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# "CBSL TO HOLD POLICY RATES STEADY, VOW TO RETAIN MARKET RATES STABLE"

PRE-POLICY ANALYSIS

19TH NOV 2020

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# Previous Pre-policy report: Recap ☑



## CBSL maintained its policy stance

In-line with our expectations, at the last policy meeting held on Oct 2020, CBSL maintained its monetary policy stance, particularly as market lending rates are yet to reflect the full pass-through of policy easing measures implemented thus far.

### Key Arguments by CBSL for maintaining its policy stance on 22nd Oct 2020

- ✓ Global monetary policy stance remained to be accommodative with the resurgence of COVID-19 pandemic across the many countries in the globe.
- ✓ Despite the surge in COVID-19 cases during recent times and negative impact to the economy during near term, high frequency data suggests that Sri Lanka is on a path towards economic revival.
- ✓ In response to previous measures, market interest rates have reduced and has declined to historic lows.
- ✓ Inflation to remain within the desired level of 4%-6%.
- ✓ Credit to the private sector picked up in Sep as well and is expected to gradually recover in the period ahead.

# Analysis of upcoming policy decision on 26th



The following factors argue that there are no requirement of further easing in the policy rates.

**Arguments against further easing**

**50%**

- **Improvement in high frequency indicators with surplus liquidity in the system**
- **Extended Moratorium: A solution for grievances**
- **Rock bottom Market Rates!!!**

**Arguments for further easing**

**50%**

- **A thrust for Development: the need of the current Government**
- **Access to less expensive domestic funding**
- **Secondary market yields heading north with auctions being undersubscribed**

Above mentioned factors spur a further leeway of a rate cut at the up coming policy meeting.

# *Arguments against further relaxation in monetary policy*

## Improvement in high frequency indicators with surplus liquidity in the system

As a response to the measures taken by the Govt, private sector credit has improved to LKR 87.4Bn in Sep while the market liquidity has reached LKR 140.0Bn by 13th Nov indicating that there is surplus liquidity in the system. Moreover, the unemployment rate, which was at 5.7% in the 1Q2020 has declined to 5.4% in the second quarter. These indicators suggest that economic activity has remained steady without much deterioration in the 2Q. Except the GDP growth numbers, where the 2Q2020 figures are yet to be seen, other indicators are signifying a recovery, inquiring the need of further policy easing at the upcoming review.

## Extended Moratorium: A solution for grievances

Considering the encounters faced by the businesses and individuals due to the second wave of COVID-19, CBSL has extended the debt moratorium for another period of six months commencing from 01 Oct. 2020. We believe that the extension of moratorium is one of the relief packages offered by the CBSL for individual/businesses to revive their business activities.

## Rock bottom Market Rates!!!

In response to previous monetary easing measures implemented by CBSL, to bring down costs of borrowing of businesses and households, both market deposit and lending rates adjusted notably so far during the year. AWPR declined to historic lows in recent weeks, while banks' lending rates also witnessed a downward adjustment in line with CBSL's expectations. We believe that considering the recovery in the private credit and historic low levels in AWPR, there is no vital requirement for CBSL to provide a rate cut and to further bring down the market lending rates drastically.

*Arguments for further relaxation in monetary policy*

## A thrust for Development: the need of the current Government

First Capital Research estimates that Sri Lanka's GDP would see its steepest contraction in history of -5.8% in 2020 following the unexpected contraction in 1Q GDP growth of -1.6% while 2Q GDP figures are yet to be seen. However, the current Govt.'s key drive is the development oriented economic growth which was spelled out through the Budget 2021 as well. Accordingly, Govt. plans to reach 6% and above GDP growth during the next 5 years commencing from 2021. As we believe a development-oriented budget coupled with further low interest rate environment can support the Govt.'s medium-term goals. Therefore, the need to accelerate the GDP growth can be considered as a major factor favouring, further policy easing at the upcoming review.

## Access to less expensive domestic funding

It is reasonable to assume that Govt. is more focused on domestic funding to finance the budget deficit. This is reflected by the improved domestic to foreign debt ratio to 54:46 by end Jul 2020 from the previous 51:49 as at end of 2019. In the midst of limited access to the international financial markets, Govt. opt to rely more on domestic borrowings to finance the budget deficit and hence easing rates at the upcoming policy meeting results in reduced funding cost favouring the Govt.

