THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

No. of Pages = 25

TOP CA CASE STUDY EXAMINATION

MAY 2012

ADVANCE INFORMATION

Migaya Ceramics

Introduction

Migaya Ceramics Lanka PLC (MCLP) is a quoted public company listed in Colombo Stock Exchange with a market capitalization of over Rs. 3 billion. MCLP was featured in the list "Asia's 200 Best under a Billion" by a famous rating agency, and received the award for "best return on investment short term in South Asia" out of more than 10,000 listed companies in the South Asian region sometimes back. The Migaya Ceramics[1] is primarily into the business of manufacturing and selling porcelain and ceramic tiles and sanitary ware products under the brand names, "Micell" and"Micell Bathware" both in domestic and international markets.

The tile segment is the largest revenue generator for Migaya Ceramics and is the market leader in the Sri Lankan floor-tile industry with a market share of 45 percent. The company operates two tile manufacturing facilities located in Godakawela and Meepe for manufacturing glazed and porcelain tiles with a capacity of 15,000 Sq.m./day. The Godakawela plant which is the oldest plant of the company manufactures porcelain tiles operating at a capacity of 5,000 Sq.m./day. The Meepe plant which has been established as a MCLP's fully owned subsidiary, Migaya Porcelain (Pvt) Limited manufactures ceramic tiles and operates with a capacity of 10,000 Sq.m./day.

The bath-ware segment of MCLP, which started its operations in Avissawella in 2009, is on its take off stage. The operation has been successful thus far in penetrating the domestic bath-ware market. Currently the company manufactures 200,000 pieces a year, which only accounts for 50 percent of the current capacity located at Avissawella.

The change of strategic orientation

The company in its initial phase of development till late 1990s exported more than 85 percent of its output. However, at the dawn of the new millennium, the company started realizing that its growth could not solely rely on export markets especially in the context of economic slowdowns in the West where their major markets were located and also due to the fierce competition coming from other tile manufacturing countries, especially from China.

[1]Migaya Ceramics refers to the entire group consisting Migaya Ceramics Lanka PLC (MCLP), Migaya Porcelain (Pvt.) Limited and Migaya Bathware (Pvt.) Limited. Both Migaya Porcelain (Pvt.) Limited and Migaya Bathware (Pvt.) Limited are fully owned subsidiaries of MCLP.

In the light of these developments, the company formulated the following new strategies to maintain the expected growth momentum:

1. to take necessary actions to continuously tighten the quality standards,
2. to be innovative in the industry by introducing new and attractive designs,
3. to diversify the product portfolio, and
4. to take necessary measures to strengthen the local market segment.

In order to strengthen the quality standards of the products while lowering the rejection rate, the company increased the training budget and started some in-house training programmes. Simultaneously, the company started conducting special seminars and workshops for its employees with the help of the best Quality Gurus in the country at the time. They also hired two design specialists, one local graduate with a First Class in B.Sc. Special Degree in Designing and another Art and Design graduate who obtained his Degree from a reputed University College for Art and Design in the UK.

With the hiring of new designers, the existing floor-tile design range started to expand rapidly. Simultaneously, the management decided to start a few more sales outlets in Colombo, its suburbs and other main cities in order to expand the local market segment. The management felt that the time was opportune for such an expansion with the peace accord signed by the Sri Lankan Government with the LTTE in 2002. By 2005, it had about 31 sales outlets and 3 warehouses.

The decision to introduce the bath-ware segment was taken with the view of diversifying the product portfolio of the company. In fact this idea came from one of the new designers hired. According to him, the available designs in the local market do not match the up market needs and there would be a high potential of getting a premium price for the product even in the local market. He further elaborated that giants in the construction industry and some hoteliers, who are seeking high quality stylish bath-ware products, have to directly import them from countries such as the US and Italy.

New strategies helped the company kept up its growth momentum. The turnover of the company grew rapidly both in local and foreign segments of the market. The growth was mainly financed through divesting some investments in financial instruments such as government securities and stocks of other companies and through both long term and short term borrowings from its network of banks.

Access to capital was not a problem at this stage of development. As a result the company did not feel any cash flow problem despite heavy investments in new plant for the bath-ware segment and the newly inaugurated series of sales outlets.

Before opening the series of local outlets, sales in the local market were limited to stock clearance sales organized by the company twice a year before festival seasons in March and December. In fact most of the stocks cleared at these sales consisted of tiles with minor defects not fit for exports. The demand at stock clearance sales was great as the company tiles were not usually sold in local markets. However, the company found that demand at stock clearance sales was not that enthusiastic after starting local sales through newly opened sales outlets.

Ambitious plan

The expectation of all corners about the Sri Lanka's economic recovery from its long and brutal civil war, which spanned over 25 years, became astonishingly high with its conclusion in early 2009.The GDP growth was estimated to be above 8 percent, which was expected to be among the most robust in the world. Much of this ambitious growth was initially expected to come from post-war reconstructions and new investments especially in tourism and hotel as well as real-estate and property development sectors, despite the global economic slowdown at that time. The acceleration in the economic activities led to improvements in the overall business confidence in the economy giving rise to a healthy investment climate. The interest rates also showed a sharp drop during the period as a result of the increase in the domestic liquidity levels mainly owing to the increasing foreign assets created by healthy inflows by way of remittances, investments and long term borrowings by the country. In this backdrop, the company thought that the increasing borrowings to finance the growth would not be a threat. The company also expected that the demand for construction products in general to improve strongly with the boom taking place especially in the hotel and property sectors. Further, they anticipated that this growth would be supplemented by increasing investments by individual home-builders with the increasing per-capita income levels.

In the past, especially prior to the ending of the war, the Sri Lankan tile sector was on a low base with the per-capita tile consumption only at 0.6 Sq.m. in comparison to developed countries in the West that had a per-capita tile consumption of 5-6 Sq.m.

