IMPLEMENTING INFLATION TARGETING IN SRI LANKA: THE FISCAL CHALLENGE

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SRI LANKA'S FISCAL MONETARY RELATIONSHIP – A CURSORY VIEW

- Exchange rate/monetary policy: "I propose to depreciate our exchange rate by 3 percent with immediate effect, to correct this disadvantageous position and to encourage our exports. I expect that the Central Bank will adopt appropriate modifications to the Monetary Policy accordingly".

  - Budget 2012

- Central Bank capital: "The performance of the Central Bank ……. in recent years, has been exemplary. Considering Central Bank's responsibilities and the recent trends in the economy, I propose to increase its capital to Rs.50 billion"

  - Budget 2014

- Monetary policy operations: "Central Bank will exempt the statutory reserve requirement on individual deposits maintained by the elderly people in all commercial banks"

  - Budget 2015

- Financial sector: "…. in order to provide the depositors with a sense of comfort and security, the Central Bank of Sri Lanka will give a 100 percent guarantee on all deposits of all the registered finance companies by end January 2016"

  - Budget 2016 (the proposal was not implemented)

- Similarly, fiscal budgets openly solicit revenues from the CBSL through the text of the budget speech

- Use of Section 116 (2) of the MLA in 1958

"…Governments can …. pursue irresponsible fiscal policy with an inflation targeting regime in place. In the long run, large fiscal deficits will cause an inflation targeting regime to break down: the fiscal deficits will eventually have to be monetized or the public debt eroded by a large devaluation, and high inflation will follow. Absence of outright fiscal dominance is therefore a key prerequisite for inflation targeting"

Mishkin (2001)

THEORETICAL UNDERPINNINGS

- Our traditional understanding: "inflation always and everywhere a monetary phenomenon" – derived from QTM
- Is this the full story? What is the role of fiscal policy?

  - Application of Fiscal Theory of Price Level

    Sargent and Wallace (1981); Leeper (1991); Sims (1994); Woodford (1995)

Inflation is the equilibrium price level that makes the real value of nominally denominated government liabilities equivalent to the present value of expected future government budget surpluses

IT FRAMEWORK

- An IT regime is one which formally announces an inflation target and adjusts a policy instrument in a way consistent with the target.
- In IT, performance of a central bank is accountable for achieving the target.
- Credibility of a central bank is linked to achieving of the target [range].
- Conditions to implement an IT regime broadly includes: (a) A mandate to pursue an inflation objective and accountability of the central bank; (b) Ensure that the inflation target will not be subordinated to other objectives; (c) A stable enough financial system; (d) Proper tools and techniques to implement the regime

SOME STYLIZED FACTS – CENTRAL BANKS' FISCAL SUPPORT

- In most advanced countries, central banks do not finance government expenditure;
- In a large number of emerging and developing countries, short-term financing is allowed in order to smooth out tax revenue fluctuations
- In most countries, the terms and conditions of these loans are typically established by law, such that the amount is capped at a small proportion of annual government revenues, loans are priced at market interest rates, and their maturity falls within the same fiscal year;
- In most countries, advances and loans cannot exceed 10 percent of government revenues of the previous fiscal year or an average of the last three fiscal years.

VULNERABILITY TO FISCAL DOMINANCE

- Past fiscal-monetary relationship
- Fiscal landscape in relation to fiscal and debt dynamics
- Compliance with fiscal rules framework

