Pathfinder Economic Flash

Timely Rate Cut

The Monetary Policy Committee's 50 BP reduction in interest rates can be timely. It can boost growth without undermining stability provided there is sound fiscal/monetary policy harmonization and the pursuit of a flexible exchange rate policy.

The IMF and several other commentators have cautioned against an interest rate reduction at this point. They have been concerned that a more accommodating monetary policy could fuel inflation and undermine the balance of payments. In their view, demand management policies are not the appropriate option to stimulate the economy at this juncture. Indeed, the IMF, and others, have argued that the correct approach would be to give the economy a boost through structural reforms that strengthen the growth framework of the economy. This position would be valid if there was no output gap i.e. the economy was growing at or near its trend rate of growth.

However, if one examines proxy indicators such as government revenue (high dependence on indirect taxes on economic activity results in a strong correlation between growth and revenue); imports (there is a strong import co-efficient in Sri Lanka's growth process); electricity sales; and cement sales (the construction sector has been a major source of growth), the balance of probability is that there is currently a significant output gap. Hence, there is space for prudent demand management policies which promote growth without undermining stability.

At this particular juncture, relaxation of monetary policy constitutes the best option to address the significant growth deficit. However, it should be supplemented by keeping the government's announced fiscal consolidation trajectory on track. This should apply to the budget deficit, the losses of SOEs on the balance sheets of state banks and arrears. The adjustment of fuel and electricity prices has been a commendable advance in this respect. However, it is important that fiscal discipline is maintained to come close to achieving this year's target of 5.8% of GDP for the budget deficit. At a time when there is a growth deficit, there is a case for loosening monetary policy to compensate for the tighter fiscal stance. However, if both fiscal and monetary policies are accommodating, overheating would be inevitable with adverse consequences for inflation and the balance of payments. There is, therefore, a high premium attached to the coordination of monetary and fiscal policies at this time.

A flexible exchange rate policy is also a necessary supporting measure for a more expansionary monetary policy. A key lesson from 2010/2011 is that monetary easing when combined with an overvalued Real Effective Exchange Rate (REER) creates incentives to borrow and import which are inimical to the stability of the balance of payments. Maintaining a stable external position is even more important in a context where Fed tapering is inevitable at some point.

It must be recognized that the economy cannot be placed on an accelerated growth trajectory of 8% on a sustained basis without structural reforms. However, there is a time asymmetry between the pain and gains associated with such reforms. Hence, it is unlikely that this will happen at this stage of the current political cycle. The challenge is to formulate a package of structural reforms that are implemented at the very beginning of the next political cycle. In the meantime, there seems to be space for some prudent demand management through lower interest rates to address the existing growth deficit.

This is the Thirty Sixth Economic Flash published by the Pathfinder Foundation (PF). Readers' comments are welcome at www.pathfinderfoundation.lk

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