MONETARY MONOPOLY:

“PLAYING THE SINGLE POLICY CARD”

PRE-POLICY ANALYSIS

19TH MAR 2024

First Capital Research

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First Capital
A Janashakthi Group Company

Previous Pre-policy report: Recap

The CBSL maintains policy rates at current levels

In line with our prediction, CBSL decided to maintain the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) at their current levels of 9.00% and 10.00%, respectively at the monetary policy review announced on 23rd Jan-24. The decision follows a thorough evaluation of both domestic and international macroeconomic conditions, with the aim of sustaining inflation at the targeted level of 5.0% in the medium term. The Board has considered recent changes in taxation and supply-side factors, which may exert upward pressure on inflation in the short term. However, the Board believes that these developments will not significantly alter the medium-term inflation outlook. Furthermore, the Board highlighted that there is sufficient room for market interest rates to adjust downward in line with past measures and the reduction in risk premia associated with government securities.

Key Arguments considered by CBSL for its policy stance announced on 23rd Jan-24

- ✓ Stable inflation outlook over the medium term and subdued demand pressures.
- ✓ A further decline in market lending interest rates is expected in the period ahead.
- ✓ Domestic economic activity is expected to sustain the recovery over the medium term.
- ✓ The external sector is expected to remain resilient in the period ahead.

Expected Monetary Policy Stance

The current economic landscape paints a picture of stability with a notable upswing in GDP during 4Q2023, coupled with a decline in headline inflation to 5.9% in Feb 2024, rising consumer confidence, and a flourishing external sector fueled by increased worker remittances and tourism earnings. Therefore, we believe that an immediate monetary relaxation may not be required at this juncture. Consequently, we assign an **80% probability for CBSL to maintain the SDF rate at its current level,** with a mere **20% probability to relax the SDF rate, potentially resulting in a 100bps reduction in the SDF rate.** However, in order to establish a singular monetary policy stance in light of the prevailing stability in the economy and to address temporary concerns on increased taxes and subdued demand, there is a strong likelihood of a **70% possibility for CBSL to relax the SLF rate, potentially resulting in a 100bps reduction in the SLF rate, whilst there is a 30% possibility to maintain the SLF rate at its current level (refer to slide 4).** Furthermore, there is an **85% possibility to keep SRR unchanged,** whilst there is a **15% possibility for a SRR hike of 50bps**, considering the risks associated with it.

Expected Monetary Policy Stance	SDF Probability	SLF Probability
Raising Policy Rates by 50bps	0%	0%
Policy Rates to remain unchanged	**80%**	**30%**
Cutting Policy Rates by 50bps	0%	0%
Cutting Policy Rates by 100bps	**20%**	**70%**
Cutting Policy Rates by 150bps	0%	0%

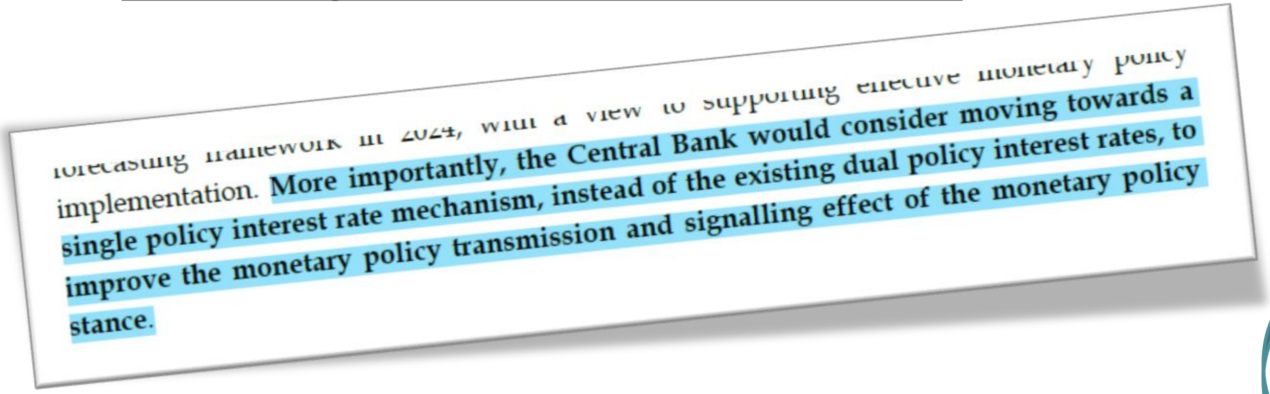
We believe that there is an 80% probability for SDF to be maintained at its current level, whilst 30% probability for SLF to be maintained, as current economic indicators are showing signs of stabilization.

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 level.

