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BOX 03
Transition to a Single Policy Interest Rate Mechanism

Introduction

The Central Bank of Sri Lanka shifted to a single policy interest rate mechanism from the dual policy interest rate mechanism on 27 November 2024 as a part of the improvements implemented under the Flexible Inflation Targeting Framework (FIT).[1] Accordingly, the Central Bank introduced the Overnight Policy Rate (OPR) as its primary monetary policy tool for signalling and implementing its monetary policy stance. This transition to a single policy interest rate mechanism aims to simplify monetary policy communication and enhance the efficiency of monetary policy transmission.

Need for a Single Policy Interest Rate

Sri Lanka's monetary policy framework has evolved from the currency board system to the current monetary policy framework of FIT, which is formally recognised under the Central Bank of Sri Lanka Act No.16 of 2023 (CBA). This Act also recognises maintaining domestic price stability as the prime objective of the Central Bank. The success of FIT relies largely on the effective transmission of policy changes and anchored expectations on inflation. Both of these are influenced by the clear signalling of the Central Bank's monetary policy stance to the market and other stakeholders. A policy tool with a single interest rate serves this purpose well.

Prior to the introduction of the single policy interest rate mechanism, the Central Bank conducted monetary policy operations under a corridor system with dual policy interest rates: the Standing Lending Facility Rate (SLFR) as the upper bound and the Standing Deposit Facility Rate (SDFR) as the lower bound. This corridor guided the Average Weighted Call Money Rate (AWCMR),[2] which serves as the operating target of the Central Bank's monetary policy framework. However, the dual policy interest rate mechanism faced some drawbacks, primarily due to its complexity and the lack of transparency in conveying the Central Bank's monetary policy stance to the market. Announcing the monetary policy stance using two policy interest rates and the movements of interbank money market rate, i.e., AWCMR, within the standing rate corridor, created some uncertainty among market participants. Also, there was a lack of clarity on where AWCMR should be positioned within the standing rate corridor and whether the changes in AWCMR can be considered as changes in the monetary policy stance of the Central Bank. This lack of transparency may have made it complicated for market participants to accurately interpret the Central Bank's monetary policy intentions.

Moreover, having multiple policy interest rates might have led to complexities in the pricing of financial products, as policy interest rates serve as key benchmarks for setting deposit and lending interest rates across financial institutions. These complexities in the dual policy interest rate approach could have led to slow adjustments in the market interest rates in response to policy rate changes, thereby reducing the effectiveness of monetary policy in influencing the economy.

Accordingly, considering the need for improving the signalling and communication of the monetary policy stance, the Central Bank embarked on exploring the introduction of a single policy interest rate mechanism in line with the roadmap for the adoption of FIT. As the initial step of the progression towards the single policy interest rate mechanism, the Central Bank gradually reduced the size of the standing rate corridor formed by the dual policy interest rates. Further, AWCMR was kept around a desired rate through effective liquidity management, which supported the Central Bank to seamlessly transit to a single policy interest rate mechanism. Thereafter, in keeping with international best practices, the Central Bank introduced a single policy interest rate framework in November 2024, following policy deliberations and consultations with the stakeholders.

1 For more information on this transition, refer the Press Release on "The Central Bank of Sri Lanka moves to a Single Policy Interest Rate Mechanism by Introducing the Overnight Policy Rate" and the underlying Concept Note, which can be accessed on https://www.cbsl.gov.lk/sites/default/files/concept_note_on_opr_e.pdf

2 AWCMR is the weighted average interest rate of overnight unsecured interbank call money transactions among Licensed Commercial Banks (LCBs) on a given date

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Merits of a Single Policy Interest Rate

The shift to a single policy interest rate mechanism offers multiple advantages, thereby significantly enhancing the effectiveness of monetary policy. By providing a clear and consistent signal to financial markets, it lowers the uncertainty in policy direction, facilitating market participants to make informed decisions with greater confidence. This improved transparency strengthens the transmission of monetary policy, ensuring that changes in the monetary policy stance translate effectively into short-term interest rates, and thus to the economy.

Furthermore, with a single policy interest rate serving as the benchmark interest rate, financial institutions can accurately price their financial products, ensuring consistency in market interest rates. This improves the mobility of funds within the financial system, facilitates better liquidity management, and fosters a more predictable interest rate environment, which is crucial for investor confidence.

Operationalisation of the Single Policy Interest Rate

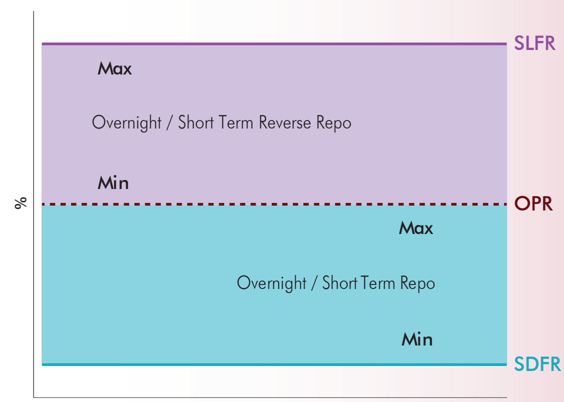
The operational framework of the single policy interest rate mechanism is designed to streamline monetary policy implementation by anchoring short-term interest rates. With the introduction of OPR, the Central Bank targets to maintain AWCMR at or around the announced OPR. Further, the OPR would be periodically reviewed and adjusted by the Monetary Policy Board as necessary to reflect changes in the Central Bank's monetary policy stance.

