



First Capital

“RATES TO HOLD; CBSL ASSURES LIQUIDITY AS ECONOMY REBOUNDS”

PRE-POLICY ANALYSIS

01ST MAR 2021

First Capital Research

Analysts: Atchuthan Srirangan
Hiruni Perera
Dimantha Mathew



CBSL maintained its policy stance

In-line with our expectations, at the previous policy meeting held on Jan 2021, CBSL maintained its monetary policy stance, after considering the macroeconomic conditions and expected developments on the domestic and global fronts. The Board, having noted the reduction in overall market lending rates during 2020, stressed the need for a continued downward adjustment in lending rates to boost economic growth in the absence of demand driven inflationary pressures, particularly considering the significant levels of excess liquidity prevailing in the domestic money market.

Key Arguments by CBSL for maintaining its policy stance on 19th Jan 2021

- ✓ The spread of COVID-19 continued across the globe causing widespread economic disruptions, but recent progress on vaccines has brightened the global economic outlook.
- ✓ The spread of COVID-19 has weighed on Sri Lanka's growth prospects in 2020, but the outlook for 2021 remains positive.
- ✓ External sector is expected to remain resilient with the support of appropriate policy measures, amidst domestic and global challenges.
- ✓ Reflecting the impact of transmission of monetary easing measures, market interest rates continued to adjust downwards in 2020, and the low interest rate structure is expected to be maintained.
- ✓ Headline inflation is projected to remain subdued in the near term, and the improvements in domestic supply conditions are expected to ease price pressures on a sustained basis.



Analysis of upcoming policy decision on 04th Mar

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



Arguments against further easing

70%

- High frequency indicators point to retrenchment in economic activity
- Credit Growth on track, but structural recovery awaits
- The changing face of monetary intervention

- Sri Lanka economy to 'bounce back' from Covid crisis
- Access to less expensive domestic funding

Arguments for further easing

30%



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

Arguments *against* further relaxation in monetary policy



High frequency indicators point to retrenchment in economic activity

Reversing the downward trend witnessed in the recent months, the LMD-Nielsen Business Confidence Index (BCI) shot up by 39 points to 122 in Jan 2021. BCI index spiked a notable 12 points above the average for the last 12 months with the Covid vaccine rollout giving some form of relief to prevent the spread of COVID-19. Index of Industrial Production (IIP) for Dec 2020 increased to 110.7 from 106.9 in Nov 2020 while Sri Lanka's Manufacturing and Service Purchasing Managers' Index (PMI) remained in expansion territory in Jan 2021. New business activity in PMI increased in Jan 2021, particularly with the improvements observed in financial services, transportation, and wholesale & retail trade sub-sectors.

Credit Growth on track, but structural recovery awaits

Private sector credit increased by LKR 25.7Bn in Jan 2021 recording a growth for the 6th consecutive month indicating a revival in gross loan disbursements. Growth reflects that both businesses and individuals are speeding-up economic activities.

The changing face of monetary intervention

CBSL continues infusing ample liquidity into the banking system via increased CBSL Holdings (Money Printing) which also support fiscal shortage. The CBSL Holdings rose to LKR 809.9Bn on 26th Feb 2021 from LKR 738.4Bn as at 31st Dec 2020.

Arguments *for* further relaxation in monetary policy



Sri Lanka economy to 'bounce back' from Covid crisis

First Capital Research estimates the Sri Lanka's GDP would recover to 3.2% in 2021, from its expected steepest contraction in the history of -5.8% in 2020. Lack of demand for credit, slowness in consumer demand recovery and import restrictions can be considered as a major factor favouring to ease the policy rates at the upcoming meeting.

