



First Capital  
A Janashakthi Group Company

# “FIRST CAPITAL UPGRADES EXCHANGE RATE OUTLOOK”

**EXCHANGE RATE REVISION – 15<sup>TH</sup> JUN 2023**

**First Capital Research**

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# Jan - May '23 Currency Performance

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# Sri Lankan Rupee Strengthened in Jan-May 2023 amidst stronger than anticipated Dollar inflows

## Crash in imports cut trade deficit by half

- In Dec-21, the monthly trade deficit reached its highest level in a decade, amounting to USD 1.1Bn. Amidst the tightened monetary policy and flexible exchange rate, the cumulative deficit dipped to levels below USD 900.0Mn during Jan-Mar 23, which is a sizeable decline from over USD 2.0Bn recorded during the same period in 2022. Higher inflation and import controls, contributed to lower consumer demand which plunged import expenditure and led to the dip in the deficit.

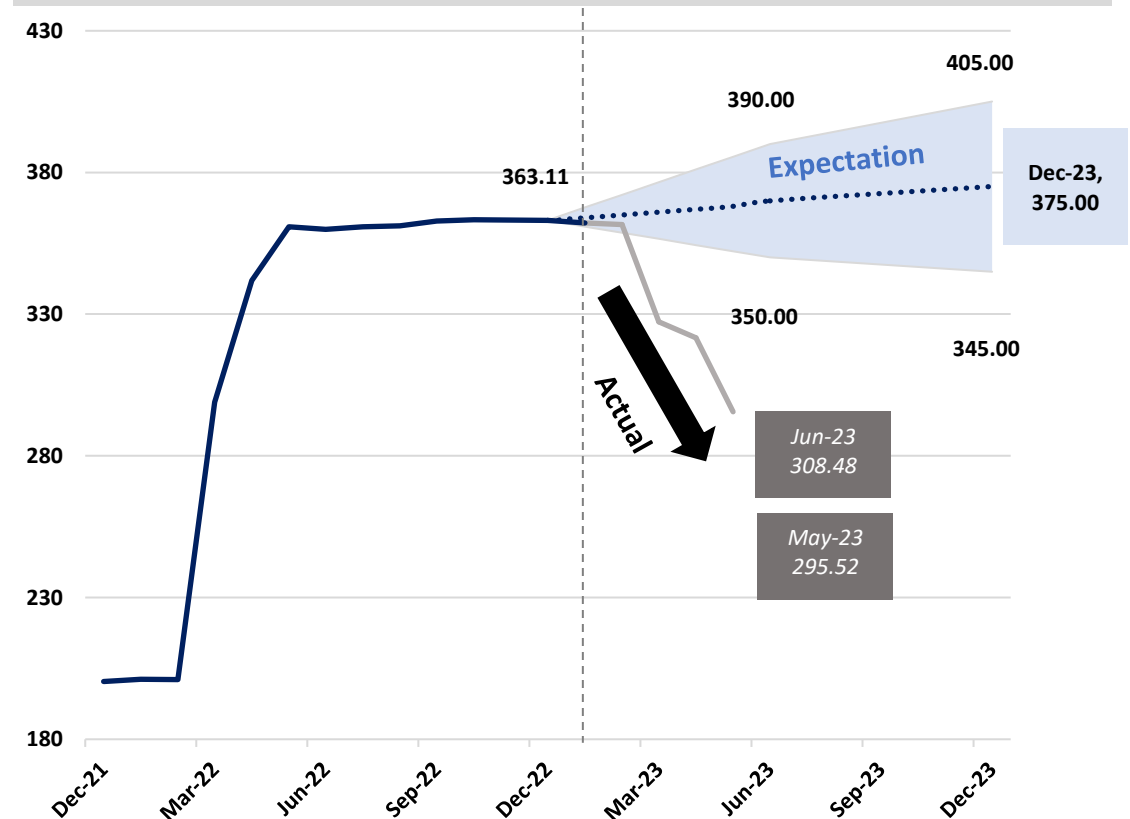
## Currency strengthens with a surge in tourism earnings, worker remittances, investment inflows

- The significant increase in worker remittances, inflows from tourist arrivals, surge in foreign inflows into Government Securities, and local currency conversions from USD to LKR led by the confidence from the IMF board approval of the USD 3.0Bn Extended Fund Facility, resulted in the Sri Lankan Rupee to appreciate significantly by 15.0% YTD (15th June - 308.5) and 9.7% in 2Q2023 (31st May - 295.5).
- CBSL also restored its FX reserves to the highest level in 15 months in May-23, thanks to the dollar inflows as CBSL purchased USD c.1.6Bn in the Jan-May-23 period, improving the gross official reserves, instilling greater confidence and exerting an upward pressure on the exchange rate, leading to further appreciation.

