"DOVISH LANDING ON THE HORIZON"

PRE-POLICY ANALYSIS

27TH SEP 2023

First Capital Research

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Previous Pre-policy report: Recap

The CBSL maintains its Monetary Policy Stance

In line with our prediction of stable policy rates, CBSL decided to maintain the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank at their current levels of 11.00% and 12.00%, respectively, at the monetary policy review announced on 24th Aug 2023. The Monetary Board acknowledged the decrease in market interest rates due to previous monetary policy measures and stressed the need for further adjustments. However, it noticed that some lending rates were still too high and not in line with current monetary policies. The Board expects a quicker decrease in overall lending rates in line with recent policy changes. Consequently, they decided to implement targeted administrative measures to lower certain lending rates and instructed licensed banks to decrease rupee lending rates by an appropriate margin in the near future.

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

- ✓ The disinflation trend continues, with headline inflation reaching single digit levels.
- ✓ Domestic economic activity is expected to recover in the second half of 2023 and gradually reach the potential level of economic growth over the medium term.
- ✓ The external sector remains resilient, allowing a gradual relaxation of balance of payments restrictions.
- ✓ Market interest rates continue to adjust downward, although disparities in adjustments remain.
- ✓ Policy interest rates are maintained at their current levels, while measures are introduced to accelerate the reduction of market lending interest rates.

Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, **there is a 60% probability for CBSL to relax the policy rates, with a higher probability of 30% for a rate cut of 100bps, 20% for rate cut of 200bps and a lower level of 10% for 50bps rate cut** in order to reduce rates and government security yields at a faster pace to facilitate the strengthening of the Financial sector. Moreover, **there is a 40% possibility for CBSL to maintain rates at the current levels,** allowing further strengthening of key economic indicators. Further, there is **85% possibility to keep SRR unchanged,** while considering the risk associated with it **there is a 15% possibility for a SRR hike of 50bps.**

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Policy Rates to remain unchanged	**40%**
Cutting Policy Rates by 50bps	**10%**
Cutting Policy Rates by 100bps	**30%**
Cutting Policy Rates by 200bps	**20%**

60%

We believe that there is a 60% probability for policy rate cut to reduce rates and government security yields at a faster pace to facilitate the strengthening of the Financial sector.

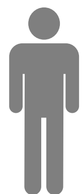
Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	**15%**
SRR to remain unchanged	**85%**
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

Considering the reduction of SRR by 200bps to 2% on 09th Aug 2023 we expect SRR to remain unchanged at the same levels.

Analysis of upcoming policy decision on 05th Oct

Arguments for a Monetary Relaxation

60%



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

- Inflation rounds down to single digit cluing in a dovish move
- Economic activities make slow-footed headway
- Financial sector volatilities cripple Business confidence
- Global interest rates may have peaked; Rating Agencies upgrade SL rating

Arguments against a Monetary Relaxation

40%

- Negative influence via delay in IMF 2nd tranche
- Back-to-Back robust cuts daunts a monetary stimulus
- Reserves on a slow pick up yet remains subpar
- Liquidity on choppy move despite SRR cut; Private credit turns positive

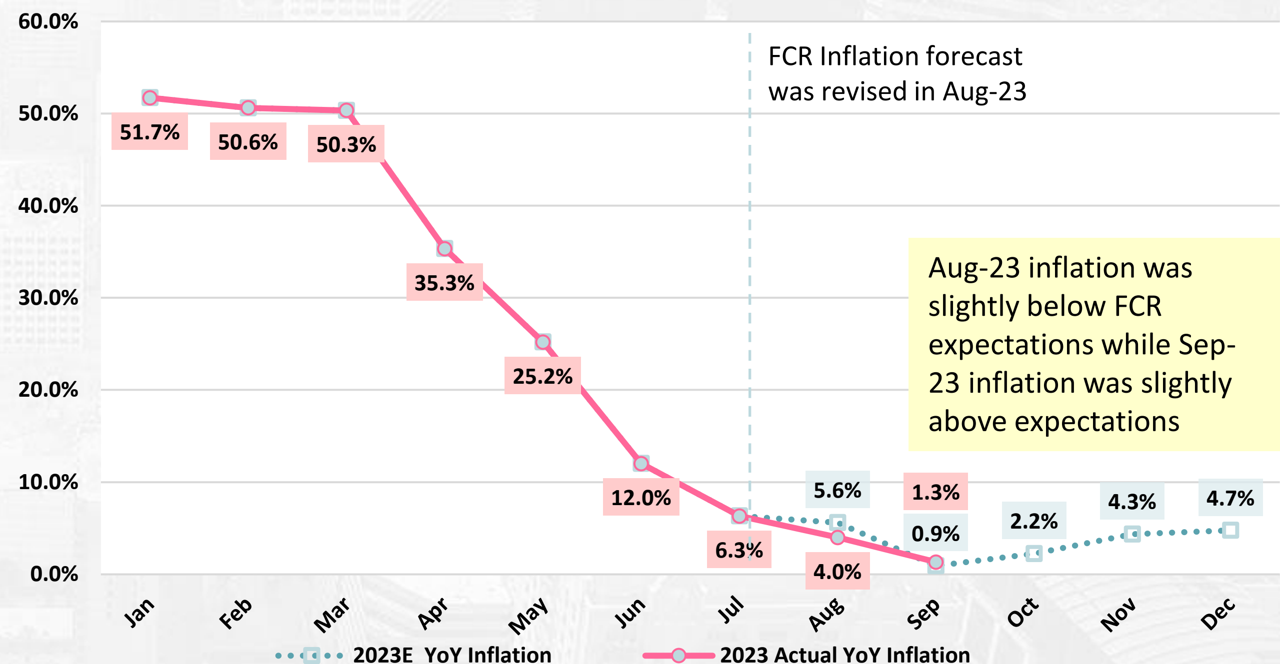
The below-mentioned factors argue against a relaxation in policy rates at the upcoming policy meeting

