"CAUTIOUSLY NAVIGATING TO A DOVISH PIVOT"

PRE-POLICY ANALYSIS

20TH NOV 2023

First Capital Research

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Previous Pre-policy report: Recap

The CBSL further reduces policy interest rates

In line with our prediction, CBSL decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank by 100bps to 10.00% and 11.00%, respectively at the monetary policy review announced on 05th Oct-23. The decision was reached by the Board after carefully analyzing present conditions and anticipated changes, including low inflation and favorable inflation outlooks within the national economy, with the goal to establish stability in inflation at the targeted 5.0% rate over the medium term. The Board believes that with this decrease in policy interest rates, combined with the substantial relaxation of monetary policy measures implemented earlier, which include directives to licensed banks from the Central Bank to lower interest rates will hasten the decline in market interest rates, especially lending rates, in the upcoming period.

Key Arguments considered by CBSL for its policy stance announced on 05th Oct-23

- ✓ The significant deceleration of inflation has helped ease inflation expectations notably.
- ✓ Domestic economic activity is expected to rebound gradually during the second half of 2023 and sustain the recovery over the medium term.
- ✓ The external sector is expected to remain resilient in the period ahead.
- ✓ Market interest rates have declined notably from their high levels while further decline is expected in the period ahead.

Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, there is a **60% possibility for CBSL to maintain rates at the current levels,** allowing further strengthening of key economic indicators. Moreover, there is a **40% probability for CBSL to relax the policy rates, with a probability of 15% for a rate cut of 100bps, 15% 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. 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	**60%**
Cutting Policy Rates by 50bps	**10%**
Cutting Policy Rates by 100bps	**15%**
Cutting Policy Rates by 200bps	**15%**

40%

We believe that there is a 60% probability for policy rates to be maintained at their current levels allowing further strengthening of key economic indicators

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 24th Nov

Arguments against a Monetary Relaxation

60%

- Impending External debt restructuring puts a break on anticipated yield downturn
- Reserves nearly stagnant amid a slow uptick
- Credit growth on track
- Safeguarding against potential inflationary pressures

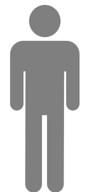
The above-mentioned factors argue against a relaxation in policy rates at the upcoming policy meeting

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

- Economic activities demonstrate healthy yet subtle upturn
- Access to affordable domestic funding opportunities
- Business confidence clouded by uncertainties
- Fed gradually pivots to a dovish stance

Arguments for a Monetary Relaxation

40%

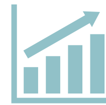


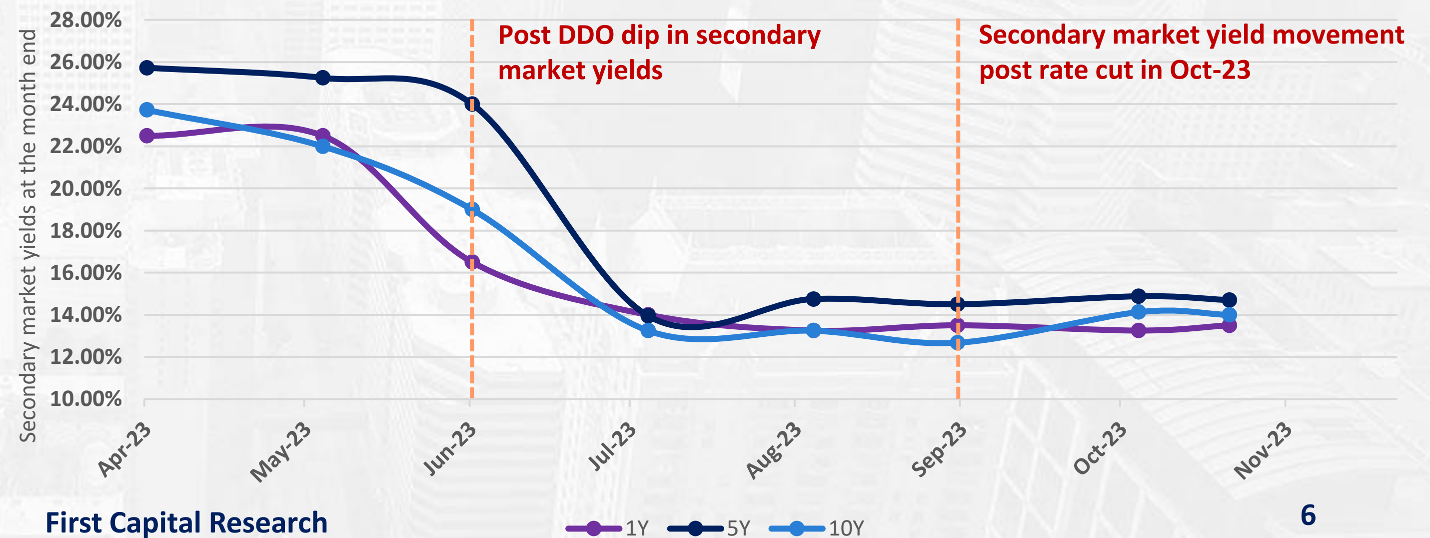
Arguments *against a relaxation* in monetary policy

Arguments against a relaxation in monetary policy

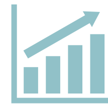
Impending External debt restructuring puts a break on anticipated yield downturn