Expectations (Sep-22/Feb-23):

Exchange Rate is likely to be stable throughout 2023E with possible marginal depreciation amidst trade relaxation

**Inaccurate**



Source: CBSL, First Capital Research

# CBSL Actions differs from First Capital Research Expectations for 1H2023

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## CBSL minimizes disruptions to market forces contrary to First Capital Research expectations

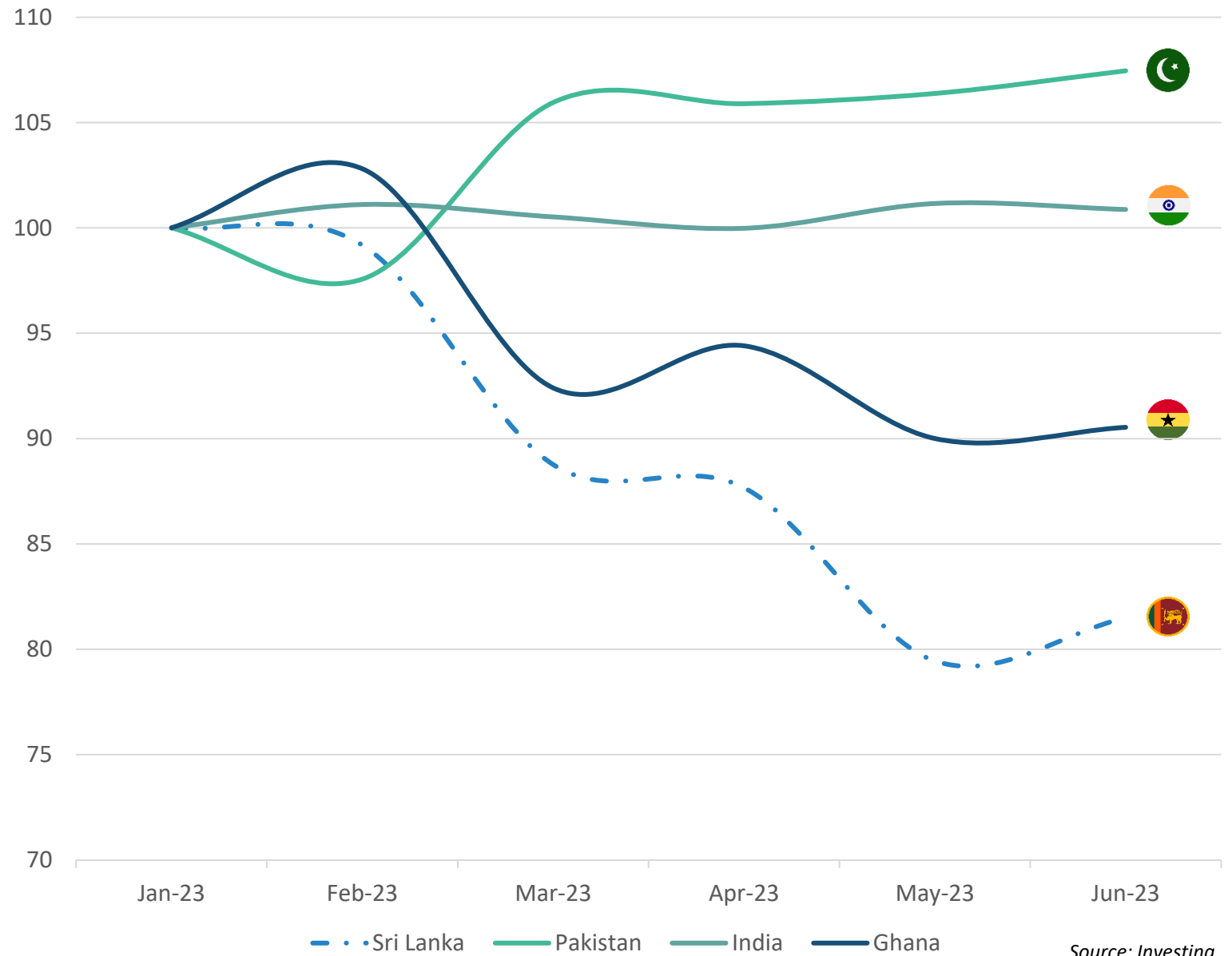
- First Capital Research Expectation (Sep-22 & Feb-23):

