"RATES TO HOLD STEADY AS INDICATORS MAKE HEADWAY"

PRE-POLICY ANALYSIS

21ST MAY 2024

First Capital Research

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Previous Pre-policy report: Recap – Partly Accurate

The CBSL further reduces policy interest rates

Partly inline with our expectations, CBSL decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 50bps to 8.50% and 9.50%, respectively at the monetary policy review announced on 26th Mar-24. The Board reached this conclusion after thoroughly examining the present and anticipated trends in both the domestic and global economy. The objective is to maintain inflation at the targeted level of 5.0% over the medium term, all while supporting the economy in reaching and stabilizing at its potential level. The Board acknowledged the subdued demand conditions, the lower than anticipated effects of recent tax adjustments on inflation, favorable near-term inflation trends following the recent adjustment to electricity tariffs, stable inflation expectations, minimal external sector pressures, and underscored the importance of continuing the downward trend in market interest rates. The Board also emphasized the importance of financial institutions swiftly and fully passing on monetary easing measures to market interest rates, especially lending rates, to expedite the normalization of market interest rates in the forthcoming period.

Key Arguments considered by CBSL for its policy stance announced on 26th Mar-24

- ✓ Inflation is expected to converge to the targeted level in the period ahead.
- ✓ The recovery in domestic economic activity is expected to continue.
- ✓ A further decline in market interest rates is warranted in the period ahead.
- ✓ The external sector continued to maintain a positive momentum.

Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, there is a **80% probability for CBSL to maintain rates at the current levels,** allowing further strengthening of key economic indicators. However, there is a **20% probability for CBSL to relax the policy rates, with a probability of 15% for a rate cut of 50bps and a lower level of 5% for 100bps rate cut** in order to further reduce rates and government security yields to facilitate the strengthening the economy. Further, there is **70% probability to keep SRR unchanged;** while considering the improved liquidity levels in the system, we consider a **30% probability for a SRR hike of 100bps**.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Policy Rates to remain unchanged	**80%**
Cutting Policy Rates by 50bps	**15%**
Cutting Policy Rates by 100bps	**5%**
Cutting Policy Rates by 200bps	0%

$\left.\begin{matrix}15\% \\ 5\%\end{matrix}\right\}$ **20%**

We believe that there is a 80% probability for policy rates to be maintained at their current levels allowing further strengthening of key economic indicators.

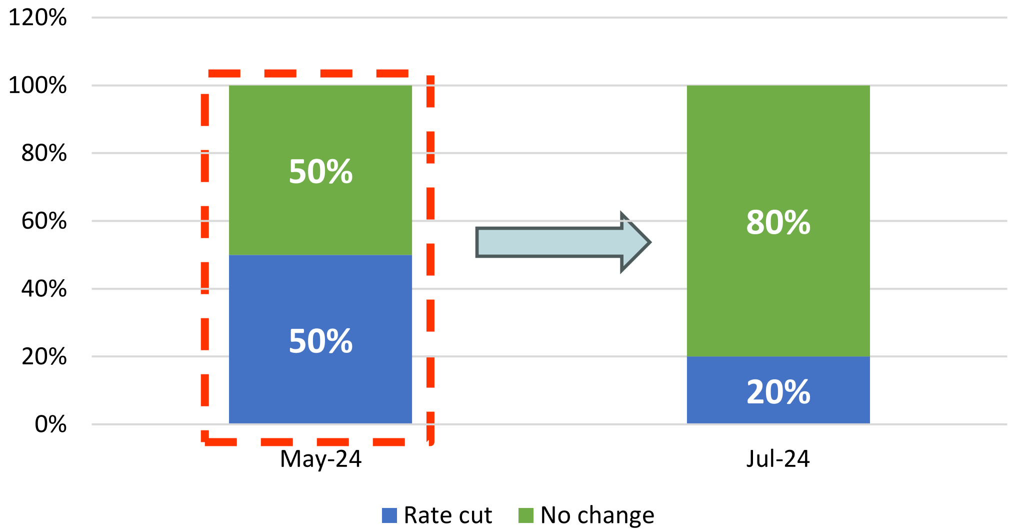
Expected Stance on SRR	Probability
Raising SRR by 150bps	0%
Raising SRR by 100bps	**30%**
SRR to remain unchanged	**70%**
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

Considering the reduction of SRR by 200bps to 2% on 09th Aug 2023, we expect SRR to remain unchanged at the same level. However, there is a 30% probability for CBSL to raise SRR by 100bps.

