



First Capital

First Capital Research

Hefty Tax Cuts, Moratorium Trims **Rate Cut** **Probability to 50%**

PRE-POLICY ANALYSIS

23RD DEC 2019

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Hefty Tax Cuts, Moratorium Trims **Rate Cut Probability to 50%...**

Previous Pre-Policy report; CBSL maintains its policy rates

- In line with our expectations, CBSL maintained its policy rates in Nov 2019 at current levels immediately following the tax revisions with the belief that it would support higher economic growth in the short term. However, CBSL was of the view that greater clarity with regard to the medium-term fiscal path of the government is required to assess the impact on the economy over the medium term.

In our previous pre-policy published on 26th Nov 2019, we mentioned that the door is open for a further policy easing in Dec 2019. We are maintaining the same stance; however lowering the easing probability to 50% in Dec, considering the recent hefty tax benefits, moratorium to SMEs and relaxation of capital adequacy requirements declared by the government and CBSL. We believe that benefits given may partly compensate an expectation of a rate cut to address the prevailing sluggish economic growth.

Recently provided hefty tax cuts to substantially boost the consumer spending

- ❑ On 27th Nov 2019, Government announced hefty tax reliefs with the expectation of increasing the consumer spending while boosting the economic growth of the country. We expect measures such as reduction of VAT to 8% (from 15%), removal of NBT and revisions to PAYE tax to increase disposable income of consumers, thereby boosting consumer spending in the economy. However, government's ability to bridge the revenue loss due to the recent tax revisions will be a concern leading to a risk in 2020. The stimulus package may potentially lead to fiscal slippage, reducing the possibility of further monetary easing in the near term.

Moratorium on top of tax cuts; Capital Adequacy relaxation follows

- ❑ Three weeks after the hefty tax cuts, Finance Ministry on 20th Dec announced a moratorium on loans for SMEs for one year and an extension of the moratorium of the tourism industry till Dec 2020 which could be considered an additional support to boost the growth in the economy. CBSL has also taken measures to ease the capital adequacy requirement for banks on 20th Dec, which we believe is an added measure to relax constraints of the banks' capacity to lend.

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Fed pause the easing cycle while rating agencies signals a negative outlook for SL

- ❑ On the external front, Fed left rates unchanged and signaled it would stay on hold through 2020. The move illustrates an end to Fed's monetary easing cycle, but also suggests no change to policy rates through out 2020 which is a favourable stance for SL. However, Fitch's recent downgrade of SL's Long-Term Foreign-Currency rating outlook to 'Negative' from 'Stable', signal a potential credit rating downgrade in the future. SL government bond market witnessed an outflow of LKR 16.9Bn since 27th Nov resulting in foreign holding in government securities declining below 2.0%. Though policy easing in the current scenario enhances foreign outflows, the historical low level of foreign holding significantly reduces risk of further outflows.

Delay in Samurai bonds; a cause for concern

- ❑ Foreign reserves dipped to USD 7.5Bn in Nov 2019, (dipping from USD 7.8Bn in Oct) and continues to remain at comfortable levels. However, the present government has delayed the planned USD 500Mn Samurai bond creating some concern on the back of foreign project loan repayments.

