



First Capital

First Capital Research

Policy Rates to be steady allowing previous monetary actions to cushion the economy

PRE-POLICY ANALYSIS

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Policy Rates to be steady allowing previous monetary actions to cushion the economy

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

- In contrast to our expectations, at the last policy meeting held in Jan 2020, CBSL reduced its policy rates by 50bps to support the continued reduction in market lending rates, thereby facilitating the envisaged recovery in economic activity.

Private sector credit to further pick up with the current low interest rate environment

- ❑ Private sector credit recorded an increase of LKR 57.9Bn in Dec 2019, illustrating a positive credit growth for the 5th consecutive month in 2019 with YTD growth at 4.5%, closing in, on our credit growth target for 2019. Going forward, a steady revival of economic activity is envisaged, supported by potentially further improved political stability after the General Election on 25th Apr 2020 and the measures taken to stimulate the economy such as heavy tax cuts and lending caps. With the decline in lending rates, credit growth has shown signs of improvement; however the acceleration is mostly likely to take place towards 2H2020.

Liquidity levels to remain positive at a manageable level

- ❑ Market saw a sudden surge in the liquidity levels over the last couple of weeks amounting to LKR LKR 48.0Bn by end of Feb (after adjusting for term repo and reverse repo auctions conducted by CBSL) compared to LKR negative 8.0Bn in the beginning of the year indicating an increase of nearly LKR 56.0Bn. The higher liquidity position favour the banking system to accelerate disbursements thus supporting the credit growth in the economy. Improving YoY credit growth may reduce the strong liquidity position towards 2H2020.

Previous rate cut accelerated the foreign outflows from the Govt. Sec market

- ❑ Since the previous rate cut, continued net foreign outflows from the Govt. sec market was witnessed resulting in an outflow of LKR 16.7Bn since 30th Jan 2020. In recent developments, foreign holding in T-Bill and T-Bonds securities declined below LKR 100.0Bn for the first time in 12 years (since 2008) due to continued foreign selling followed by the surprise rate cut in Jan 2020. With the foreign outflows, LKR witnessed a depreciation during the month to close at LKR 181.95 relative to LKR 181.34 held on 31st Jan 2020 although the depreciation in the currency was not higher due to the lesser pressure on BoP due to relatively lower imports.

Policy Rates to be steady allowing previous monetary actions to cushion the economy

Inflation accelerated to 6.2% exceeding CBSL's desired medium target of 4%-6%

- ❑ The 6.2% CCPI recorded in Feb 2020, is the highest since the 7.1% seen in Dec 2017 and was mainly led by the increase in food inflation owing to domestic supply side disruptions. In spite of such short-term fluctuations, we believe inflation to hover and stabilise between 5%-6% in 2020 assisted by recovery in supply side factors thus requiring no changes in the monetary policy measures.

A possible monetary easing in U.S to adversely impact the emerging and frontier regional markets

