First Capital

“UNPRECEDENTED EVENTS CALL FOR JUMBO HIKE IN POLICY RATES”

REVISED PRE-POLICY ANALYSIS

07TH APR 2022

First Capital Research

Analysts: **Hiruni Perera**
Vidushika Perera
Dimantha Mathew

Key developments from 01st- 07th Apr

Policy direction maintained while increasing the probability of a sizeable hike in policy rates

As mentioned in the previous pre policy report dated 1st Apr 22, we maintain our policy direction for a rate hike, but we have increased the probability for a hike to 95% and expect significant surge in policy rates considering the recent developments occurred in the country.

- **Auction yields skyrocket as uncertainty mounts**
- **Currency further plunges amidst economic meltdown**
- **Appointment of Dr. Weerasinghe as the new CB Governor favours aggressive hike in monetary policy stance**
- **Appointment of an eminent committee by President is to set accelerate IMF negotiations**

Key developments from 01st- 07th Apr Cont'd

Recent Developments

Auction yields skyrocket as uncertainty mounts

- ✓ On 6th Apr-22 bill auction, yields shot up across all maturities (03M +120bps, 06M +311bps and 01 Yr +341bps).
- ✓ As a mandate to narrow down the gap between policy rates and auction yields there is a likelihood that CBSL might seek for a sizeable increase in policy rates.

Currency further plunges amidst economic meltdown

- ✓ LKR plunged to a record low of 320.0 (selling rate) against USD as at 07th Apr 2022.
- ✓ In order to rein the pressure on currency from further depreciation, there is a higher likelihood for an aggressive surge in policy rates.

.

Appointment of Dr. Weerasinghe as the new CB Governor favours aggressive hike policy stance

- ✓ He has previously served as an Director at the IMF, CBSL's chief economist and also had chaired the CBSL's monetary policy committee.
- ✓ Dr. Nandalal to be more aggressive with regard to monetary policy decision, resulting in significant surge in policy rates at the upcoming meeting.

Appointment of an eminent committee is to set accelerate IMF negotiations

- ✓ Committee comprises Dr. Indrajit Coomaraswamy, Prof. Shanta Devarajan and Dr. Sharmini Coorey.
- ✓ We expect this move to accelerate the negotiations with IMF resulting in increased bets on aggressive policy hikes.

Expected Monetary Policy Stance

Option 01

As per our view, at the upcoming policy meeting, **there is a strong case for a sharp increase in policy rates** in order to compensate for higher inflation and to preserve the currency & foreign reserves. As a result, we believe that there is a very high probability of 95% for a hike to iron out the prevailing imbalances in the domestic financial markets and the external sector of the economy, while preempting the buildup of any excessive inflationary pressures over the medium term, thereby supporting macroeconomic stability. **Considering the recent developments and higher interest rates expectations by the market participants as reflected at the previous bill auction there is a greater prospect that CBSL might opt to go for a fairly large increase in policy rates.** However, there is also a lower probability of 5% to maintain the policy rates at its current level in order to further improve the high frequency indicators.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 501-700bps	**5%**
Raising Policy Rates by 301-500bps	**50%**
Raising Policy Rates by 101-300bps	**30%**
Raising Policy Rates by 1-100bps	**10%**
Policy Rates to remain unchanged	5%

95%

We believe that there is 95% 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.

Expected Monetary Policy Stance

Option 02

100bps increase in policy rates and restrictions on CBSL liquidity window

There is also an alternative probability that CBSL will go for an only 100bps hike in policy rates and restrict the access to liquidity window (SLFR) in order to discourage LCBs in using the facility of SLFR to borrow funds and create arbitrage profit by investing in secondary market bills and bonds.

However, we maintain our previous key arguments for upcoming policy decision as well

Factors of concern at the policy review

Inflation
CCPI 18.70% for Mar-22

Foreign Reserves
USD 2.3Bn by Feb-22

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

03M T-Bill rate
14.12% as of 06.04.22

Private Credit
LKR 61.3Bn for Dec-21

Liquidity and CBSL Holdings
LKR -586.1Bn and LKR 1.8Tn

BOT and BOP
USD -8.1Bn and USD -4.0Bn
for Jan-Dec 21

Analysis of upcoming policy decision in Apr-22

Arguments For Hike

95%

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

- **Tightening policy stance is one of the key proposition by the IMF**
- **Derailing foreign reserves and Exchange rate crisis**
- **Inflation, inflation, inflation!!!**
- **Negative liquidity in the market**
- **Bond auctions getting undersubscribed while CBSL holdings keep rising**
- **Federal Reserve shift towards jumbo hikes**

Arguments Against Hike

5%

- **Consecutive rate hikes may derail the potential recovery in GDP growth**
- **Policy tightening may not curb cost-push inflation**

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

Arguments for hike in monetary policy

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

Currently, Sri Lanka is seeking financial support from the International Monetary Fund, while planning to present policy proposals to the IMF in early April. 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 high likely hood that Sri Lanka will consider further tightening policy rates at the upcoming meeting.