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 **50% probability for CBSL to relax SLFR**, while there is a **50% probability of the CBSL maintaining the SLFR rate at its current level of 9.50%.**

If rate cut is given in May-24, probabilities for a rate cut in Jul-24 is low



Expected Single Monetary Policy Stance	Probability
Adopting a single policy stance	50%
Maintaining a dual policy stance	50%

100%

We believe that there is 50% probability for an SLF rate cut to adopt a single monetary policy stance.

Analysis of upcoming policy decision on 27th May

Arguments against a Monetary Relaxation

80%

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

- Private sector credit on the upsurge while AWPLR dropped to single digit
- Overnight liquidity continued to strengthen and remained positive
- Market rates show gradual adjustment in response to EDR progression
- Strengthening economic activities point to solid ground
- Exchange rate fluctuations hint at forex market equilibrium

Arguments for a Monetary Relaxation

20%

- CBSL to adopt a single monetary policy stance
- Promising economic trends drive for prudent rate cut
- Global interest rates to take a dip

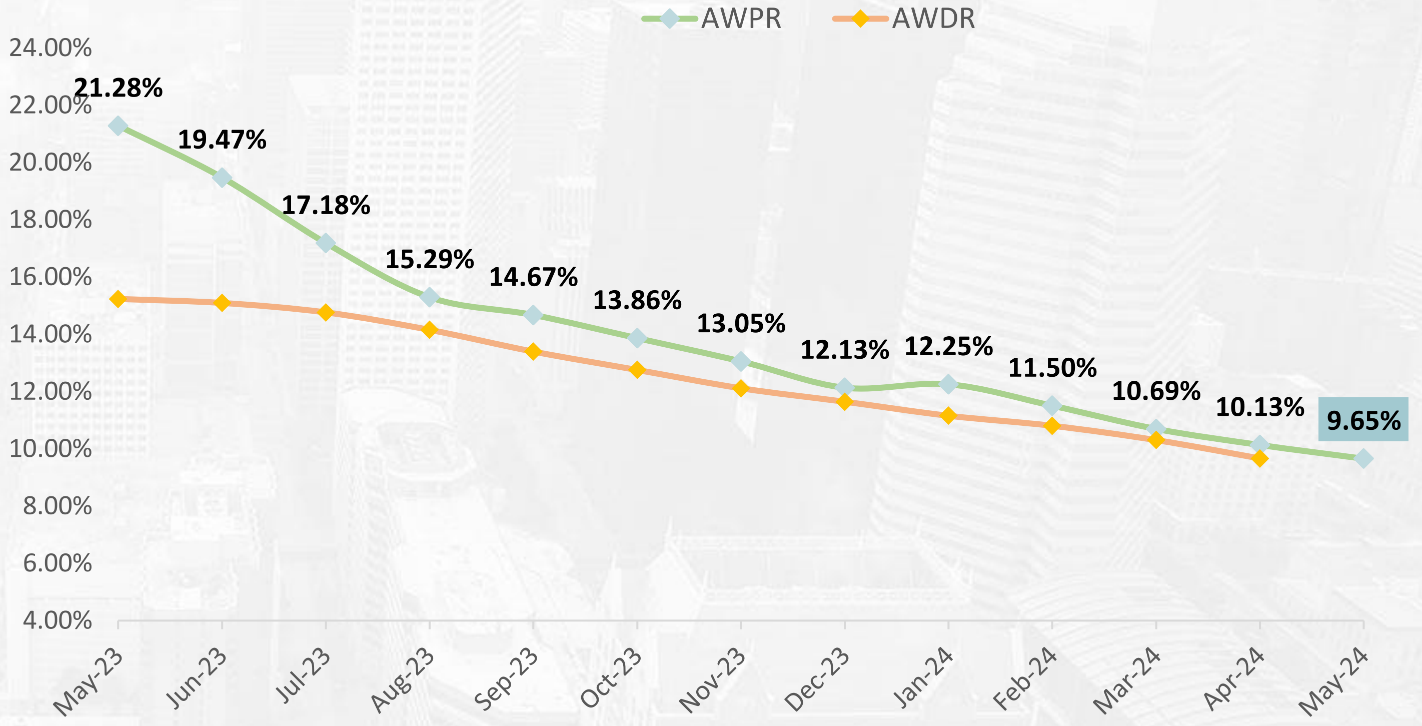
The above-mentioned factors argue for a relaxation in policy rates

Arguments *against a relaxation* in monetary policy

Arguments against a relaxation in monetary policy

Private sector credit on the upsurge while AWPLR dropped to single digit

Private sector credit surged significantly in Mar-24, marking a consecutive increase for the second month of 2024, totaling LKR 7.4Tn (increased by LKR 71.9Bn on a MoM basis), signaling a resurgence in gross loan disbursements. The uptick aligns with declining interest rates and the recovery of business activities. Moreover, the AWPLR experienced a robust continuous decline, reaching single digit in May-24 at 9.65%. With lending rates plummeting, further growth in private sector credit is anticipated. However, exercising caution is prudent to avoid potential implications of excessive borrowing and spending, which could lead to economic overheating. Therefore, refraining from policy relaxation is advised to maintain stability and balance in the economy.