Sri Lanka successfully finalized the completion of the domestic debt restructuring (DDR) in Jul-23. However, the country still has a long way to go in terms of the external debt restructuring (EDR) which comprises of debt of Paris Club, China and Private Creditors. Sri Lanka owes, nearly USD 10.0Bn to multilateral agencies (WB and ADB) and USD 11.3Bn to bilateral creditors including the Paris Club nations and China, Japan and India. The attainment of a board-level agreement with the International Monetary Fund (IMF) for the release of the 2nd tranche is contingent upon reaching a consensus on debt solutions that expedite the restoration of debt sustainability. IMF suggests that completion of the EDR is crucial for alleviating uncertainties that currently hinder Sri Lankan businesses and access to external financing. Hence, addressing and resolving uncertainties prevalent within the investor and business communities regarding the EDR is deemed imperative. This proactive approach is seen as a prerequisite to catalyze a downturn in yields within the secondary market. Notably, post finalization of the domestic debt restructuring in Jul-23, secondary market yields experienced a significant decline of 700bps-1000bps while it should be noted that secondary market yields have not displayed significant change despite the rate cuts of 550bps post DDO beyond Jul-23. This trend underscores the urgency of concluding the EDR before implementing any monetary stimulus, as it may not yield the desired outcomes.



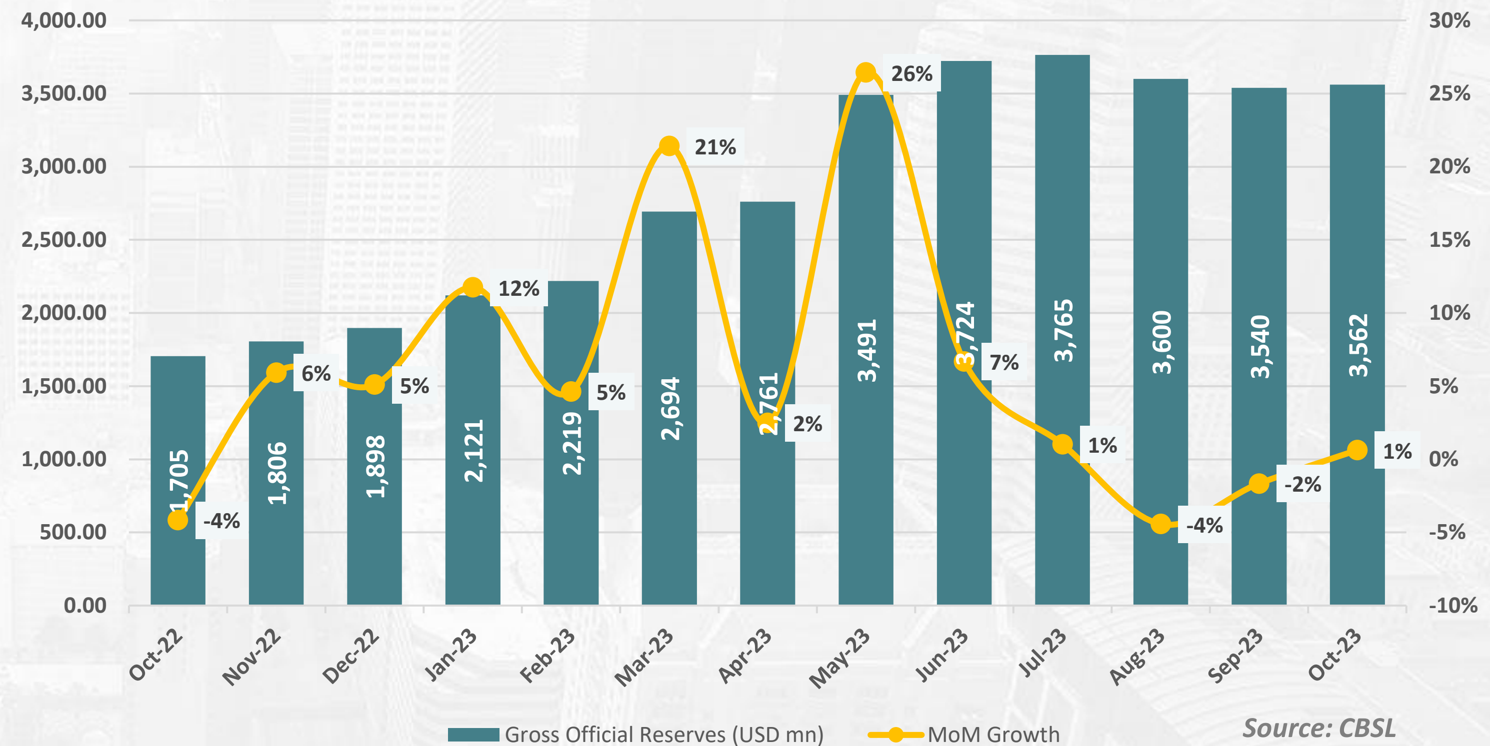


Arguments against a relaxation in monetary policy



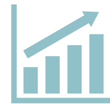
Reserves nearly stagnant amid a slow uptick

As of Oct-23, Sri Lanka's official foreign reserve assets stood at USD 3.6Bn, marking a mere 0.6%MoM growth and signaling a sluggish uptick in reserves. Despite experiencing a substantial 26% month-on-month surge in May, subsequent months have seen minimal improvement, especially in the face of a depreciating currency. The Balance of Payments (BoP) for Jan-Sep 2023 dwindled to USD 1.9Bn, declining during Aug-Sep period influenced by a net outflows, attributed to repayment of currency swaps, a monthly slowdown in tourism earnings and an expanding trade deficit. The vulnerability of reserves is exacerbated by the gradual relaxation of import bans and challenges in the export sector as well. Given these circumstances, exercising caution with regard to a rate cut is advisable, as it could potentially worsen capital outflows.



