



First Capital

“CBSL INCHING TOWARDS TAPER TANTRUM”

PRE-POLICY ANALYSIS

02ND JUL 2021

First Capital Research

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CBSL maintained its policy stance

In-line with our expectations, at the previous policy meeting held on 20th May 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 20th May 2021

- ✓ The third wave of COVID-19 pandemic has disrupted the ongoing recovery of economic activity.
- ✓ The external sector remains resilient despite a multitude of challenges.
- ✓ Prevailing historically low interest rates have resulted in an acceleration of private sector credit.
- ✓ Inflation is expected to remain within 4-6 per cent range in the near to medium term, while any pressures over the medium term will be addressed with appropriate measures.

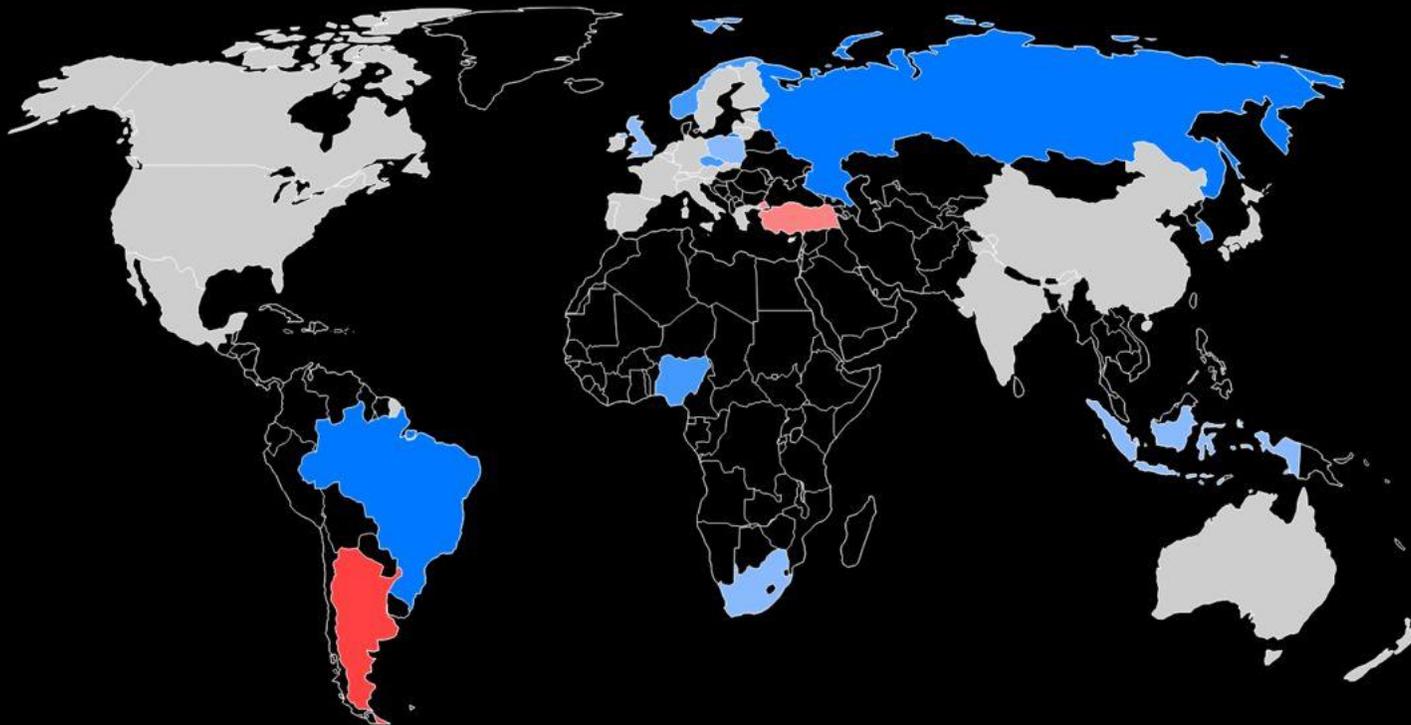


It's the Beginning of the End of Easy Money

The Bloomberg Central Bank Outlook

How interest rates will change by the end of 2022

- Hiking in 2021
- Hiking in 2021 and 2022
- Hiking in 2022
- Hiked already, cuts predicted in 2021 and 2022
- On hold in 2021, cuts predicted in 2022
- On hold through 2022



