Fiscal Dominance of Monetary Policy and Chronic Inflation in Sri Lanka[1]

Dr. Harsha de Silva

Lead Economist, LIRNEasia[2]

Abstract

This paper takes the position that high inflation in Sri Lanka is not a sudden onset to be blamed purely on the escalation of global energy and commodity prices. Instead the paper argues that it is a chronic disease that has its roots in fiscal dominance of monetary policy. The paper argues that while curative solutions to the current problem lie in a tight monetary program, the preventive remedy is to create an independent central bank, free of fiscal dominance, with pursuance of price stability as its primary objective.

1.0 Introduction

This paper focuses on 'remedies' for the 'disease of chronic inflation'; first immediate action to address the current situation and thereafter on policy required to minimise the probability of repeat. Thus, borrowing from medical parlance, the remedies prescribed are two fold; one curative, and the other preventive.

At the outset, it must be mentioned that the fallout of inflation experiencing in Sri Lanka is multi-dimensional, consisting of economic, social as well as political components. Working through the general price level, interest rates, exchange rates and wages, high inflation has led to a number of real consequences. This paper will not elaborate on these consequences, i.e., the symptoms of the disease, but only highlight that, even though comprehensive data is not readily available, it is most likely that the major socio-economic fallout is an increase in poverty, particularly among the most vulnerable segments of the population. Wijewardene (2008) explains this outcome well when he says "...when inflation raises its ugly head, it is (also) like a terrorist who has no mercy on anyone who fails to index his income with inflation. Irrespective of age, sex, wealth, creed or race, inflation impoverishes everyone... That is why during normal times, inflation is regarded as public enemy number one." At a more macro level, high inflation makes exports less competitive while artificially cheapening imports. The continuously worsening trade balances in recent times is ample evidence of this combined effect of export-tax and import-subsidy.[3] Another significant consequence of inflation is that it favours government over the public through what is referred to as inflation tax; where the value of public debt is reduced as real cash balances of the public is diminished. Furthermore, high inflation over a sustained period can take its toll in terms of political disturbances. Even though violent protests against increasing prices were not seen in Sri Lanka, dissatisfaction simmers under the surface.

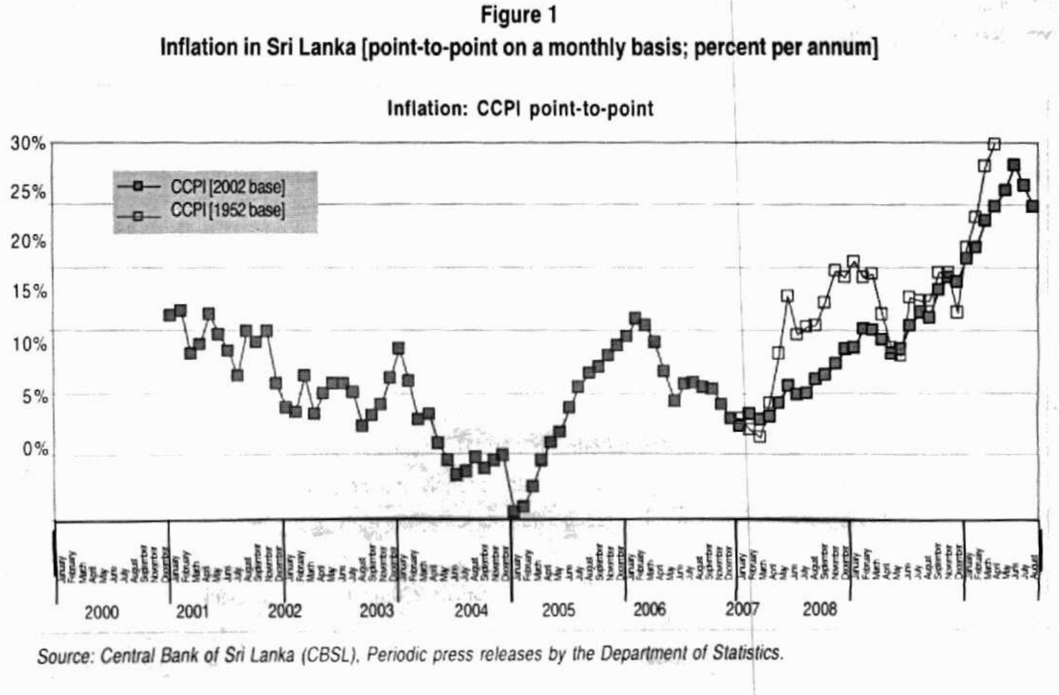
The fallout of inflation manifests itself in a combination of real consequences or, shall we say, symptoms as explained. It is not uncommon for politicians to knowingly and convincingly confuse these symptoms with the disease of inflation. By doing so, they could prescribe remedies that are politically beneficial to them in the short run, but detrimental in the long run. The New York Times of September 4th 2008 recounted a discussion between Mr Ali Zardari, the current Pakistani President and a key cabinet minister that amply demonstrates this point.[4] It said "In April, Mr. Zardari told Ishaq Dar, the finance minister at the time... that he wanted the price the government paid to farmers for wheat to be raised substantially as a way of rewarding an important constituency in Punjab Province. The government would then have to heavily subsidise the cost of wheat to the consumer. When Mr. Dar asked Mr. Zardari how he thought the government would pay for the subsidy, Mr. Zardari replied, "Print the notes," ... In an effort to solve the impasse over the subsidy, it was suggested that Mr. Zardari form a committee of experts. 'I am the expert,' Mr. Zardari said..." As we all are aware, millions of Pakistanis are suffering under a huge burden of inflation today, and as at the time of writing this paper, only slightly behind Sri Lanka.

The rest of the paper is organised as follows: Section 2 considers the extent of the inflation problem using a two-perspective assessment. Section 3 has a discussion on the causes of inflation in Sri Lanka at present. Section 4 details the issue of fiscal dominance of monetary policy, and section 5 offers solutions to the problem with some concluding thoughts.

