“TUNING TOWARDS DOVISH MODE”

PRE-POLICY ANALYSIS

23rd JAN 2023

First Capital Research

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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 23rd Nov-22, 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 recent and expected developments in the domestic and global economy and macroeconomic projections. The Board was of the view that the prevailing tight monetary policy stance is necessary to rein in any underlying demand pressures in the economy. It was also noted that, the maintenance of tight monetary policy stance is necessary to contain any demand driven inflationary pressures in the economy, while helping to further strengthen disinflation expectations, thus enabling to steer headline inflation towards the targeted level over the medium term.

Key Arguments considered by CBSL for its policy stance on 23rd Nov-22

- ✓ Headline inflation marked a turnaround as expected .
- ✓ Domestic economic activity is expected to remain tepid during 2022.
- ✓ Tight monetary and liquidity conditions have slowed the expansion of money and credit aggregates.
- ✓ The external sector remains resilient despite the heightened balance of payments pressures.

Analysis of upcoming policy decision on 25th Jan

Arguments for a Monetary Relaxation

50%

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

- **Worsened economic activities and a weak economic growth outlook**
- **Tax hike to lower disposable income and business confidence**
- **Reactivated buying interest drives down yields**
- **MoM inflation turnaround on lower consumer demand**
- **Recovery in liquidity stimulates rates to ease**

Arguments against Monetary Relaxation

50%

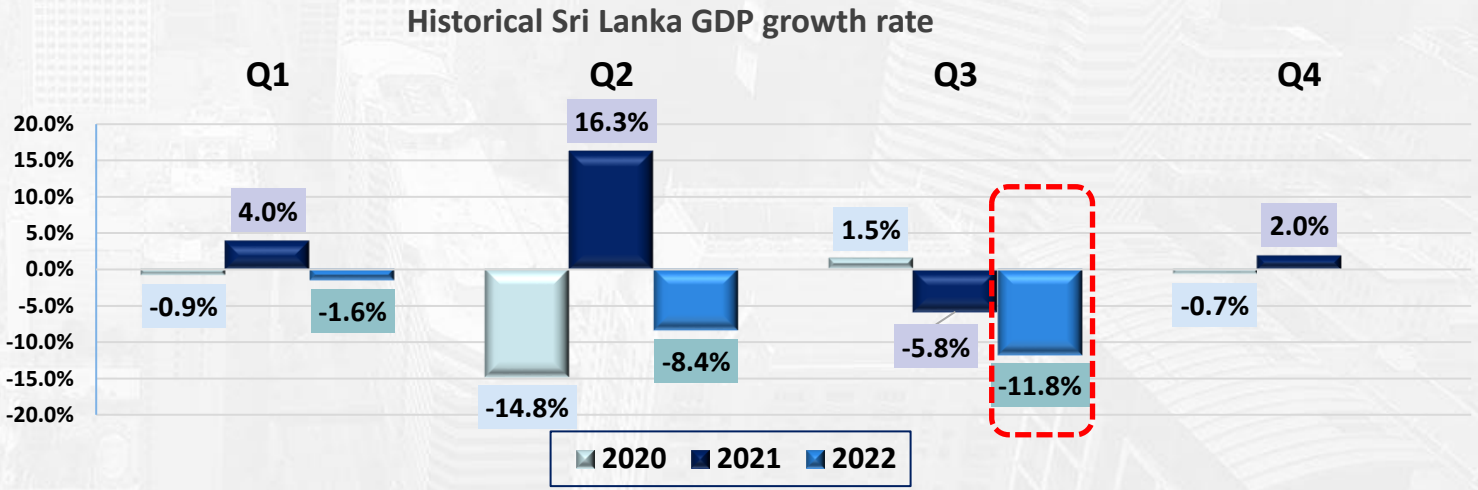
- **Delay in potential IMF board level approval**
- **Foreign reserves remain low, despite marginal improvement**
- **Monetary easing intensifies negative real rate of return**

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

Arguments for relaxation in monetary policy

Worsened economic activities and a weak economic growth outlook

Economic activities in Sri Lanka registered a contraction for the 3rd consecutive quarter and reported a GDP growth of -11.8% in 3Q2022, the second largest degrowth reported (2Q2020 – [-14.8%]). The quarterly performance has been the worst so far during the year 2022 where the largest decline was seen in Industries recording -21.2% while Agriculture contracted by -8.7%. Services also estimated to have declined to -2.6%. However, PMI for both manufacturing and Services activities marginally increased for the second straight month in Dec-22, on a MoM basis, recording 44.8 (+2.7 points) and 51.6 (+2.6 points) index values, respectively. Despite a recovery, manufacturing PMI remained below the average threshold value of 50.0 as new orders and production of mainly textiles and apparel sector remained subdued amidst lower demand while employment fell due to increased resignations, migrations and retirements - risking the level of skilled workforce in the country. Meanwhile, the World Bank has forecasted Sri Lanka's economic growth outlook for 2023 to further contract by -4.2% while ADB revised its forecast to degrowth of -3.3%. Hence, monetary stimulus is required to prevent any further downfall in the economy and to stabilize the economic conditions.