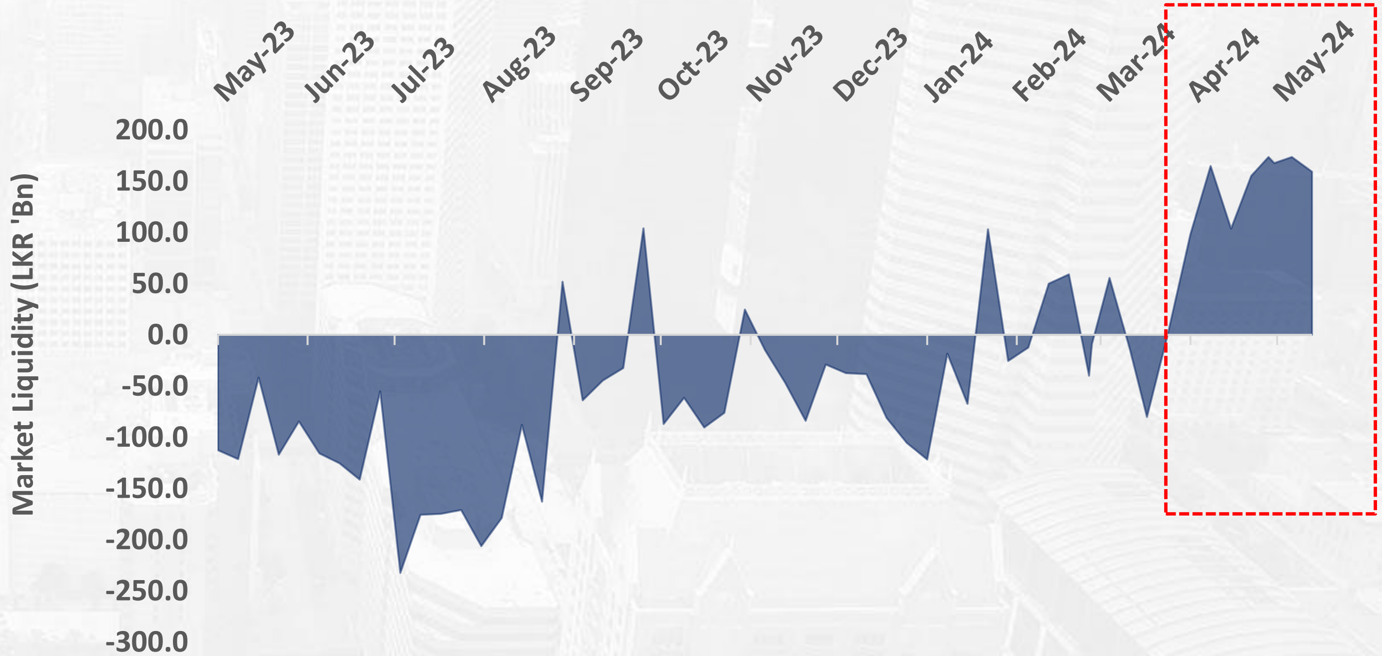


Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy

Overnight liquidity continued to strengthen and remained positive

Since the onset of 2024, the overall rupee liquidity in the domestic money market has shown consistent improvement, notably maintaining positivity since Mar-24. Followed by the relaxation of borrowing limits for Licensed Commercial Banks (LCBs) by the CBSL in Feb-24. The decision, made after reviewing prevailing market conditions and enhanced liquidity, is expected to stimulate interbank lending and borrowing, thereby facilitating a decline in market interest rates in alignment with the CBSL's monetary policy objectives. Consequently, this relaxation is anticipated to bolster banks' borrowing capacity and enhance lending activities, potentially strengthening liquidity within the financial system in the forthcoming months. As a result, a gradual decline in interest rates are expected. Therefore, considering the current rate adjustments as sufficient to provide the necessary momentum to the economy in the short term, an immediate monetary easing is deemed unnecessary.

