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First Capital Research

# Monetary Policy to be maintained allowing impact of previous rate cut to materialize

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PRE-POLICY ANALYSIS

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# Improved fundamentals signal no strong case for rate change while allowing the impact of previous cut to materialize...

## Previous Pre-Policy issue; CBSL reduces its policy rates by 50bps

- In line with our expectation of an “inevitable rate cut”, CBSL reduced the SLFR and SDFR by 50bps as they believed, policy intervention was required to address the subpar economic growth which was further affected by the Easter Sunday attacks.

## Macro economic fundamentals have shown a steady improvement

- ❑ SL maintained foreign reserve position at USD 6.7Bn as at 31<sup>st</sup> May 2019 which is noteworthy considering the major outflows in Apr 2019. Furthermore, SL successfully raised USD 2.0Bn by conducting an International Sovereign Bond offering tenors of 5 and 10 year. Following the issuance, we expect the foreign reserves to show significant improvement reaching above USD 8.0Bn in Jun 2019 while maintaining above USD 7.5Bn during Jul to Dec 2019. Cabinet approval was obtained to raise up to LKR 480.0Bn for debt management through liability management act, which provides leeway for CBSL to raise further USD 2.5Bn as indicated to manage debt in 2020, which would be a year with multiple elections. Sri Lanka’s next international sovereign repayment is only due in Oct 2020 amounting to USD 1.0Bn while 1Q and 2Q each constitute USD 0.4Bn of SLDBs maturing. Raising funds well in advance for repayments is expected to significantly strengthen macro economic outlook for Sri Lanka and to reduce unnecessary volatility.

## Impact of the previous rate cut may take time to materialize

- ❑ A sustained positive liquidity position was maintained resulting from multiple SRR cuts in Nov 2018 and Mar 2019 and due to release of long-delayed payments by the government. Net Contraction in credit during Jan-Apr 2019 period is likely to have also supported the improvement in liquidity. Considering the period within which a policy rate cut was implemented, we believe it may take a lengthier period for lending rates in the market to decline and stimulate growth. The high level of NPL in the system may delay the dip in lending rates. However, in order to accelerate the reduction in lending rates, as previously indicated by the CBSL, we expect imposition of a cap on lending rates to enhance credit flows to the economy with the intention of boosting the economic and credit growth.
- ❑ During the month of Jun, USD:LKR remained stable to close at 176.42 on 28<sup>th</sup> Jun 2019 supported by foreign inflows, exporter conversions and contraction in imports. However, REER (2017=100) continued to remain undervalued at 91.95 in May 2019 while we estimate it to be 92.35 in Jun 2019. The external environment is favoring lower yields as the weakening US economy led the Fed to rethink its interest rate normalization strategy resulting in Fed indicating a likely monetary easing in upcoming meetings. The situation has weakened the dollar further supporting the stability of rupee.

## Policy rates to be maintained as additional time is required to assess the impact of previous cut

- ❑ Considering the fact that it is too early to assess the impact of the previous 50bps rate cut, we believe that the monetary board would **continue the policy rates with no change**. We believe that Monetary Board may first consider, CBSL’s ability to implement lending rate caps before further policy rate cuts being implemented. However, considering the slowness of the economy and the contraction of credit, we would not rule out a further 25bps rate cut towards 4Q2019, if economic growth fails to accelerate.

# Expected Monetary Policy Stance

We believe there is a strong case for continuation of policy rates while permitting the effect of the recent cut to materialize. However, considering the below par GDP growth and overly sluggish credit growth, probability of a rate cut exists towards the 4Q of 2019 to boost the revival of activities.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
<b>Policy Rates to remain unchanged</b>	<b>100%</b>
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	5%
<b>SRR to remain unchanged</b>	<b>95%</b>
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%



Increased to 100% allowing the impact of rate cut in May 31<sup>st</sup> to materialize during the next 06 months period.