The management of Migaya Ceramic expected that with the economic growth supported by large investments in construction at governmental, business and individual levels would help to enhance the average tile consumption rapidly. Further, according to them, cessation of the civil war was a blessing for the company which was experiencing continuously declining exports due to the economic crisis in the West and stagnation of the local market due to the civil war. As expected by the management, company sales started to grow rapidly since 2009, and the tile segment of the company expanded its operations almost to the fullest capacity. The management was very ambitious and increased the number of sales outlets to 237 by the end of 2010, while adding 4 more warehouses to its network to serve the increasing number of sales outlets. Also, the company started offering trade credits for construction companies. The duration and the level of credit varied from client to client depending on their balance sheet strength.

The issue

As scheduled, the senior management team of the company headed by Visal Masakorala, Group Managing Director of Migaya Ceramics, met in the corporate board room of the Colombo headquarters at 9.00 am on January 25, 2012 in order to review the operational performance of the company and its subsidiaries for the year (2011) just concluded. The meeting was attended by all functional heads of MCLP and its subsidiaries.

At the outset, Visal briefed that as a group of companies Migaya Ceramics was to face a tough time. He detailed further saying "as you all may be aware our overseas market is further shrinking due to stagnating economic problems faced by the West, especially the US and Europe. Europe has been the number one destination for our products followed by the US". He also stated that though the US economy was showing some signs of recovery, according to the President Obama's new policy package declared in his State of the Union Address early this year, imports and out sourcing would be discouraged by the country in favour of local production. On the other hand, western markets were becoming more price sensitive so that cheap Chinese products were penetrating these markets during this economic slowdown, he went on elaborating. He inquired from Janaka Bandaranayake, Deputy General Manager Exports and Morin Almeda, Director Marketing about the current status.

According to Janaka, foreign orders received during the last quarter of the year 2011 in total (so far processed and yet to be processed) was down by about further 20 percent compared to what was received during the same period in 2010.

He further articulated “all in all, our overseas markets have been shrinking since 2008 and it is high time for us to find new destinations for our products perhaps, within new growth centers in Asia and Latin America.” However, he stated “the overall drop in our export sales was due to the drop in sales of the tiles and not the bath-ware products. Thanks to the superb job done by our designers, the exports of the bath-ware products showed an overall improvement in 2011.

Morin added “peace-dividends seem to be over, here in the local market. According to the reports coming from my managers of the outlets, sales growth had come to an end by mid-2011 and we would not achieve the set targets for the year 2011. In fact, there was a sharp drop in our local sales during the last few months in 2011.”

Amal Bogamuwa, Director Finance took a long time to enlighten the senior management about the seriousness of the problem being encountered by the company. According to him, like most of other companies, Migaya Ceramics had been over ambitious when the war was concluded. Drawing from detailed financial reports he stated that the company had over invested in sales outlets, some of which were running at a loss currently. He added “our margins are falling. Costs are out of control.” When he suggested closing down those functioning below the break-even, Morin opposed saying that it would badly affect the image of the company. However, the entire team agreed to put a Board Proposal requesting the suspension of the expansion program of sales outlets with immediate effect.

Moreover, Amal stated “our hands are already tightened. Credit customers are not paying in time” He elaborated that credit given to real estate developers was overdue by months. No more the company can go on rolling up with short term borrowings as the cost of borrowings is going up day by day. The government dependency on local markets was alarmingly increasing since mid 2011 and there would be no improvement in financial markets in the foreseeable future. On the other hand, according to him, the current assets build up is too much without notice. He further stated “I don’t think there is a system here to track our stocks at various points. You guys store every where possible but after all this is money stored without any return. That’s why I had to pay banks so much of interest”. Finally, he highlighted the importance of cutting all budgets and unnecessary expenses. He concluded saying “financial discipline is becoming the order of the day for the company”.

At this stage Justin Wedamulla, Deputy General Manger Operations interrupted saying “I don’t agree with cutting budgets and expenses across the board.

We have to identify our priorities and competitive edges." Further, he reminded that despite the bad time being experienced, the bath-ware segment had been doing extremely well since the commencement. However, he was in agreement with the need of cutting costs in principle but not the way that Amal was suggesting. He was speaking in the spirit of his recent experience in Japan as a technical trainee of the Japan International Cooperation Agency (JICA). Under this training program he spent more than three months in Nagoya, Japan in early 2011 studying techniques of waste elimination and lean manufacturing. According to him, the training program that he had undergone there was an excellent blend of theory and practice, as a part of which he got the opportunity to visit a number of world class manufacturing facilities covering a wide range of industries including two ceramic factories. On his return, he conducted a number of sessions for the supervisory staff and the shop floor level employees on lean manufacturing. However, he did not get an opportunity to suggest something concrete to improve the operations at Migaya Ceramics. He felt like he was marginalized and only finance and marketing people got the prominence within the company. In fact he was counting days until he got an opportunity like this meeting.

Morin was disgusted and voiceless thinking that she was also partly responsible for the rapid expansion of the branch network and the inventory buildup. Although she did not utter a word against Amal, she felt as a company everyone was over ambitious and supported the expansion. Morin was silently determined to do a store and outlet survey immediately to find out more facts about inventory buildup and sales patterns.

At this stage, Visal noticed that everybody's emotions were out of control and the entire board room looked moody. He thought that it was high time to wind up the meeting. So he broke the silence saying "by now you all must be hungry as it is already well past lunch time." Further, he mentioned that he agreed with most of the ideas that cropped up at this meeting. He added, "as Amal correctly pointed out, the company badly needs some financial discipline". Visal went on saying "you know we all are expenditure points. Therefore, it's a collective responsibility. Yet, we have to be careful in introducing a cost cutting program as Justin indicated. It could boomerang if we touch the wrong pulse so that we have to understand our priorities first". Then he went on saying, "this is only the start and we have to meet again with your proposals soon."

He requested everybody to take up the issue with the immediate subordinates of the respective divisions.

