"FLIP OF A COIN ON FUTURE RATES…"

PRE-POLICY ANALYSIS

29TH MAY 2023

First Capital Research

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Previous Pre-policy report: Recap

CBSL maintains policy interest rates

In line with our prediction, CBSL decided to maintain the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank at their current levels of 15.50% and 16.50%, respectively. Considering the recent and expected economic developments, and macroeconomic projections on domestic and global fronts, CBSL was on the view that the maintenance of the prevailing tight monetary policy stance is necessary to ensure that monetary conditions remain sufficiently tight to facilitate the continuation of the ongoing disinflation process amidst the improvements in market sentiments following the finalization of the Extended Fund Facility (EFF) from the International Monetary Fund (IMF) and the downward shift in elevated market interest rates reflecting the falling risk premia.

Key Arguments considered by CBSL for its policy stance on 4th Apr-23

- ✓ Monetary conditions remain sufficiently tightened to support the projected disinflation path.
- ✓ The external sector outlook improved with the finalization of the IMF-EFF.
- ✓ Market interest rates have continued to adjust downwards, and expected to persist in the period ahead with the falling risk premia.
- ✓ Global monetary policy continues to remain hawkish.

Analysis of upcoming policy decision on 01st Jun

Arguments for a Monetary Relaxation

50%

The below-mentioned factors argue for a relaxation in policy rates at the upcoming policy meeting

- Facilitate a faster recovery of the economy
- Strengthening reserves position and currency
- Boost credit growth and improve business confidence
- Reduce the risk premia attached to government securities

Arguments against a Monetary Relaxation

50%

- To facilitate a faster reduction in inflation
- Uncertainty in DDO and outlook
- Overall system liquidity continues to remain negative

