

The Role of Average Weighted Call Money Rate in Shaping Monetary Policy Transmission Mechanisms and Inflation Outcomes in Sri Lanka

Sri Lanka Journal of Social Sciences and Humanities
Volume 5 Issue 1, February 2025: 1-10
ISSN: 2773 692X (Online), 2773 6911 (Print)
Copyright: © 2025 The Author(s)
Published by the Faculty of Social Sciences and Languages, Sabaragamuwa University of Sri Lanka
Website: <https://www.sab.ac.lk/sljssh>
DOI: <https://doi.org/10.4038/sljssh.v5i1.125>



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Received: 12 January 2025, **Revised:** 03 February 2025, **Accepted:** 21 February 2025.

How to Cite this Article: Jayasuriya, R. N. D. & Lakmali, M.A. (2025). The role of average weighted call money rate in shaping monetary policy transmission mechanisms and inflation outcomes in Sri Lanka. *Sri Lanka Journal of Social Sciences and Humanities*, 5(1), 1-10.

Abstract

This study aims to analyse the role of the Average Weighted Call Money Rate (AWCMR) which is the operating target of the current monetary policy stance of the Central Bank of Sri Lanka (the CBSL) under the Flexible Inflation Targeting (FIT) framework and how the measures and policy actions taken by the CBSL effectively pass-through the market in order to achieve the final target of inflation control of the Sri Lankan economy. This study consists of both quantitative and qualitative methodologies to assess the influence of the AWCMR on key market interest rates and its subsequent impact on controlling inflation. The quantitative analysis focuses on the relationship between the AWCMR and a few key market interest rates, including government Treasury bill rates, Average Weighted Lending Rates, Average Weighted Deposit Rates, and Average Weighted Fixed Deposit Rates, using the monthly data from January 2018 to December 2023. Further, the qualitative analysis examines the CBSL's dynamic monetary policy stance for inflation control and economic stabilisation, targeting the language and thematic content of CBSL communication to understand how such elements shape public expectations and institutional credibility. The findings of this study witnessed that the AWCMR acts as a crucial channel for the monetary policy transmission mechanism of the Sri Lankan economy and influences, in varying degrees, other market interest rates. Further, it emphasises the CBSL's policy actions and timely measures positively yielded in shaping inflation during the study period. By combining both quantitative and qualitative approaches, this study provides a comprehensive analysis of the mechanisms through which the CBSL manages monetary policy and communicates with the public. In addition, this contributes to the prevailing literature by integrating qualitative views into the largely quantitative domain of monetary policy analysis.

Keywords: Average Weighted Call Money Rate (AWCMR), Inflation Outcomes, Interest Rates, Monetary Policy Transmission, Sri Lanka

INTRODUCTION

Interest rates remain a crucial point in implementing monetary policy, enabling central banks to manage economic stability, control inflation, and effectively shape employment outcomes. Central banks worldwide adopt various approaches to achieve their price stability objectives. They adjust policy interest rates, which in turn influence market interest rates, to either stimulate economic growth or curb high inflation within a country. These decisions influence consumer spending, investments, and the general business environment with a time lag.

Central banks in advanced economies, like the Federal Reserve in the United States (FED) and the European Central Bank (ECB), often adjust their key policy interest rates to control inflation or mitigate the effects of a recession. Afterward the financial crisis of 2008, the FED reduced its key policy rate namely the Federal Funds Rate to near zero to pick up the economy. Further, during the COVID-19 pandemic period, the FED again reduced its policy interest

rates and employed quantitative easing measures to address the economic impact. However, in response to increasing inflation in 2022-2023, the FED used a different approach by implementing substantial rate increases to support the stabilizing of market prices. Meanwhile, during the Eurozone crisis, the ECB used a strategy of deducting policy interest rates and implementing unconventional policy measures, such as negative interest rates, to stimulate lending in the market and spending throughout European economies. During 2023, facing growing inflation across the Eurozone, the ECB started to gradually increase its policy interest rates. The Bank of Thailand (BOT) substantially cut its main policy interest rate to increase domestic consumption and investment during crisis periods aiming at preventing a deeper economic slowdown. The Bangko Sentral ng Pilipinas (BSP) also adopted in policy rate cut to boost their economic activity. Further, in the 2008 crisis period, interest rates were reduced in several rounds to boost borrowing and investment. The Reserve Bank of

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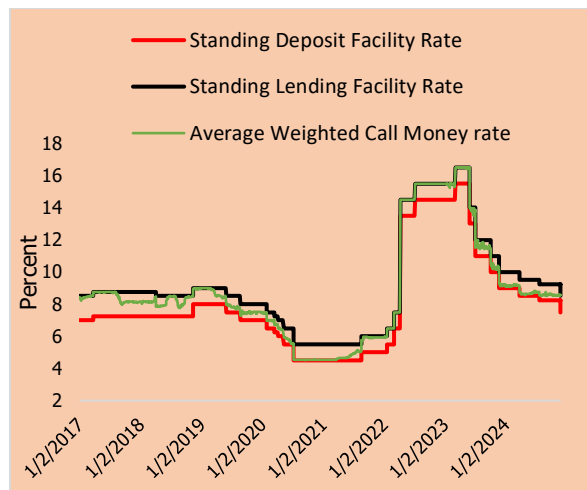
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India (RBI) also cut its policy interest rates substantially, with the repo rate being cut to historically low levels to ensure credit availability and stimulate economic activity. Further, the RBI announced targeted long-term repo operations to financial institutions to ensure credit flows, especially to sectors affected by the pandemic.

