

Concept Note on the Implementation of a Single Policy Interest Rate Mechanism in Sri Lanka

*Rationale for the transition, characteristics of the new mechanism,
and the details of the operational framework¹*

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Central Bank of Sri Lanka

1. Introduction

As part of the improvements implemented within the monetary policy framework of Flexible Inflation Targeting (FIT), the Monetary Policy Board of the Central Bank of Sri Lanka decided to move to a single policy interest rate mechanism from its dual policy interest rate mechanism, with effect from 27 November 2024. Accordingly, the Central Bank introduced the **Overnight Policy Rate (OPR)**, as its primary monetary policy tool to signal and operationalise its monetary policy stance. The OPR will be periodically reviewed and adjusted as needed by the Monetary Policy Board to indicate and communicate a change in the Central Bank's monetary policy stance. This transition is expected to enhance the efficiency and effectiveness of monetary policy transmission to the financial markets and the broader economy.

The purpose of this Note is to summarise the evolution of monetary policy frameworks in Sri Lanka in brief, the rationale for transitioning to a single policy interest rate mechanism from the previous dual policy interest rate mechanism, and the operational framework of the new mechanism.

¹ The single policy interest rate mechanism was implemented on 27 November 2024, following the consideration of findings and recommendations of the interdepartmental study group of the Central Bank of Sri Lanka appointed for the implementation of a single policy interest rate mechanism. The study group consisted of the following officers from Economic Research Department: Dr. Lasitha Pathberiya, Additional Director, Mr. Janaka Edirisinghe, Deputy Director, Mr. Navin Perera, Senior Economist; Dr. Vishuddhi Jayawickrema, Senior Economist, and following officers from Domestic Operations Department: Mrs. Udayanthi Tennakoon, Additional Director; Mrs. Nishanthi Jayasuriya, Senior Assistant Director and the late Mrs. Iresha Maduwanthi, Senior Assistant Director. The implementation of the single policy rate mechanism was guided by Dr. P Nandalal Weerasinghe, Governor, Mrs. Nelumani Daulagala, Senior Deputy Governor, Dr. Chandranath Amarasekara, Assistant Governor, Dr. Sujeetha Jegajeevan, Director of Economic Research, Dr. Anil Perera, Director of Domestic Operations Department, and the Monetary Policy Committee of the Central Bank. The proposed mechanism was approved by the Monetary Policy Board of the Central Bank.

2. Background

2.1. Evolution of monetary policy frameworks and mechanisms in Sri Lanka²

Maintaining price stability is widely regarded as the prime objective of central banks or monetary authorities worldwide. The concept of price stability refers to a situation where there are no wide volatilities in the general price level in the economy. This ensures low and stable inflation in the economy, thereby enabling a growth-conducive environment.

Since its inception, the mandate of the Central Bank of Sri Lanka has been centred on the objective of preserving price stability. Before 2002, the Central Bank of Sri Lanka was tasked with a range of objectives encompassing both stability and developmental goals. However, in 2002, these objectives were streamlined to focus on *economic and price stability* and *financial system stability*. With the enactment of the Central Bank of Sri Lanka Act No.16 of 2023 (CBA), maintaining domestic price stability was recognised as the prime objective of the Central Bank, while financial system stability was recognised as the other objective of the Central Bank. Further, the new mandate of the Central Bank also emphasised that in pursuing the primary objective of price stability, it should support the stabilisation of output towards its potential level.

In achieving the objective of price stability, central banks around the world employ diverse monetary policy frameworks, necessitated by the need for a structured mechanism to operationalise the attainment of their ultimate objective of price stability. These frameworks enable central banks to effectively utilise their policy instruments to fulfil this mandate. Further, the choice of the monetary policy framework is crucial in addressing *the impossible trinity*, as it determines which of the three policy goals, i.e., independent monetary policy, fixed exchange rate, and/ or unrestricted capital flows, a country prioritises while foregoing another. Also, monetary policy frameworks vary across countries, shaped by distinctive country-specific circumstances, including the degree of financial market sophistication, economic openness, institutional strengths and capacities, as well as the level of independence of these institutions.

