First Capital

# *"The end of easy money era?"*

PRE-POLICY ANALYSIS

12TH JAN 2022

**First Capital Research**

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# Previous Pre-policy report: Recap

50/50



## CBSL maintained its policy stance

**In the previous pre-policy report,** we assigned an equal probability for a rate hike and no change in policy rates for the policy meeting held on 25th Nov 2021, assuming there is a potential for CBSL to gradually move into the hawkish path and at the same time there is a substantial room to maintain rates as well. Consequently, CBSL maintained its monetary policy stance while the Board noted that recent acceleration of inflation was driven mainly by supply disruptions and the surge in global commodity prices and reiterated its commitment to maintaining inflation at the targeted levels over the medium term with appropriate measures, while supporting the economy to reach its potential in the period ahead.

### Key Arguments by CBSL for maintaining its policy stance on 25th Nov 2021

- ✓ The Sri Lankan economy is in the gradual recovery process and the removal of COVID-19 related lockdown measures in Oct 2021 and the successful nationwide COVID-19 vaccine rollout would help activity in the period ahead.
- ✓ The external sector remains resilient against strong headwinds.
- ✓ Market interest rates have increased, reflecting the pass-through of tight monetary conditions.
- ✓ Inflation accelerated recently mainly due to supply-side disturbances and the surge in commodity prices internationally.

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

*50%*

# Analysis of upcoming policy decision on 20th Jan



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

**40%**

**Arguments against hike**

- **GDP growth needs further acceleration: COVID-19 threat still looms**
- **Secondary market yields eased with improved market sentiment**
- **Cost push inflation cannot be addressed via monetary tightening**

**Arguments for hike**

**60%**

- **All eyes on dwindling foreign reserves and foreign currency exchange**
- **Private sector credit recovers in Nov 21 recording three month high**
- **CBSL holdings tops while inflation menace emerge**
- **Global central banks are displaying a welcome pivot towards a tightening stance**
- **To curtail the arbitrage profit making through SLFR**

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

# Global policy actions are favouring the hawkish hopes



| | Aug 2021 | Sep 2021 | Oct 2021 | Nov 2021 | Dec 2021 |
|---|---|---|---|---|---|
| Net Change | +55 bps | +630 bps | +2,715 bps | +1,005 bps | +1,365 bps |
| Total Rate Cuts | 500bps | 110bps | 200bps | 100bps | 105bps |
| Total Rates Rises | 555bps | 740bps | 2,915bps | 1,105bps | 1,470bps |
| Rate Cuts | Liberia | Turkey and Denmark | Turkey | Turkey | Turkey and China |
| Rate Rises | Armenia, Georgia, Brazil, Czech Republic, Uruguay, Mexico, Peru, Sri Lanka, Paraguay, Hungary, Iceland, South Korea and Chile | 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 |
| **Global Monetary Policy Rate** | **5.01%** | **5.02%** | **5.28%** | **5.38%** | **5.51%** |

***Source: centralbanknews.info***

Global central banks fuel new bets on Tighter money amidst stubbornly high inflation around the world although ECB is an exception

# *Arguments for hike in monetary policy*

### All eyes on dwindling foreign reserves and foreign currency exchange

Sri Lanka encountered another sovereign rating downgrade in Dec-21 by Fitch to 'CC' from 'CCC', amidst increased probability of a default event in coming months in light of worsening external liquidity position and considering foreign reserves which slumped to USD 1.6Bn in Nov-21 from USD 2.1Bn in Oct-21 (although it improved to USD 3.1Bn by Dec-21). We believe that increasing interest rates should be the "need of the hour" and CBSL should shift gears to engineer a "soft landing" in order to preserve foreign exchange while promoting the economic stability of the country.

### Private sector credit recovers in Nov-21 recording three month high

Credit to the private sector, which is considered as an important barometer of the economic health, recovered in Nov-21 from Oct-21 indicating that the economy is on a recovery phase after the end of mobility restrictions. Nov-21 credit translated into a 13.5% annual growth and YTD growth of 12.1% well within the desired range of 12.0%-14.0% projected for 2021 by CBSL and First Capital Research. Therefore, we believe that even with policy rate hike in Aug-21, interest rates still remain at accommodative levels. Consequently, interest rates wouldn't be a deterrent until at least a few rate hikes and some degree of monetary tightening will be required to restore price stability.

