



First Capital

*“COMPOUNDED UNCERTAINTY BOLSTER **RATE** **HIKE** BETS”*

PRE-POLICY ANALYSIS

01ST JUL 2022

First Capital Research

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Previous Pre-policy report: Recap



2

CBSL maintained its policy stance

In-line with our expectations, at the previous policy announcement held on 19th May-22, CBSL decided to maintain the SDFR and the SLFR at 13.50% and 14.50%, respectively. This decision has been made considering the view that although inflation is projected to remain elevated in the near term, the substantial policy measures taken by the monetary board, at its meeting held on 08th Apr-22, combined with the other measures taken to curtail the firming up of aggregated demand pressures, are expected to contain any further build-up of inflation expectations and ease inflationary pressures in the period ahead.

Key Arguments by CBSL for maintaining its policy stance on 19th May-22

- ✓ A faster passthrough to market interest rates is observed following the significant monetary policy tightening measures taken at the previous meeting.
- ✓ Inflation is projected to remain elevated in the coming months before moderating thereafter, supported by the realisation of the full impact of the policy measures.
- ✓ The external sector continues to face heightened challenges, however, has been addressed by an array of measures.
- ✓ Economic growth is expected to record a setback this year.



Analysis of upcoming policy decision on 07th Jul

3

Arguments for hike

60%



The below-mentioned factors argue to hike rates at the upcoming policy meeting.

- Heightened political risk highlights the importance of further raising the bar
- Sweltering heat of inflation and increased taxation prompts higher returns
- Bond market whipsawed by uncertainty; need to shrink arbitrage profits
- Tightening policy stance is one of the key propositions by the IMF
- Economies around the globe brace for tightening spree as central banks fight to escape stagflation episodes

- Fiscal and structural reforms to delay monetary tightening
- Stability of the currency has been assured through an array of measures introduced by CBSL
- Sri Lanka to fall into a recession?
- Policy tightening may not curb cost-push inflation

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

Arguments against hike

40%



Arguments *for* hike in monetary policy



Heightened political risk highlights the importance of further raising the bar

Despite the presence of existing government, concerns over political instability remained unchanged in Sri Lanka as the current government is yet to address some key issues including important public reforms. Moreover, in addition to that, intensified impact of fuel crisis has triggered a new wave of civil disturbances further raising the risk of the stability of the incumbent government. Consequently, in the midst of fading economic and political conditions, local currency could be further distressed on the backdrop of an already worsened external liquidity position (SL's foreign reserves only amounted to USD 1.9Bn by May-22 while usable foreign reserves were down to extremely lower levels resulting in the Govt. having to continuously rely on credit lines to bolster its finances). Hence, in order to arrest future pressure on the currency and reserves, there is a possibility for CBSL to tighten its policy rates. Moreover, although SL has concluded discussions with IMF, failing to reach a staff-level agreement by Jul-22 as expected and complexity of the existing debt restructuring process is expected to linger further ambiguity, highlighting the importance of raising policy rates at the upcoming policy review, as a proactive measure to ensure the stability of the local currency.

Sweltering heat of inflation and increased taxation prompts higher returns

Sri Lanka recorded its all-time high inflation of 54.6% in Jun-22 causing an alarm among the consumers in the country. Going forward, inflation is expected to remain further elevated due to potential rise in energy prices and continuing supply chain disruptions. Despite rising inflation is mainly led by cost push factors, market is of the view that it warrants a hawkish monetary policy stance by CBSL. In addition to that, government also took measures to improve taxes to enhance and address its fiscal drains. Accordingly, in order to reward for higher inflation and impact of increased taxes, there is a likelihood that CBSL might raise interest rates to compensate for squeezed real income and lost margins of the market participants.