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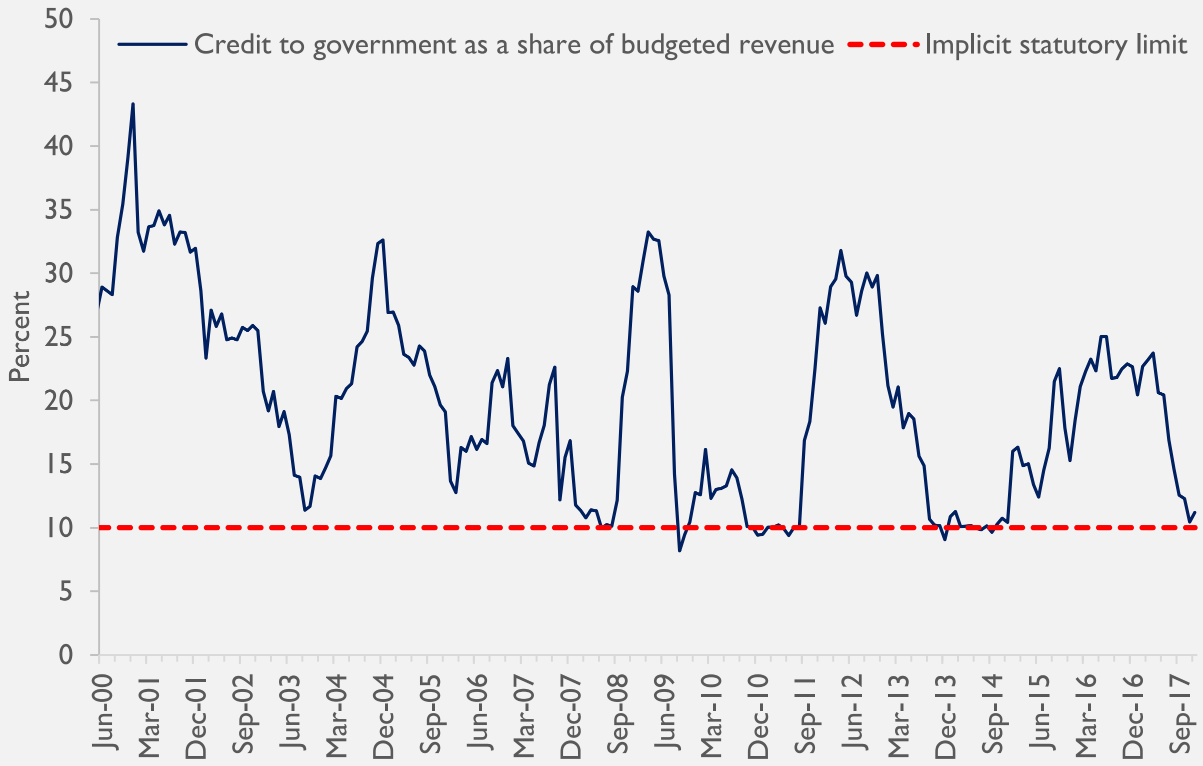
EXISTING LEGAL FRAMEWORK FOR EXCEPTIONAL FISCAL FINANCING IN SRI LANKA

- Section 89 of the MLA: "The Central Bank may make direct <u>provisional advances</u> to the Government …. the total amount of such advances outstanding at any time shall not exceed <u>ten per centum</u> of the <u>estimated revenue</u> of the Government for the financial year in which they are made"
- MLA is silent of the determination of the interest rate; as a result, the CBSL does not charge interest on provisional advances
- The MLA is not specific, if the CBSL could finance the government through its OMOs. However, they are specifically earmarked for monetary policy purposes/market liquidity management
- The spirit of MLA Section 89 is to avoid excessive monetization of fiscal deficit as enshrined in the Exter Report: "Many central banks and national economies have come to grief because Governments have had too easy access to central bank credit. In Ceylon it has been considered wise …… to limit the direct access of the Government to Central Bank credit to <u>its short-term, seasonal requirements for funds</u>".
- One could argue that the MLA does not envisage fiscal financing through purchasing of Treasury securities in the primary market; and that the access to provisional advances is limited to short-term seasonal requirements for funds; and that the total exposure at given time to CBSL financing should not exceed 10 percent of estimated revenue of the government of the particular year.