*“Following IMF Staff level agreement being signed, and Board level agreement expected around Mar-23, we expect foreign inflows in terms of investments and potential loans into the country.*

*However, CBSL is likely to use the opportunity to buy USD in the market in order to build reserves which is a significant priority. Therefore, currency appreciation opportunities are likely to be limited in the market.”*

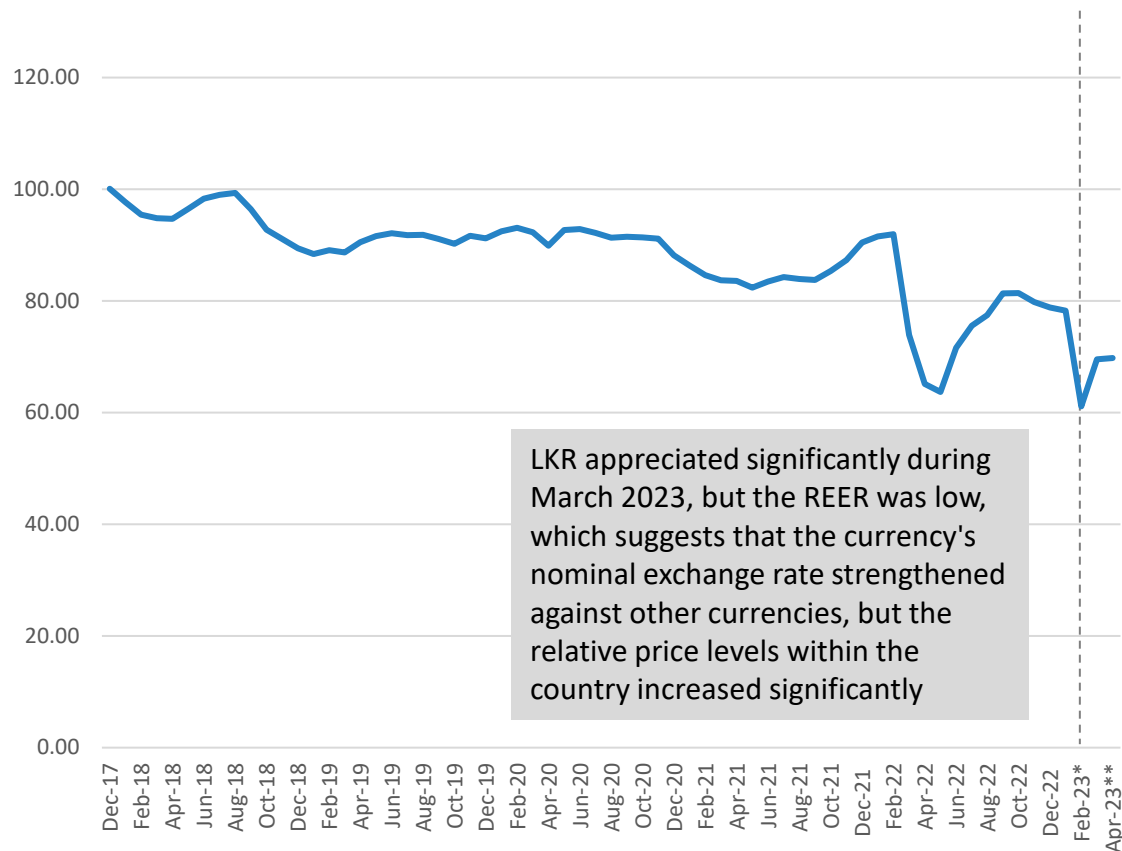
- Throughout 2022, when Foreign Currency Reserves remained at exceptionally low levels, we anticipated that the CBSL would purchase all dollar inflows in order to prevent the currency from appreciating.
- Though tourism earnings and worker remittances were broadly in line with our expectations, inflows to Government Securities and locals converting USD to LKR was well above our expectations.
- In line with our expectations, CBSL continued to purchase dollars from the market. However, inflows accelerated over the months beyond First Capital Research expectations, as CBSL purchased over USD 1.6Bn YTD and 0.6Bn in May-23 alone supported by the significantly high level of inflows.
- **In the recent interviews, CBSL announced that they do not intend to change the course or trend of the currency through their interventions. With this development, the excessive inflows have allowed the LKR to appreciate even though CBSL has been actively buying dollars from the market.**

