>
<td>78</td>
</tr>
<tr>
<td>5. Manufacture of Chemicals, Petroleum, Coal, Rubber, and Plastic Products</td>
<td>204</td>
<td>246</td>
</tr>
<tr>
<td>6. Manufacture of Non-Metallic Mineral Products except Petroleum and Coal</td>
<td>13</td>
<td>61</td>
</tr>
<tr>
<td>7. Basic Metal Products</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>8. Manufacture of Fabricated Metal Products, Machinery and Equipment</td>
<td>144</td>
<td>183</td>
</tr>
<tr>
<td>9. Manufactured Products n.e.s.</td>
<td>21</td>
<td>33</td>
</tr>
<tr>
<td>TOTAL...........</td>
<td>1,394</td>
<td>1,830</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.
which increased their production by 51 per cent. The increase in group five was as a result of the output of the petroleum refinery whose production was included for the first time in this sector. Group eight consists mainly of private sector units, which over the years 1967-70 have shown a steady increase in production, increasing by an average of 47 per cent per year, while the value of production rose by 33 per cent in 1970. The number of units in groups one and two have steadily decreased while in groups five and eight have increased. Most of the units that have stopped production in group one and two have been those inefficient industry and those speculative units that sprung up rapidly in these two sectors during the early sixties.¹

3.3.21 Table 18 shows the value of production by major economic categories for the years 1966-70 of the reporting firms. It shows the increase although at a decreasing rate of the consumer goods category, while percentage wise, there has been a decrease of 9 per cent of the whole sector in comparison with the total of all sectors. From 1966 to 1970, intermediate goods sector, while showing a slow increase value-wise, its share in total production has dropped every other year from 1966 showing only a rise of 2.1 per cent in 1970 from its 1966 figure. Investment goods sector shows a rapid increase over the five years doubling its share in total production since 1966. The table also shows different sub-groups which showed increases over the years, i.e., in the consumer goods category, dairy products, preserved meats, beer, mineral waters and rubber products showed increases; in the intermediate goods category, paper products, electrical machinery, apparatus and supplies, and petroleum products showed marked increases; while in the investment goods category sub-sections i, ii, and vi showed increases.

¹ See sections 2.4.II to 2.4.I4
### TABLE 18

**VALUE OF INDUSTRIAL PRODUCTION 1966–1970**

by Major Economic Categories

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Consumer Goods</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. Food, Drink and Tobacco</td>
<td>138.5</td>
<td>209.8</td>
<td>287.6</td>
<td>346.7</td>
<td>16.9</td>
<td>19.5</td>
</tr>
<tr>
<td>(a) Food Preparations</td>
<td>8.1</td>
<td>11.4</td>
<td>15.9</td>
<td>19.6</td>
<td>1.8</td>
<td>2.2</td>
</tr>
<tr>
<td>(b) Preserved and canned fruits, vegetables, meat and other sea foods</td>
<td>38.6</td>
<td>33.9</td>
<td>45.6</td>
<td>53.9</td>
<td>2.5</td>
<td>3.1</td>
</tr>
<tr>
<td>(c) Biscuits and sugar confectionery</td>
<td>2.7</td>
<td>3.0</td>
<td>3.6</td>
<td>4.0</td>
<td>3.1</td>
<td>3.5</td>
</tr>
<tr>
<td>(d) Aerated waters</td>
<td>11.6</td>
<td>14.5</td>
<td>17.9</td>
<td>21.2</td>
<td>1.8</td>
<td>2.4</td>
</tr>
<tr>
<td>(e) Arrack, beer, stout etc</td>
<td>5.5</td>
<td>5.5</td>
<td>6.0</td>
<td>6.0</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td>(f) Tobacco</td>
<td>11.6</td>
<td>14.5</td>
<td>17.9</td>
<td>21.2</td>
<td>1.8</td>
<td>2.4</td>
</tr>
<tr>
<td>II. Garments</td>
<td>7.5</td>
<td>11.9</td>
<td>16.5</td>
<td>19.9</td>
<td>1.1</td>
<td>1.6</td>
</tr>
<tr>
<td>III. Footwear and Leather products</td>
<td>25.7</td>
<td>31.9</td>
<td>38.9</td>
<td>45.1</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>IV. Miscellaneous Chemical Products</td>
<td>101.9</td>
<td>98.2</td>
<td>115.5</td>
<td>135.9</td>
<td>12.0</td>
<td>13.3</td>
</tr>
<tr>
<td>V. manufacture of Paper and Paper Products</td>
<td>22.3</td>
<td>20.8</td>
<td>19.4</td>
<td>13.1</td>
<td>2.6</td>
<td>2.2</td>
</tr>
<tr>
<td>VI. Fabricated Metal Products other than machinery and equipment</td>
<td>5.7</td>
<td>7.7</td>
<td>9.1</td>
<td>13.1</td>
<td>3.4</td>
<td>4.6</td>
</tr>
<tr>
<td>VII. Plastic Products</td>
<td>15.9</td>
<td>25.9</td>
<td>32.2</td>
<td>37.8</td>
<td>3.7</td>
<td>4.2</td>
</tr>
<tr>
<td>VIII. Glass and Glass Products</td>
<td>7.0</td>
<td>7.2</td>
<td>7.7</td>
<td>8.2</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>IX. Ceramics</td>
<td>2.3</td>
<td>3.3</td>
<td>4.4</td>
<td>5.5</td>
<td>1.1</td>
<td>1.4</td>
</tr>
<tr>
<td>X. Rubber Products</td>
<td>7.0</td>
<td>14.0</td>
<td>24.2</td>
<td>41.3</td>
<td>46.7</td>
<td>0.8</td>
</tr>
<tr>
<td>XI. Spinning, Weaving and Finishing of Textiles</td>
<td>37.5</td>
<td>97.1</td>
<td>136.7</td>
<td>172.2</td>
<td>173.3</td>
<td>11.2</td>
</tr>
<tr>
<td>XII. Manufactures of wood</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>XIII. Manufactured products, n.e.s</td>
<td>1.7</td>
<td>2.2</td>
<td>2.7</td>
<td>3.5</td>
<td>2.2</td>
<td>2.7</td>
</tr>
<tr>
<td><strong>B. Intermediate Goods</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. Food Preparations</td>
<td>245.9</td>
<td>236.6</td>
<td>371.2</td>
<td>534.2</td>
<td>337.8</td>
<td>28.9</td>
</tr>
<tr>
<td>II. Fabricated Metal Products other than machinery and equipment</td>
<td>8.5</td>
<td>8.5</td>
<td>8.9</td>
<td>10.7</td>
<td>11.5</td>
<td>1.0</td>
</tr>
<tr>
<td>III. Manufacture of Paper and Paper Products</td>
<td>11.5</td>
<td>13.9</td>
<td>35.7</td>
<td>48.9</td>
<td>51.9</td>
<td>1.4</td>
</tr>
<tr>
<td>IV. Plywood</td>
<td>6.8</td>
<td>6.8</td>
<td>8.9</td>
<td>10.8</td>
<td>10.8</td>
<td>0.8</td>
</tr>
<tr>
<td>V. Manufacture of Lumber</td>
<td>1.4</td>
<td>1.4</td>
<td>2.2</td>
<td>3.1</td>
<td>4.7</td>
<td>0.2</td>
</tr>
<tr>
<td>VI. Industrial Chemicals</td>
<td>1.9</td>
<td>1.9</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td>0.2</td>
</tr>
<tr>
<td>VII. Electrical machinery, apparatus, appliances and supplies</td>
<td>20.8</td>
<td>28.1</td>
<td>41.8</td>
<td>66.3</td>
<td>88.4</td>
<td>2.4</td>
</tr>
<tr>
<td>VIII. Petroleum and Coal Products</td>
<td>—</td>
<td>—</td>
<td>8.3</td>
<td>11.0</td>
<td>19.1</td>
<td>—</td>
</tr>
<tr>
<td><strong>C. Investment Goods</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. Fabricated Metal Products other than machinery and equipment</td>
<td>32.6</td>
<td>37.9</td>
<td>61.5</td>
<td>82.0</td>
<td>3.5</td>
<td>4.6</td>
</tr>
<tr>
<td>II. Rubber Products</td>
<td>11.9</td>
<td>6.7</td>
<td>13.0</td>
<td>11.5</td>
<td>9.7</td>
<td>1.4</td>
</tr>
<tr>
<td>III. Cement, cement products and asbestos products</td>
<td>28.8</td>
<td>53.5</td>
<td>70.0</td>
<td>89.0</td>
<td>124.8</td>
<td>3.4</td>
</tr>
<tr>
<td>IV. Machinery (except electrical and transport equipment)</td>
<td>—</td>
<td>19.8</td>
<td>45.9</td>
<td>77.9</td>
<td>93.2</td>
<td>—</td>
</tr>
<tr>
<td>V. Bricks and Tiles</td>
<td>—</td>
<td>10.2</td>
<td>7.3</td>
<td>14.8</td>
<td>13.2</td>
<td>—</td>
</tr>
<tr>
<td>VI. Iron and Steel Basic Industries</td>
<td>—</td>
<td>27.3</td>
<td>28.8</td>
<td>38.9</td>
<td>—</td>
<td>2.0</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>850.3</td>
<td>954.2</td>
<td>1,138.6</td>
<td>1,626.8</td>
<td>1,945.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

* Includes glass and glass products.

1. Dairy products, ice cream, salt etc.
2. Jams, jellies, sauces, fruit cordials etc.
4. Shirts, blouses etc.
5. Pharmaceuticals, cosmetics, soaps and cleaning compounds, matches, toothpaste etc.
6. Writing paper, exercise books etc.
7. Aluminium ware.
8. Car and cycle tyres and tubes, toys and household goods.

Source: Central Bank of Ceylon.

9. Brushes, slates, printing blocks, toys, musical instruments, etc.
10. Cattle and poultry foods, vegetable oil, ice, desiccated coconut, etc.
11. Containers.
12. Printing paper, cartons, other packing boxes and wrapping paper.
13. Caustic soda and chlorine.
15. Tyre retreading.
16. Rolled sections and wire products.
3.3.22 Table I9 shows the location of industries by provinces. It shows that out of a total of 1412 enterprises, 1148 or 81.3 per cent are located in the Western Province and most are in and in close proximity to the Colombo District. It was only recently that a concerted effort has been made to encourage the development of industry in other provinces and districts. Table I7 which also gives the employment figures for the years 1966-1970, shows a steady expansion of employment. In comparison to 1969 despite a drop in the number of reporting firms by 109 units there was expansion in employment by 1,379 persons. The major increases in employment were in the labour intensive industries such as food processing and textiles, and in the petroleum, rubber and chemicals group due to the commissioning of the petroleum refinery.

3.3.23 Table II showed the local and foreign raw material usage of 1,251 units in 1970. The high percentage of foreign raw material components in the manufacturing sector have been mentioned earlier. This pattern of raw material usage has remained more or less the same during the last five years. The problem becomes acute when viewed from the angle of the balance of payments situation discussed earlier, especially, when the value of raw materials comprises of nearly 50 per cent of the value of production. Out of the nine groups on this survey, seven of them use more than half foreign raw material for their products, and this is especially acute in groups (v), (vii), (viii) and (ix). Comparative figures for the last three years show that the total foreign and local raw material usage

---

1. Ceylon is divided into nine administrative provinces and into sixteen revenue districts.
2. The capital of Ceylon is Colombo. The premier harbour and airport are situated in this province. It is also the most densely populated province in Ceylon.
3. See section 3.3.10
4. See section 3.2.12
5. Group viii - the basic metal product group - uses 100 per cent foreign raw materials.
for the years 1968, 1969 and 1970 were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Local</th>
<th>Foreign</th>
</tr>
</thead>
<tbody>
<tr>
<td>1968</td>
<td>35.5</td>
<td>64.5</td>
</tr>
<tr>
<td>1969</td>
<td>34.0</td>
<td>66.0</td>
</tr>
<tr>
<td>1970</td>
<td>25.3</td>
<td>74.5</td>
</tr>
</tbody>
</table>

Despite the hope of the planners that with the establishment of the industrial base, there would be a greater increase in local raw material usage over the years, due to greater research and development, and inter-linkage of industry, the trend during the last few years have been just the reverse. This is even apparent in those sectors which were expected to have made greater substitution in local raw material in the process of production, due to the very possible prospects of producing the raw materials required locally, namely, in food, beverages and tobacco sector and textiles, wearing apparel, and leather industries. In the former foreign raw material value has increased from 46.6 per cent in 1969 to 62.4 per cent in 1970, while in the latter the increase has been from 58.3 per cent in 1968 to 73.1 per cent in 1970, price rise in the imported raw materials alone cannot account for the increase in value.

3.4. PROJECTIONS FOR THE FUTURE

3.4.1 In the medium term plan of the Government drawn up by the Ministry of Planning and Employment for the years 1972 - 1976, the plan for industry has been drawn up with four objectives in view, namely,
(a) Creation of employment opportunities
(b) To make the most effective use of available foreign exchange resources in terms of investment and raw materials
(c) The production of essential commodities for mass consumption to meet the expected increase in demand consequent to an increase in incomes and

---
1. See Bib.56
employment.

(d) The need to gear the process of industrial expansion to the export market as the potential for import substitution progressively diminishes.

In this Plan the private small scale sector has been given a prominent place in the process of social and economic development of the country. The Government envisages the small scale sector to play its part despite the Governments' intention of giving priority to the public sector industries. Further the Government intends to limit foreign exchange allocations to the large scale private sector. Thus the field is open to small scale sector industries in the Plan, while in return the Government expects this sector to meet a large proportion of the growth targets for industry in the private sector during the proposed medium term plan (1972-76).

3.4.2 The reason for the emphasis in the new Plan is the result of two problems that have plagued the economy of Ceylon for a considerable period of time, namely, foreign exchange scarcity and the rising unemployment situation in Ceylon. As seen in table I5 both in terms of output and employment the small firm sector is very much less capital consuming than the other sectors. Further due to the labour intensive methods of manufacture this sector provides employment to a large sector of the growing industrial population.1 Thus in the new Plan this sector is expected to expand with minimal use of foreign exchange reserves. With this end in view the Government by research and development intends to encourage greater use of local raw materials and expects the new industries that are to be set up to make maximum efforts to tap local raw material sources. It is also stated, that the Government plans to approve in the first instance those industries which are agro-based, while the capital goods needs of the small

---

1. In 1970 roughly about 70 per cent of the employment and around 30 per cent of the value added was in this sector.
<table>
<thead>
<tr>
<th>Industry Type</th>
<th>Western Province</th>
<th>Northern Province</th>
<th>Southern Province</th>
<th>Eastern Province</th>
<th>Central Province</th>
<th>N.Western Province</th>
<th>N.Central Province</th>
<th>Sabaragamuwa Province</th>
<th>Uva Province</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms %</td>
<td>159 72.9</td>
<td>10 4.6</td>
<td>12 5.5</td>
<td>6 2.8</td>
<td>16 7.3</td>
<td>5 2.3</td>
<td>1 0.5</td>
<td>-</td>
<td>-</td>
<td>218 100.0</td>
</tr>
<tr>
<td>1. Manufacture of Food, Beverages &amp; Tobacco</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firms %</td>
<td>159 72.9</td>
<td>10 4.6</td>
<td>12 5.5</td>
<td>6 2.8</td>
<td>16 7.3</td>
<td>5 2.3</td>
<td>1 0.5</td>
<td>-</td>
<td>-</td>
<td>218 100.0</td>
</tr>
<tr>
<td>2. Textiles, Wearing Apparel, and Leather Industries</td>
<td>353 80.0</td>
<td>12 2.7</td>
<td>31 7.0</td>
<td>3 0.7</td>
<td>23 5.2</td>
<td>12 2.7</td>
<td>1 0.2</td>
<td>1 0.2</td>
<td>5 1.2</td>
<td>21 100.0</td>
</tr>
<tr>
<td>3. Manufacture of Wood and Wood Products Including Furniture</td>
<td>12 80.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td>1 6.7</td>
<td>15 100.0</td>
</tr>
<tr>
<td>4. Manufacture of Paper and Paper Products</td>
<td>353 89.6</td>
<td>4 4.2</td>
<td>4 4.2</td>
<td>1 1.0</td>
<td>1 1.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>96 100.0</td>
</tr>
<tr>
<td>5. Manufacture of Chemical Petroleum, Coal, Rubber and Plastic Products</td>
<td>353 85.6</td>
<td>7 2.7</td>
<td>11 4.3</td>
<td>1 0.4</td>
<td>15 5.3</td>
<td>1 0.4</td>
<td>-</td>
<td>-</td>
<td>2 0.8</td>
<td>257 100.0</td>
</tr>
<tr>
<td>6. Manufacture of Non-Metallic Mineral Products except Petroleum and Coal</td>
<td>353 87.6</td>
<td>11 3.9</td>
<td>9 3.2</td>
<td>2 0.7</td>
<td>8 2.8</td>
<td>6 2.1</td>
<td>1 0.4</td>
<td>-</td>
<td>-</td>
<td>252 100.0</td>
</tr>
<tr>
<td>7. Basic Metal Products</td>
<td>353 87.6</td>
<td>11 3.9</td>
<td>9 3.2</td>
<td>2 0.7</td>
<td>8 2.8</td>
<td>6 2.1</td>
<td>1 0.4</td>
<td>-</td>
<td>-</td>
<td>252 100.0</td>
</tr>
<tr>
<td>8. Manufacture of Fabricated Metal Products, Machinery and Equipment</td>
<td>245 86.9</td>
<td>11 3.9</td>
<td>9 3.2</td>
<td>2 0.7</td>
<td>8 2.8</td>
<td>6 2.1</td>
<td>1 0.4</td>
<td>-</td>
<td>-</td>
<td>252 100.0</td>
</tr>
<tr>
<td>9. Manufacture Products</td>
<td>19 73.1</td>
<td>1 3.8</td>
<td>2 7.7</td>
<td>-</td>
<td>4 15.4</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>26 100.0</td>
</tr>
<tr>
<td>Total</td>
<td>1148 81.3</td>
<td>46 3.3</td>
<td>73 5.2</td>
<td>16 1.1</td>
<td>69 4.9</td>
<td>39 2.8</td>
<td>2 0.1</td>
<td>3 0.2</td>
<td>16 1.1</td>
<td>1412 100.0</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon
industries are to be met by a programme of local production.

3.4.3 Expansion of this sector goes hand in hand with the greater opportunity of employment prospects in rural areas and a gradual shift of population pressures in the urban areas. Another aim the Government hopes to fulfill by this Plan is to bring about regional growth and better living standards in semi-urban and rural areas. Table 19 showed that nearly 90 per cent of the industrial units are concentrated in the Western Province and most of them in and around the capital city. One problem has been the dispersion of industry in other districts, this is to be partially solved by setting up small agro-based industrial units in rural areas with feeder agricultural programmes, so that processing is near the source of supply. This proposal in turn tackles another aspect of growth that has been neglected so far, namely, the development of an industrial sector producing a wide variety of items based on domestic agriculture. For example, tapioca flour for bread and industrial starch, vegetable fibres for textiles, vegetable oils, and natural silk.

3.4.4 Though this plan shows a polarisation of policy objectives towards the important role that small firms can play in industrialization, it seems to have omitted the most important link that has eluded this sector in achieving a comparable degree of success, i.e. the provision of adequate financial facilities and services ancillary to finance. The latest policy statement observes that,

"Small scale industry has been vested with a significant role in the country's economic and social development. It is expected to ensure increasing use of indigenous raw materials, minimal use of Ceylon's scarce capital and foreign exchange resources and provide more direct and indirect employment opportunities with the available quantum of capital and foreign exchange resources. In addition to the important social objective of raising the level of employment, small scale industry is also required to bring about regional growth and better standards of living in the countryside, i.e. in semi-urban and rural areas, through a proper dispersal of industrial activity." (Bib.56)
3.4.5 This role is in fact a very responsible 'mantle' that has been put on the shoulders of the small firm sector, in the economic development of the country. But while the Government plans to provide the necessary infrastructure in all the other spheres as described in section 3.4 above, they have made no advance plans to tackle the problems of finance to this sector. For, as the Report further reads, it states that the Government intends to give first priority to the development of the State sector industries. With this end in view the Government proposes to set up a National Development Bank to provide financial facilities to the State Corporations. Further they intend to amalgamate the AICC¹ and the SMB² to form an Agricultural Development Bank for provision of finance to agriculture. The AICC despite its inactivity had provided some finance to industry, and this step eliminates even this meagre avenue to small industry. The DFCC as described in Chapter Four, provides finance to only large scale industry. Thus once again small industry is put in a 'cul-de-sac' as regards external finance. At present there are no plans afoot to create an organization, nor reorganise an existing institution to provide adequate financial facilities to the small scale sector.

3.4.6 The conclusion here is that the Government expects the small scale sector to find the finance as best as it can from the existing banks and other private sources. The primary aim of this research has been to show that the small scale sector cannot find adequate private finance and the facilities provided by the institutions are insufficient. If no immediate steps are taken, prior to the application of the new Plan, to understand the financial problems of this sector and provide the necessary financial infrastructure, this Plan too is bound to go the way of all other previous plans.

¹ Agricultural and Industrial Credit Corporation
² State Mortgage Bank
envisioned for this sector, namely, failure to 'lift-off' from the planning stage.

3.4.7 It is true that this overall plan is still in an embryonic stage and the overall financial implications of the plan has not been worked out as yet. But the absence of any thought at this preliminary stage to investigate the financial requirements of this sector leads one to doubt the practical success of this plan as far as the small sector is concerned.

3.4.8 Therefore how far the new policy will be successful depends first on the correct transfer of the plans on the 'research desk' to constructive practical application, and secondly on the provision of financial facilities and other services such as dissemination of correct techniques of financial planning and management to the would be industrialists.
CHAPTER 4

THE FINANCIAL STRUCTURE

4.1 INTRODUCTION

4.2 THE DEVELOPMENT OF FINANCIAL TRADITIONS PECULIAR TO CEYLON

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4.6 THE CENTRAL BANK OF CEYLON
4.1. INTRODUCTION

4.1.1 This chapter attempts to outline the overall financial complex of present Ceylon in relation to the industrial development of the country. In order to understand the present role of institutional finance in relation to the industrial sector it is necessary to trace the history of institutional finance briefly, as this has conditioned to a considerable extent the present structure. The outline of the structure here concentrates only on those aspects of development of the financial institutions and practices that have direct or indirect relevance to industrial financing.

4.2. THE DEVELOPMENT OF FINANCIAL TRADITIONS PECULIAR TO CEYLON

4.2.1 Before the advent of the British commercial banks in Ceylon towards the end of the first half of the nineteenth century, commerce was mainly dependent on a group of people who were traders as well as money lenders. They were from the South Indian district of Chettinad and were generally called 'chettiyars' in Ceylon. Around the beginning of the nineteenth century, their money lending activities were well established in Ceylon and for nearly three quarters of a century they played a very important role in the credit structure of the country. They had access to funds both from their well organized trade in India as well as their import/export trade between India and Ceylon. Later, when banks were established they were able to increase their capacity to lend by acting as intermediaries between the banks and the local traders and businessmen.

H.D. Andree in a paper in 1864 observed as follows:

"Judging from the fact that the entire grain trade was in the hands of the chettiyars, and that coffee planting was in its infancy, the exports consisting principally of cinnamon, coconut oil and coir, we may conclude that they met all the requirements of the merchants." 1

1. See Bib. 1 - A photostat copy of this article is available at the library of the London School of Economics.
4.2.2 The expansion of the plantation economy in the mid-nineteenth century created a demand for a proper banking system, and in 1841 the first bank in Ceylon was established, which later merged with another in 1847. In 1851 these two banks were incorporated to form the Oriental Banking Corporation of Ceylon. The early banks were bound by the Colonial Banking Regulations of 1840. These regulations influenced the development of the banking system to a considerable extent. The repercussions of some of these regulations are still prevalent in the present structure of banks. Those regulations that conditioned future banking practices in Ceylon were as follows:—It was required,

(a) that debts and engagements of the company, should not exceed at any time thrice the amount of paid up capital, with the addition of the amount of such deposits as may be made with the company's establishments by individuals in specie or Government paper

(b) that the Company shall not hold shares in its own stock, nor make advances on the security of its own stock

(c) that the discounts or advances by the company, on securities bearing the name of any director or officer thereof, as drawer, acceptor or endorser, shall not at any time exceed one third of the total advances and discounts of the bank

(d) that the company shall not advance money on the security of lands, houses or ships or on pledge of merchandise, nor hold land or houses except for the transactions of its business, nor own ships or be engaged in trade except as dealers in bullion or bills of exchange but shall confine its transactions to discounting commercial paper and negotiable securities and other legitimate banking business.

4.2.3 The banks for nearly another century operated within these regulations, and banks developed along the traditional lines of
British Banking Institutions. Clause (d) above of the regulations more or less excluded Ceylonese from access to banks, as in most cases they were only able to pledge land and merchandise as security. An examination of the principal activities of the first two banks in Ceylon bring to the fore, two prominent characteristics of banks. The principal activities were as follows:

**Deposits**: (i) acceptance of fixed and demand deposits

**Business**: (i) discounting bills of exchange drawn against the export of produce

(ii) issuing of drafts to all parts of the world

(iii) issuing letters of credit

**Loans**: (i) advancing money on cash credit account, as fixed loans for a period not exceeding six months, usually for a period of four months or less. The security of such loans consisted of (a) goods not of a perishable nature protected by fire insurance (b) life insurance policies (c) bills of lading with insurance policies attached (d) promissory notes bearing two names with not more than two months to run, and representing bona-fide commercial transactions.

4.2.4 The two principal characteristics were, (i) the essential short term character of its lending portfolio, for example, usance bills of exchange were for 6 months; advances were for 6 months, and promissory notes were for 4 months, (ii) the predominant position of financing foreign trade in its business activities, i.e. discounting bills of lading. Andree, considering the activities of the two banks of that time observed.

"the two banks established in the island are strictly and avowedly banks of exchange. The distinguishing principle of their business is to deal in foreign bills of exchange, the other branches of business being considered merely accessory... Thus the entire capital of the banks may be said to be devoted to exchange business being constantly employed in going backwards and forwards between the different branches and their head offices, while
a portion of their deposits is lent out to customers upon promissory notes and the balances held as reserve."

These activities enumerated above still are the major activities of the majority of the banks, with perhaps the exception of the two indigenous banks.

4.2.5 As most of the banks at this time were set up as appendages to the plantation economy, it was not surprising that most banks looked upon finance of exports and imports as their sphere of activity. The export trade comprised of nearly 80 per cent of tea, followed by rubber, coconut and other produce. As nearly all the tea plantations and around 50 per cent of the rubber plantations were owned by British companies, the export trade was in the hands of a few British Agency houses, Shippers and Brokers. The Agency houses, Brokering firms and Shippers, and the Bankers, were all members of the Chamber of Commerce. This brought them into close affinity and business was conducted on a basis of mutual trust and friendship and credit was often available to them on personal security. The diagram below outlines the flow of credit, during this period.

4.2.6 Upto around 1938 when the first indigenous bank was established the system remained as shown in diagram one, and the funds that the average Ceylonese investor or businessmen managed to obtain were those meagre funds which seeped through the system, namely, from the chettiyar via the shroff of the bank. The chettiyars lent money both for short and long term purposes such as for working capital, harvesting crops, purchase and development of estates, trade, production and consumption. They lent on mortgages over land and buildings, on promissory notes with or without security. But, for making credit readily available, they charged exorbitant rates of interest, sometimes ranging upto 200 per cent per annum. They

1. See Bib.I
2. Witnesses before the Ceylon Banking Commission of 1935 claimed that the rates charged varied between 10 to 200 per cent per annum, while the chettiyars claimed that the average rate was 13.5 per cent.
The diagram shows how the Ceylonese were outside the credit system prevalent at the time and the 'bottle neck' character of the flow of credit to the Ceylonese through the Shroff system.
accommodated anyone as long as adequate interest was paid depending on the riskiness of the loan. It is true that they performed an important service in filling the credit gap of the community, however, by making credit available to all and sundry, they sowed the seeds of unsound financial discipline. On this aspect of financing, Gunasekera observed, 1

"However the chettiyars were too ready to accommodate anybody, the genuine businessmen as well as the speculator and spendthrift. Thus when the commercial banks left the task of financing Ceylonese businessmen to the chettiyars, they were unwittingly encouraging the growth of an unsound credit structure."

4.2.7 They had vast resources at their disposal, i.e. their own funds and those of friends and relatives and those they obtained from the banks. The table below shows their resources in 1925.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Own Capital</td>
<td>Rs. 85 million</td>
</tr>
<tr>
<td>Friends and Relations</td>
<td>Rs. 40 million</td>
</tr>
<tr>
<td>Short term loans from Banks</td>
<td>Rs. 25 million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>Rs. 150 million</strong></td>
</tr>
</tbody>
</table>

4.2.8 The great depression of the thirties hit those who did business with the chettiyars very hard. The contraction of credit by the banks during this time resulted in the chettiyars calling back the loans and foreclosing on their mortgages, which reduced many Ceylonese businessmen and agriculturists to bankruptcy.

"During the depression, when the Ceylonese borrowers could not pay back their loans and interest, the chettiyars put their bonds and promissory notes in suit. In execution of the decrees that they obtained from the courts they sold the mortgaged and other properties of the judgement debtors and bought them in at very low prices. It was in this situation that a strong public clamour was raised for the establishment of a State Bank to provide adequate facilities to Ceylonese to develop agriculture, trade and industry." 2

4.2.9 The existing need for an indigenous bank gained momentum during the great depression, and in November 1934, the Ceylon Banking

1. See Bib. 80 - pages 183
2. See Bib. 51 - page 7
Commission recommended the establishment of a State aided Bank. The reasons behind the proposal to establish a bank and the subsequent events that followed throws much light on the present credit structure of the country. The commission made a detailed study of every aspect of credit in the country, both the organised sector comprising of the commercial banks and the unorganised sector consisting of 'bhettyar' money lenders, 'Afgan' money lenders, traders, pawn brokers and the village boutique keepers. Here in the succeeding pages a short analysis of the structure is made to enable one to understand the present structure, which in many aspects is similar and directly related to the development at the time.

4.2.10 The Commission established that foreign commercial banks limited their activities mainly to the provision of credit to foreign trade and in this sphere too preference was given to foreign business circles. The little credit that trickled down to the Ceylonese came through the middlemen appointed by the Bank, called the 'shroff'. The credit department was divided into two sections, one dealing directly with European clients, while the other dealt with non-European clients through the medium of the 'shroff'. The 'shroff' was usually a Ceylonese of some financial and social standing in the community, and the greater part of business through this department had to be guaranteed by him. He collected a commission both from the bank and the customer. The bank's commission usually amounted to 0.01 per cent of the loan, while the commission paid by the client was left to the discretion of the shroff to decide, and was said to range from 0.05 per cent to 2.0 per cent. The loans themselves to non-Europeans carried a higher rate of interest usually 2.0 per cent above the normal rate at which credit was available

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1. See Bib. 27
2. See Diagram I
3. The shroff was required to give security in cash and property to cover the liability he assumed in recommending loans.
to Europeans. Thus the availability of credit from the banks to the Ceylonese depended on the goodwill of the shroff. Further the difficulties of borrowing under this system was heightened, as when the shroff of a bank either retired or resigned from office, the process of building up goodwill firstly between the banks and the shroffs and secondly between the shroffs and clients, took considerable time. It was also the practice of the bank to recall all loans recommended by the earlier shroff. This system in effect alienated Ceylonese from the existing banking system as well as retarding the growth of intimate relationships between the banks and their non-European customers, while there was no opportunity given to the Ceylonese to prove their creditworthiness.¹

4.2.II The deficiencies of the existing system at the time of the Banking Commission cannot be blamed on anybody or any institution. Looking at the economic history of Ceylon it was principally due to historical factors, for, over seventy years the country's existing commerce and trade were in the hands of foreign interests. The banking system was directly geared to this economic situation and it functioned admirably in facilitating the development of the plantation sector and the import and export trade. The traditions of British banking were strictly adhered to and the banks being branch offices of large international banks, all policy matters which were applicable to all branches were strictly controlled and regulated by their Head Offices overseas. The management and personnel of the banks who were schooled in different traditions of banking, and coming from different environmental situations and cultures, were not primarily interested in developing new banking traditions among the indigenous population nor were they specially interested in local entrepreneurship, commerce and industry. Though much criticism has been levelled at the banks,

¹ In the case of European customers, it was exactly the opposite, as they were financially and socially members of one 'club'.
it is well to remember, that Ceylon at that time was still a Colony of the British Empire and the banks considered that their primary function was to encourage British interests in Ceylon. The 'creditworthiness' analysis was conducted on British practices, where the branch managers had close affinity and contact with the bank's clients, thus Ceylon considered in terms of an overseas 'province' of Great Britain, it was understandable that credit was available to the planting interests, shippers and brokers, who formed a closely knit community, and in majority of the cases intimately known to the bank's management.

4.2.12 The prospect of lending to the indigenous population was retarded in the absence of a well defined entrepreneurial class, Individual indigenous entrepreneurship was still weak, immature and in a stage of infancy. Few Ceylonese firms were organized as joint stock companies, and most lacked a system of proper book-keeping and audited accounts of their businesses, this made it difficult to assess the credit standing of most indigenous customers. The commission observed that the dissatisfaction with the existing banking procedure was partly based on "ignorance of the principles which governed advances by commercial banks, such as financial solvency, business integrity, reputation and availability of resources to repay and command credit in other quarters"¹ these were important criteria which are taken into account when considering the creditworthiness of a client. The tasks of the banks were made even more difficult by the deficiencies of the legal system. It was a conflict between two legal systems; while the banks based their lending on English commercial law, the security, especially land which Ceylonese could offer came under Ceylonese law which was based on Roman Dutch law. The law with regard to land is extremely complicated, and in the absence of primogeniture

¹ See Bib.27
gave doubtful titles of possession; while the system of joint ownership, made land unsuitable as security. Thus the process of litigation due to above reasons took considerable time. Further, the law relating to trust receipts and advances against lieu upon produce was unsatisfactory for banks to lend against them.

4.2.13 On the other hand, the criticism of the Ceylonese on the existing deficiencies in access to credit was fully justified. They could not be held responsible for the growth of the banking system to what it was at the time, nor could the generalised accusations of the type made by the Chamber of Commerce at that time, justifiable or applicable. The Ceylonese, if they were not of the local well-to-do class which consisted of a small number of families, were at the mercy of the money lenders if they did not have any contact with the bank at all, while those who had access through the shroff were at his mercy. The former suffered most due to the high interest rates, and sometimes in the case of 'Afghan' money lenders the interest on loans were sometimes exorted with physical force. Finally the claim that the Ceylonese had not got used to the banking habit cannot be justified, as according to the consolidated statement of the seven major commercial banks (operating in Ceylon at that time, i.e. December 1933), submitted to the Commission, out of a total deposit of Rupees 122 million, approximately Rs.42.7 million or 35 per cent of the total belonged to Ceylonese depositors who exceeded 50 per cent of the total number of depositors.

1. The Chamber's comment on the recommendations of the Commissioners were as follows: "the establishment of any institution which has a primary objective of lending money is psychologically and fundamentally undesirable in any country in which, debt does not appear to cause a certain section of the people any embarrassment or even a sense of obligation" (Bib. 80, page 206)

2. While the share of the Government in total deposits was 14 per cent and that of foreigners 40 per cent.
4.2.14 On the overall evidence presented to the Banking Commission, they came to the conclusion that there were serious deficiencies in the structure of credit in the country, such as the narrow sector of the economy for which the existing banks catered, the conservatism and rigidity of their policies, and the isolation of the banking system from the indigenous population. As a result, they felt the establishment of a bank with powerful resources at its back would place Ceylonese and non-Ceylonese borrowers of equal credit merit, on a footing of equal advantage. Thus after evaluating all evidence, they recommended that in view of "the grave difficulty in the credit machinery of the Island, a State aided bank should be established and it should also assume the principal responsibilities of providing credit for internal economic activities, whether related to agriculture, commerce or industry."¹ The idea of a State aided bank was for the reason, that if a new bank was to give comparable services and compete effectively, with the resources at the disposal of the other banks, it was of paramount importance that it should be equipped with a large amount of capital, which it would have been unable to raise entirely by public subscriptions. Therefore they concluded that State participation was necessary for provision of funds to the bank, as well as an encouragement for the public to subscribe and gain confidence in the bank.

4.2.15 The proposed bank was to have an authorized capital of Rupees 20 million. The business of the bank, while similar with the existing banks in the traditional aspects of banking such as keeping deposit accounts, buying and selling Government securities, dealing in local currencies, agency business and discounting local and foreign bills, differed in two important aspects of banking. One was the power to underwrite, subscribe and invest in joint stock banks and other companies registered

¹. See Bib. 27
in Ceylon. The second was the power to lend money on, (a) immovable properties upto 25 per cent of the paid up capital and resources of the bank, (b) agricultural produce and manufactured goods. The former was based on the principles of mixed banking which were successful in Germany, France, Scandinavian countries and the United States of America, where the Governments were striving to encourage commerce, trade and industries by providing capital directly, as well as by encouraging the banks to lend to the industrial sector. In view of the state of the country, i.e. the underdeveloped nature of the economy, the dependence of the economy on three export crops, the need for diversification into industry, the absence of any long term credit institution or a developed money or capital market, this recommendation had profound validity. The second difference was due to the problems that the existing banks had of accepting security that could be provided by the Ceylonese, i.e. immovable property was generally unacceptable as security to British banking traditions. The Ceylonese client was not always in a position to offer movable property such as stock in trade, shares of companies, insurance policies and Government securities, and in a predominantly agricultural country the only form of security they could offer in the majority of the cases, was land.

4.2.16 The proposals which were referred to a Committee of bankers in London for their expert advice, turned them down on the grounds that the proposal was not sound, "from the point of view of well tried and accepted principles of banking."1 They objected principally to the heavy initial proportion of preference capital, and to the two powers mentioned above. The first objection was due to the fear that four-fifth of the capital in the form of proposed preference shares would tempt the bank to lend on more risky investment, in order to increase her profits. The second

1. See Bib. 30, sections 33 - 35
objection was understandable, as the committee, schooled in British tradition and practices of banking, felt that there should be a clear distinction between investment financing and deposit banking. The objection to immovable property as a form of security for advances was on the grounds that it would be a liquidity and a credit risk due to the fluctuations in land values, especially in times of depression when the banks needed more liquidity. This was rather a pessimistic view, as the framers had made restrictions on lending to prevent such an eventuality. For example, the proposals provided that the total lent against immovable property was not to exceed 25 per cent of the paid up capital and reserve of the bank, while the advances on immovables were not to exceed 50 per cent of the value of the security, and that they could be made only if the yield of the property was equal to at least one and half times the interest on the proposed loan.¹

4.2.17 The proposals were submitted a second time with the omission of the clauses objected to earlier but with additional memoranda urging the need for credit for new industrial ventures and agriculture. The London Committee while rejecting for a second time the proposals for a commercial bank, concluded that there may be 'a real need in Ceylon for Government financial assistance designed to help in the development of new industrial enterprises and in the financing of agricultural debt'. They endorsed the view, that though they opposed a deposit bank undertaking these functions, they would have no objection to an institution set up specially to meet these needs. As a result of further pressure for a commercial bank it was finally approved in 1938. However, the approval granted was limited in stature to that proposed by the commission.

4.2.18 The authorized capital of the bank was to be Rs.7.5 million as compared to 20 million suggested by the commission. The bank was given

¹. See Bib. 27
normal powers of a deposit bank subject to certain restrictions. Some of the restrictions were, (a) the bank was not empowered to hold immovable property for more than five years except property required for the bank's own use, but authorization was given to the Board to hold it over the five year limitation if the property cannot be disposed of without loss to the bank. (b) The aggregate outstanding advances and loans were not to exceed 50 per cent of its total deposits. (c) No loans or accommodation was to be granted for more than Rs.10,000 without security or for a period of over six months, except in the case of seasonal loans and advances which were not to exceed twelve months. (d) The only underwriting business allowed were the underwriting of issues of the Government of Ceylon or any other public authority in Ceylon. (e) The authority of the General Manager to grant loans, advances and other accommodation, without the authority of the Board was subject to a limit of Rs.50,000. (f) The bank had no power to buy, sell or invest in shares of any company or promote the establishment of any company.

4.2.19 Therefore banking legislation that came into being, as far as industrial credit is concerned retarded the emergence of investment banking by the commercial banks for nearly twenty years. Commercial banking developed on the lines of British traditions and it took a considerable number of years to throw away the mantle imposed on it as regards the financing of industry. Industrial finance was to be the preserve of special institutions. This development delayed the diversification of the economy to a considerable extent.
4.3 THE COMMERCIAL BANKS

4.3.1 The commercial banks in Ceylon can be broadly categorized into two groups, namely, the foreign banks and the Ceylonese banks. Table 20 below gives the number of banks, their branches, the breakdown of deposits for the last five years. In 1970, there were four British Banks, three Indian Banks, one Pakistani Bank and four Ceylonese Banks.

4.3.2 In the preceding pages an outline of the development of commercial banking was made, i.e. its growth attuned to the commercial and the plantation sector, general attitudes and constraints regards advances and the restricted nature of its services. The foreign banks in Ceylon are normally classified into British banks and the Indian and Pakistani banks. Before 1948 the bulk of the business they handled were for European firms, brokers and shippers, and the plantation sector. Further the branches they opened in the principal towns were solely to serve these sectors. After 1948 the direction of their business began to change as they began to accommodate more Ceylonese. This was a result of a number of factors such as:

(a) Ceylon in 1948 became an independent country.

(b) the dwindling share of British firms and British business interests in Ceylon.

(c) the emergence and the maturity of the Ceylonese investors and entrepreneurs.

(d) a more concerted effort to understand Ceylonese business methods and practices.

However, despite the new attitude the bulk of the business was concentrated in the provision of credit for commerce and trade.

4.3.3 In 1961 by an Act of Parliament, Ceylon nationals were

1. The finance act No. 65 of 1961
prohibited from opening new accounts in foreign banks, and those that had accounts were prohibited from increasing their time deposits over the level that existed on 27th July 1961. The reason for this measure has never been publicly announced by the Government, but what can be deduced is that the Government wanted the foreign banks to play a more active role in financing of agriculture and industry. The only bank undertaking these tasks to some extent was the one Ceylonese bank in existence at that time, i.e. The Bank of Ceylon. Her capacity to finance industry and agriculture were limited due to limitations imposed upon it at its founding, as well as due to the limited resources at its disposal. Further the Ceylonese had an inclination to deposit in foreign banks in preference to Ceylonese banks. The Government resorted to moral suasion on the foreign banks to participate more actively in the economic development of the country, just as the Government in India had done. While the foreign banks in India rose to this task, the banks in Ceylon were not very enthusiastic about it. Thus, this measure could be seen as an attempt to divert funds through the Ceylonese bank already in existence and the proposed second indigenous bank that was on the verge of being set up at the time.

In 1968 this restriction was removed when the banks and the Government came to an understanding that they would play a greater role in the economic development of the country. With this end in view there was a process of reconstruction of the banking structure in Ceylon. The Eastern Bank Limited, a subsidiary of the Chartered Bank Company Limited (both British) was converted into a rupee company and commenced business as the Commercial Bank of Ceylon Limited in November 1969. The Hatton Bank Limited, a subsidiary of a European Company was amalgamated with two branches of the National and Grindlays Bank to form the Hatton
It is expected that with this reorganization, for the banks to play a more active role in agricultural and industrial financing, especially short and medium term credit requirements, although their main business would still be concentrated in the finance of commerce and trade.

The Indian and Pakistani banks as their names suggest, concentrate mostly in the finance of business, to and from, India and Pakistan. Although earlier they played an important part in siphoning credit indirectly through the chettiyars to the business sector, in the last decade or so they have functioned more as trading banks helping the import and export sector. In the future too they would continue to play this role with perhaps occasional short term advances to the industrial sector.

4.3.5 The number of Ceylonese banks have increased to four since 1969. The oldest of them is the Bank of Ceylon, the founding of which was discussed earlier in this chapter. In 1961 the second indigenous bank began business as the People's Bank of Ceylon, with the direction of its business oriented towards financing of agriculture. The Commercial Bank of Ceylon and the Hatton National Bank are recent creations having begun business in 1969 and 1970 respectively. The Bank of Ceylon and the People's Bank are both State owned banks, the former having been nationalized in 1961 and the latter floated entirely with State funds in 1961. The two new banks were the result of the recent reorganization of the banking structure referred to earlier.

4.3.6 The Bank of Ceylon commenced business in 1939, purely as a commercial bank restricted in its activities even in the sphere of normal commercial banking functions. However, it had one advantage in that the

1. They now come under the category of Ceylonese Banks
2. See above - Section 4.2.18
<table>
<thead>
<tr>
<th>Year</th>
<th>Ceylonese Banks</th>
<th>British Banks</th>
<th>Indian &amp; Pakistani Banks</th>
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<tr>
<td></td>
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<td>1966</td>
<td>89</td>
<td>1,003</td>
<td>67</td>
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</tr>
<tr>
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<td>4</td>
</tr>
<tr>
<td>1969</td>
<td>105</td>
<td>1,502</td>
<td>100</td>
<td>133</td>
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</table>

Source: Central Bank of Ceylon.
State for the first time in the history of banking in Ceylon took a hand in the financing of the bank. The entire preference share capital was taken up by the State, while Rs.350,000 was loaned to the bank in the form of a deposit repayable without interest after ten years. From the outset, considerable attention was paid to its reserve position. The statute required that the bank set aside each year 20 per cent of its profits in a fund termed the 'permanent reserve', while another fund termed the 'contingency fund' was to consist of funds that are not carried to the permanent reserve and such other sums out of the profits of the bank. This fund was intended to meet losses, if any, arising from the bank's operations and for the purposes of upkeep of the bank's property.

Some of the restrictions imposed on the bank at its inception were removed after Ceylon gained independence. They were:

(a) the non-acceptance of immovable property as primary security
(b) the limit of loans without security of Rupees 10,000 was raised in stages to Rupees 50,000
(c) the limit on maximum period of loan i.e., 24 months for seasonal credit and six months for other loans, was removed
(d) the restriction on the purchase, sale and investment in stocks and shares was modified to make it inapplicable to the shares of companies registered in Ceylon or having the principal place of business in Ceylon. The bank was empowered to underwrite stocks and shares.
(e) the bank was empowered to form companies to carry on any business that it was empowered to do under the Ordinance or for assisting and developing any such business or for enhancing the value of any property of the bank and to acquire and undertake the business of, purchase any interest in or acquire stock or shares in any company; having objects similar to those for which

the bank was established

(f) the limit on the General Manager of the bank to approve loans up to a limit of Rupees 50,000, without the approval of the Board was raised to Rupees 100,000.

4.3.7 The bank's progress from its inception was very rapid, which belied the pessimistic assumptions made when the proposal for a Ceylonese Bank was first mooted. By 1950, despite the competition of well-established foreign banks, it had attracted 30 per cent of bank deposits, given 26 per cent of total advances and held 35 per cent of all bank investments in Ceylon. In 1961, the year that the bank was nationalized, it held 43 per cent of the total bank deposits, 36 per cent of the total bank advances and about 60 per cent of the total bank investments. In July 1961 the bank was nationalized, and all the ordinary shares that were in private hands were vested in the Government. The Board of Directors was reconstituted to include six directors instead of the five it had earlier. Five of these directors were to be appointed by the Minister of Finance and the sixth was to be the Secretary to the Treasury in an ex-officio capacity. The Chairman of this Board was also to be appointed by the Minister of Finance.

4.3.8 After nationalization as was expected the functions of the bank were bound to change. Prior to nationalization it functioned primarily as another commercial bank and long and medium term financing of any venture was an exception rather than the rule. The new image of the bank was to be as a vehicle of growth for development by pursuing a more active role in development financing, besides its commercial banking functions. In its first Annual Report after nationalization the Chairman of the Board

1. Numbering six banks
2. The finance act of 1961, No.65
of Directors outlined the new policy as follows, 'steps are taken to enlarge the scope of the bank's lending activities not only to trade and commerce but also to agriculture and industry and not only to short term, but also on medium and long term.'\(^1\) With nationalization, and the curtailment by the Government in the same year, of the acceptance of new deposits by foreign banks, its share of deposits as well as its lending activities increased rapidly, although for the first time it faced competition from another indigenous bank.\(^2\) However, its movement towards the practice of industrial financing has been rather slow.\(^3\)

4.3.9 The present organization of the bank in the field of lending consists of a Credit Intelligence Department and a Credit Supervision Department. However, both these departments are more attuned to control and supervision of large loans, especially of a commercial character, than of the type under investigation in this study. The former deals primarily with loans in excess of Rupees 100,000, while the latter is concerned with loans in excess of Rupees 4 million. Though the bank's Chairman expressed the new image of the bank after nationalization as mentioned above, a business intelligence unit,\(^4\) and an economic intelligence unit as separate entities primarily concerned with these activities is still absent. However, the bank in 1968 established a subsidiary company called the Industrial and Financial Consultants (Ceylon) Limited (IFCC) with the objectives of, firstly, assisting the Credit Intelligence Department of the bank in appraising the ventures financed by the bank, and secondly, to function separately in the capacity of professional business consultants to outside clients. As such its functions were to advice and direct financial

\(^1\) The Report of the Chairman - Annual Report 1960/61
\(^2\) The People's Bank of Ceylon established by Act No.29 in 1961
\(^3\) The reasons will be examined in Chapter 6, Section 6.3
\(^4\) The meaning of business here is in the industrial sense
technical, legal and administrative matters and to assist in the establishment of joint industrial ventures with foreign collaboration. The motive for an institution of this type was very appropriate in a country where there is a dearth of this type of service, although the Development Finance Corporation of Ceylon, in its Ordinance has been vested with the very same functions, which has not been activated by the latter adequately. It would suffice here to say, that after two years of its establishment of the IFCC its activities have now come to a standstill.

4.3.10 Another scheme that was mooted by the bank in 1957, which has relevance to this study, is the scheme to grant bank loans to clients of the bank to buy shares in public companies. The bank was prepared to advance up to a limit of Rupees 7,500 towards the purchase of shares, the advances for this purpose was not to exceed 75 per cent of the lowest purchase price of the shares as quoted during the preceding years. This scheme too did not meet with much success due to the structural limitations of the stock market.

4.3.11 Despite the limitations imposed on the bank at its inception, and though being the only Ceylonese bank up to 1961, it has expanded its activities in the sphere of commercial banking to become the premier bank in Ceylon. Further, it has established a name as a bank run on sound deposit banking principles. However it has fallen short in the sphere of development banking, to the extent expected of it since nationalization. This has been due to a number of reasons, the foremost of which could be classified under five major headings, namely, structural, historical, legal, intentional, and lastly, extraneous.

4.3.12 The People's Bank of Ceylon which began business in 1961

1. See chapter 6, Section 6.14
2. See chapter 6, Section 6.3.7
was originally intended to take over the activities of the now defunct Co-operative Federal Bank. It was to act as the Apex Bank to the co-operative societies through which agricultural credit was to be disseminated, while engaging itself at the same time in normal commercial banking activities. Thus, its business at the beginning was oriented more towards agricultural financing. The bank commenced with an authorized share capital of Rupees 6 million with a provision for the increase in share capital with the approval of the Parliament. The shares of the bank are held by the Government and the Co-operative societies. Under the provisions of the Act establishing the bank, the Government could lend through the bank sums of money authorised by Parliament for medium and long term purposes. The funds for this purpose were to be raised on its behalf by the Central Bank of Ceylon by debenture issues. This bank was given much wider powers than the Bank of Ceylon and was devoid of the restrictions imposed on the latter at its inception.

4.3.13 Though the original Ordinance intended the bank to serve mainly the agricultural sector, Clause 5 (2) of the Act empowered the Minister of Finance to approve any other field for which credit was to be granted. In October 1961, under this provision the Minister of Finance permitted the bank to grant credit to four additional categories of clients. Among them were the category of individuals who intend to carry on or are carrying on small scale industrial undertakings. These new clauses changed the outlook of the bank considerably and enabled it to expand its lending activities to all sectors of the economy, though still keeping its primary character as one of the chief lenders to agriculture through the network of co-operative societies and rural banks.

4.3.14 The growth of the bank from its inception was phenomenal. For the first time the banking habit was introduced to the rural areas.
Its credit policy has been more forward looking, less stringent, and attuned to development of agriculture and to a lesser extent industry, than that of the Bank of Ceylon. Small industrialists and entrepreneurs were able to get loan accommodation from this bank when other banks had refused their requests for loans. By 1967, percentage-wise, it had overtaken the Bank of Ceylon and the all bank average in its lending to the agricultural, industrial and financial sectors. However, in recent years there has been a polarization of its activities to the commercial sector and large business and hardening of its attitude towards the small industrial sector. This could be the result of too liberal a loan policy at the outset, resulting in the accumulation of a too risky lending portfolio, with resultant bad debts; combined with experience and confidence in competing with the other banks in the finance of commerce and large scale industries.

4.4. LONG TERM CREDIT INSTITUTIONS

4.4.1 In the field of industrial financing only two financial institutions are relevant for the purpose of this study, namely, the Agricultural and Industrial Credit Corporation (AICC) and the Development Finance Corporation of Ceylon (DFCC).

4.4.2 As seen in section 4.2.17 of this Chapter, the Agricultural and Industrial Credit Corporation (AICC) was the outcome of the demand for an investment bank, with the functions of lending on a long term basis, both to agriculture and industry. The AICC was established in 1943, and was vested with powers to grant loans both to individuals and corporate bodies, for the following purposes:

(a) The purchase or lease or cultivation, development or improvement of any land used or to be used for any purposes of agriculture for the exploitation of resources thereof,
(b) The purchase or lease or the construction, repair or renewal of any building, factory, mill, mine, machinery or equipment used or to be used in connection with any agricultural or industrial undertaking.

c) The manufacture or preparation of any agricultural or industrial product or commodity for sale in the market

d) Any purpose incidental or ancillary or accessory to any purpose mentioned above

e) The liquidation of any debt already incurred for any purpose mentioned above

In addition to the functions of granting loans for agricultural or industrial undertaking the Corporation is vested with additional functions which are very broad in stature. They are:

(i) to manage, supervise and control any industrial or agricultural undertaking of a client

(ii) to act as technical and legal adviser of any client with regard to any agricultural or industrial undertaking,

(iii) to set up an organisation for selling or marketing of any product of an agricultural or industrial undertaking

4.4.3 Besides these powers she was also vested with powers to act as the purchasing agent for a client, to deal in stocks and shares, debentures, bonds or securities issued or guaranteed by the Government. In granting these wide powers to the Corporation the original motive of the planners, was for the AICC to take an active part in all spheres of agricultural and industrial management activity, i.e., from granting loans to participation in management, supervision and control, advice in legal and technical fields, and finally the powers to acquire, run its own industrial or agricultural undertakings within the broad margins of the Ordinance.
4.4.4 Despite the wide powers granted to the Corporation, its ability to play a major role in financing has been limited due to strictures on the availability of funds at its disposal. The Corporation has access to State funds, through the consolidated fund of the Government, pending the issue of its own debentures which are guaranteed by the Government with regard to the payment of principal and interest. The total amount fixed by statute for borrowing from the Government or by the issue of its own debentures is Rupees 30 million.¹ By March 1955, this sum had been drawn in full and since then new business is carried on solely with the net annual receipts consisting of capital repayments and interest received.²

4.4.5 Loans are normally granted on the security of primary mortgage of property with satisfactory title, and on industrial plant and machinery provided they are permanently installed in a factory building or mill and such building and land on which it stands are also offered as security.³ Undivided properties are not accepted as security unless all the co-owners accept joint and several liability. The minimum sum that may be granted to any person is fixed at Rupees 500, while there is no ceiling on an upper limit. The wide powers granted to the Corporation and its inability to make use of them seems paradoxical. The Corporation was expected to take wider investment risks and become the path blazer in the field of long term credit facilities to agriculture and industry, but the Ordinance establishing the AICO, by imposing financial strictures as well as strictures on the security it can accept, seems to have curtailed the

¹ Originally the maximum limit stood at Rs.10 million, which was raised to Rs.15 million in 1949 and subsequently to Rs. 30 million in 1950.  
² This averages at about Rs.4 to 5 million a year.  
³ According to the law in Ceylon, any machinery or plant which is fastened to the ground upon which it stands is deemed to be immovable property.
very same functions it was to have undertaken.

4.4.6 The other long term credit institution is the Development Finance Corporation of Ceylon (DFCC). This organisation was the outcome of the recommendation of the team of experts from the World Bank in 1953.¹

4.4.7 It is relevant to examine briefly the reasons behind the recommendations by this mission of the World Bank to establish this Corporation, before outlining its basic functions. In their analysis of the credit structure in Ceylon they rightly came to the conclusion that there were no adequate channels of credit available for long term financing of agriculture and industry. They were critical of the only existing institution for this purpose, namely, the AICC, as not being functional enough to satisfy even the existing needs at the time; therefore, they concluded that the solution would be to set up an autonomous Ceylon Development Corporation, with the capital participation of the Government, commercial banks and the investing public. This they felt would ensure the participation of private and public capital in the financing of industrial projects under competent and profitable management. They further hinted, that under appropriate conditions, it might provide the mechanism for industrial financing in Ceylon with the aid of funds made available by the International Bank for Reconstruction and Development (IBRD). They envisaged the Corporation to be a 'pioneering agency charged with giving primary impulse to economic expansion in productive fields, where private enterprise was lagging or laggard.' The institution they envisaged was to have the following functions; (i) to finance new projects in industry and agriculture or business and to assist the progress of promising ventures already started by private enterprise; (ii) to furnish or arrange for managerial and technical assistance to new ventures or to others in need of it. They emphasized that

¹ See above, Chapter 2 Section 2.3.9
the new corporation should have complete freedom of initiative in order to
explore without binding restrictions, all likely avenues of economic
development. The finances were to be independent and secure as many projects
would require considerable time before maturity.

4.4.3 The basic features of the recommendations of the mission
were important in the context of future policy. They were:

(i) that the Corporation to be an autonomous body with an independent body
of management free from the inflexibility of Government, financial and
civil service regulations, as well as arbitrary interference with management,
(ii) that capital was to be raised by the joint participation of a number of
bodies so that no single group would have a controlling interest. New
funds when necessary were to be raised by sale of bonds to the public or
to overseas institutional lenders;
(iii) that management and staff of the Corporation were to be appointed and
promoted solely on the basis of competence, and the freedom of the management
to recruit and dismiss staff without outside interference.

These observations are very important features that should be
embodied in any organization, especially in developing countries to guarantee
any measure of success. Other important recommendations of the mission that
were ultimately forgotten or pushed to the background in the final framing
of the Ordinance of Establishment were,

(a) the Corporation was to undertake studies of possible lines of develop¬
ment with the help of the applied research institute in the technical field,
the help of the Central Bank in the field of economic data for market
appraisal and related problems, and the help of the commercial banks in loan
appraisal and credit intelligence

1. The Ceylon Institute for Scientific and Industrial Research (CISIR) which
was set up on the recommendations of this same IBRD mission.
(b) help was to be given to the indigenous business enterprise both in setting up new enterprise and aiding those already established. The help envisaged was not only the disbursement of loans to them, but to encourage entrepreneurs to undertake new projects or expansion programmes, by offering them technical and economic advise and finding them suitable managerial staff, 
(c) in instances when private capital was hesitant or unwilling to participate in a new venture which is feasible, the Corporation was to float a subsidiary company of its own, subscribing the whole if necessary or part of the capital if certain amount of private participation was available. This was with a view at a later date, when the enterprise was 'on its feet', to sell its stockholdings to the public.

4.4.9 Following the recommendations of the World Bank Mission, the Development Finance Corporation of Ceylon (DFCC), was established by an Act of Parliament in 1955. The purposes of the Corporation were to be:
(a) Assist in the establishment, expansion and modernization of private, industrial and agricultural establishments in Ceylon.
(b) To encourage and promote the participation of private capital both internal and external in such enterprises.

Some of the powers the DFCC is vested with are:
(i) to provide finance in the form of long term or medium term loans with or without security or by purchasing or subscribing to shares or other securities.
(ii) to underwrite new issues of stock, shares or bonds, debentures and other securities
(iii) to guarantee loans from other private investment sources

1. Development Finance Corporation Act No. 35 of 1955
2. By an amendment to the Act in 1967, 'commercial enterprise' was added to clause (a).
(iv) to make funds available for reinvestment by selling any investments of the Corporation,
(v) to borrow funds for the purposes of the business of the Corporation from sources either in Ceylon or abroad and give security for any loans obtained,
(vi) to furnish managerial, technical and administrative advice and assist in obtaining managerial, technical and administrative services to private industrial and agricultural enterprises,
(vii) to acquire, hold, take or give on lease or hire, mortgage, pledge and sell or otherwise dispose of any immovable or movable property.

4.4.10 At its inception, the DFCC commenced business with an authorized capital of Rupees 8 million which was subsequently raised to Rupees 24 million in 1967, while the issued capital was raised to Rupees 8 million. The Act provided the Corporation to borrow from the consolidated fund of the Government for the purposes of its business a sum of Rupees 16 million, which was to be interest free and the repayments were to commence after the sixteenth year in which the loan was granted. It further empowered the Corporation to borrow from the IBRD, and such borrowings were to be guaranteed by the Government up to a limit equivalent of 24 million Ceylon Rupees, at the rate of exchange prevailing at the date of the loan agreement. The International borrowing facilities of the Corporation was enlarged in 1967 to include the IBRD or any other International or foreign organization approved by the Government. The sums to be guaranteed by the Government was increased from Rupees 24 million to Rupees 72 million.

4.4.11 The general supervision, control and administration of the affairs and business of the DFCC is vested in a Board of Directors.

1. This was amended to read 'twenty sixth year succeeding the year in which the loan was granted by the Government', in 1967
The Act underlined that all applications for financial aid dealt on behalf of the Corporation to any private, industrial, agricultural or commercial enterprise should be considered strictly on its financial and economic merits, irrespective of all other considerations and that financial assistance given is utilized for the purposes for which it is given.

4.4.12 In the original Act establishing the Corporation in 1955, the Act did not prescribe any legal limitations of enterprises that the Corporation could transact business with, nor did it define the meaning of what was meant by 'industrial enterprise'. It only defined what was meant by an agricultural enterprise. However, in the 1967 amendment to the Act the meaning of agricultural, commercial and industrial enterprise was defined, as well as, the legal limitations of enterprises that the Corporation could transact business with. The definitions were as follows:

(a) 'Agricultural enterprise' to mean a large scale agricultural or livestock enterprise operated by a limited liability company on a commercial basis.

(b) 'Industrial enterprise' to mean a large scale enterprise for a productive purpose operated by a limited liability company on a commercial basis.

(c) 'Commercial enterprise' to include any large scale enterprise operated by a limited liability company, not falling within the description of an agricultural or industrial enterprise, which shall be conducive to the economic development of Ceylon.

4.4.13 Thus by this amendment in 1967, it precluded all small scale enterprise as well as limiting itself to giving financial assistance only to limited liability companies. The Corporation has not defined what the term large scale enterprise means. However, their minimum limit for a loan is fixed at Rupees 100,000 and in the context of 'size' in Ceylon, this
would preclude all small establishments as well as a large number of medium sized establishments.

4.4.14 Loans by the Corporation are given on the security of land, buildings and machinery. The minimum amount of loan or share investment they consider is Rupees 100,000 and the only time they consider a loan below this amount is to a client who has already received a loan over Rupees 100,000. The DFCC normally limits itself to 10 per cent of the sum of its equity capital and the outstanding amount of the subordinated Government loan in their lending to share investment in any one individual enterprise. In the case of share investment plus any guarantee on behalf of any individual enterprise the limit is 20 per cent. Thus, at the present limit of her capital liabilities the maximum in the former case will be Rupees 2.6 million and in the case of the latter, Rupees 5.2 million. In the aggregate, the Corporation's share investment will not exceed the sum of its equity and outstanding amount of the subordinated Government loan. The DFCC in normal circumstances will not manage enterprises which it assists in promoting nor seek controlling interests. Therefore, the DFCC does not normally take up more than 25 per cent of the issued share capital of any individual enterprise. However, notwithstanding the above limitations, in special cases it may recourse to action it considers necessary to protect its investments. In the case of security the aggregate assistance granted against the mortgage of land and buildings does not normally exceed 75 per cent of the value, while in the case of plant and machinery, the limit is 60 per cent of the installed cost of machinery less accumulated depreciation.

1. The Corporation's equity is defined as the sum of its share capital, surplus and reserves not allocated to cover specific liabilities.
4.4.15 In examining the above powers vested in the Corporation, the Act establishing the DFCC incorporated to a great extent the recommendations of the World Bank mission, though it did not go as far as the mission envisaged. As a result, the DFCC has turned out to become just another credit institution, limited in its activities to granting credit only to large scale enterprise, devoid of the most important role the IBRD mission intended it to assume, namely, to be a dynamic institution spearheading industrial development by aiding, participating, promoting, advising, directing and establishing industrial enterprises, be they small or large. As it is now constituted, and observing its activities from its inception it embodies the first and second activities described above to a limited extent. It has taken over the years the mantle of a traditional lender, carving a selective sector to itself. It has remained aloof, in the sense of its disassociation from the 'bustle' of industrial activity and that industrialists and entrepreneurs have to come to it to seek loans rather than the Corporation going down to the level of industry to activate and promote, and in turn generate industrial development.

4.5 FINANCIAL INTERMEDIARIES

4.5.1 The Money and the Capital Market: The money and the capital market in Ceylon cannot be distinguished in so clear terms as it is done in the United Kingdom, nor does Ceylon have an organised market in the British sense of the term. The only functional organised sector in Ceylon today is the Treasury Bill market and the market in Government securities. The money market as it exists today comprise of the commercial banks and the Central Bank in the narrow sense. The money market in this sense confines itself to interbank lending. Since independence the volume

1. This denotes the very short term loans made within the system, i.e. lending and re-lending of funds among the banks.
of interbank lending has increased rapidly. Interbank lending and re-lending of funds follow the pattern of business and commercial activity in the country, rising during times of increased activity and vice-versa. Thus a yearly seasonal pattern cannot be established. The activities of the money market as defined by economists, i.e. denoting the demand and supply of all short term finance (investments and loans), was briefly touched upon when discussing the commercial bank sector and is analysed below.¹ Due to the absence of any other financial intermediaries such as Discount Houses, Merchant Banks etc., commercial banks perform some of the activities in this field, for example, the discounting of bills of exchange. The banks limit themselves principally to the discounting of documentary bills, i.e. import and export bills and the banks have the facility of rediscounting these documentary bills with the Central Bank. The market seldom deals in trade bills, thus, a Bill and Discount Market of the type found in Britain is almost non-existent.

4.5.2 In terms of a developing country and the burden on the Government to finance development, the market for Government securities play a very important part. The development of Government borrowing by way of Treasury Bills is seen in the figures given below. In 1942 Treasury Bills composed of 10 million or 13 per cent of the Governments' domestic debt, while in 1970 the comparable figures are Rupees 1,950 million or 31 per cent of the domestic debt of the Government. Table 21 below shows the ownership of Treasury Bills for the years 1965/66 to 1969/70. As the table shows the Treasury Bill Market continues to rely mainly on the Central Bank, while the share taken by the commercial banks has decreased over the years. In the non-bank sector Government Sinking Funds have

¹ See Chapter 6
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<td>1.1 Central Bank</td>
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<td>-</td>
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<td>-</td>
<td>0.3</td>
<td>0.3</td>
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<td>2.3 Other Provident Funds</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>-</td>
<td>-</td>
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<td>2.6 Other (a)</td>
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<td><strong>3. TOTAL.....</strong></td>
<td>1,425.0</td>
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<td>1,750.0</td>
<td>1,750.0</td>
<td>1,950.0</td>
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Source: Central Bank of Ceylon.

(a) Comprising co-operative banks, other companies, clubs, institutions and individuals.
absorbed the greater portion, while the depositories of long term funds such as the Employees Provident Fund, savings institutions such as the Ceylon Savings Bank, the Post Office Savings Bank and the Insurance Corporation of Ceylon, take the greater part of the balance. The sector termed 'others' in the table comprise of co-operative banks, private companies, institutions and individuals whose share is very small in comparison to the total issued. In 1969/70 the banking sector comprising of the Central Bank and the commercial banks accounted for Rupees 189 million of the increase in Rupees 200 million. This was taken wholly by the Central Bank. The issue of Treasury Bills has been used by the Government to finance its budget gaps. Thus, the Treasury Bill which in normal circumstances is a traditional instrument of financing short term requirements of the Treasury, has become an instrument merely for the purpose of financing Government expenditure. The rapid rate at which the statutory level of maximum Treasury Bill issues are raised, a greater proportion will have to be taken by the commercial banks, and to the investment portfolios of savings institutions and long term fund depositories.

4.5.3 Another source by which the Government raises funds from the market is by way of floating Ceylon Government Rupee securities. The Central Bank is responsible for the management of Government paper. Today the Government funds a greater part of its expenses by floating rupee securities. Prior to 1959, the total amount of issues did not loom large in the domestic debt structure of the Government, but since 1959, the share of the Government securities have increased in money terms nearly four-fold. In 1970 the total gross outstanding liability amounted to Rupees 3,924.9 million. This expansion of the Government securities market has been absorbed principally by the institutional lenders as seen
in tables 22 and 23 below. The increase of the gross domestic debt in 1970 by Rupees 6,294.8 million comprised of an increase of Rupees 516 million in Government securities, Rupees 200 million in Treasury Bills, Rupees 21 million in tax reserve certificates and Rupees 45 million in Central Bank advances.

4.5.4 The purpose in describing at some length the funding of the Government debt, principally by way of floating of Government securities and Treasury Bills, is to emphasise the dependence, as well as the control, the Government has on the market at the expense of other borrowers. The direction of the flow of funds of long term 'blocked' funds from the savings institutions, Employees Provident Fund, Insurance Companies indirectly deprives the market in lending atleast part of these funds on a long term basis to the industrial sector. Secondly, another factor emerges from the share of funds taken up by different groups in the market, i.e. the small share of industrial firms and the general public in the portfolio of these funds, shows the limited amount of funds available among these groups. It may perhaps be argued that the commercial and industrial firms' small share is due to the low returns that Treasury Bills and Government securities offer as against commercial bills, which perhaps the industrial sector prefers to deal in due to higher rates of return, however, this reasoning is not valid, as there are hardly any dealings in commercial bills in the market. Therefore, it is more valid to presume that there is a shortage of funds in the sector, especially long term funds.

4.5.5 Thus the active involvement of the Government as described above has retarded the independent development of the market, as now the Government 'creams' the funds available in the market. This view perhaps

1. 'blocked' in the sense that these are time deposits of the public ranging from around ten to fifty years, especially in the case of Pension funds, Employees Provident Funds and Life Insurance funds.
**TABLE 22**


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<td>I.1 Central Bank</td>
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<td>2.3 Departmental and official funds</td>
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<td>2.4 Employees' Provident Fund</td>
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<td>519.8</td>
<td>612.1</td>
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<td>2.5 Other Provident Funds</td>
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<td>140.7</td>
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<td>2.8 Other State Corporations</td>
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<td>2.9 Others (a)</td>
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<td>83.8</td>
<td>83.7</td>
<td>79.8</td>
<td>79.8</td>
</tr>
</tbody>
</table>

**3. TOTAL**

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>2,474.6</td>
<td>2,784.8</td>
<td>3,117.9</td>
<td>3,409.1</td>
<td>3,924.9</td>
<td></td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.

(a) Comprising of co-operative banks, other companies, clubs, institutions and individuals.
<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>Amount</td>
<td>Amount</td>
<td>Amount</td>
<td>Amount</td>
</tr>
<tr>
<td></td>
<td>Rs. Mn</td>
<td>Rs. Mn</td>
<td>Rs. Mn</td>
<td>Rs. Mn</td>
<td>Rs. Mn</td>
</tr>
<tr>
<td>I. Bank Sector</td>
<td>17.9</td>
<td>13.5</td>
<td>0.8</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>1.1 Commercial Banks</td>
<td>17.9</td>
<td>13.5</td>
<td>0.8</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>2. Non-Bank Sector</td>
<td>333.5</td>
<td>377.3</td>
<td>358.9</td>
<td>339.4</td>
<td>461.7</td>
</tr>
<tr>
<td>2.1 Savings Institutions</td>
<td>37.2</td>
<td>74.6</td>
<td>48.8</td>
<td>13.6</td>
<td>156.1</td>
</tr>
<tr>
<td>2.2 Sinking Funds</td>
<td>104.5</td>
<td>96.3</td>
<td>84.6</td>
<td>31.7</td>
<td>83.0</td>
</tr>
<tr>
<td>2.3 Departmental and other Official funds</td>
<td>3.7</td>
<td>10.2</td>
<td>9.5</td>
<td>8.4</td>
<td>6.2</td>
</tr>
<tr>
<td>2.4 Employees' Provident Fund</td>
<td>74.6</td>
<td>85.0</td>
<td>92.6</td>
<td>101.3</td>
<td>97.9</td>
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<tr>
<td>2.5 Insurance Corporation</td>
<td>46.2</td>
<td>47.9</td>
<td>53.2</td>
<td>42.5</td>
<td>45.5</td>
</tr>
<tr>
<td>2.6 Provident &amp; Pension Funds</td>
<td>39.2</td>
<td>43.1</td>
<td>29.2</td>
<td>36.8</td>
<td>53.9</td>
</tr>
<tr>
<td>2.7 Insurance Companies</td>
<td>10.66</td>
<td>10.6</td>
<td>4.4</td>
<td>1.2</td>
<td>16.1</td>
</tr>
<tr>
<td>2.8 Other Companies</td>
<td>0.5</td>
<td>0.3</td>
<td>0.8</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>2.9 Individuals, Clubs and Institutions</td>
<td>17.0</td>
<td>9.2</td>
<td>2.3</td>
<td>1.8</td>
<td>2.5</td>
</tr>
<tr>
<td>3. TOTAL...</td>
<td>351.2</td>
<td>390.8</td>
<td>359.7</td>
<td>340.0</td>
<td>579.2</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon
will be criticized on the grounds that the Government by absorbing these funds, in turn siphons part of it to the industrial sector by way of lending to long term credit institutions such as the AICC and the DFCC and the funding of other public institutions and Government grants for development through the various Ministries. However, the funds that go directly to the industrial sector through the AICC and the DFCC is a minute fraction of the total. The actual use of these funds by the Government is to bridge the ever increasing budget deficits every year. Though in general welfare economic terms it increases perhaps general welfare of the public, in the long run, it does not solve the problem of access to funds by the industrial sector, as one of the chief sources of funds are denied to them.