## Yields heading north with auctions being undersubscribed

Despite the improved liquidity position, yields in the secondary market witnessed a slight increase with low activities as market participants followed a wait and see approach amidst the looming uncertainty. T-Bond auction on 12$^{th}$ Nov and T-Bill auction on 18$^{th}$ Nov were both undersubscribed by a considerable amount reflecting the lack of clarity of market participants with the given economic condition and COVID 19 impacts. We believe a rate cut would be a sweetener to sustain the yields at current low levels and to enhance the activities of the secondary bond market.

# Factors of concern at the policy review

Inflation
CCPI 4.0% in Oct 2020

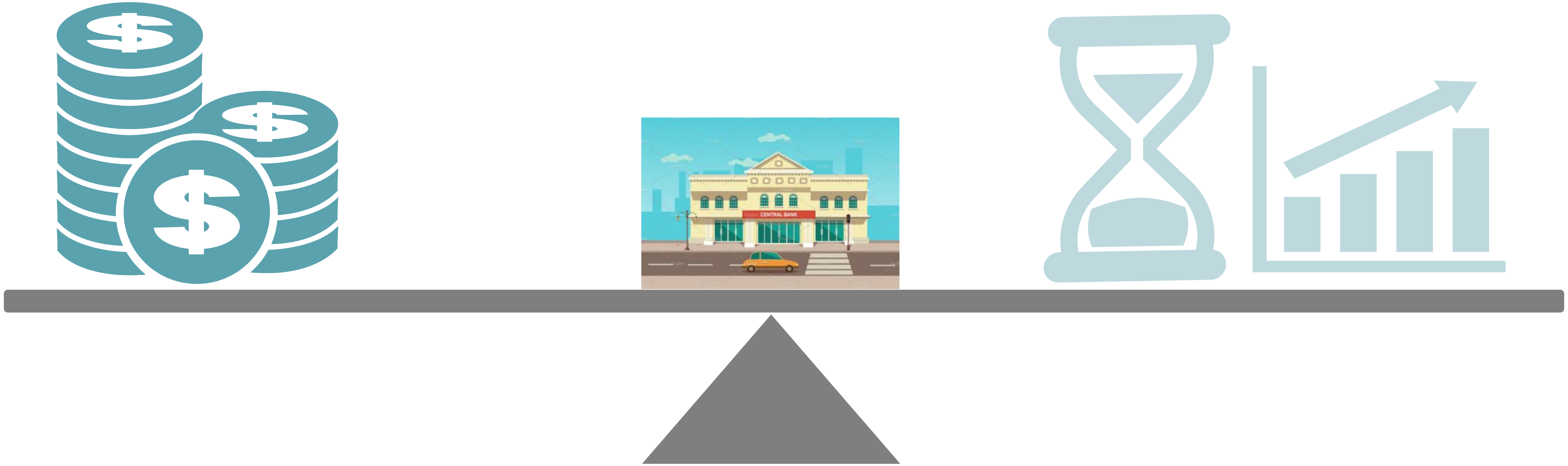
GDP Growth
-1.6% for 1Q2020

Exchange Rate
185.01 19th Nov 2020

Private Credit
LKR 87.4Bn in Sep 2020

Foreign Reserves
USD 5.8Bn Oct 2020

AWPR
6.04% 13th Nov 2020



# Journey of Monetary Policy Stance in 2020

**30 Jan**
Policy rates reduced by 50 bps

**03 Mar & 17 Mar**
03 Mar Policy rates maintained steady while 17 Mar Policy rates reduced by 25 bps and SRR reduced by 100 bps

**03 Apr**
Policy rates reduced by 25 bps
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**06 May**
Policy rates reduced by 50 bps

