



First Capital

First Capital Research

# CBSL to stand pat on monetary policy amidst recent external vulnerabilities

---

PRE-POLICY ANALYSIS

16<sup>TH</sup> AUG 2019

**Analysts:** Hiruni Perera  
Dimantha Mathew

# Economic activity and credit growth show signs of improvement...but lending caps continue to remain a possibility

---

## Previous Pre-Policy issue; CBSL maintains policy rates at same level

- In line with our expectation, CBSL, decided to maintain policy rates at their current levels as they believed, private sector credit will pick up gradually towards the latter part of 2019 and also there is ample space for market lending rates to adjust downwards in response to the policy measures already taken to address the subpar economic growth which was affected by the Easter Sunday attacks.

## Activities in the economy improved although at a slower pace

- ❑ Despite the Easter Sunday attacks, Sri Lanka's economic outlook has shown signs of resilience and ability to recover as economic activities were seen returning to normalcy. As per the Purchasing Manager's Index, manufacturing activities expanded at a higher rate in June 2019, recording an index value of 53.9 which is an increase of 3.2 index points, compared to May 2019. This expansion in manufacturing PMI is mainly attributable to the recovery in Employment, especially, in manufacturing of food & beverages and textiles & wearing apparels sectors, from the lower employment availability experienced after the Easter Sunday attacks.
- ❑ Services sector recovered in June 2019 from its lowest level recorded in May 2019, which was mainly caused by the Easter Sunday attack. The recovery in Service activities is mainly attributable to expansion in New Businesses and Business Activity, and Expectations for Activity. Moreover, the industrial production of the manufacturing sector for the 2Q2019 increased by 0.6% to 103.4 relative to 102.8 in 2Q2018. Following four months of declining fortunes, the LMD-Nielsen Business Confidence Index, shored up by 19 basis points to register 81 in June as the country is gradually emerging from the events that occurred towards the end of April. However, in July it dropped to 74 and it remains below its 12-month (89) as well as all-time (127) averages as the country has already begun preparing for the presidential election due at the end of the year.

## Credit growth and lending slightly picked up in June

- ❑ SL's private sector credit picked up in June to LKR 63.2Bn the highest credit growth for the year after contracting the for two months in a row. In response to the measures taken previously, market deposit rates have declined although the transmission of recent easing of monetary conditions to market lending rates, including AWPR, is not yet complete. The high level of NPL in the system is expected to delay the downward adjustment in lending rates. However, in order to accelerate the reduction in lending rates, we expect CBSL to impose a cap on lending rates, thus supporting the revival of demand for credit by the private sector and the recovery in economic activity. These steps, in our view, are likely to get transmitted into lower lending rates in the banking system towards 4Q2019.

# Neutral Policy stance amidst external vulnerabilities while allowing the impact of previous rate cut to materialise...

## SL to raise USD500.0Mn via Samurai Bonds

- ❑ As per Governor of CBSL, the government will soon issue Request for Proposals to raise USD500.0Mn via Samurai bonds, which may boost reserves and enable finance debt repayments. The tender board must be first approved by the Cabinet and is expected take approximately 1-2 weeks to get through all the administrative procedures. With the foreign reserves at USD 8.3Bn as at July 2019, the raising of USD 500.0Mn is likely to support to maintain reserves around the USD 8.0Bn mark throughout the rest of 2019.

