First Capital
First Capital Research

"IMPROVEMENT IN HIGH FREQUENCY INDICATORS, NUDGING EASING ON HOLD"

PRE-POLICY ANALYSIS

09TH OCT 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 Aug 2020, CBSL maintained its accommodative monetary policy stance, particularly as market lending rates are yet to reflect the full passthrough of policy easing measures implemented thus far.

Key Arguments by CBSL for maintaining its policy stance on 20th Aug 2020

- ✓ Global monetary easing continued amidst the rapid spread of the COVID-19 pandemic
- ✓ Domestic economic activities, which were adversely affected by the COVID-19 pandemic, are expected to recover in the second half of 2020
- ✓ External sector has improved with the support of proactive policy measures
- ✓ No demand driven inflationary pressure is expected during the forecasted horizon
- ✓ Credit to the private sector is expected to gradually recover in the period ahead

Analysis of upcoming policy decision on 22nd

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

Arguments against further easing

50%

- Domestic financial conditions have eased substantially with liquidity remaining in surplus
- Improvement in high frequency indicators in the economy
- Credit to the private sector reflects a gradual normalization

Arguments for further easing

50%

- GDP growth in 2020E is expected to remain in the negative territory
- Consumer confidence remain muted with weak demand
- Govt. leans heavily on domestic source of funding

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

Arguments against further relaxation in monetary policy

Domestic financial conditions have eased substantially with banking system liquidity remaining in surplus

Banks have abundant liquidity, following CBSL infusing ample liquidity into the banking system via increased CBSL holdings (Money Printing). However, outlook for credit seems lackluster given the uncertainty surrounding pandemic.

Improvement in high frequency indicators in the economy

Recovery of manufacturing activities continued in Aug 2020 (Index Value 57.9) as reflected by PMI Manufacturing, benefitting from the normalization of business activities in the country. PMI Services continued to expand for the 3rd consecutive month with index reaching 56.0 in Aug 2020. Additionally, Index of Industrial Production (IIP) for Jul 2020 increased to 111.1 from 92.8 in Jun 2020. Political stability after General Election and a slow return to normalcy was depicted in LMD-Nielsen Business Confidence Index (BCI) during Jun-Sep 2020 reflecting an improvement to 123 from 96. Domestic economic activities, which were adversely affected by the COVID-19 pandemic, are expected to recover in the 4Q of 2020, thus not requiring further relaxation in policies.

Credit to the private sector reflects a gradual normalization of economic activities

Private sector credit rebounded in Aug 2020 by LKR 78.3 Bn, for the first time since Apr 2020 reflecting the fact that both businesses and individuals are accelerating their economic activities to make up for the lost opportunities during the lockdowns period.

Arguments for further relaxation in monetary policy

GDP growth in 2020E is expected to remain in the negative territory

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%. Amidst the lack of demand for credit, import restrictions, and the slowness in recovery of consumer demand, GDP growth is expected to turn positive only by 4Q of 2020. Accordingly, GDP growth can be considered as a major factor favoring the further policy easing at the up coming review.

Consumer confidence remain muted with weak demand

The pandemic led disruption has had a lasting impact on the income of individuals with businesses being shut and either lay-offs or pay cuts experienced by salaried professionals. The lower disposable income in the hands of consumers will have a bearing on the demand for consumption with discretionary spending being either deferred or canceled for a period of time. However, higher credit growth and consumer demand can be aggravated through a further policy easing.

Govt. leans heavily on domestic source of funding

First Capital Research expects SL's budget deficit in 2020 to reach 10% of GDP. Generally fiscal deficit is funded via domestic and foreign sources of borrowing. Lack of FDI and limited foreign borrowing options in the current period may push the Govt. to borrow predominately from the domestic market. Decline in domestic interest rates in response to the aggressive monetary easing delivered the required support to soften the pandemic impact on the economy. Thereby, maintaining low interest rate environment or further reducing interest rate to benefits the Govt. finances.