**16 Jun**
SRR reduced by 200 bps

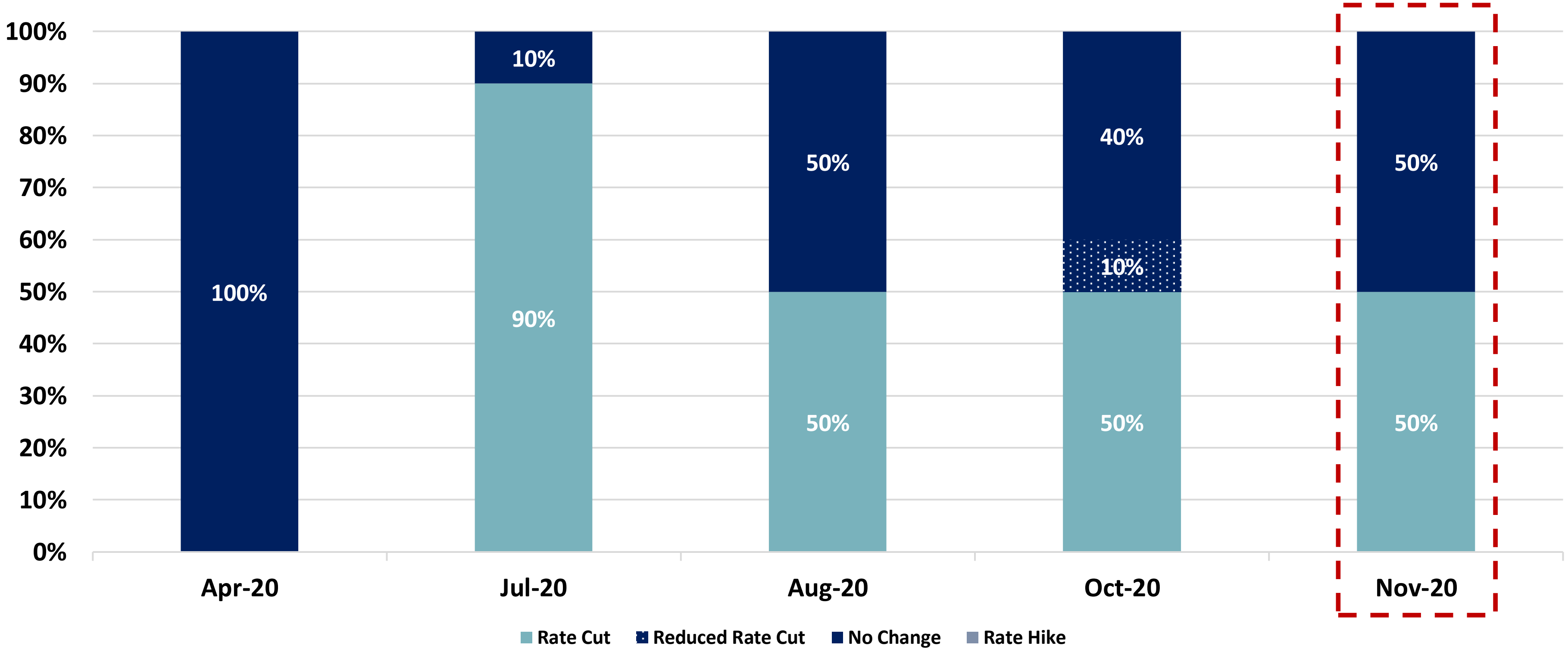
**09 Jul**
Policy rates reduced by 100 bps

**20 Aug**
Policy rates remain unchanged

**22 Oct**
Policy rates remain unchanged

# FCR Policy Rate Forecast –Nov 2020

We believe that CBSL will maintain same policy stance in this monetary policy review, but given the concerns around economic growth, CBSL is likely to retain the monetary policy stance at “accommodative”.




*In line with our previous Pre-Policy report, we maintain the same probabilities of 50% each for a rate cut and no change in rates.*

***Source: First Capital Research Estimates***

# Expected Monetary Policy Stance

As per our view, CBSL either can choose to hold policy rates steady or cut by a 25bps or 50bps while, hike is off the table due to the lackluster economic growth. We believe that there is a 50% probability to hold rates due to improvement in high frequency indicators. Moreover, there is a 25% probability for 25bps and 50 bps respectively to support economic growth.

