“FIRST CAPITAL UPGRADES EXCHANGE RATE OUTLOOK”

EXCHANGE RATE REVISION – MAY 2024

First Capital Research

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Jan - Apr ’24 Currency Performance

Sri Lankan Rupee on a persistent appreciation since Nov-23 amidst higher than anticipated inflows

Expectations (Jan 2024):

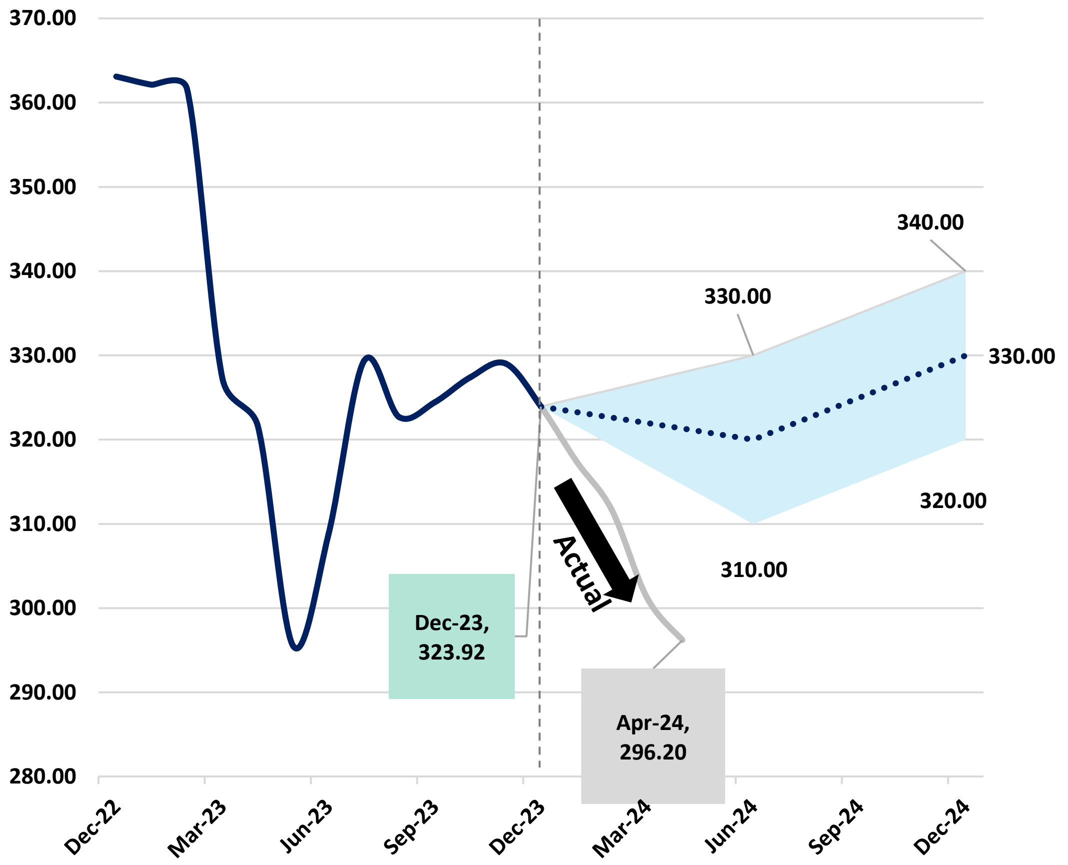
Slower economy may appreciate LKR in 1H; But depreciation pressure in 2H

Partly accurate

Strong upturn in tourism earnings, worker remittances leads currency appreciation

- The Sri Lankan Rupee has been gradually appreciating against the US Dollar since November 30th last year, marking a second instance of such appreciation. This trend is seen as a positive sign of economic recovery, supported by a positive balance in the Current Account driven by increased remittances and robustly rising tourism earnings.

- The Central Bank's efforts to bolster foreign reserves by purchasing Dollars from the market too have contributed to this appreciation. Moreover, the financial aid from multilateral agencies like IMF, World Bank and ADB during Dec-23 has further supported CBSL to strengthen its reserve positions thereby supporting the appreciation in the rupee.