He added that he would update the Board of Directors and the Chairman on matters transpired at today's meeting and everybody's concerns. He concluded saying, "I am sure that the Chairman and the other Board members would like to hear your proposals soon." Amal's final reflections put everybody some what at ease. They joined lunch while cracking some jokes as if nothing happened.

Enclosures:

1. Consolidated Summary Financial Statements of the Migaya group of companies for years 2007 to 2011.
2. The Tile Industry – A Global and Local Perspective in 2009-2010 -A Glimpse of Expert Views
3. Selected Extracts on Sri Lankan Economy and Financial Markets:

    a. The Impact Euro zone Debt Crisis on Sri Lankan Economy (*Sunday Observer- December 4, 2011*)
    b. Spain's escalating financial crisis: Is Europe committing 'economic suicide'? (*The week - April 17, 2012*)
    c. How the global economic crisis can impact on economic policy? (*The Nation - January 28, 2012*)
    d. Over heating symptoms in Sri Lankan economy (*Sri Lankan Equity Forum April 02, 2012)*

Migaya Group of Companies

Consolidated Summary Financial Statements (2007 - 2011)

Consolidated Income Statement (5 year Summary 2007 - 2011)

For the year ended 31 December	***2011****	***2010***	***2009***	***2008***	***2007***
	Rs.'000	***Rs.'000***	***Rs.'000***	***Rs.'000***	***Rs.'000***
Turnover	4,106,015	3,641,563	3,750,385	3,012,237	2,426,454
Cost of Sales	(3,026,511)	(2,512,679)	(2,625,270)	(2,123,627)	(1,698,518)
Gross Profit	***1,079,504***	***1,128,884***	***1,125,115***	***888,610***	***727,936***
Other Income Gains	3,782	4,232	2,242	4,454	1,235
Investment Income	14,422	111,849	208,557	128,988	57,001
Distribution Expenses	(462,450)	(297,914)	(129,603)	(59,591)	(44,207)
Administrative Expenses	(252,207)	(158,757)	(82,403)	(57,588)	(55,598)
Finance Cost	(252,894)	(165,562)	(105,271)	(79,300)	(12,434)
Profit Before Tax	130,157	622,732	1,018,637	825,573	673,933
Income Tax Expenses	(39,047)	(186,820)	(305,591)	(247,672)	(202,180)
Net Profit for the Year	***91,110***	***435,912***	***713,046***	***577,901***	***471,753***

***Provisional figures*

Consolidated Balance Sheet (5 year Summary 2007 - 2011)

As at 31 December	***2011***	***2010***	***2009***	***2008***	***2007***
	Rs.'000	***Rs.'000***	***Rs.'000***	***Rs.'000***	***Rs.'000***
Non-current Assets					
Property, Plant and Equipment	2,971,624	2,654,682	2,177,784	1,193,319	1,065,080
Long Term Investment	142,995	194,742	259,891	502,725	300,700
Total Non-current Assets	***3,114,619***	***2,849,424***	***2,437,675***	***1,696,044***	***1,365,780***
Current Assets					
Inventories	1,919,980	1,565,072	1,091,122	785,104	687,489
Trade and Other Receivables	978,845	591,773	461,646	395,162	245,266
Other Investments	318,859	450,027	504,339	468,621	174,311
Cash and Cash Equivalents	35,272	47,462	54,940	50,156	52,757
Total Current Assets	***3,252,956***	***2,654,334***	***2,112,047***	***1,699,043***	***1,159,823***
Total Assets	**6,367,575**	**5,503,758**	**4,549,722**	**3,395,087**	**2,525,603**
Equity and Liabilities					
Stated Capital and Reserve					
Stated Capital	2,289,750	2,096,250	2,096,250	1,075,000	1,075,000
Reserves	77,850	77,850	77,850	615,350	815,350
Retained Earnings	588,469	690,859	641,947	509,401	254,000
Total Equity	***2,956,069***	***2,864,959***	***2,816,047***	***2,199,751***	***2,144,350***
Non-current Liabilities					
Interest Bearing Loans	806,388	684,499	507,578	458,400	18,720
Deferred Tax Liabilities	40,023	101,636	169,349	123,689	95,493
Retirement Benefit Liabilities	104,276	98,017	54,307	46,482	22,509
Total Non-Current Liabilities	***950,687***	***884,152***	***731,234***	***628,571***	***136,722***
Current Liabilities					
Bank overdraft	490,086	339,239	76,114	22,454	87
Trade and Other Payables	1,134,848	514,967	225,534	146,377	47,503
Dividend Payable		193,500	240,250	111,250	107,500
Income Tax Liabilities	45,828	62,046	115,884	120,426	2,578
Interest Bearing Loans	790,057	644,895	344,659	166,258	86,863
Total Current Liabilities	***2,460,819***	***1,754,647***	***1,002,441***	***566,765***	***244,531***
Total Equity and Liabilities	**6,367,575**	**5,503,758**	**4,549,722**	**3,395,087**	**2,525,603**

Following information is also available

1. Migaya group consists of three companies; Migaya Ceramics Lanka PLC. (MCLP), Migaya Porcelain (Pvt.) Limited and Migaya Bathware (Pvt.) Limited. Both Migaya Porcelain (Pvt.) Limited and Migaya Bathware (Pvt.) Limited are fully owned subsidiaries of MCLP which is a listed company in the Colombo Stock Exchange.

2. Both the Income Statement and the Balance Sheets show the consolidated position of all three companies of the Migaya Group.

3. The investment income of the company consists of dividends received from investment in equities, interest received on debt securities and bank deposits, and capital gain or loss arose from selling equity or debt securities.

4. Information on MCLP's stated capital is as follows:

	2011	***2010***	***2009***	***2008***	***2007***
Stated capital (Rs'000)	2,289,750	2,096,250	2,096,250	1,075,000	1,075,000
Number of ordinary shares ('000)	212,850	193,500	193,500	107,500	107,500

In March 2009, the company made the first bonus issue at the rate of one (01) bonus share for two (02) existing shares. Again in April 2009, the company made a right issue of one (01) share for five (05) existing shares for Rs. 15.00 per share.