4.5.6 The Stock Market and the Stock Exchange; Ceylon does not have a stock exchange comparable to that of a developed country. The Colombo Brokers Association has functioned as a stock exchange in the absence of a proper developed exchange. Brokering firms which handle stocks and shares have been in operation for over sixty five years. The present Colombo Brokers Association in which the broking firms are members was formed in 1904. The firms concentrate more on produce broking than in share broking. The original broking firms were all European and had little or no dealings or contact with Ceylonese business and investment, while the membership of the Association was severely restricted to a few firms. However, in recent years these firms have undergone a considerable amount of Ceylonization.

4.5.7 The Association consists of two types of members, i.e. class 'A' and class 'B' members. The former restricts themselves to produce broking while the latter deal in both share and produce broking.

---

1. A sum of Rupees 25 million to the former and Rupees 16 million to the latter
The Association is responsible for furnishing data on prices and transactions of securities and it publishes a daily transactions list with the current market prices of rupee securities. The bulk of the shares listed are those of tea, rubber and tea cum rubber companies, although in recent years listed shares of commercial and industrial firms have shown a marked increase.¹

4.5.8 The underdeveloped nature of the stock exchange has been a result of number of factors. The foremost among them are,

(i) the absence of a developed Company Law
(ii) the insular nature of the market due to exchange control restrictions
(iii) the underdeveloped financial market and institutions
(iv) political uncertainty, creating pessimism in the market, which has during the last fifteen years more or less become a permanent feature
(v) the short history of the development of the industrial sector
(vi) the underdeveloped nature of the economy

These factors in combination or singularly have been the cause of the lack of adequate amount of securities in the market, the low velocity of circulation of stock, the scarcity of investors in stock, the depressed nature of quoted share prices, the inward looking policies of firms in relation to the market and the inhibition of new sellers and buyers to come into the market.²

4.5.9 The Unorganized Sector: In recent years there has been a new institution that has been growing rapidly and increasing in numbers, these are the Hire Purchase and Finance Companies.³ Today they number roughly about seventy five firms engaged in hire-purchase and financing

¹. See table 24
². See chapter 6 - See also table 25 on Share Price Index
³. Hire Purchase finance companies have been included in this sector as these companies to date fall outside the periphery of control of the Central Bank.
### TABLE 24

**COMPANIES QUOTED IN THE STOCK MARKET 1965 - 1970**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Tea</td>
<td>64</td>
<td>66</td>
<td>66</td>
<td>66</td>
<td>65</td>
<td>65</td>
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<td>Tea cum Rubber</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>27</td>
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<tr>
<td>Rubber</td>
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<td>38</td>
<td>38</td>
<td>36</td>
<td>36</td>
<td>36</td>
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<tr>
<td>Rubber (Malayan)</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
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<tr>
<td>Coconut</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Coconut (Malayan)</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
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</tr>
<tr>
<td>Financial</td>
<td>11</td>
<td>11</td>
<td>11</td>
<td>12</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Industrial, Commercial and Consumer goods and Services</td>
<td>66</td>
<td>60</td>
<td>77</td>
<td>80</td>
<td>82</td>
<td>83</td>
</tr>
<tr>
<td><strong>TOTAL...</strong></td>
<td><strong>219</strong></td>
<td><strong>213</strong></td>
<td><strong>230</strong></td>
<td><strong>232</strong></td>
<td><strong>232</strong></td>
<td><strong>232</strong></td>
</tr>
</tbody>
</table>

Source: Directory of Shares, Ceylon.
<table>
<thead>
<tr>
<th>Period</th>
<th>Text</th>
<th>Text cum</th>
<th>Rubber</th>
<th>Rubber</th>
<th>Coconut</th>
<th>Plantations Combined</th>
<th>Commercial and Industrial</th>
<th>Investment Trusts and Financial</th>
<th>Commercial, Industrial, Investment, Financial Combined</th>
<th>All Equities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1956</td>
<td>104.74</td>
<td>102.72</td>
<td>89.66</td>
<td>131.56</td>
<td>102.54</td>
<td>77.62</td>
<td>104.30</td>
<td>80.96</td>
<td>97.36</td>
<td></td>
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<tr>
<td>1957</td>
<td>114.53</td>
<td>90.17</td>
<td>96.55</td>
<td>130.48</td>
<td>105.05</td>
<td>72.65</td>
<td>103.75</td>
<td>76.53</td>
<td>98.21</td>
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<td>1958</td>
<td>87.51</td>
<td>64.25</td>
<td>77.58</td>
<td>136.45</td>
<td>80.73</td>
<td>59.66</td>
<td>95.26</td>
<td>64.11</td>
<td>76.75</td>
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<tr>
<td>1959</td>
<td>81.03</td>
<td>62.02</td>
<td>77.82</td>
<td>134.36</td>
<td>76.64</td>
<td>53.80</td>
<td>85.84</td>
<td>57.81</td>
<td>72.28</td>
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<tr>
<td>1960</td>
<td>89.37</td>
<td>77.49</td>
<td>98.45</td>
<td>139.47</td>
<td>89.40</td>
<td>59.77</td>
<td>81.40</td>
<td>62.47</td>
<td>82.75</td>
<td></td>
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<tr>
<td>1961</td>
<td>73.09</td>
<td>71.90</td>
<td>90.19</td>
<td>147.77</td>
<td>76.64</td>
<td>52.38</td>
<td>78.69</td>
<td>55.67</td>
<td>71.77</td>
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<tr>
<td>1962</td>
<td>75.51</td>
<td>64.13</td>
<td>86.96</td>
<td>140.34</td>
<td>77.51</td>
<td>50.80</td>
<td>87.36</td>
<td>53.89</td>
<td>70.94</td>
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<td>1963</td>
<td>83.89</td>
<td>64.57</td>
<td>84.39</td>
<td>142.79</td>
<td>81.79</td>
<td>53.65</td>
<td>86.62</td>
<td>56.63</td>
<td>74.91</td>
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<tr>
<td>1964</td>
<td>79.78</td>
<td>62.13</td>
<td>84.56</td>
<td>141.21</td>
<td>78.91</td>
<td>49.86</td>
<td>85.01</td>
<td>52.60</td>
<td>71.50</td>
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<tr>
<td>1965</td>
<td>89.60</td>
<td>62.04</td>
<td>84.40</td>
<td>142.34</td>
<td>84.16</td>
<td>53.89</td>
<td>85.14</td>
<td>56.58</td>
<td>76.60</td>
<td></td>
</tr>
<tr>
<td>1966</td>
<td>100.80</td>
<td>69.17</td>
<td>86.89</td>
<td>147.33</td>
<td>92.56</td>
<td>69.25</td>
<td>95.32</td>
<td>71.48</td>
<td>86.79</td>
<td></td>
</tr>
<tr>
<td>1967</td>
<td>94.69</td>
<td>58.05</td>
<td>88.75</td>
<td>156.94</td>
<td>87.18</td>
<td>70.37</td>
<td>97.76</td>
<td>72.70</td>
<td>83.22</td>
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<tr>
<td>1968</td>
<td>85.19</td>
<td>54.90</td>
<td>87.87</td>
<td>177.02</td>
<td>82.16</td>
<td>66.96</td>
<td>88.24</td>
<td>68.78</td>
<td>78.50</td>
<td></td>
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<tr>
<td>1969</td>
<td>70.84</td>
<td>55.62</td>
<td>92.46</td>
<td>193.26</td>
<td>76.28</td>
<td>69.03</td>
<td>84.54</td>
<td>70.36</td>
<td>74.66</td>
<td></td>
</tr>
<tr>
<td>1970</td>
<td>55.16</td>
<td>46.80</td>
<td>93.54</td>
<td>199.34</td>
<td>66.13</td>
<td>68.41</td>
<td>74.52</td>
<td>68.93</td>
<td>66.90</td>
<td></td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.
activities. Originally most of their working capital was borrowed from the commercial banks. Today most of them have increased their capacity to lend by taking deposits from the public. Out of these seventy five firms about seven of them share the bulk of the business as well as the deposits of the public, while a few of them have gone public and have their shares quoted in the market. The majority of the firms concentrate on the financing of both new and second hand vehicles both private and commercial and agricultural machinery such as tractors. The financing of industrial machinery has been minimal, roughly totalling about one per cent of the outstanding hire-purchase business in 1969-1970. The rates charged on hire-purchase finance inclusive of other charges vary between 10 to 24 per cent, while the rates charged on loans vary from 10 to 15 per cent. Evidence gathered during the survey showed that these companies preferred hire-purchase business to any other, this may be due to the deficiency of the law with regard to hire-purchase transactions. The law applicable to lending in Ceylon, lays down that the maximum interest to be charged as 18 per cent per annum on loans, but technically the hire purchase transaction does not come under the category of a loan, as in a hire-purchase transaction legally the goods are hired to the client and the rate charged fall into the category of rent for use of the items hired. Some companies levy interest rates on the reducing balance while others charge flat rates and in the case of the latter the effective rate is even higher. The cost of credit to the customer is further increased due to the customer having to bear costs such as stationary charges, survey fees, service charges, stamp and legal fees. Despite the high rates of interest, most companies have been increasing their business turnover very rapidly. The rates of interest paid for public deposits vary between 7 to 12 per cent.
These finance houses, some of which are organized on sound business lines perform a valuable service to the community by drawing excess funds from the depositing public and indirectly siphoning these funds into commerce and agriculture by way of hire-purchase finance. The important role they play and the need for a service of this nature in the absence of adequate financial facilities and investing opportunities is seen in the rapid expansion of hire-purchase companies and their business turnover. Table 26 shows the findings of a recent Central Bank survey, showing their business growth both with regard to accumulation of capital and hire-purchase loan business within a period of nine months.  

TABLE 26

OPERATIONS OF HIRE PURCHASE FINANCE COMPANIES

<table>
<thead>
<tr>
<th></th>
<th>As at 30th Sept.</th>
<th>As at 31st Dec.</th>
<th>As at 31st March</th>
<th>As at 30th June</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Deposit Liabilities</td>
<td>43.2</td>
<td>50.1</td>
<td>54.0</td>
<td>58.8</td>
</tr>
<tr>
<td>2. Hire-purchase business outstanding</td>
<td>71.9</td>
<td>79.4</td>
<td>75.1</td>
<td>84.4</td>
</tr>
<tr>
<td>3. Loans outstanding</td>
<td>13.1</td>
<td>16.5</td>
<td>17.9</td>
<td>19.4</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.

4.5.11 The financial sector comprising of bank and non-bank sector would not be complete if mention is not made of the indigenous and underdeveloped money market that has been in existent for over a century. At the beginning of this chapter the activities of this sector during the latter part of the nineteenth century and the early part of this century

1. See Central Bank Annual Report for 1970 -
were mentioned. It would have been reasonable to assume that with the development of the banking sector and the long term credit institutions, Government aid schemes, that the importance of money lender in the economy would have waned. However, the process of the declining importance of the money lender, does not seem to have occurred in inverse proportion to the development of the institutional finance sector. This underlines once again the need for a greater spread of institutional finance permeating down to the lower levels of the economy.

4.5.12 In the absence of adequate data only a broad generalization of the market as it exists will be outlined. The absence of information on this sector is partly due to the existing stigma in borrowing from these sources\(^1\) and the resulting reluctance of the borrowers to speak about it, with the result borrowers tend to keep their transactions as secret as possible. The stigma attached to the borrower is due to the general impressions and beliefs of the society, i.e. when borrowers resort to this source, they are assumed to be bordering on the verge of bankruptcy, or that their creditworthiness is under question, and/or that they have been refused credit by all institutional sources. Although there is some truth in some of these assumptions, this is too broad a generalisation. Some of the firms that were included in this survey showed that a few of them had resorted to this form of credit for entirely different reasons than those described above.\(^2\)

4.5.13 This sector consists of a very large number of money lenders, pawn brokers, traders and merchants. Although, earlier the chettiyar money lenders mentioned above\(^3\) dominated this sector their role

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1. Eg. Money lenders, Pawn brokers etc.
2. See chapter 8
3. See section 4.2.1
today is insignificant, and indigenous money lenders have taken their place. Despite the very high rates of interest charged, sometimes as high as 100 per cent per annum, there is considerable turnover in business. In general the persons who recourse to borrowing in this sector are the urban workers and the agricultural peasantry. However, there have been instances especially in times of a credit squeeze that small businessmen have also been compelled to turn to this source to keep their businesses going.

4.6. THE CENTRAL BANK OF CEYLON

4.6.1 In establishing the Central Bank of Ceylon, the Government obtained the services of a senior economist attached to the Federal Reserve System of the United States of America. His report for the establishment of a Central Bank in Ceylon was published in 1949 and the Central Bank commenced business in 1950. The objectives of the Central Bank as set out in the Monetary Law Act were as follows:

(i) The stabilization of domestic monetary values

(ii) The preservation of the par value of the Ceylon Rupee and the free use of the Rupee for current international transactions.

(iii) The promotion and maintenance of a high level of production, employment and real income in Ceylon

(iv) The encouragement and promotion of the full development of the productive resources of Ceylon.

4.6.2 It is relevant here to examine the powers vested in the Bank in the sphere of credit control in general as well as its powers to assist and control banks and other financial intermediaries. The Monetary Law Act of 1949 establishing the Bank gave it wide powers especially in the control of credit, as it was thought that the traditional methods of credit:

1. See Bib. 34
control such as open market operations and discount rate mechanisms would not be effective in terms of the underdeveloped nature of the economy. Among the powers vested in the bank in the regulation of credit are:

(i) the power to fix more than one bank rate, 'in accordance with the character and term of each such operation'

(ii) the power to vary the reserve ratios of the commercial banks within the range of 10 to 40 per cent against demand deposits, and 5 to 20 per cent against time and savings deposits, while special reserve ratios could be applied up to a maximum of 100 per cent on any increase of deposits after a certain prescribed date.

(iii) It could fix ceilings on the foreign exchange holdings of the commercial banks or permit holdings over this maximum ceiling specified with a view to checking inflationary expansion by requesting the funds to be kept abroad.

(iv) It has the power to regulate credit operations of banks by prescribing maximum permissible maturities for loans and investments of commercial banks and the nature and amount of security required for each kind of credit.

(v) Portfolio ceilings could be introduced for loans and investments as a whole or selectively for those particular categories of loans and investments.

(vi) It could prescribe limiting ratios which the capital and reserves of the banks should bear to various groups of assets.

(vii) It has provisions for cash margins against letters of credit and the choice of fixing different margins for different classes of transactions.

(viii) It has the power to fix maximum rates payable by commercial banks on deposits and the rates they may charge on their loans and advances.

4.6.3 The array of restrictive powers vested by law on the
Central Bank is quite formidable and one must not come to the conclusion that its powers are of a purely restrictive nature. For, in the sphere of helping the commercial banks to meet the demand for different type of credit requirements of the business sector the Bank is authorized to:

(i) discount, rediscount, buy and sell commercial bills of maturities of not more than 180 days from the date of discount resulting from the purchase sale and importation or the storage of goods,

(ii) discount, buy and sell production credits with maturities upto 270 days from the date of discount

(iii) to make advances on loans for any fixed period not exceeding 180 days on promissory notes which have been secured on the pledge of gold, Treasury Bills or other types of securities specified in the Act,

(iv) in special circumstances, the Bank could also grant loans and advances repayable within one year for the purpose of mortgage lending on movables or immovables against promissory notes given by the credit institutions to stimulate particular classes of lending operations by commercial banks and specialized lending institutions. This was further widened by the finance Act of 1963 to allow the Bank to make available medium and long term finance for productive purposes.

(v) Finally, if a situation arises, which threatens the stability of the banking structure, the Central Bank is permitted to grant loans and advances to banking institutions on any kind of security which the Monetary Board of the Central Bank of Ceylon considers acceptable.

4.6.4 In the first decade of the Bank's existence, it could not adequately influence the credit situation both in terms of contraction or direction of expansion, due to inherent weaknesses of the economy and the
lopsided financial structure. However, since then, with the early phase of industrialization in the late 1950's and the subsequent Government ownership of the two commercial banks, the powers that were embodied in the founding Act, gains more and more importance. For, it can use its powers to curtail bank lending to non-essential or speculative purposes and by moral suasion coupled with other measures request the banks to direct more of their lending to agriculture and industry. In other words, in the light of present trends in the economy, the Central Bank will have to play a much more active part in this direction, than it has hitherto done.

1. As described in the early part of this chapter
CHAPTER FIVE

THE COMPOSITION OF THE SURVEY

5.1 INTRODUCTION
5.2 STAGE ONE - HYPOTHESES & QUESTIONS
5.3 STAGE TWO - CHOICE OF INTERVIEW METHOD
5.4 STAGE THREE - SIZE MEASURES
5.5 STAGE FOUR - SELECTION OF SAMPLE POPULATION
5.6 STAGE FIVE - PILOT SURVEY
5.7 STAGE SIX - ESTABLISHMENT OF CONTACT WITH SAMPLE POPULATION
5.1 INTRODUCTION

5.1.1 All the chapters that precede this one form a background for the analysis in the chapters that follow. The discussion in the chapters that follow is made on the assumption that the reader has by now a very intimate knowledge and understanding of the economy of Ceylon, past and present in relation to its industry, the direction of policy objectives, the importance of small firms in future economic development, the direction and development of her financial institutions, and lastly, the general problems small and medium sized firms would face in the context of the outlined economic, industrial and financial development.

5.1.2 As stated at the beginning of this study, the aim of this research has been, not to analyse all the problems faced by small and medium sized firms but the problems of access to finance of firms¹. Firms have been set up with various purposes in mind by their owners and sponsors; this study concentrates on the problems of firms which are anxious to grow, and when the capital requirements exceed what the entrepreneur can comfortably supply from his own personal savings and those of friends and relatives. In this context the problems would revolve around the access to funds, for the establishment of the firm, for expansion at the right time, at various stages of development, in the right quantities, and of the right type and conditions.

5.1.3 This chapter deals with the mode of research undertaken to examine the problems. The method of research was divided into three parts, i.e. first, a survey of all financial institutions, secondly, a survey of hundred selected firms and thirdly, a series of interviews with these

¹. The word 'firm' is used here in the economic sense to mean any business enterprise regardless of its legal form. Further 'firm' is used to denote both small and medium sized firms as defined for the purpose of this study unless otherwise mentioned.
connected with industry. The intention was to assess the problems from the viewpoint of the lenders, borrowers and others involved in various ways with the industrial sector in the country.

5.2 Stage One - HYPOTHESES & QUESTIONS

5.2.1 Planning of the investigation was divided into seven stages. Stage one of the exercise was to form hypotheses in the light of what has been observed, and what is known, regarding the problems firms face, and to classify all the problems the firms face in the sphere of access to finance. Some perhaps would not be relevant in the case of Ceylon, while others would highlight peculiar problems applicable to the country. It was the task of the survey to identify these.

5.2.2 The five basic hypotheses are given below. The questions in the three surveys were drawn up to obtain and extract information on the problems firms face (see section 5.2.8). Those questions in the three surveys that have a relationship with the hypotheses to be tested are given against each hypothesis in an abbreviated form. The abbreviations are as follows,

1. S.F.S. (Q. No.) Small Firm Survey (consists of 22 questions)
2. F.I.S. (Q. No.) Financial Institution Survey (consists of 20 questions)
3. G.S. General Survey
   G.S.A. Financial Intermediaries (13 Discussion Topics)
   G.S.B. Government Ministries and Departments (16 Discussion Topics)
   G.S.C. Central Bank (9 Discussion Topics)
   G.S.D. Other Controlling Bodies (10 Discussion Topics)
   G.S.E. Business Chambers (4 Discussion Topics)
   G.S.F. Businessmen (5 Discussion Topics)
4. S.L. Selected Literature (both published and unpublished)
5.2.3 Hypothesis ONE. That all concerned with the planning of industrial development, have either overlooked or avoided the examination of the availability of finance, and the financial problems of this sector; resulting in,

(a) Inadequacy of avenues of institutional finance

(b) Unsatisfied demand for long term credit, as well as (to a considerable extent) short term credit.

(c) Large firms having access to existing institutions which is denied or beyond the capacity of the small and medium sized firms.

5.2.4 Hypothesis TWO. That 'inadequacy of credit' or 'shortage of capital' criterion of small firms could be attributed to.

(a) The fact that financial institutions themselves are too small or have smaller reserves.

(b) The fact that institutions consider loans principally on the merits of primary and collateral security as against (i) Purpose of loan, and (ii) other feasibility features

(c) Or, the alternative hypothesis that shortage of capital for small and medium sized firms in less developed countries is only an illusion created
by a large false demand for capital, and what really exists is not an immediate shortage of capital at all, but a shortage of viable projects.

(SFS. 2,3,4,6,8,9,10,13-16,20; FIS. 1,2,5,6,9,10-12,14,15,17-19; GSA. 3,5,6,9,11-13; GSB. 4,5,10,11,12,14,15; GSC. 1,5,9; GSD. 1,2,5,8,9; GSE. 2,4; GSF. 1-5; SL. )

5.2.5 Hypothesis THREE. That if a bias exists against lending to small firms by lending institutions and other financial intermediaries, it is a result of,

(a) The structure of firms, i.e. inadequate financial management, unsystematic management techniques, the desire to be independent resulting in secretiveness, and situational factors of smallness.

(SFS. 1,3,4,10,12,14-16,20-22; FIS. 2,4-12,14-16,18,19; GSA. 1-3,5,6,8,11-13; GSB. 1-6,11-16; GSC. 1-4,8; GSD. 1-10; GSE. 1,2,4; GSF. 1-5.)

(b) Legal limitations to lending.

(SFS. 2-4,6,8,9,20; FIS. 4,7,9-13,17,21; GSA. 5,6,8,11,12; GSB. 14-16; GSC. 1,2,4,9; GSD. 6,9; GSF. 1-5; SL.)

(c) Historical factors.

(SFS. ii,iii,v,vii,ix,2-8,11-13,15,19,20,22; FIS. 1-5,8-11,13-15,18,19,21 GSA. 1-3,5,10-13; GSB. 1,2,6,7,11-15; GSC. 3,4,7,8; GSD. 1-10; GSF. 1-5; SL.)

(d) Government Policy.

(SFS. 2-7,9,13,15,20,22; FIS. 4,7-9,10-12,17,21; GSA. 4,5,7,8,10-12; GSB. 1-16; GSC. 1-5,9; GSD. 1-10; GSF. 1-5; SL.)

(e) A Communication and Attitude gap.

(SFS. 2-17,19,20,22; FIS. 1-3,5,8-10,12,15,16,19,21; GSA. 2,3,5,6,10,11,12,13; GSB. 1-16; GSC. 1-5,7,8; GSD. 1-10; GSE. 1-4; GSF. 1-5.)

5.2.6 Hypothesis FOUR. That credit restraint policies of the Central bank (i.e. the Government) affect small firms more than large f;
as a result of,

(a) Rising interest rates which result from credit restraint having a more inhibiting effect on the borrowing of small business than those of large firms.

(b) Most financial institutions not trying to reduce shortages by raising lending rates so much as by tightening of other credit terms, i.e. by credit rationing; and the terms they chose to ration credit such as risk, solvency, profitability, creditworthiness, rate of return, networth, etc., necessarily hurt small more than large business.

(SFS. 8,9,15,17,20,22; FIS. 7,17; GSA. 4; GSB. 12; GSC. 1,4; GSF. 2,3,5; SL.)

5.2.7 Hypothesis FIVE. That whatever the level of development of a country, general problems of finance faced by small firms are broadly similar, while developing countries have in addition special problems peculiar to developing nations.

(SFS. 2-13,15,16,18-20,22; FIS. 1-16,18,19,21; GSA. 1-3,5,6,10-13; GSB. 3-7,10-16; GSC. 1,4,6,7,8; GSD. 1-10; GSF. 1-5; GSE. 1-4.)

5.2.8 In order to test these hypotheses and to investigate the real problems faced by firms at present, answers to a number of questions were sought. The questions were based to extract the following information:

1. Obstacles in any in the way of small firms as against large firms in credit availability.

2. Whether existing financial institutions are adequate and capable of catering for all external credit requirements of firms.

3. To examine the present access to finance of small and medium sized firms i.e. (i) The type of institutions they normally turn to for their financial...
requirements

(ii) The conditions under which loans are granted at present

(iii) The ability of large and small firms to fulfill these conditions

(iv) The reasons for refusal of credit by the institutions

(v) The difficulties or ease of obtaining different types of loans

(vi) The unsatisfied demand for credit or whether firms are satisfied with the avenues available to them at present.

(vii) Different types of credit obtained by the firms in the survey and the direction of their utilization.

4. Whether there is a tendency for large banks and other financial institutions to lend to large customers, while small institutions necessarily lent to small firms.

5. Whether interest rates charged on business loans by banks and other financial institutions tend to vary inversely with the size of loans and therefore costs as a percentage of loan value decrease with loan size.

6. Whether interest rates vary according to loan size, if so, whether the higher rates charged is a result of, (i) higher costs in assessment, (ii) due to lenders charging a higher risk premium, or (iii) due to borrowers seeking loans in imperfect markets.

7. Whether lenders tend to discriminate more against small borrowers in relative tight money periods, if so methods of credit rationing to them as opposed to large firms, such as, higher rates of interest or upgrading the terms and conditions of their loans.

8. Whether there is a bias in lending, according to size, type, age and legal form of firms.

9. The relationship between the bank rate and the cost of credit, i.e. whether there is price rigidity as market gets less competitive and the market r
becomes ineffective, and whether investment spending is negatively or inversely related to interest rates.

10. Attitudes of private firms to outside equity.

11. Attitudes of banks and other credit institutions towards the small firm sector.

12. Attitudes of Government and planning bodies and officials towards the industrial sector and small firms in particular.

13. The relationship of other factors that contribute to the problems of small firms such as, (i) structure of small firms, (ii) historical factors, (iii) social factors, (iv) faulty planning, (v) general economic policy, (vi) Government credit and fiscal policies, and (vii) legal enactments which apply to lending.

5.3. Stage Two - CHOICE OF INTERVIEW METHOD

5.3.1 Stage two of the research plan was a decision on the choice of interview method and formulations of the questions. In the case of type of questions, there was a choice between straightforward questions, i.e. 'yes' or 'no' type, providing check responses, and/or, open ended questions probing the 'why' and 'how' of different problems. The choice of interview method chosen was, direct personal interviews with the chosen firms, with the help of a prepared questionnaire. This method was given preference in place of a postal questionnaire as it was felt that, (a) a survey of this nature had first to win the goodwill of the respondents and breakdown barriers, (b) that the interviewer could check that the interviewee understood the questions, (c) to minimise the language barrier, especially with regard to accounting and financial terminology, (d) to maintain the aspect of confidentiality; as, a number of questions were of a confidential nature, the firms in normal circumstances would be reluctant to fill forms with confidential information, (e) postal questionnaires in Ceylon, have not had much succ

1. Some of the interviews were conducted in Sinhalese and Tamil, the two indigenous languages of Ceylon.
and finally, (f) a postal questionnaire, in a survey of this nature would have been too detached, thereby retarding the detailed discussion of some of the problems; as the purpose of the survey was to give adequate leeway to the respondents to unburden their grievances if any, in a context of a discussion. This would in turn give an opportunity to the interviewer to gauge the answers, weed out assumed grievances from the real problems.

5.3.2 The choice of interview method weighted the questionnaire in favour of more open ended questions providing free responses, as against check-list questions. As this is an examination of the problems of a sector of industry, the research was more of an exploratory nature with the main object of getting an insight into the problems. In formulating the questions, guidance was obtained from a check list on the construction of questionnaires and interview schedules.

5.4. Stage Three - SIZE MEASURES

5.4.1 Stage three was the establishment of a size measure. This was a difficult task as far as Ceylon was concerned due to the absence of adequate statistics on industries. Most countries which have defined industry according to size measures, 'small', 'medium' and 'large', have done so principally for administrative purposes. A size measure, facilitates the granting of special aid to different sectors of industry such as financial and tax concessions, and at the same time help to keep a better check and control of development criteria so that proper weighting could be given to industrial policy. There are no guide lines to go by in Ceylon, to date there has been no overall concerted effort to give a meaning to different firm size, except the abortive attempt in 1954. The present uses of the

2. See Chapter One, Section 1.5
terminology 'small', 'medium', and 'large', differ due to diffused objectives of analysis. The only available current industrial classification in the country is the one used by the Central Bank of Ceylon, for their annual statistical survey. The two variables used are, value of output and the wages bill. A size measure based on the value of output alone would not give any meaning to size of firms in Ceylon due to the peculiar constraints on the industrial structure, the foremost of which is foreign exchange limitations. On the other hand, a size measure on the basis of the wages bill would not give any accurate results, especially when wage scales vary so widely even for the same job in two different firms, apart from wages being tied to different grades of skill and experience and the different factor combinations. Other definitions of size apart from these two described above were also not considered for the purposes of this study due to their vagueness for purposes of statistical analysis. Therefore the option fell on those measures which are generally accepted as giving a fair differentiation although not accurate. The foremost among them were, size in terms of, (a) turnover and value of output, (b) net assets and capital employed, and (c) employment.

5.4.2 These measures were used in the classification, keeping well in mind their limitations, and that any size measure attempted will be a static one. The foremost weakpoints of these measures are, (i) measures using turnover are suspect, as there is a likelihood of firms not giving correct figures due to, ignorance, absence of proper accounting records and

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1. See the definitions in Chapter One, Section 1.5 and Chapter Two, Section 2.

2. The Central Bank of Ceylon size classification is as follows:- according to value of output: Small = Rs.250,000 and below; Medium = Rs.250,000 to Rs.2 million; and Large = over Rs. 2 million. According to wages bill: Small = Rs.15,000 and below; Medium = Rs.15,000 to Rs.50,000; and Large = over Rs.500,000.

TABLE 27

SIZE MEASURES OF SURVEY FIRMS

<table>
<thead>
<tr>
<th>Size</th>
<th>Employment No. of Persons</th>
<th>Net Assets/Capital Employed</th>
<th>Value of output/Turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>100 and under</td>
<td>Under 150,000</td>
<td>Under 300,000</td>
</tr>
<tr>
<td>Medium</td>
<td>101 to 250</td>
<td>150,000 to 500,000</td>
<td>300,000 to 1,000,000</td>
</tr>
<tr>
<td>Large</td>
<td>Over 250</td>
<td>Over 500,000</td>
<td>Over 1,000,000</td>
</tr>
</tbody>
</table>

Note: This is the same table as table 1, in Chapter 1.

TABLE 28

SURVEY FIRMS CATEGORIZED ACCORDING TO SIZE MEASURES

<table>
<thead>
<tr>
<th>Size</th>
<th>Employment No. of Firms</th>
<th>Net Assets/Capital Employed No. of Firms</th>
<th>Value of output/Turnover No. of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>76</td>
<td>66</td>
<td>79</td>
</tr>
<tr>
<td>Medium</td>
<td>23</td>
<td>34</td>
<td>21</td>
</tr>
<tr>
<td>Large</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Size</td>
<td>Number Employed</td>
<td>Number of Firms</td>
<td></td>
</tr>
<tr>
<td>------------</td>
<td>-----------------</td>
<td>-----------------</td>
<td></td>
</tr>
<tr>
<td>Small</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under 10</td>
<td></td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>10 to 19</td>
<td></td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>20 to 29</td>
<td></td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>30 to 39</td>
<td></td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>40 to 49</td>
<td></td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>50 to 59</td>
<td></td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>60 to 69</td>
<td></td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>70 to 79</td>
<td></td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>80 to 89</td>
<td></td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>90 to 100</td>
<td></td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Sub - Total</td>
<td></td>
<td>76</td>
<td></td>
</tr>
<tr>
<td>Medium</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>101 to 110</td>
<td></td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>111 to 120</td>
<td></td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>121 to 130</td>
<td></td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>131 to 140</td>
<td></td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>141 to 150</td>
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<td>1</td>
<td></td>
</tr>
<tr>
<td>151 to 160</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>161 to 170</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>171 to 180</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>181 to 190</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>191 to 200</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>201 to 210</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>211 to 220</td>
<td></td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>221 to 230</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>231 to 240</td>
<td></td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>241 to 250</td>
<td></td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Sub - Total</td>
<td></td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>Large</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Over 250</td>
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<td>1</td>
<td></td>
</tr>
<tr>
<td>Grand Total</td>
<td></td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>
### TABLE 30

**SIZE OF SURVEY FIRMS BY NET ASSETS/CAPITAL EMPLOYED**

(Detailed Breakdown)

<table>
<thead>
<tr>
<th>Size</th>
<th>Value in Rupees '000</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Small</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Below 25</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>25 to 49</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>50 to 74</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>75 to 99</td>
<td>26</td>
</tr>
<tr>
<td></td>
<td>100 to 124</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>125 to 149</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td><strong>Sub - Total....</strong></td>
<td><strong>66</strong></td>
</tr>
<tr>
<td><strong>Medium</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>150 to 174</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>175 to 199</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>200 to 224</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>225 to 249</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>250 to 274</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>275 to 299</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>300 to 324</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>325 to 349</td>
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</tr>
<tr>
<td></td>
<td>350 to 374</td>
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<tr>
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<td>375 to 399</td>
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</tr>
<tr>
<td></td>
<td>400 to 424</td>
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</tr>
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<td>425 to 449</td>
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</tr>
<tr>
<td></td>
<td>450 to 474</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>475 to 500</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td><strong>Sub - Total....</strong></td>
<td><strong>34</strong></td>
</tr>
<tr>
<td>Size</td>
<td>Value in Rupees '000.</td>
<td>Number of Firms</td>
</tr>
<tr>
<td>-------</td>
<td>-----------------------</td>
<td>-----------------</td>
</tr>
<tr>
<td>Small</td>
<td>Below 50</td>
<td>2</td>
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<tr>
<td></td>
<td>50 to 99</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>100 to 149</td>
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<tr>
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<td>150 to 199</td>
<td>23</td>
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<td>200 to 249</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>250 to 299</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>Sub - Total....</td>
<td>79</td>
</tr>
<tr>
<td>Medium</td>
<td>300 to 349</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>350 to 399</td>
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</tr>
<tr>
<td></td>
<td>400 to 449</td>
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</tr>
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<td>450 to 499</td>
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<td>500 to 549</td>
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<td>550 to 599</td>
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<tr>
<td></td>
<td>600 to 649</td>
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<td>750 to 799</td>
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<tr>
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<td>800 to 849</td>
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<td>850 to 899</td>
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<td>900 to 949</td>
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<tr>
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<td>950 to 1000</td>
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<td></td>
<td>Sub - Total....</td>
<td>21</td>
</tr>
<tr>
<td>Large</td>
<td>Over 1000</td>
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</tr>
<tr>
<td>Total</td>
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<td>100</td>
</tr>
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</table>
### TABLE 32
SURVEY FIRMS ACCORDING TO ALL THREE SIZE MEASURES

<table>
<thead>
<tr>
<th>Employment</th>
<th>Capital</th>
<th>Turnover</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>S</td>
<td>S</td>
<td>S</td>
<td>60</td>
</tr>
<tr>
<td>S</td>
<td>S</td>
<td>M</td>
<td>2</td>
</tr>
<tr>
<td>S</td>
<td>M</td>
<td>S</td>
<td>11</td>
</tr>
<tr>
<td>M</td>
<td>S</td>
<td>S</td>
<td>4</td>
</tr>
<tr>
<td>S</td>
<td>L</td>
<td>S</td>
<td>-</td>
</tr>
<tr>
<td>M</td>
<td>M</td>
<td>M</td>
<td>15</td>
</tr>
<tr>
<td>S</td>
<td>M</td>
<td>M</td>
<td>3</td>
</tr>
<tr>
<td>L</td>
<td>M</td>
<td>M</td>
<td>1</td>
</tr>
<tr>
<td>M</td>
<td>M</td>
<td>S</td>
<td>4</td>
</tr>
</tbody>
</table>

Total... 6666

Note: S denotes Small, M Medium, L Large

### TABLE 33
SURVEY FIRMS ACCORDING TO ANY TWO SIZE MEASURES

<table>
<thead>
<tr>
<th>Size</th>
<th>Employment and Capital (E-T)</th>
<th>Employment and Turnover (E-T)</th>
<th>Capital and Turnover (C-T)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of Firms</td>
<td>No. of Firms</td>
<td>No. of Firms</td>
</tr>
<tr>
<td>SS</td>
<td>62</td>
<td>71</td>
<td>64</td>
</tr>
<tr>
<td>SM</td>
<td>14</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>MS</td>
<td>4</td>
<td>8</td>
<td>15</td>
</tr>
<tr>
<td>MM</td>
<td>19</td>
<td>15</td>
<td>19</td>
</tr>
<tr>
<td>LM</td>
<td>1</td>
<td>1</td>
<td>-</td>
</tr>
</tbody>
</table>

Total no. of Firms 100 100 100

Note: S, M, and L denote Small, Medium and Large.
# Table 34

**Individual Breakdown of Survey Firms According to Age, Legal Status, & Size**

<table>
<thead>
<tr>
<th>Age</th>
<th>No. of Firms</th>
<th>Legal Status (Breakdown)</th>
<th>Size by Employment</th>
<th>Size by Capital</th>
<th>Turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before 1948</td>
<td>6</td>
<td>3 Pvte. 1</td>
<td>L</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3 Pub. 3</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td>1949 - 1954</td>
<td>9</td>
<td>1 P/ship 1</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2 Prop. 2</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5 Pvte. 1</td>
<td>S</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1 Pub. 1</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td>1955 - 1960</td>
<td>27</td>
<td>5 Prop. 5</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3 P/ship 3</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>18 Pvte. 4</td>
<td>M</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3</td>
<td>M</td>
<td>M</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>8</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1 Pub. 1</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td>1961 - 1965</td>
<td>50</td>
<td>11 Prop. 11</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1 P/ship 1</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>37 Pvte. 3</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td></td>
<td></td>
<td>8</td>
<td>M</td>
<td>M</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2</td>
<td>S</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2</td>
<td>S</td>
<td>S</td>
<td>M</td>
</tr>
<tr>
<td></td>
<td></td>
<td>21</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td>1966 - 1970</td>
<td>8</td>
<td>2 Prop. 2</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6 Pvte. 6</td>
<td>S</td>
<td>S</td>
<td>S</td>
</tr>
</tbody>
</table>

methods, and the prevalence of income tax avoidance. (ii) In the case of net assets, the definition runs into difficulties as in published accounts the term is taken to mean the total of fixed, i.e. all assets which are not current assets, plus net current assets, i.e. current assets less current liabilities. The significance of this total may be somewhat doubtful depending on whether one considers it equal to capital employed. As there is no agreement how it should be calculated the method of arriving at the figure varies considerably. For the purposes of this study the view was taken that, net assets or capital employed to be the total capital used in the business despite the disadvantage that techniques used in valuation of assets differ. (iii) The third measure in terms of employment has also its share of difficulties as affirms both large and small have different labour intensities, depending on the type of production, the ratios of capital and labour, the methods of process, and other extraneous factors.

5.4.3 Thus the above measures have been used in the study, taking into consideration these deficiencies, and in combination with our knowledge of the country's industrial history, the size of the GNP, geographical size, market size in relation to the population, the propensity to consume in relation to income levels, the terminology of 'size' as used in common parlance and as understood by the public, industrialists, planners and financial institutions, and lastly in comparison to the existing industries both local and foreign.

5.5 Stage Four - SELECTION OF SAMPLE POPULATION

5.5.1 Stage four of the survey was the selection of the sample population. As the number of financial institutions and other financial

---

1. The classification of size of firms using these guide lines is given in table 27, and the analysis of the sample firms according to these size measures is given in tables 28 to 34.
intermediaries were few in number, a decision was made to cover the whole sector. The institutions chosen for the survey were the following.

A. Commercial Banks.

(1) The Bank of Ceylon
(2) The People's Bank
(3) The Natlion National Bank
(4) The Commercial Bank of Ceylon
(5) The National and Grindlays Bank
(6) The Hongkong and Shanghai Bank
(7) The Chartered Bank
(8) The Mercantile Bank
(9) The State Bank of India
(10) The Indian Overseas Bank
(11) The Indian Bank
(12) The Habib Bank

B. Long Term Credit Institutions

(1) The Agricultural and Industrial Credit Corporation
(2) The Development Finance Corporation of Ceylon
(3) The State Mortgage Bank

C. Other Financial Intermediaries

(1) Six, Finance and Hire-Purchase Companies
(2) One, Money Lender

5.5.2 In the case of the firms, a primary decision was taken on the type of firm that should be included in the survey. To arrive at this decision a number of criteria were used, firstly, emphasis was placed on firms that had been set up by individual initiative as against those firms which

1. See Chapter Six for further details and a profile of the institutions. See also Chapter Four, for detailed structure of the institutions surveyed.
were subsidiaries, holding companies, or branches of large firms in Ceylon and overseas. The reason was that in the case of the latter type of firm, the financial characteristics were different, and in most cases their finances were interlinked with that of the parent company. Secondly, preference was given to manufacturing and processing firms, excluding processing firms connected with the three major plantation crops.¹ This is due to the emphasis given in this study to the manufacturing and processing sectors as these constitute growth points in the development and diversification of the economy. Therefore, the success of this sector is the basis for industrial growth and the solution to many basic economic problems facing the country. Thirdly, all firms that were to be considered for the sample were those that had the approval of the Department of Industries.² Finally an attempt was made to select a greater proportion of private companies falling under the category of single proprietorships, partnerships and private limited liability companies,³ while a few public companies, (medium in terms of size measures chosen here) were also selected to investigate whether there was any difference between their problems and those of the smaller firms.⁴

5.5.3 The industries were categorized according to the United Nations Industrial Classification, into nine broad groups or sectors.⁵ With the available industrial statistics in the country, a broad view of the size factor was taken in terms of employment, assets structure, turnover figures, and other related factors mentioned above. Out of the total number

¹ See Table 53, in Chapter Seven.
² All industrial units established after 1958 had to obtain the approval of the Ministry of Industries, while those that had commenced business prior to this date had automatic approval on application.
³ See Table 54, in Chapter Seven.
⁴ See Table 53, in Chapter Seven.
⁵ In the case of sector 7 in the table on industrial sector classification i.e Table 35, there were no private firms falling under this category in the country.
<table>
<thead>
<tr>
<th>Industrial Sector</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Manufacture of Food, Beverages and Tobacco</td>
<td>16</td>
</tr>
<tr>
<td>2. Textiles, Wearing Apparel and Leather Industries</td>
<td>18</td>
</tr>
<tr>
<td>3. Manufacture of Wood and Wood Products, including Furniture</td>
<td>4</td>
</tr>
<tr>
<td>4. Manufacture of Paper and Paper Products</td>
<td>8</td>
</tr>
<tr>
<td>5. Manufacture of Chemicals, Petroleum, Coal, Rubber and Plastic Products</td>
<td>16</td>
</tr>
<tr>
<td>6. Manufacture of Non-metallic Products except Petroleum and Coal</td>
<td>8</td>
</tr>
<tr>
<td>7. Basic Metal Products</td>
<td>-</td>
</tr>
<tr>
<td>8. Manufacture of Fabricated metal Products</td>
<td>20</td>
</tr>
<tr>
<td>9. Manufactured Products, n.e.s</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total...</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>
of industries falling into the sample on the basis of limiting factors described above, an attempt was made to get as wide a coverage (i.e. distribution) as possible, with selected 'reserve firms' in each sector, in case of inability or refusal of the firms first selected, to participate in the survey.

5.5.4 In the case of the General Survey, it was intended to be a series of 'discussion interviews' probing the different aspects of financial and other services, views, opinions and attitudes. Therefore it was decided not to conduct this survey in the form of a prepared questionnaire, as the field to be covered was wide and varied, and the institutions and persons to be interviewed, were connected to industry in different ways and had different objectives and responsibilities. Therefore it was felt that it will be more relevant to have these interviews in the form of discussion topics.

5.5.5 The persons and institutions to be interviewed were divided into six broad groups, and a list of discussion topics were drawn up to be used with each group. The six groups and the interview (discussion) topics are given below.

5.5.6 Financial Intermediaries: This group comprised of persons from,
(a) Commercial Banks (24 persons)
(b) Stock Brokers (2 " )
(c) Hire-Purchase & Finance Companies (10 " )
(d) Insurance Corp. (3 " )
(e) Long Term Credit Institutions, i.e. AICC, DFCC, SMB. (6 persons)
(f) Savings Institutions, i.e. The Post-Office Savings Bank, The Employees' Provident Fund, The Ceylon Savings Bank. (3 persons)
(g) The Industrial Development Board (3 persons)
(h) Private investors (3 persons)
The Discussion Topics were,
(i) Stock and Capital Market activities, shortcomings, and the future.
(ii) Attitudes towards small business
(iii) Customer - Lender relationships and typical and atypical client.
(iv) Interest rates and market rates, minimum and maximum levels.
(v) Cost and risk factor
(vi) New business versus Existing business, Small versus Large business, the differences and bias.
(vii) Firm size against loan size and size of lender
(viii) Future plans and their role in industrial lending
(ix) Process of a loan - profile.
(x) Other services provided by them.
(xi) Difficulties, problems, limitations, and 'bottle-necks'.
(xii) Information gap
(xiii) Recruitment, training and Internal organisation.

5.5.7 Government Ministeries and Departments: This group comprised of persons from different Ministeries and Departments.

(a) Ministeries of, Foreign and Internal Trade, Industries and Scientific Affairs, Agriculture, Plantation Industries, Planning and Employment, Finance. (11 persons)
(b) Departments of, Industries, Rural Development and Small Industries, Census and Statistics (19 persons)
(c) Planning Secretariat and Treasury (6 persons)
(d) Research Institutes:
   (i) The Ceylon Institute for Scientific and Industrial Research
   (ii) The Tea Research Institute
   (iii) The Coconut Research Institute
   (iv) The Small Industries Service Institute

The Discussion Topics were,
(i) Activities of the institutions mentioned above
(ii) Shortcomings and future plans
(iii) Attitudes, towards small business
(iv) Advisory and Technical services provided
(v) Financial services and advise if any
(vi) Other direct and indirect services
(vii) Training schemes for management and workforce.
(viii) Industrial Estates
(ix) Size measures of industrial units, definitions of small business
(x) Statistics – what is available, problems of collection and dissemination sectoral statistics
(xi) Research undertaken at present pertaining to industry.
(xii) Priorities, policies, incentives and disincentives, future plans.
(xiii) General attitudes towards development of private industry.
(xiv) Legal structure and its effects on industrial lending
(xv) Problems, planning misfortunes, mis-direction of objectives
(xvi) Overall problems of development and industrialisation

5.5.8 Central Bank: Full use of the expertise available at the Bank were exploited and the persons interviewed were from,
(a) Department of Economic Research, i.e. Industries Division, Trade Division, Banking Division, Rural Credit Division, Public Finance Division and Statistics Division. (16 persons)
(b) Departments of, Bank Supervision, Public Debt, and Banking and Currency (8 persons)

The Discussion Topics were,
(i) Credit restraint policies
(ii) Refinance credit, Public Debt
(iii) New Institutions and regulations
(iv) Bank Supervision and Control
(v) Future policy
(vi) Industrial Statistics
(vii) Development problems
(viii) Attitudes
(ix) Credit guarantee problems and schemes

5.5.9 Other Controlling Bodies: These included the Departments of, (i) Import and Export Control
(ii) Exchange Control
(iii) Customs and Excise
(iv) Inland Revenue (11 persons)
The Discussion Topics were,
(i) Tariffs
(ii) Quotas
(iii) Attitudes
(iv) Future Policy
(v) Cooperation, expansion and duplication of activities
(vi) Legal aspects
(vii) Information gap between themselves and the industrial sector, and other Government departments.
(viii) Wayward activities of the industrial sector
(ix) Taxes, incentives, restrictions, and disincentives.
(x) Services

5.5.10 Business Chambers: Persons interviewed were from the,
(a) Ceylon Chamber of Commerce
(b) Ceylon Chamber of Small Industries
(c) National Association of Small Industries (6 persons)
The Discussion Topics were,
(a) Attitudes.
(b) Difficulties and problems.
(c) Cooperation.
(d) Suggestions for the future.

5.5.11 Businessmen: In this group, most persons interviewed were those entrepreneurs who had begun business in a small scale. (6 persons)
The Discussion Topics were,
(i) Attitudes.
(ii) Past and present difficulties.
(iii) Problems, mis-direction, and 'bottle-necks'.
(iv) Present weaknesses.
(v) What they desire for the future.

5.6. Stage Five: PILOT SURVEY

5.6.1 Stage five consisted of testing the Financial Institution and Small firm Questionnaires by two pilot surveys to establish, (a) whether the answers to the questions covered all aspects of the problem commensurate
with the survey goals, (b) to ascertain whether the questions were easily understood by the interviewee, (c) to identify the prospects of two-way communication, and (d) to ascertain the likelihood of obstacles if any, that would arise. The results of the pilot surveys were analysed and the necessary corrections and alterations were made in the final questionnaires to overcome deficiencies found.

5.6.2. Two financial institutions were chosen for the pilot survey on financial institutions, i.e. a commercial bank and a long term credit institution. The alterations that were made to the interview schedule cum questionnaire on financial institutions as a result of the pilot study are given below.

1. Questions 1, 2 and 3 were changed into tabular form to facilitate direction of answers and easy tabulation. The basic questions remained the same.
2. Questions 4 and 5, remained the same.
3. Question 6 remained the same, however the section suggesting likely answers was deleted due to the possibility of bias entering the answers.
4. Questions 7, 8, and 9, remained the same.
5. Question 10; as there was an apparent misunderstanding of the question in its original form, it was re-worded.
6. Question 11, remained the same.
7. Question 12; as this question was a little vague and too general, it was spelled out in detail, so that the interviewee was aware of what was required of him.
8. Question 13, remained the same.
9. Question 14 was re-worded to make it more precise.
10. Questions 15, 16, and 17 remained the same.
11. Question 18 was changed from a 'check response' type of question to an

1. The forms used in the two Pilot Surveys are given in Appendix B.
'open-ended' type, as it was felt that an opportunity should be provided for the interviewee to voice his opinion on the subject.

12. The Pilot interview schedule contained only 18 questions. Question 19 in the final questionnaire was added after the Pilot survey, as it was found that this problem was not brought out adequately in the other questions.

13. Question 20 is a request for data to compile statistical tables.

14. Question 21 in the final questionnaire is an additional question to cover any other aspect of finance which could not be adequately dealt with in the other questions.

5.6.3 The Small Firm Pilot Survey consisted of ten firms. The alterations to the survey questions as a result of the pilot survey are given below.

1. Additional information was added to the introductory data, i.e. (a) 'Ownership of Industrial Premises', as this factor seems to have a connection with the access to credit, and (b) 'Total number of Employees at commencement of Business', as this was related to tax exemptions.

2. Question 1 remained the same.

3. Questions 2 and 3, the questions remained the same, but a varying scale of 'degree of difficulty' was added, having five columns for the expression of difficulty as against the single column in the Pilot survey. This was done to facilitate the interviewee to identify the degree of difficulty against each question, i.e. the type of loan in question two and the condition of loan in question three.

4. Question 4 remained the same. However, some lenders mentioned in the original question were deleted, due to, (a) all insurance business being carried out by the State, i.e. one giant insurance corporation, which do not lend directly to the industrial sector.
(b) as both private finance and hire-purchase is being carried out by the same type of company, they were amalgamated into one.

5. Question 5 remained the same, except that the answer columns were spread out and the different types of loans were mentioned to facilitate greater clarity in the answers.

6. Question 6 was re-worded and left more 'open', as it was found that expansion of firms were curtailed as a result of a number of factors, apart from the inaccessibility of credit.

7. Question 7 remained the same.

8. Question 8 was reconstructed, as it was found that the Pilot Survey question made the assumption that they had access to overdraft facilities, while in fact small firms found it difficult to obtain facilities, such as overdrafts. Therefore it was more relevant to investigate the ease or difficulty of obtaining such facilities by small firms.

9. Question 9 remained basically the same, but the direction of the answer was made more precise by naming the different type of loans, i.e. credit, that would be affected by credit control, and spelling out the reasons for the difficulty of borrowing at such times.

10. Question 10, 11 and 12 remained the same.

11. Question 13 was simplified, and the scope of the answer widened, as in its original form the question tended to restrict the answer.

12. Question 14 and 15 were changed from 'check response' type to 'open-ended' type questions, as they were intended to assess views and opinions and the original question did not give an opportunity to the respondents to support their views.

13. Question 16 and 17 remained the same.
14. Question 18, 19, and 20 of the pilot survey questionnaire intended to investigate the same problem. In the original form it was difficult for the respondents to understand the question. Therefore the three questions were amalgamated into one, i.e. question 18 in the final questionnaire, making it more concise and lucid and at the same time making it easier to tabulate the answers.

15. As a result of the amalgamation of the questions mentioned above, questions 21, 22, 23, 24, and 25 of the pilot survey were given the numbers, 19, 20, 21, 22 and 23 respectively in the final questionnaire. No change was made in these questions.

5.7 Stage Six - Establishment of Contact with the Sample Population

5.7.1 Stage six was the establishment of initial contact with the firms and institutions chosen for the survey. All firms were written to, explaining the purpose of the study and requesting an interview with either the managing director or any other at the executive level who were knowledgeable on the subject. In order to establish rapport with the firms, covering letters supporting the survey, from the Director of Economic Research of the Central Bank of Ceylon and the Chairman of the Industrial Development Board, were enclosed with the original letter to the firms. The initial response was very favourable, with eighty two of the firms written to indicating their willingness to be interviewed. The sample was brought up to hundred firms by writing to 'reserve' firms in each category. Each interview lasted on average between two to three hours. Ninety one of the firms were directly interviewed, in the case of the remaining nine firms the postal questionnaire method was used. In the case of each firm, an attempt was made to interview

1. See Appendix B for copies of letters.
2. This was due to the inability to reach these nine firms as a result of the prevailing political unrest in the country, at the time of the survey.
those individuals who were responsible for the financial administration of the firm. (see table 36). All nine firms answering the postal questionnaire were contacted by telephone to minimise any misunderstanding of the questions.

### TABLE 36

**PERSONS INTERVIEWED ACCORDING TO THEIR DESIGNATIONS IN THE FIRM.**

<table>
<thead>
<tr>
<th>Designation of person</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managing Director</td>
<td>39</td>
</tr>
<tr>
<td>Managing Director/Accountant/Secretary</td>
<td>12</td>
</tr>
<tr>
<td>Accountant/Secretary</td>
<td>18</td>
</tr>
<tr>
<td>Proprietor</td>
<td>14</td>
</tr>
<tr>
<td>Working Director</td>
<td>7</td>
</tr>
<tr>
<td>Managing Director/Accountant</td>
<td>4</td>
</tr>
<tr>
<td>Managing Partner</td>
<td>4</td>
</tr>
<tr>
<td>Working Directors</td>
<td>3</td>
</tr>
</tbody>
</table>

**Total direct interviews** 91

**Add 9 postal questionnaires** 9

**Total...** 100

5.7.2 Before concluding this chapter, it is important to observe that during the course of the firm survey, an attempt was made to obtain financial accounts of the firms surveyed. This attempt was made with the objective of assessing the relationship between the financial standing of the firm and the degree of difficulty of obtaining outside finance. However, most firms were reluctant and unwilling to make available their accounts. A second attempt was made in the form of a 'data sheet' distributed to the firms, which also guaranteed the confidentiality required by the firms and the anonymity.
of the respondent, this too provided a weak response. As the firms that acceded to this request were a mere thirty seven per cent, no attempt was made in this study to analyse the direct relationship between their present financial standing and the degree of difficulty experienced by them.
CHAPTER 6

THE ACTIVITIES OF FINANCIAL INTERMEDIARIES
AND THOSE PROVIDING SERVICES ANCILLARY TO FINANCE

6.1.  INTRODUCTION
6.2.  THE SURVEY - PROFILE
6.3.  FINANCIAL INSTITUTION SURVEY, QUESTIONS AND ANSWERS
6.4.  SPECIFIC INSTITUTION - THE COMMERCIAL BANKS
6.5.  SPECIFIC INSTITUTION - THE BANK OF CEYLON
6.6.  SPECIFIC INSTITUTION - FINANCE AND HIRE PURCHASE HOUSES
6.7.  SPECIFIC INSTITUTION - THE INDUSTRIAL DEVELOPMENT BOARD
6.8.  SPECIFIC INSTITUTION - THE DEPARTMENT OF INDUSTRIES - SMALL INDUSTRIES LOANS SCHEME
6.9.  SPECIFIC INSTITUTION - THE DEPARTMENT OF SMALL INDUSTRIES
6.10. SPECIFIC INSTITUTION - THE SHARE MARKET
6.11. SPECIFIC INSTITUTION - DEPARTMENT OF INLAND REVENUE - TAXES, INCENTIVES AND OTHER FISCAL MEASURES
6.12. SPECIFIC INSTITUTION - THE CENTRAL BANK OF CEYLON
6.13. SPECIFIC INSTITUTION - THE AGRICULTURAL AND INDUSTRIAL CREDIT CORPORATION
6.14. SPECIFIC INSTITUTION - THE DEVELOPMENT FINANCE CORPORATION
6.15. GENERAL CONCLUSION.
6.1 INTRODUCTION

6.1.1 The data for this chapter was obtained from three sources, namely, (a) the financial institution survey, (b) the general survey, and (c) available literature, both published and unpublished. This wide coverage, and the resort to use of available literature was to supplement gaps in knowledge about this sector. In section 6.2 of this chapter, the answers derived from the financial institution survey are given. An attempt has been made to report the answers as directly as possible without bias and not 'coloured' by the authors' views or that of any other. Analysis and comments on the data obtained by the survey are kept to a minimum in this chapter as detailed analysis and conclusions are made in Chapter Eight. In section 6.3 and those that follow a detailed picture of the overall (existing) credit structure in the country is brought out by an analysis of all credit institutions, credit facilities available, other financial intermediaries, and those providing services ancillary to finance.

6.2 THE FINANCIAL INSTITUTION SURVEY - PROFILE

6.2.1 The survey as mentioned in Chapter Five set out to interview all the available financial institutions and other financial intermediaries. The survey population comprised of, (a) 12 Commercial banks, (b) 3 long-term credit institutions, (c) 6 private finance houses, and (d) one money lender.

6.2.2 The break-down of the twelve commercial banks are as follows:

Indigenous Commercial Banks (four)
1. The Bank of Ceylon
2. The People's Bank
3. The Hatton National Bank
4. The Commercial Bank of Ceylon
Foreign Commercial Banks (eight)
1. The National and Grindlays Bank
2. The Hongkong and Shanghai Bank
3. The Chartered Bank
4. The Mercantile Bank
5. The State Bank of India
6. The Indian Overseas Bank
7. The Indian Bank
8. The Habib Bank

6.2.3 In the case of the commercial banks, the activities of the Bank of Ceylon was the most important, and had the greatest relevance to this study. Therefore, apart from the general interview conducted, a specific attempt was made to investigate its activities in relation to this study. This bank founded in 1938 as a private bank, is the oldest indigenous bank in the country. It was subsequently taken over by the State and run as an Government bank since 1961. At the time of the take-over (nationalization) it was adaged that the bank under Government ownership was destined to play a prominent role in development finance.

6.2.4 The People's Bank was founded in 1961 under Government ownership. It comes second in the order of importance to this study. Although it was floated under Government ownership principally to aid agriculture, it played quite an active role in financing industry during its early years. Further, during its early years its lending portfolio to industry was more attuned to the needs of the small and medium sized industry than any other commercial bank.

6.2.5 The Hatton National Bank and The Commercial Bank of Ceylon are of recent origin and their activities at the present time is of little

1. The results of this investigation is given in section 6.5 of this Chapter.
importance to the problem under investigation in this study.

6.2.6 The rest of the commercial banks, all of which are branches of foreign banks, can be broadly divided into British, Indian and Pakistani banks. These banks have undergone a considerable degree of amalgamation since their inception, with other foreign banks that previously had branches in the country. As stated in Chapter Four, their principal function has been to facilitate trade and commerce of the country, therefore their activities and lending portfolios are basically of a short term nature. The possibility of these banks widening their scope of activity was further hampered by the curtailment by the Government in 1961, the level of deposit acceptance by these banks. As a result their field of activity was severely restricted until 1968, when these restrictions were removed. Their activities, as far as this study is concerned, touch only on the short term facilities they provide. With the exception of one bank which has two branch offices in two other towns, the rest have only an office each in Colombo. This underlines the limitations of the activities of these banks. Therefore, all except one, fall into the category of 'one office' banks, or in other words a branch of a foreign bank whose head office is in another country. They could be classified, nation-wise and according to their volume of banking activities as follows,

A. British Banks
   (i) The National and Grindlays Bank
   (ii) The Hongkong and Shanghai Bank
   (iii) The Chartered Bank
   (iv) The Mercantile Bank

1. These two banks were barely a year old at the time of this investigation.

2. For example, acceptance of deposits, granting short-term advances under six months, and bill financing.

3. Since the beginning of 1959, the Mercantile Bank is a wholly owned subsidiary of the Hongkong and Shanghai Bank, although they continue to operate as two separate institutions.
B. Indian Banks
   (i) The State Bank of India
   (ii) The Indian Overseas Bank
   (iii) The Indian Bank

C. Pakistani Banks
   (i) The Habib Bank

6.2.7 From the foregoing profile of commercial banks, it would appear that the activities of the Bank of Ceylon and the People's bank (at the present time), have any significance to the problem under review. However, all banks were interviewed to get a clear picture of the credit structure of the country, and the relationship of their activities to the industrial sector.

6.2.8 In the case of the long term credit institutions, three institutions were chosen for the survey, i.e.
   (i) The Development Finance Corporation of Ceylon (DFCC)
   (ii) The Agricultural and Industrial Credit Corporation (AICC)
   (iii) The State Mortgage Bank (SMB)

It was clear during the survey that the DFCC's activities in the field of lending, largely fell outside the firms under investigation in this study due to their minimum loan limitation. However, it was decided to examine in detail its activities as this institution is the only long term credit institution in the country specializing in long term industrial lending. Besides, it was set up with the specific function of accommodating the fund needs of industry, and the provision of other industrial services.

6.2.9 The AICC is the oldest long term lender which specializes in agricultural and industrial lending. However, since its inception it has concentrated its lending principally to the agricultural sector, although

1. Table 40 shows the total lending of all banks to the private sector and the increasing share of the indigenous banks in every field except that of export bills.
as its name suggests, it was to function as a long term lender to industry as well. Despite its meagre activities in the field of industrial lending its activities too were fully investigated.

6.2.10 In the case of the SME, it was found that their lending is limited to agriculture and housing, and the industrial sector fell outside its portfolio of lending. Therefore it was decided not to include this institution in the survey as its activities fell outside the purview of this study.

6.2.11 Apart from the banks and the two long term credit institutions mentioned above, there were no other institutions either private or Government owned, that did any significant amount of lending to industry at the present time. The private finance and hire-purchase companies, though increasing in number, direct their activities to hire-purchase finance of vehicles, land sales and auctions, and to some extent financing of consumer durables. Therefore a decision was taken to interview only six such companies, which in comparison to other companies performing similar activities could be termed large and well established. The interviews by these six companies were granted on the understanding that no particular reference by name would be made to these companies. Most questions in the questionnaire were not relevant to these companies, those that were and the results obtained have been taken into account in the analysis in Chapter Eight.

6.2.12 Finally, only one money lender of any significance was willing to be interviewed, although unsuccessful attempts were made to contact three others. In his case too the questionnaire was not directly applicable.

6.3 Survey Questions and Answers

6.3.1 Question One: What are the terms and conditions of your

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1. The interest rates, maximum and minimum loan amounts, etc. which are mentioned in this Chapter refer to those prevailing at the time of the survey, i.e. between April to September, 1971.
loans of different duration?

Type of loan - Duration - Amount - Interest - Security - Other Conditions.
(durations: under 6 months, 6 to 12 months, 1 to 5 years, and over 5 years)

This question referred to all types of loans that the institutions dealt with at the present time. In the case of the banks, most of them did not lend on a long term basis, i.e. over one year, only the Bank of Ceylon (BC) and the People's Bank (PB) had any significant total in their lending portfolios as far as term-loans of one to five were concerned. However these loans were principally directed to agriculture and plantation industry such as tea and rubber factory development. The DFCC and the AICC on the other hand concentrated their lending to loans between five to fifteen years.

6.3.2 In the case of the DFCC, the minimum and maximum amounts to a single project were Rs. 100,000 and Rs. 5.2 million respectively. The maximum share investment in a single project does not exceed Rs. 2.6 million. The interest rates charged do not vary with the size of the loan, and at the present prevailing rate it is 10.5 per cent per annum for rupee loans and 10.5 per cent per annum for foreign exchange loans, payable on the disbursed amounts. In the case of the latter, a commitment charge of 1.25 per cent is levied on the undisbursed amount of the loan from the date of approval until disbursement, whereupon the prevailing interest rates come into effect. Other charges include the project appraisal fees amounting to 1 per cent of the foreign exchange loan applied for, and 0.5 per cent on a rupee loan applied for. Legal and other expenses incurred in verification of title deeds, preparation and registration of mortgages, and preparation of other documents are also to be borne by the applicant.

6.3.3 Primary security has to be provided for every loan. Usually this consists of immovable property owned by the borrower (firm
which has to be mortgaged to the DFCC. Immovable property comprises of land factory buildings, and machinery which is fastened either to the factory or the land. In the case of immovable property, DFCC's total assistance will not exceed 75 per cent of the land and buildings and 60 percent of the installed cost of machinery. In addition to primary security in the form of mortgage of property, collateral security is also taken. This takes the form of guarantees of directors of the company, and floating charges on other assets of the firm such as stock and other movable property. Other conditions of a loan include covenants such as, (a) all assets of the company to be insured against theft, fire and other risks, (b) an undertaking to be given that any other encumbrances the firm makes should be with the knowledge of the DFCC, (c) the right for the DFCC to appoint one of their executives to the board of management of the firm, and (d) the right to examine the unit at agreed times.

6.3.4 In the case of the AICC, there is no fixed minimum loan sum that would be considered at one time but generally it revolves around Rs.5,000 while the maximum that is considered per borrower in the aggregate for development purposes is Rs.500,000. In the case of non-development loans, such as repayment of debt, the maximum limit is fixed at Rs.100,000. The AICC Ordinance states that all loans must be repaid out of income, therefore at present its aggregate loan sum do not exceed six times the net disposable income of the applicant. The present multiple of six is based on the assumption that the period of repayment is 15 years and the rate of interest is 10 per cent per annum. This multiple of six is reduced if either the repayment period is less than 15 years or the rate of interest is more than 10 per cent. For the purpose of this calculation the AICC defines the net disposable income of the borrower as follows,
(i) in the case of individuals, it is the difference between his verifiable income from all sources less the sum of total tax liabilities and the amount required for the repayment of other loans to third parties.

(ii) in the case of limited liability companies, the net disposable income is the companies income after payment of tax and any other loans.

In the case of the AICC too, interest rates do not vary with the size of the loan sum, but the rate would vary depending on the quality of the security offered.

6.3.5 Loans are granted only on the first mortgage of immovable property to which there is satisfactory title. In the case of development loans, the maximum loan sum considered is equivalent to roughly 75 per cent of the value of the property mortgaged, and for non-development purposes the maximum is 60 per cent of the mortgaged property. Immovable property is defined as land, and the factory premises, buildings, if any, that stand on it, and fixtures and fittings which are permanently attached either to the land or the buildings. Other conditions of loans such as administrative charges, are similar to those of the DFCC. The borrower has to bear all expenses such as appraisal fees, title deed verification, insurance on the property to be mortgaged, registration and stamp fees. The AICC unlike the DFCC do not involve itself with share participation, nor do they have their representatives in the management of the venture.

6.3.6 In the case of the banks, as mentioned earlier, their activities in the field of long term lending is limited as they are basically institutions set up to provide short term capital needs. Only the Bank of Ceylon and the People's Bank mentioned that they have increased in recent years their medium-term lending portfolios, i.e. 1 to 5 year duration. Even in the case of these medium term loans, they concentrate on lending
for specified purposes, i.e., development loans, and the purposes for which funds are made available at present is for the development of agriculture, tea and rubber production. Manufacturing industry other than tea and rubber do not fall within this specification, and therefore the manufacturing units under investigation in this study fall outside the development lending portfolio. Those few loans that have been given to the industrial sector apart from these mentioned above, are large block loans all ranging over Rs 100,000 which are largely above the needs of small firms. The banks do not have any specified minimum and maximum limits, but in the case of term loans, they do concentrate on sums between Rs. 100,000 and Rs. 3 million.

6.3.7 All bank loans over one year are secured by immovable property, and are also covered by directors and third party guarantees, and floating charges over other assets such as stock in trade etc. The interest rates charged vary according to the type of security provided, and normally on immovable property they range between 8 to 11 per cent. All other charges, such as survey fees, stamp and documentation charges, mortgage charges, etc., have to be met by the borrower. Other conditions include covenants such as, (a) that advances should be utilized for the purpose for which it is borrowed, (b) the company to insure the assets over which the loan is secured, (c) not to dispose of any assets without their consent, (d) that attempts made to borrow from any other source to be made known to them. The property that is normally accepted as security by banks and the two long term credit institutions should have a clear title deed between 60 to 100 years, except in the case of a valid Crown grant. ¹

6.3.8 In the case of short term loans, the AICC and the DFCC primarily being long term lending institutions, do not lend for short term purposes. On the other hand most commercial banks concentrate on short-

¹. See Chapter 8, section 8.7
self liquidating advances and overdrafts. Though exact figures are not available by a process of deduction it has been possible to establish that out of the total accommodation provided to the industrial sector during the last three years the average distribution according to duration is as follows,

<table>
<thead>
<tr>
<th>Duration</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 6 months</td>
<td>33%</td>
</tr>
<tr>
<td>6 - 12 months</td>
<td>25%</td>
</tr>
<tr>
<td>12 - 30 months</td>
<td>22%</td>
</tr>
<tr>
<td>30 - 60 months</td>
<td>14%</td>
</tr>
<tr>
<td>Over 60 months</td>
<td>6%</td>
</tr>
</tbody>
</table>

The amounts lent for short term purposes varies widely, the rate of interest too differs depending on the type of security offered and the creditworthiness of the borrower. The concentration of rates varies between 8 to 11 percent with peaks at 8 and 9 per cent, and today the biggest concentration is at 2.5 per cent above bank rate.1

6.3.9 The security on which loans are secured, for short term purposes, consists of a combination of the following, i.e., stock in trade, joint stock company shares, plant and machinery, insurance policies, trust receipts, Government securities, promissory notes, bonds, usuance notes, and other personal property such as private houses, jewellery, motor vehicles, etc. In almost every case, additional collateral security such as directors and third party guarantors, are also taken over the loan sum given.

6.3.10 Other conditions of loan consists of covenants such as,
(a) undertaking by the borrower that he would not contract or seek any other loan or advance from another source without first informing the bank.
(b) a liability by the borrower to pay all other expenses involved in the transaction, such as legal and other expenses, stamp and document fees, insurance charges, etc. Usually there is no established limit to the size of a loan, the loan given varies between 60 to 75 percent of the value of

1. The bank rate is 6.5 per cent.
security offered for the loan.

6.3.11 In examining the profile of the lending institutions and the terms and conditions of the loans a few salient factors emerge. They are,

(i) The non-availability of long term financial institutions catering to the small and medium scale sector needs.
(ii) The prospects of large firms having access to avenues denied or beyond the capacity of small firms.
(iii) The direct relationship of security and the rate of interest.
(iv) The historical factors that have conditioned the present lending, i.e., demand for clear titles dating back to 100 years.

6.3.12 **Question Two:** What are the basic factors which you consider as important, before granting a loan or advance?