Source: CBSL, First Capital Research

LKR appreciates above FCR targeted range

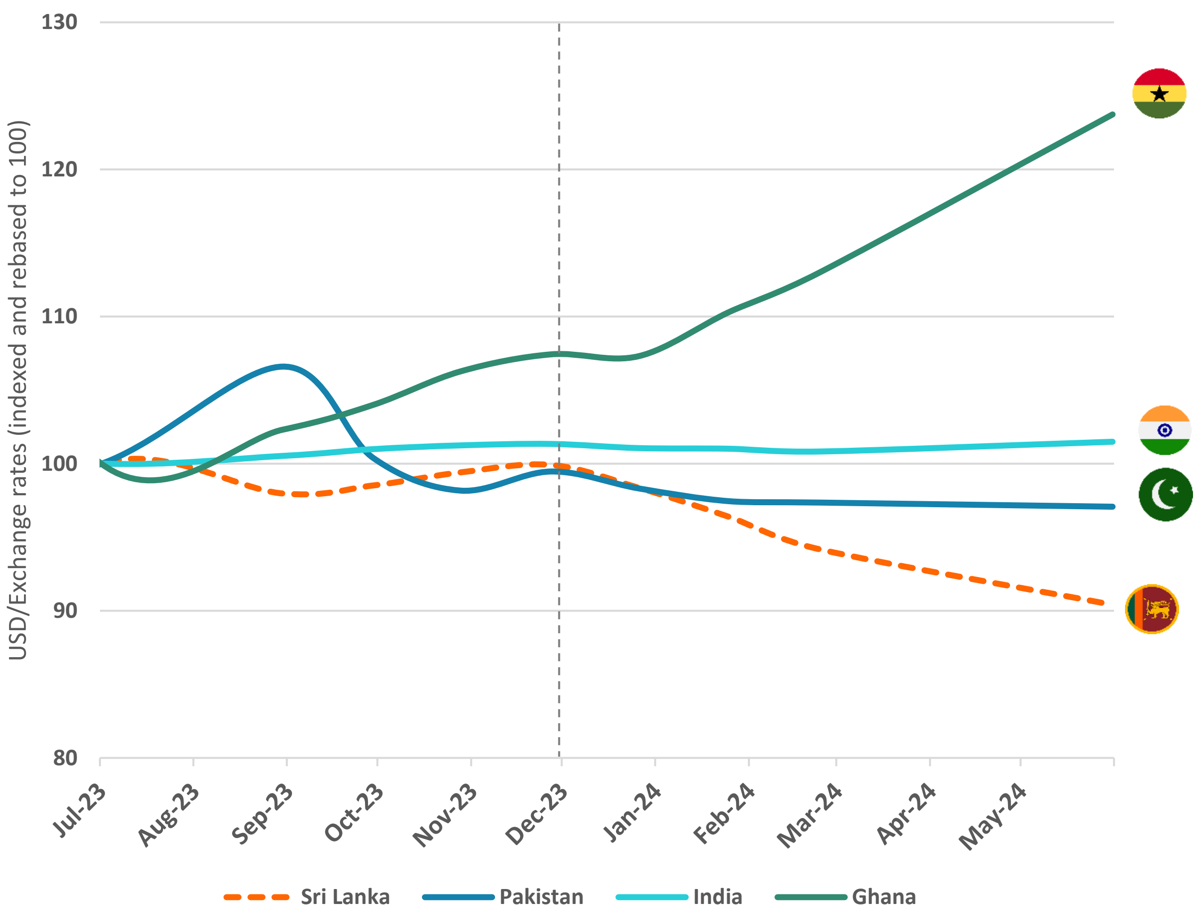
FCR expectations outperformed amidst robust improvement in tourism earnings and dollar purchases from CBSL

- First Capital Research Expectation (Jan 24):

  Slower economy may appreciate the rupee to LKR 310.0-330.0 in 1H; But depreciation pressure in 2H may push the rupee to LKR 320.0-340.0

- As per FCR expectations CBSL reserves hit USD 4.0Bn by end of 2023 aided by multilateral fundings, significantly strengthening the reserves level which supported the LKR appreciation.
- However, tourism is currently seeing a massive upturn with arrivals remaining on the high side during the first 03-months of 2024 whilst tourism earnings surpassed USD 1.0Bn already. Moreover, worker remittances too is rising at an accelerated pace resulting in a steep appreciation in the rupee.
- During the 1Q2024, consumer-driven imports experienced a notable deceleration attributed to the frontloading of imports in the Oct-23 to Dec-23 period, in order to leverage tax benefits throughout the subsequent Jan-24 to Mar-24 period, which further contributed to the strengthening of the rupee during the initial months of 2024.
- ***Accordingly, LKR appreciated robustly going above our target of LKR 310.0-LKR 330.0, breaking the LKR 300.0-level in March amidst higher-than-expected improvement in inflows and slower imports affected by tax hike.***

