“DECLINE IN RATES TO ACCELERATE…”

PRE-POLICY ANALYSIS

28TH JUNE 2023

First Capital Research

Analysts: Dimantha Mathew
Ranjan Ranatunga

Previous Pre-policy report: Recap

The CBSL relaxes its Monetary Policy Stance

Partly in line with our prediction of reducing policy rates, CBSL decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) at the monetary policy review held on 1st June 2023. However, going beyond our expectations of a policy rates cut between 50bps-100bps, CBSL decided to reduced both the SDFR and SLFR by 250bps to 13.00% and 14.00%, respectively. The decision to reduce rates was largely underpinned by the faster than expected slowing of inflation, gradual dissipation of inflationary pressures and further anchoring of inflation expectations. The reduction in rates is also expected to provide an impetus for the economy to rebound from the historic contraction of activity witnessed in 2022, while easing pressures in the financial markets.

Key Arguments considered by CBSL for its policy stance on 01st Jun-23

- ✓ Inflation is projected to decelerate notably in the period ahead, reaching single digit levels earlier than expected.
- ✓ The external sector, which underwent an unprecedented setback in 2022, begins to demonstrate improved performance.
- ✓ Downward adjustment in market interest rates together with declining inflation to support credit to private sector and softening the pressures in the financial sector.
- ✓ Domestic economic activity is expected to rebound gradually from late 2023.

Analysis of upcoming policy decision on 04th Jul

Arguments for a Monetary Relaxation

75%

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

- Facilitate a smoother DDO process
- Revive business confidence and Re-activate private sector credit
- Strengthening reserves position
- Facilitate a faster revival of the economy

Arguments against a Monetary Relaxation

25%

- Soften the blow to BOP from reopened imports
- To constraint demand and facilitate a smoother adjustment to inflation
- 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 smoother DDO process

Sri Lanka have been involved with domestic debt optimization talks with all domestic debt holders during the past few months. Briefing at the inaugural creditor meeting held in Apr-23 with the official creditors, CBSL unveiled the targets set by the IMF including reducing Debt to GDP below 95% and reducing the GFN target below 13% between 2027-32 period. Having continuously signaled by the CBSL and the GoSL that the safeguarding of the banking system stability is top priority in the process of DDO, CBSL have signaled that a principal haircut is not in the cards for domestic debt. However, considering the strict guidelines set by the IMF, we believe a coupon haircut and a maturity extension is likely to be introduced to restructure the bonds maturing between mid-long tenures in order to meet the GFN target set by the IMF. With the rate cut of 250Bps at the last policy review, 1Yr T-bill auction yield have plunged down by 592Bps to 16.99% on 21st June 2023 auction. Despite the plunge in yields, 1Yr T-bill hovers at a premium of 299Bps to the CBSL guided SLFR of 14.00%. Given the faster than anticipated taming down of inflation (CCPI inflation at 25.2% in May-23 cf. 35.3% in Apr-23) and continuous remarks from the CBSL that the T-bills held by public are not subjected to debt restructuring, we believe the premia attached to the 1Yr T-bill is unwarranted. Meanwhile, since the rate cut announcement on 1st June, the secondary bond yields have declined between 125Bps-300Bps to 22.50%-28.50% on the mid-longer tenure maturities. Therefore, considering the relatively higher yields prevailing on the government securities, despite the rate reduction at the previous policy review, we expect the CBSL to take a prudent approach and reduce rates further and bringing the overall yield curve lower, before offering new bonds to the investors under the debt optimization process.

