

# Monetary Policy Transmission in Sri Lanka

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[〈 More written comments here 〉](#)

**What do the authors do?**

# What do the authors do?

Authors raise the following questions:

1. Effect of monetary policy (**MP**) on Sri Lanka's real economy?
  - ▶ Importance of **C**redit and **E**xchange-rate channels in **MP** transmission?
2. What are the changes in **MP** Transmission Mechanism post civil war?
3. How do credit shocks affect the economy?

# What do the authors do?

## 1. Growth-rate of key variables (\*except):

- ▶ **O**il **P**rice,
- ▶ **F**ed **F**unds **R**ate,
- ▶ **F**orex **E**xchange **R**eserves,
- ▶ **Y** real GDP,
- ▶ **I**N**F**lation (CPI),\*
- ▶ **M**1,
- ▶ **I**N**T**erest rate (money market)\*
- ▶ **C**Redit to private sector from commercial banks,
- ▶ **R**eal **E**xchange **R**ate.\*

## 2. VAR( $p$ ), $p = 2$ , linear trend, constant, peace dummy (mid 2009–).

## 3. Data: 1996-Q1 to 2019-Q4.

## 4. Study **MP** transmission:

- ▶ Identify “structural” shocks assuming Cholesky factorization—variables ordered above.
- ▶ Estimated impulse response function (IRF) and variance decomposition (VD) statistics.

# Contribution and Claimed insights

Interesting question: Pre-/post-war nature of MP transmission. Has MP become better?

1. (**MP**) has “expected” dynamic multiplier effects on real economy.  
Importance of **C**redit and **E**xchange-rate channels in **MP** transmission.
2. Post civil war effect of (**MP**) has stronger and more persistent effect on the economy. (Implies “better” MP effects?)
3. Increased bank lending raises output and inflation.

# Specific Comments/Suggestions

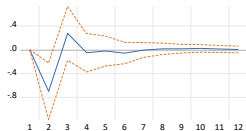
# Comment 1: MP shock and transmission

1. What is the monetary policy (instrument) said to be identified in the VAR?
  - ▶ Nowhere defined/discussed in the paper. Turns out to be **INT** (money-market interest rate). Reader inferred from Figure 1 (impulse responses).
  - ▶ Problem is that Figure 1 impulse responses are mostly “insignificant” (not statistically different from zero). Exception: output, M1, RER.
  - ▶ Are these IRF bands asymptotic bands? Tried bootstrapping these given small-sample size problem?
2. Claimed: **CR** and **RER** have more persistent responses to MP shock imply that the “credit” and “exchange-rate” channels are important to MP. Why? If anything, the rest of the variables do not respond to MP shock  $\Rightarrow$  MP is not effective in stimulating the domestic economy?

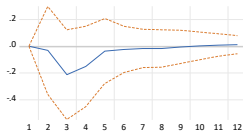
# MP shock and transmission

Response to Structural VAR Innovations  $\pm 2$  S.E.

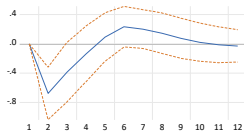
Real output



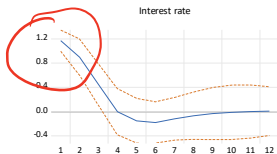
Inflation



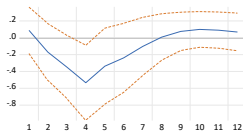
Money



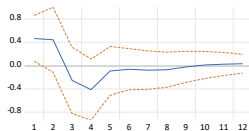
Interest rate



Bank credit



Real exchange rate





## Comment 2: Pre-/post-war MP transmission

Post war: IRFs (given MP shock) decay slower and have larger magnitudes.

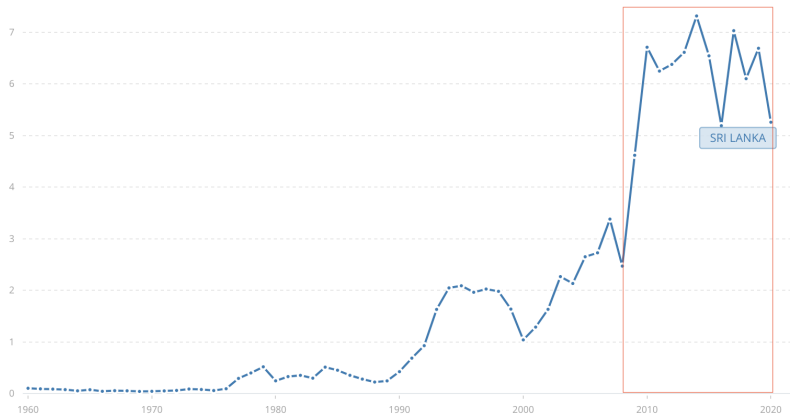
- ▶ Relative pre-/post-war comparison limited to Table 2 (point estimates).
- ▶ Suggest to plot these. Also show IRF error bands!

Stronger post-war effect of MP shock:

- ▶ Is this somehow related CBSL's declining ability to defend its currency?  
See figures next ...
- ▶ Would be interesting if authors can pursue this and tell us more: how and why.