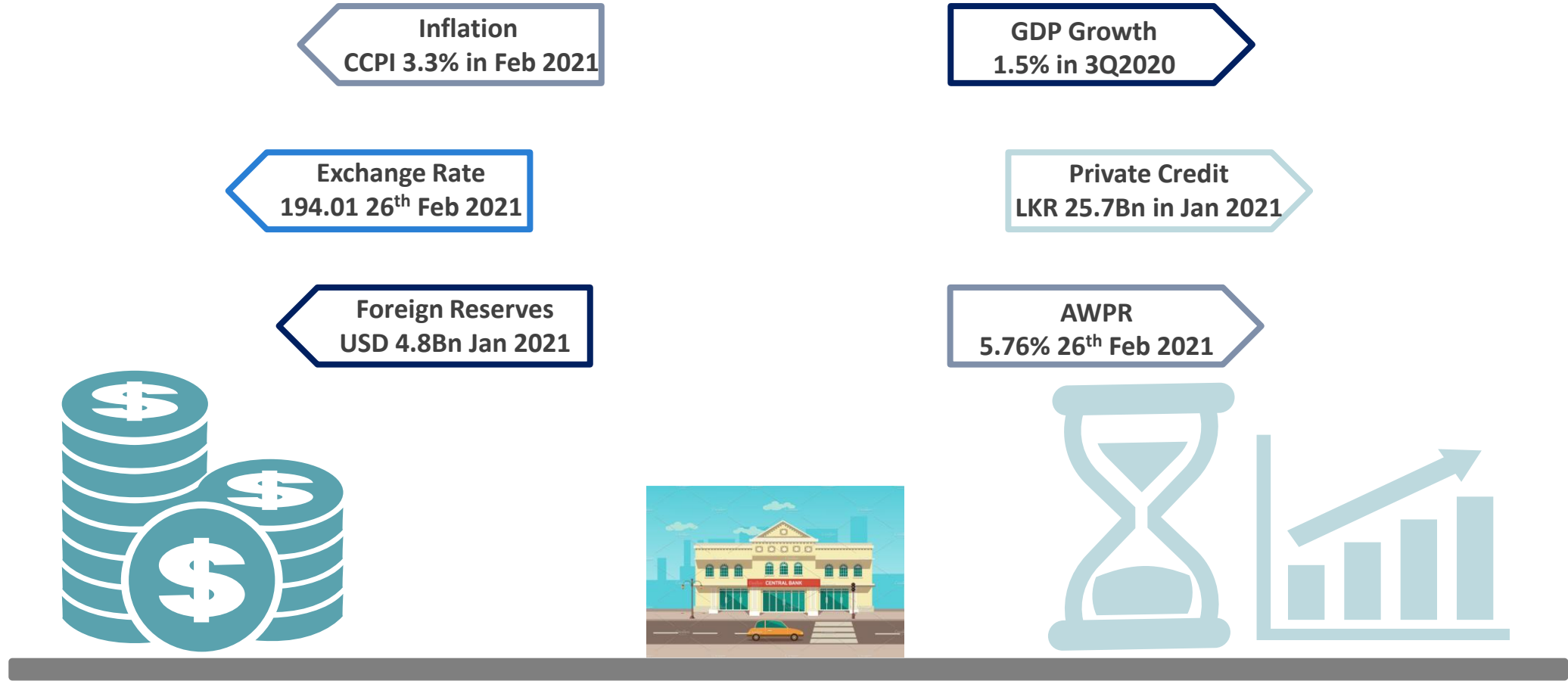


Treasury yields spike on the back of auction undersubscriptions

Yields in the secondary market witnessed an increase with moderate market activity from participants followed by a wait and see approach amidst the looming uncertainty. The last 2 Bond auctions and 5 Bill auctions were undersubscribed by a considerable amount reflecting the lack of clarity among market participants with the current economic condition. We consider a rate cut would be required to sustain the secondary market rate at lower levels.

