



First Capital

First Capital Research

Previous rate cuts portends no further policy actions for 2019

PRE-POLICY ANALYSIS

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Previous rate cut portends no further policy actions for 2019...

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

- Contrary to our expectation, CBSL, decided to reduce SDFR and SLFR by 50bps each to 7.00% and 8.00% respectively, one policy meeting ahead of our forecast, with the aim of boosting credit flows to productive sectors and in turn to assist the revival of the economy.

CBSL undertook a number of measures to improve the growth of the economy

- ❑ GDP growth for the 2Q2019 recorded at 1.6% significantly lower compared to 3.9% recorded in 2Q2018. In order to address the overly sluggish credit growth, over the past 11 months, CBSL undertook a number of monetary policy and regulatory measures to induce a reduction in market lending rates and thereby boost the GDP growth of the country. Accordingly, CBSL reduced its policy rates by 50bps each in May and Aug and also reduced the SRR applicable on rupee deposit liabilities of Licensed Commercial Banks by 2.50% in order to improve the liquidity in the financial market. These measures were expected to stimulate the demand for credit while improving GDP growth of the country.

Imposition of lending caps to further enhance the credit flows

- ❑ The growth of credit extended to the private sector has increased marginally by 1.16% since the beginning of this year, remaining far below the levels observed in the corresponding period of 2018, while NPLs have grown due to various factors. CBSL is of the view that, excessively high nominal and real lending rates are a key reason for slowing credit expansion and rising NPAs. Moreover, SL's real lending rates are found to be unacceptably high compared to its peer economies. Accordingly, the Monetary Board decided to order the Licensed Banks to reduce interest rates applicable on all rupee denominated loans and advances by at least 200bps by 15th Oct 2019, in comparison to the interest rates applicable as at 30th Apr 2019. Moreover, in the case of credit card advances, the maximum interest rate applicable has been reduced to 28% per annum. These measure are expected to lower market lending rates by banks, thereby boosting credit flows to productive sectors. This, along with improved repayment capacity of borrowers at lower interest rates, was expected to strengthen licensed banks, by addressing the challenge of rising NPLs.

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Raising USD500.0Mn via Samurai Bonds to add more cushion to foreign reserves

- ❑ The Government appointed a bid manager to raise USD500.0Mn via Samurai bonds while the issuance will take place in Oct or Nov ahead of the presidential election. We expect at present foreign reserves (USD 8.5Bn as at 30th Aug) are at a comfortable stage with sufficient foreign repayment cover suggesting the lower foreign currency requirement. The new Samurai Bond issue is expected to add a further cushion to foreign reserves.

Sri Lanka to hold its election in November while creating an uncertainty during that period

- ❑ CBSL is extremely unlikely to change its key monetary policy rates amidst the uncertainty hovering with the presidential election around the corner. The reduction of policy rates in Aug which was way in advance also supported this view.

Rupee depreciated slightly by 1% amidst foreign outflows amounting to LKR 13.8Bn since the previous rate cut

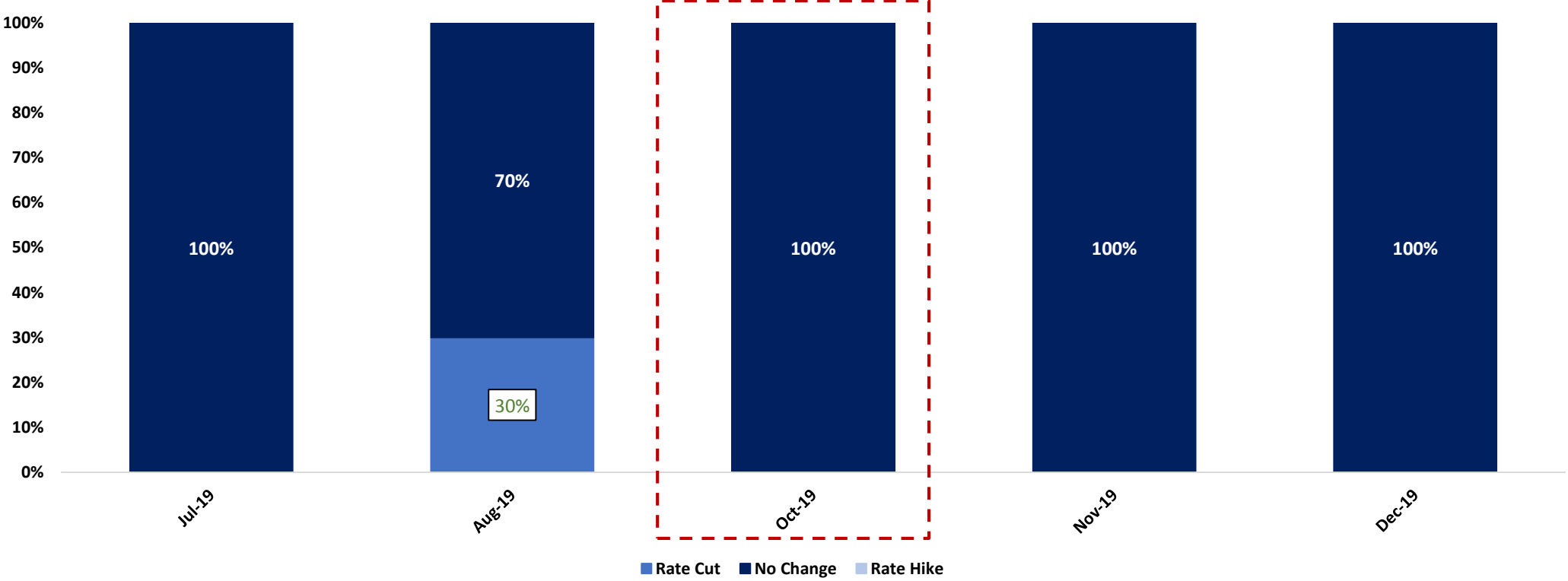
- ❑ Since the previous rate cut in Aug 23rd, Rupee depreciated by 1% amidst the foreign outflows amounted to LKR 13.8Bn which resulted in foreign holdings in Government Securities declining below 2%, lowest in recent times.

