“TOO EARLY TO BE DOVISH?”

PRE-POLICY ANALYSIS

21st NOV 2022

First Capital Research

Analysts: Vidushika Perera
Dimantha Mathew

Previous Pre-policy report: Recap

CBSL maintained its policy interest rates at the current levels

In-line with our expectations, at the previous policy announcement held on 6th Oct 2022, CBSL decided to maintain the SDFR and the SLFR at the current levels of 14.50% and 15.50%, respectively. This decision has been made considering the latest macroeconomic conditions, expected developments and macroeconomic projections. The Board was of the view that the monetary conditions remain sufficiently tight to achieve the envisaged disinflation path in the period ahead. Moreover, contractionary fiscal policies would complement the effects of tight monetary policy measures already in place, helping to mitigate any build-up of aggregate demand pressures, thereby anchoring inflation expectations and bringing down headline inflation to the targeted level over the medium term.

Key Arguments considered by CBSL for its policy stance on 6th Nov 2022

- ✓ Domestic economic activity is expected to remain subdued during 2022, before recovering in 2023.
- ✓ Private sector credit continues to contract due to tight monetary and liquidity conditions.
- ✓ Headline inflation is expected to follow a disinflationary path in the near term.
- ✓ Positive developments are observed in the external sector despite heightened challenges.

Analysis of upcoming policy decision on 24th Nov

Arguments For Monetary Relaxation

35%

The below-mentioned factors argue for a relaxation in policy rates at the upcoming policy meeting

- Repeated hits on economic activities flagging the need for monetary stimulus
- MoM inflation stages a set back in Oct 2022
- Auction yields budged down yet attractive enough for foreign investors
- Persistent negative private sector credit growth
- Upgraded business confidence and promising fiscal policies

Arguments Against Monetary Relaxation

65%

- Overnight liquidity remain negative amidst rising CBSL holdings
- Depleting foreign reserves despite external sector prospects
- A rate cut could wake the defused demand-pull inflation
- Weak foreign flows amidst stable forex rate

The above-mentioned factors argue against a relaxation in policy rates

Arguments for relaxation in monetary policy

Repeated hits on economic activities flagging the need for monetary stimulus

Sri Lankan economy is sliding on a severe contractionary path as portrayed by the continuous slump in manufacturing and service activities. According to the Purchasing Managers' Index (PMI), manufacturing index value for Oct 2022 was recorded at 38.4 with a decline of 4.2 points from Sep 2022 and a decline of 20.3 points since Jan 2022. Significant drop in new orders and production predominantly related to the food & beverage and textiles & apparels which was dampened by the deteriorated purchasing power and slowdown in the economy have caused the plummet in manufacturing activities. Moreover, PMI services index for Oct 2022 has also dipped by 3.3points MoM to 47.9 with a YTD decline of 9.6 points. New businesses in the real estate, insurance and postal & courier sectors exhibited a marginal decline during Oct 2022 while employment continued to fall due to increased resignations, migrations and retirements risking the level of skilled workforce in the country. Furthermore, persistent economic downturn has negatively impacted the living conditions of the country while substantially increasing the level of poverty which is detrimental to the rebound of the economy. Therefore, economic inducements in terms of monetary stimulus may be the need of the hour in order to prevent major economic devastation.

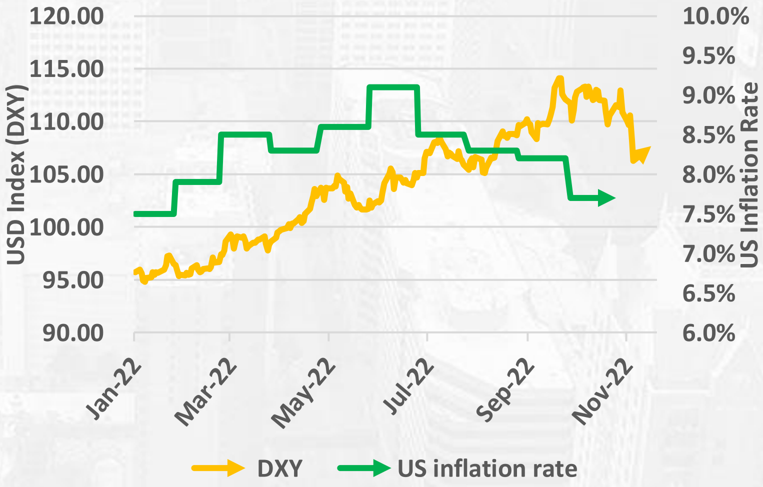
MoM inflation stages a setback in Oct 2022

