First Capital

"FURTHER TIGHTENING IN BRACING FOR GLOBAL SPILLOVERS"

PRE-POLICY ANALYSIS

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First Capital Research

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Previous Pre-policy report: Recap

CBSL tightened its policy stance

In-line with our expectations, at the previous policy meeting held on 19th Jan 2022, CBSL decided to increase the SDFR and the SLFR by 50bps each to 5.50% and 6.50%, respectively. This decision has been made along with other several measures in order to curtail the possible build-up of underlying demand pressures in the economy, which would also help ease pressures in the external sector, thus promoting greater macroeconomic stability. CBSL also stated that they expect a corresponding increase in interest rates, particularly in fixed deposits to encourage more savings and thereby discourage excessive consumption which also helps to lessen spending on import bills as well.

Key Arguments by CBSL for tightening its policy stance on 19th Jan 2022

- ✓ Economic activity is expected to record a gradual recovery following a temporary setback.
- ✓ External sector remains resilient amidst heightened challenges.
- ✓ Credit flows to the private sector continues to expand.
- ✓ Supply side factors remain the key driver of domestic price pressures amidst the possible signs of demand pressures.

Analysis of upcoming policy decision on 4th Mar

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

Arguments For Hike

80%

- **Rising inflation pose a potential threat**
- **Foreign reserves heading towards a deadly fall**
- **1Yr T-Bills get continuously rejected**
- **Credit market picks up**
- **Fed officials lean towards a rate hike**

Arguments Against Hike

20%

- **Pulling back monetary stimulus 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 for hike in monetary policy

1Yr T-Bills get continuously rejected at auctions while absorbing more demand for 03M T-Bills

The total accepted amount for 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 03M T-Bills given the lower yield on 1Yr bills vis-à-vis the 03M T-Bills which is currently trading at 8bps higher at 8.61% as opposed to 1Yr T-Bill. Currently, SLFR is at 6.50% while 03M T-bill rate in the secondary market is hovering around 8.45%-8.50% creating an arbitrage profit of *c.* 2.00% which is one of the highest in the history. On the other hand, following the results of the bond auction held on 25th Feb 2022, the secondary market yields of 01.08.25 maturity upheaved by *c.* 175bps to 13.00% and 15.01.33 maturity ticked up by around 50bps to 13.50% while pressuring up the yields on mid-long tenor maturities quoted by the market participants to that magnitude. Given the recent market developments and the prevailing negative real interest rates, another rate hike is needed to meet the return expectations of the market participants to regain market activeness.

Rising inflation pose a potential threat to a sustained economic recovery

Consumer prices reflected by CCPI rose to a record high of 15.1% in Feb 2022 fueled by the forex crunch and soaring global commodity prices, particularly the price of crude oil, which affects most of the business segments across the economy. High inflation in the food category emerged as a major concern in the Sri Lankan economy as the YoY Food inflation elevated by 25.7% in Feb 2022 from 25.0% recorded in Jan 2022 and 22.1% recorded in Dec 2021. Currency depreciation coupled with domestic food supply shortages are fueling the inflation to hover in double-digit levels moving dangerously above the CBSL's desired inflation target of 4.0%-6.0%. Apart from supply-side constraints, demand-pull effects such as low interest rate regime prevailed during the 1H2021 together with excessive money printing have given rise to the inflation in recent past. As a consequence, CBSL holdings of government securities displayed nearly a two-fold rise by LKR 691.6Bn for 2021 amidst the heightened government expenses in combating Covid-19 pandemic. Thus, it is time for a further policy rate advancement to negate the effects of demand-pull inflation.

Arguments for hike in monetary policy

Foreign reserves heading towards a deadly fall

Sri Lanka's gross official reserves dropped to USD 2.4Bn in Jan 2022 from USD 3.1Bn reported in Dec 2021 worsening the external liquidity situation. Repayment of USD 500Mn sovereign bond and other dollar denominated bonds have resulted in a further depletion of foreign reserves despite securing a swap facility of LKR 400Mn from India. Moreover, rising import bills and worsening trade deficit urged for a rate hike followed by a floating currency aiming to safeguard the foreign reserves while charming more FDIs into the country.

