Decoding Policy Puzzles and Monetary Policy Transmission in Sri Lanka through Time-Varying Dynamics

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Abstract

This study analyses evolution of key macroeconomic variables and their linkages to understand and resolve some of the policy puzzles in Sri Lanka and to check whether responses to monetary policy shocks exhibit any time-variation over two decades employing time-varying parameter vector autoregression with stochastic volatility (TVP-SVOL). In addition, interest rate pass-through is also measured employing ARDL method to update evidence on transmission of policy rate to other interest rates, including the periods that recognize short term interest rate as operational target of the monetary policy. The findings from interest rate pass-through analysis reconfirms the existing evidence of complete pass-through from policy interest rate to money market interest rate and sluggish pass-through from money market rates to other market rates, though the size and speed of adjustment are somewhat different from past findings. The time-varying analysis of macroeconomic dynamics leads to four main conclusions. Firstly, time varying mean did not show any substantial moderation in GDP growth trend over the years though a marginal moderation is observed recently. The level and volatility of inflation exhibit systematic moderation since late 2000s. The weaker linkages of money growth with GDP growth and interest rate evolve over the years, supporting the policy move to discontinue monetary targeting. Finally, the responses of growth and inflation to monetary policy shocks show time-dependence.

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