First Capital

"ULTIMATE PAUSE AHEAD OF A DOVISH LANDING…"

PRE-POLICY ANALYSIS

27TH FEB 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 24th Jan-23, 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 fronts. The Board was of the view that the prevailing tight monetary policy stance is necessary to rein in inflationary pressures of the economy. It was also noted that tight monetary conditions, together with the tight fiscal policy, are expected to adjust inflation expectations downward, enabling the Central Bank to bring inflation rates towards the desired levels by end 2023, thereby restoring economic and price stability over the medium term.

Key Arguments considered by CBSL for its policy stance on 24th Jan-23

- ✓ Inflation continued to decline as predicted in recent months.
- ✓ Domestic economy is predicted to begin to recover in the latter half of 2023 after a significant downturn in 2022.
- ✓ Excessive market interest rates have begun to adjust downward and are expected to ease further.
- ✓ The external sector remains resilient despite heightened challenges, and the outlook remains positive.

Analysis of upcoming policy decision on 02nd Mar

Arguments for a Monetary Relaxation

50%

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

- **Slow down in economic activities and feeble growth potential in the period ahead**
- **Inflation unfolds a healthy downturn**
- **Business confidence exhausts over tax and electricity hike**
- **Downslide of private sector credit; a critical cue for a monetary stimulus**

Arguments against Monetary Relaxation

50%

- **Hold back on IMF board level agreement**
- **Monetary stimulus a badly timed measure amidst lingering political uncertainty**
- **Foreign reserves remain depleted despite slow progress**
- **Liquidity swings with volatility and continues to remain negative**

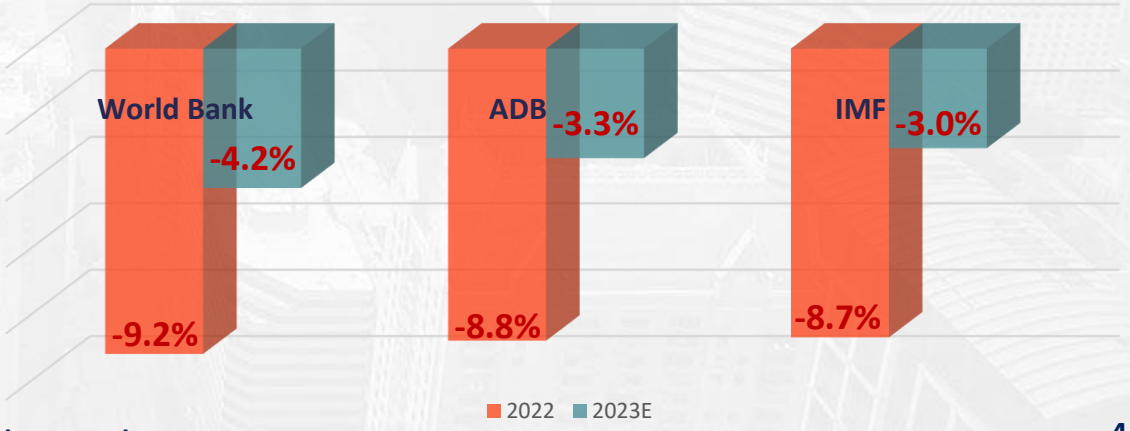
The above-mentioned factors argue against a relaxation in policy rates