Revive business confidence and Re-activate private sector credit

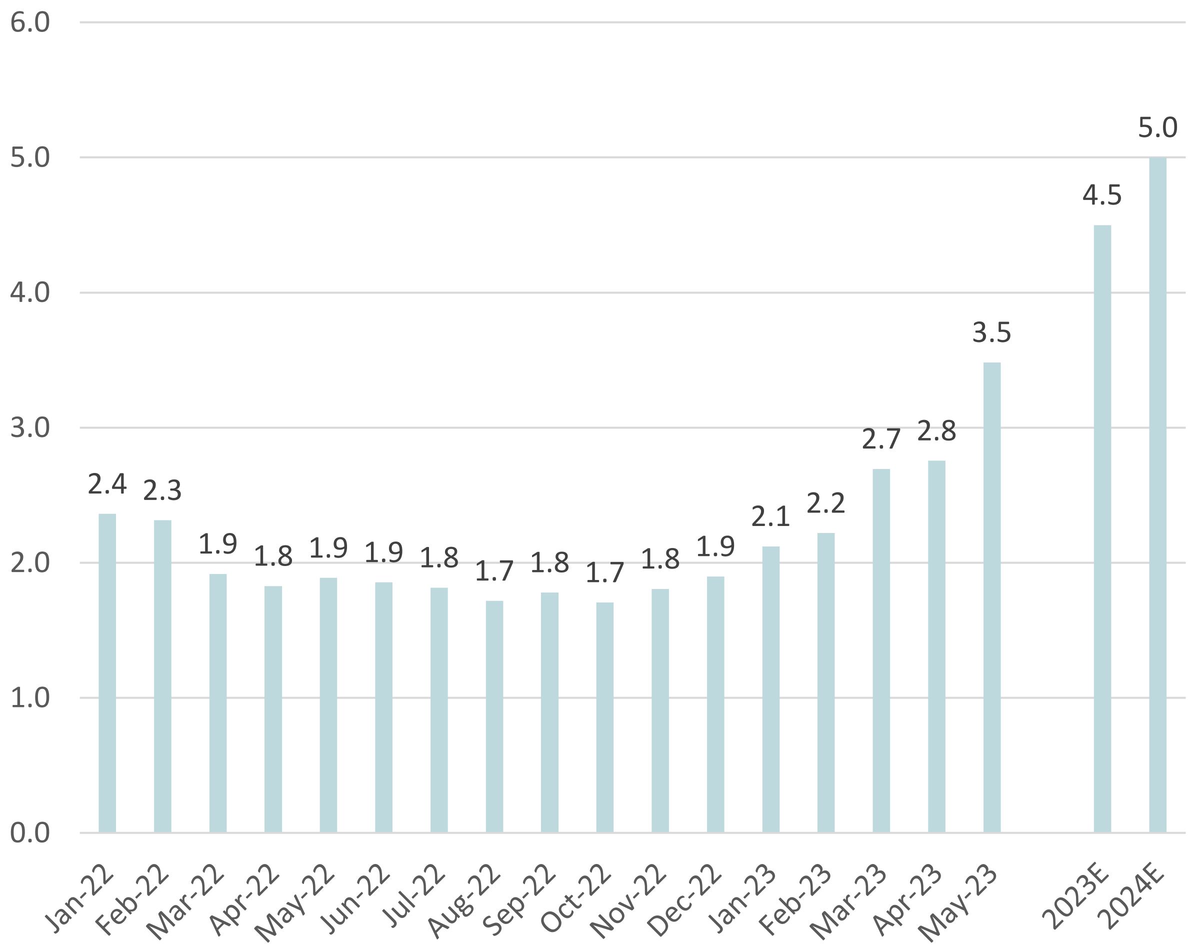
LMD-NielsenIQ Business Confidence Index (BCI) shed 06bps in May to register 102 backed by the prospects of political instability due to talks of elections, plans to pursue some form of local debt restructuring and a lackluster investment milieu. Furthermore, pushing business confidence lower, private sector credit growth continued its downward trajectory since Jun-22 and declined by 0.6%MoM to LKR 7.1Tn in Apr-23. Sharp escalation in lending rates, restriction on imports and conservative lending stance adapted by the banks resulted towards the poor performance of private sector credit during Apr-23. Furthermore, despite the 250Bps rate cut from the previous policy meeting, weekly AWPR at commercial banks fell by 57Bps to 19.69% whilst the spread between the weekly AWPR and SLFR continue to remain high at 569Bps. Therefore, we believe another rate cut will likely to bode well with the business community with efforts taken by the government to reduce the spread between banking and SLFR rates and boost private sector credit in the coming months.