2.0 Assessment of the Inflation Problem

In this background, the first task for us is to determine how bad the disease really is, in Sri Lanka. This assessment must have two dimensions. One, a measurement of the problem that provides a historical perspective and another that provides a comparative perspective. Only such an analysis would provide an independent and contextual appraisal of the problem.

Figure 1
Inflation in Sri Lanka [point-to-point on a monthly basis; percent per annum]



Source: Central Bank of Sri Lanka (CBSL), Periodic press releases by the Department of Statistics.

Sri Lanka has had a fairly chronic problem of inflation with a two-digit number being more of the norm since the reforms of 1977. The episodes of 1980-81 and 1989-90 were particularly bad registering annual average inflation, measured by Colombo Consumer Price Index (CCPI) of 26.1 and 21.5 percent respectively. While this paper will not consider these two episodes, the large government expenditure programs that resulted in increased aggregate demand that led to the high inflation periods is most relevant to the discussion to follow.

It is not possible to pin point an exact start date for the current bout of global inflation, suffice it to say that a number of countries have seen their inflation rates increasing in the last couple of years. Given the concern in this paper is Sri Lanka, we consider the actual outturn of inflation to determine a start point for the analysis. The series in Figure 1 points to a decline in inflation from the beginning of the decade until the end of 2003. Thereafter inflation rises sharply starting from 2004, dips in 2005 and accelerates in 2006, 2007 and until mid 2008 before easing in the last two months. It is necessary to note that the 1952 basket used to measure CCPI, which is generally used to calculate inflation in Sri Lanka, was replaced with a revised basket with 2002 as the base year.[5] This new data series starts from 2006 and is incorporated into the old series which ends in April 2008.

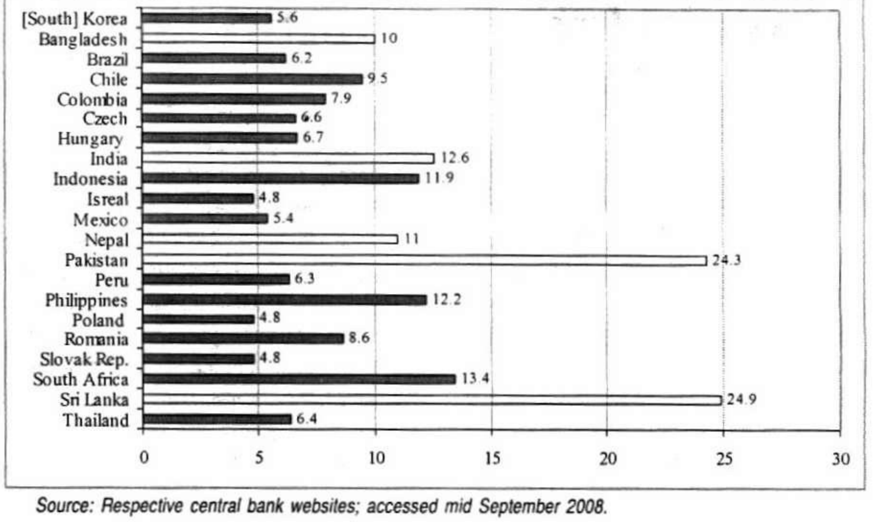
The data clearly points to a significant difference in the pre-2004 and the period thereafter. In fact, year-on-year inflation increased from 0.5 percent in January 2004 to as high as 28.2 percent in June 2008 before falling to 24.9 percent in August 2008.

The next assessment is a comparative one to consider the severity of the inflation problem in Sri Lanka compared to other countries. As in the case of period selection, this is not a straightforward assessment either. The set of countries to compare will always be subjective unless all countries are selected. Therefore, a combination of two groups of countries; one, countries of the South Asian Association for Regional Cooperation (SAARC), and the other, the set of thirteen emerging-market countries that has adopted a strict inflation-targeting regime and the subject of a number of recent analyses (Gonsalves et.al., 2008; Ball, 2008; Epstein, 2007). While the SAARC countries provide a regional comparison to Sri Lanka, the inflation targeters provide a contrast with countries that strictly adopt a single-focus monetary policy of inflation control.

Figure 2 provides an interesting comparative analysis.[6] While acknowledging that many

Figure 2

Comparative inflation rates, August 2008: Consumer prices, percent per annum



Source: Respective central bank websites; accessed mid September 2008.

countries saw significant increases in inflation over the last two years, Sri Lanka, in August 2008 (the end of period under consideration) remained the country with the highest level of inflation in the selected group. Pakistan followed Sri Lanka closely. The mean for the SAARC nations comprising of Bangladesh, India, Nepal, Pakistan and Sri Lanka (data for Afghanistan and Maldives not available) is relatively high at 16.6 percent compared to the mean of 7.4 percent for the thirteen emerging-nation inflation targeters.[7]

The two perspective assessment of inflation indicates that in Sri Lanka, the disease of inflation was and continues to be significant.

3.0 The Debate on the Causes for Inflation - Monetary Policy

Given the evidence presented earlier, Sri Lanka has faired poorly in controlling inflation in the recent past. However, there has been an unprecedented debate on the reasons behind the outcome, sometimes the officialdom even going beyond accepted norms in dealing with criticism. Critics have been arguing strongly that loose monetary policy adopted by the Central Bank has been the primary driver of the high inflation outcome of the recent past (de Silva, 2008b and 2008c; Lanka Business Online; International Monetary Fund (IMF), 2007; Hanke, 2008; Rajapatirana, (forthcoming)). However, the Central Bank has been equally strongly arguing that the primary reason was not loose monetary policy, instead, cost push factors; both domestic and external (CBSL, 2007; CBSL, 2008). The Central Bank Annual Report for 2007 provides a typical explanation of this position:[8]

"This adverse development (high inflation) was a combined effect of several factors both of domestic and external origin. On the domestic front, the terrorist disturbances in major paddy producing areas in the North and East, bad weather conditions and higher demand for rice due to the substitution effect arising from higher wheat prices had an adverse impact on domestic rice prices... On the external front, the continued escalation of global oil and gas prices led to upward adjustments in domestic prices of these items at several occasions during the year, exerting direct and indirect impact on the prices of consumer items at varying intensities. Equally, the adverse developments in the international commodity market coupled with both global supply shortages and increased demand, raised the prices of major imported food commodities such as wheat and milk foods, particularly towards the second half of the year... *These external developments and supply shocks had an overriding impact on prices, though the demand pressure was notably curtailed by implementing a tight monetary policy programme*".

