Monetary Policy Rules in Practice: Evidence for Sri Lanka

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Abstract

The paper seeks to characterise the monetary policy decision making process for Sri Lanka using standard Taylor-type monetary policy rules. Alternative monetary policy reaction functions are estimated for Sri Lanka over the period 1996Q1 to 2013Q2. An open economy reaction function is used in the analysis where the central bank is assumed to respond to changes in inflation, the output gap and the exchange rate. A forward looking specification of the reaction function is found to provide the most appropriate characterisation of policy making at the Central Bank of Sri Lanka. The results indicate that the size of the coefficient on the inflation gap has increased over time reflecting a greater focus on price stability. However, the response of monetary policy to fluctuations in output has been greater than the response to deviations in inflation reflecting the central bank's preference and the lower sensitivity of output to interest rate changes.

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