Abstract

The Central Bank of Sri Lanka (CBSL) is responsible for the management of the monetary policy of the country so as to achieve its basic economic objectives. In general, interest rate is a key channel of the monetary policy transmission mechanism. During the past two decades, interest rate has become the most important policy instrument used by the CBSL. Since 2003, through managing the policy rates (SDFR) and (SLFR), CBSL attempts to influence Interbank Call Money Market Interest Rate (CALLWA) and through this means expects the interest rate adjustments to be reflected in commercial bank retail (lending and deposit) interest rates. Undoubtedly, the efficient transfer of the monetary policy impulses to the retail deposit and lending rates is important to achieve the ultimate goal of the monetary policy.

The first stage of the process of interest rate transmission is related to the pass-through from Central Bank policy rates to CALLWA. The second stage is the pass-through from CALLWA to commercial bank retail lending and deposit interest rates. The aim of this paper is to assess through an empirical estimation and use of statistical tools, the effectiveness of managing the policy rates in influencing the commercial bank lending and deposit interest rates.

Interestingly Granger Causality test illustrates that SLFR has followed the behaviour of Money Market Interest Rates when the reverse was expected. This result suggests that it was the Money Market Interest Rates that has influenced CBSL policy rates and not the policy rate that has influenced Money Market Interest Rates as expected. It could also be interpreted that the policy maker may not have been prompt in adjusting policy rates in effective discharge of its responsibility in Monetary Policy Management.

Accordingly, the study concludes that the interest rate pass-through process in Sri Lanka is considered to be incomplete as supported by the empirical results of the current study since the proxy rate which is the Money Market Interest Rates is not totally dependent on the policy rates imposed by the Central bank.
Interest Rate Management – Theoretical Background

The interest rate management in the economy was intensively studied by many economists. Two of the most influential theories are Irving Fisher’s classical approach, extended to loanable funds theory, and liquidity preference theory, developed by John M. Keynes. Both economists advocated against the direct management of the interest rates and favoured it to be managed through the market forces. However McKinnon and Shaw (1973) presented a strong case for deliberately set high interest rates and Market failure school of economists strongly advocated direct involvement of the government or the policy makers in active management of the interest rates.

In classical theories of economics, interest rate is one of the major economic policy tools. According to classical thinking, domestic savings and investments are interest rate sensitive. In essence, as per the classical theories, savings are positively related to interest rates and investments are negatively related. According to Keynesian theories, low interest rate regimes are encouraged for higher income and economic growth. Most of the developing economies prefer to adopt Keynesian theories for economic grown, including Sri Lanka.

However, McKinnon and Shaw (1973) presented a strong case against the low interest rate policy which was advocated by Keynesian policies. The central argument of the McKinnon-Shaw (1973) hypothesis was that, an increase in the real interest rate may induce the savers to save more, which enable more investment. As advocated by McKinnon and Shaw, savings are encouraged by high interest rates thereby the lending banker may get more lendable funds so that the investments are encouraged. Therefore they proposed removing interest rate ceilings and deliberately setting the interest rates high.

Market failure school of economists strongly argued that market malpractices should be corrected through government interventions. Therefore, market failure school of economists suggests having a government intervention in determining interest rates and efficient allocation of resources.

Interest Rate Management - Context of Sri Lanka

That said, prior to 2003, the main policy instruments of the Central Bank of Sri Lanka were the Bank Rate (at which rate the Central Bank would lend to Banks if they need to borrow), Statutory Reserve Requirement (SRR) (portion of the deposits that the banks should maintain with Central Bank as a security), and moral suasion (indirect communication by Central Bank). None of these instruments had direct intervention with the interest rates quoted by the commercial banks for their deposits and lending (retail interest rates). During the past few decades, interest rate has become the most important policy instrument used by the CBSL in its monetary operations. Adopting this policy instrument, by influencing Interbank Call Money Market Interest Rate (CALLWA) at the short end of the market, the CBSL expects the interest rate adjustments to be reflected in the commercial bank retail interest rates (lending and deposit...
rates). Commercial bank prime lending rates and other lending rates as well as commercial bank deposit rates both on savings as well as term deposits are also expected to adjust.

