

Sri Lanka: slaying the bogey of inflation

SRI LANKA STARTED THE YEAR WITH AN UNWELCOME BUT not totally unexpected bang. The country's long-running civil war erupted with troops from the government and the Liberation Tigers of Tamil Eelam taking off their gloves.

In consequence of multiple violations of the ceasefire of February 2002, that truce became a bloody victim as the Norwegian-led Sri Lanka Monitoring Mission began winding down.

If the civil war flair-up wasn't bad enough, Sri Lanka's other major problem - the bogey of inflation - remains alive and kicking. As Chart 1 indicates, inflation has been spiraling up since the start of 2006. Last year ended with a disturbing 18.8 % year-over-year increase for the month of December. The specter of unanchored inflation haunts the Sri Lanka economy.

Those unanchored expectations throw into doubt the central bank's 2008 inflation target of 10% to 11%. Indeed, in light of the huge fiscal deficits that have been recorded year-after-year (see Table 1) and with the civil war heating up, it will be very difficult to control inflation and sustain strong growth with Sri Lanka's current monetary set-up. To slay the inflation bogey, Sri Lanka needs new institutions that will deliver discipline.

Monetary discipline (and ultimately fiscal discipline) can be delivered if a monetary authority has either a credible internal or external anchor. It must be stressed that these anchors are mutually exclusive: one or the other, but not both. An internal anchor requires a monetary authority to have a well-defined monetary policy. For example, this could be an inflation target or a target for money supply growth.

With an external target, a monetary authority does not have its own monetary policy. Instead, it links its currency to an anchor currency of a fixed exchange rate. In consequence, it imports the monetary policy and the inflation rate (roughly) of the anchor currency country. In this way many developing nations have been pegged against the US dollar.

At the end of the day, inflation is always a monetary phenomenon. This is, of course, the case in Sri Lanka. The problem resides



at the central bank. It doesn't have a credible anchor. In consequence, it lacks the discipline to control inflation and contain inflation expectations.

Let's take a closer look. According to the International Monetary Fund's Annual Report on Exchange Arrangements and Exchange Restriction (2007), exchange-rate regime is classified as "managed floating with no predetermined path for exchange rate." Therefore, we know that the Sri Lankan Rupee is not linked to an anchor currency at a fixed rate and that the central bank does not employ a pure external anchor. We also know that the rupee does not freely float.

Instead, the rupee's exchange rate is managed via the central bank's intervention in foreign exchange markets. This means that Sri Lanka's central bank has a mixed system of anchors: the exchange rate is used to some undefined degree (an extended external anchor) and there is also an internal anchor (inflation target).

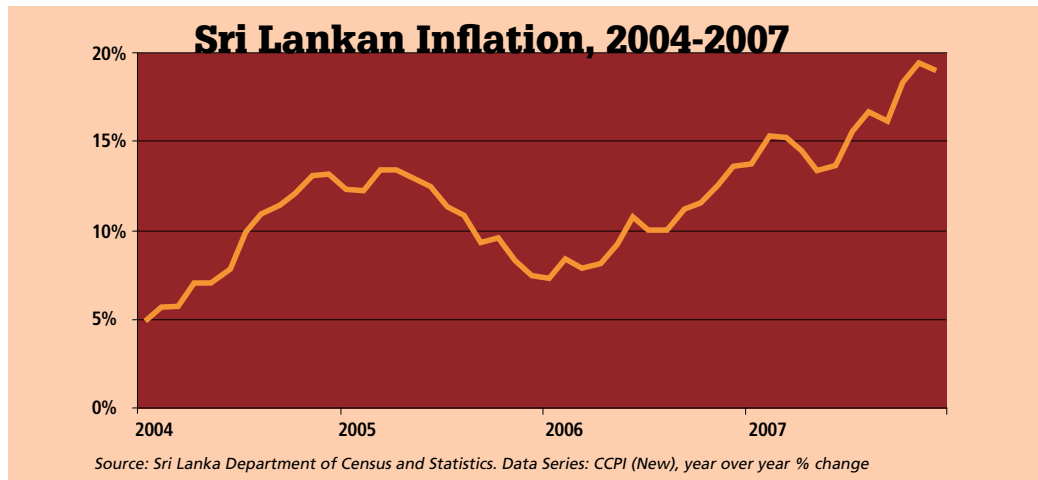
There is a straight forward way to show, with publicly available data, that Sri Lanka's central bank relies on a mixed-anchor system. For a central bank with a pure external anchor (fixed exchange rate), its net foreign reserves (foreign assets minus foreign liabilities) should be close to 100% of the monetary base (also called reserve money).

