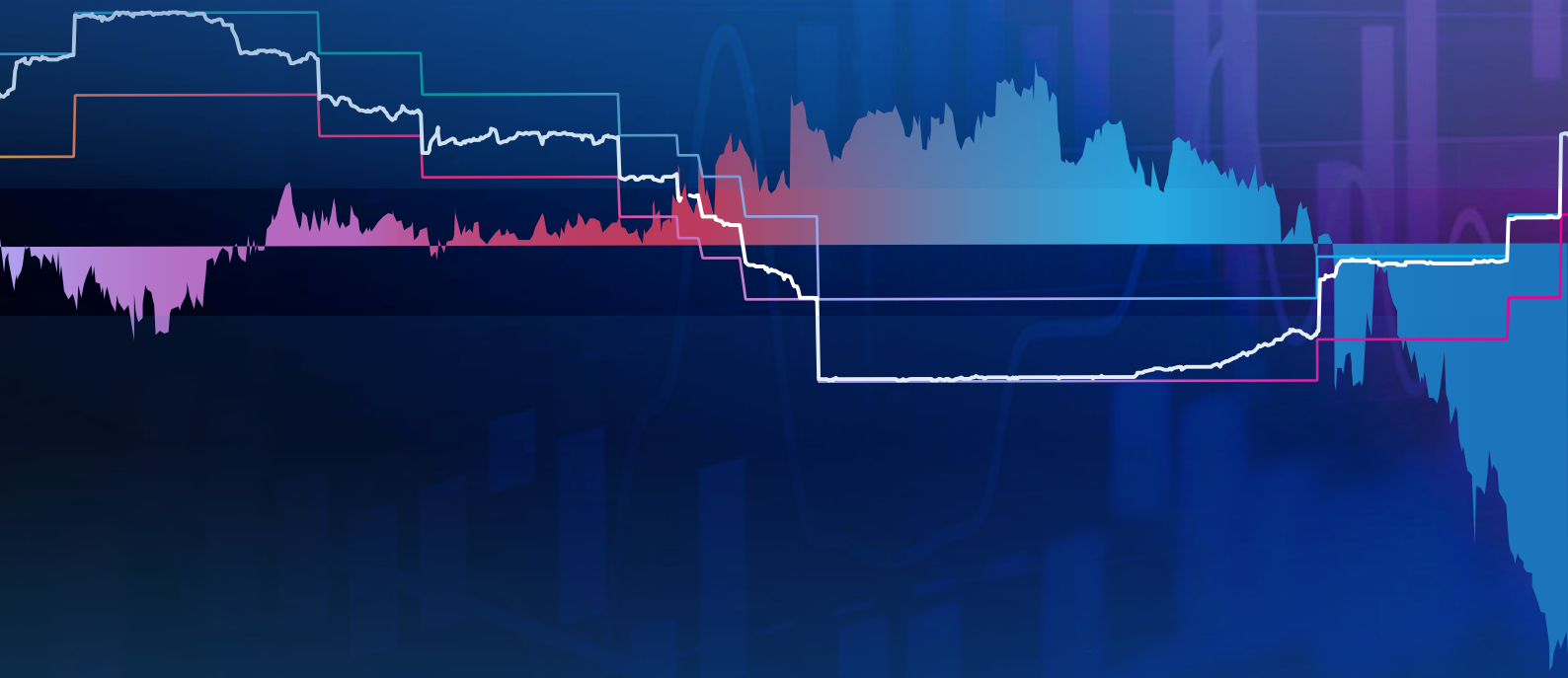
July 2023

# MONETARY POLICY IMPLEMENTATION IN SRI LANKA



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# List of Acronyms

| | |
|---|---|
| **AWCMR** | Average Weighted Call Money Rate |
| **CCPI** | Colombo Consumer Price Index |
| **DOD** | Domestic Operations Department |
| **EPF** | Employees' Provident Fund |
| **FIT** | Flexible Inflation Targeting |
| **IOD** | International Operations Department |
| **LCBs** | Licensed Commercial Banks |
| **LOLR** | Lender of Last Resort |
| **MLA** | Monetary Law Act, No. 58 of 1949 |
| **MOC** | Market Operations Committee |
| **MPC** | Monetary Policy Committee |
| **OMOs** | Open Market Operations |
| **PIs** | Participating Institutions |
| **SDF** | Standing Deposit Facility |
| **SDFR** | Standing Deposit Facility Rate |
| **SLF** | Standing Lending Facility |
| **SLFR** | Standing Lending Facility Rate |
| **SPDs** | Standalone Primary Dealers |
| **SRC** | Standing Rate Corridor |
| **SRR** | Statutory Reserve Requirement |

# Preamble

The Government and the monetary authority of a country play a vital role in enhancing economic welfare and the living standards of the people. In doing so, both the Government and the monetary authority rely on certain macroeconomic policies. The objectives of such macroeconomic policies are to ensure that the economy achieves non-inflationary, stable and sustainable growth, thereby enhancing the welfare of the society. This is achieved by implementing macroeconomic policies to minimise fluctuations in the macroeconomic variables, such as the Gross Domestic Product (output), employment, and the general price levels. Policies employed to achieve these objectives are generally two-fold: fiscal policy and monetary policy. Accordingly, both fiscal and monetary policy are instrumental in macroeconomic management and in particular, achieving macroeconomic objectives for the benefit of the citizens.

Fiscal policy of the Government is mainly related to taxation and government spending and their influence on economic conditions. Fiscal policy of the Government can ensure the overall economic stabilisation and growth. However, in general, it takes time to legislate taxes and spending changes. Moreover, economic agents may take time to respond and adjust their behaviour to fiscal policy changes. Hence, monetary policy is generally considered the more quick and effective mean of stabilising the economy, especially price levels.

Monetary policy involves the actions taken by the central bank to influence the cost and availability of money in the economy. Monetary policy actions employed by the central bank aim to achieve price stability (low and stable inflation) and reduce economic fluctuations, commonly known as minimising the intensity business cycles. The central bank uses instruments influencing the supply of money and credit and altering interest rates in the economy. Hence, adjustment to interest rates and money supply play an important role in an economy as it affects the behaviour of the borrowers and lenders. These actions affect the general price levels as well as employment, output of the economy and ultimately the welfare of the people. Such effects of monetary policy ensure low and stable price levels and thus low inflation. Proper coordination between fiscal and monetary policies is vitally important to ensure better outcomes for the macroeconomy.

The central bank, which is the apex financial institution of a country carries out key monetary and financial functions. Such functions include issuing currency, conducting monetary policy, providing and regulating payment systems, acting as a lender of last resort, and conducting financial sector supervision, among others. Generally, a central bank of a country is established as an independent institution, which is responsible for administering various statutes on money, banking, and the financial sector.

In implementing monetary policy to achieve the objective of price stability, a central bank uses a range of policy instruments. In the modern context, the most important monetary policy instrument is the use of policy interest rates and the open market operations, among several other instruments. Any changes made to policy interest rates and other policy instruments are meant to affect interest rates of money and capital markets and, in turn, affect interest rates that financial institutions deal with their customers. Accordingly, through such retail interest rates, monetary policy decisions influence consumer spending and business investments and overall demand in the economy.

In Sri Lanka, the Central Bank of Sri Lanka (referred to as 'the Central Bank' hereafter) is mandated to undertake a vital role as the nation's monetary authority. Accordingly, the Central Bank is responsible for formulating and implementing monetary policy in Sri Lanka, thereby operationalising several monetary policy instruments. As a part of achieving price stability objective of the economy and thereby implementing monetary policy, the Central Bank attempts to continuously communicate with market participants and the general public in order to enhance transparency of monetary policy actions of the Central Bank. Accordingly, the Central Bank disseminates information on its current and future policy direction, economic developments and the outlook, and the likely path for future monetary policy decisions. Such information is crucial for conducting monetary policy effectively and managing expectations of the general public.

This pamphlet aims at enhancing the awareness and understanding of the general public about the role of the Central Bank in implementing monetary policy in Sri Lanka. Having a clear understanding of the tools and policies used in monetary policy implementation would help the stakeholders in the financial system and the general public to better align their actions in line with the monetary policy decisions of the Central Bank and their intended outcomes.

This pamphlet consists of three parts. Part I provides a background discussion on monetary policy, including monetary policy objectives, frameworks, and decision making processes. Part II of the pamphlet discusses the implementation of monetary policy, including market liquidity management and monetary policy instruments in the context of Sri Lanka. Part III discusses the monetary transmission mechanism.

