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The Bottom Line

Money, inflation and output

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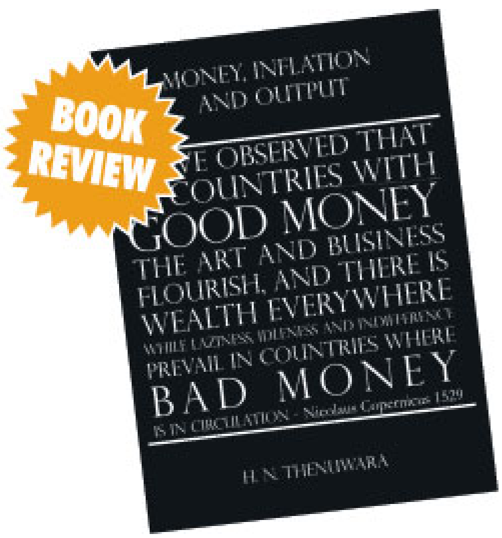

Reviewed by SAMAN KELEGAMA

The book is the latest addition to economics literature in Sri Lanka. Its basic thesis is ‘good money’ creates wealth and growth while ‘bad money’ would retard this. This observation was made by Copernicus in 1529 AD and Thenuwara shows the validity of this observation in the modern day world.

The book has 11 chapters. Some of the chapters explain basic economic concepts in the context of monetary policy while others show how monetary policy has worked and the prerequisites for positive results. The underlying theme of the book is the need for a Central Bank to conduct independent monetary policy and thereby keep inflation low, which is essential to achieve higher economic growth.

Inflation

When too much of money circulation is not matched by an increase in the supply of goods, the goods prices increase and creates inflation. Inflation inertia is created when past high inflation makes it difficult to control current and future inflation. When the public is used to a high rate of inflation, they incorporate high inflation rates to future economic plans -- expectation causes the inflation to persist by way of self-fulfilling phenomenon. Thus, to combat adverse expectations on inflation, Central Banks make an effort to sensitise the public on their plans to reduce inflation and provide forecasts of future inflation levels.

Core inflation is the extent of inflation that responds to demand management policies and usually excludes items that are very sensitive to supply side disturbances like food and energy.

Headline inflation on the other hand, is the rate of increase of the price level of all goods and services included in the consumer basket. A comparison of the two indicators shows that in Sri Lanka, core inflation has been on the decline until late 2007 but headline inflation has been on the increase from mid-2006 to mid-2008. These trends basically show the lagged effect of excessive money printing and the influence of the escalation of food and energy prices, respectively.

While presenting these trends, the author has a closer look at the revision of the Consumer Price Index (CPI) in 2007 to replace the outdated basket of currencies (based on the 1952 basket) that governed the earlier CPI, and expresses concern of Alcohol receiving a zero weight, especially when a number of commentators have expressed that Sri Lanka is a very high alcohol consuming nation.

Demand for money

Demand for money can be explained by the classical framework of the Quantity Theory of Money or Keynesian Framework or Friedman's framework – it is a complex subject. If demand for money is stable, a Central Bank can carry out monetary targeting (quantity of money) in its monetary policy to keep inflation at a low level. In the real world however, the demand for money is unstable. Thus, Central Banks adopt different monetary policy regimes at different times. It is left to the Central Bank to select the most efficient monetary policy instrument or a combination of instruments to reach the desired credit and money targets.

In monetary targeting, a Central Bank cannot directly hit at the final target, i.e., inflation, thus, it aims at operational and intermediate targets. First, the interest rate is used to hit at the operational targets such as high-powered money and short-term interest rates. Then high-powered money and short-term interest rates impact on the intermediate targets of narrow money, broad money and medium-term interest rates. Finally, narrow and broad money and interest rates impact on the aggregate demand and inflation.

Central Banks use several instruments to conduct monetary policy: interest rates, the statutory reserves, moral suasion, central bank communications and administrative instruments to control aggregate demand. The book shows that the most effective and convenient instrument is the market-based instrument of interest rate for conduct of monetary policy. But the market players should be sensitive to the interest rates. If the government is a major borrower in the market and does not change its demand for credit when changes occur in the interest rates, then monetary policy becomes ineffective.

