



First Capital

First Capital Research

Pre-Policy Analysis

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ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 7

Policy Expectation

❑ Previous pre-policy issue & surprise rate cut:

- First Capital Research highlighted a low but increased probability of a rate hike where probability of a rate hike was raised to 10% in Apr 2018 from 0% in Feb 2018, which was in line with the increase in the risk profile of the country. However, **contrary to our expectations a surprise rate cut was announced by CBSL (SLFR cut by 25bps to 8.50% while keeping SDFLR unchanged at 7.25% in Apr 2018). The rate cut was backed by CBSL's expectation of the Sovereign Bond and the requirement to boost GDP growth.**

❑ Changes took place during the period;

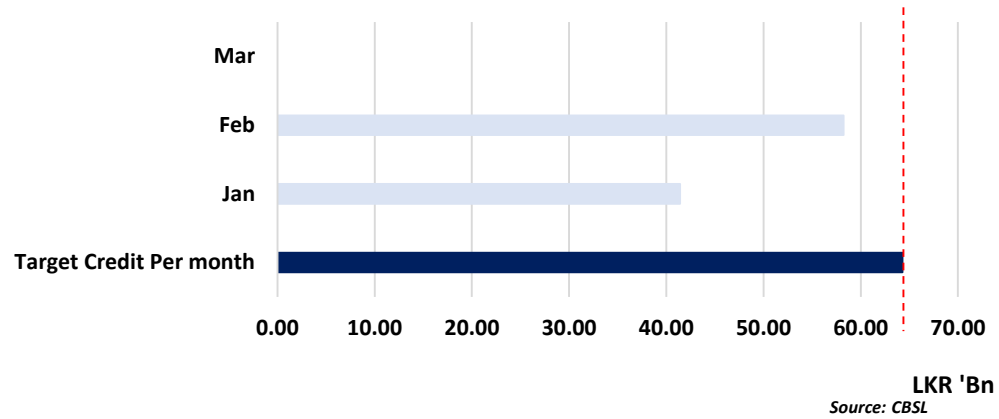
- The issuance of much anticipated USD 2.5Bn Sovereign Bond while extending the closing date of Foreign Currency Term Financing Facility improved the foreign reserve position to USD 9.9Bn, continuous widening of trade deficit and CBSL continue to offer and accept lower than maturity of SLDBs and Cabinet granting approval for the pricing formula.

❑ Private sector credit growth continues to be sluggish with no signs of acceleration. Implementation of pricing formula is expected to increase the inflation but remain within the bands of 4%-6% while also improving the future fiscal risk. REER is moving further towards the fair value in Mar 2018 from 103.35 in Jan 2018 is likely to maintain at fair value. The said indicators and the considerably slow GDP growth prevailing in the country are increasing the probability of a rate cut. However, the low level of the yield curve, higher debt payments up to Aug 2018 may push the probability of further monetary easing beyond Aug 2018. [First Capital Research through its Jan 2018 Strategy Report indicated a policy rate cut towards Sep 2018]

❑ Considering the recent developments First Capital Research believe current monetary policy is appropriate and no change is required.

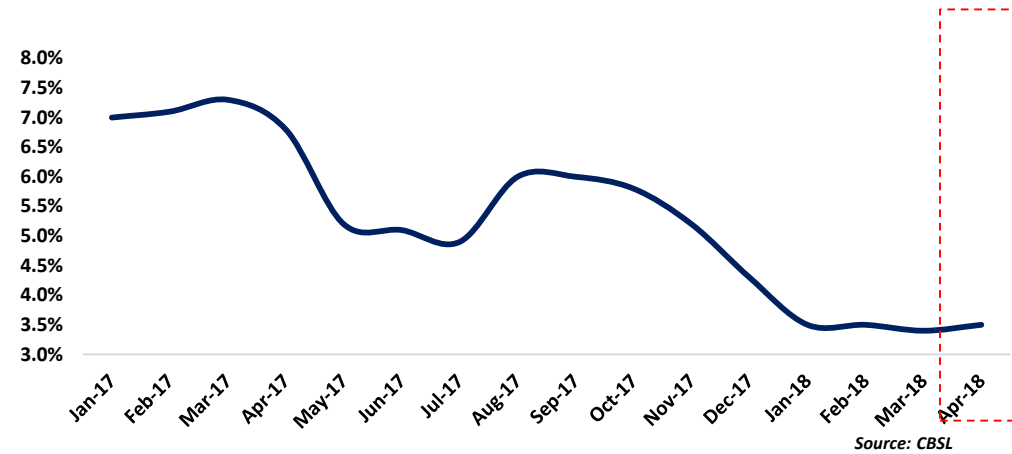
Graph 1 : Credit Growth remains slow

Credit Growth remains slow at 2%YTD, below First Capital Research target of 16%, private sector credit growth to pick up towards 2H2018.



