Ranee Jayamaha: Recent economic developments, challenges and strategies – proactive strategies in reducing inflation

Speech by Dr Ranee Jayamaha, Deputy Governor of the Central Bank of Sri Lanka, at the Central Bank of Sri Lanka, Colombo, 25 May 2007.

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Inflation is a common enemy. Its impact will be felt by every single person in a country. Managing inflation and reducing inflationary expectations cannot be achieved by the Central Bank of Sri Lanka (CBSL) alone. It can only be done collectively and with cooperation from all stakeholders.

Who are these critical stakeholders ?

CBSL, the government, banks and financial institutions, fund managers/traders/dealers operating in various markets, investors both local and foreign households and consumers.

1. Central Bank of Sri Lanka

Given its prime objective of maintaining price stability, CBSL has been proactive in the conduct of monetary policy, which is the instrument through which this purpose can be achieved. CBSL sets monetary targets taking into consideration growth prospects of the economy, liquidity requirements necessary to facilitate growth and inflation at a desired level. The ultimate aim is to keep inflation at desirable levels and reduce inflationary expectations. CBSL, at its disposal, has a limited number of instruments to conduct monetary policy. The current framework places greater reliance on market-based instruments, such as changes to the policy interest rate and conduct of open market operations.

Accordingly, CBSL has announced its monetary policy strategy and targets at the beginning of 2007. The upfront announcement of the policy targets indicates the transparency of monetary policy operations and we believe that it helps to enhance policy effectiveness. More importantly, it helps the other stakeholders to fall in line with the announced strategy.

2. Government

The fiscal policy should support monetary policy to work effectively. Therefore, government's commitment to maintain fiscal targets is essential. According to the government's medium term macro framework enunciated in the fiscal management report 2007, the overall deficit in 2007 will be contained at around 7.2% of GDP. The Govt. has taken significant steps to enhance revenue through additional measures such as improvement to tax administration, rationalize current expenditure and improve its debt management policy. The achievement of the first quarter 2007 revenue target is commendable. While maintaining the momentum in revenue targets, it is also necessary to reduce Govt. expenditure and work in tandem with monetary policy to contain inflation. In reducing government expenditure, it is also desirable to link income policies of the Govt., in particular, wage increases to productivity gains. Attempts are made to minimize income expenditure gaps and avoid deficit financing from inflationary sources such as bank financing, in particular, borrowing from CBSL.

Govt.'s medium term strategy rests largely on public investments in key sectors and infrastructure that supports growth. It is important that these investments are financed in such way that it would not place excess burden on the budget. In this regard, it is encouraging to note that the Govt. has committed to commence operations of infrastructure projects such as the South Harbour Development, Weerawila Airport and other highways within the framework of public private partnership, which will provide an opportunity to the private sector to take part in such projects.

Reducing vulnerability to rising import prices

In view of the significant volatility in oil prices in international markets, CPC has taken measures to hedge oil imports so that the price fluctuations do not adversely affect domestic prices. It may be worth exploring the possibility of introducing hedging to other critical imports such as gas, fertilizer to mitigate impacts of adverse price fluctuations in the domestic market.

3. Banks and financial institutions

Banks and financial institutions are expected to provide finances for economic activity. Some banks and financial institutions provide credit to government as well as the private sector, while others serve only the private sector. The continuing high growth in private sector credit could cause a threat to price stability as well as the financial system stability. High credit growth could deteriorate the quality of assets of commercial banks and increase the level of non-performing loans. In inflationary situations, lenders should be cautious not to fuel inflation further, but to direct investment towards productive activities.

Banks and financial institutions continue to enjoy short term profits from lending at high rates to their customers and living on interest income. But the real value of their assets and profits continue to erode in an inflationary environment. For example, the real growth of assets in the banking system in 2006, was 5% as compared to a nominal growth of 19%. Similarly, the real growth of profits of the banking sector in 2006 was 12% compared to a nominal growth of 26%. In essence, the real value of short term profits recorded by the banking sector is only half of the nominal growth. Eventually, there will be pressures for higher wages which will, together with rising non-performing loans, erode profits and threaten the stability of the banking system. Banks and financial institutions should therefore take a longer term view and be more cautious in expanding their loan portfolios towards consumption oriented credit and promoting consumerism.

