



## Revisiting SBP’s Interest Rate Corridor

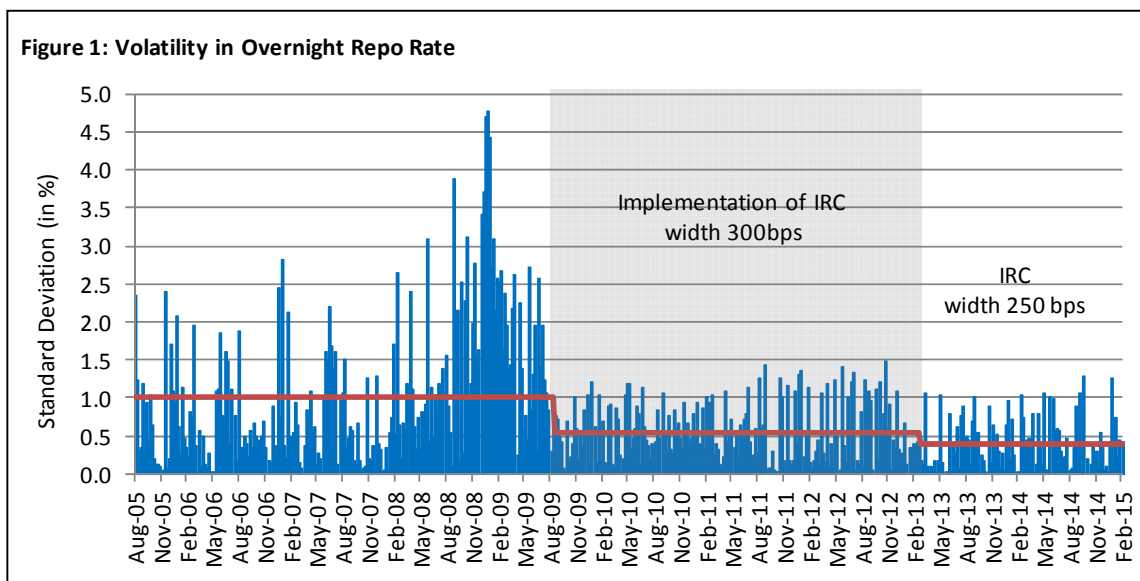
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In order to further strengthen the transmission of monetary policy; and have the desired effect on term structure of Interest Rate, State Bank of Pakistan is reviewing its interest rate corridor framework. A main feature of this planned improvement is to introduce a “SBP Target Rate” for the money market overnight repo rate. This rate will be in addition to SBP Reverse Repo Rate (ceiling rate) and the SBP Repo Rate (floor rate) of the corridor. Moreover, this rate will be specified within the corridor – lower than ceiling rate and higher than floor rate. In this context following steps are planned:

1. A proposal to this end will be submitted to the Advisory Committee on Monetary Policy (ACMP) in its March 2015 meeting, for review and its recommendations to the SBP Board.
2. SBP Board of Directors will make a final decision about needed improvements in interest rate corridor in its March 2015 meeting.

### I. Existing Interest Rate Corridor – Background and Issues

SBP established an “Interest Rate Corridor” (IRC) in August 2009 with SBP reverse repo rate, the policy rate, as ceiling and SBP repo rate as floor.<sup>1</sup> The main objective of introducing the corridor was to minimize volatility in the money market by ensuring the movement of short term interest rates within a reasonable range. IRC promoted stability in the money markets aimed at strengthening the transmission mechanism of monetary policy to achieve the ultimate goal of maintaining price stability. The width of IRC was initially set at 300 basis points (bps) and was later reduced to 250 bps in February 2013.<sup>2</sup>



Before the introduction of the IRC, market interest rates, particularly the short term rates, (overnight

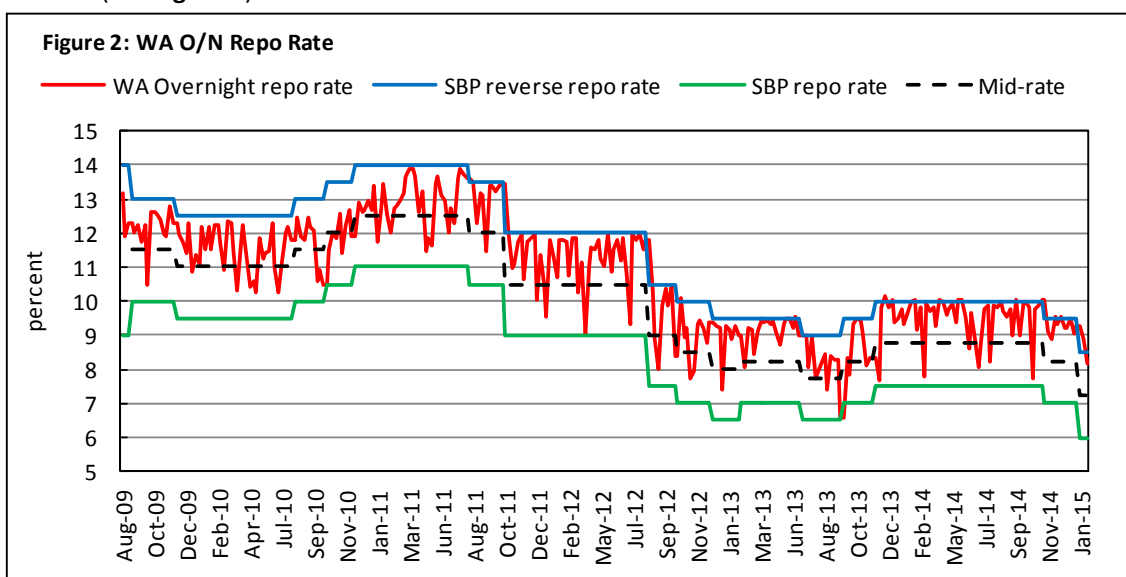
<sup>1</sup> Please see [DMMD Circular No. 1 of 2009](#) and [Monetary Policy Statement for July-September 2009](#).