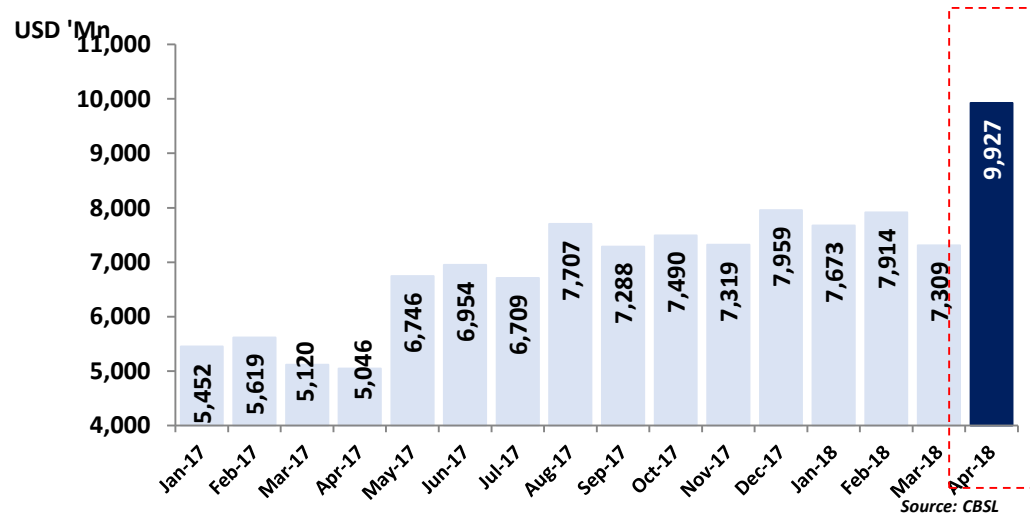
Graph 2 : Core Inflation remains below par at 3.5% in Mar 2018

Core inflation is expected to increase with the implementation of pricing formula but to remain under control within 4%-6%.



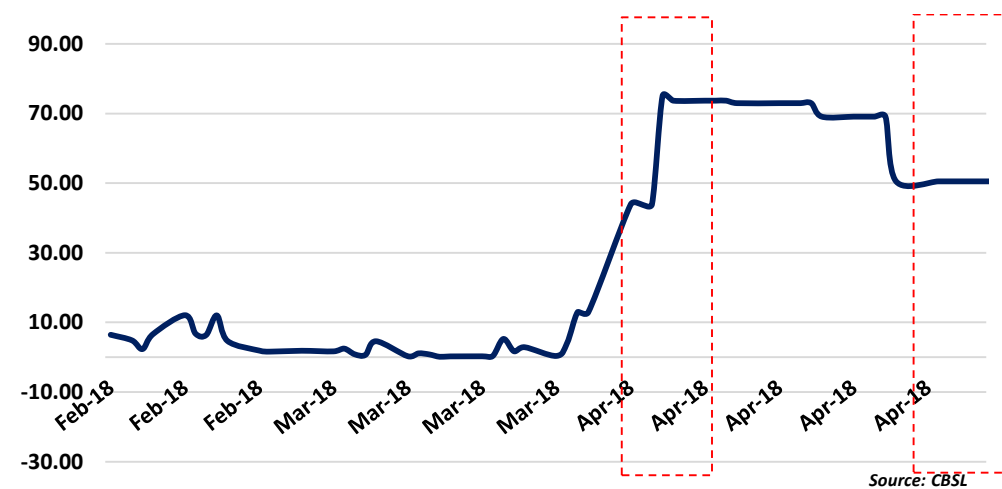
Graph 3 : Official Reserves increases to USD 9.93Bn in Apr 2018

We expect the reserve position to improve to USD 11Bn with the foreign funding facility, H'tota port payment coming in over the next 2 weeks.