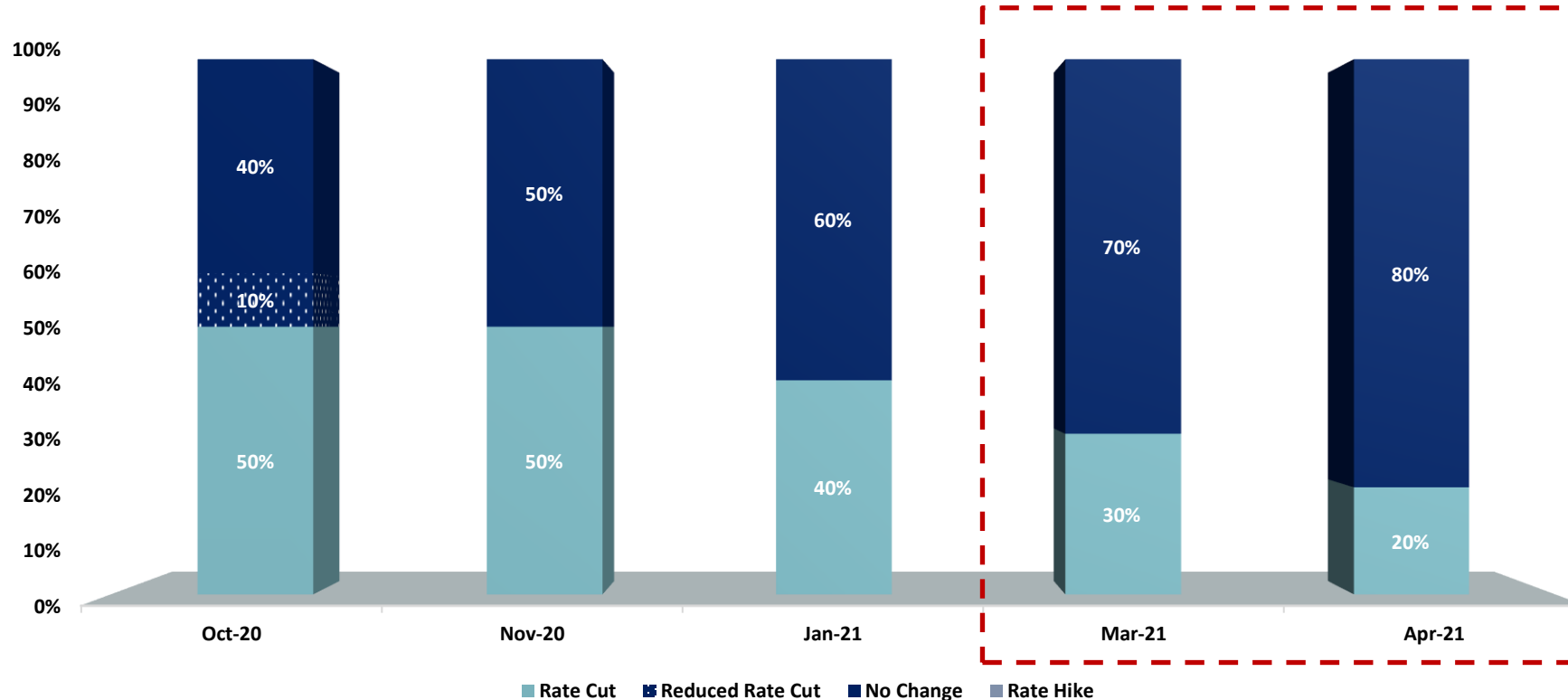


Factors of concern at the policy review



FCR Policy Rate Forecast – Mar-Apr 2021

We believe that CBSL may consider to maintain same policy stance in this monetary policy review as well, but given the concerns around economic growth, there is a probability although to a lesser extent that CBSL is likely to further ease its policy rates.



We expect only 30% probability for a rate cut at the upcoming meeting.

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 70% probability to hold rates due to the considerable improvement in high frequency indicators and with fiscal and monetary measures implemented so far. However, there is a 15% probability each for 25bps and 50bps rate cut to support economic growth.

