Monetary Policy and Inflation-Output Variability in Developing Economies: Lessons from Sri Lanka

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Abstract

The purpose of this study is to examine the impact of monetary policy on inflation-output variability trade-off for developing economies, drawing on the experience of Sri Lanka. Using time series data over the period 1980-2017, we first examine how inflation-output variability trade-off has changed across different monetary policy episodes. Secondly, we investigate the persistence of the variability of inflation and output in the face of supply and demand shocks, before exploring the contribution of monetary policy to macroeconomic performance more generally. We find that the inflation-output variability trade-off shifted favourably over time, though no strong evidence of long-run variability association could be established. The study reveals that the economy witnessed the highest level of output growth during the periods in which the negative Taylor curve relationship is satisfied. Our findings further highlight that the impact of demand and supply shocks on the variability of inflation and output are not persistent. This confirms that the deviations from the Taylor curves caused by adverse shocks are transitory if the central bank operates efficiently. Meanwhile, the estimated aversion to inflation variability of the central bank increased significantly over time, suggesting that the monetary authority took the goal of inflation stability very seriously. Using the loss function of the central bank, we also find substantial improvements in welfare loss during the post-war period compared to other periods.

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