REMARKS BY

DR INDRAJIT COOMARASWAMY
GOVERNOR OF THE CENTRAL BANK

UN PEACEBUILDING COMMISSION
New York, 20 November 2017

Sri Lanka has experienced a 27-year separatist conflict in the North and East of the country and two youth insurrections in the South (1971 and 1988-90). Tens of thousands of our people, most of them young, lost their lives. While there was complex causality behind these episodes, arguably the most significant explanatory factor was the mismatch between the expectations of and the opportunities for our young people.

As you are well aware, Sri Lanka has been an over-performer in terms of social development. It has an impressive record in terms of the UNDP's HDI ranking and performance related to the MDGs. However, we have done much less well in terms of growing the cake and generating productive livelihoods.

Sri Lanka was second to Japan on almost all social indicators at the time of independence. We have fallen behind. Now the focus must be not only on consolidating and building on our social sector achievements but also on pursuing growth and wealth creation. The Government recognizes that at the same time, the quality of that growth has to be good. It has to be inclusive and regionally balanced. The latest data indicate an improvement in the Gini Coefficient from Rs 30,814 in 2012/13 to Rs 43,511 in 2016. In addition, there was continued improvement in the regional balance of growth in the economy. The Western Province accounted for around 45% of GDP in 2010. It is now accounts for 39.7% based on 2016 GDP numbers. The North and East were two of the three fastest growing provinces in terms of nominal GDP, from a very low base.

The Government recognizes that priority also needs to be attached to employment generation which transmits the benefits of growth widely. It has a target of creating 1 mn employment opportunities in 2015 – 2020. Growth also needs to be sustainable. Sri Lanka is a signatory to the Paris Declaration. However, the bottom line is that Sri Lanka needs 6% plus growth to meet the needs of its educated, and therefore increasingly aspirational, people. The task of consolidating peace in the country will be far more challenging without economic transformation.

Let me now turn to the Government's plans achieve these objectives which are embedded in the document "Vision 2025" - A Country Enriched. The rest of my remarks will focus upon the frameworks that have been put in place for macro economic policy-making; the new growth model; the policies to strengthen the growth framework; and some of the Government's major development programmes.

Let me now address the importance of developing a new growth model which will give us 6-8% growth over 10 – 15 years i.e. the kind of economic transformation enjoyed by the successful countries of East and South-East Asia. In the years after the end of the conflict, the major growth impulses in the economy emanated from public investment in infrastructure which was largely financed by foreign commercial borrowing. Economic expansion was driven by non-tradable sectors; such as construction, transport and retail/wholesale trade.

The previous growth model no longer has any headroom due to the country's budget deficit and public debt dynamics. Arguably, the biggest indictment of the policy framework of the past decade was the combination of the sharp decline in exports and the rapid build-up in the external commercial debt burden. The situation can be managed through prudent liability management provided there are disciplined macro economic policies. The Government is aware that this is a necessary but not sufficient condition. The unsustainable debt burden can only be resolved through a combination prudent policies; proactive liability management, and above all, export transformation.

The new growth model has to be private sector driven, with exports and FDI as key pillars.

Why the ***private sector?*** Countries have achieved successful development outcomes with varying mixes of the public and private sector: China and Vietnam have been statist while others have had a much larger role for the private sector. In Sri Lanka's case, there isn't the fiscal space to have a statist development model. Hence, the emphasis on the private sector is not an ideological option. Instead, it is a pragmatic conclusion based on the country's fiscal deficit and public debt dynamics.

Why ***exports?*** With a domestic market of only 21 mn people and per capita income of USD 3,825 it is not possible to achieve sustained growth of 6-8% based primarily on domestic demand. There has to be a transformation in our export performance. Exports have fallen from 32% of GDP in 2000 to 12.7% in 2016. The corresponding figures for Malaysia, Thailand and Vietnam were 67.5%, 54.2% and 83.7% respectively in 2015. There is a lack of product (2/3 were apparel, tea and rubber products in 2016) and market (US and EU accounted for 58%) diversification. The share of external commercial borrowing has increased from 2% of GDP in 2007 to 13% in 2016. As mentioned above, this clearly is an unsustainable set of circumstances. It is being addressed by policy reforms which promote export transformation to generate non-debt creating earnings to service the debt and support growth as well as employment generation. This is being done by placing a high premium on getting the exchange rate; effective protection rates, particularly reducing parataiffs; trade policy, including trade agreements; and trade facilitation right.

Why ***FDI?*** FDI not only infuses much needed capital to fill the savings/investment gap but it also brings in technology, know-how and market access. It also facilitates access to regional and global value chains which are the most dynamic aspect of the international trading system. Over half of global exports are accounted for by cross-border production sharing networks.

