



First Capital

“IT IS TIME FOR A PAUSE”

PRE-POLICY ANALYSIS

First Capital Research

12TH MAY 2022

Analysts: Hiruni Perera
Vidushika Perera
Dimantha Mathew

Previous Pre-policy report: Recap



2

CBSL tightened its policy stance

In-line with our expectations, at the previous policy announcement held on 08th Apr 2022, CBSL decided to increase the SDFR and the SLFR by **jumbo** 700bps each to 13.50% and 14.50%, respectively. This decision has been made considering the inflationary pressures that could further intensify in the period ahead, driven by the build-up of aggregate demand, domestic supply disruptions, exchange rate depreciation and the elevated prices of commodities globally. Accordingly, CBSL was of the view that a substantial policy response is imperative to arrest the buildup of added demand driven inflationary pressures in the economy and preempt the escalation of adverse inflationary expectations, to provide the required impetus to stabilize the exchange rate and also to correct anomalies observed in the market interest rate structure.

Key Arguments by CBSL for tightening its policy stance on 08th Apr 2022

- ✓ The external sector is facing continued heightened challenges.
- ✓ Inflation is on the rise due to both supply side factors and mounting aggregate demand pressures.
- ✓ Market interest rates are adjusting upwards gradually. However, adjustments in deposit rates remain inadequate to attract deposits into the banking system from the excessive currency in circulation.
- ✓ Adverse developments in both global and domestic fronts have posed challenges to the domestic economic performance.



Analysis of upcoming policy decision on 19th May

3

Arguments against hike

60%



The above-mentioned factors argue that there is no requirement for hike in policy rates.

- Consecutive rate hikes with a total of 850bps increase in policy rates
- Bond auctions are getting filled up indicating reduced burden on CBSL holdings
- Market interest rates are adjusting upwards gradually
- Policy tightening may not curb cost-push inflation
- Impending fiscal and structural reforms on the cards

- Persistent political deadlock and tightened policy measures as a requisite to protect the currency and derailing foreign reserves
- Tightening policy stance is one of the key proposition by the IMF
- Sweltering heat of inflation prompts further hikes
- Spearheaded by U.S, world is moving towards a tightening spree

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

Arguments for hike

40%



Arguments *against* hike in monetary policy

Rates on 01Yr FD (monthly)

Bank of Ceylon	11.75%
People's Bank	13.50%
Hatton National Bank	12.25%
Commercial Bank	12.30%
Sampath Bank	12.25%
Seylan Bank	13.25%



Consecutive rate hikes with a total of 850bps increase in policy rates

Monetary Board decided to increase policy interest rates; SDFR and the SLFR by 700bps to 13.50% and 14.50% respectively and this can be considered as the highest ever policy rate hike delivered in the history of Sri Lanka. On a cumulative basis, policy rates have increased by 850bps for this year at three policy announcements. Accordingly, considering above factors we believe that CBSL might prefer to conserve its policy space and use it judiciously in the latter part of the year while also allowing the impact of previous rate hikes to get materialized as it takes roughly 3-6 months period to get reflected in the economy. Therefore, we believe that there is a lower probability for further rate hikes at the upcoming policy meeting.

Bond auctions are getting filled up indicating reduced burden on CBSL holdings

T-Bill auction held on 11th May-22 was 92.3% subscribed while auction held on 04th May was fully subscribed with yields across the tenures were seen easing somewhat after two weeks of moderating. It appears that the yields have peaked for now following the sharp correction that took place soon after the jack up in policy rates by unprecedented 700bps rate hike on 8th Apr-22. Moreover, the total accepted amount from 1Yr T-Bill at the recent weekly auctions were seen gradually rising relative to previous weeks while also attracting market participants towards long-term maturities (1Yr T- Bill) with the gradual restoration of the confidence. As a result, the distortion in yields between 03M, 06M and 01Yr is getting evaded. Gradually, full subscription of bill and bond auctions are expected to unwind CBSL holdings which surpassed LKR 1.8Tn. It also reflects that market expectations regarding further rate hikes are gradually fading away indicating that further tightening in policy rates would not be required at the upcoming policy review.

