"PIVOTAL BREATHER AS ECONOMIC INDICATORS POINT TOWARDS RECOVERY"

PRE-POLICY ANALYSIS

16TH JAN 2024

First Capital Research

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First Capital
A Janashakthi Group Company

Previous Pre-policy report: Recap ✖

The CBSL further reduces policy interest rates

In contrast to our prediction, CBSL decided to reduce policy rates, one policy meeting ahead of our expectations adopting a more aggressive monetary easing path. Central Bank reduced the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 100bps to 9.00% and 10.00%, respectively at the monetary policy review announced on 24th Nov-23. However, in line with our expectations CBSL announced a possible halt in monetary easing at the new levels. The decision was reached by the Board after carefully analyzing present conditions and anticipated changes in the domestic and global economy, with the aim of achieving and maintaining inflation at the targeted level of 5.0% over the medium term, while enabling the economy to reach and stabilize at the potential level. Further, the Board viewed that with this reduction of policy interest rates, along with the monetary policy measures carried out since June 2023, sufficient monetary easing has been affected in order to stabilise inflation over the medium term.

Key Arguments considered by CBSL for its policy stance announced on 24th Nov-23

- ✓ Stable inflation outlook over the medium term and subdued demand pressures.
- ✓ Market interest rates are expected to normalise in the period ahead.
- ✓ Credit to the private sector is expected to increase further in the period ahead, thereby supporting the envisaged rebound of domestic economic activity.

Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, there is a **80% possibility for CBSL to maintain SDF rate at its current level,** allowing further strengthening of key economic indicators. Moreover, there is a **20% probability for CBSL to relax the SDF rate, with a probability of 10% for a rate cut of 100bps, 5% for rate cut of 50bps and another 5% for 150bps rate cut** in order to reduce rates and government security yields at a faster pace to facilitate the strengthening of the Financial sector. Moreover, we believe there is a **50% possibility for CBSL to maintain SLF rate at its current levels**, while there is an **equal probability of the CBSL adopting a singular monetary policy stance, potentially resulting in a 100bps reduction in the SLF rate (refer slide 4).** Further, there is **85% possibility to keep SRR unchanged,** while considering the risk associated with it **there is a 15% possibility for a SRR hike of 50bps.**

Expected Monetary Policy Stance	SDF Probability	SLF Probability
Raising Policy Rates by 50bps	0%	
Policy Rates to remain unchanged	**80%**	**50%**
Cutting Policy Rates by 50bps	**5%**	
Cutting Policy Rates by 100bps	**10%**	**50%**
Cutting Policy Rates by 150bps	**5%**	

We believe that there is 80% probability for SDF to be maintained at its current level, while 50% probability for SLF to be maintained, allowing further strengthening of key economic indicators

Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	**15%**
SRR to remain unchanged	**85%**
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

Considering the reduction of SRR by 200bps to 2% on 09th Aug 2023 we expect SRR to remain unchanged at the same levels.

Expected Single Monetary Policy Stance

At the annual policy statement 2024, the Governor of the CBSL declared a strategic shift, indicating a transition towards a single policy interest rate mechanism, instead of the existing dual policy interest rates to improve the monetary policy transmission and signalling effect of the monetary policy stance. As per our view, at the upcoming policy meeting, there is a **50% possibility for CBSL to maintain SLFR rate at its current levels**, while there is an **equal probability of the CBSL adopting a singular monetary policy stance, potentially resulting in a 100bps reduction in the SLFR rate.**

Sri Lanka central bank to consider a single policy rate mechanism

By Uditha Jayasinghe and Swati Bhat

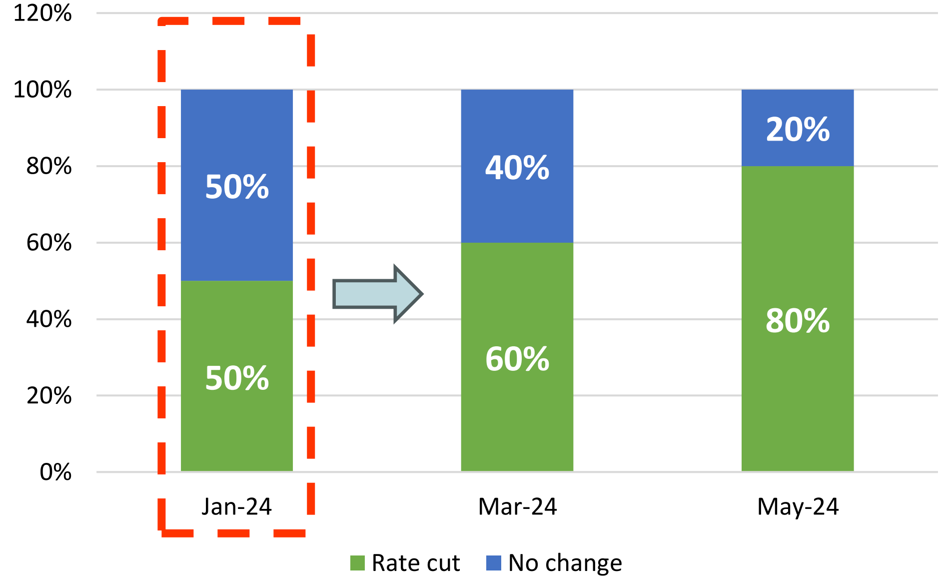
January 10, 2024 1:32 PM GMT+5:30 · Updated 8 days ago