In 2011 December, the company made the second bonus issue at the rate of one (01) share for ten (10) existing shares. The objective of this issue was to please the shareholders as the company did not wish to declare any dividends for the year 2011.

5. MCLP's EPS, DPS and the end of the year share price information for the last five years is given below.

	2011 Rs.	***2010 Rs.***	***2009 Rs.***	***2008 Rs.***	***2007 Rs.***
EPS	0.43	2.25	3.68	5.38	4.39
DPS	-	2.00	3.00	3.00	2.00
Share Price	14.60	18.40	25.80	16.40	15.20

The Tile Industry – A Global and Local Perspective in 2009-2010
A Glimpse of Expert Views

Ceramic tile industry is a multibillion business and Peoples Republic of China (herein after referred to as "China) is registered as the largest producer of ceramic tiles followed by Spain and Italy. There are three major regions in the world namely Asia, Latin America and European Union that produce and export tile in bulk. Tile market trend is correlated with housing demand, spending, characteristics of new homes, non-residential construction spending, mortgage interest rates, and other economic indicators.

Sri Lanka showed a continuous positive growth momentum and maintained its growth rate at around 8.3 percent during the year and this positive sentiment is expected to continue. For the first time the construction industry became a major contributor to the economy by showing a 17.3% growth which is a record. The rise in the economic activities has led to improvement in the overall business confidence in the economy giving rise to a healthy investment climate. The interest rates has also seen a sharp drop during the recent past as a result of rise in domestic liquidity levels owing to sterilization foreign assets created by healthy inflows by way of investments and long term borrowings by government of Sri Lanka and also due to low budget deficits. Further with the increased economic growth and the recent economic revival of the country, an upward trend is anticipated in many industries. This high growth is also expected in the building construction area and consequently the tile and sanitary ware industry too would grow remarkably opening up more competition within the industry. Further the post war reconstruction and rehabilitation requirements are expected to trigger a construction sector boom over the years. The main reconstruction requirements include the construction of the government buildings and the resettlement and rehabilitation of the families affected by the war.

According to the Central Bank of Sri Lanka, the inflation and interest rates of the country has seen bottoming out and it is expected to remain at manageable level. As a result the per capita disposable income is expected to show healthy growth increasing the purchasing power of consumers. Western and Southern provinces contributed to approximately 60% of the Gross Domestic Products (GDP) and they enjoy a highest per capita income levels in the country and also the center for the demand for tile products. These two provinces account for 70% of the tile industry sales.

The growth in demand for housing is a primary indicator of the growth of tile industry. During 2010 Sri Lanka was categorized as a middle income emerging market by the International Monetary Fund. This implied low income earners eventually converted to middle income earners and as a result they try to upgrade their living condition including housing. Moreover during 2010 Sri Lanka received major world recognition as it was ranked the 8th fastest growing economy in the world by Economist Intelligence Unit (EIU) of the United States. The demand for housing increase in any fast growing economy and same situation can be seen in Sri Lanka also. Ultimately the growth in demand for housing gets increase and it will positively affect to the tile industry.

Ceramic tile and stone consultants believe that with the economic growth and potential investments, averages in tile consumption would be enhanced consequently with the rising income levels. However, during the past few years the Sri Lankan tile cluster was on a low base with the per capita tile consumption only at 0.6 Sqm in comparison to developed countries like Europe which has an average per capita tile consumption of 5-6 Sqm per person., China - the tile manufacturing giant - has per capita tile consumption of 2 sqm per person

Tile industry consumes large quantities of clay. Currently 95% of the raw materials are supplied locally. Naturally, Sri Lanka has a rich base of diversified minerals, such as kaolin, ball clay, feldspar, silica quartz and dolomite, which are largely used in the manufacture of ceramic products. Although there is an enough supply of high quality clay in Sri Lanka, mining restrictions prevailing in the country act as a barrier in acquiring required quantities. Obtaining papers to mine raw materials is surrounded with government red tape. Stringent regulations on ball clay mining may in turn escalate raw material prices to increase the production cost future In addition illegal clay mining in the rural districts is also taking place which has a negative impact on the larger producers.

In general raw material expenses accounted for 20% of the production cost of ceramic tiles. Even though in Sri Lanka the clay is easily available, the transportation cost and the acceleration of fuel costs adversely impacts the industry at the point of obtaining raw material. Further, it is said that the consumption of raw materials is doubled over the years when compared with the early 2000.

Moreover consistently rising energy costs push the tile industry backward. Tile industry spends billions of rupees a month on energy alone. Gas fired kilns are the primary source of energy to industry and it estimates the energy component at 40 percent of production cost which acts as a critical factor for the industry.

Of the 40% of the energy cost almost 20% of energy cost for tile companies are attributed by energy requirement for operating the Kilns which is used to burn the ceramic. At present the local manufacturers are reliant on LP Gas and Kerosene to fuel their burners. The rise in energy prices is expected to increase the cost of production of the local players which would make foreign imports cheap despite the tariff discrimination they face against the local tiles products.

In order to safeguard the local tile industry government imposes taxes on the imported tile products. Sri Lankan government through the recent budget proposals has proposed an increase of import cess by 50% on the imported ceramic ware. This may directly and favourably affect the local tile producers as cheaper imports from China and India would find it expensive of their imports and this would reduce the severe price competition available in the local market. Moreover, in the recent past the depreciation of Sri Lankan Rupee causes to raise the prices imported tiles in the domestic market. However, still a huge amount of low quality ceramic tiles are been imported to the country at a lower cost resulting to decrease the market share of the local producers especially from India and China. Chinese products are relatively low cost because of its low energy and labour costs. Further, upward demand for granite, marble, and wooden planks etc creates a threat to tile industry.

