The Effectiveness of Exchange Rate Channel of Monetary Policy Transmission Mechanism in Sri Lanka.

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Abstract:

This study examines the effectiveness of the exchange rate channel in the transmission mechanism of monetary policy in Sri Lanka during the period from 1978 to 2015. A negative relationship between the two variables is accepted in theoretical insights on the topic. An increase in interest rate leads to appreciation of domestic currency against other foreign currencies. If the empirical situation is different to theoretical explanations, decision makers would not be able to make proper decisions to achieve macroeconomic targets in the economy. Monetary policy is conducted to achieve economic and price stability, and its policy shocks transforms to the economy through various transmission channels. A developing country like Sri Lanka usually prefers to depreciate local currency in order to increase export earnings and to reduce import expenditure to gain a balance of trade. Expansionary monetary policy tends to result in currency depreciation, thus increasing net exports. Higher economic growth can be achieved with domestic currency depreciation through increasing exports. In an inflationary situation, contractionary monetary policy can reduce aggregate demand with domestic currency appreciation. If there is no negative relationship between interest rate and exchange rate, the exchange rate transmission channel of monetary policy does not support the achievement of monetary policy co-objectives.

The study uses the variables nominal exchange rate, Treasury bill rate, net exports and total external debt. Co-integration and Vector Error Correction tests are employed for the analysis due to the non-stationary of all the variables used in the study, and the results prove the negative relationship between exchange rate and interest rate as expected in the long run. Estimated value of the interest rate elasticity of exchange rate is -0.178, which proves that exchange rate channel is efficient in the Sri Lankan context. According to short run dynamics, 5% of the error in exchange rate is corrected annually.

Key words: Exchange rate channel, transmission mechanism, interest rate elasticity of exchange rate, Co-integration test, Vector Error Correction Test,