Gradual pick in private credit, but economic growth remains sluggish

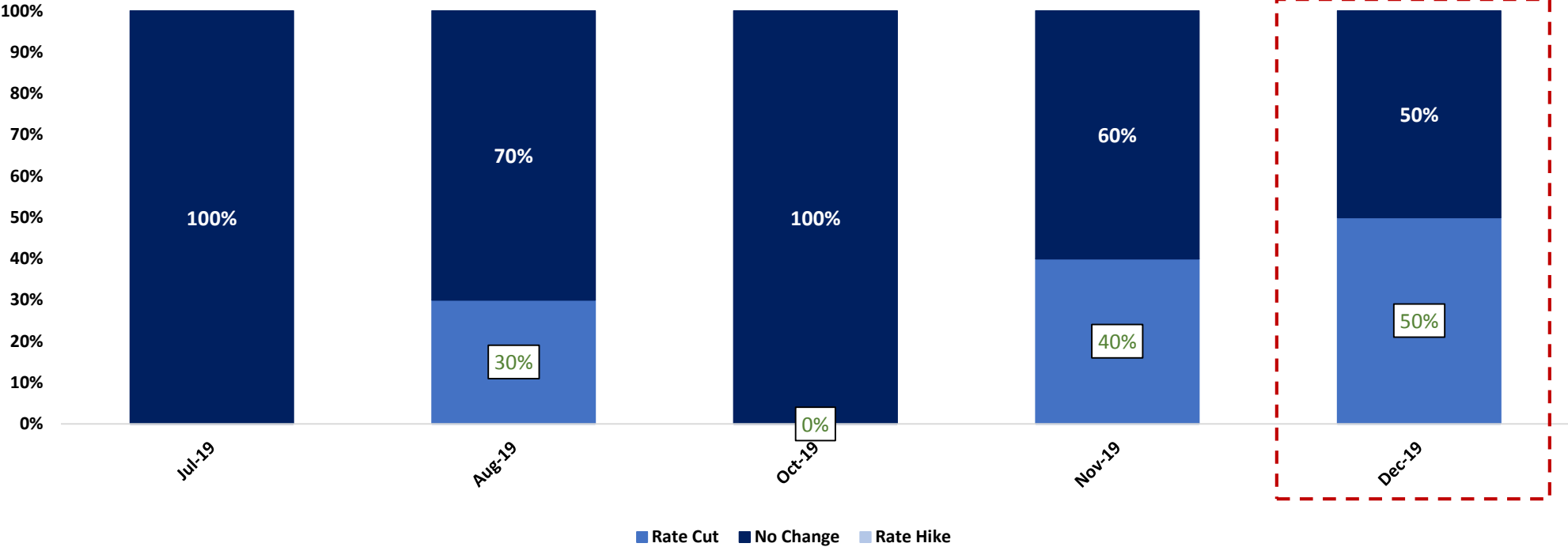
- ❑ Sri Lanka's economy grew by 2.7% in the 3Q2019, higher than our expectation of 2.2%, indicating a gradual recovery relative to 2Q2019 growth of 1.6%. Private sector credit growth recorded an increase of LKR 26Bn in Oct 2019, illustrating a positive credit growth for the 3rd consecutive month with Jan-Oct 2019 growth at 2.6%, closing in, on our credit growth target of 5% for 2019E. Despite the recovery in growth, credit and economic growth thus far remains below par, leaving room for possible aggressive action on monetary easing. Tax cuts moratorium on loans and easing of capital adequacy levels could be considered as part of the measures.

Expectation

Considering the recent major policy changes, First Capital Research trims down its **Rate Cut probability to 50%** from the previous Dec 2019 expectation of 100% probability, specifically due to the tax benefits, moratorium on loans and easing of capital adequacy to stimulate the consumer demand and revive growth in the economy. Foreign outflow is not considered a major concern considering the lower level of foreign holding in Gov. Sec market. However, we are of the view that 50% probability exists for a "No Change" in Monetary Policy as well due to the major benefits. We continue to maintain that SRR is likely to be maintained at the current level.

FCR Policy Rate Forecast–Dec 2019

Considering the recently provided tax revisions and other benefits, we are of the view that continuation of policy rates is appropriate at the current scenario. However, we also assign a 50% probability for a rate cut in Dec 2019 with the urgency to improve the lending and the economic growth.



Source: First Capital Research Estimates

Expected Monetary Policy Stance

First Capital Research assigns a 50% probability for a rate cut with the urgency to improve the economic growth. We also assign a 50% probability for no change in policy rates amidst recently provided tax revisions and other benefits.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	50%
Cutting Policy Rates by 25bps	15%
Cutting Policy Rates by 50bps	35%