IMPLICATIONS OF CBSL'S FISCAL FINANCING

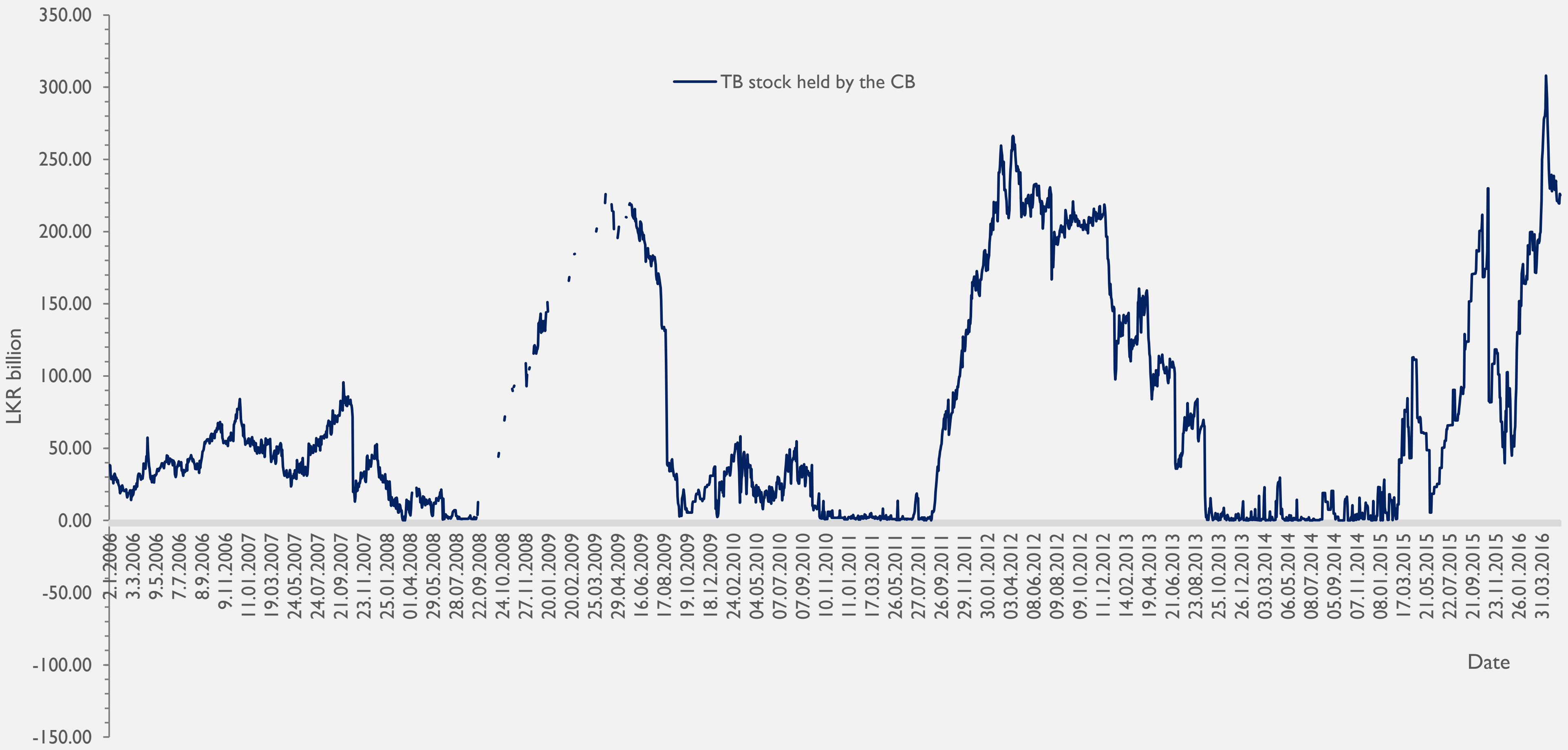


Note: CBSL credit to government includes both provisional advances and bills purchased in domestic operations