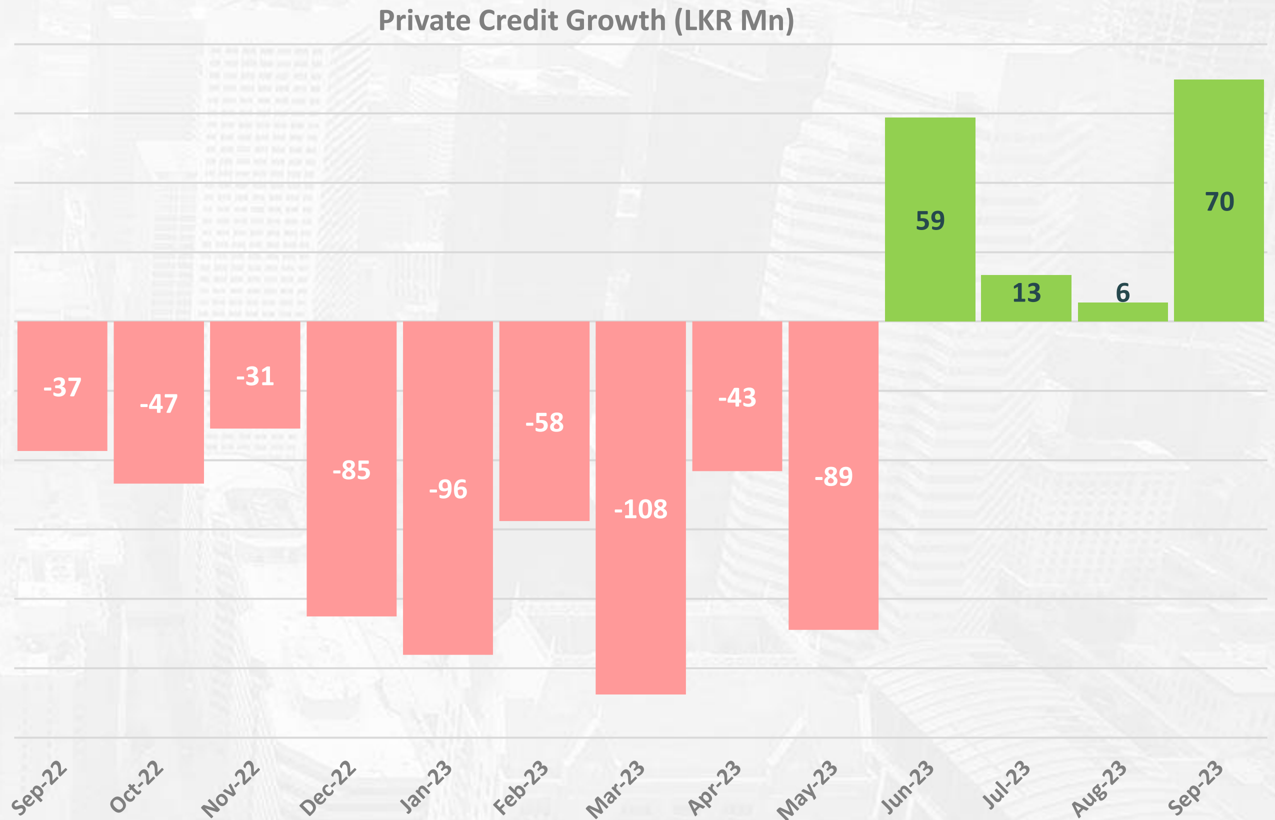
Source: CBSL

Arguments against a relaxation in monetary policy



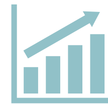
Credit growth on track

Private sector credit inclined during the month of Sep-23 by LKR 69.8Mn (+1.0%MoM) for the 4th consecutive month indicating a revival in gross loan disbursements in line with the decline in the interest rates and recovery in business activities. AWPR has registered a strong continuous decline over the last 3 months falling to 13.86% by Oct-23 from 17.18% in Jul-23 while further dipping to 13.17% by mid Nov-23. Amidst the steep fall in lending rates, private sector credit is anticipated to grow further erasing the contraction recorded during the 1H of 2023. Hence, it is a more prudent option to refrain from a policy relaxation as it may lead to excessive borrowing and spending, potentially overheating the economy.