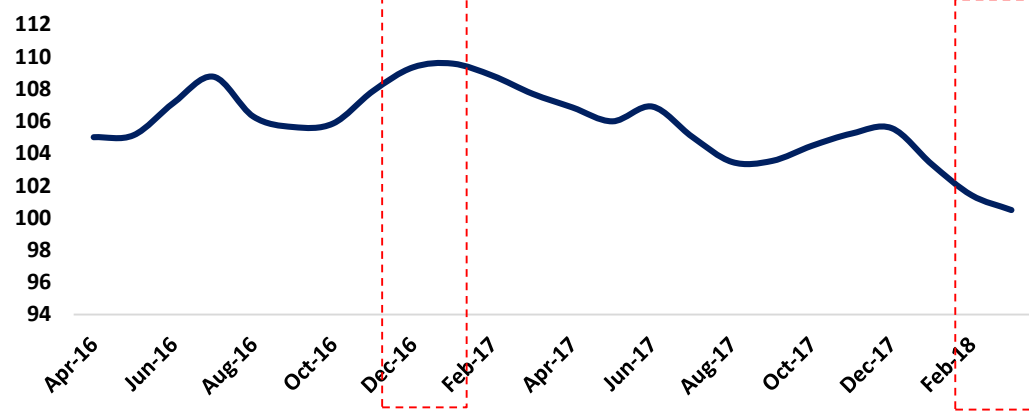
Graph 4 : CBSL holding in Gov Sec maintained above LKR 43Bn

CBSL holding in Government Securities increased to LKR 75Bn on 7th Apr 2018 prior to gradually decline prior to stabilize at LKR 50Bn in May 2018.



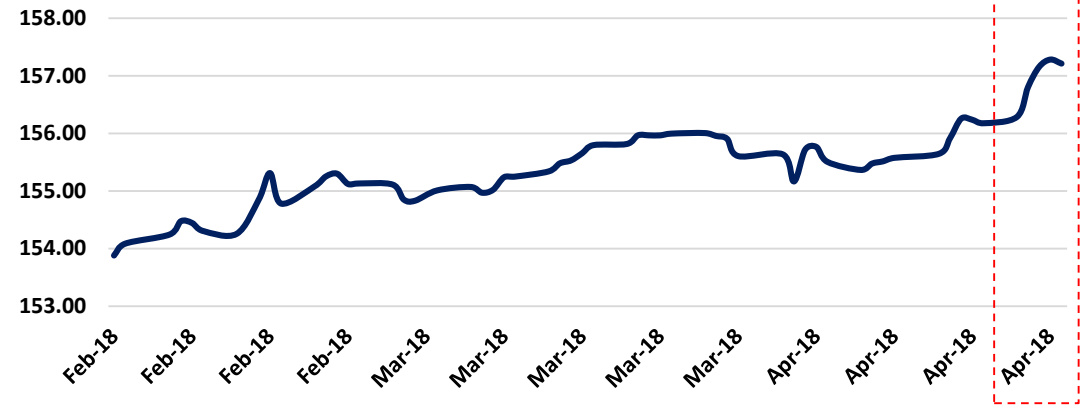
Graph 5 : Real Effective Exchange Rate improves to 100.5 in Mar 2018

REER was supported by currency depreciation witnessed in Feb to Apr 2018 coupled with USD strengthening during Apr 2018



Graph 6 : LKR weakens against strengthened USD

LKR was seen depreciating to all time lows of LKR/USD 158.20 in Apr 2018 on the back of strengthening USD.



Graph 7 : Fed Rate Hike Expectations - 2018

Surveys conducted in Dec 2017 and in Feb 2018 indicated three rate hikes (Jun 2018, Sep 2018 and Dec) for 2018.

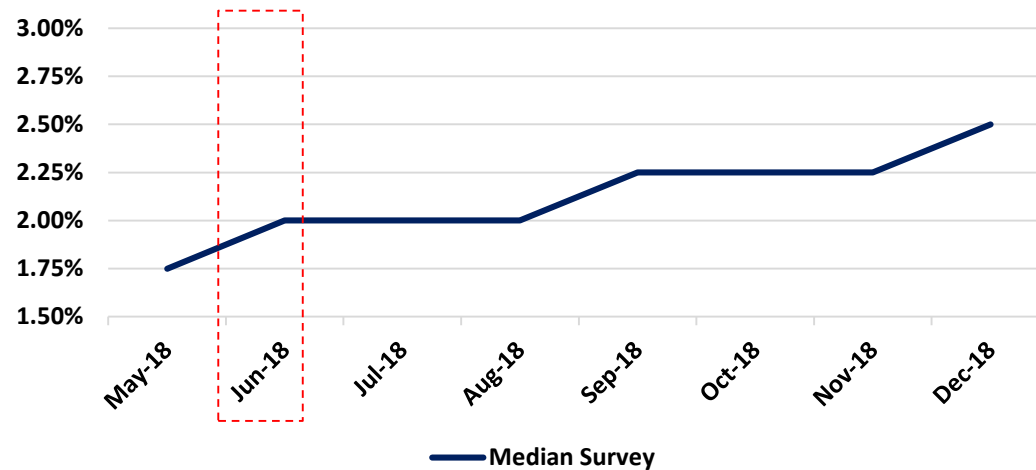


Table 1 : Pricing Formula Impact of Fuel Prices


Fuel Type	Price per Ltr (LKR)	
	Current	With Pricing formula
Petrol (Octane 92)	117	138
Petrol (Octane 95)	128	148
Auto Diesel	95	109
Super Diesel	110	119
Kerosene	44	101