Similar to many other countries, Sri Lanka's monetary policy framework has evolved over the past eight decades, transitioning from the currency board system to the current monetary policy

² For further information on the evolution of monetary policy frameworks in Sri Lanka, please refer to Olcott Oration: *Evolution of Monetary and Exchange Rate Policy and the Way Forward* by Dr. P. Nandalal Weerasinghe; <https://www.cbsl.gov.lk/en/node/2453>

framework of FIT in 2020. Sri Lanka's history of monetary policy shows how it has changed over time to adapt to economic needs, shifts in economic priorities, financial market developments, as well as global developments, as the country sought to balance stability, growth, and resilience in its pursuit of long-term macroeconomic objectives.

2.2. Flexible Inflation Targeting Framework

In preparation for adopting FIT, the Central Bank implemented an enhanced monetary policy framework during the period from 2015 to 2020 as an interim arrangement for conducting monetary policy. This framework consisted of features of both monetary targeting and FIT frameworks. Under this enhanced monetary policy framework, the Central Bank focused on stabilising inflation in mid-single digits over the medium-term, while supporting the growth objectives and flexibility in exchange rate management. Although the Central Bank did not announce any monetary targets explicitly, broad money aggregates remained a key indicative intermediate variable to guide the conduct of monetary policy. Moreover, instead of reserve money, the Central Bank used the Average Weighted Call Money Rate (AWCMR) as its operating target and increasingly relied on market-based policy instruments, namely policy interest rates and open market operations (OMOs), to conduct monetary policy.

Further, the Central Bank prepared a Roadmap for the implementation of FIT along with strengthening monetary policy formulation process, in 2017. This Roadmap included proposals to enhance liquidity management and liquidity forecasting, introduction of a monetary policy report and strengthening the AWCMR as the operating target of the FIT framework.

Commencing in 2020, the Central Bank adopted the FIT framework, with the primary goal of stabilising inflation around a target while minimising disruptions to the real economy. To support this transition, the Central Bank made significant institutional and technical advancements over time. As an important step towards building technical infrastructure, a Forecasting and Policy Analysis System (FPAS) using short-term forecasting tools and medium-term dynamic stochastic general equilibrium (DSGE) techniques, was developed by the Central Bank with the assistance of the International Monetary Fund (IMF), providing robust analytical support for monetary policy decisions. Meanwhile, fulfilling a number of requirements for adopting FIT, the CBA was enacted by repealing the Monetary Law Act, No. 58 of 1949, and reinforced the Central Bank's independence and accountability. Under the CBA, the FIT framework was formally recognised as the monetary policy framework of the Central Bank. The governance structure of the Central Bank was also reformed to include two

decision-making bodies, namely the Governing Board and the Monetary Policy Board. The latter is responsible for formulating monetary policy and implementing the flexible exchange rate regime in line with FIT. Further, the CBA also prohibits monetary financing, preventing the Central Bank from financing fiscal deficits. The Central Bank has also enhanced monetary policy communication by publishing regular monetary policy reports and press releases, and holding press conferences to explain policy decisions and inflation developments, projections and expectations, thereby ensuring greater transparency and accountability.

At present, under the FIT framework, the Central Bank aims to maintain headline inflation at a target rate of 5 per cent, while supporting economic growth to reach its potential. This inflation target was formalised through the Monetary Policy Framework Agreement between the Government and the Central Bank, which was published in the Government Gazette in October 2023. In terms of operational aspects of the FIT framework, the Central Bank uses its policy instruments to guide short-term interest rates, with AWCMR serving as its operating target. Inflation forecasts play a vital role in determining the direction of monetary policy actions. The Central Bank conducts OMOs within the Standing Rate Corridor (SRC) to manage liquidity conditions and steer short-term interest rates toward desired levels.