Sri Lanka ships glazed wall and floor tiles mainly to the US, Australia, Italy, Germany, UK, France, Canada, Netherlands, Japan and Singapore. Exports to these countries started declining due the global recession. In addition, Sri Lanka's tile exporters has mainly to compete with countries like Bangladesh, Vietnam, Indonesia and India, which have access to cheaper energy which leaves the costly Sri Lankan products less desirable to international clients.

Tile industry is characterized by certain entry barriers such as economies of scale and scope, setting of industry standards, customer loyalty etc., that the potential competitors may find it difficult to compete within the market. In contrast, ceramic and tile industry has reported a rapid growth with significant abnormal profits. With the growth potential in the market, more threat of new entrants can be expected within the industry making a high threat from the new entrants and thereby anticipating low returns by the existing players. For instance, based on the news article in Lanka Business Online on 11 November 11(http://www.lankabusinessonline.com/fullstory.php?nid=1832026427), Kohler, a US-based international sanitary ware firm which is one of America's oldest and largest privately held companies, founded in 1873 has identified Sri Lanka as one of the growth markets and has plans to penetrate Sri Lankan sanitary ware market by opening a showroom in Colombo. The company has already won an order to supply sanitary ware for 1,000 bathrooms in the first phase of the 250 million dollar Havelock City apartment and commercial property project in Colombo.

Selected Extracts on Sri Lankan Economy and Financial Markets

Extract 1

SUNDAY OBSERVER

Sri Lanka's English Newspaper with the largest circulation

Sunday, 4 December 2011

The Impact Eurozone Debt Crisis on Sri Lankan Economy

The Eurozone debt crisis could affect Sri Lanka's exports this year and in the next, according to leading exporters in the country.

They said that the sovereign debt crisis in the Eurozone could have procedural problems such the exchange rate differences and opening of LCs (Letters of Credit) which would affect exports to the region.

The Eurozone is a major market for Sri Lankan apparel which are purchased by leading brands such as Marks & Spencer, B H S, Gap, Tesco and Victoria's Secret. Sri Lanka Apparel Institute Chairman Prof. Lakdas Fernando said that currently apparel exports are doing well but exports in the future could be affected due to the decline in the purchasing power of European consumers. "Everything depends on the buying power of the consumer and how intense would the problem be in the future", Fernando said.

"Steps have been taken to market Sri Lankan apparel and promote the SME market in the Eurozone. We hope that the problem will ease off soon and the exports to the region will continue", he said. Sri Lanka Apparel Exporters Association (SLAEA) Chairman, Rohan Abeykoon said apparel industry has performed extremely well in spite of global recession that hit the world some years ago, the debt crisis currently confronting Sri Lanka's key apparel export markets, and the loss of GSP Plus facility.

"Sri Lanka 's target of achieving five billion USD in apparel exports by 2015 is on course", he said.

The figures for the period of January to October 2011 show 45 percent year-on-year rise in apparel exports, which is reflective of the relevance and perceptiveness of the industry, he said.

Trade experts said the crisis in the region will affect the purchasing power of middle-end consumers which will lead to spending cuts.

According to the Asian Development Bank the debt crisis affecting major economies in Europe will hit growth in Asia's developing economies this year and next as the key trade zone cuts back export orders.

In September, the bank forecast developing Asia, excluding Japan, Australia and New Zealand, would grow at a rate of 7.5 percent in both 2011 and 2012.

But that estimate may now be unrealistic given the lack of resolution to the Eurozone's debt problems, a top official of the bank said. "7.5 percent (growth) is probably going to turn out to be on the higher side given what's happened since our forecasts and now.

How much will depend on how soon the Eurozone crisis works itself out", he said.

Analysts said that steps taken to replace leaders in Italy and Greece and austerity measures are encouraging. Respected Corporate personality Rohantha Athukorala who was the Former Chairman of Sri Lanka Export Development Board and the National Council for Economic Development said, "I believe that the spirit of being American, will sure pull the economy out of the trouble that it is in and the vulnerability to Sri Lanka exports to the US is not that high especially with the re-introducing of GSP trade concession. But the EU, is a different issue given the political divide.

I feel Germany needs to do more to support the EU economy but it's a tough call.

There will be an impact on Sri Lanka's exports into this market(EU) and we need to develop an alternate export business of around a 750 million dollars from a combination of BRIC countries.

The Budget proposal of pursuing FTA with African nations and probably the BRIC will be a key strategy for Sri Lanka for 2012".

The European Union (EU) is suffering from its own dilemmas. Following the global economic crisis, the Single Market for the Euro has been under stress. Several countries are facing sovereign debt problems, and there is a crisis in the Eurozone. There is uncertainty about the outlook of the Euro area, and the duration of the debt crisis has exceeded the forecasts of certain key analysts.

Immediate Past President of the National Chamber of Exporters Rohan Fernando said the crisis will affect the buying power of middle and low end consumers who are hit by job reductions and pay cuts.

In the aftermath of the global economic crisis, there has been a noticeable shift in economic clout, moving from the USA and the debt-plagued countries of the Eurozone, to the emerging markets of Asia.

Extract 2

THE WEEK

April 17, 2012

Spain's escalating financial crisis: Is Europe committing 'economic suicide'?

The continent's fourth-largest economy could be heading toward a full-blown crisis, and Europe's political class only seems to be exacerbating the problem

Protesters demonstrate against spending cuts in Madrid: Spain's economy, the EU's fourth largest, is in increasingly dire straits.

Best Opinion: N.Y. Times, Telegraph, Wall Street Journal

The European Union might soon find itself in the hairiest stretch of its seemingly endless debt crisis. Spain's borrowing costs are shooting up to heights that are dangerously close to bailout levels, and as the continent's fourth-largest economy, it is "too big to fail — or to rescue," says Robert Zoellick, the outgoing head of the World Bank. Many critics are wondering how EU officials, led by German Chancellor Angela Merkel, allowed the crisis to reach this point, particularly after the European Central Bank (ECB) gave policymakers ample breathing room late last year by flooding the market with more than $1 trillion in loans. Are Europe's leaders — alternately attacked both for their aggressiveness and timidity — only making things worse?