**Type of Loan - Duration - Factors taken into account.**

The basic factors which the DFCC consider as important, before considering a loan or advance are that the project should be,

(a) technically feasible
(b) commercially viable without reliance upon excessive profit margins
(c) economically desirable
(d) catering to a market or demand, the existence of which has been satisfactorily established
(e) reasonable as to capital and cost, and
(f) that security should be available by way of a bank guarantee and/or mortgages.

6.3.13 In the case of the AICC, under their Ordinance it could grant loans only for specific purposes, hence before a loan application is entertained the Corporation has to satisfy itself that the purpose of the

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1. These factors are taken into account in the analysis in Chapter Eight.
loan and the loan applicant is eligible to receive financial assistance under the ordinance. Once this is established, the eligibility of the applicant is considered on,

(a) the nature and purpose of the loan

(b) the nature and value of security

(c) character, ability, and financial standing, i.e. loan repayment ability of the applicant.

(d) age and health of the applicant

6.3.14 In the case of the banks, the conditions looked for, do not vary with the duration of the loan but are generally applied to each loan. They are, 1

(a) that the borrower has maintained an active account with the bank for a considerable period of time, normally a minimum limit of six months.

(b) that the borrower is known to the bank.

(c) that the previous dealings of the borrower with the bank has been satisfactory

(d) capacity to repay the loan within the prescribed time and without undue hardship.

(e) adequate security for the loan

(f) viability of the project in the case of development loans, and

(g) purpose of the loan.

6.3.15 In the factors that banks look for in considering a loan, four basic features emerge which are common to commercial banks everywhere, namely, (i) safety, (ii) liquidity, (iii) dispersal, and (iv) remuneration. Among these, safety is the most important guiding principle as the banks are basically 'safe-keepers' of others money, i.e. depositors, to whom repayment

1. In the course of this study it has been possible to establish that there is a discrepancy between the lending requirements and the actual process of a loan. See Chapter 7 and 8.
has to be made on demand. Although they lend with the expectation that the borrower will repay the advance within the time stipulated, it is considered necessary for the sake of safety, that good security be provided to cover the risk of default. In developing countries where the state of the economy continuously fluctuate and many unknown factors affect the economic mix, there seems to be a greater degree between the loan and the type and amount of security provided.

6.3.16 The safety and the resulting demands on good security, conditions also the liquidity of the advance, i.e. the duration of the advance, income generation, and the capacity to repay within the prescribed period. The desirability of loan dispersal to spread risks and thereby reduce risks, is also conditioned by the safety factor. This also contributes to the desire of the lender to grant loans to those sectors where the expected risk is smallest, and in Ceylon this sector is the commercial sector. In the field of lending to the industrial sector, it is an obvious fact that the firms with the least risk are the large well established and mature firms, who apart from being less risky have also well established connections with banks, therefore the lenders seem to concentrate their lending first to this sector.

6.3.17 Finally taking into consideration the profitability factor, as interest rates on loans is their main source of income, there is apparent polarization of their lending to those sectors where the interest rates are the highest and the cost and risk factor are the least. This again directs intelligent lending to those sectors where these factors are easily identifiable. As consumption and commercial loans carry the highest rates, there is polarization of lending to these sectors, while the desire to cut down costs and risk make them look for the established firm and the larger loans.
6.3.18 As all firms, large and small have to compete for the limited amount of credit available in the market, the conditions of lending both for long term and short term accommodation, (desired by the lenders), although not directly precluding small firms are definitely more favourable to the large established firm. This is a common feature in every country, whereby the large firms score over small firms in loan accommodation. In Ceylon these factors are accentuated as a result of peculiar historical development of the economy, structure of small firms, legal limitations on lending, and the prevalence of a communication and attitude gap.  

6.3.19 Question Three: What is the extent of your supervision and control after the loan (advance) has been granted, for different types of loans?

Type of loan - Duration - Supervision and Control

This question was asked to ascertain two principal factors, i.e. (i) whether the controls and supervision of a loan clashes with the independence of a borrower, and (ii) whether the lenders face any special difficulties in the supervision of loans given especially to the small firms.

6.3.20 In the case of the AICC, the borrowing units are inspected before and after the grant of a loan. Normally AICC loans are granted outright except in the case of a development loan. Development loans are disbursed according to the different levels reached in the development programme. Usually every instalment is released only after an inspection by its officers. In case of default or mismanagement of the loan, under the rules of foreclosure, the Corporation has the power to take over the management of any project financed by it to safeguard its interests. However, it cannot expeditiously resort to this method without the consent of the borrower. If the borrower refuses to accede to such a request the AICC has to resort to

1. See Chapter Eight for analysis
legal action to recover the loan. Finally, if the Corporation comes to the conclusion that the borrower is misutilizing the loan funds, it has the power to recall the loan.

6.3.21 The DFCC seems to maintain much closer supervision and control of all projects assisted by them, especially during the construction period of the factory and the initial years of operation. When normal levels of production is reached, supervision is confined to half-yearly or annual checks depending on the efficiency of the operations.

6.3.22 In the case of the banks, the following were mentioned as the steps taken in supervising the loans given, (a) loans for development purposes were usually granted in instalments after verifying the end use of each instalment, and after ascertaining that further funds are necessary. (b) movable security is inspected every six months, while immovable security is inspected at least once a year.

6.3.23 The long term credit institutions and the banks expressed the view, that supervision of loans once granted was a very difficult prospect, as the response and willingness of the borrower to inspection is poor and not appreciated by them. There seems to be at present a communication gap between the lenders and the borrowers. In the case of the AICC and the banks, the level and degree of supervision was made even more difficult by the absence of adequately trained staff. The view according to the lenders is that supervision of loans to medium and small firms were made more difficult as a result of the attitude of the latter to supervision, i.e. as an unwarranted interference with their independence, and the feeling among the borrowers that they have provided adequate security to cover the loan obtained.

6.3.24 The banks were faced with considerable difficulties.
the unwillingness of some borrowers to accede to some of the banks demands regarding supervision and control, once a loan was obtained, and in some cases even when they had access to supervision, they were not sure of the accuracy of the figures provided by the borrowers due to various dodges perpetrated by some borrowers. The banks were not clear how they were able to establish the purposes for which the money borrowed were used. This was an apparent weakness in many loans, due to the deficiency in accounting standards and the unwillingness of some borrowers to submit proper records. Therefore even if the banks desired to keep constant check on their activities in the field of finance, it was difficult for them to do so. This was made more difficult as a result of the shortage of staff trained in the intricacies of industrial financing. It is true that the balance sheets of the company were inspected from time to time, but, considering the weakness of balance sheets as a mode of understanding the financial activities of a firm, it would not provide much help as a control weapon. It is not surprising therefore, that security for a loan has become the prime concern of the lenders more than the purpose of the loan, or the activities of the firm.

6.3.25 Question Four: What is your lending policy (a) towards small business and (b) does it vary, according to the type of business and the legal status of the firm, such as proprietorships, partnerships, joint stock companies, etc.?

The AICC since July 1970 has directed its loan policy to meet the credit requirements particularly of the small and medium sized borrower, but as the Corporation at present has insufficient funds, no priority is given to the financing of small industries. The only exception is that the Corporation may consider a loan to meet the working capital needs of a small firm. Being a Government institution, the AICC does not finance
any project which the Government thinks should not be encouraged. Thus, despite the intention of the AICC to provide finance to the small firms, it is in effect a policy only on 'paper' due to its capital limitations.

6.3.26 The DFCC does not make any distinction between small, medium and large firms. However their minimum loan limit being Rs.100,000 to a single project, this factor excluded almost 95 per cent of the firms falling into the category 'small' in this study. Further its act of incorporation limits its lending only to limited liability companies (both private and public).

6.3.27 The banks too do not make any distinction between size of business in their lending policy, but from the discussion during the interview, there seems to be a marked preference for large well established business, especially those which are limited liability companies. The conditions of lending discussed under Question Two, points to the above conclusion. As the country is small and the business units few, it was not difficult for any lender to identify the size and place of the business in the economy, therefore old established joint stock companies, both private and public, were decidedly at an advantage as compared to partnerships and proprietorships.

6.3.28 It was the general opinion of all institutions that their lending is based on the rules and regulations laid down by them to who so ever that qualifies and comes within these regulations. Therefore they felt that it was not their fault, that the majority that invariably qualified for loans and advances were well established and large business. They insisted that credit was available to all, therefore according to them all had an equal chance of credit access and basically the fittest survived. This attitude may perhaps be condoned in a free enterprise economy and in
in a developed country, but, when the economy is controlled and underdeveloped, the market mechanism does not function so efficiently in terms of welfare economics. The result is that the weak and the small are bound to suffer in comparison to those who have a considerable lead, are well established, and big. Therefore, despite the purely 'technical' benefit of credit avenues being open to all, it is obvious that if the conditions for qualification are set high and equal to all, the larger firms would definitely have an advantage in qualifying for them, as against the small firms.

6.3.29 Question Five: Do you carry out a feasibility study for new ventures and development programmes you/asked to finance? Yes/No
If Yes, what are the feasibility features for,
(a) new ventures
(b) expansion and development programmes.

The AICC where necessary carries out feasibility studies in respect of projects financed by the Corporation. However, as the amount of the loan in most cases being modest (small), such studies have been restricted only to a few projects. The DFCC on the other hand carries out a feasibility study for every project financed by them. No differentiation is made between new ventures and expansion and development programmes.

In the case of the banks, they applied feasibility criteria only in the case of very large loans, which in terms of this study fell outside the requirements of the firms. In the case of small loans, they normally do not undertake such studies but prefer to satisfy themselves from their knowledge and experience, and by personal investigation of the borrowers' creditworthiness more than the project or venture to be financed. The information necessary for this type of assessment is got from, (i) personal contact and interrogation of the borrower, (ii) observation of the borrowers
mode of living, (iii) information from other creditors and customers, (iv) transactions passing through the borrowers account at the bank, and (v) analysis of balance sheets of the business.

6.3.31 In the case of large loans, the long term credit institutions and the banks look for feasibility features that are common to lenders all over the world, which are established features of loan dispersal by any lending institution specialising in development financing. Some of these were already mentioned in answer to question two, and others which are general to all credit institutions are given below. They can be broadly divided into four groups,

(a) Accounting Data: (i) such as turnover, costs, profits, assets and liabilities of the company, (ii) return on the investment proposed, (iii) profitability and the ability to repay the loan with interest during the stipulated period from the expected profits, (iv) ratio of borrowers and the lenders investment in the project.

(b) Technical data: (i) information about factory buildings and machinery, both actual and projected, (ii) technical expertise available.

(c) Economic data: (i) availability of a ready internal and/or external market, i.e. in terms of both where the firm sells its product and where it buys its raw-materials, labour and knowhow, (ii) the continuity of this market especially where raw materials are concerned, (iii) prospects of savings on future foreign exchange from the products.

(d) Human Data: (i) evidence about the competence and integrity of the people who will be running the business, (ii) experience of the borrower in the line of business which he proposes to embark upon.

6.3.32 All institutions rely on the judgement of their staff to assess these features. With the exception of the DFCC, the other institutions
do not have specially trained staff to undertake these extensive, complicated, and intricate studies. Besides, from what has been said in the earlier chapters, regarding the limitations of statistical information about industry, the underdeveloped nature of the economy, the dependence of the economy on foreign exchange earned by the three major exports, newness of industrialisation, and other factors such as frequent changes in direction and emphasis in industrial policy, it becomes clear, how difficult it is for the lender to assess with any reasonable accuracy most of the items listed above. In their opinion, all lenders declared that it was a difficult task to make up one's mind about customers, especially when they on their best behaviour. The difficulty of easily identifying and assessing these feasibility criteria has resulted in the interpretation of these in the light of common sense and value judgements of individuals in the lending institutions rather than on specialized knowledge. Thus the results in many instances can fall short of a reliable forecast of the applicants creditworthiness.

6.3.33 Therefore it is reasonable to assume that the established large firms are better situated to qualify for loans, as compared to the small and medium sized firms, in case of both development and expansion needs. The same argument would be relevant in the case of new business where a larger project has a better chance of finding finance than a comparatively small venture. The reasons for this bias could be summarized as follows, (a) the risks being less even in the case of misjudgement of a particular project of a large firm.
(b) data collection with respect to factors given above being easier in the case of established business.
(c) the ability of the large, and established business to meet the lenders demands more successfully.
(d) better business contacts established business have with lenders, and more favourable reports established business get from suppliers and potential buyers.

(e) the profit motive of the lender, who desires to back the 'right horse'.

(f) the ability of established large businesses to show a better front, in terms of, financial efficiency, more informed management, stronger market position, and overall efficiency.

6.3.34 **Question Six:** Could you tabulate the major grounds for rejection of a loan application?

The general answer from all the lenders was that a request for a loan could be rejected for any of the above reasons given in answer to question five, or a combination of them such as, inadequate capitalisation, unsatisfactory financial position of the firm, viability in terms of either commercial, technical, market, management, and economic aspects of the venture, shortcomings in the character of the borrower, insufficient or unsuitable security, inadequate income or earnings cover, and inability of the applicant to demonstrate that repayment within a normal banking term could be achieved painlessly. In the case of all Government owned institutions, besides these factors described above, an application could be rejected if the application falls outside the scope of operations as laid down by the act of incorporation or if it does not fall within the Government's industrial policy.

6.3.35 These factors show once again a weighted disadvantage against the small firm and borrower. It is the small, young and rapidly growing firms which tend to be more dependent on borrowing from outside sources, and these are the very firms that come up against most barriers described above.

6.3.36 **Question Seven:** Has credit restraint policies of the
Central Bank in any way affected your lending portfolio and policy towards small business? Yes/No

If Yes, (a) were they different to those applied to large business, Yes/No if yes, please give your reasons

(b) during these periods what action did you take to restrict credit?

The AICC was not directly affected by the credit restriction policies of the Central Bank as the Corporation has no obligation to the Central Bank with regard to its resources. However, as the Corporation's funds are restricted, there is no possibility for it to expand or restrict credit at any time.

6.3.37 The DFCC felt that credit restriction policies affected them, especially those loans granted to private, and closely held companies which were refinanced by the Central Bank. Since smaller businesses are normally carried out by private or closely held limited liability companies the conclusion reached by them is that credit restraint policies have affected their lending portfolio towards small business. It was stated earlier that under their minimum credit limitation, only about 5 per cent of the firms in the survey could qualify for credit. Therefore it could be assumed that firms falling within this size limit in the industrial sector is also deprived of any credit from the DFCC during these times. This assumption is further strengthened by the following statement made by the DFCC, i.e. that, 'as the total quantum of refinance by the Central Bank is limited, even those large companies eligible for facilities could not get adequate credit during these times'. As a consequence of the scarcity of funds available to them from the Central Bank, the DFCC, whenever credit restraint applied, resorted to a queue system whereby loans were approved subject to availability of rupee funds.

1. The DFCC's terminology of 'small business' is roughly equal to the top 5 per cent of medium sized business, as defined according to the size measures in this study.
The banks were the most affected during these times as the Central Bank credit restraint policies were directly applied to them. During credit restraint, the Central Bank specified the sectors to which credit should be limited and also the type of credit that should be restricted. The amount of refinance facilities available to the banks were also curtailed, and the direction of the limited facilities available from the Central Bank refinance scheme were also laid down. Normally the Central Bank exempted loans which had a duration of under three years that were given for agricultural and industrial development from falling under the credit ceilings. It may perhaps be assumed that due to this exemption the industrial sector is not affected to such a degree as the other sectors, however there is only partial truth in this assumption, and from the findings in this study it becomes clear that despite this exemption the small firms felt the 'credit squeeze' affected them more than the medium and large scale industrial undertakings. The reasons for this view is contained in the actions the lenders take during these times to limit credit. During times of credit restraint the reactions of the banks were as follows,

(a) cut down consumption loans and advances for speculative stock building,
(b) cut down the number of long and medium term loans,
(c) preference was given to large public companies and state corporations (all of which fell into the size category large), while proprietorships, partnerships, closely held private limited liability companies were pushed to the back of the credit queue.
(d) minimum eligibility requirements were introduced for some type of loans, while for others, general eligibility requirements that prevailed before the onset of the restrictions were raised even further.
Although no specific restrictions were applied to small as against large business the above credit restrictions policies necessarily affected the small firms more. The reasons why the smaller firms were at a greater disadvantage are,

(a) the raising of the already strict standards of loan qualification
(b) the reluctance of the banks to upset their existing credit arrangements with important customers, and the likelihood of the banks to minister to their needs first.
(c) the development loans which are exempted from the ceiling, do not carry any specific instructions from the Central Bank that they have to be lent to any particular sector, as a result it is left to the discretion of the banks to choose its clients. Therefore in the scramble for accommodation the larger firms and the subsidiaries of larger firms get the better of the independent small and medium sized firms, as they are better placed to qualify under the conditions and standards laid down by the banks.

6.3.40 Question Eight: Do you prefer some type of business to others? Yes/No, if yes, what types do you prefer?

Question Nine: Do you prefer some types of investment to others? Yes/No, if yes, what type of investment?

All credit institutions answered 'no' to questions eight and nine. They were difficult questions for the lending institutions to answer, especially when attention is being drawn to the problems of small firms. Evidence gathered does not seem to indicate that firms are discriminated by type of business or by type of investment. However lending preferences seem to have a relationship with the legal status of the business. The preference priorities in lending seem to be based in the following order, (i) public limited liability companies, (ii) private limited liability
companies, (iii) partnerships and proprietorships. Further lending is also
directed to those industries where there is, either direct Government sponsor¬
ship or those that fall within the framework of the Government's industrial policy.

6.3.41 In the case of banks, there does not seem to be any
particular type of industrial activity which appealed to them more than
others. What could be deduced is that they are not very much attracted to,
(a) businesses which are of a speculative nature,
(b) to small technical innovators,
(c) venture capital for new small business,
(d) firms whose products are new in the market.

6.3.42 From what has been said so far in answer to the two
questions above, and from the general observations made by the interviewer,
there is reason to conclude that if a preference schedule is drawn up,
small firms, whatever the type of business or type of investment would
remain at the back of this schedule. The reasons for this conclusion is
seen in the type of financing done by the institutions at present. For
example, the AICC has not much choice in lending due to its restrictive
Ordinance and its limited funds, the DFCC loans range over Rs. 100,000
at a time, and they lend as a policy only to one firm in each group that
produces a certain type of good or goods, i.e. if they for instance accommodate
one firm producing electrical accessories and components, another firm produc¬
ing identical or similar products will not be accommodated by them. The
banks concentrate more on short term self-liquidating type of loans. The
hire-purchase and finance companies concentrate on hire-purchase financing
of motor vehicles and land sales. Thus at the present time, there is no
institution catering specially to the development needs of small and medium
sized firms such as capital to start the venture, longer term needs for
capital stock building, capital for innovation, research, and market estab-
lishment.

6.3.43 Question Ten: How do you view the problem of lending to
firms for purposes of research, innovation, or where the time required for
development of the product is long and unpredictable, thus causing a gap between
investment and return?

The AICC under its Ordinance does not lend for purposes of research
and innovation. The DFCC too does not make finance available purely for
development or research which may or may not result in a workable project.
In those instances where the DFCC lends for the setting up of an industrial
venture, it makes certain that the project is well formulated and meets its
standard of viability. In such cases they give assistance regardless of the
gestation period of the project. It also grants 'grace' periods for payback
of capital and interest to those projects which find the repayment of the
loan difficult in the initial years of operation. They also do sometimes
consider assistance to pilot projects, provided the Corporation is satisfied
that such a pilot project would result in a commercially and technically
feasible project.

6.3.44 The commercial banks, keeping in mind their normal activ-
ities, concentrate more on proved performance and experience with firms.
Following from this, no institution (bank) was willing to lend on a business
idea, however good and safe it may prove on paper, for purposes of experi-
mentation and research especially where success is unpredictable. A banker
therefore would not be easily persuaded to take on financing, if the prospe-
ccts were that the advance would mount steadily for several years and might
then level off on a plateau, so that commencement of reduction would lie
in the distant future. On average, the commencement of repayment period of bank loans begin with one month of granting the loan, and only in rare cases where the loan was categorized as a development loan under Government (Central Bank) direction, they were prepared to consider a short post-ponement of capital pay-back. Even in these cases, the average maximum was between six to twelve months.

6.3.45 Thus, this problem outlined in this question and touched upon in answer to question eight and nine, is where small firms face the greatest difficulty. In general, the provision of finance for new technical development and innovation presents some of the most formidable problems industries face today. At the beginning of industrialisation in Ceylon, this was not so acutely felt, as most new units (firms) that were started were for the purpose of substituting imported goods. The machinery, raw materials and know-how were directly imported for the production of these substitute products. This mode of operation was sufficient at the beginning of the country's industrial push, especially when the country had no experience of industry. But, if industry is to 'take-off' from this initial stage and attain the secondary stage of establishment and growth, the need arises for it to gear itself to adopt to the needs of the country, in terms of, not only of the products the sector produces, but in adopting to the available factor mix within the given constraints of the economy. This necessarily means that there has to be research and development to, (i) use and adopt available local raw materials for production of goods which were based at the beginning, almost entirely on foreign imports, (ii) finding new uses for other available raw materials, (iii) adopt new and different processes and methods of production which are more efficient, (iv) adopt new processes to cut down waste and make use of waste materials for other
by-products, (v) get more efficiency from available machine units, (vi) adopt available machines for different production processes, (vii) manufacture simple machine units, spare parts, accessories and tools, and (viii) provide technical service and training facilities.

6.3.46 It is the establishment of such a process that would make the process of industrialisation better balanced, and help it to become self-generative. From the answers received to question ten, it becomes apparent that the Government never provided adequate facilities to meet the financial needs that would be required for such a process to get under way. There is no institution at present in the country, which provide facilities similar to those provided by the National Research Development Council, and the Technical Development Capital Ltd, of Britain (principally in the field of finance), nor is there a move to set up a risk capital institution or delegate this function to an existing credit institution. It is true that there has been a feeble attempt made by the CISIR and the IDB to provide research and technical facilities, but no financial facilities have been provided by any institution.

6.3.47 It is not surprising therefore that there has been a considerable waste of resources, absence of innovation and development, continuance of the industrial sector to depend on imported raw materials and machine units, and the desire to limit production to those items for which existing knowhow, machinery and other factor inputs are available. Although, all these factors cannot be directly attributed do the absence of financial facilities alone, it could be said that this factor has been responsible to a considerable degree for the stagnation of the industrial sector, especially the small and medium sized sector.

6.3.46 Question Eleven: Do you lend on an unsecured basis? If so, under what circumstances?

This question was directed more against the banks, than the long term credit institutions. Among the banks, loans and advances without security was a very rare feature. There were a few examples of very short term advances granted on promissory notes and guarantees of directors and third parties. Apart from these among the hundred firms interviewed there was not a single instance of any firm being granted accommodation without security. From the evidence gathered from the banks, the few instances where accommodation was granted by the banks without security, were for firms which had a long business association with them and who were intimately known to the management.

6.3.49 Question Twelve: With what type of loans does your institution mainly deal? (for e.g. equity/share participation, investment/development, working capital/short-term advances, overdrafts/bridging finance)

At present the AICC concentrates on long term loans for development of agriculture and industry, and of these loans about 75 per cent is directed to agriculture. The loans are all long term development loans with durations of 5 to 15 years. The purpose for which these are granted are for, purchase of industrial property, building and machinery, and redemption of debt of industrial property. The DFCC concentrates principally on development loans to industry. These loans could be categorized into investment loans and equity financing to new ventures and development loans to established firms.

6.3.50 The banks principally concentrate on short term loans for working capital, overdrafts and bridging finance. However, in recent times their lending for periods over one year has shown an increasing trend, but on their own admission, these medium term loans are directed for specific
purposes laid down by Government policy, i.e., such as for tea factory development. Further, most of these medium term loans have been large block loans over Rs. 100,000, well above the average need of the small firms.

6.3.51 Here again there emerges a definite pattern of accommodation which is arranged against the small firm sector under investigation, not because there is open discrimination against the small firms that seek accommodation but as a result of the avenues available to them being meagre and sometimes non-existent. The AICC does only an insignificant amount of lending to the industrial sector as a whole, while the activities of the DFCC fall principally above the needs of small firms. This eliminates all long term sources of credit. It is only to the banks that the small firms could turn to for all their credit needs, but the banks cannot satisfy all their needs because, (i) their lending is mainly limited to short term needs of the economy of which industry is only one sector, and as far as the banks are concerned not the most important, (ii) all industries, small, medium and large seek loans from banks, from what has been said so far, the banks in keeping to their principles of safety and security prefer to accommodate the safest and most profitable of the loan aspirants, therefore one does not need much foresight to identify that these borrowers comprise principally of large and established business.

6.3.52 In the present credit situation in the country, it is time that the banks changed its very conservative role of being purely short term lenders. The age old conception of, 'that the business of banking rests upon a foundation of public trust, and anything likely to disturb the confidence in the bank should be avoided', must be pursued in the modern context. While agreeing that this is a golden rule of banking, from the activities of the banks in the country, one gets the opinion that too much
stress seem to have been laid on this principle of 'confidence'. The prefer-
rence to lend on short term self-liquidating advances is a direct result of
this principle. This idea of keeping high liquidity by concentrating on
short term lending seems a little far fetched in modern day finance. It is
more a relic of British banking history of the nineteenth century when there
were a number of bank failures. At present the Central Bank undertakes the
maintenance of safety margins by requesting the commercial banks to maintain
statutory and special deposits at the Central Bank. Therefore in the context
of modern organization of a country's financial activities it would be rare
for the Government not to come to the assistance of a bank if its gets into
difficulties. It would be more correct to say that in the light of Central
Bank control of activities of banks, it would be rare for such a situation to
arise, as the Central Bank would get ample warning of such a situation
before it becomes serious and would recommend to the bank to take remedial
action. Therefore, there is a case for commercial bank lending to breakaway
from its traditional lending patterns and participate more fully in the
modern pattern of demand and the needs of the economy.

6.3.53 Question Thirteen: What is the maximum amount of loan
or advance that you lend, considering,
(a) to the ratio of firms assets (assets cover)
(b) to the ratio of firms return in the case of investment loans (earnings cover)

The AICC does not consider loans on the assets cover of the borrower
firm. As mentioned in answer to question one the amount of loan considered
depends on the net disposable income of an applicant, i.e six times the net
disposal income of the applicant. The maximum amount of the loan is also
limited under its Ordinance, to Rs. 500,000 for development purposes and
Rs.100,000 for non-development purposes such as redemption of debts. The
AICC's attitude towards loan dispersal strengthens the belief that they concentrate more on established business and good security as the foremost conditions for their lending, i.e. the AICC in ascertaining disposable income of an applicant has to go on the past performance of an applicant, this automatically eliminates new business. Secondly, they lend only on the first mortgage of immovable property with clear title. Therefore, it would not be far wrong to assume that despite their declaration, 'that as a policy they make an attempt to lend to small and medium sized industry, and the reason for not having done so is a result of their capital limitation', their principles of lending exclude small business. This is based on the premise that the AICC insists on first class security, i.e. first mortgage of property with a clear title going back to hundred years, and their insistence of past records of disposable income, both of which leaves the small borrower at a disadvantage. The disadvantage faced by the small borrower is threefold, i.e., (i) most small firms are of recent origin, the owners of which on average do not own much land or other wealth, and (ii) at the commencement of many businesses those who owned any assets had already tied them up to raise the initial fund needs of the business, therefore in most cases the net disposable income less these obligations did not amount to much, and finally (iii) most small businesses do not own land which can be mortgaged for loans and those who do have property do not have clear title of the type demanded by the AICC.

6.3.54 The AICC expects a rate of return to the firm of about 20 per cent. This too underlines the difficulty small business would face in getting loan accommodation from the AICC, for, it is rare for a small business in the country to show returns as high as 20 per cent. Those who would qualify on these terms would in all probability be monopoly or oligopoly
6.5.55 The DFCC is also limited by statute to maximum lending limits as shown in answer to question one, i.e. a maximum on financial assistance of Rs. 5.2 million and within this maximum share investment cannot exceed Rs. 2.6 million. Within these limits, the DFCC have a maximum debt-equity ratio of 1:1. This norm is sometimes relaxed to about 1.5:1 in the case of very large projects with the potential for undoubted success, where the sponsor finds it difficult to raise that quantum of equity from friends, relatives and the public to match the total contribution of the DFCC and other lending organisations. The DFCC's contribution however does not normally exceed the sponsor's contribution in case of equity. Their normal quantum of equity in any single venture is kept around 25 per cent of the issued capital. Direct loans are further limited by the limits imposed on the aggregate lending levels on the security provided, i.e. 75 per cent against the value of mortgaged land and buildings and 60 per cent against the market value of the machinery.¹

6.3.56 The returns cover is usually taken on the growth prospects of the firm, market and other economic factors. Usually no figure is given to this rate of return, but according to their policy of aiding principally large business most of which are of monopoly status, the expected returns are normally over 15 per cent at the initial stages of production.

6.3.57 The banks were quite hesitant to answer this question and the responses were quite weak. They steadfastly refused to give any figures, the hesitancy was unwarranted as there is no disadvantage to a bank in disclosing these figures. Therefore one conclusion is that the banks do not lay much emphasis on these factors even when they lend to industry.

¹ this 60 percent is calculated on the installed cost of the machinery less accumulated depreciation. Valuation placed on machinery is as close as possible to its market value.
as their lending patterns to industry is not much different to commercial loans and further most loans are for short term purposes. From what can be deduced, the security provided for a loan seem to play the major role in convincing a bank about the creditworthiness of a firm and the viability of a venture. Available evidence shows that the maximum assets cover seem to range around 0.5: 1, while not much emphasis seem to be placed on the rate of return as long as the security cover is adequate.

6.3.58 Another twist to the absence of these calculations or the lack of emphasis, could be that, considering the stagnant level of the economy, frequent Government policy changes, foreign exchange crises, it is a barren exercise to calculate the rate of return on a project, especially when the factors that are taken into consideration undergoes constant change. Therefore there is adequate justification for the banks to disregard these sophisticated calculations and depend on their knowledge, and the security provided by a client to grant accommodation. In the case of the DFCC, the situation is slightly different as the firms they finance are usually monopoly or oligopoly firms, with a ready and assured market for their products, has Government approval and backing for the ventures, therefore the firms are not much affected by any change of policy. In the case of foreign exchange too, the restrictions of foreign exchange do not apply as strictly to the firms financed by the DFCC, as most of its loans consist of part rupee funds and part dollar funds (borrowed from the IBRD). Considering these factors the DFCC could with fair accuracy estimate rates of return on their investments.

6.3.59 **Question Fourteen:** How do you establish the level of credit risk of a firm for both short and long term borrowing? Do you consider the following in determining the level of credit risk?
(a) profitability measured by the average rate of return on net assets
(b) solvency measured by the average of debts-assets ratio

The DFCC seems to be the only institution that take adequate account of these calculations. They, compared to other institutions are in a position to do so, and are necessary due to the large sums they disburse. As described in question thirteen the rate of return calculation does not seem to play a significant role in lending due to the high level of uncertainty in the economy. In the case of debts assets ratio, the requests made to banks for accommodation in normal circumstances do not come up to more than 50 per cent of the assets of the companies, for most bank loans are for short term working capital purposes, unlike in the case of the DFCC where they principally concentrate in providing funds for new ventures and expansion programmes. Therefore, the banks satisfy themselves as to the credit risk of a firm by their knowledge of the applicant and those factors mentioned in answer to question two. Overall, it could be said that there are no hard and fast rules followed by the lending organisations in the country regards loan dispersal, and a considerable amount of individual institutional judgement seem to sway a loan decision one way or the other. However, as stated in answer to question thirteen no institution with perhaps the exemption of the DFCC was ready to lend more than 75 per cent of the assets value of the company. It could be concluded therefore that banks safeguard themselves against risk by lending only to those borrowers (firms) whose profitability is immediately apparent, and even in these cases, maintaining a wide margin between the loan sum and the value of the assets over which the loan is secured.

6.3.60 Question Fifteen: Have you at any time refused loans or advances when a firm to whom you have granted a loan approached you for a
This question was asked to investigate the basic reasons for refusal of accommodation to a previous customer. The reason for such a question is that there is a feeling among many customers (firms), that lending institutions, especially banks, do not tend to probe deep into reasons for default and delay in loan repayment. As will be shown later, in many instances the reasons for default and delay were as a result of extraneous factors such as change in Government policy, introduction of new tariffs and quota systems, and not due to any fault of the borrower.

6.3.61 The DFCC answered 'yes' to this question and gave the grounds for refusal as follows, (i) bad repayment of loans granted previously and (ii) when they were of the opinion that in many instances the restructuring of the existing capital structure was more appropriate than raising of additional loans. As mentioned earlier the DFCC's adequate 'grace' periods for loan repayment and as they dealt with investments that had almost 95 per cent chance of success, they were seldom faced with this problem. The DFCC was very particular about the ventures they finance and the appraisal of a prospective customer was strict and thorough, this tended to eliminate the problem of default to a great extent, besides, the availability of trained staff facilitated better checks on their investments and the provision of advise and bridging finance to help over difficult periods. Lastly, the loans they have disbursed during the whole period, i.e. 25 years, amounts to only 153 loans, this being the case their delinquency record is very small.

6.3.62 In the case of the AICC too, the cases of default were very few as a result of the small number of loans given to industry
from its inception to present day. They gave the following reasons for refusal, (i) bad repayment of loans granted previously, (ii) mis-utilization of previous loan funds, and (iii) when the earnings of the firm were sufficient to meet the proposed investment. Clauses (II) and (III) were adequate justification for loan refusal, but in the case of clause (I) above, they gave the impression that adequate consideration was not given to extraneous factors affecting repayment by borrowers.

6.3.63 The banks were faced with this problem of refusal second time around much more often than the long term credit institutions. This was a result of the large volume of lending done by banks and the absence of grace periods for loan repayment. The main reason for refusal was given as, unsatisfactory past dealings with the banks. When questioned further, whether adequate effort has been made to identify the reasons for default, the answers were very varied as well as evasive. For example, some expressed the opinion that bad repayment of loans by small firms were due to the fault and dishonesty of the borrowers themselves. They felt that some firms did not maintain good financial discipline, misutilized loan funds and used it for purposes other than the given purpose, were not cooperative and did not welcome control and supervision. Others assigned reasons such as, that they had first responsibility to the depositors, and basically they were not too interested in the reasons for default as they felt that it was not really their concern, therefore they could not stretch their good faith too much in accommodating defaulters, even if the firm had good reasons for the delay or default in payment.

6.3.64 All reasons given for refusal of accommodation a second time have some validity, but the problem is that even those who delayed or defaulted due to extraneous factors beyond their control are categorized
into the same group of borrowers who are believed to be inefficient and untrustworthy. The problem of default and delay in repayment is many sided, i.e. Government policy change resulting in change in emphasis and direction of incentives, new and sudden changes in tariffs and quota systems, foreign exchange crises limiting factor imposts, all of which could be included under the category of extraneous factors. On the side of the lenders, the lack of adequate trained staff and commitment to industrial lending, especially in the case of the banks, results in banks in many instances appreciating the working problems firms face. As shown later in chapter eight, there have been cases where a little consideration by the lender in allowing a period of further grace or another temporary advance to tide over a difficult period would have saved the borrower from going into default on the original loan.

6.3.65 Question Sixteen: Do you first investigate the viability of a project, before you discuss security and other guarantees?

This question attempted to investigate a problem that confronts any lending institution and borrower, namely the problem of having a viable venture but the sponsor cannot provide adequate security to get a loan, and the second case where the exact opposite is true. The problem of investigating one before the other would confront lenders with the problem that in the event whichever (security or viability) they investigated first was acceptable and the one they investigated second was not satisfactory they would have to refuse the application. This would involve unnecessary costs in terms of man-hours wasted by the institution to no avail, and costs in terms of jettisoned plans, broken expectations, time spent, fees paid, to the prospective borrower.

6.3.66 The answer to this question by the AICC was that,

1. This is analysed in greater detail in Chapter Eight.
according to its Ordinance it could grant loans only on the mortgage of property, therefore it dealt with the aspect of security first. The DFCC answered that they dealt with both matters simultaneously. The DFCC had the capacity to do so as they dealt with only a few loans at a time, further, their lending was only to the industrial sector and they had trained personnel to investigate and assess different aspects of a loan. Most banks were of the opinion that it depended on different types of loans, with the viability of the venture being investigated first in the case of loans with a duration of one year and over, and in cases of short term accommodation both were investigated simultaneously. There seems to be some contradiction between this statement by the banks and the findings in the small firm survey. According to the latter, most small firms felt that the banks always investigated security first and viability came as a second condition, and that if adequate security was available it would not be very difficult to get a loan from the banks.

6.3.67 No generalisations can be made from either view, the important point at issue is not what came first, but a solution to this problem or a method to minimise waste of time and money. One method is for the banks to concentrate on providing more financial information, such as, security they require for loans, other conditions they look for in an investment, the type of finance available, etc., not at the time an industrialist applies for a loan but as a general policy at all times. It will perhaps not be possible for an applicant to judge his creditworthiness, or the viability of his venture, but it would not be such a difficult prospect for an applicant to establish whether he has adequate security demanded by the lender for a loan he wishes to obtain, if there was adequate (and continuous) information from the banks and other institutions,
through the medium of pamphlets, news letters, press, seminars, lectures and discussions. This would help to cut down many unwarranted loan applications, thereby saving time and cost, both to the lender and the borrower. This information gap was investigated during the course of the General survey and the results are given in Chapter Eight.

6.3.68 Question Seventeen: Has the Bank Rate any effect on your lending policy? - Yes/No.
if Yes, what kind of effect?

He answer to this question was in the affirmative by all institutions. All lending institutions adjusted their lending rates according to the bank rate to keep their margins. In the case of the DFCC, as their duration of loans extended up to 15 years, to safeguard themselves against the rise in the bank rate, they stipulated an additional condition during the time of the loan that the rate of interest on the loan was subject to review after a period of years. From answers to this question, it was evident that despite the increase in lending rates as a result of an increase in the bank rate, there does not seem to occur a parallel decrease in the demand for accommodation. In terms of classical central banking theory, an increase in the bank rate is one way of offsetting spending and investment by making the cost of credit dearer to the recipient. The non-slackening of demand for industrial credit even when the rates go up seems to indicate that there is unsatisfied demand for credit in the industrial sector. This view was further strengthened by the desire expressed by the small firms in the firm survey, that they were ready to borrow even at higher rates than the existing rates, despite the fact they regarded the present rates of interest as high.

1. This aspect of the problem is discussed in Chapter Nine.
6.3.69 Question Eighteen: Do you consider that small firms have greater vulnerability to collapse than large firms? — Yes/No.

if Yes, what factors have contributed to this view?

This question attempted to test an 'attitude factor' common to most lending institutions not alone in Ceylon but all over the world. The DFCC and all but one bank, answered 'yes' to this question, while the AICC and the People's bank felt that there was not much of a difference between large and small firms. This attitude factor of the two groups, considering the loan records of these institutions to industry, underlines a significant factor of small firm financing in the country. The latter two institutions, are the only two institutions that have made some effort to provide finance to small firms. The DFCC soon after its inception, exempted itself from lending to small firms and those firms which were not joint stock companies, so it could be rightly concluded that the impression they have of small firms has not been gained through experience. In the case of the other banks, with the exception of the Bank of Ceylon, their lending to the industrial sector has been insignificant, therefore the impression they have regarding the riskiness of small firms is also not one gained through experience. The reasons assigned for this view of small firms, emanate from a general and accepted view that, 'it is so'.

6.3.70 This question of vulnerability of small firms has many misconceptions. The protagonists of small firm vulnerability seem to base many of their conceptions only at face value. For example they do seem to forget that most firms start small, and at that end of the scale the physical number of firms are large, and have many barriers to surpass, of which one of the foremost barriers is the adequacy of finance. Further, many successful large firms, did start small and their present success cannot turn away from
the fact that they were successful small firms which grew up to be large organisations. It is also true that the 'less vulnerable large firms', have the additional advantage that lenders and financiers are ready and willing to provide more finance to them in comparison to even the successful small firm, apart from having access to the stock market. It may not be far wrong to conclude that other factors remaining equal, vulnerability could be identified with inadequacy of finance at the correct time. Thus if the lenders begin with the maxim that small firms are more vulnerable, there would definitely be less credit available to the small firm sector, and as a result when small firms stagnate or collapse, the lenders feel rightly justified that their belief in the vulnerability of the small firm is correct.

6.3.71 The opinion in this study is that, there need not be a built in vulnerability factor in case of all small firms. Taking away the assumption, i.e. that other factors do remain equal, there may be some justification to assume vulnerability of particular types of firms, but it does not justify the general attitude that all small firms are more vulnerable than large firms. Many factors apart from the inadequacy of finance which contribute to small firm vulnerability can be removed by intelligent policy measures, and the general association of risk and vulnerability with the small firms can be alleviated to a considerable extent by the establishment of better communication patterns between institutional lenders and the small firm sector.

6.3.72 Question Nineteen: Is the cost and risk of financing small firms very much different to large firms? — Yes/No.

if Yes, please give your reasons.

All the institutions felt that the risk and cost of small firm financing was more than in the case of large firms. Two main reasons were

1. See Chapter Nine -
given for this view, i.e. (i) that the cost of processing a large loan and a small loan does not seem to vary very much, nor is there a significant difference in staff time taken in processing the loans, and (ii) risks are assumed to be greater based on the general belief associated with small firms all over the world.

6.3.73 In the case of the first, as costs remain more or less the same, and the interest rates in Ceylon do not vary with the size of the loan, the lenders feel that they have a decided advantage in terms of profitability to concentrate on larger firms. This factor coupled with the feeling that small firms are more vulnerable and risky, weights the direction of lending against the small firms. The impression the lenders gave was, that the small firms come at the tail end of their lending priorities.

6.3.74 Question Twenty: Please fill in the attached tables, if data is available.

A number of tables were drawn up to collect data, with the aim of obtaining specific data for statistical analysis. The tables were as follows, (i) Size of bank variation in interest rates on business loans by size of borrower and size of bank.

Observation in other countries have shown, that small banks tend to charge higher rates for their loans. The assumption here is that as small banks normally lend small sums, and that small sums are usually borrowed by small firms, there seems to be a relationship between the high cost of loans, the size of banks, and the size of borrower. No figures were available to construct such a table due to (a) banks do not vary interest rates by bank size or size of loan, (b) the banks found it difficult to obtain interest rates charged to different loans from their records due to lack of staff.

1: Assuming here, that in general small loans are sought by small firms.
2: For example, United States of America.
Besides, they were not prepared undertake this search nor were they prepared to make these records available.

(ii) Analysis of bank advances by type of industry and size (amount outstanding at end of December each year - 1966 - 1970 )

This was an attempt to study the direction of industrial lending by the banks according to the type and size of firm. The banks do not keep any statistics of their lending to industry by size measure of firms. Industrial lending is broadly divided into loans to the State sector and the private sector. However, individual bank lending to different sectors of industry is available, but they were not ready to divulge these records as they were classified 'secret and confidential'. The only statistics made available were those that had already been published, which show only the overall total lent by the banks to the industrial sector as a whole.

(iii) Bank advances by rate of interest.

This is to study the total quantum of lending against each rate of interest, and to identify the most common rates at which loans are presently given. The data for this table was available.

(iv) Size of loans at different rates of interest

This was to identify whether institutions varied their rates according to the loan size, and if they did, what the rates were. The underlying purpose is to investigate whether institutions charged higher rates for smaller loans. As it was found that the rates do not vary according to size of a loan but according to the type of security provided, this table was irrelevant.

(v) Business loans of Financial Institutions to small firms, as percentage of total loans to the industrial sector.

For reasons given earlier, i.e. the non-availability of data kept
on this basis of size of firms, it was not possible to construct this table. (vi) Bank advances classified according to purpose and maturity.

This table attempts to show the amount and duration of loans given to different sectors of the economy, i.e. commercial, financial, industrial and agricultural. Here again the banks were not ready to divulge their individual totals, the table constructed show only the total bank advances to these sectors.

(vii) Loan recipients and their business success.

This table was applicable only to the long term credit institutions. The intention was to investigate whether there was a relationship between the size of the loan recipients and their business success. The AICC was unable to give a detailed breakdown of their loan recipients and their business success. The DFCC on the other hand had records of their loan recipients, bad debt records, and delinquency records, but as almost all their loans were given to large business in terms of size measures used in the study, the intended relationship between size of firm and business success could not be established.

(viii) Number of loan applications made, loans granted, and rejections on viability/security/other.

This was an attempt to establish the loan records of the institutional lenders in Ceylon, towards the industrial sector, in terms of, duration of loans, i.e. short, medium and long, the number of applications in each group, number of loans granted, and the reasons for rejection of applications. This attempt too was unsuccessful as the banks were not prepared to delegate staff to get this data from their records. The AICC also gave similar reasons as the banks. The DFCC had such records but their statistics were not relevant due to reasons given above (see vii above)
6.3.75 The attempt to collect statistical data described above were not successful. The main reasons for failure were, (a) the absence of a size classification of industry, (b) the dearth of industrial statistics kept as separate records, by banks, (c) the reluctance of individual banks to divulge available data, (d) and in some cases the inability of the banks to ascertain specific data from available records.

6.3.76 Question Twenty One: Are there any other problems that you wish to discuss, with regard to your lending activities, especially to the small firm in the industrial sector?

This question was posed to mop up any other problems of small firm financing that had been left out in the preceding questions and the resulting discussion. One of the main causes they identified as a barrier to lending in general were the legal limitations applicable to lending, i.e. in terms of security for loans, recourse for default, etc. The bank of Ceylon was more affected than any of the other banks by some of the legal restrictions which were only applicable to this bank.

6.3.77 Another reason was that the banks generally regarded themselves as short term lenders and lenders to all other sectors in the economy. As such their lending is widely based, and according to the available quantum of finance they had to give consideration to all sectors and could not give special attention to industry alone. Another point raised by the banks and the AICC was their capital limitations. This made it necessary as prudent financiers to choose the best customers, the most profitable and the safest.

6.3.78 The absence of a credit guarantee organisation was another defect pointed out by the lenders as a barrier to lending and the prospects of taking greater risks.
6.3.79 The overall opinion of the lending institutions was that the industrial sector was too disorganised, the future uncertain and bleak as a result of frequent change of Government policy towards the private sector, and the belief that there was too much of 'lip service' being paid to helping this sector by successive Governments, but nothing very constructive has been achieved which is of any significance. Therefore, expecting the institutions to bear the burden of financing this sector alone was not fair nor practicable.  

6.3.80 Having given a brief description of the findings of the financial institution survey, in the following sections an attempt is made to give an overall view of the present activities of the financial intermediaries, and other institutions that provide other services to the industrial sector. The intention is to show the present level of financial services, and other services ancillary to finance, in relation to the industrial sector as a whole, the shortcomings, and the place of the small firm in obtaining financial and other services. The data for the following sections have been obtained from available published and unpublished material, and from the three investigations, i.e. the financial institution, the small firm and the general interview surveys.

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1. These factors were further investigated in the General interview survey and is analysed under relevant sections in Chapter 8, and suggestions are made to minimise some of these problems in Chapter 9.
6.4. THE COMMERCIAL BANKS

6.4.1 Table 37 shows the assets and liabilities of the commercial banks during the last ten years, i.e. 1959 - 1969. Table 38 below, derived from table 37 shows the growth rate of assets and liabilities in 1969, as compared to the level in 1959. These two tables show that there has been an increasing trend in the loans and overdrafts of the banks. Taken as a whole this does not lead one to conclude that the banks have relaxed their terms of lending but that lending has been matched by an increase in time and savings deposits, and an increase in the liquid assets of the banking structure, while demand deposits which could be taken as money at call of the public, has shown a very slow increase. The ratio of loans and overdrafts to total deposits up to 1967 had always been below 50 per cent. However, since 1967 this ratio has increased and was 66.6 per cent in 1969. Despite this trend, the table further shows this increase has not in any way impaired the liquidity position of the whole commercial banking sector, i.e. the ratio of liquid assets to total deposits has remained more or less the same since 1959, averaging around 35.2 per cent. Further the ratio of liquid assets to demand deposits have risen over the years from 47.5 per cent in 1959 to 63.9 per cent in 1969, while the ratio of investments to total deposits which is a less liquid asset has fallen by half of the 1959 ratio, i.e. 29.8 per cent to 14.8 per cent.

6.4.2 Table 39 shows the reserve position of the commercial banks. Under the Monetary Law Act, commercial banks are required to maintain with the Central Bank, reserves amounting to 12 per cent of their demand deposits and 5 per cent of their time and savings deposits. With

1. Monetary Law Act, Chapter 422, Sections 10, 93, 94 and 97
### TABLE 37

**SELECTED ASSETS AND LIABILITIES OF COMMERCIAL BANKS**

(Average of Monthly Figures)

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<td>9.1</td>
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<td>12.7</td>
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<td>Liquid Assets to Total Deposits</td>
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<td>57.0</td>
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**Source:** Central Bank of Ceylon.

**Note:** In case of 1970 figures, the calculations are based up to end of September as a result of the temporary flow of cash into the Banks due to the demonetization of Rs.100 and Rs.50 notes after this date.
effect from tenth February, 1961, banks with the exception of the People's Bank were required further to maintain special reserves of 38 per cent against any increase in their demand deposits over the level of such deposits as at close of business on first February, 1961. Apart from these reserve requirements, banks are also required to maintain reserves amounting to 10 per cent of their special deposits under the Inland Revenue Act. Thus both by purpose and by design the banks have always held themselves in a strong liquid position. The inclination to keep large liquid balances apart from the required reserves has been very prominent up to 1961. Although excess reserves have diminished since then, there has been a tendency to keep reserves on an average always in excess of the statutory requirements plus till cash balances over and above what is necessary for normal banking transactions. Columns 9 and 10 in Table 39 shows that the desire for high liquidity of the banking sector has not undergone much change over the years.

**Table 38**

**Growth of selected assets and liabilities (Percentage)**

<p>| | |</p>
<table>
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<tr>
<td><strong>Liquid Assets by</strong></td>
<td>94%</td>
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<tr>
<td><strong>Loans and overdrafts by</strong></td>
<td>21%</td>
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<tr>
<td><strong>Demand Deposits by</strong></td>
<td>44%</td>
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<tr>
<td><strong>Time and Savings Deposits by</strong></td>
<td>205%</td>
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<tr>
<td><strong>Total Deposits by</strong></td>
<td>95%</td>
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</table>

1. The People's Bank which commenced business in 1961 was required to keep a special deposit of 28 per cent applicable from first June, 1965 against any new deposits as from this date.

2. Section 69(A) (2)b of the Inland Revenue Act No.4 of 1963 as amended by Act 18 of 1965
### Reserve Requirements of Commercial Banks

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<tr>
<th>End of Period</th>
<th>Demand Deposits</th>
<th>Reserves required against Demand Deposits</th>
<th>Time &amp; Savings Deposits</th>
<th>Reserves required against Time &amp; Savings Deposits</th>
<th>Total required Reserves</th>
<th>Actual Reserves Deposits Till Central apart from Bank Reserves</th>
<th>TOTAL Excess Balance</th>
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<td>103.8</td>
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<td>1953</td>
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<td>109.6</td>
<td>334.2</td>
<td>15.4</td>
<td>36.1</td>
</tr>
</tbody>
</table>

Sources: Central Bank of Ceylon.
6.4.3 Tables 40 and 41 show the advances of the banks to the private sector as a whole and these classified according to maturity and purpose. It has not been possible to apportion funds that have gone into industry, 'size-wise' as no figures are kept in this manner. Therefore assessment has been made by a process of deduction from the available statistics. Further, prior to September 1970, the statistics on advances as supplied by the commercial banks were drawn according to the definition adhered to by the Central Bank, i.e. short term was defined as under six months, medium term six to thirty months and long term as over thirty months. Since this gives an entirely erroneous picture of advances in terms of maturity dates as compared to the general usage commonly used by financial circles in other parts of the world no attempt is made to analyse them in this context. However, since September 1970, the advances were reclassified according to new maturity times which gives a more accurate picture of the portfolio of bank advances. Finally the breakdown of the statistics into different sectors are weak and therefore should be read and interpreted with caution. This is due to the difficulty of identifying the loans given for particular purposes and the uses to which these loans have been put. For example, many commercial firms have branched off into manufacturing, thus a loan identified as going to the commercial sector would end up being used for financing of industry, advances to finance houses may be used to lend on hire purchase, while an individual loan presumably taken for consumption purposes may be used for another purpose. Thus in general movement of loans taken for different purposes is difficult to identify.

6.4.4 Table 41 shows the increase in advances to the private sector during the last three years. The increase in loans from 1968 to 1969 was Rupees 137 million and overdrafts Rupees 127.5 million.
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<thead>
<tr>
<th></th>
<th>Ceylonese Banks</th>
<th>Foreign Banks</th>
<th>Total</th>
</tr>
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<tbody>
<tr>
<td>(a) Cash items in process of collection</td>
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<td>106.8 1.2 0.2</td>
<td>1.4 52.5 33.8 171.4 108.2</td>
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<tr>
<td>(b) Local Bills</td>
<td>-    -    -    -</td>
<td>0.1     -    -</td>
<td>0.1     -    -    -</td>
</tr>
<tr>
<td>(c) Import Bills</td>
<td>60.0 35.0 16.1 25.0</td>
<td>29.4 32.9 20.3</td>
<td>8.3 89.4 67.9 36.9 33.3</td>
</tr>
<tr>
<td>(d) Export Bills</td>
<td>18.7 25.0 32.1 37.3</td>
<td>61.5 60.8 74.4</td>
<td>78.3 80.2 85.9 106.5 115.5</td>
</tr>
<tr>
<td>(e) Overdrafts</td>
<td>227.7 379.1 342.9 431.9</td>
<td>431.9 270.0 246.2 245.8</td>
<td>289.8 497.8 625.3 588.7 721.7</td>
</tr>
<tr>
<td>(f) Loans</td>
<td>538.6 637.9 731.4 818.7</td>
<td>62.0 99.2 82.3 72.7</td>
<td>600.7 737.0 814.2 891.4</td>
</tr>
<tr>
<td>TOTAL</td>
<td>896.3 1110.1 1293.7 1419.8</td>
<td>424.2 439.9 424.0</td>
<td>450.4 1320.6 1549.9 1717.7 1870.1</td>
</tr>
</tbody>
</table>

Notes:

(*) Include State Corporations

I. This includes cheques, money orders, etc. sent for collection and short term advances granted to cooperatives for the financing of purchase of foodstuffs under the guaranteed Price scheme.

Source: Central Bank of Ceylon.
### TABLE 41

**ADVANCES (1) CLASSIFIED BY PURPOSE AND ACCORDING TO MATURITY**

<table>
<thead>
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<th></th>
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<td>34.5</td>
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<td>1971</td>
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<td>36.4</td>
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<tr>
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<tr>
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<td>35.9</td>
<td>11.6</td>
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</tr>
<tr>
<td>Rs., Mn.</td>
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</tr>
<tr>
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<td>2.9</td>
<td>2.9</td>
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<tr>
<td><strong>Total</strong></td>
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<td>37.4</td>
<td>28.7</td>
<td>29.3</td>
</tr>
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<td>12.3</td>
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<td>100.0</td>
<td>100.0</td>
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</table>

**Note:** Until 1969, the maturity periods of loans and advances were classified as given in column (i) below, and thereafter as in column (ii) below.

<table>
<thead>
<tr>
<th>(Column -i-)</th>
<th>(Column -ii-)</th>
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<tbody>
<tr>
<td>Short Term...</td>
<td>Below six months</td>
</tr>
<tr>
<td>Medium Term...</td>
<td>Below twelve months</td>
</tr>
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<td>Long Term...</td>
<td>Six to thirty months</td>
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<td>Twelve to sixty months</td>
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<td>Over thirty months</td>
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<td>Over sixty months</td>
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(1) Advances include loans, overdrafts and bills discounted and exclude cash items in process of collection.
This increase in loans was partly as a result of increase in medium term lending to agriculture and industry which did not come under the credit ceilings imposed by the Central Bank. The 1969 to 1970 increase in loans and advances was Rupees 77.2 million while overdrafts decreased by Rupees 36.6 million, a greater percentage of the increase in loans were in the form of medium term loans over a year. Table 4I further shows that there has been a definite increase in trend on lending towards industry and agriculture as against loans to other sectors. A number of factors are responsible for this increasing trend, i.e. (i) Credit control which specifically exempted loans for development of agriculture and industry, coming under credit ceiling limits, as applied to other sectors, (ii) the rapid expansion of the People's Bank, which has accommodated a considerable amount of industrial loans, (iii) the reorganisation of the banking structure, and the removal of restrictions of the foreign banks, (iv) a slow emergence of a new attitude of the commercial banks towards lending, firstly on a longer term basis and secondly, towards agriculture and industry.

6.4.5 Table 42 shows the breakdown of advances for industrial purposes. Although this increasing trend towards industrial financing is an encouraging feature of overall bank advances in the last few years, the position does not look as promising to small industry as defined in this study, when the directions of loans and advances are broken down into sectors. Out of the total advances of Rupees 416 million outstanding at the end of December 1970, Rupees 160.1 million or 39.5 per cent were given to state corporations all of which fall into the large business category, Rupees 29 million went to the plantation crop processing sector, and there is reason to believe that nearly 95 per cent of the balance Rupees 225 million was shared between private large businesses, co-operatives, societies and those firms at the upper strata in the medium firm category.
<table>
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<td>19.4</td>
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<td>8.0</td>
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<td>5 Biscuits &amp; Confectionary</td>
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<td>39.6</td>
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<td>8 Other Industries</td>
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<td>74.2</td>
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</tr>
<tr>
<td>Private</td>
<td>160.7</td>
<td>234.7</td>
<td>255.9</td>
<td>262.9</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.
The same pattern of lending seemed to have persisted over the yearly increases during the last few years. The table also shows the maturity times of the loans under the new classification for 1970, out of a total of Rupees 416 million outstanding at the end of December 1970, Rupees 197 million or 47.3 per cent was for short term purposes of under one year, Rupees 151.5 million or 36.4 per cent for periods between one to five years and Rupees 67.4 million or 16.2 per cent for periods over five years. Taking into consideration the lending patterns of previous years, approximately 75 per cent of the Rupees 197 million short term advances were for periods less than six months.

6.4.6 In concluding this section on advances it is reasonable to believe that there has been a marked increase in the share of advances to industry. With the increasing Government directives to the banks this may remain at a high level, but it is too early at this stage to assume that there is positive thinking as regards industrial financing and that overall bank attitudes have changed. Still, the biggest share of industrial advances are concentrated on short term lending under six months, most long and medium term advances comprise of a few loans of large size, therefore it is right to conclude here that the share of the small scale sector in the expanding portfolio of commercial bank lending has remained small especially where medium and long term loans are concerned.

6.4.7 Tables 43 and 44 show the advances of the banks by rate of interest and type of security. The rate of interest on all advances has been creeping up over the years and the median rate on advances has also gone up from 7.5 per cent to 8 and 9 per cent for the years 1969 and 1970 respectively. This is also seen in the percentage of advances at 8.5 per cent and above increasing from 13.2 per cent in 1968 to 20.5
### Table 43

**COMMERCIAL BANK ADVANCES (1) BY RATE OF INTEREST**

<table>
<thead>
<tr>
<th>Rate of Interest %</th>
<th>Dec. 31st 1968 Amount Rs. Mn.</th>
<th>% of Total</th>
<th>Dec. 31st 1969 Amount Rs. Mn.</th>
<th>% of Total</th>
<th>Dec. 31st 1970 Amount Rs. Mn.</th>
<th>% of Total</th>
<th>Dec. 31st 1971 Amount Rs. Mn.</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.5</td>
<td>20.3</td>
<td>17</td>
<td>14.3</td>
<td>10</td>
<td>6.6</td>
<td>5.1</td>
<td>6.0</td>
<td>0.4</td>
</tr>
<tr>
<td>4.0</td>
<td>2.7</td>
<td>0.2</td>
<td>4.5</td>
<td>0.3</td>
<td>3.1</td>
<td>0.2</td>
<td>1.6</td>
<td>0.1</td>
</tr>
<tr>
<td>4.5</td>
<td>2.8</td>
<td>0.2</td>
<td>2.6</td>
<td>0.2</td>
<td>2.0</td>
<td>0.1</td>
<td>2.2</td>
<td>0.1</td>
</tr>
<tr>
<td>5.0</td>
<td>22.8</td>
<td>1.9</td>
<td>22.0</td>
<td>1.5</td>
<td>26.8</td>
<td>1.9</td>
<td>42.6</td>
<td>2.6</td>
</tr>
<tr>
<td>5.5</td>
<td>16.2</td>
<td>1.4</td>
<td>21.0</td>
<td>1.5</td>
<td>3.1</td>
<td>0.2</td>
<td>2.4</td>
<td>0.1</td>
</tr>
<tr>
<td>6.0</td>
<td>121.8</td>
<td>10.3</td>
<td>211.7</td>
<td>14.8</td>
<td>51.0</td>
<td>3.5</td>
<td>30.9</td>
<td>1.9</td>
</tr>
<tr>
<td>6.5</td>
<td>96.9</td>
<td>8.2</td>
<td>132.0</td>
<td>9.3</td>
<td>46.4</td>
<td>3.2</td>
<td>36.8</td>
<td>2.2</td>
</tr>
<tr>
<td>7.0</td>
<td>232.4</td>
<td>19.6</td>
<td>108.0</td>
<td>7.6</td>
<td>231.2</td>
<td>16.1</td>
<td>275.4</td>
<td>16.7</td>
</tr>
<tr>
<td>7.5</td>
<td>300.6</td>
<td>25.4</td>
<td>302.9</td>
<td>21.2</td>
<td>140.4</td>
<td>9.8</td>
<td>148.2</td>
<td>9.0</td>
</tr>
<tr>
<td>8.0</td>
<td>209.7</td>
<td>17.7</td>
<td>316.5</td>
<td>22.2</td>
<td>166.9</td>
<td>11.6</td>
<td>187.3</td>
<td>11.4</td>
</tr>
<tr>
<td>8.5</td>
<td>50.4</td>
<td>4.3</td>
<td>62.1</td>
<td>4.4</td>
<td>254.7</td>
<td>17.7</td>
<td>279.8</td>
<td>17.0</td>
</tr>
<tr>
<td>9.0</td>
<td>69.2</td>
<td>5.8</td>
<td>142.5</td>
<td>10.0</td>
<td>274.9</td>
<td>19.1</td>
<td>316.7</td>
<td>19.2</td>
</tr>
<tr>
<td>9.5</td>
<td>37.3*</td>
<td>3.1</td>
<td>11.0</td>
<td>0.8</td>
<td>52.0</td>
<td>3.6</td>
<td>91.8</td>
<td>5.6</td>
</tr>
<tr>
<td>10.0</td>
<td>n.a</td>
<td>n.a</td>
<td>26.6</td>
<td>1.9</td>
<td>85.6</td>
<td>5.9</td>
<td>59.8</td>
<td>3.6</td>
</tr>
<tr>
<td>10.5</td>
<td>n.a</td>
<td>n.a</td>
<td>22.1</td>
<td>1.5</td>
<td>7.8</td>
<td>0.5</td>
<td>12.9</td>
<td>0.8</td>
</tr>
<tr>
<td>11.0</td>
<td>n.a</td>
<td>n.a</td>
<td>25.6</td>
<td>1.98</td>
<td>37.1</td>
<td>2.6</td>
<td>36.0</td>
<td>2.2</td>
</tr>
<tr>
<td>11.5</td>
<td>n.a</td>
<td>n.a</td>
<td>-</td>
<td>-</td>
<td>6.5</td>
<td>0.5</td>
<td>0.9</td>
<td>-</td>
</tr>
<tr>
<td>12 and over</td>
<td>n.a</td>
<td>n.a</td>
<td>1.4</td>
<td>0.1</td>
<td>42.7</td>
<td>3.0</td>
<td>76.6</td>
<td>4.6</td>
</tr>
</tbody>
</table>

Total... 1,183.3 100.0 1,426.7 100.0 1,438.9 100.0 1,646.9 100.0

Source: Central Bank of Ceylon.

Notes:
* Includes advances given rates over 9.5 per cent

1. Excluded export bills purchased at current rates of exchange and cash items in process of collection.
### TABLE 44

**ADVANCES (1) BY TYPE OF SECURITY**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>% of Total</td>
<td>Amount</td>
<td>% of Total</td>
</tr>
<tr>
<td>Documentary Bills</td>
<td>183.0</td>
<td>14.4</td>
<td>147.0</td>
<td>9.7</td>
</tr>
<tr>
<td>Govt. Securities</td>
<td>16.8</td>
<td>1.3</td>
<td>47.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Shares of J.S.C's</td>
<td>20.9</td>
<td>1.6</td>
<td>19.8</td>
<td>1.3</td>
</tr>
<tr>
<td>Time &amp; Savings deposits incl. cash value of Life Policies</td>
<td>50.2</td>
<td>4.0</td>
<td>73.6</td>
<td>4.9</td>
</tr>
<tr>
<td>Stock in Trade</td>
<td>268.1</td>
<td>21.1</td>
<td>315.2</td>
<td>20.8</td>
</tr>
<tr>
<td>Immovable Property</td>
<td>121.6</td>
<td>9.6</td>
<td>167.9</td>
<td>11.1</td>
</tr>
<tr>
<td>Guarantees</td>
<td>n.a</td>
<td>n.a</td>
<td>254.7</td>
<td>16.8</td>
</tr>
<tr>
<td>Trust Receipts</td>
<td>n.a</td>
<td>n.a</td>
<td>139.2</td>
<td>9.2</td>
</tr>
<tr>
<td>Hire - purchase Agreements</td>
<td>n.a</td>
<td>n.a</td>
<td>32.4</td>
<td>2.1</td>
</tr>
<tr>
<td>Plant &amp; Machinery</td>
<td>n.a</td>
<td>n.a</td>
<td>6.6</td>
<td>0.4</td>
</tr>
<tr>
<td>Tractors and Motor Vehicles</td>
<td>n.a</td>
<td>n.a</td>
<td>33.1</td>
<td>2.2</td>
</tr>
<tr>
<td>Pro. Notes, Bonds &amp; Usance Notes</td>
<td>n.a</td>
<td>n.a</td>
<td>169.3</td>
<td>11.2</td>
</tr>
<tr>
<td>Other Secured</td>
<td>542.5</td>
<td>42.3</td>
<td>54.0</td>
<td>3.6</td>
</tr>
<tr>
<td>Unsecured</td>
<td>64.8</td>
<td>5.1</td>
<td>53.4</td>
<td>3.5</td>
</tr>
<tr>
<td><strong>Total...</strong></td>
<td><strong>1,268.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>1,513.5</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.

(1) Exclude cash items in process of collection

(2) Include Guarantees, Trust Receipts, Hire-purchase agreements, Plant and Machinery, Tractors and Motor Vehicles, Promissory notes, Bonds and Usance notes.
### TABLE 45
YEARN CHANGES IN BANK RESOURCES AND THEIR UTILISATION

<table>
<thead>
<tr>
<th></th>
<th>Amounts in Rupees Million</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Government Sector</strong></td>
<td>150.9</td>
</tr>
<tr>
<td><strong>Central Bank</strong></td>
<td>2.3</td>
</tr>
<tr>
<td><strong>State Corporations</strong></td>
<td>-</td>
</tr>
<tr>
<td><strong>Co-operatives</strong></td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Other Domestic</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Private Sector</strong></td>
<td>167.1</td>
</tr>
<tr>
<td><strong>Inter Bank</strong></td>
<td>62.5</td>
</tr>
<tr>
<td><strong>Foreign Sector</strong></td>
<td>7.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>390.7</td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.

(1) Amounts rounded to first decimal number.

(+ This item shows all changes in Assets and Liabilities.)
and 52.5 per cent in 1969 and 1970 respectively.¹ The table on types of security shows that the most popular form of security offered has been stock in trade, immovable property and guarantees. In Ceylon the interest rate structure is even more closely tied to the type of security offered than in developed countries.²

6.4.8 Table 45 shows the yearly changes in bank resources and their utilization over the last few years. It is evident from the pattern shown here that the cooperatives, state industry, and the overall Government sector are the biggest uses of commercial bank resources, and in most years their utilization of bank resources is far greater than their contribution to the banks. On the other hand the private sector as a whole contributed more to bank resources than they have taken out of the banks during these years.

6.5. THE BANK OF CEYLON

6.5.1 The Bank of Ceylon is discussed in further detail here as it is the oldest indigenous bank in Ceylon. Further it is state owned and have been assigned since nationalization in 1961, greater responsibility to foster the development of agriculture and industry apart from its functions as a commercial bank. In analysing the activities of this bank the intention is not so much as to pinpoint its deficiency in industrial lending but to underline the difficulty that small firms experience with regard to financial access to banks.

6.5.2 Chapter four outlined the early development of the bank and its present structure. It was also stated that the development of its lending activities to the industrial sector was very slow.³

¹. The increase in lending rates in 1970 was partly as a result of the increase in bank rate in January 1970 from 5.5 to 6.5 per cent, resulting in a corresponding increase of lending rates by banks, as well as an increase in the rate of Central Bank refinance facilities to credit institutions.
². See section 7.5.22
³. See section 4.3.6
Table 46 below shows the proportion of advances and loans that went into different sectors during the years 1961 to 1967.  

6.5.3 Keeping in mind the limitations outlined in this type of sectoral analysis, the table shows that it is more attuned to traditional types of commercial bank lending. In 1961 only 6.2 per cent of total advances went into industry, and of this meagre total a greater proportion was lent to tea, rubber and coconut processing industries and well established large firms and state industries. Its share in industrial lending has risen over the years, but in comparison to its increase in deposits over these years it has remained static, while in comparison to the all bank average as well as the percentage share of industrial lending undertaken by the other indigenous bank its share is lower. The table shows the preponderance of its activities in the commercial, financial and consumption loan sectors. The available evidence of its loan activities for 1970 too shows that its share in industrial lending as compared to other sectors still remains around 10 per cent. Thus despite the change in direction outlined by the Board of Directors in 1961, after nationalisation, and the positive criticism directed against the bank by the Commission on its low performance regards industrial lending, their lending portfolio has not changed much over the years. Since 1964 the percentage of lending to industry has revolved around a figure of 10 per cent. Therefore this static figure adds weight to the conclusion that the bank in practice has not adopted a new policy of industrial credit, but the total lent so far reflects only the normal activities of the bank in relation to all sectors, as it had done over the years.

1. The data is only upto 1967, as due to the confidentiality clause, the study has been prevented from using data that has not been published.
<table>
<thead>
<tr>
<th>Year</th>
<th>Commercial</th>
<th>Financial</th>
<th>Agricultural</th>
<th>Industrial</th>
<th>Consumption</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amt.</td>
<td>%</td>
<td>Amt.</td>
<td>%</td>
<td>Amt.</td>
<td>%</td>
<td>Amt.</td>
</tr>
<tr>
<td>1961</td>
<td>59.4</td>
<td>38.5</td>
<td>45.0</td>
<td>29.2</td>
<td>5.9</td>
<td>3.8</td>
<td>9.5</td>
</tr>
<tr>
<td>1962</td>
<td>76.1</td>
<td>42.4</td>
<td>49.0</td>
<td>27.3</td>
<td>6.5</td>
<td>3.6</td>
<td>11.4</td>
</tr>
<tr>
<td>1963</td>
<td>133.9</td>
<td>56.9</td>
<td>29.2</td>
<td>12.4</td>
<td>10.2</td>
<td>4.3</td>
<td>9.4</td>
</tr>
<tr>
<td>1964</td>
<td>122.6</td>
<td>49.4</td>
<td>40.9</td>
<td>16.5</td>
<td>11.5</td>
<td>4.6</td>
<td>26.2</td>
</tr>
<tr>
<td>1965</td>
<td>116.3</td>
<td>45.7</td>
<td>38.4</td>
<td>15.1</td>
<td>13.3</td>
<td>5.2</td>
<td>28.0</td>
</tr>
<tr>
<td>1966</td>
<td>122.1</td>
<td>44.7</td>
<td>38.7</td>
<td>14.2</td>
<td>14.8</td>
<td>5.4</td>
<td>33.5</td>
</tr>
<tr>
<td>1967</td>
<td>141.5</td>
<td>44.8</td>
<td>40.3</td>
<td>12.8</td>
<td>20.3</td>
<td>6.4</td>
<td>32.1</td>
</tr>
</tbody>
</table>

Source: Bank of Ceylon.

(+) The figures given here show advances only up to 1967, i.e. published data; this study has been prevented from using data that has not been published, due to the confidential nature of such data.
6.5.4 Even out of the total lent to industry the greater percentage of the total consisted of a few large loans to a small number of well established large firms. Although specific figures have not been made available by the bank, there is verbal evidence to confirm this factor. This view is underlined also by the statistics provided by the bank to the Bank of Ceylon Commission in 1967.