One may pose the question whether it is advisable to pursue a development strategy based on exports and FDI as key pillars in the context of the new normal for the world economy of relatively low growth and sluggish international trade. The response is that this is mitigated by Sri Lanka's strategic geographical location and excellent international relations with the capital surplus countries of East and South-East Asia and its key markets in the US and Europe. Sri Lanka is located twenty miles from India which has been the fastest growing large economy in the world. Access is particularly easy to the five fast growing South Indian states. In addition, we are at the Centre of China's Maritime Silk Route. Furthermore, countries like China, Japan, India, Singapore and South Korea have indicated their willingness to support Sri Lanka's development process. In addition, geopolitics in the Indian Ocean has increased the potential for Sri Lanka to leverage its excellent location for its commercial advantage.

Strengthening the Growth Framework

(a) Framework for Macroeconomic Policy-making

Sri Lanka has historically been characterised by stop-go policies. The excess demand pumped into the system by unsustainable budget deficits has been the main source of instability in the system. The country has tended to be a high budget deficit, high inflation, high nominal interest rate and over-valued currency economy. In order to address this and achieve sound macroeconomic fundamentals, the Government is putting in place clear frameworks for policy-making. This should serve to promote greater consistency and predictability in policies.

On ***fiscal policy***, the Government has embarked upon a medium-term revenue enhancement based budgetary consolidation programme. It is designed to reduce the budget deficit to a sustainable 3.5% of GDP by 2020. The medium-term strategy is based on the premise of fiscal consolidation with the aim of increasing revenue, rationalising expenditure and reducing government debt to a sustainable level. The recent VAT reforms, the new Inland Revenue Act and measures to strengthen revenue administration and compliance are major achievements. The Government is considering institutionalising the fiscal consolidation process by introducing more binding targets in the Fiscal Management (Responsibility) Act.

On ***monetary policy***, the Central Bank of Sri Lanka (CBSL) is making progress in introducing a flexible inflation targeting regime. This will create a framework for a data-driven, forward-looking and

proactive monetary policy. Legal and accountability frameworks are being formulated to institutionalise the flexible inflation targeting regime.

On ***exchange rate policy***, the framework being adopted is to adopt a competitive exchange rate. In this connection, one needs to adjust the nominal exchange rate gradually to bring the REER Index to 100. This is crucial for reducing the anti-export bias in the overall policy framework and increasing the competitiveness of the economy. This is an important prerequisite for transforming the country's export performance which, as mentioned above, is essential to overcome the onerous external debt burden and achieve sustained growth and employment generation.

A framework is also being established for **liability management.** There is a peak in domestic debt repayments in 2018. As there are no maturities in the last five months of 2017, this has presented an opportunity to build up a buffer to manage the elevated domestic debt repayments next year. In addition, a Liability Management Act will be enacted to create the space to address the bunching of external debt from 2019. This will relax the ceiling on Government borrowing set out in the Appropriation Act to raise financing to extend the tenor and reduce the costs of external obligations thereby reducing rollover risk. The Government also plans to utilize the proceeds of the divestment of public assets to pay down debt.

On **SOE reform**; the five major state enterprises [CPC, CEB, Sri Lanka Ports Authority, National Water Supply and Drainage Board (NWS & DB), Airport and Aviation Lanka Ltd] have signed Corporate Statements of Intent. For the first time, there will now be a framework against which the performance of these enterprises can be measured in terms of governance and financial performance. Furthermore, the Government is committed to introducing cost-reflective pricing through a formula for fuel in March 2018 and electricity in third quarter of 2018. This will go a long way towards putting these enterprises on a sounder financial footing.

On **factor market reform**, the Government will be introducing legislation establishing a **land** bank. This will address a major constraint in the business environment by identifying pre-cleared land which will be available for private investment projects. Land titling is another issue which is receiving attention. Other land-related issues under consideration include the removal of archaic laws and the need for a comprehensive review of land use/crop mix. **Labour Market** reforms include measures to increase female labour force participation from the current low level of 35.9%. On **capital market** reform, the Central Bank, SEC and the Insurance Board of Sri Lanka are all being supported by the World Bank and the Asian Development Bank to develop the government securities and share markets, as well as the insurance sector.

(b) Boosting Investment

On the ***investment climate***, Task Forces have been established on eight pillars of the World Bank's Doing Business Index. Each of the Task Forces comprises all the Government entities involved in the respective pillars. Action Plans have been launched, in May 2017, to deregulate by reducing the number of steps involved in each pillar; and technology is to be introduced where it can facilitate processes.

On ***investment promotion***, the Board of Investment (BOI) has worked with the Centre for International Development (CID) at Harvard, to identify sub-sectors with potential for attracting FDI, which will enhance the complexity of the export basket and diversify export markets.

(c) Promoting Trade

There is a great deal that is being done in the area of ***trade policy***. The Government has developed a National Trade Policy Framework. An Anti-Dumping Bill is being presented to Parliament to protect domestic business from unfair competition. A trade adjustment package is being developed with the assistance of the World Bank and the EU/International Trade Centre. It is designed to increase the competitiveness of local businesses exposed to increased competition as a result of trade liberalisation and to provide retraining for workers. There is also a medium-term plan to reduce parataiffs to create a more conducive environment for promoting linkages with regional and international value chains.