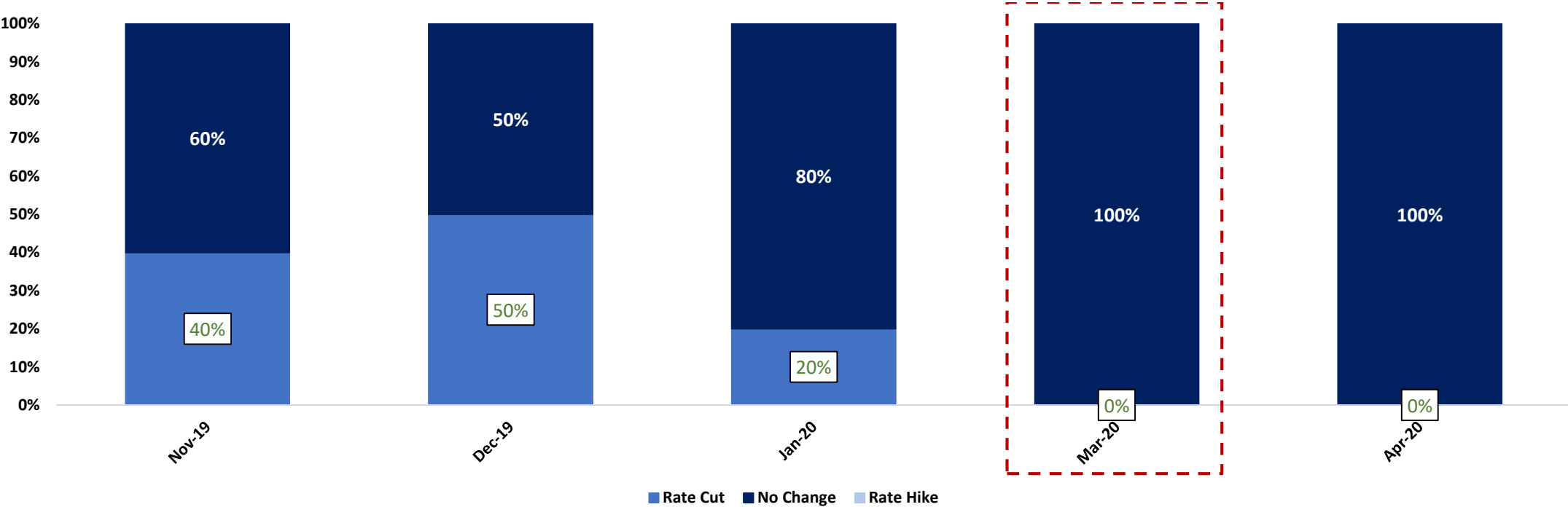
- ❑ In light of subdued global growth due to outbreak of Covid-19 and considering its impact to the economy, the Fed Reserve indicated that U.S is open for a rate cut to act as appropriate to support the economy while analysts predict that Fed is likely to announce a 50bps cut at its Mar 2020 meeting with fears over a global slowdown intensifying. With another round of monetary easing on the cards, global funds are shifting towards U.S adversely impacting emerging and frontier regional markets including SL.

Expectation -Policy rates to be maintained as additional time is required to realise the impact of previous rate cuts

Considering the recent major Fiscal and Monetary policy changes and expected pick up in private credit, First Capital Research believes that current monetary policy stance is appropriate, and credit growth is likely to accelerate towards 2H2020 with the current low level of market lending rates without requiring further adjustment in policy rates. Accordingly, we assign a 100% probability for no change in policy rates in the upcoming policy announcement.

FCR Policy Rate Forecast–Mar 2020-Apr 2020

Considering the recently provided policy rate cut, tax revisions and other benefits along with the gradual recovery of the credit, we are of the view that continuation of policy rates is appropriate at the current scenario. Accordingly, we assign a 100% probability for continuation of the current policy stance.




Source: First Capital Research Estimates

Expected Monetary Policy Stance

First Capital Research assigns a 100% probability for no change in rates while allowing the impact of previous rate cut to materialise.