Arguments *for relaxation* in monetary policy

Arguments for relaxation in monetary policy

Inflation rounds down to single digit cluing in a dovish move

In line with FCR expectations, inflation continued to demonstrate a deceleration for the 11th consecutive month as YoY CCPI for the month of August stood at 4.0% (cf. 6.3% in Jul-23). Accordingly, YoY inflation in the Food group declined to -4.8% (cf. -1.4%) while Non-food group declined to 8.7% (cf. 10.5%). Reduced inflation is a sign that tight monetary circumstances have nearly entirely eliminated demand forces. Additionally, cost-push inflation has begun to show indications of easing off as global commodity prices have started to stabilize and China's recent reopening has opened the way for a quicker-than-expected recovery. Even though commodities, like crude oil and coal, have recently risen marginally, they are still below the peaks reached in 2022. Therefore, since the magnitude of demand-driven inflation is at its lowest, any actions essential to further monetary tightening can be avoided, allowing CBSL to administer monetary stimulus through a loose monetary policy.



Source: Dept. Census and Statistics, First Capital Research

Arguments for relaxation in monetary policy

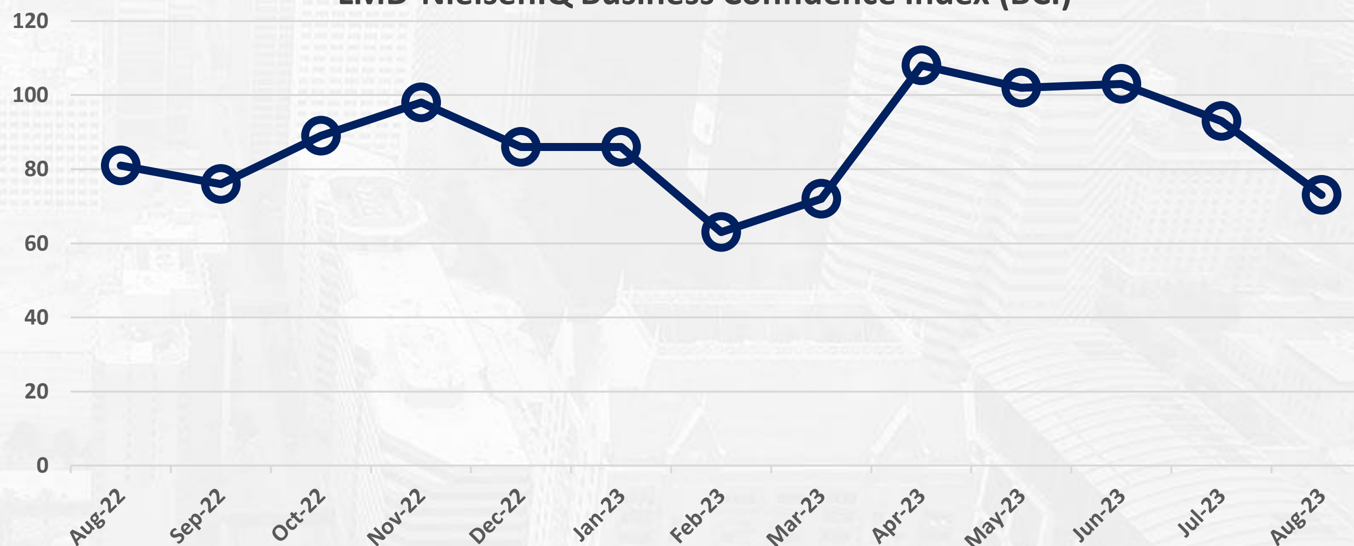
Economic activities make slow-footed headway

GDP for second quarter of 2023 displayed a contraction of 3.1%YoY (aligning with the FCR forecast of -3.0%YoY) relative to the degrowth of output by 7.4% in 2Q2022 indicating a sharp slowdown in the GDP contraction in light of decelerating inflation and anticipated interest rate stabilization during the quarter. This contraction is largely stemming from the contraction in Services and Industrial activities which declined by 0.8% and 11.5%, respectively. Conversely, Agriculture activities reported a growth of 3.6% during the quarter. Meanwhile, PMI in Aug-23 indicated an expansion in Services sector while the contraction in Manufacturing activities showed signs of easing. Accordingly, Services sector improved to an index value of 57.6 in Aug-23, led by New business that increased during the month in segments of financial services, wholesale and retail trade. Moreover, on the score of higher tourist arrivals, Business activities improved as demand grew for accommodation, food and beverage and other personal activities. Financial services too progressed on the back of rise in credit demand amidst low market rates. Meanwhile, Manufacturing segment recorded an index value of 49.3 during Aug-23, inching closer to a neutral threshold amidst sluggish recovery. This slow growth is attributed to the rise in new orders which are led by relatively higher manufacture of food & beverages amidst declining retail prices. However, setback in production extended as manufacture of textiles & wearing apparel sector segment underperformed with the subdued global demand. Taking into consideration these slow-paced developments it is apt to resort to monetary stimulus inducing further spending and to further strengthen the economic revival.