Arguments for relaxation in monetary policy

Tax hike to lower disposable income and business confidence

Individuals and multiple corporates are compelled to cut spending and investment from Jan-2023 and Sep-2022 respectively, as steep income tax rates came into effect to finance the budget deficit aggravating the impact from the bloated inflation which already depleted the disposable income of individuals. Moreover, the respondents to the Central Bank's survey of business sentiments also expressed heightened concerns about faltering demand amid higher tax rates. Meanwhile, the record high lending rates led to deteriorated private sector credit growth which reported a back-to-back negative growth for the 6th consecutive month and recorded at LKR 7,499.2Bn in Nov 2022 down from LKR 7,754.5Bn in May 2022. Persistent contraction in credit to the private sector, reflecting the impact of increased market lending rates which may lead to bankruptcies and deterioration of business confidence. Thus, appropriate direction on the interest rates is required in the present condition in order to protect SMEs and other businesses from closing down.

Reactivated buying interest drives down yields

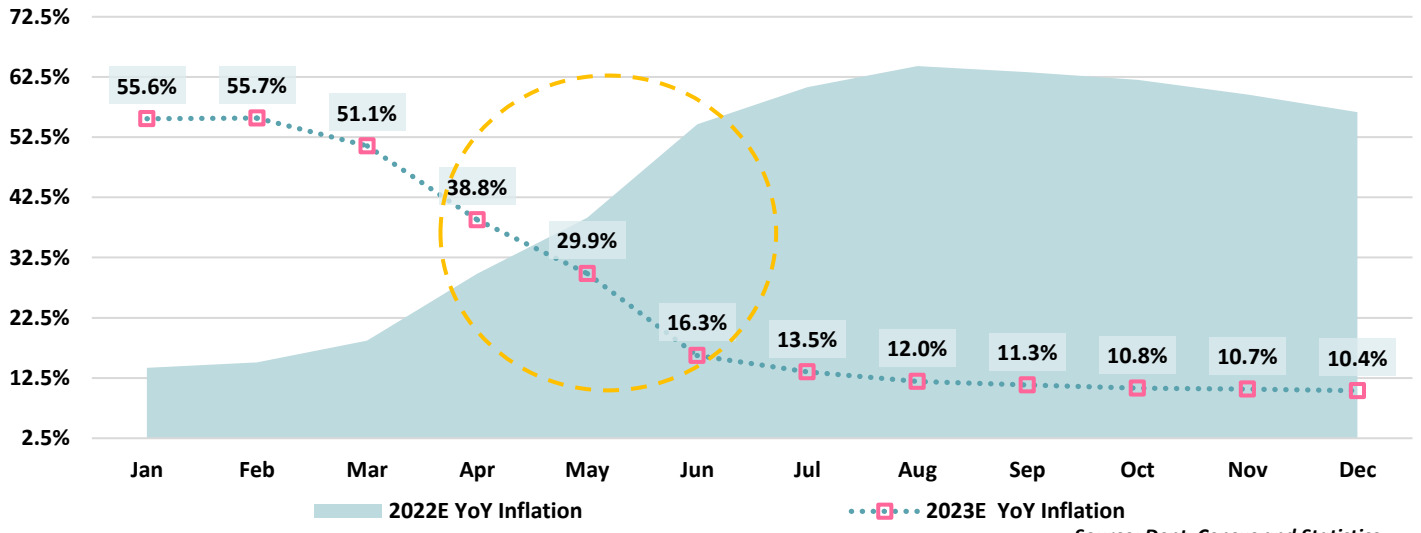
Weekly bill auction yields continued to plunge for the 6th consecutive week across the board, where the weighted average yield of 3M, 6M and 1Yr yields fell by 272bps, 319bps and 107bps, respectively from 14th Dec 2022 to 18th Jan 2023. Accordingly, in the secondary market yields were trimmed down by 50bps – 325bps mainly on the short-end maturities as investor sentiment reactivated on the back of signals issued by the CBSL governor indicating possible easing off interest rates. Moreover, the buying interest further strengthened following the restriction on SDF availability to LCBs' prompting higher demand for T-Bills in the secondary market. However, despite multiple actions G-Sec yields continue to stay elevated. Therefore, anticipations of the market participants are leaning towards a monetary relaxation in line with the falling trend of inflation and T-Bill auction yields which may support an accelerated downward shift.