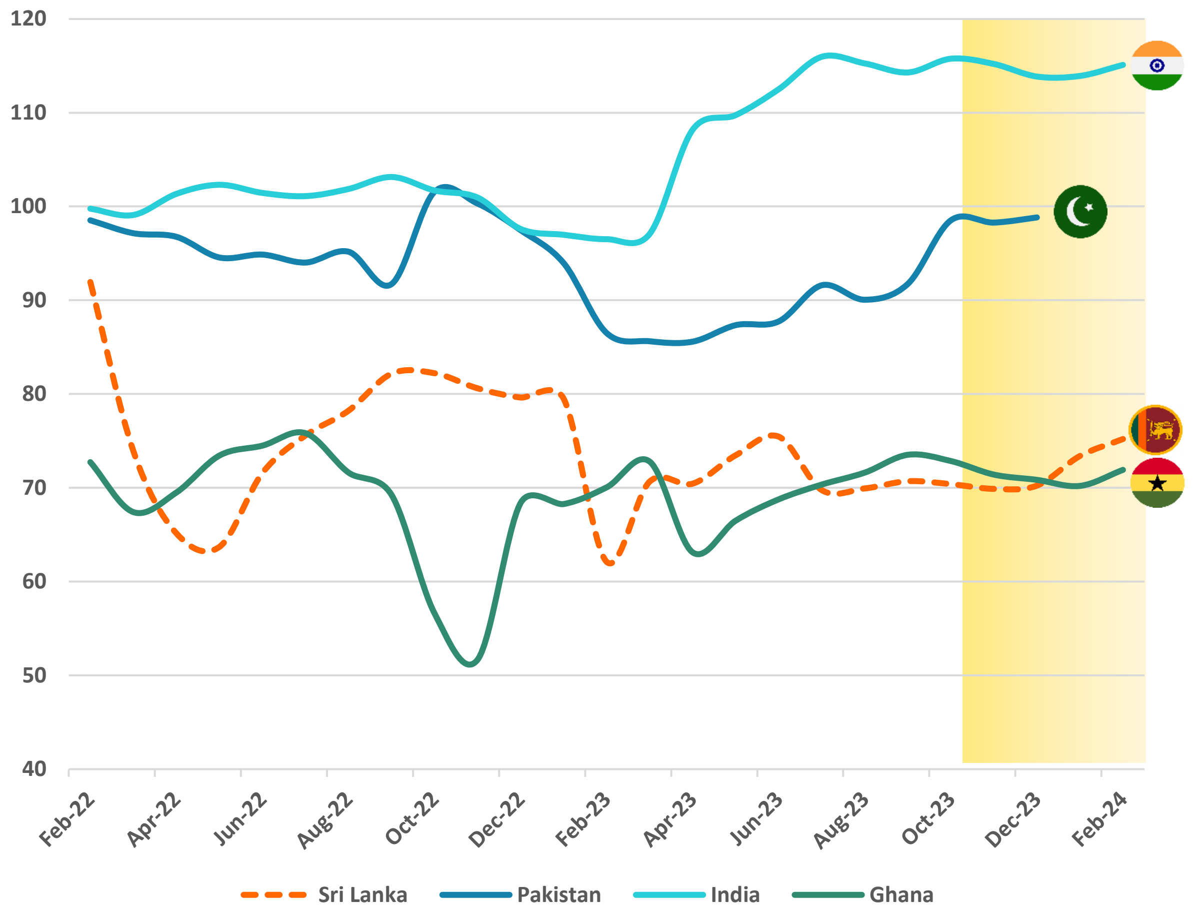
LKR has appreciated sharply since Dec-23 outperforming regional peers



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

Source: CBSL

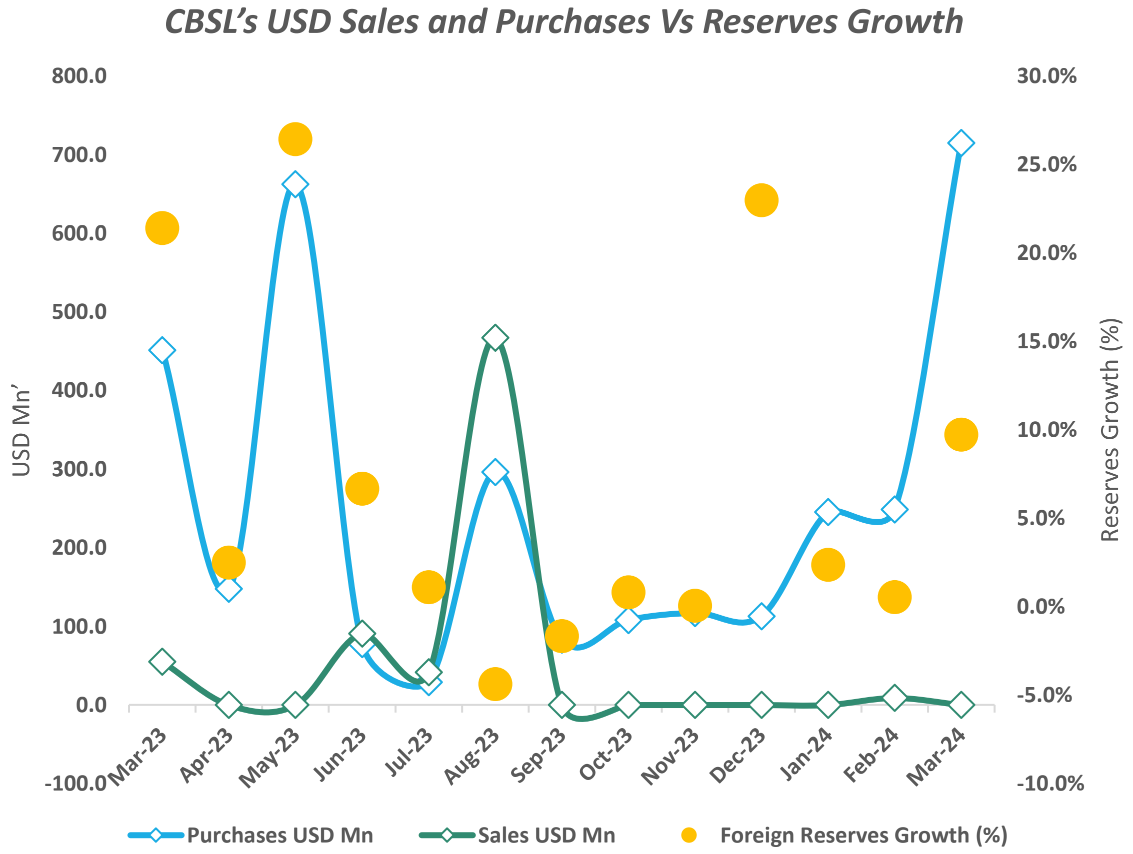
Sri Lankan Rupee REER is gradually strengthening relative to peers while aligning with global currency dynamics



