



First Capital

“AN INEVITABLE RATE HIKE !!!”

PRE-POLICY ANALYSIS

First Capital Research

01ST APR 2022

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Previous Pre-policy report: Recap



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CBSL tightened its policy stance

In-line with our expectations, at the previous policy announcement held on 04th Mar 2022, CBSL decided to increase the SDFR and the SLFR by 100bps each to 6.50% and 7.50%, respectively. This decision has been made to dampen the possible build-up of underlying demand pressures in the economy, which would, in turn, help ease pressures in the external sector, thus promoting greater macroeconomic stability. At the same time, CBSL has suggested concerted efforts to be urgently taken by the Govt. to complement the efforts taken by the CBSL to overcome the present economic challenges. Consequently, CBSL introduced various measures for the Govt. to diligently consider.

Key Arguments by CBSL for tightening its policy stance on 04th Mar 2022

- ✓ Global and domestic developments have posed challenges to the recovery of the Sri Lankan economy.
- ✓ External sector faces heightened challenges.
- ✓ Market interest rates are trending upwards.
- ✓ Supply side factors have contributed to price pressures, while the build-up of aggregate demand pressures is also visible.



Analysis of upcoming policy decision on 5th Apr

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Arguments For Hike

90%



The following factors argue to hike rate at the upcoming policy meeting.

- Tightening policy stance is one of the key proposition by the IMF
- Derailing foreign reserves and Exchange rate crisis
- Inflation, inflation, inflation!!!
- Negative liquidity in the market
- Bond auctions getting undersubscribed while CBSL holdings keep rising
- Federal Reserve shift towards jumbo hikes

- Consecutive rate hikes may derail the potential recovery in GDP growth
- Policy tightening may not curb cost-push inflation

The above-mentioned factors argue that there is no requirement for hike in policy rates.

Arguments Against Hike

10%



Arguments *for* hike in monetary policy



Tightening policy stance is one of the key proposition by the IMF

Currently, Sri Lanka is seeking financial support from the International Monetary Fund, while planning to present policy proposals to the IMF in early April. As per 2021 article IV consultation of IMF, tighter monetary policy and a market-based exchange rate were recommended as part of the comprehensive strategy. Given rising inflationary pressures and expectations, IMF believes that near-term monetary policy tightening is warranted to ensure that the recent breach of the inflation target band is only temporary. Therefore, there is a high likely hood that Sri Lanka will consider further tightening policy rates at the upcoming meeting.

Derailing foreign reserves and Exchange rate crisis

Sri Lanka's gross official reserves dropped to USD 2.3Bn in Feb-22 in the midst of worsening external conditions and lack of foreign inflows and as a result, the Govt. had to rely on credit lines to bolster its finances, including from China and India. Going forward, continuous rise in import bills and worsening trade deficit urge for a further rate hike to safeguard the foreign reserves while charming more foreign inflows into the country. Derailing foreign reserves have also led to significant pressure on the currency and since CBSL's decision to allow the flexibility in the currency on 07th Mar-22, LKR depreciated significantly by more than 40% while in unofficial trading platforms the LKR being quoted at an even far weaker rate. Hence, to arrest the existing pressure on the currency and reserves, we believe that CBSL should tighten its policy rates.

Inflation, inflation, inflation!!!

Sri Lanka recorded one of its highest inflation of 18.7% in Mar-22 relative to 15.1% in Feb-22 causing an alarm among the consumers in the country. Going forward, inflation is expected to remain high due to elevated energy prices and continuing supply chain disruptions, prompting stronger monetary policy responses by the central bank. Rising both headline and core inflation and negative real policy rates which remains below historical average of 2.5% per annum (over the past decade), warrants a hawkish monetary policy stance by CBSL.