Derailing foreign reserves and Exchange rate crisis

Sri Lanka's gross official reserves dropped to USD 2.3Bn in Feb-22 in the midst of worsening external conditions and lack of foreign inflows and as a result, the Govt. had to rely on credit lines to bolster its finances, including from China and India. Going forward, continuous rise in import bills and worsening trade deficit urge for a further rate hike to safeguard the foreign reserves while charming more foreign inflows into the country. Derailing foreign reserves 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 40% 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 tighten its policy rates.

Inflation, inflation, inflation!!!

Sri Lanka recorded one of its highest inflation of 18.7% in Mar-22 relative to 15.1% in Feb-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 both headline and core inflation and negative real policy rates which remains below historical average of 2.5% per annum (over the past decade), warrants a hawkish monetary policy stance by CBSL.

Arguments for hike in monetary policy

Negative liquidity in the market

Sri Lanka's overnight liquidity shortage hovers around LKR 600.0Bn and has been remaining continuously in the negative territory since the hike of SRR by CBSL which absorbed nearly LKR 200.0Bn in banks' excess liquidity. This prompted the banks to lean heavily on the Central Bank's Standing Lending Facility window to borrow to meet their daily liquidity requirements. Following recent monetary tightening measures, although lending rates have adjusted upwards, the adjustment in deposit interest rates remains sluggish, which has been inadequate to attract deposits into the banking system from the excessive currency in circulation. A further tightening in policy measures would be required to encourage banks and financial institutions to make the required adjustments to deposit rates in order to promote savings and to improve liquidity in the system.

Bond auctions getting undersubscribed while CBSL holdings keep rising

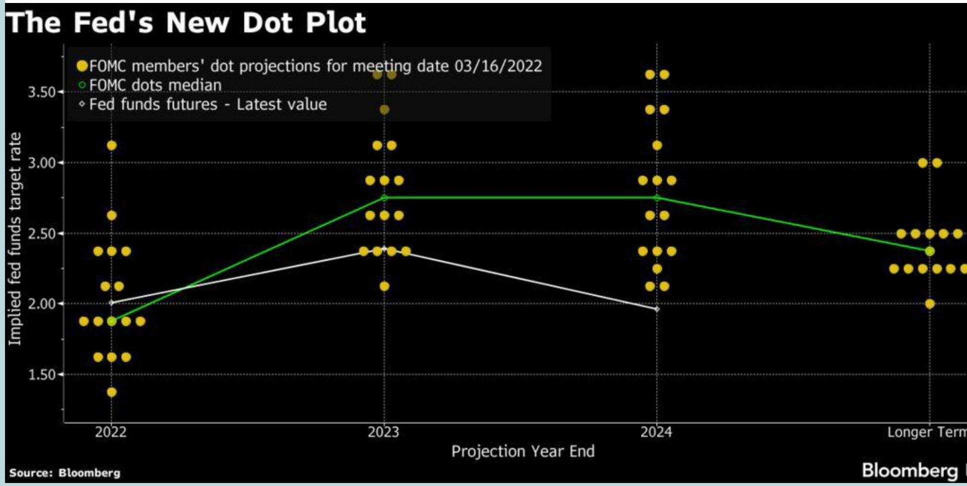
The total accepted amount from 1Yr T-Bills at the recent weekly auctions were seen falling short of the total offered amount while attracting investors towards more liquid short-term maturities resulting in yield of 03M T-Bill reaching 14.12%. Moreover, currently, SLFR is at 7.50% while 03M T-bill rate in the secondary market is hovering around 14.88% creating an arbitrage profit of c. 7.38% which is one of the highest in the history. Moreover, for the first time after more than five years, CBSL rejected all bids received at T-bond auction held on 29th Mar-22 as a result of higher yields expected by the market in order to compensate for galloping inflation and higher financing requirement of the Govt. Undersubscribed bill and bond auctions have resulted in continuous rise in CBSL holdings which surpassed LKR 1.8Tn. However, we believe that given the recent market developments and the prevailing negative real interest rates, another rate hike is needed to meet the expectations of the market participants to regain market activeness and to unwind Govt's large T-bill holdings.