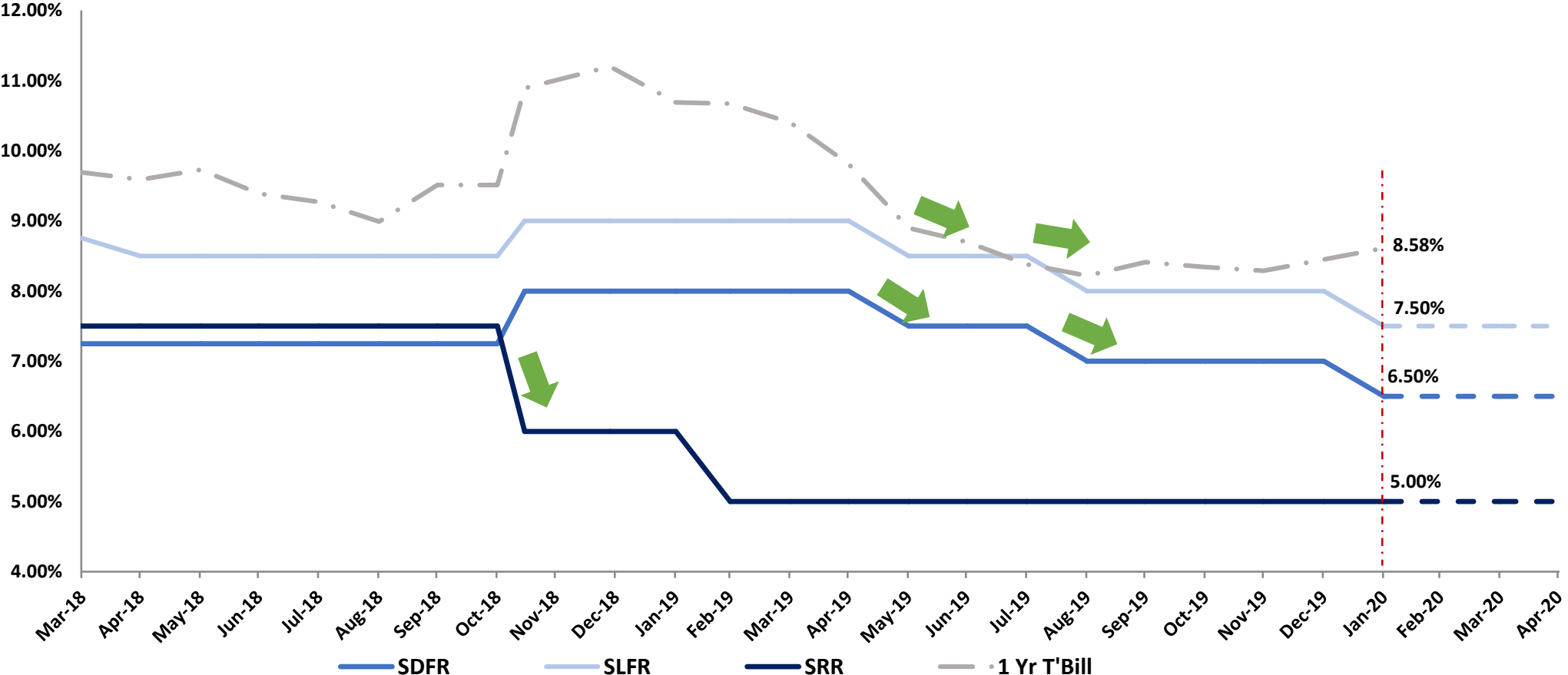
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	100%
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

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%



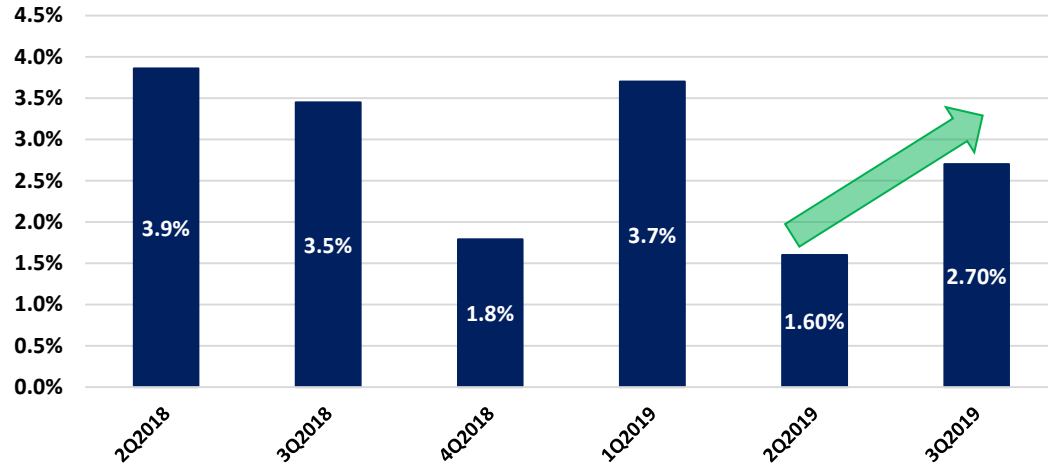
Probability for a rate cut decreased to 0% while probability for no change in rates increased to 100%

