



First Capital

# “TAPER TANTRUM 2.0”

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PRE-POLICY ANALYSIS

First Capital Research

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11<sup>TH</sup> OCT 2021



## CBSL maintained its policy stance

**Contrary to our expectations**, at the previous policy meeting held on 19<sup>th</sup> Aug 2021, CBSL increased its monetary policy stance, SDFR and SLFR by 50bps to 5% and 6% respectively. In addition, increased SRR by 200bps to 4% with effect from 1<sup>st</sup> Sep 2021. CBSL mentions rate hike decisions were made with view to addressing the imbalance on the external sector of the economy and to preempt the buildup of any excessive inflationary pressures over the medium term, amidst improved growth prospects.

### Key Arguments by CBSL for tightening its policy stance on 19<sup>th</sup> Aug 2021

- ✓ The global economy is set to make a gradual recovery in 2021, although normalization of economic activity would largely be uneven across regions.
- ✓ The Sri Lankan economy is on a recovery path despite the pandemic related disruptions.
- ✓ Most market interest rates have reached low levels resulting in the expected acceleration in credit flows to the private sector.
- ✓ The external sector continued to face a multitude of challenges requiring coordinated measures.
- ✓ Possible upside pressures on inflation are being addressed through preemptive policy measures.



# Analysis of upcoming policy decision on 14<sup>th</sup> Oct

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



**70%**  
Arguments against hike

- Lockdown likely to hurt 3Q GDP growth
- Cost push inflation cannot be controlled by rate hikes
- Continuous Quantitative easing hindrance to further rate hikes

- Continuous rapid climb in Government Securities secondary market rates
- Relaxing import restrictions may further add pressure on the exchange rate
- Pvt. Credit picks up pace while liquidity stays negative

Arguments for hike

**30%**



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

# Arguments *against* Hike in monetary policy



## **Lockdown likely to hurt 3Q GDP growth**

The Sri Lankan economy is likely to grow at a much slower pace in the 3Q2021 compared with the 2Q2021 due to the COVID-19 virus-induced restrictions on economic activities. Sri Lanka's economy grew at a robust 12.3% in the 2Q2021 resultant to an extremely low base of -16.4% in 2Q2020 due to 1st wave lockdown, which resulted in the complete closing of the economy. Sri Lanka's Purchasing Managers Index (PMI) for the manufacturing and service sectors contracted in Aug 2021. Manufacturing PMI declined 12.7 points, from 57.8 in Jul to 45.1 in Aug, driven by a decrease in sub-indices of new orders, production, employment, and stock of purchases. Meanwhile, Services PMI dropped 9.5 index points, from 55.7 in July to 46.2 in August, largely due to restrictions imposed to contain the spread of the highly contagious Delta variant.



## **Cost push inflation cannot be controlled by rate hikes**

Inflation has shown signs of a rising trend with above 5.0% inflation during the last 4 months, touching 6.0% in Aug 2021 and slightly dipping to 5.7% in Sep 2021. The primary reason for the rise in inflation is the significant depreciation in the currency resulting in repricing of most commodity prices. As rise in inflation is the cause of cost push inflation, monetary policy adjustment may not impact inflation though it may support to stabilize the currency. However, in the current situation Govt has taken stance to control the exchange rate as well.



## **Continuous Quantitative easing hindrance further rate hikes**

CBSL continued to infuse ample liquidity into the system via increased CBSL holdings supporting the fiscal shortage. The CBSL holdings rose to LKR 1,442.8Bn on 7<sup>th</sup> Oct 2021 from 1,174.2Bn as of 19<sup>th</sup> Aug 2021. We believe CBSL's continuance in quantitative easing strategy may delay further policy rate hikes.

# Arguments *for* hike in monetary policy



## **Continuous rapid climb in Government Securities secondary market rates**

Yields in the secondary market continued to witness an increase with moderate market activity from participants, followed by a wait and see approach amidst the looming uncertainty in economy. The last 11 Bill auctions were undersubscribed by a considerable amount, getting accepted in short tenors (3-6 months) reflecting the lack of clarity among market participants on future interest rate trajectory. We consider that a rate hike may support CBSL in raising additional funding via Government Securities.



## **Relaxing import restrictions may further add pressure on the exchange rate**

Despite the import restriction, imports have been on a rising trend, expanding trade deficit compared to the previous year for the 5<sup>th</sup> consecutive month in Jul 2021. Further relaxing import restrictions may also fuel consumer demand leading to a further depletion in foreign reserves adversely impacting the exchange rate. Therefore, in order to preserve the foreign reserves which is considered to be the talk of the town, there is a possibility of a rate hike.



