MASTER OF SOCIAL SCIENCES IN ECONOMICS (M.S.Sc. IN ECONOMICS)

THE IMPACT OF MONETARY POLICY ON THE MACROECONOMIC PERFORMANCE IN SRI LANKA

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Abstract

Central Bank of Sri Lanka sets price stability and economic stability as its main monetary policy objective goal. Review of past empirical works reveals that no study has examined the impact of monetary policy shocks on macroeconomic variables, using a UVAR framework with context to Sri Lanka. This study attempts to identify the various factors of monetary policy affect on macroeconomic performance in Sri Lanka. Specific objectives are to examine the impact of monetary policy on economic growth, inflation and to identify the solutions for mitigating the lack of macroeconomic performance in Sri Lanka.To that end; researcher uses a five variable unrestricted VAR model by utilizing quarterly time series data over the period 1978 - 2015 in order to focus on the impact on small open economy. Real Gross Domestic Product and Colombo Consumer Price Index were used as non-policy variables. Broad money supply, interbank call market rate and exchange rate were used as potential monetary policy indicators. Impulse response functions and variance decompositions are employed to capture the impact of monetary policy on the economic growth and inflation. Impulse response for the model with average call money market rate presents theoretically consistent results for output and inflation. Broad money supply presents theoretically consistent with output and inflation only for some periods. One standard deviation exchange rate appreciation has a positive effect on output only for some periods which indicate theoretical inconsistency. Negative impact on economic growth rate shows theoretical consistency of the estimated results only for some periods. One standard deviation exchange rate appreciation has a significant effect on reducing inflation, in 7th-10th quarter following the shock. A shock on economic growth rate, average call market rate and exchange rate it will have 79%, 16% and 3% variation of the fluctuation in economic growth rate. A shock to economic growth rate will have 96% of variation of the fluctuation in the inflation rate. At 5% significant level price level, money supply, average call rate and exchange rate can't jointly cause for economic growth rate. Economic growth rate and growth of money supply are most important variable of deciding inflation rate.

Keywords: Macroeconomic performance, Monetary policy, Impulse responses, Small open economy, UVAR model