“CBSL TO STEER TOWARDS A MORE HAWKISH DIRECTION”

PRE-POLICY ANALYSIS

19TH NOV 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 13th Oct 2021, CBSL maintained its monetary policy stance, while retreating the importance of maintaining inflation at its target levels over the medium term while also supporting the economy to reach its potential in the period ahead. CBSL has also taken into consideration the global economic outlook which set its direction towards the recovery path to achieve a growth of 5.9% in 2021E and 4.9% in 2022E as per IMF forecasts.

Key Arguments by CBSL for maintaining its policy stance on 13th Oct 2021

- ✓ The global economy continues to recover.
- ✓ The Sri Lankan economy is making headway, despite the pandemic related disruptions.
- ✓ The planned coordinated efforts by the Government and the Central Bank are expected to strengthen the external sector in the period ahead.
- ✓ Market interest rates have adjusted upwards in response to the tightening of monetary and liquidity conditions, while credit and monetary expansion remained elevated.
- ✓ Some inflationary pressures are observed, particularly due to emerging global price developments.

Analysis of upcoming policy decision on 25th Nov

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

50%

Arguments against hike

- GDP growth needs further acceleration
- Ease pressure on government securities
- Cost push inflation can not be addressed via monetary tightening

Arguments for hike

50%

- Sovereign downgrades ensued from depletion of foreign reserves urges economic stability
- Liquidity dwindling requires a solid remedy amidst revival in private credit growth
- Relaxing import restrictions may further trigger pressure on currency
- Trending hawkish move in the global context

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

Global policy actions are favouring the hawkish hopes

	Jul 2021	Aug 2021	Sep 2021	Oct 2021	Nov 2021
Net Change	+1,055 bps	+55 bps	+630 bps	+715 bps	+555 bps
Total Rate Cuts	None	500 bps	110 bps	200 bps	100 bps
Total Rates Rises	1,055 bps	555 bps	740 bps	915 bps	655 bps
Rate Cuts	None	Liberia	Turkey and Denmark	Turkey	Turkey
Rate Rises	Angola, Chile, Belarus, Ukraine, Russia, Kazakhstan, Kyrgyzstan, Hungary, Tajikistan and Moldova	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, Azerbaijan and Colombia	Poland, Czech Republic, Romania, Mexico, Uruguay, Peru, Hungary, Jamaica, Iceland, South Africa and Pakistan
Global Monetary Policy Rate	**4.96%**	**5.01%**	**5.02%**	**5.09%**	**5.14%**

Source: Centralbanknews.info (as of 22.11.21)

Global central banks are trending towards tighter monetary policy as inflation leaps sky-high

Arguments for hike in monetary policy

Sovereign downgrades ensued from depletion of foreign reserves urges economic stability

Sri Lanka encountered another sovereign rating downgrade in Oct 2021 by Moody's Investors Service to 'Caa2' from 'Caa1', as a consequence of the depleting foreign reserves position and the mounting pressure on refinancing the debt. Foreign reserves further slumped to USD 2.3Bn in Oct 2021 from USD 2.6Bn in Sep 2021. A hike in interest rates may have a positive impact on the exchange rate and thereby preserving foreign capital while promoting the economic stability of the country.

Liquidity dwindling requires a solid remedy amidst revival in private credit growth

Private sector credit growth soared to 10.6%YTD to LKR 653.7Bn displaying a strong revival amidst continual monetary stimulus. However, market liquidity witnessed persistent negativity and closed at LKR -226.2Bn on 16th Nov 2021 amidst ongoing liquidity pumping by CBSL via term repos. Therefore, a policy rate hike is expected to further slowdown the credit growth in the economy and improve the liquidity situation by discouraging consumption and shifting focus towards savings and investments.

Relaxing import restrictions may further trigger pressure on currency

In order to support GDP growth, import restrictions are likely to be gradually relaxed from 1Q2022 onwards, which may boost expenses on imports and thereby further drag down the exchange rate. A rate hike may aid in stabilizing the currency that may prevent further endangering the solidity of external activities.

Arguments *for* hike in monetary policy

Trending hawkish move in the global context

Global central banks are moving towards a hawkish stance in curbing the surge in inflation across the world that reached beyond expectations as low interest rate regime has lost its effect which requires urgent countermeasures by monetary policy makers. Accordingly, emerging market economies such as Brazil, Russia and other nations including, New Zealand, Hungary, Mexico have recently tightened their monetary policies. Following the suit, Sri Lanka may also pursue an earlier policy normalization thereby unwinding the monetary stimulus provided throughout the pandemic days.