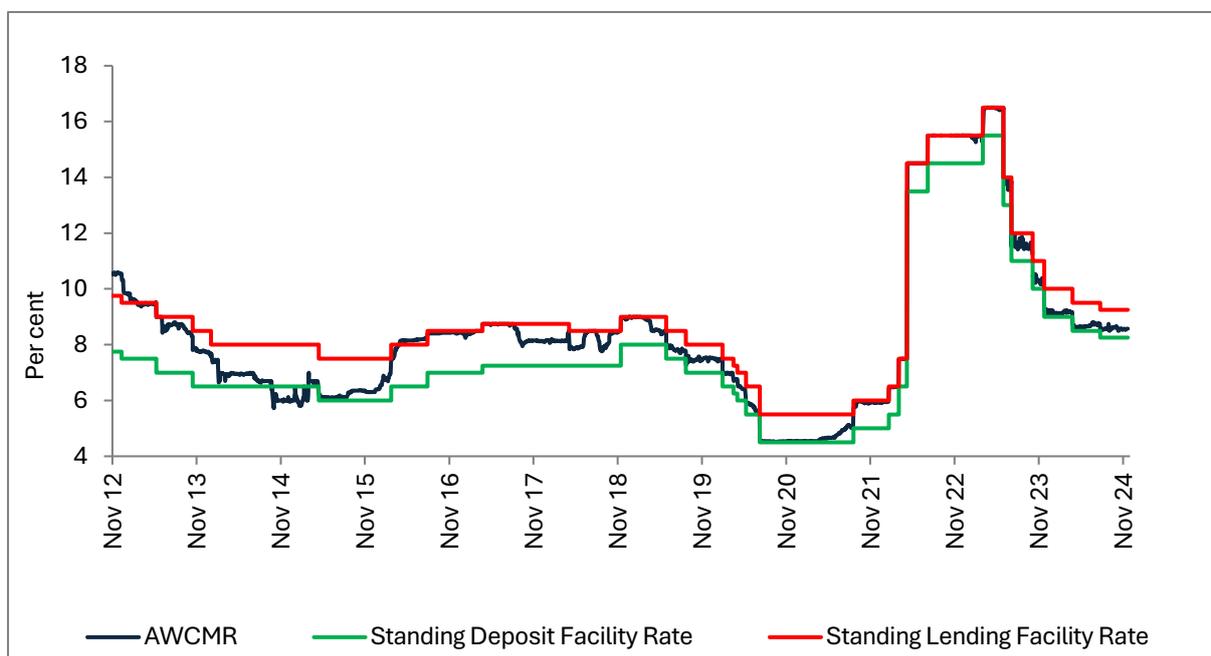
2.3 Dual Policy Interest Rate Mechanism

The adoption of a dual policy interest rate mechanism was formally initiated in the early 2000s with the implementation of active OMOs as part of the Central Bank's gradual shift from direct controls to market-based monetary policy instruments. The dual policy interest rate mechanism was used both in the monetary targeting framework and FIT, until the introduction of a single policy interest rate mechanism on 27 November 2024. Earlier, during the 1990s, the introduction of the Repurchase (Repo) Rate and the Reverse Repurchase (Reverse Repo) Rate marked significant milestones in the evolution of the Central Bank's monetary policy framework. The Repo facility, introduced in 1993, enabled the Central Bank to absorb overnight excess liquidity from the market, while the Reverse Repo facility, introduced in 1995, allowed for the injection of overnight liquidity into the market. These two rates effectively formed a corridor, serving as the floor and ceiling, respectively, for the interbank call money market rate. This dual policy interest rate mechanism or the policy interest rate corridor was used from the early 2000s to signal changes in the monetary policy stance of the Central Bank. OMOs became more structured and auction-based, incorporating overnight, short-term, and long-term operations to actively manage liquidity conditions, thereby aligning market interest rates in line with the Central Bank's announced monetary policy stance. On 02

January 2014, the Repo Rate and Reverse Repo Rate were renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively, forming the SRC, while the Standing Deposit Facility was uncollateralised effective 01 February 2014. Under this system, the interest rate corridor guides overnight interest rates in the money market as reflected by the AWCMR. The AWCMR functions as the operating target under the current monetary policy framework, through which the monetary policy stance is transmitted to the broader financial market.