Source: CBSL, SBP, RBI, CEIC

Factors influencing the Outlook of LKR

Official Reserves strengthens sharply



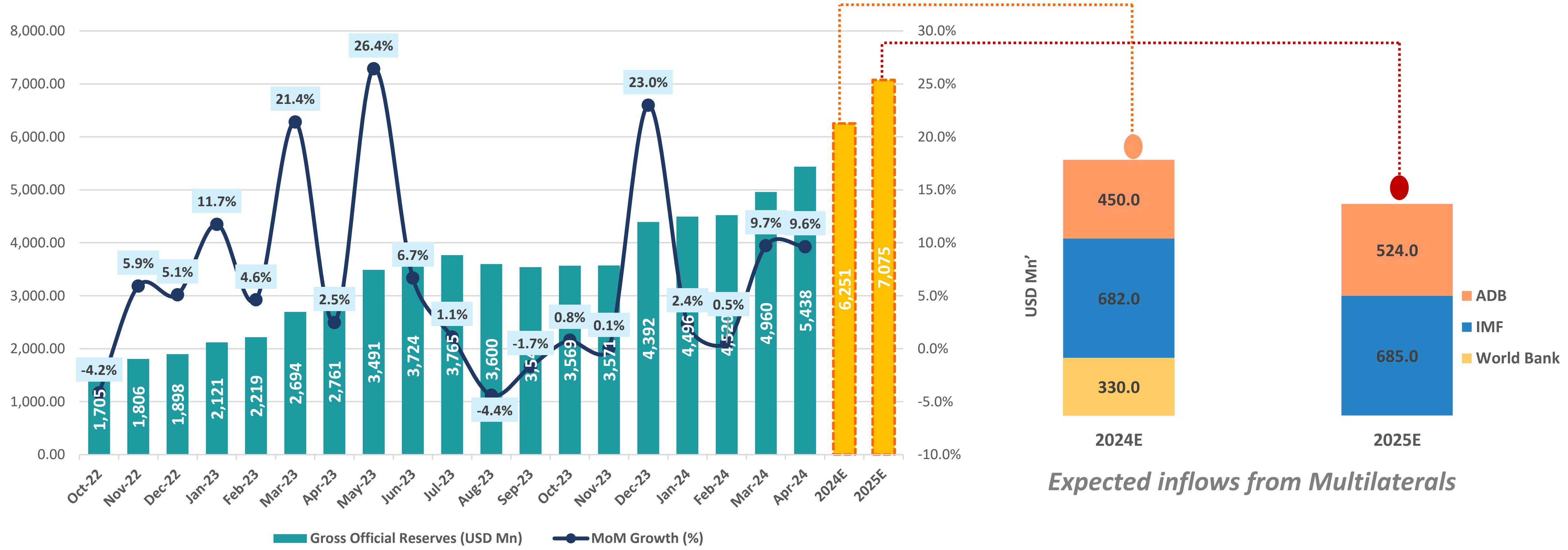
- Official reserves of the CBSL saw a sizeable uptick of 23.0% in the month of Dec-23, following the disbursements received from the IMF (2nd Tranche), World Bank and ADB. Accordingly, the reserves level climbed higher to USD 4.4Bn by the end of 2023 and continued to exhibit robust improvement in the 1H2024 amidst various positive developments as it closed at a 3 ½ -year high of USD 5.4Bn by the end of Apr-24.

- Moreover, CBSL dollar purchases continued to outdo dollar sales, since Sep-23, while Mar-24 Dollar purchases mounted to a record high of USD 715.0Mn while dollar sales were null during the month. This move has resulted in a sharp appreciation of the rupee since the onset of 2024.