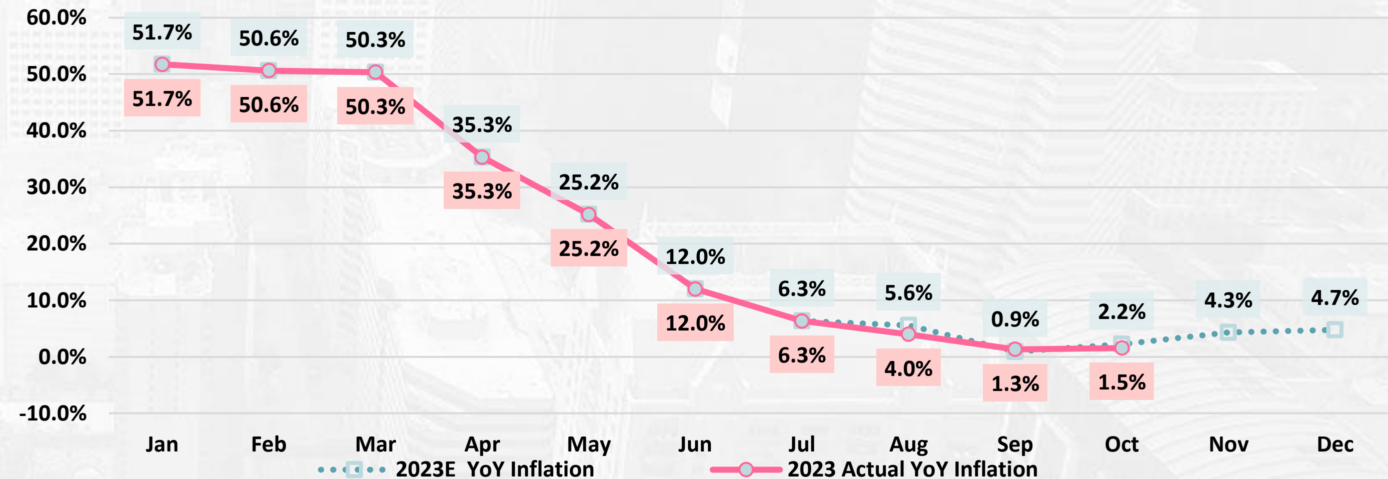
Source: CBSL

Arguments *against a relaxation* *in monetary policy*



Safeguarding against potential inflationary pressures

In Oct-23, inflation exhibited a gradual acceleration, with the YoY CCPI reaching 1.5%, compared to 1.3% in Sep-23. Notably, stability prevailed in the inflation of the food group at -5.2%, while the non-food group experienced a slight uptick to 4.9%. The substantial contribution of 3.25% to YoY inflation from the non-food group was led by a peak in Housing, Water, Electricity, Gas, and other fuels, accounting for 2.57%. Looking ahead, there is a possibility of impending price hikes, particularly in the electricity sector, driven by the recent power tariff adjustment in late October. Furthermore, an overall increase in prices is anticipated with the impending VAT hike to 18% scheduled for Jan-24, potentially leading to cost-push inflation. With the current inflation being below the targeted 4.0%-5.0% range, the current interest-rate environment creating a spike in credit, may pose a risk into the future of demand-pull inflation through heightened borrowing and spending. This could result in inflation exceeding the targeted range, creating unnecessary inflationary pressure. Therefore, implementing an additional monetary stimulus at this juncture is not deemed necessary. It is advisable to maintain stable policy rates to mitigate the potential inflationary pressures associated with increased consumer demand and price escalations in critical sectors. This cautious approach aims to strike a balance between supporting economic activity and averting the risk of excessive inflation.



Source: Dept. Census and Statistics, First Capital Research

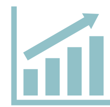
Arguments *for relaxation* in monetary policy

Arguments for relaxation in monetary policy

Economic activities demonstrate healthy yet subtle upturn

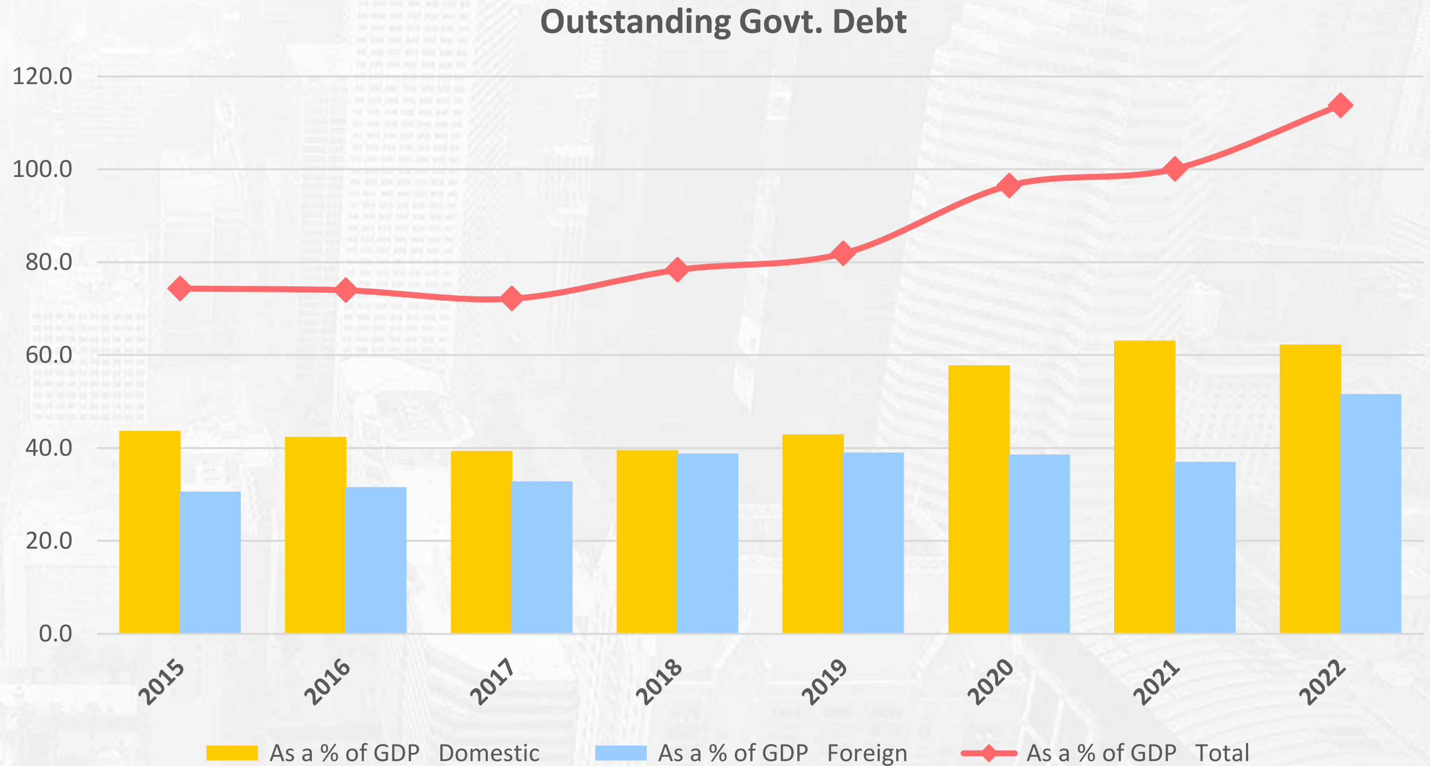
In Oct-23, economic activities demonstrated positive momentum, with the Manufacturing Purchasing Managers' Index (PMI) reaching an index value of 49.5, trending towards a neutral threshold. Notably, new orders experienced improvement, led by the textile and wearing apparel manufacturers, driven by seasonal demand. However, adverse weather conditions had a dampening effect on the production segment, particularly impacting the food and beverage sector. On a positive note, there was a notable increase in the stock of purchases, marked by the accumulation of raw materials in line with seasonal sales and production goals. Expansion in the services segment continued with it reaching an index of 56.2. Within the segment, New business increased particularly within in financial services, wholesale and retail trade. Business activities escalated on a higher pace, predominantly within the financial services sub-sector amidst the improvement in credit demand. Expectations for future business activities are optimistic, particularly in anticipation of the upcoming festive and peak tourism season. During the 2Q2023, the GDP experienced a contraction of 3.1%YoY (in line with the FCR forecast of -3.0%YoY). This contrasts with the 7.4% decline in output observed in the 2Q2022, indicating a significant deceleration in GDP contraction. This slowdown is attributed to decreasing inflation and the anticipated stabilization of interest rates throughout the quarter. Given these economic developments, adopting a dovish policy stance is deemed appropriate to support and enhance economic growth, particularly in the latter part of 2023. Such a strategic move aims to render borrowing more affordable, creating an environment conducive to increased business investment and expanded operations.

