

## The demand for money in Sri Lanka: A structural vector error correction approach

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The demand for money is of crucial importance in the conduct of monetary policy in any country. Additionally, the interest elasticity of the demand for money is an important magnitude for consideration in effective anti-inflationary monetary policy. In this paper we will examine what the major determinants of money demand are and their effects on monetary policy in Sri Lanka. Allowing for dynamic adjustments towards long run steady states relations, we will also discuss some important questions related to the effectiveness of monetary policy. The period under consideration is 1970 to 2002, and due to lack of quarterly data on some variables, we will use annual data. We identify the relevant data generating process (DGP) as a structural vector error correction mechanism (VECM) in estimating the demand for money. The structural VECM has the attractive features that the estimated long run relationships embedded in the model are theory consistent, and have a clear economic interpretation and yet the short run dynamics are flexibly estimated within a VECM framework.

The paper also focuses on imposing and testing exact (theory consistent) and over identifying restrictions on the space of the co-integrating vectors so as to determine the long run behavioral parameters (i.e. interest elasticity) and to test the validity of the Monetarist arguments in the Sri Lankan context. We will use asymptotic critical values (based on Response Surface Regressions) for testing unit roots and co-integration since these critical values are more accurate than standard critical values. We also hope to measure the time profiles (with effects) for interest rate, real money balances, inflation, and real income variables to come back to their stable condition after giving one standard error shock to each variable in a co-integrated framework using orthogonalized and generalized impulse response functions. Finally, we hope to check the resultant model's statistical adequacy using various diagnostic tools of model evaluation. This study will not only shed new light on the demand for money in Sri Lanka, but also guide monetary policy making and its influence on other macroeconomic variables.

Key Words: Econometric analysis; Demand for money; Monetary policy; Sri Lanka; Interest rate