**Speech delivered by Dr. Indrajit Coomaraswamy**
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Today, in addition to the growth and employment objectives, we have this onerous debt problem that we have to address. We can't really address that without a significant improvement in our export performance.

Now, by way of introduction, before I get into the issues relating to the export sector, specifically, let me just give by way of background, some remarks about the growth model that the government is trying to put into place. It is private sector driven with exports and FDI as key figures.

If I may say a few words about each of those: I've been a public servant all my life, so I don't subscribe to the view that the private sector is the panacea for all our ills. In fact, if you look around the world, you get different mixes of the private sector and the State in terms of delivering good development outcomes. But in our case, the public debt and deficit dynamics are such, that the State simply cannot lead the development process. It's nothing to do with ideology. It is a purely pragmatic assertion that it has to be the private sector that has to drive the growth in the regeneration process of this country.

Why exports and FDI are key pillars: when you have a domestic market of twenty-one million people and purchasing power of now almost four-thousand US dollars, you simply cannot sustain the 6% or more growth that we need to achieve by just selling into this domestic market. It's simply not possible.

And why do we need 6% growth? We have a very aspirational society now or more. It's an educated society which is exposed to all the latest communication technologies so people know what is available around the world and they aspire to achieve a lot of material benefits for their families. So if one cannot deliver that, clearly there could be tensions in terms of our social and political stability.

So it has to be growth in exports that drives our growth process to the point where we can achieve 6% plus growth to meet the aspirations of our people.

And FDI, if you look around Asia, which has been the most successful continent in terms of growth and export performance, whether it is a country as large as China or one as small as Singapore, FDI has played a key role in the export transformation that has driven those economies.

So that's the model that the government is trying to put in place. It is doing a number of things to sustain that model in terms of the macro-economic policy making. There are three frameworks that have been put in place. The government has a revenue enhancement-based Fiscal Consolidation Program which is intended to bring the budget deficit down to 3.5% of GDP by 2020.

The Central Bank is putting in place a Flexible Inflation Targeting framework which is intended to bring about monetary policy formulation which is pro-active and forward-looking. Today's interest rates, i.e. when setting interest rates today, the full pass-through effects of the transmission does not have full effects in the system for about twelve months. So, in setting interest rates today we have to have an educated view of what inflation is going to be in twelve months' time.

In the past, we tended to do too little too late. We allowed the economy to overheat and then we would move. This is why we have had big fluctuations in our interest rates which have made business planning very difficult. We are trying to put in place a framework which will now enable us to set forward-looking, pro-active monetary policy, which should smooth out these sharp fluctuations in interest rates. They will still go up and down, but you won't get the spikes and troughs that we have had in the past, if we are able to implement the flexible inflation targeting regime properly. That's what we are trying to do.

Equally, on the exchange rate, in the past, we tried to defend an over-valued exchange rate. We used depleted borrowed foreign reserves to do that. In doing so, we lost a large amount of foreign reserves and then eventually there was an inevitable sharp depreciation in due course. This doesn't make any sense, so we are trying to follow a more flexible exchange rate policy, which will, we hope, enable us to have a competitive and stable exchange rate. If we get fiscal policy and monetary policy right, then the pressure on the exchange rate is reduced. So that's crucial. You have to take all three macro-economic instruments together. If you are able to implement the other two macro policies well, then there won't be pressure on the exchange rate and it will be possible to have a competitive and relatively stable exchange rate, which is what we want to try to get to.

So that's the micro side. In addition, the Government is also very much in the forefront in terms of improving the investment climate, investment promotion, trade facilitation and trade policy. So, hopefully we are moving in the right direction in terms of macro-economic stabilization and the framework is being put in place to improve the investment climate, as well as the trading environment.

Let me now turn to the matters in hand today and focus on the export sector. I must thank my colleagues in the Economic Research Department of the Central Bank who helped me to put these remarks together.

Sustained export growth is crucial for the development of Sri Lanka, particularly given the relatively small size of its domestic economy. Relying on the domestic economy is not sufficient to enhance growth. Sri Lanka was ahead of its regional peers in liberalizing its economy in 1977. The adoption of liberal economic policies, such as private sector development, export networks and encouragement of FDI led to immediate improvements in the foreign trade openness of the country.

Trade Openness which was 36.4% in 1977, nearly doubled to 72.2% by 1979 while exports which were 18.7% of GDP in 1977, increased significantly to 29.2% by 1979, just two years after opening of the economy.