Figure 1: Standing rate corridor and AWCMR, Jan. 2017 – Nov. 2024



Source: Central Bank of Sri Lanka, 2017-2024

The CBSL also employs various policy tools, such as Open Market Operations (OMOs), policy interest rates, and Statutory Reserve Requirements (SRR), to influence short-term interest rates. These tools are aligned to maintain price stability and promote sustainable economic growth. However, previous studies have shown that the monetary policy transmission mechanism's efficacy in Sri Lanka was inadequate, resulting in a slow pass-through from policy interest rates to other market interest rates. The AWCMR has increasingly emerged as a central element of monetary policy in Sri Lanka, serving as an operating target to influence short-term interest rates and manage inflation in recent times. It captures the cost that Licensed Commercial Banks (LCBs) incur for overnight borrowing in the inter-bank money market, effectively signalling prevailing liquidity conditions. As shown in Figure 1, the CBSL used its primary monetary policy tool, the Standing Rate Corridor (SRC)², to manage short-term interest rates in accordance with the prevailing monetary policy stance. This was achieved through its operating target, the AWCMR under the FIT framework. In response to inflation and broader economic developments, the CBSL adjusted the SRC, influencing the behaviour of the AWCMR accordingly. Existing literature highlights the importance of the AWCMR in shaping other market interest rates, including Treasury bills, prime lending, and deposit rates, which collectively impact consumption, investment, and overall economic performance. The studies have identified challenges related to the efficiency of AWCMR transmission, citing factors such as regulatory constraints, informal market dynamics, and unique external economic pressures faced by Sri Lanka. Recent research highlights the urgent need for effective monetary policy actions, especially in light of the country's rising inflation and fiscal sector burdens. Sri Lanka experienced historically highest inflation rates, reaching over 60 per cent in 2022 (Annual Report of Central Bank of Sri Lanka, 2022). This unprecedented inflation increase was driven by several factors, including fiscal sector imbalances, foreign exchange deficits, and global economic distractions.

In response, CBSL faced increasing pressure to implement effective monetary policies to stabilise prices and restore economic balance (International Monetary Fund, 2022).

Accordingly, this study aims to provide a comprehensive analysis of the AWCMR's role in shaping monetary policy transmission mechanisms and its implications for inflation in the Sri Lankan context. Further, this study bridges this research gap by analysing the role of AWCMR in Sri Lanka's monetary transmission mechanism and its impact on inflation. To achieve this, we focused on two main objectives. The first was to examine how the AWCMR influences key interest rates in Sri Lanka, and the second was to examine the impact of the CBSL's policy actions on inflationary outcomes within the country.

The first objective was examined using a quantitative approach, while the second objective was analysed through a qualitative approach.

LITERATURE REVIEW

The effectiveness of the monetary policy transmission mechanism is a vital aspect of central banking, reflecting how well monetary policy measures pass-through into expected economic outcomes such as price stability, output growth, and employment. The effectiveness of this process is determined by how quickly and predictably policy signals, like adjustments in other market interest rates or reserve requirements, impact financial institutions, households, and businesses, finally influencing aggregate demand and supply of the economy. However, the efficiency of the pass-through mechanism is often subject to changes due to factors, such as the complexity and maturity of financial markets, the degree of openness to global capital flows, and institutional aspects like regulatory frameworks. The study of effective monetary policy pass-through is stranded in numerous key economic theories that describe how central bank measures influence economic variables such as inflation, output, and employment. Such theories emphasize that via various channels like interest rates, credit, exchange rates, and asset prices, monetary policy changes affect the wider economy.

The interest rate mechanism, fixed in Keynesian economics, demonstrates that changes in the central bank's policy interest rates affect the economy by altering the cost of borrowing and the return on savings. Beyer, et al., (2024) have studied monetary policy pass-through in 30 European countries and found that liquidity has contributed to weak pass-through to deposit rates.

Meanwhile, the credit channel, part of the financial accelerator framework, emphasizes how monetary policy affects the economy by influencing credit conditions and the balance sheets of firms and households. Ciccarelli, Maddaloni, and Peydró (2010) examine the role of the credit channel in monetary policy pass-through mechanism and find it to be broadly operational across different types of loans and economic channels. Their analysis reveals that incorporating the credit channel into economic models significantly intensifies the detected consequence of monetary policy shocks on the Gross Domestic Product (GDP) of the country. For firms the bank lending channel exerts the strongest influence, surpassing the effects of loan demand and firm balance-sheet channels while for

² With effect from 27 November 2024, the CBSL has shifted to a Single Policy Interest Rate Mechanism in place of Standing Rate Corridor.

households the household balance-sheet channel and loan demand channel have a more pronounced impact.

The exchange rate channel in the monetary policy pass-through mechanism influences trade balances and inflation in open economies. Sadaroo and Mallikahewa (2017) studied the effectiveness of the exchange rate channel of the monetary policy transmission mechanism in Sri Lanka and found that monetary policy shocks, such as changes in interest rates and money supply, can influence the broader economy through exchange rate movements. However, the asset price channel proposes that changes in monetary policy affect wealth and consumer spending through effects on asset prices, such as stocks and real estate. Dan (2013) finds that the asset price channel significantly influences monetary policy transmission through its effects on wealth and consumption for households and companies.

The expectations channel, underpinned by rational expectations theory, emphasises how individuals' expectations about future policy actions influence economic behaviour today. Pioneered by economists like Muth (1961) and extended by Lucas (1972), suggests that credible and transparent monetary policy can shape inflation expectations and, therefore, wage and price-setting behaviour. Further, the bank lending channel emphasises how monetary policy affects banks' ability to lend. When central banks tighten their monetary policy stance, it becomes harder for banks to source funds, dropping their lending capability in terms of volumes. This drop in lending is mainly for small borrowers who depend on bank loans. This channel has been discovered in research by Bernanke and Blinder (1988), who stress that moves in monetary policy that affect bank reserves can have separate effects on lending activity.

These theories provide a robust framework for analysing the various channels through which monetary policy actions can affect an economy. Each theory offers insights into different aspects of the transmission mechanism, and together they form a comprehensive basis for understanding the complexities of monetary policy impact. Looking at the Sri Lankan context, since the AWCMR is the operating target to maintain price stability in Sri Lanka by exploring its effectiveness and limitations, this review seeks to illuminate how the AWCMR contributes to achieving price stability objectives within a dynamic economic environment.