The above-mentioned factors argue against a relaxation in policy rates

Arguments for relaxation in monetary policy

Facilitate a faster recovery of the economy

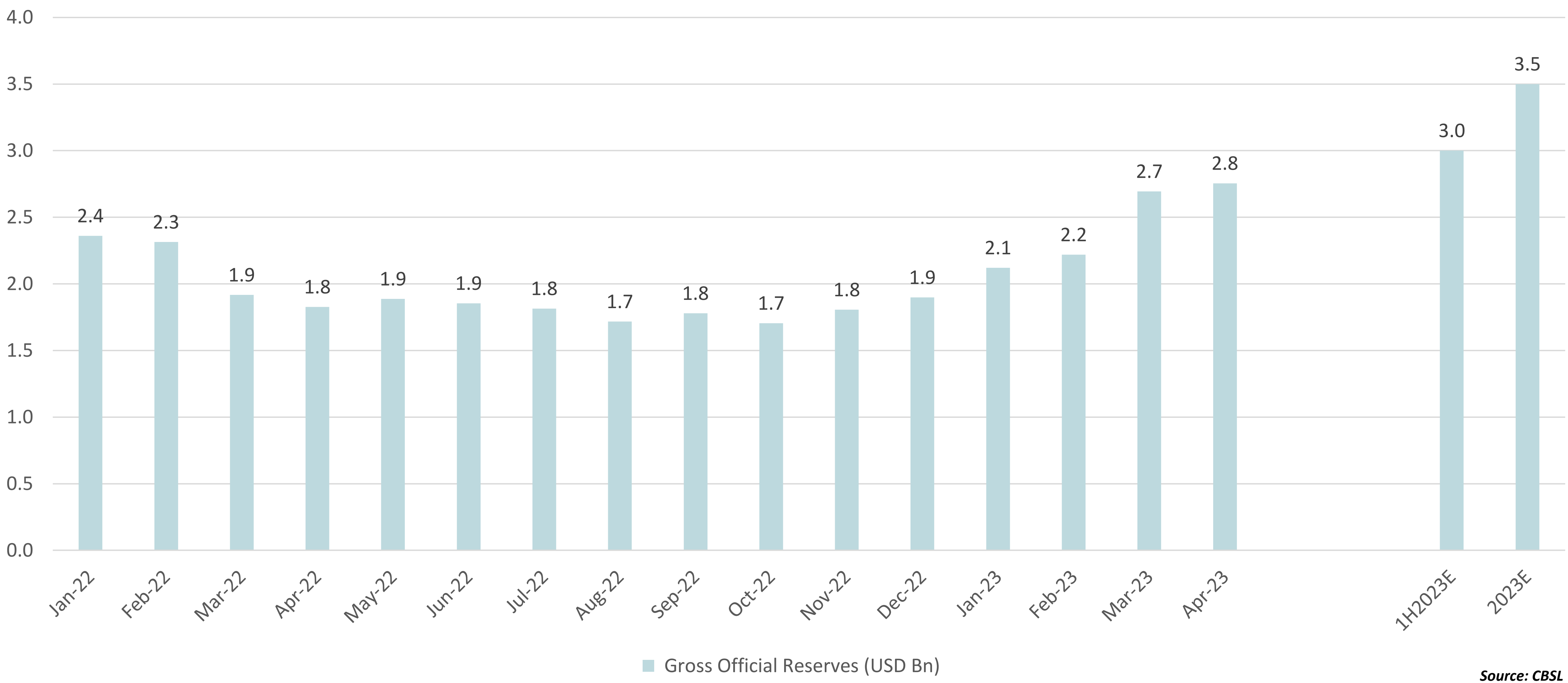
Given the weak performance during 2022 and the bleak outlook forecasted by multiple multilateral agencies (World Bank -4.3%, ADB -3.0% and IMF -3.0%), Sri Lanka needs to fast track the economic recovery. Moreover, the latest reported PMI data also remains weak after the Apr-23 PMI declined to 34.7, after recording a growth in Mar-23 to 51.4, bouncing back after nine consecutive surveys. The weak performance in Apr-23 was largely a result of the contraction in both Manufacturing and Service segments. The manufacturing PMI declined compared to the seasonal peak in Mar-23 as Production, New Orders, Employment and Stock of Purchases subindices declined. The decline in production was primarily due to the temporary closure of most of the factories in April owing to the Sinhala and Tamil new year holidays whilst New Orders declined due to soft global demand. Moreover, the Service PMI, which bounced back to positive in Mar-23, declined in Apr-23 as New Businesses, Employment and Backlogs of Works declined, whilst Business Activities and Expectations for Activity continued to improve. In an effort to boost the support SMEs and kick start growth, Sri Lanka relaxed restrictions on 100 items from the remaining 1,000 items whilst the CBSL revoked the cash margins deposit requirements against imports on 18th May 2023. Amidst such developments, we believe a relaxation in monetary policy stance will enable a smoother and a faster recovery of the economy, whilst supporting the depressed demand and consumption levels of the economy.

Arguments for relaxation in monetary policy

Strengthening reserves position and currency

Sri Lanka's reserve position improved to USD 2.8Bn in Apr-23 from USD 2.7Bn in Mar-23 and USD 2.2Bn in Feb-23. The notable improvement in the reserves position was aided the by the interventions from the CBSL with gross purchases of USD 451.0Mn from the domestic foreign exchange market in March 2023. With the inflows expected from multi-lateral lenders (USD 7.0Bn inflows from ADB and WB promised between 2023E-2027E), fast recovery of the tourism sector (expected to reach USD 1.9Bn in 2023E from USD 1.1Bn in 2022), and steady inflows from remittances (USD 5.4Bn in 2023E cf. USD3.8Bn in 2022), FCR expects Sri Lanka's reserves to improve to USD 3.0Bn by Jun-23 and USD 3.5Bn in Dec-23. The strengthened reserves position was also supported by the BOP surplus of USD 858.0Mn in Jan-Mar-23, which was boosted with 64.1%YoY contraction trade balance to - USD 861.0Mn, improved receipts from tourism (+9.8%YoY to USD 530.0Mn) and higher increase in foreign remittances (+80.6%YoY to USD 1,413.0Mn). Meanwhile, from the date of our previous policy-review, the LKR has appreciated by 7.6% to LKR 299.10/USD on 25th May 2023 and 17.6%YTD, supported by improved inflows to government securities and surplus BOP position, despite the interventions from the CBSL by mopping up USD 148.0Mn from the market in Apr-23 (nearly USD 1.0Bn YTD). However, as Sri Lanka momentarily relaxes imports amidst a backdrop of revoked cash margins on imports, FCR believes that the Rupee will bounce back and close 2023E in the range of LKR 340.0-LKR 365.0/USD (reversing from our previous estimate of LKR 350.0-400.0). Given the improving indicators, we believe that the Sri Lankan economy is positioned well to absorb a downward adjustment in the policy rates from the upcoming monetary policy meeting.