Arguments *for* hike in monetary policy



Negative liquidity in the market

Sri Lanka's overnight liquidity shortage hovers around LKR 600.0Bn and has been remaining continuously in the negative territory since the hike of SRR by CBSL which absorbed nearly LKR 200.0Bn in banks' excess liquidity. This prompted the banks to lean heavily on the Central Bank's Standing Lending Facility window to borrow to meet their daily liquidity requirements. Following recent monetary tightening measures, although lending rates have adjusted upwards, the adjustment in deposit interest rates remains sluggish, which has been inadequate to attract deposits into the banking system from the excessive currency in circulation. A further tightening in policy measures would be required to encourage banks and financial institutions to make the required adjustments to deposit rates in order to promote savings and to improve liquidity in the system.



Bond auctions getting undersubscribed while CBSL holdings keep rising

The total accepted amount from 1Yr T-Bills at the recent weekly auctions were seen falling short of the total offered amount while attracting investors towards more liquid short-term maturities resulting in yield of 03M T-Bill reaching 12.92% vis-à-vis the 01Yr T-Bill at 12.28% indicating a distortion in the market. Currently, SLFR is at 7.50% while 03M T-bill rate in the secondary market is hovering around 13.20% creating an arbitrage profit of c. 5.70% which is one of the highest in the history. Moreover, for the first time after more than five years, CBSL rejected all bids received at T-bond auction held on 29th Mar-22 as a result of higher yields expected by the market in order to compensate for galloping inflation and higher financing requirement of the Govt. Undersubscribed bill and bond auctions have resulted in continuous rise in CBSL holdings which surpassed LKR 1.7Tn. However, we believe that given the recent market developments and the prevailing negative real interest rates, another rate hike is needed to meet the expectations of the market participants to regain market activeness and to unwind Govt's large T-bill holdings.



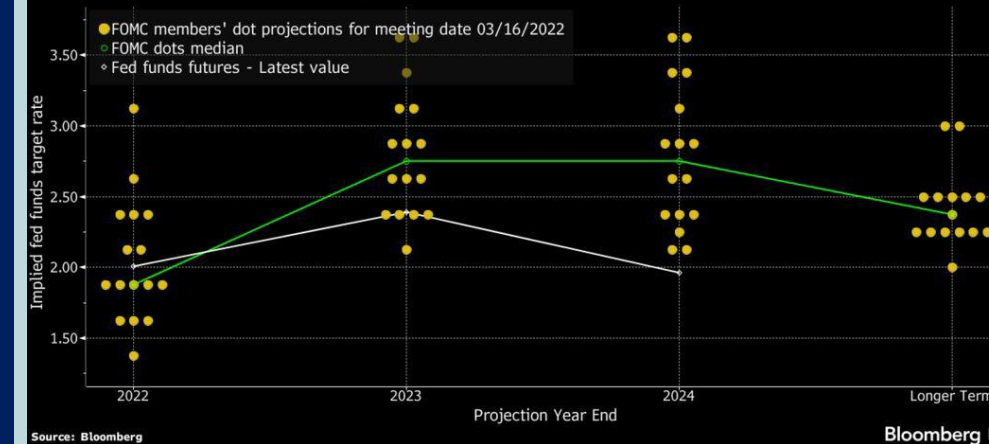
Federal Reserve shift towards jumbo hikes after being rattled by persistent inflation while other countries are expected to jump on the bandwagon...

Federal Reserve officials, rattled by persistent inflation and criticism that they're behind the curve, have pivoted toward an even more aggressive plan of interest-rate hikes than they signaled earlier this month to ensure price increases cool. At the meeting held on Mar 15-16, the Federal Reserve raised interest rates by a quarter percentage and signaled hikes at all six remaining meetings this year, launching a campaign to tackle the fastest inflation in four decades even as risks to economic growth mount.

The war in Ukraine initially made them cautious, with officials backing a quarter-point increase this month as they raised rates from near zero. Investors took the hike in stride and the Fed quickly became more concerned that the surge in food and energy prices caused by the war would entrench inflation and expectations at unacceptably high levels.