*Arguments **against** Hike in monetary policy*

GDP growth needs further acceleration

The Sri Lankan economy is gradually heading towards recovery while tolerating repeated punches from the macroeconomic effects coupled with frequent lockdowns which were inevitable in curbing the spread of Covid-19. Accordingly, GDP has recorded a growth of 4.3%YoY during 1Q2021 and 12.3%YoY during 2Q 2021 vis-à-vis the worst hit quarter by the pandemic disruptions. 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 GDP growth objectives.

Ease pressure on government securities

Rates on government securities have spiked within a range of nearly 200-250bps since Aug 2021 witnessing a sharp upward shift in the yield curve across the maturities. However, primary auctions repeatedly exhibited a low acceptance level for 1 Year T-Bill while investor focus was clustered towards 03M T-Bill as a result of the growing economic uncertainties. Therefore, a greater stability in interest rates may require in routing the market sentiment towards the desired momentum while easing further pressure on government securities.

Cost push inflation can not be addressed via monetary tightening

Sri Lanka national inflation measured by Colombo Consumer Price Index (CCPI) soars to 4-year high of 7.6%YoY in Oct 2021 from 5.7%YoY in Sep 2021, mainly driven by the increase in food prices impacted by the supply shortages and rise in global commodity prices, implying a cost push inflation. Therefore, any remedial action via tighten monetary policy may not justify the density of the current inflation.