Amarasekara (2005) emphasised that, while there is a quick and nearly complete pass-through from the CBSL policy interest rates to inter-bank call money market rates, the transmission from call money market rates to commercial bank retail interest rates is slow and incomplete due to limited competition in the financial sector, collusion among banks, issues related to adverse selection and moral hazard, the menu costs faced by commercial banks, customer switching costs, inelastic demand for banking services, risk-sharing behaviours, consumer irrationality, and the high proportion of fixed-rate loans and deposits.

Perera (2016) concludes that interest rate pass-through in Sri Lanka is sluggish and incomplete. While short-term market lending rates, especially prime lending rates, adjust quickly and nearly fully, most other market interest rates

show slow and partial adjustments. In the second part of the study, it was found that an unexpected rise in short-term market interest rates (a restrictive monetary policy shock) leads to decreases in both real GDP and consumer prices. The analysis also highlights that such an increase in short-term interest rates affects real GDP and consumer prices through various channels, including interest rates, credit, exchange rates, and asset prices. The results suggest that while all these channels play a significant role in the pass-through of the monetary policy, the interest rate channel remains the main channel among them in the Sri Lankan context.

Abeygunawardana (2017), argues that fiscal dominance will be a significant constraint on the successful implementation of an Inflation Targeting Framework (ITF), particularly in a context where domestic monetary policy has historically played a secondary role to fiscal operations, rather than serving as a tool for managing market liquidity.

Perera (2018) examined the behaviour of the prime lending rate in Sri Lanka from January 2004 to June 2013. The main objective of the research was to identify the factors affecting the prime lending rate in Sri Lanka, with particular emphasis on the persistence of the prime rate and any asymmetries in its movement. The result of this study emphasises that the downward rigidity of the Average Weighted Prime Rate (AWPR) during periods of monetary easing has been a point of criticism. This study highlights that, alongside the call money market rate, prime rate persistence remains a key factor in determining the prime lending rate in Sri Lanka.

Jegajeevan, Perera, and Kannangara (2019) explored the pass-through mechanism of monetary policy to identify changes over time and whether the transmission process exhibits time-dependent responses. They carried out a two-stage analysis to examine the pass-through of the CBSL's policy interest rates to short-tenure money market interest rates specifically AWCMR and the pass-through from money market rates to retail lending and deposit rates. The first part of this research revealed a nearly complete pass-through of short-run and long-run from policy interest rates to AWCMR. The second part of this paper discusses the evidence of overpass-through from AWCMR to AWPR in the long run. However, it shows the pass-through from AWCMR to Average Weighted Lending Rate (AWLR) in the short-run was fairly low, though it was higher in the long run, but still not complete. Further, for market deposit rates, pass-through of the short-run was weak, with slow adjustment speeds while it was identified pass-through of the long-run was nearly complete for Average Weighted Fixed Deposit Rate (AWFDR) but somewhat lower for Average Weighted Deposit Rate (AWDR).

Kannangara and Perera (2020) examine the distributional impact of monetary policy in Sri Lanka assessing the impact of monetary policy on income distribution in Sri Lanka. The study identifies monetary policy shocks by estimating their causal effect on inequality, using various measures of inequality to capture the dynamics of income distribution. The study concludes that although there is some evidence of distributional effects of monetary policy in Sri Lanka, the long-term and strong effects of monetary policy on inequality remain unclear. Furthermore, income distribution

does not appear to influence the transmission mechanism of monetary policy.

Meanwhile, Jahufer, A. and Hanainy, F. (2023) have studied, the effects of monetary shocks in the Sri Lankan economy and observed that reserve money has impacts on all other monetary variables with less percentage. Furthermore, aggregate money supply also has some impact on other monetary variables similar to reserve money.

International Monetary Fund (IMF) (2024) studied Sweden's monetary policy transmission and found that monetary policy transmission to market interest rates has been higher in Sweden than in other advanced economies, although weaker for some rates compared to historical tightening. RenZhi, N. and Beirne, J. (2024), also examined the impacts of global factors on monetary policy transmission in Emerging Economies and identified that adverse global shocks, higher global financial market uncertainty, and global climate change, could dampen the transmission of monetary policy. Further, a higher level of financial development can partially offset the dampening effects of global factors while a higher degree of capital account openness and trade openness further amplify the impact of global factors.

Musthafa, Le, and Suardi (2024) examine Sri Lanka's monetary policy transmission mechanism using a Vector Auto Regression (VAR) model for the period of 2003 to 2019. They find that unforeseen variations in monetary policy reduce economic output, the money supply, and private-sector bank lending. A tight monetary policy effectively contains inflation in the post-conflict period and in the post-conflict recovery period, both interest rate and exchange rate channels show a leading role, while the credit channel reacts more slowly.

These studies collectively illuminate the complexities associated with the role of AWCMR in controlling inflation and shaping monetary policy transmission mechanism in Sri Lanka. The research underscores the interaction between the AWCMR and other interest rates while highlighting the external and internal economic challenges that limit policy effectiveness. The literature indicates a need for additional empirical analysis on how to optimise the AWCMR within the distinct framework of Sri Lanka's economy, particularly given the rising inflationary pressures and fiscal constraints.

MATERIALS AND METHODS

To achieve the first objective of this study, monthly data spanning from January 2018 to December 2023 was used. Data was sourced from the CBSL records, supplemented by macroeconomic indicators from IMF and World Bank. Accordingly, when describing the relationship between the AWCMR and other market interest rates, several key interest rates were identified. Those include Treasury bill Rates, AWLR, AWPR, AWDR, and AWFDR.

The second objective examines various tools to analyse monetary policy statements, offering exploratory insights into the effectiveness of the CBSL's monetary policy transmission process. Accordingly, the main data for this study comprise selected twelve monetary policy review

statements of the CBSL from January 2018 to December 2023 directly from the CBSL official website.

To maintain consistency, only the English versions of the statements were analysed. Additional data on policy interest rates, inflation, and inflation expectations were sourced from the Annual Reports of the CBSL for the same period.

The methodology of this study is organised around two main objectives, each utilising different philosophical, methodological, and analytical framework. These frameworks aim to gather both quantitative and qualitative insights regarding the role of the AWCMR in the monetary policy transmission mechanism of Sri Lanka and its impact on inflation outcomes.