## **Pvt. Credit picks up pace while liquidity stays negative**

Private sector credit increased by LKR 134.0Bn in Aug 2021 indicating a sign of strong acceleration amidst continual support from monetary stimulus. Despite significant quantitative easing strategies liquidity continues on a negative ground. YTD growth stands at 10.1% broadly slightly above First Capital Research (FCR) expectation of c.12% for 2021E as YoY growth rises above 14%. With AWPR still remaining on low ground and liquidity negative, further tightening is likely to slowdown credit growth and improve the liquidity position.

# Factors of concern at the policy review

**Inflation**  
CCPI 5.7% - Sep 2021

**GDP Growth**  
12.3% - 2Q2021

**Exchange Rate**  
202.98- 07<sup>th</sup> Oct 2021

**Private Credit**  
LKR 134.0Bn - Aug 2021

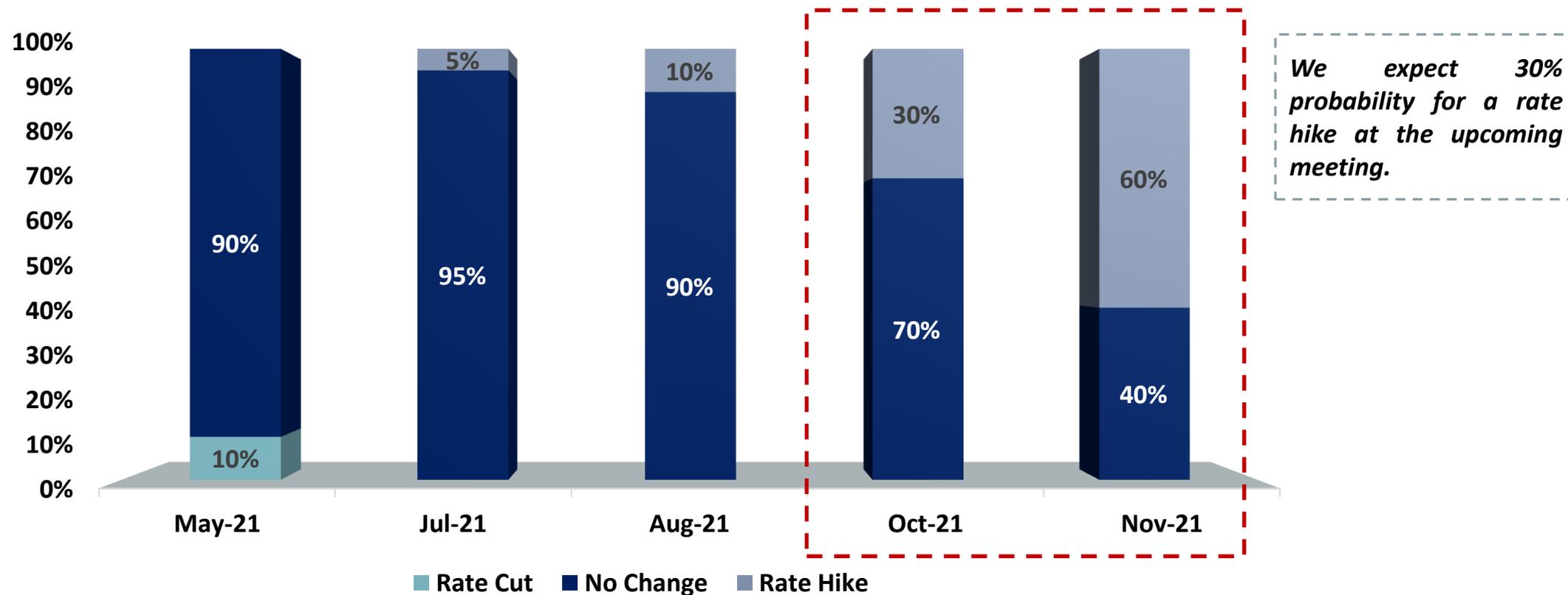
**Foreign Reserves**  
USD 2.6Bn - Sep 2021

**AWPR**  
6.71% - 01<sup>st</sup> Oct 2021



# FCR Policy Rate Forecast – Oct-Nov 2021

We believe that CBSL may consider *maintaining the same policy stance in this policy review but* given the considerable improvement in high frequency indicators to prevent an overheating of the economy, there is a considerably high probability (30%) that CBSL may hike its policy rates. 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.