Market interest rates are adjusting upwards gradually

Market interest rates have been gradually adjusting upwards in response to tight monetary policy measures adopted thus far. Accordingly, in response to 700bps rate hike on 08th Apr, AWCMR moved to 14.5% while AWPR was uplifted to 19.55%. Further, FD rates of major LCBs were seen shifting upwards in response to policy adjustments with FD ceiling on

*Arguments **against** hike in monetary policy*



Market interest rates are adjusting upwards gradually contd.,

NBFIs increasing to 26.22% as of 12th May-22. Moreover, in response to increased lending rates, credit disbursed for Feb-22 and Jan-22 declined to LKR 33.50Bn and LKR 36.10Bn respectively. Hence, we believe that further hike in policy rates would not be required at the upcoming policy review.

Policy tightening may not curb cost-push inflation

Increase in global commodity prices has become a key determinant factor of the soaring inflation in Sri Lanka. In that, escalating crude oil prices due to supply-side constraints play 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.



Impending fiscal and structural reforms on the cards

As per 2021 article IV consultation report, IMF recommends to have a substantial revenue based fiscal consolidation which includes reforms on strengthening VAT and income taxes, through rate increases and base broadening measures accompanied with energy pricing reforms to reduce fiscal risks from loss making public enterprises. Accordingly, we believe that government will have to resort to an upward revision in power tariff sooner than later while there are speculation on further fuel hikes. In the midst of impending tightening of fiscal policy measures, it is most likely that CBSL may delay further monetary policy tightening and use it prudently in the latter part of the year whenever required.

Arguments *for* hike in monetary policy



Persistent political deadlock at the helm and tightened policy measures as a requisite to protect the currency and derailing foreign reserves

Currently Sri Lanka is at an unresolved political deadlock and threatening any action for recovery. This has also resulted in a loss of confidence among market participants and investors. Moreover, in the midst of worsening external conditions and lack of foreign inflows foreign reserves amounted to USD 1.8Bn by Apr-22 while usable foreign reserves were down to less than USD 50.0Mn resulting in the Govt. having to continuously rely on credit lines to bolster its finances, including from China and India. Derailing foreign reserves and ongoing political crisis have also led to significant pressure on the currency and since CBSL's decision to allow the flexibility in the currency on 07th Mar-22, LKR depreciated significantly by more than 75% while in unofficial trading platforms the LKR being quoted at an even far weaker rate. Hence, to arrest the existing pressure on the currency and reserves, we believe that CBSL should further tighten its policy rates.



Tightening policy stance is one of the key proposition by the IMF

Currently, Sri Lanka is seeking financial support from the International Monetary Fund (IMF), while planning to present policy proposals to the IMF in the near future. As per 2021 article IV consultation of IMF, tighter monetary policy and a market-based exchange rate were recommended as part of the comprehensive strategy. Given rising inflationary pressures and expectations, IMF believes that near-term monetary policy tightening is warranted to ensure that the recent breach of the inflation target band is only temporary. Therefore, there is a likely hood that CBSL may consider further tightening policy rates at the upcoming meeting.