Expectation

Considering the previous 50bps rate cuts each in May and Aug and imposition of lending caps, First Capital Research believes that **policy change is not required for the year 2019** while allowing the impact of previous policy decisions to materialise. Accordingly, we expect Monetary Board to hold rates for the rest of the year 2019.

FCR Policy Rate Forecast – Oct 2019 to Dec 2019

First Capital Research expects a 100% probability for continuation of current policy stance while allowing the impact of previous rate cut and imposition of lending caps to be materialised.



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. Furthermore, we are of the view that any further rate cut would increase foreign outflows from the country while a rate hike would hamper the GDP growth.

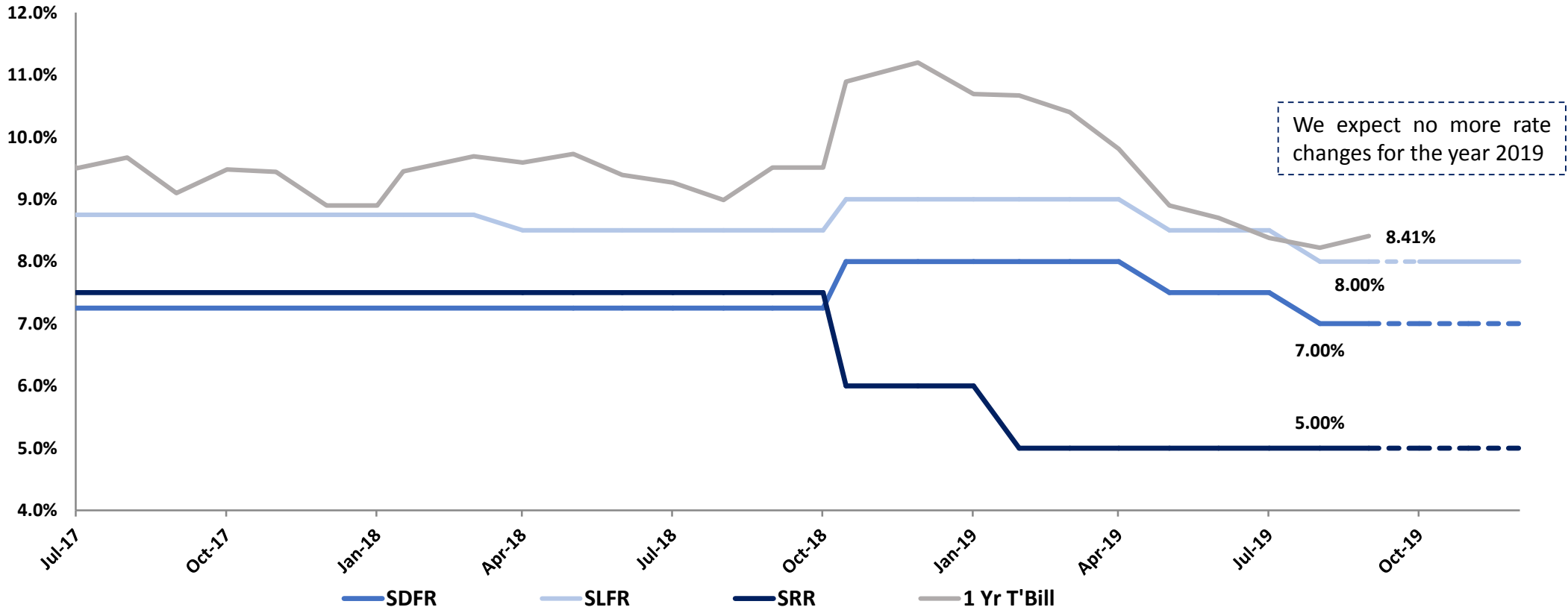
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	100%
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