Arguments for relaxation in monetary policy

MoM inflation turnaround on lower consumer demand

Inflation measured by CCPI witnessed a gradual decline on a YoY basis for the 3rd consecutive month. Accordingly, YoY CCPI for Dec 2022 was recorded at 57.2% down from 61.0% in Nov 2022 as prices of both food and non-food items started to stabilize after interest rates were allowed to move up. Meanwhile, FCR expects a steep dip in inflation in 2Q2023 amidst the higher base effect on inflation. Moreover, as the demand pushed inflation is restrained via tighter monetary and fiscal policies, cost push inflation also started to exhibit a gradual ease off in line with a decline in global commodity prices where EIU expects commodity prices to recede in 2023 in the face of slowing demand globally while Fitch Solutions reported that 73% of the key commodities are likely to experience decline in annual average price below 2022 levels. Therefore, as the demand pushed inflation is at its minimum, any actions pertaining to further monetary tightening can be eliminated while paving the way to introduce monetary stimulus by CBSL via a relaxed monetary policy.

FCR 2023 forecast illustrates a sharp dip in inflation towards 2Q2023



Source: Dept. Census and Statistics

Arguments for relaxation in monetary policy

Recovery in liquidity may stimulate rates to ease

Overnight liquidity remained volatile since the last monetary policy review meeting on 23rd Nov 2022. Liquidity turned positive and improved to LKR 156.9Bn on 17th Jan 2023 yet turned around to negative afterwards. The recent development is primarily arising through overnight injections via reverse repo where LKR 360.5Bn was injected in Jan 2023. Moreover, during the period CBSL has also deployed several mechanisms to inject liquidity into the system, such as limiting the SDF facility to LCBs to a maximum of 5 times per calendar month and limiting the availability of SLF to LCBs to 90% of the SRR on a given day. Therefore, higher level of liquidity is expected to support to stimulate the economy. However, in order to accelerate the stimulation and to push yields lower, a relaxed monetary policy stance may be the appropriate solution.

Arguments against relaxation in monetary policy

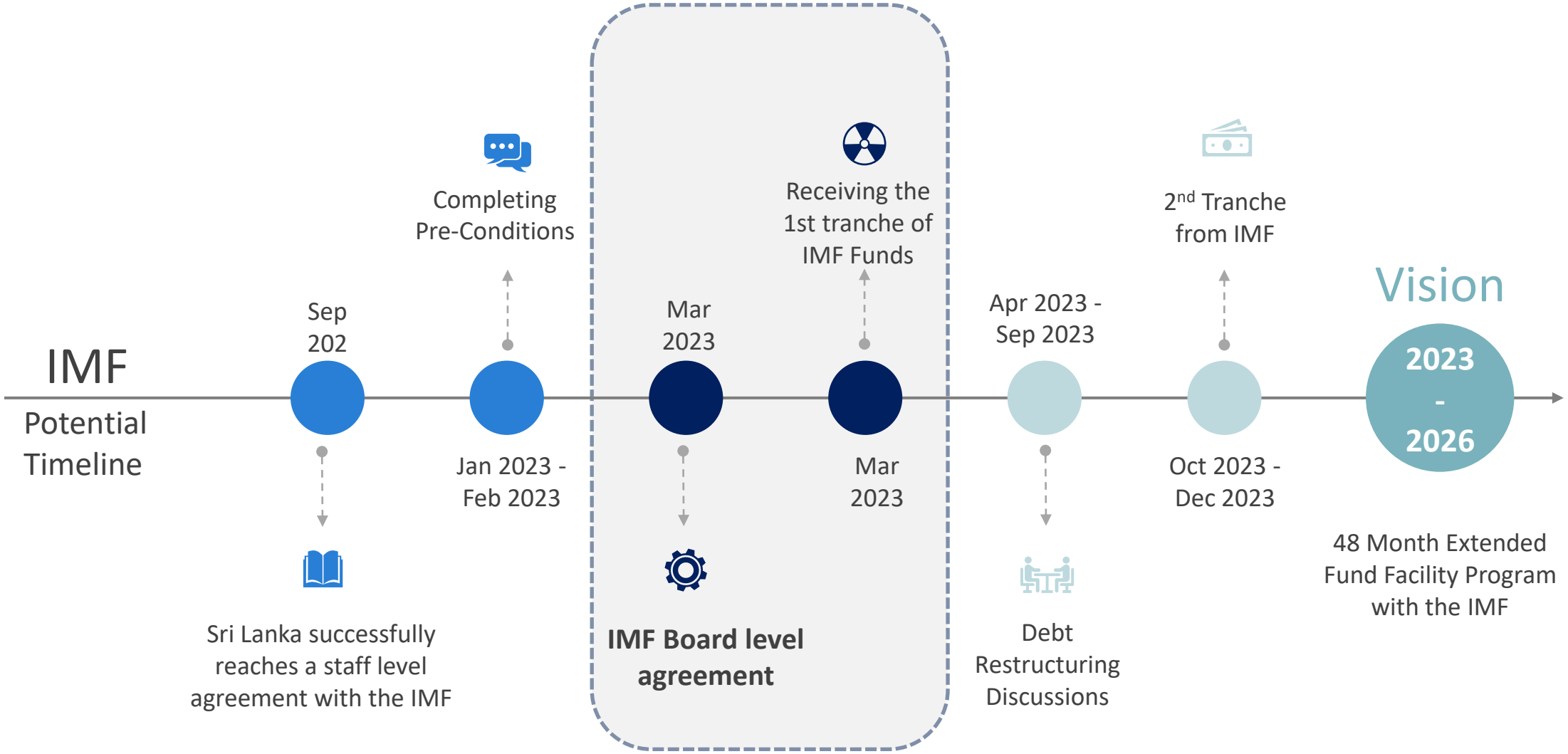
Delay in potential IMF board level approval