**Figure 1: Central Bank Mandate and Monetary Policy Implementation**

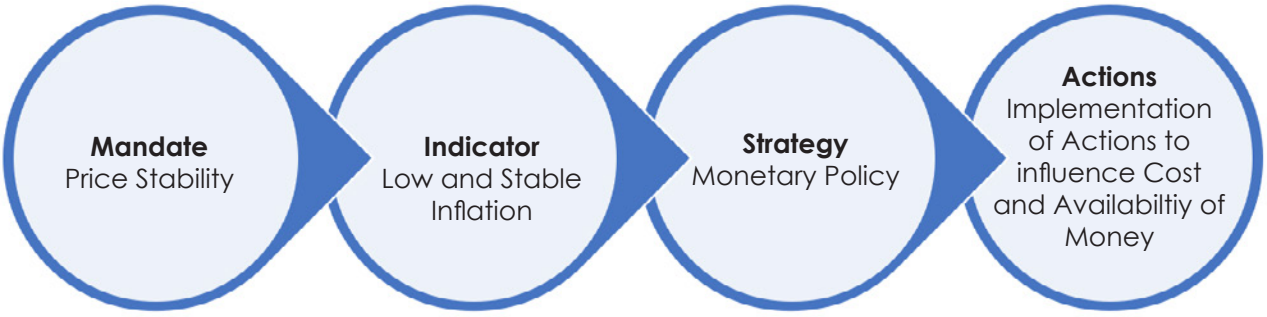
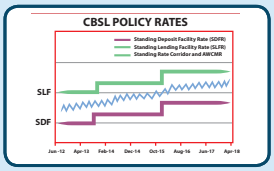


**Figure 2: Monetary Policy Formulation and Implementation in Sri Lanka - A Snapshot**

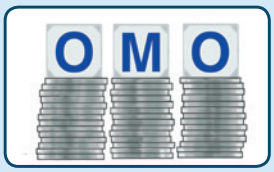

The Central Bank conducts monetary policy to achieve the objective of maintaining economic and price stability (low and stable inflation).


The Central Bank follows a Flexible Inflation Targeting (FIT) framework to maintain headline inflation (based on the Colombo Consumer Price Index-CCPI) between 4-6 per cent over the medium term.

Monetary policy actions of the Central Bank stimulate or dampen aggregate demand and help to reach the inflation target by adjusting short term interest rates. The Average Weighted Call Money Rate (AWCMR) serves as the operating target of the FIT framework.




The Central Bank deploys policy interest rates, namely the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), that form the Standing Rate Corridor (SRC) to signal the monetary policy stance along with the other policy instruments.




The Central Bank attempts to maintain AWCMR within SRC by managing liquidity in the domestic money market using Open Market Operations (OMOs).

AWCMR influences other short term and long term interest rates in the economy, including the lending and deposit rates of financial institutions, which affect economic decisions of the stakeholders.

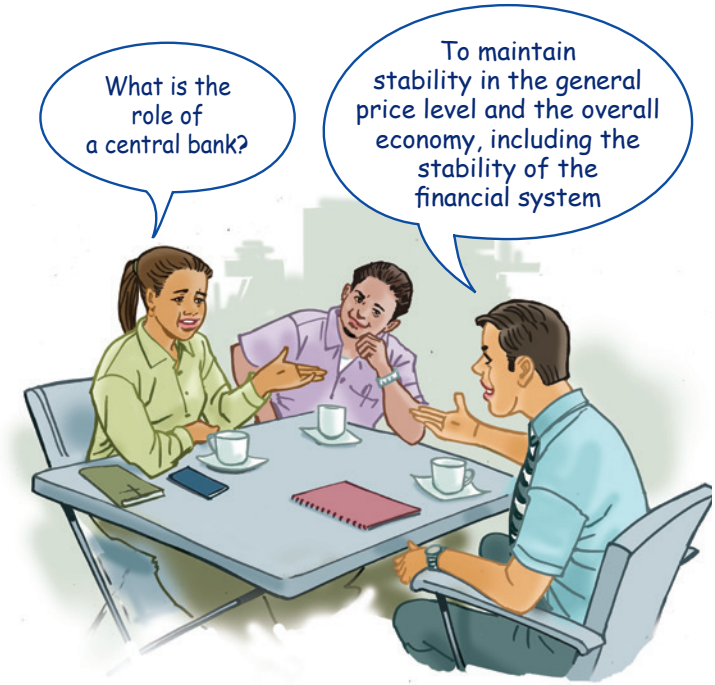
A reduction in interest rates stimulates consumer spending and business investment and supports economic growth. An increase in interest rates dampens consumer spending and business investment, thereby resulting in a slowdown in economic growth and deceleration in inflation.

The Central Bank reviews and takes decisions on the monetary policy stance and communicates the monetary policy decisions to the general public.

# Part I: Monetary Policy Formulation

## Central Bank Objectives and Monetary Policy

The Central Bank attempts to achieve two core objectives, namely, maintaining economic and price stability, and maintaining financial system stability. Price stability ensures that there are no wide fluctuations in the general price level in the economy reflecting low and stable inflation, which preserves the value of money. When there are no material price fluctuations, economic agents can make firm decisions with certainty on their consumption and investment, thus enabling efficient allocation of limited resources. This mandate of the Central Bank reflects that price stability is an essential condition for creating a stable economic and business environment, which is beneficial to economic activity, employment, and the welfare of the general public.




Financial system stability refers to the ability of the financial system to withstand both internal and external shocks such as economic recessions and economic imbalances, commodity and assets price bubbles, etc. A stable financial system supports mobilising savings and allocating them to productive investment, managing risks, and facilitating payments and settlements even under challenging economic circumstances. Hence, financial system stability ensures a conducive economic and financial environment for market participants, which facilitates investment, economic growth and welfare of the people. These two objectives are interrelated as actions taken to ensure price stability are transmitted to the economy via the financial system.

The Central Bank conducts monetary policy to achieve price stability in the economy. Monetary policy involves actions taken by a central bank to influence the cost and availability of money/ credit in the economy to achieve price stability. By controlling the cost of money (interest rate) and amount of money (currency and deposits), or the amount of credit (lent by banks and other financial institutions), a central bank is able to influence economic activities. By doing so, a central bank can influence consumption and investment spending in the economy, thereby affecting economic growth and inflation.

The Central Bank is responsible for conducting national monetary policy in Sri Lanka as per the powers vested under governing laws relating to establishment and enforcement of Central Bank's operations. Accordingly, the Central Bank adopts monetary policy decisions with the view of achieving economic and price stability. With the aim of achieving this objective, the Central Bank attempts to maintain inflation as measured by the year-on-year (Y-o-Y) change in the CCPI within the range of 4-6 per cent over the medium term. Although there could be deviations from the target temporarily due to various shocks, the Central Bank aims at maintaining price stability over the medium term through appropriate monetary policy actions.

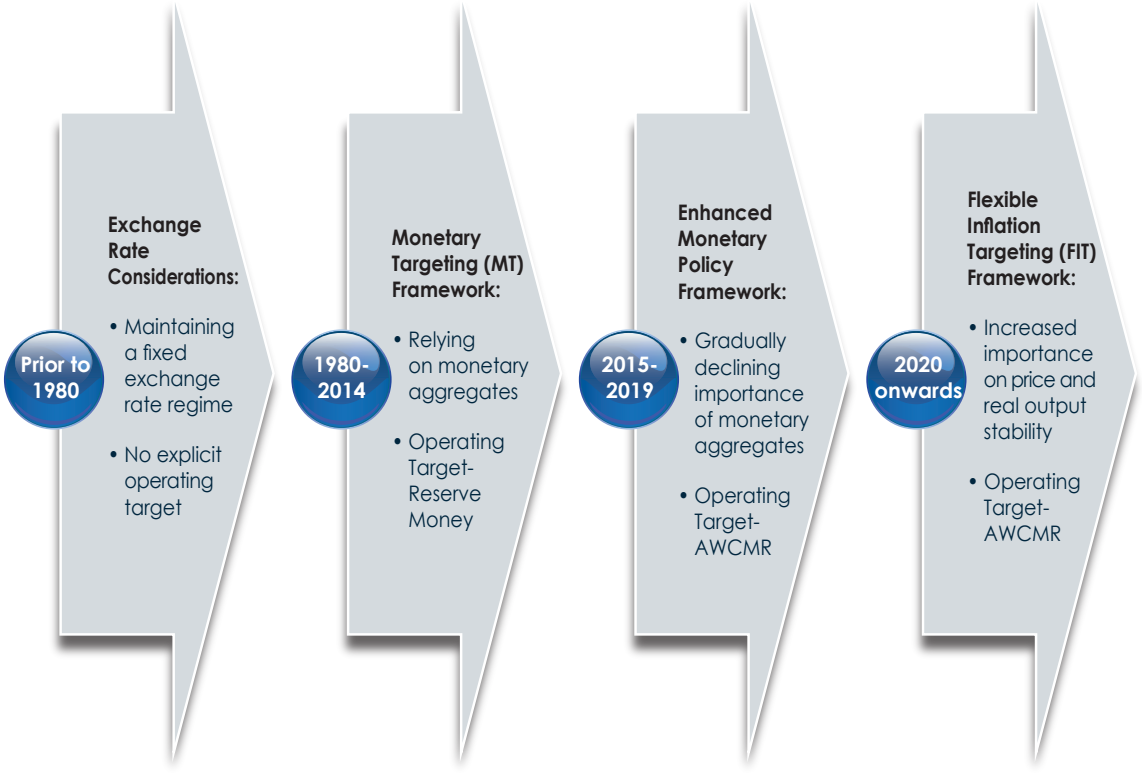
# Monetary Policy Framework in Sri Lanka

The monetary policy framework of Sri Lanka has evolved significantly over time. Since the establishment of the Central Bank in 1950 and until the introduction of economic liberalisation policies in 1977, Sri Lanka's monetary policy framework was primarily based on exchange rate considerations to fix the value of the Sri Lanka rupee to an international currency. Under this fixed exchange rate regime, the implementation of domestic monetary policy was constrained and domestic inflation was affected by foreign inflation.