Yes. Europe is destroying itself: EU leaders seem determined "to commit economic suicide for the continent as a whole," says Paul Krugman at *The New York Times*. Spain's borrowing costs are climbing because it's in a deep depression, and yet the political class continues to demand harsh austerity measures to cut deficits, which will only make the depression worse. "This is, not to mince words, just insane." The ECB must be allowed more freedom to intervene in markets, and countries must be allowed to spend their way out of economic slowdowns. Otherwise, Europe will go "off a cliff. And the whole world will pay the price." "Europe's economic suicide"

The central bank will act if politicians don't: "The idea that the ECB can now sit back and let the politicians do the rest is surely deluded," says Jeremy Warner at Britain's *The Telegraph*. Eventually the ECB will be forced to follow the U.S. Federal Reserve in implementing "full scale quantitative easing," in which the central bank buys up government bonds directly to keep their yields down. Germany will resist because it's paranoid about inflation, but "monetary policy has to be run for the benefit of Europe in aggregate, not just the Rhineland and her dominions." "Only a matter of time before ECB is forced into massive quantitative easing"

But the central bank might make things worse: Further intervention by the ECB "could lay the foundations for the next crisis," says Francesco Guerrera at *The Wall Street Journal*. The ECB's $1 trillion in loans was meant to encourage private banks to buy Spanish bonds, and the plan succeeded. But now those banks are saddled with bonds that could soon plunge in value, leaving Europe vulnerable to a "devastating domino effect." The risk of any government intervention in financial markets is the spread of "largely undetected and unknown risks within the system."

"Sowing seeds of the next major crisis"

Extract 3

The NATION

Saturday, 28 January 2012

How the global economic crisis can impact on economic policy?

The emerging gloom about the prospects for economic growth in the US and European Union countries has resulted in a downward revision of global economic growth rates. More important in so as far as Sri Lanka is concerned is the fact that the economies of the West are in crisis and their growth prospect is bleak. Several European economies are in severe financial difficulties and their slow economic growth and high unemployment levels in the US do not augur well for Sri Lankan exports. Furthermore, the growing confrontations of the US with countries in the Middle East and a likely embargo on Iranian oil exports have serious economic consequences.

The emerging gloom about the prospects for economic growth in the US and European Union countries has resulted in a downward revision of global economic growth rates. More important in so as far as Sri Lanka is concerned is the fact that the economies of the West are in crisis and their growth prospect is bleak. Several European economies are in severe financial difficulties and their slow economic growth and high unemployment levels in the US do not augur well for Sri Lankan exports. Furthermore, the growing confrontations of the US with countries in the Middle East and a likely embargo on Iranian oil exports have serious economic consequences.

Once again the vulnerability of the Sri Lankan economy to global developments has been made clear. Sri Lanka's trade dependent economy is often at risk both with respect to export prospects and import prices. This time around too the external shocks have both these dimensions: export earnings may decline, while import expenditure may increase. The consequent large trade deficit is likely to create difficulties in the balance payments. In fact, these difficulties are being currently experienced and could aggravate to huge proportions.

Although exports have grown in recent years, they are considerably less than import growth. While export grew by about 23 per cent last year, imports grew by double this. The gap is enormous when the actual amounts are considered rather than the percentage, as the import amounts are much larger. This is the reason for these export import growth rates leading to a massive trade deficit of US$ 9 billion approximately last year and an increase to about US$ 11 billion this year Therefore, curtailment of imports has been suggested as the solution to the problem.

Even without as much a global economic slowdown, a massive trade deficit exceeding last year's unprecedented trade gap of over US$ 9 billion was expected. If countervailing measures are not taken, the current Central Bank expectation of a US$ 11 billion trade deficit could be exceeded. Bridging such a massive trade deficit from earnings from services and capital inflows is too much to expect. More so as these expected inflows too would be adversely affected by the global downturn and the Middle Eastern troubles.

Suggested solutions

In this situation, several remedies have been suggested. These include the increase in exports to the Asian region that is fast growing, diversification of exports and increasing the value added component of the country's exports. On the import side, it is suggested that we curb import expenditure in several ways. Import duties have been increased already on several essential imports and others. This together with the depreciation of the currency implies much higher prices. The increases in prices are expected to curtail imports. It is even suggested that we ban imports of certain "luxury" items and even aggressively pursue a policy of import substitution, especially with respect to food imports. All these strategies have limitations.

Diversifying export markets

Some economists believe that the country's export future lies in increased exports to the region, particularly to the emerging economies of China and India, whose growth is also expected to slow down, but still maintain a high level. While this is acceptable in principle and should be pursued in practice, the diversification of exports to these countries is difficult to achieve as our exports do not have a demand in these emerging countries that also export similar products. Therefore, in the foreseeable future, the country's export markets would be in the West and the slowdown of these economies could hurt exports of manufactured goods in particular and to a lesser extent the export of tea. This slack cannot be taken by demand in the Asian region where these counties, especially the fast growing countries of Asia - India and China - are also producers of similar products and are our competitors. This is especially so in the short run.

However, in the longer run by diversifying the types of exports the country could gain from exporting to these countries. Even at present there are some select exports to these countries such as boats to India. Tyres and rubber manufactures are likely exports to this region. The diversification of exports is a long-term objective. It must be pursued by undertaking market research, establishing market links and being price and quality competitive. Diversification of export markets and export products must be a long-term objective even though it would be of little benefit in the short run.

Curtailing imports

Several means by which imports could be curtailed have been suggested. One of these is the increasing of tariffs on imports. It is generally suggested that import tariffs on non-essential imports be increased substantially so that they are curtailed drastically. An example of this is motor vehicles. The reduction of tariffs led to a surge of imports in 2010 and 2011.

Since the pent up demand for vehicles have already been satisfied, and there are large stocks of vehicles in the country, it is now unlikely that there would be large expenditure on vehicles. Nevertheless, higher tariffs are needed for these imports though their impact may not be significant in as far as the trade deficit is concerned.