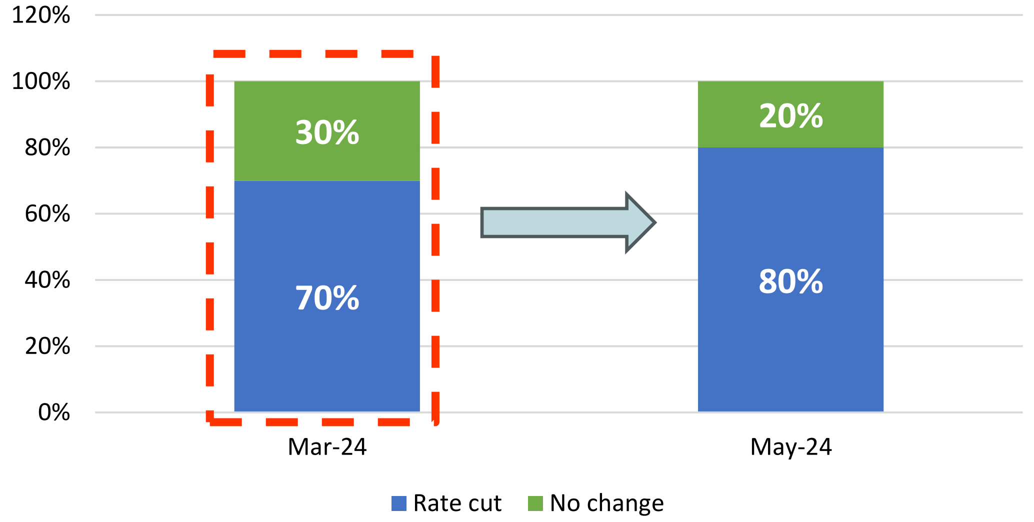
Single Monetary Policy Stance

CBSL has declared a strategic shift in its monetary policy stance, indicating a transition towards a single policy interest rate mechanism, instead of the existing dual policy interest rates currently in place, to improve the monetary policy transmission and signaling effect of the monetary policy stance. As per our view, at the upcoming policy meeting, there is a **70% possibility for CBSL to relax SLFR, potentially resulting in a 100bps reduction in the SLFR**, while there is a **30% probability of the CBSL maintaining the SLFR rate at its current level.**


forecasting framework in 2024, with a view to supporting effective monetary policy implementation. More importantly, the Central Bank would consider moving 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.

CBSL Annual Policy Statement 2024 – Jan 2024

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



Expected Single Monetary Policy Stance	Probability
Cutting SLF Policy Rate by 100bps	70%
Policy Rates to remain unchanged	30%

100%

We believe that there is 70% probability for an SLF rate cut to adopt a single monetary policy stance.

Analysis of upcoming policy decision on 26th Mar

Arguments against a Monetary Relaxation

80%

- CBSL prioritizes market adjustments, noting sufficient room for maneuver
- Potential cost-push and demand-pull inflation currents
- Fed and BOE hold steady amid inflationary tensions
- External debt restructuring stands critical for economic stability
- Relaxation in borrowing limits boosts liquidity in the financial system

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

- Subdued demand undermines consumer and business sentiments
- Private credit takes a dip after 7 months of growth
- CBSL to adopt a single monetary policy stance
- Rising reserves improves margin of safety

