

Abstract

The study examines the efficiency of the traditional interest rate channel in the transmission mechanism of monetary policy. The interest rate channel is a major monetary transmission channel to achieve monetary policy co-objectives in Sri Lanka. Monetary policy innovations transmit to macro-economic variables through several channels. The traditional interest rate channel is identified as the way that monetary policy shocks are transmitted to price levels and output through firms' decisions regarding investment.

The study uses quantitative techniques for the analysis and data was collected for the period 1978-2014. The Johansen Co-integration technique and Vector Error Correction tests are employed for the analysis, due to the non-stationarity of all the series used in the study. The study examines three objectives: the less and negative value of interest elasticity of money demand, the more and negative interest elasticity of investment and the positive money supply elasticity of price level.

The estimated interest rate elasticity of money demand is 0.038 and it is a less and negative value, as expected. The interest rate elasticity of the estimated investment model also has a negative value of 0.06, but it is not at a sufficient level. The money supply elasticity of price level has taken a positive value of 0.84, and money supply is highly influential on the price level. These estimated coefficients are statistically significant and theoretically consistent. The interest inelasticity of money demand shows that implementing monetary policy is effective in Sri Lanka, and less interest sensitivity of investment proves that declining interest rates are not sufficient reason to achieve higher investment which is expected by the economy. This means that the usefulness of the traditional interest rate channel has not been at a satisfactory level to transform monetary policy shocks to the macro economy. An expansionary monetary policy creates inflationary pressure rather than the effect on output level.

Key Words: Monetary Transmission Mechanism, Interest Rate Channel, Interest Rate Elasticity, Co-integration Test, Vector Error Correction Test,