In 2003, Central Bank shifted to Open Market Operations (OMO) as a monetary policy instrument. Through Open Market Operation, Central Bank is expected to actively manage the policy rates that will work as an interest rate corridor for the CALLWA, that in turn is expected to influence the commercial banks’ deposit and lending rates. Hence, it is clear that the Central Bank of Sri Lanka has not been directly managing the retail interest rates in the market, though strongly advocated by Market Failure economic schools of thoughts apart from McKinnon and Shaw proposing a strong link between domestic savings and investment to interest rates.

Under Open Market Operations, CBSL may purchase or sell government securities (Treasury Bills and Bonds) in the open market to control market liquidity. In doing so, the Central Bank’s key monetary policy interest rates are the Repo rate, and the Reverse Repo rate. The Repo rate is the rate at which commercial banks and primary dealers can invest their surplus funds in Government Securities through the Central Bank. Effective from 2nd January 2014, Repo rate is referred to as Standing Deposit Facility Rate (SDFR). Similarly, Reverse Repo rate is the rate at which commercial banks and primary dealers can obtain funds from the Central Bank by pledging their own holdings of Government Securities to the Central Bank. Effective from 2nd January 2014, Reverse Repo rate is referred to as Standing Lending Facility Rate (SLFR). The Repo and the Reverse Repo rates (SDFR and SLFR) are expected to facilitate reducing excess volatility in the inter-bank overnight money market, thereby directly influence the call money market interest rates.

As per the CBSL annual report (2017), the objective of the CBSL is to conduct monetary policy within an enhanced monetary policy framework with features of both monetary targeting and flexible inflation targeting. The Central Bank will conduct monetary policy within the current enhanced monetary policy framework, with a view to transiting towards Flexible Inflation Targeting (FIT) in the medium term. Under this enhanced monetary policy framework, the Central Bank attempts to stabilize inflation within single digits over the medium term, while supporting the growth momentum of the economy and flexibility in exchange rate management. In terms of operational aspects of this framework, the Central Bank uses its policy instruments to guide
short term interest rates, particularly the Interbank Call Money Market Rate or average weighted call money rate (CALLWA) as the operating target (CBSL Annual Report 2017). Accordingly, instead of reserve money, Central Bank currently uses CALLWA as its operating target under its enhanced monetary policy framework. The Central Bank of Sri Lanka being the regulator of the commercial banks, does not directly set the deposit and lending rates of the commercial banks, but expects the commercial banks to get guided by the money market interest rates.

On the other hand, commercial bank interest rate is the premium paid by commercial banks to attract deposits and the price set by them for the borrowing customers. As with any other company, one of the primary objectives of a commercial bank also could be to maximize profits, irrespective of whether it helps to achieve economic targets of the country or not.

In this context, would it be reasonable to expect the commercial banks to get guided by the CALLWA fully. If so, would the expectation of the Central Bank in impacting domestic savings, domestic borrowings, inflation and level of unemployment through influencing the commercial bank lending and deposit rate be met?

This paper is an attempt to study the effectiveness of the policy rate management adopted by the CBSL, in influencing the commercial bank lending and deposit interest rates in Sri Lanka.

Recent Monetary Policy Measures

As stated in highlights of 2017 and prospects for 2018, a CBSL publication in 2017, “the Central Bank continued to maintain a tight monetary policy stance in the first nine months of 2017 in view of the developments in inflation as well as monetary and credit aggregates. With a view to containing the build-up of adverse inflation expectations and in the excessive expansion of money supply, the Central Bank further tightened its monetary policy by raising policy interest rates by 25 basis points in March 2017. The Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank stood at 7.25 per cent and 8.75 per cent, respectively, since then.”

In response to the monetary policy stance maintained by the Central Bank and the high financing requirement of the government budget, most market interest rates moved upwards during the first nine months of 2017, although short term rates adjusted downwards with liquidity improvements in the domestic money market since July 2017. The Average Weighted Call Money Rate (CALLWA) moved around the upper bound of the policy rate corridor during the first seven months of 2017, reflecting tight monetary conditions. However, with improved liquidity conditions since July 2017, the CALLWA adjusted downwards towards the middle of the policy rate corridor by end September 2017. Meanwhile, Sri Lanka Inter Bank Offered Rates (SLIBOR) adjusted in line with movements in the CALLWA. The deposit interest rates of commercial banks increased particularly during the first seven months of 2017, reflecting the increased funding costs of commercial banks. Lending rates of commercial banks also increased further and stabilized at high levels by end September 2017. (Central Bank Annual Report 2017)
Table 01: Recent Monetary Policy Measures