### CBSL holdings tops while inflation menace emerge

Inspired by MMT, CBSL holdings increased up to LKR 1.4Tn with overnight liquidity injections topping above LKR 350.0Bn. In the midst of continuous stimulus, inflation reached 12.1% in Dec-21, highest since Jan-09, breaking country's 12 Yr record of maintaining single-digit inflation. Although inflation is majorly created through supply-side factors, we expect excess money created through CBSL holdings to chase behind premium products further aggravating the situation. Therefore, CBSL can pivot towards a more "hawkish" stance leaning towards fighting inflation in order to prevent further overheating.

# *Arguments for hike in monetary policy*

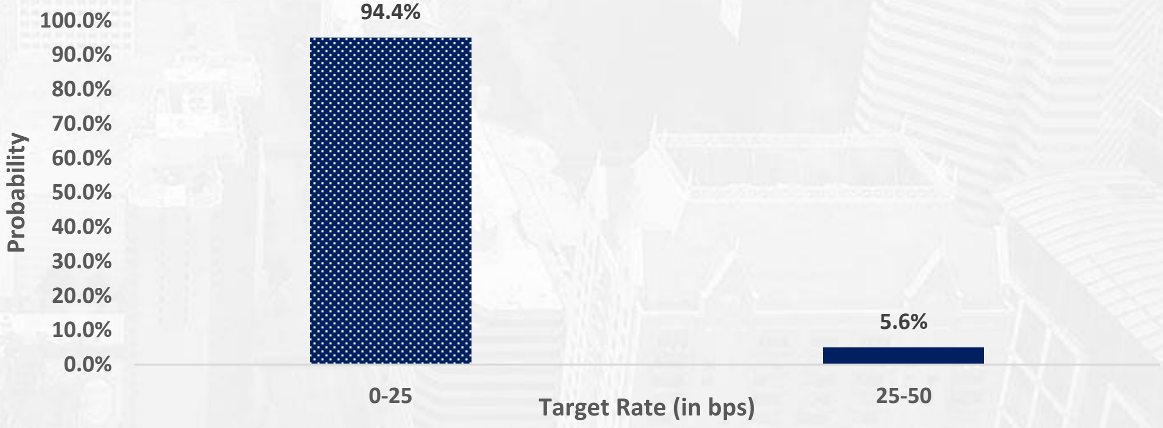

REUTERS
January 10, 2022
3:08 PM +0530
Last Updated 17 hours ago
U.S. Markets
IMF says emerging economies must prepare for Fed policy tightening


CNBC
MARKETS BUSINESS INVESTING TECH POLITICS CNBC TV WATCHLIST CRAMER PRO
FEDERAL RESERVE
Goldman predicts the Fed will hike rates four times this year, more than previously expected
PUBLISHED MON, JAN 10 2022-7:35 AM EST | UPDATED MON, JAN 10 2022-9:32 AM EST

## Global central banks are displaying a welcome pivot towards a tightening stance

Stubbornly high inflation across more wealthy economies last week prompted a shakeout in bond markets as investors began expecting central banks to quickly tighten monetary policy. This has resulted in Sri Lanka remaining with little choice but to follow suit, as investors tend to shift funds from emerging and developing markets to developed market treasuries, which provide positive returns with little risk when compared to markets with lower ratings. The European Central Bank stated on 16th Dec 2021, that its pandemic-era bond-buying program will stop in March, but that it would attempt to ease the transition by promising more help for the Eurozone economy in the coming year given the uncertainty caused by the latest variant of the coronavirus. Two other major central banks have taken an aggressive approach. The Bank of England raised the bank's interest rate by 15bps to 0.25% while the U.S. Federal Reserve signaled that it would end its pandemic-era bond purchases in Mar-22 and has penciled in three rate hikes for 2022.