Arguments for relaxation in monetary policy

Strengthening reserves position

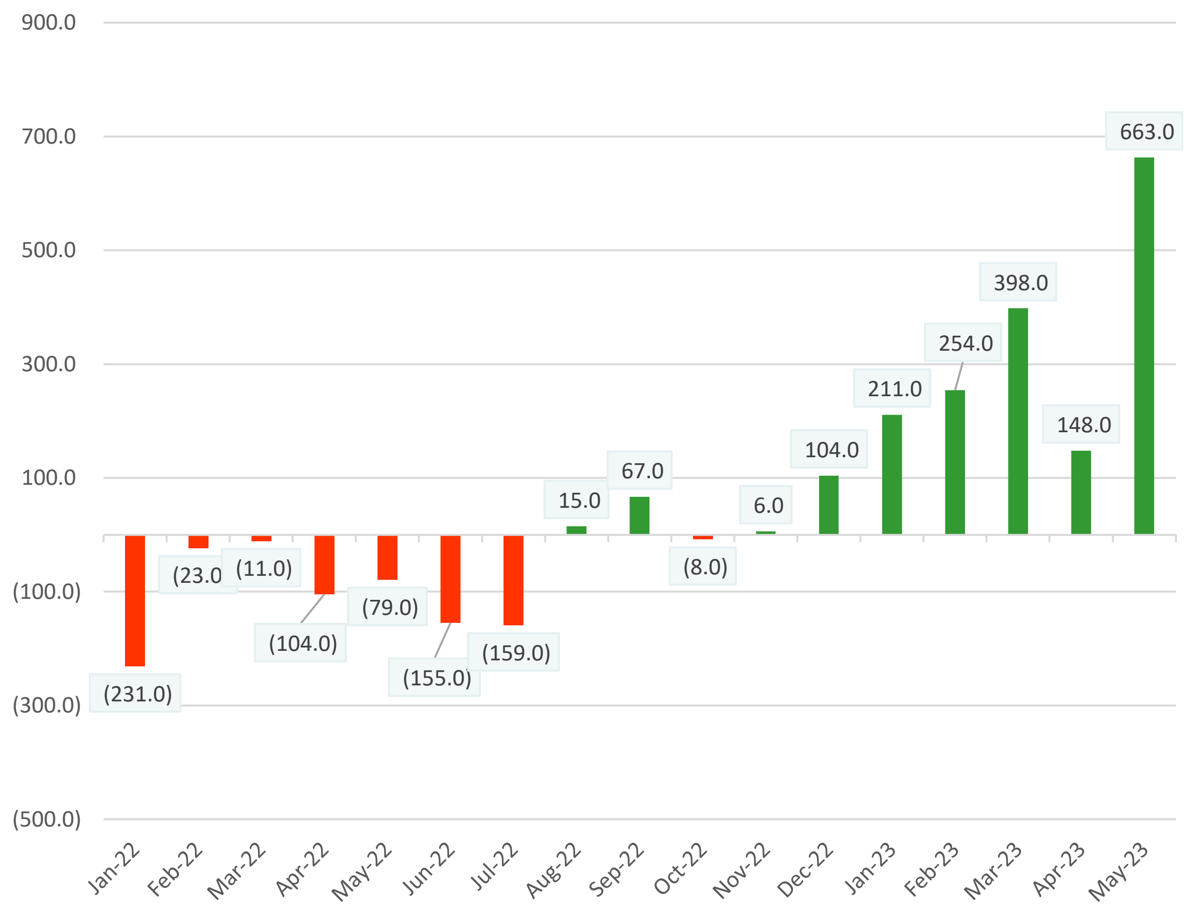
Sri Lanka’s reserve position surged to USD 3.5Bn in May-23 from USD 2.8Bn in Apr-23 and USD 2.7Bn in Mar-23 performing beyond FCR expectations (USD 3.0Bn in 1H2023E). The 26.1%MoM improvement in official reserves position was aided by gross purchases of USD 663.0Mn by the CBSL in May-23 (USD 148.0Mn in Apr-23 and YTD USD 1.7Bn) from the domestic foreign exchange market, ease of pressure on BOP position (BOP surplus of USD 883.0Mn YTD) from reduced trade balance (deficit narrowed by 53.8%YoY in Jan-Apr 2023), improved earnings from Remittances and Tourism (+81.0%YoY and 17.8%YoY, respectively). Moreover, according to Reuters the World Bank is likely to approve USD 700.0Mn in budgetary and welfare support for Sri Lanka at its next board meeting on 28-Jun. Of the proposed World Bank funding, USD 500.0Mn will be for budgetary support and is likely to come in two tranches of USD 250.0Mn each whilst the remaining USD 200Mn will be earmarked for programmes to assist the poor. The first tranche is likely to be disbursed immediately after board approval with the next possibly in October, as the bank watches the progress of Sri Lanka's debt restructuring and the first review of the IMF programme, due in September. Meanwhile, with the revocation of mandatory forex sales requirement by licensed banks to the Central Bank and discontinuation of the daily guidance on exchange rates in early March 2023, led to an improvement in the domestic foreign exchange market, which positively affected the LKR and resulted towards a 15.5% appreciation of the LKR against the USD as of 23rd June 2023. Given the improving indicators, we believe that the Sri Lankan economy is positioned well to absorb another downward adjustment in the policy rates during the upcoming monetary policy meeting.