<table>
<thead>
<tr>
<th>Date</th>
<th>Measure</th>
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<tbody>
<tr>
<td>10-May-2013</td>
<td>Repurchase rate and Reverse Repurchase rate reduced by 50 basis points to 7.00% and 9.00%, respectively.</td>
</tr>
<tr>
<td>26-Jun-2013</td>
<td>Statutory Reserve Requirement (SRR) reduced by 2 percentage points to 6% with effect from 1-Jul-2013.</td>
</tr>
<tr>
<td>15-Oct-2013</td>
<td>Repurchase rate and Reverse Repurchase rate reduced by 50 basis points to 6.50% and 8.50%, respectively</td>
</tr>
<tr>
<td>2-Jan-2014</td>
<td>The Policy Rate Corridor was renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and the Reverse Repurchase rate of the Central Bank were renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively. SLFR reduced by 50 basis points to 8.00%. The Standing Deposit Facility (SDF) uncollateralized with effect from 1-Feb-2014.</td>
</tr>
<tr>
<td>23-Sep-2014</td>
<td>Access to the SDF of the Central Bank by OMO participants at 6.50% was rationalized to a maximum of three times per calendar month. Any deposits at the SDF window exceeding three times by an OMO participant was accepted at a special interest rate of 5.00%.</td>
</tr>
<tr>
<td>2-Mar-2015</td>
<td>The 5.00% special SDF rate was withdrawn</td>
</tr>
<tr>
<td>15-Apr-2015</td>
<td>The SDFR and SLFR reduced by 50 basis points to 6.00% and 7.50%, respectively.</td>
</tr>
<tr>
<td>3-Sep-2015</td>
<td>The exchange rate was allowed to be determined based on demand and supply conditions in the foreign exchange market.</td>
</tr>
<tr>
<td>30-Dec-2015</td>
<td>SRR was increased by 1.50 percentage points to 7.50% to be effective from the reserve period commencing 16-Jan-2016.</td>
</tr>
<tr>
<td>19-Feb-2016</td>
<td>The SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.</td>
</tr>
<tr>
<td>28-Jul-2016</td>
<td>The SDFR and SLFR increased by 50 basis points to 7.00% and 8.50%, respectively.</td>
</tr>
<tr>
<td>24-Mar-2017</td>
<td>The SDFR and SLFR increased by 25 basis points to 7.25% and 8.75%, respectively.</td>
</tr>
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Source: Central Bank of Sri Lanka

As per a recent article that appeared in Daily Mirror, 2nd August 2018, under the caption ‘Central Bank seen holding rates to spur growth’, “Sri Lanka’s Central Bank is expected to keep key interest rates steady at its policy review as it looks to spur faltering economic growth amid heavy downward pressure on the nation’s currency. The Central Bank unexpectedly cut
its key lending rate by 25 basis points in April 2018 to support the economy but the policy makers must also defend a fragile rupee and prevent outflows as emerging markets come under pressure from the rising U.S. interest rates. Economists expected the Central Bank of Sri Lanka (CBSL) to keep its standing deposit facility rate (SDFR) and standing lending facility rate (SLFR) unchanged at 7.25 percent and 8.50 percent, respectively and also the statutory reserve ratio (SRR) to remain steady at 7.50 percent. Even though private sector credit and inflation are rather managed, the CBSL is expected to hold off on a rate cut given the tightening global monetary environment, which is causing other central banks in Asia to even look towards rate hikes. A rate cut could further incentivize investors to reduce their holdings in local securities. Sri Lanka’s economy grew 3.3 percent in 2017, a 16-year low and the government officials have forecasted a growth of around 4.5 percent this year, which would still be below the recent peak of 5.0 percent growth in 2015.”

