Pathfinder Economic Alert

The impossible trinity: an immutable law of economics

With the end of the 100 days, moves are currently afoot to complete the constitutional amendments and electoral reform. Elections are also on the horizon. The Pathfinder Foundation is of the view that once these important measures are completed, high priority should be attached to the imperatives for urgent economic reforms. Recent developments have made this even more important.

The impossible trinity

The Central Bank's recent 50 basis point reduction of its key policy rates and intervention in the currency market has drawn attention to the Mundell – Fleming model which introduced the 'impossible trinity' to the corpus of economic theory. This theory postulates that it is not possible for central banks to pursue a monetary policy (interest rates) which is not market driven and based on macroeconomic fundamentals; intervene in currency markets to prop up the exchange rate; and be open to capital flows all at the same time. One can only pursue two of these objectives at any given time.

Over the years, several countries have mishandled this trilemma, even though the Mundell – Fleming model was developed as far back as the 1960s. The policy challenges associated with the 'impossible trinity' have become more relevant to developing countries as more and more of them have taken steps to liberalize the capital account of their balance of payments to permit freer flows. Sri Lanka has not fully liberalized its capital account. However, a combination of partial liberalization and greater engagement (particularly through borrowing) with international capital markets have exposed Sri Lanka more and more to the discipline imposed by the 'impossible trinity'. It is a matter of concern that domestic policy-makers have deviated from this discipline from time-to-time. It happened in 2010/11 with significant adverse effects and the same mistakes are being repeated now.

Pursuing the 'impossible trinity' 2010/11

Under pressure to deliver a tangible peace dividend at the end of the conflict, the authorities in 2010/11 strayed from the compulsion of the 'impossible trinity'. An artificial policy-induced boom was delivered to meet the expectations of the people. The economy grew by 8 % and 8.2 % in those two years. There was a consumption boom, with a sharp rise in vehicle imports being a vivid reflection of this.

The policies fuelling the boom ignored the premise that all three elements of the 'impossible trinity' could not be pursued at once. Interest rates were reduced by about 500 basis points at a time when the government budget was pumping excess demand into the system. The fiscal deficits were 8% of GDP in 2010 and 6.9% in 2011. The real effective exchange rate was allowed to become 25% overvalued. There were large capital inflows through borrowings from the IMF and international bond issues. This meant that the authorities were pursuing interventionist monetary and exchange rate policies at a time when there were large capital inflows through external borrowing.

The inevitable upshot was unsustainable credit growth (elevated borrowing by both the government and the private sector) resulting in high inflation and a sharp rise in the trade and current account deficits of the balance of payments. This led to pressure on the exchange rate and $3 billion of external reserves were used in a futile attempt to defend the currency. These are all symptoms of an overheating economy which is an inevitable consequence when the discipline associated with the 'impossible trinity' is not followed.

The painful medicine

What ensued was also inevitable. The authorities were compelled to impose a stabilization package in Feb/March 2012 which contained painful austerity measures: interest rates were increased by about 300 basis points; a credit ceiling (corset) was imposed; the currency was depreciated by 15% (following an earlier adjustment of 3% in the November 2011 Budget Speech); and fiscal consolidation gained momentum with the deficit being reduced from 6.5 % of GDP in 2012 to 5.9 % in 2013. These measures had the desired outcomes. Inflation fell from10.6% in 2011 to 2.9 % in February 2015; the current account deficit declined from 7.8 % of GDP in 2011 to 3.9 % in 2013. All this brought about a regime of historically low interest rates and a stable currency; with low credit growth and compressed imports.

However, the benign macroeconomic conditions were attained at a high cost, particularly as the stabilization package was not supported by structural reforms to enhance the competitiveness of the economy. Growth momentum was lost despite the end of the conflict and favourable economic geography. Sri Lanka is located in Asia with proximity to India and excellent relations with China.The growth rate, which was artificially stimulated to 8% in 2010/11 declined. As mentioned before by the Pathfinder Foundation on several previous occasions, the official growth figures for 2012 – 2014 are contestable if one looks at the various proxies for economic expansion. The balance of probability is that the growth rate was in the 5.5% - 6.5% range during this period - disappointing for an economy which averaged close to 5% even during the conflict. In addition, average household incomes increased by only 0.5% per year.If this was the average, a significant share of the population would have experienced a reduction in real incomes. This was an important factor in influencing the outcome of the recent Presidential election. The constrained economic conditions contributed to an environment where the 'good governance' campaign was able to gain traction. The blow back would have been even more severe but for the rising inward remittances which served to provide a cushionfor household consumption (this was, of course, exogenous rather than domestically generated).

The key lessons

There is a key lesson to be drawn from the experience of 2010 – 2014. Flouting the basic premises of the Mundell – Fleming model (the ‘impossible trinity’) has inevitable consequences. It leads to unsustainable macroeconomic imbalances. The painful corrective austerity measures have eventual political costs, particularly if stabilization measures are implemented without supporting structural reforms which strengthen the growth framework of the economy. Sooner or later bad economics becomes bad politics.

