First Capital

# *"ENDANGERING PANDEMIC SIGNALS SLIGHT PAUSE ON HAWKISH STANCE"*

PRE-POLICY ANALYSIS

11TH AUG 2021

**First Capital Research**

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# Previous Pre-policy report: Recap



## CBSL maintained its policy stance

**In-line with our expectations**, at the previous policy meeting held on 08th Jul 2021, CBSL maintained its monetary policy stance, amidst renewed disruptions due to the emergence of the 3rd wave of Covid-19 and related preventive measures. CBSL also highlighted the need for continued fiscal and monetary support to place the recovery process on a firm footing. CBSL ensures the maintenance of inflation in mid single digit level in the medium term, while facilitating high and sustainable economic growth in the period ahead.

### Key Arguments by CBSL for maintaining its policy stance on 08th Jul 2021

- ✓ The Sri Lankan economy recorded a higher than expected growth rate in the 1Q2021.
- ✓ The external sector is expected to gradually recover in the period ahead.
- ✓ Market interest rates remain low, facilitating increased credit flows to the private sector.
- ✓ Any buildup of sustained inflationary pressures will be addressed through appropriate measures over the medium term.

# CBs around the world make HAWKISH turns…



| | Apr 2021 | May 2021 | Jun 2021 | Jul 2021 | Aug 2021 |
|---|---|---|---|---|---|
| Net Change | +25 bps | +50 bps | -95 bps | +1,055 bps | +325bps |
| Total Rate Cuts | 500 bps | 100 bps | 350 bps | None | None |
| Total Rates Rises | 525 bps | 150 bps | 255 bps | 1,055 bps | 325 bps |
| Rate Cuts | Congo | Ghana | Uganda, Congo and Seychelles | None | None |
| Rate Rises | Belarus, Ukraine, Russia, Kyrgyzstan, Georgia and Tajikistan | Armenia, Brazil and Iceland. | Russia, Armenia, Brazil, Hungary, Czech Republic and Mexico | Angola, Chile, Belarus, Ukraine, Russia, Kazakhstan, Kyrgyzstan, Hungary, Tajikistan and Moldova | Armenia, Georgia, Brazil, Czech Republic, Uruguay, Mexico and Peru |
| **Global Monetary Policy Rate** | **4.86%** | **4.87%** | **4.85%** | **4.96%** | **4.99%** |

***Source: Centralbanknews.info***

Despite the Delta scare, Central Banks around the world have started to move away from emergency stimulus they deployed to fight against the pandemic.

Federal Reserve chair Jerome Powell and colleagues have begun debating when and how to slow their asset purchase program while Brazil, Mexico and Russia have hiked interest rates.

# ...amidst recovery gaining steam



Increase in U.S. consumer prices slowed in July even as they remained at a 13-year high on a YoY basis.

In June, the US annual inflation rate hit its fastest pace since Aug 2008, having accelerated to 5.4% from 5.0% in May as the recovery from the coronavirus pandemic continued to gain traction.

The jump in prices will put pressure on the Federal Reserve to tighten monetary policy sooner than expected.

# SL may be little patient before following suit



As mentioned in the previous report, First Capital Research expects CBSL to adopt the ***Hawkish*** policy stance due to the following reasons:-

- Foreign reserves dropped to 12-year low of USD 2.8Bn in Jul 2021.
- Private Sector credit moving in par with CBSL expectations.
- Despite the fact, the excess liquidity in Sri Lanka reduced below LKR 100.0Bn and dipped to LKR 0.03Bn on 22nd Jul, the lowest since Sep 2019, it gradually improved amidst the CBSL continuous infusion of liquidity into the banking system via increased CBSL holdings.
- Potentially higher expectation of inflation (CCPI recorded at 5.7% for July while NCPI at 6.1% for Jun) beyond the CBSL's targeted bands.