Chapter 9 highlights the need for proper coordination between monetary authorities and fiscal policy officials to obtain best results from monetary policy. When fiscal policy is excessively used and generates high budget deficits, monetary policy becomes accommodative and ineffective leading to high inflation. Why politicians influence Central Banks and dilute their effectiveness is best captured by quoting the former Governor of the Reserve Bank of Australia; first, the tendency to push the economy to run faster than its capacity, and second, the temptation that governments have to incur budget deficits and fund these by borrowings from the Central Bank.

Global Economic Crisis

Chapters 5 and 6 deal with exchange rate management and the global economic crisis respectively.

Exchange rate management is closely linked to monetary policy. After heavy loss of international reserves during the recent global economic crisis, some Central Banks realised that defending the exchange rate (Sri Lanka spent over US$ 1 billion to defend the rupee), is not compatible with independent monetary policy and open capital account - known as the 'Impossible Trinity' (Sri Lanka had a partially open capital account). Either the Central Bank undertakes a devaluation or approaches a funding agency like the IMF for a loan to boost up the reserves and there was no case for resisting both. It is by approaching the IMF that Sri Lanka created the space to pursue and sustain a more independent and relaxed monetary policy.

In the chapter on economic crisis and monetary policy, Thenuwara argues that the Central Banks have always been either part of the causes of the crisis or part of the solution to the crisis. He highlights the US experience of the economic crisis and how the then Fed Chairman, Alan Greenspan misread the economy and quotes Paul Krugman's observations on him: "Greenspan's story is also the story of how makers of economic policy convinced themselves that they had everything under control, only to learn, to their horror and the country's pain – that they did not" (p. 107).

Regulation has always lagged behind financial innovation, partly because financial innovation takes place at a rapid pace and partly because of the belief that financial markets are self-correcting. But when regulation is introduced especially after a financial crisis, it may be an interim measure which needs to be continuously updated to face the challenges of financial innovations. In regard to regulatory responses, Thenuwara highlights the shortcomings of Basel I and II and goes on to say, "After resolution of the current crisis, international regulators, no doubt will introduce Basel III and will fine tune it until the world is hit by a brand new crisis." (p. 124).

Effective Monetary Policy

Chapter 7 is perhaps the most important chapter in the book where the key theme is addressed. While money eliminates the cost of searching associated with the barter system (discussed in Chapter 1), excessive money growth does not cause any changes in the long run growth of the economy. This phenomenon is called 'neutrality of money'. Excessive monetary growth unless matched by equivalent increase in the supply of goods, will generate inflation. Highlighting the existing literature, the book shows that an inflation level of about 2% is the best to achieve high growth rates -- completely dismissing an assertion by some commentators that having a little bit of inflation is like being a little bit pregnant that will grow to an uncontrollable level.

In Chapter 8, Thenuwara discusses inflation targeting (IT) and argues that "successful implementation of IT requires a country to meet several prerequisites: a mature financial system, monetary policy independence, fiscal discipline and transparency, accountability and good governance in the Central Bank" (p. 157). Due to the instability of the demand for money, many Central Banks have abandoned the monetary targeting framework in favour of IT. New Zealand pioneered IT and their strategy was that if the expected inflation was not realised, the Governor of the Central Bank would resign unless he could provide an explanation acceptable to the Parliament. Many countries (Canada, Australia, Chile, South Korea, Mexico, Israel, etc.) today use IT as a policy to bring down inflation. Sri Lanka is yet to create conditions for IT, although the subject has been discussed extensively. However, given the groundwork done so far, there are reasons to believe that IT will soon become the policy in Sri Lanka.

Independence of the Central Bank

The 10th chapter is on the independence of the Central Bank. Thenuwara shows that unlike New Zealand and other inflation targeting nations, the Central Bank of Sri Lanka is both goal and target independent. Basically, the goal has to be identified from the broad objectives in the law governing the Monetary Board. The key duties of the Central Bank should be to ensure price stability and financial system stability. Some Central Banks are entrusted with a large number of other functions unrelated to the key objectives. For instance, the Central Bank of Sri Lanka is encumbered with management of government funds – EPF and management of public debt, and these have conflicting interests with the key objectives of the bank. "Central Banks have realised that they do not have instruments and ways and means to achieve multiple objectives. The only task they could accomplish well is maintaining price stability." (p.19).