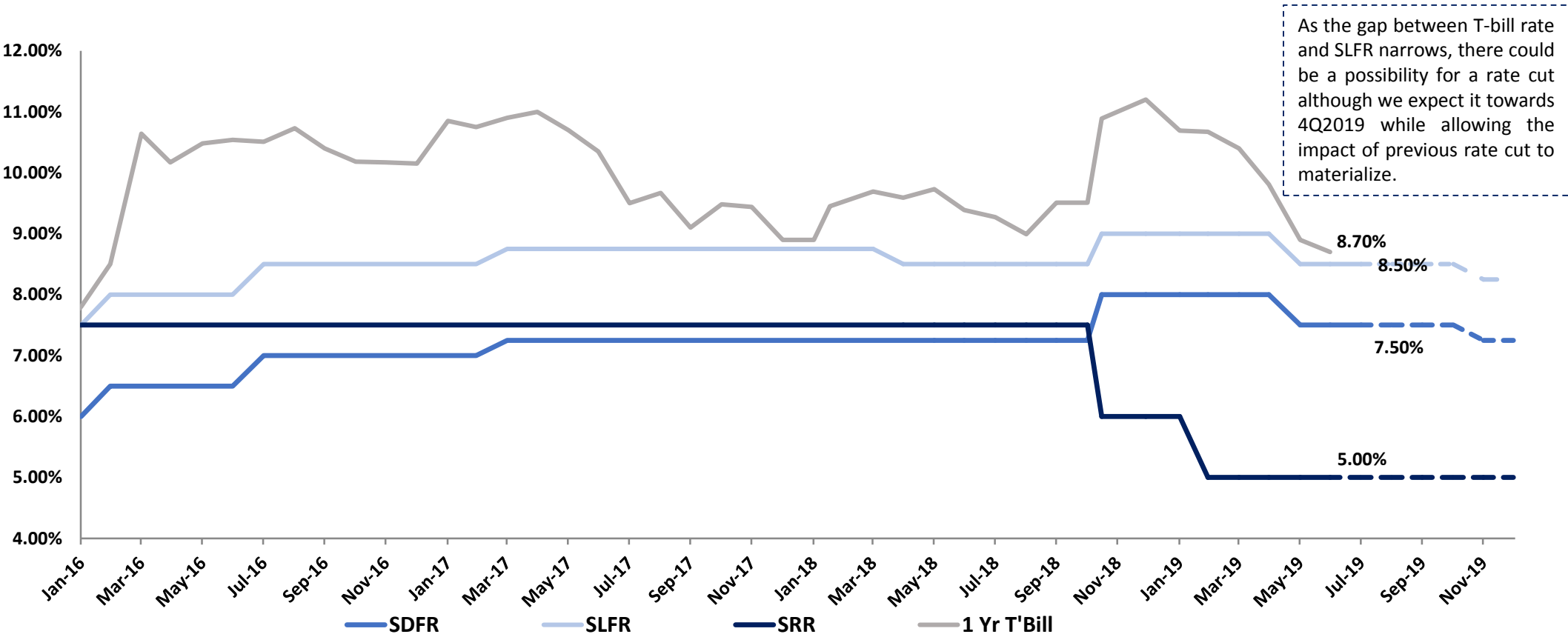


Reduced to 0% permitting additional time to monitor growth



Remains unchanged amidst healthy liquidity levels as CBSL has already taken measures to enhance the market liquidity through two SRR cuts in November 2018 and March 2019.

