First Capital

"CBSL TO ANCHOR RATES STEADY AS INDICATORS ARE ON THE ROAD TO RECOVERY"

PRE-POLICY ANALYSIS

11TH MAY 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 03rd Apr 2021, CBSL maintained its monetary policy stance, amidst the prevailing low inflation environment and well anchored inflation expectations. CBSL also observed the stronger than expected growth performance towards the end of 2020 and underscored the need for maintaining the prevailing low interest rate structure to support the sustained economic recovery in the period ahead.

Key Arguments by CBSL for maintaining its policy stance on 03rd Apr 2021

- ✓ The global economy is expected to recover faster than expected, supported by policy stimulus measures and the rollout of COVID-19 vaccines.
- ✓ The Sri Lankan economy rebounded notably from the effects of the COVID-19 pandemic.
- ✓ External sector remains resilient despite some near term challenges.
- ✓ Market interest rates declined to historic lows, reinforcing the recovery of activity.
- ✓ Credit to the private sector expanded notably thus far in 2021, reflecting the impact of growth supportive policies.
- ✓ Inflation is expected to remain subdued in the near term and any upward pressure over the medium term could be mitigated, to a large extent, by the envisaged supply side improvements.

Analysis of upcoming policy decision on 20th May

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

90%

Arguments against further easing

- **Private Credit in Mar 2021 soars to one year high**
- **Ample liquidity in the system to support the growth story**
- **Third Wave of COVID-19 to have a lesser bearing relative to last year**
- **Further low interest rates to pose negative implications on exchange**

Arguments for further easing

10%

- **Current Govt. underscore the need for aggressive growth trajectory**
- **Treasury yields heading north with auctions getting undersubscribed consecutively**

Above mentioned factors spur a further leeway of a rate cut at the up coming policy meeting.

Arguments against further relaxation in monetary policy

Private Credit in Mar 2021 soars to one year high

Private credit, one of the key gauge of the economy, increased by LKR 112.2Bn in Mar 2021 recording a growth for the 8th consecutive month indicating a revival in gross loan disbursements. Growth reflects that both businesses and individuals are speeding-up economic activities. CBSL has set a target of 14% to grow private sector credit while YTD credit growth figure of 2.57%, nearly marks an achievement of one quarter of the total credit earmarked for the entire year, indicative of that the full year target is within the reach. Despite the fact that third wave may create a temporary slow down, low interest rates are expected to be a sweetener to propel the demand for private credit in 2021.

Ample liquidity in the system to support the growth story

CBSL continued to infuse ample liquidity into the banking system via increased CBSL Holdings which also supports fiscal shortage. Despite the volatilities, liquidity continued to remain in the positive territory and remained above LKR 100.0Bn since 19th Apr 2021.

