

EFFECT OF GOOD GOVERNANCE ON CENTRAL BANK INDEPENDENCE IN SRI LANKA: MEDIATOR EFFECT OF POLICY CONVERGENCE

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1. Introduction

Previous studies on Central Bank independence (CBI) were directed to several aspects such as developing CBI measurements, developing theories for the CBI, effects of CBI on macro-economic variables, etc. With the presence of political business cycles (PBC) and poor good governance (GG) in Sri Lanka, this study argues that it would result in a lack of policy convergence. Therefore, it hypothesizes that if poor governance leads to a decrease in policy convergence, and if low levels of policy convergence further reduce CBI, then policy convergence will play a significant mediating role in the relationship between governance and CBI. Thus, the study aims to investigate the mediation effect in the relationship between GG and CBI.

2. Research Methodology

A quantitative analysis is performed to derive the results through secondary data under convenience sampling. The study concerns inflation at one integer, GG indicators, exchange rates, and interest rates as variables in the study. A three-stage least square model is used over the sample period from 1996 to 2023 to test the hypothesis. Meantime, the level of policy convergence is tested by using a vector error correction model.

3. Findings and Discussion

The results indicate that monetary and fiscal policy convergence is achieved in the short run, and therefore, the above hypothesis is partially accepted. That is, even though the prevailing governance factors significantly affected the policy convergence in the country, policy convergence, in turn, has not significantly influenced the CBI. However, the direct effect of GG on CBI is statistically significant.

4. Conclusions and Implications

Thus, this study emphasizes the importance of strengthening governance factors in the country. Further, by prioritizing improvements in governance, policymakers can increase CBI, which, in turn, is likely to lead to a more effective monetary system.

Keywords: Central bank independence, Good governance, Policy convergence, Political business cycles