"during the period under review, the bank's lending to business seems increasingly confined to established concerns. According to the figures made available to us, the bank's total advances as at the end of 1964 amounted to Rupees 248.2 million. Of this total, a sum of Rupees 124.2 million has been granted to 43 borrowers (including affiliates and allied interests) this amount to approximately 50.0 per cent of its total lending. The corresponding figures as at the end of 1967 reveal that a group of 42 borrowers obtained accommodation in a sum of Rupees 315.7 million, that is 54.2 per cent of the total. The bulk of the established firms are in the import/export business and in domestic trade. These figures include loans to industry and agriculture, in which field too, the established businessmen have ventured out in no small measure." (Bid.51, Paragraph 78)

6.5.5 In terms of maturity time of the loans given, there was a tendency for the bank to concentrate more on short term loans than the all bank average, with nearly 50 to 55 per cent of the loans being under six months, while loans over five years comprised of a very small percentage of the total loans portfolio. The Commission in its analysis upto 1967 found another peculiarity about the direction of long term loans, i.e. that the greater percentage of the long term loans were for the financing of consumption which included also loans for housing.

6.5.6 The loan assessment procedure of the bank also showed a peculiar characteristic, i.e. the assessment of industrial loans for different purposes were based principally on the same assessment procedure as used for commercial and consumption loans. In terms of security too, the bank tends to be more security conscious than any of the other credit institutions, while they apply also more stringent standards to acceptable security.
6.5.7 The reasons for the conservative attitude of the bank can be attributed to five major reasons, i.e. structural, historical, legal, intentional and extraneous. These reasons are discussed below as it throws light on a number of deficiencies not specifically of the bank, but the credit structure of the country, and the indirect repercussions it has had on the availability of credit to the small and medium firm sector.

6.5.8 In chapter four, the major limitation of the bank as regards its activities and the subsequent removal of some of these were mentioned. Under the category of structural limitations two most outstanding limitations of the bank are its limit on advances and its capital inadequacy. In the case of the former, the ordinance states, that 'the amount of the advances and loans made by the bank and outstanding at any time shall not in the aggregate exceed fifty per centum of the total of the amounts lying at the time to the credit of the depositors in current, deposit and other accounts of the bank,' (section 3 (c) of part ii of the first schedule of the Ordinance).

6.5.9 This was presumably introduced during the time of the bank's inception as a guarantee against rash lending and to safeguard the stability and the liquidity of the bank and thereby the safety of the depositors. It was understandable during that time, due to (i) the opposition to the founding of an indigenous commercial bank, (ii) other indigenous bank established prior to this bank erred on the side of caution, and (iii) the absence of a Central Bank to supervise the activities of banks.

6.5.10 In terms of modern banking functions this rule today is illogical. In normal circumstances the liquidity level of the bank is
calculated in terms of the ratio of current assets to current liabilities. In banking terms, this could be demand deposits against very liquid advances. Further a bank's vulnerability has to be seen in terms of its risky assets and current liabilities matched by its capital adequacy and total deposits. Therefore a fixed upper limit on lending alone will not guarantee a bank being liquid and stable. There are different points of view on this aspect of liquidity, the point at issue is whatever way one looks at it, the limitation, by modern standards, position, and stature of the bank, is too high. This not only introduces a credibility gap on the financial maturity of the bank, but also on its management. The important point to observe is that up to recent times the bank had not made an attempt to get this clause removed, nor had the Government shown any initiative despite the fact that since 1961 the new policy of the bank was to take an active part in lending for development.

6.5.11 The implications are that the bank seems to have been satisfied with its total lending under the ceiling, with the greater part of their loans portfolio concentrated on loans to the well established commercial sector where the risk of default was very minute, and the higher profit earning consumption loans. Till around 1961, the restriction of the lending activities of the bank would not have been felt very much as the demand for industrial loans were not very great. However, since then there has been a rising demand for loan accommodation, therefore if this clause is removed, the funds blocked by this clause could have been utilised in a very profitable manner. The indirect repercussions to the small borrower is obvious, as under this limit the bank would try to maximise its profits and this could only be done by lending to more profitable and safe enterprises where the returns on investment were assured,
and lending to those sectors where the rates charged were higher, such as consumption loans. It also introduced the possibility for the bank to refuse loans to those sectors which it considered unremunerative and more risky such as small loans to small and medium manufacturing industry, on the grounds that they have reached their maximum lending limitations. The irrelevancy of this rule is more attenuated by the fact that this rule is only applicable to the Bank of Ceylon. Its application today is in fact a wastage of resources in terms of idle money, especially as this bank today attracts the most number of depositors. Therefore, due to this 50 per cent limit a certain amount of resources lie idle in the bank for which the bank has to pay interest to its depositors.

6.5.12 The second structural limitation is the low level of authorized capital of the bank. The protagonists for a Ceylonese bank in 1935 saw the importance of good capital backing for a bank, considering the underdeveloped nature of the country. They foresaw that the new bank they envisaged need not necessarily follow the British banking pattern of low capitalised banks. The banks in Britain through centuries of development had formed their own characteristics with deposit-capital ratios ranging from 25-35 to 1 but in the case of banks in developing countries where the uncertainty factor is great, and the bank's customers perhaps have less faith in the stability of a bank as compared to that of a developed country, a bank has to be founded on good capital backing. Thus as mentioned in chapter four, the banking commission in 1931 recommended a sum of Rs. 20 mil. as authorized capital, with Rupees 10 million of it to be issued, but on modification of the proposals the authorized capital was fixed at Rupees 7.5 million while Rupees 3 million were to be issued.
6.5.13 The bank's management had pressed for some time on the capital inadequacy of the bank as seen below, in a statement made by the previous managing director of the bank.

"the capital structure of the bank is totally inadequate for the types of risks implicit in large scale and long term industrial financing .... I have put forward from time to time in the last few years various proposals to adjust the capital structure of this bank in order to enable the bank to adopt an aggressive lending policy not only for industry but also for agriculture." (G. Loganathan, General Manager of the Bank of Ceylon, Daily Mirror, Tuesday April 26, 1966)

The bank further highlighted this problem of capital inadequacy in 1967, but this was not altogether as a result of a genuine desire to lend on medium and long term, more risky and less liquid loans, but more as a result of the uncertainty introduced when the Government intended to remove the restrictions of foreign banks imposed in 1961. The bank expected that there would be a drain on its resources from its 'captive' deposits as well as other accounts to the foreign commercial banks, and feared for the stability of the bank. On the strength of these factors, the evidence given to the Banking Commission by the Bank's management that 'they could not adopt an aggressive lending policy because of its meagre capital structure' seems only an afterthought. For, capital adequacy of an institution is only one factor in a series of interlinking reasons why it cannot adopt an aggressive lending policy. If on the other hand, the desire and the motivation is absent to undertake a more aggressive policy, a strong capital structure would not automatically make the bank aggressive in its lending policy. This argument is well substantiated by the activities of the People's Bank founded in 1961, where the management from the outset adopted a more aggressive lending policy with more liberal loans, and with less stringent conditions for them. Although this bank

1. See Bib.51, Chapter 13, Paragraphs 271 - 291
was endowed with a constitution which was quite different to that of the Bank of Ceylon, it began business with only Rupees 6 million authorised capital of which Rupees 5.2 million was issued, and within five to six years of its existence it had caught up percentage-wise with the Bank of Ceylon in their lending to all sectors of the economy. 1

6.5.14 The other structural limitations that have been imposed on the Bank are,(a) prohibition to undertake hire-purchase finance. This again is a clause that has outlived its purpose, especially when seen in the light of the fact that hire purchase finance companies which borrow from the bank, compete with the bank in attracting depositors, while at the same time using certain portion of bank funds in their hire-purchase business. In other words these companies borrow from the banks at a lower rate of interest and lend on hire purchase finance at higher rates which in effect means that the bank subsidises their activities without any extra remuneration apart from the normal interest rate of loans. On the limitation the Bank Commission recommended as follows:

"The bank is not specifically empowered to undertake hire-purchase finance under the ordinance. This could be a profitable avenue of investment. It would be in the national interest for the bank to undertake such business at lower rates of interest than those prevailing at present for such finance in respect of equipment, machinery and durables required for agriculture and industrial purposes." (Commission Report, Bib 51, Paragraph 108)

Three years have elapsed since the publication of this Report and no attempt has been made to implement this recommendation.

1. The early lending policy of this bank was criticised by the Commission appointed to examine its activities and administration. However the criticism was directed more towards certain deficiencies of management decisions and shortcomings on some large loans and the desirability of concentrating on commercial loans and loans to industry as against agricultural loans. Thus, the criticism does not preclude the fact that although the aim and direction of credit was misdirected that they followed an aggressive policy of lending.
6.5.15 (b) Limits on Loans without security: The Bank Ordinance states that, 'no advance, loan or accommodation shall be granted for more than Rupees 50,000 without security'. This may have been adequate when it was last raised in 1949 considering the real value of the Rupee at that time in terms of goods and services and size of transactions, but falls short of the maturity level of the bank and is inadequate in terms of the value of the Rupee and other financial transactions.

6.5.16 (c) Restrictions on powers and duties of Directors of the Bank to grant credit: At present the General Manager is empowered to grant loan accommodation up to a limit of Rupees 100,000. This again is a limit that has remained static despite the diminished value of the Ceylon Rupee. The Commission rightly recommended that this limit be raised to a maximum of Rupees 250,000. All loans that exceed Rupees 100,000 have to be submitted to the Board for approval. This has resulted in, every loan application being referred to the Central office to check if the total credit granted to a applicant (if allowed) exceeds the limit on loans without Board approval. This has introduced in the first instance a delay mechanism, while authority tends to be concentrated in the centre. This of course is a characteristic of branch banking and there is a school of thought in developing countries whether branch banking in the way it is organised today (which is a development of British banking) is suitable for these developing countries where the economic conditions are entirely of a different character and they propose instead a decentralised banking system. The Bank Commission analysing the centrality of loan decisions, recommended that the branch managers of banks be given the authority to grant loans not exceeding Rupees 25,000 notwithstanding the provisions of this regulation, in order to facilitate the grant of small loans without undue delay.
6.5.17 In the sphere of historical limitations, the bank from its inception was conditioned to assume only the functions of a traditional commercial bank of British vintage. The Managing Director of the bank up to 1951 was a British banker, who saw to it that the bank was run on a British model. Deposit banking is synonymous with short term advances, high liquidity ratios, and very secure advances, while investment banking with its attendant risks is entirely a very different prospect. Rules, regulations, and practices of deposit banking have conditioned the bank's management and staff in its attitude towards lending and overall administration of the bank. These attitudes have been transferred to its lending portfolio where assessment is based on predominantly deposit banking principles, where cautiousness has become the prime motive. These principles more often than not would nullify even a good prospective loan to industry. Finally the bank's management keeping in mind the objections and pessimism expressed by those who opposed the establishment of the bank have always desired to prove them wrong by being even more cautious than even present day deposit banks. On this aspect the Commission Report observed thus,

"On the whole, we find that the main burden of the evidence tends to show that the bank has erred on the side of caution in its lending. The bank which was established in the aftermath of the great depression of 1928-1932 commenced its career in the knowledge of the all too brief history of two previous bank ventures in Ceylon - the Bank of Ceylon of 1841 which had an independent existence of only four years and the Bank of Colombo which commenced business in 1917 and closed its doors in 1921. It is quite natural that with this background, the bank adopted a cautious attitude to lending and tended to safeguard itself at every step with adequate cover. The development of a conservative loans policy was the logical sequel" 2

6.5.18 There are a number of legal limitations which are imposed on the credit institutions in Ceylon of which a few apply only to the bank of Ceylon. These are, (a) absence of 'parate' execution in the

1. See chapter 4
2. Bib. 51, paragraph 195
case of mortgagees of immovable property; i.e. the right to sell any property mortgaged without having recourse to a court of law. The absence of this right only in the case of Bank of Ceylon retards its activities in the field of lending, for in the case of default the bank has to take legal action to recover the losses. It took, usually a number of years for the court to reach a decision. For example, there have been cases where the immovable property under dispute especially in the case of machinery had outlived their usefulness and thereby fallen in value by the time a settlement was reached by the court.

6.5.19 (b) Pawn Brokers Ordinance, Debt Conciliation Ordinance and the Money Lending Ordinance: These ordinances were enacted to protect debtors from usurious money lenders. The bank, not being a type of money lender which these Acts envisaged, these limitations become anachronistic in its present application to the premier Bank in Ceylon, while in terms of modern commercial banking practices are utterly irrelevant.

6.5.20 The legal limitations that apply to all credit institutions in Ceylon are the following:

(i) The Tax Ordinance under the Inland Revenue Act
(ii) Registration of Documents Ordinance, creating a Fidei Commissum or Trust
(iii) The registration of old deeds and documents Ordinance
(iv) The Mortgage Act

The repercussions of these enactments on the lending activities of credit institutions will be dealt with in chapter 8.

6.5.21 The extraneous factors that contribute to lending limitations of the bank are also common to all other institutions. Foremost among them are the changing economic activity of the country, policies
of different political parties that form the Government at different times, fiscal policy, monetary policy, all of which necessarily affect industry and affect in turn the lending institutions.

6.5.22 The reasons coming under intentional, are a result of a combination of all factors mentioned above. The structural, historical and legal limitations have made the bank liquidity conscious and conservative. The result has been that the bank has been satisfied with lending to well established borrowers where risk is at a minimum. As small firms and industrial lending are associated with more risk and less liquidity they have (as far as possible) avoided the possibility of lending to venturesome small units, and have been quite satisfied with the profits they make by their business with well established customers.

6.5.23 In concluding this section on the activities of the commercial banks and their applicability to this study the following salient observations emerge,

(i) That commercial banks have principally concentrated in financing the commercial sector, with an average of around 75 per cent of their lending activities concentrated in the commercial and financial sector. Despite the declared intention of the Government since 1961, for the two indigenous banks to take a more active role in the financing of agricultural and industry, the movement towards this goal has been restricted due to the five factors mentioned above. Thus banks have not been able to achieve the rapid transformation expected, i.e. from the classical deposit/exchange banking traditions to a hybrid stage of exchange cum investment banking.

(ii) All banks have kept a high level of liquidity. This has been due to the early direction of development characteristics of the banks, and the high levels of reserve requirements desired by the Central Bank. Although
there has been an increasing level of loans and overdrafts granted to the industrial sector, this increasing trend has to be discounted by their growing volume of deposits and also the depreciated value of the Rupee when comparing their activities from one year to another.

(iii) Basically, most commercial banks concentrate on short term self-liquidating advances and overdrafts. However, in recent times there has been an increasing trend in loan advances to the industrial sector, as well as, lending for longer periods than six months. Though exact figures are not available, by a process of deduction from available information, it has been possible to establish, that out of the accommodation provided to the industrial sector, approximately 33 per cent of the advances were for periods less than six months, 25 per cent for periods between six and twelve months, 22 per cent between twelve to thirty months, about 14 per cent between thirty to sixty months, and the balance 6 per cent for periods over sixty months or five years. Of these loans those ranging from periods over thirty months, most were large block loans to established industry, which in terms of this study could be termed large, and there is reason to believe that even in the case of those ranging over one year the same pattern is prevalent.

Thus it would seem that the present lending patterns especially in the case of medium and long term loans are definitely biased against small and medium sized small firms, particularly those which in terms of age are young. It is only in case of short term funds that small firms find some access to bank funds. Some of the reasons for the direction of funds have been mentioned in the preceding pages and will be analysed further in chapter eight.

6.5.24 In fairness to the banks, it can be said that the banks in Ceylon have always kept to the four main principles of deposit banking
as found in Britain. These are (i) safety, (ii) liquidity, (iii) dispersal and (iv) remuneration.

6.5.25 Safety is the most important guiding principle of all advances. This is as a result of banks funds being mainly derived from the bank's depositors to whom repayment has to be paid on demand. As the depositors are drawn from the general public, the business of banking rests upon a foundation of public trust. Thus advances are ideally granted to able borrowers who can repay from reasonably safe sources within a relatively short period. Although the bank lends with the expectation that the borrower will repay the advance within the stipulated time, security is considered as a further safeguard of their funds. Technically, the banks do not grant accommodation strictly speaking against the security. The security is obtained by the bank to be available in case of need if something goes wrong, while in the normal course of business they do not look to the security for repayment.

6.5.26 The need for security postulates an arrangement at the outset of every advance for repayment within a reasonable time. However, good the security offered, and the means and standing of the borrower, regular repayment of the loan to liquidate the loan is the basis upon which the advance is made. Funds thus released allow fresh advances to be granted to meet the demand of all other creditworthy customers.

6.5.27 Lending is dispersed among creditworthy borrowers to reduce risks. The banks make it their policy to spread their activities over a wide field as possible and it is a natural outcome of avoidance of risks that sectors they do not well know or have experience in, are pushed to the background.

6.5.28 Finally it has to be kept in mind that banks are not philanthropic institutions, one of the foremost motives for the existence
of the banks is to make a profit. Interest on advances is their main
source of income, and they would not consider providing facilities which
did not produce a reasonable profit. It could be said that the banker
tries to cover in his income the following:
(a) interest on part of the monies deposited with him,
(b) depreciation and improvement of buildings, staff and customer facilities,
(c) staff salaries, pensions, etc.,
(d) funds for reserve and contingency funds,
(e) profits for stockholders in case of private banks.
As the banker's advances are relatively the most remunerative of his
assets, this factor influences a great deal the rate charged to borrowers,
and the direction of their lending, and the type of lending they indulge in.

6.6. FINANCE AND HIRE PURCHASE HOUSES

6.6.1 There is not very much, the hire purchase finance
companies have done in the way of financing of the industrial sector, nor
are there any definite policy patterns regards industrial lending.
Therefore, any loans that went into the industrial sector were more
accidental i.e. in the course of normal business of these organisations.
They preferred to finance business they knew well, i.e. hire purchase
finance of motor vehicles both private and commercial vehicles. In recent
times they have begun to concentrate more and more on land sales which
for them have become really lucrative business. The firm survey proved
without any doubt that many small businesses turn to these companies
to bridge temporary financial shortages. But no firm is really prepared
to talk about it, as there is a peculiar belief that persons turning to
these companies do so only as a last resort and they are less creditworthy,
however, as shown later this need not be necessarily true. The survey
findings were consistent with that of the findings of the Central Bank Survey (see section 4.5.9) that the total lent on hire purchase finance to industry was insignificant. However, it could be said that all hire purchase financing they did were with very small firms.

6.7. THE INDUSTRIAL DEVELOPMENT BOARD

6.7.1 The Industrial Development Board (IDB) was set up in 1966 under the State Industrial Corporation Act of 1957. Originally the functions allotted to it were as follows:

(a) Provision of industrial services such as training facilities, technical improvement, market promotion, product research

(b) Provision of particular needs of industry such as materials and equipment, and capital and credit.

6.7.2 In April 1970, the IDB was reconstructed and was thereafter called the Industrial Development Board of Ceylon (IDBC). New functions were added to it, in addition to the ones described above. These were,

(a) Function of promoting industries

(b) Coordination of their growth

(c) Fostering exports and regional cooperation

(d) Advising on industrial policy

6.7.3 From the activities enumerated above, it would seem that it was set up to fill an important gap in the industrial structure of the country. In effect it was to function as an advisory and service institution providing all the ancillary services needed for successful industrialisation. However, subsequent events have shown that it never took off from its planning stage, to be a practical institution. The fault was not in the very commendable and important functions allotted to it, but as a result of the faults in the internal structure of its administration,
staffing, especially in the higher management levels, and the 'ugly head' of politics entering into staffing and its administration. The failure of this institution has set back the development of industry to a considerable degree, for its failure has resulted in the non-implementation of the activities allotted to it and introduced an apparent 'black cloud' to the reintroduction of these activities in the IDBC itself or any other institution.

6.7.4 The activities of the IDBC is best described, by referring to the observations made by the Committee appointed by the Minister of Industries, in July 1970, to examine and report on certain matters relating to the IDBC.¹

6.7.5 In analysing the activities of the IDBC the Committee divided its activities into eight main functions. These were as follows:

(1) The Industrial Supplies Function
(2) The Credit Function
(3) The Information Function
(4) The Technical Service Function
(5) The Training Function
(6) The Research Function
(7) The Marketing Function
(8) The Industrial Estates Function

6.7.6 The Industrial Supplies Function: The early IDB and the reconstituted IDBC were empowered with the function of assisting industry by securing its needs of materials and equipment. This function if properly planned and administered, would have fulfilled a much needed want in the industrial sector of the country, especially, in the case of

¹ Unpublished Committee Report - 3rd September, 1970
Ministry of Industries, Colombo.
small and medium sized industries. This function was never fulfilled by the IDBC. The Committee observed as follows:

"The Ceylon Chamber of Small Industry, in evidence before us, stated its particular disappointment that the IDB had failed to discharge their functions. Apart from some information about overseas source of supply occasionally provided to callers or correspondents, the only recorded activity relates to the processing of orders for Indian machine tools under the credit provided by the Government of India in 1967. There is also some mention of assistance by way of collecting of information, provided to the Ministry of Industries. Little else worthy of mention appears to have been done . . . . . ." (Committee Report, Page 2)

6.7.7 The Credit Function: The original IDB was vested with the function of providing capital and credit to industrialists, while the IDBC was also vested with this power, with the added responsibility that the capital grants should be only made available to small industrialists. It is also important to note here that what constituted a small industry, was never established. Nothing very constructive was done during the years that this section functioned as a special division of the IDB and the IDBC. One reason given was the prevention of the IDB from entering the field of finance due to the restrictions imposed on it by the State Industrial Corporation Act of 1957. Its activities were therefore limited, to provision of hire purchase finance facilities. This they did, with a loan of Rupees 3 million granted by the Treasury. The beginning and termination of its lending activities ended with this sum, due mainly to a number of reasons principally in the region of the structure and administration of the whole institution. With this sum loaned by the Treasury, the IDB processed and approved 180 applications for disbursement totalling Rupees 3,320,890. Initially the upper limit of loans stood at, Rupees 50,000 or 75 per cent of the value of machinery to be purchased, whichever was lower, to each applicant, this limit was subsequently raised to Rupees 75,000.
6.7.8 During this time, it also ventured on a scheme of credits to industrialists who sought the assistance of the Small Industries Service Institute (SISI). The scheme envisaged the provision of machinery, dyes, and moulds ordered from the SISI on the personal security of the purchaser and an additional surety, and the deposit of 20 per cent of its cost up to a maximum loan limit of Rupees 20,000. After only two such loans, the scheme was discontinued. The reason for this is not clear, but the reason given to the Committee of Investigation was that the SISI 'could not effectively cope with the orders.'

6.7.9 The Information Function: The investment information centre was set up in 1967, aimed at dissemination of information, advice and counsel to local as well as foreign investors. They envisaged to provide information on Government industrial policy, departmental procedures and import and export control, exchange control, customs and tax requirements. This function was apparently carried out with some success, although the Committee was critical of some of the publications of this division, due to the apparent costliness and the practice of publishing them only in English.

6.7.10 The Technical Services Function: This important and necessary function was faultily administered from the start. In fact the IDB in setting up this service took over an institute, i.e. SISI, which was a going concern and brought its activities almost to a standstill. The Small Industries Services Institute was established in 1962 with machinery gifted by the Industrial Labour Organization. It constituted of a workshop, a foundry, a design section and an extension section.

When the IDB took over the administration of the SISI, a full time director

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1. The SISI was a separate going concern taken over by the IDB.
from outside the ranks of the public service appointed in 1966 was in charge. The Committee in analysing its activities observed as follows,

"Evidence led before the Committee indicates that Dr. Mahadeva had worked out fairly definite plans for the development of the SISI as a technical services agency and that he generated some optimism among its workers and staff about the future. Unfortunately, lack of understanding with the Board led to his resignation in October 1966. Since then, the SISI has not had a single full time Director and had as many as four acting part-time directors. It is not surprising that its affairs have deteriorated steadily. 

The SISI has carried on since Dr. Mahadeva's departure by the performance of odd jobs for larger firms able to commission its services. Some advice has also been proffered to small industrialists on installation and operation of industrial machinery.

Thus once again administrative bungling has almost brought to a halt a function that would have been a real boon to small industry.

6.7.11 The Training Function: This function which was vested in the original IDB failed to 'take-off' for a number of years and it was activated only when the Government in February 1968 came to an agreement with the ILO/UNSF to set up a Management Development and Productivity Centre, which was initially to be staffed with foreign experts with the prospect of local personnel understudying and replacing them. The centre proposed to provide training courses and seminars on industrial management. It began well with an array of courses and seminars.

6.7.12 The shortcomings of the activities of this function of the IDB is best illustrated by quoting the observations made by the Committee.

"No real consultancy work has been undertaken by the centre so far, though there were eleven assignments of a limited survey and advisory nature. It is significant that the work of management training performed by the MDC has been restricted to the larger industrial sector in the main. Most of the firms could well have done without the MDC's services. Only superficially can this be attributed to the high fees charged by the MDC's training courses. As a witness said in evidence before the Committee, a truer explanation appears to be neither the MDC nor the IDB itself has as yet enquired seriously what are the real problems of management in Ceylon. As a result there is a lack of local bias in

1. Twenty courses were held in 1969 with an equal number of seminars with a total participation of about 1,200 people.
the MDC's courses." (Page 7)

6.7.13 This criticism once again strengthens the observation made in this study earlier that a frequent mistake made in developing countries of importing experts and methods used, from industrially developed countries without first ascertaining the needs, goals and limitations of the recipient country. (see section 1.7)

"The same witness declared it as his emphatic opinion that the most urgent need of industry in Ceylon was not for trained top management personnel but for adequately trained maintenance personnel, especially in the minor supervisory grades. The failure of the MDC to recognise this may not be merely accidental. There appears to be a class bias in the approach to management training that concentration on top management and pays little importance to the use of popular languages. The suspicion of this increase when it is also remembered that the trade unions have been completely excluded from consultation in the work of the centre. (Committee Report - Page 7)

6.7.14 This study does not fully endorse the opinion quoted by the Committee, mentioned above. In the light of evidence there is need for training at all levels, i.e. from top management levels to the bottom rung in the shop floor. The training should comprise of all aspects of the anatomy of the firm, from administration of the overall unit to training in financial management, production management, personnel management, training on technical skills at all levels, understanding relationships between employer and employee, productivity and wages, the products of the firm and those of its competitors, and finally the relationship of the firm and its activity to the overall economic development of the country.

6.7.15 Once the need for training in this functional and sectoral basis is seen, it would become obvious who should be trained, in what. The misdirection of training as documented by the Committee would not have taken place, if in the first instance there was at least an administrative demarcation of industry according to size, and an
investigation made on this basis, prior to the actual programme on the needs of each sector of industry according to size, and the special needs of each sector in the fields mentioned in the previous paragraph.

6.7.16 The Research Function: This function vested in the IDB, made it responsible for the fostering of industrial research, with the object of utilising the natural resources of Ceylon, improving the technical processes and methods used in industries, developing appropriate technology and equipment for local industries, and discovering processes and methods for the better utilisation of waste products. The enormity of these functions vested in this objective, naturally envisages an institution with large technical skills and resources in terms of equipment and personnel. The IBD had neither, the only two divisions, i.e. the economic research division and the Technical Services Institute (previous SISI) had neither the staff, time or the ability to facilitate research investigations to fulfil the above requirements.

6.7.17 Although none of these functions got properly under way, the Committee underlines the very valuable work undertaken by the Economic Research Division. It would seem that at least this function of the IDB was a qualified success. The Committee enumerated its most important contributions to industry as follows,

"The Economic Research Division commenced functioning from early 1967. Its officers did useful and valuable work as Secretaries to the various industrial panels. They also serviced ten industrial sector working groups which collected and supplied the industrial data required for the input-output planning model of the Ministry of Planning and Economic Affairs. A painstaking survey of the industrial potential of the Gal-Coya Valley was prepared and published in 1968. Moreover in the early years when the marketing and export promotion function was within its purview, it prepared an export catalogue entitled 'Quality products from Ceylon'. In 1969 a comprehensive techno-economic survey of the regional industrial estate at Pallekelle was done by this division. It also did another survey of industrial waste products in Ceylon for the Ministry of Industries. Some officers assisted a Japanese survey team which made an economic evaluation of the Devehwa
colonisation scheme. A few other ad hoc assignments were also undertaken by the division."

However, a serious shortage of adequately competent personnel appear to have been a constant handicap. . . ."

With the limited resources available, and despite the lack of a clear sense of direction, the type and quality of economic research undertaken by the IDB is commendable." (Pages 8 and 9)

6.7.18 It is apparent that the Committee in enumerating the activities of the research division and in commending its activities brings to light an important pre-requisite for a services institute, which however seems to have been overlooked by them in their final conclusions. The four important pre-requisites for a successful service institute are the following, in the order of priorities:

(A) Research which include both desk and field research
(B) Analysis
(C) Dissemination
(D) Application

6.7.19 The importance of fulfilling these four objectives is spelled out in chapter nine (see section 9.2.44). It would suffice here to say that the IDB was partly successful in achieving the first and the most important objective. It is true that the research undertaken was limited in scope, direction and application, but this was more to functional inadequacy of its management, limited direction and the confusion at the top. What one must emphasize here is, that a good idea and an urgent necessity in the industrial structure of the country need not be shelved, due to the administrative inefficiency of its top management and lack of forethought in the planning stage of the institution.

6.7.20 The Marketing Function: The original IDB was vested with the promotion of marketing of manufactured industrial products both at home and abroad. Here again useful preliminary work was done by this
division. Its activities were recorded by the Committee as follows:

"The Marketing and Export Promotional Centre (MEPC) has provided advisory and information services on matters such as commercial legislation, import duties, export incentives etc. Otherwise, its work has been mostly confined to obtaining information on export possibilities largely from various Trade Missions abroad. This was done by channeling requests through the Ministry of Commerce to various Trade Missions abroad—a long process whose inevitable delay could not have led to satisfaction in those requiring the information.

With regard to local marketing the Centre preoccupies itself in assisting the Ministry by obtaining data of costs, prices and marketing of local industrial products. Such studies were made in respect of about 20 to 30 local industrial products . . . . .

. . . . . No doubt, several local persons were assisted by providing information on export possibilities but this information could and should have been provided quicker, if not better, by a properly organised Ministry of Trade. On local marketing certain useful preliminary studies have been done and this probably is the first time that a State sponsored organisation has made any studies in this field. Here again the scope had to be limited due to inadequate staff and the assignment of existing staff to various external assignments." (Page 10)

6.7.21 Here again this study is in basic disagreement with the observation of the Committee that the market information could have been left to the Ministry of Trade. One would agree, that basically marketing and export promotion are two legitimate functions of the Ministry of Trade among many others. But it is also important to point out, that the function of trade of the whole country encompass such a wide variety and array of work that the small demand of a few manufacturers would tend to get lost in the bureaucratic structure of a large Ministry. Therefore, it would seem better, that a separate body, concentrate on the special needs of the emerging industrialists especially those of the small and medium sized manufacturers with the active cooperation of the Ministry of Trade. It is only then that these needs could be administered with the urgency and importance it deserves, as a special body that is specially empowered with specific functions would have the necessary drive and commitment to do so.
6.7.22 The Industrial Estates Function: From what the Committee observes it would suffice here to say that the IDB was 'left carrying the baby' for the planning mistakes of the relevant ministries in the initial planning of these industrial estates. The Committee criticises the role of the IDB for the misfortunes of planning of the industrial estates by stating, 'it is extremely regrettable that a professional body like the IDB should have permitted itself to be bulldozed into setting up the Pallekelle, Boosa, and Atchuvelly industrial estates without prior investigation of these projects.' This observation is not entirely fair, due to the fact that in practice the IDBC was never a separate entity of its own with a permanent full time Managing Director. As the Committee investigation found, the Chairman of the Board of Directors of the IDB, who was at the same time the Director of Development of the Ministry of Industries and Fisheries, had the final say in all the activities of the IDB. In effect as the Committee also observed there was no delegation of authority to any one below him. Therefore the only conclusion one could come to, was that, the IDB despite its battery of functions and despite its creation as a State Corporation acted most of the time as a sub-department of the Ministry of Industries.

6.7.23 In conclusion it has to be said, the apparent failure of the IDB to become a viable institution was not the fault of the functions delegated to it, but the fault of its general structure and its administration. Added to this when an independently constituted body is made to become 'everybody's dogsbody' the result would obviously end in disaster. In the terms of an analogy, it would not suffice to find fault with the fruit a tree bears, if no heed was given to the care of this tree from seedling state to maturity. To right the fault, three alternatives are open, either to
cut the whole tree down, or be satisfied with the fruit it bears, or grow another tree of the same kind with adequate care from the first stage. Alternative three in the view of this study is the most important, for the functions vested, in the IDB were important and necessary for the success of industry in the country. Thus it is of paramount importance that a new institution should rise up from the ashes of the old. Therefore this study endorses the recommendation of the Committee to make the IDB confine its functions to the promotion and development of small and medium sized industry. However, this study is not entirely in agreement with functions proposed for this Small Industries Development Board by the Committee.

6.8. The Department of Industries Small Industries Loans Scheme

6.8.1 This scheme envisaged to provide financial assistance to individual industrialists, industrial workshops, industrial cooperative societies and Unions. This scheme was given prominence around 1962 and was put into operation by the Department of Rural Development and Small Industries. The basic features were a system of loans on plant, machinery and equipment to be purchased on hire purchase basis, without the usual requirements of security. Only handicrafts, cottage industries, and small scale industries were eligible for financial assistance under the scheme. Loans were granted both for the development of existing and the establishment of new units. Individual loans had a maximum of Rupees 3000 while cooperative unions had no upper limit.

6.8.2 This scheme was terminated in 1968. Its failure was due to its structural weaknesses, that were built into the system from the start, and shoddy administration. For example, there was no assessment of

1. By industry it is meant here, more the small and medium sized firms than large private and State industries.
2. See section 9.2.
loans on the basis of creditworthiness, eligibility or usefulness, neither were the bona-fides of the collateral or that of the loan guarantors checked, nor did the scheme ensure a legally 'water-tight' contract or agreement. From available evidence, loans seem to have been granted, to any person who called himself an industrialist and had the recommendation of the Government Revenue Officer of the district, and an inspection report from one of the Department's inspection officers. In some instances even if the inspection report was adverse it was ignored. The overall result has been a scandalous waste of resources. Nearly Rupees II.5 million was lent over a period of six years and by mid 1971 there was still a sum roughly around 8.5 million outstanding. Due to the absence of even a proper record of the loans given and dues collected, there is a likelihood of nearly half the outstanding loans being written off as bad debts.

6.9. THE DEPARTMENT OF SMALL INDUSTRIES

6.9.1 In considering the activities of this Department only a passing reference is given here, as today this term 'Small Industries' when applied to this Department becomes a 'misnomer'. Today it deals with only cottage industries and handicraft industries. There are neither advisory functions nor financial functions provided by it to the small industries. Its activities are concentrated more on the administration, management and organisation of hand-loom and power-loom textiles and cottage industries.

6.10. THE SHARE MARKET

6.10.1 Chapter four outlined the development of the market and its present limitations. The present activities of the market do not help the small and medium sized industrialists to raise funds through new issues. This is a consequence of the high cost and the limited number of
buyers. The latter seem to contribute as much as the cost of flotation, to keep the prospective industries away. As a result of the insular nature of the market, stocks quoted in the market are closely held by 'well to do' groups of investors and any new shares that come into the market, are always snapped up by the self same groups.

6.10.2 The result has been that small entrepreneurs are apprehensive about opening up their companies to these powerful groups, because of the fear that even with less than controlling shares, these groups with their powerful financial backing and influential status in the society, are likely to influence the business decisions of the firms, usurping real control from the original owners. Another reason is that most entrepreneurs who had started small, and through their own labor and effort has brought the firm into a state of growth, are extremely reluctant to open up their firms to outside equity holders. Finally, the low velocity of circulation of existing stock and the depressed share prices of existing stock due to reasons given in chapter four, has resulted in the dearth of new investors in the market.

6.II. DEPARTMENT OF INLAND REVENUE (TAXES, INCENTIVES AND OTHER FISCAL MEASURES)

6.II.I There are a number of taxes and fiscal measures which apply to industry as a whole, out of which some are unfavourable to the small firm. It is not the intention here to survey the whole tax structure but only an attempt is made to outline those that directly affect small firms. They are,

1. Tax holidays
2. Business turnover tax
3. Income tax
4. The FEEC scheme
6.II.2 The Government introduced tax holidays for industrial undertakings which commenced production prior to April 1969 and to those undertakings which commenced production on or after first April 1969. In the case of both groups the profits of the firms are exempt from tax for a period of five years from the date of commencement of production or manufacture, while at the same time all dividends declared out of the exempt income during the period of the tax holiday are exempt from income tax in the hands of the shareholders.

6.II.3 In the case of the former group they would qualify for this exemption, provided they satisfy the following conditions,

(a) it must be an undertaking for the production or manufacture in Ceylon of goods and commodities,

(b) the undertaking must not be formed by the splitting up or reconstruction of an existing business,

(c) the undertaking must employ more than twenty five persons

(d) the goods or commodities produced or manufactured by the undertaking must be certified to be of satisfactory quality by an authority

(e) the prices at which the goods or commodities are sold must be certified to be of satisfactory quality by an authority.

In the case of the latter in addition to the above conditions the following conditions have to be satisfied.

(f) the undertaking should have obtained approval from the Director of Industrial Development prior to second August 1968

(g) acquired or entered into a contract to acquire land or acquired or entered into a contract to acquire plant, machinery and fixtures or acquired or erected or entered into a contract to acquire or erect a

1. If and when an authority is prescribed for this purpose.
factory building for the purpose of the undertaking.
(h) the undertaking should commence production before a date specified by the Director of Industrial Development.

6.11.4 The conditions (b) and (c) above tended to exclude many small firms from qualifying for this exemption. In section 7.I.I it is mentioned that some converted their early businesses into manufacturing ventures, these were also precluded from qualifying for this exemption. Clause (c) effected most small firms as at the commencement of many businesses the number of employees were less than twenty five persons.

6.11.5 Those small companies that had to pay tax, were however given relief on the following basis, i.e. (i) when the issued capital of a resident company does not exceed Rupees 250,000 at any time during the year preceding the year of assessment, then, (a) if the assessable income of the company exceeds Rupees 50,000 the tax payable is restricted to one half of the company rate, that is 25 per cent of the assessable income.
(b) if the assessable income of the company exceeds Rupees 50,000 the tax payable is restricted to the aggregate of (i) 25 per cent of Rupees 50,000 and (ii) taxable income less Rupees 50,000.

6.11.6 Clause (i,b) above in certain circumstances would be diametrically opposite to a tax relief. In terms of a hypothetical example if a company has a taxable income of (say) Rupees 80,000; in the case of a company without tax relief, 50 per cent of this income will be liable for tax, i.e. Rupees 40,000. On the other hand, in the case of a company qualifying for relief (case (b) above) the first Rupees 50,000 will be taxed at half the company rate which is Rupees 12,500 and the balance Rupees 30,000 (Rs.80,000 less Rs.50,000) will be taken as tax, making a total of Rupees 42,500, thus making the company with the tax relief pay
Rupees 2,500 more than the former. Therefore this exemption would be outside those fast growing small and medium sized firms, which are those very firms the tax authorities intended to give assistance. Thus the tax incentives fall outside some of the nascent firms which need assistance at the initial stage of the business, as a result of clause (b) and (c) of the qualification measurements, while in the case of special assistance to small firms clause (b) above exempt the rapidly growing firm.

6.11.7 Another tax which affects small firms is the Business Turnover Tax. This is payable by every person whose turnover from a business (including the business of a manufacturer) carried out by him in Ceylon, is not less than Rupees 100,000. Certain businesses are partly exempt from falling within this tax, for example, the production of industrial machinery and a few consumer goods falling under the 'essential' category, i.e. products of milk, sugar etc. In the case of manufactured goods, the taxes are levied with differential rates on 'specified' goods, with the percentage of tax ranging from 1 to 10 per cent. According to the items listed considerable amount of small and medium sized manufacturers fall into the 10 per cent bracket.

6.11.8 Among the fiscal measures that affected the small and medium sized firms more than large firms, is the Foreign Exchange Entitlement Certificates (FEECs) scheme introduced in 1968. The purpose of the scheme was mentioned in section 2.5.6. On the whole it has been a successful scheme and is an intelligent piece of legislation. However, any successful scheme has its disadvantages and most of these disadvantages fell to the lot of the small firm. The small firms were hit in the following manner. Prior to the introduction of the scheme, firms importing items of raw material were subjected to pay a license duty of 10 per cent of the CIF value of the goods
imported, in most cases the bank were ready to lend this sum to the importer to clear the goods from the Customs' warehouse. The introduction of this scheme subjected the importer to pay FEECs for every Rupee of foreign exchange used (the rate being a premium of 55 per cent on every Rupee value of the import).

Taking a hypothetical case, for example, if the CIF value of the goods were £100, prior to the introduction of the goods, the importers' commitment was a duty of 10 per cent or £10. Once the scheme was introduced the importers' commitment was a duty of 55 per cent or he had to find funds to the amount of £55, which meant an increase of 45 per cent from the previous level. Earlier the banks were ready to accommodate the firms to raise the 10 per cent duty, but the banks with the introduction of the scheme refrained from providing accommodation. Thus many small and medium sized firms found it extremely difficult to raise funds. There is considerable evidence to support that small firms were hit hardest by the FEEC scheme especially during the first few months of the introduction of this scheme.

6.12. THE CENTRAL BANK OF CEYLON

6.12.1 Central banks in most developing countries, apart from their traditional roles of Central banking, have to play a more active role in the economic development of the country. This is a view that has gained more support in recent years due to the underdeveloped nature of most financial institutions in developing countries. The problems in developing countries is amplified due to the needs of rapid development in every sector of the economy. Thus while all sectors with the active aid of the Governments are striving to accelerate the process of development, financial institutions have opted to remain conservative and develop on the lines of institutions that are in existant in developed countries. This position would have been justified if the country also envisaged economic development over a long period of time with a time span of, for example 100 years.
However, as this is not the case, the desire for, and the action taken in moving the economy as rapidly as possible as outstripped economic activity, ahead of the activities of the banks. This has created a gap between the ability of the institutions to meet the financial needs of the economy. This is the main reason why there is a strong case for the involvement of the Central Bank, in the development needs of the country, instead of the Bank limiting its activities to its traditional role. Therefore one of its functions ought to be to take an active role in moulding the banks and other financial institutions according to the requirements of the economy by direct and indirect encouragement of the institutions to deviate from their traditional roles which they have espoused from activities of similar institutions in developed countries.

6.12.2 At the present time the activities of the Central Bank does not specifically enhance the availability of credit to small and medium sized firms. The survey showed that the credit restriction policies of the Bank affect in the overall the small firms more than the large firms. This is so, despite the Bank exempting advances of not less than three year duration granted for the development of agriculture and industry from coming within credit ceilings applied to commercial banks from time to time. This is due to two main reasons, (i) In times of general credit restrictions small firms are affected due to the raising of the already strict standards for loan qualification, while there is the likelihood of the banks to satisfy more established customers. (ii) The development loans which are exempted from the ceiling does not specifically direct the banks to lend only to small and medium sized industry, as a result in the scramble for accommodation the larger firms and the subsidiaries of the larger firms get the better of the independent small and medium sized firms.
6.12.3 Since 1964, the Bank has operated a new scheme of refinance facilities for banks and other long term credit institutions. This was undertaken with a view to stimulate the flow of medium and long term credit for the promotion of development of industry, agriculture and commerce. Term loans given by banks and other institutions for these purposes were refinanced by the Bank on the strength of promissory notes payable on demand and secured by the pledge of the debt owed to the lending institution by the borrower. As in the case of other directives the generality of the provision does not in any way guarantee that more loans are given to the small and medium firm sectors, but these firms have to vie with others in a tight race for accommodation. As the loans are given on very conservative and strict levels of security which distinctively favour the established large firm which in Ceylon are the firms that could qualify for accommodation for a loan in normal circumstances. Further the refinance loans which are given to the only institution that does a considerable amount of industrial lending, i.e. DFCC, go to large firms as their minimum loan limit is Rupees 100,000.

6.13. THE AGRICULTURAL AND INDUSTRIAL CREDIT CORPORATION

6.13.1 The AICC commenced business in 1943 with the primary purpose of granting loans for purchase and redemption of debt of property to individuals and corporate bodies for agricultural and industrial purposes. As table 47 shows, in its first twenty five years of existence the total lent to industry has been insignificant and the bias in lending has been towards agriculture. For example, of the total lent from 1943 to 1970 of approximately Rupees 117,379,000 only a sum of Rupees 16,745,000 or roughly 14.2 per cent has been lent for industrial purposes. Even of this meagre total of Rupees 16 million, nearly Rupees 9 million was lent to the
<table>
<thead>
<tr>
<th>Period</th>
<th>Agricultural Purposes</th>
<th></th>
<th>Industrial Purposes</th>
<th></th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount Rs. '000</td>
<td>% of</td>
<td>Amount Rs. '666</td>
<td>% of</td>
<td>Rs. '000</td>
</tr>
<tr>
<td>1944 - 46</td>
<td>3,152</td>
<td>94.3</td>
<td>192</td>
<td>5.7</td>
<td>3,344</td>
</tr>
<tr>
<td>1947 - 48</td>
<td>2,356</td>
<td>91.2</td>
<td>257</td>
<td>9.8</td>
<td>2,613</td>
</tr>
<tr>
<td>1948 - 49</td>
<td>2,013</td>
<td>92.9</td>
<td>215</td>
<td>7.1</td>
<td>3,028</td>
</tr>
<tr>
<td>1949 - 50</td>
<td>6,062</td>
<td>92.5</td>
<td>493</td>
<td>7.5</td>
<td>6,555</td>
</tr>
<tr>
<td>1950 - 51</td>
<td>8,599</td>
<td>90.9</td>
<td>856</td>
<td>9.1</td>
<td>9,455</td>
</tr>
<tr>
<td>1951 - 52</td>
<td>8,294</td>
<td>80.9</td>
<td>1,957</td>
<td>19.1</td>
<td>10,251</td>
</tr>
<tr>
<td>1952 - 53</td>
<td>6,702</td>
<td>75.8</td>
<td>2,170</td>
<td>24.2</td>
<td>8,872</td>
</tr>
<tr>
<td>1953 - 54</td>
<td>5,216</td>
<td>94.5</td>
<td>302</td>
<td>5.5</td>
<td>5,518</td>
</tr>
<tr>
<td>1954 - 55</td>
<td>5,351</td>
<td>90.3</td>
<td>575</td>
<td>9.7</td>
<td>5,926</td>
</tr>
<tr>
<td>1955 - 56</td>
<td>5,823</td>
<td>92.0</td>
<td>482</td>
<td>8.0</td>
<td>6,305</td>
</tr>
<tr>
<td>1956 - 57</td>
<td>3,614</td>
<td>89.9</td>
<td>405</td>
<td>10.1</td>
<td>4,019</td>
</tr>
<tr>
<td>1957 - 58</td>
<td>3,213</td>
<td>89.5</td>
<td>377</td>
<td>10.5</td>
<td>3,590</td>
</tr>
<tr>
<td>1958 - 59</td>
<td>3,434</td>
<td>75.7</td>
<td>1,104</td>
<td>24.3</td>
<td>4,538</td>
</tr>
<tr>
<td>1959 - 60</td>
<td>4,479</td>
<td>87.7</td>
<td>631</td>
<td>12.3</td>
<td>5,110</td>
</tr>
<tr>
<td>1960 - 61</td>
<td>2,640</td>
<td>82.4</td>
<td>562</td>
<td>17.6</td>
<td>3,202</td>
</tr>
<tr>
<td>1961 - 62</td>
<td>2,028</td>
<td>86.4</td>
<td>319</td>
<td>13.6</td>
<td>2,347</td>
</tr>
<tr>
<td>1962 - 63</td>
<td>2,816</td>
<td>81.4</td>
<td>632</td>
<td>18.6</td>
<td>3,448</td>
</tr>
<tr>
<td>1963 - 64</td>
<td>3,948</td>
<td>82.4</td>
<td>829</td>
<td>17.6</td>
<td>4,777</td>
</tr>
<tr>
<td>1964 - 65</td>
<td>4,701</td>
<td>88.5</td>
<td>610</td>
<td>11.5</td>
<td>5,311</td>
</tr>
<tr>
<td>1965 - 66</td>
<td>3,725</td>
<td>94.5</td>
<td>215</td>
<td>5.5</td>
<td>3,940</td>
</tr>
<tr>
<td>1966 - 67</td>
<td>2,576</td>
<td>72.8</td>
<td>951</td>
<td>27.2</td>
<td>3,527</td>
</tr>
<tr>
<td>1967 - 68</td>
<td>2,079</td>
<td>78.9</td>
<td>660</td>
<td>21.1</td>
<td>2,739</td>
</tr>
<tr>
<td>1968 - 69</td>
<td>3,615</td>
<td>87.0</td>
<td>494</td>
<td>12.1</td>
<td>4,109</td>
</tr>
<tr>
<td>1969 - 70</td>
<td>3,398</td>
<td>69.9</td>
<td>1,457</td>
<td>30.1</td>
<td>4,855</td>
</tr>
</tbody>
</table>

Source: Agricultural & Industrial Credit Corp.
<table>
<thead>
<tr>
<th>Type of Industry</th>
<th>Amount in Rupees.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tea Factories</td>
<td>2,584,650</td>
</tr>
<tr>
<td>Rubber Factories</td>
<td>831,130</td>
</tr>
<tr>
<td>Coconut Mills (Dessicated coconut, Copra, Fibre)</td>
<td>3,791,116</td>
</tr>
<tr>
<td>Rice and other Grain Milling</td>
<td>721,600</td>
</tr>
<tr>
<td>Fishing</td>
<td>22,000</td>
</tr>
<tr>
<td>Food, Drink, and Tobacco</td>
<td>1,551,000</td>
</tr>
<tr>
<td>Mines and Quarries</td>
<td>872,500</td>
</tr>
<tr>
<td>Animal and Poultry Foods</td>
<td>25,000</td>
</tr>
<tr>
<td>Mechanized Fishing Craft</td>
<td>15,000</td>
</tr>
<tr>
<td>Bricks and Tiles</td>
<td>662,099</td>
</tr>
<tr>
<td>Timber and Carpentry</td>
<td>462,079</td>
</tr>
<tr>
<td>Refrigeration</td>
<td>16,500</td>
</tr>
<tr>
<td>Textile (clothing)</td>
<td>397,500</td>
</tr>
<tr>
<td>Textile (except clothing)</td>
<td>25,000</td>
</tr>
<tr>
<td>Tannery and Leather Goods</td>
<td>416,000</td>
</tr>
<tr>
<td>Iron and Steel Goods (excluding machinery)</td>
<td>345,246</td>
</tr>
<tr>
<td>Metalware (excluding machinery and equipment)</td>
<td>168,350</td>
</tr>
<tr>
<td>Soap and Toilet Goods</td>
<td>330,000</td>
</tr>
<tr>
<td>Rubber Goods</td>
<td>65,000</td>
</tr>
<tr>
<td>Plastic Goods</td>
<td>30,000</td>
</tr>
<tr>
<td>Engineering</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Safety Matches</td>
<td>118,000</td>
</tr>
<tr>
<td>Drugs</td>
<td>203,750</td>
</tr>
<tr>
<td>Confectionary</td>
<td>110,500</td>
</tr>
<tr>
<td>Clocks and Watches</td>
<td>125,000</td>
</tr>
<tr>
<td>Gas Mantles</td>
<td>23,000</td>
</tr>
<tr>
<td>Ceramics</td>
<td>50,000</td>
</tr>
<tr>
<td>Packaging</td>
<td>121,000</td>
</tr>
<tr>
<td>unclassified</td>
<td>207,831</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>16,129,342</strong></td>
</tr>
</tbody>
</table>

Source: Agricultural & Industrial Credit Corporation.
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Loans</td>
<td>32,082,072</td>
<td>31,952,475</td>
<td>31,646,314</td>
<td>30,577,541</td>
<td>30,864,391</td>
</tr>
<tr>
<td>3. Cash and Other Assets</td>
<td>1,897,950</td>
<td>2,394,808</td>
<td>3,065,753</td>
<td>4,347,215</td>
<td>4,366,329</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>34,046,922</td>
<td>34,414,183</td>
<td>34,778,967</td>
<td>34,991,656</td>
<td>35,297,620</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Treasury Advances</td>
<td>29,350,000</td>
<td>29,351,500</td>
<td>29,351,500</td>
<td>29,350,000</td>
<td>29,350,000</td>
</tr>
<tr>
<td>2. Reserve Fund</td>
<td>3,157,574</td>
<td>3,451,253</td>
<td>3,729,969</td>
<td>4,948,990</td>
<td>4,192,960</td>
</tr>
<tr>
<td>3. Contingencies Fund</td>
<td>526,830</td>
<td>600,250</td>
<td>669,929</td>
<td>724,684</td>
<td>735,676</td>
</tr>
<tr>
<td>4. Profit &amp; Loss Account</td>
<td>1,646</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>5. Provision for Taxation</td>
<td>684,454</td>
<td>720,715</td>
<td>771,174</td>
<td>713,226</td>
<td>318,796</td>
</tr>
<tr>
<td>6. Other Liabilities</td>
<td>326,418</td>
<td>290,465</td>
<td>256,395</td>
<td>254,756</td>
<td>650,188</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>34,046,922</td>
<td>34,414,183</td>
<td>34,778,967</td>
<td>34,991,656</td>
<td>35,297,620</td>
</tr>
</tbody>
</table>

Source: Agricultural & Industrial Credit Corporation.
plantation sector and other extractive industries, such as tea, rubber, coconut, grain-milling and fishing. The balance of about Rupees 6 million went to manufacturing industry. (see table 48)

6.13.2 The poor record of this institution apart from other factors, has been the founding limitations imposed on its capital structure. (see section 4.4) Table 49 shows its assets and liabilities at present. Since 1965, its capacity to lend for a year, has been limited roughly to Rupees 5 million a year which comprise of capital repayments and interest received on earlier loans. Out of its present lending portfolio the share to industry is very small, for example, in 1969 out of the total lent of Rupees 4,109,979 outstanding, only Rupees 494,380 went into the industrial sector. Secondly, apart from the capital limitation, the limiting clause on acceptable security, i.e. primary mortgage of property, narrows the field of lending even further. The third barrier to lending has been the fact, that from its inception the AICC has been concentrating more on lending to agriculture, as a result their credit intelligence division has been more attuned to agricultural lending while the field of industrial lending is underdeveloped. The ability to understand and appreciate the latter type of finance is further limited due to the absence of credit intelligence facilities in the country, especially in the field of industrial lending. All these factors have limited the staff conversant with industrial finance.

6.13.3 The end result has been that, it has become an organisation content at making a marginal profit out of its limited resources and its activities are static in terms of development financing. Its present activities are a far cry from the intentions the framers had in mind for this organisation.
6.14. THE DEVELOPMENT FINANCE CORPORATION OF CEYLON (DFCC)

6.14.1 The DFCC as it is presently run, has become another provider of capital to well established large and medium sized firms. As its first fifteen years of existence it has accommodated only 153 loans amounting to roughly Rupees 85.9 million and participated only in 31 share participation of these firms, amounting to approximately Rupees 9.3 million making a grand total of Rupees 95.2 million. Thus their average yearly participation has been only about Rupees 6.4 million. From the table, one could see that this total had been inflated due to the large number of loans granted during the fiscal year 1969 - 1970.1

6.14.2 Table 51 below shows the size of loans granted. The majority of the loans granted have been for large firms and medium sized firms in the upper range of the size classification of this study. For example, the table shows that a total of Rupees 53 million or 59.6 per cent of the total lent belonged to the size range one million and over, to 26 borrowers, a total of Rupees 63 million or 31.1 per cent in the size range between Rupees 250,000 to one million, and the balance of Rupees 9.7 million or 9.3 per cent under Rupees 250,000.2 In this last category too it can be presumed that the loans were given to large and medium sized firms as the assets cover sought in their lending is on an average 1:1.5.

Technically, only those firms in the first one per cent of the small firm size range as classified in this study would qualify for loans from the DFCC. However, as most small firms have already some debt capital, the net asset figure would be even less. Therefore most small firms categorized in

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1. See table 50
2. The size range in table 51, of below 100,000 belong to those firms who had already received accommodation of loans over Rupees 100,000.
### TABLE 50

**DFCC - FINANCIAL ASSISTANCE APPROVED**

(from inception thro' Dec. 1969)

<table>
<thead>
<tr>
<th>Fiscal Year(1)</th>
<th>Loans</th>
<th>Share Investments</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>Amount Rs.'000</td>
<td>No.</td>
</tr>
<tr>
<td>1957 (10 mts.)</td>
<td>6</td>
<td>4,310</td>
<td>3</td>
</tr>
<tr>
<td>1958</td>
<td>11</td>
<td>3,375</td>
<td>6</td>
</tr>
<tr>
<td>1959</td>
<td>13</td>
<td>3,700</td>
<td>4</td>
</tr>
<tr>
<td>1960</td>
<td>12</td>
<td>6,680</td>
<td>1</td>
</tr>
<tr>
<td>1961</td>
<td>11</td>
<td>3,405</td>
<td>2</td>
</tr>
<tr>
<td>1962</td>
<td>4</td>
<td>1,240</td>
<td>3</td>
</tr>
<tr>
<td>1963</td>
<td>16</td>
<td>5,903</td>
<td>4</td>
</tr>
<tr>
<td>1964</td>
<td>6</td>
<td>4,385</td>
<td>1</td>
</tr>
<tr>
<td>1965</td>
<td>12</td>
<td>3,935</td>
<td>2</td>
</tr>
<tr>
<td>1966</td>
<td>10</td>
<td>3,065</td>
<td>-</td>
</tr>
<tr>
<td>1967</td>
<td>8</td>
<td>2,350</td>
<td>1</td>
</tr>
<tr>
<td>1968</td>
<td>10</td>
<td>9,254</td>
<td>2</td>
</tr>
<tr>
<td>1969</td>
<td>23</td>
<td>21,186</td>
<td>1</td>
</tr>
<tr>
<td>1970 (9 mts.)</td>
<td>11</td>
<td>13,120</td>
<td>1</td>
</tr>
</tbody>
</table>

Total 153 85,908 31(2) 9,336(2) 184 95,244(3)

*Source: Development Finance Corporation of Ceylon.*

**Notes:**

1. The fiscal year is from April 1st to March 31st. Thus fiscal year 1969 means the period from April 1st, 1968 to March 31st, 1969.

2. The references here is for fiscal years unless otherwise indicated.

(2) Net of cancellations. Gross approvals aggregated 32 share investments for Rs. 9,611,000.

(3) The proportion of types of assistance in total business was as follows: Loans = 90.2 per cent and Share Investments = 9.8 per cent.

(*) These figures include Share Investments of Rs. 15,100, and Rs. 301,250, in the years 1957 and 1959 respectively, out of amounts of Rs. 600,000, and Rs. 350,000, in respect of two share issues which the DFCC fully underwrote during the above two years.
### Table 31

**DFCC Loans by Size & Industrial Branch 1956 - 1969**

<table>
<thead>
<tr>
<th>Size Range</th>
<th>Loans No.</th>
<th>Amount Rs.'000</th>
<th>Share Investments No.</th>
<th>Amount Rs.'000</th>
<th>Total Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below Rs. 100,000</td>
<td>19</td>
<td>1,060</td>
<td>1.2</td>
<td>308</td>
<td>1,368</td>
</tr>
<tr>
<td>Rs. 100,000 - 249,999</td>
<td>45</td>
<td>6,987</td>
<td>8.1</td>
<td>1,450</td>
<td>8,437</td>
</tr>
<tr>
<td>Rs. 250,000 - 499,999</td>
<td>41</td>
<td>12,808</td>
<td>14.9</td>
<td>2,301</td>
<td>15,109</td>
</tr>
<tr>
<td>Rs. 500,000 - 999,999</td>
<td>22</td>
<td>13,944</td>
<td>16.2</td>
<td>3,552</td>
<td>17,496</td>
</tr>
<tr>
<td>Rs. 1,000,000 -</td>
<td>11</td>
<td>12,301</td>
<td>14.3</td>
<td>2,000</td>
<td>14,301</td>
</tr>
<tr>
<td>Rs. 1,500,000 &amp; above</td>
<td>15</td>
<td>38,808</td>
<td>45.3</td>
<td>-</td>
<td>38,808</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>153</strong></td>
<td><strong>85,908</strong></td>
<td><strong>100.0</strong></td>
<td><strong>9,611</strong></td>
<td><strong>95,519</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Industrial Branch</th>
<th>Loans No.</th>
<th>Amount Rs.'000</th>
<th>Share Investments No.</th>
<th>Amount Rs.'000</th>
<th>Total Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chemical Products</td>
<td>12</td>
<td>10,982</td>
<td>600</td>
<td>11,582</td>
<td>12.1</td>
</tr>
<tr>
<td>Textiles</td>
<td>7</td>
<td>12,248</td>
<td>1,900</td>
<td>14,148</td>
<td>14.8</td>
</tr>
<tr>
<td>Electrical Products</td>
<td>9</td>
<td>5,510</td>
<td>1,652</td>
<td>7,162</td>
<td>7.5</td>
</tr>
<tr>
<td>Hotels (1)</td>
<td>3</td>
<td>6,620</td>
<td>700</td>
<td>7,320</td>
<td>7.7</td>
</tr>
<tr>
<td>Building Materials</td>
<td>8</td>
<td>6,111</td>
<td>750</td>
<td>6,861</td>
<td>7.2</td>
</tr>
<tr>
<td>Ready-made Garments</td>
<td>20</td>
<td>6,345</td>
<td>300</td>
<td>6,645</td>
<td>7.0</td>
</tr>
<tr>
<td>Food</td>
<td>17</td>
<td>9,317</td>
<td>708</td>
<td>10,025</td>
<td>10.5</td>
</tr>
<tr>
<td>Engineering</td>
<td>15</td>
<td>3,948</td>
<td>1,300</td>
<td>5,248</td>
<td>5.5</td>
</tr>
<tr>
<td>Rubber Products</td>
<td>7</td>
<td>4,417</td>
<td>100</td>
<td>4,517</td>
<td>4.7</td>
</tr>
<tr>
<td>Printing and Packaging</td>
<td>15</td>
<td>4,070</td>
<td>200</td>
<td>4,270</td>
<td>4.5</td>
</tr>
<tr>
<td>Large-scale Agriculture</td>
<td>4</td>
<td>3,350</td>
<td>-</td>
<td>3,350</td>
<td>3.5</td>
</tr>
<tr>
<td>Beverages</td>
<td>7</td>
<td>2,290</td>
<td>601</td>
<td>2,891</td>
<td>3.0</td>
</tr>
<tr>
<td>Metal Products</td>
<td>11</td>
<td>3,555</td>
<td>50</td>
<td>3,605</td>
<td>3.8</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>18</td>
<td>7,145</td>
<td>750</td>
<td>7,895</td>
<td>8.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>153</strong></td>
<td><strong>85,908</strong></td>
<td><strong>9,611</strong></td>
<td><strong>95,519</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Development Finance Corporation.

(1) and (2) do not belong to the industrial sector, but are included here to show the direction of total amount lent during the period.

Note also that in the case of share investments, the gross amount approved is used.
this study would not qualify to receive a loan from the DFCC.

6.14.3 Examining its other activities, it has used its function of underwriting share issues only in the case of two flotations, and this too was done in its early years. It has scarcely used its other powers, such as underwriting debentures and other securities, guaranteeing loans from other investment sources, nor has it actively assisted in obtaining managerial, technical and administrative services or given advice to the business sector, except in case of those they have financed. Lastly, it has not made many attempts to use its local knowledge to introduce foreign investors to suitable local investors.

6.14.4 The only defence it could make against this poor showing is, that constant change in economic policy objectives, the resulting uncertainty in investment circles, and the constant crises of foreign exchange has obstructed its activities. However, this would not fully exonerate its inactivity as in the first place it was set up to be a development bank with wide objectives, foremost among them being to be the spearhead of industrial development. The DFCC cannot complain about any deficiency in its structure for its poor lending record. For, it has an authorised share capital of Rupees 24 million out of which only Rupees 8 million has been issued, has access to Central Bank re-finance facilities, Bank of Ceylon block loans, and lines of credit from the IBRD. Further it has been empowered to issue its own debentures or borrow from any international body and all its international borrowings are guaranteed by the Government.

6.14.5 In 1971 the DFCC requested the IBRD to reduce the lines of credit made available to it. The reasons given for this decision were,

1. See table 50 footnote(4)
(a) the cancellation of approvals given by the Government to some industries
(b) the withdrawals of other proposed projects by other clients.

It is true that there were a certain amount of project withdrawals
due to the uncertainty of future Government policy and a considerable
amount of hesitancy in the private sector to invest in new projects or
expansion of those already in existence. However, what is important is
what was left unsaid, namely, the DFCC being the suocour of large firms
and those medium sized firms in the upper range, it is not surprising that
they could not find enough clients in these sectors, as the number of
clients in these sectors are limited. Further, quite a number of them at
this level are already well established with adequate internal fund
generation, while at the same time they have ready accommodation from
the banks and access to the share market. It is also important to keep
in mind that in a small country like Ceylon, taking into consideration its
economic and geographical size, it is an exception rather than the rule that
new ventures at the outset are floated as large concerns. The DFCC to
consider its lowest loan limit of Rupees 100,000 the recipient has to match
it by his own funds or funds from another source of atleast 1.5 times this
sum. In the context of Ceylon, Rupees 250,000 at the inception of a firm
or Rupees 100,000 for expansion of an already established firm is a large
sum at one single moment of time.

6.14.6 Thus in effect it has merely become another institution
in the credit structure of the country having carved itself a special
niche in the credit structure of the country with its activities over-
whelmingly concentrated in lending to large business. When considering
its wide access to fund sources (see section 6.14.4) its activities in
disbursing these resources to a selected clientele is really a mis-
representation of its founding ideal and misuse of funds in a development sense. For, its client selection due to its self imposed limitations on lending is limited in the majority of the cases to a class of firms who by their standing and structure can well afford to raise capital by public issues and have access to most commercial bank funds.

6.14.7 The DFCC as it is presently run has alienated itself from the purpose for which it was originally founded and from similar organisations in other parts of the world. The underlying assumption of most development banks and special institutions set up in other countries is to help those firms who are unable to raise funds by way of public issues or from other existing sources at reasonable rates. The overall result has been that development funds both local and foreign available for long term financing of industry is mustered by the DFCC and siphoned to well established firms and a few large new ventures at relatively reasonable interest rates. This has deprived those firms who are in need of funds and have no access to any other source of funds.

6.15. GENERAL CONCLUSION

6.15.1 The general conclusions drawn from this section on the availability of credit from the financial institutions, Government and other sources are that the credit structure in the country is heavily weighted against the small and medium sized firms. The successive Governments since independence have not made a concerted attempt to identify or understand the problems of small firm financing, except in the case of cottage and handicraft industries.

6.15.2 The foreign banks principally concentrate on the commercial sector. In the case of the two indigenous banks, the Bank of Ceylon, concentrates more on the commercial sector and the term loans given
to the industrial sector, is in the majority of the cases to established business. The People's Bank, although in its early years accommodated to the smaller firms, this tendency has been decreasing over the years, as it grew into maturity and weaned itself away from this sector and began to concentrate in attracting larger establishments in competition with the Bank of Ceylon. Further the recommendations of the People's Bank Commission of 1965, made it turn once again to fulfil the functions it was principally set up to do, namely, provide finance to the agricultural sector.

6.15.3 In the case of the long term credit institutions, namely, the AICC and DFCC, the former is limited in its lending activities due to its fund limitations and moreover most of its available funds are directed to agricultural pursuits while the little funds that come to the industrial sector are limited in their use by the recipients, i.e. for purchase of land and buildings. The DFCC has exempted itself from financing the small firm sector.

6.15.4 Apart from the Banks and the long term credit institutions, other financial intermediaries available to the small and medium sized firms are either limited or non-existent. The stock market is underdeveloped and beyond the reach of the small firm. The hire-purchase and finance houses lending to this sector is insignificant. The Central Bank has not made any attempts to direct loans to this sector. The Government concentrates on the credit problems of the State Corporations, agricultural sector, the cooperatives and to some extent the cottage industries. Further there is a general belief in Government circles that the small firms could look after themselves, that they do not have financial problems and if there were any problems the banks could adequately satisfy their needs.
CHAPTER 7

THE FIRMS IN THE SURVEY

7. 1.  INTRODUCTION
7. 2.  PROFILE OF FIRMS
7. 3.  THE SURVEY
7. 4.  GENERAL CONCLUSION
7.1 INTRODUCTION

7.1.1 The majority of the firms in the survey were of recent origin as shown in table 52 below. This could be said to hold true of small and medium sized firms in general due to the short history of industrialisation in Ceylon. Among those who went into manufacturing business in the early 1960's, there were two types of entrepreneurs, namely, those that did not have any experience of business or manufacturing enterprises, and those who had already gained some experience and business acumen as traders, retailers, and through working in business establishments.

7.1.2 In the case of the latter, from the onset of push by the State, some of these business ventures were converted into manufacturing establishments. This change in the direction of business from trading to manufacturing had both advantages and disadvantages. The advantages were, that they had already gained an insight into the world of business, established contacts with producers, retailers, sales organisations, banks, Government institutions, and also accumulated a certain proportion of finance needed to establish the new business. On the other hand there were disadvantages, as quite a number of the new industrialists took it for granted that manufacturing establishments could be run on the same lines as their businesses which they had experience of previously, i.e. retailing, wholesale, and import and export business.

7.1.3 The financing of these trades were straightforward and simple, and were usually of a short term nature. Further the accounting systems were simple, while in some cases the accounting systems were intermingled with their personal finances of the household. Long term financing of the type needed for manufacturing were quite foreign to them, nor were they fluent in the intricacies of company finance and management.
accounts. On the personnel side too, they were more used to office staff and sales personnel than factory labour. They were also foreign to the ideas of quality of product, customer satisfaction, and after sales service. As earlier most of them were dealing with imported goods, where the quality was more less guaranteed, there was a body of customers for each branded good, and the foreign firm selling the goods took care of advertisement and after sales service. Thus all factors which necessarily influence the profitability of a firm, as well as the factors contributing to efficiency were taken more or less for granted.

7.1.4 In the case of those who came into manufacturing for the first time, it was their first hesitant steps into the world of business. Although they had a disadvantage as compared to the former, as they lacked business acumen and contacts gained by the tradesmen, they were not influenced as that group in mixing their business strategy with that of normal trading ventures. They on the other hand, had to learn their business at first hand from the very beginning. It could be said therefore they got a better grounding in business strategy and management, as more effort was made by them at the initial stages to learn the correct techniques of financing, administrative and management procedures, despite the learning process being dotted with many mishaps. However, most early business successes went to the tradesmen, and although latter events showed that a number of these were short lived, there were instances where the newcomers followed the example of the tradesmen, who formed the peer group, and learned wrong techniques, and business dodges practiced by them, which were detrimental to the business community as a whole.

7.2. PROFILE OF SMALL FIRMS

7.2.1 The survey gave a profile of the early financing of the
of the firms which could be generally applied to most small and medium sized firms in Ceylon. Most firms had founded their businesses with the greater proportion of their initial capital being drawn from personal and private sources, i.e. their personal savings and wealth, those of other businesses if any, pooling of resources of family and relatives, sale of property and other possessions. Available evidence showed that most of the businesses had very small beginnings, and these private sources alone were inadequate to meet the requirements of the business during the initial 'take-off' period. As described earlier there were two types of entrepreneurs, in the case of those who converted a going business concern into a manufacturing firm, they found it easier to find finance at the initial stage as already they had established business custom with bank and trade creditors and had income and savings from their previous trade. Therefore these firms took an early start in the industrial scene. In the case of those who started from the very bottom, they had to depend in most instances on private finance, their own funds, and those of family and relatives. In a number of cases funds were raised at considerable hardship and sacrifice to entrepreneur and his family. The total quantum of funds raised from these sources were not very large, and they necessarily had to start the business on a small scale.

7.2.2 At the initial stage of the business all firms attempted to obtain outside institutional finance to supplement what they had raised from other sources. They did not have much option or choice as the number of institutions were few and their activities were limited, in fact the only source available to them were the commercial banks. The first problem faced both by the lender and the borrower arose at this point, namely, bank loans were principally of a short term nature, and in addition industrial financing of the type desired by the new industries being somewhat foreign to their
normal lending, they were quite hesitant to lend to them, especially to the new small business. The entrepreneurs were desirous of getting long term accommodation and there were no long term credit institutions catering to their needs. This led to the adoption of various devious practices by some firms to get the necessary long term finance they needed for their business.

7.2.3 The short term character of the bank loan and the hesitancy of the banks to lend, were circumvented by the entrepreneurs in two ways. In the first case, in converting short term accommodation for long term purposes, most of them resorted to the mechanism of what is called in Ceylon 'rolling money'. The procedure which is followed in practice in obtaining funds by the above method is as follows. When a bank loan or advance is contracted and the funds are lent for a short term purpose, these funds are siphoned off for use in long term investment. This normally creates the problem of repayment of capital and interest at due dates, i.e. when the income generated by the use of these funds take longer than the maturity time of these loans. Therefore in order to meet their obligations of interest and capital repayments at due dates, the firm seeks a second loan or temporary accommodation either from the same bank or another, or from private sources such as business acquaintances, finance companies, or private money lenders. Part of this second loan is used to meet the obligations of the first, and once the first loan is paid up, they would be eligible for another loan from the first source. This loan, as previously would be used partly in the business and to meet the obligations of the second, and if the business in the meantime generates income from the investment made with the original (first) loan, the 'rolling money' phase becomes smaller and smaller. In 80 per cent of the firms interviewed this method of financing at the initial
stage of the business, was resorted to at least once.