Third Wave of COVID-19 to have a lesser bearing relative to last year

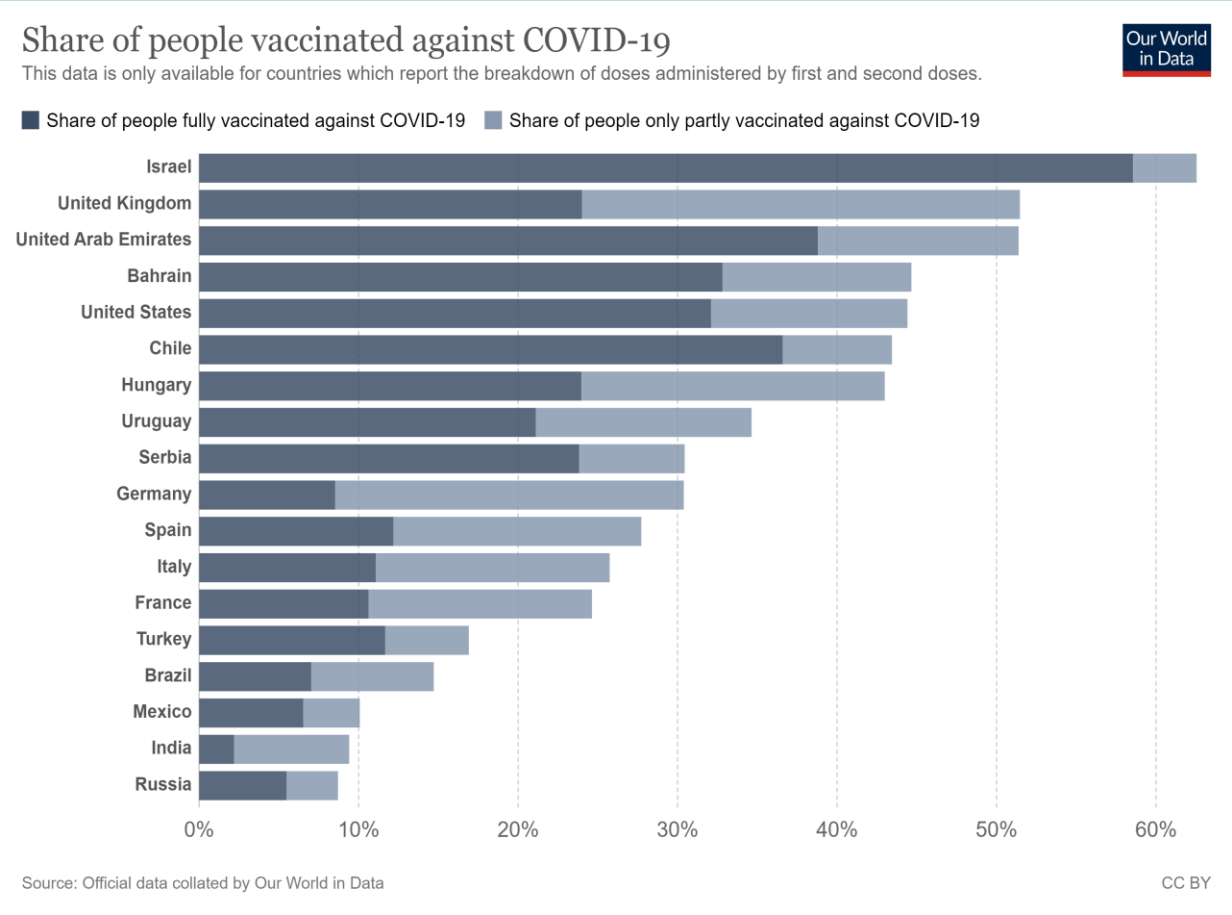
In contrast to the detrimental impact witnessed last year amidst 1st wave of COVID-19 and the complete lock down, the impact of the 3rd wave appears to be lesser as the Govt. rule out complete lockdown to ensure that economy heal with minimal scarring. Moreover, rejuvenation of the vaccination program and better preparation are expected to bolster the economic sentiment, despite a temporary slow down expected in 2Q2021.

Arguments against further relaxation in monetary policy

Further low interest rates to pose negative implications on exchange

Lower interest rates have a negative impact on the exchange rate as it can cause to lose foreign capital causing the exchange rate to decline. Despite the import restrictions, YTD USD:LKR has plunged by 6.3% to LKR 197.2 against the greenback and further rate cuts could lead to a plunge in foreign exchange. Therefore, in order to preserve the foreign currency which is considered to be the talk of the town, further rate cuts are unlikely.

An end to the pandemic is in sight for some advanced economies amidst the vaccination rollout



Source: Our World in Data

The global economy is recovering from the coronavirus pandemic faster than previously expected, largely thanks to the strength of the United States, but the IMF warned that major challenges remained as the uneven rollout of vaccines threatens to leave developing countries behind."

-The New York Times-
06th Apr 2021

Rate hikes are on the horizon for global economies?

