Impact of income and Market Interest Rate on the Demand for Money in Sri Lanka.

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Introduction:

The importance of the demand for money has become a prominent research topic in economics due to its role in monetary policy formulation. Income elasticity[1], and interest elasticity[2] of money demand affect the channels of the transmission mechanism[3] of monetary policy. Empirical interest in demand for money functions arises because a stable and predictable money demand function is a pre-requisite for the use of targets for monetary aggregates as an objective of monetary policy. Interest elasticity of such functions is crucial for the relative effectiveness of monetary and fiscal policy. *(McMorrow, 1998)*

Among developing countries, it is accepted that interest rate is an unsatisfactory measure of the opportunity cost of holding money. First, financial markets have not well developed in the developing countries, and due to this situation, possibilities of substitution between money and other financial assets are limited. Secondly, a more practical objection is that the interest rates are often determined by the government and remain constant for long periods, and there wouldn't be sufficient variation to enable its influence on the demand for money. As a developing country, Sri Lanka has experiences of low economic growth with high inflationfor a long time period. (*Central Bank Reports. Sri Lanka*).There is a research space to examine whether interest rate transmission mechanism is effective in the Sri Lankan context. For the good

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[1]. The percent change in money demand caused by a one percent change in income.

[2]. The percent change in money demand caused by a one percent change in interest rate.

[3] The monetary transmission mechanism describes how policy-induced changes in the nominal money stock or the short-term nominal interest rate impact real variables such as aggregate output and employment. (Ireland, 2005)

performance of interest rate transmission mechanism, interest rate elasticity of money demand function is crucial.

Conclusion:

In the long run model of money demand, interest rate (CBR) is positively related to real money balances (LRMd2). It means that interest rate elasticity of money demand is greater than zero and this coefficient is significant but inconsistent with the hypothesis. When the policy rate is increased, people would prefer to keep their money as savings and time deposits considering liquidity of money for transactions. They would not be attracted to financial assets such as bonds. The less developed financial market would be the reason for this inefficiency.

The elasticity of Real Gross Domestic Product (RGDP) is statistically highly significant and consistent in the long run money demand model. The estimated results show that the RGDP makes a powerful positive impact on the Real money demand. In the Sri Lankan context, demand for money is highly depended on transaction purpose.