Implementing Inflation Targeting in Sri Lanka: The Fiscal Challenge

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Abstract

The traditional Quantity Theory of Money argues that inflation is always and everywhere a monetary phenomenon. However, the recent Fiscal Theory of Price Level presents a formidable challenge to this view by recognizing that fiscal influence plays a key role in determining inflation. Some authors contend that fiscal influence over monetary policy could even break down Inflation Targeting (IT) regimes. This study pre-empts the challenge of fiscal dominance in implementing an IT framework in Sri Lanka. It argues that the balance of fiscal-monetary relationship is tilted towards fiscal dominance despite the protections – although limited in nature - included in the existing legal framework. Moreover, characteristics of the fiscal-monetary relationship go well beyond safe terrains vis-à-vis international best practices. It is important that the central bank and the government agree on phasing out fiscal influence in 'spirit' in addition to enshrining legal safeguards in a piece of legislation. The period of phasing out should form an integral part of the action plan to implement IT. Failure to do so can have implications on the success of implementing IT and adversely impact the credibility of the central bank.

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