## Monetary easing continues to gain pace worldwide, but external vulnerabilities emerge in a Sri Lankan context

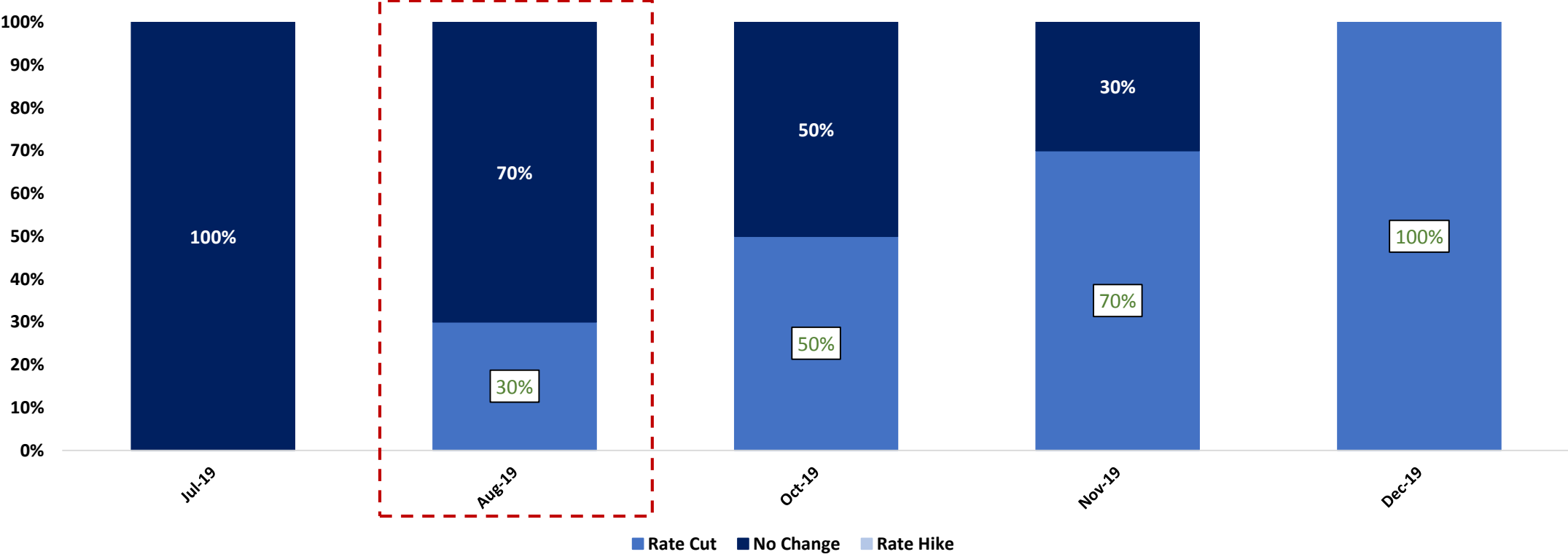
- ❑ On the external front, The Federal Reserve cut its rates for the first time since 2008 by 25bps ranging from 2.00% -2.25% to provide more support to the economy. We expect slower growth and rising risks will impel the Fed to cut rates further before the end of this year. The anticipation comes as Goldman Sachs just announcing that it reduced its GDP projections by 0.2% and Bank of America Merrill Lynch said it sees increasing chances of a recession in the next 12 months. As trade tensions escalate and economic indicators weaken, Wall Street is beginning to anticipate more aggressive interest rate cuts from the Federal Reserve. Following the US rate cut, India, Philippines, and New Zealand also cut their policy rates citing growth concerns. Central banks in a number of other countries including Malaysia, Russia, Ukraine, Nigeria, South Africa, Egypt, Brazil and Paraguay also lowered interest rates recently.
- ❑ Although, lower US rates and eased monetary conditions worldwide was expected to assist Sri Lanka in attracting more foreign inflows, heavy foreign outflows have occurred in the recent 2 weeks with dollar bonds and rupee bonds spiking across the yield curve. Global trade tensions and heightened political uncertainties due to the upcoming elections are expected to have influenced foreign investors to revert back to the safe haven of the US Dollar and other less risky asset classes. Thereby, the Rupee also has shown signs of weakness continuously depreciating over the last 4 weeks.

## Expectation

- ❑ With manufacturing and credit signaling signs of recovery in economy and the subsequently vulnerabilities affecting the external outlook of Sri Lanka, First Capital Research believes that CBSL may delay the monetary easing while also allowing the impact of previous rate cut to materialise. Accordingly, we assign a **higher probability of 70% for a neutral policy stance** at the upcoming policy meeting. Considering the slowness in the revival of economic growth, we would not rule out a possible lending rate cut though presently at a lower probability. Thereby, we maintain our Aug 2019 expectation of a 30% probability for a 25bps rate cut for the SLFR as mentioned in our previous report. However, we are more biased for a rate cut towards 4Q2019 as illustrated in Slide 4.