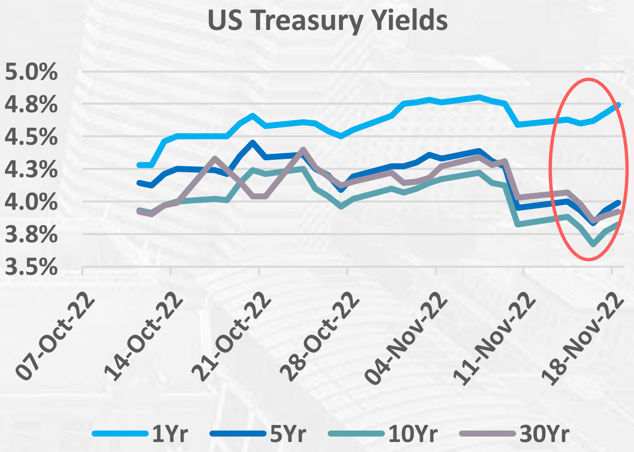
As accurately forecasted by First Capital Research in our 'Mid-Year Outlook 2022' as well as stated in the previous Pre-Policy Analysis report, inflation measured by CCPI marked a decline of 0.4%MoM in Oct 2022 while recording 66.0%YoY (cf. 69.8%YoY in Sep 2022) following a steep upswing over the past 12 months. The turnaround in MoM inflation was largely contributed by the decrease in food items by 0.8% despite an increase of non-food items by 0.4%. The scaled down inflation reveals that any built-up demand pressure has now been completely worn off owing to the sufficiently tight monetary conditions whereas cost-push inflation also started to exhibit a gradual ease off. Therefore, any actions pertaining to further monetary tightening can be completely eliminated while paving the way to introduce monetary stimulus by CBSL via a relaxed monetary policy.

Arguments for relaxation in monetary policy

Auction yields budged down yet attractive enough for foreign investors

Weekly bill auction yields started to shift downwards since the beginning of Nov 2022 after remaining flat for 3 consecutive weeks during Oct 2022 while displaying a gradual increase in the acceptance rate. Accordingly, market sentiment implied some bullishness prior to the weekly bill auction held on 16th Nov 2022 and the auction yields across the board edged down by 2-8bps after 7 weeks of mixed results hinting a welcome towards an era of monetary easing. Despite the marginal dip in yields, T-Bills and T-Bonds remained attractive for foreign investors that showcased a marginal improvement in terms of foreign holding of T-Bills and T-Bonds (c. LKR 2.7Bn) since Oct 2022. This trend may further improve as the attraction for safe heaven investments such as USD denominated assets loses its fame over weakening USD index (DXY) as a result of downward pressure on yields upon easing inflation. It is also expected that FED may deploy less aggressive monetary tightening measures in the upcoming FOMC meetings signalling a potential slowdown in the rise in interest rates ahead of the recessionary hit. Thus, in-line with the global sentiment, there is a high chance for CBSL, which is currently on the path for achieving macroeconomic stability, to opt for a monetary relaxation to signal the market participants on the direction ahead.





Source: www.Investing.com, statista.com, US Treasury

Arguments *for relaxation* in monetary policy

Persistent negative private sector credit growth

Private sector credit continued to shrink since Jan 2022, despite the boom reported during Mar-Jun 2022 due to the re-statement of foreign lending caused by the steep depreciation in LKR. Skyrocketed lending rates, deteriorated economic conditions, restricted import activities and conservative lending stance in banks due to elevated impairment provisions have discouraged the demand for credit resulting in a sharp fall in bank lending which displayed a negative growth consistently since Jun 2022. As a result, overall private sector credit in the system shed LKR 177.6Bn during Jun-Sep 2022. Persistent negative private sector credit growth impedes the chances of revival in the economy as discouraging business activities leads to high frequency of bankruptcies and loss of employment. Therefore, proper guidance for a reduction in interest rates is essential at this juncture to restore the demand for private sector credit to remedy the overly wounded Sri Lankan economy.