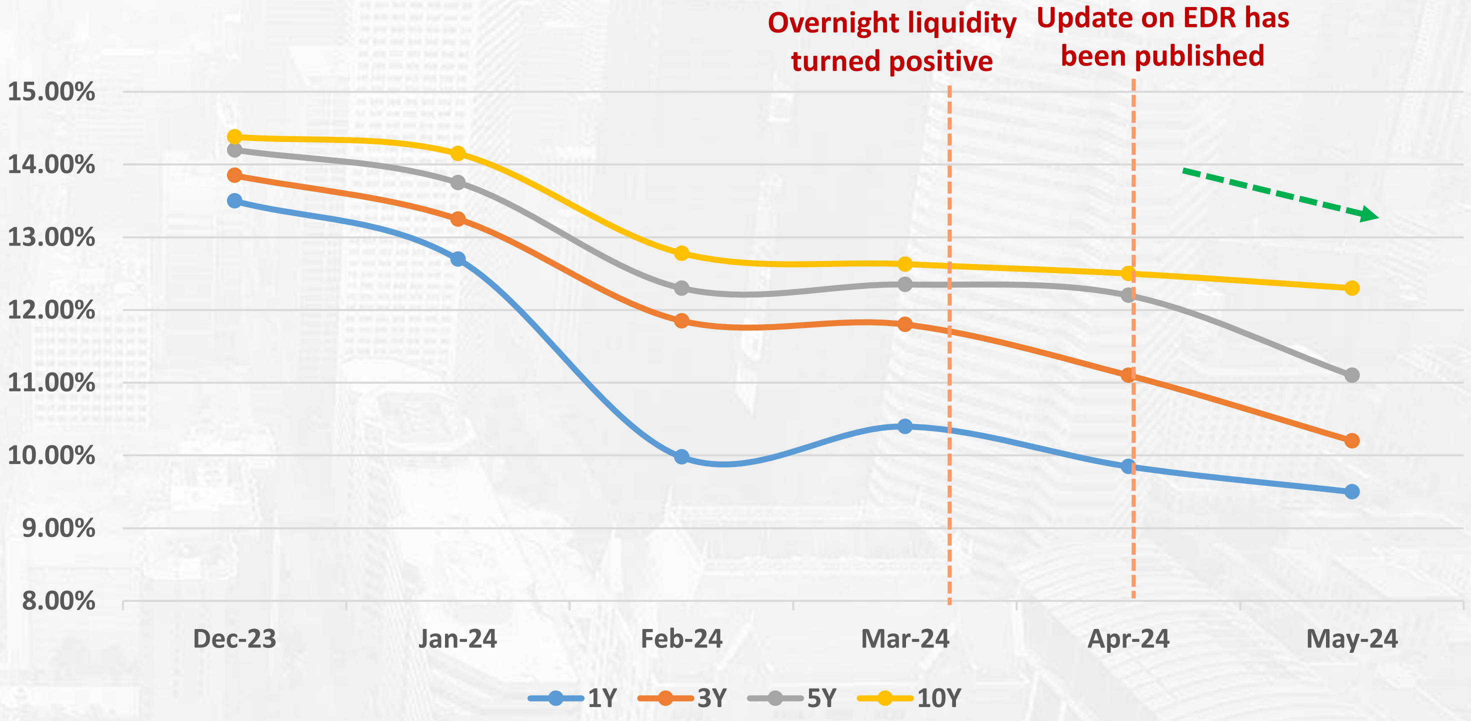


Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy

Market rates show gradual adjustment in response to EDR progression

Following the 50bps rate cut in the latest monetary policy meeting held in Mar-24, lending rates, auction yields, and secondary bond market rates have notably decreased across the board, indicating a swift pass-through of the rate cut to market rates. Notably, the weighted average yields at the T-Bill auction hit a two-year low of below 10.00% in May-24, propelled by progress in the External Debt Restructuring (EDR) talks with the Steering Committee members of the Ad Hoc Group of Bondholders. Moreover, the GoSL is optimistic on achieving a resolution regarding debt restructuring by Jun-24. Upon agreement on EDR, Sri Lanka stands to potentially receive a rating upgrade, enhancing foreign activity in the market. This could further lower yields and bolster economic recovery. As a result, we advocate that further monetary easing measures are unwarranted at present.