Following the transition to the single policy interest rate mechanism, SDFR and SLFR, which were considered key policy interest rates of the Central Bank under the dual policy interst rate system, no longer serve that role. However, SDFR and SLFR will continue to serve as the rates applicable for the Standing Deposit Facility (SDF) and the Standing Lending Facility (SLF), respectively, for the Participatory Institutions (PIs) for overnight transactions with the Central Bank.[3] In addition, SDFR and SLFR are linked to OPR with pre-determined margins set by the Central Bank and serve as the lower and upper bounds for interbank call money transactions, and overnight and short-term OMOs.

Accordingly, for overnight and short-term repurchase (repo) auctions, OPR serves as the upper limit for bidding rates, while SDFR serves as the lower bound. The Central Bank conducts repo auctions as a means of absorbing excess liquidity from the market. When PIs experience surplus liquidity, they are presented with two alternatives. They may either deposit their excess funds with the Central Bank at SDFR or choose to participate in the repo auctions. To ensure that repo auctions remain attractive to participating institutions, the Central Bank establishes a minimum bidding rate equivalent to SDFR, and a maximum bidding rate capped at OPR. Given that participatory institutions always have the option of depositing their excess funds at SDF, SDFR forms an effective floor rate for the conduct of overnight and short-term repo auctions.

On the other hand, for overnight and short-term reverse repurchase (reverse repo) auctions, SLFR serves as the upper bound while OPR defines the lower bound. The Central Bank conducts reverse repo auctions to inject liquidity into the market. When PIs face liquidity shortages, they too have two alternatives. They can either borrow funds from the Central Bank at SLFR or participate in the announced reverse repo auctions, where they can

Figure B 3.1: **Single Policy Interest Rate Structure**



Source: Central Bank of Sri Lanka

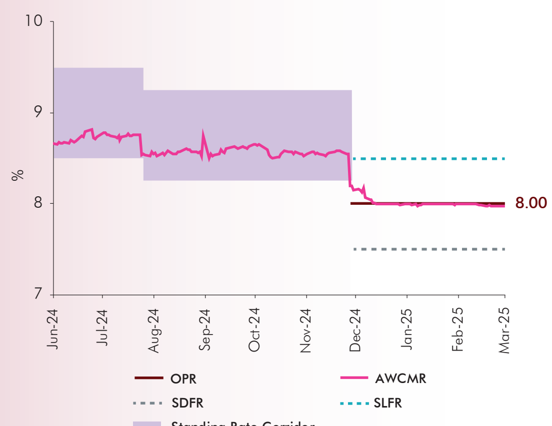
3 SDFR is the rate at which PIs get remunerated on their deposits of excess funds with the Central Bank on an overnight basis under the Standing Deposit Facility, while the SLFR is the rate at which PIs can borrow funds from the Central Bank on an overnight basis under the Standing Lending Facility.

obtain liquidity by pledging eligible securities. To maintain the competitiveness of reverse repo auctions, the Central Bank sets a minimum bidding rate equivalent to OPR, while the maximum bidding rate is capped at SLFR. Since PIs have the alternative of borrowing from the SLF, SLFR forms an effective ceiling rate for the conduct of overnight and short-term reverse repo auctions.

Post-implementation Outcomes in the Money Market

As envisaged, with the introduction of the single policy interest rate mechanism, AWCMR gradually adjusted towards OPR and continued to remain

Figure B 3.2: OPR, AWCMR and Standing Facility Rates



Source: Central Bank of Sri Lanka

closer to OPR since the second week of December 2024. This swift adjustment of AWCMR towards OPR was largely supported by increased activity in the interbank call money market. Currently, AWCMR remains at or close to OPR exhibiting a smooth transition to the single policy interest rate mechanism. Also, adjustments in short-term market interest rates have already been transmitted to other benchmark interest rates, reflecting the swift alignment of the market to the new system.

The transition to a single policy interest rate marks a significant step in strengthening the Central Bank's monetary policy framework. This is expected to enhance transparency and efficiency of monetary policy implementation, while enabling improved market predictability. With improved clarity in the monetary policy operations alongside streamlined liquidity management, monetary policy communication will also be strengthened. This shift is also expected to enhance the credibility of the Central Bank's policy actions. Further, it would ensure the efficiency and effectiveness of monetary policy signalling and transmission across markets and the economy. Overall, enhancing monetary policy effectiveness helps create a stable economy, improves investor sentiments and ultimately supports achieving the objective of maintaining price stability of the economy.

of space for further downward adjustments in market lending interest rates, compatible with the low inflation environment and outlook, the Central Bank reduced policy interest rates by 50 bps in March 2024, which was followed by an additional reduction in policy interest rates by 25 bps in July 2024. These policy actions enabled continued downward adjustments in the cost of borrowing, thereby facilitating a faster expansion of credit to the private sector and supporting the revival of domestic economic activity. Subsequently, slowing adjustment in market interest rates, subdued inflation outlook and inflation expectations prompted the Central Bank to cautiously ease monetary policy further in November 2024. This policy easing of effectively around 50 bps,[4] came along with the introduction of OPR, reflecting the transition to a single policy interest rate mechanism. Accordingly, the cumulative adjustment in the policy rate during the current monetary policy easing cycle amounted to around 775 bps by end 2024.

While overall liquidity in the domestic money market remained at surplus levels during 2024, its asymmetric distribution led the Central Bank to continue with Open Market Operations (OMOs) to provide

4 Measured by the difference between pre-policy AWCMR and OPR