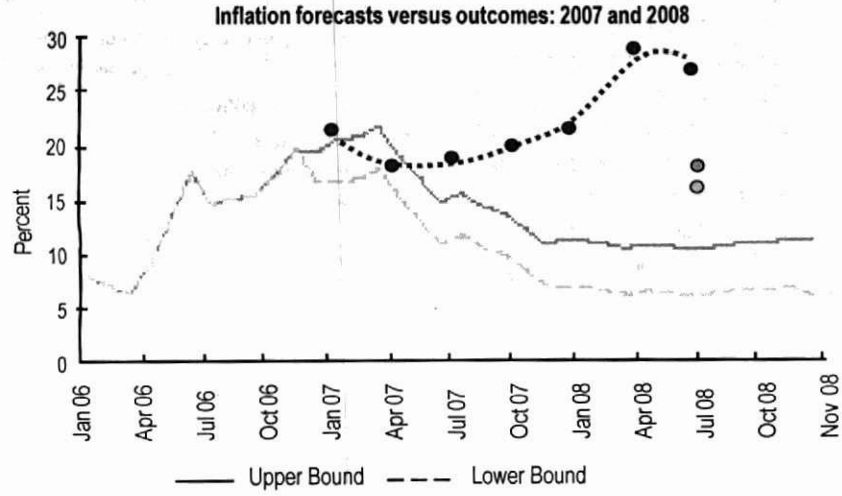
While there is no disagreement that the rapid rise in global energy and commodity prices have had an impact on inflation in perhaps every country, the moot point is that in Sri Lanka, there seem to be a large residual in inflation after accounting for the same. This is the component which critics have been arguing is due to poor monetary policy. One of the more controversial assessments is Duma (2008) who used a rigorous approach to show that external shocks explained only about 25 percent of the variation in consumer price inflation which implied that the rest was domestically generated.[9] The pertinent question is not the exact size of the domestically-generated component of inflation, but the existence of a significant amount of domestically-generated inflation which is an indictment on both the monetary and fiscal policy management, immaterial of what is officially disseminated. In this background, the argument of the authorities that monetary policy was tight and rested firmly on the position that the Central Bank successfully met its reserve money targets. This position interestingly was put forward for the period of 2007 and beyond, and not to periods prior to that. The fact is that in the pre-2007, the Central Bank overshot reserve money targets habitually, but post-2007, these targets were met almost religiously. However, the post-2007 question became one on the appropriateness of the tightness of the targets. That frequent predictions made by the Central Bank on falling inflation failing to materialise in spite of targets being met was fodder to this new debate. While there was never a contention that tightening monetary policy worked with some lag, perhaps from several months to even years, the presumption was that the Central Bank would have calculated such lags when the forecasts were published, particularly in the Monetary Policy Road Maps for 2007 in January that year and then for 2008 in January of this year. The outcome of inflation for 2007 and thus far in 2008 in contrast to the forecasts is depicted in Figure 3 as the dashed line connecting the dots depicting actual outturn.

Bank without causing any harmful effect on the growth momentum of the economy." What is noteworthy is that even though actual inflation continued to diverge from the forecasts and the criticisms highlighted the need for further tightening of monetary policy, reserve money targets were not revised downwards for a long period.[10] An officer of the Central Bank responding to one such criticism of non revision of reserve money targets put forward the position of the Central Bank on 6 April 2008 as follows "...he (referring to de Silva (2008b) now creates arguments for a further downward revision in the *reserve money which had already been set too tight*. If his suggestion is accepted, the bank should reduce the reserve money target..." Ironically, three weeks later, immaterial of the Central Bank's own statement that monetary policy was 'too tight' reserve money targets were revised downwards. A statement released to press stated the following "Therefore, after carefully reviewing the current global and local situation as well as expected developments, the Central Bank has decided to further restrict its quarterly targets for reserve money through a downward revision for the remaining three quarters of 2008."[11]

De Silva (2008a) provides a more comprehensive analysis of the relationship between reserve money growth and inflation outturn for the period of 2002 to

Figure 3

Inflation forecasts versus outcomes: 2007 and 2008



Source: Reproduced from the CBSL Roadmap for monetary and financial sector policies, 2007, Chart 6. The two points for June 2008 marked up on the same chart with same indicative colours is from the 2008 document (adverse scenario; approximate figures for June 2008: minimum 16 percent; maximum 17.5 percent)

Immaterial of the lag, the officialdom's counter to the criticism of loose monetary policy was that, if the reserve money targets were met, then monetary policy would be sufficiently tight and inflation would fall. Statements were routinely released to the public articulating this position. For instance a press release issued by the Central Bank on July 2007 pronounces "The achievement of reserve money targets clearly suggests that inflation will be brought under control as already predicted by the Central

2008 using a four sub-period setting. This analysis highlights the particularly indisciplined periods in 2004, 2006 and partly in 2007 where Central Bank exceeded its reserve money growth targets (whether sufficiently tight or not) by significant amounts feeding subsequent periods of high inflation. It must be noted however, that since 2007, the Central Bank has been generally hard-nosed about meeting the targets and have, in fact, met each of the end-quarter targets even though the daily averages may have exceeded the targets. Since the beginning of 2008, the Central Bank has gone even further by calculating reserve money targets in terms of daily averages. The discussion whether the targets were correct, particularly in the context of a managed exchange rate regime, is another matter.