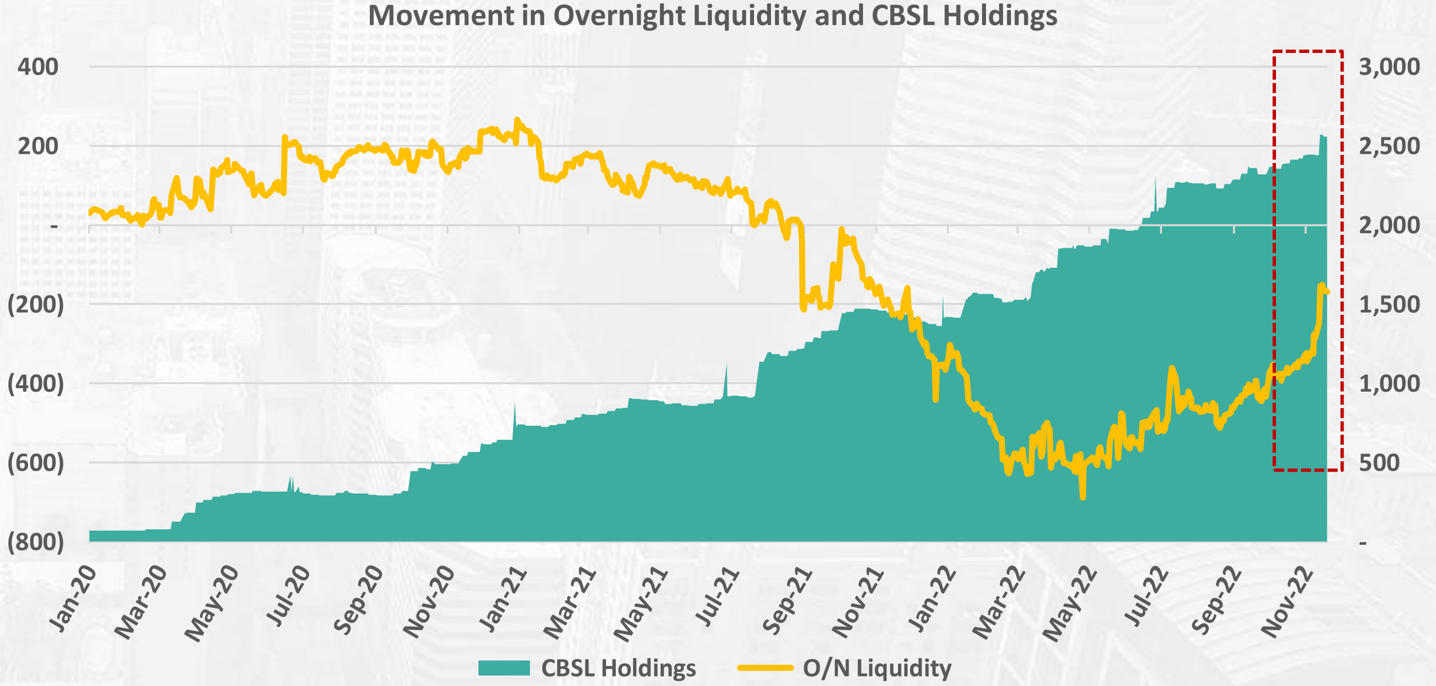
Upgraded business confidence and promising fiscal policies

Business confidence measured by the LMD-Nielsen IQ Business Confidence Index (BCI) climbed by 13 points to 89 in Oct 2022 from 76 recorded in Sep 2022. However, the barometer stood at 111 points a year ago signifying the need for additional inducements for further recovery. Securing the IMF deal by the government brought some light despite the ambiguity in debt restructuring process. Moreover, the proposed budget for 2023, which is targeted to achieve fiscal consolidation as stipulated by the IMF, is expected to lead the country towards a promising path of stabilisation. The implementation of such reforms in a timely manner may ease off the uncertainty surrounding the business environment thereby, levelling up the business confidence. Therefore, CBSL may opt for a monetary relaxation at the upcoming policy review meeting to promote business growth to brace the investor confidence.

Arguments against relaxation in monetary policy

Overnight liquidity remains negative amidst rising CBSL holdings

Overnight liquidity in the banking system improved by LKR 185.2Bn since the last monetary policy review meeting on 6th Oct 2022 narrowing down the deficit to LKR -168.3Bn as of 21st Nov 2022. However, this development is purely arising as a result of CBSL permanently injecting liquidity to the banking system via purchasing treasury securities. Accordingly, CBSL injected LKR 129.9Bn on 15th Nov 2022 as reflected by the increased CBSL Holdings of Government Securities to LKR 2,570.7Bn from LKR 2,440.8Bn on the previous day. Over the past period, CBSL has deployed several mechanisms to inject liquidity to the system, such as overnight injections via repo, term repo and outright purchases of bonds to build treasury securities up to LKR 2.6Tn. Therefore, in the midst of the currency crisis and dried up liquidity, a relaxation in the monetary policy by CBSL may not generate its desired outcome to gear up the key economic variables.