Sri Lankan Rupee is the most appreciated currency in the region since Jan-23



Source: Investing

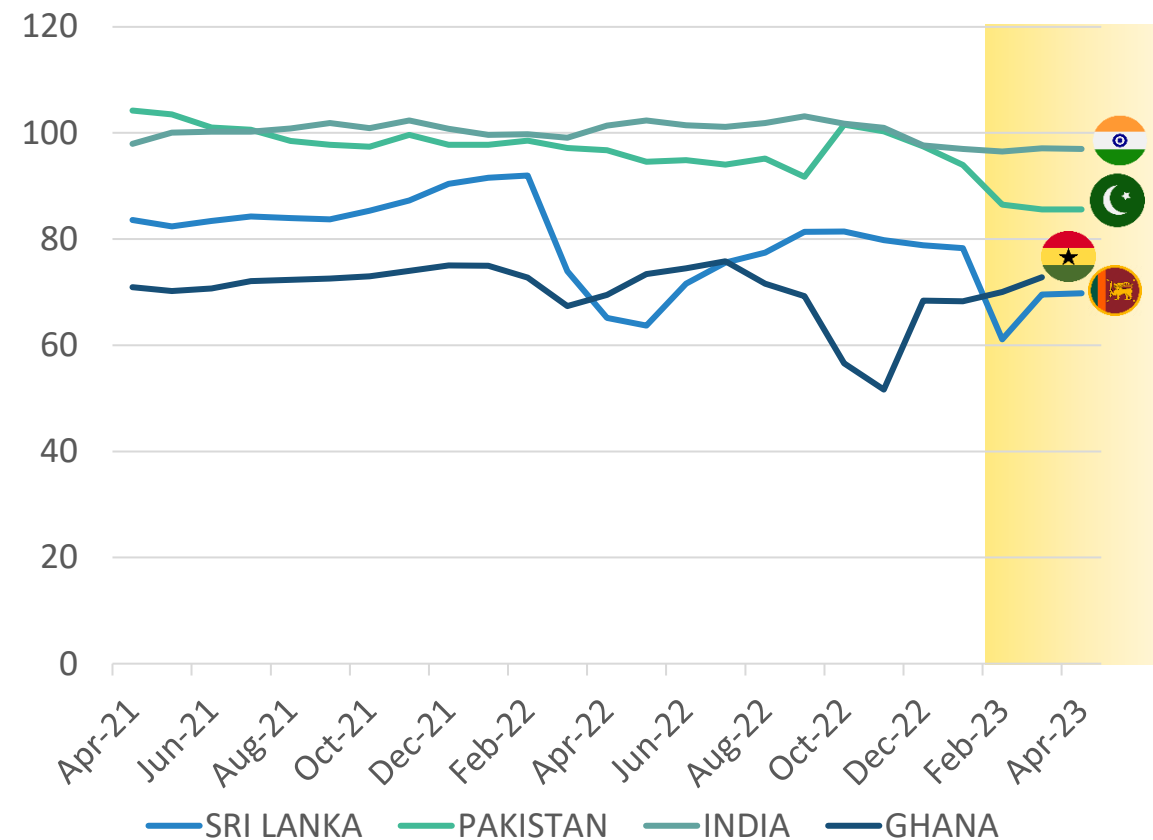
## LKR stands heavily undervalued at 61.12 after REER was released with rebased CCPI (2021=100) from Feb-23



Note: \*REER calculation uses the rebased CCPI (2021=100) from February 2023  
 \*\*Provisional data