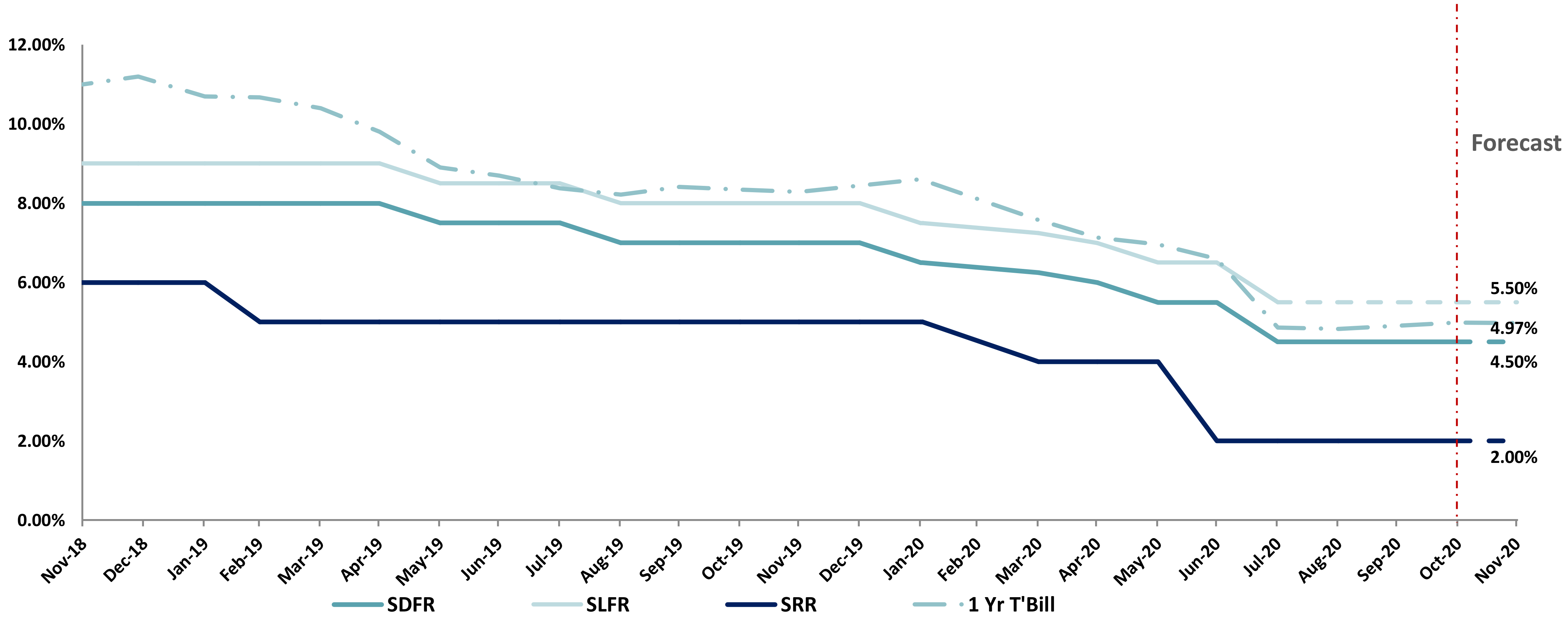
| Expected Monetary Policy Stance | Probability |
|---|---|
| Raising Policy Rates by 50 bps | 0% |
| Raising Policy Rates by 25bps | 0% |
| **Policy Rates to remain unchanged** | **50%** |
| **Cutting Policy Rates by 25 bps** | **25%** |
| **Cutting Policy Rates by 50 bps** | **25%** |

We believe that there is a 50% probability for policy rates to remain unchanged due to improvement in high frequency indicators.

| Expected Stance on SRR | Probability |
|---|---|
| Raising SRR by 100bps | 0% |
| Raising SRR by 50bps | 0% |
| **SRR to remain unchanged** | **100%** |
| Cutting SRR by 50bps | 0% |
| Cutting SRR by 100bps | 0% |

Considering the reduction of SRR by 300bps in two instances to 2% we expect SRR to remain unchanged at same levels.

# Monetary Policy Rates




*Source: CBSL, First Capital Research Estimates*

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# Thank You

*"Successful Investment Is About Managing Risk…"*