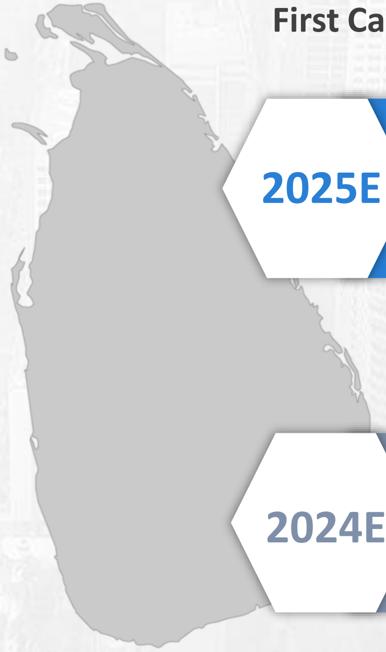
Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy

Strengthening economic activities point to solid ground

GDP displayed a YoY growth of 1.6% in the 3Q2023, a notable reversal from the previous contraction experienced since the 1Q2022. This positive trajectory continued with a substantial growth rate of 4.5% in the 4Q2023, witnessing improvements across all sectors, including Agriculture, Industrial, and Services. First Capital Research (FCR) anticipates this favorable momentum to carry into 2024, projecting a GDP growth of 2.0%-3.0% for the year. Moreover, the Purchasing Managers' Index (PMI) in Mar-24 indicated a sustained expansion in both the Manufacturing and Services sectors, signaling further signs of recovery. In Mar-24, the Services sector demonstrated improvement with an index value of 67.7, driven by increased new business activities particularly in financial services, wholesale, and retail trade segments. Meanwhile, the Manufacturing segment recorded an index value of 62.5 in Mar-24 (compared to 51.4 in Mar-23), attributed to the uptick in new orders and production, notably in food & beverages and textiles & apparel. Given these positive economic developments, it's deemed inappropriate to adopt a dovish policy stance as it could lead to an overheating of the economy.

First Capital Research projections:



2025E +3.0% - +4.0%

2024E +2.0% - +3.0%

First Capital Research

Other Projections

2024E +1.8% (International Monetary Fund)

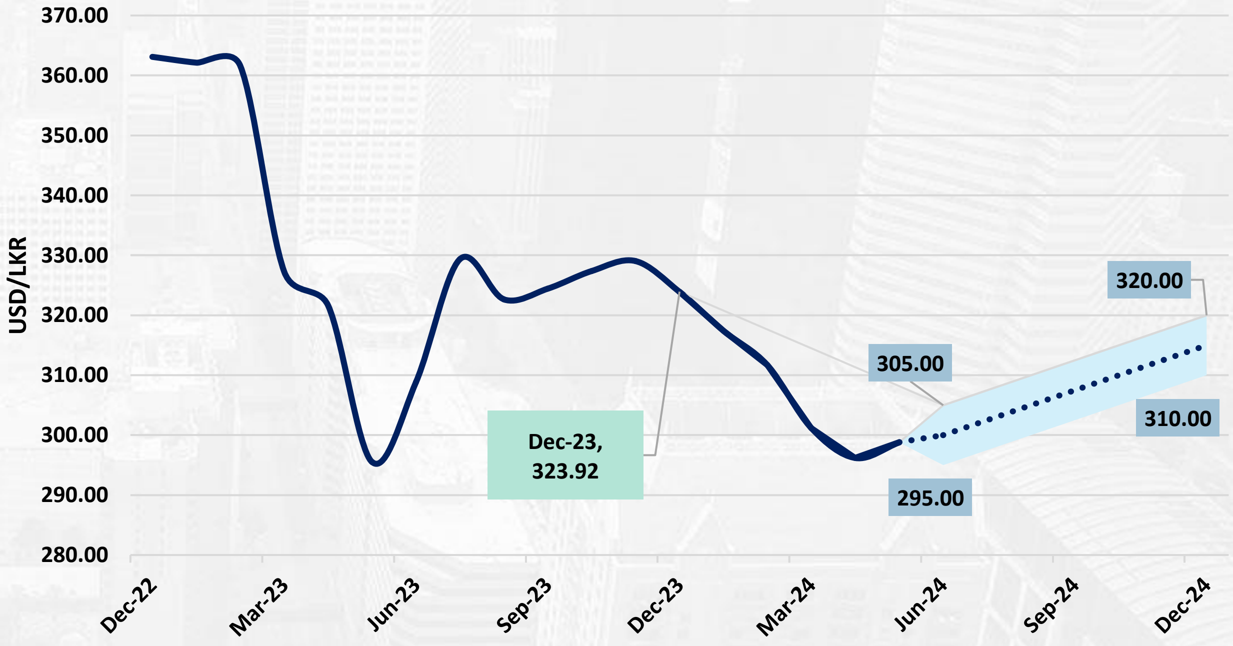
2024E +1.9% (ADB)