Arguments for relaxation in monetary policy

Slow down in economic activities and feeble growth potential in the period ahead

Business activities in the country have been subject to persistent setback as demand curtailed amidst deteriorating purchasing power which is expected to further aggravate resulting from higher personal taxes implemented from Jan-23 and another spike in electricity tariffs implemented from Feb-23. Accordingly, PMI for Manufacturing activities saw a contraction in the month of Jan-23 compared to Dec-22 and registered at 40.8 (-4.0 points) led by the decline in new orders and production as a result of restrained demand predominantly in manufacture of food and beverages. Meanwhile, export demand in the textiles and apparel sector too poised a decline with the economic slowdown in major export destinations (such as USA) which has caused industry players to operate below full capacity. Besides, employment declined at a faster pace during the month amidst resignations, migrations, and retirements. However, PMI for services recorded an index value of 50.2 in the month of January with the improvement in new businesses backed by the increases observed in financial services, education and real-estate sub sectors. With the deterioration in economic indicators, Sri Lanka's economic growth outlook for 2023 on a global point of view too remains bleak with the World Bank forecasting a contraction of -4.2%, ADB forecasting a degrowth of -3.3% while IMF forecast stands at -3.0%. Hence, a monetary stimulus in order to induce spending in the economy is appropriate to build economic strength.

GDP Growth forecast for Sri Lanka

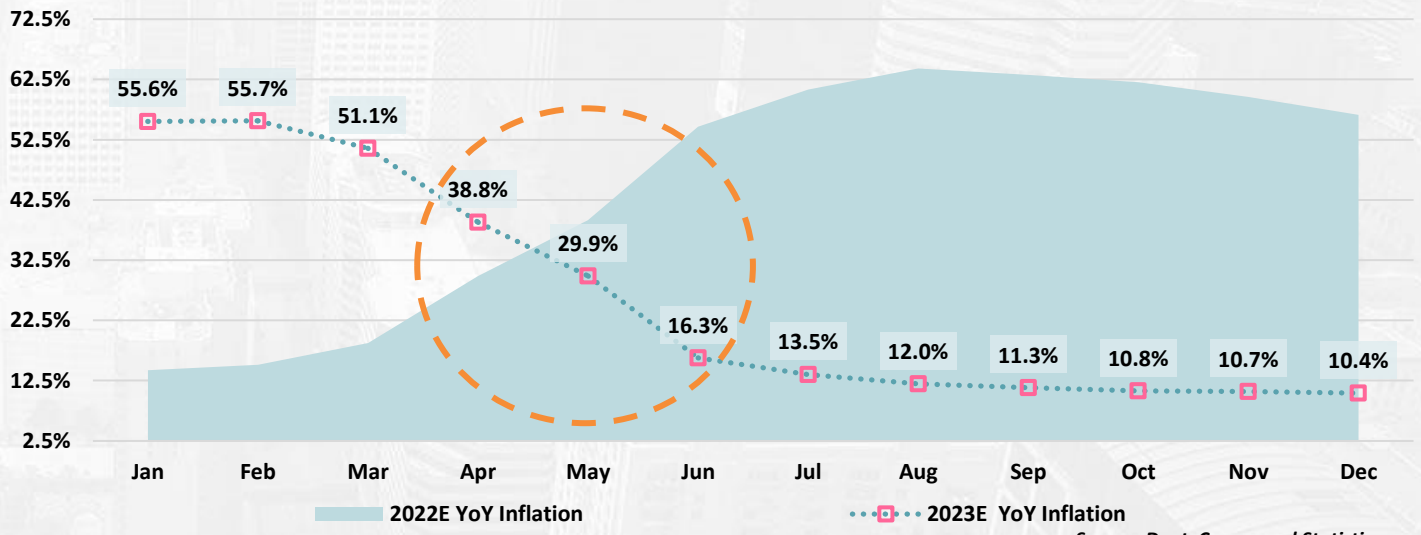


Arguments for relaxation in monetary policy

Inflation unfolds a healthy downturn

In line with FCR expectations, inflation continued to demonstrate a deceleration for the fourth consecutive month as YoY CCPI for the month of January stood at 54.2% (cf. 57.2% in Dec-22). Accordingly, YoY inflation in the Food group declined to 60.1% (cf. 64.4%) while Non-food group declined to 51.0% (cf. 53.4%). Easing inflation is an indication that demand pressures have almost completely been stamped off with the tight monetary policy conditions. Moreover, cost-push inflation also has shown signs of easing off as global commodity prices have begun to stabilize after the record-highs registered during the previous year with Russia's invasion of Ukraine. Accordingly, commodities such as crude oil and coal which skyrocketed during Feb-22 has now returned to pre-invasion levels. FCR expects inflation to tone down significantly in the upcoming quarter as a result of the higher base effect on inflation. Hence, all actions relevant to further monetary tightening can be avoided as the level of demand-driven inflation is at its lowest, opening the door for CBSL to implement monetary stimulus through a slack monetary policy.