After significant delay, Sri Lanka managed to enter into a staff level agreement with the IMF Sep-22. However, beyond the staff level agreement, in order to move into an IMF support program there were number of pre-conditions that needs to be fulfilled by Sri Lanka. In line with the other countries that have gone through a similar crisis in the economy it is understood that obtaining approval of all creditors to move into a debt restructuring process was the utmost priority condition for the IMF. We have already witnessed significant progress on the primary bilateral creditors India and China. Further pre-conditions such as passing the CBSL Act, restructuring SoEs are also pre-conditions that may further delay the IMF agreement. Amidst the delay in moving into an IMF support program, CBSL may choose to hold monetary relaxation.

Foreign reserves remain low, despite marginal improvement

Foreign Reserves dropped to its lowest level in Oct-22 to USD 1.7Bn and recorded marginal improvements on a MoM basis in Nov-22 and Dec-22 reaching USD 1.8Bn and 1.9Bn respectively. However, the usable reserves are limited to less than USD 500Mn as approx. USD 1.5Bn is representing the swap line from the People's Bank of China, which at the moment cannot be used to finance imports. Meanwhile, the Balance of Payments hit a deficit of USD 101.0Mn in Nov 2022 while trade deficit witnessed the highest deficit in 5 months of USD 450.0Mn despite an improvement on a YoY basis. Therefore, monetary relaxation by CBSL at this point may have a detrimental effect on the already diminished foreign reserves.

FCR revises timelines and expects SL to sign the IMF deal by Mar-2023



Arguments against relaxation in monetary policy

Monetary easing intensifies negative real rate of return

The headline inflation (CCPI) for the month of Dec-22 stands at 57.2% giving rise to a negative real return against the T-Bill of *c.*29.2%. Tighter monetary and fiscal conditions currently prevailing in the economy have almost entirely wiped out any sign of demand-pull inflation. The current high level of inflation is primarily considered based on the cost-push inflation caused by the rise in global commodity prices and supply side bottlenecks. With inflation signaling a slowdown, negative real interest rate may reduce promoting savings. However, introduction of monetary stimulus may reactivate demand-pull inflation while also causing to further aggravate negative real rate of return.

