Abstract

The question of orderly transmission of monetary policy decisions across the yield curve remain at the forefront of many recent policy debates. Conventional wisdom is that decrease in the monetary policy target rate leads to an immediate decrease in market interest rates, and an increase in bond prices; yet evidence for this view is elusive. The question become profound when financial markets are in transition and swamped with structural impediments. Bringing the foundations of expectation hypothesis to ascertain monetary policy impact on daily market interest rates of Sri Lanka money and government securities market for the period 2000-2009 explains that monetary policy impact monotonically decreases over the yield curve at the short-end and become segmented toward medium to long-term of the yield curve. Analyzed for heterogeneous economic environment, the impact appears to be weaker and increasingly segmented at times of financial and economic uncertainties. This invites policy attention in Sri Lanka in terms of segmented market hypothesis of yield curve behaviour in contrast to standard explanation based on expectation hypothesis.

Keywords: Yield Curve; Sri Lanka; Monetary Policy; Expectation Hypothesis and Segmented Market Hypothesis

JEL Classification: E64; E66; E68; G1