***However, amidst rising COVID cases, CBSL could be "little patient" in keeping interest rates at current levels at the upcoming meeting.***

# Analysis of upcoming policy decision on 19th Aug



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

**90%**

**Arguments against hike**

- **Economic recovery under threat amidst resurgence of COVID cases**
- **Pvt. Credit returns to normalcy and on par with a 12% target for 2021E**
- **A possible rate hike contradicts with the govt's current dovish stance**
- **Inflation pressure is expected to be TRANSITORY led by supply disruptions**

**Arguments for hike**

**10%**

- **Yields heading north in Government Securities**
- **Mounting pressure on the exchange rate**
- **Possible demand push inflation in the future**

Above mentioned factors argue to hike rate at the up coming policy meeting.

# *Arguments against Hike in monetary policy*

### Economic recovery under threat amidst resurgence of COVID cases

Despite Sri Lanka recording a modest economic growth of 4.3% for 1Q2021, rapidly escalating third wave of coronavirus infections fueled by the delta variant is expected to weaken the economy in 2021E. In spite of the fact that Sri Lanka is now among the countries with the fastest vaccination rates in the world, rapid escalation of the third wave of COVID infections stalled the momentum, indicating that the pandemic will continue to cast a long shadow over the economy. Accordingly, any consideration of a rate hike is likely to further dampen the economic growth of the country. Reflecting the prevailing negative sentiment, the LMD-Nielsen Business Confidence Index (BCI) registered at 87 in Jul 2021 from where it was 97 a year ago, while placing it more than 20 points below its 12-month average.

### Pvt. Credit returns to normalcy and on par with a 12% target for 2021E

Private sector credit increased by LKR 83.4Bn in Jun 2021 to LKR 414.0Bn for Jan-Jun 2021 indicating the continuous improvement amidst persistent support from monetary stimulus. YTD growth stands at 6.7% broadly on par with First Capital Research (FCR) expectation of *c.*12% for 2021E. Since Govt's main objective is to enable low-cost credit to the economy thus supporting the revival of economic activities, changes to prevailing easing monetary policy is unlikely.

### A possible rate hike contradicts with the govt's current dovish stance

CBSL continued to infuse ample liquidity into the system via increased CBSL holdings supporting the fiscal shortage. Accordingly, CBSL holdings recorded at LKR 1,186.1Bn as at 11th Aug 2021 surpassing LKR 1.0Tn mark. We believe CBSL's continuance in quantitative easing strategy contradicts with a rate hike, preventing any moves towards a hiking cycle.

# *Arguments against Hike in monetary policy*

**Inflation pressure is expected to be *TRANSITORY* led by supply disruptions**

It is believed that current bout of high inflation to be TRANSITORY, led by supply-side disruptions. Therefore, steering monetary policy rates wouldn't be the most appropriate remedy as it is not led by demand push inflation.

# *Arguments for hike in monetary policy*

### Yields heading north in Government Securities

Yields in the secondary market continued to witness an increase with moderate market activity from participants, followed by a wait and see approach amidst the looming uncertainty in economy. Last four bill auctions were undersubscribed with considerable amount getting accepted in short tenors (3-6 months) reflecting the lack of clarity among market participants on future interest rate trajectory. We consider that a rate hike may support CBSL in raising additional funding via Government Securities.

### Mounting pressure on the exchange rate

Lower interest rates may have a negative impact on the exchange rate as it can cause to lose foreign capital causing the exchange rate to decline and also by fueling consumer demand and impacting rising imports despite the import restrictions. YTD, USD:LKR has plunged by 7.2% to LKR 199.9 against the greenback and going forward accommodative policy implementation could lead to a further depletion in foreign exchange rate and also reserves. Therefore, in order to preserve the foreign reserves which is considered to be the talk of the town, there is a possibility of a rate hike.