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



Source: Dept. Census and Statistics

Arguments for relaxation in monetary policy

Business confidence exhausts over tax and electricity hike

Tax hike which came into effect from Oct-22 has affected profitability of many corporates as reflected by the poor quarter performance of many listed entities in the country while higher personal taxes implemented from Jan-23 has posed pressures to the disposable income of households. On this line, business confidence in the country as per CEIC data, has tailed off by 35.8% in the month of Jan-23 compared to a decrease of 26.6% in the previous month. Further, the Ceylon Electricity Board (CEB) raised electricity tariff by 66% w.e.f 15th Feb-23 resulting in another blow to demand as this move is expected to heavily impact households and SMEs. The LMD-Neilson business confidence index also indicates stagnant results in Dec-22 and Jan-23 at 86 basis points slightly declining from the recent high in Nov-22 and being a sizable 33 basis points behind Jan-22 value. Hence, it is befitting to induce a relaxation in rates in order to restore business confidence in the economy and support a recovery in demand.

Downslide of private sector credit; a critical cue for a monetary stimulus

Private sector credit slid low for the seventh consecutive month in Dec-22 and recorded at LKR 7,426.6Bn compared to LKR 7,499.2Bn in the month of Nov-22. Sharp escalation in lending rates in the banking system in wake of the severe economic crisis, restriction on imports and conservative lending stance in banks due to elevated impairment provisions have collectively discouraged the demand for credit resulting in a persistent downfall. This has resulted for private credit in the system to deteriorate by LKR 287.6Bn from Jun-Dec 2022. At a time when economic activities are on a set back, it is important to kindle recovery in private sector credit to amplify business activities, expand operations and avoid unemployment. Hence, it is vital to lower interest rates in order to induce demand for private sector credit and restore financial stability within the banking system.