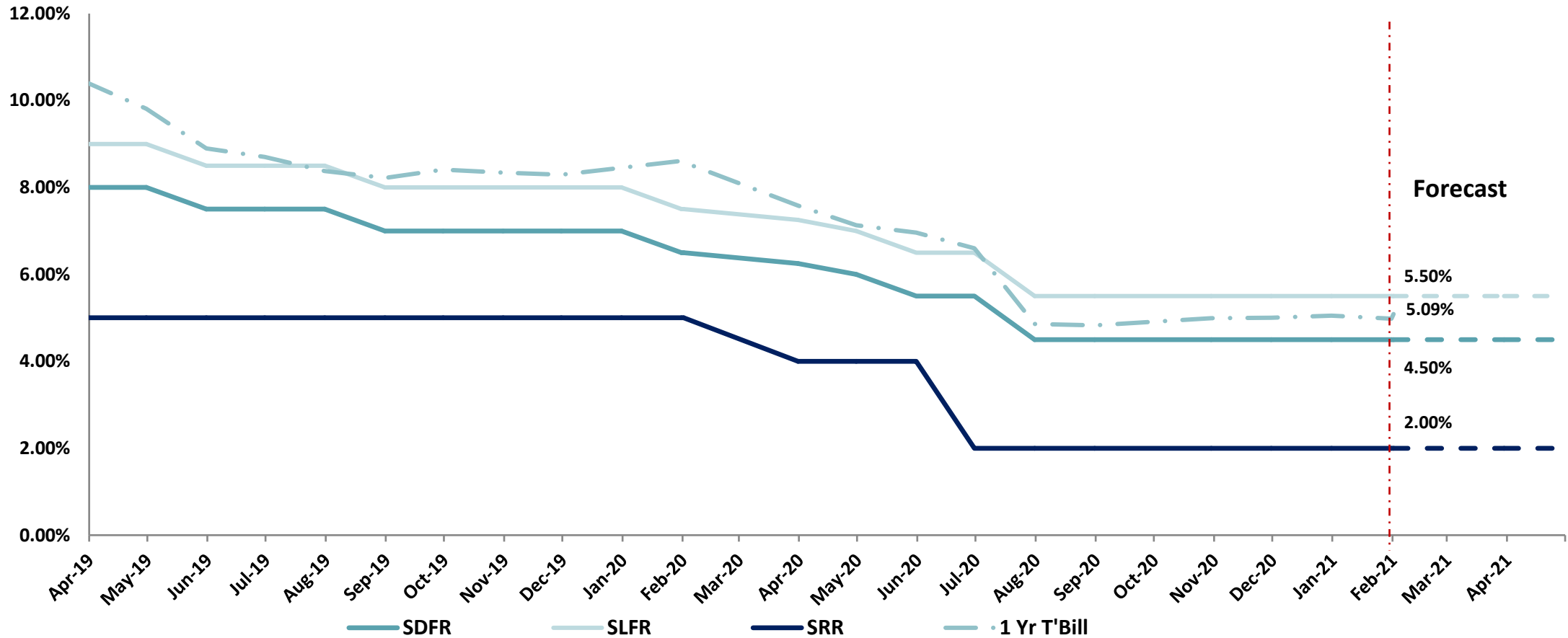
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	70%
Cutting Policy Rates by 25bps	15%
Cutting Policy Rates by 50bps	15%

We believe that there is a 70% probability for policy rates to remain unchanged due to the measures taken by CBSL to stimulate the economy.

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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Contact Us

First Capital Holdings PLC

No: 02, Deal Place,
Colombo 00300,
Sri Lanka.
E: research@firstcapital.lk



First Capital



Dimantha Mathew

Head of Research
T: +94 11 2639 853
E: dimantha@firstcapital.lk



Atchuthan Srirangan

Assistant Manager –Research
T: +94 11 2639 863
E: atchuthan@firstcapital.lk



Hiruni Perera

Assistant Manager- Research
T: +94 11 2639 864
E: hiruni@firstcapital.lk



Thank You

"Successful Investment Is About Managing Risk..."