Monetary Policy Transmission in Sri Lanka

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PhD Conference, Nov 11-12, 2021

What do the authors do?

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Authors raise the following questions:

1. Effect of monetary policy (**MP**) on Sri Lanka's real economy?
   - Importance of **Cr**edit and **Ex**change-rate channels in **MP** tranmission?

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,
   - **INF**lation (CPI),*
   - **M1**,
   - **INT**erest rate (money market)*
   - **CR**edit 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 **Cr**edit and **Ex**change-rate channels in **MP** tranmission.

2. Post civil war effect of (**MP**) has stronger and more persistent effect on the economy. (Implies "better" MP effects?)

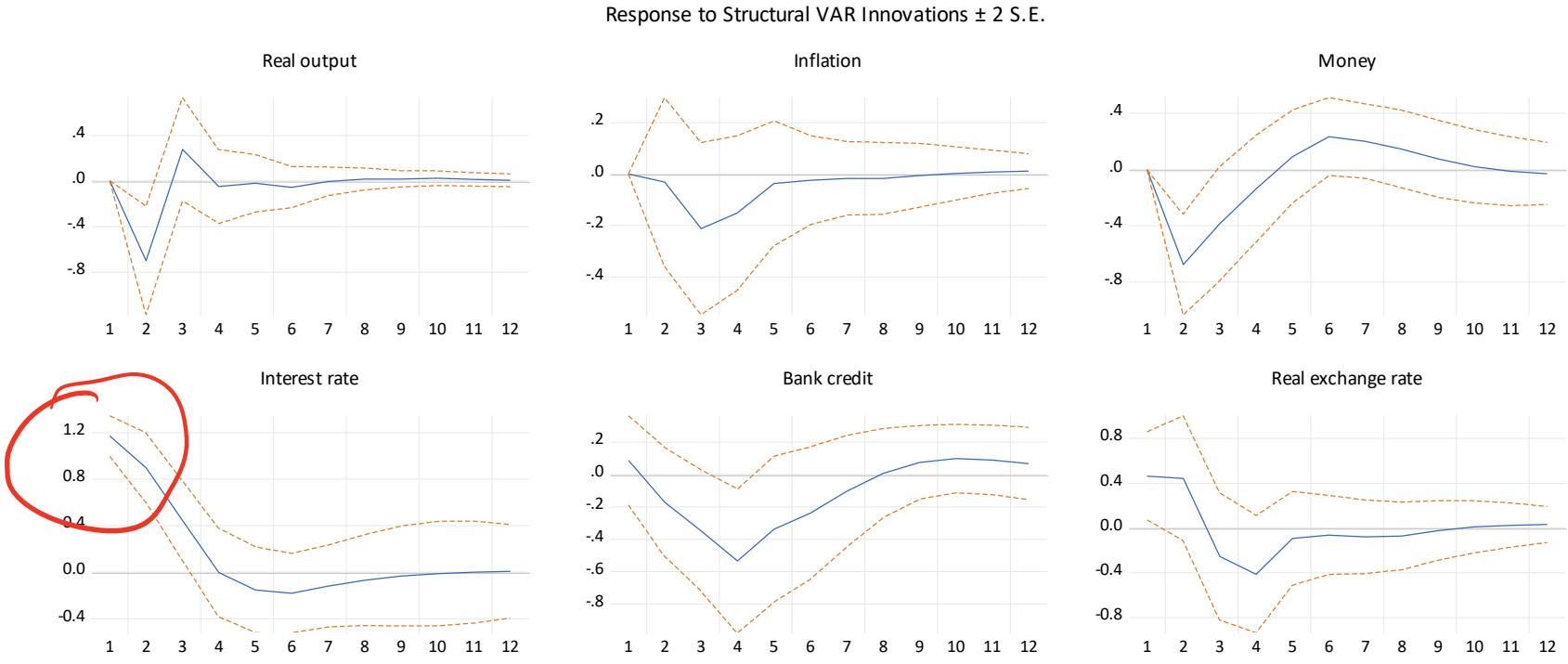
3. Increased bank lending raises output and inflation.