After implementing open economy policies from 1977, the Central Bank gradually adopted a nominal anchor to control inflation and moved away from direct controls, while adopting market based monetary policy tools. The introduction of market based monetary policy tools also aimed at strengthening savings mobilisation and improving the efficiency of resource allocation, which had been suppressed by direct interest rates, exchange rates or credit controls. A nominal anchor for monetary policy refers to a variable that the central bank uses to manage actions and pin down expectations of economic agents about the nominal price level and its path or about what the monetary authority would do with respect to achieving that desired path. Generally, two types of nominal anchors, namely, quantity based nominal anchors and price based nominal anchors are used by the Central Bank. The quantity based nominal anchor targets money, while the price based nominal anchor targets interest rates or exchange rates.

During the early 1980s, the Central Bank adopted Monetary Targeting (MT) as its monetary policy framework and under MT, monetary aggregates were used as the key nominal anchor in the conduct of monetary policy in Sri Lanka. In particular, reserve money (comprised of currency in circulation bank deposits with the Central Bank) was used as the operational target, which is under direct control of the Central Bank, and broad money was used as an intermediate target to achieve inflation outcomes.

**Figure 3: Evolution of the Monetary Policy Framework in Sri Lanka**



Under this framework, any changes in money supply were the key factors influencing price stability. Hence, monetary operations were broadly aligned to control the money supply of the country. However, due to high volatility and the weakening relationship between money supply and inflation, the role of monetary targets as a nominal anchor became uncertain and complicated the Central Bank's communication strategy, compelling the Bank to upgrade its monetary policy framework.

Accordingly, since the early 2000s, the Central Bank kept introducing several modifications to the monetary policy framework. Since 2015, the Central Bank has conducted monetary policy within an enhanced monetary policy framework with features of both MT and Flexible Inflation Targeting (FIT), mainly due to the weakened relationship between money supply and inflation. The FIT framework has been instrumental in further improving expectation management, transparency, and credibility of monetary policy. In the FIT framework, the Central Bank adjusts monetary policy tools to achieve an inflation target of 4-6 per cent over the medium term, measured in terms of CCPI based headline inflation, while supporting to achieve sustainable economic growth.

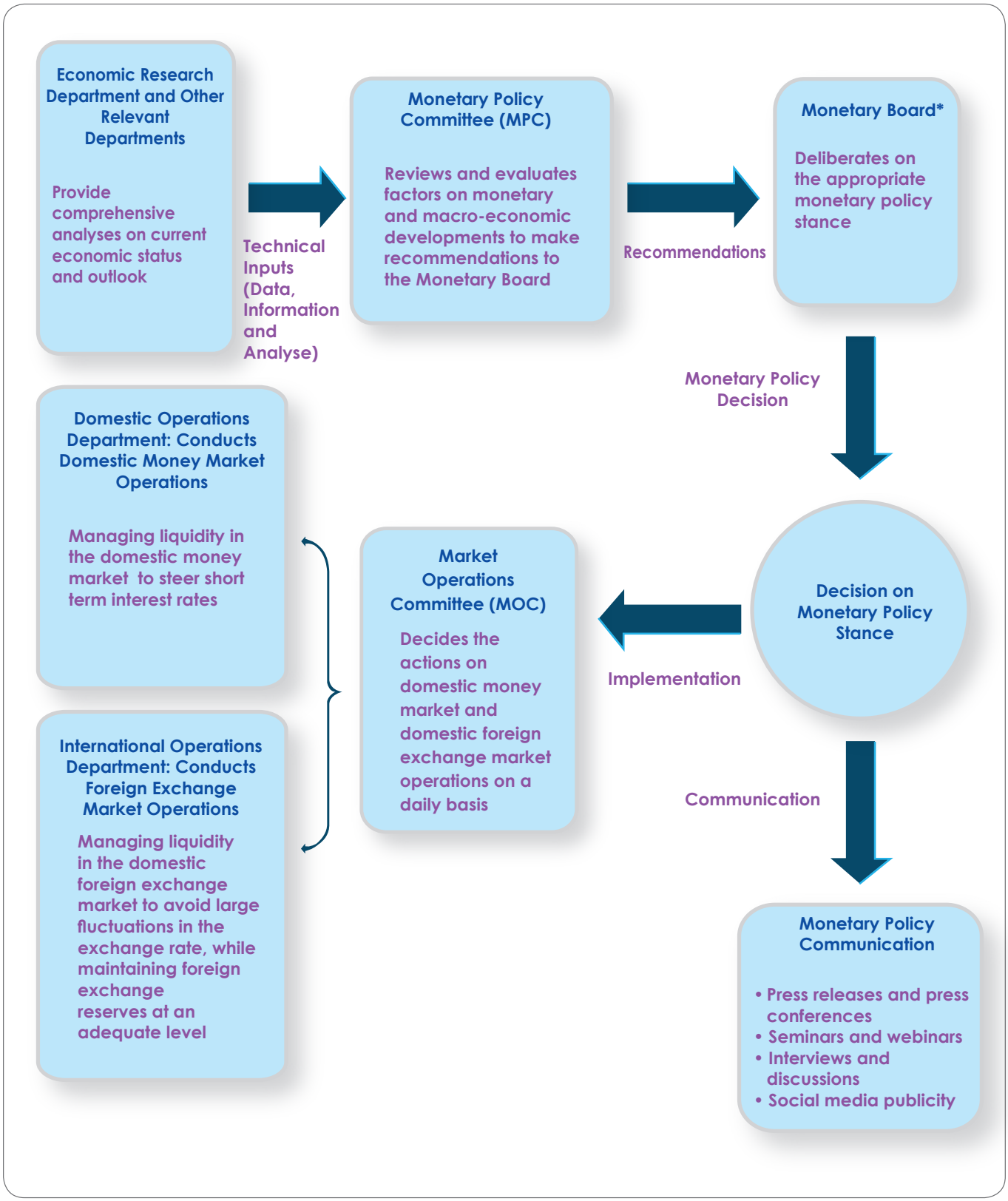
The operating target is a variable that a central bank can effectively control in support of the achievement of monetary policy objectives. Accordingly, at present, AWCMR, which is the prime indicator of interbank call money market, is used by the Central Bank as its operating target.

## Monetary Policy Decision Making Process

At present, the responsibility of decision making on monetary policy is vested with the Monetary Board of the Central Bank. The Monetary Board usually reviews the monetary policy stance eight times a year. The dates of these eight meetings are published at the beginning of the year. At each meeting of the Monetary Board, the Monetary Policy Committee (MPC) of the Central Bank, chaired by the Governor, provides a comprehensive analysis on the outlook of the economy, along with developments in the domestic and global macroeconomy and financial markets. Further, the MPC submits recommendations on the monetary policy stance to the Monetary Board based on its technical analyses and the forecasts.

The Monetary Board adopts appropriate monetary policy decisions that best suit the current and expected economic conditions. For instance, if medium term projections suggest that the economy is overheating due to fast increasing aggregate demand, the Monetary Board may increase the policy interest rates and adopt a contractionary monetary policy stance (monetary tightening) in order to stem aggregate demand pressures and minimise risks associated with high inflation. Generally, the Central Bank adopts a tight monetary policy stance during times of high inflation or high expected inflation, by setting policy rates higher, absorbing liquidity through sales of government securities under OMOs and/or increasing the Statutory Reserve Requirement (SRR). On the other hand, when medium term projections suggest slow economic growth and low inflation pressures or economic downturn or recession, the Monetary Board would follow an expansionary monetary policy (monetary easing) to stimulate the economy. An expansionary policy is intended to boost consumer spending and promote investment by lowering policy interest rates and injecting liquidity into the economy through purchases of government securities under OMOs, and/or lowering the SRR. Such monetary policy decisions are then communicated to the general public by the Central Bank.

**Figure 4 : Monetary Policy Decision Making Process (Stakeholders and Functions)**




* Under the proposed Central Bank Act, monetary policy decision making power is vested with the Monetary Policy Board.

# Part II: Monetary Policy Implementation

## Understanding Monetary Policy Implementation

Monetary policy Implementation is the use of various monetary policy tools to operationalise the monetary policy decisions taken by the Central Bank. The monetary policy decision is operationalised by adjusting the quantity (money supply, i.e., the total volume of money comprised of currency held by the public and deposits held at financial institutions) and price of money (interest rate) through monetary policy instruments, particularly, relevant to the domestic money market. The Central Bank's operations in the domestic foreign exchange market also affect domestic money market conditions.

In the context of Sri Lanka, monetary policy implementation is carried out by respective departments of the Central Bank in line with the decisions of the Monetary Board. Accordingly, the Domestic Operations Department (DOD) carries out monetary operations in the domestic money market, while the domestic foreign exchange market related transactions are carried out by the International Operations Department (IOD).