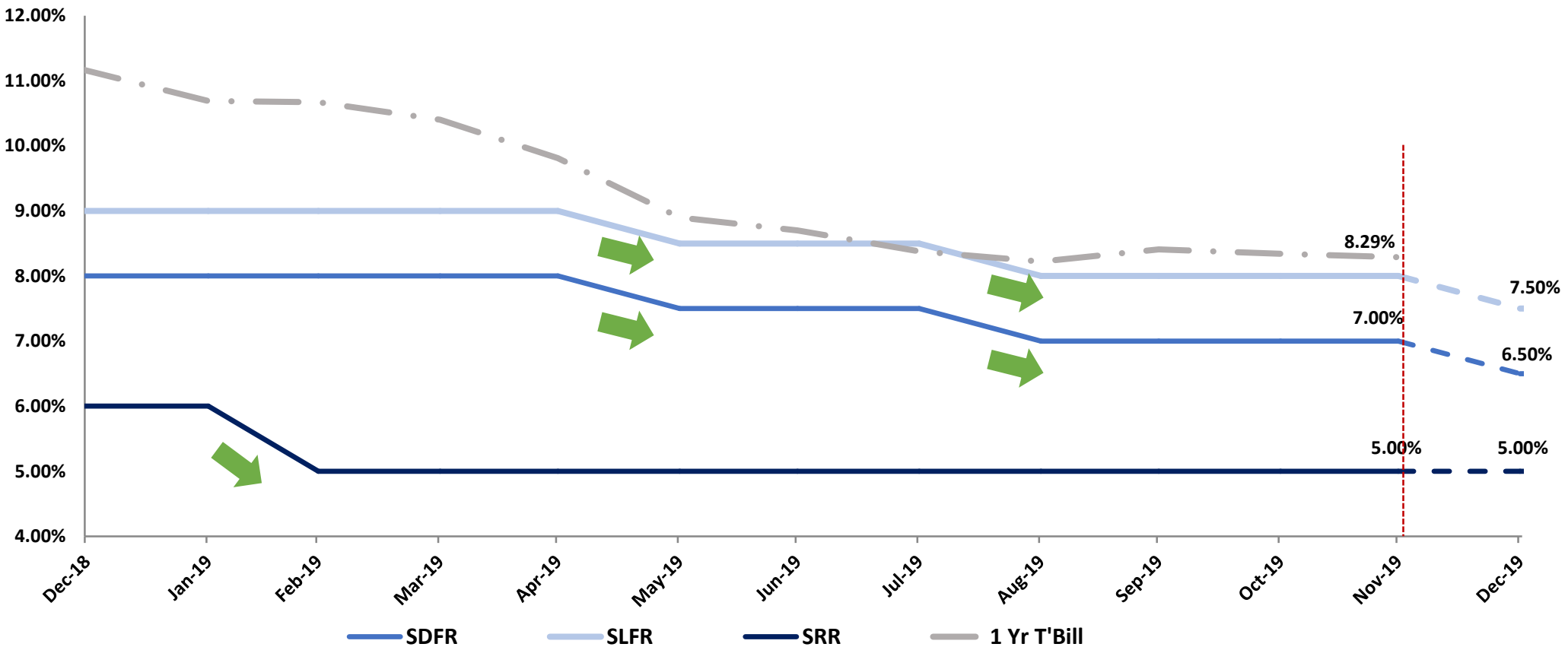
Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	0%
SRR to remain unchanged	100%
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

50%

Probability for a rate cut decreased to 50% while probability for no change in rates increased to 50%

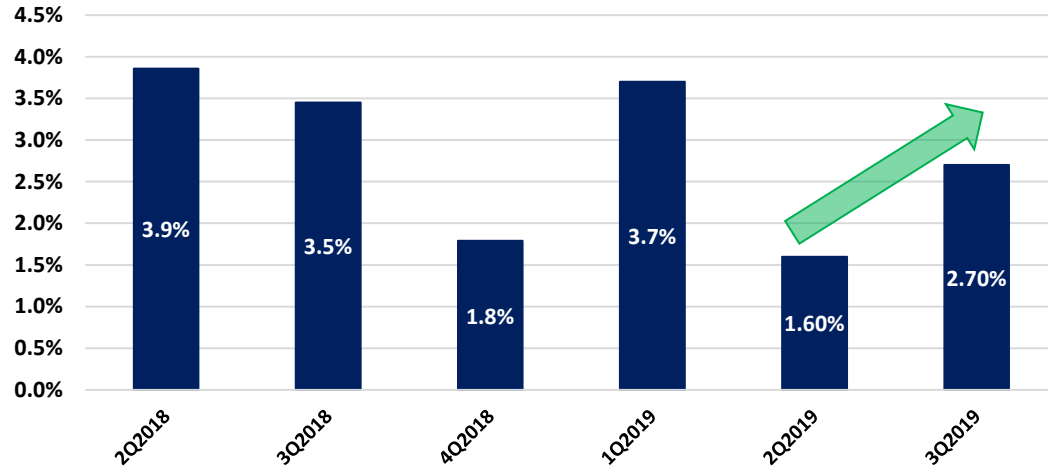
Maintained at 100% due to increased external vulnerability and continued slowness in the system.