- ***However, it is anticipated that reserve accumulation will moderate during the latter part of 2024, as the government is poised to commence loan repayments following the conclusion of the External Debt Restructuring (EDR) process. Additionally, an anticipated uptick in import expenditure in the recovering economy may place further strain on the government's reserve positions, potentially leading to rupee depreciation.***

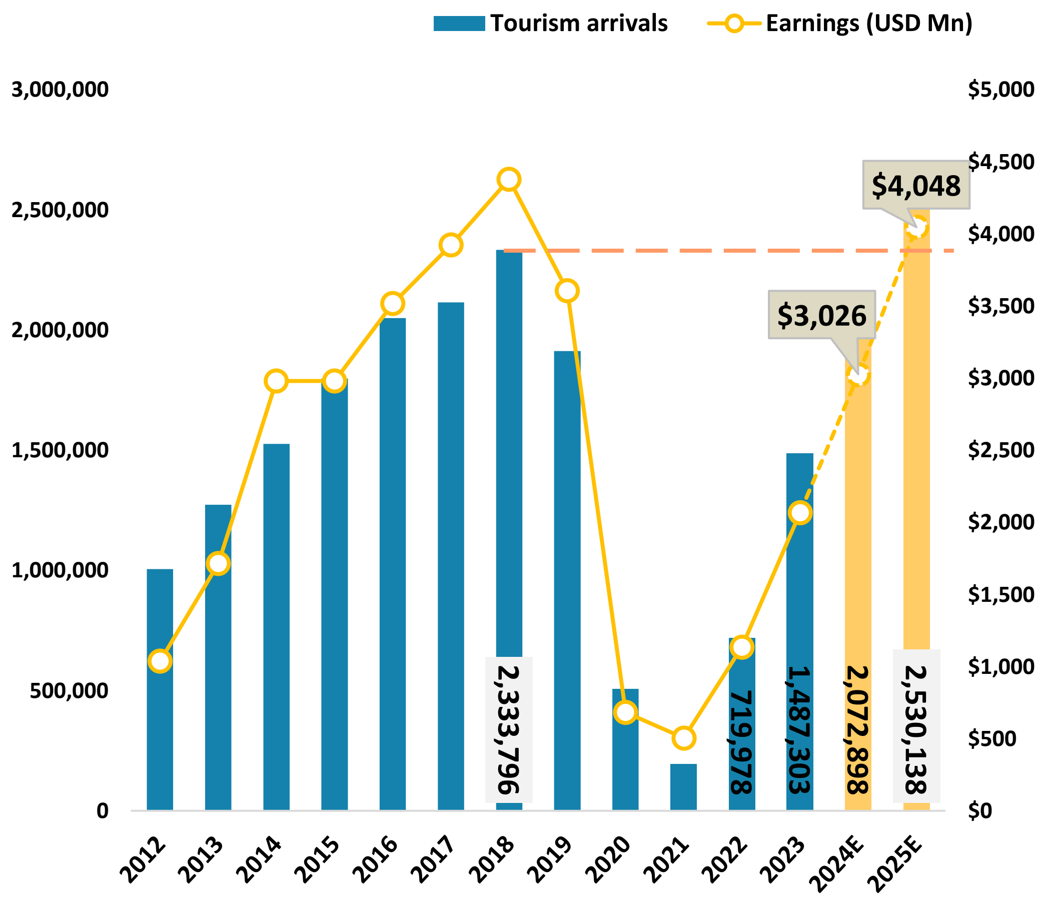
Source: CBSL

FCR Foreign reserves forecast upgraded to USD 6.3Bn for 2024E



Source: CBSL, First Capital Research

Tourism earnings thrive; expected to reach USD 3.0Bn BY 2024E



- In 2023, tourism earnings totaled USD 2.1Bn, accompanied by 1.5Mn tourist arrivals, aligning closely with the FCR target. In 2024, the tourism landscape is to witness a resurgence as numerous airlines and cruise tourism operations recommenced activities. Concurrently, extensive promotional campaigns were launched, with a notable shift in traveler preferences from the Maldives to Sri Lanka, aimed at invigorating the tourism sector.