Monetary Policy Rates



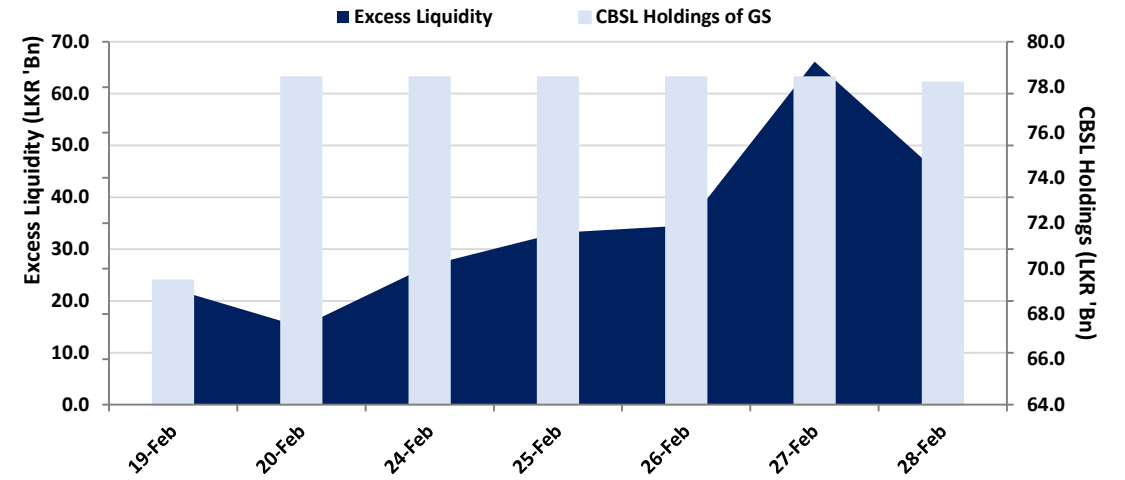
Source: CBSL, First Capital Research Estimates