For the first objective, "examine how AWCMR influences key interest rates in Sri Lanka," a positivist research philosophy is employed, focusing on measurable relationships and objective analysis of economic data. The quantitative approach utilises econometric modelling of the Autoregressive Distributed Lag (ARDL) model to explore causal relationships between the AWCMR and other market interest rates, including the Treasury bill rates, AWPR, AWLR, AWDR and AWFDR. The choice of the model for this study depends on two factors. First, is the ability to separate short-term fluctuations from long-term equilibrium effects in monetary policy transmission. It is particularly useful for understanding how monetary policy changes (interest rate adjustments) impact inflation, output, or exchange rates over time. For instance, CBSL's policy rate change might have immediate effects on short-term credit markets, but the full impact on inflation may take years to materialise. Therefore, we believe ARDL is ideal to analyse our research objective. Second, the ARDL model is well-suited for data series that include both stationary and non-stationary variables, a common feature of time series data. Since the variables selected for this study comprise both stationary and non-stationary components, the ARDL model was identified as the best fit for our analysis.

To explore the underlying relationship of the above variables, a unit root test was used to identify whether time series variables are stationary or non-stationary using the Augmented Dickey-Fuller (ADF) test. For non-stationary variables, the unit root test was used to avoid the problem of spurious regressions as follows. The equation is derived as follows;

$$Y_t = \rho Y_{t-1} + U_t$$

Here, Y_t represents the time series variable being tested for stationarity, ρ represents the coefficient that determines whether the series has a unit root ($\rho = 1$ indicates non-stationarity), Y_{t-1} represents the lagged value of Y_t , and the U_t shows the error term.

To capture dynamic interrelationships and potential causal effects in both the short-term and long-term, the ARDL model was employed. For the purpose of lag selection, we used the Akaike Information Criterion (AIC) in EViews via automatic lag selection. Accordingly, for each variable we derived,

$$Y_t = \alpha + \sum_{i=1}^p \beta_i Y_{t-i} + \sum_{j=1}^q \gamma_j X_{t-j} + \varepsilon_t$$

Where α is the constant term (intercept), β_i represents the short-run coefficients for the lags of the dependent variable of Y , γ_j represents the short-run coefficients for the lags of the independent variable of $X = \text{AWCMR}$, and ε_t is the error term. p and q are the optimal lag lengths for the dependent and independent variables, respectively.

Additionally, to find the long-term impact ARDL bounds test was used and then through the Error Correction Term (ECT) it is expected to find whether there is a long-run impact for other interest rates. The ARDL bounds test is an important tool for testing long-run relationships between variables, particularly in macroeconomics as it allows us to use a mix of stationary and non-stationary data. Further, this was effective even in small samples and directly estimated both short-run and long-run relationships.

The second objective, “To evaluate the impact of AWCMR-driven interest rate adjustments on inflationary outcomes in Sri Lanka,” is framed within an interpretivist philosophy. This approach is particularly effective for understanding context-specific impacts, especially in a policy environment where textual and thematic analysis can reveal insights into the central bank's intentions and strategies. Accordingly, to study the second objective, we employ Thematic Analysis (TA) as a main tool through manual coding to systematically identify, analyse, and interpret patterns within qualitative data used for this study. Utilising a qualitative methodology, we analyse the 12 monetary policy reviews of CBSL to provide a detailed exploration of the AWCMR's effectiveness in managing inflation from 2018 to 2023. By

concentrating on periods of monetary policy tightening (2017-2018, 2022) and easing (2019-2020, early 2023), the purposive sampling captures crucial inflationary and other economic stress periods, enhancing the relevance of the findings. Here we utilise a thematic analysis strategy, focusing on policy documents from different phases of monetary policy tightening and easing. The study will utilise secondary qualitative data, specifically monetary policy reviews from 2018 to 2023. We have categorised this full period into four sub-periods which include tightening and relaxing monetary policy cycles. Accordingly, 01 January 2018 to 30 May 2019 (tight monetary policy stance), 31 May 2019 to 18 August 2021 (accommodative monetary policy stance), 19 August 2019 to 31 May 2023 (tight monetary policy stance) and 01 June 2023 to 31 December 2023 (accommodative monetary policy stance). By reviewing 12 monetary policy reviews for these sub-periods, we have identified key themes on a broad basis, Market Interest Rates, Inflation Control, Expectations and Targets, Monetary Policy Stance and Policy Rate Corridor, Money, Credit Growth, and Private Sector Borrowing and lastly Global and Domestic Economic Conditions.

RESULTS AND DISCUSSION

The data described in the previous section were used to carry out the analysis by employing the econometric models and qualitative approach explained earlier. Descriptive statistics were obtained as shown in Table 1 for the variables that are used for the study. AWCMR and AWDR have close mean and median values, indicating symmetry. AWPR has the highest standard deviation, indicating that it fluctuates the most. Treasury bill rates also showed significant volatility. However, AWLR has the least variation, meaning its values are more stable.

Table 1: Descriptive statistics

	AWCMR	AWDR	AWFDR	AWLR	AWPR	T_B_91_D_	T_B_182_D_	T_B_364_D_
Mean	8.77661	8.71396	11.01073	13.51021	12.34135	11.58233	11.69251	11.69225
Median	8.16555	8.67500	10.83000	13.73500	11.41500	8.59600	9.13995	9.68989
Maximum	16.49302	15.23000	19.84000	18.70000	28.25000	33.05474	32.53000	30.01727
Minimum	4.52358	4.75000	5.62000	9.37000	5.65000	4.51333	4.53350	4.80900
Std. Dev.	3.20328	2.76365	3.76214	2.36373	5.55122	7.74843	7.39255	6.73749
Skewness	1.02710	0.78185	0.80860	0.21600	1.43311	1.64431	1.66028	1.66029