Figure 01: Key Policy Rates and AWCMR

(prior to the implementation of a Single Policy Interest Rate Mechanism)



Source: Central Bank of Sri Lanka

3. Drawbacks of the Dual Policy Interest Rate Mechanism and the Need for an Alternative

The introduction of a single key policy interest rate to signal the Central Bank's monetary policy stance has been a long-standing need in terms of ensuring the efficiency of monetary policy transmission to the economy. Under the dual policy interest rate mechanism, the monetary policy stance of the Central Bank is communicated to the public by way of communicating the corresponding levels and changes of any of SDFR and SLFR. However, the Central Bank usually does not communicate a specific point target for interbank transactions within SRC under the dual policy interest rate system.

Major drawbacks in the dual policy rates mechanism arose mainly due to its complexity, as well as inadequate transparency and clarity in communicating the monetary policy stance. Even though the Central Bank was aware of the rate around which it would like the interbank call money market rates to hover, transparency relating to where the AWC MR should lie within the policy rate corridor was lacking.

Another key drawback of having a dual policy interest rate mechanism is that it leads to confusion caused by complexity. Banks, other financial institutions, markets as well as the public generally have had difficulties in understanding or deducing the Central Bank's monetary policy stance by observing the dual policy interest rates or the interbank money market rate (i.e., AWC MR). Further, with multiple policy interest rates in operation, the public as well as financial market stakeholders will not know whether the Central Bank wishes to maintain short term interest rates closer to SLFR or SDFR or at the middle rate.

Moreover, complexity of the dual policy interest rate system inherently generates mixed signalling in communication, which undermines the efficacy and effectiveness of monetary policy transmission. Variation of OMO auction rates within the policy rate corridor transmits mixed signals regarding the conduct of monetary operations, and stance of the monetary policy.

Policy rates serve as critical benchmarks for pricing deposit and loan products offered by financial institutions. However, the lack of uniformity in benchmark selection by financial institutions, given the multiple options available as policy rates, undermines consistency. As a result, uneven adjustments to dual policy interest rates can lead to uneven outcomes, diminishing the effectiveness of monetary policy transmission.

Most modern-day central banks use a single policy interest rate to communicate their monetary policy stance providing greater clarity for international agencies, investors and the public to accurately assess the stance of the central bank.

4. Alternative Operational Frameworks and Country Experiences

4.1. In general, countries around the world use three main types of monetary policy operational frameworks: (i) corridor system, (ii) floor system, and (iii) ceiling system. Under a corridor system, the central banks adjust the supply of reserves using OMO and standing facilities priced at a margin around the target interest rate, which provides the upper and lower bounds for overnight market interest rates. A floor system supplies reserves in abundance through OMO and provides a floor for the interest rate via a deposit facility. Under a ceiling system, central

banks abstain from providing liquidity to the banking system through OMO. Instead, the liquidity deficit is met by the central bank's lending priced at the policy interest rate. However, the ceiling system has not been widely used since the global financial crisis. Most emerging market economies (e.g., India, Malaysia and the Philippines) are found to operate in a mid-corridor system, where the central bank's policy interest rate is announced, and in addition, a pre-determined margin is also announced to set the upper and lower bounds of the policy rate corridor. The middle of the corridor serves as the key policy interest rate of such central banks, and monetary policy aims at maintaining the overnight market interest rates closer to the target defined by the key policy interest rate.

- 4.2. Most advanced economies (e.g., Canada, the United Kingdom and the European Central Bank) operate under a floor system. This is mostly an outcome of the global financial crisis. Although the COVID-19 pandemic and the subsequent economic crisis warranted a continuation of the floor system, it is not regarded as a permanent framework for those economies.
- 4.3. Sri Lanka's previous dual policy mechanism could be classified as a corridor system. However, it fell short of a fully-fledged corridor framework because it only specified the corridor margins and lacked an announcement of a key policy interest rate within the corridor to anchor the AWCMR.