Expected Single Monetary Policy Stance	Probability
Policy Rates to remain unchanged	50%
Cutting SLF Policy Rate by 100bps	50%

100%

We believe that there is 50% probability for SLF rates to be maintained at its current level allowing further strengthening of key economic indicators

If SLFR maintained at its current level in Jan-24, probabilities for a rate cut significantly increases in Mar-24 & May-24



Analysis of upcoming policy decision on 22nd Jan

Arguments against a Monetary Relaxation

80%

- Central bank's intent to halt monetary easing to allow for market adjustments
- Yield movement temporarily paused by concerns over External debt restructuring
- Inflow of funds spurs liquidity in the financial system
- GDP turnaround in 3Q2023 and sustained Credit growth on track
- Potential cost-push inflationary pressures

The above-mentioned factors argue against a relaxation in policy rates at the upcoming policy meeting

The below-mentioned factors argue for a relaxation in policy rates

- Demand constraints amidst tax hike
- Reserve position surge enhances margin of safety
- Global policy rates peak, shifting gradually to dovish stance
- CBSL to adopt single monetary policy stance

Arguments for a Monetary Relaxation

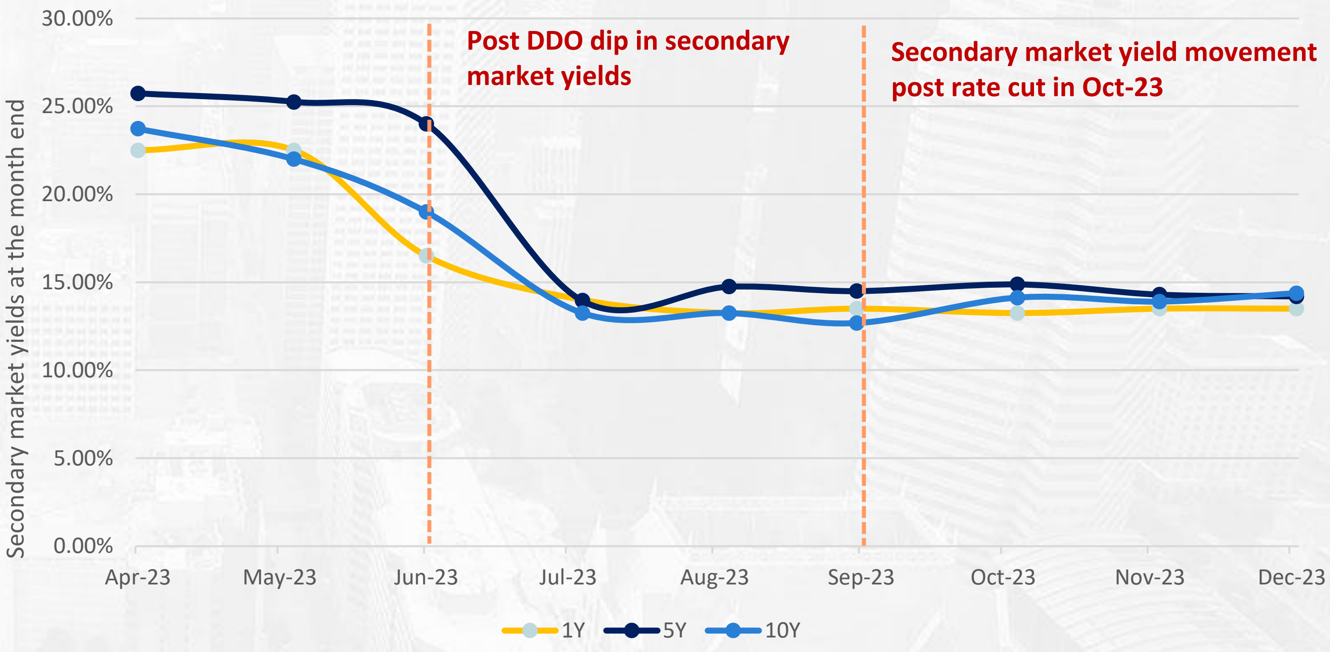
20%

Arguments *against a relaxation* in monetary policy

Arguments against a relaxation in monetary policy

Central bank's intent to halt monetary easing to allow for market adjustments

In its most recent monetary policy meeting on 22nd Nov 2023, the CBSL announced that substantial monetary easing has been implemented since Jun 2023. Emphasizing the necessity for swift transmission of these measures to market interest rates, particularly lending rates, the CBSL aims to expedite the normalization of market interest rates. The central bank also declared a temporary pause in further monetary policy easing, citing sufficient room for market interest rates to adjust downward in line with current and past measures. Despite a significant decline in secondary market yields post-DDO in Jul 2023, the CBSL noted that subsequent rate cuts have not led to substantial changes in the bond yields. Hence, it is fitting to desist from a monetary stimulus and resort to a wait-and-see approach to avert any potential macroeconomic pressures arising from policy rate relaxation.