Gross Official Reserves Position - April 2023



Source: CBSL

Arguments for relaxation in monetary policy

Boost credit growth and improve business confidence

Private sector credit slid low for the 10th consecutive month in Mar-23 and recorded at LKR 7,152.8Bn compared to LKR 7,260.4Bn in the month of Feb-23. Sharp escalation in lending rates, restriction on imports and conservative lending stance adapted by the banks due to elevated impairment provisions have collectively discouraged the demand for credit resulting in a persistent downfall. Moreover, amidst tight direction from the IMF and limited money printing, net credit to the government declined for the 1st time after 8-months in the month of Feb-23 to LKR 7,470.9Bn, yet bounced back to LKR 7,568.1Bn in Mar-23. Given the consecutive months of decline in private sector credit and the requirement to facilitate the expansion of the private sector contribution to national economy, we believe a downward adjustment in interest rates is a necessary action, to induce demand for private sector credit and restore financial stability within the banking system.

Reduce the risk premia attached to government securities

Despite the steep decline in inflation (contracted to 35.3% in Apr-23 from 50.3% in Mar-23), and consecutive signals from the CBSL with regards to future interest rates, the premia attached to government security yields have remained unchanged amidst DDO concerns. Thus, on shorter term maturities, bill yields have risen marginally by 60bps to 22.97% (compared to the policy review meeting on 4th April 2023), whilst the mid-longer tenor maturities have also witnessed an increased in yields between 50-225bps. Moreover, in the absence of bond auctions, CBSL has issued +LKR100.0Bn at its weekly bill auctions (latest LKR 160.0Bn on 24th May 2023) for the last 5 consecutive times. We believe that the high-risk premia attached to the short tenure is a big challenge for the CBSL, in the wake of strict Gross Financing Need (GFN) targets set by the IMF.

Arguments *against a relaxation* in monetary policy

To facilitate a faster reduction in inflation

Inflation in Apr-23, recorded a steep decline as FCR accurately predicted to 35.3%YoY cf. 50.3%YoY recorded in Mar-23. The decline in inflation during the concerned month came mainly due to higher than expected price decreases observed in Volatile Food and Non-Food items. Moreover, the higher base impact during Apr-22 also contributed towards the faster decline of YoY inflation during the month. Furthermore, with the 1-Yr T-bill hovering at 22.97% whilst inflation is at 35.3%, we believe that the CBSL will look to bring down inflation below the 1Yr yield to facilitate a faster reduction in yields in the near-term. Meanwhile, with ambitious target of toning down inflation to a single digit by Dec-23, which is below the FCR predicted rate of 13% and IMF targeted rate of 12%, we believe that there is a higher possibility of maintaining rates at current levels, to facilitate a faster decline in inflation to meet the ambitious targets set by the CBSL.