# FCR Policy Rate Forecast – Jul 2019 to Dec 2019

First Capital Research expects a 70% probability for continuation of current policy stance while allowing the impact of previous rate cut to be materialized and 30% probability for a rate cut amidst the slower economic growth.



Source: CBSL, First Capital Research Estimates

# Expected Monetary Policy Stance

First Capital Research expects a continuation of the rates while permitting the effect of the recent rate cut to materialise. However, we are of the view that policy intervention is required to address the protracted sluggishness in the economic activities thus we maintain the probability of a SLFR cut by 25bps to 30% in Aug 2019.

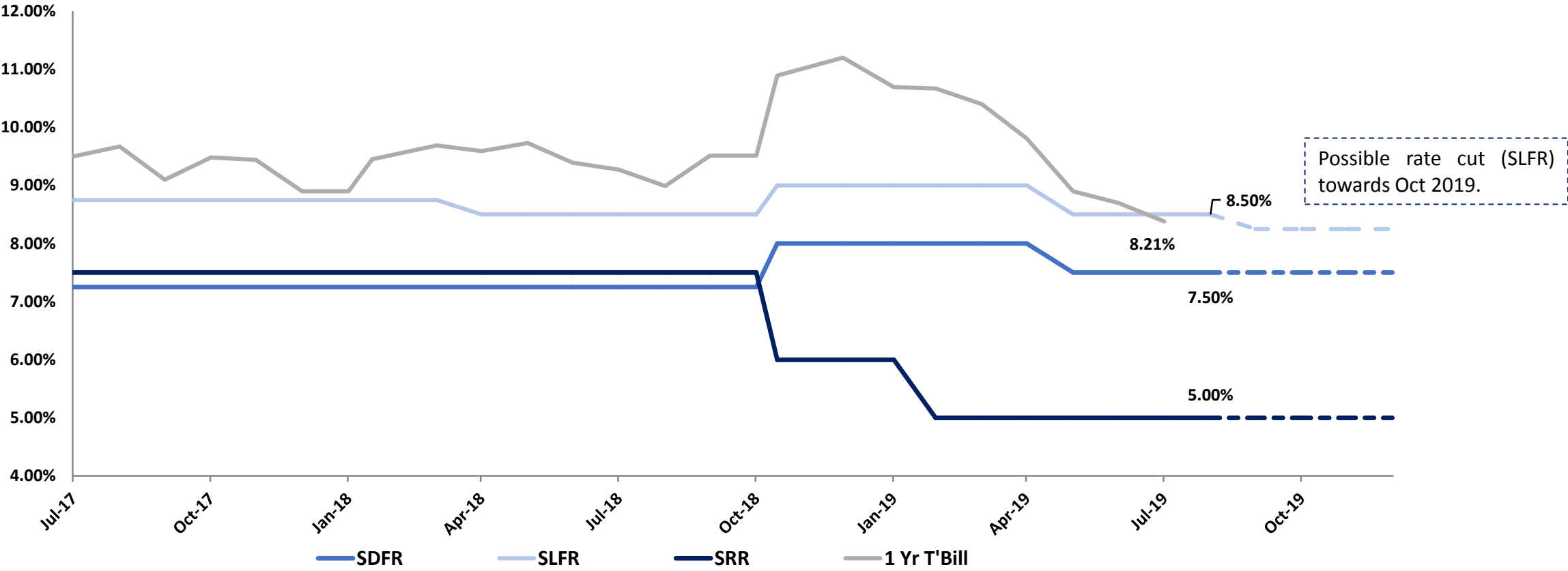
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
<b>Policy Rates to remain unchanged</b>	<b>70%</b>
<b>Cutting Policy Rates by 25bps</b>	<b>30%</b>
Cutting Policy Rates by 50bps	0%

Weightage for a rate cut maintained at 30% due to subdued economic growth conditions. However, higher weightage for no change is given due to recent external vulnerabilities