7.2.4 In the second case, the hesitancy of the banks to grant loans to manufacturing business was circumvented by entrepreneurs, by contracting a loan seemingly for a different purpose in view. Bank loans for commercial, consumption purposes, and agricultural development were easier to get than for a purely industrial (manufacturing) venture. Therefore manufacturers in the guise of obtaining loans for consumption purposes, house building, livestock farming, improvement of land and property, etc., were utilising at least a part of these loans in their manufacturing business. They were indirectly aided in this by the insufficient control banks had on the end use of loans.

7.2.5 These two methods of financing have been justifiably criticized by the lending institutions, and do not appear prudent or honest in terms of financial integrity, that has come to be associated with modern business. However, instead of condemning these actions outright, there are grounds to condone these actions on the circumstances under which they were practiced. Criticism is justifiable, if there were adequate sources available to the entrepreneur, despite which, these practices were resorted to by the borrowers. But as mentioned earlier, the avenues for long term finance available to them being meagre or sometimes non-existant, the criticism directed at these plays of the businessmen by the lenders is in fact a criticism against the existing financial structure.

7.2.6 The general profile of the survey firms was that 40 per cent owned their factory premises, while the balance rented the premises from private owners or were located in the Government industrial estate at Ekala. In the majority of the cases the factory and the administrative offices were at the same location, while the rest had separate offices in
the city. Among those who owned factory premises, i.e. 40 per cent, 31 per cent owned the land singularly or was joint family property before the commencement of the business, while the balance 9 per cent had acquired the land specially for the purpose of the business. The premises were acquired in most cases with the aid of an institutional loan combined with other savings. The factory buildings of most small firms in the survey, were not of a sophisticated nature nor, specifically, type buildings as seen in developed countries. Machinery initially required to commence production was bought on credit terms from overseas suppliers, usually on 180 days credit, with a bank acting as the intermediary. The bank guarantee was usually acquired by a process of mortgaging the machinery against the bank terms received.

7.2.7 In examining what has been said so far, the initial phase of the firm was the first critical stage in the business, for, they had exhausted their security, all available funds were tied up in the business, and they were faced with a number of loan commitments. This also left them in a considerable weak position with regard to future financial needs, as the ratio of own capital to debt capital had reached limits over which prudent lenders would not normally lend. Finally, the result of short term funds having being used for long term purposes, introduced a considerable degree of illiquidity, and strain on the firms' to generate adequate funds early, to pay back these short term obligations. At this stage many firms were vulnerable, and were not able to stand up to many mistakes or any extraneous influences in the economy such as, duties, foreign exchange restrictions, quotas on raw materials, all of which affected them. Some firms failed at this level, while in many others a stagnation factor was introduced which was bound to effect them in the future.
7.2.8 The basic disequilibrium created by these methods of financing, and the inadequacy of finance at this stage began to show its effects after a few years, especially due to the interaction of extraneous factors such as new duties and quotas, exchange control, and other tariffs. Many of the shortcomings of the firm was a result of absence of continuity of Government industrial policy. The shortcomings and the inability to cope with some of them, contributed to the failure and stagnation at the second phase of the firms' existence. However, in conclusion here, it must be mentioned that the failure and stagnation of some firms, cannot solely be blamed on the lack of financial facilities and the absence of a continuous policy, or wrong Government priorities. Some firms which failed were the result of their own excesses and have to blame themselves for the problems they created for the firms. For example, some firms did not foresee or failed to appreciate the normal cycle of business a firm has to undergo, namely, that very few businesses are immediately successful and that in the ordinary course of the business, a firm has to go through a transitional period during which losses are to be expected and even be planned for at the early stages.

7.2.9 The tables 52, 53, and 54 classify the survey firms, according to the age of firms, type of business and legal status of the firms, while table 55 that follow shows a cross classification of the firms according to the age, legal status and size of firms. These tables are given here to give a general idea of the profile of the hundred firms interviewed during the survey, the results of which will be discussed in the following pages.

1. See for example, sections 2.4.13 to 2.4.14 in Chapter 2.
## TABLE 52

**AGE OF FIRMS IN THE SURVEY**

<table>
<thead>
<tr>
<th>Year of Commencement of Business</th>
<th>Number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before 1948</td>
<td>6</td>
</tr>
<tr>
<td>Between 1949 - 1954</td>
<td>9</td>
</tr>
<tr>
<td>&quot; 1955 - 1960</td>
<td>27</td>
</tr>
<tr>
<td>&quot; 1961 - 1965</td>
<td>50</td>
</tr>
<tr>
<td>&quot; 1966 - 1970</td>
<td>8</td>
</tr>
<tr>
<td>Total...</td>
<td>100</td>
</tr>
</tbody>
</table>

## TABLE 53

**TYPE OF BUSINESS OF SURVEY FIRMS**

<table>
<thead>
<tr>
<th>Type of business</th>
<th>Number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Manufacturing</td>
<td>53</td>
</tr>
<tr>
<td>2. Processing</td>
<td>6</td>
</tr>
<tr>
<td>3. Manufacturing/Processing/Assembly</td>
<td>33</td>
</tr>
<tr>
<td>4. Manufacturing/Processing/Service</td>
<td>8</td>
</tr>
<tr>
<td>Total....</td>
<td>100</td>
</tr>
</tbody>
</table>

## TABLE 54

**LEGAL STATUS OF SURVEY FIRMS**

<table>
<thead>
<tr>
<th>Legal Status</th>
<th>Number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proprietorship</td>
<td>20</td>
</tr>
<tr>
<td>Partnership</td>
<td>5</td>
</tr>
<tr>
<td>Private limited liability</td>
<td>69</td>
</tr>
<tr>
<td>Public limited liability</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
<tr>
<td>Age</td>
<td>No. of Firms</td>
</tr>
<tr>
<td>-------------</td>
<td>--------------</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Before 1948</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>1949 - 1954</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>1955 - 1960</td>
<td>27</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<tr>
<td>1961 - 1965</td>
<td>50</td>
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<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>1965 - 1970</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
7.3 THE SURVEY

7.3.1 The survey questionnaire contained twenty-three questions. The answers to these questions are given below. In the light of the answers given by the firms interviewed partial analysis and evaluations are made under each numbered question. Further evaluation than attempted in this chapter is made in Chapter Eight, and conclusions are drawn on the problems of finance of firms by bringing together the results from this survey and the other two interview-surveys, i.e. the Financial institution and the General interview-survey, together with both published and unpublished material on this subject.

7.3.2 Question One: Please enter in the cages provided, the amounts of capital from various sources, and their uses, if you can readily quantify them for the year 1970.

<table>
<thead>
<tr>
<th>Sources</th>
<th>Total</th>
<th>Uses</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Personal savings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Owners family (wife/husband) &amp; children</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Owners brothers and Sisters</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Directors Loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Other, e.g. Trade Credit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Earnings of business retained</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Commercial Banks (name them)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(h) Long-Term Financial Institutions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Hire-purchase and Finance Co.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(j) Shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(k) Government Development loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(l) Insurance Companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(m) Private Investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(n) Money lenders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(o) Other</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The firms found it difficult to identify and quantify the amounts of capital used for various purposes from the various sources given above. Apart from this inability to get accurate data it was also felt that they were hesitant to identify the exact amount of finance received from each source. The reason for this hesitancy may be due to the prospect of having to
divulge confidential details of the firm's resources, sources of funds and directions of utilisation, in order to answer this question fully. Only about 17 per cent of the firms were able to give comprehensive details of the sources, totals, and their uses. The original purpose of this question was to estimate the dependence of small firms on different sources, quantum of funds received from each source and the direction of their utilisation for one year (1970) and if this was successful, to make efforts to obtain similar details for previous years. As the attempt to get data even for one year was not successful, this exercise was not fruitful.

7.3.3 The results that were obtained in answer to this question give only the source of funds which were used for, (a) investment purposes, i.e. enlarging and modernisation of premises, purchase of plant and equipment increasing and training of workforce, product improvement, and (b) working capital purposes. The two tables, number 56 and 57, show the different sources used by the firms for long and short term purposes during the year 1970.

**TABLE 56**

SOURCE OF FUNDS USED FOR INVESTMENT PURPOSES IN 1970

<table>
<thead>
<tr>
<th>Source</th>
<th>No. of firms</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special Financial Institutions</td>
<td>11</td>
<td>8</td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>42</td>
<td>32</td>
</tr>
<tr>
<td>Private finance Companies</td>
<td>14</td>
<td>11</td>
</tr>
<tr>
<td>Other private sources</td>
<td>17</td>
<td>13</td>
</tr>
<tr>
<td>Reserves and Profits</td>
<td>35</td>
<td>27</td>
</tr>
<tr>
<td>Own private funds</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td><strong>Total...</strong></td>
<td><strong>131</strong> *</td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Note: (*) the total does not add up to 100 firms, as some firms used two or more sources.

By investment, it is meant here funds that had a duration of over one year.
### TABLE 57
**SOURCE OF FUNDS FOR SHORT TERM PURPOSES - 1970**

<table>
<thead>
<tr>
<th>Source</th>
<th>Number of firms</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>69</td>
<td>40</td>
</tr>
<tr>
<td>Internal funds</td>
<td>38</td>
<td>22</td>
</tr>
<tr>
<td>Private self finance</td>
<td>26</td>
<td>15</td>
</tr>
<tr>
<td>Other private funds</td>
<td>12</td>
<td>7</td>
</tr>
<tr>
<td>Inter-business finance</td>
<td>18</td>
<td>11</td>
</tr>
<tr>
<td>Other</td>
<td>9</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>172</strong>*</td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

*Note: (*) the total does not add up to 100 firms as some firms have used more than one source.*

7.3.4 These figures show, that for both short and long term purposes the firms depend heavily on the banks. For example, percentage-wise, table 56 shows that 32 per cent of the time, the firms had turned to banks for investment funds, followed by 27 per cent of the time to internal funds and only 8 per cent of times to long term credit institutions. In the case of short term funds too the firms depend principally on bank funds as shown in the above table with a percentage of 40 per cent.

7.3.5 Though usually banks do not lend on a long term basis, and technically most loans contracted are for shorter periods, the firms themselves have converted some of these loans into medium term duration. This in a way accentuates the desperate situation of the firms, and their hunger for long term accommodation, when they are compelled by force of circumstances to convert short term accommodation into uses which are less liquid. Thus the firms knowingly creates a 'liquidity trap' for themselves, while this in turn contributes to the creation of a 'credibility gap' in the minds of the lenders, in terms of financial resource allocation and the
financial maturity of the firms.

7.3.6 Tables 58 and 59 shows a cross classification of the above data, with the age, legal status and size of firms. This throws more light on the sources, and the type of firm that finds accomodation from these sources. For example, in the case of loans over one year, there seems to be a close association with the age of firms and the accessibility of long term credit. The breakdown of the eleven loans utilised, from the long term credit institutions is as follows,

<table>
<thead>
<tr>
<th>Age Group</th>
<th>No. of Firms</th>
<th>No. Accommodated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before 1948</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>1945-54</td>
<td>9</td>
<td>2</td>
</tr>
<tr>
<td>1955-60</td>
<td>27</td>
<td>3</td>
</tr>
<tr>
<td>1961-65</td>
<td>50</td>
<td>2</td>
</tr>
<tr>
<td>1966-70</td>
<td>8</td>
<td>-</td>
</tr>
</tbody>
</table>

The evidence here is inconclusive to draw firm conclusions, but there appears to be close connections between established business which are old in years, are limited liability companies, and are medium in all three size categories and their accessibility to funds from institutional lenders for long term purposes.

In the case of the commercial banks too, there is evidence to support this statement. For example, all firms that were older in terms of date of commencement of business, medium in terms of size, and limited liability companies were accommodated, i.e. out of the 42 that had accommodation, with the exception of one partnership, and two proprietary firms, all were limited liability companies, while only ten (10) firms out of the 42, fell into the category small in terms of all three size measures.

7.3.7 Table 58 also underlines the institutional gap in long term accommodation, in terms of age, legal status, and size of firms. Most firms which turned into other avenues of finance, i.e. private finance

---

1. Although the statistics given in the tables (56 and 57) do not show the number of attempts made, all firms said that they have attempted to get institutional accommodation before attempting other avenues.
### Table 58

**Classification of Sources of Finance (over one year) for 1970 according to age, legal status & size of firms**

<table>
<thead>
<tr>
<th>Source</th>
<th>Before Legal Status</th>
<th>Size</th>
<th>49/54</th>
<th>L.S</th>
<th>Size</th>
<th>58/60</th>
<th>L.S</th>
<th>Size</th>
<th>61/65</th>
<th>L.S</th>
<th>Size</th>
<th>66/70</th>
<th>L.S</th>
<th>Size</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Special Financial Institutions</td>
<td>3 Pub.</td>
<td>MM</td>
<td>2</td>
<td>I P/ty.</td>
<td>MM</td>
<td>3</td>
<td>I Pub.</td>
<td>MM</td>
<td>2</td>
<td>I Pub.</td>
<td>MM</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>II</td>
</tr>
<tr>
<td>2. Commercial Banks</td>
<td>2 I P/ty.</td>
<td>MM</td>
<td>2</td>
<td>3 P/ty.</td>
<td>MM</td>
<td>3</td>
<td>3 P/ty.</td>
<td>MM</td>
<td>20</td>
<td>2 P/ty.</td>
<td>MM</td>
<td>2</td>
<td>2 P/ty.</td>
<td>SSS</td>
<td>42</td>
</tr>
<tr>
<td>3. Private Finance Companies</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3</td>
<td>2 P/s</td>
<td>SSS</td>
<td>8</td>
<td>4 P/ty.</td>
<td>SSS</td>
<td>3</td>
<td>2 P/ty.</td>
</tr>
<tr>
<td>4. Other Private Sources</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>I</td>
<td>I P/s</td>
<td>SSS</td>
<td>I3</td>
<td>10 P/ty</td>
<td>SSS</td>
<td>3</td>
<td>3 P/ty</td>
<td>SSS</td>
<td>I7</td>
<td></td>
</tr>
<tr>
<td>5. Reserves &amp; Profits</td>
<td>2</td>
<td>2 Pub.</td>
<td>MMM</td>
<td>4 I P/ty.</td>
<td>MM</td>
<td>4</td>
<td>4 P/ty.</td>
<td>SSS</td>
<td>8</td>
<td>P/ty.</td>
<td>SSS</td>
<td>2</td>
<td>2 P/ty.</td>
<td>SSS</td>
<td>I7</td>
</tr>
<tr>
<td>6. Own Funds</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>4</td>
<td>2 Prop.</td>
<td>SSS</td>
<td>7</td>
<td>7 Prop.</td>
<td>SSS</td>
<td>I</td>
<td>I Prop.</td>
<td>SSS</td>
<td>I2</td>
</tr>
<tr>
<td><strong>Total...</strong></td>
<td>8</td>
<td>II</td>
<td>37</td>
<td>67</td>
<td>3</td>
<td>131</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

Key: **Legal Status:** Pub. = Public limited liability  
**P/ty.** = Private  
**P/s** = Partnership  
**Prop.** = Proprietorship  
**Size:** L, M, and S, stands for Large, Medium and Small and denotes size according to three size measures, with the three letters denoting size by employment, capital, and turnover in that order.

(*) The total does not add up to 100 firms as some firms have used more than one source.
<table>
<thead>
<tr>
<th>Source</th>
<th>Before Legal Status</th>
<th>Size 49/54 L.S</th>
<th>Size 55/60 L.S</th>
<th>Size 61/65 L.S</th>
<th>Size 66/70 L.S</th>
<th>Size Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2 I &quot; LNM</td>
<td>2 I Pvt. MMM</td>
<td>3 I Pvt. MMM</td>
<td>4 I MMM</td>
<td>2 &quot; &quot; SSM</td>
<td>5 I MMM</td>
</tr>
<tr>
<td></td>
<td>2 Pvt. MMM</td>
<td>4 I &quot; SSM</td>
<td>2 I &quot; SSM</td>
<td>2 I &quot; SSM</td>
<td>2 I &quot; SSM</td>
<td>6 I SSM</td>
</tr>
<tr>
<td></td>
<td>1 P/s SSS</td>
<td>5 I SSS</td>
<td>2 Prop. SSS</td>
<td>2 Prop. SSS</td>
<td>I P/s SSS</td>
<td>12 &quot; SSS</td>
</tr>
<tr>
<td>2. Internal Funds</td>
<td>6 Pub. MMM</td>
<td>6 3 Pvt. MMM</td>
<td>11 4 Pvt. SSS</td>
<td>14 I Pub. MMM</td>
<td>1 I Pvt. SSS</td>
<td>6 I Pvt. SSS</td>
</tr>
<tr>
<td></td>
<td>1 P/s MMM</td>
<td>2 I &quot; SSM</td>
<td>2 I &quot; SSM</td>
<td>2 I &quot; SSM</td>
<td>4 Prop. SSS</td>
<td></td>
</tr>
<tr>
<td></td>
<td>I Prop. SSS</td>
<td>2 I Pub. MMM</td>
<td>3 P/s SSS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Self Finance</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>4 I Pvt. SMM</td>
<td>9 2 Pvt. SSS</td>
<td>12 6 Pvt. SSS</td>
<td>1 I Pvt. SSS</td>
<td>2 Prop. SSS</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2 Pvt. SMM</td>
<td>4 Prop. SSS</td>
<td>12 6 Prop. SSS</td>
<td>1 Pvt. SSS</td>
<td>2 Prop. SSS</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2 Prop. SSS</td>
<td>2 Prop. SSS</td>
<td>2 Prop. SSS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Private</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>3 I Prop. SSS</td>
<td>2 I Prop. SSS</td>
<td>2 Prop. SSS</td>
<td>2 Prop. SSS</td>
<td>2 Prop. SSS</td>
<td></td>
</tr>
<tr>
<td>5. Inter-Business</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>2 2 Pvt. SSS</td>
<td>16 13 Pvt. SSS</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6. Other</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>2 2 Prop. SSS</td>
<td>3 Prop SSS</td>
<td>4 2 Prop. SSS</td>
<td>2 Prop. SSS</td>
<td>2 Prop. SSS</td>
<td></td>
</tr>
<tr>
<td>Total...</td>
<td>II</td>
<td>18</td>
<td>46</td>
<td>82</td>
<td>15</td>
<td>172</td>
</tr>
</tbody>
</table>

Size: L, M, and S, stands for Large, Medium, and Small and denotes size according to the three size measures, with the three letters denoting size by Employment Capital and Turnover, in that order.

(+) The Total does not add up to 160 firms (i.e., size of sample) as some firms have used more than one source.
companies, other private sources, own funds, were those which were young in age and small in terms of all three size measures. Further the majority were also partnerships and proprietorships. It can be rightly concluded that the main reason these firms turned to these sources were, that they did not have accommodation from long term credit institutions and commercial banks. This is supported by the fact that private loans were usually at higher interest rates than rates prevailing among institutional lenders. Two main reasons could be put forward for this direction of borrowing, i.e. (a) the inadequacy of institutional sources, and (b) the inability of the firms to meet the conditions of the loans.¹ Both these reasons hold true in the case of commercial banks, and in the case of the DFCC, two other factors eliminate most small firms from obtaining loans, namely, (i) their minimum lending limit of Rs. 100,000, and (ii) their restriction of loans only to limited liability companies.

7.3.8 In the case of short term loans too, the distribution of loan accommodation among the firms follow a similar pattern. Table 59 shows the loans received classified according to, age of firms, legal status and size. Here too there points to a preference by the banks to lend to established firms in terms of age, legal status, and size. For example, according to the size classification in the survey, sixty firms fell into the category small, in terms of all three size categories², and among the firms accommodated here, only thirty four firms fell into this category. In the whole survey there were twenty proprietorships and five partnerships³, and table 59 shows that bank accommodation has been received by only ten proprietorships and three partnerships, while all others who received accommodation were either public or private limited liability companies. In terms of age too, all the firms

¹ With regard to (b) above, it has to be taken into account that some firms would have failed to qualify themselves for loans even if the conditions were relaxed.
² See table. 32.
³ See table. 54.
which were established before 1954, and who sought loans were accommodated.

7.3.9 Table 59, further underlines the direction of accommodation of small firms, especially partnerships, proprietorships and those private limited liability companies who fall into the size category small, in terms of all three size measures. These firms seem to have turned more often to other sources than to banks, although the banks are the chief source of funds available to them. However, the absence of adequate facilities from the banks, make them seek other avenues despite the fact that these sources are more costly than the banks. The data available here is too meagre and inconclusive to derive any specific conclusions but from the answers given here, there points to a definite gap in credit from institutional sources, in terms of both short and long term funds. This seem to underline, both an absence of adequate lending institutions and the difficult prospect of access to the meagre funds available from the limited sources.

7.3.10 Question Two: What type of finance listed below is most difficult to obtain?

<table>
<thead>
<tr>
<th>Type of Finance</th>
<th>Cannot get</th>
<th>Very difficult</th>
<th>Difficult</th>
<th>No difficulty</th>
<th>Did not try</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Short term working capital (under one year)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Bank overdrafts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Long term - 1 to 5 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) &quot; - over 5 &quot;</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Hire-purchase finance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Leasing finance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Other, e.g. Seasonal and bridging finance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This question aimed to gather information on the degree of difficulty experienced by survey firms in getting different types of finance from the available sources. Table 60 shows the answers received to this question.
TABLE 60

EXPERIENCE OF SURVEY FIRMS IN GETTING LOANS OF DIFFERENT MATURITIES

<table>
<thead>
<tr>
<th>Maturity Time</th>
<th>Cannot get</th>
<th>Very difficult</th>
<th>Difficult</th>
<th>No Difficulty</th>
<th>Did not try</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 5 years</td>
<td>55</td>
<td>34</td>
<td>6</td>
<td>2</td>
<td>3</td>
<td>100</td>
</tr>
<tr>
<td>1 to 5 &quot;</td>
<td>15</td>
<td>42</td>
<td>38</td>
<td>4</td>
<td>1</td>
<td>100</td>
</tr>
<tr>
<td>Under 1 year</td>
<td>-</td>
<td>56</td>
<td>28</td>
<td>16</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>Overdrafts</td>
<td>24</td>
<td>49</td>
<td>10</td>
<td>10</td>
<td>7</td>
<td>100</td>
</tr>
<tr>
<td>Bridging and</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seasonal Finance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance</td>
<td>19</td>
<td>37</td>
<td>20</td>
<td>15</td>
<td>9</td>
<td>100</td>
</tr>
</tbody>
</table>

Note: This table does not include the answers given to hire-purchase finance and leasing finance. In the case of the former it was not relevant as hire-purchase finance to the industrial sector is insignificant, the few times they have resorted to these companies were for financing of commercial vehicles, and according to those who obtained such accommodation, no great difficulty was experienced in getting the sum desired. In the case of the latter, this method of financing is still underdeveloped in the country and there were no instances where the survey firms had utilized this type of finance.
It must be kept in mind when examining this table that the contents of this table cannot be taken at face value, as a number of other factors apart from the size of the firm, age and legal status, could have been responsible for these experiences. For example, it has not been possible to establish, whether they had equal credit merit with others who received accommodation at the time of the loan request. However, it gives a general idea of the unsatisfied demand for credit and the impressions of the sector, on different types of loans available.

7.3.11 Examining this table according to the age of firms, legal status and size, i.e. table 61, it shows interesting results, namely, the responses of the firms vary according to age, legal status and in most instances according to size. There points to a definite relationship that the degree of difficulty experienced by long established joint stock companies is much less than firms at the other end of the scale, i.e. young joint stock companies and all partnerships and proprietorships. For example, the only firms answering 'not difficult' to all types of finance (five types given here) were public limited liability companies and a few long established private limited liability companies, the majority of them founded before 1954. In terms of size too, there showed a similar trend, i.e. those firms which answered that different types of finance is, 'not available' or 'very difficult', or 'difficult' to get were small firms in terms of all three size categories.

7.3.12 For example, in the case of loans over five year duration, out of the fifty-five(55) firms that answered that they cannot get such loans, forty one (41) were firms which fell into the category small in terms of all three size categories. Further, comparing the answers according to the legal status of the firms, it shows that all partnerships (five in number)
<table>
<thead>
<tr>
<th>No. of</th>
<th>Age -</th>
<th>Age -</th>
<th>Age -</th>
<th>Age -</th>
<th>Age -</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responses</td>
<td>Before Legal Status</td>
<td>Size</td>
<td>49/54 Legal Status</td>
<td>Size</td>
<td>55/60 Legal Status</td>
</tr>
<tr>
<td>A B C D E</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>55</td>
<td>- - -</td>
<td>3 Prop. 2 SSS</td>
<td>14</td>
<td>5 Prop.</td>
<td>5 SSS</td>
</tr>
<tr>
<td>34</td>
<td>1 1 Pvt. 1 100</td>
<td>5</td>
<td>5 Pvt. 1 100</td>
<td>12</td>
<td>19 Pvt.</td>
</tr>
<tr>
<td>6</td>
<td>3 2 Pvt. 1 100</td>
<td>1</td>
<td>1 Pub.</td>
<td>1 100</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>2 2 Pub. 2 100</td>
<td>- - -</td>
<td>- - -</td>
<td>- - -</td>
<td>-</td>
</tr>
<tr>
<td>6</td>
<td>3 1 Pvt. 1 100</td>
<td>1</td>
<td>1 Pub.</td>
<td>1 100</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>1 1 Pvt. 1 100</td>
<td>6</td>
<td>1 Pub.</td>
<td>1 100</td>
<td>12</td>
</tr>
<tr>
<td>16</td>
<td>4 1 Pvt. 1 100</td>
<td>1</td>
<td>1 Pub.</td>
<td>1 100</td>
<td>1</td>
</tr>
<tr>
<td>10</td>
<td>- - -</td>
<td>2 Prop. 2 SSS</td>
<td>13</td>
<td>10 Prop.</td>
<td>10 SSS</td>
</tr>
<tr>
<td>49</td>
<td>- - -</td>
<td>1 Prop. 1 SSS</td>
<td>18</td>
<td>3 Prop.</td>
<td>3 SSS</td>
</tr>
<tr>
<td>10</td>
<td>- - -</td>
<td>4 Prop. 1 SSS</td>
<td>4</td>
<td>4 Pvt.</td>
<td>4 SSS</td>
</tr>
<tr>
<td>7</td>
<td>- - -</td>
<td>2 Pvt. 2 100</td>
<td>1</td>
<td>1 Pub.</td>
<td>1 100</td>
</tr>
<tr>
<td>19</td>
<td>- - -</td>
<td>3 Prop.</td>
<td>3 SSS</td>
<td>10</td>
<td>8 Prop.</td>
</tr>
<tr>
<td>17</td>
<td>- - -</td>
<td>1 Pvt. 1 100</td>
<td>12</td>
<td>2 Pvt. 2 SSS</td>
<td>22</td>
</tr>
<tr>
<td>20</td>
<td>- - -</td>
<td>4 Pvt. 1 100</td>
<td>6</td>
<td>6 Pvt.</td>
<td>6 SSS</td>
</tr>
<tr>
<td>15</td>
<td>1 1 Pvt. 1 100</td>
<td>3</td>
<td>1 Pub.</td>
<td>1 100</td>
<td>4</td>
</tr>
<tr>
<td>9</td>
<td>- - -</td>
<td>1 Pvt. 1 100</td>
<td>3</td>
<td>2 Prop. 2 SSS</td>
<td>2</td>
</tr>
</tbody>
</table>

**Notes:** Responses: A = Cannot Get, B = Very difficult, C = Difficult, D = Not difficult, E = Did not try

SIZE: SIZE IS DETECTED AS SMALL, MEDIUM, LARGE AND AVERAGE IN THE FOLLOWING ORDER: 10 OF EMPLOYMENT, CAPITAL, TOURNAMENT, SIZES.
and proprietorships (twenty in number), among the survey firms were unable to get credit over five year duration. In the case of loans between one to five five years, all fifteen who answered that they cannot get loans fell into the size category small in terms of all three size measures, and in terms of legal status, three were partnerships, nine were proprietorships, and the other three were private firms. In the case of overdrafts and bridging and seasonal finance, there were similar relationships as shown in table 61. It is only in the category of loans under one year that no firm expressed that it was unable to get loans, however, fifty six firms expressed the view that it was difficult, and here too all partnerships and proprietorships were among those who answered so.

7.3.13 In conclusion it must be said that no further attempt is made to draw relationships between the degree of difficulty and age, legal status, and size of firms, than attempted here, due to the uneven size of the sample when broken into different categories. For example, in terms of age there were only six firms founded before 1948, as against nine firms founded between 1949 to 1954, twenty seven firms between 1955 to 1960, fifty firms between 1961 to 1965, and eight firms between 1966 to 1970. In terms of legal status, twenty firms were proprietorships, five partnerships, as much as sixty nine private limited liability companies and only six public companies.

7.3.14 Taking all these into consideration, no conclusive analysis can be made from the data collected on the effect of age and legal status of firms on the availability of financial facilities, nor is it pertinent to make any generalisations. What is achieved here, shows only the existence of a relationship between age, legal status, and size of firms, and the degree of difficulty experienced by the survey firms.
7.3.15 **Question Three**: What in your opinion are the main difficulties you encounter with regard to borrowing. (some are listed below, add any other that come to your mind)

(a) Security demanded by the lender
(b) Satisfy lender with regard to feasibility of project
(c) " " " " " profitability
(d) " " " " " viability
(e) " " " " " your creditworthiness
(f) Inability to offer guarantors which lenders require
(g) " " get guarantors to a loan
(h) " " get loans at reasonable interest rates
(i) Difficulty of accessibility to large finance houses
(j) Other reasons (please name them)
(k) " "

(A = very difficult, B = difficult, C = reasonable, though difficult, D = no difficulty, E = Don't know or no comment)

This question turned out to be one of the most important in terms of the information the question brought out in answer. The answers to this question gave a wealth of information on the difficulties faced by the firms in outside loan accommodation. The firms were first requested to express the degree of difficulty against each item taken into consideration by the lenders before they considered granting a loan. This was followed by an investigation in the form of a discussion on the reasons for the choice of answer. The analysis that follows is a summary of the answers given by the firms to each condition of loan.

7.3.16 Table 62 compiled from answers to question three, shows the degree of difficulty as expressed by survey firms on the conditions required by lenders.
TABLE 62
THE DEGREE OF DIFFICULTY FACED BY SURVEY FIRMS
IN QUALIFYING FOR THE CONDITIONS OF LOANS

<table>
<thead>
<tr>
<th></th>
<th>Very Difficult</th>
<th>Difficult</th>
<th>Reasonable</th>
<th>No though difficult</th>
<th>Difficulty</th>
<th>Do'nt Know/ No Comment</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security</td>
<td>71</td>
<td>12</td>
<td>8</td>
<td>9</td>
<td>-</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Feasibility of Project</td>
<td>20</td>
<td>11</td>
<td>1</td>
<td>6</td>
<td>62</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Viability of firm</td>
<td>42</td>
<td>27</td>
<td>13</td>
<td>18</td>
<td>-</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Profitability</td>
<td>53</td>
<td>18</td>
<td>11</td>
<td>15</td>
<td>3</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>General Creditworthiness</td>
<td>64</td>
<td>14</td>
<td>8</td>
<td>12</td>
<td>2</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Guarantors</td>
<td>61</td>
<td>19</td>
<td>15</td>
<td>5</td>
<td>-</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Gurantors</td>
<td>70</td>
<td>10</td>
<td>17</td>
<td>3</td>
<td>-</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

7.3.17 Security: Ninety one of the firms felt that the biggest difficulty was the provision of acceptable security demanded by the lenders. As mentioned in Chapter six, the difficulty of giving adequate weight to feasibility and viability of a venture or a project, coupled with the inadequate attention given to the end use of a loan, left the lenders with little choice, therefore security for a loan necessarily become the most important consideration for accommodation. This aspect of lending has not changed much over the years.

7.3.18 Table 63 shows the types of security accepted by banks and the rates of interest that are applied to each type of security. It shows that Government securities are the cheapest form of security for a loan or
<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Government Securities</td>
<td>3 5</td>
<td>5.5 7</td>
<td>5.5 7</td>
<td>5.75 8.5</td>
<td>5.75 8.5</td>
<td>6.5 9.5</td>
<td>6.5 9.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Stock in Trade</td>
<td>4.5 8</td>
<td>6 9</td>
<td>6 9</td>
<td>7 9.5</td>
<td>7.5 II</td>
<td>8.5 I2</td>
<td>8.5 I2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Shares in J.S.C's</td>
<td>4.5 7</td>
<td>7 9</td>
<td>7 9</td>
<td>9.5 7 I0</td>
<td>9 II</td>
<td>9 II</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Immovable Property</td>
<td>4.5 7.5</td>
<td>7 9.5</td>
<td>7 I0</td>
<td>7 9.5</td>
<td>7 I0</td>
<td>8 II</td>
<td>8 II</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Other</td>
<td>3.5 8</td>
<td>5 I0</td>
<td>7 9</td>
<td>5.5 II</td>
<td>6 II</td>
<td>6.5 I2</td>
<td>6.5 I2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Unsecured</td>
<td>4.5 8</td>
<td>7 9</td>
<td>6.5 9.5</td>
<td>7 I0</td>
<td>7.5 II</td>
<td>8.5 I2</td>
<td>8.5 I2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Central Bank of Ceylon.
advance. Although security termed 'other' also has a minimum rate as low as Government securities, loans given on the security of directors' guarantees, and those of other shareholders, and third party guarantees, all of which come under the category of 'other', are rare. It is more often taken as added collateral for a loan. In the event that some loans are considered on this basis alone, it would be only in the case of very liquid loans to long established customers. In the case of small firms, Government paper (securities) fall outside their sphere of activity, as shown in Chapter four, i.e. most Government securities are held by institutional lenders and savings institutions. Shares in joint stock companies are also rarely held by small firms, usually they are held by well to do investors and well established companies. Further, as a result of the depressed nature of the share market, most small firms and investors do not wish to hold company shares, as their transaction valued is limited. Apart from the difficulty of finding primary security, the firms found it difficult to provide sometimes collateral security demanded by lenders such as directors guarantees, as the shareholders and directors of small companies belonged to the social strata which was outside that known to banking circles.

7.3.19 The only two avenues available to most small firms are stock in trade (movable property) and land, buildings and fixtures (immovable property). To those, who do not own the premises in which the factory is situated even the latter is beyond them. Stock in trade is good enough for short term loans, but even here the amount of the loan in terms of the value of security offered is lower. On the other hand, firms which could offer immovable security is faced sometimes with insurmountable problems. For example, as mentioned earlier, up to very recent times, land which was offered as security had to have a clear title going back to hundred years,
with the exception of a Crown grant. As a result of this condition, the verification of title to land took considerable time, especially due to the deficiencies in the system of title registration and documentation of property titles.1

7.3.20 As seen in Chapter four, section 4.4, the AICC accepts land as security provided it is a first mortgage with satisfactory title, and industrial plant and machinery, provided such machinery and plant are installed in a factory building, and such building and the land on which it stands are also offered as security. In the case of the DFCC too, loans granted on land as security, carry similar conditions. The above analysis shows the unenviable position the small firm is placed in, as regards the provision of acceptable security. Considering the types of security that are accepted for loans, it is natural that large firms with means have a decided advantage.

7.3.21 Feasibility and Viability: Table 62 shows low figures as compared to other conditions for these two items, 'as difficult items to prove', by firms. This is not because that they are able to meet the requirements on these grounds, but because they are only given a cursory glance in case of small loans. This is further underlined by the high percentage of 'do not know or no comment' given to this question.

7.3.22 In the financial institution survey, in answer to the question on the basic factors which they consider necessary for a loan or advance, most banks, made a special effort to stress the factor of viability and feasibility as being important criteria besides other factors, for loans. It is doubtful from the evidence gathered in this survey whether it is possible to gauge these two factors with any accuracy, considering the number of unstable factors in the economy. Comparison of answers of

1. See Chapter 8.
borrowers and discussions with bank staff showed that although the statement is made that adequate emphasis is placed on these two criteria, this is done in a pure perfunctionary manner, after the security that is provided for a loan is first investigated. This is due to three main reasons, i.e. (i) that it is difficult to assess these two factors, especially of a small venture as a consequence of the 'unknown factors' entering the calculation, such as availability of adequate foreign exchange for industrial purposes, the introduction of duties and quotas and tariffs, and the change in emphasis in Government policy (ii) the absence of specially trained staff or experienced management in the field of industrial finance. The usual bank training of staff, and the experience they gain is in the techniques of lending to commerce and other types of normal commercial banking activities (iii) the absence of data on industry Therefore, it is not surprising that adequate security has become 'the' criterion for a loan.

7.3.23 Although it is stated above that the prospects of feasibility and viability of a venture are difficult to assess in the case of small firms, this does not necessarily hold true in the case of DFCC loans. The DFCC finances only large firms (both established and new), and in most cases these firms are either monopolies or near monopolies. Therefore it is not very difficult to assess factors such as feasibility and viability of these firms, as in the case of these firms they are more or less guaranteed. Further the DFCC from its inception had a training programme to train its personnel on the techniques of industrial lending and the experience the staff has acquired since the beginning is from financing of industry. However, the efficiency of the DFCC regarding its loan assessment techniques
is no consolation to the small firm, as their minimum loan size falls outside the periphery of the need of the small firm. What is described above, summarizes the existing situation and outlines the existing problems faced both by the lender and the borrower.

7.3.24 Creditworthiness: The term 'creditworthiness' is another elusive aspect of finance which is difficult to define, and this is more so in newly developing countries where the financial habits of customers are still in their infancy. So far the attempts made by the lenders, to wean themselves away from the normal assessment levels of credit-worthiness as applied to consumption and commercial loans, have been slow. Therefore, even at the present time, the borrowers' private financial standing, his social standing, and success in life, etc., is given considerable weight, in addition to other factors, before considering a loan. Therefore, it could be postulated that only with the process of education of the lender and borrower alike, as proposed in Chapter nine, that there could be a broad view of creditworthiness taken in the case of a loan, i.e. not alone the creditworthiness of the person but the overall creditworthiness of the venture as a whole.

7.3.25 Guarantees and Guarantors: In normal circumstances, if primary security such as land, buildings and stock in trade could be provided by the borrower, the lending institution normally requires collateral security in the form of directors and shareholders guarantees. These guarantees are normally entertained if the persons giving the guarantees are personally known to the bank, especially the management. If on the other hand, they themselves were not known, the bank would entertain other guarantors who were known to financial circles guaranteeing a loan on behalf of the recipient. In the case of small and medium sized firms, the prospect
of guaranteeing the loans were a difficult task. For example directors and shareholders of large companies were known to the bank hierarchy, and in normal circumstances they belonged to the same strata in society, socially, culturally as well as financially. In the case of the small firms, the situation was quite different. Most management of small firms were at different levels of the social hierarchy in terms of social and cultural levels, and usually did not move in the same social circles as the former. Further in case of partnerships and proprietorships, the position was even worse as in the early part of their businesses many had committed themselves by tying up their private wealth and possessions to get accommodation, and being thus tied up were not eligible to guarantee additional loans, nor to stand as guarantors. They also had little prospects of interesting outside parties to stand surety for them. The severity of this problem is seen in some small firms where they have tacitly included a person known in the social hierarchy in the country, who was known both socially and professionally, and of good standing with the financial institutions, as a director in the company, purely as a means of ensuring that their creditworthiness in the eyes of the lender is enlarged due to that person's patronage of the firm.

7.3.26 Table 64 is a breakdown of table 62 according to age, legal status and size of firms. The findings in question two is further strengthened by the similarity of the spread of firms according to these classifications. For example there seem to be a clear relationship with the age and size of firm in addition to legal status with the degree of difficulty faced by them.

7.3.27 Table 64 also shows the close relationship that exists between the legal status of the firms and the degree of difficulty as 
1. The limitations of these findings mentioned with regard to question two apply also to the analysis here.
TABLE 64

AGE & LEGAL STATUS OF SURVEY FIRM IN RELATION TO THE RESPONSES TO QUESTION 3

<table>
<thead>
<tr>
<th>Before Legal</th>
<th>49/54 Legal Status</th>
<th>55/60 Legal Status</th>
<th>61/65 Legal Status</th>
<th>66/70 Legal Status</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>B</td>
<td>C</td>
<td>D</td>
<td>E</td>
<td></td>
</tr>
<tr>
<td>71</td>
<td>-</td>
<td>5 Prop. 18</td>
<td>5 Prop. 42</td>
<td>11 Prop. 6</td>
<td>2 Prop. 71</td>
</tr>
<tr>
<td>1 P/s</td>
<td>3 P/s</td>
<td>1 P/s</td>
<td>4 Prop.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Pvte.</td>
<td>10 Pvte.</td>
<td>30 Pvte.</td>
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</tr>
<tr>
<td>12</td>
<td>-</td>
<td>5 Prop. 5</td>
<td>5 Prop. 4</td>
<td>1 Prop.</td>
<td>2 Prop. 12</td>
</tr>
<tr>
<td>1 P/s</td>
<td>3 P/s</td>
<td>1 P/s</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Pvte.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>1 P/s</td>
<td>5 Prop. 3</td>
<td>5 Prop. 2</td>
<td></td>
<td>9</td>
</tr>
<tr>
<td>2 P/s</td>
<td>1 Pub.</td>
<td>1 Pub.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Pvte.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>-</td>
<td>5 Prop. 3</td>
<td>5 Prop. 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 P/s</td>
<td>9 Pvte.</td>
<td>23 Pvte.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL........</td>
<td>6</td>
<td>9</td>
<td>27</td>
<td>50</td>
<td>8</td>
</tr>
<tr>
<td>20</td>
<td>1</td>
<td>1 Pve.</td>
<td>2</td>
<td>2 Pve.</td>
<td>20</td>
</tr>
<tr>
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<td>1</td>
<td>1 Pve.</td>
<td>1</td>
<td>1 Pve.</td>
<td>11</td>
</tr>
<tr>
<td>6</td>
<td>3</td>
<td>3 Pub.</td>
<td>1</td>
<td>1 Pub.</td>
<td>6</td>
</tr>
<tr>
<td>62</td>
<td>-</td>
<td>5 Prop. 16</td>
<td>5 Prop. 3</td>
<td>11 Prop. 6</td>
<td>2 Prop. 62</td>
</tr>
<tr>
<td>1 P/s</td>
<td>2 P/s</td>
<td>1 P/s</td>
<td>4 Pve.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Pve.</td>
<td>9 Pvte.</td>
<td>23 Pvte.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL........</td>
<td>6</td>
<td>9</td>
<td>27</td>
<td>50</td>
<td>8</td>
</tr>
<tr>
<td>42</td>
<td>-</td>
<td>8 Prop.</td>
<td>28</td>
<td>11 Prop. 6</td>
<td>2 Prop. 42</td>
</tr>
<tr>
<td>27</td>
<td>-</td>
<td>2 Prop. 11</td>
<td>11 Pve.</td>
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<td>13</td>
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<td>3 Prop. 6</td>
<td>6 Prop. 4</td>
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<td>9</td>
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<td>1 Prop. 15</td>
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<td>6 Pve. 53</td>
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<td>2 Pve.</td>
<td>10 Pve.</td>
<td>20 Pve.</td>
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<td>5 Prop. 11</td>
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<td>5 Prop. 5</td>
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(continued on next page.)

KEY: A = Very difficult, B = Difficult, C = Reasonable, though difficult
D = No difficulty, E = Do'n't Know or No comment.
<table>
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<tr>
<th></th>
<th>A</th>
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<td>Prop.</td>
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<td>P/vte.</td>
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<td>P/vte.</td>
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<td>2</td>
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<td>P/s</td>
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<td>Prop.</td>
<td>20</td>
<td>Prop.</td>
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<td>Prop.</td>
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<td>Pub.</td>
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<td>27</td>
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<td>50</td>
</tr>
</tbody>
</table>

**KEY:** A = Very Difficult, B = Difficult, C = Reasonable, though difficult, D = No difficulty, E = Don't Know or No comment.

**Legal Status:** Pub = Public Limited Liability, P/vte = Private Limited Liability, P/s = Partnership, Prop. = Proprietorship.
expressed by the firm. For example, the least difficulty in meeting the conditions of loans were experienced by the six public limited liability companies that were in the survey all of which in terms of size were medium. They were followed by the older private limited liability companies, which were also in most cases, were medium by way of at least two size measures used in the survey. These were followed by younger private limited companies with the partnerships and proprietorships coming at the other end of the scale. As all proprietorships, partnerships and most young private companies were small in terms of all three size categories, it could be rightly concluded that the greatest difficulty is experienced by the smaller firms.

7.3.28 From these relationships shown in answer to question two and three it could be concluded that there seem to exist a credit gap to small firms based on the following qualifications, i.e. the greatest difficulty experienced in obtaining outside credit is among those firms which are smallest in terms of employment, capital and turnover, are proprietorships and partnerships, and have been in business for a short period of time. These firms are followed by those private limited liability companies who are small in terms of all three size categories, and are comparatively new firms with a few years business experience.

7.3.29 However, from the findings in the survey there does not seem to be any wilful discrimination of these firms, at least openly, and therefore one could conclude that the reason seem to lie in the fact that more established firms are in a better position to meet the conditions desired by the lenders.

7.3.30 Question Four: What conditions imposed by the lender (with regard to a loan or advance) are most difficult to meet, from the list of lenders given below? (this question refers to all type of borrowing
both short and long term. Please put the appropriate number in each cage.

<table>
<thead>
<tr>
<th></th>
<th>Safety</th>
<th>Liquidity</th>
<th>Profitability</th>
<th>Viability</th>
<th>Security Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Commercial Banks</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Long</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) DFCC</td>
<td>S</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>L</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) AICC</td>
<td>S</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>L</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Private finance</td>
<td>S</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>and Hire-purchase</td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>(e) Leasing finance</td>
<td>S</td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
<td>L</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>(f) Supplier credit</td>
<td>S</td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Money lenders</td>
<td>S</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td>L</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(h) Other</td>
<td>S</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td>L</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The following numbers denote the degree of difficulty:

1 = very difficult, 2 = difficult, 3 = reasonable though difficult,
4 = no difficulty

This question was similar to question three, but here the intention was to identify the degree of difficulty of conditions for loans against individual lending institutions. The firms were requested to mark those conditions of loans listed above which they felt were difficult to meet.

7.3.31 In the case of banks, they felt that both short term loans and loans over one year, were conditioned by banks' desire for safety and liquidity, which they felt were the two most difficult conditions to satisfy. Profitability and security were closely connected to these two conditions and therefore they felt that all the conditions of loans can be
quite difficult. The difficulty experienced with the latter conditions was especially applicable to loans over one year duration, as the banks paid specific attention to the type of security that the lender could provide. The overall opinion was that the banks preferred immovable property with very good title to almost all loans which had a duration between one to five years.

7.3.32 Apart from the difficulty in meeting these conditions they also expressed the view that commercial banks, in case of requests for loans over one year were most reluctant to accommodate them. They expressed the opinion that even in normal circumstances when there were no credit restrictions, the banks laid emphasis on the fact that it was not the normal business of banks to grant loans for purposes which are less liquid and those which they considered more risky. As this was the case, the few loans that the banks were ready to grant for long term purposes were given on very tight security, and the security demanded in most instances was above, what a small firm could comfortably provide. In their opinion, short term self liquidating loans, and temporary accommodation from banks were the only forms of finance that they were able to get normally from the banks. Even in the case of these loans they felt that they were at a disadvantage, as the larger and more established firms were better known to the banks and had long association with them.

7.3.33 They were critical of the inadequate credit facilities available to them, not alone from the banks, but from all financial institutions. However, a considerable degree of realism entered their views and opinions when discussing this problem. In the case of short term loans, apart from the banks and other private sources such as friends,

1. See replies to question twenty.
relatives, and business acquaintances, some turned in times of great need, to money lenders. This was usually the last resort of finance available to them. There is a belief in the country that all firms which resort to money lenders are non-creditworthy by any standards, however, there were occasions when some firms had to turn to money lenders, despite the fact that the firm was well managed.¹ The firms that turned to money lenders in times of need expressed the fact that they were the only lenders who were ready to lend on short notice and without much question despite the rates charged by them being high, i.e. the figures mentioned varied between 30 to 40 per cent. Supplier credit and other types of business credit was another source of finance used by them, but they were reluctant to give much information and details of these transactions. However, the disadvantages described by them were similar to those described in Chapter one,² the principal disadvantage being that the recipient is at a disadvantage with 'tied' products and raw materials agreements at prices and discounts fixed by the lender firm.

7.3.34 In the case of long term accommodation, the greatest difficulty they experienced was not alone the difficulty of meeting the conditions of loans imposed by the lenders, but the absence of adequate lenders. It was stated earlier that there were only two long term lenders to industry, i.e. The AICC and the DFCC, and that their lending was very limited. The survey firms emphasized this shortage at length. For example, around 95 per cent of the firms felt that the DFCC minimum lending limitation which stood at RS.100,000 restricted their access to this institution. Even in those instances when some of them desired loan sums over RS.100,000, they were unable to meet the conditions of the loan such as feasibility and

¹. See Chapter Eight
². See Chapter One, section 1.8.15.
and profitability as measured by them, and the security for the loans.  

Finally, assuming that they surmounted these problems, there was still the problem of meeting the Corporation's minimum debt/equity ratio of 1:1. In normal circumstances a firm had some proportion of debt, and when these debts were taken into account in calculating the above ratio, the loan sum which the firm become eligible for, fell short of the minimum DFCC loan limitation of Rs.100,000.

7.3.35 The overall opinion of the firms were, that the attempts to get DFCC loan accommodation was a waste of time. They were generally of the opinion that the DFCC was not particularly interested in assisting them, nor interested in their problems, but was an institution dealing only with the 'well to do', and large firms. There seem to be a considerable degree of rancour felt by the firms against the DFCC, as they felt that the DFCC did not cater to those who really deserved aid and assistance, despite it being the only long term industrial credit institution in the country.

7.3.36 The AICC in their opinion could not help them very much as this institution was tied down by its Ordinance of establishment. The main difficulty in getting accommodation from it, was the AICC's acceptance of only first class primary mortgages, as security for its loans. With the exception of these two institutions, there were no avenues available to them for long term credit.

7.3.37 Question Five: What type of institution do you normally turn to for your fund requirements?

i.e. (a) investment needs (over one year)  
(b) short term needs (under one year)

<table>
<thead>
<tr>
<th>Type of Loan</th>
<th>Source</th>
<th>Reasons</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Even the cases referred here are firms which are limited liability companies, as DFCC lends only to those who have limited liability status.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Type of Loan</td>
<td>Source</td>
<td>Reasons</td>
</tr>
<tr>
<td>-------------------</td>
<td>---------------</td>
<td>----------------------------------------------</td>
</tr>
<tr>
<td><strong>Long - Term</strong></td>
<td>(i) Equity capital</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(ii) Capital investment</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iii) Research and Innovation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iv) Expansion</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(v) Other</td>
<td></td>
</tr>
<tr>
<td><strong>Short - Term</strong></td>
<td>(i) working capital needs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(ii) Bridging finance/ Seasonal finance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iii) Other</td>
<td></td>
</tr>
</tbody>
</table>

The answers to this question were not quantifiable in the form of a table. In the case of long term funds for equity, they felt that they had no institutional source to turn to. The only available source for private firms in the country is the DFCC, which, as stated earlier is above the size level of small firms. Therefore, in order to qualify for aid from the DFCC a new firm had to raise adequate capital of its own to match the quantum of funds that would be made available by the DFCC, i.e. the minimum being Rs.100,000. This would mean that the firm from the initial level or from inception has to be floated with a minimum capital level of Rs.300,000 of the sponsor's funds and Rs.100,000 of DFCC funds, making a total of Rs.400,000. This would automatically make the venture into a medium size firm in the upper bracket of the size category established in this study. Most small firms or entrepreneurs who start small do not wish to commence business at this level. The reasons given were, (a) entrepreneurs interviewed felt that in a small under-developed country it was too much of a risk to start big due to the great number of uncertain elements prevalent in

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1. This is based on the premise that to qualify for DFCC's minimum lending sum of Rs.100,000, the sponsor would have to match it by Rs.100,000, based on the DFCC lending ratio of 1:1, and in the case of equity participation the firm would have to raise Rs.300,000 to get a DFCC loan (equity) of Rs.100,000, as DFCC's maximum equity participation in one single firm is 25 per cent of its equity.
the economy, such as a continuous market for the products, market limitation at the beginning, the changing direction of development and the uncertainty of Government policy towards private enterprise. In combination with these factors, they were also of the opinion that most of them did not have the experience to venture into big business from the very beginning.

(b) They did not have vast private resources nor personal wealth, neither were they able raise such large sums from other private investors, to match the minimum DFCC contribution,¹

(c) The only alternative open to them to raise a sum as large as Rs. 300,000 was to float the company as a public venture and invite share participation. However, they were not prepared to go public from the start as this went against their motives of venturing into business. Most of them valued their independence and felt that too many shareholders would jeopardise their control of the firm. The possibility of retaining control by owning fifty one per cent of the shares in such a public company was beyond their means, as in this example the entrepreneur would have to raise on his own nearly Rs. 200,000 to hold fifty one percent of the equity. The conclusion here is that if he is able to raise Rs 200,000 of his own, he has no need to seek DFCC assistance as then he would be able to start the venture in a smaller scale as he originally intended, while at the same time retaining ownership and full control of the firm.

7.3.58 As a result of the unavailability of institutional funds, all firms interviewed had commenced business at the outset with the entrepreneurs own funds and those of friends and relatives. The funds so raised were not very large, and as mentioned at the beginning of this chapter, the difficulty of raising funds at the early stage introduced weaknesses

¹. See footnote in previous page.
to most firms.

7.3.39 In the case of (i) and (iv) capital investment and expansion, at the early stages of the business they had to find their own funds, as banks and other private sources were reluctant to lend to new small ventures. It was only after the initial period of establishment was over that the banks were willing to consider accommodation for expansion and new investment. The problem here seems to be that it is only after the firm has withstood its initial stages of growth, that the banks feel safe to lend to them. On the other hand it is only then that firms are able to offer adequate security and safeguards in the form of existing factory buildings, land, machinery, and stock, and directors guarantees which the banks' require.

7.3.40 (ii) Finance for Research and Innovation: There are no institutional lenders to provide finance for this purposes, nor, are proper facilities provided by the State which the firms could utilize, such as research laboratories, technical services and advisory bodies.

7.3.41 In the case of short term loans they normally turned to the banks for accommodation in respect of both working capital and seasonal needs. From the evidence in this answer it becomes apparent that the only source of institutional finance available to them to substantiate their own resources, are the banks. This however did not establish that banks adequately met the capital requirements of these firms, but it is consistent with the hypothesis that they had no other sources available. Around 90 per cent of the firms interviewed declared that they had no option but to keep on trying to get bank accommodation for both short and long term purposes, despite the realisation that the banks were hesitant to lend for longer periods, and the conditions of their lending being quite severe.

7.3.42 There seems to be a helpless resignation among some firms
to the shortage of avenues of credit, while others kept on the pressure for accommodation, and a third group has elected to carry on regardless by whatever means at their disposal. This inability to get access to credit has introduced to the firms a perennial stagnation factor, instability, and in many cases inadequate financial discipline. At present there is a tendency for most firms to use funds in their businesses, as and when it was available, sometimes quite indiscriminately, without taking into consideration, sources, uses and type of funds made available. As a result proper financial discipline is either lacking or laggard. Therefore, it could be assumed here that this is a case, not alone of business inefficiency, but also a case of fund shortage.

7.3.43 Question Six: Was planned expansion of your firm curtailed at any time due to any external factors in the economy affecting your performance? Yes/No ,

if Yes, please state circumstances

This question and question seven which follows, dealt with the same problem. It was an attempt to find the reasons for curtailment of expansion, insufficient growth and stagnation. In answer to question six majority of the firms (79 per cent) declared that at one time or the other, planned expansion was curtailed, or temporary stops were made in the production process. This they attributed to a number of factors, apart from the difficulty of accessibility to long term finance. In some cases expansion was not considered, though they had tentative plans, as they felt that the process of getting a loan, i.e. difficulties and delays, took such a considerable time of the firm's time, in addition to the gap between the original request and final receipt, that they felt it was not worth the expected benefits.

1. See Chapter Nine for further details - section 9.4.5.
7.3.44 Others had no inclination to grow due to the limitation of finance to improve their product efficiency through method research, market efficiency through market intelligence surveys, and general efficiency through rationalisation programmes, feedback intelligence surveys, and training programmes. However, the hesitancy to expand cannot be blamed on inadequacy of finance alone, for, extraneous factors have been equally responsible. For example, extraneous factors such as the lack of a long range Government policy for the private small scale sector, and the limited foreign exchange budget of the country, resulting in fluctuating exchange control restrictions giving rise to varying import control measures and tariffs. Thus, most firms felt that the uncertainties of future policy affected them as much as finance. These two problems of inadequacy of finance and the uncertain future were closely interlinked, as some remarked, given that they were able to get accommodation, the fear of adverse controls resulting in inability to meet loan commitments made them hesitate to embark on expansion.

7.3.45 This shows a lack of faith in Government policy, and the general absence of communication between planning bodies and the financial institutions. As a result, the lending policies of the institutions worked sometimes in isolation, and at other times out of step with the policy of which planning bodies; the repercussions/directly affected the industrial sector. The institutions more often than not, refused or failed to understand the difficulties of borrowers caused by the interaction of these extraneous factors when it came to meeting their loan obligations. As mentioned by some firms, in some instances when the pay-back period of loan was extended, the institutions never let the borrower forget that he had fallen behind loan repayments (despite circumstances beyond his control), when an approach
was made for another loan. There were a number of cases quoted as examples here.

7.3.46 In summary it could be said here that expansion was curtailed as a result of the following reasons,

(i) inadequacy of long term loans,

(ii) the prolonged period of processing a loan ranging from six to eighteen months,

(iii) credit 'squeeze' which affected the availability of existing fund sources,

(iv) extraneous factors such as, (a) Government duties on raw materials and machinery that has a tendency to go up without prior warning, (b) new ad-hoc regulations, for example, there was a recent Government directive, that overseas supplier credit could only be contracted if the supplier was ready to accommodate 360 day credit terms instead of the usual 180 days, (c) new foreign exchange control schemes, e.g. the FEEC scheme, (d) varying raw materials quotas given to industrialists in the case of imported raw materials which varied according to the availability of foreign exchange, (e) absence of a policy statement as to the future of the private sector, (f) the fear of appropriation due to a recently passed law, (v) general economic conditions in other parts of the world which impinge on the economic activity of the country resulting in repercussions in all sectors of the country's economy.

Thus it could be concluded here, that inadequacy of finance at the opportune time coupled with uncertainties created due to extraneous factors have retarded to a considerable degree the expansion and further development of the firms.

7.3.47 The answer to this question showed also another facet of
small industry, which contributes to their basic financial imbalance, i.e. Government activity in the sphere of controls acts as a barometer for the future strategy of the firm. This interlinkage is discussed in detail in Chapter eight.

7.3.48 **Question Seven:** Have you at any time trimmed an investment programme already commenced, because of inadequate retained profits or because of the high cost of borrowing money? Yes/No, if Yes, please give details.

Question seven confirmed that many investment programmes already commenced were trimmed and others did not give the desired results, due to reasons given in answer to question six. The relationship of inadequate retained profits to the factors given in answer to question six were pointed out by most industrialists, namely, (i) the inability to retain much of the profits as a consequence of the absence of accommodation from any other source, necessitating automatic use of funds available in the firm both for working capital and long term investments, (ii) the non-generation of expected profits from programmes undertaken as a result of frequent changes in Government policy in the field of tariffs, duties and taxes, (iii) the non-use of installed machine capacity due to shortages of capital, raw materials, and spare parts for machinery.

7.3.49 It was mentioned earlier that 79 per cent of the firms had at one time or another curtailed planned expansion or temporary stops were made in production, the remaining 21 per cent of the firms could be regarded as those firms which have resigned themselves to the insurmountable problems faced by them, and are satisfied to keep at least the present level of production. This view is put forward on the premise that all firms declared that they started their business ventures to achieve

---

1. See section 8.5.
a certain level in life, and given the conditions all were desirous of expansion and growth. In conclusion here it could be said that the attitudes of the firms, which shows a dynamism and tenacity to keep on going despite numerous obstacles faced by them, show a healthy characteristic of the small firm entrepreneur and bodes good for the future of industry in the country. Perhaps it cannot be argued that all present enterprises are necessary at the present level of development in the country, but the cogent fact to observe is that there seem to be a complete breakdown/policy in directing these energies of the entrepreneurs, by providing finance and other facilities to efficient and essential industrial units, with a policy that guarantees the least amount of disruption to normal business efficiency.

7.3.50 Question Eight: Have you received overdraft facilities during the last three years? Yes/No,

If Yes - Please describe the procedure of obtaining O/D facilities
If No - Did you attempt to get O/D facilities, if so, what were the reasons for refusal?

Among the firms, 23 per cent had received overdraft facilities during the last three years. Of this number, only ten firms have had continuous facilities at one time or another, while in the case of the others, the overdraft facilities were related to loans received, i.e. temporary overdraft facilities given in times of additional expenses, over the loan received. The main reason for the absence of overdraft facilities seem to be the result of the newness of most industrial ventures. Banks do consider overdraft facilities, normally to established customers, and those banking with them for a considerable period of time. Normally, a bank before granting overdraft facilities, checks the customer's dealings with the bank, over the whole period the customer has banked with that particular bank.
and satisfy themselves about his creditworthiness and the desirability of granting him overdraft facilities. In the case of firms the procedure is the same as described above.

7.3.51 Only seven firms answered that they had not attempted to get overdraft facilities. The reason given was that they felt it was a waste of time to attempt to get overdraft facilities, when they found it difficult even to get short term loans from the banks. The normal reasons for refusal of facilities by the banks were, that the firm did not have adequate custom with the bank and when the firm's dealings with the bank had not been satisfactory. One reason given by banks, about their reluctance to give overdraft facilities other than to their regular customers was, that small firms who obtained facilities made no attempt to cancel their overdraft as and when they were able to do so, but had a tendency to keep the account overdrawn at its maximum. From available evidence, there seems to be considerable truth in this statement. Therefore, majority of the banks felt that it was preferable to grant a loan instead of an overdraft, as the former had regular pay-back periods on agreed dates. The dearth of overdraft facilities to small firms, therefore, is a result of, (a) the misunderstanding by the borrowers in the correct use of this facility, and the resultant misuse of such facilities, (b) uncertainty of the business climate, inadequate funds of banks, and the preference of banks to play safe and service only their regular customers, and (c) the insignificant level of business pressure that a small firm could bring on the custom of the bank in addition to the smallness and newness of their business with the bank.

7.3.52 Question Nine: During times of Central Bank credit restriction policies, did you find any difficulty in raising finance for your needs? (this question assumes that you had equal credit merit with
other borrowers) Yes/No,
if Yes,
(i) What type of finance - (a) Overdrafts (b) Short-term (c) Medium-term (d) Long-term
(ii) Please give reasons for your comments.

<table>
<thead>
<tr>
<th>Reasons</th>
<th>Overdrafts</th>
<th>Short-term</th>
<th>Medium-term</th>
<th>Long-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scarcity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strict qualification level</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General difficulty of</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>borrowing at such times</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In answer to this question, 94 per cent of the firms expressed the opinion that credit restriction affected them. The reasons given were a mixture of all four reasons given in this question. All these reasons are closely related to one another, and if a division is to be made between these reasons, they could be described as follows,

(a) High costs: The problem of high costs is a two-edged one. In the case of lending institutions, if at the time of the credit squeeze the bank rate was also raised, the lending organisations adjusted their rates accordingly to keep the previous margin. In the case of the private lenders, the result of scarcity of funds in the market, the increase in the bank rate, and the increased demand for funds make it an opportune time for them to earn higher profits by raising their lending rates. Thus the small firms which normally depend on both bank and private funds are hit simultaneously.

(b) Scarcity: Scarcity of funds and higher rates affect not alone small firms but all business. In normal times some large firms extend inter-business credit to their small business associates. However, during credit scarcity this source dries up and the pressure exerted by large firms to
to keep the available funds affect the small firm in two ways. Firstly, those large firms who owed money to small firms for goods bought from them, or for services rendered by the small firm, delay payment of their debts, and secondly, those large firms who had extended credit facilities and longer repayment periods to small firms, demand early payment. The small firms are thus squeezed at both ends, and they have hardly any options open to them to take counter measures against these large firms.

(c) Strict qualification levels: As seen in answer to question seven of the financial institution survey in Chapter six, lenders during periods of credit restraint introduce measures to restrict their credit portfolios. The normal measures they take are, withdrawal or ceilings on, overdraft facilities, restrictions on size and duration of loans, queue systems for accommodation, and raising of existing conditions of loan qualification. All these measures which are introduced by the lenders generally affect all borrowers, but it is not far wrong to say that, smaller the size of the firm, weaker its competitive situation, the greater will be the effect of these policies.

7.3.53 In terms of types of credit that are most affected, it was mentioned earlier that even in normal circumstances, overdraft facilities and long term loans flowing into the small firm sector were meagre, and during these periods even these meagre avenues were closed to most small firms. The greatest effect therefore the credit restraint has on the small firm is the closure of even these meagre avenues of longer term loans. Even during normal times the long term credit institutions scarcely granted any facilities, and firms depended on bank accommodation and other private sources even for their longer term needs. During these times both these avenues become scarce. The banks usually directed their funds first to
their regular customers, and if any funds were available over and above the needs of these businesses, were the banks ready to consider accommodation to their less important customers. Therefore it was rare that loans with a duration of over one year were made available to small firms in the industrial sector.

7.3.54 Eighty five per cent of the firms felt that it was impossible to get accommodation for periods over twelve months, while 71 per cent felt that loans with a duration of six to twelve months were equally difficult. Even in the case of advances under six months, they had to compete with all other eligible borrowers, and in the tight race for accommodation the small firms did not fare so well, unless their relationship with the bank was well established and was of long duration. Most firms felt that they were pushed to the back of the 'credit queue' during such times. It also emerged that in the case of some firms, they were refused credit at times with the excuse that there was a credit restraint, when in actual fact there was no credit restriction in operation.

7.3.55 In the case of private sources of credit, the normal tendency during periods of a credit squeeze is a drying up of this avenue of credit to small firms. One of the reasons given for this phenomenon is that private lenders either lend at very high rates, and/or direct their activities to consumption and speculative purposes. For example, businesses which needed ready cash during these periods of tight money, resort to pricing down of products and 'sales', to realize cash for other needs, the resources of the private lenders with cash to spare are utilized for the purchase of these stocks for speculative stock building.

7.3.56 Overall it was found that small firms were not hit so much by rising interest rates, as by the lack of accommodation even from
normal sources which were available to them, and the total drying up of credit. The answer to this question, points to a credit crisis especially among the small firms, not alone small manufacturing units under investigation here, but all types of small business. Further this credit crisis among the small firms holds true, notwithstanding the fact that the Central Bank credit restrictions, exempt loans from the credit ceiling which are for the development of agriculture and industry. The specific reasons for this is given in section 6.3.39. Therefore it would suffice here to conclude that even in normal periods the credit facilities available to the small and medium firm sector are meagre, and during these periods it is even more pronounced. Despite the fact that credit restrictions invariably affect all customers, during these times the banks tend to pay special attention to servicing their regular customers, therefore, any curtailment of credit to the industrial sector would begin first with the small firms, who normally are not their most important customers.

7.3.57 Question Ten: Have you had any objections to any questions or details about yourself, your partners, or your company, asked or requested by the lender, before a loan is processed? Yes/No, if Yes, what type of questions or details?

This question tried to ascertain on of the characteristics of small firms, which is common to all small firms everywhere, namely their natural reticence and secretiveness. Sixty seven per cent of the firms answered both 'yes' and 'no' to this question, 19 per cent had no objections and therefore answered 'no' to this question, while the balance 14 per cent were not so happy to divulge all the details that lenders required.

7.5.58 The reasons for objections were the same. They felt that as long as they were sure that the details given about themselves and
their firms were kept confidential, they had no objections to providing the necessary information, and those who answered 'no' declared that in order to get a loan they would have to provide the necessary information about themselves and their firms, whether they objected to any details or not. The foremost objections of the firms to provision of confidential details about themselves and their firms was the doubt expressed that the details may not remain confidential. All firms had confidence in the management of the institutions to keep the details provided to them confidential, but what they were not too happy about was the lower levels of the administrative staff of the lending institutions. As pointed out by them the processing of a loan application passed through many hands and therefore it was not difficult for an unscrupulous official to leak out these details to a competitor. They gave a few examples of this happening, where confidential information had been passed to strong competitors producing similar or alternative goods, and to others who were ready to buy information with the prospect of entering the field.

7.3.59 Apart from what is described above, there were two other characteristics which although were not brought out fully in answer to this question, is relevant here. They are, (i) The prevalence of a considerable degree of tax avoidance among all business, not alone among the small industrial firms, but throughout the whole field of business enterprise. Therefore, those firms which have a reason to keep certain details of their business to themselves are hesitant to provide all details, especially those pertaining to finance. Therefore the figures they do sometimes provide are watered down to tally with their tax figures, due to the fear of exposure.

1. These were brought out in the General Survey and the Financial Institution survey.
(ii) Another characteristic which is prevalent among small firms to a considerable extent, is that once a loan is received, their belief that the only remaining obligation to the lender is to pay back the interest and capital on due dates. On the other hand lenders wish to keep a certain degree of control on the money they have lent by a process of supervision. Supervision normally takes the form of, periodical visits to the firm, interviews with management, inspection of balance sheets, and the security that has been provided against the loan, and checks on the uses to which the funds borrowed have been put. There is considerable degree of truth in the allegation made by lenders, that some borrowers are reluctant, and not so accommodating to the lender in facilitating the lender to fulfill these checks.

7.3.60 This latter problem was discussed with the firms interviewed, and one group of borrowers were of the opinion that, (a) that the original investigation prior to the disbursement of the loan was sufficient, (b) that the lender is safeguarded by the security provided against the loan taken, and (c) that the money lent to them, and the utilization of this money is their own business, as they knew how to run their business best. On the other hand there were others who felt that adequate supervision by the lenders were not properly carried out, for example, those officials who do turn up for inspection and observation were not conversant with the business and did not know their job, while others who turned up were not tactful nor courteous. In the case of the former they felt that it was a waste of time, while in the case of the latter complaint, the entrepreneurs especially in small firms felt that the behaviour pattern of some officials who turn up for inspection left much to be desired. One example given was the apparent tactlessness, in discussing business matters, and recrimination
on the running of the business in front of other staff, which was detrimental to discipline and the authority of the manager.

7.3.61 These problems could only be solved by greater understanding and tact, and better training, in the case of bank officials, and on the other hand, the provision of facilities for the education of business men and the dissemination of information on the characteristics of loans and the procedures adopted by the lenders for control of these loans.

7.3.62 **Question Eleven:** Do you consider that financial facilities offered by banks and special financial institutions is/are too expensive? Yes/No, if Yes, give reasons for your conclusions.

This question attempted to investigate the cost of credit to small firms. No firm 'yes' or 'no' answer was given to this question. They expressed the opinion that the rates were too high in comparison to other countries, but considering the scarcity of funds they were sometimes ready to pay even higher rates to get institutional finance. There seem to be a considerable degree of helplessness among the firms that they cannot do very much about the rates prevailing as the institutions are few in number and there is hardly any competition among lenders to attract borrowers especially the small firms. It has always been a lenders market and the view is that the lenders wish to keep it so.

7.3.63 The firms felt that it was the duty of the Government more than individual lenders to create special institutions like those of Japan and India where special rates of interest apply to small industrial borrowers. The present rates in the country vary between 8 to 12 per cent, while the special rates that apply to small industry in Japan and India vary between 4 to 6 per cent to those small industrial sectors which have been marked out by their respective Governments, as needing special attention.
There are no special lending rates for small industry in the country at present, therefore all borrowers have to obtain loans at the prevailing market rates. The cost factor of a loan therefore, is more attenuated in the case of small firms, as the value of a rupee has more intrinsic value to the small firm than the same rupee to a larger firm. Therefore, in these terms too a small firm getting loan accommodation for an identical amount in comparison to a larger firm (assuming both firms have equal credit merit), and paying the the same interest rate, the cost to the small firm could be assumed to be higher.

7.3.64 The majority of the firms in the survey desired loans at reasonable interest rates. The meaning given to cost of credit here, is not alone the pure rate of interest but all other costs in addition to the rate of interest, that are a part of any loan transaction. Therefore, an interesting finding during the survey was that the dissatisfaction of the firms, is not alone the pure rate of interest but the indirect costs associated with a loan. These are the costs incurred in meeting the qualification requirements such as legal fees, survey fees, documentation fees, spade work in terms of man-hours lost in working time of the firm's executives, and the costs incurred in the waiting time between the original request and the actual disbursement of the loan. Besides these costs there also arises the problem of costs which they have to bear when a loan application is rejected. Some of these are indirect costs which are quantifiable in money terms, while others are not, but these too have to be reckoned as hidden costs.