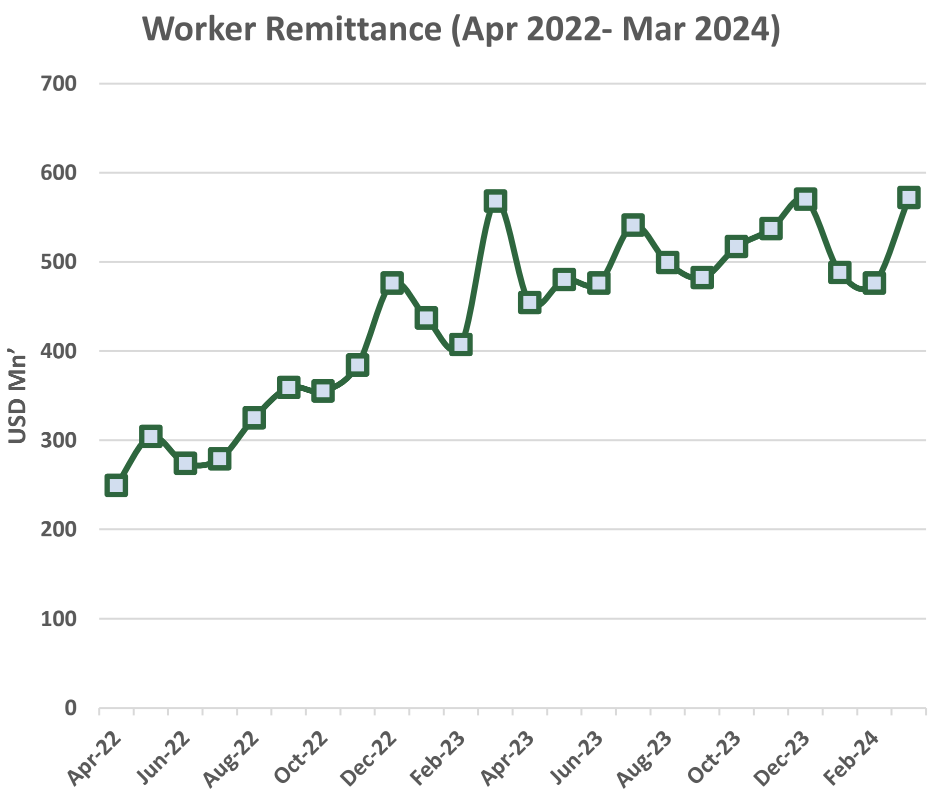
- The potential surge in tourism earnings and tourist arrivals carries the capacity to bolster the local currency through heightened demand in exchange transactions. Moreover, it can contribute to a favorable current account balance, thereby attracting foreign investment and strengthening the currency's value. Additionally, the ongoing growth and investment prospects associated with a developing tourism industry have the potential to spur economic expansion and attract capital inflows, further uphold currency appreciation.

- Further, a stable rupee will support inflows as the recovery of the economy and a possible credit rating upgrade (possibly post achieving debt sustainability by Aug-24), will make Sri Lanka an attractive destination for investments.

- ***FCR projections indicate a surge in tourist arrivals in Sri Lanka, surpassing 2.0Mn in 2024, alongside a targeted earnings figure of USD 3.0Bn, reflecting a substantial YoY increase of 46.3%. This anticipated growth is poised to augment inflows into the country, potentially mitigating any pressures of currency depreciation.***

Source: CBSL, SLTDA, First Capital Research

Worker remittances To reach USD 6.6Bn BY 2024E



- In 2023, worker remittances recorded at USD 6.0Bn, which was ***broadly in line with FCR expectations.*** Over the past six months, worker remittances have displayed a consistent upward trajectory, with a notable surge leading up to the festive season in April, registering USD 1,536.0Mn from Jan-Mar 24. Throughout the six-year span from 2015 to 2020, worker remittances averaged over USD 7.0Bn annually, significantly bolstering foreign exchange liquidity within the country and its banking system.

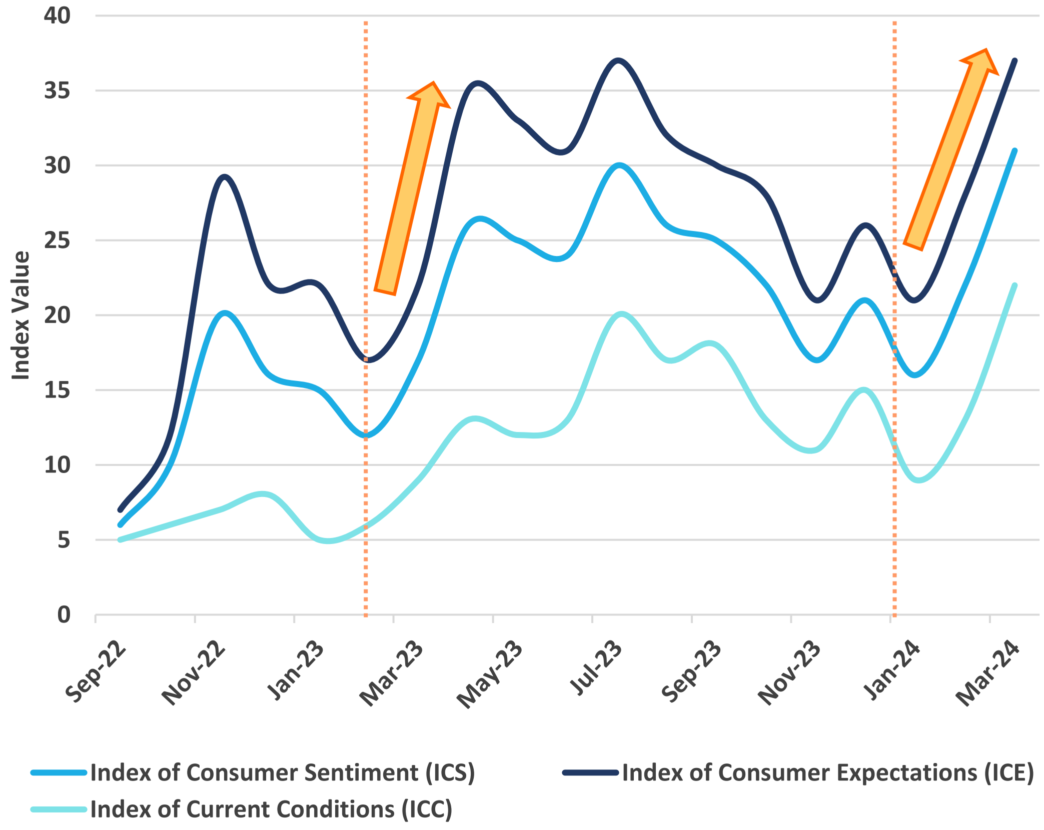
- Various initiatives have been implemented to support migrant workers who remit funds to Sri Lanka through official channels, including the provision of low-interest loans and vehicle import permits, alongside increased duty-free concessions at airports. These efforts aim to incentivize and streamline the remittance process, encouraging continued financial contributions from migrant workers, thereby exerting upward pressure on the currency.