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

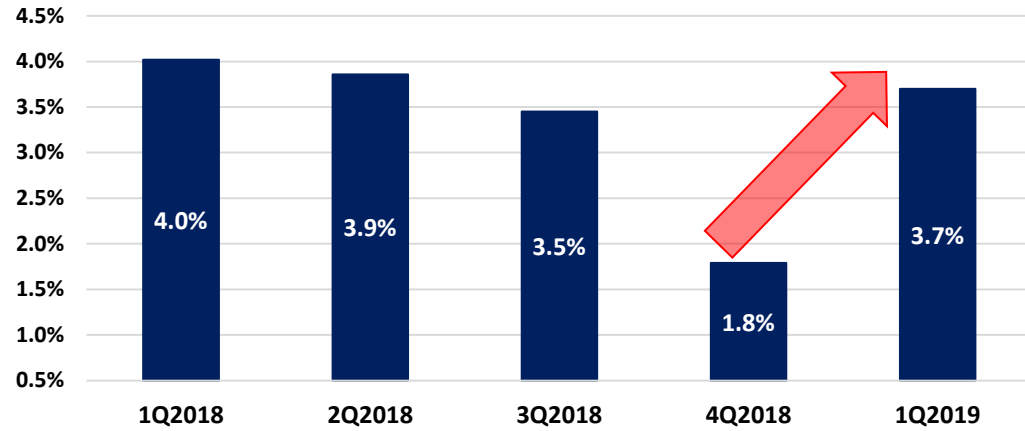
Increased to 100% due to increased external vulnerability and continued slowness in the system.

# Monetary Policy Rates



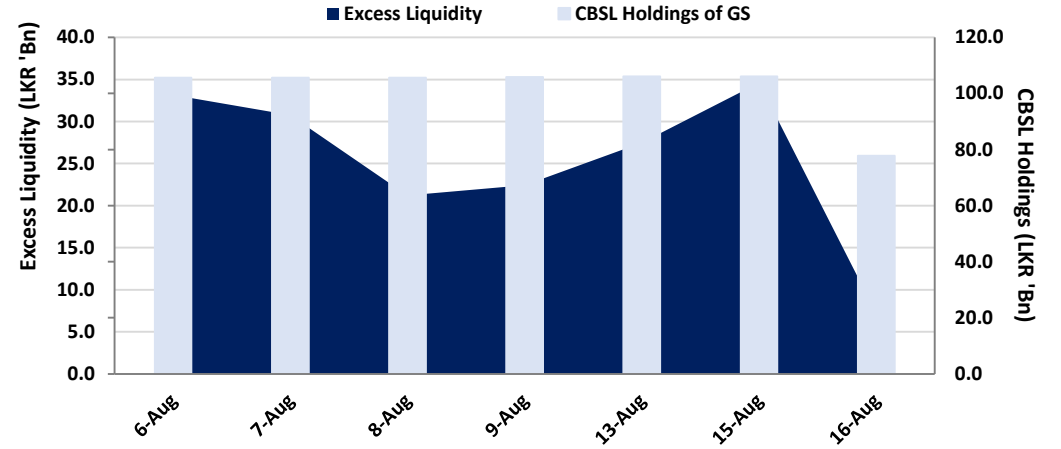
Source: CBSL, First Capital Research Estimates