Arguments for relaxation in monetary policy

Financial sector volatilities cripple Business confidence

In August, the LMD-NielsenIQ Business Confidence Index (BCI) registered at 73 (14 points below the 12-month average of 87) shedding 20 points from the previous index value indicating the highest 20-point drop since February. Financial sector volatilities has been the main cause of concern among business circles as uncertainties arose on the DDO framework while fluctuations that may result in the exchange rate after import ban easing has stirred sense of caution. Meanwhile, IMF staff team is currently in the country for the first review of the EFF which is extremely crucial to determine the confidence in the period ahead. Moreover, during Sep-23 the DDO was completed where offers for eligible Bonds totaling 37% of the outstanding principal amount were accepted while valid offers had been accepted for almost 84% of the total outstanding principal amount of Eligible Bonds among the Superannuation Funds. However, the impact of this is yet to be reflected in the yield rates which is one of the leading catalysts to determine investor confidence. Hence, it is advisable to induce a relaxation in policy rates in order to restore business confidence in the economy and support a recovery in demand.

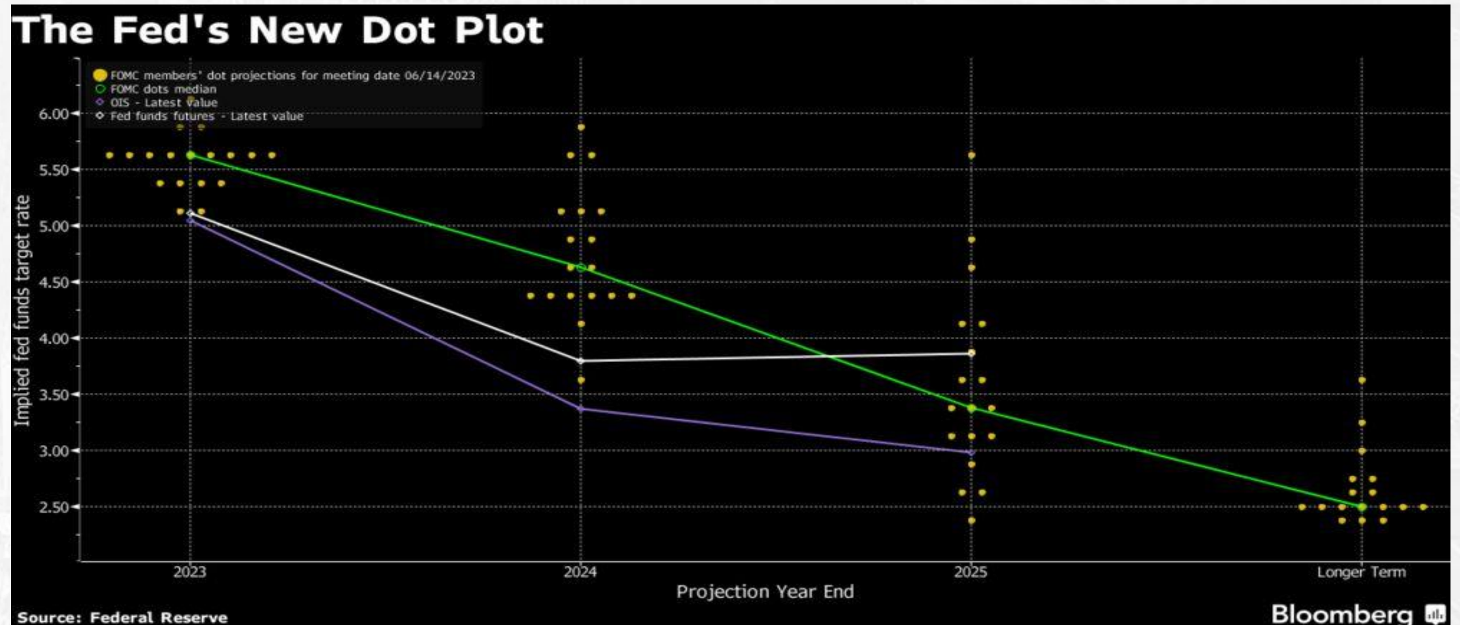


Source: LMD

Arguments for relaxation in monetary policy

Global interest rates may have peaked; Rating Agencies upgrade SL rating

At the Sep-23 meeting, the Federal Reserve has opted to maintain its benchmark interest rate at its current target range of between 5.25% and 5.50%. The Fed's September pause doesn't necessarily mean interest rates have peaked, but a growing number of investors are optimistic that the central bank will not have the requirement to raise rates further in this cycle. However, Fed indicates that one more rate hike may be possible in 2023. Federal Open Market Committee (FOMC) has been raising interest rates since March of last year in an attempt to slow down the US economy and ease inflation. Inflation levels have been trending lower in 2023, allowing the Fed to take its foot off the gas pedal a bit and reduce the pace of its rate hikes. This trend is a positive for frontier economies such as Sri Lanka which may have an ease or reduced pressure from a strengthening US Dollar due to rising rates. Moreover, with the completion of the domestic debt restructuring, both rating agencies, S&P and Fitch have decided to upgrade Local Currency Rating to CCC+ and CCC- respectively. Hence, the positive outlook on the external front supports to relax policy rates from the current high levels which may also reduce the prevailing high real interest rates.

