First Capital

"RATE HIKE BETS FADE AS INDICATORS SHOW SIGNS OF COOLING OFF"

PRE-POLICY ANALYSIS

9TH AUG 2022

First Capital Research

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Previous Pre-policy report: Recap

CBSL maintained its policy tightening stance

In-line with our expectations, at the previous policy announcement held on 07th Jul-22, CBSL decided to increase the SDFR and the SLFR by 100bps to 14.50% and 15.50%, respectively. This decision has been made considering the need of further monetary policy tightening to contain higher-than-expected escalation of headline inflation recently and the increased persistence of high inflation in the period ahead. In arriving at this decision, the board weighed the impact of tighter monetary conditions on overall economic activity, including the micro, small, and medium scale businesses, and the financial sector performance, among others, against far reaching adverse consequences of any escalation of price pressures across all sectors of the economy in the near term.

Key Arguments considered by CBSL for its policy stance on 07th Jul-22

- ✓ Central banks have become increasingly hawkish across the globe.
- ✓ Market interest rates continue to adjust upwards in response to tight monetary and liquidity conditions.
- ✓ The external sector continues to face heightened challenges.
- ✓ Domestic economic activity is expected to record a notable downturn in the near term.
- ✓ Although inflation is projected to remain elevated during the remainder of the year, a sharp disinflation path is expected thereafter with appropriate policy measures.

Analysis of upcoming policy decision on 18th Aug

Arguments for no change

80%

The below-mentioned factors argue for no change in policy rates at the upcoming policy meeting.

- **Formation of the new government alleviates the political risk; aids in establishing the currency stability**
- **Private credit collapses while liquidity improves with funds inflow to the banking system**
- **Inflation shows signs of cooling off attributed to multiple factors**
- **Correction of excessively adjusted market rates**
- **Recessionary fears haunt countries around the world**

Arguments for hike

20%

- **Tightening policy stance is one of the key propositions suggested by the IMF**
- **To fast track the pace of inflation slow down and to contain the economy from expansion**

The above-mentioned factors argue for hike in rates

Arguments for no change in monetary policy

Formation of the new government alleviates the political risk; aids in establishing the currency stability

With the resignation of the previous president, former prime minister Ranil Wickremesinghe has been voted in as Sri Lanka's new president. Despite legitimacy and credibility of the president being challenged at an early stage eventually, he seems to be getting the support of multiple parties to revive the economy out of the tailspin and to implement constitutional reforms and unlock an agreement with the IMF in the months to come. Consequently, in the midst of expectations of restoration of the economy, slight uptick in economic perceptions has been witnessed resulting in the currency getting stabilized at LKR 360.0 levels without much volatility. Despite a slight decline in foreign reserves recorded in Jul-22 by USD 39.0Mn an array of measure introduced so far by CBSL are expected to improve the external position (for Jun-22, SL recorded a trade surplus of USD 21.0Mn) while ensuring the solidity of the currency. Hence stability ensured in terms of political and external front implies no further tightening of policy rates required at the upcoming review.

Private credit collapses while liquidity improves with funds inflow to the banking system

Private sector credit for the month of Jun-22 registered a decline of LKR 40.6Bn as AWPR went through the roof to surpass 20.00% and as a result of tightened credit conditions adopted by banks to contain the asset quality considering the applicant’s capacity to service the facilities amidst the deteriorated purchasing power. Consequently, despite the deterioration in private credit, higher interest rates are expected to have drawn significant amount of money in circulation into the banking system in the form of deposits and as a result liquidity in the system has significantly improved by LKR 29.5Bn from LKR 491.5 recorded on 07th Jul-22 and is expected to further progress in the period ahead ensuring that no further rate hikes are required at the upcoming review.

