Impact of Interest Rate on Investment, in the Sri Lankan Context.

A Study to examine Effectiveness of Monetary Policy through Interest Rate Channel

Lead author: S.N.K.Mallikahewa[1]

Department of Economics, University of Colombo. Sri Lanka.

subamallikahewa@yahoo.com

Tele.No. 0702563860

Co-author: N.D. Veenavee Sandaroo[2]

Department of Economics, University of Sri Jayawardhanepura, Sri Lanka.

Veenavee92n@gmail.com

Tele. No. 0718543474

[1] Senior Lecturer, Department of Economics, University of Colombo.

[2] Student in Economics special, University of Sri Jayawardhanepura, Gangodawilla, Nugegoda.

Impact of Interest Rate on Investment, in the Sri Lankan Context.

A Study to examine Effectiveness of Monetary Policy through Interest Rate Channel

Abstract:

The study investigates whether interest rate make significant negative impact on investment. Interest elasticity of investment should be more and negative value for sound interest rate channel to achieve monetary policy objectives. Co-integration test and Vector Error Correction test are applied to estimate the long-run model and the short-run dynamics of investment and independent variables; interest rate, income, exchange rate and price level are used. Results show that the interest rate is negatively related with investment, and the value of co-efficient is 0.06. The negative relationship proves that low interest rates can negatively influence investment to achieve monetary policy objectives. Marginal effect on investment (magnitude of coefficient) is not enough to maintain the efficiency of monetary policy.

Key words: Interest rate coefficient, Long run Investment model, interest rate channel, Vector Error Correction method, Co-integration method.

Conclusion:

Interest elasticity of investment should be more and negative value for sound interest rate channel to achieve monetary policy objectives. The Interest rate (FDR) is negatively related with Investment (investment on construction) in the Sri Lankan context during the sample period. Higher nominal interest rates lead to higher real interest rates, and investments would be discouraged. Prices will not adjust quickly and real interest rate would be increased. The negative relationship proves that low interest rates can negatively influence investment to achieve monetary policy objectives. Marginal effect on investment (magnitude of coefficient) is not enough to maintain the efficiency of monetary policy.

The price level and income are positively related with investment, and in an inflationary period, individuals are encouraged to invest on constructions to minimize the cost of inflation. As well as in an economically healthy period, individuals are encourage to invest on private construction.

The Nominal Exchange Rate also negatively related with investment expenditure in Sri Lanka. Investment declines with higher exchange rate due to higher prices of imported materials used in the construction field. All the estimated coefficients of the investment model are highly significant and theoretically consistent. According to short run dynamics, -71% of the disequilibrium ($\mu_{(t-1)}$) in investment on construction will be adjusted towards equilibrium within one year period.