

**An Empirical Study on Money Demand Function in Sri Lanka:
1993 - 2013**

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The importance of the demand for money has become a prominent research topic in economics due to its role in monetary policy formulation. Income elasticity and interest elasticity of money demand affect the channels of the monetary policy transmission mechanism. This study investigates the long run demand for money and the short run demand for money. The estimation of a money demand function for M2, using annual data for 1993 to 2013 forms the basis of this investigation. The significant long-run relationships were found between Broad money demand, GDP, inflation rate and interest rate. Therefore, these variables can be taken as determinants of broad money demand in Sri Lanka. The positive elasticity of money demand in respect of GDP reveals that money demand for transaction purposes increases when income increases while the negative elasticity relationship between money demand and the interest rate and inflation rate implies that demand for money declines when interest rates and inflation rates were increase, while interest rate and inflation rate are significant in the long run, it is insignificant in the short run. The empirical findings of this study show that the demand for broad money (M2) in the analyzed period in the Sri Lanka is stable, indicating that on the basis of selected determinants, its long term prediction can be carried out. This study complements the existent economic literature by analyzing the determinants and stability of money demand in the Sri Lanka. Because of, demand for money is stable then money supply is the most suitable monetary policy instrument in Sri Lanka.

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