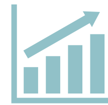


Arguments *against a relaxation* in monetary policy

Arguments against a relaxation in monetary policy

Negative influence via delay in IMF 2nd tranche

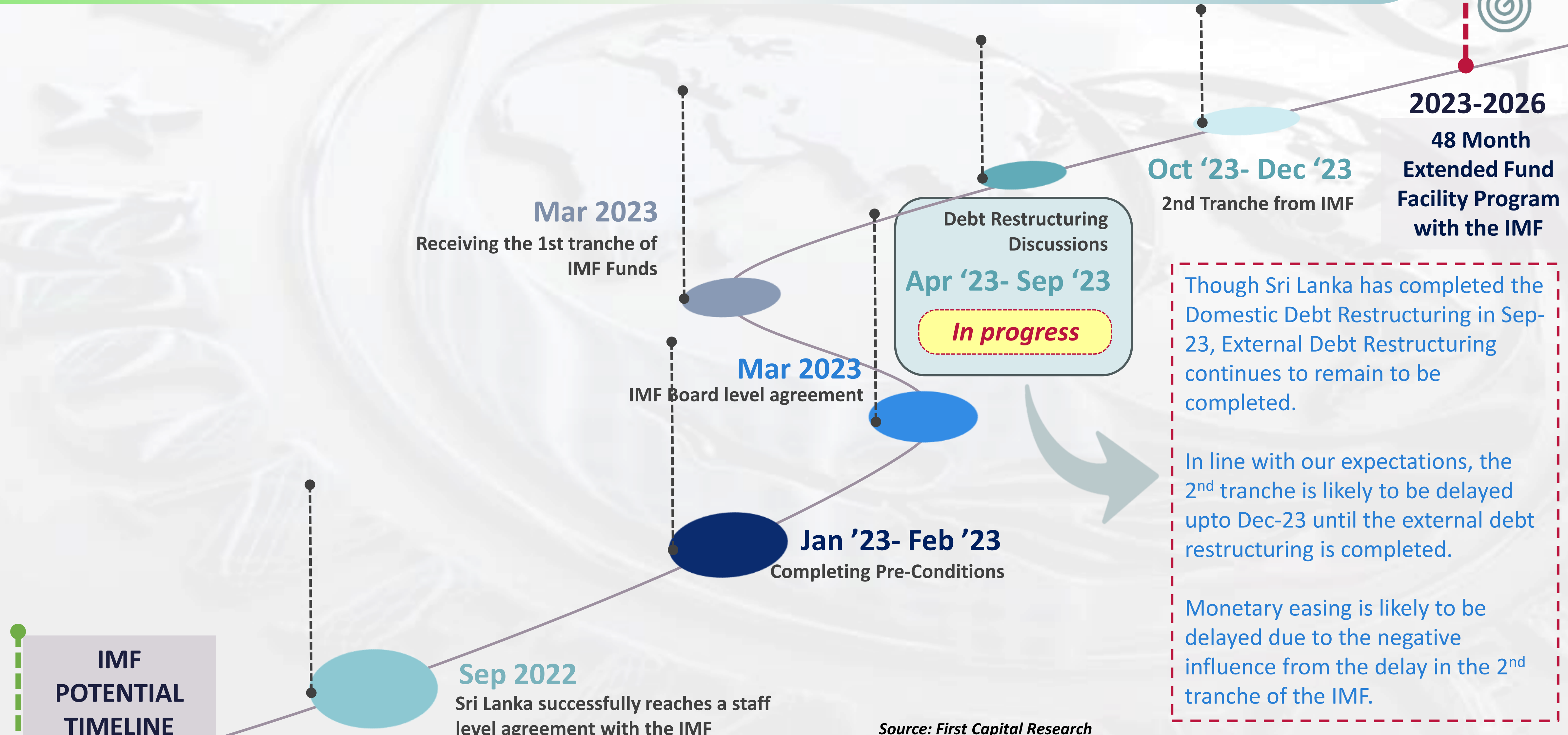
The second tranche of USD 330.0Mn out of the principal disbursement of USD 2.9Bn is currently facing possible delays with 2 key objectives yet to be satisfied by Sri Lanka. The focus of this agreement hinges on the progress Sri Lanka has made with regards to meeting the IMF's preconditions. As of 31st Aug-23, Sri Lanka has fulfilled 38% of its total commitments, while 8% remains unfulfilled. According to the IMF, though SL has some noteworthy accomplishments including the obtaining of Cabinet approval for the Banking Act, reducing the CCPI from 34% to 28% by Jun-23, decreasing the primary deficit to 0.4% of GDP by Jun-23, and limiting the stock of expenditure in arrears to a maximum of LKR 30.0Bn by Mar-23, there are areas where the country has fallen short as well. Sri Lanka has not met the target of raising tax revenue to 4.3% of GDP by Jun-23 while the government is yet to secure Cabinet approval for the restructuring plans of the key state-owned enterprises and also to develop a system for phasing out import restrictions during the program period. The other element is in the area of debt where an agreement needs to be reached with the creditors to help restore sustainability. Given the ongoing review of the IMF and the additional time required to meet some of the key objectives, it is highly likely that the CBSL will refrain from further relaxing policy rates. (Refer slide 12)



