

BOX 05

Strengthening the Price Discovery Mechanism in the Domestic Foreign Exchange Market in Sri Lanka**Introduction**

The exchange rate, a key macroeconomic variable in open economies, shapes trade flows, capital movements, and the transmission of monetary policy by significantly influencing trade competitiveness, domestic price stability, and the overall macroeconomic performance of economies. Exchange rate movements in particular, attract significant attention in small open economies such as Sri Lanka, which are highly dependent on imports and foreign exchange (FX) earnings from exports, tourism, workers' remittances, and financial flows.

The domestic FX market in Sri Lanka has undergone a structural transformation following the enactment of the Central Bank of Sri Lanka Act No. 16 of 2023, which established a flexible exchange rate regime under a Flexible Inflation Targeting (FIT) framework, institutionalising market-based price discovery as the foundation of exchange rate determination.

This article examines the process of price discovery in the domestic FX market in Sri Lanka, its importance, the role of market participants, recent initiatives by the Central Bank of Sri Lanka (CBSL) and the way forward.

Price Discovery in the Foreign Exchange Market

Price discovery is the process through which market prices are determined based on actual transactions, reflecting supply, demand, risk perceptions, availability of information and prevailing economic conditions (Rosenberg and Traub, 2009).

The FX market plays a central role in price discovery, as it determines exchange rates through the interaction of supply and demand for currencies, reflecting economic conditions and market sentiments. The FX market remains highly sensitive to new information, with exchange rates adjusting swiftly to changes in economic data, policy announcements, and geopolitical developments.

Price discovery in the FX market materialises through the interaction of diverse participants; central banks, commercial banks, institutional investors, corporates, and retail traders each with unique goals and risk preferences. Their collective trading, shaped by macroeconomic trends, capital flows, and expectations, determines exchange rates in real time, making the FX market highly efficient and information-rich for price formation (Bank for International Settlements, 2023).

Importance of Price Discovery and Economic Benefits

Through effective price discovery in the FX market, exchange rate functions as a real-time signal of an economy's competitiveness. Without market-driven price discovery, economic signals become distorted leading to mispriced trade, inefficient investment decisions and ultimately, misallocation of resources, slower growth, weakened monetary policy transmission and greater vulnerability to external shocks.

Effective price discovery ensures the exchange rate reflects actual supply and demand conditions, supporting trade competitiveness, investment decisions, and business planning, thereby fostering productivity and economic growth. Further, it supports foreign direct investment and portfolio inflows by providing confidence for investors that the currency valuation is transparent and market determined.

Furthermore, price discovery strengthens the monetary policy transmission mechanism by allowing the exchange rate to move in tandem with interest rate decisions. Under an inflation targeting framework, a market-determined exchange rate acts as a shock absorber, complementing interest rate policy and transmitting monetary policy by reflecting underlying economic fundamentals. Furthermore, transparent price discovery reduces the scope for speculative manipulation and parallel market exchange rates. Finally, it contributes to financial deepening by creating conditions for the development of derivative markets, allowing businesses to hedge against exchange rate risk.

For Sri Lanka, robust price discovery has become increasingly important following the introduction of a flexible exchange rate regime and the effective operationalisation of the FIT framework to achieve domestic price stability. By improving transparency and anchoring expectations, it contributes to macroeconomic stability and strengthens long-term economic resilience.

Effective price discovery has been a key driver of the recovery and stabilization of Sri Lanka's FX market. The improvement in market-based pricing enabled the CBSL to rebuild Gross Official Reserves from critically low levels in 2022 to a stronger position by end-2025, without creating market distortions. This was further supported by increased interbank market activity, particularly following the introduction of the FX Matching platform in 2025, which enhanced competitive pricing, liquidity, and market depth. The Sri Lanka rupee appreciated notably during 2023 and 2024, while eliminating parallel market premia, reinforcing the role of a transparent, unified exchange rate as the credible benchmark for all FX transactions.