Arguments *for* hike in monetary policy



Bond market whipsawed by uncertainty; need to shrink arbitrage profits

During the week ending, 01st Jul-22, the secondary market yield curve edged up following the outcome of the primary market auctions (both bond and bill auctions held on 28th and 29th saw an increase in rates across the board with getting accepted lower than the offered amount) while activities were limited as market participants took the sidelines over mounting uncertainties. Given the recent negative economic market developments and the prevailing negative real interest rates, another rate hike seems to be needed to meet the return expectations of the market participants to regain market activeness. We also believe that amidst the increasing fiscal deficit, offering higher rates and encouraging investments via primary markets may enable CBSL to scale down its significantly piled up CBSL holdings which amounted to LKR 2.1Tn. Additionally, a rate hike is also expected to reduce the spread between the 3M T-bill rate which is currently at 23.85% and SLFR at 14.50% thus reducing the arbitrage opportunity made by banks and financial institutions hence encouraging more deposits into the banking system, improving the overall liquidity.



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

Currently, SL is seeking financial support from the IMF, while the discussions currently continue virtually with a view to reach a staff-level agreement on the EFF arrangement in the near term. As per 2021 article IV consultation of IMF, tighter monetary policy was a key recommendation as part of the comprehensive strategy and therefore, given the rising inflationary pressures, there is a likely hood that CBSL may consider further tightening policy rates at the upcoming meeting.

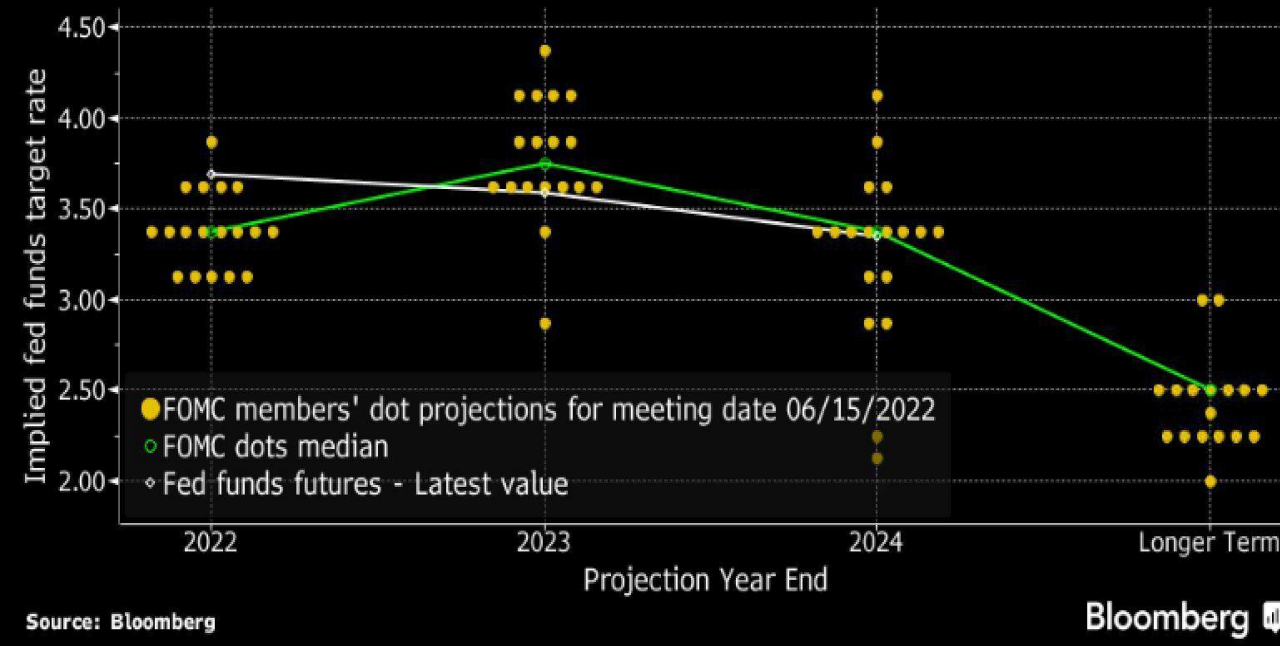
Economies around the globe brace for tightening spree as central banks fight to escape stagflation episodes

Refer slide 06 and 07

Economies around the globe brace for tightening spree...