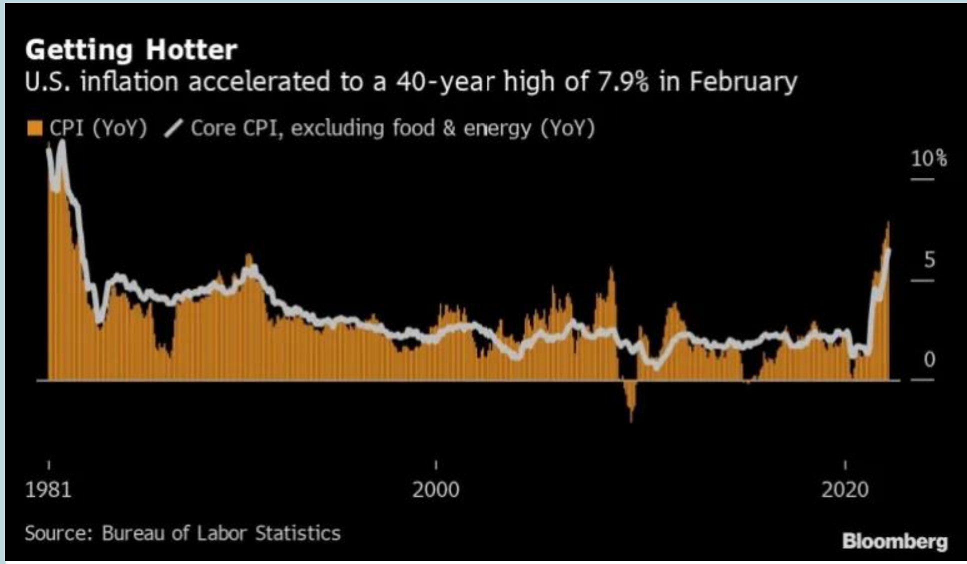
Federal Reserve shift towards aggressive hikes after being rattled by persistent inflation while other countries are expected to jump on the bandwagon…

Federal Reserve officials, rattled by persistent inflation and criticism that they're behind the curve, have pivoted toward an even more aggressive plan of interest-rate hikes than they signaled earlier this month to ensure price increases cool. At the meeting held on Mar 15-16, the Federal Reserve raised interest rates by a quarter percentage and signaled hikes at all six remaining meetings this year, launching a campaign to tackle the fastest inflation in four decades even as risks to economic growth mount.

The war in Ukraine initially made them cautious, with officials backing a quarter-point increase this month as they raised rates from near zero. Investors took the hike in stride and the Fed quickly became more concerned that the surge in food and energy prices caused by the war would entrench inflation and expectations at unacceptably high levels.

With the Bank of England having already moved on higher interest rates , the European Central Bank is likely to wait until the end of the year to raise rates.





Global policy actions are favouring the hawkish hopes

	Oct 2021	Nov 2021	Dec 2021	Jan 2022	Feb 2022
Net Change	+2,715 bps	+1,005 bps	+1,365 bps	+940 bps	+300bps
Total Rate Cuts	200bps	100bps	105bps	410bps	0bps
Total Rates Rises	2,915bps	1,105bps	1,470bps	1,350bps	300bps
Rate Cuts	Turkey	Turkey	Turkey and China	Congo, South Sudan and China	None
Rate Rises	Romania, Moldova, Uruguay, New Zealand, Iceland, Poland, Peru, Chile, Hungary and Paraguay, Russia, Tajikistan, Kazakhstan, Brazil, Zimbabwe, Azerbaijan and Colombia	Poland, Czech Republic, Romania, Mexico, Uruguay, Peru, Hungary, Jamaica, Iceland, South Africa, Pakistan, Ghana, Paraguay, Lesotho, New Zealand, Zambia, Dominican Republic, South Korea and Kyrgyzstan	Moldova, Georgia, Poland, Brazil, Ukraine, Peru, Pakistan, Armenia, Hungary, Chile, Costa Rica, Norway, United Kingdom, Mexico, Azerbaijan, Russia, Colombia, Jamaica, Paraguay, Czech Republic, Sierra Leone and Dominican Republic	Poland, Uruguay, Argentina, Peru, Romania, Moldova, South Korea, Sri Lanka, Ukraine, Paraguay, Kazakhstan, Hungary, Chile, Costa Rica, South Africa, Azerbaijan, Colombia, Kyrgyzstan and Dominican Republic	Armenia, Lesotho, Brazil, United Kingdom and Czech Republic.
Global Monetary Policy Rate	**5.28%**	**5.38%**	**5.51%**	**5.60%**	**5.63%**

Global central banks have embarked on raising rates while *none* of the country opted for a rate cut amidst firing inflation woes