The other policy suggestion is that we should curtail food imports by a strategy of import substitution. In other words by growing more food we could reduce imports. However, this too is a limited strategy as the success of import substitution in food takes time. Nevertheless, there are areas where the country has real possibilities of increasing production in a relatively short period. A good example is that of increasing sugar production. Despite the price support given for local sugar by a high import tariff, sugar production has been woefully inadequate. This is an area where there should be an effort to find out not only the agronomic factors but the economic and social factors that have hampered the country not realising the potential. In the case of milk production, there has been greater success. Yet, the potential for increasing milk production is high. Hitherto, the success stories in import substitution in food crops have been in rice, maize, and potato and to a lesser extent in a few other crops.

While import substitution in food must be pursued, it must be recognised that food imports account for only about 12 per cent of the import bill. And within this category are food crops that cannot be grown in Sri Lanka, most notably wheat. However, wheat imports have been reduced in recent years by the increase in production of rice. The possibilities as well as the limitations of import substitution in food must be recognised.

Intermediate imports

The real difficulties in curtailing imports arise out of the fact that the largest import expenditure is on oil. Intermediate imports as whole accounted for nearly 60 percent of the country’s import expenditure in recent years. In 2011, oil imports accounted for nearly 25 percent of import expenditure. There are serious difficulties in curtailing these imports as oil imports are needed for electricity generation, transport and industrial production. The increase in oil import expenditure is due to both increases in the consumption of petroleum products and soaring prices.

The uncertainties in international markets, especially owing to the threatened oil embargo pose serious problems. In the event of an Iranian oil export embargo, the main supplier will be cut off. Therefore, quite apart from the expenditure on oil imports there is a threat to our supplies of oil that are from Iran on concessionary terms of payment. The oil refinery too is geared to process only certain types of oil, especially the Iranian variety. Even at the time of writing this column international oil prices have risen. The Iranian embargo will increase prices further.

Bottom line

The trade deficit caused by international prices for oil, high imports of other consumer and intermediate goods and the slack growth in export markets requires rather drastic policies owing to the magnitude of the problem. Recognising the seriousness of the trade and balance of payments problem is the first step towards finding solutions. There are no easy solutions to the current trade imbalance. On the side of imports, the import structure provides little opportunity for decreasing imports.

Import substitution though a limited strategy must be pursued with targets for specified import commodities as was done with respect to rice over the years.

A national programme of conserving oil consumption and reduction of imports is needed. The prospect of soaring oil prices and the slack demand for exports are serious current concerns. Increasing exports in the short run is not easy owing to restraints in demand for our exports in the main markets. Diversification of export markets and export products is not an immediate solution but one that should be pursued as a planned programme. Supply inelasticity that constitutes a bottleneck to having adequate export surpluses is an issue that should be addressed. Hopefully, the expectations of earnings from tourism, increased remittances (that could also be affected by the current international recessionary condition) and capital inflows would mitigate the balance of payments problem.

Extract 4

Overheating symptoms in Sri Lankan economy

Sri Lankan Equity Forum

Mon Apr 02, 2012

UBS Securities Asia Limited, last week released a research analysis on recent achievements of Sri Lanka's economy as well as future scenarios. The report also contains several warnings. Here are excerpts.

The exchange rate is under pressure to depreciate. Sri Lanka's central bank left official interest rates unchanged at their last meeting. While this was expected by many watchers, it is highly questionable for how long further rate hikes can be delayed without prompting further currency weakness. The simple reason is Sri Lanka's balance of payments is weak and in 2012 higher yield will be needed to restore exchange rate and inflation stability.

We envisage policy rates needing to go up 150-200bp. As a result, after recent years of 8%+ economic growth we are more downbeat on economic growth in 2012 and expect an economic slump to c. 6% as the authorities are forced to tighten up the policy.

Basic picture

The economy appears to have over-expanded (8.4% as of Sep-11). Many still believe that Sri Lanka has managed to attain a new higher 8% trend growth. We disagree. At a basic level the savings rate is too low to support the kind of investment rate that has produced 8%-8.5% real GDP growth since 2010. Whereas in 2010 a savings rate of 24% supported investment of 26% of GDP and produced a minor current account gap of 2-3% of GDP, by end 2011 this imbalance had deteriorated considerably. The current account in 2011 widened to around 10% of GDP on our calculations (table 2). 2011 was also a year when credit growth was permitted to accelerate by 37%. It's not so much a degree of leverage problem, but a speed of expansion problem. On top of this, the 2010 improvement in government finances has stalled. Some of this credit expansion is supporting a rather fat fiscal deficit of c.8% GDP – versus the plan to reduce it to 6.8% in 2011 and 5.2% in 2012. This will need to be re-set lower because as the economy cools off tax buoyancy will be tested. The structure of rates needs to rise to reflect the higher yield required to bridge the current account gap and the rebound in inflation in prospect.

Weak balance of payments

Sri Lanka is ill-equipped to run these kinds of imbalances. It has a very low cushion of official FX reserves of c. $6bn as of Dec-11, down from a peak of $8bn in Aug-11. In essence we think monetary policy was left too loose for external global conditions. The economy expanded and non-oil imports went up. At the same time the slowdown in global growth depressed exports and the country was caught with a rapidly widening trade gap1. Higher oil prices aggravated the condition.

But this is not a simple case of oil pulling the trade balance out of shape, last two years saw non-oil trade gap widen from 1.8% of GDP to 9.2%. The country enjoys a steady influx of remittances (of around $380m per month).

While in 2010 this was enough to counterbalance the monthly trade gap, by 2011 it was insufficient (the trade gap ballooned way beyond this to average $1bn per month in the last 6 months). Consequently, this has led to a wider current account funding gap and a draw-down in official foreign exchange reserves to cover it. Ultimately, official reserves are just a buffer (equivalent to 6m of imports). Periodic global bond issues can help plug this gap, but without a compensating rise in yields and a cooler economy this wider current account is going to continue to drain official reserves and push the exchange rate weaker.