Arguments against relaxation in monetary policy

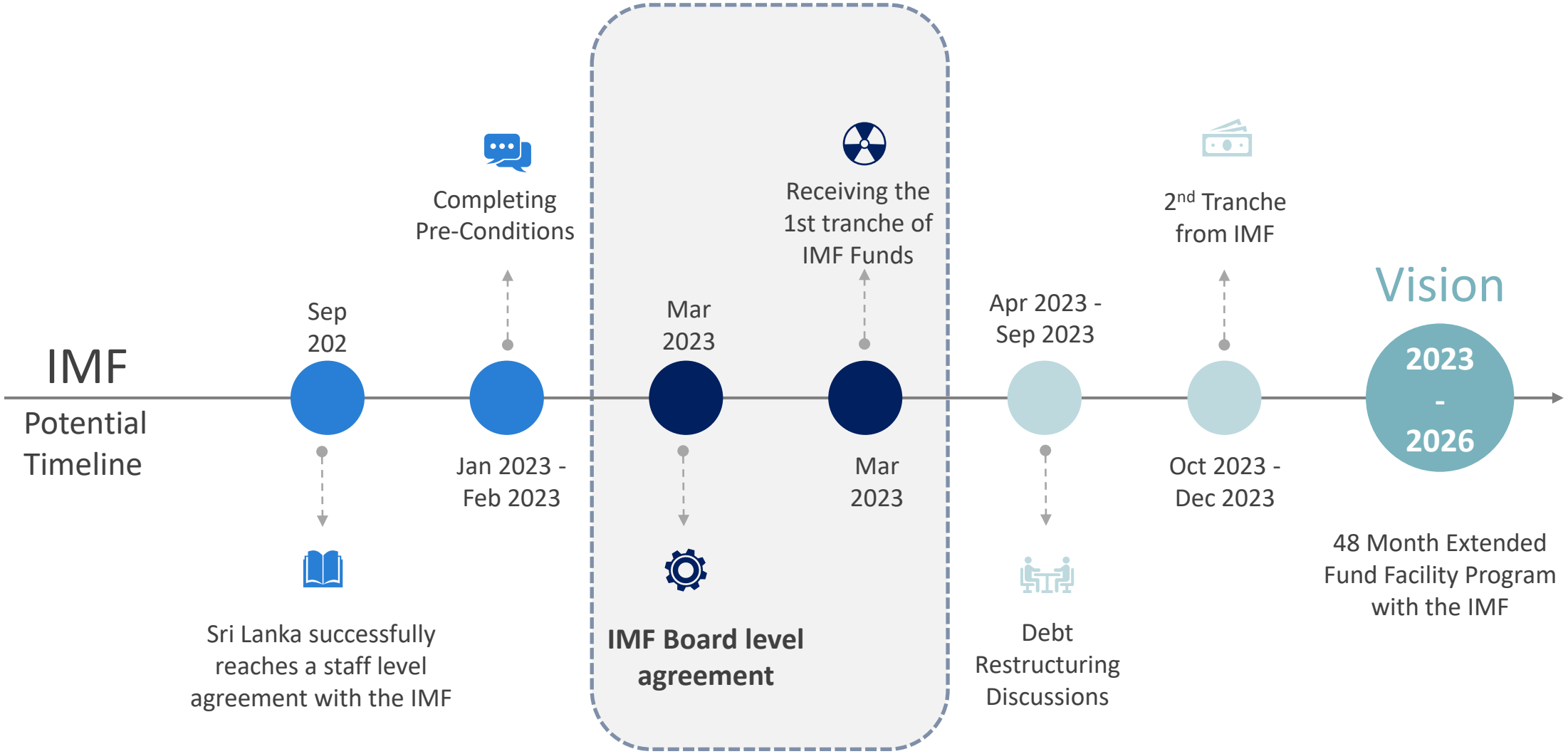
Hold back on IMF board level agreement

Following the staff level agreement from IMF on Sep-22, Sri Lanka expected to achieve the board level agreement in Dec-22. However, by December Sri Lanka failed to meet the pre-conditions set by the IMF which preliminarily involves obtaining assurances from international creditors for the debt restructuring process. Hence, there has been a substantial delay while the top lender China is yet to officially approve the restructuring of debt. However, India and Paris Club of western lenders including Japan have affirmed their approval for the same. Meanwhile, IMF had called for cost reflective electricity tariffs in Sri Lanka also as a pre-condition for the IMF bailout and this too has been fulfilled by the government as of 15th Feb-22. Accordingly, anticipations are high on achieving the board level agreement in the near term, yet CBSL is likely to abstain from relaxing policy rates until the board level agreement is attained.

Monetary stimulus a badly timed measure amidst lingering political uncertainty

Local Government elections which has been postponed continuously have yet again been postponed indefinitely after calling off the decision to conduct it on 09th Mar-23 while officials cited inadequate funds as the reason for the delay. However, this has given rise to an uncertainty among the citizens while recent tax hikes and electricity tariff hikes prompted several protests around the country backed by professionals as well as the general public. This may lead to massive protests and provoke social unrest which is unhealthy for the economy as a whole. Therefore, times of such uncertainty and unrest shall not welcome any significant changes in the monetary policy, hence discourages the possibility of a relaxation in rates.

