

Does Central Bank Financial Strength Matter for Inflation in Sri Lanka?

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Abstract

The importance of financial soundness in the central banking system is an area which was debated over the time. Due to the inherent monetary authority of central banks, it was argued that central banks do not necessarily require an adequate financial position compared to commercial banks. Also, its' costless ability to create domestic fiat money trivializes the need of maintaining a sound financial position. But, recent empirical studies claimed conflicting findings which drew the attention to the importance of financial strength in the context of central banks.

The central bank financial strength was a key factor which determines the effective conduct of monetary policy in terms of achieving policy objectives. Accordingly, linking central bank financial strength with price stability: maintaining a low level of inflation which is a primary objective of the majority of central banks came to the discussion which has been disregarded for a longer period of time.

This study was conducted with the aim of investigating the relationship between central bank financial strength and inflation in Sri Lanka considering the individual country characteristics for the time period ranging from 1980 to 2015. Time series regression was conducted with the basic model where the independent variable is central bank financial strength and the dependent variable is inflation; proxy to price stability.

Empirical result of this study provides a significant negative relationship between central bank financial strength and inflation suggesting a probable impact from central bank financial strength on inflation in Sri Lankan context which is claimed to be true in many empirical studies. Hence, it was concluded that maintaining adequate financial position is crucial even for central banks irrespective of the inherent monetary authority they consume.

KeyWords: central bank financial strength, inflation, sri lanka