Despite the turn-around in the immediate aftermath of the adoption of liberal policies, Sri Lanka's international trade performance has been lackluster since then, regressing to levels that were seen during the pre-liberalization era. In 2015, Sri Lanka's Trade Openness was 36.5% - it was 36.4% in 1977. While exports, relative to GDP, declined to 12.7% in 2015, having increased to 29.2% in 1979, and it rose as high as 32% in 2000.

So we've gone backwards. And we have gone back to almost where we were in 1977, in terms of trade performance.

Although the common notion is that there is a by-directional relationship between export and economic growth, this relationship has not been seen in relation to Sri Lanka. This was especially so between 2000 and 2016, wherein GDP increased by a compounded annual growth rate of 10.4%, while exports grew only 4%.

Sri Lanka's economic growth during the past decade or so has mainly been generated by the expansion of domestic demand, rather than increased exports. The tradable sector, that is Imports and Exports as a percentage of GDP, declined from nearly 80% to 45% from 2005 to 2015. As a Small Open Economy you simply cannot do that. The problems were compounded by a heavy recourse to foreign commercial borrowing for projects with low returns. That is what has led to the debt problems and many of the other difficulties we are having.

When compared with regional peers and competitors, Sri Lanka's export performance has lagged behind significantly. The Export Value Index presented by the World Bank shows the extent to which Sri Lanka's export sector has been lagging in comparison to its regional counterparts, during the period from 2000 to 2015. Sri Lanka has only increased its exports by 1.9 times in that period 2000 to 2015, while Vietnam and Bangladesh have increased by 11.2 times and 5.1 times respectively. Even South Korea and Thailand which have a much higher base, increased their exports by 3.1 times, whereas we, as I said only recorded a 1.9.

A key weakness as far as Sri Lanka's exports structure is concerned is a lack of diversity in products and markets, as well as low complexity in the export basket. Exports continue to be concentrated on two traditional products, namely garments and tea, which account for more than half of total exports. No major export item has been developed since the 1990s. The Export sector shows a lack of diversification in terms of markets as well. Europe and the USA continue to account for over half of total exports. Further, approximately 70% of tea exports are to the Middle East and Commonwealth of Independent States, where demand is sensitive to oil prices which have been transformed by shale technology.

The absence of effective trade finance also contributed to the subdued promotion of exports. At present, despite the share of industrial exports being around 77% of total exports, it is estimated that high-tech exports account for less than 1% of Sri Lanka's total manufactured exports.

Improving this ratio entails investment in machinery, technology and skilled labour. It is necessary for our exporters to compete in complex products that are more technologically advanced. We are no longer a low wage economy, therefore we need to invest in, and become competitive in fairly complex export products, if we are to meet the aspirations of our people.

Now, there was, I think, a very legitimate question asked about the availability of labour. If you get into higher value exports, you create jobs which will give attractive wages, which will then make it much more likely that people who going to the Middle East, to Korea, to Italy, to wherever they are going now, would prefer to remain at home rather than migrate temporarily without their families, which will help address a number of social problems as well.

So it is a question really, of relative wages. If we can create higher paying jobs, and jobs in the export sector tend to be higher paying in other countries, particularly if they are created by FDI. Sri Lanka does not have a labour shortage problem. It is just that the labour is in the wrong places. We have 27% of our workforce in agriculture, giving us 7% of GDP. It is politically difficult to move people from low-productivity, low-income agriculture to higher productivity, higher income activities, like the export sector.

We have 15% of our work force in the Public Sector Service – 1.5 million people. It has increased from 700,000 in 2005 to 1.5 million. So there is plenty of labour. We have to create the incentives and the types of jobs to get people into the competitive and modern sectors. And that's to do with relative wages. And so we need to get the investment to get higher value employment.

Penetrating global value chains and production sharing networks will also boost industrial exports. Intra-firm trading in Asia has been the most dynamic segment of the international trading system. Sri Lanka has a minimal presence in these networks. This has to be reversed for Sri Lanka to transform its export performance by leveraging its geographical location in Asia.

I need to say something about location at this point. A lot of people say: you are talking about export led growth, FDI etc., when the global economy is rather subdued. That this is a low-growth, sluggish international trade environment era and we are trying to say that we want to pursue an export led growth model. The answer to those people, in my view, is that our location, and our international relations help to overcome the headwinds in the global economy. We are right in the middle of China's Maritime Silk Road. We are twenty-miles from the fastest-growing large economy in the world, India, and the five Southern States of India, are growing at 10% plus, and have been for a number of years. The middle class has been increasing dramatically in these States.