Source: Developed by author, 2025

Table 2: Unit root test – ADF

Variable	Level		1 st Difference		2 nd Difference		Process
	Static.	Prob.	Static.	Prob.	Static.	Prob.	
AWCMR	-1.943168	0.31144	-5.51110	0.00001			I(1)
5% Level	-2.892536		-2.89254				
AWDR	-3.40873	0.01303	-2.00549	0.28411	-9.32539	0.00000	I(2)
5% Level	-2.892536		-2.89254		-2.89287		
AWPR	-2.178163	0.21560	-4.36550	0.00060			I(1)
5% Level	-2.892536		2.89254				
AWLR	-3.11625	0.02870					I(0)
5% Level	-2.892536						
AWFDR	-3.161713	0.02550					I(0)
5% Level	-2.892536						
91-day T-bills	-2.602201	0.09623	-2.41552	0.14032	-13.29400	0.00010	I(2)
5% Level	-2.89323		-2.89323		-2.89323		
182-day T-bills	-2.431421	0.13606	-2.85534	0.05468	-13.32580	0.00010	I(2)
5% Level	-2.89323		-2.89323		-2.89323		
364-day T-bills	-2.543682	0.10868	-3.05871	0.33316			I(1)
5% Level	-2.89323		-2.89323				

Source: Developed by author, 2025

First, to understand the mechanisms through which the AWCMR affects other market interest rates, we analyse the results of the ADF test as given in Table 2, which helps determine whether interest rate series, such as Treasury bill rates and deposit rates, are stationary or non-stationary, offering insights into their long-term stability and sensitivity to short-term fluctuations. This analysis is crucial for identifying whether the AWCMR consistently influences these rates over time, thereby indicating a transmission channel for monetary policy via short-term market rates.

The findings reveal that most variables, including the AWCMR, AWPR, and Treasury bill rates for 364-day

maturities are non-stationary at their levels but become stationary after the first difference. This indicates that these variables are integrated in order I (1). In contrast, AWFDR and AWLR are stationary at their level, meaning it is integrated of order I (0) and does not require differencing. However, AWDR and Treasury bill rates for 91-day maturities and 182-day maturities do require a second difference to become stationary. As these are I (2), to run the ARDL model, it requires transformation of data, to reduce it to I (0) or I (1). The transformation was carried out by taking the first differencing of these variables ($\Delta Y_t = Y_t - Y_{t-1}$).

Table 3: ARDL model coefficients

	DAWDR (4,4 model)		AWFDR (3,2 model)		AWPR (3,4 model)		AWLR (2,2 model)	
Lag	Cof.	Prob.	Cof.	Prob.	Cof.	Prob.	Cof.	Prob.
AWCMR (-1)	0.15567	0.00002	0.22992	0.00000	0.58082	0.00032	0.13626	0.00063
AWCMR (-2)	-0.11156	0.00729	-0.14554	0.00034	-1.38119	0.00000	-0.19622	0.00000
AWCMR (-3)	-0.00492	0.90596			0.92414	0.00000		
AWCMR (-4)	-0.06237	0.03475			-0.20398	0.11187		
	D91 T_B (2,3 model)		D182 T_B (4,2 model)		364 T_B (4,2 model)			
Lag	Cof.	Prob.	Cof.	Prob.	Cof.	Prob.		
AWCMR (-1)	-2.34598	0.00000	-2.53933	0.00000	-2.54001	0.00000		
AWCMR (-2)	0.45823	0.29120	0.59228	0.03614	0.80751	0.00164		
AWCMR (-3)	0.34136	0.12184						
AWCMR (-4)								

Source: Developed by author, 2025

For the purpose of model specification analysis, we have used previously explained variables; AWCMR as the independent variable and all other variables as dependent variables. The lag structure of the ARDL model was identified through the Akaike Information Criterion (AIC). Accordingly, as shown in Table 3, for AWDR and AWPR variables ARDL (4,4) model was used while for AWFDR, ARDL (3,2) model and for AWLR, ARDL (2,2) model was used. By examining how AWCMR impacted the other interest rates through an ARDL model we have identified the following for short-run and long-run. First, changes in AWCMR have significant delayed effects on AWDR, as shown by the significant

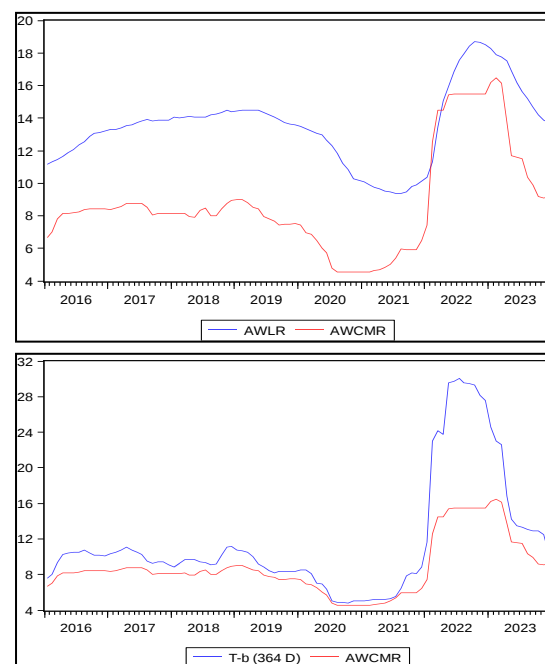
positive coefficient for Δ AWCMR and the subsequent negative coefficients for Δ^2 AWCMR. The positive one-period lag suggests that monetary policy changes (as reflected by AWCMR) require at least a month to influence deposit rates (AWDR). The negative second lag implies a correction mechanism, where the initial increase in deposit rates due to changes in AWCMR is counterbalanced over time. Meanwhile, changes in AWCMR affect AWFDR primarily with a lag of one month (Δ AWCMR), demonstrating the monetary policy transmission mechanism. A positive effect at lag 1 indicates that an increase in call money market rates leads to a rise in fixed deposit rates in the short run. However, the negative effect

at lag 2 suggests a correction mechanism, where the initial increase in AWFDR is partially reversed over time. The study by, Musthafa, Le, and Suardi (2024) which provides a lagged analysis of the AWCMR's effect on AWDR and AWFDR shows that changes in AWCMR influence deposit rates after about a month, with the effects partially reversed in the following period, which is somewhat similar to findings of our study.