Gross Official Reserves Position (USD Bn) - May 2023



Source: CBSL

Net forex market purchases / Sales by CBSL (USD Mn)



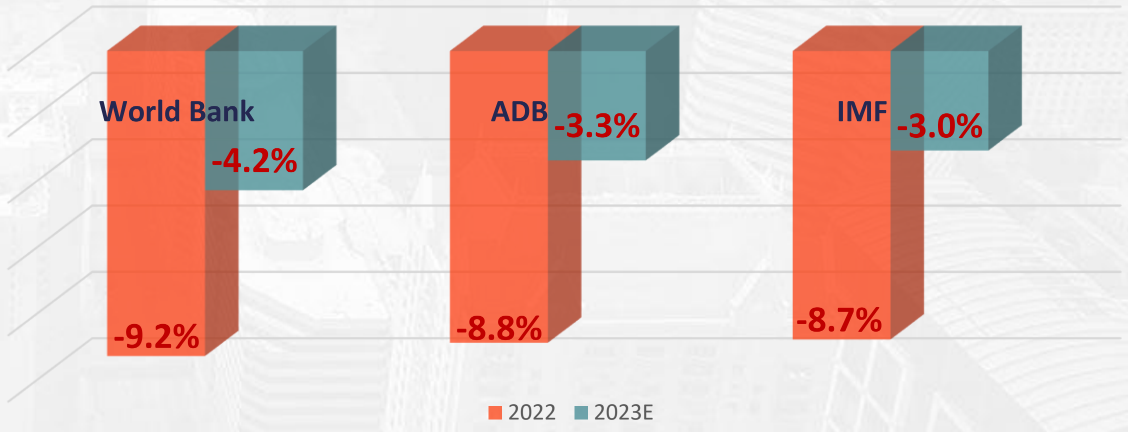
Source: CBSL

Arguments for relaxation in monetary policy

Facilitate a faster revival of the economy

Sri Lankan economy reported a steep decline of 11.5%YoY in 1Q 2023. The downturn in YoY GDP was driven by high inflation and high interest rates, the rising cost of components, as well as restrictions on imports and lower earnings from apparel exports, which resulted in Industries and Services subsegments reporting a contraction of 23.4%YoY and 5.0%YoY, respectively whilst the marginal growth (0.8%YoY) in Agriculture subsegment partly offset the overall poor performance. Meanwhile, in May-23 Purchasing Managers Indices indicated an expansion in Services activities and a contraction in Manufacturing activities. The expansion of the Service sector PMI was largely led by the increases observed in New Businesses (insurance, professional services and transportation sub-sectors), Business Activities (personal activities, insurance, professional services and human health sub-sectors) and Expectations for Activity. Meanwhile, Manufacturing PMI declined, yet on a slower rate indicating a MoM contraction mainly due to the decline in Production and New Orders of the Food & Beverage subsegment owing to the seasonal drop in demand after the festive season and the deterioration in purchasing power of the consumers. Moreover, orders received for manufacture of textile and apparel sector remained