**Target rate probability for 26th Jan 2022 Fed meeting**



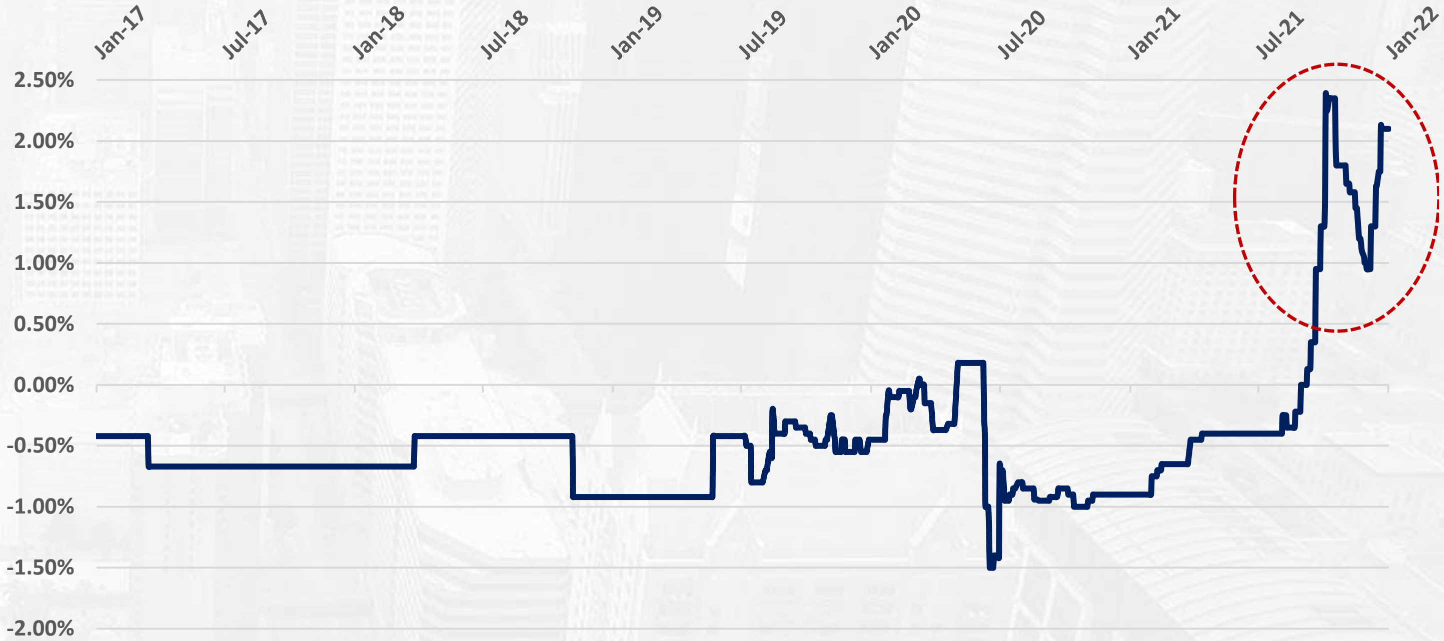

*Source: CME group*

# Arguments *for* hike in monetary policy

## To curtail the arbitrage profit making through SLFR

CBSL conducts its monetary policy under a system of active OMOs. The key elements of the system are an interest rate corridor formed by the main policy rates i.e. Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), and Open Market Operations. SLFRs are available for banks/financial institutes to cover their liquidity shortages. Currently, SLFR is at 6.00% while 03M T-bill rate in the secondary market is hovering between 8.20%-8.00% (8.38% in the primary market as at 12.01.22) creating an arbitrage profit above 2.00% which is one of the highest in the history. Therefore, in order to prevent banks and financial institutions from making arbitrage profits using low SLFR, a rate hike would be inevitable.

**Gap between 3M T-Bill (secondary market) and SLFR**




*Source: CBSL and First Capital Research*

# *Arguments against hike in monetary policy*

### GDP growth needs further acceleration: COVID-19 threat still looms

Sri Lankan economy recorded -1.5% economic growth rate for the 3Q2021, reflecting the negative impact of the quarantine curfew imposed throughout Sri Lanka from 20th Aug to 1st Oct. Therefore, further bolstering is required in terms of the monetary and fiscal stimulus in sustaining the growth momentum achieved so far. Thus, a monetary tightening may act contrary to the Govt's GDP growth and development objectives and is expected to keep a lid on rising policy rates.

### Secondary market yields eased with improved market sentiment

Despite the fact that rates on government securities have shoot higher in Nov-Dec 2021 witnessing a sharp upward shift in the yield curve across the maturities, yields in the secondary market stabilized with the regained confidence with the boosted foreign reserves up to USD 3.1Bn amidst the drawdown on the existing currency swap facility with the People's Bank of China (PBOC) and with brimmed hopes on further foreign inflows in 2022. Therefore, we consider that market participants are complacent with the prevailing yields while not requiring further policy hikes at the upcoming policy meeting.