Credit market picks up and require less monetary stimulus

Private sector credit soared in 2021 recording a growth of 13.1% during the year, placing well within the desired target range of 12.0%-14.0% by CBSL as well as the First Capital Research projection of 13.5%. The cumulative credit granted by commercial banks to individuals and businesses amounted to LKR 810.5Bn in 2021 amidst the disruption of economic activities caused by the re-emergence of Covid-19 pandemic. Improvement in credit growth, which is a key barometer in ascertaining the health of the economy, is conveying positive signals that the economy is rebounding even with the forex crunch and inflation hits. Therefore, further monetary stimulus may not require in cushioning the economic growth and thereby paving the path for a rate hike at the upcoming policy meeting.

Fed officials lean towards a rate hike urging a global policy tightening

Looming aggressive move on policy rates at the upcoming FOMC (Federal Open Market Committee) meeting in Mar 2022 is disseminating global tensions especially on the emerging economies such as Sri Lanka. Fed aims to battle against soaring inflation and unemployment via hike in rates and this move will result in an increase in borrowing rates globally, especially in nations like Sri Lanka which has heavily relied on borrowing via dollarized bonds. Therefore, the spillover effect of looming fed rate hike may pressure local monitory authorities to adopt tightened policy measures. Furthermore, foreign investors may also be ready to shift their investments out of emerging markets towards the safe heaven instruments such as US Treasuries if the emerging nations like Sri Lanka fail to offer them more attractive interest rates.

Arguments against hike in monetary policy

Pulling back monetary stimulus may derail the potential recovery in GDP growth

Sri Lanka economy has embarked on a gradual recovery during 1Q and 2Q of 2021 recording a GDP growth of 4.3% and 12.3%, respectively recovering from a steep contraction in 2020. However, during 3Q 2021, economy exhibited a momentary contraction of 1.5% as a result of the imposition of nationwide quarantine curfew which disrupted activities in most part of the economy. Therefore, further pampering in terms of fiscal and monetary stimulus may require in near to medium term to stabilize the economic growth. Thus, a 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 plays 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.

Global policy actions are favouring the hawkish hopes

	Sep 2021	Oct 2021	Nov 2021	Dec 2021	Jan 2022
Net Change	+630 bps	+2,715 bps	+1,005 bps	+1,365 bps	+940 bps
Total Rate Cuts	110bps	200bps	100bps	105bps	410bps
Total Rates Rises	740bps	2,915bps	1,105bps	1,470bps	1,350bps
Rate Cuts	Turkey and Denmark	Turkey	Turkey	Turkey and China	Congo, South Sudan and China
Rate Rises	Moldova, Ukraine, Peru, Russia, Kazakhstan, Armenia, Azerbaijan, Pakistan, Hungary, Paraguay, Brazil, Norway, Czech Republic, Mexico, Jamaica and Colombia	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
Global Monetary Policy Rate	**5.02%**	**5.28%**	**5.38%**	**5.51%**	**5.60%**

Source: centralbanknews.info

Global central banks embarked on raising rates while Fed signaling more aggressive monetary tightening amidst firing inflation woes

What the Russia-Ukraine crisis means to Sri Lankan economy?

Sri Lanka as a country with strong diplomatic and trading ties with Russia is required to be on alert for any adverse or favourable developments of the tensions over Russia's invasion of Ukraine. Although some officials predict that the unfolding of conflicts between Russia and Ukraine may hinder Fed's aggressive move towards a tighter monetary policy, it may not change the course completely. Fed may opt for a softer landing given the add-on financial uncertainties upon Russia's invasion which welcomes inflation via further shocks in oil and other commodity prices. However, with the latest update that Russian and Ukrainian negotiators agreed on negotiation talks, there is a possibility of peace talks to get successful and the threat of the tension to wear off and thereby letting Fed to deploy its aggressively hawkish decisions as planned. In terms of the Sri Lankan context, the following effects may stem over this geopolitical tension.

Crude oil prices may skyrocket due to imminent supply shortages

The OPEC and allies led by Russia, collectively known as OPEC+ is in the verge of increasing their output targets for 2022 amidst the soaring oil prices. However, possible sanctions on Russia upon invasion of Ukraine may crack the output targets and thereby further fuelling the global prices. Sri Lanka, as a nation currently undergoing severe economic downturn with foreign reserves failing to accommodate essential supplies, may get further hammered at a higher degree out of this move.