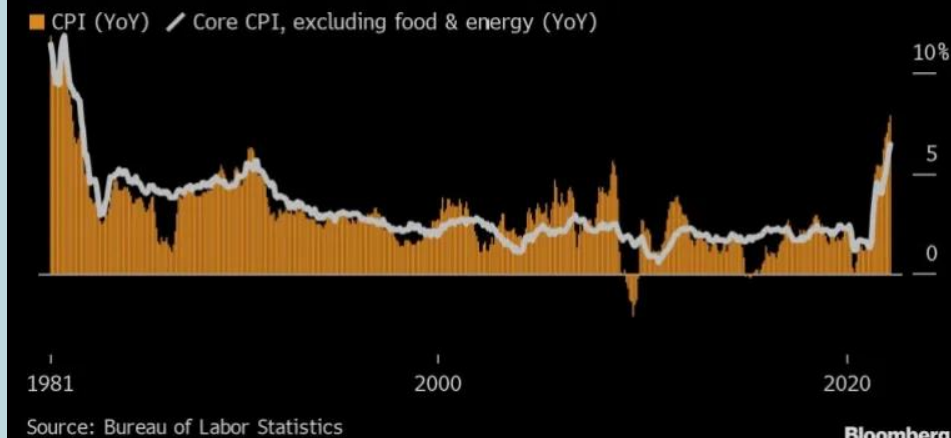
With the Bank of England having already moved on higher interest rates, the European Central Bank is likely to wait until the end of the year to raise rates.

The Fed's New Dot Plot



Getting Hotter

U.S. inflation accelerated to a 40-year high of 7.9% in February



Global policy actions are favouring the hawkish hopes

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	Oct 2021	Nov 2021	Dec 2021	Jan 2022	Feb 2022
Net Change	+2,715 bps	+1,005 bps	+1,365 bps	+940 bps	+300bps
Total Rate Cuts	200bps	100bps	105bps	410bps	0bps
Total Rates Rises	2,915bps	1,105bps	1,470bps	1,350bps	300bps
Rate Cuts	Turkey	Turkey	Turkey and China	Congo, South Sudan and China	None
Rate Rises	Romania, Moldova, Uruguay, New Zealand, Iceland, Poland, Peru, Chile, Hungary and Paraguay, Russia, Tajikistan, Kazakhstan, Brazil, Zimbabwe, Azerbaijan and Colombia	Poland, Czech Republic, Romania, Mexico, Uruguay, Peru, Hungary, Jamaica, Iceland, South Africa, Pakistan, Ghana, Paraguay, Lesotho, New Zealand, Zambia, Dominican Republic, South Korea and Kyrgyzstan	Moldova, Georgia, Poland, Brazil, Ukraine, Peru, Pakistan, Armenia, Hungary, Chile, Costa Rica, Norway, United Kingdom, Mexico, Azerbaijan, Russia, Colombia, Jamaica, Paraguay, Czech Republic, Sierra Leone and Dominican Republic	Poland, Uruguay, Argentina, Peru, Romania, Moldova, South Korea, Sri Lanka, Ukraine, Paraguay, Kazakhstan, Hungary, Chile, Costa Rica, South Africa, Azerbaijan, Colombia, Kyrgyzstan and Dominican Republic	Armenia, Lesotho, Brazil, United Kingdom and Czech Republic.
Global Monetary Policy Rate	5.28%	5.38%	5.51%	5.60%	5.63%

Global central banks have embarked on raising rates while *none* of the country opted for a rate cut amidst firing inflation woes

Source: centralbanknews.info

*Arguments **against** hike in monetary policy*



Consecutive rate hikes may derail the potential recovery in GDP growth

Recovering from a steep contraction in GDP in 2020, Sri Lanka's economy has embarked on a gradual recovery during 2021 recording a GDP growth of 3.7%. However, The domestic economy is expected to be somewhat affected by recent adverse developments such as supply chain disruptions and rising commodity prices, as well as power and energy supply interruptions. These disruptions have to be addressed immediately to ensure the continuation of uninterrupted domestic production and the momentum in exports, while continuing the efforts to strengthen the production economy through well-targeted growth policies. Therefore, further pampering in terms of fiscal and monetary stimulus may require in near to medium term to stabilize the economic growth. Thus, back-to-back rate hikes may act in contrary to these beliefs.