We also have excellent relations with the Capital surplus countries of East and South-East Asia – Japan, China, Korea, even some of the ASEAN countries. And in Asia, you can leverage government-to-government relations to bring investment into your country. So, whatever is happening in the global economy, we can trump that with the advantages of location and excellent international relations.

As Sri Lanka's per capita GDP continues to rise, the country is losing its competitiveness in terms of its labour costs as wages increase. As a result, Sri Lanka will not be able to compete in exporting labour-intensive, low-value products, since exporters with low wage structures such as Bangladesh, Cambodia and Vietnam will become more competitive.

At present, Sri Lanka is not able to match the competitiveness of countries such as Malaysia and Thailand. So we are in little bit of a limbo. We find it difficult to compete on wages with Bangladesh's, Myanmar's, Cambodia's and Laos's, and we find it difficult to compete on productivity and competitiveness with Malaysia and Thailand. So we have to have an absolute laser-like focus on increasing productivity and competitiveness. That is how we have to move to support our export drive.

The modernization of the services sector is also important, as the production flow processes are now largely dominated by services. Service exports have increased rapidly since the end of the conflict, with significant increases recorded in tourism, transport, and ICT. By transport I mean logistics as well. However, given the competitive advantages the country enjoys, particularly in relation to its location, there is great potential for further increase in services exports.

Persistent large trade deficits, which have become a fundamental weakness in the balance of payments of Sri Lanka, are a serious concern that needs to be addressed in the long-term interests of the country. The substantial trade deficit indicates that comprehensive strategies, which focus on promotion of high-value exports, expanding the export base, and diversifying markets by strategically planned trade in growing economies, particularly in Asia, are essential for its reduction.

We clearly need to protect, consolidate and if possible increase our traditional markets in the US and Europe. But the real exponential increase that we are looking for has to come from Asia - from India, from China, *etc.* and as we know incomes and growing markets are expanding in these countries - we need to get part of that action.

Restoring external sector stability in a challenging environment requires the building up of external buffers with policies to reduce spill-over effects from adverse developments in other areas. In this connection, priority has to be attached to fiscal sustainability and prudent monetary policies to ensure that excess demand is not pumped into the system. The generation of higher export revenue will, in turn, increase the capacity to service the large accumulated stock of foreign liabilities. It can also be utilized for the stabilization of the exchange rate, and the building up of a sustainable level of reserves which we serve to increase the country's economic resilience.

In addition, a renewed focus on exports can help divert investment to more efficient segments sectors of the economy, thus raising overall productivity. This is what I was saying – to shift people and financial resources to more productive sectors of the economy. Growth in exports also entails several other benefits, such as the creation of an efficient price mechanism, inflow of new technology, employment creation, greater economies of scale, and expansion of the productive resource base of the country.

In the last decade, increasing reliance on unsustainable levels of foreign borrowing was an inevitable consequence of growth which was dependent on non-tradeable domestic goods. If you go for an inward looking growth strategy, as we did in the last 10-12 years, inevitably you run into the difficulties we now confront because you have to borrow to invest and we haven't created the capacity to earn the foreign exchange to service that debt.

The country requires a growth process which is driven by a surplus in the current account of the balance of payments. In the past, we have experienced high growth supported by unsustainable budget deficits. If you look at our growth performance, and you correlate it with the size of the budget deficit, our high-growth years are also characterized by high budget deficits. When growth is created by pumping money into the system through excessive fiscal deficits, it is just not sustainable, because it is not productive; it is essentially driven mainly by consumption. In the past, we tended to keep our interest rates low, and our exchange rate over-valued, so people borrowed and imported. After a couple of years you have balance of payment problems, and also pumping money into the system creates inflation.

When you look at the last thirty or forty years, you see repeating cycles of stop-go-policies. So, the trick is to attack the budget deficit, which is crucial. If you are able to do that, then other things will fall into place.

The Government has taken several measures recently to boost exports. By recognizing the need for broad-based institutional support, the Government has already taken steps to create an

Agency for International Trade. The AFIT is taking the lead in negotiating a series of trade Agreements. An early harvest is being sought to increase the benefits from the existing FTA in goods with India. These include Mutual Recognition Agreements among Standard Institutions and relaxing quotas on goods of interest to Sri Lanka. Negotiations are also underway to deepen and broaden the Agreement in goods through adjustments to the negative lists. The ETCA will also extend the application of negotiated rules to services, investment, training and technology. Similar agreements are being negotiated with China and Singapore.