The Impact of expansion of consumption credit

Expanding credit to less productive areas specially consumption, would reduce current as well as potential savings and add to inflationary pressures in a situation where there is limited availability of goods and services and resources. Such lending would also lead to high credit risks as short term consumption credit is not backed by realizable collaterals although banks make high profits on interest income. Banks and financial institutions re-arrange their credit portfolios in a manner that support the growth and investment drive.

Arranging funding sources without relying on CBSL funds

CBSL wishes to see market liquidity “broadly in balance” as it will enable the Bank to conduct its monetary policy more effectively. That means when there is excess liquidity in the system, borrowing from CBSL would add to enhancement of reserve money which will have multiple effects in expanding money supply and liquidity in the economy. Banks should make concerted efforts to adjust their funding sources to meet credit demands by mobilizing deposits and enhancing revenue through fee-based activities. For emergencies, they should establish credit lines within their peers. Mobilization of deposits does not depend solely on high interest rates, but also on improved customer services and justifiable fees and charges. Similarly, banks should diversify business operations beyond core business of lending and that will help to reduce high credit risks.

Improvements in efficiency to reduce intermediation costs

Banks need to improve operational efficiency and reduce interest spreads and margins thereby reducing transaction costs to customers. High spreads and margins and related profits of banks and financial institutions will raise transaction costs to borrowers and investors who will pass such costs to customers through high prices of goods and services. This is inflationary. Compared to most countries in the region, banking and financial services in Sri Lanka are provided at very high margins. For example, India’s interest margin is 2.6% and Bangladesh is 2.5%. In Sri Lanka, it is 4%. In fact, even the big investors have begun to feel the impact of high transaction costs although many of them have the bargaining power to obtain funds at prime rates. The medium to small enterprises have no choice or access to finance.

4. Fund managers/dealers/traders

Interbank market

The tight monetary policy stance adopted by CBSL and its possible continuation would result in increased reliance by banks on the inter-bank call market. Given the self imposed limits by banks on lending to each other, if a few banks attempt to raise a large volume of funds from the inter-bank market , there could be volatility in interest rates. Banks should not often rely on a potentially volatile call money market as an alternative to mobilizing deposits or exploring other funding sources. The heavy reliance by some banks on the call money market drives short term interest rates and make borrowing costs to investors and business community to very high levels. The volatility in the call market also creates uncertainty among the businesses and that adds to inflationary expectations.

Forex market

Given the current account imbalances, there is a mismatch in foreign exchange inflows and outflows. Sri Lanka's foreign exchange market is not deep enough to absorb relatively large transactions, though its size and operations have gradually increased. In such a market, huge speculative trades could be rather disturbing and they could move the exchange rate against economic fundamentals. No doubt, forex market is a key source of foreign exchange income to banks. Its price, which is the exchange rate, is determined according to demand and supply forces. CBSL recognizes that demand and supply forces should be allowed to determine the exchange rate and that some amount of speculative trading is needed to develop the market. When there are trade bills of customers or banks themselves and, if banks do not have adequate forex with them, it is natural to borrow from the market. However, more often than not, traders/dealers speculate to make short-term gains in the forex market and try to drive the exchange rate to levels which they prefer it to be. Banks should earn profits and be financially viable. CBSL wishes to see a well-capitalized and profitable banking sector. In many instances, it was noted that the exchange rate depreciates to levels which are not in line with inflation differentials of our trading partners measured through the real effective exchange rate. This could be due to market domination by a few dealers who wish to earn unusually high profits.