at the same low level recorded in April, mainly due to subdued global demand and losing market share to more competitive countries. Given the weak performance during 2022 and the bleak outlook forecasted by multiple multilateral agencies (World Bank -4.2%, ADB -3.3% and IMF -3.0%), and to achieve the GoSL target of gradual economic recovery from late 2023, we believe the CBSL may have the option to reduce rates further and propel the economy and achieve the envisaged growth target for 4Q 2023.

GDP Growth forecast for Sri Lanka



Arguments against a relaxation in monetary policy

Soften the blow to BOP from reopened imports

Having restricted imports for more than +2 years with a ban of +3,200 items, Sri Lanka is currently on a path of lifting restrictions placed on imports. Signing of the IMF agreement and strengthening reserves position have aided Sri Lanka to raise the ban on +2,272 items, whilst the ban on remaining +900 items including vehicle imports is expected to be relaxed momentarily in the coming years. Furthermore, having relaxed policy rates in the previous policy meeting and operating with a YTD BOP surplus of USD 883.0Mn amidst a backdrop of declining exports (-9.0%YTD), we believe that the sensitive position of the reserves will likely prompt the GoSL to take a cautionary stance against another rate cut, which may enable the GoSL to evaluate the potential impact on imports and soften the blow on the BOP position.

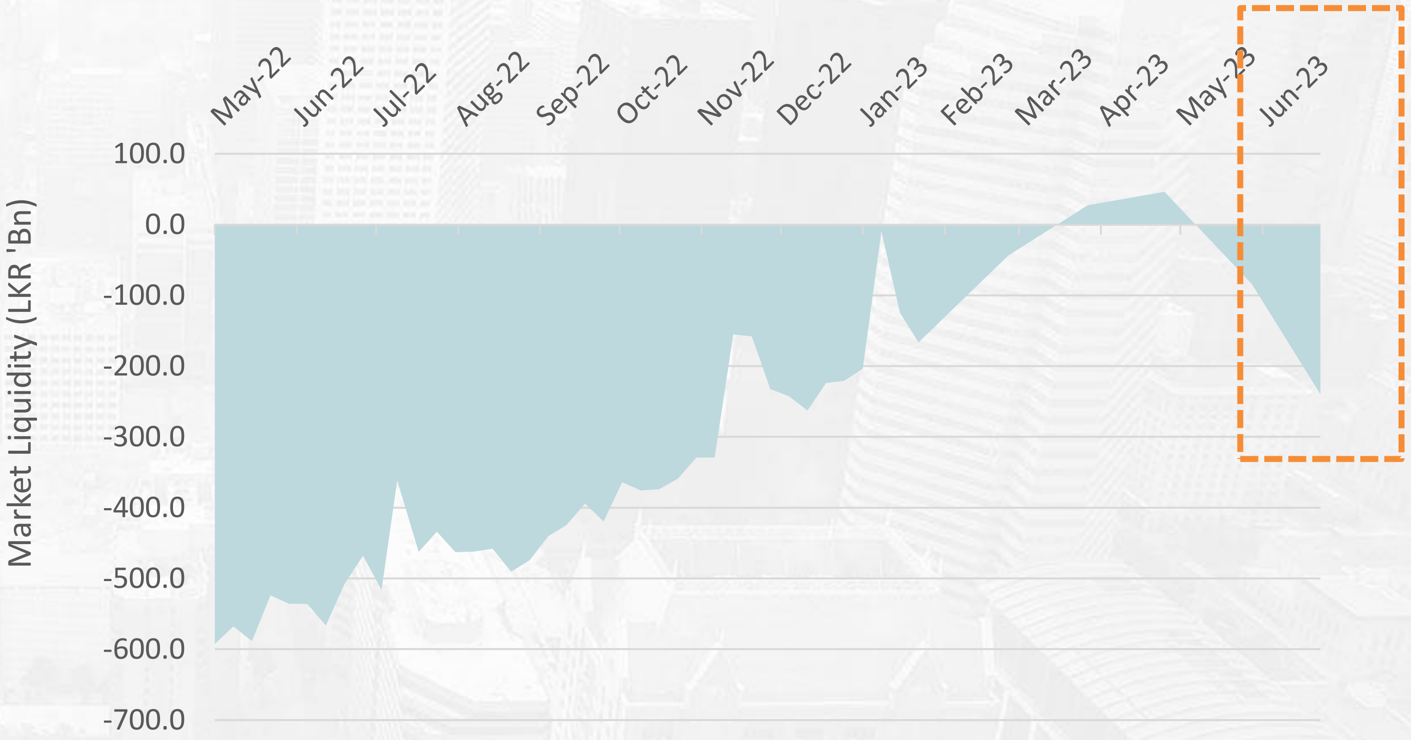
To constraint demand and facilitate a smoother adjustment to inflation