"Rates may have to rise to prevent overheating"

-Janet Yellen-
U.S. Treasury secretary

	Jan 2021	Feb 2021	Mar 2021	Apr 2021	May 2021
Net Change	+275 bps	+600 bps	+110 bps	+25 bps	+125 bps
Total Rate Cuts	25 bps	50 bps	300 bps	500 bps	0 bps
Total Rates Rises	300 bps	650 bps	410 bps	525 bps	125 bps
Rate Cuts	Romania	Mexico and Indonesia	Congo	Congo	None
Rate Rises	Mozambique	Armenia, Tajikistan, Zambia, Zimbabwe and Kyrgyz Republic	Ukraine, Denmark (technical adjustment rather than monetary policy stance change), Georgia, Brazil, Turkey and Russia.	Belarus, Ukraine, Russia, Kyrgyzstan, Georgia and Tajikistan	Armenia and Brazil
Global Monetary Policy Rate	**4.50%**	**4.85%**	**4.89%**	**4.86%**	**4.87%**

Source: centralbanknews.info

Arguments for further relaxation in monetary policy

Current Govt. underscore the need for aggressive growth trajectory

First Capital Research estimates that Sri Lanka's GDP would recover to 3.2% in 2021E, from its expected steepest contraction in the history of -5.8% in 2020. Moreover, SL govt. aims at achieving an economic growth of 6.0% or higher for 2021. In addition, further need to improve the demand for credit, fragile consumer demand recovery and import restrictions can be considered as the major factors favouring to ease policy rates at the upcoming meeting.

Treasury yields heading north with auctions getting undersubscribed consecutively

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 6 Bond auctions and 10 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 cut would be required to sustain the secondary market rate at lower levels.