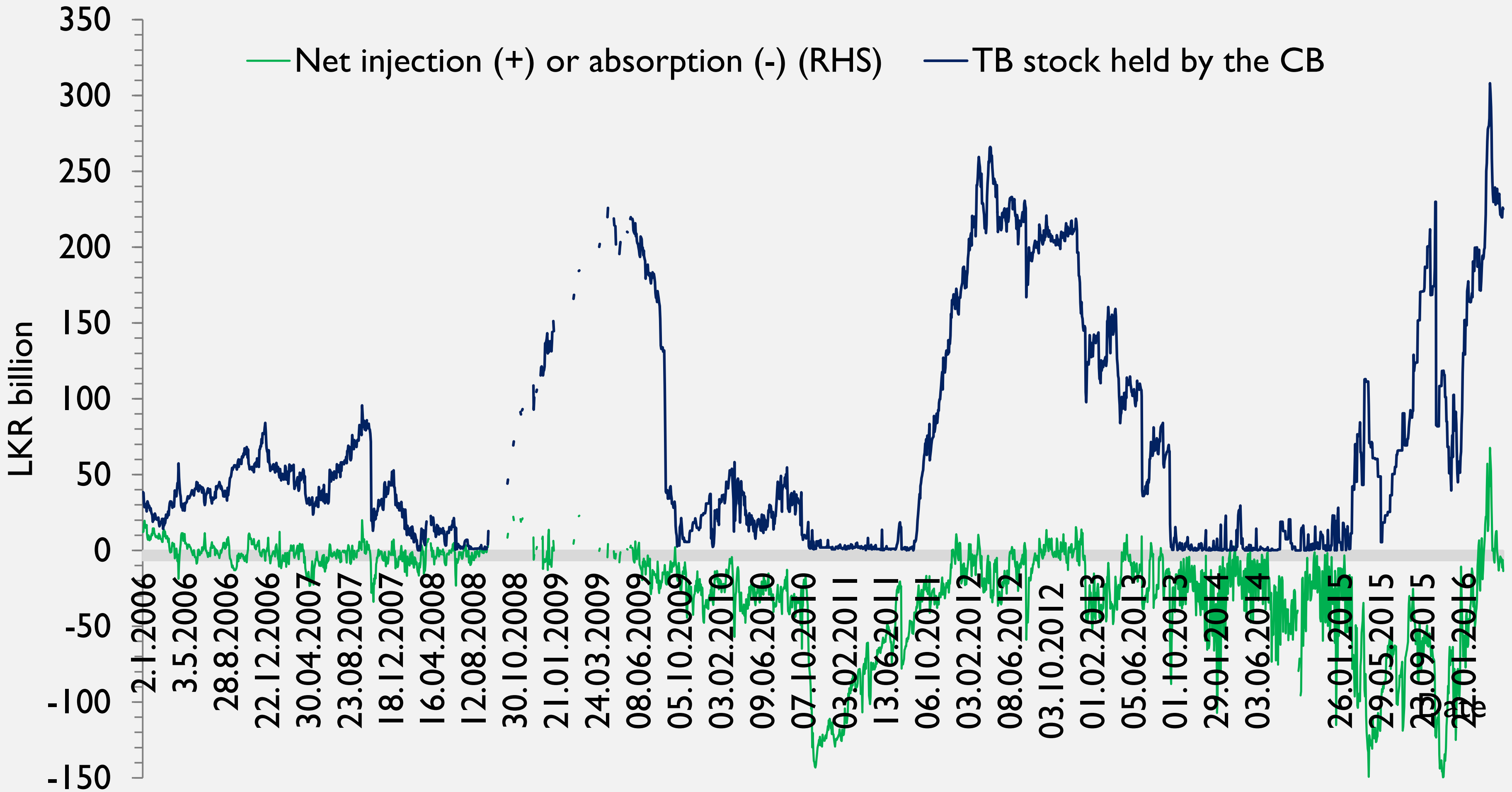
Implications

- CBSL credit to the government exceeded the 10 percent limit set by the MLA, consistently
- Government interest cost was underestimated (0.4 percent of GDP, 2000-2017, on average)
- Computation of provisional advances on the budgeted revenues increased the volume of provisional advances by LKR 72 billion, 2012-2017