Back-to-Back robust cuts daunts a monetary stimulus

Throughout the year, the CBSL implemented significant rate cuts, reducing the SDFR and SLFR by a total of 450 basis points, and lowering the SRR to 2.00% in Aug-23. These measures were taken to stabilize inflation within mid-single-digit levels and support the gradual economic recovery. Consequent to the back-to-back cuts, market lending rates too have showcased sizeable downward adjustments driven by heavy buying appetite. Hence, it is fitting to desist from a monetary stimulus and resort to a wait-and-see approach to ward off against any macro-economic pressure that may arise from a relaxation in policy rates.

IMF 2nd tranche possible by end of 4Q2023



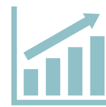
Though Sri Lanka has completed the Domestic Debt Restructuring in Sep-23, External Debt Restructuring continues to remain to be completed.

In line with our expectations, the 2nd tranche is likely to be delayed upto Dec-23 until the external debt restructuring is completed.

Monetary easing is likely to be delayed due to the negative influence from the delay in the 2nd tranche of the IMF.

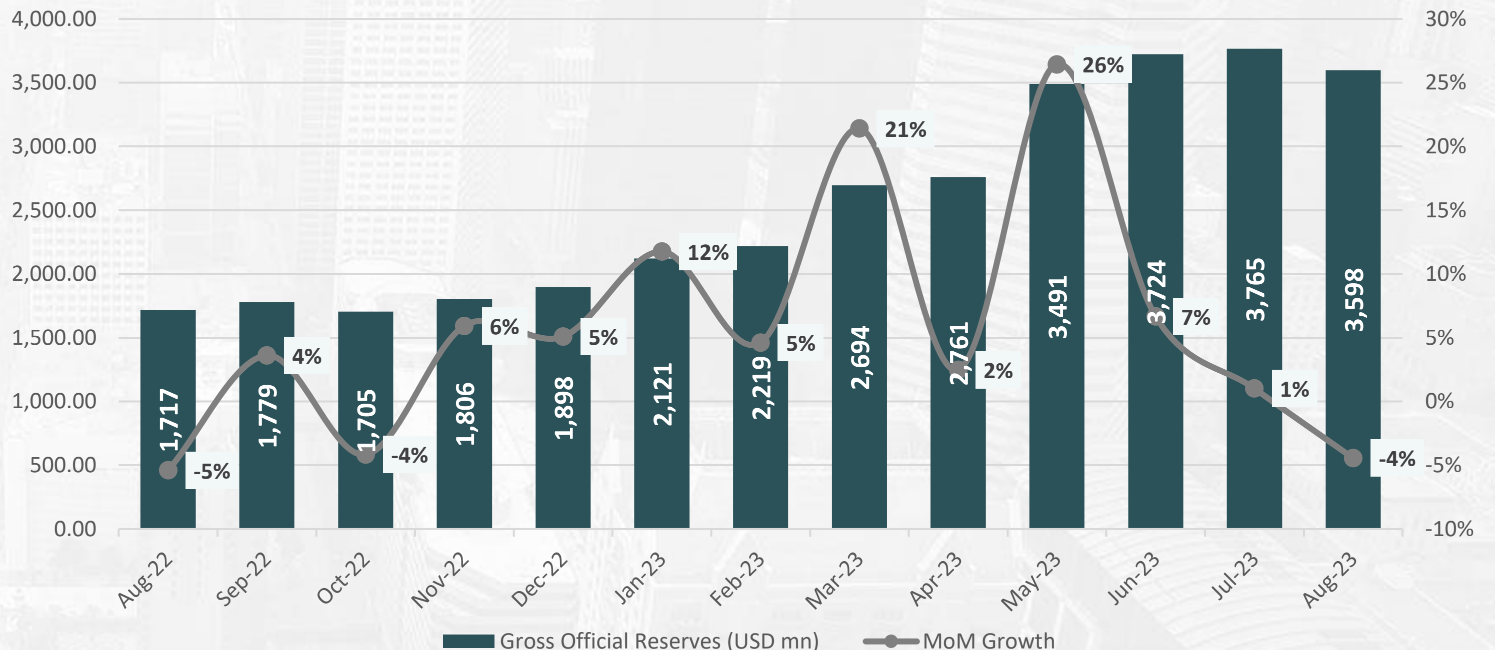
Source: First Capital Research

Arguments against a relaxation in monetary policy



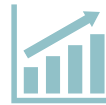
Reserves on a slow pick up yet remains subpar

Foreign reserve level of Sri Lanka has showed gradual progress with the highest MoM peak of 26% witnessed in May-23 where it touched the USD 3.5Bn mark. There on, reserves continued to perk up marginally till Jul-23 while in Aug-23, reserves dipped by 4% to USD 3.6Bn as the country settled a significant portion of the Bangladesh swap facility. Substantial progress in Tourism Earnings (+43.1%YoY) and Worker remittances (+78.0%YoY) contributed largely to the growth in reserves level. Further, BoP remained in the positive territory aided by the shrinking trade deficit that was recorded at USD -2.7Bn in Jul-23 compared to USD -3.6Bn recorded during last year. However, reserves still remain below required levels while the gradual relaxation of import ban and struggling export segment (mainly apparel) is likely to hinder the reserves growth. Taking into consideration these dynamics, it is fitting to opt out of a policy relaxation to prevent any further pressure to the already scarce reserves.



