Empirical Relationship between Money Demand and Interest Rates in Sri Lanka

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Abstract

The interest elasticity of the demand for money is an important indicator in an effective counter-inflationary monetary policy. The objective of this study is to examine the nature and the extent of the relationship between the demand for money and nominal interest rates in Sri Lanka on the basis of the Baumol-Tobin theory of the demand for money. The ARDL approach to co-integration is used to evaluate the overall impact of interest rates on the demand for money. The results of the unit root test show that the interbank call loan rate is stationary at level form [I (0)], while the saving rate, 3 month, 6 month and 12 month fixed deposit rates, Treasury bill rates, banking rates and loan rates with securities are stationary in the 1st difference. There are joint long-run co-integration relationships among the variables of demand for money, deposits rates and lending rates in Sri Lanka. The results of ARDL suggest that there is a negative relationship among the normal saving deposit rates, fixed deposit rates, lending rates and real money demand, while there is a positive relationship between the real GDP and real money demand in the long run. The results of the short-run dynamic coefficients associated with the long-run relationships obtained from the ECM show a high percentage value of the disequilibria of the previous year's shock is adjusted back to equilibrium. The results suggest that the Central Bank of Sri Lanka needs to formulate sound monetary policies that will ensure a stable demand for the money function, thereby encouraging economic growth in the country. A policy of attracting more participants (non-government) and private sector funds to the money market is necessary as this will deepen the market and make the market more dynamic and amenable to monetary policy.

Keywords: Money Demand, Interest Rates, Baumol-Tobin Model, Autoregressive Distributed Lag Model, Error Correction Model, Sri Lanka.

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