4.0 Fiscal dominance of monetary policy

Even though the discussion thus far dealt with the issue of loose monetary policy, the diagnosis cannot be limited only to monetary policy, because if so, the remedies to the disease of inflation too will be limited. Therefore, the crucial question of why the Central Bank of Sri Lanka behaved in the way it did must be inquired. Wijewardene (2008), provides a number of clues to answer to this question, without pointing any figures. He highlights three major issues that many emerging country central bankers have been plagued with in recent times: dealing with the fallout of high global energy and commodity prices; financing counter terrorist measures; and resisting the use of central banks for development finance. In the case of high energy and food prices, his thesis is that central banks should advise governments to pass through the market prices to the consumers and restrain from monetising subsidies to keep the domestic prices at below market levels. In the case of financing counter-terrorism, he points out that real resources must be utilised for this purpose instead of money created by central banks and adds that a "Central bank's best support for fighting terrorism by a government is to maintain price stability and help the society to create more wealth". In the case of money creation for government development programs, he insists that central bankers should not be tempted by governments to using monetary policy for creating employment and output. He reiterates the fact that the twin central bank objectives of employment and price stability are in conflict with each other, and that when a central bank expands money supply to spur economic growth, it ends up creating inflation, not employment. He adds that is why Milton Friedman repeatedly announced that "inflation is always and everywhere a monetary phenomenon".

In answering our question, it becomes important then to examine how the Central Bank of Sri Lanka responded to the three challenges. In the case of increasing global fuel prices, the Government quite early on, in 2002, adopted a transparent formula by which international market prices were passed on to the consumers. (IMF, 2006) While there were one-off price revisions during the period the formula was in implementation, inflation actually fell.[12] But, the use of the formula was abandoned electionin 2003, and since then fuel prices became heavily subsidised until another pass through mechanism was introduced in late 2006. De Silva (2008a) provides an analysis of excessive growth in reserve money in 2004 and 2006 (by 40 percent more than the target) corresponding to this period of heavy fuel price subsidy possibly indicative of the role played by the Central Bank.

In the case of funding counter-terrorist measures, it is not possible to identify episodes of money creation for the specific purpose, but suffice it to say that the resources allocated to the Ministry of Defense increased significantly during the period (Ministry of Finance Annual Report, 2007). Given the sensitivity of the subject, this paper refrains from discussing this matter further. But it has to be noted that for the Government to continue to finance the war on terrorism, it must cut down unnecessary and poorly-conceived projects. In time of a national emergency, it behoves the Government to be even more circumspect than usual by saving money by not undertaking poor projects

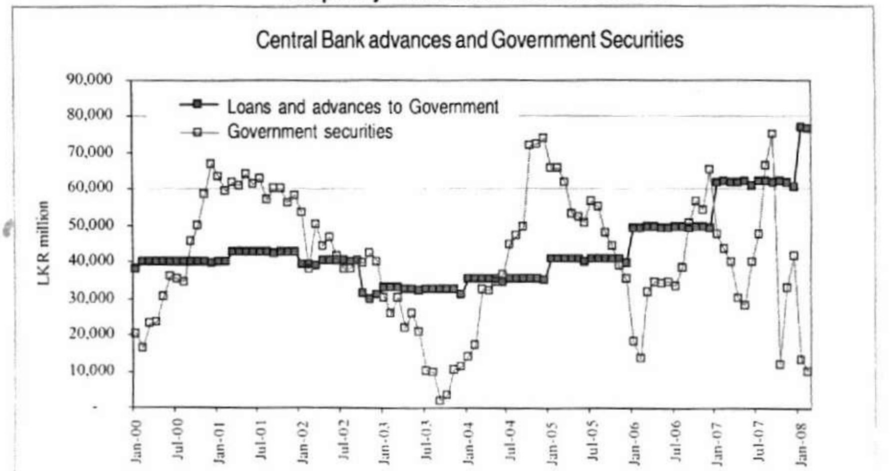
Next, and most importantly, in the case of a central bank being called upon by the government to finance development projects, the score is not at all good. Sargent and Wallace (1981) highlight the difficulties of running monetary policy in an environment where fiscal policy is unsustainable. They bring in the notion of a 'fiscal dominant' regime, where the fiscal authority independently sets its budget, announcing current and future deficits and, hence, determining the amount of revenues that must be raised through bond sales and seignorage. Liviatan (2003) simplifies the fiscal dominance of monetary policy argument as follows "That any arbitrary fiscal policy has to be supported by monetary policy." Whether admitted or not, this phenomenon has been experienced in Sri Lanka, not only in the recent past but in earlier periods as well. Rajapatirana (forthcoming) points to the massive bout of inflation in the 1980-81 period when the CCPI recorded its highest increase of 26.1 percent since its compilation; as a result of precisely such government action where expansionary impact of the fiscal operations was the highest recorded in absolute amounts since independence with the overall fiscal deficit soaring to 23.1 percent of GDP with a massive increase in public expenditure on the Accelerated Mahaweli Development Program, and similar public expenditures accommodated by monetary policy. This was only one of many such episodes. By Sri Lanka's own bitter experiences, policy makers are very much aware of the dangers of allowing monetary policy to be dominated by fiscal policy.