2024E +2.2% (The World Bank)

Arguments *against a relaxation* *in monetary policy*

Exchange rate fluctuations hint at forex market equilibrium

The Sri Lankan currency has been strengthening since the beginning of 2024, buoyed by increased tourism earnings and remittances. Meanwhile, the recent fluctuations suggest that the exchange market has reached an equilibrium level, signifying the currency's adaptability to market conditions. Looking ahead, 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. As a result, FCR anticipates a strengthening of the USD/LKR within a range of LKR 295.0-305.0 during the 1H2024. Yet, during 2H2024, external pressures that may lead to a slight depreciation, with an expected range of LKR 310.0-320.0. Hence, we believe further monetary policy easing could stimulate economic overheating, potentially accelerating currency depreciation.



Source: CBSL, First Capital Research

Arguments *for relaxation* in monetary policy

Arguments for relaxation in monetary policy

CBSL to adopt a single monetary policy stance

In the 2024 annual policy statement, the Governor of the CBSL unveiled a strategic change by moving towards a single policy interest rate mechanism, departing from the current dual policy rates. This shift is intended to bolster the effectiveness of monetary policy transmission and amplify the signaling impact of the overall monetary policy stance. The decision to pursue this modification arises from the constraints within the existing system, which encompasses both the SDFR and the SLFR. Therefore, we anticipate a potential reduction in the SLFR, which is currently standing at 9.50%.

Rates & Bonds

Sri Lanka central bank to consider a single policy rate mechanism

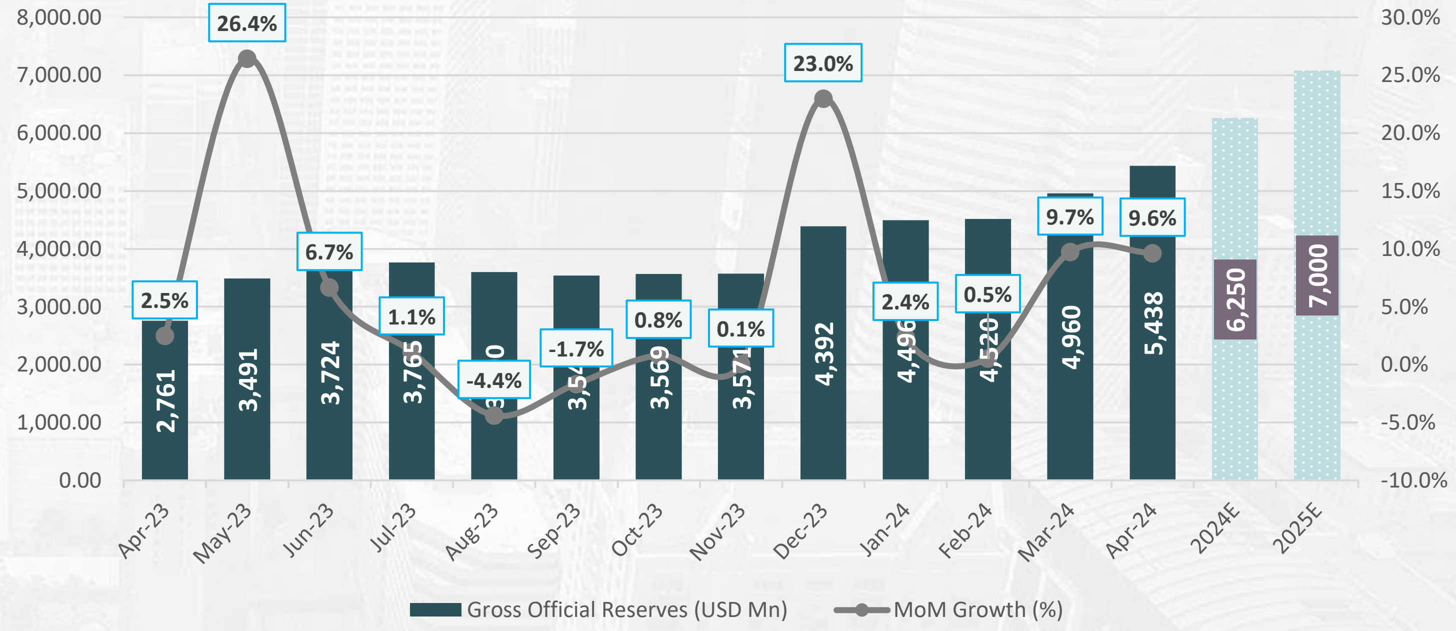
implementation. More importantly, the Central Bank would consider moving towards a single policy interest rate mechanism, instead of the existing dual policy interest rates, to improve the monetary policy transmission and signalling effect of the monetary policy stance.