Source: Bloomberg Economics forecasts, survey of economists for Switzerland, Poland, Czech Republic
Note: Mapped data show rate decision forecasts for distinct central banks. Russia predicted to cut in 2022, but rate at end of that year still higher than it is now

Central banks are gradually tip-toeing away from emergency stimulus already deployed to fight the pandemic-driven global recession.

Central banks expect the recent surge in inflation to soon wither away assuming it to be temporary due to the sudden opening up of the economy while they also pledged to avoid a roil in financial markets.

Sri Lanka To follow the path



First Capital Research expects CBSL to change from ***Dovish*** to ***Hawkish*** Policy due to the following reasons:-

- ❑ Foreign reserves dropped to 10-year low of USD 4.0Bn in May 2021.
- ❑ Private Sector credit moving in par with CBSL expectations.
- ❑ Excess liquidity in Sri Lanka's money markets system is adequate, but on a reducing trend falling below LKR 100.0Bn.
- ❑ Potentially higher expectation of inflation beyond the CBSL's targeted bands.

Thereby, First Capital Research move away from possible relaxations to monetary policy and considers to estimate potential hikes to monetary policy.

Analysis of upcoming policy decision on 08th Jul

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



95%
Arguments against hike

- Downside risk to GDP growth
- Pvt. Credit just returns to normalcy
- CBSL avail itself of Modern Monetary Theory (MMT)

- Elevated yields in Govt. Sec secondary market
- Low interest rates and a pegged USD further adds pressure on exchange rate

Arguments for hike

05%



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

Arguments *against* Hike in monetary policy



Downside risk to GDP growth

The resurgence of COVID-19 infections and the accompanying restrictions could be a setback for the nascent economic recovery. The near-term GDP outlook for the Sri Lankan economy is clouded with accentuation of downside risks and potential externalities of global spillovers. These downside risks include the resurgence of possible multiple waves of the pandemic, slower than expected pace of vaccination, staggered pace of unlock (reflected by a jump in **Oxford's Stringency Index** for Sri Lanka from 59 at the start of May 2021 to 85 during the month of Jun 2021), drop in consumer confidence, low-capacity utilization which can impede the recovery in private investment. Any consideration of hikes may dampen, the already 'low' growth prospects of the economy.



Pvt. Credit just returns to normalcy

Private sector credit increased by LKR 55.6Bn in May 2021 to LKR 330.6Bn Jan-May 2021 indicating a sign of gradual improvement in economic activities amidst continual support from monetary stimulus. YTD growth stands at 5.4% broadly on par with First Capital Research expectation of c.12% for 2021E, LKR 740.5Bn of private credit by year end 2021E. With credit flowing in-line with the expectation, changes to monetary policy is unlikely to materialize.



CBSL avail itself of Modern Monetary Theory (MMT)

CBSL continues to infuse ample liquidity into the banking system via increased CBSL holdings which also supports fiscal shortage. The CBSL holdings rose to LKR 919.24Bn on 1st Jul 2021 from 874.02Bn as of 13th May 2021. CBSL's continuance in quantitative easing strategy prevents any moves towards a hiking cycle for policy rates.

Arguments *for* hike in monetary policy



Elevated yields in Government Securities secondary market

Yields in the secondary market witnessed an increase with moderate market activity from participants followed by a wait and see approach amidst the looming uncertainty. The last 17 Bill auctions were undersubscribed by a considerable amount reflecting the lack of clarity among market participants with the current economic condition. We consider that a rate hike may support CBSL in raising additional funding via Government Securities.