Arguments for relaxation in monetary policy



Access to affordable domestic funding opportunities

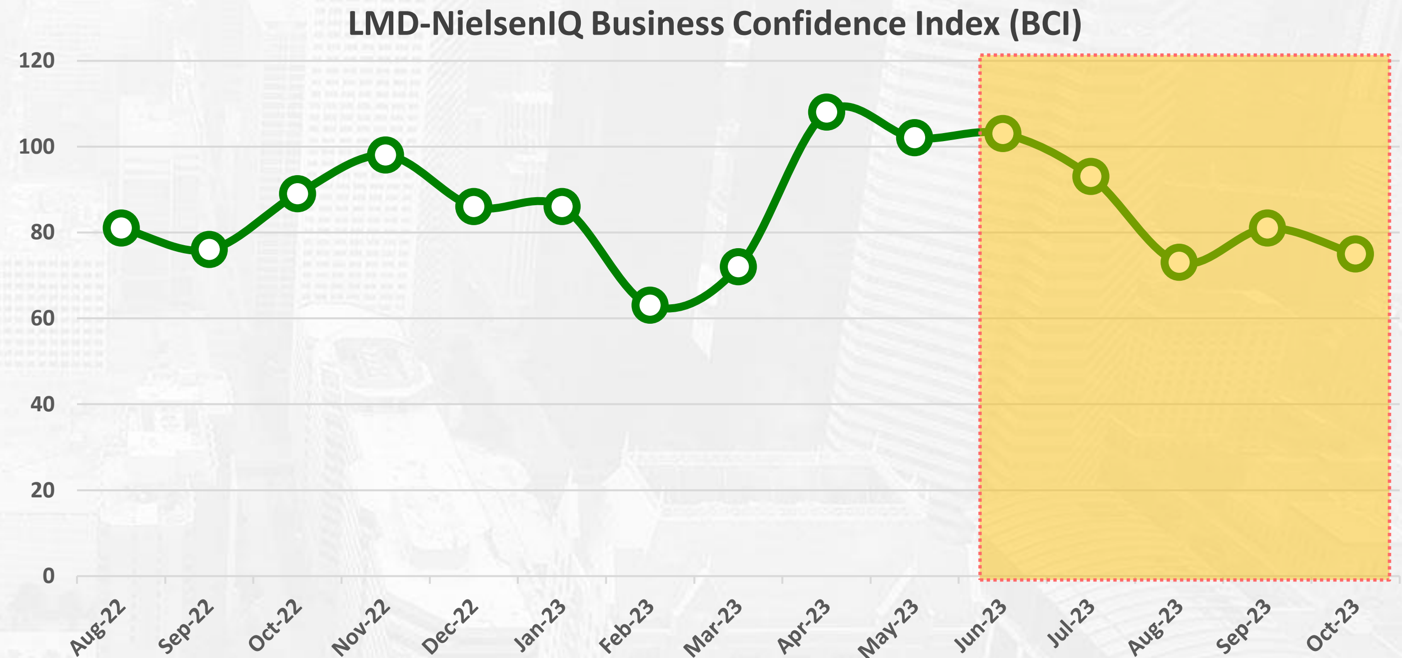
As of April 2023, Sri Lanka's budget deficit has witnessed a noteworthy YoY expansion, surging by 57.0% to LKR 824.3Mn and increasing to 2.7% of GDP from the previous 2.2%. Moreover, the GoSL has outlined an ambitious budget deficit target of 9.1% of GDP in the Budget proposal for 2024, surpassing the revised 8.5% of GDP projected for the current year, with the original target set at 7.9%. Amidst constrained access to international financial markets, the government is strategically opting for increased reliance on domestic borrowings to address the budget deficit. In light of this scenario, a considered downward adjustment in policy rates is seen as a proactive measure to assist the government in reducing its cost of servicing, thereby enhancing the overall affordability of the debt.