CBSL Annual Policy Statement 2024 – Jan 2024

Arguments for relaxation in monetary policy

Promising economic trends drive for prudent rate cut

Amidst significant improvements in economic indicators surpassing expectations, both reserves and inflation have outperformed targets set by First Capital Research (FCR). Inflation, in line with FCR projections, has shown a consistent deceleration since the start of 2024, and slightly picked up in Apr-24 amidst seasonality, reaching 1.5%, exceeding the FCR target. Notably, YoY inflation in the Food group decreased to 2.9%, while the Non-food group increased to 0.9%, indicating that tight monetary conditions have effectively subdued demand pressures. Concurrently, the official reserves of the Central Bank of Sri Lanka (CBSL) soared to a 3 ½ year high of USD 5.4Bn by the end of Apr-24, driven by increased earnings from tourism and worker remittances. This surge in reserve position along with the BOP expansion has led to a sharp appreciation of the rupee since the beginning of 2024. With these promising indicators, it is believed that the CBSL is well-positioned to consider another prudent rate cut, which would not only support the ongoing economic recovery but also foster an environment conducive to sustained growth and stability.



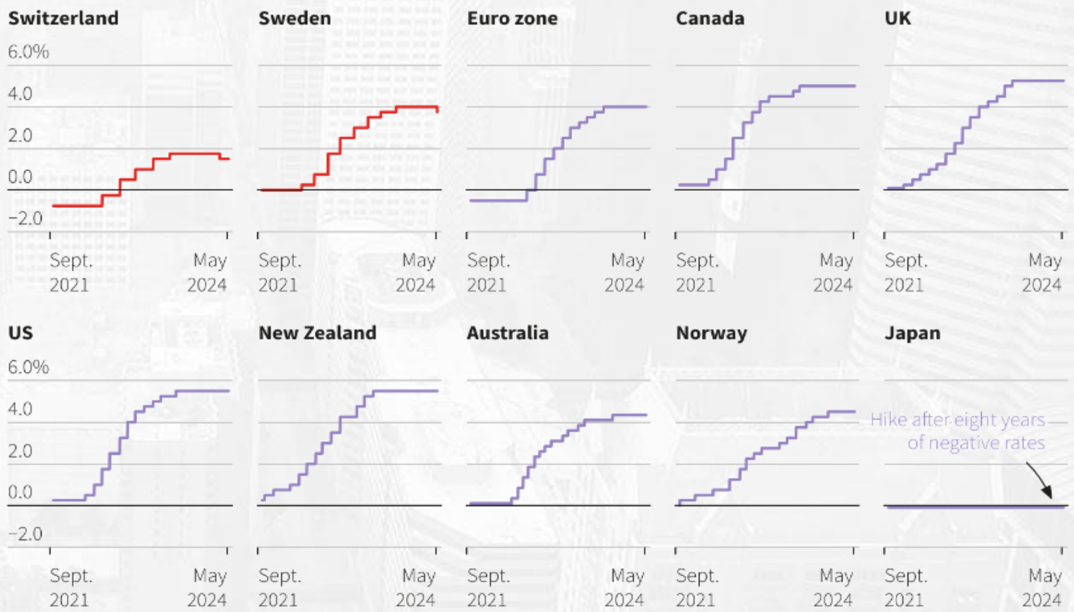
Source: CBSL, First Capital Research

Arguments for relaxation in monetary policy

Global interest rates to take a dip

The European Central Bank (ECB) is leaning towards a more dovish stance, with indications suggesting a potential rate reduction in Jun-24. The shift is prompted by inflation hovering near its 2.0% target in Apr-24 alongside subdued economic growth. Notably, the Eurozone economy exceeded expectations by expanding by 0.3% in the 1Q2024, marking its most robust growth since 3Q2022 and potentially paving the way for the ECB's initial rate cut in Jun-24. In contrast, the U.S. economy experienced modest growth of 1.6% in 1Q2024, its slowest pace since 2Q2022 when it contracted. This represents a significant deceleration from the fourth quarter's 3.4% growth and falls short of economists' projections of 2.2%. Despite this, there is growing confidence among traders that the Federal Reserve might commence interest rate reductions as early as Sep-24, fueled by a cooler-than-expected inflation data in Apr-24. This optimistic outlook on the global economic landscape bolsters the case for lowering policy rates from their current levels.

