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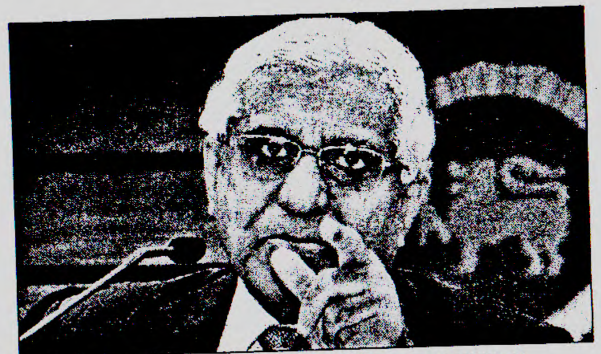
CB warns against fiscal slippage

- Says Govt. challenged by public sector salary demands
- External situation, slow growth, inflation, and currency pressure make case to keep policy rates unchanged
- But warns possibility of fiscal slippage may push CB to tighten rates
- Keen to see interest rate caps impact
- Private sector credit moderates to 7.2%, broad money growth slows to lowest since Dec. 2008



Central Bank Governor Dr. Indrajit Coomaraswamy – Pic by Lasantha Kumara

By Uditha Jayasinghe

CLIMBING inflation, currency pressures, and impact from reducing interest rates as the Presidential Elections move closer promoted the Central Bank to keep policy rates unchanged. Central Bank Governor Dr. Indrajit Coomaraswamy said, but he warned that possible fiscal slippage could push the Central Bank to tighten policy rates.

Dr. Coomaraswamy told reporters on Friday (11 October) that the global economic slowdown, slow private sector credit growth, and salary increases tagged for implementation from January next year, higher inflation and lending rate caps were among the points discussed by the Monetary Board when they met to decide on the latest policy stance.

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Year-on-year credit to the private sector moderated to 7.2% in August from 7.7% in July. Private sector credit in absolute terms recorded an increase of Rs. 22.2 billion in August following a marginal decline of Rs. 1.2 billion in July. The cumulative increase during the first eight months of 2019 was Rs. 64.7 billion.

Broad money growth decelerated to 7.7% in August from 8.2% in July, recording the lowest growth rate since December 2008. Market lending rates have also declined, with weekly AWPR declining by 128 basis points to 10.46% for the week ending 4 October from 12.24% recorded at the end of April.

"Clearly, the world economy is going through a synchronised slowdown. In fact, the new IMF Managing Director has indicated that 90% of the countries in the world will have slower growth this year. That clearly argues for some relaxation of monetary policy because it gives us space for domestic policy action, unlike in 2018 when there was capital outflow, which constrained the space for domestic monetary policy action.

"In terms of domestic factors, we continue to have an output gap, but potential growth is about 5%, which argues for some relaxation of policy. Private sector credit growth has slowed down significantly, and by the end of the year, we expect to see 5% credit growth. In an ideal world, we would like it to be 10-15%. Monetary aggregates are at about 7.7%, which again we think is lower than where it should be."

In the short-run, there is likely to be an uptick in inflation, especially on food price inflation that has increased, partly due to the fish price hike owing to the monsoon. The vegetable prices have gone up for the same reason, and the Yala production was less than what was anticipated. This could lead to inflation reaching the upper boundary of the target of 4-6%, Dr. Coomaraswamy said.

"From time to time last week there has also been pressure on the rupee, so that could lead to higher prices. These developments make the case for holding rates. We also need to allow time to see what is going happen due to the measures taken so far in relaxing policy rates."

Inflation is expected to return to about 5% once the festive season is over. The external environment, which is Sri Lanka's biggest vulnerability, given its debt dynamics, was pronounced by the Governor to be in "reasonable shape".

"Trade deficit has come down by $ 2.5 billion in the first eight months of the year, but the services account has been adversely impacted by the tourism receipts, which declined after the Easter Sunday attacks. The targeted revenue was $ 5 billion, but the projection is $ 3.7 billion, which means that the improvement in the trade account has set off about $ 1.3 billion from the services account. There has also been some reduction in shipping revenue due to the slowdown in the Indian economy. However, the current account deficit, which was 3.2% last year, is projected to be 3.6% in 2019," the Governor said.

Responding to questions, he also cautioned that high salary increases that are expected to come into play from January could present a case for tightening rates. He acknowledged that both the constitutional crisis and the Easter attacks had placed pressure on Government revenues but called for the Government to maintain its commitment to fiscal consolidation.

"There is a medium term framework that has been set out that will enable Sri

to inflation but the monetary policy can be increased to counter it; but the more challenging thing is, you have to keep borrowing.

"If you borrow too much domestically, interest rates go sky high. If you borrow internationally, your external debt burden becomes onerous. Our debt dynamics are very precarious. So, we have to stay within a certain framework. If salaries are increased, then to stay within the framework, one would have to reduce other expenditures or increase revenue. That is the challenge for the Government."

The Central Bank has also widened open market operations to include some liquid bonds. Dr. Coomaraswamy recalled that in the past, the Central Bank focused only on Treasury bills but it has currently decided "some liquid Treasury bonds were also being made use of".

"We have taken measures to reduce bank lending rates and we have to see what will happen at the end of all that. The final reason, and this is one that possibly argues for tightening rates, is the (public sector) wage increases in the pipeline. We need to see how that will play out".

The Governor reiterated the argument that stronger economic growth through lower interest rates will create the space for banks to reduce their non-performing loan ratios, which currently average about 4.8%.

"Since the time the deposit rate caps were introduced in April, we have seen the average weighted new deposit rate has come down by 284 basis points. In that same period, the average weighted lending rate has come down by 87 basis points.

"It was acknowledged that banks cannot pass on the lower interest rates immediately as the earlier stock takes time to mature, especially since a lot of deposits are for a one-year duration. This is why the Central Bank said the reduction in the deposit rates that were generated by the deposit cap be passed onto the customers. In an ideal world after the Elections, when confidence and sentiment improves, there will be a lending rate structure that can boost growth."