Arguments for relaxation in monetary policy

Business confidence clouded by uncertainties

Concerns loom large as the Business Confidence Index (BCI) experienced a decline of 6 points, registering at 75 in Oct-23. This volatility has persisted since July when the index fell from 103 in June to 73 in Aug-23, rebounded to 81 in Sep-23, only to dip once again in Oct-23. The fluctuations in the BCI can be attributed to several factors, notably the IMF review of the four-year Extended Fund Facility (EFF) and the ongoing discussions with creditors regarding External Debt Restructuring. Additionally, short-term sensitivities surrounding the 2024 budget have impacted investor confidence in the month of Oct-23. The relaxation of policy rates emerges as a crucial measure to address these uncertainties within the business community, Therefore, CBSL may consider opting for a policy rate reduction to not only eliminate uncertainties but also to stimulate business growth and foster confidence among investors.

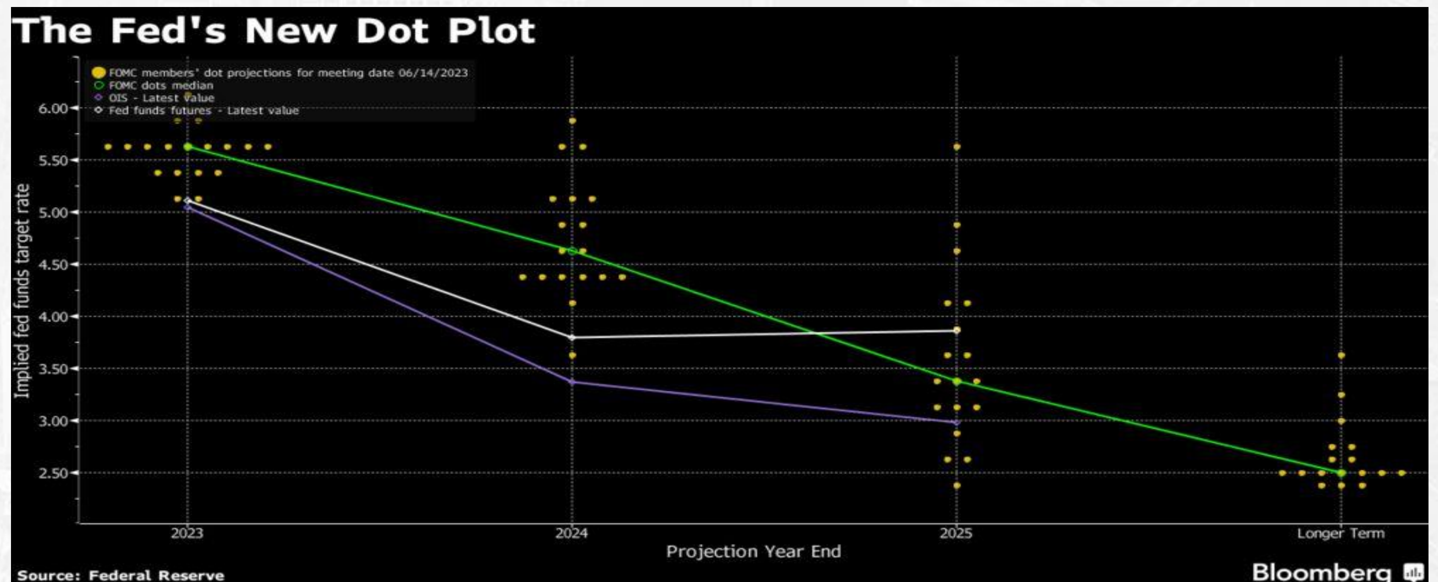


Source: LMD

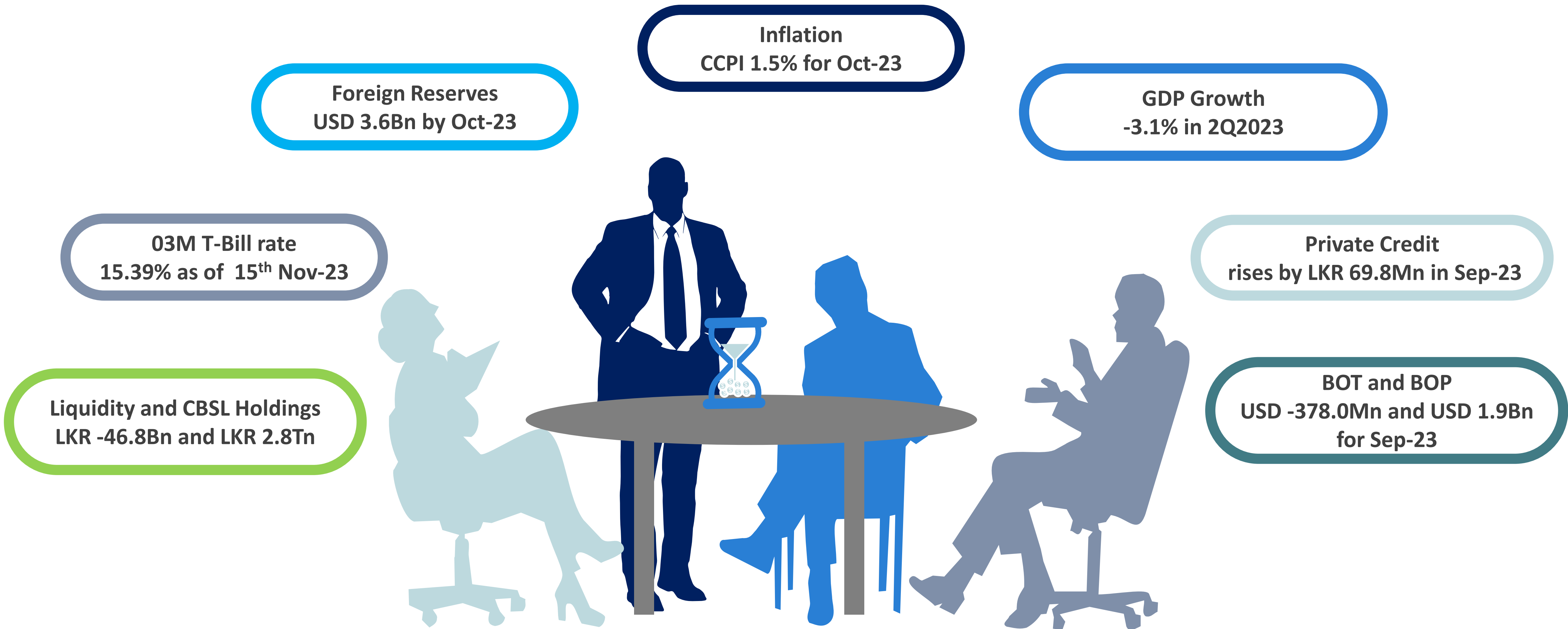
Arguments for relaxation in monetary policy

Fed gradually pivots to a dovish stance