- Meanwhile, stability in the rupee will help wiping out spreads between official channels and undiyal, making people to opt for official channels to remit money in the future.

- ***If the current positive trajectory in worker remittances persist, FCR anticipates that such inflows could reach USD 6.6Bn in 2024E. This influx of funds has the potential to bolster the country's foreign exchange reserves, thereby contributing to upward momentum in the exchange rate.***

Source: CBSL, First Capital Research

Consumer confidence on the rise as the economy signals recovery



- Consumer confidence remained positive, reflected by the steady uptrend in index since Jan-24. Consumers have shown a fast adoption to the current economic conditions following the value-added tax (VAT) hike while expectations of sustaining sales volumes over the period ahead amidst reduced operating costs through reduction in electricity tariff and fuel prices has contributed to the rise in business confidence.

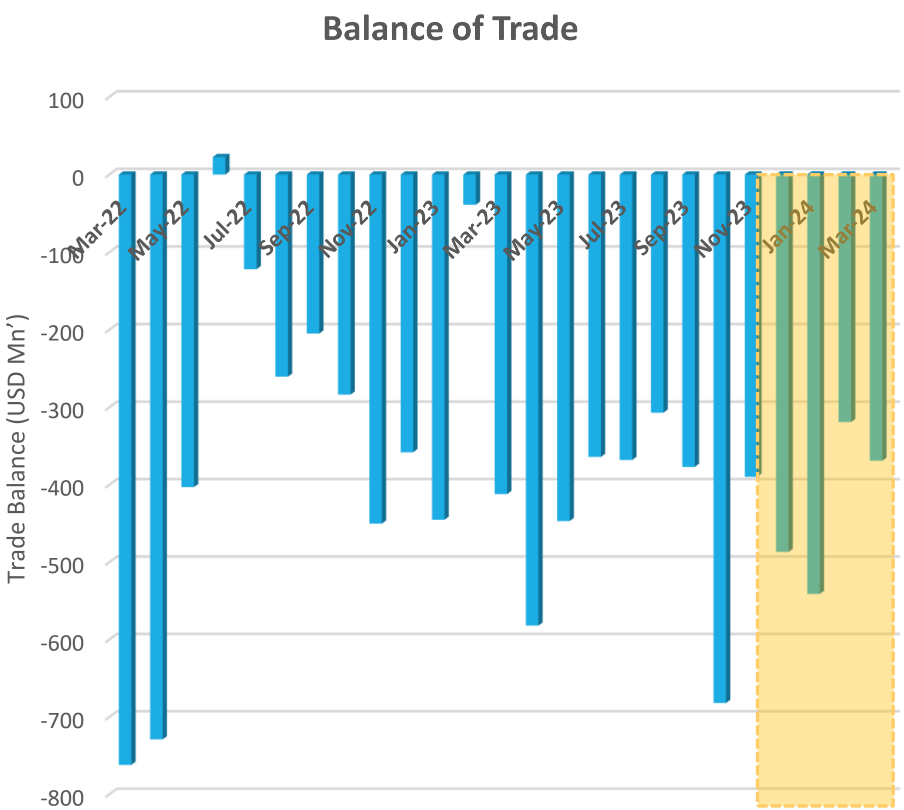
- Anticipated ongoing positive consumer sentiment is poised to drive imports, buoyed by strengthening purchasing power, thereby exerting pressure on the rupee.

- Furthermore, heightened tourism activity may amplify consumer demand for imported goods, potentially widening the trade deficit and further depreciating the LKR.

- ***A positive turnaround in GDP is forecasted for 2024, signaling increased consumer demand. As domestic spending rises, there is a likelihood of greater preference for imported goods and services, consequently driving import demand whilst off-peak tourism season may place downward pressure on the Sri Lankan Rupee in the latter half of 2024.***

Source: IHP

As import restrictions ease, rupee faces pressure



- In 2022, the Sri Lankan Government implemented restrictions on over 3,200 imported items. Subsequently, a gradual easing of these restrictions occurred, with the majority of items being permitted for import by October 2023, excluding vehicles. This adjustment is anticipated to stimulate increased import activity, particularly in the latter half of 2024, and subsequently contribute to downward pressure on the exchange rate.

