The Influence of Central Government Debt on Inflation Rate in the Sri Lankan Economy

AMK Weerakoon
Department of Economics and Statistics, Faculty of Arts, University of Peradeniya, Sri Lanka
araliya.weerakoon@gmail.com

In general, one of the main purposes in most economies is a high economic development of stable or low inflation. Therefore, monetary establishments in countries implement monetary policies to control and maintain inflation at a desirable level. Sri Lanka has undergone a public debt crisis and it is highly impacts the budget deficit over the past years. The level of high inflation and public debt resulted in harmful effects on the Sri Lankan economy. The relationship between government debt and inflation is not much explored in Sri Lanka. Hence, this research strives to analyze the impact of central government debt on inflation using econometric techniques. This study adopted the Keynesian Theory of Public Debt and the Quantity Theory of Money as the theoretical framework. Time series data from 1978 to 2019 was used for the analysis. The study adopted Augmented Dickey-Fuller (ADF), Auto-Regressive Distributed Lag (ARDL) and Error Correction Model (ECM) tests to check the Stationarity, Long-run and Short-run relationships respectively. Inflation is the dependent variable and public debt, GDP, exchange rate, interest rate, savings, trade balance and trade openness are the independent variables used in this study. According to the test findings, all the variables are stationary; and there is an insignificant and significant positive impact on inflation in the long-run and short-run respectively, while other variables also have an impact on inflation. Hence, this study confirms that a 1% increase in central government debt will raise inflation by 376% in the short run in Sri Lanka. The study confirms the positive contribution of the public debt to enhance inflation in Sri Lanka. Hence, it is recommended that public debt be well managed and should invest in viable projects which lead to earning higher returns; maintaining price stability and accelerate the economic growth in Sri Lanka.

Keywords: *Central Government Debt, Economic Growth, Inflation, Savings, Trade Openness*