The AWLR exhibits strong persistence, with significant coefficients for its first and second lags, indicating that past values of AWLR heavily influence its current level. The AWCMR affects AWLR in both the current and lagged periods. The contemporaneous effect AWCMR and first lag Δ AWCMR are both positive, showing a short-run transmission mechanism. The second lag Δ^2 AWCMR is negative, suggesting a reversal or correction mechanism, consistent with monetary policy transmission where the initial effect on lending rates diminishes over time. Changes in AWCMR have both immediate and lagged effects on prime lending rates, with the strongest impacts occurring contemporaneously and after one and three months. Immediate (contemporaneous) and one-month lagged effects are positive, showing that increases in AWCMR push up prime rates. Similarly, Musthafa, Le, and Suardi (2024), found that AWLR shows persistence, with past values significantly affecting the current rates, and AWCMR impacting AWLR both immediately and with a one-month lag. The second lag, however, suggests a reversal of the initial impact, consistent with the delayed and incomplete pass-through. Moreover, Jegajeevan, Perera, and Kannangara (2019) confirm a nearly complete pass-through from CBSL rates to short-term money market rates, but a slower response to retail lending rates, particularly in the short run, with some overpass-through for lending rates in the long run.

By looking at the impact on Treasury bill rates, specially AWCMR has a significant and positive contemporaneous effect on yield rates on 364-day Treasury bills. This highlights the immediate transmission of changes in AWCMR to long-term government borrowing costs. The alternating signs of lagged effects Δ AWCMR and Δ^2 AWCMR, reflect an oscillatory adjustment in yield rates on Treasury bills in response to changes in AWCMR. A study by Perera (2016) found sluggish pass-through, noting quick adjustments in short-term market lending rates, but slower responses from other rates and accordingly short-run pass-through of 0.07 percentage points and 0.10 percentage points to 1 percentage point change in the 91-day Treasury bill rate.

Figure 2: AWCMR relationship with AWLR and 364 Treasury bill rates



Source: Developed by author, 2025

In order to identify long-run impacts we first use the results of the bound test (Table 4). The ARDL bounds test results show the presence of a long-run relationship (cointegration) between AWCMR and AWFDR. Accordingly, the error correction mechanism also confirms the presence of a long-run relationship between AWCMR and AWFDR. A sustained change in AWCMR (e.g., due to monetary policy adjustments like policy rate changes) will gradually influence AWFDR over time, with the speed of adjustment governed by the ECT coefficient (-0.0866). Similarly, there are important insights into the relationship between Δ AWDR and Δ AWCMR. The results confirm both short-run and long-run effects, with a moderate speed of adjustment toward equilibrium and significant lagged response AWLR and yield rates on 364-day Treasury bills do not exhibit a long-run equilibrium relationship as per the results of the bound test. This confirms through ECT that there is no evidence of a strong long-run relationship between these variables. The presence of a cointegrating relationship between the variables of AWCMR and AWPR was observed since the F-statistic exceeds the upper bound ($I(1)$) at all levels, rejecting the null hypothesis. In addition, yield rates on Treasury bill rates for 91-day and 182-day maturities also exhibit a long-run relationship with the AWCMR.

Table 4: Bounds test and error-correction results

Bound test							
	AWFDR	DAWDR	AWLR	AWPR	91 T bill	182 T bill	364 T bill
F-Static	6.855	14.319	1.067	8.598	58.887	8.330	4.936
Prob. (1%)	5.157	5.157	5.157	5.917	5.157	5.157	5.917
Error correction term							
Cof.	-0.087	-0.280	-0.027	-0.200	-2.073	-0.640	-0.174
Prob.	0.000	0.000	0.086	0.000	0.000	0.000	0.001

Source: Developed by author, 2025

The qualitative findings of this study focus on six key dimensions of monetary policy transmission as given in Table 5. However, initial coding is not present in this paper as it contains large details.

Table 5: Key themes under thematic analysis

	Tight monetary policy stance (2018.01.01-2019.05.30)	Relaxed monetary policy stance (2019.05.31-2021.08.18)	Tight monetary policy stance (2021.08.19-2023.05.31)	Relaxed monetary policy stance (2023.06.01-2023.12.31)
1	Market Interest Rates	Market Interest Rates	Global and Domestic Economic Conditions	Market Interest Rates
2	Inflation Control	Inflation Control	Monetary Policy Stance and Policy Rate Corridor	Inflation Control
3	Monetary Policy Stance	Expectations and Targets	Market Interest Rates	Monetary Policy Stance
4	Money and Credit Growth	Monetary Policy Stance and Policy Rate Corridor	Money, Credit Growth, and Private Sector Borrowing	Money and Credit Growth
5	Global and Domestic Economic Conditions	Money, Credit Growth, and Private Sector Borrowing	Inflation Control, Expectations, and Target	Global/Domestic Economic Conditions
6	-	Global and Domestic Economic Conditions	-	-

Source: Developed by author, 2025

Note: Qualitative analysis carried out for the period starting from 01.01.2018 to 31.12.2023