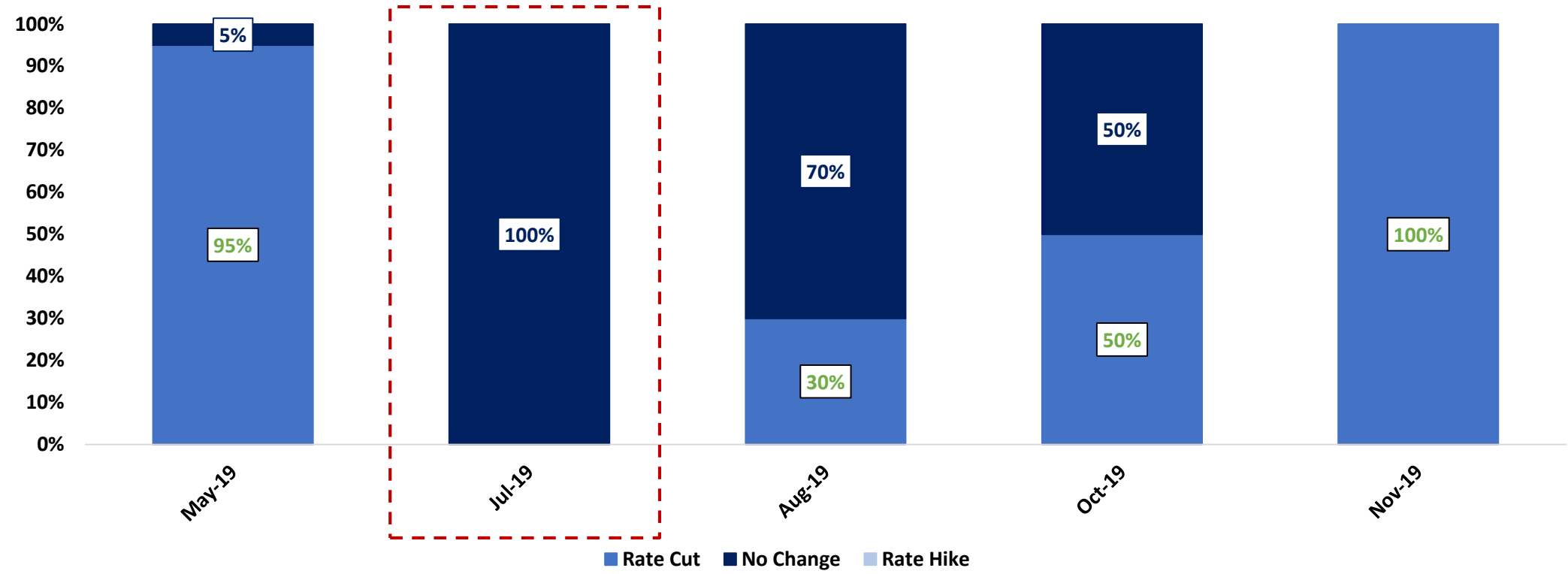
# Monetary Policy Rates



Source: CBSL, First Capital Research Estimates

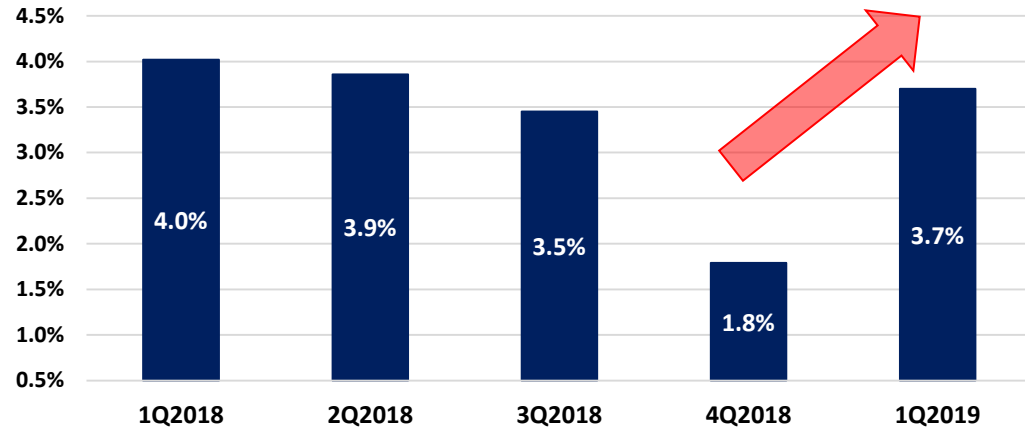
# FCR Policy Rate Forecast – Apr 2019 to Nov 2019

First Capital Research expects a 100% probability for continuation of current policy stance allowing the impact of previous rate cut to be materialized.



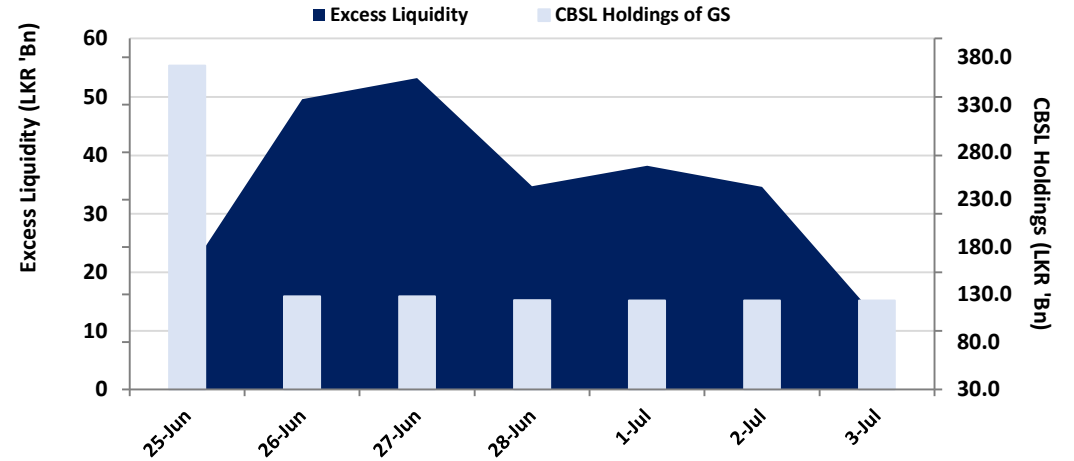
Source: CBSL, First Capital Research Estimates