The Central Bank uses an array of monetary policy instruments to make an impact on the domestic market conditions. The policy interest rates, OMOs, and the SRR on deposit liabilities of the Licensed Commercial Banks (LCBs) remain the key monetary policy instruments used in monetary policy implementation in Sri Lanka. The objective of monetary policy implementation using these instruments is to maintain the short term interest rates at a level in line with the monetary policy stance of the Central Bank so as to achieve the objective of price stability. The implementation of monetary policy is facilitated by the Participating Institutions (PIs) of the domestic money market. Participation of such PIs helps to transmit the impact of monetary policy actions to the money market and then to the overall interest rate structure of the economy.

## Liquidity Management in Monetary Policy Implementation

Liquidity management remains the central element of monetary policy implementation by a central bank. It is defined as the framework, set of instruments and especially the rules and procedures that the central bank follows in managing the amount of bank reserves (liquidity) in order to control their price, i.e., short term interest rates consistent with its ultimate goal of price stability. Hence, liquidity remains an important variable in facilitating the process of monetary policy implementation, as market interest rates and credit creation are closely related to liquidity.

Accordingly, the framework for estimating and forecasting liquidity by a central bank invariably forms the initial step of monetary policy implementation. It determines the type of monetary operations that needs to be conducted by the central bank with the market participants on a daily basis. Proper understanding and close surveillance of liquidity are critically important as the selection of the tools and strategies of monetary implementation depends largely on liquidity conditions. In fact, an accurate estimation of liquidity helps effective implementation of monetary policy decisions taken by the Central Bank, in terms of steering the AWCMR, at a desirable level and in the desired direction as per the monetary policy stance of the Central Bank.

# Central Bank Liquidity in Liquidity Management


In general, banks hold cash in a central bank account to meet their day today settlement obligations. In addition, the central bank requires all banks requiring them to keep a certain portion of banks' deposit liability with the central bank account to prevent banks from lending all deposits to their customers, which is generally known as the reserve requirement. Banks keep this reserve in the same account which is used to make their daily payments. In Sri Lanka, all LCBs maintain reserve balances with the Central Bank to fulfil the SRR and to meet their day-to-day settlement obligations (clearing purposes) as a key depository institution for money creation. The reserve balances maintained by banks at the central bank to fulfil the reserve requirement, remain the key component of central bank liquidity management.

The concept of 'central bank liquidity' is different from the concept of market liquidity, which is generally seen as a measure of the ability of market participants to undertake securities transactions without triggering large changes in their prices. In addition, the term 'liquidity' is used with several meanings and connotations, depending on the context within which it is being used.

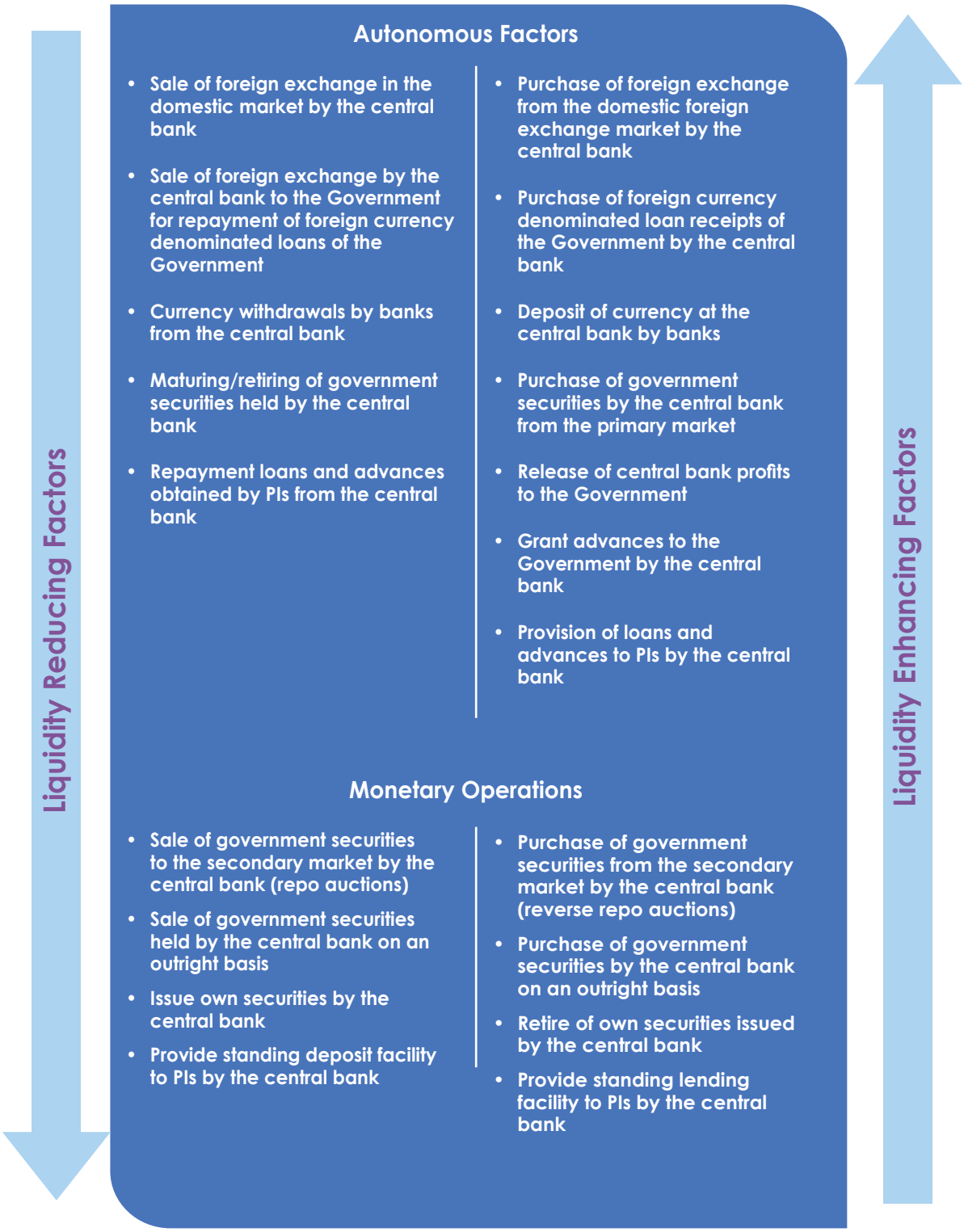
The sum of the reserve balances, i.e., reserve deposits of financial institutions (also known as the balances in the current account, settlement account or clearing balances) held with the central bank on a particular day is considered the liquidity with the central bank for monetary policy implementation.

Accordingly, central bank liquidity depends on these actual balances held by financial institutions in their reserve accounts with the central bank. For instance, if all LCBs in Sri Lanka hold Rs. 150 billion in aggregate in their respective reserve accounts at the Central Bank on a given day for the purpose of covering their SRR obligation and to meet their clearing requirements, the overnight liquidity position of that particular day amounts to Rs. 150 billion.

Individual LCBs (Participating Institutions) can borrow and lend these funds in the interbank market. However, for the system as a whole, the only source of these funds is the central bank itself. Accordingly, the liquidity position can only be changed due to the transactions of the central bank with its counterparties as reflected by the changes in its balance sheet. In this context, the factors that determine central bank liquidity are broadly categorised into two main subgroups, i.e., autonomous factors and monetary operations related factors.

Autonomous factors affecting liquidity can be defined as the items in the central bank balance sheet, excluding the reserve accounts of financial institutions, whose change is independent of the direct control of the central bank. The most important autonomous factors are the net foreign

**Figure 5: Factors Contributing to Changes in Central Bank Liquidity**



assets of the central bank, currency in circulation, and the balances of government current accounts with the central bank. The change in these items provides or withdraws (increases or reduces) liquidity and thus directly and independently affects the reserve accounts of financial institutions held with the central bank. For example, foreign currency transactions such as purchases of foreign currency in the market by the central bank and foreign currency loan receipts of the Government sold to the central bank lead to changes in net foreign assets of the central bank and increase the reserve balances of financial institutions, and increase in liquidity. Further in the context of Sri Lanka, the provisional advances to the Government by the Central Bank cause increase in net credit to the Government by way of depositing money to the reserve account of a LCB maintained at the Central Bank on behalf of the Government, thereby causing an increase in liquidity. Thus, any transaction that changes the balance sheet of the central bank by crediting or debiting any reserve account maintained by a financial institution would cause changes to the central bank liquidity position.

A central bank decides the volume and nature of monetary operations required to be conducted in line with the prevailing monetary policy stance and based on the daily liquidity forecast prepared on account of the changes in autonomous factors. Accordingly, the second subgroup of the factors that determines the reserve levels (central bank liquidity) comprises of the monetary operations, mainly the OMOs of a central bank.

The impact on liquidity due to the conduct of OMOs can be explained using the following example. Assume that the Central Bank purchases government securities in the secondary market from LCBs operating in Sri Lanka. Then, the Central Bank needs to pay them by crediting their reserve accounts at the Central Bank, in effect, causing a rise in the balances of the respective reserve accounts of LCBs, thereby increasing liquidity level. In the same way, when the Central Bank sells securities to LCBs, the resultant impact on reserve accounts and liquidity would be the opposite. Accordingly, a host of factors in combination provides an estimate of the overall reserve balance of LCBs held with the Central Bank (see Figure 5).