Source: First Capital Research

Arguments against a relaxation in monetary policy

Yield movement temporarily paused by concerns over External debt restructuring

Sri Lanka successfully finalized the IMF 1st review and obtained the approval for the 2nd tranche in Dec 2023. During the first review, the IMF urged the prompt completion of the Memorandum of Understanding with official creditors and highlighted the importance of reaching agreements with commercial creditors before concluding the second review. The IMF underscored the significance of finalizing the External debt restructuring to alleviate uncertainties currently impacting Sri Lankan businesses and hindering access to external financing. Moreover, the prevailing stagnation in secondary market yields is largely attributed to delays in finalizing the EDR, however, the expectations for its completion by the 1Q2024E, followed by a potential rating upgrade which may consequently translate into gradual decline in yields. Hence, we believe addressing and resolving uncertainties prevalent within the investor and business communities regarding the EDR is deemed imperative before considering further monetary easing measures.

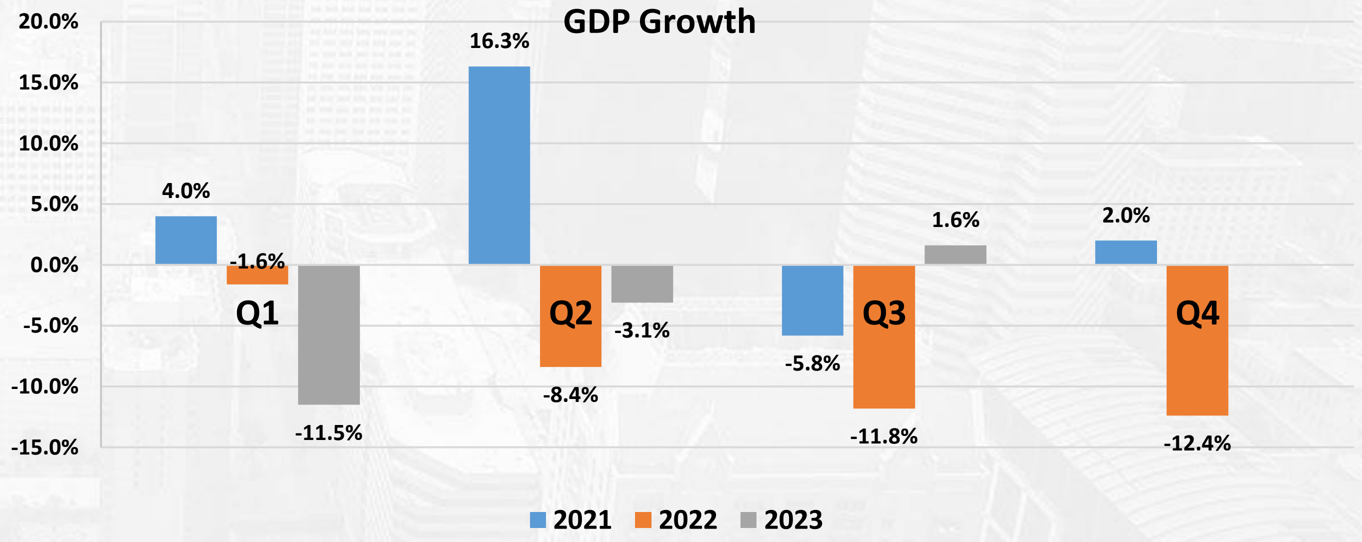
Inflow of funds spurs liquidity in the financial system

By the end of 2023, government revenue has surpassed the revised budget target, reaching LKR 3,115.0Bn, credited to the implementation of tax reforms throughout the year. Additionally, the Balance of Payments (BOP) has achieved a surplus after nearly two and a half decades, driven by a significant inflow of worker remittances and a rise in tourism earnings. On the other hand, the CBSL has consistently raised an excess of debt compared to the maturities for the 3 consecutive months till Dec 2023. We believe that the substantial influx of funds to the CBSL has the potential to induce liquidity in the system in the near future, naturally resulting in a decline in interest rates. Therefore, we believe an immediate monetary easing is unnecessary, as the existing rate cuts are deemed sufficient to propel the economy in the short term.

Arguments against a relaxation in monetary policy

GDP turnaround in 3Q2023 and sustained Credit growth on track

During the 3Q2023, Sri Lanka's economy exhibited a moderate YoY growth of 1.6%, marking a notable turnaround from the contraction experienced since 1Q2022. Notably, both the manufacturing and services purchasing manager indices exhibited robust growth in Nov 2023, driven by seasonal factors, with manufacturing surpassing the neutral threshold of 50.0, driven by increased new orders and production. Concurrently, the private sector credit witnessed a consecutive monthly growth of LKR 62.9Bn in Nov 2023, indicating a resurgence in gross loan disbursements aligned with declining interest rates and a rebound in business activities. The sustained upward trajectory in private sector credit until Nov reflects an acceleration in economic activities by both businesses and individuals, contributing to the GDP turnaround in the 3Q2023. Despite the sharp decline in lending rates (AWPLR lowered to 11.87% in Jan 2024), caution is advised against policy relaxation, as it may potentially result in excessive borrowing and spending, posing a risk of overheating the economy. Therefore, maintaining a prudent approach is recommended to prevent any unwarranted economic imbalances.