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



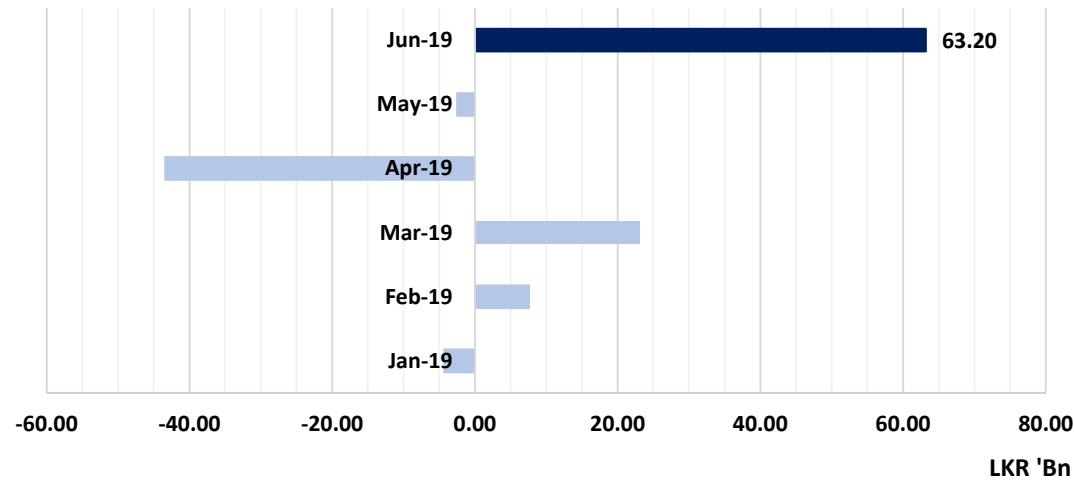
Source: CBSL

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



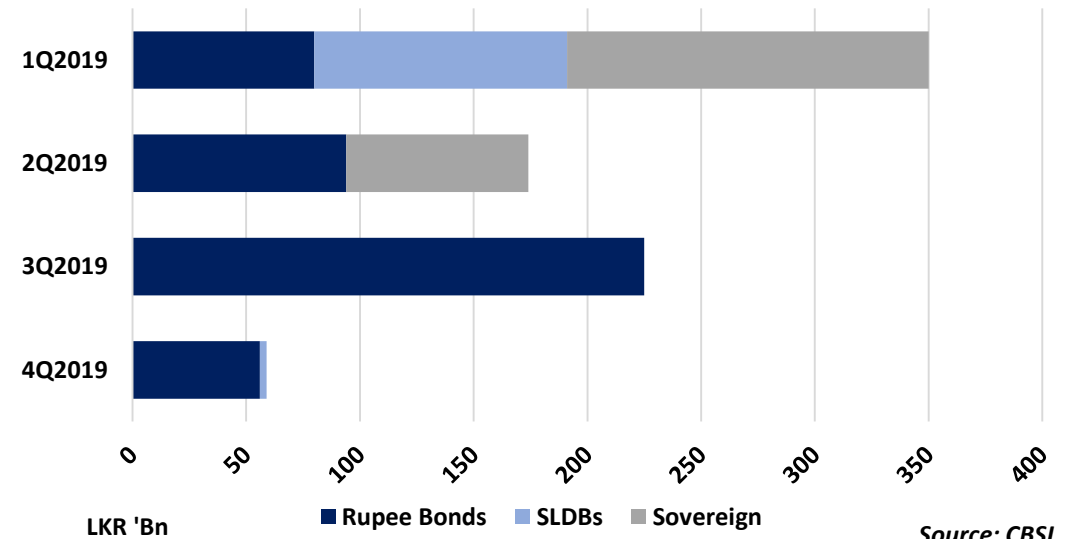
Source: CBSL

**Graph 3 : Private Sector Credit turned positive in Jun 2019 after two consecutive months of negative growth in credit**