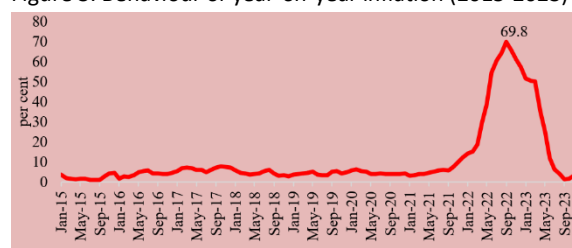
In 2018, CBSL managed its monetary policy carefully, responding to subdued inflation, modest economic growth, and external sector pressures. In April 2018, the CBSL ended its monetary tightening phase by reducing the Standing Lending Facility Rate (SLFR) by 25 basis points. Subsequently, it adopted a neutral stance for the remainder of the year due to weak domestic economic performance and persistent external pressures. By September 2018, the CBSL witnessed a substantial liquidity shortage and therefore, the Statutory Reserve Ratio (SRR) applicable for all rupee deposit liabilities of the LCBs was reduced by 1.50 per cent in November 2018, by injecting permanent liquidity into the domestic money market. To offset the liquidity supply while maintaining a neutral stance, the CBSL increased the Standing Deposit Facility Rate (SDFR) and SLFR by 75 basis points and by 50 basis points, respectively, narrowing the policy rate corridor to 100 basis points. If we consider a direct quote from the 2018 November monetary policy review, “The Board arrived at this decision following a careful analysis of current and expected developments in the domestic and global economy and the domestic financial market, with the broad aim of stabilising inflation at mid-single digit levels in the medium term....” (Monetary Policy Review – November 2018) clearly highlights future expectations on inflation. Such actions were yielded to reduce the liquidity pressures in the market, which kept market interest rates raised. As a result, the AWLR rose to 14.40 per cent in 2018 from 13.88 per cent in 2017. AWCMR generally stayed near the middle of the SRC but occasionally moved higher due to increased private sector credit and external sector pressures.

Meanwhile, to address weak economic activity and sluggish private-sector credit growth, the CBSL adopted an accommodative monetary policy stance from May 2019 to April 2020. This approach was supported by muted inflation, stable external conditions, and global monetary easing. As detailed in the monetary policy review, key measures included reducing policy interest rates by a cumulative 200 basis points, reducing the SRR on rupee deposits by 2 percentage points, and imposing interest rate caps to lower borrowing costs and stimulate credit flows. According to the monetary policy review, while lending rates gradually declined, further policy rate cuts and liquidity injections were introduced in early 2020, including emergency

measures in response to the COVID-19 outbreak, to stabilise the economy and financial markets.

In response to the challenges posed by the COVID-19 pandemic, the CBSL implemented unprecedented monetary easing in 2020 to support growth, recovery, and stability. With inflation remaining low and demand subdued, as highlighted in the monetary policy review, policy interest rates were cut five times by a total of 250 basis points. The SRR was reduced by 3 percentage points, and the Bank Rate was lowered by 650 basis points, as outlined in the monetary policy review. “The Board recognised the necessity to continue the accommodative monetary policy stance, particularly as market lending rates are yet to reflect the full pass-through of policy easing measures implemented thus far..... encouraging borrowing for productive economic activity and reinforcing support for COVID-19 hit businesses as well as the broader economy, given the conditions of subdued inflation” (Monetary Policy Review – August 2020), highlighted the necessity to continue its accommodative policy stance to help restore subdued inflation. CBSL also funded the government, enhanced market liquidity, launched concessional loan schemes for pandemic-affected businesses, and capped certain lending rates, including those for mortgage-backed housing loans. As per the review result, such actions resulted in historically low interest rates, a recovery in private-sector credit growth, and substantial growth in public sector credit, leading to a quick pick up in the money supply by the end of 2020.

Figure 3: Behaviour of year-on-year inflation (2015-2023)



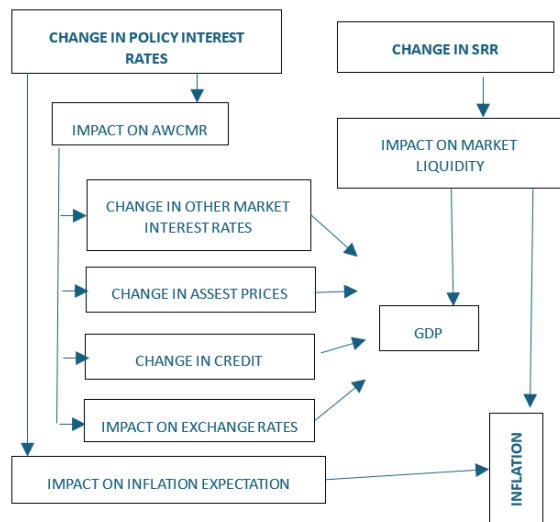
Source: Central Bank of Sri Lanka, 2015-2023

The CBSL overturned its relaxed monetary policy stance to address increasing inflationary pressures and external imbalances in 2021. The review said that while the monetary support from the COVID-19 pandemic continued early in the

year, leading to historically low interest rates and growth of private-sector credit and broad money supply, tightening actions were presented in August 2021. These measures comprised increases in policy interest rates and the SRR and these actions, along with foreign loan repayments and increased currency in circulation, lowered market liquidity and decreased market interest rates, including yield rates on government securities.

As per the monetary policy review of the CBSL, in 2022, the Central Bank significantly tightened its monetary policy stance to counter soaring inflation, anchor expectations, and address unprecedented external vulnerabilities, including severe balance of payments (BOP) stresses and concerns over domestic debt restructuring. As highlighted in the review, inflation surged due to supply disruptions, global commodity price hikes, currency depreciation, and the lagged effects of pandemic-era monetary accommodation. Tight policy measures, including elevated interest rates, constrained money and credit growth, with private-sector credit contracting sharply, as noted in the review. However, according to the monetary policy reviews, improvements in the BOP and supply conditions eased inflation pressures late in the year, with headline inflation peaking in September 2022 and declining thereafter. As per the reviews, government borrowing and high yields on government securities persisted but moderated with optimism surrounding the IMF's Extended Fund Facility (IMF-EFF). CBSL eased liquidity stresses and guided a gradual decline in market interest rates, as emphasised in the monetary policy review. In March 2023, as outlined in the review, policy rates were increased to meet IMF-EFF conditions, while declining inflation and clarity on domestic debt optimisation are expected to lower risk premia and foster private-sector credit recovery.

Figure 4: The CBSL policy measures & its impact on inflation



Source: Developed by author, 2025

The recent surge in inflation was effectively controlled through the tightening monetary policy measures implemented by the CBSL during the period under review (Figure 3). This suggests that the qualitative study findings validate the effectiveness of these monetary policy interventions in managing inflation outcomes. The analysis highlights that CBSL's policy adjustments, particularly in interest rates and liquidity management, played a crucial role in stabilising price levels thereby ensuring low and

stable inflation in the economy. Moreover, the qualitative evidence reinforces that these measures helped curb inflationary pressures, aligning with broader macroeconomic stabilisation objectives (Figure 4).