Role of Market Participants in Price Discovery

The efficiency of price discovery is shaped by the diversity and conduct of market participants, alongside the role of the central banks in ensuring orderly market conditions and sustaining confidence, while allowing exchange rates to be guided by market forces (Osler, Mende and Menkhoff, 2011). In Sri Lanka, Licensed Banks, act as primary intermediaries and market makers, supporting interbank and customer transactions. Further, exporters, importers, institutional investors, foreign portfolio investors, and migrant workers contribute through trade and investment driven FX demand and supply. Active participation from a wide range of agents ensures that the exchange rate captures the economic fundamentals.

The CBSL actively intervenes in the FX market primarily to build reserves and ensure orderly market conditions, while exchange rates are determined through market-based price discovery. Ongoing infrastructure initiatives of the CBSL further enhance transparency, efficiency, and market depth.

Introduction of a Reference Exchange Rate in Sri Lanka

The CBSL has been introducing initiatives to improve liquidity and enhance transparency. A key milestone was the adoption of the FX Global Code in 2024 by the CBSL, all Licensed Commercial Banks (LCBs), and the National Savings Bank (NSB), aligning the domestic FX market with global standards.

As announced in the Policy Agenda of the CBSL for 2026, a benchmark exchange rate ("Reference Exchange Rate") is to be introduced to the domestic FX market in 2026 to enhance price discovery by providing a transparent, market-reflective reference point. Its design follows international best practices, particularly the International Organization of Securities Commission Principles (IOSCO) for Financial Benchmarks (2013), which provides a comprehensive framework for ensuring the integrity, governance, and accountability of financial benchmarks.

The benchmark design includes broadening the transaction base to capture a wider range of actual market activity, thereby ensuring the rate reflects underlying dynamics in the FX market. It incorporates strengthened data validation processes, including filters for anomalies, ensuring both accuracy and reliability. The introduction follows the launch of an FX matching platform for the domestic interbank market, in early 2025 featuring a central limit order book for spot USD/LKR transactions (Central Bank of Sri Lanka, 2025; Bloomberg, 2025).

Governance arrangements of reference exchange rate are being reinforced through the establishment of an independent oversight structure with an Oversight Committee already formed comprising representatives from the Sri Lanka Forex Association (SLFA) and the CBSL. The CBSL further strengthened this initiative by obtaining technical assistance from the IMF, knowledge and experience of peer countries and consultations with domestic FX market stakeholders to ensure practical relevance.

The proposed Reference Exchange Rate is expected to facilitate the development of hedging instruments such as forwards, swaps,

and options, strengthening market confidence through alignment with international standards whilst improving the transmission of monetary and exchange rate policies by offering a clear signal of market conditions.

Conclusion

Efficient price discovery is essential for the proper functioning of the domestic FX market and the broader macroeconomic framework. Ensuring that it is determined through a transparent and well-governed market process is therefore critical. The CBSL's ongoing reform agenda represents a

comprehensive approach to strengthening price discovery and deepening the domestic FX market and these measures are expected to support Sri Lanka's sustained real economic performance.

References

1. Bank for International Settlements (2023) 'The Foreign Exchange Market', BIS Working Papers, No. 1094.
2. Bloomberg (2025) 'Foreign Exchange Market in Sri Lanka Chooses Bloomberg FXGO's Electronic Matching System for the Interbank Foreign Exchange Market', Press Announcement, March 2025.
3. International Monetary Fund (2024) Sri Lanka: Staff Report for the Third Review Under the Extended Fund Facility. IMF Country Report No. 24/161.
4. International Organization of Securities Commissions (2013) Principles for Financial Benchmarks: Final Report, FR07/13. Madrid: IOSCO.
5. Osler, C.L., Mende, A. and Menkhoff, L. (2011) 'Price Discovery in Currency Markets', *Journal of International Money and Finance*, 30(8), pp. 1696–1718.
6. Rosenberg, J.V. and Traub, L.G. (2009) 'Price Discovery in the Foreign Currency Futures and Spot Market', Federal Reserve Bank of New York Staff Reports, No. 262.