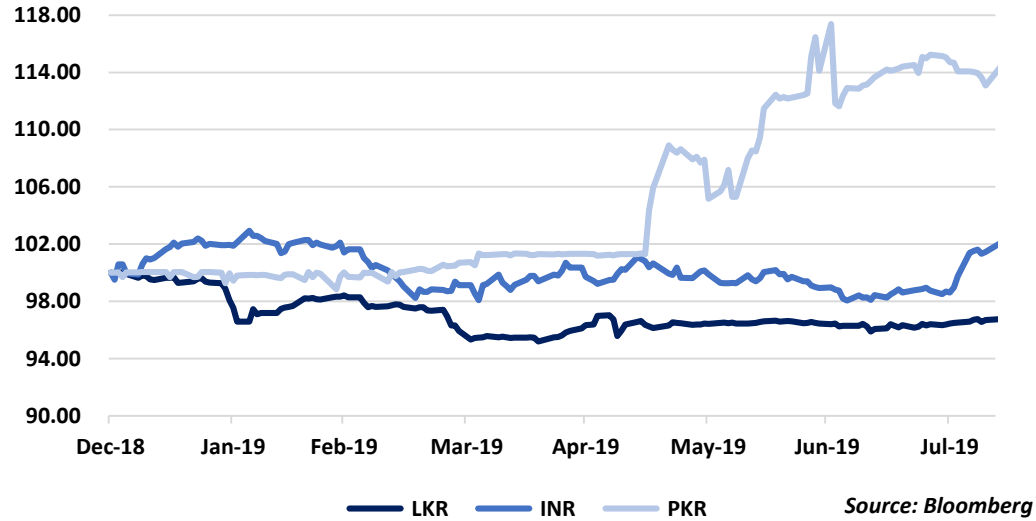
Source: CBSL

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

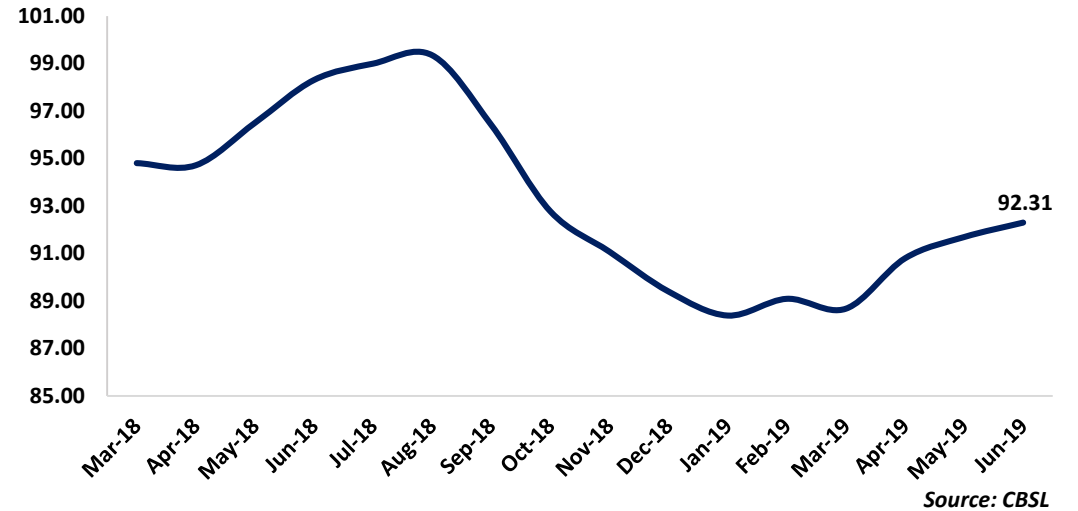


Source: CBSL

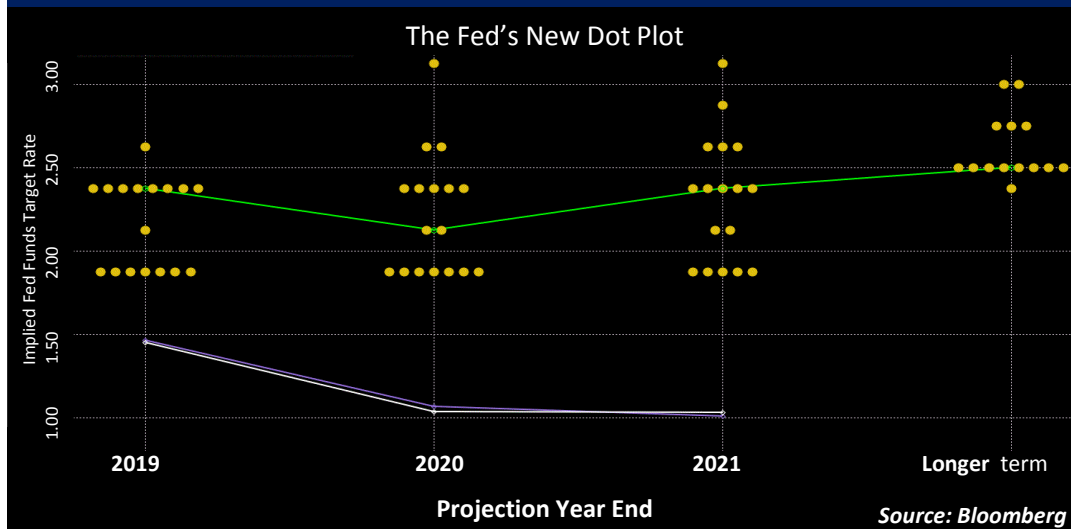
**Graph 5 : LKR remained mostly stable against USD while steep depreciation in PKR and marginal appreciation in INR on a YTD basis**