Weightage for stable policy rates increased to 100% due to the previous rate cut announced by CBSL.

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%

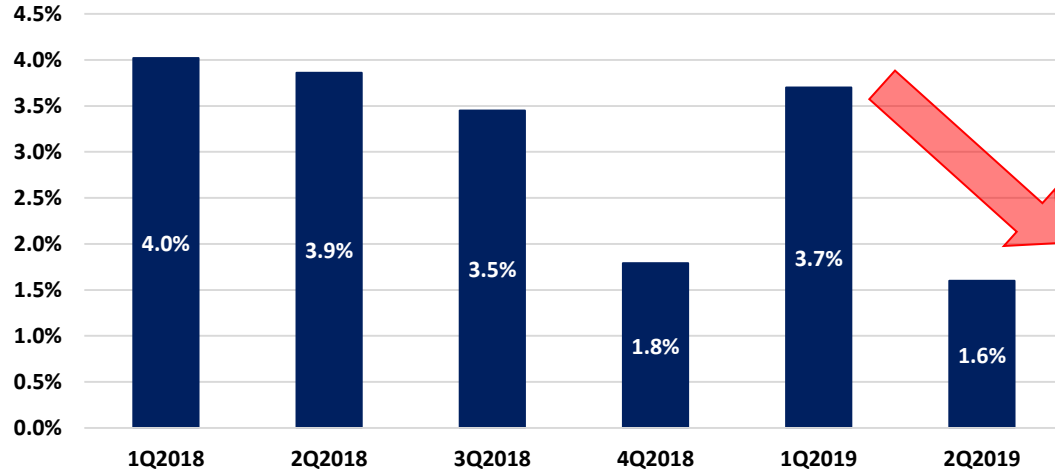
Maintained at 100% due to increased external vulnerability and continued slowness in the system.

Monetary Policy Rates



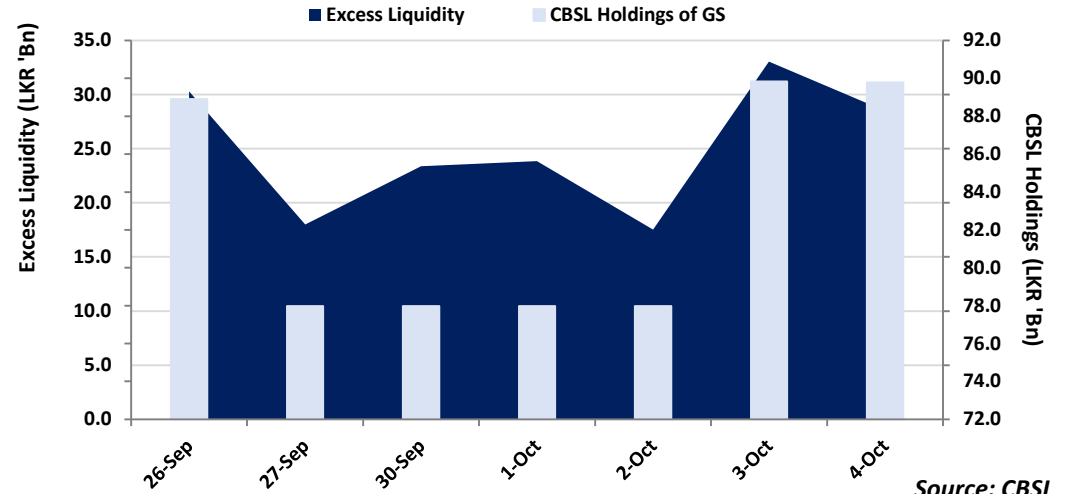
Source: CBSL, First Capital Research Estimates

Graph 1 : GDP growth declined in 2Q2019 to 1.6% as a result of the Easter Sunday attacks although it was higher than our expectation