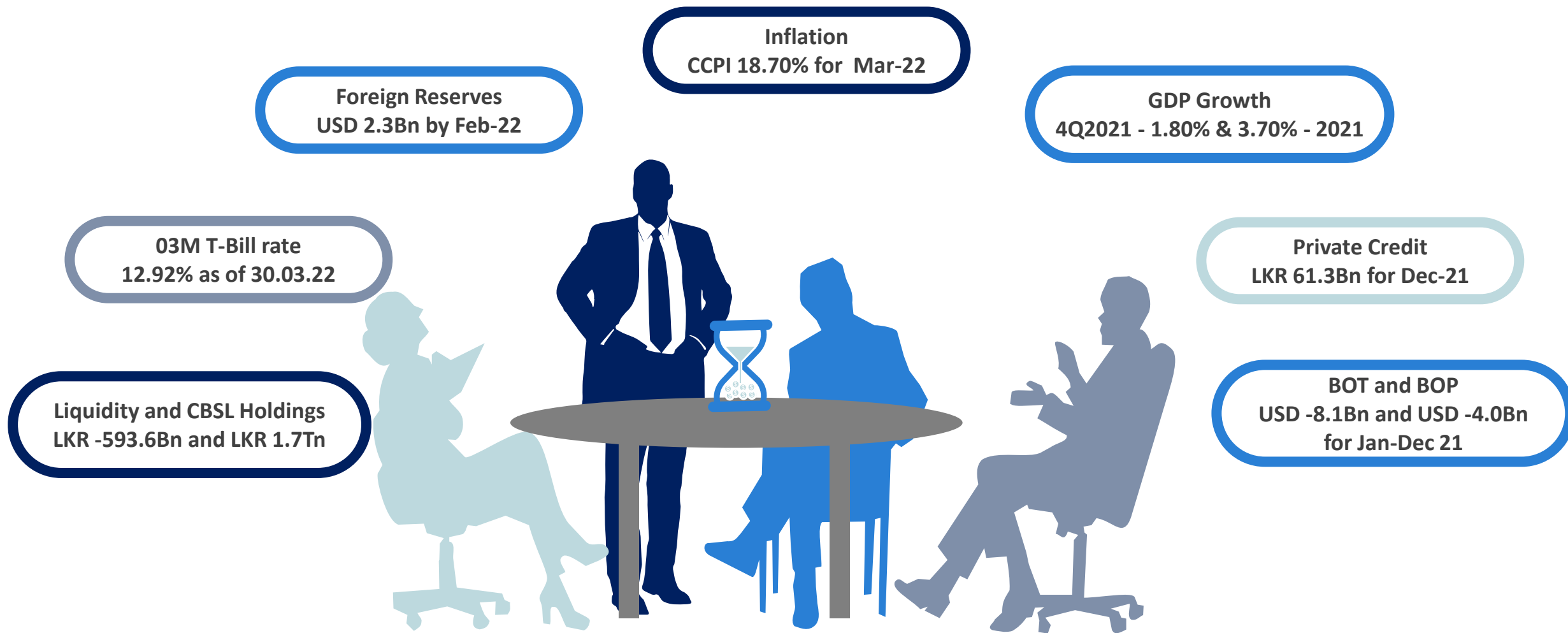


Policy tightening may not curb cost-push inflation

Increase in global commodity prices have become a key determinant factor of the soaring inflation in Sri Lanka. In that, escalating crude oil prices due to supply-side constraints play a major role in the domestic context by inflating prices of the overall economy. Moreover, import restriction and Sri Lanka's heavy dependency on imports are also promoting supply-side shocks, while also wearing out the competitiveness of certain local industries and thereby causing detriments to the consumers due to discretionary rise in prices of goods and services by suppliers. Therefore, a monetary tightening may not address these issues arising via cost-push effects on inflation.