Source: CBSL

## Sri Lankan Rupee REER compared to regional peers



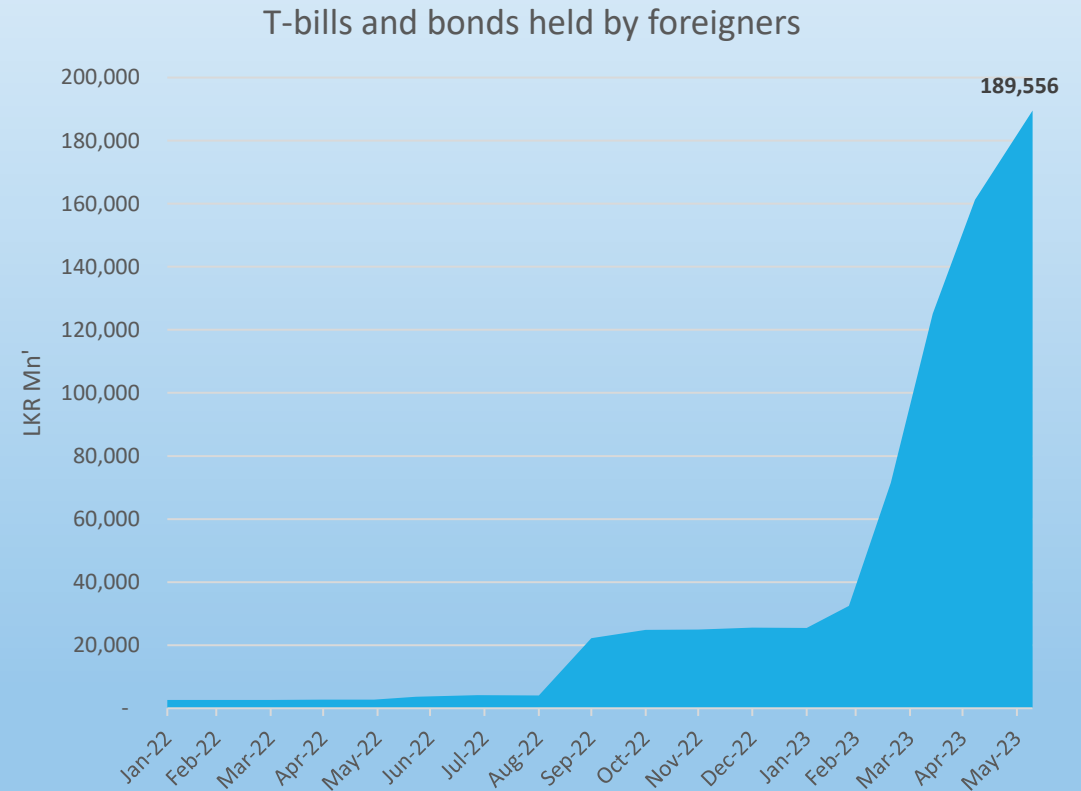
Source: CBSL, SBP, RBI, CEIC

# Factors influencing the Outlook of LKR

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# Inflows to Government Securities to remain strong

- Foreign investors are converting their foreign currency into the local currency to invest in Sri Lankan government securities. This increased demand for the local currency can lead to an appreciation of the exchange rate. As more foreign currency is exchanged for Sri Lankan Rupees, the value of the local currency may strengthen.
- It can also attract foreign investment and encourage capital inflows, as investors are attracted by the stronger currency.
- Inflows into G-Sec can affect the balance of payments (BOP). If inflows are significant and more foreign currency enters the country, it can help further strengthen the overall BOP.
- ***Inflows into Government Securities have reached LKR 189.6Bn by Jun-23, with YTD inflows at LKR 164.0Bn. We expect inflows to continue to strengthen as the economy recovers at a faster pace with most economic indicators improving at an accelerated pace.***



