

Selvarajah, M. K.
Faculty of Arts, Department of Economics, University of Colombo

Paper: Transformability

Inflation in Sri Lanka: A cointegration and causality analysis

Despite a number of external and internal shocks, the expansionary economic policies followed by the government and the Central Bank of Sri Lanka during the post liberalization period resulted in improvement in various macroeconomic indicators including economic growth, which remained above five percent. However, inflation is yet to be considered as a significant indicator which remained at double digit level. It is also important to note that during the last three decades, inflation rate in Sri Lanka has been relatively higher than average rate of South Asian countries. There are several factors which have made a huge contribution to this high level inflation.

The purpose of this study is to analyze the experience of inflation in Sri Lanka during the post liberalization period through focusing on three main factors such as: growth of money supply, budget deficit, and depreciation of Sri Lankan currency. The annual time series data for the period 1977 to 2010 have been used and all the data were drawn from various annual reports of the Central Bank of Sri Lanka. Further, this study uses Johanson and Juselius Cointegration approach and Vector error correction models to analyze the causal relationship among the variables. The empirical results of the study indicate the existence of long run dynamic relationships among variables. At the same time, the Granger Causality analysis suggests the existence of unidirectional causality running from money supply to inflation, exchange rate to inflation and budget deficit to inflation. However, this paper does not find any causation from inflation to money supply, exchange rate and budget deficit. Further analysis indicates that inflation in Sri Lanka during the post liberalization period is mainly attributed to the monetary expansion followed by the country. Therefore, this study concludes that money supply variable can be used as an effective policy instrument to maintain the price stability.

Keywords: Budget deficit, Cointegration, Exchange rate, Inflation and Money supply