Arguments for no change in monetary policy

Inflation shows signs of cooling off attributed to multiple factors

Increase in global commodity prices has become a key determinant factor of the soaring inflation in Sri Lanka. However, First Capital is of the view that inflation has peaked, and stabilization is expected amidst the ease off in global commodity prices and with the stabilization of supply conditions over the medium term. Hence softening pressure on inflation suggest that recent tightening of monetary conditions are sufficient to contain the inflation expectations of the public in the period ahead and therefore further hikes in policy rates would not be required at the upcoming meeting. Moreover, 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 followed by an upward revision in power tariffs. As a result of the series of fiscal policy measures, the overall demand in the economy is expected to be subdued hence questioning the need for an additional tightening.

Correction of excessively adjusted market rates

Despite primary and secondary bond market yields adjusting upward with greater deal of uncertainty over the alarming statements on local debt restructuring, we believe that uncertainty has been already captured into existing yields. It appears that the current rates have peaked for now following a series of uncertainties which took place since the start of the political crisis. At the bond auction held on 10th Aug-22 CBSL also rejected the acceptance of 01.06.25 maturity amidst higher yields quoted by the market participants expecting a high impact on short-midterm bonds via restructuring. However, with CBSL showing unwillingness to accept rates at higher level (above 30.0%) there is an indication that yields have adjusted upwards beyond their expectations and hence it is important to cap rates at existing levels and below. Moreover, relative to 100bps increase in policy rates on 7th Jul-22, immediately afterwards yields in the secondary market broadly remained stable indicating an anchor in rates at the prevailed market rates. Hence, in the aforementioned circumstance CBSL is more

Arguments for no change in monetary policy

Correction of excessively adjusted market rates contd.,

likely to maintain key policy rates at current levels in order to prevent further upward adjustments in market yields.

Recessionary fears haunt countries around the world

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, industrial and service activities across the board resulting in a recession. Moreover, on the global front despite the fact that central banks have become increasingly hawkish to tame the inflation, policy tightening is expected to slow immediately as global countries may soon be teetering on the edge of a global recession. As such we believe that CBSL may not seek to further tighten the economy as the country is already sailing through painful conditions. (Refer slide 07 and 08)

Pace of monetary policy tightening may slow down…

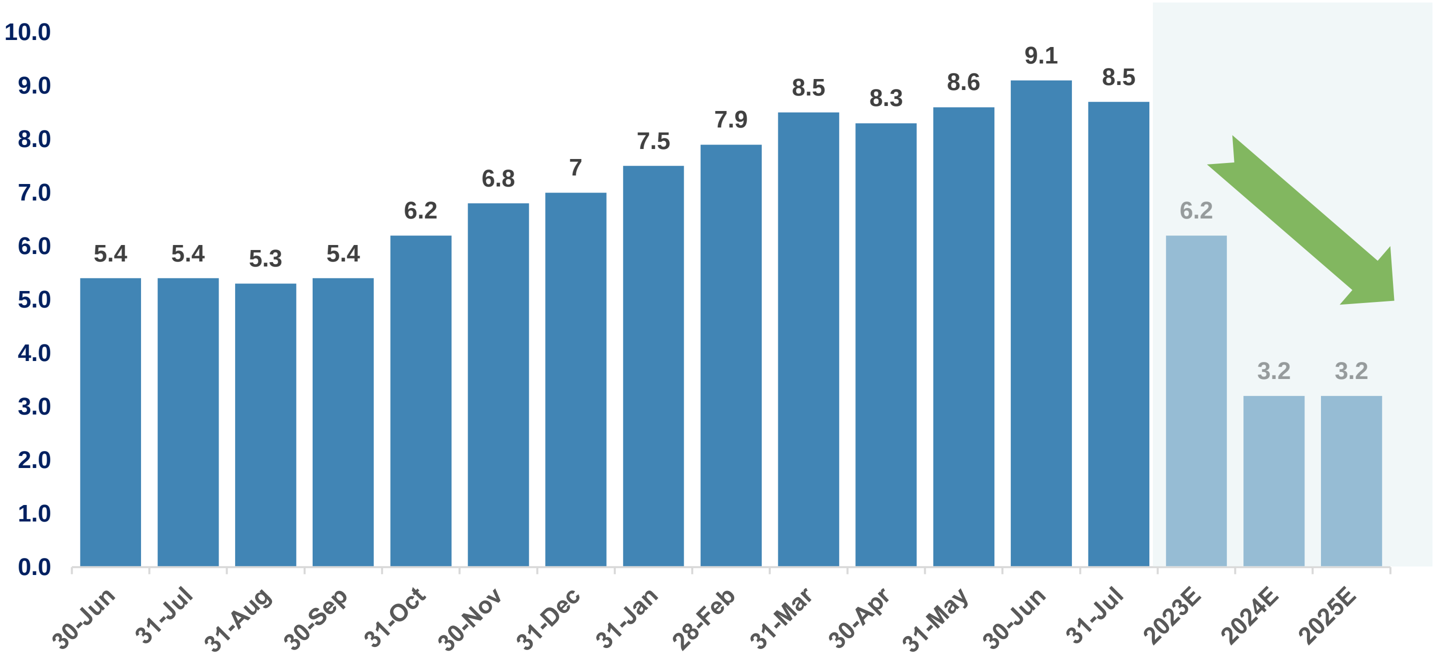
In U.S, pace of tightening is expected to slow down over fears of economy tipping into recession