7.3.65 A second finding is that, the majority of the firms expressed the desire, that despite what they thought were high rates for loan accommodation, they were willing to pay even higher rates than those
existing at present, if the institutions were willing to relax the eligibility rules and tie up the cost and risk factor envisaged in lending to small firms, by a higher rate of interest. The reason behind this desire is, that even with a higher rate institutional accommodation would be cheaper than borrowing in the unorganized money market, trade credit, or private funds. It is also true that in certain circumstances it is necessary to keep in production, even at higher cost, to assure long term profitability of the firm, while at other times the long term success or failure would depend on loan accommodation even at higher rates at different times, in the life cycle of the business.

Table 65 in answer to question two gave the present rates charged by the banks. Table 65 shows the interest rates charged by the long term credit institutions. These two tables, give a clear picture of the interest rate structure on all loans and advances at present.

| TABLE 65 |
|------------------|------------------|
| **INTEREST RATES CHARGED BY LONG TERM CREDIT INSTITUTIONS \_\_ 1970.** |
| **AICC - Development Loans** | **Rate of Interest %** |
| secured by (i) immovable property | 9 |
| (ii) movable property | 10 |
| **Non-development Loans** | |
| secured by (i) immovable property | 10 |
| (ii) movable property | 12 |
| **DFCC - All Loans** | |
| Loans refinanced by the Central Bank | 9.5 |
| Other Loans | 10.5 |
| Foreign Currency Loans | 10.5 |

Source: AICC and DFCC.
7.3.67 In Ceylon the interest rates are not geared to the size of the loan, but the rates are geared to the type of security provided against the loan. This again underlines the problem discussed earlier, i.e. the security consciousness of the lenders. As shown in table 67, after 1956 the minimum rates for all types of security with the exception of those termed 'other' have doubled, i.e. a hundred per cent increase, while the maximum rates have increased by at least fifty per cent. This table also shows that with the exception of the security termed 'other', the minimum rate of 1970 is more than the maximum rate of 1956. The table below shows the increase in the minimum and maximum rates from the level in 1956 to 1970.

**TABLE 66**

**INTEREST RATES 1956 and 1970**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Securities</td>
<td>3</td>
<td>7</td>
<td>133</td>
<td>4.5</td>
</tr>
<tr>
<td>Stock in Trade</td>
<td>4</td>
<td>4.5</td>
<td>113</td>
<td>8</td>
</tr>
<tr>
<td>Shares in J.S.C's</td>
<td>4</td>
<td>6.5</td>
<td>100</td>
<td>8.5</td>
</tr>
<tr>
<td>Other 1</td>
<td>3.5</td>
<td>6.5</td>
<td>86</td>
<td>7.5</td>
</tr>
<tr>
<td>Immovable property</td>
<td>4.5</td>
<td>8</td>
<td>78</td>
<td>7.5</td>
</tr>
</tbody>
</table>

Source: Central Bank

1. this includes movable property, guarantees, promissory notes, etc.

7.3.68 The steep rise in rates may perhaps be accounted by the rate of inflation prevalent in the country. However this alone cannot answer this steep rise in rates since 1956. This belief is also strengthened by the fact that the rise in minimum and maximum rates do not follow any particular pattern. This almost hundred per cent increase in the minimum
rates and over fifty per cent increase in the maximum rates cannot be accounted solely by the level of inflation. For example, if a weighting factor is introduced to the value of the rupee to compensate for an inflation of 40 per cent since 1956, this still leaves a considerable upward gap in the rates. The weighting factor is not relevant in the case of all firms, as there is Government control of prices of most consumer goods. Therefore those firms, whose manufacture fall under price controls have to keep their price levels under the ceiling despite the fact that the borrowing rates have gone up, and factor costs of imported raw materials (which most firms depend on) have increased. For example in the case of raw materials, the increase in price since 1956, has been nearly 25 per cent and in the case of machinery and spareparts the increase is over 100 per cent, while the increase in wage rates between these years have been around 70 per cent.

7.3.69 Taking all these factors into account, and considering the ceiling on prices in some goods, the firms cannot generate adequate income, after meeting these additional expenses to meet the high cost of loans. Therefore taking all these into consideration, the prevalent interest rates for advances by the banks which are parallel to interest rates charged by long term credit institutions, there is a case for atleast for some short term advances to be provided at special rates, to small industrial firms. This is made on the assumption that in the short run the loss in profit to the banks would, not be too severe even with prevailing inflation.

7.3.70 Question Twelve: In obtaining funds for investment are you prepared to share equity ownership with lenders? Yes/No, if the answer is No. please give your reasons.

This question tried to ascertain whether firms keep potential lenders away by their negative attitude to, the participation of lenders
in the equity of the firm. The answers to the question were as follows,

**TABLE 67**

**ANSWERS TO QUESTION TWELVE**

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>'YES' to all lenders</td>
<td>12</td>
<td>-</td>
<td>-</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>'YES' with reservations</td>
<td>18</td>
<td>6</td>
<td>-</td>
<td>12</td>
<td>-</td>
</tr>
<tr>
<td>'YES' to Financial Institutions only</td>
<td>60</td>
<td>6</td>
<td>3</td>
<td>51</td>
<td>-</td>
</tr>
<tr>
<td>'NO' to all lenders</td>
<td>10</td>
<td>8</td>
<td>2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>20</strong></td>
<td><strong>5</strong></td>
<td><strong>69</strong></td>
<td><strong>6</strong></td>
</tr>
</tbody>
</table>

7.3.71 The table shows that only limited liability companies were prepared to accommodate all lenders by way of equity participation, and the preference schedule for lender participation is at a minimum among the proprietorships and partnerships. This compares with the general characteristics of small firms, especially those which are closely held. Among these latter firms there is a genuine reluctance to take in new shareholders.

7.3.72 Those who answered 'yes' with reservations, were prepared only to accommodate financial institutions and other private lenders who they have had long association with, both socially and in the business world. In the case of those who were only prepared to accommodate financial institutions, the main objections they had to private participation were:
(a) the fear that some lenders would try to usurp control of the firm
(b) obligations to employ relatives and friends of new shareholders
(c) the desire to keep the business closely held within the family or among the original participants
(d) the view that they have striven hard and undergone many hardships during the initial phase of the business, and the feeling that benefits should be reaped only among themselves, and not to be sacrificed to those who come into the firm as a shareholder, only when the prospects of success was assured and the business was on a firm footing.

7.3.73 This behaviour pattern of small firms and their mode of thought, and the opposite view taken by private lenders was well documented in Chapter one. It would suffice here to mention that this view is prevalent among most small firms. Therefore, time in terms of the firms' expansion from proprietorships and partnerships, to limited liability companies would ease many of these existing objections. It could be said in conclusion that small firms by their insularity tend to an extent to keep potential lenders away.

7.3.74 Question Thirteen: Have you found the lenders you approached sympathetic towards the gap of investment and return (especially when time required for the development of a product, commencement of production, etc. is long and sometimes unpredictable) Yes/No,

This question attempted to understand another deficiency in the financial structure, namely the attitudes of lenders towards the gap in investment and return, i.e. the provision of risk capital. This was specifically asked to ascertain, whether the institutions were aware of the nature of different aspects of finance to industry. Sixty two per cent of the firms felt that they were not sympathetic to this problem, 9 per cent felt that different institutions at one time or the other had accommodated their problem, 8 per cent felt that they were satisfied with the facilities provided, and the balance 21 per cent had no comment to make. Almost all firms however expressed the opinion, that there was no possibility

1. See Chapter One, section 1.3.5.
of getting a loan from the banks for technical development, where the return was not easily assessed or was in the far off future. Among the long term credit institutions, only the DFCC made any special provision for delay in payback in their loan agreements, while in the case of the banks it was more a adhoc decision depending on the borrower, and there was no laid down policy on this matter. This difference between the banks and the long term lenders is expected, as the banks were not set up to provide such type of finance. However, what is at issue here is that there are no credit institutions in the country, dealing with this aspect of industrial credit, i.e. finance for development such as technical development, innovation, research, and other long term investment needs where the return is in the far off future.

7.3.75 Question Fourteen: Do you feel that lenders give preferential treatment to big business in general? Yes/No, if Yes, give reasons for this opinion.

Questions fourteen to twenty of the questionnaire, confirmed answers given to the earlier questions regarding the unsatisfied demand for credit. In answer to this question 93 per cent of the firms felt that the lenders give preferential treatment to big business. However the answers to this question has to be gauged with considerable caution, due to factors such as persecution complexes, natural antagonism to big business felt by small firms, frustration, coupled with inadequate financial discipline and lack of credit merit preventing them getting loans, all of which would flavour the answer. But, in terms of the whole investigation, there is adequate evidence to suggest that the affirmative answer given by the firms to be true. The reasons for this answer were the same as those given for the earlier questions where the conditions of loans etc, which favour
the large firms as against the small firms.

7.3.76 Question Fifteen: Have you at any time observed that small firms have special difficulties in obtaining loans from banks and other sources? Yes/No, if Yes, please elaborate

This was a control question to check answers to questions two and three. The answers and the analysis there, apply here. Apart from the similarity of problems discussed here, the answer to question three (i), was discussed in more detail here. The majority of the firms felt that access to existing institutions were difficult and some times non existant. Although the lenders especially the banks made the statement that they were ready to accommodate all creditworthy borrowers, to most firms this statement appeared to have been said in jest. The problem here is of course three sided, as will be shown in Chapter eight, i.e. there are factors contributed by the Government, the lenders as well as the firms, for the credit gap that exists in the small firm sector.

7.3.77 On the whole it could be said that the majority of the entrepreneurs who were interviewed were realists, and accepted that in the present context of the economy where nothing was certain, and taking into consideration the uncertainty of future Government policy towards the private sector, that there existed a desire among the lenders to adopt an attitude of 'play safe' or a policy of escapism. The firms affected most by this policy are the small firms, as a consequence of which better position the large firms are in to fulfill the conditions the lenders require. As a result of this uncertainty the terms and conditions of loans were biased against them, and at the present time no lender had any genuine interest in understanding their problems and meeting some of their needs. They felt it was an uphill task with all factors arranged against them.
and in the case of accommodation they felt that the law of the jungle prevailed, i.e. the survival of the fittest.

7.3.78 Question Sixteen: Do you believe that small firms are able to obtain with reasonable terms,

(a) adequate short-term credit (under one year) Yes/No
(b) " long-term " (over one year) Yes/No

Question Seventeen: Is short or long term credit the greater problem?

The answers to these questions confirmed earlier answers about the shortage of credit experienced by the firms, i.e. (a) the non-availability of institutional finance for capital investment at the initial stage of the business, i.e. venture capital, (b) lack of long term credit facilities at the secondary or interim stage of the firm, for expansion, innovation, and research, and (c) the inadequacy of short term capital at all stages.

7.3.79 In reply to question sixteen 90 per cent of the firms expressed the opinion that small firms were not able to obtain adequate long term credit with reasonable terms and conditions, while 79 per cent had the same impression about short term accommodation. In reply to question seventeen, 97 per cent felt that long term loans were the greater problem, and 63 per cent felt that short term loans were equally difficult to get.

7.3.80 The meaning of reasonable terms in question sixteen, included the aspect of non-availability of institutions, inaccessibility of existing institutions, and the difficulty of access to loans. The opinions given in answer to these two questions are general opinions of the management of these firms. These views have been founded on their own observations and experience and those of others. The general view of all
firms is that there definitely exists a credit gap towards the small firm sector in the country.

7.3.81 Question Eighteen: Indicate in column one below, if your firm had attempted to borrow outside funds within the last five years if answer is Yes,

(d) Did you get the full amount requested? (indicate in column two below)
(b) Was the sum requested reduced, but not denied at any time? (indicate in column three below)
(c) Was your request denied? (denied to mean whether refused outright or their terms unacceptable) - (indicate in column four below)

<table>
<thead>
<tr>
<th>Financial intermediary</th>
<th>1 Attempts made</th>
<th>2 Success in getting total sum requested</th>
<th>3 Lesser amounts than total sum requested</th>
<th>4 Refused or terms unacceptable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>DFCC</td>
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<tr>
<td>AICC</td>
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<tr>
<td>IDB</td>
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<td></td>
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<tr>
<td>Private finance</td>
<td></td>
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<tr>
<td>Hire-Purchase</td>
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<tr>
<td>Inter-business</td>
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<tr>
<td>Money Lenders</td>
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<tr>
<td>Other</td>
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</tbody>
</table>

This confirmed earlier findings that all firms were desirous of getting outside loan accommodation and had made at least one attempt to get outside funds during the last five years. Table 68 gives the breakdown of attempts made, those who succeeded in getting the sum desired, those that got lesser amounts than requested, and others who failed outright. It has not been possible to assess the reasons for the loans, and why they failed due to the time limitation of this study, the reluctance of both borrowers
<table>
<thead>
<tr>
<th>Financial Intermediary</th>
<th>Total Attempts made</th>
<th>% of Total</th>
<th>Success in Getting total sum desired</th>
<th>% of Total</th>
<th>Lesser amounts than requested</th>
<th>% of Total</th>
<th>Failures: loan refused or terms unacceptable</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks (individual %)</td>
<td>1612 (100)</td>
<td>61.0</td>
<td>287 (17.8)</td>
<td>10.8</td>
<td>546 (33.9)</td>
<td>20.7</td>
<td>779 (48.3)</td>
<td>29.5</td>
</tr>
<tr>
<td>D.F.G.C (ind. %)</td>
<td>42 (100)</td>
<td>1.7</td>
<td>-</td>
<td>-</td>
<td>5 (11.9)</td>
<td>0.2</td>
<td>37 (88.1)</td>
<td>1.5</td>
</tr>
<tr>
<td>A.I.C.C (ind. %)</td>
<td>111 (100)</td>
<td>4.2</td>
<td>4 (3.6)</td>
<td>0.2</td>
<td>17 (15.3)</td>
<td>0.6</td>
<td>90 (81.1)</td>
<td>3.4</td>
</tr>
<tr>
<td>I.D.B (ind. %)</td>
<td>89 (100)</td>
<td>3.4</td>
<td>5 (5.6)</td>
<td>0.2</td>
<td>26 (29.2)</td>
<td>1.0</td>
<td>58 (65.2)</td>
<td>2.2</td>
</tr>
<tr>
<td>Private Finance (ind. %)</td>
<td>261 (100)</td>
<td>9.8</td>
<td>52 (19.9)</td>
<td>2.0</td>
<td>99 (37.9)</td>
<td>3.7</td>
<td>110 (42.2)</td>
<td>4.1</td>
</tr>
<tr>
<td>Hire-Purchase (ind. %)</td>
<td>130 (100)</td>
<td>4.9</td>
<td>21 (16.2)</td>
<td>0.8</td>
<td>68 (52.3)</td>
<td>2.6</td>
<td>41 (31.5)</td>
<td>1.5</td>
</tr>
<tr>
<td>Inter-Business (ind. %)</td>
<td>376 (100)</td>
<td>14.2</td>
<td>203 (54.0)</td>
<td>7.7</td>
<td>111 (29.5)</td>
<td>4.2</td>
<td>62 (16.5)</td>
<td>2.3</td>
</tr>
<tr>
<td>Money Lenders (ind. %)</td>
<td>21 (100)</td>
<td>0.8</td>
<td>14 (66.7)</td>
<td>0.5</td>
<td>7 (33.3)</td>
<td>0.3</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>2642</td>
<td>100.0</td>
<td>586 (22.2)</td>
<td>22.2</td>
<td>879 (33.3)</td>
<td>33.3</td>
<td>1176 (44.5)</td>
<td>44.5</td>
</tr>
</tbody>
</table>
and lenders to divulge the reasons for rejection.

7.3.82 The table however, gives a clear picture of the unsatisfied demand for credit. For example, out of the total attempts made only per cent 22.2 per cent were successful and 33.3 were partially successful, while the rejection rate was as high as 44.5 per cent. Taking individual institutions, those who sought loans from the DRFC fared the worst, followed by the AICC, and the IDB, with rejection rates of 88.1, 81.1 and 65.2 per cent respectively. At face value, the money lenders come out the best, having a rejection rate of zero, followed by inter-firm finance where the rejection rate is as low as 16.5 per cent. Although the last two sources appear to come out best, firms if they can do without loans from these quarters, they would refrain from turning to these sources, the reason being that the cost of credit from the money lender is very high, while inter-firm finance carry with it certain obligations which the borrower has no option but to accommodate. The table also underlines that the banks are the most popular source, having 61 per cent of the total attempts made, although their rejection rate is high as 48.3 per cent.

7.3.83 As mentioned earlier it has not been possible to identify the reasons for rejection of loans, but from the answers given to question two and three it can be presumed that it is a result of all the factors described there, in addition to the indirect factors such as Government policy and the weak bargaining position of the borrowers. Therefore it would be wrong to assume that all rejections were a lack of viability and/or non feasibility of investment proposals.

7.3.84 Question Nineteen: If answer to question 18 was 'No', please tick the appropriate cage/s below.
(a) no need to satisfied with present situation
(b) use own sources or directors provide funds
(c) wish to keep business from outside interference
(d) do not like loans, wish to avoid debt
(e) too costly
(f) have other sources
(g) waste of time trying, we would not get it
(h) do not have acceptable security
(i) no wish to grow
(j) do'nt know
(k) did not try

This question was not applicable as every firm had made an attempt to get outside credit during the last five years.

7.3.85 Question Twenty: Have you or any of your colleagues in other firms, encountered any special problems in obtaining outside finance for your/their business? Yes/No, if Yes, please elaborate.

This question was posed to include any other aspect of finance that had not been covered in the earlier questions. It elicited answers that were already given in answer to the preceding questions. If a summary is made of the subject matter on which they laid emphasis, it would be as follows,

(i) shortage of institutions catering to different needs of industry
(ii) absence of adequate facilities from existing institutions
(iii) the apparent bias against the small firm by all existing sources of credit
(iv) the lack of understanding and interest on the plight of the small firm.
(v) the absence of ancillary services
(vi) the absence of specific Government policy and inadequate incentives
7.3.86 **Question Twenty One:** In your opinion, what is the strength of competition for the products of your firm as compared with other firms producing and/or selling similar or alternative products?

(a) Strong competition
(b) Moderate
(c) No

The intention here was to estimate the competitive strength of the firms, in order to facilitate inter-firm comparisons with the accounting data that the survey intended to collect, but as the attempt to collect such data was unsuccessful, the data collected here served no valid purpose.

7.3.87 **Question Twenty Two:** Are there any other matters you wish to discuss on the question of industrial finance and any other related matter.

This question too had somewhat a similar purpose to question twenty above. All firms as a whole felt that despite the emphasis on industrialisation during the last decade, nothing very constructive had been achieved in the way of services both financial and other. If the opinion of the firms that commenced business before 1960 (6 firms before 1948, 9 firms between 1949 - 54, and 27 firms between 1955 - 60) is taken at face value, the avenues available to small industry and the economic climate for small industry have been retarded during the last decade. They based this argument on the lower interest rates available, the absence of restrictive policy and unnecessary intervention by the Government, and the more stable economic climate that prevailed.

7.3.88 The foremost criticism the firms made for the present plight of the sector, i.e. the stagnation of small industry, waste and misdirection in the industrial sector, was against the haphazard and uncertain
Government policy directed towards this sector. Their arguments emphasized what was described in chapter two and three, i.e. (a) the failure to study and identify the place of the private sector in the industrial structure of the country, (b) the failure to appreciate and evaluate the financial and other difficulties faced by industry, especially the case of the small firm, here a parallel was drawn with agriculture, where much effort has been put to study their financial difficulties, resulting in extensive agricultural credit facilities, (c) the failure to provide adequate and correct incentives to different industrial sectors, and (d) the inadequacy of the existing credit structure to meet the needs of new industry and the expanding industrial structure as a whole.

7.3.89 The basic incentives they desired, among others, for successful industry in the country were,

(i) A long term credit institution to meet the different financial needs of the small firm sector

(ii) The need for another institution to provide economic, technical and market data

(iii) Service institutions to aid technical and research facilities

(iv) Educational programmes to learn techniques of financing, management methods, as well as training facilities for the workforce.

(v) A policy statement on the place of private industry in the economic development of the country, and an assurance that such a policy would be continuous.

(vi) Re-training of staff of the financial institutions on different aspects of industrial finance.

7.3.90Q Question Twenty Three: Could you please provide your Balance Sheets, Appropriation and Profit and Loss accounts for the last
three years.

After the interviews, an attempt was made to collect accounting data, to study the financial structure of the firms, with a view to relate the answers obtained from the individual firms to the existing financial structure of the firms and to make inter-firm comparisons. However as mentioned in Chapter five the response was poor. Percentage-wise the number of returns were too small to make any significant cross classification between firms and to correlate the answers with the financial data. Therefore, no attempt has been made in the study to evaluate such relationships.

7.4 GENERAL CONCLUSION

7.4.1 From the overall results of this survey, it could be concluded that the present financial climate and the avenues of credit, is weighted against the small and to some extent the medium sized firms, and that there is a serious institutional gap of credit to these firms. It has been possible to assess beyond a reasonable doubt that this sector faces problems of finance, at every stage of their business, from inception to the intermediate stage of their growth and from there onwards to future expansion and development.

7.4.2 Many problems of finance are of course common to the type of firms under investigation here, as well as to other firms in the industrial sector, but every problem which is common to small as well as large firms is multiplied in terms of the small firm. This is not to say that small and medium sized firms do not get any credit at all, but to emphasize that due to the present structure, they have to compete with large firms in all sectors of the economy, for a limited amount of credit. Therefore, a choice of a lender between a creditworthy small and large borrower falls naturally in favour of the latter, while the conditions
required by the institutions to grant accommodation, keep out a great number small firms.

7.4.3 The reasons for the problems discussed in the preceding pages, cannot be justifiably laid at the door of financial institutions alone, it is a combination of causes both internal to the firm as well as external, the shortcomings in the institutional lenders, interaction of Government policy and the general economic problems in the country. The next chapter makes an attempt to understand the different causes and their inter-linkage to the central problem of finance.
CHAPTER 8

EXPOSITION OF RESEARCH FINDINGS AND CONCLUSIONS

8. 1. INTRODUCTION

8. 2. INSTITUTIONAL GAP

8. 3. FUND GAP

8. 4. ATTITUDE AND COMMUNICATION GAP

8. 5. POLICY GAP

8. 6. STRUCTURAL GAP

8. 7. QUALIFICATION GAP

8. 8. A TEST OF A HYPOTHESIS

8. 9. GENERAL CONCLUSION
8.1 INTRODUCTION

8.1.1 In the light of research undertaken and reported so far in the preceding chapters, it has been possible to conclude that there exists a credit gap in the country where small and medium sized firms are concerned. Further the findings also established that this shortage of credit is specially acute in the case of small firms. The two surveys directed its enquiry to all forms of credit that a firm needs, i.e. venture capital for new firms, short term needs, such as working capital and bridging finance, funds for long term needs of the new firm and already established firm, development finance and risk capital. It was possible to establish that there exist shortages for all types of finance, although in some spheres it was not so acute as in the others, while in some fields there were no avenues at all for the firms under investigation. This general shortage of funds has been a result of a number of interlinking causes, which for the purpose of this study is demarcated into six sub-groups. However, it is important to keep in mind that these sub-groups are so closely connected that no attempt is made here to make very specific demarcation but the purpose of this attempted separation is to give emphasis to the main features in the sub-groups. Therefore there may arise a certain amount of repetition, although an attempt is made to keep it to a minimum.

8.1.2 The six sub-groups are:

(i) Institutional Gap, i.e. the absence of any properly constituted institution or institutions to (a) provide finance (b) educate, advise, direct and establish liaison and the shortfall of the existing credit institutions and other intermediaries

(ii) Fund Gap, i.e. the shortage of funds in the institutions, shortfall
of savings in the economy, the direction of funds that could have been made available

(iii) Attitude and Communication Gap, i.e. the short-comings in the chain of communications between lenders and borrowers

(iv) Historical and Policy Gap, i.e. the historical setting, the development policies of successive Governments

(v) Structural Gap, i.e. the short-comings in the management and the financial structure of the firms, and the organisation structures of the institutions, coupled with the backwash of structural limitations of the whole economy.

(vi) Qualification Gap, i.e. the difficulties the lenders and borrowers face alike. In the first category are the degree of risk/ small firms and new ventures, legal obstacles, costs in lending. In the second category are the problems of meeting loan requirements.

8.2. INSTITUTIONAL GAP

8.2.1 Chapter four outlined the present institutions that form the credit structure of the country, while chapter six surveyed their lending activities and the problems they face, and chapter seven discussed the interactions of small and medium sized firms with external credit. This section attempts to tie up the findings of these chapters on the shortage of financial intermediaries, and the short-comings of the external avenues, and the absence of services ancillary to finance.

8.2.2 Diagram 2 outlines the existing institutional structure and the present flow of credit to industry according to size. The survey so far established beyond any reasonable doubt that there is no institution especially created, or part of an institution empowered to give financial aid to the small and medium firm industrial sector, of the type found in
DIAGRAM 2.

THE PRESENT INSTITUTIONAL STRUCTURE & THE FLOW OF CREDIT
both developed and developing countries. There were only two attempts made to finance this sector and both had ended in failure due to structural features more than any fault of the firms that they were to finance.

8.2.3 In recent times there has been an attempt in Government circles to restructure the institutions. Though specific plans have not been made public and the proposals are still in a planning stage, the basic proposals for the future are as follows:

(i) the establishment of an export and import bank
(ii) the establishment of a development bank to finance the State corporations
(iii) the amalgamation of the Agricultural and Industrial Credit Corporation and the State Mortgage Bank1 to form an Agricultural Bank

The proposed new institutional structure is given in diagram 3.

The proposed amalgamation and the new institutions would certainly fulfill particular needs, but as many times before the new proposals are based on limited sectoral analysis and deduction rather than through the result of systematic analysis of the whole credit structure from an overall investigation and survey. The results of the new structure would be to place the small and medium scale sector, even in a worse situation than before.

8.2.4 This study is of the opinion that the assistance available to the industrial sector as a whole, and small and medium size firms in particular is so meagre that even a mere establishment of a bank catering to small firm finance would hardly solve the problems of finance the small firms face. During the interviews it was possible to gather from those responsible for development policy of the country that there was a general

1. The State Mortgage Bank was founded in 1931 with the object of granting long term loans for agriculture and other prescribed purposes such as for housing, building and construction
DIAGRAM 5.

GOVERNMENT PROPOSALS - THE PLANNED CREDIT SYSTEM.
AND THE LIKELY RESULT OF CREDIT FLOW TO INDUSTRY

**AICC + SMB**

**AGRICULTURAL DEVELOPMENT BANK**

**AGRICULTURE**

**LARGE PRIVATE INDUSTRY**

**STATE INDUSTRY**

**COMMERCIAL BANKS WITH FURTHER DEVELOPMENT ORIENTATION OF THE BANK OF CEYLON & PEOPLE'S BANK**

**RESIDUAL**

**SMALL & MEDIUM SIZED FIRMS**

**STOCK MARKET**

**TO FORM NEW**

**REMAIN AS IT IS**

**A NEW BANK TO FINANCE STATE ENTERPRISE, I.E. THE INDUSTRIAL DEVELOPMENT BANK**
understanding among them that the needs of the small firms could be adequately met by present commercial banks. It was assumed by them, that they had no serious credit problems, on the other hand, if they had any problems it was believed that it was their own creation through their own folly. If this totally illogical reasoning with regard to the fulfilment of the credit needs of the small firms by commercial banks alone is true, this would put the Ceylonese small firm sector in a truly enviable position 'vis-a-vis' his counterpart in other developing as well as developed countries. However, this assumption is far from the truth as has been painstakingly pointed out in this study.

8.2.5 It is difficult to understand how this conclusion of the adequacy of finance has been reached, when to date no overall attempt has been made in the country to investigate the credit needs of the private sector as a whole nor that of the small industrial sector. It is true that there has been sectoral studies, desk research of particular aspects of finance and two commissions that sat to investigate the working of the two 'old' indigenous banks, but apart from that, there is no evidence that any attempt was made to study the intricacies of development financing of industry of the private industrial sector, or that of the overall credit structure of the country. The only overall study of major merit, of the credit structure of the country, in the country's history, has been that of the Banking Commission investigation of 1934 (see 4.2.9). Therefore the only conclusion one could come to, for this attitude, is that there exists an erroneous understanding of industrial finance, i.e., all forms of finance, a firm seeks are categorised under one general term 'finance'. If on the other hand an attempt was made to evaluate various forms of finance a firm needs, such as short term working capital and bridging finance, medium and long term capital for development, expansion, diversification, innovation
capital for equity, pure risk capital, capital needs of new firms and those of already established firms, one feels that they would not express so complacent an attitude.

8.2.6 After examining the availability of institutional financial sources to provide finance to firms, the existing situation today could be summarized as follows:

(i) There are no long term credit institutions for small firms, nor is there any future plans to set up any.

(ii) The AICC as mentioned in chapter four and six has been insignificant in small firm financing, nor is it able to do so even if it so wishes, due to its capital limitations.

(iii) The DFCC from the outset opted themselves out of financing this sector and by their self imposed limitations have not fulfilled the responsibilities assigned to it nor those envisaged by the World Bank Mission.

(iv) The stock market is underdeveloped and its activities are limited, while whatever future development it envisages, it will still be above the small firms.

(v) There are no special financing programmes undertaken or sponsored by the Government for the manufacturing sector. The 'finance for small firm programme' was doomed to fail from the start (see section 6.3).

(vi) The IDB began with serious structural limitations and expanded its activities and responsibilities ahead of its capacity, without first getting its internal structure well organised and its priorities right.

(vii) The hire purchase and finance companies are oriented towards consumption financing.
(viii) The foreign banks which developed alongside the plantation and commercial sector of the country have remained principally Banks of Commerce of British vintage.

(ix) What little finance that has come by way of the small firm, has been from the two indigenous banks, namely, the Bank of Ceylon and the People's Bank of Ceylon. However, even here the former due to its structural limitations and historical factors developed along the lines of British commercial banking practices. Out of its total industrial lending, the major share has gone to well established large firms and it is only the overspill if any, that has come to the small firms. Even the meagre funds that come to the small firm sector are principally for short term purposes. The People's Bank on the other hand stretched itself at first to accommodate a great number of small firms but since the Commission Report it has re-oriented itself to lend to the agricultural sector. While in the case of industrial lending, as it gained maturity a greater portion of their lending to the industrial sector was directed towards large industries in competition with the Bank of Ceylon.

(x) The Department of Rural Development and Small Industries is only concerned with the organisation and administration of textile weaving and services to cottage industries with a capital investment of below Rupees 10,000.

(xi) The National Small Industries Corporation occupies itself in running a few small industries of its own.

3.2.7 Apart from these, there are no other institutional sources which the small and medium firm could turn to for their various needs. It is expected that with the restructuring of the commercial banking sector, that the banks will play a more active role in financing of industry. However,
even if they increase their lending activities to industry, there is no guarantee that this increase would benefit the small and medium sector more, and secondly, this assumption is based on a wrong premise that industrial financing is similar to financing of commerce.

8.2.8 The commercial banks keeping in mind their development, nature of their funds, and other limitations such as trained staff cannot be expected to fulfill all the needs of finance mentioned earlier. Perhaps if the early development of the Bank of Ceylon took a turn on the lines of continental banking as envisaged by the sponsors, the problem of re-orientation would not have been as difficult, as it is today. (see section 4.2.14) Considering these factors even if their basic orientation to lending changes, it would only result in meeting the short-term needs of the firms and at worst some medium-term needs. Beyond that, it would be inadvisable to stretch their structure which is geared to liquidity, to accommodate all long-term finance of the small sector and risk capital. This is not to say that banks cannot lend on medium-term and perhaps even some for longer periods, but to emphasize that it would be impracticable to burden them with the whole responsibility. The non-Ceylonese banks, on the other hand, being branches of foreign banks, not much should be expected of them in the field of industrial financing than they have already done, keeping in mind the tenants of the purpose of their existence. It has been popular to make them 'scapegoats' for inadequate financial facilities experienced by the growing needs of the country. The survey firms felt that, within their given constraints, they had done a satisfactory job in allowing a certain amount of credit to them. Further they were established to finance/plantation and the commercial sector and in this sphere they have done quite a satisfactory job.
8.2.9 It is worthwhile to conclude the shortcomings of the existing institutions by looking at the DFCC, the institution that was specially created to finance the industrial sector. The DFCC as it is presently run is very sophisticated and thorough in its loan appraisal and credit procedure. Its credit appraisal policy and the conditions on which credit is granted, is beyond reproach. However, their approach would have been justifiable in a developed country which deals with a more educated (financial-wise) and better informed entrepreneur, their mode of operation today, in a country which is just beginning industrialization and where tenants of financial practice is still in its infancy, is a little too advanced, i.e. a form of 'putting the cart before the horse' approach. The foregoing criticism does not in any way attempt to deride the high principles set up by the DFCC regards good financial management, the point at issue is that the Corporation's activities today is a little out of context to the existing situation and is deficient in terms of the original intentions of the proposers. (see section 4.4)

8.2.10 In fulfilling only one aspect of its intended functions, i.e. granting financial accommodation it has jeopardised its usefulness. The credibility of this argument has to be seen from what was stated in chapter four and the survey of its present activities in chapter six. Therefore in terms of its present activities it has,

(i) alienated itself from the small and to great extent from the medium sized firms which form the majority of the industrial units in the country

(ii) failed to appreciate that most firm in developing countries could only start small.

(iii) made no attempt during its fifteen years of existence to go down to the level of the industrialists by (a) contacting prospective entrepreneurs
on its own initiative, than waiting at the desk expecting them to come to 
the Corporation and (b) by disseminating knowledge by way of workshop 
seminars, lectures, publications, or through the media of newspapers and/or 
radio.

(iv) not encouraged or made an attempt to appoint agents to seek out 
prospective clients, both in the city and the countryside.
(v) not made any attempt to nurture future industrialists by a long term 
policy of nursery ventures or on the other hand following policy (b) 
and (c) mentioned in page 164 of chapter four.
(vi) not helped actively to underwrite stock issues.
(vii) by its present activities, acted as a barrier against the development 
of a stock market, and prevented funds, that could have been made available 
to the small firm and the medium firm sector, from flowing into this sector.

8.2.11 It can only be presumed today, that, if the DPCC followed 
a dynamic policy of disseminating knowledge and sowing the seeds of good 
credit management (without limiting themselves as it has presently done to 
serve a few large customers) it would have by now reaped a rich harvest of 
creditworthy clients and viable small firms. A good example of such a 
procedure paying itself, is seen in Japan today.

8.2.12 So far, this exposition dealt with the aspect of availability 
of institutions to provide finance, however, it is equally important to 
emphasize that provision of adequate institutions concerned only with the 
provision of finance would not suffice to solve the problems of infant 
industrialization, in fact this is only part of the solution. It is 
equally important that (i) parallel institutions and policy should be 
developed to pave the way for good financial understanding on the one hand
and (ii) institutions to aid the financial intermediaries in easing their lending problems, neither of which are available today.

8.2.13 In the first category are those educational services such as financial techniques, firm management, technical services, management accounting, in short advisory and counselling services for all aspects of industry. At present there is no properly organized viable body in the country, like for example the Small Industries Service Institute of India or the Small Business Administration programme of the United States, or the various bodies as found in Japan. It is true that the Industrial Development Board of Ceylon attempted to fulfill this function to some extent but due to reasons given in section 6.6, it touched only the periphery of the problem.

8.2.14 In the second category are (a) a programme of staff training of the financial institutions to appreciate and learn techniques of industrial financing and to provide the necessary motivation for development financing. In all the institutions surveyed with perhaps the exception of DFCC the staffing patterns show that they depend on the traditional methods of acquiring and absorbing skills as they go along, interspersed with a few courses in banking procedure and related academic training. However, this process not only takes a considerable period of time but also gives them only a generalised knowledge as against specialised skills, with the result the development of experienced staff versed in techniques of industrial and development banking with capabilities of assuming lending responsibilities and leadership is retarded.

8.2.15 (b) an institution or a subsidiary of another institution specialising in development capital. It is important to differentiate normal financing of long term needs, as against financing of greater risk bearing investments. In general, the provision of finance for new technical
development presents some of the most formidable problems with the industrial scene today. It is the problem of reconciling the risk during the long period of development with subsequent rewards which may in fact never accrue. The provision of this type of finance cannot be done by banks. A banker would not be easily persuaded to take on financing if the prospects were that the advance would mount steadily for several years and might then level off on a plateau, so that the commencement of reduction of the advance would lie in the more distant future.

The Radcliffe Committee which investigated this problem in Britain stated,

"there are certain special problems about the provision of finance for the commercial development by small businesses and private companies of new inventions and innovations of technique. One problem is that the amount of capital required to finance development may be larger in relation to a small company's capital structure and apparent earning prospects than the financial institutions would ordinarily feel justified in putting up." (Cmd. 827 Para.948)

8.2.16 Most large concerns have specialised research facilities and the financing of innovation is a normal part of the process of growth. The small firm however, does not have these facilities and yet it is very often the small unit which provides an outlet for originality which could not be stimulated in the large concerns. Many innovations originate from small firms where due to close knowledge and concentrated thinking about particular specialised problems many innovations which require ingenuity rather than large scale resources, are developed. However, the innovator working on a small scale often lacks both the experience, facilities, and finance to make the innovation a success. The observation made by the Radcliffe Committee on the risks of innovation apply specially to the small firm,

"... the risks in the commercial exploitation of technical innovation are likely to be greater than those in expanding an existing line of production
or extending into existing lines of business, and, however promising the innovation, the risks are certainly more difficult to assess. This makes it more difficult for the company that wants to develop an invention to convince potential lenders that their money will be well invested."
(Cmand, paragraph 948)

8.2.17 In Britain to offset the problems of the small innovator, the National Research Development Corporation was founded in 1948, followed by Technical Development Capital Limited in 1962. NRDC gave assistance in various ways. For example, inventions by small firms which were communicated to the NRDC were first screened and if selected were assigned for exploitation. Although the rights were transferred to the Corporation, arrangements were made for the innovator to share in the revenue. This arrangement is much more favourable to a small firm when compared with the existing situation where due to the absence of technical and financial facilities the firm is compelled to sell their rights and patents. The NRDC was prepared to put up direct finance for projects which required further development.

8.2.18 Technical Development Capital Limited of Britain was founded following the recommendations of the Radcliffe Committee with the specific aim of providing risk capital for technical innovations and inventions. The TDC's aim is to ensure that worthwhile technical innovation in the private sector of British Industry is commercially developed and exploited and the management is not thwarted through lack of financial support.

8.2.19 Thus there is a case for an institution to provide development capital and another to work alongside this providing the necessary facilities. This would not only help banks and other institutions to provide other capital needs of firms but the risk of misuse of funds and the risks of loss of their other funds lent to an industrial unit would be minimised considerably.
8.2.20 (c) A credit guarantee programme to enable the financial institutions to participate more fully in industrial financing.

8.2.21 (d) A service or services for technical, economical, and development appraisals of financing proposals. The Bank of Ceylon floated a subsidiary company called the Industrial Financial and Commercial Consultants Limited to undertake services of this kind, but although the intentions of the institution were admirable it was a failure due to factors extraneous to what it set out to do, i.e. administration.

8.2.22 In concluding this section, it must be emphasized again that the institutional gap does not mean merely a shortage of institutions to provide normal financing needs of the firms but also a shortage of parallel institutions providing ancillary services. Therefore in this context the problem of finance is not merely to extend more finance but to improve the quality of its services and those services ancillary to it.

8.3 FUND GAP

The diagram below shows the various possible sources of funds available to the firm.

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**Diagram 4**

- **Internal Sources**
  - Reserves
  - Profits retained
  - Owner’s savings
  - Personal income
  - Owner’s family, directors, and shareholders funds

- **External Sources**
  - Equity
  - Debt
    - Private backers
    - Public issue
    - DFCC
    - STOCK MARKET

- **Commercial Banks**
  - AICC
  - DFCC
  - Finance companies
  - Hire purchase
  - Inter-business
  - Private lenders
8.3.1 Chapter seven outlined the extent of internal funds that were available to the early firms and the conclusion there, was that internal sources accounted principally for most small firms at the initial stage of their business. There is factual evidence that most firms began business in a small scale, except those that converted a going business into manufacturing, principally due to a shortfall of necessary funds. The prospects of starting with little capital and/or with a high percentage of debt capital introduced weaknesses in fund generation as has been discussed in the previous chapter. There is also evidence that most small entrepreneurs having invested their funds, and those of the family, were depended solely on the earnings of the firm for a living. In other words at the initial stage of the business they had exhausted their fund sources. As mentioned in chapter two there was a considerable amount of leakages from the early profits of the firm for non-productive purposes. These consisted of (a) entrepreneurs household expenses, (b) raising his standards of living, (c) conspicuous consumption purposes, (d) religious, social and cultural purposes, (e) hoarding in the form of gold and jewellery.

8.3.2 Thus, at the early stage of the firm all sources that were available to the entrepreneur were tapped to the full, while a considerable amount was wasted in non-productive expenses. Therefore, apart from the weaknesses introduced due to the limitation of funds at the early stage, the critical stage in most firms were reached when the firms began to move from the 'setting up' stage, to consolidation and expansion stage. The options open were, resorting to reserves or accumulated profit, interesting private financiers, and/or turning to credit institutions. The profit accumulation of most firms did not coincide with the plan of the firm. This is always
a problem as the total sum of the accumulated profits does not always coincide in terms of size and time with development expenditures, which must be met at specific times and in certain amounts. Normally profit accumulation takes a number of years. For example, in a developed country reserves could be invested in high yielding bonds that can be converted into cash at very short notice. But, in Ceylon avenues of this nature were limited, while at the same time one is prevented from investing in overseas markets due to exchange control, the only alternative was to deposit any excess funds in commercial banks at low rates of interest. Further the value of these funds is also eaten away by inflation. Thus small entrepreneurs apart from their early financial indiscipline, whereby certain portion of their funds were wasted, usually prefer to take funds out of the firm if they are not immediately needed by the firm.

8.3.4 The firms that made early profits were mostly those who had converted a going business concern into manufacturing, who were in a position to do their own marketing and sales and were able to capitalise on the scarcities in the economy. However, quite a number of the firms were heavily depended on a number of middlemen for sales, and there was a tendency among the middlemen to drain away all profits. This finding is general to most developing countries where the middlemen who take a short view of his interests tend to drain away profits and leave the small firm client with insufficient income to develop their full potential. (see 1.8.12). Further, as the small firm is under heavy pressure to extend finance to their customers in the form of credit sales and the lengthy delays by their customers in paying for the purchases leaves them also with inadequate funds. This is specially acute in the case of sales to State Corporations and Government departments. Thus, apart from the middlemen siphoning off a good
portion of the profits of the small manufacturer, the dependence of most small units on large established units and chains of retailers for their sales, necessarily directed the financial flows more in favour of the latter.

8.3.5 The absence of development of a healthy attitude to inter-firm finance is also a result of the peculiar nature of industry in the country. The country's business structure, have failed to develop much inter-linkage between productive units. Therefore most firms strive to be self-sufficient, from the raw materials stage to final manufacture, sometimes at great cost and under-utilisation of capacity. Thus, the development of input producing units that feed other units has been retarded. This characteristic is prevalent in all industrial units from private industry to large state corporations. One of the successes of inter-business finance is when industrial units vie with each other to sell product components to one another. This is absent in Ceylon, and the trend among the firms is that if they cannot manufacture a component themselves, they prefer to import if from overseas. Thus financial flows from large firms, to small firms producing components for the larger firm, is very weak and in most cases non-existent. It is in fact a rarity to find feeder units manufacturing intermediate goods.

8.3.6 Government credit restriction policy is another cause that contribute to fund shortage. Usually funds coming into small and medium units even in normal times are small. It was possible to establish during the survey that there was an indirect tendency to ration credit away from the small firm during these times. This finding is true, despite the exemption of development loans to industry and agriculture from falling within the credit restrictions. The raising of interest rates does not have
much effect on the demand for credit nor is there a gearing in interest rates according to the size of the loan. The methods, banks use to ration credit during these periods is by (a) introduction/queue systems, (b) rationing size of loans, (c) raising conditions for loan qualification, (d) withdrawing, refusing, reducing or not renewing overdraft facilities. Though these measures were not specifically directed against small borrowers, most of them necessarily hurt small borrowers more than his large counterpart. This is especially true with respect to items (a), (c), (d) above.

Another peculiar finding by the survey while investigating the effect of credit restrictions on small firms was that in certain instances lenders had given the 'credit squeeze' as an excuse to turn away prospective small borrowers, when in fact credit restrictions were not applicable at the time.

8.3.7 Fund limitation in the market, has already described in chapter four and chapter six. In the case of private investors, their funds flowing into the small and medium scale sector are limited as,

(a) the greater proportion of the population come under the category of low income earners, i.e. those engaged in farming and agricultural pursuits and those who are fixed income earners engaged in 'white' and 'blue collar' jobs,

(b) the few well to do investors, i.e. those that have amassed wealth through a commercial and other business pursuits, and those that have come into wealth through heritage, prefer either to invest their funds in land and housing or in the commercial plantation sector and in large established commercial and other business. Even in the case of those who acquire wealth, following other pursuits over a period of years, their priorities lie with investment on land and trying to get a foothold in big business.

8.3.8 The characteristic of the investing public was well
documented by the IBRD mission of 1952 (see section 2.3.8). From evidence
gathered during the survey, the situation seemed to have not changed very
much over the years and any change at all that has taken place, is more to
sharpen the very same characteristics, due to restrictions, controls and
the uncertain economic prospects in the country.

8.3.9 The reasons for the meagre flow of funds into the small
and medium scale sector could be summarized as follows:
(i) Most small and medium sized companies are either single proprietorships,
partnerships and private companies, where ownership is very tightly
controlled. Further in case of shareholders, they have no security for
their investments and no guarantee that they will be paid a dividend or
in the event of the company getting into difficulties that they will be
repaid the money which they put up.
(ii) As it is usually believed that small businesses are considered more risky,
investment funds are more shy of taking the risks. Therefore private
investors who have the means are willing to make funds available only on
unquestionable security and a high degree of liquidity. Others who have
meagre savings prefer to deposit them either in the banks or as in recent
times, in finance companies where they get a guaranteed return on their
deposit, i.e. between 8 to 12 per cent.
(iii) The preference for investment in land is prevalent in all sectors of
the economy. Another lucrative field which has arisen due to import controls
and scarcities in the economy, is speculative stock building of scarce food-
stuffs, consumer durables and other luxuy goods. Since the Government
ban on import of private motor vehicles and restrictions on import of
commercial vehicles, the buying and selling of motor vehicles is another
lucrative field of activity.
(iv) In the average household the savings are meagre and they are socially too unsophisticated to think of investing funds in an industrial venture. Therefore, they prefer to hold their wealth in fields which they know something about, such as, investment in houses, jewellery and pure hoarding of money. The latter proved to be a very popular form of saving, as was shown by the demonetization of the Ceylon hundred and fifty rupee notes by the Government in 1969 and the resulting flow of hoarded money into the banks.

(v) All groups spend considerable sums of money in non-productive pursuits, most of which are socially and culturally accepted by the Ceylonese society. These are funds spent on religious observances, festivals, spiritualism, astrology, celebrations to commemorate birth, coming of age and marriage, observations to commemorate the dead, and the 'purchase of salvation' for the dead and the 'dowry' system at marriage, which is more or less compulsorily observed. As one small industrialist remarked, 'whether he liked it or not, he had to apportion part of the profits of the firm, as dowry for his three daughters and in the eyes of the public the more successful he seemed, the more was expected as 'dowry' for his daughters.' All these social, cultural and religious practices drain quite a large proportion of a family's resources, and as the average family in Ceylon is large these expenses were naturally multiplied. The influx of foreign culture over five centuries of foreign rule has added to these drain of funds.

6.3.10 It has already been described that bank funds most of which come from depositors are short term in character, and therefore they cannot be expected to use these funds for long term purposes. The AICC's limitation of funds is due to its charter. (see section 4.4.4) Therefore,
since 1965 their funds have been severely restricted. As this is the case their preference today is to lend to safe customers as they have to depend on limited funds, i.e. capital and interest repayments, to generate further lending.

8.3.11 In the case of banks, only the lending patterns of the two 'old' indigenous banks are relevant here. The lending of other banks to small industry is insignificant. In the preceding chapters, and in the different sections in this present chapter, the reasons for the fund shortage of banks to finance the industrialist was given. Therefore, it would suffice here to underline two basic reasons why limited funds flow into the industrial sector.

(i) Inadequate capital backing to undertake lending, especially of a long term and more risky character.

(ii) Their source of funds

8.3.12 The inadequacy of capital was discussed in chapter six in relation to the bank of Ceylon. Though it was stated there, with reference to the Bank of Ceylon that this alone is not a sufficient excuse for their lending attitudes, there is a relationship between capital inadequacy and the hesitancy to provide finance for long term purposes, especially when the success of the investment programme is not guaranteed.

8.3.13 In the case of the second, i.e. source of funds, it was mentioned in section 6.4.18, that banks were restricted in their lending activities as a result of this factor. A bank's first duty is to its depositors, and it is also presumed, that depositors are willing to make deposits in banks only on unquestionable security and high degree of liquidity. This is the basic tenet on which bank lending is founded, and despite modern developments in banking, where there is a greater degree of
fixed deposits in banks and greater confidence in the security of banks, they have opted to remain conservative. The point at emphasis here is that, even if the banks were desirous of lending for longer periods, the ingrained characteristic of the structure of banks, limits the funds that would be used for long term lending. The nature of bank funds also limits their direction of funds for two other reasons, namely

(i) normally merchants and commercial establishments tend to be the major source of bank deposits in less developed countries. Small industrialist being insignificant as customers banks tend to extend them finance only to the extent that funds are not required by primary customers;

(ii) as uniform rates of interest apply to bank deposits, it is in the interest of the bank to attract large clients, and this is tied to, according them priority in loan considerations. Banks have therefore, sound economic reasons for channeling a large part of their loans to merchants and to commercial establishments and tailoring their lending procedures in terms that are best suited to these factions. Thus, banks lend only residual funds after the demands of large business and other favoured clients are served and in capital shortage economies this residual may be small or transitory.

8.3.14 Two other primary source of funds which are presently denied to this sector are:

(1) DFCC funds and (ii) funds from long term savings institutions.

In the first part of this chapter (see section 8.2.9) it was stated that the DFCC by its present activities acts as a barrier to the development of a market in industrial securities and redirect funds which could otherwise be made available to the small and medium scale sector. Ninety five per cent
of DFCC borrowers are those who could well afford to obtain funds by a public issue of shares. The DFCC by its self-selective policy siphons funds which are received from the Government, Banks, the Insurance Corporation, Central Bank and the IBRD to those very firms that could by themselves create the avenues to obtain funds by going public. This policy has had two effects, (a) it has proliferated the type of firm which prefers to remain privately held by 'well to do' influential investors and indirectly hindered the development of a stock market. (b) It has prevented some of these funds being made available to those who were too small to go public. These firms that have access to the DFCC would naturally prefer to get their funds through the DFCC for a number of reasons, i.e. (i) loan funds are cheaper to obtain than capital by way of public issues (ii) the interest for debt capital is a deductible expense for income tax while equity capital is not, (iii) ownership is still retained in the original group of shareholders, and lastly, (iv) the firms are able to keep itself in a monopoly situation as on principle, the DFCC makes funds available only to one firm in each category of product or products. Thus, the DFCC in fact acts as a barrier against development funds coming into the sector which deserves them most, and in which the units are too small to go public.

8.3.15 The second source of funds denied to the industrial sector is the vast funds accumulated in voluntary and compulsory savings institutions. The voluntary savings funds comprise of (a) the Post-Office Savings Bank (b) the Ceylon Savings Bank and (c) the Insurance Corporation of Ceylon. The compulsory savings fund, which was introduced in 1969, where a percentage of all incomes earned over and above a fixed maximum has

1. All private insurance companies were nationalized in 1961 and all insurance business today is monopolized by this institution.
to be deposited in this fund. There are also two other funds that fall in between these two categories, i.e. (i) Widows and Orphans Fund and (ii) Pension Fund.

8.3.16 A major share of all these funds are more or less blocked for long periods and therefore could be considered long term deposits. The Ordinance of the Post Office Savings Bank enables the bank to invest only in Ceylon Government securities, debentures of the State Mortgage Bank and Government securities of India and the United Kingdom. As seen in chapter four and six, the greater proportion of its funds are invested today in Ceylon Government securities. The Ordinance further does not allow this institution to diversify its investments. In the case of funds of the Ceylon Savings Bank, the position is very similar, as under its ordinance the funds could be invested only in Treasury Bills, and Ceylon Government debentures. The Insurance Corporation of Ceylon which today has a monopoly of all insurance, is limited, as the other institutions, in its investment decisions. For, the Act of its incorporation stipulated that at least half of the assets of insurance companies should be invested in Ceylon Government securities. The funds of these mentioned above are administered by Government or quasi-Government bodies and as shown in chapters four and six the Government monopolises these funds by limiting them to/purchase of Treasury Bills and Government securities.

8.3.17 It is not the contention of this study that all the funds of these bodies be directed to the industrial sector, but there is the possibility for a certain proportion of these funds to be fed into the small and medium scale sector through an appropriate development agency, such as a reconstructed DFCC, or an Investment Trust.
8.3.18 From what has been described above in the preceding pages, there is firstly a shortage of funds available in the market and secondly, there is a definite gap in fund flow to the small and medium scale sector, and the present available funds in this sector are inadequate in relation to the investment requirements of the sector.

8.4. ATTITUDE AND COMMUNICATION GAP

8.4.1 The communication patterns that have developed between the financial institutions and its customers are principally a result of history. The early development of banking practices was well outlined in chapter four. From what was described there, it could be concluded that the banking system that prevailed in Britain at the time Ceylon became its dependency, was directly super-imposed on the economy of Ceylon. The repercussions of this move were not felt at that time, for in the first instance, Ceylon was a colony of Britain and the commerce and trade of any significance were in the hands of British companies, therefore the operations of these banks were not very much different from that of provincial banks in a British township. Secondly, almost all customers, the banks had direct contact with, were British, while the few Ceylonese and Indian customers never came in contact with the management of the banks, as all their dealings were channeled through the 'shroff' (see section 4.2.). Thirdly, the legal system under which they operated was British and almost all transactions were with the mother country.

8.4.2 All business that mattered were in British hands and the British as a community in Ceylon were closely linked both socially and culturally. Therefore, close contacts were established between the management and its clients both in terms of business and social fields.
feeling that they were a close community far away from home enabled them to cast aside even the normal social barriers that were prevalent in the mother country. Thus, during these early times, the banks functioned very efficiently, and there was little need for the banks or their management to study the social and cultural habits of the indigenous population. Therefore, the early development of the financial structure became completely divorced from the people of the country, while little effort was made to introduce the banking habit or cultivate business relationships with the public. The attitudes of the ruling minority was well underlined when the Ceylonese first demanded a bank of their own, as seen in the opposition from the existing banks, trade chambers and general business circles. (see section 4.2.13)

8.4.3 The results of this early development had great significance to the attitude and communication patterns that were established. Development of banking in Britain was a very gradual development alongside the economic development of the country. It goes back to the goldsmith bankers of the seventeenth century. These early banks were small, mostly doing business only in their own town or district and the majority of them grew up as family businesses or small private partnerships. Although at a later stage there was considerable degree of amalgamation of these individual banks resulting in the head offices of the new large banks being situated in London. Two characteristics of this early development remained, namely (i) the wide network of branches in every township and the desire, and (ii) the efforts of the management to integrate both socially and culturally with the people of the area in which the branch was situated. Thus the relationship between the banker and the customer in Britain has been built up on the basis that the customer normally deals with the local representative of the bank in his area. Thus the customer and the banker get to know each others' personalities and
methods of approach, with the bank manager making every endeavour to understand the complexities of his customer's trade or profession. The result of this close liaison between the parties is that when the customer requires assistance from the bank, it is not usually necessary to begin a minute investigation of his affairs as the manager will have built up a picture of the customer's activities over a considerable period, and will be in a position to give an early answer one way or another when faced with the request for accommodation. There were of course occasions when the amount involved was too large, and due to technicalities involved, it was necessary to have consultations and utilise the services of specialised departments in the banks' head office, before a decision was taken. But it is important to stress, that one of the most important points taken into account at the head office is the local manager's assessment of the customer's business acumen and financial position. Thus it was not always, that banks accepted or rejected propositions solely on balance sheet figures, but in certain instances they were willing to back the judgement of their local manager.

8.4.4 The establishment of this form of close relationships in Ceylon has been slow in developing, and due to factors such as different social and cultural levels, the dearth of branch banks till recent times, the frequent transfer of branch managers, rigid centralisation of loan decisions, dearth of delegation of authority to branches, and the concentration of most business in the capital of the country, i.e. Colombo. The present situation in Ceylon has close similarity to the observations made by Davenport, although this observation is made with regard to another aspect of banking.

"Most countries lack the tradition of unsecured lending based on the
banks knowledge of an applicants management capabilities and the nature of his operations, it is this tradition which has given commercial banks in the U.S. some preparation for undertaking some productively important and complex types of financing. Banks which in screening applications focused exclusively on the supporting guarantees have not built up the knowledge, the staff or the procedures necessary to apply development lending criteria or to appreciate the possibilities of sound lending programmes being created for small enterprises" (Page 146)

8.4.5 Another important development of the British banking system was that the British banker did not play a major role in the process of long term investment in industry. However, he filled an important gap in the economy as the fountain of short term capital to agriculture and industry. It is a significant feature of commercial banking in Britain that has prevailed up to recent times. The bankers never thought of themselves as providers of long term capital and they regarded the risks involved in tying capital to long term investment outside their sphere of involvement. This development of the British banking practice is even more pronounced in view of the fact that their counterparts in the European continent did not think on the same lines. For example, the German and Scandinavian bankers were of the opinion that they should play an active role in fostering and developing industrial expansion, and even went to the extent of associating themselves with the management of industrial enterprises.

8.4.6 Thus in Ceylon, the British banking traditions brought along with it the short term character of bank loans and advances, resulting also in the management and the staff being trained in these traditions, along with the attitudes that go with them. As up to the last decade, the commercial and the plantation sector being the developed sectors, banking procedures were attuned to serve the needs of this sector. Further, most commercial and business transactions being concentrated in Colombo, there was a tendency for the bank's activities to be centralised in the city.
3.4.7 The communication and attitude gap that exists today, and thereby the shortage of credit flowing into the small and medium sized industries, could be attributed to the following factors:

(i) The management and staff of banks have been trained in short term lending, principally to the commercial sector, which only requires established routines but very little specialised knowledge. Therefore, the knowledge of industry and accumulation of industrial financing techniques have been retarded.

(ii) Centralisation of banking in the city has cut away, the customer-banker relationships to a minimum, while the policy of rotational transfer of branch management and staff from one provincial town to another, has further disrupted the cultivation of close customer-banker relationships, minimising at the same time the chances of the management learning the habits, characteristics and business of their customers.

(iii) The concentration of activity principally on the commercial sector has further diminished the opportunities for management to learn about industry. For, development financing, even when it involves short term credit extension requires a knowledge of industries and of the ways industries use finance.

(iv) The results of what has been described above has been, that banks being deficient on information on industry have opted to extend finance only to those well established large industries and to those industries principally round the city where the management is known to the financing circles.

(v) Further as a result of inadequate knowledge, there has resulted in a lack of standardisation of lending procedures, and loans when given to the small and medium firm sector which were outside the close circle of customers, were heavily secured, while the process of loans from the date
of application to the date of grant was spread over a number of months, sometimes extending over one year.

(vi) Short term liquid loans being on the whole more secure loans, the banks were used to and preferred to concentrate on this type of advance where safety is assured. Thus financing of small firms needs, both short and medium term, where safety was not immediately apparent, was a risk that they were reluctant to embark upon. It is more or less an accepted fact, that small firm financing involves greater risks, but sometimes these risks are magnified when lenders attach great importance to minimise risks. Banks sometimes have failed to appreciate that risks could be influenced by other factors, besides the characteristics of the borrower. For example, the banks themselves could contribute to risks by their method of financing. A case in point is described in section 8.6.

(vii) Due to staff training patterns and the absence of economic and industrial intelligence units in the banks, information necessary for guiding and evaluating industrial operations is scarce and the information gathered in haste is not reliable. The collection, analysis, and dissemination of industrial information requires skilled trained staff, and due to the absence of training directed to this field such persons are exceptionally in short supply.

(viii) Finally, the social factor plays an important role in the communication gap. As mentioned earlier the foreign banks dealt principally with foreign clients, and the only Ceylonese bank upto 1960 was brought up in this tradition. As commerce and trade passed first to Indian merchants and to those in the upper hierarchy in Ceylonese society, the attitudes of the banks took a considerable time to change. The middle class that came into the forefront in industry in the early 1960's were principally entrepreneurs who ventured
out into small industry. The banks and its regular customers as one group, came to be divided into a different social group from that of the new small industrialist, having little knowledge and confidence in one another. Thus one cardinal factor necessary for easy flow of credit was missing, i.e. the existence of mutual confidence between the supplier and recipient of funds. There are also a considerable amount of complexes that are prevalent in the Ceylonese society as a result of the mixture of western culture and values, with the indigenous culture and values resulting in a 'hybrid culture'.

Although there has been a tendency for these to be pushed to the background it is still prevalent to a considerable extent in the financial institutions. For example, a person who is clad in western attire (trousers, shirt and tie) and speaks good English is still accorded a better 'welcome' treatment than others who wear the native dress and speaks a native tongue. This attitude is seen from the minor office boy to the top management levels. This is also accentuated by the fact that the Ceylonese having been subjected to nearly four centuries of foreign domination, has resulted on the one hand, in development of a servile attitude and inferiority complex among some of them, and on the other, those who have been educated and are in positions of management and administration have taken the position of the foreign administrator. The former not been equally fortunate have continued to play the role of the 'ruled'. The bank buildings and the seating arrangements of the management also contributes to this division. Most of the buildings themselves are imposing structures which give them a forbidding atmosphere of sophistication, making the average man hesitant to enter the building. As one small industrialist remarked 'it puts the fear of god into me, to walk into the

1. This is prevalent in most other institutions too, but only financial institutions are mentioned here due to its relevancy.
bank and attempt to interview the manager'.

(ix) The lack of communication has also resulted in the development of an attitude, that financial institutions, specifically banks, are citadels of orthodox high finance where sound, well established and conservative practices prevail, where the small man does not belong nor matter. Added to these the intricacies of 'red tapism', bureaucratic practices, and to some extent the arrogance of 'officialdom' have served to keep the small entrepreneur away.

(x) The results of the present direction of credit have also hampered industrial lending. For example, in the case of extending medium term credit banks have been handicapped by the lack of knowledge of the fundamentals of economic development, trends in various industries, and the inter-linkage between industry and development. The little knowledge they get about industry is obtained during the processing and screening of a loan, but the equally important knowledge essential to sound medium term financing, i.e. the various interactions of industry and the economy, is deficient. The heavy dependence on security as a safety measure is no alternative to unsound lending knowledge, for example, sometimes the security would be too safe, i.e. the security on which the money is lent may be so securely tied up that it would be difficult to obtain quickly in the form of cash if the need arises.

(xi) Finally, the assumptions about small firms, which is general to small firms in any country, has been given greater stress here. One reason for this attitude is a result of the early activities of the 'pseudo entrepreneur' (see section 2.4.14). Among the various reasons given for non-interest in this sector are that, (a) they are unscrupulous and deficient in business methods and practices, (b) there is greater vulnerability to collapse, both in good times as well as bad, (c) small management is unstable especially
in the case of single proprietorships and partnerships. Taking these allegations singularly there is bound to be truth in each one of them, but to date, as not much effort has been made to study and understand their problems, these assumptions point to a more preconceived idea of riskiness of financing this sector and the result of play safe policy, than a result of actual experience.

8.4.8 It is important to end this section by stating that institutions alone have not been responsible for this communication and attitude gap, both the industrialists and the Government have also been responsible, however as these aspects of the problem are dealt with under the section 'policy gap' and 'structural gap' that follow, little attention is paid here to them. Therefore, it would suffice to mention in passing, that there is a definite reluctance of firms to give the necessary information and accounting data and reliable details of the strategy of the firm to the financial institutions and other administrative bodies dealing with industry. This is a result of a number of factors. Firstly, it is the lack of mutual trust mentioned earlier. Industrialists who were interviewed remarked, that even if they trust the integrity of management, details of the firm passed through many hands during the period of processing of the loan application. Therefore they were of the opinion, that business secrets sometimes leaked out to their competitors, especially those who had the means and were larger than them. They also expressed a lack of faith in the Department of Industries, the reason once again was similar, for example, the firms had to submit to the Ministry of Industries a detailed breakdown of the firm's activities, its intended activities with financial breakdowns, cost estimates, their suppliers, methods of production etc. A few specific examples were given by those interviewed (although this study made no attempt to pursue them) where the
plans, estimates, and details of projects were leaked out to more influential competitors. There appears to be a very pronounced confidence gap between the small industrialist and the Department of Industries. Apart from these mentioned above, another reason for the reluctance of the firms to give details about themselves, especially financial data, is result of the prevalence of income tax avoidance.

8.5. POLICY GAP

8.5.1 Chapter two outlined very comprehensively the planning misfortunes, and the frequent policy changes of the industrial sector. A recurrent theme passing through the period up to about 1960 was that, plans made for the private sector of industry never properly got off the planning stage, to practical applicability. After 1960 when some of the plans for industrialisation got under way the development that followed was diametrically opposite to what the planners envisaged. Reading through the industrial history of the country to date, a significant finding is that there was no continuity of policy objectives, while small and medium sized firms never got the emphasis it really deserved. Further, except for two abortive attempts to finance this sector which ended in dissatisfactory failure, there has been no proper attempt to tackle the basic factors which this study considers as the 'sine qua non' of a good small industrial base, namely, provision of good services both by way of funds and counseling and education. The financial infrastructure for viable small and medium sized industry has never been created, nor is there an attempt as shown by the new policy, to do so in the future. In terms of an analogy, it is similar to, building a house with very weak foundations, however good the rest of the structure is, it is bound to result in deficiencies. This is what has happened with industrialisation in the country. The number of plans and strategies which
could be taken as the 'props' to keep the structure up, have been unsuccessful and the whole structure becomes weaker and more complicated to set right.

8.5.2 The absence of adequate infra-structure and continuity of policy and directives has resulted in misdirection of industry from the beginning. When the majority of the firms began manufacturing at the early stage, they were aided by the Government's policy of import substitution. As already a latent demand for the goods of the manufacturing units existed, due to import restrictions, the early manufacturers had no difficulty in marketing the goods to a captive market. Most early manufacturing was more a process of assembling imported components into the final product, or a case of processing foreign raw materials. In some units there was a hundred percent dependence on foreign raw materials for their manufacture. As stated in chapter two, not much emphasis was placed on quality, specifications, durability and service, nor were any pricing policies adhered to, except to flood the market with sub-standard goods at the highest price the market would bear. For example, in some goods the market price of the home produced goods were higher than the similar imported goods, which they replaced, notwithstanding, that the foreign goods were of a better quality and finish.

8.5.3 Thus inadequate planning and the absence of direction and control created in the long term economic sense a number of uneconomic firms. The term 'uneconomic' is used here in every sense of the structure of the firm and policy rather than in the narrow sense of making merely a financial profit. Therefore the absence of a Government policy in fact did a real injustice to the entrepreneur especially in the case of those who ventured into industry for the first time. As was mentioned earlier for a tree to bear good fruit, it has to be cared for, from the seedling stage to maturity. The absence of directives, made the industrialist deviate and learn ways and
methods that would have repercussions to their firms. It is also important to keep in mind that once particular processes, methods and practices are learned, it is a difficult procedure both to set them right, unlearn them and start anew again. This has become the bane of industry in Ceylon.

The early firms paid scant attention to proper costing and financial techniques, forward planning, market appraisal and all other preliminary controls and disciplines that are necessary for industrial success. The only motive was the short term prospect of reaping maximum gains in a captive market from minimum effort. Even in the case of initial profits made by some firms from this artificial situation, little was reinvested in the businesses but were fritted away in non-productive and frivolous expenditures.

As time passed many early ventures showed no promise in fulfilling the intentions for which they were encouraged, namely, to provide employment and save foreign exchange. Rough calculations have shown that more foreign exchange was wasted than saved during this time. As a consequence of this early chaos new restrictions on industry were introduced. This again was a case of 'treating the symptoms' rather than the real cause of industrial illness.

As mentioned earlier most of the restrictions had the effect of multiplying the problems of small firms and weakening its financial standing more than in the case of large business.

8.5.7 Most firms that continued in business despite considerable Government restrictions and resulting financial problems, can be taken as those more genuine firms interested in playing a serious role in the economic development of the country. However the many scandals of foreign exchange waste, 'black market' operations, under invoicing of exports and over-invoicing of imports, excessive profiteering, on goods and raw materials,
which were perpetrated by unscrupulous businessmen have fallen as a bad 'mantle' on the whole private sector of industry. This early phase of industrialisation has to a considerable degree conditioned the attitudes of the Government, financial institutions, and the customers alike.

8.5.5 The general attitudes created in Government circles are that private industry does not serve much of a useful purpose in the economic development of the country and there has been an orientation towards the belief, that the future lies in more and more State controlled factories. The financial institutions in some cases have lost their desire to finance new ventures, especially those that are small, due to experiences with unscrupulous borrowers. The result has been that their direction of finance has even turned more than before to financing of established business. In the case of the general public, the shoddy goods, unfair prices, and the absence of after sales service have influenced them to believe that the manufacturers were exacting, unscrupulous and devoid of moral scruples. The result has been, that they have refrained from buying locally manufactured goods, if they can do without or if the import banned foreign goods are available even at a higher price. Thus, apart from losing custom, they have lost public sympathy as well. In the case of the employees, apart from them being customers, the absence of any benefits from the early profits of the firms being passed on to them, by (say) better working facilities, health benefits, higher wages, have alienated them from involving or committing themselves to the future aspirations of the firms.

8.5.6 The assignments of all these industrial faults to the private sector in industry does not in any way preclude state industry as being free of faults nor are all private firms classed in the same category.
as those described above. The emphasis here is to show that when a few firms blacken a general image, the attitudes created as a result, do not try to discover the good from the bad but have been applied as a general mantle on the whole sector. It is obvious that the attitudes created have been disastrous to the business climate in the country and especially to small firms, as curiously enough the 'bad guy' image has been assigned more to the small firm than the large. As shown in the earlier section attitudes have had direct repercussions on the availability of finance to this sector. In the final analysis the new private industries, which mainly are small and medium sized firms, are blamed for the industrial chaos created, but as shown here the absence of directives and controlling policy of successive Governments, must bear more than a fair share of the blame.

8.5.7 Other causative factors, that have hampered small and medium industry and thereby contributed to their financial problems and weakness, stem from the absence of size demarcation of industry. The whole private industrial sector has been treated as one sector with the exception of perhaps the cottage industries. A comprehensive attempt at size variation for administrative and policy measures is an important pre-requisite, if planned economic development with minimum delay and waste is the aim. It is a barren exercise, to plan development of industry to suit the needs of the development priorities of the country, if adequate attention is not paid to direct incentives to the necessary sectors, and to monitor the effects of services and incentives to gauge their success, and to take corrective measures if necessary with minimum delay. The policy of having only a vague idea of what small, medium and large industry is, has so far not paid any dividends, especially when these vague definitions varied from time to time.
8.5.8 The result has been, that various policy measures both restrictive and 'incentive', when applied to this sector has hurt small firms more than medium and large firms. Some of these measures that have been detrimental to small firms are given below.

8.5.9 (i) Credit restraint: It was stated earlier that credit restriction policies had rationed away even the little credit available to this sector. It was further stated that despite exemptions of development loans, these loans due to different 'gaps' enumerated in this chapter went to more established firms. The small firms in the survey, did not complain about the rise in interest rates or other restrictions during these times, as much as the total by-passing of this sector as a result of the generality of the exemptions. It would be true to say that pressures on small firms are greater than those of large firms due to Government credit policy. For example, apart from controls applied by banks being much harder on them, larger firms have the advantage in generally making payments to their creditors, and at the same time are in the position of squeezing the smaller firms for prompt payments of their outstanding amounts. It is also true that banks are reluctant to upset their existing credit arrangements with important customers. The overall brunt of the squeeze is normally felt by smaller borrowers in need of fresh facilities. The selection being particularly severe in cases where the loans are not of the self liquidating short term kind. The overall result is that new or smaller applicants for industrial loans are liable to be pushed back in the queue, specially at a time when their needs for finance are not easily met from any other sources.