TREASURY BILL STOCK HELD BY THE CBSL

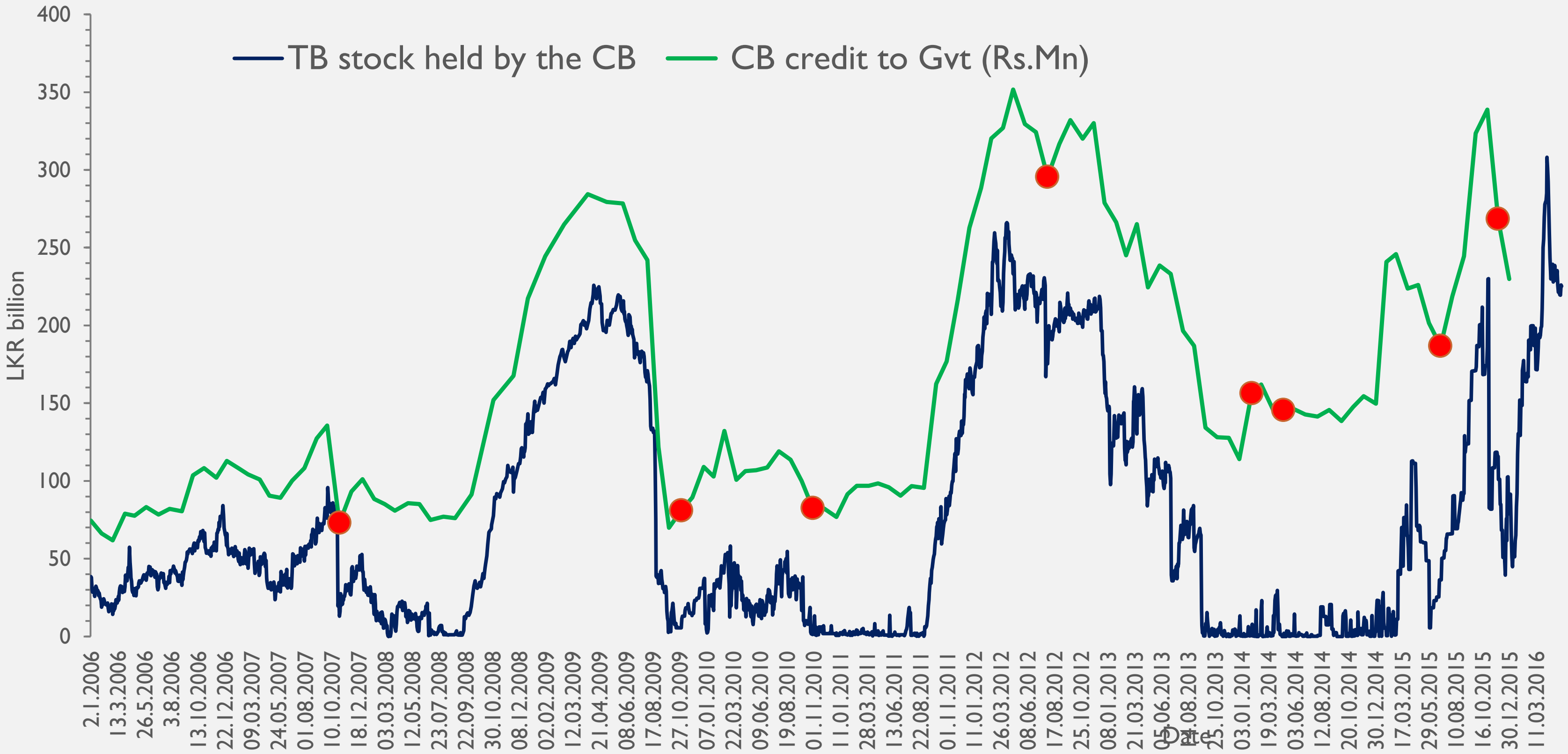


Source: CBSL



Note: T bill stock held by the CBSL includes gross book value of T bills plus total value of reverse repos and standing lending facilities minus repos with the CBSL.

Source: CBSL



Note: Daily data for CBSL credit to government is interpolated based on month end figures; markers in red represent months in which proceeds of sovereign bonds were received.

Source: CBSL

Correlation matrix	CBSL credit to government	Net injection	TB stock held by the CB
CBSL credit to government		(0.04)	0.82
Net injection	(0.04)		0.21
TB stock held by the CB	0.82	0.21	

Source: CBSL and author's calculations

- Treasury bill stock held by the CBSL has limited facilitation effect on market liquidity management.
- Treasury bill stock has mainly been used for providing fiscal support in a low revenue context.
- This argument is further strengthened by the fact that the CBSL did not conduct daily auctions for extended periods when the market was experiencing excess liquidity