Arguments *against relaxation* in monetary policy

Depleting foreign reserves despite external sector prospects

Official Reserve Assets continue to drain on a MoM basis depleting by USD 75.0Mn in Oct 2022 to USD 1.7Bn from USD 1.8Bn reported in Sep 2022. However, the usable reserves are limited to an insignificant number of approx. USD 1.5Bn is representing the swap line from the People's Bank of China, which cannot be used to finance imports. Meanwhile, the Balance of Payments hit a surplus of USD 108.0Mn in Sep 2022 which implied a rise in foreign reserves in Sep 2022, however, repayment of reserve related liabilities obstructed a continuous growth in reserves. Moreover, trade deficit also narrowed to USD 4.1Bn during 9M to Sep 2022 compared to USD 6.0Bn in 9M to Sep 2021 merely due to the extended import restrictions in effect. Therefore, monetary relaxation by CBSL at this point may have a detrimental effect on the already diminished foreign reserves.

A rate cut could wake the defused demand-pull inflation

Tighter monetary and fiscal conditions currently prevailing in the economy have almost entirely wiped out any sign of demand-pull inflation. Therefore, the headline inflation is considered to be purely based on the cost-push inflation triggered by the supply side bottlenecks and rise in global commodity prices. As inflation measured by CCPI shows signs of taming down, introduction of monetary stimulus via a relaxation in the policy rates could bring back demand-pull inflation into the play. In order to avoid this, CBSL may choose to hold rates at the current levels until inflation solidifies its way to a disinflationary path.

Weak foreign flows amidst stable forex rate

USD/LKR spot exchange rate depreciated by only 0.8% during Jul-Nov 2022 displaying greater stability following the highest ever devaluation experienced in Mar-May 2022. However, despite deeply undervalued but broadly stable forex rate, foreign inflows remained feeble due to uncertain economic, social and political conditions. Equity market net foreign inflows during Jun-Nov 2022 recorded at LKR 18.7Bn while increase in foreign holding of rupee bonds recorded at LKR 22.1Bn for the same period indicating the foreign attraction is not strong enough to deploy a policy rate cut at this juncture.

Factors of concern at the policy review

Inflation
CCPI 66.0% for Oct-22

Foreign Reserves
USD 1.7Bn by Oct-22

GDP Growth
-8.4% in 2Q2022

03M T-Bill rate
33.06% as of 16.11.22

Private Credit
LKR -37.3Bn for Sep-22

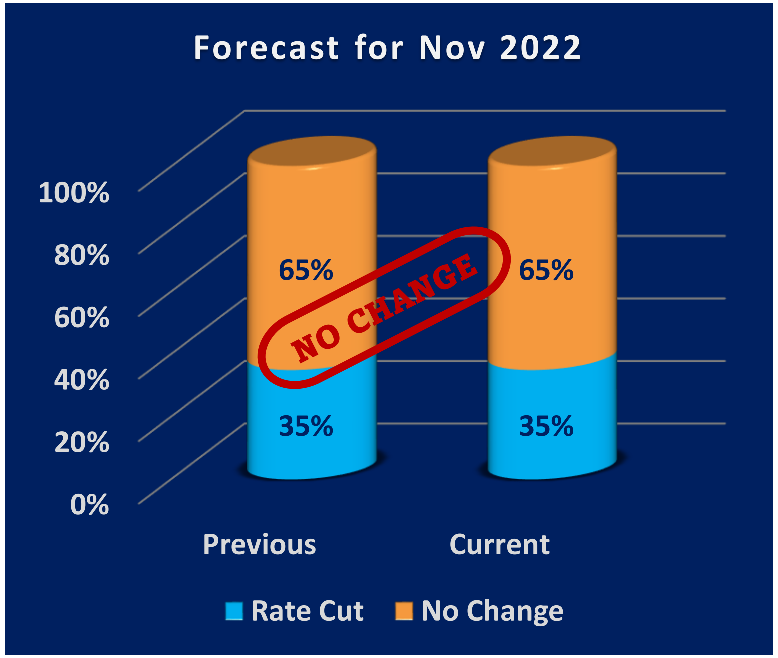
Liquidity and CBSL Holdings
LKR -168.3Bn and LKR 2.6Tn