6

The Fed's New Dot Plot



The Federal Reserve raised its benchmark interest rates by 0.75% to a range of 1.50%-1.75% in its most aggressive hike since 1994. According to the “dot plot” of individual members’ expectations, the Fed’s benchmark rate will end the year at 3.40%, an upward revision of 1.50% from the March estimate. The committee then sees the rate rising to 3.80% in 2023, a full percentage point higher than what was expected in Mar-22. The **president of the Federal Reserve Bank of Cleveland, Loretta Mester said, if economic conditions remain the same when the U.S. central bank meets to decide its next monetary policy move in Jul, she will be advocating for a 75bps basis point hike to interest rates.**

Source: CNBC

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) on 08th Jun-22 increased the repo rate by 50bps to 4.90% in a bid to slow inflation that it estimates will average 7.50% in the current April-June quarter.

Source: The Indian Express

The Philippine central bank may consider bigger interest rate hikes to support the peso in Aug-22, though will not be obliged to match policy tightening by the U.S.

Source: Reuters

Most Gulf central banks followed the U.S. Federal Reserve on 15th Jun-22 lifted their key interest rates by three-quarters of a percentage following the Federal Reserve’s 75 basis point hike.

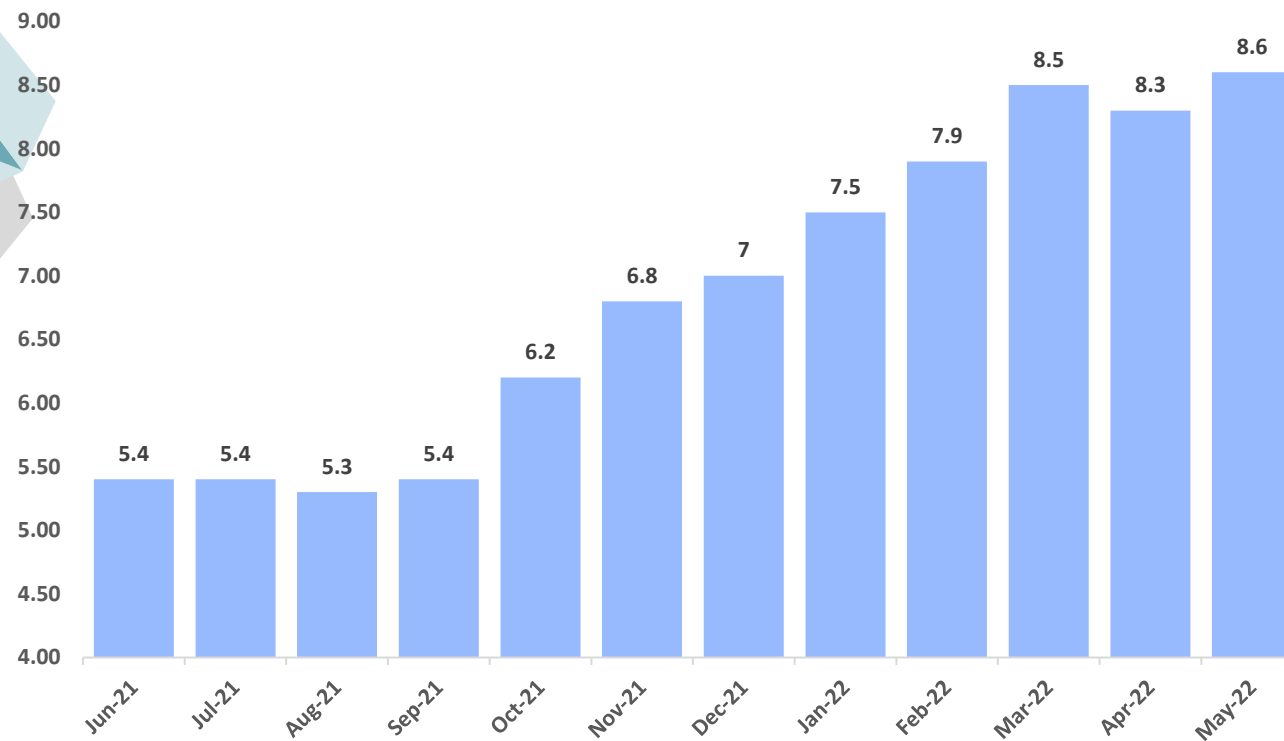
Source: Reuters



...as central banks fight to escape stagflation episodes

7

Inflation rate in U.S accelerated to 8.60% in May-2022, the highest since Dec-1981



Source: Trading economics

Canadian consumer prices increased in May-22 at rates not seen since Jan-83, ahead of analyst forecasts, driven by pricey gasoline, upping pressure on the central bank to follow the U.S. Federal Reserve with a supersized rate hike.

Source: CNBC

Euro zone inflation reached a new record high in Jun-22 just ahead of the European Central Bank's first-rate increase in 11 years. Headline inflation came in at 8.6%YoY for Jun-22 and ECB, vowed to tackle the surge in prices, by increasing rates in late Jul-22 and said it will hike again in Sep-22.

Source: CNBC

Arguments *against* hike in monetary policy



