Abstract

The amendment to the Monetary Law Act in 2002 defines "economic and price stability" as one of Central Bank of Sri Lanka's core objectives. Using a standard aggregate demand – aggregate supply model with varying policy preferences this paper discusses the achievability of "economic and price stability" when the economy is faced with aggregate demand disturbances and aggregate supply disturbances. As demand disturbances move both output and prices in the same direction, monetary policy can counter the shock thus achieving output and price stability simultaneously. However, supply disturbances move output and prices in opposite directions, and the central bank may not be able to maintain both output and price stability. In such circumstances, extreme policy aimed purely at price stability aggravates the effect of the supply disturbance on the real economy. This confirms that, while price stability must remain the focus of a modern central bank, the stability of the real economy cannot be totally ignored in monetary policymaking.

Keywords: central banking, monetary policy, supply disturbances, demand disturbances

JEL classification: E10, E52, E58, E61