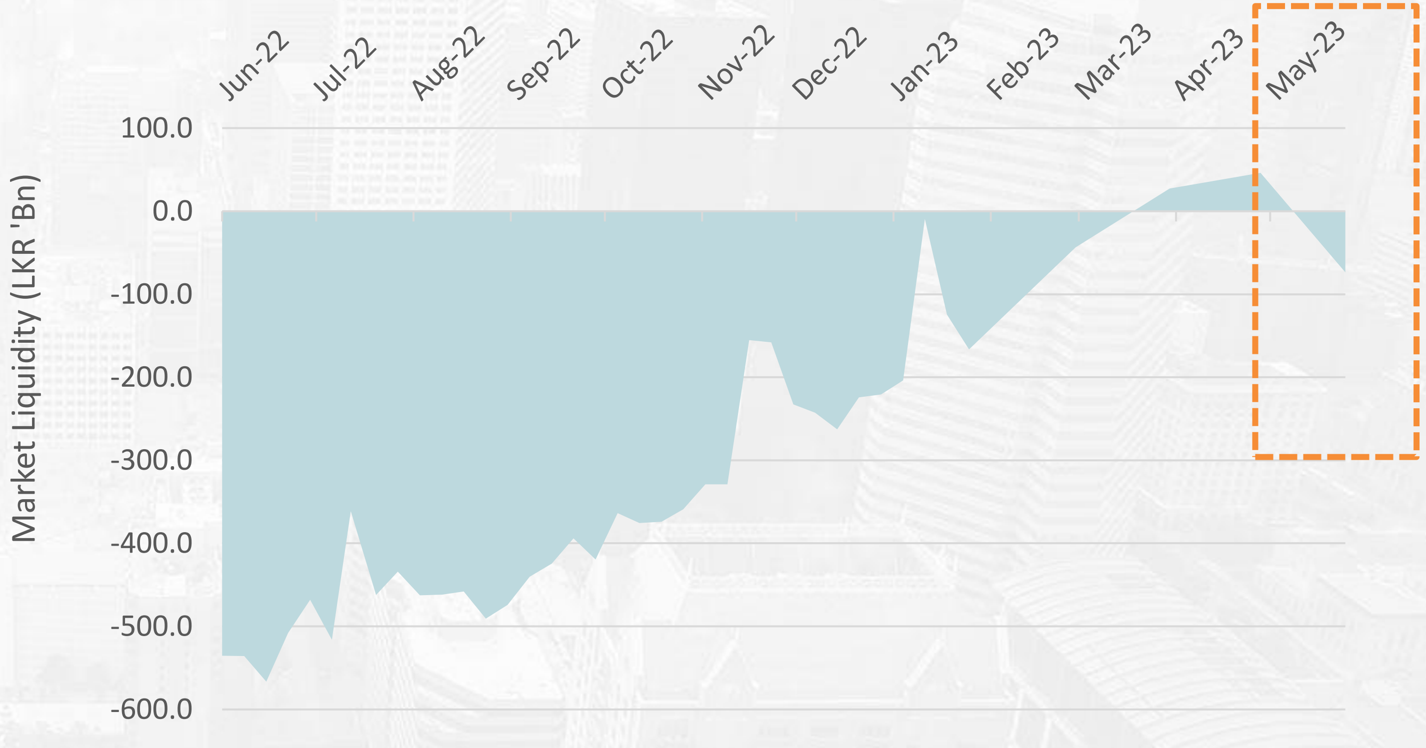
Uncertainty in DDO and outlook

Having witnessed a reduction of rates upon the confirmation of the IMF Extended Fund Facility and prior to the last policy meeting, the overall yield curve has picked up between 50-225bps across all maturities on concerns with regard to voluntary domestic debt optimization discussions and meeting the IMF indicated GFN targets. Furthermore, having previously announced that the DDO plan will be produced in mid-May, the delay in finalizing the DDO plan have also raised concerned among investors on the challenges of achieving the debt sustainability targets. This has also resulted towards the increase of risk premia on government securities since the previous policy announcement. Given the increased challenges in bringing down the risk premia of securities amidst consecutive signals issued by the CBSL, we believe it will be feasible for the CBSL to adopt a wait and see approach until the DDO plan is released, to relax policy rates and facilitate a faster reduction in yields, in-line with expectations. The FCR expects the current risk premia attached to yields to ease and close the year with the 1Yr T-bill in the range of 17%-19%.

Arguments against a relaxation in monetary policy

Overall system liquidity continues to remain negative

Overnight liquidity continued to display significant volatility during the month of May-23 as overall liquidity position continued to swing back and forth from positive to negative amidst liquidity injections from CBSL via Repo and Term Repo transactions. Since the last monetary policy review, overall banking sector liquidity has declined to - LKR 73.4Bn cf. negative LKR 27.5Bn. Hence, it may not be suitable to relax policy rates at this juncture since it may result in a disequilibrium of demand and supply, which shall further aggravate financial instability in the economy.