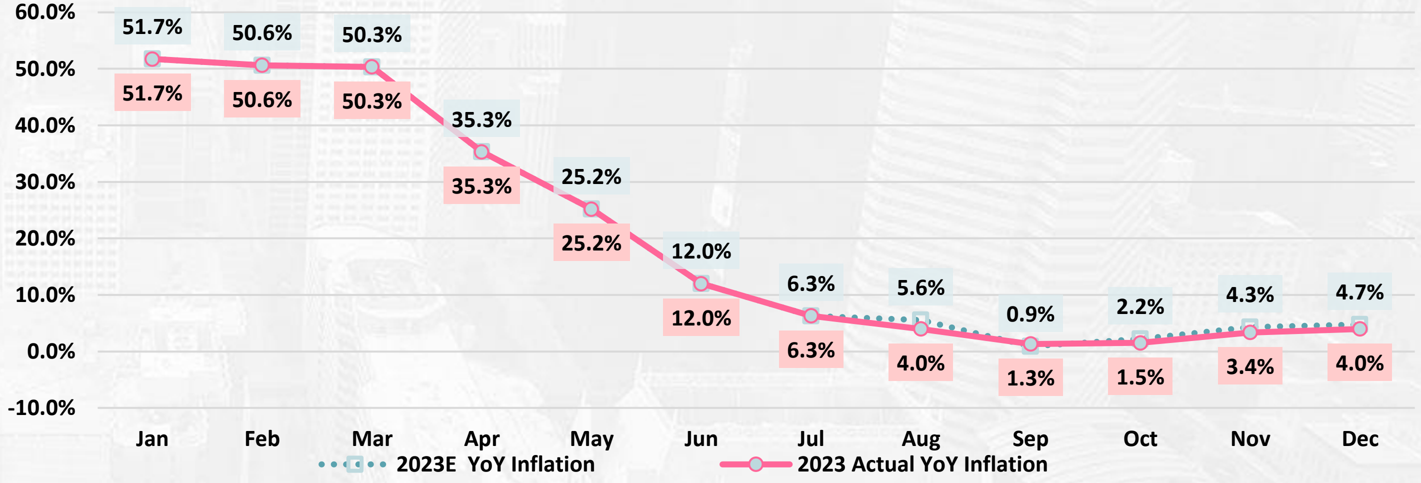


Source: CBSL

Arguments against a relaxation in monetary policy

Potential cost-push inflationary pressures

In Dec 2023, inflation experienced a notable acceleration, with the YoY CCPI rising to 4.0%, compared to 3.4% in Nov 2023. Both Food and Non-Food items contributed to this increase, with a 0.3%YoY uptick in Food and a substantial 5.8%YoY increase in Non-Food items, primarily driven by a significant 3.9% contribution to YoY inflation from the non-food group, particularly led by a peak in Housing, Water, Electricity, Gas, and other fuels. Against the backdrop of ongoing tax reforms and recent power tariff adjustments, an overall surge in prices is anticipated in the near term, potentially resulting in cost-push inflation. Despite the current inflation remaining below the Central Bank's targeted 5.0% range, the prevailing low-interest-rate environment has led to a surge in credit, posing a potential risk of demand-pull inflation through increased borrowing. This could lead to inflation surpassing the targeted range, exerting unnecessary inflationary pressure. Therefore, it is deemed advisable to refrain from implementing additional monetary stimulus at this juncture.