Arguments for a Monetary Relaxation

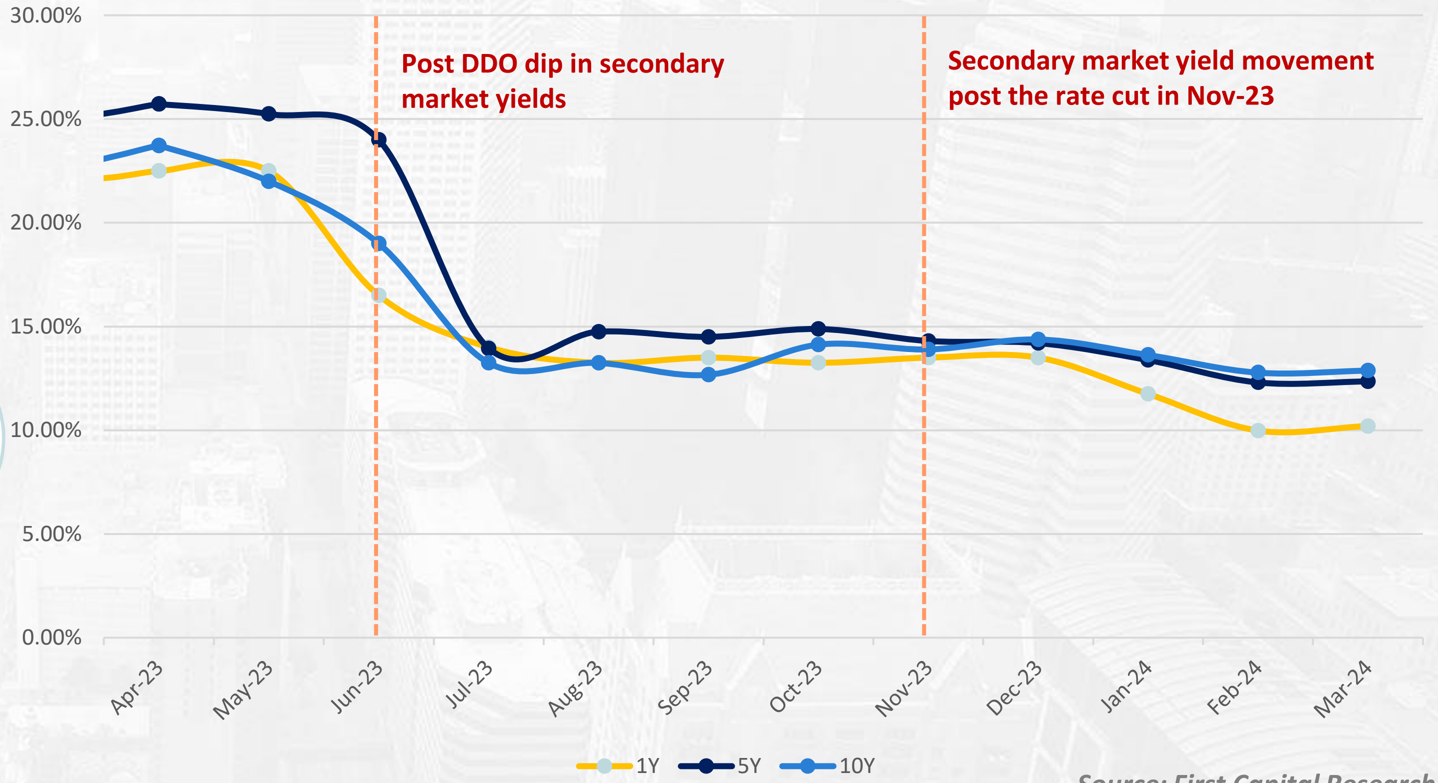
20%

Arguments *against a relaxation* in monetary policy

Arguments against a relaxation in monetary policy

CBSL prioritizes market adjustments, noting sufficient room for maneuver

In its monetary policy meeting round in Jan 2024, CBSL declared that there is sufficient room for market interest rates to decline in the period ahead, in line with the substantial monetary easing since Jun 2023 and the falling risk premia of government securities. Accordingly, T-Bill yields declined by 12.0%-15.0% by Mar 2024, following the monetary policy easing stance since Jun 2023, while T-Bond yields have also displayed moderation, paving the way for a normalized upward-sloping yield curve, which is indicative of a more balanced market landscape. Given these developments, the decision to refrain from further monetary stimulus and adoption of a cautious approach is deemed appropriate to preempt any potential macroeconomic pressures stemming from relaxation in policy rates.

