Forum on Sri Lanka's Sustainable Development Trajectories and Pathways

Achieving Resilience through Digitalization, Sustainability and Sectoral Transformation

General Sir John Kotelawala Defence University

Keynote Speech

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Vice Chancellor of the General Sir John Kotelawala Defence University, Major General MP Pieris,

Keynote Speaker, Prof. Leland Hartwell,
Members of the University and Academia,
Researchers,
Ladies and Gentlemen!

It gives me great pleasure to deliver the keynote speech on the occasion of the 16th International Research Conference on the theme of 'Achieving Resilience through Digitalization, Sustainability and Sectoral Transformation.'

We are all aware that Sri Lanka is gradually exiting from the most arduous economic episode in its post-independence history. The **coordinated and transparent undertaking of several policy measures** by the Government of Sri Lanka and the Central Bank of Sri Lanka has been pivotal to the country's **faster-than-expected exit from severe economic hardships** faced by the population. The swift and sizeable policy intervention that was undertaken by the Central Bank helped ensure economic and price stability amid mounting inflationary pressures. Accordingly, the **Central Bank proceeded with large and persistent monetary policy tightening** that enabled arresting of excessive demand pressures in the economy, thereby helping to curb any de-anchoring of inflation expectations and also helped correct anomalies in the interest rate structure while addressing external sector imbalances. This was also coupled with measures to limit unwarranted volatilities in the exchange rate through the introduction of daily guidance, strengthening of monitoring mechanism of export proceed repatriation and conversation along with active enforcement of foreign exchange regulations to ensure compliance, imposition of 100 per cent cash margin requirements to curb import expenditure, the continuation of restrictions on certain foreign exchange outflows and payment terms for import financing.

Over the last year, **the Government and the Central Bank also persevered to secure the Extended Fund Facility (EFF) from the International Monetary Fund** and this enabled us to secure this essential lifeline within a very short period, thereby unlocking other multilateral foreign exchange flows too. As part of the EFF programme, the Government is also **engaged with domestic and foreign creditors on debt restructuring**. Accordingly, the Domestic Debt Optimization programme is underway, and the proposed plan is to bring about the most optimum solution with the least burden to the citizenry. Through the course of these developments, the **Central Bank of Sri Lanka remains committed to ensuring the stability of the financial system as well as the macroeconomy**.

Since the peak inflation of 69.8 per cent in September 2022, we have seen inflation sharply decelerating to 4.0 per cent in August 2023. Having seen continuous contractions in economic growth since early 2022, we expect a gradual recovery from the second half of 2023 onwards. This is to be underpinned by the steady improvements seen in trade, worker’s remittances, tourism sector and of course the stable exchange rate which has recorded over 12 per cent appreciation so far this year. These have culminated in a gradual build-up of gross official reserves which have reached US dollars 3.8 billion as at end July 2022 from the lowest level of 1.7 billion in Aug 2022.

Having seen these positive developments over the recent months, the **Central Bank embarked on a monetary policy easing cycle** given that inflation has eased at a faster-than-expected pace, the need to provide leeway for the economy to recover, strengthening of the balance of payments and the need for faster and sizable reduction in market lending rates. You may all be aware that the Central Bank has also issued targeted directions in this regard, urging banking and financial sector to pass on the benefits of this significant easing to individuals and businesses, thereby supporting the rebound of economic activity in the period ahead.

With due consideration to improvements seen in the external sector, **gradual relaxation of import controls and foreign exchange outflow measures have also commenced**. With the steady progress on the IMF-EFF programme and debt structuring initiatives, there have been **steady improvements in foreign flows and in overall investor confidence**. Accordingly, leading indicators already show some signs of recovery, and we strongly believe that the economy will gradually recover from its deepest economic contraction in 2022, supported by the stabilisation of inflation, positive outlook for the external sector and the restoration of debt sustainability with the government's expansive and comprehensive fiscal consolidation programme that seeks to improve revenue while rationalizing expenditures and undertaking several structural reforms.

A cornerstone to **building economic resilience in the future is the expected enactment of the Central Bank Act**. Maintaining domestic price stability becomes the primary object of the Central Bank under the Act, while the other object of the Central Bank shall be to secure financial system stability. More importantly, the Act provides the **necessary legal framework to adopt Flexible Inflation Targeting (FIT)** as the monetary policy regime of the Central Bank. Accordingly, it warrants more accountability to all economic stakeholders through the Central Bank's commitment to maintaining inflation at the targeted level, while communicating the forecast and policy rationale transparently. The Act also eliminates government representation in monetary policy formulation and prohibits monetary financing of budget deficits, supporting the domestic price stability that would pave the way for long term economic growth. Moreover, **insulating monetary policy formulation from political pressures and ensuring more economic, financial,**

and operational independence would help build the credibility of the Central Bank in the eyes of its stakeholders.

The Act also appoints the Central Bank as the macroprudential authority in Sri Lanka, strengthening the financial system stability framework further. Hence the Central Bank Act will be a milestone in securing macroeconomic stability which is imperative to the recovery process and building resilience in the short-run and sustained growth over the long-run.