### Cost-push inflation cannot be addressed via monetary tightening

As mentioned before, higher inflation witnessed was mainly attributable to the increase in food prices impacted by the supply shortages and rise in global commodity prices, implying a cost-push inflation. Therefore, one may argue that any remedial action via tightening monetary policy may not justify the density of the current inflation.

# Factors of concern at the policy review



Inflation
CCPI 12.1% - Dec 2021

Foreign Reserves
USD 3.1Bn - Dec 2021

GDP Growth
-1.5% - 3Q2021

03M T-Bill rate
8.38% as at 12.01.22

Private Credit
LKR 60.5Bn - Nov 2021

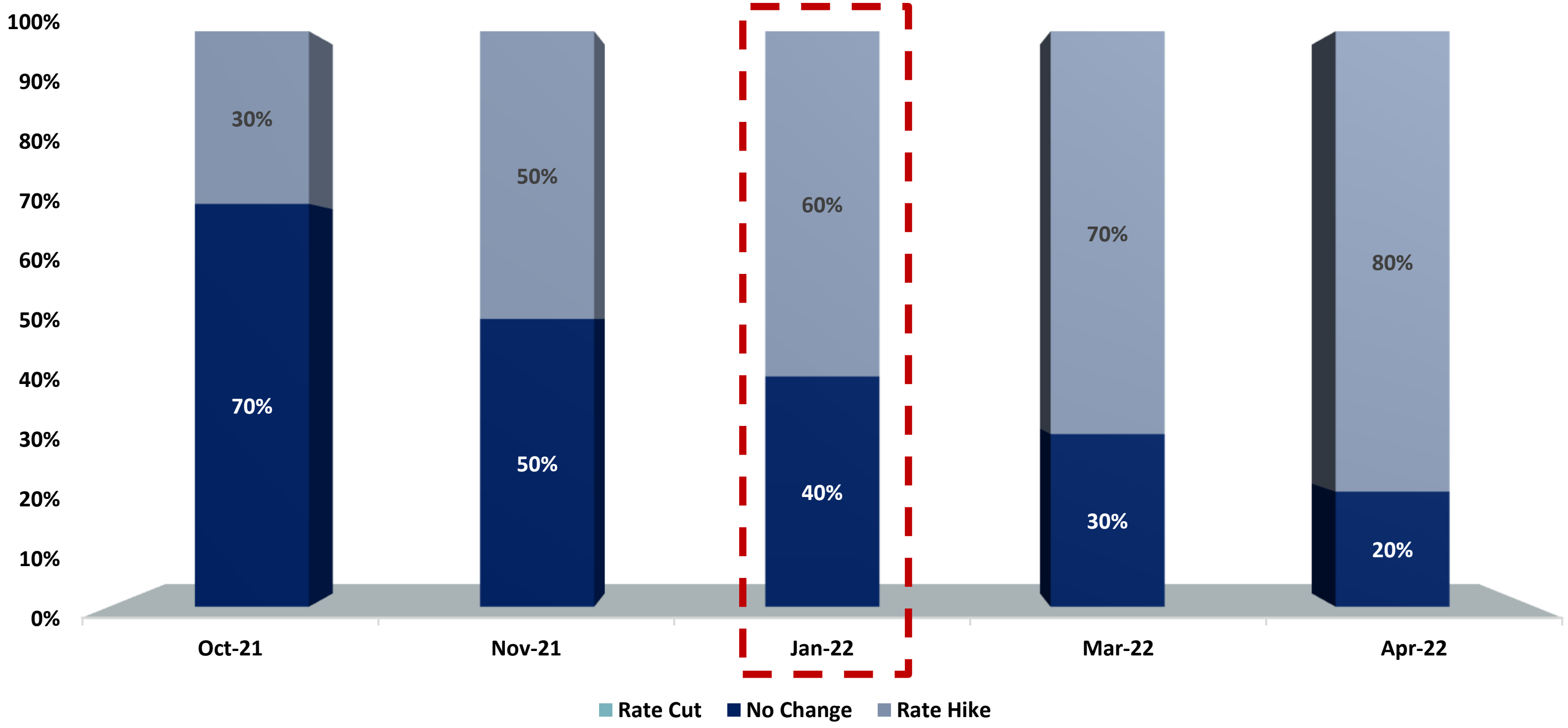
Liquidity and CBSL Holdings
LKR -364.0Bn and LKR 1.42Tn