**Graph 1 : GDP growth increased in 1Q2019 although it is expected to be lower in 2Q2019 as a result of the Easter Sunday attacks.**



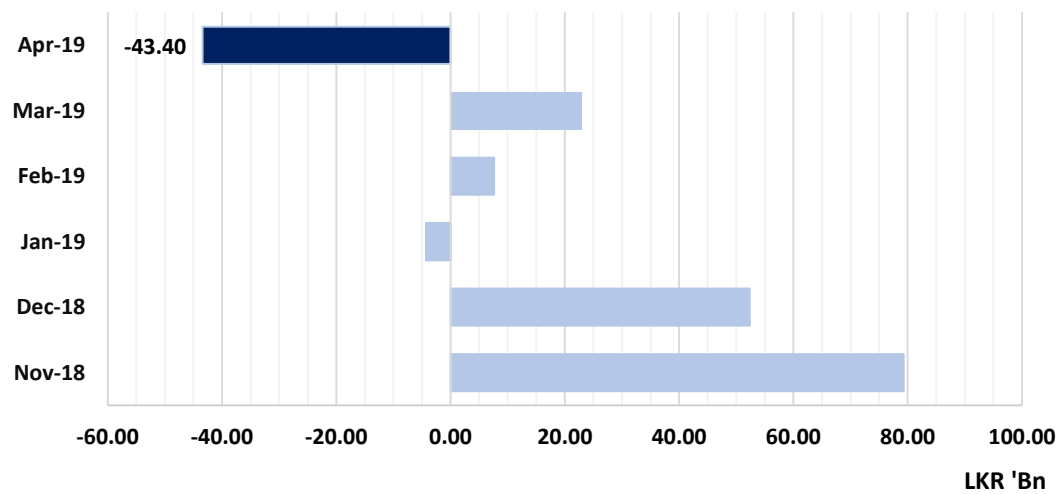
Source: CBSL

**Graph 2 : Excess Liquidity and CBSL Holdings of Gov. Securities**



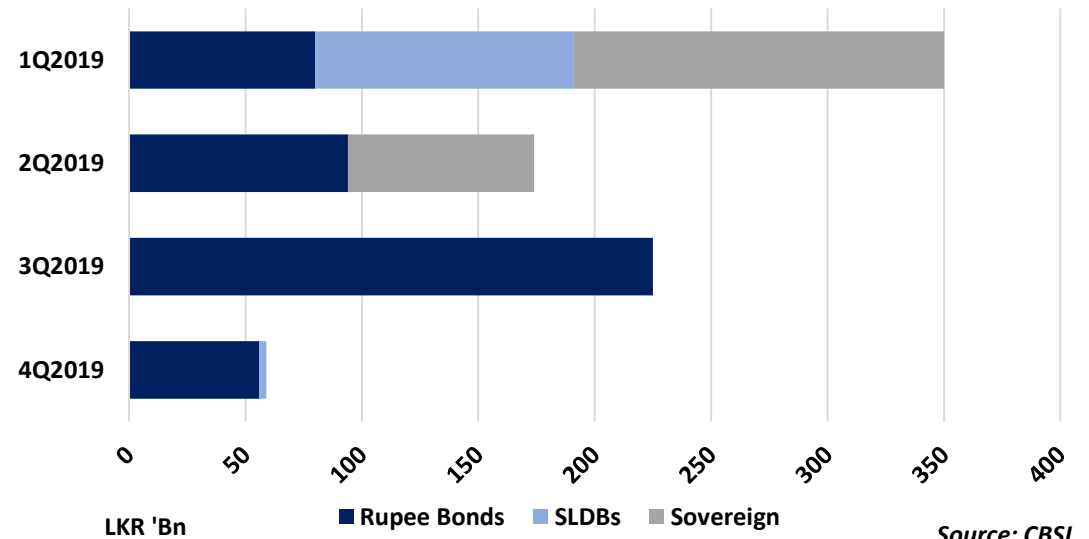
Source: CBSL

**Graph 3 : Private Sector Credit turned negative in April 2019 