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 boostrapping 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



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.

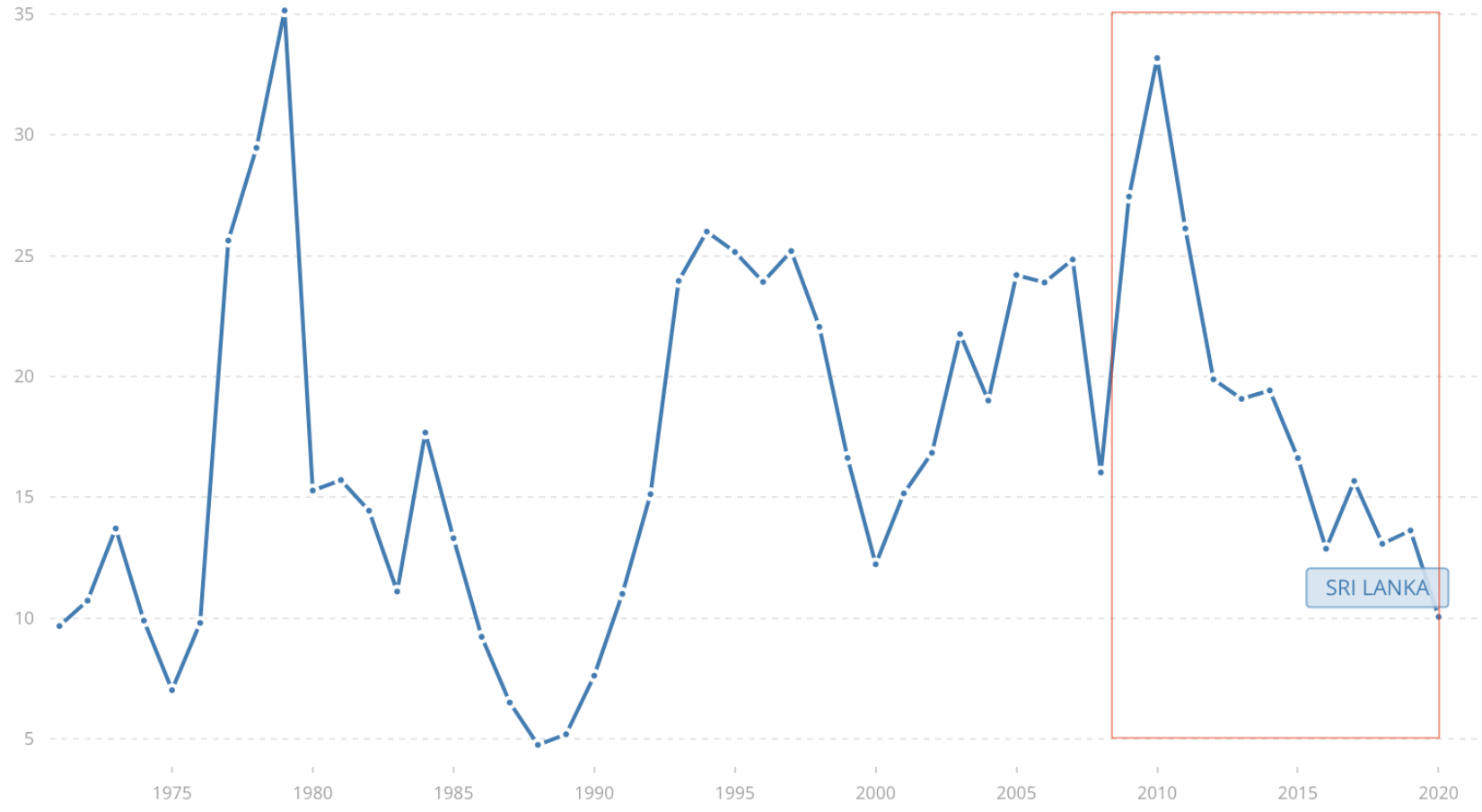
An FER story? How?

Drastic jumps and volatility circa/post 2009

Total Reserves (minus gold)

An FER story? How?

