ABSTRACT

High inflation persistence implies long-run effects of a shock to inflation, and, consequently, may involve high disinflation costs. Why inflation is more persistent in certain periods, than in others? Is inflation persistence a structural feature of the economy, such that, eradicating it may involve some significant loss of economic activity; or does it vary with the stability and transparency of monetary policy regimes? These are some of the issues, which attracted a lot of research interest among academics and policymakers alike, over the years. This paper examines inflation persistence in Sri Lanka from 1960q1-2009q4, a period of high variation in inflation and some significant policy changes. By employing both classical and Bayesian models, we find that inflation persistence has been high and almost unchanged during 1970s and 1980s; it starts falling since early-1990s; and at present, it stands at some moderate levels. Meanwhile, the CPI inflation process has been subject to significant parameter instability over the sample period, in that, during late-1970s through 1980s, it has been very close to a unit root process (implying long-run effects of an inflation shock), and currently, it is not well-characterized as a process with a unit root. We find that, during the period of high inflation persistence, inflation dynamics are mainly driven by shocks to the trend component, making inflation sticky at some higher levels. By contrast, during recent years, the effects of inflation shocks turn out to be transitory, resulting relatively lower degree of persistence. Further, we document evidence of some significant moderation of innovation variance of inflation and output growth, in recent years. By weighing all the evidence, we conclude that inflation persistence has shown significant time-variation, as such, we take side with those who claim that inflation persistence need not be 'hardwired' into the deep structure of the economy.

Keywords: Inflation Persistence, Monetary Policy, Structural Breaks, Time-Varying Parameter Models

JEL Classification: C11, E31, E52