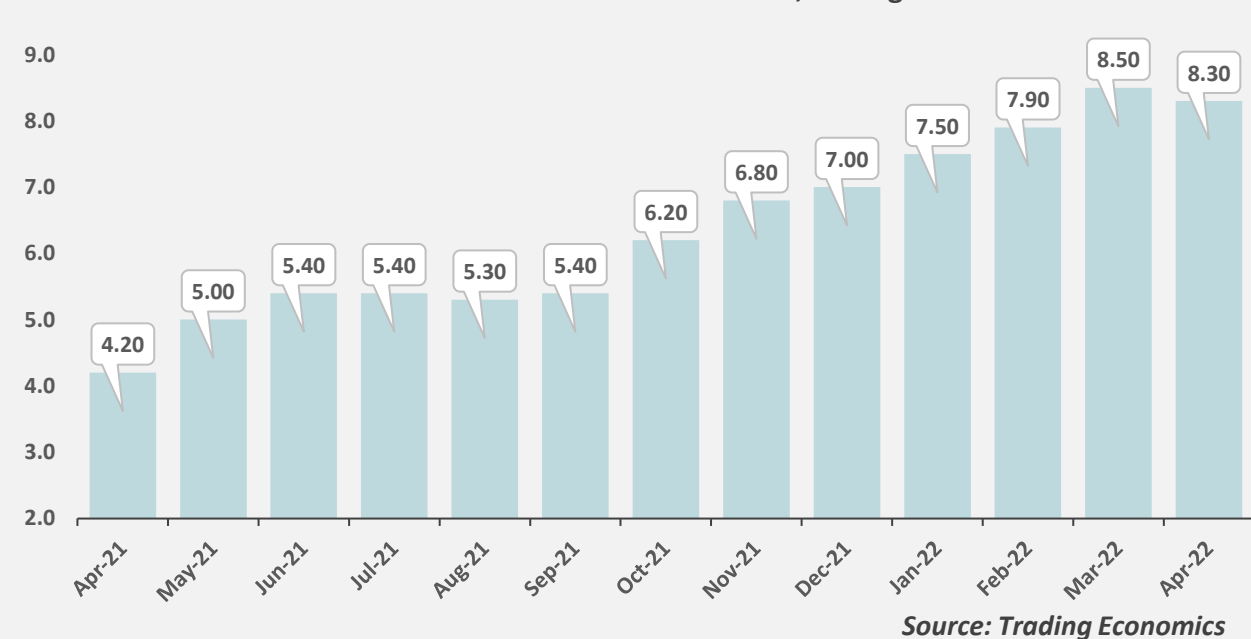
Sweltering heat of inflation prompts further hikes

Sri Lanka recorded one of its highest inflation of 29.8% in Apr-22 relative to 18.7% in Mar-22 causing an alarm among the consumers in the country. Going forward, inflation is expected to remain high due to elevated energy prices and continuing supply chain disruptions, prompting stronger monetary policy responses by the central bank. Rising inflation and negative real policy rates warrant a further hawkish monetary policy stance by CBSL.

The Fed's New Dot Plot



Inflation rate in U.S accelerated to 8.5% in Mar-2022, the highest since Dec-1981



Spearheaded by U.S...

The Federal Reserve on 04th May raised its benchmark interest rates for the second time by 0.50%, the most aggressive step yet in its fight against a 40-year high in inflation. Along with the move higher in rates, the central bank indicated it will begin reducing asset holdings on its USD 9.0Tn balance sheet. The Fed had been buying bonds to keep interest rates low and money flowing through the economy during the pandemic, but the surge in prices has forced a dramatic rethink in monetary policy.

Source: theguardian.com

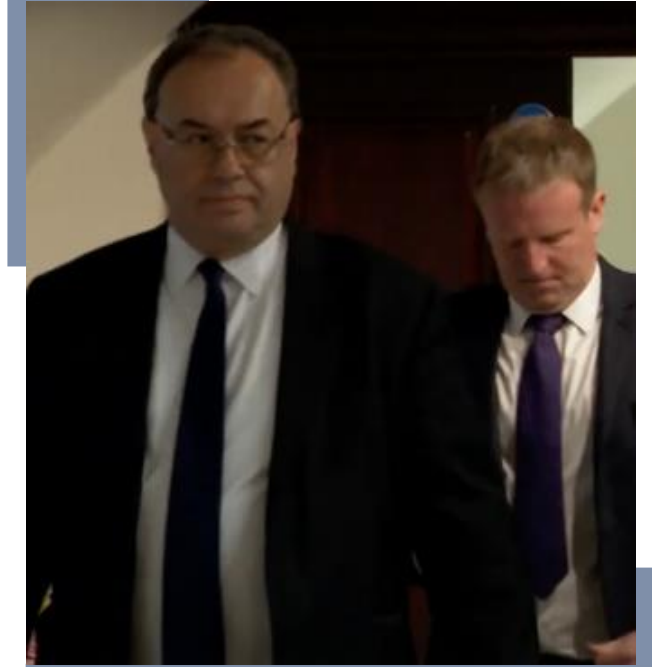
...world is moving towards a tightening spree