Through analysing various reports by the IMF, World Bank, and ADB it was evident that the stabilisation process in Sri Lanka clearly recognised. Accordingly, the IMF Country Report (June 2024) highlights significant changes in the monetary policy stance of Sri Lanka during the crisis period. In response to inflation, the policy interest rate was initially raised by 900 basis points. As inflation decreased, the CBSL reduced policy rates by 700 basis points between June 2023 and March 2024 and accordingly, inflation control measures of the CBSL caused a significant reduction in inflation.

Asian Development Outlook (April 2024) by the ADB, highlighted that "the CBSL's cut rates four times for a total of 650 basis points, but that was outpaced by the decline in inflation, which fell sharply from 53.2 per cent in January 2023 to 4.2 per cent in December". This reveals that policy actions and their impact on inflation were aligned. Similarly, as stated in the Sri Lanka Development update by the World Bank (October 2024), "inflation remained well below target, the CBSL continued to maintain an accommodative stance. Slowing inflation has allowed CBSL to cut policy rates by a cumulative 725 basis points (bps) since May 2023". Accordingly, the World Bank's view further confirms that CBSL's policy actions on bringing down inflation were in the right direction.

As highlighted in these reviews, overall, CBSL effectively controlled inflation and inflation expectations despite the challenging domestic and external conditions, with the measures it implemented having a positive impact on the economy and being successfully transmitted to the market. Finally, by integrating both quantitative and qualitative findings of this study, it was determined that the monetary policy transmission mechanism in Sri Lanka, operating through the AWCML, exhibits both short-run and long-run effects on the economy. While adjustments in AWCML influence the other market interest rates, inflation, and liquidity conditions in the short-term, the full impact on macroeconomic variables such as inflation, investment, and exchange rates unfold over a longer period. However, the effectiveness of this transmission process is subject to time lags, meaning that policy changes may not yield immediate results, and their impact may vary depending on market responses, external shocks, and structural conditions within the financial system.

CONCLUSION

There are a few limitations for this study as it does not capture financial market developments, regulatory changes, and banking sector reforms as this type of factor may alter how AWCML influences the other market interest rates, credit, and inflation. Further, the impact of external shocks such as global financial crises and commodity price fluctuations can also distort the transmission mechanism, making it hard to isolate AWCML's role. Meanwhile, the effectiveness of AWCML in influencing inflation may be influenced by fiscal policies, such as government spending and taxation which could interfere with the monetary transmission mechanism, making it difficult to isolate the role of AWCML.

However, this study provides critical insights into how changes in the AWCMMR, a key monetary policy instrument, influence various interest rates in both the short and long run. In the short run, AWCMMR exhibits significant delayed effects on deposit rates (AWDR and AWFDR), lending rates (AWLR), and Treasury bill rates. Notably, these effects are characterised by an initial adjustment followed by a correction mechanism, as evidenced by alternating positive and negative lagged coefficients. This oscillatory behaviour highlights the complex dynamics of monetary policy transmission, where the immediate impacts of AWCMMR adjustments on the other market interest rates are moderated over subsequent periods. The findings also demonstrate that the response of yield rates on Treasury bills to changes in AWCMMR is contemporaneous and significant, reflecting the direct and immediate influence of monetary policy on government borrowing costs.

In the long-run, our results confirm a cointegrating relationship between AWCMMR and several key interest rates, including AWFDR, Treasury bill rates, and AWPR. The error correction mechanism (ECT) confirms the presence of long-term equilibrium adjustments for these variables, with the speed of adjustment varying depending on the rate. For instance, the AWFDR exhibits a gradual adjustment to long-term changes in AWCMMR, with a moderate ECT coefficient suggesting the persistence of policy effects over time. However, AWLR and yield rates on 364-day Treasury bills do not show evidence of a strong long-run equilibrium relationship with AWCMMR, implying that lending rates are more influenced by short-term dynamics than by sustained monetary policy adjustments.

As per the second objective, CBSL employed a dynamic and adaptive monetary policy framework between 2018 and 2023, effectively responding to evolving domestic and external shocks and challenges. The analysis of monetary policy reviews highlights how the CBSL used a range of tools, adjustments to policy interest rates, the SRR, and liquidity injections to address inflation, credit growth, and market liquidity. During periods of subdued economic activity, such as the pandemic, accommodative policies stimulated growth through reduced borrowing costs, while tightening measures were adopted to combat inflation and stabilise external imbalances during recovery periods. Overall, CBSL successfully managed inflationary pressures, liquidity conditions, and credit growth, highlighting the effectiveness of its transmission mechanisms in steering the economy through complex and volatile conditions. Accordingly, qualitative analysis strongly supports AWCMMR-driven interest rate adjustments on inflationary outcomes in Sri Lanka. Since our findings include both quantitative and qualitative aspects of monetary policy transmission, this study provides a comprehensive analysis fulfilling the scarce literature on the qualitative aspect.

The findings of the study indicate that policymakers need to further strengthen the transmission mechanism of the AWCMMR to other market interest rates in Sri Lanka. This is mainly due to the quantitative analysis of the selected interest rates of this study does not exhibit strong relationships with the AWCMMR. Hence, it is required to improve the slow interest rate pass-through in monetary policy transmission mechanism, and the CBSL should

enhance their communication strategies which include providing clear and transparent forward guidance about future policy intentions, engaging directly with market participants, other stakeholders and the general public in an economy in order to improve transmission. For this purpose, various communication strategies can be introduced such as through social media to reach a wider audience. Further, regular reports on actions and measures taken by the CBSL and activation of digital platforms for real-time communication also yielded enhanced healthier understanding and faster response times. Similarly, promoting financial literacy among stakeholders is also important to ensure faster pass-through of policy rates and a more efficient monetary policy transmission mechanism.

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