- Enhanced economic conditions and heightened demand expansion are set to drive an increase in imports. The availability of imported goods will afford consumers greater variety and more cost-effective options. Additionally, the projected rise in tourist arrivals could further bolster consumer demand, leading to a scenario where the demand for dollars surpasses the available supply, thereby exerting pressure on the currency.

- ***Since January 2024, the trade deficit has been widening, mirroring the uptick in imports, and this trend is anticipated to continue in the period ahead. As a positive reversal in GDP is forecasted for 2024, we anticipate a resurgence in purchasing power and heightened demand for imports, consequently exerting pressure on the LKR and potentially leading to currency depreciation.***

Source: CBSL

Recommendation Revision

Exchange Rate 2024 Outlook upgraded

- Heavy debt repayments & easing global monetary conditions are expected to weigh on the Rupee. Sri Lanka has annual repayment obligations of nearly USD 6.0Bn-7.0Bn (may decline to USD 3.0Bn - 4.0Bn, post EDR) 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.

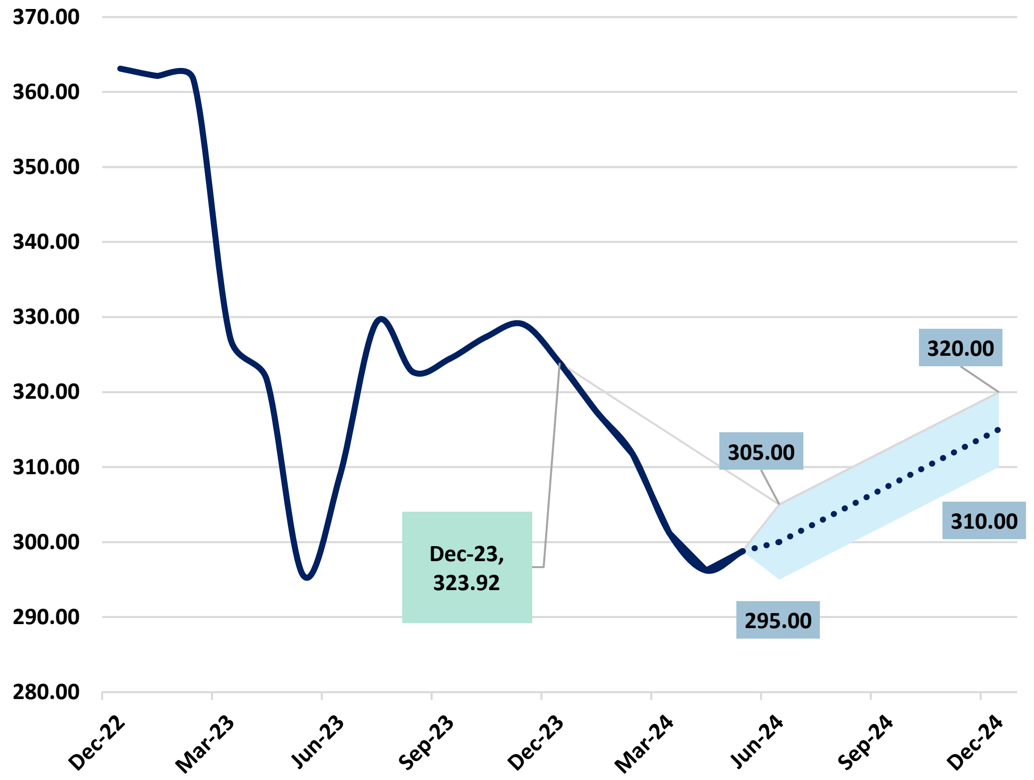
- In May 2023, CBSL relaxed the cash margin deposit requirements on specific imports and also expects the gradual removal of the existing import restrictions in the near future, which can potentially exert downward pressure on the exchange rate.

- Although the currency is on an appreciating trend in the midst of improved tourism earnings, higher remittances and inflows. Upon completion of the EDR and a possible credit upgrade, inflows may flow in from multilateral and bilateral countries upholding the appreciation trend.

- ***However, trade relaxations and repayments of loans expected from 4Q2024 may partly 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 appreciation trend.***

First Capital Research *upgrades* Exchange Rate Outlook

Exchange Rate outlook upgraded to LKR 295.0-305.0 for 1H2024 and LKR 310.0-320.0 for 2H2024



Source: CBSL, First Capital Research

In the first half of 2024, the outlook for the LKR has been revised upwards, with potential appreciation pressure. This adjustment stems from the implementation of higher taxes, expected to notably dampen rising consumer demand in the short term amid the escalation in the cost of living.

Consequently, the LKR is projected to appreciate within a range of 295.0-305.0. Slower consumer demand may lead to a reduction in imports, while the peak tourism season in the 1Q2024 and higher worker remittances could further bolster the LKR. Subsequently, some stabilization is anticipated as consumer demand improves and tourism income moderates.

Conversely, in the second half of the year, depreciation pressure on the LKR may ensue. This is attributed to the restart of loan repayments post EDR, heightened demand for imports amidst improved economic conditions. In light of these factors, the LKR is expected to experience depreciation, targeting a range of 310.0-320.0 for the latter half of 2024.

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