Monetary policy rules and macroeconomic stability: Evidence from Sri Lanka

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Abstrak

This study estimates the forward-looking monetary policy reaction function for Sri Lanka using monthly data from 1980 to 2017. The results indicate that the Central Bank of Sri Lanka (CBSL) followed the Taylor rule to set interest rates. Our forwardlooking model estimations show that the coefficient on inflation increases over time, reflecting the greater focus on price stability by the bank. The results suggest that the CBSL reacted to nominal exchange rate depreciation by tightening monetary policy. Although the degree of interest rate smoothness gradually decreases over time, the study shows that the CBSL did not react to movements in fiscal deficit during the period under investigation. This finding suggests that the inclusion of fiscal deficit in the Taylor rule does not provide a better specification of the policy reaction function in Sri Lanka.