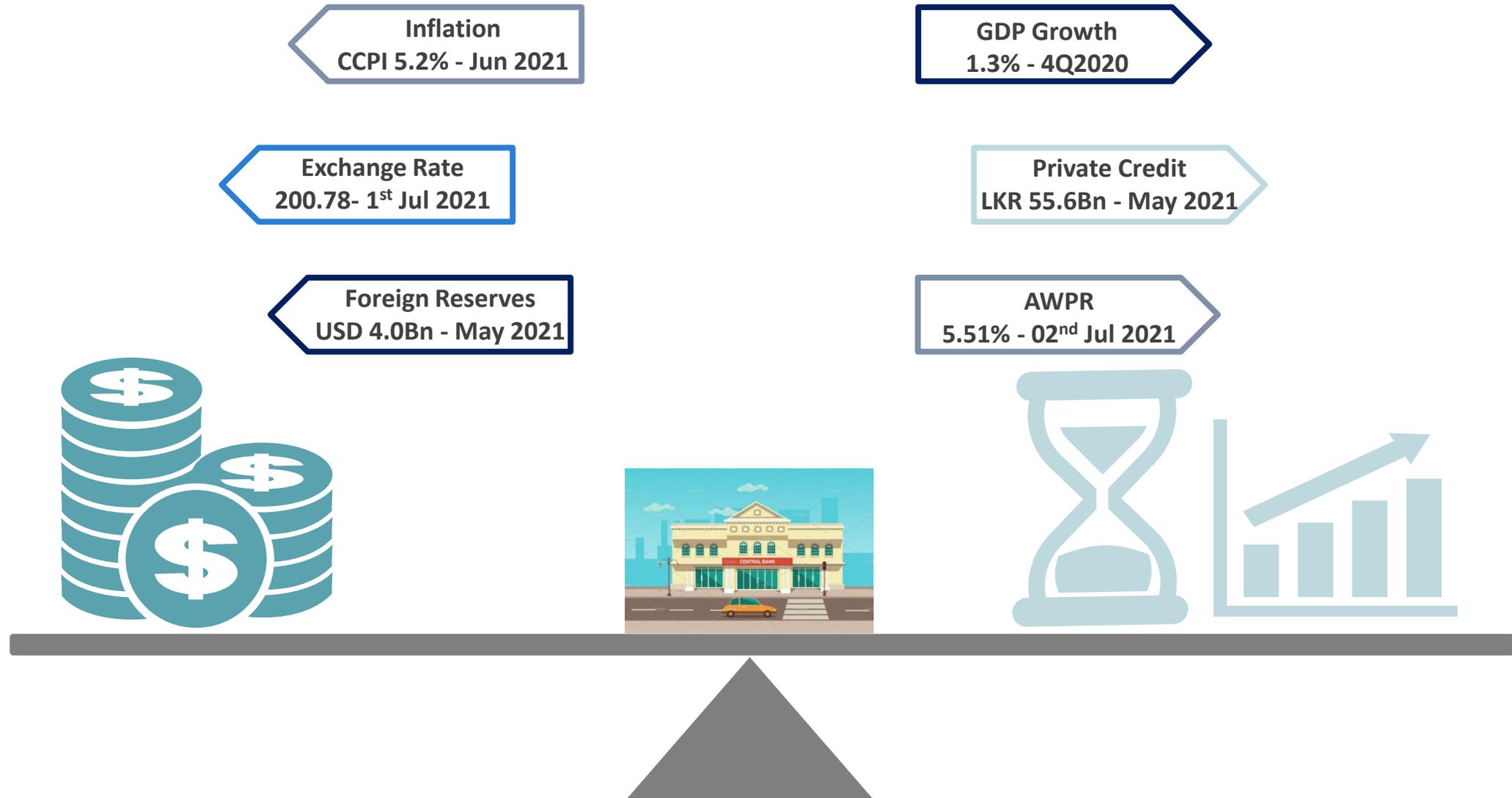


Low interest rates and a pegged USD further adds pressure on exchange rate

Despite the import restrictions imports have been in a rising trend expanding SL's trade deficit. In Mar 2021 imports were at a 3 year high with Apr following a similar suit, in spite of the prevailing import restrictions. Amid restrictions on forex transactions, USD:LKR has plunged by 7.8%YTD to LKR 200.78. The Low interest rate environment is gradually fueling consumer demand influencing the spike in imports. The Rising interest rate may gradually ease the pressure on the exchange rate.