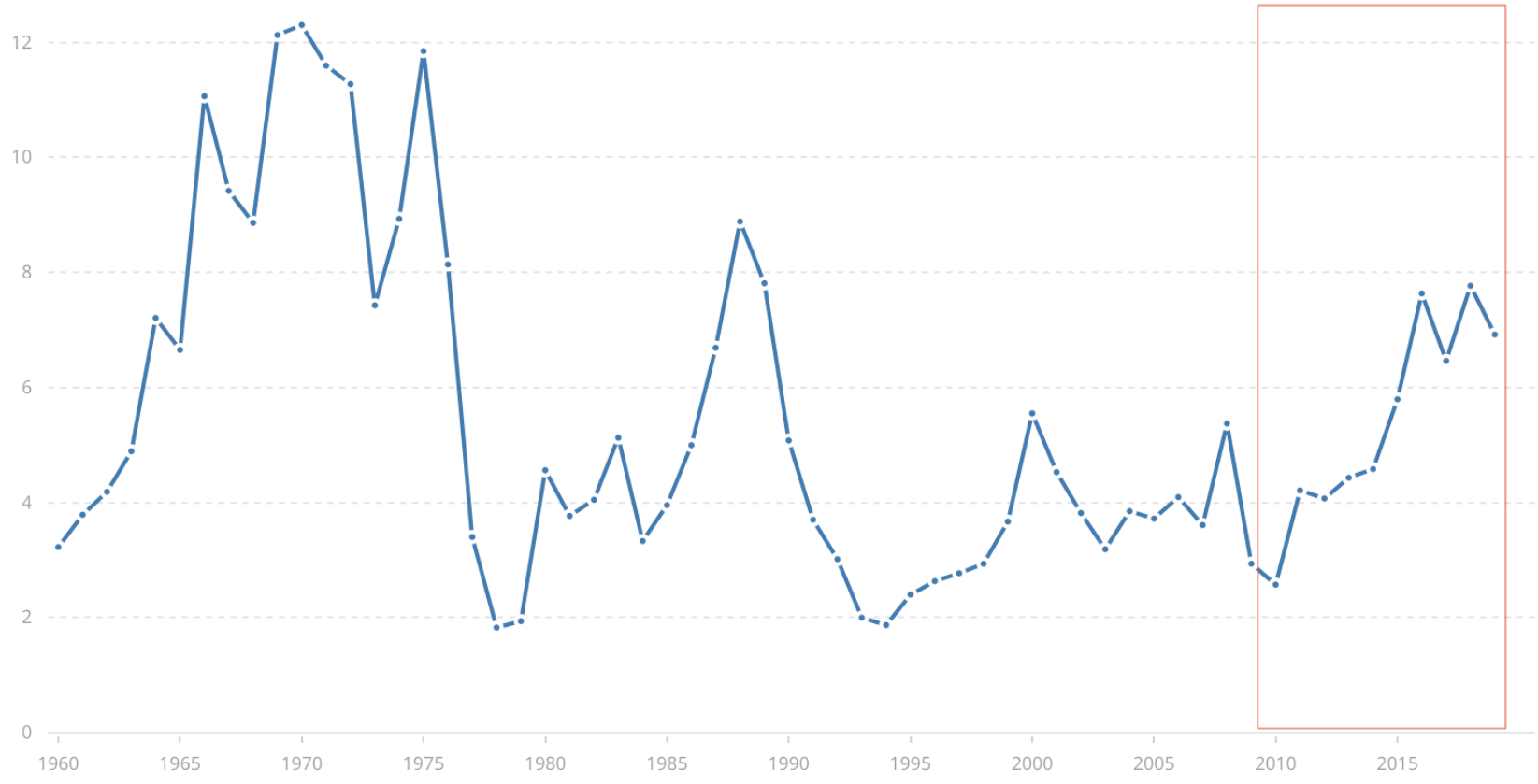
Declining ability to defend currency and/or rising debt burden?



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?