In Nov-23, the Federal Reserve opted once again to maintain the key federal funds rate within the 5.25%-5.5% target range, a status quo since July. This marked the second consecutive decision by the Federal Open Market Committee to hold rates following a sequence of 11 rate hikes, including four in the same year. While the Fed has hinted at the possibility of one more rate hike in 2023, an increasing number of investors are optimistic that further rate increases may not be necessary in this cycle. The moderation in inflation, exemplified by unchanged consumer prices in Oct-23 compared to the previous month, provides an indication that the Federal Reserve might abstain from additional interest rate hikes and could potentially commence rate cuts by mid-2024. This shift in monetary policy is particularly advantageous for frontier economies like Sri Lanka, as it may alleviate or diminish the pressure stemming from a strengthening US Dollar due to rising rates. Additionally, following the completion of domestic debt restructuring, credit rating agencies S&P and Fitch have upgraded the Local Currency Rating to CCC+ and CCC-, respectively. This positive outlook on the external front provides support for a relaxation of policy rates from their current levels, potentially reducing prevailing high real interest rates.



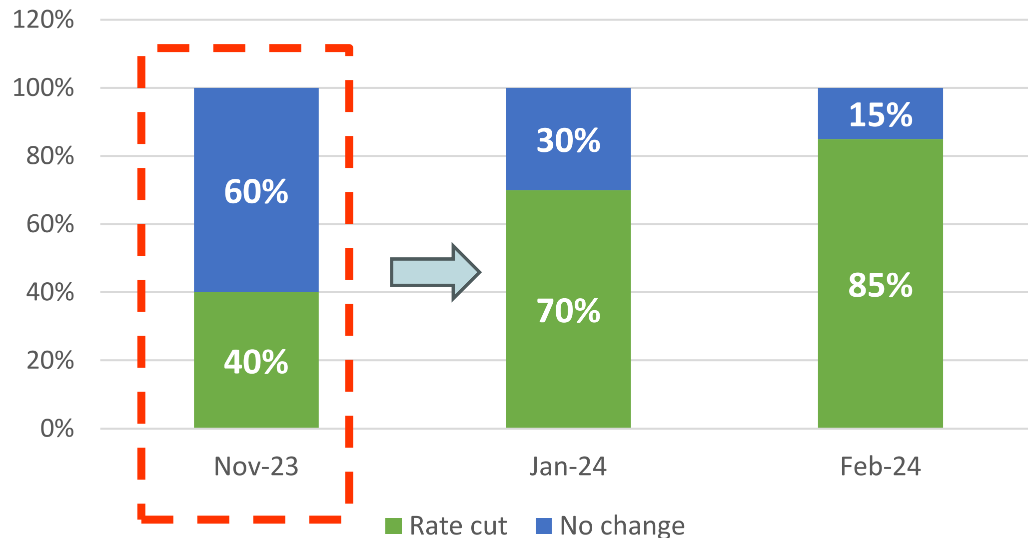
Factors in consideration at the policy review

