MONETARY TRANSMISSION IN THE EMERGING COUNTRY CONTEXT: THE CASE OF SRI LANKA

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Abstract

The main purpose of this study is to provide a comprehensive assessment of monetary policy transmission in the emerging country context. As such, the paper examines the effectiveness, relative importance of different transmission channels, distributional effects of monetary policy across different financial institutions as well as the structural changes in monetary transmission in Sri Lanka using monthly and quarterly aggregate data and disaggregated data. Based on the empirical estimates obtained employing both unrestricted and structural vector auto regressions, this study mainly suggests that monetary policy is quite effective to influence target variables of Central Bank of Sri Lanka, i.e. output and prices. It also shows that monetary policy changes affect target variables through intermediate transmission channels such as exchange rates, asset prices as well as bank credit. Based on the bank-wise data, consistent predictions are observed to support the view that small financial institutions find it more difficult to shield their activity against a monetary policy shock than large institutions. Finally, the results suggest that transformations in the economic and financial environment play a role in increasing the sensitivity of output and prices to interest rates suggesting the changes in monetary transmission. These results provide important policy implications for emerging country central banks, particularly Central Bank of Sri Lanka.

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