The independence of the Central Bank of Sri Lanka is then discussed, first highlighting that the Central Bank has no legal identity and it is only the Monetary Board that has a legal identity; thus, what matters is the independence of the Monetary Board. The book highlights four areas which have contributed to the dilution of the independence of the Monetary Board:

(1) Section 89 of the Monetary Law Act permits the Central Bank to grant provisional advances to the Treasury up to 10% of the estimated revenue. In the past, the Treasury has always availed of this facility fully, thus preventing the Central Bank from controlling this injection of money to the economy

(2) the Central Bank is the agent for the government in raising public debt – thus making it vulnerable to subscribe to the public debt

(3) the Central Bank is the banker to the government – thus causing difficulties in controlling money supply

(4) the Secretary to the Treasury being a member of the Board (ex-officio) may influence the board to accommodate the fiscal needs of the political establishment. The book argues that the Central Bank should be made independent by law (this was also the recommendation of the Final Report of the Presidential Commission on Finance and Banking, Vol. II, 1992, pp. 266-267), to make monetary policy more effective.

What should be the attitude of a Central Banker? Always pessimistic – always look for risks to the stability of the economy. Quoting another Central Bank Governor, the author argues that this attitude should permeate from bottom to top in a Central Bank: "When my minister is elated about high economic growth, I worry about overheating of the economy, when he talks about high foreign inflows, I worry about external stability, and when he beams with appreciating currency, I worry about competitiveness of the country" (p. 215-216).

Looking Beyond

There are a few areas in the book where some questions could be raised. First, in the final chapter, the book argues the case for a regional Monetary Integration for bringing more binding commitment to monetary discipline than perhaps an independent Central Bank that will be difficult to create due to the political economy. This idea of course requires harmonising of macroeconomic policies – which would be difficult given the fiscal indiscipline in the regional members of South Asia.

Second is the reemergence of Keynesian economic policy after the recent global economic crisis where a fiscal stimulus was injected by many countries (that had fiscal space) to rejuvenate their economies, rather than sticking to the monetarist doctrine of inaction. The latter is based on the belief that self-adjustment of the economy is sufficiently fast, while government action may cause undue harmful effects on the economy, which could have in any case reach its equilibrium before any government action takes effect. The rapid global recovery – at least at present – shows that the Keynesian formula has worked with reasonable control over inflation.

The book says: "..when governments resort to Keynesian policies of active engagement, countries may recover, but may cause other long-term problems of high budget deficits and high debt levels" (p. 121). The author presents the case where the monetary formula did not work when Japan was on a 'liquidity trap' in the 1990s and how it resorted to a fiscal stimulus to revive the economy resulting in budget deficits. This issue needs elaboration and Paul Krugman today advocates a 4% GDP fiscal stimulus package to the US economy instead of the current 1% GDP stimulus package of the Obama administration. Krugman believes that at a time when credit markets are frozen, producers are closing factories and consumers are not spending, there are unused resources that could be put into effective work via a Keynesian stimulus and argues that any adverse consequences of such a policy could be effectively managed (see The Return of Depression Economics and the Crisis of 2008 by Paul Krugman, Norton, 2008). This area should have received more attention in the book where better harmony could be worked out between fiscal policy and monetary accommodation to minimise the adverse consequences of a fiscal stimulus after a crisis.

Reflections

The book is written in a very simple language without using much mathematical jargon. One need not be an economist to read and understand the book as all key concepts and terms are well explained. The book draws examples from various countries and is not confined to the Sri Lankan scenario alone.

It is very clear from the book that the author had a deep understanding of Central Banking and monetary policy. Although he is no longer serving the Central Bank, he has shared his experience and made a significant contribution to understanding monetary policy. The book will be useful for Central Bankers, policy makers and economists in Sri Lanka and it is an essential reading for anyone interested in the subject.

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