Needless to say that exchange rate depreciation on a continuous basis makes imports more expensive given the high import content of Sri Lanka's trade basket. High import expenditure has cascading effects on all imports, including oil and other intermediary goods imports. Then the cost is felt by entrepreneurs, industries, investors, and finally by the whole country. Banks operating in the forex market therefore, should not only be concerned of their profits but also of their public policy responsibilities. In their own interest too, banks should be mindful of the uncertainties they create in the forex market which is not conducive to its smooth operations and, therefore, the perception by international markets and investors.

As you are aware, worker remittance has financed around 69% of Sri Lanka's trade deficit. There has been an increase in worker remittances in the recent past responding to active promotional campaign launched by CBSL with the support of the Sri Lanka Foreign Employment Bureau, overseas job agencies, foreign missions and the banks. Recently, the number of professionals and skilled worker categories were encouraged to take up foreign employment, which is catching up fast. Banks should make extra efforts to mobilize their remittances, as this will add to their fee-based income through enhanced financial services. The increase in remittances will have a beneficial impact in reducing the current account deficit and creating a greater stability in the foreign exchange market.

Govt. securities market

Commercial banks and a few non-banks are the primary dealers who buy and sell Govt. securities and create secondary transactions in this market. The Govt., tends to borrow from the debt securities market which is non inflationary. It appears that there are market collusion and cartel type operations which tend to drive returns on treasury bills and bonds to levels which are not in line with the current and expected movements in key macro variables. Often, CBSL has to reject bids because of the very high bidding rates quoted by primary dealers. CBSL is the banker to the Govt. When market collusion does not enable the Govt., to borrow at reasonable rates, CBSL has to take treasury bills which inflating financing, as it compels CBSL to issue reserve money into the system which has multiple effects in increasing money supply and liquidity in the system. Primary dealers, specially the banks, have a responsible role to play in this regard and be mindful of unusually high bidding and its repercussions on the whole economy.

5. Investors and the business sector

One way of beating inflation is to enhance productivity. Improvements to the factor productivity should be introduced using improved technology and higher productivity methods. Investing in technology today will not only increase productivity but also help lowering product prices. They may have to look for foreign collaboration, joint ventures and partnerships if additional funding and technical skills are not available within the country. They should also facilitate investments outside the Western province and promote regional development and employment generation in outstations while using factors of production available in such areas.

Businesses and investors have many opportunities under the Public Private Partnership (PPP) program. Given the Govt.'s commitment to commence large infrastructure projects during this year and some in 2008, the private investors and businesses could contribute to the development process, in particular, by participating in infrastructure projects through PPPs. It will help reduce financing of capital expenditure by the Govt.

Businesses should continue to focus attention on improving, branding, investing in research and development, and promote innovation. Businesses should increase efficiency of resource usage by reducing waste. Waste add to cost of production of goods and services. For instance, post harvest losses in perishable agricultural products is estimated to be around 30%-40% which has been repeatedly articulated by CBSL in its past annual reports. Businesses should also attempt to shift from the traditional methods of employing labour and capital towards IT-based new technologies. In addition, knowledge based product markets should be developed to attract business and knowledge processing centres. Such activities would not only bring in additional sources of foreign exchange, but will also move production processes towards high tech methods.

6. Households and the general public

Misconceptions about the term inflation

Inflation is interpreted in various ways by various circles. The price tags on products and services in shops, supermarkets and service centres is not the inflation but it is the rate of increase in prices. In other words, it refers to a continuous growth in general price levels in the economy. Households and the general public should also recognize that short term shocks like droughts, floods and landslides could temporary raise the prices of basic food items but it will stabilize when situation is back to normal. The high prices at a given point in time should not be construed as inflation and they need not build-up inflationary expectations.

Reducing inflationary expectations

The self-fulfilling prophecy that inflation is continuing to rise will eventually result in high inflation. All stakeholders are informed that action has been taken to reduce inflation by relevant authorities and that there is hope of bringing it down.

In essence, inflation is eroding the value of assets, wealth and profits of the financial institutions, businesses, investors and public at large. Inflation can only be beaten with adequate commitment by all stakeholders.