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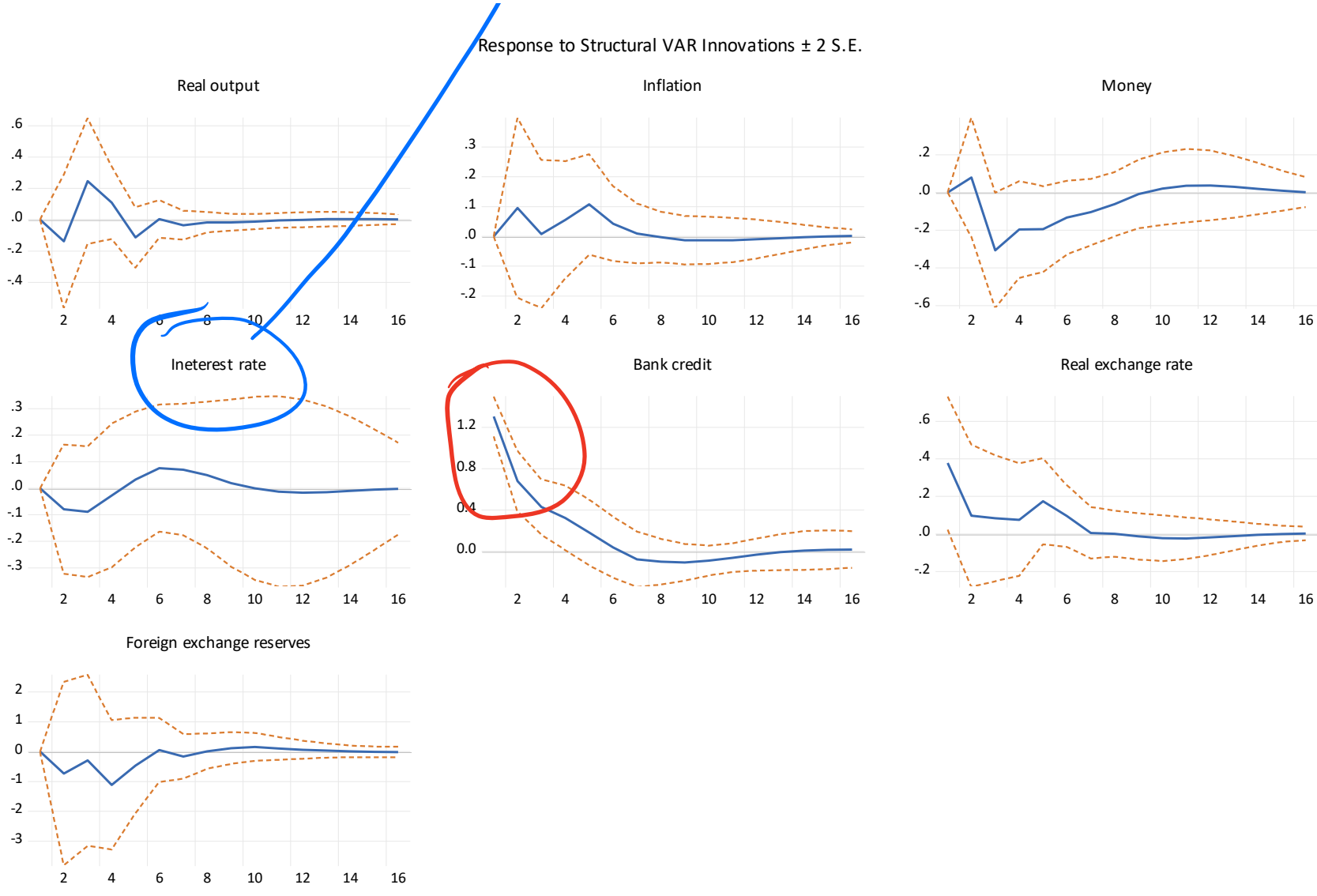
- How to separately identify structural **INT** variations in the presence of potential **FER** management?
- Is merely "chucking" in **FER** sufficient for identifying policy variations hidden in observed **INT** outcomes?
- Given current setup ... Suggestion: Order **FER** then **INT** lowest in the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



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.