Source : <http://www.dailymirror.lk/article/Fuel-price-hike-from-midnight-today-149736.html>

Expected Monetary Policy Stance

With the issuance of Sovereign bond leading to an improved reserve position has reduced the risk considerably. However, considering the fact of overly slow GDP growth and appropriate levels of other economic indicators (inflation, REER, credit growth, CBSL holding) we believe current monetary policy is appropriate and no change is required.

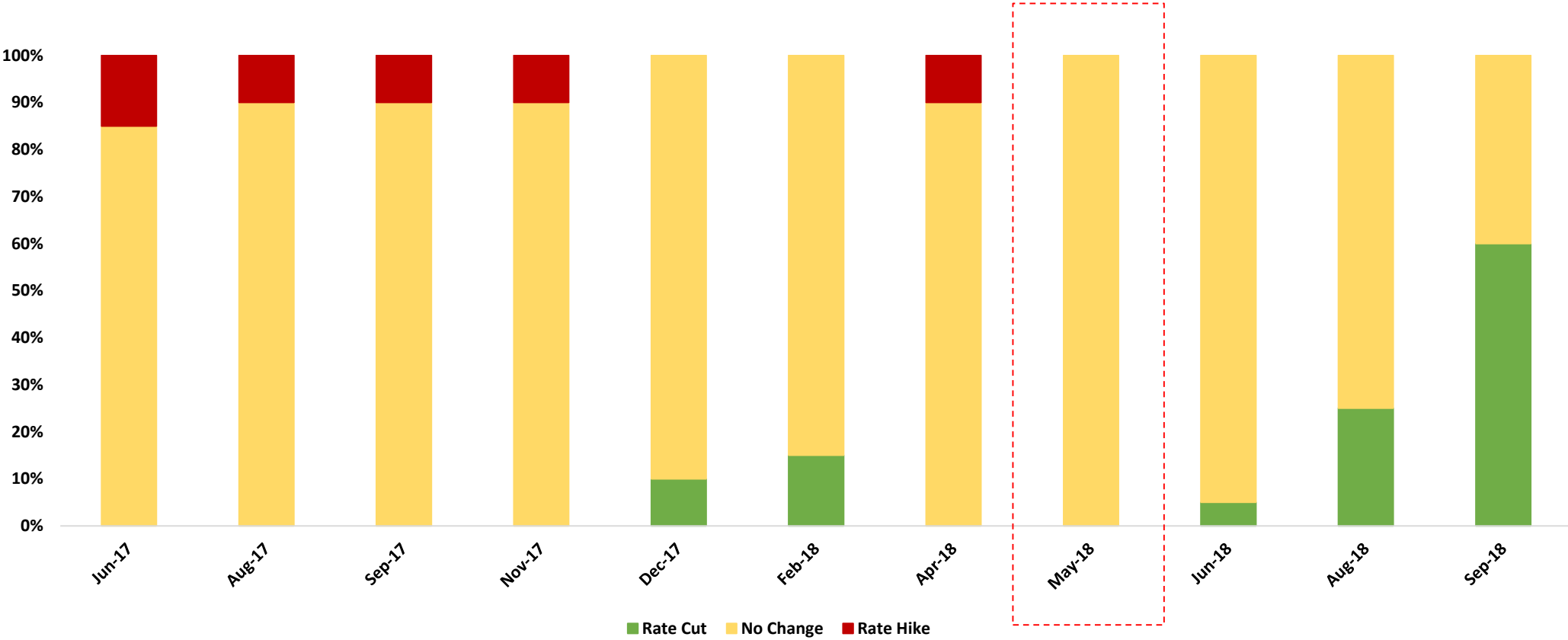
Expected Monetary Policy Stance by CBSL	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	100%
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

 Probability decreased to 0% from 10% in Apr 2018

Current Policy Rates	
Standing Deposit Facility Rate (SDFR)	7.25%
Standing Lending Facility Rate (SLFR)	8.50%
Statutory Reserve Ratio (SRR)	7.50%

We expect the CBSL to keep Statutory Reserve Ratio (SRR) unchanged at 7.50%

First Capital Expectations



Source: First Capital Research

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