Effectiveness of the Traditional Interest Rate Channel to Achieve Core Objectives of Monetary Policy in Sri Lanka

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The study examines whether the interest rate channel serves well as the major monetary policy transmission channel to maintain monetary policy core objectives in the Sri Lankan context. Monetary policy innovations, are transmitted to the macro economic variables through several transmission channels, and the traditional interest rate channel was identified as the way that transmits the monetary policy shocks to the price level and output through firms' business decisions on investment. The study uses quantitative techniques for the analysis, and the data has been collected for the period of 1978 to 2014. The Johansen Co-integration technique is employed for analysis due to the non-stationarity of all the series used in the study. The three objectives of the study are to examine: less and negative value of interest elasticity of money demand, more and negative interest elasticity of investment and the positive money supply elasticity of price level. 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 has also taken 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 three coefficients are statistically significant; 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 the usefulness of the interest rate channel to maintain economic growth is not at a satisfactory level. The declining interest rate is not sufficiently effective to achieve higher investment, which is expected by the economy. An expansionary monetary policy creates an inflationary pressure than a positive effect on the output level.

Keywords: Monetary transmission mechanism, Interest rate channel, Interest rate elasticity, Co-integration Test, Vector Error Correction Test