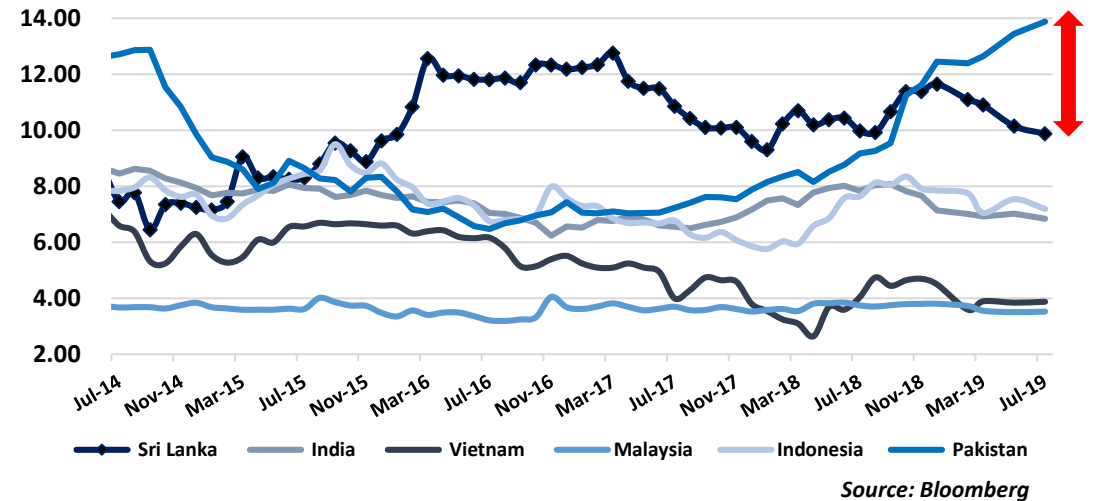
**Graph 6 : Real Effective Exchange Rate continued to be undervalued at 92.31 in Jun 2019 although it showed a slight increase (REER 2017=100)**



**Graph 7 : Fed reserve officials decided to cut rates at the meeting held in July 2019**



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





# Disclaimer

This Review is prepared and issued by First Capital Holdings PLC. based on information in the public domain, internally developed and other sources, believed to be correct. Although all reasonable care has been taken to ensure the contents of the review are accurate, First Capital Holdings PLC and/or its Directors, employees, are not responsible for the correctness, usefulness, reliability of same. First Capital Holdings PLC may act as a Broker in the investments which are the subject of this document or related investments and may have acted on or used the information contained in this document, or the research or analysis on which it is based, before its publication. First Capital Holdings PLC and/or its principal, their respective Directors, or Employees may also have a position or be otherwise interested in the investments referred to in this document. This is not an offer to sell or buy the investments referred to in this document. This Review may contain data which are inaccurate and unreliable. You hereby waive irrevocably any rights or remedies in law or equity you have or may have against First Capital Holdings PLC with respect to the Review and agree to indemnify and hold First Capital Holdings PLC and/or its principal, their respective directors and employees harmless to the fullest extent allowed by law regarding all matters related to your use of this Review. No part of this document may be reproduced, distributed or published in whole or in part by any means to any other person for any purpose without prior permission.

# CONTACT US

---



First Capital

Dimantha Mathew +94 11 2639 853

Hiruni Perera +94 11 2639 864

Atchuthan Srirangan +94 11 2639 863

Nisansala Kuruppumudali +94 11 2639 866

Amanda Lokugamage +94 11 2639 868