CCPI inflation for May-23 declined further and recorded at 25.2%YoY cf. 35.3% in Apr-23, in-line with the disinflation path envisaged by the CBSL in April 2023. The decline in inflation during the month was largely as a result of the decrease in both food and non-food categories which was recorded at 21.5%YoY (cf. 30.6%YoY in Apr-23) and 27.0%YoY (cf. 37.6%YoY in Apr-23), respectively. Having decreased policy rates from the previous policy review, amidst stable currency and inflation toning down at a double-digit rate, a wait and see approach by CBSL ahead of another rate cut is sensible, in order to avoid the risk of aggravating the pent-up demand in the system. Moreover, with inflation declining in-line with the CBSL envisaged targets (declining to mid-single digit by 3Q2023) ahead of the FCR expectation of 10.4% (by Dec-23E) and an IMF estimation of 15.0%, we believe that CBSL may look to maintain rates and facilitate a smoother adjustment to inflation.

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 Jun-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 239.5Bn in 26-Jun cf. negative LKR 153.4Bn in 01-Jun. 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

Inflation
CCPI 25.2% for May-23

Foreign Reserves
USD 3.5Bn by May-23

GDP Growth
-11.5% in 1Q2023

03M T-Bill rate
23.00% as of 21.06.23

Private Credit
LKR 7,109.6Bn for Apr-23

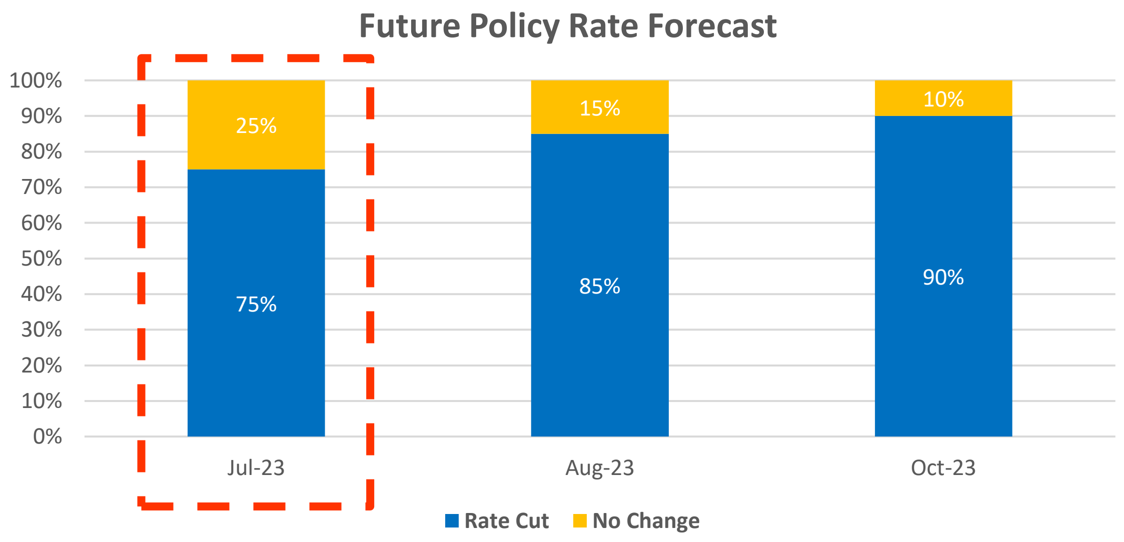
Liquidity and CBSL Holdings
- LKR 239.5Bn and LKR 2.8Tn