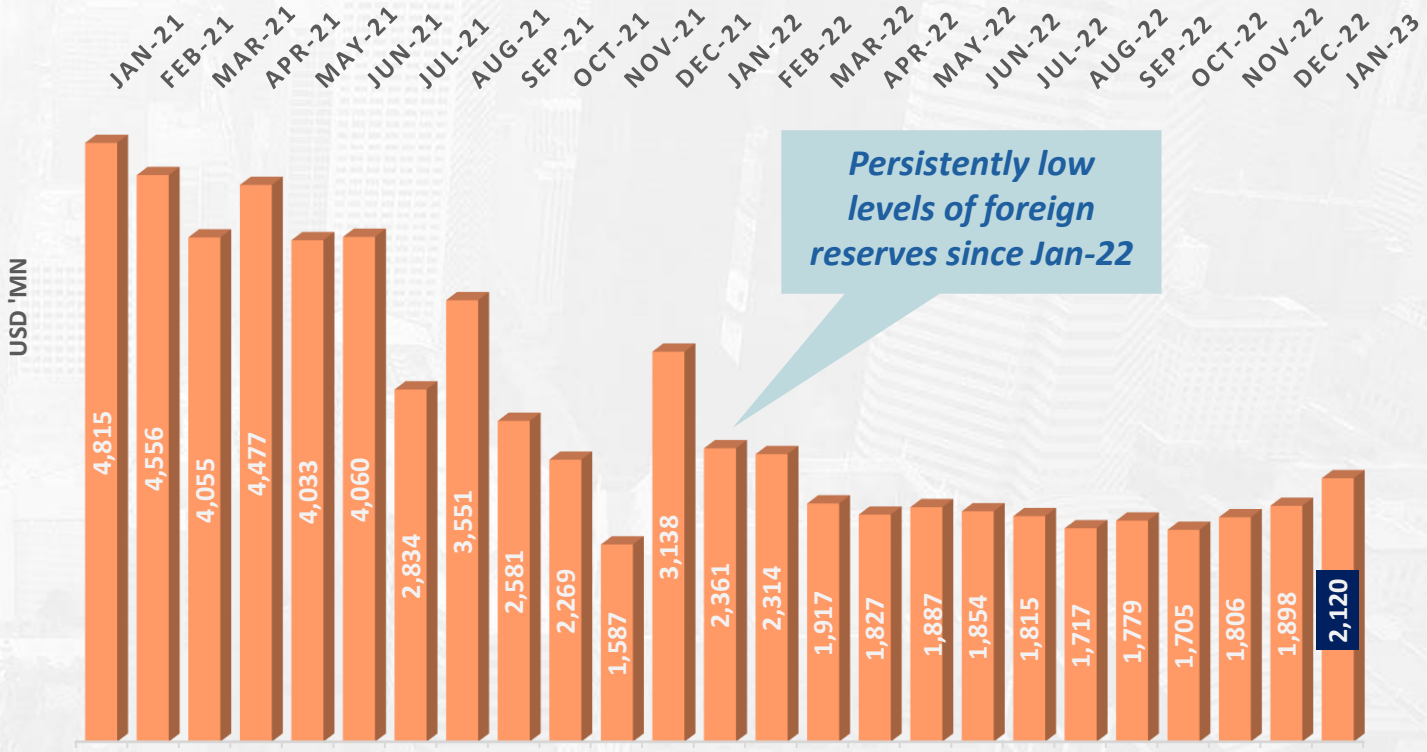
FCR revises timelines and expects SL to sign the IMF deal by Mar-2023