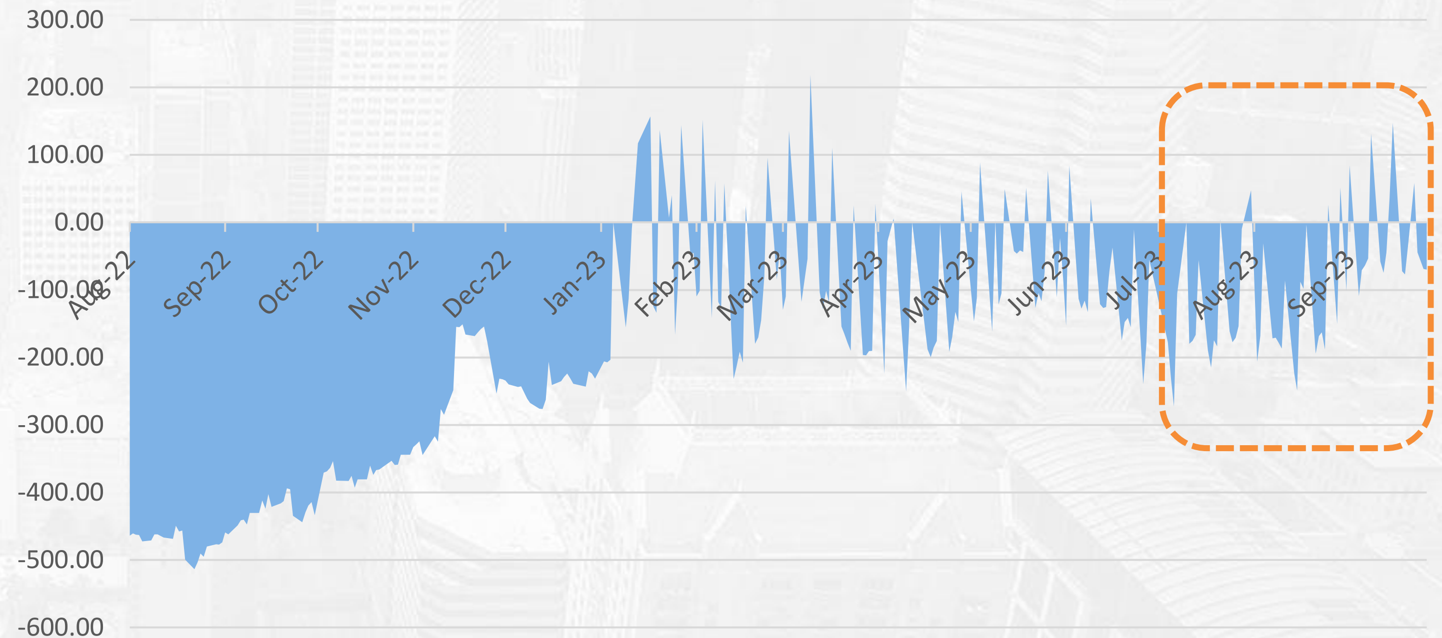
Source: CBSL, First Capital Research

Arguments *against a relaxation* in monetary policy



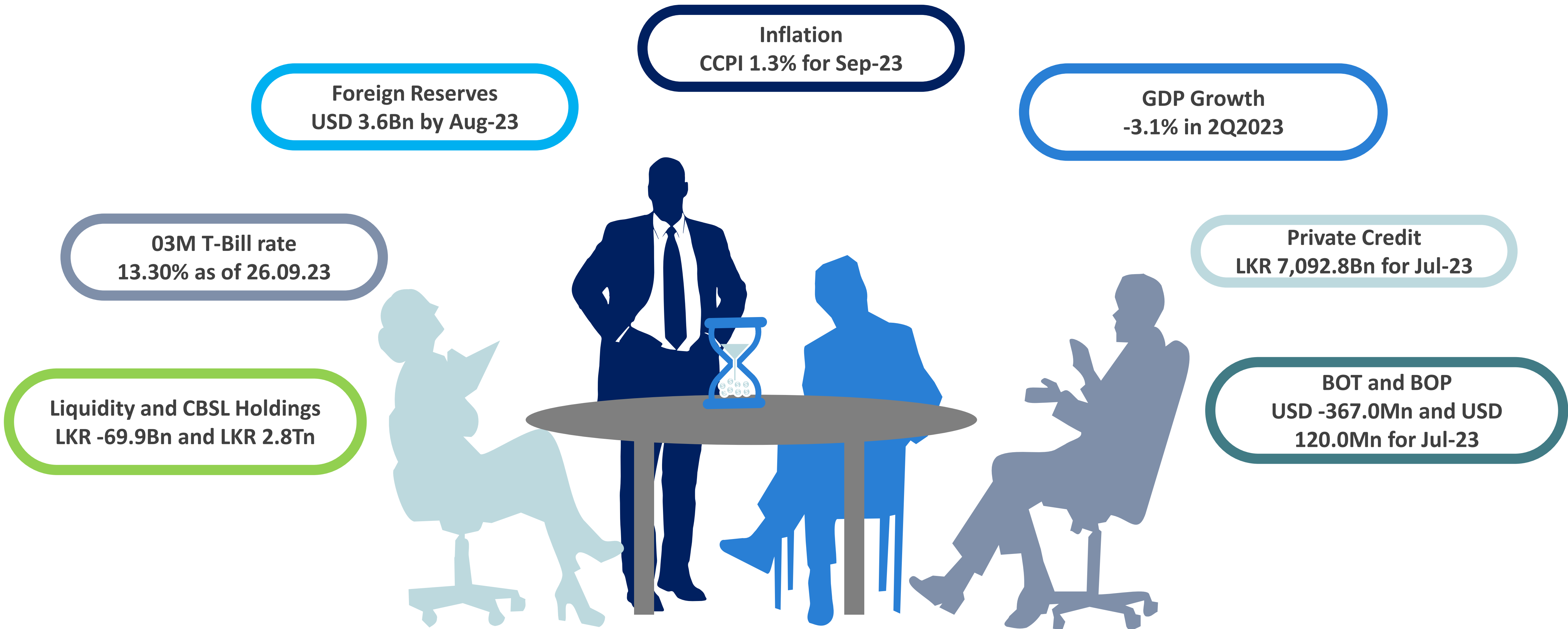
Liquidity on choppy move despite SRR cut; Private credit turns positive

