Effectiveness of the Interest Rate Channel for Controlling Price Level in the Sri Lankan Context

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Keywords: Interest Rate Channel, Price Level, Co-integration Test, Vector Error Correction Test, Unit Root Test

Introduction:

The aim of this study is to examine the effectiveness of interest rate channel as a main monetary transmission channel to control the price levels in Sri Lanka. The conduct of monetary policy serves as common ground for discussion of the specific policies called for in particular situations. The central elements of this consent are that the instrument of monetary policy ought to be the short term interest rate, that policy should be focused on the control of inflation, and that inflation can be reduced by increasing short term interest rates.

In the monetary policy literature, there is a view that monetary transmission mechanisms operate more effectively in the periods when price stability is achieved (Gali, 2008). Most economists agree that in the long run, output (GDP) is fixed and any changes in the money supply only cause prices to change. But in the short run, changes in the money supply can affect the actual production of goods and services because prices and wages usually do not adjust immediately. This is why monetary policy is a meaningful policy tool for achieving both inflation and growth objectives. A central bank should be able to adjust its policy interest rate carefully to achieve its inflation target to a level which is steady with growth objectives of the economy. The relationship between the monetary policy decisions and changes in the level of output and price level of the economy is explained by the monetary policy transmission mechanism. According to Mishkin (1996) the monetary transmission mechanism with interest rate channels had been a standard feature in the literature for over sixty years going back to the period of Keynes and it is the primary mechanism at work in conventional macroeconomic models.

Thiessen (1998) describes that Monetary Transmission Mechanism takes place in four stages. First, Central Bank actions affect short term interest rates via the banking sector liquidity. In the second step these short term interest rates affect other interest rates and exchange rates. In the third step interest rates and exchange rates affect aggregate economic activities such as consumption, investment and national income. At the last the aggregate demand and supply affect inflation. Dakila and Paraso (2004) also describe these stages of transmission mechanism as the interest rate channel.

There is a doubt whether Sri Lanka could perform monetary policy targets through the interest rate operations. If the interest rate channel of monetary policy is effective in Sri Lanka, interest rate could be able to control inflation and to maintain economic growth.

Conclusion:

According to the data, higher interest rate leads higher price level. Higher interest rates lead people to save money in the fixed deposits in the Sri Lankan experience. With higher interest rates and higher savings would leads to raise money creation activities of the commercial banks

due to higher liquidity of the banks. In the meanwhile higher investment and consumption lead higher price level. This result indicates that the credit channel of the transmission mechanism of monetary policy is more effective than the interest rate channel to achieve price stability as well as the growth stability, in relation to Sri Lanka.

A positive innovation of income or output leads lower price level in the long run. A higher exchange rate leads to raise domestic prices in one hand due to importation of goods and other hand higher aggregate demand with higher export earnings. If Central bank can control exchange rate through the monetary aggregates as a monetary policy tool, the exchange rate transmission channel of monetary policy also would be more effective than the interest rate channel in Sri Lanka. Price level has a long run relationship with other related variables in the system but not short run dynamics.