Now there is a natural concern, natural nervousness about a small country like Sri Lanka negotiating Partnership agreements with enormous countries like China and India. We are not the first small country to negotiate trade agreements with a large country. Mexico is not a small country, but it is interesting that Mexico has benefited most from NAFTA, much more than the US or Canada. So it shows that a smaller country can still benefit by negotiating Partnership Agreements with a much larger economy.

For that to happen, the Agreement has to be based on two principles. One is the principle of non-reciprocity, that is, the larger country has to do much more than the smaller country. And two, special and differential treatment in terms of the phasing of the trade liberalization. So you build in mechanisms which take into account the asymmetry in the economies. Both China and India recognize the principles of non-reciprocity and special and differential treatment. Their negative lists would be much shorter than ours; their positive lists would be much longer than ours. They will allow us, I am confident, o negotiate safeguard agreements. These mean that if you have a sudden surge in imports,; if say imports go up by say 20-25% over a short period of time, you can automatically put in place safeguards through increased tariffs. That's a well-used practice, so that you get protection as a small country against import surges from larger countries. Equally, you can negotiate a good dispute resolution mechanism, which gives you a chance to address your issues that come up when in dealing with a larger country. So, there are these mechanisms, well tried and tested mechanisms, which can be used for us to ensure that we get a good deal. Our trade negotiators are well aware of these principles and mechanisms and I am sure they will negotiate effectively.

Now in addition to all the deals which that have been negotiated with India, China and Singapore, we have the bilateral FTA in goods with Pakistan which is being invigorated, and on top of that, of course we have EU GSP plus. If you take all this together, if we are able to conclude these Trade Negotiations successfully, Sri Lanka could have access, preferential access, to a market of 3 billion people, which is a massive USP. Now I think Singapore has preferential access to both China and India. But they don't have preferential access to EU. So there is no other country in the world that I know of, which has preferential access to China, India and

Europe. I know that GSP plus is only for four years. But four years is enough time for us to take advantage of it.

So that is a massive opportunity. Now, of course this market of three billion people is going to provide opportunities for our own exporters. But on top of that the trick is to use this preferential access to this 3 billion person market to leverage the trade/investment nexus. We can tell people you can come and locate here and sell on a preferential basis to China, India and Europe. That is a massively attractive narrative one can offer for potential investors from all over the world.

Now, if I may talk about some of the policy support offered by the Government. The EDB has initiated a National Export Strategy which, as you know, is a collaborative effort between the Government and the private sector and it provides a five-year action-oriented frame work for the development of trade and competitiveness.

Simultaneously, a National Trade Policy has now been drafted. It is a very neat 20-page document, very tightly and coherently drafted, and this is the first time we have formulated, in this concise way, the country's trade policy, which for me, is actually very well presented.

An Anti-dumping bill is also in Parliament. It is very important, if we are going to open up some sectors as part of the trade agreements. The Government is also working on a Trade Adjustment Package with the World Bank and the International Trade Center, in Geneva. What that intends to do is to assist companies, which are going to be affected by liberalization to become more competitive, and also to assist workers, whose jobs have been threatened, to re-train.

Now, I've talked on SMEs, for export promotion. There are four areas where they require support. 1. Training; 2. In-puts, including technology; 3. Access to finance; and 4. Marketing.

Invariable the biggest challenge is marketing. To get them to produce output that they can sell in the domestic market and abroad. So one challenge is really how we link our SMEs into International Supply Chains, either through larger companies, or directly. We really need to think in terms of linking up our SMEs to supply chains.

The Government has already taken some decisive measures to overcome the short-comings of the export sector. With some improvement in the performance in the export sector, so far, there are signs that the initiatives are favourable. Since March, we have now seen an improvement in export numbers. We've got numbers up to May – in March April and May the numbers have shown an up-turn in export revenue. Hopefully that will gather momentum. I think with the GSP-plus kicking in, and hopefully, a more stable macro-environment, export growth will continues.

As I said, Sri Lanka cannot attain 6-7% growth on a sustained basis without transformation of its export performance. Nor can we overcome the constraints associated with our external debt burden without significantly enhanced non-debt creating foreign exchange receipts, generated, inter alia, by increased exports. So, export transformation is crucial for both boosting growth and employment, as well as to stabilize our vulnerability stemming from our external debt. The performance of the EASL will be a key determinant of the future prosperity of all Sri Lankans.

Thank you very much.