Factors of concern at the policy review

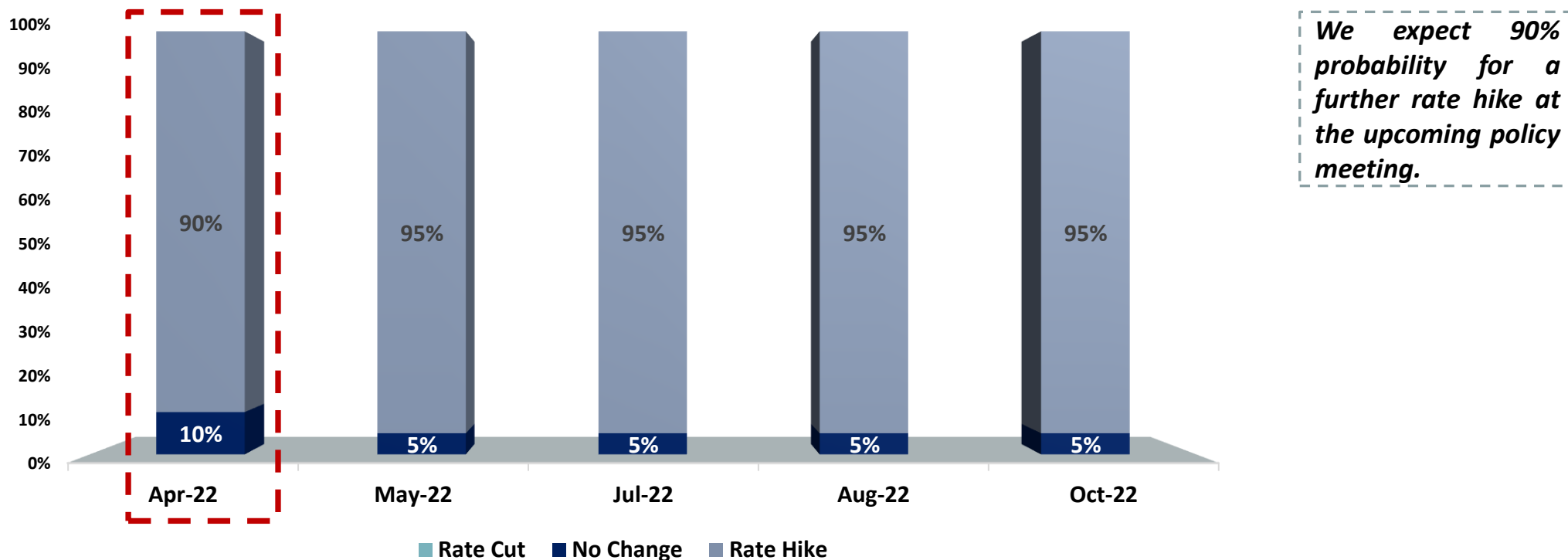
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FCR Policy Rate Forecast – Apr 22- Oct 22

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We believe that CBSL may consider further ***tightening the monetary policy rates in this policy review but*** given the concerns over economic growth, there is a lower probability of 10% for CBSL to maintain its policy stance at current levels. With high frequent indicators improving in line with expectations, we have eliminated any probability of a rate cut. We expect a continued increase in probability for a rate hike in order to prevent overheating of the economy amidst the given fiscal and monetary stimulus.