Policy Rate Management - Regional Experience

International Monetary Fund (IMF) has done a comparative study in 2015 on the effectiveness of the operation of the monetary policy in developing countries (IMF study 2015, Evolving Monetary Policy Frameworks in Low Income Countries) that included Sri Lanka. This paper explained the respective policy frameworks, effectiveness of the implementation and also the challenges to monetary policy, both specifically related to the design and implementation of monetary policy and more generally related to the macro and financial environment in which monetary policy operates. Most central banks place price stability as the primary objective of monetary policy, its role in the policy framework varies widely. They noted that central banks often follow other objectives in addition to price stability. More than two thirds of the survey respondents had two or more objectives, these range from attempting to support economic growth and, at times, to explicitly targeting financial sector development and credit growth, and exchange rate stability. According to the study, the primary objective of a Monetary Policy which is the inflation targeting is generally not well established and also those countries did not have numerical targets. The policy horizon in most of the countries often was very short. The IMF study clearly identified that restrictions on access to central bank standing lending and deposit facilities, excessive spreads between central bank lending and deposit rates, short reserve maintenance periods and insufficient averaging and interest rate volatility that have weakened policy transmission. IMF study concluded that, large variances between policy rates and the market rates relevant for commercial bank liquidity management risk, rendering the policy rates irrelevant for commercial bank pricing and lending decisions.

Nils Maehle (2014) in their study on Monetary Policy Implementation: Operational Issues for Countries with Evolving Monetary Policy Regimes, an IMF study, argued that short-term interest rates and not the reserve money should be the operational target for the daily liquidity operations for countries that mainly rely on monetary aggregates for guiding policy formulations. The paper discussed how a monetary targeting based policy formulation framework can be combined with an interest rate focused operational framework; the use of momentary aggregates as information variables in guiding the setting of short term interest rates. Analysing further
they concluded that the direct interest rate channel is often weak in developing countries. The strength of the channel depends on both the degree of pass-through from monetary policy actions to lending, deposit, and securities rates, and the interest rate sensitivity of investment and consumer spending decisions.

**Previous Studies on Policy Rate Management in Sri Lanka**

The results are somewhat mixed for studies done in countries such as China, Africa, Argentina, Euro market, Namibia, Austria and Central African countries. Some countries, the interest rate pass-through had been effective whereas most of the countries the second lag of the transmission had not been that effective. There were few previous studies focusing on Sri Lanka that mostly suggested policy rate management as a policy instrument in influencing commercial bank interest rates is not so effective.

Amerasekera C. (2005), in his study on interest rate pass-through in Sri Lanka, attempted to assess whether there is one to one pass-through in policy instruments to call money market interest rate or at what rate a unit change in policy rate affect the call money market rate. Further his study attempted to measure the correlation between the call money market rate and the commercial bank deposit and lending rates. Having analyzed data from 1995 to 2004, his study revealed that although there is a rapid and almost complete pass-through from the Central Bank policy interest rates to call money market rates, the pass-through from call money market rates to commercial bank retail interest rates is sluggish and incomplete. With this conclusion he explained that the sluggish and incomplete pass-through poses a challenge to the Central Bank as it hinders the achievement of its monetary policy objectives as desired. His study suggested several possible reasons for sluggish adjustments in commercial bank retail interest rates. However, the writer feels that the assumptions used in the above study, especially the causality test conducted, need further justification to prove the effectiveness of the policy rates on the interbank call money rate. This is briefly discussed in this paper and the writer feels that this area should be further considered in future researches for effective discharge of Central Bank responsibilities.

Abeygunawardana K and Thilakaratne C (2013), using a Vector Auto Regression (VAR) method, examined the impact of monetary policy instruments on output, prices, and interest rates in Sri Lanka during the period from 2003 to 2012. Their study indicated a strong transmission of policy rate onto the money market rates and the government securities market yields. However, they argued that banking sector interest rates exhibited a smaller and slower impact compared to money and government securities market rates. They concluded that the existence of a large informal economy, volatile excess market liquidity, shallowness of financial markets, relatively less flexible interest rates on deposit and loan products are identified as reasons for weak transmission. However, analysing the direction of the change, whether policy rate influence the call money rate or otherwise, was not within the scope of this study.

Perera, A., (2016) in his study on monetary transmission mechanism in Sri Lanka provides
a comprehensive assessment of the transmission of monetary policy in Sri Lanka starting from changes to Central Bank policy to the response of final target variables-output and prices. His study provides estimates for interest rate pass-through and suggests that pass-through is yet to achieve the completeness except for prime lending rates. Based on the empirical estimates obtained employing both unrestricted and structural vector auto regressions, this study observed that monetary policy in Sri Lanka is quite ineffective to influence the target variables of the Central Bank. It also suggests that monetary policy changes affect target variables through different intermediate transmission channels such as bank credit, exchange rates as well as asset prices.