Change in policy rates by central banks overseeing the 10 most traded currencies



Source: LSEG, First Capital Research

Factors in consideration at the policy review

Inflation
CCPI 1.5% for Apr-24

Foreign Reserves
USD 5.4Bn by Apr-24

GDP Growth
+4.5% in 4Q2023

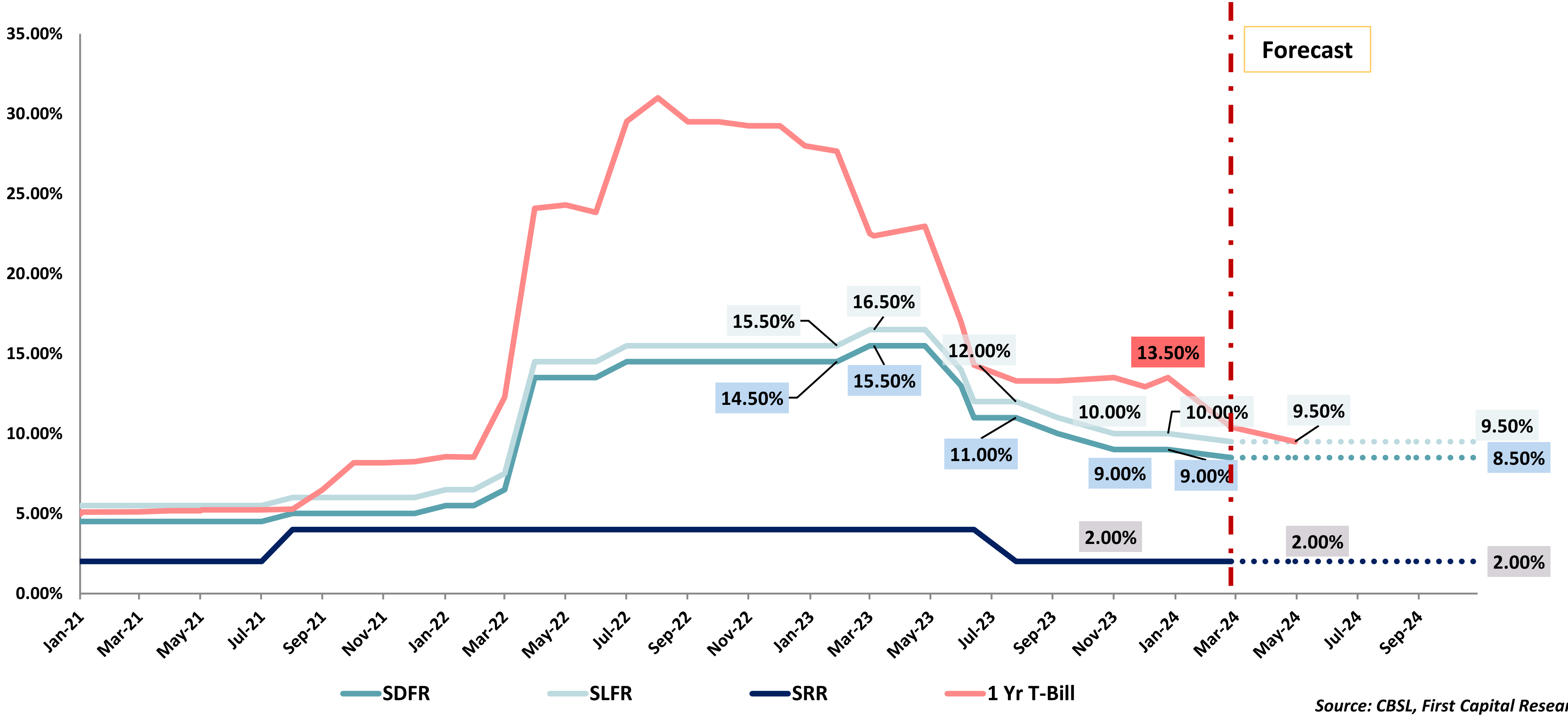
03M T-Bill rate
9.04% as of 15th May-24

Private Credit increased by LKR 71.9Bn in Mar-24

Liquidity and CBSL Holdings
LKR 138.9Bn and LKR 2.7Tn

BOT and BOP
USD -369.0Mn and USD 472.8Mn for Mar-24

Monetary Policy Rates



Source: CBSL, First Capital Research

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