Overnight liquidity has continued to exhibit considerable volatility, despite the Central Bank of Sri Lanka (CBSL) taking the decision to reduce the Statutory Reserve Ratio (SRR) on 8th Aug-23, from 4.0% to 2.0%. Since this adjustment, liquidity has registered an improvement, with the figure standing at LKR -69.9Bn as of 26th Sep-23, compared to the previous position of LKR -170.7Bn on 08th Aug-23. However, it's worth noting that this improvement has been marked by sharp fluctuations, swinging from positive to negative territory. The CBSL has also taken steps to stabilize liquidity by conducting Reverse Repo and Term Reverse Repo transactions. Nevertheless, on a broader perspective, liquidity remains in the negative territory and is yet to make significant progress. Further, private sector credit which contracted for 12 months upto May-23, turned positive for the 2nd consecutive month recording LKR 13.3Bn for Jul-23 indicating that the economic recovery is in progress. Therefore, it may not be advisable to consider relaxing policy rates at this juncture which could lead to an imbalance between demand and supply, which in turn may exacerbate financial instability within the economy.



Source: CBSL, First Capital Research

Factors in consideration at the policy review

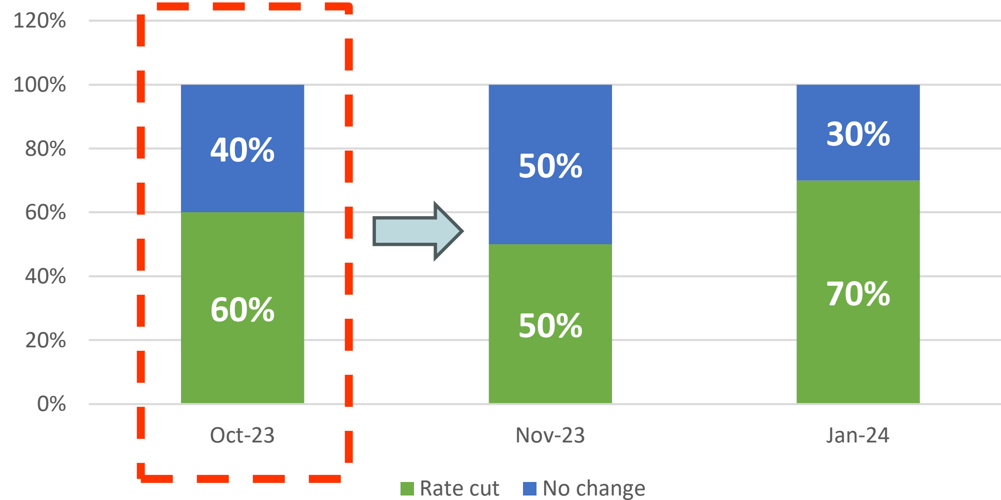


FCR Policy Rate Forecast (Oct-23 to Jan-24)