Fiscal and structural reforms to delay monetary tightening

As a prime step of fiscal consolidation through revenue enhancement, the government announced a taxation overhaul to boost revenue, which included hiking value-added taxes & corporate income tax and slashing the relief given to individual taxpayers. Further, measures were introduced accompanied with fuel pricing reforms while we also believe that government will have to resort to an upward revision in power tariff sooner than later. As a result of the series of fiscal policy measures, it could be argued that CBSL may delay further monetary policy tightening and use it prudently in the latter part of the year while allowing the impact of previously introduced fiscal reforms to get materialized in the economy.



Stability of the currency has been assured through an array of measures introduced

The guidance provided by the CBSL to all licensed banks in the determination of the interbank spot exchange rate since mid May-22, is expected to minimise any excessive volatility in the domestic foreign exchange market. This, coupled with the recent tightening of the monetary policy stance and restrictions on imports on open account terms (although this was relaxed partially), is expected to ease pressures on the LKR. Some recovery in foreign exchange inflows in terms of workers' remittances has also been noticed in the month of May-22 which was recorded at USD 304.1Mn relative to USD 249.0Mn in Apr-22 and is expected to further improve due to the notable reduction in the gap between the official exchange rate and the rate offered by the grey market and the continued increase in migration of workers. Consequently, current stability of the currency along with the other measures implemented by CBSL implies no further tightening in policy rates at the upcoming review.

Sri Lanka to fall into a recession?

SL's economy contracted during 1Q2022 recording a negative GDP growth of -1.6% indicating a considerable downtick compared to 1Q2021. We believe that GDP of 2Q2022 to contract even more amidst the economic headwinds resulting from an acute shortage of foreign currency, rising inflation and tightening financing conditions further impacting agricultural,