Australia's central bank on 03rd May-22 raised its cash rate by a surprisingly large 25bps to 0.35%, the first hike in over a decade, and flagged more to come. On 06th May-22, RBA drastically revised up forecasts for inflation, foreshadowing how far interest rates might have to rise to bring the country's cost of living crisis under control.



India's central bank raised its main lending rate by 40bps to 4.4% in a surprise move on 04th May-22 to contain rising inflation, shocking markets and pushing the benchmark 10-year bond yield to its highest levels in three years. The change in rates is the first change in the rate in two years and its first-rate hike in nearly four years.



The Bank of England (BOE) on 05th May-22 raised interest rates by 25bps to 1.0% to their highest level in 13 years in a bid to tackle soaring inflation. In a widely expected move, policymakers at the BOE voted for a fourth consecutive rate hike since Dec-21 at a time when millions of U.K. households are struggling with skyrocketing living costs.

Factors of concern at the policy review

9

Foreign Reserves
USD 1.8Bn by Apr-22

Inflation
CCPI 29.8% for Apr-22

GDP Growth
4Q2021 - 1.80% & 3.70% - 2021

03M T-Bill rate
24.07% as of 11.05.22

Private Credit
LKR 33.5Bn for Feb-22

Liquidity and CBSL Holdings
LKR -561.5Bn and LKR 1.9Tn

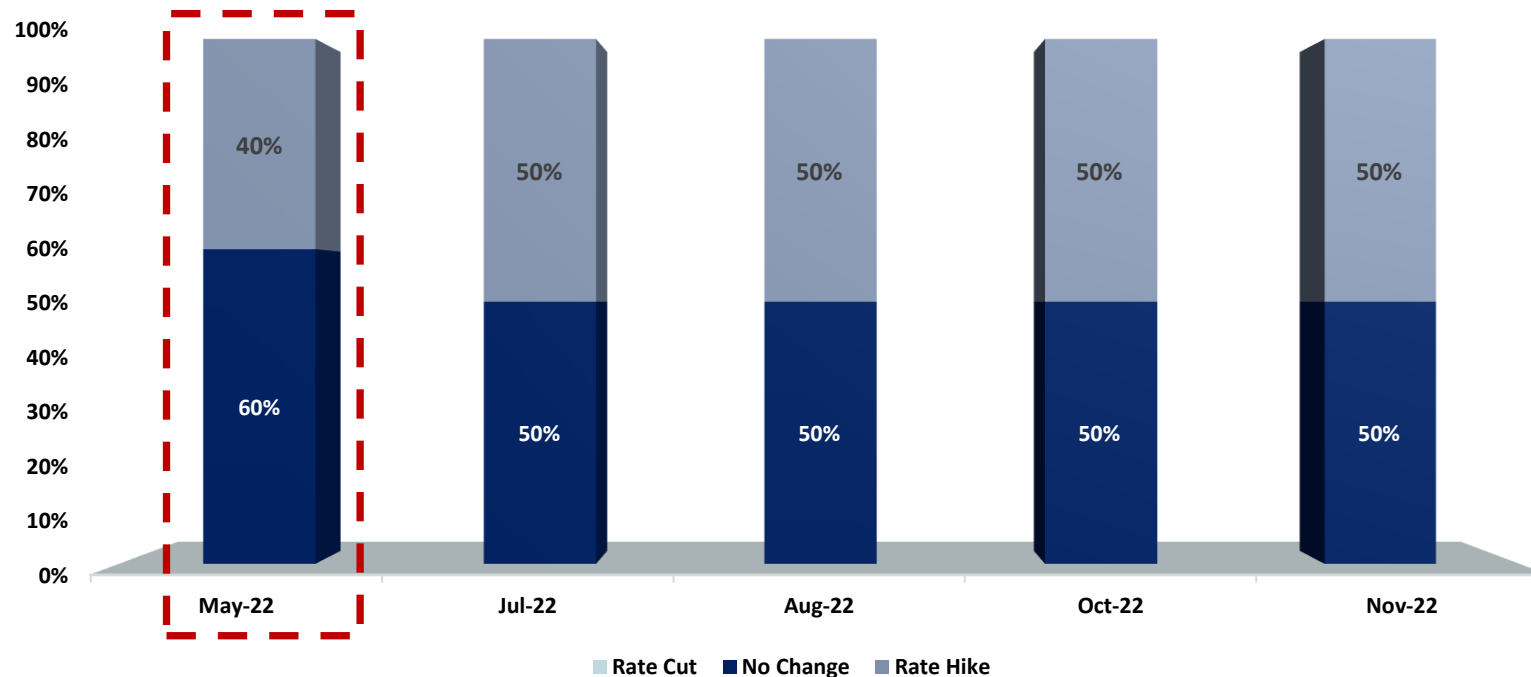
BOT and BOP
USD -1.6Bn and USD -5.7Bn
for Jan-Feb 22