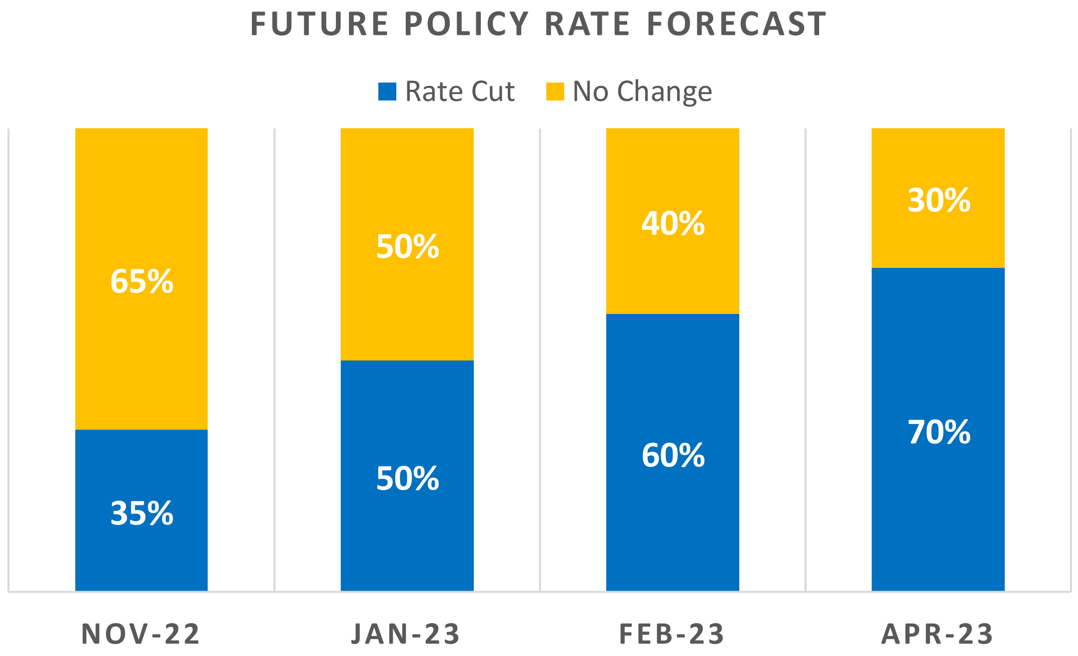
BOT and BOP
USD -4.1Bn and USD -2.9Bn
for Jan-Sep 22

FCR Policy Rate Forecast (Nov-22 to Apr-23)

We believe that CBSL may consider maintaining the monetary policy rates at its current levels in the upcoming policy review meeting allowing a soft landing from its hawkish to dovish stance. However, given the necessity to provide monetary stimulus to prevent further weakening of the economy and the notable improvement in majority of the key economic indicators, we have assigned a lower probability for a relaxation in the monetary policy to alleviate the overreacted interest rates in the tighter monetary environment. Thereby we have assigned a probability of 65% for rates to remain unchanged at the upcoming policy review while also assigning a 35% probability for a relaxation in policy rates.

However, we expect a complete normalization of the economy with the country being able to secure necessary financing from IMF and other multilateral creditors while regaining its access to the global capital market. Thus, the complete stabilization of economic indicators may give rise to a possibility of sizeable rate cuts towards 1H2023 with a significant probability to fast track the revival of the economy.





Unchanged from our previous forecast, we expect 65% probability for rates to remain unchanged with a 35% probability for a relaxation in policy rates.

Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, **there is a high probability for CBSL to maintain the rates at its current levels** allowing further strengthening of key economic indicators, along with **a lower probability for a dovish stance to relax its policy rates** in order to prevent a major economic downturn as well as to signal the market participants a clear direction on the way ahead. As a result, we assigned a major probability of 65% to maintain the rates while also assigning a lower probability of 35% towards a monetary relaxation. Moreover, considering the persistent negative liquidity in the banking system, we assigned a lower probability of 20% for a cut in the SRR while placing majority bets on the SRR to remain unchanged.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 100bps	0%
Raising Policy Rates by 50bps	0%
Policy Rates to remain unchanged	**65%**
Cutting Policy Rates by 25bps	**30%**
Cutting Policy Rates by 50bps	**5%**