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



Sri Lanka to fall into a recession? Contd.,

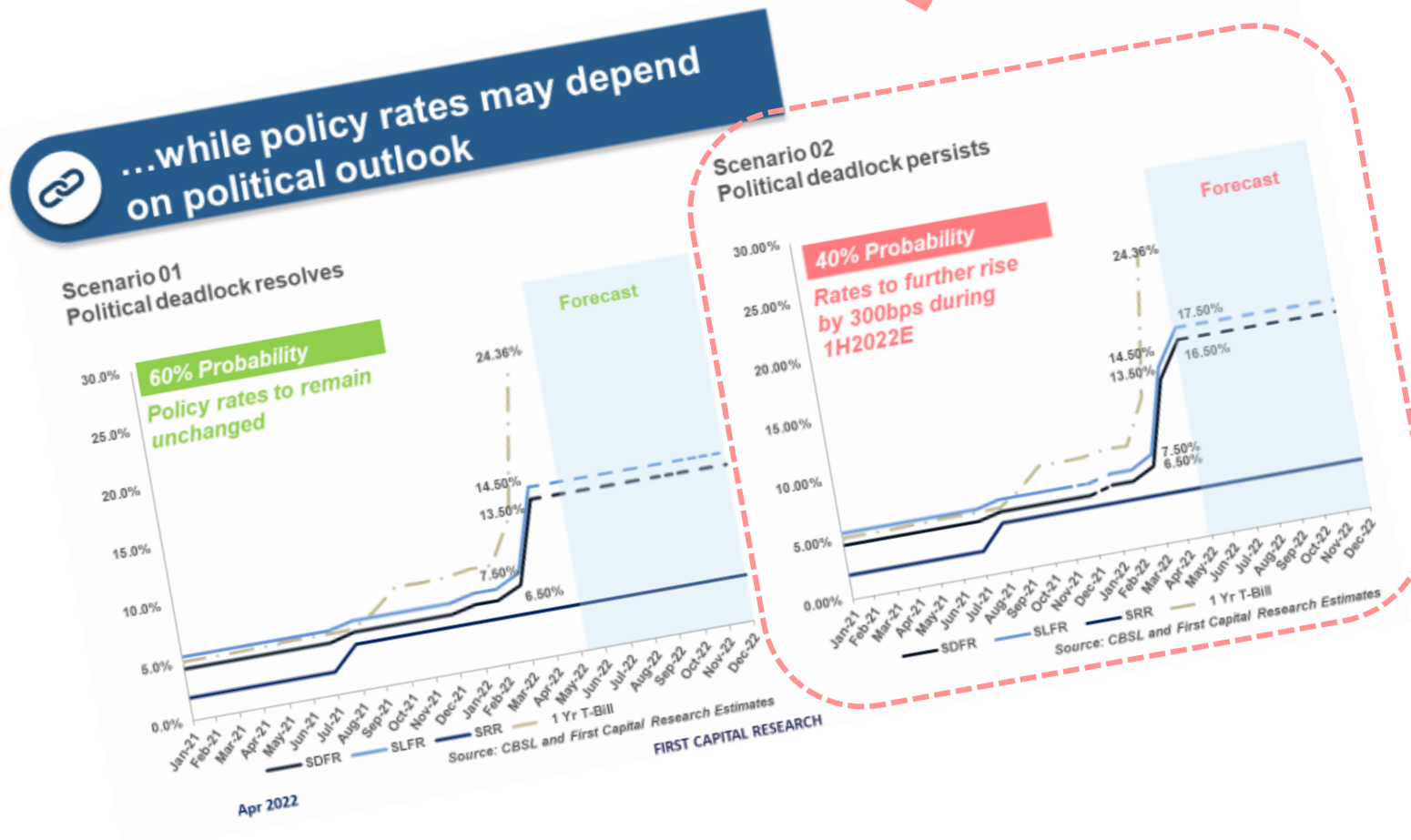
industrial and service activities across the board resulting in a recession. As such we believe that CBSL may not seek to further tighten the economy as the country is already sailing through painful conditions.

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 restrictions 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.



40% Probability takes priority amidst the uncertainty getting created in the system



RECAP Economic Outlook – Apr 2022

As, forecasted in ECONOMIC OUTLOOK REPORT dated 25th Apr-22, SL is currently heading to scenario 02 and thus expects nearly a 300bps rate hike at the upcoming meeting.