Inflation illusion

Headline inflation has slowed to sub-5% (2.7% Feb-12) from a peak of 8.8% in Apr-11. There are a few reasons for the remarkably tame inflation rate during the 2010-11 overheating episode. First, food inflation has slowed dramatically; second, despite rising oil local fuel tariffs and transport costs were suppressed. Third, the exchange rate was stable, if not appreciating for a while. Finally, there can be a lag between excess demand and inflation.

2012 could turn out to be the opposite. The suppressed inflation within transport is finally percolating through, the exchange rate is depreciating and the effect of rapid credit growth is likely to accommodate higher pricing power.

The net effect of these factors could be to lift headline inflation back to the 5-10% range in the months ahead. Nonfood inflation could be a better short term gauge of inflation pressures – this remains higher at 7.4%. Perhaps the bigger question is how should we regard this upcoming inflation episode. Is it a repeat of that in 2006-8, 2000-2 or even the early or mid-90s? The inflation impulse varies in each of those periods. Food plays a large role in each one. Another common feature is exchange rate weakness. In almost every case a devaluation or slide in the exchange rate of at least 5-10% has accompanied the inflationary impulse. Today, food inflation is slow, but there is exchange rate weakness which to us suggests headline CPI can zip back up to 8-10% in 2012. A re-run of the 2006-08 inflation episode seems unlikely given the softness in global pricing of food and manufacturing.

Interest rates in catch-up mode

But when it comes to policy rates it is more than a simple question of inflation profile. In current global conditions there may be a more urgent need for a catch-up in policy rate hikes due to the weakening balance of payments and still rapid credit growth (37%). The 2011 current account (using monthly merchandise trade and remittances) as a proxy is close to -$6bn which, in turn is around 10% of GDP – roughly three times that in 2010.

As a small open economy with low foreign exchange reserves there is very little room for the central bank to conduct independent monetary policy in the face of an external shock. The central bank started in earnest to hike policy rates by 50bp in February, but we feel much more is needed.

While we do not see the kind of ramping up in the structure of rates that happened in 2006-08 or in the early 2000s (inflation is not enough of a problem for that) we do foresee the whole market rate structure rising another 150bp, with the official reverse repo/repo rates hiked another 150bp. Our current expectation is peak official reverse repo/repo rates up to 10.5%/9%. Central bank meetings are monthly so we fully expect rates hikes in the next few.

Fiscal improvement stalls

Fiscal discipline has been an Achilles heel (as is the case in much of the rest of South Asia). While the fiscal deficit has improved it could be short-lived. We suspect expectations ran ahead of reality and looking ahead into 2012 a slower economy will mean that further improvement is unlikely without spending cut-backs. By way of a brief review, Sri Lanka's budget deficit and general government debt ratios were high in 2010 at 8% and 82% of GDP.

The war ended in 2009 and after the parliamentary and presidential elections (early 2010) the 2011 budget implemented many of the recommendations of a Presidential Commission on Taxation. These included moves to: simplify the system, broaden the base, lower tax rates and improve collection. Corporate and personal tax rates were cut from 35% to 28% and 24% respectively – the burden of taxation swung more towards expenditure taxes. But long term tax exemptions were given to large state owned enterprises (SOEs) such as power, airlines and petroleum. And there were no major incentives on the spending side. In 2011, despite the 8-8.5% real GDP growth, what appears to have happened is a slide in tax collection while spending has gone up. As a result the gap has centered around 8% of GDP and not declined to the 6.8% as planned (chart 14). Certainly 5.2% in 2012 looks quite out of reach given the slowdown in economic growth in prospect. While it may be early to judge the full impact of these tax improvements it is easy to envisage how tax gains can be given back easily through spending leakages in a year where economic growth sinks. Consequently, we do not expect further fiscal improvement in 2012. Credit ratings which may have been granted on the basis of further fiscal improvement may be tested in 2012.

Economic activity

How does the business cycle look? This is not yet an economy predominantly driven by exports. Exports are equivalent to 17% of GDP. Yet big swings in exports can affect activity and real GDP (chart 2). On the domestic side the main components of GDP were just starting to hook over in Sep-11; this should continue (chart 17). The monthly indicators are in general softer with exports in an advanced state of slowdown. Taxes and real cash in circulation (a measure of wholesale & retail transactions) are both already slower (chart 19). All these are yet to be confirmed by a slowdown in real GDP headline numbers. IP and implied profits (calculated from CSE all share listed universe) have yet to decisively slow though we suspect they too will follow the move lower in export trends soon (chart 18). As with other economies we do not envisage a sharp arresting seizure of economic activity (as happened in 2009 post Lehman's bankruptcy), but a more moderate one. However, the key to escape from this slump (as in other places) will not be policy stimulation.

Sri Lanka cannot afford much in that department. Instead recovery will ride on: (i) global growth and export trends (which should look up from June quarter onwards and; (ii) the ability of the local private sector to stage a rapid profits recovery following interest rate hikes and a fuller translation of higher fuels costs – lagged. In sum, we see real GDP growth slow to c. 6% in 2012 while businesses adjust to the higher costs of doing business.

Conclusion

Sri Lanka is going through a modest episode of overheating. We expect interest rates in Sri Lanka to go up another 150-200bp to reflect the much wider external gap and higher headline inflation in prospect. The domestic economy is already softer, but further weakness appears likely as higher rates depress spending and the current red-hot credit growth slows down. Overall we look for real GDP growth to slow to around 6% in 2012 from a number likely to be close to 8% in 2011.

The fiscal picture started to improve, but this trend has stalled as higher spending has used up some of the tax gains. While this is not a fiscal or balance of payments crisis for investors financial markets could be in for a bumpy time while the economy adjusts to the higher inflation lower growth mix.

Source:http://www.ft.lk/2012/04/02/overheating-symptoms-in-sri-lankan-economy/