Pathfinder Economic Alert

Is there Scope for further Monetary Policy Relaxation to Boost Growth?

Overheating to Cooling-off

The growth momentum in the economy has slowed sharply, since 3Q 2012. As mentioned in previous Pathfinder Foundation (PF) articles, this is reflected in reduced government revenue, imports, electricity sales and company profits. Such a slowdown in growth has been an inevitable consequence of the stabilization measures introduced in Feb/March 2012. These became necessary to address the overheating of the economy, which was reflected in elevated inflation and balance of payments imbalances which exerted pressure on the currency/reserves.

The Feb/March 2012 stabilization measures have been supplemented subsequently by adjusting electricity and fuel prices to minimize the losses of CEB and CPC. These have enhanced the stability of the financial system by strengthening the balance sheets of the state banks and have improved the government's balance sheet by addressing the contingent liabilities arising from the threats to the viability of the Bank of Ceylon and the People's Bank. However, the downside of the progress made in stabilizing the economy has been the drag on the prospects for growth and productive employment.

The upshot has been greater stabilization of the economy in terms of lower inflation and a reduction in the deficit of the current account of the balance of payments. However, as mentioned above, this increased macroeconomic stability has been gained through reduced growth i.e. it has been necessary to trade-off growth for stability. One may conclude that the current situation is similar to the engine of a vehicle not overheating when it is driven at 30mph. The objective should be to drive the vehicle at 60mph without overheating of the engine. In this context, the challenge for policy-makers is to achieve the twin objectives of accelerated growth and macroeconomic stability (moderate inflation and sustainable current account balance) simultaneously. In an ideal world this would require a combination of macroeconomic policies that maintain stability and structural reforms that strengthen the growth framework of the economy through increased efficiency (productivity) and higher confidence, particularly among domestic and foreign investors (a menu of structural reforms was suggested in PF Economic Alert no: 27 available at www.pathfinderfoundation.org).

Political timing of structural reforms

However, it is unrealistic to expect a package of structural reforms at this stage of the country's political cycle (major elections are expected within the next 18 months). Typically, the pain associated with structural reforms is experienced almost immediately, while the gains **will only** materialize with a lag effect of two – three years. This asymmetry between the political costs and benefits of structural reforms means that in a competitive polity, like Sri Lanka, there are little prospects of significant growth-boosting structural reforms prior to the next set of major elections.

This poses a question whether there is scope for greater macroeconomic policy activism to boost growth and productive employment in the short-term.

The scope for macroeconomic policy activism

Demand management, exercised through adjusting macroeconomic instruments (monetary, fiscal and exchange rate policies), can influence the growth rate. There is scope for boosting growth through such demand management, particularly if an economy is growing below the trend rate i.e. it has an "output gap". The trend rate of growth is the rate at which the economy can grow without overheating. Hence, the policy-makers first need to determine whether the Sri Lankan economy is currently growing below the trend rate. If so, one would then need to determine the appropriate mix of macroeconomic policy measures to boost growth without undermining stability i.e. fueling inflation and triggering unsustainable balance of payments imbalances.

Is growth below trend?

The Sri Lankan economy averaged 5% growth during the conflict period. It tended to overheat whenever growth exceeded 6%. With the onset of peace, powerful headwinds are no longer a factor. The war risk premium has been removed and the whole country is now available for accelerated economic activity. As against these positive features, some new headwinds have also emerged in the post-conflict period: the global economy is less propitious following the crisis in 2008; and Sri Lanka is transitioning from enjoying a demographic dividend (peaking of the share of the population in the working age group) during the conflict period to ageing. On balance, it would seem realistic to expect a trend growth rate of 7% for post-conflict Sri Lanka, even without more structural reforms to strengthen the growth framework of the economy. With such reforms, Sri Lanka would be capable of growing at 8% - 10% on a sustained basis without overheating.

The balance of probability is that growth has been well below 7% during the four quarters since 3Q 2012. There is likely to be some upturn in 2H 2013 as a result of more favourable base effects due to the deceleration of growth in 2H 2012; and the easing of monetary policy during the course of this year. Even allowing for this, it is likely that growth will still be well below the potential trend growth rate of 7% (without politically difficult structural reforms). This seems to indicate that there is some scope for macroeconomic policy activism on the part of the authorities.

Macroeconomic policy stance to support growth: is there scope to relax monetary policy?

There seems to be merit to examining the scope for a more activist stance in relation to monetary policy at this moment in time.