Factors of concern at the policy review

11

Foreign Reserves
USD 1.9Bn by May-22

Inflation
CCPI 54.6% for Jun-22

GDP Growth
1Q2022 - 1.60%

03M T-Bill rate
23.85% as of 29.06.22

Private Credit
LKR 2.0Bn for May-22

Liquidity and CBSL Holdings
LKR -518.8Bn and LKR 2.1Tn

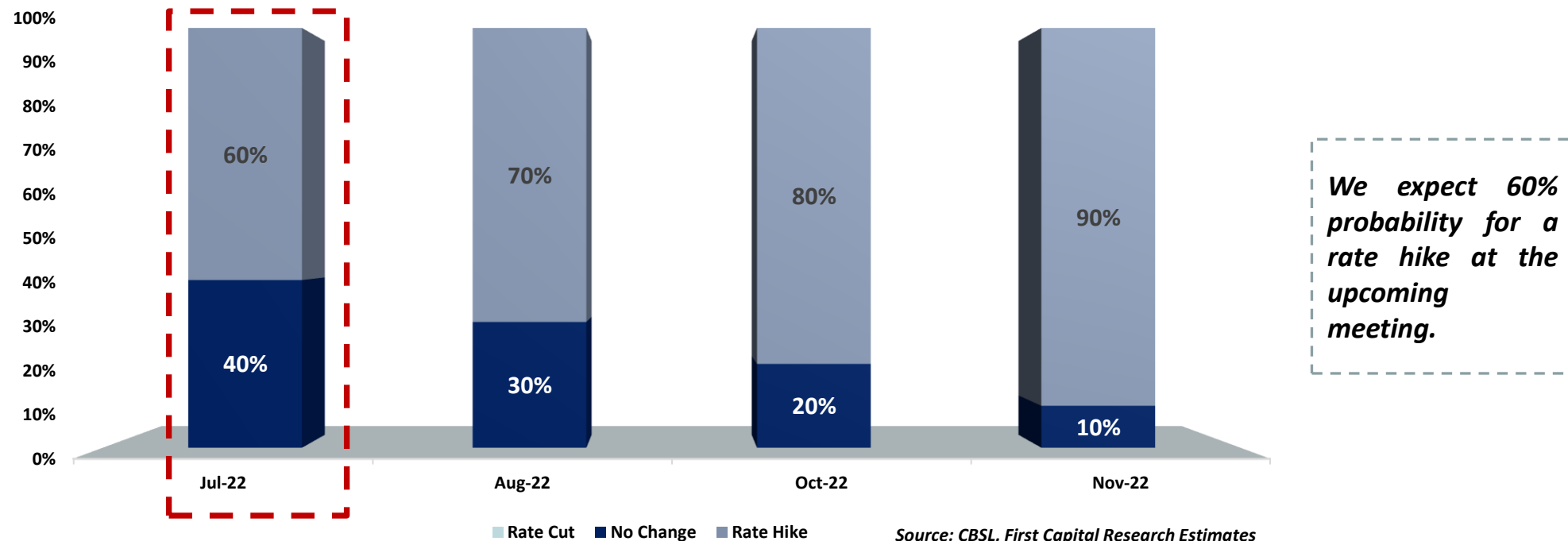
BOT and BOP
USD -3.1Bn and USD -2.6Bn
for Jan-Apr 22



FCR Policy Rate Forecast – Jul 22- Nov 22

12

We believe that CBSL may consider further tightening monetary policy rates in the upcoming policy review, but given concerns over economic recession, there is a lower probability of 40% for CBSL to maintain its policy stance at current levels. If policy tightening does not occur at the upcoming review, we have continued to increase probability for a rate hike at future policy meetings in order to safeguard stability on all fronts and to counter economic headwinds.



Source: CBSL, First Capital Research Estimates

Expected Monetary Policy Stance

13

As per our view, at the upcoming policy meeting, there is a robust case for an increase in policy rates in order to compensate for heightened political risk and thus to preserve the currency & foreign reserves. As a result, we believe there is a higher probability of 60% 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 rate expectations by the market participants as reflected at previous bill and bond auctions, there is a greater prospect that CBSL might opt to go for a fairly large increase in policy rates such as 300bps. However, there is also a lower probability of 40% to maintain the policy rates at its current level in order to improve the high frequency indicators.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 300bps	25%
Raising Policy Rates by 200bps	20%
Raising Policy Rates by 100bps	15%
Policy Rates to remain unchanged	40%
Cutting Policy Rates by 25bps	0%