### Possible demand push inflation in the future

Despite the fact that inflation is considered TRANSITORY, the envisaged improvements in aggregate demand conditions and the likely increases in global commodity prices, may generate some inflationary pressures over the medium term. In order to steer such pressures, timely policy intervention will be required by moving onto a campaign of hiking stance to ensure the maintenance of inflation in mid-single digit levels over the medium term.

# Factors of concern at the policy review



**Inflation**
CCPI 5.7% - Jul 2021

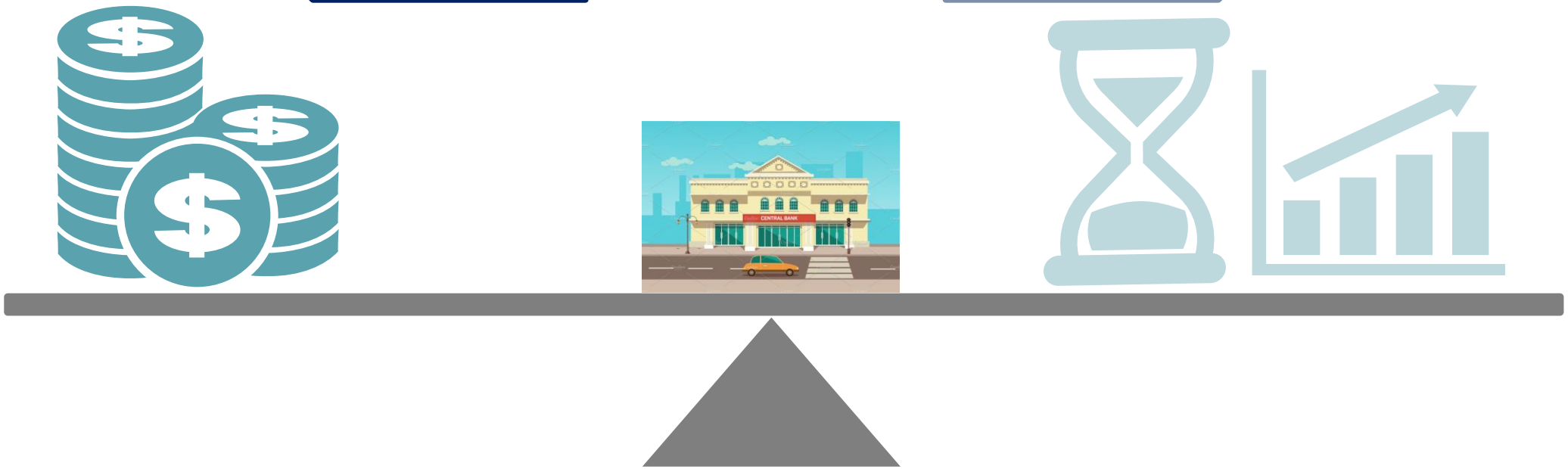
**GDP Growth**
4.3% - 1Q2021

**Exchange Rate**
199.92- 11th Aug 2021

**Private Credit**
LKR 83.4Bn - Jun 2021

**Foreign Reserves**
USD 2.8Bn - Jul 2021

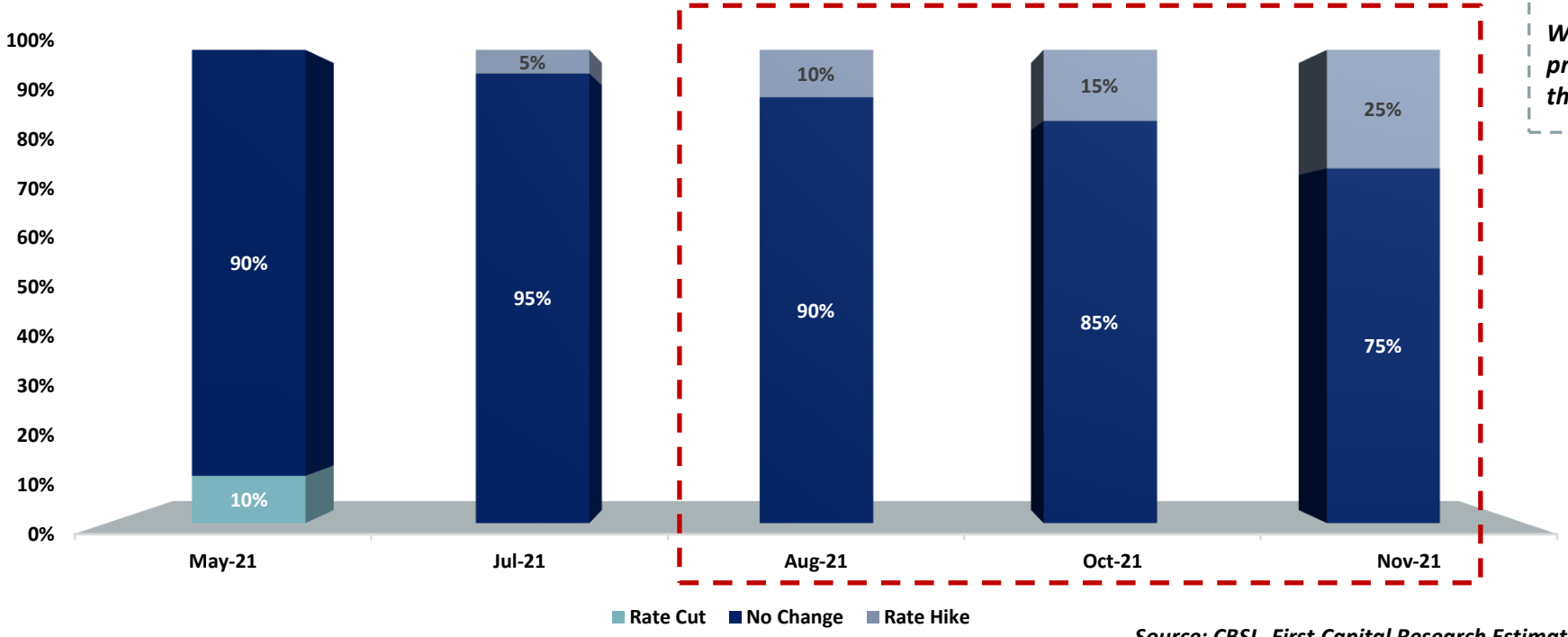
**AWPR**
5.72% - 06th Aug 2021



# FCR Policy Rate Forecast – Aug-Nov 2021



We believe that CBSL may consider ***maintaining the same policy stance in this policy review as well but*** given the considerable improvement in high frequency indicators to prevent an overheating of the economy, there is a considerably low probability that CBSL is likely to hike its policy rates. With high frequent indicators improving in line with expectations, we have eliminated any probability of a rate cut. Towards the 2H2021E, 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. However, probability for ***maintaining rates continues to be the majority probability for the rest of the year***.




***We expect only 10% probability for a rate hike at the upcoming meeting.***

*Source: CBSL, First Capital Research Estimates*

# Expected Monetary Policy Stance



As per our view, CBSL either can choose to hold policy rates steady or hike by 25bps while, rate cut is off the table due to the high debt repayment and the high domestic borrowing requirement. We believe that there is a significant probability (90%) to hold rates due to the considerable improvement in high frequency indicators with the fiscal and monetary measures implemented so far. However, there is a 10% probability for 25bps rate hike to balance external pressure.

| Expected Monetary Policy Stance | Probability |
|---|---|
| Raising Policy Rates by 50bps | 0% |
| Raising Policy Rates by 25bps | 10% |
| **Policy Rates to remain unchanged** | **90%** |
| Cutting Policy Rates by 25bps | 0% |
| Cutting Policy Rates by 50bps | 0% |