Factors of concern at the policy review

Inflation
CCPI 3.9% - Apr 2021

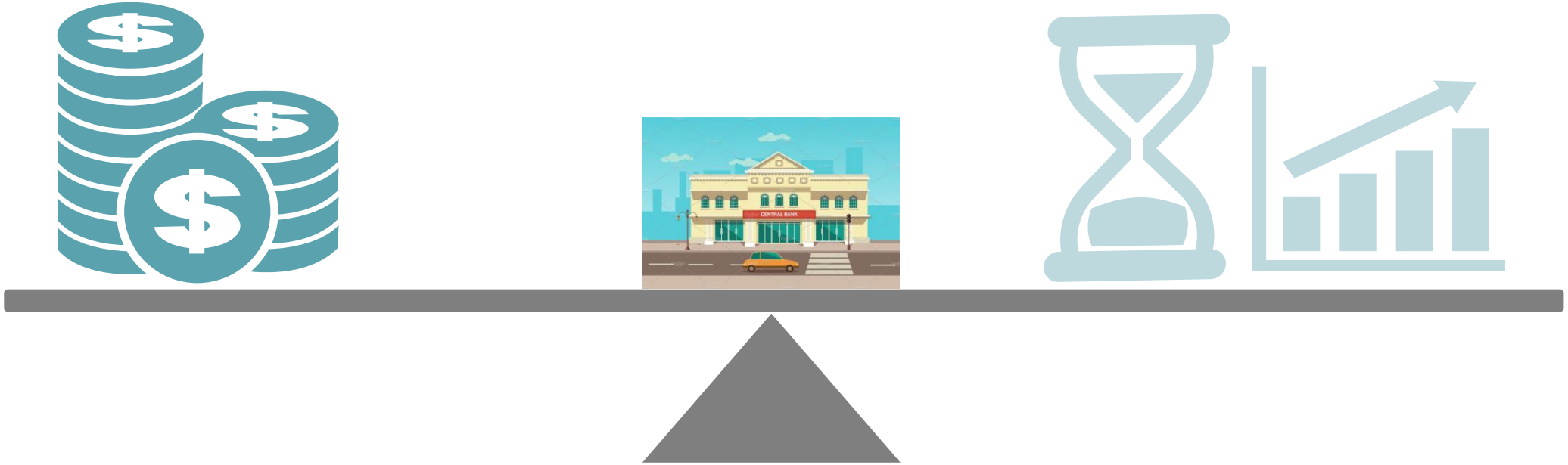
GDP Growth
1.3% - 4Q2020

Exchange Rate
197.18- 10th May 2021

Private Credit
LKR 112Bn - Mar 2021

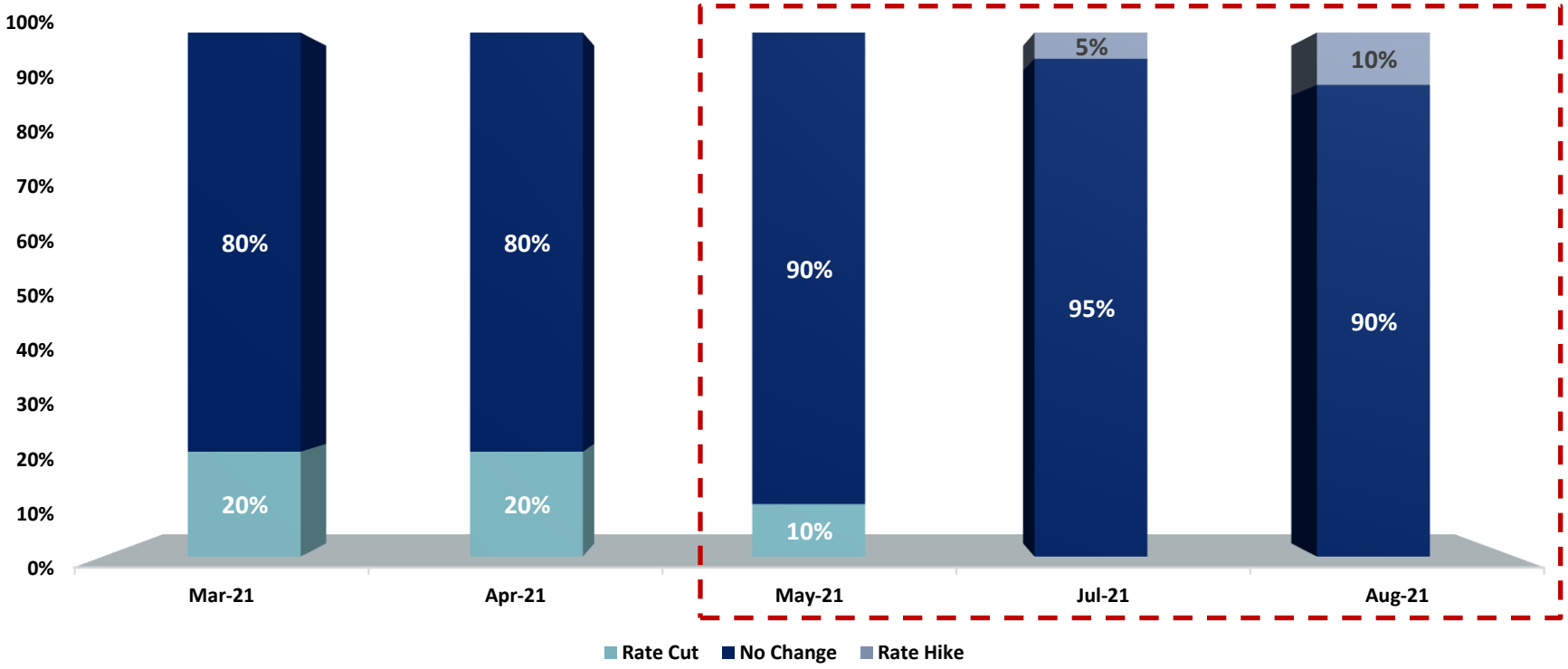
Foreign Reserves
USD 4.5Bn - Apr 2021

AWPR
5.74% - 07th May 2021



FCR Policy Rate Forecast – May-Aug 2021

We believe that CBSL may consider to maintain same policy stance in this monetary policy review as well, but given the concerns around economic growth, there is a considerable low probability that CBSL is likely to further ease its policy rates. Towards the 2H2021, we expect a probability for a rate hike in order to prevent overheating of the economy amidst the given fiscal and monetary stimulus.