In this context it is necessary to examine the recent experience of fiscal dominance of monetary policy; here to mean the monetary accommodation of (arbitrary, or quasi arbitrary) fiscal policy. The Government in office from roughly 2002 to 2004, maintained an unusual amount of fiscal discipline; subsidies were slashed, expansion of government was halted, no new state jobs were granted, an early retirement program was started and the privatisation program continued (Central Bank Annual Reports, 2003, 2004, 2005). It also passed a piece of legislation called the Fiscal Management (Responsibility) Act (FRMA) which by 2006, bound Governments to a fiscal deficit to 5 percent of GDP and total government borrowing to 85 percent of GDP. During this period, reserve money growth was well under control at 12 percent per year and inflation fell quite dramatically from almost 14.9 percent in November 2001 to 2.5 percent in March 2004 (de Silva 2008a). However after April 2004, this policy was reversed. The job freeze was overturned and some forty thousand new state jobs were granted in the first year alone (CBSL, , subsidies were enhanced (CBSL, the privatisation program was halted and numerous new state ventures, some obviously lacking in careful analysis, were established. This obviously punched a hole in the tight fiscal restraint program. De Silva (2008a) shows how the reserve money targets in 2004 overshot the 15 percent target by 6 percentage points indicating massive monetary accommodation (a 40 percent increase). The change of presidency in late 2005 reiterated the policies of the Government in office with continued increases in the cadre of public sector and the armed forces, substantial increases in salaries, wages and pensions of state employees as well as the continuation of subsidies in petroleum, electricity, water, transport, education and numerous other welfare measures. Even after substantial reductions in capital investments, the current expenditure overruns still meant substantial fiscal deficits in the 8 percent of GDP range; well above the 5 percent limit prescribed by the FMRA (Central Bank, 2005). De Silva (2008a) points to evidence of fiscal dominance of monetary policy again available in 2006 with the 15 percent reserve money target once again breached by a forty percent increase to 21 percent. As expected, inflation at the beginning of 2007 registered a high level of 20.5 percent, and, at the beginning of 2008, yet again, 21.6 percent.

Usvatte-aratchi (2008) referring to the ongoing debate on the subject makes an interesting observation.[13] He says "... is on rock solid ground when he argues that the Central Bank has the authority and indeed the instruments to control inflation." But he continues "The Central Bank is in a hard place because while it has authority, it has no power to pursue monetary policy independent of Government..."

The crucial issue is if the status-quo remains, what would the future hold? While it is not going to be easy to explain to the Government that continued fiscal dominance of monetary policy is 'suicidal', the Central Bank cannot and must not turn a blind eye to reality. In fact, in the role of the 'economic adviser to the Government' people do expect the Central Bank to undertake this arduous task. Wijewardene (2008) provides direction when he asserts that "The biggest challenge faced by central bankers is to first convince themselves that it is hard work that creates wealth, output and employment and not money, and then convincing all others who have illogically kept high hopes about central banks that they should use monetary policy to spur economic growth." Perhaps it is worthwhile to provide just one simple aspect of this phenomena that has not received the attention it requires. In Sri

Figure 4
"Temporary" advances to the Government



Source: Central Bank monthly bulletin (latest available figure is for February 2008)

Lanka, under Section 89 of the Monetary Law Act, the Government is entitled to borrow up to 10 percent of the expected revenue of the year through what is referred to as a 'provisional advance' from the Central Bank; in a sense, a printed money overdraft. Even though they are to be paid back, within six months, these 'provisional' advances have become permanent credits. The current situation as depicted in Figure 4 indicates that since 2000, except for two occasions (January and July 2002), these provisional advances have not been repaid. Instead, the volume had doubled from LKR 40 billion to LKR 80 billion during the period under review.[14]

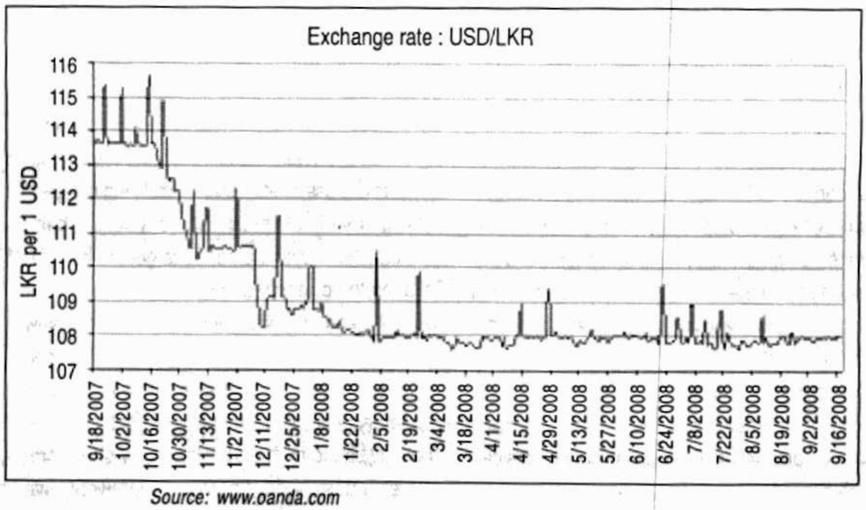
5.0 Remedies and concluding thoughts

5.1 Curative remedy

The preceding discussion provides the background to make a rational diagnosis of the domestic component of the inflation disease, as measured by the large residual in inflation after accounting for the global shocks, particularly in terms of energy and food prices. *Immaterial of the exact size of this* component, the foregoing discussion pointed to evidence to implicate monetary accommodation of fiscal needs by overshooting reserve money targets by as much as 40 percent be it via monetising subsidies to deal with rising global energy and commodity prices; financing counter terrorist measures; or provision of Central Bank funds for various Government projects.