Source: CBSL



# Tourism Earnings and Worker Remittances to continue in line with expectations

## TOURISM EARNINGS TO REACH USD 1.9BN BY 2023E

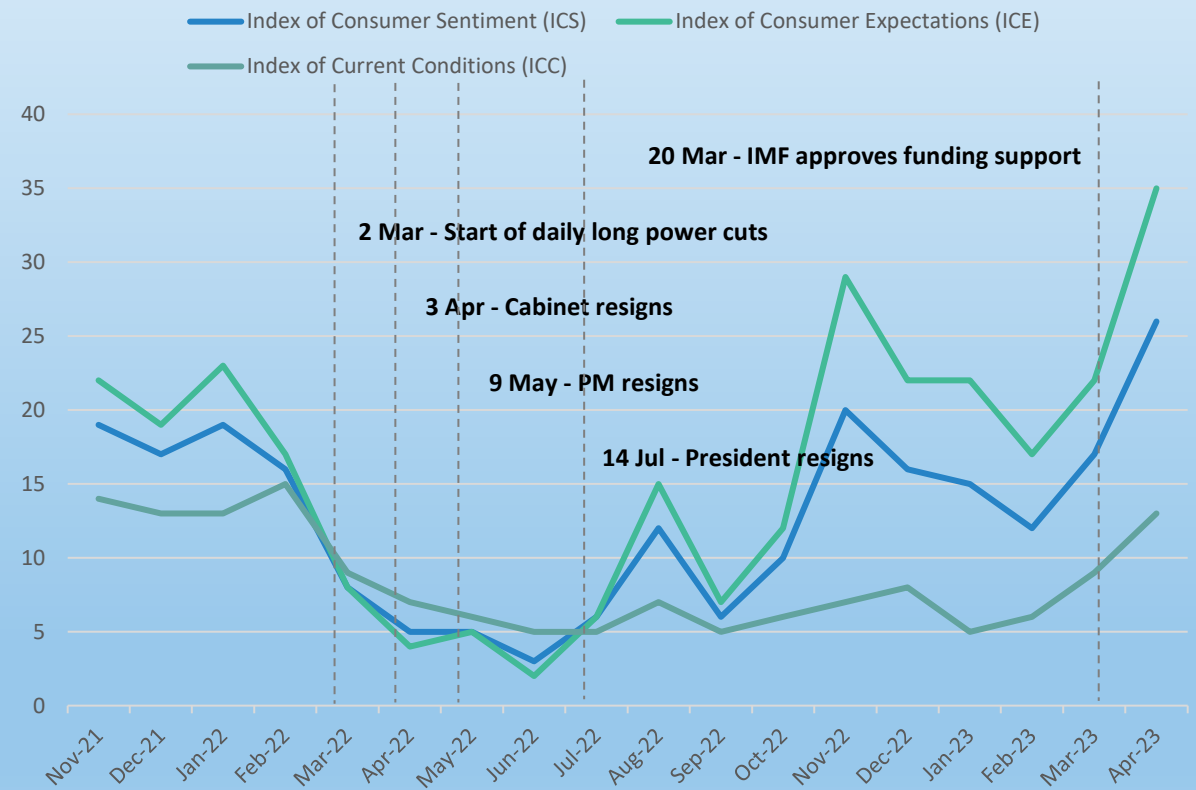
- In 2022, tourism earnings amounted to USD 1.1Bn while the number of tourist arrivals reached 719,978. These figures were largely **consistent with the expectations of FCR**. In the course of 2023, multiple airlines and cruise tourism resumed operations, and extensive promotional campaigns were initiated, particularly focusing on MICE tourism, to boost the tourism sector.
- An increase in tourism earnings and tourist arrivals can appreciate the currency by boosting demand for the local currency through exchange transactions. It can also contribute to a positive current account balance, attracting foreign investors and strengthening the currency. Additionally, the growth and investment opportunities associated with a thriving tourism sector can stimulate economic growth and attract capital inflows, further supporting currency appreciation.
- *We expect tourist arrivals in Sri Lanka to surpass 1.0Mn in 2023E with a target of USD 1.9Bn (+67.3%YoY) in earnings, which is expected to further increase the inflows into the country and may act as a cushion against any depreciation pressure.*

## WORKER REMITTANCES TO REACH USD 5.4BN BY 2023E

- In 2022, worker remittances recorded at USD 3,789Mn, which was **broadly in line with FCR expectations**. Worker remittances significantly increased to USD 1.9Bn (+81.0%YoY) in Jan-Apr 2023, and has historically covered around 80% of the country's annual trade deficits over the past 2 decades. In the six-year period from 2015 to 2020, worker remittances averaged over USD 7.0Bn annually, significantly improving foreign exchange liquidity in the country and the banking system.
- Efforts have been made to provide low-interest loans and vehicle import permits to migrant workers who legally send money to Sri Lanka, along with an increase in duty-free concessions at the airport. These measures aim to incentivize and facilitate the remittance process for migrant workers and encourages them to continue sending money back to Sri Lanka, which will exert an upward pressure on the currency.
- *If the current positive trend in worker remittances continues, FCR projects that such income could reach USD 5.4Bn (+42.2%YoY) in 2023E, which may increase the foreign exchange reserves of the country, thereby exerting an upward pressure on the exchange rate.*