Repeating the folly

It is concerning that the recent 50 basis point interest rate cut and intervention in the currency market seems to indicate that these lessons have not been learnt. It is necessary to examine current policies related to each of the ‘impossible trinity’ to explore this further.

Monetary policy has been relaxed with the recent 50 basis point reduction in the policy rates. It has also been implied that there could be further such cuts. This has been justified on the grounds of excess liquidity and a loss of growth momentum in the economy with weak investor sentiment (domestic and foreign) due to the current political uncertainty and a slowing down of government investment projects. However, as against this the credit cycle has turned and the trade balance has deteriorated, despite low commodity import prices, especially oil, and good rains. There is a four – five quarter transmission lag for interest rates adjustments to take effect in Sri Lanka (e.g. the current loosening cycle commenced in 4Q 2013 and private sector credit growth began to pick up in 4Q 2014). Hence, interest rate adjustments at the present time should be based on economic conditions likely to prevail at the end of this year and beyond. By that time, the effects of the two expansionary budgets (November 2014 and January 2015) would have worked their way through the system. The resulting increase in aggregate demand, with a boost to consumption rather than investment, would have had an adverse impact on inflation and the balance of payments. The latter is likely to be the more pressing problem. Inflation may be contained, particularly if import prices continue to be very low. However, the favourable impact of low imported inflation is likely to be offset by the deterioration in the budget deficit and its impact on domestic aggregate demand. Hence, loosening monetary policy at a time of a rising budget deficit is fraught with danger.

Not only has monetary policy been relaxed but the Central Bank has been intervening in foreign exchange market both directly and through moral suasion. This has been a major causal factor for the decline in external reserves from $9 billion in December 2014 to $7 billion in March 2015. A combination of loose fiscal policy and an accommodating monetary policy stance will continue to exert pressure on the exchange rate. One may conclude that at the present time the authorities are seeking to reduce interest rates and prevent the exchange rate from depreciating i.e. intervening in two elements in the ‘impossible trinity’.

This makes it important to examine the prognosis for the third element: capital flows. With weak fiscal / monetary coordination and pressure on the exchange rate, there is likely to be capital outflows. It would also become more difficult to roll over existing debt resulting in the

use of depleting foreign reserves to service debt repayments. This has already begun to happen as reflected in the delay in the $1.5 billion bond issue and the decline in external reserves. The recent swap arrangement with the Reserve Bank of India provides a cushion. However, it only serves to buy some time and does not resolve the problem. The current situation is further exacerbated by the political uncertainty and the effects on emerging / frontier markets of the looming US Federal Reserve interest rate rise expected later this year. The imbalances on the external front are also likely to be adversely affected by delays in the repatriation of export proceeds in the context of the downward pressure on the currency and the political uncertainty.

Another concern is that the current financing of the government's liquidity requirements through high levels of domestic borrowing and Central Bank money printing is unsustainable. Sooner or later, there will have to be an international bond issue or borrowing from the IMF or both. The costs of the bond issue will be elevated, if risks are not reduced through improved macroeconomic policies.

Failure to take early remedial action would result in a steady deterioration of macroeconomic fundamentals. The balance of payments will decline and reserves will continue to fall. In addition, the currency will come under increasing pressure. There will also be upward pressure on inflation and interest rates. The earlier the remedial measures are implemented the less painful will be the adjustment.

The way ahead

Governments do not focus on stabilization measures and structural reforms before impending elections. Hence, a stable political dispensation is urgently required as without this nothing is possible.

The current priorities for the country on the economic front are:

- Fiscal consolidation through a combination of increased revenue and reduced expenditure particularly recurrent expenditure.
- Monetary policy, which is based on emerging trends rather than historical data, while taking into account the lag in transmission (4-5 quarters) as well as the need for sound fiscal/ monetary policy coordination.
- An exchange rate which reflects underlying macroeconomic fundamentals and the competitiveness of the economy.
- Structural reforms which improve the productivity/competitiveness of the economy, including the development of a new FDI led export expansion based growth model (see PF article: *Charting the way forward prosperity for all* at www.pathfinderfoundation.org). The lesson from recent years is that implementing stabilization policies without supporting structural reforms will stifle growth and depress real incomes.

It is important that the authorities move beyond politics to embark upon sound economic policy-making which recognises the discipline imposed by the 'impossible trinity'. It is also necessary to learn from recent experience and supplement the necessary stabilization measures with structural reforms which are urgently required to provide impetus to the growth process in the economy. The experiences from 2010 /11 demonstrate very clearly that boosting growth through expansionary monetary/fiscal policies and an over-valued exchange rate is unsustainable. Furthermore, the later the corrective stabilization measures are introduced, the more painful the adjustment. The shifting of focus from politics to economics needs to be swift and decisive once the elections are over.

This is the Seventy Second Economic Alert of Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org