5. Rationale for Implementing a Single Policy Interest Rate Mechanism

The transition from the dual policy interest rate system to a single policy interest rate mechanism reflects the efforts by the Central Bank to simplify its monetary policy communication and ensure the effective transmission of monetary policy. The Central Bank gradually streamlined the gap in the policy rate corridor formed by the SLFR and SDFR in recent years. Narrowing such margin from 200 basis points eventually to 100 basis points helped to enhance the signalling mechanism and reduced the dispersion in money market interest rate. This gradual transition paved way for the move to a single policy interest rate mechanism without major disruptions to the markets. Adoption of a single policy rate mechanism is a further step in the endeavour to enhance credibility and transparency in the monetary policy implementation.

- 5.1. The rationale for the change from the dual policy interest rate system to a single policy interest rate can be detailed as follows: Firstly, transition to a single policy interest rate simplifies policy communication. A single policy interest rate is more effective in signalling the monetary policy stance and the transmission of monetary policy decisions. When only a single policy interest

rate is announced, it is easier for stakeholders to understand the stance of monetary policy, thus enhancing clarity for markets and it helps in aligning market expectations and behaviour of market participants. The existence of multiple policy interest rates, i.e., SDFR and SLFR, created confusion about which rate was more relevant for monetary policy. A single policy interest rate system eliminates such uncertainties, and simplicity helps reduce misunderstandings about the Central Bank's actions and intentions.

5.2. Secondly, a single policy interest rate system enhances the transmission of monetary policy. The Central Bank can focus on influencing a single policy interest rate, making the implementation of monetary policy more efficient by manoeuvring the AWCMR around the single policy interest rate, rather than allowing the AWCMR to move within the policy interest rate corridor, as practiced under the dual policy interest rate system. Hence, temporary movements in the AWCMR due to short-term liquidity fluctuations or any other exogenous factors are unlikely to affect the monetary policy transmission mechanism, as the Central Bank's policy stance is clearly communicated by the single policy interest rate. Further, a single policy interest rate will act as a sound benchmark for setting other market interest rates, thereby enhancing the transmission of monetary policy.

6. Characteristics of the Single Policy Interest Rate Mechanism

The Central Bank implements the single policy interest rate framework after numerous policy deliberations and consultations with market participants, Monetary Policy Committee and Monetary Policy Board of the Central Bank.

- 6.1.** The characteristics of the mechanism are as follows: The Central Bank introduced the Overnight Policy Rate (OPR), as its primary monetary policy tool to signal and operationalise its monetary policy stance with effect from 27 November 2024. With this policy change, the Central Bank targets to maintain AWCMR, the rate at which Licensed Commercial Banks (LCBs) transact with each other in the interbank market, at or around the announced the OPR. The AWCMR continues to remain the operating target of the Central Bank under its FIT framework.
- 6.2.** Meanwhile, the standing facilities, namely the Standing Deposit Facility and the Standing Lending Facility continue to be available to participatory institutions for overnight transactions with the Central Bank. The applicable rates for these facilities, namely the SDFR and the SLFR, are linked to the OPR, with pre-determined margins as decided by the Central Bank. The