Source: centralbanknews.info

Arguments against hike in monetary policy

Consecutive rate hikes may derail the potential recovery in GDP growth

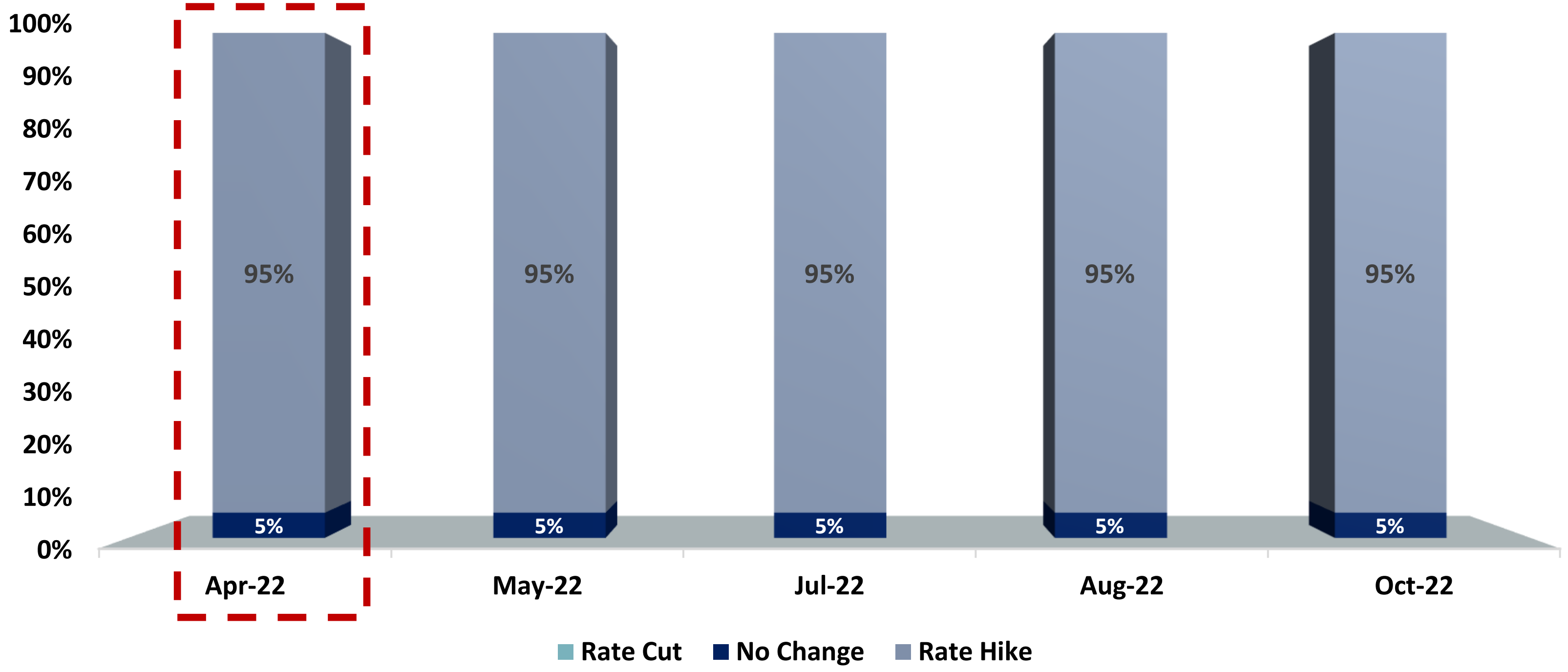
Recovering from a steep contraction in GDP in 2020, Sri Lanka's economy has embarked on a gradual recovery during 2021 recording a GDP growth of 3.7%. However, The domestic economy is expected to be somewhat affected by recent adverse developments such as supply chain disruptions and rising commodity prices, as well as power and energy supply interruptions. These disruptions have to be addressed immediately to ensure the continuation of uninterrupted domestic production and the momentum in exports, while continuing the efforts to strengthen the production economy through well-targeted growth policies. Therefore, further pampering in terms of fiscal and monetary stimulus may require in near to medium term to stabilize the economic growth. Thus, back-to-back rate hikes may act in contrary to these beliefs.

Policy tightening may not curb cost-push inflation

Increase in global commodity prices have 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.

FCR Policy Rate Forecast – Apr 22- Oct 22

We believe that there is a higher probability that CBSL may further ***tighten the monetary policy rates in this policy review but*** given the concerns over economic growth, there is a marginal probability of 5% 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 significant probability of 95% for a rate hike at the upcoming policy meeting.

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