Moreover, the reserve pass-through (the change in the monetary base divided by the change in net foreign reserves over the



Sri Lanka: CPI Point to Point % Changes

	CCPI	CCPI(N)
2004	0.5%	4.8%
	0.9%	5.5%
	2.5%	5.7%
	4.6%	6.9%
	5.9%	7.0%
	6.8%	7.7%
	8.9%	9.9%
	10.5%	10.9%
	11.6%	11.4%
	12.1%	12.1%
	13.1%	12.9%
	13.8%	13.0%
2005	14.6%	12.2%
	15.9%	12.1%
	15.5%	13.3%
	14.0%	13.3%
	11.8%	12.8%
	9.4%	12.4%
	10.8%	11.3%
	10.9%	10.7%
	10.5%	9.2%
	10.4%	9.5%
	9.1%	8.2%
	8.0%	7.4%
2006	8.0%	7.3%
	7.1%	8.3%
	6.4%	7.9%
	9.2%	8.1%
	13.2%	9.2%
	17.7%	10.6%
	14.7%	9.9%
	15.3%	10.0%
	15.4%	11.1%
	17.2%	11.5%
	19.8%	12.4%
	19.3%	13.5%
2007	20.5%	13.7%
	19.2%	15.2%
	19.5%	15.1%
	16.3%	14.3%
	13.7%	13.2%
	13.0%	13.5%
	17.6%	15.4%
	17.3%	16.5%
	17.3%	16.1%
	19.6%	18.2%
	19.6%	19.3%
	16.4%	18.8%



period in question) should be close to 100%. For a central bank with a free floating exchange rate, the reserve pass-through should be close to 0%, because it rarely has reason to buy or sell its currency for foreign reserves.

As Chart 2 shows, Sri Lanka's central bank does not have a fixed exchange rate which would deliver a 100% reserve pass-through. Nor does it have a free-floating exchange rate which would be accompanied by a reserve pass-through of 0%. Sri Lanka's system is neither fish nor fowl.

To introduce more discipline and inflation-fighting credibility into Sri Lanka's monetary setup, an exchange-rate system must be adopted. And as Professor Ronald McKinnon from Stanford University concluded in *Exchange Rates Under the East Asian Dollar Standard* (2005), for a country like Sri Lanka "a satisfactory free float is impossible." Therefore, the establishment of a credible internal anchor is not feasible. This is not the case for a Sri-Lankan external anchor.

By establishing an orthodox currency board, Sri Lanka could gain a secure external anchor.

Just what is a currency board?

IT IS A MONETARY AUTHORITY THAT ISSUES NOTES and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. As reserves, it holds low-risk, interest-bearing bonds denominated in the anchor currency and typically some gold. The reserve levels are set by law and are equal to 100%, or slightly more, of its monetary liabilities (notes, coins, and if permitted, deposits).

By design, a currency board has no discretionary monetary powers and cannot engage in the fiduciary issue of money. Its operations are passive and automatic. The sole function of a currency board is to exchange the domestic currency it issues for an anchor currency at a fixed rate. Consequently, the quantity of domestic currency in circulation is determined solely by market forces, namely the demand for domestic currency.

Over 70 countries, including Sri Lanka, have employed currency boards. Contrary to much that has been written about Argentina's convertibility system of the 1990's, that system was not a currency board. All real currency boards have acted to enforce both monetary and fiscal discipline.

Sri Lanka – or Ceylon as it was once called - established a currency board in accordance with the Paper Currency Ordinance (No. 32 of 1884) on December 10, 1884. It was modeled after the Mauritius currency board. On January 1, 1885, the board began issuing rupee notes redeemable at a fixed rate of (1) Ceylon rupee per (1) Indian silver rupee. Swept up by the fashion of the time, the currency board was replaced by the central bank in 1950.

If Sri Lanka wishes to slay its inflation bogey, it must enforce monetary and fiscal discipline. The only way to do that is to install a currency board with a strong external anchor. ☞

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