The balance in the reserve account of LCBs can be, on a daily basis, lower or higher than the reserve requirements imposed by the Central Bank although they need to cover the reserve position on an average basis over a specified period. For example, assume that LCBs on aggregate basis should maintain a balance of Rs. 150 billion based on the current level of SRR. On a particular day, if such reserve balance falls to Rs. 135 billion, LCBs should fulfil the required level of reserves on average over a 15 day period, which is termed as the reserve maintenance period. Accordingly, at the end of the reserve maintenance period, LCBs have to fulfil their reserve requirements for the reserve period, which is determined based on the deposit level of individual LCB. This means that the average of the current account balances of the LCB over a maintenance period must be at least equal to the minimum reserve requirement.

However, in reality, LCBs normally hold some excess reserves as the intraday transactions of banks are uncertain or there could be some shortage of reserves due to unforeseen or unplanned transactions. Accordingly, deficit or excess liquidity is defined as the difference between the balance in the reserve accounts held by LCBs and the level of their required reserves on a given day. The banking system is considered in excess (excess liquidity) on a given day if the deposit balances of LCBs with the Central Bank are higher than the balance that they would need to maintain in their reserve account under the SRR requirement. For example, if the required reserve level on a given day is Rs. 150 billion and the actual balance in the LCBs' account with the Central Bank is Rs.165 billion, then the amount over the required liquidity of Rs.15 billion is considered excess liquidity. In contrast, the banking system is considered short (deficit liquidity) on a given day, if the deposit balances of LCBs with the Central Bank are lower than the balance

that they would need to maintain on account of the SRR requirment.

LCBs individually manage their excess liquidity/reserves by either lending in the interbank money market or parking the excess at the Central Bank for different tenures under OMO auctions or on overnight basis under the Standing Deposit Facility (SDF) as the excess reserves are unremunerated if it was held idle in the SRR account. On the other hand, when a bank is in a short position, such short is generally funded through interbank borrowings. Accordingly, when fulfilling the liquidity requirements, LCBs may use the interbank call money market, which is an overnight or short term market for LCBs to meet their overnight liquidity requirements by allowing them to borrow and lend money among each other without collateral. These transactions are very short term in nature and reflect the demand for and supply of liquidity in the market. However, if any bank could not fully cover its liquidity requirement through the interbank bank, they will have to borrow from the Central Bank under OMO auctions or through the overnight Standing Lending Facility (SLF).

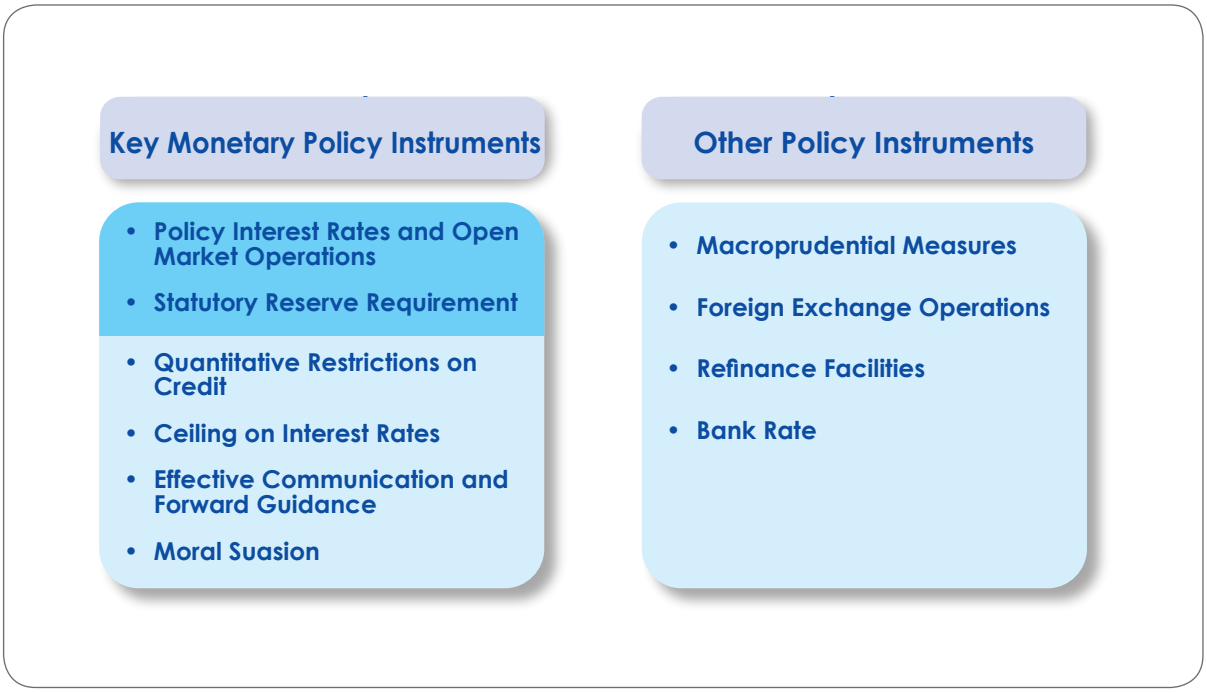
In managing excess or deficit liquidity by a central bank, it is paramount to have an effective framework for monetary operations. This is due to the impact of liquidity movements on the interest rates of the markets and the economy. For example, when there is excess liquidity with LCBs, there could be a tendency to induce a downward bias on AWCMR below the desired level. Hence, in the event of excess liquidity, the Central Bank would conduct monetary operations to absorb the excess to prevent an undue decline in the short term interest rates. Similarly, when there is a liquidity shortage, there is a tendency to push AWCMR above the desired level. Hence, in the event of a liquidity deficit, the Central Bank may supply liquidity through its monetary operations to meet market requirements, thereby minimising any undue pressure on interest rates. Hence, absorptions or injections of liquidity are instrumental for the Central Bank to steer the interest rates, in particular AWCMR which is the operating target of monetary policy, in the context of Sri Lanka, thereby affecting the cost and availability of money and credit in the broader economy.

Liquidity provision is linked with the core tasks within the central bank mandate. It constitutes an essential pillar for the smooth functioning of the payments system and hence, safeguarding financial stability and for transmission of monetary policy. Adequate liquidity supports the smooth functioning of the payment system in the economy, ensuring sufficient funds to honour payment obligations. Although banks can fulfil liquidity needs of one or a few institutions, they cannot cover the entire needs of the system. However, the central bank can provide liquidity to cater to the needs of the entire system and play an important role in regulating liquidity in the financial system by lending to, or borrowing from, financial institutions. In that respect, proper management of liquidity through close monitoring and timely actions by the central bank will ensure healthy levels of liquidity in the market, which is vital in stabilising interest rates and ensuring the smooth functioning of the payment and settlements systems. Therefore, liquidity management plays an important role in attaining stability in the interest rates, the money market and the overall financial system in an economy.

# Key Monetary Policy Instruments

The Central Bank uses an array of monetary policy instruments to manage liquidity in order to maintain short term interest rates at the desired level. To that effect, policy interest rates, OMOs and SRR remain the key monetary policy instruments of the Central Bank.

**Figure 6: Policy Instruments of the Central Bank**



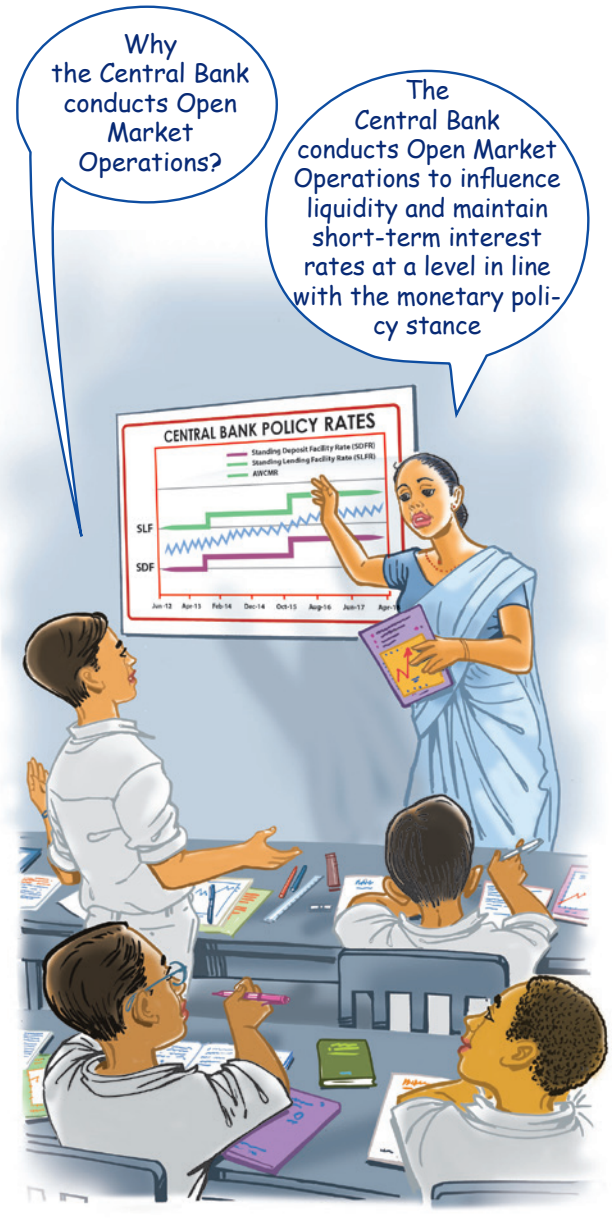

## Policy Interest Rates and Open Market Operations (OMOs)

At present, the Central Bank predominantly implements country's monetary policy under a market based system of active OMOs. The primary objective of OMOs is to manage liquidity levels in the banking system and to influence the money supply (reserves in the banking system) and short term interest rates, which ultimately affect other longer term interest rates and assets prices. The resultant impact on other interest rates, such as the deposit and lending rates, will in turn influence saving and spending decisions of the households and businesses, and ultimately economic activity and the general price level in the economy.