BOT and BOP
USD -6.5Bn and USD -3.3Bn
for Jan-Oct 21

# FCR Policy Rate Forecast – Jan 2022-Apr 2022



We believe that CBSL may highly consider ***tightening the monetary policy rates in this policy review but*** given the concerns over economic growth, there is a probability of 40% 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 a 60% 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 hike policy rates by 50bps or 100bps or hold policy rates steady, while a rate cut is off the table due to the high debt repayment and the high domestic borrowing requirement. We believe that there is a 60% probability for a rate hike due to the remedial actions required in achieving external stability. However, there is also a 40% 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 100bps** | **10%** |
| **Raising Policy Rates by 50bps** | **50%** |
| **Policy Rates to remain unchanged** | **40%** |
| Cutting Policy Rates by 25bps | 0% |
| Cutting Policy Rates by 50bps | 0% |

*60%*

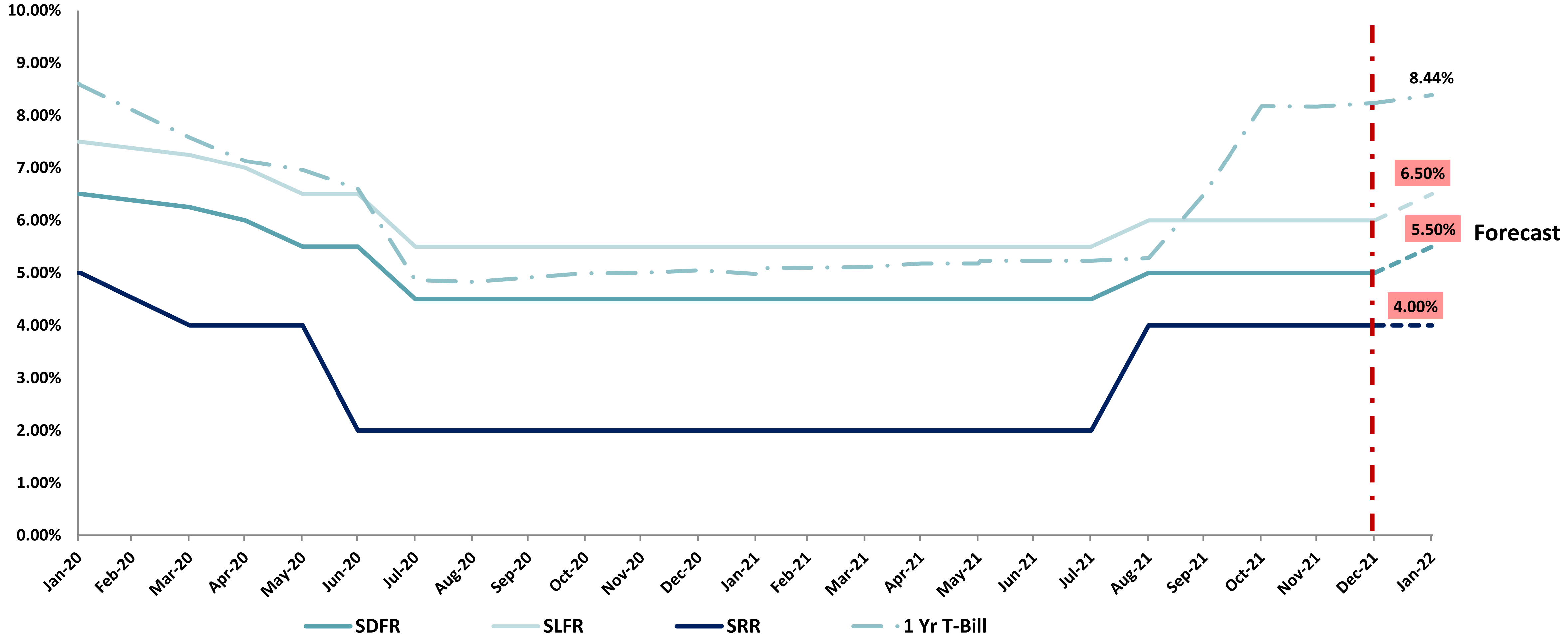
We believe that there is a 60% probability for a policy rate hike in warranting for greater economic stability.

| 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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