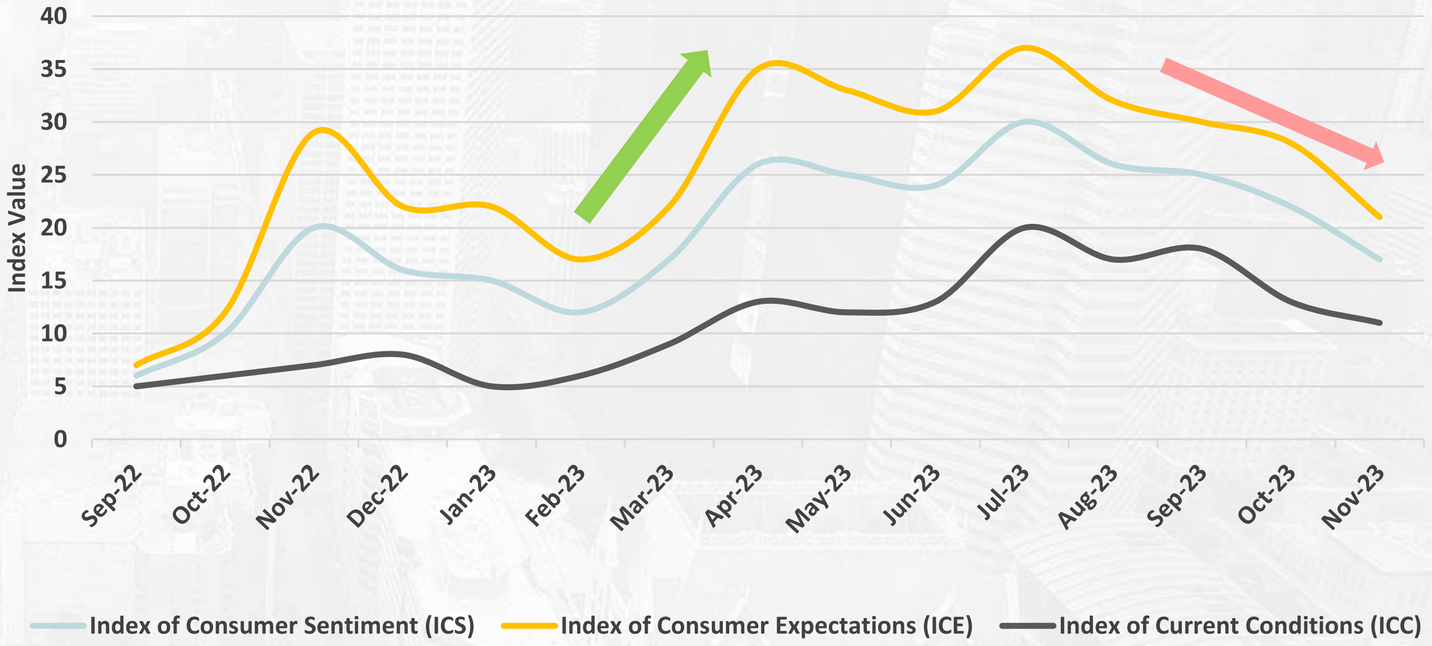
Source: Dept. Census and Statistics, First Capital Research

Arguments *for relaxation* in monetary policy

Arguments for relaxation in monetary policy

Demand constraints amidst tax hike

To achieve the 2024 IMF revenue target of LKR 4.2Tn, the government enacted tax reforms, elevating the VAT rate from 15% to 18%, effective from 1st Jan 2024, marking its highest level in two decades. The subsequent adjustments in prices for essential items, comprising electricity, fuel, gas, and food, have raised concerns about potential social unrest, given the anticipated decline in disposable income. This situation poses a challenge where the positive impact of wage hikes might be offset by the additional tax burden, potentially impacting overall consumer spending patterns. Faced with concerns about inflation, consumer spending has shifted toward essential items, indicating a cautious approach to discretionary expenditures. In light of these challenges, it is advisable to consider a relaxation in policy rates to restore consumer confidence in the economy and facilitate a recovery in demand.