BOT and BOP
USD -583.0Mn and USD 192.0Mn for Apr-23

FCR Policy Rate Forecast (Jul-23 to Oct-23)

We believe that there is a higher chance that the CBSL may further relax rates from the current levels at the upcoming policy review meeting allowing rates to come down at a faster rate, ahead of the unveiling of the DDR framework. However, considering both arguments for and against monetary easing, we have assigned a 75% probability for policy rates to be relaxed from the current levels whilst 25% is allocated for policy rates to be maintained.

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. Moreover, given that the DDO discussions are in final stages, with a higher possibility for a maturity extension and coupon reduction, CBSL is likely to offer a rate cut at the upcoming policy review to bring down yields at a faster pace.



Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, **there is a 75% probability for CBSL to reduce rates from the current levels** allowing further strengthening of key economic indicators. Moreover, **there is a 5% possibility to relax its policy rates by 100bps, 10% possibility for a rate cut of 150bps, 35% possibility for a rate cut of 250bps and 25% possibility for a rate cut of 300bps,** in order to reduce rates and government security yields at a faster pace to facilitate a successful DDR process. 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
Policy Rates to remain unchanged	25%
Cutting Policy Rates by 100bps	**5%**
Cutting Policy Rates by 150bps	**10%**
Cutting Policy Rates by 250bps	**35%**
Cutting Policy Rates by 300bps	**25%**

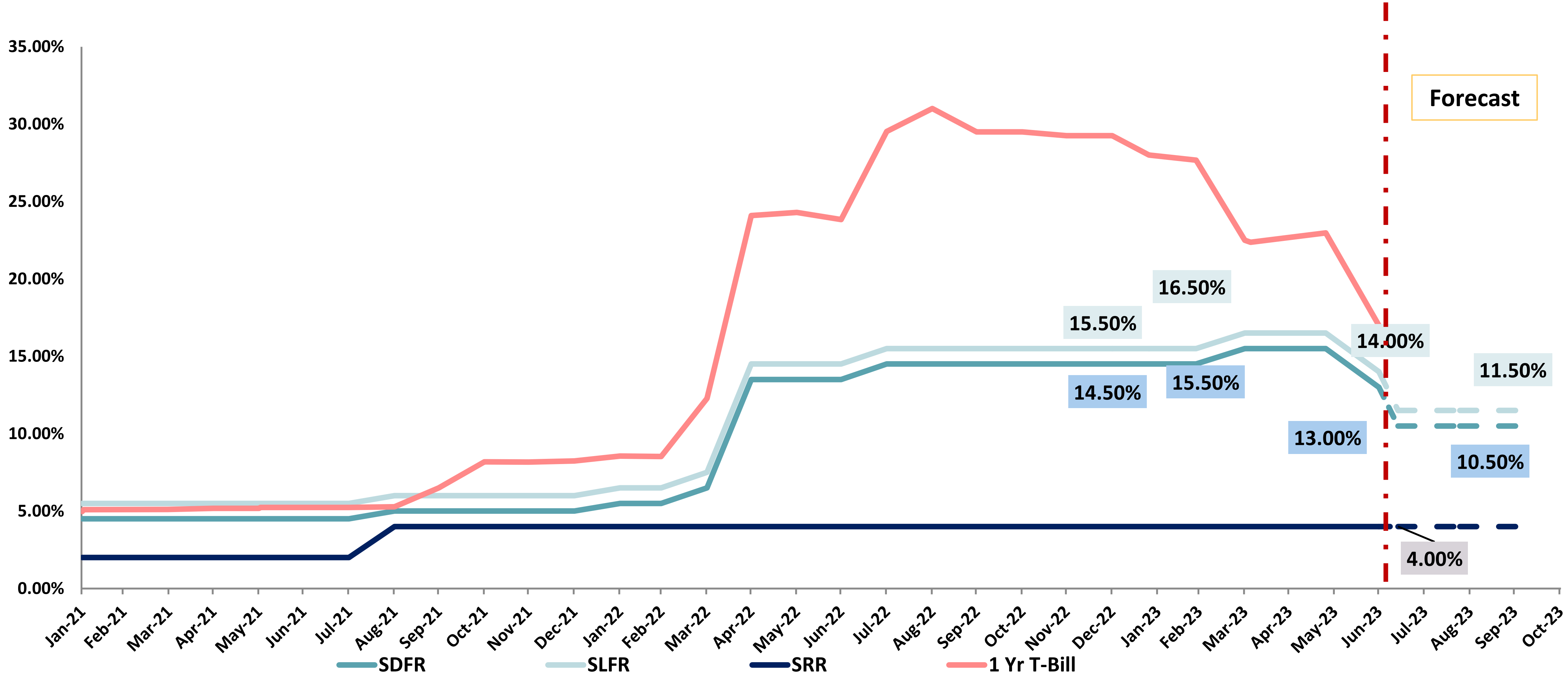
$\left.\begin{array}{l} 5\% \\ 10\% \\ 35\% \\ 25\% \end{array}\right\}$ **75%**

