The Pathfinder Economic Alert

Monetary Policy towards increased Investment, Employment and Prosperity

Persistent fiscal imbalances have consistently complicated macroeconomic management, since the liberalization of the economy in 1977. For much of the past three decades, the Sri Lankan authorities have found themselves in the position of a "one club golfer."

Macroeconomic Management involves the judicious use of fiscal, monetary and exchange rate policies to create the economic stability required for accelerated long-term growth and development. However, over the years monetary policy has had to bear a disproportionate burden in managing aggregate demand because the other macroeconomic instruments have been severely constrained. Hence the reference to "one club golfer."

It has also been said that macroeconomic policy-making is similar to tuning a sound system. One manipulates all the knobs (treble, bass, volume etc) to achieve the appropriate balance to generate the best possible sound. One does not achieve good outcomes, if one uses only the treble. This is a good analogy for macroeconomic policy-making in Sri Lanka.

Fiscal policy has been very much part of the problem rather than the solution, when it comes to demand management. The lack of fiscal discipline has fuelled excess demand resulting in inflationary pressures and unsustainable current account deficits in the balance of payments. Consequently, budget deficits have been the main source of instability in the system.

As explained in the previous Pathfinder Foundation Economic Alert, exchange rate policy has also been largely neutered in the context of structural budget depicts. The pursuit of an active exchange rate policy in the context of a loose fiscal policy can trigger an inflationary spiral. The impact on external debt servicing is another concern. The upshot is that an active exchange rate policy has not been available as an instrument to manage excess demand, let alone provide a competitive edge to exports and import competing goods and services.

In an environment characterized by loose fiscal policy and constrained exchange rate policy, it becomes inevitable that monetary policy has to bear the brunt of the burden of demand management. The consequence of this over-reliance on monetary policy, in a context of excess demand fuelled by a lack of fiscal discipline, has been persistently high nominal interest rates. (High spreads are a different issue that falls outside the scope of this note. Interest rates have been high even when one allows for high spreads.)

This has raised the cost of capital in the economy, thereby reducing its competitiveness. This loss of competitiveness has been compounded by an exchange rate which has often been over-valued. High interest rates and an over-valued exchange rate have been the transmission mechanisms through which unsustainable budget deficits have "crowded out" the private sector.

As highlighted in the previous Pathfinder Economic Alert, it is the private sector that has to play the lead role in generating the incremental investment essential for meeting the government's accelerated growth targets (8 -10% per annum) on a sustained basis. Public investment cannot sustainably exceed its current level of 6-7% of GDP, if the twin problems of unsustainable budget deficits and excessive debt are to be addressed effectively. Over the last three decades, the capacity of the private sector to drive the economy to a higher trajectory of growth and development has been severely constrained by high interest rates, an over valued exchange rate, the war risk premium attached to the economy and, for a part of the period, political uncertainty associated with governments which had a fragile parliamentary majority. Consequently, the private sector's ability to find viable projects has been severely restricted. Few projects cleared the "hurdle rate of return" used by private investors.

As a result, the government was, forced to offer major concessions to boost the rate of return. This served to undermine further the fiscal framework by reducing the revenue base. It is encouraging that these concessions are expected to be rationalized in the forthcoming budget. However, this places an even higher premium on fiscal consolidation because the removal of concessions without addressing the main cause of instability in the system would have an adverse impact on investment, growth and employment.

Despite these concessions, the overall macroeconomic conditions and the investment climate have been such that the private sector has inevitably tended to focus on projects with short pay-back periods and/or where a significant share of the risks could be transferred to the government. This has meant that private investment, both domestic and foreign, has been well below potential. As Prof. Sirimal Abeyratne has stressed in a

Pathfinder Policy Brief the crucial challenge is to improve the overall policy environment.

The upshot of a weak investment climate has been that investment, growth and employment have been overly driven by public expenditure. This has inevitably led to unsustainable budget deficits and a worrisome debt level. This model is inherently unsustainable and cannot be the basis for accelerating growth and development, as envisaged by the government (a doubling of per capita GDP by 2015).A new approach needs to be developed based on longer term investment horizons in the private sector and less dependence on a fiscally constrained government.

A stable and predictable macroeconomic framework is an essential component of a conducive enabling environment for promoting the private investment necessary to meet the government's growth targets. The forthcoming budget presents an opportunity to set the direction and put in place the framework for achieving this fiscal consolidation, which is essential for achieving the low interest rates and stable and competitive exchange rate that are necessary for increasing the competitiveness of the economy and for improving investor confidence. Sound macroeconomic policies need to be supported by structural reforms and streamlined procedures which address rigidities in the economy and improve its efficiency.

This is the Second in the series of Economic Alerts issued by the Pathfinder Foundation. Readers' comments via email to pm@pathfinderfoundation.org are welcome.