Factors of concern at the policy review

Inflation
CCPI 4.0% in Sep 2020

GDP Growth
-1.6% for 1Q2020

Exchange Rate
184.28 09th Oct 2020

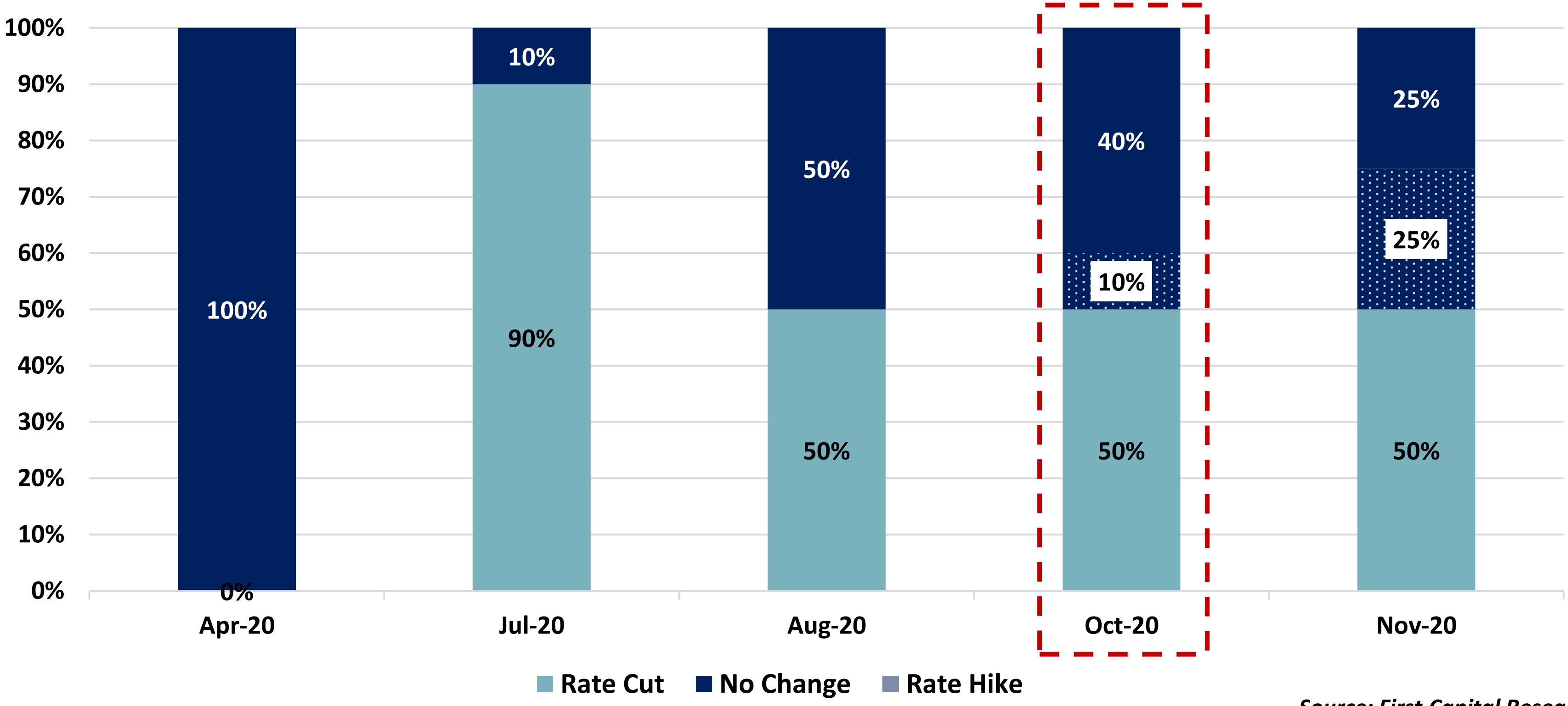
Private Credit
LKR 78.3Bn in Aug 2020

Foreign Reserves
USD 6.6Bn Sep 2020

AWPR
6.32% 09th Oct 2020

FCR Policy Rate Forecast – Oct-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”.