The key element of the OMO framework is the interest rate corridor formed by the policy interest rates which is referred to as the Standing Rate Corridor (SRC). Policy interest rates are the benchmark interest rates in the economy, on which all other interest rates are determined. Banks and other financial institutions in the economy are free to set their own interest rates for lending and deposits, based on guidance provided by the policy interest rates on the level and the direction of interest rates. Accordingly, policy interest rates play a key role in the financial system, the banking system, and the overall economy, and hence remain the main instrument to achieve the targeted inflation path. Policy interest rates are also used as a mechanism to signal the monetary policy stance of the Central Bank and to ensure stability in interest rates of the economy.

Policy interest rates which form the SRC of the Central Bank, serve as the upper and lower bounds for the overnight interest rates in the money market. The Standing Deposit Facility Rate (SDFR), which is the lower bound of the corridor, and the Standing Lending Facility Rate (SLFR), which is the upper bound of the corridor, are instrumental in stabilising short term interest rates in the economy. It is of utmost importance that interest rates, in particular, short term interest rates, which can be directly impacted by the Central Bank, remain stable to ensure overall stability in interest rates. Once the Central Bank announces changes to the policy interest rates, that will have an immediate effect on the interbank call money market. Changes in interbank call money rate get transmitted to other short term money market rates (such as Treasury bill rates) within a short period of time. Subsequently, such changes get transmitted to all medium and long term interest rates in the economy including lending and deposit rates of financial institutions. The Central Bank attempts to maintain the interbank call money rate (i.e., AWCMR) within the SRC, which is the first loop of the interest rate transmission and to ensure its stability.

The Central Bank conducts OMOs for this purpose. OMOs refer to buying and selling of securities to inject or absorb liquidity in the market by the Central Bank to maintain AWCMR within the SRC. Hence, OMOs are the main market based monetary policy operations conducted by the Central Bank by using government securities to manage liquidity in the domestic money market to influence short term interest rates, which inturn influence longer term interest rates and the overall economic activity.

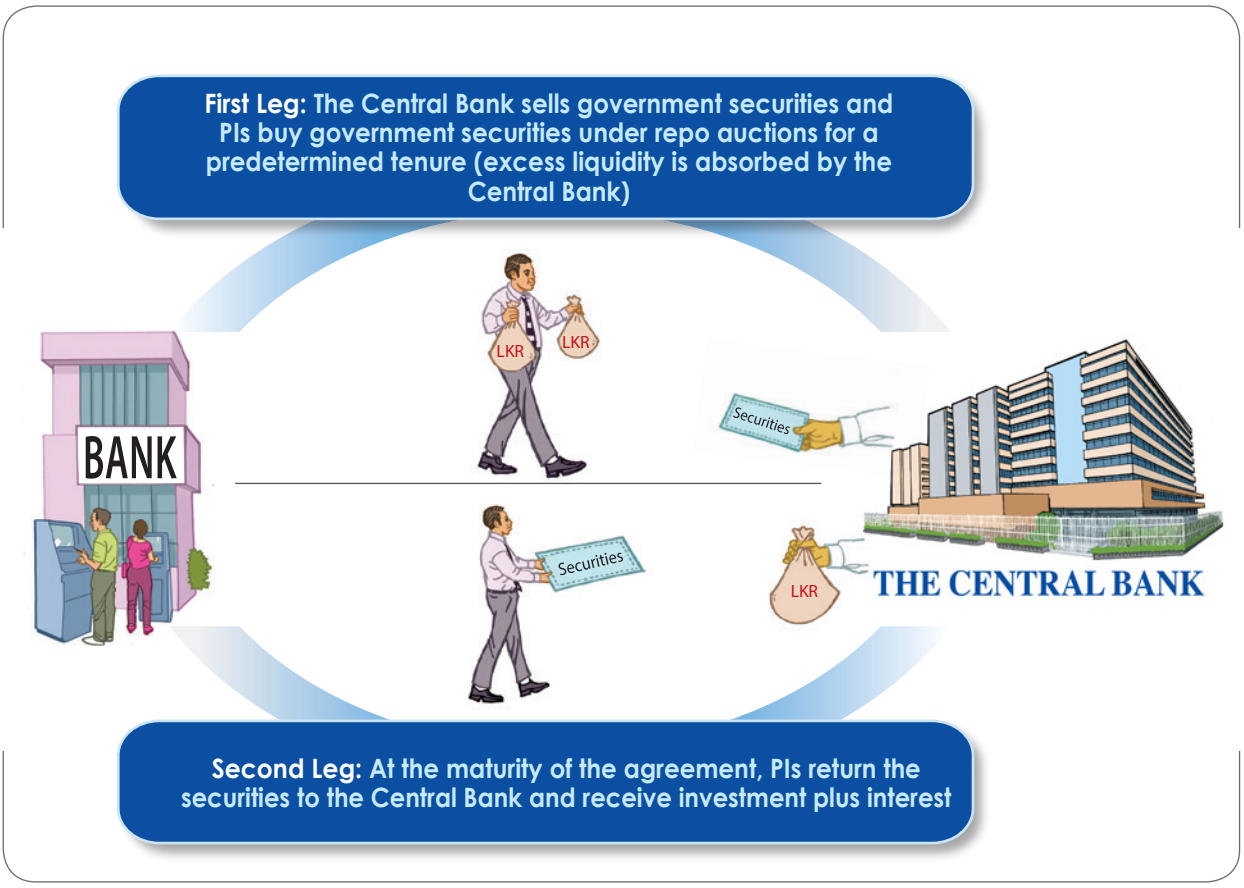



The Central Bank conducts OMOs based on the decisions of the Market Operations Committee (MOC), which is responsible for translating monetary policy decisions into daily monetary operations. MOC decides on the operational activities in line with the prevailing monetary policy stance, by taking into consideration various factors, such as the estimated liquidity forecast, desired level of the operating target, liquidity distribution amongst PIs, and the need for devising appropriate market signals.

For example, if the Central Bank observes an excess amount of money (liquidity surplus) in the banking system, it would consider absorbing such excess as it might lead to a downward bias in interest rates. In such instances, the Central Bank attempts to reduce surplus liquidity by selling government securities under repurchase agreements, usually called as repo transactions, thereby absorbing liquidity. When there is a liquidity shortage (liquidity

deficit), the Central Bank may buy government securities and release money to LCBs using the reverse repo transactions (liquidity injection). At the maturity of repo or reverse repo transactions, the cashflows and the collaterals are reversed (see Figure 7).

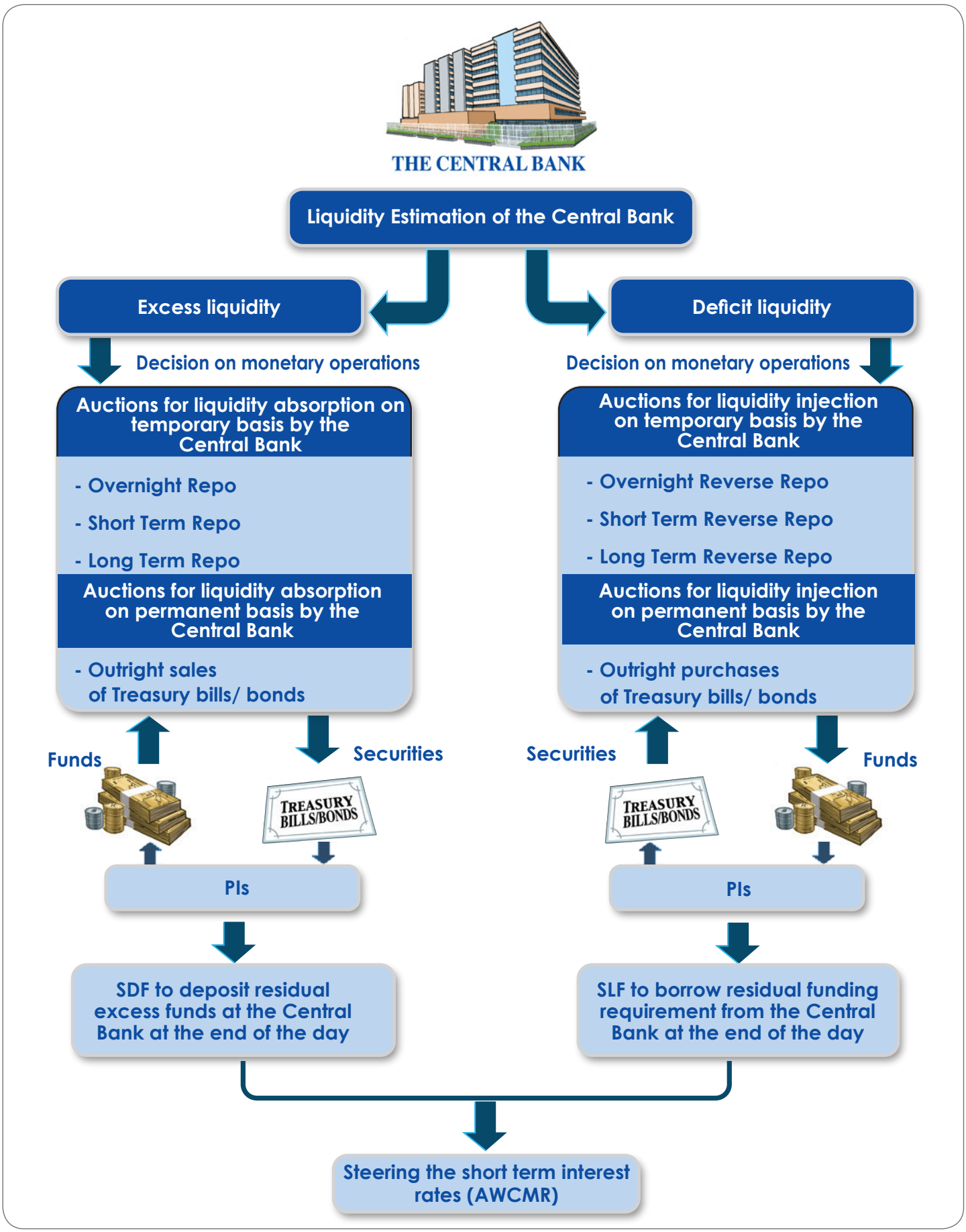
**Figure 7: Repurchase (Repo) Transactions of the Central Bank**