The Fed on 26th Jul-22 raised its policy rate by another 0.75%, bringing the total interest rate hikes since Mar-22 to 225 basis points. Fed Chair Jerome Powell acknowledged the softening economic activity as a result of tighter monetary policy stance. However, the US economy has shrunk for the second quarter in a row, a milestone that in many countries would be considered an economic recession signaling that it could slow the pace of its hiking campaign at some point. A strong majority expect the Fed to hike its policy rate by 50bps in Sep-22 in the midst of softening inflation.

…amidst potential deceleration in inflation reined in by falling energy costs

U.S. consumer prices rose at a much slower pace in Jul-22 due to a sharp drop in the cost of gasoline, delivering the first notable sign of relief for U.S citizens who have watched inflation climb over the past two years.

The New York Federal Reserve's monthly Survey of Consumer Expectations showed that respondents expect inflation to run at a 6.2% pace over the next year and a 3.2% rate for the next three years.



Source: Trading economics and CNBC

Arguments for hike in monetary policy

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

Currently, SL is seeking financial support from the IMF, while the discussions are underway with a view to reaching a staff-level agreement on the EFF arrangement with the possible expectations of reaching a conclusion by end Aug-22. 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 higher inflationary environment of 60.8% which is significantly above the interest rates and to compensate for squeezed real income, there is a probability although at a lower scale to further tighten policy rates at the upcoming meeting.

To fast track the pace of inflation slow down and to contain the economy from expansion

Sri Lanka recorded its all-time high inflation of 60.8% in Jul-22 owing to higher commodity prices and supply side interruptions. Hence in order to prevent hyperinflationary scenario in the period ahead and to fast track the slow down in inflation expectations there is a possibility that CBSL might apt to choose further tightening in policy rates. Containing the hyperinflation seems to be far more important as it could lead to significant negative consequences such as expansions in the economy. (for an instance, owing to soaring inflation, Argentina has witnessed daily barter trades among people with significant volatilities in daily prices resulting in further inflation in the form of a vicious cycle)