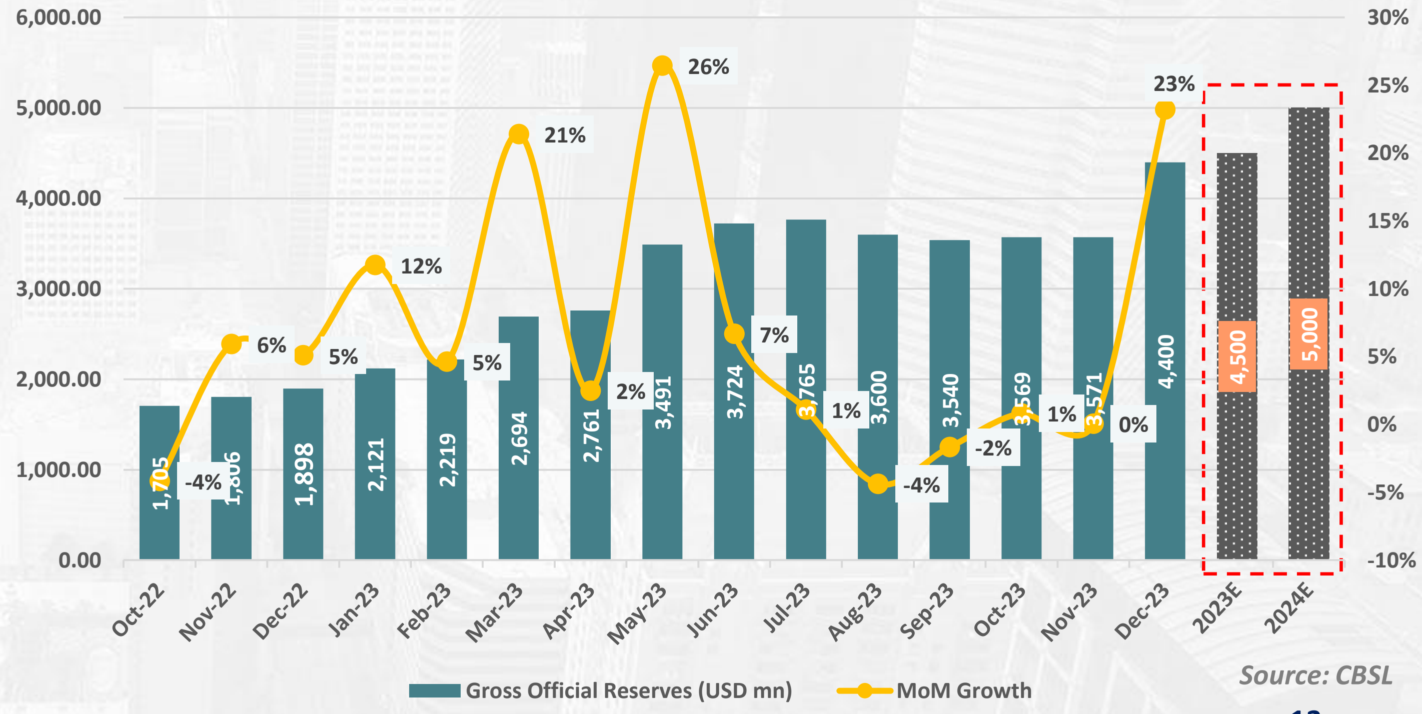


Source: DCS

Arguments for relaxation in monetary policy

Reserve position surge enhances margin of safety

In Dec 2023, Sri Lanka's official reserve assets saw a significant rise, reaching USD 4.4Bn, boosted by financial support from multilateral lenders such as the ADB, World Bank, and IMF. The reserves level for 2023 aligns closely in line with First Capital Research 2023 expectation of USD 4.5Bn. Notably, reserves increased by USD 829.0Mn in Dec 2023, marking the most substantial MoM absolute rise since Dec 2021. The Ministry of Finance attributes this notable boost to the disbursement of USD 337.0Mn by the IMF, along with contributions of USD 200.0Mn from the ADB and USD 250.0Mn from the World Bank. Given Sri Lanka's status as a net importer, unlocking the economy for imports is expected to bolster economic growth and business confidence. As First Capital Research expects reserved position to continue strengthen in 2024E to reach LKR 5.0Bn, and demonstrating a sufficient margin of safety, we believe that the CBSL is well-positioned to consider another prudent rate cut, a measure aptly poised to accelerate the ongoing economic recovery.