***Note:*** *The process of a reverse repo transactions is as follows: First Leg – The Central Bank purchases government securities from PIs for the agreed tenure (liquidity is injected by the Central Bank). Second Leg – At the maturity, PIs return the borrowed funds with an interest to the Central Bank and receive their securities back.*

The Central Bank conducts different types of auctions under OMOs to change liquidity in the domestic money market on a temporary and/or permanent basis. Currently, all OMO transactions in Sri Lanka are collateralised by Treasury bills or Treasury bonds. Usually, repo/reverse repo transactions are carried out to add/drain liquidity on a temporary basis through overnight, short term, and long term bases. However, when there is a persistent liquidity shortage/excess, the Central Bank uses outright purchases/sales of government securities in order to permanently affect market liquidity (see Figure 8).

Figure 8: Synopsis of OMOs and Standing Facility



## Standing Facility

Standing facility is a window under OMOs that allows PIs to borrow funds overnight on collateralised basis or deposit funds on an overnight basis without a collateral. Accordingly, these facilities help LCBs and other eligible PIs to fulfil their day-to-day residual liquidity requirements. The Central Bank offers two types of overnight standing facilities on each business day: the Standing Lending Facility (SLF) and the Standing Deposit Facility (SDF).

SLF allows PIs to cover short term anticipated or unanticipated liquidity requirements that cannot be fulfilled from the money market or from the auctions conducted by the Central Bank. SDF allows PIs to deposit excess funds with the Central Bank on an overnight basis. The interest rate on SLF, i.e., SLFR and the interest rate on SDF, i.e., SDFR provide a ceiling and a floor, respectively, for the overnight interest rate in the money market. The main purpose of the standing facility is to minimise volatility of short term money market interest rates as this facility supports PIs to fulfil residual funding needs and remunerate idle funds. At present, in the context of Sri Lanka, SDF remains uncollateralised (no securities are provided by the Central Bank on such deposits of LCBs), while SLF is provided as a collateralised facility (LCBs pledge government securities when obtaining funds).

## Statutory Reserve Requirement (SRR)

SRR is a policy instrument used to influence liquidity on a permanent basis and the level of money in the economy through the money multiplier. In the context of Sri Lanka, SRR is defined as the proportion of average rupee deposit liabilities of LCBs, which is required to be maintained as reserves at the Central Bank as per the MLA. At present, rupee deposit liabilities, including demand deposits, time and savings deposits and other deposits of LCBs, are considered for the calculation of required reserves under SRR. The Central Bank relies on SRR mainly to address persistent liquidity issues in the market, which influence the money supply and interest rates in the economy. By changing SRR, the Central Bank can influence the amount of funds that the banks can use to make loans to their customers.

In the process of maintaining SRR, LCBs are allowed to maintain a certain percentage in the form of currency notes and coins as a part of their required reserves, which is known as the till cash concession. Such amount is allowed to be deducted from SRR, as a concession, in deriving the amount of required reserves to be maintained by LCBs. For example, if the average total rupee deposit liabilities of LCBs is Rs. 8,000 billion, SRR is 4%, and the till cash concession is 1% of rupee deposit liability (i.e., Rs. 80 billion), total reserves required to be maintained by LCBs is Rs.240 billion during a particular reserve maintenance period (see Table 1).

**Table 1: Calculation of SRR**

| Component | Amount (Rs. Bn.) |
|---|---|
| 1. Average Total Deposit Liabilities (Rupee Deposits) | 8,000 |
| 1.1 Demand Deposits | 400 |
| 1.2 Time & Savings Deposits | 7,500 |
| 1.3 Other Deposits | 100 |
| 2. SRR (assuming the SRR as 4% of rupee deposit liability) | 320 |
| 3. Till Cash Concession (assuming 1% of rupee deposit liability) | 80 |
| **4. Total Required Reserves for the Reserve Period (2-3)** | **240** |

By increasing SRR, the Central Bank can influence the amount of money that can be used for lending by LCBs by controlling the money creation ability of LCBs (contraction of the money supply), resulting an increase in interest rates (cost of funds) in the economy. Conversely, by reducing SRR, the Central Bank provides additional reserves to LCBs, allowing them to expand their credit (expansion of the money supply), resulting in a reduction in interest rates. Further, SRR acts as a cushion for LCBs as it facilitates any unexpected settlement of payment obligations that could occur during the day. Accordingly, the balances under SRR are also referred to as settlement balances of the current account of LCBs maintained at the Central Bank.

The impact of changes in SRR on the economy is depicted in Figure 9.

In addition, the Central Bank can use restrictions on credit granted to certain industries or sectors and ceilings on interest rates that could be charged on lending or offered to customer deposits as a part of monetary policy actions.

Transparent and credible communication is also used by the Central Bank as another monetary policy tool as the decisions of economic agents are often based on the expectations on future economic developments as well. Effective communication and providing forward guidance to the market by the Central Bank are vital, particularly during the times of high economic uncertainty.

The Central Bank uses moral suasion with a view to guiding PIs to align their activities to support the attainment of the objectives of the Central Bank. Accordingly, the Central Bank directs PIs towards the desired path whenever the market behaviour and expectations are misaligned with the intended policy direction.

## Other Policy Instruments

Depending on the need and circumstances in the economy, the Central Bank deploys other instruments to complement monetary policy such as the macroprudential measures, foreign exchange transactions refinance facilities, and the Bank Rate.