# An FER story? How?

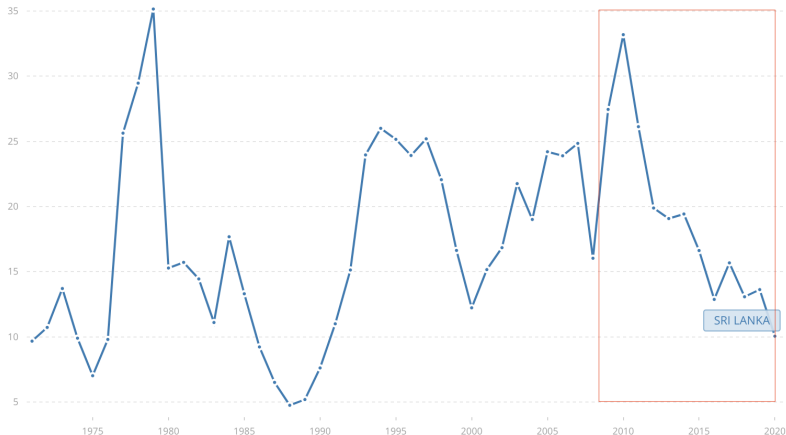
Drastic jumps and volatility circa/post 2009



Total Reserves (minus gold)

# An FER story? How?

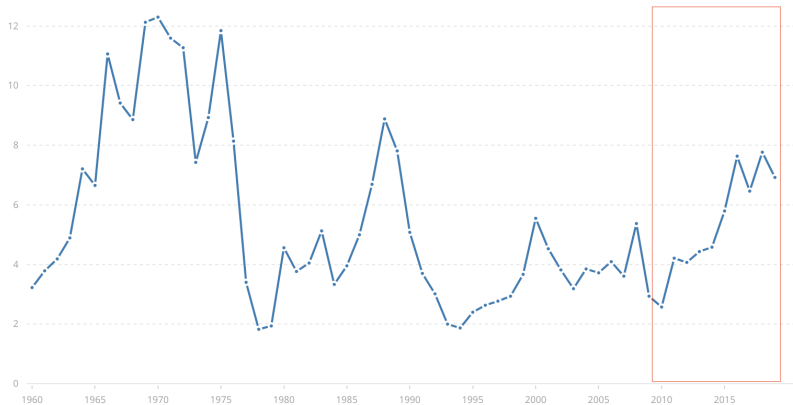
Declining ability to defend currency and/or rising debt burden?



Total Reserves / External Debt ratio

# An FER story? How?

Post 2009: CBSL's rising liability against FER asset ...



MO / Total Reserves

## Comment 2: An FER story? How?

From CBSL's operations and news commentaries, CBSL official interest-rate corridor policy seems to be tempered by **FER** (forex reserves management).

Suggestion: Focus on this aspect of policy?

- ▶
- ▶ How to separately identify structural **INT** variations in the presence of potential **FER** management?
- ▶ Is merely "chucking" in **FER** sufficient for identifying policy variations hidden in observed **INT** outcomes?
- ▶ Given current setup ... Suggestion: Order **FER** then **INT** lowest in the "triangle"?

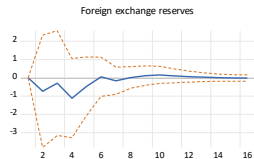
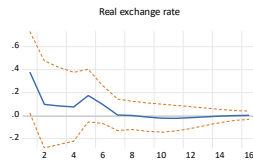
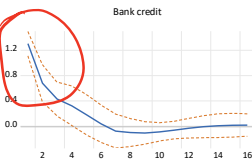
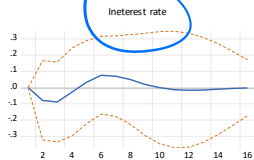
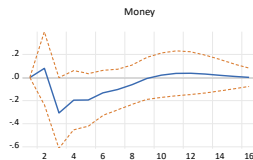
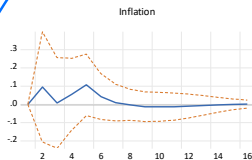
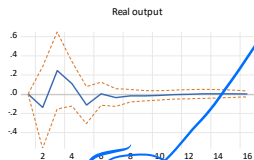
## Comment 3: "Credit channel"

Positive shock to lending (**CR**)

- ▶ Claimed: raises output and inflation
- ▶ Comment: But all these IRFs are statistically no different from zero.
- ▶ What really is "credit channel"? Is a shock to **CR** a supply-side (lender) or a demand-side shock? Here, it seems to be both since **CR** only measures observed lending and borrowing. Do they have different MP implications? If so, do we need to separately identify a lending-side shock in line with authors' intention?
- ▶ Suggestion:
  - ▶ Is modelling the economy in a growth-rates VAR appropriate? E.g., a shock to **INT** would actually be a shock to the *acceleration* of monetary policy rate.
  - ▶ Have authors tried a VECM with mixture of  $I(0)$  and  $I(1)$  variables? Phillips (1995); Chang and Phillips (1995).

# "Credit channel"

Response to Structural VAR Innovations  $\pm 2$  S.E.



## Comment 4: Real trade sector?

Sri Lanka has been heavily dependant on tourism, trade and FDI.

Suggest to include

- ▶ FDI
- ▶ Current/capital account elements



## Comment 5: Miscellany

Please check:

- ▶ Spelling
- ▶ Punctuation
- ▶ Long sentences
- ▶ Footnoting convention
- ▶ Make growth-rate variables notation more obvious?
- ▶ Report lag-length selection criteria?
- ▶ Report estimation method: OLS, software. Replicable science!
- ▶ Consistency of citation style

Detailed [notes/comments here](#).

# References



Chang, Yoosoon and Peter C. B. Phillips (1995). "Time Series Regression with Mixtures of Integrated Processes". In: *Econometric Theory* 11.5, pp. 1033–1094. ISSN: 02664666, 14694360. URL: <http://www.jstor.org/stable/3532601>.



Phillips, Peter C. B. (1995). "Fully Modified Least Squares and Vector Autoregression". In: *Econometrica* 63.5, pp. 1023–1078. ISSN: 00129682, 14680262. URL: <http://www.jstor.org/stable/2171721>.