60%

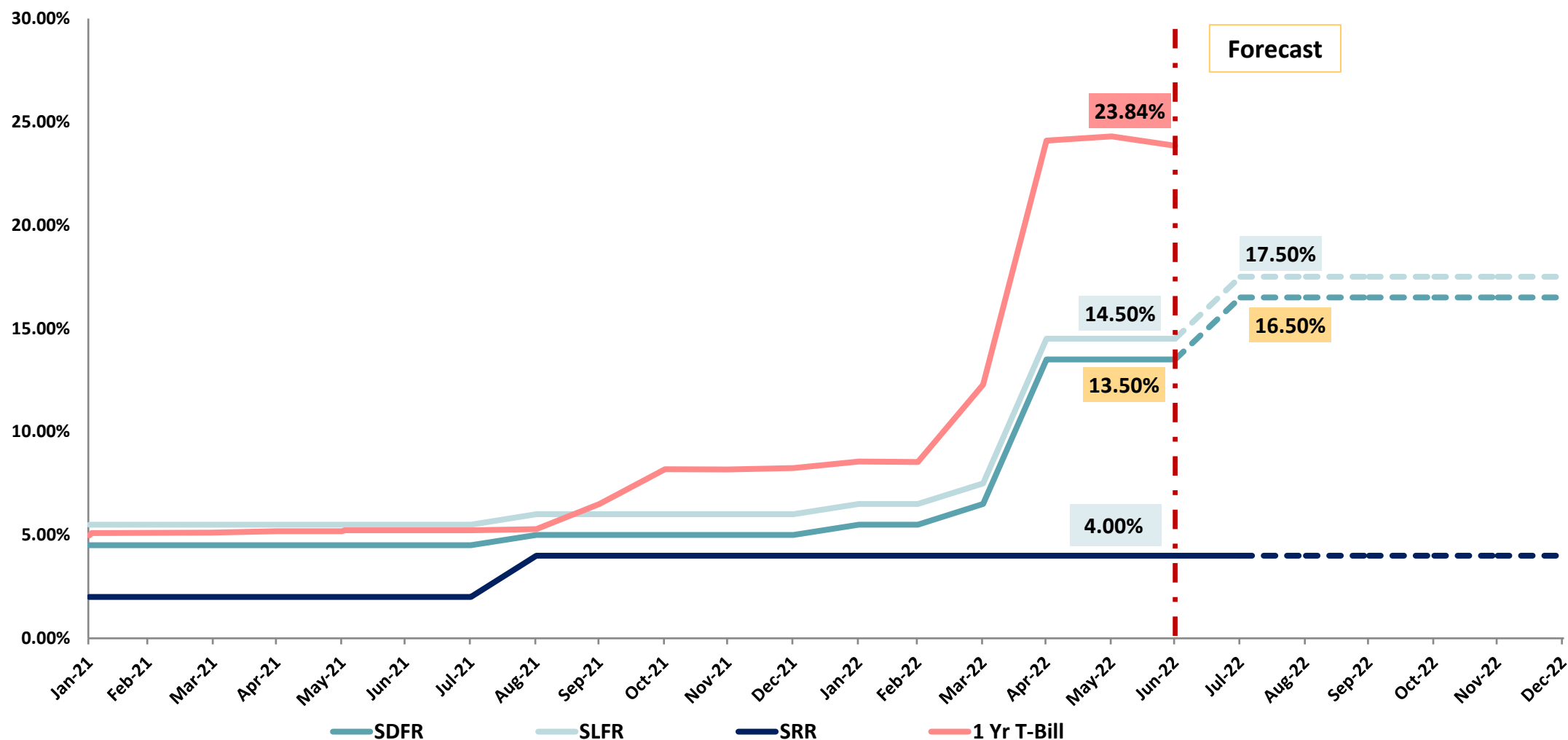
We believe that there is 60% probability for a policy rate hike in warranting for greater economic stability.

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

14



Source: CBSL, First Capital Research Estimates

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