In the recent months, we have seen a faster-than-envisaged disinflation process with inflation rapidly returning to our intended mid-single digit level target and we also observe benign inflation expectations in the domestic economy. Going forward, with the country's transition to FIT and lower level of public debt after debt restructuring, it has to be understood that the interest rate structure will also adjust downward in line with the single digit inflation levels and lower risk premium. Accordingly, it is important for **all stakeholders of financial markets to seek means to maximize their returns in ways other than on interest income**. There is a need for the financial sector to also revisit and transform itself with new, innovative and flexible products.

This low interest rate environment that we are currently establishing helps remove a key bottleneck that the Industry sector was struggling with. **There is a strong push for banks to lend to productive sectors, especially those which are export oriented and also to Small and Medium Enterprises which have for long been the backbone of the economy.** Alongside lower borrowing costs, market driven exchange rate in line with the FIT framework will also offer a competitive edge to domestic industries and entrepreneurs. Accordingly, I believe these developments will provide a conducive environment for businesses to not only recover but also to reposition themselves firmly in the domestic and/or global market. **The industrial sector has to leverage this low interest and low inflation environment to transform itself into a high value-adding one by**

moving away from traditional and simple products to more complex yet competitive and high quality products.

Globally, there is a growing demand for various products which Sri Lanka has immense potential in, for example, value added agricultural products, leather products, niche products such as handlooms, batik and ayurvedic products and also for sustainable and environmentally friendly products, as a whole. Although, Sri Lanka traditionally possesses immense expertise and natural resource advantages in relation to these products, our industries have not reaped the benefits of these global trends. It must be acknowledged that the **Industry sector and thereby the export sector has also experienced setbacks due to the lack of a coherent and cohesive long-term national plan**. Hence, there needs to be concerted policy initiatives and a drive by stakeholders to expand and diversify domestic production, improve export orientation and also attract Foreign Direct Investments (FDIs) into tradable sectors. Being located in South Asia and on a key maritime route, Sri Lanka could benefit immensely if it improved its trade linkages with regional counterparts. Such initiatives, if carried out in a timely manner, could set off a spiral of improved export performance and the creation of a resilient Industry sector which can serve as a buffer for the external sector and also create positive spillover effects on overall macroeconomic performance.

An ongoing transformation that has been long overdue and one that the economy will immensely benefit from is the digitalisation drive. Even before the ongoing drive, Sri Lanka has had a strong IT-BPO sector which has been a key foreign exchange earner for several years. This highlights that the country already possessed potential in this sector. This was further underscored by the COVID-19 pandemic wherein all stakeholders were quick to transition to digital platforms to ensure continuity of activity across several spheres of the economy. Accordingly, in line with national policy initiatives, we see that the digital economy in Sri Lanka is on a gradual rise, with notable strides in software and IT services, planned launch of several e-government services, including the Sri Lanka Unique Digital Identity (SL-UDI) project and of course fintech. **In the short term, we expect such initiatives to greatly contribute to addressing several grass-root level issues which are spilling over onto our macroeconomy, such as in relation to tax evasion, the large and vulnerable informal economy which has been a drag on productivity, and even the long-standing issue of growing inequalities.** Accordingly, the DIGIECON 2030 program of the Government which seeks to accelerate Sri Lanka's transformation into a digital economy will help consolidate Sri Lanka's efforts towards sustained and inclusive growth and of course, the progression towards the middle-income status. However, **this transformation requires multi-sectoral coordination**. Investments in digital infrastructure must continue alongside the promotion of digital literacy and skills development to address the 'digital divide.' As seen across the economy, **a conducive regulatory environment that encourages innovation, technology transfer and foreign investment is imperative to fast-track progress in this extremely dynamic sector**. Accordingly, private sector participation will also be crucial to this drive, especially to mobilise investment, and to induce innovation, technology transfer and human capital development all of which are essential to bridge the digital divide and thereby enable the economy to reap the benefits of such transformation. On the note of digitalization, **an ongoing transformation that has been long overdue and one that the economy will immensely benefit from is the digitalisation drive.** Accordingly, we are committed to creating an enabling regulatory environment that fosters innovation while ensuring consumer protection and financial stability.

By collaborating with industry stakeholders, we aim to promote the development of a robust digital financial ecosystem that serves the diverse needs of our population. During the Budget Speech of 2023, the President of Sri Lanka proposed to implement measures for all Government Institutions to accept online payments by 1st of March 2024. **The Central Bank together with the national payment infrastructure provider LankaPay (Pvt)**

Ltd, and the Ministry of Technology is currently engaged in implementing a system that will make this proposal a reality.