Arguments against relaxation in monetary policy

Foreign reserves remain depleted despite slow progress

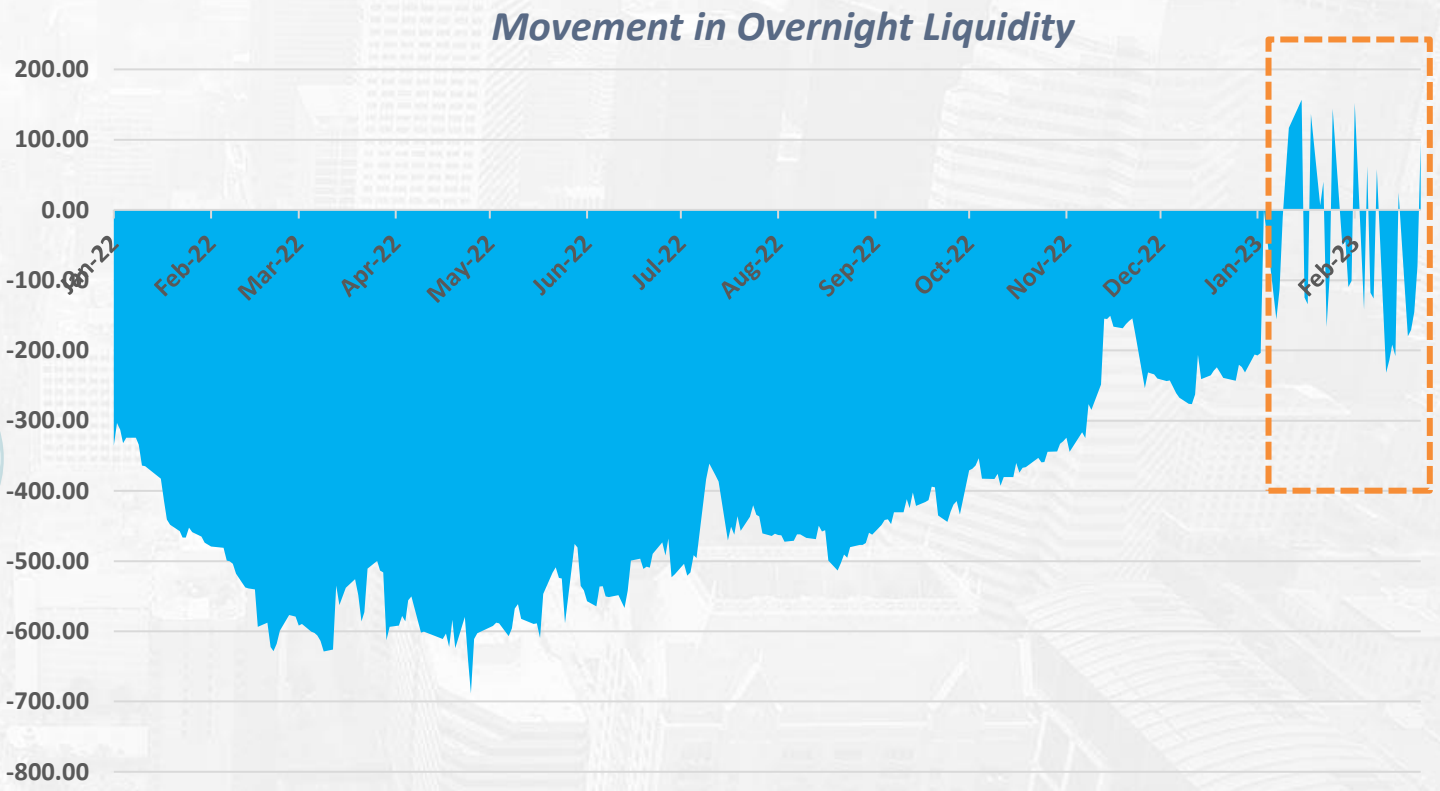
Foreign reserves displayed a moderate improvement during the month of January and recorded at USD 2.1Bn (cf. USD 1.9Bn in Dec-22) peaking to the highest value in 11 months. However, this comprises of nearly USD 1.5Bn from the swap facility from Peoples Bank of China which is subject to conditionalities on usability. However, trade deficit from Jan-Dec 2022 narrowed lower to USD 5.2Bn cf. USD 8.1Bn during the Jan-Dec 2021 period largely owing to the decline in imports with restrictions in place. Nevertheless, foreign reserves still remain at relatively poor levels and considering governments' decision to service USD 2.6Bn in 1H2023 through multilateral loans, it is unlikely for CBSL to relax monetary policy rates as they cannot afford to exhaust the existing reserves.