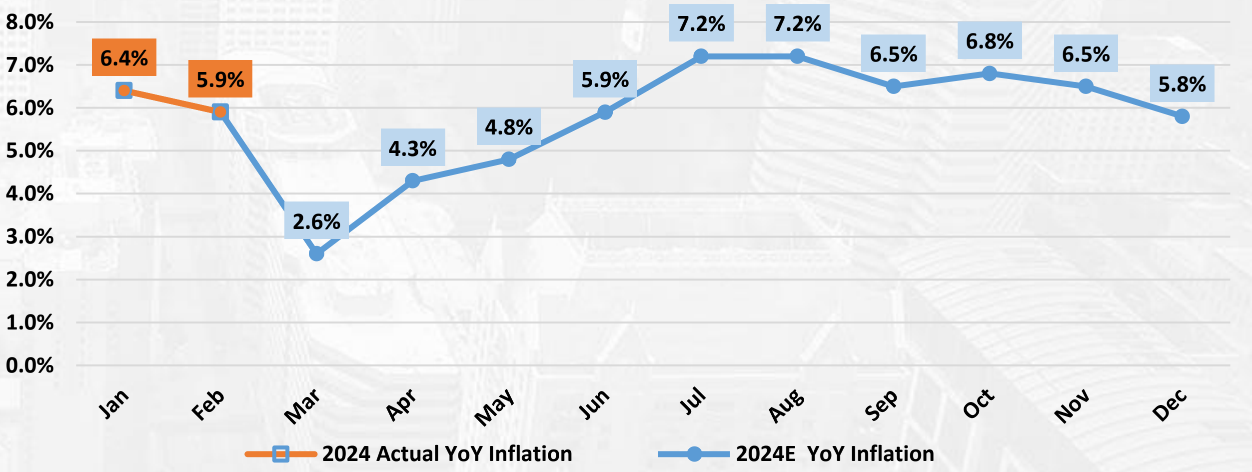


Source: First Capital Research

Arguments *against a relaxation* in monetary policy

Potential cost-push and demand-pull inflation currents

In Feb 2024, inflation exhibited a deceleration, with the YoY CCPI decreasing to 5.9%, compared to 6.4% in Jan 2024, although it remained above CBSL's targeted level of 5.0%. The decrease was primarily driven by non-food items, which saw a 7.0%YoY decline, notably contributed by reductions in the Transport and Furnishing Household Equipment categories, making a significant 4.7% contribution to YoY inflation. Looking ahead, headline inflation is expected to accelerate in the short term, driven by domestic price adjustments following the implementation of the VAT hike to a 20-year high of 18.0% and the elimination of VAT exemptions on 97 out of 138 goods. However, it is projected to stabilize around the targeted level over the medium term. Additionally, inflation is anticipated to peak in 3Q2024, influenced by an unfavorable base effect resulting from sharp disinflation recorded in the same period of 2023. Furthermore, recent reductions in both electricity tariffs by 21.9% and fuel prices in Mar 2024, coupled with the potential for price decreases in domestic goods due to increased competition from imports, may stimulate demand in the economy in the coming months, leading to demand-pull inflation. Such developments may push inflation beyond the targeted range, thereby exerting an unwarranted inflationary pressure. Consequently, it is prudent to exercise caution in implementing further monetary stimulus measures at this juncture.

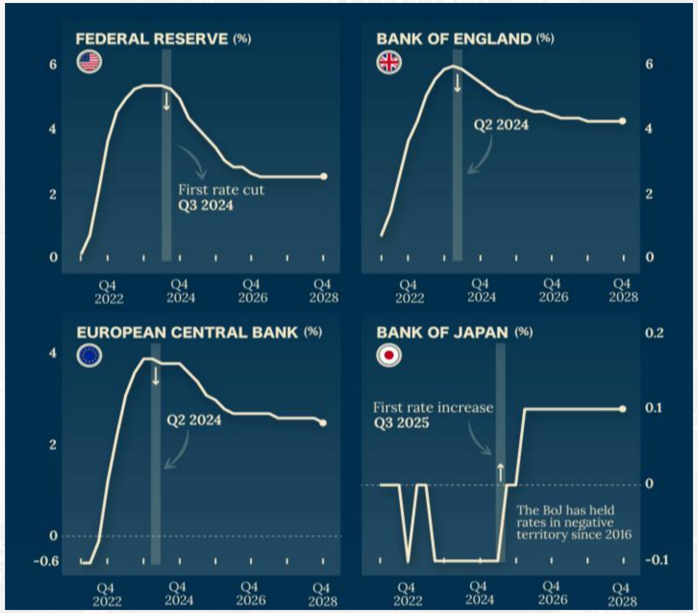


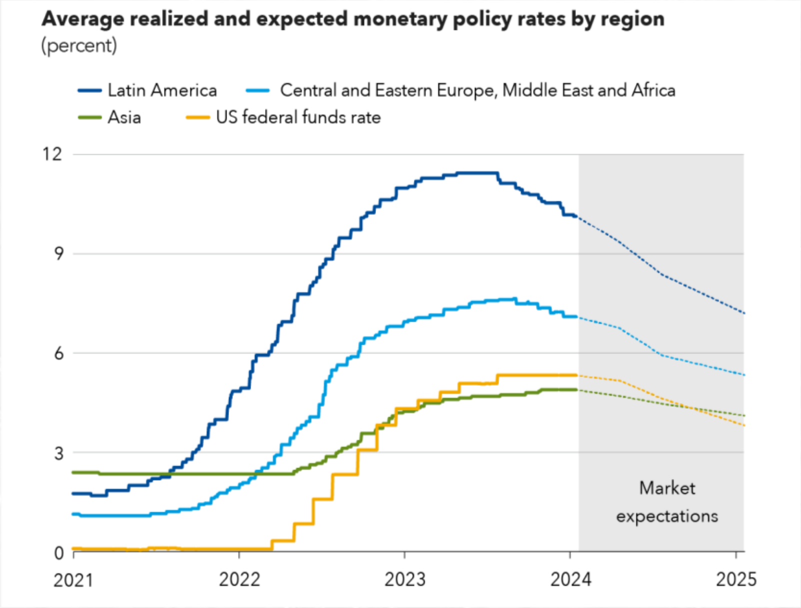
Source: Dept. Census and Statistics, First Capital Research