Factors of concern at the policy review

Inflation
CCPI 7.6% - Oct 2021

GDP Growth
12.3% - 2Q2021

Exchange Rate
201.34 - 17th Nov 2021

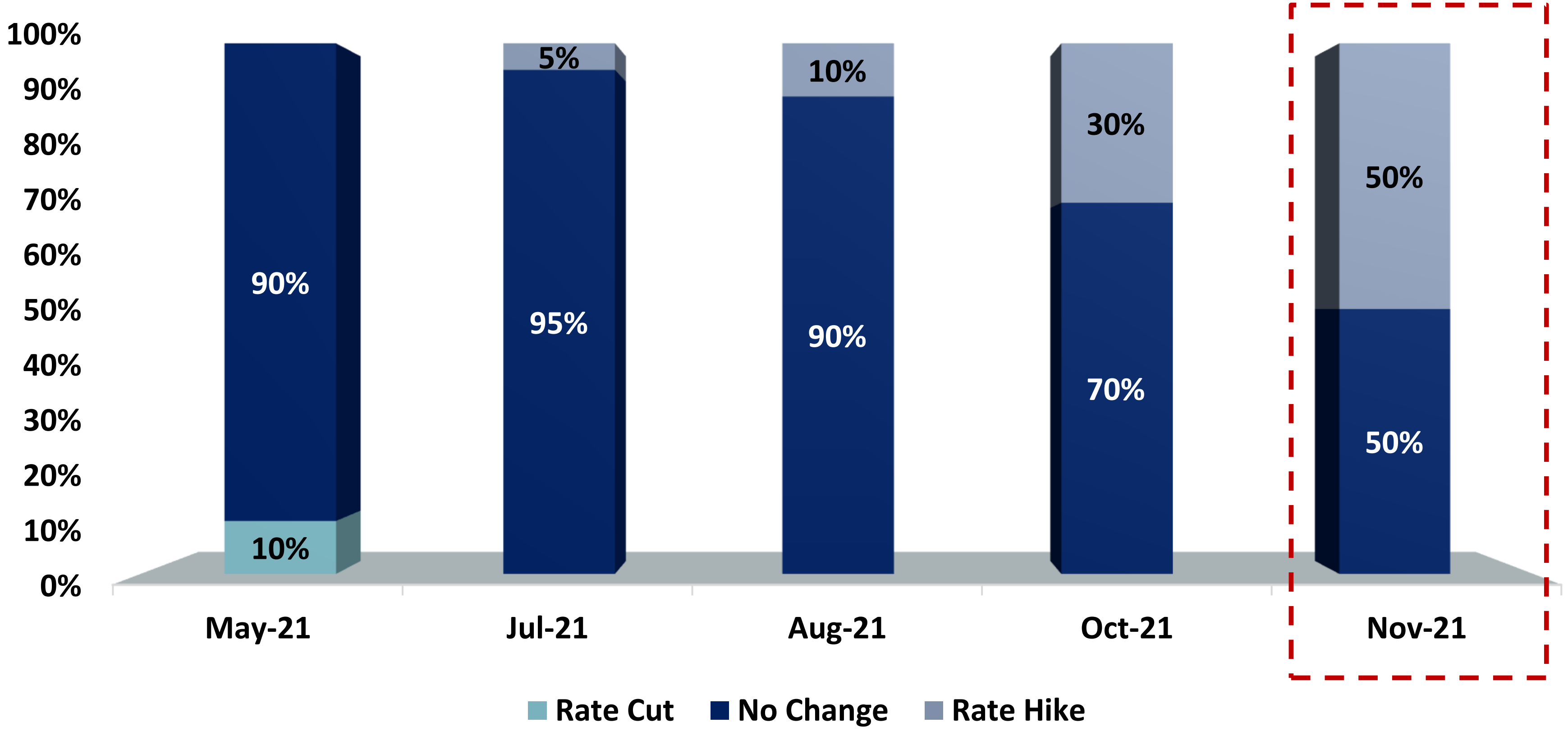
Private Credit
LKR 29.1Bn - Sep 2021

Foreign Reserves
USD 2.3Bn - Oct 2021

AWPR
7.64% - 12th Nov 2021

FCR Policy Rate Forecast – Nov 2021

We believe that CBSL may consider ***tightening the monetary policy rates in this policy review but*** given the concerns over economic growth, there is a considerable probability of 50% 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 50% probability for a rate hike at the upcoming meeting.

Expected Monetary Policy Stance

As per our view, CBSL either can choose to hike policy rates by 25bps or 50bps 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 50% probability for a rate hike due to the remedial actions required in achieving external stability. However, there is also a 50% probability to maintain the policy rates at its current level given the notable improvement in the high frequency indicators.

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%

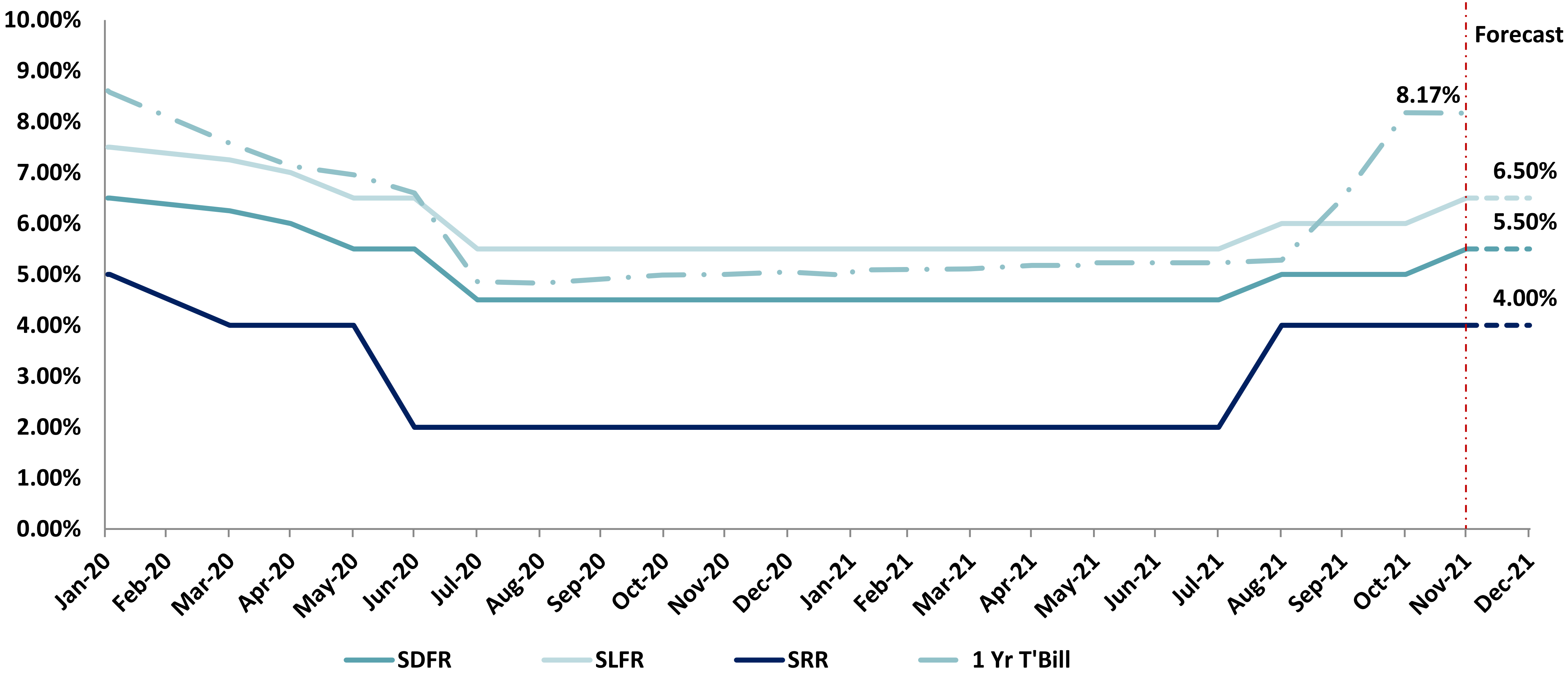
50%

We believe that there is a 50% 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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