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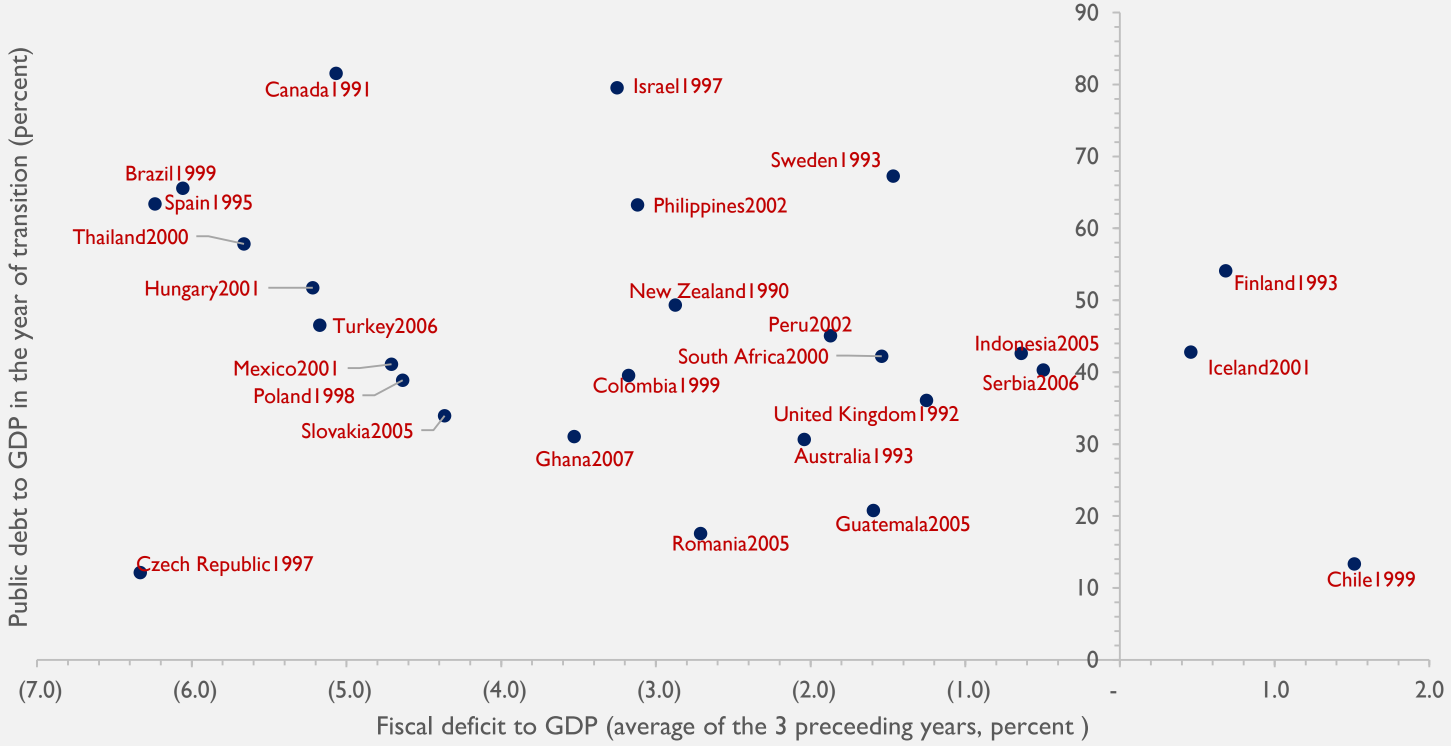
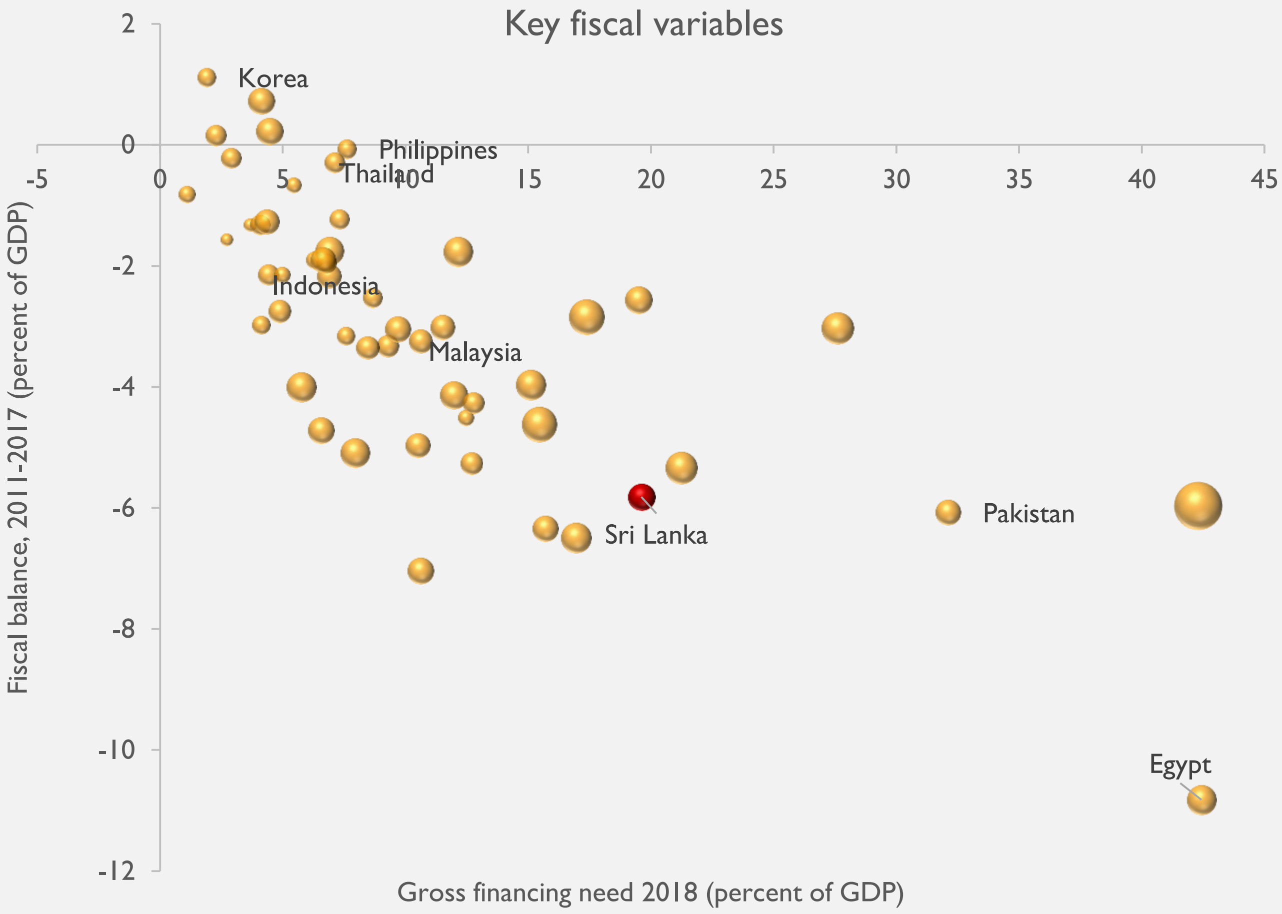
FISCAL STRENGTH AT THE POINT OF TRANSITION