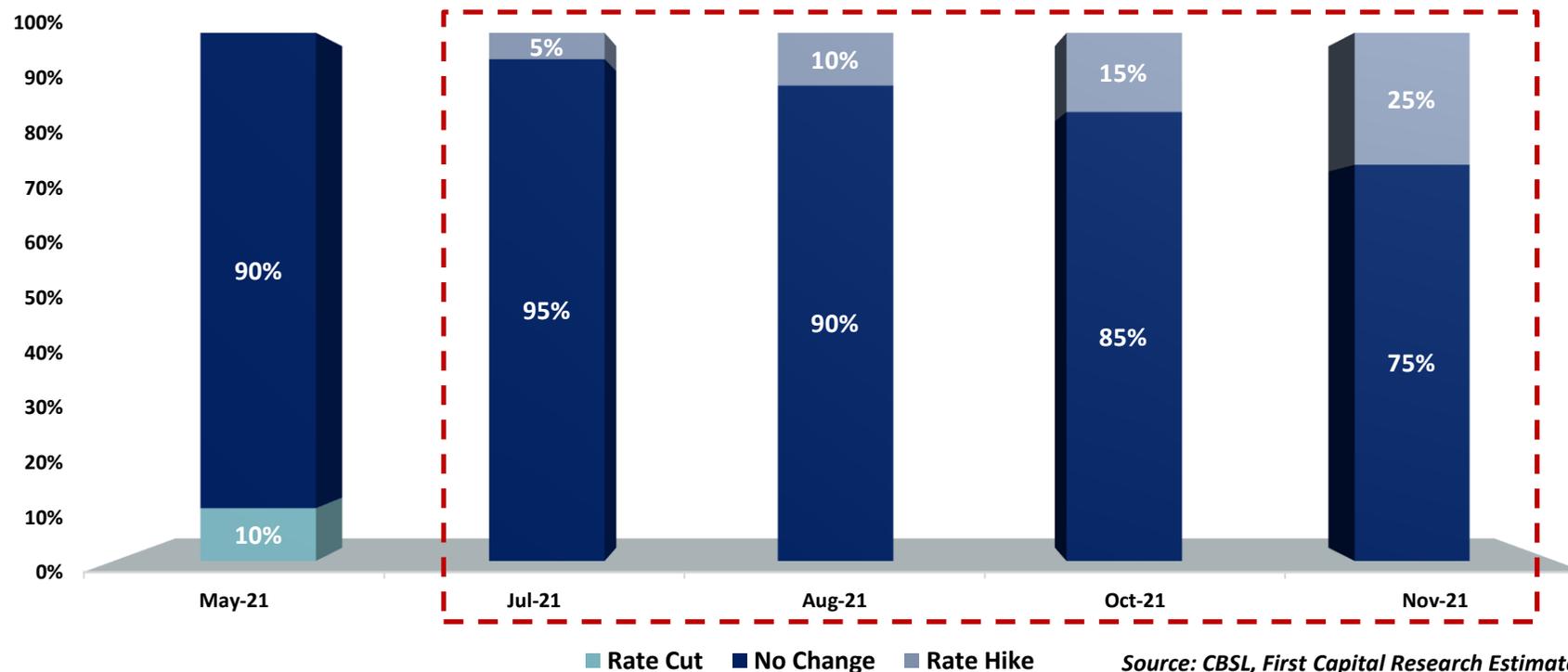


Factors of concern at the policy review



FCR Policy Rate Forecast – Jul-Nov 2021

We believe that CBSL may consider to *maintain the same policy stance in this policy review as well*, but given the concerns around economic uncertainty and considerable improvement in high frequency indicators to prevent an overheating of 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 5% 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 (95%) 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 5% probability for 25bps rate hike to balance external pressure.