The remedy, it was mentioned at the beginning of the paper would be two-fold; one curative, the other, preventive. As it is clear from the foregoing discussion, the curative remedy in the face of high inflation is to maintain a sufficiently tight monetary policy for demand management via the appropriate tools available to the Central Bank; policy interest rates, open market operations to maintain reserve money levels and statutory reserve requirements. In this regard, the Central Bank has in the recent past stubbornly maintained a tight regime based on its annual 'monetary policy roadmap' which is released to the public at the beginning of the year. Both these activities; keeping money tight and sticking to pre-determined targets must be applauded as it helps bring in predictability and would certainly help build the much needed reputational credibility, perhaps the greatest asset of a central bank. In the meantime, however, the Central Bank should not attempt to use the significant discretion it has over exchange rates for short-term gain within the current managed-float regime. Rajapatirana (2008) notes that in the recent past, the Central Bank has kept the exchange rate, as it claims, on a stable path, not allowing wide swings in either direction leading to appreciating or depreciating rates. Noting that the former is more tempting for the Central Bank since it can use the exchange rate to keep prices from rising further, he points out that such a policy is damaging the economy in the sense an appreciated exchange rate acts as a tax on exports and a subsidy on imports. He notes that it will harm both export and import activities. This takes on much significance as the exchange rate of the US dollars in Sri Lankan rupees has been unusually stable (see Figure 5); almost constant since the beginning of 2008 to date [10 September 2008] even though Sri Lanka registered a cumulative 15 percent inflation over the period as measured by monthly changes. The problem would take a more serious turn if, as it seems, the Central Bank resorts to borrowing abroad to defend the exchange rate at these levels.

Figure 5
Movement of USD/LKR nominal exchange rate



Source: www.oanda.com

The tight monetary policy remedy is not without significant side effects. Uswatte-aratchi (2008) analyses the consequences of tight monetary policy to bring down inflation. He says "Government expenditure will rise when it sells treasury bills at new high interest rates and debt interest payment will rise. Tax revenues will fall because at such high rates of interest, as economic activity, which in our country depends heavily on bank loans and overdrafts, will wither. Tax revenue will also fall because exports will fall with a rise in exchange rates. If Government will not cut government expenditure drastically, inflation will rage on with high money interest rates. If the Central Bank then raises money interest rates further to control inflation, this whole spiral will continue screwing down the economy to high unemployment." Tight money will certainly reduce demand and slow down growth; that's after all its objective. The point is that once demand falls and inflation comes back down, there is no need to continue to have an unnecessarily tight monetary policy; the Central Bank can maintain the right amount of liquidity in the economy that is necessary for lubricating growth. This is the balancing act a central bank is expected to play. Whether it is possible for any central bank to actually perform this role in an environment of fiscal dominance is the important question.

5.2 Preventive remedy

The foregoing section makes it clear as to why the longer-term remedy for inflation is preventive in nature. One of the more sustainable long-term remedy would be to create an independent Central Bank with pursuance of price stability as its primary objective. Implicit in the proposed independence are institutional arrangements to ensure that the Central Bank is effectively safeguarded from being dominated by the Government. At the outset it must be admitted that, the evidence on central bank independence and low inflation, is still ambiguous. The literature on the subject is vast; see Crowe and Meade (2008) for some interesting new findings. Among the problems with the ambiguity of the research findings is due to problems in the measurement of central bank independence; legal independence enshrined in law; goal independence where a central bank has the authority to independently set and follow its own policy prerogatives; instrument independence where a central bank sets a policy instrument in pursuit of a goal specified by the government, etc. Another issue is dejure versus de facto independence as, in many occasions the independence on paper measured by researchers and the independence in reality are substantially different. However, the important fact is that while there is still debate among academia over the strength of the causal relationship, there has been a significant global trend towards increasing independence of central banks in the last decade and a half, in an attempt to achieve sustainable low inflation (Jácome and Vázquez, 2005)

As one would expect, the discussion of central bank independence is usually politically-charged and in many developing countries that have not seen periods of hyperinflation, the promotion of central bank independence is looked by the political establishment as a way to reduce the 'power' of an elected Government. This is not uncommon to Sri Lanka.

In this context, it is interesting to note some early thinking of the subject form a developing country standpoint. In 1933, Sir George Schuster, the civil servant who had been de facto Finance Minister of India had introduced the Reserve Bank of India (RBI) Bill in the following manner:[15]

> "In modern life and in modern economic organisations, there are two important functions: There are the functions of those who have to raise and use money and there are the functions of those who are responsible for producing the actual tokens of money, the money in circulation. The basis of the whole proposal for setting up an independent central bank is to keep those two functions separate. The largest user of money in a country is the government, and the whole principle of the proposal is that the government, when it wants money to spend, should have to raise that money by fair and honest means in just the same way as every private individual has to raise money which he requires to spend for his own maintenance. If the government is in control of the authority responsible for exercising the other function, then all sorts of abuses can intervene."

Schuster was right; numerous abuses ensued in varying degrees over time. By the 1980s and early 1990s, the Government of India's habitual deficit monetising program had created inflation problems for India. Narendra Jadhav, Principal Advisor and Chief Economist of the Reserve Bank of India was recently quoted as having commented that "RBI had become like a cookie jar, where the Government, as and when they wanted, could just dip into the cookie jar and take what they wanted".[16] It was only in the mid nineties that significant changes in this 'abusive' relationship took place when agreement was reached to reduce and then eliminate the arbitrary financing of government debt by the reserve bank via rampant and unpredictable issuance of supposedly short-term, but in fact permanent, 'ad hoc' treasury bills to fund what was called ways and means advances. In fact, it was a contractual agreement singed in 1993 between the RBI and the Ministry of Finance that finally paved the way for the elimination of the automatic monetization of deficits over a four year period leading to generally lower levels of inflation since the mid 1990s albeit the recent surge.[17] In this context, to achieve a more sustainable low inflation regime, new recommendations have been made for RBI independence. The recent draft report on Financial Sector Reforms for India becomes noteworthy in this context.[18] The report makes two key recommendations: The Reserve Bank of India must start targeting inflation; and RBI should use only interest rates to manage its monetary policy. Traditionally, as in the case of Sri Lanka, the twin pillars on which the monetary policy of the RBI rests are price stability and growth. In underlining the need for independence of the RBI to move into an inflation targeting regime, the report noted that "The committee would like to stress the importance of leaving the determination of monetary policy and interest rates entirely in the hands of RBI."