We expect only 10% probability for a rate cut 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 cut by 25bps or 50bps while, hike is off the table due to the lackluster economic growth. We believe that there is a significant (90% probability) to hold rates due to the considerable improvement in high frequency indicators and with fiscal and monetary measures implemented so far. However, there is a 5% probability each for 25bps and 50bps rate cut to support economic growth.

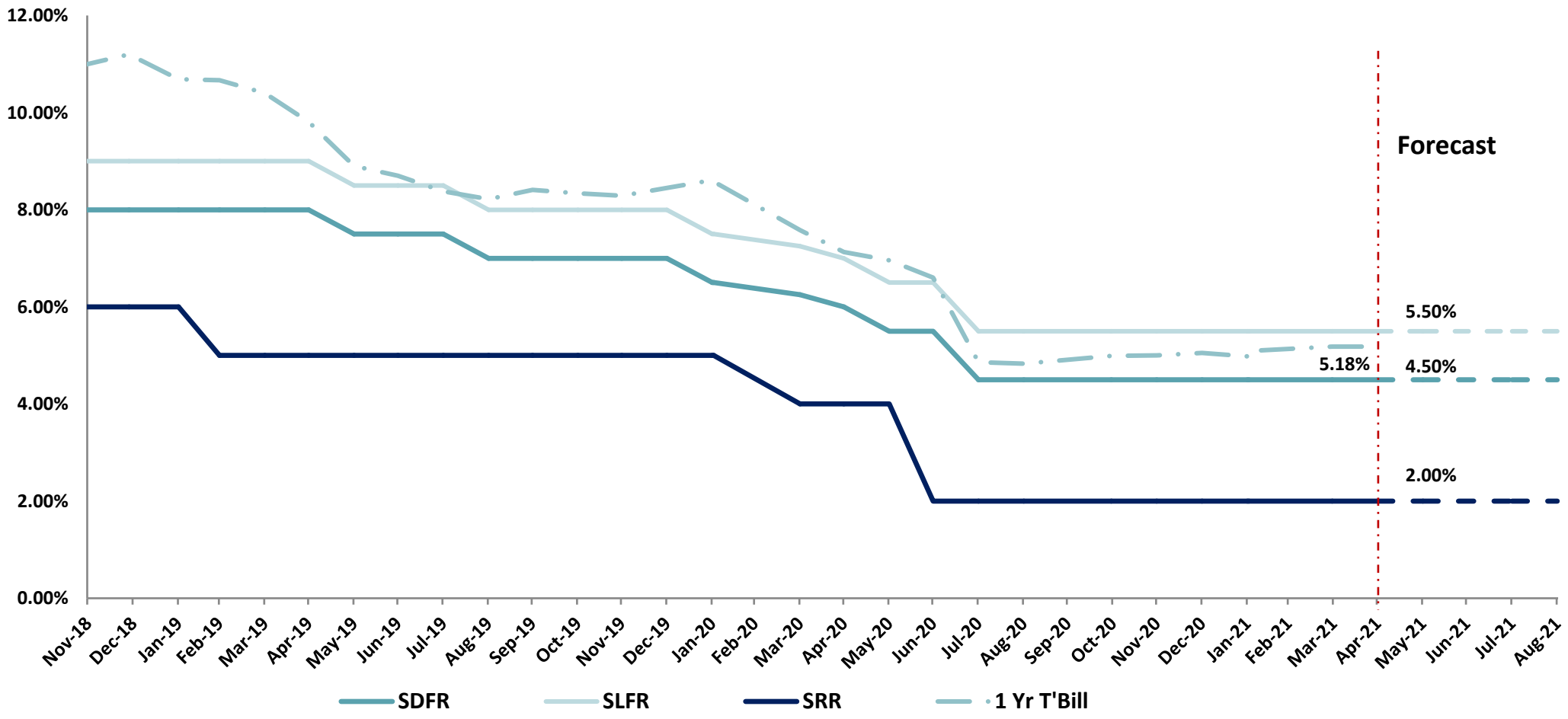
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	**90%**
Cutting Policy Rates by 25bps	**5%**
Cutting Policy Rates by 50bps	**5%**

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…"