8.5.10 Quotas: As most raw materials needed for the manufacturing sector were imported, giving rise to excessive drain of foreign exchange, a system of quotas (in terms of foreign exchange) were given to individual
manufacturing units based on their declared requirements of raw materials. These were usually given with a validity of one year. There was not much wrong with the system of quotas itself, but the problems arose when the manufacturers had to find the necessary funds in local equivalent of the foreign exchange cost of the material they intended to import. The results were as follows:

(a) There were those industrialists mainly large firms who were able to get bank accommodation quickly or had command of other sources of funds, had better contact with overseas suppliers and had better storage facilities. Therefore they were able to import their full quota of needs with minimum delay and disruption of their production runs.

(b) The second group comprising of small and medium sized firms, who did not have adequate fund supply or quick access to funds, nor adequate storage facilities were able to import only their immediate needs at one time, while they depended on further income, from these production runs, to import the balance of their quota.

(c) The third group consisting primarily of small firms, who did not have residual funds to import even a portion of the quota at the beginning, had to turn to institutional finance. However, the process of getting bank accommodation, necessary quotations from the suppliers and fulfilling all the other administrative requirements which took a considerable period of time, necessarily resulted in their inability to make use of their full quota, and sometimes their whole quota was left unused at the end of the expiry of the quota period.

(d) Finally, there was another group comprising of firms from all size sectors who could be termed the 'rapacious middlemen' with considerable funds at their disposal and who through devious ways were able to get quotas approved which were far in excess of their needs.
8.5.11 The overall result was that large established manufacturers, who had the finance or quick accommodation to funds and the special staff to deal with all the administrative requirements, succeeded in getting their full requirements. In the case of those small and medium sized industrialists, their inability to use their full quota during a given period of time resulted in setbacks to their production schedules. Their plight was made even worse by the Government penalties imposed for not utilizing their full quota when subsequent applications were made for the following year. The penalty took the form of a cutback in quotas to the actual level of the quota used during the preceding year. Thus a chain reaction set in affecting the firm's production for the coming year. In a number of instances the type of industrialist described in (d) above, made use of this opportunity to sell industrial raw materials in the 'black market' to the needy genuine industrialists at absorbant prices. This type of activity was so pronounced and lucrative due to the laxity of controls on the use of raw materials in their particular industries, There have been clear examples, that some of them concentrated only in importing raw materials for 'shadow' manufacturing units and selling them raw material in the 'black market' by which they were able to make a higher profit than if they used the raw materials to produce final goods themselves.

8.5.12 (iii) The FEBC Scheme: This scheme, in short was an export bonus scheme for exporters of locally manufactured goods and therefore an incentive measure, however at the beginning, this had the exact opposite effect on most small industries. Prior to the introduction of the scheme the import duty on some of the goods remained on an average at 10 per cent of their CIF value. When the goods arrived by ship at the port, the banks were willing to lend the 10 per cent duty payable to the importer to clear the
goods from the customs warehouse. However, with the introduction of the scheme, the 10 per cent duty rose to 55 per cent (the process how this duty was calculated was given earlier in sections 2.5.6 to 2.5.9) of the foreign exchange value of the goods, the banks were not ready to lend this sum to the importer to clear the goods from the port. This resulted in many instances where the small importer (industrialist) having to turn to even money lenders to raise the money necessary to clear the goods. For delay in clearance resulted in the disruption of their production apart from extra port levies that had to be paid. Therefore this again contributed to financial strain of the firm. It was true that some small firms were exempted from the payment of FEEDs and therefore all were not equally hard hit. Further the hardships incurred were felt immediately after the introduction of the scheme and gradually the manufacturers were able to plan ahead to meet this duty. But this example is given here in order to underline that, when a policy measure is applied generally to the whole sector without taking into consideration its side effects and repercussions to particular sub-sectors, the process of disruption that takes place as a consequence.

8.5.13 (iv) Duties: Another example of adhoc policy resulting in disruptions, especially to small firms, is the system of varying duties that exist on different imports. Usually when a firm intends to import certain items such as raw materials, machinery and spare parts, good financial management desires that provisions are made in advance to find access to funds for the CIF value of the goods as well as to meet the local duties prevailing at the time of the import of goods. The result of adhoc changes of duties has been that even a firm with good financial discipline has been brought into a state of crisis. A hypothetical example of such a situation is as follows, when a firm made plans to import a certain amount of goods,
for example, raw materials where the CIF value was (say) Rupees 100,000, and the prevailing duty at (say) 10 per cent was Rupees 10,000; the firm would make arrangements to raise this sum of Rupees 110,000. However from the date of order of the goods from the foreign supplier and the date of arrival at its destination takes a period of time depending on the distance. In the meantime the Government without adequate warning introduces a change in the duty chargeable increasing the rate from the existing (say) 10 per cent to a new rate of (say) 30 per cent. This results in the importer having to find funds to pay the new rate, i.e., another Rupees 20,000 (Rs.30,000 - Rs.10,000) for which he had not made any provision, thereby subjecting even the better managed firm to undergo financial difficulties.

8.5.14 The problem created, is not only that the firm has to find funds and borrow at short notice, but if they cannot clear the goods from the Customs Warehouse within a stipulated time, they have to pay additional penalty in the form of wharfage. Further, the problem does not end once the additional money is found and the goods cleared, for a chain reaction sets in (i) the overall financial plan of the firm is disrupted due to them having to pay higher interest rate for the sums borrowed at short notice. (ii) The delay in clearing the goods interrupts the production schedules resulting in further delay in getting the final product into the market. (iii) This necessarily delays income generation which the firm needs to repay the loan and interest, on the funds borrowed initially to pay for the CIF value of the goods, and the additional loan taken to pay the increased duty. (iv) In the meantime the sales plan of the firm gets disrupted, as the firms pricing policies were based on original planned cost and with these additional costs, the final product would probably have to be marketed at a higher price. This further introduces uncertainty about expected sales and profits
depending on the product and the demand for it at the new price. (v) In the final analysis, it is also true, that if the firm was aware in the first place of the higher cost of imports and the resulting increase in the final goods, they in certain instances would not have undertaken to produce those goods at all, depending on the demand for the goods at different prices.

8.5.15 It is not a difficult exercise to judge the difficulties experienced by a small firm in such a situation when, (i) their access to funds are limited, (ii) that they usually do not get a 'grace' period from the lender for the payback of capital and interest, (iii) the lender not considering the reasons for the delay in capital payback penalises him by charging penalty rates in addition to categorising the borrower as a credit risk in case of future borrowing.

8.5.16 (v) Taxes : As stated in section 6.10, tax incentives given to the new firms fell outside many small firms. This was partly as a result of the clause in the tax provisions that a firm had to employ more than twenty five people to qualify for this concession. This policy failed to appreciate that most firms due to capital limitation as well as for reasons of caution, did not wish to commence business on a larger scale than they could handle at the start, which in most circumstances meant also a small workforce. Therefore a large number of firms which were supposed to benefit from this measure did not actually derive any benefits.

The turnover tax was another tax that affected small firms more than large firms, as the latter were able to get around it, to pay a lesser amount in tax. For example, the turnover tax was payable by every person whose turnover from a business (including the business of manufacturer) carried on by him is not less than Rupees 100,000. Most manufacturing
companies have to pay a turnover tax of 10 per cent.¹ Large businesses which had floated subsidiary companies were able to reduce the total quantum of turnover tax paid by selling the goods at ex-factory prices to their subsidiary companies which not coming under the category manufacturing had to pay only one (1) per cent of their turnover.

8.5.17 As stated in chapter two and three the industrial policy has been influenced to a considerable degree by the interactions of political ideologies and the general instability of the economy. The result has been considerable chaos in the machinery of administration resulting in frequent changes in policy objectives, non-application and partial application of policy directives, absence of clear policy with regard to certain sectors and direction of development, and absence of guidance and controls and introduction of restrictive measures. Another reason for this planning malaise, apart from the two reasons given above, is that the problems of development of the economy are so varied and immense that the responsibilities have tended to exceed the administrative capacity of the various bodies, resulting in the inability of the various administrative bodies, firstly, to cope and secondly, to come together and co-operate on the various policy measures.

8.5.18 This is clearly seen from the analysis in the preceding chapters. For example chapter two underlined that early Government policy encouraged the indiscriminate mushrooming of manufacturing units. The early concessions such as import ban of imports, ban of foreign manufactured goods, tax concessions, abortive attempts at financing, helped some of the firms to establish themselves irrespective of whether they were necessary or not, in

¹ A few classified items which were deemed essential carried turnover tax of 1 and 3 per cent.
other words the Government policy helped to 'hatch' industry after which they were left to themselves to develop within the constraints imposed by the political and economic environment such as those mentioned in chapter two. This has resulted in a warped sense of business discipline, management weaknesses, structural weaknesses, financial weaknesses and general instability. Thus when the second stage of a firm's 'life cycle' was reached, i.e. stabilization and expansion, many firms had already built into their systems characteristics of instability some of which were their own making while others were due to no fault of their own. At this stage there was no adequate financial advisory and counseling services nor a policy of monitoring the effects of different policy measures, the heat of the movement to be self-sufficient in industry had spent itself in the initial chaos created.

Therefore, the policy measures, made no attempt to probe into and understand the causes and effects of the problems that were faced. Attempts made, which were always tied to the malaise of economic development were feeble attempts, as far as the small sector was concerned, in treating the symptoms of industrial illness than finding the cause of the problems.

8.5.19 Therefore it can be concluded here that there has been no attempt to date to study the problems of the small and medium scale sector of industry with due regard to its financial availability and the other ancillary services. This has not only left this sector in a vacuum it has made it equally difficult for the financial institutions to extend services to this sector even if they desired to do so.

8.5.20 In a diagramatical form the probable causes of financial insecurity of this sector could be depicted as follows.  

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1. See Diagram 5
THE INDIRECT CAUSES FOR FINANCIAL INSECURITY

1. BAD MANAGEMENT, ILLIQUIDITY, UNPROFITABILITY
2. RELUCTANCE TO LEND
3. RISK, COST
4. ATTITUDE CREATION
5. LEAD TO REFINANCE
6. STRICT QUALIFICATION FACTORS LENGTHY PROCESSING AVOIDANCE OF LENDING REFUSAL.
7. RETHINKING PATTERNS OF PAYMENTS OF LOANS
8. CAUSING FOR E.G., FINANCIAL INBALANCE IDLE CAPACITY SHORTAGE OF RAW MATERIALS SHORTAGE OF MACHINE SPARES DISRUPTION OF PRODUCTION MARKET DISRUPTION REDUCTION OF PROFIT
9. BORROWERS: SMALL FIRMS
10. DELAY IN REPAYMENTS OF LOANS

NEW DUTIES, TAXES QUOTAS EXCHANGE CONTROL, FISCAL CONTROL, CREDIT SQUEEZE, CHANGING INDUSTRIAL POLICY, AD-HOC MEASURES

ABSENCE OF TECHNICAL SERVICES, FINANCIAL AID, CREDIT GUARANTEE, COOPERATION BETWEEN DEPARTMENTS, FEED-BACK ANALYSIS TRAINING FACILITIES INFORMATION

DEPARTMENT OF IMPORTS/EXPORT

DEPARTMENT OF EXCHANGE CONTROL

CENTRAL BANK

DEPARTMENT OF INDUSTRIES

DEPARTMENT OF PLANNING

GOVERNMENT POLICY

ECONOMIC FISCAL FINANCIAL REGULATORY
8.5.21 As far as the problems of small firms are concerned
the Government and the planner alike have overlooked their problems and have
left the problems for the firms themselves to solve. If developed countries
find, that small firms face problems of finance, despite a whole array of
financial intermediaries, more mature and developed levels of financial
management techniques, availability of technical services and other advisory
services, availability of quick access to machinery and raw materials,
better marketing techniques and informed management, better services such
as transport, shipping etc., it is rather pathetic, to blindly assume that
small firms have no problems of finance or that financial facilities
available are adequate. It would be apt to conclude this section by
underlying the Government attitude from the only developed industrial
nation in Asia, i.e. Japan.

"The weakness of the social and economic basis of the small enter-
prises is mainly due to the shortage of capital, and this weakness inevitably
leads them into poor financial status, and any financial tightness
becomes seriously intensified in smaller enterprises. Hence an important
phase of the overall measure to assist smaller enterprises and to rouse them
to a competitive level against big enterprises must necessarily involve
the means by which their credit standing is improved and their source of
finance is secured"
(Administration for development of Smaller enterprises in Japan,
Government of Japan, Ministry of International Trade and Industry,
Smaller Enterprise Agency, 1962, page 4.)

8.6. STRUCTURAL GAP

8.6.1 There are many structural gaps in the small and
medium sized firms in Ceylon, some of which are similar to the shortcomings,
in any small firm in other countries, notwithstanding whether they are
developed or developing economies, while others are peculiar to the small
firm structure in Ceylon. It is a difficult prospect to decide whether
the reasons for these deficiencies are due to the lack of funds or whether
the shortage of funds led to these deficiencies.
8.6.2 The foremost among them is weakness in management accounting techniques. It was stated earlier that there were two types of entrepreneurs, i.e. those that began business for the first time in their career and those that converted a going concern such as wholesale trading, import/export business and retailing, into a manufacturing concern. Both types of entrepreneurs had different forms of accounting difficulties. In the first case as they were new to the business it was a process of learning as they went about their business and converting his knowledge of simple household accounting to that of the business. Among them many at the early stage found it hard to separate the two while most of them were ignorant of costing techniques as applied to the firm. For most accounting was synonymous with the drawing up of a balance sheet to be presented to the income tax authorities at the end of the financial year. Therefore the accounting systems were haphazard and many did not keep even these accounts in the double entry form.

8.6.3 In the case of the latter it was natural at first to apply the accounting systems they were used to in their earlier business. As it was mentioned earlier, these accounting systems in most instances were simple book-keeping methods, where only the purchases and sales of products they were dealing with were of any significance. Therefore both types of entrepreneurs came into manufacturing with built in weaknesses for management accounts. These rudimentary accounting systems have been the cause for many structural weaknesses of firms. Thus financial management systems, as a control tool designed to monitor a firm's financial efficiency, overall efficiency, and as a guide to corporate policy, are very weak. In most firms, sources of losses and leakages are not known, nor is it possible to identify them from yearly and half yearly accounts. Cost
accounting, to provide unit cost data and comparative costs on the products they make, are scarce. The consequence of these deficiencies is that, management is not able to identify costs relating to a particular product or process of manufacture, those responsible for excessive costs and costs necessary for product pricing etc. All these reasons have made it difficult to apply techniques for internal budgeting and management of cash flows, which are crucial to the financial life of the enterprise.

8.6.4 With experience in management of some firms have begun to realise these weaknesses but their dilemma is that they cannot afford to employ qualified accountants to do the job for them, nor have they the capacity, to train them on the job. The type of accounting services available from professional bodies do not sufficiently justify their costs to the small firm. Further most accounting services that are presently available concentrate on meeting accounting requirements of income tax authorities and those requirements by financial institutions in the case of loans.

8.6.5 Another deficiency that has accounted for the external fund shortage of this sector is the newness of the industrial society. As mentioned earlier industrialisation got underway only during the last thirteen years, and most of the new industrial units that were set up during these years were small and medium sized units. Thus there was bound to be a considerable amount of blundering, waste, and misdirection during the early years. It took a considerable number of years for the learning process to take root and get a foothold. For most Ceylonese, industry was a new field, and most of them had to learn the skills of this new trade by a process of trial and error. This unpreparedness of the Ceylonese was well documented in chapter two. It would suffice here to
mention that Ceylon as a Nation attained independence only in 1948. During four centuries of foreign domination they neither had the opportunity to decide their future, nor was the climate created for them to learn management and technical skills in the industrial field. Even in the case of present large private firms the process of Ceylonisation of management has been a very gradual process and it was only during the last fifteen years that this process has been accelerated. Upto now adequate facilities have not been created by the State or any other private organisation to teach management techniques and methods. The premier University in Ceylon, i.e. The University of Ceylon, has still not opened up a Business School or School of Management, although a few years ago one of the new Universities began to offer a course in management at post-graduate level going up to a Masters degree in Business Administration. Therefore most skills in this sphere had to be learned at the work place and some of the skills learned were not necessarily the best suited to the country, as a result many lack the capabilities that come with experience. This is one of the factors that have contributed to a communication gap between the present financial institutions schooled in the techniques of industrial assessment in the developed countries with the strategy of management of the local firm which is still in its infancy.¹

8.6.6 A third aspect of industry in the country is that, most firms are dependent on imported raw material inputs for their manufacture, while depending almost wholly on imported machine units and spare parts for their industries. Some reasons for the first were given in chapter two, i.e. absence of local raw material surveys and research into adopting them for use, scarcity of input producing industries, deficiency of inter-industry linkages etc. As this is the case, this introduces weaknesses

¹ A good example is the DFCC
into the industrial structure, mainly as a result of the shortage of foreign exchange in the country (chapter 3). Thus, industry operates from one foreign exchange crisis to another. The result is that during these processes of 'stop-go' release of foreign exchange to the industrial sector, there is a tendency for the small firms to suffer most. As production is dependant on imported inputs, the frequent stoppages give rise to constant instability, especially to the small firm. In the case of small firms, continuous income generation is an essential life line for their existence, as this would ensure that they keep themselves liquid and free from debt. In the case of the larger firm, better facilities to keep larger stocks, reserve funds to keep it going during low production periods, and the general ability to get stocks faster enable them to weather these frequent foreign crises. Even if the smaller firms were able to acquire a certain amount of reserves in funds and in stock, they could do so only with considerable difficulty due to finite margins they keep between stock and production, as a consequence of fund limitation.

8.6.7 The exchange scarcities have contributed to another peculiarity of the small firm. Their dependence on imported machinery and spare parts has given rise to two opposite tendencies, i.e. some firms having low capitalisation in equipment, while others are burdened with high capitalisation in equipment. The former, is a result of the lack of adequate funds to get the required machinery, while the latter results, due to uncertainty of foreign exchange. For example, foreign exchange availability is necessarily connected to the policy of successive Governments in slapping import restrictions, therefore, these firms whenever they had the opportunity, under existing regulations, had imported far more than the machinery requirements of the firm at that level of the firm's development,
as a safeguard against future restrictions. The latter was also a result of changing policy from one Government to another. For example, under one policy, when permission is given for an industrialist to start production or expand his existing capacity, during the time gap between the industrialist importing the machinery and setting it up for production, the policy changes leaving him with excess machine capacity or with excess machine units, without the raw materials to produce any product.

8.6.8 The results of both situations are detrimental to the efficiency of the firm. In the first case the factory cannot run at full efficiency due to machine limitation, while further hazards are introduced due to machine breakdown and shortage of spare parts. In the second case, excess capacities are created with much needed funds blocked up in spare machinery and inventories. In the second case it is true that excess machinery had been imported with the intention of future expansion, but in all cases this expansion cannot take place due to perhaps, the import ban on raw materials or that the new policy, has deemed the industrial unit as unnecessary.

8.6.9 This dependence on imports for machinery and raw materials weakens also the base for desirable types of financial and other type of services from lenders and local suppliers. Further, it increases the riskiness of financing these industries, as little information is available about imported factory requirements, while there is also the danger in the delay of the items being supplied promptly, due to factors affecting the foreign supplier.

8.6.10 Another factor contributing to structural weakness is the characteristics of those in management. Some of these characteristics are common to small firms all over the world and was mentioned in earlier
chapters, while others are peculiar to developing countries. For example,

(i) the rashness of management at the early period of industrialisation described in chapter two, and earlier in this chapter by private firms, both large and small, has created in the minds of the financial intermediaries, the Government, and the consumers a bad image of the entrepreneur,

(ii) the inadequate facilities for management and technical training, have resulted in slip-shod management decisions, inferior technology and product design,

(iii) poor response to statistical and financial data, firstly, as a result of their desire for secrecy, secondly, not understanding the requirements, and thirdly, due to mistrust and lack of communication and fourthly, due to shortage of staff to deal with all these requirements.

8.6.11 The desire to be independent is also a contributory factor to their isolation from financial intermediaries. Most of those interviewed expressed the view that they do not wish to have private participation at all, or more than they already had. The reasons for this were given in chapter one (see section 1.8.5). This general reluctance to share ownership meant also that they were eliminating one source of capital. This contributed to another risk, namely, the lenders had to depend on the efficiency of one man or at most a few for the success of the firm. The dangers of this were underlined earlier as, death, succession and family disagreements, jeopardised the security of the lenders investment.

8.6.12 There was also a lack of unity among the small firms to stand together. There seem to be a considerable amount of differences of opinion among them, resulting in absence of unity and making them incapable of organising themselves into a close group for common advantage. This division has resulted in the creation of two Chambers of small firms, while
even these two Chambers, do not incorporate all the small firms.

8.6.13 Another criticism that has been directed at the management of small firms is that they resort to numerous business dodges, tax evasion, unfair pricing, short weights and adulteration of their products. However, this is an unfair criticism to be specifically directed at industry and principally to the small firm sector. Some of these practices are prevalent in all sectors of the economy and as mentioned earlier, the 'sins of the few' have been applied to the whole. In all fairness to the small firm, it has to be stated here, that malpractices are prevalent in all sectors but usually it is the 'small man' who has been taken to task, while the 'big fish' have always been able to extricate themselves from trouble. Further the economy is inundated with controls, some of which have been applied without much forethought, and those coming under them have found ingenious methods of getting around them. This is a bane of any controls anywhere in the world.

8.6.14 All these factors enumerated above have contributed to the structural gap, creating financial problems for the small firm. As mentioned at the beginning of the section, it is difficult to decide which preceded the other, but it could be concluded that some of these were the cause of the other and vice-versa. In concluding this section it is important to underline the shortage of funds that have contributed to the structural weakness of the firm, thereby contributing to a 'vicious circle' of less funds generating less access to further funds.

8.6.15 A consequence of shortage of funds at the birth of the firm is that, small firms begin their business with limited capital put together from their own savings and those of family, or borrowed at high rates of interest. The meagre capital resources limit acquiring of good
factory premises, suitable machine units and equipment, necessary technical expertise, trained and efficient management staff, and skilled workforce. As a result the efficiency of the firm is bound to suffer, giving rise to low margins of profit, for further investment. Other contributing factors for low profitability of small firms were given in section 8.3. Further the theory of high profitability of small firms due to technical advantages does not apply here. For, if certain economies are available to certain size of plant, those large enough to afford the capital could benefit, while if economies are open to small firms, and technical development may sometimes favour the small firm, there is nothing to prevent the big firm to invest in a number of small plants. This is what has happened in Ceylon. From this asymmetry it follows that small firms in the long run cannot earn high profits as the large firms due to this factor, as all technical advantages open to the small firm is also open to the large firm. The high profits of the early firms mentioned earlier lasted only a short period as they were catering to an artificial situation. In fact, they were catering only to a small section of the market, namely, those high income earners. Therefore it has to be kept in mind that small firms in general have always had the need for more funds.

8.6.16 Therefore it could be concluded that there is an intrinsic shortage of funds among small firms, starting with the inability of the firm to generate excess funds, making savings inadequate in relation to investment needs of the firm, while all outside funds have avoided the small sector. Thus the problem of basic fund shortages contributing to the structural weakness of the firm, adds to the belief of financial institutions that small firms are unstable. Thus the firm is caught in a 'vicious circle' of lack of capital leading to industrial backwardness and industrial
backwardness leading to a lack of capital. Davenport commenting on the problems, identified the situation of most developing countries as follows,

"Those with the best capacity to develop small factories often do not have the savings required and those who have savings, that might be appropriately devoted for this purpose often do not have the capabilities required . . . . . . . . . . . . . .

It is an unequal struggle with everything on the side of those who have their personal wealth added to facilities for external finance. Thus in the long run those who survive are those with capital, whether they are good, bad or indifferent industrialists." 1

The causes of structural weaknesses of small firms are shown in Diagram 6.

8.6.17 The structural weaknesses of small firms due to features common to all small firms, those peculiar to Ceylon and those directed at small firms could be summarised as follows,

(a) Less diversification and lack of experienced management coupled with the frequent limitation of managerial abilities when the founder is replaced by a successor.

(b) Narrower range of business opportunities.

(c) Less reserves for unexpected hazards, therefore they are purported to be more vulnerable to business depressions, and are expected not to survive many mistakes.

(d) Do not usually command a body of established customers, therefore the market for their product is always unstable.

(e) Cannot afford to spend much on employing professional management nor do they have the capacity to pay for consultancy services.

(f) The uncertain future, introduced by Government policy and the changes in the economy makes the computation of cash flows less dependable foundations for evaluating of capital expenditures, and refined computations of 'present value and rate of return' become largely academic for the small firms.

1. See Bib, 61
1. Causes contributing to structural weaknesses.

DIAGRAM 6

STRUCTURAL WEAKNESSES OF SMALL FIRMS

Those peculiar to small firms in Ceylon

- Weakness in accounting techniques & financial management.
- Newness of industrial society
- Dependence on imported factor inputs, therefore frequent stops
- Under capacity, excess capacity & under-utilisation
- Inexperienced management and other non-productive pursuits
- Secretiveness and lack of unity & cooperation among firms
- Industrial mal-practices, e.g., foreign exchange, tax dodges, etc
- Inferior technology, low skills, lower productivity ratios
- Low profitability
- Intrinsic shortage of funds leading to instability and vulnerability
- Absence of services, training and information
- Wrong factor combinations and inferior goods
- Poor marketing facilities and limited market

Those common to small firms all over the world

- Narrow range of business opportunities
- Excessive competition
- Insufficient management capabilities
- Lag behind business recovery after business recession
- Dearth of outside funds
- Too much reliance on cash purchases and credit sales
- High debt to equity ratios, i.e., Gearing
- Shortage of facilities for research & innovation
- Likelihood of taking greater risks in decision making
- Inaccessibility to the Stock Market
- Desire to be independent and pride in their achievements
- Serenity of funds for development & expansion
- Lack of competitive strength against large firms
(g) Those firms which attempt to finance expansion from savings by trimming present investments to accumulate capital for future needs put themselves into a 'vicious circle' of fund shortage, for, as a result of lack of present expansion and profits, savings are lessened the next year. Further fund shortage, makes them borrow from all available channels resulting in high gearing.

(h) Low capital participation due to their limited resources, introduces constraints to equity participation from investors.

(i) The excessive dependence on short term funds and the use of these funds for long term investment purposes create illiquidity making them in the opinion of lenders undeserving of further credit.

(j) As a result of inadequate budgetary control, most firms seek loans only when they are in bad financial straits. The process of getting a loan being long and arduous, by the time the loan is available, the firm has fallen into further financial difficulties.

8.6.18 In concluding this section it is interesting to evaluate some of the observations made about industry in the Bank of Ceylon Commission Report of 1968.²

"Even before independence, a few Ceylonese took to commerce and later as foreign interests gradually withdrew, greatly increased their holdings in tea and rubber plantations. Reared in the traditions of a patriarchal society, many of these investors did not bring a well developed code of commercial discipline to bear on their new enterprises. This is a common experience in any developing country. Leisurely habits born of an agrarian society are not easily transformed into the ordered disciplines of a developed society. (Para., 184)

It is this rather casual attitude of the borrowers to the fulfilling of their obligations, which has only gradually improved over the years, that has created difficulties for the bank and has prevented it from adopting more generous lending policies. In evidence it has been shown convincingly that the average borrower thinks nothing of protracted delays in repaying his instalments, considers it a trifling matter if he exceeds his overdraft from time to time and thinks there is no harm in disposing of goods held on Trust Receipts without remitting the proceeds to the bank. The outcome of these habits is that the creditworthiness

². See Bib.51
of these borrowers in the eyes of the Bank is reduced and the bank consequently requires from them increased security. (Para., 185)

It has also transpired in evidence that even long standing borrowers of the bank have misused credit by diverting funds granted for one purpose to another without the knowledge or consent of the bank. We have scrutinised a list of private companies of fair standing where directors borrowings from the company have exceeded the subscribed share capital and even equalled the credit granted to the company by the bank. We have been informed of instances where stock offered as security for overdrafts have disappeared and one case where a leading businessman blandly admitted to the bank that his clerk had sent a return showing a level of stocks which was not physically in the warehouse. (Para., 186)

A further aspect of this problem is the difficulty experienced by the banks in obtaining from a client the full details of the purpose for which the loan sought is to be utilised. When one of our Commissioners visited a branch office he found that under the heading 'purpose' in the loan application only very sketchy details appeared, whereas there was much greater detail in the cage for 'security' which again seems to confirm our view that there is a concentration on security which has been caused by a certain lack of confidence in the creditworthiness of borrowers in general. In another case, where detailed and convincing evidence was led before the Commission, it appeared that the 'purpose' entered on the loan application was an afterthought." (Para., 188)

8.6.19 This study has underlined some of the reasons for this behaviour pattern. Taking this criticism at face value, and generalising it in the context of all borrowers, (this study believes), will do considerable injustice to all industrialists. It can only be concluded that this view is only a 'mirror image' of only what the banks sees and not a conclusion drawn from deep analysis for the reasons and causes of this behaviour pattern.

8.6.20 It could be summarised that some of the reasons for this behaviour are a result of all 'gaps' enumerated so far. In the form of an analogy, if a tree has been neglected from the seedling stage through to maturity, it is not fair, nor suffice if criticism is directed against the fruit it bears. Therefore any criticism that is directed at the final outcome is necessarily a reflection on the shortcomings of the 'grower' than on the 'fruit' itself.
8.7. QUALIFICATION GAP

8.7.1 It has been mentioned that there is a shortage of institutions and that there is a shortage of external finance to the small and medium scale sector, therefore, it is the task of this section to enumerate the difficulties faced by the existing institutions in loan dispersal and the equally difficult task by the borrowers to qualify for loans.

8.7.2 It has to be expected that whatever new role is assigned to the banks, they have been principally set up to facilitate commerce, and most of their lending will be of short term character. As this is the case, four main limiting principles are imposed on bank lending which are taken to be the four main requisites of a sound lending policy, i.e. (i) safety, (ii) liquidity, (iii) dispersal and (iv) remuneration.¹

8.7.3 This study so far has outlined the present deficiencies of the banks. What the study has tried to emphasize is that keeping within the limitations described above, the functions of the banks could be stretched further to understand 'modern day' finance and industrial lending and by doing so they would be able to act as the link that could fuse capital, knowhow, and other services ancillary to the provision of finance, between the small firms and the financial intermediaries.

8.7.4 For the banks to act as the intermediary for industrial finance, the first priority is to qualify themselves to understand the technicalities of development finance, which one feels that the banks do not have at the present time. In fairness to the banks it has to be said that it was only recently that they were empowered with the added responsibility of financing industry for which they were ill prepared.

¹ See chapter six section 6.3.15 to 6.3.17
The staff has not been trained in development lending techniques nor do they have any experience of industry. Having said this, no excuses could be given to their somewhat lethargic attitude towards the whole problem of industrial lending and the delay in diversification of their lending portfolio and change in attitudes. The only excuse here would be that the mantle of lending habits, practices and attitudes cultivated over decades of experience is not an easy mantle to dispense with, at short notice. However this study does not accept this at face value as development has to be measured in dynamic terms, and the institutions that are an intrinsic part of the vehicle of development, such as banks, should move and adopt themselves in step with the changing face of the whole economy. They should not move too fast nor too slow as either would convert them into 'misfits' in relation to the needs of the economy.

8.7.5 Thus after a decade of commitment to industrial financing, the banks still do not have any proper terms of reference where industrial lending is concerned, nor do they keep separate statistics on industrial lending on a size wise basis for feedback analysis. Most loans are considered on the same principles, be they, for personal consumption, export/import, trade, building and land investment or other commercial purposes. There are no guiding principles set down, for the information of Borrowers, nor any precedents in lending followed. The bias is towards a person's credit standing at different times with varying guiding principles. These added to the low keyed dissemination of information has alienated the small borrower from the banks.

8.7.6 Given the existing credit structure in the country and the conditions that have to be adhered to, before a loan is granted,
it is important to see the difficulties faced by both the lender and the borrower in keeping to these conditions. Most short term accommodation by banks is granted on the security of shares of companies, insurance policies, guarantees of directors, pledges of raw material and stock, other guarantors and promissory notes. Loans over one year, are normally secured on immovable security such as land and buildings, and the other additional guarantees. In chapter seven some of the difficulties of the borrowers in meeting some of the requirements of the lenders were mentioned. However the problems on lending on long term, is a two sided problem, both to the lender and the borrower. On the side of the lenders, their problem is partly as a result of the existing legislation governing financial relationships, property titles, and other matters pertaining to finance. The following legal enactments act as barriers to lending by financial institutions.

(i) The Tax Ordinance under the Inland Revenue Act
(ii) Registration of documents creating a Fidei Commissum or Trust
(iii) The registration of Old Deeds and Documents Ordinance
(iv) The Mortgage Act

8.7.9 (i) The Tax Ordinance under the Inland Revenue Act provides that tax in default, is a first charge on all assets of the defaulter subject to certain provisos, i.e. (a) exemption in favour of leases or mortgages of immovable property created 'bona fide' and for value duly registered prior to seizure (b) movable property that is subject to a lien or encumbrance created 'bona fide' and for value prior to date of default, if any tax is in default, tax payable for one year ranks in priority over such claim.

Therefore this Act, while giving priority to the lender in the case
of immovable property mortgaged, does not give the same rights in the case of movable property. This hinders lending by financial institutions, and the Bank of Ceylon Commission of 1968 rightly recommended that the second clause above, be amended to qualify for exemption, as in the case of the first.

8.7.10 Another tax Ordinance which effects lending institutions, is the power of the Commissioner of Inland Revenue to apply to the District Court for a vesting order in respect of immovable property where tax is in default. After serving of such summons on such an application, any alienation of the property by a third party is void against the claim of the Commissioner. This would effect the institutions in case of a loan on a floating charge on the assets of the debtor.

8.7.11 (ii) Usually long term loans are secured on mortgage of immovable property, which according to Ceylon Law is defined as land, including things attached to the earth or permanently fastened to anything attached to the earth. The difficulty of establishing clear title to land is the foremost obstacle both to the borrower and the lender at the present time. In the case of land the first comprehensive attempt to register land was made in January 1864. All instruments affecting land executed prior to this date was declared null and void. Therefore, all titles to land accepted as valid have to bear a registration date of or after this date. This in itself, does not create a problem with regard to the title to the land. The problem arises, because of the possibility of the existence of deeds creating 'fidei commissa', executed but not registered after this date. In such an event the validity of the second title is in question. This is the reason that all credit institutions require a clear documentary chain of title from a point prior to first January 1864. It is only in the
case of a title deemed 'good', such as a Crown grant or a valid partition decree, that the institutions are ready to accept the title, as from that date. Thus this process of establishing a clear title to the land to be mortgaged takes considerable time apart from the costs involved, before a loan could be granted on the security of land.

8.7.12 (iii) The registration of Documents Ordinance is another legal clause that has resulted in many problems regarding the establishment of ownership. The regulation reads as follows:

"Every instrument presented for registration shall be registered in the book allotted to the division in which the land affected by the instrument is situated and in or in continuation of, the folio in which the first registered instrument affecting the same land is registered. Provided that, (1.a) an instrument may, if the Register thinks fit, be entered in a new folio. Cross references being entered in the prescribed manner so as to connect the registration with any previous registration affecting the same land or any part thereof; and (1.b) where no instrument affecting the same land has been previously registered, the instrument shall be registered in a new folio to be allotted by the Registrar."

"(2) An instrument, whether registered before or after the commencement of this Ordinance, shall not be deemed to be duly registered under this chapter unless it is registered in accordance with the foregoing provisions of this section."

8.7.13 Thus according to the Ordinance, 'in the prescribed manner' meant, according to decided cases. The exact words prescribed had to be used for this purpose, the absence of which meant, that the cross reference would be considered bad, and the instrument lost the benefit of registration. As the Bank of Ceylon Commission found many Registrars had
failed to comply strictly with these requirements. Further the Registrars are required under this section to maintain separate registers for registration of pledges, mortgages and bills of sale of movable property, while separate books had to be kept for book debts, stock in trade and trust receipts. The cumbersome methods of keeping these registers naturally led to many incorrect entries, while the process of searching the registers to ascertain whether movable property is subjected to any pledge, sale or mortgage was equally cumbersome and time killing exercise. It is apparent that these factors contributed to the delay and the difficulties faced by both parties.

8.7.14 (iv) The sections 46 and 47 of the Mortgage Act is another reason that financial institutions attribute as a cause for not accommodating 'not so creditworthy' clients. The two sections read as follows,

Section 46: No decree in any hypothecary action upon any mortgage of land which is created after the appointed date and no decree in any action for the recovery of any moneys due upon any such mortgage, shall order any property whatsoever, other than the mortgaged 'land' to be sold for the recovery of any moneys found to be due under the mortgage, and no property whatsoever, other than the mortgaged land, shall be sold or be liable to be sold in execution of any such decree.

Section 47: The provisions of section 46 shall have effect notwithstanding any thing in any law or in any mortgage bond or other instrument.

The strict rules of qualification adhered to by the lending institutions such as clear titles, the ratio of loan sum to the value of land, and the additional security sought over the mortgage given, is attributed to these clauses. For, if the mortgage of land is taken as the sole security,
in the event of the lending institution having to sell the land to recover the monies due, it was imperative to safeguard themselves first, that the title to land is clear, as in the event that the title to the land was defective the loss would fall entirely on the mortgagor, because as the law stands, 'only the land so mortgaged' could be sold in execution of a decree to recover monies due. The low ratio of the loan sum to the value of land is to safeguard against the depreciation of the value of the land, while the reason for the additional guarantees and safeguards, are to cover themselves in the event of any loss as a result of either of the two reasons given above and/or due to the possibility of fraud.

8.7.15 The lenders also pointed out that the legal process of getting compensation takes time. Thus the qualification gap here is not alone the deficiency of the lenders or the borrowers, it is as much the shortcomings in the legal structure. Apart from the legal enactments that act as a barrier, the escape clauses that are built into the legal structure, automatically gives rise to further loopholes that could be made use of by an unscrupulous borrower. An example in point, is the peculiar definition of immovable property mentioned earlier, i.e. the law declares that fixtures such as machinery installed in a factory and fixed to the floor or wall with bolts and nuts form part of the land on which the factory stands. Thus a mortgage on immovable property which includes the land, the factory, and the fixtures that are attached to the factory, could run into difficulties, in the event that the machinery is disconnected from the factory by the removal of bolts and nuts, as then, these items would cease to be part of the immovable property. As the law states, that only the land so mortgaged could be sold in execution to recover the debt, legally, the machinery so detached no longer comes within this clause.
8.7.16 Another difficulty faced by the lenders, is with regard to the mortgage of life insurance policies. In the event of death of the Insured the process of recovering the debt from the insurance company takes considerable time, sometimes as long as three years. This is due to legal intricacies of ascertaining first the wealth of the deceased, his or her financial obligations to outsiders and the payment of estate duty. The Bank of Ceylon Commission of 1968 recommended a number of alterations in the law, to ease these difficulties, and it would suffice here to mention that this study fully endorses them, and concludes with the observation that although these recommendations were made in 1968 and accepted by the Government and the institutions concerned, so far these proposals have not been translated into practical application. The shortcomings of the legal system/reards/land, especially affects the small firm, as in most instances this is the only type of security they could provide. On this aspect of security the Commission observed as follows:

"Ordinarily, land should be the most readily available security in any developing country, but the defects of the law in Ceylon which we have dealt with elsewhere lowers its usefulness as security ........." (Bank of Ceylon Report, Para., I83)

8.7.17 Given these legal deficiencies as a barrier to qualification for loans there are other factors that equally affect the financial deficiency experienced by the sector. They could be broadly divided into the risk and the cost factor. These are more a cause of structural and situational factors of smallness that could be generally applied to small firms in any country.

8.7.18 In case of Ceylon too, the risks involved in financing

1. See Bib. 51
small firms are based on the general characteristics of smallness. It was mentioned that the constraints under which the banks lend were conditioned by safety, liquidity, dispersal and remuneration.\(^1\) Therefore the conditions such as security, guarantees, capital ratios, repayment ability, length of loan, size of loan, interest rates, market for products and the general purposes of the loan is a result of these four objectives. Equally, the grounds for rejection such as the inadequacy of those mentioned above and other factors such as the knowledge of the lender by the institution, his previous dealings, the prospect of investment and delay are also a result of these.

8.7.19 All these conditions for a loan adds to make the general term 'creditworthiness'. The term creditworthiness is a difficult concept to define, for as Bates observes the 'Accountant, Banker and the Economist have different ideas of credit worthiness'. Therefore it is a difficult proposition to arrive at a specific formula for credit qualification that could be applied to all borrowers. There is however, the possibility to eliminate some of these difficulties that face the borrower as well as the lender. At present the order of priorities in the credit institutions for a loan seem to be (a) security, (b) firm's or borrower's previous relationship with the lender,\(^2\) and its personal knowledge of the owner or director of the firm, (c) capacity to repay the loan from the firm's income generation as well as from personal income, (d) the purpose of the loan (e) viability of the venture. As a result of the difficulties of identifying

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1. These are relevant to other financial intermediaries as well.
2. The criterion of past performance is not adequately analysed. In majority of the cases past performance was based on loan repayment on due dates. As described earlier, in a number of instances the inability to pay back the loan is a consequence of (a) conditions of the loan (b) lack of further credit availability (c) inter-action of duties, taxes and uncertain economic conditions in the country.
credit worthiness there has been a polarisation of credit qualification, both on the part of the lender and the borrower on the security provided. This, the study feels is detrimental to the development of a good credit base for industry. The institutions have thus, attempted to go round the intricacies of loan qualification by concentrating their lending on well established and proven large firms, where risk is at a minimum and profit is at a maximum. The observation by Davenport regards bank lending is very relevant here,

"Banks which in screening applications focus exclusively on the supporting guarantees tend not to build up the knowledge, the staff, or the procedures necessary to apply development lending criteria or to appreciate the possibilities of sound lending programmes being created for small enterprises." 1

Thus the proliferation of the security angle for a loan at the expense of other factors, would contribute further to the retardation of the principles of industrial lending.

8.7.20 The difference between this type of lending and proper industrial lending is well illustrated by the procedure followed by banks in the United States. The American banking system, in case of term loans, lends more on prospects than on assets or security and therefore are in direct contrast with much of traditional British banking practices followed in Ceylon. In the case of long term credit institutions this attitude is seen in the lending of the ICFC in Britain. Tew, investigating the activities of this institution remarks, that the degree of lending risks could be reduced either by (a) turning away business whose safety is not immediately apparent, or (b) by investigating all 'prima facie' propositions as thoroughly as possible and rejecting only those whose safety cannot be reasonably established. He remarks that the ICFC follows the second principle,

1. See Bib.61, page 146
while in Ceylon all evidence leads to the conclusion that the institutions prefer to follow the first principle above.

8.7.21 The reasons given by lenders for the meagre flow of credit to this sector are that small firms are not creditworthy. This is based on the assumption that small firms are more risky to finance. The risks attributed to small firm financing are four fold.

8.7.22 (i) The first category of risks comprise of those inherent in smallness such as, managerial inadequacy and lack of adequate funds. Usually management is exercised by one or two primary owners. Most of them do not bring with them acquired knowledge of financial management. The process of learning the 'rules of the game' is sometimes long and devious, others adopt trial and error techniques. Given that they learn over time, good techniques, it does not necessarily follow that there would be continuity of these techniques in the case of death, illness or retirement of the primary owner. In most instances management is passed into the hands of their own children or that of relatives, who may not have the same skills or the same level of commitment. History of business in the country, is dotted with examples where a dynamic business had died with the founder. Among these owner managers, there is also the conservative manager who is adament in his belief that he is always right, and is cynical in changing the strategy of the firm. The death of a owner of a small firm introduces further financial problems to the small firm, such as, on the question of payment of estate duty and other private obligations. All these types of risks are not prevalent in the large limited liability company where ownership is divorced from management.

(ii) A second category of risks are those that are attributed to small firms as against large firms, although these are not necessarily
restricted to small firms. These comprise of bad financial management, greater probability to collapse, greater vulnerability during good as well as bad times, illiquidity and bankruptcy, probability of greater risks taken by management, unscrupulous business techniques, all of which are deemed to add to the riskiness of lending.

(iii) The third are, risks which are influenced by extraneous factors such as environmental pressures, i.e. competition, changing markets, shifts in supply position, taxes, Government policies, changing economic conditions and business depressions. Most small firms are deemed to be more vulnerable to these influences, and as a consequence are liable to suffer more than large firms.

(iv) Fourthly, there is an information gap about small firms. In general it is accepted that even in developed countries statistics, data and information on small business is laggard as compared to large business. In Ceylon this is more so, as described earlier, there is a dearth of statistics on the whole industrial sector, especially in the case of small firms and even the available statistics and data on this sector is inconclusive and consists mostly of estimates. Therefore the absence of reliable data make it difficult to evaluate their activities and needs, and to control subsequent commitments.

8.7.23 The conclusion that one could come to, after investigating the problems of lending, is that the institutions follow a policy of 'escapism' from the risks and costs, real or perceived, involved in financing this sector. They follow a process of going round the problem by concentrating their lending on established large firms where credit worthiness according to them is immediately apparent and discarding those borrowers who at 'first glance' seem risky. This is a natural outcome of a profit making body which
attempts to take the path of least resistance. This tendency is accentuated by the fact that most institutions seem to be well satisfied with their present activities and the profit levels combined with the general reluctance to deviate from well traversed and known paths.

8.7.24 This theory of escapism has two basic characteristics, i.e. (i) reliance on minimum risks loans, (ii) the application of the same basic procedure or accepted principles being followed for every type of loan and the repetition of the same procedure for repetitive loans for the same borrower. The first results in only those established firms qualifying for loans, whose safety is beyond doubt, which leaves out most small firms, and the second results in inordinate delay, adding cost both to the lender and borrower. In the case of both, there is an urgent need for diversification from traditional beliefs and practices. This pattern of behaviour would have found no critics if the country envisaged a gradual reorientation programme of economic development stretching over a number of decades. But, as this is not the case, an effort has to be made to reorientate themselves with the development needs of the country. It is true that this effort should not be put squarely on the shoulders of the institutions alone, an equal effort has to be made both by the Government and the small firm sector. In the final analysis, it is true that concepts of development financing are more complex and that it implies acceptance of some degree of risk, but the concept of risk and difficulty accepted as fact today, seem to be based more on belief than on factual knowledge based on experience. Therefore, there seems to be an exaggerated notion of risks with regard to the financing of the small firm, prevalent in the financial community.

8.7.25 The cost factor involved in financing the small firm is two edged, i.e. costs to the lender and the borrower. In the case of the
financial institutions, it was mentioned earlier, that the interest rates charged do not vary with the size of the loan. This factor introduces a restrictive clause to small loans as costwise the processing of a loan whether large or small is more or less the same. There is also reason to believe that at present in Ceylon the costs of processing a small loan are even higher. The reasons behind this statement are, (i) small firms in the majority of the cases cannot provide comprehensive accounting records and easily identifiable and standard type of security and collateral as compared to the large firm. Therefore this necessitates a greater degree of processing in terms of the lenders time.

(ii) small firms generally tend to borrow proportionately small amounts, and as the return to the lender falls progressively with the decline in the size of the loan, they are less profitable,

(iii) on an average the rejection level of loan applicants are higher in the small firm category. This again adds to the screening costs without much remuneration coming to them,

(iv) statistically the ratio of bad debts is higher among the smaller borrowers. Thus in general, costs together with legislative ceilings on lending rates may result in it being less profitable to lend to small and medium sized industrialists, as against the alternative of lending to large firms.

8.7.26 The cost factor to the borrower was already described in chapter seven. These can be summarised as follows:-

(i) Interest rates charged on the loans. Although the survey firms expressed the desire that they were willing to borrow even at higher rates than those that apply at present, this in no way leads one to conclude that the present rates of interest are low. But, it seems to underline a
gap in credit from institutional sources which forces many firms to seek accommodation from non-institutional sources such as private finance companies and money lenders whose rates are very high. Ceylon's small industry, has no parallel level of development financing interest rates, as found in other developing countries, nor loans commensurate with rates fixed for the plantation sector and the agricultural sector in Ceylon. Although the effect of paying the existing market rates of interest, is common to all sectors, and the relationship of this with the future financial difficulties of the firm are not immediately apparent, the observation during the survey seem to prove that there is a direct relationship between the two. This necessarily adds to the qualification gap experienced by the firm.

(ii) Few small firms can provide the information required by the lender. When the firms do oblige with the necessary information in order to qualify for the loan, the charges for these services such as legal expenses, appraisal fees, insurance charges, stamp fees and commitment charges, tend to be too costly and time consuming in relation to the sums they normally require.

8.7.27 Thus the qualification gap has two sides to it, i.e. the problems of the lenders as well as the borrowers. It is not the contention of this study that all these problems and barriers to lending that exists at present could be removed. But there is nothing to prevent the complete removal of some barriers and the lessening of others and the adoption of alternative procedure to go around these barriers that are a permanent feature in the country.

1. There are special loans at low rates of interest for the development of agriculture and tea plantations.
8.8. A TEST OF A HYPOTHESIS

8.8.1 Before concluding this chapter it is important to deal with one important theory of the adequacy of funds and industrialisation directed at developing countries. This is the hypothesis 'that shortage of credit in less developed countries is only an illusion created by a large false demand for capital and that what really exists is not an immediate shortage of credit at all, but a shortage of viable projects.' This was a theory advocated by Schatz in 1965 on the basis of his research on the loans experience of Nigeria's Federal Loans Board.¹

8.8.2 The exposition of this view is based on the following assumptions, (i) viable project: projects, that all things considered, promise to be sufficiently profitable to attract indigenous private investment, (ii) not viable: when a project is considered unlikely to be commercially successful for any reason, i.e. whether the project itself is badly conceived, or because the applicant has insufficient entrepreneurial ability or because conditions external to the enterprise are unfavourable.

8.8.3 The conclusions drawn from the activities of one lending institution, applicable to one particular country, has been generalised and applied to all developing countries. This study, in the course of its research, examined the validity of this argument as well as its application to Ceylon, and the conclusion reached was that it had no basis for overall application to developing countries, nor, could it be applied to one single country.

8.8.4 It fell short of validity due to a number of reasons, (i) The assumptions made about viability were static. Viability was measured as sufficiently profitable. Firstly, profitability is a term that

¹. See Bib.156, Page 309
cannot be measured in developing countries by pure money terms alone. All developing countries are desirous of rapid expansion and the economies are continuously striving to expand in all sectors. This is aided by a national conscience, i.e. the Government of the country striving to inject life into all sectors and are desirous of giving encouragement to enterprise. Therefore even if a venture seemingly would not be making a profit the interlinkage effect of this unit with others would in many instances bring benefit to the economy and thereby profits if not for the particular firm, to other firms. Further as the economy is changing rapidly profitability of the firm depends on the changes in the economy and not alone on the static viability of the firm at one given moment of time.

8.8.5 Secondly, the resulting experience of entrepreneurs and the resulting addition to the pool of knowledge in the country itself, is a profit in a long term sense. Therefore even if at the beginning, the venture is just covering its costs it could still be considered to be earning a 'profit'.

8.8.6 Lastly, as seen in this study, due to many weaknesses in the economy, viability and profitability are jeopardised at different times, while also policies of the Government of the country, lack of other services and other interacting forces in the economy, add to the problems. However, it must be remembered that these are not permanent features, but constantly changing for the better.

8.8.7 (ii) The mistake most researchers from developed countries make, in analysing different problems in developing countries is that, assessment levels prevalent in the developed country are applied directly to measure factors which look superficially the same in the developing country. It has to be remembered that sometimes the development lag is as
wide as hundred years, as such the overall situation in the economy is different. Therefore, when Schatz talks of a venture that is not viable as, (a) when the project is badly conceived, (b) the applicant has insufficient entrepreneurial ability, (c) or conditions external to the enterprise are not favourable, he is presumably talking in static terms with a background of credit assessment found in developed countries in terms of a free economy.

8.8.8 (a) Firstly, if a project is badly conceived in terms of assessment of a developed country’s viewpoint, it need not be the end of the project. The credit institution itself or advisory bodies in the country could make the entrepreneur change the unappealing part of the project, be it financial, management, machine mixture, marketability or any other aspect, whereby the project could be restructured and therefore there is the likelihood that many projects that are altered could be viewed with a prospect of success.

(b) There cannot be hard and fast rules to judge a person’s entrepreneurial ability. Basically it is a value judgement influenced by many factors. For example, there may be deficiencies in the institutions themselves, such as inadequately trained staff on investment and development financing, to judge what the entrepreneurs real capabilities are. Developed countries abound with examples of successful entrepreneurs and firms, where at the beginning of their career or business the entrepreneur or firm was judged to have insufficient ability or the project was judged to be ill conceived. Further the staff of the lending institutions could be biased due to the environmental upbringing, their earlier training, or even other cultural and social factors and staffing patterns of institutions. It is also true that in developing countries, assessment purely in economic terms
cannot be applied as a whole without taking into consideration gaps in development. A good example of this was given in chapter seven, section 7.2.3, where the early entrepreneur resorted to unconventional forms of financing, not because he did not possess ability, but purely as a consequence of inadequacy of long-term finance. Further even if it is accepted that the entrepreneur himself did not have the ability, the existence of services for him to learn as he goes along, enables lending to be considered, while in the meantime the entrepreneur could be requested to hire advisory staff or as in the case of Development banks in some countries, the banks themselves could have a stake in management during the initial period.

(o) Thirdly, a project cannot be dropped purely for the sake of 'conditions external to the enterprise being unfavourable', without asking the questions, what are the conditions, in which way are they unfavourable, and how long will they remain unfavourable. Therefore in static terms one may be able to agree that at a point of time some factors could be unfavourable, if so the most practical thing to do is to either postpone, alter or reorganize objectives of the venture and not drop it altogether.¹

8.8.9 In practical terms the factors unfavourable to an enterprise among others is the market, normally if other basic factors were not favourable, the project would not have been mooted in the first place. The market factor could be either within the country or outside, i.e. the world market. In the case of the first it has been already stated that Governments are continuously trying to better themselves so it would not be difficult for the correct policy to set the market factor right, for

¹. See principles of the Development Bank of Canada quoted in section 9.2.22
example, import tariffs on foreign goods. In case of the outside market, the view taken by most economic experts on the possibility of selling a developing country's products in the world market, is based on the erroneous view that developing countries should develop according to the needs, created by the developed countries. The exposition of this fallacy is too lengthy to include in this thesis, but it would suffice here to say that prospects of growth for developing countries are judged by experts from developed countries on the feasibility of increasing its natural resources, i.e. primary commodities in their crude and raw state, so that the developed country makes them into the final product. This pattern of trade naturally introduces distortions to the economies brought about as a result of their integration into the world market from a position of weakness, i.e. their exports and imports are determined almost exclusively by the pattern of production and consumption within the centre, i.e. developed countries. If on the other hand, the countries themselves geared themselves to a process of production of these commodities that they export in their raw state, either into semi manufacture or final manufacture, this problem would not arise. The point at issue is, if the projects are unfavourable in most instances they are the wrong projects for the developing countries to start in the first place, proper planning by the Government could set this right. It need not necessarily follow, that the developing countries have to follow the same path to industrialisation as the developed countries have done.

8.8.10 Sahats does considerable injustice to developing countries by generalising his observations of one institution in one country. For example, every developing country has different capacities and different levels of development and comparative advantages. Therefore, a broad
statement such as the hypothesis stated here is very superficial. This is accentuated by the data on which the analysis was made. As stated earlier the findings were based on the loan applications made to the Nigerian Federal Loans Board. Out of 290 applications made, 229 (79 per cent) were rejected by the criteria of commercial viability, and of the 61 (21 per cent) were approved, 7 (II per cent) were rejected on inadequate security. Thus he concludes that 236 (90 per cent) had a false demand for capital.

8.8.11 The DFCC too concluded on a number of occasions that there were a shortage of adequate creditworthy clients and viable ventures. In the light of this study it seems to be a defence mechanism and a process of escapism. This contention could be true if one accepts the present activities of applying sophisticated credit assessment methods and practices to an unsophisticated business structure. But, the cogent fact to remember is that no developed country's industry at its early stage (at the beginning of industrialisation) could have qualified for credit on the assessment methods used today by this institution. It was a gradual process of teaching and being taught resulting in a common pool of knowledge and a parallel building up of a climate for investment as well as the necessary infrastructure. While the developed countries had the disadvantage that there were not many examples and experience to learn from, the developing countries, like Ceylon, have access to a large store of knowledge accumulated by other countries from which it could be wisely borrowed. The fault has not been that they have not borrowed, but what they have borrowed, they have tried to apply directly without much alteration, nor having created the necessary infrastructure for them to be immediately successful.
8.9. GENERAL CONCLUSION

8.9.1 In concluding this section, the attitude of 'the non-viable firms' and 'not so creditworthy clients', could be illustrated by referring to a story of 'two shoe salesmen', who went to under-developed country 'X' to sell shoes. When they realised that the inhabitants did not wear shoes, they cabled their respective head-offices as follows:
Salesman 'A': "no prospects, no market, the natives do not wear shoes"
Salesman 'B': "great growth prospects and future market, the natives do not wear shoes"

8.9.2 The Salesman 'A', took a defensive attitude and a short view of prospects as he reasoned that as the natives did not wear shoes he could not sell shoes. A reasonable short view assumption due to an absence of a ready market. On the other hand salesman 'B' showed a dynamic attitude on looking to the long term prospects of teaching the natives to wear shoes, i.e. by a process of education (advertising) and thereafter selling shoes to them. The role of the institutions in a country, when they deny access to small firms on the grounds of real or perceived risk, 'lack of creditworthiness', is similar to the thinking patterns of the static shoe salesman 'A'.
CHAPTER 9

NEW HORIZONS - PROSPECTS FOR THE FUTURE

9. 1. INTRODUCTION

9. 2. THE GOVERNMENT
   (1) POLITICAL
   (2) FINANCIAL
   (3) INCENTIVES
   (4) SERVICES

9. 3. FINANCIAL INSTITUTIONS

9. 4. FIRMS
9.1. INTRODUCTION

9.1.1 Reading the preceding chapters, it becomes apparent that the problems of development of the country are many, of which the problems of finance of small and medium sized industry is only one. Thus the financial problems of the firms cannot be solved in isolation to the overall problems faced by the economy. Keeping in mind the interactions of the various sectors of the economy and the restrictions imposed by one another, an attempt is made here to examine likely solutions to ease the burden to some extent of the small and medium scale industrial sector in the sphere of finance. No attempt is made to recommend solutions or go into the intricate details of the various solutions, as this is outside the purview of this study. This study concentrates on pointing out the problems and this has been done in the previous chapters. Therefore, only basic guidelines on the direction of change will be given.

9.1.2 In doing so it has to be kept in mind that the problem of finance dealt with in this study is not alone the unavailability of adequate access to credit or the mere shortage of financial intermediaries, but it is the outcome of many obstacles dealt in the preceding chapters and summarized in chapter eight. Further, who, or what contributed to the problem, cannot be laid at the door of the successive Governments, the financial intermediaries or the industrial sector, but each have contributed to the problem together with the interlinking pressures of the economy and the historical development of the country. Therefore, the plan of this chapter is to outline what each, i.e. The Government, Financial intermediaries and the Industrial sector, could contribute to ease the burdens.

9.2. THE GOVERNMENT

9.2.1 In chapter Four the future prospects of the small and
medium sectors were outlined. According to planning circles the 'rediscovery' of planning for this sector is to be handed over to Divisional Development Councils (DDCs) set up in different regions in the country. Initially twenty Development Councils have been proposed. The proposed activities of these DDCs are not yet known but from initial reports they are also to be given the function of financing small industries that come within their jurisdicitive areas. Therefore at the present moment not much could be said about what the final form it would take. What can be done at the present time is to assess the difficulties that any programme would face and the pitfalls that have to be avoided.

9.2.2. It has to be kept in mind that development financing has many facets, such as (i) the financing of new industries, their need for equity finance, short and long term needs, (ii) financing of existing industries, their short and long term needs, such as expansion of capacity, output, diversification, equipment financing either outright purchase or hire purchase or leasing finance; and (iii) venture and risk capital needs which have entirely different characteristics than those of normal needs, for example, financing of research and innovation. Therefore a programme with a general purpose set up with just a broad objective of financing small firms would immediately run into difficulties, if adequate emphasis is not placed on the provision of finance for different aspects and needs of the firm. A mistake very often made is the assumption that financing of industry is very similar to provision of finance for any other purpose in the economy such as agriculture and commerce.

9.2.3 Another erroneous assumption that is made, is that any person who is a good administrator is capable of administering financial services. This was the main failure of the abortive attempt at 'financing
the small firms programme mentioned earlier (see section 6.7). For, in this case the administrative offices in the various districts were given the responsibility to assess the creditworthiness of the clients. The fact that the applicants were deemed honest men and were able to provide some sort of guarantee or security were the two criteria most often used, while factors such as feasibility features, comparative advantage, inter-linkage, availability of factors of production, income generation, profitability, growth prospects, marketability of products, experience and ability, were given scant attention. It has to be kept in mind always that development financing is more complex than the criterion of providing finance merely to earn a profit. Therefore, if the DDCs are given the function of financing the small industries in their particular areas, one grave error to be avoided is the delegation of authority to the District Administrative Officers, to administer the function of financing in the development programme. If, as before, initial screening is to be done by those who have perhaps the local knowledge of the persons but no special knowledge of industrial and financial matters, the scheme is doomed to fail from the start.

9.2.4 This study from the experience gained in its survey of the small firm sector is however pessimistic about the success of adding more financial schemes, without first studying the overall financial structure in the country, something similar to what was done by the Radcliffe Commission and the Bolton Committee in the United Kingdom.

9.2.5 What is suggested here is a four fold programme by the Government and the successive Governments to create the infrastructure for the healthy growth of industry. This can be broadly divided into,
(i) Political, (ii) Financial, (iii) Incentives, and (iv) Services.
I. POLITICAL : 9.2.6 Chapter two outlined the varying interactions of political ideologies that resulted in the haphazard growth of industry, as a result of lack of continuity and non implementation of plans. It was also mentioned (see section 2.5.14 to 2.5.15) that during the last decade there has been a polarisation of policy objectives towards industry and agriculture of both political parties that have formed the Government since independence. If development in all spheres and a prosperous country is the objective of all political parties, it is only a small step at present to have an all party conference to agree and iron out the minor differences in their development ideologies in the sphere of industry and agriculture. It has become quite apparent to everyone, that a period of five years is not adequate for the success of any industrial unit or for the implementation of any industrial policy. Especially, whenever a new Government that is elected devotes two to three years evaluating what the previous Government had done, and another year or two is spent in planning a new policy, leaving only a year or less than a year for the practical implementation of the plan, with the likelihood of the plan being shelved or inadequately administered if the party is voted out of power at the subsequent General Election.

9.2.7 If on the other hand, casting ideology aside, there is a general understanding among all parties of the need for a common and continuous programme, resulting in a development policy once embarked upon and implemented, is continued, notwithstanding what party forms the Government, the cause of the basic disequilibrium in the industrial sector could be eliminated. The resulting guarantee of continuity of policy measures would increase the stability of investment, optimism in the financial and investment market, and the growth of confidence in the lenders and borrowers alike.
This would give time for maturity of industrial programmes, lessening the industrial chaos that has been the hallmark of industrialisation in Ceylon, resulting in waste in human, material and financial resources. This would contribute to the growth of real economy. By real economy, it is meant here, not mere saving, stinting, and doing without as has been the case so far, but it means the prevention of waste, conservation of all valuable energies and materials and the abolition of muddle.

9.2.8 Having laid this basic foundation which up to now has been absent, it is opportune to plan the strategy of industrial development. In chapter one a case was made for small industries, it would suffice here to stress it in the words of Staley.

"Modern manufacturing industry is one of the requisites for attainment of the economic, social and political goals of developing countries - along with progress in other important fields like agriculture and education. A country usually needs to develop a nucleus of large factories in carefully chosen lines and also many smaller (but modern) factories, likewise in carefully chosen lines. Its industrialisation programme will then be more solid, better balanced and more effective in meeting the needs of the people for manufactured goods, and for employment, than if promotional efforts were to be concentrated exclusively on very large industrial projects or on small industry alone" (Bib.146)

9.2.9 Presuming that all are in general agreement that for every industrial giant there are many much smaller units which also play their part in the economic life of the community, a basic decision has to be taken in the demarcation of industry into sectors in terms of size. This is very essential for administrative and policy purposes, as otherwise the usual tendency for all industry to be lumped together and any measures, be they incentives, financial or fiscal or services, become ambiguous. When this is the case the result has always been that the small and medium sized firms have not benefitted from any incentives or services, while they have suffered most from any restrictive measures introduced.
9.2.10 Having established some form of size demarcation, it has to be followed by a survey of all present industries both large and small, parallel to a survey of all raw-material and man-power resources and a survey of all financial institutions and intermediaries, various ancillary agencies, Government Departments and all other bodies presently dealing with industry. The results of these studies are expected to bring out the limitations, shortages, scarcities, misdirection, duplication, and the present situation and interlinkages of the industrial sector as a whole. Once this is achieved the immediate needs, and those of the future, of the industrial sector, in relation to the development of other sectors, would become clear.

9.2.11 With this background, it is time to consider the specific needs and directions of development of the different sectors. Apart from demarcation of industry into size, it is important to identify at the outset what small industry is. A common mistake is that small industry has been identified with handicraft and cottage industries. This study is of the opinion that developing cottage crafts alone is no ultimate solution to industrial expansion due to a number of limitations, such as, marketability, quality, uniformity, continuous supply, employment and application of modern methods. Therefore, fostering of ancient skills and crafts have more a social and cultural value than economic. This is not a plea, to discontinue help to all these traditional crafts, for in some cases, good commercial linkages could be forged with modern manufacturing industry. A few examples of such linkages are those between crafts such as pottery, mat and basket weaving with modern industrial units such as interior lighting and decoration, and luxury packing, but to observe that helping small industry does not begin and end with fostering of cottage industry.
2. **FINANCIAL** : 9.2.12 Once the prospects of continuity, recognition, size, and stability are achieved it is relevant in this study to limit the possible solutions to improvement of the financial accessibility of small and medium sized firms. As stated above this has to be tackled first with an investigation similar to the Bolton Committee Report in the United Kingdom, on the existing financial sources their present direction, limitations and deficiencies in the provision of financial facilities to the needy small and medium sized firms in the country.

9.2.13 This limited study here, has shown that the existing institutions cannot cope with the needs of this sector especially in the field of new industrial ventures, provision of risk capital for innovation, and the provision of long term capital for expansion and development. It has also shown that at present there are no long term credit institutions directing their activities to this sector. In relation to the size of the country, and in physical numbers perhaps, there are adequate number of institutions, but the point at issue is, that most of them have over the years deviated from their original intentions for their establishments, while others, as they are presently constituted cannot be functional due to the special problems of development financing, especially of the small firms. Therefore what is suggested here, is not a mere proliferation of financial institutions, but a restructuring of the present institutions. It has already been mentioned that there is a process of restructuring that has been contemplated, but even in this proposed structure the case for an institution or a subsidiary of an institution to provide finance to the small sector is absent. As Davenport remarks, 'Governments in both developed and developing countries have concluded that the financial needs of small enterprises are sufficiently distinct and urgent and inadequately served
to require special financial facilities,' but this does not seem to be the case in Ceylon.

9.2.14 In summarising the present structure here, the commercial banks, keeping in mind their development and structure, cannot, even with reorganisation be made to fulfil all the financial needs of the small and medium scale sector. At best considering what has been said in earlier chapters, the banks could be made to fulfil the short term and to some extent the medium term needs of this sector. This still leaves the most important needs unfulfilled, namely, long term capital.

9.2.15 This leaves the field open to two alternatives, i.e., either the setting up of an entirely new organisation or restructuring an existing one and attaching this role of provision of long term finance to small industry. This study is not in favour of the first alternative, due to a number of reasons. The foremost among them are, the inadequacy of trained staff and administrators to staff entirely a new organisation, limitation of funds, and the limitation to spread risks of such an institution. In the case of the second alternative, there is already an institution that has so far kept its head above small firm financing, i.e., the DFCC, despite the fact that its sponsors envisaged that a creation of such an institution was in the main, for this purpose. For the IBRD mission, who recommended the establishment of a development bank, envisaged that the country at the beginning should embark on small industry. 'Our conclusion is that for the present, Ceylon's main industrial growth should be centered on the development of numerous small and medium sized industries, rather than a few large ones. These should be widely scattered and diversified, to take advantage of labor and raw materials in various parts of the island.' (Bib.89, Page., 43) It is apparent therefore, that along with this
recommendation, when they suggested a parallel institution to provide finance, what they had in mind was an institution to provide financial services to those industrial units that could not find long term finance elsewhere, implying that they really had the small firms in mind. However, since its establishment, it avoided the task of small firm financing altogether.

9.2.16 Recently, the Government made an attempt to have a greater say in the activities of the DFCC. This was no solution to the problem at all as this would have introduced the very dangers the IBRD mission sought to avoid. (see section 4.4.8) What is suggested here is, first an expansion of its scope of lending and other services with perhaps separate divisions concentrating on different size sectors of industry. To begin with, expansion could take the form of lowering the 'minimum sum' loan scale that stands today at Rupees 100,000, at least by half, to..., Rupees 50,000. It is interesting to note that even the ICPC of the United Kingdom has a minimum lending limitation lower than the DFCC.

9.2.17 Expansion also involves greater access to funds by the institution both local and foreign, at their disposal. There is not much problem about foreign funds as they have access to IBRD funds and the likelihood of contracting funds from any other overseas institution. In fact recently it returned the second line of credit made available to it by the IBRD, with the reason that there were not enough creditworthy clients. As regards domestic funds the shareholding of banks both local and foreign, could be increased with also the likelihood of contribution to funds from the savings institutions and long term fund depositories. Further there is nothing to prevent the DFCC floating its own development debentures.

9.2.18 At present there are a certain number of private shareholders, most of whom are private companies. They should be made to
sell their shares to credit institutions. The reason being that it is unethical for an organisation, which lend to business and industry (mainly from Public funds, i.e., Government loans, Central Bank loans, Bank of Ceylon loans and the IBRD loans fully guaranteed by the Government), to have private shareholders from the very sector it lends to. This statement gains more strength when a comparison is made of the shareholders' funds that have remained at Rupees 8 million since inception, while their total lending has been in the region of Rupees 95.5 million. Therefore the capital contributed by private shareholders although is a minute fraction, they reap the benefits of dividends from other funds most of which are public funds.

9.2.19 Though no attempt is made here to cast allegation or insinuate any misdemeanours on the part of the present shareholders, directors and the management and staff, experience in other countries has shown that businesses, for their own interests, have bought over controlling shares or have high investments in financial organizations with the intention of influencing its credit policy favourably towards themselves or their colleagues and also prevent loans being disbursed to their competitors. There could also arise the possibility when private shareholders are involved that it would stray from the objectives of its establishment namely, to be a development bank in the correct sense of the word. When security, safety and profitability objectives of shareholders become the overriding objective there is a tendency for the organisation to become conservative with its direction merely to make a profit. In fact there is evidence of this happening to the DFCC, where, as mentioned earlier it has exempted itself from small firm financing and most other founding objectives and has concentrated on financing large firms which are predominantly taken

1. Total loans and equities outstanding at end of December 1970 was Rupees 70.9 million
2. See Bib.61
to be 'safe'.

9.2.20 The concentration of the direction of its activities, predominantly as a profit making body, involving itself with loans only with a high degree of profitability and safety is also supported by its recent statement when they returned the second line of credit made available to them by the IBRD with the following observation namely that 'DFCC's ultimate obligations are to the shareholders and it is imprudent to invest in projects which may or may not result in a fair return on the investment'. Such a viewpoint, this study considers, a very conservative statement for the only development bank in the country to make, and all the more objectionable when the obligations they speak of to shareholders whose liability is limited, have shares of only Rupees 8 million.

9.2.21 It is important to digress here, from the main subject, and mention the objectives of the ICFC in Britain. The ICFC, in its loan policy admits that most small loans show no profit at all on a strict allocation of expenses, as the cost of investigation, negotiation, and administrative costs do not decrease as the size of loan decreases, and on a correct provision of risk capital. However, the ICFC undertakes certain investments to encourage new developments within its field, where the risk is impossible to assess with the accuracy required for a strictly commercial investment, or terms which do not offer a reward corresponding to the risks even if the venture is successful. (as reported by Tew, Bib.163)

"Loans of £5,000, £10,000 or £15,000 cannot pay us but they are part of our business and we do as many as we can. . . . It is the feeling that if there is a need for money which they cannot raise conveniently else where, and there is a case for them having the money, then we ought to provide it" (as stated in an interview by the first Chairman of the ICFC, the late Lord Piercy)
9.2.22 From what has been said above, this study in no way desires the DFCC to become a philanthropic institution, and accommodate whoever requires credit, but it is a case of not having their development priorities right. In this regard it is apt to quote the principles and activities of the Canadian Development Bank from which the DFCC, could well borrow a few examples.