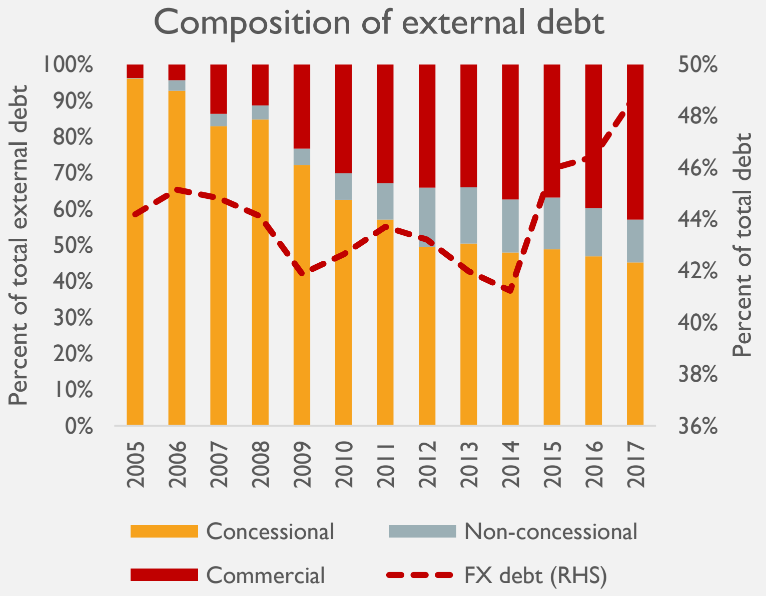
- While a strong fiscal position at the point of transition is not essential for implementation of IT frameworks, it is very important that monetary policy is not dominated by fiscal operations (Debelle, 2001; Masson et al., 1997; Mishkin, 2001)
- However, fiscal reform in developing countries is an 'indispensable step' before implementing inflation targeting regimes (Kumhof et al., 2008)
- A country needs to strengthen its fiscal position prior to the transition to inflation targeting (Carare et al. 2002)

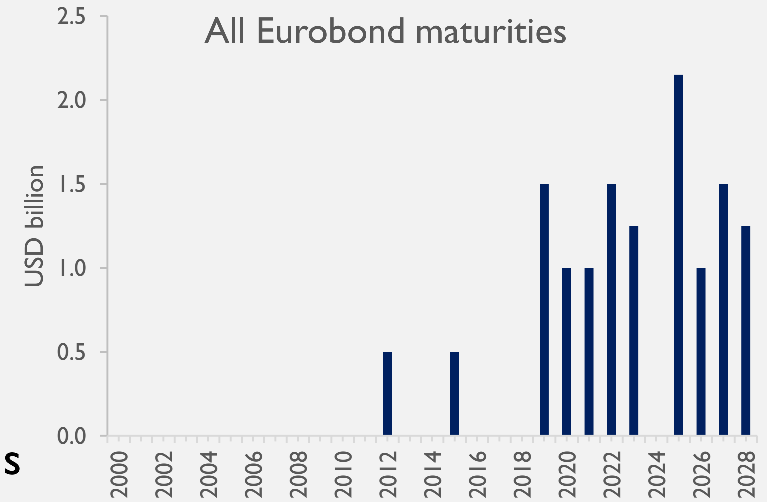


Source: World Economic Outlook; Rogers (2009); and author's calculations

FISCAL POSITION IS CHARACTERIZED BY HIGH DEFICIT/DEBT, GROSS FINANCING NEEDS & A DETERIORATING DEBT PORTFOLIO







Note: The bubble size corresponds to the gross debt to GDP ratio.
IMF World Economic Outlook, IMF Fiscal Monitor, CBSL and author's calculations