Perera, A., (2016), in his conclusion argued that according to his findings, the interest rate pass-through in Sri Lanka is not complete. Despite the fact that short term lending rates, particularly prime lending rates show some speedy and complete adjustment, a majority of interest rates report sluggish and incomplete adjustments. This calls for the need for implementing policies to further develop the financial and banking sector in Sri Lanka while promoting competition among financial intermediaries. He further points out that prime lending rates and 3-months fixed deposit rate of commercial banks have a strong association with money market interest rates. It may therefore be argued that using short-term rates would be much appropriate when assessing the effectiveness of monetary policy.

Pathberiya T., (2016), examined the transmission of monetary policy impulses to bank retail interest rates in Sri Lanka. Among other econometric techniques, the Error Correction Mechanism has been used in this study as a main technique to analyse the interest rate pass through mechanism empirically. The data used were for the 10-year period from 2003 to 2013. The key conclusion was, that there is no one for one interest rate pass-through to the long-run commercial bank rates from money market rate. Nevertheless, there is a sizable and satisfactory pass-through in the long-run in fixed deposit rates. In contrast, the long-run pass-through was not satisfactory with regard to retail loan interest rates. In the short-run, bank retail rates deviated from the equilibrium due to monetary policy shocks, but were adjusted to their equilibrium levels in the long-run. Also it was found that, on average, short-run adjustment speed of deposit rates is less compared with the lending rates. Further, the short-run adjustment speed is higher for shorter maturities. In general, there is no asymmetry in interest rate pass-through in Sri Lanka.

In summary, the limited previous studies on the effectiveness of the interest rate pass-through in Sri Lanka referred to above collectively conclude that the process adopted by the Central Bank is quite ineffective to influence the target variables of the Central Bank. Abeygunawardana K and Thilakaratne C (2013) indicated a strong transmission of policy rate onto the money market rates but ineffective transmission from money market rates to commercial bank retail interest rates. Similar observations were made by Amerasekera C. (2005). That said, analyzing the direction of the change, whether policy rate influence the call money rate or otherwise, was not within the scope of these studies, which the writer believes to be a vital assessment to assess the effectiveness of the policy implementation. Hence this short paper in addition to assessing the effectiveness of the policy rate management is an attempt to study the direction of the influence, whether policy rates influence the money market rates or vise versa.
Empirical Analysis – Expectation Vs Reality

Contrary to the theoretical expectation, a simple analysis of the deposits, loans and the respective average interest rates revealed that there is no direct relationship between the movement of deposits and loans to their respective interest rates. Similarly, despite the expectation of the policy makers, the call money market rate had not been moved strictly within the interest rate corridor during some of the months.

Rate Sensitivity of Deposits

Figure 02 compares monthly movement of the domestic savings base of Sri Lanka against the Average Weighted Deposit Rate (AWDR) for the period 2008 to 2017. All these data have been extracted from respective Annual Reports of the CBSL. Quite interestingly a steady growth in domestic savings has been witnessed from 2008 to 2017 despite a clear cyclical behaviour in the AWDR over the same period. This clearly evidenced that the domestic savings in Sri Lanka is not purely interest sensitive and there may have been other influencing factors such as culture, demographic distribution, income levels, access to banks etc. The same observation was made by Hemachandra W M (2010), in his study of interest rate as a policy instrument in Sri Lanka. His conclusion was that interest rate has not influenced in determining domestic savings and private savings in Sri Lanka, which is amply evidenced through Figure 02.

Figure 02: Average Weighted Deposit Rate and Domestic Savings

Rate Sensitivity of Investments

Very similar to the domestic savings movement a steady growth in domestic investment has been witnessed from 2008 to 2017 despite a clear cyclical behaviour in the AWPLR rates over the same period. This clearly shows that the domestic investment in Sri Lanka is not purely interest sensitive and there may have been other influencing factors, a study of which is not
within the scope of this study. Similar view was expressed by Hemachandra W M (2010), where he argued that total investment has not been influenced by the changes in lending interest rates, yet the interest rates should not be ignored in assessing the financial deepening in Sri Lanka.