35%

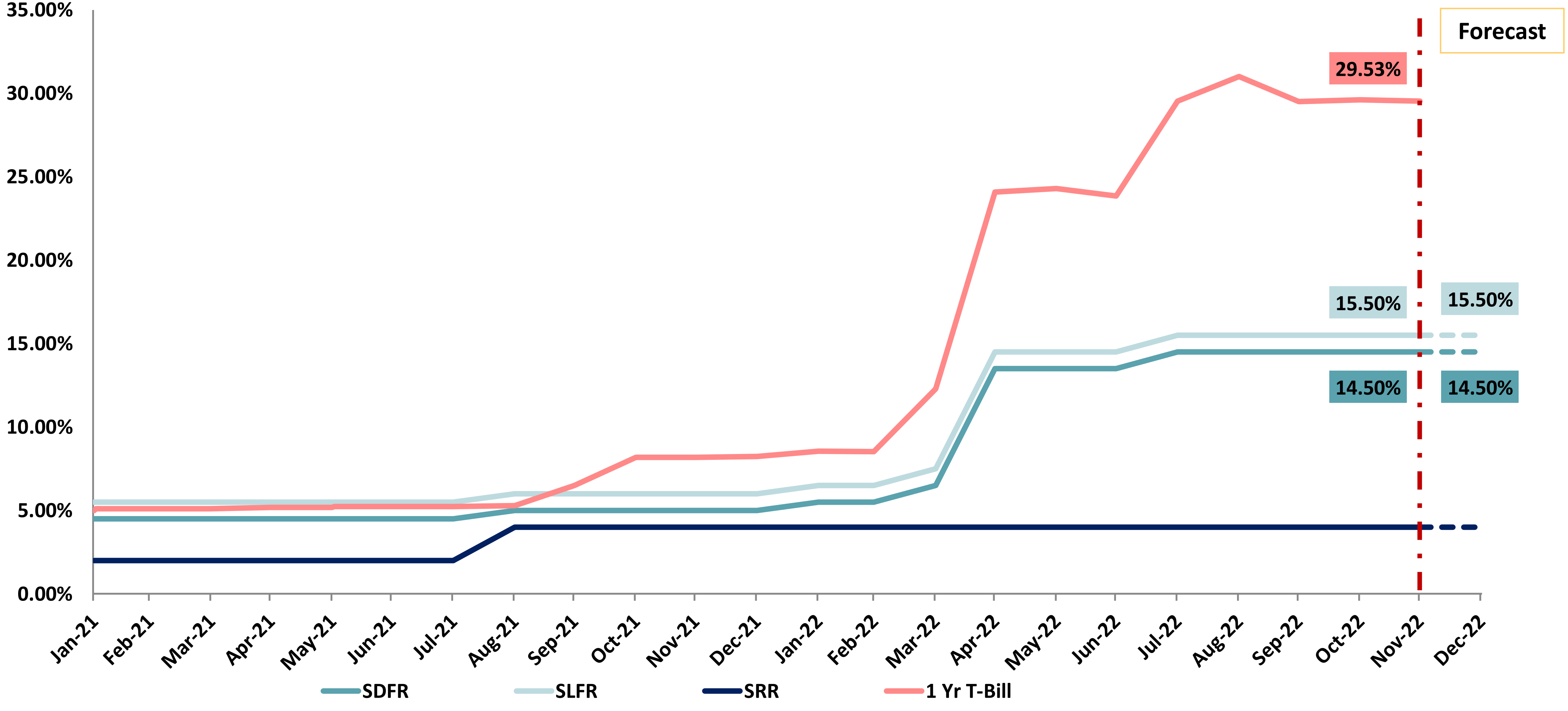
We believe that there is 65% probability to maintain the rates at its current levels to further promote the stability of the key economic indicators.

Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	0%
SRR to remain unchanged	**80%**
Cutting SRR by 50bps	**15%**
Cutting SRR by 100bps	**5%**

20%

Considering the increase of SRR by 200bps to 4% on 19th Aug 2021 we expect SRR to remain unchanged at same levels despite a lower probability of a SRR cut.

Monetary Policy Rates



Source: CBSL, First Capital Research Estimates

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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

Ranjan Ranatunga
Assistant Manager- Research
T: +94 11 2639 863
E: ranjan@firstcapital.lk

Vidushika Perera
Assistant Manager- Research
T: +94 11 2639 865
E: vidushika@firstcapital.lk

Tharusha Ashokgar
Research Analyst
T: +94 11 2639 866
E: tharushaash@firstcapital.lk

Zaeema Jihan
Research Analyst
T: +94 11 2639 868
E: zaheema@firstcapital.lk