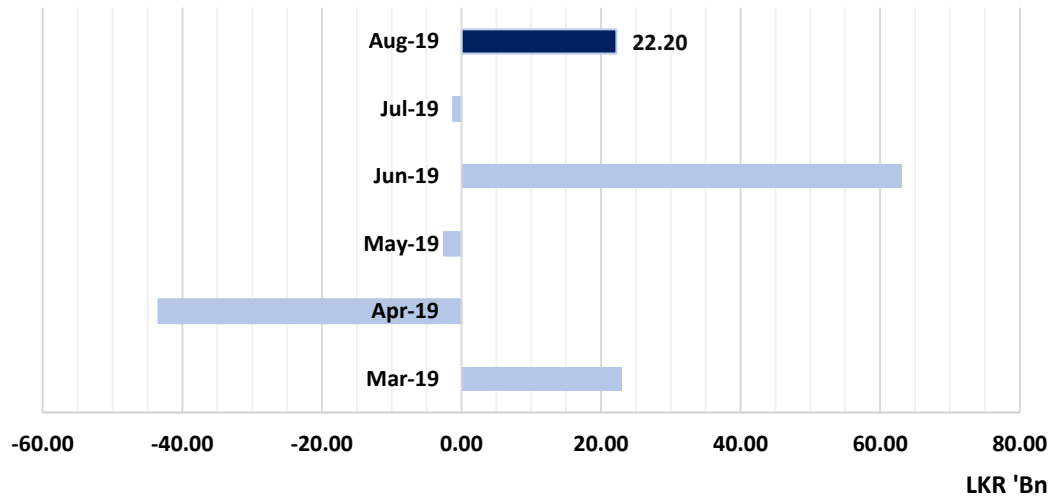
Source: Census & Statistics

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



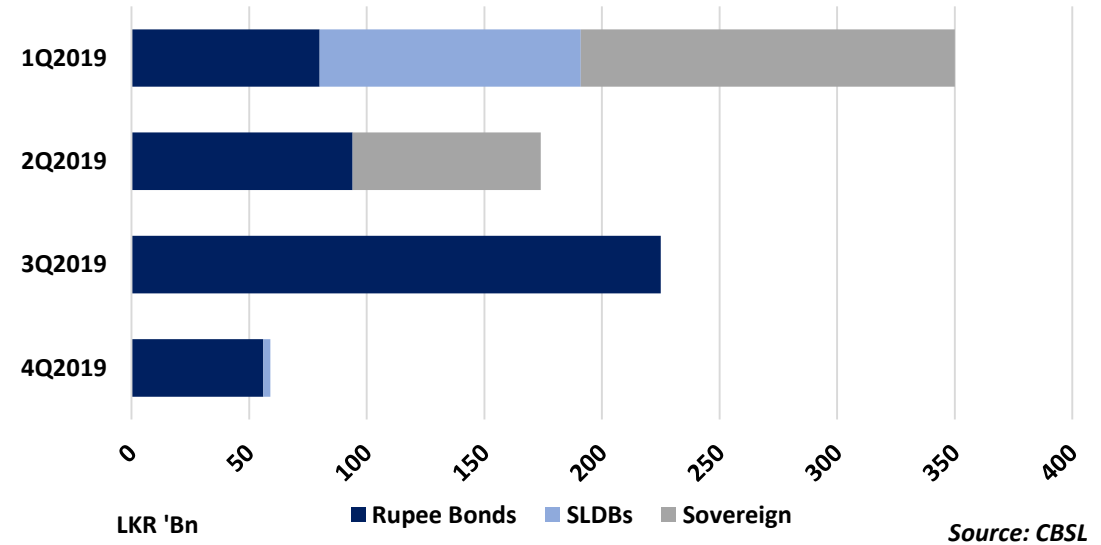
Source: CBSL

Graph 3 : Private Credit turned positive in Aug 2019 after recording a negative growth in July