Arguably, the most significant trade policy measure is the negotiation of bilateral Partnership Agreements. The FTA in goods with India is being deepened and it is being broadened to include services, investment, technology and training. In addition, an "early harvest" is being pursued to address some of the shortcomings of the existing FTA, including some NTBs and quotas. Similar partnership agreements are being negotiated with China and Singapore. The FTA in good with Pakistan is being invigorated. In addition, GSP plus has been restored providing preferential market access for 6000 items. If things proceed according to plan, it is possible the narrative will be that Sri Lanka has preferential access to a market of over 3 bn. people: China, EU, India, Pakistan and Singapore. In a world where over 190 countries are competing for FDI, this preferential market access can be a unique differentiator. It will greatly enhance our capacity to leverage the trade/investment nexus to our advantage. Of course, the Partnership Agreements need to be negotiated vigorously with positive and negative lists; safeguard arrangements; transition periods and dispute resolution mechanisms which pursue national interests.

On ***trade facilitation***, Sri Lanka is a signatory to the WTO Trade Facilitation Agreement. A single electronic window is scheduled to be fully operational in the Customs Department shortly. These measures are intended to reduce the transaction costs of the cross-border movement of goods and services thereby enhancing the trade competitiveness of the economy.

All these measures are intended to improve the investment climate and trading environment for both domestic and foreign investors.

(d) Education, Training and Skills Development

Arguably, the biggest challenge is to move as quickly and as decisively as possible to align the emerging sectors having a dynamic comparative advantage with the labour market and the education, training and skills development systems.

(e) Facilitating R & D; Innovation and Entrepreneurship

A concerted effort is being made to create an eco-system which promotes innovative thinking to create value in the market. Priority is also being given to lower risks and barriers associated with start-ups.

(f) Energy Security and Sustainability

The country's energy security needs to be established through a robust long-term energy generation plan based on credible demand forecasts. Priority is being given to LNG as the energy source of choice.

The increase in the frequency and intensity of extreme weather events highlights the need to mainstream sustainability into the planning and budget processes. Greater Priority is being attached to mitigation and adaptive measures to address droughts and floods.

(g) Social Safety Net

The Government has recognized the need to shift from untargeted subsidies which benefit the non-poor disproportionately to a system of well -targeted cash transfers. The new bio-metric identity card will serve to reduce leakages of scarce public resources in the delivery of the social safety net.

The Budget 2018 has announced measures to address the acute challenges confronting debt-distressed families. These will be initially piloted in the North and North Central Province.

Major Development Programmes

The Government is launching a number of major development programmes around the country.

Surbana Jurong, the Singaporean Consultancy, which developed the Western Region Megapolis Plan, is also preparing a Master Plan for the Trincomalee area in the Eastern Province. Tourism, real estate and industrial zones will be major features of this development. There are plans to develop the road and rail network in the North Central Province and the North to improve connectivity to the Trincomalee Port.

In the North, Palaly airport and the Kankasanthurai port are being rehabilitated. There are also plans to improve road and rail connectivity. In addition, there will be a 200% upfront investment allowance for businesses locating in these areas.

Japan is developing a Master Plan for the Kandy area. Given the religious and cultural importance of this area, the Japanese have been chosen as they are able to understand Buddhist sensitivities and priorities. It is expected that there will be a religious/cultural orientation to this development programme as well as an economic zone.

Then coming down, the Colombo/Kandy Highway that is being built, industrial zones are planned in the Kurunegala/Kuliyapitiya areas of the North-Western Province.

The Western Region Megapolis Plan covers the three districts of the Western Province. It is a USD 40 bn. programme over 15 years. It envisages elevated highways; a light railway; residential and commercial real estate, including affordable housing; a logistics hub, involving the Colombo Port and Bandaranaike International Airport, as well as a tech city.

The Port City Project, involving reclamation of 269 hectares, will have the Colombo International Financial Centre as its centrepiece. The intention is to develop a business area which has an investment climate which would rank in the top 10 in the World Bank's Ease of Doing Business Index.

An industrial zone is being established by a Thai company in Kalutara. Tourism developments and additional industrial zones are being planned along the Southern Coast. Further South, there is the major proposal to develop the Hambantota area. The long-lease of the port will not only generate much needed non-debt creating flows for liability management, which is essential to address the bunching of external debt repayments from 2019 onwards, but also assist in commercialising an asset which is currently a major loss-maker casting a heavy burden on the people through its impact on the Government budget. The leasing of the Port to China Merchant will also catalyse a plan which envisages investment in a refinery, LNG Plant, Cement factory, steel billet plant and a ship repair company. Subsequent phases are expected to involve development of industrial zones by Chinese companies on up to 15,000 acres of land.
There are also Master Plans for the development of the tourism and ICT sectors.

Given the lack of fiscal space, much of the investment for these major programmes will have to come from private investment, domestic and foreign. High priority is, therefore, being given to PPPs, particularly BOTs, and alternate financing instruments which are off the Government balance sheet.

Conclusion
There are massive opportunities embedded in the plans that are in place.

The combination of location and international relations provide a very favourable backdrop for executing these plans.