The Transition from Exchange Rate Targeting: The Case of Sri Lanka[*,†]

Harsha PARANAVITHANA[1,2] Rod TYERS[1,3] Leandro MAGNUSSON[1]

[1]Business School, University of Western Australia
[2] Central Bank of Sri Lanka
[3] Centre for Applied Macroeconomic Analysis (CAMA), Australian National University

Abstract

This paper uses an elemental macro model to quantify the effect of a range of alternative Sri Lankan monetary policy regimes to which its transition from exchange rate targeting might be directed. Faced with a variety of supply, demand and external shocks, the inflation targeting regime is shown to offer lower macro-economic volatility than the alternatives, most strongly under demand and external shocks. This is notwithstanding the sensitivity of real purchasing power to inflation targets, even where employment is stabilised. Consistent with Mundell's financial trilemma, the increase in Sri Lanka's financial integration after 2012 is shown to have made external shocks more prominent, further supporting the transition to inflation anchored monetary policy framework.

JEL classification: E37, E52, F15, N15

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Correspondences: Harsha Paranavithana, Business School, University of Western Australia, Crawley, WA 6009, Australia.
Tel: +61 426440612; Email: paranavithana.paranavithana@research.uwa.edu.au

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