FCR Policy Rate Forecast – May 22- Nov 22

10

We believe that considering consecutive rate hikes in the previous three policy meetings, CBSL may consider sustaining ***monetary policy rates in this policy review***. Thereby we have assigned a probability of 60% for no change in policy rates. However, there is also a 40% probability for further tightening in the midst of prevailing political deadlock and in order to preserve the currency and foreign reserves.



We expect 60% probability for no change in policy rates at the upcoming policy meeting.

Source: CBSL, First Capital Research Estimates

Expected Monetary Policy Stance

11

As per our view, at the upcoming policy meeting, there is a strong case for maintaining policy rates in order to realize the impact of previous rate hikes amounting to total of 850bps. As a result, we believe that there is a major probability of 60% to maintain rates at current levels. However, there is also a probability of 40% for tightening to compensate for higher inflation and to preserve the currency & foreign reserves thereby supporting macroeconomic stability. However, at the upcoming policy review we expect CBSL to maintain rates at current levels.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 100bps	20%
Raising Policy Rates by 50bps	20%
Policy Rates to remain unchanged	60%
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

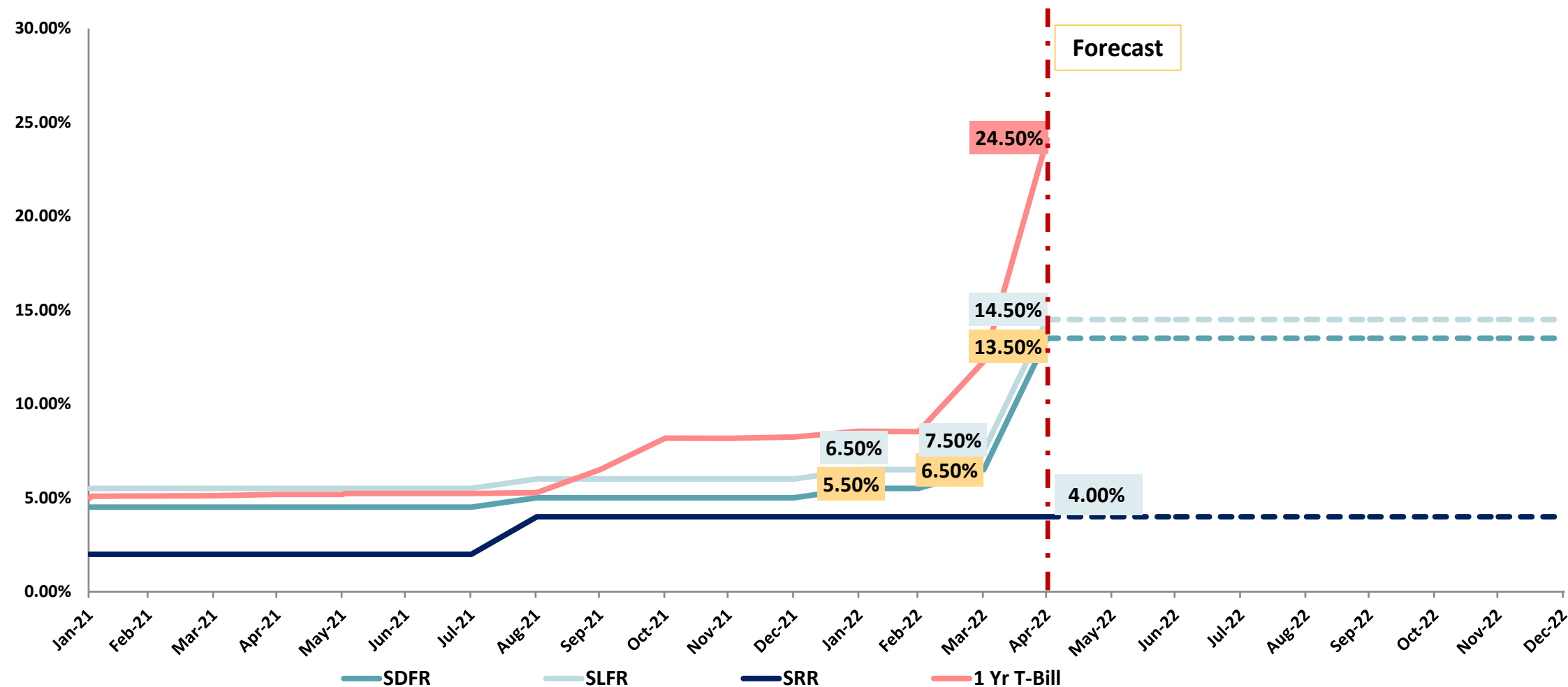
40%

We believe that there is 60% probability for no change in policy rates considering consecutive rate hikes in the 1Q2022.

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

Disclaimer