Arguments against relaxation in monetary policy

Liquidity swings with volatility and continues to remain negative

Overnight liquidity displayed significant volatility during the month while it improved by LKR 262.6Mn since the last monetary policy on 25th Jan-23 reversing the negative liquidity to LKR 96.1Mn as at 24th Feb-23. However, overall liquidity remains low and is subject to constant volatility which does not ensure a healthy liquidity level. Although, CBSL attempts to inject liquidity via repo and term repo transactions on multiple occasions, it has not reaped the desired outcome. Hence, it is not suitable to relax policy rates at this juncture since it may result in a disequilibrium of demand and supply, which shall further aggravate financial instability in the economy.



Factors of concern at the policy review

Inflation
CCPI 54.2% for Jan-23

Foreign Reserves
USD 2.1Bn by Jan-23

GDP Growth
-11.8% in 3Q2022

03M T-Bill rate
29.72% as of 22.02.23

Private Credit
LKR -72.6Bn for Dec-22

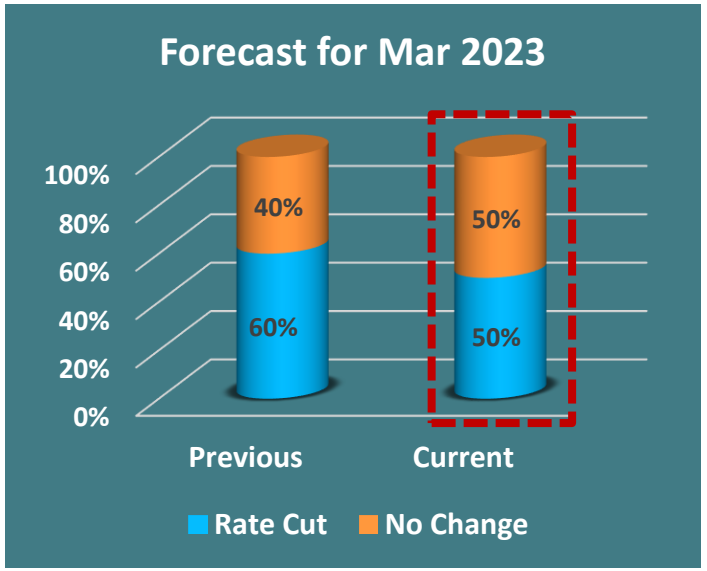
Liquidity and CBSL Holdings
LKR +96.1Bn and LKR 2.6Tn

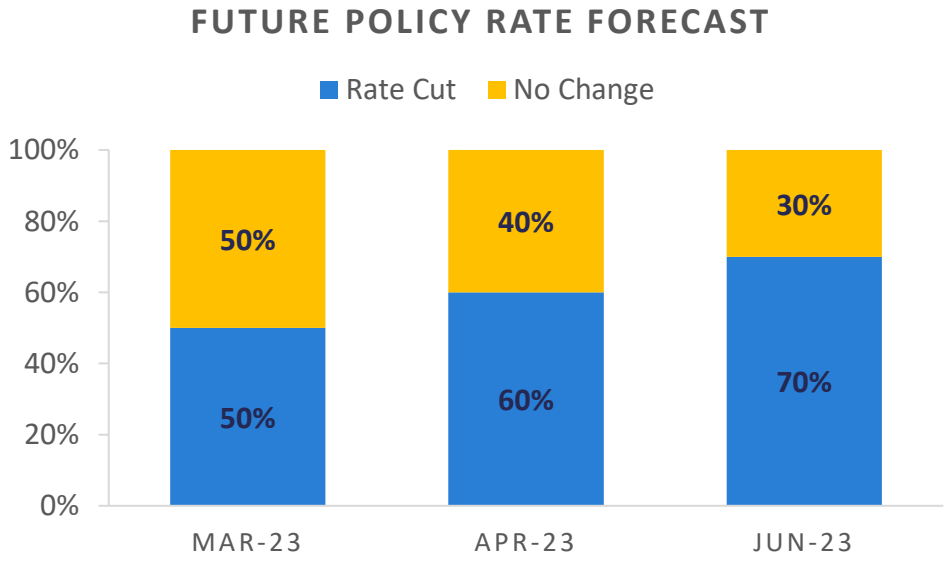
BOT and BOP
USD -5.2Bn and USD -2.8Bn
for Jan-Dec 22

FCR Policy Rate Forecast (Mar-23 to Jun-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, we expect concentration would be shifted towards fast tracking the revival of the economy giving rise to a sizable rate cut in 2Q2023.