Factors of concern at the policy review

Inflation
CCPI 57.2% for Dec-22

Foreign Reserves
USD 1.9Bn by Dec-22

GDP Growth
-11.8% in 3Q2022

03M T-Bill rate
31.15% as of 11.01.23

Private Credit
LKR -30.9Bn for Nov-22

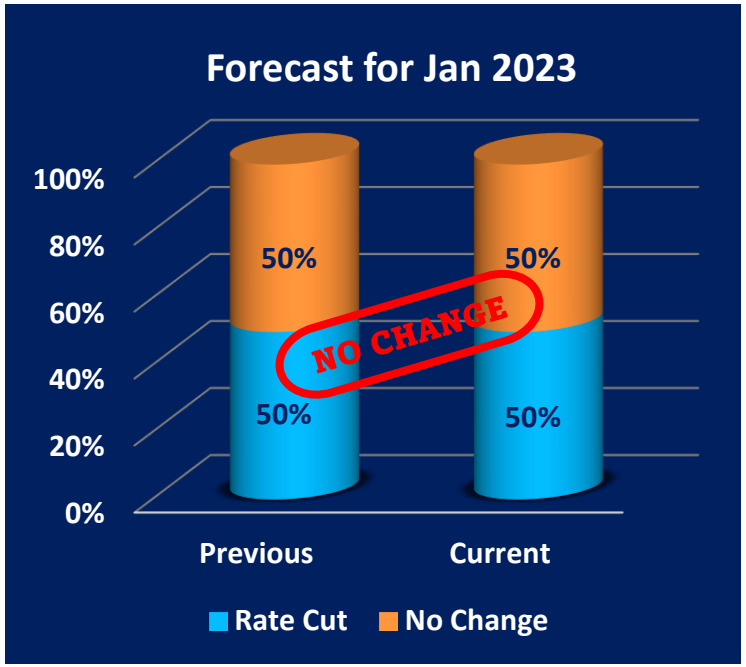
Liquidity and CBSL Holdings
LKR +156.9Bn and LKR 2.6Tn

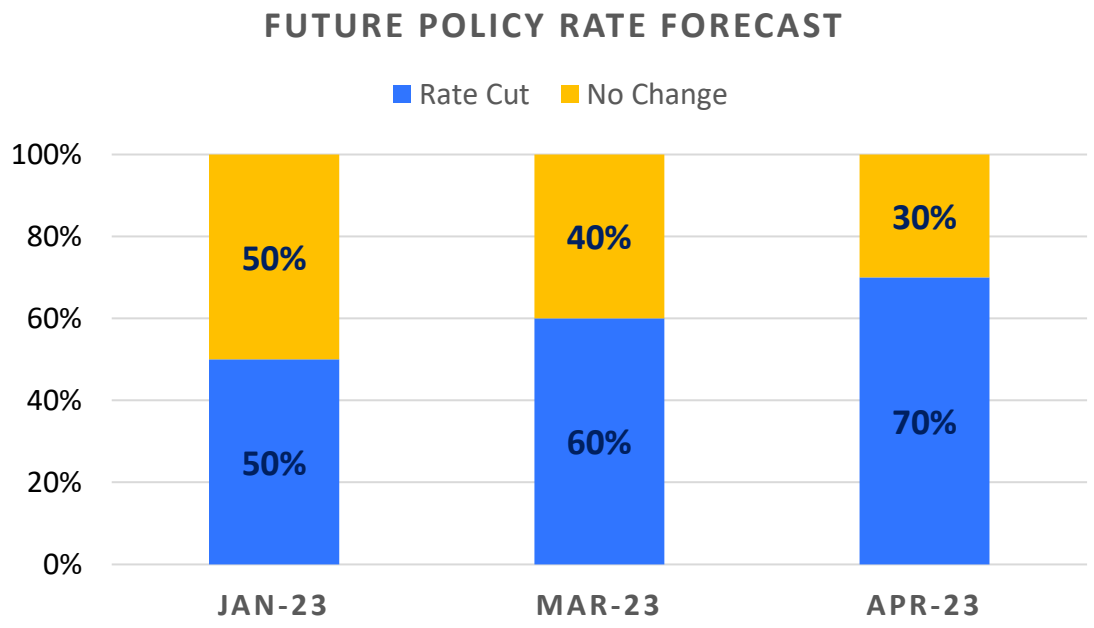
BOT and BOP
USD -4.8Bn and USD -2.9Bn for Jan-Nov 22

FCR Policy Rate Forecast (Jan-23 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, considering both arguments for and against monetary easing, we have assigned an equal probability for both scenarios. Accordingly, we have assigned 50% probability for a relaxation in the monetary policy to alleviate the overreacted interest rates in the tighter monetary environment. Meanwhile, the remaining 50% probability for rates to remain unchanged at the upcoming policy review.