Arguments against a relaxation in monetary policy

Fed and BOE hold steady amid inflationary tensions

The US Federal Reserve (Fed) is expected to cut policy rates by end of 2Q2024, despite headline inflation rising by 3.2% in Feb-24, slightly exceeding the 3.1% increase recorded in Jan 2024. With a 2nd consecutive month of higher-than-expected inflation, the prospect of a Fed rate cut before Jun 2024 has diminished and signals possible delays in anticipated Fed rate cuts. Policymakers forecasted that inflation would fall to 2.1% by 2025, and eventually align with the 2.0% target by 2026. However, with the gap between inflation and its 2.0% target increasing, it appears reasonable to consider a fourth pause in rate hikes. Similarly, the Bank of England (BOE) is anticipated to maintain higher interest rates for an extended period before implementing more substantial rate cuts in 2H2024. The BOE forecasted that inflation will return to its 2.0% target for the first time in three years during 2Q2024, and it is anticipated that BOE will currently maintain its policy rates, with the possibility of a first-rate cut anticipated in 3Q2024, with a 40% chance of such action occurring in 2Q2024. Moreover, central banks in the Asian region are unlikely to enact rate cuts ahead of the Fed due to the stronger USD, which is keeping most Asian currencies weaker, as noted by Morgan Stanley.





Source: IMF

Arguments *against a relaxation* in monetary policy

External debt restructuring stands critical for economic stability

External debt restructuring (EDR) discussions have seen significant progress, particularly with Sri Lanka reaching agreement in principle with its Official Creditor Committee on the financial terms of a debt treatment covering USD 5.9Bn in outstanding public debt. While negotiations regarding International Sovereign Bonds (ISBs) are currently ongoing with the bondholder group, an imminent conclusion is expected which paves the way for EDR. Upon reaching an agreement on EDR, Sri Lanka stands to potentially achieve a rating upgrade, which could bolster foreign activity in the market. This, in turn, may contribute to yields lowering further and fosters a stronger recovery in economic activity and credit growth. Given these potential benefits, it is crucial to address and resolve uncertainties prevailing within the investor and business communities regarding EDR before considering further monetary easing measures.

Relaxation in borrowing limits boosts liquidity in the financial system

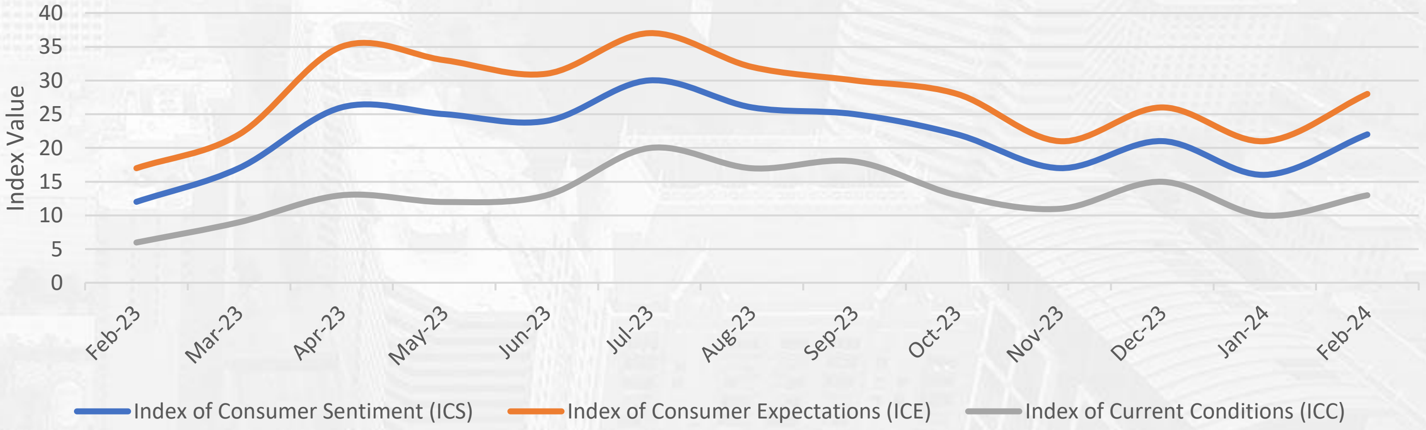
The overall rupee liquidity in the domestic money market continued to improve in 2024, primarily after the CBSL relaxed the borrowing limits for Licensed Commercial Banks (LCBs) in Feb 2024. The decision followed a review of the prevailing market developments and improved liquidity conditions. CBSL now expects that this relaxation will further stimulate interbank lending and borrowing, accelerating a decline in market interest rates in line with its monetary policy direction. Consequently, we believe that this will increase the borrowing power of banks and improve lending activities, potentially stimulating liquidity within the financial system in the coming months. This, in turn, could pave the way for a gradual decline in interest rates. As such, we believe that an immediate monetary easing is unnecessary, as the current rate adjustments are deemed sufficient to provide the necessary impetus to the economy in the short term.

