



First Capital

“RATES TO HOLD STEADY AS INDICATORS MAKE HEADWAY”

PRE-POLICY ANALYSIS

05TH APR 2021

First Capital Research

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CBSL maintained its policy stance

In-line with our expectations, at the previous policy meeting held on Mar 2021, CBSL maintained its monetary policy stance, after considering the need for the financial system to actively lend to productive sectors in order to support the ongoing recovery of domestic production-based economic activity. Despite the recent uptick in certain market interest rates, CBSL re-emphasised its commitment to continue the low interest rate structure until the economy shows signs of sustained revival, in the context of the low inflation environment.

Key Arguments by CBSL for maintaining its policy stance on 04th Mar 2021

- ✓ The Sri Lankan economy is expected to make a notable recovery in 2021, supported by policy stimulus and improving business sentiments.
- ✓ The external sector performance is being closely monitored by CBSL and remains committed to maintain debt service record in the future as well.
- ✓ Monetary policy easing measures implemented since early 2020 have resulted in historically low interest rates.
- ✓ Inflation is projected to remain subdued in 2021.
- ✓ Reflecting the expansion in domestic credit, the growth of broad money (M2b) continued to accelerate. Going forward, the growth of credit to the private sector is expected to gather pace supported by low lending rates, the introduction of priority sector lending targets for banks on lending to MSME sector, and rising demand for credit driven by improving investor sentiments.



Analysis of upcoming policy decision on 08th Apr

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



Arguments against further easing

80%

- Economic Indicators beat COVID blues to bounce back
- Impressive Pvt credit figure in Feb; but structural recovery awaits
- A surplus liquidity in the system

- Government underscore the need for higher growth trajectory
- Treasury yields heading north with auctions getting undersubscribed consecutively

Arguments for further easing

20%



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

Arguments *against* further relaxation in monetary policy



Economic Indicators beat COVID blues to bounce back

Reversing the fragile trend witnessed in the recent months, the vaccination program has bolstered the economic sentiment, paving the way for an economic revival in 2021. So far nearly a million people have received the first jab fueling the positive sentiment in the country resulting in resumption of activities. This is expected to support the economic revival over the short to medium term. The outcome of the LMD-Nielsen Business Confidence Index in Mar points to a cautiously growing sense of optimism in the business community as the country looks to return to a semblance of normalcy by recording an increase of 6 points to 126, following a decline in Feb 2021.



Impressive Pvt. credit figure in Feb; but structural recovery awaits

Private credit increased by LKR 79.4Bn in Feb 2021 recording a growth for the 7th consecutive month indicating a revival in gross loan disbursements. Growth reflects that both businesses and individuals are speeding-up economic activities. However, growth of credit towards productive sectors of the economy appears to remain inadequate.



A surplus liquidity in the system

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 844.0Bn on 01st Apr 2021 relative to LKR 738.4Bn as at 31st Dec 2020.

Arguments *for* further relaxation in monetary policy



Government underscore the need for higher growth trajectory

First Capital Research estimates that Sri Lanka's GDP would recover to 3.2% in 2021, from its expected steepest contraction in the history of -5.8% in 2020. Moreover, SL govt. aims at achieving an economic growth of 6.0% or higher for 2021. In addition, further need to improve the demand for credit, fragile consumer demand recovery and import restrictions can be considered as the major factors favouring to ease policy rates at the upcoming meeting.



Treasury yields heading north with auctions getting undersubscribed consecutively

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 4 Bond auctions and 4 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