Monetary Policy Rates



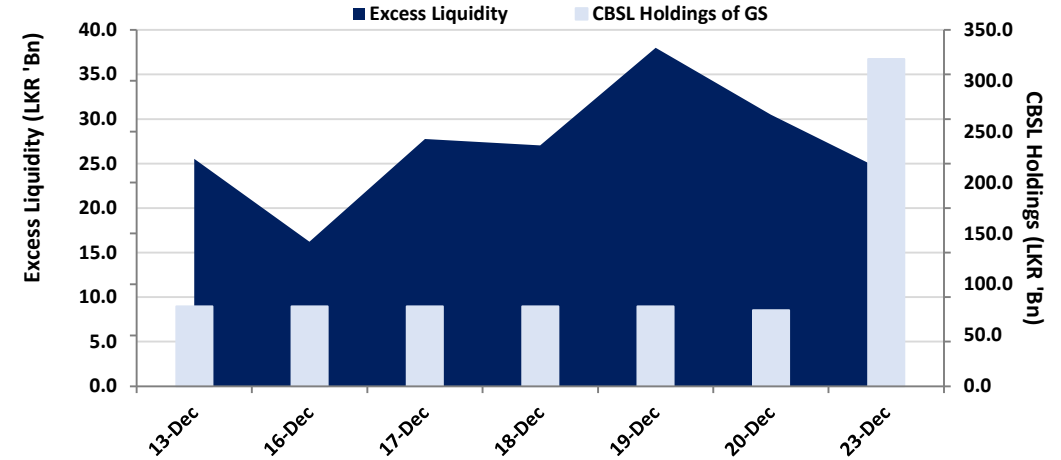
Source: CBSL, First Capital Research Estimates

Graph 1 : GDP growth showed a gradual recovery recording 2.7% relative to 2Q2019 GDP growth of 1.6% as a result of the Easter Sunday attacks