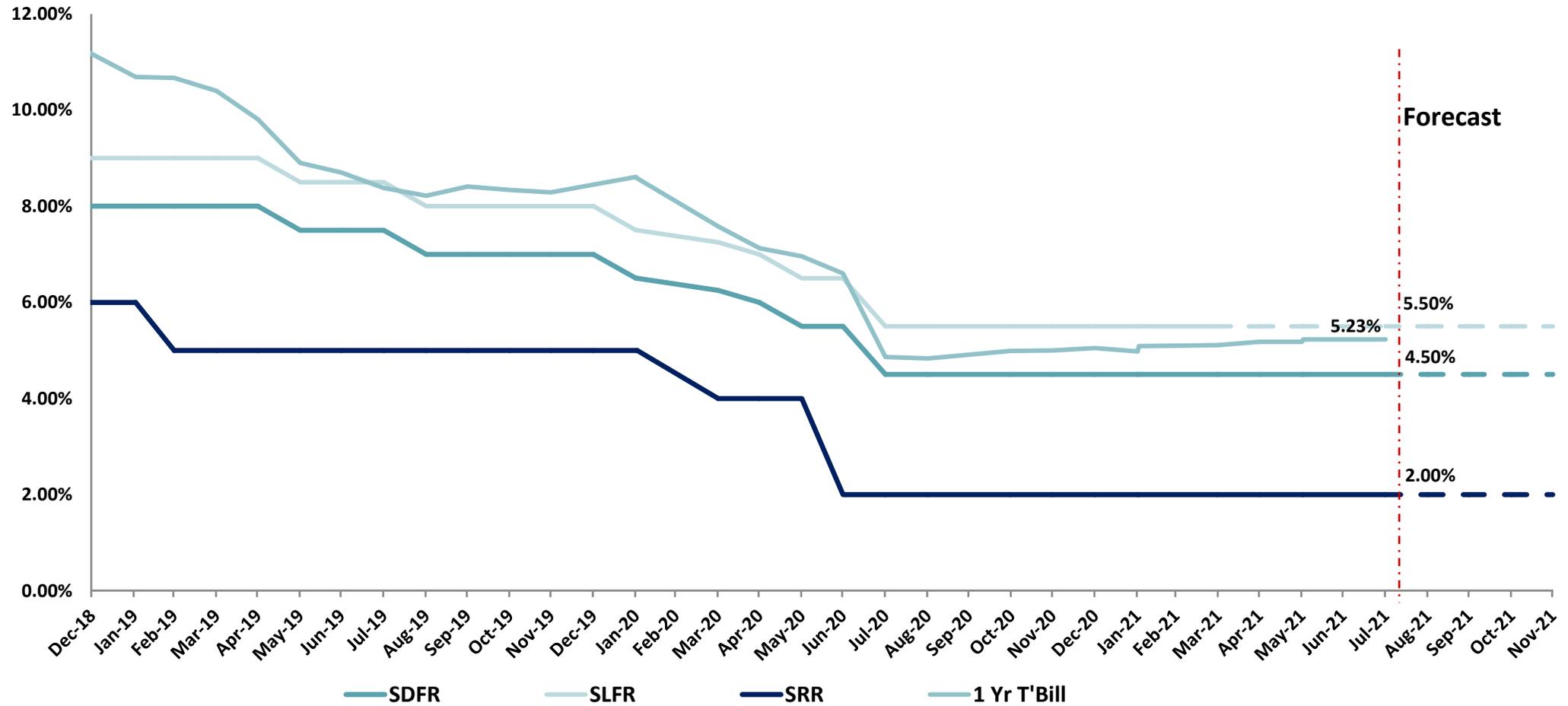
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	5%
Policy Rates to remain unchanged	95%
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

We believe that there is a 95% 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..."