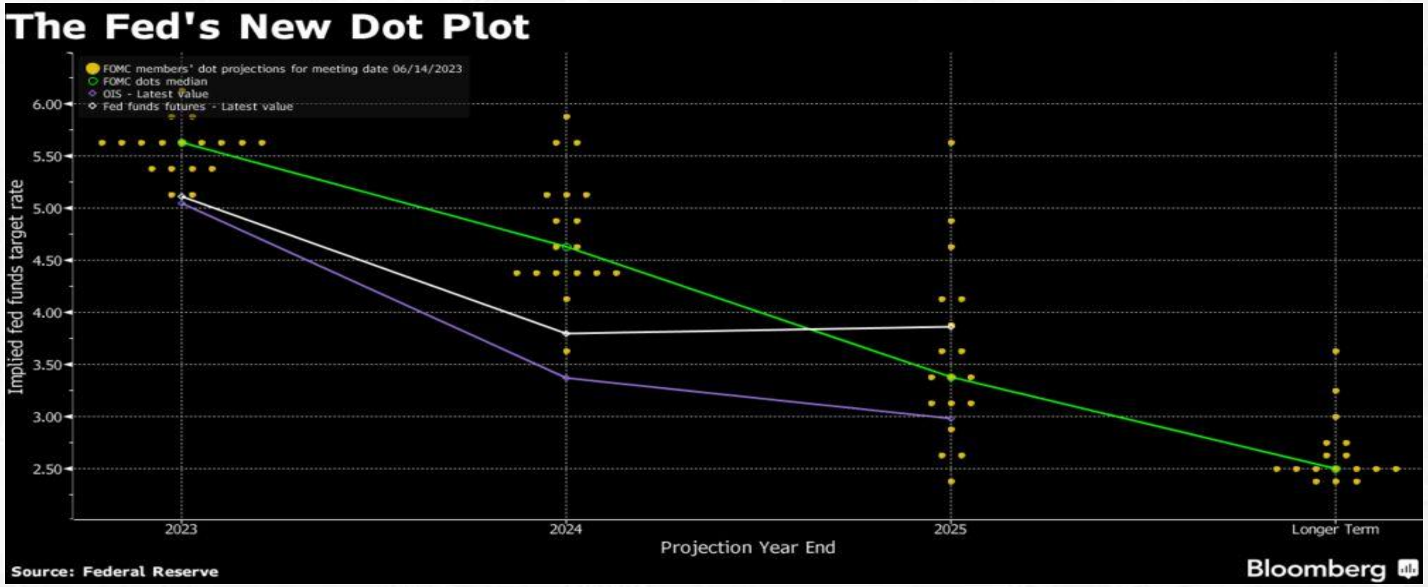


Source: CBSL

Arguments for relaxation in monetary policy

Global policy rates peak, shifting gradually to dovish stance

As of the 3Q2023, policy interest rates in the US, eurozone, and the UK have remained stable, likely reaching their peaks for the current tightening cycle. Considering the recent dovish statements from Fed Chairman Jay Powell, it is anticipated that the next actions from the Federal Reserve (Fed), European Central Bank (ECB), and Bank of England (BOE) will involve rate cuts, although at a pace slower and less pronounced than currently anticipated by financial markets. Fitch Ratings further projects a 75bps reduction in policy rates by the end of 2024 across these three economies. This would result in the Fed Funds rate (upper band) settling at 4.75%, the ECB Main Refinancing Rate at 3.75%, and the BOE Bank Rate at 4.50%. This shift in monetary policy is deemed beneficial for frontier economies like Sri Lanka, potentially alleviating pressure arising from a strengthening USD due to rising rates. This positive outlook on the external front provides support for a relaxation of policy rates from their current levels, potentially reducing prevailing high real interest rates.



Arguments for relaxation in monetary policy

CBSL to adopt single monetary policy stance

During the annual policy statement 2024, the Governor of the CBSL announced a strategic shift towards adopting a single policy interest rate mechanism, departing from the existing dual policy rates. This adjustment aims to enhance the effectiveness of monetary policy transmission and strengthen the signaling impact of the overall monetary policy stance. The decision to pursue this change stems from the limitations within the current system, which involves both the SDFR and SLFR. Therefore, we anticipate a potential reduction in the SLFR, which is currently standing at 10%.

Factors in consideration at the policy review

Inflation
CCPI 4.0% for Dec-23

Foreign Reserves
USD 4.4Bn by Dec-23

GDP Growth
+1.6% in 3Q2023

03M T-Bill rate
14.27% as of 10th Jan-24

Private Credit
rises by LKR 62.9Mn in Nov-23

Liquidity and CBSL Holdings
LKR -122.8Bn and LKR 2.8Tn

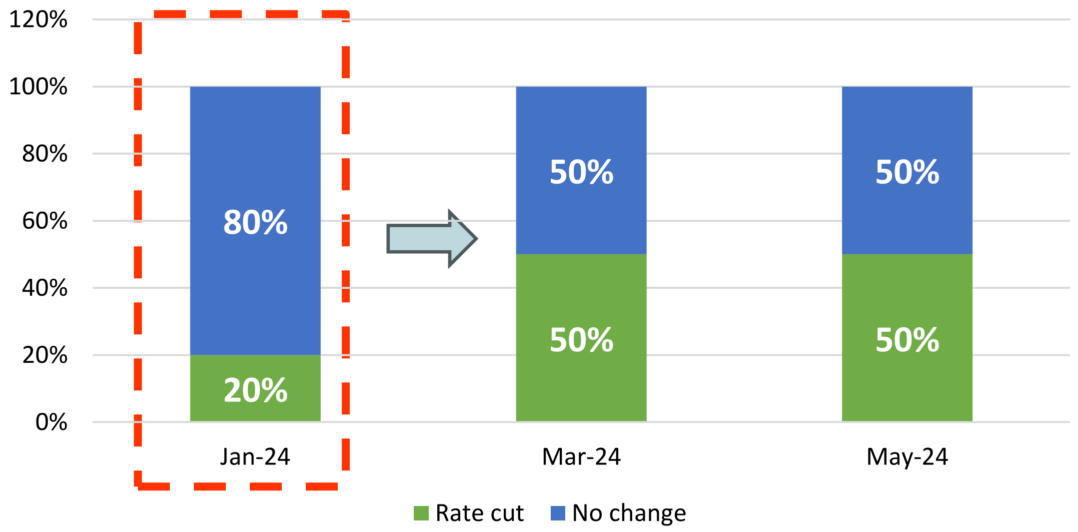
BOT and BOP
USD -4.4Bn and USD 1.9Bn for Jan-Nov -23

FCR Policy Rate Forecast (Jan 24 – May 24)

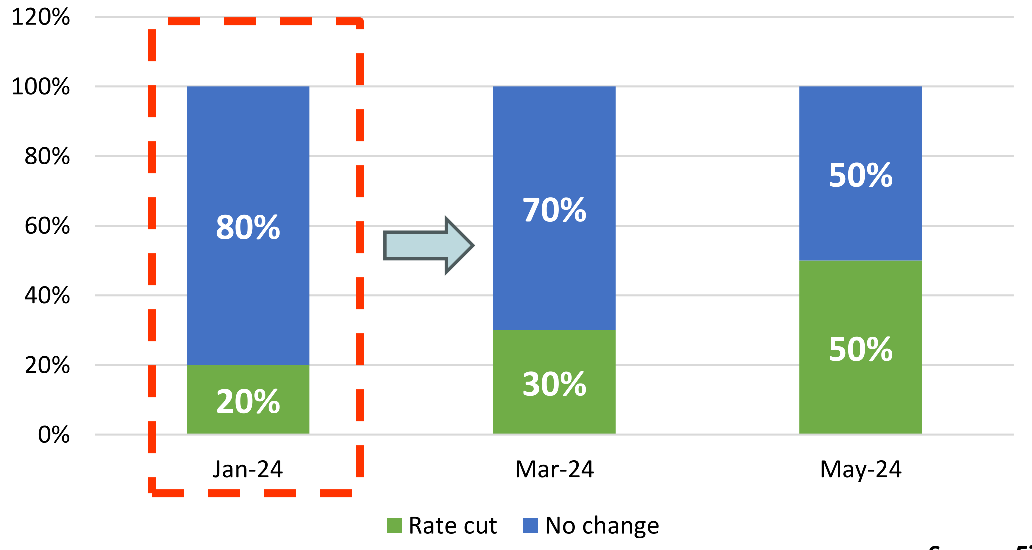
We believe that there is a 80% probability that CBSL may consider maintaining policy rates in the upcoming policy review meeting before gradually moving into a dovish stance allowing further strengthening of key economic indicators. With economic indicators stabilizing and the economy projected to recover during 2H2023 with a drastic slowdown of inflation witnessed in 3Q2023, we believe a monetary relaxation may not be the need of the hour.