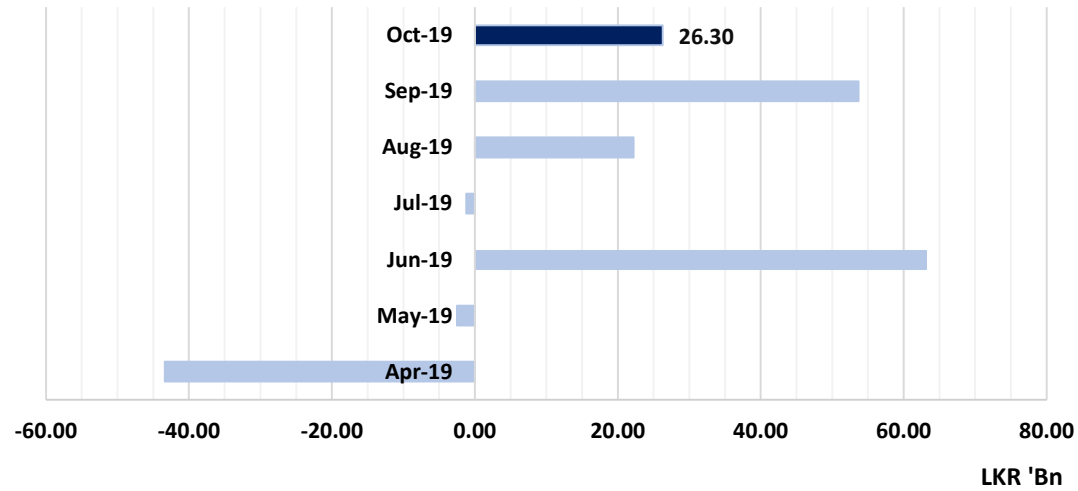
Source: Census & Statistics

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



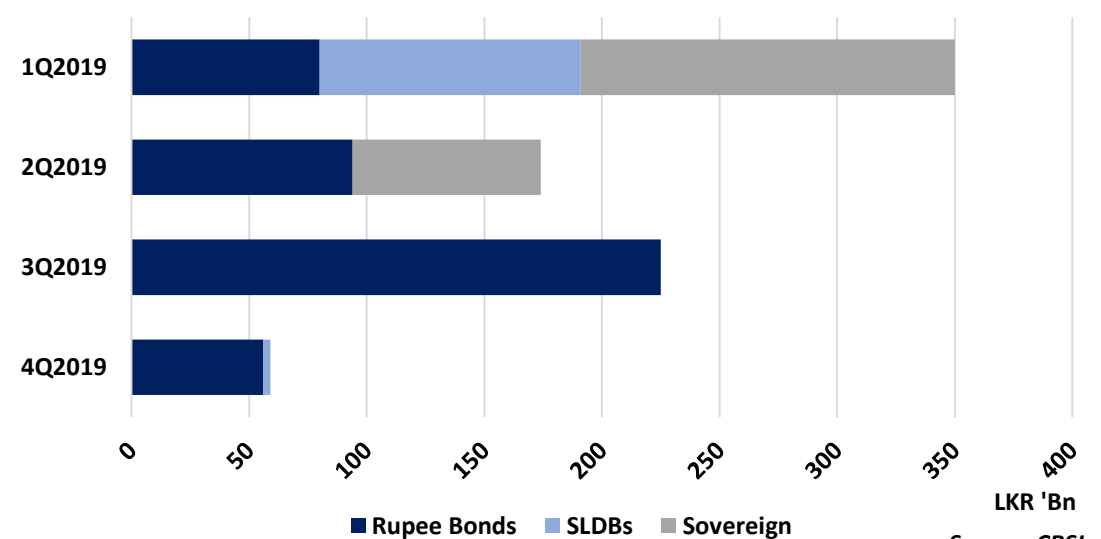
Source: CBSL

Graph 3 : Private Credit recorded a positive figure in Oct 19 for the third consecutive month recording a YTD growth of 2.6%



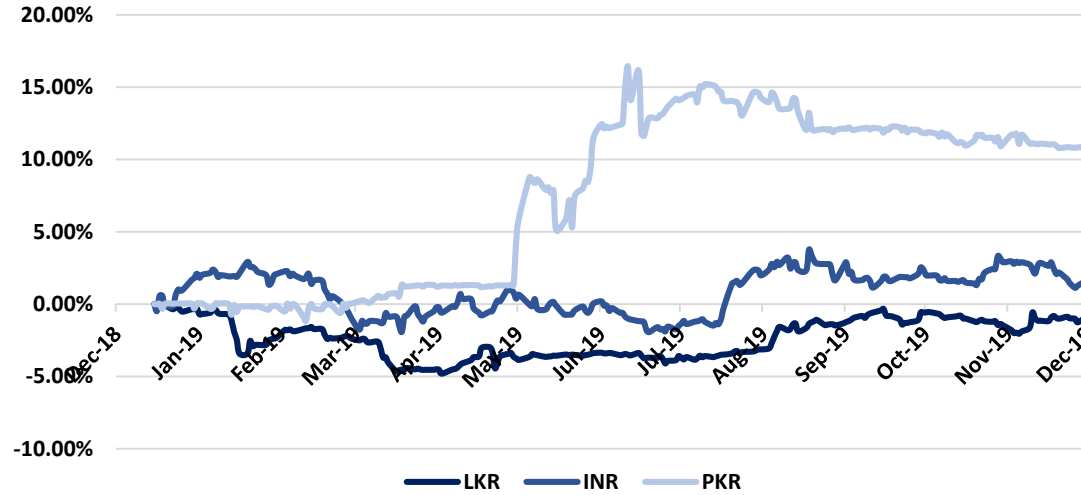
Source: CBSL

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



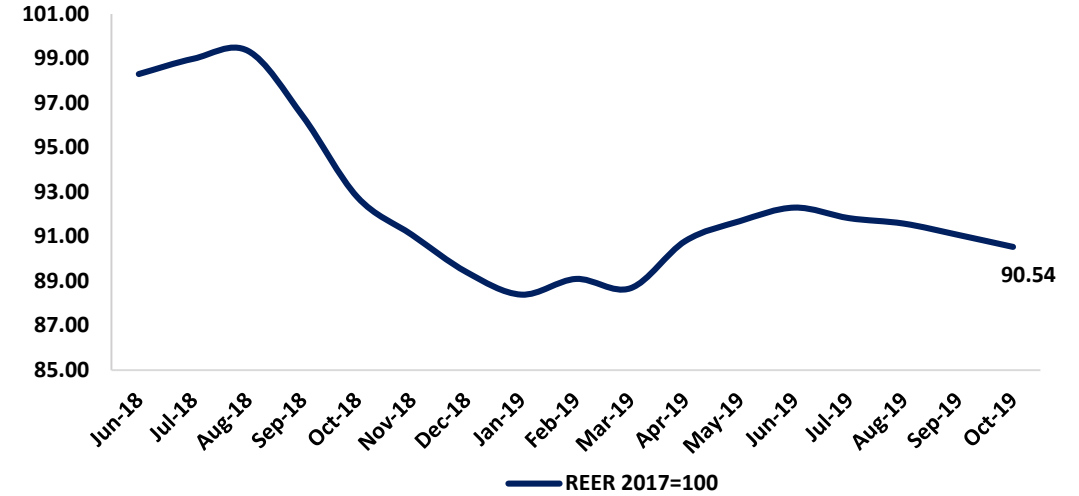
Source: CBSL

Graph 5 : LKR remained mostly stable compared to other currencies against USD while steep depreciation in PKR in YTD basis was witnessed