Revising 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 35% possibility to relax its policy rates by 25bps and a 15% 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	**35%**
Cutting Policy Rates by 50bps	**15%**

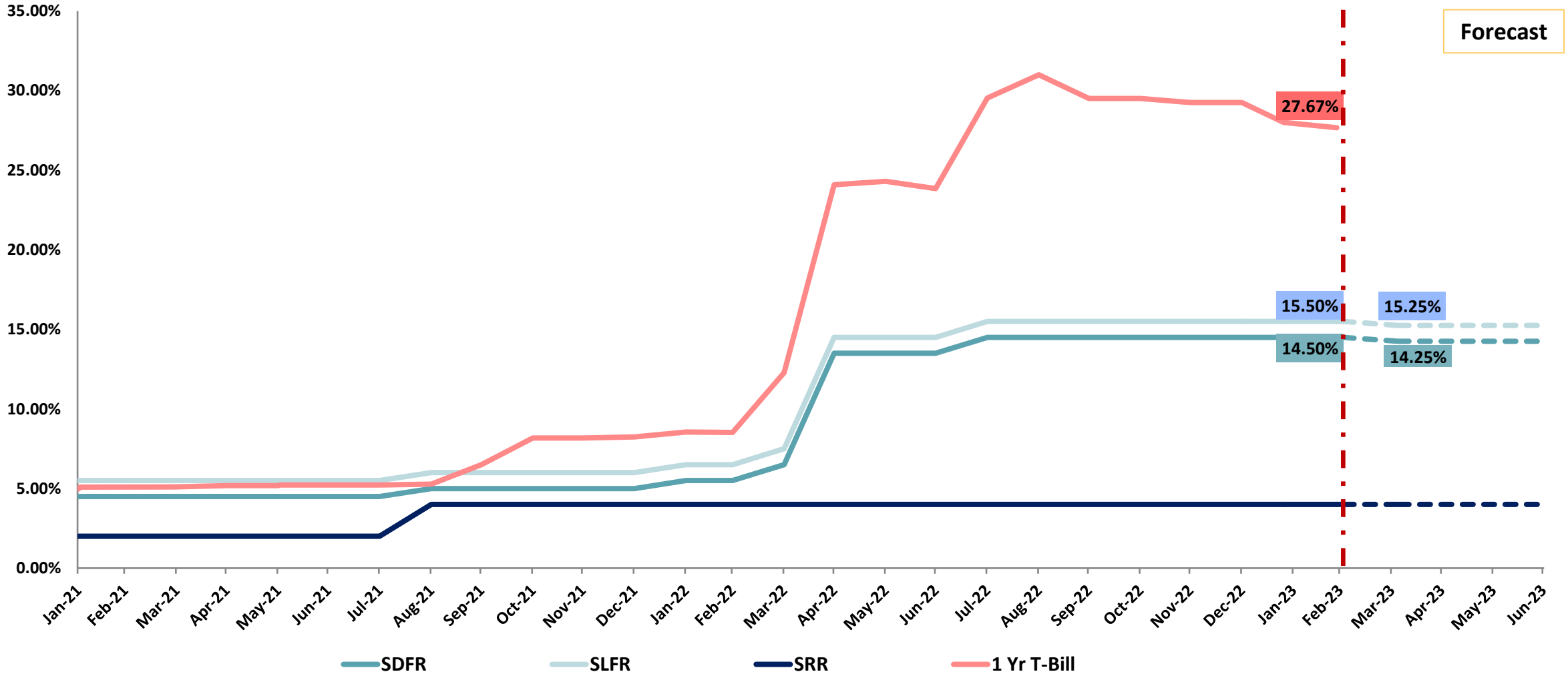
50%

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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