As in the case of central bank independence, the debate on inflation targeting is also yet to merge into universal acceptance of its usefulness in creating low inflation regimes. However evidence to suggest that inflation targeting is perhaps a better solution than the alternative has been growing in recent times. While it is beyond the scope of this paper to discuss inflation targeting at length, suffice it to say that it is a policy where a central bank publicly announces a numerical target or a band for inflation to be reached over a period of time for which it takes *full responsibility*. 'Invented' in New Zealand in 1989/90, inflation targeting is a rule-based regime where the central bank will conduct monetary policy to achieve the target by utilising tools available to it; particularly very short-term interest rates. Today, there are over twenty five countries that have adopted inflation targeting with remarkable success. Some recent work, particularly Goncalves and Salles (2008) considering the evidence of inflation targeting in a number of developing countries concluded as thus; "Compared to non-targeters, developing countries adopting an inflation targeting regime not only experienced greater drops in inflation, but also in growth volatility, thus corroborating the view that the regime's constrained flexibility to deal with adverse shocks delivered concrete welfare gains". Comparing Brazil, Chile, Columbia, Czech Republic, Hungary, Israel, Mexico, Peru, Philippines, Poland, South Africa, Thailand and South Korea that had moved on to inflation targeting regimes by 2001, with a similar set of countries without an inflation targeting regime, the authors find that the targeters were able to bring down inflation by 11.4 percentage points during the study period (until end 2005) whereas the non-targeters were only able to reduce inflation by 6.5 percentage points. These findings for developing countries are even more relevant as they deal effectively with the findings of Ball and Sheridon (2005) that inflation targeting may have been irrelevant among Organisation for Economic Cooperation and Development (OECD) countries and that larger drops may be attributed to mean reversion.

Recalculating the Goncalves and Salles (2008) inflation data for August 2008, it is found that the mean inflation for the 13 inflation targeters in the sample is 7.4 percent as opposed to 5.5 percent in end 2005. Comparing this figure with the mean of 16.6 percent for the SAARC nations (author's calculations) comprising of Bangladesh, India, Nepal, Pakistan and Sri Lanka (data for Afghanistan and Maldives not available) who are all non-targeters with much less independence than the targeters provides some useful food for thought. While no claim is made that the targeters' mean is less than the non-targeters, purely because of the inflation targeting regime, it would not be implausible to make such an inference, and call for further study on the subject.

In the current situation, one must make a decision. Should Sri Lanka continue the way it has or should it change course by creating a more independent Central Bank with the primary objective of price stability. This paper provides some evidence for the latter. It seems that is also the position of the Central Bank; as it announced in the 2008 announcement of the Monetary Policy Roadmap that inflation targeting could possibly be an option for the Central Bank to consider at 'some stage in the future.'[19] Perhaps it might be better to accelerate the time line and bring the target date closer to the present.

5.3 Concluding thoughts

This paper took the position that the current inflation crisis in Sri Lanka is not a sudden onset, but a chronic disease. The resulting implication is that it is not possible to allocate the total blame to the ongoing global inflation with regard to commodities and energy. While there is some external impact on local inflation, the paper argued that fiscal dominance of monetary policy has been an overarching long-term problem pointing to a number of examples during the period under review and even beyond. Thus, the paper naturally argued that while the short-term or curative solution to inflation lie in tight monetary policy the sustainable long-term or curative remedy would be perhaps to create an 'independent' Central Bank, free (or with limited) fiscal dominance, with pursuance of price stability as its primary objective. This means that action to deal with the disease of chronic inflation is political in nature and must be initiated by Government with the full knowledge that the 'power' enjoyed by politicians in getting the Central Bank to accommodate fiscal programs for short-term political gain has to be let go for the longer-term benefit of the people of this country in terms of low and stable inflation.

References

Ball, Laurence (2008) Does inflation targeting matter? Johns Hopkins University, mimeo.

Ball, Laurence and Sheridan, Niamh (2003) Does Inflation Targeting Matter? National Bureau of Economic Research Working Paper, 9577.

Central Bank of Sri Lanka (2003). Annual Reports.

Central Bank of Sri Lanka (2004). Annual Reports.

Central Bank of Sri Lanka (2005). Annual Reports.

Central Bank of Sri Lanka (2007a). Annual Reports.

Central Bank of Sri Lanka (2007b). Monetary Policy Review, monthly.

Central Bank of Sri Lanka (2008). Monetary Policy Review, monthly.

Crowe, Christopher and Meade, Ellen E. (2008). Central Bank Independence and Transparency: Evolution and Effectiveness. IMF Working Papers 08/119.

De Silva, Harsha (2008a). Turbulence in inflation in Sri Lanka: A look at the recent past, in Managing Financial Institutions in Turbulent Times, Association of Professional Bankers, 20th Anniversary Publication.

De Silva, Harsha (2008b). "Money printing, inflation and inflation targeting: Right of reply", Sunday Times, 20 April 2008 http://sundaytimes.lk/080420/FinancialTimes/ft313.html .

De Silva, Harsha (2008c). Time for legislating 'inflation targeting' Sunday Time 16 March 2008 http://sundaytimes.lk/080316/FinancialTimes/ft315.html .

Duma, Nombulelo (2008). IMF Working Paper WP/08/78, March 2008, Pass-Through of External Shocks to Inflation in Sri Lanka.

Epstein, Gerald (2007). Central banks as agents of employment creation, DESA Working Paper No. 38, ST/ESA/2007/DWP/38.

Gonçalves, Carlos Eduardo S., Salles, João M. (2008). Inflation targeting in emerging economies: What do the data say? Journal of Development Economics 85.