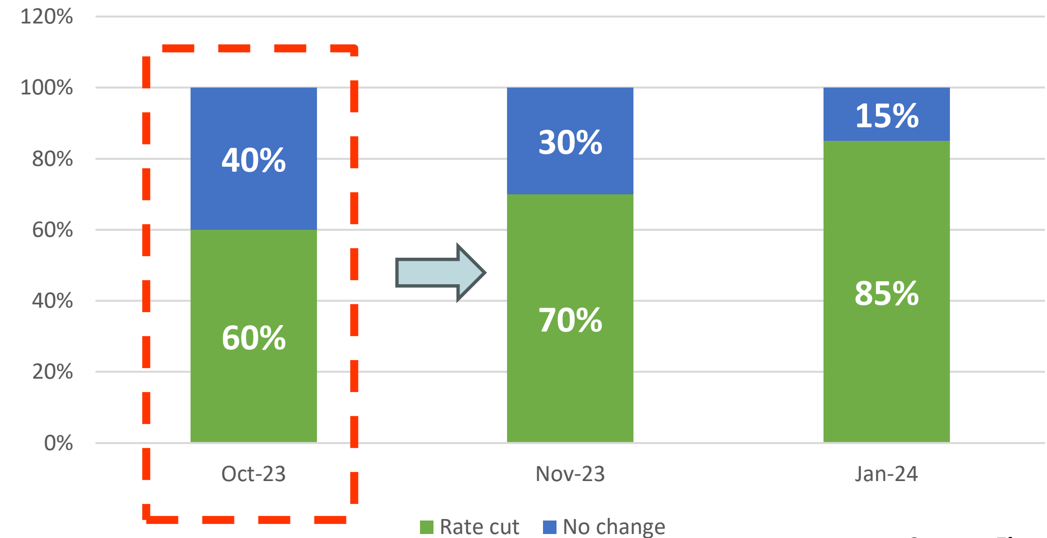
We believe that there is a 60% probability that CBSL may consider relaxing policy rates in the upcoming policy review meeting moving into a dovish stance with a view to stimulate economic growth and accelerate the decline with interest rates. With economic indicators stabilizing and the economy projected to recover during 2H2023 with a drastic slowdown of inflation witnessed in 3Q2023, we believe a sizeable monetary relaxation may be required in the latter part of 2H2023.

However, considering both arguments for and against monetary easing, we have assigned a 40% probability for policy rates to be maintained at the current rates allowing further strengthening of key economic indicators.

If a rate cut is given in Oct-23, probabilities for a rate cut in Nov-23 is low & the next rate cut may be in Jan-24

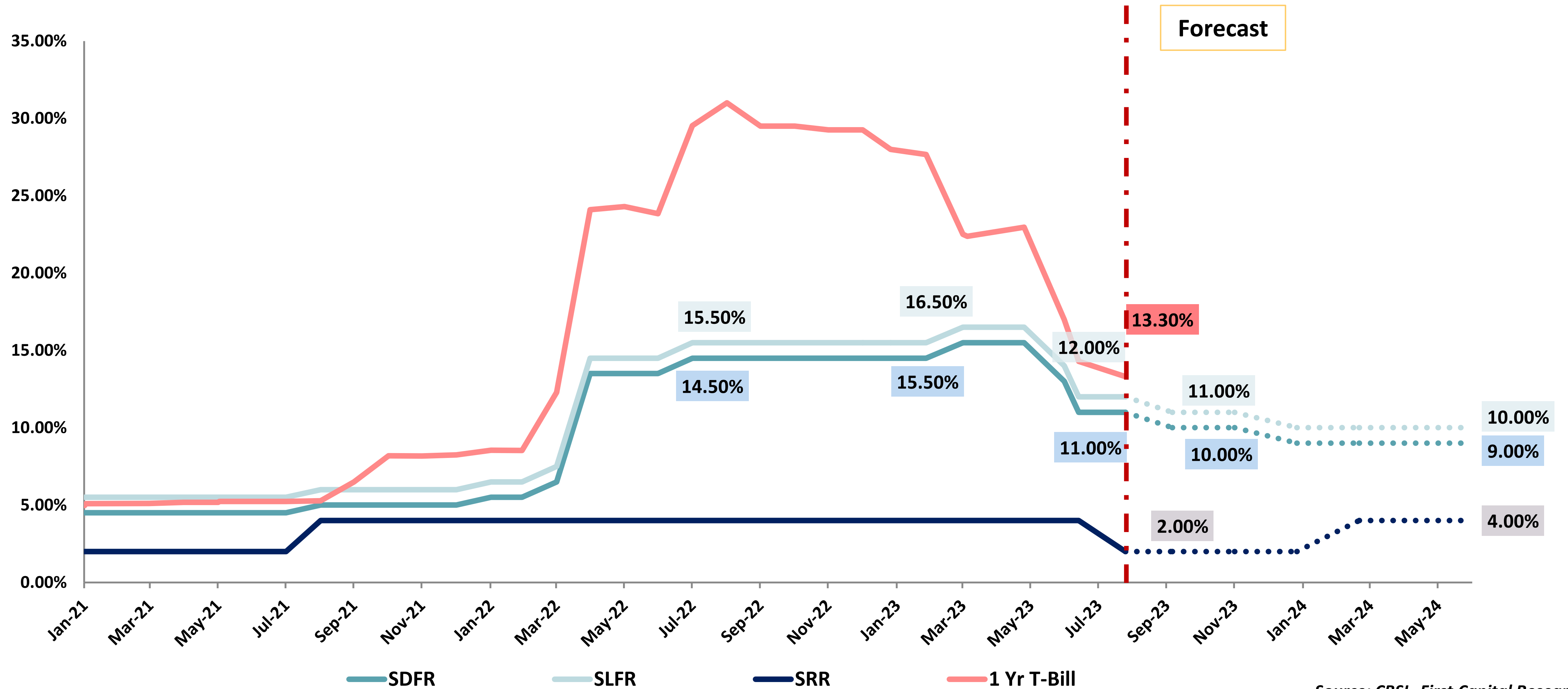


If there is no rate cut in Oct-23, probabilities for a rate cut significantly increases in Nov-23 & Jan-24



Source: First Capital Research

Monetary Policy Rates



Source: CBSL, First Capital Research

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