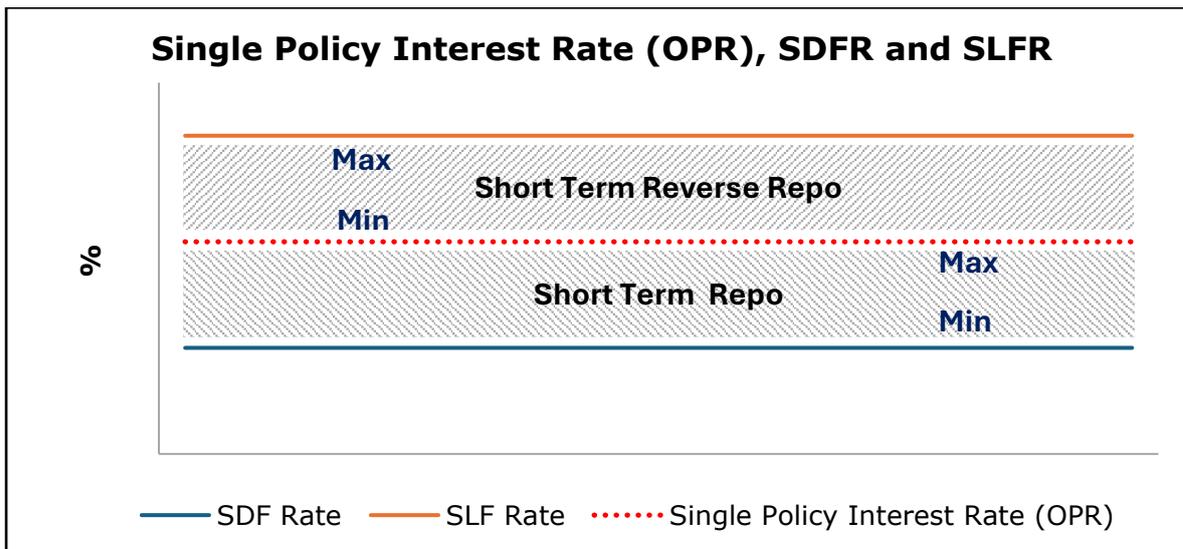
Central Bank has the option to determine symmetric or asymmetric margins. The SDFR and SLFR continue to provide the lower bound and upper bound, respectively, for interbank call money rates. With this transition to the single policy interest rate mechanism, the SDFR and SLFR are no longer considered policy interest rates of the Central Bank.

- 6.3.** Under the single policy rate system, the OPR will be periodically reviewed and adjusted as needed by the Central Bank to indicate and communicate a change in its monetary policy stance. The new development in the monetary policy framework is expected to enhance the efficiency and effectiveness of monetary policy transmission to the financial markets and the broader economy.

7. Operational Framework of the Single Policy Interest Rate Mechanism

- 7.1.** Under the single policy interest rate mechanism, the OPR serves as the benchmark interest rate for overnight transactions in the money market. Accordingly, the operational framework of the single policy interest rate mechanism is designed to streamline monetary policy implementation by anchoring short-term interest rates. The OPR serves not only as the primary reference rate but also underpins the Central Bank's OMOs, which manage liquidity in the financial system.
- 7.2.** The OMOs include a range of tools aimed at aligning market interest rates with the OPR. These tools include repurchase and reverse repurchase auctions, which involve liquidity injections and absorptions against collateral, and outright auctions, which involve the sale or purchase of government securities by the Central Bank from the secondary market. Each of these operations is strategically calibrated with OPR to ensure stability in market interest rates, thus reinforcing the monetary policy stance and monetary policy transmission.
- 7.3.** For overnight and short-term repo auctions, the Central Bank sets the OPR as the upper limit for bidding rates, while the SDFR serves as the lower bound. On the other hand, for reverse repo auctions, the range for bidding rates is established between the OPR and the SLFR. The Central Bank permits the spread of bid rates for overnight and short-term auctions to fluctuate within this range, providing a controlled, yet flexible mechanism for liquidity adjustments.

Figure 02: Single Policy Interest Rate Structure



Note: SDFR and SLFR could be symmetrically distributed around the single policy interest rate (Overnight Policy Rate - OPR), or otherwise, as determined by the Monetary Policy Board of the Central Bank.

8. Concluding remarks

The transition to the single policy rate mechanism is an important aspect of continued improvements the Central Bank is introducing to enhance the efficiency and effectiveness of monetary policy signalling and transmission to the markets and economy. The Central Bank will continue to review and update its monetary policy making and operational processes in line with the changing domestic and global conditions, and with international best practices.