# Expected Monetary Policy Stance

As per our view, CBSL either can choose to hold policy rates steady or hike by 25bps or 50bps 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 significant probability (70%) 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 30% probability for 25bps/50bps rate hike to balance external pressure.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	20%
Raising Policy Rates by 25bps	10%
<b>Policy Rates to remain unchanged</b>	<b>70%</b>
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

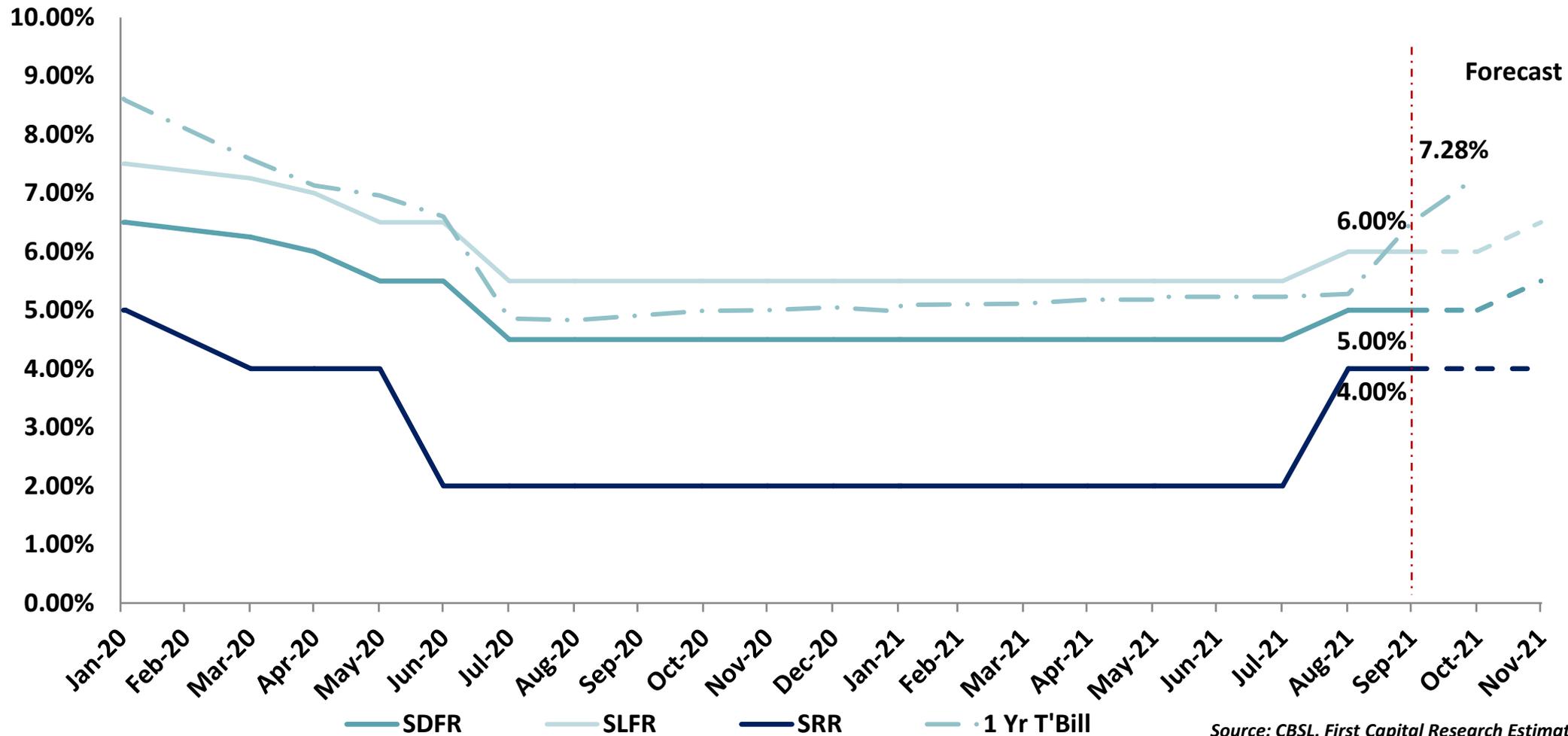
30%

We believe that there is a 70% 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%
<b>SRR to remain unchanged</b>	<b>100%</b>
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

Considering the increase of SRR by 200bps to 4% in 19<sup>th</sup> Aug 2021 we expect SRR to remain unchanged at same levels.

# Monetary Policy Rates



Source: CBSL, First Capital Research Estimates

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