Figure 03: Average Weighted Prime Lending Rate and Domestic Investment

Interest Rate Corridor and Call Money Rate Movement

As per the pure theoretical explanation, the call money rates should move within the interest rate corridor. Figure 4 below indicate how it has moved during January 2008 to December 2017. Contrary to what is expected, a closer look suggest that the call money market rate has been moving outside the range specified, during 2008, early 2009, 2012, 2014 and 2017. This challenges the argument whether the CBSL policy rates were effective in influencing the call money rates.

Figure 04 CBSL Policy Rates and CALLWA – Monthly

(2) Interest Rate Corridor and Call Money Rates
Jan 2008 - Dec 2017

- SDFR
- SLFR
- CALLWA
Statistical Results

With an object to assess the effectiveness of the pass-through process of the policy rates to retail interest rates, the writer analysed the data gathered using SPSS statistical software version 20 and EViews. Monthly data were used covering the period from January 2008 to December 2017. All the data used in this paper have been extracted from the publications of Central Bank of Sri Lanka. Descriptive Statistics, Correlation, Regression analysis and Granger Causality test have been deployed as major techniques for data analysis. The analysis has been conducted under two sections. First section consists of the pass-through from the CBSL policy interest rates to the call money market interest rates and the second section deals with the pass-through from call money market interest rates to the commercial bank retail lending rates and deposit rates.

First Leg - Pass Through from Policy Interest Rates to Money Market Rate

Descriptive statistics mean values indicate that the call money market rate (CALLWA) on average remained between standing deposit facility rate (SDFR) and standing lending facility rate (SLFR). Standard deviation indicates the volatility of the interest rates. Based on the above results it can be observed that there is a high volatility in call money rates since the standard deviation was nearly 2.62. When considering the minimum and maximum values of the call money rates, it can be recognized that the maximum value has exceeded the upper ceiling rate of the interest rate corridor which is SLFR and on the other hand minimum value of the call money rate has fallen below the lower limit of the corridor which is SDFR.

Consequently, based on the correlation results of annual interest and monthly interest rates, it can be concluded that the policy interest rates and call money market rates are relatively highly correlated in the short run when comparing with the correlation in the long run. Coefficients of each independent variables indicate the number of units change in the dependent variable when the independent variable changes by one unit. Accordingly, when SDFR increases by one unit CALLWA increases nearly by 2.36 and vise versa. Considering the impact of SLFR to the CALLWA, it shows a negative impact with a unit change of 0.425.

When applied regression analysis, T- statistics and probability levels show to which extent the independent variables can influence the dependent variable individually. Since t-statistics of SDFR was greater than 2 and probability level was less than 0.05, it can be concluded that Standing Deposit Facility Rate significantly and individually has impacted on the CALLWA. However, based on the above results, it can be seen that the Standing Lending Facility Rate is insignificant in influencing the CALLWA since the value of t-statistics is less than 2 and probability level is greater than 0.05.
Does Policy Rate Influence Money Market Rates?

CBSL has been using SDFR and SLFR as its key policy interest rates to influence the behaviour of the CALLWA. Having closely studied the behaviour of the interest rate movement the writer felt it was important to analyse whether the CBSL has in fact set the direction for the behaviour of call money market rates or whether call money market rates have been behaving independently. The writer deployed Granger Causality test to analyse the relationship. Causality tests have been conducted up to 6 lags. Results of the Granger Causality test for 3, 4 and 6 lags were identical, irrespective of the number of lags considered.

SDFR and CALLWA

When considering the relationship between SDFR and CALLWA, it can be seen that both null hypotheses were rejected since probability levels were less than 0.05. Therefore, it can be determined that SDFR rate movement has influenced the movement in CALLWA.

SLFR and CALLWA

Causality test results for SLFR and CALLWA indicate that the behaviour of CALLWA has been followed by changing the SLFR since the null hypothesis which is “CALLWA does not Granger Cause SLFR” was rejected. As the null hypothesis “SLFR does not Granger cause CALLWA” too was accepted under all lags, it can be concluded that the changes in Standing Lending Facility Rate has not been a cause to direct the behaviour of the Call Money Market Rates in Sri Lankan banking industry.

This is a very interesting indication wherein it suggests that, SLFR as a Central Bank policy instrument has not been able to influence the Call Money Market Rate.