Arguments *for relaxation* in monetary policy

Arguments for relaxation in monetary policy

Subdued demand undermines consumer and business sentiments

In Feb 2024, Sri Lanka recorded an improvement in consumer confidence due to a resurgence in optimism regarding the country's situation in the next 12 months and a rebound in purchasing conditions. This followed a period of subdued confidence experienced in Jan 2024, which had dipped to its lowest levels since the initiation of the IMF program. Meanwhile, the government revenue reached LKR 3,115.0Bn in 2023, with tax revenue accounting for 88.3% of the revenue, driven by a remarkable 144.6%YoY increase in the number of tax filings. To sustain this momentum, the government has set a revenue target of LKR 4.2Tn for 2024, aiming to achieve it through increased VAT and tax collections, coupled with the expansion of the tax base by almost doubling it to 1.0Mn by this year-end. Additionally, the rise in private sector wages is expected to bolster PAYE tax collections. However, these measures could potentially impact consumer confidence, as the positive effects of wage increases might be offset by tax burden on the current non-tax paying community, potentially altering overall consumer spending behavior. Furthermore, business sentiment in Feb 2024 painted a more cautious picture, with over 50.0% of businesses anticipating a worsening economic situation due to concerns over deteriorating sales in the next 12 months, amidst subdued consumer demand. This could be further exacerbated by escalating wage costs, the emigration of skilled labor, and disruptions in the supply chain, among other challenges in the coming months. In light of these challenges, it is advisable to consider a relaxation in policy rates to restore both consumer and business confidence in the economy and facilitate a faster recovery in demand.

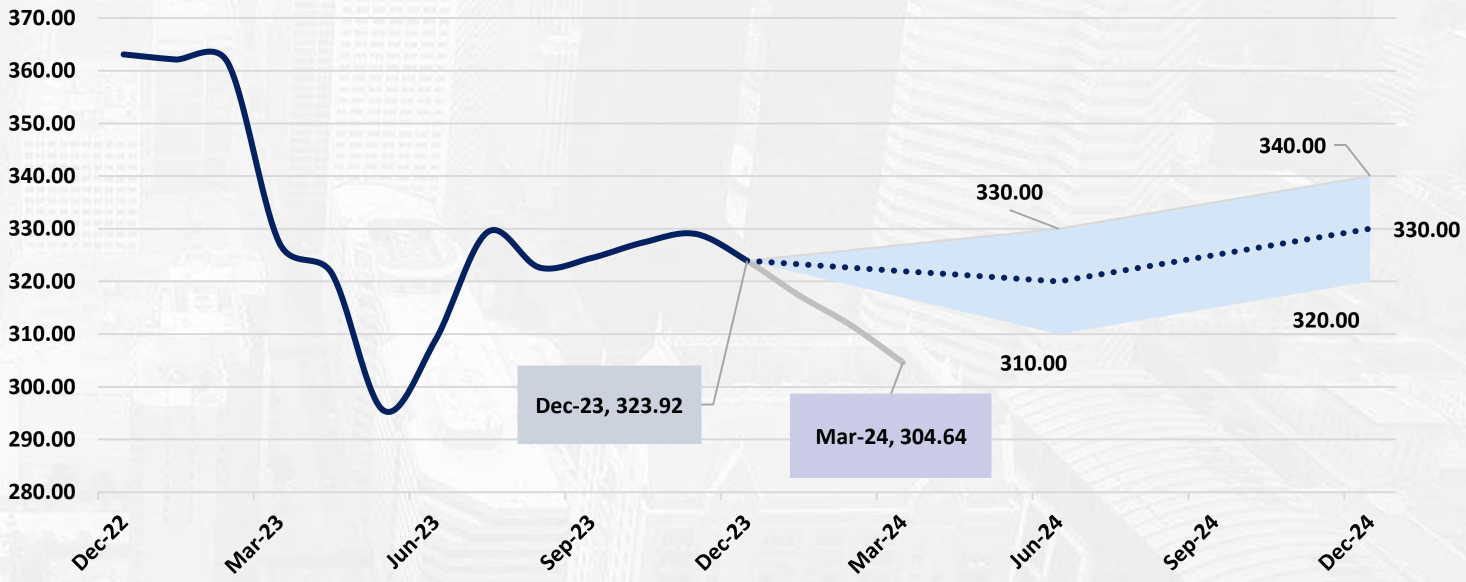


Source: IHP

Arguments for relaxation in monetary policy

Private credit takes a dip after 7 months of growth

During 4Q2023, Sri Lanka continued to exhibit a YoY GDP growth rate of 4.5%, despite experiencing a contraction of 2.3% during 2023. However, there was a degrowth in private sector credit by LKR 52.2Bn in Jan 2024, below the expectations set by First Capital Research. This decline follows 7 consecutive months of growth, despite a backdrop of declining government yields and lending rates. It suggests a potential slowdown in the economy, likely influenced by increased taxes and rising living costs. During Mar 2024, the AWPLR declined to 11.35%, reaching its lowest point since Mar 2022 and falling below the 3Yr bond rate. First Capital Research expects that the AWPLR may further decrease to a range of 10.0%-12.0% in 1H2024, given the subdued credit environment. Moreover, the appreciation of the LKR, which reached USD/LKR 304.64 as of Mar 2024, its lowest level since Jun 2023, drives additional demand for cheaper imports, consequently easing domestic inflationary pressures and stabilizing the currency in the near term. Hence, amidst a stronger currency, we believe that the CBSL is well-positioned to consider a prudent rate cut, potentially stimulating private credit growth, domestic demand, and enhancing GDP growth in the coming months.