However, we expect the economy to return to normalcy with the country being able to sign the IMF deal by Mar-23 and secure necessary financing from IMF and other multilateral creditors while regaining its access to the global capital market during the year. Thereby, with the complete stabilization of economic indicators, concentration would be shifted towards fast tracking the revival of the economy giving rise to a sizable rate cuts towards the end of 1Q2023.





Unchanged from our previous forecast, we expect 50% probability for rates to remain unchanged with a 50% probability for a relaxation in policy rates.

Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, **there is a 50% possibility for CBSL to maintain the rates at its current levels** allowing further strengthening of key economic indicators. Moreover, **there is a 45% possibility to relax its policy rates by 25bps and a 5% probability for a rate cut of 50bps** in order to prevent a major economic downturn as well as to signal the market participants a clear direction on the way ahead. Moreover, considering the persistent improvement in liquidity in the banking system, we assigned a higher probability of 90% 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	**50%**
Cutting Policy Rates by 25bps	**45%**
Cutting Policy Rates by 50bps	**5%**

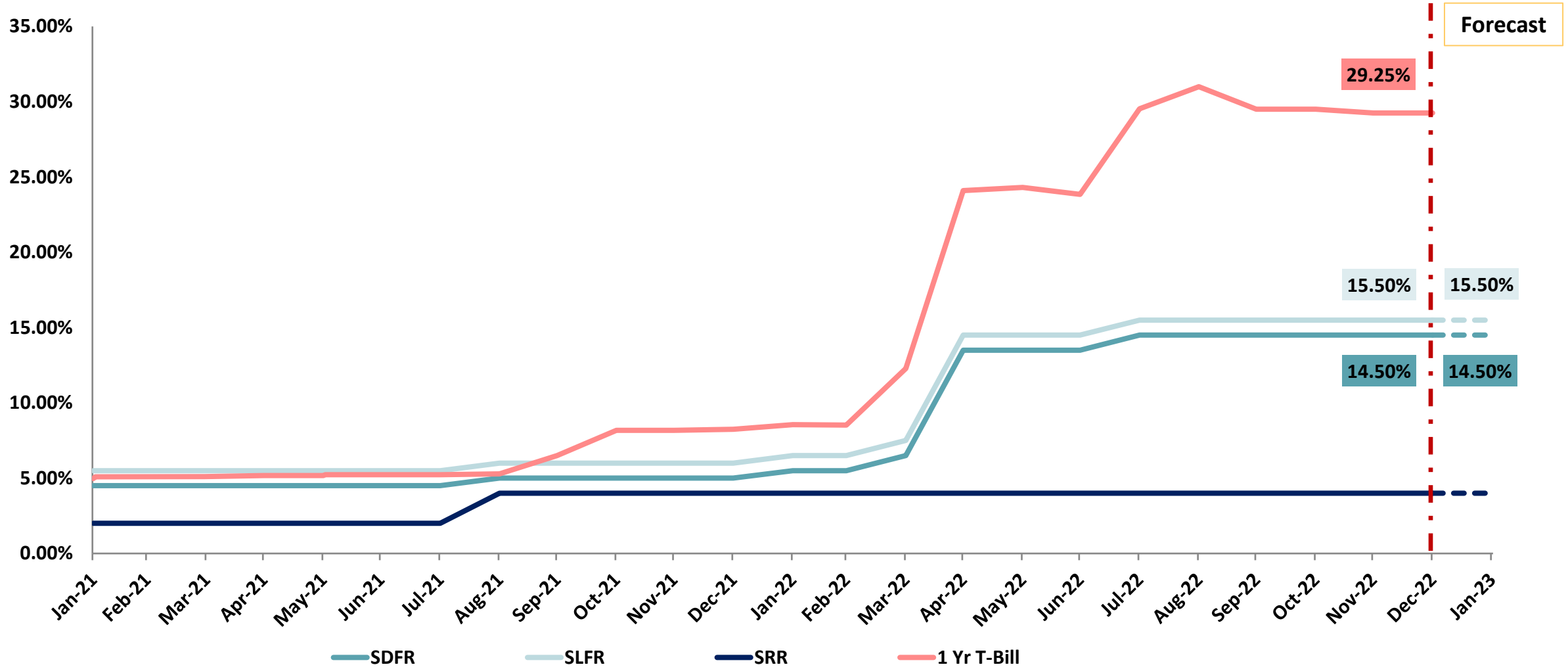
50%

We believe that there is 50% 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	**90%**
Cutting SRR by 50bps	**10%**
Cutting SRR by 100bps	0%

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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