Section 15 of the Industrial Development Bank Act empowers the bank to extend credit to any industrial enterprise in Canada provided that such credit would not otherwise be available on reasonable terms and conditions, and provided also that the character of the investment and the amount invested by others are such as to afford the Bank reasonable protection. The Bank interprets this section of the Act to mean that it should go as far as it can to meet applications for financial assistance which appear to satisfy the foregoing requirements. No approach to the Bank is declined in the grounds that the effort required to investigate it and reach a decision would be disproportionate to the financial return which might be earned on it by the Bank. The Bank is prepared to give just as much attention to small loans and to borderline proposals as to larger requests which would provide a greater financial return to the Bank. It is not unusual for an application to the IDB for (say) a $15,000 loan to receive considerably more effort and time than one for (say) $100,000.

Frequently, a small business is dependent upon one or two principals who may be highly skilled in certain respects such as production or sales but may be less experienced in accounting and finance. As a result, the applications which the bank receives from small businesses sometimes have, in their original form, weaknesses which would justify declining the application. However, the Bank's approach is to look into the matter carefully in order to ascertain whether it is possible to work out some basis - perhaps different from that originally proposed - on which the bank can assist the applicant.

A prime factor in determining the extent to which the Bank can help provide financing is the future earning prospects of the business. To assess this feature properly it is necessary to consider carefully all aspects of an applicant's business. In most cases which appear to warrant serious consideration by the Bank this includes a visit to the applicant's place of business for on-the-spot discussions with those responsible for the operation of the enterprise. This adds to the effort and time to process applications but in the experience of the Bank greatly improves the Bank's understanding of the business and its problems and enables the Bank to maximize its financial assistance. The Bank continues to try to shorten the time taken to process applications and has, on average, reduced the period appreciably in recent years.

The Bank makes a practice of following the progress and problems of borrowers after loans are approved and the proceeds disbursed. The
principal way in which this is done is to have borrowers furnish financial statements periodically. By keeping in touch with events the bank is frequently able to help the borrower, if difficulties develop, before they have progressed too far.

When changing circumstances and the financial condition of the business warrant, the bank may amend the original terms and conditions of loans. For example, it may be that before a loan is repaid the borrower is faced with the need to acquire additional fixed assets. The bank may be able to assist by deferring a number of principal instalments on its loan and adding them on to the end of the originally scheduled repayment period. This is also sometimes done to ease a tight working capital position or to see a business through a difficult period when earnings have been temporarily reduced. During the past year the Bank agreed to defer payments for a period of several months in the case of approximately 250 customers.

In numerous cases the bank also provides further assistance by making an additional loan before the outstanding loan has run its course; such loans accounted for 17% by number and 21% by amount of the bank's total loan authorizations during the fiscal year 1962.

The general approach which the bank takes to satisfy itself that the credit being applied for would not be available elsewhere on reasonable terms and conditions is as follows:

1. On the signed application which the IDB obtains from each applicant, the applicant certifies that he is unable to obtain the loan from other sources on reasonable terms and conditions. In any case where it seems to the bank that the overall needs of the applicant might be met from some other source, the bank suggests that the applicant discuss his needs with any source of credit which he may have overlooked.

2. On the application form, the applicant agrees to instruct his chartered bank to give the IDB full information concerning his affairs and the IDB writes to the chartered bank, explaining that an application has been received and requesting a banker's report on the applicant. This serves two purposes: it provides the IDB with an up-to-date report from the bank at which the applicant is well known, and it also advises the chartered bank of its customer's intention to seek financing from the IDB. The Chartered Bank thus has an opportunity to intervene if the situation appears to be one in which it could itself appropriately provide medium or longer term financing.

3. If an application for credit is of a size and character which makes it seem possible that a mortgage lending institution would be interested in providing the required funds, the applicant is asked to contact this type of lender.

4. If the applicant's business is a subsidiary of a large company or is controlled by a wealthy individual, the IDB considers that there is a presumption that funds are available from the owner, and unless it can be specifically shown otherwise, the applicant is expected to obtain the needed funds from that source.
5. If it appears that the applicant could obtain funds by way of a public issue of stock or securities he would be expected to explore this possibility by contact with those engaged in the underwriting business.

6. If an applicant to the bank involves refinancing lien obligations which are held by another lender in more than a relatively small amount, the applicant is asked to get in touch with the other lender to try to re-negotiate the terms of his contract on a mutually satisfactory basis.

7. Applicants who appear to come within the scope of the Small Business Act are advised of the facilities provided under this Act, through the branches of chartered banks.

8. Applicants who appear to come within the scope of such legislation as the Farm Credit Act are directed to the appropriate Government department or agency.

(Taken from the submission by the Industrial Development Bank of Canada to the Royal Commission on Banking and Finance, October 3, 1962)

9.2.23 Apart from reorganisation of the present institutional structure as suggested above, there are also additional steps which the Government could take to increase the fund availability to this sector. Some of which are relevant, are given below.

(i) As mentioned above, following the principles of the Industrial Development Bank of Canada, the DFCC should be persuaded to refrain from giving accommodation to those large firms which could well afford to go public. This would not only provide greater funds to the small and medium firm sector but would activate the stock market.

(ii) It was mentioned earlier that the Government siphons off the major proportion of the funds from the savings institutions and the long term fund depositories (see section 8.3.15). There could be an arrangement by which at least some of these funds are reserved for investment in the industrial sector, either by a method of direct Government loans through the medium of the commercial banks, or through lending to a long term credit institution like a restructured DFCC. The need to follow such a course of action is accentuated by the fact that private investors, especially the small investor,
are both unwilling to come to the market, and invest in private companies for reasons given earlier. As these savings institutions and other compulsory and quasi-compulsory resources consist of funds of the public, this is an indirect method to encourage greater savings, as by such a course, these institutions could be able to offer higher interest rates to the depositors. The loss of sources of funds for the Government could be taken care of, by a greater effort to harness unproductive and hoarded funds, firstly, by uplifting the activities of the savings movement, and national savings bonds, greater fiscal controls on unproductive fund usage, a scheme of activity such as Premium Bonds in Britain, and duplicating the very successful lotteries system.

(iii) An alternative or parallel to this arrangement is the issue of development debentures backed by a Government guarantee, with higher interest rates than those presently given on Government securities, which in turn is siphoned off to Banks and other lending institutions.

(iv) Setting up an Investment Trust to harness small savings.

(v) Another urgent need in the country is a Credit Guarantees Corporation. A case was made for such a guarantee scheme by the Bank of Ceylon Commission in 1968. This study is not aware yet, of any serious thinking on this recommendation of the Commission, by the Government. The form, and method of such an institution has to be worked out with the cooperation of all those institutions that are presently concerned with the financing of industry, agriculture and commerce. Whatever forms it takes, there have to be checks so that a programme of this nature would not stimulate indiscriminate financing of enterprise.

(vi) The present law on rates charged for lending may have to be changed so that banks and other institutions accredited by the Government could charge
differential rates to borrowers, whom the lenders regard as more risky. It has been said, that there is a differential in the marginal cost of lending and risks between large and small loans. Therefore, according to economic price theory, higher marginal costs of lending and risk should be reflected in higher interest rates. The cost to the borrower of higher lending rates could be alleviated to some extent by a credit guarantees programme and secondly, by a system of rebates. The latter could operate, when the lenders consider that there is an additional risk in some types of accommodation. When this is the case, an additional risk margin of interest could be charged by the lender which is refundable if the borrower honours his commitment at due dates.

(vii) Funding Banks and other institutions: At present, banks lend only residual funds to small firms after their favoured and regular clients are served. During certain periods this residual is small or non-existent. The Central Bank directs banks to lend for development purposes, but the term 'development' is rather ambiguous for checks to be set in, to ascertain that these funds really go for development purposes and to really deserving enterprise. Therefore, there should be specific directives like, those that presently exist for tea factory development, for small industry as well. A portion of Central Bank funds that is lent to banks, could also carry the directive that it should be lent only to small and medium sized industry.

(viii) Supplier Credit for equipment: If equipment such as machinery and even raw materials are imported by an authorized body who could resell it on an instalment or hire purchase terms, it could first cut down heavy financial commitments of firms at one time, while it would also eliminate, the present dodges practiced by some firms, such as, overinvoicing of imports, and keeping a certain margin of their funds abroad. This would also help
to cut down the monopoly of sellers and help the process of standardization of equipment. However, care should be taken that the usual Government bureaucratic practices do not enter the administration of such an organisation, as this would jeopardise the efficiency of such an institution. Illiquidity of small firms is also due to a lack of raw materials; in many instances, small firms are forced to buy their raw material requirements from the 'black market'. State Corporations have been given priority in raw material imports, there should be a policy, that deserving units irrespective of their size should have equal access to raw materials.

3. INCENTIVES : 9.2.24 Incentives can take many forms. The foremost among them, is, assurance of continuity of policy measures. This could be achieved by adopting the political measures described earlier. Continuity, naturally brings along it security and certainty of the future. These are the key factors that have been absent up to now, since the commencement of the industrial push in the country. Industry, and for that matter any enterprise, cannot manage their units by 'fits and starts' based on the ever changing policy of Governments. Planning processes need a number of years to develop and an assurance of continuity for forward planning and investment decisions. Once policy and incentives are made known, the Government must fulfil them, as otherwise, apart from the disruption caused, another important criteria for growth would be lacking, namely, trust and lack of faith in Government policies, assurances and incentives. Finally policy when laid down should be clear and unambiguous, so that, on the one hand little is left to the discretion of minor officials and on the other hand the prospective entrepreneur knows precisely the type of assistance that is available.

9.2.25 Recently some new measures have been proposed by an
Ad-hoc Committee appointed by the Minister of Industries to consider what fiscal incentives should be given to industry, one of them is of special concern to the small and medium sized firms. The recommendation was that, apart from foreign earnings released to registered exporters on special applications, registered exporters be granted a percentage of their FOB earnings in foreign exchange. The Committee further suggested that such exchange be utilised for authorised purposes, including travel abroad, advertising abroad, export promotion work, participation in exhibitions, fairs and seminars and export marketing purposes.

9.2.26 This study is not aware of the detailed recommendations, but being familiar with the early deficiencies of the FESC scheme with similar aims, where the benefits accrued to the wrong people, there is a case for a clear and precise definition of, who the real beneficiaries would be, and what precisely should be done with the accrued benefits. In other words ambiguity has to be avoided, the term 'registered exporters' has to be defined. For, in the case of the FESC scheme, at first, registered exporters were erroneously presumed to be the middlemen who exported the final goods, and not the manufacturers and producers themselves, resulting in the benefits of the FESC's accruing to the middlemen whose only contribution was the shipping of the goods. Many of the middlemen refrained from passing these benefits to the manufacturer. In the case of manufacturers who are themselves the exporters the problem would not arise, but in the case of small firms who do not have the capacity to export their goods themselves, the benefits would be siphoned off by the middlemen unless adequate checks and balances are introduced.

9.2.27 This benefit proposed is to increase the export potential of non-traditional goods, produced mostly by small and medium sized firms.

1. Traditional exports are deemed to be the products of the plantation industries.
thereby increasing the foreign exchange earnings of the country. However, the net gain under any scheme, such as that proposed above, the FEBC scheme, or Export Bonus Voucher Scheme, or any other scheme where part of the foreign exchange earned is passed on to the exporter/manufacturer, depends upon the import content of the input goods in the final export goods. The higher the import content of the inputs, lower will be the net foreign exchange gain. Therefore considerable caution has to be exercised when applying a scheme of this nature to exports of products of industries, whose import content is very high. For, if the benefit is calculated on the gross FOB value, it may result in a growth of an artificial re-export trade for the purpose of merely cashing in on the benefits.

9.2.28 Most fiscal incentives given have had a tendency to be ambiguous, this has naturally resulted in, (i) the small and medium sized firms being overlooked and (ii) the 'pseudo industrialist', by all the artful dodges at their disposal, qualifying for them. The overall outcome has been a misutilization of these incentives, resulting in the creation of attitudes by the Government which is detrimental especially to the small firm. (see section 8.5.5) For example, it was described earlier why the five year tax holiday for new industries failed. It would suffice here to recapitulate a few key factors that went wrong.

(a) The absence of proper size demarcation of industry: tax incentives were given to those firms with over twenty five employees. This left out all small industry in the country. As it was shown here in this study, most small firms started business with their own personal capital and family savings, the total of which was small. Therefore it is imperative in this statement, that new units which were set up, began with small workforces inclusive of management. The survey findings showed that in the case of
seventy eight firms (78 per cent) that the workforce, when they began business had under twenty five employees.

(b) As it worked out, the tax holiday did not really bring the results it was expected to do (see section 2.4.12). The reason being that the system was self-defeating as a result of, (i) that profits as well as dividends were exempt from tax for five years. This added to the uncertainty of the future that has always been prevalent in business circles, made those who qualified for this incentive, take the shortest and what they deemed the wisest route out, following the maxim, 'make hay while the sun shines'. The result was that, not much of the profits were reinvested into the business but were taken away as dividends, much of which seem to have been spent on conspicuous consumption purposes, such as purchase of luxury cars, building luxury houses with luxury furniture and fittings, hoarding in the form of gold and jewellery, expensive social functions and parts of it converted to foreign exchange in the 'black market'.

9.2.29 In this regard it is interesting to note that in Britain during the post war reconstruction period between 1945 to 1950, when the Government as part of its economic policy introduced tax incentives, there was an accompanying limitation on dividend disbursement by those qualifying for the incentives, i.e. for many years the profits tax discriminated powerfully between distributed profit and undistributed profit in favour of the latter. Thus the introduction of a disincentive tax on dividend disbursement should be a natural outcome of any profit tax incentive, not only to that guarantee profits are reinvested, but that they are reinvested wisely.

9.2.30 Other incentives in the light of difficulties mentioned earlier is to restructure the legal system, as far as it affects the industrial sector and industrial lending. This would be a boon to both the lenders and
the industrialists alike, especially the small entrepreneur, as time, intricate legal procedure and costs could be pared to a minimum. Another measure that would help to increase the profitability of small firms, is the likelihood of the Government assuring them of a better market for their goods, such as giving them Government contracts, and ensuring that the state industries use some of their products as inputs in their production.

9.2.31 There have also been other Government policies which have affected the small firms adversely. For example, fiscal measures such as increase in duties, decrease in quotas, and import ban of certain raw materials, have created problems in this sector. It is not the measures themselves that are at issue here, most of which were necessary due to the scarcity of foreign exchange at various times, but that they come too suddenly and without prior warning, which takes even the best managed firm unawares (see section 8.5.13). Therefore, it is for the good of all, that there should be clear advance warning of any new quota restrictions and increase in duties, as then, the industrialists could plan ahead to either find more funds to meet the impending increase in duties, or alter their production processes to work within the impending decrease in raw materials, so that the disruption of the production process is minimised. There is also a good case for advance consultation, of all who will be affected by any new policy, before a policy is finalised, and for implementation to take place with a 'time gap' depending on the circumstances. The latter would not only give time for those affected to prepare themselves, but also would show in advance deficiencies that may arise.

9.2.32 Even in the case of Government incentives, there have been cases where the absence of forethought had seriously affected the small and medium sized firms. Two examples are, (1) the five year tax holiday, and
(ii) the result of the introduction of the FESI scheme, on small firms was mentioned earlier. The former placed the small firm at a serious disadvantage, against their competitors who had the financial capacity to start the firm with greater factor inputs (over 25 employees) thereby qualifying for the tax holiday. Both these measures, although they were incentives, seriously affected the small firm, and weakened their competitive position against the larger firms. This further pushed them back in the 'queue' for accommodation from the financial institutions.

9.2.33 It was mentioned earlier that the Government had introduced income ceilings on the accumulation of capital in private hands, and a compulsory savings scheme, where a certain percentage of one's income is compulsorily acquired by the State.¹ In the case of the former it has two serious effects on the economy as a whole which indirectly affect the small firm. Firstly, the prospect of a ceiling on income, necessarily cuts down savings, some of which could have been harnessed as a source of funds to industry. It was mentioned earlier, that those large firms who still turn to credit institutions for their long term fund needs could be persuaded to go public to acquire their funds, but an income ceiling would retard private capital accumulation and thereby lessen the number of private investors who could enter the share market, and the stock market would stagnate further. This will further discourage firms going public and the institutions underwriting stock issues, due to absence of buyers. The result would be, that large firms even more than before, will have to turn to institutional finance, and as has been the case before, given the choice it is natural for the institutions to accommodate established large firms in preference to small firms. Secondly, this income ceiling necessarily cuts

¹ Technically the compulsory savings are to be refunded by the Government every two years.
down incentive for enterprise, resulting once again in less capital accumulation and therefore, even the little capital that flowed into small and medium firms from private sources is lessened further and the prospects of increasing this flow in the future is jeopardized.

9.2.34 In the case of the latter, i.e., compulsory savings, perhaps the welfare aspects of the scheme cannot be faulted with, but once again a certain amount of funds in private hands is lessened, thereby indirectly increasing the financial vulnerability of entrepreneurs and the necessity to turn more often to outside finance. It may be said that the observation above, is a narrow analysis based on the viewpoint of a sub-sector in the economy, but even in the case of enlarging it to encompass the whole economy, the results will be the same. The reasons for this view are not discussed here, as it would deviate from the subject under review in this study. It would suffice here to say that especially in the former case this income ceiling should be removed at the earliest opportune moment, not alone for the benefit of the small firm but for the whole economy.

4. SERVICES: 9.2.35 It was mentioned in section 8.2.12, that the mere provision of more financial avenues alone would not solve the problems of small and medium firms, but that this is only part of the solution, while the balance is the provision of services. This is a very vital link in the solution to ease the difficulties of financial accommodation, not only of the borrowers, but the difficulties, the lenders face as well. Further it would also aid Government planning and control of this sector with minimum waste and maximum efficiency.

9.2.36 The services would consist of direct services, such as facilitating the availability of machinery, raw materials and spare parts, guarantee of fair prices, marketing, transport, factory facilities, and indirect services, such as counseling, advisory bodies, training facilities
and monitoring services.

9.2.37 The most profitable method to evaluate the types of services needed is, by a series of surveys. The important points to be established are, (i) to examine the present situation of the firms, their needs, prospects and to establish the type of special assistance they require, (ii) to examine the presently available services and the facilities that they provide, the degree of overlap if any, and the deficiencies.

9.2.38 As the type of direct services described above are self-explanatory, emphasis here is placed on the indirect services. Once the basic requirements are found from the type of overall surveys mentioned above, the need would arise for specific surveys on each problem identified. Specific surveys are many faceted, and a number of types of surveys and their usefulness are mentioned below.

(A) Industrial opportunities based on development priorities: This would show their attractiveness based on raw material and other factor availability. Therefore funds which is a scarce resource could be better utilized from the outset.

(B) Factor surveys:

9.2.39 (i) Human: This would show human resources available in terms of experience, skills and qualification. It would facilitate to set up training programmes in the skills that are scarce and show the rate at which local expertise could replace foreign consultants and technicians, in the various industrial units.

9.2.40 (ii) Raw material and Capital goods: It would facilitate development of new units, expansion of existing units and termination of those which are uneconomic, and serve no useful purpose. Further, the results that could be achieved, consist of finding new products based on
new raw materials, different uses for existing raw materials and forging of correct machine, manpower and raw material mixtures. It would also show the state of existing machinery, the need for imports of spare parts and replacements, well in advance, and the desirability of manufacturing local machinery and spare parts. All these findings would cut down fund wastage, while at the same time enabling the lenders to take an active approach to financing, by making them aware of promising sectors.

9.2.41 (iii) Financial: In the light of this study, this is the most important, as basically 'money' is the core of all enterprise. Financial surveys would basically pinpoint the existing services and their bottlenecks, financial management of firms and their weaknesses. Further the surveys would facilitate, (a) the integration of financial measures with other measures to uplift the efficiency of the sector, (b) to understand the problems of both the lender and the borrower as shown in this study, (c) the lenders to understand the development importance of alternative allocations of financing, which is vital especially in the case of long term loans, (d) the combination of other studies such as on markets, level of competition and other aspects of industry in which the applicant plans to operate, thereby enabling the institutions to appraise the viability, profitability, and safety of different classes of loans, (e) encourage better use of entrepreneur funds and indirectly improve the quality of loan applications, and finally, (f) to reveal the levels of finance needed for different enterprise, and whether this need is real, or the finance required is too high or low.

(C) Market Surveys:

9.2.42 This would once again cut down fund usage, by prevention of ill thought and uneconomic ventures and the ills of perceived market as
against the real market, help pricing of products, quality control, health safeguards, forward planning and fund disbursement of firms.

(D) Monitoring Surveys:

9.2.43 This is one of the most important surveys that should be in continuous use when an economy is Government controlled and planned, as is the case in Ceylon. This would help to evaluate the end results of services, facilities and incentives, which would show the prospects for the future, profitability of services in the economic sense, the reasons for success and failures of programmes and the need for new services.

9.2.44 It is apparent if surveys are to be successful that they should not be too prolonged nor, done with undue haste, as both would result in unsuccessful results. Further there is a case for a considerable degree of publicization of the surveys very much in advance, so that maximum commitment and interest is generated among all groups who would be the participants. Once surveys are complete and appraisal is made, intelligent implementation of the results should be made within the shortest possible time as otherwise, the whole exercise would turn out to be a waste of resources in terms of time and money.

9.2.45 Even in the case of a small country like Ceylon, the whole burden of all these services cannot be done by one planning body as the tasks and the problems of the economy are too numerous, while on the other hand the division of services and attaching them to Government Departments, result in duplication, a lack of purpose and direction, insufficient stress and weak application. At present, the Department of National Planning has a standing committee on rationalization of the Industrial sector while various tasks of data collection are done by various Department as and when necessary. The result of putting the industrial
sector into one group, has always resulted in the problems of the small firm sector being overlooked. One solution is to demarcate the industrial sector by a size measure as proposed earlier, and reconstruct the old IDB into a Small Industries Development Board (SIDB).

9.2.46 The possible structure for such an institution is given below. The administration of this body is to consist of an appointed body of permanent staff together with representatives appointed on a rotational basis from all other bodies that are connected to small industry. The latter group of representatives would consist of,

(i) The Central Bank, i.e., Economic Research Department and Exchange Control.
(ii) Government Ministries and Departments, i.e., Import and Export Control, Inland Revenue, Department of Industries, Department of Census and Statistics, Department of Marketing, Ministry of Trade, Ministry of National Planning, Ministry of Labor and Cooperative Wholesale Establishment.
(iii) Financial Institutions: Commercial Banks, Long Term Credit Institutions, Insurance Corporation, Other Savings Institutions, Finance Companies and Institute of Accountancy.
(iv) Trade Chambers.
(v) Other Research Institutes: E.g. Universities, Ceylon Institute for Scientific and Industrial Research, Rubber Research Institute, Coconut Research Institute, and Tea Research Institute.
(vi) Trade Unions.

9.2.47 The purpose of having such a varied representation is to forge direct and closer links between the various organizations, in order to build up cooperation, sense of involvement, commitment and awareness, to smoothen the coordination of decisions and to avoid duplication of effort and services.
9.2.48 The function of the SIDB should be separate from the actual financing of projects. This is advocated due to a number of reasons. For an organization of this nature should have a friendly orientation towards the small and medium firm sector with sympathetic orientation towards their needs. Therefore, at first there ought to be a considerable degree of goodwill building between the organisation and this sector in terms of trust, faith and respect, and develop itself as a confessor, advisor and counsellor. It is only when this is achieved, it could more effectively play the role of a service organization with the goodwill necessary for the achievement of two way communication.

9.2.49 If one the other hand, this institution was responsible for lending to this sector, it might not be able to penetrate the defence shields of the industrialists nor achieve the amount of goodwill and the degree of impartiality that is necessary because of the following reasons:

(a) A financial institution in granting or refusing loans has to keep themselves necessarily on a formal though friendly basis. 

(b) A lending institution cannot always please every applicant. Therefore, decisions taken on reducing, withdrawing, and refusing loans involve painful decisions, which more often antagonises the borrower. 

(c) It does not facilitate the process of balanced decision making. 

(d) The danger arises of a lender cum counsellor getting too involved with management decisions to protect their investment, and they, being blamed for wrong management decisions and the refusal or inability of the borrower to pay back the capital borrowed.

9.2.50 Therefore it is in the best interests of the lender, the policy maker and the borrowers, that this institution be a separate entity of its own, being distinctly separate from direct financing although closely connected with every functional aspect of the firm. If doubts of
such an organisation becoming too powerful or autocratic is entertained, and a level of control is necessary, the most appropriate institution that could administer it as a subsidiary, though separate from its normal functions, is the Central Bank of Ceylon. Such a function would not entirely be a new addition to functions of Central Banking in developing countries. For example the Reserve Bank of India concerns itself to a considerable extent and in fact occupies a key role, in the development programme of small industries.

9.2.51 The activities of the proposed SIB can be broadly divided into three main functions, (a) Information gathering (b) Analysis, Assessment and Appraisal, and (c) Dissemination.

9.2.52 In setting up such an institution, two major pitfalls that are to be avoided are,

(a) it should be independent from direct Agencies or Departments of the Government, though responsible to Parliament through the appropriate Minister, or bureaucratic Government regulations and unnecessary political intervention which would sap the energy and the dynamism of such an organisation, however it should work closely with the development objectives and priorities of the country.

(b) staffing is one of the most important criteria for its success. An Organization with such responsibilities and activities should be staffed

1. See diagram 7
Diagram 7

Some of the Likely Activities of the Proposed SIDB

SIDB

Information Gathering
- Survey Units
  1. Industrial Statistics
  2. Financial Data
  3. Products
  4. Markets
  5. Raw Materials
  6. Personnel - Management
  7. Labour Relations
  8. Government Incentives
  9. Government Policy
  10. Inter-Industry Linkages
  11. Technical
  12. Problem Identification
  13. Other...

Analysis - Assessment - Appraisal
- Data Bank - Credit Intelligence
  1. Assessment for Screening of Loan Applicants
  2. Identification of Industrial Opportunities
  3. Identification of Financing Opportunities
  4. Factor Appraisal
  5. Project Evaluation
  6. Enterprise Evaluation
  7. Management Evaluation
  8. Evaluation of Policy Incentives, Restrictions
  9. Sector Appraisal
  10. Recourse Evaluation
  11. Problem Evaluation
  12. Processing Data from All Surveys

Dissemination
- Training School
  1. Seminars, Lectures
  2. Workshop, Simulation
  3. Publications, Books, etc.
  5. Counselling
  6. Advisory Assistance
  7. Training School Courses, In-Management, Finance, Lending Techniques, Assessment, Technical Courses, Other Related
  8. Library & Reference Facilities
  9. Reminding Service
  10. Liaison between Different Administrative Bodies, Private Capital, Inter - Firm etc.

Monitoring and Feedback
with people based on experience, achievement, qualification and capability,
and with a sense of purpose and commitment.

9.3. FINANCIAL INSTITUTIONS

9.3.1 As mentioned in section 9.2.4, this study is of the opinion that mere proliferation of institutions is doomed to failure from the beginning. This statement is made on the strength of what was said in chapters four and eight. The basic weakness in all financial measures has been a misunderstanding of what industrial finance and development banking embody. Therefore, any new institution created, would go the same way as the earlier institutions like the AICC and the DFCC, namely, to carve a 'safe niche' in the credit structure and be satisfied with occasional and feeble attempts at financing the small and medium firm sector.

9.3.2 Before considering the possible future prospects, it would be pertinent here to delve briefly on the principal aspects of development banking. In the context of this study, the description below, concentrates only on the development banking aspects of industry. In this context, their activities would be, (a) provision of long term finance for the establishment of new units which are likely to contribute to the development of the country, and for establishment and modernization of existing industry which have already demonstrated their growth potential, (b) enterprise participation, i.e. participating in management, supervision, control, counselling, seeking and identification of firms, that need financial aid. These two clauses make it possible to differentiate between traditional lenders, i.e., Commercial Banks and Development Banks. In the case of development banking, it calls for a greater degree of involvement of the lender in the activities of the borrower and extends beyond the mere provision of financial facilities, for example, sometimes temporary participation in
management, or at least commitment to the cause of industrialisation by active provision of counselling services and aid.

9.3.3 The degree of involvement and the purposes for which funds are borrowed necessitates that the lender should base his judgement on providing accommodation and other services, not only on the accompanying guarantees that lenders are prepared to give for facilities provided, but on the need for funds, the best method for use of such funds, the likely results arising from such funds and the prospects of such lending, advancing the cause of general economic growth. To be able to fulfill these requirements, the management and staff of the bank, besides being trained in the techniques of development lending, should have advance knowledge of industry and the interlinkage of specific sectors of industry with the direction of the country's development. Having achieved this degree of knowhow, the lender, prior to allocation of funds would be able to ascertain the right priorities in lending to industry by the following methods.¹

(a) Management evaluation, i.e. evaluating the capacity, motivation and other characteristics of the individuals and firms, responsible for the proposed fund use.

(b) Enterprise evaluation, i.e., identifying those who need help, forecasting success, earning prospects and repayment possibilities, and the importance of the enterprise in the industrial and economic 'mix' of the country.

(c) Project evaluation, i.e., identifying sound projects for development by existing firms and new firms, and encouraging entrepreneurs to venture into new projects.

(d) Recourse evaluation, i.e., assessment of the security provided and the safety of the loan.

¹ The importance of these techniques would vary with the form and type of financing, type of applicant, purpose of finance and the general economic situation at different times.
9.3.4 The world of finance is a hard-headed, calculating and selfish one, and however much lip service is paid that institutions should be more adventurous and sympathetic towards the small borrower, no level headed financier is willing to listen to these pious hopes as long as more safe, and profitable avenues are available to them. Therefore the solution seems to be a Government backed financial organisation of the type found in developed countries, like the Small Business Administration in the United States of America, the Industrial, Commercial and Financial Corporation in Britain, and the Industrial Development Bank in Canada, or those found in Asian countries such as the numerous institutions, as mentioned in section 1.6.6 in Japan, and the Small Industries Service Institute of India, to mention only a few. The structure for such an organisation already exists in the DFCC. The DFCC could be enlarged in its activities as suggested in the previous sections with perhaps two departments both lending to those firms which are too small to go public, one concentrating on firms that are already established, while the other concentrating on new firms.

9.3.5 In proposing the direction of services of the DFCC to those firms that are too small to go public, there is no suggestion here for the indiscriminate financing of small firms regardless of their feasibility, viability, profitability and creditworthiness. In fact extensive financial facilities for the sake of giving assistance really does a disservice to the entrepreneur. It is true that due to an umbrella of import restrictions of foreign goods, there has arisen a number of firms which are inefficient, and are doing the cause of industrialisation an injustice. Here, Government intervention is necessary, firstly, either close down some of them completely, and or, direct others to branch out into
more urgent needs of the economy based on factor availability and export markets, and secondly, to embark on a process of amalgamation of others to break the deadlock of duplication, vertical expansion and waste.

9.3.6 Financial help to such firms will be wasted, just as there are a number of inefficient firms, there are equally a great number of efficient or potentially efficient firms which need finance. These are the firms that need a helping hand. There are likely to be many firms doomed to suffer from financial difficulties due to cost of capital being higher than their return on investment at the beginning. Equally many firms tend to remain inefficient and small due to the failure to obtain capital at the correct moment. The accessibility to external funds is strategic in the life cycle of many small units. Good terms and quick accessibility can be the difference between success and stagnation, while high costs and inaccessibility can be the death of many firms.

9.3.7 The problems, present limitations, and attitudes of banks, were adequately described in the earlier chapters. Solutions to most of them are self-explanatory in the limitations themselves. Therefore, with adequate information, education and intelligent restructuring, part of the funds of the banks could be harnessed to meet the short term and to some extent medium term needs of the firms. There have been moves to harness bank funds for development needs both for agriculture and industry, but there has been no specific movement to direct them to small firms. In organising bank lending to small and medium sized firms, there arises once again the demarcation of size, there is no escape from this problem. This has so far been the proverbial 'fly in the ointment' in all efforts. For when incentives and aid is demarcated to industry, it really goes to those firms that can manage without it, this is more so in the field of
finance, as it is always thought safe to lend to well established large enterprises: "A great many financing programmes turn out, on close examination, to be programmes making small loans to borrowers with much larger resources than one would expect from programme objectives" (Davenport)

9.3.8 It is true that a size measure cannot be defined precisely, but for purposes of serving the sector there is no avoidance of this concept. This is especially important when setting up financing programmes for small industries, where the definition of small industry may need to be specifically demarcated. This definition could have different levels for example, to owner managed enterprises, and those owned and managed by persons who devote a major part of time and resources to them, while excluding small ventures of wealthy persons, and those owned by large enterprise.

9.3.9 There is also a necessity for a basic change in attitude, of the whole financial sector towards the small firms. This could only be improved with adequate knowledge of the sector. This is where the proposed SIDB could help, by bringing the lender and the borrower closer together. Some of the facilities it could extend to the lenders are,

(i) Information on applicants and their businesses; for often the fear of risks is due to a lack of information.

(ii) Appraising projects: due to limitation of staff they cannot give as much attention as they would wish to do, in appraising a loan applicant, nor can they keep adequate data necessary for quick appraisal. Today, appraisal begins only when a borrower makes an application for a loan, resulting in delay, which is costly to both sides.

(iii) Training Facilities: Training staff on development financing
techniques, giving them a greater understanding of industry, its management and objectives. At present training programmes are few, and are too generalised. Training programmes should be geared to specific needs and those that are trained should be able to assume lending responsibilities.

(iv) Sector Appraisal: to give guide lines to development importance of financing different sectors.

(v) Information services: information on markets and level of competition and other aspects of the sector.

(vi) Enterprise selection: selection for firms which can make the most productive use of financing. This is especially necessary as funds are a limited resource.

9.3.10 As it is at present the entire responsibility of gathering information cannot be laid at the door of the industrialists or the financial institutions. However, it has to be kept in mind, that the prospect of the existence of an organisation providing these facilities does not diminish the urgency for the institutions themselves to develop a certain amount of knowledge of industry. It is obvious that financial institutions should have their own loan officers with specialised knowledge and training and perhaps practical experience, in industrial operations, to assist in loan appraisals and to follow up their loan commitments. It is only by doing so that there could be a basic change in attitude. A change of attitude can only come, within and not due to pressure from outside. The present structure of banks could be harnessed for this process to take place, for bank offices are spread throughout the country and therefore the bank staff have the opportunities, if they so desire, to get to know the industrialists, build up knowledge of industries and other characteristics of small and medium sized industry, in their specific areas.
9.3.II Greater involvement would automatically lessen many of the barriers to lending. For example, there have been cases where the banks have been hesitant to give relief in cases where they have already lent in the form of an extension of repayment time. In some of these cases the actual causes of delay were not the borrowers own making, but due to Government policy (see sections 8.5 and 8.6). Therefore, if they were ready to look a little further, for the actual rather than the perceived reasons for delay, the case of default would not have arisen in the first instance or could have been avoided at minimum loss both to the bank and the industrialist. Knowledge of firms would increase further the profitability of such lending, as time and therefore cost could be pared by eliminating the preliminary 'jousting' that takes place between the two parties, whenever an application for a loan takes place. Therefore, brief and practical are the preliminaries, less time and cost would be involved. This involvement, and the continuous contact with the proposed SIDB, would result in the staff being capable of understanding modern industrial operations with a fair practical knowledge of technology and methods of operations of the average firm, both of which are essential to correct appraisal of the enterprise to be financed, and those that are already financed. Increasing knowledge apart from contributing to reducing risk and cost, would also increase the development orientation of financing. This would eliminate also a complex that is prevalent among lenders towards small borrowers, namely the feeling that they are doing them a favour by lending to a small borrower, making this attitude known to the borrower, and the borrower for reasons given earlier (section 8.4.5 (xiii) accepting it as such. Finally the increase in development orientation of financing would also make them seek out prospective clients. For example, as Davenport
remains, 'loan officers in the more progressive banks, no longer sit at
their desks waiting for customers to come in at their place of business'.
From what was mentioned by industrialists interviewed, loan officers in
Ceylon not only sit at their desks but sometimes they are 'too busy to
see small clients.

9.3.12 At present the hire purchase companies do not extend
much credit to industry. A popular fallacy is that private financiers make
no contribution to development. Seeing it in a narrow point of view,
private financing of consumption during times of credit restraint may be
harmful, but if recognition is given that both financiers and borrowers
are engaged in productive activities, it may be possible to foster a more
productive approach from the private finance and hire purchase companies.
Therefore, rather than criticise and suppress them, regulatory measures
would be taken to direct a part of their activities to more productive
channels. Despite what has been said of the high cost of private finance
houses, it has to be admitted that financiers themselves are vulnerable
to be deceived by customers. Therefore, the high costs is not alone a
result of strong bargaining power, but also a hedge against greater risks,
due to the likelihood of most customers turning to them only as a last
resort, their lack of knowledge of industry, and the staff to evaluate
business finance.

9.3.13 The new institutions, if any, that would result from
restructuring of the existing ones should be based within the limitations
of the economic framework of the country. The recurring feature of all
plans namely, the 'ceteris paribus' cliché should be avoided. In developing
countries everything does not remain equal nor can there be ideal conditions.
It is true that examples could be borrowed from other countries, but in
borrowing ideas and institutional structure, adequate caution should be exercised. The reason being that even if the needs to be served seem the same, and the institution dealing with these in another country is successful, it need not necessarily follow, that the identical institution would be successful in the borrower country for reasons such as cultural and social traditions, habits, education, commitment, legal structure, level of development, experienced personnel, and a host of other factors which differ from country to country. This is a basic fallacy, applied not only to industrialisation and development banking, but for every aspect of life, i.e., an attempt to apply a norm to all and every relationship. There are no norms or certainties for success, the only basic certainty in life is death.

9.3.14 The enlarged DFCC proposed here, could take steps to expand their activities to suit the different needs of the firm, such as the ICFC has done in Britain, i.e., finance for innovation, venture capital, equity capital, and the medium and long term needs of new and existing firms. Profitability of a loan alone should not be the criteria for lending, for example, the higher cost of lending to small enterprises could be regarded as promotional expenses. In other words a form of 'farming' of small firms, just as one seed of rice brings forth a sheaf, containing about eighty to ninety grains, the profitability can be seen only on a long term basis. Lending to a large number of small firms also helps to enlarge and diversify their commitments, resulting in a spread of risks and the ability to adjust without much disruption in case of default. The validity of this argument can be underlined by the observation of Davenport, who states that it may be in the interest of the lenders, (although they do not always realise it), when according to conventional calculations expenses are expected to exceed
income and where the demand of large clients for funds and staff time fluctuate, little real costs will be incurred by serving additional clients which help to smoothen out demand. This is based on the economic principle of maximum profit where MC = MR. When applied to this, if the minimum facilities essential to serve a small number of highly profitable customers are not always fully utilised, then additional clients may be profitably served, if they provide a return at least greater than variable costs incurred in extending services to them.

9.3.15 In concluding this section it could be said that the basic criterion for 'success', is a thorough understanding of small and medium-sized industry in the country in relation to development goals. This understanding should embody not only knowledge of the owner and product, but the process of manufacturing, management, workforce, inter-linkage of finance and the market. It is only then that the institutions could appreciate and assess the general needs and specific needs, i.e. the financial needs that are basic and those that are peripheral. It has been said that actual needs are frequently quite different from commonly voiced needs. This again is prevalent in all forms of activity. It is well illustrated in the field of industrial relations, where, although the declared and immediately perceivable cause of a strike is for higher wages, the real cause or causes could be a juxtaposition of many reasons, such as insecurity, social needs, dissatisfaction with work environment and a host of other reasons. The problem of finance is also very similar. For example, on the one hand when a firm requires financial accommodation, it need not necessarily be that they need finance at all or not as much as requested. The survey confirmed that when some small firms complained that they did not have adequate financial facilities to expand, it was not alone inadequacy
of institutions or refusal of others to lend but in some instances it was a result of a number of factors, such as, (a) what they had was adequate but ill-utilised, (b) wrong direction and priorities, (c) that they were basically an uneconomic unit although the entrepreneur would not think so, (d) results of Government restrictions, (e) results of other bottlenecks in the economy, (f) results of bad management (g) lack of education, training, management and financial skills. On the other hand when an institution complained that financing small firms were risky or that they were not enough credit worthy clients, this once again was a result of a mixture of different factors, such as (a) ignorance of industry and industrial financing, and profitable avenues (b) the fear to venture (c) fear to deviate from traditions and known areas (d) satisfaction with present activities and profits, (e) lack of commitment, (f) uncertainty of future, (g) the desire to back a 'winning horse', and finally, (h) suspicion and disinterest in small firms and their owners.

2.4. FIRMS

9.4.1 It has been said that small and medium sized firms have been partly responsible for some of the problems of finance they face. It can be broadly generalised that some of their characteristics are the cause of lack of finance, while others are, the effects. It is an accepted fact of nature, that all seeds sown would not produce healthy plants and this would be more so if the ground has not been prepared properly. This has been the plight of the small firms sector in the country. By such a statement, no attempt is made to exonerate the whole sector from some of the wrongs committed, but to show causal factors behind their characteristics, some of which could be eliminated by intelligent policy measures, while others, would have to be lessened by a systematic weeding out process, and controls. It has to be accepted that there will always be some 'wolves in sheep's clothing'
in any sphere of activity of man. Therefore branding all entrepreneurs as 'guilty till proven innocent' is doing them an injustice.

9.4.2 Among the small and medium sized industrialists there are those, that whatever finance and other services are provided, would not reach the level of maturity, breadth of vision, and expertise, one requires for successful enterprise and most of them will be condemned to stagnation and subsequent 'death'. These could be for purposes of identification called, the 'stragglers'. The case argued for, in this study, is not the plight of these 'stragglers', but those who are anxious to grow. Among them there are three types namely, the 'deviates', 'sleepers' and 'thrusters'. All of them have similar problems and aims but the way they react to them is different. The difficulties they face are twofold, i.e., (i) structural features of smallness and (ii) the lack of adequate finance and ancillary services. Both result in making them credit risks and costly to finance.

9.4.3 The problem is that although institutional lenders have spelled out over the years, the terms, conditions and controls over which they would lend, the lenders themselves have been greatly surprised that the borrowers cannot come up to, or meet the standards laid down by them. The reasons have been quite obvious for a considerable period of time, although no attempt so far has been made to study them and take action accordingly. The main reason is that, there is quite a measurable gap between the development of the financial institutions, i.e., a product of developed countries directly imported, and the birth of indigenous small and medium sized industry, with the result a synthesis between the two, has upto now, never taken place. This has left a considerable chasm of misunderstanding between the two groups, and whenever the two groups meet, they
think on different planes, although they talk the same 'language' of finance. The result is that the lender for example, thinks, 'what do they no about finance' and the industrialist thinks, 'what do they know about industry'. This is the crux of the problem and the proposed measures here, for example, the setting up of the SIDB as a liason and counselling service could be the medium through which the problems of both groups could be untangled.

9.4.4 The absence of a liason, counselling and other service facilities provided by a special body, and the absence of any of these facilities provided by the financial institutions or other Government Departments, have retarded the growth of firms. It is apparent that this has led to many undesirable financial practices and the absence of good internal financial and management discipline by some firms. For example, many firms become sceptical of obtaining outside finance, while others are frightened away and apply only after they have fallen into difficulties, and need funds only to avoid collapse. It is not surprising that many of them do not have accessibility in such circumstances.

9.4.5 The overall result is that quite a number of them have accepted their plight as inevitable and resigned themselves to keep on going by whatever avenues available to them, be they prudent or imprudent, in terms of correct financial management, legal or illegal in terms of the law of the country. These are the 'deviates' referred to above. The next group like the first has resigned themselves and become secretive about their business, and show a reluctance to discuss their problems although they would always complain about their plight. They are uncooperative with each other, as well as with institutions dealing with them, these are the so-called 'sleepers'. Finally there is a third group who can be termed the 'thrusters', who has the tendency to take very big risks, are the most
cooperative in 'airing' their problems, are ready to argue it out with lenders and seem to have tackled their problems with grit, audacity and perseverance. The different ways these three groups, and the 'stragglers' mentioned earlier set about, getting on with their business, has made the lenders come to the conclusion that small and medium sized firms are risky and costly to finance. Therefore, despite their method of activity being different, all face the same problems, namely, access to finance and other services.

9.4.6 The problems they face are not devoid of solutions. The structural and situational features of smallness will always be there and have to be accepted as characteristics of smallness. What ought to be done, is to find practicable solutions to make loans to this sector less risky and more profitable. One and perhaps the only method of doing so is by a process of systematic education on financial and management techniques, as this would not only help them to organise their units more efficiently but also enable them to make use of all other services provided to their best advantage. In doing this it would serve no useful purpose if at the outset an attempt is made to educate them on techniques directly borrowed from developed countries. What is needed at first is, simple and lucid instructions on basic techniques, such as,

(i) inter-linkage of finance to the activities of the firm,
(ii) how to raise the funds to start the venture,
(iii) where to seek funds,
(iv) how to invest and where to invest funds,
(v) the proper uses of funds borrowed for different purposes,
(vi) the methods of raising outside capital,
(vii) methods of borrowing from banks and other institutions, funds for, equity, innovation and research, working capital, and long term capital.
(viii) how to assess his requirements and identify the purposes for which the finances are needed, length of commitment, the methods of repayments.
(ix) how to set about the provision of security.
(x) how to keep accounts not alone for purposes of income tax, but principally for the purpose of keeping a constant check on the enterprise.
(xi) the presentation of loan applications, how and when to judge the future financial needs even before the need becomes apparent.
(xii) the art of demonstrating the possibility and prospects of a venture.
(xiii) the obligations they have towards lenders, when a loan is received.
(xiv) technicalities of the legal system as applied to them.
(xv) information of credit services and types of finance available, availability of other services.
(xvi) information on Government incentives, duties, tariffs, exchange control, credit restraint etc.
(xvii) information on different types of taxes and how to provide for them.
(xviii) information on raw materials and their uses.
(xix) information on markets.
(xx) information on how to set about exporting their goods.
(xxi) product pricing, packaging and services.

9.4.7 These are only a few measures that are suggested above. Surveys would reveal what other measures and advice is necessary. Once, such a programme of education is set underway, many of the probabilities of instability, risk and cost which make them non-creditworthy, would diminish. Further at the same time, Government policy could help to increase their profitability by low cost legal aid, technical services, cheaper direct services to lower their production costs, assigning them Government contracts, hire purchase and leasing facilities together with the other services provided by the proposed SIDB.
9.4.8 There have been allegations directed at them that provision of such facilities will not be appreciated by them, and that they would misuse them anyway. This is an erroneous concept based more on misunderstanding and disinterest. For example, there has been disinterest among some of those administering services due to a lack of commitment and absence of responsibility for their actions. Further, planning weaknesses, continuous change in policy and experimentation, have also contributed to this misunderstanding. It is also true that controls breed deviations and unproductive practices resulting in further controls, and as stated earlier there will always be some 'wolves among the sheep'. While discussing these breaches of controls and other devious practices of industrialists, one of them remarked that 'a river's flow, could never be stopped outright by building a dam, sluice gates and escape flows have to be provided for, as otherwise, the water would breach the dam at the weakest spot, once again'. This has been the outcome of some controls, the ingenuity of man to find alternatives can never be stopped. The danger is that some of these practices are tending to become the norm, this bodes ill not alone to the cause of industrialisation but to the development of the country as a whole.

In the final analysis it has to be admitted that when a person or a group of persons venture into business there is already a level of commitment, sense of involvement and participation ending in a desire to be successful, if these desires were not present they would not have ventured out in the first place. Therefore provision of better facilities cannot be denied or neglected for the sins and commissions of a few.
CHAPTER 10

GENERAL SUMMARY AND CONCLUSION
This study set out to investigate one aspect of a sector of the industrial structure in the country. At a micro level, the problem under investigation was the access to finance of small and medium sized manufacturing firms in the country. However, if the problem was dealt with in isolation to industrialisation as a whole, and the development of other sectors in the economy, it would have not been possible to identify the importance and significance of this sector in the future development of the economy, nor, identify the causes, of the problems faced by this sector in the sphere of finance and those ancillary to it.

Therefore, beginning from chapter one, the historical, social and economic background, together with the relevant areas of Government Policy affecting industry as a whole, and small and medium firms in particular were examined. Within this framework the place and importance of this sector for the future, the causes for its backwardness leading to financial inaccessibility, and financial inaccessibility leading to backwardness were examined.

It was the task of the investigation detailed in chapter five, to identify the reasons. Therefore, in order to achieve the best results, a series of questions were framed and hypothesis formed, first to cover every aspect of finance of the firm, and secondly, to cover all other aspects that were interlinked to finance.

The results of the investigation are found in chapters six and seven, with partial conclusions, where relevant. While, chapter eight, sets down the final conclusions derived through overall comprehensive analysis of the results found in the two preceding chapters, in combination with all other chapters. Finally, chapter nine, attempts to suggest ways and means by which some of the basic financial problems of this sector could be minimised, and identifies the directions for further research and study.
At the beginning of chapter five, the hypotheses that were framed with regard to this sector were set down and it is pertinent to mention the results of the relevancy or irrelevancy of the hypotheses in this chapter, before concluding this study. However, it has to be kept in mind that this study being limited in scope, the results achieved show only supporting evidence for some of the hypotheses. Therefore, to establish more conclusive evidence, a very comprehensive investigation of the whole industrial sector and the financial institutions would have to be carried out by the Government, following the findings in this study, i.e., an investigation similar in scope to that of the Bolton Committee investigation in the United Kingdom.

The following hypotheses were supported by the findings in this study, i.e.,

**Hypothesis One**: That all concerned with the planning of the industrial development, have either overlooked or avoided the examination of the availability of finance, and the financial problems of this sector; resulting in,

(a) Inadequacy of avenues of institutional finance,
(b) Unsatisfied demand for long term credit, as well as (to a considerable extent) short term credit
(c) Large firms having access to existing institutions, which is denied or beyond the capacity of the small and medium sized firms.

**Hypothesis Two**: That 'inadequacy of credit' or 'shortage of capital' criterion of small firms could be attributed to,

(a) The fact that financial institutions themselves are too small or have smaller reserves

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1. See chapter one for limitations of the study, and chapter five for limitation of statistical data.
(b) The fact that institutions consider loans principally on the merits of primary and collateral security as against (i) purpose of loan, and (ii) other feasibility features

Hypothesis Three: That if a bias exists against lending to small firms by lending institutions and other financial intermediaries, it is a result of,

(a) The structure of firms, i.e. inadequate financial management, unsystematic management techniques, the desire to be independent resulting in secretiveness, and situational factors of smallness.

(b) Legal limitations to lending.

(c) Historical factors.

(d) Government Policy, and

(e) A communication and Attitude gap.

Hypothesis Four: That credit restraint policies of the Central Bank, i.e. (the Government) affect small firms more than large firms, as a result of,

(a) See below.

(b) Most financial institutions not trying to reduce shortages by raising lending rates so much as by tightening of other credit terms, i.e., by credit rationing; and the terms they chose to ration credit such as risk, solvency, profitability, creditworthiness, rate of return, networth etc., necessarily hurt small more than large business.

Hypothesis Five: That whatever the level of development of a country, general problems of finance faced by small firms are broadly similar, while developing countries have in addition special problems peculiar to developing nations.

In the case of hypothesis four (a), i.e. Rising interest rates which result from credit restraint having a more inhibiting effect on the
borrowing of small business than those of large firms, the results were inconclusive to establish any support for this statement. In Ceylon the banks do not have different interest rates tied to the size of the loan. Further, even if the general interest rates do go up, as shown in section 7.2, the firms were prepared to borrow at the higher rate. However, in general terms, this clause (a), has some truth as lending rates in the unorganised money market rises, (which is a source of funds to the small firm) in times of scarcity, and as scarcity occurs due to credit rationing in terms of clause 4(b) above, it affects the small firms.

Finally, hypothesis two (c) was found inconsistent with the findings, i.e., that shortage of capital for small and medium sized firms in less developed countries is only an illusion created by a large false demand for capital and what really exists is not an immediate shortage of capital at all but a shortage of viable ventures.

On the strength of the findings in the study, the following could be identified as the broad causes for the problems of access to finance of this sector.

(i) A shortage of institutions dealing with industrial and development finance and other services to this sector.

(ii) A shortage of funds both local and foreign in the economy, and a short of existing funds coming into this sector.

(iii) The absence of continuity of Government policy and the illeffects of present policy, i.e., its ambiguity and lack of coherence.

(iv) Historical development of the economy and the importance placed on the development of the other sectors, together with the overall problem of development, having pushed the needs of this sector to the background.

(v) The structural and other limitations of the financial intermediaries.
The structural and situational features of smallness in combination with the shortcomings in management and deficiencies in financial discipline.

A triangular, attitude and communication gap between the Government, Financial Institutions and the small and medium firm sector.

The interactions of all these features enumerated above resulting in a qualification gap, both on the part of the lenders to provide finance, and that of the borrowers to meet the present conditions of finance.

The inter-linkage of all these problems could be seen in Diagram 8.

The likely solutions to most problems identified above, are made on the basis of macro analysis, as this study, is of the opinion, that correct and adequate infrastructure has to be created as a first priority. This would pave the way, first, for a considerable number of problems to solve themselves, and secondly, specific attention could be directed to minimise more serious problems that remain, despite the overall reorganisation.

In concluding this study, it is apt to surmise the overall problems of industrialisation and the relationships of the small firm sector in the form of an analogy. Large state owned industry has tended to dominate the minds of the planners and politicians for the last two decades since Ceylon became an independent nation. The subject of 'farming' small firms to play an increasing role in development, is only just dawning on the industrial scene. Therefore, there is an urgent case to provide the facilities for this growth, the principal of which, being finance. The growth principle of the firms could be expressed in terms of a much used analogy in this study, namely, a tree which is cared for from the seedling stage to maturity would bear in all probability better fruit, than one, where the subject of care arose, only after it had reached maturity.
Factors Contributing to Financial Inaccessibility of Small Firms
Therefore, replanting a tree on foreign soil need not necessarily bear good fruit, unless one has taken into consideration, the state of the terrain where it is to be replanted, i.e., development level of the country, and constraints; climate, i.e., economic plans and priorities; Soil, i.e., adequacy of management, raw materials, labor, finance and market. However, the good points in the art of growth could be gained from others' experience, and adopted to suit some local conditions while some local conditions could be changed to suit other necessary conditions for success. Therefore, the principles to be followed for healthy growth could be as follows:

(i) Good seedling, i.e., small firms suitable to the economic environment and within the constraints of the economy and the development policy.

(ii) Area with best climatic conditions to be chosen, i.e., economic plans and priorities, location, availability of raw materials and other factors

(iii) Preparing the ground, i.e., infra-structure namely direct and indirect services, correct man and machine mixtures.

(iv) Good fertiliser: finance at the beginning and at every stage of development as and when necessary.

(v) Pruning: Government directions and controls, financial management and firm management.

(vi) Safeguard against climatic hazards and physical hazards: labor unrest, strikes, illiquidity, duties and quotas, interaction of other sectors

(viii) Safeguard against pests and fungus: mis-management, corruption, misutilisation of services and incentives.

To recapitulate, a few large trees replanted haphazardly, disregarding these factors enumerated above, at the beginning, would necessarily result in a poor final product, while a number of trees both large and small cared from the seedling stage maturity is likely to result in a bountiful harvest.
GLOSSARY OF TERMS USED IN THE THESIS

Business discontinuances: Comprise both liquidation of firms and transfers by sales, etc.

Capital Employed: This term is used here to denote the total capital used in the business for the acquisition of profit.

Capital Output Ratio: Amount of fixed capital per unit of output.

Collateral Security: Security put up by a borrower in addition to his promise to pay and assets on which the loan is charged. It may take the form of a guarantee from a third party, floating charge on other assets, or deposit of documents of title.

Current Assets: Assets that are continually turned over in the course of the business, e.g. debtors, stock, work in progress, cash and investments which are not trade investments.

D A - Terms: Discount allowed on a transaction by the seller of the goods to the buyer, if the payment for the goods is made within a specified period.

D P - Terms: Deferred payments, where goods are sold with the condition that the bill is to be met by the number of days specified and agreed, i.e. normally 180 days.

Earning Power: Conventional analysis for judging profitability, i.e. ability of a given investment to earn a return from its use.

Exchange Rates: Approximate figures

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Firm: This term is used in the economic sense to mean any business enterprise regardless of its legal form.

Intangible Assets: Invisible assets such as Goodwill, Patents & Trade-marks.
Liquidity: Assets of a firm which can be readily converted into cash within a short time. For example a test of liquidity of a firm is to calculate what is termed the 'Current Ratio', i.e. the ratio of Current Assets to Current Liabilities.

Short Term Loan: Taken here to mean a loan with a maturity of less than one year.
Medium "" : A Loan with a maturity period of over one year but less than five years.
Long "" : A loan with a maturity period of over five years.

Liquid Assets: Cash, Accounts receivable (debitors), near cash less bad debts.

Net Current Assets: Total of current assets less the total of current liabilities.

Net Worth: The difference between total assets and outside liabilities.

Profit net of Tax: Disposable income.

Parate Execution: Legal term, meaning the right to sell any property mortgaged without having recourse to a Court of Law.

Primary Security: Assets on which the loan is charged.

Profit: Used here in the economists' sense, i.e. the difference between total revenue and total costs.

Turnover: Gross takings or total sales before any deductions.

Tangible Assets: Visible assets of a Company.

Tangible Fixed Assets: Premises, Plant and Machinery.

Value of Output: This term and 'Turnover' is used here to mean the same thing, i.e. gross takings on total sales before any deductions.
APPENDIX - B.

THE SURVEY DOCUMENTS

1. Covering Letters (three in number).


3. Small Firm Survey - Pilot Survey Questions

4. Attempts made to collect Statistics.

1. Covering Letters. (letter one)

Phone 96641
Telegrams "Karmantha"
Cables: Indusboard

SECRETARIAT
INDUSTRIAL DEVELOPMENT BOARD

Dear Sir,

I have great pleasure in introducing Mr. C. Anton Balasuriya, Economist from the Central Bank of Ceylon, who is at present studying for his Ph.D. at the University of Edinburgh. The subject of his thesis for the Ph.D. is "Problems of Finance in Small and Medium Scale Firms and Businesses in a Developing Country - Ceylon".

You would agree that Mr. Balasuriya's studies would be great relevance to the country in the context of the attempts that are being made at present to develop small and medium scale industries.

I shall be glad if you could give him whatever assistance possible in his endeavour to collect the data necessary for his research.

Thanking you,

Yours faithfully,

Sgd. E de Silva

General Manager
INDUSTRIAL DEVELOPMENT BOARD.

16, Gregory's Road
Colombo 7.
20th May, 1971.
Dear Sir,

This note serves to introduce Mr. C. Anton Balasuriya who is an Economist from the Central Bank of Ceylon. He is studying at present for his Ph.D., at the University of Edinburgh. As a part of the course he is writing a thesis on the "Problems of Finance in small and medium scale firms and businesses in a developing country - Ceylon".

He has returned to Ceylon for a period of six months to conduct field research by way of questionnaire interviews. I would be pleased if your institution/firm would grant him all assistance to enable him to gather the necessary data.

I would appreciate your cooperation and assistance very greatly.

Yours faithfully,

Sgd: N.S. Karunatilake
DIRECTOR OF ECONOMIC RESEARCH
1. Covering Letters ( letter three )

Department of Economic Research
Central Bank of Ceylon
Queen's Street
Colombo - 1.

Dear Sir,

The attached introductory letters serves to introduce me and my main purpose in desiring an interview with you.

This study attempts to investigate the problems faced both by the lender and the borrower in the sphere of industrial finance.

I have taken the liberty of writing to you, in order to enable me to get as wide a coverage as possible. The interviews will be conducted on the basis of a questionnaire covering the basic areas of finance, while the opportunity will be provided for free discussion within the framework of the questions.

It may be pertinent to mention that the results of this survey will help to identify most problems common to small and medium sized firms in the country and the difficulties faced by the lending organisations. You would agree that an examination of the problems faced by both parties would help to alleviate the difficulties to a considerable extent.

As part of the data I wish to obtain may be of a confidential nature, I wish to assure you, that all data gathered will be used in the strictest confidence and no mention of your self, firm or institution will be made in the final study.

I will be glad if an opportunity is afforded me at an early date to interview your goodself or any other you consider knowledgeable on the subject. An early reply suggesting a convenient date for an interview will be greatly appreciated. Please use the reply paid envelope for this purpose.

Thanking you,

Yours faithfully,

Q-1. What are the basic terms of your loans?

<table>
<thead>
<tr>
<th>Long Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short Term (including overdrafts)</td>
</tr>
</tbody>
</table>

Q-2. What are the basic factors which you consider as important before granting a loan or advance?

Q-3. What is the extent of your supervision and control after the loan (advance) has been granted, for different type of loans?

Q-4. (a) What is your lending policy towards small business

(b) Does it vary according to the type of business and the legal status of the firm, such as one man proprietorship, partnership or Joint Stock Company?

Q-5. Do you carry out a feasibility study (i.e. such as profitability, return on investment, safety, liquidity, etc.) for new ventures and development and expansion programmes, you are asked to finance?

If answer is Yes

Yes/No

What are the feasibility features for

(a) New Ventures, (b) Expansion and Development Programmes

Q-6. Could you tabulate the major grounds for rejection of a loan application (for e.g. inadequate net worth, viability, etc.)

Q-7. (a) Has 'Credit restraint policies of the Central Bank in any way affected your lending portfolio and policy towards small business?

Yes/No

(b) If Yes, were they any different to those applied to large business?

Yes/No

(c) If Yes give your reasons

(d) During these periods what action did you take, to restrict credit?

Q-8. Do you prefer some types of business to others? Yes/No

If Yes what types do you prefer??

Q-9. Do you prefer some type of investment to others? Yes/No

If Yes, what type of investment?
Q-10. How do you view the problems of science based companies? (as the time required for development work is long and unpredictable, thus causing a gap in investment and return).

Q-11. Do you lend on an unsecured basis? If so, under what circumstances?

Q-12. With what types of loans does your institution mainly deal?

Q-13. What is the maximum amount of loan or advance, do you consider,
(a) to the ratio of the firms assets (assets cover)
(b) to the ratio of the firms return in the case of investment loans (earnings cover)

Q-14. How do you judge the credit-worthiness of a borrower? (are the principal determinants of the level of credit risk of a firm for both short and long term borrowings the following)
(a) profitability measured by the average of return or net assets?
(b) Solvency measured by the average of debt - assets ratio?

Q-15. Have you at any time refused loans or credit when a firm to whom you have granted a loan approached you for the second time.
If Yes, the reasons, Yes/No

Q-16. Do you first investigate the viability of a project, before you discuss security and other matters?

Q-17. Has the Bank rate any effect on your lending policy? If Yes, what kind of effect? Yes/No

Q-18. Do you consider that small firms have greater vulnerability to collapse than large firms?


Introductory Data:
(i) Name of Company:
(ii) Legal Status
(a) Sole trader/Proprietor
(b) Partnership
(c) Private Co.Ltd.
(d) Public Co.Ltd.

(iii) Type of Business:
(a) Manufacturing. (b) Processing. (c) Service. (d) Other.

(iv) Date of acquiring present legal status:
(v) Date of original founding of the business:
(vi) Products:
(vii) Total number of employees at present:
Q-1. Please enter in the columns provided the amounts of capital from various sources and their uses if you can readily quantify them for the year 1970.

<table>
<thead>
<tr>
<th>Sources</th>
<th>Total</th>
<th>Uses</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Personal Savings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Owners family (wife/husband, children)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Owners Brothers and Sisters</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Directors loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Others (please name them)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Trade Credits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Earnings of business retained</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(h) Commercial Banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Special Financial Institutions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(j) Private finance Houses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(k) Shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(l) Government Development loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(m) Insurance Companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(n) Debentures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(o) Others (please name them)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Q-2. What type of finance listed below is most difficult to obtain? (Tick appropriate cage)

(a) Short term working capital (under one year)
(b) Bank overdrafts
(c) Temporary (seasonal) finance or bridging finance
(d) Long-term (over one year)
(e) Hire purchase finance
(f) Leasing Finance
(g) Others

Q-3. What in your opinion are the main difficulties you encounter with regard to borrowing (some are listed below, add any other that come to your mind). (Tick appropriate cage)

(a) Security demanded by the lender
(b) Satisfy lender with regard to feasibility of project
(c) " " " " profitability
(d) " " " " viability
(e) " " " " your creditworthiness
(f) Inability to offer guarantees, which lenders require
(g) " " get guarantors for a loan
(h) " " get loans at reasonable interest rates
(i) Difficulty of accessibility to large finance houses & banks
(j) Other reasons (please name them)

Q-4. What conditions imposed by the lender (with regard to a loan) are most difficult to meet from the lenders given below. (This question refers to all types of borrowing both short and long term)

(a) Commercial Banks - Short
   Long
(b) D.F.C.C - Short
   - Long
Q-4 (contd.)

<table>
<thead>
<tr>
<th></th>
<th>Safety</th>
<th>Liquidity</th>
<th>Profitability</th>
<th>Viability</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>(c) A.I.C.C</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) S.M.B</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Private Finance-Houses</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Hire-Purchase</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Leasing</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(h) Supplier Credit</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Money Lenders</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(j) Insurance Co.</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(k) Other</td>
<td>Short</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Q-5. What type of Institution do you normally turn to for your capital requirements?
(a) Investment needs (long term over one year)
(b) Working Capital (short term under one year)

Type of Finance | Source/s | Reasons
---|----------|-----------

Q-6. Was planned expansion of your firm curtailed at any time, due to the difficulties of accessibility of long term credit?
If Yes, Please state circumstances.
Yes/No

Q-7. Have you at any time trimmed an investment programme already commenced because of inadequate retained profits or because of the high cost of borrowing money?
If Yes, Please give details
Yes/No

Q-8. Was plans for modernisation of plant and expansion sales involving capital expenditures hampered at any time during the last five years due to refusal of the banks to grant you accommodation especially additional overdraft facilities
Yes/No

Q-9. During times of Central Bank credit restrictions policies did you find any difficulty in raising finance for your needs?
If Yes,
(a) What type of finance? (Short, Medium, Long)
(b) Was it due to high cost of borrowing?
(c) Or because of the general difficulty of borrowing at such times?
Yes/No

(this question assumes that you had equal credit merit with large companies)
Q-10. Have you had any objections, to any questions or details about yourself your partners, or your company, by the lender before a loan is/was processed?  
If Yes, what type of questions or details?  
Yes/No

Q-11. Do you consider that financial facilities offered by Banks, special Financial Institutions are too expensive?  
If Yes, give reasons for your conclusions  
Yes/No

Q-12. In obtaining funds for investment are you prepared to share equity ownership with lenders?  
Yes/No

Q-13. Have you found the lenders you approached, sympathetic towards the gap of investment and return (especially when time required for the development of the product is long and unpredictable)  
Yes/No

Q-14. Do you feel that lenders give preferential treatment to big business in general?  
Yes/No

Q-15. Have you at any time observed that small firms have special difficulties in obtaining loans from banks and other sources?  
Yes/No

Q-16. Do you believe that small business firms are able to obtain with reasonable terms,  
(a) adequate short-term credit (under one year)  
(b) " Long-term " (over one year)  
Yes/No

Q-17. Is short or long-term credit the greater problem?  

Q-18. Indicate in column (1) and (2) if your firm has attempted to borrow within the last five years from  

(a) Commercial Banks  
(b) D.F.C.C  
(c) A.I.C.C  
(d) S.M.B  
(e) Private Finance Houses  
(f) Govt.Development Loans  
(g) Insurance Co.  
(h) Hire-Purchase  
(i) Leasing  
(j) Business (inter-firm)  
(k) Money Lenders  
(l) Others (name them)  

Q-19. If answer to Q. 18 is yes, was your firm refused a loan at any time within the past five years (refused to mean, whether refused outright or their terms unacceptable) Answer in column 3 of Q.18 either Yes/or
Q-20. If answer to Q.18 is 'yes', indicate in column (4) of Q.18, if your firm has had a request for a loan reduced but not denied at any time within the past five years.

Q-21. If answer to Q.18 was 'No', please tick the appropriate column/s (cage) in this question.

Reasons for not using outside sources

(a) No need to, satisfied with present situation
(b) Use own sources or directors provide funds
(c) Wish to keep business from outside interference
(d) Do not like loans, wish to avoid debt
(e) Interest is too high
(f) Prefer only bank overdrafts
(g) Have other sources
(h) Waste of time trying, as we would not get it
(i) Do not have acceptable security
(j) No wish to grow
(k) Don't Know
(l) Did consider, and did try
(m) Did not try

Q-22. Have you or any of your colleagues in other firms encountered any special problems in obtaining outside finance for your/their business? If Yes, please elaborate.

Q-23. In your opinion what is the strength of competition for the products of your firm, as compared with others producing similar or alternative products?

Strong Competition
Moderate "
No "

Q-24. Are there, any other matters you wish to discuss, regarding finance?

Q-25. Could you please provide the Balance sheets, Appropriation and Profit and Loss statements, of your firm for the last three years.

4. Attempts made to collect statistics.

The attempt made at question twenty five of the small firm survey to collect the financial accounts of the firms was not successful (see Ch.5). In a second attempt to get the details required an answer sheet was drawn up (given below) which preserved the anonymity of the firms. But this attempt too proved unsuccessful.
The Accounts of the Firm for the last three years

BALANCE SHEET INFORMATION

<table>
<thead>
<tr>
<th>Amount in Rupees</th>
</tr>
</thead>
<tbody>
<tr>
<td>1968</td>
</tr>
</tbody>
</table>

**Capital Reserves and Liabilities**
- Ordinary Shares
- Preference Shares
- Other Shares

**Issued Capital and Reserves and Provisions**
- Future Tax Reserves
- Total Capital Reserves

**Long Term Liabilities**
- Net Assets
- Bank Loans
- Directors' Loans
- Trade Creditors
- Other Liabilities
  - i.e. (1) Dividend & Interest
  - (ii) Current Taxation
  - (iii) Other

**Total Capital, Reserves and Liabilities:**

**ASSETS**
- Land & Buildings
- Plant & Machinery
- Other Fixed Assets

**Tangible Assets**
- Intangible Assets
- Trade Investments

**Fixed Assets**
- Stock & Work in Progress
- Trade Debtors
- Marketable Securities
- Tax Reserve Certificates
- Cash

**Current Assets**

**Total Assets:**

**Balance sheet explanation of terms.**
- Preference Shares: Include participating Preference shares
- Provisions: Refer in the main to provisions for deferred expenditure
- Future Tax Reserves: Refer tax payments due in final year
- Long Term Liabilities: Include all overdrafts and loans from bank
(explanation of terms contd.)

Current Taxation: Comprising all unpaid income and profit tax
Tangible Assets: Represents the balance of original costs after depreciation
Intangible Assets: Are almost goodwill and other preliminary expenses
Trade Investments: Investment by way of trade, i.e. involving some element of direct participation in trading concerns
Stock & Work in progress: Are as valued by firm

**APPROPRIATION ACCOUNT INFORMATION**

<table>
<thead>
<tr>
<th></th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading Profit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less provision for depreciation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating Profit</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Plus Other Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Profit (Income to be appropriated)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less tax on current year's income</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Net Profit (disposable income)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less dividends net on (i) Ordinary Shares</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) Preference Shares</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less Other payments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained Profit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transfer to Reserves and Provisions:</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Appropriation account explanation of terms.**

Trading Profit: Comprises net sales (i.e. net of discounts allowed) less total costs, interest on long-term liabilities and Directors' remuneration is treated as a cost.
Other income: Comprises in the main, income from property and investments.
Tax: Represents profits and income tax calculated on current year's profits.
Dividends: To be shown net of tax.

**SOURCES & USES OF FUNDS.**

<table>
<thead>
<tr>
<th></th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue of - ordinary shares</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- preference shares</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-Term Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Capital Issued:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in loans from banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>from Directors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decrease in amounts due to trade creditors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additions to accruals</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends and interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td></td>
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</tbody>
</table>
(sources & uses of funds contd.)

Additions to other liabilities
Retained profits
Provisions for Depreciation
Additions to future tax reserves
Other Capital receipts and profits

Total Sources of Funds

Gross expenditure on - tangible fixed assets
   intangible assets
   trade investments

Decrease in value of stocks
Increase in debtors
Other capital payments
Funds devoted to operating assets
Increase in holdings of - marketable securities
   - cash
   - tax reserves
   - increase in liquid assets
   - residual differences and adjustments

Total Uses of Funds

Sources & Uses of funds explanation of terms.

Capital Issued : Excludes bonus issues, expenses of issue, etc.
Increase in credit received : Represents changes in corresponding items on the balance sheets
Retained profit & depreciation : Correspond exactly to the items on the Appropriation accounts
Other Capital receipts & Profits : Unexplained changes in reserves
Gross expenditure on tangible assets: Includes depreciation, allowance for revaluation and sale of assets
Other capital payments : Unidentified items of expenditure of a capital nature
Residual differences & adjustments : Comprises any unidentified items which cannot be fitted into any other category.
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<th>No.</th>
<th>Author(s)</th>
<th>Title</th>
<th>Publisher/Details</th>
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<tr>
<td>16</td>
<td>Benston, G.J.</td>
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<tr>
<td>21</td>
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<tr>
<td>32</td>
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<td>45.</td>
<td>&quot; &quot;</td>
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<td></td>
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