Source: CBSL, First Capital Research

Arguments for relaxation in monetary policy

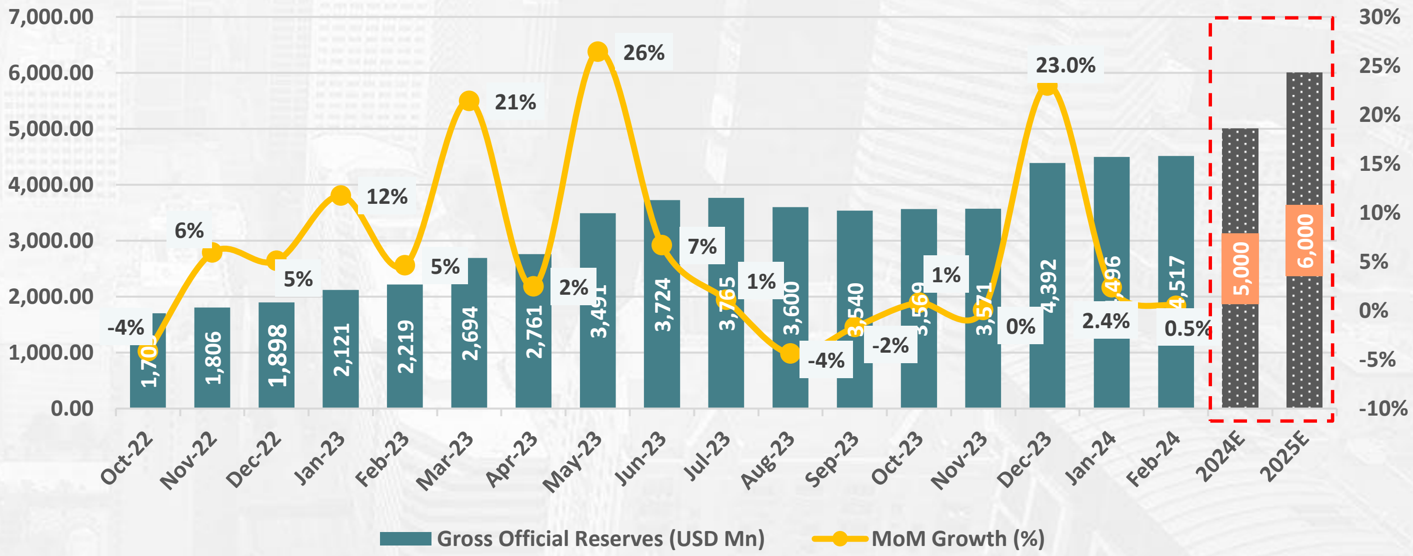
CBSL to adopt a single monetary policy stance

During the annual policy statement of 2024, CBSL unveiled a strategic transition towards implementing a singular policy interest rate mechanism in 2024, departing from the dual policy rates currently in place. This shift is intended to improve the effectiveness of monetary policy transmission and strengthen the signaling impact of the monetary policy stance. The decision to pursue this adjustment arises from the constraints inherent in the existing system, which encompasses both the SDFR and SLFR. Given the favorable conditions across various indicators, we believe that the current stability in the economy offers an optimal opportunity to contemplate a reduction in the SLFR, presently set at 10.0%.

Arguments for relaxation in monetary policy

Rising reserves enhances margin of safety

In Jan 2024, the Balance of Payments (BOP) continued its positive trajectory, showcasing a net inflow of USD 178.0Mn (c.f. USD 211.0Mn in Dec 2023). This uptrend was fueled by a significant increase in worker remittances and a rise in tourism earnings. Additionally, official reserves saw a modest uptick in Feb 2024, climbing by USD 21.0Mn to reach USD 4.5Bn, representing a 0.5%MoM growth (c.f. 2.4% MoM in Jan 2024). This was supported by financial assistance from multilateral lenders including the ADB, World Bank, and IMF, with the World Bank contributing USD 150.0Mn of financing in Feb 2024 alone. Looking forward, First Capital Research foresees a strengthening of the reserves throughout 2024, with expectations of reaching USD 5.0Bn. This optimistic projection is underpinned by anticipated improvements in worker remittances and tourism earnings, serving as crucial buffers against the widening trade deficit as the economy gains momentum and establishes a sufficient margin of safety. Given these promising indicators, we believe that the CBSL is well-positioned to contemplate another prudent rate cut, which would not only support the ongoing economic recovery but also cultivate an environment conducive to sustained growth and stability.