The interest in digital currencies has been gaining traction and within the Central Bank of Sri Lanka, we are also engaged in studies on the potential of Central Bank Digital Currency (CBDC) which is the digital form of legal tender issued by the Central Bank. There is consensus **across global central banks that CBDC will help enhance the efficiency and resilience of the payment system while also serving to increase financial inclusion**. Importantly, other potential benefits of CBDC include more effective monetary transmission and improved financial transparency. Some initial steps that have been taken to dabble with such innovations has been the introduction of the ***Financial Technology Regulatory Sandbox* of the Central Bank of Sri Lanka in February 2020**. This was introduced with the intention of facilitating innovations that can enable more efficient financial intermediation, greater financial inclusion and creating a 'less-cash' society through digitalization. This has been a starting point for several FinTech applications. Despite the availability of such applications and relatively high levels of mobile phone and internet penetration, there seems to be a strong penchant for the use of physical cash among the public. Also, in spite of the several benefits, the **Central Bank of Sri Lanka is weighing issues such the impact of CBDC on the existing financial market structure, the balancing of privacy of citizens' transactions while maintaining AML/CFT compliance**.

The economy's cybersecurity status is also an important consideration in this regard. Hence, we will continue to study the potential and feasibility of CBDC for Sri Lanka while actively engaging with global developments in this regard, which **in the future may or may not hasten our adoption of digital currencies**. Having looked at the way forward, I want to take a few minutes to go back to the drawing board and draw out some lessons for all of us to take forward with us. The whole world is now adopting a **VUCA** model – it is embroiled in volatility, uncertainty, complexity and ambiguity. **The economy**

can no longer strive on traditional growth models, instead it has to reverse engineer to achieve sustainable growth. One aspect that has to be urgently addressed is **improvements to productivity** broadly through diversification, technological improvements, innovation and also capacity building of our labour force. Although several initiatives and plans in this regard are available or underway, these need to be cohesively implemented.

There is also a need to **revisit our consumption and production patterns to ensure efficiency in resource utilisation** especially considering that Sri Lanka has lived beyond its financial means over several decades which resulted in the 'twin deficit' legacy that drove us into the economic crisis. Needless to say, several structural reforms that will pave way for such changes are underway, such as in relation to fiscal consolidation, social safety nets, fiscal institutions and state owned enterprises, addressing corruption vulnerabilities and raising potential growth, for example. However, it is important to remain committed to these and ensure that such long overdue reforms are expeditiously implemented to set the economy on track towards sustained, inclusive and sustainable growth.

In the wake of climate change, we will need to also focus on the preservation of natural resources which we had taken for granted in the past, such as water, forests and our land and marine ecosystem which are not only lifelines to our population but also to other key economic activities, such as tourism. Since long, **there have also been concerns specifically regarding the quality of the human capital base**. Contributions of educational institutions as the Kotalewala Defence University are becoming increasingly vital to ensure that our human capital base, are equipped with not only the best but the most relevant skills to induce, handle and take forward the next wave of growth. Improvements to the education system will resolve several other structural issues in the economy, such as underemployment, youth unemployment, the high degree of informality in the economy and even inefficiencies in the public sector. **There are several reforms already underway in this regard and the support of all sectoral stakeholders in the timely finalisation**

and implementation of these will be pivotal to safeguarding the economy's resilience. Domestically, **the crisis saw the rapid mobilisation of all key stakeholders**, the Government, the Central Bank, government agencies, financial institutions, private sector firms and even individuals at grass root level seeking solutions and means to assist. This highlights the enormous importance of partnerships at every level, especially in the complex 'global village' setting that we are a part of. **Sri Lanka will have to maintain or even accelerate its current pace of building international partnerships for the country to position itself on global value chains and to create export-led growth.** Such partnerships will also be necessary for Sri Lanka to tap into financial and technical resources that are amply available in the global arena especially in novel and time-sensitive areas such as climate change, agriculture modernisation, technology and digitalisation, responsible production, and natural resource management, among others. The crisis also highlighted that domestic partnerships are also essential to overall resilience of the economy. It is imperative that public sector organizations work together in a coordinated and cohesive manner to ensure effective outcomes. As I mentioned previously, **in the next wave of growth, the private sector will also need to play a key role and be engaged more actively with the public sector to create 'win-win' situations for both sectors.** With the renewed sense of macroeconomic stability and the introduction of several investor-friendly reforms, we believe this is an opportune moment for the development of such mutually beneficial engagements.

In 2022, Sri Lanka faced the worst economic and social crisis in its history, leaving everyone in a quagmire. But as in the past, Sri Lanka has rebounded faster than expected and now it is up to all of us to work together to build back better. Remember that the economy is not something 'abstract' – it is all of us. For us to transform and achieve resilience and sustainable growth, whether as individuals or as an economy, it is not possible overnight. This

will require reforms in the short term and in the medium term. With these measures being steadfastly implemented, we are beginning to see the results. Going forward, the onus lies on us, as policy makers, members of academia, researchers and students to continuously interact with each other and exchange ideas through such conferences to thereby identify innovative channels of growth for the economy, at micro and macro levels.

On that note, I would like to express my sincere gratitude to the Vice Chancellor Major General MP Pieris and the organizing committee of the Conference for giving me the opportunity to share my thoughts and I wish all the researchers the very best and hope you will all have a fruitful session today.

Thank you.