Source: CBSL, First Capital Research Estimates

Expected Monetary Policy Stance

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As per our view, at the upcoming policy meeting, there is a strong case for a sharp increase in policy rates in order to compensate for higher inflation and to preserve the currency & foreign reserves. As a result, we believe that there is a very high probability of 90% for a hike to iron out the prevailing imbalances in the domestic financial markets and the external sector of the economy, while preempting the buildup of any excessive inflationary pressures over the medium term, thereby supporting macroeconomic stability. Therefore, CBSL is expected to deliver a minimum of 100 bps or more rate hike at the monetary policy meeting scheduled in Apr-22. However, there is also a lower probability of 10% to maintain the policy rates at its current level in order to further improve the high frequency indicators.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 300bps	10%
Raising Policy Rates by 200bps	25%
Raising Policy Rates by 100bps	50%
Raising Policy Rates by 50bps	5%
Policy Rates to remain unchanged	10%
Cutting Policy Rates by 50bps	0%

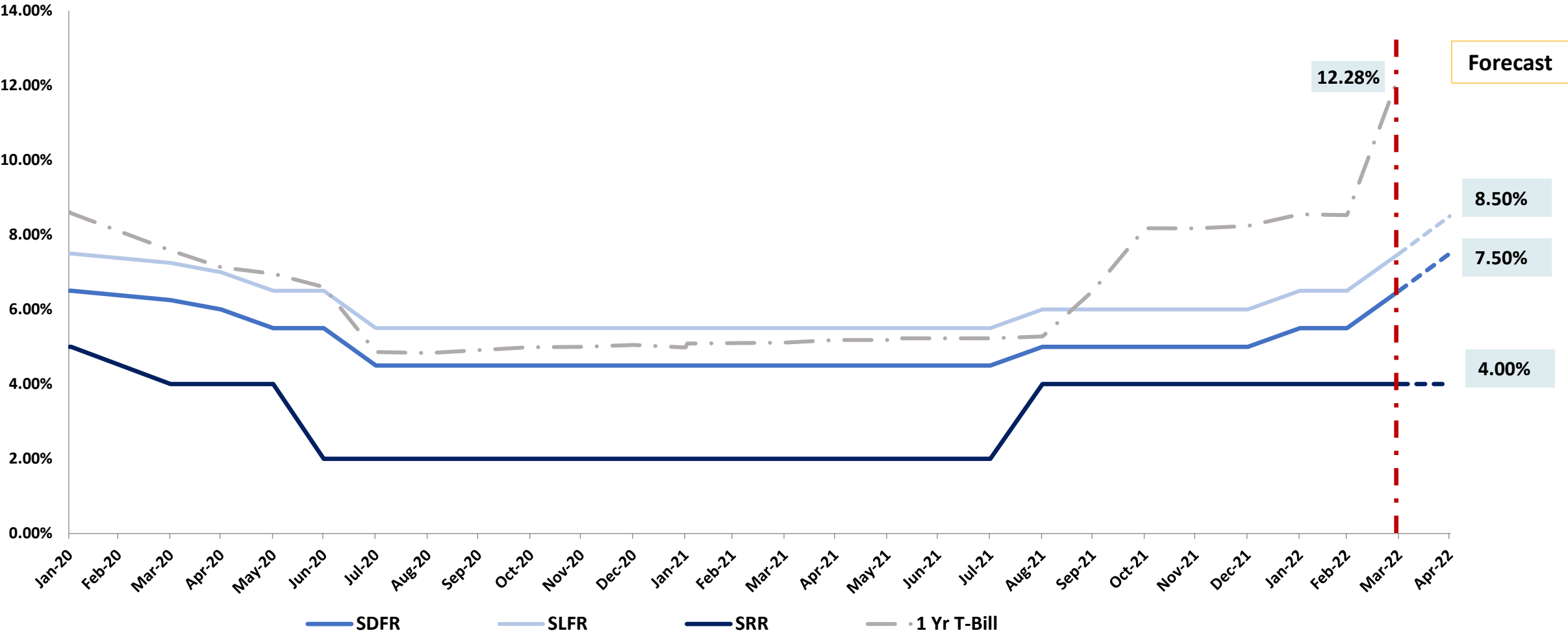
90%

We believe that there is 90% probability for a policy rate hike in warranting for greater economic stability.

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 increase of SRR by 200bps to 4% in 19th Aug 2021 we expect SRR to remain unchanged at same levels.

Monetary Policy Rates



Source: CBSL, First Capital Research Estimates

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