Weighing negative effects on Tourism and Tea may worsen the BoP

With the reopening of boarders and gradual rebound of tourism in Sri Lanka following the Covid-19 pandemic, Russia and Ukraine were identified as the biggest source markets for tourist arrivals in Sri Lanka. Therefore, this geopolitical tension is prone to have a negative effect on the earnings from tourism and worsen the Balance of Payments (BoP). Furthermore, Russia is one of the largest buyers of Sri Lankan tea. Therefore, any global sanctions for Russia may adversely effect export earnings and thereby adding further pressure on the trade balance.

Factors of concern at the policy review

Inflation
CCPI 15.1% - Feb 2022

Foreign Reserves
USD 2.4Bn - Jan 2022

GDP Growth
-1.5% - 3Q2021

03M T-Bill rate
8.61% as of 23.02.22

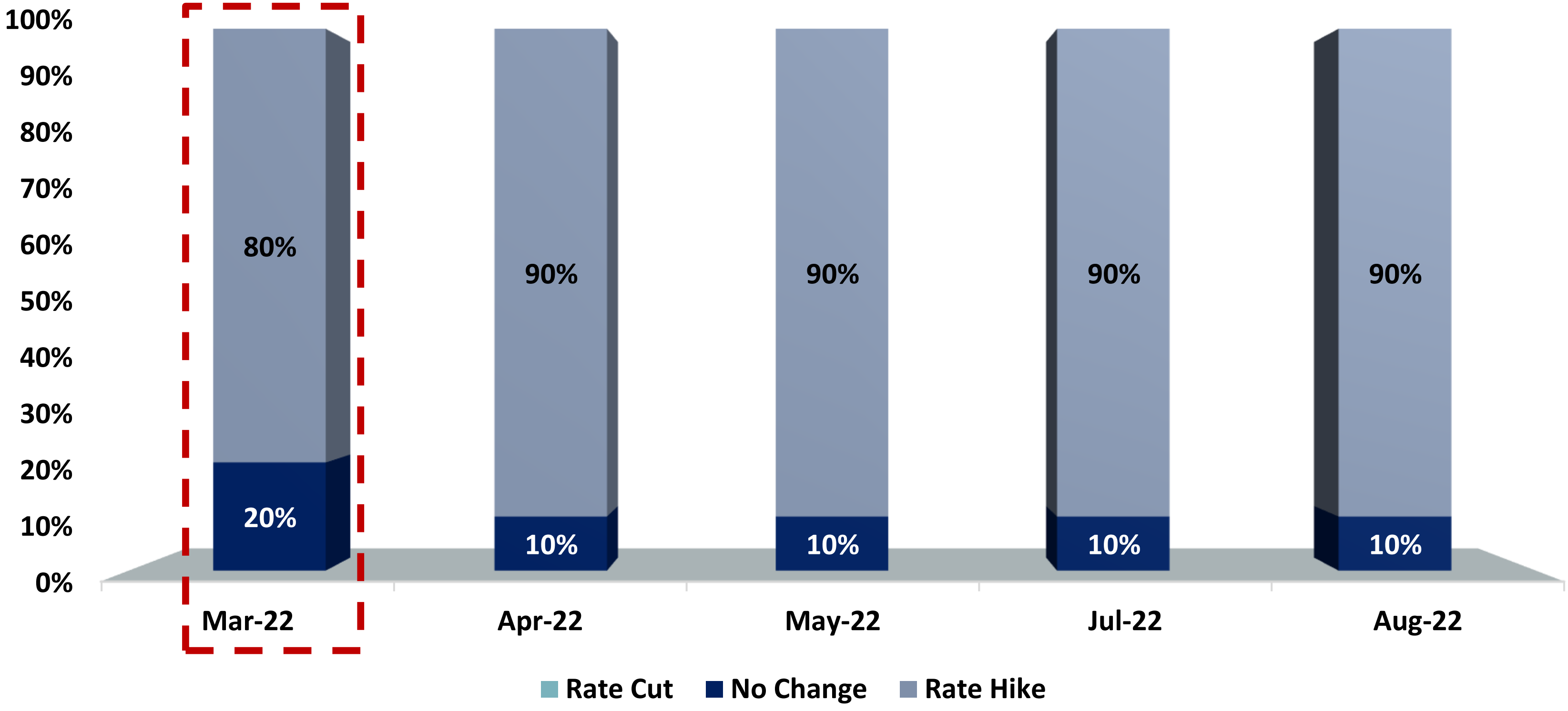
Private Credit
LKR 61.3Bn - Dec 2021

Liquidity and CBSL Holdings
LKR -651.88Bn and LKR 1.53Tn

BOT and BOP
USD -8.1Bn and USD -4.0Bn
for Jan-Dec 21

FCR Policy Rate Forecast – Mar 2022-Aug 2022

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 probability of 20% 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.