Factors of concern at the policy review

Inflation
CCPI 60.8% for Jul-22

Foreign Reserves
USD 1.8Bn by Jul-22

GDP Growth
1Q2022 - 1.60%

03M T-Bill rate
28.43% as of 09.08.22

Private Credit
LKR -40.6Bn for Jun-22

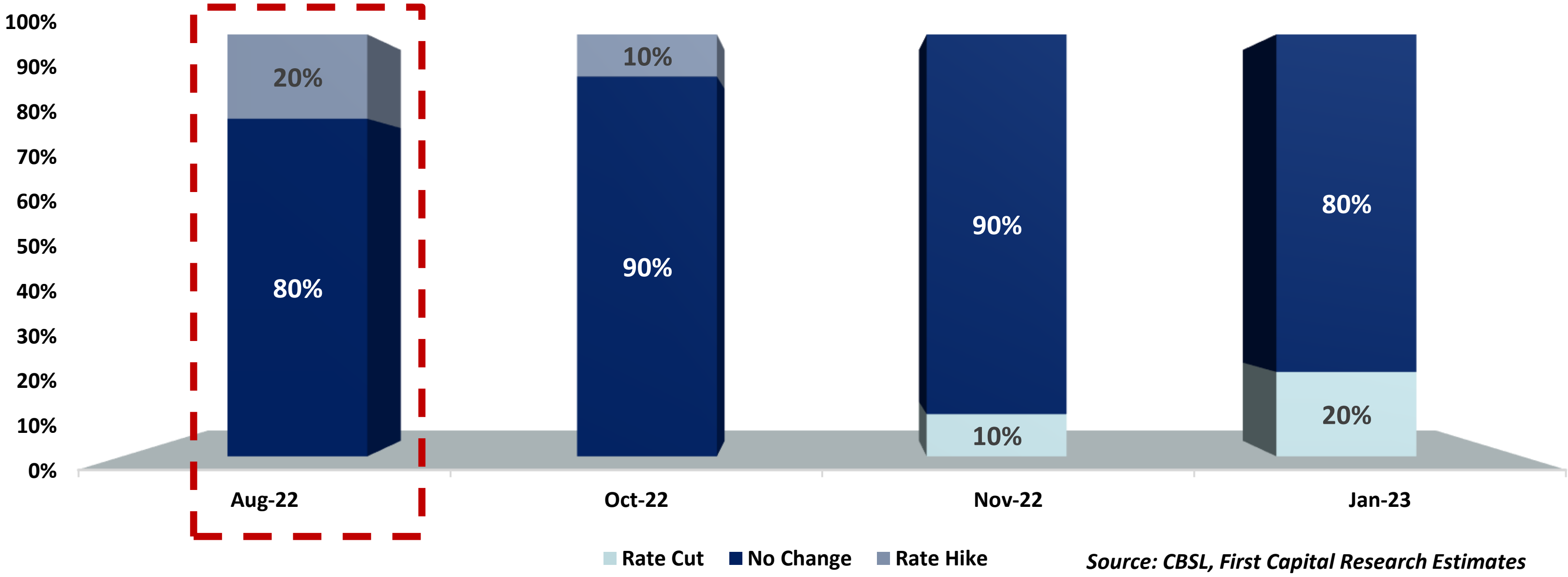
Liquidity and CBSL Holdings
LKR -461.9Bn and LKR 2.3Tn

BOT and BOP
USD -3.5Bn and USD -2.8Bn
for Jan-Jun 22

FCR Policy Rate Forecast- Aug 22-Nov-22

We believe that considering the impact of the previous 950bps tightening in rates in three instances, CBSL may consider sustaining monetary policy rates in this policy review in the midst of gradual revival in key economic indicators. Thereby we have assigned a probability of 80% for no change in policy rates. However, there is also a 20% probability for further tightening in order to curtail high inflation and to comply with key propositions of IMF.

Considering the outlook over the next 06M-01Yr, we expect the complete normalization of the economy with the country being able to enter into an IMF EFF support program. Thereby with the complete stabilization of economic indicators, concentration would be shifted towards fast tracking the revival of the economy giving rise to a possibility of a rate cut towards 4Q2022 to 1Q2023 although at a lower probability of 10%-20%.



Source: CBSL, First Capital Research Estimates

We expect 80% probability for no change in policy rates at the upcoming meeting.

Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, **there is a robust case for maintaining policy rates** in order to realize the impact of previous rate hikes amounting to a total of 950bps. As a result, we believe that there is a major probability of 80% to maintaining rates at current levels. However, there is also a lower probability of 20% for tightening to compensate for higher inflation and to comply with IMF conditions.