# Consumer Confidence gradually improves, may add downward pressure with more imports

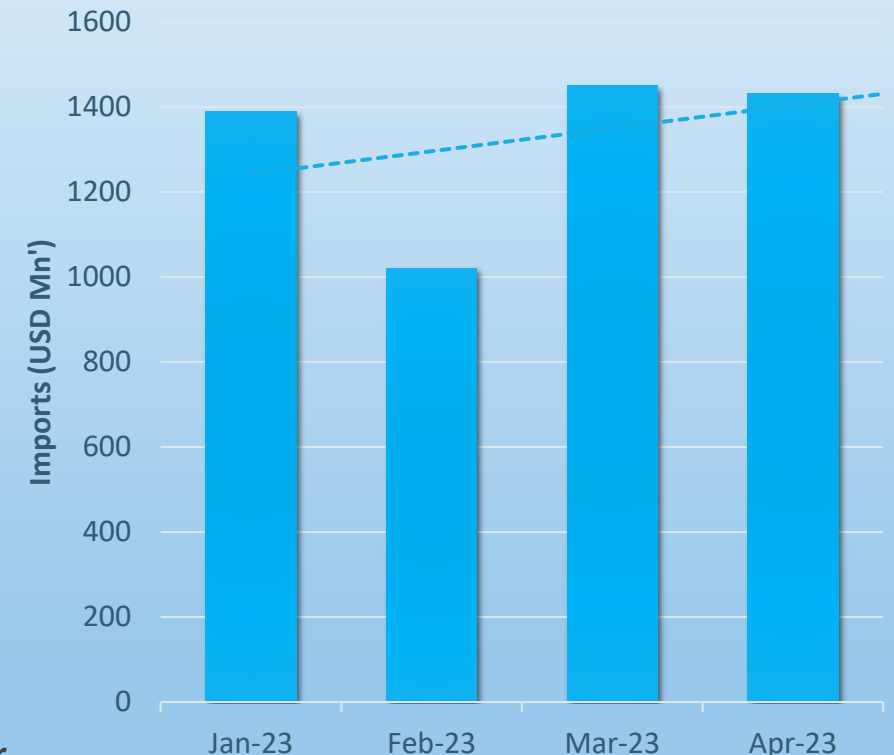
- Sri Lanka’s consumer confidence index spiked to its highest in 2 years during April 2023, following the IMF deal. We expect this to further improve as this was driven by improvements in public perceptions about their future personal financial situation and of the country in the next 5 years.
- We expect consumer confidence to gradually improve during the year and as a consequence, there may be a potential rise in imports which might lead to currency depreciation.
- In addition, tourism may also increase consumer demand for imported goods which might contribute to an increase in the trade deficit, and which may further weaken the LKR.
- ***The recovery in GDP may also increase consumer demand. As domestic consumers spend more, they may opt for imported goods and services which may increase demand for imports and lead to higher outflows, placing a downward pressure for the Sri Lankan Rupee towards 2H2023.***



Source: IHP

# Trade Relaxation continues, may add pressure to LKR towards 4Q

- In 2022, the Sri Lankan Government imposed limitations on the import of more than 3,200 items.
- However, since then they gradually removed these restrictions on multiple occasions, and currently only 928 items have restrictions in place.
- In May 2023, CBSL relaxed the cash margin deposit requirements on specific imports and also expects the gradual removal of the existing import restrictions in the near future, which may lead to a possible pressure on imports especially towards 4Q 2023 and exert a downward pressure on the exchange rate.
- The availability of imported goods would offer consumers more choices and lower-cost alternatives, ultimately reducing inflation. This, combined with the anticipated increase in tourist arrivals may increase consumer demand, increasing overall imports and adding pressure to the currency.
- ***With the GDP expected to recover during 2H2023 and turn positive towards 4Q2023, we expect a recovery in purchasing power and stronger demand for imports to add pressure to the LKR, potentially resulting in the currency to depreciate.***