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



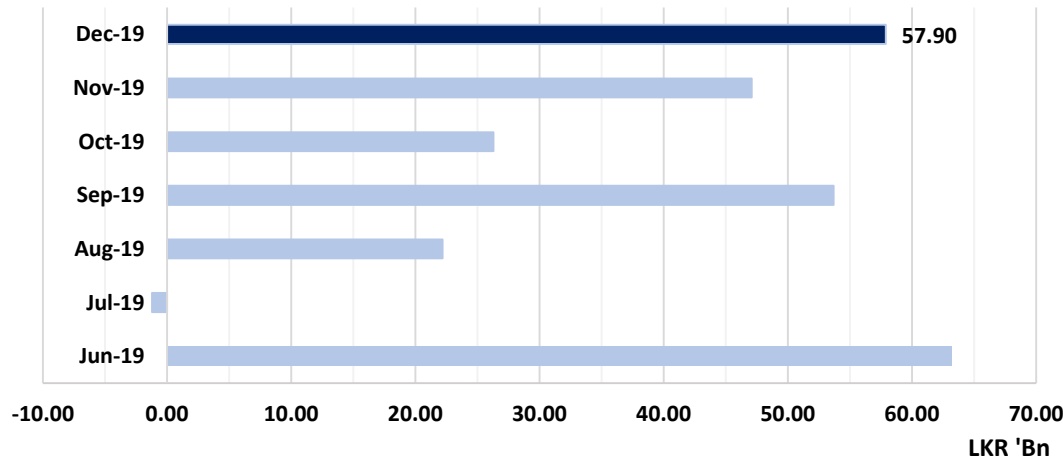
Source: Census & Statistics

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



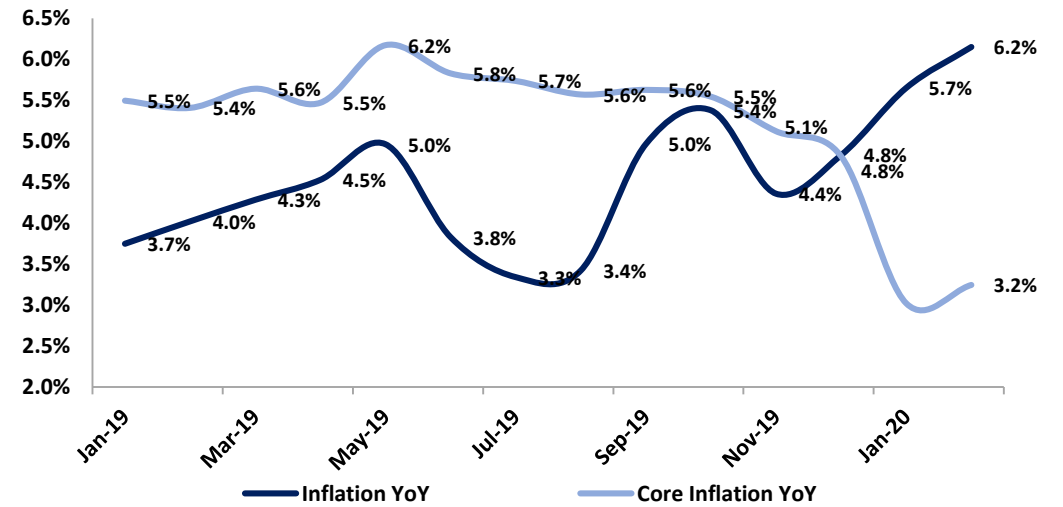
Source: CBSL

Graph 3 : Private Credit continued to remain positive and recorded a YoY and YTD growth of 4.5%



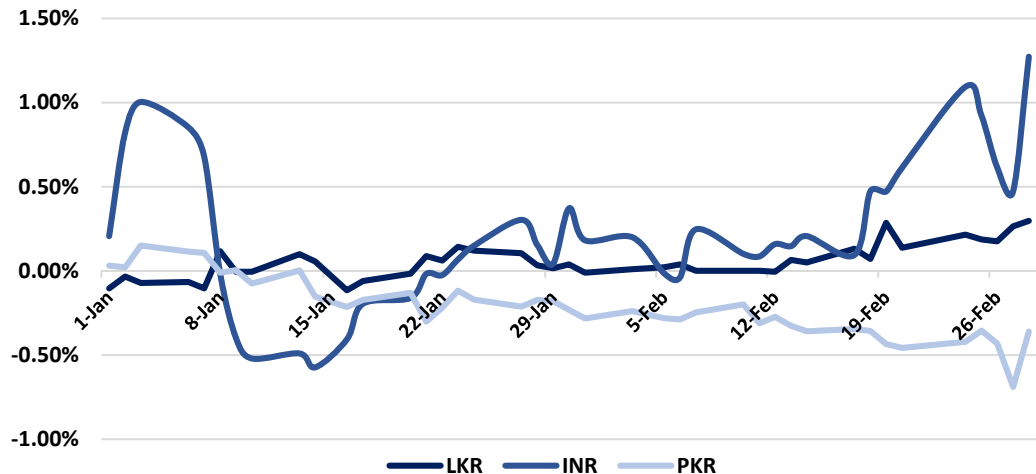
Source: CBSL

Graph 4 : Inflation as measured by CCPI increased to 6.2% in Feb 2020 from 5.7% reported in Jan



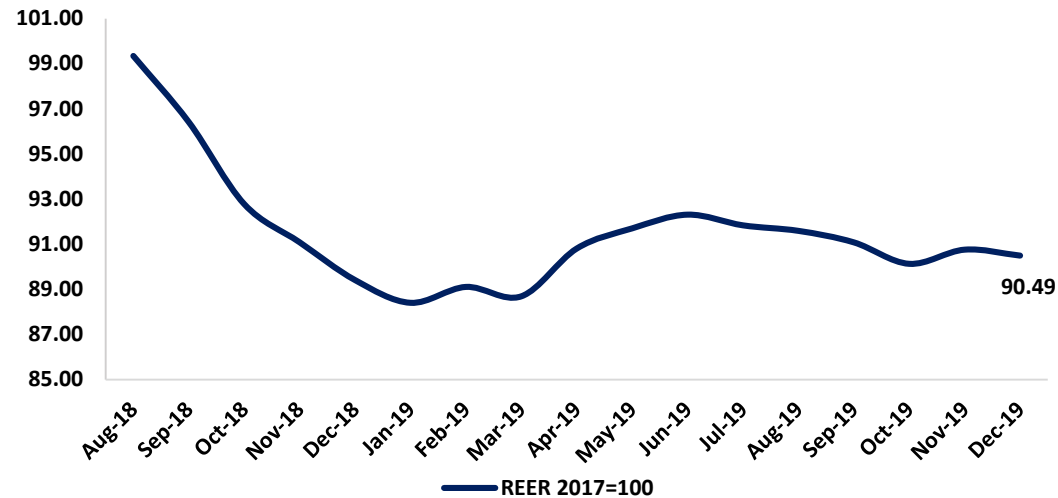
Source: Dept. Census and Statistics

Graph 5 : LKR remained mostly stable against USD while steep depreciation was witnessed in INR during the month