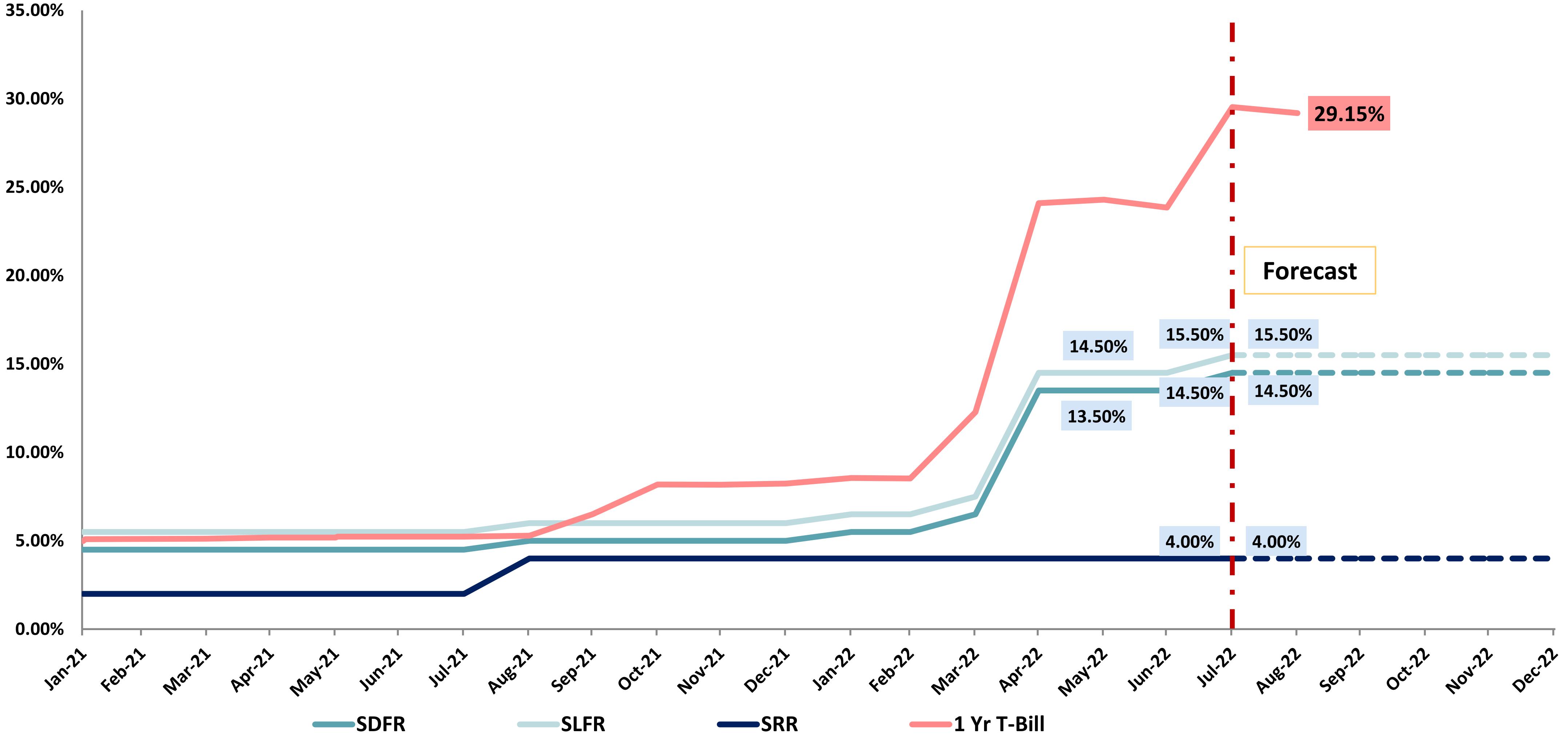
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 100bps	5%
Raising Policy Rates by 50bps	15%
Policy Rates to remain unchanged	80%
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

We believe that there is 80% probability for no change in policy rates considering the impact of previous rate hikes and gradual improvement in high frequency indicators.

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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