Factors in consideration at the policy review

Foreign Reserves
USD 2.8Bn by Apr-23

Inflation
CCPI 35.3% for Apr-23

GDP Growth
-12.4% in 4Q2022

03M T-Bill rate
25.66% as of 24.05.23

Private Credit
LKR 7,152.8Bn for Mar-23

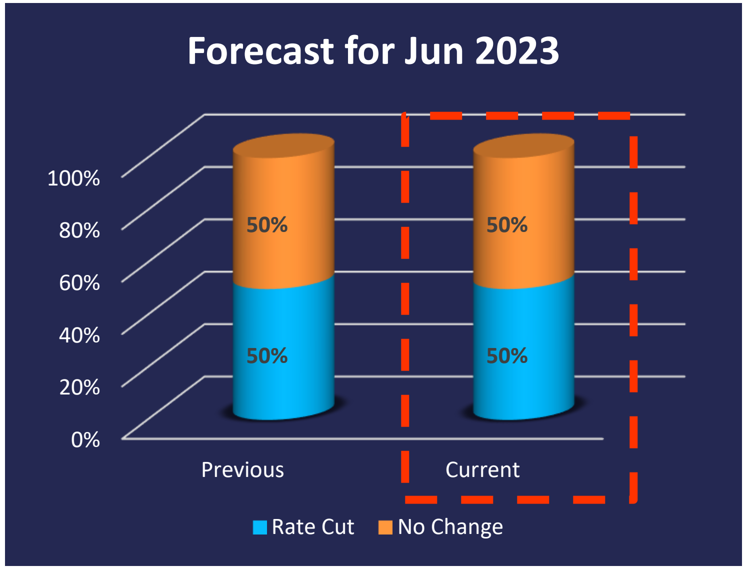
Liquidity and CBSL Holdings
- LKR 73.4Bn and LKR 2.7Tn

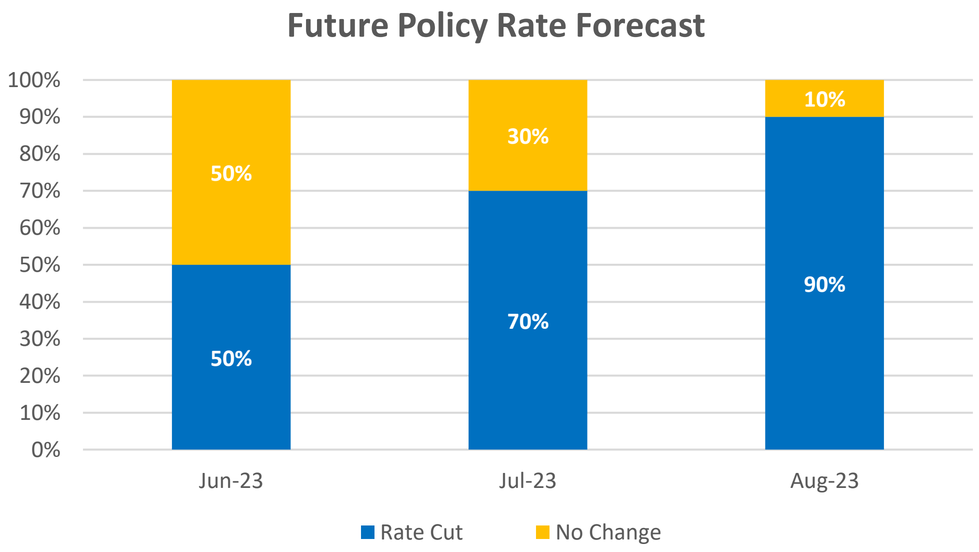
BOT and BOP
USD -861.0Mn and USD 858.0Mn for Mar-23

FCR Policy Rate Forecast (Jun-23 to Aug-23)

We believe that there is a 50-50 chance that the CBSL may maintain or relax rates from the current levels at the upcoming policy review meeting allowing a soft landing from its hawkish to dovish stance. However, considering both arguments for and against monetary easing, we have assigned a 50% probability for policy rates to be maintained at the current rates whilst 50% is allocated for a relaxation of policy rates.

Having signed the IMF deal in mid Mar-23, Sri Lanka has been already promised with USD 7.0Bn of funds by the IMF, WB and ADB between 2023-2027. However, as per the IMF and with debt restructuring in play, Sri Lanka may access the global capital market only by the year 2027. Thereby, with economic indicators stabilizing and economy projected to recover during 2H2023 with a drastic slow down of inflation from 2Q2023 onwards, we believe a sizeable monetary relaxation may be required in the latter part of 2Q2023 with a view to stimulate economic growth and accelerate the decline in interest rates.





Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, **there is a 50% possibility for CBSL to maintain the rates at its current levels** allowing further strengthening of key economic indicators. Moreover, **there is a 30% possibility to relax its policy rates by 50bps and a 20% probability for a rate cut of 100bps,** in order to prevent a major economic downturn as well as to signal the market participants a clear direction on the way forward. Moreover, considering the persistent improvement in liquidity in the banking system, we assigned a higher probability of 90% on the SRR to remain unchanged.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 100bps	0%
Raising Policy Rates by 50bps	0%
Policy Rates to remain unchanged	**50%**
Cutting Policy Rates by 50bps	**30%**
Cutting Policy Rates by 100bps	**20%**

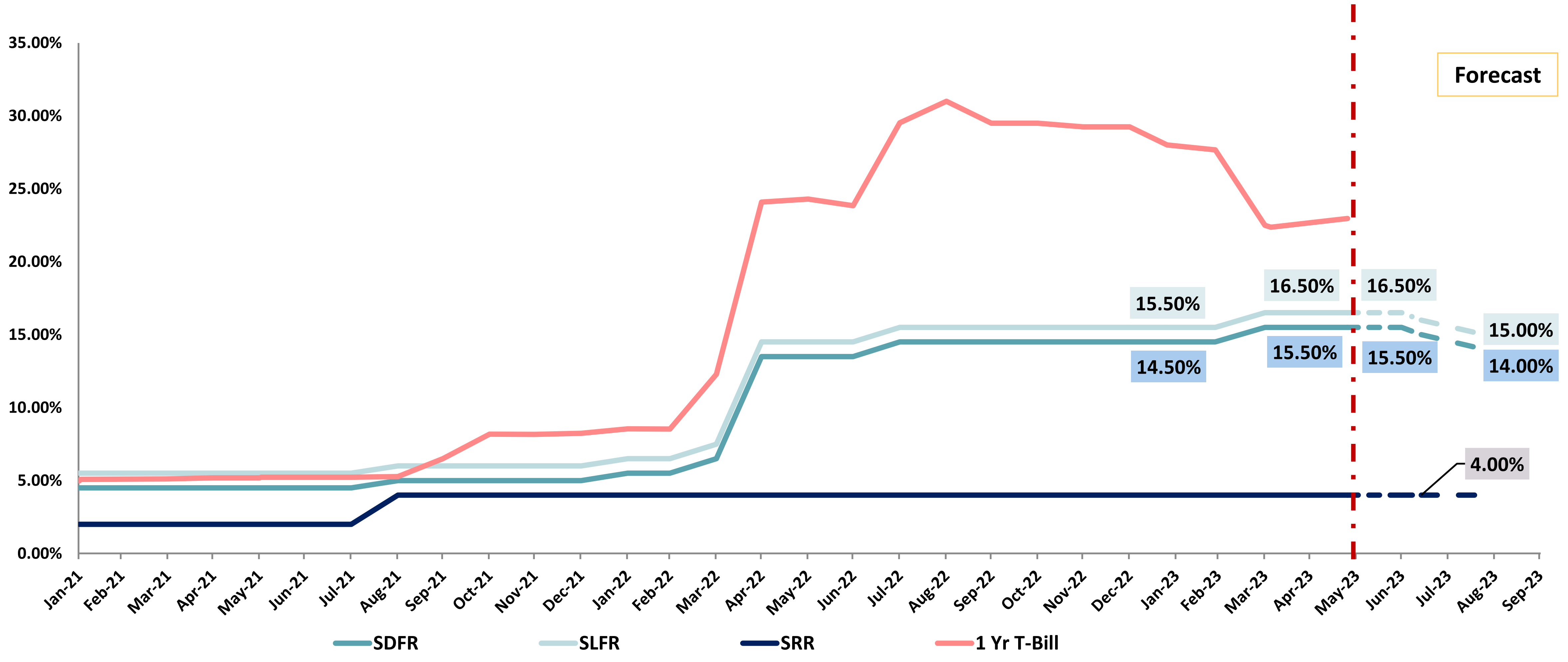
50%

We believe that there is 50% probability to maintain the rates at its current levels to further promote the stability of the key economic indicators.

Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	0%
SRR to remain unchanged	**90%**
Cutting SRR by 50bps	**10%**
Cutting SRR by 100bps	0%

Considering the increase of SRR by 200bps to 4% on 19th Aug 2021 we expect SRR to remain unchanged at the same levels despite a lower probability of a SRR cut.

Monetary Policy Rates



Source: CBSL, First Capital Research Estimates

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