<sup>2</sup> Vide [DMMD Circular No. 02 of 2013](#).



repo rates) witnessed considerable volatility (**Figure 1**). It was mainly due to uncertain flows in the system such as government related deposits, taxes, borrowing for commodity operations, borrowings from the SBP, etc. While the SBP reverse repo rate (policy rate) served to keep a lid on the upside movement of overnight rate, there was no instrument available with the SBP for providing a binding floor to limit its downward movement. As a result, repo rate used to drop very frequently and with high magnitudes. Such volatility diluted SBP's efforts to keep the weighted average money market overnight repo rate close to the policy rate that was essential to ensure effective transmission of monetary policy stance of SBP.

As envisaged, IRC has helped in reducing volatility in overnight money market repo rate as evidenced by **Figure 1**. Though the volatility of short term interest rates has come down sharply since August 2009, the present IRC framework is such that the overnight money market repo rate can alternate between the Floor and the Ceiling rates, depending on the prevailing liquidity situation. In Pakistan; however, short term interest rates have remained mostly in the upper half, close to ceiling of the corridor (see **Figure 2**).



Overnight rates close to the policy rate; however, made the ceiling rate less penal and increased the probability of banks availing SBP reverse repo facility (discount window) more frequently. In order to dissuade frequent usage of the SBP standing facilities, SBP introduced penal rates for accessing SBP standing facilities more than seven times in a quarter in 2012.<sup>3</sup> This measure has, however, allowed the overnight money market repo rate to go above the SBP's reverse repo rate (policy rate) at times.

Consequently, to enhance the effectiveness of monetary policy and better manage liquidity in the interbank market, SBP has decided to gradually improve its interest rate corridor by setting the Target rate (policy rate) between the floor and ceiling rates of the corridor.

<sup>3</sup> In order to dissuade frequent accesses to the SBP Overnight Reverse Repo and Repo facilities SBP imposed a spread of +/- 50bps over and above the SBP overnight reverse repo and repo rates respectively for the remaining quarter in case an eligible institution accesses either of the above facilities more than 7 times during a given quarter (DMMD Circular No. 20 of 2012).



## II. Changes Under Consideration in the Monetary Policy Operational Framework

In accordance with the best international practices and to address the above issues, SBP plans to align the operational target of overnight money market repo rate with the proposed Policy Rate. This O/N repo rate target would be a single policy rate to unambiguously signal SBP's stance of monetary policy to achieve macro-economic objectives with price stability. The SBP Policy Rate will be set between the Floor and Ceiling of the interest rate corridor. Specifically, using liquidity management tools, mainly OMOs and outright sale/purchase of government securities, SBP will aim at keeping the money market weighted average overnight rate close to the SBP Target rate. The existing SBP's reverse repo and repo rates will be above and below the proposed policy rate, as ceiling and floor of the interest rate corridor, respectively.

### Instruments and Frequency of Operations

Under the current practice, SBP is conducting OMOs mostly on weekly basis to manage the liquidity in the interbank market. The reserve maintenance period in Pakistan is two weeks starting from Friday and ending on Thursday in the subsequent week. SBP conducts at least two weekly OMOs during a given reserve maintenance period. Moreover, short dated OMOs are also conducted as and when required. In order to ensure that overnight money market repo rate remains close to the target rate (i.e. Policy rate), SBP would increase the frequency of OMO repo operations of varying tenors including overnight.

In the absence of more frequent SBP intervention, unexpected liquidity shocks (especially those emanating from government flows) on any given day increase the likelihood of banks accessing the standing facility which eventually induces volatility in the overnight repo rate. Thus, increase in the frequency of OMOs will sterilize the effect of any autonomous liquidity shock and would reduce the volatility in the overnight rates. This practice would facilitate in keeping the overnight repo rate close to the proposed Target rate.

SBP will conduct short term OMO repo operations to address temporary liquidity mismatches in the banking system and ensure adherence of the overnight repo rate to the policy rate; however, any permanent liquidity shortage / surplus will have to be addressed by SBP conducting term repos or buying or selling outright government securities.