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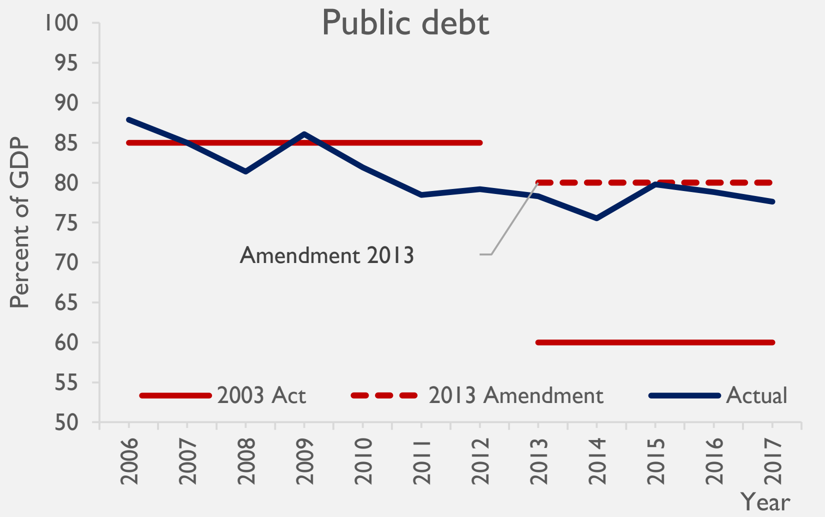
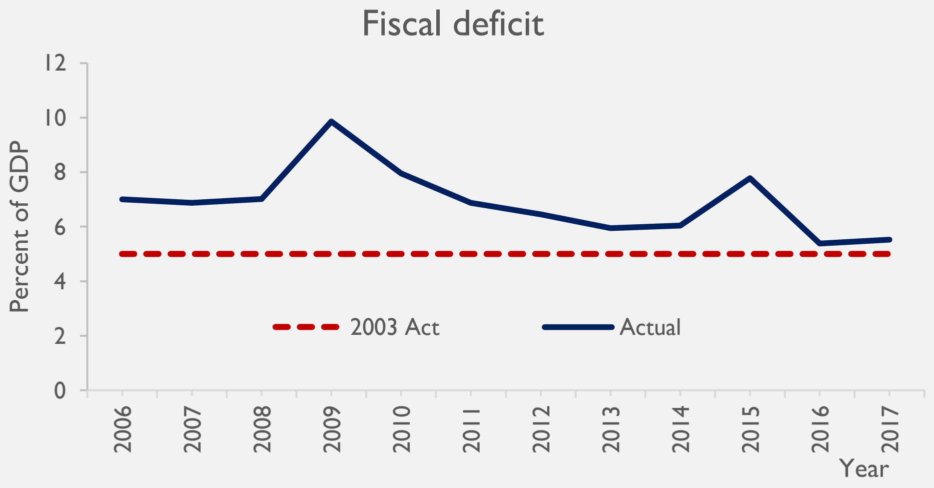
SRI LANKA'S ADHERENCE TO ITS FISCAL RULES FRAMEWORK

Requirement	FMRA 2003	Amendment 2013	Amendment 2016
Fiscal deficit (share of GDP)	Less than 5 percent by 2006 and beyond	Unchanged	Unchanged
Public debt (share of GDP)	Less than 85 percent by 2006 and less than 60 percent by end 2013	Less than 80 percent by end by end 2013 and less than 60 percent by 2020	Unchanged
Treasury guarantees (share of GDP)	Less than 4.5 percent based on 3-year moving average GDP	7.5 percent of GDP	10 percent of GDP





CONCLUSIONS

- A monetary authority has limited space to acknowledge even if it is adjunct to fiscal operations.
- However, implementing an IT regime could expose a monetary authority unlike a TMT by making it accountable for achieving an inflation target while fiscal operations continue to complicate monetary policy operations
- There is no perfect time; however, it is important to get the 'right' timing (e.g. Turkish example)
- Sri Lanka's balance of deficit/debt and legal/institutional dynamics is tilted towards fiscal dominance by international norms
- Provisional advances based on budgeted revenue, zero interest, purchase of treasury bills in the primary market are characteristics that go well beyond international practices, even in the context of the developing world.
- In addition to systemic issues, there were sporadic interventions by the fiscal budget. Fiscal improvisation can not be rule out.
- Cabinet approval for Amendments to the MLA by 2018 for submission to Parliament by March 2019 is a SB under the IMF EFF.
- Agreeing on phasing out fiscal influence in 'spirit' in addition to enshrining legal safeguards before implementing IT.
- Failure to do so might impact the success of implementing IT and the credibility of the CBSL.