Our previous pre-policy report had assigned a 60% probability for a rate cut in Oct 20 and 75% probability in Nov 20. However, considering the improved macro economic indicators we have reduced the probability of a rate cut by 10% to 50% in Oct-20 and by 25% to 50% in Nov-20.

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.

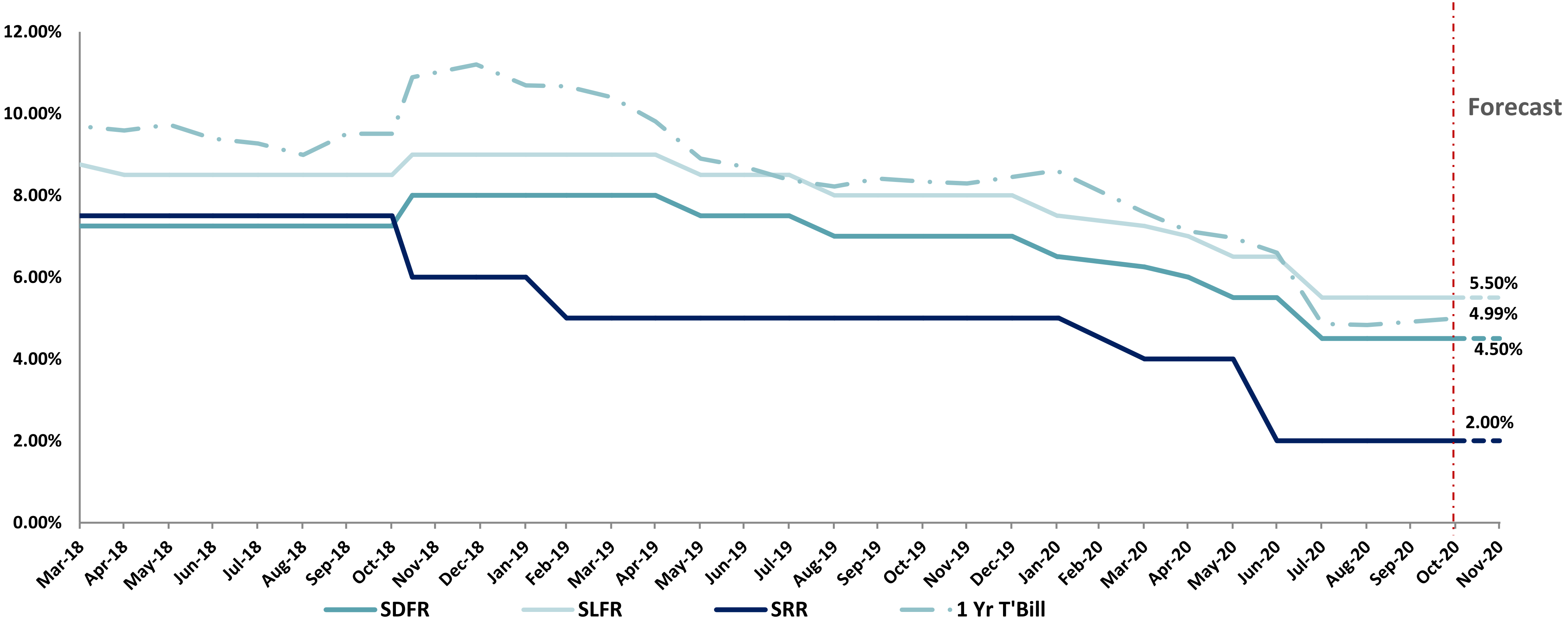
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50 bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	**50%**
Cutting Policy Rates by 25 bps	**25%**
Cutting Policy Rates by 50 bps	**25%**

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…”