We expect 80% probability for a rate hike at the upcoming policy meeting.

Source: CBSL, First Capital Research Estimates

Expected Monetary Policy Stance

As per our view, CBSL either can choose to hike policy rates by 50bps, 100bps or 200bps or hold policy rates steady, while a rate cut is off the table due to the continuous depletion of foreign assets and high debt repayment requirement. We believe that there is 80% probability for a rate hike due to the remedial actions required in achieving macroeconomic stability. However, there is also a 20% probability 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 200bps	**10%**
Raising Policy Rates by 100bps	**30%**
Raising Policy Rates by 50bps	**40%**
Policy Rates to remain unchanged	**20%**
Cutting Policy Rates by 50bps	0%

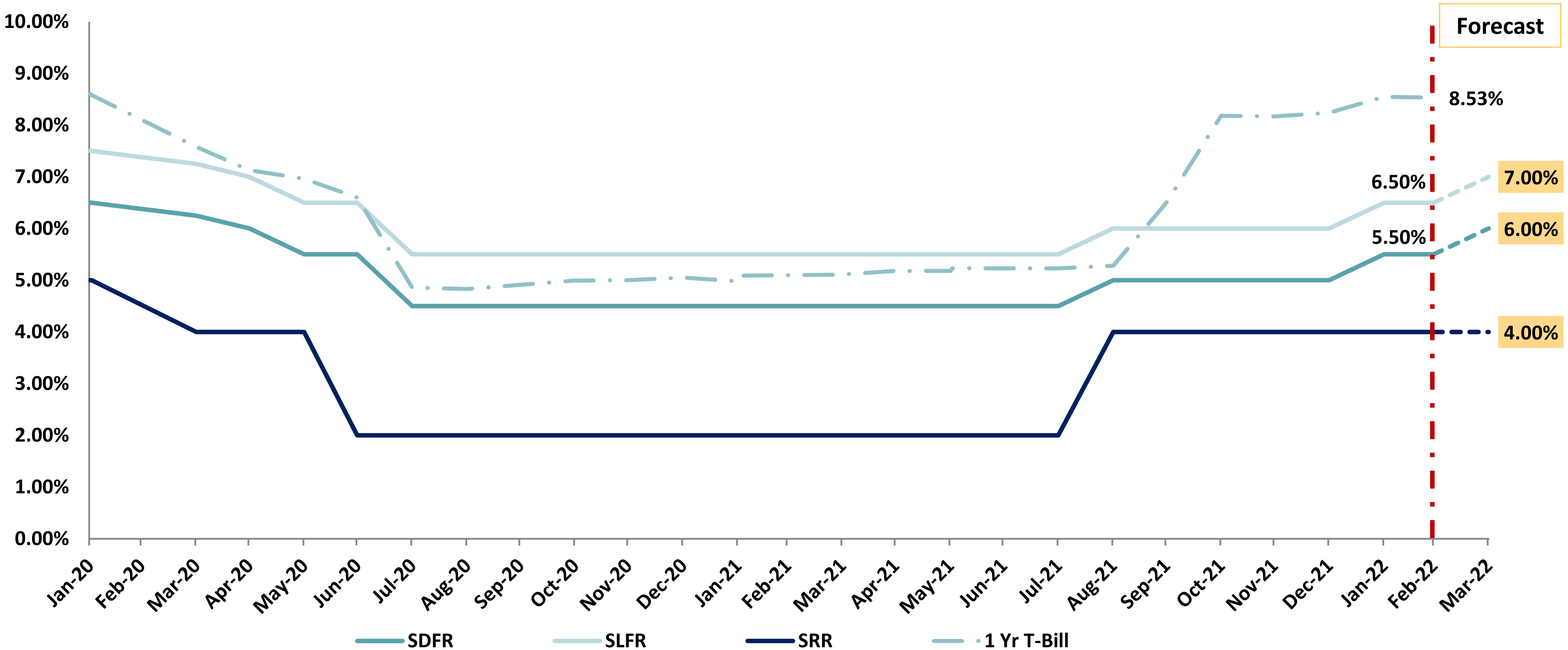
80%

We believe that there is 80% 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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"Successful Investment Is About Managing Risk..."

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