However, considering both arguments for and against monetary easing, we have also assigned 20% probability for a relaxation in policy rates with a view to stimulate economic growth and accelerate the decline with interest rates.

If there is no rate cut in Jan-24, probabilities for a rate cut significantly increases in Mar-24 & May-24

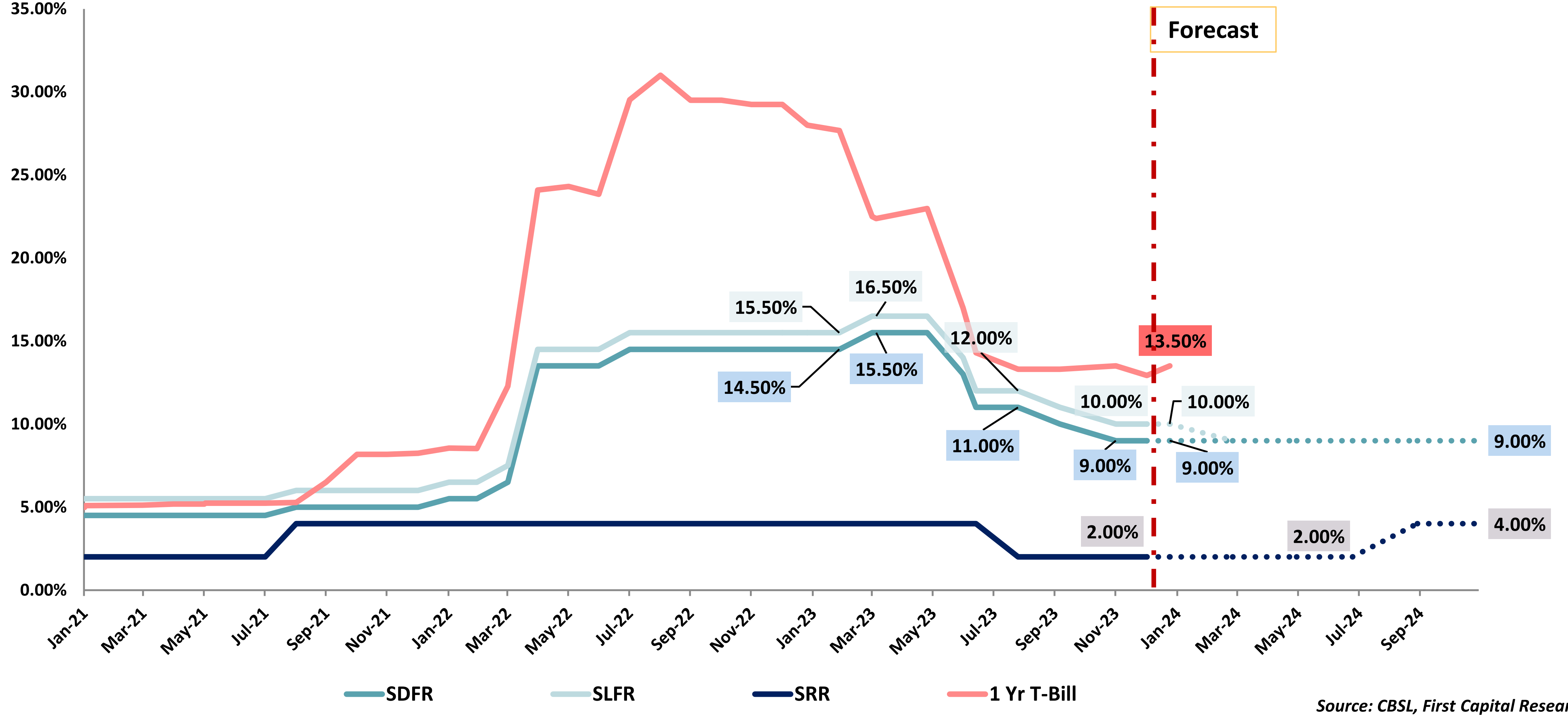


If a rate cut is given in Jan-24, probabilities for a rate cut in Mar-24 is low



Source: First Capital Research

Monetary Policy Rates



Source: CBSL, First Capital Research

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Thank you!

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