Hanke, Steve H. (2008). Sri Lanka: Slaying the Bogey of Inflation, CATO Institute.

Hefeker, Carsten, Hayo, Bernd (2008). Does Central Bank Independence Cause Low Inflation? A Skeptical View, University of Marburg - Faculty of Economics and Business Administration, Paolo Baffi Centre Research Paper No. 2008-04.

IMF (2006). Sri Lanka: Selected Issues, Country Report No 06/447.

IMF (2007). Staff Report for the Article IV Consultation.

Jácome, Luis I., and Vázquez, Francisco (2005). IMF Working Paper, Monetary and Financial Systems Department, Any Link Between Legal Central Bank Independence and Inflation? Evidence from Latin America and the Caribbean.

Lanka Business Online; The Thrift Column, http://www.lankabusinessonline.com/showsubcategory.php?cc=23&t=s&nm=The%20Thrift%20Column

Liviatian, Nissan (2003). Bank of Israel Discussion Paper, Fiscal Dominance and Monetary Dominance in the Israeli Monetary Experience

Ministry of Finance, Government of Sri Lanka (2007). Annual Report

Mohan, Rakesh. (2003). Fiscal issues and central banks in emerging markets: An Indian perspective, BIS Papers 20, Bank for International Settlement http://www.bis.org/publ/bppdf/bispap20l.pdf

New York Times, 4 October, 2008

Rajapatirana, Sarath. (forthcoming). Recent Inflation in Sri Lanka: Recent Inflation in Sri Lanka: Causes and Consequences.

Sargent, T and N Wallace, Fall (1981). Some unpleasant monetarist arithmetic, Federal Reserve Bank of Minneapolis Quarterly Review.

Usvatte-aratchi, G. (2008). Between a rock and hard place: The controversy over monetary policy, The Island, 2008 Sept 08 http://www.island.lk/2008/09/08/features6.html .

Wijewardena, W. A.(2008) Central banking in turbulent times: Challenges for central bankers, John Exter Memorial Oration. http://www.cbsl.gov.lk/pics_n_docs/02_prs/_docs/lecture/public_lecture_20080828e.pdf

Footnotes

[1] Original paper presented at Sri Lanka Economic Association Annual Sessions in September 2008. This revised version benefited from some valuable comments from an anonymous reviewer.

[2] LIRNEasia is a regional think tank focusing on infrastructure provision at the bottom of the pyramid in emerging Asia; particularly on information and communication technology.

[3] The trade deficit expanded by 92.4 percent for the first six months in 2008 over the same period last year.

[4] http://www.nytimes.com/2008/09/05/world/asia/05zardari.html?_r=1&hp&oref=slogin

[5] A valid criticism of the new CCPI is that it has dropped the entire subcomponent of alcohol and tobacco on the grounds of an anti-alcohol and tobacco policy of the Government. This violates international norms of measuring cost of living indices and therefore understates true inflation due to fairly regular increases on alcohol and tobacco taxes.

[6] The recent argument advanced by the Central Bank of Sri Lanka that inflation cannot be compared across countries because inflation calculations are made from different baskets and weights in different countries is invalid because the same error term appears in each calculation. Suppose the inflation rates of Sri Lanka is compared with that of Bangladesh and knowing that the Bangladesh inflation estimates are made on a different basis, it is quite legitimate to compare the rates of growth of prices [or inflation] between Sri Lanka and Bangladesh because the error disappears when price changes are calculated in the same way in the same country between two periods.

[7] It is noteworthy that the end 2005 mean for these nations was 5.5 percent. This point will be discussed later in the preventive remedies section.

[8] CBSL Annual Report, 2007, page 73.

[9] After protests were lodged by the Central Bank, the IMF reiterated the same findings explaining that while 25 percent of the variation in inflation was external, 16 percent was directly attributed monetary growth and the rest to what they called 'changes in government subsidies and volatile domestic food prices'. It also noted that the analysis was for the period 2003 to 2007, which implied that half the period of analysis; 2003 and 2005, for completely separate reasons, were not periods of loose monetary policy. It is also noteworthy that when the Central Bank was criticising the Duma methodology, the use of a Vector Error Correction Model (VECM), the Central Bank had continued to use the same model to make its forecasts. The fact is that all econometric modelling is done under a set of given assumptions which lead to a substantial variance in the predictions. Rather than criticising the messenger in uncharacteristic style for a Central Bank, it should have done well to improve its own for ecasts.

[10] The actual reserve money outcome however turned out to be lesser than the target in some quarters.

[11] www.cbsl.gov.lk/pics_n_docs/02_prs/_docs/press/press_20080430ea.doc

[12] Between Nov 01 and March 04 oil prices increased by 91 percent, but inflation in Sri Lanka fell from 14.9 percent to 2.5 percent.

[13] http://www.island.lk/2008/09/08/features6.html

[14] It is true net domestic assets of the Central Bank of Sri Lanka consists of both provisional advances as well as the Central Bank holdings of Government securities (treasury bills) and that reserve money can be reduced by bringing down this total (leaving aside net foreign assets). The issue is in the context of doubling advances, reducing treasury bills to even zero will still mean the necessity for the issuance of Central Bank's own securities by the amount of increased advances to main tain the same level of monetary tightness without the increase in advances in a no reserve money growth scenario.

[15] In 1993, the former Governor of the Reserve Bank of India Chakravarthi Rangarajan quoted his Kutty Memorial Lecture "Autonomy of Central Banks"

[16] www.lbo.lk/fullstory.php?newsID=1445930831

[17] Rakesh Mohan, BIS Papers No 20.

[18] Raghuram Rajan committee's report: http://planningcommission.nic.in/reports/genrep/rep_fr/cont_fr.pdf

[19] Central Bank of Sri Lanka, Road Map: Monetary and Financial Sector Policies for 2008 and beyond