Causality test we conducted for 3, 4 and 6 lags gave the same result, however Amerasekera (2005), performing similar Granger Causality test in 2005 for a lag level as high as 10, has proved that CBSL policy rates have influenced the CALLWA. Hence the writer believes that this area warrants attention of the policy makers to assess the real impact of the policy rate influence over market rates.

Second Leg - Interbank Call Money Rate to Commercial Bank Rate

Descriptive Statistics results indicated that on average, AWPLR is higher than the CALLWA and AWDR is lower than the CALLWA. It confirms the high interest rate spread between lending rates and deposit rates that prevail in Sri Lankan banking industry. Standard deviation of prime lending rate is higher than that of deposit rate. It specifies that retail lending rates are more volatile than commercial bank deposit rates. It is important to measure the correlation between the CALLWA and the retail bank interest rates in order to identify the level of causality between the said interest rates. Pearson correlation has been used and the result suggested that both
Conclusion

The Central Bank of Sri Lanka (CBSL) is responsible for the management of the monetary policy of the country so as to achieve its basic economic objectives. In general, interest rate is a key channel of the monetary policy transmission mechanism. During the past few decades, interest rate has become the most important policy instrument used by the CBSL. As with its regional counterparts, Central Bank of Sri Lanka has not been directly managing the commercial bank lending and deposit interest rates. Through managing the Policy rates (SDFR) and (SLFR), CBSL expect to influence money market interest rate in the short run and through this means expects the interest rate adjustments to be reflected in commercial bank retail (lending and deposit) interest rates. The efficient transfer of the monetary policy impulses to the retail deposit and lending rates is important to achieve the ultimate goal of the monetary policy.

The aim of the study was to assess how effective this approach had been in managing the commercial bank lending and deposit interest rates through the policy rates. Through an empirical estimation, this study attempted to ascertain the effectiveness of policy rates in influencing Money Market Rates and in turn, the Money Market Rates on commercial bank lending and deposit interest rates. The first stage of the process of interest rate transmission is related to the pass-through from Central Bank policy rates to money market interest rates. The second stage is the pass-through from call money market interest rates to commercial bank retail lending rates and deposit rates. As followed by few previous studies referred to in this report, the writer too deployed various statistical tools to understand the relationships. As an additional step, having closely studied the behaviour of the interest rate movement, the writer felt it was important to analyse whether the CBSL has in fact set the direction for the behaviour of call money market rates or whether call money market rates have been behaving independently.

The writer deployed Granger Causality test to analyse the relationship. Granger Causality test illustrates that SLFR has followed the behaviour of CALLWA when the reverse was expected. This result suggests that it was the call money rate that has influenced CBSL policy rates and not the policy rate that has influenced call money rates as expected. It could also be interpreted that the policy maker has not been prompt in adjusting policy rates in effective discharge of its responsibility in Monetary Policy Management. We have tested Granger Causality for different lags and the results of the tests irrespective of the number of lags were the same. To major extent the writer believes that this explains the reason for the fluctuations noted in Figure 4, wherein the call money market rate has been moving beyond the upper limit of the policy range specified, during 2008, early 2009, 2012, 2014 and 2017.

Accordingly, the interest rate pass-through process in Sri Lanka is considered to be incomplete as supported by the empirical results of the current study since the proxy rate which is the call money market rate does not totally depend on the policy rates imposed by
the Central Bank and the same is insignificant in determining all the commercial bank retail deposit and lending rates.

**Policy Recommendation**

As part of this short study, the writer attempted to identify previous studies conducted in recognizing the sensitivity of the economic indicators to the commercial bank interest rates. However studies that concentrated on Sri Lanka were limited and also the availability of the historical data was limited. However, considering the regional studies, it was clear that economic indicators such as domestic savings, investment, informal markets, unemployment and inflation are highly sensitive to the movements in commercial bank interest rates across many countries and the visible active management of interest rates in some of the countries. Hence the writer believes that the policy makers shall encourage more studies on such areas and publish available statistics so that the data could be easily accessible to potential researchers.

Policy makers for a long period have been using interest rate as a policy instrument to exercise open market operations. Writer feels that it is now opportune for the policy makers to analyse the effectiveness of the interest rate as a policy instrument in the above context.

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