This Review is prepared and issued by First Capital Holdings PLC based on information in the public domain, internally developed and other sources, believed to be correct. Although all reasonable care has been taken to ensure the contents of the Review are accurate, First Capital Holdings PLC and/or its Directors, employees, are not responsible for the accuracy, usefulness, reliability of same. First Capital Holdings PLC may act as a Broker in the investments which are the subject of this document or related investments and may have acted on or used the information contained in this document, or the research or analysis on which it is based, before its publication. First Capital Holdings PLC and/or a connected person or associated person may also have a position or be otherwise interested in the investments referred to in this document. This is not an offer to sell or buy the investments referred to in this document. This Review may contain data which are inaccurate and unreliable. You hereby waive irrevocably any rights or remedies in law or equity you have or may have against First Capital Holdings PLC with respect to the Review and agree to indemnify and hold First Capital Holdings PLC and/or its principal, their respective directors and employees harmless to the fullest extent allowed by law regarding all matters related to your use of this Review. No part of this document may be reproduced, distributed or published in whole or in part by any means to any other person for any purpose without prior permission.

THANK YOU

“Successful Investment Is About Managing Risk...”

CONTACT US

First Capital Holdings PLC

No: 02, Deal Place, Colombo 00300, Sri Lanka.

E: research@firstcapital.lk

Dimantha Mathew

Head of Research

T: +94 11 2639 853

E: dimantha@firstcapital.lk

Hiruni Perera

Assistant Manager- Research

T: +94 11 2639 864

E: hiruni@firstcapital.lk

Vidushika Perera

Assistant Manager- Research

T: +94 11 2639 865

E: vidushika@firstcapital.lk

Tharusha Ashokgar

Junior Analyst-Research

T +94 11 2639 866

tharushaash@firstcapital.lk



First Capital