Inflation
CCPI 4.1% - Mar 2021

GDP Growth
1.3% - 4Q2020

Exchange Rate
199.47- 01st Apr 2021

Private Credit
LKR 79.4Bn - Feb 2021

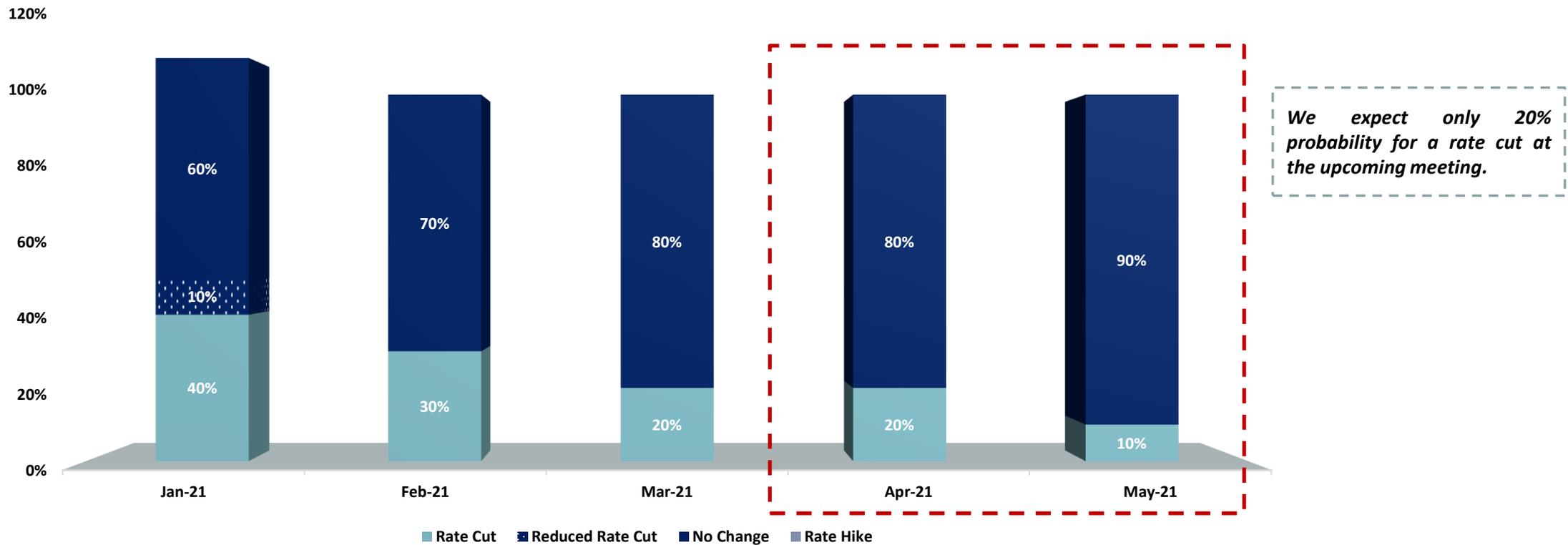
Foreign Reserves
USD 4.6Bn - Feb 2021

AWPR
5.78% - 01st Apr 2021



FCR Policy Rate Forecast – Apr-May 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.



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 80% 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 10% probability each for 25bps and 50bps rate cut to support economic growth.

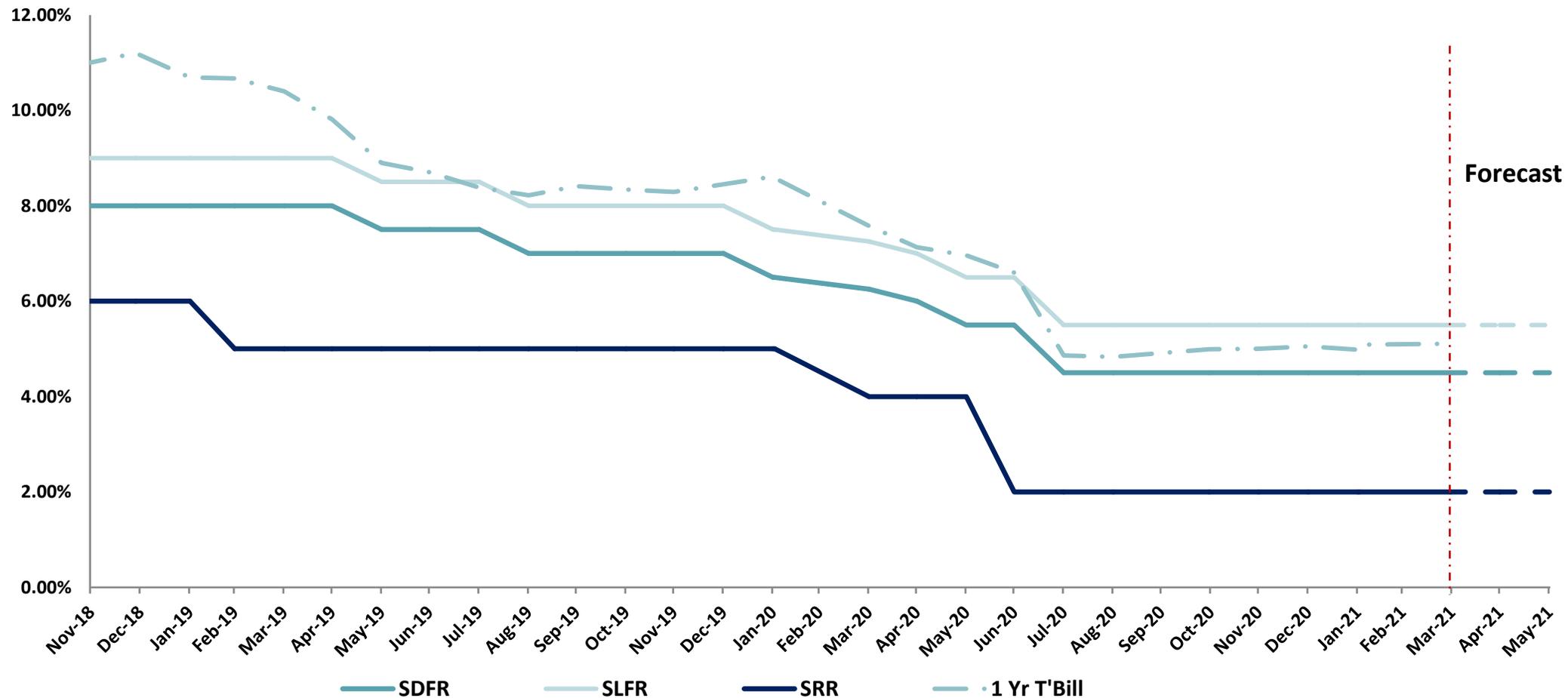
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	80%
Cutting Policy Rates by 25bps	10%
Cutting Policy Rates by 50bps	10%

We believe that there is a 80% 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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Thank You

"Successful Investment Is About Managing Risk..."