after January 2019**



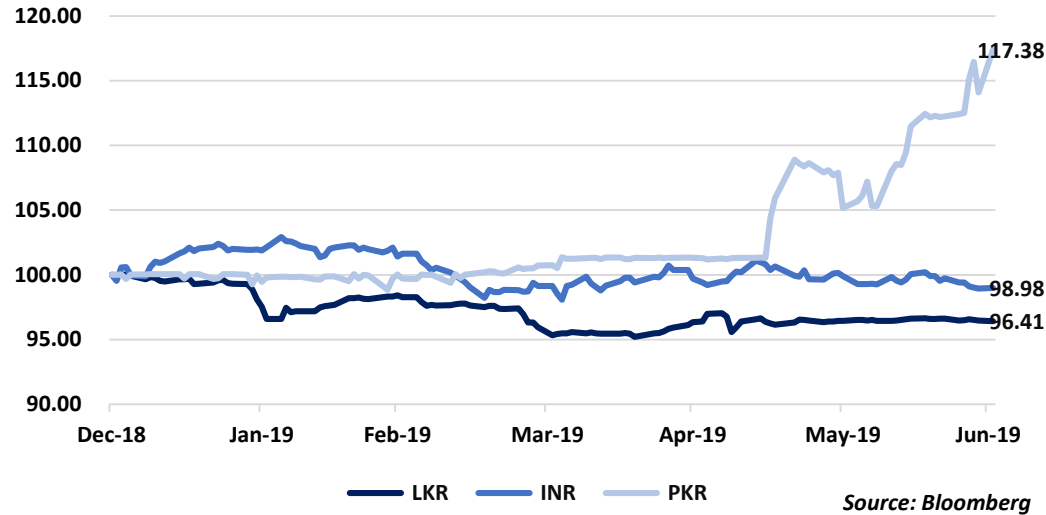
Source: CBSL

**Graph 4 : Sri Lanka's Foreign debt repayments – 2019**

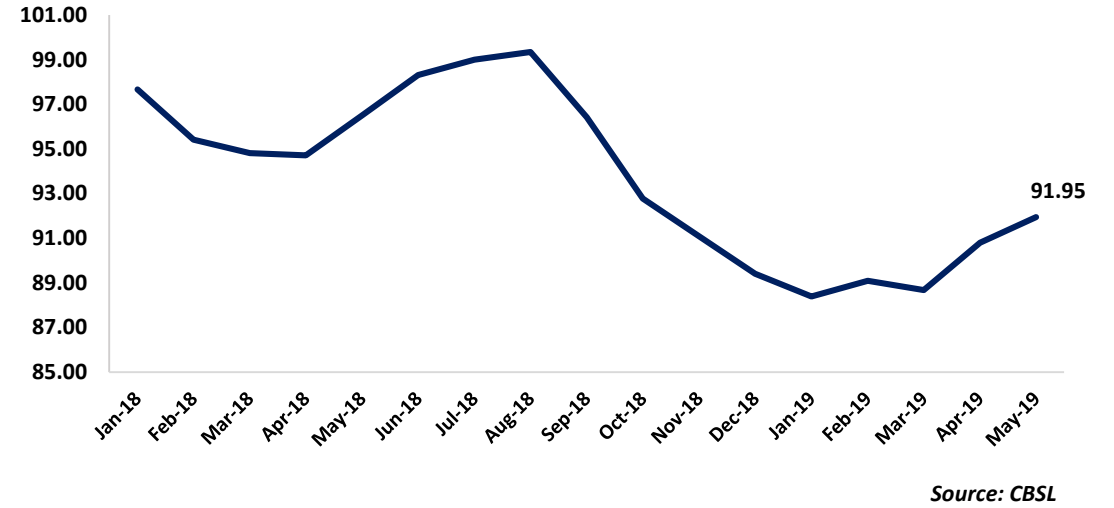


Source: CBSL

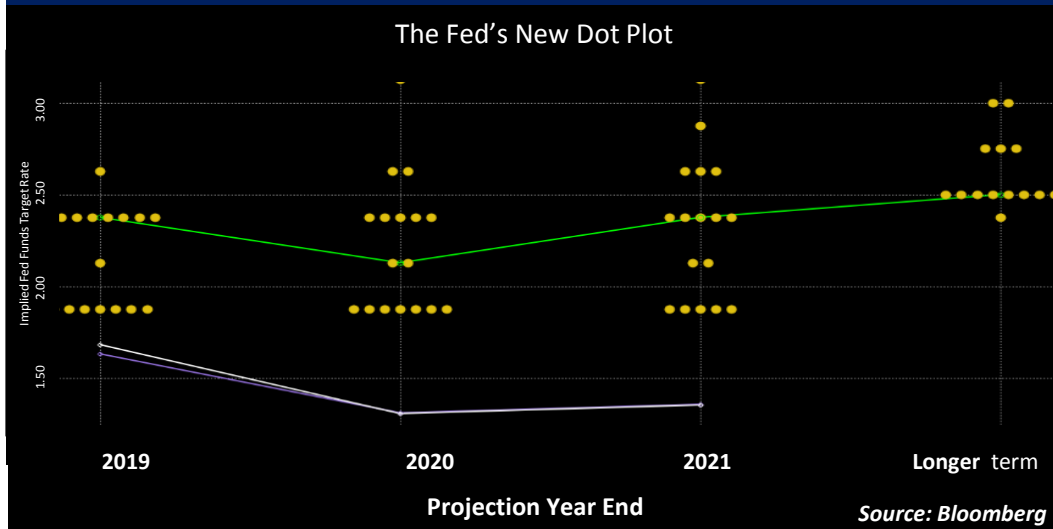
**Graph 5 : Notable appreciation in LKR against USD while steep depreciation in PKR and marginal appreciation in INR on a YTD basis**



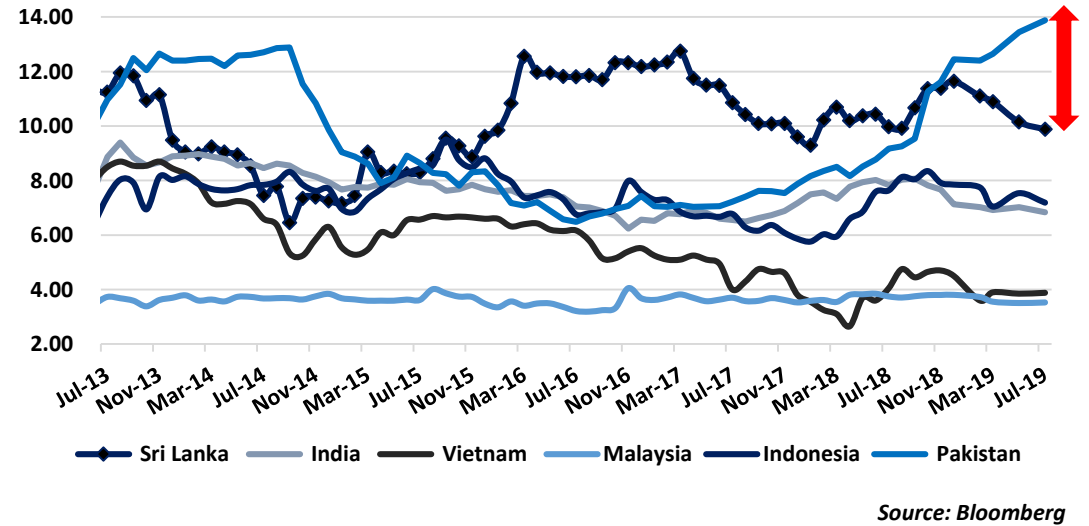
**Graph 6 : Real Effective Exchange Rate continued to be undervalued at 91.95 in May 2019 although it showed a slight increase (REER 2017=100)**



**Graph 7 : Fed reserve officials decided to keep rates unchanged at the meeting held in June 2019**



**Graph 8 : Comparative 5-year yields**



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