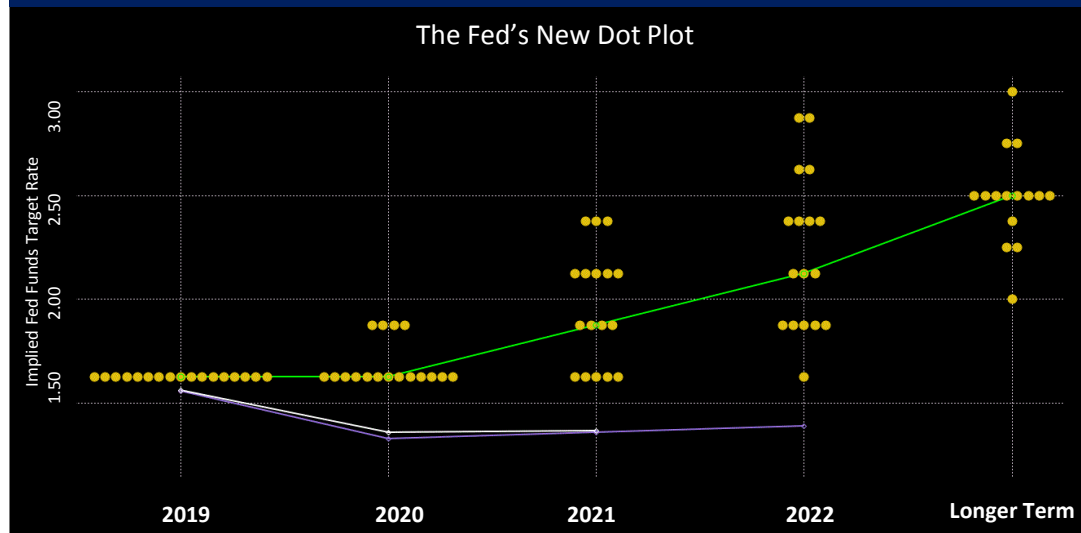
Source: Bloomberg

Graph 6 : Real Effective Exchange Rate continued to be undervalued at 90.54 in Oct 2019



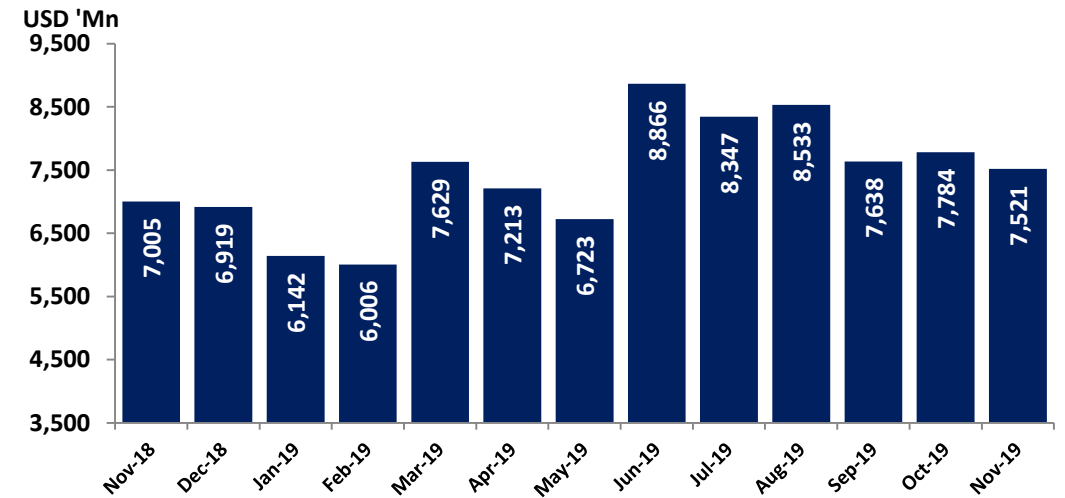
Source: CBSL

Graph 7 : Fed reserve officials held rates steady at the meeting held in Dec 2019



Source: Bloomberg

Graph 8 : Foreign Reserves slightly declined to USD 7.5Bn in Nov 2019 from USD 7.8Bn in Oct 2019



Source: CBSL

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