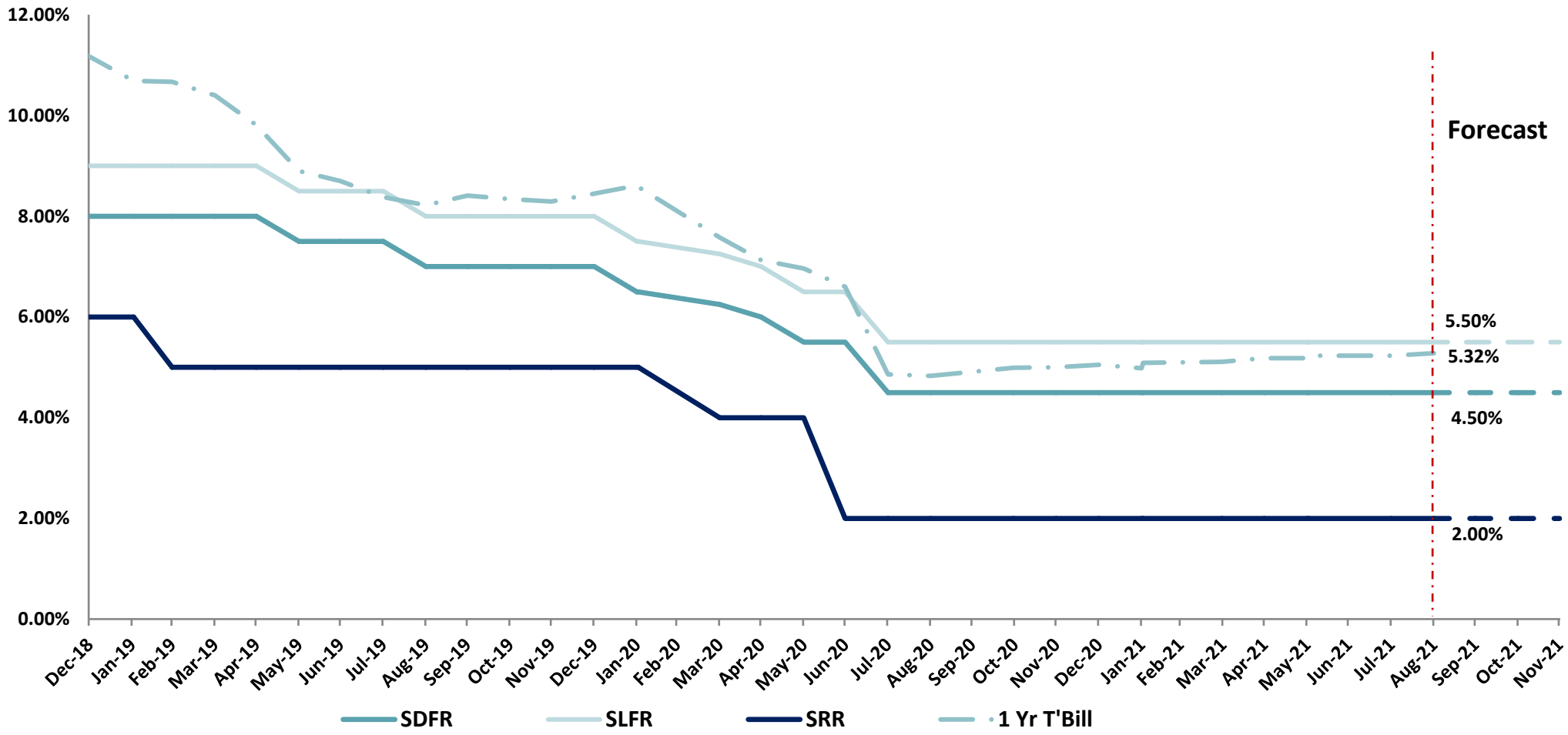
We believe that there is a 90% probability for policy rates to remain unchanged due to the measures taken by CBSL to stimulate the economy.

| 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% in 2020 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…"*