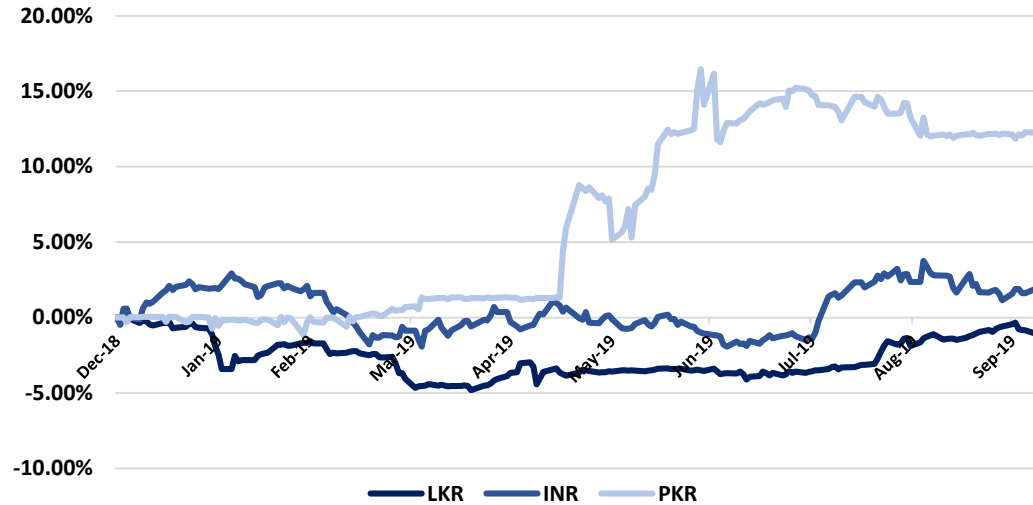
Source: CBSL

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



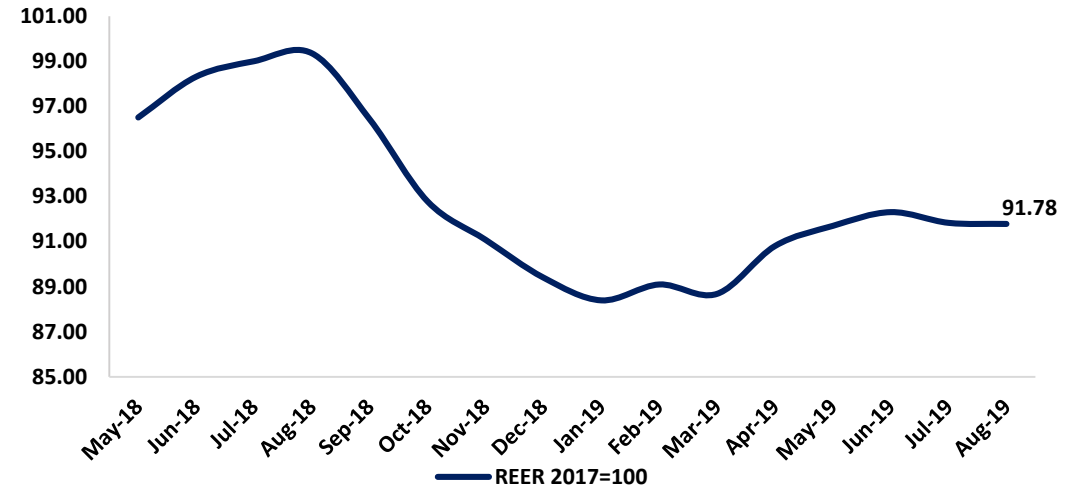
Source: CBSL

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 91.78 in Aug 2019



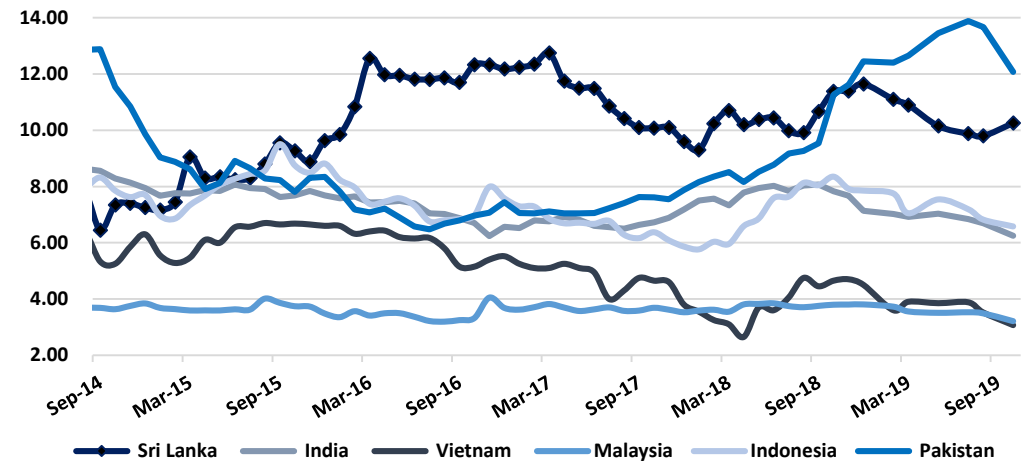
Source: CBSL

Graph 7 : Fed reserve officials cut rates at the meeting held in Sep 2019 by 25 basis points



Source: Bloomberg

Graph 8 : Comparative 5-year yields



Source: Bloomberg

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