We believe that there is 75% probability to reduce the rates at its current levels to further promote faster recovery of the economy.

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

Disclaimer

This Review is prepared and issued by First Capital Holdings PLC based on information in the public domain, internally developed and other sources, believed to be correct. Although all reasonable care has been taken to ensure the contents of the Review are accurate, First Capital Holdings PLC and/or its Directors, employees, are not responsible for the accuracy, usefulness, reliability of same. First Capital Holdings PLC may act as a Broker in the investments which are the subject of this document or related investments and may have acted on or used the information contained in this document, or the research or analysis on which it is based, before its publication. First Capital Holdings PLC and/or a connected person or associated person may also have a position or be otherwise interested in the investments referred to in this document. This is not an offer to sell or buy the investments referred to in this document. This Review may contain data which are inaccurate and unreliable. You hereby waive irrevocably any rights or remedies in law or equity you have or may have against First Capital Holdings PLC with respect to the Review and agree to indemnify and hold First Capital Holdings PLC and/or its principal, their respective directors and employees harmless to the fullest extent allowed by law regarding all matters related to your use of this Review. No part of this document may be reproduced, distributed or published in whole or in part by any means to any other person for any purpose without prior permission.

First Capital
A Janashakthi Group Company

Thank you!

"SUCCESSFUL INVESTMENTS IS ABOUT MANAGING RISKS"

Contact Us

First Capital Holdings PLC
No: 02, Deal Place,
Colombo 00300,
Sri Lanka.
E: research@firstcapital.lk

Dimantha Mathew
Chief Research & Strategy Officer
T: +94 11 2639 853
E: dimantha@firstcapital.lk

Ranjan Ranatunga
Manager- Research
T: +94 11 2639 863
E: ranjan@firstcapital.lk

Vinodhini Rajapoopathy
Assistant Manager- Research
T: +94 11 2639 866
E: vinodhini@firstcapital.lk

Tharusha Ashokgar
Executive- Research
T: +94 11 2639 866
E: tharushaash@firstcapital.lk

Zaeema Jihan
Executive- Research
T: +94 11 2639 868
E: zaheema@firstcapital.lk

Nethmi Fernando
Junior Executive
T: +94 11 2639 866
E: nethmi@firstcapital.lk