Source: CBSL

# Recommendation Revision

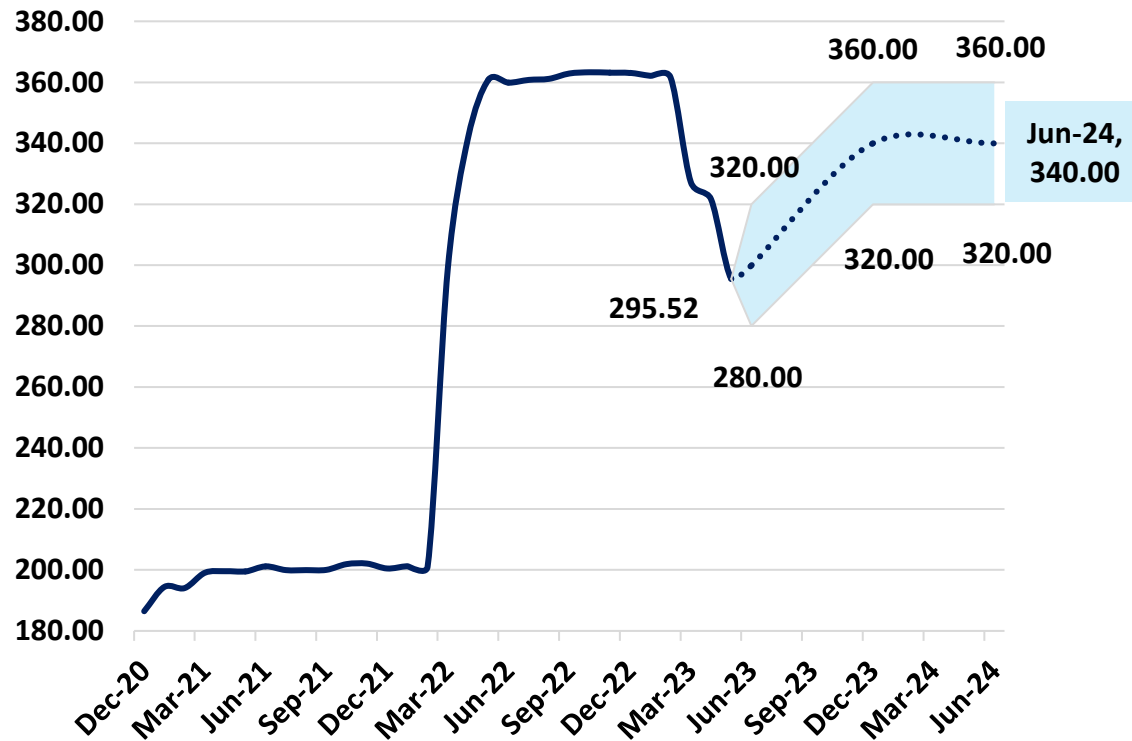
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# Exchange Rate 2023 Outlook upgraded

- Heavy debt repayments & tightening global monetary conditions will weigh on the rupee. Sri Lanka has annual repayment obligations of nearly USD 6.0Bn-7.0Bn in foreign loans until 2029 and may build up its foreign reserve buffer over the coming months which may exert a downward pressure on the exchange rate.
- In May 2023, CBSL relaxed the cash margin deposit requirements on specific imports and also expects the gradual removal of the existing import restrictions in the near future, which can potentially exert downward pressure on the exchange rate.
- CBSL has mentioned that through their purchases / sales of the dollar, they will not disrupt the market trend. Government Securities are experiencing large inflows, which is likely to further accelerate as the country potentially nears the completion of the DDO process.
- ***However, trade relaxations may completely offset the appreciation of the currency. We expect that the turnaround in the GDP coupled with the relaxation of import restrictions may set the tone for the currency to be on a slower than expected depreciation trend.***

# First Capital Research *upgrades* Exchange Rate Outlook

*USD/LKR is expected to gradually depreciate in 2H2023 & 1H2024 amidst trade relaxation, hovering within a range of LKR 320.0-360.0 over the next 12 months (Jun-24)*



Source: CBSL, First Capital Research

Following the approval of the IMF loan in Mar-23, foreign inflows into government securities and dollar to rupee conversions by locals were **beyond FCR's expectations**, particularly the local conversions which strengthened the LKR.

Along with the potential increase in inflows, we expect CBSL to continue its dollar purchases in the market. Furthermore, CBSL took a decision to prevent disrupting the trend of the dollar, at the bond proposal meeting held recently.

However, currency appreciation is likely to be limited as the government plans to gradually ease import restrictions which could potentially exert a downward pressure on the currency, especially considering the ongoing recovery in GDP growth.

The exchange rate is expected to gradually depreciate towards 2H2023 to a range of LKR 320.0-360.0 for Dec-23 while the target for Jun-24 also remains the same at LKR 320.0-360.0.

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