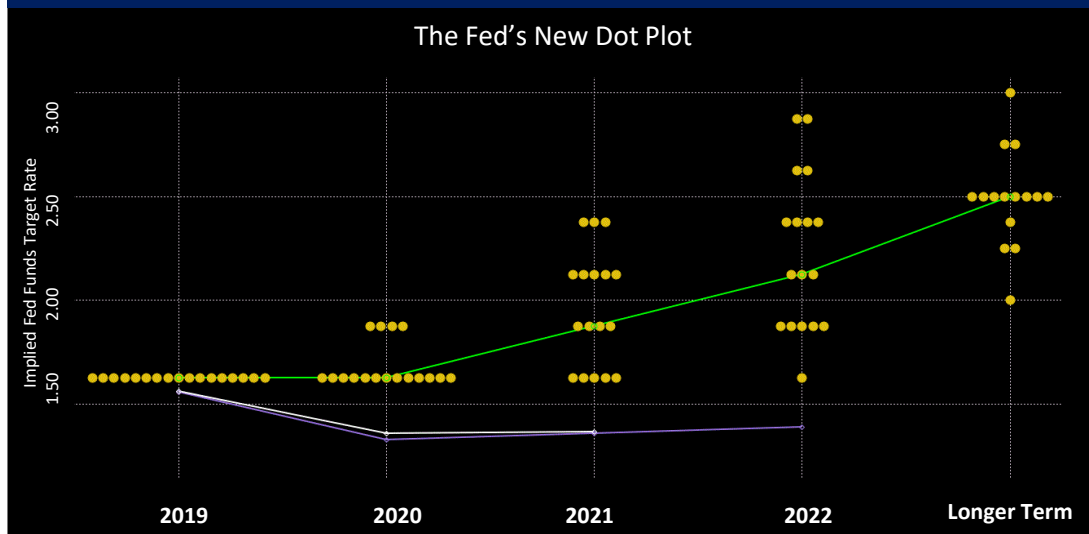
Source: Bloomberg

Graph 6 : Real Effective Exchange Rate continued to be undervalued at 90.49 in Dec 2019 and showed a slight decrease relative to Nov 2019



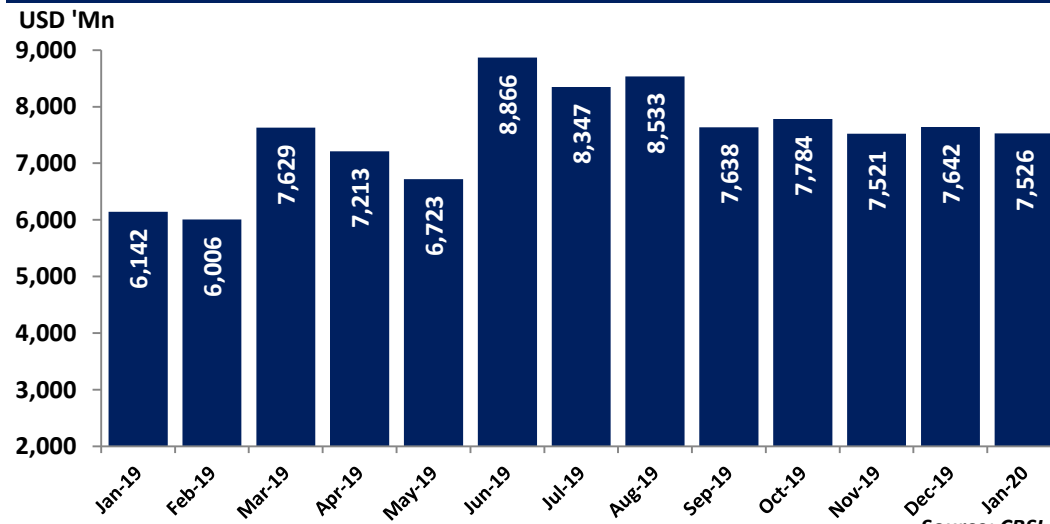
Source: CBSL

Graph 7 : Fed reserve officials held rates steady at the meeting held in Jan 2020



Source: Bloomberg

Graph 8 : Foreign Reserves slightly declined to USD 7.5Bn in Jan 2020 from USD 7.6Bn in Dec 2019



Source: CBSL

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