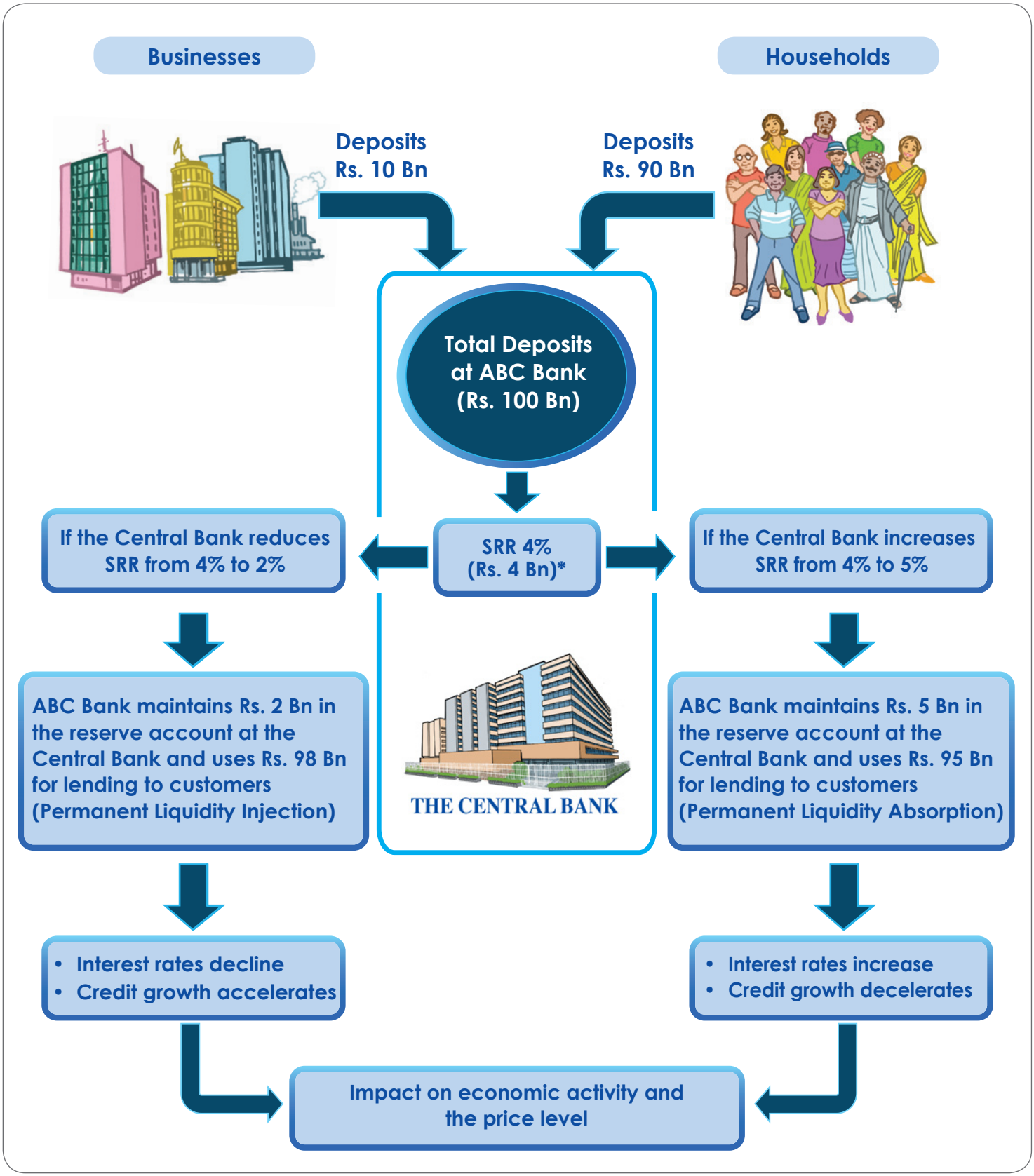
The Central Bank uses macroprudential instruments, which are generally introduced to address the systemic risk faced by the financial system. For example, introducing margin requirements on imports to curtail imports to minimise the pressure on the external sector and introducing measures such as countercyclical capital buffers, capital conservation buffers, caps on leverage ratios, caps on debt services - to income ratios can be used to address unstable conditions in the overall financial system and economy.

The Central Bank also deploys foreign exchange operations in conducting monetary policy. For example, the Central Bank may enter into foreign exchange swap transactions where it purchases/sells foreign currency with an undertaking of selling/buying back such foreign currency at a future date. These operations affect money market liquidity.

In addition, to support the economy and the financial system in extraordinary circumstances, the Central Bank can provide refinance facilities to the identified sectors via financial institutions or provide loan facilities to financial institutions.

Banks can also receive funds from the Central Bank not only through monetary operations, but also through liquidity assistance facility to address system wide liquidity stress as well as emergency liquidity assistance in exceptional circumstances faced by a banking institution. The Bank Rate is the rate at which the Central Bank provides liquidity assistance facility to banking institutions under the current legal provisions. Usually, the Bank Rate is relatively a higher interest rate.

**Figure 9: Monetary Policy Implementation under SRR**




*Assuming that till cash concession is zero

# Part III: Transmission Mechanism of Monetary Policy

The transmission mechanism of monetary policy describes how changes in monetary policy actions of the central bank flow through to economic activity to achieve the objective of price stability. This is generally a two stage process, involving a large degree of uncertainty in the timing and size of the impact on the economy, and hence a complex process. The exact relationship as well as timing of transmission is unclear, particularly for long term interest rates and hence transmission is referred to as a black box in the monetary economics literature.

The first stage of transmission explains how changes to policy interest rates influence other interest rates (both short term and long term interest rates), which is widely known as interest rate pass-through. The second stage of transmission explains how the changes to interest rates influence economic activity and inflation.

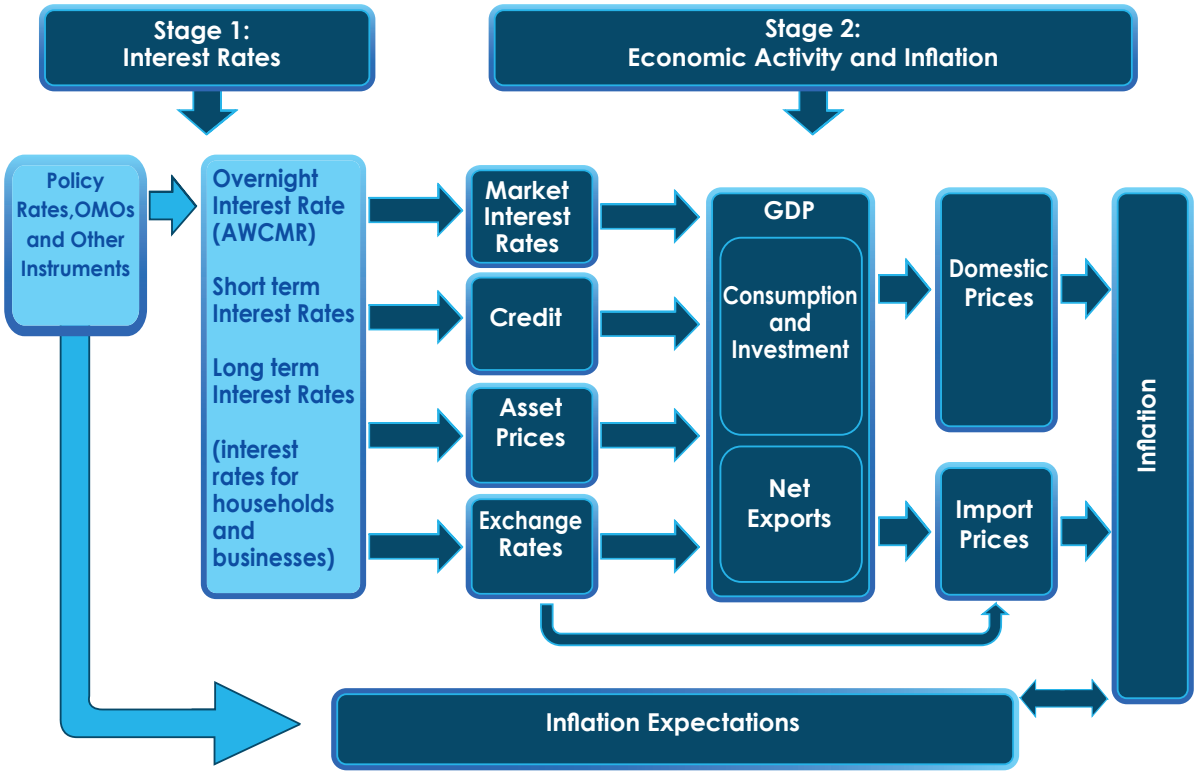
The interbank call money rate is the first loop of interest rate pass-through, which has a strong influence over the other interest rates in the economy, generally as depicted by the yield curve. In general, policy rate changes cause a quick adjustment in the interbank call money rate. Hence, once the central bank announces changes to the policy interest rates, such changes have an immediate effect on the call money rate. Then such changes get transmitted to short term and long term interest rates, including lending and deposit rates of financial institutions. However, other factors, such as the market competition as well as maturity and risk involved in the different markets and products, affect the timing and size of short term and long term interest rate adjustment.

In the second stage of transmission mechanism of monetary policy, the central bank decisions affect the spending and investment decisions of economic agents, thereby affecting the aggregate demand conditions and subsequently the inflation rate in the economy. However, there is a time lag between the policy decisions and their effects on economic activity and inflation as households and firms would take time to adjust their behaviour. A simplified standard version of the second stage of monetary transmission is illustrated in Figure 10.

Accordingly, for example, when the central bank reduces policy interest rates (known as monetary easing), individuals will increase consumption rather than savings due to low interest rates in the banking system. Accordingly, lower interest rates increase overall demand (aggregate demand) in the economy by stimulating spending. However, producers take relatively more time to change the supply of goods as they need to hire more workers and equipment to cater to the increased demand resulting in an excess demand, which creates an upward pressure on prices, leading to higher inflation.

On the other hand, when the central bank increases policy interest rates (known as monetary tightening), borrowings become less attractive due to the high cost of borrowings. Accordingly, higher interest rates tend to decrease the aggregate demand and lead to a slowdown in economic activity, ultimately resulting in a deceleration in inflation. However, this second stage of monetary policy transmission is much more complicated than the first stage. As depicted in Figure 10, the changes in the policy interest rates and impact of monetary policy instruments are usually transmitted to the broader economy via different, but interconnected channels such as market interest rates, credit, asset prices, exchange rates, and expectations. While the exchange rate channel affects net exports, other channels mainly affect the other components of GDP, i.e., consumption and investment.

**Figure 10: Transmission Mechanism of Monetary Policy**




The transmission of monetary policy is also affected by inflation expectations. Economic agents' expectations about future inflation affect their current behaviour. For example, if employees in the economy expect inflation to rise, they may demand wage increases in line with the expected changes in inflation. Higher wage growth would then contribute to higher prices. By having an inflation target and through effective communication, the central bank attempts to anchor inflation expectations. This enhances the confidence of households and businesses in terms of making decisions about saving and investment due to reduced uncertainty. The effectiveness and success of monetary policy are also dependent on the credibility and independence of the central bank ■