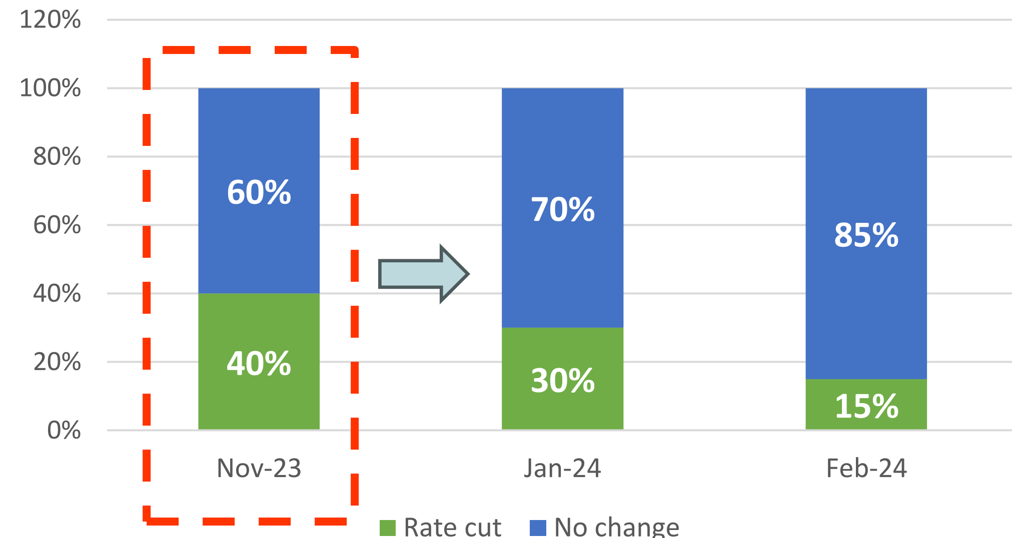


FCR Policy Rate Forecast (Nov 23 – Feb 24)

We believe that there is a 60% probability that CBSL may consider maintaining policy rates in the upcoming policy review meeting before gradually moving into a dovish stance allowing further strengthening of key economic indicators. With economic indicators stabilizing and the economy projected to recover during 2H2023 with a drastic slowdown of inflation witnessed in 3Q2023, we believe a monetary relaxation may not be the need of the hour.

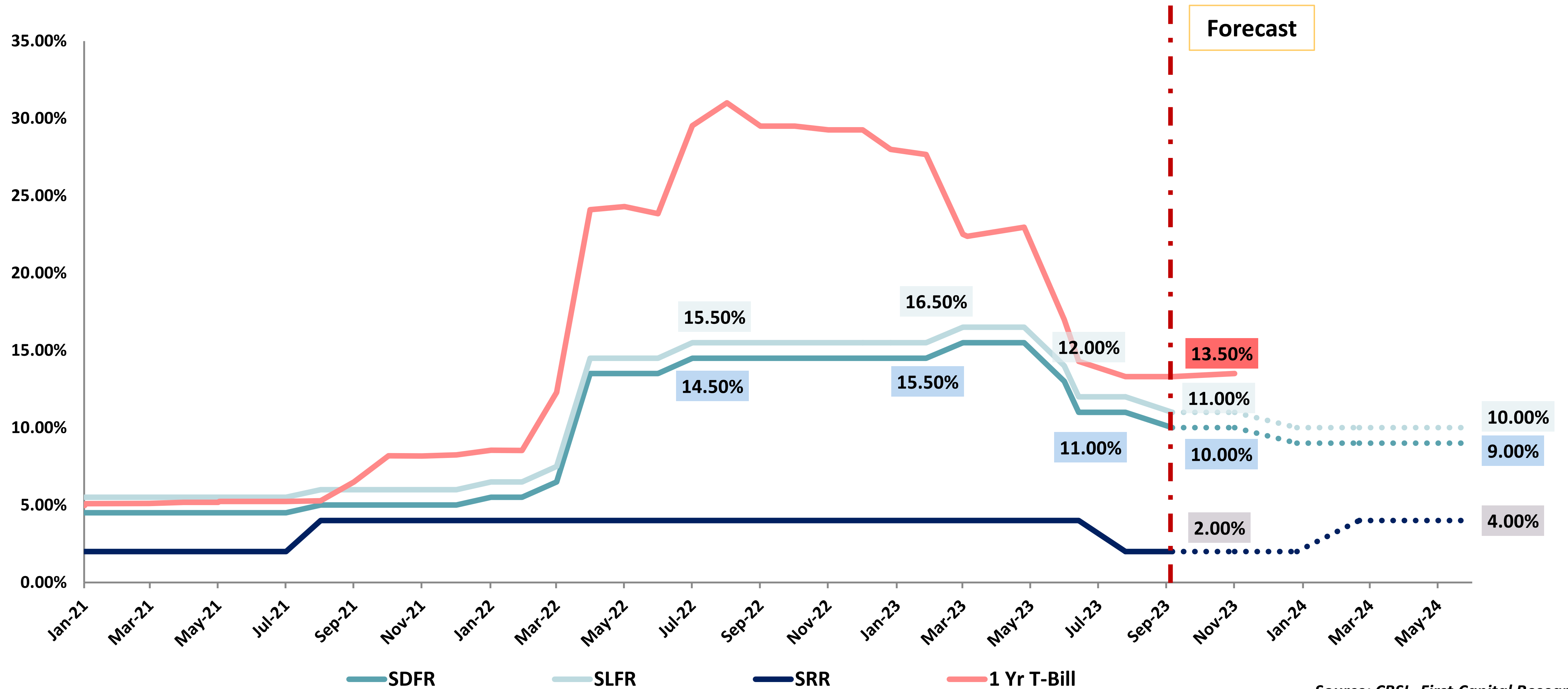
However, considering both arguments for and against monetary easing, we have also assigned 40% probability for a relaxation in policy rates with a view to stimulate economic growth and accelerate the decline with interest rates.





Source: First Capital Research

Monetary Policy Rates



Source: CBSL, First Capital Research

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