As pointed out on many occasions in the past in these columns, the budget has been the main source of instability in the system since liberalization of the economy in 1977. The current account of the budget has been in deficit in every year since 1987. This has consigned Sri Lanka to being a high inflation/high interest rate/overvalued exchange rate economy. This adverse macroeconomic policy framework has acted as a drag on private sector activity. This has meant that there has been an unhealthy correlation between the budget deficit and the growth rate. Growth has been driven by the budget deficit rather than the strength of the current account of the balance of payments (i.e. export performance), as was the case in the successful economies of East and South East Asia. The upshot has been a repeating cycle of stop-go policies as the economy inevitably overheated when the budget deficit became unsustainable with the acceleration in growth.

This non-virtuous repeating cycle of economic performance needs to be broken, if Sri Lanka is to achieve sustained growth of 8% in the medium to long-term. Hence, the government's commitment to fiscal consolidation should be maintained and reinforced (and lauded). The Treasury has announced that the budget deficit would be reduced to 5.8% of GDP in 2013 from 6.4% last year. Closer examination of the fiscal outcome last year reveals a budget deficit of 6.4% of GDP; a quasi fiscal deficit of 2% of GDP (SOE losses, particularly CPC, CEB and Sri Lankan Airlines); and arrears of about 5% of GDP. This yields a total of 8.9% of GDP. In 2013, the fiscal deficit is expected to decline to 5.8% of GDP (a reduction of 0.6% of GDP). With the adjustment of fuel and electricity prices, it is not unreasonable to expect the quasi fiscal deficit (i.e. the losses of SOEs) to come down to 0.5% to 0.75% of GDP (a reduction of 1.25 to 1.5% of GDP). Even if arrears remain unchanged, one could reasonably assume that there could be fiscal tightening of about 2% of GDP this year. This amounts to about Rs. 160 billion (US$ 1.2 billion.). The result of this is that fiscal tightening will take place at a time when growth has slowed down significantly below the potential trend rate. As mentioned above, this fiscal consolidation is necessary to achieve a macroeconomic framework that is more growth –friendly and to maintain the financial viability of the state banks.

Next, it would be important to examine the implications for fiscal/monetary policy coordination of the current combination of a fiscal squeeze and a loss in growth momentum. Monetary policy has already been relaxed with two policy rate cuts amounting to 0.75% and a reduction in the Statutory Reserve Ration (SRR) from 8% to 6% being the major measures. This raises the question whether there is hope for further monetary policy relaxation. There is a case to be argued in favour of policy relaxation given the current scenario of: well below trend growth; reduced inflation; some improvement in the current account of the balance of payments; and a necessary fiscal squeeze.

When considering the option of relaxing monetary policy, it is important to recall a key lesson that emerged from the experience of 2010/2011. Relaxation of monetary policy must be supported by a flexible exchange rate. The failure to abide by this basic rule of economics will result in pressure on the balance of payments and external reserves, as happened in the recent past.

A more flexible exchange rate policy will exert pressure on the price level. However, the impact could be muted at the present time as businesses may already have priced-in a rate of US$/SLR 134 – 135, when it depreciated to this level last year. The challenge for the authorities is to balance the political fallout of any increase in inflation against the implications of lower growth, productive employment and profitability of businesses, large and small, in a country where aspirations have been boosted by the end of the war and the inflow of Rs. 750 billion directly into households through inward remittances.

The way forward: Gradual monetary easing with exchange rate flexibility

The authorities are faced with the delicate challenge of balancing growth and stability. Growth has clearly slowed down as implied by indicators, such as government revenue, imports, electricity sales and corporate profits. The authorities have reaffirmed their commitment to a much needed program of fiscal consolidation in a context of muted growth. This fiscal tightening is necessary to take the economy out of the repeating cycle of stop-go policies and create a pro-growth friendly macroeconomic framework. In addition, rating agencies and international capital markets are increasingly focusing on the government's fiscal performance at a time when global liquidity conditions for emerging markets are tightening with the prospect of Fed QE3 tapering and the increase in advance**d** country bond yields. Any deviation from the trajectory of fiscal consolidation will, therefore, be counterproductive at this time.

The combination of a loss in growth momentum and fiscal tightening places a high premium on fiscal/monetary policy coordination. In the current context of slower growth, lower inflation, some improvement in the current account in the balance of payments and fiscal consolidation, the scope seems to exist for further relaxation of monetary policy. However, this needs to be done very cautiously with gradual easing supported by a flexible exchange rate and a very rigorous monitoring of the impact on prices and the balance of payments.

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