Source: CBSL

Factors in consideration at the policy review

Inflation
CCPI 5.9% for Feb-24

Foreign Reserves
USD 4.5Bn by Feb-24

GDP Growth
+4.5% in 4Q2023

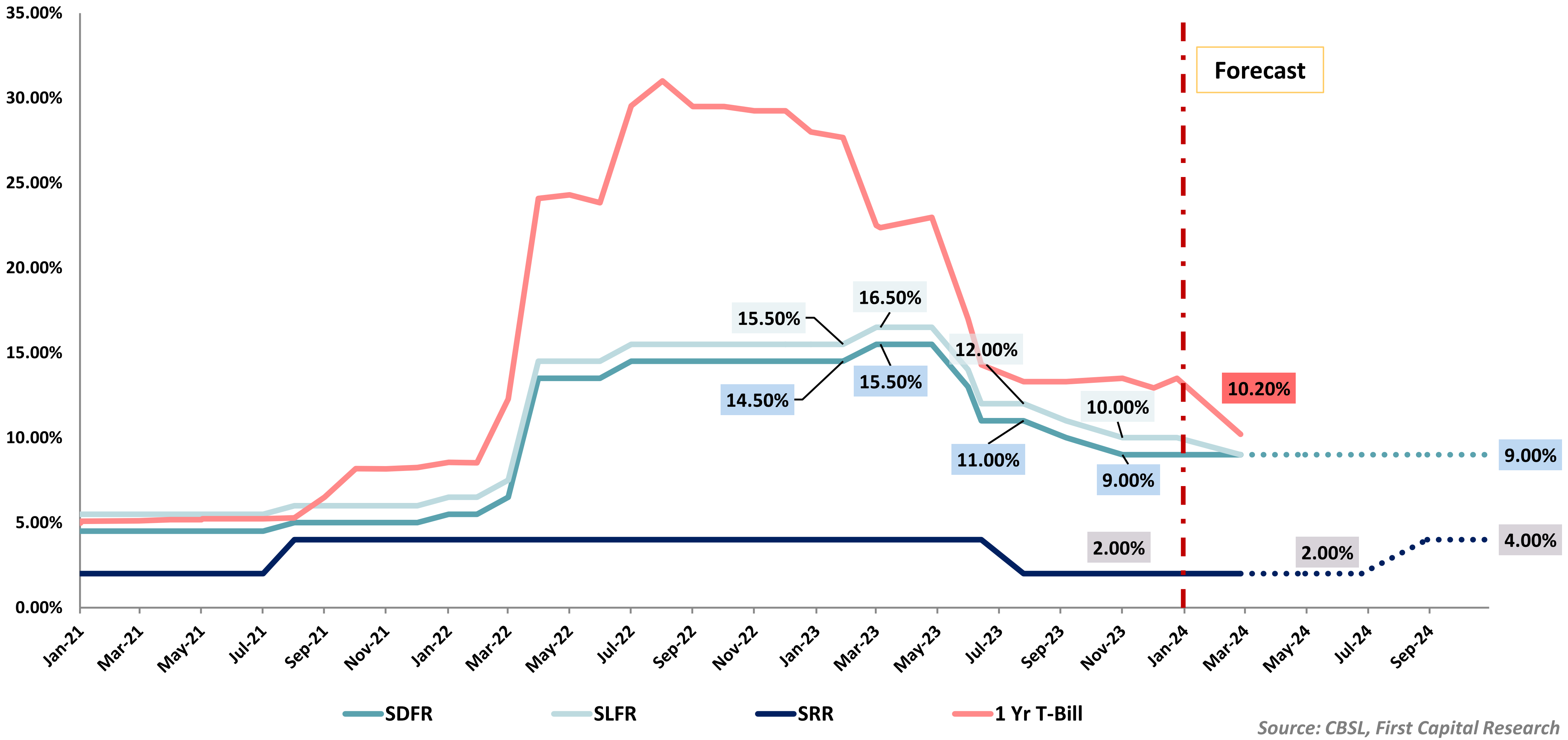
03M T-Bill rate
10.00% as of 15th Mar-24

Private Credit declined by LKR
52.2Bn in Jan-24

Liquidity and CBSL Holdings
LKR 11.9Bn and LKR 2.7Tn

BOT and BOP
USD -541.0Mn and USD 178.0Mn for Jan-24

Monetary Policy Rates



Source: CBSL, First Capital Research

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